CIBC Asset Management

PERSPECTIVES

For the 12-month period beginning October 1, 2019

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Cushioning the downturn

As the trade war intensifies and economic growth disappoints, global interest rates continue to move lower—there are 19 bond markets with a 10-year government bond yield below 1%. With very little policy leeway left, monetary authorities now have to rely on fiscal policy-makers, who need to take on a bigger role to support global growth.

Asset class highlights

Equity: Although Canada doesn't face the trade war and political uncertainty that other markets do, the global slowdown will limit the upside for cyclical Canadian equities.

Fixed Income: While bond yields in developed markets may have already seen a bottom, they are unlikely to march meaningfully higher in the short term.

Currencies: For other currencies to move decisively higher against the U.S. dollar, monetary authorities in the rest of the developed world have to take a more hawkish turn. This is not likely to happen anytime soon.

Commodities: The quick return to lower oil prices after the drone attack on Saudi oilfields highlights a situation where market supply will outstrip demand as we move into 2020.

Multi-asset outlook

Asset class	Current September 30, 2019	Most likely minimum of range for next 12 months	Most likely maximum of range for next 12 months
Canada 3-month T-Bills rate	1.75%	1.15%	1.80%
Canada 2-year government bond yield	1.58%	1.00%	1.65%
Canada 10-year government bond yield	1.36%	1.15%	1.95%
U.S. 10-year government bond yield	1.67%	1.35%	2.10%
Germany 10-year government bond yield	-0.57%	-0.75%	0.00%
Japan 10-year government bond yield	-0.22%	-0.25%	0.30%
Canada 10-year real-return government bond yield	0.26%	0.05%	0.45%
Canada investment grade corporate spreads	1.14%	0.95%	1.55%
U.S. high yield corporate spreads	3.99%	3.80%	4.80%
Emerging market sovereign (USD dominated) bond spreads	338	290	500
S&P/TSX price index	16,659	15,900	17,300
S&P 500 price index	2,977	2,750	3,025
Euro Stoxx 50 price index	3,569	3,250	3,590
Japan Topix price index	1,588	1,460	1,600
MSCI Emerging Markets	56,357	54,700	59,800
U.S. Dollar/Canadian Dollar	1.3240	1.29	1.36
Euro/U.S. Dollar	1.0902	1.07	1.18
U.S. Dollar/Japanese Yen	108.08	100.0	112.0
U.S. Dollar/Offshore Chinese Yuan	7.14	6.80	7.35
Gold	1,474	1,370	1,600
Oil price, WTI (West Texas Intermediate)	54.07	50	60

Asset class outlook

Global overview

Expansion showing clear signs of fatigue
The global economic expansion is showing clear signs of fatigue with an increasingly uncertain global outlook. For the first time in more than a decade, our world real GDP forecast calls for a pronounced global growth slowdown. Our forecast moves from +3.6% last year to +2.6% over the forecast horizon. The projected slowdown is expected to be broad-based, with downward growth revisions in almost all the countries we cover.

For global investors, navigating this downturn could prove to be quite challenging—many of our recent observations about global monetary policy are even more relevant this quarter, and bear repeating. On an encouraging note, policy-makers across the globe have expressed concern about the impact of the trade war on the world economy and have already started to provide more policy relief. With the U.S. Federal Reserve (Fed) switching to easing mode, the efforts being deployed are now truly global.

What is less encouraging is that monetary authorities don't have the policy leeway to cushion the landing that they had in previous global economic downturn episodes. The problem isn't just that interest rates are already ultra-low, it's also that the unorthodox policies (i.e. Quantitative Easing (QE) and sub-zero policy rates) delivered in recent years came with significant negative side effects. This is very apparent when looking at interest rates across the whole maturity spectrum. For the first time ever, the global yield curve is inverted in the context of ultra-low policy rates and increasingly adverse economic conditions. This spells trouble for the financial sector. The longer this situation prevails, the more intense the pressure will become for global banks. From this angle, delivering more QE and/or lowering policy rates further probably isn't the right prescription to get the world economy back on its feet.

With very little policy leeway left, monetary authorities have to pass the baton to fiscal policy-makers. Fiscal policy now has to assume a bigger role in supporting global growth. At first glance, it may be tempting to conclude there is not much that fiscal policy can do. Government debt loads are already elevated across the developed world. However, as we learned in the last decade, it's important not to underestimate the ingenuity and creativity of policy-makers. When conditions required it, they did not hesitate and took action.

