CIBC Asset Management

PERSPECTIVES

For the 12-month period beginning July 1, 2021

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A cautious return to normal

Global real GDP growth hit a record level in the second quarter, with estimates exceeding an exceptionally strong 12%. The good news? We project global growth will stay strong, averaging +5.6% over the next 12 months. The caveat? Developments on the economic and vaccination fronts are so good that policymakers can finally start breathing easier and begin to contemplate some form of policy renormalization.

Asset class highlights

Equity: Equity valuation is expensive, but a strong economic outlook and low interest rates should help support those valuations at higher levels than usual.

Fixed Income: Crosscurrents should continue to make it difficult for bond yields to find a clear direction and range trading remains the more likely scenario.

Currencies: Recent developments may not be enough to propel the U.S. dollar back to March 2020 cyclical highs but may allow it to move into a consolidation phase.

Commodities: Rising global demand and ongoing supply discipline (for now) should help support the oil price through the summer and into the fall.

Multi-asset outlook

Asset class	Current June 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	0.45%	0.25%	0.65%
Canada 10-year government bond yield	1.39%	1.00%	2.00%
U.S. 10-year government bond yield	1.47%	1.25%	2.25%
Germany 10-year government bond yield	-0.21%	-0.45%	0.10%
Japan 10-year government bond yield	0.05%	-0.25%	0.25%
Canada 10-year real-return government bond yield	0.11%	0.15%	0.25%
Canada investment grade corporate spreads	1.17%	1.50%	1.00%
U.S. high yield corporate spreads	2.98%	4.75%	2.65%
Emerging market sovereign (USD denominated) bond spreads	313	250	500
S&P/TSX price index	20,166	18,300	21,200
S&P 500 price index	4,298	3,800	4,500
Euro Stoxx 50 price index	4,064	3,800	4,400
Japan Topix price index	1,944	1,850	2,150
MSCI Emerging Markets	76,677	70,750	83,750
U.S. Dollar/Canadian Dollar	1.2398	1.219	1.282
Euro/U.S. Dollar	1.1858	1.160	1.230
U.S. Dollar/Japanese Yen	111.11	104.00	112.00
U.S. Dollar/Offshore Chinese Yuan	6.47	6.28	6.90
Gold	1,770	1,600	2,200
Oil price, WTI (West Texas Intermediate)	73.47	55.00	77.00

Source: Thomson Reuters Datastream, CIBC Asset Management Inc.

Asset class outlook

Global overview

Time for policy renormalization
After colossal efforts from monetary and fiscal authorities around the world and a successful and accelerating global vaccination campaign, the global economy has, as expected, roared back to life. Global real GDP growth hit a record level in the second quarter of 2021, likely exceeding 12%, an exceptionally strong showing. The good news is that global growth is projected to stay strong, averaging +5.6% over the forecast horizon.

The only caveat is that news on the economic and vaccination fronts is so good that policymakers around the world can finally start breathing easier and begin to contemplate some form of policy renormalization. For nearly all central banks in the developed world, it's way too early to envisage putting on the brakes. Their help is still needed to keep the fiscal situation under control—that is, by monetizing to some extent new government debt issuance while keeping borrowing costs ultra-low. Faster economic growth and higher inflation are both required over a prolonged period for governments to get their fiscal houses in order. Monetary authorities are fully aware of this.

The timing, however, seems appropriate for many central banks to start lifting their foot off the accelerator. New government debt security issuance is projected to substantially decline over the forecast horizon, thanks to the improving global cyclical backdrop. This means monetary authorities probably won't have to buy as much, opening the door for some tapering. At first glance this may seem to be too subtle a policy change to have an impact on financial markets and that is where the risk lies. There's no doubt that all policy renormalization efforts will be deployed with the implicit objective of having as little as possible negative impact on financial conditions. However, this is easier said than done. A year ago, the world shifted to a monetary policy regime of abundant liquidity. In this ongoing policy regime, excess reserves held at central banks play a key role in shaping financial conditions.

The first challenge for central bankers is to figure out how much they can reduce the dosage of routinely administered liquidity injections. This is much harder to determine than any decision to augment it. In other words, they can refill the punch bowl as many times as they want but can't be perceived as taking it away. Ample liquidity is an essential condition for keeping risky assets in rallying mode. The second challenge for monetary authorities is they'll need to consider that all central banks will be trying to renormalize policy simultaneously. This complicates the task at hand and increases the risk of policy mistakes.

