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THE OPTICS OF 2021

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We look at 2021 thru two views, assigning each a probability, as best one can forecast in these COVID times.

Vaccine Success (75% Prob): This scenario gets the World successfully thru the winter flu season without total shutdowns. The vaccine gains popular acceptance of 70% plus, thus minimizing the COVID spread as we know it today. Business confidence builds in Q2 & Q3 2021 with upticks in GDP, earnings and lower unemployment. Bonds start pricing in a recovery with the yield curve steeping in late 2021 and into 2022. Higher yields will produce negative returns in bond portfolios. Emerging markets, with a focus on non-China US production countries, such as Vietnam, benefit. South America becomes a selective opportunity due to its demographics with economic growth expected in the latter part of the decade. We will watch for quality opportunities.

COVID Success (25% Prob): Not a good picture. However, we should see this develop, if it does by the middle of January. Increased death rate has the governments turning to increased shutdowns. Fear and protest rallies all result in slowdown in GDP and earnings. Interest rate decline, stimulus not effective and a min of 10% market correction. Key support zones for the S&P 500 (today close to 3700) are 3200, 2800 the March 2020 lows of 2200.

Given the “vaccine rally” since the beginning of Nov 2020, we approach the new year with cautious optimism. We believe it is likely human behavior will find it hard to stay apart thru the holidays. Thus, we maintain our high-quality names, with target sells should our support zones be broken.

Philosophy: Tow kinds of losses, loss of capital and loss of opportunity. If we maintain the capital, there is always another opportunity.

Favoured Sectors:

- Banks: Global Banks have surprised in the latter half of 2020. We believe they should do well over 2021 – 2023, for the following reasons:
  - Loan Growth: Personal loan growth is increasing. Business loans are down, but the rate of change is declining. We look for a positive growth in business loans in Q2 2021.
  - Loan Loss: The Cdn Banks took loan loss provisions in early 2020. However, the losses have not materialized as provisioned for. We believe if this trend continues, the funds set aside could be brought back into earnings in the latter half of 2021.
  - Capital Ratios: The Cdn Bank capital ratios are all in great shape. Actually better than pre-Covid times. This will allow for dividend increases in 2021. We also look for acquisitions into 2022 particularly in US expansion.
  - Valuation Multiples: very attractive now, especially as we look out into 2022-2023 and anticipate a rising interest rate environment.
- Technology: Keeping an eye on rotation within the sector. We like exposure to 5G, Asia large tech names, various semiconductors.
- Gold: A protection from the vast money supply & country debt that the global stimulus has caused. We monitor a breakdown of 1700 which is the 2019 uptrend line.
- Base Metals & Materials: Copper should benefit from the Asia growth as well the huge shift coming in this decade to electric cars and more. Copper has had a wonderful rally off 2.50 area, currently at 3.50 area. We believe it will stabilize around the 350-380 area for now. We participated in this rally via three stocks, Southern Copper, Rio Tinto and BHP. Dec 18th, we exited Southern Copper as the valuation became extended in the view of JP Morgan research. Trading in the high 30s price to earnings, with our position up 60% plus. We maintain BHP and RIO as their valuations today are still reasonable.

AN INTRODUCTION TO CBDCs

Bipan Rai, North America Head, FX Strategy, CIBC Capital Markets

When was the last time you used physical cash and/or coins to pay for your coffee? Or for your groceries? How frequently do you use cash or coins to pay for your purchases now relative to the past?

We'll wager to say that your response to the first two questions is somewhere along the lines of "it's been a while", and that your use of cash has dwindled over the years. Going a step further, you might be one of many that are now turning to sources of private digital money or alternative payment methods. And that is a concern for central banks.

Money is a public good, and its been the responsibility of central banks to provide money to the public for hundreds of years as part of its policy objectives. But as the world continues to evolve, so too are the methods in which monetary transactions are being conducted in the real economy. As such, central banks are finding that it is now crucial to evolve the manner in which they provide money as well. One of the ideas they've come across is the idea of 'Central Bank Digital Currency' (or a CBDC). With no intention of hyperbole on our part, CBDCs have the potential to be the most important monetary development since the dawn of the fiat currency era.

The purpose of this note is to provide a quick introduction to CBDCs, why central banks are pursuing them, what the risks are and what it means for markets going forward.

Research in this space is very young and there's still lots of uncertainty with respect to how each central bank will approach the design of CBDCs. For now, we're in the 'hypothetical stage' and as a baseline, we're using the report from the Bank for International Settlements (BIS)i which was done in collaboration with seven other major central banks a few months back as a reference.

