GPS MONTHLY

GLOBAL POSITIONING STRATEGIES

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Where's the Value?

Economics (Shenfeld): Europe has addressed the near-term crisis, but investors have learned that even in developed country sovereigns, credit quality matters. Canada's long end is favoured in that context, given smaller deficits and net debts than other major economies. Although the Bank of Canada is set to launch a tightening cycle, we now see less damage from that to the long end, as markets viewing sovereigns as credits will be attracted to Canada's fiscal rectitude.

Rates (Ahmed): Rather than alter our fundamental flattening bias, the recent rally in the front end presents an opportunity to add to short positions in the 2-year sector. Unfortunately, the negative carry associated with flatteners means that these positions will be costly under our base case scenario of a gradual tightening. We recommend the 2s-10s-30s butterfly as a carry-effective means of profiting from the resumption of a flattening trend.

Government Finance (Lovely): We present a framework for examining provincial credit spreads, investigating performance across a host of metrics and isolating movements before, during and after the 2008-09 financial crisis.

Credit (Zapior): The seasonally adjusted pace of new issue activity suggests to us a "normal" issuance year, with banks returning to domination of new issue flows. New issue pricing in the first four months provides evidence of increased risk appetite in the market.

Foreign Exchange (Ohayon): The global economic outlook and commodity prices are still dictating the winning currencies. Financial issues in the eurozone continue to be a big drag on the Euro common currency against currencies with a brighter economic future, even after the steep slide year-to-date. Commodity currencies, such as the Canadian Dollar and Norwegian Krone will likely outperform.

Commodities (Buchanan): Flying PIIGS probably won't provide a great deal of lift for oil in the near term. Inventories are rising rapidly again and China's thirst alone won't fully offset the effect of weak OECD demand, which is still down over 8% from mid-decade highs. New capacity growth and OPEC's 5-6 mn bbl overhang, moreover, will keep markets well supplied in the next couple of years. We expect WTI to average a modestly below-consensus $80/bbl this year and $85 in 2011 given all of this.

Internet:
http://research.cibcwm.com/economic_public/download/gps_may10.pdf

on Bloomberg:
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ECONOMICS

AVERY SHENFELD

Sovereigns as Credits

Our tour of European fund managers this past month has us thinking about government bonds in a different light. On this side of the pond, investors are used to viewing domestic-currency sovereigns, whether Treasuries or Canadas, as a default-risk-free base rate over which all other bonds are priced. Credit quality analysis was left to the purview of those who wade into the messier world of sub-nationals or corporates.

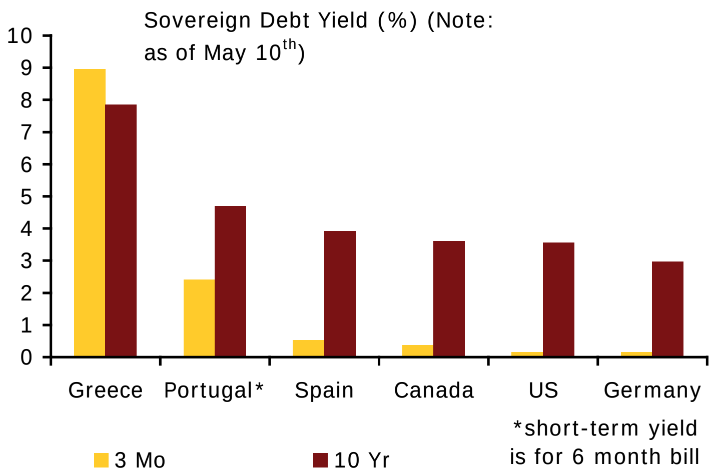
In contrast, eurozone portfolio managers have long been forced to think about sovereigns from a credit perspective. Since there are multiple states issuing in the same currency, none of which hold the power of the printing press, no government bond is risk-free in the same sense, and in practice, each state issue was judged as a spread product over Germany's bunds. Of course, divining the good from the bad in sovereign credit quality has become the issue for the eurozone market in the past year, as the red flags went up over Greece, Ireland, Portugal and Spain in particular. By waiting so long to put the Greek issue to bed, Europe helped set fire to a run on the market against other weaker members. Even after ECB buying and the launch of a bailout fund this week, Portuguese and Spanish 10-year bonds faced yields above those in Canada (Chart 1), where the central bank, unlike the ECB, is set to tighten soon.

Thinking about sovereigns as something other than a base yield curve and more like a credit is already spreading across the Channel to UK's gilt market, despite the fact that Westminster's fiscal woes are largely funded in a true domestic currency over which it has control. Investors in

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

		2010				2011			
END OF PERIOD:		**10-May**	**Jun**	**Sep**	**Dec**	**Mar**	**Jun**	**Sep**	**Dec**
CDA	Overnight target rate	0.25	0.50	1.00	1.25	1.25	1.75	2.25	2.50
	98-Day Treasury Bills	0.37	0.65	1.15	1.05	1.15	1.75	2.35	2.55
	2-Year Gov't Bond	1.94	2.10	2.35	2.15	2.40	2.85	3.00	3.25
	10-Year Gov't Bond	3.62	3.70	3.80	3.75	4.00	4.05	4.00	4.10
	30-Year Gov't Bond	3.97	4.05	4.10	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	1.00	1.50	2.25
	91-Day Treasury Bills	0.15	0.15	0.10	0.15	0.40	0.85	1.30	2.05
	2-Year Gov't Note	0.90	0.90	1.00	1.20	1.75	2.20	2.60	3.00
	10-Year Gov't Note	3.57	3.60	3.90	4.10	4.45	4.45	4.35	4.50
	30-Year Gov't Bond	4.44	4.45	4.70	4.85	5.05	5.05	5.00	5.10
Canada - US T-Bill Spread		0.22	0.50	1.05	0.90	0.75	0.90	1.05	0.50
Canada - US 10-Year Bond Spread		0.05	0.10	-0.10	-0.35	-0.45	-0.40	-0.35	-0.40
Canada Yield Curve (30-Year — 2-Year)		2.03	1.95	1.75	1.85	1.80	1.40	1.15	0.95
US Yield Curve (30-Year — 2-Year)		3.54	3.55	3.70	3.65	3.30	2.85	2.40	2.10
EXCHANGE RATES	CADUSD	0.98	1.02	1.02	1.01	0.96	1.00	1.01	1.02
	USDCAD	1.02	0.98	0.98	0.99	1.04	1.00	0.99	0.98
	USDJPY	93	93	92	91	90	89	87	85
	EURUSD	1.29	1.27	1.24	1.25	1.28	1.32	1.35	1.38
	GBPUSD	1.50	1.49	1.48	1.50	1.51	1.53	1.53	1.53
	AUDUSD	0.904	0.910	0.940	0.980	1.000	0.995	1.000	1.020
	USDCHF	1.10	1.12	1.14	1.13	1.11	1.09	1.10	1.09
	USDBRL	1.78	1.80	1.75	1.72	1.70	1.69	1.67	1.65
	USDMXN	12.5	12.5	12.4	12.3	12.3	12.2	12.0	12.0

Chart 1. ***Investors Differentiating Between PIIGS and Less Indebted Borrowers***



the UK see the prospect of rising long gilt yields if the newly elected Tory plurality is unable to win approval for tough fiscal restraint. Credit concerns over the UK are well justified given a deficit of Hellenic proportions sitting at 12% of GDP.

The risk to gilt holders isn't, like that of Greek bonds, a "restructuring," which would be equivalent to default. While governments have in the past defaulted on domestic currency debt, the greater risk to debt holders is that the debt is monetized by the central bank, hitting long bond holders with inflation and currency devaluation.

Bad News is Bad

Thinking about sovereigns as credits can turn the conventional relationship between government bonds and economic developments on its head. Typically, for the government bond market, good news is bad news. Stronger economic reports lead to bond price declines as yields rise in anticipation of greater inflation risks and the resulting central bank rate hikes at the front end.

But in the topsy-turvy world of sovereigns as credits, good economic news can lower government bond yields, particularly at the long end. We saw the flip side of that in Spain, when a sharp jump in the unemployment rate was a negative for Spanish bonds, as the deteriorating economy cast doubt on the government's ability to stick with severe fiscal restraint and meet its revenue targets.

Canadas as a Credit

Is any of this relevant to Canada, where the sovereign debt floats in the calm waters of a solid AAA rating? For the front end, stronger-than-expected reports on Canadian employment or GDP are still, directionally, going to put upward pressure on yields across the curve. From bills to five-year bonds, the market is fixated on the timing and pace of coming rate hikes. The ripple effects from the eurozone debt story may have dented equities here, and has the market viewing Carney as less of a man in a hurry. Still, with Canada's trade dominated first by the US, then by resource-hungry Asian markets, it's hard to see the periphery of Europe, or even the UK, taking the Bank of Canada off its tightening course in the near term.

