

PERSPECTIVES

For the 12-month period beginning October 1, 2021

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Global cooldown in the making

It's becoming obvious there's too much money chasing too few goods and services. Price increases everywhere are much larger than usual, while disposable incomes aren't rising fast enough to stop the erosion of consumers' purchasing power. If the current higher inflation is transitory, and global policymakers adjust accordingly, the global economy will experience a soft landing. If higher inflation proves to be longer lasting, the risk of a policy mistake increases.

Asset class highlights

Equity: Equity returns should be positive, but much lower than in the recent past. The risk of a correction is rising and could come from multiple catalysts. Too much growth would create inflation fears and push interest rates higher, while too little growth and earnings would fall short of bullish expectations.

Fixed Income: We continue to recommend an overweight in emerging market (EM) versus developed market bonds, but with a more selective approach to EM bond exposures. Negative global economic surprises have increased since our summer forecast and some emerging markets are more vulnerable than others.

Currencies: Although Canada's trade picture and higher energy prices support the loonie, we see limited upside until concerns about a potential hard landing for the world economy fully dissipate.

China: We see no appetite for a government bailout for real estate developer Evergrande, but we expect policymakers to intervene swiftly if forced by adverse financial conditions, limiting the magnitude of downside risks.

Multi-asset outlook

Asset class	Current September 30, 2021	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	0.53%	0.40%	1.00%
Canada 10-year government bond yield	1.51%	1.20%	2.10%
U.S. 10-year government bond yield	1.49%	1.25%	2.25%
Germany 10-year government bond yield	-0.20%	-0.45%	0.10%
Japan 10-year government bond yield	0.07%	-0.25%	0.25%
Canada 10-year real-return government bond yield	-0.36%	-0.55%	-0.25%
Canada investment grade corporate spreads	1.15%	1.00%	1.45%
U.S. high yield corporate spreads	3.03%	2.70%	4.20%
Emerging market sovereign (USD denominated) bond spreads	324	250	500
S&P/TSX price index	20,070	18,500	21,200
S&P 500 price index	4,308	3,850	4,535
Euro Stoxx 50 price index	4,048	3,825	4,400
Japan Topix price index	2,030	1,875	2,150
MSCI Emerging Markets	70,963	65,000	80,000
U.S. Dollar/Canadian Dollar	1.2680	1.205	1.282
Euro/U.S. Dollar	1.1580	1.120	1.180
U.S. Dollar/Japanese Yen	111.29	108.00	114.00
U.S. Dollar/Offshore Chinese Yuan	6.45	6.36	6.90
Gold	1,757	1,600	2,100
Oil price, WTI (West Texas Intermediate)	75.03	55.00	90.00

Source: Thomson Reuters Datastream, CIBC Asset Management Inc.
All prices in home currency unless otherwise specified.

Asset class outlook

Global overview

Inflation Headwinds Blowing Stronger

Policymakers around the world brought out the heavy artillery last year to cushion the impact of lockdown measures used to fight the pandemic. Monetary and fiscal authorities cooperated closely by opening wide the global liquidity taps. The adoption of this ultra-accommodative global policy stance did wonders and allowed risky assets to bounce back very quickly. Shortly after, the world economy recovered most of the ground it had lost during the recession.

At this point, it's becoming clearer and clearer that there's too much money chasing too few goods and services. Global inflationary headwinds are blowing harder and everywhere you look, price increases are much larger than usual. Unfortunately, disposable incomes aren't rising fast enough to stop the erosion of the consumer's purchasing power. For this reason, we believe a global economic cooldown is in the making. Real GDP is projected to substantially decelerate, from more than +5% currently to +3.7% over the forecast horizon.

With inflation now rearing its head, central banks have no other choice but to prudently embark on the policy renormalization road. The first step is obviously for governments to clean up their fiscal houses by considerably reducing the size of their deficits. In turn, downsized fiscal deficits imply that monetary authorities will have to proportionally reduce their purchases of government debt securities (i.e. tapering). For the moment, only a minority of central bankers are actually contemplating hiking policy rates over the forecast horizon, on the assumption that the current higher inflation will prove to be transitory. If all goes well and the right dose of policy renormalization is delivered, the global economy will experience a soft landing, but from a very high altitude.

For many reasons, however, a harder and bumpier landing for the world economy can't be ruled out. At the top of the list are China's real estate problems. In China, the property market is probably the single largest driver of the country's economy. Tighter regulations are being put in place by Chinese authorities to make housing more affordable. The risk is for a more severe policy-induced housing downturn than originally aimed for, wreaking havoc on the Chinese economy.

There are also growing concerns globally that today's shortages of everything from microchips to natural gas could end in an inflationary blowout. If the shift to a higher inflation environment proves to be longer lasting, central banks around the world will have to renormalize policy sooner and at a much faster pace. This increases the risk of a policy mistake.

