CIBC Asset Management

PERSPECTIVES

For the 12-month period beginning January 1, 2021

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The road back to normal

White-knuckled global investors can breathe a little easier as we begin 2021. Developments on the COVID vaccine front are encouraging and consumers are sitting on a record amount of cash after restraining their spending for nearly a year. There's a lot of pent-up demand out there, but will the global economy get too strong for comfort and force monetary authorities to start draining liquidity from the system?

Asset class highlights

Equity: The reopening of the economy benefits all equities, but some will still benefit more than others. Sectors and countries that have been harder hit stand to gain more from the recovery, with the exception of industries that have been permanently damaged. In particular, small cap companies should outperform large caps.

Fixed Income: We're maintaining a pro-cyclical stance in global bond portfolios by underweighting developed market bonds and overweighting emerging market bonds.

Currencies: We expect U.S. dollar weakness to continue against many currencies in 2021. Despite its rally in 2020, the Canadian dollar still qualifies as undervalued against the USD and will likely continue to strengthen.

China: The rise of the Chinese consumer and the Chinese central bank on the sidelines will both support the Chinese economy. This strength will also result in important, positive spillovers for the global economy.

Multi-asset outlook

Asset class	Current December 31, 2020	Most likely minimum of range for next 12 months	Most likely maximum of range for next 12 months
Canada 3-month T-Bills rate	0.25%	0.25%	0.25%
Canada 2-year government bond yield	0.20%	0.20%	0.70%
Canada 10-year government bond yield	0.68%	0.55%	1.40%
U.S. 10-year government bond yield	0.91%	0.75%	1.50%
Germany 10-year government bond yield	-0.57%	-0.60%	0.00%
Japan 10-year government bond yield	0.02%	-0.25%	0.25%
Canada 10-year real-return government bond yield	-0.29%	-0.40%	0.05%
Canada investment grade corporate spreads	1.16%	0.85%	1.35%
U.S. high yield corporate spreads	3.79%	3.25%	5.50%
Emerging market sovereign (USD denominated) bond spreads	323	250	500
S&P/TSX price index	17,433	16,250	19,000
S&P 500 price index	3,756	3,300	4,000
Euro Stoxx 50 price index	3,553	3,300	3,875
Japan Topix price index	1,805	1,650	1,950
MSCI Emerging Markets	71,693	65,000	79,000
U.S. Dollar/Canadian Dollar	1.2725	1.219	1.330
Euro/U.S. Dollar	1.2216	1.180	1.250
U.S. Dollar/Japanese Yen	103.25	100.00	107.00
U.S. Dollar/Offshore Chinese Yuan	6.50	6.28	6.90
Gold	1,898	1,800	2,200
Oil price, WTI (West Texas Intermediate)	48.52	47.00	64.00

Source: Thomson Reuters Datastream, CIBC Asset Management Inc.

Asset class outlook

Global overview

Global economy: too strong for comfort in 2021?
The year 2020 will go down as one of the wildest roller-coaster rides ever taken by global investors. Once COVID-19 emerged, it didn't take long for the storm to hit. Global liquidity conditions deteriorated sharply and risky assets took a severe and intense beating between mid-February and late March. In less than one month, global equity prices plunged by more than -30%. Caught in the eye of the storm, monetary authorities around the developed world reacted promptly by opening liquidity floodgates and launching ambitious asset-purchasing programs to monetize surging government debt loads. These bold policy actions allowed for a spectacular turnaround in global financial conditions, with risky assets quickly reverting to rally mode. By year end, the ground lost during what qualifies as one of the most violent financial storms to ever hit, had been completely recouped. For many markets, 2020 actually ended in positive territory.

Looking into the new year, white-knuckled global investors can finally start breathing a little easier. Regarding the pandemic, developments on the medical front have been very encouraging, with the global distribution of COVID-19 vaccines starting in late 2020 and expected to sharply accelerate in early 2021. If everything goes according to plan, this should allow for a relatively faster return to normal, with the world economy completing its recovery phase in early 2021 and returning to expansion mode over the second half of the forecast horizon.

The dominant risk is that global growth could surprise on the strong side in 2021. The new year is starting with consumers sitting on a record amount of cash after being forced to hold back on their spending for nearly a year because of the pandemic. To be sure, there's a lot of pent-up demand out there. The day the battle against COVID-19 is won could very well mark the start of a particularly intense consumer spending spree all around the developed world.

