



Economics & Strategy

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“At the heart of this reversal of fortune is the huge shift in the global terms of trade over the last decade, which has seen economic value-added migrate from information technology back to resource rents under the ground.”

A Nickel Back

by Jeff Rubin

While it's been three decades since Canadians have seen their currency at par with the once almighty US dollar, the loonie's flight is far from over. By the end of next year you'll get as much as a nickel back when you trade your loonies for greenbacks, the biggest premium since 1960.

A similar if not more dramatic story is being told in housing prices. US prices continue to fall on mounting foreclosures, while Canadian housing prices continue to rise on a surging domestic economy. And for the fourth year in a row, the resource-based TSX is set to outperform the S&P 500. Across a wide spectrum of assets, the tables have suddenly turned. Canadians are getting richer compared to their American neighbours, after having fallen so far behind during the IT-driven economy of the 1990s.

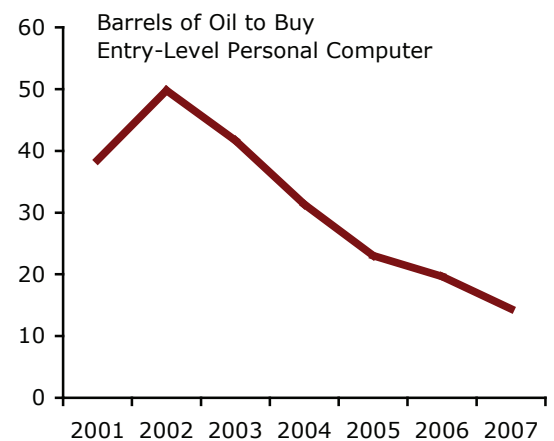
At the heart of this reversal of fortune is the huge shift in the global terms of trade over the last decade, which has seen economic value-added migrate from information technology back to resource rents under the ground. Nowhere is that shift more evident than when comparing soaring crude oil prices against stagnant or plunging technology prices. It takes only a third as many barrels of oil to buy a basic computer as it did at the start of the decade (Chart 1), when Silicon Valley drove the world economy.

Today it's not Russian or Mexican defaults that de-stabilize global credit markets, but defaults by homeowners deep inside the American heartland. The American economy

has gone from the global engine of growth to the world economy's Achilles heel in the space of a decade.

In the past, weakness in the American economy would spill over the border in a hurry, particularly when a par Canadian dollar exchange rate left exporters fully exposed. But with the developing world, not the US, now driving global resource demand, the umbilical cord that has always connected the Canadian economy to the much larger American market is being severed. That's already apparent in the very fact that Canadian real GDP growth will surpass the US in a year when the Canadian dollar appreciated from 85 cents to parity. And growth is likely to remain stronger in Canada next year as well, despite a premium exchange rate (Table 1).

Chart 1 Terms of Trade



http://research.cibcwm.com/res/Eco/EcoResearch.html

Table 1

FORECAST SUMMARY					
(% Change Except Where Noted)					
	2004A	2005A	2006A	2007F	2008F
CANADA					
GDP at Market Prices	6.4	6.5	5.2	6.1	5.8
GDP in \$2002	3.1	3.1	2.8	2.6	2.7
Consumer Price Index	1.9	2.2	2.0	2.2	2.4
Unemployment Rate	7.2	6.8	6.3	6.0	6.0
Employment	1.8	1.4	2.0	2.2	1.4
Merchandise Trade Balance (C\$ Bn)	65.8	63.5	51.3	56.8	58.8
Current Account Balance (C\$ Bn)	29.0	27.9	23.6	25.4	25.0
Pre-tax Profits	17.1	11.9	5.0	5.6	7.0
Housing Starts (K)	233	224	228	231	220
Real Disposable Income	3.6	2.6	4.9	3.9	3.3
Personal Saving Rate (% of disposable income)	2.9	1.6	2.3	2.2	2.0
UNITED STATES					
GDP at Market Prices	6.6	6.4	6.1	4.7	4.2
GDP in \$2000	3.6	3.1	2.9	1.9	1.9
Consumer Price Index	2.7	3.4	3.2	2.7	2.6
Unemployment Rate	5.5	5.1	4.6	4.6	4.9
Current Account Balance (US\$ Bn)	-640	-755	-811	-764	-750
Pre-tax Profits (with IVA/CCA)	24.0	11.5	13.2	4.4	4.1
Housing Starts (Mn)	1.96	2.07	1.80	1.38	1.19

Table 2

INTEREST AND EXCHANGE RATE FORECAST							
		2007		2008			
END OF PERIOD:		12-Oct	Dec	Mar	Jun	Sep	Dec
CDA	Call loan (mid-point of range)	4.50	4.50	4.50	4.50	4.50	4.50
	98-Day Treasury Bills	3.96	4.25	4.30	4.40	4.40	4.45
	Chartered Bank Prime	6.25	6.25	6.25	6.25	6.25	6.25
	2-Year Gov't Bond (4.25% 12/09)	4.37	4.30	4.25	4.40	4.45	4.50
	10-Year Gov't Bond (4% 06/17)	4.50	4.40	4.35	4.40	4.50	4.80
	30-Year Gov't Bond (5.75% 06/33)	4.54	4.65	4.55	4.60	4.65	4.90
U.S.	Federal Funds Target	4.75	4.50	4.25	4.25	4.25	4.50
	91-Day Treasury Bills	4.18	3.95	3.90	4.05	4.20	4.40
	2-Year Gov't Note (4% 09/09)	4.21	3.95	3.85	4.00	4.55	4.60
	10-Year Gov't Note (4.75% 08/17)	4.68	4.50	4.40	4.55	4.70	4.95
	30-Year Gov't Bond (5% 05/37)	4.90	4.75	4.70	4.80	4.95	5.00
	Canada - US T-Bill Spread	-0.22	0.30	0.40	0.35	0.20	0.05
	Canada - US 10-Year Bond Spread	-0.18	-0.10	-0.05	-0.15	-0.20	-0.15
	Canada Yield Curve (30-Year — 2-Year)	0.17	0.35	0.30	0.20	0.20	0.40
	US Yield Curve (30-Year — 2-Year)	0.69	0.80	0.85	0.80	0.40	0.40
EXCHANGE RATES	— (US¢/C\$)	102.7	103.7	103.0	100.2	105.0	105.0
	— (C\$/US\$)	0.973	0.964	0.971	0.998	0.952	0.952
	— (Yen/US\$)	117	115	114	115	114	110
	— (US\$/euro)	1.42	1.45	1.42	1.40	1.37	1.37
	— (US\$/pound)	2.03	2.03	2.03	2.00	1.98	1.98
	— (US¢/A\$)	90.3	90.0	89.0	85.0	82.0	87.0

Where the umbilical cord still remains, US economic weakness has been transmitted to the Canadian economy. But the once critical manufacturing nexus that connected the two economies is becoming increasingly marginalized in Canada, as it is in the US as well. Both the auto and forestry sectors are feeling the full brunt of a US economic slowdown, but the losses in manufacturing are being readily offset in today's economy.

