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MONTHLY FX OUTLOOK

January 23, 2012

CURRENCY STRATEGY HIGHLIGHTS

- Ongoing sovereign debt concerns have already contributed to one leg down in the euro. Commodity currencies such as the loonie have performed better but could see near-term downward pressure, with US and emerging market growth likely to downshift.
- In Brazil we now see the real stabilizing close to current levels in the near-term, but a gradual weakening starting in H2 2012. In Mexico high inflation and decent economic growth, combined with significant currency undervaluation, should drive a peso rally until mid-April.

EVENTS TO WATCH IN COMING MONTH

- **Summitting up details of fiscal union:** The upcoming euro summit on January 30th looks increasingly unlikely to tie up all the loose ends surrounding the plans for fiscal union promised at the December 9th resolution. With details of the Greek haircut also yet to be fully finalised, disappointment regarding progress could result in further euro depreciation.
- **Interest-ing new forecasts?** January's FOMC decision and updated economic forecasts (January 25th) will be the first to publish members' projections for the path of interest rates. The central tendency of those forecasts will likely suggest rates being kept on hold for longer than the current promise of mid-2013, and could become an important tool for monetary policy communications in the future.

CURRENCY OUTLOOK

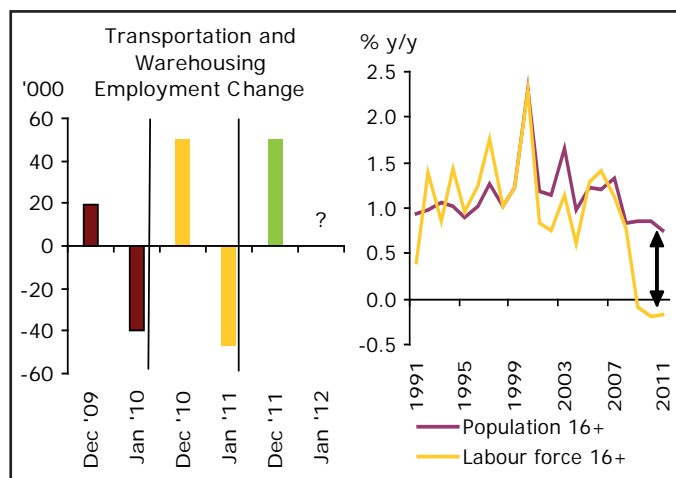
End of period:	19-Jan-12	2012 I	2012 II	2012 III	2012 IV	2013 I	2013 II
US\$ Rates:							
USDCAD	1.01	1.04	1.06	1.01	1.00	1.01	1.02
EURUSD	1.30	1.24	1.23	1.29	1.33	1.35	1.38
USDJPY	77	77	77	75	74	74	73
GBPUSD	1.55	1.51	1.50	1.56	1.60	1.63	1.66
USDCHF	0.93	0.98	1.00	0.96	0.94	0.94	0.93
AUDUSD	1.04	0.98	0.95	0.97	0.98	0.99	0.99
USDBRL	1.77	1.81	1.82	1.84	1.83	1.85	1.89
USDMXN	13.22	12.95	12.55	12.45	12.10	12.40	12.71
USDKRW	1137	1210	1230	1250	1250	1225	1200
USDCNY	6.32	6.20	6.15	6.10	6.05	6.00	5.95
USDSGD	1.27	1.35	1.38	1.41	1.44	1.40	1.35
Other Crosses:							
CADJPY	76	74	73	74	74	73	72
AUDCAD	1.05	1.02	1.01	0.98	0.98	1.00	1.01
GBPCAD	1.57	1.57	1.59	1.58	1.60	1.64	1.70
EURCAD	1.31	1.29	1.30	1.30	1.33	1.36	1.41
EURJPY	100	95	95	97	98	100	101
EURGBP	0.84	0.82	0.82	0.83	0.83	0.83	0.83
EURCHF	1.21	1.21	1.23	1.24	1.25	1.27	1.28

US a Source of Near-term Stability

From zero to hero, the US economy has gone from appearing close to recession six months ago to posting annualized growth of around 3% in Q4 2011. Although the underlying trend remains one of circa 2% growth, that tops the pace in many other developed nations, particularly within troubled Europe. As a result, the US\$ has seen continued support over the past month, most notably against European currencies. Recent better news regarding US labour market conditions—so long the Achilles' heel of the recovery—and continued troubles in Europe will likely lend further support to the dollar during the first half of 2012.

