CIBC

CIBC ASSET MANAGEMENT

PERSPECTIVES

For the 12-month period beginning April 1, 2023

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Investors still facing uncertainty

As we see with recent events in the US banking sector, investors are still facing a fair amount of uncertainty. The key will be to evaluate at what point the risks are sufficiently recognized by the market and, as such, well-reflected in prices. Our central scenario of a global economic recession is still intact. In fact, recent events may have increased our conviction at the margin. However, the tail risk of a more severe negative outcome cannot be ignored. On the other side, there is still a possible way to achieve the desired soft landing. Given such views, our strategy continues to favour cash and government fixed income over equities. The potential decline in bond yields will be limited by the inflation outlook. However, in a recession, bonds are expected to generate small positive returns. This is a contrast with equities, which will face pressure on earnings and valuation.

Asset class highlights

Equity: assuming the global economy slows down into a recession, corporate profits of the S&P 500 could decline by 15% to 20% on a year-over-year basis. Other regions could suffer similar declines, if not bigger for the more cyclical countries. Canada and emerging markets are in a relatively better position going into a global recession because of valuation and could be outperformers.

Fixed Income: we believe that global bonds are likely to offer positive returns over the next twelve months; the yield of 10-year treasuries should trade in a range of 3.00% to 4.25%, around a pivot of 3.50%.

Currencies: if economic activity decelerates on a broad basis, the USD may play its role as a global safe haven and remain resilient relative to cyclical currencies; heightened volatility is to be expected in currency land over the forecast horizon.

China: China's post-Covid recovery is underway, and it has been strong so far. Consensus expects consumers unleashing pent-up demand to lead a strong and self-sustained expansion. We are skeptical about this view, particularly for the second half of our forecast horizon. Our outlook averages 5.3% growth for 2023, inflated by a positive base-year effect in 23Q2.

Multi-asset outlook

Asset class	Current March 31, 2023	Most likely minimum of range for next 12 months	Most likely maximum of range for next 12 months
Canada 3-month T-Bills rate	4.50%	4.00%	4.75%
Canada 2-year government bond yield	3.73%	3.00%	4.00%
Canada 10-year government bond yield	2.90%	2.75%	3.50%
U.S. 10-year government bond yield	3.47%	3.00%	4.25%
Germany 10-year government bond yield	2.29%	1.75%	3.25%
Japan 10-year government bond yield	0.33%	0.00%	1.00%
Canada 10-year real-return government bond yield	1.21%	0.75%	1.25%
Canada investment-grade corporate spreads	1.66%	1.50%	2.00%
U.S. high-yield corporate spreads	4.49%	4.25%	7.00%
Emerging market sovereign (USD denominated) bond spreads	400	250	500
S&P/TSX price index	20,100	17,000	21,500
S&P 500 price index	4,109	3,400	4,300
Euro Stoxx 50 price index	4,315	3,400	4,400
Japan Topix price index	2,004	1,700	2,100
MSCI Emerging Markets index	59,416	50,000	65,000
U.S. dollar/Canadian dollar	1.3516	1.333	1.434
Euro/U.S. dollar	1.0839	1.000	1.120
U.S. dollar/Japanese yen	132.86	120.00	140.00
U.S. dollar/Offshore Chinese yuan	6.87	6.60	7.25
Gold	1,969	1,800	2,100
Oil price, WTI (West Texas Intermediate)	75.67	55.00	92.00

Source: Thomson Reuters Datastream, CIBC Asset Management Inc. Based on data available as at March 31,2023.
All prices in home currency unless otherwise specified.

Asset class outlook

Global overview

Central banks stuck in catch-22 situation

Do you remember the Global Financial Crisis (GFC) of 2008? Fifteen years ago, the world experienced a devastating sequence of unexpected "black swan" events that brutally hit financial markets and, by ricochet, the global economy. The big question now is whether we are experiencing the early rumblings of a 2008-style banking panic and credit crunch? Not long ago, most investors would have put very low odds on such a nasty turn of events. After the collapse of two US banks and record outflows from smaller lenders, however, jittery investors aren't so sure anymore. At this juncture, the possibility that the banking crisis will prove to be longer-lasting and more damaging cannot be dismissed. It really all depends on how well central banks handle it.

Suddenly, the task at hand for central banks all around the developed world has become more complicated. They seem stuck in a situation that increasingly looks like a catch-22. Everywhere, inflation is still uncomfortably elevated, implying that the fight on inflation isn't over. For any credible inflation-fighting central bank, this means that the monetary policy stance should remain in restrictive territory. Putting it differently, short-term interest rates should stay high enough to eventually curb inflationary pressures.

