



The Year Ahead

Mohammed Ahmed

Rates

(416) 594-8415

mohammed.ahmed@cibc.ca

Zafar Bhatti

FX Structuring

(416) 594-8090

zafar.bhatti@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

Internet:

http://research.cibcwm.com/economic_public/download/gps_jan10.pdf

on Bloomberg:

WGPS <GO>

Economics (Shenfeld): Healthy first half growth will fade in the latter part of the year, but not in time to prevent the Bank of Canada from raising rates by 75 bps in Q3, a couple of quarters ahead of the Fed, temporarily pushing the C\$ through parity, and contributing to a bearish flattening trend in bonds (pages 2-3).

Rates (Ahmed): Tighter monetary policy as Canada navigates an exit from the recession will result in higher rates and flatter curves, although longer-dated Canadas will continue to see outperformance relative to the US (pages 4-5).

Government Finance (Lovely): Notwithstanding a nascent recovery, nursing public finances back to health will take years. The 2010 budget season is the first and best opportunity to put budgets on a sustainable footing. Regardless, near-term funding needs will remain elevated, keeping provincial credit on the defensive and underperforming corporates. Fundamentals will increasingly exert influence on relative spreads (pages 6-8).

Credit (Zapior): Corporate spreads at the tail end of the Grand Spread Rally have some room to tighten further, but we believe this will happen over time when the market sees evidence of true recovery, however tepid it may be. Corporate debt issuer fundamentals are solid in Canada, but due to current valuation we think spreads will be range-bound in the near term, with the new reference range for spreads being the peaks from the 2002 downturn, and mid-2007 pre-crisis spreads (rather than the tightest levels from the mid-2000s) (pages 9-11).

FX Structuring (Bhatti): When it comes to the commodity currencies (AUD, CAD, NOK, BRL), let the trend be your friend in 2010—at least in the first half. These currencies have had a good run in 2009 but they are still below their 2008 highs. The next push higher may come from a recovery in demand from the US, but it could also come from widening interest rate differentials between these countries and the US (pages 12-13).

Commodities (Buchanan): Commodity prices have rallied earlier and far more forcefully to date than in past recoveries, and are at risk of getting ahead of themselves. While conditions remain supportive for now, a slackening in the US recovery's pace and moves by emerging market banks to retighten could catalyze a sizeable bull market correction in the second half of 2010 (pages 14-16).

Strategic Risk (Rosborough): The second year of recoveries from recessionary bear markets have portended positive and generally above normal returns if the S&P 500 is a reliable guide. Historically this is driven by earnings growth rather than multiple expansion and is consistent with our expectations for US earnings this year and next. Positive returns should also be expected from credit and from levered long trades in the belly of the US yield curve. The argument for a resumption of broad US dollar weakness in 2010 is less compelling, however, as secular imbalances decline and a cyclical story re-emerges (pages 17-18).

ECONOMICS

AVERY SHENFELD

Outlook 2010: Hot, Then Not

As the new decade gets underway, signs of economic momentum aren't hard to find, not only in North America, but globally. In part, that reflects a slightly disappointing finish to 2009, when, particularly in Canada, an expected second half surge came in at only half strength, leaving more room for the typical inventory cycle to lift output early this year. But revised Q3 US data also showed weaker inventories. As a result, we lifted our first half growth outlook for the US, and by extension, we now see Canada doing a bit better on the export front in that period. A faster revitalization in housing demand in Canada also leaves more room for the lagged lift to housing starts.

But near term momentum will include sources of growth that will fade, or even turn into drags, by the second half of the year. First, as is typically the case post-recession, restocking inventories will see production grow faster than underlying demand, but most of that juice will be gone by mid-year. The depths of the recession, particularly in the industrial sector, might argue for a larger or extended boost from inventory restocking, but there are reasons to be cautious on that score. Having been saddled with excess inventories in 2009, manufacturers might be more cautious in the near term. Just-in-time production and a greater economic role for services have seen inventories playing diminished roles in economic recoveries compared to decades past. Moreover, in Canada, a lot of the lift from rebuilding domestic inventories will benefit imports rather than homemade goods.

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

END OF PERIOD:	2010					2011	
	13-Jan	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	0.18	0.20	0.60	1.15	1.05	1.15	1.75
2-Year Gov't Bond	1.33	1.45	1.90	2.35	2.00	2.40	2.70
10-Year Gov't Bond	3.61	3.65	3.85	3.95	3.75	4.00	4.05
30-Year Gov't Bond	4.14	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	0.06	0.10	0.10	0.10	0.20	1.00	1.50
2-Year Gov't Note	0.96	1.05	1.10	1.20	1.35	2.20	2.45
10-Year Gov't Note	3.79	3.85	4.00	4.15	4.10	4.45	4.45
30-Year Gov't Bond	4.71	4.70	4.75	4.95	4.85	5.05	5.05
Canada - US T-Bill Spread	0.12	0.10	0.50	1.05	0.85	0.15	0.25
Canada - US 10-Year Bond Spread	-0.18	-0.20	-0.15	-0.20	-0.35	-0.45	-0.40
Canada Yield Curve (30-Year — 2-Year)	2.81	2.70	2.40	2.10	2.30	1.95	1.70
US Yield Curve (30-Year — 2-Year)	3.75	3.65	3.65	3.75	3.50	2.85	2.60
EXCHANGE RATES							
CADUSD	0.971	0.935	0.971	1.020	0.971	0.962	1.000
USDCAD	1.030	1.070	1.030	0.980	1.030	1.040	1.000
USDJPY	91	94	93	90	87	86	86
EURUSD	1.45	1.37	1.38	1.44	1.47	1.48	1.50
GBPUSD	1.63	1.56	1.58	1.66	1.69	1.69	1.71
AUDUSD	0.924	0.940	0.925	0.960	1.000	0.990	0.995
USDCHF	1.02	1.09	1.08	1.03	1.02	1.01	1.00
USDBRL	1.76	1.80	1.75	1.70	1.68	1.65	1.64
USDMXN	12.7	13.5	13.0	12.7	12.5	12.3	12.3

Second, US fiscal stimulus will turn from a source of growth to a drag by the final quarter of the year. In Canada, the timing of that swing is less clear, as governments have provided less clarity in when the money will be spent, but certainly, by 2011, the economy faces a substantial fiscal belt-tightening.

Finally, American consumers surprised a bit on the upside in Q4 2009, but the longevity of that lift is in doubt. Even if, as we expect, job creation turns positive in Q1, income growth could remain lacklustre in the face of substantial labour market slack that will depress wage rates. While wealth is recovering from the trough set last spring, losses on housing assets leave a huge hole in net worth that will prompt another leg higher in the savings rate. Banks are still weighed down by nonperforming loans, and are going to be slow in loosening lending standards to the household sector.

Canadians haven't been shy about borrowing at low rates from much-better-financed lenders, and house prices have recovered and pressed ahead to new highs in some markets. But debt accumulation is starting to put pressure on debt service levels, even before rates have come off their lows. That, and a potential correction in house prices as supply hits the market and mortgage rates begin to rise, could dampen both home building and the related wealth effect on consumption later in 2010.

Thus, in terms of economic growth, 2010 will enter like a lion, but exit like a lamb, with a disappointing deceleration in the second half. But that's a forecast, and asset markets won't see that slowdown coming for some time. First half results for equities, commodities and fixed income markets will, therefore, reflect generally healthy data.

Central banks are going to have to look carefully through the trees to see the overall forest. The US track record shows that the Fed can be extraordinarily patient—it took three years from the trough of prior recessions, each less deep than the 2008/09 slump, before the Fed's first tightening. Odds are that Bernanke will leave rates on hold until early 2011.

But the Bank of Canada has, historically, been more trigger happy. It launched premature rate hike cycles in 1992 and 2002, only to reverse them when the recovery disappointed. While we would counsel patience, particularly with a strong C\$ providing a brake on prices, we now see Carney hiking by 75 bps in Q3, before going back on hold in Q4 as softer news rolls in. Look for a flattening sell-off in the bond market, with room for a modest corrective steepening rally in the final quarter.

The Canadian dollar could be held in a sideways range by a tug of war from either end. A return to positive US employment data should see the greenback rally against other majors, but an earlier rate hike in Canada is likely to take the loonie temporarily through parity near mid-year.

Add it all up, and bond fund managers will have to be nimble to earn their keep, as a buy-and-hold strategy for government bonds will not fare well in a rising rate environment. And with the C\$ likely to explore both ends of a largely sideways trading range, currency investors are also going to have to be careful not to get too married to an existing trend.