Table 2. ***Economic Update***

CANADA	09Q4A	10Q1F	10Q2F	10Q3F	10Q4F	2009A	2010F	2011F
Real GDP Growth (AR)	5.0	5.7	2.5	2.3	1.7	-2.6	3.1	2.5
Real Final Domestic Demand (AR)	4.6	4.3	3.0	2.7	2.4	-1.7	3.7	2.1
All Items CPI Inflation (Y/Y)	0.8	1.6	1.9	2.4	1.9	0.3	1.9	2.1
Core CPI Ex Indirect Taxes (Y/Y)	1.6	1.9	1.8	1.9	1.9	1.8	1.9	2.0
Unemployment Rate (%)	8.4	8.2	8.1	8.1	8.2	8.3	8.2	8.1
U.S.								
Real GDP Growth (AR)	5.6	3.2	4.1	2.5	1.3	-2.4	3.2	2.5
Real Final Sales (AR)	1.7	1.6	3.7	2.5	1.5	-1.7	2.1	2.5
All Items CPI Inflation (Y/Y)	1.4	2.4	2.0	1.6	1.3	-0.4	1.8	2.1
Core CPI Inflation (Y/Y)	1.7	1.3	0.9	0.8	0.7	1.7	0.9	1.5
Unemployment Rate (%)	10.0	9.7	9.8	9.9	9.8	9.3	9.8	9.4

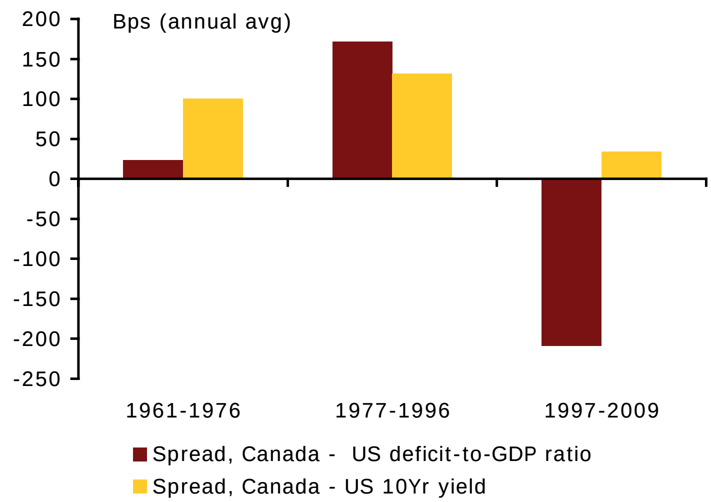
But stretch your eyes to 10s and 30s and it's a whole different world. Global pools of capital are in search of safety from risks of default, devaluation, or collapsing currency regimes, and Canada stacks up well on all these fronts. Not only is Canada's net debt-to-GDP lower than other G-7 players, but this year's total projected federal-provincial deficit, at 5% of GDP, is less than half that of the US or the UK. The fact that the Bank of Canada is prepared to hike in an early defence of its 2% inflation target gives further comfort that there will be no move to monetize the debt burden.

For the long end, in terms of Canada's credit rating, recent upward revisions in both real and nominal GDP growth outlooks promise that the timetable for reducing deficits could be beaten. Even our below-consensus nominal GDP forecast of 6.6% for 2010 is 1.7%-points above that assumed collectively by the provinces and Ottawa in their budgets.

All of that could continue to attract safe-haven inflows into Canada's bond market, even as rates rise at the front end. History shows that Canada-US 10-year spreads over the medium term are affected by relative fiscal performance (Chart 2).

With credit quality now taking centre stage, we're therefore chopping our targets for 30-year yields, having already allowed for little damage to 10s from the 225 bps of hikes we expect through 2011. That tightening cycle is a lot milder than some have projected, and allows for the drag on global growth from a worldwide fiscal tightening in 2011. But Canada's safe-haven status will give yet another reason for the long end to be fairly sheltered. Flattening trades look extremely attractive, as does a bet that with the US deficit still in 10% territory, Canadas will outperform long Treasuries. When it comes to quality, global investors will give credit where credit is due, and Canada's past success in paring deficits will put its bond market in good stead.

Chart 2. ***Relative Deficits Impact Bond Spreads***



Rates

Mohammed Ahmed

Carry On

Prior to the Bank of Canada's April 20th announcement, market participants were split with respect to expectations for the timing and scope of pending monetary tightening. Although the scope remained uncertain, the removal of the Bank's conditional commitment in April was largely viewed as a signal that Governor Carney would initiate a tightening cycle by raising the overnight rate in June. In prepared remarks before a Senate Committee on Banking, Trade and Commerce, the Governor stated that the removal of the commitment itself represented a tightening of monetary policy. And judging by the reaction of rates in the front end, this certainly appeared to be the case. Rates on overnight indexed swaps reacted almost instantaneously to the announcement and priced in a series of quarter-point rate hikes, beginning in June and lasting for the duration of 2010.

As sovereign credit risks flared up in early May though, the period of stability in the front end quickly came to a halt. The ensuing flight-to-quality bid to shorter-dated bonds caused realized volatility at the front end of the Canada curve to spike. Furthermore, despite strong domestic economic data, the extent of this move was amplified by the short-covering of bearish bets at the front end. And while the European rescue package has prompted a partial retracement of the rally in the front end, fundamentally the sector remains rich.

Expect a Quarter-Point Hike on June 1st

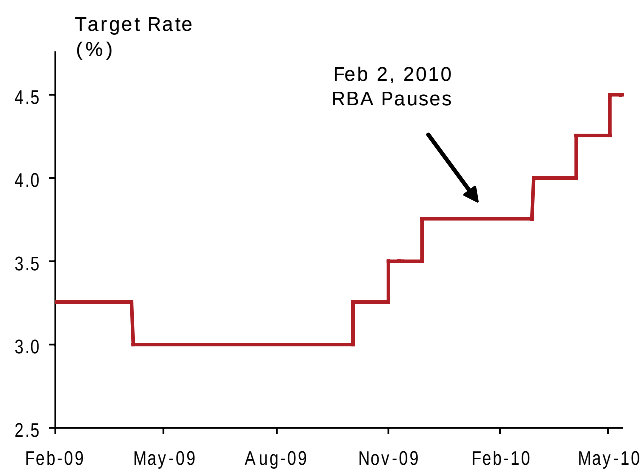
CIBC Economics has long held that fiscal restraint will act as a drag on growth globally. Given a committment to federal and provincial stimulus programs, the impact of fiscal belt-tightening is not likely to be felt domestically until 2011. In the meantime, and as indicated by April's employment reports, Canada and its most important trading partner are in the midst of a healthy recovery, with the former poised to record a second consecutive quarter of 5%-plus annualized GDP growth in Q1.

Contagion fears associated with European debt woes have some market participants questioning the likelihood of a June hike. Yet, while they were premature in October of 2009, comparisons to the policy actions taken by the Reserve Bank of Australia are more appropriate now.

Recall that in October of last year, the RBA began tightening monetary policy months before it was clear that major global economies were on a sustained path towards recovery. The RBA determined that, irrespective of the issues plaguing global financial markets, domestic growth warranted tighter monetary policy and began raising the cash target rate in quarter-point increments.

We anticipate that the Bank of Canada will adopt the RBA's gradualist approach to tightening and initiate this process with the June 1st rate announcement. In fact, much in the same way that our *Economics* group forecasts a pause from the BoC later this year, note that the RBA took a breather from tightening after having delivered its first 75 bps of hikes (Chart 1).

Chart 1. ***RBA Cash Target Rate***



Twos Too Rich

On April 20th, immediately following the Bank of Canada's announcement, we reiterated our curve flattening bias and also recommended establishing long positions in 5s versus 2s and 10s. Rather than alter this fundamental bias, the nature and extent of the recent rally in the front end presents a chance to enter, or add to, short positions in the 2-year sector.

Recent trading activity in the 2-year sector can appropriately be described as startling. Not only did Canada 2s rally after April's record jobs numbers, but more surprisingly, they also managed to outperform 2-year Treasuries in a period of heightened risk aversion. We maintain our bias to sell strength in the front end of the curve and regard the Canada-US 2s spread as a means of expressing this view. Currently, OIS rates imply an 80% probability of a ¼-point increase on June 1st. If, as we expect, the Bank of Canada hikes in June while the Fed stays on hold until 2011, the recent narrowing of this spread should reverse course.

Underperformance of the 2-year sector in response to rekindled rate hike expectations will also be apparent versus rates further out the curve. In particular, the recent steepening episode of 2s/10s represents an opportunity to add exposure to flatteners.

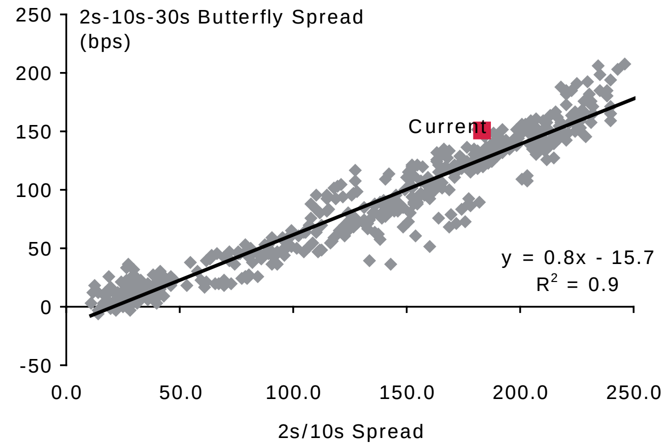
From a longer-term perspective, our forecast for a measured tightening by the Bank argues for a commensurate pace of flattening of the curve. Thus, we expect that a significant flattening of the curve in the weeks leading up to, and immediately following, the June 1st announcement will give way to a slow grind flatter.

