GPS MONTHLY

GLOBAL POSITIONING STRATEGIES

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A Slower World

Economics (Shenfeld): History suggests that there are limits to how far the Bank of Canada can diverge from the Fed without subsequent regrets, with anything wider than a 2% gap in overnight rates proving too painful. We have trimmed our call for rate hikes and currency strength in Canada. Carney may have seen enough evidence of a slowdown to pause on rates after a September hike, and we don't see Canadian overnight rates getting through 2% next year as the Fed stays on hold.

Rates (Ahmed): Currently, OIS markets price in some 27 bps of rate hikes by the Bank of Canada over the balance of the year. Our analysis shows that OIS rates have a substantial margin of error in forecasting actual overnight rates six months hence. We look at trading opportunities suggested by these divergences, as well as the role of foreign demand in shaping the yield curve.

Foreign Exchange (Stretch): Attempting to discern FX trends during the summer liquidity lull is a notoriously unreliable business. That, perhaps, should lead us into being careful in attempting to glean too much from the recent EUR USD gyrations. Nevertheless we would anticipate that the broad EUR concerns that undermined the EUR during Q2 are set to come back to the fore. Therefore, we expect to see EUR USD re-test 2010 lows prior to year-end.

Government Finance (Lovely): We examine the tidal wave of foreign investment into Canada's bond market. Fundamentals suggest this net investment will continue, although the composition is likely to evolve as the Government of Canada's net funding needs ease.

Credit (Zapior): With a possible economic slowdown ahead of us, we find a modest amount of incremental comfort in the fact that Canadian corporate debt issuers have stabilized and even slightly improved their revenues and operating profitability, as well as balance sheet leverage, relative to the depths of the credit crisis, and in the aggregate have done so more successfully than their US peers.

Commodities (Spector): China has claimed two new records in the past month. This week China took Japan's spot as the world's second largest economy, and in mid-July the International Energy Agency revealed that China had displaced the US as the world's largest consumer of energy. In terms of oil, China's self-sufficiency continues to decline, but recent refinery capacity additions have made China less dependent on foreign refined product imports, and a correspondingly bigger importer of foreign crude.

ECONOMICS

AVERY SHENFELD

Parting Company, But How Far?

Make no mistake, Canada's economy is still tied by an umbilical cord to that of its southern neighbour. Our recession and subsequent rebound have clearly been linked to America's housing crash and policy-induced recovery.

Now America's story is again darkening (Table 1). We were looking for a material second-half slowdown for the US, but as it turns out, it's already happened. Revisions and new data for June show that second quarter growth could be revised to only 1½% and even that could be generous. While the next two quarters might be a tad better, growth is clearly going to disappoint the Fed's last formal outlook.

Key cyclical indicators like the ISM, corporate spreads, and our composite Recession Probability Index (see *Economic Insights*, July 2010) point to slow growth rather than a recession in the second half. But still ahead is a further fiscal belt tightening in 2011 that will have to be softened, and accompanied by quantitative easing, if the US is to stay out of recession in early 2011 and get back to potential growth by the end of that year. Forget about any rate hikes from the Fed until sometime in 2012 at the earliest. As a result, shockingly low 2-year Treasury yields actually make some sense, given the scant returns available by rolling over T-bills at less than half that rate. Although newer two-year bonds issued next year will start to incorporate rate hikes in 2012 (Table 2), we have pared back our expectations for a Treasuries sell-off in the near term.

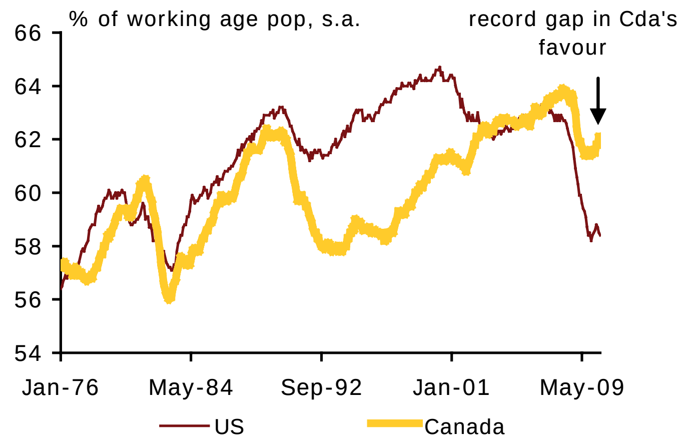
Canadian data haven't been as dire, with Canada also leading the Eurozone, UK and Japan in first half growth. There's no major gap in comparable Canada-US inflation rates: CPI, or CPI excluding food/energy, are nearly identical in the two countries. Since Canada's output gap is still material, it's too soon to expect to see steady upward pressures on core inflation. But measures of slack in the labour market have parted company, with a record gap in Canada's favour in the share of the working age population holding a job (Chart 1). In that sense, Canada is already where the US might only hope to be by the end of 2012.

The key for fixed income and FX investors, then, is to assess how much that considerably better starting point will mean for the divergence in monetary policy. Canada cannot move all the way to normalized interest rates while the Fed is still on hold. For one, an interest differential of, say, 300-400 basis points would take the Canadian dollar substantially stronger. Commodity markets are somewhat supportive for trade, but with global growth likely to slow in 2011, and the US dollar not in a free fall, the outlook is only mixed, and we now see less upside in natural gas, and downside for some metals (Table 3).

Table 1. ***Economic Update***

CANADA	10Q1A	10Q2F	10Q3F	10Q4F	11Q1F	11Q2F	2009A	2010F	2011F
Real GDP Growth (AR)	6.1	2.6	2.5	1.4	1.7	2.9	-2.5	3.2	2.5
Real Final Domestic Demand (AR)	4.7	6.8	2.3	1.6	2.1	1.9	-1.8	4.4	2.4
All Items CPI Inflation (Y/Y)	1.6	1.4	2.1	1.7	1.8	2.2	0.3	1.7	2.1
Core CPI Ex Indirect Taxes (Y/Y)	1.9	1.8	1.9	1.8	1.7	2.0	1.8	1.9	2.0
Unemployment Rate (%)	8.2	8.0	8.0	8.1	8.2	8.2	8.3	8.1	8.1
U.S.									
Real GDP Growth (AR)	3.7	2.4	1.9	1.7	0.7	2.5	-2.6	2.6*	1.9
Real Final Sales (AR)	1.1	1.3	2.0	1.6	1.3	2.6	-2.1	1.3	2.1
All Items CPI Inflation (Y/Y)	2.4	1.8	1.2	1.1	0.9	1.3	-0.4	1.6	1.5
Core CPI Inflation (Y/Y)	1.3	0.9	0.9	0.7	1.0	1.1	1.7	1.0	1.1
Unemployment Rate (%)	9.7	9.7	9.8	10.1	9.8	9.8	9.3	9.8	9.6

Chart 1. ***Employment Rates Diverge***



Any surge in the C$ would therefore mean that overall monetary conditions would be tightening sharply. Further, to the extent that the external environment will be one of less-than-normal growth as fiscal tightening bites in Europe and the US, and with our own upcoming fiscal tightening also hitting domestic demand, monetary policy might have to be set at stimulative levels to allow the economy to return to potential and remain there. To keep moving at all, you have to step on the gas if your car is trying to roll up a steep incline.

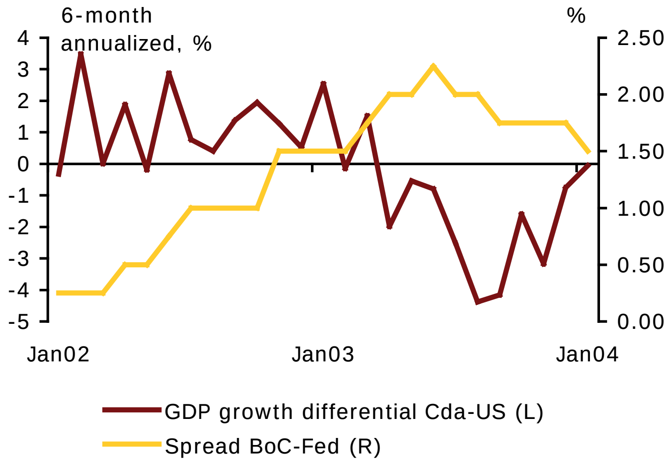
History provides some guide on how far Canada can diverge towards tighter policy without regretting it. In recent years, episodes in which rates were 2% or more above those stateside were, with 20-20 hindsight, unwise.

