



**Jeffrey Rubin**  
(416) 594-7357

**Avery Shenfeld**  
(416) 594-7356

**Benjamin Tal**  
(416) 956-3698

**Peter Buchanan**  
(416) 594-7354

**Meny Grauman**  
(416) 956-6527

**Krishen Rangasamy**  
(416) 956-3219

Avery Shenfeld, Toronto • Krishen Rangasamy, Toronto

**WHAT'S INSIDE:**

- US Dollar Nears Turn
- M&A Flows Could Tip C\$
- Europe Matters
- Yen to Find Support in 2009
- A\$ Vulnerable if RBA Stands Pat
- Yield Play to Support Peso for Now

**CURRENCY STRATEGY HIGHLIGHTS**

- **US\$ Nears a Turning Point:** While we see a final leg to broad-based US\$ weakness, we're nearing a turning point. Next year the dollar's performance will be more mixed, with any depreciation much more regionally focused.
- **C\$ Looks to M&A Flows:** We touched our Q2 target for dollar-Canada (0.985). Further strength in the loonie could come from M&A flows if high oil and gas prices spark foreign takeover interest. But sustaining a significantly stronger level is unlikely if the US\$ is less out of favor in 2009 and the Fed out-guns the BoC in 2009 rate hikes .

**EVENTS TO WATCH IN COMING MONTH**

- **Oil Prices:** Crude came a long way in a hurry, helping push the C\$ a bit in the process. Corrections along the way are inevitable, but won't alter the longer-term trend
- **US Employment (Jun 6<sup>th</sup>):** The modest pace of job losses has, thus far, been in line with only a minor GDP drop in Q2-Q3.
- **Eurozone Ind Prod (Jun 12<sup>th</sup>):** The market will see if the downtick in the German IFO is confirmed in this broader indicator of industrial activity.
- **Bank of Canada (Jun 10<sup>th</sup>):** A quarter-point rate cut seems inevitable, so markets will look at wording surrounding future action. At this point, Carney is going to leave the door open for a further cut, given the BoC's view that the US recession could get uglier. If so, slightly negative for the C\$.

**CURRENCY OUTLOOK**

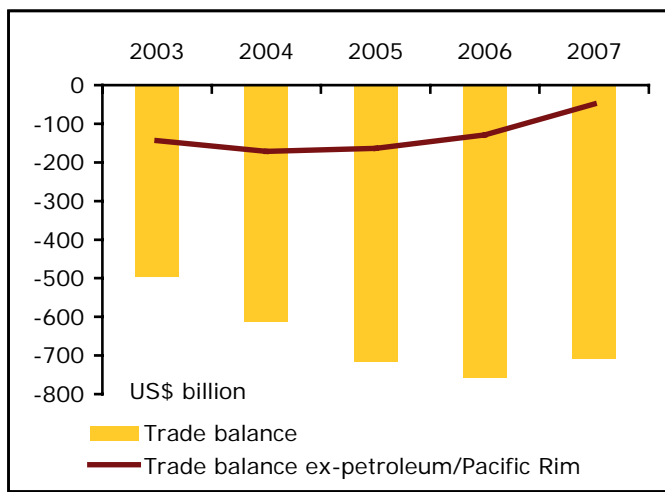
End of period:	2008 III	2008 IV	2009 I	2009 II	2009 III	2009 IV
<b>US\$ Rates:</b>						
C\$/US\$	0.955	0.952	0.970	0.980	0.980	0.985
US\$/Euro	1.62	1.56	1.50	1.49	1.49	1.50
Yen/US\$	104	106	100	97	96	94
US\$/Sterling	1.99	1.96	1.90	1.90	1.88	1.90
SFr/US\$	1.00	1.04	1.09	1.09	1.10	1.09
US cents/A\$	96.5	93.0	92.5	91.0	92.0	93.0
Mex Peso/US\$	10.2	10.5	10.5	10.4	10.3	10.2
<b>Euro crosses:</b>						
Yen/Euro	168	165	150	145	143	141
Sterling/Euro	0.815	0.795	0.790	0.785	0.788	0.790
SFr/Euro	1.620	1.624	1.630	1.630	1.635	1.635

### US Dollar Nears Turn

The US dollar could still have one more bout of generalized weakness. For one, economic numbers stateside will continue to trail those for the eurozone, Australia, and other trading partners. Second, the market is assuming that a stand-pat decision by the Fed in June means rate cuts are done for good, but a Q3 rate cut is still possible if economic results deteriorate. But we would sell euros, sterling and the A\$ beyond September, as Fed tightening lies ahead for 2009.

