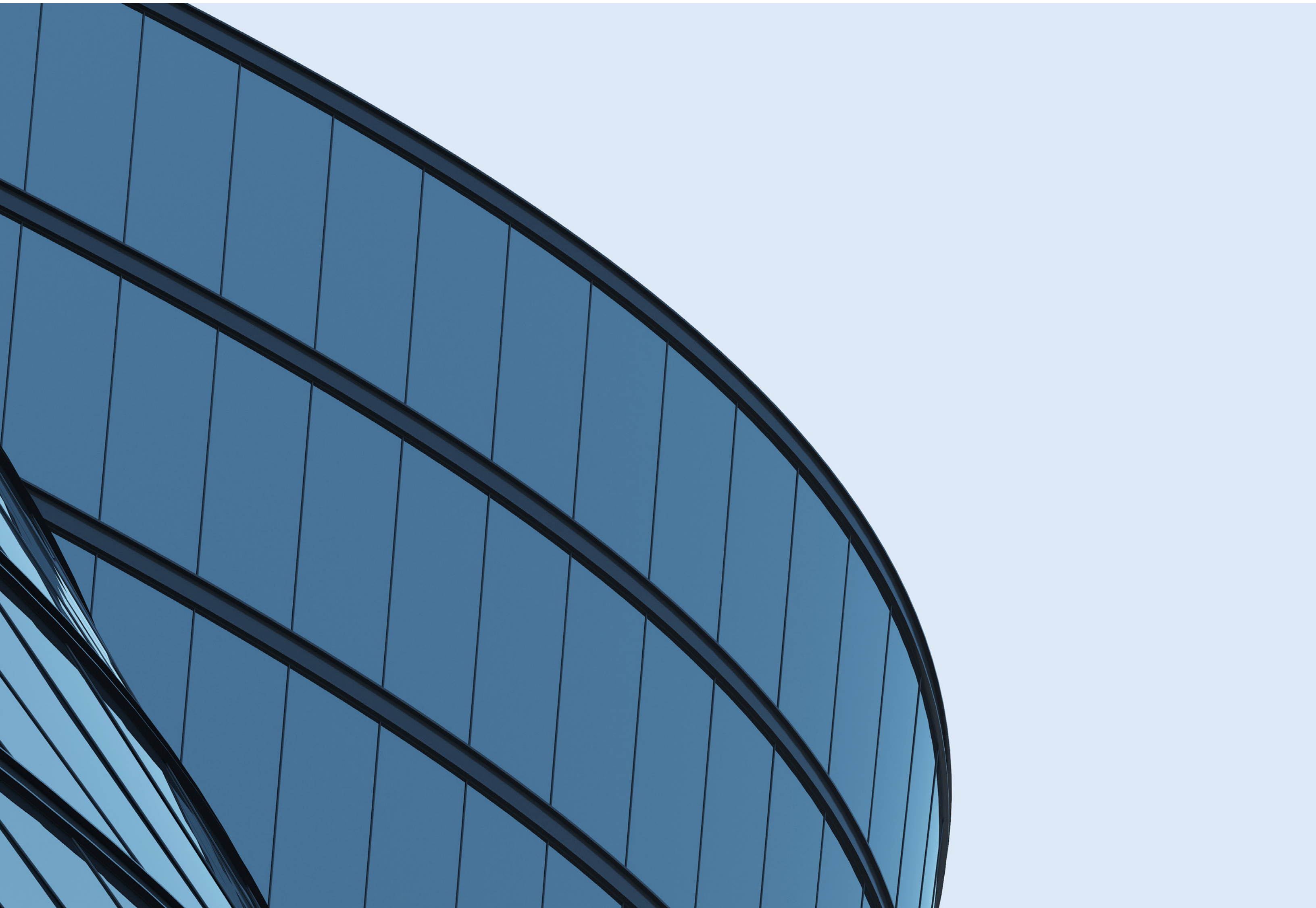
2024 LONG-TERM ANNUALIZED CAPITAL MARKET EXPECTED RETURNS

March 2024

By Éric Morin, Michael Sager, Francis Thivierge and Luc de la Durantaye



Each year, CIBC's Multi-Asset and Currency Management team develops long-term return and volatility expectations for a broad set of asset classes, in collaboration with our Total Investment Solutions team. These expectations are the cornerstone of our firm's strategic asset allocation thought leadership and client advisory services.

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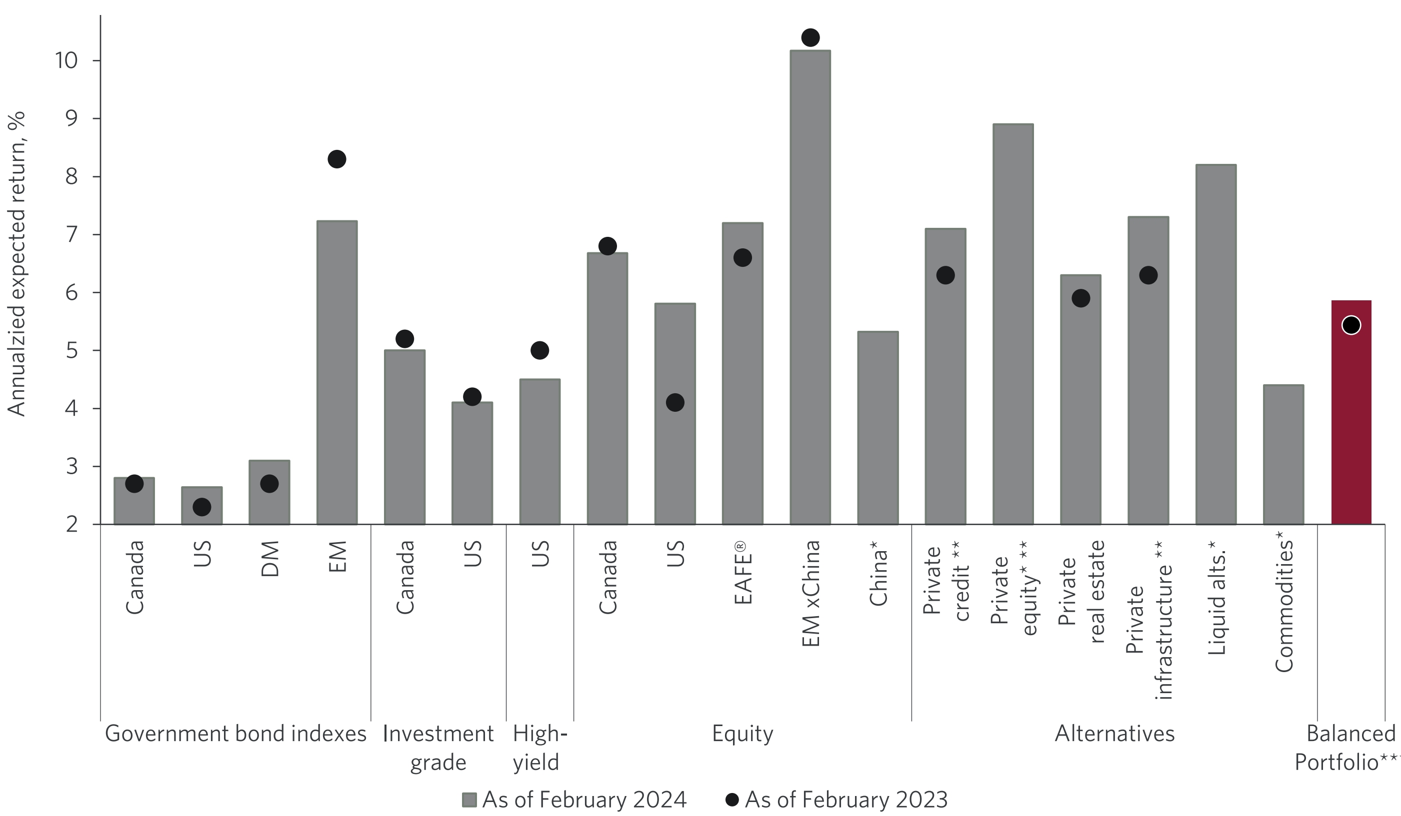
Key takeaways

- The factors that determine the balance between investment spending and savings are shifting, with important implications for expected asset class returns (Chart 1). We expect the next 10 years to be characterized by strong investment tailwinds, driven by geopolitical risks, strong technology demand, the energy transition and elevated infrastructure needs. At the same time, the supply of savings is expected to slow due to an ageing population and, particularly in the US, persistent fiscal deficits.
- Reflecting strong investment demand, we expect economic growth in the next 10 years to be slightly above the historical average of the past 20 years in several countries. This should result in positive output gaps and average inflation that is slightly higher than central bank policy targets.
- Our economic outlook projects higher bond yields than were common during the 2010s, back to levels closer to those experienced in the 2000s. We expect the 10-year US Treasury yield to average 4.1%. Higher equilibrium yields are consistent with more attractive expected returns on government bonds. We also expect returns on corporate, high-yield and emerging markets (EM) bonds to be proportionately higher.
- Our expected returns on developed market (DM) public equity have improved, also reflecting a more constructive economic outlook. This includes the US and EAFE®, for which expected returns in local currency terms are now at levels comparable to Canada.
- Expected returns remain attractive for EM equity, excluding China. Growth in several EM countries will likely be boosted by positive demographics, friendshoring manufacturing investment, strong technology demand and the global energy transition.
- Our outlook for Chinese assets is less constructive. The country is facing a chronic excess of housing supply and an accelerating population decline. China has limited policy options to close a large negative output gap, is highly leveraged with bad debt, and is facing weak private investment.
- For Canadian investors, asset returns are expected to be impacted by various currency outlooks. This dampens returns for US assets (the US dollar remains overvalued, and we expect it to weaken over the next 10 years) and boosts expected returns for most EM assets.

