Perspectives

For the period beginning July 1, 2015

INTEREST RATES: READY, SET, CRAWL

The investment community is laser-focused on estimating when the U.S. Federal Reserve (Fed) should start raising interest rates. We believe this obsession misses the bigger picture. The widely-used term *lift-off* is the wrong way to characterize the Fed's policy approach—*crawling* is probably more appropriate.

The second half of 2015 looks more promising than the first, judging by the improved economic momentum in the second quarter. The global economy is counting on the impact of continued easy monetary policies in Europe, Japan and China, as well as the benefit of lower energy prices. These factors should support the consumer sector over the coming months.

CIBC Asset Management

Current Asset Allocation as at July 1, 2015

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

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

Highlights

Fixed Income Versus Equity: In our central scenario of continued sluggish growth with moderate inflationary pressures, equities should continue to outperform.

Equity: Equities should continue to generate mid-single-digit returns. European equities (particularly banks) and Japanese equities could outperform.

Fixed Income: Expect heightened volatility as the Fed could begin to slowly raise interest rates. Agencies and corporate bonds are likely to outperform government securities. Relative to U.S. Treasuries, Canadian bonds may underperform.

Currencies: The Canadian dollar has likely transitioned to a trading range from the pure depreciation trend of the past two years.

Expected Returns

Recent central bank speeches confirm that they see the risk of tightening too early as more significant than the risk of tightening too late, given the remaining global headwinds of slowing demographics and high debt levels. Central banks continue to protect the world economy against disinflation, which implies inflation risks should be monitored more closely as they may err on the side of overstimulating.

Expected returns for the 12-month period beginning July 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%	0.7%	0.4%	0.9%	0.7%	0.4%
Canada Bond	-1.5%	0.5%	6.5%	-1.5%	0.5%	6.5%
Canadian Federal Government Bond	-2.4%	0.0%	5.9%	-2.4%	0.0%	5.9%
Canada Corporate Bond	0.6%	1.3%	4.3%	0.6%	1.3%	4.3%
Canada RRB	-1.7%	0.0%	11.0%	-1.7%	0.0%	11.0%
Canada High-Yield Bond	6.8%	4.5%	-3.5%	6.8%	4.5%	-3.5%
International Government Bond	-8.2%	-0.5%	13.1%	-5.3%	-0.3%	5.7%
Canada Equity	14.3%	3.1%	-10.7%	14.3%	3.1%	-10.7%
United States Equity	7.8%	6.5%	-8.3%	11.7%	3.9%	-13.3%
International Equity	9.0%	7.6%	-8.3%	13.0%	9.3%	-12.0%
Emerging Equity	12.2%	11.9%	-10.9%	12.4%	11.2%	-12.6%

Source: CIBC Asset Management Inc.

Global Outlook

This year had a slow economic start, hampered by weather disruptions in North America in the first quarter and geopolitical worries in Europe. Judging from the improved economic momentum in the second quarter, the second half of 2015 looks more promising. The global economy is counting on the impact of continued easy monetary policies in Europe, Japan and China, as well as the benefit of lower energy prices that should support the consumer sector over the coming months. Our global growth forecast anticipates 3.3% real GDP growth over the next year. We also anticipate a gradual pick-up in headline inflation as the impact of lower oil prices dissipates over the year.

The fed funds rate has stayed at zero for almost seven years. In the coming months, a self-proclaimed "data dependent" Fed could find enough evidence in U.S. economic activity to implement its first interest-rate hike before year-end. Low inflation and ample economic slack in Europe, Japan and China will leave those central banks on the sidelines for the next 12 months. We expect the Bank of Canada (BoC) to trail the Fed as the Canadian economy continues to adjust to the oil shock, a still highly indebted consumer and a fragile real estate market.

There are a number of risks around this broad economic outline. Business investment in the U.S. remains below expectations due to a lack of business confidence in the sustainability of the U.S. and global recoveries. Long-term sluggish business investment can also have detrimental effects on long-term potential growth. We will be closely monitoring this sector of economic activity over the coming months. Failure to see a pick-up in investment could derail the sustainability of the U.S. recovery.

