

# Review & Strategy

CIBC Private Investment Counsel

## Emerging nations poised to lead recovery

Probable scenario: Modest recovery likely by 2010, with China leading the way\*

The contraction in the global economy appears to be showing signs of easing, as government actions undertaken over the past year begin to take effect. We believe a sluggish recovery is the most likely scenario for the second half of 2009.

In the developed countries, central banks are likely to keep short-term interest rates low, even beyond the next twelve months.\*

Long-term interest rates will likely be caught in a tug of war between lingering deflationary forces and a slow growth recovery.

We expect that the massive stimulus implemented by several governments over the past year and a half, combined with low interest rates, can provide the support that is needed to improve global economic activity.

### Canadian equities could outperform

Canada is turning into a two-speed economy, characterized by a vibrant service sector and an ailing manufacturing sector.

Proportionally, the contraction in Canadian employment pales in comparison with U.S. job losses. The service economy in the U.S. has seen a contraction in jobs, while service industry employment continues to expand in Canada.

Unfortunately, the picture is bleaker for the Canadian manufacturing sector. In recent years, Canadian unit labour costs have increased significantly. Coupled with strong appreciation of the Canadian dollar against the U.S. dollar, the effect makes Canadian labour appear expensive.

The recent strength of the Canadian dollar increases the challenges facing the Canadian manufacturing sector. The stronger the currency gets, the deeper the Canadian manufacturing recession could become.

Still, while overall corporate earnings are below their historical average in many countries, earnings for many Canadian companies are running above trend.

Given the relatively attractive valuation of many Canadian shares, Canada's equity market is likely to outperform most other developed world markets — but underperform emerging equity markets.

### Struggling consumer weighs on U.S.

U.S. economic recovery hinges on consumer spending, which accounts for 72% of gross domestic product (GDP). But job losses are high, particularly in the service sector, which accounts for nearly 90% of the U.S. labour market. As a result, consumer spending remains weak.

Still, there are reasons for optimism:

- Productivity is up. Economic growth typically starts to pick up once productivity gains become significant and sales start to improve. At the end of the second quarter, productivity was growing by nearly 4% in the U.S. service industries — a record high.
- Credit is easing. There is typically a close link between credit conditions and growth in consumer spending. Recent easing in credit conditions may have a positive impact on domestic demand.

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— CIBC Global  
Asset Management

*Continued on back*

## Emerging nations poised to lead recovery

Continued

- Fears of a global recession no longer seem to be priced into the equity markets. Historically, equity prices usually start to improve a year before earnings; corporate earnings could hit their cyclical bottom sometime in 2010 and accelerate upwards thereafter.

At the end of the first half of the year, the broad U.S. market traded at just below 15 times earnings, close to its long-term average. Adjusting for the trend in earnings, it is likely that the majority of the equity market undervaluation has been corrected, and that U.S. equity valuations remain reasonable.

### European prospects not bright

The Bank of England (BoE) has responded forcefully to the financial crisis with monetary and quantitative easing. As a result, financial conditions in the U.K. have eased remarkably, raising hopes that the pace of contraction might be slowing.

The European Central Bank (ECB) has not been as aggressive as the BoE in

its monetary easing campaign so far and appears to maintain its muted response. This is likely to strengthen the euro. However, a bigger risk for the eurozone and its currency remains the poor state of the Central and Eastern European and Baltic countries. The eurozone is highly exposed to these countries through trade and through the banking sector. Those regions are likely to continue weighing on any prospects for a quick eurozone recovery.

By keeping the euro overvalued for another quarter, the ECB could just be delaying the inevitable. The corresponding damage to the balance of trade is likely to be reflected in a much weaker euro later in the year and into 2010.

### Signs of Japanese recovery

Since the Bank of Japan's key interest rate has reached zero, monetary authorities must rely on quantitative easing (essentially printing money) and currency market interventions to attempt to ease financial conditions.

There appears to be some light at the end of the tunnel. Business confidence has risen for the first time in three years and the industrial output has risen roughly 14% from February levels.

### China stimulating domestic growth

China, India, and Indonesia — the largest manufacturing countries in emerging Asia — have managed to avoid the steep decline in industrial production that has plagued the developed nations. Indeed, with leading indicators providing very encouraging recovery signals, China has become the world's primary growth engine and is expected to lead the rest of the world out of the recession.

With the sharp drop in foreign demand and the strong appreciation of the Chinese currency, growth will have to come from the domestic economy. Monetary authorities have been trying to stimulate domestic demand by both spending and increasing money supply. In the process, they have increased the budgetary deficit to 3.8% of GDP from 0.3%.

With economic growth in the emerging markets appearing stronger than in developed markets, emerging markets rallies will likely be stronger as well.

### Risks to the main scenario

The anticipated course of events described above might be altered should either of the following circumstances occur.

**Economic expansion.** If the economic expansion is more robust than expected, markets could quickly normalize, leading to a multi-year global equity bull market and underperformance from government bonds.

**Failed recovery.** A short-lived global recovery, with deflation a real threat, could lead to a resumption of a bear market in equities and a bullish scenario for government bonds.

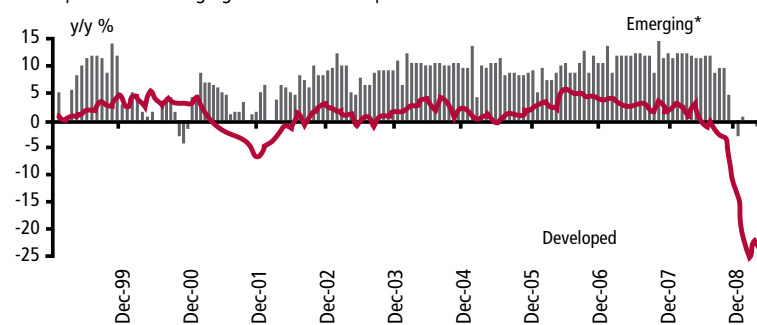
\* *Twelve-month forecast to June 30, 2010. This article and the information within, in part using information from Datastream, were prepared by the Asset Allocation team at CIBC Global Asset Management Inc., a member of the CIBC Group of Companies.* ■

### Asian economies weather the storm

While production in the developed world has declined substantially, production in major Asian countries has held steady and even expanded in some periods.

#### Shifting Production to Emerging Asia

Developed versus emerging world: industrial production



Source: Datastream & CIBC Global Asset Management Inc. \* China, India, Indonesia & South Korea

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