



## Executive Summary

**Macro and FX View (Shenfeld):** Yes Virginia, there is a recovery, but North America's nascent rebound will be neither strong enough, nor sufficiently self-sustaining, to justify fixed income market expectations for rate hikes in the first half of 2010. Recent gains by commodity currencies also look to be ahead of reality, and are vulnerable to a correction in the near term ([p. 2-3](#)).

**Rates (Ahmed):** The conventional wisdom is that in a low rate, high volatility environment, a 2s-10s barbell will outperform a 5-yr bullet of equivalent duration due to the pick-up from added convexity. But our analysis shows that an investor in the wings would now be overpaying for that benefit, with the 5-yr area cheap relative to the wings and likely to outperform ([p. 4-5](#)).

**Government Finance (Lovely):** Gross Canadian federal issuance will ease after 2009/10 and be proportionally nowhere near the US Treasuries tidal wave. A slow economic rebound will keep provincial issuance elevated, but we see room for outperformance by selected provinces ([p. 6-7](#)).

**Credit (Zapior):** In the US, supply will be a challenge to corporate spreads in the next several years, but the situation in the Canadian domestic investment grade space is much less problematic, with gross issuance remaining well below earlier mid-decade peaks ([p. 8-9](#)).

**Commodities (Buchanan):** Oil's recent climb looks premature relative to demand fundamentals and potential supply increases in the near term, since OPEC is not running full tilt. Shorting Dec 09 WTI futures looks attractive, or as an alternative, going long May '10 heating oil futures against a short position in the matching crude futures ([p. 10-11](#)).

**Strategic Risk (Rosborough):** The linchpin of even a slow economic recovery is a healing in the financial sector, suggesting staying long the US financials ETF. Excess liquidity in China may be helping fuel a bubble in emerging market equities, so while not yet recommending the trade, we are keeping an eye out for an opportunity to short the EEM emerging market ETF ([p. 12-13](#)).

**Equity Derivatives (Bamber):** The term structure of US equity vols is similar to last fall, and suggests markets are nervous as that season approaches. Selling autumn calls looks attractive for the healthy premium, perhaps buying back deeper out-of-the-money strikes as a safeguard against a robust rally ([p. 14-15](#)).

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## ECONOMICS

AVERY SHENFELD

**Not So Fast**

Yes, it's a recovery. With few exceptions what was sinking in the first half of the year will be advancing in the second half (Table 1). But for fixed income, currency and commodity markets, it's not just *whether* the economy is growing, but where, how, and most critically, *why* it's growing.

The "where" was initially in East Asia, and that region continues to advance at a more brisk pace than elsewhere. That was partly due to the exaggerated severity of the earlier drop in places like South Korea and Japan, but also, importantly, it was fed by aggressive monetary and fiscal stimulus in China. The latter's advance, heavily tilted towards capital spending, will continue to be a big plus for base metal prices. Next up for growth are North America and the United Kingdom, with the Eurozone hampered by its lingering banking fragilities.

The "how" it's growing is, for North America, not so fast. US production will pick up now that inventories have been brought to rock bottom levels in some sectors, and that will draw in Canadian exports. But beyond that one-off pop, further gains require a lift in demand. Anything that relies on US consumer, housing or even capital spending will remain subdued, as both business and households conserve cash to repair the damage from the earlier

economic shock. While Canada has some advantages in less-ravaged household and banking sectors, its ability to double the US pace of growth in 2010, as the Bank of Canada assumes, seems unlikely with exports hit by a strong loonie and US buy-America provisions. Instead, we expect real GDP to advance at a tame 1.6% next year, keeping unemployment at lofty levels.

The "why" it's growing is all about stimulus, both fiscal and monetary. The auto sector leapt ahead on temporary US incentives to trade in "clunkers," while American after-tax household incomes were boosted in Q2 from one-time impacts of the Obama stimulus plan. That helped drain excessive inventories and set the stage for auto and other manufacturing production gains in the second half.

Both the US and Canada will feel even more of the recent fiscal boost in 2010, but absent further stimulus packages, the drop-off in government largesse would slow the North American economy in 2011. Sustaining those gains could, therefore, require a second package, particularly stateside where households saw a larger wealth decline. The Treasuries market is going to feel the load of heavy supply for the foreseeable future, more so than in Canada where financing requirements are much

**Table 1. Economic Forecast**

	09Q1A	09Q2F	09Q3F	09Q4F	10Q1F	10Q2F	2008A	2009F	2010F
<b>CANADA</b>									
Real GDP Growth (AR)	-5.4	-3.1	1.9	2.2	1.6	1.5	0.4	-2.2	1.6
Real Final Domestic Demand (AR)	-5.7	1.0	1.1	1.8	1.7	1.9	2.6	-1.8	1.8
All Items CPI Inflation (Y/Y)	1.2	0.1	-0.5	0.6	1.0	1.5	2.4	0.3	1.4
Core CPI Ex Indirect Taxes (Y/Y)	1.9	1.9	1.8	1.4	1.3	1.3	1.7	1.8	1.4
Unemployment Rate (%)	7.6	8.4	8.7	8.8	8.9	9.0	6.1	8.4	9.0
<b>U.S.</b>									
Real GDP Growth (AR)	-6.4	-1.0	3.2	1.4	1.9	1.8	0.4	-2.6	1.8
Real Final Sales (AR)	-4.1	-0.2	-1.7	1.5	1.7	0.5	0.8	-2.3	1.1
All Items CPI Inflation (Y/Y)	0.0	-1.2	-1.7	0.5	1.1	1.2	3.8	-0.6	1.8
Core CPI Inflation (Y/Y)	1.7	1.8	1.5	1.9	2.1	1.9	2.3	1.7	2.2
Unemployment Rate (%)	8.1	9.3	9.8	10.0	10.1	10.0	5.8	9.3	10.0

smaller relative to GDP (see page 10-11), putting pressure on long yields in 2010 and favouring outperformance by Canadas (Table 2).

Short rates should hold in better, for now. Record low interest rates have clearly been a factor in a flurry of home buying in Canada, and a somewhat brighter consumer outlook. Take that away any time soon, and domestic demand would wilt under the weight of what will soon be a 9%+ jobless rate. With inflation contained, that should extend the period of low overnight rates a lot longer than the market now expects. It's much the same stateside, where low interest rates are even more critical in dampening the next wave of defaults from commercial real estate, and from Option ARMs and Alt-A mortgages that are faring no better than subprimes. Remember than the Fed didn't raise rates until years, not quarters, after the last two recessions ended.

Currencies have also been behaving as if the recovery will be more robust than we are likely to see. In the past year, on the logic that growth is key for resource-related assets, there has been a correlation of nearly one between daily levels for the S&P 500, the TSX, the oil price, and the value of the Canadian dollar. But at some point, an ever-appreciating loonie would be a huge negative for economic growth in Canada and for many Toronto equities. And oil is getting close to levels that would prompt a supply increase from OPEC (see page 13).