However, there remain headwinds which could begin to weigh on the US\$ later this year and into 2013. First, the US labour market is still struggling. December's acceleration in payrolls growth appears to have been boosted by shifting seasonality, particularly within sectors such as transportation and storage (Chart 1, left). Meanwhile, a third successive annual decline in the civilian labour force was the main factor behind 2011's reduction in the unemployment rate (Chart 1, right). If the workforce had risen a mere 1%, average monthly increases in employment of 135K would have only been enough to keep unemployment stable. With weak labour force growth owing to demographic changes (implying weaker trend GDP growth) and lower labour force participation (implying unemployment could rise if workers return to the labour force), the recent decline in the jobless rate may not be supportive for the US\$ over a longer time horizon.

Chart 1 - Recent Cheer for the US Labour Market May be Premature



Source: BLS, CIBC

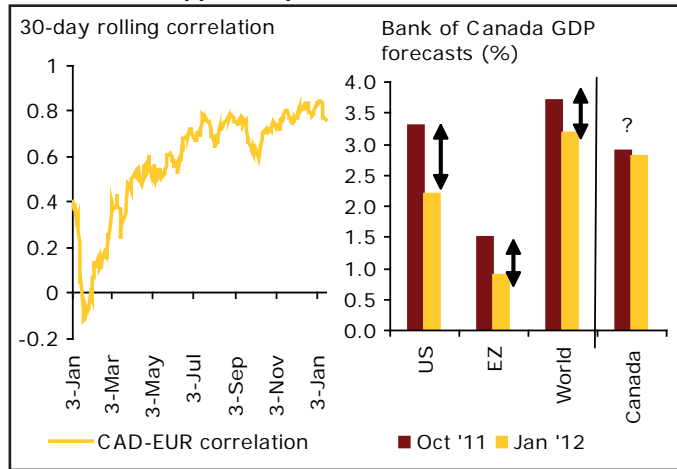
Second, the US will eventually be forced to take its fiscal medicine. While events in the euro area have in a way benefited US policy makers, taking the spotlight off the dire position of public finances stateside, ratings agencies and investors may only allow the can to be kicked so far down the road. Assuming the payrolls tax cut is extended for the entirety of 2012, the fiscal drag would begin in earnest in 2013, which risks economic growth next year underperforming this year's pace. Once that becomes more evident, the US\$ could well see renewed downward pressure.

Are the Shackles of Europe off the Loonie?

Commodity-linked currencies such as the C\$ have performed better over the past month in comparison to other risk-correlated currencies such as the euro and British pound. Signs of economic strength in the US and easing inflationary pressures in China, increasing the scope for monetary easing there, have supported the price of oil and other commodities despite the onset of recession in Europe. Stronger-than-expected growth, both at home and in the US, forced the BoC to revise up its growth forecasts in the latest Monetary Policy Report, lessening the likelihood of an imminent interest rate cut. However, the BoC's new forecasts remain cautious regarding the outlook, and although the 2012 forecast was revised higher, this largely reflected surprising strength towards the end of 2011. Events in Europe are still seen as a significant downside risk in the near-term.

While a simple recession in Europe should not prove much of a concern for the Canadian economy, given its limited direct trade exposure, the ongoing risk of a worst-case outcome (sovereign defaults causing a global banking crisis) could well weigh on sentiment towards the Canadian economy. Despite its outperformance so far this year, movements in the C\$ remain highly correlated with those of the euro (Chart 2, left). With upcoming data expected to show the eurozone already back in recession in Q4 2011, and given ongoing debate surrounding haircuts on Greek debt and details of a new fiscal union, events in Europe could apply modest downside pressure on the loonie during the first half of 2012. A further weakening in the domestic labour market, which nudged up the unemployment rate, and a reversal of recent encouraging trade data could also soften the C\$ in the near term.

Chart 2 - C\$ Still Highly Correlated With Europe (L), BoC 2013 Forecast Appears Optimistic vs Cuts Elsewhere (R)



Source: BoC, Bloomberg, CIBC

Should fears of a worst-case scenario in Europe lessen as 2012 progresses, the C\$ should strengthen again against a weakening US\$. However, the Bank of Canada's forecasts for 2013 growth look too rosy, particularly in comparison to their revised projection for the US (Chart 2, right). Thus, the possibility that rates remain on hold throughout next year as well should keep the loonie from breaking back through parity.

