

# GLOBAL ECONOMY SHIFTING INTO LOWER GEAR

Global trade tensions, Italian fiscal risk and rising interest rates are just some of the issues world equity markets have faced this year. Only a select few countries, including the U.S., have managed to deliver positive returns. Portfolio diversification has not been very helpful—global bond markets have also delivered negative returns year-to-date. The global economic cycle is settling into a weaker path as we move into a late expansion phase, yet growth will remain above potential.

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## ASSET ALLOCATION OUTLOOK

as at October 1, 2018

ASSET CLASS	UNDERWEIGHT		NEUTRAL	OVERWEIGHT	
	SIGNIFICANT	MODERATE		MODERATE	SIGNIFICANT
<b>EQUITY RELATIVE TO FIXED INCOME</b>					
<b>FIXED INCOME</b>	Canadian Money Market				
	Canadian Government Bond				
	Canadian Corporate Bond				
	International Government Bond				
<b>EQUITY</b>	Canadian Equity				
	U.S. Equity				
	International Equity (Developed Markets)				
	Emerging Markets				

CURRENCY (VERSUS U.S. DOLLAR)	UNDERWEIGHT		NEUTRAL	OVERWEIGHT	
	SIGNIFICANT	MODERATE		MODERATE	SIGNIFICANT
Canadian Dollar					
Euro					
Japanese Yen					
British Pound					
Swiss Franc					
Australian Dollar					
Emerging Markets					

## HIGHLIGHTS AND KEY THEMES

**Fixed Income vs. Equity:** Geopolitical risks are receding but not disappearing. With the cyclical outlook more supportive, we see a window of opportunity for equities to perform well, with increased volatility.

**Equity:** China has implemented some stimulative measures to support its economy and soften the effects of its trade war with the U.S. While much of the bad news is priced into emerging markets (EM), a little more time may be needed to see EM equities turn around.

**Fixed Income:** Global bond yields should continue to climb, with 10-year sovereign bond yields reaching 3.25% (U.S.) and 2.75% (Canada).

**Currencies:** The short-term outlook for the Canadian dollar has improved, although it remains structurally challenged over the longer term.

	GDP OUTLOOK Direction	INFLATION OUTLOOK Direction	MAIN THEMES	THEME'S IMPORTANCE
U.S.	....	...	Slow and steady Fed policy rate renormalization, but changes required to QT timeline and target	
Canada	...	....	Better growth fundamentals, a more comfortable BoC	
Europe	...	...	Italian fiscal risk resurfacing but no full-blown eurozone fiscal crisis	
China	....	...	Preemptive easing to cushion impact of U.S. trade sanctions	
Japan	...	...	More QE tapering via changes to Yield Curve Control (YCC) policy	
World	...	...	Growth above potential and synchronized	

## EXPECTED RETURNS

Expected returns for the one-year period beginning October 1, 2018.

	IN CANADIAN DOLLARS			IN LOCAL CURRENCY		
	Global Reflation	Policy Renormalization	Global Recession	Global Reflation	Policy Renormalization	Global Recession
<b>Probabilities</b>	<b>20.0%</b>	<b>50.0%</b>	<b>30.0%</b>	<b>20.0%</b>	<b>50.0%</b>	<b>30.0%</b>
Canada Money Market	2.2%	1.9%	1.3%	2.2%	1.9%	1.3%
Canadian Bond	-0.3%	1.3%	5.8%	-0.3%	1.3%	5.8%
Canadian Federal Govt. Bond	-0.3%	1.4%	7.0%	-0.3%	1.4%	7.0%
Canadian Corp. Bond	2.0%	2.0%	2.6%	2.0%	2.0%	2.6%
Canadian RRB	-0.8%	-0.6%	2.0%	-0.8%	-0.6%	2.0%
Canadian High Yield	4.5%	3.3%	-8.0%	4.5%	3.3%	-8.0%
International Govt. Bond	-4.4%	0.1%	14.6%	-2.6%	-0.8%	6.2%
Canada Equity	15.7%	8.0%	-16.3%	15.7%	8.0%	-16.3%
United States Equity	5.9%	2.8%	-10.7%	10.9%	4.6%	-15.7%
International Equity	15.5%	9.0%	-15.4%	14.1%	6.3%	-20.5%
Emerging Equity	22.9%	9.8%	-24.7%	19.4%	9.4%	-23.9%

## GLOBAL OUTLOOK

### Clearing skies?

Investment conditions have been particularly difficult for global investors so far in 2018, to say the least. More than two-thirds of world equity markets are down for the year and, other than the U.S., only a few equity markets have managed to deliver positive returns. Unfortunately, portfolio diversification hasn't been very helpful, with global bond markets also delivering negative returns year-to-date. It seems that there have constantly been a number of very good reasons to cause global investors to worry about another financial storm. Looking into the distance, however, skies may finally be clearing.

