Perspectives

For the period beginning April 1, 2016

MONETARY POLICY RUNNING ON EMPTY

While some global risks have recently receded, they have not disappeared. Global debt levels remain high by historical standards. Even though the cost of financing the debt is lower, the global growth supporting the eventual debt repayment has also declined, leaving a precarious equilibrium.

Meanwhile, demographic trends are still deteriorating; this is one of the root causes of persistent sluggish economic activity. With interest rates near zero and many unconventional monetary policy tools close to their practical limit, the ability of central banks to stimulate growth seems more limited. This could leave the U.S. Federal Reserve as the "last man standing".

Asset Allocation Outlook as at April 1, 2016

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: While we still find equities more attractive than fixed income, investors should not ignore bonds. In the current uncertain, volatile environment, we favour a cautious strategy that is well-diversified across and within asset classes.

Equity: Equities are expected to deliver single-digit returns with above-average volatility.

Fixed Income: We expect yields in Canada and the U.S. to remain around their current levels over the next 12 months, although yields may decline further over the shorter term.

Currencies: For currencies with safe-haven features like the euro and Japanese yen, the U.S. dollar's cyclical peak has probably already been reached. For cyclical/commodity-sensitive currencies, the U.S. dollar's long-term uptrend should remain intact as the economic adjustments to lower commodity prices are not yet complete.

Expected returns for the 12-month period beginning April 1, 2016	In Canadian Dollars			In Local Currency		
	U.S. Renormalization	Sluggish Expansion	Policy Limits	U.S. Renormalization	Sluggish Expansion	Policy Limits
Probabilities	15.0%	50.0%	35.0%	15.0%	50.0%	35.0%
Canada Money Market	0.6%	0.3%	0.2%	0.6%	0.3%	0.2%
Canada Bond	0.2%	2.2%	4.7%	0.2%	2.2%	4.7%
Canada Federal Government Bond	-1.5%	1.1%	4.3%	-1.5%	1.1%	4.3%
Canada Corporate Bond	2.9%	3.1%	2.7%	2.9%	3.1%	2.7%
Canada Real Return Bonds	0.5%	2.6%	7.2%	0.5%	2.6%	7.2%
Canada High-Yield Bond	10.5%	5.5%	-5.0%	10.5%	5.5%	-5.0%
International Government Bond	-8.0%	5.0%	19.9%	-2.3%	0.9%	2.6%
Canada Equity	11.3%	2.6%	-23.8%	11.3%	2.6%	-23.8%
United States Equity	3.2%	3.5%	-10.2%	6.8%	-0.1%	-21.6%
International Equity	9.8%	8.1%	-5.9%	15.2%	5.3%	-18.5%
Emerging Equity	17.0%	4.5%	-12.1%	15.3%	5.9%	-16.7%

Source: CIBC Asset Management Inc.

Global Outlook

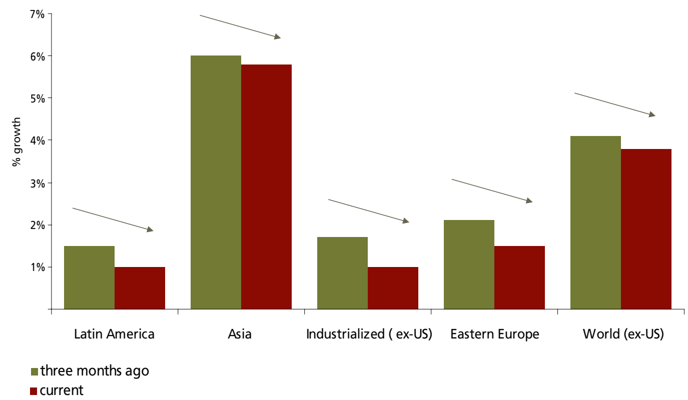
Sluggish Expansion

The global economic landscape remained uninspiring in the first quarter of 2016—consistent with our main scenario of sluggish economic expansion. Our growth outlook is similar to our last quarterly forecast; global growth will reach +3% over the next 12 months (ending March 2017), slightly lower than our +3.1% expectation three months ago. The consumer should continue to be the dominant growth engine, particularly in the U.S., supported by an improving labour market, low oil prices and a slight easing in fiscal policies in the U.S., Canada and core Europe. Japan is a notable disappointment, with continued subdued wage growth.

