



The Unfolding Story

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Economics (Shenfeld): Can equity market weakness on eurozone debt issues continue a flight to safety bid on Treasuries and Canadas? While government debt concerns will be longer term drags on growth, solid economic reports in the next two quarters should calm the equity market enough for bonds to give back recent gains and explore higher yields.

Rates (Ahmed): As the expiry of the Bank of Canada's conditional commitment approaches, investors are increasingly contemplating the initiation of flattener trades. While an initial round of monetary tightening will motivate a bear-flattening of the curve, a subsequent pause will result in increased volatility and range-bound term spreads. Observed seasonal patterns provide valuable insights with respect to the timing and execution of a flattening bias.

Government Finance (Lovely): As Canada's 2010 budget season gets underway, we examine the country's relative fiscal standing. Sovereign debt fears in Europe increase the attractiveness of Canada's fiscally prudent federal government. The provincial sector is poised to put its finances on a more sustainable track, and we highlight a number of factors that will colour near- and long-term performance.

Government and Corporate Credit (Lovely/Zapior): As we carefully watch the unfolding events in Greece, we raise a yellow flag over our view that Canadian corporates are positioned to outperform provincials this year. After we have examined the possibility of Canadian provincial spreads outperforming relative to corporates should a global FTQ bid unfold, we conclude that our investment thesis remains intact.

Credit (Zapior): A message from corporate CEOs this quarter is best encapsulated by the following quote: "2010 will be a transitional year of growth between depressed markets of 2009 and better conditions in 2011". The conference calls dispense a dose of optimism about 1H10, rooted in an inventory rebuild and slight improvement in consumer attitudes, and tempered by a lack of visibility into 2H10.

Foreign Exchange (Ohayon): In light of the Greek budget debacle, the European single currency has been under a fair amount of pressure. The market seems net short EUR, Spot is down 9% since December 09 and the option market is pricing further downside risk for the Euro. The enclosed strategies allow clients to monetize on a bearish EUR/USD view over the next 3 to 12 months.

Commodities (Buchanan): Natural gas prices lagged other commodities in 2009. The lift to demand from a recovering US factory sector has prompted a modest upgrade in our forecast to \$6.00/Mn Btu this year and \$7.00 in 2011.

Strategic Risk (Rosborough): Is small beautiful or is big better? Uncertainty over the pace and direction of financial reform in the US could cause problems for the markets as the Fed ponders its exit strategy, particularly from the mortgage market next month. Whether "too big to fail" really was the problem south of the border is debatable. The dis-intermediated nature of the pre-crisis US financial architecture was unique, but the shape of what replaces it and the viability of turning back the clock to the traditional small bank model should be a concern to investors.

ECONOMICS

AVERY SHENFELD

Can Equities Save the Bond Market?

With low inflation already taken as a given in the short term, the economic backdrop does not appear to be particularly encouraging for the North American government bond market. Whatever one's views on its strength, some sort of economic recovery is underway in both the US and Canada. Overnight rates are as low as they can go, and while the timing can be widely debated, at some point in the next couple of years, they will be higher. And finally, the supply outlook for sovereign debt is plentiful, with deficits staying high in 2010, and central banks withdrawing liquidity. While the economy could go sour again—there are still lots of risks to US housing prices and a drag from fiscal restraint lies ahead—none of these seem operable in the next couple of quarters.

So the year-to-date recovery in both Treasuries and Canadas was largely about a rush out of stocks, with some seasonal factors, explored by Mohammed Ahmed (on pages 4-5), added in for good measure. Stock jitters

hit all major developed world equities, and extended to a run-up in the VIX, last year's favourite fear-factor gauge. The flight to safety became the last refuge for bond market bulls, and North American bonds were favoured over those in the eurozone, where default risks are on the rise.

Two specific concerns have weighed on equities in recent weeks. First was the package of measures announced by China to tighten monetary policy. But these were largely aimed at preventing a bubble in housing and other asset classes owing to the very aggressively loose lending practices encouraged by Beijing during the global recession. There is no sense that China really wants to slow growth materially, or that inflation is getting out of hand to require such a cooling-off period.

The second, and more legitimate fear, was that Greece and other nations in Europe's periphery are on a crash

Table 1. Interest and Exchange Rate Forecast

END OF PERIOD:	2010					2011	
	10-Feb	Mar	Jun	Sep	Dec	Mar	Jun
CDA Overnight target rate	0.25	0.25	0.25	1.00	1.00	1.00	1.50
98-Day Treasury Bills	0.17	0.20	0.60	1.15	1.05	1.15	1.75
2-Year Gov't Bond	1.31	1.45	1.90	2.35	2.00	2.40	2.70
10-Year Gov't Bond	3.40	3.65	3.85	3.95	3.75	4.00	4.05
30-Year Gov't Bond	4.01	4.15	4.30	4.45	4.30	4.35	4.40
U.S. Federal Funds Rate	0.15	0.15	0.15	0.15	0.25	0.75	1.50
91-Day Treasury Bills	0.11	0.10	0.10	0.10	0.20	1.00	1.50
2-Year Gov't Note	0.87	1.05	1.10	1.20	1.35	2.20	2.45
10-Year Gov't Note	3.65	3.85	4.00	4.15	4.10	4.45	4.45
30-Year Gov't Bond	4.57	4.70	4.75	4.95	4.85	5.05	5.05
Canada - US T-Bill Spread	0.06	0.10	0.50	1.05	0.85	0.15	0.25
Canada - US 10-Year Bond Spread	-0.25	-0.20	-0.15	-0.20	-0.35	-0.45	-0.40
Canada Yield Curve (30-Year — 2-Year)	2.70	2.70	2.40	2.10	2.30	1.95	1.70
US Yield Curve (30-Year — 2-Year)	3.71	3.65	3.65	3.75	3.50	2.85	2.60
EXCHANGE RATES							
CADUSD	0.94	0.93	0.97	1.02	0.97	0.96	1.00
USDCAD	1.07	1.07	1.03	0.98	1.03	1.04	1.00
USDJPY	90	94	93	90	87	86	86
EURUSD	1.37	1.37	1.38	1.44	1.47	1.48	1.50
GBPUSD	1.56	1.59	1.61	1.67	1.71	1.72	1.73
AUDUSD	0.873	0.920	0.940	0.960	1.000	0.990	0.995
USDCHF	1.07	1.06	1.04	1.01	0.99	1.00	1.01
USDBRL	1.86	1.87	1.82	1.77	1.72	1.70	1.69
USDMXN	13.1	13.5	13.0	12.7	12.5	12.3	12.3

course towards default. Europe's major economies have plenty of reason to prevent Greece from triggering a run on the sovereigns, just as the US ultimately aided Mexico with debt guarantees. The IMF could also provide funding if bond investors run to the hills. But note that, either way, Greece will have to undertake a fiscal austerity program, one joined by Spain, Ireland and Portugal. That will hit growth in the eurozone. With the US, the UK and Japan also facing the need for restraint beyond 2010, the battle of the fiscal bulge raises concerns over economic and earnings growth ahead. Slower growth is therefore seen as enough of a concern for equities, and a barrier to monetary tightening, that it is helping the bond markets of higher rated sovereigns like the US and Canada.

Just how likely is that source of salvation to stick around in the next few months? Some point to high valuations as a reason why equity investors could bail at a moment's notice. Indeed, the sense that the S&P and TSX had come a long way was an ingredient in itchy trigger fingers among institutional players.

But a sustained correction would have to fly in the face of what will likely be a dose of strong economics reports, and the earnings growth that accompanies them. Several factors suggest that the strength we've seen in Canadian and US economic forecasts for Q4 will persist into the first half of 2010 (Table 2). In the US, inventories were still falling in Q4, leaving room for additional production increases to meet demand, and then exceed it to restore now-depleted stockpiles. The latest spike in the ISM manufacturing index likely captures that ramp-up. Factory orders are also tilting higher in Canada on low inventories here and in the US, there is still a dose of infrastructure spending coming this spring, and employment momentum should sustain gains in interest-sensitive demand for housing and related durables.

As a result, we expect relatively healthy growth rates in both the US and Canada through the first half of 2010. With that will come enough top-line revenue growth to keep analysts reasonably content with their projections. While targets for 2010 look on the high side in the bottom-up consensus, year-on-year earnings will look very impressive the first half of the year, when the comparable quarters in the prior year were so abysmal. Downward revisions to analysts' expectations could be the story in the second half of the year, but our sense, looking at dividend yields on stocks vs. corporate bond yields, and other valuation metrics, is that investors may already be pricing in more temperate aggregate gains in earnings than the bottom-up consensus, and more in line with what top-down strategists expect.