Structurally, the US dollar is no longer clearly overvalued against most of its trading partners. Strip out trade with the Pacific Rim and energy trade, and America's trade deficit is negligible (Chart 1), with high shipping costs likely to impede import penetration ahead. The overall trade deficit is still unsustainably large, so look for a trend appreciation for the Chinese yuan, Japanese yen, and if they break their pegs to the greenback, the currencies of OPEC and other major oil exporters.

Chart 1 - US Trade Close to Balance Excluding Oil and Pacific Rim

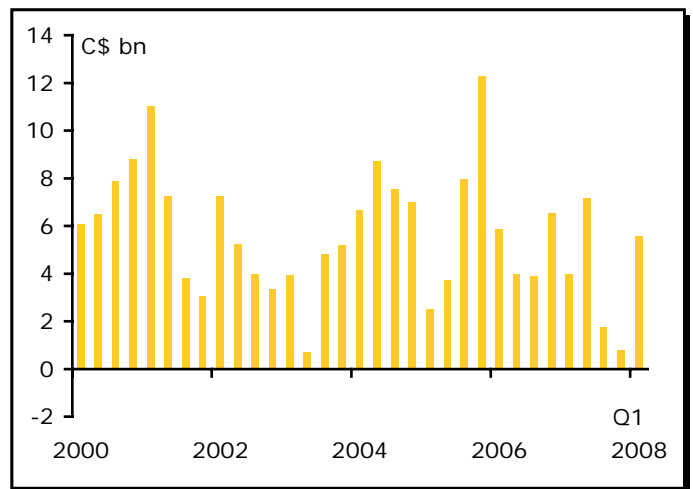


### M&A Flows Could Tip C\$

The current strength in the C\$ roughly balances the trade gains being reaped by commodities producers against the trade trauma suffered by non-resource manufacturing exports, particularly in the automotive sector. The last two quarters' current account results

reflected that delicate balance, showing a return to a healthy Q1 surplus after a nearly balanced Q4 (Chart 2), despite the drag from tough economic conditions in the US market. We look for further surpluses ahead, helped by high nominal prices for oil, gas, grains and some metals.

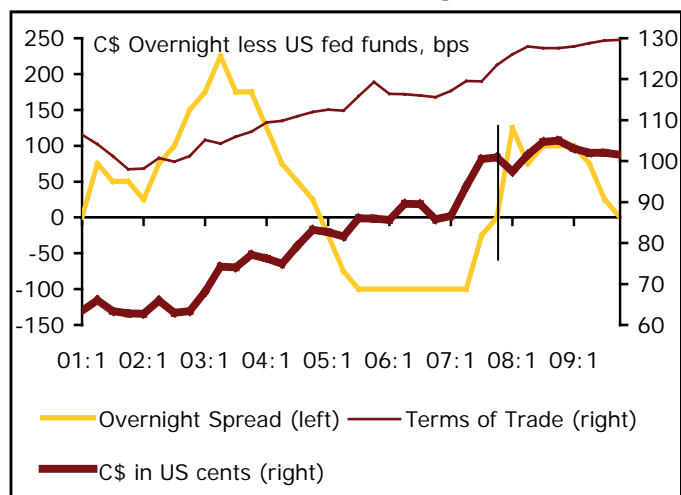
Chart 2 - Cdn Current Account Balance Rebounds



With the current account still supportive, swings in capital flows will be in control for dollar-Canada over the next 18 months. In the near term, with Canada-US interest rate spreads not likely to shift much to year-end, the sharpest capital flow swings could lie in foreign direct investment, particularly in the typically choppy flows tied to M&A transactions. Leveraged deals are tougher to complete these days, but debt financing is hardly the issue in the cash-laden energy sector. Last year's C\$-boosting takeover wave in base metals left fewer buy-out candidates left, but we wouldn't be surprised to see a global player take a run at some of Canada's prized oil and gas assets.