Table 2. *Economic Update*

	09Q3A	09Q4F	10Q1F	10Q2F	10Q3F	10Q4F	2008A	2009F	2010F	2011F
CANADA										
Real GDP Growth (AR)	0.4	3.5	3.8	3.1	1.5	1.9	0.4	-2.5	2.3	3.0
Real Final Domestic Demand (AR)	4.7	2.5	3.5	3.0	2.7	2.4	2.6	-1.5	3.0	2.5
All Items CPI Inflation (Y/Y)	-0.9	0.8	1.6	2.0	2.4	1.7	2.4	0.3	1.9	2.2
Core CPI Ex Indirect Taxes (Y/Y)	1.6	1.6	1.8	1.7	1.7	1.6	1.7	1.8	1.7	2.1
Unemployment Rate (%)	8.6	8.6	8.3	8.2	8.3	8.4	6.1	8.3	8.3	8.1
U.S.										
Real GDP Growth (AR)	2.2	4.0	4.0	3.3	1.4	0.7	0.4	-2.5	2.8	2.4
Real Final Sales (AR)	1.5	3.0	2.1	1.8	1.2	0.7	0.8	-1.6	1.8	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	10.3	9.9	10.2	10.5	5.8	9.3	10.2	9.5

RATES

MOHAMMED AHMED

Higher, Flatter, Stronger

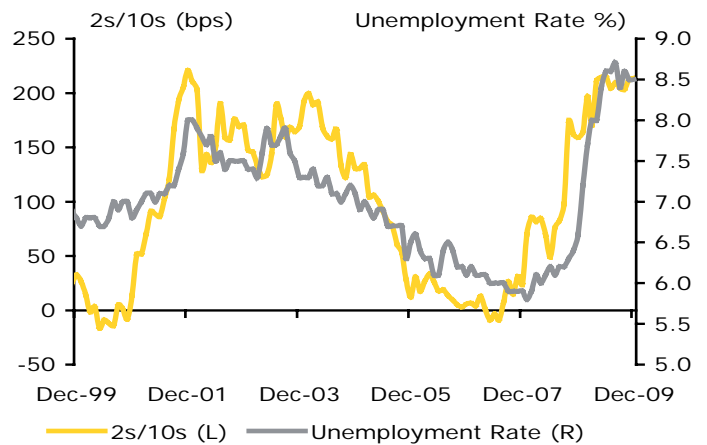
Following two years of steepening in an almost linear fashion, the Canada curve enters 2010 poised to flatten. However, the upcoming flattening episode may not be quite what markets are expecting to see. The path to cyclically flat curves will be a long and volatile one—a stark contrast to the express steepening route which has brought the curve to its current state.

In November’s edition of *GPS Monthly*, we stated the case for maintaining steepening exposure. Now, in light of the better-than-expected momentum in the Canadian economy, we are positioning with a flattening stance. While steepening pressures remain, sustained improvement in the coming months will motivate the Bank of Canada to raise the target rate by the third quarter of this year.

The recent past is littered with periods in which OIS and BAX markets had prematurely and aggressively projected rate hikes by the Bank of Canada, only to subsequently retreat. Still, although very short rates may not get the exact timing of the first rate hike right, a bear-flattening led by 2s can reasonably be anticipated prior to the expiry of the Bank of Canada’s conditional commitment to maintain the overnight target at the effective lower bound. In fact, history suggests that the bond market tends to lead central banks and pre-empt the improvement, or deterioration, of economic indicators. To this end, particular attention will be paid to labour markets as the unemployment rate stabilizes and jobs are added—albeit slowly (Chart 1).

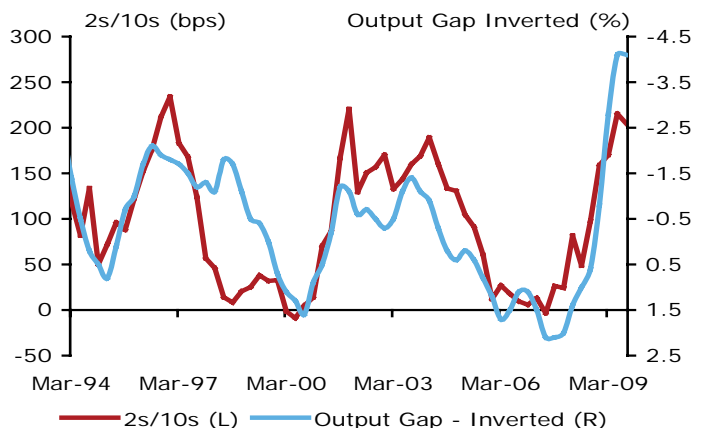
The upcoming trading year warrants an emphasis on the timing and execution of a flattening bias for several reasons. First, given the severity of the recession, the probability of a smooth recovery is slim (Chart 2). Uncertainty surrounding the resilience of the recovery has the potential to resurface in the second half of the year and push rates in the front-end down. Second, and at the other end of the curve, explosive growth in money supply may weigh on longer rates as investors will justifiably demand a greater inflation risk premium.

Chart 1. **Bond Markets Lead Fundamentals**



We forecast a swift bear-flattening of the curve, as steepening pressures are overcome by higher rates in the front-end, to be followed by a period of range-bound curves and heightened volatility. Recall that the period following the 2001 slump shared these characteristics and, as such, may be viewed as a plausible precedent. At that time, the Bank of Canada prematurely tightened monetary policy, only to reverse course when it became apparent that the economy wasn’t recovering as expected. True cyclical tightening didn’t begin until 2004 and, as a result, 2s/10s traded in an 80-bp range for almost three

Chart 2. **Steepening Pressures Remain**



Source: CIBC, Bank of Canada

years after the initial tightening. Although our forecast (see page 2) calls for a narrower trading range, the historical lesson is that complacency, once a flattening is seemingly underway, will be punished by volatility.

The negative carry of traditional flatteners, coupled with our outlook for a shallow flattening, encourages the use of alternative trades to maintain flattening exposure. For example, 2s/10s and 2s/30s term spreads cost 1 and 3 basis points per month, respectively, in financing charges. A less expensive alternative is a 2s/5s flattener; at -0.25 basis points per month, the carry is relatively affordable. A more cost efficient trade is to be long the belly versus the wings of the 2s/10s/30s butterfly. The butterfly spread is highly correlated with the slope of the 2s/30s curve, narrowing as the curve flattens (Chart 3), while also being carry-neutral.

Relatively Speaking

Monetary tightening by the Bank of Canada will not be matched by the Federal Reserve in 2010, as the latter faces drags associated with the unwind of fiscal and quantitative easing programs. Consequently, underperformance of Canada 2s versus US 2s will be significant.

Further out the curve, Canadas will outperform Treasuries in 10s and 30s. Canada's stronger fiscal position translates into relatively less supply to weigh on longer-dated yields north of the border. Moreover, as we have noted in the past, Canadas tend to outperform Treasuries in a rising yield environment (Chart 4). Hence, given the extent to which Canada has outperformed the US in the long-end over the past year, we look for periods of falling yields to enter this trade.

Prior to initiating a flattening bias, we had identified the potential for policy rates across the Dollar Bloc to diverge further and accordingly proposed a steepener in Canada versus a flattener in Australia (see "The Dollar Bloc Box", *GPS Monthly – December*). We now recommend exiting this trade at the target of 120 bps, for a profit of 20 bps.

In summary, 2010 will be characterized by higher rates, flatter curves and stronger relative performance in the long-end for Canada. Profiting from these themes will require being prepared for periods of increased volatility in which none of the above appear to hold.