Just as the loss of the once mighty trade surplus in motor vehicles and parts no longer matters in today's resource-dominated trade flows, nor does the recent loss of almost 300,000 manufacturing jobs show up in a three-decade low national unemployment rate. In fact, once measurement differences are accounted for, Canada's jobless rate will fall as low as the US rate next year for the first time since 1982. Nor have plant closures managed to shut down the pace of economic growth, even though manufacturing output is approaching its lowest share of GDP in the post-war period (Chart 2).

Soaring Energy Rents Inflate Domestic Incomes

The terms of trade will continue to dictate a stunning reversal of fortune between Canada and the US, with rising resource rents continuing to swell corporate earnings, personal incomes and government tax revenue. With consumer spending, business investment and government spending all well financed, the domestic economy will be firing on all cylinders.

A much stronger domestic economy north of the border will in turn translate into divergent monetary policies in the two countries, with the Federal Reserve Board following through with another 50 bps of easing while the Bank of Canada remains on the sidelines (Table 2). With interest rate spreads turning against the greenback and commodity prices buoyant, the Canadian dollar should climb to a 5% premium against the US dollar by the end of 2008.

TSX: Greater Leverage to Resource-Consuming Economies Than to US

Just as the Canadian economy is delinking from the cyclical rhythms of its much larger neighbour, so too are the fortunes of the TSX. Strength in energy, base metals and gold prices should drive the TSX to the 16,200 level by the end of 2008, providing the fifth consecutive year of double-digit total returns. Soaring crude demand outside of the OECD, particularly among OPEC countries themselves (Chart 3), should push WTI to as high as US\$100 per barrel by the fourth quarter of next year, as rapidly growing domestic consumption in many major oil-producing countries begins to cannibalize export capacity.

Meanwhile base metal prices seem poised to hit new highs, with global growth set to post another near-5% year. With 45% of the market capitalization in energy and materials, and only 14% in non-resource manufacturing, the TSX provides a lot more leverage to the soaring economies of Russia, China and India than it does to a clearly sick and troubled US economy.

Chart 2
Manufacturing Share of Canadian GDP

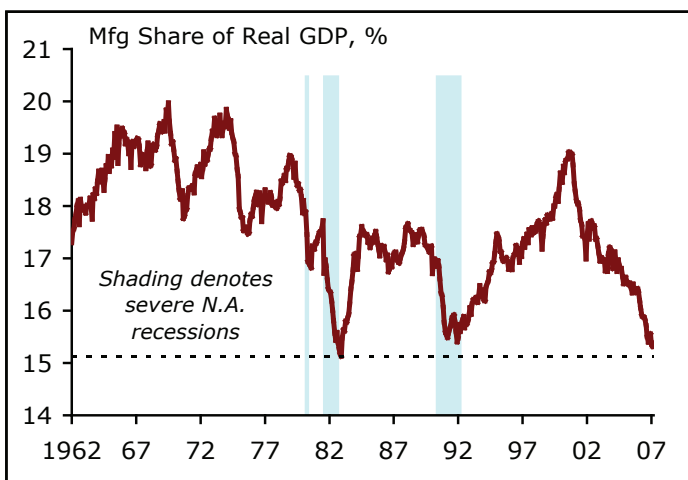
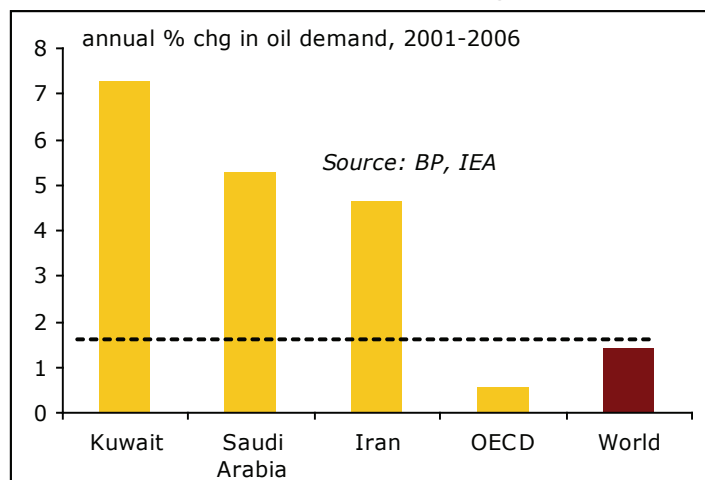


Chart 3
Oil Consumption in Oil-Producing Countries



The US Economy: Scraping By

Avery Shenfeld

After a decent two-quarter burst, America's economic growth engines are about to sputter. The most telling evidence has been in the labour market. A deceleration in trend payrolls growth akin to that seen through September has historically been either a lead-in to recession, or as in 1986 and 1995, part of a substantial slowdown that induced Fed rate cuts (Chart 4).

Absent an ease to 4.25% on the funds rate, the credit market squeeze would have acted as an ill-timed tightening. A credit crunch has meant that beyond the funds rate, key short rates, including 3-month Libor, are barely 15 bps below July levels. A further half-point reduction in the funds rate will be needed, along with the weak exchange rate, to provide any meaningful stimulus.

