Forecast

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'19 Shades of Grey

by Avery Shenfeld

We would like to say something dramatic about the coming year's outlook, but the real world isn't always a case of black or white. Sometimes, the truth is a less exciting shade of grey, and that looks to be the story for 2019: not as bright as what markets were expecting as of last summer, but not as dark as the fears that emerged during the final trimester of 2018. Or at least, not yet that dark, as there are still some risks for 2020 when we expect US leadership in terms of growth to fade away (see pages 4-6).

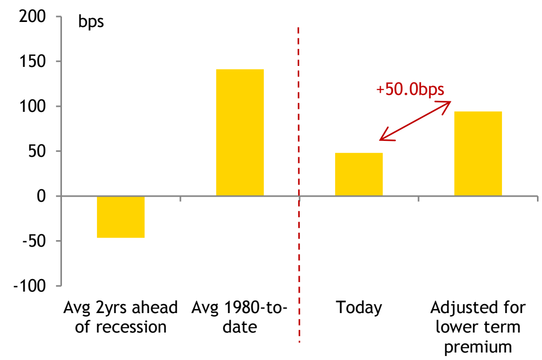
The global backdrop isn't ugly, but is certainly showing some wear and tear (See pages 10-12). But two of the typical recession drivers (excessive rate hikes to combat a visible inflation overheating, or an upside oil price shock) are not in evidence.

A third historic trigger, a financial market shock, is lurking as a risk in some corners of the debt market, and we've already seen bouts of selling in credit spreads. There are concerns about Italian banks, Brexit, fading Chinese demand, and trade wars, but we've had similar worries earlier in this cycle (Greece, Chinese capital spending excesses) that we managed to work through.

There are political solutions to some of those now exigent. We're giving politicians the benefit of the doubt that the worst case outcomes—a further escalation in the China-US tariff war, a hard Brexit, an endless US government shutdown—will be avoided.

The only other scary signpost, the flattish yield curve slope, is not the harbinger of doom it's made out to be. There's a "new normal" in which the term premium, which used to provide a substantial added yield as a reward to investors for locking in, has been stuck in negative territory even in good times in this cycle. That may owe in part to global QE, and to greater confidence across major bond markets that central banks have a permanent lid on inflation, making long term debt less risky. Adjusted for that plunge in the term premium, and the resulting lower norm for long rates, the spread between 10 year and short-term rates is not ominously flat (Chart 1).

Chart 1
CDN 10Yr-3month Slope: Not That Scary



Source: Bloomberg, CIBC

But markets are clearly worried. The pendulum of expectations has swung so far to the negative that our outlook, which hasn't changed materially for the US, or for the non-energy elements of the Canadian economy (see pages 7-9), now looks more hopeful when judged by what markets

Table 1

FORECAST SUMMARY
(% Change Except Where Noted)

CANADA	2017A	2018F	2019F	2020F
GDP at Market Prices	5.6	**4.1**	**3.4**	**3.9**
GDP in $2007	3.0	**2.1**	**1.8**	**1.5**
Consumer Price Index	1.6	**2.2**	**1.9**	**2.3**
Unemployment Rate	6.3	**5.8**	**5.6**	**6.0**
Current Account Balance (C$ Bn)	-60.1	**-59.7**	**-62.3**	**-57.3**
Pre-tax Profits (net Operating Surplus)	20.1	**4.4**	**-0.7**	**6.5**
Housing Starts (K)	220	**214**	**188**	**176**

UNITED STATES	2017A	2018F	2019F	2020F
GDP at Market Prices	4.2	**5.2**	**4.1**	**3.7**
GDP in $2009	2.2	**2.9**	**2.2**	**1.5**
Consumer Price Index	2.1	**2.4**	**1.8**	**2.3**
Unemployment Rate	4.4	**3.9**	**3.7**	**4.3**
Current Account Balance (US$ Bn)	-449	**-483**	**-522**	**-525**
Pre-tax Profits (with IVA/CCA)	3.2	**8.0**	**3.2**	**4.3**
Housing Starts (K)	1,208	**1,264**	**1,237**	**1,190**

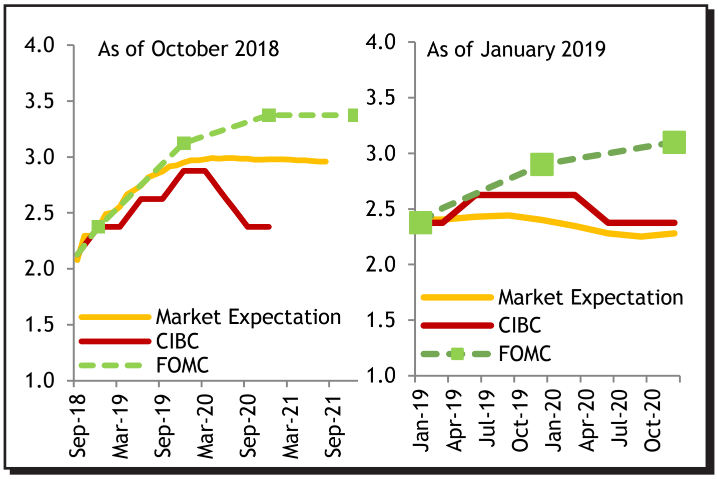
Table 2

INTEREST AND EXCHANGE RATE FORECAST

		2019	2019				2020	
END OF PERIOD:		**14-Jan**	**Mar**	**Jun**	**Sep**	**Dec**	**Jun**	**Dec**
CDA	Overnight target rate	1.75	1.75	1.75	2.00	2.00	2.00	2.00
	98-Day Treasury Bills	1.60	1.60	1.75	1.95	2.00	1.85	1.75
	2-Year Gov't Bond	1.86	1.80	2.00	2.30	2.25	1.90	1.70
	10-Year Gov't Bond	1.94	1.90	2.10	2.30	2.30	2.05	2.00
	30-Year Gov't Bond	2.16	2.15	2.25	2.40	2.30	2.20	2.10
U.S.	Federal Funds Rate	2.375	2.375	2.625	2.625	2.625	2.375	2.375
	91-Day Treasury Bills	2.41	2.35	2.65	2.70	2.80	2.40	2.25
	2-Year Gov't Note	2.53	2.65	2.90	2.90	2.80	2.40	2.35
	10-Year Gov't Note	2.70	2.75	3.00	3.20	3.20	2.90	2.70
	30-Year Gov't Bond	3.05	3.00	3.25	3.40	3.40	3.25	3.00
Canada - US T-Bill Spread		-0.81	-0.75	-0.90	-0.75	-0.80	-0.55	-0.50
Canada - US 10-Year Bond Spread		-0.76	-0.85	-0.90	-0.90	-0.90	-0.85	-0.70
Canada Yield Curve (10-Year — 2-Year)		0.08	0.10	0.10	0.00	0.05	0.15	0.30
US Yield Curve (10-Year — 2-Year)		0.17	0.10	0.10	0.30	0.40	0.50	0.35
EXCHANGE RATES	CADUSD	0.75	0.77	0.76	0.76	0.75	0.76	0.76
	USDCAD	1.33	1.30	1.31	1.32	1.34	1.32	1.32
	USDJPY	108	107	106	106	105	103	100
	EURUSD	1.15	1.15	1.17	1.19	1.22	1.26	1.24
	GBPUSD	1.29	1.32	1.36	1.40	1.44	1.46	1.44
	AUDUSD	0.72	0.74	0.75	0.76	0.77	0.79	0.80
	USDCHF	0.98	0.97	0.95	0.95	0.93	0.92	0.94
	USDBRL	3.70	3.55	3.50	3.65	3.80	3.95	3.80
	USDMXN	19.0	19.1	19.4	20.1	19.9	20.4	20.7

