



Reversal of Fortune

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Economics (Shenfeld): Markets are on the mark in anticipating a downshifting from a steep V-shaped recovery to a flatter U. But earnings yields on equities, and interest rate futures, appear to have priced in room for disappointments in growth. Look for a reversal of some of the recent flight to safety out of risky assets if, as we expect, the eurozone sees slow growth from fiscal tightening rather than an outright default in the next few quarters.

Rates (Ahmed): A sharp increase in volatility during May has been accompanied by an increase in the correlation between stocks and bonds. However, as volatility mean-reverts, bonds should decouple from equities and resume their ascent from historic lows, irrespective of the short-term performance of stocks. In this rising rate environment, 10-year Canada bonds will outperform their US counterparts.

Government Finance (Lovely): Provincial governments have been borrowing aggressively since April 1st. That's a prudent strategy and one consistent with the well-observed seasonal trends in issuance. We examine seasonal swings in supply, noting that US corporate spreads have much more predictive power on spreads. And more than a summertime lull, it's positive quarterly updates that have the potential to spur spread performance.

Credit (Zapior): We reassess our spread forecast for 2010 in light of spread response to events in April and May, and conclude that in the base case we remain comfortable with the spread range we had forecast in January. A worst-case scenario, which we are not forecasting, sees this spread range extended to levels seen in the Bear-Stearns crisis days.

Government and Credit (Lovely, Zapior): We exited our long corporate/short provincial recommendation in our conference call for clients in May. In this note, we examine relative spread performance, including a specific look at financials vs. Ontario, and argue that Canadian corporates are poised for relative underperformance vs. provincials in the months ahead.

Foreign Exchange (Ohayon): Market participants are cautious about getting into new trades even on the back of good news. While the C\$ should move through parity, it will be limited to 2-3% through this level given that caution, and will revert to weaker levels during bouts of negative news on the global recovery. We present structures for dollar-CAD participants designed to take advantage of that trading environment.

Commodities (Buchanan): Public debt concerns and broader growth worries have stolen some of the wind from the resource recovery's sails. "Financialization" tied to large-scale passive investment flows has increased markets' susceptibility to financial shocks like the Euroland one. Gold likely has further to run given a delayed global tightening cycle and ongoing fiscal turmoil. Greater risk aversion, dollar strength and an uninspiring growth picture have led us to pare our targets for the industrial metals.

ECONOMICS

AVERY SHENFELD

From "V" to "U"

Implausible as it might have seemed a year ago, the Canadian economy has traced out the first stages of a classic, "V"-shaped rebound. As sharply as it fell, real GDP has rebounded even more sharply, nearly returning to its pre-recession peak, although leaving the unemployment rate some 2%-points higher. South of the border, the US economy had a longer and steeper tumble, but it too has shown solid growth. Long-suffering Japan has put together two solid quarters, and China's GDP is up near 12% in the past year. All of which puts them in the V-for-victory camp as well.

For investors, of course, that's all water under the bridge. Looking at the recent jitters in equities, markets are clearly concerned that what lies ahead won't be as rosy. Judging by trends in sovereign CDS markets and bond

spreads, markets are still concerned about an intensified credit shock in the eurozone, one that would begin with a sovereign default and spread to the banking system.

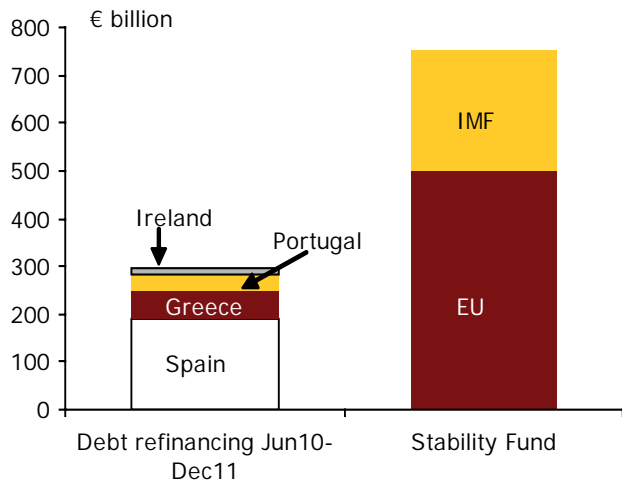
While that might still transpire, it seems less likely to happen in the next year than further out. Europe's recent collective borrowing proposal, with a potential IMF supplement, would be enough to refinance all of the weakest player's maturities through 2011 (Chart 1). The lack of any additional evidence of a move to the brink of default should allow some of the recent flight to safety, away from equities and corporate bonds into Treasuries and Canada, to be reversed.

But equity markets may still be onto something. Rather than being hit by a one-time shock wave, investors

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

END OF PERIOD:	2010			2011			
	14-Jun	Sep	Dec	Mar	Jun	Sep	Dec
CDA Overnight target rate	0.50	1.00	1.25	1.25	1.75	2.25	2.50
98-Day Treasury Bills	0.54	1.15	1.05	1.15	1.75	2.35	2.55
2-Year Gov't Bond	1.83	1.95	2.15	2.40	2.85	3.00	3.25
10-Year Gov't Bond	3.46	3.50	3.75	4.00	4.05	4.00	4.10
30-Year Gov't Bond	3.85	3.90	4.00	4.20	4.25	4.15	4.20
U.S. Federal Funds Rate	0.23	0.20	0.20	0.20	0.50	1.25	2.00
91-Day Treasury Bills	0.06	0.10	0.15	0.15	0.45	1.15	1.90
2-Year Gov't Note	0.77	1.00	1.20	1.40	2.00	2.40	2.80
10-Year Gov't Note	3.30	3.60	3.95	4.10	4.25	4.30	4.40
30-Year Gov't Bond	4.22	4.50	4.75	4.75	4.95	5.00	5.05
Canada - US T-Bill Spread	0.48	1.05	0.90	1.00	1.30	1.20	0.65
Canada - US 10-Year Bond Spread	0.16	-0.10	-0.20	-0.10	-0.20	-0.30	-0.30
Canada Yield Curve (30-Year — 2-Year)	2.02	1.95	1.85	1.80	1.40	1.15	0.95
US Yield Curve (30-Year — 2-Year)	3.45	3.50	3.55	3.35	2.95	2.60	2.25
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	92	92	91	90	89	87	87
EURUSD	1.22	1.18	1.20	1.22	1.24	1.27	1.30
GBPUSD	1.48	1.40	1.43	1.44	1.46	1.48	1.49
AUDUSD	0.862	0.870	0.890	0.910	0.930	0.940	0.950
USDCHF	1.14	1.19	1.18	1.16	1.15	1.13	1.12
USDBRL	1.80	1.77	1.75	1.73	1.73	1.71	1.70
USDMXN	12.6	12.5	12.5	12.3	12.2	12.0	12.0

Chart 1. **Stability Fund Covers Refinancing**



could simply be disappointed by the pace of economic and earnings growth ahead. Europe stands alone in undertaking a major fiscal belt tightening this year. Its own growth trajectory will be helped by a weaker euro, offsetting much of the fiscal drag. But that's a zero sum game for the global economy, and a weaker euro will, in effect, transmit some of Europe's fiscal drag to the US and Japan.

More troubling is that in the broader global economy, fiscal restraint has become the new, and perhaps, overdone, orthodoxy. Even countries like the US and the UK, where bond markets seem perfectly willing to finance deficits at very manageable funding rates, are seeing the political mood swing away from stimulus towards a more immediate assault on deficits. While detailed plans are still rolling in, in many countries, fiscal retrenchments

will subtract 1%- to 2%-points from economic growth in each of the next two years.

That fiscal tightening will be central to a deceleration from today's global "V" into a flatter "U"-shaped advance, with just under 4% 2011 growth for world GDP, and on the order of 2½% for North America (Table 1). Unlike Greece, Spain and Ireland, policymakers have room to go slowly enough to avoid the dreaded "W" of a renewed recession. But what are the implications for investment strategies of going from V to U?

How Much Room for Disappointment?

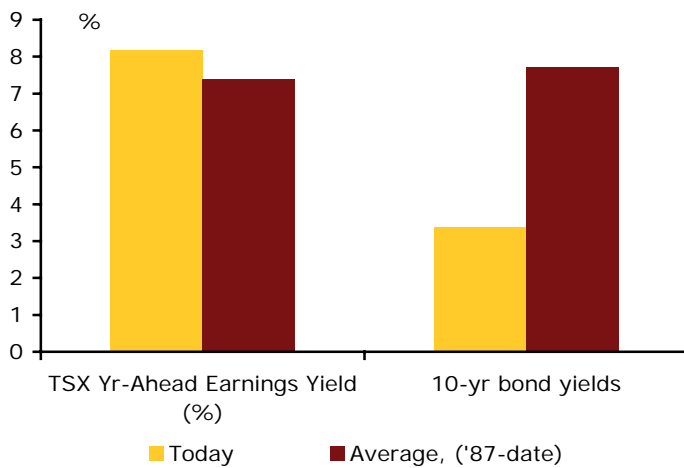
In the equity market, the difficulty is in discerning just what is being priced-in for the next six quarters. Analysts' bottom-up consensus estimates for TSX earnings, showing growth of over 20% this year, might not be too far out of reach, given the solid start and the weak base of comparison from a year ago. It's their call for a further, nearly equivalent profit jump next year that seems far too optimistic for an economy where nominal GDP looks to rise by no better than 5½% in 2011.

