GPS MONTHLY

GLOBAL POSITIONING STRATEGIES

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Higher Rates, More Supply

Economics (Shenfeld): The Bank of Canada will start taking rates higher by July, but there are seven good reasons for a gradualist approach that will leave overnight at 1.25% at year end (up 25 bps from our prior call), and a still-low 2.5% by the end of 2011. That won't relieve pressure on the bond market in the near term, as investors seeing the first hike will price in a more aggressive path.

Lovely (Government Finance): As 2010 budget season wraps up, we examine the economic and fiscal prospects of Canada's government sector. There's room for improvement in official budget targets, but bond supply, particularly in provi land, will remain elevated. There's more than $75 billion to be issued this fiscal year, with international markets likely to serve as an important outlet for a growing number of issuers.

Ahmed (Rates): With the Canada curve already 50 bps into 'bear-flattening mode', attention has turned to the implications of higher rates on the shape, rather than the slope, of the curve. In addition to an outlook for overnight rates, we find that positioning for changes in the shape of the curve should take into account the relative volatilities of the short and long wings.

Credit (Zapior): Historically, during "normal" market conditions, spreads have been correlated with issuance net of maturities. While we see potential growth in net issuance in 2010, we think the impact will be mitigated, with minimal effect on spreads.

FX Structuring (Gunja): The European single currency has suffered a crisis of confidence of late. Concerns stemming from sovereign debt obligations, notably Greece and possibly other member states have punished the Euro in the G10 currency universe. We offer up a suite of strategies for those looking to express a view through the options market.

Commodities (Buchanan): Despite cyclical highs for oil and some of the metals, the pace of the commodities rally has downshifted from 2009's frenzied clip. Higher interest rates are likely to slow rather than kill the rally, based on past experience. Industrial metals and oil have continued to rise in past cycles after monetary restraint began.

Strategic Risk (Rosborough): China's currency is again facing external pressure for revaluation. Chinese equities, which have lagged the rest of the world since the authorities began their moral suasion tightening in August and actual tightening of conditions via bank reserve requirements since the beginning of this year, may get a shot in the arm if, as, and when a revaluation begins.

ECONOMICS

AVERY SHENFELD

Take it Easy

The Canadian economy surprised to the upside in the past two quarters. Although we've only had a taste of the first quarter news, we've raised our real GDP call by a full percentage point to 5.1% (Table 2) with risks of a further upgrade. In line with that shift, we've added a further quarter-point to our forecast for rate hikes this year, seeing the overnight rate hitting 1.25% (Table 1).

Most of that news is now priced into the yield curve. But as we warned in the March issue of *GPS Monthly*, once the first hike is in place, the bond market is likely to become even more aggressive in its expectations for subsequent moves. The first hike could also prompt more Canadians to fix their variable rate mortgages, putting even more pressure on five-year yields.

Still, hikes in 2011 won't end up being as steep as what the bond market will, at some point, fear. In that regard, Governor Carney should take some time standing on the corner in Winslow, Arizona. For there are seven reasons on my mind as to why the Bank of Canada will "Take it Easy," leaving overnight rates at an historically low 2.5% at the end of 2011.

Don't Fight the Fed (Part 1): The Fed is eyeing a 9.7% jobless rate, and looks to be several quarters away from launching its first rate hike. It will first spend months mopping up excess reserves from the banking system through reverses and maturities before moving to a higher funds rate. US labour markets have only seen one true month of healing, leaving a long road to putting the household sector on the income footing needed for sustained growth.

Why should Carney care about getting too far ahead of the Fed? Because when the Fed is still on hold, it reflects

Table 1. ***Interest and Exchange Rate Forecast***

		2010				2011			
END OF PERIOD:		**7-Apr**	**Jun**	**Sep**	**Dec**	**Mar**	**Jun**	**Sep**	**Dec**
CDA	Overnight target rate	0.25	0.25	1.00	1.25	1.25	1.75	2.25	2.50
	98-Day Treasury Bills	0.29	0.60	1.15	1.05	1.15	1.75	2.35	2.55
	2-Year Gov't Bond	1.83	1.90	2.35	2.00	2.40	2.70	3.00	3.25
	10-Year Gov't Bond	3.68	3.70	3.80	3.75	4.00	4.05	4.00	4.05
	30-Year Gov't Bond	4.13	4.20	4.40	4.30	4.35	4.40	4.35	4.45
U.S.	Federal Funds Rate	0.15	0.15	0.15	0.25	0.75	1.50	2.00	2.25
	91-Day Treasury Bills	0.20	0.15	0.15	0.20	1.00	1.50	1.80	2.05
	2-Year Gov't Note	1.10	1.10	1.20	1.35	2.20	2.45	2.80	3.00
	10-Year Gov't Note	3.96	3.96	4.05	4.10	4.45	4.45	4.35	4.50
	30-Year Gov't Bond	4.85	4.80	4.95	4.85	5.05	5.05	5.00	5.10
Canada - US T-Bill Spread		0.09	0.45	1.00	0.85	0.15	0.25	0.55	0.50
Canada - US 10-Year Bond Spread		-0.28	-0.26	-0.25	-0.35	-0.45	-0.40	-0.35	-0.45
Canada Yield Curve (30-Year — 2-Year)		2.30	2.30	2.05	2.30	1.95	1.70	1.35	1.20
US Yield Curve (30-Year — 2-Year)		3.75	3.70	3.75	3.50	2.85	2.60	2.20	2.10
EXCHANGE RATES	CADUSD	1.00	0.99	1.02	1.01	0.96	1.00	1.01	1.02
	USDCAD	1.00	1.01	0.98	0.99	1.04	1.00	0.99	0.98
	USDJPY	94	93	90	87	86	86	85	85
	EURUSD	1.34	1.35	1.41	1.45	1.47	1.48	1.50	1.51
	GBPUSD	1.52	1.48	1.55	1.61	1.65	1.68	1.72	1.74
	AUDUSD	0.929	0.940	0.960	1.000	0.990	0.995	1.000	1.020
	USDCHF	1.07	1.08	1.05	1.03	1.02	1.03	1.02	1.02
	USDBRL	1.76	1.80	1.75	1.72	1.70	1.69	1.67	1.65
	USDMXN	12.2	13.0	12.7	12.5	12.3	12.3	12.0	12.0

Washington's judgment that a self-sustaining rebound isn't yet assured. Back in 2002 the Bank of Canada jumped ahead of the Fed, expressing more optimism about growth. That time at least, the Fed had it right, and the Bank subsequently had to ease.

Don't Fight the Fed (Part 2): The other hazard in diverging too far from the Fed is that it risks an ever-stronger Canadian dollar. Hiking 100 bps likely won't mean more than a few cents on the loonie, but carrying on beyond that without matching moves from Bernanke could send the C$ into record territory, judging by the swift move in the A$ as the RBA ratcheted up Australian spreads. While factories are recovering in Canada alongside a global industrial revival, output remains nearly 20% below the pre-recession peak, and wages are now substantially above those stateside without the productivity gains to match. There's only so much of a competitive challenge that non-resource exporters can take in short order.

Still Substantial Output Gap: Even after two strong quarters, Canada's output gap is 2-3%. Recent pressure on CPI needn't indicate excess demand. In part, some of the price hikes are simply the mirror image of huge recession-era discounts, with the base effect making for tough comparisons. That sort of impact is one reason why the Bank has looked at price-level targeting as an alternative to its current approach.

Fiscal Tightening: The Federal/provincial budget season had a common theme. Fiscal 2011/12 will entail serious belt tightening, with tax hikes and an abrupt swing from spending largesse to restraint (see pages 6-9). That effort could take a huge slice off next year's growth rate. If so, overnight rates might have to remain stimulative, as rates at 2½% or less would be.

Broke-Back Debt Mountain: Last year, Canadian households leapt at low interest rates, racking up debt at an unprecedented after-inflation pace for a recession. The legacy of that borrowing binge is a household debt-to-income ratio nearing 150%, far more than at the start of the last tightening cycle. As a result, each 100 bps of rate hikes will have a roughly 40% greater impact on household debt financing burdens, putting a greater squeeze on spending power.

Spartan Foreign Budgets: Greece's troubles remain front page news, and its CDS spread continues to show market concern. Even absent an imminent default there, austerity budgeting will impede global growth. Ireland's success in deficit reduction is being applauded, but its economy remains mired in recession as a result. If the US, the UK, and Japan all move from huge stimulus to even modest restraint, Canada will feel it in our export prospects come 2011.

Banking Reforms: The ink isn't yet dry on the new rules of the game. While they might not bite as hard in Canada, G20 regulations requiring added capital and reduced leverage will cut into global bank lending capacity. The more credit tightens due to regulatory actions, the less need for central banks to do it through the overnight rate.