Chart 4

Payrolls Trend: At Least a Slowdown

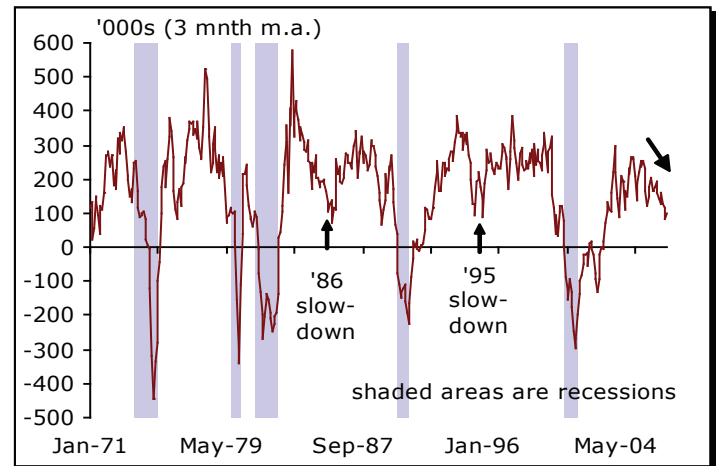


Table 3

US FORECAST DETAIL

(real % change, s.a.a.r., unless otherwise noted)

	07:2A	07:3A/F	07:4F	08:1F	08:2F	2006A	2007F	2008F
GDP At Market Prices (\$Bn)	13,769	13,937	14,007	14,158	14,294	13,195	13,816	14,401
% change	6.6	5.0	2.0	4.4	3.9	6.1	4.7	4.2
Real GDP (\$2000 Bn)	11,520	11,603	11,614	11,657	11,714	11,319	11,537	11,762
% change	3.8	2.9	0.4	1.5	2.0	2.9	1.9	1.9
Final Sales	3.6	2.7	0.6	1.4	2.1	2.8	2.2	1.8
Personal Consumption	1.4	3.2	1.1	1.4	1.9	3.1	2.9	1.9
Total Govt. Expenditures	4.1	1.8	1.1	1.6	1.2	1.8	1.7	1.2
Residential Construction	-11.8	-19.0	-18.0	-19.4	-9.5	-4.6	-16.4	-14.3
Business Fixed Investment	11.0	2.9	4.1	2.9	5.5	6.6	3.8	4.6
Inventory Change (\$2000 Bn)	5.8	13.0	7.1	10.7	6.6	40.3	6.5	19.1
Exports	7.5	13.1	5.6	7.4	6.9	8.4	7.3	7.6
Imports	-2.7	5.5	4.9	1.9	3.6	5.9	2.4	3.3
GDP Deflator	2.6	2.0	1.7	2.8	1.9	3.2	2.7	2.2
CPI (yr/yr % chg)	2.7	2.3	3.3	2.9	2.0	3.2	2.7	2.6
Unemployment Rate (%)	4.5	4.6	4.7	4.7	4.9	4.6	4.6	4.9
Housing Starts (AR, Mn)	1.46	1.33	1.27	1.22	1.18	1.82	1.38	1.19

Tumbling construction, business caution on inventories, and a consumer sector hit by credit concerns threaten to take GDP growth to near zero in the fourth quarter (Table 3), with not much better in Q1. But a trend drop in housing starts was a feature of the last half of the 1980s, without triggering a recession. With the Fed doing the right thing and cutting another 50 bps, more positive, if still sluggish, growth is set to resume in 2008.

Worst to Come for Housing?

In terms of mortgage defaults and house prices, the worst is yet to come. Resets on adjustable-rate mortgages (ARMs) will peak in the next two quarters, and some ARMs whose initial resets were capped will face yet another dose of higher rates. Real house prices typically tumble when the stock of listings soars relative to sales, with pressures on prices evident in the new housing market, for example, whenever there are more than six months of listings stuck on the market (Chart 5). Huge overhangs of unsold listings in both the new and existing markets suggest a further 10-15% slide in house prices lies ahead.

Similarly, the bottom has yet to be hit in construction. Tighter mortgage lending practices, bleak readings from homebuilders, weak sales and high inventories point to a further dive to an only 1.15 mn starts pace by the middle of next year. Related commercial construction (shopping centres, schools, etc.) also tends to respond with a lag to a drop in new housing developments.

That said, in two respects, the worst might already be behind us. Recent quarters have been feeling the impact of a drop from a 2.3 mn starts pace to 1.3 mn. While some of that is still to come in terms of the decline in housing under construction, the quarter-to-quarter drag on activity from the further drop in starts will start

to diminish by next spring. And our earlier research suggested that mortgage-backed securities markets might already be pricing in an excessively gloomy outcome in terms of losses on defaults.

“Collateral” Damage to Consumers

Consumer spending carries ten times the weight of housing, and its healthy 3% real growth rate provided key support in Q3. Spending has held up despite a drop in home mortgage equity withdrawals (Chart 6). Solid compensation gains (particularly bonus- or options-related) helped, but some of the funding has come from greater use of other non-mortgage consumer credit, a tap threatened by tighter lending standards. The squeeze from oil markets is a further risk, since there has been a clear mirror image relationship between spending and gasoline prices (Chart 7). As a result, look for a sharp deceleration to barely 1% real consumption in Q4, with wholesale prices pointing to at least some upward pressure at the pumps, and more to follow in 2008.

Falling house prices, if left unchecked, could do serious damage. A 10% drop in house prices would subtract about US\$2 trillion in widely distributed wealth, potentially chopping about US\$100 bn or 1% from consumer spending. Houses no longer look like surefire collateral for consumer debt to banks carrying eroding mortgage portfolios. That’s where Fed easing comes in, as lower interest rates should keep the savings rate from rising materially, allowing for positive, though sluggish, real consumption.

Net Exports “Really” Positive

The weaker dollar isn’t going to help America’s nominal trade deficit much—not with oil prices headed higher,

