# GPS MONTHLY

GLOBAL POSITIONING STRATEGIES

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***Mohammed Ahmed***
*Rates*
*(416) 594-8415*
*mohammed.ahmed@cibc.ca*

***Eric Ohayon***
*Foreign Exchange*
*(416) 594-8416*
*eric.ohayon@cibc.ca*

***Peter Buchanan***
*Commodities*
*(416) 594-7354*
*peter.buchanan@cibc.ca*

***Warren Lovely***
*Government Finance*
*(416) 594-8041*
*warren.lovely@cibc.ca*

***Michael Rosborough***
*Strategic Risk*
*+44 (0) 207 234-7232*
*michael.rosborough@cibc.co.uk*

***Avery Shenfeld***
*Economics*
*(416) 594-7356*
*avery.shenfeld@cibc.ca*

***Joanna Zapior, CFA***
*Credit*
*416) 594-8498*
*joanna.zapior@cibc.ca*



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***http://research.cibcwm.com/economic_public/download/gps_dec09.pdf***

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## Resourceful Thinking

**Economics (Shenfeld):** Canada and Australia are as far apart economically as they are geographically. That will see upside surprises in the gap between Australian and Canadian policy rates, allowing the A$ to outperform the loonie in 2010, but making Canada's bond market a safer place to be at the front end.

**Rates (Ahmed):** Since the RBA's hike on October 6th the Canada-Australia 2-year bond spread has narrowed just 8 bps, while Canada 10s have richened by 40 bps relative to Aussie 10s. We believe the Canada curve will remain steep and expectations for higher overnight rates will propel bear-flattening of the Aussie curve. We propose a 2s/10s box trade predicated on divergent monetary policies across the Dollar Bloc.

**Government Finance (Lovely):** A muted global recovery and below-consensus energy price forecast implies limited upside for Canada's resource-based provinces. But commodity-centric provinces are still likely to outperform their Central Canada cousins in 2010. As a more forceful expansion takes hold in 2011, commodities will again trigger a wide divergence in economic and fiscal performance, allowing resource-rich provinces to eliminate deficits at a much faster pace.

**Credit (Zapior):** Three ways in which the Canadian bond market may follow Australian market developments: 1) growth in foreign investor demand for C$ product, 2) return of non-resident issuance (Maples are to Canada as Kangaroos are to Australia), and 3) further into the future, additional domestic demand from potential new pension saving schemes.

**Foreign Exchange (Ohayon):** While commodities currencies have rallied in sync, AUD has outpaced others as the RBA hiked rates. We recommend a long-Aussie, short C$ trade to capitalize on further momentum in that direction, and NOK could also break out of the pack in gains vs. the USD as Norway follows Australia's lead in hiking rates.

**Commodities (Buchanan):** After an unexpectedly hearty recovery from early 2009's six-year lows, oil's rally appears to have run into some headwinds recently. While an upwards sloping supply curve points to loftier prices down the road, the run-up has outpaced fundamentals. Bloated inventories, weak demand in the world's largest consuming country and above-trend efficiency growth create near-term downside risks.

**Strategic Risk (Rosborough):** Some of the gains in commodities and related currencies might be attributable to the increased supply of dollars rather than resource fundamentals.

# ECONOMICS

AVERY SHENFELD

## Dollar Bloc: Advantage Australia

When we venture abroad, investors often ask about how Canada stacks up against Australia, rather than the US. The temptation is to lump the two into a broader dollar bloc (with New Zealand) or in a basket of commodity currencies (throw in South Africa, Norway, Brazil). But Australia is today as far economically from Canada as it is geographically, a gap that makes Aussie the better bet for a currency play, but one favouring Canada in terms of short bond prices.

### A Clear Lead Down Under

Recent economic trends make it abundantly clear that the two English-speaking, commodity-exporting, dollar bloc countries have parted company of late (Table 2). On every key dimension, the Aussie data are head and shoulders above Canada's. That reflects a dramatic difference in the overall economic story in the past year: Canada had a severe recession from which it is only now emerging. Australia had a single-quarter dip in output, one it has since readily recouped.

Geography, more than anything, accounts for Australia's advantage. Our close ties with the US exposed us to the full brunt of the 2008-09 "Great Recession." Nearly one in four Canadian jobs are dependant upon sales to the US, which accounts for about three-quarters of our exports. In contrast, less than 5% of Aussie shipments are US-bound, as Australia instead helps feed China's voracious minerals appetite. As in Canada, currency appreciation poses competitive challenges for Australian manufacturers. But there aren't as many of them to worry about, as Canada had nearly 25% more factory jobs at stake prior to the recession than Australia, adjusted for labour market size.

Table 2. **Australia's Economy Has Been Much Healthier**

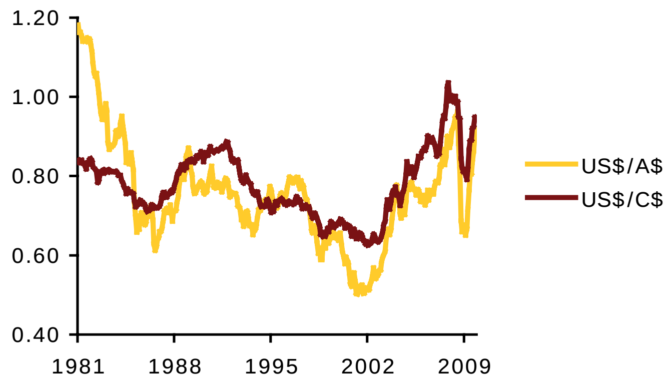
| chg. since Q308 | Australia | Canada |
|---|---|---|
| GDP | +0.3% | -3.2% |
| Employment | +36K | -319K |
| Unemployment rate | +1.5% pts | +2.3% pts |
| Retail volumes | +6.0% | -0.4% |

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

| | | 2009 | 2010 | | | | 2011 | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| END OF PERIOD: | | 9-Dec | Mar | Jun | Sep | Dec | Mar | Jun | Sep | Dec |
| CDA | Overnight target rate | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 1.00 | 1.75 | 2.50 | 2.75 |
| | 98-Day Treasury Bills | 0.21 | 0.25 | 0.30 | 0.30 | 0.30 | 1.15 | 1.90 | 2.65 | 2.90 |
| | 2-Year Gov't Bond | 1.20 | 1.10 | 1.20 | 1.40 | 1.60 | 2.10 | 2.35 | 3.00 | 3.35 |
| | 10-Year Gov't Bond | 3.31 | 3.35 | 3.40 | 3.85 | 3.95 | 4.00 | 4.05 | 4.15 | 4.25 |
| | 30-Year Gov't Bond | 3.95 | 3.95 | 4.00 | 4.30 | 4.35 | 4.35 | 4.40 | 4.40 | 4.40 |
| U.S. | Federal Funds Rate | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 1.50 | 2.25 | 3.50 | 3.75 |
| | 91-Day Treasury Bills | 0.03 | 0.15 | 0.20 | 0.25 | 0.35 | 1.70 | 2.25 | 2.60 | 2.90 |
| | 2-Year Gov't Note | 0.74 | 0.90 | 1.10 | 1.30 | 1.65 | 2.20 | 2.45 | 3.15 | 3.45 |
| | 10-Year Gov't Note | 3.43 | 3.45 | 3.60 | 4.20 | 4.35 | 4.45 | 4.45 | 4.55 | 4.60 |
| | 30-Year Gov't Bond | 4.42 | 4.40 | 4.65 | 5.00 | 5.00 | 5.05 | 5.05 | 5.15 | 5.15 |
| Canada - US T-Bill Spread | | 0.18 | 0.10 | 0.10 | 0.05 | -0.05 | -0.55 | -0.35 | 0.05 | 0.00 |
| Canada - US 10-Year Bond Spread | | -0.13 | -0.10 | -0.20 | -0.35 | -0.40 | -0.45 | -0.40 | -0.40 | -0.35 |
| Canada Yield Curve (30-Year — 2-Year) | | 2.75 | 2.85 | 2.80 | 2.90 | 2.75 | 2.25 | 2.05 | 1.40 | 1.05 |
| US Yield Curve (30-Year — 2-Year) | | 3.68 | 3.50 | 3.55 | 3.70 | 3.35 | 2.85 | 2.60 | 2.00 | 1.70 |
| EXCHANGE RATES | CADUSD | 0.945 | 0.901 | 0.943 | 0.971 | 1.000 | 0.990 | 1.000 | 0.990 | 1.020 |
| | USDCAD | 1.058 | 1.110 | 1.060 | 1.030 | 1.000 | 1.010 | 1.000 | 1.010 | 0.980 |
| | USDJPY | 88 | 94 | 93 | 90 | 87 | 86 | 86 | 85 | 85 |
| | EURUSD | 1.47 | 1.43 | 1.43 | 1.44 | 1.47 | 1.48 | 1.50 | 1.51 | 1.52 |
| | GBPUSD | 1.62 | 1.61 | 1.63 | 1.65 | 1.69 | 1.70 | 1.71 | 1.71 | 1.73 |
| | AUDUSD | 0.904 | 0.880 | 0.925 | 0.960 | 1.000 | 0.990 | 0.995 | 1.000 | 1.020 |
| | USDCHF | 1.03 | 1.05 | 1.04 | 1.03 | 1.02 | 1.01 | 1.00 | 1.00 | 0.99 |
| | USDBRL | 1.77 | 1.80 | 1.75 | 1.70 | 1.68 | 1.65 | 1.64 | 1.62 | 1.60 |
| | USDMXN | 12.9 | 14.0 | 13.5 | 13.0 | 12.5 | 12.3 | 12.3 | 12.0 | 12.0 |

Canada's greater dependence on factory exports to the US has long served as a partial anchor against excessive dollar-Canada exchange rate moves. With much less at stake for its economy, Australia has lived with much larger swings in the A$-US$ cross than we've seen in Canada (Chart 1).