At this juncture, the relevant question for global investors is not whether world growth will become a reality. The global economy will be sizzling hot in 2021. Our forecast calls for the highest yearly global growth on record, with world real GDP projected to grow at +7.1%. The relevant question now is whether the global economy could be too strong for comfort, with monetary authorities deciding to start draining liquidity from the system. In our opinion, this is unlikely to happen. Faster economic growth and higher inflation are both required for governments to get their fiscal houses in order and monetary authorities are fully aware of this. As such, they will keep the global monetary policy stance ultra-accommodative through their joint policy actions. In the new policy regime, this means keeping policy rates near zero while heavily monetizing new government debt issuance. It's just too soon to take away the punch bowl. Global liquidity will remain abundant over the forecast horizon.

Global strategy

The road back to normal
The COVID-19 second wave continues to grow, along with lockdown implementations to halt its spread. So far, there's general agreement that lockdowns need to be more targeted to avoid broad economic disruption. But the game changer is three vaccines that have shown higher-than-expected efficacy during their final clinical trials. They've been granted emergency approval by health authorities in some countries and distribution has already started, with some limited number of doses available at this time. Billions more doses will be produced throughout 2021. Furthermore, there are other vaccines still under clinical trials that are expected to eventually become available in 2021. Obviously, that won't help in the near term and the holiday season creates the conditions for another flare-up. However, given that we now have a clearer path out of this pandemic, markets are likely to downplay what happens in the near term and focus on the ultimate endgame of getting back to normal, whatever normal will mean.

The U.S. economy is recovering faster than generally expected and China's recovery has good momentum. Recreational sectors are being predominantly impacted by these second lockdown measures while the manufacturing sector continues to do well. Importantly, the consumer is in good shape. As we've mentioned, while the 2020 recession was quite severe, disposable and household income continued expanding thanks to generous government transfers. Monetary policy is highly accommodative and central banks have guided that they will maintain these policies until growth and inflation are back to target. On the fiscal front, the outlook is less certain. The recent Senate win by the Democrats adds to the probability of stronger fiscal support. However, if the economy reopens and continues to grow strongly, there will be less need for the extraordinary fiscal measures that have been in place during the pandemic. But governments will need to tread carefully when the time comes to unwind financial support to avoid jeopardizing the recovery. Overall, we expect that conditions will remain in place for a strong economic recovery and, in turn, that will continue to support risky assets.

At this time of year, we publish our annual *Long Term Capital Markets Returns* forecast in addition to our quarterly *Perspectives*. This is an important part of our research efforts that aims to identify the trends that will impact financial markets—not only for the next 12 months but for years to come. In a normal year, long-term secular trends move slowly. However, this year has been anything but normal, and there have been significant changes in the long-term outlook. This year's complete long-term forecast will be available in February, but here are a few highlights.

While vaccines will allow the economy to restart and recover swiftly, the subsequent economic expansion will need ongoing policy support. We expect the return towards full employment to lag, restrained by slow job creation for less qualified workers, as has been the case historically after a recession. Also, more than a year of pandemic has likely permanently modified working and consumption habits. Work-from-home will likely remain more frequent where possible, shopping online more common, and business travel less in demand. As a result, to bring the economy to self-sustained full employment, and to prevent any damage to potential growth, fiscal support will remain necessary for an extended period of time. Given already low interest rates and the small effect of QE on the real economy, fiscal policy will have to continue doing the heavy lifting. In this world of large deficits, central banks will need to keep policy stance extremely accommodative. While potential growth will continue to decline because of demographic and debt level headwinds, actual growth should turn out to be stronger. The COVID-19 recession is leaving the economy with a large output gap, and closing this gap will require faster growth than potential. In general, equity market valuation is not excessive, and much more attractive when compared to bonds. While equity returns over the next 10 years should be lower than historical performance, they should outperform fixed income. Given the dynamic at play, we expect this outperformance to be more front-loaded before slowly drifting back to trend.

Moving back to the cyclical outlook, market volatility has declined following the U.S. election results and the vaccine announcements. Although markets remain susceptible to headline risks, overall uncertainty is lower and therefore tail risks for portfolios have diminished. Based on all of the above, we see an improving outlook for equites but a less attractive outlook for bonds. Investors should remain alert for potential signs that would indicate the environment is changing and becoming less favourable. Liquid alternative products like multi-asset absolute return strategies are well positioned to capitalize in this type of rapidly evolving environment and could be considered, depending on individual circumstances.

