



**Mohammed Ahmed**

Rates

(416) 594-8415

mohammed.ahmed@cibc.ca

**Zafar Bhatti**

FX Structuring (416) 594-8090

zafar.bhatti@cibc.ca

**Peter Buchanan**

Commodities

(416) 594-7354

peter.buchanan@cibc.ca

**Warren Lovely**

Government Finance

(416) 594-8041

warren.lovely@cibc.ca

**Michael Rosborough**

Strategic Risk

+44 (0) 207 234-7232

michael.rosborough@cibc.co.uk

**Avery Shenfeld**

Economics

(416) 594-7356

avery.shenfeld@cibc.ca

**Joanna Zapior, CFA**

Credit

(416) 594-8498

joanna.zapior@cibc.ca

**Internet:**

[http://research.cibcwm.com/economic\\_public/download/gps\\_mar\\_10.pdf](http://research.cibcwm.com/economic_public/download/gps_mar_10.pdf)

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## Bracing for Rate Hikes

**Economics (Shenfeld):** The Canadian bond market will continue its front-end-loaded sell-off, as investors take a first rate hike in July as evidence of a lot more to come. Instead, a subsequent economic slowdown, a strong C\$, and the drag from fiscal tightening, will mean a go-slow approach to rate hikes beyond Q3.

**Rates (Ahmed):** Consistently strong Canadian economic data suggest that flatteners are the obvious trade. However, a rush to simultaneously enter flattening positions since mid-February has left the market vulnerable to a corrective re-steepening. Historical yield curve dynamics provide a framework with which to analyse trading strategies predicated on a view that the Bank is poised to embark on a tightening campaign.

**Government Finance (Lovely):** With government debt levels and interest rates heading higher, debt affordability is eroding, impairing fiscal flexibility and in some case threatening provincial credit ratings. There's still time to defuse this time bomb, but the window is narrow for some.

**Credit (Zapior):** The Canadian high yield market is enjoying a "second debut". We ask whether, like US high yield, it will earn a label of a "separate asset class". As we do so, we observe that US high yield data suggests that in the 2000s high yield became more equity-like, and less debt-like than it was in its early and middle years (1980s and 1990s).

**FX Structuring (Bhatti):** After a massive amount of volatility last year, USD/CAD has spent the last 6 months stuck in a tight six-cent range. Eventually some market event will push the exchange rate out of this comfortable zone. The attached strategies would allow clients to monetize a bullish, bearish or range bound view on USD/CAD.

**Commodities (Buchanan):** Gold prices remain well below their 1980's real peak. Although renewed pressure against the dollar and fiscal jitters will lend interim support, we expect prices to ease in 2011 when the Fed belatedly starts retightening. Spot prices should end 2011 around \$1150/oz, down from a new record high of \$1250 later this year.

**Strategic Risk (Rosborough):** Homebuilding stocks have been one of the best performing parts of the US equity market since its bottom a year ago. Can the outperformance of this distressed sector continue? The economics suggest it can but regulatory uncertainty and the end of some important market supports augur for a near term retracement that could provide a buying opportunity.

## ECONOMICS

AVERY SHENFELD

**Rate Hikes and Potato Chips**

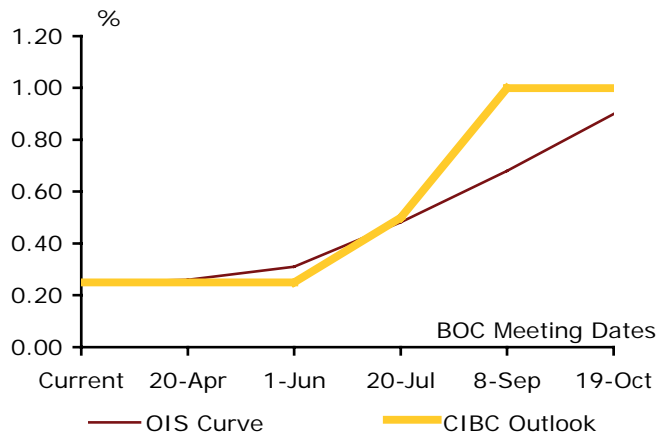
Is it too late to jump on board the flattening trade in the Government of Canada bond market? It would seem that we've come a long way to pricing in the damage to the two-year part of the curve from anticipated rate hikes by the Bank of Canada. For a central bank committed to keeping rates near zero through the end of June, Carney's team could hardly have been more hawkish in its recent statement. Inflation risks were back to balanced having previously been tilted to the low side of the forecast, and some of the recent upward pressure on core prices was judged to be a reflection of improving demand rather than dismissed as temporary. So nobody should be surprised, the bond market included, if the Bank begins hiking rates as soon as its June-end line in the sand has passed.

Yet don't be quick to conclude that the worst has been priced in. Thus far, the OIS curve still has less than a 75-bp course of rate hikes over the first three post-June BoC rate setting dates, a bit below even our relatively dovish forecast for the projected pace (Chart 1). And although we believe the Bank will indeed take it very slowly after the first 75-100 bps of hikes, that's not the way the bond market is likely to see it once the ball gets rolling.

History shows that in the market's eyes, rate hikes are like potato chips—once you open the bag and take the first bite, you end up eating them all. As a result, once one hike is in the books, investors are likely to tack on many more to existing expectations, whether justified or not. At that point, two-year yields will be substantially higher than they are today (Table 1).

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

END OF PERIOD:	2010			2011		
	8-Mar	Jun	Sep	Dec	Mar	Jun
<b>CDA</b> Overnight target rate	0.25	0.25	1.00	1.00	1.00	1.50
98-Day Treasury Bills	0.20	0.60	1.15	1.05	1.15	1.75
2-Year Gov't Bond	1.52	1.90	2.35	2.00	2.40	2.70
10-Year Gov't Bond	3.51	3.65	3.80	3.75	4.00	4.05
30-Year Gov't Bond	4.12	4.20	4.40	4.30	4.35	4.40
<b>U.S.</b> Federal Funds Rate	0.15	0.15	0.15	0.25	0.75	1.50
91-Day Treasury Bills	0.16	0.10	0.10	0.20	1.00	1.50
2-Year Gov't Note	0.88	1.10	1.20	1.35	2.20	2.45
10-Year Gov't Note	3.70	3.80	3.95	4.10	4.45	4.45
30-Year Gov't Bond	4.68	4.75	4.95	4.85	5.05	5.05
Canada - US T-Bill Spread	0.04	0.50	1.05	0.85	0.15	0.25
Canada - US 10-Year Bond Spread	-0.19	-0.15	-0.15	-0.35	-0.45	-0.40
Canada Yield Curve (30-Year — 2-Year)	2.59	2.30	2.05	2.30	1.95	1.70
US Yield Curve (30-Year — 2-Year)	3.80	3.65	3.75	3.50	2.85	2.60
<b>EXCHANGE RATES</b>						
CADUSD	0.97	0.99	1.02	0.97	0.96	1.00
USDCAD	1.03	1.01	0.98	1.03	1.04	1.00
USDJPY	90	93	90	87	86	86
EURUSD	1.36	1.35	1.41	1.45	1.47	1.48
GBPUSD	1.50	1.48	1.55	1.61	1.65	1.68
AUDUSD	0.914	0.940	0.960	1.000	0.990	0.995
USDCHF	1.08	1.08	1.05	1.03	1.02	1.03
USDBRL	1.78	1.80	1.75	1.72	1.70	1.69
USDMXN	12.8	13.0	12.7	12.5	12.3	12.3

Chart 1. **Overnight Rate Outlook**

Source: Tullett Prebon (Mar 5), CIBC

In this case, that will likely represent an overshoot of the coming reality. Because there are many good reasons for the Bank of Canada to be extremely cautious in the timetable for bringing rates back to historical norms.

For one, if as we expect, the Bank is out in front of the Fed by a couple of quarters, a higher Canadian dollar will help to tighten monetary conditions. The Aussie dollar jumped five cents in the days after the RBA launched its rate hike cycle. That move was ahead of market expectations by a few months, and the Canadian dollar is instead likely to move more in anticipation rather than in reaction, given Carney's greater communication with the market. Indeed, we've already seen the Canadian dollar gain several cents in recent weeks as the market begins to firm up expectations for a July hike, even against the backdrop of US dollar strength. But it's easy to see the C\$ running a few cents through parity after the first hike as the market prices in an even wider short-rate differential vs. the US.

Second, is the fiscal drag set to hit in 2011. Flaherty's budget chops \$19 bn out of the Canadian economy in one fell swoop, simply by letting stimulus plans expire on schedule. Most provinces will be following a similar course. Note that Canada survived the post-1994 tightening by easing monetary conditions (mostly through the C\$) during the sharpest period of fiscal restraint, as did the US when, under Clinton, falling bond yields spurred private investment as the US moved from deficit to surplus. That option isn't available this time, with interest rates already near zero, and the Canadian dollar finding a bid as investors look at a much worse fiscal picture in most other developed economies.