Chart 5
Unsold Homes Pressure Prices

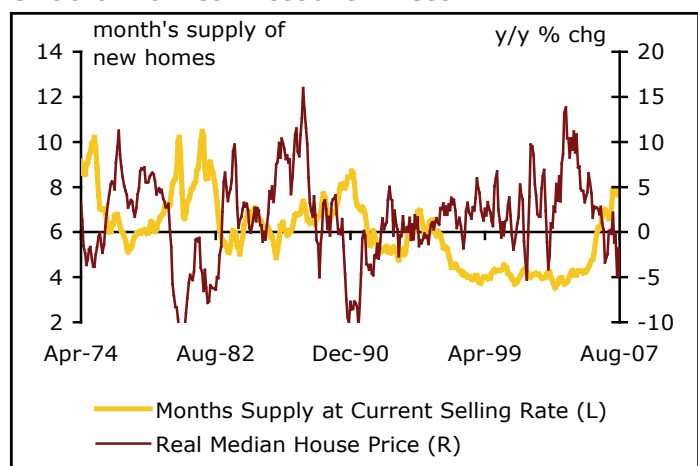


Chart 6
Credit Cards Supplant Home Equity Withdrawal

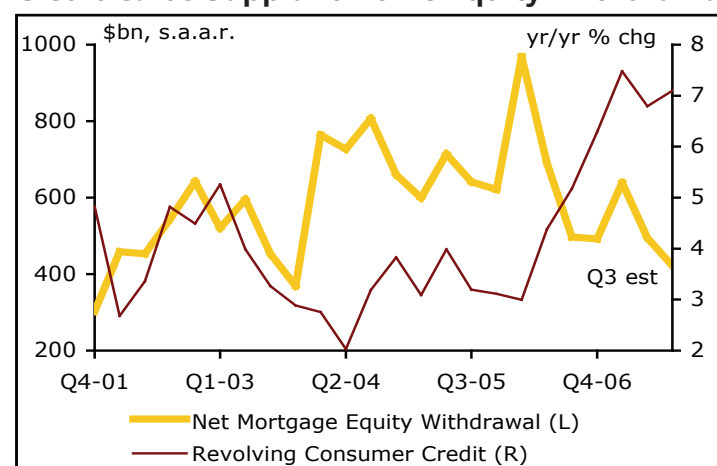
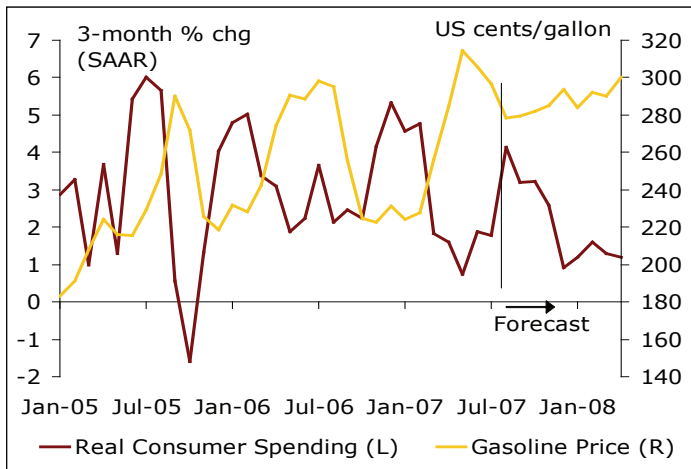


Chart 7

Consumer Spending Mirrors Gas Prices



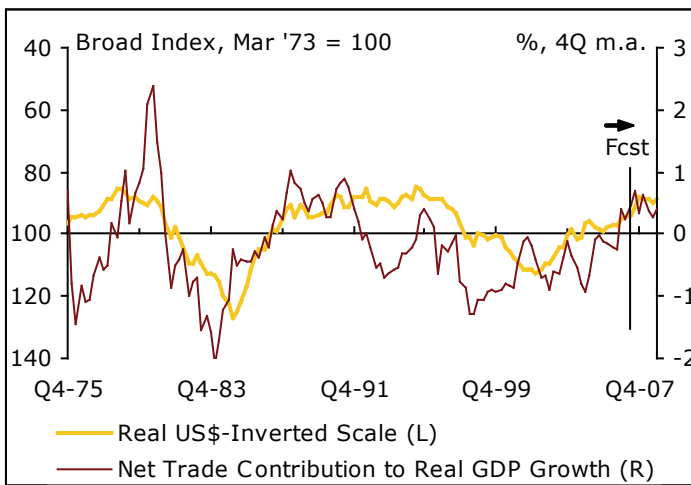
and a cheap greenback also seeing rising-dollar prices for other goods. Even Chinese export prices to the US are now inching higher, although that has a trivial impact at the retail level, with so much of the retail price now covering transportation, wholesaling and retailing. A further US\$20/bbl rise in crude oil will alone add US\$60 bn to the annualized deficit by the fourth quarter of 2008.

But in real terms, a soft dollar has turned trade to a growth contributor (Chart 8). With demand holding up in key markets beyond America’s borders, net exports should add about a half-point to growth to 2008.

Although the fuse will be much longer, a cheaper dollar should also be a plus for capital spending beyond 2008. The corporate sector has been flush with cash for the past few years, but capital spending remained lackluster relative to past cycles. Why invest in the 50 states when there were such extensive cost advantages abroad?

Chart 8

Weak Dollar Makes Real Trade a Winner



Now, foreign automakers could be incited to increase assembly operations stateside by a strong euro and yen, even as the Big-3 pare back capacity. Rising transport costs also provide a shelter from more distant sources of production on heavier-to-ship items.

Wall Street will also be playing increasing attention to what lies beyond America’s borders. US corporate profit growth is now coming almost exclusively from foreign operations (Chart 9). A cheap US currency translates overseas subsidiary earnings into more greenbacks, and stronger economic performance overseas also plays into better profitability.

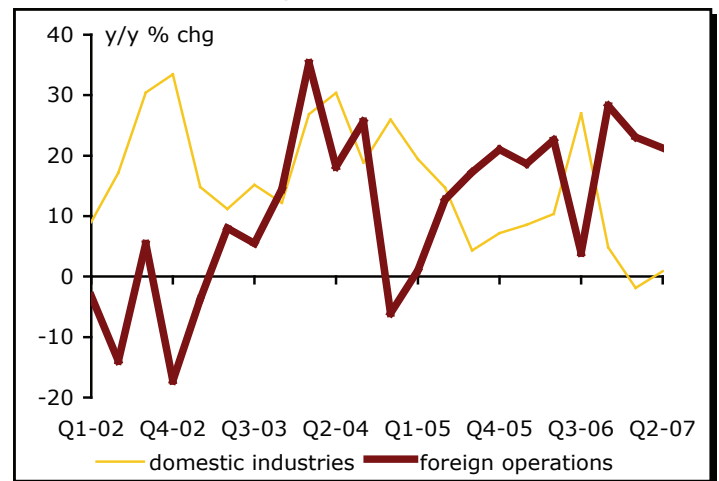
Inflation: Parting Ways

The Fed has shown its willingness to live with what it sees as temporary spikes in headline inflation if core prices are well behaved and the economy is soft. That could make inflation-protected TIPs an interesting near-term play. Headline CPI is poised to create at least some psychological market discomfort as it shoots above 3% over the rest of 2007, as we pass the one-year anniversary of the prior year’s dip in gasoline prices.

Core prices aren’t that sensitive to the exchange rate in the US, since exporters to America often price to the market competition. Instead, abundant home vacancies are putting a damper on “owners equivalent rent.” Services inflation has been boosted by rising wage gains (hourly earnings are up 4%, with total compensation soaring due to options and bonuses). But a bit of extra labour market slack should see some deceleration in such cost pressures. Look for core CPI to hold below 2% in the coming year as a result.

