Perspectives

For the 12-month period beginning July 1, 2017

GLOBAL BRIGHT SPOTS EMERGE

The current global landscape reveals economies growing "at potential"—but slowing—no strong inflation pressure and gradual policy normalization from central banks. In this setting, we see more opportunities in specific economic regions than between broad asset classes.

In Europe, the economy is showing signs of improvement, and some political uncertainties have been reduced with the large majority win of new French President Macron. Earnings are quickly accelerating and have room to keep growing. Emerging markets offer the best long-term value in the equity universe. In the past year, we've seen a strong rebound in earnings in Asia (ex. China), Eastern Europe and Latin America.

CIBC Asset Management

Asset Allocation Outlook as at July 1, 2017

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

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

Highlights

Fixed Income vs. Equity: We see more opportunities in the relative movement between economic regions than between broad asset classes and are maintaining our neutral stance between equity and fixed income.

Equity: Europe offers good potential for catch-up growth at a reasonable price, while emerging markets offer the best long-term value in the equity universe.

Fixed Income: Bond yields in the United States and Canada are expected to head higher, but the rise should be limited in the context of intensifying global disinflation.

Currencies: Whether Canadian monetary authorities actually hike rates once or twice before year end is of little relevance for the Canadian dollar which, to some extent, has already priced in such policy actions.

Expected Returns

Expected returns for the one-year period beginning July 1, 2017	In Canadian Dollars			In Local Currency		
	U.S. Renormalization	Balancing Act	Global Recession	U.S. Renormalization	Balancing Act	Global Recession
Probabilities	15.0%	65.0%	20.0%	15.0%	65.0%	20.0%
Canada Money Market	1.1%	0.9%	0.4%	1.1%	0.9%	0.4%
Canadian Bond	-1.8%	0.9%	6.1%	-1.8%	0.9%	6.1%
Canadian Federal Govt. Bond	-2.1%	1.0%	7.4%	-2.1%	1.0%	7.4%
Canadian Corp. Bond	0.2%	1.4%	2.8%	0.2%	1.4%	2.8%
Canadian RRB	1.6%	1.0%	9.7%	1.6%	1.0%	9.7%
Canadian High Yield	2.5%	2.8%	-2.8%	2.5%	2.8%	-2.8%
International Govt. Bond	-6.9%	-0.2%	10.0%	-3.8%	-0.5%	5.4%
Canada Equity	16.3%	5.9%	-19.2%	16.3%	5.9%	-19.2%
United States Equity	10.0%	5.5%	-10.6%	13.3%	3.8%	-15.3%
International Equity	14.2%	6.3%	-15.4%	17.0%	6.4%	-17.0%
Emerging Equity	14.8%	8.7%	-22.3%	17.5%	8.6%	-19.5%

Global Outlook

Balancing Act, Part II: Central banks on the move

The latest update from our quarterly forecast sessions points to a continuation of the global economic expansion over the coming 12 months. With some declining momentum, that growth should track around the estimated global economic potential—around 3% in real economic activity. The world economy has continued to chip away at global excess capacity in the labour and product markets. While pockets of inflationary pressure in the U.S. labour market may be percolating, clear signs of inflationary pressure globally are still absent. After more than nine years since the Global Financial Crisis (GFC), the U.S. Federal Reserve (Fed) and the European Central Bank (ECB) are indicating confidence in the self-sustainability of the current economic expansion—to the point that they are sending signals they are moving away from extraordinary policy accommodation. More recently, other central banks in smaller economies (the likes of Canada, Sweden and Norway) have also shown more confidence in the eventual removal of some of the excess policy stimulus. Some political risks have also receded, mainly in Europe, as pro-European forces have maintained power in France and will most likely in Germany at the upcoming election in September. After September, there is a four-year political window free of national elections in the core of Europe (something that occurs only once every two decades or so, given their election cycles). The political stars are aligning in the euro area for major political and economic reforms, which should be viewed as positive.

As central banks scale back years of aggressive monetary stimulus, our signposts will be monitoring a number of key economic and policy developments to determine their success. After years of underinvestment, investment growth must pick up in order to lift growth and increase long-term potential GDP. While there have been tentative signs of a pickup, this must continue in order to ensure the self-sustainability of this recovery. Fiscal policy will be required to remain looser than tighter to cushion the removal of quantitative easing. The global economy will also need to demonstrate it is not unduly sensitive to rising interest rates, despite a higher level of debt today than at the start of the GFC.

