CIBC

CIBC ASSET MANAGEMENT

PERSPECTIVES

For the 12-month period beginning July 1, 2023

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Should investors consider a global recession avoided or delayed?

In September 2022, we identified an increased probability the global economy would experience a recession over the following 12 months. This became our baseline and most likely scenario. Since then, the recession has not materialized. Equity markets took this as a sign a soft landing was underway, and they rebounded strongly from late-2022 lows. Has a global recession been avoided, or has it just been delayed? Our baseline scenario still calls for a global recession. Although inflation is slowing, it's still uncomfortably high. For any credible inflation-fighting central bank, this means policy tightening campaigns are not over. It also means the monetary policy stance will have to stay in restrictive territory for a while longer to completely wash out inflationary imbalances.

Asset class highlights

Equity: Although some specific segments of the market might be stretched, this is not necessarily the case for the overall market. Europe is now in a technical recession. Canada's valuation is more attractive, but it's a cyclical market dependent on the US economy. In addition, some regions appear more attractive than others, such as emerging markets outside China.

Fixed Income: Global bonds are likely to offer positive returns over the next 12 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: We're in the late stages of the global tightening cycle. In this stage, the risk of a financial system shock is relatively higher than normal. FX volatility is expected to increase considerably over the second half of the year.

China: Although underlying economic growth in China is expected to remain weak, additional policy stimulus is likely to limit downside risks. We expect GDP growth to average approximately 5% in the next four quarters. This projection is in line with the consensus but also embeds total policy support of about 1%-1.5% of GDP.

Multi-asset outlook

Asset class	Current June 30, 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	4.75%	4.00%	5.25%
Canada 2-year government bond yield	4.58%	3.25%	5.00%
Canada 10-year government bond yield	3.27%	2.85%	3.75%
U.S. 10-year government bond yield	3.84%	3.00%	4.25%
Germany 10-year government bond yield	2.39%	1.75%	3.25%
Japan 10-year government bond yield	0.39%	0.00%	1.00%
Canada 10-year real-return government bond yield	1.35%	1.25%	1.35%
Canada investment-grade corporate spreads	1.47%	1.30%	1.90%
U.S. high-yield corporate spreads	4.01%	4.00%	7.00%
Emerging market sovereign (USD denominated) bond spreads	363	250	500
S&P/TSX price index	20,155	17,000	21,500
S&P 500 price index	4,450	3,600	4,700
Euro Stoxx 50 price index	4,399	3,500	4,600
Japan Topix price index	2,289	2,000	2,550
MSCI Emerging Markets index	59,844	50,000	65,000
U.S. dollar/Canadian dollar	1.3242	1.310	1.430
Euro/U.S. dollar	1.0909	1.000	1.120
U.S. dollar/Japanese yen	144.31	130.00	150.00
U.S. dollar/Offshore Chinese yuan	7.27	6.60	7.25
Gold	1,919	1,800	2,100
Oil price, WTI (West Texas Intermediate)	70.64	55.00	85.00

Source: Thomson Reuters Datastream, CIBC Asset Management Inc. Based on data available as at July 11, 2023.
All prices in home currency unless otherwise specified.

Asset class outlook

Global overview

Global recession avoided or delayed?
When looking at the Canadian and US economies, one might be tempted to conclude a soft landing is in the making. When looking at the rest of the world, however, the landing is proving to be a hard one. Many European economies, including Germany, have already technically slipped into recession. The situation in China is also an important focus. Although official GDP numbers show the Chinese economy is simply shifting into lower gear, other indicators, such as imports, are consistent with a contraction in Chinese economic activity. All in all, 25% of the 33 economies that we track have slipped into recession, and 50% are clearly heading in that direction. Only one-quarter of all those countries are proving to be more resilient. The United States is one of them.

Has a global recession been avoided or just delayed? Our baseline scenario still calls for one. While inflation is slowing down, it's still uncomfortably high. For any credible inflation-fighting central bank, this means that tightening campaigns are not over. It also means monetary policy stance will have to stay in restrictive territory for a while longer to completely wash out inflationary imbalances. Unfortunately, this will come with more damage on the economic front.

What explains the resilience of so many economies over the first half of the year? We see three reasons. The first reason is that the negative impact of high inflation and fast-rising interest rates on household income has, so far, been cushioned by the depletion of excess savings accumulated during the pandemic. The second reason, in the context of inverted yield curves, is that commercial banks have cushioned the impact of interest rates on homeowners. Across the developed world, mortgage rates have not increased in lockstep with policy rates. The third reason, and also due to the inversion of yield curves, is governments have been depleting their cash balances held at central banks—mitigating the efforts of monetary authorities to drain liquidity from the financial system.

On all three fronts, economic support is turning into an economic drag. In most developed economies, excess savings have now been depleted. Looking forward, households are expected instead to increase savings as they normally do during economic downturns. This means less money to spend on consumer goods and services.