However, the bottom-up consensus is consistently biased on the upside, and even in bull markets it's typical for earnings projections to come down to earth as the year gets underway. The market, therefore, already chops something off the analysts' calls in deciding how much to pay. Year-ahead (i.e. 2011) forward earnings yields (relative to analysts' consensus) are in fact below the historical norm for that far out (Chart 2), suggesting that investors have taken a larger-than-normal haircut off the consensus in valuing Canadian equities.

Table 2. **Economic Update**

	10Q1A	10Q2F	10Q3F	10Q4F	11Q1F	11Q2F	2009A	2010F	2011F
CANADA									
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	1.8	2.4	1.9	2.0	2.3	0.3	1.9	2.1
Core CPI Ex Indirect Taxes (Y/Y)	1.9	1.8	2.0	1.9	1.9	2.0	1.8	1.9	2.0
Unemployment Rate (%)	8.2	8.1	8.1	8.2	8.2	8.1	8.3	8.2	8.1
U.S.									
Real GDP Growth (AR)	3.0	4.2	2.5	1.3	1.6	2.7	-2.4	3.2	2.5
Real Final Sales (AR)	1.4	3.9	2.5	1.5	1.8	2.4	-1.7	2.0	2.5
All Items CPI Inflation (Y/Y)	2.4	1.9	1.5	1.3	1.2	1.8	-0.4	1.8	2.1
Core CPI Inflation (Y/Y)	1.3	0.9	0.9	0.8	1.1	1.4	1.7	1.0	1.6
Unemployment Rate (%)	9.7	9.8	9.9	9.8	9.8	9.5	9.3	9.8	9.4

Chart 2. **Stock Valuations Not Stretched by Some Measures, Cheap Against Bonds**



So much so, that earnings growth could be about half the consensus projection (i.e. closer to 10%) and still leave forward earnings yields at roughly the historical norm. While even a 10% earnings gain next year might still be hard to achieve, note that bond yields are also below the historic average, so investors should, in fact, bid down comparable earnings yields on stocks.

All told, then, equities are already discounting a much weaker year ahead than analysts, and might therefore crawl higher over that period. Best bets, therefore, are for sluggish gains, rather than an outright bear market. Historically, Canadian equities have seen a deceleration after the first rate hike, averaging a roughly 4% gain in the six months after an initial BoC move, vs. a double-digit return in the preceding six months. And stocks in Canada have become much more sensitive to overseas equities than was the case in prior decades (see CIBC's *Economic Insights*, May 2010), leaving them vulnerable to adverse news on economic developments in countries with deeper fiscal adjustments ahead.

We can also learn a lot about what investors are now assuming by looking at yield curves. Fed fund futures, for example, already price in no hikes in 2010. We've long shared that view, and in the wake of the latest employment shortfall, are pushing our first rate hike back another quarter, into late Q2 2011. Still, a no-rate-hike expectation in the futures market leaves a wide range of plausible assumptions for growth, given how much slack there currently is in the economy, and the inability to price in an outright rate cut.

More telling is the fact that north of the border, Canadian OIS contracts are priced for a 1% overnight rate by December. That would allow for the Bank of Canada to skip two rate decision dates over that period, an even more dovish outlook than our sub-consensus forecast for a 1.25% rate that includes a pause in December (Table 2). Since the Bank would likely continue to tighten if Canada's growth rate remained above its estimate of the non-inflationary potential (i.e. above 2%), it appears that equity markets are already cushioned for a substantial slowing from the first quarter's 6.2% pace. Equities, therefore, have room to rally, and bonds to sell off, if growth in Q2 matches our 3½% projection.

But with all of the pressure points globally, just as equities are likely to move only sporadically higher, we face some corresponding choppiness in fixed income markets as investors price in, then price out, additional rate hikes.

All of this suggests that buy-and-hold strategies may not be the way to go in either equities or fixed income. Our rate strategist looks at the appropriate way to position a portfolio for such a choppy world. Similarly, dollar-Canada could see days at either end of the recent trading range—rallying the C\$ to parity or stronger in periods of upbeat news on global growth, then selling off to the 1.05 to 1.08 level when concerns re-emerge. Hedging strategies should therefore be designed to allow for some participation on weakness in the C\$, even while maintaining an overall bullish view on the loonie.

RATES

MOHAMMED AHMED

The Evolving Flight-to-Quality Dynamic

For the second time in a row, Governor Carney surprised the bond market with the Bank of Canada's June 1st policy rate announcement. While the April 20th removal of the conditional commitment was somewhat unexpected, markets viewed the decision as being indicative of the near-term path for overnight interest rates. In contrast, despite delivering a broadly expected rate hike this time around, the BoC's most recent announcement has cast the market into a period of heightened uncertainty and non-domestic economic data sensitivity.

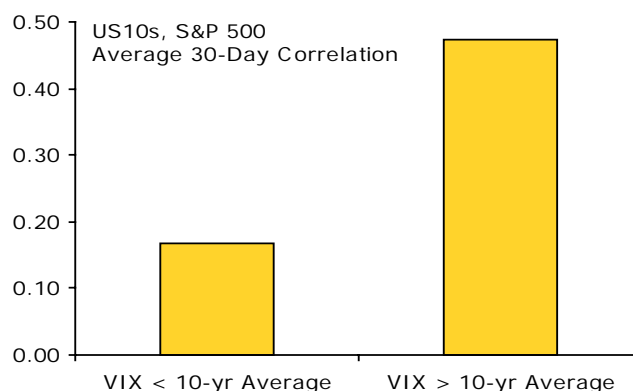
Arguably, developments in Hungary should have little impact on the prospects for Canadian growth; yet, as witnessed in early June, Canadian short rates have demonstrated considerable sensitivity to such events. This is only in part due to the Bank's statement that "further reduction of monetary stimulus would have to be weighed carefully against domestic and global economic developments." Rather, the more important driver has been the evolving global flight-to-quality dynamic—one that has been dependent on the performance of equities and most apparent further out the curve.

Stocks, Bonds and Vols

While longer-term correlations between stocks and bonds exhibit significant variance, short-term correlations tend to increase proportionally with market volatility (Chart 1). That is to say, in a period of event-driven risk aversion, equities and bond yields tend to move in near lock-step. Although the factors contributing to the most recent decline in risk appetite were diverse—ranging from the ongoing European sovereign debt crisis, to political tensions between North and South Korea—the market reaction was in line with this precedent. Going forward though, there will be limited scope for bonds to rally further, given the currently elevated level of market volatility.

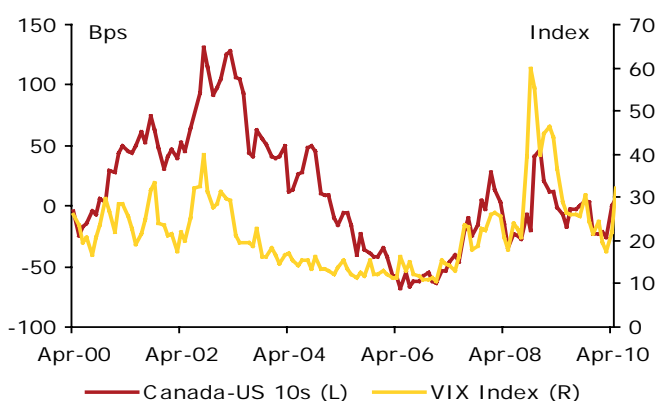
With the VIX currently near 30%, options markets reflect an expectation that the S&P 500 will move almost 2% on a daily basis. Barring the impact of a new exogenous shock, this level may prove to be difficult to achieve.

Chart 1. **Correlation between Stocks and Bonds Rises with Volatility**



And as volatility declines, so too should the correlation between yields and equities. Thus, even if North American equity markets continue within their current consolidative phase, as long as it is in an orderly fashion, 10-year bonds should decouple from equities and resume their ascent from historic lows. Alternatively, yields could be driven lower if expectations of a deflationary environment resurface; however, this is a very low probability outcome given relatively strong economic data and recent Fed speak. In this environment of rising rates and falling volatility, 10-year Canada bonds should demonstrate their fundamental advantage and outperform (Chart 2).

Chart 2. **Canadas Should Outperform as Volatility Mean-Reverts**



The Canadian Advantage

The 50-plus basis point underperformance of Canada 10s relative to US 10s since early April is unsurprising given prevailing market conditions. However, the mean-reverting tendency of volatility should act as a catalyst for a near-term corrective performance of longer-dated Canadas. Meanwhile, in the long-term, Canada will continue to enjoy a fiscal advantage that should contribute to the sustained outperformance of 10- and 30-year Canada bonds (see May's *GPS Monthly*). Among the transmission mechanisms for this performance will be the continued divergence in the term of North American federal debt issuance, with the weighted average term of US Treasury issuance increasing and that of Canada's stabilizing (Chart 3).