Chart 2

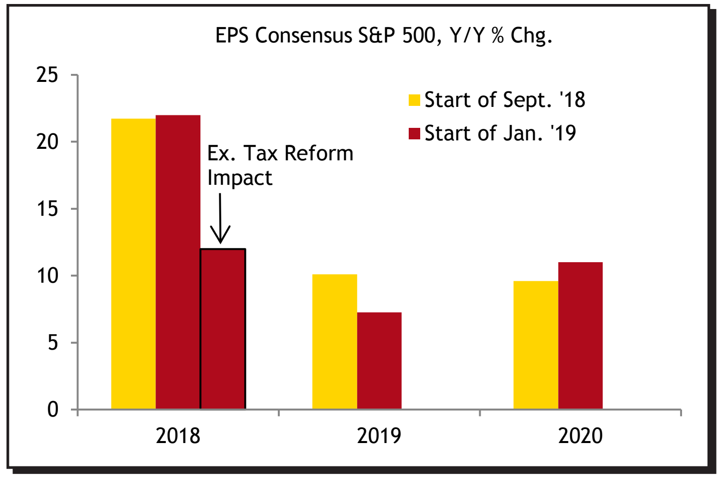
Market Pendulum Has Swung Too Far on Fed Funds Forecasts



Source: Federal Reserve, Bloomberg, CIBC

Chart 3

2019 Hopes Are More Reasonable; 2020 Earnings Expectations Look Too Lofty



Source: Factset, CIBC

have been assuming for central bank rates. Our call for modest and subsequently reversed Fed hikes looked dovish back in October, but our current call for one hike in 2019 is above today's market pricing (Chart 2).

Similarly, we still see room for the Bank of Canada to nudge rates a quarter point higher this year, assuming WTI oil gets back above the mid-$50 range at some point. That's one hike fewer than our October forecast, which was more dovish than the consensus or Bank of Canada hints, but is now more than the yield curve is pricing in. That could give a short term lift to the Canadian dollar as well, but one that will reverse as lackluster trade data reminds us of the need for a competitive exchange rate if exports are to fill in for housing as a source of growth.

That said, with US real GDP advancing at only a shade above 2% in the coming year, and Canada at 1.8% (Table 1), growth will only briefly stray into the range that would justify a further tightening. As the year closes we're likely to see a return to talk of a policy ease ahead, at least for the US where rates will have reached higher levels. Bond yields could take a round trip in 2019 as a result, climbing towards earlier peaks in the first half, and then rallying in the back half (Table 2).

The US equity market climbed a mountain early in 2018 only to descend just as quickly. Part of that reflected an inevitable correction for a market that had ventured into thin air in terms of multiples, but it also captured some sober second thoughts about 2019 earnings prospects. Canadian equities have also sharply adjusted to take into account the impacts of softer energy prices and slower household credit demand on sectors like energy and financial services.

That leaves room for at least some upside in the next couple of quarters. But we share the view of our equity strategist that the economic backdrop for corporate results will temper returns in the year as a whole. As 2020 earnings expectations come into focus later this year, we may be in for a repeat of the rethinking we saw heading into this year. The S&P 500 consensus calls for EPS growth of roughly 10%.

Even with some help from a weakening greenback to boost overseas earnings, that's a tall order if, as we expect, US economic growth further decelerates next year. It would essentially match the EPS gains achieved in brighter times in 2017 and, excluding tax reform impacts, in 2018 (Chart 3). As markets look ahead to a darker shade of grey for the economy in 2020, high grade bonds and cash could look good again in the back half of the year.

US Economy: Slowing Slowly

Benjamin Tal and Katherine Judge

Let's start with the easy part. 2019 will be slower than 2018. An abnormal year lifted by (an unnecessary) fiscal stimulus will give way to an economy that is more in line with its real potential. Despite the signal from the yield curve, a recession is not our base case scenario. We expect growth to decelerate gradually in 2019 with the first half of the year actually showing relatively solid gains. The lapse in government funding appears to be a minimal risk to the Q1 outlook given that it is only impacting roughly one-third of federal government employees which account for less than 1% of national employment. With the labour market overshooting and wages finally on the rise, the key question is whether the Fed should stick to its semi-dovish mode and avoid monetary policy errors that in the past triggered recessions? Our answer is yes.

Chairman Powell was right in describing 2018 as an extraordinary year. By almost any measure the economy is solid. And the labour market is where that strength is most visible. Be it job gains, the unemployment rate, hours worked, quit rate, job openings or any other measure you can think of, the job market is at an historically strong level.

The Good News

But this publication is called "forecast", so let's talk about the future. Although it's been carrying the economy for years, the consumer is poised to continue to spend in 2019. Recent gains in retail sales are almost entirely explained by income growth, and that's a reflection of

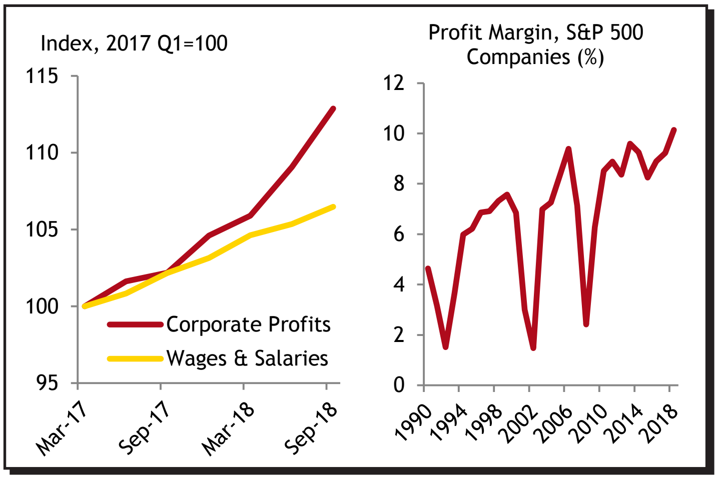
Table 1

US FORECAST DETAIL

(real % change, s.a.a.r., unless otherwise noted)