Chart 3. 2s/10s/30s Butterfly Narrows as Curve Flattens

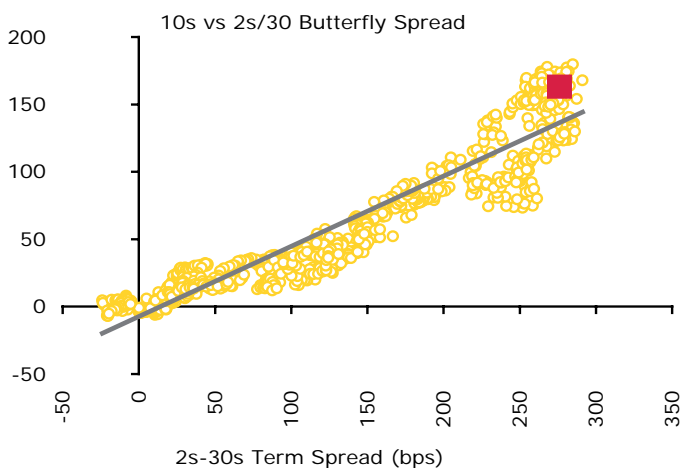
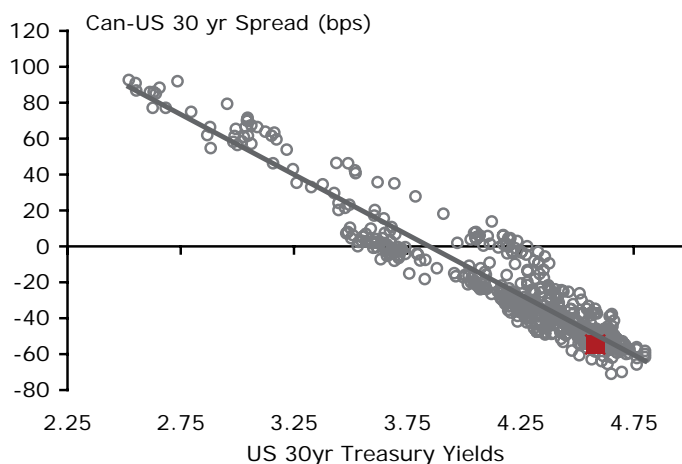


Chart 4. Canadas Outperform as Yields Rise



GOVERNMENT FINANCE

WARREN LOVELY

Governments Face Long Road Back

While an economic recovery is being cheered the world over, a fiscal correction will be slow in coming. Public sector stress will remain an overarching theme in the year(s) ahead. The relative strength of Canada's public finances is increasingly evident. Still, a commitment to stimulus and risks to growth mean a quick fiscal recovery will mostly prove elusive. Implications for citizens, taxpayers and debt capital markets will be real and lasting.

Plotting Exit Strategies

The focus of fiscal policy is shifting to exit strategies; how best to unwind stimulus without jeopardizing a nascent recovery. Healthy domestic demand means new programs won't be forthcoming, and unused allocations will be funneled to deficit reduction. Public support for tackling debt means Canada will be more aggressive than other, economically weaker countries in plotting an exit, cementing the country's superior fiscal credentials.

The coming 2010 budget season is a key vehicle to transition from stimulus to restraint. Given the size of the fiscal hole, one could characterize 2010 budgets as the most important in 15 years (Chart 1). With

majority governments in every province, there's hope for transformative thinking. However, a desire to seek re-election risks delaying painful fiscal medicine to another day, in what would be an unfortunate development to be sure.

To be fair, there is no easy fix; program spending needs to be placed on a sustainable track, a trend deceleration in revenue must be addressed and demographic challenges can no longer be ignored. While spending is receiving the greatest scrutiny, asset sales are on the table and higher taxes can't and won't be forever ruled out.

Meanwhile, debt affordability is a looming issue, serving as a potential catalyst for renewed pressure on provincial credit ratings. Our weighted-average provincial *Credit Rating Score* eroded by 10% in the past year (Chart 2), with downgrades (3) outstripping upgrades (1) and positive outlooks taken off four provinces. It could have been worse, as reprieves were in some cases granted till 2010 budgets. While there's not a single province currently on negative outlook from any one of S&P, Moody's or DBRS, that likely won't be the case in three months' time.

Chart 1. Largest Deficits in 15 Years

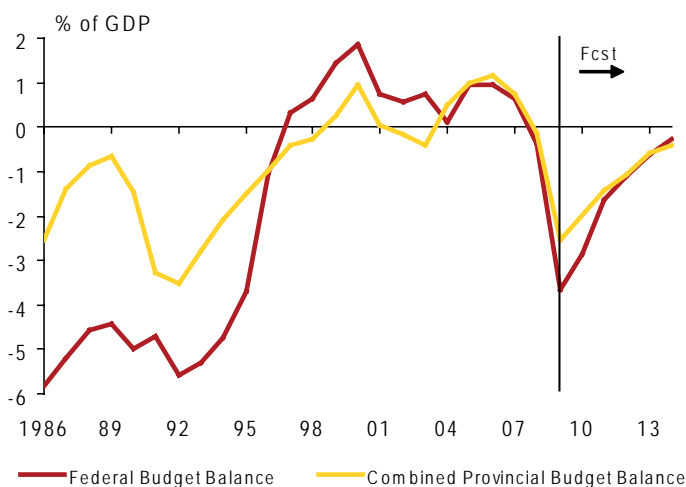


Chart 2. Provincial Credit Ratings Under Pressure

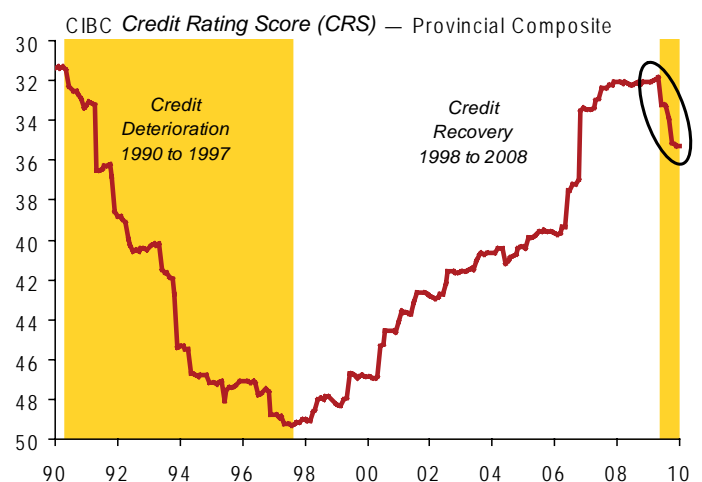
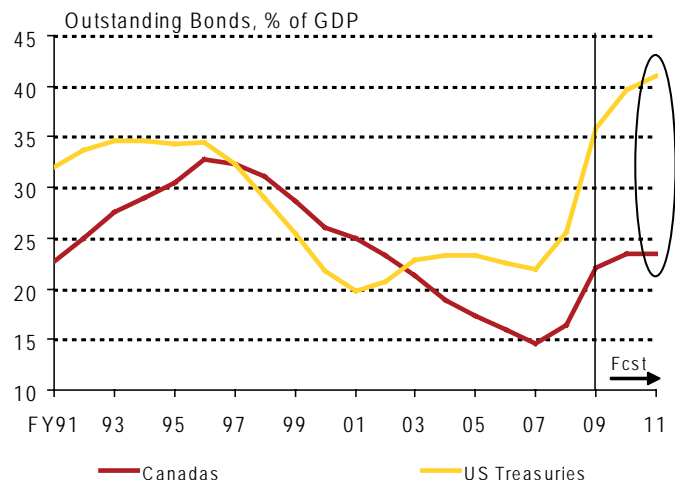


Chart 3. **Pronounced Funding Gap, Canada vs US**



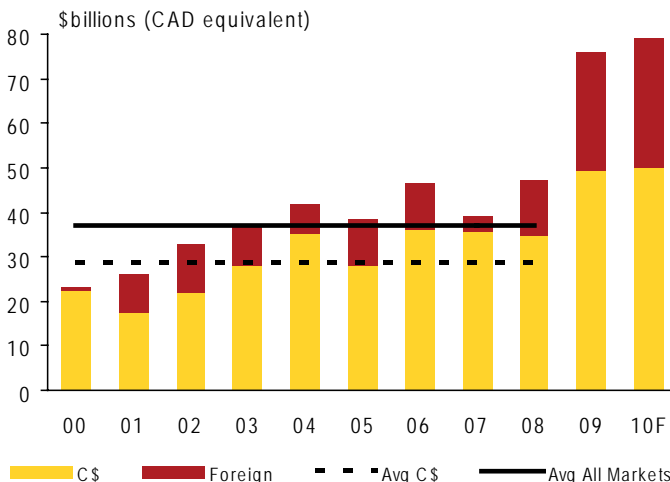
Government Borrowing Remains Elevated

In the end, supply matters. With a fundamentally smaller deficit, Canada’s federal government will maintain every bit of its edge vs Treasuries in bond supply (Chart 3). For the coming fiscal year, net Treasury issuance should be equivalent to 5%-plus of GDP, rising twice as fast net Canada issuance. Debt burdens have proven an effective predictor of long-term yields and support Canadian outperformance vs Treasuries in a post-QE world, even if premature BoC tightening triggers underperformance in the front-end (see pages 4-5).

What of Canada’s provinces? Although down from 2009/10’s peak, the combined provincial deficit should still top \$30 billion in fiscal 2010 or 2% of Canadian GDP. Add cash requirements for infrastructure programs and there will be no pullback in aggregate provincial bond supply. CIBC sees roughly \$80 billion of gross issuance in 2010, up from the \$75 billion brought to market in calendar 2009 (Chart 4) and comprising a growing share of government sector supply. While not part of our base case assessment, asset sales do have the potential to provide temporary relief.