A gentle hand at the Bank of Canada still won't be that friendly to the bond market. At least not yet, as investors are still bracing for what's to come. For equities, robust growth will, at least this year, be more than enough to offset the drag of higher rates (see *Economic Insights,* March 29, 2010). And for the C$, higher rates are the key to spending a few quarters through parity against the greenback.

Table 2. ***Economic Update***

CANADA	09Q4A	10Q1F	10Q2F	10Q3F	10Q4F	2009A	2010F	2011F
Real GDP Growth (AR)	5.0	5.1	2.5	2.3	1.7	-2.6	3.0	2.5
Real Final Domestic Demand (AR)	4.6	4.3	3.0	2.7	2.4	-1.7	3.7	2.1
All Items CPI Inflation (Y/Y)	0.8	1.8	1.8	2.1	1.7	0.3	1.9	2.1
Core CPI Ex Indirect Taxes (Y/Y)	1.6	2.0	1.9	1.9	1.9	1.8	1.9	2.0
Unemployment Rate (%)	8.4	8.2	8.0	8.1	8.2	8.3	8.1	8.1
U.S.								
Real GDP Growth (AR)	5.6	2.5	4.6	1.3	0.7	-2.4	3.0	2.5
Real Final Sales (AR)	1.7	1.9	3.6	1.7	0.7	-1.7	1.9	2.3
All Items CPI Inflation (Y/Y)	1.4	2.3	1.5	1.2	0.9	-0.4	1.5	2.0
Core CPI Inflation (Y/Y)	1.7	1.4	1.0	1.0	0.9	1.7	1.1	1.6
Unemployment Rate (%)	10.0	9.7	9.8	10.0	10.0	9.3	9.9	9.5

Rates

Mohammed Ahmed

Identifying Value in a Volatile World

With the Canada curve already 50 bps into 'bear-flattening mode', attention has turned to the implications of higher rates on the shape, rather than the slope, of the curve. Curvature of the term structure is commonly defined as the difference of slope measurements across sectors and quoted as a butterfly spread. However, the behaviour of term spreads is dependent on the maturities under consideration. Take as an example the 2s-10s-30s butterfly. One would expect that there is more room for movement in the wider 2s/10s spread than there is in the typically narrower 10s/30s spread. Hence, in addition to an outlook for overnight rates, forecasting—and positioning for—changes in the shape of the yield curve should take into account the relative volatilities of the short and long wings.

Higher Rates, Volatile Curves

For the second time in as many quarters, the Canadian economy's surprising strength has prompted upward revisions to 2010 annual GDP forecasts. January's 0.6% GDP increase puts the Canadian economy en route towards a second consecutive 5% annualized GDP print. Consequently, we are now just months away from a new interest rate tightening cycle; short rates currently reflect an expectation that at least one quarter-point hike will be delivered by the Bank of Canada at the July 20th announcement. And while pressure on longer-term yields will be relatively contained, it is clear that the decline in interest rates that characterized the past two decades has drawn to an end. An analysis of the term structure's volatility profile provides a framework with which to tackle portfolio positioning in the looming rising rate environment.

Interest rate volatility is a well-documented determinant of the shape of the yield curve. Typically, volatility rises ahead of expected rate hikes and the belly of the yield curve underperforms the front end. Meanwhile, the additional value of convexity causes rates in the long end to outperform medium-term rates.

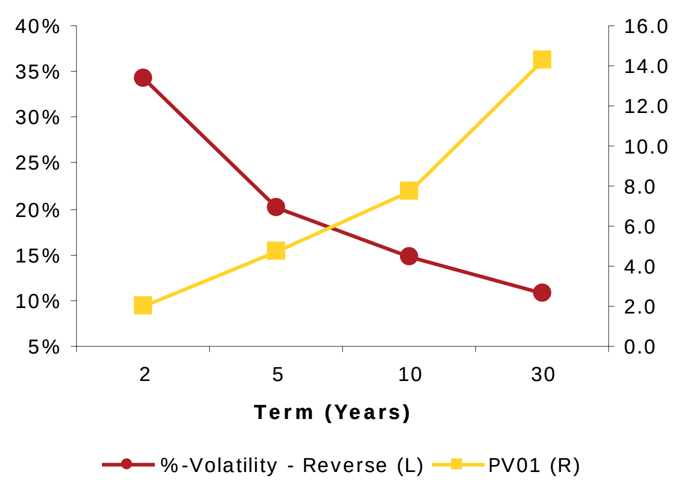
Furthermore, it is intuitive to expect that the performance of a portfolio is not singly dependent on the dollar-sensitivity of a particular sector to changes in yield, but also on the relative rate at which that yield moves up and down. This argues in favour for structuring curve trades as volatility-neutral.

Traders traditionally weight butterfly trades to be neutral in terms of a parallel shift of the curve by using the duration-based measure PV01. In reality, the curve tends to be whipsawed, with greater movement at the front-end, as demonstrated by its higher percentage volatility (Chart 1). Volatility-weighted butterfly trades take into account volatility differentials across the curve and allocate risk by multiplying basis point volatility and PV01. Consequently, trades weighted in this fashion are well-suited to exploiting relative value opportunities. However, like other econometric risk-weighting techniques, this approach faces the challenge of defining an appropriate period for estimating volatility.

Past, Present and Future Volatility

We have developed a proprietary econometric model to generate past, present and future volatility estimates for benchmark terms on the Canada curve. Given estimates

Chart 1. ***Percent Volatility and PV01 Profiles of the Curve***



of past volatility, it is possible to quantify the degree to which the shape of the curve has historically reacted to a given change in volatility. In turn, equipped with these sensitivities, we can determine a fair value for curvature based on the present level of volatility and compare this to the shape of the yield curve observed in the market.

The mean-reversion effect makes it possible to determine future volatility and consequently, a timeline for the evolution of the shape of the curve. Note, however, that such analysis should be approached with caution in the current context. Namely, conditioning volatility forecasts for the forthcoming rising rate environment on a period of consistently falling interest rates relies on the critical assumption that long-term volatility will be the same irrespective of whether rates are rising or falling. Our model addresses this concern by imposing a forecast for long-term volatility and calculating the term structure of volatility accordingly.

Trading Implications

Unsurprisingly, this volatility-based model of curvature indicates that the 5-year sector is the cheapest among benchmark terms on the Canada curve (Chart 2). While we anticipate this cheapness to persist in the near-term, this further corroborates our outlook for the performance of 5s towards late-May/early-June, as seasonal pressures abate.

From a portfolio management perspective, traditional 50/50 duration-neutral trades maintain their value as a carry-effective means of expressing directional curve views. For example, on a 50/50 weighted risk-neutral basis, the 2s-10s-30s butterfly has performed very well as the Canada curve has undergone an end-to-end flattening. However, in addition to providing a framework with which to identify relative value on the curve, volatility also offers a means to take advantage of these opportunities.

As detailed above, volatility-neutrality can be imposed as a trade constraint much in the same way that duration-neutrality is traditionally employed. This constraint can also be paired with the cash-neutrality constraint that investors may face. Importantly, our historical analysis finds that the performance of volatility- and cash-neutral butterfly trades is closely correlated to the performance of traditionally weighted butterfly trades (Chart 3). Thus, although imposing cash-neutrality skews the risk-profile of a butterfly trade relative to a 50/50 weighting, incorporating volatility into the structure ensures that the trade retains its relative value bent.

Chart 2. ***Fair Value of 2s-5s-10s Butterfly***

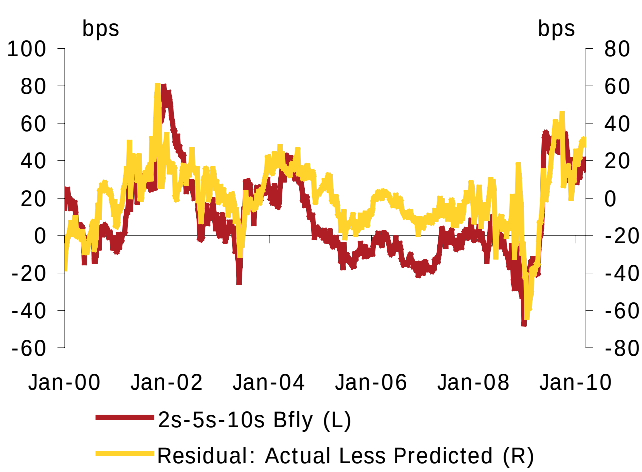
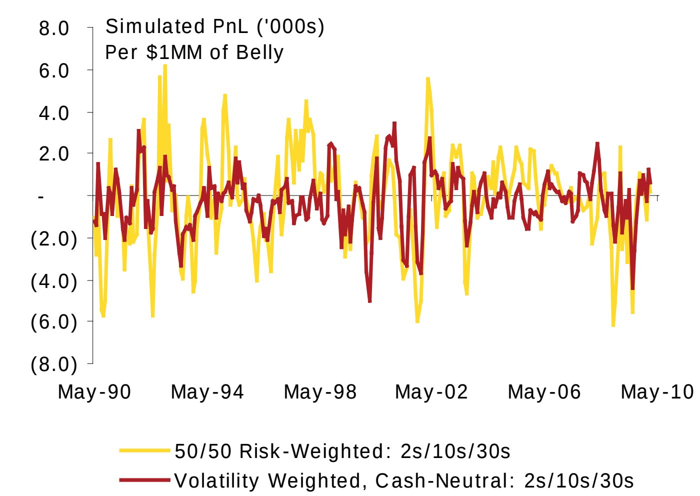