Mitigating Carry

Unfortunately, the negative carry associated with flatteners means that 2s/10s flatteners will be costly under our base case scenario. For this reason, we have previously highlighted the merits of the 2s-10s-30s butterfly as a carry-effective flattener alternative. The recent flattening of the 10s/30s component of this trade makes it all the more appealing.

The key question is whether or not the carry advantage of a 2s-10s-30s butterfly position—which is the combination of a 2s/10s flattener and a 10s/30s steepener—offsets the risk of 10s/30s flattening in a rising rate environment.

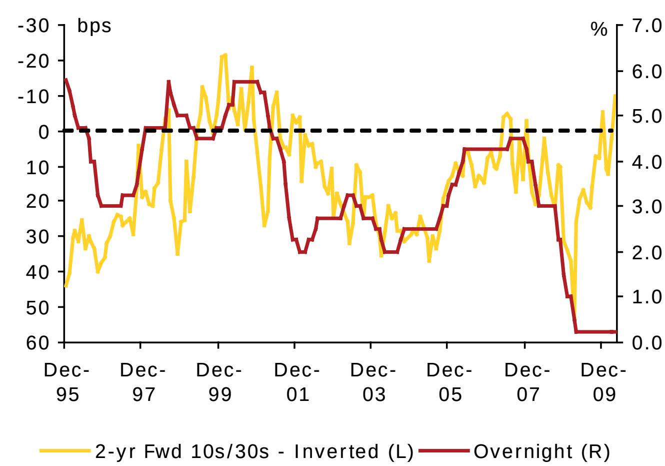
Chart 2. ***2s-10s-30s Butterfly vs 2s/10s Spread***



Empirical analysis and volatility modeling of yield curve dynamics suggest that much of the variance of the 2s-10s-30s butterfly spread can be attributed to the 2s/10s component of the trade (Chart 2). That is to say, in a bear-flattening environment, 2s/10s has historically out-flattened 10s/30s by a wide margin.

More importantly though, note that 10s/30s has flattened significantly as of late. In swaps, the 2-year forward 10s/30s curve is presently inverted by 10 bps. As one would expect, there is a negative relationship between the slope of the 10s/30s curve and the overnight rate. As the Bank tightens monetary policy, the inflation risk premium embedded in longer-dated rates falls. Meanwhile, the volatility profile of the curve suggests that as rates rise, 10s will feel the brunt of that pressure, while 30s will be relatively insulated, resulting in a flattening of the curve. That being said, the implied forward level represents an expectation of a quicker-than-expected return to a 'normal level' for the overnight rate (Chart 3).

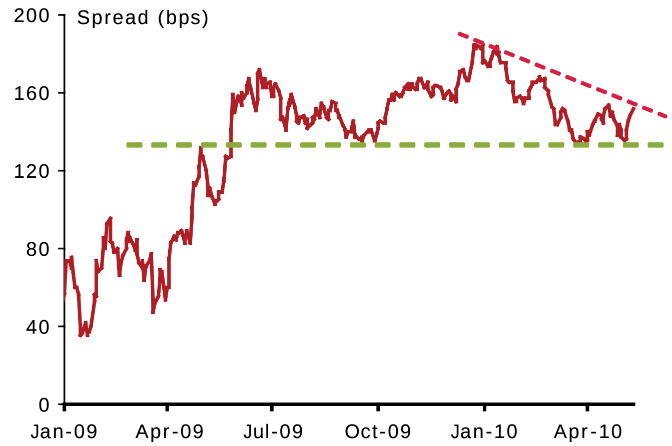
Chart 3. ***2-Yr Forward 10s/30s vs Overnight***



From an historical perspective, consider that it took 250 bps of tightening over a period of three years to invert the curve (early-'04 to late-'07). However, given our outlook for a gradual tightening of policy, the 10s/30s curve has limited scope to flatten as dramatically as forwards presently imply. Instead, we expect that the curve will flatten some 10 bps by the end of the year, spurred in part by interest in the credit quality of longer-dated Government of Canada bonds (see pages 2-4).

Consequently, the potential cost associated with the 10s/30s component in a 2s-10s-30s butterfly is dwarfed by the carry advantage of this trade relative to a 2s/10s flattener. Specifically, as detailed in the table of Current Recommendations given below, the 2s-10s-30s butterfly carries better than the 2s/10s flattener by 2.5 basis points per month. With a little over 7 months to go in the trading year, this advantage more than offsets the impact of the forecasted flattening of the 10s/30s curve over the same period. As such, we recommend entering long positions in 10s versus 2s and 30s to profit from the resumption of the flattening trend, while mitigating the impacts of carry (Chart 4).

Chart 4. ***2s-10s-30s Butterfly***



Current Recommendations

	Proposed Date	Recommendation	Entry	Target	Stop	1-Mth Carry	Current	Gain/Loss	Duration (Days)
1	24-Mar-10	Canada 2s/10 Flattener	185 bp	145 bp	200 bp	-4 bp	173 bp	12.0 bp	49
2	20-Apr-10	Long Canada 5s vs. 2s/10s	65 bp	35 bp	70 bp	-1 bp	55 bp	10.0 bp	22
3	*NEW*	Long Canada 10s vs. 2s/30s	130 bp	100 bp	140 bp	-1.5 bp	-	-	-

A complete summary of trade recommendations is available upon request.

Government Finance

Warren Lovely

Provincial Credit Spreads: Theory of Relativity

Waypoints are critical when navigating turbulent markets. That's as true for credit spreads as it is for other financial assets. Looked at in isolation, credit spreads yield only a partial roadmap. A clearer picture can been gleaned from relative spread analysis, examining the term structure of credit, measuring correlations with and ratios to underlying Canadas, comparing to other fixed income classes and other funding markets, gauging performance across individual credits, etc. For provincial credit, this broad theory of relativity offers investors more reliable signals as we wind our way through a choppy financial recovery.

Framework for Analysis

The following presents a framework for analyzing provincial credit spreads, examining three distinct time periods: a five-year 'pre-crisis' period, characterized by relative stability in underlying GoC yields and credit spreads; the 12-month 'crisis' period from July 2008 to June 2009; and the 'recovery' period, which commenced in earnest in the second half of 2009. A host of spread metrics is presented in Table 1 (page 11), including current readings for comparison purposes.

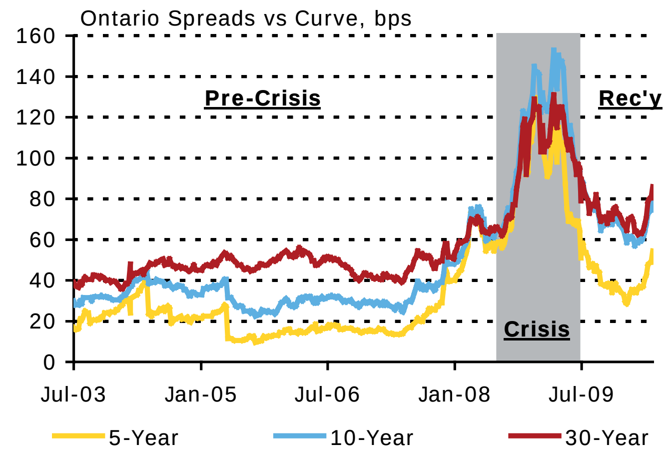
Spreads in Isolation

While recovering some important ground, provincial spreads remain well above 'pre-crisis' levels across the curve. In the 10-year sector, spreads are today nearly two-and-a-half times wider than the average pre-crisis level (Chart 1). Chalk part of that up to elevated borrowing requirements and an erosion in credit quality. But spreads have pushed out some 25 bps just since the start of the year, as global credit concerns (most notably sovereign debt fears) triggered fallout on domestic credit. Across the main benchmark terms, spreads are now a dozen or so wider than the average recorded in recovery.