To their credit, Canada’s provinces have stayed ahead of their borrowing programs. A continuation of that theme would translate into meaningful pre-funding in the final weeks of fiscal 2009/10. A steady drum beat of supply suggests recent spread performance will stall out before budget and rating agency blackouts become a factor in March and April.

Chart 4. **Provincial Issuance Heads Towards \$80 Bn**



International Markets Remain Vital Outlet

Provinces will remain keenly focused on international markets as a means of limiting domestic market saturation. Some \$27 billion was raised in foreign markets in calendar 2009, soaring nearly \$20 billion above the prior long-term average. Foreign currency supply will likely head higher still in 2010, with a growing list of names tapping key international markets. Witness Manitoba’s recent USD offering, the first non-Ontario province to issue in that market since Spring 2008.

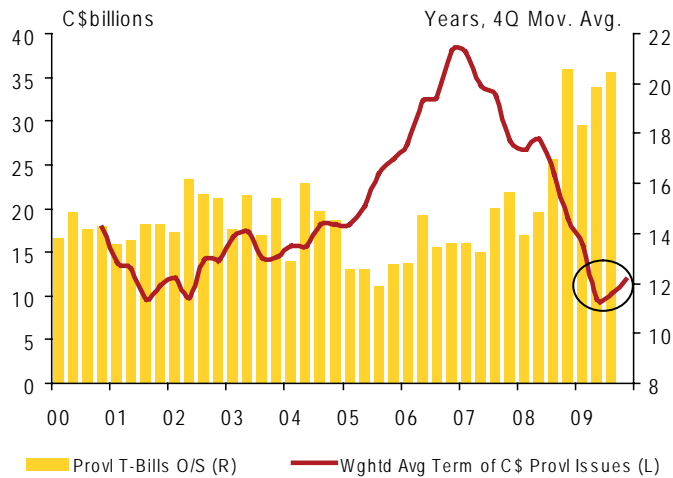
We are encouraged by recent deals which show Canadian credit is in demand, but note that further pressure on ratings has the potential to dull the appetite for some provincials. And relative to corporates, provinces have attracted a smaller share of foreign bond investment of late.

Overall, we see provincials lagging corporates in the credit cycle, characterized by spread underperformance despite today’s historically tight basis between provincials and corporates.

Issuing Strategy Will Evolve

Issuers will aim to extend duration where possible, correcting for disproportionately shorter supply in 2008-2009 and locking-in rates before they get away from them. Recall that many provincial issuers were pushed down the curve by a flight to safety and by a technical bid from bank treasuries. During 2009, some 45% of

Chart 5. **Provinces Have Been Driven Down the Curve**

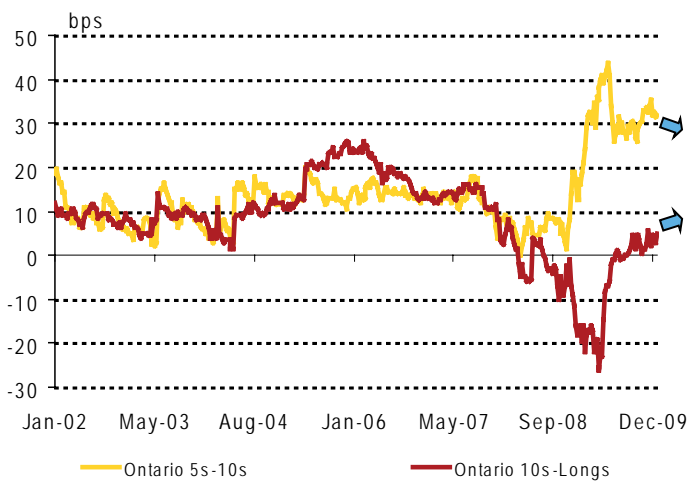


domestic provincial issuance was 5-years or under, the largest annual share of the decade. Meanwhile, the weighted-average term of all C\$ provincial issues, at 12-years, was some five years shorter than the pre-crisis trend (Chart 5).

Meanwhile, the money market has been more than a short-term funding tool for some. While cost-effective, an enlarged provincial bill stock, alongside increased issuance of FRNs is boosting interest rate reset risk in what will soon be a rising interest rate environment.

With issuers eyeing the long end, spread performance out the curve looks to be met with supply, leaving us biased towards a steepening of the 10s-longs credit curve (Chart 6). Economic uncertainty and financial market volatility may argue for staying short, but we see value in

Chart 6. **Provincial Credit Curves: Value in 10s**



10-years and anticipate a flattening of 5s-10s as demand moves out the curve in search of spread and yield.

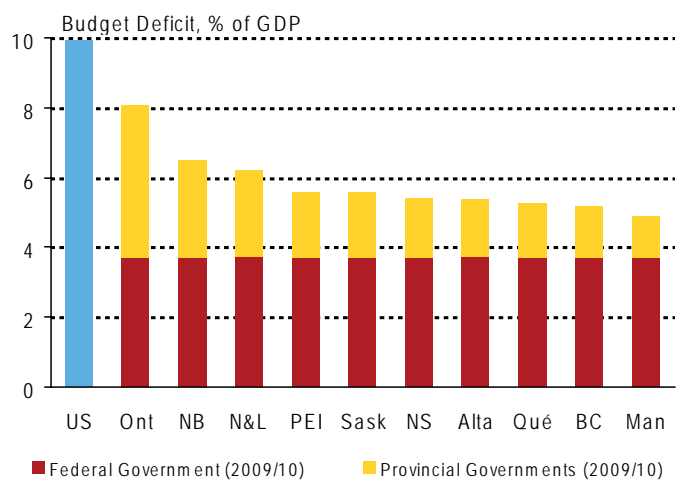
Fundamentals to the Fore

Not all provinces are created equal. In recession and recovery, national growth rates mask an uneven regional backdrop, and the starting point for the coming fiscal correction varies significantly across the country (Chart 7). Manitoba has the smallest deficit to address, while resource-rich jurisdictions will generally dig themselves out of deficit much sooner than Central Canada. Refer to our December issue of GPS for a look at fiscal prospects in Canada’s commodities provinces.

With illiquidity premiums shrinking, fiscal fundamentals and relative supply expectations will dictate relative spread performance. There’s value to be placed on name diversity and rating agency actions have the potential to re-price the space this Spring, similar to what we witnessed last Fall. In sum, expect ongoing re-alignment within a broadly defensive environment.

The good news: recovery is at hand, competition from other sectors is manageable, international markets are embracing Canadian credits, and ample cash remains to be deployed in the domestic market. It won’t be easy, but now’s the time to embark on the tough journey ahead.

Chart 7. **Uneven Fiscal Performance**



CREDIT
JOANNA ZAPIOR

Expectations of Mild Recovery Spell Range-Bound Corporate Spreads

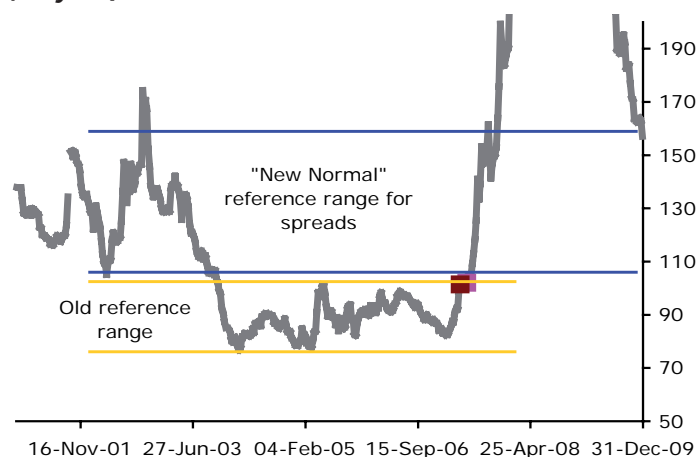
Our base case scenario for Canadian corporates is a mild recovery in the underlying economic fundamentals. The downside scenario would likely be driven by a return of macro headline risks, most likely related to an ungraceful withdrawal of the global stimulus. It is the double-dip scenario—similar to what we had in Canada in the early 1990s.

Domestic Corporate Credit Fundamentals are Solid

Our market is investment grade (with an average rating around BBB+), corporate leverage is stable and manageable, companies have built liquidity buffers and have controlled both operating and capital expenditures. The downgrade to upgrade ratio among Canadian corporates has been 1.3 downgrades for each upgrade for the past two years, and fewer than 20% credits are on negative outlook by a rating agency. To put this in context, globally downgrades exceeded upgrades by three to one in the third quarter of 2009, and by 14 times in the first quarter of 2009. In the US alone, according to S&P, about 50% of ratings have negative outlooks, though the most recent agency activity has been positive. The one thing we are watching is operating profits; notably, we are looking for evidence of operating leverage that companies argue they created through the restructuring and cost cutting of the last two years. We also note evidence of an increase in “shareholder friendliness”.

