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CURRENCY STRATEGY HIGHLIGHTS

- **US\$ Can Run Further:** A comeback of risk aversion and the associated safe-haven flows should continue to fuel the greenback's ascent over the near term. But we continue to expect a dollar sell-off later in 2011, as global growth returns and markets once again focus on America's fiscal imbalance, quantitative easing, and the need for stronger net exports to drive US growth.
- **Revised Targets:** With the now slightly dimmer outlook for global growth, currencies like the C\$, A\$ and the Brazilian real should be under pressure and we've trimmed our targets accordingly. We've also cut our forecasts for the Mexican peso in line with the now softer outlook for Mexico's exports given the US slowdown.

EVENTS TO WATCH IN COMING MONTH

- **Bank of Canada Interest Rate Decision:** We continue to expect a 25-bp rate hike in September, which should provide a near-term lift to the Canadian dollar as long as the accompanying statement isn't too bearish on growth. Soft inflation should give the BoC comfort in keeping rates on hold after September through mid-2011, which should leave the C\$ vulnerable over the period.
- **US Non-Farm Payrolls for August:** While the weekly jobless claims were biased upwards by various factors, August private sector payrolls will likely remain on the soft side. Oddly, it's the greenback that benefits from the resulting safe-haven flows.

CURRENCY OUTLOOK

| End of period: | 30Aug10 | 2010 III | 2010 IV | 2011 I | 2011 II | 2011 III | 2011 IV |
|-----------------------|---------|----------|---------|--------|---------|----------|---------|
| US\$ Rates: | | | | | | | |
| USDCAD | 1.06 | 1.04 | 1.07 | 1.09 | 1.05 | 1.02 | 1.00 |
| EURUSD | 1.27 | 1.25 | 1.24 | 1.19 | 1.23 | 1.27 | 1.30 |
| USDJPY | 85 | 84 | 87 | 89 | 92 | 90 | 89 |
| GBPUSD | 1.55 | 1.52 | 1.53 | 1.50 | 1.56 | 1.62 | 1.67 |
| USDCHF | 1.02 | 1.02 | 1.02 | 1.06 | 1.06 | 1.06 | 1.04 |
| AUDUSD | 0.89 | 0.88 | 0.87 | 0.85 | 0.87 | 0.89 | 0.92 |
| USDBRL | 1.76 | 1.79 | 1.81 | 1.82 | 1.78 | 1.75 | 1.70 |
| USDMXN | 13.12 | 13.10 | 13.30 | 13.50 | 12.80 | 12.50 | 12.35 |
| Other Crosses: | | | | | | | |
| CADJPY | 80 | 81 | 81 | 82 | 88 | 88 | 89 |
| AUDCAD | 0.94 | 0.92 | 0.93 | 0.93 | 0.91 | 0.91 | 0.92 |
| GBPCAD | 1.64 | 1.59 | 1.64 | 1.63 | 1.63 | 1.65 | 1.67 |
| EURCAD | 1.34 | 1.30 | 1.33 | 1.30 | 1.29 | 1.30 | 1.30 |
| EURJPY | 107 | 105 | 108 | 106 | 113 | 114 | 116 |
| EURGBP | 0.820 | 0.820 | 0.810 | 0.795 | 0.790 | 0.785 | 0.780 |
| EURCHF | 1.299 | 1.280 | 1.270 | 1.260 | 1.300 | 1.340 | 1.350 |

Dollar's Turn to Shine

After several weeks of being pummeled by a euro revival, the US\$ found its feet again in August. Growing concerns about global growth, after the US, China and Japan posted softer-than-expected data, fueled a comeback of safe-haven flows towards Treasuries. The greenback may have further room to run over the near term, buoyed not only by safe-haven flows, but also by the lack of any worse news on the US economy. It won't be too difficult to build on 1.6% US GDP growth for Q2. In contrast, the euro is likely to fall back as the eurozone finds it tough to replicate its strong Q2 data, particularly as governments make do on austerity promises. Japan similarly looks headed for weaker news.

