Perspectives

For the period beginning April 1, 2015

THE SUB-ZERO EFFECT

Sub-zero interest rates have been a rare event for major economies—until now. The spread of negative rates, and the unintended consequences for the economic landscape, has captured our attention. When confronted with negative rates, consumers and businesses could opt to save instead of borrow and consume, possibly triggering a more sluggish economic environment.

Overall, a sluggish expansion remains our central scenario with a below-consensus global growth expectation of 3.5%. The continuing recovery in developed markets will be offset by a slowdown in some emerging economies, particularly China. More aggressive monetary policy actions in recent months, combined with declining oil prices, provide some upside risk to our growth estimate.

Current Asset Allocation, as at April 1, 2015

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

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

CIBC
Asset Management

Highlights

Fixed Income Versus Equity: Cyclical forces may continue to support higher-than-average equity valuations a little longer, making equities more attractive than fixed income.

Equity: With a rally in equity markets already this year, our capital market forecasts predict lower returns in equities than at the start of the year. Non-commodity sectors in emerging Asia have been resilient and actually stand to benefit from lower commodity prices.

Fixed Income: With a sharp decline in interest rates already this year, our capital market forecasts also predict lower returns in fixed income than at the start of the year. Canadian agencies and corporate bonds represent a better opportunity than sovereigns in the next year.

Currencies: In the context of a very dovish Canadian central bank and oil price weakness, the Canadian dollar is expected to consolidate around current levels for some time—probably well into the summer.

Expected Returns

The probabilities of our three economic scenarios are unchanged from our previous forecast. However, with a sharp decline in interest rates and a rally in equity markets already this year, forecast returns are lower than at the beginning of the year. The unintended consequences of negative interest rates—a recent development in the global sovereign bond market—are also worrisome. We will continue to evaluate whether negative yields can stimulate economic activity in the long run.

Expected returns for the 12-month period, beginning April 1, 2015	In Canadian Dollars			In Local Currency		
	Global Renormalization	Sluggish Expansion	Global Slowdown	Global Renormalization	Sluggish Expansion	Global Slowdown
Probabilities	15.0%	55.0%	30.0%	15.0%	55.0%	30.0%
Canada Money Market	0.9%	0.5%	0.4%	0.9%	0.5%	0.4%
Canada Bond	-2.7%	0.5%	3.2%	-2.7%	0.5%	3.2%
Canadian Federal Government Bond	-4.0%	-0.3%	3.7%	-4.0%	-0.3%	3.7%
Canada Corporate Bond	-0.1%	1.5%	1.8%	-0.1%	1.5%	1.8%
Canada RRB	-6.5%	-2.6%	1.5%	-6.5%	-2.6%	1.5%
Canada High-Yield Bond	7.5%	4.4%	-6.4%	7.5%	4.4%	-6.4%
International Government Bond	-11.4%	-1.8%	11.8%	-6.5%	-0.4%	4.6%
Canada Equity	19.4%	0.4%	-10.6%	19.4%	0.4%	-10.6%
United States Equity	11.0%	5.4%	-9.7%	16.6%	3.5%	-13.4%
International Equity	13.3%	6.2%	-7.7%	17.8%	9.0%	-12.2%
Emerging Equity	15.9%	9.6%	-13.5%	17.7%	10.2%	-12.3%

Source: CIBC Asset Management Inc.

Global Outlook

A sluggish expansion remains our central scenario with a below-consensus global growth expectation of 3.5%. The continuing recovery in developed markets will be offset by a slowdown in some emerging economies, particularly China. More aggressive monetary policy actions in recent months, combined with declining oil prices, provide some upside risk to our growth estimate.

On the inflation front, the negative impact of the decline in oil prices should slowly dissipate from headline inflation numbers as energy prices are expected to stabilize. Core inflation should only grind higher as the global economy's sluggish expansion removes excess capacity very slowly. In particular, wage growth will improve only modestly in the U.S. and Japan, mitigating long-term inflationary pressures. High unemployment in Europe should keep wage pressure dormant for a while longer. Global inflation is expected to pose no obstacle to continued easy monetary policy over the next 12 months in most regions, with the possible exception of the U.S. We are therefore maintaining our 55% probability that a sluggish economic expansion will continue over the coming 12 months. With a sharp decline in interest rates and a rally in equity markets already this year, this leaves our capital market forecasts with lower expected returns than at the start of the year.

From zero lower bound to negative yields: What's next?

As we evaluate the alternative risk scenarios, we are struck by the frequency at which consensus economic growth expectations have been revised lower, despite continued monetary policy efforts in many parts of the world. The U.S. Federal Reserve (Fed)'s Summary of Economic Projections is the latest example of declining growth expectations—economic growth, inflation and the path of policy tightening have all been lowered. Given these observations, we are growing increasingly concerned about the effectiveness of unconventional monetary policies to stimulate economic activity.