Global economic weakness remains in the trade/manufacturing sector as well as capital investment. These continue to be a drag on growth, particularly for China and its main trading partners. Headline inflation should show meaningful signs of bottoming, as the effect of lower oil prices rolls out of the data as the year progress. The U.S. could see a slight pick-up in inflation, as the strength of the U.S. dollar during 2015 dissipates and its negative impact on imported goods prices gradually reverses. We will be closely watching the continued tightening of the U.S. labour market, and its effect on wage growth, to anticipate the U.S. Federal Reserve's (Fed's) response. Global inflation is expected to reach 3.9% at the end of our forecast horizon (next 12 months), up from 3.6% three months ago.

The risks to our main scenario are to the downside. While some risks have recently receded, they have not disappeared. Global debt levels remain high by historical standards. The cost of financing the debt has been pushed lower but the global growth supporting the eventual debt repayment has also declined, leaving a precarious equilibrium. Meanwhile, demographic trends are still deteriorating; this is one of the root causes of persistently sluggish economic activity. More cyclical risks also remain in China—its challenging economic rebalancing could potentially cause more disruption during the next year. This could include more pressure that leads to continued depreciation of its currency. Political risks are also present over the coming months with the EU referendum in the U.K., the U.S. presidential election and the related inability to use fiscal policy until after the election. While a sluggish economic expansion remains our central scenario over the coming 12 months with a 50% probability, we are raising the probability of our more pessimistic scenario (Policy Limits, see sidebar) from 30% to 35%.

CAM growth forecast for 2016: Spring vs. Winter Forecast



Source: Thomson Reuters Datastream, CIBC Asset Management Inc.

Alternative Scenarios

Policy Limits

Since 2009, major central banks have been very creative. They have found and implemented new, unconventional policies as conventional policy rates reached zero following the global financial crisis. These included forward guidance, quantitative easing (direct purchases of assets—government bonds, mortgage-backed securities or corporate bonds), credit easing (funding for lending in the U.K. or LTROs and TLTROs in Europe) and zero-to-negative interest rates (so called ZIRP and NIRP). These policies have succeeded at pushing interest rates to historically low levels, tightening sovereign bond spreads in the eurozone and pushing equity markets higher. Interest-sensitive equity sectors in particular are now trading at historically high valuation multiples. The objective of these policies was to generate higher asset prices, which would translate into a wealth effect as consumers and corporations regain confidence in borrowing, consuming and investing.

While the world economy has been expanding, its performance has been disappointing in terms of the level of growth and inflation that were generated. Aside from the secular challenges of excessive debt levels and deteriorating demographics, we suspect another reason why central banks' aggressive monetary policies have not been particularly effective—the expected wealth effects have been relatively weak.

Fast forward to 2016 and we are left to wonder what stimulative tools are still available to major central banks. On the interest rate front, central bank policy interest rates in Europe and Japan have now reached what is estimated to be the maximum level of negative interest rates (estimated around -0.5%). Beyond that level, depositors would likely withdraw their savings from the banking system to avoid being charged a negative rate to safeguard savings. With asset purchase programs (or quantitative easing), the constant buying by central banks in Europe and Japan has also pushed interest rates on longer maturities into negative territory.

Under this scenario, central banks may still have some options in their toolkits. But their effectiveness is greatly reduced given the low starting point of interest rates and the uncertainty of their side effects. Consider the impact on the profitability of the banking system of negative interest rates or the impact on the solvency of pension plans. This scenario highlights the downside risks to the growth outlook, as the ability of central banks to protect against negative economic shocks is more limited going forward.

U.S. Renormalization

A more positive scenario could come from stronger-than-expected benefits related to energy price declines and a stronger-than-expected U.S. recovery. This could lead to more robust global consumer spending, as consumers spend most of the 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 could foster better lending activity and increased consumption in the eurozone and lead to a stronger-than-expected global economic recovery. Even now, a gradual improvement in European lending is slowly surfacing.

This scenario would bring renormalization of U.S. monetary policies sooner than expected. Higher interest rates would not impede higher equity markets as earnings would provide a positive surprise, supporting equity market valuation. We have limited this renormalization to the U.S. economy only. Recent signs of weakness in the Japanese and European economies and ample slack in their labour markets are unlikely to trigger a renormalization of monetary policy outside the U.S. At the same time, we have reduced the probability of this positive U.S. renormalization scenario to 15%.