Most recently, the US was quicker off the mark in cutting rates in 2008, and while the Bank of Canada soon caught up, the Fed's earlier timing was prescient. A 2002-03 tightening on this side of the border, while the Fed was still cutting, also proved misguided, as the Bank was led astray by a short-lived blip in inflation, and growth sagged enough in 2003 to put Canada below the US pace (Chart 2). A 180 degree U-turn was required with all the hikes reversed. And finally, there was the 1990-91 episode, in which Governor Crow ran a tighter monetary policy ship in an effort to bring inflation down, but which with hindsight did so more abruptly than the Bank's target range (Chart 3), thereby sacrificing growth.

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

					2011			
END OF PERIOD:		**16-Aug**	**Sep**	**Dec**	**Mar**	**Jun**	**Sep**	**Dec**
CDA	Overnight target rate	0.75	1.00	1.00	1.00	1.25	1.75	2.00
	98-Day Treasury Bills	0.68	0.95	0.85	0.85	1.20	1.60	1.85
	2-Year Gov't Bond	1.35	1.60	1.50	1.65	2.00	2.55	2.75
	10-Year Gov't Bond	2.94	3.15	3.10	3.20	3.50	3.75	3.85
	30-Year Gov't Bond	3.56	3.70	3.70	3.80	3.95	4.05	4.15
U.S.	Federal Funds Rate	0.24	0.20	0.20	0.20	0.20	0.20	0.25
	91-Day Treasury Bills	0.16	0.15	0.15	0.15	0.15	0.15	0.20
	2-Year Gov't Note	0.50	0.60	0.60	0.80	1.00	1.25	1.50
	10-Year Gov't Note	2.59	2.75	2.70	2.75	3.00	3.50	3.65
	30-Year Gov't Bond	3.74	3.85	3.80	3.95	4.20	4.40	4.50
Canada - US T-Bill Spread		0.52	0.80	0.70	0.70	1.05	1.45	1.65
Canada - US 10-Year Bond Spread		0.35	0.40	0.40	0.45	0.50	0.25	0.20
Canada Yield Curve (30-Year — 2-Year)		2.21	2.10	2.20	2.15	1.95	1.50	1.40
US Yield Curve (30-Year — 2-Year)		3.25	3.25	3.20	3.15	3.20	3.15	3.00
EXCHANGE RATES	CADUSD	0.96	0.99	0.95	0.92	0.95	0.98	1.00
	USDCAD	1.04	1.01	1.05	1.09	1.05	1.02	1.00
	USDJPY	85	84	87	89	92	90	89
	EURUSD	1.28	1.25	1.24	1.19	1.23	1.27	1.30
	GBPUSD	1.56	1.52	1.53	1.50	1.56	1.62	1.67
	AUDUSD	0.900	0.880	0.870	0.850	0.870	0.890	0.920
	USDCHF	1.04	1.08	1.08	1.13	1.11	1.09	1.08
	USDBRL	1.76	1.79	1.81	1.82	1.78	1.75	1.70
	USDMXN	12.7	12.9	13.0	13.2	12.8	12.5	12.4

Chart 2. ***Rate and Growth Differentials***



Source: Haver Analytics, CIBC

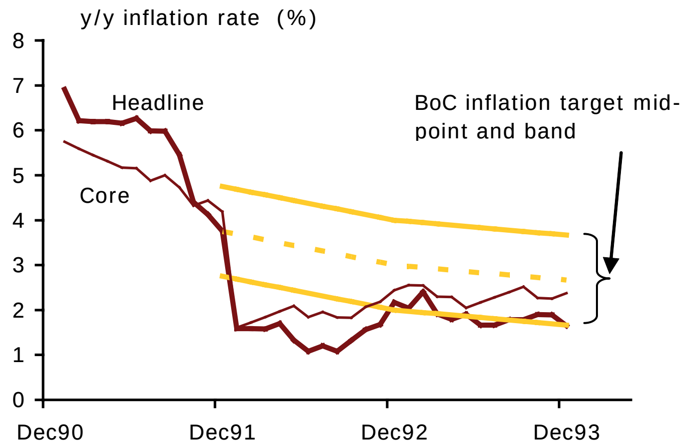
Lessons learned, we hope. As a result, we see Canada taking its overnight rate no higher than 2% by the end of 2011 (with the Fed still on hold), a quarter-point lower than our last projection, reflecting the dampened external growth outlook. That more dovish path and the commodities revisions also took our projections for the C$ roughly two cents weaker over the forecast horizon.

A Pause, But When?

Since a hike at every rate setting date through 2011 would take rates substantially higher than 2%, a pause is coming on the road to tightening. Any pause is going to require a period in which growth either runs below 2% or would be at risk of doing so if rates were pushed higher.

We doubt the Bank of Canada has been shocked enough to forestall a rate hike in September. But our forecast has both Q2 and Q3 falling below the Bank of Canada's outlook, enough to warrant a rethinking in the October *Monetary Policy Report*. If so, having perhaps scared the bond market by going ahead with a September hike, rates could rally back a bit in the fourth quarter as the Bank turns dovish.

Chart 3. ***Early '90s Hikes Overdone***



Source: Haver Analytics, Bank of Canada, CIBC

Table 3. ***Spot Commodity Prices***

			Average				
		13-Aug	2007	2008	2009	2010 (f)	2011 (f)
Oil (WTI)	$/bbl	75	72	100	62	80	85
RBOB gasoline	$/gal	1.87	2.09	2.49	1.69	2.03	2.20
Heating Oil (NYH)	$/gal	1.95	2.03	2.86	1.65	2.05	2.20
Natural Gas (Henry)	$/Mn Btu	4.35	6.97	8.89	3.82	4.70	5.50
Gold	$/troy oz	1214	695	872	1088*	1300*	1150*
Copper	$/lb	3.24	3.24	3.16	2.35	3.25	3.20
Aluminum	$/lb	0.95	1.20	1.17	0.76	0.95	0.85
Nickel	$/lb	9.62	16.86	9.57	6.69	9.00	8.00
Zinc	$/lb	0.92	1.48	0.85	0.76	1.00	0.95

** end of period*

Rates

Mohammed Ahmed

The nOISe in the OIS

Since the development of the market in early 2000, rates on overnight indexed swaps (OIS) have gained broad acceptance as a measure of the market's monetary policy expectations. The most recent bout of risk aversion has driven these rates down quite dramatically, with the implied probabilities of hikes in September, October and December declining considerably since June. Currently, there are some 27 bps of tightening priced in through the end of the year. But how accurate have the market's expectations, as implied by OIS rates, proven to be?

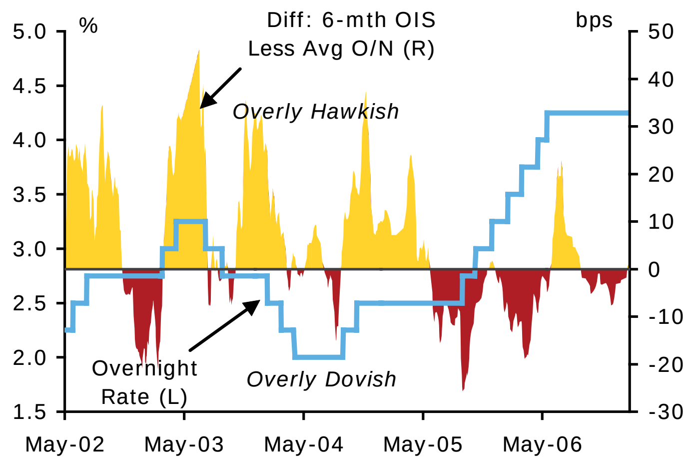
In the same way that breakeven rates on inflation-linked bonds represent the market's expectation of the average rate of inflation over a given period, OIS rates reflect the market's forecast for policy rates within a pre-defined timeframe. As such, it's possible to determine, on a historical basis, the extent to which the market has over- or under-estimated the realized policy rate. We compared the 6-month OIS rate with the weighted average of the overnight rate that was realized six months after the quote date. Despite a limited data set, this analysis reveals some interesting results.

Large Margin of Error, Not-So-Large Room to Err

On average, from 2002 to present, the absolute error between the 6-mth OIS rate and the realized average overnight rate has been 17 bps. This is a significant degree of variance, as most six-month periods overlap just four policy announcement dates and, excluding outliers, the Bank has tended to change the policy rate in ¼-point increments. That is to say, there is roughly a 17% margin of error in OIS implied probabilities. Our analysis reveals that, with a few exceptions, the error is due to the market initially getting carried away in extrapolating the current trend, whether in the midst of a tightening or easing cycle.