Whether we like it or not, the global credit impulse is now fading and will continue to do so as policy renormalization takes place almost everywhere. While it's unlikely that a financial storm is

coming, more difficult navigation conditions are likely, implying higher volatility and greater uncertainty for the direction of financial markets.

Global strategy

After peak growth comes deceleration

Earlier this year we concluded that the economic cycle was moving away from the recovery phase to the expansion phase. At that point, the bigger concern was not that the economy would experience a hard landing—instead, we worried that the transition would create uncertainties, force investors to reassess their expectations, and ultimately lead to market turbulence. However, we believed any turbulence would be temporary.

Markets had been relatively calm until early September. Until then, most equity markets had been resilient and had moved up in a straight line this year. But eventually reality started to sink in and equities declined in September. The correction has so far been shallow and, for the most part, is bringing markets back to their 200-day moving average, a useful gauge of the trend. While equity indices declined, within the market, cyclical sectors outperformed defensives, clearly not a sign of growth anxiety. The trend in bond yields was more uneven, but generally yields have increased this year. Rising bond yields are also not a sign of economic weakness. In light of current conditions, they could be a sign of inflation or an indication the market is getting ready for the Fed tapering of its asset purchase program. Forward-looking economic indicators, like the purchasing manager surveys (PMI), show that the growth slowdown so far remains benign.

The big picture is that while we're past the peak, we're still near peak growth and in the process of transitioning to the next phase. The recent market action is consistent with an ongoing adjustment to the post-peak economic cycle. The risk coming out of the Chinese real estate sector (i.e. Evergrande) has also led to fears and contributed to weaker equity prices. While growth currently remains solid, every quarter that passes brings an increasingly weaker outlook into the forecasting horizon. The post-lockdown impulse that fueled the recovery will gradually dissipate. Average growth is expected to remain robust over the next 12 months, but at the end of the forecast horizon, sequential growth should be close to or slightly below potential. Earlier this year it seemed Fed tapering was far off, but here we are only a few months away from it.

The odds are that equities will continue to outperform bonds. In our central scenario, bond yields should be flat within a trading range and bond returns are therefore expected to be weak. Equity returns should be positive, but much lower than in the recent past. The risk of a correction in equities is rising and could come from multiple catalysts. Too much growth would create inflation fears and push interest rates higher. Too little growth and earnings would fall short of bullish expectations. There is still a path for good equity returns, but it's a narrow one. This is, of course, not unique to the current

cycle and equity investors always need to climb a wall of worry. Looking beyond the near or the medium term, the risk premium for equities is higher than for bonds (the U.S. market being a notable exception). Nevertheless, an environment characterized by slowing and disappointing growth makes it less attractive to take on the volatility associated with equities.

Global equity markets

A question mark on margins

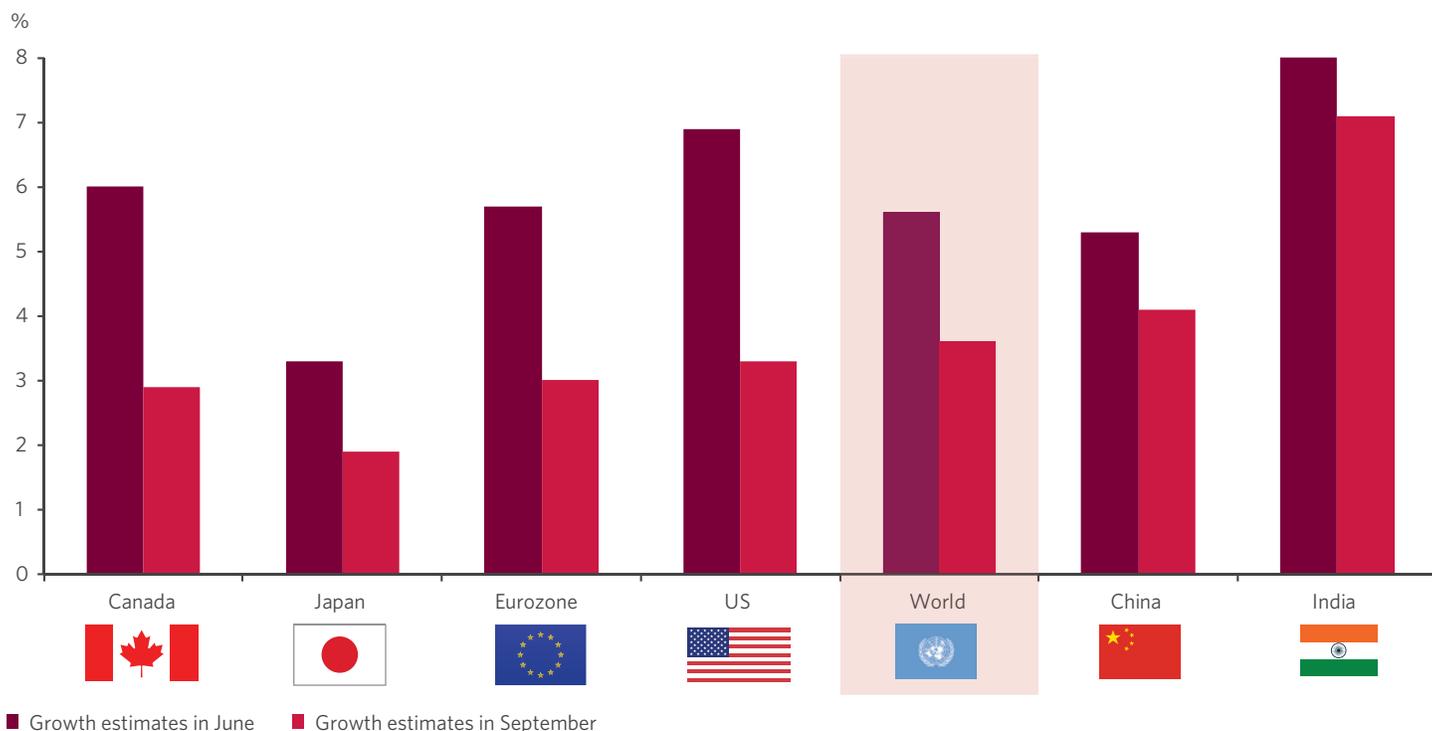
While equity valuation is expensive and will be a headwind to equity returns, valuation isn't a good tactical timing tool. What happens in the near term depends more on the cyclical outlook. The economic environment could very well continue to support higher-than-normal valuation if it remains in a Goldilocks state where growth slows (but not too much), inflation fears fade and interest rates remain in a trading range. Given our forecast, these conditions are possible, but may be difficult to achieve and maintain.