Chart 9

Pre-Tax Corporate Profits: Domestic vs Foreign Operations



Canada: America's Dance Partner No More

Warren Lovely

Once the de facto 51st state of the USA, Canada is looking less Americanized every day. A once tight relationship between Canadian and US growth has come untethered; the ebb and flow of US activity is today less relevant to Canada's economic record than at any time in the past half century. So while it takes till 2009 for America to get its groove back, that needn't stand in the way of healthy Canadian growth in the year ahead (Table 4).

Outpacing US Despite Premium Exchange Rate

An ultra-cheap currency allowed Canada to reel off four years of substantial outperformance versus the US during 1999-2002 (Chart 10). Once the loonie embarked upon its unprecedented ascent, that growth edge vanished. That Canada lagged during those, the early stages of adjustment to a stronger currency, is of little surprise. More striking is the resumption of Canada's outperformance in the face of ever-higher levels for the Canadian dollar.

Once seen as mutually exclusive events, Canadian real GDP growth is outpacing the US whilst the loonie trades at a premium to the US\$. Far from a harbinger of the country's economic demise, today's premium exchange rate is testament to hearty global demand for the nation's abundant resources. Canada's economy has, in effect, thrown down the crutch of a cheap currency and proven surprisingly sturdy on its feet.

Where Ties Still Bind

No two countries share a larger bilateral trade relationship than Canada and the US. Foolish then, to think that a slowdown stateside leaves Canada entirely unblemished. Economic ties run deep in manufacturing, where Canadian production is geared heavily to the US. For non-resource manufacturers, where prices haven't risen to offset currency strength, strict cost containment is vital to survival. Some 300,000 manufacturing jobs have already been shed (Chart 11)—all in Central Canada—and cumulative layoffs are likely to exceed half a million by decade's end.

Manufacturing's share of total employment is en route to a post-war low of 10%. As the factory sector's share of jobs and output shrinks, the economy's ability to stomach a parity exchange rate is solidified.

High profile sectors like autos and forestry will, however, remain distressed. Once enormous, Canada's trade surplus in autos has swung to deficit, and risks serving as an ever larger drag on net exports going forward. Elsewhere, non-resource exporters are being displaced by China and other emerging countries, unable to compete on cost.

Buoyed by Energy, Industrials

More positively, Canadian exports are now less sensitive to shifts in underlying US demand. Energy supplanted autos as the single largest export to the US in 2005 (Chart 12), and that gap will widen as WTI approaches US\$100/bbl

Chart 10
Canada Shakes Off C\$, Outperforms US

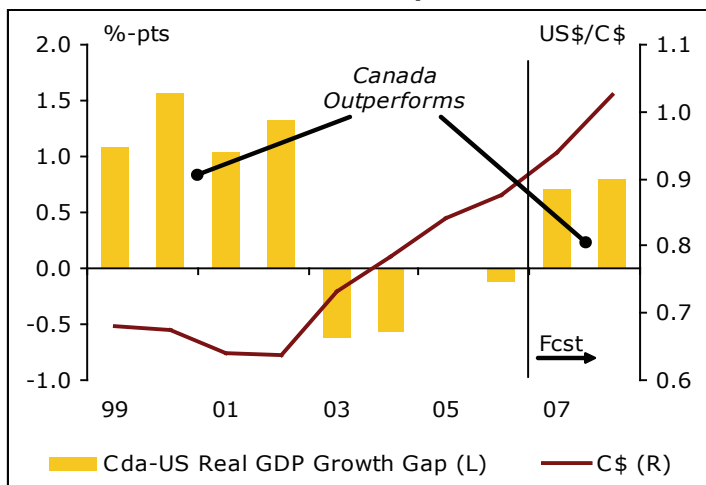


Chart 11
Factory Layoffs Pile Up, Other Sectors Hiring

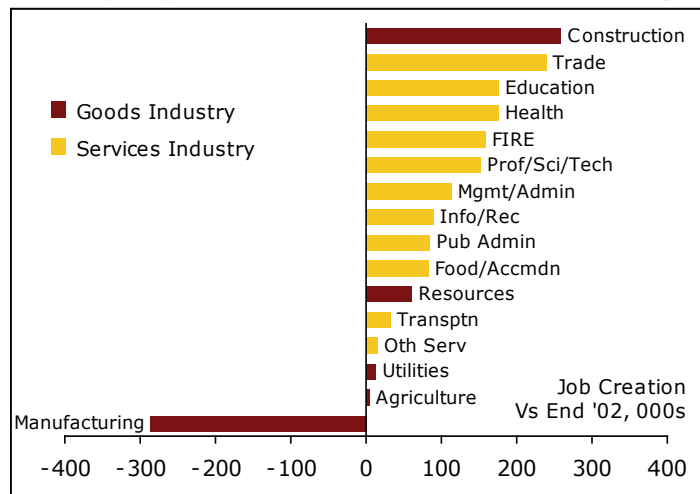
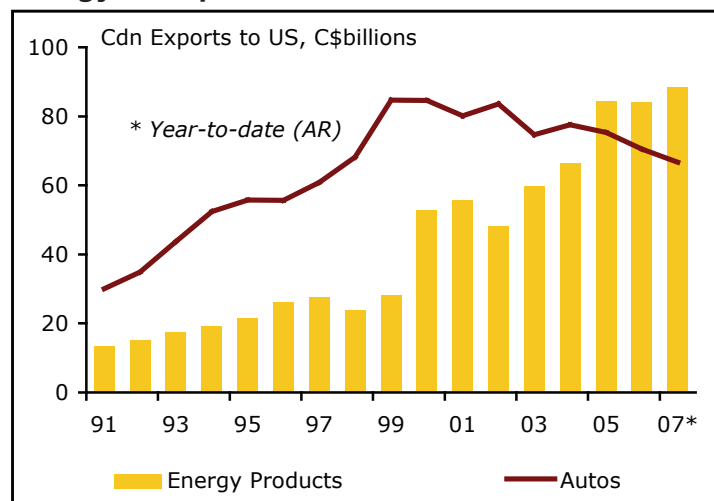


Chart 12

Energy Trumps Autos in Trade With US



and oil sands production ramps up. Longing for a secure supply of energy, America will lap up all the incremental oil Canada has to offer. Industrials are also proving vital to Canada's trade fortunes, with resource development and a still-healthy global expansion keying future gains.

Canada's *nominal* trade surplus, residing entirely in energy and commodities, has indeed weathered the currency's rise. But when it comes to *real* economic growth, net trade remains a persistent drag, leaving GDP heavily reliant on domestic economic sectors. Fortunately, Canada is enjoying exceptionally brisk growth on that front, with real final domestic demand growing at an above-trend 3.7% year-on-year pace (as of Q2), double the US growth rate.