Global equity markets

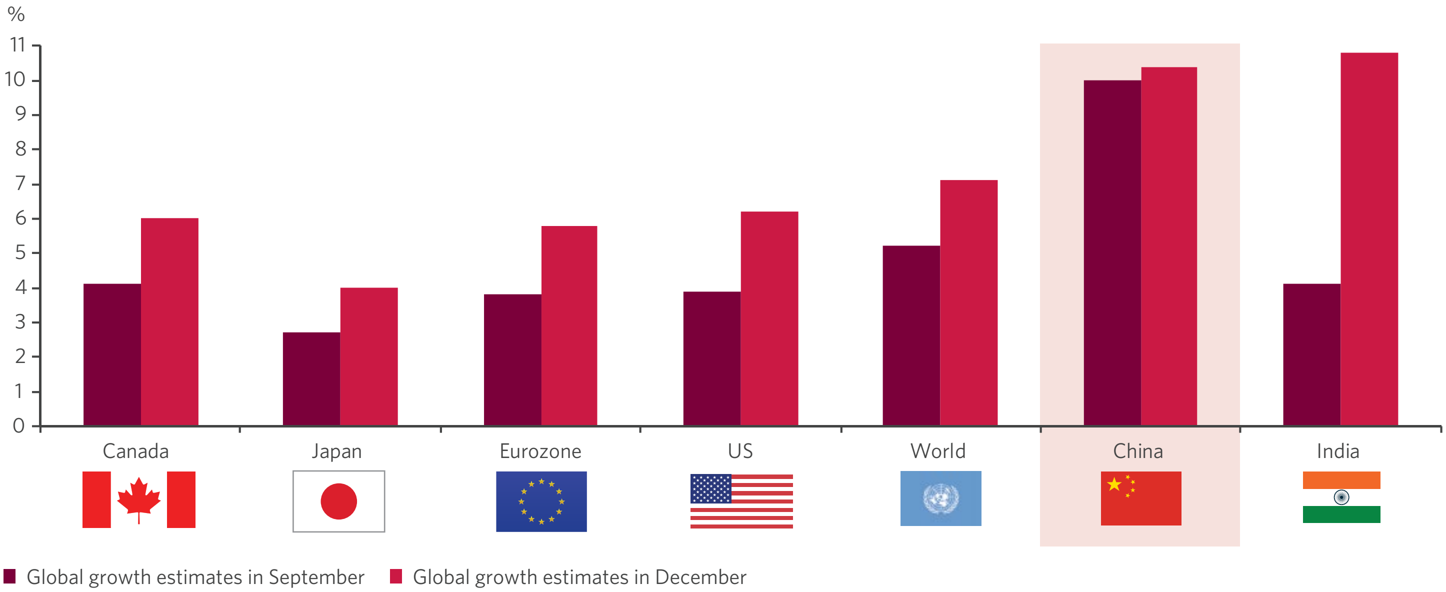
Earnings may drive equities higher

Despite concerns over the new wave of COVID-19, the equity market continued to move up in the last quarter of 2020 as many countries registered double-digit gains and made new all-time highs. Because the equity market is a forecasting machine, investors are sensing better days ahead and aren't waiting to buy. If that seems at odds with the health crisis we're experiencing every day, this optimism can be explained by three factors. First, despite the latest lockdown measures, the economy is currently improving rapidly. Second, the distribution of a vaccine fuels the hope that the recovery will continue and the economy will reopen completely in 2021. Finally, financial conditions are extremely loose, thanks to central bankers and fiscal authorities.

To assess how much of the good news is already priced-in, we can look at consensus earnings estimates. Undeniably, the consensus is upbeat and expects a sharp recovery in earnings. Earnings in Canada, the U.S. and the eurozone are expected to grow by +52%, +22% and +47% respectively over the next 12 months. If this seems high, we have to keep in mind that in the last 12 months those earnings contracted by -35%, -15% and -36%. The fourth quarter of 2020 will likely be the bottom for earnings and, as a result, the year-over-year comparison in 2021 will have a relatively easy base. Furthermore, even with this strong rebound, earnings a year from now (in dollar terms) will barely be back to where they were before the pandemic[1]. In terms of valuation, global equities on average are trading close to fair value. That is, the price being paid for expected earnings is still reasonable.

If the reopening of the economy benefits all equities in general, some will still benefit more than others. Sectors and countries that have been harder hit by the pandemic stand to gain more from the recovery. The exception is some industries that have been permanently damaged. In particular, small cap companies should outperform large caps. Small caps are typically more cyclical than large caps and don't have the same scale to absorb the shock during a recession—they've significantly underperformed. Large caps are, by construction, dominated by companies that have outperformed. Last year, those that outperformed were the biggest of the large caps, especially the large technology companies. As the market rotates away from winners, and laggards play catch up, large caps should underperform small caps. There is also a longer-term trend brewing behind the scenes. The dominant U.S. technology companies (Facebook, Google, Apple etc.) are in the sights of regulators, both at home and in Europe. They're facing multiple lawsuits alleging they're abusing their power and repressing competition. This could be a long battle in the courts, but the result could be a significant hit to their business models. One strategy they've adopted is to buy small startups before they can become potential competitors. Going forward, regulators are likely to watch their acquisions more carefully. All in all, the largest companies have managed to do pretty well during the pandemic. Now it's time for small caps to take the lead.