Central banks in the developed world are moving into the late stages of tightening cycles. As the pressure on commercial banks intensifies, the risk of monetary policy overkill increases considerably. At this stage in the tightening cycle, bank lending rates tend to rise faster than policy rates. This means much more money will have to be spent on interest payments by households, non-financial corporations, and governments. That means less money for discretionary spending.

Finally, it's worth noting the cash balances of governments at central banks are near empty. They will have to be replenished by issuing large amounts of T-bills just as the borrowing requirements of governments will be increasing significantly. For this reason, we expect a resumption of drainage of excess reserves out of the global financial system. It also means bond markets will likely soon start to feel the full impact of the quantitative tightening (QT) being undertaken by central banks.

As mentioned last quarter, central banks are stuck in a catch-22 situation. The move into a regime of relatively high short-term interest rates was absolutely required for central banks to bring inflation back to target. However, this regime comes with an undesired side-effect: increased financial instability. A case in point is the bank failures that took place in March. Should more financial instability be expected over the forecast horizon? It's hard to say, but one thing is certain: commercial banks will remain under pressure. The bank liquidity squeeze currently unfolding across the developed world is a direct consequence of the sharp rise in short-term interest rates. 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.

Last quarter, we argued monetary authorities would, at times, be forced temporarily to move away from inflation-fighting objectives to support distressed banks, switching back into inflation-fighting mode as soon as the situation was under control. That is exactly what the Fed did in the first half of 2023. Luckily, the financial disruption was short-lived and not too painful. The constructive market conditions that have prevailed in recent months are unlikely to persist. More bouts of financial instability are to be expected.

Global strategy

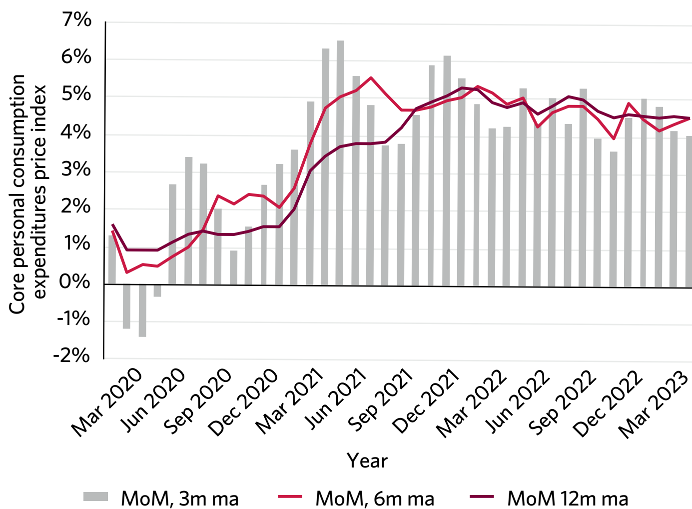
Is our recession scenario still intact?
In September 2022, we increased the probability of a global recession over the following 12 months to 50% from 35% previously. This became our baseline and most likely scenario. Our two alternative scenarios (a global soft landing at 30% probability; and stubborn inflation at 20% probability) acknowledged the possibility a recession could be avoided. Since then, the recession has yet to materialize. Equity markets have taken that as a sign a soft landing is under way, and they have rebounded strongly from late-2022 lows. Is our scenario for a recession still valid, and what does it mean for markets?

CIBC Asset Management's investment solutions are based on, among other things, fundamental macroeconomic analysis, and several signposts. Amongst these signposts,

the Goldman Sachs Financial Conditions Index (FCI) has stopped tightening this year, but lending-standard surveys and mortgage rates, both of which are not included in the FCI, have shown additional tightening. Leading economic indicators (such as housing indicators and purchasing manager surveys) have been weak and have declined to recessionary levels. The Chicago Fed National Activity Index, a broad coincident indicator, turned negative in mid-2022 and remains on a downward trend. Retail sales and industrial production have declined to a near-zero growth rate, but they are not yet at levels consistent with recession. And there are signs the labour market is weakening, including a decline in temporary and part-time workers. In sum, although the expected recession has been delayed, we are not in the midst of a continued robust expansion. The indicators we track show the economy is growing below potential and continuing to slow.

Inflation is moderating, but it's expected to remain above targets. The Fed's main measures of inflation, the core personal consumption (PCE) expenditures price index, is sticky and elevated.

The Fed's main inflation measure: core PCE



Sources: Refinitif-Datastream and CIBC Asset Management Inc.
Based on data available as at July 11, 2023.

Goods price deflation is over, due to improvements in supply chains. The rapid decline in "super core" inflation, defined as services excluding shelter, offers some hope. However, inflation has spilled over into the cost of labour. Central bankers tried to avoid this as much as possible because it tends to be more persistent. As such, they will need to remain hawkish until the labour market has rebalanced sufficiently to ease inflation pressures.