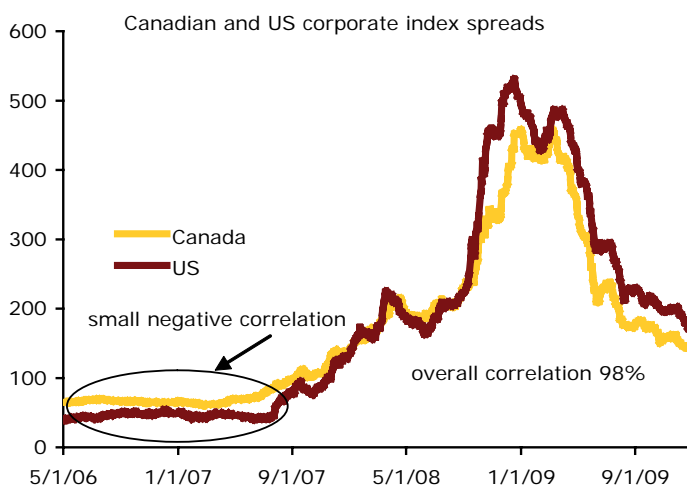
In our base case scenario, we see range-bound spreads. We feel that the spread rally has run its course, and the market should see a confirmation of real economic recovery before it embarks on the last leg of spread tightening. Nevertheless, even after the Grand Spread Rally, our spreads are still at levels that we saw near the peak of the 2002 downturn (Chart 1). This gives us some comfort that we are pricing in at least some downside risk. With firm evidence of continued recovery, there will be room to tighten further, though we see a new reference range for corporate spreads, bound at the tight end by spreads we saw in the first half of 2007.

Chart 1. **Our New Reference Range for Corporate Spreads (10-year)**



There is one proviso. Canadian corporate debt spreads have historically been very highly correlated with US corporate bond spreads (high 90% range) (Chart 2). This correlation does not necessarily hold at all times. For example, it was actually slightly negative in the heady days of the mid-2000s, when structured credit demand pulled global credit spreads to historically tight levels,

Chart 2. **Canadian Spreads Have Historically Been Correlated With US Spreads**



with Canadian spreads following suit but not quite to the last basis point. Should US spreads continue to rally, (as Michael Rosborough argues they may— see our Strategic Risk article on page 17) they may pull Canadian spreads tighter “in sympathy”, and sooner than the macro-economic fundamentals would suggest. In the first two weeks of the year, it certainly seemed as if this proviso was in effect, though as we go to print spreads have paused.

We See New Issue Supply as Fully Manageable

Supply will likely be front-loaded on the calendar, given that the all-in cost of funding is possibly at a minimum level (Table 1). We expect an increase in bank issuance after the dramatic decline in 2009. More so, we anticipate a continuation of strong issuance in the non-financial space, as new and higher-yielding names shift their funding towards public markets and away from the banks. The scale of this issuance, combined with the composition of the buyer base, has the potential to make our higher yielding space more robust than it turned out

Table 1. **New Issue Supply Patterns**

	2007	2008	2009	
Bank	\$32,470	\$35,350	\$15,589	↑
Life insurance	\$1,768	\$2,350	\$5,221	↓
Other financial	\$6,845	\$3,475	\$7,175	
Energy	\$2,055	\$5,291	\$9,640	
Oil and gas	\$1,750	\$1,450	\$150	
Consumer	\$467	\$830	\$1,400	
Telecom	\$2,400	\$500	\$8,100	↓
Other	\$9,949	\$7,462	\$8,192	↑
Maples	\$27,790	\$805	\$1,250	↑
ABS	\$6,111	\$5,160	\$1,390	
TOTAL	\$91,604	\$62,672	\$58,107	↑
Canadian Yankees	\$25,668	\$31,523	\$39,285	

to be in the mid-1990s, when high yield issuance fizzled out after the initial enthusiasm.

Our market continues to be driven by domestic investors, but we think that going forward we may see more foreign interest in C\$ issuance as Canada is attractive in

the global context. We think a return of Maples could become a catalyst here—not just financial and quasi-sovereign Maples, but also perhaps some corporate names.

There is a small supply risk, actually external, as we could see corporates crowded out by mounting government issuance. We think this risk is small given a good track record of provincial issuers in managing their new issue supply between domestic and foreign issuance in past periods of elevated funding. In fact, given this elevated funding need, and a deteriorated fiscal position of Canadian governments—in contrast to a better managed credit quality of Canadian corporate debt issuers—our top-down analysis suggests that corporate spread performance should lead provincial spread performance in the next three to six months.

Under the Circumstances, a Small Overweight on Corporates is Still Appropriate

Just as our top-down approach leads us to a conclusion that we are comfortable with corporate exposures, our bottom-up analysis leads us to a small overweight on corporates. Our recommendation framework combines sector fundamentals and valuation in our two scenarios—downside with a spread reference point to mid-2002, and upside with a spread reference point to the first half of 2007.

Based on these considerations, we overweight insurance vs. banks (on valuation, as well as due to the benefit of insurance companies’ exposure to the growing and demographically favourable markets), oil and gas (mostly on a combination of scarcity in the bond market and good fundamentals as valuation is getting expensive) vs. the rest of the energy sector (but notably the rich in spread gas utilities), and retail (especially the discount-oriented credits) vs. telecoms (Table 2 and Chart 3, next page).

Given the macro and yield curve environment our preference is for the short end, though in the near term we see potential for credit curve flattening as it has not fully normalized, whether we compare the current steepness of the credit curve to a long-term average, or to the curves at each of our reference points, 2002 and 2007 (Table 3).

Table 2. Summary Sector Recommendation

	% index	% '09 issuance	rating	current spread ¹	our view
Financials²	41%	37%			
Banks	32%	28%	AA	57 bps	MW
Insurance	9%	9%	A+	78 bps	OW
Energy	19%	17%			
Power	8%	10%			
Generation			BBB+	200 bps	MW
Diversified			A-	93 bps	MW
Wires			A+	56 bps	MW
Oil + gas transp.	11%	7%			
Gas utility			A-	56 bps	UW
Pipelines			A-	71 bps	MW
Exploration	2%	<1%	BBB+	94 bps	OW
Consumer³	11%	18%			
Retail	4%	3%	BBB+	124 bps	OW
Telecom	7%	15%	A-	120 bps	UW

¹ Constant maturity five-year spread vs. curve. Average of selected frequent issuer spreads. Telecom includes telcos and cable. However, cable shifted from high yield to investment grade during our comparative period, making comparisons over time difficult. Even within the telco space, spreads comparisons are distorted by a major, aborted, LBO activity). As of January 11, 2010.

² Excludes non-domestic bank and all speciality finance issuance. Including those, all financial credits account for 57% of the index, and 50% of 2009 issuance.

³ Overweight in retail is focused on the discount segment. In telecom, UW telcos and MW cable. OW = overweight. MW = market weight. UW = underweight

Chart 3. Sector Relative Value

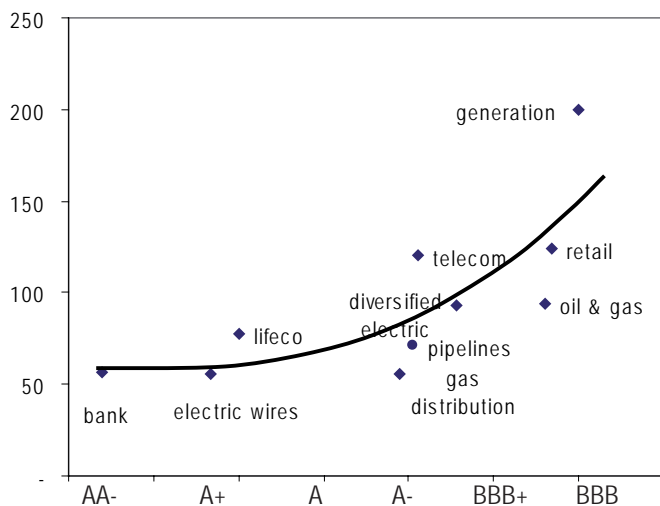


Table 3. Credit Curve is Still Historically Steep

in bps	5-10s	10-30s
Current	43	53
15-Jun-07	33	42
2-Aug-02	40	16
vs. 2007	10	12
vs. 2002	3	37
vs. avg ¹	9	28

¹ Average calculated since 2001

FX STRUCTURING

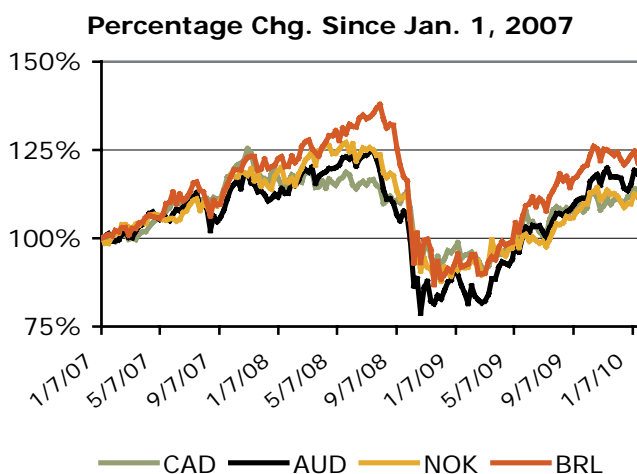
ZAFAR BHATTI

Commodity Currencies to Perform in 2010

It is difficult not to be bullish of commodity currencies going into 2010. Their performance last year was impressive and the commodity currencies (AUD, CAD, BRL, NOK) recovered most of their strength versus the USD but none of them are stronger than their pre-crisis 2008 highs (Chart 1). As a group, the easy move stronger has already occurred but each currency still has potential to strengthen further this year.