Global growth projections: CAM forecast December 2020 vs. September 2020



Source: Thomson Reuters Datastream, CIBC Asset Management Inc.

Global bond strategies

Our bond strategy remains similar to last quarter. Reflecting our base case scenario, we recommend a pro-cyclical stance in global bond portfolios, **underweighting developed market** (DM) bonds and **overweighting emerging market** (EM) bonds.

Developed market bonds are unattractive, as rate cuts by DM central banks have pushed most of their real yields into deeply negative territory. Central bank asset-purchasing programs have also moved DM bond yields away from fair value, leaving very little risk premium for investors. In addition, most DM yield curves have become very flat over the last year, leading to unappealing yield roll-down opportunities. For these reasons, DM bond investors are not being well rewarded for taking DM interest rate risks.

The opposite can be said for EM local bond markets—they represent better opportunities. Our upbeat forecast on commodities and our bearish secular view on the USD point towards improving economic performance for most EM countries. This positive economic momentum, combined with mild inflationary pressure, means a potential Goldilocks environment can unfold in 2021. Such a non-inflationary growth landscape is usually good for bond investors. Moreover, EM local bond valuation remains compelling; EM real yields have increased in the last twelve months and most EM yield curves have steepened markedly due to significant monetary policy easing across EM central banks. That said, we're less enthusiastic about EM bonds denominated in USD. Although their outperformance should continue, it will come at a much slower pace as spreads are already incorporating lots of good news.

In terms of country allocation, our upbeat view on China's outlook supports an overweight exposure to Asian bond markets like Malaysia, South Korea and Thailand. These economies should benefit from positive economic spillover from China, leading to sustained foreign inflows into the region and its capital markets. In contrast to last quarter, where we remained nimble with higher yielding bonds (Indonesia, Colombia and South Africa for example), we now recommend progressively increasing risks to these higher beta markets as major external uncertainties are now abating (think the U.S. election and COVID-19).

Turning to DM duration, we advocate an underweight stance. Despite a lot of improving cyclical data and higher inflation expectations, U.S. Treasury yields have remained subdued, a consequence of Quantitative Easing, but this dynamic can't last forever. If global growth continues to beat expectations (as we forecast), this dislocation will need to be addressed by the Federal Reserve (Fed) at some point. The goal will be to avoid any unintentional consequences that spring from keeping financial conditions out-of-sync with economic reality for too long. In the meantime, an overweight stance to real return bonds represents a compelling idea for 2021. A potential inflationary scare and nominal yields capped by the Fed should continue to push real yields lower.

Accounting for all crosscurrents, U.S. and Canadian 10-year bond yields should drift very slowly higher in the next twelve months, inside a 0.75% to 1.50% range in the U.S. and between 0.55% and 1.40% in Canada.

Currencies

U.S. Dollar

In early 2020, the world experienced a severe tightening in global U.S. dollar liquidity conditions that pushed the U.S. dollar to record highs against many currencies. However, the Fed reacted promptly in late March by opening wide the U.S. dollar liquidity floodgates via the establishment of unlimited swap lines with other central banks. For the remainder of the year, it's been a downhill ride for the greenback.

For many reasons, further U.S. dollar weakness is expected in 2021. First, the greenback typically underperforms in global economic recovery phases like the one now taking place. Second, with the Fed's policy rate anchored near zero, the U.S. dollar no longer has an interest rate advantage. Last but not least, with the adoption of its new Average Inflation Targeting (AIT) policy framework, the Federal Reserve will attempt to keep real interest rates low, which should put downward pressure on the U.S. dollar.

Canadian Dollar

Since hitting cyclical lows in late March, the Canadian dollar has been in rallying mode against the greenback, for a cumulative appreciation of approximately +10%. Will the good times continue to roll? We suspect they will.

First, valuation is still not an obstacle for further appreciation of the Canadian dollar. When the Canadian dollar shifted to rallying mode in late March, so did its fair value via a quick improvement in terms of trade. The result has been almost no deterioration on the valuation front. At current levels, the Canadian dollar qualifies as undervalued, because fair value has moved from less than 80 cents to 85 cents. We also need to consider there is plenty of room for a bigger positive terms-of-trade shock. Looking forward, global demand for oil is expected to strengthen in the context of a faster return-to-normal for the world economy. This implies more upside for oil prices.