Finally, there's the uncertainty that the Bank will still face regarding the global outlook after 2010. It's not just Canada that will be weathering a fiscal tightening—it's the US, Europe, Japan and China as well. Banking reforms could restrain lending room globally, and the US housing market, the root source of the 2008-09 shock, is still a mess. Going full bore with rate hikes in the first year or so of recovery risks having to do an about-face if any of these minefields blow up. That's exactly the lesson we hope the Bank learned after its go-it-alone rate hikes in 2002 had to be subsequently reversed.

Indeed, we expect fiscal tightening, the end of the initial inventory cycle boost to US growth, and a cautious consumer stateside to visibly slow North American growth in the latter part of the year (Table 2), putting Canada's rate hike cycle on pause after only the first 75 bps of hikes this summer. Look for a nice rally in the front end when the market senses that the Bank of Canada can leave a lot of the chips in the bag after its first few bites. But until then, it's not too late to bet on a further bear market flattening in the Canadian curve as the market overshoots in its expectations for monetary policy tightening.

Table 2. **Economic Update**

	09Q4A	10Q1F	10Q2F	10Q3F	10Q4F	11Q1F	11Q2F	2008A	2009A	2010F	2011F
<b>CANADA</b>											
Real GDP Growth (AR)	5.0	4.1	3.1	1.5	1.9	2.9	3.4	0.4	-2.6	2.7	2.9
Real Final Domestic Demand (AR)	4.6	3.8	3.0	2.7	2.4	1.9	1.9	2.6	-1.7	3.6	2.4
All Items CPI Inflation (Y/Y)	0.8	1.7	1.8	2.1	1.7	1.5	2.0	2.4	0.3	1.8	2.0
Core CPI Ex Indirect Taxes (Y/Y)	1.6	1.9	1.7	1.7	1.6	1.6	1.9	1.7	1.8	1.7	2.0
Unemployment Rate (%)	8.4	8.2	8.0	8.2	8.3	8.2	8.1	6.2	8.3	8.2	8.0
<b>U.S.</b>											
Real GDP Growth (AR)	5.9	3.2	4.0	1.3	0.7	2.4	2.6	0.4	-2.4	3.1	2.4
Real Final Sales (AR)	1.9	2.5	3.0	1.7	0.7	2.0	2.2	0.8	-1.7	2.0	2.3
All Items CPI Inflation (Y/Y)	1.4	2.3	1.6	1.9	2.0	2.3	3.2	3.8	-0.4	2.0	3.1
Core CPI Inflation (Y/Y)	1.7	1.3	0.9	0.9	1.0	1.5	1.8	2.3	1.7	1.0	2.0
Unemployment Rate (%)	10.0	9.8	9.9	10.1	10.1	10.2	9.6	5.8	9.3	10.0	9.5

# RATES

MOHAMMED AHMED

## The Uncertainty Principle

Consistently strong Canadian economic data and the correspondingly hawkish Bank of Canada rate announcement suggest that flatteners are the obvious trade. However, the more precisely the direction of the curve becomes known, the less precisely momentum can be determined. Case in point, a rush to simultaneously enter flattening positions since mid-February has left the market vulnerable to a corrective re-steepening (Chart 1). Fortunately, historical yield curve dynamics provide a framework with which to analyse trading strategies predicated on a view that the Bank is poised to embark on a tightening campaign.

Fourth quarter GDP growth and recent jobs data indicate that the Canadian economy is in the midst of a recovery. Subtle changes to the Bank's March 2<sup>nd</sup> rate announcement signal an acute awareness of the fact that the speed of the recovery is quicker than originally forecast. Consequently, the front end of the Canada curve has undergone a swift re-pricing.

Notwithstanding the view that the Bank is set to commence an initial round of tightening, the starting point for the overnight rate is unprecedented. Moreover, as CIBC Economics points out, no economic recovery goes in a straight line and the current one risks being one of the most non-linear. Fiscal tightening, Canadian dollar strength and a correction in the housing market are just some of the factors with the potential to weigh on growth in the second half of 2010. Thus, the pace of tightening will be gradual and the curve is likely to maintain a degree of residual steepness. Currently this phenomenon is most evident in the 5-year sector, which has underperformed as the Canada curve has bear-flattened.

### Fives: Seasonals Still in Play

Conventional wisdom regards the 5-year sector as a pivot point on the Canada curve; 5s are second only to 2s in terms of both liquidity and volatility. The 5-year term is also an important one for bank treasury departments, which hedge mortgage assets in the sector by selling 5s, or paying in swaps.

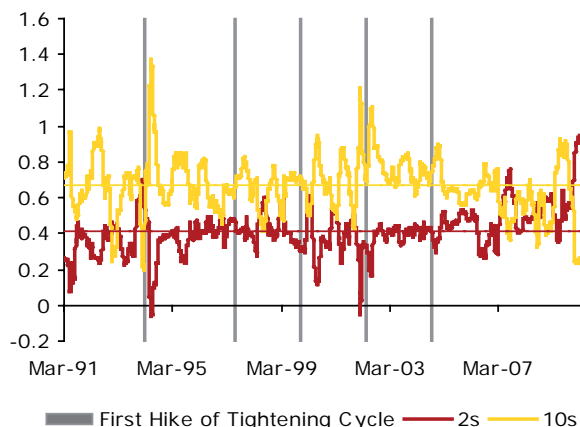
As detailed in February's *GPS Monthly*, Canada 5s seasonally underperform the wings in May and June, when the housing market is most active. Introduce a flattening of the curve to the mix and there is potential for an exacerbated underperformance of 5s in coming months. With interest rates poised to rise in the front end, variable-rate mortgages will begin to lose their historic appeal. In turn, the mix of variable- to fixed-rate assets in banks' mortgage portfolios will shift to favour the latter and treasury departments will have greater hedging requirements in the 5-year sector.

The outlook for 5s, though, changes decidedly beyond June of this year, when the Bank's conditional commitment expires. Two decades of empirical evidence confirm that the 2s/5s curve is more sensitive to changes in overnight rates than broader term spreads. Specifically, while 2s/10s historically anticipates a given change in overnight rates as many as two months in advance, 2s/5s tends to move in a more synchronized fashion with policy rates. This can be attributed to the relative stability of longer-dated rates and the propensity for 5s to behave more like 2s as the bond market braces for short rates to move significantly higher, or lower. Yet, the recent bear-flattening episode represents an extreme occurrence of the observed pattern.

Chart 1. **Canada 2s/10s (Swaps)**



Chart 2. **Regression Coefficients: 5s versus 2s and 10s**



Since mid-February Canada 5s have moved in near lock-step with 2s. Not only is the 2s/5s curve just marginally flatter relative to 2s/10s, but a regression of 5s versus 2s and 10s reveals that almost 90% of the rise in 5-year yields can be explained by the move in 2-year yields. Historically this figure has averaged 40% (Chart 2). Hence, as seasonal factors fade and the bank initiates tighter monetary policy in Q3, the reversion of 5s to a normal relationship with 10s will result in a sharp bear-flattening of the 2s/5s curve. In fact, of the four tightening cycles which occurred in the last fifteen years, three demonstrated a strong tendency for 2s/5s to significantly out-flatten 5s/10s following the first hike of a tightening cycle (Chart 3). The lone exception is the 1999 cycle, in which 5s remained relatively range bound against the wings.

Chart 3. **2s-5s-10s Following the First Hike of a Tightening Cycle**

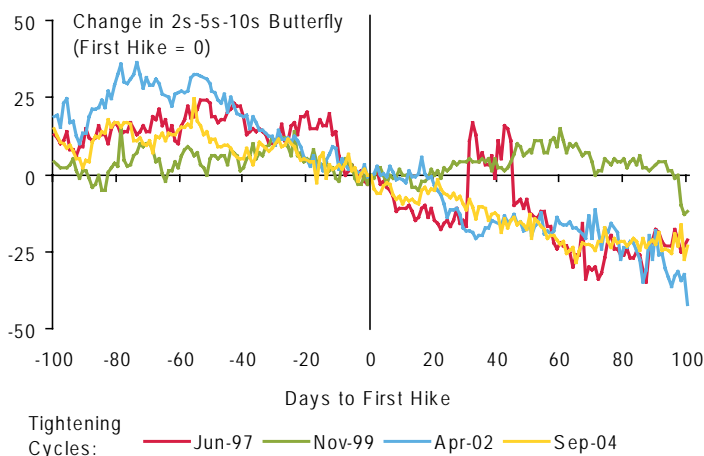
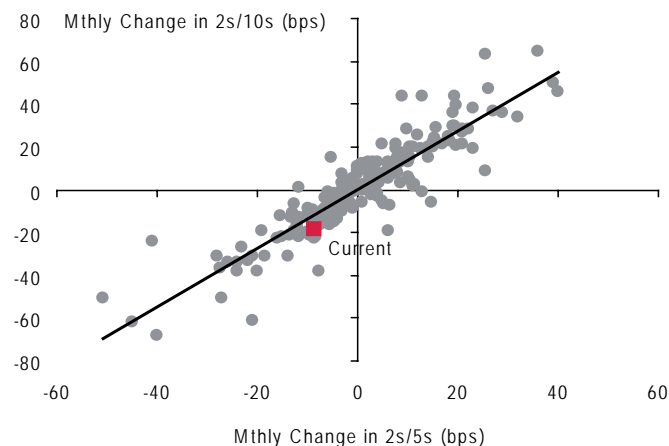


Chart 4. **Performance of 2s/10s Bounded by 2s/5s**



**Tens: Too Far Too Fast**

Further out the curve, 2s/10s has been the clear beneficiary of weakness in the front-end. Note, however, that of the 30-bp flattening of 2s/10s since mid-February, the majority of this move can be attributed to 5s/10s. While underperformance of 5s can reasonably be expected to persist as rates in the front-end rise, a sustained flattening of the 2s/10s curve will require a corresponding move from 2s/5s (Chart 4). As a result, the appeal of establishing new 2s/10s flattener positions at current levels is significantly diminished.