We are also worried about the unintended consequences of negative interest rates, a recent development in many parts of the global sovereign bond market. In Europe, major central banks such as the European Central Bank (ECB), the Swiss National Bank, the Swedish Central Bank and the Danish Central Bank have all implemented negative policy rates. Furthermore, it is estimated that over $2 trillion USD worth of sovereign bonds with maturities ranging from one to 10 years now have a yield to maturity below 0% (these include German Bunds, French, Swiss and Japanese bonds). This feature of the economic landscape is taking a prominent place in the risk assessment of our alternative scenarios.

In the coming months we will continue to evaluate whether negative yields can stimulate economic activity in the long run. When confronted with negative interest rates, consumers and businesses could feel the need to save more rather than borrow and consume more. Faced with a more challenging investment environment of negative returns, consumers could feel the need to increase their savings rates and consequently trigger a more sluggish economic environment. Negative interest rates could also pose a challenge to insurance companies and pension plans that use domestic sovereign bonds to help immunize their portfolios against their long-term liabilities. Negative rates can pose long-term funding issues when the rate of return on assets cannot meet the required rates of return of liabilities.

Alternative Scenarios

Global Slowdown

In this scenario, we see a gradual change in consumer and corporate behaviour, as they adapt to growing debt burdens, a marked deterioration in demographics and extremely low interest rates. The sluggish lending growth of recent years may signal that consumers and corporations have reduced their risk tolerance. This may be due to high existing debt levels combined with a change in consumption habits related to an aging population. In this environment, accommodative monetary policies are less effective, as even extremely low interest rates cannot revive the appetite for borrowing. Combined with reduced government fiscal flexibility to spend to stimulate growth, these factors could produce an economic slowdown. A better approach for policymakers would be to address overdue structural reforms and present more credible fiscal consolidation plans to regain some fiscal policy flexibility. While adopting such policies would eventually raise potential growth, they would likely have an initial negative impact in the first year of implementation. Our growth slowdown scenario probability is estimated at 30% to reflect these growing risks.

Global Renormalization

A more positive scenario could come from stronger-than-expected benefits related to energy price declines and stronger than expected U.S. recovery. This could lead to stronger global consumer spending, as consumers may spend most of their savings from lower energy costs instead of reducing their debt or saving more. A stronger U.S. recovery would also help a global recovery through stronger export growth. In addition, the end of deleveraging by European banks fostering better lending activity and stronger consumption in the eurozone could lead to a stronger-than-expected global economic recovery. This scenario would bring renormalization of monetary policies sooner than expected, starting with the Fed in 2015. Higher interest rates would not impede higher equity markets, as earnings would provide a positive surprise, supporting equity market valuation. We maintain the probability of this positive scenario at 15%.

An intensified search for yield?

For European and Japanese investors facing negative yields, North American sovereign bond markets still provide positive, albeit low, yields. North America may continue to benefit from this intensified search for yield in the coming months. This alternative may appeal to the less-conservative foreign investor who can take on the foreign currency risk of investing in a foreign bond market.

The search for yield could also extend further to other asset classes providing some form of enhanced yield, such as corporate and high-yield bonds or high-paying dividend stocks. This could push the valuation of these assets to even higher levels. This central bank liquidity boom is expected to continue through at least September 2016, based on the new ECB quantitative easing program. However, the purpose of the ECB intervention is not based on investment-return-seeking behaviour, but rather an economic agenda to lift the eurozone out of the risk of deflation at all costs. With this abundance of liquidity, it will be difficult to apply a disciplined valuation framework to many asset classes. This will prove to be a challenging investment environment for investors who, like us, seek to maintain a rational investment discipline anchored by relative valuation investing. In the current environment, valuations run the risk of being pushed to unreasonable levels.

Fixed Income Versus Equity

Above-average equity valuation = lower future returns

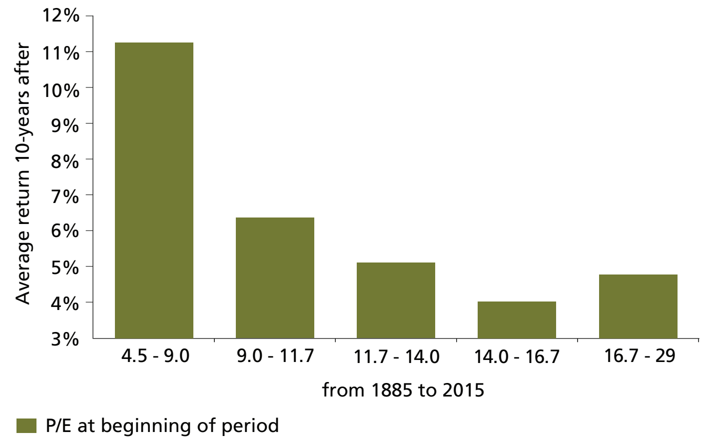
Equity performance since 2009 might have reignited hopes that the stocks-for-the-long-term mantra is back, but equities will face increasing valuation headwinds. Why pay attention to valuation when the business cycle is in full swing, supported by aggressive central bank actions?