Earnings gains aren't a foolproof guide to the direction of equities, but there is a strong historical correlation. The exception was in 1994, when central banks ramped up interest rates aggressively, leaving stocks in a losing year. But given the huge economic slack now evident in North America, a highly levered household sector that will feel the pain of even moderate rate hikes, and in Canada, the anti-inflation buffer of a strong loonie, we're likely due for a much shallower rise in central bank rates this time (Table 1). Upward pressure on long bond yields will be more tied to supply pressures associated with funding huge deficits.

Add it all up, and while we are vulnerable to corrections in equities when the market gets nervous over some of the credit hangovers from the recession (including the ongoing troubles in US real estate), healthy growth in the first half of the year should be enough to steady the equity market's ship, undoing the upside for bonds in the process.

Table 2. **Economic Update**

	09Q3A	09Q4F	10Q1F	10Q2F	10Q3F	10Q4F	2008A	2009F	2010F	2011F
CANADA										
Real GDP Growth (AR)	0.4	4.1	3.8	3.1	1.5	1.9	0.4	-2.5	2.4	3.0
Real Final Domestic Demand (AR)	4.7	3.0	3.5	3.0	2.7	2.4	2.6	-1.5	3.1	2.5
All Items CPI Inflation (Y/Y)	-0.9	0.8	1.5	1.8	2.1	1.7	2.4	0.3	1.8	2.0
Core CPI Ex Indirect Taxes (Y/Y)	1.6	1.6	1.7	1.7	1.7	1.6	1.7	1.8	1.7	2.0
Unemployment Rate (%)	8.5	8.4	8.2	8.1	8.3	8.3	6.2	8.3	8.2	8.1
U.S.										
Real GDP Growth (AR)	2.2	5.7	4.0	2.7	1.1	0.7	0.4	-2.4	3.0	2.3
Real Final Sales (AR)	1.5	2.2	2.5	2.1	1.6	0.7	0.8	-1.7	1.9	2.2
All Items CPI Inflation (Y/Y)	-1.6	1.4	2.1	1.3	1.7	1.8	3.8	-0.4	1.7	3.0
Core CPI Inflation (Y/Y)	1.5	1.7	1.5	1.2	1.1	1.2	2.3	1.7	1.3	2.0
Unemployment Rate (%)	9.6	10.0	9.8	9.9	10.1	10.1	5.8	9.3	10.0	9.5

RATES

MOHAMMED AHMED

Timing is Everything

With the expiry of the Bank of Canada's conditional commitment on the horizon, investors are increasingly contemplating the initiation of flattener trades. While an initial round of monetary tightening will motivate a bear-flattening of the curve, a subsequent pause will result in increased volatility and range-bound term spreads. Hence, and as detailed in the January issue of *GPS Monthly*, the coming months warrant an emphasis on the timing and execution of a flattening bias. Observed seasonal patterns provide valuable insights to this end.

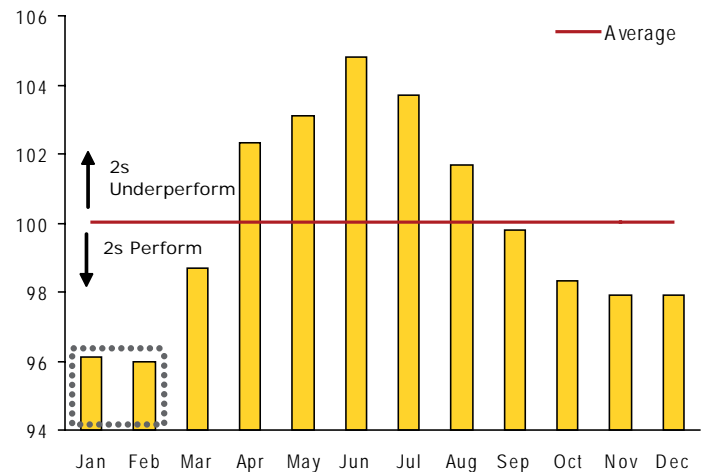
Despite a surprising 0.4% rise in November GDP and ensuing upward revisions to Q4 estimates, Canadian front-end yields continued to fall in January and early February. Anecdotal evidence suggests that at least some of this performance is due to client and dealer activity in the sector. More specifically, these flows are attributed to the hedging of a seasonal influx of funds into registered retirement savings plans (RRSPs) and guaranteed investment certificates (GICs).

Meaningfully Significant Seasonality of 2s and 5s

A by-product of the transfer pricing process, bank treasury departments hedge the sale of 1- and 2-year GICs—the most popular terms for retail investors—by purchasing fixed-rate assets of similar maturities. This liability-hedging activity is most prevalent during January and February, coinciding with the peak period for RRSP investment in Canada. In fact, some treasury departments are mandated to hedge this exposure as soon as a restrictive risk limit is exceeded. As a result of this structural demand, there is a significant impact on the front-end of Canadian rates markets.

The census bureau's seasonal adjustment program, X-12-ARIMA, reveals that not only is there a statistically significant seasonality in Canadian 2-year swap rates, but that the seasonality is also meaningfully significant. All else equal, 2-year swap rates perform, on average, 4% better in January and February than they do the rest of the year (Chart 1). As an aside, the next best

Chart 1. X-12-ARIMA Seasonal Factors: Canada 2-Year Swaps



months for 2-year swap rates are October and November, corresponding to the historical precedent of equity market weakness. Although this analysis relies on swap rates to minimize the impact of benchmark rolls, the same effect is observed in 2-year bond yields.

The relatively small size of the Canadian bond market amplifies the impact that structural dynamics have on sectors of the yield curve. Recall the anomalous richening of the 5-year sector that followed the launch of CMHC's Insured Mortgage Purchase Program (IMPP) in October of 2008. With swap spreads negative at the time, bank treasury departments replaced mortgages sold into the IMPP with 5-year bonds (Canadas, CHTs, Provincials). Then, as participation in the IMPP subsided in March and banks rapidly originated mortgages—a function of historically low interest rates—the 5-year sector cheapened. From trough to peak, this reversal represented a 100 basis point cheapening of Canada 5s versus 2s and 10s. Admittedly, this was an extraordinary period; however, seasonal patterns associated with the Canadian mortgage market are evident in more normal environments.

Canadian housing and, by extension, mortgage markets exhibit fundamental seasonality, as harsh winters encourage buyers to be more active during summer months. An analysis of historical mortgage issuance volumes identifies June as the busiest month. To hedge the interest rate risk of these assets, banks pay fixed in swaps and also sell bonds. Thus, there is a common belief that 5-year bonds underperform on the curve during the spring and summer seasons.

A multivariable regression model provides a telling indicator with respect to the extent to which the belly leads, or lags, the wings. The model examines the short-term historical relationships among the three legs of a butterfly by regressing the yield on the belly bond against the yields on the wings (Equation 1). The directional indicator is then defined as the sum of the two regression coefficients. It indicates how the butterfly spread can be expected to vary in response to parallel upward and downward movements in the yield curve. A directional indicator greater than one indicates that the butterfly spread should tend to widen in response to parallel upward shocks to the yield curve and vice versa.

Equation 1. Butterfly Regression Model

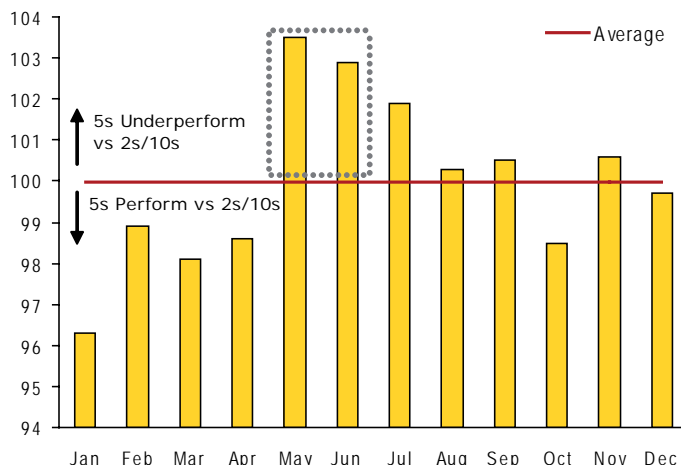
$$Y_{Belly} = b_0 + b_1 \cdot Y_{ShortWing} + b_2 \cdot Y_{LongWing}$$

In this case, a test of seasonality analyzing the directional component of the 2-5-10 butterfly confirms that 5s tend to underperform in May and June, as hypothesized (Chart 2). Note that there are two important caveats to this analysis. First, mortgage flows are well known in the Canadian markets and consequently, positioning from dealers may exacerbate any relative performance. Second, given the current steepness of the yield curve, fixed-rate mortgage origination may underwhelm in 2010. On balance, we forecast that seasonal factors will prevail and 5s will correctively cheapen from current levels as the spring approaches.