As with other assets, the currency market appears to have moved a bit too fast to price in the coming economic expansion. The commodities currencies, including CAD, AUD, and to a lesser extent, the Brazilian real, look vulnerable to a correction in the near term, with more support awaiting firmer resource markets later in 2010 and beyond.

**Table 2. Interest and Exchange Rate Forecast**

END OF PERIOD:	2009		2010			
	11-Aug	Dec	Mar	Jun	Sep	Dec
<b>CDA</b> Overnight target rate	0.25	0.25	0.25	0.25	0.25	0.25
98-Day Treasury Bills	0.25	0.23	0.25	0.30	0.30	0.30
2-Year Gov't Bond	1.41	1.15	1.25	1.30	1.40	1.60
10-Year Gov't Bond	3.54	3.30	3.50	3.70	3.85	3.95
30-Year Gov't Bond	4.03	3.90	4.10	4.25	4.30	4.35
<b>U.S.</b> Federal Funds Rate	0.25	0.25	0.25	0.25	0.25	0.25
91-Day Treasury Bills	0.19	0.15	0.15	0.20	0.25	0.25
2-Year Gov't Note	1.23	0.95	1.20	1.30	1.45	1.65
10-Year Gov't Note	3.77	3.50	3.85	4.05	4.20	4.35
30-Year Gov't Bond	4.51	4.50	4.70	4.95	5.00	5.00
Canada - US T-Bill Spread	0.06	0.08	0.10	0.10	0.05	0.05
Canada - US 10-Year Bond Spread	-0.23	-0.20	-0.35	-0.35	-0.35	-0.40
Canada Yield Curve (30-Year — 2-Year)	2.62	2.75	2.85	2.95	2.90	2.75
US Yield Curve (30-Year — 2-Year)	3.28	3.55	3.50	3.65	3.55	3.35
<b>EXCHANGE RATES</b>						
— (US\$/C\$)	91.2	85.5	87.7	90.9	92.6	94.3
— (C\$/US\$)	1.097	1.170	1.140	1.100	1.080	1.060
— (Yen/US\$)	97	97	95	90	89	87
— (US\$/euro)	1.42	1.35	1.35	1.37	1.39	1.40
— (US\$/pound)	1.65	1.58	1.59	1.62	1.64	1.67
— (US\$/A\$)	83.5	79.5	82.5	85.5	87.5	89.5

## RATES

MOHAMMED AHMED

### Why the Belly Won't Flop

Following a brief reprieve the belly has resumed its course of drastic underperformance and again appears undervalued. To an extent this may be driven by inflation risk, given the ongoing debate about central bank exit strategies. Historically low interest rates, coupled with high percentage volatility, might also contribute to an underperformance of the belly given that these conditions favour duration-neutral purchases of the wings versus the belly.

However, irrespective of a view on the Bank of Canada's timeline for monetary tightening, the belly of the curve is still technically underpriced. In particular, the current cheapness of 5s versus 2s and 10s is attributable to dislocations fuelled by bank treasury departments. We therefore propose buying 5s to sell 2s and 10s, in anticipation of a decrease in curvature in the 5-yr area of the term structure.

The conventional wisdom is that, in times like these, the wings of the curve are the place to be. Although one can construct a portfolio of 5s that has the same duration as a portfolio combining 2s and 10s, the latter will have greater convexity. Recall that convexity, which increases with the square of term to maturity, always makes a positive contribution to return, accruing a benefit for the volatility of interest rates, rather than the direction. As such, convexity acts as a 'cushion' for a long duration portfolio should rates move higher.

But, investors in the wings would now be giving up too much yield for that benefit. A model of curvature incorporating interest rate expectations and volatility produces an equilibrium level of the belly that is substantially better valued relative to what is currently observed in the market. Technical factors have contributed to the market's undervaluation, even when one takes into account the increased volatility associated with yields near historical lows, and the expectation for rising rates ahead.

We find that the spread between spot 3-mth and one-year forward 3-mth, a proxy of near-term rate expectations, is a significant predictor of curvature. This is a readily available expectations measure, calculated as the difference between CDOR and the 4<sup>th</sup> BAX contract, making it all the more convenient for determining historical relationships. The addition of a volatility term further increases the significance of this convexity-motivated framework. It is well documented that the curvature of the term structure increases with volatility, a consequence of the increased value of convexity. Specifically, our model employs a simple average of the 50-day basis point volatility on the 2-, 5- and 10-year yields. Both independent variables of the model are statistically significant and produce a model with a relatively high R<sup>2</sup> over a 10-year period (Table 1).

Table 1—Model Regression Results

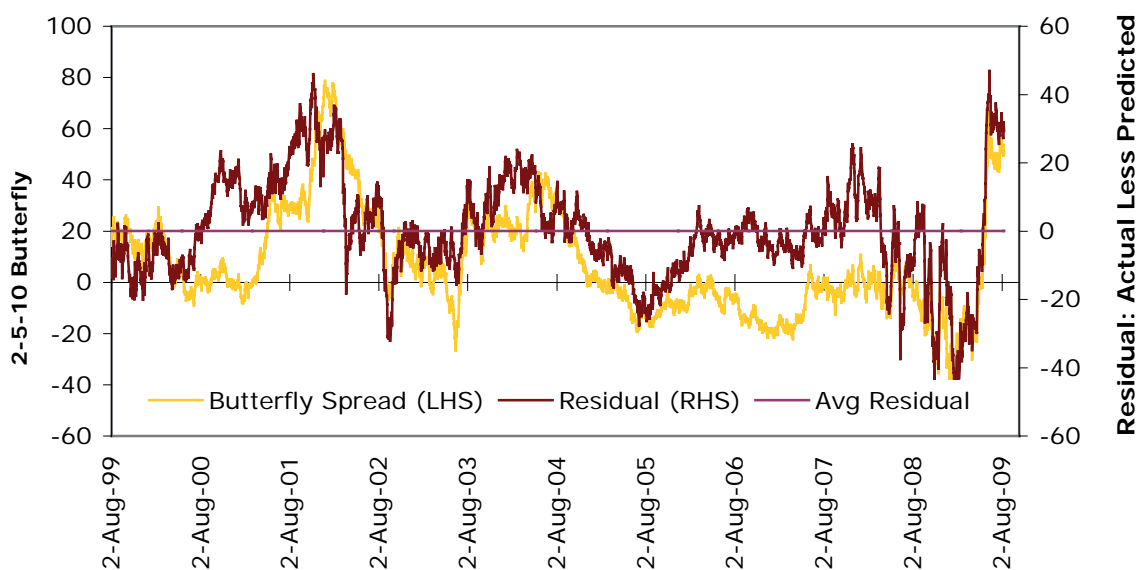
Adjusted R <sup>2</sup>	0.50	
Standard Error of Regression	14.79	
	<u>Coefficient</u>	<u>t-Stat</u>
Rate Expectations: 1-yr Forward 3-mth Less Spot 3-mth Spread	16.93	33.63
Volatility: Weighted Average Basis Point Volatility	36.39	26.88

This model projects the fair value of the 2-5-10 butterfly in swaps to be 20 basis points, implying that 5s are 30 basis points cheap (as of yesterday's close). Moreover, this residual has a mean of zero basis points, as well as a high correlation with the actual butterfly spread (Chart 1). We translate this analysis to cash rates and propose that purchasing 5s to sell 2s and 10s presents an attractive risk-reward profile, while at the same time being an effective means of capturing value as implied by this model.