Over the last year, global investors have become accustomed to the unusually good navigation conditions. It's all been smooth sailing because of the massive credit impulse delivered by policymakers. The global credit impulse is now fading and will continue to do so as policy renormalization takes place. While there likely is no financial storm coming, more difficult navigation conditions are likely, implying greater uncertainty for the direction of financial markets and higher volatility.

Global strategy

A transition in the cycle
An economic cycle can last for a number of years and can be broken down into a few shorter phases. Typically, we think of a full cycle as a sequence of recovery, expansion, slowdown and finally, contraction. This is then followed by another recovery that marks the start of a new cycle. Any investor interested in global macro strategies like tactical asset allocation should pay attention to this cycle.

While every cycle is different and generalizing too much can damage performance, there are some lessons to learn from studying past cycles. For example, a very rough rule of thumb would be to avoid equities and favour bonds during recessions, while doing the reverse during expansions. Of course, a closer analysis of the prevailing economic conditions is required to validate any rule based on historical patterns.

Another reason investors need to pay attention to the cycle is that the transition from one phase to the next can lead to significant repricing in markets and could be somewhat turbulent. A phase that's been in place for a while and has been well recognized by investors is less likely to generate worry. However, when the cycle moves on to a new phase, doubts surface regarding what the future will look like.

The current cycle that began last year is far from typical. Cycles are typically the result of macroeconomic forces and imbalances in the economy. In the current cycle, a recession was caused by governments that had no other choice but to close the global economy to fight the COVID pandemic. The recovery was also brought on by government decisions. As the virus came under better control, and vaccines were developed and distributed to protect populations, the economy has gradually reopened. As such, the recovery phase that started in the middle of last year was characterized by an impressive acceleration in economic activity driven by massive, pent-up demand. Monetary and fiscal policies have erred on the side of caution and remained extraordinarily accommodative. Markets have made enormous gains, fueled by the high-octane cocktail of very strong growth and record low interest rates.

We are now at a point where the cycle is moving away from the "recovery" phase into the "expansion" phase and this next phase will look quite different from its predecessor. There

are 2 important takeaways: 1) we're past the peak of growth, i.e. growth will stop accelerating and the change in growth will be flat; 2) central banks will start to talk about policy normalization—i.e. policies that were put in place to respond to the COVID crisis will, at a certain point, no longer be needed. This is important because this is a major change from what we experienced in the last 9 to 12 months, and markets are priced on incremental information.

"Peak growth" doesn't necessarily mean growth will slow down substantially going forward. While the actual growth numbers will decline, that will be, in large part, because the base effect[1] currently boosting economic statistics will fade. In fact, our GDP forecasts show growth will remain quite strong by historical standards and will still be above potential. Monetary policy normalization will be slow and gradual, and financial conditions will remain very accommodative. So the upcoming phase for the economy should still be supportive of risky assets, but less so than before.

At this point, the bigger concern is not that the economy will experience a hard landing. The concern is that the transition will create uncertainties, force investors to reasses their expectations, and ultimately lead to market turbulence. There are risks of policy errors if stimulus is removed too quickly. There are also risks of creating inflation pressure if the economy continues to be red hot. Let's not forget there are still risks that COVID could return with another wave from a new variant or from the unvaccinated part of the population. There are also risks that high valuation could become a headwind.

While we expect these risks to remain benign and outside the scope of our central scenario, the bottom line is the easy gains in equities and other risky assets like high-yield bonds or commodities are behind us. We maintain our view that equities should outperform fixed income over the next 12 months, but we recognize the rising risks to that strategy. Any turbulence should be temporary, and there's still a blue sky on the other side of the storm. But attempts to navigate to avoid the storms along the way could be difficult and, ultimately, counterproductive.

