2022 LONG-TERM EXPECTED RETURNS FOR CAPITAL MARKETS

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Every year, CIBC Asset Management develops long-term capital markets expectations for a number of asset classes to guide investors with their strategic asset allocations. The Multi-Asset and Currency team prepares the forecast, with inputs from our Fixed Income and Equity teams. Our team includes economists, quantitative analysts, investment strategists and portfolio managers.

Key takeaways for the next 10 years

- **Balanced return:** We forecast a traditional balanced fund (60% equities / 40% bonds with a home bias) to return somewhere close to 4%, or roughly 2.0% in real terms. The lower-than-historical return can be explained by the higher starting point in valuation for some markets, as well as high profit margins with rising cost headwinds.
- **Fixed income returns:** Canadian bonds are more attractive than the prior two years, helped by the rise in yields, while Canadian corporate bonds offer an additional risk premium, giving an expected return of 3.4%. Emerging market bond yields rose substantially in 2021 and are now offering attractive expected returns in local currency terms.
- **Equity returns:** the high starting valuation and historically high profit margins in some developed markets offer headwinds for forward-looking returns. Some of these headwinds may be partially offset by low equilibrium interest rates. Single-digit returns are similar to prior years, with better returns in the Canadian and, particularly, emerging markets, following a disappointing recent decade.
- **Currency impact:** The U.S. Dollar is expensive relative to many world currencies. This will be a headwind to returns from a Canadian investor's perspective. On the other hand, a number of emerging currencies are undervalued and should provide added returns when converted to Canadian dollars.
- **Alternatives:** In order to improve their returns and also diversify their risks, investors should look beyond traditional assets classes. In that regard, alternative asset classes can be part of the solution. Private alternative investments offer prospects between 5% and 6%.
- We derive expected returns using our macroeconomic projection, which sets a path for interest rates and earnings, and provides inputs to estimate long-term equilibrium P/E ratios. Over the long-run, demographics become a larger headwind for earnings growth and interest rates, while productivity growth should only provide a limited offset. Supply-side factors should bring trend inflation closer to target.
- Low interest rates and more normal inflation across major economies should bring more capital flows in emerging markets over time and reduce the need for their central banks to implement aggressive defensive hikes of their policy rates.

Table 1: Long-term expected returns in selected currencies (highest to lowest)

Asset classes	CAD (%)	USD (%)	Vol. in CAD (%)
MSCI Emerging Latam	**9.8**	**10.5**	22.6
MSCI Emerging Europe	**9.7**	**10.5**	19.6
MSCI Emerging	**9.6**	**10.4**	12.3
MSCI Emerging Asia	**9.6**	**10.4**	12.6
JPM Emerging	**8.5**	**9.3**	7.6
Private Infrastructure (North America)	**5.6**	**6.4**	13.6
MSCI Japan	**5.4**	**6.2**	12.0
MSCI EAFE	**5.1**	**5.9**	11.2
Private Core Real Estate (North America)	**5.3**	**6.1**	13.4
Private Debt (North America)	**5.1**	**5.9**	9.7
Canada S&P/TSX	**4.8**	**5.6**	11.6
NAREIT Developed Real Estate	**4.7**	**5.5**	14.8
MSCI Europe	**4.6**	**5.4**	12.5
Brookfield Global Infrastructure	**4.1**	**4.9**	13.6
MSCI All Country World	**4.0**	**4.8**	10.2
CN Corporate	3.4	**4.2**	4.5
BoA Global High Yield	2.8	3.6	6.8
U.S. High Yield	2.7	3.5	7.0
U.S. S&P 500	2.6	3.4	11.0
Canada Universe	2.4	3.2	4.1
U.S. Corporate	2.3	3.0	8.2
BoA Global Corporate	2.1	2.9	7.9
CN 10-y Government	2.1	2.8	5.8
JPM World ex-Canada	1.6	2.3	8.1
CN Money Markets	1.3	2.0	0.8
U.S. 10-y Treasury	1.2	2.0	11.2
Average Local Inflation	1.9	2.1	
Target Local Policy Rate	1.8	2.2	

Alternatives | DM Fixed Income | DM Equity | EM Fixed Income | EM Equity | **Returns >4% in bold**

Source: CIBC Asset Management calculations (projections based on data available as of January 31, 2022).

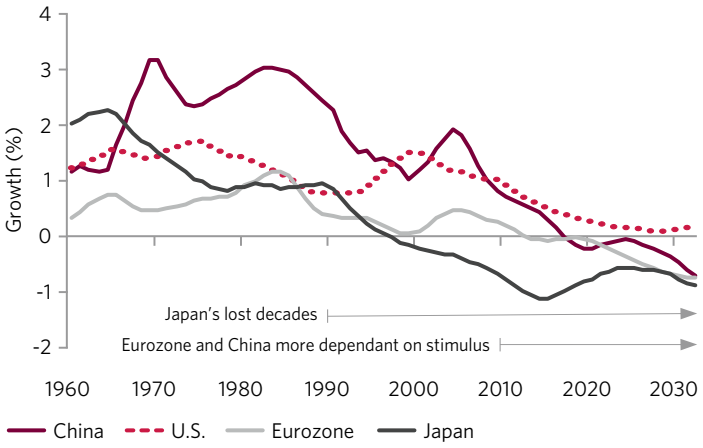
Major macroeconomic forces at play

Demographic forces to push down GDP growth across countries

Increasing demographic headwinds

Demographics matter considerably for economic growth, providing workers and consumers to the economy. In recent decades, the working-age population (WAP) has been growing at a falling pace across major economies **(Figure 1)**.