In China, it is too early to determine if the easing efforts of the Chinese central bank and its macroprudential measures (designed to mitigate risk in the financial system) will succeed in reversing its economic slowdown. For the moment, housing prices are showing signs of stability and home price increases are more frequent in a number of cities. But economic activity is not expected to rebound yet, as growth in construction remains negative and the trade sector continues to be sluggish. This is putting downward pressure on producer prices and increasing deflationary risks across the globe, given China's importance as a global trade partner. Meanwhile, the European quantitative easing experiment is still in its early stage and the jury is still out regarding its effectiveness. Recurring altercations between Greece and its creditors could impact consumer and business confidence and further delay the European economic recovery.

To hike or not to hike is NOT the question

The investment community has directed a lot of focus to estimating when the Fed should start renormalizing monetary policy. They have coined the term *lift-off* to characterize the event, and speculation has been rampant about this finite point in time. With the Fed's increasingly transparent communications policy, the upcoming tightening cycle will likely be one of the most pre-announced in monetary policy history. We would therefore be surprised if the first rate hike triggers an important market move. In our minds, the obsession with the exact starting point of the U.S. tightening cycle misses the bigger picture. The path and reaction function (relationship between interest rates, inflation and full employment) of the Fed are the important issues, not the specific starting point.

In previous editions of *Perspectives*, we often expressed the view that we expect the Fed to be prudent. This led us to be more dovish about tightening expectations, both in our estimates of starting point and the speed with which the Fed would proceed. After a recent speech, Vice Chairman Fischer mentioned that *lift-off* is the wrong term to qualify the Fed's policy approach and that the term *crawling* would probably be more appropriate. Other Fed speakers have also emphasized the importance of international economic conditions when assessing U.S. policy-making. On that front, continued weakness and excess capacity abroad should motivate U.S. monetary policy authorities to conduct a prudent renormalization of its interest-rate policy.

We also believe that fears of a broad-based shock to emerging markets from Fed renormalization may be overstated. Emerging market assets do not appear stretched from a valuation perspective. Many fixed income, equity and currency markets remain undervalued relative to developed markets. While there are a number of vulnerable economies with large current account deficits, political instability and low interest rates that may be affected, they do not constitute the majority.

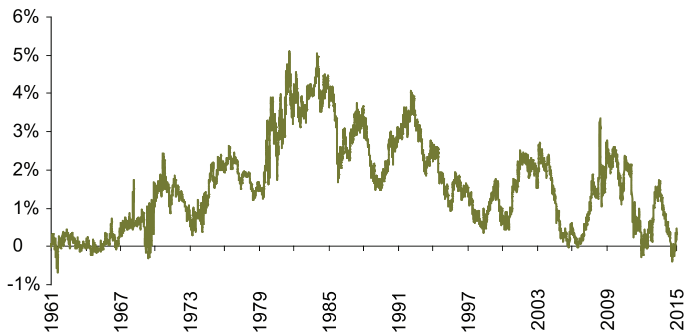
Unless U.S. economic data comes in much stronger than expected, we doubt that the anticipated first rate hike, if it occurs, will spoil the party. After all, why would the Fed spoil its own party?

Fixed Income Versus Equity

Will the Fed Spoil the Party?

In the last *Perspectives,* we made the point that equity valuation is a good determinant of future long-term returns. There is a clear historical relationship between a lower starting price/earnings ratio (P/E) and higher real returns 10 years later (conversely, higher starting P/Es lead to lower future returns). This is an important tool in our long-term asset allocation framework. Over shorter investment horizons—such as the next 12 months—P/Es can remain over- or undervalued. Today, some equity valuations, particularly the U.S. equity market, are high by historical standards but not yet unreasonably high. However, the Fed could short-circuit the current equity rally if it pushes interest rates higher than the market anticipates.

Federal Reserve - ACM Treasury Term Premium 10Yr



Source: Federal Reserve Bank of New York, Tobias Adrian, Richard Crump, and Emanuel Moench (or "ACM")

To determine the potential impact of a rising fed funds rate, we looked at how interest rates play a role in traditional equity valuation models. In financial theory, interest rates are used to discount future expected cash flows to determine the value of equity markets. All else being equal, lower interest rates should lead to higher valuation, and vice-versa. However, some qualifiers are necesary.

First, equities should not be valued using short-term government rates (the risk-free rate), but the long-term cost of equity. Second, the cost of equity should be the risk-free rate plus a risk premium. Third, this risk premium is not just influenced by interest rates but also by changing earnings expectations—the reasons *why* interest rates are rising are important.