Impact on Trading Biases

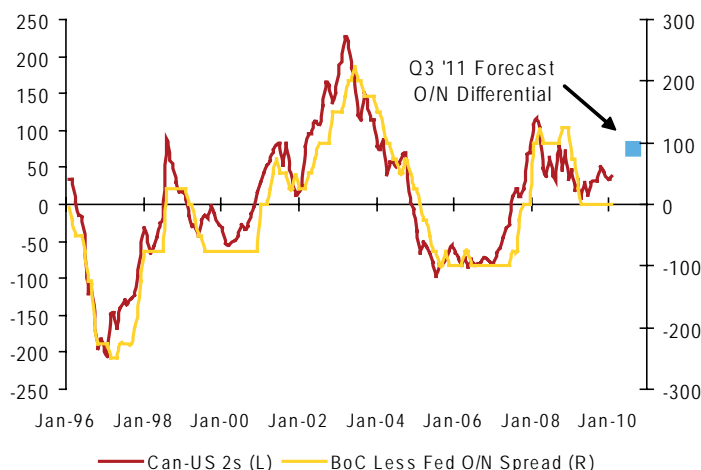
The empirical analysis presented above facilitates the formulation of a more granular trading strategy for 2010. In the front end, fundamental trades predicated on a relative underperformance of Canada's versus Treasuries

Chart 2. X-12-ARIMA Seasonal Factors: 2-5-10 Butterfly Directional Indicator



are likely best reserved for late-Q1/early-Q2, once technical factors related to GICs fade. This effect has the potential to be even more pronounced in 2010, if nervous retail investors opt for the safety of GICs over equities. Separately, an analysis of the Canada-US 2s spread and the differential of overnight rates suggests that the bond markets historically pre-empt anticipated policy changes by two months (Chart 3). This corroborates the late-Q1/early-Q2 timeline. Further out the curve, a bear-flattening of 2s/5s is expected by early Q3, as 5s overcome seasonal selling pressure and the front end reacts to tighter monetary policy.

Chart 3. Canada-US 2s Spread and Overnight Target Differentials



GOVERNMENT FINANCE

WARREN LOVELY

It's All Relative

At the risk of overstating recent events, 2010 has so far been more about a sovereign debt crisis than the early stages of an economic recovery. For a number of European countries, Greece and Portugal chief among them, a fiscal reckoning is at hand, sparking concerns of broader contagion on (and off) the continent (Chart 1).

We've long advocated the economic and fiscal merits of Canada. But as a sovereign debt crisis swirls, the nation's relative standing has strengthened further. Simply put, highly rated Canada offers safe harbour in today's global debt storm.

Canada's Favourable International Standing

Few advanced economies boast stronger real GDP growth prospects—a view endorsed by our own economics department, a broad cross section of private sector banks, the Bank of Canada, the IMF and, as per Table 1, the OECD. Meanwhile, Canada's near-term growth in nominal GDP should lead the G7, which given its closer ties to government revenue, implies an easier fiscal row to hoe in the coming years.

Chart 1. **Sovereign Default Fears on the Rise**

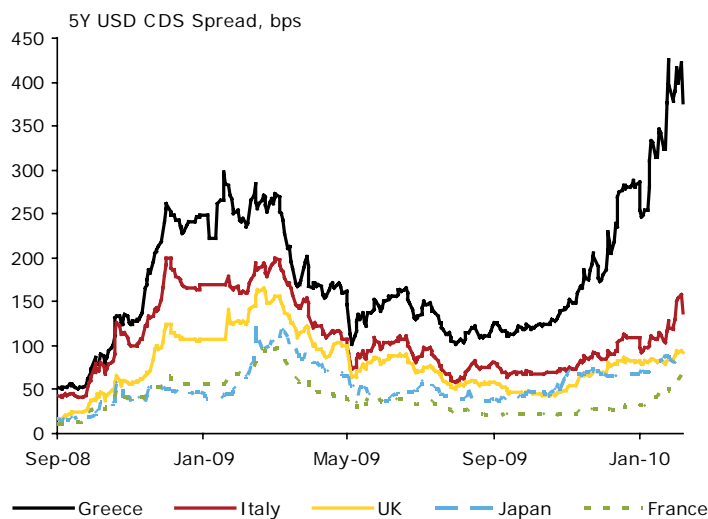


Table 1. **Economic/Fiscal Prospects: International Perspective**

	Real GDP	Nominal GDP	Budget Balance	Net Debt		Current Rating/Outlook	
	%	%	% of GDP	2011F	10Yr Chg	S&P	
North America							
Canada	2.5	4.4	-4.8	36	-9	AAA	Stb
United States	2.6	3.6	-10.0	72	37	AAA	Stb
Other G7							
France	1.5	2.2	-8.3	67	31	AAA	Stb
Germany	1.7	1.9	-5.0	58	21	AAA	Stb
United Kingdom	1.7	2.8	-12.9	70	47	AAA	-ve
Japan	1.9	0.7	-8.8	113	46	AA	-ve
Italy	1.3	2.3	-5.3	103	8	A+	Stb
Other Distressed Europe							
Spain	0.3	0.4	-8.1	49	7	AA+	-ve
Ireland	-0.6	-1.0	-11.9	49	36	AA	-ve
Portugal	1.2	1.8	-7.7	69	38	A+	-ve
Greece	0.4	2.7	-9.9	101	8	BBB+	-ve*
Other							
Australia	3.0	5.1	-3.1	2	-5	AAA	Stb

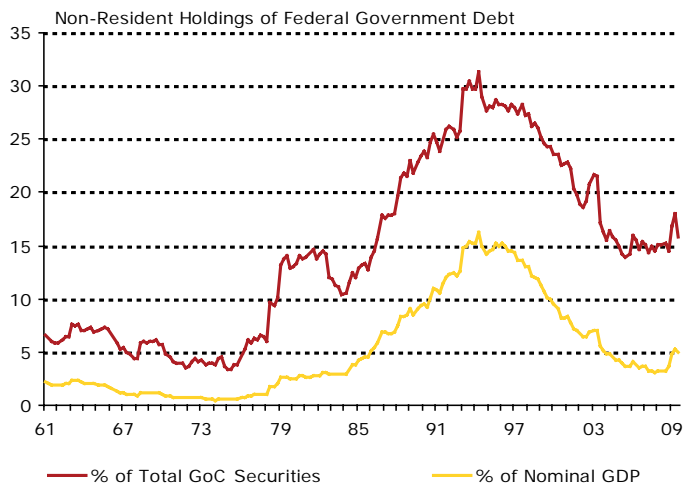
Source: For comparison purposes, all eco/fin'l data from OECD Economic Outlook #89 (Nov-09)
 Notes: Budget Balance and Debt for General Government Sector;
 unless otherwise noted, results reflect averages for 2010-2011;
 Greece's S&P rating on negative watch

Indeed, it's fiscal credentials that shine the most favourable light on Canada. The country's general government budget deficit, which incorporates lower levels of government, is not trivial. But after slaying large structural deficits in the early 1990s and reeling off a decade of surpluses, Canada's fiscal rectitude is well proven. There's a staunch commitment on the part of the main parties in Ottawa to restore fiscal health, and expect the upcoming Federal Budget (to be released March 4th) to chart a course back to balance. Whereas the federal deficit should be all but eliminated come 2015, Obama's recent budget suggests the US will still face a deficit of 4%-pts of GDP in five years' time.

More important than the budget shortfall, debt levels increasingly see Canada standing out in the crowd. Canada is, after all, one of the very few countries where general government debt (as a percent of GDP) is lower than it was a decade ago.

