



What's Hot, What's Not

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Macro and FX View (Shenfeld): An uneven and modestly-paced global rebound in 2010, as opposed to an economic boom in which profits and prices advance everywhere, will mean that investors will have to search for growth rather than stumble upon it wherever they look. Countries and sectors with less of a lingering hangover from the financial shock are positioned for better returns on equities and better spread performance on corporate bonds. (p.2-3)

Rates (Ahmed): A great deal of emphasis has been placed on simultaneous performance of stocks and bonds. The past two quarters have been marked by an increase in the number of days on which both Treasuries and the S&P 500 have moved together. Given the economic backdrop, there is further scope in the near term for both asset classes to perform concurrently. (p.4-5)

Government Finance (Lovely): Credit fundamentals are reasserting their influence on provincial spreads. Our new Provincial *Credit Rating Score* is now in the early stages of decline, though the magnitude of the erosion should pale in comparison to early-1990s carnage. Individual *Credit Rating Scores* account for nearly 90% of the current deviation in relative provincial spreads, with a one-point drop in our *CRS* implying a six basis point relative widening. (p.6-8)

Credit (Zapior): Global credit default swap markets rallied hard from the widest levels in late 2008-early 2009. CDS sector spreads overall are still three times their tightest levels of June 2007. Current projections for default rates are also three times those made in the summer of 2007. At this stage in the cycle, there is little value left in sector plays, and we now seek value through security selection. (p.9-11)

FX Structuring (Bhatti): Brazil has been hot, and it is getting hotter. It declared an end to the recession after only six months, all of its sovereign debt ratings are now firmly investment grade after the latest upgrade from Moody's, and it enjoys capital flows into the economy. We believe that the appreciation of the Real still has room to continue, and expressed this belief through a structured trade. (p.12-13)

Commodities (Buchanan): We have three reasons to move to underweight on gold. 1) Weak dollar drove the recent rise of gold, and we believe that the dollar has overshot to the downside, with a relief rally expected in the next two to three quarters, 2) Investor anxieties continue to subside, crimping appetite for financial insurance, including gold, and 3) We see an unwinding of the present exaggerated market fears about near-term inflation. (p.14-15)

Strategic Risk (Rosborough): Emerging markets have been hot. This holds true whether one looks at equities, fixed income or currencies. The recovery was led by credit and followed by rates, then emerging equities, and finally G7 equities. Sequencing of the recovery suggests that G7 equities, and particularly those of the US and UK that had been hit the hardest during the credit crunch, still have the best potential upside. We are long the UK equity market, US financials and US homebuilders. (p.16-17)

ECONOMICS

AVERY SHENFELD

In Search of Growth

The world's economy is again in drive, but operating on only half its cylinders. In economic boom times, profits and prices can be advancing almost everywhere, rate hikes can be nearly ubiquitous, and every asset class other than true safe havens like government bonds can be performing well. But the uneven and modestly-paced global rebound in 2010 will mean that investors will have to search for growth rather than stumble upon it wherever they look.

Disparities Reflect Recession's Hangovers

Large declines create room for initially impressive bounce backs, and that will be seen in comparing early growth rates across regions and sectors. Having nearly shuttered the North American auto sector, for example, rates of growth as plants came back on line in the second half will look impressive. We similarly saw brisk rebounds in some East Asian economies in Q2 after very severe pullbacks in prior quarters, where trade finance was an issue.

But looking through a longer lens that takes us through 2010 gives a more meaningful perspective for investors. On a regional basis, both the US and the parts of Europe that suffered through the worst of the credit crunch, will see a lingering hangover in 2010, owing to the damage done to household finances, real estate and the banking

system. A weakened banking system underscores our view that the eurozone will see limited growth in 2010 (Table 1). In the US, despite efforts to repair the banking system's ability to finance growth, loan demand in the household sector will remain weakened as Americans try to increase savings and repair the damage to their net worth caused by the past year's severe house price crash. A lacklustre consumer is key to our call for growth to decelerate again in 2010 after a nice bounce to end this year.

Conventional interest rate medicine has been more potent in Canada, and Australia, where households were not as scarred by real estate losses, and therefore in a better position to take advantage of low interest rates, and where the banking system is in a better position to extend credit where credit is due. Canadian household credit has continued to expand, despite the recession, as those still working take advantage of the lowest rates in a lifetime, in contrast to declining credit flows seen stateside.