Intensifying global trade tensions have been at the top of the list of market concerns for most of the year. While plenty of uncertainty remains on that front, it is important to recognize that progress has been made. For one thing, the U.S., Canada and Mexico finally struck a new USMCA deal. For another, the U.S. has delivered on its promises by imposing tariffs against China. However, the hit on the Chinese economy seems manageable—particularly when considering that Chinese monetary authorities have preemptively eased monetary conditions to cushion the impact of the recently announced U.S. trade sanctions. In light of these developments, concerns about a potential Chinese economic slowdown have significantly dissipated.

All is well in the eurozone—except for the fact that Italian fiscal risk has resurfaced and is not likely to go away. For the last three years, while good times have rolled for the Italian economy, little progress has been made on the fiscal front. Italy still remains stuck with a heavy government debt load, making it extremely vulnerable in the context of rising debt servicing costs and growth disappointment. The good news is that while the Italian fiscal risk will remain omnipresent over the forecast horizon, we are still a long way from a fiscal crisis like the one experienced in 2011 and 2012.

In America, the Federal Reserve (Fed) has a difficult balancing act. When focusing solely on domestic liquidity conditions, it's tempting to conclude that the Fed is not tightening fast enough. After all, the U.S. economy is increasingly at risk of overheating and inflationary pressures are building. However, when looking at U.S. dollar liquidity conditions in the rest of the world, it is becoming clearer that the Fed is probably tightening too fast. Luckily, the Fed's operating framework allows it to isolate the interest rate policy from the size of the Fed's balance sheet. This makes it possible for the Fed to change its quantitative tightening (QT) timeline and long-term target for excess reserves, while at the same time staying on its interest rate tightening path.

At this late stage of the business cycle, the challenge for global central banks is to figure out the right pace to close the global liquidity tap. As argued in previous editions of Perspectives, this promises to be a difficult task, implying that there will likely be a lot of back-and-forth. Judging by the recent market action, global liquidity has probably been drained too fast over the first half of the year. Let's not forget that, after years of easy money trading in an environment of abundant liquidity, global investors have developed a strong dependency on central bank liquidity injections. With Chinese monetary authorities back in easing mode and the Fed's excess reserve targets under review, global investors will likely soon be able to breathe a little easier.

## TRADE WAR VIEWS

### Goodbye NAFTA, hello USMCA

After more than a year of renegotiations, Canada and the United States have finally agreed to replace the 24-year-old NAFTA pact. Given all the huffing and puffing that preceded it, the new trade agreement looks like a pretty paltry achievement for the U.S. administration. On the most critical issue—the retention of a mechanism to resolve disputes over anti-dumping and anti-subsidy duties—Canada won a complete victory. This came in exchange for minor concessions with regard to U.S. access to Canada's dairy market.

To be clear, moving from the old NAFTA to the new USMCA trade agreement is not likely to radically change the North American economic landscape. However, from an investor's perspective, this new trade agreement is a non-trivial development, as it substantially alleviates the uncertainty relating to building trade tensions. For the Bank of Canada (BoC), NAFTA uncertainty has been one of the reasons that justified its unusually slow pace of policy renormalization. This, in turn, was limiting the Canadian dollar's upside.

Less trade uncertainty means less of a reason for the Canadian monetary authorities to be gun shy. Looking forward, the Bank of Canada will likely be delivering rate hikes at a faster pace (or at least signal its intention to do so), providing more support to the Canadian dollar over the short term.

Having said this, trade uncertainties have not completely vanished. The new trade agreement between Canada and the United States is not a done deal yet, as it will require approval by the U.S. Congress. Some senior Democrats have already expressed concerns about the proposed deal, signaling their intention to block it. If Democrats gain control of the House of Representatives in the November midterm elections, as widely expected, the Trump administration could well face a stand-off with Capitol Hill on the new deal.

# REGIONAL OUTLOOK

## Canada

### BoC walking a tightrope

- We expect Canadian real GDP growth to average +1.9% over the next four quarters—a slightly below-consensus expectation.
- With an improving Canadian cyclical backdrop and dissipating concern about Canadian housing and trade risks, we anticipate the Bank of Canada will deliver three rate hikes over the forecast horizon.

