

PERSPECTIVES

For the 12-month period beginning January 1, 2023

Table of contents

Asset class highlights	1
Multi-asset outlook	2
Global overview	3
Global strategy	3
Global equity markets	4
Global bond strategies	5
Currencies	5
Commodities	6
Regional views	7
Alternative scenarios	10
Economic forecasts	11

Is the worst over for financial markets?

A global recession will likely mark the start of 2023, but this is turning out to be well expected. We've been talking about the risk of a hard landing as an alternative scenario for most of 2022. In this issue of *Perspectives*, a global recession is our central scenario.

While growth prospects continue to dim for the global economy, this has, to some extent, already been priced-in by forward-looking financial market participants. Markets typically bottom well ahead of the economy. To ensure a more lasting economic recovery, central banks will have to win the battle against inflation for financial markets to deliver less volatile returns. Unfortunately, it's still too early for central bankers to declare victory in their fight against high inflation. Accordingly, it seems too early to sound the all clear for financial markets, and selectivity remains the prudent approach, in our view.

Asset class highlights

Equity: The regional outlook for equities could offer some relative opportunities. Specifically, the U.S. and Europe are still too expensive considering the slowdown and high inflation they're facing. On the other side, emerging markets have underperformed since 2021, as their own economies started to overheat earlier.

Fixed Income: Over the next 12 months, global bonds are likely to offer better returns, due in part to much better levels to start the new year. The risks to developed bond markets are numerous entering into 2023. In terms of emerging markets (EM) local bonds, investors should remain selective.

Currencies: At this point in time, the U.S. dollar (USD) is deeply overvalued, making it particularly sensitive to changes in market expectations about Fed policy and global USD liquidity conditions. As the global recession unfolds, deep investor mood swings are to be expected—that is, just like the ones experienced during the 2008-09 global recession. Moving further out into the forecast horizon, the USD's uptrend will very likely be challenged again. The key takeaway here is that heightened volatility is to be expected in currency land in 2023.

China: Chinese real GDP growth is expected to disappoint further, averaging +4.4% in 2023. While we do expect large-scale liquidity injections by the People's Bank of China and policy banks, as well as small policy rate cuts. However, these efforts deployed by Chinese monetary authorities will pale in comparison with the ones deployed in previous policy-induced recoveries.

Multi-asset outlook

Asset class	Current December 31, 2022	Most likely minimum of range for next 12 months	Most likely maximum of range for next 12 months
Canada 3-month T-Bills rate	4.25%	4.00%	4.75%
Canada 2-year government bond yield	4.05%	3.65%	4.40%
Canada 10-year government bond yield	3.30%	2.85%	3.95%
U.S. 10-year government bond yield	3.87%	3.00%	4.50%
Germany 10-year government bond yield	2.57%	1.75%	3.25%
Japan 10-year government bond yield	0.41%	0.00%	1.00%
Canada 10-year real-return government bond yield	1.17%	1.00%	1.45%
Canada investment-grade corporate spreads	1.58%	1.35%	1.95%
U.S. high-yield corporate spreads	4.73%	3.90%	7.10%
Emerging market sovereign (USD denominated) bond spreads	374	250	500
S&P/TSX price index	19,385	15,500	20,500
S&P 500 price index	3,840	3,200	4,100
Euro Stoxx 50 price index	3,794	2,900	4,000
Japan Topix price index	1,892	1,550	2,025
MSCI Emerging Markets index	57,479	47,900	61,000
U.S. dollar/Canadian dollar	1.3554	1.333	1.434
Euro/U.S. dollar	1.0705	0.950	1.100
U.S. dollar/Japanese yen	131.12	120.00	140.00
U.S. dollar/Offshore Chinese yuan	6.92	6.70	7.25
Gold	1,824	1,700	2,000
Oil price, WTI (West Texas Intermediate)	80.26	60.00	95.00

Source: Thomson Reuters Datastream, CIBC Asset Management Inc. Data as at December 31, 2022.
All prices in home currency unless otherwise specified.

Asset class outlook

Global overview

Looking back at 2022

The ongoing invasion of Ukraine by Russia is one of the most important events, not only for 2022 but also so far into this century. While it's obviously a great humanitarian tragedy, we, as investors, focus on the impact it has on the global economy and financial markets. First, both Russia and Ukraine are key producers of essential agricultural and energy commodities. The disruptions created in these markets have led to spikes in energy and food prices. Investors and companies are usually reluctant to make decisions under higher-than-normal uncertainty. The fact that a war has broken out on European soil involving a major nuclear power shouldn't be expected to fuel risk appetite.

The rise in inflation has been accelerated by the war in Ukraine, but it really took root in the post-pandemic world. As a result of massive liquidity injections during the lock-down phases, the economy has overheated, leading to widespread inflation pressures. Central banks had no choice but to embark on an aggressive tightening campaign. Few analysts or portfolio managers active today have ever gone through such a cycle. As such, this new inflation regime is a paradigm shift that was both sudden and unexpected.

