2023 LONG-TERM EXPECTED RETURNS FOR CAPITAL MARKETS

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Every year, CIBC Asset Management develops long-term capital markets expectations for a number of asset classes to guide investors with their strategic asset allocations. The Multi-Asset and Currency team prepares the projection, with inputs from our fixed income and equity teams. Our team includes economists, quantitative analysts, investment strategists and portfolio managers.

Key takeaways for the next 10 years

- **Growth:** Potential GDP growth will decelerate, influenced by the trend in demographics. Stable productivity growth will not provide an offsetting trend.
- **Inflation:** Unfavourable supply-side forces should keep inflation somewhat above central banks' targets over the long term. This is a stark contrast with the period of low inflation that followed the Great Financial Crisis and preceded the Covid-19 pandemic.
- **Monetary policy:** Monetary policy will be more difficult to conduct in the context of more persistent inflation, which should lead to higher terminal policy rates.
- **Cash:** It is now a reasonable alternative to risky assets. This is important because the risk premium on risky assets is expressed relative to the return on risk-free assets (i.e., cash). However, this attractiveness is magnified by current cyclical conditions; policy rates are generally above their respective long-term terminal values, providing a temporary boost to the long-term average cash return.
- **Fixed income:** Global fixed income is expected to return 2.7% (up from 1.6% last year). Bond yields have moved up and so will provide more attractive income. However, as bond yields increased, inflation has pushed up fair value as well. The inversion of the yield curves will limit the potential return on fixed income.
- **Developed market (DM) equities:** Global equities are expected to return 5.5% in CAD (up from 4.0% last year). Sales are expected to grow in line with trade-weighted nominal GDP, which will be lower than historically. Profit margins have been supported by globalization and technology but are historically strong, and these forces will abate. Valuations have decreased from overvalued levels but are still somewhat elevated.
- **Emerging markets (EMs):** Emerging countries still rank as the most attractive region, for both equities and fixed income. EMs have better growth prospects due to more favorable demographics and higher productivity growth. That said, the gap over DM economies is narrowing as EM economies catch up to them. Undervalued currencies will also contribute to returns in EM asset classes.
- **Alternatives:** In order to potentially improve their returns and thereby hedge against inflation risks, as well as to provide diversification, investors should consider including alternative investments in their portfolios. Private market alternative investments offer expected potential returns above 6%. However, prospects are highly heterogenous, reflecting specific and concentrated idiosyncratic risk.

Table 1 – Long-term expected returns in selected currencies (highest to lowest)

Asset classes	CAD (%)	USD (%)	Vol. in CAD (%)
MSCI Emerging Asia	10.9	12.0	14.2
MSCI Emerging	10.6	11.7	13.3
MSCI Emerging LATAM	9.7	10.8	23.9
JPM Emerging Gov. Debt	8.3	9.3	7.8
MSCI Japan	8.1	9.2	12.3
MSCI Emerging Europe	8.0	9.1	39.9
Canada S&P/TSX	6.8	7.8	12.5
MSCI EAFE	6.6	7.7	11.9
NAREIT Developed Real Estate	6.4	7.6	16.3
Private Debt	6.3	7.4	10.4
Private Infrastructure	6.3	7.3	14.9
Brookfield Global Infrastructure	5.9	7.0	14.9
Private Core Real Estate	5.9	7.0	14.7
MSCI Europe	5.8	6.9	13.2
Commodities	5.7	6.8	29.4
MSCI All Country World	5.5	6.6	11.3
Canada Corporate	5.2	6.3	5.3
US High Yield	5.0	6.1	7.4
US Corporate	4.2	5.3	8.4
US S&P 500	4.1	5.2	12.2
Canada Universe	3.5	4.6	4.9
2-y Canadian Bonds	3.0	4.0	1.2
JPM World ex-Canada	2.7	3.8	8.3
CN 10-year Government	2.7	3.8	6.6
US 10-year Treasury	2.3	3.4	11.1
Average Local Inflation	2.1	2.2	
Terminal Local Policy Rate	2.3	3.0	
Average Local Cash	3.7	3.9	

Alternatives · DM fixed income · DM equity · EM fixed income · EM equity

Source: CIBC Asset Management calculations (projections based on data available as of January 31, 2023).

Key forces that will shape the global economy

Labour and its productivity are the two inputs of potential GDP growth from a supply perspective. Over the next 10 years, slowing or declining population will weigh negatively on potential GDP growth, while a full offset from higher labour productivity appears unlikely. As a result, real potential GDP growth will continue to decline at a slow but steady pace, particularly for countries with more adverse demographics and faster aging.

Most EMs should continue to experience higher productivity growth than DMs, generally retaining their positive growth differential in relation to DMs.

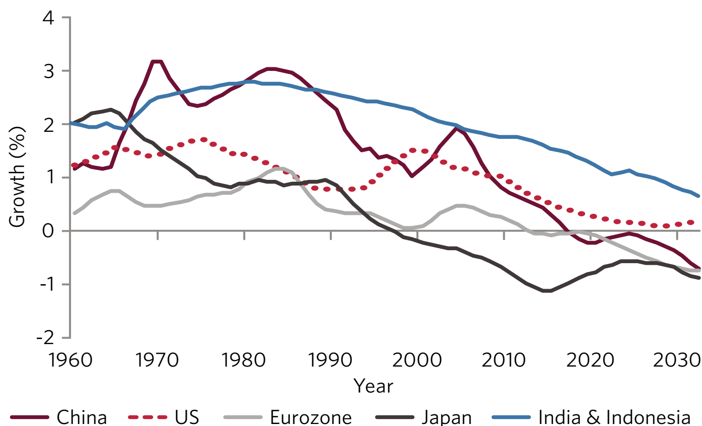
Regarding prices, we expect several supply-side forces to keep inflation somewhat above central banks' targets, complicating the conduct of monetary policy in a context of elevated indebtedness and loose fiscal policy.