Simply put, valuation is a key determinant of future returns. There is a clear and indisputable empirical relationship between current equity valuation and future returns. Lower starting valuation (using P/E ratio) leads to higher real returns 10 years later, while higher valuation leads to lower real returns (see chart). For example, investors who bought the S&P 500 in 1977, a time of extremely low valuation, would have realized an 8.7% real total return 10 years later. Meanwhile, at the peak of the market in August 2000, the S&P 500 traded at 27.7, and returned -4.1% real total return over the following 10 years.

This valuation pattern is present in most countries, so it is worth our attention. Although some investors calculate P/E ratio using trailing earnings and others argue for the use of cyclically-adjusted earnings, both measures show the same pattern.

Where are we now? Based on trailing earnings, most countries are represented by the 4th or 5th bar on the chart (at right). Using cyclically-adjusted earnings, most countries are represented by the 3rd or 4th bar. With either method, current P/E ratios are higher than average, leading us to expect lower real equity returns going forward. These conclusions, drawn from empirical evidence, actually correspond to our views about weaker potential economic growth. The combination of demographic shock and high level of debt will result in slower potential global economic activity—and thus slower corporate earnings growth.

10-Year Real Equity Return (S&P 500 Total Return)



Source: Thomson Reuters Datastream, CIBC Asset Management Inc.

The second reason to pay attention to valuation now is that equity prices already discount some of the expected cyclical recovery. Since 2009, P/E ratios have roughly doubled in most countries. Initially, P/Es were at very depressed levels. This is no longer the case, yet P/Es continue to rise while consensus earnings estimates are declining. Investors are not excited that earnings are stronger than previously expected. Rather, central bank actions are fuelling hopes that earnings will eventually be stronger. This state of affairs can only last for so long. Eventually, companies will need to deliver the strong earnings that investors are "hoping and paying for."

Our analysis is consistent with equity markets that are overvalued, but not extremely overvalued. This distinction is important because it leaves room for cyclical forces to outweigh the valuation headwinds. Foreign central banks are still in the midst of deploying their quantitative easing policies and the Fed is expected to remove its accommodation with extreme caution. Cyclical forces may continue to support higher-than-average equity valuations a little longer, making equities more attractive than fixed income. As always, timing the peak of the equity market is a tricky decision. However, with more than six years since the bottom of the equity market and above-average valuations, now is not the time to be complacent.

Equity Market Outlook

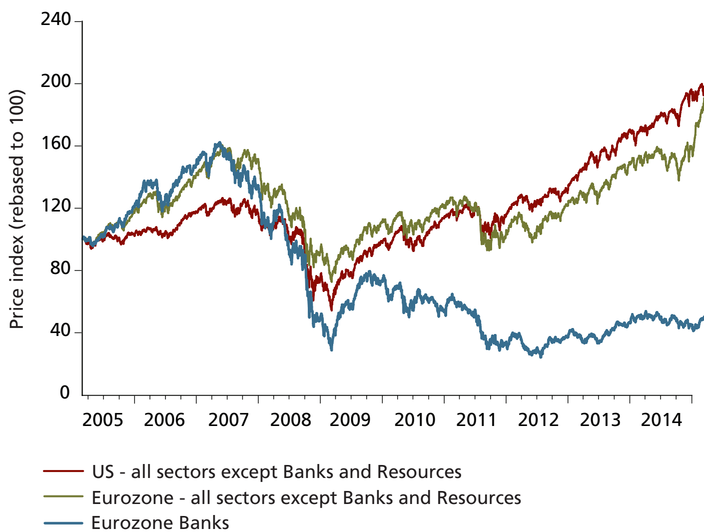
Regional Differences

Equity returns in the U.S. and Canadian equity markets have been muted since the beginning of the year, although eurozone and Asian equities have been relatively strong. European exporters have done especially well, boosted by the

weakness in the euro. However, the ECB will need to do more than depreciate the euro to ensure a sustainable rally. It will also have to stimulate domestic demand, motivate banks to start lending again and help companies restore profitability. This could be a long road to full recovery.

The chart below makes this point. First, there has been a very large gap between the performance of eurozone banks as compared to most other sectors (excluding resources) in the U.S. and the eurozone. Second, most sectors in the eurozone have actually performed very well, in line with their counterparts in the overvalued U.S. Ultimately, improved performance of the banking sector should be a sign that the European recovery is moving from being export driven to domestically driven. Equities will also need to show continued strong performance even if the euro's depreciation slows. Finally, valuation in many sectors leaves little room for further appreciation. The road to full recovery could indeed be long.