A global recession will likely mark the start of 2023, but this is turning out to be well expected. We've been talking about the risk of a hard landing as an alternative scenario for most of 2022. In this issue of *Perspectives*, a global recession is our central scenario. We're not the only ones thinking this way. An increasing majority of economic forecasters is also predicting a recession. Many major central banks have either explicitly or implicitly embedded a recession in their forecasts. Still, it's a very important development, and financial markets haven't yet fully priced-in the risk.

One of the most important developments in financial markets has been the rise in short-term interest rates (aka the 'risk-free rate'). This is very significant because risk premia for all financial assets are expressed relative to the risk-free rate. When equity prices go down, forward-looking returns improve, and if the risk-free rate is constant, then the equity risk premium improves as well. But this doesn't hold if the risk-free rate rises. This is what happened this past year. Equity prices have come down, but since central banks have increased interest rates, the equity risk premium has actually declined. The same observation can be made on the bond market. Despite higher bond yields, the bond-risk premium is lower than it was at the start of 2022.

Portfolio returns were disappointing this past year. When looking back at how markets behaved, it certainly feels like it was a wild ride with plenty of turbulence. Among other things, many historical patterns broke down. In periods of turbulence, investors typically find refuge in safe havens like gold and the

JPY/EUR exchange rate. Not this year. The yen depreciated all year, and gold ended flat after a recent rebound but was down most of the year. As the economy slows down, investors can typically find opportunities in the defensiveness of government fixed income. Not this year. Pretty much every segment of the bond market showed negative performance this year. Of course this is understandable, because it was all about inflation. So real assets have done well, right? Not so fast. Real return bonds are down because real interest rates have sharply moved up. Swings in commodities have been wild, but the result has been great volatility with little net changes in prices.

These developments had a significant impact on portfolio returns in 2022 and should continue to be important factors in 2023 and beyond. Periods of economic recession are rarely good for risky assets but can create opportunities as markets reprice valuations lower. For the moment, markets have not yet fully priced-in the risk of a recession that is taking place in the context of elevated inflation. As such, our tactical asset allocation strategy is putting more weight on the need for capital protection and remains defensive.

Global strategy

Is the worst over for financial markets?

Moving into the new year, investors have their fingers crossed that the chaos will soon be over and that global monetary authorities will successfully engineer a soft landing. Their wish is that 2023 will come with little damage to the global economic backdrop. They hope for enough of a deceleration in inflation to allow central banks to stop pulling the brakes and start pushing the accelerator. But, will things really be calmer in 2023?

Such high hopes are quite understandable. In the past three decades, investors have learned that when the economy tips into recession, central banks promptly react by aggressively easing their policy stances—a loud-and-clear lift-off signal for financial markets. Why would it be different this time around? The only reason why central banks did flip-flops policy-wise was because inflation wasn't an obstacle. All of the recessions experienced since the early 1990s qualify as 'disinflationary busts'.

What's in store for 2023 is a different kind of recession than the ones endured since the early 1990s. What all central bankers around the developed world have finally come to grips with is that stagflation is making a comeback. Putting it differently, the current episode qualifies instead as an 'inflationary bust'—that is, similar to the ones experienced in the mid-1970s and early 1980s. Needless to say, this makes a huge difference. It means that increased prospects of a global hard landing most likely won't be enough to convince global monetary authorities that it's time to take a dovish turn. To win the battle on inflation, labour market conditions have to be loosened long enough to break wage pressure. In other words, the global monetary policy stance will have to stay in restrictive territory for longer than generally believed.

It's important to recognize that we're now moving in the late stages of the global monetary policy tightening campaign and that global financial conditions have already tightened considerably—that is, over a long enough period to act as a substantial drag on growth. Our global growth forecast has been revised lower to 1.0% average growth in 2023. We estimate that a global downturn of this magnitude is necessary for inflation to return closer to central banks' targets and for a better and more sustainable recovery in the longer term.

While growth prospects continue to dim for the global economy, to some extent, this has already been priced-in by forward-looking financial market participants. Markets typically bottom well ahead of the economy. To ensure a more lasting economic recovery, central banks will have to win the battle against inflation for financial markets to deliver less volatile returns. Unfortunately, it seems too early for central bankers to declare victory in their fight against high inflation. Accordingly, it's too early to conclude that the worst is already over for financial markets.

Global equity markets

When will the equity market bottom?

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 decline by 15% to 20% on a year-over-year basis. They're still showing positive growth. On a quarterly basis, they've been declining over the last four quarters, but the contraction is still relatively small so far. Despite a bleak outlook over the next months, at one point the cycle will turn and equities will offer more attractive returns. But we're not there yet, and more downside risk still exists. By looking at past episodes of recessions, we can determine the conditions that would be required to mark the bottom in the market. We should point out that every cycle is different in some ways, so the ability to draw generalizations is limited.