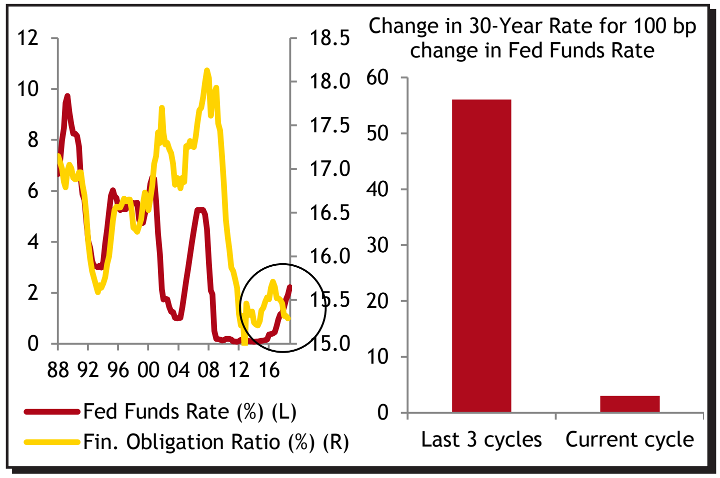
	18:3A	18:4F	19:1F	19:2F	19:3F	19:4F	20:1F	2018F	2019F	2020F
GDP At Market Prices ($Bn)	20,658	20,855	21,024	21,247	21,422	21,614	21,832	20,491	21,327	22,126
% change	4.9	3.9	3.3	4.3	3.3	3.6	4.1	5.2	4.1	3.7
Real GDP ($2009 Bn)	18,665	18,770	18,856	18,958	19,005	19,062	19,146	18,568	18,970	19,246
% change	3.4	2.3	1.9	2.2	1.0	1.2	1.8	2.9	2.2	1.5
Final Sales	1.0	2.2	2.6	2.0	1.9	1.5	1.3	2.8	2.2	1.5
Personal Consumption	3.5	3.4	2.7	2.0	1.8	1.7	1.7	2.7	2.7	1.7
Total Govt. Expenditures	2.6	2.2	0.6	0.8	0.9	0.6	-2.0	1.6	1.3	-0.6
Residential Investment	-3.5	2.8	1.9	1.2	0.8	0.7	-1.0	0.2	0.8	-0.1
Business Fixed Investment	2.5	3.0	2.0	2.6	2.6	2.4	3.7	6.8	2.9	3.2
Inventory Change ($2009 Bn)	89.8	93.1	61.1	68.1	24.1	10.6	33.1	44.1	41.0	32.6
Exports	-4.9	3.1	3.7	3.3	3.0	2.3	2.1	4.0	2.6	2.2
Imports	9.3	8.1	1.5	2.1	1.6	2.8	1.7	4.9	3.7	2.0
GDP Deflator	1.8	1.6	1.4	2.1	2.3	2.4	2.3	2.2	1.9	2.3
CPI (yr/yr % chg)	2.6	2.2	1.6	1.6	1.9	2.3	2.7	2.4	1.8	2.3
Core CPI (yr/yr % chg)	2.2	2.2	2.0	2.3	2.4	2.5	2.5	2.1	2.3	2.2
Unemployment Rate (%)	3.8	3.8	3.6	3.6	3.7	3.8	3.8	3.9	3.7	4.3
Housing Starts (AR, K)	1,234	1,245	1,248	1,244	1,235	1,220	1,206	1,264	1,237	1,190

Chart 1
Subdued Compensation Growth (L) Has Helped Bolster Profit Margins (R)



Source: BEA, Bloomberg, CIBC

Chart 3
Household's Finance Obligations Still Down Due to Unresponsive Bond Markets



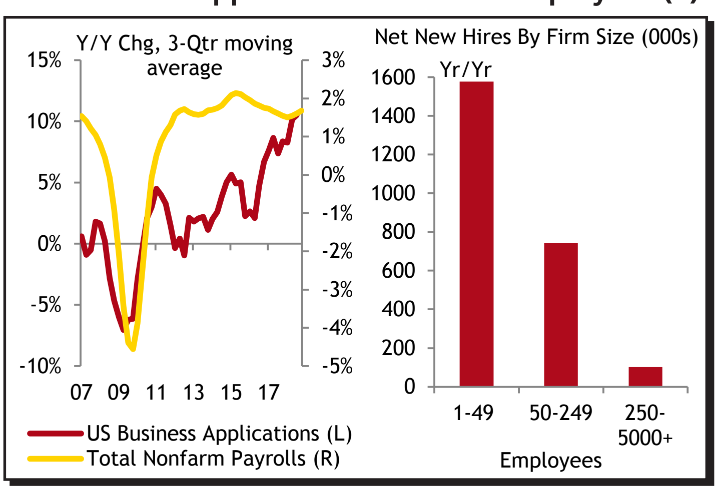
Source: FRB, CIBC

solid job gains and wage increases in an environment of a high savings rate. We have little reason to believe that that trajectory will soften dramatically in the coming quarters. Wage gains are broadly-based, implying sustainability, and elevated business profit margins (Chart 1) suggest that there is some room for wage increases even without the need to transfer rising costs to consumers. While the labour market is tight, it might get even tighter in the coming year. The number of new business applications is rising at a pace never seen before, suggesting that hiring by small businesses will maintain its recent strong momentum (Chart 2).

Also helping here is the fact that so far, higher interest rates are hardly hurting consumers. In fact, despite 225bps of Fed hikes since late-2015, households' financial obligation ratio has been trending downward—reflecting the unresponsive bond market. The 30-year bond yield (most US mortgages are for 30 years) showed little regard to Fed tightening in absolute terms and relative to previous cycles (Chart 3). So consumers entered 2019 in excellent shape. Looking ahead, elevated tax refunds will boost disposable income early in the year.

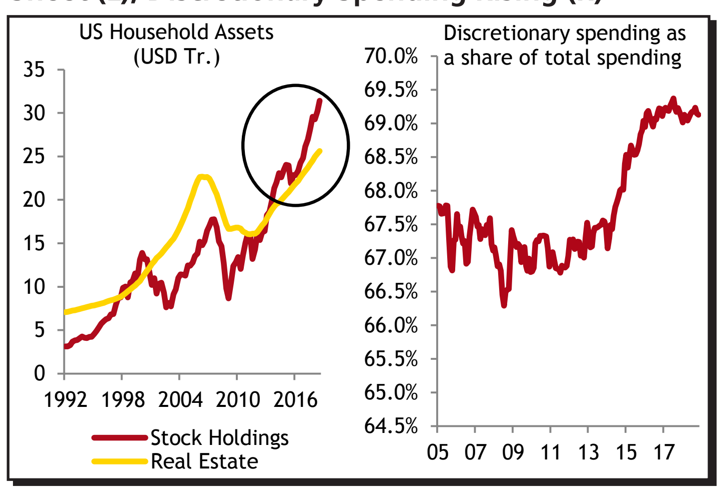
Where we see some fragility is in the elevated share of equities in total household asset position (Chart 4, left) which will work to raise the sensitivity of household spending to stock market fluctuations (equity positions in retail equity funds flows have recently turned sharply negative). Furthermore, as illustrated in Chart 4 right, the share of interest-sensitive discretionary spending has risen recently—suggesting increased sensitivity of spending to

Chart 2
Rising New Business Applications (L), Might Continue To Support Small Business Employees (R)