More likely, equities will need to rely on earnings growth. The good news is those earnings should be supported by strong sales. Sales growth is highly correlated with economic activity which, although slowing, should remain robust. The consensus expectations on sales growth in the high single digits look reasonable but margins are a potential sticking point. Margins are also strongly correlated with economic growth, but consensus expectations for margins look optimistic, given they're already high. It remains to be seen if companies can pass higher input costs to the consumer and

protect margins—some companies are concerned about this. They fear inflation will persist and are concerned that supply chain bottlenecks, the rising cost of materials and rising labour costs could dent margins. Others show more optimism, expecting inflation to be transitory and margins to recover or expand. A number of companies also plan to pass price increases on to consumers and implement cost controls to protect their margins. A world of post-pandemic inflation driven by supply bottlenecks has, needless to say, never been seen before. As such, it's difficult to predict how companies will cope with these developments. The bottom line is profit margins could rise or fall and may become one of the tipping factors for equity returns.

In the previous edition of *Perspectives*, we issued a warning about emerging markets. The caution arose from the rise of the Delta variant, the slowdown in the Chinese credit impulse and issues with the Chinese real estate sector. Those issues were expected to be temporary and we continue to expect as much. The latest wave of COVID is receding and many countries are moving on to live with the virus. This is becoming possible as more and more people have been vaccinated, and vaccines have proven effective at preventing the more severe cases even as time passes. The saga of Evergrande, the largest Chinese property developer, is not over yet but the market has basically assumed that they will default and need restructuring. Contagion has been limited to other real estate developers. The Chinese credit impulse is near its bottom and the deterioration might be close to its worst. All this to say, emerging markets are still facing a few headwinds in the near term, but these should continue to fade.

Global growth projections: CAM forecast September 2021 vs. June 2021



Source: Refinitiv-Datastream and CIBC Asset Management Inc.

Global bond strategies

In the third quarter, developed market (DM) bond performance was flat. U.S. 10-year yields finished the quarter pretty much where they started, moving in a fairly tight 1.13% to 1.56% corridor. Subdued DM bond market volatility will likely prevail over the next twelve months.

Crosscurrents should continue to make it difficult for bond yields to find a clear direction and range trading remains our favoured strategy. On one hand, the reopening of economies after the pandemic shock and the prospects of bond purchase tapering by major central banks might allow yields to move higher in the very short term. However, looking a bit further out on the horizon, shifting monetary, credit and fiscal impulses might push the global cycle to the downside and trigger a move lower for DM bond yields.

As a result, U.S. 10-year yields should oscillate between 1.25% and 2.25% over the next twelve months. Breaking it down by components, 10-year **real** yields should remain well anchored between -1.00% and -0.50%. Meanwhile, 10-year **breakeven** yields should decline towards 2.00% (from 2.40% currently), as we see inflationary pressure progressively abating in our base case scenario. But note that this view could be challenged if supply bottlenecks and labour shortages linger for longer than expected (as we've seen in the last few months). A prolonged period of elevated breakeven rates can't be discounted.