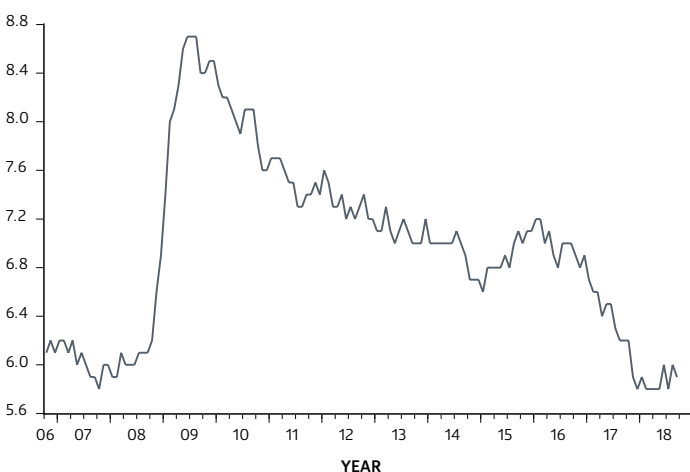
The Canadian economy still faces important structural headwinds, such as chronically weak competitiveness, and remains stuck with financial vulnerabilities. However, recent developments have been more encouraging, leaving the Bank of Canada with fewer impediments to restrain the pace of monetary policy renormalization.

As signaled by improving home sales and prices data, the Canadian housing market has stabilized following the setback it experienced after new macroprudential rules were announced last year. Overall, recent housing developments imply less downside risk for home prices. This was an important source of concern for the Bank of Canada.

Another source of comfort for Canadian monetary authorities is a much healthier Canadian economic growth mix. By post-crisis standards, full-time employment growth has remained elevated and Canadian households seem to have lost the appetite for credit. Also, the proportion of industries posting positive growth has picked up, standing at a higher level than during the previous economic expansion. The takeaway here is that the Canadian economy seems to be in better shape and better equipped to cope with rising interest rates.

### TIGHT LABOUR MARKET CONDITIONS

Canadian Unemployment Rate (percent)



Source: Thomson Reuters Datastream, CIBC Asset Management Inc.

Our Canadian economic outlook expects above-potential growth, thanks to well-supported consumption and private investment. Solid U.S. economic prospects and building Canadian excess demand should be supportive for investment. With an improving Canadian cyclical backdrop and dissipating concerns about housing and trade risks, the Bank of Canada should deliver three rate hikes over the forecast horizon.

## United States

### Fed sails into inflationary waters

- The already sizzling hot U.S. economy is not expected to shed much momentum moving into 2019, growing at 2.6% between Q4 2018 and Q3 2019. Headline inflation should creep higher, reaching 2.5% by the end of the forecast horizon.
- The Federal Reserve is projected to deliver four more rate hikes, while altering its quantitative tightening (QT) timeline and target.

With U.S. core CPI inflation now running at its fastest yearly pace in nearly a decade, the Fed is clearly sailing into more inflationary waters. Under normal conditions, this would force it to step up the pace for delivering rate hikes. However, these are not normal times. This Fed tightening cycle is unique because the Federal Reserve is not just hiking policy rates, it is also shrinking its balance sheet (i.e. quantitative tightening or QT). This makes the Fed's navigation particularly challenging.

The first difficulty facing the Fed arises from the very asymmetrical impact of its QT policy. For more than a year, the Fed has been draining U.S. dollars out of the global financial system—and at an accelerating pace. However, the squeeze in offshore U.S. dollar liquidity conditions has been three times greater than the tightening in onshore conditions. This has severely impacted the more fundamentally challenged (USD cash-starved) emerging economies like Turkey, Argentina and Brazil—with important contagion effects in the rest of the emerging world. From this perspective, Fed relief is required. It is time for the U.S. monetary authorities to reevaluate the QT timeline and target.

The second difficulty for the Fed is that the interest rate increases delivered so far (i.e. +200 basis points (bps) since the launch of its tightening campaign in late 2015) have not led to a slowdown in credit activity. On the contrary, this year we have witnessed a broad-based reacceleration in U.S. credit growth. This may sound counterintuitive: higher rates, more credit? The reality is that QT policy just isn't QE (quantitative easing) in reverse. At the time of the Fed's QE policy, the U.S. banking system was not functioning normally, with a steady decline in the velocity of money. Now that the U.S. economy is on much more solid footing, there is stronger demand for credit in the private sector and a greater bank appetite to lend—even if borrowing costs are rising. In short, the velocity of money is finally turning around.