Global equity markets

Strong earnings growth will support equities

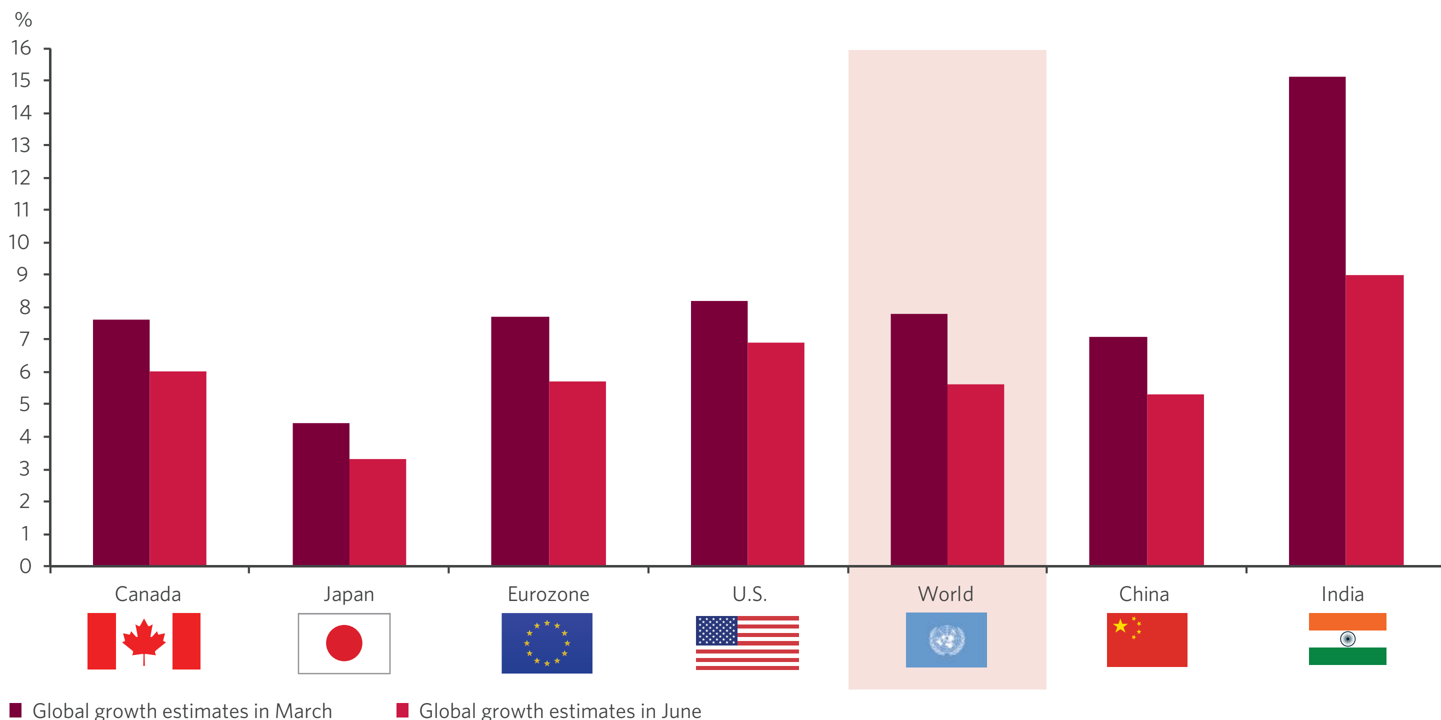
If investors are concerned about risks related to the transition in the economic cycle, it's not showing in equity prices. In fact, equities continued to move up during the second quarter. Canadian equities, represented by the TSX index, are 12% above their pre-COVID level, and 8% of it came in the most recent quarter. U.S. equities have performed even better, with 27% and 8% return over the same periods. Cyclical sectors like materials and consumer discretionary led the way, while defensive sectors like consumer staples and utilities underperformed.

One sign that the cycle is moving on is that the recent rise in prices was driven by strong earnings. Early in a cycle investors push P/E (price/earnings) ratios higher with the expectation that earnings will eventually recover. This is what happened between March 2020 and March 2021. Since March 2021 though, it was earnings growth that's pushed prices higher, while P/E ratios were declining. This is consistent with the transition to an expansion phase and we expect this trend to continue. The consensus for earnings growth over the next 12 months is 32% and 21% for Canada and the U.S. respectively, which will provide good support for equity markets. Valuation is expensive, but a strong economic outlook and low interest rates should help to keep valuations higher than usual. Eventually, valuation will become a headwind, most likely nearer the end of the cycle.

Looking at the evolution of COVID across countries, there are growing divergences. Generally speaking, in developed countries vaccination campaigns have progressed more rapidly than in emerging countries. Those successful at controlling the virus will be able to reopen their economies more freely, while others will need to maintain lockdown measures. This is creating a two-speed world where the intensity of COVID is becoming an important differenting factor. Furthermore, China is facing a more pronounced slowdown because of a decline in credit growth, which has repercussions across many other countries. As such, the outlook for emerging equities is mixed over the next few months, with underperformance already playing out, although it's expected to be transitory. Looking forward, emerging countries will eventually catch up to the rest of the world as vaccinations are slow but improving. Already we see signs that the People's Bank of China is ready to act to support its economy. Emerging equities still have some support coming from valuation, which is not as attractive as it's been in the past, but still more attractive than many developed countries. Investors exposed to emerging equities also get exposure to emerging currencies, which are among the most attractive.