Chart 3. ***Historical Volatility and Duration-Neutral Trade Performance***



Current Recommended Strategies

	Proposed Date	Recommendation	Entry	Target	Stop	1-Mth Carry	Current	Gain/Loss	Duration (Days)
1	24-Mar-10	Canada 2s/10 Flattener	185 bp	145 bp	200 bp	-3 bp	184 bp	1.0 bp	15

GOVERNMENT FINANCE

WARREN LOVELY

Every Journey Begins With a Single Step

Having emerged from a record fiscal deterioration, governments are now keenly focused on restoring financial health. The theme of deficit eradication resonated from 2010 budgets at both the federal and provincial levels. Getting back to balance will take time and energy, but as the ancient Chinese proverb holds, a journey of a thousand miles begins with a single step. That first step has now been taken.

Economic Recovery: Conservative View of 2010, Longer-term Risks

Having been scarred by last year, when global financial ruin saw official growth forecasts fall well short of expectations, Canadian governments are taking a conservative view on 2010 growth. In most cases, forecasts have been set below the private sector average. More positively, the consensus outlook is getting brighter by the day, with our own 2010 call for Canadian real GDP growth boosted from 2.3% in January to fully 3% with today's publication (see Table 2, page 3).

With the weighted average of provincial forecasts from 2010 budgets implying a 2.5% growth pace for the country as a whole, there's economic upside for most jurisdictions. And nominal GDP is likely to better budget forecasts by an even wider margin (Table 1), an important development owing to its closer ties to many own-source revenue streams.

At this point, there appears no such upside for real GDP in 2011. The majority of provinces, along with the federal government, expect growth to accelerate further in 2011. But as North American inventory restocking winds down, stimulus is removed and government's swing to outright restraint, growth risks slowing. Again, we're more sanguine on nominal GDP and note that the *level* of nominal output is likely to end 2011 above official projections in most, if not all, provinces.

The longer-term outlook is clouded by concerns around fiscal restraint, an elevated C$, slower labour force growth and what has heretofore been stagnant productivity growth. Few provinces can count on an extended expansion at growth rates equivalent to past growth cycles. This poses a key challenge to long-term fiscal planning, and creates obvious downside risk for the less conservative planners.

Fiscal Upside for Governments in 2010/11

For Canada's government sector, 2009/10 will go down as the single biggest one-year fiscal erosion in the post-War period. Ottawa racked up $54 billion in red ink, while the aggregate provincial deficit swelled to $34 billion. The combined federal-provincial shortfall, at $87½ billion, represented a one-year fiscal swing of more than 5%-pts of GDP.

For the provinces, last year's combined shortfall was roughly $7 billion larger than the original forecast but not as bad as feared at the time of mid-year updates (Chart 1). And at 2.2% of GDP, the combined provincial deficit, while marking a substantial departure from recent years, was less pronounced than during the early 1980s or early 1990s recessions.

Table 1. ***Official Government Growth Forecasts***

	Real GDP			Nominal GDP		
Y/Y % Chg	2009E	2010F	2011F	2009E	2010F	2011F
Provincial Forecasts						
BC	-2.7	2.2	2.3	-5.0	4.5	4.7
Alta	-2.5	2.6	2.9	-17.5	7.9	7.6
Sask	-1.6	2.6	3.3	-12.5	3.8	10.0
Man	-0.9	2.5	3.0	-0.2	4.0	4.6
Ont	-3.4	2.7	3.2	-3.5	4.4	5.0
Qué	-1.4	2.3	2.6	-0.4	4.0	4.5
NB	-0.5	1.7	NA	1.0	3.9	NA
NS	0.2	1.9	1.2	-1.0	4.4	2.7
PEI[1]	NA	NA	NA	NA	NA	NA
N&L	-8.9	4.0	3.1	-26.7	10.9	8.9
Canada Forecasts						
Provincial[2]	-2.6	2.5	2.8	-6.2	4.9	5.4
Federal	-2.5	2.6	3.2	-4.6	4.9	5.4
CIBC[3]	-2.6	3.0	2.5	-4.5	6.4	5.4

1. 2010 Budget has yet to be tabled
2. Weighted average of individual provincial forecasts
3. CIBC's current national forecast
Source: Provincial budgets, CIBC

Chart 1. ***Provinces Turn Corner on Budget Deficits***

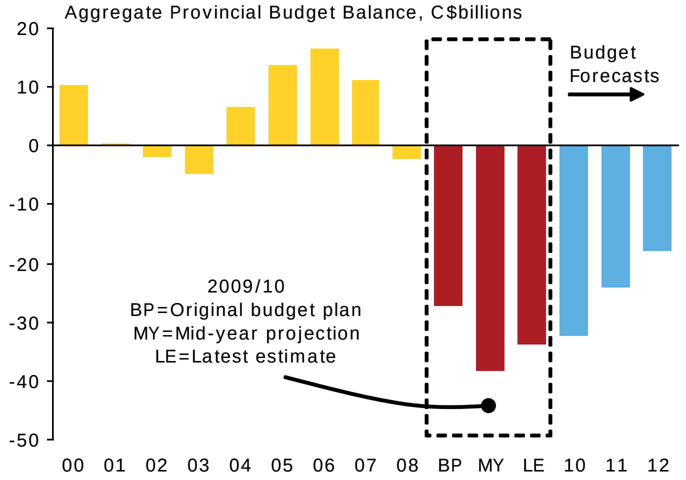
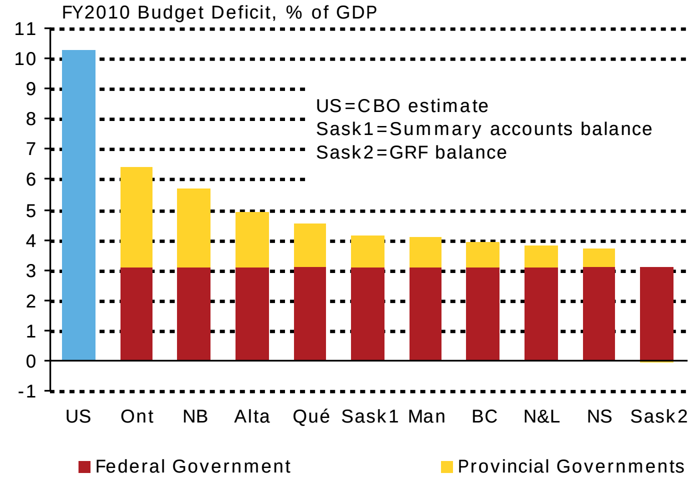


Chart 2. ***Deficits Relatively Modest in Most Provinces***



For the current fiscal year, Canada's provinces collectively project a $32½ billion deficit, with government's universally committed to year two of a major fiscal stimulus effort. On the surface, then, official forecasts suggest little near-term improvement in the aggregate provincial deficit, seeing more steady progress thereafter. But as noted above, a stronger economy suggests governments will better fiscal targets in 2010/11, allowing for a good first step along the road to deficit reduction.

Indeed, a stronger profile for nominal output should inflate key own-source revenue streams. Moreover, some have built in budgetary reserves that, given economic upside, likely won't be needed. Other contingencies provide a further buffer. Finally, given robust economic growth in late 2009/early 2010, there's the potential for positive prior-year adjustments—a beneficial base effect for 2010/11. (Recall that economic weakness in late 2008/early 2009 created a significant negative base effect that carried into last year.)

Even allowing for above-plan program spending, Canada's provinces have the potential to improve on their official budget balance forecasts by as much as $5 billion in 2010/11.