We initially recommended buying Canada 10s versus US 10s in early April, based on this same fundamental view. At the time, Canada 10s appeared oversold and the Canada-US 10s spread was testing a descending

trendline that was anticipated to act as meaningful support. Shortly thereafter, as equity markets rapidly unraveled, US 10s rallied and this spread widened beyond the recommended stop loss level. From a technical perspective, the damage done by breaching this long-term trendline has now resolved.

At a current spread of 15 bps, the Canada-US 10s spread has completed a 50% retracement of the move from late 2008's lows to the peak reached in April 2010. Furthermore, this has been an important level of support over the past year (Chart 4). Should 10-year US Treasury yields re-test resistance at 3% though, this spread would likely widen a further 10 bps. While such an outcome is possible, the probability of a sustained push beyond 30 bps is low, given the extent of the move to date. Thus, periods of further underperformance in Canada 10s should be taken as opportunities to establish long positions, with the view that yields will rise from currently low levels and longer-dated Canada bonds will demonstrate Canada's fiscal advantage.

Chart 3. **Weighted Average Term of Monthly Gross Issues**

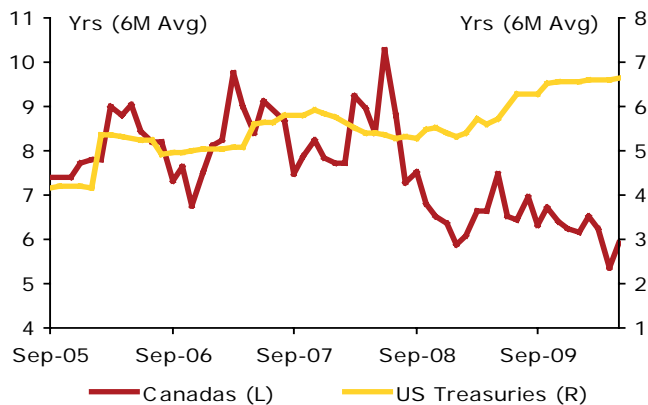
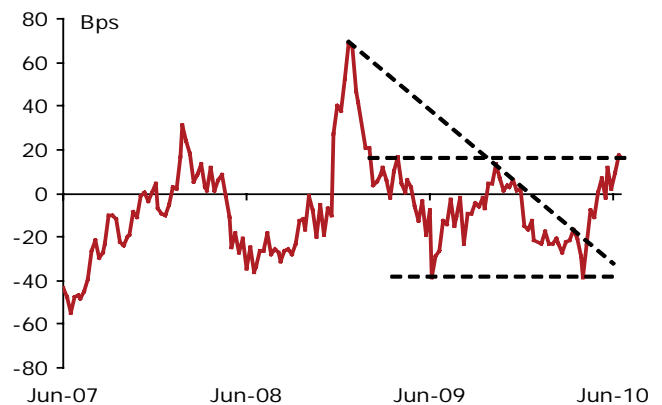


Chart 4. **Canada-US 10s Spread**



Current Recommendations

Proposed Date	Recommendation	Entry	Target	Stop	1-Mth Carry	Current	Ex-Carry Gain/Loss	Duration (Days)
1 24-Mar-10	Canada 2s/10 Flattener	177 bp	140 bp	200 bp	-4 bp	163.0 bp	14.0 bp	83
2 20-Apr-10	Long Canada 5s vs. 2s/10s	43 bp	20 bp	70 bp	-1 bp	27.0 bp	16.0 bp	56
3 10-May-10	Long Canada 10s vs. 2s/30s	130 bp	100 bp	140 bp	-1.5 bp	123 bp	7.0 bp	36
4 20-May-10	Long Can-US 2s/30s Box Flattener, US Steepener)	(Can -125 bp	-150 bp	-115 bp	-1.0 bp	-143 bp	18.0 bp	26
5 7-Jun-10	Short Canada 2s	1.64%	1.95%	1.55%	-6.0 bp	1.82%	18.0 bp	8
6 7-Jun-10	Short Canada 30s	3.73%	4.00%	3.60%	-1.5 bp	3.84%	11.0 bp	8

GOVERNMENT FINANCE

WARREN LOVELY

Changing Seasons: Monthly Patterns in Provincial Bond Supply

In Europe, sovereign debt paranoia forced the implementation of extraordinary financial supports to ensure some sovereigns avoided default. By comparison, Canadian governments are enjoying privileged access to debt capital markets. Witness the \$23 billion in term funding Canada's provinces have managed to complete since April 1st—a two and a half month blitz that has met with robust investor demand in Canada and abroad. Granted, deals are getting done at wider spread levels than before sovereign debt fears rattled credit markets globally, but Canada's provinces are printing record amounts of 30-year bonds at historically low yields. A vote of confidence if there ever was one.

Ahead of the Game?

On the surface, the wave of provincial issuance since April 1st looks to put provincial borrowers collectively ahead of schedule. As of June 14th, barely 20% of the fiscal year was in the books, yet provincial issuers had already completed nearly one-third of their estimated funding requirement (Table 1).

This aggressive funding stance is a nod to both the sheer magnitude of the borrowing program and competition from other sectors (notably corporates). And for some, moving quickly was designed to lock in attractive rates ahead of an anticipated sell-off. Many households adopted a similar strategy, front-running a Bank of Canada tightening cycle by moving into fixed rate mortgages *en masse* this Spring.

But this springtime surge isn't that unusual. Bond supply exhibits tremendous seasonality in Canada. My colleague, Joanna Zapior, recently examined seasonal fluctuations in corporate issuance, noting the front end-loaded nature of corporate supply. In the provincial space, supply is not so much clustered into one half of the year, rather it is concentrated into a handful of busy months, with the timing very much dictated by the budgetary/fiscal planning process.

Table 1. Progress Against Provincial Borrowing Programs

	2010/11 Bond/MTN Program ⁽¹⁾		
	Projected Issuance	Complete to 14-Jun	
	C\$bn	Total C\$bn	Share %
British Columbia	8.7	2.7	31%
Alberta	1.3	0.0	0%
ACFA ⁽²⁾	2.5	1.4	57%
ATB	-	0.0	NA
Saskatchewan	0.9	0.0	0%
Manitoba	3.1	1.0	33%
Ontario	38.7	12.9	33%
Québec ⁽³⁾	12.2	3.6	29%
Financement-Québec	3.5	0.3	8%
Hydro-Québec ⁽²⁾	2.0	0.5	26%
New Brunswick	2.8	1.5	54%
New Brunswick MFC	0.2	0.1	37%
Nova Scotia	1.9	0.4	21%
Prince Edward Island	0.1	0.0	0%
Newfoundland & Labrador	-	0.0	NA
Provincial Total	77.9	24.4	31%

1. Excl. retail/savings bonds & CPP rollovers

2. Calendar year

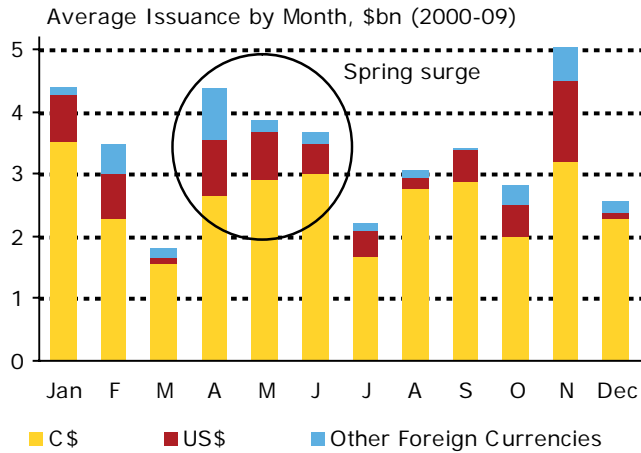
3. Incl. CIBC assumption of \$4bn in pre-funding

Blackouts stemming from budgets and mid-year updates tend to produce muted supply in March and October, while July vacations and December holidays also trigger a relative lull in supply. As for the "busy" months, the spring trimester stands out (Chart 1). Catch-up issuance is also evident in November and January, making these months some of the busiest in the calendar.

Borrowing Aggressively in Spring a Prudent Strategy

For much of the 2000s, modest provincial borrowing requirements meant governments could spend plenty of time away from market without derailing funding programs. But as borrowing programs have grown, so too has the importance of an uninterrupted spring funding season. Two years ago, in fiscal 2008/09, provincial

Chart 1. **Provincial Issuance Pattern Highly Seasonal**



governments borrowed aggressively from April to June, a strategy that paid dividends when Lehman's collapse and subsequent market turmoil imperilled access to capital markets. And last April, the provincial sector pumped out what still stands as a record month of issuance, *en route* to getting nearly 40% of an unprecedented borrowing program wrapped in the first three months of the fiscal year (Chart 2). Against this backdrop, governments are right where they need to be in fiscal 2010/11, nicely positioned to ride out G20 disruptions and a summer-time slumber without throwing the aggregate funding target off track.

