GPS MONTHLY

GLOBAL POSITIONING STRATEGIES

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Canada: A Position of Strength

Economics (Shenfeld): While markets have trimmed their medium-term inflation expectations, debt monetization could offer a longer-term exit from the fiscal box that countries like the US now find themselves in. That argues against a portfolio of 10-year Treasuries yielding under 3%. The BoC's potentially firmer commitment to capping inflation at 2% is a plus for Canadas.

Rates (Ahmed): Rather than domestic economic fundamentals, the performance of global equity markets has dictated the direction of Canadian short rates. There is scope for 2s to sell off meaningfully, if, as we expect, the Bank of Canada delivers a hike on July 20th. However, profiting from this view in the present environment will prove to be challenging, particularly when accounting for the often under-appreciated impact of roll-down effects on curve trades.

Government Finance (Warren): We reflect on recent investor meetings in the US and Asia, where Canada's strategic advantages over a growing number of advanced economies are increasingly well recognized. The country's fiscal edge remains a cornerstone of the country's superior fundamentals, with mounting evidence of a significant near-term improvement in fiscal fortunes for Ottawa and many provincial governments.

Credit (Zapior): We sized up a potential pool of higher yield issuance from income trusts and listed non-issuing corporates. In the base case scenario we see $33 billion in potential issuance from 184 candidates. In the near term, our analysis of current supply and demand suggests $3 billion in annual issuance.

FX Structuring (Gunja): We take a look at driving factors in GBP and the CAD and suggest several ideas to capitalize on any future strength in the two currencies versus the US Dollar using FX options.

Commodities (Spector): The Deepwater Horizon spill has reached historical proportions. While short-term oil and gas production impacts are negligible, longer-term repercussions are potentially more meaningful. Deepwater accounts for an increasing percentage of the total offshore production of both oil and gas, and regulatory uncertainty has already impacted activity in the region.

Economics

Avery Shenfeld

"Dissing" Inflation, or Going Negative?

Markets have moved dramatically in line with our long-held view that global growth will disappoint from here as the impacts of fiscal ease and inventory restocking subside. Indeed, in short-term government bonds, but not in equities, one could argue that settings are closer in line with a return to recession, given that US 2-year yields are now in territory seen at the depths of the 2008-09 slump. The Canadian front end is at a generous spread, although at far lower rates than would be consistent with the Bank of Canada's last published forecast, which hints at a more sizeable tightening in an economy headed, in its view, to a zero output gap in less than a year.

Longer yields on Treasuries and Canadas remain above the extremes of the prior year's flight-to-safety levels (Table 1). But there is more afoot in the latest rally than simply a flight to safety from recently retreating equities. Markets are also taking down expectations for the path of inflation over the medium term. That comes after downside surprises in inflation in both the US and Canada. Stateside, headline inflation has been zero since the start of the year, while core CPI is barely above that pace in the last five months.

Canada's CPI has moved much less drastically from running a bit on the high side of Bank of Canada forecasts to slightly below the central bank's call (Chart 1). Thus far the differences are too trivial to have a meaningful impact on near-term policy, but they might just hint that the output gap is wider than the Bank's estimate.

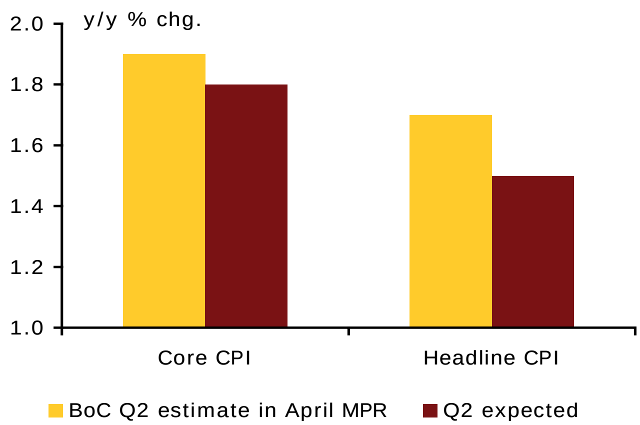
Disinflation vs. Deflation

Where bonds go from here will therefore depend not simply on how extensive the upcoming slowdown

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

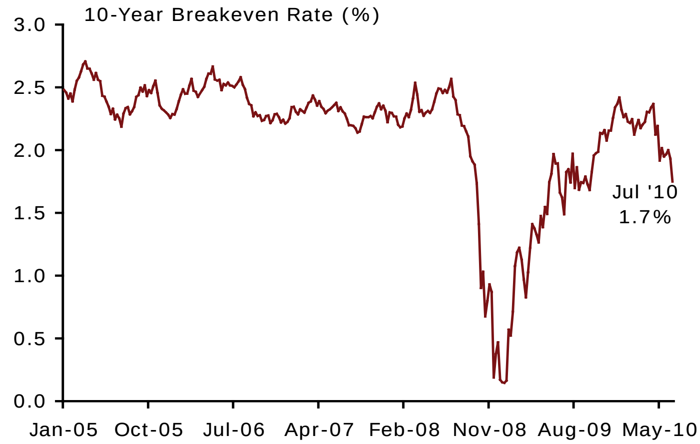
		2010			2011			
END OF PERIOD:		**13-Jul**	**Sep**	**Dec**	**Mar**	**Jun**	**Sep**	**Dec**
CDA	Overnight target rate	0.50	1.00	1.25	1.25	1.50	1.75	2.25
	98-Day Treasury Bills	0.52	1.15	1.05	1.15	1.50	1.80	2.20
	2-Year Gov't Bond	1.72	1.75	1.85	1.90	2.35	2.75	3.00
	10-Year Gov't Bond	3.26	3.35	3.65	3.85	3.90	3.90	4.00
	30-Year Gov't Bond	3.77	3.85	3.90	3.90	4.00	4.10	4.25
U.S.	Federal Funds Rate	0.20	0.20	0.20	0.20	0.20	0.75	1.25
	91-Day Treasury Bills	0.16	0.10	0.13	0.15	0.15	0.70	1.15
	2-Year Gov't Note	0.67	0.75	0.90	1.00	1.45	1.85	2.05
	10-Year Gov't Note	3.12	3.30	3.50	3.75	3.90	4.00	4.25
	30-Year Gov't Bond	4.10	4.10	4.25	4.45	4.65	4.75	4.80
Canada - US T-Bill Spread		0.36	1.05	0.92	1.00	1.35	1.10	1.05
Canada - US 10-Year Bond Spread		0.14	0.05	0.15	0.10	0.00	-0.10	-0.25
Canada Yield Curve (30-Year — 2-Year)		2.05	2.10	2.05	2.00	1.65	1.35	1.25
US Yield Curve (30-Year — 2-Year)		3.44	3.35	3.35	3.45	3.20	2.90	2.75
EXCHANGE RATES	CADUSD	0.97	0.99	1.01	0.96	1.00	1.01	1.02
	USDCAD	1.03	1.01	0.99	1.04	1.00	0.99	0.98
	USDJPY	89	92	91	90	89	87	87
	EURUSD	1.27	1.18	1.20	1.22	1.24	1.27	1.30
	GBPUSD	1.52	1.46	1.47	1.50	1.51	1.53	1.55
	AUDUSD	0.880	0.880	0.900	0.910	0.930	0.940	0.950
	USDCHF	1.06	1.13	1.11	1.10	1.09	1.08	1.07
	USDBRL	1.76	1.76	1.75	1.73	1.73	1.71	1.70
	USDMXN	12.7	12.5	12.5	12.3	12.2	12.0	12.0

Chart 1. **Inflation Has Been Trailing BoC's Forecast**



Source: Bank of Canada, CIBC

Chart 2. **TIPS Priced for Sub-2% US Inflation**



proves to be, but also on its consequences for prices. In particular, for US Treasuries, at issue is whether we are merely going to see further disinflation, or are headed for outright deflation, with a sustained period of falling prices.

Bonds are not yet priced for the latter, even in the US. Note, for example, that 10-year Treasury yields are still a far cry from the sub-0.5% yields offered at times by Japanese bonds, during that country's era of falling prices. The spread between nominal Treasuries and inflation-adjusted TIPS is also far too wide to be consistent with anything beyond a short-lived brush with deflation. That spread is not always indicative of inflation expectations—it plummeted to nothing during the financial crisis when the more liquid nominal Treasuries became the asset to own. Recently, the spread has narrowed somewhat, but it still indicates that if we do see deflation, markets don't expect it to last (Chart 2).