Since the inception of the CMHC's Insured Mortgage Purchase Program (IMPP), deviations from fair value in the 5s have been intensified by bank treasury departments. For example, following the program's launch in October, as treasury departments sold mortgages into the program and replaced these assets with bonds, the 5-yr sector richened dramatically. Then, as participation in the IMPP dwindled in March and banks aggressively originated mortgages, fixed rate paying caused 5-yrs to cheapen.

We initially presented this argument mid-June, in anticipation of a deceleration in the pace of seasonal mortgage origination and subsequent paying by treasuries, but historically low interest rates caused this phenomenon to persist longer than originally expected. Often, the uncertainty with anomalies that result from market flows is not 'if' the reversion to fair value will take place, but rather 'when' it will occur. Hence, as treasury desks have recently been observed actively purchasing 5s, the likelihood of a reversion to fair value as defined by our model has increased.

Chart 1—The Belly is Historically Underpriced



**Current Recommended Strategies**

Proposed Date	Recommendation	Entry	Target	Stop	1-Mth Carry	Current	Gain/Loss	Duration (Days)
1 *NEW*	Long Canada 5s vs. 2s/10s	37.5 bp	15 bp	45 bp	0.5 bp	37.5 bp	-	-
2 27-Jul-09	Long Can 4.25%/Jun-18 vs. [4%/Jun-17 and 3.75%/Jun-19]	5 bp	0 bp	7 bp	-	4.5 bp	0.5 bp	15

## GOVERNMENT FINANCE

WARREN LOVELY

### *The Good, the Bad and the Bonds*

Proclamations of recession's end are welcome news for government leaders. But the resumption of positive growth won't translate into instant fiscal salvation. There's still plenty of bad news to digest, with budget balances remaining strained and issuance elevated during this, the early stages of expansion. For the government sector, a bona fide recovery is still two-plus years away.

#### The Good...

Good management and good fortune (i.e., a global commodities boom) combined to leave Canada's government sector better positioned than most for a slowdown. Ottawa's decade of debt reduction left ample fiscal flexibility to battle an economic downturn head-on. Although less aggressive, the provinces also made positive strides during the past expansion, creating scope for aggressive stimulus.

In terms of fiscal stimulus, cost-shared infrastructure works are getting money into the ground, paying economic dividends through 2010 and rolling off at a time when the private sector will be better prepared to stand on its own. Taxes have been cut, with reforms laying the foundation for future growth and investment.

Meanwhile, the federal Insured Mortgage Purchase Program earlier served up liquidity when it was required most, whilst simultaneously creating a captive buyer of Crown and provincial debt when traditional investors were heading to the sidelines.

With recovery at hand, fiscal 2009/10—and its roughly \$80 billion combined federal-provincial budget shortfall—will represent the worst year for public finances. Much of the aggregate budget shortfall should well prove cyclical, melting away over the medium term as growth reverts to its long-term potential and temporary measures come off the books. More than before, governments possess the luxury of time and the policy room should the fiscal recovery ultimately lag.

Notwithstanding the political uncertainty that accompanies minority governments, the country's fiscal discipline is well ingrained, as is the will to act. The required correction is, after all, less severe than that required in the wake of past recessions, and much more manageable than that facing other developed countries (Chart 1). Deficits or not, there is no debt crisis here. Canada's international fiscal standing remains firmly intact.

#### ...The Bad (Or the Not-So-Good)...

Canadian governments are doing their part, but so much is out of their hands. Just as events outside its borders served as the catalyst for Canada's recession, so too must the seeds of recovery be sown on foreign soil. A sub-par American recovery could then disappoint the country's Finance Ministers already eying a resurgent loonie with unease.

Notwithstanding the resumption of growth, today's economic landscape is simply not the one envisioned in 2009 budgets. As a result, fiscal results will deviate materially from plan. Warnings are already rolling in and future updates will acknowledge difficulty in achieving original budget targets.

Just as we saw in the wake of the early 1990s recession, federal-provincial fiscal performance risks lagging the

Chart 1

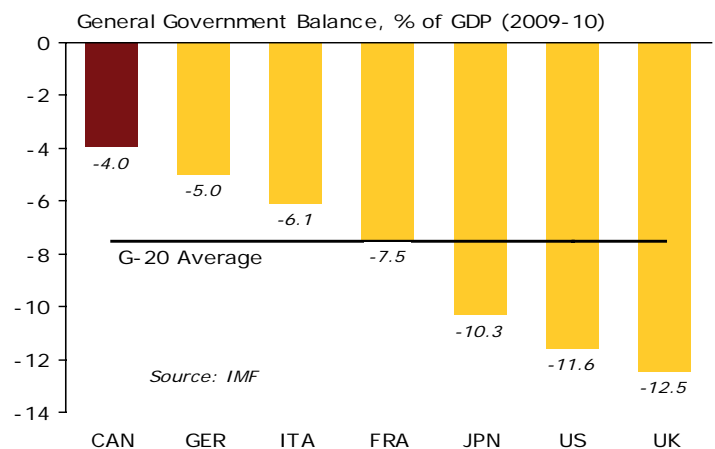
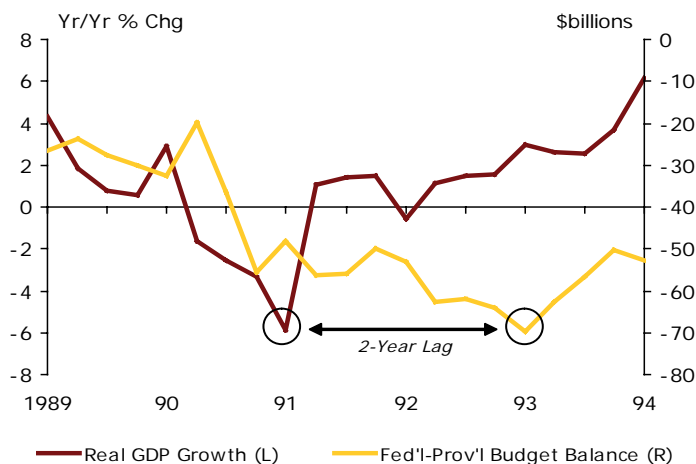


Chart 2



turn in the broader economy. Back then, the combined deficit grew during the first two years of 'recovery', keeping credit ratings under pressure (Chart 2). Today's tax revenues are vulnerable to negative adjustments, and as the legion of jobless grows, pressure on social programming will become more acute. Ottawa's minority government is being pressed on the speed and efficacy of stimulus efforts. Whether rooted in economics or politics, any additional government action risks stalling the initial stages of fiscal recovery.