Spreads vs. Canada Yields

As expected, movements in the underlying sovereign market can exert influence on provincial spreads, but

Chart 1. ***Provincial Spread History: Pre-Crisis to Recovery***



relationships are imprecise. Rising yields have traditionally meant narrower spreads, and that inverse relationship was heightened dramatically during the financial crisis (Chart 2). The predictive power of Canada yields evaporated last summer, however, with no meaningful correlation between 5- or 10-year spreads and the underlying Canada market. In longs, a higher yield/tighter spread dynamic has remained intact, albeit at less pronounced levels than during the financial crisis. In general, heightened global credit fears have helped re-establish traditional ties between spreads and yields, and

Chart 2. **Inverse Relationship Between Spreads & GoC Yields**

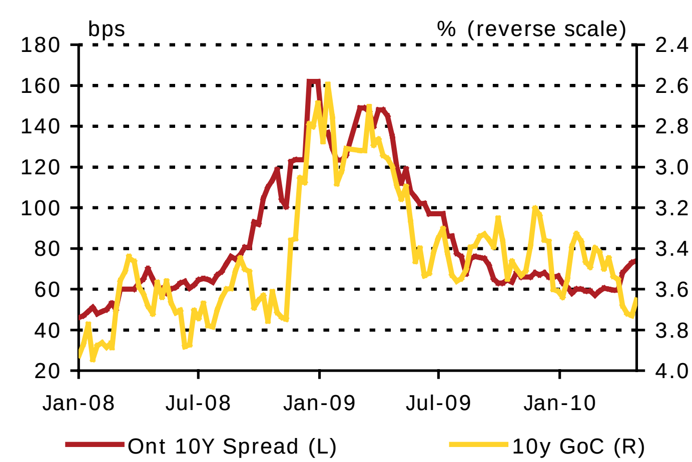


Chart 3. ***30-Year Yield Ratio: Ontario vs Canadas***

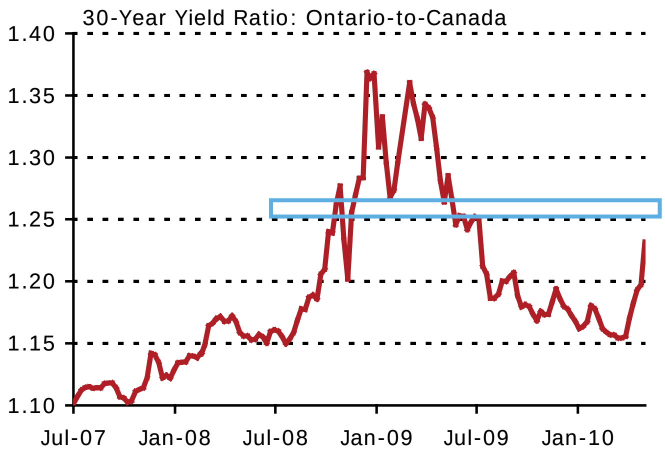
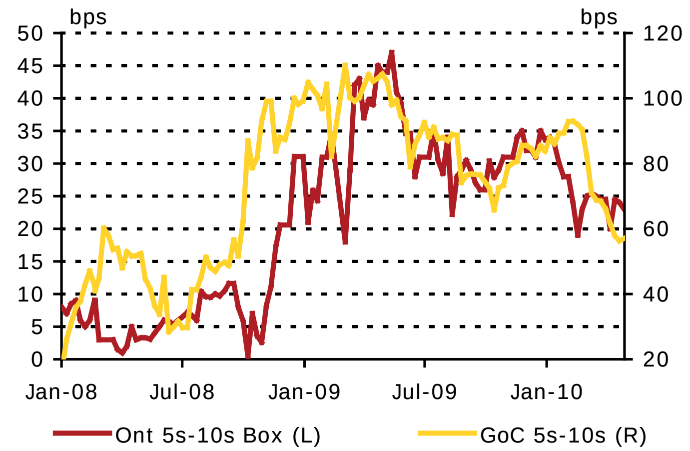


Chart 5. ***5s-10s Credit Curve vs GoC Curve***



to the extent this connection holds, a forecasted sell-off in Canadas would, all else equal, lend support to spreads.

Provincial-to-Canada Yield Ratios

The ratio of provincial yields to Canada yields puts spreads into greater perspective, providing an effective risk premium for a given tenor. In pre-crisis times, that risk profile was upward sloping (i.e., yield ratios increased further out the curve). Today these ratios are uniform across the curve (at ~1.22). In the long end, the yield ratio breached the 1.35 level at the peak of the crisis, with a zone of congestion in the 1.25-1.26 range offering resistance should tone again deteriorate (Chart 3).

Credit Curve vs. Underlying Canada Curve

Provincial credit curves swung wildly during the crisis, and have seen only a partial normalization. An earlier technical bid for 5-year product from bank treasuries (an offshoot of Ottawa's Insured Mortgage Purchase Program) meant that the 5s-10s provincial credit curve steepened from single digits to as wide as +45 bps by spring 2009 (Chart 4). This occurred despite a rate cut-induced steepening in the underlying GoC curve (Chart 5). That credit curve has since flattened, but at 28 bps, the pitch is still more than twice as steep as the pre-crisis average.

Tens-longs, meanwhile, went sharply inverted at the peak of the financial crisis, regaining positive slope as recovery took hold in summer 2009 (Chart 4). Notwithstanding a strengthened appetite for long product—a positive for 30-year spreads—shifting supply fundamentals argue for further steepness in 10s-longs. Issuers are keenly focused on extending duration, as evidenced by record long supply in the month of April and follow-on long issuance in May.

Chart 4. ***Partial Normalization in Provincial Credit Curves***

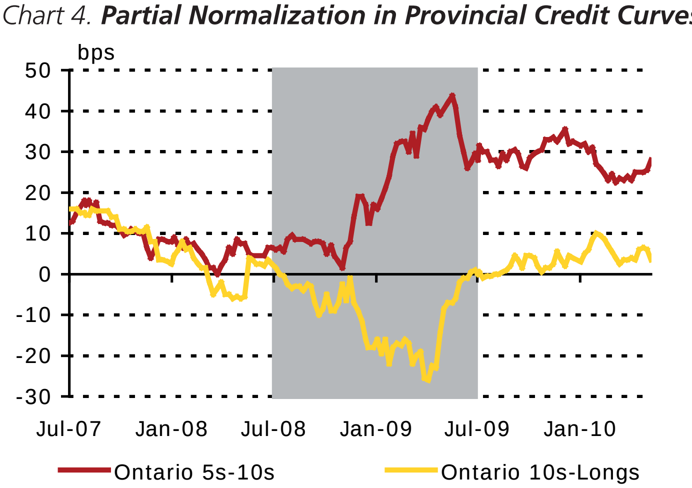
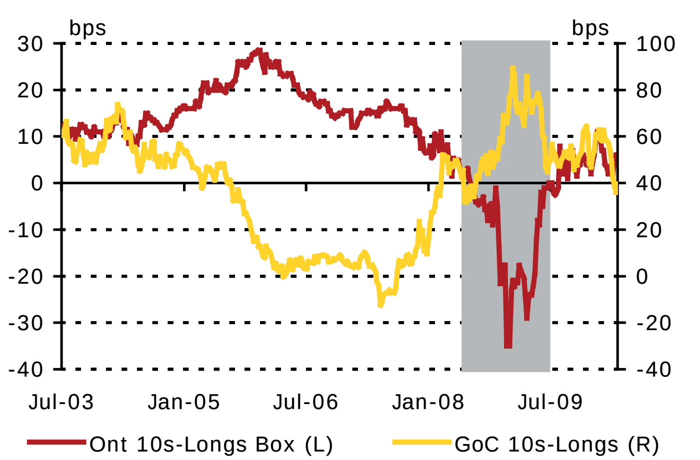


Chart 6. ***10s-Longs Credit Curve vs GoC Curve***



The 10s-longs credit curve has proven to be inversely correlated to the underlying GoC curve (Chart 6). On that score, a projected flattening of the Canada curve (see Table 1, page 2) further supports credit curve steepening from 10s to longs. Provincial credit spreads and curves will have to compensate for a safety bid to long Canadas, which looks to produce artificially lower yields and flatter curves in the sovereign market.

Spreads vs. Other Fixed-Income Sectors

During the crisis, lower-rated corporate paper widened more dramatically than provincials. By January 2010, the stage was set for corporate outperformance and the resulting move has been striking, with the ratio of corporate-to-provincial spreads narrowing to an historically tight basis. At barely 2-times, the 5-year spread ratio is less than half the relative premium demanded of corporates at the height of the crisis (Chart 7).

The bulk of that trade has now played out. Riskier assets like corporates have more downside should credit fears again resurface. Interestingly, provinces could manage to hold their own in a calmer credit environment, at least in the near term. Having budgeted conservatively, upcoming quarterly and mid-year updates should usher in positive fiscal surprises, including smaller deficits and lighter borrowing needs. Longer-term, fiscal adjustment is a work in progress.

Provincials have also seen notable underperformance vs. Canada Mortgage Bonds. In both absolute and relative terms, the basis between 5-year Ontario and CMB spreads looks sufficiently wide to attract provincial buying.

Provincial Rolls

Underlying credit quality and supply expectations explain as much as 90% of the current variation or "roll" between long-term provincial credit spreads. Since long before the crisis, the gap between individual 30-year spreads has hovered in a roughly 25-bp range from tightest to widest. That spread gap remains intact today. But the ratio of provincial rolls tells another story. During the crisis, investor demand for liquidity meant spreads traded in a narrower band relative to the underlying level for Ontario. Given where spreads now trade relative to pre-crisis levels, there appears to be scope for greater dispersion in provincial rolls.