Risk premiums in risky assets, including many equity markets, are generally tight by historical comparison, reflecting the sharp increase in short-term risk-free interest rates. Bonds and equities have a different view of the world. Yield curve inversions suggest the sovereign bond markets are pricing in a recession. Meanwhile, the bottom-up consensus for equity earnings expects steady growth for every quarter until the end of 2024. There is also a disconnect between bond and equity market volatility. Recent high bond market volatility reflects uncertainty about inflation and monetary policy. Equity market volatility remains low, suggesting a more contructive view regarding economic and geopolitical risks. If our scenario of a recession plays out, with central banks unwilling to provide easing, risky assets are likely to face downside risk.

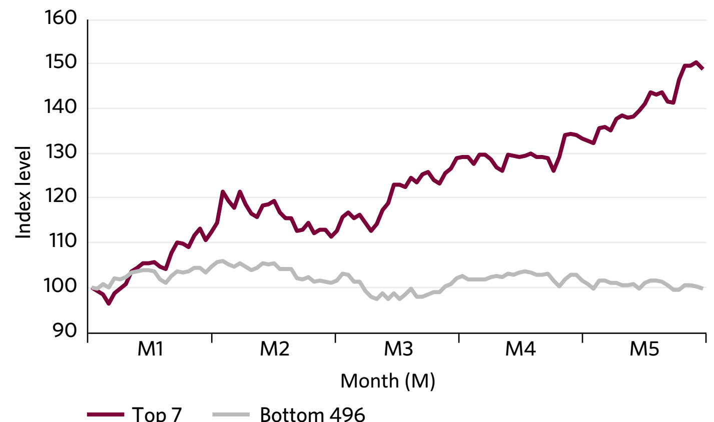
We recognize there is a path to a more constructive outlook. A recession could turn out to be short and shallow, and the equity market might look through the proverbial valley. However, equities are a risky asset class, and both the upside and downside need to be evaluated. As of now, it seems the potential upside is insufficient to compensate for the downside risk.

Global equity markets

A strong rally with narrow participation

Equity markets performed relatively well in the first half of the year, supported by positive sentiment and expectations of a possible soft landing. Returns were driven primarily by several large technology companies, such as Apple and Microsoft. For comparison, the Nasdaq 100 Index was up 38.75% over the first half of this year, whereas the Dow Jones Industrial Average and S&P/TSX Composite Index, which both have much less exposure to technology, gained only 3.80% and 3.97%, respectively, during the same period. The year-to-date performance of the S&P 500 was between these extremes. The performance of technology stocks was driven almost entirely by multiple expansion, not earnings growth. Technology companies are considered Growth stocks, which have an increased likelihood of multiple expansion over time. Over the 3 years prior to 2023, technology stocks generally exhibited a close, and expected, relationship with interest rates, outpeforming when rates declined, and underperforming in the context of rising rates. This relationship has completely broken this year.

S&P 500: Very narrow breadth



Sources: Refinitiv-Datastream and CIBC Asset Management Inc.
Based on data available as at July 11, 2023.

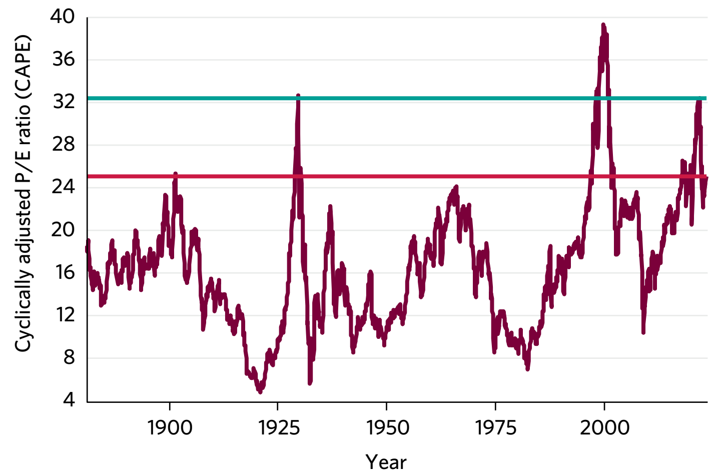
One possible explanation for relatively strong equity returns during the first half of 2023, is a potential soft landing was already priced into equity values, leading investors to believe a recession would cause less market volatility. In addition, a fear of missing out on a market rebound following a potential recession was an important contributing factor. Interest in Artifical Intelligence (AI) also focused investor attention on technology stocks.

The market has had many shocks to absorb. Global equities, as measured by the MSCI World Index, corrected 23% in local currency terms from peak to trough (January 4, 2022, to October 12, 2022). This is relatively shallow by historical comparison. The correction was driven mostly by overvaluation and rising interest rates, with higher inflation, volatility and geopolitical tensions also contributing. It's debatable whether these shocks were fully priced in or not. Regardless, It's difficult to argue a recession has also been fully priced.