Fixed Income Versus Equity

Favouring a Cautious and Well-Diversified Strategy

Markets remained volatile early this year. Fears of a continued economic slowdown pushed equities and commodities lower, while bond prices and gold increased. The continued rout in oil prices led to speculation about the solvency of high-yield debt, and further contributed to global risk-off sentiment. The European Central Bank (ECB) remained committed to quantitative easing and pledged more stimulus if required, while the Bank of Japan (BOJ) introduced additional stimulus measures. However, the impact was not as hoped for, as investors started to question whether central banks are running out of options. Meanwhile, the Fed recently signaled that it would be proceeding more cautiously with policy normalization—a step that surprised many market participants but was consistent with our last quarterly forecast.

In our most likely scenario*, global economic activity is expected to remain sluggish over the next 12 months but face structural headwinds, such as low demographic growth and high levels of debt, over the long term. In this environment, equities are expected to deliver single-digit returns with above-average volatility.

Our alternative, adverse scenario has significant market implications. The challenge for investors is how to properly position their assets. Risk-on or risk-off? Of course, the world is more complex than a simple "one or the other" outcome, but this is a useful starting point. Tilting a portfolio too much one way or the other could have serious consequences if the scenario plays out differently than expected. With this backdrop, we favour a cautious strategy that is well-diversified across and within asset classes.

One consequence of ultra-stimulative central bank policies has been higher valuations for risky assets. Our measure of the cyclically-adjusted P/E ratio for global equities has increased from 8.1 in 2009 to 14.1 today, yet it remains below the long term-average of 15.3. Equity markets are moderately cheap compared to their own history, but especially cheap when compared to government bonds. Investors could also turn to high-yield bonds as a risky asset that provides an alternative to equities. They are less volatile than equities and their low correlation with other asset classes means they can diversify a portfolio.

Government bond yields are very low by historical standards, and many countries have negative yields on maturities up to 5 years, in some cases up to 10 years. A simple look at valuation would therefore strongly favour equities over bonds. However, this is not to say that investors should ignore bonds. Diversification is most important during periods of economic and market uncertainty. While bonds may generate low returns in our most-likely scenario, they could still protect a portfolio if the global economy slips further.

*Global Outlook section provides details on our three scenarios

Equity Market Outlook

Corporate Profit Margin Concerns

Profit margins at U.S. companies have been rising since the early 1980s. They have been supported by lower compensation costs (as a proportion of corporate GDP) and declining interest rates. However, the trend reversed in 2011 and margins have been declining since. Wage pressures are creeping up as the labour market moves closer to full employment. The Fed's zero-interest-rate policy and quantitative easing have pushed interest rates as low as they have ever been. As a result, profit margins are expected to continue to drift lower from here.

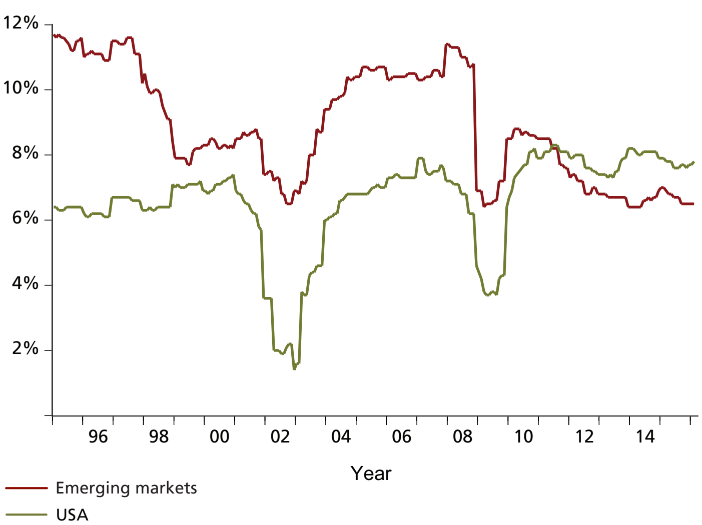
The reason for concern over U.S. corporate profits is twofold. First, earnings growth can be broken down into sales growth and the change in margins. Over the long term, sales growth typically mirrors nominal GDP growth, which we expect to be lower than in the past.

Margins, on the other hand, cannot grow forever. High profit margins will attract new companies, and the increased competition usually brings margins down to their long-term average. Although it is difficult to determine what this long-term average should be, margins at historically high levels are more likely to fall than rise. This should act as a drag on earnings growth.

Second, every recession since the 1950s has been preceded by margin contraction. Only once, between 1985 and 1987, was a decline in margins not associated with a recession. When companies see their margins fall late in the cycle, they tend to slow both hiring and investment to protect their earnings. Although we are in an atypical cycle that could play out differently this time, this is definitely an important indicator to follow.