Figure 1: Working age population: A lingering headwind for major economies



Sources: United Nations Projections, CIBC Asset Management calculations.

Economies that have been facing more adverse demographics have been more dependent on various policy supports. Think of the aggressive quantitative easing (QE) from the Bank of Japan since 2013 and the ECB since 2015, or more than a decade of aggressive rounds of infrastructure stimulus in China.

Demographic headwinds are projected to get bigger. A long list of economies will experience a decline of their WAP, including, China, the eurozone, Japan, Eastern European countries, Russia, and Korea.

In populous low-income countries in Asia (such as India, Indonesia, and the Philippines) and in Latin America, relative demographic prospects are much better, with population growth projected to remain a growth tailwind (although a smaller one). India will supplant China as the world's most populous country before 2027, according to the latest UN forecast.

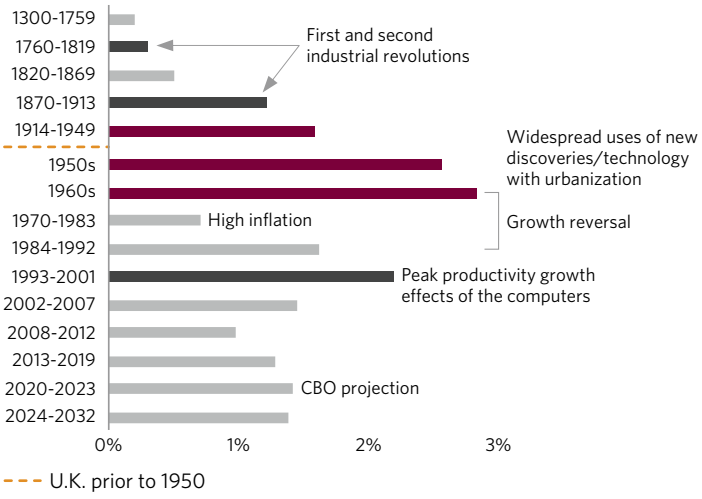
Immigration is projected to keep population growth positive in the Anglosphere. In the U.S., it is projected to remain constant, but eventually to account for nearly 2/3 of population growth by the end of the current decade. Greater participation by senior citizens and possibly also women could provide some offset if the work-from-home paradigm shift provides more work flexibility to attract these cohorts. But fear of illness from recurring pandemics and a less friendly environment for immigration created by populist governments could offset these potential gains.

No offset from higher productivity growth (despite a stratospheric and impressive pace of innovation)

Impressive innovation has failed to boost labour productivity growth since the 2000s **(Figure 2)**. The nature of innovation and its effects on the bargaining power of workers has likely reduced its impact on economic growth.

Figure 2: Stable U.S. labour productivity in recent decades

Potential labour productivity growth, %



Sources: Gordon (2012), Our World in Data, Refinitiv-Datastream, CBO, CIBC Asset Management calculations

As pointed out by Gordon (2012)[ii], nearly a decade ago, the nature of "invention since 2000 has centered on making entertainment and communication devices smaller, smarter, and more capable, but has not fundamentally changed labour productivity or the standard of living to the same extent that electric light, motor cars, or indoor plumbing changed it." Also, IT-driven innovations and robotization have pushed down the cost of capital relative to labour and increased the possible substitution of workers by other inputs (machines, software, other workers). As a result, innovations have generated less macro-economic spillovers and downward pressures on inflation.

Nonetheless, the stabilisation of productivity growth in recent decades is impressive compared to the downward secular experience from the 1960s to the 2000s, suggesting that innovations have prevented further decline of productivity growth.

In line with the CBO outlook, we expect trend U.S. productivity growth to remain broadly constant in the next decade (but a little higher than in the last decade). Historically, productivity growth in the U.S. has been a key driver of global productivity growth (i.e., the common component of productivity prevailing across economies).

We will be monitoring the effects the pandemic may have on growing adoption of digitization, communication tools and other advances into the capital stock that could lead to a transitory acceleration in productivity—potentially similar to what we saw in the 1990s. Some authors, like Ray Dalio, a hedge fund manager, are more optimistic than Gordon, noting that: "...AI [Artificial Intelligence] and robotics in healthcare, health monitoring... advances in and practical use of genome sequencing and gene editing; mRNA in vaccines and breakthroughs in nutrition...there will be many more inventions that we can't yet fathom"[iii]. We feel it is too early to speculate on the degree of adoption and the true potential productivity impact of these new trends.