THE ABCDs OF CBDC

Ok, so what is a Central Bank Digital Currency?

A CBDC is a conceptual digital form of a fiat currency that is currently being researched and developed by central banks globally. Each CBDC will be issued by a country's central bank, and like the other forms of money, it will represent a claim on the central bank's assets.

CBDCs will also be denominated in the home currency. For instance, a CBDC issued in the US will still be denominated in USD, while one issued in Canada will be denominated in CAD - so there won't be any impact on the way that exchange rates are quoted. CBDCs will still have all the same functions of money (as a unit of account, medium of exchange and as a store of value). System and instrument features will vary depending upon each central bank's choice.

That sounds pretty similar to the system we have now – how is a CBDC different?

First, let's take a step back and examine the current system. Providing money to the public in most developed countries is the responsibility of the central bank.

Generally, central banks accomplish this task in two major ways while providing support for a third.

a.) The first is by making physical cash widely available. The $20 bill in your pocket is an example.

b.) The second is through the use of electronic central bank deposits (or central bank reserves). These are only available to qualifying financial institutions.

c.) The third is private money or electronic commercial bank deposits. Unlike the first two, these deposits aren't considered liabilities of the central bank. However, a central bank does support the infrastructure behind them.

CBDCs would represent a different form of 'money' from the above and would require a different system consisting of the central bank, operators, payment service providers and banks for distribution to end-users.

Importantly, the CBDC in each country should work in conjunction and complement the other forms of money mentioned above.

How are CBDCs different from Bitcoin, altcoins, tokens and other subcategories of cryptocurrencies?

Simple – CBDCs are issued by the state and have legal tender status in a country. Cryptocurrencies like Bitcoin, and Ether do not.

Unlike tokens, CBDCs will use their own ledger technology. But the specifics like whether the system will be centralized or decentralized will depend on each central bank's preference.

Why are central banks considering CBDC's in the first place?

Central banks have many mandates, but the two most important ones are monetary and financial stability. A growing risk in many economies is the ongoing digitalization of the economy and the methods in which people transact.

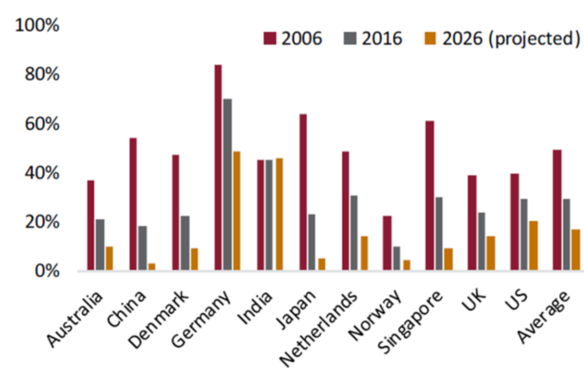
Indeed, an important problem for central banks now is that the use of cash is falling and being replaced by private 'digital money' and/or alternate payment methods. A greater concentration of transactions in the latter two represents a risk for many reasons including the fact that the private sector motivations are often at odds with a central bank's mandate.

For instance, commercial payment service providers (PSP) are generally private and have profit motives. Also, they use 'closed loop' systems that benefit from strong network effects. As such, the larger these network effects are, the greater the profitability for a PSP. This also increases the risk of concentration in the payment sector that could give way to monopolistic powers over time and lead to issues like financial exclusion and the protection of money as a public utility.

Another example would be the rise of cryptocurrencies (like Bitcoin, or Ether) and their increasing use in transactions. Significant public adoption of these types of currencies would severely curtail the impact of monetary policy or the ability to support financial stability.

A CBDC is one way to obviate these concerns and to ensure that all end-users have access to central bank money. The mechanics (and the underlying technology) on how it would work are still being investigated.

Chart 1 - The Share of Cash used in the Market is Falling



Source: IMF Working Paper WP/19/46[1]

What are the other motivations?

The primary motivations behind the design and adoption of a CBDC are as a means of payment, to enable greater access to central bank money in areas where cash is in decline (financial inclusion) and to provide resilience. The last point is very salient considering that if cash becomes marginalized, it also becomes less useful as a backup payment method if electronic systems cease to function.

Additional motivations are to:

Improve cross-border payments: This would require a collaborative approach between central banks to ensure that system designs are interoperable.