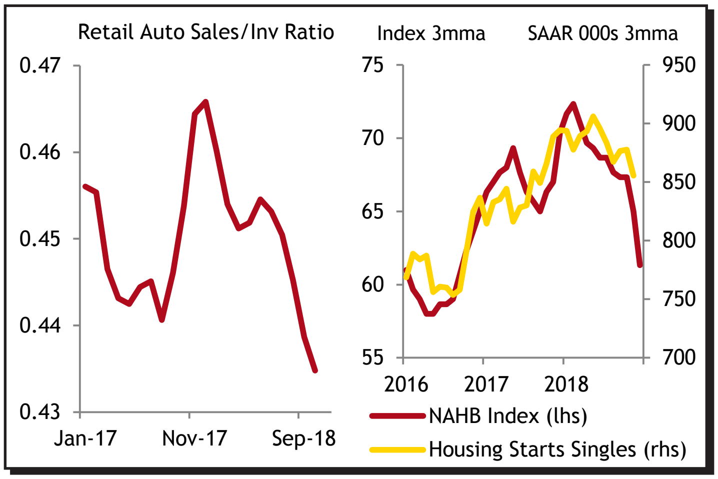
Source: US Census, BLS, CIBC

Chart 4
Elevated Equity Position in Household Balance Sheet (L), Discretionary Spending Rising (R)



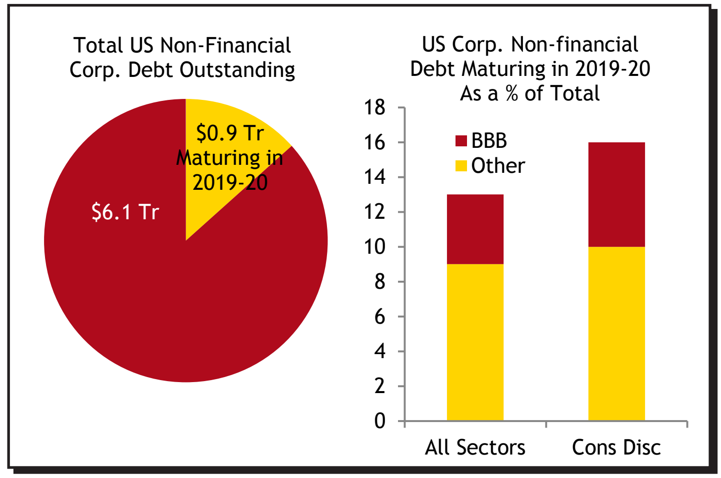
Source: BEA, Federal Reserve, CIBC

Chart 5
Auto and Housing Slowing



Source: NAHB, Census Bureau, CIBC

Chart 6
Limited Near-Term Refinance Risks For Corporate America



Source: Bloomberg, CIBC

higher rates. Overall, we expect consumer spending to match its 2018 performance of 2.7%, with the first half notably stronger.

The Bad News

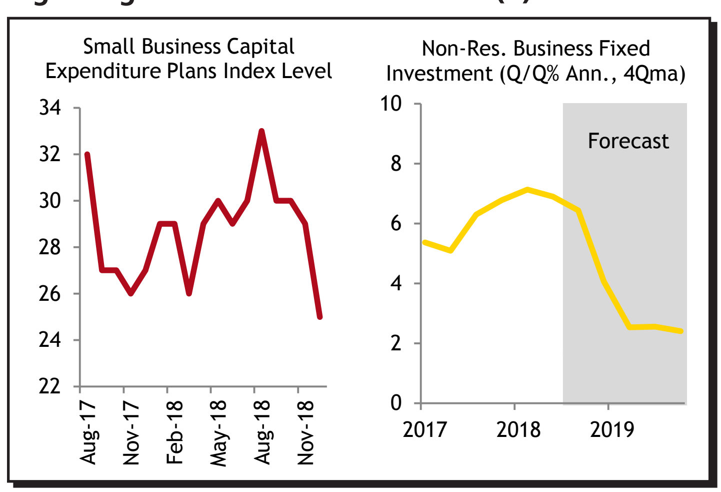
By the latter half of 2019, and into 2020, the deterioration in the auto and housing markets will translate through more meaningfully to spending. Unit sales of vehicles were flat through 2018 and nominal sales have shown a deceleration. Despite those signals of softer demand, auto production remains higher than it was when demand for vehicles peaked in late 2016. Retail inventories of autos relative to sales have risen (Chart 5, left) , suggesting that there could be a negative impact on production in the near future.

Housing market activity has been notably soft for a while now but homebuilder confidence, as measured by the NAHB index has fallen sharply recently after only inching down over most of 2018 (Chart 5, right). That index's strong correlation with single-family homebuilding indicates that further retrenchment in activity here too is likely.

Where we see weakness in 2019 is in capex. And it's not really because of higher interest rates. With less than 3% of US corporate debt outstanding linked to floating rates and only 13% of non-financial US corporate debt facing refinancing risk in the coming two years (Chart 6) the negative impact of higher rates in that space is likely to be minimal. However, early signs of fragility in global business conditions have started to erode business confidence stateside. Although a still-solid domestic economy has allowed small business optimism to remain relatively healthy, business investment intentions have fallen (Chart 7). Moreover, core capital goods orders have floundered along with a fall in capital goods imports, suggesting that the biggest boost from tax cuts on business spending is now behind us. Additionally, the fall in the price of oil will limit investment in the mining sector.

The retrenchment in global growth indicators also suggest that American businesses won't be getting much support from global demand. Exports have fallen as the impacts of front-running tariffs have evaporated, and any easing in US-China trade tensions will come at a time when growth is cooling, minimizing that positive impact. The US can't be an island unto itself in a decelerating global economy.

Chart 7
Business Investment Intentions (L), Signaling a Slowdown is Imminent (R)



Source: BEA, NFIB, Bloomberg, CIBC

Canada: The (Oil) Pit and the Pendulum

Royce Mendes

Much like the pendulum of an old clock, markets have a tendency to swing in one direction, only to swing back not long after. For Canada, it was the late-2018 meltdown in oil prices that proved most concerning heading into the new year. But, we're already seeing signs that the extreme pessimism that plagued markets during the holiday season is fading. So long as oil prices swing at least some of the way back, and the Bank of Canada stays patient, the economy should be able to post a respectable growth rate in 2019, with a couple of quarters running above potential.

This Time Will Be Different

Incoming data will, however, be weighed down by production cuts in the oil patch. An historically steep discount for Canadian crude prompted some producers north of the border to dial down production at the end of 2018, with the Alberta government mandating further reductions beginning January 1st.

While the drag on GDP from those cuts will start showing up in Q4 data, the worst will be left for the opening quarter of 2019 (Chart 1, left). That slower pace to growth will likely send Canada's output gap to its widest level since 2016 (Chart 1, right). The good news is that the shortfall should prove only temporary.

The production cuts have been far more successful in narrowing the spread between Canadian heavy crude and US West Texas Intermediate prices than was expected. The efficacy of the cuts means that they're likely to begin reversing by the second quarter.