The narrowness of the equity market rally during the first half of this year can be seen as a positive or a negative. A negative interpretation is the equity market isn't as resilient as it superficially appears. From a more positive perspective, specific segments of the global equity market may be stretched, such as US, European and technology stocks, but this isn't necessarily the case for the overall equity market.

Europe is now in a technical recession. Canada's valuation is more attractive, but it's a cyclical market dependent on the US economy. Some regions also look relatively attractive, such as emerging markets outside China. China is a special case due to potential geopolitical tensions with the US. Other countries in Asia and Latin America are not too expensive and have either a better growth outlook or central banks preparing to ease monetary policy. As an asynchronous cycle unfolds across the world, opportunities will arise.

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



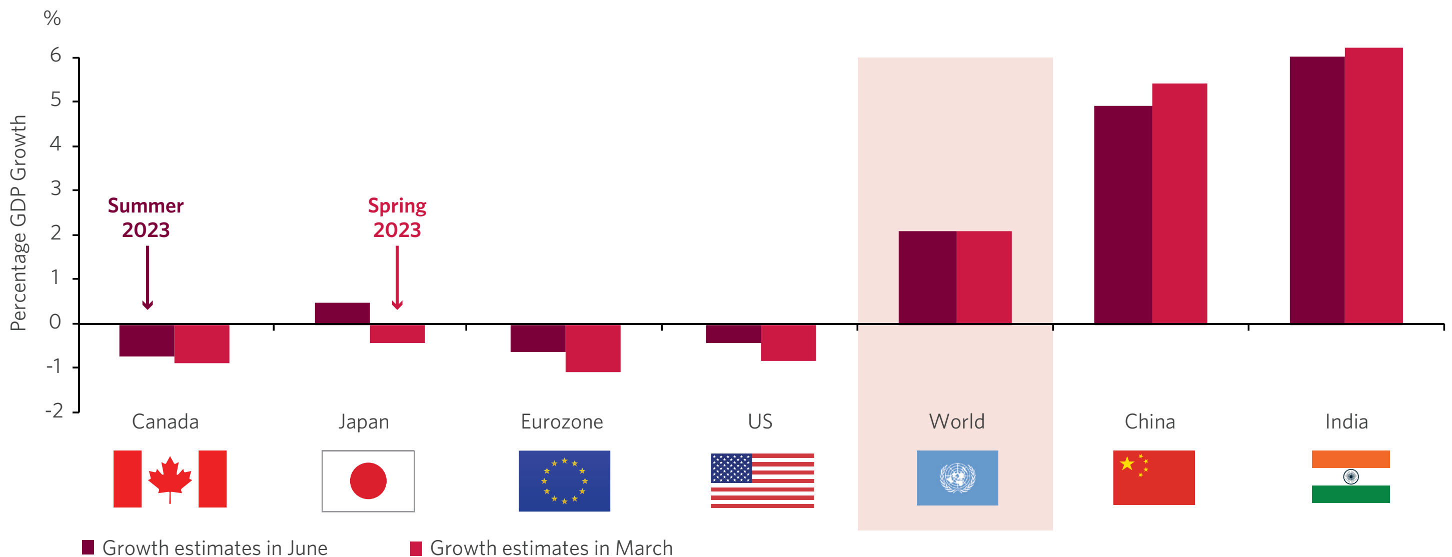
Sources: Refinitiv-Datastream, Robert Shiller and CIBC Asset Management Inc. Based on data available as at July 11. 2023.

Global bond strategies

Global bond markets were relatively stable in the second quarter. The WGBI index (Canadian dollar hedged) was flat during Q2, and is up 3.00% year-to-date. Mixed signals from economic data and uncertainty about future central bank policy actions have kept global bond markets on indecisive footing.

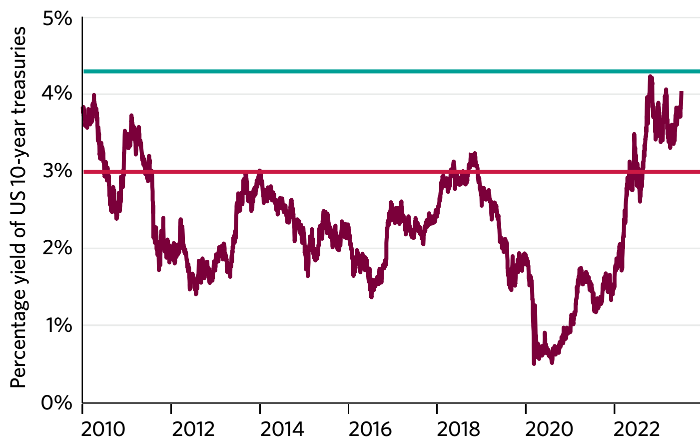
Nonetheless, we expect global bonds to offer positive returns over the next 12 months. The yield of 10-year treasuries should trade in a range of 3.00% to 4.25%, around a pivot of 3.50%. The Fed will likely have to keep its policy rate in restrictive territory to decisively tame inflation. The terminal Fed funds rate should be reached in the next quarter or so. This is consistent with market expectations, suggesting bond market volatility should decline compared to the last 12 months.