A strong case can be made for the commodity currencies regardless of the path of the US economy. If the US economy shows signs of life then commodity currencies will strengthen in anticipation of an increased demand for resources. A weak US economy could tempt the American government to tacitly support a weaker US dollar in an effort to stimulate exports. The follow-on effect of this strategy is that commodity prices will tend to move up in US dollar terms because resource producers demand higher prices for their products when the transaction currency weakens. Recent economic numbers out of the US lend some credence to this line of thought. The US economy is having a difficult time creating jobs which may delay US rate hikes, while US debt continues to be racked up. These factors may ultimately cause capital to move out of the US dollar and into higher yielding currencies.

Chart 1.



As Australia showed us in September and Norway in October, resource-driven economies may be the first ones to raise interest rates from historically low levels. A combination of international demand (i.e. China) for their products and robust local demand driven by low interest rates is raising inflation fears. These central banks have raised rates in an attempt to cool domestic demand and head off inflationary concerns. However, in the developed world where everyone has pushed domestic rates to near zero, a single country raising rates attracts unusual attention from yield-seeking international investors. This foreign inflow of funds has caused these currencies to strengthen in response. The combination of higher interest rates and a strengthening currency makes the trade even more profitable in the short-term and leads to follow-on investing.

There are a couple of reasons why Canada and Brazil have been slower to act on the interest rates than Australia and Norway. The economic fundamentals have shown that inflation concerns are minimal right now and both economies are concerned about the drag on exports from historically high exchange rates. Although both central banks have taken up the challenge of providing economic life support through low interest rates, they are mindful of the impact on exchange rates once they start raising interest rates. In an ideal world, the Bank of Canada would not raise interest rates until the US did the same, in order to avoid the collateral damage to the economy from a stronger Canadian dollar. As CIBC's 2010 forecast suggests, a rate increase in Canada ahead of the US will push the Canadian dollar through par. How long the Canadian dollar stays stronger than par is largely a function of how much the world dislikes the US dollar and Canada's ability to adapt to the strong local currency. History would suggest that Canada will see par this year, yet the real question is how far through par and can the move be sustained.

On the basis of this view, two option strategies have been presented that allow investors to sell the USD versus the AUD and/or CAD.

TRADE IDEA: SWITCH FORWARD FOR USD SELLER

The Switch Forward strategy allows clients to enter into a forward contract in which they sell USD at a significantly improved rate relative to the prevailing outright forwards and agree to receive either CAD or AUD at maturity. The USD/CAD and AUD/USD forward rates are determined at inception and are both better than the respective vanilla forward rates. At maturity, CIBC will decide whether it wants to deliver CAD or AUD in exchange for the USD.

INDICATIVE TERMS: SPOT REF. OF 1.0280 CAD PER USD & .9240 USD PER AUD

Client Position:	Sell USD / Buy CAD or AUD
Term:	3 months
Premium:	none
Notional:	US\$ 10,000,000
Switch Rates:	Sell USD vs. CAD @ rate of 1.0490 CAD per USD Sell USD vs. AUD @ rate of .9010 USD per AUD
Switch Condition:	At maturity, CIBC will choose to deliver either CAD or AUD at its sole discretion. Client will either <ol style="list-style-type: none"> 1. Sell US\$ 10,000,000 / buy CAD 10,490,000 OR 2. Sell US\$ 10,000,000 / buy AUD 11,098,779

As a basis for comparison, the 3 month vanilla forward rates are:

1.0280 CAD per USD and .9150 USD per AUD which would only net the following CAD 10,280,000 or AUD 10,928,962. In cash terms, the switch forward improves the amount to the client by either CAD 210,000 or AUD 169,817.

TRADE IDEA: FREE PUT INTO A COLLAR STRATEGY

This strategy is suitable for clients that have a view that the US Dollar is going to weaken and they want to own a USD Put without the upfront premium. At inception, the client owns a USD Put with no cash outlay. This option is financed by the client agreeing to double the notional of the USD Put and capping the upside potential (buy selling a USD Call) if the USD strengthens and touches a Conditional Trigger level before expiry. If the trigger is touched (at any time), the client now owns a collar that has a better terms then were available at inception.

INDICATIVE TERMS: SPOT REF. OF 1.0300 CAD PER USD

Client Position:	Sell USD / Buy CAD
Term:	3 months
Premium:	none
Notional:	US\$ 5,000,000 or US\$ 10,000,000 if the trigger is touched.
Conditional Trigger:	Spot market touches a level of 1.1100 CAD per USD over the term
Payoff:	At maturity, the client will either receive the payoff of either a USD Put or a Collar <ol style="list-style-type: none"> 1. If the trigger has not been touched → Own a USD Put with a strike of 1.0100 for US\$ 5 million, 2. If the trigger has been touched → Own a Collar with a range of 1.0100 to 1.0650 for US\$ 10 million,

As a basis for comparison, the zero cost Collar that would be available today would have a range of 1.0100 to 1.0500 on even notional amounts. This range is 150 points less attractive then the collar shown above. The USD Put that the client is receiving for no cash outlay would cost 1.5% of the USD notional if the client was to pay for it outright.

COMMODITIES
PETER BUCHANAN

A Strong Start But Growth, Policy Risks Could Cool the Party

It's a new year so we've zoomed out for a broader look at the landscape this month. Commodity markets followed up 2008's epochal sell-off with an epic rally in 2009. The S&P GSCI Index and CRB both racked up their best performance in three decades, as the emerging market economies paced by China helped to lead the world out of its deepest, broadest recession since World War II, breathing life back into global resource demand.

The global economy should expand by 3.8% this year and 3.5% in 2011 (Chart 1). That's a percentage point shy of the pace before the Great Recession, but not so bad given earlier beaten down expectations. Those averages, however, mask some sharp variations, among countries as well as over time. Growth in the US, and other industrial countries should start the year at a decent clip, but slow appreciably from there, as the forceful two-pronged lift from fiscal policy and inventory rebuilding fades. The emerging markets will again be in the driver's seat this year. In a change, investors will clearly be focusing not just on economic prospects in those countries, but also discretionary changes, as rising inflation in some countries like China pressures policymakers.

Chart 1—Global GDP Growth

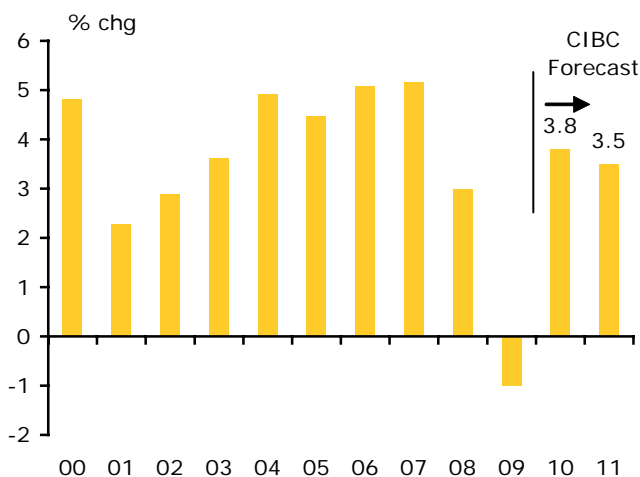
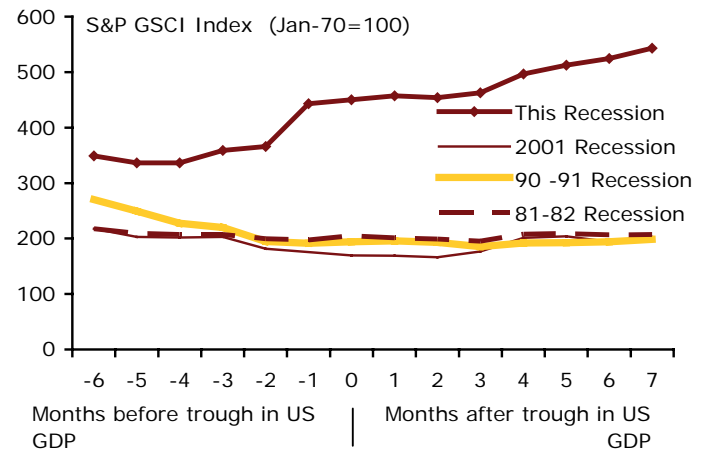