Table 1

CANADA FORECAST DETAIL

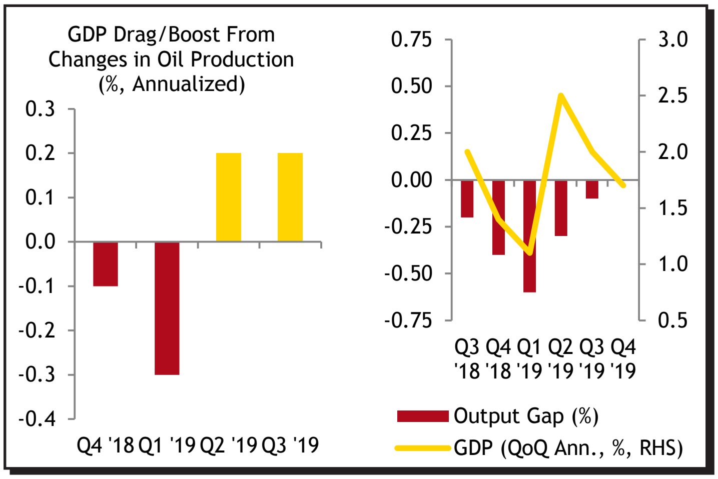
(real % change, s.a.a.r., unless otherwise noted)

	18:3A	18:4F	19:1F	19:2F	19:3F	19:4F	20:1F	2018F	2019F	2020F
GDP At Market Prices ($Bn)	2,242	2,251	2,263	2,288	2,312	2,334	2,357	2,225	2,299	2,390
% change	5.0	1.6	2.1	4.5	4.2	3.9	3.9	4.1	3.4	3.9
Real GDP ($2007 Bn)	2,059	2,066	2,072	2,085	2,095	2,104	2,110	2,052	2,089	2,121
% change	2.0	1.4	1.1	2.5	2.0	1.7	1.3	2.1	1.8	1.5
Final Domestic Demand	-0.1	2.0	1.3	1.9	1.9	1.5	1.5	2.5	1.5	1.6
Household Consumption	1.2	2.1	1.8	2.0	2.1	1.6	1.4	2.3	1.9	1.6
Total Govt. Expenditures	1.9	1.6	1.7	1.8	1.4	1.4	1.7	3.0	1.6	1.6
Residential Construction	-5.9	2.3	-2.8	0.4	-0.7	-1.2	-0.8	-0.9	-1.1	-0.8
Business Fixed Investment*	-6.8	2.8	0.6	2.7	3.7	3.5	2.8	4.8	1.0	3.1
Inventory Change ($2007 Bn)	6.6	5.2	3.8	5.3	4.0	3.6	3.4	10.5	4.2	3.4
Exports	0.9	1.7	3.0	3.4	3.0	2.9	2.5	3.2	3.2	2.4
Imports	-7.8	2.8	2.9	2.5	2.1	2.1	2.9	3.3	1.4	2.4
GDP Deflator	3.0	0.2	1.0	2.0	2.2	2.2	2.6	2.0	1.5	2.4
CPI (yr/yr % chg)	2.7	1.9	1.6	1.7	1.9	2.6	2.7	2.2	1.9	2.3
Unemployment Rate (%)	5.9	5.7	5.6	5.6	5.6	5.7	5.8	5.8	5.6	6.0
Employment Change (K)	60	102	66	54	49	50	35	236	257	162
Goods Trade Balance (AR, $bn)	-6.9	-21.1	-32.0	-26.7	-19.8	-18.0	-19.0	-21.4	-24.1	-22.4
Housing Starts (AR, K)	197	217	196	189	188	180	181	214	188	176

* M&E plus Non-Res Structures and Intellectual Property and NPISH

Chart 1

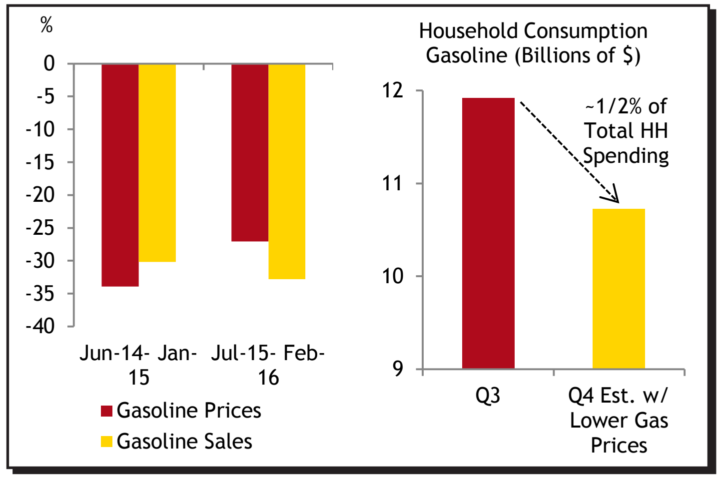
Drag from Oil Cuts to Show Up Most in Q1 Data (L); Recently Opened Output Gap to Close by Q4 (R)



Source: Statistics Canada, Bank of Canada, CIBC

Chart 3

Gas Sales Have Tracked Prices Lower In Past (L) Q4 Drop Could Boost Spending Power in 2019 (R)



Source: Haver Analytics, CIBC

Moreover, unlike the US, Canadian oil production doesn't have much of a correlation with short-term movements in crude prices (Chart 2, left & right). So, even if global benchmarks average $10 cheaper than last year, as long as the spread doesn't blow out again, Canadian production should hold at those higher levels after the second quarter.

It's usually oil and gas capital spending that provide the greatest swing for the Canadian economy as crude prices rise and fall. But, this time will be different than what happened in 2015. Oil and gas spending represented roughly one-third of all capital outlays four years ago, but the share has since fallen to only one-tenth of total business fixed-investment today.

Furthermore, what remains is mostly money being doled out for maintenance and repairs, something that oil producers aren't going to cut back on just yet. So, while the 2015 fall in capital spending sliced almost 1 ½%-pts from GDP, CIBC estimates that the drag will be less than a fifth of that this time around.

Regions and sectors across Canada will be affected very differently by the fall in oil prices. Oil producing provinces will, of course, feel the pain, and the net effect for the Canada-wide economy will be negative. But, for provinces like BC, Ontario and Quebec, declining gasoline prices could prove to be somewhat supportive.

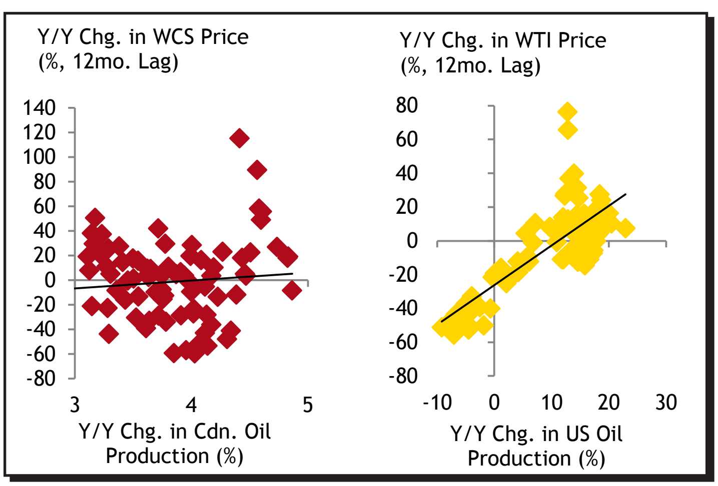
In the past, Canadians have adjusted their spending at the pump almost dollar-for-dollar when gas prices have fallen (Chart 3, left). If households follow that same tack this time around, we estimate that the savings from gasoline prices in Q4 could add as much as half-a-percentage point annualized to spending power elsewhere in the economy in Q1 (Chart 3, right).