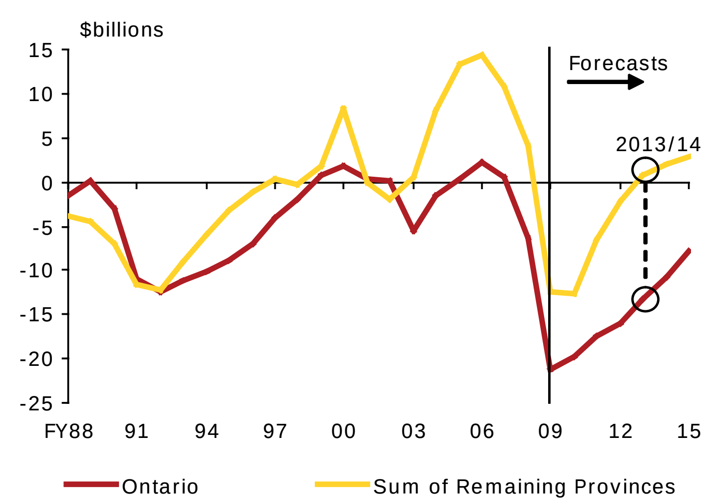
Province-by-Province: Meaningful Fiscal Discrepancies Remain

Individual projections for 2010/11 show deficits from coast-to-coast. For many provinces, deficits hover in the range of 1-2% of GDP (Chart 2). Ontario and New Brunswick anticipate larger shortfalls, while Nova Scotia's projected deficit is the smallest in the country. Saskatchewan anticipates another surplus for its general revenue fund, but the broader summary accounts—a comparable measure to other provinces—see a deficit of roughly 1% of GDP. Even after adding Ottawa's shortfall, the combined federal-provincial deficit, at 5% of GDP, is half that seen in Washington.

Canada's provinces have embraced different timetables when it comes to deficit elimination, but outside of Ontario, the combined balance should be back in black by 2013/14 (Chart 3). Ontario is going slower, looking to halve its deficit in five years and eliminate it in eight years.

Cost containment has been a predominant focus of 2010 budgets. Governments are taking a tough line on public sector wages and cutting headcount. Putting program spending (mainly health care) on a structurally slower growth track is a key ingredient of medium-term

Chart 3. ***Ontario Going Slower on Deficit Reduction***



plans, but will be difficult to execute. In some cases, other savings will need to be found. Others rely on a sustained economic expansion to cure their fiscal ills. That strategy is not without risk, and should the economy hit another speed bump—or progress on program spending disappoint—additional fiscal measures could be necessary. Québec and Nova Scotia, recognizing the fiscal and economic challenges that lie ahead, have been proactive on taxes. While unpopular, tax increases could prove inevitable for others.

In general, Ontario's slower path back to balance will see its relative debt position vs. other provinces deteriorate. Ontario's accumulated deficit-to-GDP ratio isn't expected to peak for roughly five years. Québec, the most indebted of the provinces, expects some progress on its accumulated deficit-to-GDP ratio in 2010/11. By 2017/18, the ratio of accumulated deficits-to-GDP for Ottawa, Ontario and Québec are seen converging (Chart 4).

As we've recently argued in these pages, increased debt levels and rising rates risk eroding debt affordability. That could prove a catalyst for downward pressure on credit ratings.

Government Bond Supply: Another Busy Year Ahead

Whether a material fiscal improvement emerges or not, fiscal 2010 will be another busy year in the government bond market. Ottawa, focused on working down its bill stock, will keep domestic issuance at elevated levels, adding some $60 billion to the bond stock by the end of the fiscal year. We see gross Canada Mortgage Bond (CMB) issuance easing slightly to $40 billion in fiscal 2010/11. Net CMB supply, at $18 billion, will be down more than $5 billion vs. the prior year and off nearly $10 billion from the prior peak.

Chart 4. ***Convergence in Accumulated Deficit Measure***

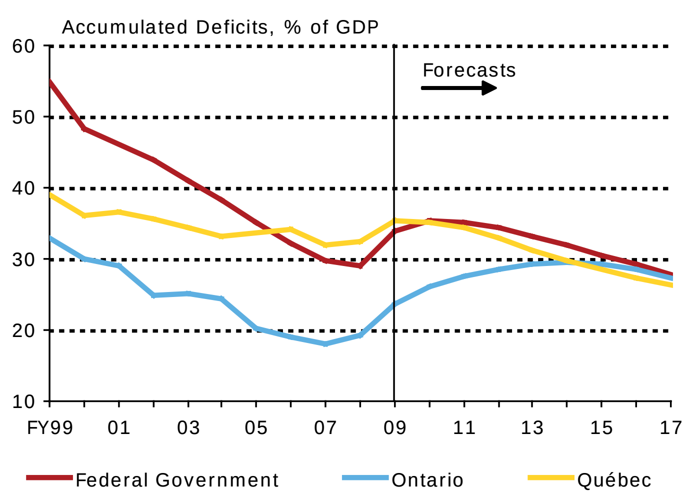


Table 2. ***Gross, Net Issuance by Government Sector***

	2008/09A	2009/10A	2010/11F	2011/12F
Gross Issues (C$billions)				
Canadas (C$)	75	102	95	85
CMB	46	42	40	42
Provincial	53	77	78	73
Municipal	4	5	5	4
Total	178	226	218	204
Net Issues (C$billions)				
Canadas (C$)	41	73	60	28
CMB	27	24	18	18
Provincial	21	47	50	44
Municipal	1	2	2	1
Total	90	146	130	91
Provincial Share of Government Supply (%)				
Gross	*30*	*34*	*36*	*36*
Net	*23*	*32*	*38*	*48*

Source: CIBC

In the provincial sector, fiscal 2010/11 looks to be just as busy as last year—itself a record tally. Drill into financing plans and you'll find the makings of $78 billion in gross provincial issuance, largely in line with the $77 billion that was issued in fiscal 2009 (Table 2).

Net of maturities, the provincial bond stock could grow by some $50 billion this year, accounting for nearly 40% of net government issues. By 2011/12, provincial issuance should be heading lower, but the sector would nonetheless comprise an ever-greater share of net government issues.

Table 3 provides a province-by-province look at budget balances and projected issuance, excluding retail products and anticipated rollovers of CPP-held debt. As noted, budget balances are set to improve on official forecasts, easing funding requirements. British Columbia's 2010/11 bond requirement looks the most overstated. But, in general, the pass-through from smaller deficits to lighter financing requirements could be muddied by pre-funding efforts that are based on a desire to both get ahead of an elevated borrowing requirement for fiscal 2011/12 and to lock in rates at historically low levels. Note that our projected issuance includes an assumption of $4 billion in pre-funding by Québec, which has pre-funded year-in and year-out (to the tune of $3.5 billion per year over

Table 3. ***CIBC Projections of Provincial Bond Supply***

	Budget Balance		Gross Bond Issuance[1]	
C$billions	2009/10	2010/11	2009/10	2010/11
BC	-2.775	-1.715	3.983	8.735
Alta	-3.624	-4.748	2.400	1.268
ACFA[2]	-	-	1.907	2.500
ATB	-	-	-	-
Sask	0.425	0.020	-	0.900
Man	-0.555	-0.545	3.903	3.102
Ont	-21.330	-19.690	42.700	38.700
Qué[3]	-4.257	-4.506	10.829	12.236
Fin-Q	-	-	3.318	3.500
HQ[2]	-	-	4.207	2.000
NB[4]	-0.743	-0.749	1.800	2.800
NB MFC	-	-	0.153	0.150
NS	-0.488	-0.222	1.750	1.949
PEI[5]	-0.085	NA	0.200	NA
N&L	-0.295	-0.194	-	-
N&L Hydro[2]	-	-	-	-
Prov'l Total	**-33.7**	**-32.3**	**77.1**	**77.8**
Domestic			***50.4***	***53.4***
Foreign			***26.7***	***24.5***

1. Excludes retail products and rollovers of CPP-held debt
2. Calendar year
3. 2010/11 issuance includes $4bn pre-funding towards 2011/12
4. 2009/10 issuance excludes $300mn issued Mar-10 but settling Apr-10
5. 2010 Budget has yet to be tabled
Source: Provincial budgets, CIBC

the past decade). We do not include such an allowance for other provinces, where pre-funding has been less a regular feature of the borrowing strategy.

Ontario, which faces a $38.7 billion requirement excluding savings bonds, looks to comprise a smaller share of aggregate provincial issuance in 2010/11. Notwithstanding a continued presence in international markets (witness this week's US$2 billion 10-year trade), Ontario aims to raise *at least* half of its 2010/11 program in the Canadian market. That compares to 2009/10, when just under half was raised domestically. So while total issuance from Ontario heads lower, the supply of bonds hitting the domestic market could be just as large (if not larger) than last year.

Elsewhere, we expect a number of provinces to tap international markets in 2010/11. Québec, Manitoba and British Columbia were all active in foreign markets in 2009/10, but relatively large borrowing programs and domestic competition from other sectors could incent international issuance from others. Overall, we expect the provinces to raise the equivalent of $24½ billion in international markets during 2010/11, representing just over 30% of the aggregate borrowing program.

With little desire to maintain foreign currency exposure, international issues will continue to be swapped back to Canada. That leaves provincial issuers beholden to swap market mechanics, and axed to take the other side of the swap flow emanating from resurgent Maple bond issuance. Swap market volatility adds a degree of uncertainty to our issuance projections.