A sluggish Q2, and the steep retreat in housing activity as tax incentives expired, has rekindled talk of a double-dip recession in the US. But other indicators, including the ISM, the Philadelphia Fed's ADS index and our own Recession Probability Index, still point to slow growth rather than an outright recession (see July 2010 publication of *Economic Insights*). In either case, the greenback looks poised to benefit further from risk aversion if history is any guide. Note the US\$'s healthy showing during past recessions or periods of slow growth (Chart 1).

But, near-term strength should give way to long-term weakness in 2011. Low inflation and slow growth will have the Fed put off rate hikes until well into 2012 while several major central banks could be tightening sooner. Moreover, markets will anticipate that the US

will need a weaker currency if net exports are to pick up some of the role formerly played by excessively levered households in driving growth.

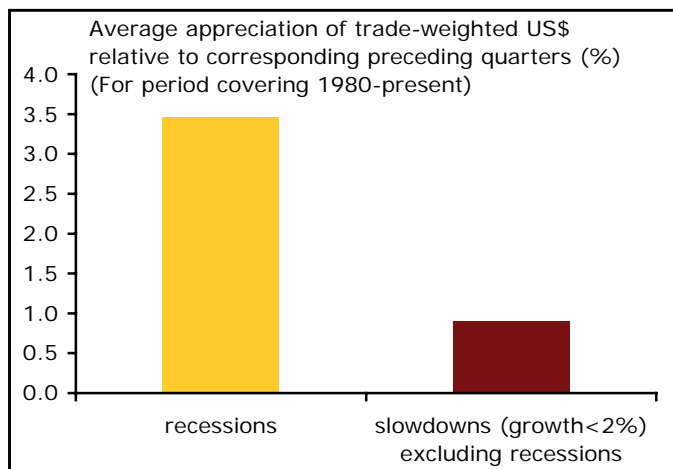
Canadian Dollar Hurt by Soft Data

Not surprisingly, the Canadian dollar struggled as the US\$ took off in August, losing roughly 3% against the big dollar in the month. Weaker global outlooks took oil prices lower, but the string of soft data at home didn't help either, as markets trimmed odds of a September Bank of Canada interest rate hike (Chart 2). The core inflation rate for July surprised to the downside, dipping below the BoC's estimate for Q3, suggesting that the negative output gap may be larger than initially thought. Growth for the second quarter is also expected to end up below the BoC's estimate. Chances are, however, that the Bank has not sufficiently trimmed its growth forecast (which was more bullish than ours) to justify leaving rates on hold just yet, and the surprise of a September rate hike could see dollar-Canada spike down to 1.02, but unable to hold that level if it becomes clear that the hike is the last for a while.

The current account deficit deteriorated further in Q2 to \$11 bn or roughly 2.7% of GDP. Until global growth puts fresh momentum into commodities, that run of red ink is likely to continue. Clearly, then, the C\$ remains vulnerable to any drying up of capital inflows.

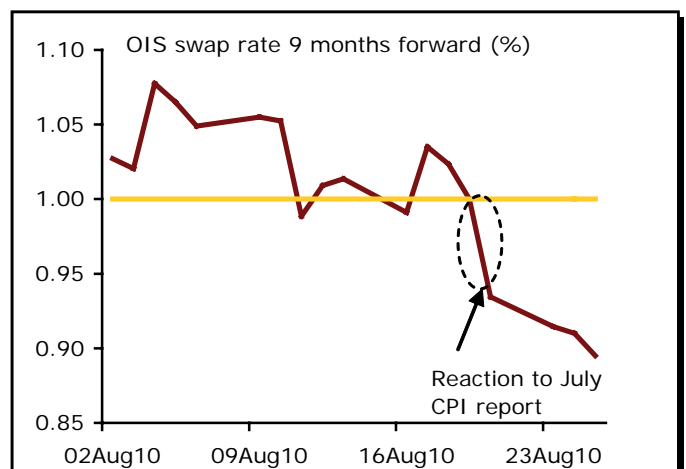
The slowdown already in evidence in the US, and a stall in housing-related activity at home, will see Canadian