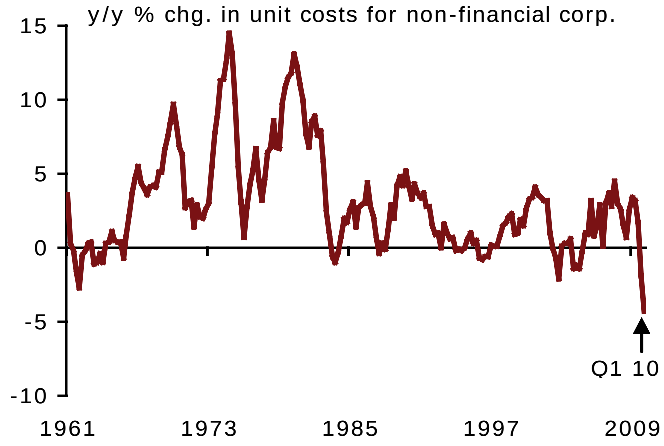
Canadian TIPS yields also point to positive inflation over the medium term. After a run-up last year as the economy turned, there has been some movement towards a smaller inflation premium recently in the nominal bond. But at this point, the market is still pricing in something close to the Bank of Canada's 2% target. Note that in the near term the headline rate referenced in the TIPS will spike higher, as the HST raises prices in Ontario and BC. Oddly, despite Canada's visibly smaller output gap, and substantially higher inflation rate than the US, inflation-indexed bonds in the two countries anticipate roughly the same medium-term price trends.

Theory suggests that, with its wider output gap, the US faces more material near-term risks of outright deflation. Indeed, downward pressure on prices from the ocean of slack in labour markets and capacity use is well in evidence. Wages have been very subdued, productivity brisk. Not only are unit labour costs falling in the non-

Table 2. **Economic Update**

CANADA	**10Q1A**	**10Q2F**	**10Q3F**	**10Q4F**	**11Q1F**	**11Q2F**	**2009A**	**2010F**	**2011F**
Real GDP Growth (AR)	6.1	3.5	2.0	1.5	2.1	2.5	-2.5	3.3	2.5
Real Final Domestic Demand (AR)	4.7	3.5	2.6	2.0	1.6	1.7	-1.8	3.8	2.1
All Items CPI Inflation (Y/Y)	1.6	1.5	2.2	1.9	1.9	2.3	0.3	1.8	2.1
Core CPI Ex Indirect Taxes (Y/Y)	1.9	1.8	2.0	1.9	1.8	2.0	1.8	1.9	2.0
Unemployment Rate (%)	8.2	8.0	8.1	8.2	8.2	8.2	8.3	8.1	8.1
U.S.									
Real GDP Growth (AR)	2.7	3.7	2.5	1.3	1.6	2.6	-2.4	3.0	2.5
Real Final Sales (AR)	0.8	3.7	2.4	1.5	1.7	2.4	-1.7	1.8	2.5
All Items CPI Inflation (Y/Y)	2.4	1.8	1.2	1.0	0.8	1.2	-0.4	1.6	1.5
Core CPI Inflation (Y/Y)	1.3	0.9	0.8	0.5	0.8	0.9	1.7	0.9	1.1
Unemployment Rate (%)	9.7	9.7	9.8	10.1	9.7	9.8	9.3	9.8	9.7

Chart 3. ***Corporations' Unit Costs Falling at Record Rate***



Source: Bureau of Labor Statistics, CIBC

financial sector, but corporations' overall unit costs are declining at a record pace, helped by lower financing costs (Chart 3).

As a result, we see core inflation edging lower, to as little as 0.5% year-on-year later in 2010 (Table 2), and can't rule out a short-lived dip into negative territory. But there are still some impediments to a run of outright deflation in the US. In particular, the drop in core inflation has been led by the disappearance of inflation in the two measures of rent that make up more than 40% of that basket. Of late, they have seen some signs of a turn higher again. Excluding housing, core inflation has a larger cushion above zero, since rising wages put upward pressure on prices of various services.

In Canada, the various measures of price pressures have been moderate, but nowhere near deflation. Wages are running in the 2% range year-on-year, leaving unit labour costs still positive, but at a tame 1% pace in the year to Q1. Measures of economic slack still point to disinflation, but unless the Canadian dollar depreciates markedly from here, deflation seems unlikely in the near term.

Inflation Could Still Be the Longer-Term Story

It won't be coming to an economy near you any time in the next couple of years, but inflation could still prove to be an issue for longer-dated bonds in a buy-and-hold strategy. While not a necessary consequence of excessive government debts, inflation is one way out of the fiscal box that the US and other major economies now find themselves in.

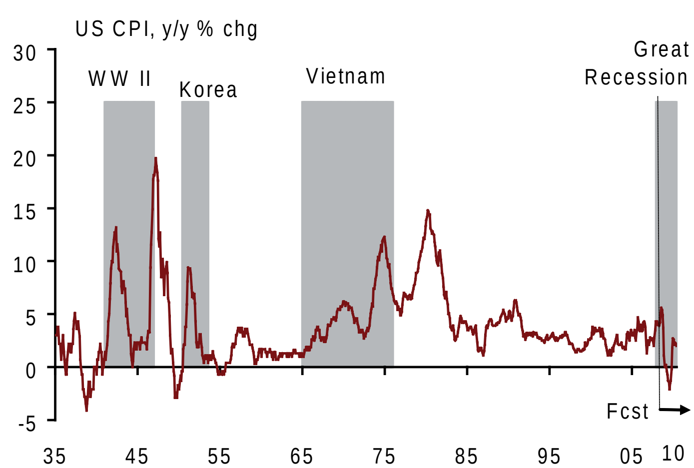
Generating somewhat higher inflation in the coming expansion would be of particular use to the US, Spain and other regions where depressed property prices are a key issue in household financial stress. Higher inflation would help shrink the US debt/GDP ratio by growing nominal GDP, but would also raise house prices and bring them into better line with outstanding mortgages.

Cross country historical research by Reinhart and Rogoff found no linkage between high government debt and inflation rates in developed economies as a group. Debt itself doesn't cause inflation, and indeed, fiscal tightening to address it would tend to slow growth and dampen inflation on its own. But for the US, the same study found that periods in US history with fiscal and debt troubles were indeed characterized by higher-than-average inflation (Chart 4). Most recently, one could argue that the US helped ease the debt left by the legacy of the Vietnam War by letting inflation accelerate.

How to generate inflation with so far to go to close the output gap? That's easy—print enough money to buy up government bonds and at some point the market will devalue its buying power, long before full employment is attained. For those who don't think a huge output gap can co-exist with high inflation, remember the early 1980s—or Zimbabwe, in the extreme.

Carney is certainly not going to drop his 2% inflation target, and Canada's debt levels and housing market give him no reason to. It's less certain that an Obama-stacked Fed might not tolerate a few years of 5% inflation to grease the economic wheels down the road. That's why we would not get too comfortable with buying a portfolio of 10-year Treasuries yielding 3% or less, and would instead favour TIPS if we were looking at a longer-term buy-and-hold strategy.

Chart 4. ***Historical Fiscal Shocks and Inflation***



Rates

Mohammed Ahmed

Of Ranges and Rolls

Having traded in a 25-bp range for the better part of the month, 2-year Canada yields pushed decisively through identified resistance levels in the last week of June. While the recent better-than-expected increase in net new jobs prompted a partial retracement of this strength, there is still scope for a further sell-off, as market participants return their focus from global risk assessments to domestic economic fundamentals.

Although domestic economic data released in June was somewhat underwhelming, it was not sufficient in and of itself to propel the rally witnessed at the front end. In fact, when viewed in the context of stronger-than-expected data from the prior month, June's releases don't appear quite as bad. In particular, as *CIBC Economics* highlights, despite April's flat GDP print, the strong set-up from March keeps Canada on track towards 3-3.5% annualized growth for Q2. Moreover, the results of June's Labour Force Survey, released on July 9th, confirm that the Canadian recovery is continuing apace. As such, the likelihood of a meaningful downward revision to the Bank's quarterly growth forecast is low.