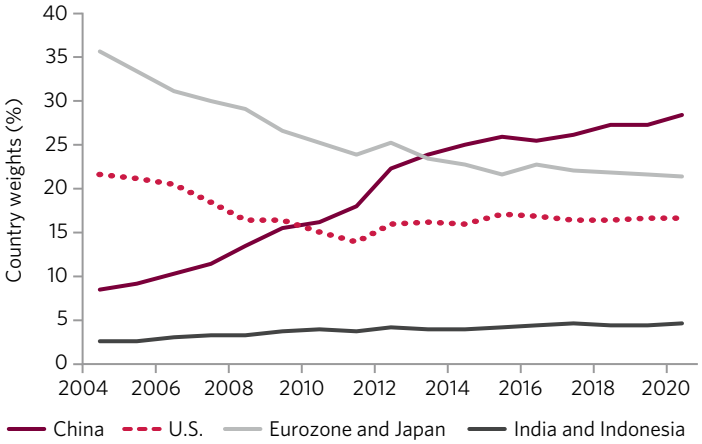
China: from deflationary to inflationary influence

Supply-side forces have pushed down global trend inflation in the last three decades. China's rapid integration into the global economy over the past 25 years, with its large pool of available workers, has been a lingering source of goods disinflation. However, unfavorable demographic change in China should gradually remove that source of global disinflation.

More inflationary Chinese demographics

China's integration into the global economy with its massive pool of workers has been a substantial and lasting positive global supply shock. It has more than offset the negative effects of unfavorable demographics in Japan and the eurozone—two other important manufacturing hubs. Together, their share of global manufacturing production has fallen in half (in value-added terms) since the mid 2000s as China filled the gap **(Figure 3)**. It now accounts for 30% of the global manufacturing production, nearly 4 times more than in 2004.

Figure 3: Global manufacturing weights

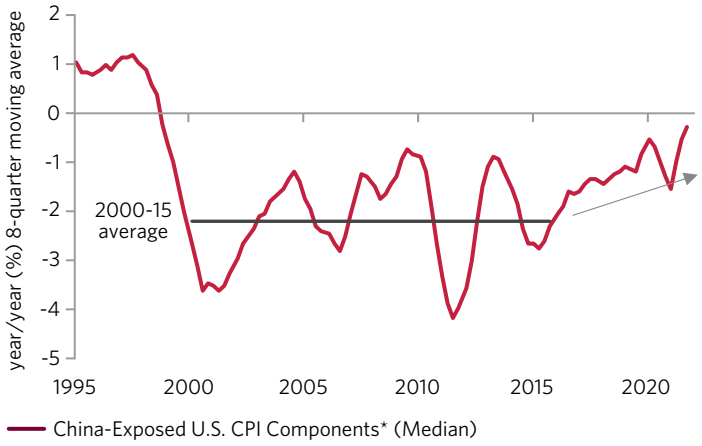


Sources: World Bank, CIBC Asset Management calculations.

When it joined the WTO in 2002, China's working-age population (WAP) was already half larger than that of all advanced countries combined. The surge in global manufacturing capacity has remained in the last decade, with ongoing in China adding nearly 150 million new workers in the 2010s.

The effects of the China shock on inflation has been visible in several segments of U.S. CPI, where the median inflation print of the basket exposed to Chinese products (television, toys, footwear, home furniture, etc.) has been negative since the mid-1990s **(Figure 4)**, when China started becoming a large-scale global manufacturing supplier (Xiaobo, 2018)[iv].

Figure 4: China's receding deflationary influence in U.S. CPI



* Toys, footwear, home furnitures, durable goods ex. motor vehicles
Sources: Refinitiv-Datastream, CIBC Asset Management calculations

Looking ahead, China's working-age population is projected to decline by about 5% in the next 10 years, while its median age is projected to increase from 38 years in 2020 to 45 in 2035. Although technology and innovation should continue to put downward pressures on global goods inflation, the decline and ageing of the working-age population in China should reduce disinflation forces.

While China's demographic challenges represent a boon to populous low-income countries with positive demographic prospects, we don't expect the latter countries will be able to generate the next China shock. India, for example, has a much more disaggregated and fragmented economic and political system, complicating national coordination and limiting competition across states. In China, by contrast, competition between provinces has been a key driver to attract foreign enterprises, even prior to the 2000s (Xiaobo, 2018). Also, India ranks poorly on competitiveness and ease of doing business: it is not in the top 60, and reform momentum has stagnated since 2019. India is not expected to be a substitute to China's manufacturing influence. Indonesia, the fourth-most populous country in the world, offers better prospects but its population is five times smaller than China's.

Overall, the demographic changes developing in China over the coming years could increase trend inflation by about 0.2 p.p. on average across countries.