For these reasons, the Canadian dollar is likely to remain strong, with an expected trading range between 75 and 82 US cents (or 1.22 to 1.33 USDCAD) over the forecast horizon.

Euro

For more than 13 years, the euro has been on a secular downtrend against the U.S. dollar. On four occasions, breakouts on the upside were attempted with no success. We witnessed a fifth breakout attempt over the second half of 2020 that was finally successful. The euro decisively broke out above 1.18 in mid-November and ended the year on a high note. We see more upside moving into 2021. Fluctuations in the EURUSD bilateral exchange will likely be increasingly dictated by supportive fundamental determinants. The EURUSD exchange rate is projected to trade between 1.18 and 1.25.

Japanese Yen

In 2020, the Japanese yen was the currency with the lowest volatility in our trading universe. However, it did participate in the general rally against the U.S. dollar. The USDJPY bilateral rate depreciated by nearly -5% over the year. Given the Bank of Japan's policy regime, which consists of full government debt monetization, yield curve control and heavy purchases of private sector debt securities, the lower-than-usual volatility in Japanese financial markets is expected to continue in 2021. This should limit the Japanese yen's upside against the U.S. dollar and keep it relatively better behaved than other currencies. In this environment, the USDJPY bilateral exchange rate is expected to fluctuate between 100 and 107 over the forecast horizon.

Commodities

Oil

Oil prices strengthened through the final few months of the year and are starting 2021 at about US$50/barrel, an increase of 39% from the low of US$36/barrel at the end of October. Market optimism is being driven by positive vaccine news, which is somewhat tempered by rising COVID cases around the world.

Looking forward, on the demand side investors remain focused on vaccine rollout in key countries and potential for a move towards a normalization of the global economy in 2021. Ongoing monetary and fiscal stimulus measures, along with vaccination programs, have the potential to drive meaningful global GDP growth in 2021, which would be a positive for global oil demand. In the near term, the offset remains ongoing lockdowns and rising virus case counts in key countries dampening demand. There also remains an inventory overhang that needs to be worked through. That said, investors, for now, seem to be looking through negative data points in anticipation of wider vaccine rollouts and a return to some semblance of normalcy in the year ahead.

On the supply side, the focus for investors remains on OPEC+ and the potential for output increases (or not) in the coming months. For now, the key countries appear to be on the same page and are not bringing barrels back too aggressively, but we will see how long that lasts. At the same time, with the recent strength in the oil price, we will be looking for signals from producers on 2021 budgets and the potential for increases in production from other (non-OPEC) sources.

Gold

The gold price has been choppy of late, falling from a peak in August of US$2,063/oz (an all-time high in real terms), to US$1,775/oz by the end of November, before strengthening back to US$1,950/oz in early 2021. Conflicting forces have been at work. Optimism around vaccines is weighing on prices but is offset by ongoing loose monetary and fiscal policy measures, which remain supportive for precious metals.

Looking forward, we believe the market remains supportive for gold, as we expect a weaker USD and declining real interest rates to help support the price over the medium term. We don't expect to see nominal interest rates rise and believe central banks (specifically the Federal Reserve) will be willing to let inflation run a bit hotter than normal. We believe this scenario will keep real rates negative and provide support for the gold price. At the same time, we expect fiscal policies to remain accommodative as well, another potential tailwind for gold.

As signals on the outlook for precious metal prices, we continue to watch:

- Global fiscal and monetary policy
- The shape of the yield curve
- Inflation indicators
- Global macro data, pandemic data and political/social developments

Regional economic views

Canada

- The Canadian consumer is likely to remain Canada's growth engine in 2021.
- Canadian real GDP growth is projected to average +6% over the forecast horizon.

In 2020, Canadian economic developments resembled those in the United States. Owing to effective lockdown measures and mobility restrictions put in place to slow the pandemic, the Canadian economy experienced a deep consumer-led contraction in economic activity over the first half of last year. However, this was followed by a very rapid recovery in Canadian consumer spending, which came as a big surprise to many, given the massive job losses.

The shock that hit the Canadian labour market in 2020 has been exceptional in many ways. While many Canadian workers lost their jobs, it's essentially low-wage workers that took the hit. For these unfortunate Canadians, the negative income shock has been very real. For the majority of Canadians, however, 2020 produced a significant improvement in financial conditions.