Having not been at the epicenter of the financial crisis, countries like Brazil are also positioned for a decent rebound, along with emerging Asia, where banks avoided the deep losses experienced in Europe and the US. Note that savings rates in the developing world didn't dive in the past decade as they did stateside leaving more room for consumption growth ahead.

Table 1. Real GDP Growth Rates

| | 2006A | 2007A | 2008A | 2009F | 2010F | 2011F |
|----------|-------|-------|-------|-------|-------|-------|
| World* | 5.1 | 5.1 | 3.1 | -1.5 | 2.7 | 3.7 |
| US | 2.7 | 2.1 | 0.4 | -2.5 | 1.5 | 3.3 |
| Canada | 2.9 | 2.5 | 0.4 | -2.4 | 2.0 | 3.8 |
| Euroland | 3.1 | 2.7 | 0.6 | -4.0 | 1.0 | 2.3 |
| UK | 2.8 | 3.0 | 0.7 | -4.5 | 1.3 | 2.0 |
| Japan | 2.0 | 2.3 | -0.7 | -6.0 | 1.5 | 1.8 |
| Brazil | 3.8 | 5.9 | 5.1 | -0.2 | 4.0 | 4.2 |
| Russia | 7.7 | 8.1 | 5.6 | -8.0 | 3.0 | 4.0 |
| India | 10.0 | 9.3 | 7.5 | 5.5 | 6.8 | 8.0 |
| China | 11.6 | 13.0 | 9.0 | 8.5 | 9.8 | 9.0 |

*Country growth rates are weighted using purchasing power parities.

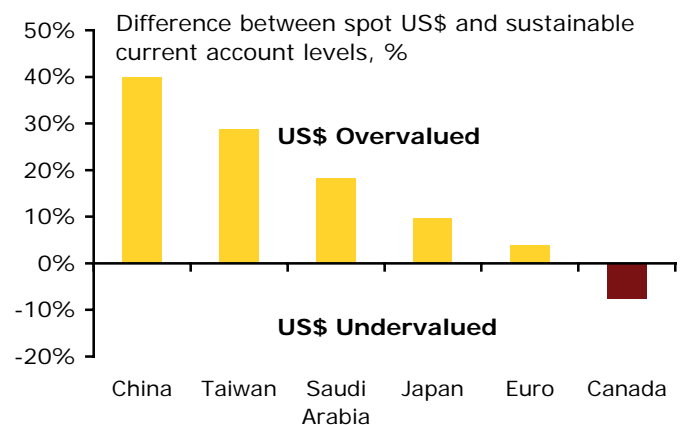
Add it all up, and the broad message is that countries with less of a hangover from the financial shock are ripe for better returns on domestically oriented equities (retailers, real estate, etc.), and superior spread performance on related corporate bonds.

Whose Turn to Appreciate?

Faster growth needn't mean a stronger currency, and an excessive appreciation can serve to dent growth prospects. The conventional wisdom is that America will need a weaker US dollar to allow exports to fill in the gap for an economy that will see leaner growth in consumption and housing. Our own analysis lines up with that view, as we estimate that a further 20% depreciation in the greenback will be needed to bring the US to a sustainable current account deficit of 2% of GDP.

But that builds on what has already been a 20% dollar devaluation since 2002, one that has disproportionately been built on appreciations in only a subset of currencies. Among the large US trading partners, there has been little or no appreciation in some of America's major trading partners in the Middle East and East Asia, and a massive move against others, including the Canadian dollar. So much so, that when we updated a model by Cline and Williamson to allow for FX moves in the last half year, we found that the C\$ was already overvalued relative to the level deemed to produce a sustainable current account

Chart 2. **US\$ vs. Fundamental Equilibrium Exchange Rate**



Source: Cline & Williamson (2009)

balance for Canada (Chart 2). Others still have huge room for appreciation given their hefty current account surpluses.

Momentum trades are still moving in Canada's favour, but what's been hot thus far, like the loonie, will ultimately give way to other currencies to take the lead vs the greenback. And the US dollar could see a temporary correction in its favor if, as we expect, North American economic growth disappoints early in 2010 as momentum from inventory rebuilding fades. That would not only hurt the growth-oriented C\$, but would also take some of the shine off of gold (see pages 13-14).