Against the long end, performance of 10s has not been nearly as striking. Core and headline inflation rates, which both rose faster than the Bank forecast for the first quarter, are not indicative of a deterioration in Canadian inflation prospects. As a result, in the near-term, the balance of risk favours a flattening of the 10s/30s curve. The diffusive nature of rate volatility further supports the case for outperformance of 30s.

In summary, although economic data are supportive of a flattening bias, the extent of the dramatic move in favour of this trade—particularly as evidenced by broader term spreads—is cause for concern. As such, we anticipate a corrective cheapening of 10s, with an initial target of 220 bps on 2s/10s for new flattener positions (Chart 1). Furthermore, we reiterate our 2s/5s flattener recommendation as one of the top trades for 2010, with a projected timeline of late-Q2/early-Q3. And finally, the relative stability of the 10s/30s segment of the curve supports our case for outperformance of the belly as the curve bear-flattens.

# GOVERNMENT FINANCE

WARREN LOVELY

## Tick, Tick ... Boom?

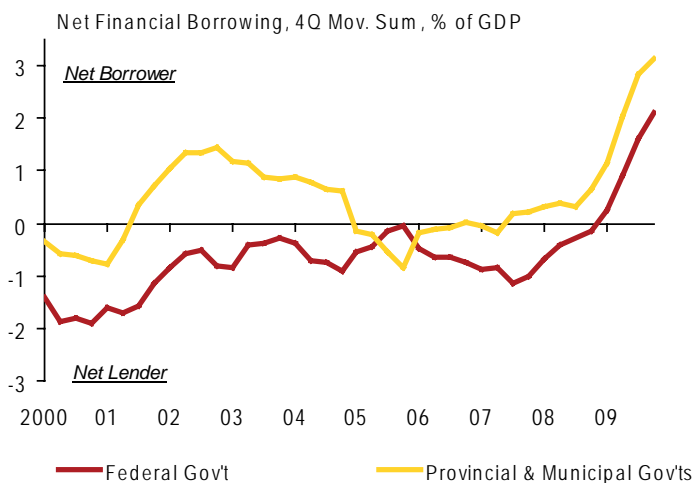
Burgeoning debt levels and rising interest rates are not a friendly combination. In Canada, risks of excessive household borrowing in a rising rate environment have caught the attention of policy makers and market players alike. But consider recent developments in the government sector, where debt is piling up due to the recession's fallout and ongoing stimulus. With interest rate hikes looming, is government debt affordability a ticking time bomb?

### No Near-Term Slowdown in Debt Accumulation

With economic recovery only now taking root, and governments committed to stimulus programs, debt levels continue to shoot higher. Ottawa's recent budget shows more than \$100 billion being added to the federal debt in the two years to 2010/11. Over the same two-year period, we estimate the combined provincial deficit at roughly \$70 billion, which translates into an even larger increase in debt, given elevated infrastructure-related borrowing.

All this has been reflected in aggressive net borrowing in financial markets by Canada's government sector (Chart 1) and sparked a notable increase in debt-to-GDP ratios, which will continue their ascent in 2010/11.

Chart 1. Aggressive Borrowing by Government Sector



### Rising Rates Complicate Matters

The heavier debt burden would be notable enough in a stable interest rate environment. Complicating matters, however, we are now only months away from the start of a new interest rate tightening cycle in Canada. The expected adjustment will be concentrated down the curve as the Bank of Canada ratchets overnight up to 1.5% by mid-2011 (Table 1 on page 2 and Chart 2). Pressure on longer-term yields will be more contained. Still, the structural decline in interest rates that characterized the past 20 years is history.

Governments had benefited handsomely from that one-way street for rates. Aided by outright debt reduction, debt servicing costs have consumed an ever smaller share of the government revenue dollar since the mid-1990s (Chart 3). But again, all that is ending.

We needn't be particularly concerned about debt affordability at the federal level. Ottawa may not balance its books till 2015, but the annual interest bill will by then, be no more onerous as a share of GDP or revenue than it is today, and only a third of its prior peak. By way of comparison, Washington's net interest charges will more than double as a share of GDP in the coming five years, effectively matching post-War highs.

Chart 2. Rising Rate Era Dawns

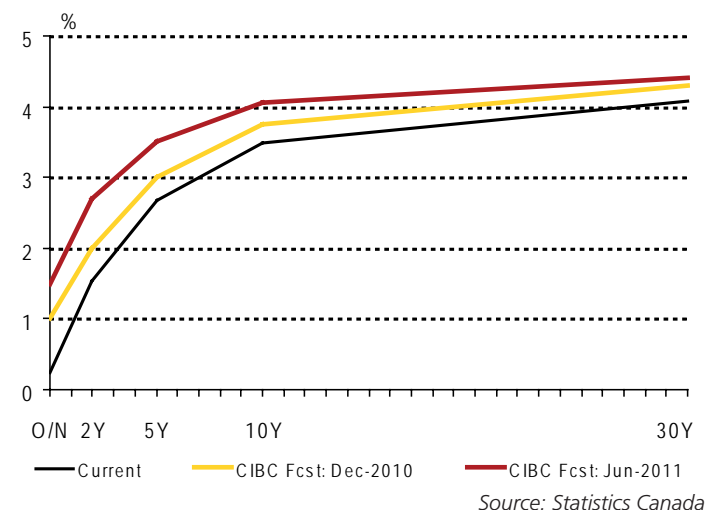
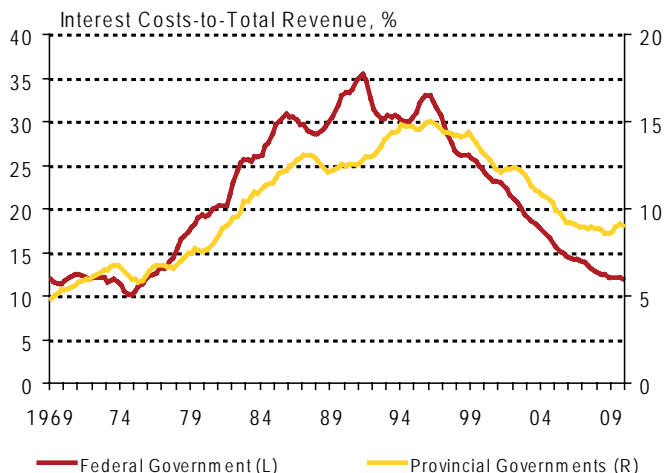


Chart 3. **No Further Relief in Interest Burden**



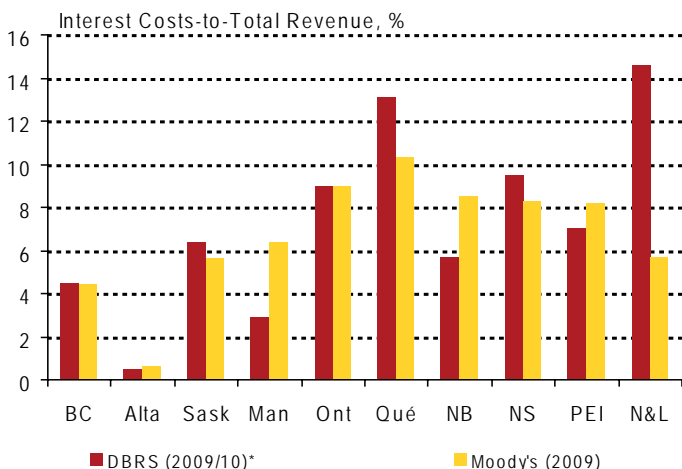
Source: Statistics Canada

**Eroding Affordability at Provincial Level a Greater Concern**

While provincial debt charges eat up a proportionately smaller share of revenue than at the federal level, recent trends in debt affordability have been less sanguine and have greater potential to move markets. While most provincial governments maintain a fair degree of fiscal flexibility, eroding debt affordability is an unwelcome development for a sector that faces considerable long-term funding pressure from an aging population.

On average, nine cents of every revenue dollar is needed to cover provincial interest charges, rising in 2009 for the first time in more than a decade. And as with everything provincial, there is wide divergence in individual interest burdens (Chart 4). Note the divergence between DBRS and Moody's estimates, which owes to the former's inclusion of unfunded pension liabilities. Pension liabilities

Chart 4. **Interest-to-Revenue Across Provinces**



\* Includes unfunded pension liabilities

add to an already heavy debt burden in Québec, and also contribute meaningfully to the higher interest-to-revenue ratio in Newfoundland and Labrador.