**...And the Bonds**

Gross Canada supply will nonetheless peak in 2009/10, easing thereafter as special programs fade and the deficit gradually shrinks. Longer-term, as the investments made during the height of the financial crisis mature, net financing requirements will ease, hinting at debt reductions even if Ottawa retains a residual deficit. Relative to a tidal wave of Treasuries, short-, medium- and long-term supply fundamentals, all else equal, strongly favour Canadas.

Provincially, although some special factors are unlikely to be repeated (e.g., Ontario's auto sector bailout), substantial capital outlays inflate near-term funding requirements. Absent a near-term improvement in budget balances—likely trickier to engineer at the provincial level than federally—there won't be a material near-term let-up in what is currently record provincial supply (Chart 3).

To their credit, the provinces have proven adept at managing elevated borrowing requirements. Witness the \$30-plus billion raised in the past four months alone (Chart 4), an amount that not long ago would have represented nearly a full year's work. Having completed an outsized share internationally, the required increase in domestic issuance has been mitigated. Still, without much let up in financing needs, provinces will need to remain active in foreign markets in an effort to insulate domestic spreads.

On that score, much ground has been regained, with 10-year spreads having snapped in to half their peak crisis level only four months ago. A slow fiscal recovery and an overhang of supply suggest limited scope for additional tightening. Still, relative spreads will continue to adjust. Manitoba, Québec and the Atlantic Provinces, enjoying relative economic outperformance and possessing incremental yield, could tighten further, although for the latter group, liquidity remains a consideration.

Having being driven down the yield curve by investors either seeking safety or prevented from extending term, expect provincial issuers to, where possible, extend duration—a shift further incited by historically low long-term rates. But again, facing a heavy borrowing calendar, an issuer's desired tenor risks taking a back seat to market access and investor preference.

Chart 3

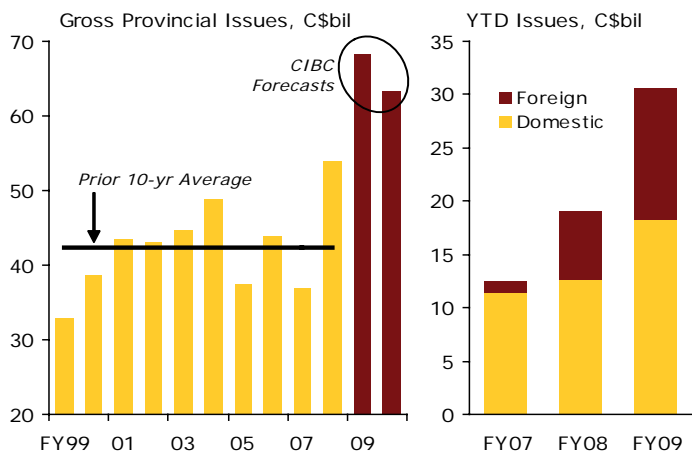
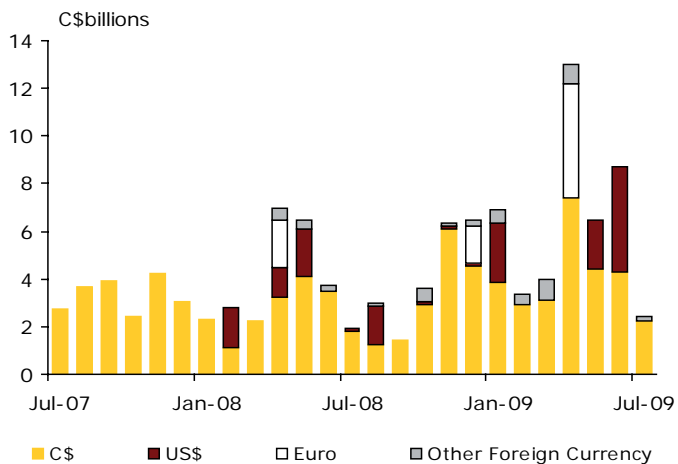


Chart 4



## Supply Story in Credit Markets

If supply continues to be an important driver of credit spreads, the markets will be challenged over the next several years as a wall (or a bump, depending on one's perspective) of maturities will come to the markets to refinance, starting in 2010 and not subsiding until 2015.

In the US, this view has been well publicized for a few months now. Upcoming maturity charts have been circulating that look like a very symmetrical bell curve, with volumes to refinance dramatically rising in 2011 (and double the 2009 and 2010 refinancing volumes). The refinancing peak is in 2013 at close to \$600 billion of investment grade, high yield, and leveraged loan debt, which is three times the total of 2009 and 2010 annual maturities. The pressure will be unrelenting, as the refinancing volumes do not come down until 2015, and even then they are 30% higher than the 2009 and 2010 yardstick.

Another interesting observation from these US charts is that the composition of maturing debt changes starting in 2011. Until then, investment grade debt accounts for a lion's share of total corporate maturities, but it falls to half of the total by 2013. The oft-cited view is that with the demand from structured vehicles decimated, there simply won't be enough investor appetite to meet all of the below-investment-grade demand for funding, leading to potentially higher defaults at the bottom of the credit range, and generally wider spreads as both credit concerns and supply push spreads out.

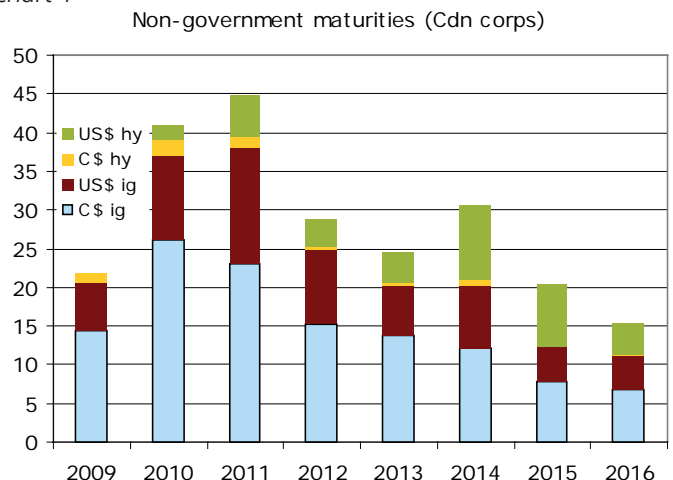
What about Canada? Well, the one big difference with the US is that we do not really have a similarly well-developed public high yield and leveraged loan domestic market. Chart 1 shows that our domestic high yield is a very thin sliver compared to our investment grade, though it becomes more material when non-investment grade US\$ issuance by Canadian corporates is included. While our spreads are likely to be dragged out in sympathy with US spreads, particularly if credit quality deteriorates in the below-investment-grade space on inability to refinance,

we would expect this effect to be much dampened in Canadian investment grade.