The picture on margins is somewhat better in the rest of the world. Using income statement data (as opposed to national accounts data for the U.S.), we can break down margins in various regions and sectors. First, we need to exclude the energy and materials sectors. Their margins are heavily influenced by the volatile market price of commodities. Second, we also need to exclude financials. Margins, defined as the ratio of earnings over sales, are not relevant for financials, where net interest margin is more appropriate.

Profit Margins



Source: Thomson Reuters Datastream, CIBC Asset Management Inc.

The most striking observation from this analysis is the gap between the U.S. and emerging markets. Emerging markets used to have higher margins than the U.S., but this has changed. After the 2008 financial crisis, margins recovered after a cyclical dip in both regions. However, they stayed high in the U.S. but drifted lower in emerging markets. This decline could be observed across all sectors. Today, margins are historically low in emerging markets, leaving room for profit margin improvements, while they are historically high in the U.S. and more likely to deteriorate. We find a similar gap between the two regions using equity market valuation. In absolute terms, the emerging market P/E (price/earnings) is at its lowest level ever. In relative terms, it has never been cheaper when compared to the U.S. If the U.S. and emerging markets are at the upper and lower end of margins and equity valuation, other countries (i.e. Canada, Europe and Japan) stand somewhere in the middle.

Commodity Insight

Although commodities rallied in the first quarter, the factors driving prices higher had more to do with the global economic backdrop and currency moves than improved fundamentals.

The Fed's move to increase interest rates by 25 bps (basis points) in December 2015 had an immediate impact on credit markets, currency and commodity prices. Market participants became increasingly concerned that the global economy was about to tip back towards a period of deflation. Global equities sold off as concerns mounted and credit stress increased—loans to energy companies came under particular scrutiny. Gold was the only commodity which traded higher on increasing concern that central banks would no longer be able to stimulate growth.

As 2016 began, central banks reacted to this challenging outlook for global growth. The BOJ and the ECB extended stimulus programs while the Fed began to talk down the pace of future interest rate hikes. The markets reacted quickly to the more accommodative policies and U.S. investment-grade credit spreads tightened, the U.S. dollar weakened and commodities rallied (irrespective of their fundamentals). Largely driven by short covering, equities also rallied—especially the stocks of companies that employ leverage.

In the current environment, we are careful not to lose sight of the fundamentals. Without an improvement in actual demand, the financial short covering could eventually reverse and commodity prices and commodity stocks could decline; unfortunately, the backdrop is not all roses.

Copper prices have rallied even as inventory levels have increased—not a sustainable situation. Demand from end-users has yet to appear and consumers in China, although cautiously optimistic, are hesitant to restock inventories. We continue to closely monitor end-user demand before becoming more optimistic about copper pricing.

Oil markets also rallied, after marking new lows in mid-February. For this commodity, we see the first signs of stability, as reduced investment in new production leads to the first year-on-year declines in U.S. production. These declines, although small, are further supported by production disruptions in Nigeria and Iraq. More recently, Venezuelan production has come under increasing stress, as drought conditions have reduced the power supply needed for the country's upgraders*.

Late in 2015, we increased our allocation to gold producers as we became concerned over the possibility of more hawkish central bank policies. We will continue to maintain our exposure to this commodity as we remain skeptical of the ability of central banks to drive economic growth through monetary policy alone. Recently, governments globally have started to look to fiscal stimulus to drive additional growth. While fiscal stimulus would be a positive catalyst for commodities, we believe that high levels of government debt will limit fiscal spending.

Overall, select commodities, including oil, are stabilizing as supply and demand start to rebalance. But recent price improvements have been largely driven by financial flows and need to be supported by fundamentals to ensure further improvement.

*An upgrader is a facility that upgrades bitumen (extra heavy oil) into synthetic crude oil.

Fixed Income Outlook

Growing Divergence

- **We are revising down our 12-month forecast for the U.S. 10-year Treasury yield to 2.00% (from 2.50%) and its Canadian equivalent to 1.25% (from 1.50%), given the renewed deterioration in the global growth and inflation outlook.**

Last year, our projections for North American bond markets accounted for some renormalization in the monetary policy stance of the Fed. Our thought was that a small step toward U.S. policy renormalization would be achieved this year. We also believed that growth disappointments, both globally and domestically, would eventually force the Fed to the sidelines. Now that the central bank of the world's growth engine has curbed the expected trajectory of its policy rate, our conviction about the limited upside for bond yields has grown even stronger.

This conviction also stems from the fact that other major central banks recently increased their asset purchase programs over our forecast horizon (next 12 months), helping to anchor bond yields globally. These forces are at work in both the eurozone and Japan, where deflationary pressures are intensifying, not abating.