What of the costs associated with refinancing maturing debt? Table 1 provides an examination of upcoming government maturities, including, most critically, the weighted average coupon of bonds set to mature in the next two years. In some cases, there is legacy, high-coupon debt coming due. Witness the weighted average coupon of maturities in Atlantic Canada. The coupon on maturing BC debt is also relatively high. Refinancing these bonds at current levels will help mitigate the pressure on debt affordability associated with today's deficits.

Where provinces have relied more heavily on FRNs or skewed their issuance down the curve (e.g., Ontario, Alberta, Manitoba), the weighted average coupon can be significantly lower. As it relates to FRNs, these provinces will see less refinancing relief once front-end rates undergo a more substantial move higher.

It's worth noting that \$84 billion, or fully 25%, of existing Government of Canada bonds mature in the coming two years. But Ottawa holds significant interest-bearing assets against these issues, which eases substantially the refinancing risk for the government.

Note that Table 1 does not control for liability swaps which convert fixed-rate payments into floating-rate exposure. Nor does the table include other floating-rate debt due to mature beyond March 2012, which can

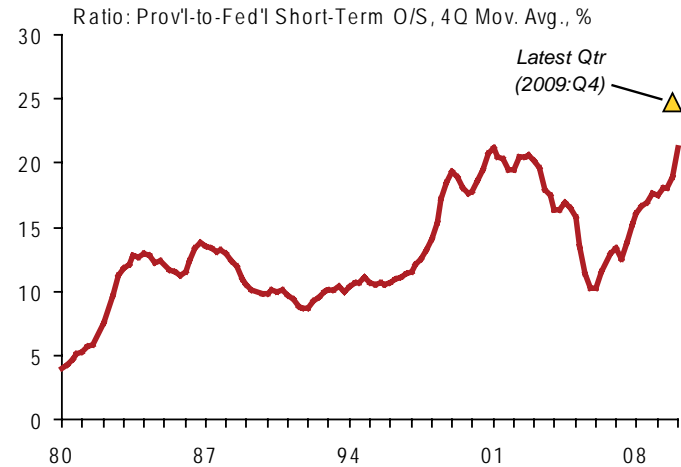
Table 1. **Provincial Maturity Profile**

2010/11 to 2011/12 (As at 8-Mar-10)	Gross Maturities \$mil (CAD eq.)	Share of Bonds O/S %	Weight'd Avg Coupon %
<b>Provincial Governments</b>			
BC	4,852	16.4	7.23
Alta <sup>1</sup>	2,179	18.8	3.11
Sask	550	6.2	6.15
Man	3,831	16.8	3.86
Ont <sup>2</sup>	24,592	14.1	3.47
Qué <sup>3</sup>	17,342	11.2	5.08
NB	2,000	14.9	6.42
NS	1,800	14.4	6.37
PEI	160	12.5	11.19
N&L <sup>4</sup>	563	8.1	6.54
<b>Federal Government</b>			
Can	83,661	25.5	3.08

(1) Includes ACFA, ATB; (2) Includes former Ontario Hydro; (3) Includes Fin-Q, Hydro-Québec; (4) Includes N&L Hydro

Source: CIBC, Bloomberg

Chart 5. **Provinces Lean More Heavily on Money Market**



Source: Statistics Canada

increase the share of debt subject to interest-rate reset significantly. It's also important to consider developments in short-term outstandings, which again, vary considerably by province.

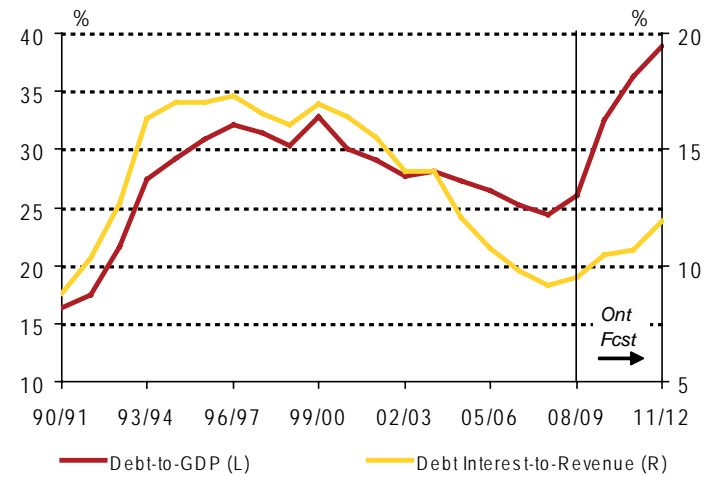
Short-term provincial debt has always represented a fraction of outstanding Canada T-bills. But in recent years, provincial governments, led by Ontario, have come to rely more heavily on the money market (Chart 5). While increased provincial bill issuance has been well absorbed, the near-tripling of provincial short-term outstandings since 2006 implies additional pressure on interest charges once a rate hike cycle begins in earnest.

For its part, Ontario has estimated that a 1%-point increase in rates adds more than \$500 million to annual interest costs, which for 2009/10, amounted to roughly \$9½ billion.

Ontario's mid-year update puts increased debt-servicing charges into perspective. After declining for the better part of a decade, interest on Ontario's debt bottomed out at \$8.6 billion in 2008/09. The current plan sees the annual interest tally rising to \$11.9 billion by 2011/12, a three-year increase of \$3.3 billion. And while well shy of the prior peak of 17%, the amount of each revenue dollar siphoned off by debt charges is rising, projected at roughly 12% by 2011/12 (Chart 6).

As we've argued in these pages before, Canada's government sector, being relatively less indebted than other major industrialized nations, hardly faces an unwieldy interest burden. Still, debt affordability is eroding. Further deterioration will be closely scrutinized by the rating agencies, and could serve as the catalyst for negative action on outlooks and/or ratings. The 2010 Budget season—with seven provinces yet to go—is the first and best opportunity to implement deficit reduction plans that limit fallout on debt affordability. There's still a window to diffuse this fiscal time bomb, but for some, there's no time to delay.

Chart 6. **Ontario's Interest Burden Rising**



**CREDIT**  
JOANNA ZAPIOR

## High Yield—A Mercurial Asset Class

Riding the quest-for-yield wave on one hand, and encouraged by a curtailment of bank credit availability on the other, high yield is enjoying a “second debut” in Canada. It came around for the first time in 1997, but did not last into the new century as issuance died down.

### That Was Then...

At the peak, in November 1998, the CIBC High Yield Index included 21 bonds issued by 19 issuers. Total face value of these bonds was C\$3.7 billion. Three issues were outsized compared to the rest; excluding those the average issue size was C\$125 million (and including those three, C\$180 million).

- A vast majority of the bonds were issued in 1997-1998.
- In fact, only three were “old bonds” from 1987 and 1989. One issuer-family issued in 1994, 1996 and 1997.
- Since then, some of the issuers disappeared through mergers, a few became rising stars and now issue as investment grade credits, one or two reorganized (either after the bonds matured, or with a resulting bond exchange), a few redeemed bonds, and a couple stopped issuing public debt. Only one bond we listed in our comprehensive pricing review in November 1998 is still listed in Bloomberg as outstanding but the issuer has since been acquired, and its new parent is currently reorganizing.
- In addition, a few fallen angels were added to the Canadian high yield basket in the 2000s (bonds issued as investment grade and subsequently downgraded). At least two of those issuers were rapidly upgraded back to investment grade as the downgrades were either misguided or of “technical” nature.

### ...And This is Now

Ten years later, we identified 12 bonds from eight issuers as candidates for today’s high yield index, with face value of C\$2.7 billion, and an average issue size of \$225 million (or \$200 million if one excludes a single outsized issue in this sample).

- Of those 12 issues, six are new issues of the 2009-and-later vintage.

- We have one “old” bond of the 1996 vintage.
- Five remaining bonds from two issuers were issued between 2005 and 2008.

### Will Canadian High Yield Earn the “Separate-Asset-Class” Label?

*“...and a new kind of professional has emerged, the data scientist, who combines the skills of software programmer, statistician and story teller/artist to extract the nuggets of gold hidden under mountains of data.”*

*(The Economist, February 27, 2010)*

An asset earns a “separate-asset-class” label based on its risk-adjusted return track record. By early 2000 we had enough Canadian data to analyze the nature of “Canadian high yield” (it certainly made us feel like this new kind of professional that The Economist refers to...). As was “fashionable” in the 1990s (refer to various US studies reported in the *Financial Analyst Journal*, and *Journals of Finance, Financial Economics, Financial Research and Fixed Income*), we studied the hybrid (debt/equity) nature of high yield. We found that, despite a rather limited data sample, Canadian high yield was beginning to display similar characteristics to the more mature US high yield asset class:

- 1) Overall better risk-adjusted returns than investment grade (due to higher returns and lower volatility).
- 2) Correlation with both equities and government bonds, but a stronger affinity with equities than that displayed by investment grade bonds (and stronger with small cap equity indices than with large cap or broad indices).
- 3) High sensitivity to the business and economic cycle, and to liquidity conditions, which makes entry point into high yield a key investment decision. Notably in the 1980s and 1990s, in “good times” periods, high yield debt-like characteristics were strengthening while it was still showing relatively higher correlation with equities than investment grade debt. However, in “bad times” periods, high yield was losing its affinity with government bonds and was becoming more equity-like (Table 1).