Today's ratio of spreads also highlights the relative underperformance of Ontario. The widest provincial spread is now just 1.15-times that of Ontario—tighter than at any time in the past decade. At the other extreme, there's ample precedent for the higher-rated provinces to be trading further through Ontario, in both absolute and relative terms (i.e., as a ratio to Ontario).

Wild Cards

There remains significant event risk for Canadian credits, and renewed sovereign debt fears have the potential to significantly destabilize the space.

The ability of provincial governments to access deep pools of liquidity in international markets has been key in eliminating pressure on domestic spreads. As the US$ arbitrage improved, April saw fully $4 billion of USD paper issued. An up-surge in international issuance has cushioned the home market from what has been a roughly 70% increase in the pace of provincial supply relative to pre-crisis levels. In recent sessions, selling pressure and a wider BA-LIBOR basis have seen US-dollar provincial spreads cheapen to domestic levels, most notably in the 10-year sector.

As noted, provincial updates may well revise budget balances and borrowing programs. But don't expect a near-term slowing in domestic provincial issuance, as borrowers aim to lock in rates at attractive levels and skew issuance to what is currently a more cost-effective domestic market.

Chart 7. ***Tighter Basis Between Corporates & Provincials***

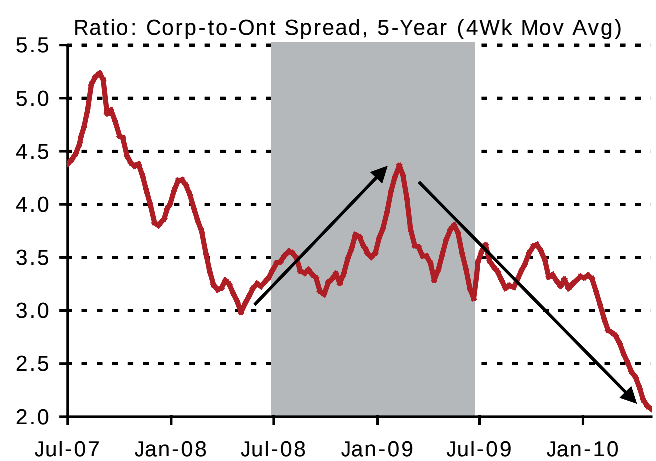


Table 1. ***Provincial Spread Metrics: Pre-Crisis, Crisis and Recovery***

Unless otherwise indicated, provincial spreads/yields reflect Province of Ontario	Pre-Crisis Jul-03 to Jun-08 (5 Years)	Crisis Jul-08 to Jun-09 (12 Months)	Recovery Jul-09 to May-10 (10+ Months)	Current 10-May-10
Provincial Spreads[1] (bps)				
5Y	24	91	41	**55**
10Y	35	111	70	**83**
30Y	48	101	73	**86**
Provincial Spreads vs. GoC Yields[2] (Correlation)				
5Y	-0.38	-0.70	0.07	NA
10Y	-0.34	-0.86	-0.07	NA
30Y	-0.45	-0.69	-0.44	NA
Provincial Yields[2] (%)				
5Y	4.07	3.36	3.07	**3.54**
10Y	4.61	4.40	4.15	**4.41**
30Y	5.06	4.88	4.71	**4.79**
Provincial Yields vs. GoC Yields[2] (Ratio)				
5Y	1.06	1.39	1.15	**1.22**
10Y	1.08	1.35	1.20	**1.23**
30Y	1.11	1.26	1.18	**1.22**
Provincial Credit Curves[1] (bps)				
5s-10s	12	21	28	**28**
10s-Longs	13	-10	4	**4**
5s-10s-Longs Bfly	-1	31	25	**25**
Provincial Credit Curves vs. GoC Curve[2] (Correlation)				
5s-10s	0.23	0.69	0.40	NA
10s-Longs	-0.39	-0.75	0.32	NA
Provincial Spreads vs. Other Fixed Income Sectors, 5-Year[1]				
Corporate vs. Provincial (bps)	57	233	85	**62**
Corporate vs. Provincial (Ratio)	3.65	3.55	3.08	**2.13**
Provincial vs. CMB (bps)	4	45	16	**22**
Provincial vs. CMB (Ratio)	1.24	2.10	1.66	**1.68**
Provincial Rolls to Ontario, 30-Year[1]				
Tightest (bps)	-12	-4	-11	**-13**
Excl. Alberta (bps)	-8	-3	-5	**-6**
Widest (bps)	12	22	15	**13**
Tightest (Ratio)	0.74	0.95	0.85	**0.85**
Excl. Alberta (Ratio)	0.83	0.97	0.90	**0.93**
Widest (Ratio)	1.25	1.21	1.21	**1.15**
Provincial Arbitrage, US vs. Canada[1,3] (bps)				
3Y	4	5	10	**-1**
5Y	6	6	17	**12**
10Y	10	17	20	**27**
Reference: Average Issuance Pace				
GoC (C$bn)	2.9	7.1	8.6	NA
Provincial (C$bn)	3.4	5.4	5.8	NA
Domestic Share (%)	80	68	68	NA
International Share (%)	20	32	32	NA

Source: CIBC

1. New issue spreads, off-the-curve
2. Secondary market spreads, constant maturity benchmark
3. Incomplete pre-crisis period; reflects Jan-08 to Jun-08

CREDIT

JOANNA ZAPIOR

Don't Be Fooled by the First Four Months

Primary market is the apple of the eye for corporate markets anywhere around the world. The pace of activity, as well as pricing, in the new issue market is often monitored carefully as the sign of the health of the market. The pace of corporate issuance in the Canadian market has intensified such that if maintained for the year, 2010 would be a record year with over $75 billion in just domestic issuance, excluding Maples (Table 1). We actually don't think this is in the cards. Seasonality of new corporate issuance suggests front-loading during the first half of the year. In the last three years, 62% of annual issuance was completed in the first six months of the year (Chart 1). We think that this will be amplified this year given the general expectation that rates will rise in the second half, which, we believe has brought forth some of the issuance, notably by the banks, into the wide-opened window in the market.

Table 1. **Pace of Corporate Issuance in the Canadian Market Has Intensified**

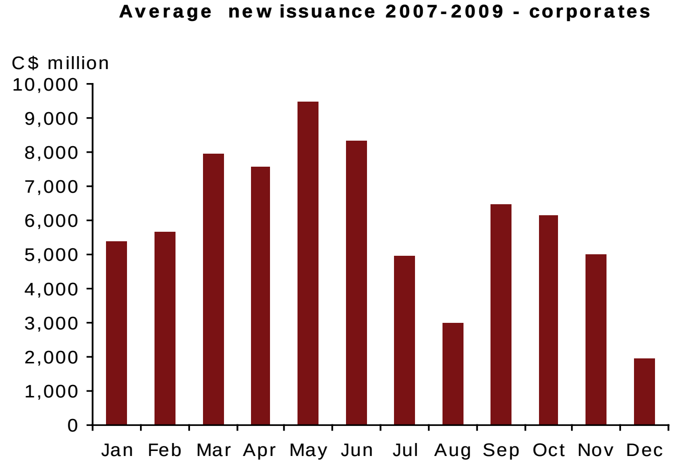
	2010 YTD	2009 YTD	2009 Full Year	2008 Full Year	2007 Full Year	2006 Full Year	2005 Full Year
Auto	$750	$0	$0	$1,500	$2,335	$2,350	$2,322
Bank	$11,940	$5,395	$15,589	$35,350	$32,470	$19,406	$20,025
Non-bank	$3,275	$1,675	$7,175	$3,475	$6,845	$5,375	$11,275
Life Insurance	$250	$1,217	$5,221	$2,300	$1,768	$2,650	$1,250
Telecom	$300	$600	$8,100	$500	$2,400	$1,850	$1,500
Communications & Media	$500	$750	$1,565	$1,200	$475	$0	$0
Industrial	$355	$0	$1,486	$875	$725	$200	$1,125
Infrastructure	$700	$1,234	$2,906	$2,147	$3,756	$3,203	$3,491
Real Estate	$780	$910	$2,235	$1,365	$2,658	$950	$1,370
Consumer	$275	$675	$1,400	$830	$467	$1,025	$4,035
Energy	$3,655	$3,100	$9,640	$5,291	$2,055	$4,800	$4,600
Oil and gas	$700	$0	$150	$1,450	$1,750	$750	$900
Transportation	$0	$0	$0	$375	$0	$0	$0
Healthcare	$0	$0	$0	$0	$0	$0	$0
Corp. Issuance	$23,480	$15,556	$55,467	$56,657	$57,704	$42,559	$51,893
ABS/CMBS	$1,986	$468	$1,390	$5,160	$6,111	$17,181	$11,697
Total domestic	$25,466	$16,024	$56,857	$61,817	$63,814	$59,739	$63,590
Maple bank	$1,050	$0	$700	$280	$16,810	$13,875	$9,475
Maple non-bank	$0	$0	$350	$475	$12,325	$8,750	$9,395
Maple infrastructure	$0	$0	$0	$0	$425	$800	$150
Maple energy	$0	$0	$0	$0	$100	$300	$100
Maple telecom	$0	$0	$0	$0	$0	$725	$0
Maple life insurance	$300	$0	$200	$100	$800	$2,975	$0
Maple auto	$0	$0	$0	$0	$100	$150	$0
Maple govt	$0	$0	$0	$0	$550	$0	$550
Maple Issuance	$1,350	$0	$1,250	$855	$31,110	$27,575	$19,670
TOTAL	$26,816	$16,024	$58,107	$62,672	$94,924	$87,314	$83,260
Yankees (US$)	$13,100	$3,560	$39,285	$31,523	$25,668	$24,304	$17,539

Thus we think that the pace of issuance will slow down in the second half of the year, making 2010 only an average issuance year, perhaps at par with 2008, and similarly dominated by financials. The current episode of poor market liquidity, if it extends, will likely change the seasonally strong issuance pattern in May through July, and may prompt us to further downgrade our issuance forecast.