[1] This refers to the effect that the choice of a basis of comparison or reference can have on the result of the comparison between data points.

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



Sources: Refinitiv-Datastream and CIBC Asset Management Inc.

Global bond strategies

In the second quarter, global bond performance stabilized significantly compared to the volatile first quarter. Our reference benchmark, the FTSE WGBI hedged in Canadian dollars, gained just 75 basis points during the period. U.S. 10-year Treasury yields remained between 1.40% and 1.80% and German bunds hovered in a narrow range of -0.32% to -0.10%.

Over the next twelve months, volatility is likely to return to developed market (DM) bond markets as DM central banks exit very accommodative policies—a move that might prove complicated. This is especially true when accounting for the symbiotic relationship with Treasury departments and considering the extensive set of new policy objectives, like reducing income inequality. The timing and pace of the eventual Fed tapering will be crucial for maintaining favourable financial conditions. This increasingly difficult balancing act poses important risks for bond markets, on the upside and the downside.

All else being equal, crosscurrents should continue to make it difficult for bond yields to find a clear direction and range trading remains the more likely scenario. On one hand, existing strong cyclical forces resulting from extremely loose monetary and generous fiscal stances globally might push yields higher in the very short term. However, looking a bit further out on the horizon, the move to reduce monetary and fiscal impulses is likely to push DM yields lower.

Dividing U.S. 10-year yield into its two main components, 10-year **real yields** should remain well anchored between -1.00% and -0.50%, while 10-year **breakeven yields** should come down towards 2.00% as inflationary pressure abates. Putting the two together, U.S. 10-year Treasury yields should oscillate between 1.25% and 2.25%. As a result, our bias is for a slight underweight duration stance to begin the third quarter.

Turning to sovereign bond allocations, we recommend a continued overweight in emerging market (EM) versus DM bond markets. First, EM bond valuations remain attractive; yield curves generally remain steep and local 10-year real yields are high by historical standards. Second, the EM growth outlook should benefit from a weaker U.S. dollar, resulting in lower foreign exchange pass-through to inflation, a better fiscal stance and, by extension, lower premiums to own EM bonds. Third, demand for commodity prices should lead to improving terms of trade for EM commodity exporters and better growth prospects. Finally, the markets are pricing in too aggressive rate hikes in many EM countries, in our opinion. In terms of risks, the actions taken and the degree of success in each EM country to rein in last year's fiscal largesse will be important to closely monitor.

Currencies

U.S. Dollar

Over the last year, the U.S. dollar has been steadily losing ground, depreciating by approximately -12% on a trade-weighted basis. Until recently, the balance of risk had been clearly tipping to the side of continued U.S. dollar weakness. With improving global growth prospects, this has all been rapidly changing—central banks around the developed world have to start thinking about renormalizing their still ultra-accommodative policy stance. In particular, the U.S. Federal Reserve has already started signaling its intention to do just that.

At first glance, this may seem too subtle a change to have an impact on financial markets in general and foreign exchange markets in particular. Better look again. We've been arguing for a while now that with the adoption of its new Average Inflation Targeting (AIT) policy framework a year ago, the Federal Reserve was implicitly targeting a weaker U.S. dollar and would continue to flood the world with U.S. dollar liquidity. This may no longer be true. The Fed is no longer fast-expanding its balance sheet and is planning on gradually reducing its purchases of debt securities over the forecast horizon.

This may not be enough to propel the greenback back to March 2020 cyclical highs but should be enough to allow for the U.S. dollar to move into a consolidation phase. From this point on, its potential upside or downside will be determined by the Fed's ability or inability to convince market participants that there is nothing to worry about. However, investors will likely be increasingly jittery, remembering the lessons from 2018—in effect, reducing the dose of Fed liquidity injections is a much harder thing to do than augmenting it.

Canadian Dollar

After hitting cyclical highs around 83 cents against the U.S. dollar in early June, the Canadian dollar has recently lost some of its luster. 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?

The Canadian dollar still has many sources of support. For one thing, valuation is not an obstacle. Based on our in-house valuation metrics, it qualifies as undervalued against the U.S. dollar. When the Canadian dollar shifted to rallying mode in late March 2020, so did its fair value, via a fast improvement in terms of trade. The result has been almost no deterioration on the valuation front.