Markets usually bottom well before the economy does. That being said, the economy usually bottoms well after a recession has started. And we have never seen a case in the last 50 years in which the equity market had bottomed before the beginning of a recession. As such, predicting that a recession will start soon is not a sufficient condition for a market bottom: we need to identify that the recession has already started. The National Bureau of Economic Research (NBER) provides the official dating of U.S. economic cycles. Unfortunately, they identify start and end dates long after the fact, so it's not a useful tool. However, we can monitor in real time a number of economic variables—such as employment, production, sales and income—which can help to identify peaks and troughs. Employment remains robust, but production, sales and income are close to levels that have been associated with recessions. The conclusion is the equity market typically bottoms some time after the start of a recession, but the expected recession hasn't started yet.

Once the recession has started, a second condition is that we need to have seen the peak in monetary policy. The U.S. Federal Reserve Board (Fed) has identified three conditions that could lead to a pause in its tightening campaign:

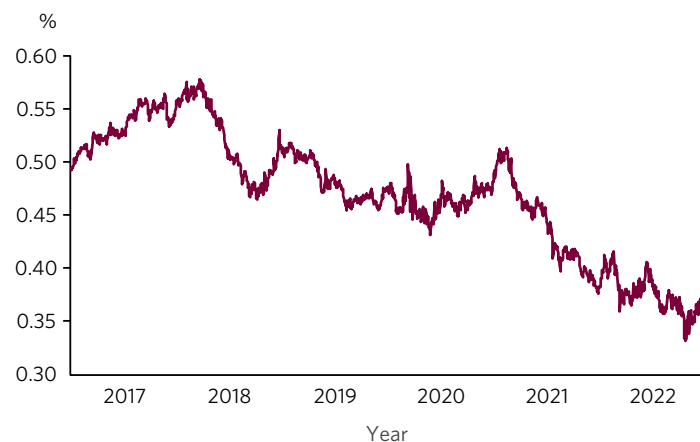
1. Growth remains below trend for an extended period of time
2. Having a better balance between supply and demand in the labour market
3. Making significant progress to bring inflation back towards target

Based on these conditions, we see that the Fed might have done most of the tightening already but there's still some more to come. An important caveat, however, is that historically, the central bank was conducting policy by adjusting interest rates. In recent years, it has acted on rates but also on quantitative tightening and forward guidance. Quantitative tightening is expected to continue, while forward guidance communications will be especially key to identify the peak hawkishness in monetary policy.

Finally, some signs that leading economic indicators—like purchasing manager surveys—are improving would provide additional confirmation that the cycle is turning. The equity market typically turns before those indicators, so they should be used as a confirmation only. All in all, the conditions for a market bottom are not met yet. More downside risks remain as investors need to price-in the contraction in earnings that's typical of recessions.

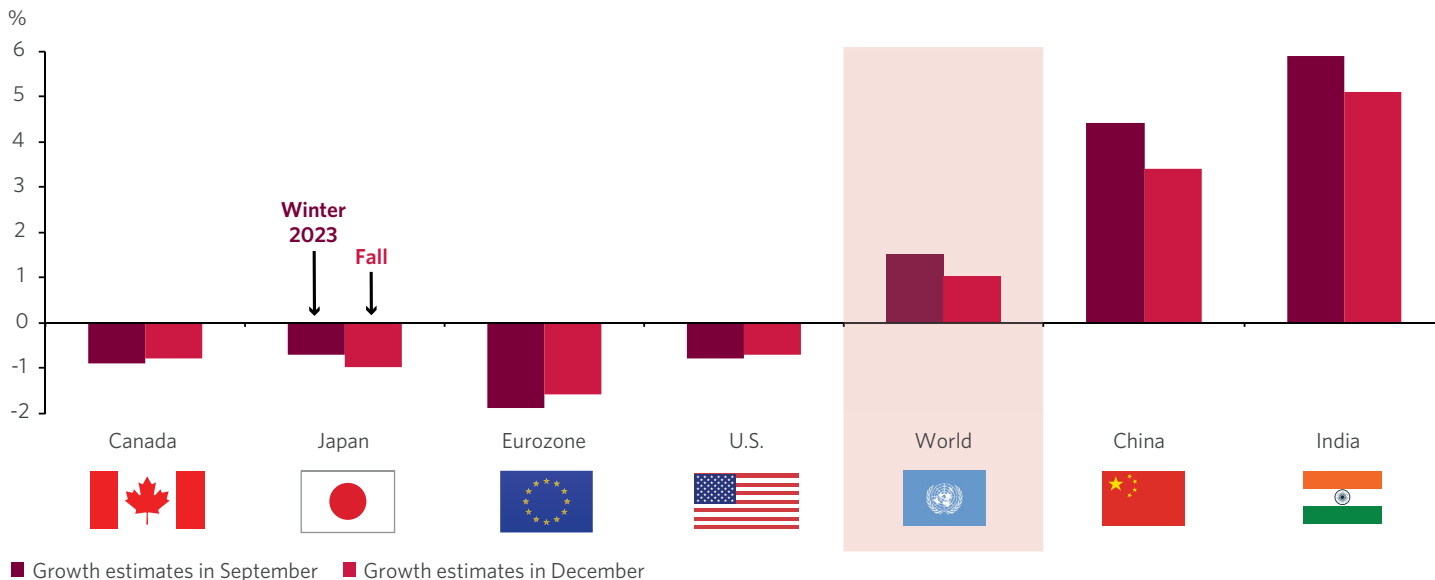
The regional outlook for equities could offer some relative opportunities. Specifically, the U.S. and Europe are still too expensive considering the slowdown and high inflation they're facing. On the other side, emerging markets have underperformed since 2021, as their own economies started to overheat earlier. They're now at the point where central banks have stopped hiking interest rates. The Chinese economy is reopening after its harsh Covid lockdown measures, which should support Asian equities. Canadian equities are mixed, with slightly better perspectives than the U.S. or Europe. Valuation is more attractive; however, Canada is a small, opened economy that is highly sensitive to the global economic cycle.