Renewable-energy revolution could bring higher food inflation in the early phase of the transition

China will have no choice but to be at the epicenter of a global renewable-energy revolution. It has been, by far, the biggest emitter of CO2 globally in recent years, emitting 30% of new global emissions and four times more emissions than India according to BP's Statistical Review of world energy[v]. Without China, global emissions would have already started to decline. The root of the problem is an excessive reliance on coal, which accounts for nearly 70% of energy produced in China.

Policymakers have set targets to cap CO2 emissions in the next few years and to reduce them subsequently. Several other countries have set ambitious objectives. Demand for renewable-energy equipment will surge at a faster pace. This is a boon for China, which is a world leader in the production of renewable-energy equipment. For example, China produces about 70% of solar panels globally. However, producing renewable-energy equipment is highly energy-intensive. Until renewable-energy capacity reaches a critical mass, we should expect upward pressures on the prices of coal, natural gas (a substitute) and commodities that are energy-intensive to produce, including fertilizers, which should translate into higher food inflation. China is the largest global producer of fertilizers.

Monetary policy renormalisation not reaching the stars

With inflation rising and home prices booming, it has become more obvious that monetary policy is generally far too accommodative. The key question is: by how much will central banks be able to increase rates in a sustainable manner over the long run?

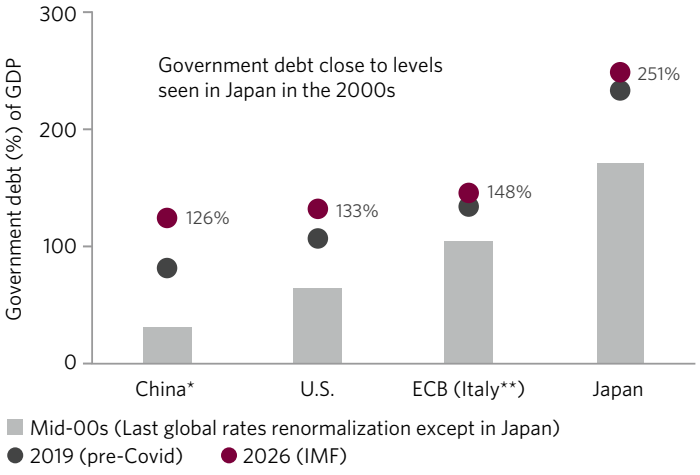
The answer is not by much, especially for developed countries with: 1) adverse demographics; 2) high leverage; and/or 3) with long-term inflation expectations anchored below target. Policy rates should remain considerably below the textbook neutral rate[vi] (or r-star) in several countries, including the biggest economies: China, the eurozone, Japan, and the U.S.. Also, the balance sheets of central banks that have conducted large-scale QE should remain at elevated levels.

An environment of low interest rates and inflation closer to target across major economies should result in more capital flows in emerging markets and reduce the need for their central banks to implement aggressive defensive hikes of their policy rates.

The reality of higher debt levels

Government debt levels have increased materially since the last time central banks have been able to achieve renormalization of their policy stance in the mid 2000s **(Figure 5)**. Indebtedness ratios nearly double when we take into account non-financial corporate debt.

Figure 5: Much higher debt for governments



* Augmented debt (fiscal + quasi-fiscal entities such as SOEs and LGFVs).

** Italy is the most vulnerable large economy in the eurozone over the long-term and the ECB will have to anchor its monetary policy on Italy.

Sources: IMF, Refinitiv-Datastream, CIBC Asset Management calculations.

Owing to current elevated fiscal deficits, generally adverse demographics (with booming healthcare costs), and low interest rates, indebtedness as a share of GDP should continue its ascent for governments.

High debt is problematic for monetary policy as a given increase of interest rates results in a much larger increase of debt-servicing costs. Leveraging makes monetary policy a more powerful tool to slow growth (and a less powerful one to boost it). Research suggests that the impact of increasing interest rates doubles when the debt-to-GDP ratio increases by 100 percentage points[vii]. By the end of the current decade, global non-financial debt should have increased by approximately this amount compared to the last renormalisation cycle of the mid-2000s.

As a result, central banks will have to continue targeting a low terminal value for policy rates in order to limit potentially important negative growth spillovers. In a context of low trend growth across developed markets, the risk of a policy mistake is bigger. We estimate the high debt channel lowers terminal values of policy rates by about 40%.

Also, public healthcare expenditures should put increasing fiscal policy impediments and bring increasing pressures on deficits and indebtedness—similar to the effects of monetary policy renormalization. For example, in the U.S., the CBO projects healthcare costs as a share of GDP will increase by 1.5 p.p. to 7.4% by 2031. Surging healthcare and debt-servicing costs will put downward pressures on discretionary government expenditures (which have a larger multiplier). At best, we should expect discretionary government expenditures to grow at a pace below potential GDP.