Global growth projections: June vs. March CAM forecast



Sources: Refinitiv-Datastream and CIBC Asset Management Inc. Based on data available as at July 11, 2023.

US 10 year



Sources: Bloomberg and CIBC Asset Management Inc. Based on data available as at July 11, 2023.

Decomposing the nominal bond yield into its real and breakeven inflation components, our base case is for stable bond yields over the forecast horizon. 10-year real bond yields increased above 1.6% during Q2, a level we believe is now sufficiently restrictive to ultimately achieve the Fed's inflation objectives. Structural factors are likely to keep breakeven yields more elevated than in the past. These could even drift higher if the economy proves more resilient than we expect.

Our pessimistic alternative scenario is more bullish for bonds. In this scenario, developed-market (DM) economies experience deeper recessions than expected because of monetary policy overkill.

Our strategy for emerging market (EM) local bonds remains unchanged, and suggests investors remain prudent and selective. Periods of unexpected negative global growth often lead to EM bond outflows. And as EM US dollar (USD) debt valuations are unappealing, we're keeping a low exposure, waiting for better entry points.

Currencies

US dollar

On a trade-weighted basis, USD finished the second quarter pretty much where it started. Moving into the second half of the year, one might be tempted to conclude the greenback will remain well supported as long as the Fed stays in tightening mode. After all, US short-term rates are higher than they are in much of the rest of the developed world.

However, having a policy rate higher than everywhere else in the developed world also means US banks are experiencing a more intense policy-induced liquidity squeeze. Tensions in the US banking sector abated late in the second quarter, but bank funding conditions continued to deteriorate. As long as problems in the US banking sector are viewed as US-centric by most market participants, USD will remain under downward pressure.

Volatility in FX markets considerably diminished in late 2023Q2. Looking forward, however, calmer market conditions are unlikely to persist. In the late stages of a global tightening cycle, the risk of financial accidents is higher. FX volatility is expected to increase considerably over the second half of the year.

Canadian dollar

The Canadian dollar (CAD) appreciated against USD late in the second quarter, from 74 to 76 US cents. For more than a year, CAD has been trading well below levels consistent with key short-term fundamental determinants: relative BoC/Fed monetary policy expectations, and the price of oil. CAD is a cyclical currency. Deteriorating global growth prospects typically weigh heavily on it. CAD's recent appreciation reflects a lessening of global growth concerns amongst market participants late in the second quarter.

If our baseline forecast of a global recession is correct, global growth concerns will re-intensify over the forecast horizon. This will exert renewed downward pressure on CAD. For this reason, CAD is expected to trade between 1.31 and 1.43 in the next 12 months.

Euro

Over the second quarter, the euro held its ground against USD, trading between 1.07 and 1.10. In contrast with the Fed, the European Central Bank (ECB) did not take a pause at its June policy meeting, and instead announced another rate hike. Relative ECB-Fed policy expectations should be roughly neutral for the EUR/USD bilateral rate over the forecast horizon. What's in store for the euro will depend largely on developments in the eurozone banking system. European banks are experiencing a sharp contraction in the money supply, as are their US counterparts. Now essentially US-centric, bank stress could also become apparent in the eurozone. For these reasons, the euro is expected to trade between 1.00 and 1.12 over the forecast horizon.

Japanese yen

Downward pressure on the Japanese yen (JPY) re-intensified over the second quarter. The USD/JPY bilateral exchange rate appreciated by nearly 9%, close to the cyclical highs of October 2022. The main reason why this happened relates to the inaction of the Bank of Japan (BoJ). With Japanese core CPI inflation running at its fastest clip in more than 30 years, a policy regime shift should already be underway in Japan. However, the BoJ made no change to its Quantitative and Qualitative Easing (QQE) with Yield Curve Control (YCC) policies at its June policy-setting meeting. The fact remains that, for the first time in a very long time, Japan is experiencing a build-up in inflationary pressures. The BoJ will soon have to lift its foot off the accelerator. When that happens, the de-anchoring of Japanese government bond (JGB) 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 130 and 150 over the next 12 months.

Commodities

Oil

Oil has generally traded sideways this year, bouncing between $70 and $80/bbl, falling into the $60s a few times, and now settling closer to $70/bbl as we move into the summer driving season. Investors continue to weigh positive supply-side discipline against growing angst around global demand as recession fears pick up.