Note that Canada's reliance on foreign investors has diminished materially. So while an increasing appetite for Canadian debt has been welcomed, the country is less

Chart 2. **Canada Less Reliant on Foreign Investors**

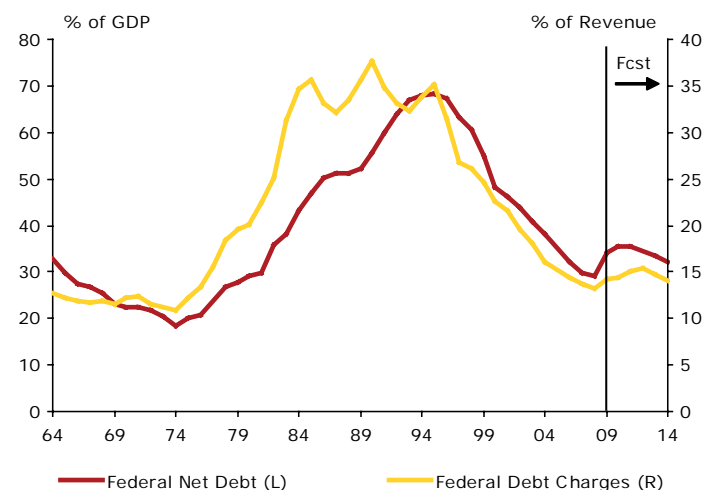


beholden to foreign investors to fund its budget shortfalls than many. Specifically, little more than 15% of federal securities outstanding are held by non-residents, with Ottawa’s exposure to foreign investors having been cut in half relative to the early 1990s. As a share of GDP, non-resident holdings of federal debt are now only a third of the prior peak (Chart 2).

The country’s AAA rating is rock solid. Recall that in March 1995, when Canada’s sovereign rating, then AA+, was put on negative outlook, net federal debt hovered around 70% of GDP, with interest costs eating up more than one-third of Ottawa’s revenue dollar. When it gained AAA status in 2002, net debt was down to 45% of GDP, with 20% of revenue needed for debt servicing. Today, net debt is 35% of GDP, and likely to turn lower starting fiscal 2011, with only 14 cents of every revenue dollar required to service the debt (Chart 3).

Contrast Canada’s ratings strength with the UK, which is currently on negative outlook, or the US, where the sanctity of the AAA rating has come into question. France and Germany remain AAA rated, but with the outlook for the euro weighed down by aforementioned debt troubles in Greece et al, there are major risks to investing in their home currency. We are decidedly more bullish on the outlook for the C\$, seeing 5-10% near-term upside for the loonie (see Table 1, page 2), with the country’s rich endowment of natural resources providing longer-term support.

Chart 3. **Lower Debt Burden Supports Canada's Rating**



In sum, Canada, represents a compelling investment, with a growing roster of foreign investors likely to remain hungry for the name.

2010 Budget Season Underway

More than in past downturns, an examination of Canada’s general government budget deficit captures erosion at the provincial level. While we remain cautious on the sector overall, anticipating ongoing underperformance versus domestic corporates, the foundation of a fiscal healing will soon be in place.

Of course, a commitment to existing stimulus programs and some near-term economic uncertainty suggests little near-term relief on deficits or funding needs. But 2010 budgets will outline medium-term plans aimed at reining in the deficits that currently exist coast to coast. That was evident in the recent Alberta budget; despite a larger deficit in 2010/11, the province is on a path towards balance by 2012/13. In general, we anticipate that most provinces will eliminate their deficits in three to five years.

But as with comparisons of individual sovereigns, relative provincial performance will be subject to wide divergence, with near- and long-term prospects far from uniform.

Refer to Table 2 for a broader perspective on how Canada’s provinces stack up across a host of key indicators. The table examines relative fiscal pressures (deficits and debt loads), as well as the recent track record and forecasts for GDP growth. In terms of financial standing

and economic prospects, Canada's resource-rich provinces, namely Alberta, Saskatchewan, Newfoundland & Labrador and British Columbia have a distinct edge going forward, although it should be noted that Manitoba currently boasts the smallest relative deficit. (Our Economics department explored relative economic performance in its January issue of *Provincial Forecast*.)

Table 2 also highlights past performance in productivity and labour force growth—the key determinants of longer-term economic growth. Western Canada's stronger growth performance has attracted migrants from other parts of the country and resulted in superior labour force growth. The provincial productivity record is varied, with little to no gains in BC and parts of the Maritimes, contrasting with sturdy growth in Newfoundland & Labrador, Manitoba and Saskatchewan. Note that as more oil sands production comes on stream, Alberta's seemingly weak productivity record will improve notably, setting the stage for a healthy long-term potential growth rate.

Long-term population projections indicate a more serious demographic challenge in Atlantic Canada, where seniors will comprise a larger share of total population. Ontario, Manitoba and Alberta compare favourably here. Finally, the table illustrates the relative carbon intensity of each province's economy. On the strength of its vast hydroelectric power assets, Québec is the least carbon-intensive of all the provinces. Saskatchewan and Alberta are heavy emitters, although (for now) political momentum towards tough carbon standards appears to have faded.

With Canada's resource wealth a key determinant of our international outperformance, it stands to reason that the key resource-based provinces will have an easier go of it. Within the provincial sector, we remain fundamentally bullish of these credits, and expect the remaining 2010 budgets to fully support our bias.

Table 2. **Key Drivers of Relative Provincial Performance**

	Fiscal		Economic				Productivity/Demographics				Other
	Summary Deficit ⁽¹⁾	Government Debt ⁽²⁾	Real GDP ⁽³⁾			Nominal GDP ⁽⁴⁾	Labour Product'y ⁽⁵⁾	Labour Force ⁽⁶⁾	Work'g Age Pop. ⁽⁷⁾	Senior Pop. ⁽⁸⁾	GHG Intensity ⁽⁹⁾
	2009/10 % of GDP	2009/10 % of GDP	Last 5Yrs % CAGR	2010F Y/Y %	2011F Y/Y %	Last 5Yrs % CAGR	Last 5Yrs % CAGR	Last 5Yrs % CAGR	2030 % of Total	2030 % of Total	2007 M/\$B GDP
BC	-1.5	18.9	1.9	2.8	3.4	3.6	-0.1	1.9	62.4	23.8	0.38
Alta	-1.5	3.6	2.0	2.4	4.2	4.8	0.6	2.9	62.8	21.1	1.31
Sask	-1.9	17.1	1.6	3.0	4.1	6.5	1.7	1.5	58.9	24.7	1.81
Man	-1.2	31.2	2.3	2.3	3.1	4.7	1.8	1.0	61.4	21.5	0.51
Ont	-4.4	34.3	0.7	2.4	2.8	1.8	0.6	1.2	63.2	21.7	0.37
Qué	-1.6	60.9	1.2	2.2	2.7	2.7	0.7	0.9	61.3	25.0	0.32
NB	-2.7	32.4	0.7	2.2	2.8	3.2	0.1	0.7	59.4	28.1	0.79
NS	-1.7	41.1	1.0	2.1	2.6	2.8	0.1	0.6	59.5	27.7	0.72
PEI	-1.9	38.9	1.3	1.8	2.4	2.8	1.3	0.9	60.1	26.0	0.50
N&L	-1.9	41.4	2.3	2.6	3.3	3.7	2.1	0.0	59.1	29.0	0.53

Sources: (1) Provincial governments, CIBC; (2) DBRS, adjusted to include unfunded pension liabilities; (3) Statistics Canada, CIBC; (4-6) Statistics Canada; (7-8) Statistics Canada, projections based on medium growth, medium migration scenario; (9) Environment Canada, National Inventory Report

Note: Yellow shaded cells denote top 3 provincial positions red shaded cells denote bottom 3 provincial positions

GOVERNMENT AND CORPORATE CREDIT

WARREN LOVELY/JOANNA ZAPIOR

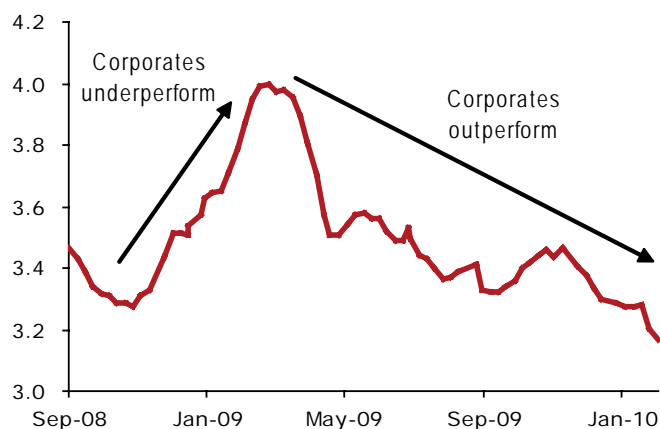
Provincial and Corporate Spreads: Greece Enters the Stage

As we carefully watch the unfolding events in Greece, we raise a yellow flag over our view that Canadian corporate credit is positioned to outperform provincial credit this year. After we have examined the possibility of Canadian provincial spreads outperforming relative to corporates should a global flight-to-quality (FTQ) bid unfold, we conclude that our investment thesis remains intact.