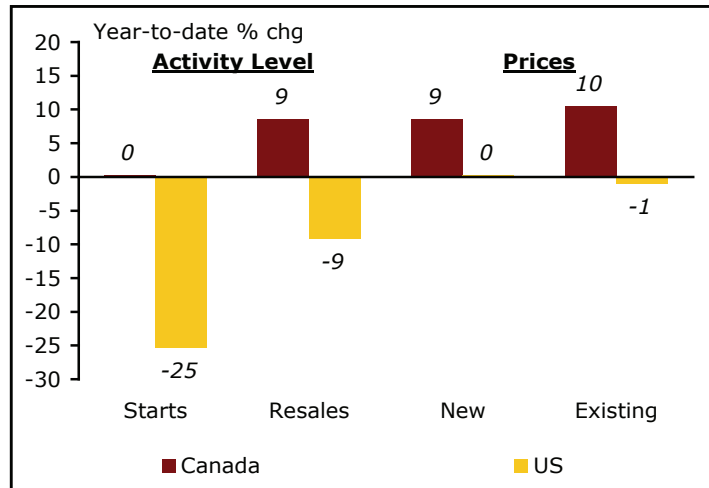
That performance gap is centred in housing (Chart 13). US homebuilding is mired in recession, whereas Canadian housing starts have held at impressive levels. Resale activity is brisk, although as with everything, growth is uneven across the regions. Nationally, home prices are slated to rise 5% in 2008, slowing from their current clip but in line with personal income growth. With homeowners protected from the wealth destruction wrought on so many Americans, don't anticipate a bump up in the savings rate, allowing real consumer spending growth, at 3.0%, to outstrip the US for a fourth straight year in 2008.

Table 4

CANADA: GDP FORECAST DETAIL								
(real % change, s.a.a.r., unless otherwise noted)								
	07:2A	07:3A/F	07:4F	08:1F	08:2F	2006A	2007F	2008F
GDP At Market Prices (\$Bn)	1,531	1,545	1,564	1,585	1,609	1,446	1,534	1,623
% change	9.5	3.9	4.9	5.5	6.1	5.2	6.1	5.8
Real GDP (\$2002 Bn)	1,312	1,320	1,327	1,335	1,345	1,282	1,315	1,351
% change	3.4	2.4	2.0	2.4	3.0	2.8	2.6	2.7
Final Domestic Demand	4.3	3.4	3.4	3.2	3.4	4.7	3.5	3.4
Personal Consumption	4.9	2.7	3.0	2.9	2.9	4.2	3.8	3.0
Total Govt. Expenditures	2.3	2.8	3.0	3.2	3.4	3.9	2.4	3.1
Residential Construction	5.2	2.3	1.4	-2.7	1.8	2.1	2.2	0.3
Business Fixed Investment*	4.1	8.2	6.4	6.9	6.1	9.9	4.8	6.4
Inventory Change (\$2002 Bn)	4.8	8.9	7.6	6.6	6.6	10.2	6.1	6.9
Exports	2.9	2.4	1.0	3.6	3.9	0.7	1.8	3.3
Imports	6.4	8.0	3.3	4.5	4.7	5.0	3.4	4.9
GDP Deflator	5.7	1.5	2.8	3.0	3.0	2.4	3.4	3.0
CPI (yr/yr % chg)	2.2	2.1	2.6	2.2	2.0	2.0	2.2	2.4
Unemployment Rate (%)	6.1	6.0	5.9	5.9	6.0	6.3	6.0	6.0
Employment (m/m avg, K)	13	29	15	18	19	29	27	20
Trade Balance (AR, \$bn)	63.9	51.5	53.8	56.4	57.4	51.3	56.8	58.8
Housing Starts (AR, K)	226	244	230	225	220	228	231	220

Chart 13

Canadian Housing in League of its Own



Government Pitches In

In the past five years, no industry has hired more workers or boosted output faster than construction. In addition to heightened residential activity, Canada has witnessed a private and public sector investment boom. The former aims to capitalize on global growth opportunities, with the latter made possible by surging government revenues.

Government stimulus is apparent in the labour market, with the public sector share of employment at a decade high. Healthy surpluses hint at further government-related hiring ahead, although investments in social programs need to be balanced against other priorities. Having made monumental progress, the pace of federal debt reduction can now be scaled back, and with the fiscal imbalance largely addressed, the time is ripe for meaningful tax relief—a winning strategy for a federal government in the hunt for a majority, and a prospective boon for disposable incomes. An infrastructure deficit will continue to be redressed, with all levels of government having a role to play.

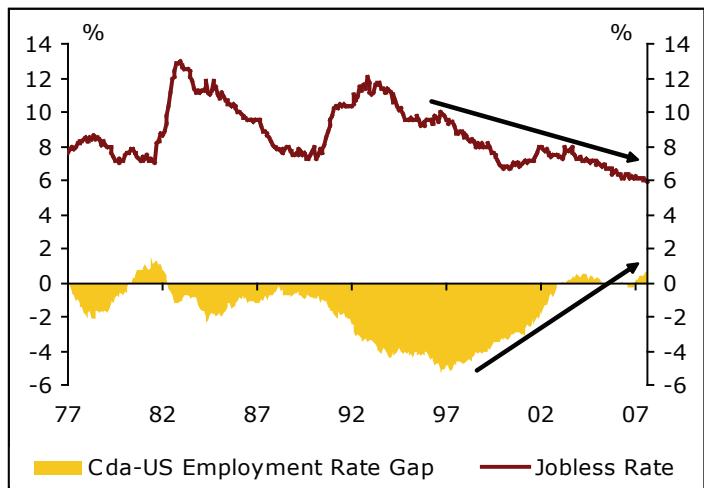
Labour Market Tight, Wage Growth Accelerates

Multi-decade records abound in the labour market. The unemployment rate has plumbed depths not seen in thirty-plus years (Chart 14). The gap between the Canadian and US unemployment rates is the narrowest in a quarter-century and would effectively vanish if not for measurement differences.