MSCI Emerging relative to MSCI World (in USD)



Sources: Refinitiv-Datastream and CIBC Asset Management Inc.

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



Sources: Refinitiv-Datastream and CIBC Asset Management Inc.

Global bond strategies

The performance of global bonds was quite disappointing in 2022. The WGBI index (Canadian dollar hedged) delivered a negative performance of 12%. This violent pullback in global bond markets can readily be explained by the fact that global inflation considerably surprised to the upside. This forced central bankers around the globe to take a very hawkish turn.

Over the next 12 months, global bonds are likely to offer better returns, due in part to much better levels to start the new year. In the U.S., the yield of 10-year Treasuries should trade in a range of 3.00% to 4.50%, around a pivot of 3.75%. Real 10-year yields' upward momentum has already abated, as the Fed seems to be approaching its neutral policy rate. Meanwhile, inflation breakeven should soften slightly in 2023, as a global recession appears to be a high probability, and might potentially be deeper than currently expected by the general consensus.

Having said this, the risks to developed bond markets are numerous entering into 2023. For one, global bond holders will have to cope with the continued de-anchoring of German bund yields and Japanese government bonds (JGBs). The upward pressures on German yields are intensifying for three reasons:

1. The European Central Bank (ECB) has stopped buying bunds
2. Ex-ECB European central banks have turned into net sellers of bunds
3. New bund issuance is rising fast

Meanwhile in Japan, the Bank of Japan (BoJ) announced an important policy shift in December by changing the yield cap on its yield curve control policy, which may very well be only the beginning of BoJ's monetary policy renormalization. Taken together, these developments point to heightened volatility in global bond markets early in 2023.

In terms of emerging markets (EM) local bonds, investors should remain prudent and selective. Yes, China's re-opening and exit from the zero-Covid policy has been positively taken by the markets so far. However, the global macroeconomic environment will remain dicey for holding the riskier part of our bond universe, especially in the first half of the year. A protracted global growth scare could lead to further EM bonds outflows. As a consequence, our local bond exposure will stay defensive, probably until the Fed starts signaling an eventual pivot more clearly. As for EM USD debt, since spreads tightened markedly in Q4 2022, we are now biased towards reducing exposure at current levels, and waiting for better entry points.

Currencies

U.S. dollar

Mounting concerns about the outlook for the world economy propelled the USD higher in 2022. By the autumn, it was up by a whopping 10% on a trade-weighted basis. Since late September, however, the USD has given back roughly half of the gains made earlier in the year. Is this the start of a longer-term USD trend reversal, or is it simply a short-term counter-trend pullback?

In our opinion, the greenback's multi-year bull market is starting to be more seriously challenged. With the Fed's policy stance expected to stay in restrictive territory, global USD liquidity concerns should keep it well supported. However, the balance of risk could abruptly tip on the downside if something was to break in the global financial system. This would force the Fed to reverse course and open the global USD liquidity tap. The problem at this point in time is that the USD qualifies as deeply overvalued. This would make it particularly sensitive to changes in market expectations about Fed policy and global USD liquidity conditions. As the global recession unfolds, deep investor mood swings are to be expected—just like the ones experienced during the

2008-09 global recession. Moving further out into the forecast horizon, the USD's uptrend will very likely be challenged again. The key takeaway here is that heightened volatility is to be expected in currency land in 2023.

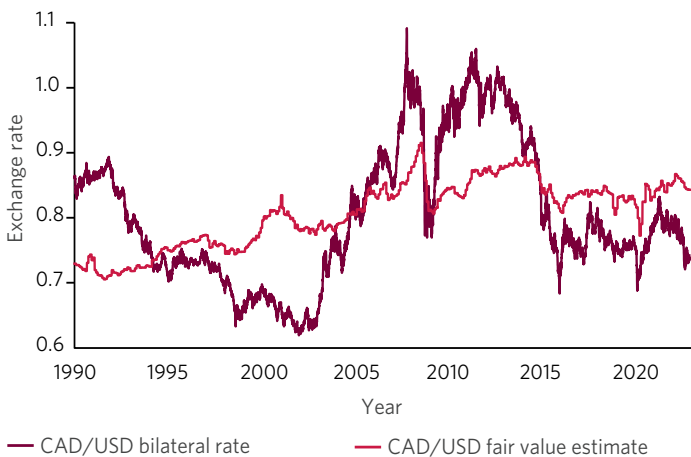
Canadian dollar

The Canadian dollar (CAD) has been trending lower for more than a year, depreciating by more than 12% against the greenback from the cyclical peak reached in the summer of 2021. It's recently found support at around 0.73 USD.