Looking forward, the policy accommodation will likely be inspired by what is now referred to as Modern Monetary Theory (MMT). The idea is to connect both fiscal and monetary policies to get enough stimulus to jumpstart the global economy. In simple terms, it's all about debt monetization—the central bank prints money to finance the government's borrowing needs. This is not a regime where policy-makers adjust interest rates to reach inflation and growth targets. This regime keeps interest rates ultra-low to provide more flexibility to fiscal policy-makers to meet growth and inflation objectives. A shift from the current policy regime to a MMT-style regime is obviously easier said than done, as it would come with major risks. These tools have the power to do appreciable good, but there are downside risks if they're not used responsibly. The governance and decision rights need to be carefully engineered and there's still a long way to go before we get there.

Global strategy

Valuing equities when interest rates are negative
As the trade war intensifies and economic growth continues to disappoint, global interest rates have moved down to levels last seen during the turbulent 2015/6 period, in the era of quantitative easing. For the first time, thirty-year U.S. Treasuries traded below 2% while eurozone bonds dipped deeper into negative territory. There are now over $15 trillion (U.S. dollars) worth of bonds with a negative yield. Across 43 countries, both developed and emerging, there are 19 bond markets with a 10-year government bond yield below 1%.

This unique environment raises challenges for investors looking for yield. It also raises fundamental questions for equity investors trying to determine a fair value for equities. The level of interest rates is a key determinant in valuation models, and bond yields approaching 0% would seem to argue for rising equity valuations. This is indeed what's been happening this year. With almost no contribution from earnings growth, the equity market is up by double digits—all the heavy lifting is coming from rising P/E ratios.

Interest rates act as a discounting factor in valuation models, where expected future earnings are discounted into present day values. Lower interest rates increase the present value of these earnings and make the equity market look undervalued. When interest rates fall, does the equity market become more attractive or does the bond market become more expensive?

A valuation model should estimate the intrinsic value of the market, and this value should move slowly over time. Day-to-day changes in the bond market should not lead to day-to-day changes in the fair value of equities. Our top-down valuation approach measures the historical relationship between P/E ratios and fundamental macro variables. Among those variables is the level of interest rates. In our model we use the Laubach-Williams estimate of the neutral policy rate. This rate reflects where rates should be, as opposed to where they are. Using this method, we are able to circumvent the issue of valuing equities using zero or negative interest rates. This provides a more stable estimate of fair value.

This analysis leads us to believe that the recent rise in the equity market is unsustainable. The rise in equities this year was driven by higher P/E ratios, which were pushed higher by the rally in bond yields. To the extent that the bond rally has moved too far, too fast, bond yields will eventually revert back to higher, more sustainable levels. When that happens, equity valuation will suddenly look less attractive.

It's also possible that bond yields will stay at these low levels, or move even lower. If they do, it will most likely be in an environment where the global economy is moving towards stall speed or falling outright into recession. In this case, the positive benefit of lower interest rates is offset by the negative impact of slower growth. Currently, earnings outside of North America have been negative. The consensus expects a sharp improvement as well as an acceleration in the U.S. and Canada. Leading economic indicators point to slower economic growth ahead, which should translate into below-consensus earnings growth. The bottom line—equity valuation will be challenged one way or another.

Global equities

Canada

Although Canada doesn't face the trade war and political uncertainty that other markets do, the global slowdown will limit the upside for cyclical Canadian equities. Valuation is not a major headwind, but slower earnings growth and Canada's exposure to commodities will limit the potential for P/E expansion.

United States

The P/E of the U.S. market has been pushed up by falling interest rates. Lower interest rates can support higher equity valuation, but only as long as earnings growth remains robust. A deteriorating economic outlook and rising unit labour costs will prove to be difficult for the market to digest. Margins have already moved from being a significant tailwind to a mild headwind and further compression should be expected. Slower sales growth will also contribute to earnings disappointment.

Global earnings growth

Source: Thomson Reuters Datastream, CIBC Asset Management Inc.