A paucity of available labour has bid up wages, which combined with lackluster productivity growth, has ignited unit labour costs—a contributor to core inflation in the

Chart 14

Joblessness Down, Employment Rate Tops US

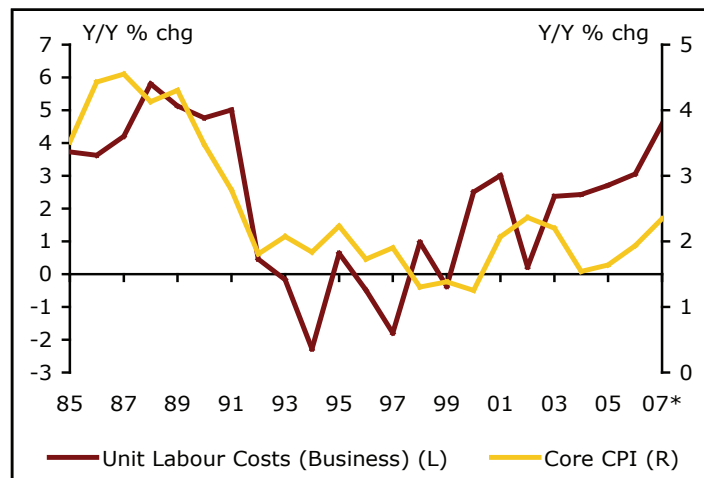


past (Chart 15). Still, the C\$ remains a mitigating force. Despite a stronger domestic expansion, the currency's impact on import prices will mean tamer consumer goods inflation than in the US, with relative relief expected in food, energy, autos, clothing and an array of other imported products.

Together, robust wages, soaring profits and bulging government coffers are hallmarks of the country's rapidly expanding wealth. For the first time in a generation, Canada is enjoying a major reversal of fortune versus the US, one characterized by superior economic growth, stronger job creation, outperforming asset markets and unmatched fiscal latitude. A strong US is still good business for Canada, but the country's ability to go its own way is sure to make believers out of remaining financial market detractors.

Chart 15

Wages Boost Unit Labour Costs, An Inflation Threat



Little US Contagion to Global Growth

Peter Buchanan

Thanks in part to healthy demand conditions in emerging markets, which are increasingly vital customers for Canada's resource exports, world GDP growth should remain solid in coming quarters even with the subprime crisis and record oil prices taking a toll stateside. Although we've trimmed our forecast for growth to 4.9% in 2008 (Table 5), that figure still compares very favourably with longer term historical trends. The fact that the US slowdown has been concentrated in housing, which has low import content levels, reduces the likelihood of significant adverse spillover to other economies.

Central Banks Less Hawkish

The global credit squeeze has seen overseas central banks shelve plans for further rate hikes that earlier appeared all but certain. As a result, higher spreads are merely substituting for what would have been higher government yields. In Europe, the ECB looks stuck at a 4% target rate for some time to come, Japan is postponing further tightening until 2008, and the UK could even see a rate cut next year.

Oil's trip above above US\$80 might seem threatening, but that increase is more a testament to strength on the demand side, tied to spirited economic growth globally, than the sort of supply shocks that sparked recession-inducing price spikes in decades past. Currency appreciation has also insulated many countries from the full impact of rising US\$ energy prices, with declining energy intensity levels further shielding the larger industrial countries from energy cost pressures (Chart 16).

With interest rate spreads less attractive as the Fed cuts rates, we look for further US\$ weakness, initially favouring gains by the euro (to US\$1.45) and commodities currencies. Later in 2008 and beyond, given the scale of trade imbalances, we look for East Asia to take over the adjustment process, with the yen making a run to 110 yen/US\$ as the BoJ raises interest rates, China perhaps allowing a somewhat faster yuan appreciation trend, and other developing Asian currencies following suit. As already noted, the C\$ should benefit from its ties to resource prices driven by strong global growth.

Chart 16

Industrial Economies Less Vulnerable Today to Oil Prices

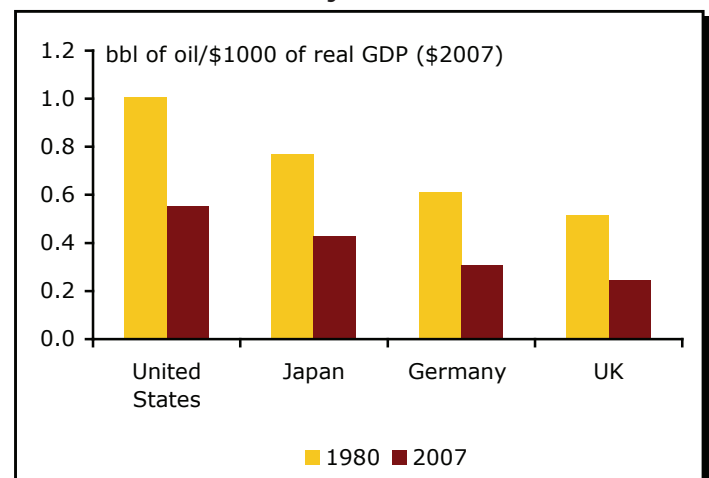


Table 5

REAL GDP GROWTH RATES					
	2004A	2005A	2006A	2007F	2008F
World GDP*	5.3	4.9	5.4	5.2	4.9
Key Overseas Economies					
Eurozone	2.0	1.5	2.8	2.6	2.3
UK	3.3	1.8	2.9	2.9	2.0
Japan	2.7	1.9	2.2	2.4	2.2
China	10.1	10.4	10.7	11.0	10.7
India	7.5	9.0	9.2	9.0	8.5
Latin America	6.0	4.6	5.5	5.0	4.3

*at purchasing power parity weights

Emerging Markets Have Weathered Turbulence Well

As evidenced by a range of indicators, including credit spreads (Chart 17) emerging markets have proven to be much less susceptible to credit market volatility than they were during previous crises, like the late-1990's Asian crisis and blowup of hedge fund LTCM, an event that was, itself, sparked by Russia's debt default. Those countries have become increasingly critical to global resource markets, accounting for 80% of the growth in global oil consumption in the last five years and a comparable share of added base metals demand. Good prospects there point to continued strength in resource prices (Table 6), which have snapped back from the losses seen during the early days of credit market turmoil. Instead of the large current account deficits of the past, many emerging markets like Russia are now running surpluses, helping to shield them from financial turmoil.

Emerging Asia in particular has largely ignored slower growth and mortgage troubles in the US. Although the region is highly dependent on trade and financial flows, the US is no longer the primary focus for those links and the strength of domestic demand in countries like China provides a potential offset to export weakness.

US-bound exports account for about 7% of China's GDP, vs the 40% going into domestic investment. The economy there expanded at its fastest pace in twelve years in the latest quarter and we expect that momentum to carry over into 2008, resulting in a further impressive 10.7% rise in real GDP. That comes after an increase of well over 11% this year. Although the central bank is likely to continue tightening policy in graduated steps, rising profit levels and infrastructure needs point to strength in investment spending, the economy's main engine (Chart 18).