Rather than Canadian economic fundamentals, the performance of global equity markets has dictated the near-term direction of interest rates. And although it was reasonable to expect a decline in rates on this basis, the most recent rally at the front end of the Canada curve was exacerbated by a lack of liquidity due to G20-related closures in late June and North American holidays in early July.

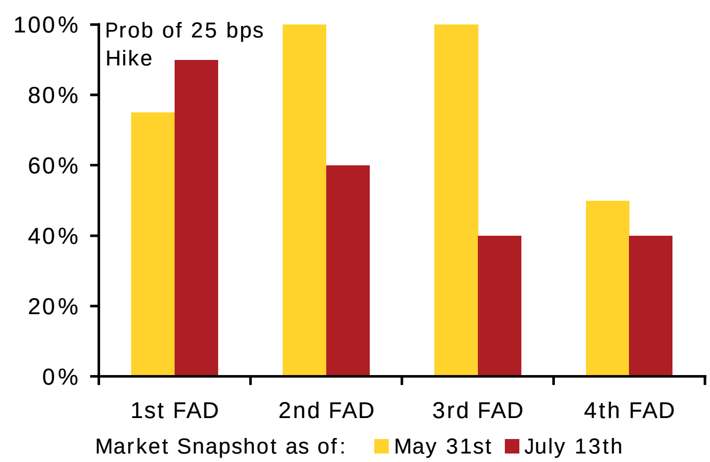
Thus, given both the nature and extent of the rally in 2s, the balance of risk-to-reward is tilted decidedly towards higher rates in the near-term. Much in the same way that the June 1st announcement prompted a dramatic move in yields, the upcoming announcement, too, should cause 2-year yields to swing significantly. This time around, though, while the policy action will be the same—i.e. a quarter-point hike—the market reaction should be notably different.

Lower Expectations

To reconcile the difference between the projected response of 2s to the upcoming announcement and the realized reaction of 2s to the previous announcement, it is important to note that the respective starting points are at opposite ends of the policy expectation spectrum. Prior to the June 1st decision, market participants had almost fully priced in consecutive rate hikes through the end of 2010. However, the dovish June 1st announcement caused bond traders to rapidly re-evaluate this view. Consequently, despite a quarter-point increase in the overnight rate, 2-year yields fell more than 10 bps on the day, as bets on future rate hikes were aggressively pared.

Six weeks later, overnight indexed swap rates reflect a relatively dovish expectation for Canadian monetary policy. In total, the market has priced in about 50 bps of hikes by December. Equally important as the cumulative figure, though, is the implied path to higher rates. Currently, there is a 90% probability of a quarter-point hike on July 20th and approximately 50% odds of a hike at each of the three meetings thereafter. This is in stark contrast to the hawkish expectations prevalent prior to the June 1st announcement (Chart 1).

Chart 1. ***OIS Implied BoC Expectations***



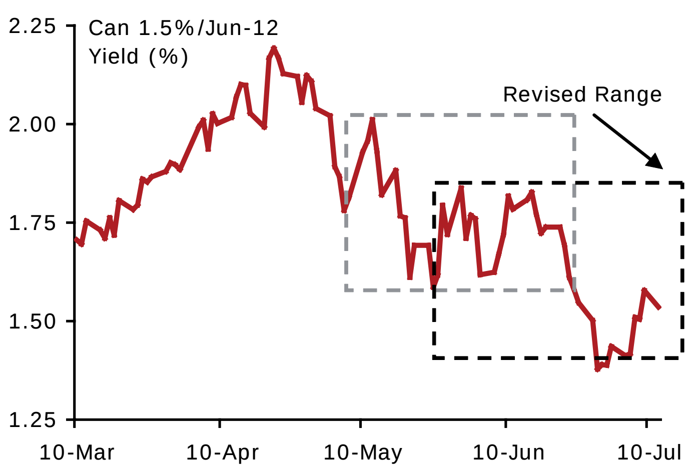
Yet, short of suspending rate hikes altogether, it will be difficult for the upcoming announcement to be more dovish than the last and cause a further downward revision of policy expectations. In fact, even if the message remains unchanged, at this stage of the cycle each passing rate hike will erode the Bank's stance on future hikes not being pre-ordained. As such, there is potential for a further push higher in 2-year yields around the July 20th announcement, given the currently low expectation for continued tightening.

Revising "The Range"

Our forecast calls for the Bank of Canada to raise rates by a quarter-point at each of the next three announcement dates. By December, a quicker-than-expected deceleration of growth should induce a pause in the tightening cycle, which we see lasting until the second quarter of 2011. This base case scenario argues for higher 2-year yields, as well as heightened rate volatility.

In early June, we identified a range of 1.60% to 2% within which to trade a short bias, where strong fundamental data would motivate a push to the high end of the range and concerns about global growth, as reflected by equity markets, would take yields towards resistance. Just as there is uncertainty with respect to the market's forecast for the Bank's overnight target, there is a low probability that the yield on 2s will rise in linear fashion. Thus, while the case for range-bound trade remains, recent trading, albeit on light volumes, has caused us to revise this range. Specifically, while maintaining our short bias, we have shifted the targeted band by 15 bps and believe that 2s will be bound between 1.45% and 1.85% in the near-term (Chart 2).

Chart 2. ***Canada 2-Year Yields***



The drive towards lower yields at the front end of the curve and corresponding bull-steepening has re-ignited interest in establishing flatteners. Unfortunately, not only will ongoing volatility make these positions challenging to manage, but so too will the often under-appreciated impact of rolling down the curve.

The Cost of Flatteners

Market participants typically calculate the net cost of carry on curve trades holding yields to maturity on the underlying bonds constant. With this characterization, gains or losses due to changes in yield are defined as trading profits.

However, when forecasting returns over a holding period, a constant yield is not an appropriate assumption because a given bond's yield will tend to change as its term to maturity contracts. This change in yield is known as the roll-down effect.

It is common to measure roll-down effects assuming that the yield curve remains constant over the holding period. This can be construed as a somewhat heroic assumption. However, unless a significant re-shaping of the curve is expected, the roll-down effects under a constant yield curve assumption will capture important information about the relative magnitude of expected returns on bonds of different maturities. In fact, a key advantage of accounting for roll-down returns is that doing so allows us to quantify just how significant a re-shaping of the curve is required to realize profits on a particular trade.

To illustrate the impact of rolling down the curve, consider as an example a 2s/10s flattener. Traditional net carry calculations suggest that the curve will have to flatten by 5 bps over the next three months for this position to be profitable. However, incorporating the current shape of the curve into the analysis implies that the projected flattening would have to be almost three times as quick as the net carry figures imply.

A large part of this difference is due to the fact that the front end of the curve is much steeper than the belly (the remainder is due to convexity and bond-specific pricing adjustments). Hence, the yield on the 2-year bond will decline faster than the yield on the 10-year bond and, all else equal, the yield spread between the bonds will widen over the horizon period (Table 1). Thus, outright flattener positions will prove to be challenging due to the roll-down effect.

Table 1. ***3-Month Rolling Yields***

	Beginning Yield (July 9)	Forecast Yield (October 9)	Change (bps)
Can 2%/Sep-12	1.712%	1.577%	(13.5)
Can 3.5%/Jun-20	3.231%	3.205%	(2.6)
2s/10 Spread (bps)	151.8	162.8	10.9

Table 2. ***Canada Curve Breakeven Points***

	Current	3-Mth Carry and Roll-Down	Breakeven Point
Term Spreads			
2s-5s	82.4	(9.3)	73.0
2s-10s	151.8	(15.1)	136.7
2s-30s	204.2	(20.0)	184.2
5s-10s	69.5	(6.0)	63.5
5s-30s	121.8	(10.9)	110.9
10s-30s	52.3	(5.0)	47.3
Butterfly Spreads			
2s-5s-10s	12.9	(1.9)	11.0
2s-5s-30s	-39.5	0.6	-38.9
2s-10s-30s	99.5	(5.1)	94.3
5s-10s-30s	17.1	(0.6)	16.5

Fortunately, as detailed in May's *GPS Monthly*, 2s-10s-30s butterfly spreads closely track the performance of the 2s/10s curve. Our analysis reveals that up to 80% of the variance in the butterfly can be attributed to the 2s/10s component. Furthermore, on the proposed returns basis, the 2s-10s-30s butterfly has a much more achievable breakeven point than the 2s/10s flattener (Table 2). This framework confirms our bias to own 10s versus both 2s and 30s, as opposed to against 10s alone.