If rising interest rates are accompanied by improving corporate cash flows, the negative effect of rising rates on the equity risk premium will be offset. The positive effect of rising cash flows on the risk premium can allow equity markets to outperform fixed income securities. In fact, similar measures of risk premium for the fixed income market show that bond term premiums are historically low. This is a result of the massive intervention by central banks using their asset purchase programs to push bond yields to historical, even negative, levels. As we enter the renormalization process, likely to start with the Fed, risk premiums will likely deteriorate more in the bond market than in the equity market under our central scenario of continued sluggish economic expansion.

The bottom line is we remain in an environment that favours equities over bonds. Rising valuation makes equities more vulnerable to an adverse scenario. However, in our central scenario of continued sluggish growth, with only moderate inflationary pressures and moderate upside to bond yields, equities should continue to generate mid-single-digit returns.

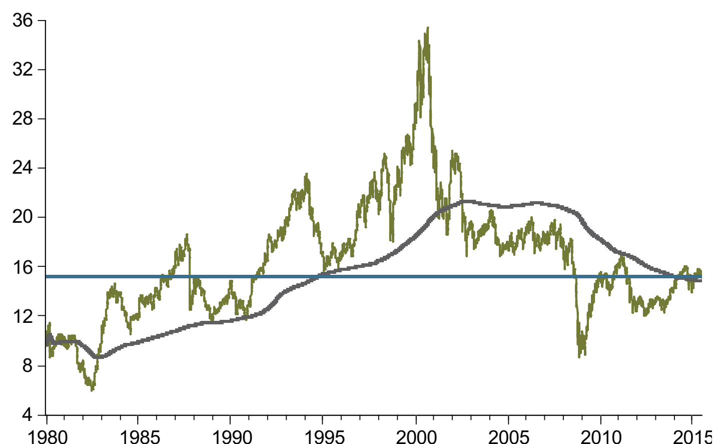
Equity Market Outlook

Regional Differences

While equity markets in the eurozone have performed very well since July 2012, banks have lagged and, consequently, their valuations have remained more attractive. The European Central Bank's (ECB's) program of quantitative easing has depreciated the euro, mostly benefiting exporters. Should monetary policy efforts lead to a sustainable, domestic-driven economic recovery, European banks could be some of the primary beneficiaries. Several factors could contribute to a recovery in bank earnings. As the economy slowly recovers, the credit cycle is turning positive and non-performing loans have peaked. This will lead to lower loan-loss provisions and, combined with the cheap financing provided by the ECB, more leeway to increase lending. European banks' return-on-equity (ROE) remains depressed, and so are price-to-book ratios. An improving earnings landscape would raise ROE, and could justify a valuation re-rating. Recent weakness in the euro is also expected to improve the competitiveness of European companies, helping the region outperform other equity markets over the coming months.

While the rally in Japanese equities has been spectacular, a longer-term perspective shows that prices are not yet back to the top of the trading range established during the deflation era. Since 2005, the link between the Japanese stock market and the yen has been impressive—they have both moved according to the tone set by the Bank of Japan. The sharp depreciation of the yen has helped to boost the profitability of Japanese companies. However, ROE has yet to improve. Relative to the rest of the world, Japan's ROE is still significantly lower, which explains much of the valuation discount. Again, the yen can be faulted, as its appreciation during the early part of the 2000s led to decreased competitiveness. That could be changing. As part of its three arrows of economic policy, the Abe government has implemented a number of reforms aimed at improving corporate governance. The reforms should be shareholder friendly, in the form of an increased focus on ROE, returning cash to shareholders as dividends or share buybacks, as well as balance-sheet restructuring (unwinding cross-holdings) to unlock value.

Canada Equity Valuation



CAM cyclically-adjusted P/E
10-year moving average
Long term average

Source: CIBC Asset Management Inc.

Canadian equities remain neutrally rated in our regional allocation strategy. Valuation remains around the historical average, but we fail to see a catalyst that would support an outperformance of this equity market. Commodities are expected to remain in a consolidation phase following a strong correction. Consumer sectors remain plagued by overvaluation and a Canadian consumer saddled with a large debt burden leaves little room for positive surprises. Meanwhile, the energy sector continues to adjust to lower energy prices for longer than many had anticipated, leaving little upside potential for the moment.