Eurozone vs. U.S. Equities



Source: Thomson Reuters Datastream, CIBC Asset Management Inc.

There is one region where our conclusions on valuation do not really hold—emerging markets. While emerging markets are significantly cheaper than developed markets, we need to distinguish those regions where cheap valuation is justified and where it is not. Latin American and Eastern European equity markets have been dominated by commodity sectors, at least until recently. With the bust in commodity prices, earnings have plunged and it is no surprise that these sectors have become cheaper. By comparison, only 11% of emerging Asian equity markets are comprised of commodity sectors. The non-commodity sectors in emerging Asia (emerging Asia represents 62% of global emerging markets) have been resilient and actually stand to benefit from lower commodity prices. These sectors became cheaper just as their earnings began to accelerate.

The most significant development of the last few quarters has been the divergence in monetary policy between the U.S. and the rest of the world. A resulting trend has been the record appreciation of the U.S. dollar. This matters for U.S. companies, especially exporters, which rely on foreign sales. Foreign sales represent roughly 33% of all S&P 500 sales. Anecdotal evidence from quarterly corporate reports shows that the strength of the dollar could have subtracted as much as 5% from earnings in the recent quarter.

The U.S. equity market remains one of the more expensive equity markets and profit margins are starting to show signs of peaking. The ratio of output prices to unit labour cost, a good proxy for profit margins, has declined from a year ago. While companies have little power to raise their prices, unit labour costs are slowly rising. Not surprisingly, this market has made little progress since we moved our market exposure to neutral.

The fate of the Canadian energy sector is closely related to the price of oil and earnings growth is strongly correlated with changes in the price of oil. Because earnings growth represents what companies earn during a year compared to the previous year, our calculations use the average price of oil (in Canadian dollars) received during the year, compared to the average of the year before. As such, our forecasts predict another 20% decline in earnings. Even if spot oil prices rise to near $60, the average oil price would be lower than last year. Such a decline is consistent with earnings forecasts from bottom-up analysts, and produces a drag on the overall Canadian equity market.

The Canadian real estate market is also a concern. House prices are overvalued by 10-30%, according to the Bank of Canada (consistent with our own in-house estimates) and Canadian households are highly indebted. That leaves little room for additional credit growth, a previously reliable source of growth for banks. Because of the structure of the Canadian market, a decline in housing prices would not imply a banking crisis, but it would provide a headwind.

Commodity Insight

Since its rapid price decline in the back half of 2014, oil has continued to garner much attention in the financial markets. From a Canadian perspective, this attention is even greater, given its importance to the economy of Canada and the province of Alberta, in particular. OPEC's decision not to curtail production in order to support the oil price is, in our opinion, logical from a long-term perspective. Allowing the price to fall in the short to mid-term has already garnered a response from the fast-cycle, North American, unconventional shale producer. This can be seen by the dramatic decline in the oil-directed rig count. Given current prices, we believe that the production of crude in North America will start to slow its pace of growth and eventually decline, as a result of the reduction in drilling activity and given the high decline nature of shale wells. However, wells that were drilled in the late part of 2014

are still being completed over the coming months and will continue to bring new supply to market. This supply is adding to storage surplus in the U.S., which may delay the eventual return of higher prices.

The activity reduction has forced service providers to reduce the prices they charge producers, in some cases by as much as 20-30%. As a result of these price declines, and further efficiencies, producers in the North Dakota Bakken, Texas Eagle Ford and Texas Permian basins have recently indicated that they are likely to return to drilling new wells if the price of West Texas Intermediate recovers to $60 to $65. Should the activity level increase at this price level, it will suppress and possibly delay the return to higher prices, pushing out the eventual recovery.

Given the ability of North American unconventional production to return to the market in a relatively short period of time (in some cases an oil well can be drilled and completed in under 30 days), it would seem illogical and counterintuitive if OPEC's only strategy was to target this production. From a global perspective, shale oil is only expected to provide approximately 20% of future production additions. We believe that OPEC's real target is the marginal producer of the remaining 80% of expected supply additions. This remaining 80% is made up of long-lead, lower decline and longer duration projects such as the deep-water targets in the Gulf of Mexico and offshore West Africa or unconventional projects like the Canadian oilsands.

Reducing the production associated with lower-decline wells will take time given the longer construction period of these projects and the existing projects that are nearing completion. However, by convincing producers to reduce new capital allocations to future long-duration projects, OPEC's current behaviour will likely be effective at achieving its objective of maintaining its position as the global swing producer.

In coming quarters we will continue to outline our thoughts on the long-term price of oil. We will discuss how our experience in examining commodity markets has shaped our view of the cost curve and its role as a price-setting mechanism.