EAFE

Despite Germany slowly slipping into recession and negative earnings growth, European equities have performed well this year. However, hopes for a European Central Bank (ECB) rescue plan will face the reality that there is not much the ECB can do. Fiscal policy is also likely to disappoint. Germany has less fiscal leeway than perceived due to the impact of a tax revenue slowdown. Furthermore, the German mind set is that they don't need fiscal stimulus. A sharp increase in the unemployment rate would be necessary to change the minds of policy-makers. Unfortunately, this is unlikely to happen soon given the rigidity of the labour market. Europe remains a collateral casualty of the U.S.-China trade war even as it faces its own domestic political crisis.

The yen has generally traded on the strong side in recent years, putting pressure on profit margins. The slowdown in earnings has been quite severe, moving from +30% (year-over-year) in early 2018 to -7% now. Like Canada, Japan is a cyclical equity market that will face headwinds during an economic slowdown. Japan is also closer to China economically, so it is more impacted by the trade war.

Emerging Markets

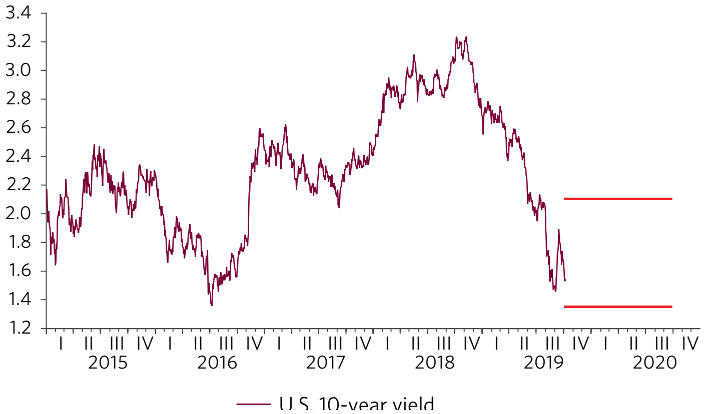
Emerging markets (EM) traded below the lower limit of our estimated range in the recent quarter, as the trade war continues to affect Asian equities. We are marginally downgrading our expected range for EM equities to 54700-59800 (compared to 56300-61600 previously), to reflect ongoing weakness in the region. This new range still leaves a bit more upside than developed markets. Earnings growth will improve to slightly positive from the current negative results, but will still come up short of consensus. We expect that the tariffs already announced by the U.S. administration will be implemented, but there will be no further escalation. Another positive: a number of emerging countries have relatively high real interest rates. Given the recent stability in their currency and inflation, they have the leeway to support the domestic economy by cutting interest rates.

Global bonds

High demand For developed market bonds

Developed market (DM) bond yields continue to reprice lower, with U.S. Treasuries and Bund yields touching low levels of 1.45% and -0.71%, respectively, during Q3. In the same vein as Q2, global uncertainties remained elevated in Q3. Volatile U.S./China trade-related news flow, weakening worldwide economic data and subdued inflationary forces supported the demand for safe-haven bonds.

High demand for DM bonds



Source: Thomson Reuters Datastream, CIBC Asset Management Inc.

For the most part, this favourable environment for DM bonds should remain for the next twelve months. Several of our most important signposts continue to signal that there is no recovery in sight. Global leading indicators are flashing red, global trade headwinds are blowing hard and business surveys offer little reassurance. Additionally, several idiosyncratic stories have combined to generate greater market concerns. Tightening liquidity conditions in U.S. money markets, an attack on oil fields in the Middle East and the beginning of proceedings to impeach the U.S. President are also pressuring global bond yields to the downside.

As a base case scenario, the U.S. Treasury 10-year yield should hover in a range of 1.35%-2.10% over the forecast horizon. Several factors will soften the downward pressure on DM bond yields going forward. First, dovish DM central banks, reflationary efforts by the People's Bank of China (PBOC) and synchronous rate cuts by most EM central banks should help stabilize global growth in the latter part of our forecast horizon. Second, the trade war between the U.S. and Chinese administrations should proceed without further major escalation or de-escalation; tariffs will be implemented as announced. The lack of surprises on that front should reduce the volatility in the bond market. While bond yields in developed markets might have already seen a bottom, they are still unlikely to march meaningfully higher.