Table 2. **Interest and Exchange Rate Forecast**

| END OF PERIOD: | 2009 | | 2010 | | | |
|---------------------------------------|-------|-------|-------|-------|-------|-------|
| | 8-Oct | Dec | Mar | Jun | Sep | Dec |
| CDA Overnight target rate | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 |
| 98-Day Treasury Bills | 0.20 | 0.23 | 0.25 | 0.30 | 0.30 | 0.30 |
| 2-Year Gov't Bond | 1.33 | 1.20 | 1.25 | 1.30 | 1.40 | 1.60 |
| 10-Year Gov't Bond | 3.36 | 3.18 | 3.35 | 3.70 | 3.85 | 3.95 |
| 30-Year Gov't Bond | 3.89 | 3.80 | 4.10 | 4.25 | 4.30 | 4.35 |
| U.S. Federal Funds Rate | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 |
| 91-Day Treasury Bills | 0.07 | 0.10 | 0.15 | 0.20 | 0.25 | 1.00 |
| 2-Year Gov't Note | 0.88 | 0.90 | 1.20 | 1.30 | 1.45 | 1.65 |
| 10-Year Gov't Note | 3.25 | 3.25 | 3.55 | 4.05 | 4.20 | 4.35 |
| 30-Year Gov't Bond | 4.09 | 4.05 | 4.30 | 4.85 | 5.00 | 5.00 |
| Canada - US T-Bill Spread | 0.13 | 0.13 | 0.10 | 0.10 | 0.05 | -0.70 |
| Canada - US 10-Year Bond Spread | 0.11 | -0.07 | -0.20 | -0.35 | -0.35 | -0.40 |
| Canada Yield Curve (30-Year — 2-Year) | 2.56 | 2.60 | 2.85 | 2.95 | 2.90 | 2.75 |
| US Yield Curve (30-Year — 2-Year) | 3.21 | 3.15 | 3.10 | 3.55 | 3.55 | 3.35 |
| EXCHANGE RATES | | | | | | |
| CADUSD | 0.950 | 0.901 | 0.855 | 0.877 | 0.909 | 0.943 |
| USDCAD | 1.053 | 1.110 | 1.170 | 1.140 | 1.100 | 1.060 |
| USDJPY | 88 | 93 | 97 | 95 | 90 | 87 |
| EURUSD | 1.48 | 1.44 | 1.35 | 1.35 | 1.37 | 1.40 |
| GBPUSD | 1.61 | 1.60 | 1.58 | 1.59 | 1.62 | 1.67 |
| AUDUSD | 0.906 | 0.840 | 0.795 | 0.825 | 0.855 | 0.895 |
| USDCHF | 1.03 | 1.05 | 1.11 | 1.11 | 1.09 | 1.08 |
| USDBRL | 1.74 | 1.84 | 1.95 | 1.89 | 1.82 | 1.75 |
| USDMXN | 13.3 | 13.6 | 14.0 | 13.5 | 13.0 | 12.5 |

RATES

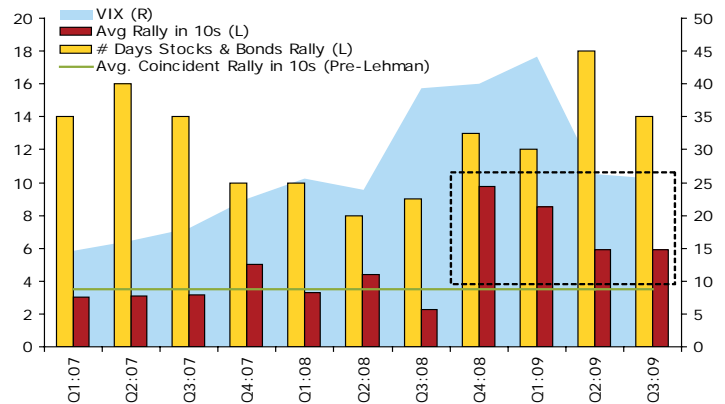
MOHAMMED AHMED

Dancing To the Same Beat

Traditional technical analysis cites deviations in cross-asset correlations as foreshadowing shifts in market direction. Recently, a great deal of emphasis has been placed on the simultaneous performance of stocks and bonds (Charts 1 and 3). As Chart 2 shows, the past two quarters have been marked by an increase in the number of days on which stocks and bonds have rallied synchronously. Moreover, the average rally in rates on days that both Treasuries and the S&P 500 have moved together has risen sharply. Contrary to what inter-market technical analysis would suggest, this development does not portend a near-term correction in either asset class.