Potential GDP force 1: Increasing but uneven demographic headwinds

Labour force growth has contributed to slower growth for most countries in recent years, contrasting with prior decades of relatively constant and decent support. Long-term projections show more headwinds or receding tailwinds from this channel.

Figure 1 presents examples of uneven prospects across the most populous economies. China and the eurozone are part of a long list of economies that will follow Japan's path of a declining population. This is unprecedented. The second, third, and fourth largest economies will experience a decline of their respective labour forces. Other manufacturing countries, such as Korea, Taiwan, Thailand, and eastern European countries, will experience a contraction.

Figure 1 – Demographics: a lingering but uneven headwind
Working age population growth, United Nations projections



Sources: Refinitiv-Datastream, CIBC Asset Management calculations based on data available as of January 31, 2023.

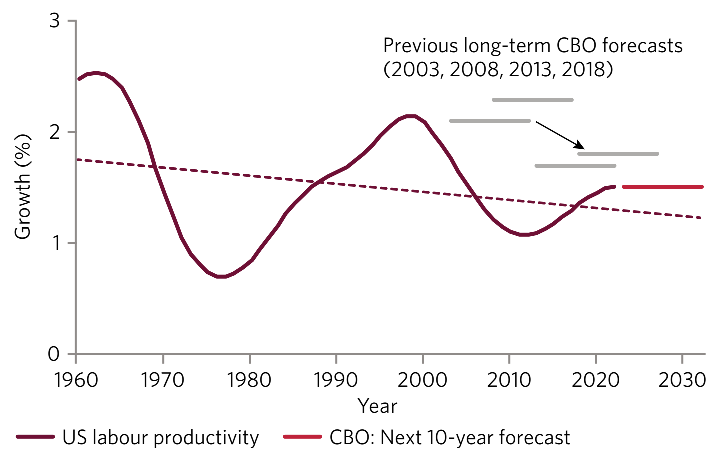
Meanwhile, immigration is projected to keep population growth positive in the Anglosphere, limiting the decline of potential growth. For example, the US Congressional Budget Office (CBO) projects that immigration in the US will account for nearly 2/3 of population growth in 10 years. However, there is a risk that political opposition could reduce the reliance on immigration.

In populous low-income countries in Asia (such as India, Indonesia, and the Philippines) and in Latin America (LATAM), relative demographic prospects are better, with population growth projected to remain a decent growth tailwind, although a smaller one. Furthermore, countries with better demographic prospects generally have a younger population. They should continue to attract manufacturing foreign direct investment (FDI), especially in a context of more acute labour scarcity in DMs and China. For example, the median age in India is low at 28, well below China (38), Japan (48), and the US (38); it is instead similar to that of China in 2000.

Potential GDP force 2: No relief from higher labour productivity growth

The CBO has overestimated long-term labour productivity growth most of the time since the early 2000s (see **Figure 2**). Its current forecast of 1.5% corresponds to the long-term average.

Figure 2 – Labour productivity unlikely to provide an offset



Sources: CBO, Refinitiv-Datastream, CIBC Asset Management calculations based on data available as of January 31, 2023.

It appears more difficult for productivity to surprise on the upside and replicate the transient boost that took place between the second half of the 1990s and the first half of the 2000s. Over that period, a more widespread use of computers and the rise of the internet expanded production and market frontiers, making it easier to do business.

Until the late 1960s, a more widespread use of internal-combustion engines, telecommunications, and electrification, in a context of strong urbanization, had similar but larger positive effects on the supply-side of the economy.

However, the technological advances we've witnessed since the early 2000s have not boosted the production frontier in the same manner, resulting in lackluster productivity growth. According to Gordon (2012)[i], a prominent academic in the field of productivity, the nature of innovation since the early 2000s has "centered on making entertainment and communication devices smaller, smarter and more capable, but has not fundamentally changed labour, productivity or the standard of living." In a more recent paper, Gordon (2018)[ii] concluded again that ongoing innovation has had less impact in raising productivity growth than formerly.

Like the CBO, a surge of productivity is not our base case. The working assumption is productivity growth remaining around its historical average at 1.5%.[iii] We will be monitoring the effects of growing adoption of digitization, communication tools, AI, robotics in healthcare, health monitoring, and other innovations that could lead to a transitory acceleration in productivity growth. However, the timing of an aggregate labour productivity boost, if any, is uncertain. Also, the 1.5% assumption is above the current trend line, suggesting downside risks. On net, we consider risks surrounding this assumption to be balanced.

US productivity is an important variable for our projection. Historically, it has been highly correlated with the common component of productivity growth across economies. In our framework, productivity growth across countries is impacted by this common component and country-specific factors. One of the factors for EMs is the "emerging" character of their economies, which results in larger GDP and productivity growth rates.

History shows that growth in EM countries 'emerges' when they have sufficiently adequate institutions and are able to attract foreign capital. In that case, the lower the GDP per capita is, the stronger we should expect productivity and GDP growth to be in the future, resulting in a more rapid subsequent increase of GDP per capita. This emerging force has boosted economies like Singapore, Korea and Taiwan in the past. China is still in the process today, while India and Indonesia are at earlier stages. Most EMs are benefiting from this tailwind. The EM story is important because the low absolute growth outlook we expect for most DMs makes the "emerging" story of EMs more appealing, particularly in Asia.

Higher trend inflation from supply shocks

Supply-side forces have pushed down global trend inflation in the last three decades: China's rapid integration into the global economy with its large pool of young and available workers; a declining global age-dependency ratio; and a rising supply capacity of fossil energy (in the past decade). We expect the negative contribution to inflation from these forces to disappear, resulting in higher trend inflation compared to the last ten years.