The Fed faces quite a dilemma. Considering domestic liquidity conditions, it seems that the Fed is not tightening fast enough. The U.S. economy is at risk of overheating and inflationary pressures are building. Looking at USD liquidity conditions in the rest of the world, it seems that it is tightening too fast. Luckily, since 2008, the Fed's operating framework allows it to isolate the interest rate policy from the size of the Fed's balance sheet. This makes it possible for the Fed to alter its QT timeline and steady-state target for excess reserves, even while staying on its interest rate tightening path.

## Europe

### Resurfacing Italian fiscal risk?

- The end of QE in early 2019 is no minor development, as European Central Bank (ECB) officials are well aware. This means the ECB will stick to its sub-zero policy rate until the impact of ending QE is fully assessed.
- A growth slowdown is projected for the eurozone economy, with real GDP growth decelerating from +2.0% currently to +1.6%.

With the eurozone economy growing at a healthy pace, the ECB has turned sufficiently upbeat to announce it will be ending its asset purchasing program (i.e. QE) in early 2019. This is certainly good news. Unfortunately, not everything is hunky dory in the eurozone—the Italian fiscal risk has been resurfacing.

Italy's new government is planning both tax cuts and a universal basic income in its first budget to show financial markets it won't back down from its agenda. It also wants to deliver some fiscal stimulus ahead of new elections that will likely be held in the first half of 2019. The problem is the new government has very little manoeuvring room. Let's not forget that Italy's government debt load is huge (more than 130% of GDP) and, as a result, it comes with big debt servicing costs (-3.9% of GDP). This means that Italy has to produce large primary surpluses every year just to keep its debt-to-GDP ratio stable. However, every year comes with another deficit and rising debt servicing costs—even as borrowing costs have been declining thanks to the ECB's QE. A likely rise in effective borrowing costs and slowing nominal GDP growth in 2019 promises to make the upcoming year particularly challenging.

The bottom line is that, after a relatively calm summer, Italy's fiscal mess is gradually coming back into focus as markets start pricing in potentially more negative developments on the fiscal front. To avoid confrontation on the fiscal rules, the Italian government may be tempted to work with a deficit target of -1.6% of GDP for 2019. However, given its desire to show progress on tax reforms and minimum income, Italy's primary surplus is set to shrink, in the context of rising debt servicing costs and slowing nominal GDP growth. There is a high risk that the Italian

government is about to set in motion very negative market dynamics. Having said this, while the Italian fiscal risk will remain omnipresent over the forecast horizon, we are still a long way from a fiscal crisis like the one experienced in 2011 and 2012.

## China

### China proactive to avoid trade war spillovers

- Our projection for real GDP is revised up to 6.3% (from 6.1%) by Q3 2019, due to a faster-than-expected reaction by policy-makers to support growth.
- The outlook for CPI remains at 2.5% over the next 12 months, an environment that provides the central bank with the flexibility to adopt increasingly accommodative policy.

The Chinese economy has been showing signs of slowing in Q3, as uncertainty surrounding the U.S.-China trade dispute added to expectations of a downturn in economic growth. Consumer spending has shown important pockets of increasing thrift, with car sales and travel spending abroad uncharacteristically soft. This said, the slowdown was not as broad-based as we expected. Areas of positive surprise include residential real estate and industrial production activity. Despite macroprudential measures across the country to limit price and activity expansion, activity in the housing sector has been robust. In addition, several signposts for industrial activity, including electricity consumption growth and freight turnover, have been stronger than expected.

Over the past quarter we have also revised our expectations for credit growth to the upside. The central bank, through the decrease of reserve requirement rates, has adopted easier conditions with significant liquidity injection into the banking system. Fiscal policy has also provided relief, with increased tax allowances and an expansion in the issuance of local government bonds. In addition, the RMB<sup>1</sup> has helped ease financial conditions, with a depreciation of approximately 10% against the USD since April 2018. Below-target inflation provides an environment which allows the PBoC<sup>2</sup> to adopt this proactive policy approach to growth. We expect CPI to average 2.5% over the next 12 months.