We continue to recommend an overweight in emerging market (EM) versus DM bond markets. All else being equal, several factors will help EM bonds to outperform. First, the Fed is expected to remain patient and will delay the beginning of its hiking cycle beyond the next twelve-month time horizon. Second, the repricing of many EM yield curves (steeper) has recently improved valuation in many EM countries, making them very attractive from an historical standpoint. Finally, solid commodity price gains will continue to benefit EM commodity exporters' growth prospects; this positive development usually translates into increased capital market inflows.

That said, and despite our positive take on EM, we recommend a more selective approach to EM bond exposures. Negative global economic surprises have increased since our last summer forecast. In the U.S., our alternative scenario, "Persistent Inflation" (see page 10), could negatively impact demand towards EM economies. Similarly in China, the latest crackdown on a key sector of the economy, woes in the housing market and the lagged impact of credit impulse decline could also lead to underwhelming Chinese demand. Although the probabilities are still low, a deeper global cyclical downturn could complicate things for EM economies. The investment implication—exercise prudence with higher beta EM bond exposure such as Colombia, Indonesia and South Africa, for example.

Currencies

U.S. Dollar

Since the Fed signaled its intention to slow its purchases of debt securities in late September, the U.S. dollar has been generally stronger, appreciating by roughly +2% on a trade-weighted basis. Is the secular U.S. dollar bull market about to resume? At first glance, it's tempting to call for renewed U.S. dollar weakness given the greenback's weak fundamentals. America's consumer-led recovery came with a sharp rise in imports and a widening current account deficit.

In the case of the U.S. dollar, the Fed's balance sheet matters a lot more than the size of the current account deficit. From this angle, the fact that the Federal Reserve is about to slow its purchases of debt securities is non-trivial. If our "taper" forecast materializes, the Fed will be gradually slowing its debt security purchases (a reduction of \$450 B over twelve months). At first glance, this doesn't seem to be a big enough policy change to have a meaningful impact on the value of the greenback. Indeed, under our baseline forecast, the Fed modestly tapers as planned with no excessive drainage of excess reserves. As a result, the monetary-base-to-GDP ratio will likely stabilize and the U.S. dollar will stay in consolidation mode. The risk is for the Fed's modest tapering to translate to an excessive drainage of excess reserves. In that context, the monetary-base-to-GDP ratio would likely trend lower and the U.S. dollar would broadly gain ground.

From this point on, the U.S. dollar's potential upside or downside will be determined by the Fed's ability or inability to convince market participants that its tapering is nothing to worry about. However, investors will likely be increasingly jittery remembering the lessons from 2018—that is, reducing the dosage of Fed liquidity injections is a much harder thing to do than augmenting them.

Canadian Dollar

After hitting cyclical highs around 83 cents against the U.S. dollar in early June, the Canadian dollar lost some of its lustre. From this point on, does the Canadian dollar have more downside or will the uptrend that's been in place since March 2020 soon resume?

Looking at the Canadian dollar's short-term determinants, it's tempting to argue that there's more upside for the loonie. For one thing, markets are expecting that the Bank of Canada will start hiking its policy rate before the Fed. For another, Canadian terms of trade continue to improve with fast-rising crude oil and natural gas prices. In light of these two developments, the Canadian dollar should already be trading at much higher levels. In fact, the misalignment has rarely been this wide. The last time this happened was at the start of the Great Recession in late 2007. The Canadian dollar's upside is currently capped because of the global cooldown now underway. Fluctuations in the Canadian dollar are, to some extent, influenced by market

expectations about global economic conditions. We see limited upside until concerns about a potential hard landing for the world economy fully dissipate.

All in all, with offsetting forces likely at work, the Canadian dollar is expected to trade sideways against the USD—between 0.78 and 0.82 U.S. cents.

Canadian dollar: Limited upside

CAD/USD bilateral rate and key technicals



Sources: Refinitiv-Datastream and CIBC Asset Management Inc. as of September 2021.

Euro

In recent months, the euro has gradually given back some of the ground gained against the U.S. dollar in 2020. Why is that? While the ECB has started its policy renormalization by slowing the expansion of its balance sheet, its policy stance remains relatively easier than the Fed's. What's more, there are good reasons to be less upbeat about the eurozone's growth prospects. Under such conditions, the euro is expected to stay in consolidation mode against the U.S. dollar, trading between 1.12 and 1.18.