Increase payment diversity: CBDCs could provide a common mean to transfer between the different fragmented closed-loop systems of PSPs.

Support public policy: The BIS report concedes that a CBDC is unlikely to provide the same level of anonymity that cash does, and that the system will still be designed to combat illicit transactions, money laundering, terrorist financing, etc. A balance will need to be struck between maintaining some degree of privacy and reducing illegal activity.

Facilitate fiscal transfers: In a crisis, a government could use a CBDC to quickly transfer funds to the public and businesses in a crisis.

One point that the BIS report did emphasize is that the primary research motivation is for a CBDCs use of payment and that enhancing monetary policy would be viewed as a secondary motivation.

What are the design considerations for a CBDC?

The key features of a CBDC that the BIS report identifies include convertibility, convenience, availability and low cost. Within that, there are two main design choices that are under consideration:

i.) To make a CBDC that is more 'cash-like'.

ii.) To make a CBDC that is remunerated (or interest bearing).

Option i.) is the one that most central banks are considering at the moment. It appears to be the least disruptive to financial stability. The drawback here is that it doesn't have the features it needs to make it attractive enough to drive wide-scale adoption by the public.

Option ii.) might be a better way of driving adoption. It also has some advantages including the fact that a remunerated CBDC could more easily pass central bank rate decisions to the real economy and allow the public to hold significant amounts of CBDC. It would also allow a central bank to more easily stimulate aggregate demand through direct public transfers.

The major drawback with option ii.) is that it implies that it may lead to competition between commercial banks and the central bank in attracting private sector deposits (note that this could still happen under the first choice as well). This could lead to severe risks like a 'run to central bank money' that would disrupt the financial stability of an economy.

What are the major risks and challenges?

These include (but are not limited to):

a.) **Financial stability via disintermediation**: A remunerated CBDC is controversial because it would potentially introduce competition for private sector deposits between a central bank and the commercial banks in a country. In an extreme scenario, this could lead to a 'digital run to central bank money' and the need for commercial banks to tap wholesale markets for additional funding. In turn, that could restrict the credit supply in an economy.

One way that the BIS report suggests to address this risk is by imposing a cap or limit on individual holdings of a CBDC, or imposing tiered rates by volumes held. But those could create additional complications and calibration challenges for central banks and end users.

b.) **The line between fiscal and monetary policy**: Fiscal transfers under a CBDC would risk blurring the line between the two policies. Indeed, it could also lead to questions regarding a central bank's independence.

c.) **Foreign holdings of a CBDC**: A significant number of foreign holdings of a domestic CBDC could create additional problems including an increase in the volatility of exchange rates, 'digital dollarization', tax avoidance, and privacy concerns.

In designing the instrument and the system, central banks are researching possible ways to maximize the benefits driven by motivations while reducing the above risks.

How likely is it to happen?

The momentum is there to so with over 80% of central banks are currently engaged in investigating CBDCs. In fact, the major developed market central banks (Fed/BoE/ECB/BoJ/SNB/BoC/Riksbank) recently

The report also underlined that coordination of research/development between all parties was extremely important to address key risks of CBDCs (including spillover effects into cross-border payments).

Also, a few central banks (namely the PBoC) have already begun the testing phase for CBDCs in several areas.

How are Central Banks in the G-10 space tackling this?

All participating central banks are working together in developing CBDC's according to the following rules:

i.) CBDC's should not compromise monetary or financial stability.

ii.) CBDC's need to co-exist and complement existing forms of money.

iii.) CBDC's should promote innovation and efficiency.

That being said, design choices are driven by domestic circumstances and there is no 'one size fits all' approach for CBDCs.