Domestic supply, which we currently project at $53½ billion, would be up from 2009/10 levels. The sheer magnitude of supply, and a fading technical bid at the front end of the market, could leave spreads on the defensive and keep the provincial-corporate basis trading at historically tight levels. Downside pressure on credit ratings cannot be ruled out, but for many, coming fiscal updates should usher in upside surprises and create the potential for relative spread outperformance.

Credit

Joanna Zapior

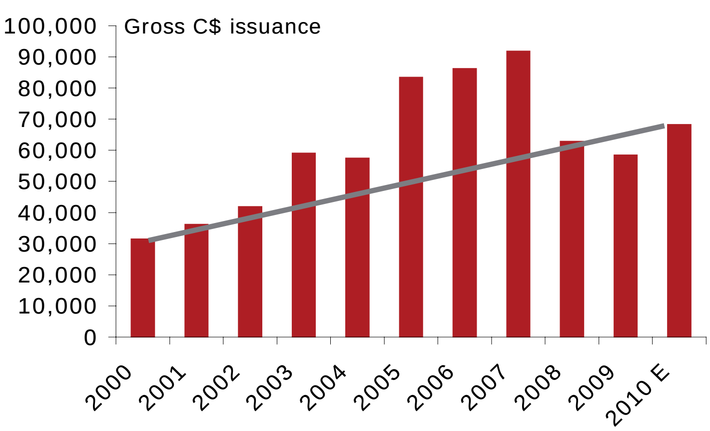
Net Issuance Drives Corporate Spreads

After global macro factors and asset allocation-related flows of monies, product supply is a key determinant of spreads. It is relatively easily observable, certainly compared to the demand for bonds, as demand can, at best, be sized based on anecdotal evidence and "market colour". Under normal market conditions, outside of large relocations in valuation such as the credit crisis and recovery of valuations of the last three years, new issue supply calculated net of maturities is, in fact, a better spread determinant than just gross supply. However, it is gross supply that is usually reported and discussed as it is easier to track than net issuance.

A Dozen Dozens—Gross Issuance

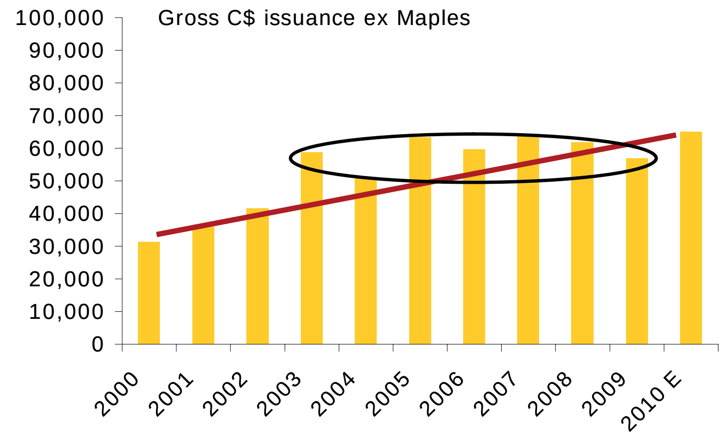
In the Canadian corporate debt market, gross issuance suggests that up until 2007 the market was growing at an annually compounded rate of 37%. Including the last two years when bond issuance globally declined, and using our projection for 2010, the annually compounded rate of growth is a still respectable 20% for the last decade (Chart 1). Maple issuance has been responsible for a large portion, though not all, of this growth (Chart 2). Without Maples, the growth in the domestic market corporate debt supply has been very smooth in the last decade, and the decline in issuance in 2009 appears as only a small dent below trend. Gross issuance by domestic corporate issuers, ex-Maples, had actually been remarkably stable since 2005, and even since 2003.

Chart 1. ***Gross Issuance Enjoyed a 20% Compound Annualized Growth Rate Over the Last Decade***



Note: All ratings; term > 1yr at issue; includes term ABS & Maples; excludes traditional private placements

Chart 2. ***Gross Issuance ex-Maples Has Been Stable Since 2003***

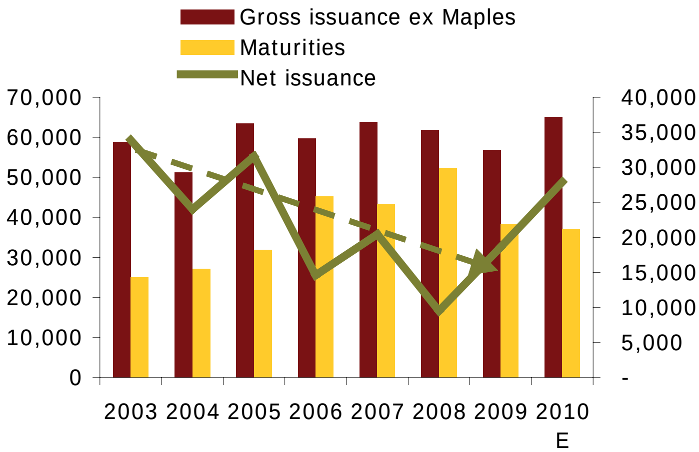


Let's Net it Out

A more insightful look at supply is based on net issuance —net of bond maturities.

- Arguably, if new issue supply only managed to replace maturating debt, we would expect a tightening pressure on spreads as, at a minimum, cash received from coupon payments also has to be reinvested (assuming, unrealistically, no money flows and no other spread drivers, which is never the case). As such, a decline in net new issuance should be a contributor to a tightening in spreads.
- For net new issuance to have a neutral impact on spreads, we need it to be positive so that it can satisfy demand from not just principal but also coupon payments, and incremental growth in demand that manifests itself in new cash flowing into the corporate bond market (whether from savings, or re-allocation among asset classes).
- Large increases in net new issuance would suggest that it may have a widening impact on corporate spreads.

Chart 3. **Declining Net Issuance T*rend to 2009***

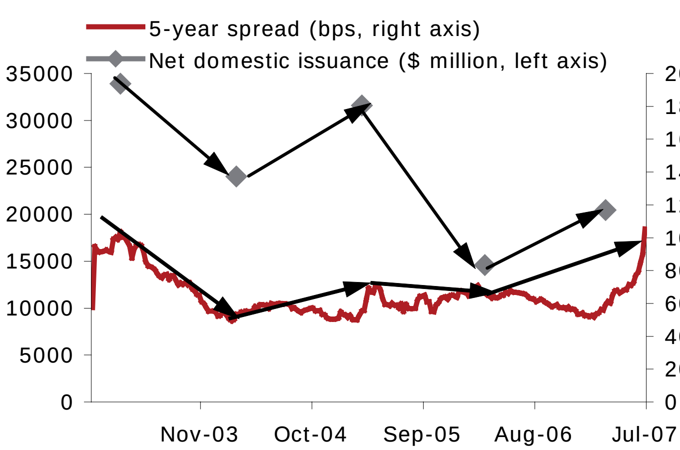


Note: All ratings; term > 1 yr at issue; includes term ABS; excludes traditional private placements. Maples excluded both from issuance and maturities.

In fact, over the long run we have seen a generally declining net new domestic issuance since 2003 in the Canadian market (Chart 3), making it a candidate for a contributor to spread tightening in the mid-2000s (and a mechanism that supported spreads when other macro factors drove them wider in the credit crisis).

Over shorter periods of time, year-over-year changes in net new issuance have been large enough, whether positive or negative, to argue that net supply has been a contributor to spread-tightening or widening, although the macro factors during the credit crisis have clearly overshadowed the impact of supply. When we focus on the "more normal", less cyclical period before 2008, the directional relationship between net issuance and spreads is quite detectable (Chart 4).

Chart 4. ***Net New Issue Supply is a Key Spread Driver Under Normal Market Conditions***



What Do We Know About the Future?

Stepping back from new issue supply considerations, our view is that corporate spreads are poised for trading in a range in 2010 after the tremendous rally in 2009, as the market considers the global macro economic data to determine the quality of recovery.

- We believe that this range is bound at the bottom by the tights of June 2007 (pre credit-crisis but wider than the tightest levels of spreads in the decade, which were driven by structured credit demand).
- At the top, we think that, barring a double-dip credit crisis, the spread range is bound by the levels seen in the 2002 downturn. For the five-year domestic spread we are using in this note, this range is defined as about 75 bps at the tights and 125 bps at the wides.
- Since we made this call in December 2009, corporate spreads have actually tightened, with our five-year spread bouncing around in the range of 120 bps (December 09) and the current 91 bps.

In terms of the impact from supply, gross domestic new issue issuance in Q1 progressed at a healthy clip, which, if sustained, is indicative of total issuance in 2010 likely to exceed the 2009 level. Maturities in 2010 are comparable to 2009 so in this scenario net issuance in 2010 would be bigger than in 2009 and thus at first blush could cause some upward pressure on spreads. We think this impact will be moderated by a number of factors. First, we believe that several of 2010 maturities have already been pre-funded. Second, new issuance may slow down in 2H10 as rates back up. Third, we are seeing good diversity of new issue supply, especially of high and higher yielding bonds, and we expect these new names to be met with incremental demand. This demand stems from reallocation from equities to fixed income. In addition, with the Maple market now five years old, Maple maturities coming up this year will also be available to absorb supply.