Takeaways

There are two key takeaways from this analysis. First, a returns-based approach, like the one presented above, fully captures the profit on a bond position and, as such, is better suited to measuring the breakeven point on curve trades than net carry. Second, as we have advocated since the publication of our 2010 Outlook, given the costly nature of flatteners and the volatile state of the market, directional trades will rely more than ever on astute timing. And with 2s presently near the bottom of our identified trading range, now is the right time to establish short positions.

Recommentation Summary

	Proposed Date	Recommendation	Entry	Target	Stop	1-Mth Carry	Current	Ex-Carry Gain/Loss	Duration (Days)
1	10-May-10	Long Canada 10s vs. 2s/30s	130 bp	100 bp	140 bp	-1.5 bp	115 bp	15.0 bp	63
2	20-May-10	Long Can-US 2s/30s Box (Can Flattener, US Steepener)	-125 bp	-150 bp	-115 bp	-1.0 bp	-125 bp	0.0 bp	53
3	7-Jun-10	Short Canada 2s	1.64%	1.85%	1.45%	-6.0 bp	1.56%	-8.0 bp	35
4	7-Jun-10	Short Canada 30s	3.73%	4.00%	3.60%	-1.5 bp	3.76%	3.0 bp	35
5	15-Jun-10	Long Canada-US 10s	15 bp	0 bp	20 bp	0.5 bp	16 bp	-1.0 bp	27

A complete summary of trade recommendations is available upon request.

Government Finance

Warren Lovely

Getting Religion

Let's not kid ourselves; Canada isn't an overwhelming force on the global economic stage. With some notable industry exceptions, the country often plays a bit part in matters of global economics, at least in terms of its contribution to global growth or, more tellingly, the weighting the country garners in global investment portfolios.

But having spent the better part of the last month on the road, seeing investors across the US and Asia, we can safely say that Canada is increasingly on the lips and minds of international investors. And those we've talked to are getting religion on Canada's potential outperformance vs. a growing list of advanced economies. Indeed, it's hard to recall a time when the country possessed such relative, if not absolute, strength.

Growing List of Strategic Advantages

In the developed world, Canada is emerging as a growth leader, with the IMF the latest forecaster to see the country leading the G7 in terms of average real GDP growth during 2010-11 (Chart 1). In fairness, the projected gap between Canadian and US growth is, for the time being, modest. But there's a substantial divergence in key indicators of domestic economic health, not least of which is employment.

The story doesn't end here. A well capitalized banking sector is well understood to be a strategic advantage, with a less dramatic adjustment to regulation in store. Many foreign investors took note of Canada's limited direct exposure to slow-growing Europe and success in increasing exports to the faster-growing BRIC region, the latter remaining a work-in-progress. Less well understood is the provincial composition of trade, with Québec sending a larger share of its exports to Europe, while BC, Saskatchewan and Manitoba have fostered the greatest ties to BRIC countries (Table 1). Also noteworthy, less onerous demographic pressures support a faster potential economic growth rate, with Western provinces again standing out due to healthy international and interprovincial migration (Chart 2).

Fiscal Edge More Important Than Ever

But central to Canada's strong story is its fiscal advantage. Having opened up an ever-wider gap in its structural budget balances vs. other countries, notably the US (Chart 3), a much smaller fiscal adjustment is now needed to stabilize debt ratios.

Canada's provinces are not feeling the same heat as some US states, are less prone to severe program cuts or increased revenue measures, and are therefore putting

Chart 1. **Canada to Lead G7 in Growth**

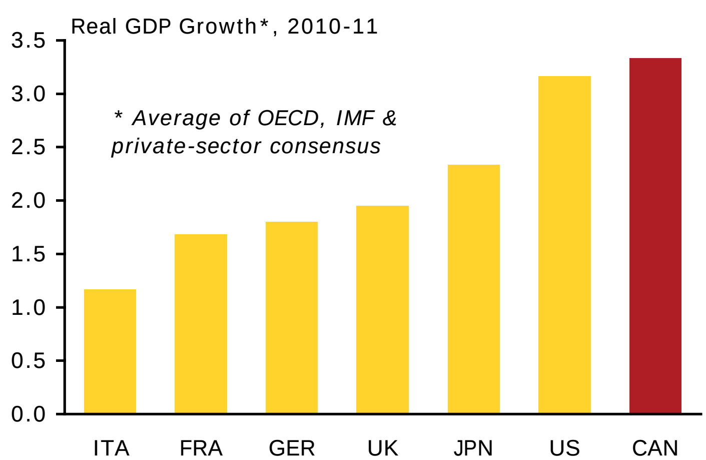


Table 1. **Provincial Exports by Country of Destination**

	Share of International Exports, 2009			
%	US	Japan	EU	BRIC
BC	50	14	7	12
Alta	83	2	2	5
Sask	61	3	7	11
Man	67	5	3	8
Ont	81	1	9	2
Qué	69	1	15	4
Atlantic	78	1	9	6
Canada	**75**	**2**	**8**	**4**

Note: Above-average shares are shaded

Source: Industry Canada

Chart 2. ***Migration an Important Population Driver***

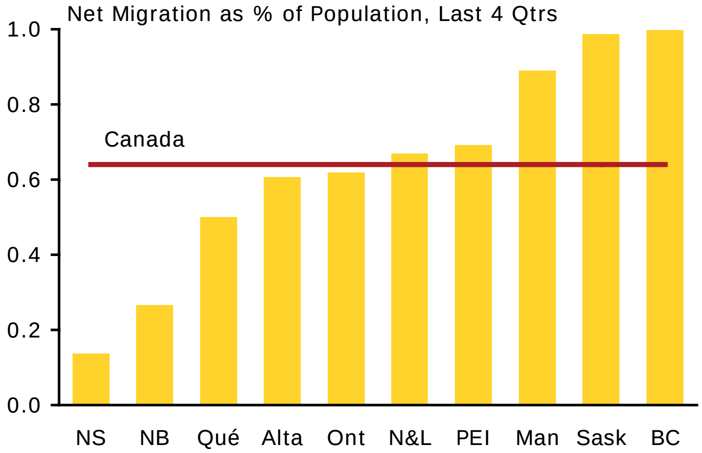
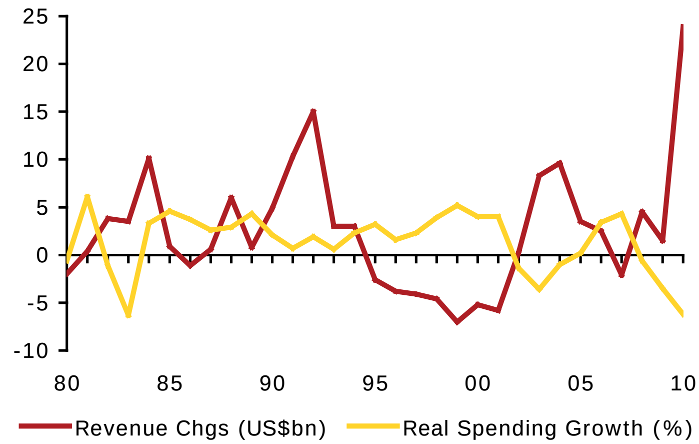


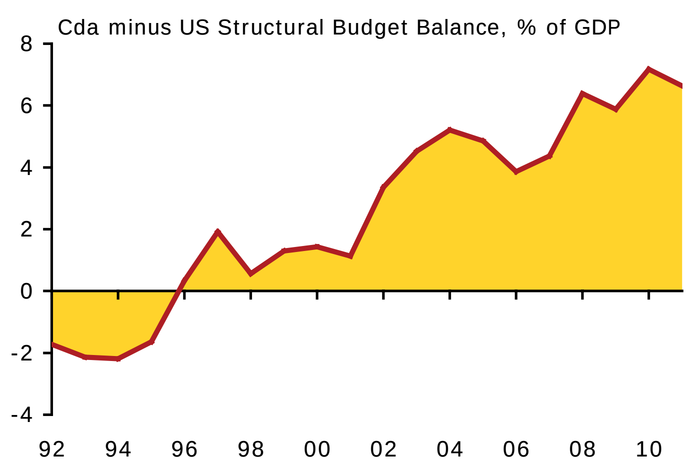
Chart 4. ***US States Cut Spending, Hike Taxes/Fees***



their regional economies at less risk (Chart 4). Not only are provincial governments pushing through less painful adjustments, they are seeing their revenue picture brighten materially—a development, we continue to argue, that is not yet fully appreciated by all investors. As we highlighted in our June issue of *Economic Insights*, Canada's federal and provincial governments are poised to rake in an extra $15 billion of revenue vs. the 2010/11 budget plan.