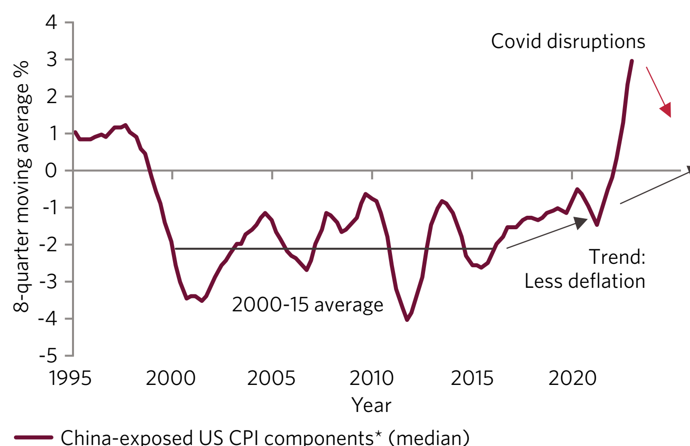
Shock 1: Deflation coming from China to end

China's rise and integration into the global economy in the past decades has boosted the global supply capacity in an unprecedented manner. China now accounts for about 30% of global manufacturing production, up from less than 5% thirty years ago.

The rise of China has been a prolonged transitory event, resulting in global supply capacity rising more rapidly than global demand, contributing to a deflation of manufactured goods.

This is visible in the US CPI where components of the basket exposed to imports from China have been in deflation since the mid-1990s (see **Figure 3**). The decline of deflation we've witnessed since around 2017 has coincided with the start of a secular decline of the working-age population in China.

Figure 3 – China's receding deflationary influence in US CPI



* Toys, footwear, home furnitures, durable goods ex. motor vehicles.

Sources: Refinitiv-Datastream, CIBC Asset Management calculations based on data available as of January 31, 2023.

China's working-age population is projected to decline by about 5% in the next ten years. Furthermore, the median age is projected to reach 45 years by 2035. With labour becoming less abundant and older, the deflation of manufactured goods from China should continue to disappear (as a trend) and eventually translate into mild inflation. This swing would increase inflation across countries by about 0.1 to 0.2 percentage points on average.

China's demographic challenges represent a boon to populous low-income countries. However, we don't expect they'll be able to generate an increase of manufacturing capacity proportional to what China accomplished. India, for example, has a much more fragmented political system, complicating and slowing the implementation of large-scale industrial policies. Indonesia, the fourth-most populous country, offers appealing manufacturing prospects, but its population is only about one fifth of China's.

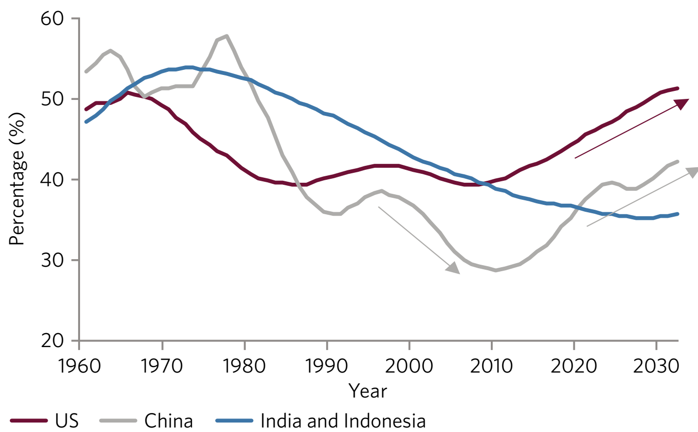
Shock 2: Ageing to bring higher services inflation in most countries

Ageing has been a key driver of the swings of trend inflation over time and across countries (Juselius and Takats, 2018).[iv] The dependency ratio, a measure of the number of dependents to the total working-age population, was a key driver of rising US inflation in the 1970s. It resulted in a subsequent decline of trend inflation. Dependency ratios in the US, in most DMs, and in China are expected to increase further, reaching levels last seen in the 1970s (see **Figure 4**).

Figure 4 – Higher dependency ratio, higher inflation

Dependency ratios, United Nations projection

(<15y old + >65y old)/working age population



Sources: Refinitiv-Datastream, CIBC Asset Management calculations based on data available as of January 31, 2023.

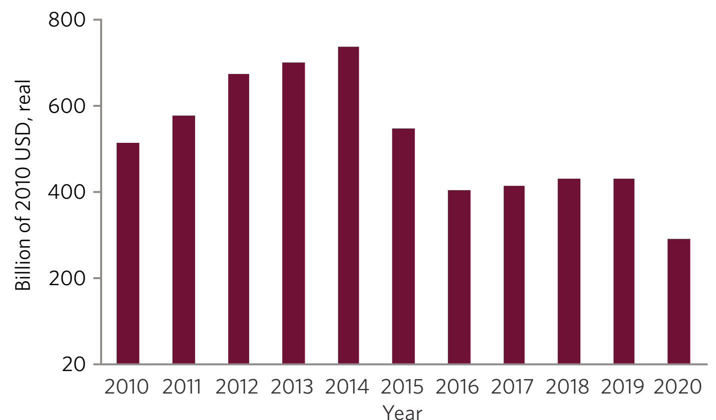
Note that each age cohort has a different impact on inflation. Increases of the dependency ratios caused by a young population have been much more inflationary than increases caused by an ageing of the population. Using elasticities of the aforementioned paper (and applying them to services inflation only), we estimate that the ageing of the population is compatible with trend inflation moving up by 0.1 to 0.2 percentage points on average in most DM economies. Meanwhile, dependency ratios in most EM economies are not expected to increase materially.

Shock 3: The energy transition is inflationary

One characteristic of the decade that followed the Global Financial Crisis was a downward trend of energy inflation in most countries, reflecting the surge of production capacity of both shale oil in the US and coal in China. In the US, for example, energy inflation averaged -1.2% between 2012 and 2019. Absent of overheating demand or supply-shock, energy inflation has averaged about 3.0% historically—which is our working assumption for the next 10 years. We expect environmental considerations to result in higher trend energy inflation (compared to the last 10 years). This change of regime would increase trend inflation by almost 0.1 percentage point in DMs and by 0.2 percentage points in EMs, depending on the size of energy in CPI baskets.

Higher energy prices would come from three channels. First, the global underinvestment in oil (**Figure 5**) should remain in a context of ESG constraints, supportive of ongoing upward pressures on oil prices.