*Chart 1.* ***Aussie Currency Historically More Volatile***




Even in resources, Australia has had an edge. Although they have partly recovered recently, depressed prices for lumber, a key part of our basket not shared by the Aussies, have been a burden on Canada. Second, all natural gas is not alike—location, location, location matters here as in housing. Spot gas in Asia, due to its proximity to the buoyant Chinese market, trades at nearly twice the price of Canadian gas bound for an oversupplied American market. The result of these and other composition differences is that Canada's commodity basket sank during the US recession by roughly 40% relative to Australia's, and has since recouped only half that ground.

## Who's Afraid of a Big High Junior Dollar?

Not Australia. Right now, a strong A$ is simply a complement to the RBA's tightening cycle in terms of dampening growth a bit to contain inflation, with Australia's core rate stuck at uncomfortably high levels. In contrast, a firm C$ is exactly what the Bank of Canada doesn't really want as it tries to propel growth and bring inflation back up to the 2% target.

While Carney is reluctant to intervene in the foreign exchange market, he might get a temporary retreat in the C$ in early 2010 if the US$ enjoys a temporary correction in its favour. Such a move would, of course, also dent the Aussie dollar. If so, that might accelerate the timing of further increases in the RBA's cash rate, which could hit 4.5% in the next two quarters. That would open up a larger yield gap with Canada, and allow the A$ to outperform the loonie as both return to a strengthening trend in the balance of 2010 (see Table 1).

Longer term, the major question mark for the Aussie dollar is the country's huge current account deficit. Low savings rates and ample investment opportunities have made Australia a consistent foreign borrower. Australia has managed to live with deficits in the 5-6% of GDP range without unduly straining its ability to finance the resulting debt service outflows. But further down the road, much higher global rates could pose a larger burden of interest outflows that could stall or even reverse the A$'s near-term climb.

What's good for the A$, the prospects of upside surprises in policy rates to conquer stubborn inflation, will be bad news for Australia's bond market, particularly when contrasted with Canada's well anchored short rates. Both face upward pressures on long yields, but Canada's central bank is more likely to deliver pleasant surprises in terms of how long the wait is until its first hike. If, as we expect, growth is no better than 2% in 2010 (Table 3), we might not see the first hike until 2011.

*Table 3.* ***Economic Update***

| CANADA | 09Q2A | 09Q3A | 09Q4F | 10Q1F | 10Q2F | 10Q3F | 10Q4F | 2008A | 2009F | 2010F | 2011F |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Real GDP Growth (AR) | -3.1 | 0.4 | 3.5 | 2.4 | 2.2 | 2.4 | 2.6 | 0.4 | -2.5 | 2.0 | 3.8 |
| Real Final Domestic Demand (AR) | 0.6 | 4.7 | 1.7 | 2.2 | 2.7 | 3.3 | 3.2 | 2.6 | -1.6 | 2.6 | 3.5 |
| All Items CPI Inflation (Y/Y) | 0.1 | -0.9 | 0.5 | 1.1 | 1.5 | 1.8 | 1.6 | 2.4 | 0.2 | 1.5 | 2.2 |
| Core CPI Ex Indirect Taxes (Y/Y) | 1.9 | 1.6 | 1.4 | 1.5 | 1.4 | 1.5 | 1.6 | 1.7 | 1.7 | 1.5 | 1.9 |
| Unemployment Rate (%) | 8.4 | 8.6 | 8.6 | 8.5 | 8.5 | 8.6 | 8.5 | 6.1 | 8.3 | 8.5 | 8.1 |
| **U.S.** | | | | | | | | | | | |
| Real GDP Growth (AR) | -0.7 | 2.8 | 2.9 | 1.2 | 0.9 | 2.3 | 1.7 | 0.4 | -2.5 | 1.7 | 3.4 |
| Real Final Sales (AR) | 0.7 | 1.9 | 1.9 | 0.9 | 1.2 | 1.6 | 0.8 | 0.8 | -1.7 | 1.3 | 2.8 |
| All Items CPI Inflation (Y/Y) | -1.2 | -1.6 | 1.4 | 2.1 | 1.5 | 1.6 | 1.5 | 3.8 | -0.4 | 1.7 | 3.0 |
| Core CPI Inflation (Y/Y) | 1.8 | 1.5 | 1.8 | 1.7 | 1.6 | 1.8 | 2.1 | 2.3 | 1.7 | 1.8 | 2.3 |
| Unemployment Rate (%) | 9.3 | 9.6 | 10.1 | 10.4 | 10.6 | 10.6 | 10.5 | 5.8 | 9.3 | 10.5 | 10.0 |

# Rates

Mohammed Ahmed

## The Dollar Bloc Box

Early-October's surprise rate hike by the Reserve Bank of Australia prompted a swift re-pricing of expectations implicit in the front end of the Canada curve. At that time market participants drew parallels between the two commodity-exporting, dollar bloc economies and anticipated that the Bank of Canada would soon follow the RBA's lead. However, as this month's lead story highlights, fundamental differences between the condition and composition of the Canadian and Australian economies should prevent a naive twinning in expectations for their respective policy responses. Two months and two successive RBA rate hikes later, while outlooks for the path of Canadian and Aussie policy rates have diverged significantly, bond yields in the front end have not.

OIS rates and futures markets now imply 100 bps of tightening in Australia and 50 bps of tightening in Canada over the next 12 months. Cumulatively, for the period spanning October 2009 to December 2010, actual and predicted changes in overnight rates sum to 175 bps for Australia, versus 50 bps for Canada; that is to say, one year from now the market expects that the RBA will have raised overnight rates from their historic lows by 125 bps more than the Bank of Canada. Although a divergence in policy rates had been anticipated by markets prior to October's hike, as the reaction of the Aussie Dollar indicated, the speed and magnitude of this divergence was underestimated.

### Canada 2s are Relatively Cheap...

In spite of this, Canada 2s currently appear cheap versus their Aussie counterparts. Since the RBA's first hike on October 6th, the Canada-Australia 2-year bond spread has narrowed just 8 bps, while the spread of Canadian and Australian 3-mth OIS rates has narrowed nearly 40 bps (Chart 1).

Historically, Canadian and Australian yields have been very loosely correlated, reflecting the structural differences of their respective economies—a fact which is acutely apparent when contrasted with the correlation of Canadian and US yields (Chart 2). Moreover, our Economic's group's forecast that prospective fiscal tightening and a strong Canadian Dollar will postpone tightening by the Bank of Canada until 2011 strengthens the case for performance of the Canadian versus Aussie front end.

*Chart 1.* ***Can-Aus 2s Spread Flat Relative to Change in Policy Expectations***

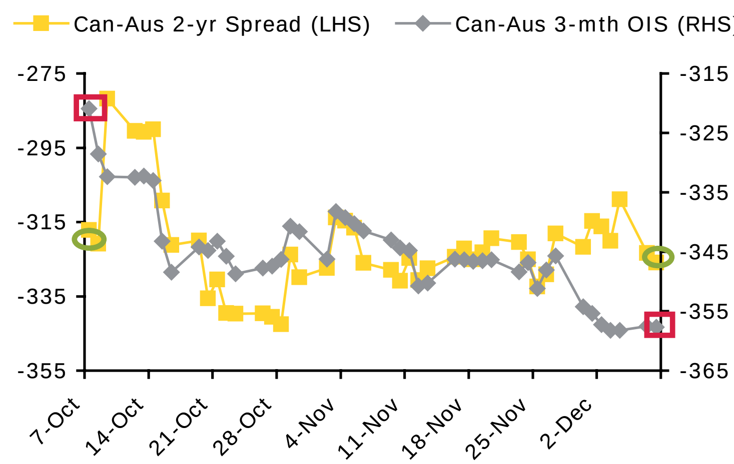
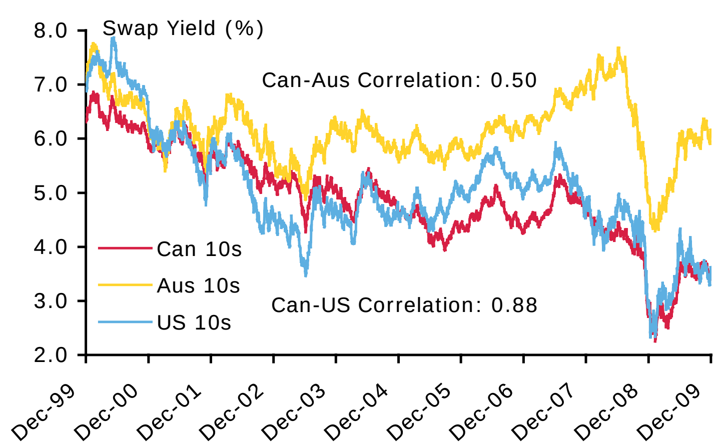