Looking forward, is there more downside for the CAD? In our opinion, further weakness is to be expected. 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 pressure on the CAD against the USD. Second, 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. Last but not least, energy prices are projected to weaken further, particularly over the shorter term. If our forecast about energy prices materializes, Canada's energy surplus with the U.S. will likely be cut by half. In turn, this could push Canada's total trade balance with the rest of the world back into deficit. On net, the CAD will remain under pressure, trading between 1.333 and 1.434 in 2023.

More downside for the Canadian dollar?

CAD/USD bilateral rate and CAM fair value estimate



Sources: Refinitiv-Datastream and CIBC Asset Management Inc.

Euro

In late 2022, the euro (EUR) recouped some of the ground lost against the USD over the last two years, thanks to a particularly hawkish turn taken by the ECB. It took a while, but the monetary authorities in the eurozone have finally realized that the eurozone is stuck with a vicious wage-price spiral.

The only way to break it is to deliver enough of a tightening in the monetary policy stance to get a significant loosening in labour market conditions. The risk is for a more severe downturn for

the eurozone economy. This would likely come with increased market concerns about another sovereign debt crisis in the fiscally challenged eurozone economies. Given that the ECB is now reducing its support to commercial banks, a more severe economic downturn would also likely come with increased concerns about another eurozone banking crisis. For these reasons, we think that the recent counter-trend rally in the EUR/USD bilateral rate will be short-lived and that the EUR's downtrend will resume. The EUR is expected to trade between 0.950 and 1.10 over the forecast horizon.

Japanese yen

Since the BoJ introduced its yield curve control (YCC) policy in 2016, the Japanese yen (JPY) has lost substantial ground against the USD. It has moved from overvalued to deeply undervalued territory. The JPY continued to trend lower over most of 2022—that is, up until the fourth quarter. What changed? For the first time in a very long time, Japan is experiencing a build-up in inflationary pressures. Indeed, yearly import-price inflation is now running at more than 30%—its highest reading since the early 1980s.

What's more, Japanese core CPI inflation is now running at its fastest clip in 12 years. Given that this is all happening in the context of particularly tight Japanese labour market, odds are rising that inflation is staging a comeback and the BoJ is fully aware of it. The changes just announced to the YCC policy signal that a policy regime shift is underway. It's very likely that the de-anchoring of Japanese government bond (JGB) yields will eventually lead to capital repatriation, exerting upward pressure on the JPY. The USD/JPY bilateral exchange rate is projected to trade between 120 and 140 in 2023.

Commodities

Oil

The trajectory for oil has mainly been lower since hitting a peak of \$120/bbl in June. The spot West Texas Intermediate (WTI) price is now closer to \$75/bbl as uncertainty around demand has moved to the front of investors' minds with global recession risks rising. At the current price of \$75/bbl we're basically back to where we started in January 2022, despite two trips to +\$120/bbl during the year. Clearly, it has been a volatile period for energy with both demand and supply uncertainty pushing prices around.

On the demand side, investor focus is on global recession risks and Covid in China. Inflation and the path forward for interest rates could impact energy demand in 2023 as central banks around the world work to curb inflation and growth with higher rates. Risk of recession in key end markets could negatively impact oil demand in 2023. Investors are also closely watching China as the country lifts its zero-Covid policy. Although currently in the middle of a heavy Covid wave, there's potential for China to return to something closer to normal this year, which could have a positive impact on oil demand.

On the supply side, producer discipline generally remains in place. Producers in North America continue to bring limited new supply to the market, while OPEC+ agreed at its most recent meeting to keep production flat after lowering its quota by 2 mmbbls/d back in October.

Looking forward, we'll continue to watch for signals on demand growth or contraction in the coming months to gauge where support is for oil prices this year. On the supply side, we are looking for potential outcomes from the war in Ukraine and how OPEC+ responds to the recent drop in the price.

Gold

Gold has caught a bit of a tailwind over the past few months, increasing from approximately \$1,650/oz in late-September to approximately \$1,850/oz in early January. The move in gold is closely tied to the recent relative weakness in the USD, as we have seen the U.S. Dollar Index (DXY) fall from 114 in late-September to 105 in early-January. Clearly, gold continues to be closely related to moves in the USD.

Looking forward, we continue to see possible tailwinds for gold into 2023. There is potential that inflation is peaking and that rate hiking cycles are closer to a top. At the same time, recession risks are rising. Taken all together, these factors could help support the gold price in the coming months. Risks to gold could come from stronger-than-expected economic growth and therefore further rate hikes beyond current expectations.

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 around recession risks from investors. A tight physical market with limited visible inventory has helped hold prices up in the \$3.80/lb range in recent months.