These characteristics earned US high yield a label of a “separate asset class”—and the nascent Canadian high yield was heading in the same direction as US high yield.

## Separate But Mercurial Asset Class

In the 2000s, high yield lost its attractiveness as a field of financial research—with interests undoubtedly shifting to structured credit<sup>1</sup>. Meanwhile, the temporarily dormant nature of the Canadian market has not been particularly interesting to study. Given the reduced published interest in high yield and the new challenges that the market and economic environment posed for high yield in the last decade, we re-examined the hybrid, and business-cycle sensitive, nature of the US high yield asset class. Augmenting and updating the sample to the end of 2009 reveals a rather mercurial nature of high yield.

Over a long period of time, since the mid-1980s through to the end of 2009, high yield generated total returns that were still superior to investment grade. However, those came with a higher volatility, even in “good times”, unlike what we saw in the earlier period (Table 2).

Seemingly counter-intuitively, in “bad times” during this long time period high yield bonds—as an asset class—actually managed to produce slightly lower volatility of return than investment grade bonds!

High yield returns through the cycle now appear more correlated with equities, and less with government bonds than the earlier studies indicated. Moreover, we find that investment grade bond performance is also more correlated with equities than it was described earlier. Fundamentally this makes sense given that since the late-1990s market environment was dominated by a succession of major credit events, first in the sovereign area (Asian and Russian currency crises), then in technology, telecoms, and energy, followed by the auto industry, and culminating in the 2008 credit crisis.

What we think also happened here is a change in the mix of indices based on which the market measures performance. The credit events of the 2000s resulted in a large number of fallen angels, notably in telecoms, power generation, and autos, that migrated from investment grade to high yield changing the profiles of both assets. We believe that the large number of fallen angels in the high yield asset class in the 2000s has lowered its return volatility in “bad times”, and has “evened out” the overall sensitivity of high yield to equities through the cycle, as shown in Table 2.

**Table 1. High Yield in the US in the 1980s-1990s and the First Wave of Canadian High Yield (late 1990s)**

1980s and 1990s	Relative to investment grade		
	Through the cycle	In good times	In bad times
Returns	higher	higher	lower
Risk (volatility of returns)	lower	lower or same *	higher
Sensitivity to the cycle:			
A. correlation with equities	higher	sensitive	very sensitive
B. correlation with government bonds	lower	sensitive - and more debt-like than equity-like	not sensitive

*Good times are periods of economic growth, business cycle expansion and/or good liquidity in capital markets.*

*Based on various academic studies of US high yield and past CIBC research*

*\* Depending on source*

**Table 2. High Yield in the US in the 1980s, 1990s and 2000s**

1980s, 1990s and 2000s	Relative to investment grade		
	Through the cycle	In good times	In bad times
Returns	higher	higher	higher
Risk (volatility of returns)	<b>higher</b>	<b>higher</b>	<b>slightly lower</b>
Sensitivity to the cycle:		<b>sensitive, with less differentiation for the cycle than in the past</b>	
A. correlation with equities	<b>much higher</b>		
B. correlation with government bonds	<b>much lower</b>	<b>not very sensitive</b>	not sensitive

*Bold represents changes from the shorter sample in Table 1.*

<sup>1</sup>Just as the first time around, earlier this year we ran a search through financial journals for the past 10 years and found 25 relevant studies, or less than three per year. While in the 1990s a key research theme emerged (hybrid nature of high yield), in the past decade a single theme was more challenging to identify – the somewhat ambiguous winner was research into defaults and bankruptcies, followed by a couple of drill-downs into performance of high yield bonds, focusing on fallen angels versus original-issue bonds, stock performance of firms post initial high yield bond offering, and evidence of bondholder-stockholder conflict in security performance data.

What this “story teller extracts from the high yield mountains of data” is that high yield continues to produce high returns but with more volatility as it may be more akin to equities than it was in its earlier days, and less to interest rates. The definition of “good” and “bad” times is a matter of art, and the performance of the high yield asset class is quite sensitive to when one starts and ends the measurement. Removing just the last 18 months from the sample (the crisis and subsequent rally months) leads to different observations than when those months remain in the sample. Finally, looking forward, it is perhaps less relevant how high yield has behaved in “good” and “bad” times, but more relevant what it has done during periods when central banks embarked on a tightening cycle.

We will be happy to discuss with clients our observations in this regard.

# FX STRUCTURING

ZAFAR BHATTI

## The Canadian Dollar—Stuck in a Range

A year ago in the depths of the recession, the USDCAD exchange rate was wildly unpredictable. The Canadian dollar had just moved 30 cents weaker in the span of a month and it was anyone’s guess whether the next move was higher or lower. Now the USDCAD market is at the other extreme. It has just spent the last six months bouncing in a six-cent range between 1.02 and 1.08. Each time it approaches one of those boundaries, it seems to find a reason to reverse (Chart 1) thus keeping the exchange rate in a well defined range. In general, the exchange rate has traded at the low end of the range when the Equity markets are doing well, and has reversed higher during periodic bouts of panic (Dubai World, Greece, Chinese inflation concerns, etc). Eventually the exchange rate is going to break out of this range, but the simple question is—which way?

Right now the exchange rate is at the low end of the range and the reasons are mostly economic. The latest GDP numbers showed that Canada grew at an annualized rate of 5.0% in the 4<sup>th</sup> quarter. Also at the most recent policy meeting the Bank of Canada did not extend its commitment not to raise rates. This puts the Bank of Canada between a rock and a hard place, if they signal rates are going to rise, the Canadian dollar will make a run for parity or stronger. The damage to exporters in this scenario could seriously hinder Canada’s economic

recovery. However, if they hesitate on the interest rate front, the BoC will appear soft on inflation which also could be damaging to the long term health of the economy. It is CIBC’s view that the BoC will raise rates early in Q3 of this year which will be at least six months before the US starts its own rate hikes.

The interest rate outlook is not the only thing that could push CAD through parity. Other factors that could see the Canadian dollar strengthen include:

- World demand for commodities—Increased demand for oil, minerals, fertilizer etc. could result in a stronger Canadian dollar as exporters repatriate profits.
- Resurgent capital markets—Canada is one of the friendliest environments for foreign acquisitions. If the capital markets finally get an appetite for M&A then Canada could be one of the first places to see the benefit of foreign inflows.
- The Carry Trade—The US dollar has become a “carry currency”. Investors are borrowing US dollars at low rates and then investing them in foreign markets in an effort to pick up the yield differential. This investing behavior partially explains why the USD/CAD exchange rate is highly correlated to the TSX. In simplistic terms, USD converts to CAD as the TSX goes up and converts back as the TSX declines (Chart 2).

Chart 1. USD/CAD Exchange Rate

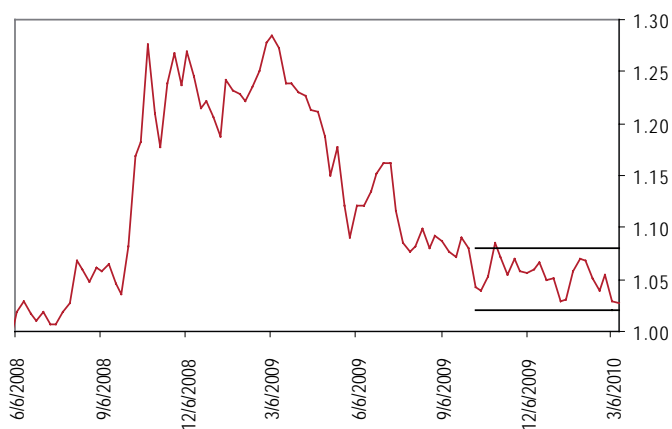
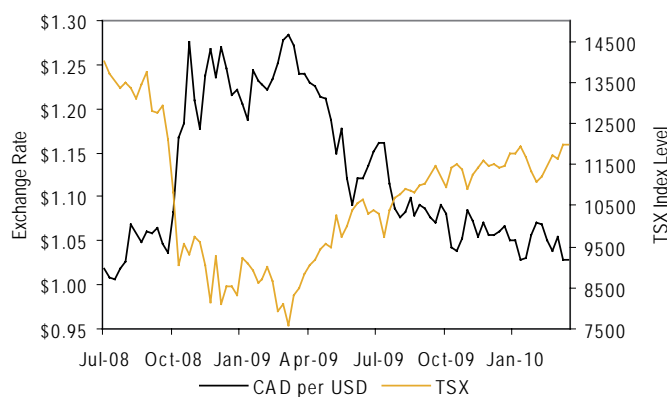


Chart 2. USD/CAD, TSX Correlation



- Fears of Sovereign Default—If the investing world starts looking for a place to park capital in the wake of deteriorating sovereign credits then Canada would look very attractive. Canada is one of the few remaining AAA credits with a healthy outlook and the Canadian dollar could benefit from a switch trade out of weak sovereign names to Canada.

the 1.05 level. They might be tempted to try this again, or use stronger measures if parity becomes a reality.