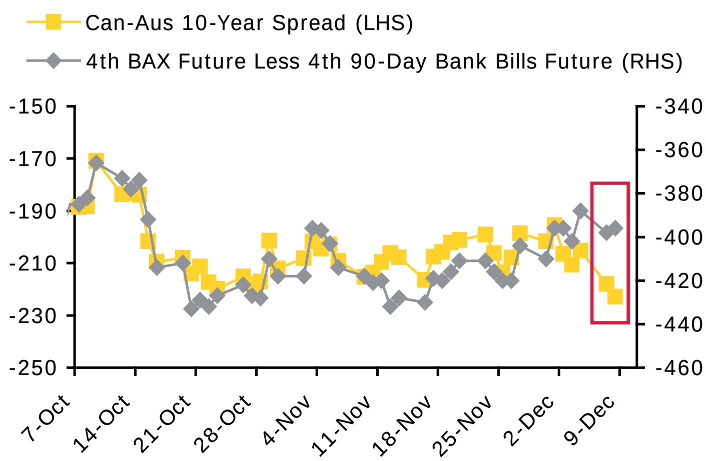

*Chart 2.* ***Historical Correlation of Cdn, Aus and US Yields***



### ...While Canada 10s are Rich

Further out the curve the picture is markedly different. Yields on Canada 10s have dropped by 40 bps relative to Aussie 10s over the past two months. In the context of the short rate differential, determined using the 4th 90-Day Bank Bill and 3-mth BAX futures, the current richness appears extreme (Chart 3).

*Chart 3.* ***Spread Performance of Can-Aus 10s, Short Rates***



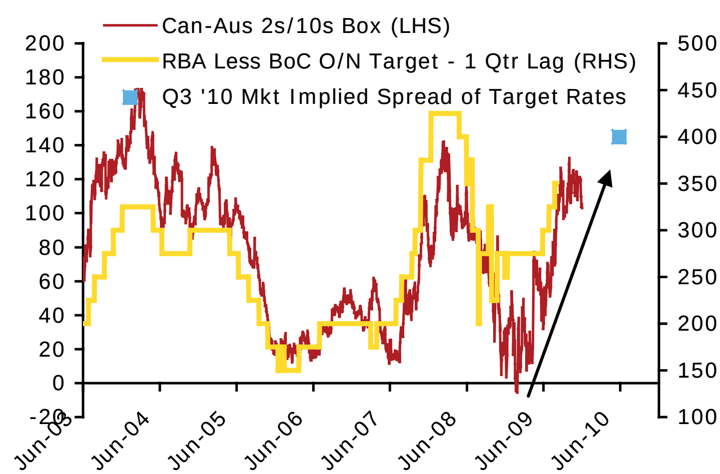

Generally speaking, the past 6 months have seen 10-year yields globally trade in well-defined ranges. Now, with Canada 10s at the bottom of their recent range and Aussie 10s in the middle of theirs, the Canada-Australia 10-year spread is at the richest level since June of this year. Hence, we believe that the balance of risk is tilted towards being short Canada 10s versus Aussie 10s in anticipation of a corrective retracement of the recent Canada strength.

### Putting the Box Together

Individually, long Canada versus Aussie in the front end and short Canada versus Aussie in the belly are attractive trades. As a box trade, long a steepener in Canada and a flattener in Australia, the argument is all the more compelling.

As we highlighted in November's *GPS Monthly*, we expect the Canada curve, in particular 2s/10s, to remain steep in the near term as the front end becomes anchored. Meanwhile, expectations for higher overnight rates will continue to propel bear-flattening of the Aussie curve. As a result, not only will divergent monetary policies result in an outperformance of Canada in the front end, but also an out-flattening of the Aussie curve (Chart 4).

*Chart 4.* ***Can-Aus 2s/10s Box and Overnight Target Differentials***




We recommend entering the proposed box trade around 100 bps with an initial target of 120 bps and a stop just below the ascending trend line at 95 bps, for a risk-reward ratio of 4.0.

## Current Recommended Strategies

| | Proposed Date | Recommendation | Entry | Target | Stop | 1-Mth Carry | Current | Gain/Loss | Duration (Days) |
|---|---|---|---|---|---|---|---|---|---|
| 1 | **NEW** | Short Can-Aussie 2s/10s Box (Can Flattener, Aus Steepener) | 100 bp | 120 bp | 95 bp | - | 100 bp | - | - |
| 2 | 4-Dec-09 | Long Canada 4.5%/Jun-15 vs. [3%/Jun-14 and 4%/Jun-16] | 4.5 bp | 2 bp | 6 bp | - | 4 bp | +0.5 bp | 5 |

*A complete summary of trade recommendations is available upon request.*

# Government Finance

Warren Lovely

## *Commodities Colour Provincial Performance Once More*

The 2009 recession has turned out to be the great equalizer, as it looks to take real GDP in all ten provinces lower, producing a more broadly based downturn than previous recessions (Table 1).

A muted 2010 recovery could leave real GDP growth in most provinces hovering in the 2-2½% range. But there stands to be greater differentiation in nominal output and fiscal performance, with resource-focused provinces generally faring better. And come 2011, commodities should again be driving a wedge through relative economic and fiscal performance, entrenching provincial 'have' and 'have not' status.

*Table 1.* ***Real GDP Forecasts vs Past Recessions***

| Y/Y % | Actual 2008 | CIBC Forecasts 2009 | CIBC Forecasts 2010 | CIBC Forecasts 2011 | Reference: Past Recessions 1982 | Reference: Past Recessions 1991 |
|---|---|---|---|---|---|---|
| BC | 0.0 | -2.2 | 2.5 | 4.1 | -6.1 | 0.2 |
| Alta | 0.0 | -2.6 | 2.1 | 4.8 | -3.2 | 0.5 |
| Sask | 4.2 | -1.5 | 2.4 | 5.2 | -1.9 | 1.1 |
| Man | 2.0 | -0.5 | 2.0 | 3.8 | -2.6 | -3.4 |
| Ont | -0.5 | -3.5 | 2.1 | 3.5 | -2.7 | -3.9 |
| Qué | 1.0 | -1.4 | 1.9 | 3.5 | -3.6 | -2.7 |
| NB | 0.0 | -0.6 | 2.0 | 3.4 | 1.9 | 0.0 |
| NS | 2.2 | -0.3 | 1.8 | 3.3 | 3.7 | -0.9 |
| PEI | 0.5 | -0.2 | 1.7 | 3.0 | 0.9 | -0.3 |
| N&L | 0.5 | -3.0 | 2.3 | 4.1 | 1.0 | 0.5 |
| CDA | 0.4 | -2.5 | 2.0 | 3.8 | -2.9 | -2.1 |
| *US* | *0.4* | *-2.5* | *1.7* | *3.4* | *-1.9* | *-0.2* |

*Note: Shading denotes annual decline in provincial real GDP*

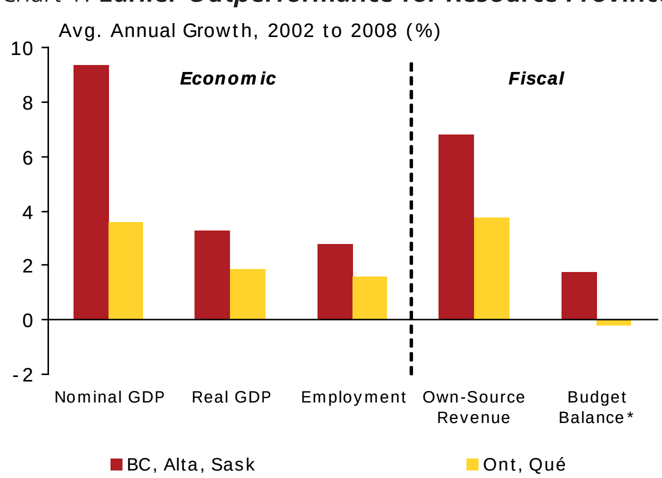
### Sharp End to Earlier Outperformance

During the earlier commodity heyday, covering the six years from 2002 to 2008, Canada's resource-centric provinces registered superior gains in real and nominal GDP, labour markets and a host of other key economic indicators.

More critically for taxpayers and investors, the strong economic record translated into robust if volatile government revenue growth and strengthened budget balances (Chart 1)[1]. That meant relatively lighter bond supply and more pronounced reductions in debt outstanding. It's no coincidence that today, Canada's 'have' provinces (i.e., those that do not receive equalization transfers from the federal government) are in all cases resource-based.