Figure 5 – Global investment in oil and gas



Sources: IEA, Refinitiv-Datastream, CIBC Asset Management calculations based on data available as of January 31, 2023.

Second, self-imposed objectives of slowing CO_2 emissions in EMs, particularly in China, should bring additional upward pressures on coal prices. They surged in 2021 when China tentatively made its self-imposed environmental constraints binding.

Third, the transition towards renewable energy will be increasingly costly, with annual investment increasing from <0.5% of global GDP currently to about 2% by the end of the decade, according to IEA estimates. Because China is the biggest producer of renewable energy equipment, which is energy-intensive to produce, an important proportion of the transition will be accomplished by burning more coal.

To alleviate upward pressures on coal prices, we unfortunately expect EM governments to relax their self-imposed environmental objectives until renewable energy becomes a true alternative in terms of capacity. This increases inflation risks from global warming.

Upside risks to inflation

Global warming should bring upside pressures on inflation from different channels. The timing and magnitude of these pressures are highly uncertain. China's experience with a prolonged drought in the Summer of 2022 is a relevant case study. The Yangtze river and reservoirs dried up, affecting both the supply of hydropower and maritime shipping. The drought was unprecedent and lasted more than 10 weeks. Authorities were forced to impose rotating blackouts and boost coal production.

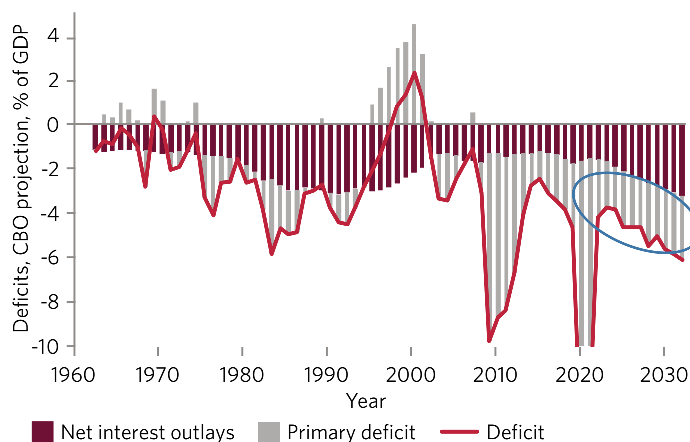
Over the long term, global warming makes food supply more vulnerable. Projections of global warming point to a material decline in the maximum yield of maize, wheat, and rice in several regions, including the US, Brazil, Western Europe, China, Africa, and Australia.[v]

Deterrence to avoid war: Democratic countries have started to take Putin's and Xi's hegemonic aspirations more seriously after Russia's invasion of Ukraine, rediscovering the geopolitical necessity of deterrence and hard power. We expect military spending as a share of GDP to move higher in the upcoming decade. Japan has already announced it will be doubling military spending (from 1% to 2% of GDP). South Korea has already signaled it wants to embark on a path of overwhelming military superiority against North Korea. For the US, pundits estimate that adequate deterrence would require military spending increasing from 3% to 5% of GDP.[vi] In a context of limited potential GDP growth, a significant and permanent increase of military spending would result in higher inflation and interest rates, unless it is offset by other fiscal spending or higher taxes.

Fiscal indiscipline: ongoing elevated deficits in several countries are a long-term fiscal concern, particularly for the US and China. Loose fiscal policy poses an upside risk to inflation.

In the US, for example, the CBO projects aging and interest payments will lift deficits to 7% of GDP in 10 years (**Figure 6**). Prospects are not better in China, where augmented fiscal deficits are likely to remain near 10% in the foreseeable future. Appetite for fiscal consolidation is low. The political economy does not appear favourable, especially in a context of elevated costs of living and a lack of affordable housing

Figure 6 – US fiscal policy projected to remain loose



Sources: Refinitiv-Datastream, CIBC Asset Management calculations based on data available as of January 31, 2023.

Our macroeconomic outlook in a nutshell

We conduct a macroeconomic rule-based projection for more than 30 economies to derive variables needed to forecast long-term capital markets returns. Our methodology (see **Appendix**) results in expected returns that are consistent across asset classes and regions. We project several variables, including potential GDP growth, inflation, and target policy rates.

Potential GDP: EM countries, particularly in Asia, retain the most attractive long-term outlook (see **Table 2**). At projected paces, India, Indonesia, and China will nearly double the size of their economies over the next 10-15 years. The outlook for most DMs is more lackluster—less than half of Chinese growth. Within DMs, the US, Canada, and Australia have growth profiles well above the regional aggregate, reflecting better demographic prospects (immigration) and also stronger labour productivity. The growth outlook for the eurozone and Japan, currently the third and fourth largest economies, is modest. Our approach results in a GDP outlook that is similar to that of the IMF.[vii]

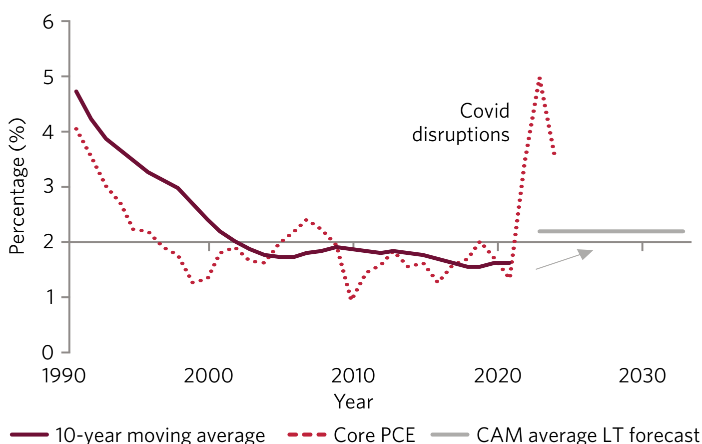
Table 2 – Macroeconomic projections summary (next 10 years)