However, it is worth noting that, similar to the US, Canadian issuers also have significantly higher refinancing needs in the coming years than in 2009. Our peak comes in 2010-2011, a couple of years sooner than in the US. Note in Chart 1 that in the domestic investment grade space alone (bottom part of the stacked bar), the magnitude of the increase in the refinancing need, relative to 2009, should not be overwhelming, unlike in the US. This should help keep the supply-related pressure on spreads in check in our domestic market.

While not of mind-boggling magnitude, it will be mildly interesting to watch what happens in 2011 in the market segment of Canadian borrowers issuing US\$ investment grade debt. 2011 is the peak refinancing year for this debt, and, not surprisingly, it happens to be the year when domestic US investment grade refinancing needs double the previous year's levels, and stay that way for three years in a row. Given the possible crowding-out effect, some of the Canadian Yankee issuers may choose to refinance in Canada, given that by 2011 we

Chart 1



Source: CIBC, Bloomberg

will actually start, ever so slightly, to come off the peak refinancing volumes.

End of story? Not quite so. While an analysis of the Canadian market can ignore non-investment grade, we cannot ignore governments. Including provincial and municipal government refinancing needs somewhat changes the picture. Have a look at Chart 2. The second bar from the left in each year is the C\$ investment grade refinancing volume we illustrated in Chart 1 at the bottom of each stacked bar. It is obviously dwarfed by government volumes. However, that's not the point. Our point is that while domestic corporate investment grade refinancings grow from the 2009 level by about 75% to the peak year 2010, government refinancings grow by 160% to their peak in 2011.

And while domestic corporate refinancing requirements stay at the higher than current level for a couple of years, government refinancing needs remain elevated for three more years after the 2011 peak. So, unlike in the US where supply is likely to exert pressure on spreads from the bottom (of the credit quality spectrum) up, in Canada, we are more likely to see a supply-related spread pressure from the top down.

But wait, there is more..... Refinancing of existing debt is usually only part of the supply story. We have not yet accounted for new financing needs from government deficits and corporate growth and investment (the latter two, after all, should materialize at some point in the future). Those are difficult to project far out, but history offers some lessons. Chart 3 shows that in deficit-prone years, gross government issuance exceeded debt retirement by a margin of 20-33%. For corporates, we estimate that this margin has recently been in excess of 60%.

Another 30% on the margin is not going to make much of a difference in the government space—we know we have a potential supply challenge there. And another 60% for domestic investment grade corporates? Even if gross issuance doubled refinancings in the peak maturity years, we'd still be a good margin below the peak gross issuance years in the middle of the decade. No matter how hard we try, we cannot find a supply problem in the Canadian domestic investment grade space. Unlike in the US, in Canada we don't see upward pressure on spreads from supply.

Chart 2 Including government refinancing...

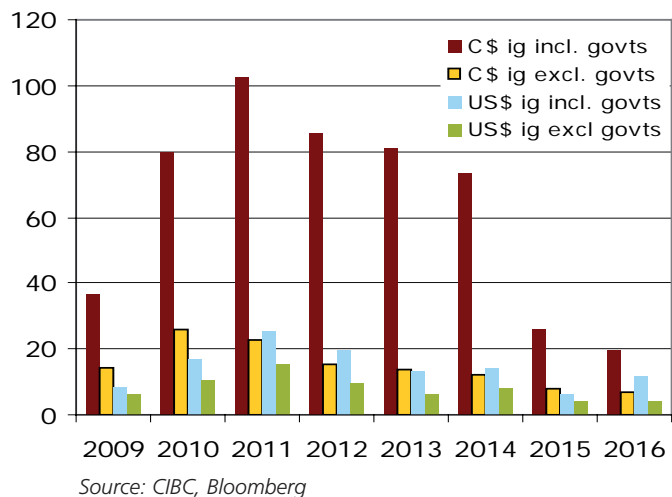
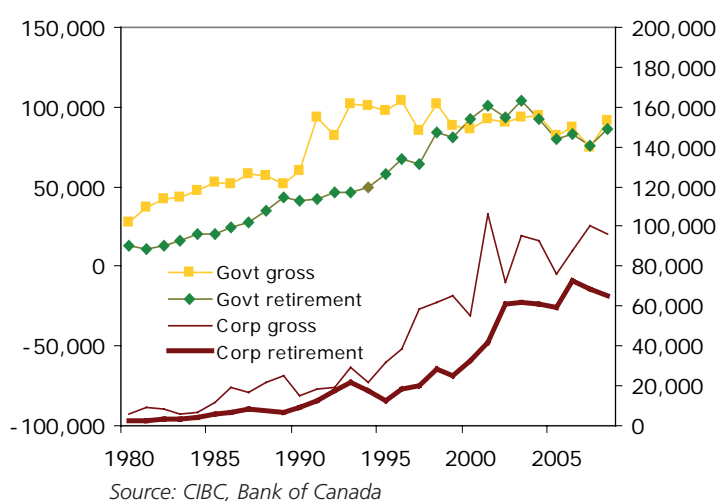


Chart 3 Gross issuance and debt retirement



**COMMODITIES**  
PETER BUCHANAN

**Oil's Gusher Could Soon Run Dry**

Oil prices have re-ignited with a vengeance after last year's crash, doubling since late February despite a cloudy demand picture. That's three times the rise in commodity prices generally over the same period, and stronger than the initial phases of oil's rebound from the shorter-lived 2001 US recession.

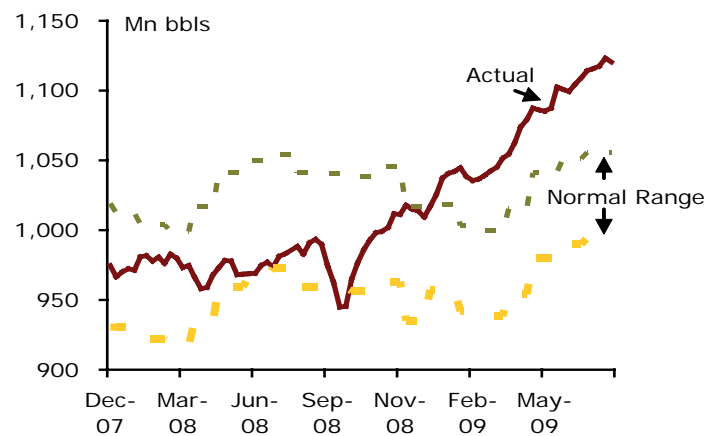
While climbing production costs, rising Asian demand and capacity cuts still signal longer term headroom, the risk of an appreciable correction in the next 3-4 months appears to have risen markedly, as bullish investor sentiment diverges from still bearish demand-supply fundamentals. That could see prices retreat by as much as 15-20% from early August's highs. A sub-par global recovery also points to less aggressive run-up in prices that the near-record \$9-10 premium embedded into the front 12 months of the NYMEX light sweet futures' strip.

