MARKET UPDATE

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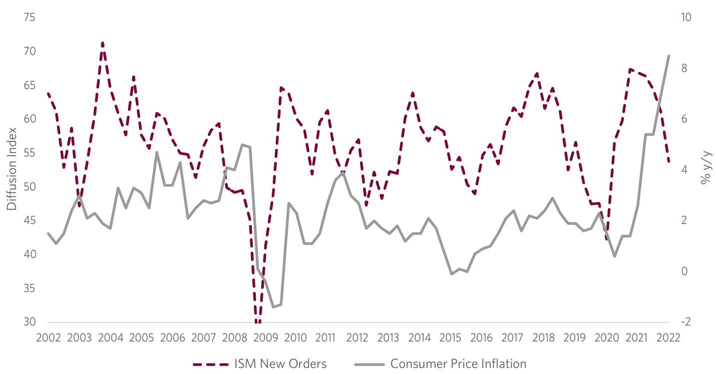
What's Happened?

We are at the high point of the current economic cycle. Growth in the global economy, particularly in the U.S and Canada, remains strong, but is expected to gradually slow over the next year to a rate broadly in-line with its long-term trend. Leading economic indicators, including measures of consumer and business confidence, are consistent with this expectation. So are the expected actions of central banks around the world, including the U.S. Federal Reserve (Fed) and Bank of Canada (BoC). Both the Fed and the BoC have signaled an intention to engineer a tightening in financial conditions sufficient to tame inflation, which, at 40-year highs, is well above rates previously expected due to a mix of binding supply constraints and excessive demand. We do expect inflation to start to moderate from the middle of this year, in response to a combination of tighter monetary policy and some easing in supply bottlenecks. But it will likely remain well above central bank target rates for the foreseeable future.

Chart 1 - Economic Lead Indicators Are Moderating; Inflation is at 40-Year Highs



Source: Bloomberg® LP, as at April 29, 2022.

Risks to this relatively benign economic outlook are rising. Recent messaging from the Fed appeared to take a more aggressive turn as it aims to do everything necessary to ensure long-term inflation expectations remain anchored to its 2% inflation target. This has raised the risk of a hard economic landing. Adding to downside growth risks elsewhere in the global economy, the Ukraine conflict and high inflation have compromised the strength of the Euro growth recovery, and Covid-related risks have risen in China with the continued pursuit of its zero-tolerance policy.

Implications for Equity Markets

Top-Down Macro Investment Perspective

Economic slowdowns are typically associated with lower and more volatile equity returns. After strong calendar-year performance in 2021, outside of Emerging Markets, equity markets experienced significant volatility throughout the first quarter of 2022. From a top-down macro perspective, we expect equities to trade in a broad range over the coming year. Valuations have come down a little as a result of the current market correction but remain expensive for some markets, particularly U.S. Large Cap. And the tailwind from earnings, sales, and margins will likely weaken along with economic growth, particularly in the context of tight labour markets.

Bottom-Up Investment Perspective

Macroeconomic factors do not drive bottom-up investment decisions. But our equity teams are cognizant of the impact interest rates and inflation have on our underlying holdings and expect that stocks with long-dated cash flows will continue to be impacted disproportionately by high inflation and interest rate increases. We have continued to add to high-quality names while increasing the defensive nature of our portfolios.

One sector of particular interest in the Canadian market is Banks. Bank stocks may remain volatile over the short term, but we continue to have confidence in this sector. Although the risk of a hard landing has increased, we think it is too early to worry about the impact of this event on bank profitability. Strong loan growth and credit conditions, an expanding net interest margin, excess capital, and a sector valuation in line with its historical average, all contribute to an attractive risk-reward profile. We continue to own banks and carefully monitor their trajectory along with the speed and extent of Bank of Canada rate hikes.

Implications for Fixed Income Markets

Sovereign Bonds

Sovereign bond yields have risen aggressively in recent months as market participants have moved to price an increasing amount of policy tightening. A further, moderate increase in U.S. and Canadian government yields is certainly possible if the flow of macroeconomic data causes the market to price even more policy action. But a lot of tightening is now priced in, and market participants may have become overly optimistic in terms of what the Fed and BoC will ultimately be able to deliver, for instance given high household debt levels in Canada. This suggests we are close to the peak in yields. A similar conclusion results from technical analysis of market dynamics.

Credit

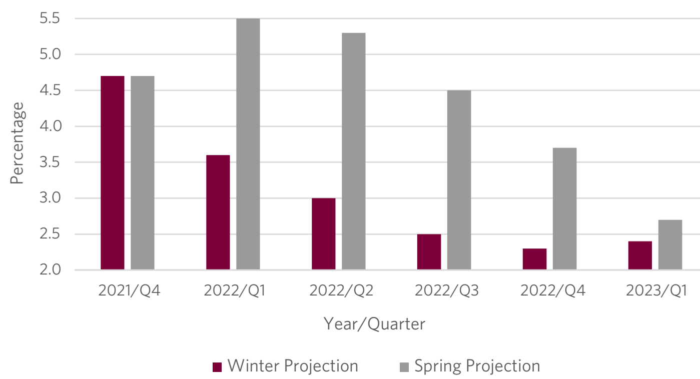
Corporate fundamentals remain strong and our fair value model suggests a modest credit spread tightening over the next few quarters. However, in response to elevated macroeconomic uncertainty, we are maintaining a moderate risk allocation to credit positioning, and a bias towards higher-quality companies.

What CIBC Asset Management is Watching

Inflation

We think the peak in inflation is close. Rates of inflation are expected ultimately to return to levels consistent with long-term central bank policy targets, but this process is likely to be relatively lengthy (Chart 2). We monitor many indicators to verify whether our assessment is unfolding as expected, including the following: are financial conditions tightening as expected; is wage inflation running persistently ahead of productivity growth; are long-term inflation expectations moving beyond levels consistent with achievement of policy targets; and are commodity prices fueling sustained high inflation.

Chart 2 - Inflation Projections Revised Up



Source: Refinitiv-Datastream and CIBC Asset Management Inc. Data as of April 1, 2022.

Central Banks

Most central banks have begun to tighten policy in an effort to transition financial conditions from very accommodative to a more neutral level at which they are neither stimulative or contractionary for economic growth. Determining where this neutral level lies is a difficult task, increasing the risk that central bankers will make a policy mistake: either tightening policy too fast and too much, inadvertently tipping the global economy into recession in their efforts to tame inflation, or too slowly and timidly, failing to prevent a de-anchoring of long-term inflation expectations. For any central bank, engineering a soft landing is no easy task. The fact that so many are concurrently seeking to achieve the same outcome is an important complication.

We will continue to monitor data flow and central bank communications to assess the policy outlook. Currently, we consider that market participants expect a little too much tightening from both the Fed and BoC. How this assessment evolves will be an important input into our outlook for asset prices and returns.

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