Take for example the tightening campaign initiated in 2004. Following the first hike of the cycle, the OIS market proceeded to aggressively price in an expectation for further tightening (Chart 1). And while the Bank of Canada did indeed continue to deliver six successive rate hikes after a pause, the initial reaction by the OIS market

Chart 1. ***Error of OIS Market Expectations: 2002-2007***



proved to be excessive. In fact, by the time the Bank started to tighten systematically in 2005, the OIS market was actually forecasting an easing of policy.

A notable exception to the rule was the easing episode of 2003. Having taken rates up by 125 bps since 2002, the Bank signaled a neutral stance on policy rates in mid-2003. The perceived pause proved to be short-lived though, when at the July announcement, the Bank unexpectedly slashed rates by ¼ point. Consequently, OIS traders were largely caught by surprise.

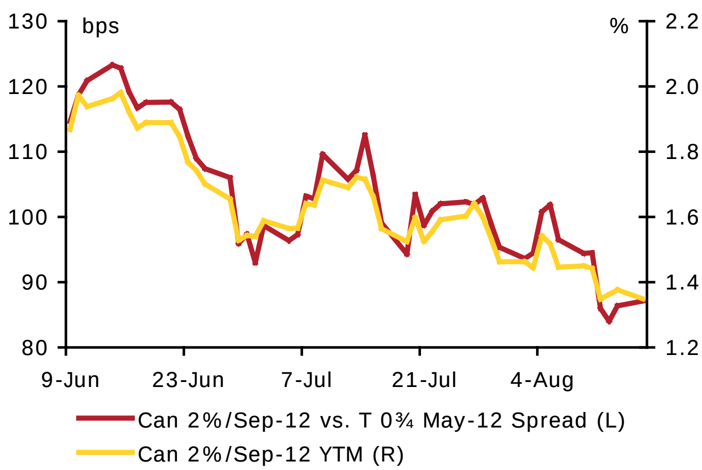
As Avery Shenfeld highlights, the 2002-2003 period was also the most recent in which the Bank of Canada tightened while the Federal Reserve kept rates on hold (pages 2-4). During that period, the market's expectations for policy moved dramatically. This volatility reached its peak in late 2002, when the market swung from expecting further hikes, to anticipating an easing. Interestingly, market activity since April of this year appears to be following a very similar path. Recall that just after the expiry of the conditional commitment in April, OIS rates implied a probability of hikes in 50 basis point increments. In contrast, now the market is calling into question the likelihood of a hike at the September 8th meeting.

Barring a severe exogenous shock though, the Bank of Canada continues to have a reasonable case for raising the overnight rate by ¼ point in September. All else equal, if the Bank delivers on this expectation, the value proposition of holding Canada 2s will be seriously diminished. In this scenario, the spread between the overnight target as of September 8, 2010 and the yield to maturity on a bond set to mature on September 1, 2012 will be just 35 bps. Knowing the illustrated tendency for the market to overshoot both dovish and hawkish outcomes and considering the dovish stance currently priced in by the OIS market, this 35-bp buffer may be inadequate.

The Foreign Factor

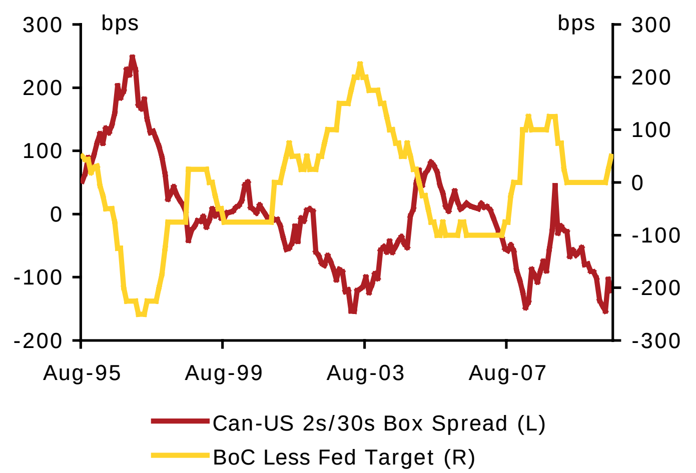
That said, value judgments on Canadian bonds may not be driven solely by fundamentals. As highlighted by a notable bond market pundit's comments in the media last week, Canada continues to be viewed favourably by foreign investors. This is corroborated by the explosive growth in foreign purchases of Canadian bonds, which Warren Lovely details in this month's Government Finance feature (pages 7-9). And as a case in point, with 2-year yields in the US seemingly anchored at 50 bps, 2-year Canada bonds have attracted significant foreign interest, contributing to the sharp decline of 2-year yields (Chart 2).

Chart 2. ***Canada 2s Outperformed as US 2s Became Anchored***



Foreign demand may also help to explain the relative underperformance of the 10- and 30-year terms of the Canada curve. Not only does foreign investment in Government of Canada bonds tend to be concentrated in shorter duration bonds, but relative to the US, there is a perception that the Canada curve is too flat. Historically, this view may have been justified on the basis of overnight rate differentials (Chart 3). This time around though, the Treasury curve will likely retain some structural steepness as the Fed keeps policy rates near zero until Q2 2012, while the Canada curve should resume flattening apace next year as the Bank of Canada comes off the sidelines and re-initiates its tightening campaign mid-2011.

Chart 3. ***Canada-US Policy Rate Differential and 2s/30s Box Spread***



Foreign Exchange

Jeremy Stretch

Structural Risks Remain a EUR Drag

Attempting to discern FX trends during the summer liquidity lull is a notoriously unreliable business. That perhaps should lead us into being careful in attempting to glean too much from the recent EUR USD gyrations. Nevertheless, what is evident is that those who were prescient enough back in early June to unwind record EUR short positions registered a short-lived period of profitability. In the two months from June 7th the EUR rallied more than 11% versus the USD.

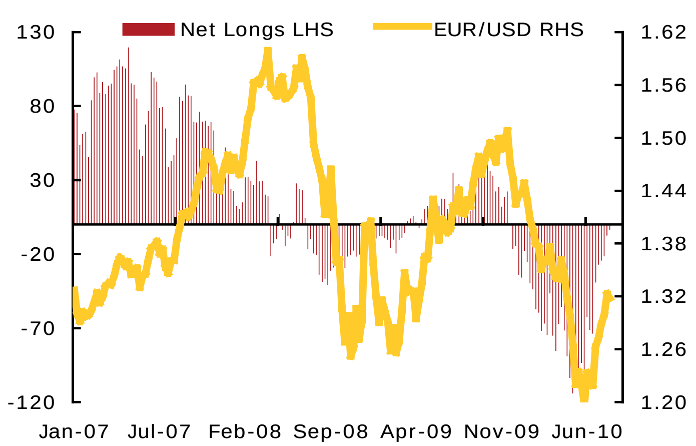
It is notable that we have retreated from oversold EUR conditions, back to neutrality—witness the paring of IMM speculative EUR shorts. We would regard the pullback as opening the way for a rebuilding of positions as the broader risks that undermined investor sentiment in the EUR during early Q2, namely sovereign concerns and economic divergences, remain. In particular, the seemingly bullish economic backdrop painted by ECB President Trichet in the recent post rate meeting press conference is likely to prove overly optimistic.

The combination of rising front-end interest rate spreads and a reversion in negative Euro sovereign sentiment in conjunction with oversold speculative positions predicated the EUR short squeeze. It can be argued that the recent pro-active stance of the ECB had, at least initially, to be seen as relatively successful, with the ECB's gradual removal of liquidity measures, plus its bond buying programme allied to the bank stress tests, temporarily resulting in an easing in bond market tensions and CDS spreads. Thus we have seen the ECB squeeze 3m rates back towards the refi rate, at 1%, in part as the market temporarily at least anticipated reduced financial sector uncertainties.

EUR Structural Risks Remain

But it remains evident that a number of banks across the region, in particular Spain and Portugal, remain reliant upon ECB funding, the former accounting for almost a third of borrowing from the ECB in July. On that proviso, despite the likely demands of the Bundesbank faction within the central bank, there appears little probability of the ECB adopting an early tightening stance. Indeed the greater the risks of a deceleration in activity, the greater the possibility of additional liquidity measures, which are likely to see front-end rates coming under renewed pressure, dragging spreads back lower.