Indicators point to a well-supplied crude market, casting doubt on WTI's ability to build on, or even sustain, its nearly \$40/bbl rise since the late winter.

US implied demand is falling less rapidly these days, but is still down 3% on the year, as declines in kerosene-type jet fuel and residual fuel use offset slightly firmer gasoline consumption. The driving season's onset has so far done little to whittle down crude and product inventories, which are now a hefty 10% above seasonal averages (Chart 1). Echoing supply patterns stateside, OECD industry stocks rose by 27.8 mb in May to 2,768 mb, reflecting increases in all key global regions. That's up 7.0% from year-earlier levels, and implies a month-end forward cover of 62.5 days, 7.2 days higher than a year ago.

Putting added pressure on prices, production increases in some countries suggest that stocks could remain on the heavy side for some time. This isn't 2007, when producers were running full tilt, and prices were the only relief valve for rising demand. Despite heightened Nigerian violence, OPEC output rose for a second month by 75,000 bbl/day to 28.7 mn bbl/day in June. The cartel's spare capacity now stands at a 10-year high of 6.4 mn bbl/day, giving it

Chart 1—US Oil and Product Inventories, ex-SPR



ample room to bolster production further. Outside OPEC, Russia's production is also likely to grow by as much as 1-2% this year, more than reversing 2008's decline.

Demand revisions could also impair sentiment. The International Energy Agency (IEA) is forecasting a 1.7% rise in global oil consumption in 2010, half the decline expected this year. Oil demand growth, however, has lagged annual global GDP growth by about two points on average in the last 15 years due to efficiency gains. The Agency's latest estimates consequently look a touch strong given our own forecast for a modest 2% rise in world GDP in 2010 (Chart 2, Table 1).

Chart 2—Global GDP Growth vs Global Oil Demand Growth (1980 - 2008)

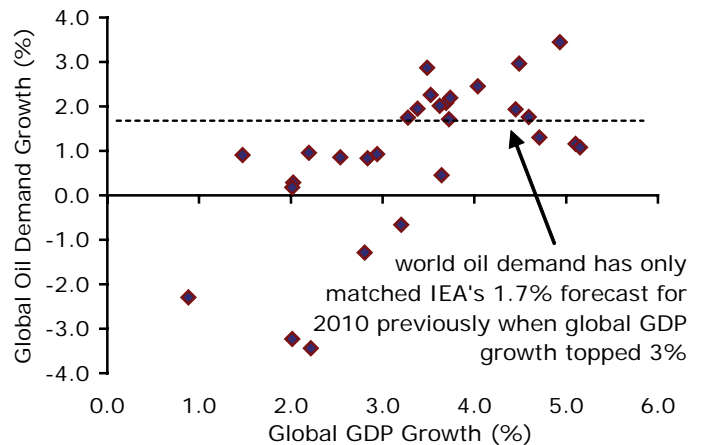


Table 1—World Oil Supply and Demand

	2005	2006	2007	2008	2009 (f)	2010 (f)
<b>World Oil Demand</b>	84.00	84.98	85.90	85.33	83.19 *	83.61 *
<b>-% ch</b>	1.9%	1.2%	1.1%	-0.7%	-2.5%	0.5%
<b>World Oil Supply</b>	84.57	84.54	84.42	85.49	-	-
<b>-OPEC</b>	34.95	34.74	34.39	35.72	-	-
<b>-Non-OPEC</b>	49.62	49.80	50.03	49.77	-	-
<b>Stock Draws &amp; Discrepancy</b>	-0.57	0.44	1.48	-0.17	-	-

Source: US Department of Energy

\*CIBC Forecast

An Asian-centric global recovery is likely moreover to lift non-energy commodity demand more than oil. China's oil use may have grown by leaps and bounds in the last decade, but demand there, in absolute terms, is still just half to a third of US levels. And the country's aggressive infrastructure plans will do more to boost metals than oil demand.

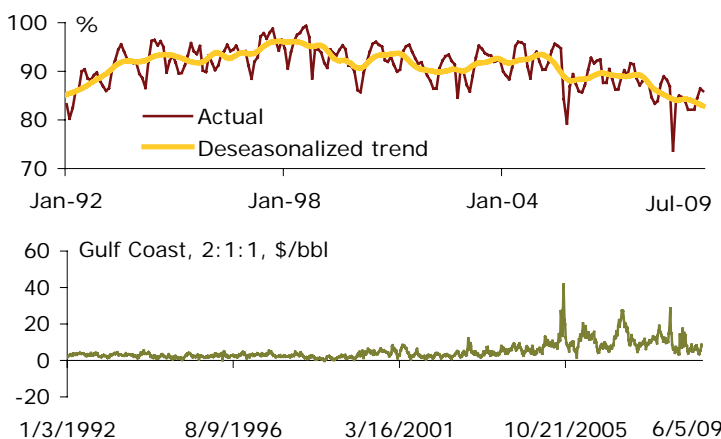
Even after the past year's drop, West Texas prices today are by no means cheap, compared to the \$50/bbl average of the last decade in today's dollars. Oil has typically been a late, rather than early, responder to cyclical developments, making the recent rally look premature and overdone. Our research suggests that oil prices have historically lagged global industrial production by about nine months, a longer time fuse than other commodities.

Our favoured trade given our bearish near-term take on crude is a short exposure at the front end of the NYMEX strip.

Investors looking for a trade which does not involve a call on the direction of oil prices, might alternately consider a long position on crack spreads, executed via matching long and short positions in the May-10 NYMEX heating oil and crude contracts.

Crack spreads ordinarily increase between the end of the driving season, when refiner's pare their runs, and the spring, when they ramp back up to build inventories for the summer season. The potential for added pressure on refinery capacity (Chart 2) as the economy recovers creates the potential for more than the normal amount of seasonal widening. For the best returns, investors should employ a "buy-the-dips" strategy to capitalize on near-term seasonal weakness.