As for 2011, maturities are just barely lower than those in 2010, so we don't expect a dramatic change in impact from net supply, unless gross supply trends start changing dramatically.

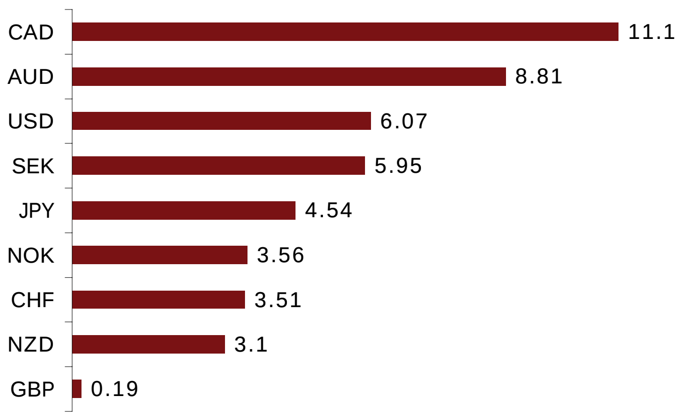
FX STRUCTURING

ROBERT GUNJA

Euro—Out of the Woods?

The Euro has been under pressure and since the beginning of the year has been the worst performer in the G10 currency universe. It has fallen 6% vs. the US$, and nearly twice as much or 11% vs. CAD$, the best performer of the group.

Chart 1. ***YTD Currency Performance vs EUR***



Euro weakness has been as a result of strains in the union of late that have proven difficult to resolve. Fiscally restrained Germans are unwilling to bail out their free spending Greek neighbours. The focus on Greece and their sovereign debt issues has played a heavy role in bashing the European union's single currency. After much debate and uncertainty surrounding the outcome, the only assistance the other countries have come up with was a weak backstop provision offered jointly between the EU and IMF. These loans would become available if efforts failed to lure investors to backstop the Greek economy.

This backstop has provided little relief as borrowing costs for Greece still remain elevated with yields 340 bps north of equivalent German bonds as Greece faces raising another €10 bn by the end of May. The situation in Europe has, for now, stabilized somewhat. However, it has raised a spectre of concern on other Euro-member states' financial obligations, notably Portugal, Italy and Spain.

The US, while not immune to issues concerning ballooning government deficits has witnessed its currency rise on the back of concerns in Europe. It is also benefitting from positive economic signals domestically, which are pointing to possible FED hikes by the year end, well ahead of the ECB.

A worse crisis in Europe may have been averted for the time being, which could serve to bring some relief to the ailing Euro. If nothing else, interest to pick up a cheaper Euro may come in the form of high yield investors.

TRADE IDEA: **Buy 3 Month EUR Put w/ Knock In**
Indicative Terms & Conditions
Spot Ref.: 1.3500

One can enter a trade with a bearish EUR/USD view while looking for a near-term rebound in spot. Purchasing a Knock in EUR Put offers a substantial discount to the vanilla Put since the option is only active if the spot ever touches the trigger prior to expiry. The client owns a 3 Month 1.3500 EUR Put / USD Call if spot ever trades at or above 1.3750, the cost upfront is 0.8% of the notional. The EUR/USD spot needs to strengthen by 2.5 cents before the option is activated. By comparison, the 1.3500 vanilla EUR Put / USD Call would cost 2.2%, close to triple the cost of the alternative.

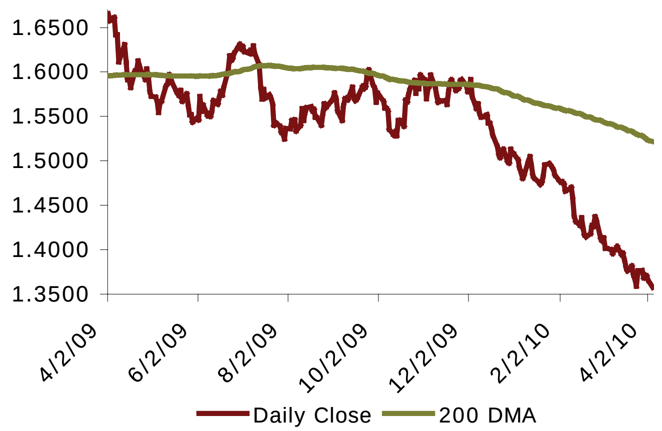
TRADE IDEA: **Looking for a bounce in EUR/USD spot - 3 Month EUR/USD Digital**
Indicative Terms & Conditions
Spot Ref.: 1.3500

A Digital allows the client to take a leveraged view that EUR/USD spot will strengthen above the strike at expiry. The client buys a 3 Month expiry EUR Call / USD Put with Strike at 1.4050, costs 25% of the Payout. The trade results in a 4 to 1 payout, i.e. for US$250,000 one would earn US$1,000,000 if spot were to close above 1.4050 at expiry. The loss is limited to the premium paid. This trade can be unwound early, i.e. if EUR/USD spot moves to 1.4050 1 month from now, the trade could be unwound for 2 times the original cost.

EUR Versus CAD…

The move in the Euro is most pronounced versus the Canadian dollar. Not only is the Canadian dollar benefiting from rising commodities prices, stronger economic fundamentals are emerging which are increasing the outlook for the Canadian economy. Further, there are growing expectations that the BoC will begin hiking interest rates, which should buoy the Canadian currency. There has been little reason to doubt the recent performance of the Canadian dollar against the European single currency, or any sign that the move will let off.

Chart 2. ***EUR/CAD Spot vs 200-Day Moving Average***



The EUR vs. CAD is trading over 10% below the current 200-day moving average. Implied volatilities have actually come off quite substantially in spite of the aggressive move lower in the currency pair. Speculating using options has become more attractive as vols have come off. A 1 Month at-the-money EUR Put / CAD Call costs 1.16% of notional using current implied vols of 9.75. In February, a similar option would have cost 1.32% of notional with vols at around 11.2 high.

TRADE IDEA: **Continued weakness in EUR/CAD Spot -3 Month EUR/CAD Fly 1x2x1 notional**
Indicative Terms & Conditions
Spot Ref.: 1.3500

Looking for continuation of EUR weakness vs. CAD over the next 3 months, a butterfly strategy can be executed at a premium less than half the cost of a straight vanilla Put.

Position: Long a 1.3500 EUR Put on EUR 10 mn
Short a 1.3000 EUR Put on EUR 20 mn
Long a 1.2500 EUR Put on EUR 10 mn
Maturity: 3 months
Upfront Premium: 0.95% EUR

Payout: Below 1.3500 the payout is positive. The maximum return of this structure would be 3.85% with spot at expiry trading at 1.3000 (4:1 return on the initial investment). This return would decline to zero at a 1.2500 EUR/CAD exchange rate.

TRADE IDEA: **Protecting a short EUR/CAD position: 3 Month Transatlantic Forward**
Indicative Terms & Conditions
Spot Ref.: 1.3500

The Transatlantic Forward strategy gives clients the right to buy EUR / sell CAD at a pre-agreed Strike. In the event that spot trades at or below the Trigger at maturity (European style trigger) without having previously traded at or above the Strike (American-style trigger), the clients' right becomes an obligation to buy EUR at the same Strike. In the event that spot ever trades at or above the Strike, the obligation disappears and client owns an outright vanilla EUR Call with the right to buy EUR at the Strike. The strategy can be entered into for zero upfront premium.

Client Position:	Buy EUR / Sell CAD Forward
Expiry Date:	3 months
Notional:	EUR 10,000,000
Strike:	1.3750 CAD per EUR
Trigger:	1.3100 CAD per EUR
Premium:	zero

If spot ever trades at or above 1.3750, the trade becomes a vanilla EUR Call position with the same strike at 1.3750. Clients will have the right to buy EUR 10,000,000 at 1.3750 with no further obligation and can fully participate in any Euro weakness below the strike. Otherwise, the payout is determined at maturity. Client is guaranteed to buys Euro vs. CAD at no worse than 1.3750 and can participate in any Euro weakness down to 1.3100. If the spot at Maturity fixes at or below 1.3100, the client is then obligated to buy EUR 10,000,000 at 1.3750.

Commodities

Peter Buchanan

Commodity Prices and Rising Rates

History Points to a Slower Climb Rather Than Knockout Blow

CIBC's 16-component proprietary commodity index (Bloomberg: CIBZCCI index) has eased by an incremental 5% year-to-date (Chart 1, left). There are few signs for all that of a serious threat to what to date has been an impressive rebound in resource prices from early 2009's lows. The latest data signals a stronger global factory sector upturn (Chart 1, right). The rising phase of the typical resource price rally, moreover, has lasted in excess of three years according to recent World Bank research. By that standard, the present one should still have some life left.