The rise of the healthcare burden will be more important for countries with more adverse demographics such as the eurozone, Japan, and China. In China, the fiscal squeeze is likely to be particularly stringent where augmented deficits, which encompasses revenue shortages of quasi-fiscal entities like SOEs and LGFVs, are projected by the IMF to remain close to 15% of GDP in the next few years.[viii]

Average inflation targeting mindset

Despite an outlook of receding goods disinflation, we expect central banks to remain moderately reactive (but not complacent) to higher trend inflation where it had previously undershot target over an extended period of time. In our framework, the average inflation-targeting mindset lowers the policy rate target (in our 10-year horizon) by about 50 bps on average across countries. The adjustment is much bigger for the ECB and the BoJ, where inflation has undershoot targets substantially and remained unanchored.

Our macroeconomic outlook in a nutshell

To derive long-term capital markets expectations, we conduct a macroeconomic rule-based projection for more than 30 economies, in which we project several variables such as potential GDP growth, inflation, and policy rate targets. Relying on rule-based macroeconomic projections allows us to derive expected returns that are driven by the same forces and assumptions, making them fully consistent across asset classes and regions. Appendix 1 presents key working assumptions and an overview of our methodology.

Trend economic growth: we construct our outlook by subtracting the effects of policy rates moving to their respective long-run targets to our long-term estimate of potential GDP.[ix] Our set of cross-country assumptions results in an outlook lower than in the past and generally slightly below the IMF outlook **(Table 2)**. The IMF does not have a long-term projection, but its forecasts end in the middle of our next ten-year window, in 2026. The growth outlook in that year is not driven by cyclical forces. India stands out in our projections, with an outlook above that of the IMF. For the world economy, our outlook is at 3%, about 1 p.p. below trend growth seen in the decade prior to the pandemic.

Table 2: Macroeconomic projections summary (next 10 years)

Regions	Trend real GDP growth outlook history*	Trend real GDP growth outlook IMF**	Trend real GDP growth outlook CAM***	Inflation	Policy rate target in 10 years
US	2.1	2.3	**2**	2.1	2.2
China	7.5	4.9	**4.8**	2.6	2.4
Eurozone	0.8	1.2	**1.1**	1.5	0.3
India	7.1	6.1	**6.4**	4.9	5.7
Canada	1.9	1.6	**1.7**	1.9	1.8
DMs	1.4	1.5	**1.3**	1.5	1.3
EMs	5.3	4.3	**4**	3.6	3.9
Asia	6.7	5	**4.7**	3.3	3.5
CEEMEA	3	2.4	**2**	5.2	4.8
LATAM	2.5	2.3	**2.1**	4.1	4.7

* Trend growth for the 10-year window preceding the pandemic.

** IMF does not produce a long-term outlook. The last year of their projeciton in 2026, the mid-point of the next 10-year window.

*** Our outlook includes potential GDP plus the impact of monetary policy.

Sources: Federal Reserve, Refinitiv-Datastream, CIBC Asset Management calculations. (Projections based on data available as of January 31, 2022.)

Policy rate targets: Our outlook is substantially below what is prescribed by textbook neutral policy rates (long-term nominal potential GDP). For example, our target rate is 2.2% for the Fed, nearly half the expected nominal potential GDP (4.1%). That said, our target rate value is close to the median long-run projection of the Fed's Board members of 2.5% (projection as of January 31st). Fed members are not, however, explicit on the factors (and contributions) that keep their terminal rate projections below nominal GDP. Within our universe, the gap between our long-term target and nominal potential GDP is the highest in China (due to high-leveraging), followed by the eurozone (due to low inflation, low growth, and unanchored inflation expectations). Without the constraint of negative rates, the policy gap would be the highest in Japan.

Inflation: Despite higher inflation from China, technology and innovation should continue to weigh negatively on trend inflation. On net, we expect trend inflation to be close to central banks' targets over the long run. The exceptions remain the eurozone and Japan, where unanchored inflation expectations should remain a lingering impediment to higher inflation. Nonetheless, the ECB and BoJ should experience inflation closer to target than in the past.

Long-term capital markets expected returns

Fixed income

Canada Government Bonds: Our long-term expected returns for Canadian government bonds were uninspiring over the last 2 years, as we had warned that returns would be challenging. Bond yields have moved up significantly since our last publication a year ago, improving the forward-looking expected return meaningfully. While they remain low by historical standards, expected returns improved to 2.1% this year **(Table 3).** This is an important improvement, as investors can now expect a (small) positive return in real terms.

Table 3: Fixed income breakdown of expected returns (%)

Assets classes	Average income	Valuation	Expected return (LC)	Currency impact	Expected return (CAD)
CN 10-year Government	2.5	-0.5	**2.1**	0.0	**2.1**
CN Corporate	3.8	-0.3	**3.4**	0.0	**3.4**
Canada Universe	2.8	-0.3	**2.4**	0.0	**2.4**
U.S. 10-year Treasury	2.8	-0.8	**2.0**	-0.8	**1.2**
U.S. Corporate	4.1	-1.1	**3.0**	-0.8	**2.3**
U.S. High Yield	6.5	-3.0	**3.5**	-0.8	**2.7**
JPM World ex-Canada	2.1	-0.7	**1.5**	0.1	**1.6**
JPM Emerging	7.4	0.8	**8.0**	0.5	**8.5**

Source: CIBC Asset Management calculations (projections based on data available as of January 31, 2022).