Pricing signals so far have been indicative of increased risk appetite

We have recorded 65 bonds issued this year into the Canadian corporate debt market. By number of issues, 38% were in the 6- to 10-year term (40% by volume), and 11% in the longer than 10-year term (but only 4%

Chart 1. ***Seasonality—Corporate Issuance Tends to be Front-Loaded***



by volume). The largest portion of issuance was short bonds. The 6- to 10-year bucket is where the action has been (Chart 2). This maturity bucket has offered a much bigger diversity of credits than the short bucket, in which issuance was dominated by AAs at 61%, followed by AAAs at 19% and As at 17%, and only two BBB issues amounting to 3% of the short-bond volume.

Chart 2 plots, chronologically by date of issue, new issue spreads for the bonds issued in the 6- to 10-year maturity bucket so far this year. The bonds are colour- and symbol-coded by rating. Our analysis of new issue pricing leads us to conclude that:

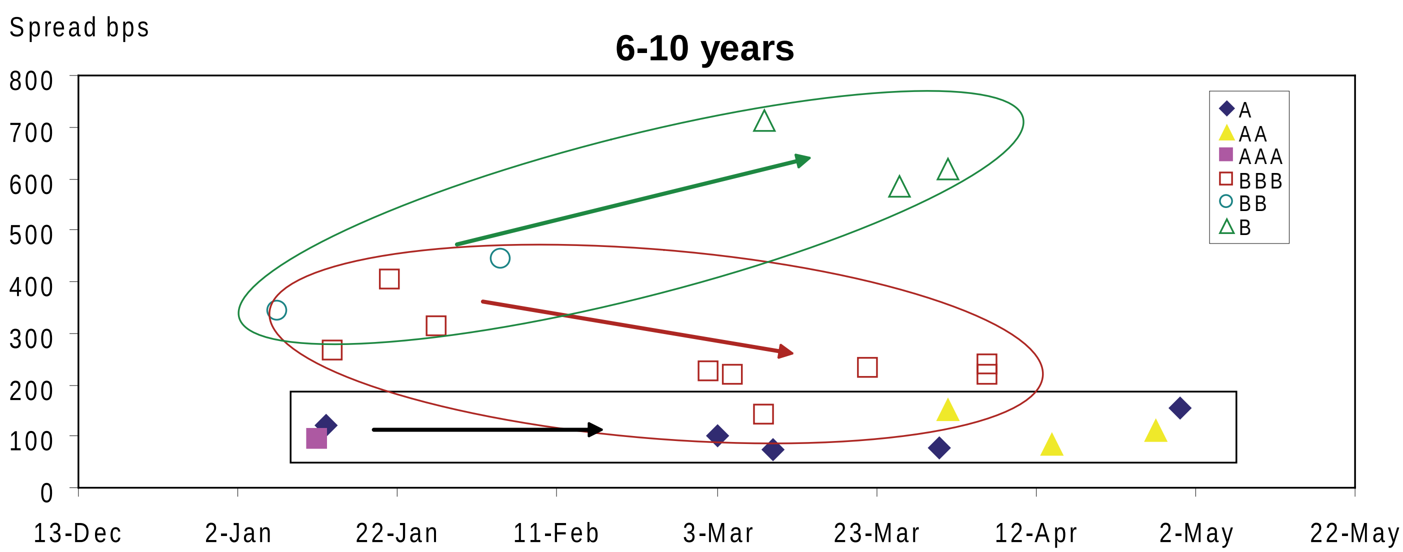
1) High-end investment grade pricing marks a remarkably tight range of spread (black rectangle, solid shapes) with little differentiation between AAA, AA and A credits. This range does not appear to have changed over the first four months of the year. This is suggestive of indiscriminate buying in the first four months of the year.

2) BBBs (red squares) have come to market at progressively tighter spreads over the four months. No BBB is of the same credit quality as the next one, making generalizations a challenge. Still, we are comfortable concluding, based on the observed new issue pricing, that the market in the last four months has been progressively more receptive to BBB credits.

3) Only five high-yield bonds have come to market so far this year, and again generalizations are dangerous. However, the increased risk appetite in the market is confirmed by the progression of increasingly lower-rated issuance since the beginning of the year.

This new issue market behaviour is consistent with "good times"—which we don't expect to continue into the second half of the year.

Chart 2. ***New Issue Pricing Indicates Increased Risk Appetite Accompanied by Indiscriminate Buying of High Credit Quality***



FX Structuring

Eric Ohayon

Fundamentals Decide Winning Currencies

Europe has stepped up the defence of its weakest state bond markets, with buying by the ECB and a pledge of nearly US$1 trillion to stand behind any euro member state in crisis. While that has given the euro some near-term support after an earlier steep slide (Charts 1, 2), markets could easily take the European currency weaker again in the next few months. Not only is Greece still facing a likely default when its temporary support runs out, but other states that have seen credit downgrades (Portugal to A- and Spain to AA), along with Ireland and Italy, still face heavy budget-cutting demands, since austerity plans will likely be a precondition for receiving any of the now-promised European/IMF support. Fiscal belt tightening will impede growth over the next couple of years, a negative for the euro since it will delay and soften any ECB tightening plans in that period.

While Europe is trying to deal with its spreading financial crisis, the US continues its economic recovery. Our first look at Q1 real GDP growth came in at a middling 3.2%. The Fed restated its intention to keep rates on hold for an "extended period" and mentioned that the labour market is "beginning to improve". Despite an economy that has been growing for almost a year, the lack of inflationary pressures and relatively high unemployment rate does not warrant a rate hike just yet.

The Canadian dollar has soared a hefty 20% against its US counterpart over the past year to momentarily trade stronger than parity in April (Chart 3). The drive behind the appreciation of the loonie can be associated with surging commodity prices, funds flow looking for an alternative to the greenback and potential BOC rate hikes. A rate hike for June is largely priced in and the CAD-US two-year spread trades around 100 bps, which also means that 2yr GOCs have double the yield of the US 2-year Note. Commodity prices seemed to have stabilized with oil trading around $80 and Gold (in USD terms) firmly in the all-time-high range of 1,100-1,200.

Overall, the CAD could appreciate a few cents stronger than parity before a potential retracement. A move in USD/CAD beyond the 0.9700 / 0.9800 levels is likely to

Chart 1.

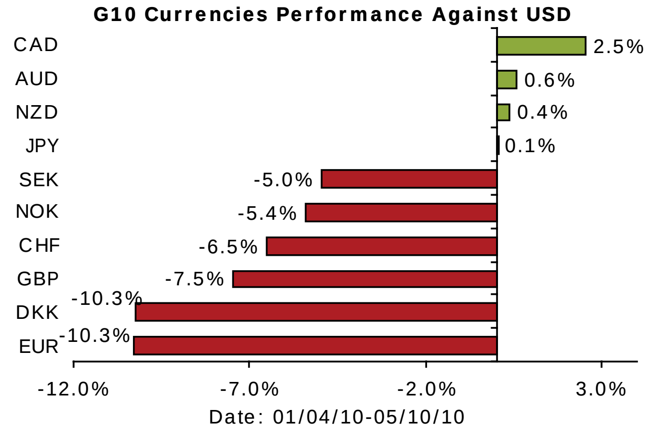


Chart 2.