Implications for Future Supply

We've seasonally adjusted monthly provincial issuance

Chart 2. **Tracking Progress Through the Fiscal Year**

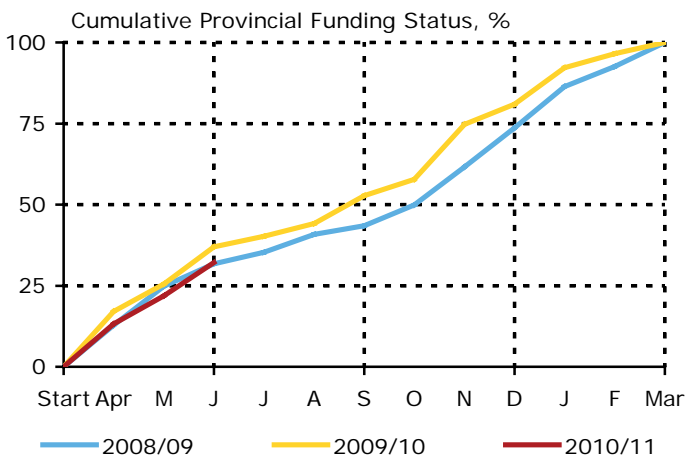
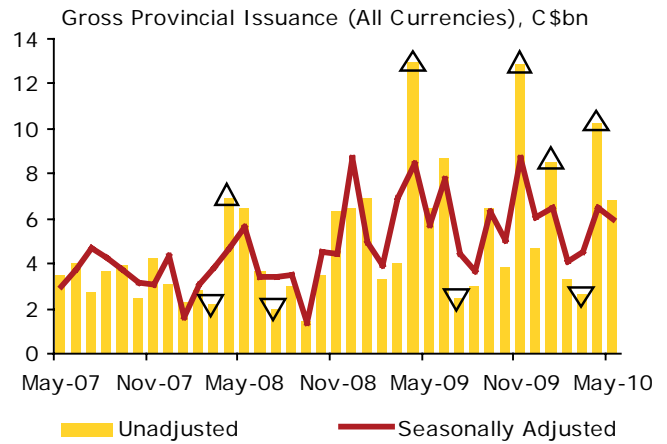


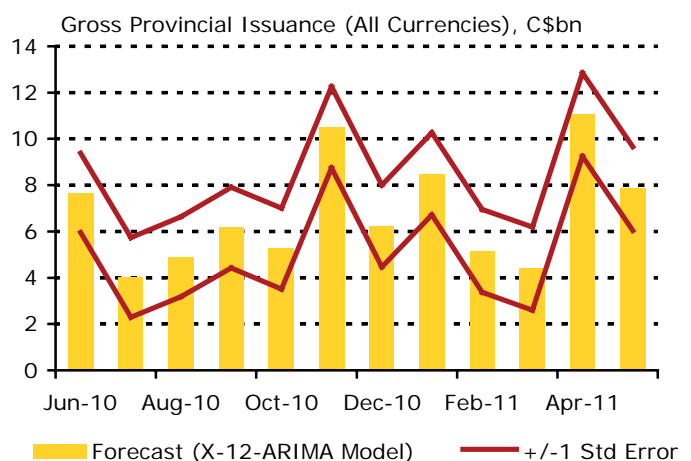
Chart 3. **Raw & Seasonally Adjusted Supply**



using the X-12-ARIMA model developed by the US Census Bureau. More than smoothing out the violent ups and downs in the raw data (Chart 3), the seasonal adjustment model provides a degree of guidance into future supply. At risk of implying false precision, the underlying seasonal pattern would, on its own, point to roughly \$8 billion of supply in June. We're well on our way to hitting that mark, with just shy of \$6 billion completed in the first fourteen days of the month. Seasonals imply a pull back to \$4-5 billion in July and August (Chart 4), although the actual pace of issuance will be dictated by the market's overall appetite for risk and by the availability of cost-effective foreign market opportunities.

What impact will the near-term pace of supply have on spreads? To some extent, it will depend on your market

Chart 4. **Implied Provincial Issuance**



of interest. Seasonality is evident in both domestic and international supply, although owing to the reduced frequency and larger transaction size, international deal flow is inherently choppy. While the busy spring and November story holds in the US\$ market, provincial spread performance will continue to be heavily influenced by global credit developments.

Supply will, however, remain an important driver of relative spread performance internationally (i.e., where one provincial credit trades in relation to another). Consider the basis between Ontario and Québec. Despite a relatively weaker credit rating and higher level of indebtedness, Québec 5-year bonds currently trade as much as 10 bps through Ontario in the US\$ market. Much of that can be attributed to the fact that Québec hasn't issued in US dollars since May 2008, while Ontario has brought more than US\$25 billion of new product since that time.

Domestic Spread Impact

In the domestic market, where at least two-thirds of provincial supply is generally conducted, issuance patterns are characterized by stable and significant seasonality.

Over the long term, elevated levels of supply clearly contribute to wider spreads. And in the short term, markets may be under the impression that seasonal supply flows

serve to influence domestic spread behaviour. The data would appear to lend support to this thesis. Empirical analysis suggests that provincial spreads tend to lead big swings in supply by one month, weakening in the lead-up to the spring funding surge, recovering ground during the summer, only to push wider in advance of late-fall supply (Chart 5). But this relationship is spurious. Provincial credit spreads remain much more closely correlated with the tone in US credit markets than with domestic supply. Indeed, US corporate and Canadian provincial spreads exhibit the same monthly seasonality, and during the past decade, movements in US corporate spreads have explained the majority of the variation in provincial spreads (Chart 6).

So rather than a summer slowdown in supply, provincial spreads will be driven by more fundamental developments, some of which look to lend support to a sector that has shed 25 to 30 bps vs. early-year tightness. Canada's improved growth backdrop signals provincial government revenue running well above plan. At least some of that extra revenue will translate into smaller deficits and slower debt accumulation, improving credit fundamentals and setting the stage for a more legitimate easing in seasonally adjusted bond supply. Medium-term challenges are not to be underestimated, and we maintain a more defensive view on 2011 growth than many. Still, a near-term fiscal improvement should, at a minimum, support relative performance vs. corporates, a theme we explore on pages 12-13.

Chart 5. **Spread, Supply Dynamic**

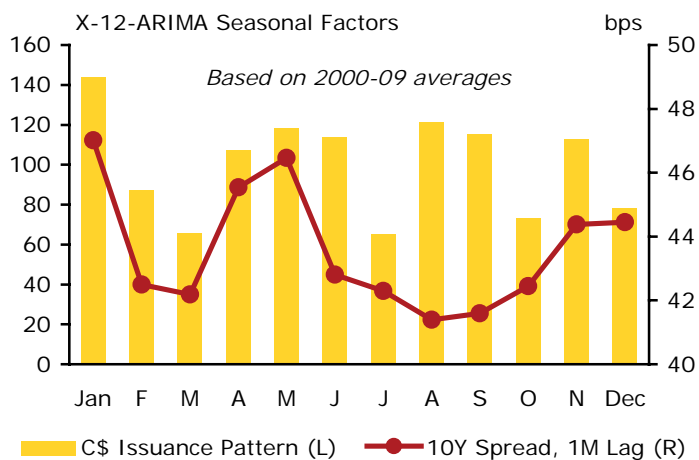
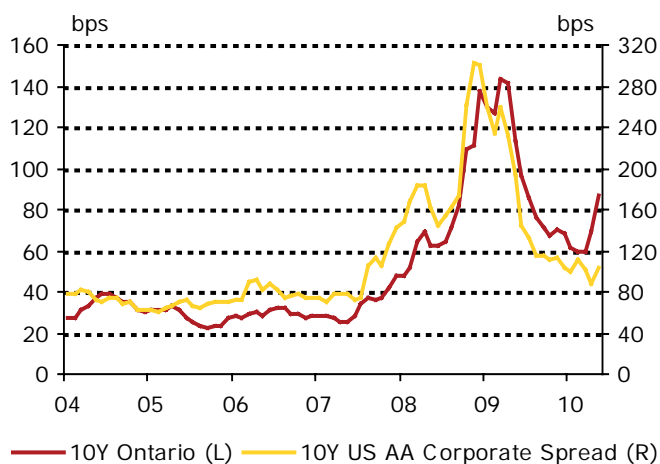


Chart 6. **Provincial Spreads Track US Corporates**

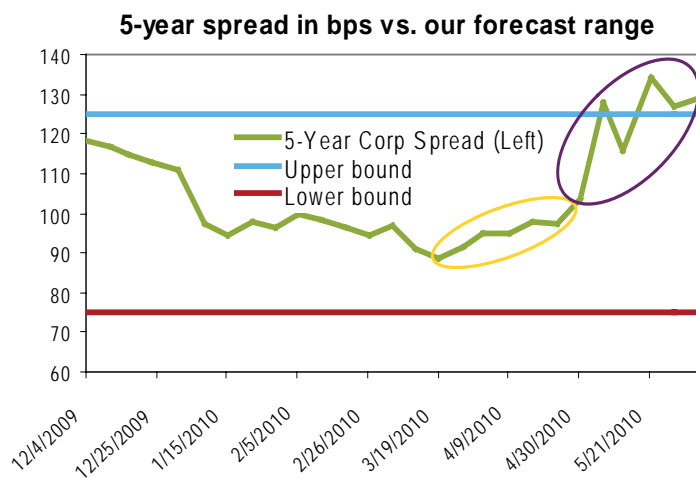


Picking Up the Pieces

Arguably, damage to Canadian investment grade spreads in May and June so far has been substantial (Chart 1) as global headlines kept showing up and taking the markets on intra-day roller-coaster rides.