We've yet to see a single issuer restate their 2010/11 budget balance or borrowing requirements, but positive adjustments are nonetheless coming—from the federal government, British Columbia, Ontario and others. Just wait for it. Importantly, this fiscal improvement will protect provincial credit ratings from additional downward pressure, at least in the near term. That's of material importance to Ontario, with a number of investors clearly worried about potential selling pressure arising from any further downgrade to the province's long-term rating.

Chart 3. ***Growing Gap in Structural Budget Balances***



At the federal level, Ottawa's looming fiscal improvement means less Canada issuance, which has already moved past its peak. Given a well established issuance pattern and a preference, at the margin, for shorter-dated supply, the market will see limited supply of 30-year Canadas. That will leave plenty of room in the long end for provincial and corporate issuers, with many provincials preferring longer-dated supply as a way to both lock in attractive rates and add length to their debt portfolios. While a far cry from the outright reductions in the federal bond stock of yesteryear, Ottawa is once again making room for provincial issuers, dousing earlier fears in some corners of crowding out.

Canada is already benefiting from an earlier legacy of fiscal outperformance, with past surpluses creating sufficient budgetary room to slash corporate taxes, thereby opening up a growing advantage over competing tax jurisdictions—an improvement not fully appreciated by many. And together with other important tax reforms, including the recent implementation of an HST in Ontario and British Columbia, a friendlier tax environment looks to incent the business investment needed to turn around an admittedly poor productivity record (Chart 5). We were asked repeatedly where Canada stood on a mining super tax. On that score, Canada's governments are going the other way, with intense competition in Western Canada taking royalty rates for many key commodities lower, not higher.

Not All Sunshine and Roses

As we've repeatedly warned investors, a US slowdown will leave its mark on Canada. Yes, the country has diversified its trade away from the US (to a degree), but three-quarters of Canadian exports still find their way

Chart 5. **Productivity Growth Has Lagged**

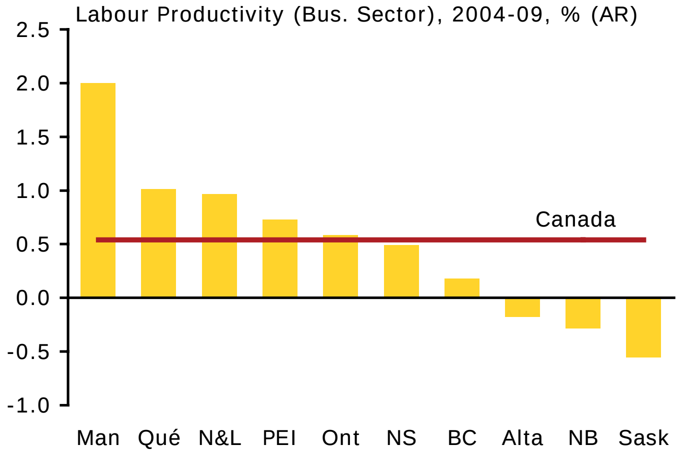
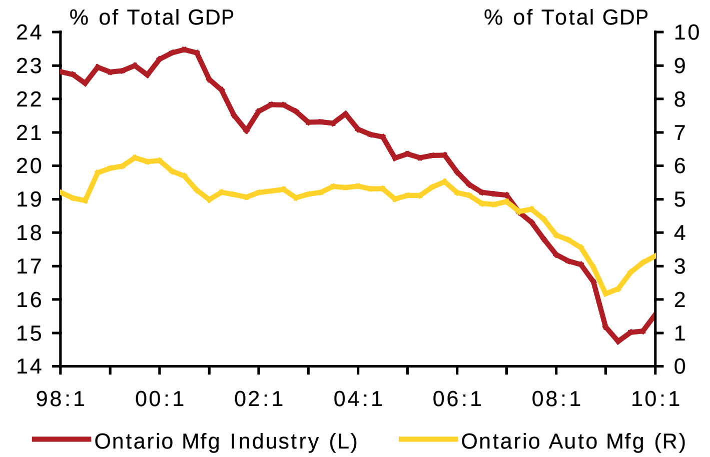


Chart 7. **Smaller Factory Sector Footprint**



south of the border (Table 1)—this still gets people's attention. And throwing cold water on a 'decoupling' theme that gained some favour in the mid-2000s, Canadian and US real GDP growth has never been more tightly correlated than during the past five years (Chart 6). So the end of an American inventory rebuilding process will sap demand for Canadian wares, but importantly for Canada's government sector, nominal output looks to attain much higher ground than in the US, with a recovery in corporate profits and superior personal income growth helping to rebuild government coffers faster.

The Canadian dollar remains a challenge, and while the ongoing threat to the factory sector is real, the manufacturing sector's footprint has shrunk markedly, particularly in Ontario (Chart 7). An overheated housing market and highly indebted household sector are clear risks, and housing market activity is due to slow in most regions. But Canadian housing isn't in bubble territory and a gradualist approach to rate hikes should prevent a sharp contraction. For many, the relative outperformance of Canada's housing market remains one of the more striking elements of any comparison to the US.

Notwithstanding these challenges, Canadian governments are courting international investors from a position of strength, hardly beholden to foreign capital, but happy to take full advantage of a healthy appetite for Canadian fixed income product. The message is getting through, and there's every reason to believe that today's strong foreign investor interest in Canada will have staying power.

Chart 6. **Heightened Correlation in Cda/US Growth**

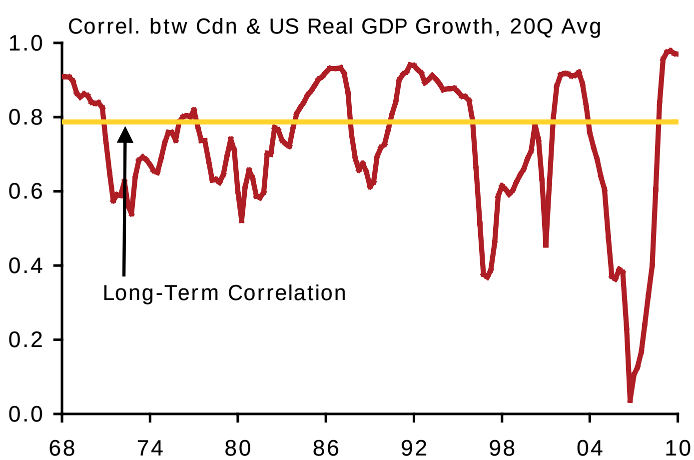
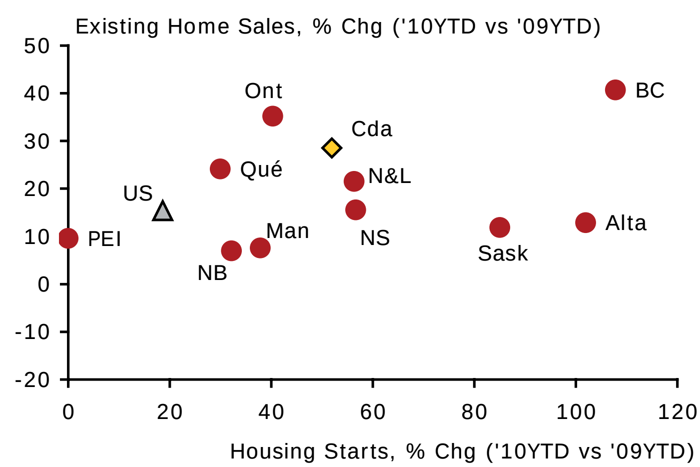


Chart 8. **Canadian Housing Activity: Hot Now, Set to Slow**



Credit

Joanna Zapior

What If It Actually Comes to Pass?