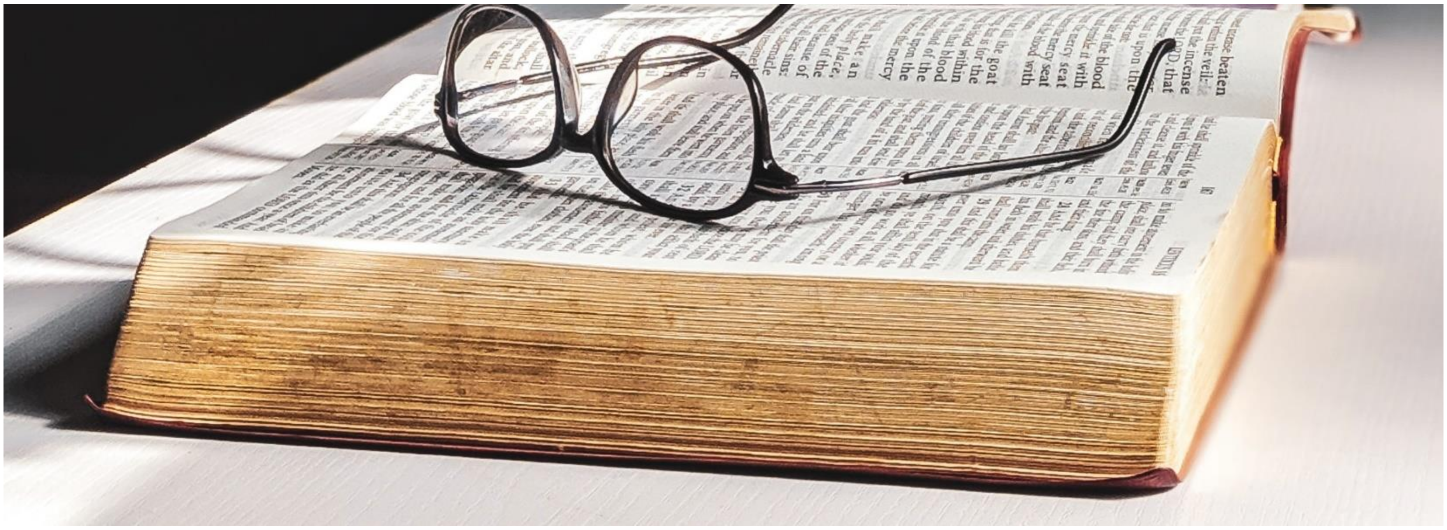
What are the takeaways for the market?

The biggest takeaway is that the CBDC will dent the appeal of the USD as a reserve currency going forward.

Remember that as a reserve currency, the USD has monopolistic characteristics. This characteristic primarily comes from the power of network effects. For instance, it is far easier for an Italian exporter to conduct trade with a South African importer using the USD than it would be using either the EUR or the ZAR. Over time, this effect has made the USD larger and cheaper to use than other currencies. An apt analogy would be in the world of search engines – the more that people/businesses that use Google, the more its utility increases.

The power of this 'network effect' is one of the reasons why central banks have kept USD in reserves in a greater proportion than that of its home country's trade with the US. For instance, it's estimated that the over 20% of global trade is conducted with the US, but over 60% of foreign exchange reserves are held in USD.

But one of the main motivations for researching CBDCs is to improve and enhance cross-border payments. An international system that is focused on improving interoperability between different countries could make cross-border payments more efficient. Over time, that potentially reduces the need to hold USD in reserve over time. Naturally, this would be bearish for the USD.



WHAT WE'RE READING

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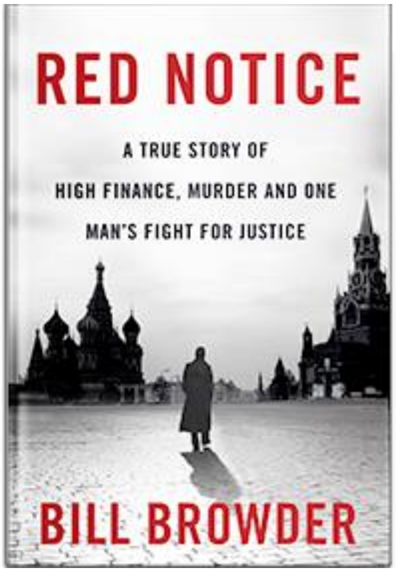
Sheldon Hines, Portfolio Manager, Hines Investments, CIBC Private Wealth Management

We would like to tell you about great books that we have read and believe you our readers will enjoy.

Red Notice is a real – life political thriller about an American born financier in the Wild East of Russia, the murder of his principled young attorney, and his dangerous mission to expose the people responsible in the Kremlin.



I read Red Notice a number of years ago. It reads like mystery fiction novel. I could not put it down. The most unbelievable aspect of this book is that it is all true. As I read the book, I could not believe that in today's world these events could actually happen, a real eye opener.

The great part that has come out of this book is the Magnitsky Act. This ACT imposes visa sanctions and asset freezes on those involved in gross human rights abusers. It has been globally adopted in 34 countries to date. The latest is the EU. Canada adopted this Act a few years ago.

For more information please visit:
www.billbrowder.com

If you do like Red Notice, keep an eye out for his follow up novel, Freezing Order due out in December 2021.

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