Looking Beyond Oil Prices

It's true, however, that even outside of developments in oil markets, growth is likely to decelerate. Pockets of weakness such as the housing sector or the pinch from higher interest rates on consumer spending will be important themes this year, keeping the Bank of Canada from hiking to the 3% neutral rate that it continues to

Chart 2

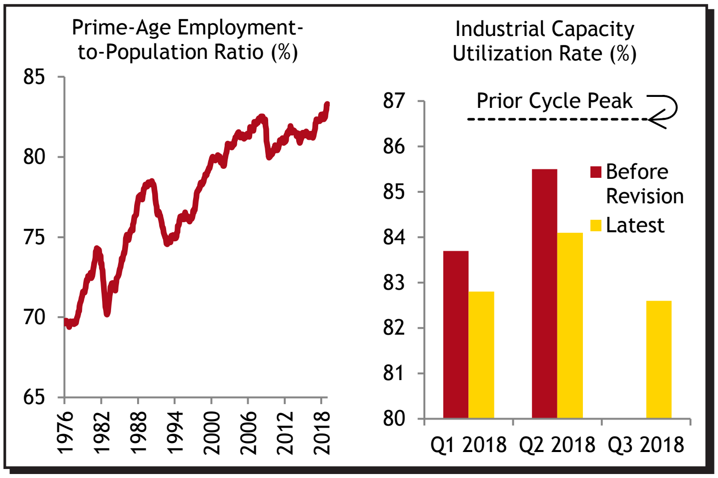
Production in Canada Isn't Usually As Sensitive to Oil Price Movements (L) Relative to the US (R)



Source: Bloomberg, Haver Analytics, CIBC

Chart 4

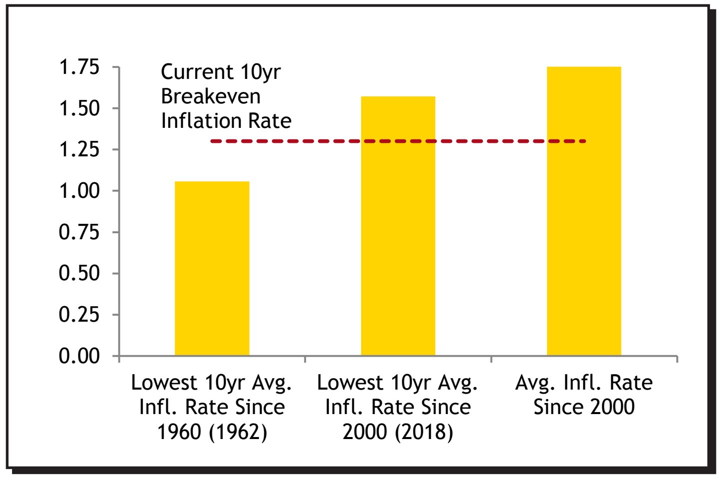
A Little More Room for Non-Inflationary Growth From Production But Less Need For CAPEX



Source: Haver Analytics, CIBC

Chart 5

Current Market-Based Inflation Indicators Underestimating the Persistence of Inflation



Source: Haver Analytics, Bloomberg, CIBC

publish. Nevertheless, growth is not likely to come to a crashing halt, and markets might now be overpricing the odds that the Bank is done for the cycle.

In historical terms, the labour market looks tight. Unlike the US, where the unemployment rate is low, but the prime-age employment-to-population ratio suggests there is still some slack, the jobless rate in Canada has sunk to an all-time low, while prime-age employment has similarly eclipsed its former record (Chart 4, left). The strong employment gains of the past year will blunt some of the pain on the macro-economy from higher interest rates, and should see consumers still being a major contributor to GDP growth in 2019, albeit at a reduced pace relative to last year.

But some room has opened up in terms of industrial capacity utilization as a result of revisions since our last forecast (Chart 4, right). The lower capacity utilization rates are more likely to show up in reduced capital spending plans rather than any material downward drag on inflation, which isn't well correlated with domestic capacity use levels. In addition, labour markets are likely to stay tight enough to prevent a deceleration in core inflation.

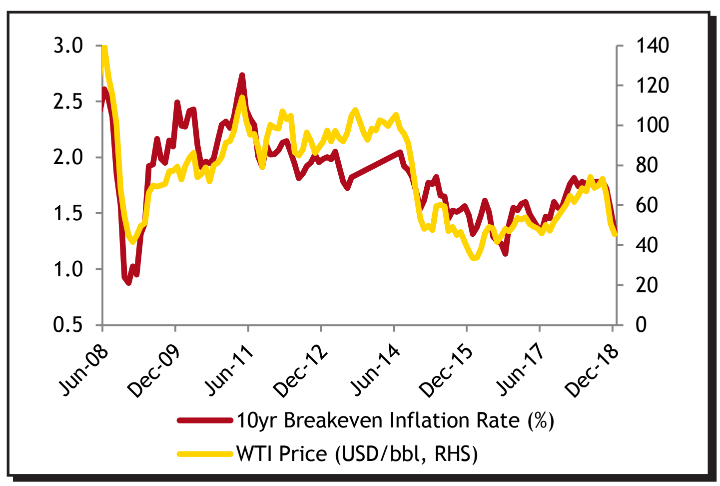
Some Undue Pessimism Remains

Markets are betting, via real-return bonds, that over the next ten years inflation will average lower than during any other ten-year period since 1952-62 (Chart 5). While they are supposed to be a hedge against inflation over longer-periods of time, breakeven rates almost always track short-term movements in oil prices (Chart 6), opening up the potential for mispricing. The large swing in oil prices has done just that this time around, with the expected inflation rate appearing too low for a 10-year average.

For most of last year, we were more bearish than the consensus and markets on the Canadian economy. But, even though we've shaved off one rate hike and more or less stuck with the same economic forecasts, we're now looking somewhat optimistic for this year. But keeping the economy in gear in 2020 could be more of a challenge for a trade-oriented economy like Canada as the pendulum for global growth swings the wrong way.

Chart 6

Long-Term Market-Based Inflation Measures Highly Correlated With Near-Term Movements in Oil Prices



Source: Bloomberg, CIBC

Global Economy: Fear vs Reality

Andrew Grantham

We were anticipating global growth to slow, and what we've seen out of Europe and China has been little worse than we previously forecast. As a result, you won't spot many differences between Table 1 of this article and what we published back in September. However, while these forecasts are still a little below the consensus for this year, such an outturn may actually be better than what financial markets appear to be fearing.

Things Could, and Have, Been Worse

So just how bad has global growth really been? Not that bad at all, at least in comparison to pre-2017 levels. Yes, trade volumes and industrial production growth have decelerated notably from the peaks seen in 2017. But increases, both on an annual and quarterly basis, have been broadly in line with the average pace seen since 2012, and in most cases well above the lows seen in that same time period (Chart 1).