Chart 1: Long-term expected returns, 10-year average, %



Source: Information calculated by CIBC Asset Management Inc. using data from the following third-party providers: Bloomberg, LSEG Datastream and PitchBook. Calculations based on data available as of December 31, 2023. *Data not available in 2023. **Assumes 75% investment in the US and 25% in Canada. ***The representative Balanced Portfolio assumes the following strategic allocation: 39% fixed income, 53% equity and 8% alternatives. This is consistent with the Income & Growth, Diversified Portfolio presented in our Long-Term Strategic Asset Allocation outlook report. Return data expressed in Canadian dollars. "EAFE" is a registered trademark of MSCI Inc., used under license.

1. How we calculate expected returns

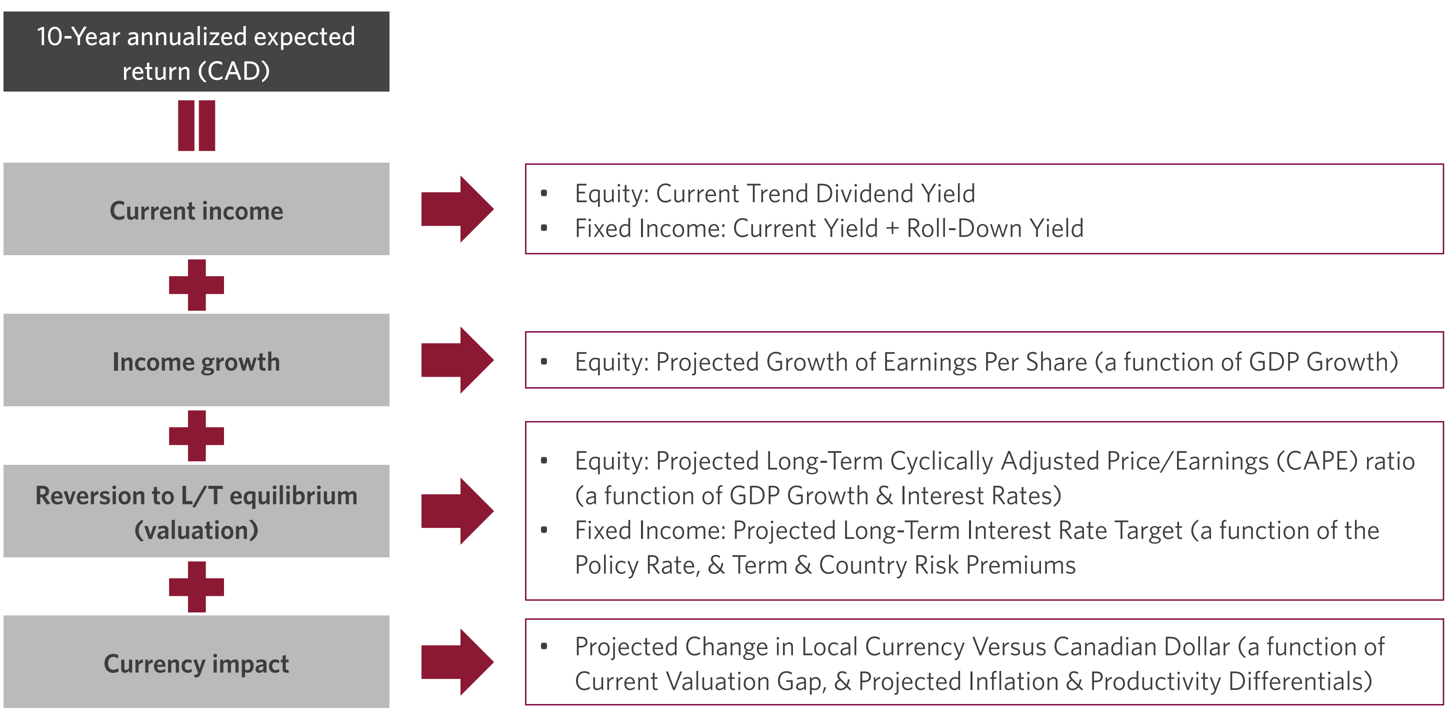
We construct annualized expected returns for a broad set of public and private asset classes with a focus on the next 10 years. This horizon is long enough not to be overly influenced by cyclical trends, which we cover in our companion quarterly Perspectives publication. It is also not so far into the future that the determinants of returns are no longer forecastable with a reasonable degree of confidence.

We consider macroeconomic variables, such as gross domestic product (GDP) growth, inflation and interest rates, to be the primary drivers of long-term capital market returns. We project the path of these variables for a broad group of countries accounting for about 85% of global GDP. We then use these projections as key determinants of future corporate earnings and dividends, default risk and currency valuations.

Public market fixed income and equity

We calculate our expected returns for public fixed income and equities using a building-block approach that encompasses, as appropriate: 1) current income, 2) income growth and 3) reversion to long-term equilibrium valuation (Figure 1). For both fixed income and equity—and also currencies—we adopt the simplifying assumption of linear reversion to long-term fair value over our 10-year forecast horizon.

Figure 1: Building-block approach for calculating expected returns for public markets



Source: Information prepared by CIBC Asset Management Inc.

Current income for equity: This is the current dividend yield for each market index in our universe.

Current income for bonds: We rely on coupons and roll-down yields, as well as expected defaults net of recovery.

Income growth for equity: This captures the expected annualized percentage change in earnings per share (EPS). Growth is a function of projected trade-weighted nominal GDP growth and a multiplier. For most countries, this multiplier has a value of 1.0, meaning that total earnings grow at the same pace as aggregate demand. For a select group of countries with relatively large exposure to technology or where we expect strong investment tailwinds resulting from geopolitical risks—including the US, Japan, Korea and Taiwan—we assume a multiplier ranging between 1.2 and 1.5.

Our EPS outlook is also impacted by share buybacks/dilution and the expected change in profit margins. In both cases, our methodology assumes a gradual reversion to a long-term target that is tied to historical averages.

Income growth for bonds: This is the impact on returns of expected changes in yields. Combining current income and income growth generates an average rolling yield (equal to the coupon of a bond plus its roll-down yields).

Long-term equity valuation: For each country, we assume that the current cyclically adjusted price-to-earnings (CAPE) ratio will move towards a long-term fair value. Long-term CAPEs are estimated using proprietary econometric models that incorporate potential GDP growth, the output gap and long-term interest rates.

Long-term fixed income valuation: For each country in our universe, we assume the current 10-year government yield converges towards a long-term equilibrium yield. We construct this equilibrium yield as a combination of long-term policy rates, plus country and term risk premiums.

Long-term policy rates are calculated using a Taylor rule, which approximates the policy reaction function of a central bank. This identifies long-term policy rates as a function of real GDP growth, inflation, the output gap and a sacrifice ratio (defined as the output cost of reducing inflation).

Country-risk premiums are determined by current sovereign credit default swaps, projected debt levels and the quality of domestic institutions. Term premiums are determined by the projected supply of and demand for savings.

Liquid alternatives and commodities

For liquid alternatives, we assume an expected return of 5% plus cash. This is the standard return target of investment strategies in this asset class, which is broadly consistent with historical experience. For commodities, we use a global supply-demand model in which future prices are predominantly driven by our GDP growth projections for EM countries.

Private market alternatives

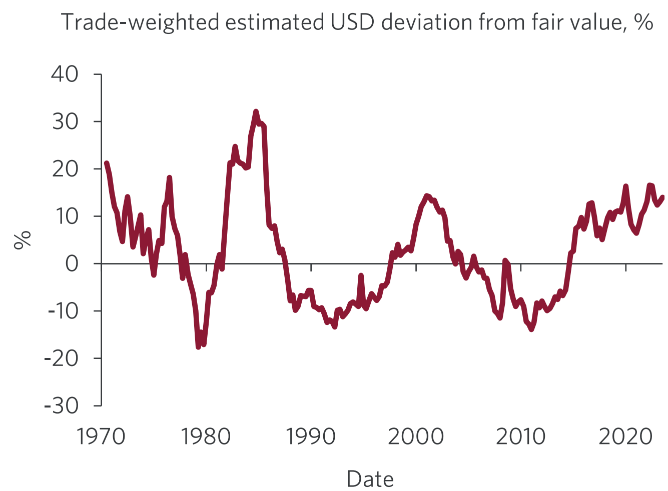
We also use a building-block approach to project expected returns for private market alternatives. These building blocks include adding an appropriate risk premium to relevant benchmark indexes, and are measured as a function of the historical spread to Public Market Equivalents (PMEs). We also add the expected change of any associated illiquidity premium, as well as idiosyncratic factors specific to individual private alternative asset classes. For example, our private core real estate outlook includes a positive premium to reflect the impact of the expected generalized housing shortage.

Currency valuations

Projected currency returns are determined by current deviations of exchange rates from estimated equilibria—measured using proprietary Behavioural Equilibrium Exchange Rate (BEER) models that incorporate price levels, productivity and terms of trade—and projected changes in estimated equilibria driven by country inflation and productivity differentials.