All central bankers agree: the shift back into a regime of relatively high short-term interest rates is absolutely required to bring inflation back to their respective policy targets. However, this regime also comes with an undesired side-effect: increased financial instability. Case in point: the bank liquidity squeeze currently unfolding all around the developed world is a direct consequence of the rise in short-term interest rates to the levels that prevailed more than 16 years ago. Because of this regime change, the money supply (bank deposits) is in deep contraction in nearly all developed economies. Unfortunately, tight liquidity conditions in the banking system will likely prevail for as long as short-term rates stay elevated—in other words, as long as the battle on inflation hasn't been won.

The only way out of this vicious circle is via a global economic downturn deep enough to get sufficient slack in the economy to bring inflation back to target. In past business cycles, low inflation allowed monetary authorities to provide quick relief by delivering aggressive rate cuts. This cycle is different. While our baseline forecast calls for a significant global economic cooldown, inflation is not expected to substantially decelerate. This will considerably limit the leeway for central bankers to ease policy.

This all means that monetary authorities will, at times, likely be forced to temporarily move away from their inflation-fighting objectives and provide support to distressed banks by injecting liquidity into the system and *de facto* expanding their balance sheets. However, they will switch back into inflation-fighting mode as soon as the situation is judged to be under control. These back-and-forth policy swings will come with very difficult navigation conditions for investors. Three months ago, we argued that it was too early to conclude that the worst is already behind for financial markets. With central banks now stuck in a catch-22 situation, this conclusion seems even more valid.

Global strategy

One more thing to worry about

As we see with recent events in the US banking sector, investors are still facing a fair amount of uncertainty. The key will be to evaluate at what point the risks are sufficiently recognized by the market and, as such, well reflected in prices. Our central scenario of a shallow economic recession is still intact. In fact, recent events may have increased our conviction at the margin. However, the tail risk of a more severe negative outcome cannot be ignored. On the other side, there is still a possible way to achieve the desired soft landing. Given such views, our strategy continues to favour cash and government fixed income over equities. The potential decline in bond yields will be limited by the inflation outlook. However, in a recession bonds are expected to generate small positive returns. This is a contrast with equities, which will face pressure on earnings and valuation.

The recent rally in equities has created hopes that the bear market is over. Is this the case? Sharp bear market rallies happen in most recessions. It's typical to see the equity market rebound by 10% or even 20%, three or four times before the ultimate bottom. Those counter-trend rallies usually prove to be unsustainable. The question is whether the conditions that could signal the end of the bear market are present or not. We think they are not yet. Those conditions include: growth that remains below trend in order to ease inflation pressures; a rebalancing of supply and demand in the labour market; inflation that comes down toward the central bank target; valuations that reflect an environment of uncertainty; and consensus earnings expectations, which need to be revised down.

One important difference with previous episodes is the valuation the market was trading at the peak. In the US equity market, despite a 14% correction from the peak in early 2022, the S&P 500 still qualifies as overvalued. This is because the starting point was an extreme level of overvaluation, and the correction was too shallow to bring valuation back to fair value.

Whether we look at valuation in absolute terms relative to inflation, or relative to rates, the S&P 500 is expensive either way. Inflation and policy rates would need to come down substantially to justify current valuation. In fact, the decline required would be compatible with the scenario of a deeper and longer recession. If such a scenario materialized, valuation would likely not go back to normal—it would overshoot into undervalued territory. If our views play out, valuation will need to come down.

Assuming the global economy will slow down into a recession, the equity market will face headwinds coming from declining corporate profits. In a typical recession, the annual profits of the S&P 500 tend to decline by 15% to 20% on a year-over-year basis. On a quarterly basis, they have been declining over the last quarters, but the contraction is still relatively small so far. They are still growing at a decent pace and are expected to continue to grow by the consensus estimate. Expectations will need to be revised down.

We acknowledge that there is a path for a more constructive outlook. The equity market might be just fine in a soft landing. However, the equity market is a risky asset class. Investors should consider equities only if they are confident these risks are sufficiently rewarded. It is always possible that, after the fact, we look back and see the risks have not materialized. In that case, one may feel regret that a good opportunity was missed. But we don't know that ahead of time. Be careful with the fear of missing out (FOMO).

Global equity markets

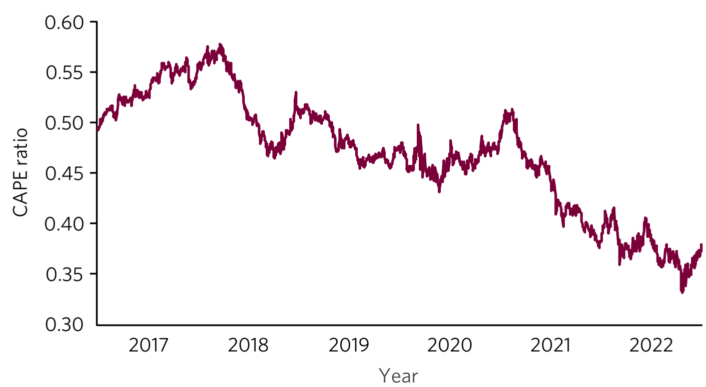
Equities are vulnerable to more downside