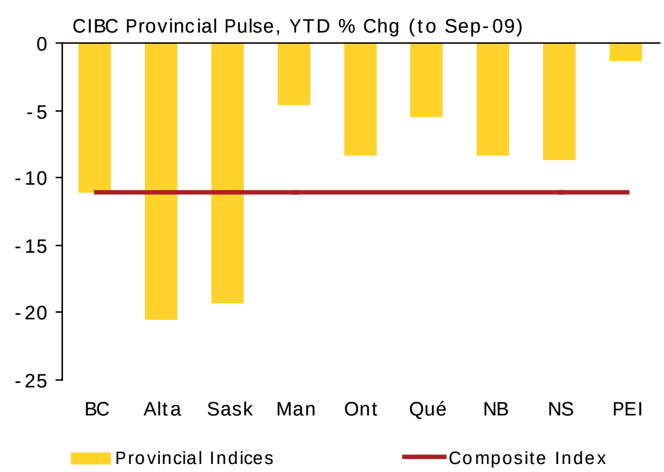
But last year's crack in the commodities complex brought previously high-flying resource provinces back to earth. Our *CIBC Provincial Pulse* indicator—designed to mimic movements in nominal GDP—highlights the more pronounced weakness in the resource-rich Western provinces (Chart 2).

*Chart 1.* ***Earlier Outperformance for Resource Provinces***




* Reflects average level over six-year period

*Chart 2.* ***Nominal GDP Hit Hardest in West***



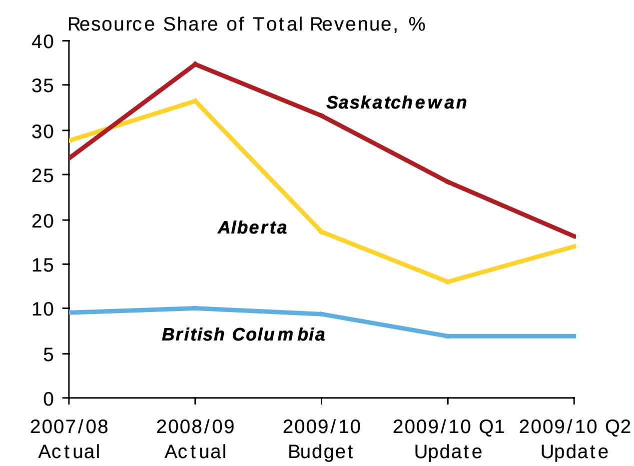
The corresponding fiscal correction has been both rapid and severe. The spring budget season was sobering and in many cases, post-budget updates have cut expectations for resource royalties even further (Chart 3). Rating agencies, while noting the erosion and volatility of own-source revenue, have hardly hit the panic button, owing to relatively low debt levels and superior fiscal flexibility. There's greater concern surrounding the outlook for some other provinces where fiscal imbalances are more pressing.

## A Commodities Boom, No; Grounds for Outperformance, Yes

The same forces that colour our more cautious commodity view blunt prospects in less resource-centric provinces too. While the translational effect of a stronger C$ is a negative for resource royalties, currency appreciation is a material drag on growth in Central Canada's industrial heartland as well. In sum, a lukewarm North American recovery would limit near-term fiscal healing for *all* provinces, leaving aggregate issuance heading higher, not lower, in the year ahead.

Given today's prices, there's upside for many key resource revenue streams. While 2010 will still be soft, there's still upside for provinces where fiscal fortunes are tied more closely to natural gas. Count Alberta, Nova Scotia and BC in that camp. The ongoing substitution away from more costly oil, and a gradual reduction in inventories, will allow natural gas to stage a comeback, although the magnitude of North America's shale gas reserves ultimately limits the upside on price.

*Chart 3.* ***Forecast for Resource Revenue Cut***

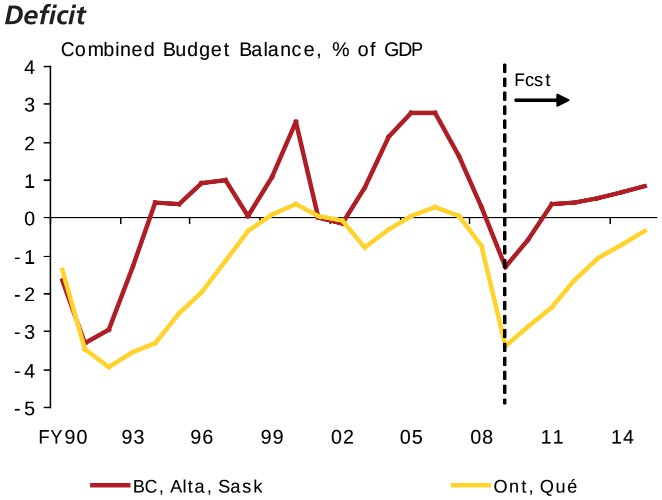



In the near-term, crude has likely overshot the mark, and with OPEC's still-ample shut-in capacity ready to meet any increase in demand we see crude settling back to $70/bbl in 2010. That means less of a positive fiscal adjustment in the more oily provinces, including Saskatchewan. Of course, that province's resource fortunes rest more squarely on potash, and on that score, royalties are unlikely to go lower. Indeed, there exists substantial upside for next fiscal year assuming potash sales revert to anything close to the long-term average.

It's 2011 that looks to usher in a much more dramatic commodity resurgence, as a more coordinated global recovery drives production volumes and upward sloping supply curves push prices higher. Overall, we see Canada growing by nearly 4% in 2011, with resource-based provinces moving back to the front of the pack (Table 1), enjoying more explosive growth in nominal output and government revenue.

With commodities lending support, Western-based provinces look to erase their deficits at least twice as fast as in Central Canada, where structural imbalances are more pronounced and the measures needed to close the budget gap have yet to be fully identified (Chart 4). Atlantic Canada's resource-based provinces stand to make more substantial progress on deficits as well. Although far from a replay of the mid-2000s' commodity boom, the resource sector continues to wield considerable influence over provincial economic and fiscal prospects. The more things change, the more they stay the same.

*Chart 4.* ***Commodity Provinces Much Quicker to Erase Deficit***




[1] *Collectively, BC, Alberta and Saskatchewan account for roughly one third of total Canadian output and are each highly dependent on natural resources as a source of economic growth and government revenue. Other provinces are highly levered to resources, including Newfoundland & Labrador and Nova Scotia, but for the purposes of this analysis, Canada's three Western provinces will serve as the representative sample.*

# Credit

Joanna Zapior

## *Three Ways in Which the Canadian Bond Market May Follow Australia*

When the Australians write about their market, the story they tend to focus on is the extraordinary strength of non-government issuance since the mid-1990s (Chart 1). As it happens, the revival of the domestic Canadian corporate debt market started at about the same time (though our Maple bonds did not kick into action until 2004, thus making comparisons relevant only from 2004 onward (Chart 2).

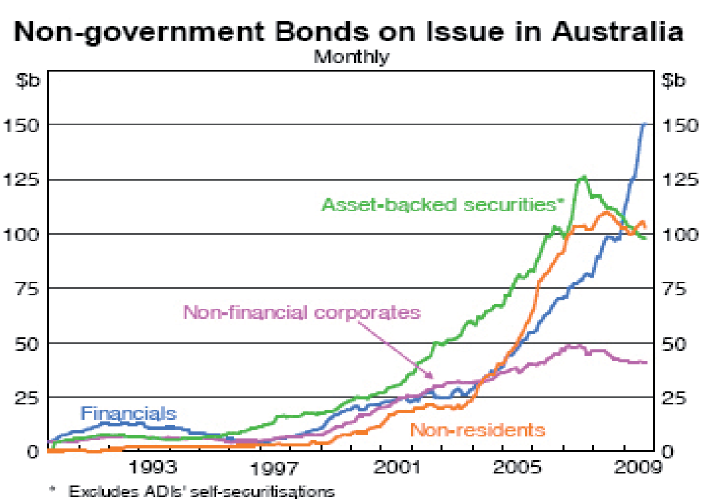
By size, the economies of the two countries are comparable—in 2008, the nominal GDP of Australia was US$1 trillion, and of Canada US$1.5 trillion—and so are their corporate debt markets. According to the Reserve Bank of Australia (RBA), non-government issuance in A$ exceeded $100 billion in the peak year 2006, and our numbers show total C$ issuance at close to $100 billion a year later in 2007. However, the pattern and the timing of market developments and the size of the market is where similarities end.

The issuing heroes of the Australian market have been Kangaroo bonds, ABS (and more specifically RMBS) and banks in general. In Canada the workhorses of the corporate debt market have been the banks, closely followed by non-financial corporates. Last year the limelight distinctly shifted to non-financial, and lower-rated, corporates. It is worth noting that the prospects for ABS issuance in both countries are no longer as bright as in the past, given regulatory changes anticipated post-crisis (though both countries' governments have provided support for the ABS markets in 2009).

Another material difference between the two markets is in offshore issuance. Offshore issuance by Australian borrowers is a bigger market segment than domestic issuance. This is not the case for Canada despite material issuance by Canadian corporates into the Yankee market.

The drivers behind these differences lie both on the demand and supply side. Looking at the Australian market, we see two demand-side forces, and one supply-side element that we think are poised to influence the Canadian market in the future. On the side of demand, we see 1) growth in foreign investor demand for C$ product, and 2) further into the future, potential additional pension saving schemes. On the side of supply, we expect 3) a return of the non-resident borrower issuance (Maples are to Canada as Kangaroos are to Australia). On the other hand, the Australian market may follow Canada and revitalize its non-financial corporate primary market in this cycle.