Japanese Yen

Since the beginning of the year, the Japanese yen has depreciated by nearly -8% against the U.S. dollar. At first glance, such weakness may seem surprising. This currency normally has strong fundamental support, given Japan's wide and widening current account surplus. We suspect that the BOJ's policy actions largely explain the yen's unusual behaviour. For nearly five years, the Bank of Japan has been anchoring JGB 10-year yields around zero via its Yield Curve Control (YCC) policy. As a result, pullbacks in the U.S. Treasury bond market have typically led to the strengthening of the USDJPY bilateral rate. Looking forward, we see limited upside for Treasury yields and, in turn, for the USDJPY bilateral exchange rate. We're working with a targeted range of 108 to 114 between now and the third quarter of 2022.

Commodities

Oil

Oil prices continued to march higher, to about \$80/barrel in mid-October, a level not seen since 2014. Year-to-date WTI¹ oil prices have climbed an impressive 65% as the global economic recovery took hold and supplier discipline remained in place. Demand has been reasonable as economies have returned to more normal

industrial output levels and travel restrictions have eased somewhat around the world. On the supply side, OPEC+ has remained disciplined in its return of barrels to the market. At the same time, other sources of supply growth (e.g. U.S. shale) have not returned aggressively, as investors have continued to demand a return of capital rather than growth. So far, producers have been listening.

Looking forward, we'll continue to watch for signals that demand growth remains in place to support the higher oil price in the coming months. We expect demand for gasoline, jet fuel and other end products to ramp up as more vaccines are administered and more countries and economies return to normal. On the supply side, we continue to watch for signals around the return of incremental barrels of oil to the market. The next data points should come with third-quarter earnings, where we should get an idea of what producers are thinking in terms of budgets and output for 2022. For now, OPEC+ discipline has helped support the commodity price as well. With oil prices at current levels, there is likely an incentive for producers to bring more barrels back to the market. We will be watching closely for production growth signals through the remainder of the year and into 2022.

Overall, we believe the setup for oil prices over the next few months remains positive. Demand remains reasonable for now and the supply side remains disciplined, both of which indicate support at current prices.

Gold

Gold continues to drift, bouncing between \$1,750/oz and \$1,800/oz as the market looks for direction on key indicators such as inflation, interest rates and economic growth. Sentiment has worked against gold in recent months, as investors gained confidence in economic growth with vaccine rollouts and increased clarity on a path to normalcy. This return to normal implies higher interest rates and less government stimulus, which have been perceived as a headwind for gold.

Looking forward, inflation has become a focus for investors in recent months and the commentary around stagflation has probably helped support the gold price in the past few weeks. Slower economic growth and higher and more persistent inflation could be a tailwind for gold in the coming quarters. A healthy discussion around the transitory nature of the current inflation cycle and the timing and magnitude of interest rate hikes remain the key debates in the gold price outlook for coming quarters. We continue to believe the outlook for gold remains constructive into 4Q21 and 2022. We expect monetary and fiscal policy generally to remain supportive for gold in the months ahead.

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

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

Copper

The copper price drifted through the summer and into the autumn, generally trading between \$4.10/lb. and \$4.40/lb. While upward momentum has stalled lately, we note that the current price is at a very healthy level, well above the marginal cost of production, signaling demand is good and supply is tight.

Looking ahead, the focus remains on China and its industrial output and housing sector demand, two key end users of copper. Growth is starting to slow in China, and the recent property sector issues there have added an element of concern to the near-term copper narrative. Despite these recent data points, physical inventory levels remain low and the copper price has held in well.

Over the medium to longer term, we continue to believe the narrative around a structural bull market in copper remains in place. Copper will be a critical metal in the transition to a lower-carbon economy. Significant new volumes of the metal will need to be incentivized into the market to meet this new area of demand. To bring additional supply into the market, a higher copper price will be needed.

Regional economic views

Canada

- Canadian households, like everywhere else, are feeling the pinch from higher inflation.
- Even if the BOC doesn't deliver rate hikes over the forecast horizon, market expectations have started and will continue to shift upward.

From a boost to a drag

The good news is that the Canadian economy came roaring back to life over the last year, experiencing its highest real GDP growth on record. The not-so-good news is that things are now going so well that Canadian policymakers have started lifting their foot off the accelerator. The biggest policy shift surrounds the federal government's ultra-loose fiscal policy stance. The federal government deficit is projected to substantially narrow from -\$155 B in FY2021 to -\$60 B in FY2022. Putting it another way, last year's big fiscal boost will turn into a big fiscal drag on growth over the forecast horizon. This will have a meaningful impact on government spending as well as on government transfers to Canadian businesses and households.

At the current juncture, the consensus view remains that the drag from fiscal policy will be more than offset by particularly strong growth in consumer spending, keeping the Canadian economy sizzling hot. The problem is that Canadian households, like everywhere else, are feeling the pinch from higher inflation. Growth in disposable income simply isn't high enough to

compensate for the rise in inflation. Case in point, fast-rising home prices and rents are pushing the Canadian housing bill substantially higher, with the share of disposable income that's going to housing-related expenses increasing by +6% over the last year. The same thing is happening to the household energy bill, owing to surging oil and natural gas prices.