- Sovereign Default—In the short term, a sovereign default could trigger another crisis of confidence in various financial institutions that could cripple capital market liquidity again. In this extreme scenario, the US dollar would ratchet higher against everything.
- US Inflation Resurfaces—Just the threat of interest rate hikes in the US could shut down the carry trade and see the US dollar move higher as foreign investments get unwound.

If the last year has shown investors anything, it is that the future is unpredictable. Although the USD is trading at the low end of the range versus CAD right now, it has been here before and always seems to bounce higher. There are numerous factors that could push the USD higher and through the upper end of its range:

- Profit-taking—Leveraged investing has a short investing horizon and after a good run in the equity markets, some of this money could be taken off the table and brought back to the US.
- Global growth stalls—China is trying to slow its economy in an effort to curb inflation. If these efforts are too effective, this will dampen demand for commodities and ultimately send the Canadian dollar weaker.
- Bank of Canada Intervention—The BoC was quite effective last summer using verbal intervention around

The USDCAD exchange rate can break out of the range in either direction. If investors are pessimists on the outlook for a global recovery then this would correspond with the USD stronger view. However, if investors have a view that the world economy is on the mend and Canada has the products that the world needs then this would support the view that the exchange rate will break out of the range with CAD stronger. There is a third possible outcome. If there is no clear direction for the global economy then the exchange rate could stay range bound. Each of these views can be acted on through a structured foreign exchange investment. A few ideas have been presented below for investor consideration.

## USD/CAD Range Bound View

This structure is designed for clients that have a view that the USDCAD exchange rate will stay range bound over the next year. If the exchange rate stays within the range then the client gets the benefit of a high coupon,

but if the exchange rate trades at either end of the range at any time, then the coupon disappears. However, the client will still receive their full principal back at the end of the term.

### Indicative Terms & Conditions

Client View:	USDCAD will stay in a range over the next 12 month	
Term:	1 Year	
Spot Reference	1.0300 CAD per USD	
Principal Protected	100% Full Principal Protection	
Lower boundary	.9700 CAD per USD	
Upper boundary	1.1000 CAD per USD	
Notional Investment:	C\$ 1,000,000	
Coupon At Maturity	USD CAD stays in the range	5% coupon
	USDCAD touches .97 at any time during term	0% coupon
	USDCAD touches 1.10 at any time during term	0% coupon
Total Return at Maturity	100% of principal + applicable coupon	

## Bullish USD View

This structure is designed for clients that have a view that the USDCAD exchange rate will break out of the range to the high side over the year. If the exchange rate stays below 1.09 then the client gets 99% of their principal back but no coupon, but if the exchange rate

trades above this level, then the client participates fully in the appreciation up to 1.2000. However if 1.2000 is touched at any time during the term then the client forgoes market participation and receives a guaranteed 2% coupon.

### Indicative Terms & Conditions

Client View:	The USD will get significantly stronger versus CAD	
Term:	1 Year	
Spot Reference:	1.0300 CAD per USD	
Principal Protected:	99% Principal Protection	
Participation Level:	1.0900 CAD per USD	
Conditional Trigger:	1.2000 CAD per USD	
Notional Investment:	C\$ 1,000,000	
Coupon At Maturity:	USDCAD is below 1.09 CAD per USD at maturity	0% coupon
	USDCAD is above 1.09 and 1.20 has never been touched during term	Variable coupon up to a maximum of 10.6% depending on Spot at maturity
	USDCAD touches 1.20 at any time during term	2% coupon
Total Return at Maturity:	99% of principal + applicable coupon	

## Bullish CAD View

This structure is designed for clients that have a view that the USDCAD exchange rate will break out of the range to the low side over the year. If the exchange rate stays above .9700 then the client gets 99% of their principal back but no coupon, but if the exchange rate trades

below this level, then the client participates fully in the CAD appreciation down to .88 CAD per USD. However, if .8800 is touched at any time during the term then the client forgoes market participation and receives a guaranteed 2% coupon.

### Indicative Terms & Conditions

Client View:	The USD will get significantly weaker versus CAD	
Term:	1 Year	
Spot Reference:	1.0300 CAD per USD	
Principal Protected:	99% Principal Protection	
Participation Level:	.9700 CAD per USD	
Conditional Trigger:	.8800 CAD per USD	
Notional Investment:	C\$ 1,000,000	
Coupon At Maturity:	USDCAD is above .9700 CAD per USD at maturity	0% coupon
	USDCAD is below .9700 and .8800 has never been touched during term	Variable coupon up to a maximum of 8.7% depending on Spot at maturity
	USDCAD touches .8800 at any time during term	2% coupon
Total Return at Maturity:	99% of principal + applicable coupon	

**COMMODITIES**  
PETER BUCHANAN

**Going for Gold**

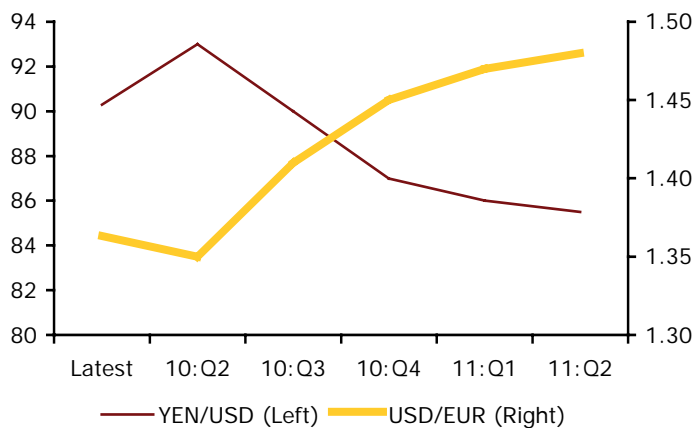
**A Double Top for the King of Metals Looks Likely**

Gold rocketed to an all-time high of \$1,218/oz early last December, as near-zero interest rates pummeled the greenback. The US currency's revival ended that advance. We believe that some of the forces underlying that rally remain in place, and are likely to reassert themselves. That includes dollar weakness (Chart 1) as attention reverts to still-wide US current account deficits, and a fragile recovery delays monetary re-tightening. Unfolding debt troubles in Europe and elsewhere should also continue to support demand.

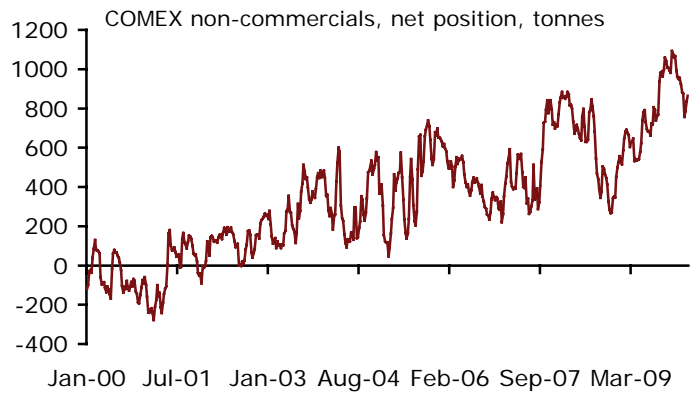
**Currency, Fiscal Trouble Supportive but Fed Policy a Longer Term Risk**

While all this points to a retest of late 2009's highs later in the year, Fed tightening has ordinarily been a negative for gold, as with other non-interest bearing assets. That was demonstrated strikingly by the metal's dramatic fall from early 1980 on as the Fed ramped up its war on inflation. We expect a less forceful turn back to monetary restraint in the US early next year to contribute to a modest pullback from an interim high of \$1250/oz. late this year to \$1150/oz. by the end of 2011 (Table 1).

**Chart 1—Renewed Pressure on US\$ Will Lift Gold in Near Term**



**Chart 2—Speculative Interest High Though Off Recent Peak**



Although high levels of speculative interest (Chart 2) imply some vulnerability to shifting sentiment, the rally does not look particularly overextended when inflation is removed from the equation. In today's dollars, gold reached over \$2000/oz in the 1980 rally, double current levels (Chart 3).

**Golden Fundamentals**

Gold demand can be broken into three separate components—jewelry, investment, and a limited use in industrial/medical applications. Jewelry consumption is the most important of these, with a 60% share of identifiable demand in recent years. It is worth noting, however, that fashion use in any one year represents a quite modest 1-2% of the estimated 160,000 tonnes of refined gold presently in existence. Gold prices are, in consequence, heavily influenced by factors like exchange and interest rates that affect what is essentially a stock demand for the metal from private investors as well as central banks and supranational organizations like the IMF. Those latter two groups collectively hold about a fifth of the world's gold. Mine production adds about 2,600 tonnes or under 2% each year to the world's gold supply. That is far less than for commodities like oil or natural gas and prices are consequently affected much less by short-term supply shifts than prices for those commodities.