On the demand side, investors remain concerned key global economies are either slowing (US and Europe) or experiencing a stalling recovery (China). This has weighed on the sentiment and price for oil in recent months.

On the supply side, producer discipline remains in place. North American producers continue to live within their means, with limited incremental supply coming to the market. Rig counts are falling in the US, signaling producers are price-sensitive and acting rationally. Meanwhile, within OPEC+, Saudi Arabia recently announced it will extend voluntary cuts of 1mmbbls/d through August. Russia also has indicated it will cut 500mbbls/d in August.

Looking forward, we will continue to watch for evidence of demand growth or contraction in the coming months to gauge where support is for oil prices this year. On the supply side, we're watching rig counts in key markets, guidance from companies on production targets, and signals of ongoing OPEC+ discipline to support the price.

Gold

Gold has been choppy year-to-date, trading from around $1,800/oz at the start of the year, through $2,000/oz a couple of times, before tailing off at the start of the summer to trade closer to $1,900/oz. Fluctuations in the price of gold remain inversely related to USD.

Looking forward, we think the Fed is close to the end of its rate-hiking cycle. As rates peak and then roll over, we could see renewed strength in gold. Global recession risks and the ongoing war in Europe could also help support gold as investors weigh uncertainty in the market, reflecting its hedging properties. Risks to gold include a prolonged rate-hike cycle in the US if inflation and growth prove harder to tame than expected. Additional signals on the outlook for gold, as well as other precious metal prices, include global fiscal policies, yield curves, pandemic data, and political and social developments.

Copper

Year-to-date, the copper price has been effectively flat, but relatively volatile. We saw prices spike in January to $4.25/lb before tailing off in subsequent months back to where we started the year at approximately $3.80/lb. The physical market remains tight, with low visible inventory levels. This tightness has helped support prices. By contrast, macroeconomic data in China, the world's largest consumer of copper, have been mixed, with strong demand to start the year, but then a tepid follow-through as the recovery after Covid lockdowns stalled.

Looking forward, the primary demand factor for Copper is China. We are looking for signals further government stimulus is coming to help support the economy, and specifically which sectors are being targeted for stimulus. The housing market in China remains weak, and we are looking for signs of stabilization there.

On the supply side, visible global copper inventory levels remain depleted, sitting at the lowest levels since 2008. This helped support the price, despite concerns around demand. Over a longer-term horizon, while a few new mines are starting up, growth beyond these new operations appears to be minimal. Copper will be a critical metal in the transition to a lower-carbon economy. Higher prices will be required to incentivize new volume of the red metal into the market. We remain bullish on the medium- to longer-term outlook for copper.

Regional economic views

Canada

Landing gear down

Last spring, the BoC was quick to move to the sidelines. At the time, this decision made perfect sense. The BoC wanted to wait a little to see how the Canadian economy would react to the rate hikes already delivered, before tightening its policy stance further.

In June, the BoC surprised markets by raising the overnight rate to 4.75%—its highest level in 23 years. It had many reasons to shift back into tightening mode. Inflation remains stubbornly elevated, based on the BoC's favorite price indexes. Labour-market conditions (the main driver of wage inflation over the medium term) remain ultra-tight. Canada is coping with its biggest negative productivity shock on record. Also, inflation expectations have started to de-anchor.

The Canadian economy has been resilient over the first half of the year because the impact of BoC tightening has been attenuated by three developments. Excess savings accumulated during the pandemic have been depleted, cushioning the negative shocks on income from high inflation and rising interest rates. Canadian commercial banks have made significant efforts to cushion the impact on homeowners. The federal government has been depleting its cash balance at the central bank, offsetting the BoC's efforts to drain liquidity from the banking system. For these three reasons, the economic downturn projected for Canada has been delayed, but not avoided.

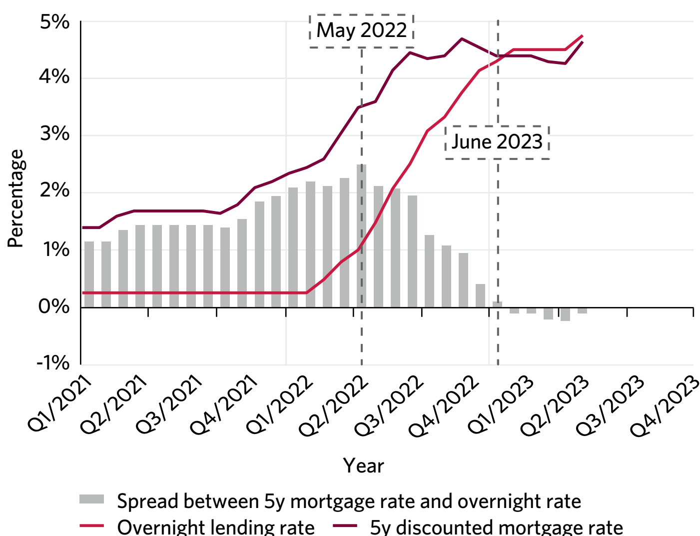
We're in the late stages of the BoC's tightening cycle, with an intensifying squeeze on bank liquidity and profitability conditions. As the pressure on commercial banks intensifies, the risk of a monetary policy overkill increases considerably. At this point in the policy cycle, the impact of central bank tightening is amplified by a tightening in bank lending conditions. This means lending interest rates typically rise a lot faster than the policy rate.