Using our proprietary valuation methodology, we estimate the US dollar (USD) to be overvalued by about 13% against a broad basket of currencies (Chart 2). This overvaluation appears similar to the early 2000s during the dot-com bubble, the mid-1980s and the early 1970s. Each of these periods was followed by prolonged USD weakness as the currency reverted back towards its long-term equilibrium valuation. We expect the next 10 years to be characterized by sustained but gradual USD weakness, on average. For Canadian investors, this represents a headwind to expected returns from US assets equivalent to an annualized rate of 1.2%. Conversely, many EM currencies appear cheap. Their expected appreciation over the next decade should provide additional returns for Canadian investors exposed to local assets in these countries.

Chart 2: USD expensive, represents headwind for US assets



Source: Information calculated by CIBC Asset Management Inc. using data from the following third-party providers: Bloomberg and LSEG Datastream. Data as of December 31, 2023.

Macroeconomic inputs

Nominal GDP growth: This variable is key to our long-term projections for equity earnings growth, price-to-earnings ratios and interest rates. Nominal growth is composed of inflation and real growth. Real GDP growth is further broken down into the growth of hours worked (labour) and productivity. In Box 1, we discuss our global long-term real GDP growth outlook.

- **Labour**: Our projections for working-age populations are based on data from the United Nations, which we supplement with country-specific assumptions on trends in participation rates and immigration. This allows us to estimate percentage changes in hours worked.

- **Productivity**: We determine our outlook for long-term productivity across our universe of countries by adjusting past-trend productivity growth by the expected change in US productivity, which we use as a proxy for the global common component of innovation. Our projections also include the impact of country-specific factors, such as geopolitical factors, the energy transition, housing investment and the quality of domestic institutions.

- **Inflation**: Our projection includes the expected inflation effects of demand and supply shocks on country output gaps and monetary policy. These are added to our estimate of current cyclically adjusted trend inflation for each country.

Box 1: Long-term global GDP growth outlook

A bipartisan consensus in Washington identifies China as a long-term economic, political and military threat. We expect this consensus to drive investment spending intended to reduce US economic exposure to China. The relevance of this risk is also rising in Europe and several countries in Asia-Pacific.[1] Together with technological competition with China, the global renewable-energy transition and infrastructure shortages, we expect this to create important investment tailwinds in several countries. In economies where we expect the strongest investment tailwinds—the US, Asia-Pacific excluding China, Latin America and, to a lesser extent, Canada—our productivity growth projections exceed the rate implied by the historical (downward sloping) trend. For the US, we project annual average productivity growth at 1.8%, which exceeds the average of the past 30 years (1.6%) and the Congressional Budget Office's projection of 1.4%. By itself, higher productivity growth is consistent with higher trend GDP growth (Table 1).

Table 1: Trend GDP growth outlook for selected economies, %

Developed economies	Next 10 years	Last 20 years
US	2.20	2.00
Canada	2.10	2.00
Eurozone	1.00	1.10
UK	1.40	1.30
Japan	0.80	0.70
Australia	2.70	2.70
Emerging economies	**Next 10 years**	**Last 20 years**
EM Asia ex. China	5.40	5.30
China	3.70	8.10
Latin America	2.60	2.40
CEEMEA	1.90	3.80
World*	3.00	3.60

Source: the information was prepared by CIBC Asset Management Inc. using data from the following third-party service providers: Bloomberg; LSEG Datastream. Projections based on data available as of December 31, 2023. * Our universe of countries encompasses 85% of World GDP.

We project immigration to continue to contribute positively to population growth in Canada, Australia and the US, although not at the same pace as the last few years. This is expected to benefit trend GDP growth in these countries.

In contrast, our projections for trend real GDP growth for Europe and CEEMEA are below long-term historical averages. For these economies, investment tailwinds, and hence productivity growth, are weaker. Demographics are also expected to represent a drag on GDP growth.

In China, we expect several persistent headwinds to challenge investment and economic growth. These include geopolitical tensions, a structural excess supply of housing, a large negative output gap, elevated and ill-performing leverage in banks and local government financing vehicles, and a declining population. Although China's position as the manufacturing leader of renewable-energy equipment and electric vehicles (EV) should provide some mitigation to these headwinds, we expect trend GDP growth to decline below 4%. This represents a marked change compared to previous decades.

We also expect other manufacturing hubs in Asia, including Japan, Korea and Taiwan, to experience a decline in working-age populations. This should encourage accelerated economic development in populous low-income countries in the region, including India, Indonesia and the Philippines. The size of these three economies is expected to approximately double over the next 10 to 15 years.

2. Long-term expected returns

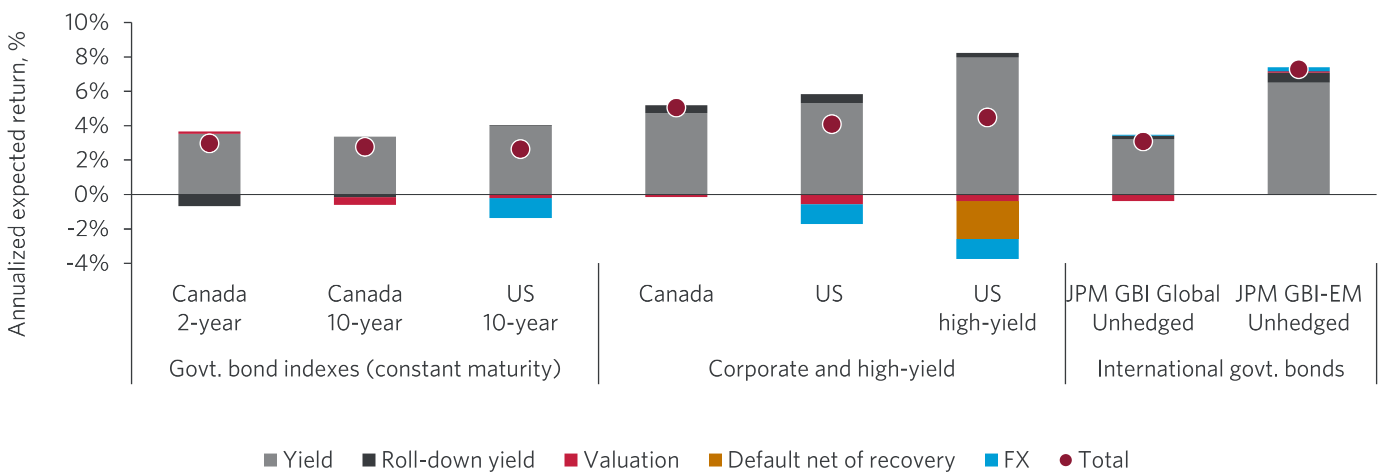
Fixed income

Our expected returns methodology for fixed income captures the average return an investor would receive with a one-year holding period for each of the next 10 years. It differs from a buy-and-hold strategy for the whole 10-year period (for which the current yield, adjusted for currency valuations, represents a good proxy for expected returns). Our approach replicates what investors can expect to receive from an index. It also allows expected returns for sovereign Canadian and US bonds to be compared against those for corporate bonds and EM debt.

At 2.8%, our outlook for long-term annualized expected returns on a Canadian 10-year government bond index is little changed from last year, but it is markedly better than a few years ago (Chart 3 and Appendix 1). This improvement primarily reflects higher current yields, which are partially mitigated by current upward pressures on yields and negative roll-down yields caused by continued yield curve inversion. Over the long term, we expect positively sloped yield curves—the normal state of the bond market—which would result in a return to positive roll-down yields.

For a 10-year buy-and-hold investor, the expected return is higher and similar to the projected average bond yield of 3.4%.

Chart 3: Fixed income long-term expected returns, %



Source: Calculated by CIBC Asset Management Inc. using data from the following third-party service providers: Bloomberg and LSEG Datastream. Calculations based on data available as of December 31, 2023. Total return data expressed in Canadian dollars.

Elsewhere in the DM universe, our expected long-term annualized return for a US 10-year Treasuries index is slightly higher this year at 2.6% in Canadian dollar terms, although currency valuation remains a headwind. There is a more noticeable improvement for global bonds due to their higher current yields. Our 10-year annualized expected return for the JP Morgan GBI Global Ex-Canada Index (unhedged) is 3.1%, compared to 2.7% previously.

Canadian corporate bonds offer investors an expected long-term annualized return a little above 5%, similar to our assessment last year. As with sovereign bonds, this expected return primarily reflects a relatively attractive current yield, with a smaller positive contribution from the roll-down yield.