The US equity market rose by 7% over the first quarter of 2023. By comparison, the Eurozone appreciated 14%, Canada 4% and emerging markets 3%. The strong performance was driven by positive developments in economic data. Economic activity, which was improving in some sectors by the end of 2022, continued to surpass expectations, reviving hopes that a soft landing could be achieved. However, the data on inflation showed that pressures are still very well present. The implications were that the US Federal Reserve (Fed) would need to deliver more tightening in order to reach its objective. All of that became uncertain when a few banks failed and ignited fears of a wider liquidity crisis. The result is that equities managed to move higher, but with big up and down swings.

Let's take a step back to look at the last 12 months. The invasion of Ukraine by Russia has cut off from the world one of the biggest commodity producers, threatened a potential direct conflict with NATO, and risked a nuclear war. A massive inflation shock pushed headline and core measures far above the central banks' target. The Fed has taken policy rates from 0% up to 5% in a short time, and started removing liquidity from markets with quantitative tightening. With deposits flowing out of the banking sector, bank runs led to failures at a couple of banks. A recession is expected not only by us but also by the bond market (see the yield curve), by many economic forecasters, and by central banks that have either explicitly or implicitly acknowledged the significant risk of a recession. Before all of these developments, the US equity market qualified as being more overvalued than it has been at most other times over the last 70 years. Despite the overvaluation and these negative developments, the result was a moderate correction of 14% from the early 2022 peak for the S&P 500. By comparison, in other recessions equities declined 36% on average. It's safe to say that the equity market has underreacted to recent events.

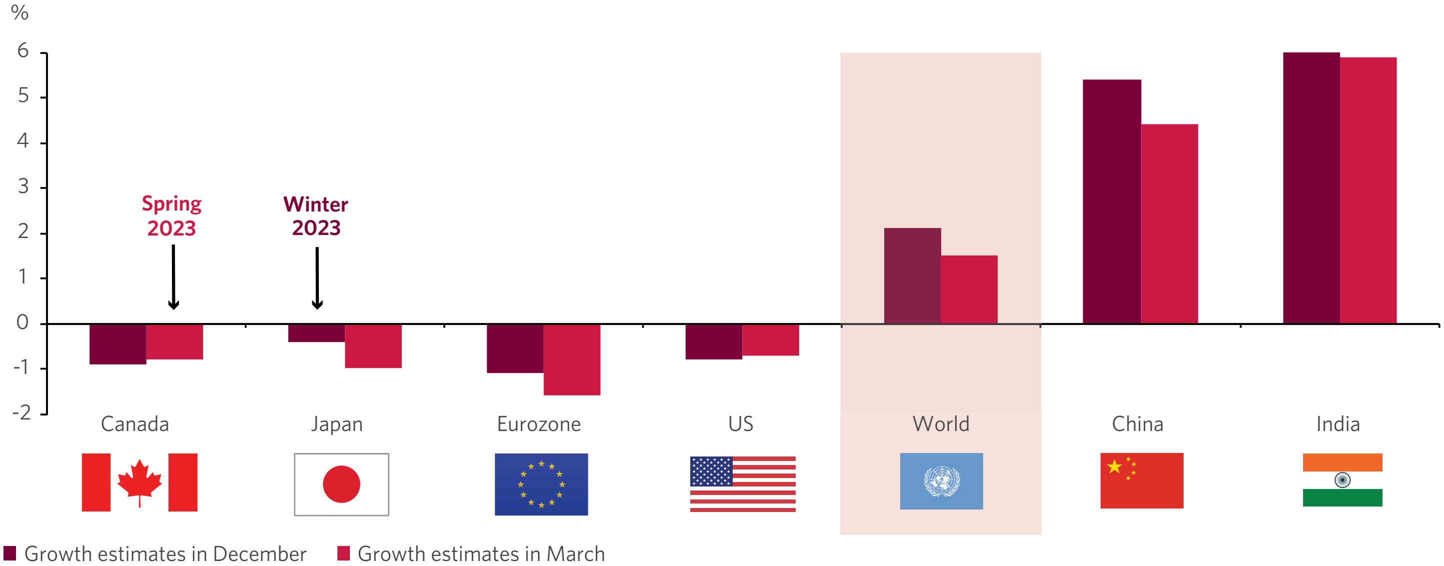
While the US is a bellwether of the global equity market, we cannot necessarily extrapolate what we see in the US to other countries. In fact, on valuation, most other countries look relatively more attractive. Canada, Europe and emerging markets are not under-valued, but they don't suffer from the same over-valuation as the US market. On the earnings front, growth is well correlated across countries and mostly dictated by the economic cycle. We see that consensus expectations are too elevated pretty much everywhere. Assuming the global economy will slow down into a recession, corporate profits of the S&P 500 should decline by 15% to 20% on a year-over-year basis. Other regions would suffer similar declines, if not bigger for the more cyclical countries. Canada and emerging markets are in a relatively better position going into a global recession because of valuation. They would not be immune to any turmoil in markets, but could be outperformers.