Chart 1 - US\$ Showed Decent Gains in Past Recessions or Slowdowns



Source: Haver Analytics, CIBC

Chart 2 - OIS Markets Now Not Fully Pricing in a September Rate Hike



Source: Bloomberg

growth dipping below 2% annualized in Q4. With no additional progress in further narrowing the output gap, we see the Bank of Canada staying on hold after its September hike until mid-2011. While demand for Canadian bonds should remain healthy over the longer term (see August 2010 publication of *GPS Monthly*), and M&A interest in the resource sector remains supportive, the recognition that short-rate spreads will not get more generous in the near term will take some of the momentum out of capital inflows.

We have accordingly weakened our year-end call for the Canadian economy by two cents, with dollar-Canada at 1.07 C\$/US\$ en route towards our end of Q1 forecast of 1.09. We could see temporary periods above 1.10 when the market gets particularly nervous on global growth. Longer term, we remain C\$ bulls, expecting a lift from commodities as global growth prospects improve, coupled with rising interest rates (relative to a static Fed), which should allow for another run towards parity by end of 2011.

Eurozone: Worlds Apart

Economic divergence across the eurozone has proved to be writ large in the wake of the Q2 data, with Germany registering its strongest quarterly gain since reunification, just as Greek quarterly output declined 1.5%. Fiscal austerity measures which were seen as necessary to assuage nervous bond market investors earlier in the year are now being seen as economic headwinds. Such measures, in conjunction with an ECB bond safety net, had temporarily stemmed the slide in the euro and set aside talk of an imminent break-up of the European Monetary Union. But it is apparent that eurozone structural strains are once more coming to the fore. With building expectations that the US may be forced to embark upon QE2, there is little reason to suggest that the EU will be immune from pressures to follow a similar, albeit alternative, path.

A deceleration in global economic activity will raise the risk that necessary and agreed upon structural reforms are scaled back. As Fed Governor Bernanke noted in 2002, albeit in relation to Japan, '... in the short run, comprehensive economic reform will likely impose large costs on many, for example, in the form of unemployment and bankruptcy. As a natural result, politicians, economists, business people and the general public...have sharply disagreed about competing proposals for reform.' Thus while we are

seeing investors continuing to push capital into bond markets, taking German yields to all-time lows, the underperformance in the eurozone's peripheral bond markets has seen bond spreads blow back out towards the crisis wiles, as investors remain skeptical of the closing out of underlying imbalances.

While Ireland argued that the methodology behind its recent ratings downgrade was flawed, fears of additional downgrades tied to the rising costs of bank re-capitalization will weigh on broader eurozone sentiment. The continued increase in CDS levels (Chart 3), capturing the rising cost of insuring the periphery's debt, suggests that additional sovereign downgrades are being discounted, underlining a decoupling between core 'old' Europe and the peripheral members. Moreover, the reliance of the parts of the European banking sector on ECB funding, explicit or otherwise, underlines domestic fragilities. Overall, then, the structural negatives that had prompted the previous sell-off in the euro are still manifest.

Markets had been anticipating a move towards policy normalization from the ECB. But recent comments from arch Bundesbank hawk and potential ECB President candidate Weber hint at maintaining unlimited lending to banks past year end. Leaving potential exit discussions until at least Q1 2011 underlines that even though the ECB may attempt to shy away from discussions regarding forms of quantitative easing, we are likely to see pressure towards something similar, even if it's known under a different name. Thus we would anticipate that additional downbeat European newsflow will continue to underline negative euro sentiment into 2011. Even if a Bernanke-led Fed

Chart 3 - Eurozone CDS Spreads Soar



Source: Thomson Reuters

embarks on QE2, downside risks for the USD are likely to be short-lived. Look for structural divergence and a likely drag on German export activity to prompt a re-test of 2010 lows in EUR USD prior to year end.