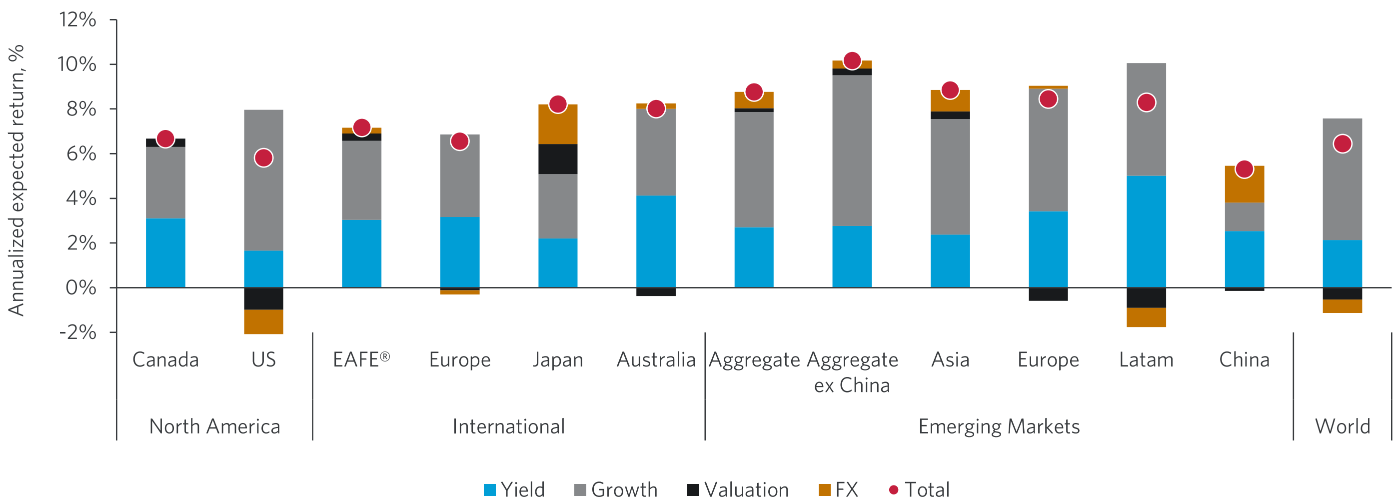
The annualized expected returns on US investment grade and high-yield bonds continue to be negatively impacted by currency valuations, and both offer Canadian investors a lower expected return than Canadian corporate bonds.

At 7.2%, EM government bonds (in local currency terms) continue to offer the most attractive annualized expected returns within the public fixed income universe, supported by high-yielding countries such as Brazil, India, Indonesia, Mexico and South Africa. Unlike DM bonds, currency valuations and roll-down yields are both expected to contribute positively to expected annualized returns for EM government bonds. However, expected returns associated with EM debt are lower than at this time last year (8.3%), as current yields are now closer to long-term equilibria.

Public equity

Canadian equities are expected to provide an annualized return over the next 10 years of 6.7% (Chart 4 and Appendix 1). This is little changed from our outlook in last year's report. Compared to most developed markets, Canada has better demographic trends and a larger structural housing shortage—meaning favourable tailwinds for both residential construction and the banking sector. The balance of risks appears tilted to the upside, reflecting the potential for strong dividend growth in two key constituent sectors of the Canadian market: 1) banks, which have accumulated record capital, and 2) energy firms, which generate attractive free cash flows at current commodity prices.

Chart 4: Equity long-term expected returns, %



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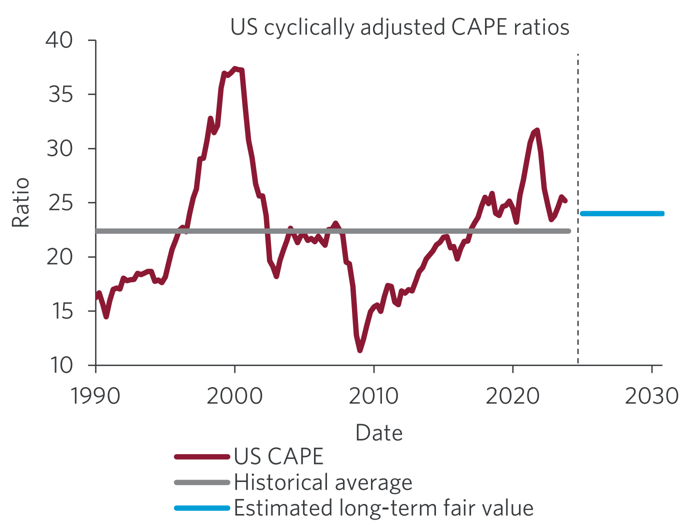
The outlook for annualized returns to US equity, at 5.8%, has improved relative to last year (4.1%). This improvement reflects stronger expected corporate earnings growth, which more than compensates for a low dividend yield, and a smaller valuation drag due to an upwardly revised long-term CAPE ratio (Chart 5). We expect share buybacks to continue to support expected returns, albeit by slightly less than in recent years. As for other US asset classes, currency valuation is expected to remain a headwind for Canadian investors (local currency annualized expected return for US equity is 7.0%).

Chart 5: US equity valuations remain a modest headwind



Source: Information prepared by CIBC Asset Management Inc. using data from the following third-party service provider: Bloomberg. Data as of January 17, 2024.

Our stronger outlook for US earnings growth reflects expectations of robust demand growth, particularly in technology, and a stronger earnings multiplier from GDP growth, as discussed earlier. Our estimated long-term CAPE ratio is revised to 24.2, from 22.5 previously and above the historical average of 22.4. This upward revision reflects our stronger long-term economic outlook and the inclusion of the output gap in our proprietary econometric CAPE model. Despite being cyclically adjusted, CAPE ratios are highly sensitive to the output gap, along with trend economic growth and real rates. We expect the output gap to remain positive on average over the next 10 years, boosting the equilibrium CAPE ratio. In addition, the equilibrium real interest rate is expected to remain below its historical average, which is also supportive of a higher CAPE ratio.

We consider the balance of risks surrounding our US equity outlook in Canadian dollar terms to be skewed to the upside. US industrial policies should remain supportive of Corporate America, boosting earnings growth and market valuations, particularly for technology and high value-added manufacturing companies. Furthermore, we assume the US will remain the frontier technology country over the next 10 years, which could lead to the emergence of new market leaders that potentially replace the current "Magnificent 7."

We are also cognizant of several downside risks to the existing "Magnificent 7." Over the long term, large technology companies could face more stringent regulation and antitrust actions. In a recent example, the European Commission charged Google with violating antitrust laws by exploiting its dominance in online advertising.[2] Artificial intelligence (AI) companies could increasingly threaten Google's long-running dominance.[3] Similarly, the global rise of Chinese electric vehicle manufacturers could erode the long-term profitability of Tesla (BYD recently surpassed Tesla as the world's biggest electric vehicle producer).[4] Overall, however, we do not consider these downside risks to be as significant as the upside potential.

Our long-term outlook on international equities (EAFE®) is relatively favourable, with an annualized expected return of 7.2% in Canadian dollar terms. This aggregate number encompasses heterogeneity across economies, with the outlooks for Japan (8.2%) and Australia (8.0%) being noticeably stronger than Europe (6.6%). Given its the large exposure to industrials and manufacturing, the Japanese equity market, in particular, appears well positioned to benefit from global investment tailwinds in technology, as well as efforts to reduce economic exposure to China. The government-backed Japanese chip-foundry venture Rapidus aims to manufacture the world's most advanced chips in Japan by the second half of the decade, with the support of other domestic and foreign companies.[5,6] On the military front, Japan is expected to ship domestically made Patriot missiles to the US.[7] Australia is likely to be an important beneficiary of the global renewable-energy transition. It has large reserves of lead, nickel, copper and lithium, all major metals heavily used in the manufacturing of electric vehicles,[8] and the International Energy Agency (IEA) expects demand for these metals to increase by a factor of 10 by 2040.[9] Our strong economic outlook for many EM economies outside of China also likely represents a boon for coal and liquefied natural gas, of which Australia has significant reserves. Domestic housing prospects are also a tailwind for Australia's financials sector.

For Europe, we expect fewer investment tailwinds, and we project valuations and currency effects to have a negative impact on annualized expected returns. European stocks could nonetheless benefit from the energy transition away from fossil fuels. Europe is home to several important green energy companies, and the European Green Deal could result in sizeable investment.

We consider the risks surrounding expected returns for international equities to be balanced. For Japan, there is a risk of a smaller-than-projected currency appreciation, but this is offset by upside potential for earnings growth and valuations. For Europe, German car manufacturers could lose market share in China, where potential GDP growth is projected to slow materially and domestic brand electric vehicle sales are booming. Also, Italy's long-term precarious fiscal position could bring political difficulties, including the absence of structural reforms, more dysfunctional governance, less political cohesion and challenging fiscal consolidation. More positively, as noted earlier, the climate transition could bring sizeable investment spending. In addition, given NATO commitments, Europe could benefit from increased military investment, which would be a boon for its manufacturing base.

Emerging markets, excluding China, have the highest annualized expected returns, at 10.2% for Canadian investors. This outlook is driven primarily by earnings growth; a small valuation headwind is offset by a currency tailwind. Within EM economies, Asia has the highest expected return, supported by strong domestic demand, geopolitical tailwinds and, for Korea and Taiwan, a comparative advantage in the manufacture of semiconductors. Latin American emerging markets follow, with expected returns supported by strong global demand for commodities and improving domestic demand. CEEMEA has fewer appealing prospects, offering lower expected returns and higher volatility.

Another tailwind for EM economies outside of China is the ascent of the consumer, which is visible in the composition of equity indexes. This sector now accounts for about 70% of market capitalization, up from around 50% two decades ago. The rise of the EM consumer, and with it domestic demand, is consistent with an improvement in the quality of expected returns and a decline in market volatility—tertiary sectors exhibit less cyclicality than commodities and manufacturing.