Success breeds risks, though. For resource markets, what may well be the largest risk on the horizon—keeping gains this year from matching 2009's torrid ones—is a byproduct of recent policy successes. That's the spectre of higher rates. Accelerating inflation in China points to further steps there to scale back the successful efforts to restore muscular growth. Brazil will likely become the third of the resource-intensive BRIC countries to tighten at late April's policy meeting. Policy tightening is not imminent in the US, but a potent combination of fiscal worries and heartier growth has lifted long-term yields there to 18-month highs.

*Chart 1—**CIBC Composite Commodity Prices (L), Global Factory Bounce Accelerates (R)***

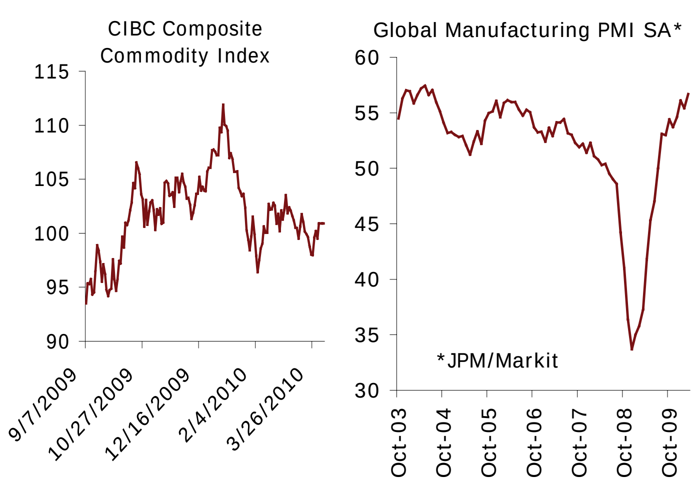
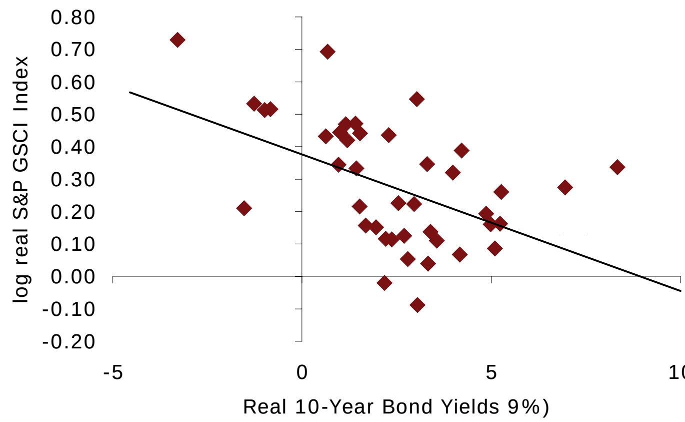


*Chart 2—**Relationship Between Real Yields and Commodity Prices, 1969-2009***



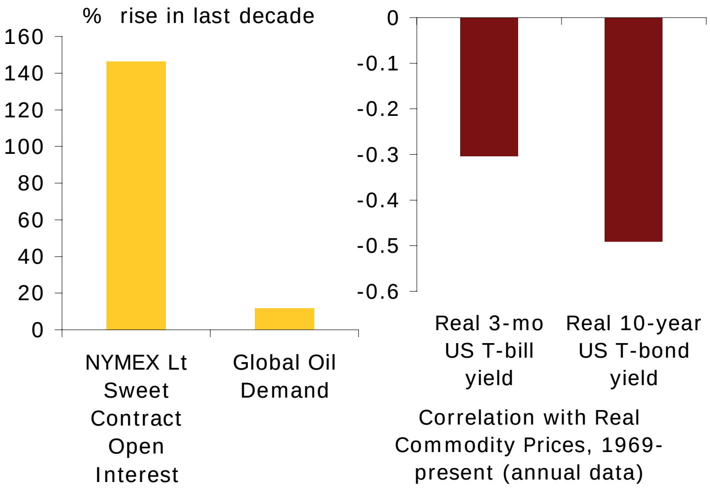
Interest Rates Impact Resource Prices Via Several Channels

The longstanding inverse historical relationship between resource prices and interest rates (Chart 2)—or more precisely inflation-adjusted yields—operates through several channels. In particular, rate hikes (or declines) affect markets and prices:

- by increasing in the incentive for resource production now rather than in the future,
- by affecting the level of GDP and hence resource demand,
- by increasing or decreasing the incentives of producers and speculators for holding inventories, or commodity contracts, compared to other assets like Treasury bills.

The explosion in both futures trading activity and the added opportunity for exposure created by a fast-expanding range of ETFs and other vehicles suggests that, if anything, the last of these three channels—the impact of rates on investment demand and speculative

*Chart 3—**Oil Market: Futures vs Physical Demand (L), Long Yields Move Resource Prices More (R)***



activity—has been rising in importance with time. The oil market provides a good example of the closer relationship between "physical" and so-called "paper" supply and demand. While the world uses only about 10% more crude today than a decade ago, trading in one of the world's most liquid futures instruments, the NYMEX light sweet oil contract, has rocketed by no less than 150% in that time period (Chart 3, left).

That still leaves the question as to whether resource prices are more impacted by long-term or money market yields. Although changes in short-term rates do carry weight, our research suggests that as with stocks, long-term yields are appreciably more important than short-term ones to market performance (Chart 3, right). The GSCI index's 0.49 correlation with real 10-year Treasury yields in the last four decades exceeds its 0.30 correlation with bill rates.

Holding other factors steady, a 100-bps rise in 10-year yields ordinarily has resulted in an opposing move of about 4% in aggregate commodity prices[1], according to our investigation of quarterly data for the period from 1992 through 2009. That suggests an unlevered investment is about 10-20% more sensitive to a rise in yields than a broad portfolio of Canadian stocks, but only half as susceptible as a portfolio composed of high-quality, longer-term Government of Canada or corporate securities.

Industrial Metals, Oil Continued to Rise After Past Policy Tightening

The Fed is no longer the only central bank that resource markets heed closely. But a study of past Fed cycles still arguably provides useful information about how commodity markets may react to pending restraint actions by emerging market banks and the BoC this year, and both the Fed and ECB looking ahead to early 2011.

Notwithstanding the general sensitivity of commodity prices to interest rates, our analysis suggests that resource prices ordinarily continue to show momentum after the rate trigger is pulled. That may, in part, be due to the fact that the level of rates is as important as the direction of changes. The S&P GSCI index gained an average 9.9% in the six months before the Fed began hiking in the last 11 cycles, covering the period from early 1973 to the present. The mean 4% gain in the half-year after tightening began was more muted but better than the average for the 36-year period as a whole (Table 1).

Those broader patterns appear, moreover, to mask some notable differences, drilling a bit deeper. Industrial metals prices actually have generally performed better after the trough in rates than before, as has oil. That's not so surprising. It takes time, after all, for rate hikes to slow growth. Prices, therefore, are likely to draw support from more pronounced strains in available capacity, later in the cycle.

Table 1. ***% Change in Commodity Prices and Fed Tightening Cycles***

Rate Trough	6-months before	6-months after
Jan-73	35.4	38.9
Aug-77	-9.6	15.1
Sep-80	31.7	-12.5
Mar-83	6.1	-1.5
Mar-84	3.9	-8.3
Jan-85	1.5	-10.4
Jan-87	10.1	7.4
Mar-88	-1.4	-5.3
Feb-94	-2.6	-0.6
Jun-99	22.8	19.1
Jun-04	9.9	8.4
Average**	9.0	3.6

** S&P GSCI Index, ** Geometric*

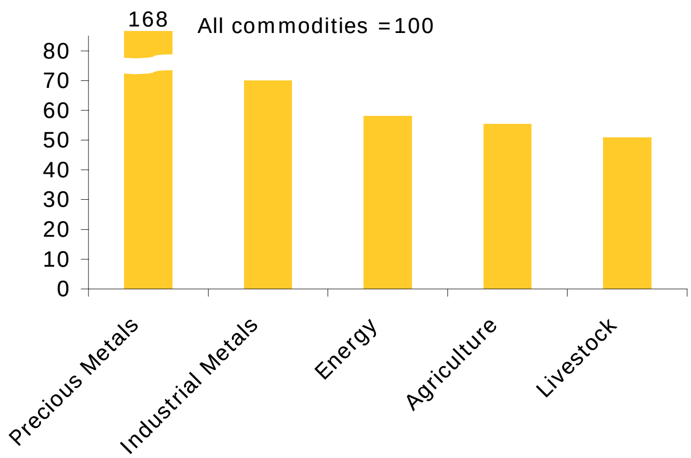
Recommendation Summary:

Buy Sep-10 CMX Copper (approx. 3.65) horizon 4-5 mos.
Sell Oct-10 NYMEX Lt Swt Oil (approx 88.60) horizon 5-6 mos.
Buy Oct-10 NYMEX Henry Hub (approx. 4.48) horizon 5-6 mos.