U.S. equities might be the most at risk, because their valuations are among the highest of all major countries. As expected, profit margins are showing signs of peaking, with gradual wage pressure mounting and continued strength in the U.S. dollar. These pressures are not about to reverse and are the reason behind the underperformance of this market year-to-date. We expect continued underperformance in the coming months.

Commodity Insight

OPEC's decision not to cut oil production in November 2014, in response to a negative supply-and-demand dynamic, pressured the price of crude into the first quarter of 2015. Global supply had been growing, led by unconventional U.S. shale production, given the supportive price environment. This was occurring as demand faltered due to slower global economic growth. OPEC's actions sought to reduce, and perhaps reverse, the pace of production additions from competitors, while stimulating the global economy through a *de facto* tax cut. This, in turn, could stimulate demand for crude. The decline in the price of crude led to a reduction in oil-directed investment, most evident in the reduction in the U.S. onshore rig count. We are also seeing the first signs of an increase in global demand, as evidenced by the strength in refining margins globally.

The reduction in the U.S. oil-directed rig count has stalled the production pace. Weekly reports from the U.S. Energy Information Administration indicate that production from this region has stabilized around 9.1 million barrels per day (bbl/d). That is up about 1.1 million bbl/d from the same period one year ago. However, it appears that week-over-week growth has been curtailed. We expect to see both week-over-week and year-over-year growth declines as we move into the second half of the year.

The capital and cost-cutting efforts by the global integrated oil companies are more significant. The impact of these capital reductions will be more notable in coming years as the 38.2 million bbl/d of non-OPEC, non-shale production starts to decline. Market participants are watching U.S. production data and global investment closely for indications of further price support.

From a demand perspective, current price recoveries from the lows seen in the first quarter of 2015 are partly due to normal seasonal demand strength. The North American summer driving season has historically been responsible for 1.5 to 2 million bbl/d of incremental demand between the second and third quarter of any given year. However, just as demand increases into the third quarter, it also declines with normal refining maintenance into the end of the year. Without a decline in the pace of production, concerns over the size of U.S. storage may return in the seasonally weak fourth quarter.

Beyond the seasonal pattern, we are seeing broader improvements in demand. In its June 11 release, the International Energy Agency revised demand for the first quarter and full year of 2015 to 1.7 millions of barrels per day (mb/d) and 1.4 mb/d respectively. More significantly, they indicated that backwardation* has returned to the refined crude product market, indicating strength in end demand. The return of European refiners to the market after their planned spring maintenance has not softened refining margins. As refiners are the only source of demand for raw crudes, high refining margins in a market of high refinery utilization indicates strong end-market product demand.

OPEC's strategy of maintaining supply appears to be having the desired impact on market participants. Capital expenditure reductions will lead to a more notable supply response in the coming months, while demand increases are already being noted by market observers. Unlike the early 1980s, when OPEC had sizeable spare production capacity, today's spare capacity is relatively small by comparison. The dynamic of rising demand and limited-to-declining supply additions should eventually lead to a higher crude oil price.

*Backwardation occurs when the price of a commodity for future delivery is lower than the spot price (the price of the commodity today).

Fixed Income Outlook

Higher volatility ahead

- **We are revising our 12-month targets slightly higher for U.S. 10-year Treasuries to 2.7% (previously 2.25%) and the Canadian equivalents to 2.1% (previously 1.55%).**
- **This takes into account the higher premium that heightened volatility normally requires. It also acknowledges that the Fed will likely initiate its renormalization process within the next 12 months (our forecast horizon).**

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 policymakers are navigating a challenging environment, keeping investors on their toes and making bond markets increasingly volatile. Despite projections that suggest a renormalization process will be well under way 12 months from now, the Fed is keeping all options open by specifying that decisions will remain data dependent.

Greater uncertainty is also emerging in other parts of the world. While pursuing a well-defined quantitative easing program, the ECB advised investors to start "getting used" to greater market volatility. Conditions have changed now that some central banks, like the Fed, try to manoeuvre policy back to normal while others, like the People's Bank of China, increase measures to support their economy.

Bond markets are well aware of these crosscurrents. The upward adjustment in yields during the second quarter illustrated how sensitive they are to signs that could either launch the renormalization process or delay it. The net impact of this added volatility will be to push volatility premiums higher as investors demand to be compensated for this type of risk.