Whether tapering can be successful without creating a financial market tantrum is an important question that remains unanswered. This will be a prevalent issue on the minds of financial markets over the next 12 months. It is also likely to create more volatility in the coming forecast horizon than we have witnessed so far this year. We suspect that it will continue to be a challenging balancing act for central banks as well as for investors, as they attempt to navigate this policy and economic transition.

Alternative Scenarios

Global Recession

We suspect that the key recession risk is more likely to come from the U.S., which is the most advanced in its business cycle. We are watching financial stability risks that could come from the corporate leverage build-up as interest coverage ratios fall with rising interest rates. Stronger wage increases would support the rise in inflation but could put downward pressure on corporate profitability. Policy risks, both monetary and fiscal, are also prominent in the U.S. The pace of interest rate hikes and/or the shrinking of the Fed balance sheet could be more damaging than expected, causing a meaningful tightening in financial conditions. Failure to pass healthcare legislation would reduce the fiscal flexibility to pass meaningful tax cuts that would be stimulative to the U.S. economy. Global trade tensions could also be back on the agenda, which could be disruptive to business and consumer confidence and exacerbate a potential downturn. Finally, the recent chorus of central banks voicing their intentions to renormalize monetary policy could turn into a policy mistake that miscalibrates the sensitivity of the global economy to rising interest rates.

U.S. Renormalization

Stronger-than-expected U.S. fiscal stimulus and infrastructure spending in China could provide enough stimulus to push global economic activity higher than in our *Balancing Act* central scenario. This would bring faster-than-expected renormalization of U.S. monetary policies. Stronger earnings growth would provide an offset to higher interest rates, supporting equity market valuation and providing stronger-than-expected returns. We have limited this renormalization to the U.S. economy. However, recent signs of strength in the Japanese and European economies and reduced slack in their labour markets have led to discussions around renormalization of monetary policy outside the U.S. as well. Furthermore, constructive political developments in Europe could lead to improved business and consumer sentiment and stronger economic activity than in our central scenario.

Fixed Income Versus Equity

Late-cycle expansion with rising headwinds

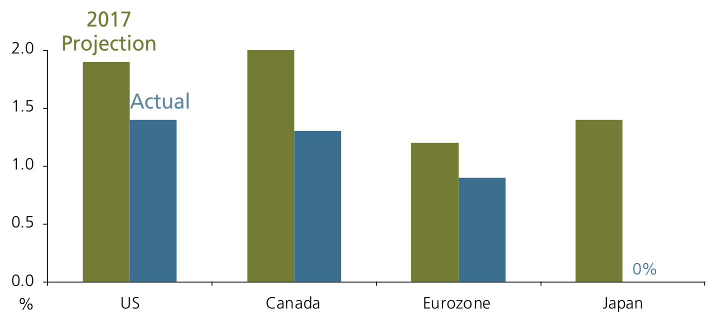
After strong growth in late 2016, global economic momentum has faded this year. Supported by accommodative monetary conditions, the global economy should eventually resume its sluggish expansion and grow in line with its economic potential. However, the expansion is getting long in the tooth, headwinds are rising and growth could disappoint market expectations. The global credit impulse, a measure of credit growth in the economy, has turned negative and become a headwind to economic activity. Imbalances are rising—in the form of excess leverage, overvalued real estate prices and excess capacity in commodity production.

Despite the slowdown and these rising headwinds, risk assets such as high yield bonds and equity markets have so far proven resilient, implicitly assuming a goldilocks-style backdrop. Valuations in both high yield credit and equities are becoming less compelling, and further disappointment in data could prompt investors to question the growth path ahead. Equity markets have, for the most part, so far disregarded the unfolding slowdown. The good news is that gains have been mostly driven by higher earnings. While earnings have been robust, slower economic growth will likely translate into slower earnings growth. Equities may still end up generating positive returns over the long term, and even over a tactical horizon. For now, however, the rising possibility of an economic bump makes them less attractive on a risk/reward basis.