Still More Questions than Answers for Eurozone

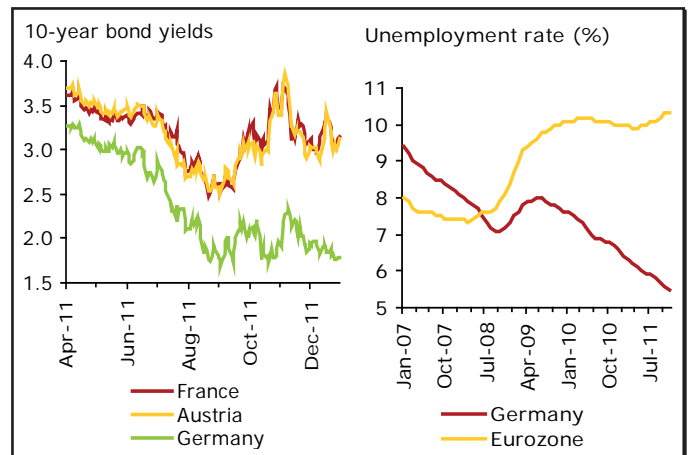
In the course of the last three months we have seen the single currency underperform all 16 other currencies tracked by Bloomberg. Investors built record net shorts into late-2011, only to subsequently extend them further into January as euro negativity remained pervasive. Of course the market could be wrong, but we remain of the view that risks for the euro are biased to the downside, aside from occasional speculative short covering rallies.

Politicians will not absolve the problems of the eurozone by creating a 'stability union' built in the image of Germany, even if the January 30th summit were able to deliver on the details promised in the wake of the December 9th resolutions. Ongoing crushing austerity seems unlikely to be tolerated by the periphery in anything other than the short term. Indeed we have recently seen Italian Prime Minister Monti implore Germany to move and help lower domestic borrowing costs for fear of a voter backlash.

The market proved able to relatively easily move beyond the ratings downgrade of nine European sovereigns, including France and Austria, in large part because previous fixed income performance suggested markets had already largely discounted differential creditworthiness. The downgrading of the EFSF to AA+, while undermining the potential scale of the EFSF rescue mechanism, also proved to be largely ignored. Markets are no longer fixated upon the EFSF, or even its successor the ESM, but rather what the ultimate response of the ECB will be. The affirmation of the AAA rating for Germany, removing it from negative watch, accentuates differentials between the region's largest economy and the rest, a scenario which is hardly beneficial for a swift move towards strong ECB action (Chart 3).

Q1 and early Q2 see sizeable bond redemptions in the periphery, while Greece still looks unlikely under current circumstances to be able to make a €14.4 bn redemption on March 20th, even if the negotiations over private sector involvement prove fruitful. Therefore, apart from occasional positioning rallies, we continue to view EURUSD downside risks as dominant, suggesting lows in line with the mid point of the all-time trading range and below 'fair value' estimates which we would put around EURUSD1.24.

Chart 3 - Inter-euro Divergences Remain a Roadblock on Further ECB Action



Source: Bloomberg, Eurostat, CIBC

SNB: New Look, Same Enemy—Deflation

Having surprised the market back in September by the announcement of the floor in EURCHF at 1.20, the internal workings of the central bank were brought back into the public domain for all the wrong reasons in recent weeks with the scandal over currency trades of former Governor Hildebrand’s wife triggering his resignation. But despite the unpleasant headlines, the scandal has done nothing to change the stance of the central bank. Interim Governor Jordan has indicated that the policy stance remains unchanged, this as he remains a staunch defender of price stability as the main goal of monetary policy.

Thus, while Jordan continues to defend the central bank mantra of price stability, the rationale for the floor in EURCHF remains the return of deflationary tendencies. Consumer prices ended 2011 having seen the biggest annual drop in two years (Chart 4). In addition, business confidence has moved sharply lower, partly in response to the currency and partly in view of reducing demand across the eurozone.