The solace for bond investors lies in the longer-term global growth perspective. Over our forecast horizon, we believe that longer-term nominal growth could disappoint. This should provide support to the long end of the curve and could even push yields lower in the event of a growth disappointment that worries monetary authorities. Along the way, we acknowledge the possibility of potential overshoots due to a higher-volatility environment.

In this context, we believe that the search for extra yield will continue. This will help agencies and corporate bonds outperform government securities in the next year. Relative to U.S. Treasuries, Canadian bonds are at risk of underperforming, on the back of a potential loss of appetite from foreign buyers. Foreign investors currently hold a record share of the Canadian fixed income market.

Currency Markets

U.S. Dollar

The U.S. dollar appreciated by 18% (trade-weighted basis), over just nine months from June 2014 to March 2015. The fact that it gained so much ground over such a short period makes it vulnerable to a short-term, counter-trend setback. Our valuation estimates also show that the greenback will likely face headwinds unless the cyclical elements of the U.S. recovery reaffirm themselves in the second half of this year.

Our projection of further, modest U.S. dollar strength is predicated on a number of expected cyclical developments. The employment market needs to remain healthy and continue to put upward pressure on wages. This would necessitate a first rate hike from the Fed at a time when no other central banks are contemplating such a move. There are also a number of countries with weaker fundamentals and low-to-negative interest rates, currency overvaluation and current account deficits that provide relative cyclical support to the greenback. An eventual peak in the U.S. currency could come if the Fed pauses its hiking cycle, reducing the cyclical divergence with other countries.

Canadian Dollar

Based on our valuation metrics, the Canadian dollar is undervalued by about 5%—not a meaningful undervaluation. The interest-rate differential is not a major support either, with only 50-75 bps favouring the Canadian dollar. We expect the Fed to lead the tightening cycle, further eroding support.

In terms of the oil price outlook, the view remains that the market is oversupplied and oil prices (based on West Texas Intermediate) should have difficulty sustaining levels of $60 USD. Finally, relative cyclical growth looks likely to favour the U.S. economy as there are fewer economic imbalances, particularly at the consumer level. We expect the Canadian dollar has likely transitioned to a trading range from the pure depreciation trend of the past two years. While valuation should now limit the CAD downside to recent lows of 1.28 CAD/USD, cyclical forces and oil prices should limit the upside to the 1.22 level.

Japanese Yen

Since the Bank of Japan (BOJ) adopted its quantitative and qualitative easing (QQE) policy in late 2012, the Japanese yen has lost a lot of ground. The yen's decline against the U.S. dollar has been massive—cumulatively nearly -37%. Based on our valuation metrics, the Japanese yen is now undervalued against the U.S. dollar by about -14%. Does this mean that valuation has become an obstacle, limiting further yen weakness? Not for the next little while. We believe that monetary policy differentials will continue exerting downward pressure on the yen against the U.S. dollar over the next 12 months.

The BOJ has committed to QQE as long as inflation, excluding the effects of consumption tax hikes, stays below 2%. In its last *Outlook for Economic Activity and Prices*, the BOJ revised its inflation forecast down another notch from +1.0% to +0.8% for 2015. These additional downward revisions should be interpreted as a signal that QQE policy will remain in place throughout 2015 and well into 2016. Monetary policy differentials should therefore continue supporting the U.S. dollar against the yen.

Euro

After plunging nearly -25% against the greenback, the euro has shifted to consolidation mode in the last five months. This was not a surprise, as we were expecting the euro to retrace some of its lost ground over the short term. Fundamentally, very little has changed since the ECB launched its asset

purchase program in early 2015. From a cyclical perspective, eurozone unemployment remains high at 11.2%, with full employment estimated to occur at 9%. Various measures of the labour market show the U.S. economy is much closer to full employment, with unemployment approaching the Fed target around 5%. The relative slack in economic activity between the eurozone and the U.S. economy still requires a wide divergence in relative monetary policy, which should continue to favour the U.S. dollar.

The euro is now about 10% undervalued. This undervaluation should limit the speed of future declines. However, this doesn't mean that it can't move deeper into undervalued territory. For example, between 2000 and 2002, the euro stayed deeply undervalued (-25%) against the U.S. dollar. Our forecast expects the EUR/USD bilateral exchange rate to move closer to parity by the middle of 2016.