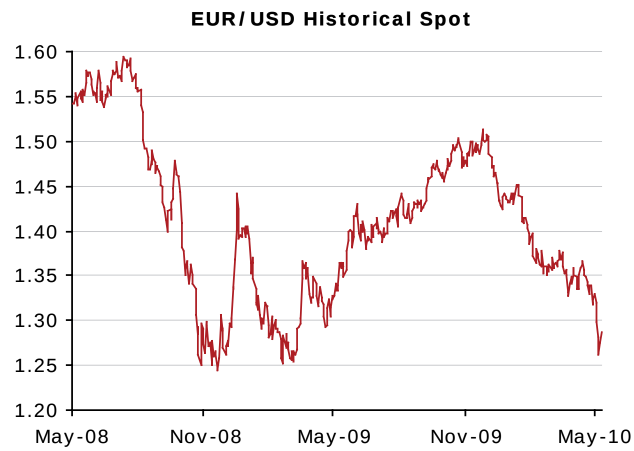
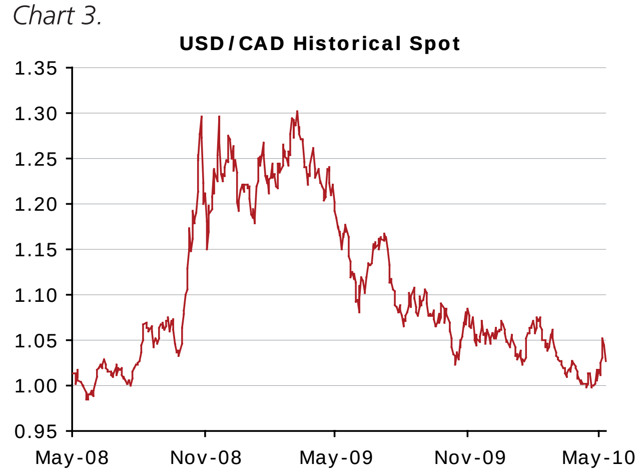


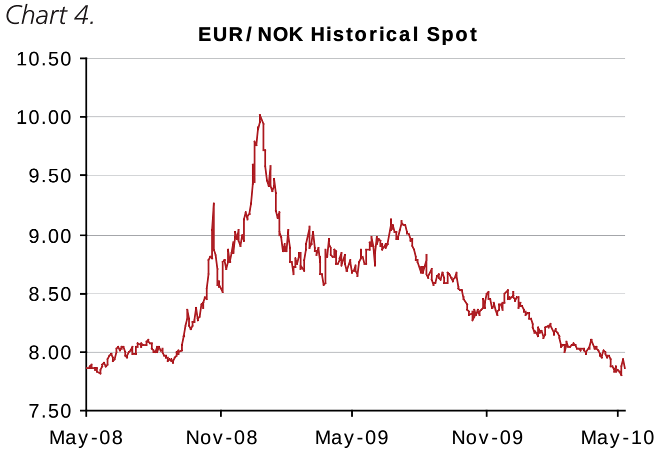
Chart 3.



raise concerns and should be short lived. In short, USD/CAD should continue to range trade with a potential to break on the top side at times due to potential increase in risk aversion. It is worth noting that Risk Reversals are trading 2 vols in favour of USD Calls.

Norway, while technically a European country, is not part of the European Union and benefits from economic strengths over its neighbours that are very similar to those of Canada over the US. Norway is the 5th largest oil exporter and 3rd largest natural gas exporter in the world, behind only Russia, Canada, and the Persian Gulf, while the US and European Union are by far the two largest importers of oil. Norwegian interest rates are significantly higher than in Europe or the US with the 2Y swap at 3.15% and 5Y swap around 3.80%. The NOK has appreciated in tandem with the rest of the commodity currencies (AUD, NZD, CAD) but just not to the same extent. With a 10% appreciation against the greenback and 12% against the euro over the past 12 months, the Krona seems to have more room to both rise on fundamentals and provide a good carry return (Chart 4).

Chart 4.



In light of the above, the following strategies are designed to take advantage of a potential continued weakness of the euro.

Trade Ideas:

Switch Forward EURNOK / EURUSD
Spot Ref.: 1.2950 USD per EUR
7.8800 NOK per EUR

Client Position:	Sell EUR against either USD or NOK
Strike:	1.3350 in EUR/USD and
	8.3435 in EUR/NOK
Expiry Date:	6 months
Notional:	EUR 10,000,000
Chooser Condition:	At expiry, the client will sell EUR against either USD or NOK.
	CIBC will choose to pay either the USD or NOK at it sole discretion.
	The two potential scenarios at expiry are:

1. Client sells € 10,000,000 against USD at 1.3350, outperforming the 1.2955 outright forward by 0.0395 USD per EUR.
2. Client sells € 10,000,000 against NOK at 8.3435, outperforming the 7.9460 outright forward by 0.3975 NOK per EUR.

Upfront Premium:	Zero

EUR/USD Fade-In Forward
Spot Ref.: 1.2950 USD per EUR

Client Position:	Sell EUR/USD Forward
Strike:	1.3350 USD per EUR
Expiry Dates:	Weekly for the next 52 weeks
Notional:	EUR 1,000,000 per week

Fade-In Level: 1.2120 USDS per EUR

Every week, if spot EUR/USD fixes at or above the 1.2120 Fade-In level, the client sell € 1,000,000 at 1.3350 for that week. Outperforming the outright forward by 395 USD pips.

Every week, if spot EUR/USD fixes below the 1.2120 Fade-In level, no transaction will take place for that week.

Upfront Premium: Zero

USD/CAD Range Bonus Accumulator
Spot Ref.: 1.0250 CAD per USD

Client Position: Buy USD/CAD Forward

Strike: 0.9650 CAD per USD

Expiry Dates: Weekly for the next 52 weeks

Notional: USD 1,000,000 per week

Every week, if spot USD/CAD fixes below 0.9650 CAD per USD, the client will buy US$ 1,000,000 at 0.9650 for that week.

Bonus Range: 0.9650 – 1.1550

Bonus Payout: C$ 12,500 per week

Every week, if spot USD/CAD fixes within the pre-defined Bonus Range, the client will receive the C$ 12,500 payout for that week.

Upfront Premium: Zero

Conditional EUR/NOK Put Spread
Spot Ref.: 7.8800 NOK per EUR

Client Position: Buys a 7.8800 EUR Put / NOK Call
Sells a 7.8650 EUR Put / NOK Call RKI 7.4990

Expiry Date: 3 months

Notional: EUR 10,000,000

Upfront Premium: 0.75% EUR

Analysis: The client is initially long a 7.8800 (ATMS) USD Put / NOK Call for 0.75% EUR (half the price of the standard vanilla option). Only in the event that spot EUR/NOK ever trades at or below the 7.4990 Trigger Level, will the client be long a 7.8800 - 7.8650 EUR/NOK Put spread. In which case, the client will benefit from a maximum gain of 150 NOK pips.

Alternative

In order to fully finance the upfront premium associated with the above Conditional EUR/NOK Put Spread, the client could sell the 8.0000 EUR Call / NOK Put 8.2000 RKI and 7.4990 KO.

The KIKO EUR Call only exists if spot EUR/NOK ever trades at or above the 8.2000 RKI trigger. In addition, in the event that spot EUR/NOK ever trades at or below 7.4990, the option will cease to exist.

Commodities

Peter Buchanan

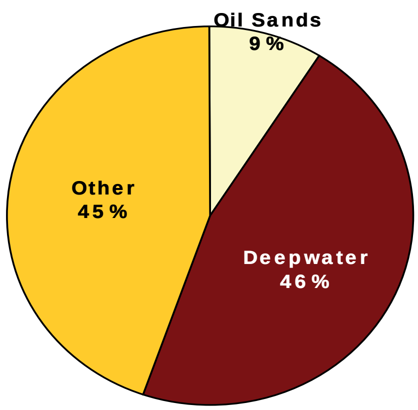
Why Flying PIIGS May Not Lift Oil Prices a Lot

Fears that we could soon see triple-digit oil prices have eased in recent weeks. That has occurred, moreover, even as observers continue to ponder the potential impact of last month's accident in the Gulf of Mexico on the cost of offshore oil, which has accounted for about half of the growth in global oil production in the last decade, making it a critical source of new supply (Chart 1).

Other factors have obviously been at play. The most apparent contributor to WTI's recent sell-off has been the effect on the market's appetite for risky assets and growth expectations from the crisis in Greece. That country isn't a heavy economic hitter, accounting for only about 2% of the eurozone's GDP. Nor is it a heavyweight in oil markets. The 440 thousand barrels of oil that Greece uses daily makes it only the world's 32nd largest consuming country. What matters for oil markets, however, is the fact that Greece's problems are unique only in their severity. Many other countries including the world's top oil consumer, the US, will have to cut bloated budget deficits, and the drag from those efforts will keep the global recovery's pace from matching past ones, retraining oil demand.

Even if eurozone's $955 billion bailout plan succeeds in putting a fairly ugly fiscal genie back in the bottle, there are reasons in our opinion, not to look for a large upside in oil prices in the next 12-18 months.

Chart 1. ***Deepwater Oil Has Been a Key Driver of Recent Global Supply Growth***



Global Oil Production Rose by 9.3 mn bbl/day from 1999-2009

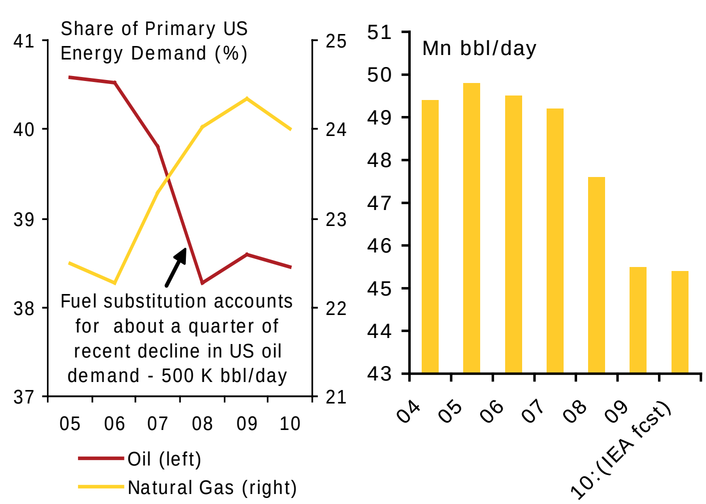
Source: US DoE, Canadian Assoc. of Petroleum Products, CIBC

OECD Demand Not Strong—Drought May Be Distorting China's Numbers

Oil demand in China started the year with a bang, rising by nearly 20% on the depressed year-earlier levels in the first quarter. Part of that rise, however, may be transitory—a consequence of increased consumption by the power sector to offset reduced hydroelectric production resulting from the worst drought to hit the country in a century.