The U.S.-China trade dispute has intensified over the past quarter, with U.S. tariffs on \$250Bn of U.S. imports from China. The direct impact from these actions on the Chinese economy is estimated to be relatively small, under 0.2% of GDP. Further escalation is possible in 2019, however the marginal cost of further U.S. tariffs on Chinese goods is likely to decline. This is due to the fact that the majority of Chinese exports to the U.S. not yet targeted are consumer goods that are difficult to substitute. This suggests that, despite the possibility of further escalation, the short-term uncertainty surrounding the trade war may have peaked.

## MULTI-ASSET STRATEGY OUTLOOK

### Rebuilding the risk premium

Our view at the beginning of this year was that the early 2018 growth slowdown and market shakeout was a transition phase. Global economies were leaving the “Goldilocks” phase that prevailed before and moving into a late cycle expansion that we are still waiting for. This transition led to valuation and growth expectation readjustments, based on an environment of tighter liquidity and rising inflation pressure. The recent turmoil in emerging markets is a manifestation of these readjustments.

One way that quantitative easing (QE) worked was through the portfolio substitution effect. By buying bonds and pushing yields lower, central banks forced investors to move away from government bonds and buy riskier securities. This, in turn, pushed the yields of these securities lower as well. Investing is all about reward for taking risk, and the risk premium is the measure of this reward. After years of QE, the lack of attractive safe assets has led to shrinking risk premiums across asset classes. With policy rates close to zero or even negative, investors were happy to buy riskier assets without a significant reward.

Now the Fed is unwinding QE and raising its policy rate, and other central banks have signaled they will soon follow. This continued normalization of monetary policy will make risky assets look less attractive compared to safe assets.

Despite weak returns and market turbulence, risk premiums have improved unevenly this year. In emerging equities, bonds and currencies, we see more attractive risk premiums than at the start of the year. In other regions however, risk premiums have really not improved. Low risk premiums basically mean that markets are overvalued. Yet cheaper valuation would not be sufficient to improve the risk premiums. Because the risk premium is measured relative to T-Bills, valuation has to become cheaper at a faster pace than the T-Bill rate rises.

The normalization of risk premiums will not follow a straight line but will most likely come in turbulent episodes—global growth will be a key driver of these episodes. We see evidence of stabilization in the global economy. Our cyclical indicators signal the soft patch is over and are pointing toward a stabilization of growth. The global economic cycle is settling into a weaker path as we move into a late expansion phase, yet growth will remain above potential. Growth may be peaking in the U.S. and about to recover in China. On the other hand, geopolitical risks are receding but not disappearing. With the cyclical outlook more supportive, we see a window of opportunity for equities to perform well, with increased volatility.

## EQUITY MARKET OUTLOOK

### United States

Earnings growth is very strong in the U.S. this year, thanks to robust economic activity, tax cuts and share buybacks. These effects should continue to support earnings in the short term but will eventually fade. Inflation is expected to remain stable, but wage inflation will gradually move higher, putting pressure on corporate margins. Debt service costs should also continue to increase. Overall, sales growth will remain strong, but margins will resume their downward trend due to the rising costs of labour and debt financing.

The S&P 500 is the most overvalued developed equity market, and its cyclically-adjusted P/E ratio is back at its earlier peak. Meanwhile, the P/E fair value is declining due to higher inflation and the Fed policy rate. This means that the valuation argument against the U.S. is still very strong.

### International Equities

Economic growth in EAFE has lagged North America, with particularly weak growth in Japan and the U.K. While we expect a further deceleration overall, the slowdown is expected to be milder in Europe (outside of the eurozone) and Japan’s growth should remain stable.

Brexit is already weighing on the U.K.’s economic growth, while the fiscal outlook in Italy is a concern. The Italian government has indicated they will use as much fiscal leeway as they can get away with. Given their high level of debt, an economic slowdown would push the Italian deficit onto an unsustainable path. That outcome would reignite fears of an existential crisis in the eurozone. The ECB’s planned end for their QE program could also lead to higher bond rate volatility, putting more strain on Italy and the banking sector, and likely spilling over into higher equity market volatility.

On average, EAFE countries trade slightly above our fair value, but are more attractive than the U.S. However, international equities have weaker growth prospects than North American markets.

### Canada

Canada’s economic growth is expected to remain above potential, but will still experience a small deceleration. Earnings should remain relatively strong, but decelerate as the bulk of the boost to earnings from higher commodity prices is behind us.

Banks’ net interest margins generally benefit from higher rates, as they are mostly funded by deposits on which they pay little interest. The slow tightening from the BoC is positive as long as it does not choke off growth. Banks also benefit from improving profitability from their U.S. operations, an important driver of growth in recent quarters.