This leaves Canadian monetary authorities in a tough spot. The BOC has started tapering and is projected to taper further. However, with regard to its rate-setting policy, the BOC would probably much prefer waiting for the Fed to move first before following suit. The problem is that persistently higher inflation could eventually force the BOC's hand. Based on the BOC's preferred inflation measures, core inflationary pressures have been intensifying. The reality is even if the BOC doesn't deliver rate hikes over the forecast horizon, market expectations have started and will continue shifting upward, translating into tightening financial conditions.

United States

- The U.S. economy is expected to shift into lower gear, with real GDP growth averaging +3.3% between the fourth quarter of 2021 and the third quarter of 2022.
- Inflation is projected to decelerate from more than +4% currently to less than +2.5% in late 2022.

Feeling the pinch from higher inflation

Last year, the U.S. economy experienced a very strong consumer-led recovery, in large part because U.S. households received very generous government transfers. The biggest chunk of the helicopter money² received was used to buy consumer goods and invest in real estate. This produced sizzling growth in both sectors and amounted to the largest spending binge ever experienced in America.

U.S. producers never saw the demand shock coming. Production could not be ramped up fast enough and inventories were quickly depleted. Excess demand conditions rapidly developed, exerting upward pressures on prices. Home prices are up nearly 20% from levels observed a year earlier, while the price of durable goods is up +6.9% over the same period. This is very unusual, as deflation is more the norm for durable goods' prices. In short, the purchasing power of U.S. consumers is fast eroding.

It's clear that U.S. consumers are feeling the pinch from higher inflation. This is very apparent when looking at the latest readings from consumer confidence/sentiment surveys. Plans to buy a new home or a new car in the next six months are down to their lowest levels since the Great Recession. This hardly comes as a surprise, given the sharp deterioration in U.S. consumer fundamentals. True, employee compensation is

² Helicopter drop: an idea of economist Milton Friedman, this is a type of monetary stimulus that injects cash into an economy as if it was thrown out of a helicopter. Helicopter money refers to increasing a nation's money supply through more spending, tax cuts, or boosting money supply.

growing at a robust pace, reflecting elevated wage inflation and solid employment growth. However, this is largely offset by the contraction in government transfers and the increase in taxes paid, leaving nominal disposable income at a standstill. Given the currently observed elevated inflation, disposable income is actually in contraction when expressed in real terms.

With the U.S. savings rate hovering well above its historical average for more than a year, it's tempting to conclude that U.S. households still have enough excess savings to further fuel the spending binge. However, it isn't clear to us that there are any excess savings left to be spent. For one thing, the savings rate has already dropped a lot. For another, the unusually large excess savings of 2020 were likely used by low- and middle-income households to either pay down debt or make a lump sum payment on the purchase of a home and/or durable goods.

The U.S. economy is expected to shift into lower gear, with real GDP growth averaging +3.3% between the fourth quarter of 2021 and the third quarter of 2022. With inflation projected to decelerate from more than +4% currently to less than +2.5% in late 2022, the Fed is expected to renormalize its policy stance very gradually. It will start with the reduction of its monthly purchases of Treasury and MBS debt securities.

Europe

- GDP growth in the eurozone is projected to decelerate over our updated forecast horizon (to +3.0%, down from +5.7% in our last forecast).
- We see a transitory but very substantial increase in EU inflation, followed by a deceleration below +1.5%.

Paying more for everything

We've been very upbeat about the eurozone's growth prospects for some time. However, we think it's time to now add shades of grey to an otherwise still-rosy eurozone outlook. Our biggest concern relates to the recent acceleration in inflation. CPI inflation is now running at more than 3% in the eurozone—the highest inflation rate in more than a decade. While this is expected to be transitory, eurozone households now have to pay more for pretty much everything.

Growth in the eurozone is also likely to disappoint because of shifting fiscal policy stance. Last year, real GDP growth in the eurozone got an unusually big boost from government spending. If the ECB's fiscal projections materialize, the big fiscal boost of 2021 will turn into a fiscal drag in 2022. We also have to consider that developments on the trade front probably won't be as good as last year, a year when the eurozone economy got a big boost from net exports. With foreign demand projected to grow at a much slower pace and domestic demand projected to strengthen considerably, last year's boost from net exports is likely to turn into a small drag on growth. GDP growth is projected to decelerate over our updated forecast horizon (to +3.0%, down

from +5.7% in the last forecast). We see a transitory but very substantial increase in EU inflation, followed by a deceleration below +1.5%.

Like other central banks in the developed world, the ECB has shifted to tapering mode. Since the start of the year, it's been gradually slowing the expansion of its balance sheet—from +20% of GDP in early 2021 to +13% currently. With economic growth and inflation projected to decelerate in the eurozone and accounting for the recent switch to a symmetrical inflation³ 2.0% target, the ECB is expected to stay prudent. It will quickly backtrack if financial conditions deteriorate too much.