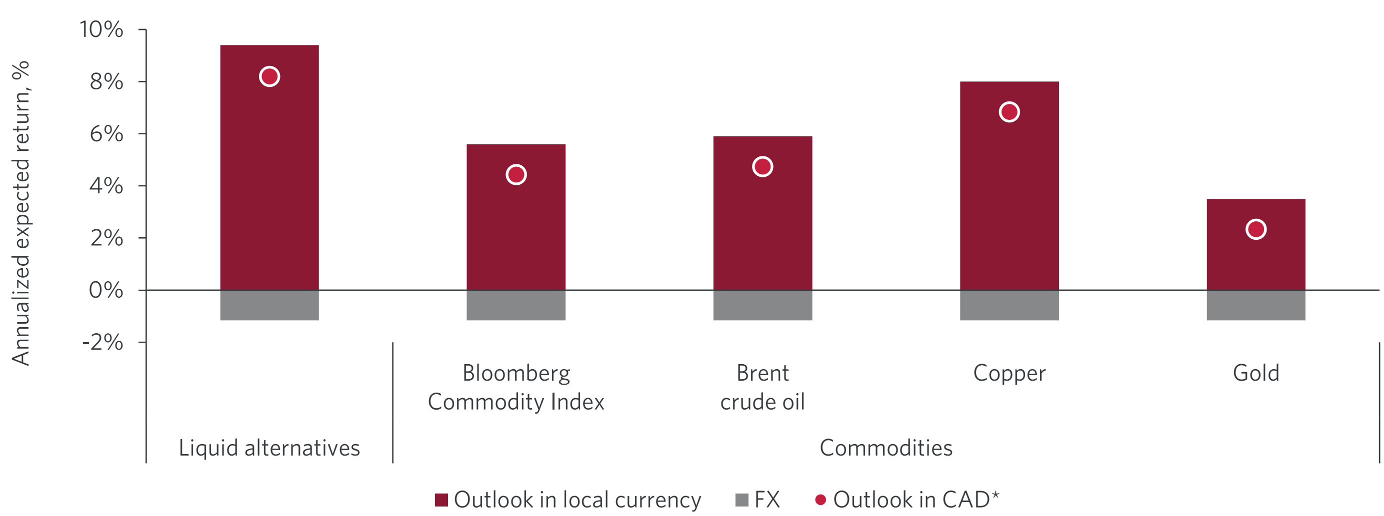
Annualized expected returns for the Chinese equity market, at 5.3% in Canadian dollar terms, are much lower. This relatively weak outlook is driven by declining potential economic growth and, to a lesser extent, reduced access to US technology for certain software and semiconductor technologies. There is a risk China could move up the semiconductor value chain at an increasing pace and secure a much more dominant position among EV-producing countries. However, we consider the balance of risks to be skewed to the downside for foreign investors for the following reasons:

- Weak housing activity and declining potential growth could adversely impact the profitability of state-owned enterprises by more than expected. These firms, which account for about half of Chinese market capitalization,[10] are generally more exposed to domestic demand and are about 20% less productive on average than private firms in the same sector.[11]
- Several Chinese companies are facing long-term risks from sanctions and index exclusion. The US House of Representatives Select Committee on the Strategic Competition Between the United States and the Chinese Communist Party (CCP) has flagged several listed Chinese companies that are tied to companies contributing directing or indirectly to "develop and build weapons for the People's Liberation Army (PLA) and which advance the CCP's stated mission of technological supremacy."[12] Flagged companies account for about 5% of the value of A-shares, and the Select Committee considers this to be the tip of the iceberg.
- In addition, China provides important subsidies to its successful electric vehicle manufacturing ecosystem. This poses geopolitical risks, and both the US and EU could impose tariffs. The US Select Committee has already recommended an increase in tariffs, and the Economist Intelligence Unit sees tariffs in the EU as inevitable.[13,14]
- Reflecting all these factors, we expect Chinese stocks to become more volatile.

Liquid alternatives and commodities[15]

Liquid alternative strategies implement diversifying long/short positions exclusively in public markets, using similar investment strategies to hedge funds but with more stringent regulation that includes a requirement to offer investors daily liquidity. This combination of diversification and liquidity makes them an attractive addition to investor portfolios. We assume an annualized expected return of 5% plus cash (Chart 6). This is the standard return target of investment strategies in this asset class and is broadly consistent with historical experience.

Chart 6: Liquid alternatives and commodities, long-term expected returns, % (CAD)



Source: Calculated by CIBC Asset Management Inc. using data from the following third-party service providers: Bloomberg and LSEG Datastream. Calculations based on data available as of December 31, 2023. Total return data expressed in Canadian dollars.

With the exception of copper, commodities offer much lower annualized expected returns and are more volatile than other alternatives. However, they also offer an (imperfect) hedge against inflation. Annualized expected returns to the Bloomberg Commodity Index are reduced because of the small expected increase in the price of gold. As a non-interest-bearing asset, gold generally underperforms in higher interest rate environments. Box 2 provides technical details underpinning our outlook for commodities.

Box 2: Technical details underpinning our expected return outlook for commodities

Brent crude oil: Our expected return methodology assumes non-OECD oil spending gradually rises to an equilibrium of 5% of GDP. We expect OECD demand to remain flat, consistent with the average of the last 15 years. In this scenario, the price of Brent crude oil is expected to rise at an annualized rate of 6%.

LME copper: We assume the ratio of LME copper to Brent crude oil prices rises to 120, which is above the historical norm (100) and reflects the transition away from fossil fuels towards greener, copper-intensive alternatives. In this scenario, the price of copper rises at an annualized rate of 8.0%.

Gold: We assume that the ratio of gold to Brent crude oil prices declines to 16.5, which is below the historical norm (18.0) and reflects the higher interest-rate environment (gold is a non-interest-bearing asset). Our target is more in line with the experience of the 1990s. In this scenario, the price of gold rises at an annualized rate of 3.5%.

Bloomberg Commodity Index: We assume the ratio of this index to Brent crude oil prices declines to 6.0, which is above the historical norm (5.3) and reflects the outperformance of industrial metals. In this scenario, the index rises at an annualized rate of 5.6%.

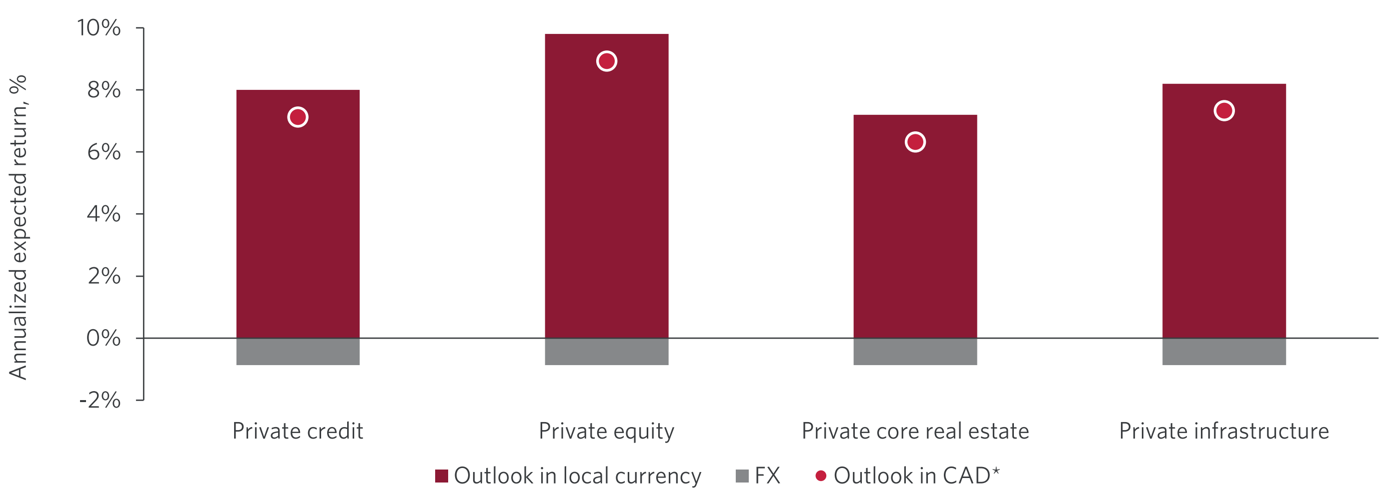
Private market alternatives

Private market alternatives should be viewed as complements, not substitutes, to traditional public market asset classes. Each one offers distinct attributes to investors, and the elevated annualized expected returns relative to PMEs reflect distinct risk premiums. Private equity offers the potential for enhanced expected returns relative to public equity, as a reward for illiquidity and complexity. Private credit provides investors with an enhanced expected yield relative to bank loans or high-yield bonds. In the case of direct lending strategies, it also offers floating interest rates, which provide the ability to better hedge against rising interest rate risk. The eclectic mix of sectors and structures encompassed by this asset class may also provide diversification benefits. Real estate and infrastructure offer the possibility of steady income streams in strategies that emphasize the quality of assets. In addition, these assets may provide a greater ability to hedge inflation risks, particularly in sectors where rent or toll resets occur frequently and the threat of substitution is low.

Private credit, private core real estate and private infrastructure all offer bond-like income streams and an illiquidity risk premium. Annualized expected returns range between 6.3% and 7.3% in Canadian-dollar terms (Chart 7 and Appendix 1). The annualized expected return to private equity is higher, at 8.9%. For all private alternatives, we assume 75% investment in the US and 25% in Canada. This introduces a negative currency impact, given the overvalued USD.

Listed REITs and infrastructure are projected to provide higher annualized expected returns than their private counterparts, but they are less attractive on a risk-adjusted basis.

Chart 7: Private alternatives, long-term expected returns, % (CAD)



Source: Calculated by CIBC Asset Management Inc. using data from the following third-party providers: Bloomberg, LSEG Datastream and PitchBook. Calculations based on data available as of December 31, 2023.
*Assumes 75% investment in the US and 25% in Canada. Total return data expressed in Canadian dollars.