With the uncertainty regarding NAFTA now behind us, investment should also improve.

The S&PTX Composite trades 12% above our fair value. In the context of expensive equity markets, this is relatively attractive, especially when compared to the U.S.

## Emerging Markets

After outstanding returns in 2017, emerging markets (EM) have had a difficult year so far in 2018. The 20% underperformance in the last 6 months for MSCI Emerging (in USD) relative to the S&P 500 is one the weakest on record. A number of headwinds caused this sharp underperformance.

The most important is likely the slowdown experienced by the global economy. Emerging markets remain more cyclical than the U.S. and usually underperform in periods of weak economic growth. Emerging markets also tend to underperform when the U.S. dollar is strong, as was the case this year. Again, one of the drivers of U.S. dollar strength was the weak economic outlook. A few countries (i.e. Turkey and Argentina) went through severe crises. Turkey has been known for some time to carry significant structural imbalances, but investors remained complacent as long as growth was strong. When growth weakened, investors become more risk averse—what had appeared to be manageable imbalances suddenly became unsustainable. One last headwind for EM this year has been the ongoing trade war that the Trump administration has conducted against many trade partners.

Investors were clearly not positioned for this outcome. According to the Bank of America Merrill Lynch Fund Manager Survey, investor sentiment toward EM was very positive coming into this year and very negative toward the U.S. This has now completely reversed.

Going forward, it seems that a lot of the bad news is already priced in. China has implemented some stimulative measures that will lead to a stabilization of credit growth and support the economy. The trade war with the U.S. could escalate further but, so far, the expected impact on China's GDP for next year is manageable. The growth differential between emerging markets and the U.S. will turn in favour of EM, where GDP growth deceleration is expected to be less pronounced than in the U.S. The USD impact on EM should also be more muted over the next 12 months.

That being said, shorter-term indicators still point toward EM weakness for the immediate future. A little more time may be needed to see EM turn around.

## FIXED INCOME OUTLOOK

### The lid is off for developed market bond yields

The U.S. 10-year Treasury yield remained in a narrow range of 2.80% to 3.00% during most of the third quarter. However, bonds sold off substantially in mid-September and yields finished the quarter at 3.09%. U.S. domestic forces continued to

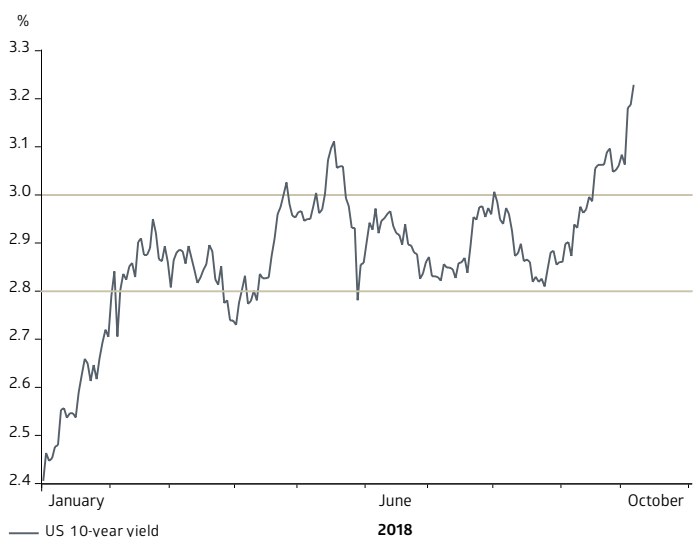
be negative for bonds—robust employment numbers of around 200K a month further tightened the labour market, leading to increased wage pressure, which reached a new post-GFC<sup>3</sup> high of +2.9% y-o-y in August. Moreover, after the U.S. administration finally announced 10% tariffs on \$200Bn Chinese goods imports, U.S. yields actually surged higher instead of declining, as this news had been discounted in prior weeks.

Outside the U.S., several positive developments have reduced negative perceptions surrounding global risk and, to the same extent, helped remove the lid on bond yields in developed markets (DM). In Europe, the Italian political scene became somewhat less volatile as the new government signaled its intentions to comply with EU rules in terms of fiscal deficit. In Asia, Chinese cyclical data held up relatively well despite the negative headlines related to the U.S.-China trade war. In emerging markets (EM), several idiosyncratic risks subsided as Russia and Turkey responded to economic sanctions by adopting more orthodox monetary policies to protect against further currency depreciation. This resulted in renewed optimism among EM bond investors.