Chart 2—Commodities Have Rebounded Earlier and Steeper Than in Past Cycles

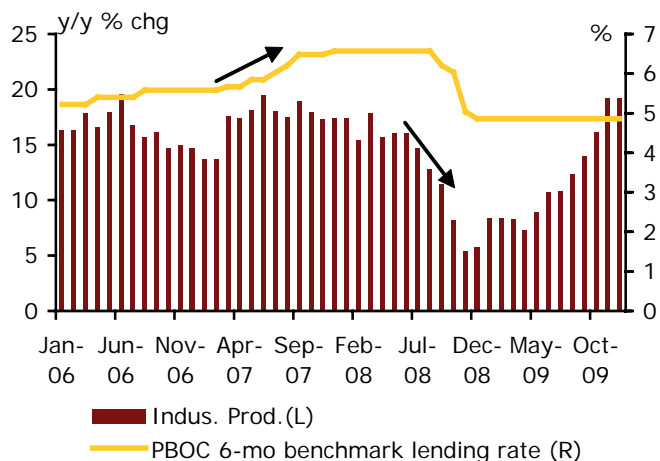


Risk of 2nd Half Bull Market Correction as Rally Outpaces Fundamentals

Resource prices for the most part never fell as low in this recession as past ones and have raced out of the recovery starting gates earlier and faster (Chart 2). Barring a double dip—which we don't currently envision—the global economic recovery is still in its infancy. While that suggests further headroom looking two to three years down the road, the rally's sheer exuberance in the context of a still somewhat uneven global recovery creates appreciable nearer term risks.

Emerging markets still appear to have lots of steam. China's recent tightening moves will take time to materially slow near-20% annual production growth there, if history is any guide (Chart 3). Investors are also treating commodities these days as an investment class, reinforcing demand. Restocking, only getting underway in many industrial countries, should also lift demand. While those forces should help to keep the rally on track for now, recoveries never move in a straight line. We would not be surprised to see a 10-15% bull market correction in the second half of the year, as industrial economies like the US decelerate and emerging market central banks start or intensify their restraint efforts.

Chart 3. History Suggests China's Tightening Moves Won't Slow Economy Immediately

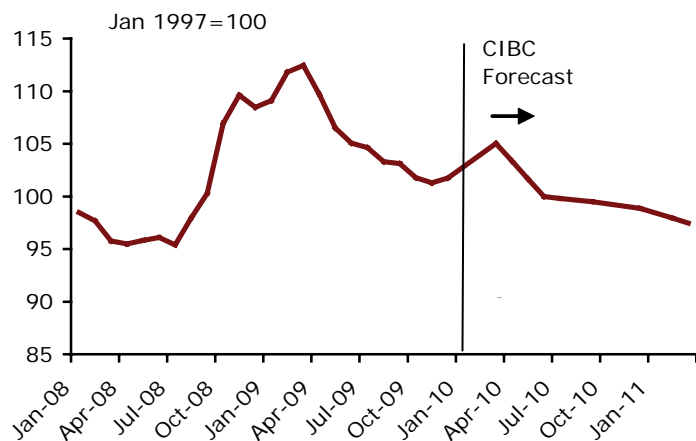


One of 2009's drivers, a downsized greenback, also likely won't offer such steady support this year. While the greenback will likely end the year lower than today in trade-weighted terms, we think the currency's relief rally could continue for 2-3 months more. In the short run, that could also help to temper still-supportive fundamentals in some sectors (Chart 4).

Oil Rally Has Outpaced Underlying Fundamentals

A severe start to the winter in many countries has helped lift both oil and gas in the last month. Although a continuing recovery and rising supply curve could offer longer term support, the size of oil's run-up from its recessionary lows appears unwarranted on a number of fronts. OPEC spare capacity remains at unusually high levels, at 5-6 mn/bbls per day (Chart 5, left). Demand in China grew by 6% last year but in what is still the world's

Chart 4. US Dollar Broad Trade-Weighted Index



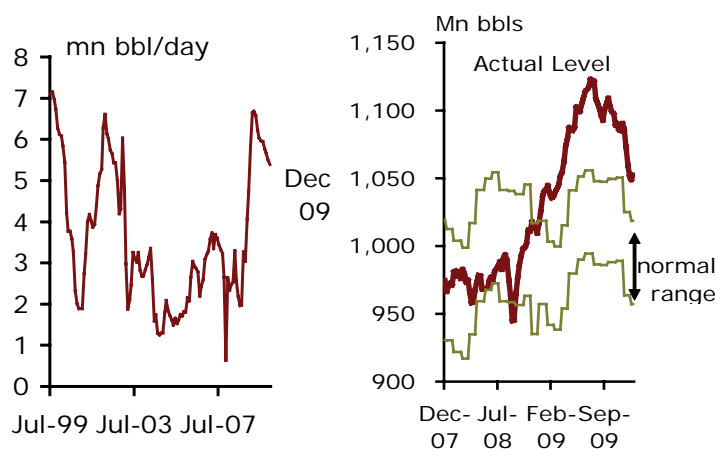
largest market, the US, it remains nearly 10% below its pre-recession peaks. Our forecast of an average well head price of \$75/bbl this year and \$80 in 2011 implies some downside risk for prices in the near term, and a slower ascent thereafter than some observers expect. Meriting caution, inventories in both the US and the OECD remain on the high side (Chart 5, right).

Henry Hub natural gas spot prices have risen from 8-year lows last fall to \$5.70/Mn Btu recently. As the economy recovers, we expect prices to benefit from improving demand, particularly from industrial users and power generators. Unless temperatures continue to match recent extremes, however, US inventories are likely to enter the Spring shoulder season on the high side. US dry gas production, moreover, rose by nearly 4% last year even with drilling cutbacks. Given rising conventional production, a subdued recovery and still-above-average storage levels, we expect price increases, but not dramatic ones, over the next 12-18 months. Henry Hub prices should average \$6.50/Mn Btu in 2011, compared to \$5.50 this year.

Paced by a doubling in copper and zinc prices, the base metals segment readily eclipsed most other commodity segments last year. A stronger-than-expected recovery in some consuming countries and interest in commodities as an investment contributed to 2009's forceful gains. While China's imports have settled back in recent months, they remain much above historical levels, suggesting some resilience in demand (Chart 6).

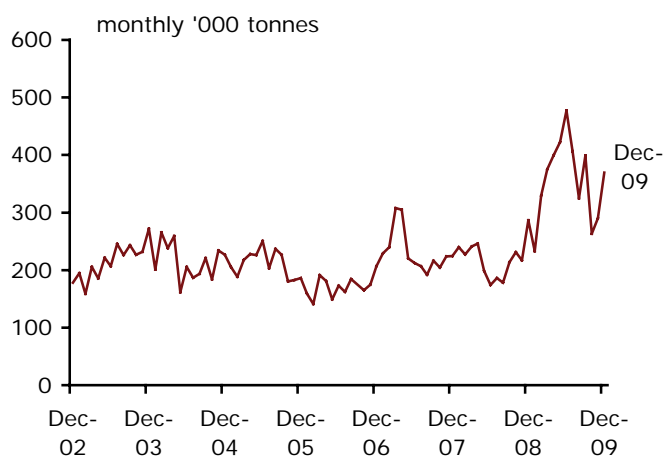
Copper remains our favourite area for exposure within the metals group, based on supply and demand fundamentals, although neither it nor other segments

Chart 5. OPEC Spare Capacity (L) and US Oil/Product Inventories Still High (R)



will emerge totally unscathed in the event of a broadly based temporary pullback in resource prices in the second half of the year.