In Canada, our base case scenario is for 10-year sovereign bond yields to trade between 1.15% and 1.95% over a twelve-month horizon. Structural soft spots, such as elevated household and non-financial corporation debt loads and housing imbalances, leave the Canadian economy in a vulnerable position with respect to the current global economic slowdown. If our below-consensus Canadian real GDP forecast materializes (highlighted on page 7), the Bank of Canada will need to cut interest rates more than is currently priced in.

Currencies

U.S. Dollar

As expected, a Fed switch to easing mode and an interest rate cut in the third quarter were not been enough to produce a broad-based weakening of the U.S. dollar. On the contrary, the U.S. dollar actually gained more ground over the third quarter, hitting its highest levels in over 36 years on a trade-weighted basis (revisiting the 1985 all-time highs). As a result, it is now overvalued by more than 10% on an export-weighted basis—a severe hit for U.S. competitiveness. This is very apparent in the U.S. trade numbers, as the U.S. trade deficit with the rest of the world is rapidly widening. However, for the moment, the U.S. current account deficit is not wide enough to produce sustained USD weakness. For other currencies to decisively move higher against the U.S. dollar, monetary authorities in the rest of the developed world have to take a more hawkish turn. This is not likely to happen anytime soon. In the meantime, currency market volatility should remain elevated.

Canadian Dollar

Since the beginning of the year, the Canadian dollar has been surprisingly resilient—the top-ranking currency of the developed world against the U.S. dollar. We see two reasons for this. First, the price of oil has been very stable, oscillating around $57 U.S. Second, markets have been expecting the Fed to cut rates much more aggressively than the Bank of Canada (BoC). So far, the Fed has delivered two rate cuts, while the Bank of Canada has remained on the sidelines. Looking forward, we suspect this will change.

Just like the rest of the world, the Canadian manufacturing sector is experiencing a downturn and leading indicators are signaling more pronounced weakness over the coming months. At first glance, this may not seem enough to conclude that the Bank of Canada will soon take a dovish turn. However, this negative shock has to be combined with the continued contraction in construction activity. More importantly, in the context of a global economic downturn, oil price weakness should be expected. In other words, the Canadian energy sector will also likely take a severe hit. All in all, Canadian goods-producing industries will soon act as a big drag on Canadian real GDP growth. That will be more than enough to convince market participants that the Bank of Canada is about to take a sharp dovish turn. Lower oil prices and downshifting BoC expectations will translate into pronounced Canadian dollar weakness.

Euro

For nearly half a year the euro has been very stable against the U.S. dollar, fluctuating in a tight trading range. However, we don't believe this is an indication of things to come. With an intensifying economic downturn and declining long-term inflation expectations, the ECB is doing all it can to jumpstart the moribund eurozone economy. However, as we emphasized in past editions of *Perspectives*, the ECB is running out of policy options. By cutting rates deeper into negative territory and resuming QE, it is implicitly targeting a weaker euro. Just how successful this will be remains to be seen, but we would argue that the balance of risk is tipping to the side of further euro weakness.

Japanese Yen

The Bank of Japan (BOJ) is increasingly concerned about Japan's growth prospects and has signaled that it is ready to make policy adjustments, as appropriate. However, the BOJ's balance sheet is already heavily loaded with government bonds and 10-year Japanese Government Bond yields are trading well below the lower band of the Yield Curve Control target band. The BOJ is running short of options to combat threats to growth.

Currency-wise, the fact that the BOJ is hitting its policy limits has important implications. For one thing, it implies that the spread between U.S. and JP 10-year bond yields will likely continue to narrow. This is very important because relative U.S.-Japan liquidity conditions have played a key role in the determination of the USDJPY exchange rate in recent years. Fluctuations in the USDJPY bilateral exchange rate have essentially been driven by two variables: the spread between US-JP 10-year bond yields and the relative expansion of the BOJ and Fed's balance sheets (i.e. relative growth in the monetary base). Until recently, the Fed was busy shrinking its balance sheet while the BOJ remained in expansion mode. The tides now appear to be turning. The BOJ is drastically slowing the expansion of its monetary base just as the Fed is getting ready to substantially expand its own balance sheet to alleviate pressure in U.S. money markets. In short, developments on the liquidity front should continue to be more supportive for the Japanese yen.