- Our reference five-year spread initially widened 15 bps since its lows in mid-March to end of April. Subsequently it gapped out 30 bps to its peak on May 21. As we go to print, this spread is 40 bps, or 46%, wider than its tightest level this year.
- The five-year corporate yield premium (corporate yield divided by the underlying Canada yield) was largely unchanged through to the end of April, at which point it shot up almost 20 points (from 1.32 to 1.50), on a combination of a 30 bp corporate spread gapping and a 40 bps decline in the underlying Canada yield.

Chart 1. **Damage to Canadian Investment Grade Spreads**



Note: The horizontal lines are the boundaries of the spread range we called at the beginning of the year for 2010, using the five-year reference spread for a basket of frequent issuers.

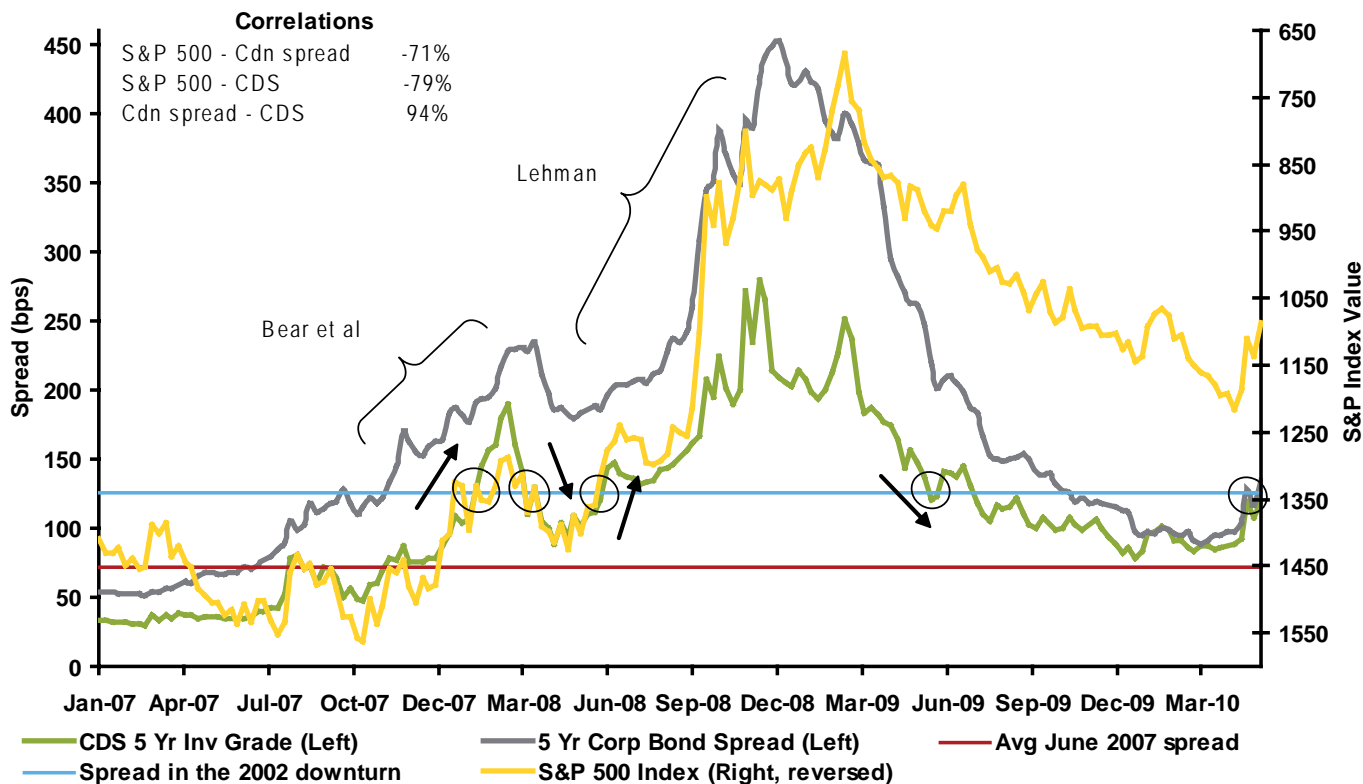
Where Do We Go From Here?

It is not a very comfortable position from which to forecast (Chart 2) as we find ourselves in this “middle-of-the-road” spread zone of the post Bear-Stearns days, and all markets clearly seek guidance from equities, again, not unlike in the previous credit spread widening swings in 2007/08 and 2008/09.

Our reference spread clearly breached the level we point to as the yardstick from the 2002 downturn experience. It did so in response to global headline news, rather than on fundamentals. Note that even in 2002 spreads pierced through the yardstick we now use as our upper bound a few times during the four-week period of peak spreads from mid-October to mid-November.

- Canadian corporate fundamentals have so far been supportive for spreads. But they are not going to stay so favourable. The anticipated government stimulus withdrawal will likely turn into a fiscal drag, as the *CIBC Economics* expects, perhaps as early as the second half of 2010 and into 2011, not just in Canada, but more importantly around the globe. A realization of this will likely keep pressure on spreads and prevent them from tightening.
- However, given the much graver importance of global macro events, we don't expect the market to focus in the near term on anticipating a possible turn for the worse in fundamentals, until it actually sees the “proof in the pudding” of deteriorating economic numbers and company results.
- The traditional wild-card of new issue supply will also play its role. Its impact tends to be overtaken by global headlines as market windows for new issuance periodically shut down. When they do re-open, we can possibly see again the mildly spread-widening impact of large bank paper supply. We have been experiencing it this year as Canadian banks are back to the old-normal issuance, which dominates many a corporate debt market in the world, including Canada. Please refer to our Side Story side bar.

Chart 2. Corporate Spreads in an Uncomfortable Spot



All in all, today we still feel that in the base case scenario spreads should be able to remain in the upper half of the June 2007-summer 2002 range for the rest of 2010. This spread range amply reflects potential negatives of deteriorating fundamentals in response to stimulus withdrawal, and makes an accommodation for “lumpy” supply.

As to a worse-case scenario, which we are NOT forecasting at this point, it is easy to see spreads responding to global event risk and pushing well above this range, with the next stop perhaps another 30-50 bps wider as during the pre-Lehman, post-Bear days (Chart 2).

A Side-Story, Supply-Side To Be Precise

Interestingly, the spread widening in Canadian spreads since mid-March was not solely attributable to an increase in risk aversion in reaction to global headlines. A careful analysis highlights a technical undercurrent that is commonly seen as an important spread driver—new issue supply. While event risk undoubtedly weighs much more heavily on spreads than any other “regular” driver, when it subsides, we will still have to reckon with the technicals of supply.

As we look back at the spread widening since mid-March (Chart 1), until the last day of April according

to the daily trader narrative it was driven in large part by heavy, mostly senior, bank paper supply in C\$, with global events much in the backdrop. Between March 22, which marked the end of spread tightening of the early months of 2010 and the date when BNS issued C\$1 billion in deposit notes, and April 28 when NBF issued C\$900, the market absorbed C\$9.8 billion in new issuance, of which C\$6.5 billion or 67% was bank paper. Comparable number for the entire YTD is 53%, also illustrating that the initial spread widening period in March/April was indeed in part due to heavier than normal bank paper issuance.

GOVERNMENT & CORPORATE CREDIT

WARREN LOVELY & JOANNA ZAPIOR

Trading Places

In our *January 2010 Outlook* conference call, we argued that fundamental and supply dynamics would propel another round of provincial sector underperformance versus corporates. By April, the basis between our broad basket of 5-year corporates and Ontario had tightened to just 50 bps, representing a tiny fraction of the 300-plus bp spread registered in early 2009, at the peak of the financial crisis (Chart 1). Moreover, the move left the ratio of broad corporate-to-provincial spreads—a relative measure of spread premiums—at historic tights, based on a decade of weekly new issue spreads (Chart 2).