Of course there are downside risks to the global economy gaining much concern in financial markets, most immediately US-China trade tensions and Brexit. However, even though these downside risks have certainly grown since 2017, the probability that the consensus places on, for example, a US recession or China hard landing is no higher than previous peaks (Chart 2).

The 20% consensus odds of a US recession this year, for example, is the same as was placed in 2012 around the time of the US fiscal cliff uncertainty. And one really big risk to the global economy over the past decade, a possible Eurozone breakup, still appears much less likely than when Draghi pledged to do "whatever it takes" to save the euro.

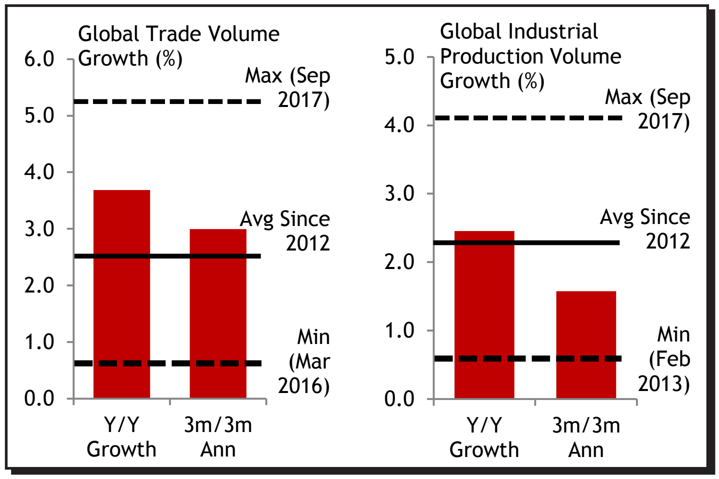
Table 1

	2015A	2016A	2017A	2018F	2019F	2020F
World*	3.5	3.3	3.7	3.4	3.1	2.9
US	2.9	1.6	2.2	2.9	2.2	1.5
Canada	0.7	1.1	3.0	2.1	1.8	1.5
Euroland	2.0	1.9	2.5	1.8	1.3	1.3
UK	2.3	1.8	1.8	1.4	1.2	1.3
Japan	1.3	0.6	1.9	0.7	0.8	0.8
China	6.9	6.7	6.9	6.5	6.2	6.0

** at Purchasing Power Parity*
Source: National statistical agencies, IMF, CIBC

Chart 1

Global Growth Still Close to Average, Above Lows, Since 2012



Source: CPB, CIBC

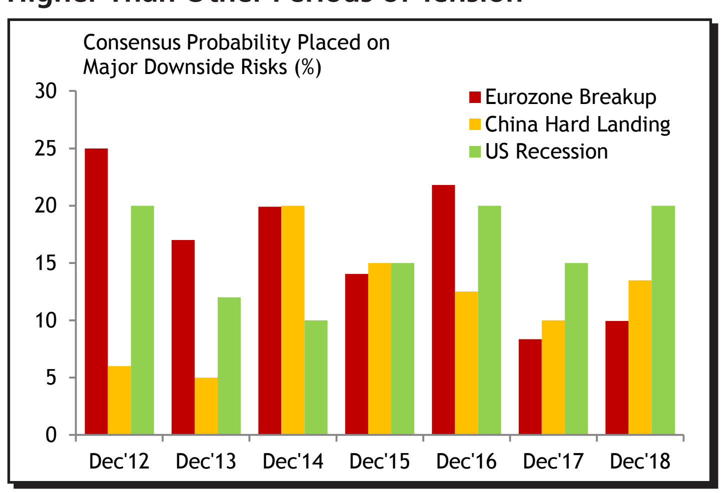
Eurozone: How Much Slower Could it Go?

While fears of a euro breakup remain low, concern regarding how much growth in the region has slowed is high. That doesn't just have implications for global growth, but has had implications socially within the region given the rise of populism in Italy and recent rioting in France.

However, there are reasons to believe that growth could now stabilize at this slower pace, rather than decelerate much further. Figures for Q4 2018 may continue to disappoint, particularly in France where recent protests are

Chart 2

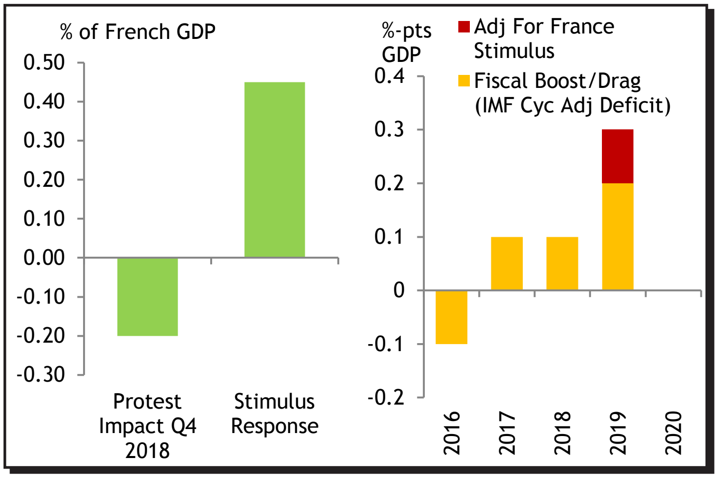
Probabilities Placed on Major Downside Risks No Higher Than Other Periods of Tension



Source: Bloomberg, CIBC

Chart 3

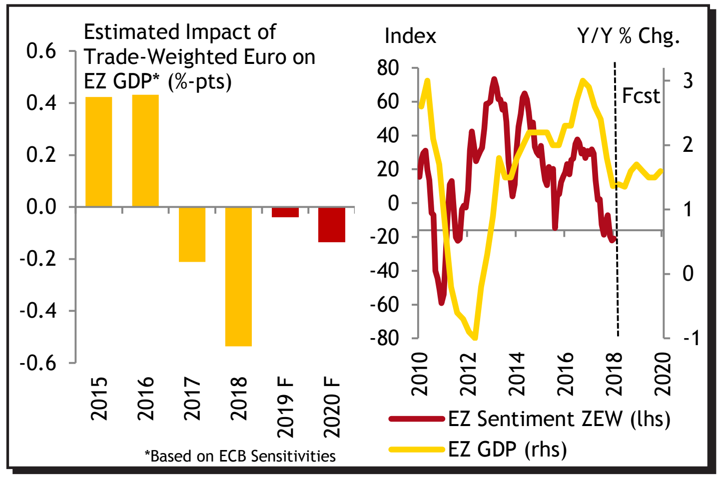
France Policy Response to Protests Strong (L), Adding to Small Eurozone Fiscal Boost (R)



Source: Banque de France, IMF, CIBC

Chart 4

Drag From Past Euro Appreciation Fading (L), Investor Expectations Low Relative to GDP Growth (R)



Source: ECB, ZEW, CIBC

estimated by the central bank to have reduced growth by 0.2%-pts (not annualized). But the policy response to try and calm protesters has been strong (Chart 3, left), adding to what was already shaping up to be a small fiscal boost in 2019 for the region as a whole.