Much has been said about market conditions being ideal for the re-emergence of Canadian high yield. Identifying the onset of this opportunity was actually the easy part. It is more difficult to assess the potential size of this market. High yield issuance can come from public and private companies that have never issued public debt, as well as from issuers who in the past sought funding in the US high yield market, but do not need US funds as a natural hedge and would perhaps prefer to re-finance in Canada.

Focus on Publicly Listed Non-Issuers

Of these potential C$ debt issuers, publicly listed non-issuers are an interesting bunch. This is because among them are the income trusts, and we think that conversion of trusts into corporates is a catalyst for a potential re-capitalization and ensuing debt refinancing. However, as trusts convert on an almost daily basis, it is increasingly more difficult to track trusts and corporates separately. As a result, we look at the listed companies in the aggregate.

By count, the universe of listed non-issuers is much bigger than of issuers. Not surprisingly, however, market capitalization of non-issuers in the aggregate is smaller than that of C$ issuers (Table 1). Even above the minimum size cut-off we imposed, the market capitalization of an average non-issuer is much smaller than that of an average issuer: nine times smaller for corporations, and three times smaller for the remaining trusts. This suggests that potential debt issuance from this segment would be more diversified by name and more fragmented by size than the C$ corporate debt market as we know it.

We initially found 475 listed entities, described as a group in the "Non-issuers" column in Table 1, that have sufficient size to make them plausible candidates for public market issuance (a minimum of $80-100 million market cap). This is not an homogenous universe by credit quality. Short of assigning a rating to each of these entities to assess how much debt and of what credit quality they could issue, we applied a second "screen" to select those companies that could, with a good dose of probability, be rated at least BB, which we consider to be the "sweet spot" in the Canadian developing high yield market. However blunt the tool, we settled on the Total Debt / EBITDA ratio, which we applied to each industry sector using the averages generated by the rating agencies for debt issuers in the BB rating category.

We found 184 such entities, and concluded that most of them appear under-leveraged relative to the BB standard. Given the under-leveraging relative to the BB standard, we also recapitalized each of these companies to the BBB standard, with the proviso that for some of them their size and position in their industry may not allow them to garner the BBB rating. At the BB level, this group of potential issuers would generate $77 billion in total debt, and at the BBB level $55 billion (Table 2, next page). In a scenario where half of this potential debt would make its way over time to public debt markets, we would size up this issuance at $33 billion in the aggregate, split between BB and BBB issuers.

Table 1. ***Existing Issurers and Potential Issuers (Non-Financials)***

M = million, B = billion		C$ issuers	Non-issuers: All	Non-issuers: Subset above min cut-off
Corp	**#**	51	710	399
	Mkt cap	$484 B	$443 B	$432 B
	Mkt cap range	$84 - 53 B	$1 M - $39 B	$0.1 - $39 B
	Avg mkt cap	$9.5 B	$0.6 B	$1 B
Trust	**#**	22	113	76
	Mkt cap	$63 B	$59 B	$57 B
	Mkt cap range	$ 0.1 - 14 B	$4 M - $5.2 B	$83 M - $5.2 B
	Avg mkt cap	$2.9 B	$0.5 B	$0.8 B

C$ issuers include companies that issue in C$, but may also have some US$ public debt. Size cut-off is roughly $80-100 million in market cap.

Table 2. ***Maximum Debt Potential From Likely Issuers***

Non-issuing Universe: BB/BBB candidates	
# Entities	184
Current Debt (Aggregate)	$37 billion
Current Debt / EBITDA	1.4x
BB Debt Capacity	$77 billion
Debt / EBITDA if BB	2.9x
BBB Debt Capacity	$55 billion
Debt / EBITDA if BBB	2x
% trusts	21%

This is not a forecast. Rather, it is merely an exercise in sizing up a potential pool of issuance. Our near-term forecast calls for C$2.5-3 billion in annual high yield issuance. Here's how we get to this number.

On the side of demand, IFIC reports that Canadian high yield mutual fund net sales settled in the last five months (excluding May) at $120 million per month. This follows eight months of average sales in excess of $300 million per month. The more recent monthly run rate suggests a total demand of $1.2 billion a year from mutual funds alone. We extrapolate this number to $2-3 billion of total market demand.

Recent supply, which balanced the demand we characterized above, has been running at an annualized rate of $3.2 billion. Since the summer of 2009, the overall run rate of supply has been $2.7 billion. Those run rates suggest near-term supply potential of $2.5-3 billion.

$33 Billion Would Change the Face of the Market

Keeping in mind that this is just one of many scenarios that may or may not come to pass, this $33 billion of BB issuance would change the face of the Canadian market (Table 3).

Qualitative change would perhaps be even more pronounced (Chart 1). When we decompose the investment grade index into industry sectors and add existing high yield outstandings, we see a market dominated by financials, which account for 54% of its market value. Adding $33 billion in potential issuance would materially shrink the percentage of financials. The biggest diversification would come from materials, industrials, and the consumer discretionary sector, and, though to a much lesser degree, energy and healthcare.

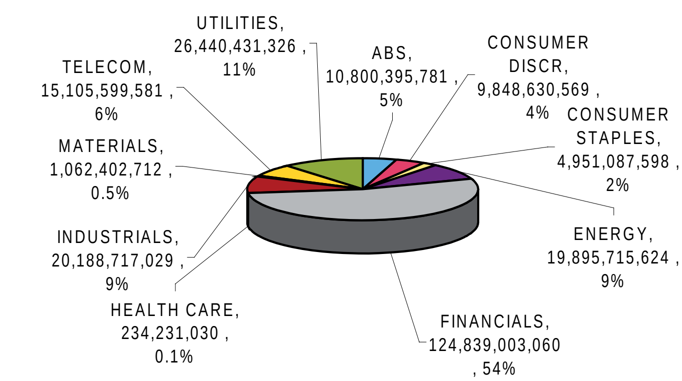
It is true that benefits of diversification have been questioned, and even thought to have been undermined, during the credit crisis when all assets became correlated. However, instinctively, adding new names and expanding the sparsely represented industry sectors must be seen as a risk-mitigating and market-expanding catalyst.

Table 3.

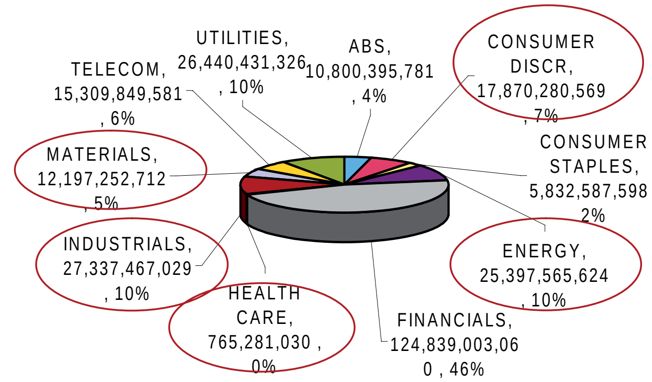
High Yield	Investment Grade
We currently have C$3.4 billion in public high yield bonds YTD in 2010, high yield issuance totalled $1.6 billion. Net sales of Canadian high yield mutual funds settled in the range of $120 million per month (excluding the negative May in the midst of the sovereign debt crisis)	Market value of the CIBC Research investment grade bond index on June 16 was $230 billion, and excluding financials and ABS, $94.4 billion YTD, investment grade issuance totalled $38 billion. Of that, BBB issuance adds up to $3.4 billion. Since 2002, average annual investment grade issuance has been $64.5 billion, and average annual BBB issuance $7.5 billion

Chart 1. ***Before and After the $33 Billion***

Before — status quo (IG index + HY outstandings)



After — adding potential $33 billion from 184 issuers



FX Structuring

Robert Gunja

Currency Option Plays for GBP and CAD vs USD

Are You a Cadbury's Fruit & Nut Case?