Commodities

Drone attack fallout

Oil prices traded mostly in a range between $50 and $60 during the quarter, a range that has held for much of 2019. However, a drone attack on Saudi Arabian oilfields that temporarily incapacitated much of Saudi oil production, briefly spiked prices in mid-September. As investors scrambled to determine how long the situation would persist and how much capacity would be lost, the uncertainty pushed oil futures up about 10%. Despite the initial panic, most production capacity was restored within a few days, and full capacity is expected in November. As the situation returned to normal, oil futures trended back down to levels lower than prevailed before the attacks. Investors are now forced to weigh the additional risk factor of drone attacks, something previously dismissed as of little importance—but this uncertainty seems to have added little in terms of risk premium. The quick return to lower prices highlights the current pendulum swing of the supply/demand equation—now emphasizing an oversupply that will outstrip demand as we move into 2020. On the supply side, the market in 2020 will see oil production increases from Norway, Brazil, Guyana and U.S. shale. On the demand side, the U.S./China trade war is depressing global growth and consequently lowering the demand for oil.

A major upcoming event in the energy market is the initial public offering (IPO) of Saudi Aramco[1]—likely to take place in October or November. This imminent date is no doubt part of the reason that Saudi scrambled to quickly restore oilfield capacity. The chance of an event that could seriously hurt Saudi Aramco's business prospects is something the Saudi government will look to strenuously protect against. The "whisper" valuation of the IPO is around 2 trillion USD, with the Saudi government continuing to hold about 95% of the company. This initially leaves about 5% available for public purchase but the float[2] will likely increase over time. With dividends of about $75 B announced for 2020, the yield comes in around 4%—contrast that with 5-6.5% yields for other major global oil companies.

The U.S. election is another issue we're reflecting on, even though it is a year away. Potential Democratic presidential nominee Elizabeth Warren has stated that part of her platform would be a ban on oil and gas fracking[3]. Obviously, if this proposal ever became law, it would limit U.S. oil and gas production growth and almost certainly send commodity prices higher. The U.S. would need to import from other countries to meet domestic demand and Canada could benefit from its close proximity. On the down side, higher energy prices would be a negative for the average consumer. While many events need to occur for this to actually unfold, we are monitoring the proposed platforms of all U.S. political players, as U.S. legislative changes can have a profound effect on the energy landscape.

[1] Saudi Arabian national petroleum and natural gas company based in Dhahran, Saudi Arabia.
[2] The float is the number of shares actually available for trading.
[3] The process of injecting liquid at high pressure into subterranean rocks, boreholes, etc. so as to force open existing fissures and extract oil or gas

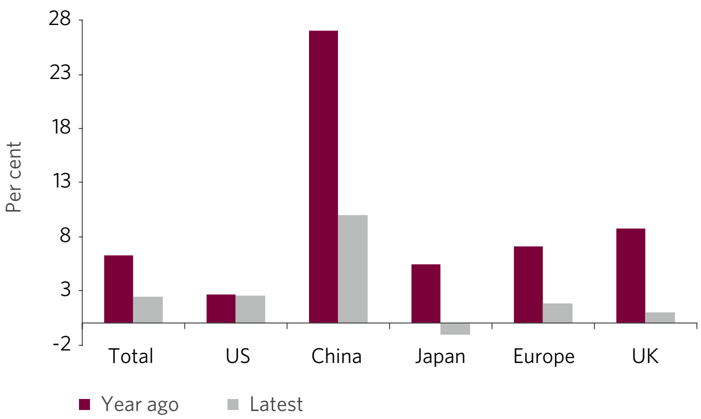
Regional economic views

Canada

Bank of Canada will take a dovish turn

- The Canadian economy has remained surprisingly resilient, but growing global trade headwinds are coming its way.
- Real Canadian GDP growth is projected to decelerate from +1.6% currently to +0.9% over the forecast horizon.
- With an increasingly hostile global environment, the Bank of Canada will soon need to take a dovish turn.

Canadian Exports by Country
(latest vs. year ago, y/y growth)



Source: Thomson Reuters Datastream, CIBC Asset Management Inc.

Despite the deepening global slowdown already underway, Canadian domestic demand has remained surprisingly resilient and inflation remains near target. These conditions allowed the Bank of Canada to stay on the sidelines and watch other central bankers deploy more policy accommodation. However, this doesn't mean that Canada is insulated from what's happening abroad—far from it.