S&P 500 CAPE (cyclically adjusted price -to-earnings ratio)



Sources: Refinitiv-Datastream, Robert Shiller and CIBC Asset Management Inc. Based on data available as at March 31,2023.

Global growth projections: March vs. December CIBC Asset Management forecast



Sources: Refinitiv-Datastream and CIBC Asset Management Inc. Based on data available as at March 31,2023.

Global bond strategies

After a difficult year in 2022, global bond markets started the year on the right foot. The WGBI index (Canadian dollars hedged) appreciated 3.20% in the first quarter. Global inflation surprises have subsided, and the hawkish rhetoric of central banks has moderated, allowing yields to drift lower.

As indicated in the last edition of *Perspectives*, we believe that global bonds are likely to offer positive returns over the next twelve months. The yield of 10-year treasuries should trade in a range of 3.00% to 4.25%, around a pivot of 3.50%. Forward guidance by the Fed is no longer pushing 10-year real yields decidedly higher, as it did in the first three quarters of last year. This has helped real 10-year yields to stabilize in a narrow range. Meanwhile, inflation breakeven has also remained contained lately, due to mounting evidence of an accelerating global cyclical downturn, which influences inflation expectations.

The global economy will continue to face many headwinds for the rest of 2023, and this should keep a lid on bond yields. In the US, to win the battle on inflation, the Fed will have to keep its real policy rate in the restrictive zone. This increases the risk of financial instability. In China, a misplaced faith in the consumer, declining domestic manufacturing jobs due to dwindling foreign demand, and negative wealth effects due to an unbalanced domestic housing sector could lead to negative economic surprises. Finally, in Europe, economies will need to cope with reduced ECB support to domestic banks. They will also need to cope with a deeply contracting money supply, the lagged impact of the tightening already delivered by the ECB policy, and the tightening in bank lending conditions. In sum, demand destruction will become increasingly tangible over the investment horizon. As such, a bout of safe-haven bid episodes directed at developed bond markets (DM) are to be expected.

In terms of emerging markets (EM) local bonds, investors should remain prudent and selective. As described above, the global macroeconomic environment will remain dicey for holding the riskier part of the bond universe. Periods of global growth negative surprises often lead to EM bond outflows. Consequently, our local bond exposure will stay defensive, probably until the Fed starts signaling a pivot more clearly. As for EM USD debt, we advise keeping a low exposure for now and wait for better entry points, since spread levels do not offer enough protection at the moment.

Currencies

U.S. dollar

Mounting concerns about US banks have fueled the depreciation of the US dollar (USD) late in the first quarter of 2023. On a trade-weighted basis, the USD dropped by more than 2.0% since March. Is there a lot more downside for the greenback?

Last March, the US Federal Reserve (Fed) deployed colossal efforts to support America's distressed banking sector. The overall bank support amounted to a little more than $300 billion, a liquidity injection comparable to the one provided to banks back in March 2008 at the time of the Global Financial Crisis (GFC). The fact that the Fed is expanding its balance sheet at a time when other central bankers are shrinking theirs essentially explains the USD's renewed weakness.

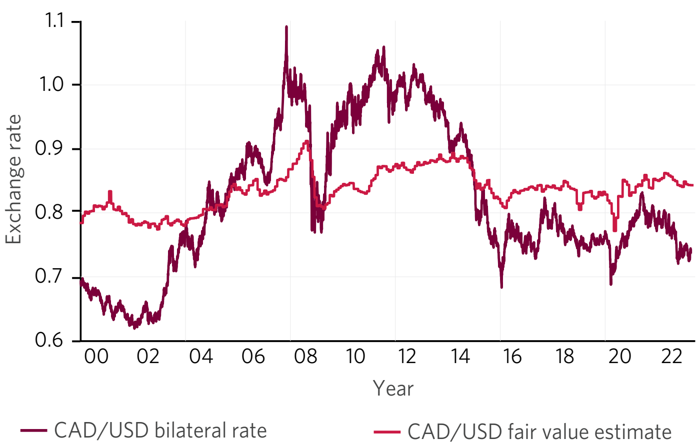
The USD will remain under downward pressure as long as the banking crisis continues to be viewed by market participants as US-centric. If, on the other hand, economic activity decelerates on a broader basis, the USD may play its role as a global safe haven and remain resilient relative to cyclical currencies. The key takeaway is the same as it was three months ago: heightened volatility is to be expected in currency land over the forecast horizon.