Balanced Portfolio

Reflecting the outlook for its various components, the 10-year annualized expected return for a representative Balanced Portfolio appears relatively attractive. Assuming a well-diversified allocation to public fixed income, public equity markets, and a mix of liquid and private market alternatives, we expect this portfolio to deliver an annualized return of 5.9%.[16] This is about 0.5 percentage points higher than our expectation in last year's outlook report, although it is a little below the historical average of the past 10 years. This expected return can be further enhanced by allocating, as appropriate, to actively managed investment strategies—our analysis in this report excludes potential alpha returns from manager skill—and tactical asset allocation, as well as informed manager fulfillment.

3. Long-term themes

Trend GDP growth winners and losers

The outlook for trend GDP growth is an important input into our assessment of long-term asset market returns. Several themes are likely to influence the path of trend growth in the next 10 years. Here, we focus on two in particular: Sino-US economic and political tensions, and the energy transition. In a majority of affected countries, these themes will represent tailwinds that boost trend growth and local asset class returns. In China, however, these themes conflict. Geopolitical tensions and strategic competition with the US will likely present headwinds that dampen the country's potential growth rate and reduce the attractiveness of domestic assets. Meanwhile, the energy transition will be more supportive and should partially mitigate any headwinds.

Persistent Sino-US economic and political tensions, and the strategic competition and friendshoring they trigger, are likely to positively impact trend GDP growth in several countries (see Box 3). Principal beneficiaries in Asia will likely include Japan, Korea, Taiwan, India, the Philippines, Vietnam and Thailand. In the Americas, the US, Mexico and, to a lesser extent, Canada are also expected to experience a boost to trend GDP growth. For all these countries, the improvement will primarily result from sustained, and often subsidized, investment spending in high-tech, AI, military infrastructure, supply-chain resiliency and rare earth mining, all intended to reduce excessive economic reliance on China. Investment spending to protect domestic industries from Chinese subsidies and unfair trading practices, and to deter China's expansionary goals, will also likely be supportive. In contrast, heightened economic and geopolitical risk will likely represent a persistent headwind to trend GDP growth in China. Foreign direct investment into the country has already weakened sharply (Chart 8).

Chart 8: Foreign direct investment into China has weakened

Source: Information prepared by CIBC Asset Management Inc. using data from the following third-party service providers: Bloomberg and LSEG Datastream. Data as of January 17, 2024.

Evidence of US high-tech manufacturing tailwinds are already apparent, set in motion by the 2022 CHIPS (Creating Helpful Incentives to Produce Semiconductors) Act (Chart 9). These tailwinds are likely to continue as the US looks to counter China's aspirations to build an AI-focused world-class military.[17] Using Stanford and PitchBook data, we estimate that AI has already contributed almost 0.1 percentage points to US GDP growth per year since 2020, as a result of booming defence investment in intellectual property products (Chart 10).[18] We also expect substantial long-term upside for US investment in robotics as the country seeks to catch up to China. In 2021, China installed almost 270 thousand industrial robots, almost eight times more than the US.[19]

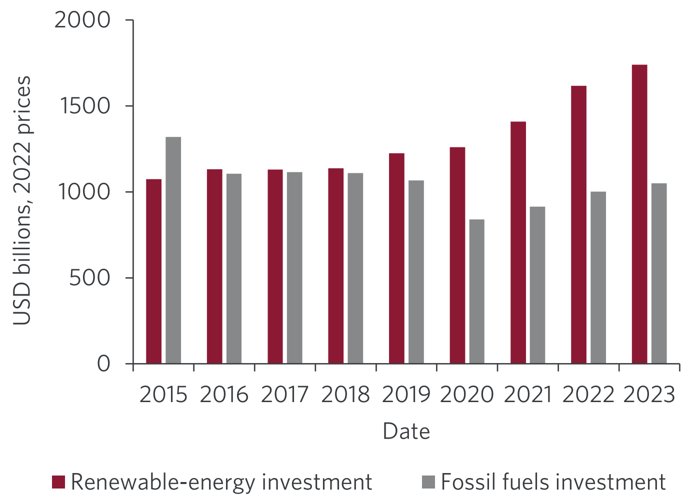
Chart 9: US manufacturing construction booms

Source: Information prepared by CIBC Asset Management Inc. using data from the following third-party service providers: Bloomberg and LSEG Datastream. Data as of January 17, 2024.

Chart 10: US defence spending sees upside after decade of underinvestment

Source: Information prepared by CIBC Asset Management Inc. using data from the following third-party service provider: LSEG Datastream. Data as of January 17, 2024.

Chart 11: Global investment in renewable-energy infrastructure rising strongly



Source: Information prepared by CIBC Asset Management Inc. using data from the following third-party provider: IEA. Data as of January 17, 2024.

Binding supply-side constraints and elevated labour costs will likely limit the extent of US manufacturing investment and reshoring, as well as the resulting improvement in trend US GDP growth.[20] This suggests that a substantial proportion of pro-growth tailwinds will likely be realized outside the US, in allies, trusted partners or countries that share aligned interests. Tailwinds are also already visible in Asia. Japan has begun to adopt major new industrial policies with the objective of restoring the international competitiveness of its semiconductor industry.[21] In India, Foxconn, Apple's most important manufacturing partner, has set aside nearly $3 billion to construct a new factory.[22] India now manufactures about 7% of all iPhones, tripling production in the last fiscal year.[23] On the geopolitical front, Japan, Korea and the Philippines have all signalled a long-term commitment to higher defence spending as a share of GDP. For example, Japan has announced its intention to double its military spending to 2% of GDP by 2027,[24] increased its military and diplomatic collaboration with the Philippines,[25] and resumed high-level strategic talks with Korea that have been stalled since 2016.[26]

The renewable-energy transition is another investment-intensive force supportive of trend growth and local asset returns in many countries. Total global annual investment in green energy has already surpassed fossil fuels and could become an increasingly important driver of GDP growth (Chart 11). The Bank for International Settlements (BIS) estimates a contribution to annual global GDP growth of 0.1 percentage point or more per year for the rest of this decade.[27] The impact should be more substantial for countries extracting mining inputs needed to produce batteries and renewable-energy equipment, including Chile, Peru, South Africa, Indonesia, Australia and, potentially, Brazil.

The energy transition is also a tailwind to Chinese trend GDP growth, as China is by far the biggest producer of renewable-energy equipment and electric vehicles. It is also the country with the most substantial increase in new renewable-energy capacity. According to the IEA, China accounts for almost 60% of new renewable capacity expected to become operational globally by 2028.[28] Our constructive outlook for trend GDP growth in several DM economies includes two additional investment tailwinds. First, we expect an infrastructure investment gap. According to the American Society of Civil Engineers, a substantial proportion of US infrastructure is reaching the end of its lifespan. To close this gap implies a need for investment spending equivalent to nearly 10% of GDP in the next 10 years.[29] This problem also exists in other developed economies. Second, insufficient housing in North America and Australia suggests investment in this sector should grow, on average, at a higher pace in the next few years.

Box 3: Three facets of Sino-US tensions expected to drive stronger investment spending

1. **Security risks**: In Washington, there is a bipartisan consensus that China, under President Xi Jinping, will present national security risks for the foreseeable future. President Xi has already removed term limits and achieved an unprecedented concentration of power. China has become more assertive in its long-term territorial expansion objectives, including with respect to Taiwan, territorial waters of the Philippines, Malaysia, Indonesia, Vietnam and several Japanese Islands (Senkaku).[30],[31] Another concern is the growing influence of the Chinese Communist Party cells in corporate decisions of foreign companies located in China. This influence could facilitate the transfer and assimilation of foreign technology in Chinese military equipment.[32,33]

2. **Economic de-risking**: Washington seeks to reduce its economic exposure to China. Most efforts seek "to curb China's access to top-notch US innovation, thereby preventing Chinese firms from using US know-how to climb the innovation ladder,"[34] minimizing its ability to become a global technology leader and a stronger military power. Given the massive financial support provided by Beijing to its industrial base and technology development, a successful de-risking strategy will require ongoing fiscal support from Washington, as well as coordination with allies and private companies, to incentivize and coordinate technology investment. Less exposure to China also requires efforts to reduce excessive reliance on Chinese supply chains in sectors that are strategically important for national security, such as rare earth elements that are key inputs for technology, military equipment and weapons.

3. **Deterrence**: According to its Department of Defense, the US is "laser-focused on deterring conflict in the Indo-Pacific as China doubles down on its efforts to boost its military power."[35] Deterring China's territorial ambitions is considered important for geopolitical stability, technology dominance, free passage of vessels in international waters and, ultimately, national security.

   Defence treaties mean the US has an obligation to defend Japan and the Philippines if they are attacked. The challenge is that China's military capacities have increased materially. China has the world's largest naval force, mostly consisting of modern multi-mission ships and submarines,[36] and is the world's leading exporter of combat drones.[37] Its hypersonic missiles could threaten US power in the Pacific.[38]

   At the same time, the war in Ukraine has exposed vulnerabilities in NATO's defence sector industrial base, with members running out of ammunition to supply Ukraine.[39] Also, a second Trump presidency would present a risk that the US will not make good on its defence commitments to allies. Former US President Trump, who is currently a Republican presidential candidate, said in February 2024 he had warned NATO allies he would encourage Russia to do "whatever the hell they want" if alliance members failed to meet the 2% of GDP defence-spending targets.[40]

Inflation: Down but not completely out

The low-inflation decade that followed the 2008 global financial crisis was a historical outlier. Our 10-year outlook has inflation hovering around or moderately above central bank targets in a majority of countries, reflecting a combination of positive demand and negative supply shocks (Table 2).