Inflation pressure should be balanced between upside pressure from an economy at full potential and downside pressure from global deflationary forces. Despite a unemployment gap that has closed in the U.S., wage inflation has been very modest. Structural trends in the composition of the labour market play a big role in containing wage inflation. This comes at the same time as broad weakness in goods inflation and commodity disinflation, in part from an oversupplied energy market and an engineered slowdown in China. The Fed is expected to continue on its normalization path, albeit at a slow pace, and will most likely favour being behind the curve as opposed to preempting any building inflation pressure. The ECB sees an improving economic outlook with no inflation pressure. While the ECB can justify leaving its QE program in place because inflation is expected to remain below target, there is a limit to how long tapering can be delayed. In China, the policy objective behind the recent credit tightening is not an economic slowdown, but rather engineered, targeted deleveraging.

The current backdrop encompasses an economy growing at potential yet slowing, a lack of strong inflation pressure and gradual policy normalization. As a result, we see more opportunities in the relative movement between economic regions than between broad asset classes—we are maintaining our neutral stance between equity and fixed income. Government bond yields should remain in a wide trading range. We continue to anticipate the outperformance of select emerging market bonds, as their macro fundamentals remain on a stable or improving path. General improvements in current account balances across the emerging market universe, stable domestic inflation and decent growth offer a continued opportunity to earn attractive carry in the strongest markets.

Central banks (year ago) projections for inflation in 2017 vs. actual



Source: ECB, BOJ, Fed, BoC & CIBC Asset Management Inc.

Equity Market Outlook

P/E expansion passes the baton to earnings growth

The consensus is still upbeat on the earnings outlook. After 8% growth for global equities in the past 12 months and some abating tailwinds, earnings should remain buoyant, yet lose some of their momentum. Some of the recent gains came from the recovery from depressed levels for commodity companies' earnings. This effect has been particularly strong in Canada, where earnings have almost doubled in commodity-related sectors. International and emerging markets, as compared to the U.S., are less advanced in their economic cycle and have more potential to maintain strong earnings growth. This revival in earnings growth is very welcome. Until early 2017, most of the gains in equity prices were driven by higher P/E ratios, and little came from higher earnings.

Canadian equities have underperformed global markets year-to-date, as oil prices dropped and the reflation trade was being priced-out. There is still some upside to energy earnings, but growth is bound to decelerate as the base effect (i.e. the comparison to depressed prices in a previous period) fades. Canadian equities are overvalued in absolute terms, but slightly more attractive when compared to other markets.

Valuation in U.S. equities is expensive no matter how we look at it. In recent years, low interest rates and inflation have supported ever higher valuations. But P/Es are already higher than was typical in other similar, low-inflation episodes. Small firms with high leverage are starting to feel the effects of the Fed renormalization, with higher interest expenses eating into profit margins. Larger firms still have high interest coverage ratios, but a continued rise in interest rates would put that under pressure. The U.S. market remains our largest underweight.

In Europe, the economy is showing signs of improvement, and some of the political uncertainties have been reduced with the large majority win of new French President Macron. Earnings are quickly accelerating and have room to keep growing. Europe is still just recovering from years of weak growth. Profit margins do not immediately face the headwinds of higher debt servicing costs and higher inflation in employees' compensation. Valuation is also more attractive than in other regions. The start of the Brexit negotiations will lead to some volatility in the markets, and some concerns remain in Italy. But Europe does offer good potential for catch-up growth at a reasonable price. This is thanks to an improvement in fundamentals and a central bank that will stay accommodative for longer as inflation data has been disappointing.

Emerging markets offer the best long-term value in the equity universe. However, the cyclical picture has weakened lately. China now faces the fading impact of last year's fiscal easing, at a time when monetary conditions are tightening. In the past year, we've seen a strong rebound in earnings in Asia (ex. China), Eastern Europe and Latin America. Emerging markets will still benefit from the continuing economic expansion and remains our largest overweight.

Commodity Insight

Given the implications for resource demand, China's economic outlook is a focus for Canadian investors. This year is of particular significance, given it will see the 19th meeting of the National Congress of the Communist Party of China (or the Party Congress), in October/November. Market consensus anticipated that the central government would support the Chinese economy ahead of this meeting to help ensure both social stability and the status of the current leadership. The economic paths, post this meeting, and the willingness of the government to remain supportive have been areas of debate.

In early 2016, the Chinese government implemented a stimulus program that led to an industrial and construction cycle which supported price improvements in commodities globally. This stimulus came after a multi-year inventory destocking, and the resulting credit impulse led to a large restocking cycle and pursuant industrial growth. As the capital spending surge has leveled off in 2017, investors have become concerned over the durability of growth into the second half of the year and 2018.