Regional Outlook
Canada

- **We believe there is still too much optimism about the Canadian economic outlook. Over the next 12 months, real GDP will likely disappoint, finishing closer to +1.5% than the +2.2% that is widely expected.**
- **With an already low policy rate, the BoC is running out of ammunition. Any additional easing will be conditional on deteriorating growth prospects.**

The consensus view remains that the Canadian economy has hit a soft patch due to the oil shock, but should start recovering in the second half of the year. For the next twelve months, most private sector forecasters are betting that real GDP growth will reaccelerate to about +2.2%.

The impact of the oil shock is already being felt and will provide easier year-over-year real GDP comparisons for the next 12 months. Yearly real GDP growth has already slowed notably from +2.8% in late 2014 to +1.5% last March. Assuming that oil prices remain depressed over the next year, the energy sector will remain a drag on growth moving ahead.

Energy accounts for only one-third of the growth deceleration just experienced. The recent Canadian economic softness is also explained by weaker activity in the other key goods-producing sectors. The construction sector has slowed considerably. We are also witnessing a pronounced slowdown in Canadian manufacturing production from +5.1% at year-end 2014 to just +1.2% as of March.

A revival in the construction sector requires stronger consumer fundamentals. Unfortunately, the Canadian labour market is no longer adding jobs as it used to and household debt is at an all-time high. Employment growth is running at only +1.0%, not enough to produce much stronger construction activity numbers, especially given elevated debt loads. This is precisely where the BoC and consensus could be wrong about the Canadian outlook.

The fate of the Canadian manufacturing sector is closely tied to developments south of the border. The slowdown in Canadian manufacturing activity so far this year has coincided with cooling U.S. manufacturing activity. The BoC is betting on stronger U.S. demand for Canadian products moving into next year. It actually penciled in a real GDP growth contribution of +0.9% from net exports. This projection has to materialize to push Canadian growth above +2%. We are not as optimistic about growth prospects for the United States (CAM 12-month projection at +2.20% vs. a projection of +2.85% used by the BoC). If the BoC's forecast doesn't materialize, Canadian manufacturing activity will remain depressed and the economy will miss the real GDP growth target.

We believe there is still too much optimism about the Canadian economic outlook. Over the next 12 months, real GDP will likely disappoint, finishing closer to +1.5% than the +2.2% that is widely expected.

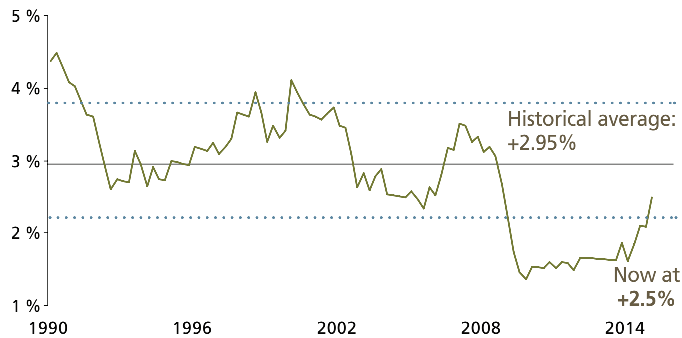
United States

- **Our forecast calls for +2.2% average real GDP growth between the third quarter of 2015 and the second quarter of 2016, a forecast below the Fed's implicit objective.**
- **Wage inflation is finally accelerating. This is a clear positive for U.S. households, but a negative for U.S. nonfinancial corporations.**
- **Since growth could initially seem to be in line with its target, the Fed will likely deliver a first rate hike. However, the tightening cycle may be relatively muted.**

For more than a year, U.S. monetary authorities have been preparing financial markets for some policy-rate renormalization. Judging by the recent behaviour of market participants, it looks like the moment of truth is fast approaching, with the first rate hike expected before year-end. For this forecast to materialize, the U.S. economy has to continue to behave as expected by the Fed. This potential policy move will be data-dependent, especially in the context of a clear warning by the IMF and World Bank to be more patient before hiking rates.

For the coming year, the Fed and most private sector forecasters are betting on stronger domestic demand to produce real GDP growth of about +2.5% in both 2015 and 2016. Owing to the strength of the U.S. dollar, net exports are expected to act as a drag on overall growth. This means that the Fed's policy shift is conditional on a significant strengthening of the domestic economy. The Fed is betting not only on continued strength in consumer spending, but also on much stronger investment spending.