Chart 1. ***Speculative Investors Pared EUR Shorts***



Source: Bloomberg

Chart 2. ***EUR USD and 3m Interest Rate Spreads***

The general easing in US rates in the wake of deteriorating US data, allied to the guidance of rates towards the refi rate by the ECB, had seen front-end spreads widen to beyond one year highs. Investors who have been riding EUR USD on the back of the rise in short-end rate spreads risk a reversal. The loosening of the relationship between spreads and EUR USD is perhaps indicative of an increasing realization that spreads are a less significant FX driver amidst a slowing global environment that makes the job of Eurozone fiscal consolidation all the harder and increasingly politically unpalatable.

The risk rebound in June and July prompted a USD depreciation against all the top 16 major currencies tracked by Bloomberg. A pullback in sovereign crisis fears from extreme levels helped see peripheral bonds spreads against the EUR narrow back in, arresting what had appeared to be an almost headlong rush towards EUR USD parity early in Q2 as EU break-up scenarios were starting to be openly discussed. Subsequently of course we have seen Eurozone economic activity outpace that in the US in Q2 as Germany produced the fastest pace of quarterly activity since reunification. But such German resilience comes at something of a price. German economic competitiveness compared to the rest of the eurozone has been honed by structural reforms and aggressive gains in productivity. That risks increasing economic divergences and structural strains going forward.

Peripheral EU economies, once inducted into EMU, have for years basked in the low-rate environment, underpinned by benign global conditions and ECB monetary credibility. But now they find their previous competitive advantage eroded by real equilibrium exchange-rate gains that render their economies uncompetitive amidst the worst global environment since the 1930s. Thus fiscal austerity is likely to test the resolve of EU politicians to the euro project, albeit the alternatives (EMU withdrawal) are at least equally unpalatable, if not more so.

Facing Fiscal Mountains

Hence we are left with a number of eurozone economies facing extreme austerity measures, which in the short run will result in significant challenges to economic performance—witness the worse than expected 1.5% contraction in Q2 Greek GDP. Of course weak economic performance merely exacerbates austerity challenges as growth and tax revenues slide, and benefit payments rise. The picture may not be totally negative as the fiscal crisis will bring valuable structural reforms. But the results of such measures take time to come through, and such time horizons are well beyond market horizons.

For market participants the prospect of a more challenging economic environment than that faced in Q2 underlines the scale of the fiscal mountain. Hence we have seen renewed evidence of widening of bond and CDS spreads for those economies seen to face the greatest structural pressures. It can be argued that, despite the best efforts of the ECB, the reliance of the European banking sector on ECB funding, whether explicit or otherwise, underlines domestic fragilities, and that the structural negatives evident back in early Q2 are still manifest.

Thus we anticipate that the broad EUR concerns which undermined the EUR during Q2 will come back to the fore. The deceleration in global economic activity underlines the increasing difficulties for those forced to indulge in aggressive fiscal consolidation. Therefore we would expect that we are set to see EUR USD back below its PPP 'fair value' level, which we estimate to be around US$1.21—this as we anticipate a re-test of 2010 lows prior to year-end.

Chart 3. ***Real Effective Exchange Rates (REER)***

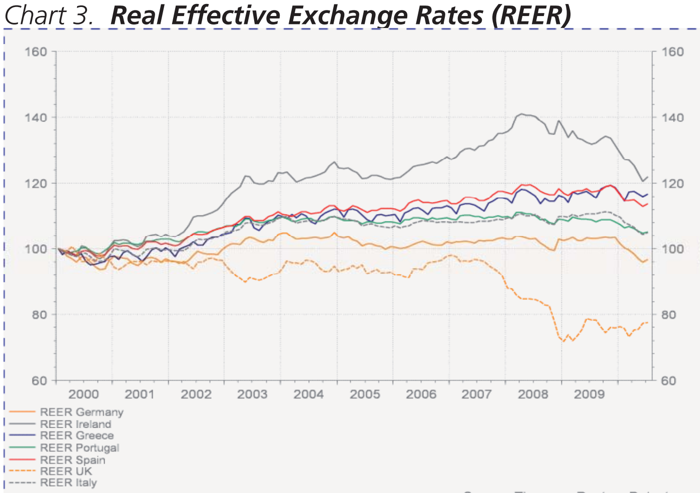
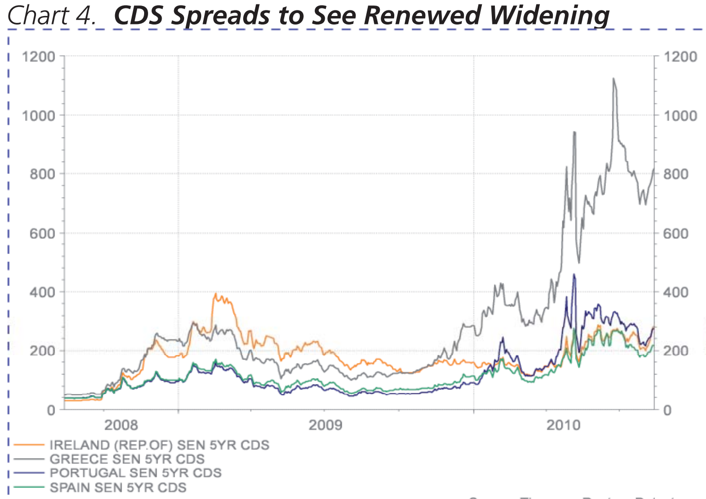


Chart 4. ***CDS Spreads to See Renewed Widening***



Government Finance

Warren Lovely

Buying Canada: A Closer Look

There's been much discussion of the tidal wave of foreign portfolio investment flooding into Canada. Less has been said on the fundamental origins of these capital flows and how long they might last. Fewer still have delved into the finer details, dissecting flows and holdings by asset class and sub-sector, currency and geographic origin. We aim to extend the analysis, picturing what these capital flows may look like in the months (and years) ahead.

Balance of Payments: A Fundamental Perspective

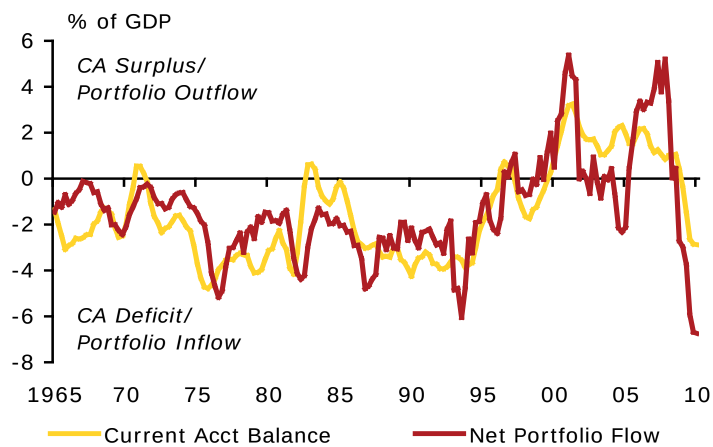
In just a year and a half, foreign investors have accumulated a stunning $170 billion of Canadian portfolio securities. Many focus on the demand side when explaining this tidal wave of interest. Indeed, foreign investors have found much to like, be it stronger economic growth, a generally appreciating currency, political stability, a superior fiscal standing or unparalleled banking sector strength.

But balance of payments accounting offers a more fundamental way to look at capital flows for any open economy. As every economist learns, a country's balance of payments must balance, such that current account shortfall must be made up in the capital account, generally through the importation of financial capital.

Prior to the 2000s, Canada consistently ran a current account deficit, offset by a steady net inflow of foreign capital. Trade fortunes improved markedly last decade, transforming Canada into a net exporter of financial capital. From 2000 to 2007, the equivalent of $200 billion of portfolio capital flowed out of the country.

Today, the current account is back in the red, necessitating the net inflow of capital we now see (Chart 1). A sputtering US economy could stall progress on improving Canada's trade surplus in any meaningful fashion. So barring a substantial repatriation of capital from abroad, lingering current account shortfalls will likely require ongoing purchases of Canadian securities by non-resident investors.

Chart 1. **Balancing Canada's Balance of Payments**



Bonds, Bonds and More Bonds

As in years past, the predominant flow of foreign capital has been into the bond market. The $135 billion of Canadian bonds acquired by non-residents since 2009 is four times what has gone into Canadian stocks and money-market paper combined (Chart 2). The dollar value of today's net inflow into the Canadian bond market dwarfs all prior records. And even as a share of GDP, which controls for growth in the economy, records are falling (Chart 3).