Energy industry terms defined

Unconventional oil - Oil found in low-permeability rock, including sandstone, siltstone, shale, and carbonates.

Oil-directed rig - Onshore rigs that are drilling hydrocarbon wells where the bulk of production is oil.

High decline/lower-decline wells - While conventional wells can produce relatively stable rates for a long period of time, shale oil and gas wells experience an initial burst of production in the first few years, followed by a precipitous decline.

Swing producer - A swing producer is able to increase or decrease commodity supply at minimal additional internal cost, and thus able to influence prices and balance the markets.

Cost curve - Graph of the costs of production as a function of total quantity produced.

Fixed Income Outlook

Stuck in a low-yield environment

- **We are revising lower our 12-month targets for U.S. 10-year Treasuries to 2.25% (previously 2.75%) and the Canadian equivalent to 1.55% (previously 2.25%), given the recent proliferation of dovish biases by central banks globally and their impact on yields.**

The most striking development to impact fixed income markets in the last quarter was the growing number of global central banks that jumped on the monetary easing bandwagon. For the Fed, which is expected to start hiking rates at some point during the year, this means having to swim against stronger currents.

Monetary stimulus measures have become so widespread that the only central banks that have recently moved in the opposite direction were those trying to limit a freefall of their currency. The monetary stimulus measures are a direct consequence of the fight to avoid a prolonged period of deflation as well as preventing their respective currencies from appreciating.

It seems clear that the Fed will be the first major central bank to start renormalizing policy rates, but the speed that rate hikes will be delivered remains unclear. The strong appreciation of the USD against all major world currencies over the last six months has been a form of tightening. Is the U.S. economy strong enough to withstand both higher yields and further appreciation of its currency?

Both the Bank of Japan and the ECB are highly likely to pursue their quantitative easing in the year to come. Consequently, this will force smaller competing economies into further loosening of their policy. We are sceptical of the Fed's ability to tighten much in this environment.

In the context of oil prices that will likely remain depressed, we expect the Canadian bond market to do marginally better than its U.S. equivalent. The BoC's concerns over the domestic economy, along with a prudent renormalizing process by the Fed, should help keep Canadian yields low and prevent further selloff of credit securities. Considering that the yield premium of agencies and corporate bonds over government securities recently deteriorated, we believe that they represent a better opportunity than sovereigns in the next year.

Currency Markets

U.S. Dollar

In March, the Fed's dovish revisions of its growth, inflation and NAIRU* forecasts sent a clear message that the Fed would be cautious before starting policy renormalization. As we expected, the Fed will delay the beginning and flatten the path of eventual U.S. interest rate increases. As the U.S. dollar has gained a lot of ground in a short period of time, this sets the stage for a milder rise in the greenback going forward. This is particularly true as the U.S. dollar no longer qualifies as an undervalued currency.

However, we believe there is still room for further selective U.S. dollar strength, as the remaining slack in the U.S. economy is narrower than that in a number of other economies, particularly many parts of Europe and Canada. This divergence in economic cycle should support the greenback through favourable relative monetary policies. At the same time, a number of emerging markets usually see their currencies weaken during a Fed tightening cycle due to their close economic and monetary policy ties to the U.S. Rising U.S. interest rates typically increase their cost of financing and place downward pressure on currencies of countries with negative current accounts. A slow Fed tightening cycle is expected to exert less pressure, leaving a number of emerging currencies with attractive return opportunities.

** non-accelerating inflation rate of unemployment*

Canadian Dollar

The Canadian dollar downtrend that began in the summer of 2014 intensified over the first quarter of 2015, owing to the sharp drop in oil prices. The loonie hit a cyclical low of 78 cents against the U.S. dollar in March. Recent CAD weakness was not just attributable to weak oil prices—relative expectations about monetary policy in the U.S. and Canada also played an important role. Prior to the surprise Bank of Canada (BoC) rate cut on January 21, nearly all the move was attributable to shifting expectations about Fed policy (i.e. pricing in rate hikes). At this juncture, the BoC's next move will be just as relevant in determining the fate of the Canadian currency. Will the Canadian economy continue to grow in line with the central bank's projections or will it start to disappoint, justifying another policy shift?

In the context of a very dovish Canadian central bank and oil price weakness, the Canadian dollar is expected to consolidate around current levels for some time. Given the damage done, and using the 2008-09 consolidation phase as a guide, this consolidation will likely continue well into the summer. The risk, however, is for a deeper short-term undershoot of our Canadian dollar fair value based on Canadian growth concerns and a retest of the cyclical lows reached in late 2008 and early 2009.