Three things happened last year. First, fiscal authorities cushioned the hit on Canadian households and small businesses considerably by quickly providing generous government transfers. Second, total worker compensation quickly recovered because of the very unusual employment growth mix (i.e. job cuts for low-wage workers, full employment recovery for high-wage workers). Finally, a good chunk of the money earned in 2020 was saved because of forced consumer retrenchment. All this readily explains the speedy recovery in consumer spending over the second half of 2020. Looking into 2021, the Canadian consumer is likely to remain Canada's growth engine.

2020 was a turning point for the Bank of Canada (BoC), which had no other option but to roll out the heavy artillery. With the fiscal deficit reaching record proportions, the BoC reacted promptly by heavily monetizing the federal government's rapidly rising new borrowing needs and cutting its policy rate near zero. With yields also capped at the long end of the curve, the federal government's new funding costs have dropped to the lowest they have ever been. The BoC also provided a lot of short-term liquidity to commercial banks to alleviate liquidity pressures in early 2020. With all these policy actions combined, 2020 goes down as the year with the biggest expansion of the BoC's balance sheet ever recorded (increase of roughly +420 B or +20% of GDP).

The BoC is expected to keep its policy stance ultra-accommodative in 2021. This implies keeping the policy rate anchored near zero, while continuing to monetize a large portion of the federal government's new issuance of debt securities. In other words, the BoC's balance sheet will continue its fast expansion. Given the significant improvement in Canada's consumer fundamentals and considering the ultra-accommodative measures taken by fiscal and monetary authorities, Canadian real GDP growth is projected to average +6.0% over the forecast horizon.

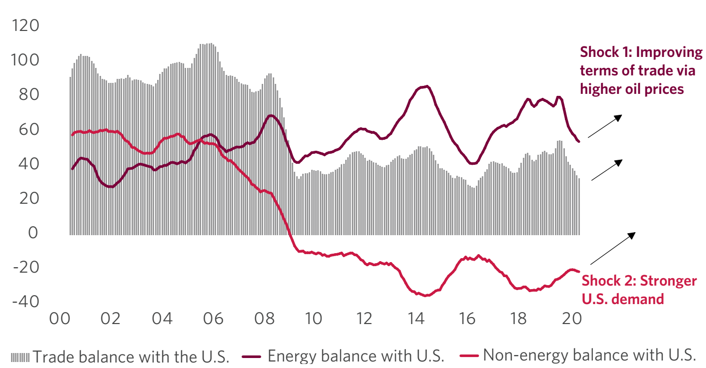
The Canadian consumer's firepower

Household savings as % of consumer spending

Sources: Refinitiv-Datastream and CIBC Asset Management Inc

Two positive shocks coming

Canadian trade balance with the U.S. (CDN 6-12 months cumulated)



Sources: Refinitiv-Datastream and CIBC Asset Management Inc.

United States

- As we begin 2021, U.S. personal savings represents more than two times the normal consumer firepower with more fiscal support on the way.
- U.S. real GDP growth is projected to average +6.2% over the forecast horizon.

Massive U.S. consumer firepower
Last year's sequence of events was highly unusual, to say the least. The early 2020 U.S. recession was like no other, with a very severe and very rapid contraction in economic activity. This resulted from effective lockdown measures and mobility restrictions put in place to slow the pandemic. However, the speed of recovery in consumer spending was just as impressive. This speedy recovery occurred because the disposable income of U.S. households continued expanding thanks to generous government transfers to households and small businesses (i.e. helicopter money). It was also because consumers were forced to reduce their spending owing to the economic shutdown.

Normally, U.S. consumers have a high propensity to spend—when disposable income rises, so does consumer spending, to a large extent. In early 2020, the propensity of American consumers to spend turned negative, with most of the substantial increase in household incomes turning into excess savings. The best way to look at this excess savings is to express it as a percentage of total consumption to get a measure of consumer "firepower". From that angle, 2021 is starting with personal savings that represent more than two times the normal consumer firepower.

We also have to account for the fact that more fiscal support is coming. In late 2020, fiscal policymakers finally reached a deal on a new spending package to bolster the U.S. economy. The plan is providing direct payments to most Americans, while enhancing unemployment benefits. The federal government will also be providing additional support to small businesses. Overall, the new round of helicopter money will considerably boost incomes.

There is more to this story. In 2021, cash-rich U.S. consumers won't just be getting more helicopter money from the government. Worker compensation is also set to substantially increase, given the projected growth in employment and hourly earnings. This represents another big boost to the U.S. consumer's potential spending power.