Our position on corporates relative to provincials in 2010 has been as follows:

- We view corporate credit fundamentals more favourably than provincial fundamentals.
- New issue technicals are also supportive of our view that corporates are positioned to outperform provincials.

Chart 1. **Ratio of Corporate and Provincial Constant Maturity Spreads (5-year)**



Current sovereign debt fears have the potential to change our relative picture. 1) The unfolding fiscal stress is not likely to directly pressure the fundamentals or new issue technicals of Canadian corporates. 2) We think it more likely that there could be an impact on provincial spreads through the technicals of market flows in the context of battered global spread markets. This is where our yellow flag comes out.

- Should a sovereign crisis lead to a flight to quality in global markets, we think it could create demand

for Canadas, and potentially CHTs, among foreign investors.

- It is less clear whether this FTQ would extend to Canadian provincials—we think that foreign investors are more likely in a flight to quality to seek exposure to sovereign and sovereign-guaranteed paper, rather than sub-sovereigns.

However it is possible that, after demand for Canadas and CHTs is satisfied, some foreign investors might consider short-term provincial paper as safe heaven. Even then, it is debatable whether this interest would extend just to foreign currency-denominated debt, or to C\$ paper as well. If the interest extended into domestic provincials, even inflows that would be very small from an international perspective would be material for our domestic market and would support provincial spreads, potentially leading to outperformance relative to corporate spreads.

- We do not believe that Canadian corporates would enjoy the benefit of a global FTQ—hence the potential for relative underperformance. In fact, being higher-beta than provincials, we do run a risk they could widen more than provincials in response to global macro forces.

It is important to note that so far THERE IS NO EVIDENCE of the Greece-induced flight to quality materially impacting Canadian provincial paper. Our trader notes that right now foreign investors appear to be diversifying within US\$ holdings, with more interest in supra-nationals than in sovereigns or sub-sovereigns. We have not observed any out-of-pattern buying of US\$-denominated provincial paper, or for that matter C\$ paper.

CREDIT

JOANNA ZAPIOR

With An Ear to the Ground ...

The quarterly reporting season is in full swing for Canadian corporate debt issuers. A number of bell-weather US companies have also reported. Just as the beginning of the year is conducive for economists and analysts to come up with outlooks for the year, company managements are also inclined to offer insights into what to expect.¹

Quarterly calls can be very granular, but if one listens to a sufficiently large number of them (for this report we reviewed 60+), patterns begin to emerge. What jumped at this credit analyst is best encapsulated by the following quote from an industrial goods company.

"2010 will be a transitional year of growth between depressed markets of 2009 and better conditions in 2011."

Top Line, Bottom Line

So far in this crisis, despite hammered top lines, operating profitability largely recovered from the initial shock thanks to brutal cost cutting. Looking into 2010, as one US telecom company put it, we should expect "stable revenue and stable-to-improving income margins, as we see significant opportunities to improve operations—and more cost efficiencies".

Our overall impression, though, is that there is a lot more talk this quarterly season about preservation of the impact of the cost cutting that already took place in 2009 than about significantly more to come. "2009 was a big year for cost reductions. I expect more in 2010, but not as high as that achieved in 2009", says one Canadian company CEO.

¹ While the methodology of listening with an ear to the ground has a lot of merit, we admit there is a risk of circularity here. We all track the same numbers, and the economists and analysts have already made their outlooks available to their corporate clients. Nevertheless, we do believe that the comments we are hearing, as much as they reflect the analyst consensus macro views, they are also coloured by the direct experience the companies are gathering while doing business.

When it comes to the top line in 2010, one important source of support will be re-building of inventories. However, the unfolding picture is mixed: "modest growth in the first half of the year, and the second half will depend on the economic recovery", as a transportation company CEO puts it. "When volumes recover, we will be able to handle them without adding costs at the same rate (though mix will be an important factor)". The CEO notes that operating leverage faces headwinds, such as the type of recovery and its sustainability. And the punch-line this CEO delivered is that a recovery driven by inventory re-build will be a stop-and-go phenomenon: "inventory fill, check, see how the business gets consumed".

A little more colour on inventory re-build:

- A glass manufacturer expects 1Q10 LCD glass volumes to be driven by "inventory replenishment in the supply chain"—this company is guiding for above-seasonal 1Q results. Note also that "in 4Q the pull from set assembly and retail was strong enough to keep inventories from rising. We now need to backfill for the strong 4Q sell-through and in preparation for a larger end-market in 2010". But the same manufacturer also expects a moderate price decline in 1Q, following flat pricing in 4Q09, suggesting to us the risk of supply/demand imbalances may develop while inventories re-build.
- A steel company that, incidentally, sees "a continued challenging environment" in 2010, notes that "inventories at US service centres are near historic lows though they showed a small uptick in 4Q", and that "4Q saw restocking in the automotive sector". This is corroborated by the glass manufacturer we cited above, who also makes auto parts. Its CEO noted that it saw "recent strength from building inventories" in the auto sector. Management expects that this inventory build will peak in 1Q10 as current demand "suggests the supply chain is preparing for a 75-million auto build level. That's not realistic."

End Market Behaviour

It takes the so-called “mosaic theory” to draw conclusions about the state of the consumer from quarterly conference calls. What we heard so far in the season revolves around key macro variables of employment and housing, as well as credit availability and unfolding consumption patterns.

Unemployment...

While admitting that the peak in US unemployment is on the horizon for 2010, many CEOs are soberly budgeting for the fact that this, nevertheless, will likely mean that unemployment for the full year will remain above 10% and still elevated in 2011, just under 10%. A CEO of a Canadian financial services company interestingly points out that “it hurts to take people out of the business, and I think people will be very cautious in adding people to the business over the next short little while, because it was a tough task to remove people from the business”.

Housing...

With an expected range for housing starts of 600,000-900,000 units in 2010, one international, Canadian-based, forest products company is “feeling better about the business outlook” but still expects it to be a “bumpy and fragile recovery” due to “limited mortgage availability, high unemployment and unprecedented foreclosures”. This CEO thinks that “the first half of 2010 will be very confusing on housing starts, with mixed messages and contradictory reports”, and that there “won’t be a positive tone about housing until 2011”. Note that the actual for 2009 was about 500,000 units, and the trend line, absent downturn, would have been a now-unattainable 1.5 million. And how unprecedented are these foreclosures? According to a mortgage insurer, as the US “shadow inventory” makes its way through foreclosures, it can add four million homes to existing supply. We note that this is roughly equivalent to nine months of supply in existing homes at current sales rates.

Credit....

We will not hear from Canadian banks until late in the month, but all US banks reported. The consensus is that credit losses have peaked. Credit cards may still be bumpy, though losses are also likely near peaking. Commercial losses will continue to increase (impacting large banks in general, while commercial real estate losses will impact regional banks more significantly). Mortgage trends are difficult to read due to various “support” programs, but a mortgage insurer noted that unemployment-related

pressures pushed delinquencies higher in 4Q, and “we would expect that to continue”. Having said that, the Canadian experience is likely to continue to diverge from the US experience. We saw consumer credit growth all along, while credit usage in the US was being cut.

Most critically, if banks continue to deleverage (over the next two years, as one CEO suggested), recovery could be more drawn out as lending standards will remain tight. There will also be less propensity to lend due to higher capital requirements and regulatory uncertainties.

Consumption...

Advertising trends appear to be turning positive. 4Q saw an improvement in tone from national advertisers (though not necessarily supported by commitments), and even some improvement in the beleaguered classifieds. We should not have illusions, though—improvement in classified advertising only means that for one large US newspaper company real estate advertising volumes are down 28% year-over-year in 4Q, compared to down 35% in 3Q YOY. Similarly, its job ads were down 38% YOY in 4Q, which compares favourably with 55% down YOY in 3Q09.