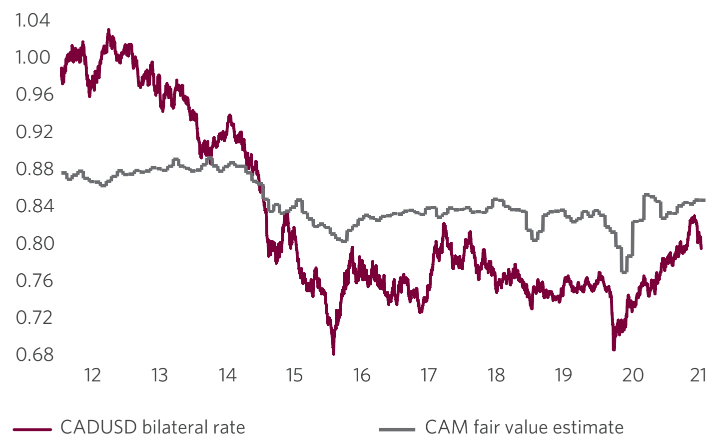
Looking forward, relative terms of trade are expected to stay supportive for the Canadian dollar. However, oil prices are projected to hit their cyclical peak over the coming months and weaken somewhat moving further out over the forecast horizon. Putting it differently, this source of support will likely weaken moving closer to year end.

Recent Bank of Canada policy actions have also been supportive for the Canadian dollar. In April, the BoC recalibrated its weekly purchases of federal government debt securities (from $4B to $3B per week). This move was interpreted by many market participants as the start of BoC tapering. With new federal government borrowing requirements projected to materially decline, Canadian monetary authorities will have to continue reducing their purchases of federal government bonds. That said, the potential positive impact on the Canadian currency will likely be largely offset by the Fed's policy renormalization efforts.

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

Canadian dollar shifting to consolidation mode

CAD/USD bilateral exchange rate & CAM fair value estimate



Sources: Refinitiv-Datastream and CIBC Asset Management Inc

Euro

As argued in the Europe economic section (pg. 9), the eurozone economy is expected to grow at a relatively fast pace over the forecast horizon. In the context of the improving cyclical landscape, the ECB—just like other central banks—had to start renormalizing by significantly reducing the pace at which it expands its balance sheet. The growth rate in ECB's total assets has already been cut by half, from a record of +40% to +20%. While this constitutes a sharp reduction, it has to be put in the context of policy actions taken by the other central banks. In relative terms, the ECB is expanding its balance sheet faster than the Fed, and it's projected to continue doing so. Under such conditions, the euro is shifting into consolidation mode against the U.S. dollar, trading between 1.16 and 1.23.

Japanese Yen

Since the start of 2021 and among the major currencies, the Japanese yen has depreciated the most against the U.S. dollar. Why is that? 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, U.S. Treasury bond market pullback episodes have typically led to the strengthening of the USDJPY bilateral rate. This is exactly what happened in early 2021. With limited upside expected for Treasury yields from current levels, the USDJPY bilateral exchange rate probably also has limited upside. We are working with a targeted range of 104 to 112 between now and the second quarter of 2022.

Commodities

Oil

Oil prices have been strong through the first half of the year. We've seen the price increase an impressive 55% year-to-date to trade around $75/barrel in mid-July from about $48/barrel at the start of the year. The strength has been driven by accelerating vaccination rates around the world that increase demand for energy as lockdowns are lifted and more normal routines return. At the same time, the supply side has remained disciplined in its approach to bringing barrels back to the market, which has clearly helped support the oil price as well.

Looking forward, we expect end-user demand for oil to continue to grow as vaccination rates increase and more people return to a somewhat normal lifestyle. We expect demand for gasoline, jet fuel and other end products to also ramp up as more vaccines are administered. On the supply side, OPEC+ has remained disciplined in returning barrels to the market which, to this point, has helped support the commodity price as well. In other key non-OPEC producing regions, supply growth remains reasonable and constrained as investors continue to focus on capital returns ahead of growth and producers are maintaining discipline for now. With oil prices at current levels, there is an incentive to bring more barrels back to the market and we will be watching closely for production growth through the remainder of the year.

Overall, we believe the setup for oil prices over the next few months looks good. Rising global demand and ongoing supply discipline (for now) should help keep the market fairly tight, which we believe will support the commodity price through the summer and into the fall.