However, looking through the industrial restocking, we see a continued positive backdrop for a number of resources that should support pricing, contrary to current consensus expectations. Fundamentals for both zinc and copper continue to improve as supply constraints, due to a lack of new mine supply or mine disruptions, are leading to a tightening of these markets. In addition, the iron ore price decline appears to have more to do with speculative curtailment than fundamentals and the recent price recovery supports this thesis. Chinese domestic supply continues to be curtailed and has not restarted post the 2015 price declines. Furthermore, steel production continues to be robust to date and mill profitability remains very strong.

Fixed Income Outlook

More challenging times ahead

Over the first half of 2017, bond yields generally drifted lower and global bond markets outperformed most forecasters' predictions. In the second half of the year, the outlook promises to be more challenging.

Although the Fed launched its monetary policy renormalization campaign some time ago (late 2015), other major central banks are only now seriously considering easing up on the monetary accelerator. Across the developed world, economic and financial conditions no longer justify the ultra-accommodative policy stance still in place. What's more, central banks like the ECB and the Bank of Japan cannot pursue quantitative easing indefinitely. This is due to some program limitations and the distortions to financial market pricing these policies can cause. This implies that policy renormalization via reduced asset purchases has to be seriously contemplated. We anticipate that communicating these required policy changes will be challenging and could potentially trigger increased market volatility, as we experienced towards the end of June.

Under such conditions, it will be difficult for North American bond markets to remain well-behaved. This is particularly true in the context of a Fed determined to further renormalize its monetary policy stance and a more hawkish Bank of Canada (BoC). For these reasons, bond yields in the United States and Canada are expected to head higher over the forecast horizon.

Having said this, the rise in bond yields should be limited. For the last few months, we have witnessed fewer and fewer global inflation surprises. In fact, in light of the recent developments in commodity prices, the global reflation theme is increasingly turning into a "global disinflation" theme. In the context of intensifying global disinflation, a brutal global bond market pullback seems unlikely. Our twelve-month forecast calls for U.S. and Canadian 10-year sovereign bond yields hitting 2.5% and 1.85%, respectively, by the middle of 2018.

Currency Markets

U.S. Dollar

The U.S. dollar bull market is starting to show its age. After three consecutive years in rallying mode, the greenback has appreciated by more than 25% on a real effective basis. Since the beginning of the year however, we have witnessed broad-based U.S. dollar weakness. Is a trend reversal in the making or does this simply qualify as a short-term, countertrend pullback? The answer will depend on the determination of the central banks outside of the U.S. regarding monetary policy renormalization. What has changed this year is that the monetary policy divergence between the U.S. and the rest of the developed world has not been as supportive for the U.S. dollar. True, the Fed has remained in tightening mode. However, other central bankers have started signaling their intentions to begin reversing course on their own aggressive policies, particularly in Europe.

Whether they find the courage to actually start easing up on the accelerator remains to be seen. While economic conditions seem strong enough, developments on the inflation front are still not adequately convincing. As a result, there will likely be a lot of back and forth on the part of monetary authorities, with some risk of policy mistakes—the perfect recipe to produce increased currency market volatility. Looking forward, the U.S. dollar is expected to remain in consolidation mode in real effective terms within a wide trading range.

USD: Trend reversal or countertrend short-term pullback?
CAM U.S. Dollar real effective index

Source: CIBC Asset Management Inc.

Canadian Dollar

Fuelled by the BoC's drastic change in views, the Canadian dollar gained substantial ground against the U.S. late in the second quarter. Previously concerned that Canada was stuck in a low-growth environment, the BoC is now convinced that the Canadian economy is on more solid footing. As a result, the two rate cuts delivered more than a year ago to cushion the impact of the oil shock are no longer viewed as necessary. Currency-wise, whether Canadian monetary authorities actually hike rates once or twice before year end is of little relevance. The Canadian dollar has, to some extent, already priced in such policy actions.

From this point on, the relevant question to determine the Canadian dollar outlook is whether the BoC's projections for the Canadian economy and inflation will materialize or not. If they don't (as we suspect), the BoC will certainly strongly hesitate before actually delivering rate hikes. This is especially true given the strong appreciation of the Canadian currency and the prevailing weakness in oil prices. Given the forces at work, we see limited short-term upside for the Canadian dollar at current levels. Over the longer-term, the Canadian dollar is expected to drift lower, owing to a BoC-led downshift in relative Canadian versus U.S. monetary policy expectations and more persistent oil price weakness.