Chart 2. **Purchases of Bonds Dwarf Interest in Stocks, ST Paper**

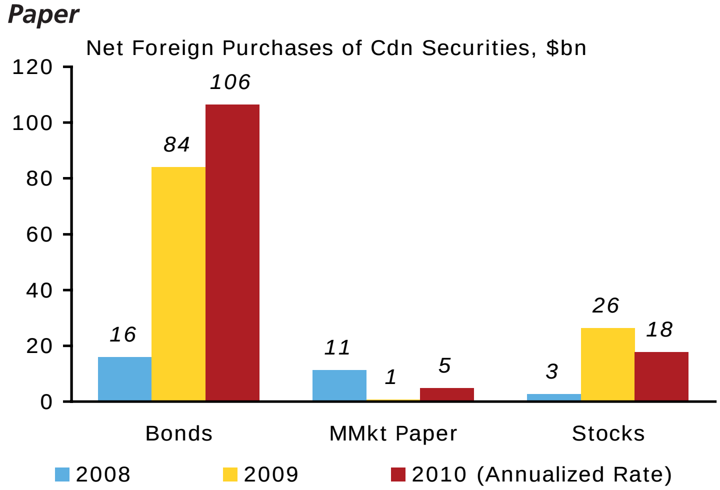
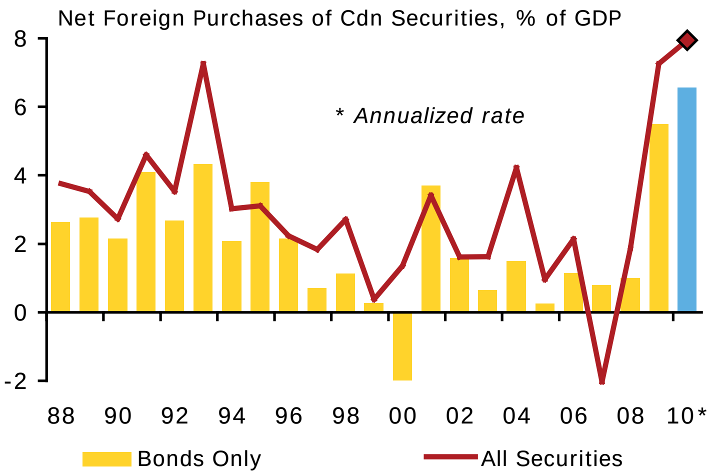


Chart 3. ***Bond Market Inflow Unprecedented***



On the surface, US investors account for an overwhelming share of interest. UK investors are a distant second when it comes to accumulating Canadian fixed income assets, with more modest buying out of Japan and a number of "other" countries. Interestingly, investors in continental Europe have been net sellers (Chart 4).

But as with the US TICS data, attribution by country does not provide a true picture. Purchases are recorded on the basis of where the counterparty or financial intermediary resides, which can differ from the end investor's home country. That 'transaction bias' skews the figures to countries with large international financial centres, such as the US (New York) and the UK (London).

So don't make too much of the fact that the geographic breakdown suggests modest buying from "other" countries, such as China. In general, the number of foreign countries moving into the Canadian bond market has grown meaningfully, adding significant geographic diversity to the investor base.

A breakdown by currency reveals that fully 60% of the Canadian bonds foreign investors have digested since 2009 have been denominated in the C$, with US$ debt accounting for much of the rest. But consider that some 80% of outstanding Canadian bonds are denominated in our country's home currency. And it's C$ bonds that offer an easy diversification tool away from the US$ that some investors desire. Sizeable purchases of C$ product help explain the Canadian dollar's underlying strength (Chart 5)—a missing link in more traditional models which seek to ascribe currency performance to commodity prices and interest rate differentials.

Hefty net buying of C$ bonds also reflects the type of bonds foreign investors are most aggressively pursuing. During the past 12 months, more than half of all net purchases have gone towards Government of Canada bonds (Chart 6), which are almost exclusively denominated in C$s. Corporate bonds have attracted nearly 30% of the net buying, including more recent foreign currency covered bonds. While provincials have garnered a smaller share of net buying, the sector continues to attract solid interest. Witness the success of recent US$ issues from a growing number of provinces.

There's a striking comparison between net foreign purchases of Canadas and federal Crowns. The 12-month trend shows the lightest net purchases of Crown debt since the Canada Mortgage Bond (CMB) program was

Chart 4. ***Geographic Origin of Foreign Interest in Cdn Bonds***

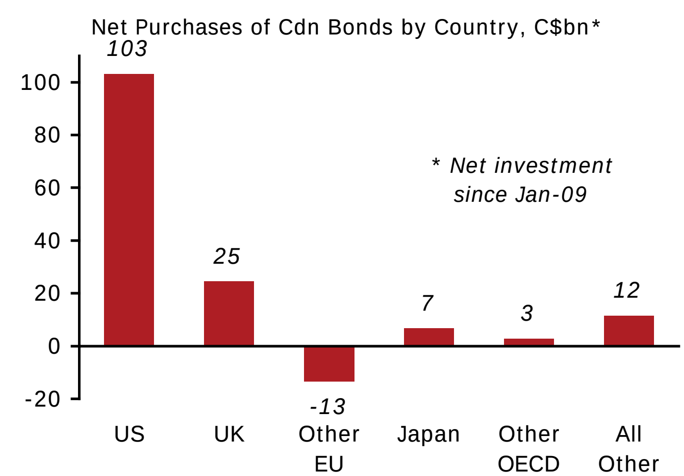


Chart 5. ***C$ Bond Purchases Have Given Currency a Lift***

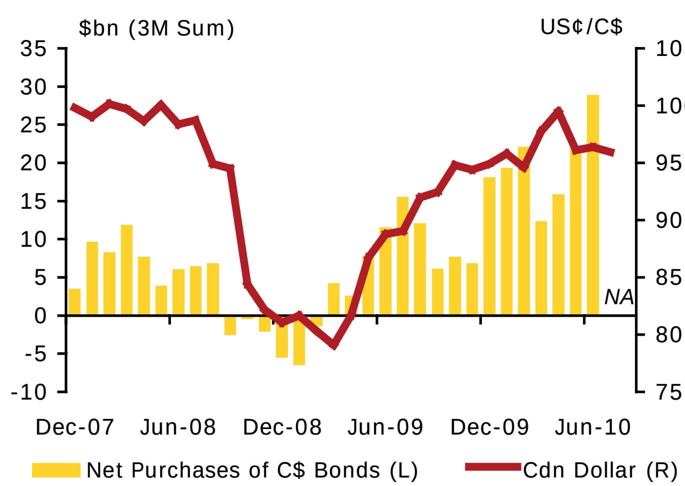


Chart 6. ***GoC Bonds Account for Majority of Net Buying***

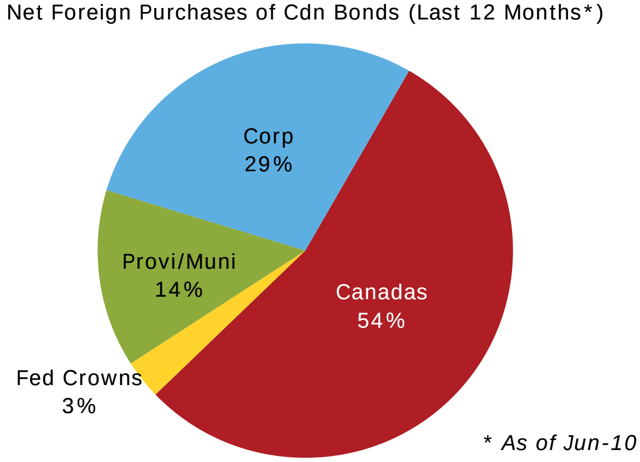
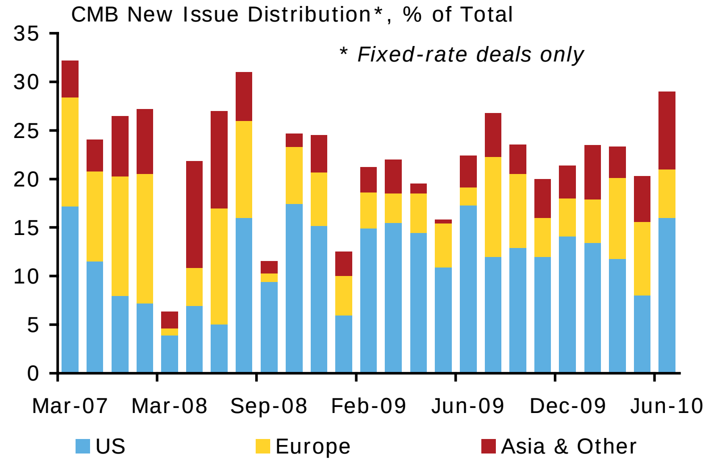


Chart 8. ***CMB New Issues Continue to Attract Foreign Interest***



introduced in 2001 (Chart 7). It's not as though the CMB program has lost its traditional international following, with foreign sales on new issues continuing to average roughly 25% (Chart 8). But as a mature program, gross and net CMB supply has receded from prior peaks, whereas Canada issuance shot to historic levels in 2009/10, before easing only modestly in the current fiscal year. Moreover, requirements for some Crowns were consolidated with the federal government starting in April 2008.