Gold

Gold has generally been drifting lower to the $1,800/oz range since hitting an all time high of $2,060/oz in early August 2020. To some extent, sentiment has worked against gold this year as investors gain increased confidence in vaccine rollouts and a path towards normalcy—hopefully in the second half of 2021 and into 2022. With that outlook in mind, some of the speculative risk positioning in gold has come off, which has weighed on the price. Concerns around inflation and the growing Delta COVID variant have helped support the gold price in recent weeks.

Looking forward, debates around the transitory nature of the current inflation cycle and the timing and magnitude of interest rate hikes remain the key debates for the gold price outlook in the coming quarters. We believe the outlook for gold remains constructive into the second half of the year. In our opinion, both monetary and fiscal policies will remain accommodative as global economies begin to recover and reopen as vaccinations ramp up. Increasing money supply, lower interest rates and a willingness by central banks to tolerate higher-than-normal inflation could provide a tailwind for gold this year and into 2022. On the other hand, if vaccination rates slow, or the Delta variant proves to be a bigger challenge and the global economic recovery stalls, investors could choose a flight to safety. This could also provide a positive environment for the gold price in the coming months and quarters.

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

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

Copper

The copper price has held up well this year, starting January at about $3.50/lb., before peaking in May near $4.75 and consolidating at a very healthy $4.30, where the price remains as of this writing. Demand in China, the key end user for copper, has been strong while supply from key producing regions has been challenging as miners navigate operations through the pandemic.

Looking ahead, continued strong demand from China will be an important driver of the copper price over the remainder of the year. Recently, there have been mixed signals from China. Growth has started to slow and the country has attempted to manage commodity prices lower through various means, including the sale of metals from the strategic reserve to bolster supply. On the other hand, we're also starting to see some loosening of monetary policy to maintain growth in the near term.

With the U.S. and the EU starting to reopen more aggressively, we expect that demand in the rest of the world can help pick up some of the slack from a slowing China. However, Chinese demand will remain critical to the outlook for the copper price in the coming months and years. With that in mind, we may not return to all-time highs in the copper price in the near term, but the current price is very healthy and well above the marginal cost of production.

Looking a bit further out over the medium term, we believe the outlook for copper remains strong. Copper is a metal that will be a critical component for the transition to a lower carbon economy. Significant new volumes of the red metal will be needed to build out the infrastructure that will deliver renewable, lower carbon energy to end users. We believe a significant mine supply response will be required to meet this new area of demand growth and a higher copper price will eventually be needed to incentivize this new production into the market.

Regional economic views

Canada

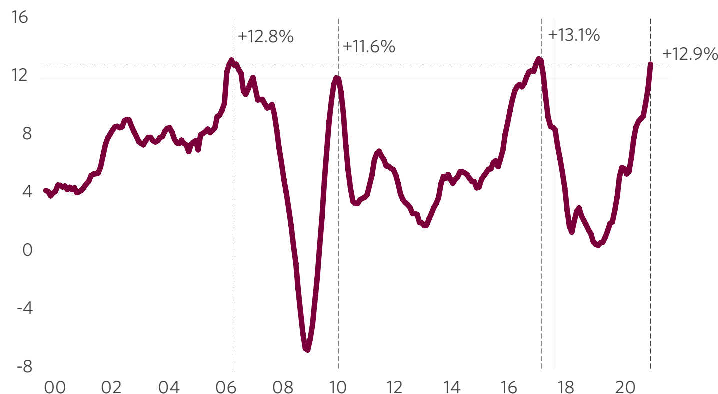
- We expect Canadian average real GDP growth of 6% (y/y) over the next 12 months, the fastest growth in more than 57 years.
- We don't expect the Bank of Canada to start hiking interest rates over our projection horizon.

The perils of BoC tapering
With a vaccination roll-out that's significantly picked up speed and relaxed public health restrictions, the Canadian economy is expected to experience solid growth over the forecast horizon. Our baseline scenario calls for average yearly real GDP growth that should reach +6.0% between the third quarter of 2021 and the second quarter of 2022. If we're right, this would qualify as exceptionally strong—the fastest Canadian real GDP growth in more than 57 years.

In the context of a fast-improving cyclical backdrop, the Bank of Canada (BoC) will have to hop on the central banker bandwagon and begin to renormalize policy. We don't expect the Bank of Canada to start hiking interest rates over our projection horizon. However, we do believe that it will need to further reduce the pace of its purchases of federal government debt securities.

Canadian monetary authorities probably have a gradual taper in mind, so its purchases of federal government debt securities will track the projected decline in new debt issuance. With a federal government deficit that's projected to narrow substantially (from -$155B in FY2021 to -$60B in FY2022), this implies aiming for a reduction in its monthly purchases from $12B (currently) to approximately $4B moving into 2022.