Euro

We expect the EUR/USD to gradually retrace towards fair value over the next 12 to 18 months, from its current undervaluation of approximately 10%. While European growth has improved and the ECB's normalization process has slowly begun, our euro appreciation expectations remain somewhat restrained from current levels. Ultimately, eurozone inflation expectations continue to be subdued owing to existing slack in the labour market—we expect that will cap euro appreciation in the year ahead. Adding complexity to the outlook is the fact that the ECB has less flexibility to restrain the euro's appreciation, given the reduced monetary policy flexibility. The ECB has very little leeway left on policy rates. At -0.4%, the ECB's deposit facility policy rate is already close to what is generally viewed as the lower limit. Meanwhile, short-term market interest rates have moved even deeper into negative territory, owing to market dislocations.

If lowering rates is no longer a possibility, the only option left for the ECB would be to keep its asset purchasing program unchanged (i.e. delay any QE tapering). This relies on the hope that excess money supply conditions would be enough to keep the euro weak. The problem here is that the expansion of the ECB's balance sheet has not just been a result of the asset purchasing program (QE). The TLTRO lending scheme accounts for 40% of the expansion (see chart on page 8). The last TLTRO refinancing operation took place in early March, with banks borrowing 233 billion euros more from the ECB. In other words, the TLTRO II refinancing program has been completed. This implicitly amounts to a reduction in the overall amount of euros injected into the financial system.

Still significantly undervalued and fundamentally well-supported via a current account surplus, the upward pressures on the euro are intensifying. Keeping the euro in undervalued territory will be difficult for the ECB. Under such conditions, the euro's downside against the USD should prove to be limited.

Japanese Yen

Under its current "inflation-overshooting" commitment, the BOJ is insisting that it will continue expanding the monetary base. This will occur until the year-over-year rate of increase in the observed CPI inflation rate exceeds the price stability target of 2% and stays above target in a stable manner. However, the BOJ's preferred inflation measure (core ex-fresh food) is now running at 0%—still a very long way from target. Given its commitment, the BOJ is unlikely to put an end to its asset purchasing program (QQE policy).

The U.S and Europe are already signaling a retreat from their non-conventional policies and converging towards a gradual monetary policy renormalization. Japan stands in stark contrast by keeping its yield curve control policy operative. This policy divergence is likely to cause the yen to diverge (remain weak) against other major currencies. The caveat is if the Japanese economic recovery is unsuccessful at lifting inflation soon enough. This must occur before the BOJ runs into its own policy limits and can no longer buy Japanese government bonds (JGBs) in sufficient quantities to keep the yen from appreciating. To be successful, the BOJ needs to slow the pace of purchases significantly and maintain market confidence through forward guidance. This will remain a difficult balancing act.

Regional Outlook
Canada

Peaking economic growth momentum should force the Bank of Canada to be moderate in its monetary policy renormalization

The Canadian economy has finally shifted into higher gear in a convincing way, exceeding our growth expectations. Recently, the Canadian economy has been strong enough to convince the BoC that it is time to introduce a more hawkish policy bias. Canadian monetary authorities now believe that it may soon be time to ease up on the accelerator. This represents a drastic change in views and is a long way from the "lower-for-longer" narrative adopted by the BoC more than a year ago. We agree with Governor Poloz and his team that the Canadian economy is now on more solid footing—and we have accordingly revised our growth projections upward. However, looking forward, some growth disappointment likely lies ahead for the following reasons:

First, oil prices have not been following the BoC's script, which assumes that oil prices will average $55 over the forecast horizon. With oil prices now trading below $50, this forecast is very much at risk. If oil prices don't soon recoup the ground recently lost, the boost provided to the Canadian economy by the energy sector could quickly turn into a drag. Second, we are less upbeat than most forecasters on the outlook for consumer spending. This is owing to receding tailwinds from consumption credits and fiscal stimulus transfers. Consumer credit growth is elevated and has little room to expand, while the positive influence of government transfers on growth has mostly ended. Third, given our below-consensus view on U.S. economic prospects and the recent BoC-induced appreciation of the Canadian dollar, we think that Canadian non-energy exports will likely disappoint. Last but not least, disappointing demand will restrain business investment, a sector where the BoC has high expectations.