One must also account for the fact that the maximum impact of policy tightening already implemented will be felt over our one-year forecast horizon. This matters a lot for Canada. At 180% of disposable income, the debt load of Canadian households is at record highs and two times bigger than the debt load of US households. The Canadian total debt servicing ratio has increased by 320 bps since the start of 2022.

For all of these reasons, we're more downbeat than most forecasters on Canada's growth prospects. Our baseline forecast calls for an average contraction of 0.7% in Canada's real GDP over the next 12 months. The soft landing the BoC is aiming for seems increasingly unlikely. In our view, a harder landing is to be expected. Hopefully, it won't come with financial instability.

Attenuated impact of BOC tightening

BOC overnight rate vs. 5-year discounted mortgage rate



Sources: Refinitiv-Datastream and CIBC Asset Management Inc. Based on data available as at July 11, 2023.

United States

The Fed's battle on high inflation is not over

Has the US economy slipped into recession? It's still hard to say. On the one hand, the economic downturn is apparent in various leading indicators. It's also apparent from corporate profits, employee compensation, Gross Domestic Income (GDI), real imports, and household employment. On the other hand, the two economic indicators that receive the most media attention—payroll employment and Gross Domestic Product (GDP)—tell a different story.

Our baseline view hasn't changed. The recession we've been projecting for the US economy has been delayed, not avoided. In the past, payroll employment and GDP have underestimated the extent of the downturn when the US economy was falling into recession. Our forecast calls for average US real GDP growth of -0.4% between the third quarter of 2023 and the second quarter of 2024.

The problem for the Fed is that inflationary imbalances haven't been washed out. Since the end of 2022, the Fed's projection for the nominal Fed funds rate and PCE inflation imply a much tighter policy stance for much longer. US monetary authorities have realized they'll have to fight a lot harder to win the battle on inflation. Last June, the Fed's projections were revised even higher, with a real Fed funds rate projected at +2.0% in 2024 and +1.3% in 2025. By historical standards, this is quite aggressive. Over the last 30 years, the real Fed funds rate has rarely moved above potential real GDP growth, which is now estimated at +1.8%. Whenever it did, the US economy sank into recession not long afterward.

The Fed is trapped in a catch-22 situation. To win the battle against inflation, it has to tighten its monetary policy stance substantially. However, by aiming for macroeconomic stability, the Fed is putting a lot of pressure on commercial banks, especially small ones. It is *de facto* increasing the risk of instability in the US financial system.

A much tighter Fed policy stance also means already wide US fiscal imbalances are likely to get a lot bigger. Higher interest rates come with higher debt-servicing costs for all economic agents carrying heavy debt loads. The US federal government is one of them, with outstanding public debt above 100% of GDP and a yearly deficit in excess of $2 trillion or 8% of GDP. The supply of Treasury debt securities is set to increase massively. In past episodes of large Treasury issuance, the Fed was always there to monetize debt and cushion the supply shock. This time around, the Fed is busy shrinking the size of its balance sheet—reducing its holdings of US Treasuries. In short, a tighter-for-longer Fed policy stance comes with a rising fiscal risk.

Europe

From shallow to deeper recession?

Technically, the eurozone is already experiencing a German-led recession. This recession has, so far, been shallow because of the boost to the eurozone economy coming from net exports and inventory building. The surprise so far is the recession has been narrow, with Germany hit a lot harder than other eurozone economies.

Eurozone economic resilience over the first half of the year can be explained by the same three reasons as most other developed economies: depletion of excess savings accumulated during the pandemic; efforts by eurozone commercial banks to cushion the impact of higher borrowing costs on homeowners; and governments depleting their cash balances at the ECB, offsetting ECB efforts to drain liquidity out of the banking system. On all three fronts, economic support is turning into a drag on growth.

We expect the eurozone recession to deepen over the forecast horizon. In sharp contrast with the US, financial conditions in the eurozone have tightened considerably since the fall of 2022, mainly owing to the trade-weighted appreciation of the euro. Our baseline calls for a eurozone recession, with real GDP growth averaging -0.6% over the forecast horizon. This contraction will be similar to the one experienced in 2012, qualifying as a mild recession.