Even if underlying demand in China is rising at a healthy clip, moreover, it's unlikely to offset a still-uninspiring demand picture elsewhere. At about 19 mn bbl/day, US oil demand is still about 10% or 2 mn bbl/day below the all-time peak set in 2007. While the weak economy is responsible for a good part of that decline, about a quarter is due to increased competition from natural gas, and won't be readily reversed as the economy heals (Chart 2, left). The picture elsewhere, moreover, isn't so different. The International Energy Agency (IEA) is looking for effectively no growth in OECD oil consumption this year. That would leave demand still running a good 8% below its 2005 peak (Chart 2, right).

Chart 2. ***Cheap Natural Gas Taking Share From Oil (L), Was 2005 the Peak Year for OECD Oil Demand? (R)***



Continuing Inventory-Price Paradox

Inventory levels, which have been creeping up again as the more heavily contangoed futures strip encourages stockpiling, are another sign that markets are well supplied. And that also makes a further sharp rise in prices unlikely for now. The DOE's announcement that US commercial crude oil stocks jumped by 2.8 million barrels in the last reporting period lifts overall supply to nearly 1.1 billion barrels. That's about 8% higher than usual (Chart 3), a level that historically would have meant prices $30 or so below today's spots. Gasoline inventories are now also nearly 8% above the long-term average. Distillate fuel inventories are even heavier, exceeding seasonal norms by 28%. Supply at the international level looks more than adequate as well. OECD industry stocks fell by 38.4 mn bbl to 2,685 mn bbl in February, according to the IEA. That puts forward demand cover at 60 days, 10% or so above normal levels for this time of the year.

OPEC Spare Capacity Remains High Even With Added Production

Thanks in part to capacity additions by Saudi Arabia and Angola, OPEC's spare capacity interestingly enough has remained close to decade highs at well over 5 mn bbl/day, even as the cartel has raised production by 1.5 mn barrels over the last year (Chart 4). Five of OPEC's dozen members have surplus capacity in excess of 100,000 barrels daily, suggesting output could rise further in coming months.

Even if the cartel opts for one reason or another to maintain its current well-above-normal levels of reserve capacity, net capacity growth, moreover, should suffice to meet global demand for the next 2-3 years. New oil field developments are expected to add about 6 mn barrels per year to capacity in the near term, which works out to a net increase of about 2 mn barrels/day, allowing for the effect of depletion, the inexorable loss of production in existing fields.

Some key energy-using products like cars are replaced on average only once every twenty years or so. Our VAR forecasting model, which incorporates global GDP growth, real oil prices and lagged demand, suggests not surprisingly that it takes 2-3 years for higher or lower oil prices to exert their maximum effect on demand, given that fact. Estimates from the model point to a rise of about 1.7% (Table 1), or about 1.5 million barrels per day in global demand this year—a bit less than expected capacity—if the world economy grows at a 4% clip as we expect. The model forecasts only a 1% rise in demand next year, assuming that GDP growth eases slightly due to fiscal restraint in the industrial countries, who still account

Chart 3. ***US Oil Inventories Surging Again***

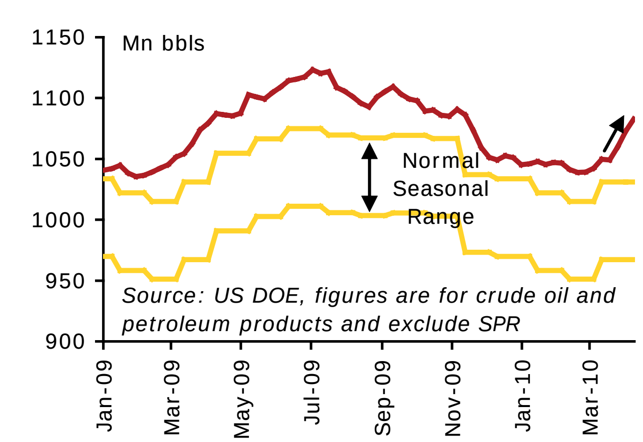
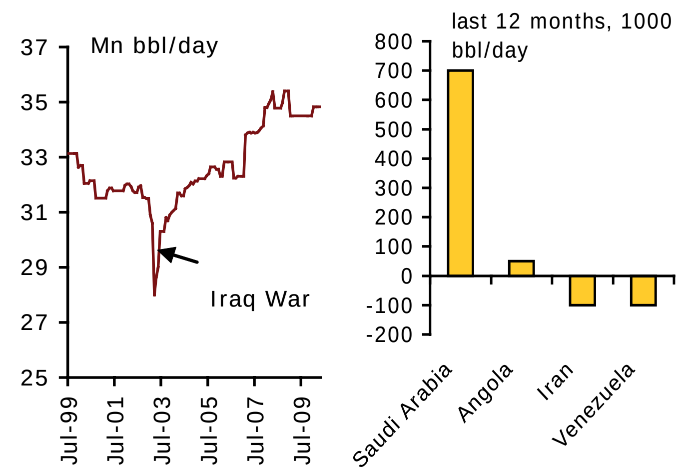


Chart 4. ***OPEC Capacity Still Rising (L), Change in Last Year in Selected Members (R)***



Recommendation Summary:

Buy Aug-10 Lt Sweet Crude (approx $82.60) Time Horizon 2-3 months
Sell Nov-11 Lt Sweet Crude (approx $87.90) Time Horizon 2-3 months

for over half of demand. That latter estimate is softer than annual demand growth in the years just before the recession, but close to the average growth rate of the last decade.

Based on these developments, we expect oil to average about $80/bbl this year and $85 in 2011 (Table 2). Both estimates are a bit short of those currently embedded in the futures strip curve. While $20 crude isn't likely to return any time soon, oil prices are nonetheless fundamentally cyclical. Surging demand historically has amplified price shocks, leading to recession or slower growth, which in turn has begat lower prices. Those have helped grease the wheels of economic recovery.

The historical evidence suggests an average of 4-5 years between price peaks (Table 3). That would suggest 2012 or 2013 as the next highwater mark for oil prices, although the exact timing will obviously depend on the pace of demand and capacity growth.

Table 1. **World Supply and Demand (mn bbl/day)**

	2005	2006	2007	2008	2009	2010 (f)	2011 (f)
World Oil Demand	84.04	85.20	86.14	85.75	84.04	85.47	86.32
-% ch	1.9%	1.4%	1.1%	-0.5%	-2.0%	1.7%	1.0%
World Oil Supply	84.55	84.52	84.41	85.37	84.16	85.66	86.87
-OPEC	34.95	34.72	34.37	35.70	33.88	34.78	36.11
-Non-OPEC	49.60	49.80	50.04	49.67	50.28	50.88	50.76
Stock Draws & Discrepancy	-0.51	0.68	1.73	0.38	-0.12	-0.19	-0.55

Source: US Department of Energy, CIBC

Table 2. **Spot Commodity Prices**

			Average				
		10-May	2007	2008	2009	2010 (f)	2011 (f)
Oil (WTI)	$/bbl	77	72	100	62	80	85
RBOB gasoline	$/gal	2.17	2.09	2.49	1.69	2.05	2.25
Heating Oil (NYH)	$/gal	2.11	2.03	2.86	1.65	2.10	2.20
Natural Gas (Henry)	$/Mn Btu	4.05	6.97	8.89	3.82	5.00	6.00
Gold	$/troy oz	1197	695	872	1088*	1275*	1150*
Copper	$/lb	3.13	3.24	3.16	2.35	3.40	3.30
Aluminum	$/lb	0.93	1.20	1.17	0.76	1.00	0.85
Nickel	$/lb	10.20	16.86	9.57	6.69	9.75	9.00
Zinc	$/lb	0.94	1.48	0.85	0.76	1.10	1.05

** end of period*

Table 3. **Historic Oil Price Cycles**

Peak WTI Price, US$/bbl	Date of Peak	Years Since Prior Peak	Subsequent Trough
$39.50	Apr-80	-	Jul-86
$22.39	Jul-87	7.3	Nov-88
41.02	Oct-90	3.3	Mar-94
28.1	Dec-96	6.2	Dec-98
37.21	Sep-00	3.8	Dec-01
77.03	Jul-06	5.8	Jan-07
145.29	Jul-08	2.0	Feb-09
Average, last 6 cycles		4.7	

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