China

- Our GDP growth outlook is +4.1% y/y for the next four quarters, 1.1% below consensus.
- Policymakers should stay the course as macroprudential policies rein in real estate debt. Regulatory pressure to meet environmental targets should result in ongoing energy production curbs, another drag on growth.

The economic disappointment isn't over

The Chinese economy materially disappointed consensus growth projections in recent months, as we predicted in our July *Perspectives*. This environment resulted in disappointing sales for real estate promoters in recent months (-20% y/y) relative to an aggressive industry target (+9% for 2021). This is a major liquidity shock for an industry fueled by growth.

China's macroprudential policies have reined in debt growth for real estate developers with more vulnerable balance sheet metrics—another important liquidity headwind. The “three red lines policy” imposes maximum levels for debt-to-asset and net debt-to-equity ratios and requires cash to be at least equal to short-term borrowing.

The policy has forced about 1/3 of promoters to keep debt unchanged (the consequence if all lines are crossed) or growing below 5% (the consequence when two lines are crossed), a stark contrast with the double-digit debt growth experienced in recent years.

While concerns about Evergrande should peak in coming months, this won't be the case for the rest of the industry (see pg. 9). Given that about 1/3 of developers have interest coverage ratios below one,⁴ and the size of maturing real estate debt will remain elevated, we expect defaults to surge and spreads to widen for the industry. As a result, construction activity should become an increasing drag on GDP growth.

³ A symmetrical inflation target is a requirement placed on a central bank to respond when inflation is too low as well as when inflation is too high.

⁴ That is, interest expenses exceed gross earnings.

Power rationing of energy-intensive industries is another growth impediment. China has the ambitious objective to reach peak carbon dioxide emissions by 2030. Most provinces have fallen behind their annual emission targets and Beijing recently urged them to act. Power rationing and production curbs have ensued. China’s increasing reliance on energy imports have pushed up global coal and LNG⁵ prices, exacerbating supply challenges.

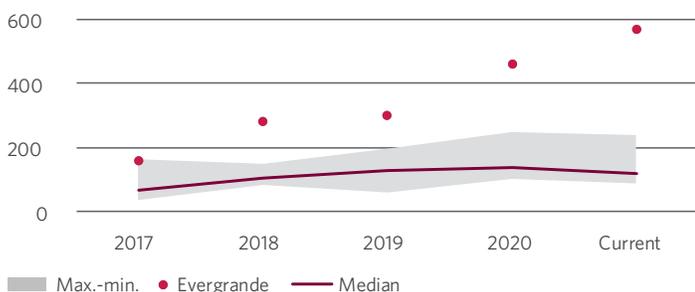
Turning to policy, we expect the PBoC to cut the reserve requirement ratio by 150 bps and inject liquidity as needed. This should keep banks functioning normally despite the hit from defaults of real estate promoters. However, given the ultimate policy objective of limiting the buildup of housing imbalances, we expect policymakers to keep rates unchanged and stay the course with macroprudential tightening (although some relaxation of the rules is likely).

China’s Real Estate Risks and Policy

Evergrande, previously China’s largest real estate promoter, has lost about 80% of its value this year. The company was hit hard by slowing Chinese growth and macroprudential rules implemented last year. That said, liquidity problems were already mounting prior to the pandemic, as evidenced by surging days for account payables (see chart below).

Evergrande is a “too big to fail” institution, with liabilities of nearly 3% of GDP (about 3 RMB trillion). About 2/3 of liabilities are related to accruals and payables. Interest-bearing debt is also substantial in absolute terms (about 0.6 RMB trillion), with domestic financial institutions bearing most of the exposure by far. While foreign investors are only marginal bondholders (<0.05 RMB trillion), Evergrande is nevertheless the biggest issuer in China’s offshore bond market.

Days in account payables: Evergrande vs. other real estate large promoters (with a market share of at least 5%)



Sources: Refinitiv-Datastream and CIBC Asset Management Inc.

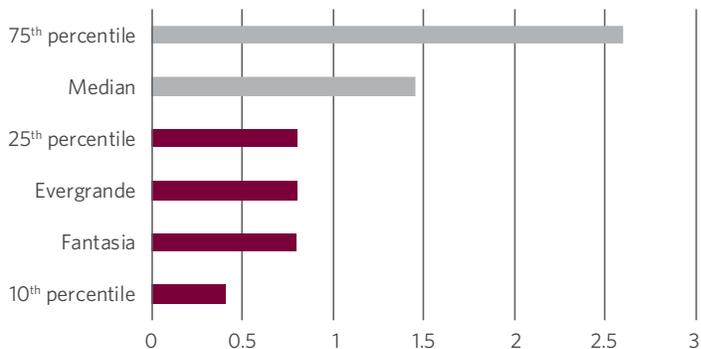
We see three priorities for the Government. The first is to secure the delivery of projects under construction (state-owned enterprises could acquire/finance them). The second is to avoid/limit defaults on foreign bonds given the risk of deteriorating financing conditions (foreign demand is more elastic and

vulnerable). The last priority is to restructure activities over the medium term, which could result in haircuts for bondholders and a bankruptcy.