The relative onrush into Canadas has reversed what had been a long-term decline in holdings of Canadian sovereign debt by non-residents, which are now in line with holdings of federal Crowns (Chart 9). But it's corporate and provincial debt that continues to make up the majority of foreign holdings, consistent with the fact that these sectors have traditionally issued a larger share of their debt in foreign currencies. Some 25% of provincial debt is now non-C$ denominated, while that ratio is more than 40% for corporate issuers.

Where do we go from here? As the federal government's fiscal situation continues to improve, Government of Canada net issuance will slow materially. As foreign investors seek ongoing and increased exposure to Canada, net investment into other sectors can be expected to grow. For some, CMB could again serve as a highly liquid substitute for a reduced net supply of Canadas, while maintaining direct exposure to the currency. For others, including a growing number of central banks, provincial debt will be viewed as a higher-yielding alternative, an important source of demand for a sector that still faces elevated borrowing needs in the years ahead. Overall, foreign capital will continue to seek out Canada's bond market, adding additional sources of liquidity and price tension that existing investors covet.

Chart 7. ***Gap Between Purchases of Canadas & Crowns***

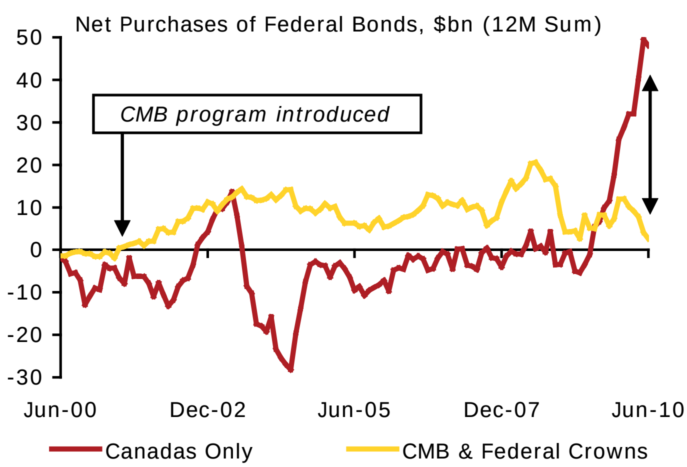
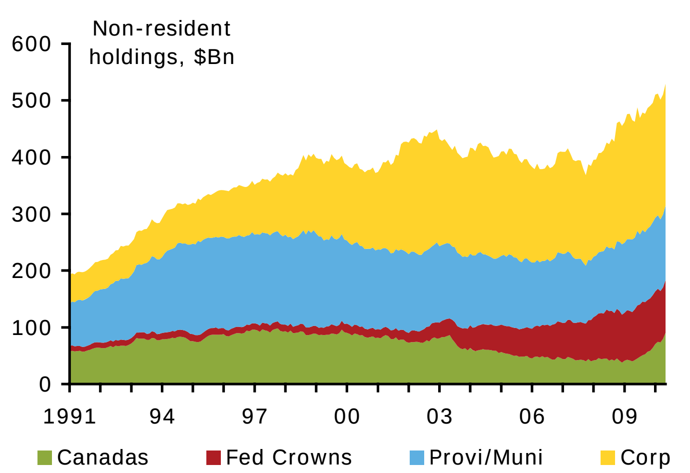


Chart 9. ***Holdings of GoC on Rise, But Still Lighter Than Corps/Provis***



Credit

Joanna Zapior and Olga Dadabayeva

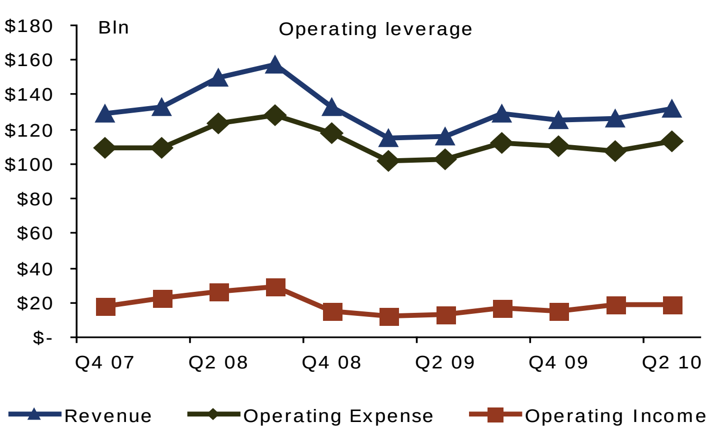
Be Prepared—For Any Old Thing

As we head into a period of potential economic slowdown, the focus of headlines has been shifting to the top line, with such titles on analyst reports as "Sales Continue to Go Stale" or "Sales Up, But Where is Revenue Growth?". In this context, we find a modest amount of comfort in an observation that Canadian corporate debt issuers appear to have taken heed of the good old boy scout motto "be prepared" as they have been nurturing their aggregate income statements and balance sheets.

Top Line Stabilization Though Not Recovery Just Yet

Aggregate revenues have been trending higher since the trough in the first half of 2009, and are slightly higher than the levels seen in late 2007, though well below the peak of 3Q08 (Chart 1). Operating profitability has stabilized since the rapid decline in 4Q08, and has been on a gradual, albeit very slight, uptrend. It has in fact recovered slightly past the levels registered in late 2007, though still below the 3Q08 peak.

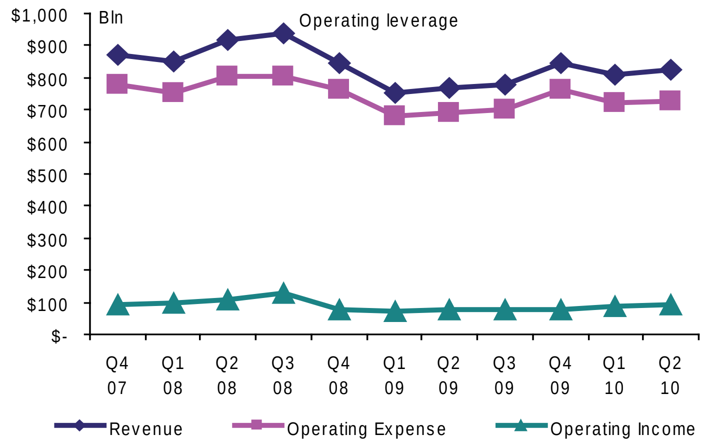
Chart 1. ***Cdn Corporate Debt Issuers Have Stabilized Operating Profitability and Grown Revenues Slightly***



Canadian Issuers Compare Well with Their US Peers

Canadian corporate debt issuers are not much different in this respect than their US peers (Chart 2), though the aggregate "re-build performance" in Canada is stronger. The aggregate revenue of Canadian issuers is 2% higher than in 4Q07, while US companies are still 5% below that level. Operating profits for Canadian issuers are 4% higher than in 4Q07, while for US issuers they are 2% lower than in 4Q07. Granted, Canadian companies had a larger tumble from peak levels, both in revenues and operating profitability, than their US counterparts. Canadian revenues are down 16% from the peak, and operating profits 35%, vs. only 12% and 28% down, respectively, for the US.

Chart 2. ***US Corporate Debt Issuers Have Also Stabilized, But Trend Not as Good as in Canada***



Top Line is Only Part of the Story

Canadian issuers have reduced reported balance sheet leverage from the peak levels in 4Q08 (Chart 3). This reduction in leverage has been a combination of debt reduction and increases in shareholder equity (though in the last quarter Canadian issuers have started to reduce equity through buy-backs). We find comfort in the stabilization of Canadian issuer revenues and operating profits especially when accompanied by balance sheet improvement. This creates some cushion for what may lie ahead. Again, as in the performance at the top line, in terms of balance sheet leverage we find Canadian issuers better positioned than their US peers (Chart 4).