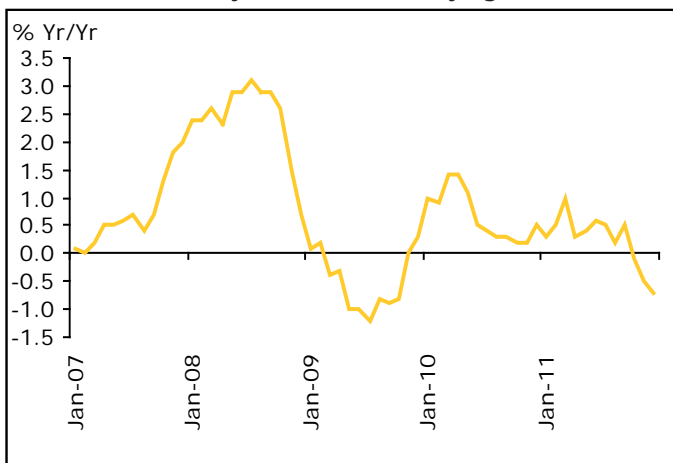
The lagged effect of the ascent of the franc prior to the imposition of the EURCHF floor has yet to work its way through the system. As a result, Switzerland will struggle to generate positive price pressures in the near term. Such deflationary pressures will lead to ongoing speculation of a move towards increasing the EURCHF floor. Indeed the Economics Minister would prefer to see the franc trading in a 1.35-1.40 range against the euro, as of course would Swiss exporters.

But for now, such hopes are unlikely to be fulfilled, in view of ongoing euro-related uncertainty, notably in H1 2012 as Greek membership in the euro looks set to be challenged. Trying to move the floor up to 1.25 or beyond at present could see the SNB’s credibility challenged and risks being costly to maintain. Thus far, the current floor has been relatively costless, in contrast to the previous policy of unilateral intervention which proved both expensive and a failure. Thus, despite ongoing deflationary tendencies, we would expect the current floor to be maintained and the Swiss franc to remain near the top of the currency overvaluation league versus the euro.

Euro Negativity Weighs on UK

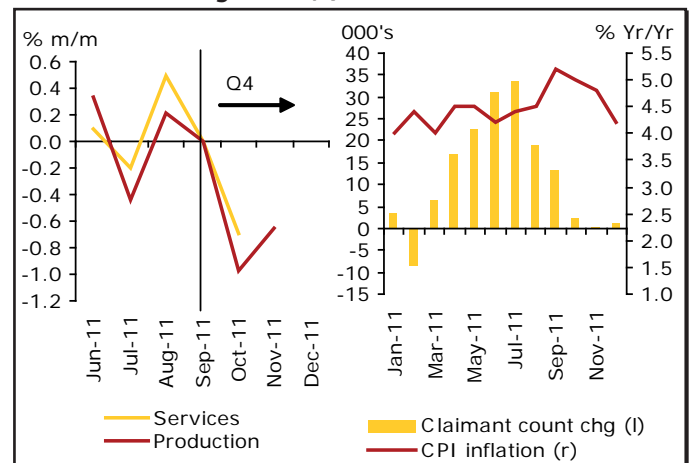
The UK economic environment will remain challenging both this year and next. Though the risks of a significant double-dip recession remain modest unless the eurozone were to implode, GDP is currently shaping up for a modest contraction in Q4 2011 (Chart 5, left) while the ILO unemployment measure continues to climb, reaching levels last seen nearly 17 years ago. Recent better news on the claimant count measure of unemployment and weakening inflationary pressures suggest some respite ahead for hard pressed consumers (Chart 5, right), but consumers are likely to remain cautious at best given heightened uncertainty. As a consequence there appears little immediate reason to be paring GBP short positions, aside from presumptions of fixed income investors looking to the UK as an alternative within the European time zone.

Chart 4 - Deflationary Pressures Intensifying



Source: SFSO, CIBC

Chart 5 - GDP Likely Fell in Q4 (L), But Some Pressure on Consumers is Being Lifted (R)