Meanwhile, central bankers in the developed world stayed the course in accordance with previously communicated guidance. The Fed hiked rates once, to 2-2.25% on September 26, and continued to signal a rate hike every quarter for the next 12 months. The ECB reaffirmed their objective to terminate the asset purchasing program in December 2018. The BoE hiked its official bank rate to 0.75% in August. Finally, the BOJ kept the yield curve control policy intact but, nonetheless, reduced asset purchases in a “stealth mode”.

Going forward, our forecast for higher global bond yields remains unchanged, although the shrinking of USD liquidity poses a clear risk. However, global growth momentum should remain above potential and strong enough to maintain the mantra of monetary policy renormalization for DM central bankers. As bond demand from the Fed, the ECB and the BOJ recedes in a synchronized fashion, the path of least resistance for DM sovereign bond yields will be higher.

### BREAKOUT TO THE UPSIDE



Source: Thomson Reuters Datastream, CIBC Asset Management Inc.

From both a qualitative and a quantitative perspective, the fair-value yields for DM bond markets remain higher than current levels. As a base case scenario, 10-year sovereign bond yields should reach 3.25% and 2.75%, in the U.S. and Canada respectively, over a twelve-month horizon (with possible periods where yields “overshoot” those targets).

## CURRENCY MARKETS

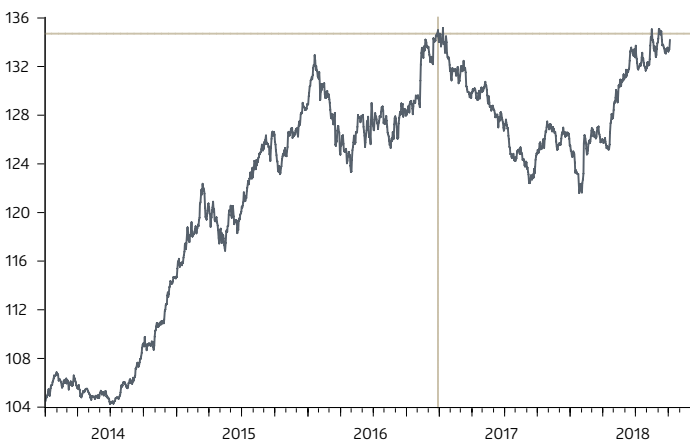
### U.S. Dollar

One of the most widely unexpected turn of events so far in 2018 has been the renewed strength of the U.S. dollar. Between the cyclical lows of early February and the cyclical highs hit in September, the U.S. dollar has appreciated more than 11% on a trade-weighted basis. In late 2017, consensus was calling for exactly the opposite. From this point on, the upside for the U.S. dollar should be limited, given its already-significant overvaluation. However, what’s next also depends on a number of other factors.

All year, the U.S. dollar has stayed well-supported because of a gradually deteriorating global risk environment. There were plenty of reasons for investors to be concerned: intensifying global trade tensions, resurfacing Italian fiscal risk and, last but not least, a Fed-induced global liquidity squeeze. On all three fronts recent developments should allow concerns to start dissipating. In turn, this should allow for a broad-based but very gradual trend reversal for the U.S. dollar. Having said this, for other currencies to decisively move higher against the U.S. dollar, the launch of tightening campaigns in the rest of the developed world must be clearly signaled by monetary authorities. In the meantime, currency market volatility should stay elevated.

#### U.S. DOLLAR REVISITING 2016 CYCLICAL HIGHS

CAM U.S. dollar trade-weighted index



Source: Thomson Reuters Datastream, CIBC Asset Management Inc.

### Canadian Dollar

To a large extent, Canadian dollar weakness over the last year was simply the mirror image of broad-based U.S. dollar strength. We now suspect that a widespread U.S. dollar trend reversal is in the making, owing to upcoming Fed policy changes with regard to U.S. dollar global liquidity.

Lately, fluctuations in the Canadian dollar have, to some extent, been driven by relative BoC-Fed monetary policy expectations. As argued in the Canadian economic section, we think that there is a short-term window of opportunity for the Bank of Canada to turn more hawkish. This is a result of an improving Canadian cyclical backdrop and dissipating concerns about Canadian housing and trade risks.

Meanwhile, oil prices are expected to stay well supported thanks to a favourable global economic backdrop. While Canadian Western Select is now trading at a large discount to West Texas Intermediate (WTI), this price discount is expected to converge back to its historical mean.