Regions	Trend real GDP growth outlook history*	Trend real GDP growth outlook IMF**	Trend real GDP growth outlook CAM***	Inflation	Policy rate target in 10 years
US	1.8	2.1	**2.1**	2.2	3.0
China	6.0	4.8	**4.7**	2.6	2.0
Eurozone	1.0	1.0	**1.0**	2.0	2.1
India	6.3	6.2	**6.3**	4.4	4.7
Indonesia	5.0	4.8	**4.9**	3.2	5.0
Canada	1.9	1.7	**1.9**	2.1	2.3
DMs	1.5	1.3	**1.3**	2.0	2.3
EMs	4.6	4.3	**4.1**	3.7	3.9
EM Asia	5.5	4.8	**4.8**	3.0	3.0
LATAM	2.5	1.7	**1.9**	3.9	4.4
CEEMEA	2.7	2.4	**2.1**	6.0	7.1

* Trend growth for the 10-year window preceding the pandemic.
** IMF does not produce a long-term outlook. The last year of their projection is 2027, the mid-point of the next 10-year window.
*** Our outlook includes potential GDP plus the impact of monetary policy.
Sources: Bloomberg, Refinitiv-Datastream, CIBC Asset Management calculations.
(Projections based on data available as of January 31, 2023).

Inflation and monetary policy: Reflecting aforementioned supply-shocks from ageing, China, and the energy transition, we project average inflation to remain a few percentage points above central bank targets over the next 10 years. For example, in the US, our outlook is an average rate of 2.2% (see **Figure 7**). Taming inflation will be difficult given the supply-side nature of inflation tailwinds.

Figure 7 – Inflation to remain above target (US) %

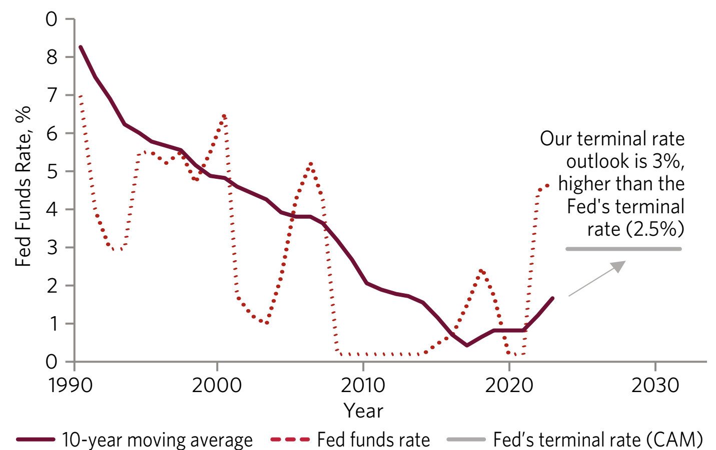


Sources: Bloomberg, CIBC Asset Management calculations based on data available as of January 31, 2023.

Also, elevated leveraging of governments and households will limit the magnitude at which central banks will be able and willing to hike rates. Owing to a large burden from higher debt-servicing costs, the policy rate that has a neutral impact on growth should remain well below nominal potential GDP (the textbook neutral stance). For the US, our debt-adjusted target rate is 2.3%. This is nearly half of long-term nominal potential GDP, but close to the Fed's long-term estimate of 2.5%. Note that the debt adjustment to the textbook-neutral target is generally more important in most DMs and China owing to higher leveraging in the system. The downward debt adjustment is smaller in most EMs. This makes their interest rates further appealing relative to highly leveraged DMs and China.

However, above-target inflation will force central banks to position policy rates above their respective debt-adjusted neutral rates. For the US and most other countries, we expect the reaction function of central banks (Taylor rule) to have a sensitivity of 1.5 to excess inflation. Looking at the Fed, for example, the policy response to above-target inflation is a terminal rate of 3.0% (**Figure 8**). This is 50 basis points (bps) above the Fed's current long-term policy rate.

Figure 8 – Higher trend for the terminal policy rate (US)



Sources: Bloomberg, CIBC Asset Management calculations based on data available as of January 31, 2023.

Note that anchored inflation expectations should continue to limit upward pressures on inflation, while technology should continue to contribute negatively to inflation. In other words, an inflation spiral remains a tail risk.

Long-term capital markets expected returns

Fixed income

Government Bonds: Improving but still lackluster prospects (Table 3). Our long-term expected returns for bonds were uninspiring over the last three years. We had warned that the bond market was overvalued, with a large number of government bonds having negative yields or near zero percent. Bond yields have continued to move significantly higher since our last publication a year ago. However, with the upward adjustment we made to policy-rate targets, reflecting higher inflation, fair value has increased at the same time. As a result, bond yields stand close to their long-term fair value and valuation is now only a marginal drag, if any. They are not overvalued anymore, but not undervalued either.

While the absence of a large valuation drag is a positive development, bond yields remain relatively low by historical standards. Low yields will not only limit the contribution from valuation, they will also limit the income generated. Furthermore, yield curves are inverted across many countries in the developed world. With a positive yield curve—the normal state of the bond market—the passage of time implies that yields "roll down the curve." This normally contributes to returns. However, a negative slope of the yield curve means that the return from the roll-down yield would be much lower than historically.

Our long-term fair value for 10-year US government bonds is 3.5%, which includes a term-premium of 0.4% to compensate for inflation uncertainty and less abundant liquidity. Our fair value is lower than the 3.8% projected by the CBO in 10 years. The attractiveness of US government bonds for foreign investors is, however, significantly reduced by negative currency impact from the overvalued USD. For Canadian investors, the projected greenback's depreciation brings the expected returns for US fixed income close to inflation.

Expected returns are not materially better for Canadian and global bonds, reflecting lower yields. Instead, prospects are more appealing for shorter-term bonds, where 2-year yields are above our fair value. The inverted yield curves mean that the higher volatility of longer-duration bonds is not compensated with a higher expected return.

As a stand-alone investment, bonds have become marginally more attractive. But we also need to consider how they behave within a broader portfolio. With yields back to fair value, we can now expect that fixed income will reassert itself as a defensive asset class, playing an important diversification to cyclical risky asset classes.