GBP Trading the Range

The fortunes of sterling remain largely tied to those of the global economic environment, this as the correlation between the performance of the FTSE index (which is as much a barometer of international activity due to its composition) and GBP USD and EUR GBP remain significant (Chart 4). The three-month correlation between the FTSE and GBP USD equates to around 0.71 while over six months EUR GBP has a correlation coefficient of 0.77. Therefore it is evident that the fortunes of a small open trade-orientated economy such as the UK are inextricably entwined with expectations for the global economy.

Thus the deterioration in global economic sentiment has helped constrain the near-three-month ascent of sterling against the US dollar from a post-election low of US\$1.42 to the narrow failure to trade through the US\$1.60 threshold. The inability to breach that key psychological level could be significant, and we look to trade the range US\$1.50-1.60 over the course of the next 12 months, levels at which we would consider sterling to be fairly valued against the USD.

Against the euro, although equity correlations will remain significant, and the anticipated UK fiscal tightening will be a drag on growth expectations, we expect those factors to be outweighed by structural negatives within the eurozone that will favour sterling

Chart 4 - Sterling Correlated With Equities



Source: Thomson Reuters

on a relative basis. Concerns over potential defaults by peripheral eurozone governments will hurt the euro. That, and the lack of any move to normalize eurozone rates until well into 2011 given the need to support the banking sector, point to modest downside risks for EUR GBP.

The latest BoE quarterly inflation bulletin incorporated a more moderate growth outlook, but the central bank remains overly optimistic in projecting a rebound to growth of 2.8% in 2011 and 3.2% in 2012. With fiscal policy tightening, that would require a sharper acceleration in private sector demand than seems likely, given labour market pressures. But even if growth disappoints, it's unlikely to come down so far from the robust cyclical peak of 1.2% in Q2 that it would require additional monetary stimulation in terms of an extension of the quantitative easing program, which has been capped at £200 bn since November 2009.

Nevertheless, while the initial response to QE was to weaken the currency in a world where such credit easing is now regarded as less unorthodox, even should the BoE re-start the QE process we would not regard such a policy as uniformly GBP negative. A proactive approach to reigniting growth might be seen as more of a positive, particularly if it were accompanied by similar moves within the G4.

CHF Shrugged Off Intervention

The Japanese, now considering unilateral intervention to weaken their currency, could find the Swiss experience to be instructive. The SNB attempted to cap the appreciation of the CHF, but in view of the recent surge to its all-time strongest level against the euro and the resulting loss of CHF14.3 bn on their foreign exchange reserves, showed that, at least to this point, currency intervention at the scale that the Swiss were prepared to undertake was an expensive failure.

Swiss concerns over CHF strength centred on both deflation fears and the negative implications for its corporate competitiveness relative to Germany, with which it both trades and competes in other markets. But those concerns could be waning, with European economies doing better in Q2, and Swiss exports also getting a lift from demand outside the euro area, leaving it less sensitive on demand from its immediate neighbours. So for now, the SNB may be a bit less fearful of the growth and inflation dampening impacts

of a strong currency, even if weaker growth ahead challenges such presumptions into year end.

Should the SNB continue to stand aside from the currency, the prospective path for EUR USD will remain a key driver for underlying CHF performance (Chart 5). As a result, our expectation for a further slide in the euro against the dollar implies fresh record lows in EUR CHF, to perhaps as far as CHF1.25. For USD CHF, we are likely to continue to see downside momentum in the near term, although we would not expect to see a durable break below CHF1.01.