Chart 17
No Turmoil in Emerging Markets This Time

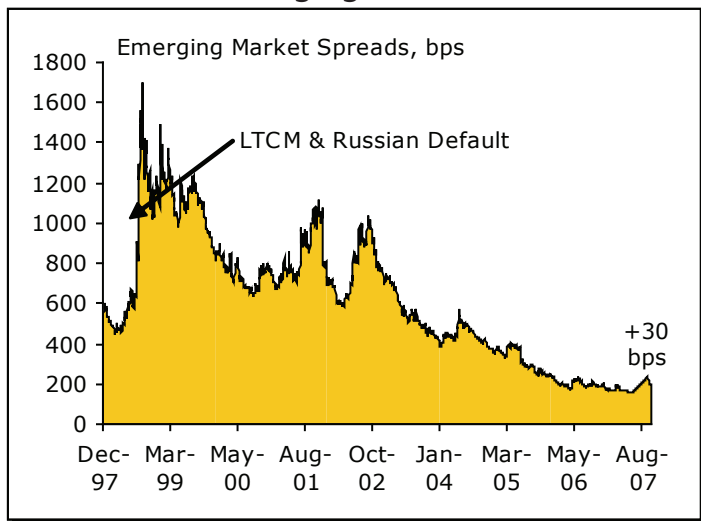


Chart 18
Strong Investment Spending Fueling China's Boom

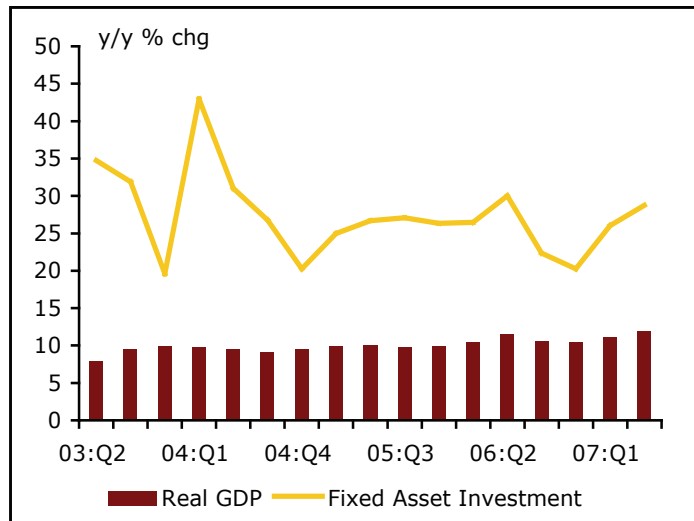


Table 6

Commodity Price Forecast		Average				
		12-Oct	2005	2006	2007 (f)	2008 (f)
Oil (WTI)	\$/bbl	83.77	57	66	70	90
Natural Gas (Henry)	\$/Mn Btu	6.46	8.89	6.73	6.80	8.50
Gold	\$/troy oz.	750	444	604	765	800*
Copper	\$/lb	3.70	1.67	3.06	3.35	3.75
Aluminum	\$/lb	1.10	1.23	1.17	1.20	1.10
Nickel	\$/lb	14.43	6.71	10.98	16.75	14.50
Zinc	\$/lb	1.40	0.63	1.48	1.50	1.65
Uranium (contract price)	\$/lb	95	31	50	100*	120*

*Year-end

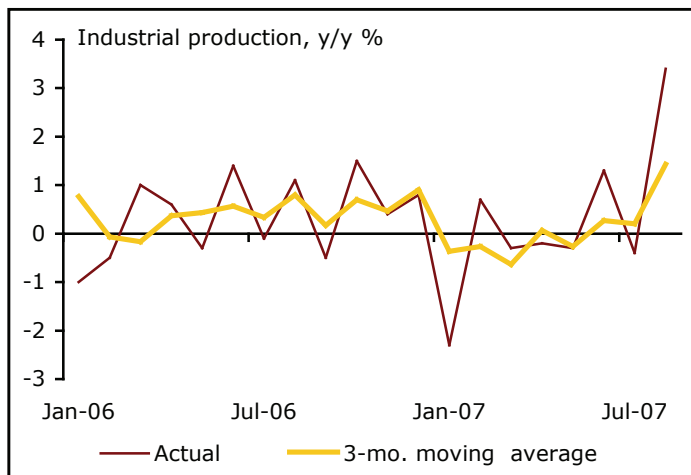
Turning to the other largest emerging Asian economy, resilient domestic demand will contribute to ongoing strength in India, even with drag from recent interest rate hikes and an appreciating currency. GDP there is likely to expand by 8.5% in 2008 after a rise of around 9% this year.

Japan Regains its Economic Footing

Japan's links to the rest of Asia, and a still-accommodative monetary policy, should serve it well. After a sluggish second quarter, according to the country's oft-revised GDP data, Japan's economy also seems to have regained its edge. Allaying concerns about business spending, September's Tankan Survey showed continued momentum in planned investment spending by larger manufacturers. Manufacturing has also recovered from the summer's doldrums, with industrial production up substantially in August (Chart 19). The latest customs data point to a solid contribution from trade to Q3 GDP. We expect the economy to grow by 2.4% in 2007, a bit stronger than recent consensus estimates, and 2.2% in 2008.

Chart 19

Japan's Economy Recovering From Soft Patch



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Eurozone: ECB and BoE Steer Soft Landing

The euro's climb looks impressive against the dollar but is much smaller against its trading partners as a whole (only about half of that endured by Canada since 2002 on a trade-weighted basis), limiting the economic toll. Recent signposts point to resurgent industrial production. Labour markets are also supportive for consumer activity, with a drop in September taking the year-to-date decline in German unemployment to 400K, and jobless levels also on a downtrend in France and Italy in recent months.

With the ECB eschewing further rate hikes, the eurozone should cruise to 2.3% real GDP growth in 2008, slower than the past two years but still a strong pace by historical standards. Eastern Europe, still gaining market share on the continent, could advance at nearly triple that pace. The UK looks a bit more vulnerable, with the BoE having steered a tighter course. Consumers and homeowners are looking stretched in terms of debt financing burdens relative to disposable income growth, and house prices are also threatening to recede. Look for UK growth to decelerate to 2.0% in 2008 after a brisk 2.9% 2007 advance, with the next rate move by the BoE looking increasingly like it will be a cut.