Chart 2—Rebounding US Refinery Cap. Utilization (Top) Could Support Crack Spreads (Bottom)



**Recommendation Summary:**

- 1) Sell Dec-09 Lt Sweet Crude (approx. 7350) Stop 7600 Time Horizon 2-3 mths
- 2) Sell May-10 Lt Sweet Crude (approx. 7700) Buy HO May-10 (approx. 207) Time Horizon 7-8 mths

Table 2—Spot Commodity Prices

		10-Aug	2006	2007	Average 2008	2009 (f)	2010 (f)
Oil (WTI)	\$/bbl	71	66	72	100	60	70
RBOB gasoline	\$/gal	2.08.68	1.88	2.09	2.49	1.70	2.00
Heating Oil (NYH)	\$/gal	1.92	1.80	2.03	2.86	1.60	2.05
Natural Gas (Henry)	\$/Mn Btu	3.55	6.73	6.97	8.89	4.00	5.00
Gold	\$/troy oz	945	604	695	872	1000*	1100*
Copper	\$/lb	2.78	3.06	3.24	3.16	2.40	2.85
Aluminum	\$/lb	0.88	1.17	1.20	1.17	0.75	0.85
Nickel	\$/lb	9.15	10.98	16.86	9.57	6.75	7.50
Zinc	\$/lb	0.83	1.48	1.48	0.85	0.75	0.90

\* end of period

# STRATEGIC RISK

MICHAEL ROSBOROUGH

## 1991 Redux Times Three

It has been a spring and summer like few others for the markets with risky assets posting stellar gains since the March 9<sup>th</sup> lows. As I have argued in the last few issues of *Properspective* the decline and recovery in the markets is following a very similar pattern to that it traced both into and out of the last US credit crunch from 1989 to 1992. The slow pace of economic recovery envisaged by our economics team also corresponds closely to what happened during the prior period.

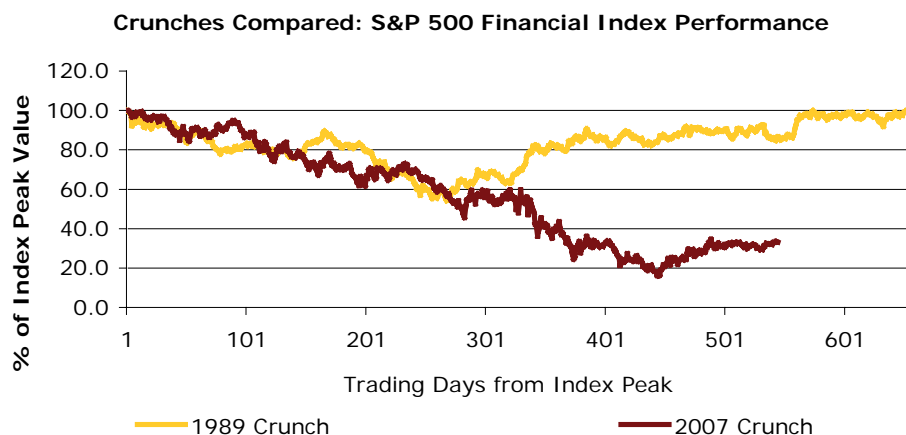
The key difference between then and now of course is magnitude. If IMF estimates are correct credit losses in this crunch are likely to be about three times the size of the last one. In similar fashion the loss in US output and the required returns in key US asset prices to get back to where they were when the crunch began are roughly triple those of the early 1990's.

Because the intermediation process is so important to both the markets and the economy the linchpin of recovery is the healing of the financial sector. This was a key theme during the last crunch and is why a long position in the US financials ETF XLF is one of my favourite trades. Just as they led the markets into the crunch they have been leading the market out and outperforming the broader indices since the bottom.

This is exactly the same as the pattern in the early 1990s' crunch. This time around, because the crunch was several-fold more acute, the measures required to stabilize the financial system have been unprecedented, but the guarantees extended and capital injected into two of the largest US banks in the spring appear to have been the final brick required to lay the foundation for recovery.

Equally important is that the backdrop going forward favours financial stocks. The yield curve is steep and is likely to remain so for a prolonged period, competition has been reduced, margins have increased and balance sheets are improving in quality as lending standards improve and banks replace poorer quality assets with higher-rated ones such as Treasury notes and bonds. Legacy issues remain of course and how those play out depends on the strength of the economic recovery, but as the performance of the financials and the economy are intimately linked they become somewhat self-reinforcing once the bottom is in place.

While I like financials as a recovery story, one area of the market that seems to be getting well ahead of itself in following the pattern of the last crunch is the emerging world. Recovery in emerging equities began late last year on the heels of the massive (13% of GDP) stimulus package announced by the Chinese in November. Since



the beginning of this year equity markets in the BRICs (Brazil, Russia, India and China) have risen 60-90%, while the S&P 500 has gained just over 11% and Canadian stocks, the best performing of the G7 are up 20% in Canadian dollar terms and 36% in US dollars.

During the last credit crunch emerging markets stocks were also exceptionally strong performers, more than tripling in value over two years. So far they've already doubled since their October 2008 low. The backdrop then was very different however. The Berlin Wall had recently fallen, Eastern Europe and Russia were just emerging from the shackles of communism, Latin America had finally restructured its debts, Chinese economic reforms were beginning in earnest and the rest of developing Asia was beginning to lever itself in a race for growth.

Critically, while America was then enduring a credit-based slowdown, US savings rates were high and just at the cusp of a 15-year secular decline that saw an unprecedented expansion of the US current account deficit feeding directly into growth in the emerging world. This time the process is going into reverse as America rebuilds its savings and the Asian model of growth through exports is being tested.

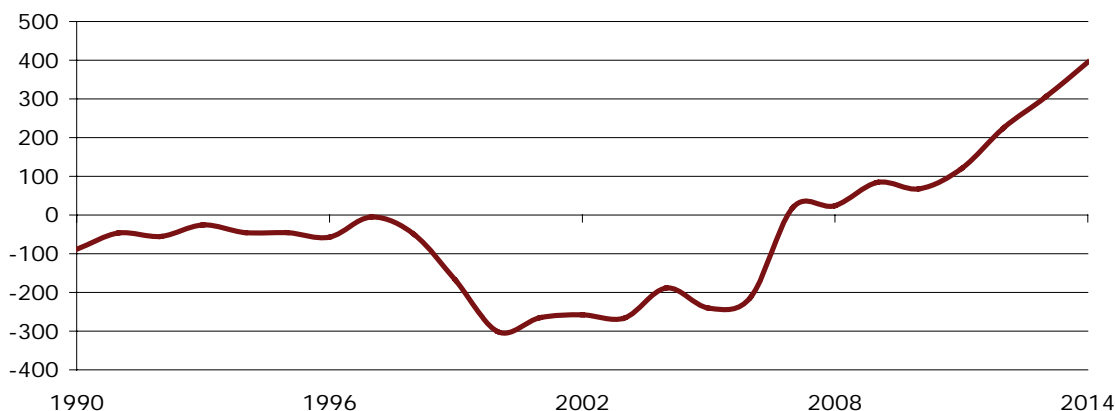
To get a sense of whether there really is an inconsistency in the global growth model, I went to the IMF's database to see what they forecast the combined current account positions of the G7 and the BRICs plus two of the other major emerging-market economies, Mexico and South Korea, to be versus historical experience. Collectively the group represents every country in the world except Spain that has a GDP of US\$1 trillion or more.