Chart 1. ***Issuance in the Australian Non-Government Bond Markets***



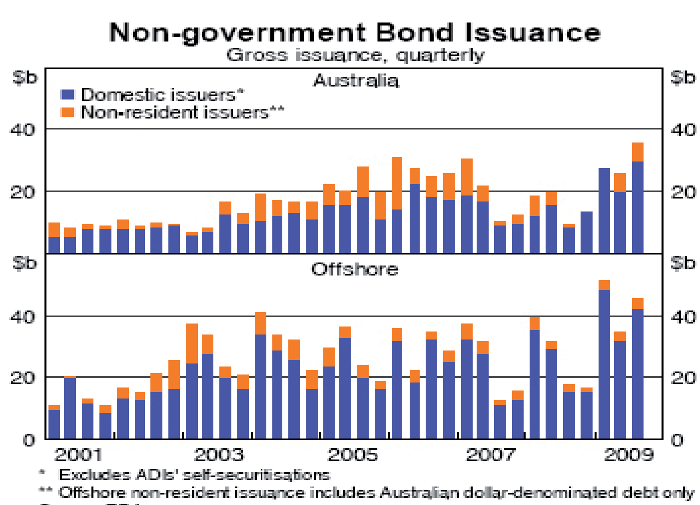
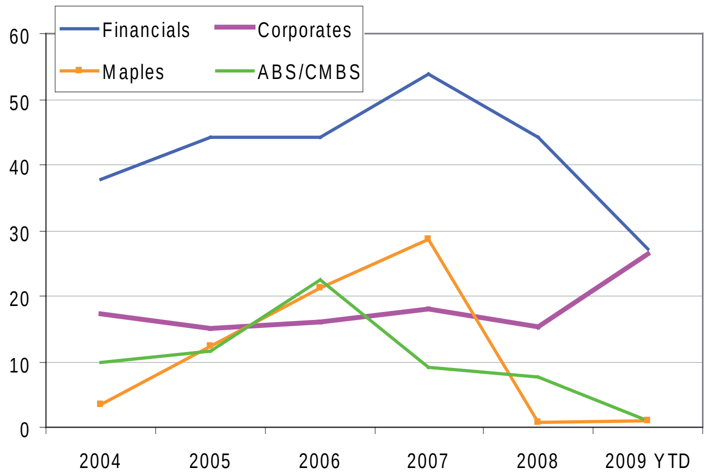



*Chart 2.* ***Issuance in the Canadian Corporate Debt Market***





## Demand Side — Canada May Become More Similar to Australia on Two Counts

One of the key differences between the two markets that is, at least partly, responsible for the dissimilar issuance trajectories is on the demand side. Australia's market experienced a transformational change that started in 1986 and ended only in 2002. Wide-sweeping pension reform, which created both compulsory and voluntary superannuation (pension) schemes, gained critical mass in the mid-1990s and has been diverting savings towards retirement funds.

In addition, cross-border investment trends brought increased foreign investor interest in Australian dollar debt, whether domestic or offshore. RBA reports that non-resident holdings of A$ bonds rose from 15% to 30% of local A$ outstandings between 2000 and 2007. In Canada, we have only very recently begun to see such increase in foreign interest, as the impact of Canada's higher-yielding currency has been accompanied by new-found fame related to the safety of our financial system and to the solid investment-grade quality of our corporate issuer base. Note that eventually we may also see a Canadian superannuation scheme, given that pensions are a hot issue for politicians of all stripes in Canada. That's a possible reason #1 and reason #2 why the Canadian debt market may become more similar to what Australia has experienced in terms of growth of pension savings and foreign investor participation.

We think that there is one key difference in the nature of demand between the two countries. While both markets have been very much investment-grade focused, the Canadian market has been open to the lower end of investment grade, and recently shows interest for high yield bonds. Australian investors have been focused on the high end of investment grade. This may be one of the reasons why many Australian corporate borrowers issue in the US private placement market rather than domestically. It also explains the strong domestic interest in the highly rated Kangaroos and ABS, as well as banks.

## Onshore and Offshore Supply — and a Third Reason Why Canada May Go Australian

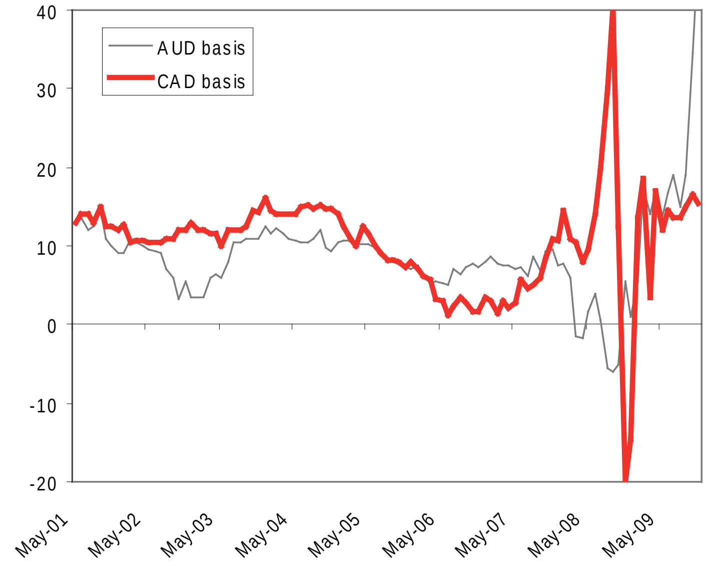
On the supply side of the domestic market, half of the story behind the remarkable growth in non-government issuance in Australia is bank, and related, ABS issuance (specifically, RMBS). The other half is Kangaroos (Chart 1).

Two key factors lie behind the very strong bank issuance in Australian wholesale markets, both directly and via RMBS. First, there has been heavy demand for bank lending, with housing booming as mortgage rates fell, and growth in lending for corporate and infrastructure also responding to the strengthening in the economy since the mid-1990s. Second, banks were losing their deposit base as retail savings moved towards superannuation funds that sought more diversification, thus aiding the boom for ABS and Kangaroos. Note that in the Canadian statistics, due to a different structure of the mortgage market, a significant portion of mortgage funding is buried in the federal issuance (through the Canada Housing Trust and NHA mortgage pools).

The boom in Kangaroo issuance was, in part, supported by domestic investor demand. According to the RBA, between 2000 and 2007 Australian investor holdings of bonds issued by non-resident issuers (Kangaroos) increased from 15% to 25% of total holdings, as they wanted to diversify but preferred to stay with their higher yielding A$.

Kangaroo issuance was also supported by the growing interest of non-resident investors in higher yielding A$ product, whether from domestic or international borrowers (as we mentioned, their holdings increased from 15% to 30% of the outstanding stock of bonds). Until 2007, less than 50% of most Kangaroo issues were placed in Australia, with the balance bought by investors in Asia and Europe—in contrast to Maples, which we believe were mostly placed domestically. It is highly likely that the vast majority of both Kangaroo and Maple issuance has been swapped back to US dollar obligations for the issuer.

*Chart 3.* ***Basis Swap Explains Kangaroo and Maple Issuance Patterns (5-year shown)***




At the same time as the domestic market in Australia was growing in leaps and bounds, offshore issuance by Australian companies held strong (as we have shown in Chart 1), and in fact at higher levels than the issuance in the domestic market. According to RBA, the bulk of offshore issuance has been swapped into A$. Canadian corporate flows offshore have been relatively weaker compared to domestic issuance (Chart 2), and not all of the Yankee flow has been swapped back. In the case of Canada, one needs to consider as well the sometimes appreciable government offshore issuance that likely is being swapped backed into C$s.

No country likely knows better than Australia that the basis swap is a "delicate balancing act" (to quote *KangaNews*) between the onshore and offshore issuance flows. Despite its relative strength, Kangaroo issuance (combined with offshore A$ issuance) has almost always been lower than Australian offshore issuance in other currencies (such as in US$ in the US private placement market). This net balance has almost always kept the basis swap in positive territory, not unlike in Canada (Chart 3). Some of the unusual fluctuations in the basis swap are driven by anticipated (or realized) cross-border M&A activity (and related funding flows). For example, the two spikes in the basis swap in Canada in the fall of 2008 were related to the proposed BCE leveraged buyout.

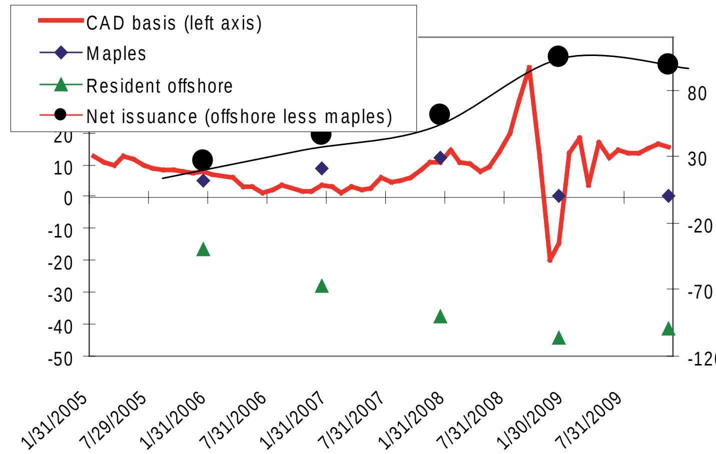
The basis swap has historically been a good predictor of Kangaroo flows. A wider spread encourages Kangaroo issuers to come to market, and a narrower spread makes them lose interest. Indeed, Kangaroo borrowers lost interest in both 2002 and 2007 when the basis swap spread was grinding to, and through, zero. In 2002, Kangaroo issuance fell by 60% in the second half of the year, but bounced back in 2003 following the basis swap widening. In 2007, as Euroweek said in the annual issue of *Australia in the Capital Markets* published in September 2007, "Stars misaligned for Kangaroo market".