Policy actions in China are another source of downward pressure on global bond yields. Further monetary policy easing by Chinese monetary authorities is expected in order to cushion the economic slowdown currently underway in China.

Canadian bonds are expected to outperform U.S. bonds over the forecast horizon. Increased fiscal spending won't be enough to boost Canadian economic growth. With the Fed looking to reduce monetary policy stimulus and the BoC further easing its monetary policy, Canada-U.S. sovereign bond yield spreads are expected to widen.

All in all, we expect yields in Canada and the U.S. to remain around their current levels over the next 12 months, although yields may decline further over the shorter term. We believe that global economic and monetary conditions continue to provide a favourable backdrop for fixed income securities.

Currency Markets

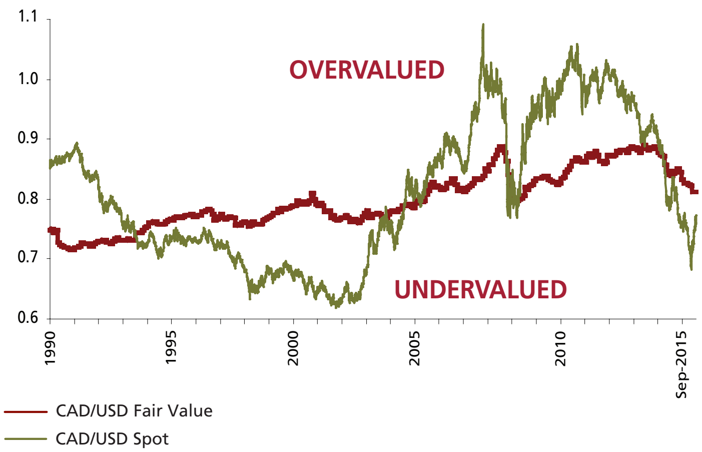
U.S. Dollar

For the last three years, the U.S. dollar steadily gained ground against most other currencies. Over this period, the greenback's supremacy was never seriously challenged—until the start of 2016. Very early in the year, we witnessed a downshift in market expectations about Fed policy, as optimism about the U.S. economy's resilience to adverse global developments quickly faded. The impact on the U.S. currency was immediate, with a depreciation of nearly -3.0% on an export-weighted basis by the end of the first quarter. Is this simply a short-term counter trend pullback or the start of a longer-term trend reversal for the mighty U.S. dollar?

The answer depends on the currency considered. For most emerging market currencies and cyclical/commodity-sensitive currencies, the U.S. dollar's long-term uptrend should remain intact. Most of these economies still have to cope with heavy damage linked to the commodity shock, and their respective central banks must remain locked in easing mode. Meanwhile, the Fed is busy debating the need for further rate hikes and the speed at which they should be delivered.

For currencies with safe-haven features like the euro and the Japanese yen, the U.S. dollar's cyclical peak has probably already been reached. For one thing, relative valuation against the USD is already stretched for these two currencies. For another, in both cases monetary authorities have likely deployed their last bullets. Any U.S. growth disappointment would quickly translate into U.S. dollar weakness against these two currencies.

CAD/USD versus Fair Value



Source: Thomson Reuters Datastream, CIBC Asset Management Inc.

Canadian Dollar

Over the last year, the Canadian economy has been one of the hardest hit in the developed world. As a result, the BoC's year-ago growth projections for 2015 proved to be too optimistic (i.e. projection of +2.5% vs. realized real GDP growth of +0.5% at year end). Weakness also became very apparent in the Canadian labour market, with employment growth nearly stalling.

In this context, the recent appreciation of the Canadian dollar against the U.S. dollar might be surprising. However, this short-term retracement can be entirely explained by two developments: lowered market expectations for Fed policy tightening that triggered widespread U.S. dollar weakness and a short-term oil price recovery from about $30 to more than $40. On both fronts, the countertrend short-term moves now seem exaggerated. The Fed has not permanently moved to the sidelines. In addition, wide global imbalances in the oil market remain, raising questions about the sustainability of recent strengthening in oil prices. Finally, markets have paid very little attention to developments in the Canadian domestic economy. However, an economic slowdown is apparent, and deep enough for the BoC to soon reiterate the need for a more dovish monetary policy stance. Looking forward, we expect the Canadian dollar to give up most of the ground gained in the first quarter.