Japanese Yen

The BOJ has committed to QQE (Quantitative and Qualitative Easing) as long as inflation, excluding the effects of the consumption tax hikes, stays below 2%. In its last Statement of Monetary Policy (released January 21) the BOJ revised its inflation forecast lower (from +1.7% to +1.0% for 2015) and kept its 2016 forecast roughly unchanged (+2.2% from +2.1%) to account for the impact of lower energy prices. These revisions should be interpreted as a signal that QQE policy will remain in place throughout 2015 and well into 2016. Monetary policy differentials should thus continue to weigh against the yen.

In addition, foreign direct investment and portfolio outflows from Japan continue at a solid pace. Data shows that Japan, led by pension funds, has accelerated its cross-border investment. This should put further downward pressure on the yen.

However, the pace of yen depreciation may be moderating as offsetting factors are also present. Based on our valuation metrics, the Japanese yen is now 14% undervalued against the U.S. dollar. Further yen weakness could be more difficult to achieve, all else being equal. Also, with a number of European Central Banks adopting negative interest rates, the yen is no longer the preferred funding currency for carry trades. The yen's official rate remains positive while the eurozone, Switzerland, Sweden and Denmark post negative interest rates, increasing their appeal for carry trades. The currency war is alive and well as countries compete to prevent their currencies from appreciating by lowering interest rates, even below zero.

Euro

Over the last year, the euro lost substantial ground against the U.S. dollar, dropping from a cyclical peak of 1.40 in June 2014 to a cyclical low of 1.05 in March. Is there any downside left? In the very short term, the euro could certainly retrace some of the ground lost, but the longer-term outlook remains negative.

The eurozone economy remains plagued with very large excess capacity in its labour market with a high unemployment rate. There is also excess production capacity, as highlighted by the low capacity utilization rate. This excess capacity necessitates a very accommodative monetary policy stance. The ECB has committed to such a policy in multiple ways by extending liquidity in the form of Targeted Long Term Refinancing Operations (TLTRO), which provides large sums of liquidity to the financial systems. This helps anchor European short-term interest rates at very low levels for an extended period. The ECB's quantitative easing program is also pushing longer-term bond yields lower by buying 60 billion euros worth of bonds on a monthly basis until at least September 2016 or until euro inflation returns to its long-term target of 2% on a sustainable basis. The broad weakness of the trade-weighted euro over the last few months can be mostly explained by these eurozone policy decisions.

Adding to the euro's downside risk is the behaviour of European commercial banks. The end of the disorderly deleveraging phase in 2012 translated into a renewed appetite for foreign assets by European banks. In recent years, European financial institutions moved their capital out of Europe at a relatively fast clip, with net external assets now amounting to a whopping €752 billion. If sustained, these bank capital outflows will continue to exert downward pressure on the euro.

Regional Outlook
Canada

- **The Canadian economy is expected to shift into lower gear, with real GDP growth slowing from +2.6% currently to an average of +1.8% over the next 12 months.**
- **The risk is for more growth disappointments moving into the second half of 2015.**
- **With an already low policy rate, the Bank of Canada (BoC) is running out of ammunition. Any additional easing will depend on deteriorating growth prospects.**

In response to the sharp drop in oil prices, the BoC surprised markets by lowering its policy rate in late January. Concerned about the negative impact of lower oil prices on economic activity, the Canadian central bank significantly revised down its real GDP projections for 2015 from +2.4% to +2.1%. This is closer to, but still above, our own in-house forecast.

In our opinion, the risk is for more growth disappointments moving into the second half of 2015. The BoC apparently still feels very upbeat about the U.S. economy. In the January edition of its Monetary Policy Report, BoC staff revised upward their forecast for U.S. real GDP growth from +2.9% to +3.2%. If this forecast materializes, the Canadian economy would get a very welcome and timely boost from stronger activity south of the border. The problem is that the Fed doesn't seem to be as upbeat about U.S. economic prospects. In March, the Fed released its latest assessment for the U.S. economy, forecasting that growth would more likely be around +2.5% this year. This latest assessment by the Fed corresponds to our own U.S. growth projections. If we are right and the U.S. economy shifts into lower gear, Canadian growth will very likely disappoint.

The oil shock is another concern. With oil prices dropping from $100 to less than $50 per barrel, Canada is coping with a very severe terms-of-trade shock. The extent of the damage to the Canadian economy will depend on what happens next to oil prices. If prices stay depressed, the BoC estimates that the economic impact will likely be much larger than currently assumed. By cutting its growth forecast by only 0.3%, the BoC is implicitly betting on recovering oil prices.

The projected Canadian economic slowdown is very concerning because of Canada's two major financial system vulnerabilities: elevated levels of household indebtedness and imbalances in the housing market. Over the last decade, the increase in Canadian household debt has been breathtaking. The household debt-to-disposable-income ratio has climbed from 100% to 165%. Elevated debt loads are not a problem as long as incomes are growing. However, if Canadians experience a large negative shock to their incomes, highly-indebted households would have a harder time servicing debt, potentially triggering a sharp correction in the housing market. While such an unfortunate turn of events remains unlikely, the risk is significant—particularly in the context of a slowdown in economic activity.