Note that that time it was not just the lack of interest by issuers. Importantly, there was also a lack of interest by Asian buyers of Kangaroos, as well as increased competition from other non-core dollar markets (such as Canada, which in 2007 experienced the largest ever Maple issuance), and from growing borrowing requirements at the state level in Australia. The impact of the decrease in Kangaroo issuance was further reinforced by the increase in Australian bank issuance onshore and offshore in late 2008 and 2009, much of which happened under the government guarantee instituted in October 2008.

Given how wide the basis swap spread became, Kangaroos were poised to stage a comeback, and indeed they did. Mid-October 2009, Kommunalbanken returned to Australia for the first time since March 2007 with its biggest A$ issue, while the World Bank priced a record-sized two-tranche issue at A$1.4 billion after a three-year absence. This record lasted for barely one month. In mid-November 2009, EIB completed the largest ever single-tranche Kangaroo bond sized at A$1.5 billion.

While the basis swap spread in Canada is not at present as supportive for Maple issuance as the Australian basis currently is, it is back at levels seen in 2004-2005, which buoyed up the Maple market the first time around. Canadian onshore and offshore flows are distinctly imbalanced (Chart 4), and with the investor base now familiar with many Maple issuers, we think that swap market and currency developments will be reason #3 why the Canadian corporate debt market may follow Australia and create a second Maple boom.

*Chart 4.* ***Net Flows and Basis Spread - Canada***



# FX Structuring

Eric Ohayon

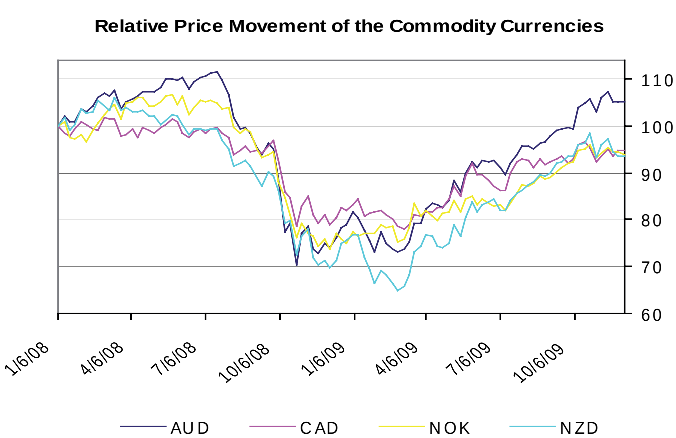
## Commodity Currencies ... Where is the Value?

- *AUD set to continue strengthening*
- *NOK armed to outperform in the G-10 space*
- *CAD held back by a dovish central bank and relatively slow-growing trade partners*
- *NZD to strengthen but at a lower pace*

Following the nosedive experienced in the second half of 2008, commodity currencies have soared significantly in 2009, recovering most of their losses. The move lower that started in July 2008, on the back of de-leveraging and risk aversion, pushed the Australian dollar (AUD) and New Zealand dollar (NZD) 33% lower, the Norwegian Krone (NOK) lost 28% of its value whilst the Canadian dollar (CAD) moved 20% lower. As chart 1 shows, although all the currencies have travelled different paths over the last two years, there has been a remarkable convergence for three of the four currencies. Relative to the USD – CAD, NZD and NOK are all sitting at 93% of the value in January 2008. The standout is AUD which is at 104% of its Jan 2008 value. This gap nearly closed in September but the surprise rate hike by the RBA gave AUD a surge that the others have not replicated.

The outlook is good for all four commodity currencies longer term, but the interesting trade may be to see if one of the other three commodity currencies can break out of the pack and follow AUD more sharply higher. This could easily happen if one of the other central banks pursue a policy of aggressive interest rate hikes.

*Chart 1.*




The NOK should be a strong performer in 2010, supported by Norway's sound economy, large public sector, rising investments in the offshore petroleum sector and aggressive monetary policy. The currency seems fairly valued relative to oil prices and should benefit from the recent rate hike at the end of October as well as anticipated future rate hikes.

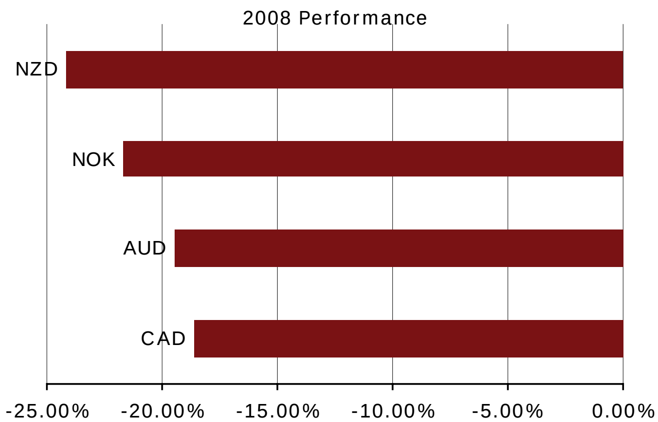
The AUD is the leader of the pack having soared from 0.6000 at the end of Oct 08 to hover around 0.9300. The Aussie should continue to outperform on falling risk aversion, rate hikes by the RBA and solid exports to China primarily.

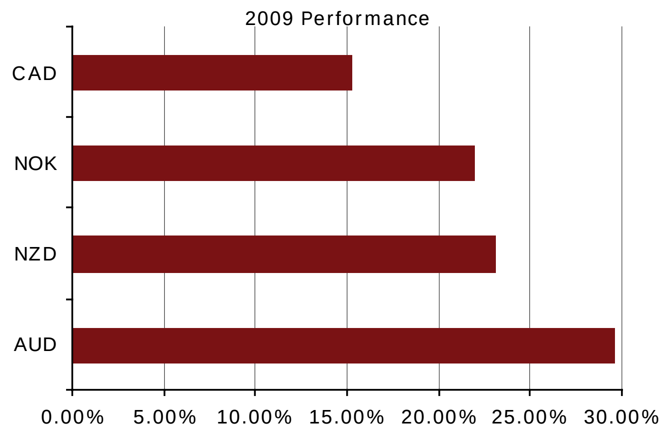
The CAD continues to range trade (1.0200 - 1.1100), unable to make a clear break on either side. The loonie should continue to benefit from relatively strong economic fundamentals and commodity prices. However, the US role as Canada's main trade partner means that an overvalued CAD against the greenback could be damaging for economic growth. The overvalued C$ already left a dent in the 3rd quarter activity and the BoC has committed to keeping rates on hold for the first half of 2010. Nonetheless, we continue to forecast a relatively strong CAD especially towards the 2nd half of 2010.

The NZD remained popular amongst investors throughout 2009. The currency gained 46% over the past 9 months and has shown a strong correlation to the AUD. The demand for New Zealand's soft-commodity exports should remain strong in 2010-11. Whilst somewhat cyclical, agricultural exports are a lot less variable than most other commodity exports. This should provide the kiwi with stable ground for further appreciation. Nonetheless, the RBNZ is concerned that an overvalued NZD could jeopardize New Zealand's economic recovery and hence, likely keep rates on hold till late 2010.

The USD is currently undervalued and likely to continue to overshoot to the downside against commodity currencies.

*Chart 2.*




A continued weakness of the greenback is likely to be accompanied by rising commodity prices in USD terms. At the moment, the market reacts to "good US numbers" with an increase in risk appetite, pushing the US$ lower. However with US interest rates near zero, the commodity currencies are especially sensitive to relative interest rates and expectations for rate hikes.

In the near term the RBA and the Norges Bank are on a clear rate hike path while RBNZ and the BoC have been more dovish in their actions if not words. Whilst all four should continue to benefit from recovering economies, strong commodity prices and increase in risk appetite, AUD and NOK look set to lead the pack. The NOK has not seen the sustained rally that AUD has, but future rate hikes could change that.

Investors with a view that NOK will follow AUD higher versus the USD may wish to consider the following strategy.