Euro

Euro weakness is generally perceived as unavoidable, given the policy-easing efforts already deployed by the ECB. Our view is that consensus could be wrong about what lies ahead for the eurozone currency. Now that the deposit facility rate has been moved to -0.40%, the potential for further rate cuts seems very limited. Having the ECB reach monetary policy limits before the Fed makes an important difference. This implies that U.S.-EU relative monetary policy differentials will essentially be driven by shifting Fed policy expectations from this point on. From this perspective, any U.S. growth disappointment could translate into euro strength against the U.S. dollar.

Relative valuation also has to be considered. The EURUSD bilateral exchange rate is already in undervalued territory and fundamentals don't justify a move deeper into that territory. Based on our valuation metrics, the euro is currently undervalued by roughly -12% against the U.S. dollar. What's more, our fair value estimate has been trending higher owing to relative prices and relative terms of trade. Our 12-month forecast for the EURUSD bilateral rate stands at 1.14.

Japanese Yen

Around the world, it is becoming more and more obvious that central banks are running out of ammunition, with policy rates already at or getting closer to zero. One central bank that likely has virtually nothing left in its policy tool box is the BOJ. Its asset purchasing program is already huge and policy rates have recently been moved into negative territory. This is very unfortunate because, at this juncture, Japan could certainly use an additional boost from monetary policy.

Nearly two years after the consumption tax was hiked substantially, the Japanese consumer still hasn't started to recover. Japanese exports remain depressed despite past yen weakness, which provided a very positive shock for Japan's terms of trade with the rest of the world. As a result, real GDP growth is running well below the BOJ's target (+0.8% realized vs. +1.5% projected).

There is an even bigger problem facing the BOJ—the return of deflation. The whole point to launching Qualitative and Quantitative Easing (QQE) policy four years ago was to weaken the currency, temporarily boost inflation and hopefully produce a long-lasting impact on long-term inflation expectations. However, the Japanese yen has now reversed course, appreciating by nearly +12% on a yearly import-weighted basis and exerting intensified downward pressures on import prices and overall CPI inflation.

With the BOJ hitting its policy limits as yen fundamentals improve, it will be very difficult for the yen to depreciate further. Our 12-month target stands at 103.

Regional Outlook
Canada

- **Real GDP will likely further disappoint in 2016, ending closer to +1.3% than the +2.0% consensus expectation. The BoC will likely be forced to cut rates further and start a debate about the eventual need for unorthodox monetary policy instruments.**

- **Canada experienced a recession in its manufacturing sector in 2015. Luckily, this was more than offset by the ongoing expansion in the service industries. Nevertheless, the end result was a substantial growth slowdown—from more than +2.0% real GDP growth in early 2015 to only +0.5% by the end of the year.**

The BoC is apparently still wearing rose-coloured glasses, convinced that the Canadian economy is about to experience an export-led recovery. This recovery would essentially be driven by strengthening demand from the U.S. and restored competitiveness (i.e. owing to Canadian dollar weakness). If this forecast materializes, goods-producing sectors should exert less drag on growth, allowing for a brighter overall Canadian economic outlook. Unfortunately, we are not as upbeat as the BoC for three reasons:

First, the staff at the Canadian central bank is too optimistic with regard to growth prospects south of the border. The BoC works with the assumption that the U.S. economy will grow by +2.4% over the next 12 months. This is more bullish than the Fed's own projections. We are also less optimistic than the Fed, working with a +1.8% U.S. growth forecast. If this assessment is correct, U.S. demand for Canadian products will likely be weaker than the BoC's expectations.

Second, the Canadian dollar's recent appreciation against the greenback is significant enough to compromise the BoC's hoped-for recovery in non-oil exports. True, Canadian non-oil exports to the U.S. started recovering in late 2015. However, this happened because weakness in the Canadian dollar allowed for a significant decline in Canadian unit labour costs (in U.S. dollar terms)—that is, below U.S. labour costs for the first time in eight years. Unfortunately, since the start of the year, the Canadian dollar has recouped a lot of the ground it lost in 2015. As a result, when expressed in U.S. dollar terms, Canadian unit labour costs are back above U.S. costs.

Finally, for the BoC's growth forecast to materialize, the Canadian consumer has to remain in high gear. With employment growth running at only +0.65%, slowing wage inflation and strong demographic headwinds, this forecast is very much at risk.

One could be tempted to conclude that sluggish growth in the private sector will largely be offset by stronger public spending. After all, the federal government's latest budget allows for a substantial increase in public spending. True, the federal deficit will be a lot larger. However, this in part reflects the impact of weaker economic growth on government revenues. The actual fiscal stimulus amounts to no more than +0.5% of GDP for the coming year.