Advertising is still weak for travel, financial services and retail (a US newspaper) but improving for food, toys, and entertainment, as well as foreign cars, beverages, and services in certain customer categories (a Canadian TV company).

Corroborating this, airlines expect a long and slow recovery. “While premium traffic is slowly returning, corporate travel budgets remain tight and discount airlines are increasing pressure.” And a Canadian grocer believes that the “economic environment is challenging with high unemployment, and we expect consumers to remain prudent”.

The auto sector became tricky again to assess, with a major dislocation expected from the wide-ranging recalls at Toyota. But those manufacturers that make greener, more fuel-efficient and smaller cars are more than averagely optimistic. In a departure from the style of this note, we will actually name a company: even before the Toyota recalls, Hyundai’s management said it expects an increase in sales and market share in 2010—from 3.1 million vehicles in 2009 to 3.46 million. Hyundai’s belief in opportunity is certainly supported by others: “automotive prospects are better as consumer replacement demand kicks in with credit availability and restored confidence”. But here’s what we heard from a company that transports

vehicles (harking back to the glass manufacturer's comment): "US auto sales are expected to be slightly higher than 2009. Stronger production will spur first-half shipments, and the second half will depend on sales volumes".

Someone Is Happy

It is not everywhere in the corporate world that we hear about transitions and modest growth. We would be remiss if we did not mention Cisco, a global supplier of data networking products and a recognized barometer for business IT spending. From the IT spending bellwether come 4Q09 results significantly above guidance, and also a positive outlook for a "dramatic across-the-board acceleration and sequential improvement in our business in almost all areas". Cisco plans to hire another 2-3 thousand employees on top of the 2,100 hired in 4Q09, and sees operating expense growing faster than revenue on account of this hiring. Note that North America accounted for 54% of Cisco's revenue in 2009, but it is increasing focus on emerging markets.

Cisco argues that 4Q marked a turnaround in capital spending. This comment is not being made across the board. For example, oil and gas avows to generally live within its cash flow means though oil sands spending appears to be turning upward, power generation is generally still cutting capex, and industries with curtailed capacity, such as forest and paper products, see capex increasing only when the indefinitely curtailed capacity will be brought back. But we do note a tad more optimistic tone from some US telecom companies, such as "large businesses are beginning to look at projects, and also at

outsourcing". For this to be sustainable, the CEO wants to "see growth in employment and fixed investment in large businesses, and better capital availability and new business formation in SME". But another CEO says "we are not seeing any significant pick-up yet in capital or IT spending by our largest customers... The key to a turnaround will be a return to hiring on the part of large enterprise businesses".

Last But Not Least

We also have an insight from Governor Carney. While it does not strictly qualify as a quarterly release corporate comment, he spoke on February 4th in Winnipeg (reflecting the thoughts advanced in the January *Monetary Policy Report*), so the timing of the speech fits with our sample. The tone of the Governor's comments matches that which we are picking up from corporate conference calls. He stated that the recovery has begun, but qualified this statement by pointing to significant risks to this outlook.

- Global growth will not only be lower in the future, but also more volatile, partly because of significant fiscal pressures.
- Domestic factors will be key to the Canadian recovery in the short-term, but due to expected ongoing weakness in many of Canada's traditional markets Canadian firms may require "deeper restructuring and bolder strategic initiatives".

It looks to us like 2010 will indeed be a year in which we may only be able to get a glimpse on how this cookie will crumble post 2010...

FX STRUCTURING

ERIC OHAYON

EUR/USD Outlook

The European single currency has been under a great deal of pressure since the Greek budget debacle surfaced in late 2009. Credit spreads in the eurozone have soared to an all-time high with Greece sovereign debt trading 400 bps over its German counterpart (Chart 1).

The greater perceived risk in euro-denominated investments has caused foreign investors to re-evaluate these positions. The resulting outflow from euro investments has put downward pressure on the EUR versus the USD. It has lost almost 9% of its value against the greenback since December. Have investors decided that the USD dollar is a better place to park money in these uncertain times? Or are these unwinds of carry trades where US dollars were borrowed and then invested into higher yielding euro-denominated assets? Carry trades are the first to be unwound because they cannot withstand the negative drag of a weakening currency. At present the situation is very fluid, the market has added to short euro positions and despite a potential short-term bounce, the lack of clarity around Greece's fiscal situation continues to weigh on the single currency especially if fiscal problems spread to other European countries.

Chart 1. **Sovereign Yields**

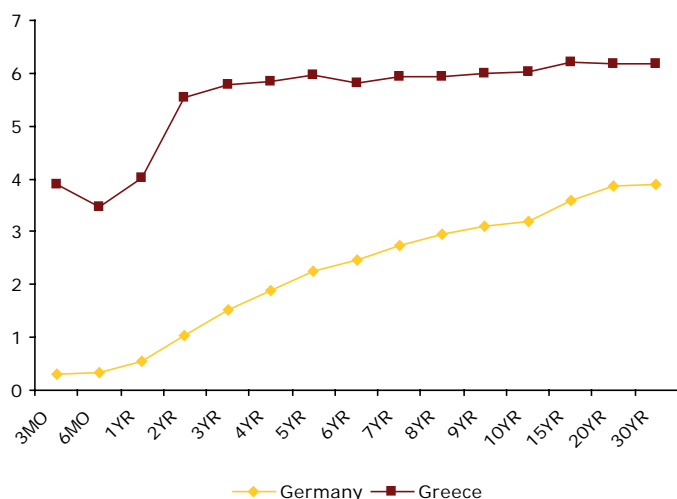
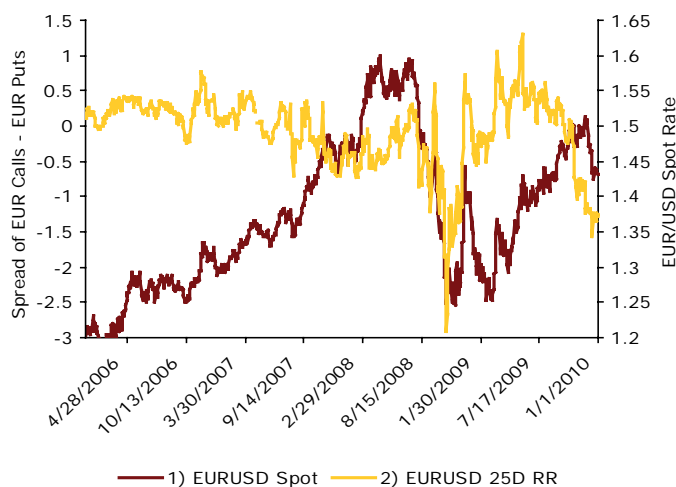


Chart 1. **EUR Spot and 25D Risk Reversal**



The option's market is pricing the risk of a further depreciation of the euro. Despite a relatively stable implied vol, the risk reversal is skewed to the downside with the 25 delta EUR Puts trading 1.70 vol higher than the EUR Calls for both 1m and 1Y tenors (Chart 2).

In light of the above, the following strategies are designed to take advantage of further euro weakness for the remainder of 2010.

EUR/USD Cancellable Forward

Spot Ref.: 1.3750

The Cancellable forward allows the client to enter into a strip of monthly outright forwards to sell EUR/buy USD over the next 12 months. The rate at which the client agrees to sell the euro represents a 242 pips advantage relative to the prevailing market rate (1.3728 Par Forward). At the end of the first six months, on the Cancellation Date, CIBC has the right to cancel part or all of the remaining forwards at its own discretion.

Indicative Terms & Conditions

Client Position:	Sell EUR/USD Forward
Expiry Dates:	Monthly from 26 Feb 10 to 28 Jan 11 (12 expiries)
Strike:	1.3970 USD per EUR
Notional:	€ 1,000,000 per month
Cancellation Date:	30 Jul 10 On the 30 Jul 10, CIBC has the right to cancel part or all of the remaining six forward contracts
Upfront Premium:	Zero
Analysis:	The client is guaranteed to sell EUR/USD forward for the next six months at the pre-agreed 1.3970 rate, outperforming the par forward by 242 USD pips. On the 30 Jul 10, CIBC can exercises its right to cancel part or all of the remaining forwards.

EUR/USD Conditional Put Spread

Spot Ref.: 1.3750

The Conditional Put Spread allows the client to monetize at or below the 1.3150 Conditional Trigger will the client's option position transform into a Put Spread.

on a mildly bearish EUR/USD view. The client starts with a Long EUR Put/USD Call option position at a reduced premium. Only in the event that spot EUR/USD ever trades In comparison, the price of a standard 3-month 1.3750 EUR Put is 2.50% EUR.