The reality is that the Canadian manufacturing and trade sectors have taken a hit, just like the rest of the world. What's more, leading indicators are signaling more pronounced weakness for Canada's goods-producing sectors over the coming months. Case in point: the Markit PMI survey for new manufacturing orders has dropped to its lowest level since December 2015.

Another concern is that Canada has not benefited from currency weakness to cushion the hit on trade—unlike most other economies outside of North America. Looking ahead, the global economic slowdown is expected to deepen, implying that global trade headwinds will be blowing even harder—too hard for a small, open economy like Canada.

At first glance, this may not seem a big enough shock to conclude that the Bank of Canada will soon take a dovish turn. However, oil prices typically weaken considerably in a global downturn and the Canadian energy sector will also likely take it on the chin.

All in all, Canadian goods-producing industries will soon act as a big drag on Canadian real GDP growth, with potential spillovers to service-providing industries. We are working with a below-consensus forecast of +0.9% average real GDP growth over the next four quarters. Under these conditions, the BoC will have to follow the Fed's lead and start easing its monetary policy stance by delivering two rate cuts over the forecast horizon.

United States

An export-led U.S. economic slowdown

- The slowdown in economic activity in the rest of the world is hitting corporate America via weaker exports.
- The hit on profitability is too big to avoid negative spillover to U.S. households.
- U.S. real GDP growth is projected to substantially decelerate, averaging +1.3% over the forecast horizon.

As we argued in the previous edition of *Perspectives*, it may be difficult to foresee anything but a mild slowdown for the U.S. economic outlook. This is because the focus is typically on the health of the consumer. From that angle, with job creation still running at a hefty pace and the strongest wage inflation in more than a decade, why should we worry about the risk of a deeper U.S. economic downturn? Consider, however, that these same developments turn into a source of concern from the perspective of the other key U.S. economic agent—non-financial corporations.

At this juncture, U.S. non-financial corporations are being hit with a quadruple-whammy: weakening demand from Asia owing to the China slowdown; a German-led weakening in demand from Europe; a deeply overvalued currency that is hurting competitiveness and finally, this is all happening in the context of fast-rising compensation costs. The end result is a very severe squeeze on profitability. So far, the good news is that there has been very limited negative spillover to households. Looking forward, however, with no pick-up in demand in sight, there is a high risk that what started as a profit recession could turn into a broader U.S. economic downturn. Our forecast calls for some negative spillover to households, with real GDP growth slowing from +2.2% currently to +1.3% over the next four quarters. With deteriorating U.S. and global growth prospects, it didn't take long for the U.S. Fed to switch back to easing mode, delivering two back-to-back 25 bps rate cuts at its July and

September policy-setting meetings. While the Fed seems to be in no rush to ease policy further, we think that more policy accommodation will need to be delivered over the forecast horizon. Not just rate cuts are necessary—the Fed will also have to start expanding its balance sheet and create a new repo facility. The sooner this happens, the better.

The bottom line is that the slowdown in economic activity in the rest of the world is hitting corporate America via weaker exports. We think that the hit on profitability is too big to avoid negative spillover to U.S. households. As a result, U.S. real GDP growth is projected to substantially decelerate, averaging +1.3% over the forecast horizon.

Europe

ECB passing the baton to fiscal policy-makers

- Germany is heading for a hard landing and the rest of Europe will feel the repercussions.
- Real GDP growth in the eurozone is projected to average only +0.6% over the forecast horizon.
- After running out of monetary policy options, the ECB is turning to fiscal policy-makers.

A year ago, most pundits argued that the manufacturing slowdown in Germany would be short-lived with very little impact on the rest of the world. A year later, the slowdown has turned into a long-lasting contraction, with a cumulative decline in manufacturing production of -8.1% from the cyclical peak of late 2017. Unfortunately, this is proving to be a difficult blow for the German economy, with apparent negative spillovers to service-providing sectors.

Needless to say, what happens in Germany matters a lot for the rest of Europe and the rest of the world. Germany is the European growth engine and Europe represents the biggest block in the world economy. Earlier in the year, ECB officials made it clear that they were ready to act with all instruments, as appropriate, unless the euro area economic situation improved. It didn't take long for the ECB to deliver on its promises.