### *USD/NOK Trade Idea*

| INDICATIVE TERMS & CONDITIONS (SPOT REF.: 5.6500 NOK PER USD) | |
|---|---|
| Client Position: | Long a 5.6500 USD Put / NOK Call, Short a 5.5500 USD Put / NOK Call Reverse Knock In @ 5.3500 |
| Maturity: | 3 months |
| Conditional Event: | In the event that spot USD/NOK ever trades at or below 5.3500, the clients original long 5.6500 USD Put position will be capped at 5.5500. |
| Upfront Premium: | 1.35% USD |
| *In order to finance the above Conditional Put Spread, the client can sell the following Knock-in Knock-out option:* | |
| Client Position: | Short a 5.6500 USD Call / NOK Put 5.5500 KO and 6.1000 RKI |
| Maturity: | 3 months |
| Conditional Events: | In the event that USD/NOK ever trade at or below 5.5500, the short option position will cease to exist (KO) |
| | The short option position only exists if spot USD/NOK ever trades at or above 6.1000 (KI) and never trades at or below 5.5500 (K0) |
| Upfront Premium: | Zero Cost strategy when combined with the Conditional Put Spread strategy |
| *Investors with the view that AUD will appreciate to par versus CAD may wish to execute the following trade.* | |

### *AUD/CAD Trade Idea*

| INDICATIVE TERMS & CONDITIONS (SPOT REF.: .9681 CAD PER AUD) | |
|---|---|
| Client Position: | Long a .97 AUD Call (Knock out at .95) on AUD 1 mn<br>Short a 1.00 AUD Call (Knock out at .95) on AUD 2 mn<br>Long a 1.03 AUD Call (Knock out at .95) on AUD 1 mn |
| Maturity: | 3 months |
| Conditional Event: | In the event that spot AUD/CAD ever trades at or below .9500, the structure will disappear |
| Upfront Premium: | .48% AUD |
| Payout: Above .97 the payout is positive. The maximum return of this structure would be 3.00% at parity (6:1 return on the initial investment). This return would decline to zero at a 1.03 AUD/CAD exchange rate. | |

# COMMODITIES

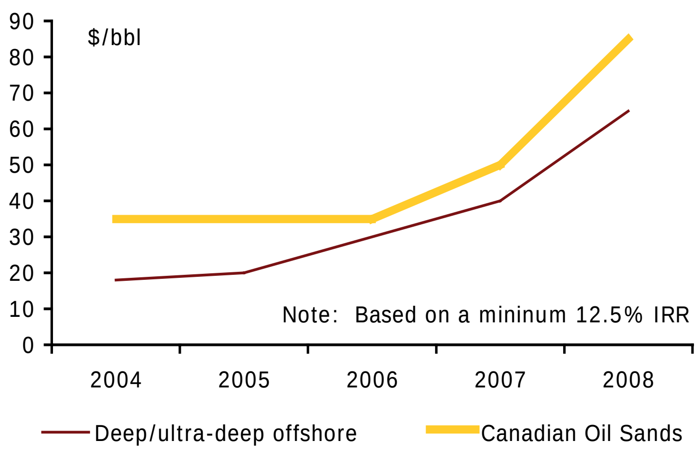
PETER BUCHANAN

## Oil Prices Could Lack Energy for a While

After a surprisingly spirited snap back, oil's rally appears to have run out of gas. WTI spot prices have eased by 10% recently from late October's one-year highs.

The breakeven price for finding, developing and producing a barrel of crude doubled between 2004 and late 2008, according to producing-company data (Chart 1). While we believe that prices will climb appreciably further in the next decade, in step with marginal costs, the oil market appears to have gotten ahead of itself for now. Belying recent signs of momentum, OECD inventories and OPEC spare capacity are at or near decade highs. Demand in the US, still the world's largest consumer, also remains soft. We expect those realities, coupled with the demand effects of a not overly strong global recovery and above-trend efficiency growth, to hold WTI to an average $70/bbl next year, rising modestly to $80/bbl in 2011. The unusually close 0.8 correlation between WTI and US equity prices since the spring suggests the rise in prices has been largely driven by broad changes in investor sentiment as opposed to appreciably stronger market fundamentals.

*Chart 1.* ***Typical Breakeven Costs for Major New Oil Projects***




*Source: CIBC, based on data from Total.SA*

### OPEC Has Room To Lift Output Further

Underpinning our cautious near-term outlook, OPEC so far has reactivated only a quarter of the 5 million barrels of daily capacity shut in a year ago to support prices. That leaves the cartel with ample room to lift output further in coming months. Russian production is also expanding again, thanks in part to Eastern Siberia's new Vankor field. Further gains there and in Brazil, Azerbaijan, Kazakhstan, Canada, and the US will help to lift non-OPEC supply by about 400,000 bbl per day next year (Table 1). On the demand side, we expect the global economy to expand at a near-3% pace next year and by almost 4% in 2011, well below the feisty 5% gait seen before the recession. The demand effects of a sub-par recovery and rising energy efficiency levels add to the likelihood that existing and planned new supply will be more than adequate to meet demand for the next couple of years.

Emerging Asian demand undeniably remains a source of support. After stagnating earlier in the year, China's implied consumption has rebounded smartly in step with the economy, rising at the fastest year-on-year pace in over three years in September. India, another growing user, posted a surprisingly hearty 7.9% year-on-year

*Table 1.* ***World Oil Supply and Demand***

| | 2005 | 2006 | 2007 | 2008 | 2009 (f) | 2010 (f) |
|---|---|---|---|---|---|---|
| **World Oil Demand** | 84.04 | 85.20 | 86.14 | 85.78 | 84.14 | 84.98 |
| **- % ch** | 1.9% | 1.4% | 1.1% | -0.4% | -1.9% | 1.0% |
| **World Oil Supply** | 84.56 | 84.52 | 84.39 | 85.37 | 84.19 | 85.78 |
| **-OPEC** | 34.95 | 34.74 | 34.39 | 35.72 | 34.01 | 35.20 |
| **-Non-OPEC** | 49.61 | 49.78 | 50.00 | 49.65 | 50.18 | 50.58 |
| **Stock Draws & Discrepancy** | -0.52 | 0.68 | 1.75 | 0.41 | -0.05 | -0.80 |

*Source: US Department of Energy, CIBC*

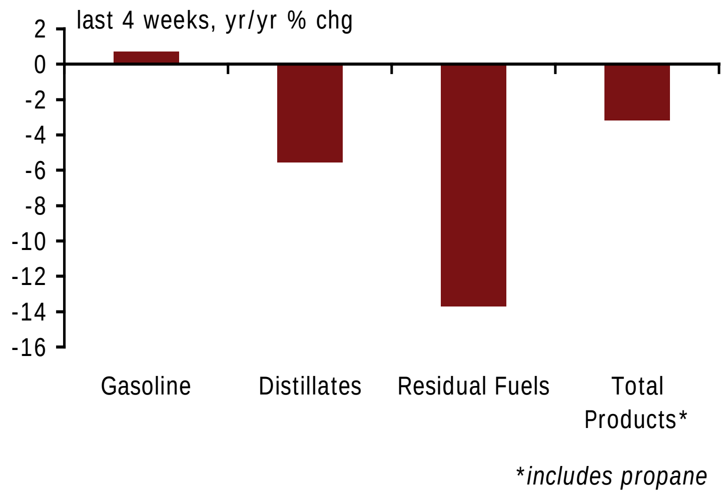
rise in GDP in Q3. In the final analysis, however, rising emerging market demand will go only so far towards offsetting lagging demand growth in the US and other industrial countries. While China uses 2-3 times as much copper as the US these days, its oil consumption is still just a third of US levels. Given those realities, an emerging Asia-driven recovery is likely to provide much more of a lift to industrial metals use than crude consumption (see Table 2, and trade recommendations).

### Revisions Suggest US Demand Still Soft

The industrial countries still account for 54% of global oil demand. Although gasoline consumption in the US is now up measurably on the year, demand for distillates and residual fuel is more closely tied to the business cycle. Weakness in these components remains a key constraint on demand (Chart 2). Revisions by the IEA showing that US consumption in September was nearly 3% lower than previously believed, also suggest that oil demand may not be recovering as quickly as expected.

Beyond the recovery's anticipated modest pace, continued above-trend efficiency growth should also limit incremental crude demand coming out of the recession, delaying the prospects for a further up-leg in prices (Chart 3). The decline in the amount of oil needed per global dollar of GDP has accelerated to a near-4% annual rate in recent years, double the longer-term average. It takes many years for a rise in oil prices to fully effect consumption patterns and even with the recent decline, oil prices remain well above where they were a few years ago. Those facts, and the ongoing efforts of countries like China and the US to conserve energy, suggest that efficiency will continue to rise at a pace significantly above the long-term average in the next few years. That, in turn, will limit the pace of

*Chart 2.* ***Soft Demand From Industry, Transport Sectors Still Crimping US Oil Consumption***




the recovery in global oil consumption after an expected 2% decline this year.

Oil demand stateside is also being impacted by competition from other fuels, particularly natural gas. Thanks, in part, to ultra-cheap gas as a result of burgeoning non-conventional production, oil's share of total US energy demand has fallen by about 2%-pts in recent years while gas' share has risen.