Chart 6. **China's Unwrought Copper Imports**



Raising Year-End Target for Gold But Fed Tightening a Risk For 2011

Notwithstanding our caution on the next 10-12 months, we've raised our year-end target modestly for gold to \$1250/oz for the end of 2010. The US dollar's relief rally has reduced, though not eliminated, the near-term risk for the metal from what we believe was earlier excessively bearish dollar sentiment. Helping non-interest bearing assets and gold in particular, a weak recovery will also keep the Fed on hold until early 2011. While stable US rates, a renewed selling trend in the dollar and equity market disappointments could help gold as the year wears on, rising rates are likely to weigh once policy does turn in 2011. Inflation also isn't likely to come roaring back in the next year or two, even with strong recent money supply growth. We consequently see the metal ending 2011 back at the \$1150/oz mark, 10% or so off its interim peaks.

Table 2—**Spot Commodity Prices**

		Average					
		15-Jan	2007	2008	2009	2010 (f)	2011 (f)
Oil (WTI)	\$/bbl	78	72	100	62	75	80
RBOB gasoline	\$/gal	2.04	2.09	2.49	1.69	1.80	2.10
Heating Oil (NYH)	\$/gal	2.03	2.03	2.86	1.65	1.95	2.15
Natural Gas (Henry)	\$/Mn Btu	5.77	6.97	8.89	3.82	5.50	6.50
Gold	\$/troy oz	1128	695	872	1088*	1250*	1150*
Copper	\$/lb	3.36	3.24	3.16	2.35	3.50	3.30
Aluminum	\$/lb	1.03	1.20	1.17	0.76	0.85	0.80
Nickel	\$/lb	8.40	16.86	9.57	6.69	7.80	6.50
Zinc	\$/lb	1.11	1.48	0.85	0.76	1.10	0.90

* end of period

STRATEGIC RISK

MICHAEL ROSBOROUGH

A Year of Living Normally?

Looking forward into 2010 after the drama of the past two and a half years is it safe to bet that we are embarking on a year of living normally? If so, what does that portend for asset returns and strategic risk taking? What mix of leverage, asset selection and active trading will be required to generate the mid-teen levels of return that are the mandate of most hedge funds and proprietary traders? It is instructive to look at history to get a sense of the type of gains one sees in the second year of a market recovery and what the drivers of those returns are. The table below includes all US economic recessions since the market crash of 1929 (as defined by the National Bureau of Economic Research) that were accompanied by equity bear markets (a peak to trough fall of 20%).

Table 1 should be viewed in the context of compound annual returns of 5.9% without dividends and 9.9% with dividends for the period from 1937 to 2009. The average

Shiller P/E ratio for the period is 17.6 and the median is 16.5. (The Shiller P/E is a trailing 10 year inflation adjusted P/E multiple). It is a small sample set but assuming history is a guide, returns in the second year of recovery from a recession bear market have been uniformly positive. Second year returns tend, however, to be much more in line with, though generally above, "normal" returns versus the exceptional gains we had in 2009 and in the first year of past market recoveries when multiple expansion and earnings recoveries off a depressed base are working in the investor's favour.

In the second year of recovery multiples tend to be stable to expanding slightly leaving earnings as the primary driver of market return. In the context of CIBC's expectations for US pre-tax profit growth of 17.5% in calendar 2010 and 9.2% in 2011, a stable to slightly expanding multiple should generate low to mid-teen US equity returns over

Table 1. **S&P 500 Performance in Recessions and Recoveries**

NBER Recession Dates	Market Peak	Market Trough	S&P 500 Decline	Dividend Adjusted	Trough + 1 year return	Trough + 1 year to + 2 years return	Shiller Peak P/E	Shiller Trough P/E	Shiller P/E Trough +1 year	Shiller P/E Trough +2 years
05/1937 06/1938	3/10/37	3/31/38	-54.5%	-51.5%	34.5%	16.9%	22.4	12.4	15.7	16.2
11/1948 10/1949	6/15/48	6/13/49	-20.6%	N/A	42.0%*	12.0%*	11.6	9.1	11.6	11.6
08/1957 04/1958	7/15/57	10/22/57	-20.7%	N/A	31.0%	9.7%*	16.9	14.2	16.6	18.0
12/1969 05/1970	11/29/68	5/26/70	-35.9%	-32.5%	48.0%	14.7%	22.2	14.0	17.6	17.7
11/1973 03/1975	1/11/73	10/3/74	-48.2%	-45.0%	43.9%	25.6%	18.7	8.7	10.3	11.4
07/1981 11/1982	11/28/80	8/12/82	-27.1%	-20.1%	65.9%	6.4%	9.7	6.6	9.7	9.6
07/1990 03/1991	7/16/90	10/11/90	-19.9%	-19.2%	33.6%	10.1%	17.8	14.8	18.3	19.4
03/2001 11/2001	3/24/00	10/9/02	-49.0%	-47.0%	36.2%	9.9%	43.2	22.0	25.7	26.5
12/2007 ?	10/9/07	3/9/09	-56.8%	-55.3%	71.1%**	?	27.3	13.3	20.8	?

* Does not include dividends ** Return from March 9, 2009 to January 15, 2010

the forthcoming year without leverage. With the VIX now just below 18% and trailing volatilities now falling quickly from their exceptional peaks, risk appetite should continue to improve. Given the low level of current interest rates and declining volatility, a Sharpe ratio near 1.0 is conceivably achievable on an unlevered long S&P 500 position this coming year. Judicious trading and sector selection augur for a potentially very attractive risk adjusted year for stocks particularly as volatility tends to lead both credit and equities (see Chart 1).

Turning to fixed income, the US yield curve enters 2010 at an historic degree of steepness with the US Treasury 2-year versus 10-year spread at an unprecedented 280 basis points. The views of our economics team are for 10-year yields to rise to match the level implied by the forward curve by the end of 2010 (4.10%) but for shorter dated yields to rise significantly less than the curve currently implies (CIBC's forecast for 2-year Treasuries at the end of this year is 1.35% versus the forward curve implied level 2.0%) and Fed Funds to remain anchored near zero. The roll and carry on a funded long fixed income position in the belly of the curve looks "abnormally" attractive but it is consistent with the profile of a US financial system still in recovery. The required level of gearing to get a mid teens return in the US interest rate space is much less than usual, incumbent of course on the assumption that the Fed remains on hold as we expect.

Returns on US credit product, like equities, are likely to be above normal this year as spreads remain wide of pre-crisis levels while continuing to converge towards them in

both the investment grade and high yield universe. From a timing perspective the recovery in credit has been more aggressive than it has in equities and is consistent with the overall onus to deleverage. Debt funds have been the darlings of investors for the past year and should remain in vogue as long as the Fed remains on hold and the corporate and household deleveraging continues. This argues for another positive year for credit, with below normal levels of leverage required to generate mid-teen returns.

While one can construct strong positive arguments for equities, levered curve trades and credit, the outlook for currencies is more uncertain and the case for the re-emergence of a trend trade in the dollar index is more difficult to build. A breakdown in the short US dollar long equity correlation that re-emerged when equity markets turned last spring appears to have begun in December. Whether this decoupling was a function of year-end book squaring or something more fundamental is not clear yet. With the major macro imbalance that is the US current account deficit having been cut in half in the past three years the secular impulse to further devalue America's currency against its G7 peers is much less strong however. G7 interest rate differentials are now so narrow the forces of mean reversion may be reasserting themselves in foreign exchange making currencies much more of a tactical trading play driven by cyclical considerations than a trending market in 2010. The absence of a discernible secular trend would mark a return to the "normalcy" of the mid 1980's to mid 1990's (see Chart 2).

Chart 1. Relative Performance of Credit, Equity Volatility and the S&P 500

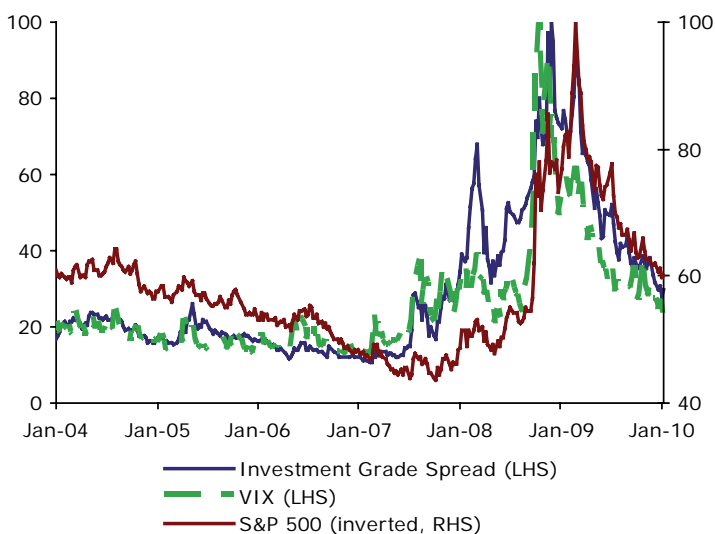


Chart 2. Dollar Index



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