As expected, at its September policy setting meeting, the ECB announced a full package of easing measures. It cut its deposit rate by 10bp to -0.50%, promising to keep it there, or lower, until inflation approaches target. It eased terms on its TLTRO 3 bank funding operations while introducing a two-tier deposit rate for bank reserves. This simultaneously helps banks in both northern and southern Europe. Finally, it will reintroduce Quantitative Easing (QE), purchasing assets at a pace of €20bn a month "for as long as necessary," while fully rolling over its holdings.

While this may sound like a lot of policy relief, it really isn't, and validates our view that the ECB has reached the limits of monetary policy. More negative rates won't help jumpstart the euro economy. In our opinion, more negative rates just put more pressure on eurozone banks via an intensifying squeeze on net interest margins. From this angle, more negative rates will likely do more harm than good to the eurozone economy.

The TLTRO 3 lending scheme was off to a bad start, with eurozone banks taking up only €3.4B in September (Tranche 1) —well below consensus expectations of €20-30 B. What's more, banks voluntarily decided to repay €32 B to the ECB, resulting in a net liquidity drain, not an injection of new liquidity.

Finally, the new round of QE that starts in November pales in comparison with what was delivered between 2015 and 2017. The ECB plans to buy €20 B per month (€240 B annually) of government bonds—four times smaller than what was delivered in 2016.

This is why Draghi made it very clear that the ECB is passing the baton to fiscal policy-makers. Quoting Draghi: *"Governments with fiscal space should act in an effective and timely manner"*. He is obviously referring to Germany. The problem is that Germany's fiscal leeway is more limited than generally perceived because of falling tax revenues. In short, the eurozone economy remains mired in the mud. The bottom line is that Europe will feel the repercussions of a dramatic slowdown in Germany. Real GDP growth in the eurozone is projected to average only +0.6% over the forecast horizon.

China

External shocks weigh on Chinese growth

- Chinese real GDP is forecast to grow below 5.5% over the next four quarters.
- The ongoing trade dispute with the U.S. administration will continue to weigh on trade activity. A slowdown in global growth, spearheaded by Europe, is an additional important shock now affecting China's trade sector.
- CPI growth will once again decelerate below 2% by Q4 2020, providing room for the central bank to adopt any needed policy accommodation.

The Chinese growth story is looking more challenging than it did earlier this year. External shocks are creating a difficult environment for the economy, particularly for the export-heavy manufacturing sector. The elevated likelihood of continued external stress over the next couple of quarters is setting the stage for increased pressure on trade—so far, this has had an impactful spillover to the domestic economy. As a result, Chinese real GDP is forecast to grow below 5.5% over the next four quarters.

The ongoing trade dispute with the U.S. administration will continue to weigh on trade activity. The elevated likelihood of additional tariffs by year end paints a disappointing picture for a near-term trade recovery. In addition to ongoing escalation in the U.S.- China trade dispute, a slowdown in global growth spearheaded by Europe is a second important shock now affecting China's trade sector. Leading indicators in Germany point to a recession, with likely repercussions for growth across Europe.

The domestic economy is feeling the pinch of these external shocks—and the worst is still ahead. Most indicators that help evaluate the health of the domestic economy continue to point to a growth slowdown. Whether we look at below-target government revenue growth, weakening industrial production growth, or the deterioration in consumer spending, the general outlook has yet to provide signs of a recovery. A key factor for a soft landing is the Chinese government's ability to support its labour market. However, the latest job-market-related indicators show increased signs of labour market stress. As a result, policy initiatives will need to increase over the next few months to offset ongoing weakness. Monetary policy will need to become increasingly accommodative with additional cuts in the reserve requirement ratio for Chinese banks. The PBOC may even have to cut policy rates to avoid a hard landing.

Fiscal policy continues to support the economy, particularly with the issuance of local government special bonds. In Q3, the government announced that it will increase its quota for the 2019 calendar year to support credit growth. This being said, the current level of fiscal stimulus is not enough and will need to increase further given the external shocks hitting the Chinese economy.

In the context of a deteriorating economic backdrop, inflation is expected to weaken in 2020. Producer prices are expected to move into deflation over the coming months, pressuring industrial profits. Consumer prices, on the other hand, are being hit with polarizing forces. Food prices are surging due to supply shortages, while the bulk of the consumer price basket will most likely see price growth decelerate in the year ahead. Ultimately, CPI growth will again decelerate below 2% by Q4 2020, giving the central bank room to adopt a more accommodative policy stance.