U.S. ECI Wage Inflation (y/y, %)



Source: BLS and CIBC Asset Management Inc.

With improving consumer fundamentals, the Fed probably doesn't feel that its projections for the U.S. consumer are at risk. What about its upbeat outlook for investment spending? Underinvestment has been one of the key features of the U.S. economic expansion. In our view, this is where the risk lies.

There are many reasons why investment has disappointed in recent years. For one thing, the housing recovery has been very modest and very slow to unfold. In our view, this is not about to change. Housing supply and demand conditions will continue to limit the recovery in residential investment spending.

Another reason why investment spending has been sluggish relates to the contraction in federal government spending. To put the U.S. fiscal house in order, both defence and non-defence spending have been radically reduced over the last five years. Looking forward, the Congressional Budget Office projects only a very mild pick-up in federal government spending—not enough to propel total investment higher. State and local sectors also face persistent, long-term fiscal pressures. These pressures are primarily driven by rising health-care costs, adding to the nation's overall fiscal difficulties. In short, we don't expect much from the government side.

This leaves only one option to produce better investment spending numbers—non-residential investment. U.S. non-financial corporations have to start investing more. The problem is, since 2011, these corporations have been restoring profitability by buying back shares and issuing corporate bonds, taking advantage of the ultra-low interest-rate environment. The net impact of this reshuffling on the liability side of the balance sheet has been very sluggish investment spending. Unfortunately, these dynamics should remain at work in the U.S. over the next year.

Bottom line: odds are high that growth will undershoot the Fed's implicit target for the next 12 months. Our forecast calls for +2.2% average real GDP growth between the third quarter of 2015 and the second quarter of 2016, a forecast below the Fed's objective. Since growth could initially seem to be in line with its target, the Fed could deliver a first rate hike. However, the tightening cycle may be more muted than expected.

Europe

- **Our real GDP growth forecast is unchanged at 1.3%—a below-consensus projection.**
- **The ECB is unlikely to reach its inflation target. Stuck with wide excess capacities, it will have no choice but to continue expanding its balance sheet well into next year.**

The launch of an ambitious asset purchase program by the ECB raised hopes of a eurozone cyclical revival led by Germany. Over the first quarter, this hope fueled a powerful rally in German financial assets. Since April, however, financial tides have been turning. Are investors losing confidence in Germany's economic lift-off and will eurozone growth disappoint? After taking a closer look at developments in Germany, we suspect the eurozone will soon disappoint again.

The positive surprise this year has clearly been the strength in German consumer spending. Strong fundamentals (i.e. high savings rate, higher compensation, energy relief and reasonably good employment growth) have convinced German households to open their wallets a little more than usual. Consumer spending grew more than 2% on a yearly basis—the strongest consumption numbers since 2011. While this may not look like a lot, this qualifies as a spending binge for German households. In the just-released outlook for the German economy, the Bundesbank remains relatively upbeat, betting that consumers will continue to spend at the same pace in 2015 and in 2016. In our opinion, this is quite a stretch. According to the German central bank, this would allow real GDP growth to hit +1.7% in 2015 and +1.8% in 2016.

Although the Bundesbank projects better times ahead for Germany, its growth projections are not particularly strong. This implies that the positive side effects for other eurozone countries won't be huge. At best, their exports to Germany should rise by €23.7 billion or +0.38% of GDP (non-Germany eurozone). In reality, the boost to exports will likely be smaller, as eurozone countries (ex-Germany) have been steadily losing market share to highly competitive countries like China.

In addition, other eurozone countries probably won't be exporting as much to Germany as generally expected because German domestic demand will likely be weaker than the German central bank expects. Similar to the U.S. and the United Kingdom, underinvestment is the number one risk factor for Germany (and the rest of the eurozone).

To achieve their growth objectives, German monetary authorities are projecting that investment spending will significantly contribute to growth (+3.1% growth with a +0.62% real GDP growth contribution). This looks too optimistic. As of the first quarter of 2015, real investment spending was already contracting. In other words, a very strong pick-up would be required to reach +3.1% by year end.

The situation in Germany is very much like the United States. Employment growth has picked up (+0.8%) and wage inflation is accelerating (+2.6%). On the bright side, this has allowed for a consumer-led German cyclical revival. On the downside, compensation costs are now rising faster than GDP. To avoid a squeeze on profitability, German non-financial corporations have been cutting back on investment spending. This largely explains why the Bundesbank has systematically overestimated Germany's investment recovery.