On the demand side, the investment tailwinds discussed in the previous section should keep trend GDP growth somewhat above potential in several countries, resulting in positive output gaps and upward pressure on inflation. Relevant supply factors are related to the energy transition and ageing population.

Table 2: Long-term economic outlook for selected economies, %

Developed economies	Trend GDP growth Next 10-year average	Inflation Next 10-year average	Inflation Target	Long-term policy rate target*	10y yield long-term fair value*
US	2.20	2.30	2.00	3.25-3.50	4.10
Canada	2.10	2.10	2.00	3.00-3.25	3.60
Eurozone**	1.00	1.90	1.90	2.25-2.75	3.30
UK	1.40	2.20	2.00	3.25-3.50	4.00
Japan	0.80	0.80	2.00	0.50-0.75	1.20
Australia	2.70	2.70	2.50	3.50-3.75	4.20

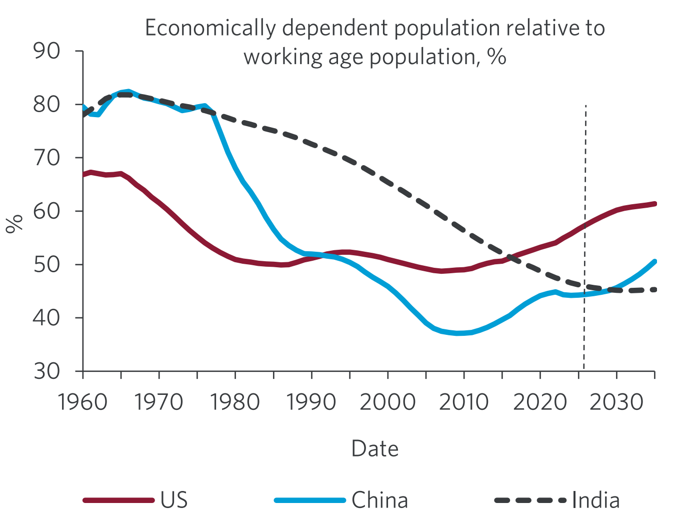
Emerging economies	Trend GDP growth Next 10-year average	Inflation Next 10-year average	Inflation Target	Long-term policy rate target*	10y yield long-term fair value*
EM Asia ex. China**	5.40	3.60	3.30	4.90	5.80
China	3.70	1.30	3.00	2.70	3.30
Latin America**	2.60	3.30	2.90	6.90	8.60
CEEMEA**	1.90	5.80	3.80	6.80	9.80

Source: Information prepared by CIBC Asset Management Inc. using data from the following third-party service providers: Bloomberg and LSEG Datastream. Projections based on data available as of December 31, 2023. *CIBC Asset Management's long-term equilibrium estimates. **GDP-weighted composite of member economies.

Notwithstanding the ongoing transition away from fossil fuels, our strong growth outlook for several EM countries should keep energy inflation close to its historical average. We expect oil prices to increase by an annualized 6% over the next 10 years. This is well above the 1% seen in the 2010s, although still below the nearly 10% average increase observed in previous decades. Higher trend energy inflation, as well as spillovers to food prices, should raise trend inflation by about 0.1 percentage points per year in DM economies and 0.3 percentage points in EM economies, on average.

Ageing populations, most prevalent in DM countries, also suggest higher trend inflation.[41] Projections by the United Nations suggest the US dependency ratio will reach levels in the next decade last seen in the 1960s (Chart 12). AI adoption is likely to mitigate the inflationary effects of tighter DM labour markets, reflecting a partial automation of low value-add tasks, but not until towards the end of the next decade. On net, we expect ageing to increase trend inflation by about 0.2 percentage points across DM countries. In contrast, for most EM countries, excluding China, dependency ratios are projected to remain low and stable, dampening inflation in some countries.

Chart 12: Ageing to result in rising dependent populations and increasing labour shortages

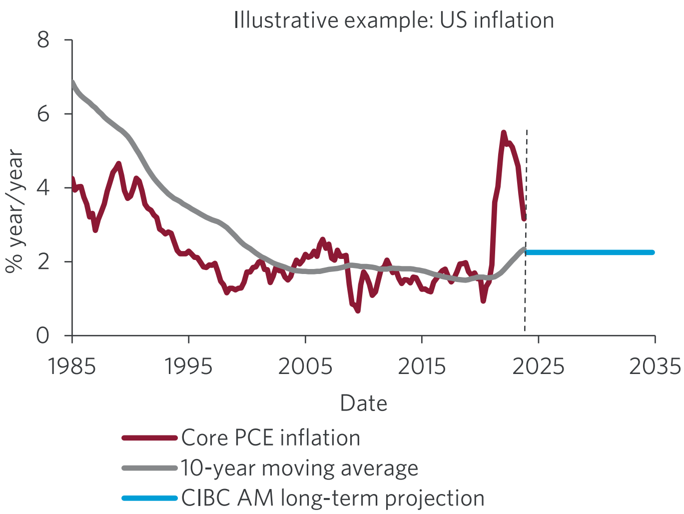


Source: Information prepared by CIBC Asset Management Inc. using data from the following third-party service providers: LSEG Datastream and United Nations projections. Data as of January 17, 2024. The economically dependent population is the sum of the under-15 and over-65 cohorts.

Another factor likely to keep average inflation rates moderately above policy targets in several countries, including the US, is a positive implicit policy choice in favour of growth by central banks. In the context of strong and inelastic investment demand, we expect central banks to face relatively high sacrifice ratios, defined as the output costs of reducing inflation with higher policy rates. As a result, bringing inflation back to target in the face of demand and supply shocks would require central banks in these economies to impose a more substantial constraint on growth. This would likely be accompanied by important risks to financial stability, fiscal deficits and debt, and political stability in the context of rising populism. Instead, we expect central banks to tolerate inflation moderately above target.

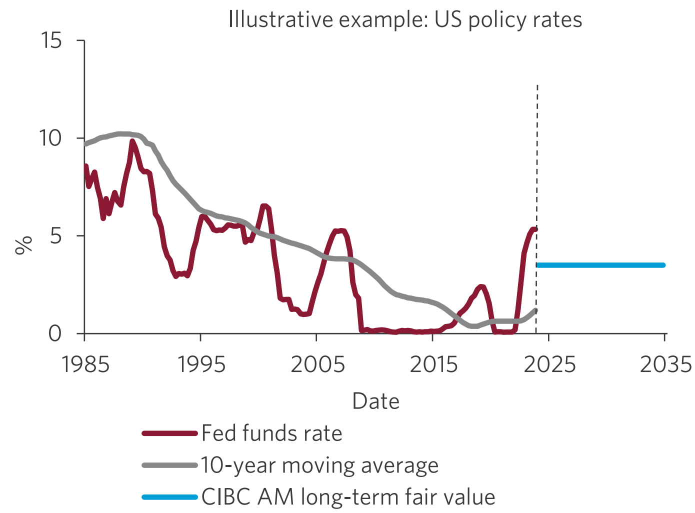
Reflecting these various factors, we expect US annual inflation to average 2.3%, as measured by the Federal Reserve's (Fed) preferred core Personal Consumption Expenditures (PCE) Price deflator (Chart 13; inflation as measure by core PCE is typically 0.4% lower than the core Consumer Price Index). This would be above the Fed's 2% target but similar to outcomes since the mid-2000s. We also expect inflation to run above target on average in several other DM economies, including the UK, Australia and Canada. In contrast, average inflation in the euro area will likely remain close to target, reflecting weaker investment tailwinds. For Japan, despite important investment tailwinds, unanchored inflation expectations and an expected continued inability to foster sufficient consumption demand to achieve escape velocity likely means that inflation will remain well below the central bank's target over the next 10 years on average.

Chart 13: Inflation to remain above target over next 10 years



Source: Information calculated by CIBC Asset Management Inc. using data from the following third-party service provider: Bloomberg. Data as of January 17, 2024. PCE: Personal Consumption Expenditures. Core inflation excludes volatile food and energy prices.

Chart 14: Limited downside for policy rates over next 10 years



Source: Information prepared by CIBC Asset Management Inc. using data from the following third-party service provider: Bloomberg. Data as of January 17, 2024.

Interest rates and bond yields: Back to the 2000s, not the 2010s

Policy rates

Reflecting the various investment tailwinds and inflation factors discussed earlier, we expect policy interest rates in most countries to remain elevated compared to the last 10 years. A return to levels that held in the 2000s before the global financial crisis seems much more likely. In the US, we expect the Fed's long-term neutral nominal policy rate—at which the domestic economy is in balance and inflation pressures are neither rising or falling—to settle in the range 3.25% to 3.50% (Chart 14 and Table 2). This is above the Fed's current assumption of 2.50%.

Our long-term policy rate outlook can be separated into a real policy rate—which we estimate to lie in the region of 1.00% to 1.25%—and an expected average inflation rate of 2.3%. While our estimated real policy rate is close to the historical average, it is low compared to the 2.00% rate observed between 1995 and 2007, a period during which investment growth was strong and the output gap was positive. As noted previously, we expect the Fed and several other central banks, facing a higher sacrifice ratio in coming years, to tolerate inflation moderately above target by maintaining a less hawkish policy stance.

Elsewhere, we project long-term policy rates at or above 3% in Canada, Australia and the UK, which also marks a return to the 2000s. Reflecting lower trend growth and weaker inflation dynamics, we project neutral nominal policy rates of 2.5% to 2.75% for the euro area and 0.5% to 0.75% for Japan. In contrast, for most EM countries, we expect neutral nominal policy rates at or above 4.5% over the next 10 years, consistent with higher trend growth than their DM counterparts.