Chart 1. History of Corporate, Provincial Spread Differential

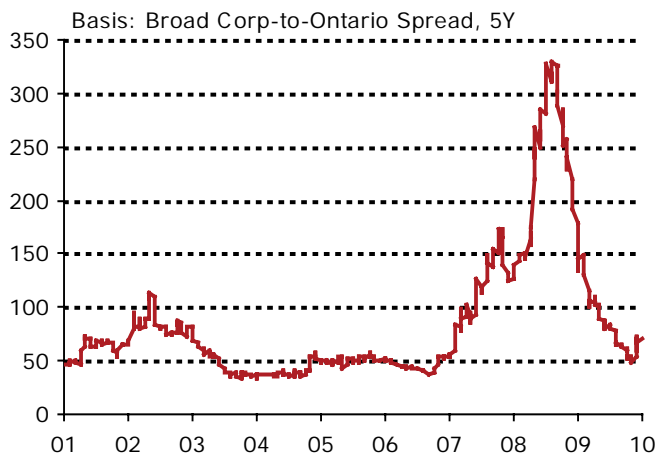
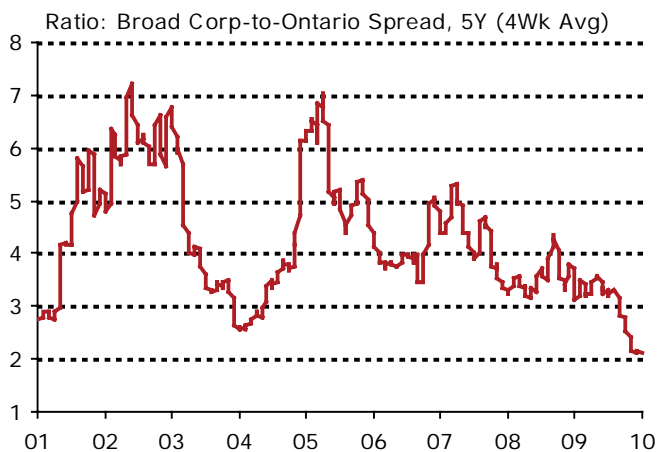


Chart 2. Ratio of Corp-Provi Spreads at Historic Tights



With sovereign debt fears destabilizing credit markets, corporates have come under more intense pressure since May. And we used our May investor call to exit our long corporate/short provincial recommendation. In the subsequent weeks, corporate spreads have posted relative underperformance. We believe there's more to come, and expect this theme to hold in the coming months.

Should the market's worst fears be realized, an environment of heightened credit fears and broad risk aversion would see corporates suffer much greater damage than less-risky provincial bonds. Note, however, that even in a more benign environment, Canadian corporates could see further underperformance vs. provincials.

As noted on pages 7-9, provincial governments are due to table some encouraging results in upcoming quarterly and mid-year reports. That will be welcome news for a sector where recession and unprecedented stimulus spending have eroded credit fundamentals, and we see potential for provincial spreads to recoup some of the considerable ground lost since early 2010. Canadian corporates, meanwhile, while still enjoying relatively robust balance sheets, are susceptible to a likely weakening of the global economic growth driven by further deleveraging across Europe and, however cautious, stimulus withdrawal in Canada, the US and other healthier parts of the world. While Canadian corporates have a good credit quality buffer, their top line growth has not recovered fully and there is material headline risk in the Canadian corporate sector in the scenario of waning economic fundamentals.

In terms of supply, provincial borrowing requirements remain elevated by historic standards, but a number of provincial governments are moving beyond the high-water mark for gross and net issuance. In general, gross and net corporate supply remains very manageable (Table 1). One exception, perhaps, will be financials. Canadian banks, after a short pause in 2009, again account for more than 40% of total new issuance so far this year (with all financials accounting for 55% of the total).

Table 1. Corporate Supply Recovers, Provincial Supply Topping Out?

	2007	2008	2009	2010F	2011F
Gross Issues (C\$billions)					
Canadas	34	75	102	95	85
CMB	39	46	42	41	40
Provincial	36	53	77	78	73
Municipal	4	4	5	5	4
Government ¹	113	178	226	219	202
Corporate ²	64	62	57	63	70
Total	177	240	283	282	272
Net Issues (C\$billions)					
Canadas	-5	41	72	60	28
CMB	27	27	24	19	17
Provincial	8	21	47	50	44
Municipal	1	1	2	2	1
Government ¹	31	90	145	131	90
Corporate ²	21	10	19	26	26
Total	52	99	163	157	116

1. Government figures presented on a fiscal year basis
 2. Corporate figures exclude Maples; forecasts based on current run-rate

As such, the supply dynamic looks to exert notable influence on the basis between banks and provincials. As with our broader corporate spread, the ratio of senior bank debt to Ontario has narrowed to levels not seen in years (Chart 3). Granted, this tight basis reflect a convergence in credit rating strength (Chart 4). But if the bank supply dynamic continues, even if only periodically, to be anything like what we saw in the second half of March (as we discuss on pages 10-11), we expect to see incremental pressures on the bank-provincial basis.

In the end, provincial and corporate borrowers are effectively trading places. It was governments after all that paid for much of the economic recovery we are now enjoying, racking up billions in debt while creating opportunities and growth for corporate Canada. With

Chart 3. Bank Debt Trades Rich to Provincials

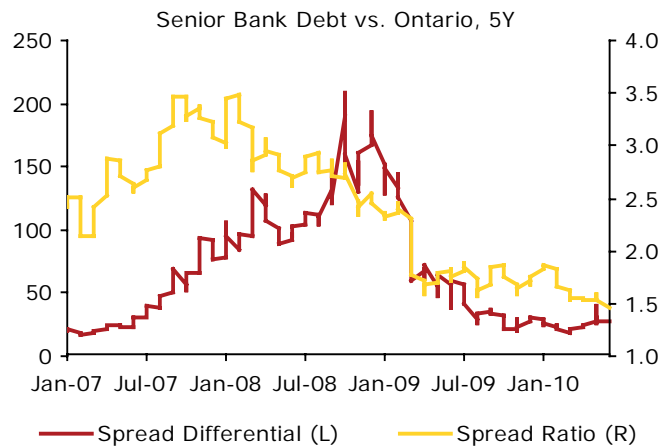
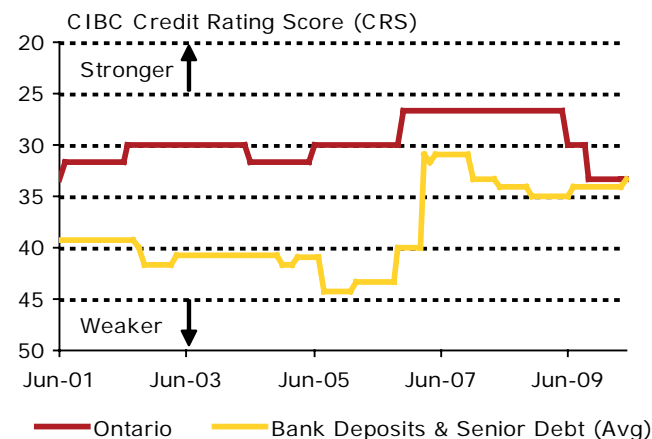


Chart 4. Convergence in Bank-Provincial Ratings



the end of government stimulus ahead, a new era of fiscal restraint looms. Fiscal belt-tightening and a gradual elimination of deficits will be supportive of provincial credit fundamentals. But the slower growth that results, will pose a challenge for a corporate sector that currently looks rich to provincials.

FX STRUCTURING

ERIC OHAYON

Four Dollar-CAD Structures

Following the recent rate hike by the Bank of Canada, the loonie continues to trade in a relatively tight range, partly as a result of the BoC statement that came with the rate increase. While the rate hike was hawkish for the loonie, the market seems to have interpreted the accompanying statement as dovish.

In the statement, the BoC commented that: "Given the considerable uncertainty surrounding the outlook, any further reduction of monetary stimulus would have to be weighed carefully against domestic and global economic developments...".

We interpret the BoC comment to mean that if economic recovery in Canada, and to some extent in the US, continues the BoC will continue to hike rates in order to control inflation and prevent any overheating. However, the Bank is not oblivious to the fact that the "global recovery is increasingly uneven" and that financial markets are coming under pressure. Therefore, we can expect the BoC to hike rates another 75 bps to 100 bps in 2010 only if we do not witness significant weakness in commodity or equity markets.

The following table reflects the potential BoC rate hikes priced by the market on:

- 70% probability of a 25 bps hike on Jul-20
- 85% probability of a 25 bps hike on Sep-8
- 60% probability of a 25 bps hike on Oct-19
- 65% probability of a 25 bps hike on Dec-17

While the financial markets remain relatively nervous, in the absence of any negative news an uneasy stability should prevail. That being said, any bad news would instigate immediate risk aversion. Overall, market sentiment continues to favour a limited appreciation of the loonie for the rest of 2010 with 0.9700 / 0.9800 as a realistic target.

The following strategies are designed to take advantage of a potential appreciation of the Canadian dollar over the next three to six months whilst limiting the risk associated with potential spikes higher in USD/CAD.