Table 3 – Fixed income breakdown of expected returns (%)

Assets classes	Average income	Valuation	Expected return (LC)	Currency impact	Expected return (CAD)
Canada 2-year Government Bonds	2.7	0.3	**3.0**	-	**3.0**
Canada 10-year Government	2.6	0.0	**2.7**	-	**2.7**
Canada Corporate	4.9	0.3	**5.2**	-	**5.2**
Canada Universe	3.4	0.2	**3.5**	-	**3.5**
US 10-year Treasury	3.3	0.0	**3.4**	-1.1	**2.3**
US Corporate	5.5	-0.2	**5.3**	-1.1	**4.2**
US High Yield	8.2	-2.1	**6.1**	-1.1	**5.0**
JPM World ex-Canada	3.0	0.0	**3.0**	-0.3	**2.7**
JPM Emerging	6.5	1.2	**7.7**	0.5	**8.3**

* Includes roll-down yield.
Source: CIBC Asset Management calculations (projections based on data available as of January 31, 2023).

Investment-grade and high-yield corporate bonds: 5% returns (CAD). Owing to the unfavourable currency movement from the overvalued USD, US corporates offer a 4.2% return to Canadian investors. The return is 5% for high-yield (HY) bonds. Less risky Canadian corporate bonds offer a better alternative, with a 5.2% outlook.

From a risk-management perspective, corporate bonds have an interesting feature. In a world with limited policy leeway and high leverage, central banks are likely to resume corporate bond purchases quickly if needed (in the event of a rapid tightening of credit conditions, for example). Since 2016, to limit a deterioration of financial conditions, several central banks, including the US Federal Reserve (Fed) and the Bank of Canada (BoC), have, at some point, intervened in corporate bond markets. Potential interventions reduce negative tail risks.

Emerging Bonds: Above 8% (CAD). Emerging market government bonds are the most attractive fixed income asset class in our universe. The outperformance reflects elevated yields and a positive valuation effect (starting yields are above long-term equilibrium levels). Furthermore, currencies in EMs are generally more undervalued than the CAD, resulting in a positive contribution from relative appreciation of EM currencies. The expected return is 8.3% (CAD), nearly three times the outlook for DM government bonds.

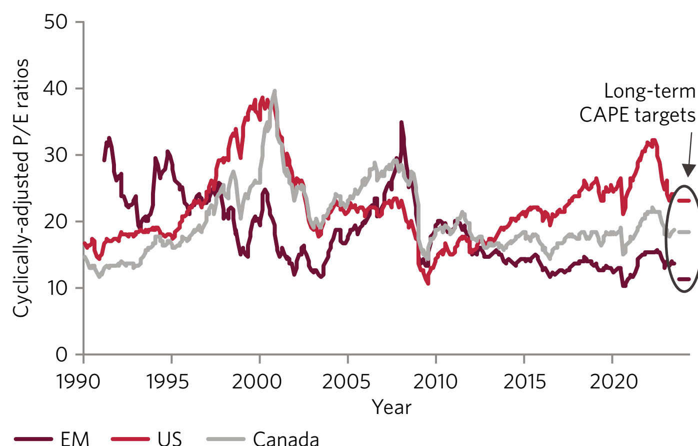
Higher real yields in EMs reflect higher trend economic growth and smaller downward pressures on neutral policy rates from indebtedness (with the notable exception of China). A secular increase in the appetite for the asset class should contribute to lower volatility. This should make demand less sensitive to episodes of global risk aversion. The continued inclusion of the Chinese and Indian markets over the coming years will also expand the opportunity set for managers and increase liquidity over time, adding to the attractiveness of the asset class as a must-have in a portfolio.

Equities

Canadian Equities: Appealing with returns near 7% (see **Table 4**). Across regions, the equity outlook has improved from last year, owing to less expensive valuation (see **Figure 9**). Cyclically-adjusted Price-to-earnings (CAPE) ratios are now much closer to their long-term fair values, which are a function of terminal interest rates and potential growth.

Canada has the second highest equity return in developed markets. This reflects attractive earnings growth and the absence of a negative currency impact for Canadian investors.

Figure 9 – Smaller valuation headwinds, particularly in the US



Sources: Refinitiv-Datastream, CIBC Asset Management calculations. Long-Term CAPE Targets are projections based on data available as of January 31, 2023 .

We consider the balance of risks surrounding this outlook to be positive. Canadian banks have accumulated record capital and have room to increase dividends. This likely will happen over several years, but it is a strong opportunity for dividend growth. Furthermore, demographic tailwinds from immigration should remain a lingering force, particularly in a context of a housing shortage. There is also a potential for outsized growth in dividends from the energy sector. The large caps, especially, are generating lucrative free cash flow levels at current commodity prices. They continue to show a very high level of discipline with respect to production growth.

Table 4 – Equity breakdown of expected returns (%)

Asset classes	Dividend yield	Earnings growth	Valuation	Expected return (LC)	Currency impact	Expected return (CAD)
Canada S&P/TSX	3.0	4.0	-0.2	**6.8**	--	**6.8**
US S&P 500	1.8	4.3	-0.8	**5.2**	-1.1	**4.1**
MSCI EAFE	3.1	2.9	0.2	**6.3**	0.3	**6.6**
MSCI Europe	3.2	3.0	-0.1	**6.0**	-0.2	**5.8**
MSCI Japan	2.3	1.8	1.8	**5.9**	2.1	**8.1**
MSCI All Country World	2.3	4.2	-0.6	**5.9**	-0.4	**5.5**
MSCI Emerging	3.1	6.6	-1.0	**8.7**	1.9	**10.6**
MSCI Emerging Asia	2.7	6.7	-1.1	**8.4**	2.6	**10.9**
MSCI Emerging Europe	3.4	6.9	-0.6	**9.6**	-1.6	**8.0**
MSCI Emerging LATAM	6.7	5.8	-0.9	**11.6**	-1.9	**9.7**

Source: CIBC Asset Management calculations (projections based on data available as of January 31, 2023).