JPY Caught in the Crossfire

The Japanese yen proved to be one of the leading beneficiaries of risk aversion, alongside the other major current account surplus currency, the CHF. Indeed the yen was the best performing major currency against both the EUR and USD in the past month, taking it to its strongest levels in 15 years against the USD and in nine years vs. the euro. Those gains came, at least in part, on the back of domestic investors unwinding JPY net short positions. The appreciation, which has a negative correlation with equity market performance and thus broader economic confidence, has led to renewed speculation that the monetary authorities will be forced to intervene to prevent additional JPY appreciation. Clearly, a strong yen is an anathema in a world of decelerating growth, particularly with Japan still stuck in a deflationary spiral and currency gains leaving downside pressures on imported goods prices.

Although Japanese intervention did work to weaken the yen in the mid-1990s, the Swiss experience suggests that it might take large scale, unsterilized intervention to have much of an impact. For now, Japan's only timid musings in that direction leave the yen vulnerable to a further strengthening, since risk aversion is seeing market flows out of high-yielding currencies like the AUD, and central banks are diversifying out of US Treasuries into other currencies, including the yen. Japan might want to avoid the risks to trade relations from an aggressive move into currency intervention, and getting a green light from major trading partners would in any event have to wait until an October 22-23 meeting for Finance Ministers in South Korea. Even then, more effective bilateral intervention would appear to be ruled out, since the US faces similar concerns over deflation and growth risks, and would therefore not participate in a move aimed at strengthening the dollar against the yen.

In the near term, in the absence of aggressive steps by Tokyo, we could see dollar-yen drift lower, potentially even testing ¥80 extremes for the first time since 1995. But if, as we expect, the global economy manages to avoid an outright double dip, somewhat reduced risk aversion could take the shine off further inflows into the yen into 2011.

Longer term, as the Japanese economy slowly returns to health, it could still be one of the countries that could tolerate a firmer currency against the greenback, given its bilateral surplus with the US. That would be particularly true if the currencies of other, increasingly important Japanese trading partners like China and South Korea are also gaining on the greenback at that

Chart 5 - CHF Moves in Sync With Euro



Source: Thomson Reuters

Chart 6 - Real Effective Yen



Source: Thomson Reuters

point. Note that even at today's levels, Japan's overall real effective exchange rate is not nearly as overdone as it was in the mid-1990s (Chart 6).

AUD Balancing Post-Election Risks

Traditionally, the key drivers of AUD performance have been the usual FX dynamics in terms of short- and long-term interest rate spreads allied to relative growth dynamics. While relative growth remains a significant influence, it is now being swamped by sentiment on the global economic environment, and its impacts on commodity prices, equity valuations, and the demand for commodities currencies.

As a result, AUD performance against the USD has seen a correlation coefficient of 0.93 against the S&P index over the last three months, and vs. the CRB index, the correlation coefficient is 0.89. Thus the AUD remains a currency highly correlated with risk appetite and global economic activity, in particular in the commodity space and via trade linkages with China (Chart 7).

The recent deterioration in sentiment and risk appetite has left the AUD with significant underperformance against the traditional safe havens of the JPY and CHF over the last month. But despite the CRB slide, and the political uncertainties surrounding a hotly contested Aussie election, speculative investors maintained significant net long positions in the AUD. In the week ended August 17, long positions equated to more than US\$5 bn, which in view of the market liquidity of the AUD is sizeable. While we can expect to see some residual position reduction in the wake of the first

inconclusive election result in 70 years, we would argue the example of the UK in the immediate aftermath of the hung Parliament in May could be instructive. If so, any political negativity for the AUD could be relatively short-lived if economic/fiscal management is not a key issue and the central bank is still regarded as credible.