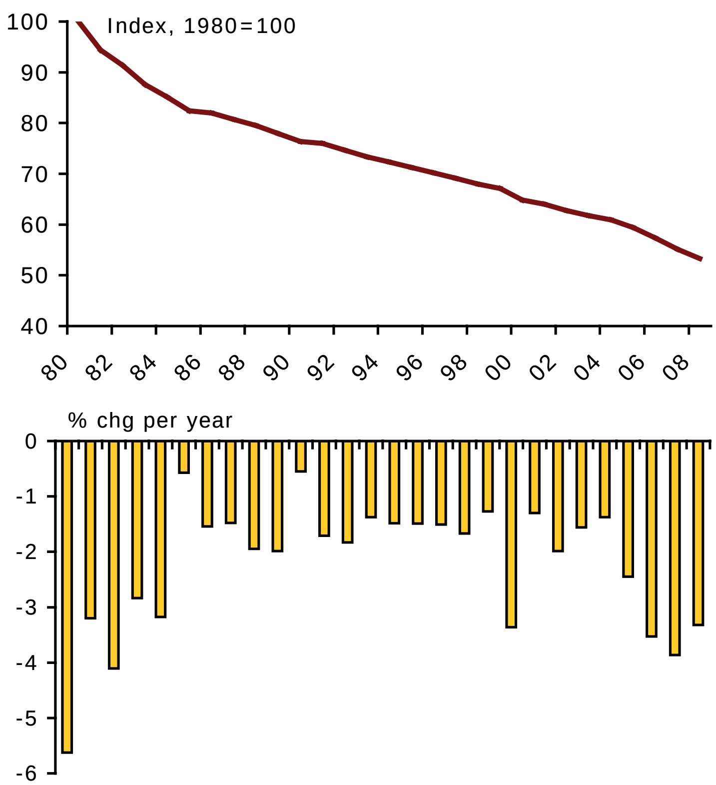
Inventory levels in the US have begun to come down from the high levels seen during the recession, but are still about 5-10% above normal seasonal levels, counting both refined products and crude oil. Ditto for the OECD as a whole. As of early November, the IEA estimates that on-land stocks for the industrial countries amounted

*Table 2.* ***Spot Commodity Prices***

| | | | Average | | | | |
|---|---|---|---|---|---|---|---|
| | | 7-Dec | 2007 | 2008 | 2009 (f) | 2010 (f) | 2011 (f) |
| Oil (WTI) | $/bbl | 74 | 72 | 100 | 61 | 70 | 80 |
| RBOB gasoline | $/gal | 1.91 | 2.09 | 2.49 | 1.70 | 1.80 | 2.00 |
| Heating Oil (NYH) | $/gal | 1.96 | 2.03 | 2.86 | 1.62 | 1.95 | 2.10 |
| Natural Gas (Henry) | $/Mn Btu | 4.78 | 6.97 | 8.89 | 3.82 | 5.50 | 6.50 |
| Gold | $/troy oz | 1143 | 695 | 872 | 1150* | 1050* | 1100* |
| Copper | $/lb | 3.16 | 3.24 | 3.16 | 2.29 | 3.25 | 3.50 |
| Aluminum | $/lb | 0.96 | 1.20 | 1.17 | 0.74 | 0.85 | 0.80 |
| Nickel | $/lb | 7.22 | 16.86 | 9.57 | 6.60 | 7.00 | 6.50 |
| Zinc | $/lb | 1.03 | 1.48 | 0.85 | 0.73 | 1.15 | 1.00 |

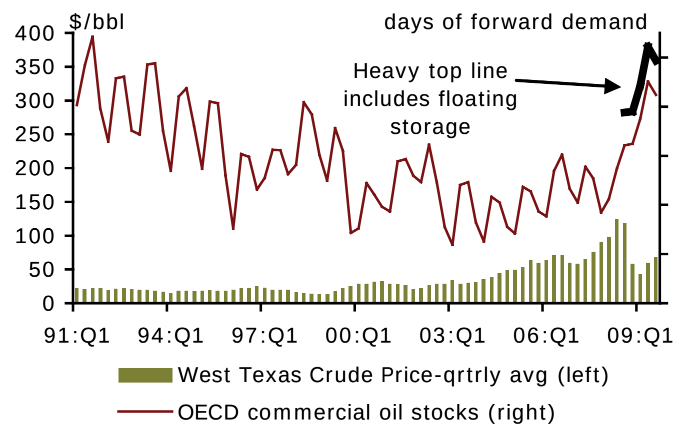
* *end of period*

*Chart 3.* ***Oil Consumed Per Dollar of World GDP***




to 60 days of forward cover, about 12% above normal levels. That rises to over 63 days when approximately 140 mn barrels of floating storage are included (Chart 4). Historically, 57 days of forward cover has been bearish for prices, and 60 days very bearish. Although oil prices in five years time will be higher, perhaps much higher than at present, both the strength of the recent rally and fundamentals create downside risks in the months ahead.

*Chart 4.* ***Still-High Inventories Cast Doubt on Sustainability of Oil's Recent Gains***




## Recommendation Summary:

Sell June-10 Lt Sweet Crude (approx. 8050)
Buy May-10 Copper (approx. 323) Time Horizon 7-8 mths

# Strategic Risk

Michael Rosborough

## "Commodity" Currencies or Something Else?

Foreign exchange often displays some interesting correlations between currencies and other markets. Many of these have an intuitive appeal to them while others are arguably more tenuous and indeed possibly completely spurious. In the jargon of foreign exchange the Canadian and Australian dollars are "commodity" currencies in that their performance is presumed to be driven at least in part by the prices and volumes of their key commodity exports. In Canada's case those are crude oil (and other petroleum products), natural gas and gold. For Australia iron ore, coal and gold dominate.

Part of the problem in looking at currency correlations to commodity prices is that they use the same denominator, i.e. US dollars. In the simple Economics 101 sense anything that causes the supply of US dollars to increase (quantitative easing for example) should lead to the price of other things, be they currencies or commodities, rising in US dollar terms. One way to control for this is to look instead at whether the commodity currencies tend to outperform other individual currencies or some broader basket of them when commodity prices are rising in US dollar terms. How you phrase the question and what answer you expect matters a great deal however.

For example, if I assume oil prices will rise it seems to make sense that I should buy Canadian dollars in preference to euros since Canada is a producer and exporter of oil and the eurozone is an importer. The problem is whether I am really expecting oil prices to rise because of increased demand for oil or some restriction in its supply, or whether what's really pushing oil prices up is a broader devaluation of the US dollar caused by its own relative excess supply.

In the first two cases, buying Canadian dollars in preference to euros makes sense, in the latter it's not clear. Oil prices could still be rising in dollar terms simply because of an excess supply of dollars while underlying demand for oil itself could be weak and the supply plentiful. In that instance one should be better off buying euros. Conversely the underlying demand and supply of oil might be stable and I could be just as well off buying either Canadian dollars or euros or even oil itself as a way of speculating that there is an excess of dollars floating around the globe.

Other interesting conundrums occur. Australian dollars and Canadian dollars have almost exactly equally strong trend correlations to the price of oil (90 to 95% in the past year and 80% over the past five years) yet Australia is not a notable producer of petroleum. Perhaps changes in the price of oil have just been reflective of a changing supply of US dollars. Or, perhaps it's more subtle. Growth in oil demand has been emanating from China and Asian nations which have been growing faster than the G10. Based on its trade patterns Australia is more directly levered to growth in Asia and particularly China than is Canada. It's a second order effect but conceivably a very powerful one.

The tables on the following page show the results of regressions of Canadian and Australian dollars (the dependent variables) and the prices of their three key commodity exports (the independent variables). Two versions of each regression are run. In the first it is price of the Canadian and Australian dollars relative to the US dollar and in the second it is the price of the Canadian and Australian dollars relative to the dollar index (DXY)—a basket of currencies dominated by the euro (57.6%), the Japanese Yen (13.6%) and the British Pound (11.9%). In each case 250 weekly observations are used.

The results are pretty much in line with what one should expect. Against the dollar the regressions possess good R squareds (i.e. they fit well) and the dominant commodity export is both statistically significant and displays the expected sign. Controlling for dollar strength and weakness by measuring the Australian and Canadian dollars against a broader basket of non-dollar currencies weakens the results significantly however. The price trend of their dominant commodity export clearly still matters but the results suggest that the relative supply of dollars (or perhaps the perception of the current or future supply of them) has a significant bearing on the commodity trend itself.

*Regression 1.* ***AUDUSD***
***R squared = 64.5%***

| Independent Variable | T Test | Statistically Significant? | Sign | Expected Sign? |
|---|---|---|---|---|
| Iron Ore Price | 15.18 | Yes | Positive | Yes |
| Coal Price | -4.00 | Yes | Negative | No |
| Gold Price | 3.35 | Yes | Positive | Yes |

*Regression 2.* ***AUDDXY***
***R squared = 39.5%***

| Independent Variable | T Test | Statistically Significant? | Sign | Expected Sign? |
|---|---|---|---|---|
| Iron Ore Price | 11.98 | Yes | Positive | Yes |
| Coal Price | -6.25 | Yes | Negative | No |
| Gold Price | -1.98 | Borderline | Negative | No |

*Regression 3.* ***CADUSD***
***R squared = 69.0%***

| Independent Variable | T Test | Statistically Significant? | Sign | Expected Sign? |
|---|---|---|---|---|
| Oil Price | 15.22 | Yes | Positive | Yes |
| Nat Gas Price | -2.47 | Yes | Negative | No |
| Gold Price | 1.81 | No | Positive | Yes |

*Regression 4.* ***CADDXY***
***R squared = 18.2%***

| Independent Variable | T Test | Statistically Significant? | Sign | Expected Sign? |
|---|---|---|---|---|
| Oil Price | 4.18 | Yes | Positive | Yes |
| Nat Gas Price | 0.02 | No | Positive | Yes |
| Gold Price | -4.96 | Yes | Negative | No |

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