Chart 3. **Gold Prices Still Nowhere Near a Record in Inflation-Adjusted Terms**

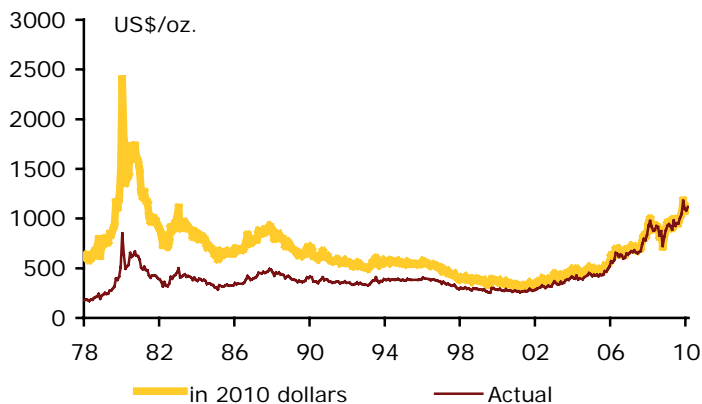
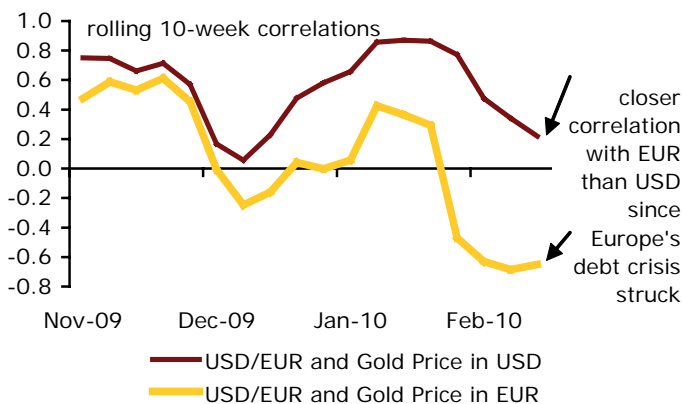


Chart 4. **Gold Price Affected Recently by Developments in Eurozone**



**Gold’s Changing Tango with the Currency Markets**

Because gold is viewed as a dollar alternative or even super-currency, a declining exchange rate has historically put upward pressure on the metal. Our own estimates suggest longer-term elasticity of about -1.0 against the broad trade-weighted US dollar. While the focus has historically been on the link between US-denominated spot gold and the greenback, an even stronger correlation has existed of late between the euro-gold price and euro’s trading level. That suggests that outflows from the eurozone on debt fears may have temporarily taken over the driver’s seat (Chart 4). Given the sizeable variation between gold’s returns in US\$ and other currencies, and the prospects for continuing volatility on the crosses, investors might consider incurring some of any exposure in non-US currencies like the euro or yen.

Gold is arguably the oldest inflation hedge known. Changes in inflation nonetheless do not appear to have had as large a bearing in recent years as in 1973-74 and again in 1978-80, when the Fed failed to act decisively to staunch the inflationary effects of a hot economy and bubbly commodity markets (Chart 6). Even with faster money supply growth, ample slack in many industrial countries is likely to limit general price pressures, reinforcing our belief that exchange rate moves will have a larger bearing on gold’s performance than inflation in the next year or two.

**Gold has Historically Moved Inversely to Real Interest Rates**

Examining another market driver, the gold lease rate is a physical or real interest rate—the amount paid to borrow gold from central banks or other holders. If gold prices are expected to track general inflation over the longer term, investors should, in theory at least, be indifferent between buying an inflation-protected instrument like a TIPS, or buying gold and leasing it out. Chart 5 shows the general inverse relationship between gold prices and the lease rate or other real interest rates.

Chart 5. **Relationship Between Gold Prices and the Gold Lease Rate**

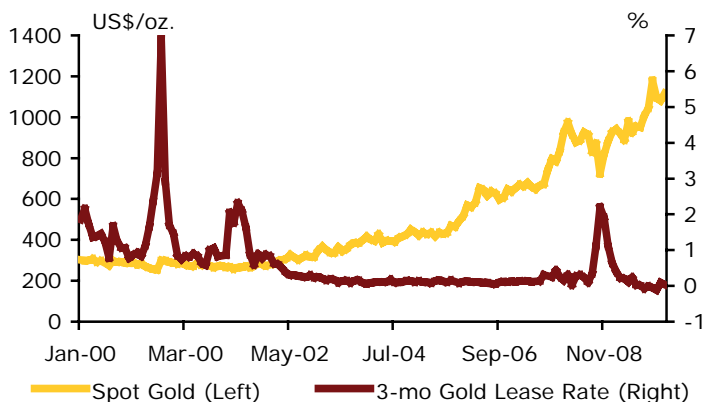
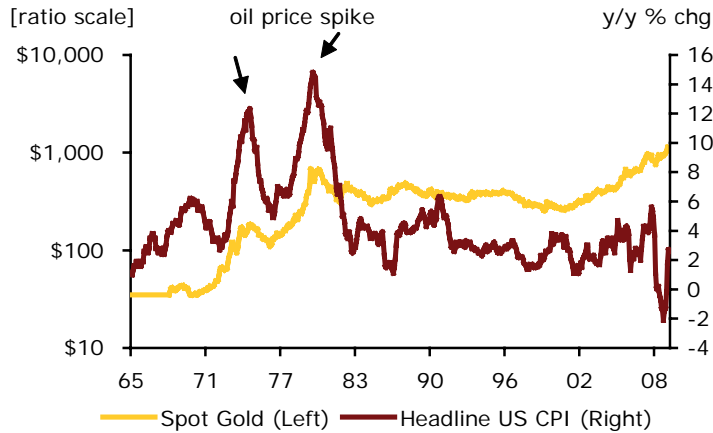


Chart 6. **A Stronger Link Between Gold and US Inflation Back Then**

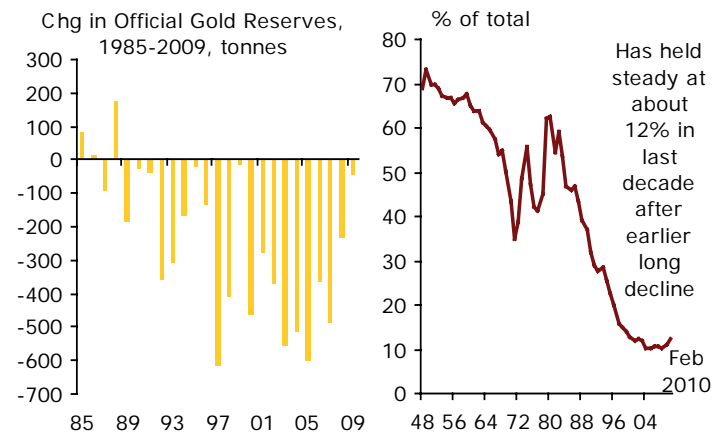


**Central Banks Likely to Help Cushion Price Swings, Not Fuel Speculative Bubble**

As noted, central banks and supra-nationals own about a fifth of the world’s gold. Net sales by those institutions fell by about 80% in 2009, continuing a longer-term downtrend. While reduced net selling by such institutions (Chart 7, left) has helped support the market in recent years, we remain dubious of claims that greatly increased official buying led by the emerging markets is about to send prices spiraling. Central banks in India and Mauritius did step in last fall to purchase 202 tonnes of IMF gold, averting an open market sale. (The Fund has recently confirmed plans to sell 191 more tons of its holdings). Central bank officials from some other major emerging markets like China have signaled, however, that they are not presently contemplating a major increase in their holdings.

Rather than fueling volatility, we also think central banks are more likely to play a stabilizing role in the market. Central bankers are apt to be more concerned about the dollar value of their reserve gold, as opposed to the physical amount. After declining sharply from 1948-2000, gold’s dollar share of central bank reserves has held fairly steady at around 12% in recent years (Chart 7, right). If in fact central banks are acting in an ostensibly rational manner and targeting a fixed ratio for gold in their dollar reserves, higher prices should lead them to cut their purchases or sell gold, and vice versa. That should dampen price oscillations.

Chart 7. **Waning Official Sales (L) Have Seen Gold's Share of Global Central Banks' Reserves Stabilize (R)**



Source: World Gold Council, IMF, CIBC

Table 2—**Spot Commodity Prices**

		Average					
		8-Mar	2007	2008	2009	2010 (f)	2011 (f)
Oil (WTI)	\$/bbl	82	72	100	62	75	80
RBOB gasoline	\$/gal	2.17	2.09	2.49	1.69	1.95	2.15
Heating Oil (NYH)	\$/gal	2.09	2.03	2.86	1.65	1.85	2.10
Natural Gas (Henry)	\$/Mn Btu	4.47	6.97	8.89	3.82	6.00	7.00
Gold	\$/troy oz	1126	695	872	1088*	1250*	1150*
Copper	\$/lb	3.39	3.24	3.16	2.35	3.45	3.50
Aluminum	\$/lb	1.05	1.20	1.17	0.76	0.95	0.80
Nickel	\$/lb	10.12	16.86	9.57	6.69	9.50	8.00
Zinc	\$/lb	1.08	1.48	0.85	0.76	1.10	0.95

\* end of period

**STRATEGIC RISK**

MICHAEL ROSBOROUGH

***Shaky Foundations, or Solid Footings?***

Although an overextended US housing market was the proximate cause of the global credit crunch, homebuilding itself, the part which is relevant to GDP growth, has never been as big a part of the American economy as one might think. In the last 50 years residential investment has averaged less than 5% of total US GDP (4.6% in fact). While ultimately driven by the relatively steady underlying demographics of population growth and household formation, homebuilding is by nature notoriously cyclical.