United States

- **The Fed and most private-sector forecasters are underestimating the slowdown in the manufacturing sector, as well as the potential contagion to the services sector. We are working with a lower-than-consensus real GDP growth projection of +1.8%.**

- **Under these conditions, the Fed will need to stay extremely prudent and vigilant with its next rate hikes. Rate increases will be delivered at a slower pace than generally expected.**

The predominant financial market view remains that the U.S. economy is on solid footing and the Fed's tightening campaign will resume as soon as the second quarter. We are less upbeat about U.S. growth prospects. In the last edition of *Perspectives*, we argued that the consensus view about the U.S. economy seemed too optimistic moving into 2016. Since then, consensus expectations about U.S. economic growth prospects have been revised lower. Optimism about the U.S. economy's resilience to adverse global developments is fading. More recently, the Fed added shades of grey to its economic outlook and revised 2016 real GDP growth from +2.4% to +2.2%. Is this the last time that U.S. monetary authorities will revise down their growth outlook or are there more downward revisions to come? We think that the risk of further growth disappointment is still present. Here are the main growth risk factors:

First, U.S. manufacturers have been harder hit than generally assumed and this will have some spillover effects on service industries. The strength of the U.S. dollar (on an export-weighted basis) combined with disappointing growth abroad have caused the U.S. non-oil trade deficit to deteriorate and will continue to do so. In other words, the drag from net exports will intensify, not fade.

Second, underinvestment will remain a dominant feature of the U.S. economic landscape. Since 2012, U.S. productivity growth has declined considerably (from +2.0% to +0.5%). This is very bad news for corporate America as stronger productivity has not compensated for growth in labour costs. Under these conditions, growth in capital spending has been particularly weak and this is not about to change.

Third, U.S. consumer fundamentals are weakening and are projected to weaken further. Consensus for employment growth is now +1.75% (or +184K job creation per month, on average). This is well below the +2.3% observed a year ago. More importantly, both manufacturing and non-manufacturing employment PMIs have dipped below 50, indicating a growth slowdown. These flashing yellow lights from the PMIs are consistent with the signal provided by weaker consumer confidence indicators.

If our risk assessment materializes, the drag on growth from net exports will be larger than that estimated by the Fed. In turn, the services economy won't be totally immune to the slowdown in the U.S. manufacturing sector and underinvestment will persist due to low productivity and squeezed profitability. Weaker fundamentals will lead to more sluggish consumer spending. Under these conditions, growth in U.S. economic activity is expected to drop below 2.0%, keeping the Fed on a very prudent path as it removes policy accommodation.

Europe

Vain ECB Efforts

- **The risk of deflation in the eurozone will remain elevated for the foreseeable future, keeping the ECB in easing mode. Unfortunately, the ECB is running out of ammunition to combat the problem.**
- **With very limited ECB leeway to jumpstart the eurozone economy and eliminate deflationary pressures, eurozone growth will remain below consensus (+0.9%).**

In the ECB's battle against deflation, the situation is getting challenging. The problem for ECB President Draghi and his colleagues is inflation refuses to follow their script. HICP* inflation in the eurozone has dropped into negative territory (-0.2%), well below the inflation levels projected by the ECB a year ago. The same pattern was observed a year ago, with inflation widely undershooting the ECB's projections. These developments are a big concern because the longer the CPI flirts with deflation, the harder it will be for the ECB to keep long-term inflation expectations well-anchored. Already, indicators show that long-term inflation expectations have been drifting lower.

The official projection is for inflation to reaccelerate closer to target by 2017. The reality is that the ECB will very likely miss its inflation target again—for the third year in a row. The ECB projects that headline CPI inflation will reach +0.4% over the next 12 months and that core CPI will run at +1.1%. Our in-house forecast calls for both lower headline (-0.3%) and core (+0.5%) inflation. Part of the problem is that the eurozone economy is expected to downshift into lower gear. As a result, wide excess capacity conditions in the labour market will continue to prevail, exerting downward pressures on overall inflation. In other words, the risk of deflation will remain elevated, keeping the ECB in easing mode.

At this juncture the question is: what's left in the ECB's policy toolbox? With the ECB's deposit facility rate now at -0.4%, the potential for further rate cuts seems very limited. Central banks have been able to set negative interest rates to a limited degree owing to the cost of storing physical cash and the administrative inconvenience for a bank to hold physical cash. There is a significant amount of uncertainty about exactly where the limits to negative rates lie. However, the external research "consensus" seems to be that a deposit rate of -0.5% to -0.75% or below may precipitate significant transfers of reserve balances into physical cash. The ECB definitely doesn't want to trigger such an outcome.