For all these reasons, we are working with a below-consensus projection of +2.0% for real GDP growth. This expected growth disappointment will contribute to weak inflation, already held back by lingering supply-side factors such as increased competition and weak trend productivity. With the weakest momentum for inflation in nearly two decades and the Canadian dollar close to its yearly highs, the BoC will likely be forced to stay on the sidelines for longer than generally expected.

United States

- **U.S. real GDP growth is projected to average +1.9%, a less optimistic view than consensus.**
- **If our below-consensus forecast materializes, the Fed will likely take longer than generally expected before hiking rates again.**

As widely expected, the Fed delivered another rate hike in June. In the Fed's judgment, the U.S. economic and inflationary prospects were strong enough to justify a further removal of credit easing. The target range for the Fed's policy rate now stands at 1.0% to 1.25%. With interest rates still very low, it might be tempting to conclude that there is no reason to be concerned about the risk of a Fed policy mistake. After all, the Fed has been very prudent, moving gradually since the beginning of its monetary policy renormalization campaign in late 2015.

While it is true that interest rates are still very low, the fact remains that the Fed has been draining excess liquidity out of the U.S. financial system. This has become apparent in the U.S. bank lending numbers. Over the last six months, credit growth has slowed for nearly all credit types—from longer-term lending to purchase homes to shorter-term lending to buy cars and other durable goods. The overall U.S. credit support remains positive, but has been cut by half—from 3% to 1.6% of GDP. At the time of the last Fed tightening campaign in the mid-2000s, it took four times more Fed policy tightening to produce a similar impact on credit growth. In other words, the slowdown in credit growth now underway is already four times larger than what was observed in previous tightening cycles.

Given the magnitude of the credit growth slowdown currently unfolding, it is hard to imagine that it won't negatively impact the interest-sensitive sectors of the U.S. economy. There is already some early evidence of cooling activity in the housing and retail trade sectors. Another interest-sensitive sector that deserves particular attention is commercial real estate. Commercial real estate bank-lending growth has been cut by half, from more than 12% to 6%. In the meantime, commercial real estate prices appear to have peaked at overvalued levels. Commercial real estate ranks at the top of the Fed's list of concerns.

In light of these developments, it is hard be very upbeat about U.S. economic growth prospects. Our twelve-month forecast calls for +1.9% average real GDP growth and 1.8% headline CPI inflation between the third quarter of 2017 and the second quarter of 2018. If our below-consensus forecast materializes, the Fed will likely take longer than generally expected before hiking rates again.

Europe

With improving economic prospects for the eurozone and abating deflationary headwinds, the ECB was expected to start signaling its intentions to proceed with some form of policy renormalization. While the ECB did hold a policy-setting meeting in June, there was no concrete declaration on the need to eventually start renormalizing policy. Instead, the ECB provided its new multi-year forecast for the eurozone economy, penciling in stronger economic growth but weaker inflation. By doing so, it deliberately signaled to markets that policy accommodation will likely be required for a while longer. What explains this policy move?

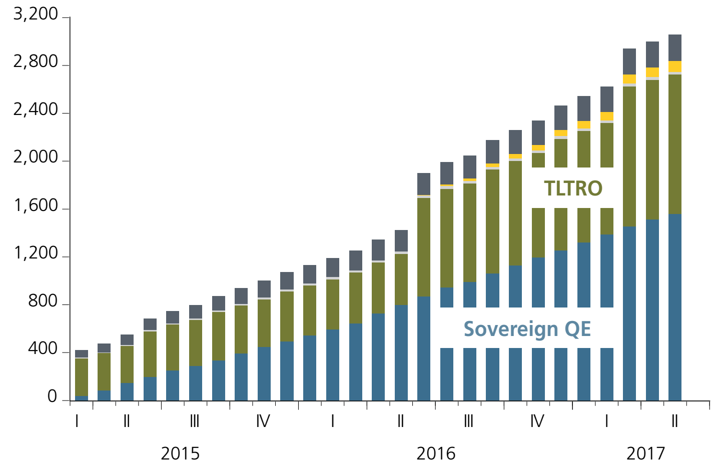
One thing has changed over the last three months: the euro has been strengthening. By considering only the EURUSD bilateral rate, it could be tempting to conclude that there hasn't been enough euro appreciation to seriously alter inflation and eurozone growth prospects. However, on a trade-weighted basis, the euro move has been fairly significant, justifying ECB concerns.