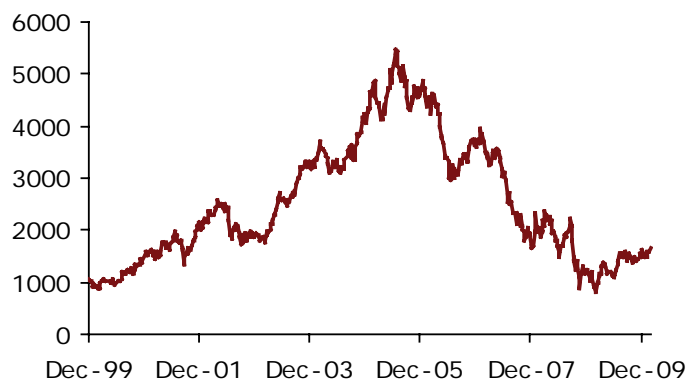
Why did something that is normally less than one twentieth of the American economy have such an outsized and global impact this time? The answer is due primarily to two factors. The first is the balance sheet effect on financial institutions and homeowners of the once-in-several-generations collapse in US house prices due to overbuilding. The other is the extreme magnitude of this cycle's peak to trough fall in homebuilding itself.

In terms of units, at the peak of the US housing cycle in January 2006 total starts crested at an annualized rate of just over 2.25 million units. Four years later we are down to 591,000 units after bottoming at 479,000 in April of last year. The fifty-year mean is over 1.5 million units per annum and that on a total population that averaged 244 million versus the 316 million Americans alive today. The last two bull markets in housing started from much higher troughs—837,000 units in 1981 and 798,000 in 1991. The 1991 level marked the lowest trough in 50 years—until now.

Measured relative to the economy the swing in residential investment as a percent of GDP was from 6.25% in Q4 2005 to 2.5% now—by far the biggest swing in post war history. As an investor I am a very big believer in mean reversion and the intuitive appeal of something so distressed as housing made the interrelated complex of financial, REIT and homebuilder ETFs (represented by XLF, IYR and XHB respectively) my preferred equity market sector picks last year and into the start of this one. The S&P homebuilders Select Industry Index (on which XHB

Chart 1.

S&amp;P Homebuilders Select Industry Index

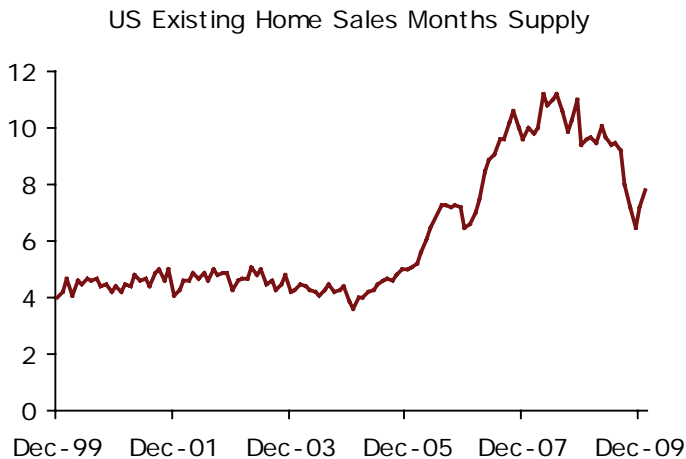


is based) shows just how far homebuilding stocks have fallen from their peak in 2005 (Chart 1).

As we celebrate the first anniversary of the market's trough last March that triumvirate of market sector ETF's are among the very best performers—up between 100% and 145% over the past twelve months handily beating industrials, technology, materials, energy, healthcare, consumer staples, utilities and the broader market as a whole. Homebuilders continue to dramatically outperform the market so far this year (the total return of XHB is 11.3% as of Monday versus 2.5% for the S&P 500) with regional banks (KRE is the ETF, up 12.7% year to date) the only US sector ETF among the liquid ones I track closely to outperform homebuilders.

Have homebuilders done so well purely because the market overshot to the downside and can they continue to outperform? The strikes against housing are well known—the initial overbuild that translated into falling prices, historically high foreclosures with a backlog for the banks still to work through, continuing tight credit conditions, high unemployment and a weak economy. One way to gauge the backlog is to look at existing home sales versus listings which gives almost 8 months of supply

Chart 2.



(Chart 2)— still well above historical norms. Housing data in the past few months has in fact disappointed (most recently part of this could be weather related) and new single family home sales saw a new low for the cycle at 309,000 units in the latest data released for January 2010.

In that context the strength of homebuilding stocks this year and last looks truly contrarian, and with the Federal Reserve about to end its support for the mortgage market at the end of this month and the \$8,000 new homebuyer tax credit set to expire April 30<sup>th</sup>, some of the stimulus that supported the market will disappear in short order. Being a contrarian play isn't always enough to make something a good bet, however, and with these supports going away can the homebuilders continue to outperform?

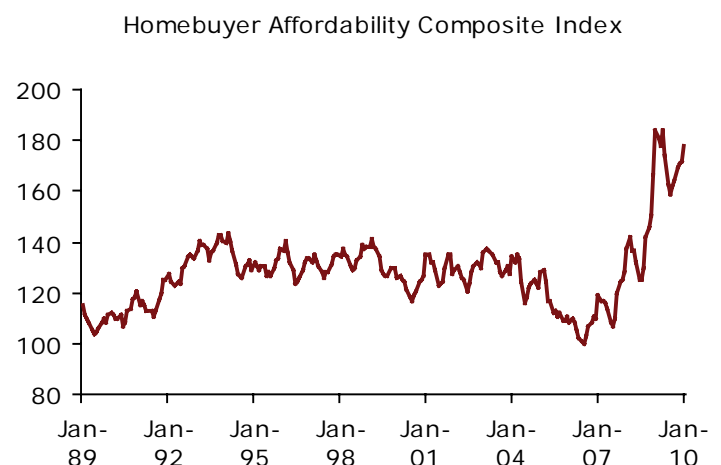
Valuation matters and it is what has made taking the risk of a position in homebuilding stocks an interesting proposition from the perspective of both the equity and housing markets. Like banks but unlike the respective pre-crash peaks of the Nikkei or Nasdaq, the highs in homebuilder stocks weren't primarily a function of grossly expanded or historically anomalous multiples but rather of what proved to be unsustainable earnings driven by well above normal levels of home prices and unit sales. Now these companies are working through their residual losses and building new properties at a much slower pace, consistent with the working off of past excess supply. The upturn in volumes and prices, when it comes, at least won't be faced with the problem of the stocks themselves working off an unrealistic expansion of pre-crash multiples.

The key question then is when will that volume expansion and price recovery finally take hold and what could delay or mute it? The biggest argument in favour of the start of a new cycle for homebuilding is that affordability (i.e. the nexus of home prices, consumer incomes and cost of financing) remains at very high levels. In fact houses are significantly more affordable than at the start of the last secular bull market in US housing in the early 1990's and hugely improved from the low in affordability that coincided with the peak in the housing market in 2006 (Chart 3—the National Association of Realtors Affordability Index). Once excess supply is worked back down to more normal levels the eventual turn in building, prices and hence profits could be pronounced but is not yet apparent in the data on starts.

The key risks to the optimistic scenario are not so much the known ones of supply, the weak economy and the end of the tax credit but the unfinished business of financial reform in the US and the shape the US mortgage market will take after the Fed steps away on March 31<sup>st</sup>. This risk potentially becomes critical in the next quarter or two. With Fannie Mae and Freddie Mac constrained in their ability to expand their balance sheets as I noted in last month's *GPS Monthly*, a rise in mortgage rates in the next few months is a distinct possibility and this will crimp affordability.

The shape the re-regulated US financial sector will take still remains nebulous. The Senate has yet to unveil its legislative proposals though there is a possibility something will be announced shortly, probably ahead of

Chart 3.



the Easter recess. The House of Representatives has a bill before it (HR 3996—the Financial Stability Improvement Act) containing provisions that may make lending in the very dis-intermediated financial system of the US more balance sheet intensive for the originators of securitized financial products (i.e. a proviso requiring the originator to retain portions of the securitization) thereby tying up more of banks and other financial intermediaries capital when they create mortgage backed securities.

Recent comments by Barney Frank, Chairman of the House of Representatives Financial Services Committee and sponsor of HR 3996, have also re-opened the debate on the role and future of the GSEs (Fannie and Freddie). While their conservatorship remains in place for now, how important to the market Fannie and Freddie will be going forward and how easy private sector entities will find it to take their place are an important, unresolved concern. The House of Representatives hearings on the future of the GSEs are now scheduled to take place March 23<sup>rd</sup>.

The bottom line is that the economics of housing are much improved in the US and while starts remain hugely depressed, the ongoing outperformance of the homebuilder stock index should be seen in the context of it being a distressed asset with a potentially much better future ahead of it when activity reverts to historically normal levels. It could still be a long while before we return to the housing start run rates of the past and the risks from the Fed withdrawal from the mortgage market, the end of the tax credit and regulatory uncertainty augur for some retracement in the near term, but that dip is more likely to be a buying opportunity than the end of the trade.

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