China

Stimulus needed

The unappealing expectations we communicated last quarter for the Chinese economy have been materializing. China's re-opening post-Covid-19 didn't go as expected by the consensus, reflecting weak household fundamentals. As we look forward, these negative forces remain at play for the strength of the Chinese economy.

Labour-market dynamics are particularly weak for key segments of housing demand. For instance, the youth unemployment rate has risen above 20%, its highest level on record. In addition, demand for rental housing by migrant workers has remained sluggish. Rent deflation, excess housing supply, and low affordability should keep housing investors on the sidelines for now. Without a significant growth contribution from housing, it's difficult for China to grow strongly.

Policymakers are concerned about China's slower-than-expected recovery. Slow growth will likely widen the negative output gap. This gap has already pushed core inflation down to 0.5%, well below the 3% target for 2023 of the People's Bank of China (PBoC). Weak inflation is a problem for a highly leveraged economy like China because it makes debt servicing a heavier burden. Under such conditions, policymakers have no choice but to deliver more stimulus—hopefully large enough to avoid falling into a deflationary trap. This is easier said than done.

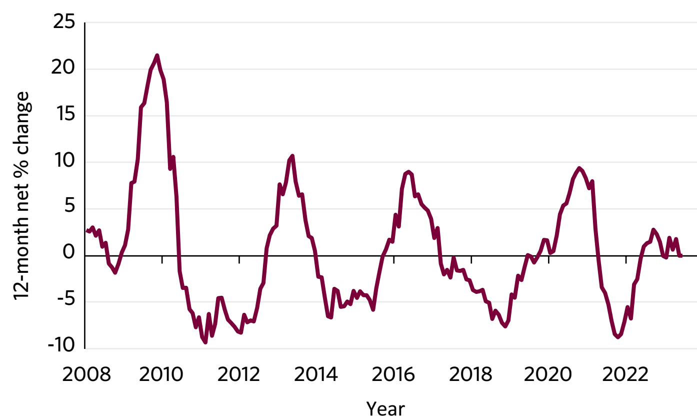
Chinese policymakers have less policy leeway this time around than in past economic slowdown episodes. The PBoC can't cut rates. It doesn't want to magnify the excess supply of housing by creating another housing-led recovery as it did between 2016 and 2018. Regarding fiscal policy, the excessive reliance on infrastructure stimulus since 2008 means China has most of the infrastructure it needs. In the past, infrastructure stimulus has come with an increasingly important financial stability cost. Reflecting this, the debt of local government financing vehicles (LGFV) has increased by almost 50% of GDP in the last decade. Most LGFVs are unprofitable and have negative operating cash flows, suggesting limited leeway for traditional infrastructure.

Instead, we expect large-scale stimulus to come from China stepping up its energy transition, targeting electric vehicles, solar panels, wind power, smart grids, and battery factories. We expect policy banks or the PBoC to play a major role in financing this accelerated transition. The Chinese government will also need to help fuel the stimulus with clean energy tax incentives.

While underlying economic growth in China should remain weak, stimulus should limit the downside for the Chinese economy. We expect GDP growth to average approximately 5% in the next four quarters. This is in line with the consensus expectation but also embeds larger policy support of about 1%-1.5% of GDP.

Stimulus needed

Chinese credit impulse (12-month net % chg.)



Sources: Refinitiv-Datastream and CIBC Asset Management Inc.
Based on data available as at July 11, 2023.

Alternative scenarios

Global soft landing (30% probability)

There is still a path to avoid a recession. For any central bank, engineering a soft landing is no easy task. The fact so many central banks are simultaneously aiming for this outcome is complicating the achievement of this goal. 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 support continued good market conditions for risky assets.

Financial instability (10% probability)

In this scenario, the speed and amount of monetary tightening already undertaken turns out to be too much for the banking sector and the economy to cope with, leading to bouts of financial instability. Facing a more severe impact on profitability, as well as deteriorating liquidity conditions, banks would have no choice but to tighten lending standards substantially. The combined impact of the sharp rise in policy rates and tighter bank lending conditions would result in a deeper and longer global recession than expected in our baseline projection. More severe demand destruction would be accompanied by a faster deceleration in inflation. Under such conditions, central banks would 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	2.2%	0.6%	-0.7%	4.4%	2.7%	3.4%	+50 bps
United States	1.6%	0.4%	-0.4%	4.0%	3.0%	3.5%	+50 bps
Eurozone	1.0%	0.8%	-0.6%	6.1%	3.2%	4.3%	+50 bps
China	4.5%	4.8%	4.9%	0.2%	2.0%	1.1%	-
Japan	1.9%	1.2%	0.5%	3.5%	2.1%	2.2%	-
World	2.2%	2.3%	2.1%	6.0%	3.6%	5.0%	-

Source:CIBC Asset Management Inc. Based on data available as at July 11, 2023.

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

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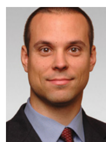

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