Looking forward, the focus on the demand side is on China and its emergence from its zero-Covid policy. While clearly in the middle of a significant Covid wave now, there is some optimism from investors that demand for commodities could accelerate into the second quarter and second half of 2023 as China returns to something closer to normal. The potential offset to stronger Chinese demand could be growing recession risks in Europe and the United States.

On the supply side, visible global copper inventory levels remain low, which has helped support the price. Rising geopolitical risks have also been a tailwind for copper as risk of disruption to supply

remains in focus for investors. While there are a few new mines starting up and ramping up in the near term, growth beyond these new operations appears to be minimal. Over the medium to longer term, we continue to believe that copper will be a critical metal in the transition to a lower-carbon economy. And we believe that over the medium-term higher prices will be required to incentivize new volume of the red metal into the market.

Regional economic views

Canada

BOC moving to the sidelines

The Bank of Canada (BoC) is still expecting Canada will experience a soft landing, with inflation slowing down to target by 2024. However, the most reliable leading indicator of Canadian economic activity is flashing red, sending a strong recession signal. Indeed, the Canadian yield curve has been moving deeper and deeper into negative territory over the last six months, implying rising odds of a Canadian recession in 2023. To be more precise, the yield curve is sending its strongest signal since the late 1980s—just before the severe Canadian recession of the early 1990s.

Can a recession be avoided this time around? We don't think so. Our baseline forecast calls for an average contraction of 0.8% in Canada's real GDP in 2023. We're more downbeat than most forecasters for two reasons. First, a housing recession is already underway, with existing home sales down 45% from their 2021 cyclical peaks and down 21% from pre-pandemic levels. Using the Housing Affordability Index compiled by the BoC, the hit on housing now compares with the one experienced in the early 1990s.

Second, most forecasters are underestimating the impact of the negative wealth effect that will soon be hitting Canadian households. Over the last year, Canadian households have been spending like crazy, with real consumer spending rising 8% on a yearly basis. Now that they have to deal with the biggest inflation shock in decades—as well as with the devastating impact of fast-rising borrowing costs on their wallets—why haven't Canadian consumers started retrenching? They're still being lifted by the biggest positive wealth effect ever experienced.

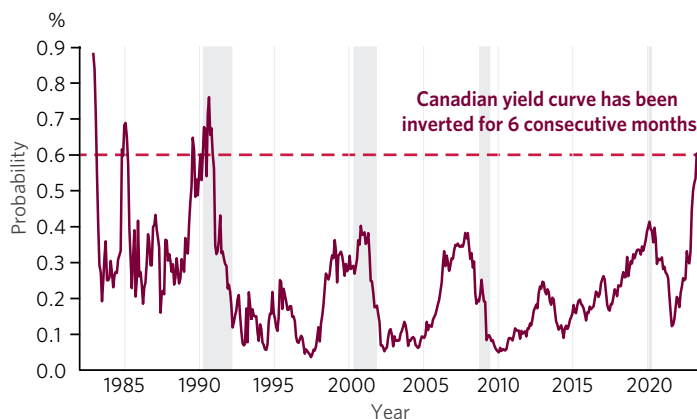
Moving into 2023, however, they'll have to cope with a particularly nasty negative wealth effect—one big enough to drag the Canadian consumer down. Back in 2008-09, the negative wealth effect was the main reason why consumer spending turned negative and de facto why Canada experienced a recession. In 2023, the negative wealth effect is projected to be even bigger than in 2008-09, pointing to a contraction in real consumer spending.

The weakening of the Canadian economy hardly comes as a surprise. After all, the BoC has been aggressively tightening its monetary policy stance over the last year—hiking its policy rate by

400 basis points (bps) and reducing further the size of its balance sheet (-\$100 billion). Determined to break the vicious wage-spiral, it will keep its policy stance in its restrictive zone over the forecast horizon. However, a move to the sidelines in early 2023 seems justified. The BoC will need time to evaluate the damage done to the Canadian economy, as well as the progress made on the inflation front.

Odds of a Canadian recession rise to 60%

Odds derived using 10Y-2Y CDN yield curve



Source: Refinitiv-Datastream and CIBC Asset Management Inc.

United States

Taming inflation is only half the Fed's battle

Moving into the new year, investors are hoping that inflation will fall enough in 2023 to let the Fed to pause, and perhaps reverse course on, some of its interest rate hikes. In turn, this would allow for a bigger loosening in financial conditions and a better year for financial markets. Well, not so fast. Taming inflation is only half the Fed's battle. If the Fed eases up too soon, the risk is high that this would trigger a whole new round of overheating and tightening. The Fed has to keep its monetary policy stance in restrictive territory long enough to get substantially looser labour market conditions and ultimately win its battle against inflation. Instead of rate cuts, the surprise of 2023 could very well be that the Fed will keep policy in the restrictive zone longer than generally expected. After all, the dominant view remains that inflation will still be well above target by late 2023.