Canadian dollar

With intensifying global growth concerns, the Canadian dollar (CAD) has been trending lower for more than a year, depreciating by more than 12% against the USD from the cyclical peak reached in the summer of 2021. It found support at around 0.73 USD earlier this year and benefited from the unexpected OPEC oil output cuts early in the second quarter. Looking forward, given our expectation of further global economic activity deceleration, we think the Canadian dollar may continue to be weak relative to many less cyclical currencies.

For one thing, global economic conditions are projected to deteriorate further over the forecast horizon. This means that global growth concerns will continue to exert downward pressures on the CAD against the USD. For another, with the Bank of Canada (BoC) moving to the sidelines before the Fed, relative BoC-Fed monetary policy expectations should, at the margin, be more supportive of the USD. Finally, energy prices are projected to weaken further. On net, the Canadian dollar will remain under pressure, trading between 1.333 and 1.434 in 2023.

What's next for the Canadian dollar?
CAD/USD bilateral rate vs. CAM fair value estimate



Sources: Refinitiv-Datastream and CIBC Asset Management Inc. Based on data available as at March 31,2023.

Euro

So far into 2023, the euro (EUR) has been doing well against the USD, appreciating by more than 14% from its September 2022 cyclical lows. This outperformance is largely attributable to the particularly hawkish turn taken by the ECB over that period. The latest bout of euro strength/USD weakness can be directly linked to the troubles experienced by US banks.

Now that the ECB has shifted into inflation-fighting mode, liquidity is being drained out of the eurozone's banking system. So, if nothing changes, it's both the Fed's USD liquidity injection and the ECB's EUR liquidity drain that will continue to exert upward pressure on the value of the euro against the USD. What's in store for the euro will largely depend on whether or not eurozone banks can continue to weather the banking storm. It seems unlikely, given that European banks have to cope with a sharp contraction in the money supply just like US ones. For these reasons, the euro is expected to trade between 1.000 and 1.120 over the forecast horizon.

Japanese yen

Late last year, the Japanese yen (JPY) plunged very deep in undervalued territory (-40% against the US dollar)—its widest undervaluation in nearly 40 years. The main reason it got there relates to the Bank of Japan's Yield Curve Control (YCC) policy. In late October, Japan started to recoup some of its heavy losses. What changed? For the first time in a very long time, Japan is experiencing a build-up in inflationary pressures. Japanese core CPI inflation is now running at its fastest clip in more than 30 years. This means that a policy regime shift is underway in Japan. When it happens, the de-anchoring of Japanese government bond yields will likely lead to capital repatriation, exerting upward pressure on the value of the JPY. The USD/JPY bilateral exchange rate is projected to trade between 120 and 140 in 2023.

Commodities

Oil

The oil price has generally settled into a \$70-\$80/bbl range over the past few months. More recently, the price has traded closer to the higher end of the range as OPEC+ announced surprise production cuts in early April to help support the market. In the near term, we think the outlook for oil remains volatile. The daily push and pull from risk on / risk off sentiment in the market is dragging oil around with it.

On the demand side, the market continues to swing between global recession risks and the potential negative impact on oil demand vs China re-opening and the potential positive impact on oil demand. Most recently, recession risks have been winning out as uncertainty over recent US bank failures has had a negative impact on pro-cyclical assets like oil. That said, we see upside to oil demand potential from China re-opening and targeting 5% GDP growth this year. We are seeing signs of demand growth with industrial production numbers and with flight activity picking up in China, a positive for jet fuel demand.

On the supply side, global energy producers have remained disciplined. Balance sheets are strong, and capital is being returned to shareholders, which has helped support oil prices as investments in growth have been limited in favour of capital returns. Russian supply has not come off as much as expected, but OPEC has shown a willingness to support the market by taking barrels out if needed. Similarly, North American supply has not grown rapidly at higher commodity prices.

Looking forward, we will continue to watch for signs of demand growth or contraction and the potential impact on energy prices. On the supply side, we will watch for Russian export levels and signals from OPEC. We will also be watching for signals on US and Canadian supply changes.

Gold

Gold continues to be closely correlated (negatively) with the US dollar, which through the start of 2023 has provided a material tailwind for the price. Gold has moved from approximately $1,840/oz at the start of the year to over $2,000/oz in April, while the US Dollar Currency Index (DXY) has fallen from 105 in January to approximately 102 in April. The weaker US dollar has been a function of changing interest rate expectations as regional banking failures in the US in March have shifted expectations on the outlook for rate hikes in the near to medium term. Gold has again shown its worth as a portfolio hedge in a time of uncertain macroeconomic outlook.

We continue to see a case for owning gold in a portfolio with numerous uncertainties around the world adding risks to the outlook. Inflation risk, recession risk, and uncertainty over the outlook for interest rates are all major areas of unknowns right now in the global economy. Gold can benefit as investors look to hedge risks by adding exposure to the commodity in their portfolios.