A sizzling hot Canadian housing market
Canadian home prices (yearly % change)



Sources: Refinitiv-Datastream and CIBC Asset Management Inc

The challenge for the Bank of Canada will be to figure out the right tapering pace. As one of the first central banks to start shrinking its balance sheet, the BoC already has to deal with some tightening in Canadian financial conditions owing to the strengthening of the Canadian dollar and a steepening yield curve. Looking forward, a continued tightening in overall Canadian financial conditions could quickly become problematic, forcing the BoC to move to the sidelines. Too much tightening in mortgage financing conditions could become very problematic, given the wide and widening imbalances in Canadian housing.

United States

- We project U.S. real GDP growth will average +6.9% over the next 12 months, the best showing in more than 37 years.
- The Fed will start to shift to policy renormalization mode with a slowdown in monthly purchases of Treasury and MBS debt securities (i.e. tapering).

The perils of Fed tapering
From a growth standpoint, the U.S. economic outlook remains very rosy. We project real GDP growth will average +6.9% between 2021Q3 and 2022Q2. If this forecast materializes, this would be the best growth showing in more than 37 years. Now that the U.S. economy is back on its feet and the U.S. COVID-19 curve has been flattened, the U.S. Federal Reserve has to start shifting to policy renormalization mode, just like nearly all other central banks in the developed world. However, in the new policy regime this doesn't mean starting with policy rate hikes. It means starting policy renormalization by slowing the Fed's monthly purchases of Treasury and MBS debt securities (i.e. tapering). This is necessary because the improving cyclical landscape comes with shrinking government budget deficits, implying less need for debt monetization by the central bank.

Back in 2018, when it finally put its balance sheet normalization plan into action, the Fed quickly realized that draining excess reserves from the financial system was a perilous exercise. Given the lessons learned, the Fed will likely proceed very gradually this time around. The plan is probably to signal its intention to taper later this year and to start reducing its monthly purchases of debt securities in early 2022.

If everything goes according to plan, this will simply translate into slower growth in the amount of excess reserves held by commercial banks at the Fed. The risk, however, is that it instead translates into shrinking excess reserves in the banking system because of faster-than-expected growth in non-reserve Fed liabilities. But why worry about a contraction in the amount of excess reserves? The harsh reality is that excess reserves held by central banks play a key role in shaping financial conditions in a monetary policy regime of abundant liquidity. There are two past episodes when excess

reserves were significantly reduced: (1) when the Fed concluded its asset purchasing program in August 2014 and (2) when it implemented its balance sheet normalization program in the fall of 2017. In both cases, what eventually followed was a deterioration in U.S. financial conditions. If the past is any guide, the risk is for a similar turn of events over the forecast horizon. If the tightening in financial conditions becomes too intense, the Fed's tapering efforts will promptly be adjusted to limit the damage. It's going to be all about finding the right tapering speed and that will be no easy task.

Europe

- The eurozone's growth prospects have been materially improving and the time has come for some ECB policy renormalization.
- The ECB has already shifted to tapering mode, cutting its monthly purchases of debt securities via its Asset Purchasing Program (APP) by nearly half in early 2021.

ECB to stay prudent, backtrack if necessary

We've been arguing for some time that the ECB would be keeping both feet on the accelerator. However, now that the COVID-19 curve has been flattened in the developed world and the eurozone's growth prospects have been materially improving, the time has come for some ECB policy renormalization. To say the least, this promises to be a difficult rebalancing act. Let's not forget that one year ago, the ECB brought out the heavy artillery in an effort to cushion the hit from tightening lockdown conditions.

The reality is that the ECB has already shifted to tapering mode. In fact, the monthly purchases of debt securities via its Asset Purchasing Program (APP) were nearly cut by half in early 2021 when the €120B temporary envelope added in early 2020 was fully spent. More ECB tapering is expected over the forecast horizon when considering that a large chunk of the €1850B envelope of the Pandemic Emergency Purchase Program (PEPP) has already been spent. Additionally, the PEPP facility is a temporary asset purchasing program due to be terminated in March 2022.

What happens next with the TLTRO-III bank lending scheme will also play a role. What's unique about the ECB is that half of its 2020 balance sheet expansion was the result of increased TLTRO III lending to banks. With the changes made late last year (i.e. higher maximum potential take-up, new tranches), there is still a lot of TLTRO-III fire power. However, eurozone commercial banks seem to have a lot smaller appetite, with many of them still uncertain if they will increase their borrowing from the ECB despite very attractive borrowing conditions.