Indicative Terms & Conditions

Initial Position:	Long a 1.3750 (ATMS) EUR Put / USD Call
Expiry:	3 months
Conditional Position:	Long a 1.3750 – 1.3600 EUR Put Spread
Conditional Trigger:	1.3150 USD per EUR In the event that spot EUR/USD ever trades at or below 1.3150, the client's long option position transforms into a 1.3750 – 1.3600 EUR Put Spread
Upfront Premium:	0.75% EUR
Maximum Payout:	4.35% (599 USD pips)
Conditional Max Payout:	1.10% (150 USD pips)

COMMODITIES
PETER BUCHANAN

US Factory Recovery Should Help Ease Natural Gas Glut

Natural gas prices have been laggards in the past year's resource price recovery. Base metals prices rocketed by 100-200% in 2009 on Asian recovery hopes, while natural gas prices, tied to a much more tentative North American upturn, posted a tepid 3% increase.

Several recent developments, including a sharply reduced inventory overhang (Chart 1, left) and improving industrial demand outlook, are constructive for gas prices. That has prompted us to modestly upgrade our target for benchmark Henry Hub to \$6/Mn Btu this year from a previously estimated \$5.50 and \$7/Mn Btu in 2011. Those estimates, derived from our model tying prices to oil, storage levels, and other factors, would still leave prices trading at a relatively inexpensive 50% of WTI in BTU terms (Table 1, Chart 1, right).

Depressed Industrial Demand Shows Signs of Thaw

Industrial firms and the electrical power industrials are the two heaviest-duty gas users in the US with a nearly 60% share of consumption in 2009 (Chart 2).

Chart 1—Easing Storage Overhang (L) Contributes to Improved Outlook for Natural Gas (R)

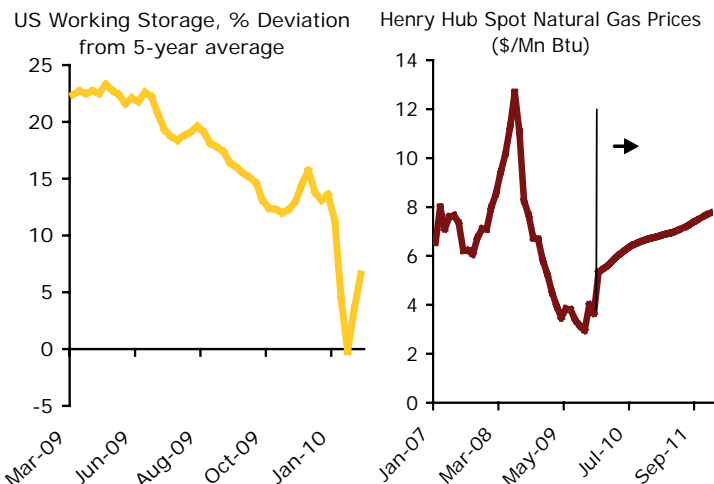
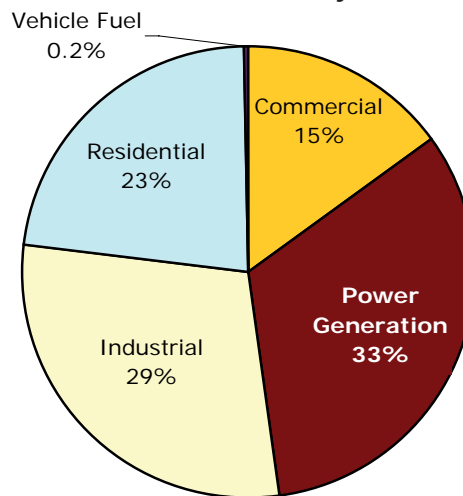


Chart 2—US Natural Gas Demand by Sector (2009)

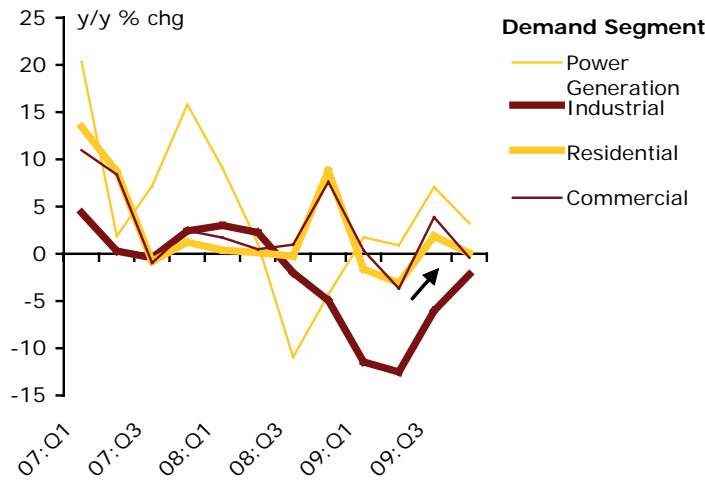


Source: US DoE, CIBC Estimates

US industrial natural gas demand fell about 25% in the Great Recession, much more than in the far milder 2001 downturn. While US GDP growth is unlikely to set records in coming quarters as job-challenged consumers show caution, the turn in the inventory cycle is now providing support to the factory sector, helping to lift industrial natural gas from its recent two-decade lows (Chart 3). Although natural gas has widespread industrial applications, a handful of cyclically sensitive sectors like metals, pulp and paper, petroleum refining, plastics and non-metal minerals account for four-fifths of overall use. Recovery in those sectors should lift demand.

Rising air conditioner use means demand from power generators is climatically sensitive. Predicting the weather is no easy feat but cooling degree days hit eight-year lows in 2009. Even a return to the pattern of recent years could consequently mean significantly higher demand this summer. Motor vehicle fuel use is growing exponentially but at well under 1% is still too limited to greatly impact overall demand.

Chart 3—US Factory Upturn Lifts Deeply Depressed Industrial Gas Demand



Source: US DoE, CIBC Estimates

Inventories High But Coming Down

While US inventory levels remain above seasonal norms, unseasonably cold weather combined with strong industrial demand pushed withdrawals to near-record levels in late December and early January. That has helped cut the surplus to the five-year average by two-thirds from as much as 20% last summer. Working storage levels should, consequently, end the current heating season several percentage points below previous expectations.

Waiting for a downturn in US natural gas production has resembled nothing more than waiting for Godot in recent years. Production rose by about 3% in 2009 from hurricane depressed levels the year before, despite a 42% drop in drilling activity. Soft weekly tracking data for early 2010 suggest, however, that the long awaited decline in US gas production may now have arrived.

Shale Gas: Abundant But Not Necessarily Cheap

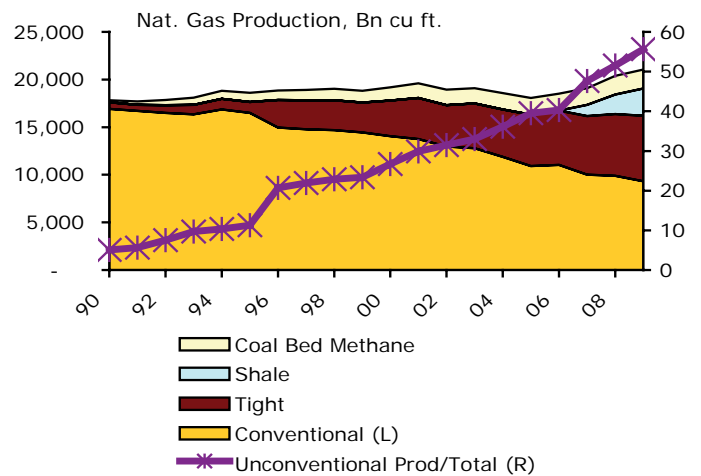
The rapid swing in the supply pendulum from conventional to non-conventional capacity has lifted US gas production in recent years, reversing an earlier, long-running decline. Unconventional production—coal bed methane, tight sandstone, and shale gas—surpassed conventional

production for the first time in 2008 (Chart 4). Shale gas is still a modest part of that total, but its explosive growth and future potential has invited comparisons with the oil sands. Although shale gas remains predominantly a US phenomenon, deposits in Northern BC, southern Québec and other areas point to sizeable potential future production in Canada.