Looking forward, we are watching for signs of further stress in the US/global financial system, plus inflation data, and GDP growth data. We're also watching employment numbers as potential leading indicators on interest rate policy (and the read-through to the USD). To the extent that the US Federal Reserve may have to pause rate hikes for now, we see potential support for gold in the coming months.

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

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

Copper

The copper price has held in reasonably well despite growing fears of recession amongst investors. Like oil, the copper market continues to weigh global recession risks against Chinese growth potential in 2023. In the near-term, copper will most likely continue to trade around with sentiment on the global macroeconomic outlook, with a close focus on China, as it remains the key consumer of the red metal. With China re-opening and targeting 5% GDP growth this year, we think the outlook is potentially supportive for copper in the near term.

Looking out over the medium term, we continue to see a compelling case for copper price appreciation. The transition to a lower-carbon economy will be copper intensive with the manufacture of renewable energy assets and in the distribution networks to deliver the low-carbon electricity to end users. We continue to believe that the demand for copper is set to accelerate meaningfully with the energy transition. It is our expectation that copper prices will have to move higher to incentivize the next generation of copper projects into the market to supply the material needed for the energy transition.

Regional economic views

Canada

Recession avoided?

Has the Canadian economy already slipped into recession? Focusing on GDP numbers, the answer is an obvious no. Yearly Canadian real GDP growth was still running at 3.0% in early 2023. Looking at other indicators of economic activity, however, the answer isn't as clear cut.

The reason why the Bank of Canada (BoC) has already moved to the sidelines relates to the Canadian housing market recession already underway. Indeed, housing activity is in deep contraction, with existing home sales down 42% from their 2021 cyclical peaks, and down 16% from pre-pandemic levels. Meanwhile, home prices have been correcting for more than one year, with a yearly average home price decline of 19%. The biggest concern for Canadian monetary authorities relates to the deterioration in housing affordability. The share of disposable income that a representative household is putting toward housing-related expenses has increased from roughly 32% when the pandemic shock was hitting Canada in 2020 to 50% in early 2023.

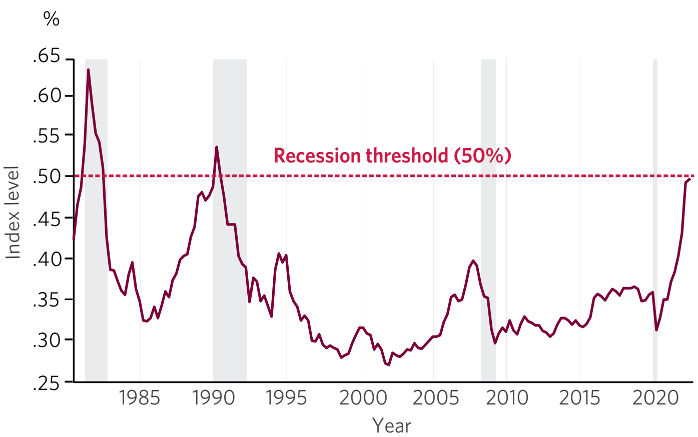
The last time that Canadian households had to cope with a shock of this magnitude was just before the recession of the early 1990s. As a reminder, the recession of the early 1990s qualified as a particularly severe one (i.e., from March 1990 to April 1992). As for most recessions, the economic downturn of the early 1990s was housing-led. That is, the housing market recession rapidly turned into a full-blown economic recession. Because it wishes to avoid such a nasty turn of events, the BoC has prudently moved to the sidelines.

Can a recession be avoided? We do not think so. Our baseline forecast calls for an average contraction of 0.9% in Canada's real GDP over the forecast horizon (2023Q2-2024Q1). We are more downbeat than most forecasters for three reasons. First, there's the impact of last year's surge in interest rates that is now being felt by heavily indebted Canadian households. The BoC has hiked rates by 400 basis points (bps) over the last year. In the past, such a massive rate shock triggered eight recessions and just one soft landing. Secondly, Canadian households have to cope with a particularly big negative wealth effect. Back in 2008-09, the negative wealth effect was the main reason why consumer spending turned negative and *de facto* why Canada experienced a recession. Moving into 2023, the negative wealth effect is projected to be even bigger than in 2008-9, pointing to a contraction in real consumer spending. Most forecasters are underestimating the impact of the negative wealth effect. Last but not least, Canada will also have to cope with a very negative foreign demand shock, owing to the unfolding global recession.

The soft landing that the BoC is still aiming for seems increasingly unlikely to unfold. In our view, a harder landing is already underway. Hopefully, it won't come with financial instability. If it does, the BoC could be forced to temporarily flip back into easing mode just like the US Federal Reserve did last March.

The reason for the BoC's pause

BoC Canadian housing affordability index



Source: Refinitiv-Datastream and CIBC Asset Management Inc. Based on data available as at March 31,2023.