With compensation costs projected to continue rising, the risk is that underinvestment will remain one of the key features of the German economic expansion. In short, German growth will likely undershoot the Bundesbank's projections as a result of underinvestment. If German corporations don't start investing soon, the Bundesbank will have to adjust its growth forecast. This would imply a smaller boost to growth in the rest of the eurozone and, consequently, our below-consensus growth expectation.

China

Economic deceleration forcing policy changes

- **Slowing economic momentum casts doubts on China's 7% GDP growth target this fiscal year. The economy is also experiencing disinflationary pressures. These factors point to continued easing of financial conditions by the central bank.**
- **As China aims for more sustainable growth, it will likely adopt a more market-determined and liberal economic model.**
- **Several important changes relating to interest-rate and capital- account liberalization are expected within the next year.**

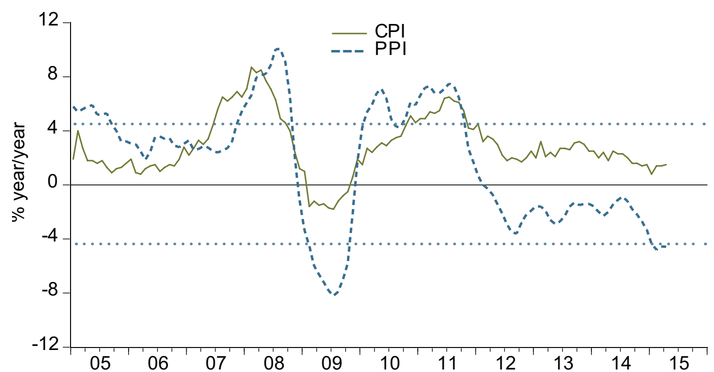
The first half of 2015 was a challenging period for Chinese economic growth. Economic momentum has slowed, casting doubts on China's 7% GDP growth target this fiscal year. Consumption has held up, but investment spending has seen a significant deceleration in growth. The weakness in fixed capital investment is largely related to lower real estate and construction-related activity.

Looking ahead, we expect some stabilization in growth. The seeds of easier monetary policy have been sown with multiple reductions since November 2014 in both the benchmark interest rate and reserve requirement rate. This will likely start to have a visible impact in the second half of 2015. That being said, the central bank has not finished loosening financial conditions. Consumer price inflation (CPI) remains well below the annual 3% target and the People's Bank of China (PBoC) estimates that CPI will still be below the desired rate 12 months from now. Persistent deflation in the goods-producing sector is a concerning sign. This could have consequences, including pressures on meeting interest payments and possible defaults in specific industries. As a result, we expect the PBoC to continue its easing cycle in the second half of 2015.

As China aims for more sustainable growth, it will likely adopt a more market-determined and liberal economic model. Several important changes are expected within the next year related to interest-rate and capital-account liberalization. There is a strong likelihood that China will lift its restrictions on deposit rates in the next few months, finalizing a long-awaited process of full interest-rate liberalization. Until recently, the PBoC set the level of deposit rates as opposed to allowing competitive market forces to determine it. This liberalization process has been underway since late 2014 when the PBoC began to increase the deposit rate ceiling that banks are allowed to offer, relative to the benchmark deposit rate.

We also anticipate increased capacity for foreign investors to access Chinese mainland financial assets. Until recently, foreign investors have been restricted from buying mainland assets. As China improves market accessibility, quota allocation and capital repatriation rules, two important developments will take place. International equity benchmark indices will begin to include Chinese A-shares in their baskets, triggering an inflow of capital into Chinese equities. The second impact relates to the internationalization of the renminbi (RMB). As China accelerates RMB internationalization, which implies a more accessible and freely-used currency, it will attempt to persuade the IMF to include the RMB in its Special Drawing Rights (SDR) basket of currencies. This will potentially increase China's quota and voting power at the IMF. The intention is that central banks globally will increase RMB holdings in their foreign exchange reserves, providing support and increased demand for Chinese financial assets and strengthening the Chinese currency.

China Also Experiencing Disinflation



Source: Thomson Reuters Datastream, CIBC Asset Management Inc.

Signposts

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

Canadian Signposts

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

U.S. Signposts

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

Chinese Signposts

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

Other Market Signposts

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

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