Look for the C\$ to settle back to only slightly above parity as we move through 2009. Although the Bank of Canada will be hiking rates, it will be out-gunned by the Fed. Inflation will be slightly hotter stateside, and having cut interest rates more aggressively, the Fed will be playing catch-up (Chart 3).

**Chart 3 - C\$ Stable as Rising Terms of Trade Counters Loss of Yield Advantage in 2009**



## Europe Matters

While much of the dollar's descent since 2002 was a made-in-the-USA story, Europe is starting to matter more for the direction of the euro. First-quarter growth, led by business capital spending, surprised analysts to the upside, although it was consistent with our view that a sagging US would not have as much of a spillover impact as some feared. Germany looked particularly healthy.

On the inflation front, the ECB has always been much less willing than the Fed to sweep aside rising energy prices and focus on a more benign "core" inflation concept. As a result, the central bankers continue to talk hawkishly. While we doubt that a rate hike is forthcoming, given the economic drag of high oil prices, a strong euro and a US slump, the consensus continues to put some odds on a Q4 rate cut, which we judge as unlikely. A stand-pat ECB, coupled with reasonable odds of a final Fed cut in Q3, leaves room for a renewed push for the euro above US\$1.60, and we've retained our \$1.62 target.

Longer term, however, we see the euro as having essentially completed its adjustment against the US dollar. The currency area's current account has been roughly in balance in the last four quarters, and its exporters will already be at a competitive challenge in the US market at anything near this exchange rate. A narrowing of the US-Eurozone interest rate differential in 2009 should see the dollar recoup some of its earlier drop.

Cable is likely to largely mirror the dollar-euro trend. The Bank of England's recent inflation report suggested that further rate cuts aren't going to be forthcoming unless economic performance opens up substantial additional slack. The first quarter didn't provide that elbow room, with a healthy consumer keeping growth steady, if unspectacular, at 0.4% not annualized vs. Q4. Manufacturing looks to be softening, as is the labor market, though not enough to send the jobless rate higher. Q2 growth might be weak enough, and housing prices under enough threat to keep some hopes for rate cuts alive, even as the BoE stays on hold. As a result, we expect sterling to underperform the euro in the coming quarter.

## Yen to Find Support in 2009

Economic jitters over the US, and a return by the Fed for a final rate cut in Q3, should prevent carry traders from getting carried away with short-yen positions, keeping dollar-yen largely rangebound over the remainder of the year. But some disappointing recent data have us calling for a slightly softer yen than our previous 2008 targets. Consumer confidence has slipped and nationwide department sales were down year-on-year in both March and April. In addition, machine orders fell in March adding to the 12% drop in the prior month, while industrial production also saw a significant monthly drop to its first year-on-year contraction in almost three years. Note that all of this does, however, come after an extremely strong performance in the latter half of 2007.

Look for a stronger yen come 2009. After a decade or so of deflation, Japan finally has inflation, with the headline now above 1% and the core lying in positive territory for the first time in nine years. Tight labor markets have also allowed for some modest wage inflation, while pressures from global food and energy prices will continue to push headline inflation. The BoJ will renew rate hikes in 2009, which while not outpacing the Fed, will narrow the yen's yield disadvantage against other dollar alternatives.