United States

A more prudent Fed

The US economy clearly downshifted into lower gear in 2022, with yearly real GDP growth slowing from 3.6% to 0.9%. Is this enough of an economic cooldown for the inflation-fighting Fed to declare victory and move to the sidelines? The harsh reality is that more than one year since the start of the Fed's tightening campaign, the battle on inflation is far from being over. Inflation remains stubbornly elevated, and the US labour market remains sizzling hot.

What's next for the Fed policy-wise will depend on the upcoming turn of events. One possibility is that the US economy will avoid a recession. *A priori*, this may sound like great news. However, the not-so-good news is that this simply means that the US monetary authorities would have to keep the policy stance in restrictive territory a lot longer, potentially having to further tighten the screw.

Another possibility is that the tightening delivered so far will turn out to be sufficient to push the US economy into recession. This corresponds to our baseline scenario. Our forecast calls for US real GDP growth to average -0.8% over the forecast horizon (2023Q2 to 2024Q1)—a below-consensus projection. If our forecast materializes, the mild contraction experienced by the US economy will likely help the Fed to bring inflation closer to target. However, it's not clear that the loosening in labour market conditions will suffice to eliminate the cost-push inflationary pressures currently present in the US economy.

In light of the recent US banking turmoil, we now must consider a gloomier scenario in which financial instability becomes so problematic that it forces the Fed to temporarily set aside its macroeconomic stability objectives and focus on restoring financial stability by providing the liquidity needed to facilitate the orderly functioning of financial markets. To be clear, the Fed has already taken steps in that direction with the creation of its Bank Term Funding Program (BTFP) and the large liquidity injection it provided via the discount window and its other credit extensions.

With the balance of risk tipping on the negative side, the Fed will likely be more gun-shy than projected last quarter and deliver only one more rate hike over the forecast horizon. What happens over the coming months will be critical in determining the path of Fed policy.

Europe

ECB walking a tightrope

Last March, the inflation-fighting European Central Bank (ECB) courageously delivered another 50 bps rate hike while officially starting to offload bond holdings (Quantitative Tightening or "QT"). But did it really have a choice? With headline CPI inflation running at 8.5% and core CPI inflation at 5.6%, eurozone inflation numbers remain way out of the ECB's comfort zone.

Based on the ECB's most recent projections for the eurozone area, there is no justification for a move to the sidelines. Indeed, core inflation is projected by ECB staff to stay elevated throughout the year, owing to elevated cost-push inflationary pressures. For this reason, the ECB is widely expected to move its policy rate deeper into restrictive territory over the forecast horizon.

For many reasons, however, the ECB could be forced to the sidelines. For one thing, the current tightening in eurozone financial conditions is already bigger in magnitude than the one that took place in 2011. Back then, this was sufficient to push the eurozone economy into recession. Our baseline calls for a eurozone recession with real GDP growth averaging -1.1% over the forecast horizon (2023Q2-2024Q1). If it materializes, the contraction in economic activity will be very similar to the one experienced in 2012—qualifying as a mild recession.

While the 2012-13 eurozone recession qualified as a mild one, it led to both a fiscal crisis and a banking crisis. Could the same thing happen this time around? There certainly are reasons for concern. The sharp and intensifying contraction in the money supply of the eurozone certainly is a negative shock on bank liquidity/profitability. The pressure on banks is not likely to dissipate, particularly given that the ECB is considerably reducing its support to banks through targeted longer-term refinancing operations (TLTRO).

To avoid a sovereign debt crisis, the ECB has put in place two lines of defence to keep a lid on peripheral spreads. However, as it reduces its holdings of government debt securities, the challenge will be to avoid the continued de-anchoring of German bund yields. This promises to be a difficult task, given that ex-ECB European central banks have turned into net sellers of bunds, and that new bund issuance is expected to more than double.

Just like other central bankers in the developed world, the ECB remains determined to win its battle on inflation. The more it raises the risk-free short-term interest rate, and the more it reduces the size of its balance sheet, the bigger the risk of getting a fiscal crisis, a banking crisis, or both, just like in 2011-12.

China

China: misplaced faith in the consumer?
China's post-Covid recovery is underway, and it's been strong so far. Consensus expects consumers to unleash pent-up demand, leading to a strong and self-sustained expansion. We're skeptical about this view, particularly for the second half of our forecast horizon.

Income worries have remained elevated. Consumer surveys show tenuous spending intentions. Low- and middle-income households have the weakest outlook. They've been hit harder by the economic effects of lockdowns and mobility restrictions.

Labour market prospects are weak. This is particularly the case for migrant workers, who account for about a third of the labour force. Nearly half of them work in manufacturing and construction industries. Falling exports should be a major drag for manufacturing employment, while excess supply of real estate should continue to put to a lid on construction employment.