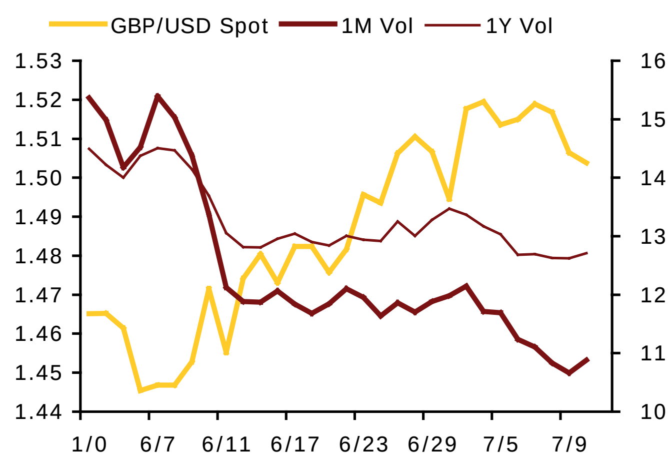
With the new coalition government in place and passage of new austerity measures, the UK is firmly pushing ahead of its peers still embroiled in the European crisis. The UK Emergency Budget forecasts a fall in the fiscal deficit to £20 bn from £149 bn by 2015-16. This will be accomplished through a sector pay freeze, an increase in capital gains tax and a rise in VAT to 20%. There will be a cut in corporate taxation. A bank levy will be applied to UK banks, building societies, and subsidiaries of overseas banks.

Spot GBP/USD has, after trading down to a low of 1.4300 on June 8th, rebounded back above 1.5000 and to as high as 1.5250. The Bank of England's Monetary Policy Committee on July 8th left its bank rate intact and kept QE purchases unchanged at £200 billion. The minutes will be released July 21st. While this was as expected by most analysts, it is noteworthy that the previous meeting saw one dissenting vote calling for a 25-bp rate hike.

On July 6th we saw vigorous demand for UK debt at the 10-year bond auction, which further buoyed GBP/USD. After the successful takeover by Kraft of Cadbury's earlier this year, the UK press has been noting further interest in some of Britain's largest corporations by American companies due to a weak pound versus the US Dollar. These are positive signals which should support the GBP currency in the weeks and months ahead.

In options trading, the implied volatility on the GBP/USD pair has dropped significantly. One-month ATM strikes now trade mid 10's vs. a high of 15.5% in June and 52-week highs of 18.25% in May. The level of one-month at-the-money GBP/USD implied volatility is now near levels not seen since prior to the Lehman Brothers collapse. This can be read as a discounting of further weakness in the pound and the expectation of a less volatile period of trading for the currency.

Chart 1. ***GBP/USD Spot and Implied Volatility***



TRADE IDEA: GBP/USD Conditional CALL Spread

Indicative Terms & Conditions

Spot Ref.: 1.5100

The Conditional CALL Spread allows the client to monetize on a mildly bullish GBP/USD view. The client starts with a Long 1.5100 GBP CALL / USD PUT option position at a reduced premium. Only in the event that spot GBP/USD ever trades at or above the 1.5750 Conditional Trigger will the client's option position transform into a CALL Spread.

In comparison, the price of a standard 3-month 1.5100 GBP CALL is 2.40% GBP.

Initial Position:	Long a 1.5100 (ATMS) GBP Call / USD Put
Expiry Date:	3 Months
Conditional Position:	Long a 1.5100 – 1.5250 GBP Call Spread

Conditional Trigger: 1.5750 USD per GBP

In the event that spot GBP /USD ever trades at or above 1.5750, the client's long option position transforms into a 1.5100 – 1.5250 GBP Call Spread

Upfront Premium: 0.75% GBP

Maximum Payout: 4.30% (649 USD pips)

Conditional Max Payout: 1.00% (150 USD pips)

TRADE IDEA: GBP/USD Fade-In Forward

Indicative Terms & Conditions

Spot Ref.: 1.5100 USD per GBP

Client Position: Buy GBP/USD Forward

Strike: 1.4750 USD per GBP

Expiry Dates: Weekly for the next 52 weeks

Notional: GBP 1,000,000 per week

Fade-In Level: 1.6000 USD per GBP

Every week, if spot GBP/USD fixes at or below the 1.6000 Fade-In level, the client buys £ 1,000,000 at 1.4750 for that week, outperforming the outright forward by 350 USD pips.

Every week, if spot GBP/USD fixes above the 1.6000 Fade-In level, no transaction will take place for that week.

Upfront Premium: Zero

TRADE IDEA: Looking for a higher spot GBP/USD - 3 Month GBP/USD Digital

Indicative Terms & Conditions

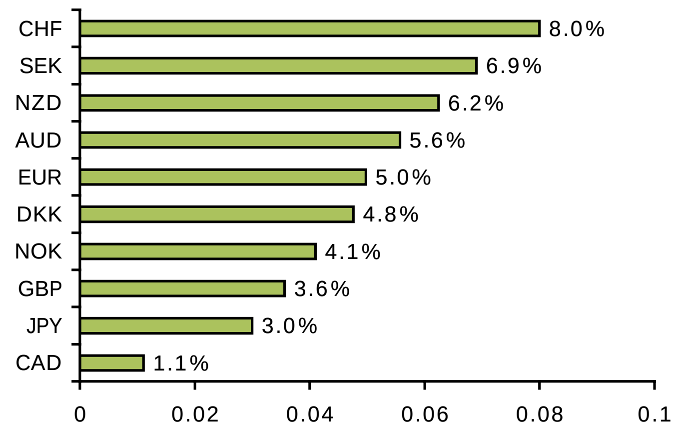
Spot Ref.: 1.5100 USD per GBP

A Digital allows the client to take a leveraged view that GBP/USD spot will strengthen above the strike at expiry. The client buys a three-month expiry GBP Call / USD Put with a Strike at 1.5800, which costs 25% of the desired Payout. The trade results in a 4 to 1 payout, i.e. for US$250,000 one would earn US$1,000,000 if spot were to close above 1.5800 at expiry. The loss is limited to the premium paid. This trade can be unwound early, i.e. if GBP/USD spot moves to 1.5800 one month from now, and assuming no change in other pricing parameters, the trade could be unwound for two times the original cost.

CAD Has Been the Worst Performer Against G10 vs. USD in the Last 30 Days; Is This About to Change?

USD/CAD over the last month has been the worst performer amongst the G10 in currency trade vs. the USD. The recent sell-off in the USD has kept the pressure on its closest neighbour; however, continuing impressive economic numbers coming from Canada should help support the CAD currency overall. Most recently, Canadian employment numbers beat expectations with employment posting a 93.2K net change in the month of June vs. the surveyed 20K change, and leading to the decline in the unemployment rate to 7.9% from the prior 8.1%. The market is now pricing the probability of a

Chart 2. ***G10 30-Day Spot Return vs. USD***



rate hike at the next BoC meeting on July 20th (9:00 EST) increased to 90% up from 67% prior to the employment release, and we saw spot USD/CAD trade sharply lower on the back of this news. The employment figures now show that almost all the jobs that were lost during the recession have been recouped. We continue to expect the Bank of Canada to keep a bias towards tightening, with a 25-bp rate increase in July followed by two more 25-bp moves before the year is out.

TRADE IDEA: Short Term Bearish USD/CAD

Indicative Terms & Conditions
Spot Ref.: 1.0350

Position:	Long a 1.0350 USD Put on USD 10 million
	Short a 1.0000 USD Put with RKI 0.9650 USD 10 million
	Short a 1.0350 USD Call with RKI 1.0850 or KO 1.0000 USD 10 million
Maturity:	3 months
Upfront Premium:	This structure can be entered into with zero upfront cost.

Long the 1.0350 USD Put. The trade can benefit from a potential appreciation of the Loonie down to 0.9650. In the event that spot USD/CAD ever trades at or below 0.9650, potential gains will be capped at 1.0000. The short a 1.0350 USD Call only exists if spot USD/CAD ever trades at or above 1.0850. In addition, the short 1.0350 USD Call option position will cease to exist if spot USD/CAD ever trades at or below parity. This trade is suitable for those with the view the Canadian Dollar will strengthen against the Greenback over the next three months and also have the view that the move will not extend beyond 0.9650 CAD per USD.