Alternative scenarios

Global Reflation (20% probability)

While the risk of a recession is increasing, the prospect of a more positive scenario is fading. As such, we are decreasing the probability of the Global Reflation scenario to 20% (25% previously). In this scenario, the buildup in inflationary pressure becomes strong enough to convince more central bankers to "lift a foot off the accelerator". Stronger earnings growth would provide an offset to higher interest rates, supporting equity market valuation and providing stronger-than-expected equity returns, but weaker fixed income. Continued Chinese easing efforts and constructive political developments in Italy could lead to improved business and consumer sentiment and stronger economic activity than in our central scenario.

With an inverted global yield curve signaling an upcoming recession, an upturn in the economic cycle combined with rising inflation pressures would be a major negative for the bond market. The implications for the equity market are less straighforward. Rising rates would hit valuations, but the improving growth outlook would support the market. Emerging equities have more to gain, as they wouldn't face the headwind of valuation.

Global Recession (30% probability)

We are increasing the probability of a global recession from 25% to 30%. We suspect the key recession risk is more likely to emerge from Asia and/or Europe. Both regions are currently coping with a cyclical growth slowdown. Given the relief efforts deployed by policy-makers, economic growth will most likely stabilize over the forecast horizon. However, there is significant risk that the policy stimulus provided won't be sufficient to avoid a more pronounced economic downturn, creating spillover effects to the rest of the world. This could produce a meaningful tightening in global financial conditions and possibly spill over to weaker emerging economies, creating more contagion and risks to financial stability.

In this scenario, cyclical and risky assets will face a significant correction. The equity market has done well this year on the belief that lower interest rates were a reasonable justification for rising valuations, and the expectation that earnings growth will remain resilient. These assumptions would be severely challenged in a global recession. Given that much of the global bond market is already in negative yield territory, only a few countries will have room for declining bond yields. As such, safe-haven assets like gold will surge.

Scenario	Less Favourable	More Favourable
Global Reflation (20% probability)	International bonds Canadian bonds U.S. Treasuries	Emerging Asia equities European equities Commodities
Global Recession (30% probability)	Global equities High yield bonds Emerging market currencies	Gold U.S. Treasuries Japanese yen

Economic forecasts (next 12 months)

Region	Current GDP[4]	GDP - Consensus	GDP - CAM View	Current Inflation[5]	Inflation - Consensus	Inflation - CAM View	Policy Rate - CAM View
Canada	1.6%	1.5%[6]	0.9%	1.9%	2.0%	2.0%	-50 bps
United States	2.3%	1.7%	1.3%	1.7%	2.0%	2.3%	-75 bps
Eurozone	1.2%	0.3%	0.6%	0.9%	1.3%	0.9%	-20 bps
China	6.2%	6.0%	5.3%	2.8%	2.2%	2.7%	Fiscal + monetary stimulus
Japan	1.0%	0.2%	-0.2%	0.2%	1.0%	0.2%	-
World	3.2%	3.1%	2.6%	2.7%	3.0%	2.6%	-

[4]Real GDP Growth (y/y %)
[5]Year/year %
[6]Implied (converted from a Q/Q basis)

Data as of October 9, 2019
Source: Datastream, Bloomberg, CIBC Asset Management Calculations

Long-term capital market returns (10 year)

A key input in our investment process is projected average returns for major financial market asset classes for the next 10 years, based on our internal macroeconomic research.

While counterintuitive in the current environment, higher policy rates will be needed over the next 10 years to create the capacity to cope with any economic slowdown. Higher rates could also prevent a build-up of financial imbalances associated with too-low for too-long interest rates. Along with slowing potential economic growth, higher policy rates will be a lingering global headwind, particularly where indebtedness is elevated.

From a relative perspective, emerging economies are experiencing better long-run macro prospects (higher trend economic growth, smaller debt), have more policy leeway to boost growth if needed (smaller fiscal deficits, higher policy rates), and have become much less risky (higher reliance on domestic services, better institutions, structural reforms).

As a result, emerging market asset classes are more attractive from a long-run perspective. While developed market asset classes will be challenged to exceed 5% average annual returns over the next 10 years, we project that emerging market government bonds and equities will deliver average returns of 8% and 12%, respectively.

For full details, please request a copy of *"2019 Long-Term Capital Market Returns"*.