Global Government Bonds: Prospects are lower than for Canadian bonds, owing to a more negative duration effect (for non-U.S. bonds) and a negative currency impact (for U.S. bonds). U.S. government and JPM World ex. Canada bonds should provide returns for Canadian investors that are below inflation.

More generally for fixed income, remaining financial repression resulting from continued coordination of fiscal and monetary policies means investors will continue to face lower real returns than historical experience. Reflecting this, we project the term premium to remain at low levels as we expect major developed market central banks to keep their balance sheets at elevated levels.

Investment-grade and High Yield Corporate Bonds: Canadian corporate bonds are relatively attractive within the fixed income world, with an expected return of 3.4%. Prospects of high yield bonds are similar in local currency but face a negative currency impact from a Canadian perspective (the majority of the high yield market is in the U.S.). The prospect for high yield bonds is limited due to the current low spreads. For reference, the long-term target for high yield spreads is 4.7%, while they stood at 3.6% as of January 31th.

An interesting feature for corporate bonds is that, in a world with limited policy leeway and high leverage, central banks are likely to resume corporate bond purchases quickly if needed. Since 2016, to limit a deterioration of financial conditions, the Bank of England, the European Central Bank, the U.S. Federal Reserve Board, the Bank of Canada, and the Bank of Japan (since 2010) have been, at some point, intervening in corporate bond markets. While they do not eliminate the credit risk, potential interventions would provide needed support during periods of turbulence and so would help to stabilize markets, limiting downside risks on prices.

Emerging Bonds: Emerging market (EM) government bonds are the most attractive fixed income asset class, due to higher starting yields and the absence of a valuation drag for the aggregate index (several countries have rates near or above their long-term policy targets). Undervalued currencies in EM countries should also provide some tailwind. The expected return is 8.5% in Canadian dollars. The environment of low real interest rates across major economies will increasingly force investors to consider EM bonds in their portfolios. A secular increase in the appetite for the asset class should lessen the need for defensive interest rate hikes, which have, in the past, made these countries more cyclical. Continued inclusion of the Chinese and Indian markets over the coming years will expand the opportunity set for managers and increase liquidity over time, adding to the attractiveness of the asset class.

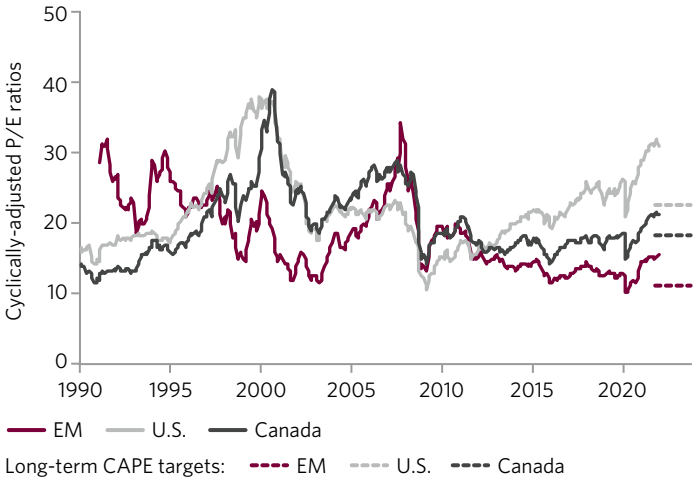
Equities

Canadian Equities: The outlook is, more or less, in line with that of international equities: not as attractive as emerging equities, but more than the U.S. due to a less-negative valuation effect. With a P/E ratio currently above 21, Canadian equities are expensive compared to our long-term fair value of 18.6. We derive our long-term fair value for P/E ratios using econometric models, in which interest rates and potential growth have shown explanatory properties.

We consider the balance of risks to be positive. Canadian banks have accumulated record capital and have room to increase dividends. This likely will happen over several years, but it is a strong opportunity for dividend growth. In addition to the potential dividend catch-up by the banks and insurance companies, there is also a potential for outsized growth in dividends from the energy sector. The large caps especially are generating lucrative free cash flow levels at current commodity prices, and continue to show a very high level of discipline with respect to production growth.

U.S. Equities: We expect returns of 3.4% in local currency, 2.6% in Canadian dollars. U.S. equity prospects are reduced by an important drag from valuation **(Figure 6)**, given loftier P/E ratios as a starting point. Also, corporate America has benefited from rising profit margins as a driver of earnings growth in recent years. Margins are expected to normalize gradually.

Figure 6: Equity valuations headwinds, particularly in the U.S.



Sources: Refinitiv-Datastream, CIBC Asset Management calculations. Long-Term CAPE Targets are projections based on data available as of January 31, 2022.

The balance of risks appears to be tilted to the downside, owing to policy considerations. There has been increasing evidence of more market dominance by large firms (Covarrubias et al., 2019)[x]. This increases the risk of more regulation for Big Tech and a less-friendly regulatory environment overall. Also, elevated deficits in the U.S. and projected increases of debt servicing and healthcare costs are pointing to higher taxes eventually, most likely including higher corporate taxes. These all touch on elements that were previously tailwinds for the U.S. equity market.