As noted in the Bank of Canada's Financial System Review, imbalances in the Canadian housing market have been edging higher. The Bank of Canada estimates that home prices are probably overvalued by more than 10% but less than 30%. These estimates are consistent with our own in-house numbers. Our valuation model suggests that Canadian home prices are overvalued by roughly 14%.

Partly because mortgage rates have continued to decline over the past year, a slowdown in Canadian housing activity has not yet materialized. The housing starts and building permits numbers show a cooling in activity, but home sales remain strong. There is no doubt that the BoC will be paying close attention to developments in the housing market moving into the second half of the year.

The need for additional rate cuts will depend on whether the Canadian economy follows the BoC's script, with growth slowing to +1.9% by year end. If the economic data starts to disappoint, the BoC will have to turn more dovish and eventually ease again. From a strategy angle, however, the BoC also has to consider that it is quickly running out of ammunition with the policy rate already near zero.

United States

- **Our forecast calls for 2.5% average growth in U.S. real GDP over the next 12 months—a below-consensus call.**
- **The impact of lower oil prices on CPI inflation will gradually dissipate, allowing inflation to reach +1.9% by early 2016.**
- **Assuming that wage inflation accelerates sufficiently, the Fed should start prudently hiking rates in late 2015.**
- **The Fed's plans to tighten could be further delayed by additional appreciation of the U.S. dollar on a broad basis, further weakness in U.S. housing activity or both.**

In March, the Fed released its latest three-year economic projections. Many pundits were surprised to learn that the Fed had once again revised lower its real GDP growth projections for 2015. A year ago, its members had penciled in a solid +3.1% growth forecast for this year. By September, conviction started to wane and the Fed's growth projection was lowered

to +2.8%. Three months into 2015, additional shades of grey were added to the U.S. outlook, resulting in projected growth of +2.5% for real GDP for the year as a whole.

Why is the Fed less upbeat than it was last year? For one thing, it had to account for developments on the currency front. As the Fed signaled its intentions to launch a tightening campaign in 2015, the U.S. dollar gained substantial ground against most other world currencies. On an export-weighted basis, it has appreciated more than 12% over the last year. In fact, the U.S. dollar has gained so much ground that it now qualifies as overvalued based on our in-house valuation metrics. In other words, the quick ascent of the U.S. dollar is significantly hurting U.S. exporters. While these developments are not enough to put the U.S. economic expansion at risk, they do imply that the drag on growth coming from net exports will likely remain significant.

The Fed's less-upbeat assessment probably also relates to weaker-than-expected housing activity. A year ago, the prospect of a strong housing recovery was part of the reason why most forecasters—including the Fed—were expecting solid growth in 2015. With such high expectations, the actual turn of events has been disappointing and very preoccupying. It is not just that home sale and mortgage lending numbers have been weaker than expected. Housing has also failed to recover in the context of a substantial drop in mortgage rates. Over the last year, mortgage rates in the United States have declined by more than 100 basis points (bps), reaching all-time historical lows. So far, this very positive development has not fuelled a pick-up in mortgage lending and home sale activity. At this juncture, Fed members are probably crossing their fingers, hoping that the housing recovery has simply been delayed.

Assuming that wage inflation accelerates sufficiently, the Fed should start prudently hiking rates in late 2015. However, the Fed's plans to tighten could be further delayed by some further appreciation of the U.S. dollar on a broad basis, further weakness in U.S. housing activity or both.

Europe

- **Europe is experiencing a German-led cyclical revival thanks to weaker oil prices, ultra-easy ECB policy and euro weakness.**
- **Real GDP growth in the eurozone is projected at +1.3% for the next four quarters—an upward revision from our last round of projections.**
- **Burdened with large excess capacity in its labour market, the ECB is unlikely to reach its inflation target. Under these conditions, it will have no choice but to continue expanding its balance sheet well into next year.**

Three key questions have surfaced regarding economic prospects in the eurozone. First, is Europe experiencing a short-term cyclical revival? Second, are structural deflationary headwinds still blowing across the eurozone? Finally, how long will the ECB need to continue to expand its balance sheet?

Short-term economic prospects are rosier than they were just a few months ago. The latest economic data show that the eurozone's growth engine, Germany, is on more solid footing than previously believed. Germany is benefiting from the easing in domestic financial conditions as well as the depreciation of the euro on an export-weighted basis. The end result is a healthy growth mix driven by strong consumer spending. This is exactly what the economies in the rest of Europe need to shift into higher gear. Our new eurozone 12-month forecast calls for average real GDP growth of +1.3%. This is definitely more upbeat than the projections in our winter 2015 forecast, but less optimistic than the ECB's own projections.