The bottom line here is that the 2021 positive income shock could very well be just as big as the one in 2020. It will include more helicopter money from the government and a sharp increase in worker compensation on top of the excess savings already in hand. Under these conditions, U.S. real GDP growth is expected to be stronger than generally projected (+6.2% vs. +3.6% for consensus) with a much more pronounced acceleration in inflation over the first half of 2021.

To be clear, the Fed will keep its ultra-accommodative policy stance in place over the whole forecast horizon, even if inflation rises above target. Its adoption of an Average Inflation Targeting (AIT) policy framework implies that it has anchored short rates near zero for a prolonged period. It's also aiming for new government borrowing costs to be significantly lower than the effective borrowing cost by adjusting its purchases of debt securities. This implies continued debt monetization and a fast expansion of its balance sheet.

Europe

- Given the second COVID-19 wave hitting Europe, the projected V-shaped recovery in the eurozone is likely to be somewhat flatter than projected.
- Our forecast calls for +5.8% average real GDP growth in the eurozone over the next 12 months.

Upbeat about Germany and ECB support
The resurgence of COVID-19 cases is setting back economic recovery hopes across Europe but, in our opinion, it's too early to abandon our V-shaped recovery scenario for the eurozone. One of the reasons to stay upbeat relates to the still encouraging situation in Germany, the eurozone's growth engine; and the main reason to stay upbeat about Germany relates to recent developments in German manufacturing activity. German manufacturing production has already recovered more than 80% of all ground lost in early 2020. Looking forward, the recovery is expected to remain on track.

The big difference for eurozone economies now is exports to China, which are strongly recovering. This is very important for Germany, because the multi-year growth slowdown in German exports to China largely explains the difficulties for German manufacturing since late 2017. This is all changing. The big drag on German growth experienced in 2019 and early 2020 has now turned into a substantial boost.

The third reason to remain upbeat about the eurozone's growth prospects relates to the size and composition of the ECB's balance sheet. In 2020, the ECB (European Central Bank) massively expanded its balance sheet (+2.2 trillion increase in total assets or nearly 20% of GDP). The unique feature here is that more than half of the 2020 balance sheet expansion reflects increased lending to banks via the ECB's TLTRO III. The ECB recently announced more policy easing for 2021, with many more PEPP[2] debt security purchases and the potential for another 1.5 trillion EUR worth of ECB loans to eurozone banks. All in all, the ECB will be keeping both feet on the accelerator over the forecast horizon.

As we emphasized in the last edition of *Perspectives*, the ECB has primarily been expanding its balance sheet by extending its lending to eurozone banks. This makes a big difference, as it basically eliminates the national limits determined by capital keys[3]. How is that possible? The ECB is now directly monetizing a good chunk of the new government bond issuance via its PEPP and AP programs. It's also indirectly monetizing government debt by lending to euro banks at a negative rate and having them buy more government bonds. When combining both the ECB's and the eurozone banks' purchases of government bonds, we find that 70% of the new debt issued has so far been monetized, with more support going to fiscally challenged countries. In short, the ECB has found a way to eliminate the risk of a government debt financing crisis in the eurozone.

Given the second COVID-19 wave hitting Europe, the projected V-shaped recovery in the eurozone is likely to be somewhat flatter than projected a few months ago. However, the eurozone economy remains in recovery mode. In light of the developments on the monetary policy front, and accounting for the still-to-come fiscal impulse associated with the EU recovery fund, our forecast calls for +5.8% average real GDP growth in the eurozone.

China

- The Chinese economy will continue to surprise consensus on the upside.
- We expect 10.4% average GDP growth in 2021, boosted by a base-year effect in Q1.

China economic outperformance to continue

The strong momentum of the Chinese economy has continued and has been broadening, finally reaching the consumer. We expect that consumer to play a prominent role in the economic expansion, leading the handoff from stimulus-led growth to self-sustained organic growth. Historically, GDP growth has remained strong for a few quarters following the peak of the policy impulse (reached at the end of last year) and this tendency supports our outlook.