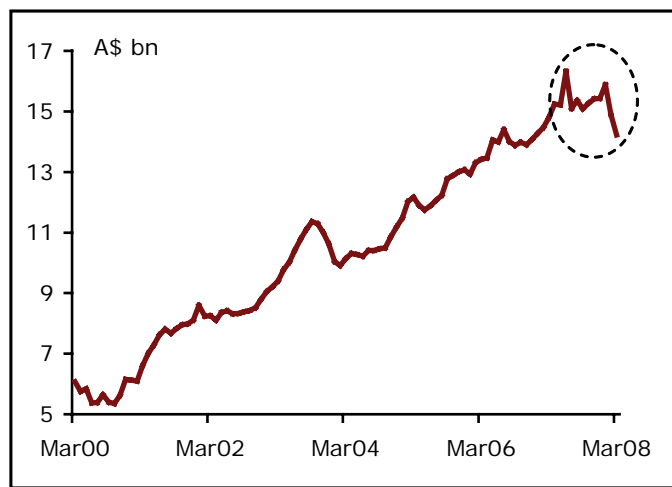
Japan's overall nominal trade balance has deteriorated on high energy import bills, but unlike US-Europe trade which has turned, the strong yen has yet to dent America's bilateral balance with Japan. That leaves room for the yen to appreciate, particularly if other Asian currencies also head higher, mitigating the impact of our dollar-yen outlook on Japan's overall competitive position against its trading partners. Increasingly, Japan's trade will be regionally based, reflecting not only rapid demand in the Pacific Rim, but also higher shipping costs to the US market.

### A\$ Vulnerable if RBA Stands Pat

The A\$ overshot our end-of-June target, but that move looks unsustainable, being based on expectation for a rate hike by the Reserve Bank of Australia that doesn't look probable. True, the last RBA minutes showed that a rate hike was discussed before the Bank eventually stayed put. But not enough has changed to alter that call at the upcoming June 3<sup>rd</sup> meeting.

Although CPI will remain elevated for a while, unlike the Fed, the RBA has already fired a lot of rate hike bullets battling it. There are enough signs those rate hikes are beginning to bite for the central bank to stand aside. Real retail sales fell in Q1 on weakness in discretionary items. Cracks are appearing in Australia's real estate market as demonstrated by deteriorating housing affordability, weak building approvals and slower construction activity in Q1, all direct results of the cumulative tightening in financing conditions. And fresh news since the RBA's last meeting had business confidence continuing its decline and home loans approvals in March falling another 6.1% following a 6.8% drop in the prior month (Chart 4). Even wage cost growth slowed more than expected.

**Chart 4 - Australia Housing Finance Value of Loans Sees Downturn**



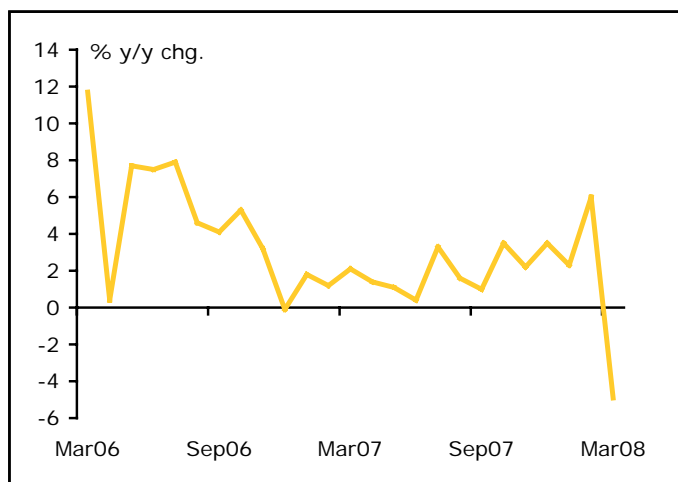
By September, the A\$ could rebound from any June disappointments if the Fed dispatches one last rate cut in the third quarter. In addition, the Australian terms of trade is expected to improve further given elevated prices for Australia's exports. As a result, we have revised our forecast towards a slightly stronger A\$ with the currency peaking in Q3 and leveling off thereafter, as markets look ahead to US rate hikes in 2009.

### Yield Play to Support Peso for Now

The Mexican peso rode the wave of high oil prices and widening yield spreads to reach its strongest level in five years against the US dollar. But while the oil boost should continue, look for the peso to weaken off after Q3 as interest rate spreads with the US narrow.

Signs point to a slowing Mexican economy, with Q1 retail sales seeing a moderate decline from the prior quarter and industrial production falling significantly in March (Chart 5). Interest rate cuts are, however, not feasible for the Banco de Mexico given that core inflation rate has been stuck above 4% for the past seven months, which has instead fueled talks of interest rates moving even higher from an already elevated 7.5% target rate. Such talk should see the peso drawing support as a yield play for another quarter or so, particularly if the Fed has a final rate cut in store.