Source: ONS, CIBC

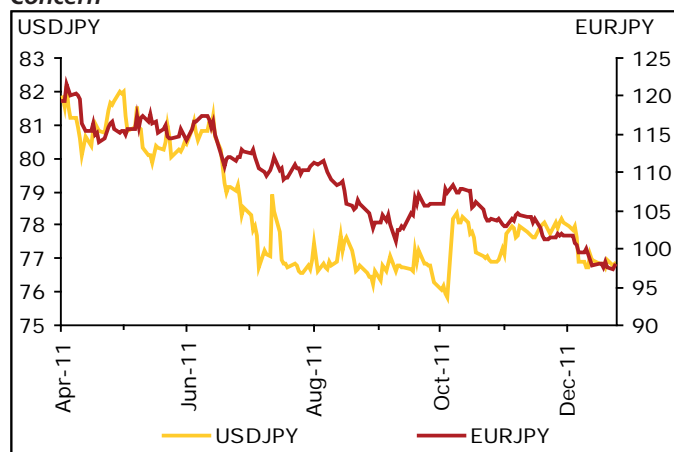
Looking forward we can expect the prospect of more QE, likely another £75 bn in February. In total we could see £300 bn in asset purchases during the course of UK's QE2. However, even such funds may not prove the significant drag on sterling that QE2 was for the US\$. A tight fiscal policy, boosting UK fiscal credibility, allied to a pro-active monetary policy is rather counter-intuitively being viewed as relatively currency-supportive, at least in the short term. Moreover, amidst euro-related woes we are likely to see EURGBP downside risks, in part as front-end spreads narrow as the ECB faces up to pressure for more monetary easing. The expansion of the ECB's balance sheet is also set to weigh upon the euro.

But of course sterling remains highly risk-correlated. Thus, we expect negative euro news to gradually crystallize prior to the end of H1, risking sterling underperformance versus the liquidity and safe haven boosted US\$. While we are trading a 1.50-1.60 range, sterling is relatively fairly valued. But the risk that we breach the bottom of this range could increase due to euro concerns.

Yen Appreciation Concerns Change to Euro Cross

Investors continue to favour capital preservation amidst still heightened broad-based uncertainty. Having already seen EURJPY trade down to levels last seen in 2000, the additional downside risks remain significant, especially as euro region bond redemptions are likely to trigger additional flows back to Japan ahead of fiscal year end. Only when domestic investors are suitably encouraged by global recovery prospects to resume offshore asset purchases can we expect capital flows to cap yen gains. Indeed while the BoJ clearly has a

Chart 6 - Yen Appreciation Against Euro Now Causing Concern



Source: Bloomberg, CIBC

pain threshold below 76 for USDJPY, it seems that the EURJPY cross is becoming increasingly significant for Japan's policy makers as European operations become more uncompetitive.

Investors have rebuilt yen long positions on the assumption of fund inflows, alongside ongoing presumptions that unilateral intervention (covert or otherwise) is unlikely to be successful. The rebound in economic activity following the disasters of Q1 2011 underpins a positive fundamental rationale for yen resilience. Of course, Japan continues to worry about the hollowing out of domestic industry, this as the competitive position of the nation versus trading partners and competitors such as South Korea and Thailand continues to be closely monitored.

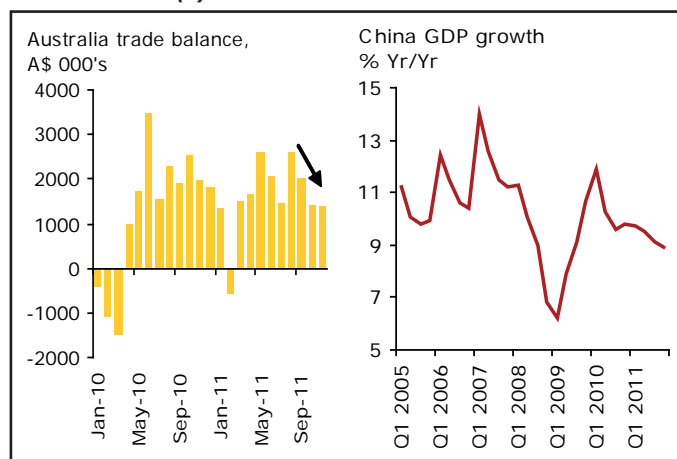
Fiscal dynamics in Japan remain negative, hence why Prime Minister Noda is attempting to raise the consumption tax. Perhaps there should be a lesson from history here, as the rebound from the early 1990's recession proved to be undermined by the exact same policy mix. However, the debt imbalance is unlikely to weigh negatively on the yen other than in the longer term. Rising political risks allied to the long positioning skew have to be set alongside ongoing efforts to cap yen strength. As a result, USDJPY may remain relatively range-bound in the near term, but EURJPY downside risks will remain an unwanted reality.

A\$ Ripe for a Correction

Having already seen back-to-back rate cuts, the prospect of weakening domestic economic activity alongside dissipating inflationary pressures is likely to keep the market looking towards the central bank, supporting growth through further easing. With the real prospect of an additional ease coming in Q1, we can expect rate spreads to continue to moderate, and eventually prove to be a net drag on A\$ performance.