With Australia one of the few developed economies to have avoided an outright recession, the early stages of a global recovery saw the RBA moving to normalize policy after Q3 2009, hiking rates from 3.0% to 4.50%. Although the relationship between short end spreads and the AUD may have become less direct, it is evident that expectations of even higher rates was behind the extended run towards the AUD. Those hopes were then dashed by both global growth disappointments and less robust domestic data. After seeing December 2010 implied rates peak at almost 6% back in Q4 2009, additional rate hikes have been priced out of the system. Since they are unlikely to return any time soon and global growth concerns will be at play in the near term, the AUD will remain vulnerable to position squaring that sees it weaken further over the next few months.

US Slowdown Takes Steam Out of Mexican Peso

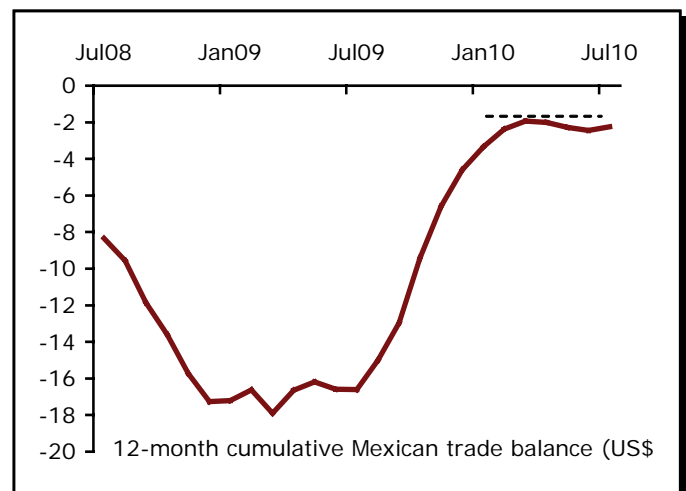
Like most other majors, the peso struggled to stand its ground against the US\$ in August, losing roughly 4% in the month. A spate of soft US data had markets question the sustainability of US demand for Mexican exports. Note that earlier in this US recovery, it was the lift from US demand for Mexican products, and the resulting narrowing of the Mexican trade

Chart 7 - A\$ Highly Correlated With Commodities



Source: Thomson Reuters

Chart 8 - Mexican Trade Balance Levels Off



Source: Bloomberg, CIBC

deficit (Chart 8) that had given life to the peso. Now, the evident US slowdown puts those gains at risk, particularly as softer US inventory building in the second half feeds through into lower orders south of the Rio Grande.

Indeed, July's manufacturing index of economic activity from the Mexican Institute of Finance Executives (IMEF) showed a third consecutive monthly decline, suggesting that the slowdown in factory activity and its hit to GDP is already underway in Q3. Domestic demand is unlikely to fill the breach, as soft June retail sales data and weak consumer confidence point to challenges on that front. High food prices may be constraining the ability of consumers to buy other items. All of that makes rate hikes from the Banco de Mexico less likely, a negative for the peso in terms of capital flows. We have, therefore, trimmed our forecasts for the currency, with our end-of-year target now at 13.3 peso/US\$. Tighter monetary policy next year, together with a more positive economic outlook, should help the peso make a comeback in 2011.

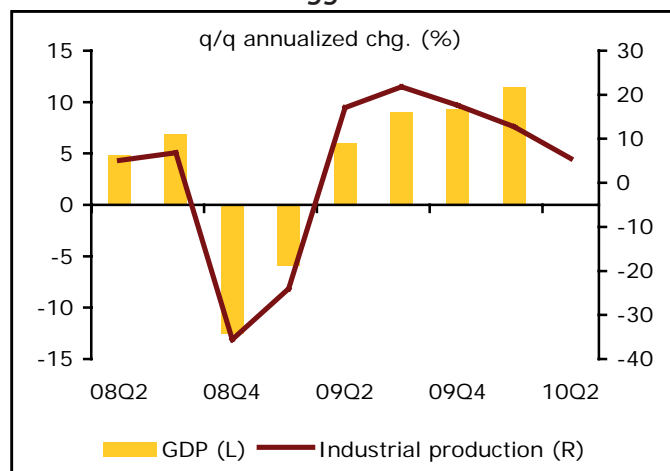
Brazilian Real Targets Revised

After seeing a sharp V-shaped recovery, Brazil is due for a moderation in its economic growth rate. Repeating Q1's sizzling 11% annualized rate of growth was always a tall order for Brazil and it's becoming apparent, after the release of soft industrial production data for June, that second quarter GDP growth will be modest, perhaps less than half the prior quarter's print (Chart 9). And July's manufacturing PMI reading suggests that