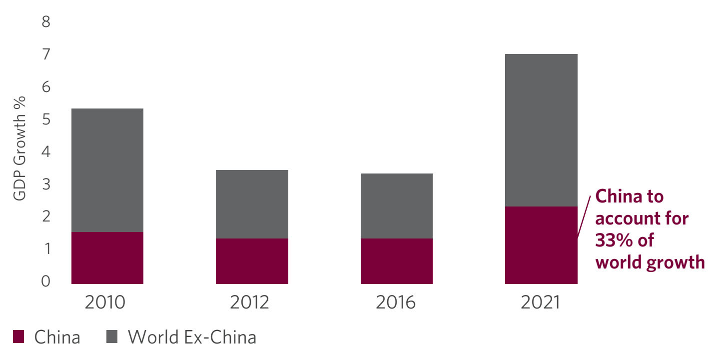
Two important factors will support the consumer. First, the savings rate is elevated, meaning that lots of firepower is available. The removal of a previously large international tourism current account deficit (almost 5% of GDP) and months of precautionary savings have boosted the savings rate. The recent pick-up of consumption indicators shows a consumer that is now confident and finally willing to consume. Second, external demand should remain strong, despite a stronger currency which is an indirect tailwind for employment and consumption. Pandemic-related global demand for personal protective equipment, electronics (the result of work-from-home), and online shopping (an abundance of Made in China products) could be receding tailwinds. However, we expect the strong global recovery should keep Chinese export growth elevated.

Despite our upbeat outlook, we expect the central bank (PBoC) to remain on the sidelines. Weak inflation pressures are relatively widespread. For example, housing rental prices have been in deflation since last winter, suggesting still difficult employment conditions for internal migrant workers. The negative output gap has also been weighing on the highly leveraged (and less efficient) State-Owned Enterprises (SOEs), which account for about 2/3 of corporate debt. The pace of SOE defaults rose significantly this year, much more than in 2015-16. Higher rates and potentially less accommodative financing conditions are an important risk that could result in a larger wave of defaults and ultimately impair the expansion.

While the rise of the consumer and the PBoC on the sidelines will support the Chinese economy, they will also result in important, positive spillovers for the global economy.

China-led global recoveries

Contributions to World GDP Growth



Source: Thomson Reuters Datastream, CIBC Asset Management Inc.

Alternative scenarios

Sluggish global recovery (25% probability)

In this scenario, the global distribution of the vaccine is too slow. The pandemic continues to intensify and spread, while policy response is largely inadequate. Cyclical and risky assets would face a significant correction. In addition, while the Chinese economic recovery remains on track, it comes with more limited spillovers for the rest of the world. The equity market rebounded rapidly after the recession, on hopes for a V-shaped recovery. As these hopes fail to materialze, equities and commodity prices would severely correct. Given that much of the global bond market is already in negative yield territory, only a few countries would have room for declining bond yields. Safe-haven assets like gold would surge.

Speedy return to normal (15% probability)

The best-case scenario calls for herd immunity to be reached faster than in the baseline scenario. Low risk aversion allows life to return to normal faster than anticipated and the world economy gets an extra boost from the consumer. The global yield curve remains very low and is inconsistent with a stronger-than-expected upturn in the economic cycle. Near 0% bond yields can only be justified by the very accommodative central bank policies. Facing rising inflation expectations, the bond market would start to test the central banks' commitment. The equity market would continue to rally, and the sectors most dependent on reopening the economy would strongly outperform.

Scenario	Less Favourable	More Favourable
Sluggish Global Recovery (25%)	Global Equities High Yield Bonds Industrial metals	Gold U.S. Treasuries Swiss franc
Speedy return to normal (15%)	International bonds Canadian bonds U.S. Treasuries	Small cap equities Value equities Oil

Economic forecasts (next 12 months)

Region	Current GDP[5]	GDP - Consensus	GDP - CAM View	Current Inflation[6]	Inflation - Consensus	Inflation - CAM View	Policy Rate - CAM View
Canada	-5.2%[7]	4.7%	6.0%	1.0%	1.7%	2.0%	Near 0%
United States	-2.8%	4.2%	6.2%	1.2%	2.0%	2.9%	Near 0%
Eurozone	-4.3%	4.9%	5.8%	-0.3%	0.9%	0.9%	Near 0%
China	4.9%	9.0%	10.4%	-0.5%	1.4%	1.1%	Cutting RRR[8]
Japan	-5.7%	2.7%	4.0%	-1.0%	-0.1%	0.0%	Near 0%
World	-4.4%	5.2%	7.1%	2.1%	2.6%	2.7%	-

[5] Real GDP Growth (y/y %)
[6] Year/year %
[7] Implied (converted from a Q/Q basis)
[8] Reserve requirement ratio

Data as of December 2020
Source: Datastream, Bloomberg, CIBC Asset Management Calculations

[1] To illustrate, $100 that declines by 35% equals $65; $65 that grows by 52% equals $98.8.
[2] pandemic emergency purchase program
[3] The capital of the ECB comes from the national central banks (NCBs) of all EU Member States. The NCBs' shares in this capital are calculated using a *key* which reflects the respective country's share in the total population and gross domestic product of the EU.