Chart 5 - Industrial Production Dives in Mexico



But late this year and into 2009, rising US bond yields will narrow that yield support. And in the longer term, the peso will be dealing with the drag from a chronic current account deficit. High oil prices will be countered by depleting reserves and declining production at Mexican oil fields, and the country's increasing domestic appetite for its oil. The best defense against a significant depreciation beyond 2009 is the prospect for Mexico to begin to gain share in the US market at the expense of distant Asian factories that will face the dual challenges of stronger currencies and rising overseas shipping costs.

**Conflicts of Interest:** CIBC World Markets' analysts and economists are compensated from revenues generated by various CIBC World Markets businesses, including CIBC World Markets' Investment Banking Department. CIBC World Markets may have a long or short position or deal as principal in the securities discussed herein, related securities or in options, futures or other derivative instruments based thereon. The reader should not rely solely on this report in evaluating whether or not to buy or sell the securities of the subject company.

**Legal Matters:** This report is issued and approved for distribution by (i) in Canada by CIBC World Markets Inc., a member of the IDA and CIPF, (ii) in the UK, CIBC World Markets plc, which is regulated by the FSA, and (iii) in Australia, CIBC World Markets Australia Limited, a member of the Australian Stock Exchange and regulated by the ASIC (collectively, "CIBC World Markets"). This report is distributed in the United States by CIBC World Markets Inc. and has not been reviewed or approved by CIBC World Markets Corp., a member of the New York Stock Exchange ("NYSE"), NASD and SIPC. This report is intended for distribution in the United States only to Major Institutional Investors (as such term is defined in SEC 15a-6 and Section 15 of the Securities Exchange Act of 1934, as amended) and is not intended for the use of any person or entity that is not a major institutional investor. Major Institutional Investors receiving this report should effect transactions in securities discussed in the report through CIBC World Markets Corp. This report is provided, for informational purposes only, to institutional investor and retail clients of CIBC World Markets in Canada, and does not constitute an offer or solicitation to buy or sell any securities discussed herein in any jurisdiction where such offer or solicitation would be prohibited. This document and any of the products and information contained herein are not intended for the use of private investors in the United Kingdom. Such investors will not be able to enter into agreements or purchase products mentioned herein from CIBC World Markets plc. The comments and views expressed in this document are meant for the general interests of clients of CIBC World Markets Australia Limited.

This report does not take into account the investment objectives, financial situation or specific needs of any particular client of CIBC World Markets Inc. Before making an investment decision on the basis of any information contained in this report, the recipient should consider whether such information is appropriate given the recipient's particular investment needs, objectives and financial circumstances. CIBC World Markets Inc. suggests that, prior to acting on any information contained herein, you contact one of our client advisers in your jurisdiction to discuss your particular circumstances. Since the levels and bases of taxation can change, any reference in this report to the impact of taxation should not be construed as offering tax advice; as with any transaction having potential tax implications, clients should consult with their own tax advisors. Past performance is not a guarantee of future results.

The information and any statistical data contained herein were obtained from sources that we believe to be reliable, but we do not represent that they are accurate or complete, and they should not be relied upon as such. All estimates and opinions expressed herein constitute judgements as of the date of this report and are subject to change without notice.

Although each company issuing this report is a wholly owned subsidiary of Canadian Imperial Bank of Commerce ("CIBC"), each is solely responsible for its contractual obligations and commitments, and any securities products offered or recommended to or purchased or sold in any client accounts (i) will not be insured by the Federal Deposit Insurance Corporation ("FDIC"), the Canada Deposit Insurance Corporation or other similar deposit insurance, (ii) will not be deposits or other obligations of CIBC, (iii) will not be endorsed or guaranteed by CIBC, and (iv) will be subject to investment risks, including possible loss of the principal invested. The CIBC trademark is used under license.

(c) 2008 CIBC World Markets Inc. All rights reserved. Unauthorized use, distribution, duplication or disclosure without the prior written permission of CIBC World Markets Inc. is prohibited by law and may result in prosecution.