Gold Benefited From Inflation But Not Efforts to Fight It

Research suggests gold is the most influenced of the major commodities by rate movements, followed by the industrial metals energy and agricultural commodities, in that order (Chart 4). Excluding the 1973 episode, when gold prices were still rising to a higher market-determined level after President Nixon's suspension of convertibility, gold prices, have typically done appreciably better before than after the Fed began tightening. That's not so surprising, given the metal's non-interest-bearing status. While fears of inflation have historically been a plus for gold, moreover, steps to combat it have been anathema. The classic case was in 1980, when the ultra-aggressive Volker Fed virtually single-handedly killed the rally. While we believe gold could make headway in the next 8-9 months on renewed dollar selling, we see risks when the Fed does ultimately pull the rate hike trigger in 2011, given that history.

Chart 4. ***Importance of Real Interest Rates to Different Commodity Prices***



Source: Adams, Fuss & Kaiser, 2008

Turning to some of our earlier projections and recommendations, we've added $5/bbl to our forecast for oil prices this year and next, to $80 and $85 respectively (Table 2). Crude and product inventories in the US are still running about 6% above normal seasonal levels and consumption remains about 2 million barrels below its pre-recession peaks. Demand in China, however, has shown strength recently. While fund demand may be adding to the market's recent bid, ample OPEC spare capacity presents a major hurdle to a re-attainment of the triple-digit level.

Aided by evidence that US production may be overstated, US hub natural gas prices have been showing signs of life for the first time in a long while. Prices fell much more steeply than we had anticipated, but the industrial side of the US economy is clearly leading the recovery. We believe that markets may be underestimating the potential for a strong rebound in chronically depressed industrial and electric power consumption, which represent nearly two-thirds of demand. An unwinding of record speculative shorts could also help to lift prices back above the $5/Mn Btu level in coming months.

Copper Should Continue to Lead Within Base Metals

Base metals prices have rebounded to varying degrees from transitory weakness earlier in the year occasioned by growth jitters and the US$'s strong Greece-related rally. Copper, which has led the way recently, remains our preferred area for exposure within the segment, based on demand and constrained supply fundamentals. China's use of the red metal is expected to rise by a further 5-10% this year. Investment to meet booming emerging market power needs and rising hybrid/electric vehicle production should help to drive growth in long-term demand.

*Table 2—***Spot Commodity Prices**

			Average				
		6-Apr	2007	2008	2009	2010 (f)	2011 (f)
Oil (WTI)	$/bbl	86	72	100	62	80	85
RBOB gasoline	$/gal	2.28	2.09	2.49	1.69	2.05	2.25
Heating Oil (NYH)	$/gal	2.24	2.03	2.86	1.65	2.10	2.20
Natural Gas (Henry)	$/Mn Btu	4.16	6.97	8.89	3.82	5.50	6.50
Gold	$/troy oz	1133	695	872	1088*	1250*	1150*
Copper	$/lb	3.61	3.24	3.16	2.35	3.70	3.50
Aluminum	$/lb	1.06	1.20	1.17	0.76	1.00	0.85
Nickel	$/lb	11.25	16.86	9.57	6.69	10.50	9.00
Zinc	$/lb	1.10	1.48	0.85	0.76	1.10	0.95

* end of period

[1] *"Currencies, Cycles and Commodity Prices", Economic Insights, September 30, 2009*

Strategic Risk

Michael Rosborough

(Re)valuing China?

In our inaugural *GPS Monthly* last August I closed my section with the comment "bubbles are hard to trade but if China starts to undertake an exit from its stimulus strategy this should be the signal for a retracement in this frothy market". That comment was made in the context of Chinese official concern over the sharp rise in equity prices since the massive (13% of GDP) fiscal stimulus the Chinese enacted in the fall of 2008. As with many things in the state-"guided" economy of the Middle Kingdom, moral suasion exerts a stronger power than it does elsewhere, and the expression of concern by the authorities was enough to mark the recovery peak in the Shanghai Composite in early August with the market falling over 20% in the course of that month.

Official "action" didn't take place until mid January when bank reserve requirements were hiked from 15.5% to 16.0% and raised again in late February to 16.5%. Chinese equities duly responded with a 10% correction and the Shanghai Composite is one of the rare major markets to be in negative territory on the year. Against this background the growing chorus for a revaluation of China's currency seems curious. China's trade surplus is trending closer to a sub $15 billion monthly rate—about $11 billion off its late 2008/early 2009 peak and now closer to the pre-credit crunch levels of late 2006.

On balance the fall of China's trade surplus is due to the sharp decline of the economies to which China exports (specifically the G7) which depressed China's export growth. That China's stimulus-enhanced and less financially impaired domestic economy rebounded sooner and stronger than other major economies is no doubt a major factor explaining why China's imports are now back at their pre credit crunch levels. Another factor in the compression of China's surpluses could well be the lagged impact of the over 17% rise in the value of the Renminbi (CNY) versus the US dollar during the last bout of currency revaluation between July 2005 and July 2008.

Is now really the time for America and others to increase the pressure on China to undertake another round of CNY revaluation and will China respond? What are the likely impacts on markets if it does? The most compelling arguments for revaluation now in my estimation are the rebounds in the G7 economies from their troughs in early 2009 and the fact that revaluation provides China with another policy tool to contain the inflationary impacts of the stimulus it undertook and the forces of a strengthening global economy. Call it nipping imbalances in the bud if you will. When China stopped allowing the Renminbi to appreciate in July 2008 it wasn't clear that the currency had yet reached the authorities' intended level but was more likely a reflection that the impacts of the credit crunch on China's growth were beginning to bite more visibly and hence a cessation of revaluation was tantamount to a relative loosening of policy that was followed up a few months later by the fiscal stimulus programme.

Historically making money by being long CNY through the non-deliverable forward market has been difficult. Implied Chinese deposit rates in offshore forwards tend to diverge from onshore rates and become more a reflection of the pace of expected currency appreciation. At present that differential between offshore implied rates and onshore deposits is about 4.5 to 5% implying a relative currency appreciation of a similar amount over the course of the year. This is consistent with the pace of appreciation during the last round of Renminbi revaluation between 2005 and 2008 and there is little a priori reason to assume that the pace of a new revaluation phase, if undertaken, will vary markedly from before. The real money to be made at this point is actually to bet against an appreciation of the CNY should the authorities surprise by signalling conclusively that no rise in the currency will be tolerated.

Where the impact of revaluation could be truly interesting is its effect on the Chinese equity market. Normally it's currency devaluations that spark sharp rallies in the domestic currency value of equities. Ostensibly as a "tightening" measure the effect on Chinese equities of revaluation should be negative but the experience of the 2005 to 2008 period was anything but. Chinese stocks languished behind other markets in the recovery from the post tech bubble lows of 2002 to 2005 but entered a massive bull market where they almost quintupled in value after the decision to steadily revalue the CNY was announced in July 2005.

Part of that extreme outperformance was no doubt a catch-up after trailing the rest of the world for three years but there is an interesting historical parallel where a currency revaluation in a highly competitive economy reverberated positively through its equity markets. The post Plaza Accord (September 1985) appreciation of the Japanese Yen where the currency's value almost doubled in two years coincides neatly with the steepest part of the ascent of the Japanese Nikkei during its bubble of the late 1980s.

I'm not suggesting that a return to revaluation is about to set off another Chinese equity bubble but I would argue that there are plausible reasons for an appreciation of the currency to feed into an equity bull market where the starting point for the currency is undervaluation. With China's currency reserves rising 23% in the past year on an already enormous base I think it's hard to sustain the case that the Renminbi is fairly valued. First is the signalling effect—by allowing an appreciation the authorities sanction the view that the economy is very competitive and possibly that its "assets" are cheap. Second, and particularly in the case of China with its rudimentary fixed income markets and its non-deliverable currency the equity market becomes a key relief valve for the capital flows attracted by the revaluation (in reality the reappraisal) of the economy's prospects and potential.

Finally, ending the subsidy to US consumers and Chinese exporters that China's growing mountain of currency reserves represent and redistributing it instead to domestic consumers and those that produce for domestic consumption is a more efficient, sustainable and profitable use of China's resources than the continued accumulation of G7 sovereign debt in the country's currency reserves. Making China a more efficient economy is the ultimate goal and that in itself is a positive for China's equities and why, if the Chinese authorities allow the CNY to resume its appreciation I think we may begin to see outperformance of Chinese equities again tempting me into buying FXI—the ETF representing the largest companies in China's equity market.

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