A key theme is that policymakers have a larger-than-usual pain threshold for housing woes. China wants to limit the build-up of housing vulnerabilities associated with high and increasing leveraging, unaffordability and oversupply. As a result, we see more downside than upside risks and no appetite for a bailout. That said, we expect policymakers to intervene swiftly if forced by adverse financial conditions, limiting the magnitude of downside risks.

We’re mainly concerned with vulnerabilities from the rest of the industry. Interest coverage ratios (ICRs) are small for a large share of promoters (see chart below). About ¼ of them have a ratio below 0.8, similar to the ratios of Evergrande and Fantasia (which recently defaulted). The confluence of slow economic growth, ongoing macroprudential tightening, and elevated maturing debt magnify the risks of negative spillovers.

Interest coverage ratios on China real estate dollar bonds



Sources: Bloomberg and CIBC Asset Management Inc.

We expect a surge of defaults among promoters in upcoming months, which should magnify downward pressures on construction activity. However, spillovers should be limited in magnitude and duration as promoters with low ICRs are generally smaller in size.

5 Liquid natural gas

Alternative scenarios

No more pent-up demand (20% probability)

After a strong government-induced spending binge, the consumer runs out of fuel. Disposable income takes a hit as government transfers shrink. The excess savings that the consumer was forced to accumulate during the lockdown are insufficient to make up for the fiscal drag. The consumer has already front-loaded purchases of durable goods and inflation has eroded its purchasing power. Although not a recession, growth slows down significantly and comes up short of expectations in this scenario. Corporate earnings disappoint and equity markets generate negative returns. Bond yields decline toward the bottom of their trading range as central banks need to reaffirm a commitment to policy support.

Persistent inflation (20% probability)

The supply bottlenecks created by the pandemic prove hard to fix. The tightness in both inventories and the global supply chain means a disruption in one can create supply shortages all along the chain. Limited supply is met by solid demand as the global economy benefits from ongoing reopening. Inflation persists in housing, commodities, goods and spreads to labour costs. Initially, this scenario is positive for cyclical assets like equities and commodities as they benefit from the robust growth. But eventually, markets face the fact that central banks are falling behind the curve and an accelerated tightening triggers a correction. Nominal bond yields move up sharply as both the real yield and the inflation breakeven yield move up.

Scenario	Less favourable	More favourable
No more pent-up demand (20%)	Global Equities High Yield Bonds Commodities	Gold U.S. Treasuries Japanese Yen
Persistent inflation (20%)	Eurozone Bonds U.S. Treasuries EM Bonds	EM Equities Commodities Breakeven Inflation



Economic forecasts (next 12 months)

Region	Current GDP ¹	GDP - Consensus	GDP - CAM View	Current Inflation ²	Inflation - Consensus	Inflation - CAM View	Policy Rate - CAM View
Canada	12.7% ³	3.9%	2.9%	4.5%	2.9%	3.5%	Near 0%
United States	12.2%	4.8%	3.3%	5.3%	3.8%	3.8%	Near 0%
Eurozone	14.3%	4.9%	3.0%	3.4%	2.2%	2.8%	Near 0%
China	7.9%	5.2%	4.1%	0.8%	2.2%	1.2%	Cutting RRR ⁴
Japan	7.6%	2.4%	1.9%	-0.4%	0.4%	0.7%	Near 0%
World	12.3%	4.8%	3.7%	3.4%	3.3%	3.6%	-

1 Real GDP Growth (y/y %)

2 Year/year %

3 Implied (converted from a Q/Q basis)

4 Reserve requirement ratio

Data as of September 2021.

Source: Datastream, Bloomberg, CIBC Asset Management Calculations.

Authors



Luc de la Durantay

Chief Investment Strategist,
CIO and Managing Director,
Multi-Asset & Currency Management



Vincent Lépine

Director, Economic and Market Research,
Multi-Asset & Currency Management



Francis Thivierge

Senior Portfolio Manager,
Multi-Asset & Currency Management



Jean-Laurent Gagnon

Assistant Portfolio Manager,
Multi-Asset & Currency Management



Éric Morin

Senior Analyst,
Multi-Asset & Currency Management



Anne-Katherine Cormier

Senior Analyst,
Multi-Asset & Currency Management



Daniel Greenspan

Senior Analyst &
Resource Team Director



Karen Mueller

Senior Editor
Wealth Marketing & Communications

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