On the inflation front, euro appreciation that is too strong (on an import-weighted basis) would unavoidably lead to import price deflation and make it nearly impossible for the ECB to reach its inflation target. With regards to the economy, what happens next to the euro is just as important. For the last five years, eurozone recovery has essentially been export-led. Strong foreign demand and the undervaluation of the euro allowed for a sharp widening of the eurozone trade surplus with the rest of the world. More precisely, eurozone economies gained significant market share in two foreign markets: the United States and the United Kingdom. The eurozone now has a record trade surplus with both economies and could lose its competitive advantage if the euro appreciated too much on an export-weighted basis. This would amount to choking the economy's growth engine—not a desirable outcome.

Under these conditions, the ECB's efforts to delay policy renormalization as much as possible are not surprising. However, there is a limit to how long it can be delayed. Because of the "sub-zero rate and QE policy" combination currently in place, the ECB is facing intensified tensions in specific market segments—specifically, at the short end of the German bund curve. This critical dislocation is a direct consequence of the scarcity of German bonds, which results directly from the ECB's massive purchases. Tapering is unavoidable; if nothing changes, there will be no bunds left to buy by the spring of 2018.

ECB Policy: Not just about QE

Cumulated interest in ECB balance sheet (EUR Billions)



Source: Thomson Reuters Datastream & CIBC Asset Management Inc.

China

Expect slower growth as stimulus unwinds

- **The unwinding of policy stimulus will result in some growth deceleration over the next year. Our projection for real GDP growth is +6.1% by Q2 2018.**

- **With CPI increases below the target growth rate, Chinese central bank policy has room to become increasingly accommodative.**

The Chinese economy has shown significant firming over the past year, with GDP growth reaccelerating to +6.9% year-over-year. This growth reacceleration was supported with significant stimulus through increased government spending, lower interest rates and a depreciating currency. Looking ahead, the unwinding of this stimulus will result in some growth deceleration over the next year. Our projection for real GDP growth is +6.1% by Q2 2018. This deceleration will result from a slowdown in activity in the industrial sector, which has already started showing some signs of peak growth. Another important reason for the slowdown is the ongoing deceleration of growth in fixed investment. From a structural perspective, the fixed investment slowdown is a result of China's aim to rebalance its economy away from fixed investment and towards increased consumer spending.

The Chinese central bank's policy will likely continue to be driven by an environment where CPI increases are below the +3% target over the next 12-months. CPI growth has failed to gain enough traction to sustain a growth rate of over +2% year-to-date. This occurred despite a large advance in producer price inflation, which achieved its strongest growth since 2011 (+7.8% over the past year). Now, the commodity price environment is pointing to a significant deceleration, and consequently a renewed weakness in producer price inflation. This will likely weigh on consumer price growth in the months ahead. Note that even core inflation has only averaged +2% year-to-date and expectations do not warrant a sustainable acceleration over the coming year. As a result, the central bank will have the option to maintain a relatively flexible policy environment and could adopt an increasingly easy policy stance if needed.

China reached an important milestone in June with the introduction of its domestic equities into the MSCI Emerging Market (EM) and All Country equity indices. This represents another step forward in the deepening of its financial markets. The inclusion process will, however, be relatively slow and undertaken in two steps. Chinese domestic equities will initially comprise only 0.73% of the MSCI EM index, representing less than $20B in funds allocated to Chinese shares by August 2018. MSCI suggested that further financial, regulatory and economic reforms will be needed to increase the size of China's inclusion in the future. However, now that the initial inclusion is underway, China is likely to see its index size increase in the years ahead. This will provide much-needed capital inflow to offset potential capital outflows from local investors looking to diversify their domestic holdings.

Signposts

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

Canadian Signposts

- Employment growth, wage growth
- Housing activity and property prices
- Retail sales (monitoring impact of fiscal policy)
- Oil impact on trade balance (energy vs. non-energy)

U.S. Signposts

- Fiscal policy announcements (healthcare reform, tax cuts, tariffs etc.)
- Wage growth (best measure is Employment Cost Index)
- Core PCE inflationary pressures (favoured Fed measure)
- Domestic oil production trend (following OPEC agreement)
- New orders versus inventories
- Capital goods orders (monitor investment growth)

Chinese Signposts

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

Other Market Signposts

- European bank lending
- ECB tapering announcements
- Brexit negotiations
- German and Italian elections
- Global Purchasing Managers' Indices
- Eurozone banks' relative performance
- U.K. commercial real estate activity