RKO with Rebate Spot Ref: 1.0350 CAD per USD

Client Position:	Long a USD Put / CAD Call
Strike:	1.0300 CAD per USD
Expiry Date:	3 months
Conditional Trigger:	0.9750 CAD per USD
Conditional Rebate:	100% Upfront Premium
	In the event that spot USD/CAD ever trades at or below 0.9750, the client's long option position will cease to exist and the client will receive a Rebate equal to 100% of the premium paid upfront
Upfront Premium:	1.00% USD
Analysis:	The client is initially long a 1.0300 USD Put / CAD Call for a upfront premium of 1.00% USD as compared to the 2.50% premium associated with the equivalent vanilla option. In the event that spot USD/CAD ever trades at or below 0.9750, the trade will cease to exist and the client will be rebated 1.00% USD (100% of the premium paid upfront)

Conditional Put Spread Spot Ref: 1.0350 CAD per USD

Client Position:	Long a USD Put / CAD Call
Strike:	1.0300 CAD per USD
Expiry Date:	3 months
Conditional Trigger:	0.9750 CAD per USD
Conditional Position:	Long a 1.0300 – 1.0200 USD Put Spread
	In the event that spot USD/CAD ever trades at or below 0.9750, the client's long option position will become a Long 1.0300 – 1.0200 USD Put spread
Upfront Premium:	1.00% USD
Analysis:	The client is initially long a 1.0300 USD Put / CAD Call for a upfront premium of 1.00% USD as compared to the 2.50% premium associated with the equivalent vanilla option. In the event that spot USD/CAD ever trades at or below 0.9750, the client's position will transform into a 1.0300 – 1.0200 USD Put spread. In which case the client will benefit from a potential 100 pips gain.

Free Put Spot Ref: 1.0350 CAD per USD

Client Position:	Long a USD Put / CAD Call
Strike:	1.0200 CAD per USD
Initial Notional:	US\$ 5,000,000
Expiry Date:	3 months
Conditional Trigger:	1.0650 CAD per USD
Conditional Notional:	US\$ 10,000,000
Conditional Premium:	2.30% of the Conditional Notional
	In the event that spot USD/CAD ever trades at or above 1.0650, the notional of the client's long option position will Double from US\$ 5 mio to US\$ 10 mio. The client will then be required to pay the Conditional Premium on the full notional.
Upfront Premium:	Zero
Analysis:	The client is initially long a 1.0200 USD Put / CAD Call for free (zero upfront premium). In the event that spot USD/CAD ever trades at or above 1.0650, the notional of the client's position will double and the client will be required to pay the 2.3% Conditional Premium on the Conditional Notional.

Fade-In Forward Spot Ref: 1.0350 CAD per USD

This strategy is designed for USD/CAD sellers looking to outperform the prevailing USD/CAD exchange rate over the next 6 months

Client Position:	Sell USD/CAD Forward
Strike:	1.0600 CAD per USD
Notional:	US\$ 1,000,000 per week
Expiry Date:	Weekly over the next 26 weeks
Fade-In Level:	1.0000 CAD per USD
	On a weekly basis, If spot USD/CAD fixes at or above 1.0000, the client will sell US\$ 1,000,000 against CAD at the rate of 1.0600 for that week In the event that spot fixes below 1.0000, no transaction will take place for that week.
Upfront Premium:	Zero
Analysis:	The client can potentially sell USD/CAD on a weekly basis at the advantageous rate of 1.0600, outperforming the outright forward by 250 pips. In the event that USD/CAD fixes below 1.0000, no transaction takes place for that week.

COMMODITIES

PETER BUCHANAN

“Financialization” of Commodities: Implications for the Outlook

With oil trading back over \$75/bbl and copper at around \$3.00/lb, most key commodity prices remain well above their year-ago lows. The first half of 2010 has, nevertheless, proved disappointing for those who looked for a carryover of last year’s strong momentum. Topping the global worry list and hurting sentiment are eurozone debt woes. Belt-tightening will restrain growth and resource demand there in the next few years—a larger potential obstacle for metals than energy markets, based on past consumption patterns (Chart 1). May’s disappointing US non-farm payrolls numbers and China’s efforts to restrain its ebullient property market in the meantime have also clouded prospects in two even-larger resource consumers, although recent strong export data suggest the trade side of China’s economy is holding up. That’s helped to ease, for now, fears of a hard landing there.

Financialization Heightens Susceptibility to Shocks Like Greek Tragedy

The eurozone crisis, while not to be underestimated, appears unlikely to match the systemic damage wrought by the collapse of the \$10 trillion US mortgage market in 2007 and 2008, based on the evidence so far. The recent

Chart 1—Eurozone Slowdown May Be a Greater Negative for Metals Than Energy

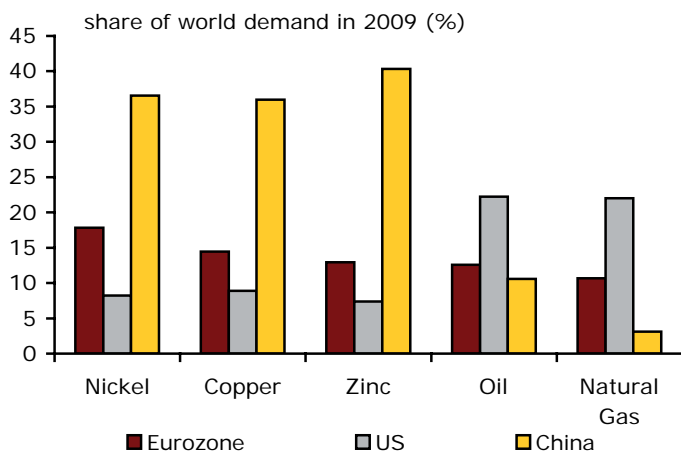
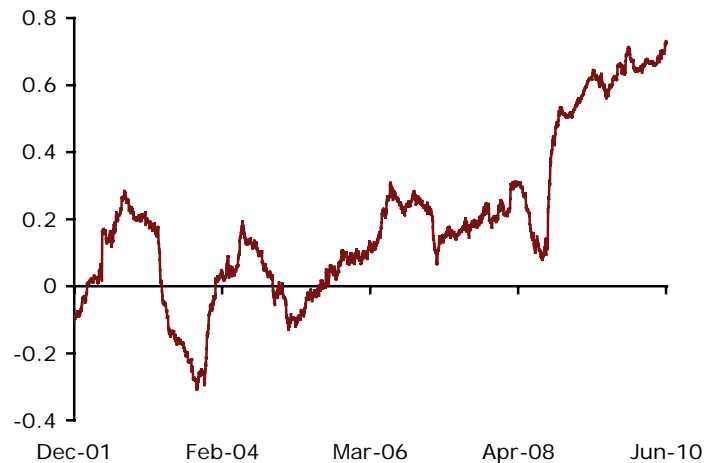


Chart 2—Rolling One-Year Correlation Between S&P GSCI and MSCI World Equity Index

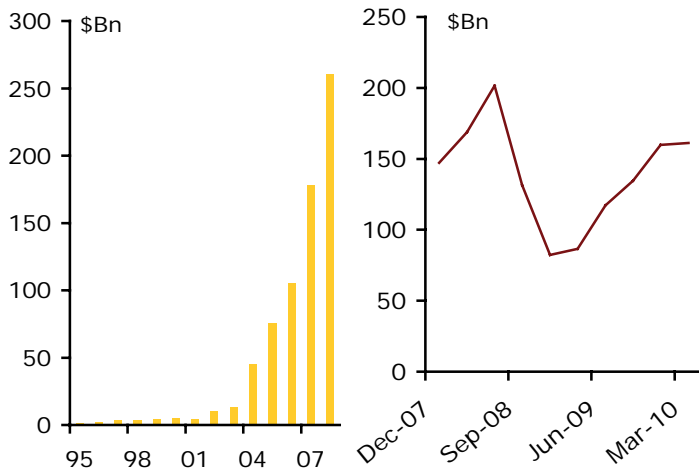


crisis does bear comparison, however, in that it combines a measurable economic shock with a material financial one—an all-the-more important development for resource markets, given the past decade’s “financialization”. That process has served to materially increase the level of correlation between the general level of resource prices and financial variables (Chart 2), including key equity market gauges and the US dollar.

Widely cited research by Fund Manager Michael Masters, presented to a US Senate committee in 2008, showed that the total value of indexed investment exposure to commodities rose by a striking thirteen-fold in the half-decade preceding 2008 (Chart 3, left). That increase has been driven by a number of forces, including investors’ pursuit of enhanced returns during a period of sub-par stock market performance, diversification considerations and a proliferation of new investment vehicles like indexed ETFs. That has reduced the cost, particularly for retail investors, of obtaining exposure to a broad commodity basket.