Of course while rate spreads remain a significant driver, the impact of commodity markets on the A\$, through the trade channel, cannot be discounted. While Australia continues to run a trade surplus, has been a weakening trend recently as exports of natural resources continue to be challenged (Chart 7, left). Although we do not expect a hard landing in China, rather a gradual deceleration, any easing in Chinese demand (Chart 7, right) will affect key Australian exports such as coking

Chart 7 - Australia's Trade Surplus Shrinking (L) as China Growth Slows (R)



Source: ABS, NBS, CIBC

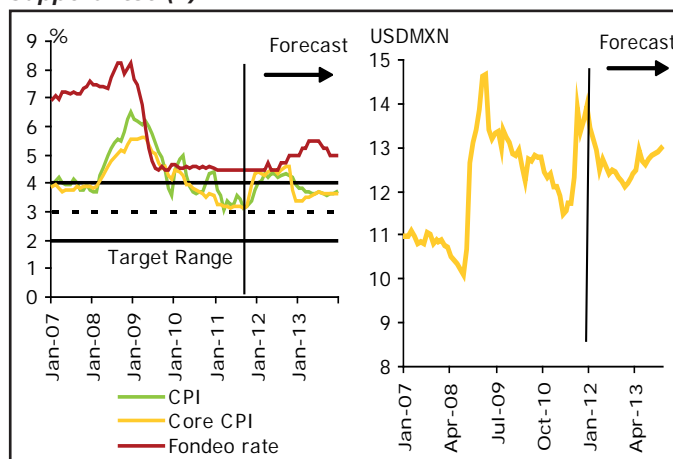
coal and iron ore. During recent months we have seen global growth expectations continually revised down, with potentially negative consequences for those currencies that are either cyclically correlated or intrinsically linked to commodity market performance, both criteria fitting the Australian dollar.

The A\$ is the most overvalued currency against the US\$ according to OECD estimates, and the RBA clearly sees the value of the currency as an increasing headwind for the economy. Despite that, the market has remained long the A\$ since early 2009, extending these to five-month highs in early January. The A\$ also remains positively risk correlated, with the three-month correlation between AUDUSD and the US S&P index currently at 0.94. With uncertainty in Europe likely to heighten in H1 2012, as Greece faces the possibility of a selective default, the risk of an ongoing flight to USD liquidity should grow. The combination of positioning and valuations, in addition to narrowing rate spreads, leaves the currency ripe for a correction lower in the near term.

Peso to Rally as Inflation Concerns Return

Banxico's policy board kept the Fondeo rate unchanged at 4.5% in January and we expect a hold at this level until well into 3Q 2012. With higher-than-expected inflation in December and a surge in tortilla prices in January, along with decent economic activity, we expect that the next move by Banxico will be an increase in the Fondeo rate (Chart 8, left). December wage negotiations settled with an increase of 4.66%, higher than our 4.1% forecast and Banxico's poll consensus.

Chart 8 - Higher Rates to Combat Inflation (L) Should Support Peso (R)



Source: Bloomberg, INEGI, CIBC

Wages rose 4.82% in the manufacturing and 4.32% in the service sector. For 2011 as a whole, wages increased 4.5% on average, only slightly below the 2010 move of 4.6%. We expect wages to increase by 4.7% in 2012 amid a gradual recovery in the labour market.

A number of indicators show that internal demand growth is taking over as the external sector slows. Meanwhile, inflation for December came in surprisingly high and the large increase in tortilla prices in January is setting the stage for a high print in that month. We expect most data to show good but moderate growth that should not only keep Banxico on hold well into Q3, before inflationary concerns move the bank's hand, but also support a rally in the peso (Chart 8, right). As the peso is the most undervalued Latin American currency, we expect USD/MXN to fall to 12.0, before rising to 12.4 towards the end of 2012. Presidential elections (July 2012) are always a risk to foreign exchange forecasts and we do expect some volatility starting after Easter in April.