For the longer term, eurozone economic prospects are not as bright. While it is true that Europe is finally creating jobs, the European employment recovery still significantly trails the U.S. recovery. This is a problem for the ECB because large excess capacity in the European labour market means that the environment will remain very deflationary. In turn, this means that the ECB will have trouble achieving its inflation target of 1.5% in late 2015. The ECB's inflation and economic forecast is based on the assumption that wage inflation will climb from +1.3% currently, to +2.3% by 2017. This is a very aggressive forecast. The only time that Europe experienced a similar increase in wage inflation was the period of prosperity between 2004 and 2007. During that time, the forces at work produced a strong acceleration in wage inflation—6.8 million jobs were created and the unemployment rate dropped from 9.2% to 7.5%. It now stands at 11.2%. In addition, the eurozone economy was getting a huge boost from credit growth. These days, European households are still working hard to reduce their debt loads.

Conditions are clearly not as favourable today, making it unlikely that the ECB will reach its inflation target. Under such conditions, it will have no choice but to continue expanding its balance sheet well into next year.

China

China targets more sustainable growth

- **The Chinese economy is expected to grow by less than 7% in 2015, a more sustainable growth target. The growth mix is set to continue showing an increased contribution from consumption and less from investment as the economy attempts a long-term rebalancing process.**
- **Slowing growth accompanied by weaker-than-desired inflation suggests that financial conditions are too restrictive in China. The central bank has begun a new easing cycle where it will become increasingly more accommodative as the year progresses.**

The National People's Congress was held in March and policy makers laid out objectives for 2015. Major economic targets for the current calendar year include an annual growth rate of 7% in GDP (set at 7.5% the previous year), Consumer Price Inflation at approximately 3% (set at 3.5% the previous year), and an unemployment rate that remains below 4.5% in combination with the creation of 10 million new jobs.

Policy makers see the economic growth target of 7% as challenging yet realistic—it is more optimistic than our own estimate of 6.6%. Driving the growth in economic activity will be another year of relatively robust consumption growth from both the private and public sectors. Private consumption could see a weaker-than-expected advance in 2015 if average wage growth for employees disappoints. To offset possible deceleration in consumption, we expect the public sector to foster growth in government spending on education and health care and accelerate the development of broad-based social programs. On the investment front, spending on gross capital formation is going to see another year of slowing, with contribution from investment lagging consumption. This is due to several factors including a continued slowdown in the real estate sector and important reform initiatives within state-owned enterprises. This is consistent with further deceleration in credit growth over the 2015 fiscal period.

Inflation in China has been significantly below target, which is most likely the reason for the revision to the CPI target for 2015. Consumer price inflation averaged 2% in 2014, a significant decrease since the decline in international energy prices. Inflation is expected to firm as we approach year-end but will likely remain below 3%. Consistent with this view is the continued weakness in producer prices, which have previously been a good indicator of potential consumer price pressures. With PPI in contraction and not yet showing signs of stabilization, this suggests few pressures in the pipeline for consumer prices as we approach the midpoint of 2015.

The overall outlook for the economy suggests that we can expect the central bank to loosen monetary policy further. The Peoples Bank of China (PBoC) has lowered lending rates twice since Q4 2014 and reduced the reserve requirement ratio for banks in Q1 2015. We believe this is just the beginning of the current easing cycle. There is growing concern within the Chinese central bank over slowing growth, while real financing conditions remain historically tight despite recent rate cuts. The PBoC could cut rates another 100 bps in 2015, consistent with the desire to reduce financing costs without igniting another surge in domestic credit growth.

Signposts

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

Canadian Signposts

- Employment and wage growth
- Oil price impact on trade balance (energy versus non-energy)
- Investment growth
- Housing activity and property prices
- Foreign appetite for Canadian sovereign bonds

U.S. Signposts

- Employment growth, underemployment (decline in U6 measure) and wage growth (ECI)
- Core PCE inflationary pressures (pass-through from U.S. dollar strength and oil price decline)
- Household formation
- Domestic oil production decline
- New export orders (assess impact of strong U.S. dollar)
- Recovery in housing activity and house prices

Chinese Signposts

- GDP growth mix (industrial production versus retail sales)
- Lending to households and businesses
- Speed of currency depreciation (foreign exchange policy)
- Fiscal and monetary policy initiatives

Other Market Signposts

- Japanese labour market wage growth
- Japanese 2% inflation target
- European bank lending surveys
- European Purchasing Managers' Indices
- Import versus export trends in current account deficit countries
- Monetary policies in India, Turkey and Brazil to control inflation
- Improving European job creation
- U.K. employment and wage growth

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