The Canadian dollar remains structurally challenged, limiting its appreciation potential over the longer term. However, in light of the developments enumerated above, the short-term outlook for the Canadian dollar has improved.

### Euro

For many market participants, the euro’s 2018 performance has so far been a big disappointment. After peaking at 1.25 in early February, it lost substantial ground against the U.S. dollar early in the summer, shifting into consolidation mode since June and trading around 1.16. In the context of a gradual U.S. dollar trend reversal, the euro is not likely to be one of the currencies that benefits the most. The omnipresent Italian fiscal risk will make it difficult for the euro to gain substantial ground against the U.S. dollar over the forecast horizon. In addition, while the eurozone economic landscape has clearly been improving, there is still very little evidence of a significant buildup in inflationary pressures in the eurozone. As a result, the ECB has very little incentive to precipitate the launch of a tightening campaign and will likely stick to its sub-zero rate policy for a while longer. In light of these developments, the euro’s upside seems somewhat limited.

### Japanese Yen

So far in 2018, the Japanese yen has been one of the few currencies that managed to hold its ground against the U.S. dollar. This hardly comes as a surprise. As we have often argued in the past, the BOJ has reached its QE policy limits. Case in point: a few years ago, below-target inflation was the main justification used by the Bank of Japan to increase the size of its asset purchasing program. Recently, even with Japanese CPI inflation that remains stubbornly below target, the BOJ is not buying more securities. Instead, it is substantially slowing the pace for buying them. Indeed, the Bank of Japan is accumulating Japanese government bonds at the slowest pace in more than seven years.



The BOJ's holdings accounted for 42% of the market, yet they rose only 7% from a year earlier. In short, despite its official rhetoric, the BOJ is clearly in tapering mode and tapering at an accelerating pace. In light of these developments, the Japanese yen should remain well supported.

## COMMODITY INSIGHT

Oil prices remain supportive due to the pending reintroduction of sanctions on Iran. Countries importing Iranian barrels will likely cease import this November, resulting in approximately 1 MB/D to be filled from other oil-producing nations. With OPEC spare capacity at limited levels, as OPEC had already increased production to bring quota levels back to 100% compliance, this pending shortfall is positive for oil prices. In addition, Venezuela oil production continues to be challenged from the fallout of the social and economic chaos since the new government took control of the country. Finally, tensions remain high in the Middle East, resulting in a geopolitical risk premium that further supports oil prices.

Steady global economic growth has increased the demand for oil products and gasoline and distillate inventories in the Americas, Europe and Asia have fallen to five-year-low inventory levels. The International Energy Agency forecasts 1.4 MB/D and 1.5 MB/D of demand growth in 2018 and 2019, respectively. A key indicator to watch going forward will be finished product prices, which could result in decreased demand if sharp increases in oil prices hurt consumers at the retail level.

U.S. natural gas prices hover around \$3/Mcf, despite inventory levels that are below historical five-year averages. Supply growth from associated gas regions and ongoing well-productivity gains in the Permian and Marcellus/Utica continue to cap prices. Western Canadian gas continues to be challenged. The lack of pipeline capacity from Alberta has weakened prices, widened the basis and resulted in producers scaling back production growth.

# SIGNPOSTS

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

## Canadian Signposts

- Employment growth, wage growth
- Housing activity and property prices
- Developments on the USMCA front (new NAFTA)
- Canadian oil price discount to U.S.

## U.S. Signposts

- Wage growth
- Labour participation rate
- Trade negotiations
- Excess reserves held at the Fed
- Spread between EFR<sup>4</sup> and IOER<sup>5</sup> rates
- Core PCE inflation
- Domestic oil production trend (following OPEC agreement)
- New orders

## Chinese Signposts

- Housing data
- Inflation
- Trade balance
- Electricity consumption
- GDP growth mix (industrial production vs. retail sales vs. services)
- Lending to households and businesses
- Credit growth (local government bond issuance, bank loans, shadow banking)
- North Korea geopolitical tension

## Other Market Signposts

- Excess reserves held at the ECB and the Bank of Japan
- European inflation
- Brexit negotiations
- U.K. commercial real estate activity
- Italian government coalition
- Global Purchasing Managers' Indices

<sup>1</sup>Renmimbi

<sup>2</sup>People's Bank of China

<sup>3</sup>Global financial crisis

<sup>4</sup>Effective fed funds rate

<sup>5</sup>Interest rate on excess reserves

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