The IMF's projections swing from a net pre-crunch deficit (funded in large part by Switzerland and oil-producing nations) to a huge post-crunch surplus in the next five years. This works if the rest of the world's economies switch from being lenders to borrowers but that's a tall order when the countries included account for 70% of the world's economic output. The glaring inconsistency that drives the change in the balance is the reduction of the US deficit from a peak of \$788 billion in 2006 to \$476 billion in 2014 while China's surplus is forecast to rise from \$250 to \$800 billion over the same period for a net swing of over \$860 billion—a bigger net swing than that of the group as a whole.

I agree with the reduction in the US deficit (in fact I think it will be even greater) but I'm not sure I can square the circle of how China can keep running surpluses of 10% of GDP (which is what the IMF forecasts) when the world's biggest economy is likely to rebuild its depleted savings rather than run them down. While the IMF isn't the market I think the same inconsistent thinking pervades the extreme outperformance of emerging equities versus those of the G7 and particularly the US this year.

The Chinese fiscal and monetary stimulus is clearly an effort to offset the drag of the export slowdown, but given its massive size and the growing concern of Chinese authorities over the rise in their equity markets, the risk is that the stimulus is spilling too much into the markets and fuelling a bubble. I am watching EEM, the emerging markets equity ETF, closely for an opportunity to put on a short position. Bubbles are hard to trade but if China starts to undertake an exit plan from its stimulus strategy this should be the signal for a retracement in this frothy market.

**G7 and BRICS plus\* Current Account (US \$ Billion)**



# EQUITY DERIVATIVES

BILL BAMBER

## Legends of the Fall

It is almost a full year since we saw the carnage of the marketplace swallow once-venerable firms Lehman Brothers (into Bankruptcy) and Merrill Lynch (into Bank of America). The ensuing market volatility began a process of exsanguination that left investors and global institutions shell-shocked.

But now, the S&P 500 Index is up approximately 50% off its March 2009 lows. The VIX Index (CBOE SPX Volatility Index), which is arguably the most transparent benchmark for equity market volatility, is at a more moderate 25%, down about 71% from its panic fever peak of 89.5% in October 2008 (Chart 1).

So as we head into the fall on the back of an attractive bounce in equities and continued low interest rates, what is forward market volatility telling us? The market is nervous. The term structure of S&P 500 Volatility is fairly steep (Chart 2).

Arguably, had we not had the rally over recent months would the markets be as nervous? There is certainly no shortage of nasty data points still. Certainly from an historical context and the desire to reap gains, the current

term structure tells us protection buyers are setting up for a decline in equity values in the coming months. Despite encouraging US employment numbers recently, there are still fundamental problems in the US economy. Of course with the market leading the way out of recession the current S&P 500 Index P/E level is a robust 18.50, well off the March lows of 9.87. Equity markets have moved onside so quickly even some of Warren Buffet's short put positions have moved out of the red.

So given all of this, does it make sense to be a buyer of volatility, either in the options or the variance market? At present the VIX forward curve certainly sits above where we were at this time last year. At the time Bear had been absorbed by JP Morgan, there were valuation tremors in the hedge fund space and most knew Lehman was in trouble. While the vol curve was lower, it had roughly the same level of steepness as today. Spot volatility was at 19% to about 25%. Today we start at 25%, upticking to October futures at just over 29%. In effect an expectation of volatility to come. However as we now know, if last year is at all a guide, the future's forward prices may not be high enough. Over the last month volatility has moved downward as the equities market has moved higher.

Chart 1

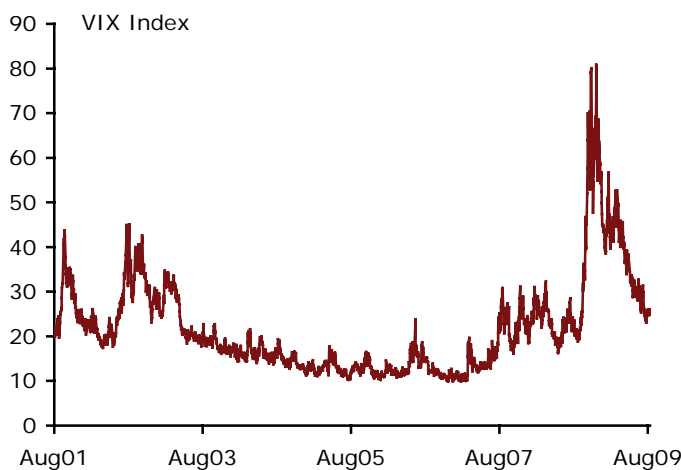
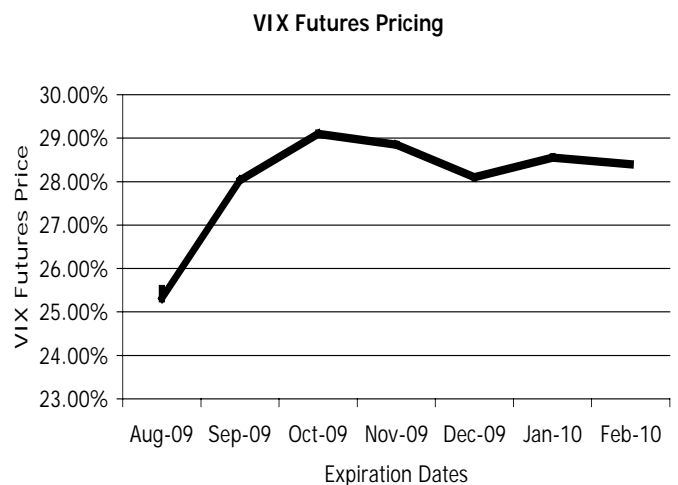


Chart 2



Good time to buy forward vol or sell it? 2-month ATM SPX Puts are running just over 4% as we write, or approximately 24% on an annualized basis. If the market gives back 20%+ even with elevated volatility this would be an appropriate amount of profitable insurance. But as expectations of a bloody fall look to repeat, vol will likely continue to uptick with every subtle downturn. Of course, with all such expectations taking hold will such an event come to fruition? Or will volatility sellers be rewarded for betting against any sort of drama and we close out 2009 with a flat level of complacency?

The natural bias in the marketplace for institutional put buying could be a hefty reward for call sellers. As put buying increases as we move towards autumn, call sellers will be able to monetize this situation against the backdrop of either a correcting equity market or at best a range-bound market. Given the term structure, this is one of the best macro trades to put on in the equity derivative space.

The largest risk for the active call seller is if a bloody autumn does not repeat itself, equity buyers may step further in and liquidate lower yielding cash positions under the rubric that lack of a pullback is confirming further recovery in the major equity markets. The call/volatility seller may wish to put on a spread trade by buying back deeper out-of-the-money strikes as a safeguard against a robust rally.

Similar volatility profiles are playing out in other asset classes, providing opportunities to sell vol profitably. As banks race to turn back on client flows, the defensive mindset begins to bend once again to competitive pressures, and risk is once again put on by banks in order to glean returns.

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