Chart 3. ***Canadian Issuers Have Reduced Balance Sheet Leverage***

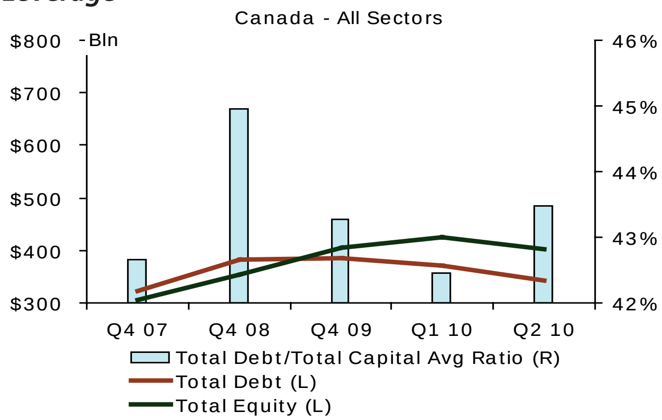
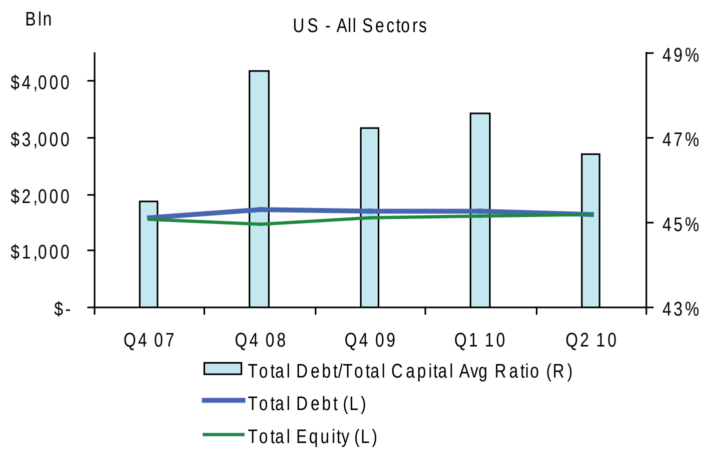


Chart 4. ***US Issuer De-leveraging Trend Not as Pronounced***

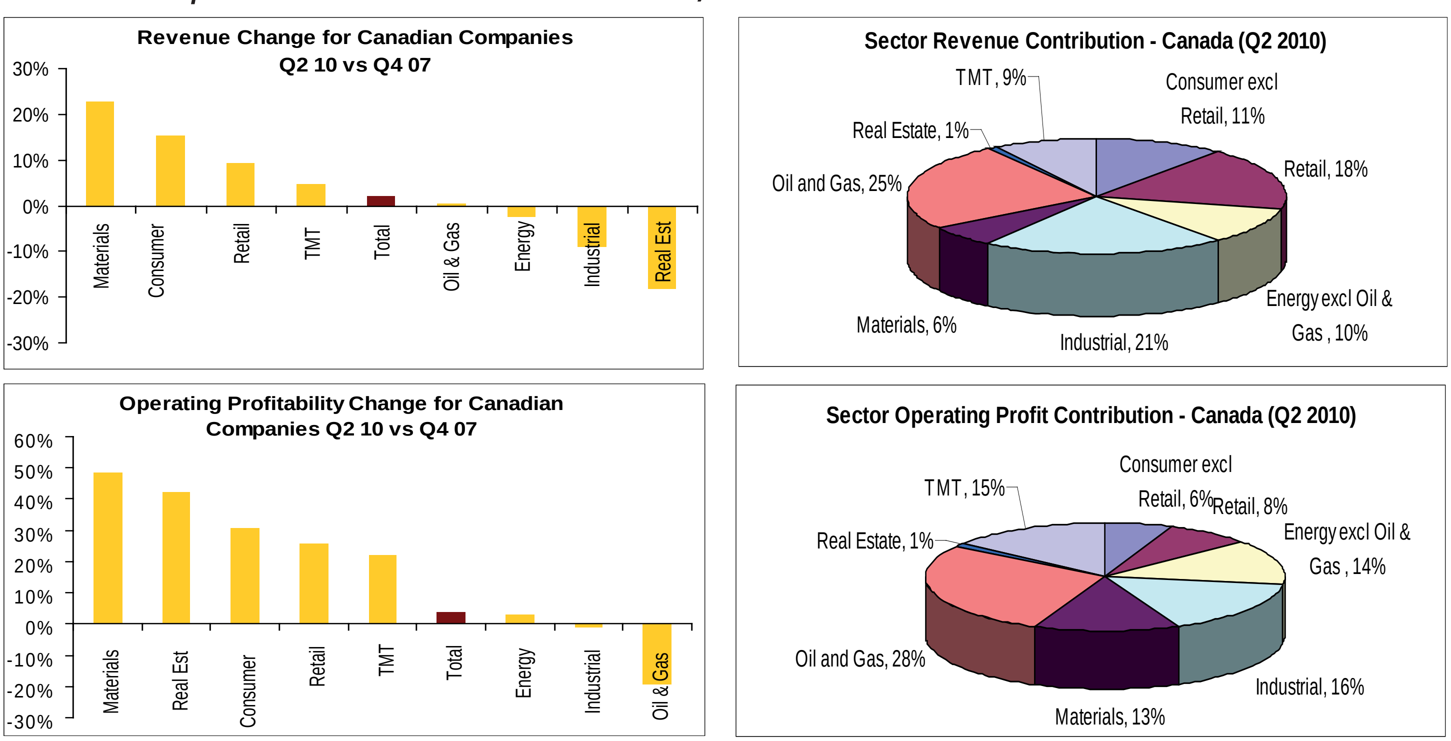


Not All Sectors in Our Sample Are Equal

While the revenues of Canadian issuers in the aggregate have bested the 4Q07 levels by a modest 2% (as we have calculated above), some industries appear to have done distinctly better than others at the top-line performance (top panels in Chart 5; note that in Chart 5 we also show the weights of the sectors both at the revenue and operating profit levels).

A word of caution, though, is necessary as we move from the macro-level analysis to a more granular sector drill-down. The small size of our corporate debt market universe makes this level of analysis more difficult. For example, of the two top revenue-performers, revenues in the materials sector reflect as much business activity as rising prices of certain commodities to which the sample is skewed. The comparison in our non-retail consumer sector, as reported, is significantly affected by three large M&A transactions, not counting a few smaller ones, which distort our revenue statistics. The next two sectors in Chart 5, retail and telecoms, are quite close to the overall revenue and profitability stats. What Chart 5 does not illustrate is that both of these sectors, and notably telecoms, have shown remarkably stable revenue and operating profit trends through the period we analyze. Adjusting for such factors suggests that, apples to apples, it is indeed only a modest stabilization, but stabilization nevertheless it appears to be.

Chart 5. ***US Corporate Debt Issuers Have Also Stabilized, But Trend Not as Good as in Canada***



Commodities

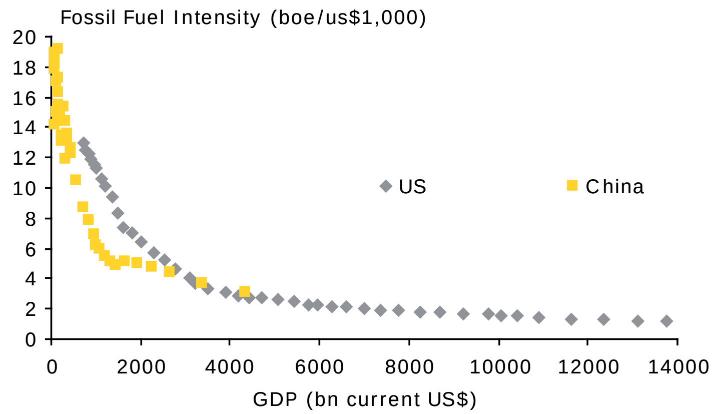
Katherine Spector

Oil Fundamentals in the World's Largest Energy Consumer

China has claimed two new records in the past month. This week China took Japan's spot as the world's second largest economy, and in mid-July the International Energy Agency revealed that China had displaced the US as the world's largest consumer of energy. China seemed to view the latter honour as a dubious one at best, insisting that the IEA's measure of its energy use was too high, but whether the record is set this year, next year, or the one after, the trend is clear.