US Equities: Still less attractive, especially for non-US investors. Despite having the strongest earnings-per-share (EPS) growth outlook in DMs, US equity has the least attractive outlook in our equity universe, facing important currency and valuation headwinds. Despite a less lofty P/E ratio compared to last year, valuation remains a headwind, reducing expected returns by 0.8 percentage points. Furthermore, for a Canadian investor, the currency drag reduces returns by 1.1 percentage points. The projected return is 5.2% in local currency (up from 3.4% last year) and a mere 4.1% in Canadian dollars.

Two additional factors also weigh negatively on the outlook: a partial normalization of profit margins and slowing share buybacks. Corporate America has benefited from rising profit margins as a driver of earnings growth in recent years. Margins are expected to normalize gradually from elevated levels. While they should remain at elevated levels, it is the change of profit margins that impacts earnings growth. Share buybacks have been adopted as part of regular dividend policies in the US As such, they are unlikely to go away. However, part of the abnormally high level of buybacks in the last decade can be attributed to low interest rates. Companies were able to optimize their balance sheets, but this trend has limited ability to be maintained over time. As a result, both factors make the earnings growth outlook less appealing than in the past.

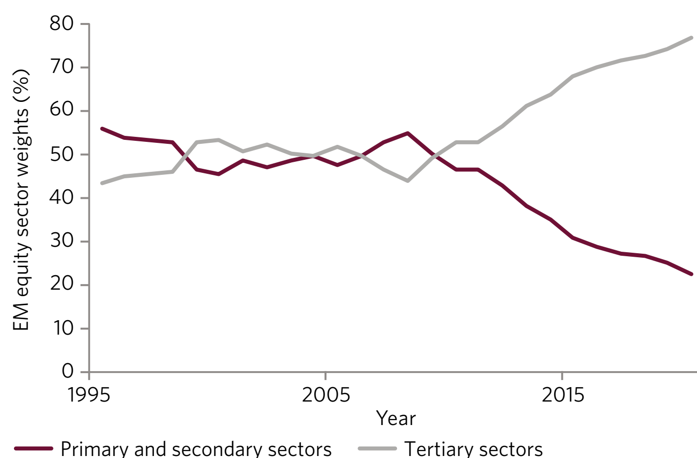
Risks appear to be balanced. On the positive side, geopolitical factors could spur Washington to spend more on military investment (a permanent 1% of GDP is a substantial amount) and to provide government-financed investment in strategic industries such as artificial intelligence or semiconductors to compete successfully against China's heavily subsidized industries.

On the negative side, elevated deficits could lead to fiscal consolidation. Also, there has been increasing evidence of more market dominance by large firms in recent years. This could lead to more regulation of Big Tech and a less-friendly regulatory environment overall. Negative risks touch on elements that were previously tailwinds for the US equity market.

Emerging equities offer the highest prospects. Despite valuation headwinds, our return outlook is at 8.7% in local currency and 10.6% in CAD. Higher earnings growth is the main distinctive factor. This reflects mostly higher potential sales growth but also a smaller drag from the mean-reversion of margins.

Within EMs, Asia offers the highest returns, underpinned by higher earnings growth and a positive currency impact. This is a consequence of current undervaluation and higher productivity growth. Another source of attractiveness for EMs in general is the ascent of the consumer, which is visible in the composition of equities (see **Figure 10**). This is pointing towards an improvement in the quality of expected returns and lower volatility. Indeed, tertiary sectors are more related to final demand from the consumer and are much less cyclical than commodities and manufacturing. That being said, the gap of EM over DM returns is narrowing as these economies are catching up and becoming more mature.

Figure 10 – EM equities increasingly driven by the consumer



Sources: Bloomberg, CIBC Asset Management calculations based on data available as of January 31, 2023.

Risks appear balanced. On the positive side, the rise of India and Indonesia, along with tailwinds from China, could spill over to other EM countries. A more significant opening up of China to foreign investors is another upside risk. The global energy transition could also bring more tailwinds than widely assumed to EM Asia (large-scale production of renewable energy equipment) and LATAM (as a large supplier of critical minerals such as copper, lithium, and Nickel).[viii]

On the negative side, the rise of China as a major economic power has led to increasing political tensions with the United States. The two economies are deeply integrated, and as such a more important breakdown of the relationship is unlikely. But a nationalistic agenda from either side could lead to geopolitical uncertainties as well as an increased cost of doing business. Other EM countries are also facing rising populism and nationalism, posing a risk to their institutions. Finally, upside surprises in energy and food inflation could bring larger problems in EMs, given their larger weights in the CPI basket. That risk is partly mitigated by the fact that several EMs are producers of energy, food, and minerals critical to the energy transition.

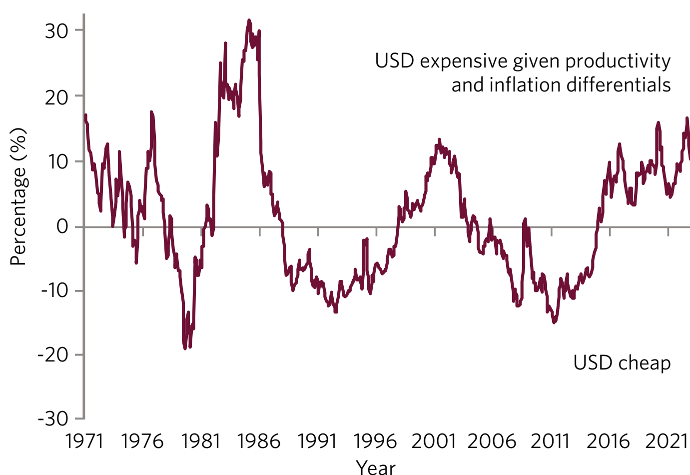
International Equities (EAFE®): Similar prospects to Canadian equities. We project international equities to average a 6.6% return in the next 10 years for Canadian investors (6.3% in Local currencies). Valuation and currency are positive factors, compensating for lower earnings growth.