Stuck with weak growth in the U.S. labour force, the Fed has no other choice but to aim for enough loosening in labour market conditions to break the wage-price spiral. This will only happen in the context of a significant increase in the unemployment rate and a substantial drop in the job vacancy rate. Putting it differently, this boils down to a Fed-engineered hard landing for the U.S. economy. Of course, the Fed won't officially admit this, just as it won't officially project a hard landing for the U.S. economy. However, looking at how the Fed's views have been changing between the start and the end of 2022, it's becoming clear that the Fed has come to grips with the fact that stagflation is making a big comeback.

The Fed is now probably fighting one of its biggest battles ever against high inflation. It's still a long way from declaring victory. The necessary conditions to win the battle haven't been met yet, with much looser labour market conditions being required. Unfortunately, this can only come with a big-enough hit on the still red-hot jobs market. Our forecast calls for a sharp growth deceleration in U.S. real GDP growth to -0.8% on average in 2023.

Europe

A replay of the 2012-13 episode?

Like most other central banks in the developed world, the European Central Bank (ECB) is fighting its toughest battle ever against high inflation. For the first time since the euro was launched in early 1999, monetary authorities in the eurozone have to deal with the biggest energy price shock on record and intensifying domestic cost-push inflationary pressures. As if these weren't enough, they also have to deal with a demographic shock that makes fighting high inflation even harder. There really is no way around it: the ECB has to engineer an economic downturn to break the wage-price spiral.

In late 2022, the staff at the ECB finally recognized that stagflation is making a big comeback. The ECB significantly revised its inflation projections up, and sharply lowered its growth numbers. It now projects a rise in core HICP inflation (excluding food and energy) from +3.9% in 2022 to +4.2% in 2023. These upward revisions to the inflation outlook came with big downward revisions to growth prospects. Its 2023 projections for average real GDP growth in the eurozone have been cut from +2% six months ago to +0.5%. In its last financial stability report, the ECB even argues that the mix of high inflation out-turns and rising interest rates is weighing so much on economic growth that one-year ahead recession probabilities have increased markedly. Putting it differently, the ECB is now implicitly forecasting an inflationary bust (or stagflation) for the eurozone.

This hardly comes as a surprise. The current tightening in eurozone financial conditions is comparable in magnitude to the one that took place in 2011. Back then, this was sufficient to push the eurozone economy into recession. While the 2012-13 eurozone recession qualified as a mild one, it led to both a fiscal crisis as well as a banking crisis. Could the same thing happen this time around?

There certainly are reasons for concern.

To avoid a sovereign debt crisis, the ECB has put two lines of defense in place to keep a lid on peripheral spreads. However, its real 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.

The risk of a banking crisis is also elevated. To win its fight on inflation, the ECB can't continue to expand its balance sheet. This means that any future TPI purchases will have to be sterilized, implying less support to the banking system at a time when banks will probably be needing more support.

China

Falling foreign demand to bring more housing woes

The swift removal of zero-Covid policies and the current virus outbreak have fueled hopes of a V-shaped recovery for the Chinese economy, similar to what was experienced by Taiwan and Korea. In these countries, solid external demand and booming housing activity were strong cyclical tailwinds. Unfortunately for China, underlying conditions aren't as supportive. Looking into the new year, we expect a steep contraction in external demand and important negative spillovers to housing.

As the world's factory, China is highly vulnerable to a global slowdown. Last year, fueled by insatiable foreign demand, exports surged, preventing a crisis that could have been potentially worse than in 2015. For this year, we expect that Chinese exports will experience a steeper decline than the one that took place 2015.

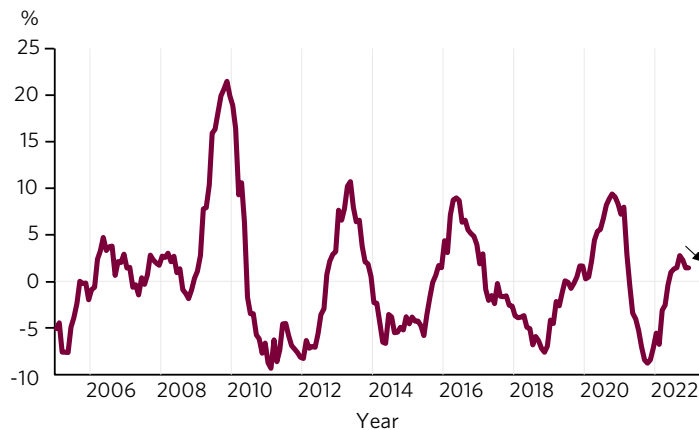
The negative external shock hitting China will have spillover effects. In particular, the hit on housing demand will likely be harder than usual due to elevated excess supply of housing units. China employs about 300 million migrant workers. An important proportion of these migrant workers are renters. The problem is that demand for shelter from that cohort has slowed materially since 2018. In a context of booming supply, this has resulted in rent deflation since 2019—a very unusual development. Excess supply conditions will make policymakers reluctant to engineer a housing-led recovery.