China has reason to be defensive —China still trails the US by a long shot in terms of per capita energy use, and has managed to cut the energy intensity of its growth far more quickly than its predecessors in the developed world. Most countries see a sharp uptick in the energy intensity of growth as they move from agriculturally based economies to industrial ones; then they typically see a logarithmic decline in intensity as GDP grows, the manufacturing sector sees efficiency gains, and the services sector becomes dominant. China's shift over the past fifty years has been steep and rapid (Chart 1). A mere twenty years ago, it took nearly 15 barrels of oil equivalent (boe) of fossil fuels to grow China's economy by US$1,000. Now it takes little more than three barrels. The US economy required about 2.5 boe to grow US$1,000 two decades ago, and has since improved to just over one boe (Chart 2).

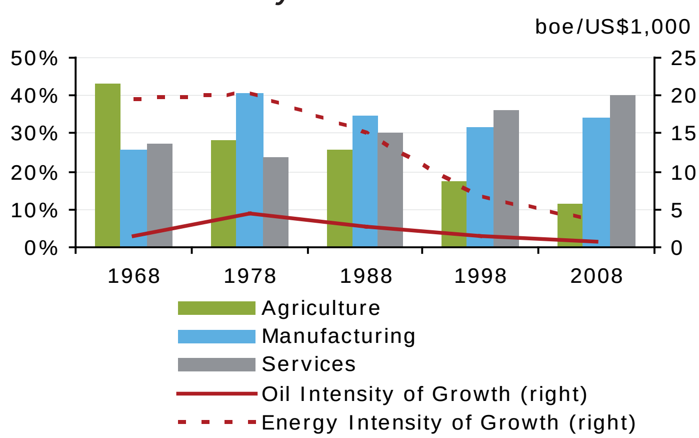
Chart 2. **Fossil Fuel Intensity of Growth as GDP Grows**



Source: CIBC Macro Strategy — Commodities, World Bank

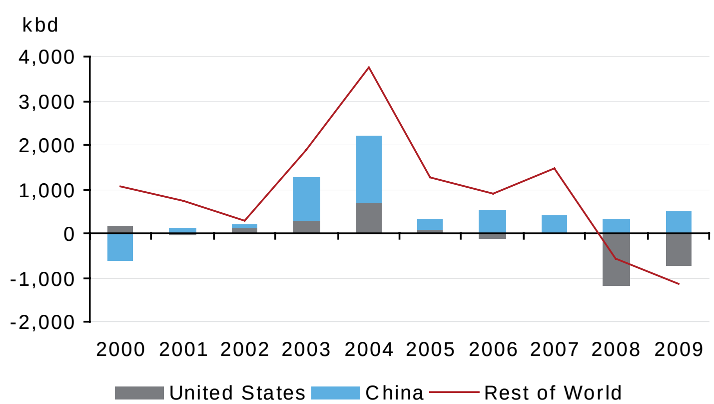
With respect to oil, the US is still the world's biggest consumer by far, and dwarfs Chinese demand by a factor of more than two. However, for much of the past decade, China has contributed far more than the US to the world's oil demand *growth* (Chart 3). Notably, Chinese oil demand sustained growth through this most recent recession, when world demand contracted for the first time since a very slight stall in 1993.

Chart 1. **China's Energy Intensity of Growth, & Contribution to GDP by Sector**



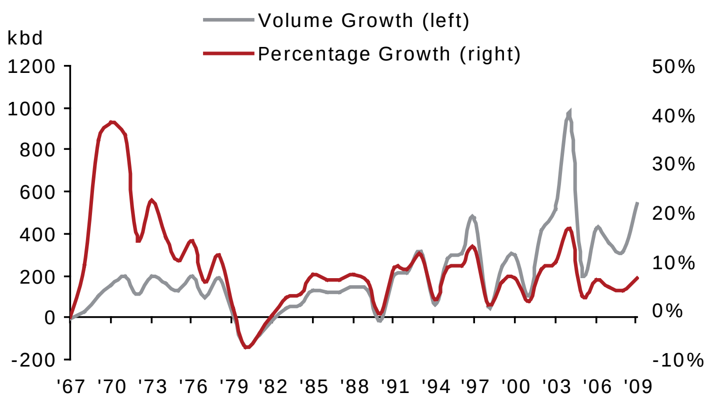
Source: CIBC Macro Strategy — Commodities, World Bank

Chart 3. **Chinese Oil Demand Growth Drives the Global Trend**



Source: CIBC Macro Strategy — Commodities, Chinese Customs General Administration

Chart 4. **Chinese Oil Demand Growth (Volume and %)**

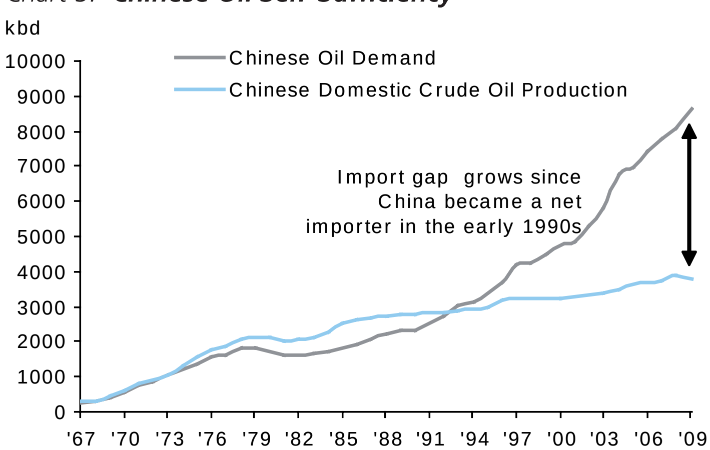


Source: CIBC Macro Strategy — Commodities, Chinese Customs General Administration

It is now well-recognized that 2004 was an unusual year even for Chinese oil demand growth. Demand grew by 17%, or nearly one million b/d that year, a pace that has not been matched since (Chart 4). That said, 2010 is on track to post the biggest oil demand growth seen since 2004. Similar to what we have seen in most recent years, diesel demand is contributing most to total oil demand growth this year, while fuel oil demand is contracting. However, a few other changes in Chinese oil fundamentals are worth noting.

- Although total Chinese oil self-sufficiency continues to decline (Chart 5), recent refinery capacity additions have made China less dependent on foreign product imports, but a correspondingly bigger importer of foreign crude. In the first six months of 2010, crude imports increased one million b/d relative to the first half of 2009. Coupled with a more minor increase in domestic crude production, those extra barrels fed 1.3 million b/d of growth in refinery runs. At the same time, refined product imports have fallen by 272 kbd. China has been a steady net exporter of gasoline for years, but has lately become a more consistent exporter of diesel and jet fuel as well.
- Like in 2004, growth in 'other products' has been a major component of total oil demand growth since mid-2009. What we term 'other product' demand is actually the difference between reported refinery runs and the sum of reported output of major refined products, such as gasoline and diesel. We attribute this 'phantom' demand to requirements for additional minimum operating inventory to run new refinery capacity and the transport infrastructure associated with it. According to BP's Statistical Review, China's refinery capacity grew by more than 800 kbd in 2009, by far the biggest incremental gain since—not surprisingly—2004, when capacity grew by a similar volume. While these barrels are not true demand in the sense of end-user consumption, they are barrels off the market.
- Fairly consistently over the past five years, Chinese oil demand has been highest in the second and third quarters of the year—specifically, demand peaks in June or July. Interestingly, oil demand in Mideast Gulf countries has also contributed significantly to global growth in recent years, and also peaks in the summer (July-September).
- In OECD countries, demand is highest in the winter months. As China and other non-OECD countries contribute more to the global picture, historical rules of thumb about seasonality change.

Chart 5. **Chinese Oil Self-Sufficiency**



Source: CIBC Macro Strategy — Commodities, BP Statistical Review

Table 1 . **Chinese Oil Fundamentals**

kbd	YTD'10	YTD'09	Year Chg.	Year Chg. (%)
Crude Production	4,001	3,768	233	6.2%
Net Crude Imports	4,712	3,661	1,051	28.7%
Net Product Imports	172	444	-272	-61.2%
Refinery Throughputs	8,297	6,996	1,301	18.6%
Demand				
LPG	696	722	-26	-3.6%
Gasoline	1,578	1,550	28	1.8%
Naphtha	716	608	109	17.9%
Jet Kero	339	289	50	17.5%
Diesel	3,030	2,551	479	18.8%
Fuel Oil	640	706	-67	-9.4%
Total	9,002	7,919	1,083	13.7%

CIBC Macros Strategy — Commodities, Chinese Customs General Administration

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