With better growth prospects for the eurozone, there is less need for the ECB's heavy artillery. The ECB's balance sheet is projected to expand at a much slower pace moving into 2022. Obviously, this comes with the risk of a policy mistake. However, with inflation projected to significantly decelerate in the eurozone, the ECB will stay prudent, quickly backtracking if financial conditions deteriorate too much.

China

- China has just entered a more difficult phase in its economic cycle where growth prospects are weaker.
- With slowing growth, we expect the People's Bank of China (PBOC) to remain more dovish than generally expected.

Bank liquidity squeeze intensifies

Following several quarters of solid economic growth, China has just entered a more difficult phase in the cycle, where the credit impulse turns increasingly negative, weakening growth prospects.

The credit impulse, which measures the change in total credit as a share of GDP, has recently turned negative and should contract much further in upcoming months. This will reflect an exit from fiscal stimulus and reining in credit creation in sectors that pose a potential risk to financial stability. Debt issued by local government financing vehicles (LGFVs), mostly used to finance off-balance-sheet investment by local governments, and liabilities from real estate developers have both surged in recent years. In contrast, returns on assets in both sectors have continued to trend down, reaching anemic levels of around 1-2%.

In past episodes of negative credit impulses, the Chinese economy hasn't been too impacted when global trade was strong. Strong foreign demand, along with healthy consumer fundamentals, should cushion some of the hit from slowing credit growth on the economy. That said, key global factors currently boosting China's external demand (such as vaccination, stimulus abroad, and inventory replenishment) are temporary. Delaying the credit drag with more stimulus and credit appears unlikely, as it would result in tenuous growth just ahead of the 20th National Party Congress in late 2022.

Despite the upcoming slowdown of credit growth, debt issuance should remain at stratospheric levels. Together, high government deficits and elevated financing needs of state-owned enterprises (SOEs) and LGFVs should result in an 'augmented deficit' of about 17% of GDP in 2021. This is very close to the 2020 level and about 5 percentage points more than in 2019. Challenges regarding absorption of debt supply should also be magnified by a surge of debt maturing for real estate developers and LGFVs.

To prevent a liquidity squeeze and help banks absorb high debt supply in a context of slowing growth and rising defaults, we expect the PBOC to remain more dovish than generally expected. They'll accomplish this by keeping policy rates on hold, continuing to inject liquidity when needed, and further lowering reserve requirement ratios (RRR) for banks.

Alternative scenarios

Sluggish global recovery (20% probability)

In this scenario, the global distribution of the vaccine is too slow and not as effective against new viral variants. The pandemic continues to intensify and spread while policy response is largely inadequate. Cyclical and risky assets would face a significant correction. In addition, China slows down more than expected with spillovers for the rest of the world. The equity market rebounded rapidly after the recession on hopes for a V-shaped recovery. As these hopes fail to materialize, equities and commodity prices would severely correct. Given that much of the global bond market is already in negative yield territory, only a few countries would have room for declining bond yields. Safe-haven assets like gold would surge.

Speedy return to normal (20% probability)

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

Scenario	Less Favourable	More Favourable
Sluggish Global Recovery (20%)	Global Equities High Yield Bonds Oil	Gold U.S. Treasuries Swiss franc
Speedy return to normal (20%)	Eurozone bonds Canadian bonds U.S. Treasuries	European equities Industrial metals EM bonds

Economic forecasts (next 12 months)

Region	Current GDP[2]	GDP - Consensus	GDP - CAM View	Current Inflation[3]	Inflation - Consensus	Inflation - CAM View	Policy Rate - CAM View
Canada	0.3%[4]	5.6%	6.0%	3.6%	2.7%	2.7%	Near 0%
United States	0.4%	6.3%	6.9%	5.0%	3.3%	3.4%	Near 0%
Eurozone	-1.3%	4.7%	5.7%	1.9%	1.9%	1.9%	Near 0%
China	18.3%	5.6%	5.3%	1.3%	2.2%	2.0%	Cutting RRR[5]
Japan	-1.6%	2.8%	3.3%	-0.1%	0.5%	0.8%	Near 0%
World	3.9%	5.2%	5.6%	2.0%	3.1%	3.5%	-

[2] Real GDP Growth (y/y %)
[3] Year/year %
[4] Implied (converted from a Q/Q basis)
[5] Reserve requirement ratio

Data as of June 2021
Source: Datastream, Bloomberg, CIBC Asset Management Calculations

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