Meanwhile, it will be difficult for public infrastructure spending to be China's growth engine. Policymakers have again reopened their infrastructure stimulus playbook, but the aggregate investment impulse remains modest by historical standards. After several rounds of large-scale infrastructure stimulus since 2009, the pool of high-quality projects available is insufficient to implement a large-enough stimulus without increasing financial stability risks. Balance sheet vulnerabilities of investment vehicles under the umbrella of local governments have become more important.

The bottom line is that Chinese real GDP growth is expected to disappoint further, averaging +4.4% in 2023. While we do expect large-scale liquidity injections by the People's Bank of China (PBoC) and policy banks, as well as small policy rate cuts, the efforts deployed by Chinese monetary authorities will pale in comparison with the ones deployed in previous policy-induced recoveries.

No massive Chinese credit impulse this time around

Chinese credit impulse: 12-month net change (Bloomberg)



Source: Refinitiv-Datastream and CIBC Asset Management Inc.

Alternative scenarios

Global soft landing (30% probability)

While our main scenario has shifted from a soft landing to a hard landing, there's 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 will try, and all central bankers have their fingers crossed, hoping to successfully avoid a hard landing. The path to a soft landing relies on two necessary conditions. First, growth needs to slow down just enough to remove the risk of overheating, but not too much. Economic indicators are showing this is under way. Second, inflation needs to cool down. The disruptions in supply chains that initially sparked inflation have improved. There are signs that the housing market is cooling as well. After significant backup in bond yields and corrections in equity prices, a soft landing would pave the way for better market conditions.

Stubborn inflation (20% probability)

In this scenario, the monetary policy renormalization delivered globally ends up being too late to prevent a self-re-enforcing cost-push inflation shock. Labour markets remain tight and continue to fuel growth, so the global economy doesn't cool off sufficiently to get inflation under control. As a result, inflation remains stubbornly elevated, convincing more and more market participants that central banks will need to do more tightening. In this context, the fact that the global economy remains on solid footing isn't necessarily good news for financial markets, as it points to more policy tightening further down the road. In this scenario, a continued pullback in bond markets would likely materialize, making it very hard for risky assets to forge ahead.

Scenario	Less favourable	More favourable
Global soft landing (30%)	USD Real return bonds Precious metals	Global equities EM bonds Commodities
Stubborn inflation (20%)	Eurozone bonds U.S. treasuries EM bonds	Cash Commodities Breakeven inflation



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	3.9%	0.5%	-0.9%	6.8%	3.8%	4.2%	+25 bps
United States	1.9%	0.3%	-0.8%	7.1%	4.0%	4.0%	+75 bps
Eurozone	2.3%	-0.1%	-1.9%	10.1%	6.1%	6.0%	+75 bps
China	3.9%	4.7%	4.4%	1.6%	2.3%	2.1%	RRR cuts
Japan	1.5%	1.3%	-0.7%	3.8%	2.0%	3.0%	-
World	2.9%	2.0%	1.5%	6.5%	4.8%	5.6%	-

Data as of December 2022.

Source: Datastream, Bloomberg, CIBC Asset Management Inc. calculations.

¹ Real GDP growth (y/y %)

² Year/year %

Authors



Luc de la Durantaye

Chief Investment Strategist,
CIO and Managing Director,
Multi-Asset & Currency Management



Daniel Greenspan

Senior Analyst &
Resource Team Director



Francis Thivierge

Senior Portfolio Manager,
Multi-Asset & Currency Management



Vincent Lépine

Director, Economic and Market Research,
Multi-Asset & Currency Management



Éric Morin

Senior Analyst,
Multi-Asset & Currency Management



Jean-Laurent Gagnon

Associate Portfolio Manager*,
Multi-Asset & Currency Management

*Registered as an Associate Advising Representative.

This document has been prepared for the general information of our clients and does not constitute an offer or solicitation to buy or sell any securities, products or services and should not be construed as specific investment advice. All opinions and estimates expressed in this document are as of the time of its publication and are subject to change. CIBC Asset Management Inc. uses multiple investment styles for its various investment platforms. The views expressed in this publication are the views of the Multi-Asset Allocation and Currency Team and may differ from the views of other teams within CIBC's integrated investment platform. The information does not constitute legal or tax advice.

Certain information that we have provided to you may constitute "forward-looking" statements.

These statements involve known and unknown risks, uncertainties and other factors that may cause the actual results or achievements to be materially different than the results, performance or achievements expressed or implied in the forward-looking statements.

Bloomberg® is a service mark of Bloomberg Finance L.P. and its affiliates, including Bloomberg Index Services Limited ("BISL"), the administrator of the indices (collectively, "Bloomberg") and have been licensed for use for certain purposes by CIBC Asset Management Inc. Bloomberg is not affiliated with CIBC Asset Management Inc., and Bloomberg does not approve, endorse, review, or recommend any CIBC Asset Management Inc. products. CIBC Asset Management and the CIBC logo are trademarks of CIBC, used under license.

The content of this presentation is proprietary and should not be further distributed without prior consent of CIBC Asset Management Inc.