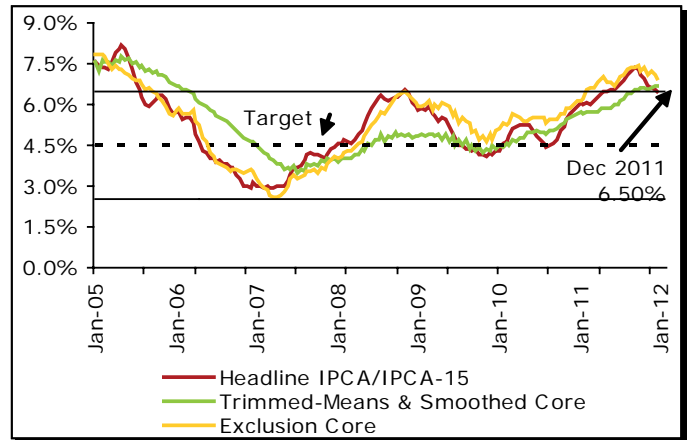
End of SELIC Cutting Cycle to Support Real

In the January policy meeting, the Central Bank Monetary Policy Committee, COPOM, cut the SELIC rate by a further 50 bps, as had been widely expected. However, the statement and the following minutes should prove more important than the action, as some analysts found the inflation report more hawkish. That hawkishness may also explain the new cuts in expenditure announced recently by the government. For our own part, we continue to think that the COPOM will have to reconsider its current course of rate cuts

as it becomes clear that fiscal adjustment—although welcome—is not sufficient to keep inflation falling. The COPOM has reduced rates with little indication that inflation is falling significantly (Chart 9). Hence, we expect the BCB to reverse course on cutting rates in the not-too-distant future.

The Dilma administration has improved the country's fiscal accounts but not by enough to bring inflation down or stem the real appreciation of the BRL. We have heard further noise about budget cuts and the Dilma administration has announced that it will go down this road, but details will only come out in February. However, recent reports suggest that parts of the administration are resisting further fiscal austerity. The effort so far is not enough to bring inflation down without a reversal in the easing of the Banco Central. For now, investors will sell USDBRL first when the market is bullish, simply because of the high positive carry. But we see upside to the USDBRL because other fundamentals, namely the terms-of-trade falling moderately, point to USDBRL rising towards its current equilibrium rate of 1.86.

Chart 9 - Inflation Proving Sticky in Brazil



Source: IBGE, CIBC

INTEREST RATE AND ECONOMIC OUTLOOK

End of period:		2012 I	2012 II	2012 III	2012 IV	2013 I		2011	2012	2013	
Canada	Overnight target rate	1.00	1.00	1.00	1.00	1.00	Canada	Real GDP growth (%)	2.4	2.0	2.1
	2-Year Gov't Bond	1.00	1.20	1.40	1.50	1.40		Unemployment rate (%)	7.5	7.5	7.2
	10-Year Gov't Bond	2.05	2.40	2.70	2.75	2.65		CPI (%)	2.9	1.6	2.0
US	Federal Funds Rate	0.10	0.10	0.10	0.10	0.10	US	Real GDP growth (%)	1.7	2.1	1.9
	2-Year Gov't Note	0.30	0.35	0.40	0.40	0.35		Unemployment rate (%)	9.0	8.7	8.8
	10-Year Gov't Note	2.00	2.25	2.45	2.60	2.60		CPI (%)	3.2	1.6	1.9
Eurozone	Refin. operations rate	0.75	0.75	0.75	0.75	0.75	Eurozone	Real GDP growth (%)	1.5	-0.7	0.8
	2-Year Gov't Bunds	0.20	0.40	0.50	0.60	0.70		Unemployment rate (%)	10.1	10.6	10.5
	10-Year Gov't Bunds	1.85	2.00	2.20	2.40	2.60		CPI (%)	2.7	1.9	1.8
UK	Bank rate	0.50	0.50	0.50	0.50	0.50	UK	Real GDP growth (%)	0.9	0.4	1.4
	2-Year Gilts	0.45	0.55	0.75	0.85	1.00		Unemployment rate (%)	8.0	8.5	8.3
	10-Year Gilts	2.00	2.35	2.70	3.00	3.20		CPI (%)	4.5	2.4	2.1
Japan	Overnight rate	0.10	0.10	0.10	0.10	0.10	Japan	Real GDP growth (%)	-0.2	1.6	1.5
	2-Year Gov't Bond	0.13	0.15	0.17	0.17	0.17		Unemployment rate (%)	4.5	4.5	4.4
	10-Year Gov't Bond	0.98	1.00	1.10	1.20	1.20		CPI (%)	-0.3	-0.3	0.0

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