Finding a job for new graduates is also reported to be difficult. The trending-up supply of new graduates from colleges and universities has surged in recent years—by almost 50% since 2019. New graduates also end up in jobs with salaries a far cry from their original expectations. It's not a coincidence that applications for public sector jobs have surged.

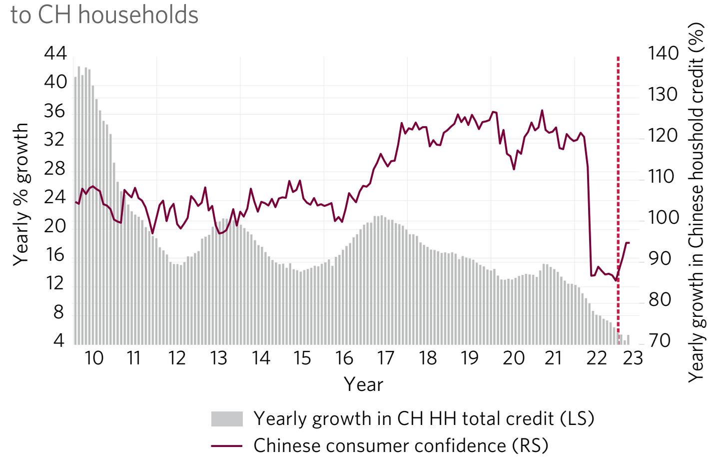
In a context of a declining working-age population, migrant workers (urbanization) account for the bulk of new housing demand, followed by new graduates. We don't expect housing to be a key growth engine. Positive wealth effects, if any, should be limited.

Tourism abroad is another important headwind (imports of services). A surge of demand (led by wealthier households) for traveling abroad to half pre-pandemic levels would cut GDP growth by nearly 1%.

China has set the bar low for 2023 growth, with a 5% GDP target. Favourable base-year effects and the re-opening should make this annual target easily achievable. However, aforementioned growth impediments along with falling external demand should bring growth below 5% near the end of the year. This would force policymakers to announce new infrastructure stimulus. Our outlook averages 5.3%, inflated by a positive base-year effect in 23Q2.

China: Misplaced faith in the consumer?

Chinese consumer confidence & yearly % growth in credit to CH households



Source: Refinitiv-Datastream and CIBC Asset Management Inc. Based on data available as at March 31,2023.

Alternative scenarios

Global soft landing (30% probability)

While our central scenario of a global economic recession is still intact, there is still a path to avoid a recession. For any central bank, engineering a soft landing is no easy task, if past experience is any indication. The fact that so many of them are simultaneously aiming for exactly that is certainly complicating the achievement of this goal. Yet they are aiming for exactly that, keeping their fingers crossed that a hard landing will be avoided. The path to a soft landing requires a policy-induced growth slowdown that provides just enough slack in the economy to get inflation back to target. In this scenario, the disruptions in supply chains that initially sparked inflation are no longer at play. A successful soft landing would obviously pave the way for better market conditions.

Financial instability (10% probability)

In this scenario, the speed and amount of monetary tightening that has already taken place turns out to be too much to cope with for the banking sector and the economy, translating into bouts of financial instability. Stuck with a more severe hit on profitability, as well as deteriorating liquidity conditions, banks have no other choice but to substantially tighten lending standards. The combined impact of the sharp rise in policy rates and the tightening in bank lending conditions end up being too big of a shock, knocking the global economy down. As a result, the global recession turns out to be deeper and longer than expected in our baseline projection. The more severe demand destruction comes with better-entrenched expectations of a faster deceleration in inflation. Under such conditions, central banks shift back into easing mode a lot faster to restore financial stability.

Scenario	Less favourable	More favourable
Global soft landing (30%)	USD Real return bonds Precious metals	Global equities EM bonds Commodities
Financial instability (10%)	Global equities Commodities High-yield corporate bonds	Cash Government bonds Gold

Economic forecasts (next 12 months)

Region	Current GDP[1]	GDP - consensus	GDP - CAM view	Current inflation[2]	Inflation - consensus	Inflation - CAM view	Policy rate - CAM view
Canada	2.1%	0.3%	-0.9%	5.2%	3.0%	3.9%	-
United States	0.9%	0.7%	-0.8%	6.0%	3.6%	4.3%	+25 bps
Eurozone	1.8%	0.6%	-1.1%	8.5%	4.2%	4.5%	+25 bps
China	2.9%	5.9%	5.4%	1.0%	2.4%	2.4%	RRR cuts
Japan	0.4%	1.0%	-0.4%	3.3%	2.0%	2.2%	-
World	1.8%	2.5%	2.1%	6.5%	4.3%	5.7%	-

Data as of March 31 2023.
Source: Datastream, Bloomberg, CIBC Asset Management Inc. calculations.

1 Real GDP growth (y/y %)
2 Year/year %

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