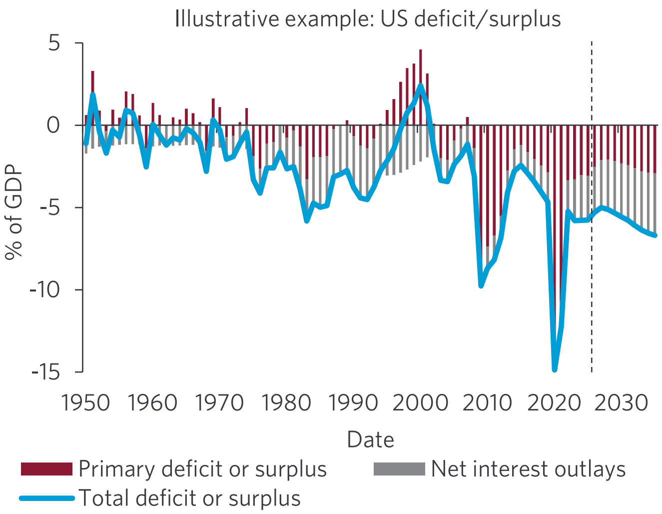
In China, the neutral policy rate is expected to be 2.7%. This is weak by historical Chinese standards and much lower than other EM economies. A low long-term policy rate in China is symptomatic of several structural growth impediments, including:

- Excessive leveraging of non-profitable local government financing vehicles, households and banks
- An excess supply of housing outside tier-1 cities in the context of a declining population
- Geopolitical headwinds that make it more difficult to attract high-end foreign technology and investment
- Double-digit fiscal deficits that will likely require higher taxes
- A negative output gap that will likely take years to close

Term premiums

Alongside neutral policy interest rates, another key component of equilibrium bond yields is the term premium. This compensates investors for accepting duration risk. It is predominantly driven by forces impacting the supply and demand of capital. As discussed earlier, these include adverse demographic trends that will reduce the flow of new savings and result in a more elevated cost of capital. On the demand side, the projected persistence of US fiscal deficits, along with above-trend investment spending, should increase the demand for savings, also placing upward pressure on the cost of capital (Chart 15).

Chart 15: Fiscal policy represents a drain on available savings pool

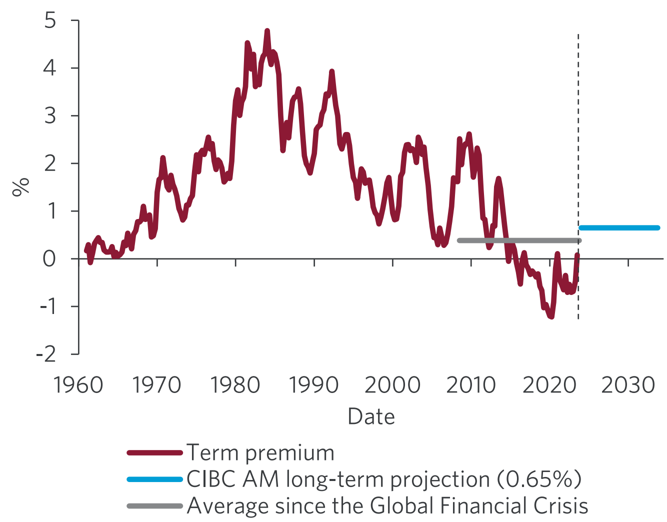


Source: Information prepared by CIBC Asset Management Inc. using data from the following third-party provider: US Congressional Budget Office. Data as of January 17, 2024.

We expect an average US term premium of 65 basis points over the next 10 years. This is higher than recent years but still low by historical standards (Chart 16). The Fed's balance sheet will likely remain an important dampening factor. For several years, in an effort to transition the US economy away from the immediate post-financial-crisis era, the Fed engaged in quantitative easing. This involved large-scale purchases of government bonds, which resulted in a substantial increase in the size of the Fed's balance sheet and broke the relationship between the term premium and fiscal deficits. Although the Fed has now transitioned from quantitative easing to quantitative tightening, its balance sheet will likely remain large for the foreseeable future.

Our term premium estimates in other countries are impacted by the same factors as the US.

Chart 16: Term premium to see upside pressure



Source: Information prepared by CIBC Asset Management Inc. using the following third-party service providers data: Bloomberg and LSEG Datastream. Data as of January 17, 2024. Dissavers: Population older than 65. Super savers: Population between ages 45 and 65.

Equilibrium 10-year government yields

Our long-term equilibrium estimate for the 10-year nominal US bond yield is 4.1% (Table 2). This is calculated as a combination of the neutral nominal policy rate, the term premium and a country-risk premium (which is close to zero in DM countries). Our estimated equilibrium yield for the US is a little above the Congressional Budget Office's 3.8% projection. The difference can be explained by our stronger outlook for the long-term neutral policy rate. Despite the expectation of persistently large US fiscal deficits, our equilibrium bond yield is below our expected nominal GDP growth rate of around 4.5%, based on a still-low term premium. This wedge is a positive long-term force for local US equity returns, as well as US fiscal sustainability.

Outside the US, our 10-year equilibrium bond yield estimates are based on country-specific risk and term premiums. We project equilibrium 10-year government yields in most DM countries to lie within the 3% to 4% range. Outliers include Australia (4.2%) and Japan (1.2%), with the latter's yield being depressed by ongoing financial repression by the Bank of Japan. Italy (4.0%), with its low potential growth, high debt and elderly population, presents a fiscal tail risk to the euro area.

Our equilibrium yield projections are higher in EM countries, consistent with higher estimated trend GDP growth rates. They include a GDP-weighted yield near 6% in EM Asia excluding China, 6.4% in CEEMEA countries (excluding Turkey and Russia) and 8.6% in Latin America. China is the outlier at 3.3%, based on the structural weaknesses discussed earlier, low inflation and a small country-risk premium (most of China's elevated debt is internal). For the JP Morgan GBI-EM Global Diversified Composite Unhedged Bond Index, the implied equilibrium bond yield over the next 10 years is 6.6%.

Appendix 1: Long-term expected returns and volatility

Fixed income	CAD (%)	USD (%)	Vol. in CAD (%)***
Canada 2Y government index*	3.0%	3.0%	1.3%
Canada 10Y government index*	2.8%	2.8%	6.9%
FTSE Canada All Corporate Bond Index	5.0%	5.0%	5.5%
Canada FTSE Universe Index	3.5%	3.5%	5.2%
US money markets	3.4%	4.5%	0.0%
US 10Y government index*	2.6%	3.8%	10.9%
ICE BofA US Corporate Index	4.1%	5.3%	8.2%
ICE BofA US High Yield	4.5%	5.7%	7.1%
JP Morgan GBI Global Ex-Canada Unhedged	3.1%	3.0%	8.2%
JP Morgan GBI-EM LC Unhedged	7.2%	7.0%	7.7%

Equity	CAD (%)	USD (%)	Vol. in CAD (%)***
Canada S&P/TSX Composite Index	6.7%	6.7%	12.8%
US S&P 500 Index	5.8%	7.0%	12.3%
MSCI EAFE® Index	7.2%	6.9%	12.0%
MSCI Europe	6.6%	6.7%	13.3%
MSCI Japan	8.2%	6.4%	12.0%
MSCI Australia	8.0%	7.8%	16.8%
MSCI Emerging Markets Index	8.8%	8.0%	13.3%
MSCI EM ex China	10.2%	9.8%	13.9%
MSCI Emerging Asia	8.8%	7.9%	14.3%
MSCI Emerging Europe	8.4%	8.3%	40.4%
MSCI Emerging Latam	8.3%	9.2%	24.0%
MSCI China	5.3%	3.7%	23.8%
MSCI All Country World Index	6.5%	7.1%	11.4%

Alternatives	CAD (%)	USD (%)	Vol. in CAD (%)***
Private credit**	7.1%	8.3%	5.1%
Private equity**	8.9%	10.1%	9.4%
Core real estate**	6.3%	7.5%	7.9%
Private infrastructure**	7.3%	8.5%	9.1%
Dow Jones Brookfield Global Infrastructure	6.9%	8.1%	12.9%
FTSE EPRA NAREIT	8.2%	9.4%	19.0%
Liquid alternatives	8.2%	9.4%	8.0%
Bloomberg Commodity Index	4.4%	5.6%	17.0%
Crude oil (Brent)	4.7%	5.9%	35.0%
Copper	6.8%	8.0%	14.0%
Gold	2.3%	3.5%	17.0%

Source: Calculated by CIBC Asset Management Inc. using data from the following third-party providers: Bloomberg, LSEG Datastream and PitchBook. Calculations based on data available as of December 31, 2023. *Represents the expected return of a constant-maturity bond index that maintains a specific maturity by rebalancing every year, and which would be different from a buy-and-hold-to-maturity investment. **Assumes 75% investment in the US and 25% in Canada. *** Historical data. "EAFE" is a registered trademark of MSCI Inc., used under license.

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Authors

Eric Morin
Senior Research Analyst
Multi-Asset & Currency Management

Michael Sager, Ph.D.
Managing Director & Head
Multi-Asset & Currency Management

Francis Thivierge, M.Sc., CFA
Senior Portfolio Manager
Multi-Asset & Currency Management

Luc de la Durantaye
Vice Chair
CIBC Asset Management

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