Index investment has several notable features affecting its general market implications. The first is that investors are typically motivated by the potential returns on the entire

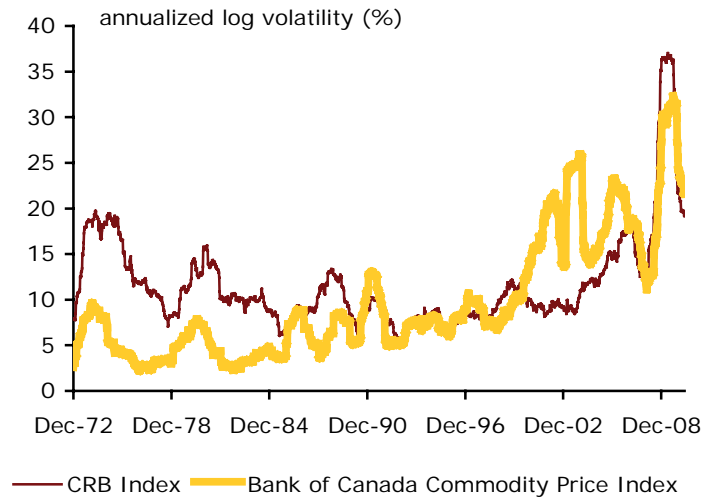
Chart 3—Commodity Index Investment Has Surged in Last Decade (L), Recent Developments (R)



Source: M. Masters, Presentation to Committee on Homeland Security & Governmental Affairs, May 2008

Source: CIBC, Commodity Futures Trading Commission

Chart 5. Commodity Price Volatility Has Risen Markedly Since 2000



“commodity class”, rather than specific commodities. Moreover, until recently, index investors have been almost all long. Another apparent consequence of financialization is the much greater synchronization in price movements for individual commodities (Chart 4). Contributing to that is the fact that the passive investors who have helped to drive money flows in the last decade effectively hold positions in a broad range of major markets.

While there’s always a danger in drawing strong conclusions from time correlations, it’s noteworthy that the past decade’s money inflows and growing view of commodities as an asset class has been associated with a strong rise in volatility (Chart 5). That trend was apparent, well before oil prices surged to historic highs in 2008.

Chart 4. Marching Increasingly to the Same Drummer

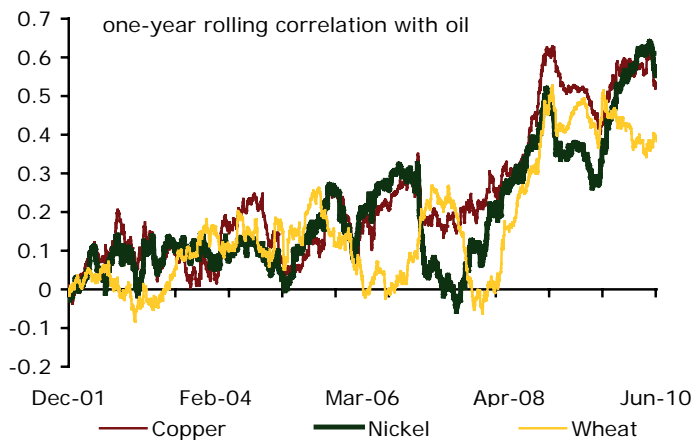
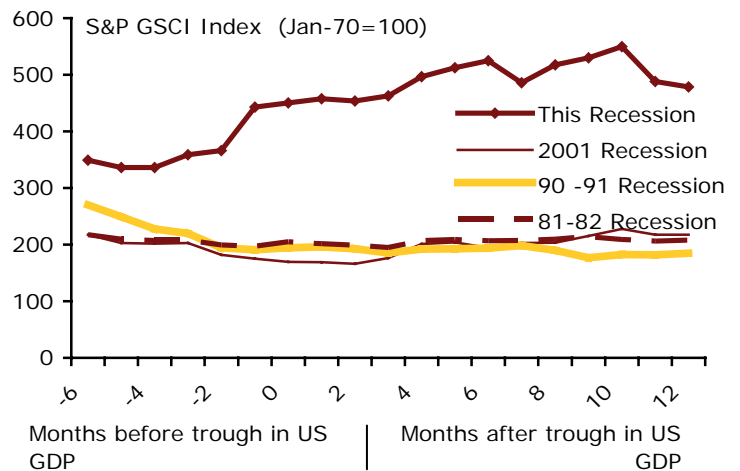


Chart 6. Resource Recovery Still Looks Strong Even with Recent Sell-Off

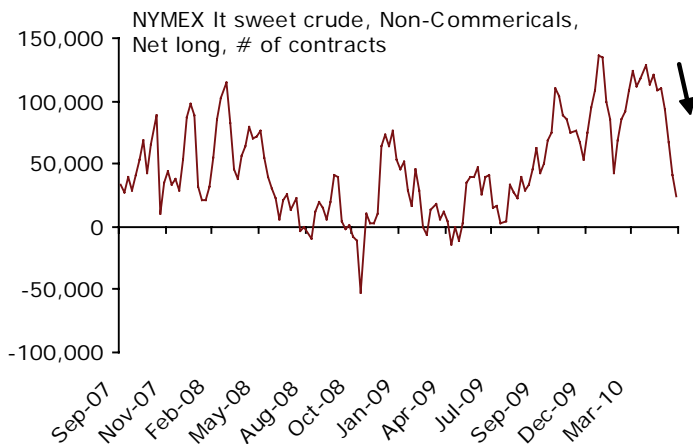


Recommendation Summary:

Buy Aug-11 Natural Gas (approx \$5.41)
Sell Jun-11 Nickel (approx \$19,550)

Time Horizon 12 months
Time Horizon 9-10 months

Chart 7. Speculators Pare Bets That Commodities Have Further to Climb



Investors Aggressively Paring Long Positions Amidst Recovery Uncertainties

Our own investigation of the post-2008 period, drawing on published CFTC data—which differs somewhat from the Masters’ data in coverage—shows that commodity index investment rebounded strongly in the early stages of the recovery (Chart 3, right), contributing to a vigorous rally in resource prices (Chart 6) despite the still somewhat uneven economic backdrop. Lately, the pendulum has swung the other way. Non-commercial or “speculators” have aggressively liquidated their sizeable long exposure to oil (Chart 7), copper and other key commodities, as financial and economic uncertainties have re-emerged.

Some observers have argued that speculative forces cannot lift spot prices without commensurate inventory-building, heightening pressure on supply. That ignores the potential for “in-ground” inventory accumulation by producers, who may hold back production if they expect prices to rise. Also obscuring the impact of speculative pressure, undocumented stock building means reported inventories may understate true levels.

Maintaining Bullish View on Natural Gas and Gold, Cutting Industrial Metals

What are some of the more specific implications of these and other developments for individual sectors? Risk is clearly back these days, after not such a long absence. Renewed safe-haven demand has helped gold set new highs despite the US dollar’s stronger recent bid. Fiscal problems are unlikely to disappear entirely, fuelling ongoing demand for secure, alternative investments. We

are consequently maintaining our bullish view on gold, at least for the next 9-12 months, with an upwardly revised \$1300 target for the year’s end (Table 1). The one clear consequence of the debt crisis is a deferred timeline for central bank restraint (see pages 2-4), which will lend support to the yellow metal.

Industrial metals prices have shown particular volatility recently. While prices have arguably now overshot to the downside in some areas, increased risk aversion and the prospect of data disappointments as fiscal austerity measures bite merit a more cautious view on performance in the next year or two. We have accordingly made downward revisions to our targets for copper and zinc, which we now see averaging \$3.25/lb and \$1.00 in 2010, and more modest ones to nickel and aluminum. China’s authorities are unlikely to clamp down so hard as to kill the recovery. Copper demand there is likely to rise by 5%-10% this year—respectable, though only half last year’s increase.

While oil prices could get some transitory lift from an expected active Atlantic hurricane season, fundamentals are likely to keep WTI prices from averaging much above \$80/bbl this year and \$85/bbl in 2011. OPEC has continued to lift production in recent months. Non-OPEC supply is projected to increase by 700,000 bbl/day this year, the fastest pace since 2004. As with other resources, demand could be hit if the expected global recovery does not progress as quickly as anticipated. Ample excess capacity means that development delays from a temporary US drilling moratorium are unlikely to have much impact until mid-decade, when markets are expected to be tighter. Moreover, the US accounts for only about a fifth of global deepwater production, so the fallout will depend on the extent to which other countries follow suit.

Henry Hub gas prices have defied selling pressures elsewhere, rising by as much as 20% from the spring’s lows. We’ve pared our 2010 target modestly but continue to see prices averaging \$6.00 mn Btu in 2011, about 10% more than the futures strip is currently pricing in. Prices should continue to draw support from curtailed rig activity due to the Gulf spill as well as, potentially the weather. Reviving industrial and power sectors account for 60% of US natural gas consumption and more normal summer temperatures could also support summertime demand. If fervor for tightening up on drilling spreads onshore, that could also lift shale gas costs.

Table 1. **Spot Commodity Prices**

		11-Jun	2007	Average			
				2008	2009	2010 (f)	2011 (f)
Oil (WTI)	\$/bbl	74	72	100	62	80	85
RBOB gasoline	\$/gal	2.01	2.09	2.49	1.69	2.05	2.25
Heating Oil (NYH)	\$/gal	2.00	2.03	2.86	1.65	2.10	2.20
Natural Gas (Henry)	\$/Mn Btu	4.68	6.97	8.89	3.82	4.90	6.00
Gold	\$/troy oz	1220	695	872	1088*	1300*	1150*
Copper	\$/lb	2.93	3.24	3.16	2.35	3.25	3.15
Aluminum	\$/lb	0.87	1.20	1.17	0.76	0.95	0.85
Nickel	\$/lb	8.84	16.86	9.57	6.69	9.50	8.00
Zinc	\$/lb	0.78	1.48	0.85	0.76	1.00	0.95

* end of period

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