The big difference between 2018 and 2019 though will come from the fading of the negative impacts of past euro appreciation. While the ECB's quantitative easing programme has only just finished, financial markets started pricing in that actuality as early as 2017, sending the trade-weighted euro steeply higher in the process. Given the open nature of the euro area and the large share of exports in GDP, that was always going to be a sizeable drag on 2018 growth and was the primary reason we were forecasting a slowdown a year ago.

However, the slight depreciation in the trade weighted euro last year means that the drag from 2017's appreciation will be much lower this year. Using the ECB's own exchange rate sensitivities and lags, prior movements in the trade weighted euro likely shaved 0.5% from growth last year. That accounts for the majority of the 0.7%-pts slowdown versus 2017. While the lagged impact of the large appreciation two years ago will still outweigh 2018's modest depreciation, the overall drag will be much lower both this year and next (Chart 4, left).

A stabilization of growth around current levels, while still resulting in only a 1.3% expansion for 2019 and 2020 as a whole, would, it seems, be better than financial markets are expecting currently. The ZEW investor sentiment indicator suggests expectations are the lowest since 2011, a time when the euro area was falling back into recession (Chart 4, right).

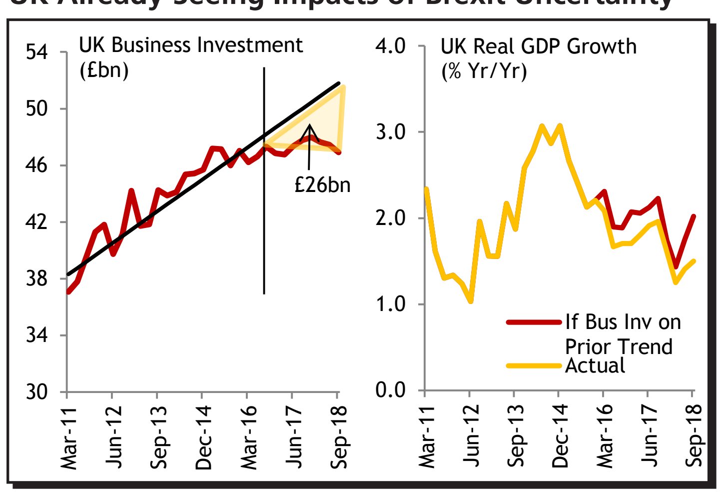
Of course, uncertainty regarding growth in another European country remains very high, with details of exactly how (and if) the UK will leave the EU in late March still unclear. That uncertainty has already resulted in underinvestment by UK businesses relative to pre-referendum trends (Chart 5, left) which is impacting overall GDP growth (Chart 5, right). However, even if the UK does exit the EU without a deal, and suffers a decline in GDP akin to the very pessimistic assumptions of the BoE, the impact on global growth would be a mere 0.1%-pts given the size of Britain's economy on a global scale, but would of course cause at least short term problems for large multinational companies.

China: Still Some Room to Stimulate

Unlike the UK, a downturn in China would most definitely show up in global growth figures. And there

Chart 5

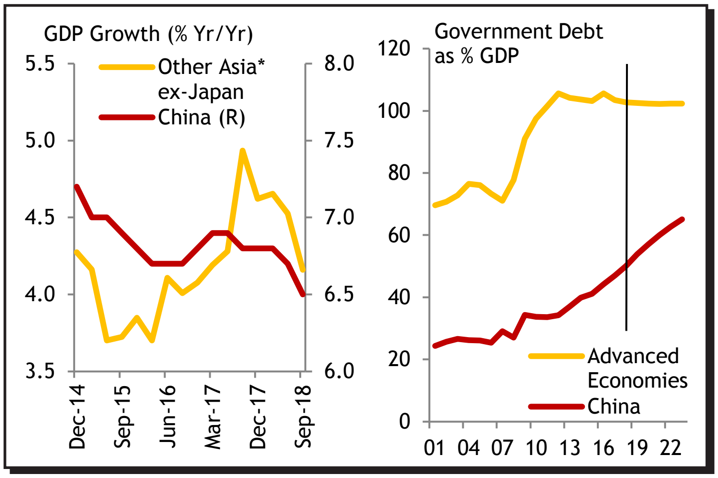
UK Already Seeing Impacts of Brexit Uncertainty



Source: ONS, CIBC

Chart 6

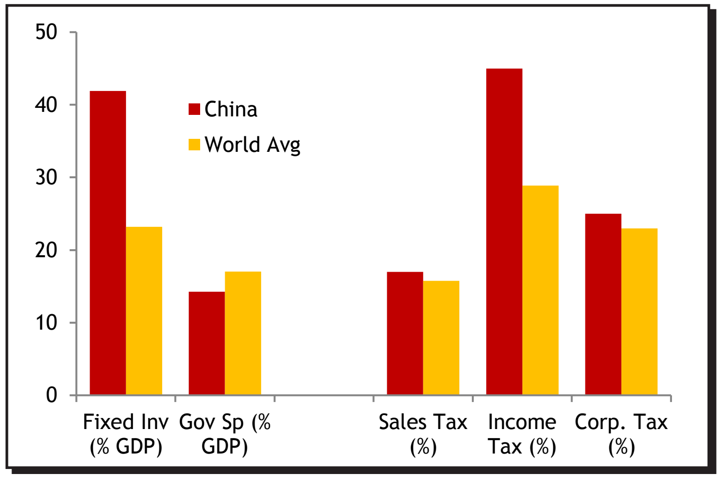
Rest of Asia Hints at Sharper China Slowdown (L), Government Debt Rising But Still Fairly Low (R)



Source: Bloomberg, IMF, CIBC
*S. Korea, Taiwan, Malaysia, Thailand, Vietnam, Singapore, Indonesia, Philippines

Chart 7

Still Some Room to Raise Spending Outside Infrastructure, and Lower Taxes



Source: World Bank, Tax Foundation, Bloomberg, CIBC

are already concerns that given the impact of US tariffs and government efforts to stem the growth in credit, the economy there could be slowing more than official numbers suggest. That's certainly plausible judging by the sharp slowing in growth among neighbouring Asian countries (Chart 6, left), which we have previously argued probably paints a more accurate picture of what's actually happening within the Middle Kingdom.

Already high government deficits and infrastructure investment also raise concern that Chinese policymakers are running short of levers to pull in case growth does actually slow more than they would like. However, there is still a little room there. Despite rising, government debt levels in China remain much lower than the average developed country (Chart 6, right). And there's a little room for government spending to rise, or taxes cut, when compared with the global average (Chart 7).

So while, much like in the Eurozone, growth numbers could continue to disappoint slightly in the coming quarter, around mid-year we would expect to see signs of stabilization albeit at a slower pace than seen in 2017.

Fearing Fear Itself

While we are far from bullish on the global economy, it certainly feels that financial markets recently have feared something worse than the current and expected future reality. As such, even a stabilization of growth at lower levels in Europe and China should be a positive for cyclical equities and commodities in early 2019.

However, with Chinese growth likely to be stimulated more by lowering taxation and spurring domestic consumption, rather than debt-fueled infrastructure projects, the positives for commodity markets will be lower than in the past decade. And with the US economy potentially slowing more dramatically in 2020 as fiscal policy turns from boost to drag, any rally could fade as investors eye next year's outlook.

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