the downshift in factory activity extended to the third quarter as well. While retail activity has been robust during the recovery, there are signs of it also cooling down. With the expiry of temporary government incentives, the contribution of consumption spending to growth should ramp down a notch in the second half of the year.

Export growth is likely to decelerate a bit in response to the reported slowdown in China, Brazil's largest customer. That will put further pressure on the current account deficit, which is already starting to widen. Capital inflows are, for now, helping support the real, but the currency remains vulnerable to a reversal of those flows should there be a marked negative turn in market sentiment. All told, despite inflation remaining slightly above target, the Banco Central do Brasil could take a pause in its tightening cycle sooner rather than later, in response to the slowdown underway. That prospect prompted us to weaken our end-of-year target from 1.75 to 1.81 real/US\$.

Chart 9 - Brazilian IP Suggests Softer GDP Growth



INTEREST RATE AND ECONOMIC OUTLOOK

| End of period: | 2010 IV | 2011 I | 2011 II |
|-----------------------|---------|--------|---------|
| Canada | | | |
| Overnight target rate | 1.00 | 1.00 | 1.25 |
| 2-Year Gov't Bond | 1.50 | 1.65 | 2.00 |
| 10-Year Gov't Bond | 3.10 | 3.20 | 3.50 |
| US | | | |
| Federal Funds Rate | 0.20 | 0.20 | 0.20 |
| 2-Year Gov't Note | 0.60 | 0.80 | 1.00 |
| 10-Year Gov't Note | 2.70 | 2.75 | 3.00 |
| Eurozone | | | |
| Refin.operations rate | 1.00 | 1.00 | 1.00 |
| 2-Year Gov't Bunds | 0.60 | 0.70 | 0.80 |
| 10-Year Gov't Bunds | 2.70 | 3.25 | 3.40 |
| UK | | | |
| Bank rate | 0.50 | 0.50 | 0.50 |
| 2-Year Gilts | 1.00 | 1.10 | 1.20 |
| 10-Year Gilts | 3.50 | 4.00 | 4.10 |
| Japan | | | |
| Overnight rate | 0.10 | 0.10 | 0.10 |
| 2-Year Gov't Bond | 0.18 | 0.18 | 0.18 |
| 10-Year Gov't Bond | 1.20 | 1.35 | 1.40 |

| | 2010 | 2011 |
|-----------------------|------|------|
| Canada | | |
| Real GDP growth (%) | 3.2 | 2.5 |
| Unemployment rate (%) | 8.1 | 8.1 |
| CPI (%) | 1.6 | 1.9 |
| US | | |
| Real GDP growth (%) | 2.6 | 1.9 |
| Unemployment rate (%) | 9.8 | 9.6 |
| CPI (%) | 1.6 | 1.5 |
| Eurozone | | |
| Real GDP growth (%) | 1.5 | 0.9 |
| Unemployment rate (%) | 10.1 | 10.4 |
| CPI (%) | 1.5 | 1.5 |
| UK | | |
| Real GDP growth (%) | 1.5 | 1.5 |
| Unemployment rate (%) | 8.3 | 8.7 |
| CPI (%) | 3.1 | 2.1 |
| Japan | | |
| Real GDP growth (%) | 2.8 | 1.8 |
| Unemployment rate (%) | 5.1 | 4.9 |
| CPI (%) | -1.2 | -0.2 |

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