International Equities (EAFE): We expect returns of international equities to average 5.1% in the next 10 years. Prospects are limited by low earnings growth, reflecting a renormalisation of historically elevated profit margins and lackluster income growth. However, valuation is a much smaller drag than in the U.S. or Canada.

The positive renewable energy outlook suggests upside risks for Europe. While the region is home of several important green-energy companies, the European Green Deal should bring sizeable investment in renewables in the E.U. (about 3% of GDP in the current decade). Bloomberg NEF projects that the stock of solar panels in the E.U. will increase by a factor of 4 between 2021 and 2030. The expected return for European equities is 4.6% for Canadian investors.

Table 4: Equity breakdown of expected returns (%)

Asset classes	Dividend yield	Earnings growth	Valuation	Expected return (LC)	Currency impact	Expected return (CAD)
Canada S&P/TSX	2.6	3.6	-1.3	**4.8**	0.0	**4.8**
U.S. S&P 500	1.4	4.2	-2.2	**3.4**	-0.8	**2.6**
MSCI EAFE	2.6	2.5	-0.7	**4.5**	0.7	**5.1**
MSCI Europe	2.6	2.7	-1.0	**4.2**	0.4	**4.6**
MSCI Japan	2.2	1.2	0.3	**3.8**	1.6	**5.4**
MSCI All Country World	1.9	4.0	-1.7	**4.2**	-0.2	**4.0**
MSCI Emerging	2.8	6.6	-0.9	**8.4**	1.2	**9.6**
MSCI Emerging Asia	2.2	6.6	-0.8	**7.9**	1.7	**9.6**
MSCI Emerging Europe	4.6	6.7	-0.9	**10.3**	-0.7	**9.7**
MSCI Emerging Latam	7.1	6.0	-2.1	**11.0**	-1.3	**9.8**

Source: CIBC Asset Management calculations (projections based on data available as of January 31, 2022).

Emerging Equities: At 9.6%, this is the most attractive asset class in our universe, underpinned by higher earnings growth, which reflect in turn elevated nominal sales growth and a smaller drag from mean-reversion of margins. Solid income growth prospects reflect higher potential growth. Elevated dividend yields augment the attractiveness of EM Europe and Latam, but negative currency effects provide an offset. At the opposite end, currency prospects are appealing in EM Asia, underpinned by higher productivity, lower inflation and elevated yields.

The ascent of the consumer as a key growth engine and its rise in the composition of EM equities **(Figure 7)** are pointing towards lower volatility of EM equities and an improvement in the quality of expected returns. Tertiary sectors are more related to final demand from the consumer and are much less cyclical than commodities and manufacturing.

Figure 7: EM equities increasingly driven by the consumer

Sources: Bloomberg, CIBC Asset Management calculations.

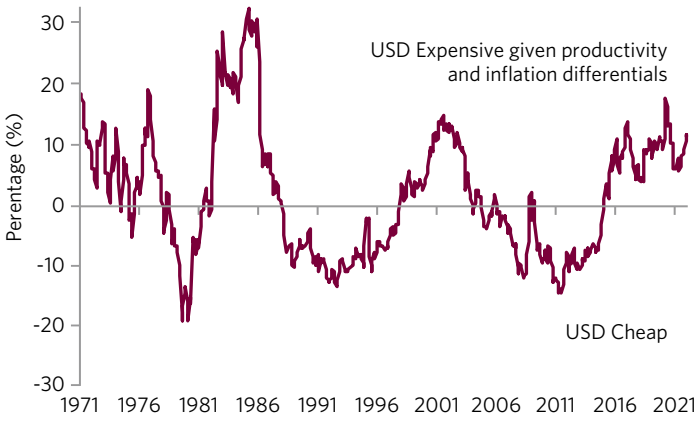
The surge of green energy investment in Asia should support the domestic economy and green energy stocks in EM Asia. The region is likely to be the main winner in the surge of renewable energy. It has an excessive reliance on coal, generally imported, but has the most important manufacturing base for renewable energy-producing equipment (in particular Taiwan, Hong Kong, and China).

Currencies

USD: The Greenback is cyclically overvalued on a trade-weighted basis in our FX model by almost 10% **(Figure 8)**. Downward pressures towards fair value over the long term should make U.S. assets less appealing to foreign investors and non-U.S. assets more appealing to Americans over the long run. EM currencies are the cheapest against USD. For EM Asia, the relative fair value of currencies should also increase vis-à-vis the U.S. due to higher productivity.

Figure 8: USD expensive on a trade-weight basis

Trade-weighted USD deviation with fair value, %



Sources: Bloomberg, CIBC Asset Management calculations.