The balance of risk is moderately tilted to the upside. For Europe, the region is home to several important green-energy companies and the European Green Deal should bring sizeable investment in renewables in the EU (about 3% of GDP in the current decade). For Japan, prospects for a technology-security alliance with the US and a rise of military expenditures could bring significant tailwinds to the technology sector.

Currencies

USD: Overvalued. The greenback is cyclically overvalued on a trade-weighted basis by about 11% (see **Figure 11**), similar to the early 2000s and before the Plaza Accord in 1985. Both episodes were followed by a prolonged period of weakening USD. Looking ahead, downward pressures on the dollar towards its long-term fair value should make US assets less appealing and non-US assets more appealing. The mirror image of an overvalued USD is the meaningful undervaluation in EM currencies where, in most cases, it exceeds 15%

Figure 11 – Expensive USD, a headwind for US Assets
Trade-weighted USD deviation with fair value



Sources: CIBC Asset Management calculations based on data available as of January 31, 2023.

CAD: Undervalued, but less than for most countries. The loonie is currently undervalued by almost 12% in relation to the USD. However, about 60% of currencies in our investment universe are actually cheaper than the CAD—mostly EM currencies in Asia and the yen. For Canadian investors, the currency factor reduces the attractiveness of US investment but improves prospects in Asia.

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Alternatives

Alternatives: Attractive returns and inflation hedge. Alternatives refer to various types of investments, including private market investments. Private debt, private real estate, and private infrastructure all offer a bond-like stream of income and an elevated liquidity risk premium. Direct investment can capture most of this liquidity risk premium.

Alternative investments can also help mitigate the impact of inflation on portfolios. For example, in the case of private alternatives, pricing power and periodic reset within contracts could allow income to keep up with inflation.

However, private market alternatives are highly illiquid and heterogenous. Specific investment characteristics of these alternatives are key drivers of expected returns. One risk is that the liquidity risk premium could decline over time (but not the liquidity risk), as more institutional investors chase the same opportunities.

For Canadian investors, the outlook for private market alternative investments is around 6% on average (see **Table 5**). As with other asset classes, a negative valuation effect from the greenback is reducing expected returns for Canadian investors.

Table 5 – Expected returns of alternatives (%)

Asset classes	Expected returns (LC)	Expected returns (CAD)
Private debt (North America)*	7.2	6.3
Private core real estate (North America)*	6.7	5.9
Private infrastructure (North America)*	7.1	6.3
Dow Jones Brookfield Global Infrastructure** (USD)	7.0	5.9
FTSE EPRA NAREIT developed markets (USD)	7.6	6.4
Commodities	6.8	5.7

* Currency impact assumes 75% investment in the US, 25% in Canada.
** Listed global companies with >70% of cash flows derived from infrastructure.
Source: CIBC Asset Management calculations (projections based on data available as of Jan. 31, 2023).

The outlook is also appealing (although similar) for equity exposed to alternative assets, such as NAREIT developed markets or Brookfield Global Infrastructure. In both cases, an equity risk-premium replaces the illiquidity premium of private investment.

Last but not least, oil and copper have also attractive long-term prospects. This outlook reflects ESG-related underinvestment in oil capacity; a gradual transition toward renewable energy (copper is an important input); and a strong increase of energy demand in EMs. India is an example of future strong demand for renewable energy and copper. In upcoming years, the government expects it will have to increase power generation capacity by 40%.[ix] New solar panels could make up more than half of new supply. Wind power and coal-fired capacity would make up the rest.

Appendix: Capital markets projection methodology

Economics: We derive our outlook using a framework that is consistent across countries.

- **Labour:** For the working-age population outlook, we use projections from the United Nations; where needed, we implement specific assumptions on the expected change of the participation rates and immigration.
- **Labour productivity:** For each economy, we calibrate the outlook of trend labour productivity, adjusting past trend productivity to the expected change of US productivity (a proxy for the common component of global innovation). For emerging markets, we reduce productivity growth proportionally to the past increase of GDP per capita. This captures the slow-moving effects of converging living standards on economic growth. Our outlook also includes the impact of likely structural reforms or deteriorating institutions.
- **Inflation:** The outlook is composed of a cyclically adjusted trend, on which we include relevant supply-side shocks. Inflation is also reduced by monetary policy tightening.
- **Policy rates:** Above-target inflation will force central banks to target terminal rates above their respective debt-adjusted neutral rates. In most cases, we expect them to react to excess inflation by a factor of 1.5. The impact of policy tightening on inflation is estimated with a Taylor rule.

Fixed income: Coupon income, a valuation effect from moving interest rates and spreads towards long-term targets, a roll-down yield, and expected defaults net of recovery are the inputs in the calculation of expected returns. Long-term target interest rates are composed of a terminal policy rate, a term premium, and a spread. For investment-grade and high-yield bonds, the spread is a long-term historical average. For EM government debt, the spread is empirically a function of indebtedness, competitiveness, and CDS spreads.

Equity: Expected returns are a function of the dividend yield, earnings growth, and the convergence of price-to-earnings (P/E) ratios to their long-term targets. Long-term P/E targets are estimated econometrically using trend growth (positive impact) and interest rates (negative impact) as independent variables (conceptually consistent with a Gordon framework). Earnings growth is driven by the trade-weighted nominal GDP outlook.

Foreign exchange rates: Long-term foreign exchange movements are impacted by current deviations to fair-value estimates provided by our currency model and by the projected change of fair values. Over the long-run, the fair value is impacted by inflation (negatively) and by productivity.

Alternatives: For private market alternatives, we estimate historical spreads between past returns and relevant listed benchmarks. Our projection is composed of this spread plus our projection of the listed benchmark. Note that we lower the spread to reflect the view of a lower liquidity risk premium. Listed alternatives are projected using our equity framework. For commodities, we use a global supply-demand model. In this framework, oil prices become more sensitive to demand because of a more inelastic supply. For copper, demand is expected to increase more and to become more inelastic given the global transition towards renewable energy.

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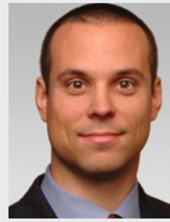

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