As in the case of the oil sands, shale gas abundance will come at a cost, although the exact price tag remains a matter of ongoing debate. Some analysts cite a \$5-6/Mn Btu full-cycle cost for extensive development, others perhaps more realistically, a \$7-8/Mn Btu threshold. That divergence attests to a lack of information on some key cost variables like long-term well decline rates. It also reflects uncertainties about whether the costs of some recent discoveries will match older, prolific formations.

Rising LNG imports have added to the range of gas supply options in recent years. Although the volume of US LNG imports will continue to increase, the short-run effect will be tempered by a continuing sharp drop off in Canadian pipeline volumes. Canadian production, about 60% of which is exported representing 15% of US supply, fell by about 9% in 2009. Longer term, the availability of low cost offshore LNG should however create a ceiling

Chart 4. US Supply Pendulum Has Swung Dramatically Towards Unconventional Production



Source: US DoE, Advanced Resources Int., CIBC

for North American gas prices, as rising liquefaction and import capacity leads to closer market integration.

recent decline in favour of a steepening trade on the front end of the NYMEX natural gas strip.

Two months ago we recommended a short exposure to the forward part of the NYMEX crude strip. We're recommending taking profits on that exposure after the

Table 2—**Spot Commodity Prices**

		Average					
		8-Feb	2007	2008	2009	2010 (f)	2011 (f)
Oil (WTI)	\$/bbl	72	72	100	62	75	80
RBOB gasoline	\$/gal	1.88	2.09	2.49	1.69	1.80	2.10
Heating Oil (NYH)	\$/gal	1.87	2.03	2.86	1.65	1.95	2.15
Natural Gas (Henry)	\$/Mn Btu	5.73	6.97	8.89	3.82	6.00	7.00
Gold	\$/troy oz	1064	695	872	1088*	1250*	1150*
Copper	\$/lb	2.92	3.24	3.16	2.35	3.30	3.30
Aluminum	\$/lb	0.90	1.20	1.17	0.76	0.85	0.80
Nickel	\$/lb	7.70	16.86	9.57	6.69	7.40	6.50
Zinc	\$/lb	0.91	1.48	0.85	0.76	1.00	0.90

* end of period

Recommendation Summary (for Institutional Investors):

Buy June-10 Lt Sweet Crude (approx. 74.50).

Buy Sep-11 NYMEX Henry Hub (approx. 6.00) Time Horizon 3-4 months.

Sell May-10 NYMEX Henry Hub (approx. 5.30) Time Horizon 3-4 months.

STRATEGIC RISK

MICHAEL ROSBOROUGH

Perception, Reality, Reform and Recovery

In the past two weeks the Financial Times of London and the New York Times have run articles praising Canada's financial system and citing it as a model for reform south of our border and elsewhere (*What Toronto Can Teach New York and London*, January 29, 2010, by Chrystia Freeland), and *Good and Boring*, January 31, 2010, Op ed by Paul Krugman). What's striking to someone like me who has spent parts of his career working in both the Canadian and American systems and in the British one is just how great a gulf exists between perception and reality in the US political debate about financial sector reform at the moment and how it is playing out in the market.

Where the debate leads is not just a matter of academic interest but is critically important in keeping the economic recovery on track. What is being proposed in the US is arguably much more relevant to fixing UK banks where the largest institutions truly were too big to be allowed to fail and where two of the big four banks, each with a balance sheet roughly the size of the British economy are now majority owned by the British taxpayer.

The real question in the US is not whether the banks were too big to fail but rather whether the financial system

was actually too dis-intermediated and too fragmented to succeed. The US government, unlike its British counterpart, has ended up with a minority equity interest in only one major bank and that institution, the largest US bank by assets when the financial crisis began, had a balance sheet that was less than one fifth the size of the American economy.

What did fail either outright or in fulfilling their missions in the United States were the agents and beneficiaries of the dis-intermediation process—investment banks (Bear Stearns, Lehman Brothers), credit insurers (MBIA, AMBAC), insurance companies (AIG), the GSEs (government sponsored enterprises, i.e. Fannie Mae, Freddie Mac), and, arguably the rating agencies in their evaluations of housing securities. It's hard to understand how a too big to fail regulatory reform process focused on US commercial banks addresses or ameliorates the problems posed by those non-bank entities and by the gaps that now exist.

What makes the question of how the intermediation process in the US will be fixed particularly important right now is that the "intermediary" of last resort, i.e. the Federal Reserve, is preparing to wind down its

Chart 1. **US 30-Year Mortgage Spread**



mortgage purchase program in March. This comes as the Federal Housing Finance Agency (the FHFA), the regulator in charge of Fannie Mae and Freddie Mac, has said it remains committed to reducing those companies' mortgage portfolios and that neither Fannie nor Freddie will be significant buyers or sellers of mortgages after the Fed's program ends. Rather, the FHFA expects private sector investors to step in to fill the gap as the Federal Reserve steps back.

The concern is that banks, under pressure on one side from politicians not to get "too big" and from shareholders on the other side to make sure that whatever new loans they do make are done to creditworthy borrowers at profitable spreads, will not take up the role traditionally played by Fannie and Freddie. A rational investor would be hard pressed not to think that mortgage spreads will widen when the Fed steps aside next month, and that can't be good for what remains a tenuous recovery in the housing market.

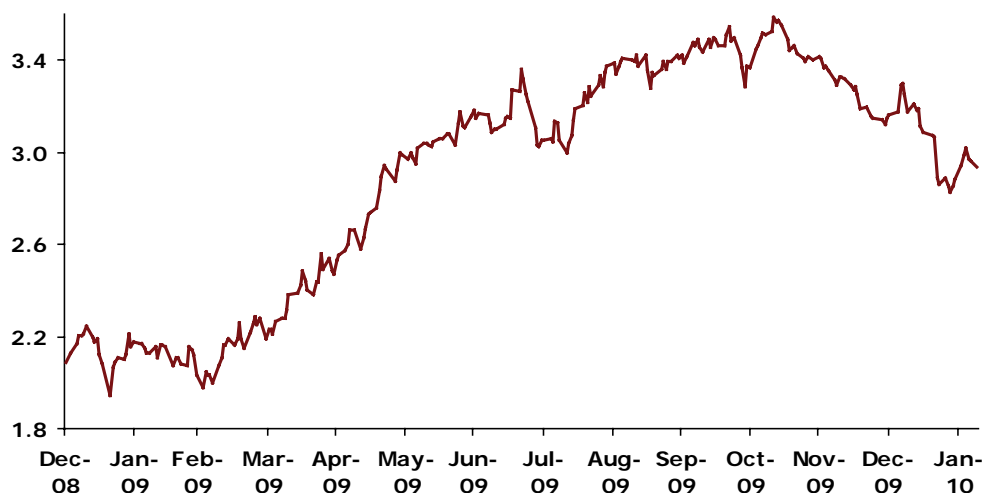
While it is too early to say anything conclusive about where American financial reform will ultimately lead, the betting now is shifting away from the "pre crisis" model of consolidation into fewer, bigger banks and an architecture based on dis-intermediation. In its place is a return to the "traditional" model of small regional based banks presumably originating and keeping loans and mortgages on their books funded primarily by domestic deposits. One way to look at the impact of the "Volcker Rule" and the underlying political shift from the pre crisis

to the traditional model is to compare the performance of the Amex Financial Select Index (IXM which has a related Exchange Traded Fund – XLF) versus the KBW Regional Banking Index (KRX with the ETF equivalent KRE).

IXM contains not only the big money centre banks but as well broker dealers, rating agencies and a number of the producers and end buyers of the securities that are products of dis-intermediation (REITS, insurance and mutual fund companies). The first part of the recovery of equity markets since March of last year clearly favoured the pre crisis model as the financial system pulled back from the brink. The shift to the traditional model since late last year has become more apparent as "too big to fail" has gained increasing currency in the political debate (note especially the drop in January this year on the announcement of the Volcker rule).

The speed with which US financial sector reform plays out and the ultimate shape it assumes is critically important. This is especially true as the Fed ponders its exit strategy since it entails a shift of lending back to private sector balance sheets. One of the drivers of the dual track bank consolidation and financial dis-intermediation process in the United States was the problem the traditional model had in managing and distributing risk as credit markets liberalized and interest rates became more volatile. Small was not necessarily beautiful as anyone who remembers the collapse of US savings and loans can attest. Big is not necessarily bad as Canada has shown. Adequate and coherent regulation is the key.

Chart 2. IXM Divided by KRX



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