CAD: the loonie is currently undervalued almost 9% vis-à-vis USD and should appreciate relative to USD over the long run. However, about 60% of currencies in our investment universe are actually cheaper than the CAD (on a trade-weighted basis and vis-à-vis USD). For Canadian-based investors investing abroad, relative long-term currency prospects make U.S. assets less appealing but magnify the investment outlook in Europe, Japan, and Emerging Asia.

Alternatives

Alternative investment refers to various types of investments. Our focus is on private debt, private real estate, and private infrastructure, which offer an appealing liquidity premium. Alternatives are characterised by a high heterogeneity of assets within the same category. To project returns, we rely on large-scale disaggregated data (from Preqin), where we compare historical returns (IRR) with listed benchmarks. For the projection, we include the spread to our outlook of the benchmark. We also impose negative judgment on the liquidity premium, as we expect alternatives to become increasingly popular for smaller investors, reducing the forward-looking returns as investors compete for limited availability of assets.

Expected returns in local currency are around 6% for private infrastructure, core real estate and private debt. Listed alternatives asset classes offer returns closer to 5% in local currency. They are projected using our equity framework.

Table 5: Expected returns of alternatives (%)

Asset classes	Expected returns (LC)	Expected returns (CAD)
Private debt (North America)*	5.7	5.1
Core Real Estate (North America)*	5.9	5.3
FTSE EPRA NAREIT Developed Markets (USD)	5.5	4.7
Private Infrastructure (North America)*	6.2	5.6
Dow Jones Brookfield Global Infrastructure (USD)**	4.9	4.1

* currency impact assumes 75% investment in the U.S., 25% in Canada. Expected Returns are the same in local currency.

** Listed global companies with >70% of cash flows derived from infrastructure.

Source: CIBC Asset Management calculations (projections based on data available as of Jan. 31, 2022).

Appendix: Capital markets projection methodology

Economics: We use the following methodology to derive our long-term economic outlook:

- We estimate the trend labour input of potential GDP using United Nations demographics projections;
- For each economy, we calibrate the outlook of trend labour productivity using past trend productivity (empirically persistent) adjusted for the change of U.S. productivity (a proxy for the common component of global innovation). For emerging markets, we also lower productivity growth by a factor proportional to the increase of national GDP to capture the effects of converging living standards; low-income EMs generally have much higher productivity growth for that reason.
- We assume central banks will bring their policy rate to a target equivalent to long-term nominal potential GDP growth minus 1) an adjustment proportional to leveraging in the system; and 2) a adjustment function of past undershoot of inflation relative to target.
- The inflation outlook is equal to its pre-pandemic cyclically-adjusted trend and includes upward adjustments to take into account higher inflation from China.

Fixed income: Expected returns are a function of expected coupon payments, expected defaults net of recovery, and the valuation effects of interest rates moving toward their long-run targets. Long-term targets are a function of the terminal value of the policy rate, a risk premium, and the term premium.

Equity: Expected returns are a function of the dividend yields, earning growth, and the convergence of P/E ratios to their long-term targets. Earnings growth is driven by a trade-weighted nominal GDP outlook and a reversal of transitory factors impacting margins. Long-term P/E targets are estimated econometrically using trend growth and interest rates as independent variables (conceptually consistent with a Gordon framework).

Foreign exchange rates: Long-term foreign exchange movements are impacted by current valuation deviations with fair-value estimates provided by our currency model and by the projected change of fair value. Over the long-run, the fair value of a currency is impacted by inflation (negatively), by productivity, and by rates.

Alternatives: For private alternatives, we estimate a historical spread between past returns (IRR) and listed benchmarks. For the forecast, we include the spread to our benchmark projection. We lower the liquidity premium, as we expect private alternatives to become increasingly popular for non-large investors. Listed alternatives are projected using our equity framework.

i Éric Morin is Assistant Vice President, Luc de la Durantaye is Chief Investment Strategist, CIO and Managing Director, Vincent Lépine is Director, Economic and Market Research and Francis Thivierge is Senior Portfolio Manager. All authors are part of the Multi-Asset & Currency Team at CIBC Asset Management (CAM).

ii Gordon, 2012. Is U.S. Economic Growth Over? Faltering Innovation Confronts the Six Headwinds. Working Paper 18315. August.

iii Dalio, 2021. The changing world order. Avid Reader Press. November.

iv Xiaobo, 2018. China Emerging, 1978-2018. China Intercontinental Press. November.

v BP, 2021. Statistical Review of World Energy. July.

vi The textbook neutral stance corresponds to long-term nominal potential GDP growth.

vii Hofmann and Peersman, 2017. Is There a Debt Service Channel of Monetary Transmission? BIS Quarterly Review. December.

viii IMF, 2021. China Article IV. January.

ix Our projections don't include the impact of closing the output gap (more uncertain to estimate) and fiscal policy (not rule-based, unlike monetary policy). Our view on both is that output gaps have declined substantially and that fiscal policy should be a modest headwind to growth (high structural deficits will be gradually reduced but not materially).

x Covarrubias et al., 2019. From Good to Bad Concentration? U.S. Industries over the past 30 years. NBER. Working Paper 25983. September.

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