TRADE IDEA: USD DENOMINATED KNOCK-OUT DUAL CURRENCY DEPOSITS

Indicative Terms & Conditions
(Spot Ref.: 1.0350)

For a one-month term, a USD Deposit and a conversion level at 1.0500 CAD per USD, with any obligation knocked out if spot USD/CAD ever trades at 1.0175. Client can earn a coupon of 5.85% p.a.

If the USD/CAD strengthens beyond the conversion level at maturity and spot USD/CAD has never traded at 1.0175, the client will be paid their principal and interest converted to CAD (converted at the conversion level). If the USD/CAD at maturity is below the conversion level, the client is paid back their full principal and interest in USD. Additionally if at any point during the term of the deposit, spot USD/CAD ever trades at 1.0175, the conversion obligation above 1.0500 disappears and the deposit is repaid in USD.

Commodities

Katherine Spector

Putting the US Gulf Oil Spill Into Context

With so many issues outstanding—not least of which is the fact that the spill is ongoing—it is difficult to estimate the full scope of the Deepwater Horizon oil spill in the Gulf of Mexico (GOM), but we can put GOM oil and gas production into context and highlight some of the key issues that have emerged.

The Deepwater Horizon spill has reached historical proportions—in terms of volume of oil spilled, it dwarfs the 1990 Exxon Valdez spill by roughly a factor of 20 and has even outpaced the 1979 Ixtoc I spill in Mexico. Only multiple-source spills in Kuwait and the Arabian Gulf post-Gulf War I rival the size of this disaster.

While we will not attempt to estimate the economic cost to the region or the potential liability of the companies involved, losses attributed to the spill are sure to include tourism, fishing, real estate, intrinsic wildlife value, and jobs. Waterborne commerce has yet to be affected, but scrubbers stand ready to clean ships that arrive at Gulf ports contaminated. By way of comparison, the 'all in' cost to Exxon of the Valdez spill totaled $4.3bn.

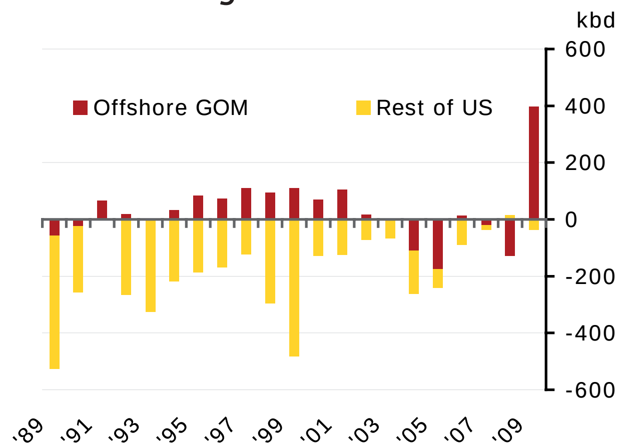
While short-term oil and gas production impacts are negligible, longer-term repercussions are potentially more meaningful. The offshore GOM is more critical to the future of US oil production than it is to natural gas, particularly with the growing importance of shale in the US gas production outlook (Table 1). The share of total US oil production and reserves found in the GOM has grown markedly in the past two decades, and in fact the vast majority of US oil production growth has come from that region (Chart 1). But the deepwater accounts for an increasing percentage of the total offshore production of both oil and gas (Chart 2), and regulatory uncertainty has already impacted activity in the region.

It is still unclear whether the drilling moratorium will stick, and what its duration will be if it does, but the count of active rigs offshore is of course down precipitously, and at least one rig has left the GOM for employment

Table 1.

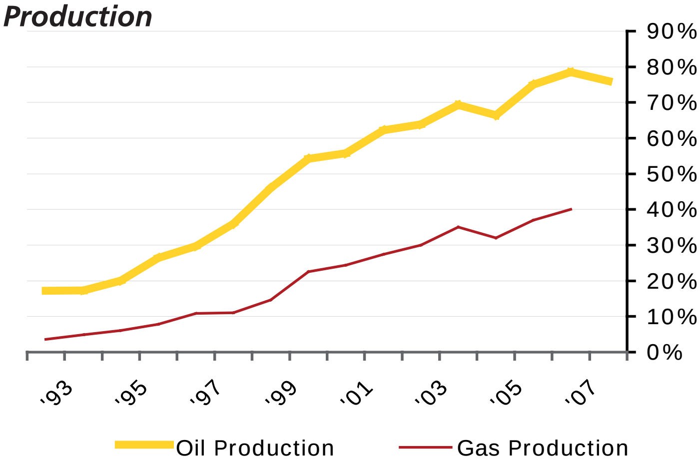
Offshore GOM Share of Total US			
	1988	1998	2008
Oil Reserves	7%	14%	19%
Oil Production	11%	21%	24%
Gas Reserves	5%	17%	6%
Gas Production	0%	21%	9%
	1988-1998	1998-2008	
New Oil Field Discoveries	11%	75%	
New Gas Field Discoveries	58%	65%	

Chart 1. **Annual Change in Oil Production**



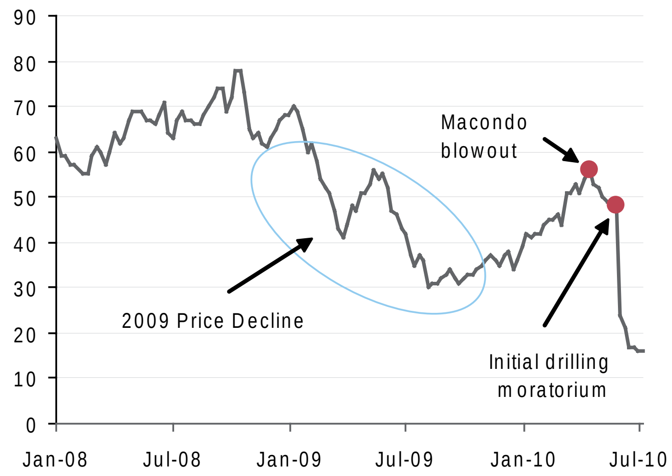
Source: CIBC Macro Strategy, Commodities , EIA

Chart 2. **Deepwater (>200m) Share of GOM Production**



Source: CIBC Macro Strategy, Commodities , EIA

Chart 3. ***Active Rigs, US Offshore***



Source: CIBC Macro Strategy, Commodities , Baker Hughes

abroad (Chart 3). The Energy Information Administration currently estimates that production losses will ramp up to an average of 68 kbd of oil and 0.2 Bcf/day of gas in 2011. Other estimates have put 2011 oil production losses at 80-200 kbd assuming a six-month drilling moratorium.

Other Issues:

Prospects for an Energy Bill: Prior to the spill, incentives for increased offshore drilling were seen as a carrot to garner Republican support for climate change legislation. But climate change is the biggest challenge to passing comprehensive energy legislation; passage of a carbon cap in general, and the Kerry-Lieberman American Power Act specifically, looks increasingly unlikely. Other elements—conservation, alternative energy, and offshore drilling regulation—have better odds and will likely be considered this week. Proposed legislation is expected to remove or significantly increase the $75 million spill liability cap currently in place, impose tougher regulations on offshore drilling and granting of leases, and give states the right to limit drilling within 75 miles of their shores.

Boxing out the little guy? Currently, several hundred entities hold leases in the GOM. The Big Five—Chevron, BP, Exxon, Shell and Conoco—hold about 20% of leases between them. A new regulatory framework for offshore drilling could make it difficult for small companies to own or operate leases in the GOM, limiting the space to bigger players.

The Share Price Wealth Effect: At its low, BP's stock price decline amounted to a $100 bn loss to shareholders—not to mention the temporary suspension in the company's dividend, which had been a major source of income for many funds. British pension funds have been particularly hard hit. The UK's National Association of Pension Funds estimated in June that UK pension funds' exposure to BP was some 1.5% of assets under management on average (a loss of 0.75% when the stock price was halved) though clearly some individual funds were harder hit. Losses from other companies tied to the accident—Anadarko, Transocean, Diamond and Halliburton—at one point totaled more than $50 bn.

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