The only option left for the ECB is to maintain its "massive" asset purchasing program for longer than initially planned. This is precisely what the ECB was doing when it recently announced even larger asset purchases, covering a wider range of assets to purchase. However, even quantitative easing has downsides. The more assets the ECB buys, the larger the excess reserves held by commercial banks at the ECB. The bigger the excess reserves, the higher the cost for eurozone commercial banks resulting from negative rates charged on those reserves. In a desperate effort to offset the hit on bank profitability, the ECB engineered and recently launched its TLTRO II lending scheme. While it was designed to alleviate pressures on the banking system, it is far from obvious that euro banks will fully use the ECB's new lending scheme. It is even less clear that this liquidity injection will ultimately find its way to the real economy.

*Harmonised Index of Consumer Prices

China

Further Slowdown in Chinese Economy

- **The Chinese GDP growth target range of +6.5% to +7% is too optimistic and unlikely to be achieved.**
- **The Chinese economy is depending on another year of robust service sector growth, driven in part by consumer leveraging. Countering this, a negative contribution from net exports in 2016 may weigh on economic growth.**
- **The soft economic growth outlook suggests further loosening of monetary policy from the central bank.**

The National People's Congress was held in March and policy makers laid out the government's objectives for 2016. Major economic targets presented in the plan included an annual growth rate of +6.5% to +7% in real Gross Domestic Product (set at +7% the previous year) and Consumer Price Inflation maintained at approximately 3%. The plan also seeks to ensure that the unemployment rate remains below 4.5%, in combination with the creation of 10 million new jobs. These targets are very similar to those from one year earlier.

The current GDP growth target range of +6.5% to +7% is optimistic and unlikely to be met under current conditions. Ultimately, the Chinese economy is depending on another year of robust service sector growth, driven in part by consumer leveraging. The structural changes taking place in China remain key to its growth plan, with a rebalancing from investment to consumption. The Chinese government is also providing support to the growth environment through an increase in its fiscal deficit to -3% of GDP, an increase of 0.7% of GDP compared with 2015.

This being said, significant obstacles in 2016, including a weakening of the external growth environment, will make growth very challenging. In 2015, net exports provided a 0.3% contribution to real GDP. However, the 2016 calendar year has started with a large decline in exports. If this trend continues, it will likely result in a negative contribution from net exports and weigh on economic growth. Another concern is whether it is too early for the real estate market to provide direct and indirect support for economic growth. The residential real estate industry remains mired in substantial inventory surpluses, which cap the upside for new residential construction activity. Finally, the government has suggested that it will begin a much-needed restructuring in industries related to coal and steel, which have significant overcapacity. On the margin, this will negatively impact production and labour market conditions over the calendar year.

Consumer price inflation dynamics should experience some stabilization in 2016, driven by reduced drag from energy prices and a positive contribution from food price appreciation. We expect total CPI to average 2% to 2.2% growth, a level above 2015 but below the 3% target. Core inflation is also expected to remain below the 2% growth rate. The price contraction in producer prices should slow as the negative impact of energy prices begins to fade. However, the challenges from overcapacity remain and will continue to weigh on producer prices in 2016.

The overall economic outlook suggests that the central bank will further loosen monetary policy. The slowing growth and growing stress in the financial system, driven by a large corporate debt overhang, will support the continued adoption of accommodative policy at the Chinese central bank. We expect additional cuts in the policy rate and reductions in the reserve requirement ratio that will provide the economy with a lower cost of debt financing and appropriate liquidity conditions. In an environment of looser monetary policy, the People's Bank of China will continue to tightly manage the currency. Nevertheless, given the easing bias and expected further cuts in policy rates over the next year, the renminbi will likely depreciate versus its main trading partners in developed economies.

Signposts

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

Canadian Signposts

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

U.S. Signposts

- Underemployment (decline in U6 measure) and wage growth (ECI)
- Manufacturing vs. non-manufacturing (relative strength or weakness)
- 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 sales, prices and housing starts
- GDP growth mix (industrial production vs. retail sales vs. services)
- Lending to households and businesses
- Fiscal and monetary policy initiatives

Other Market Signposts

- Japanese labour market wage growth
- BOJ monetary policy guidance
- European bank lending surveys
- European Purchasing Managers' Indices
- Monetary policies in Turkey and Brazil to control inflation
- Improving European job creation
- U.K. wage growth
- U.K. referendum on EU