In contrast to the notion that returns on stocks and bonds are 'generally inversely correlated', the "Currencies, Cycles and Commodities" feature in this month's Economic Insights (published September 30th) demonstrates that the relative performance of global stocks and bonds is dependent on the phase of the economic cycle (Table 1). On average, bonds offer positive total returns in any stage of the cycle, while stocks perform exclusively in recoveries/expansions. Furthermore, weak recoveries tend to be

Chart 2. Qtlly Coincident Performance of S&P 500 and US 10s

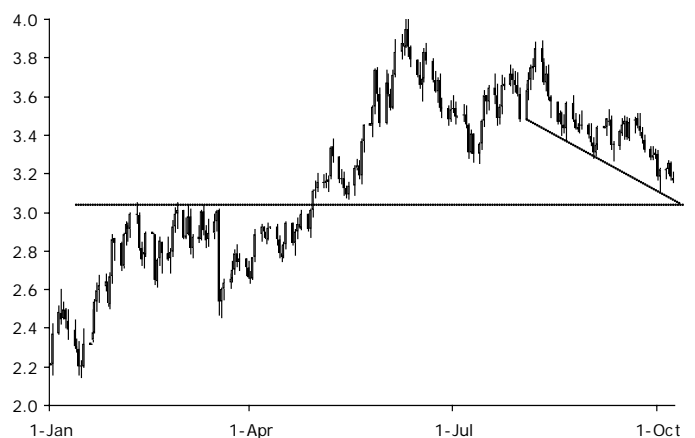


relatively better for equity returns than strong recoveries. This phenomenon can be attributed to concerns about the unsustainability of a rapid recovery, fears of tighter monetary policy or cost pressures squeezing profit margins.

Chart 1. S&P 500



Chart 3. US 10s (%)



Narrowing in on Canada, our economic forecast can be characterized as one of middling growth and tame inflation in 2010, followed by a strong recovery in 2011. Similar economic backdrops have been experienced during three distinct periods over the past 20 years: November 1991 to June 1993, September 1995 to September 1996 and May 2001 to June 2002 (Chart 4). During these periods of low growth and inflation, not only do we observe positive returns for both stocks and bonds, but we also see an increase in the positive correlation of returns relative to the two decade period under consideration.

As such, a period of concurrent performance in stocks and bonds should not be unexpected.

In terms of technical analysis, conventional wisdom regards bonds as a leading indicator for stocks. Thus, the rally in rates could be construed as an ominous development for equities. However, as Michael Rosborough argues (see pages 16-17), equities continue to possess significant fundamental upside potential. This apparent inconsistency is resolved when viewed in light of the historical precedence for phases of modest recovery.

Chart 4. Canadian Real GDP and Headline CPI

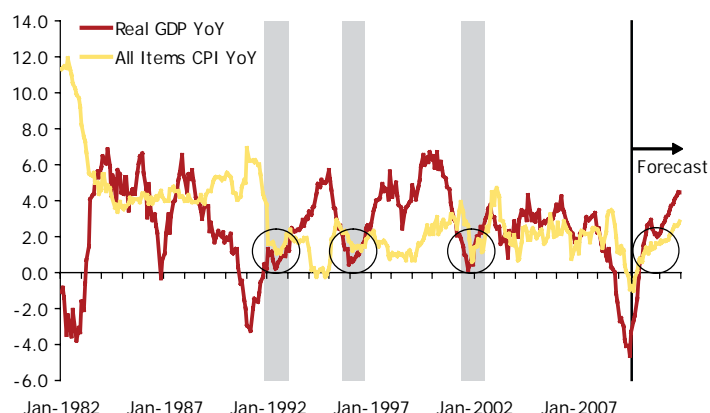


Table 1. Global Financial Asset Performance Over the Cycle 1980-2009

| q/q % chg | Bonds TR* | Equities TR** | World Production |
|-----------------|--------------|------------------|---------------------|
| Deep Recession | 1.1 | -1.5 | -1.4 |
| Mild Recession | 2.8 | -0.8 | -0.3 |
| Weak Recovery | 2.1 | 4.8 | 0.6 |
| Strong Recovery | 1.3 | 3.1 | 1.2 |

* JPMorgan Global Aggregate bond Index, Unhedged USD

** MSCI World Equity Index, USD

Current Recommended Strategies

| Proposed Date | Recommendation | Entry | Target | Stop | 1-Mth Carry | Current | Gain/Loss | Duration (Days) |
|---------------|---------------------------|--------------------|--------|-------|-------------|---------|-----------|-----------------|
| 1 9-Sep-09 | Long Canada 2s vs. US 2s | 29 ^a bp | 5 bp | 40.0 | 1 bp | 40.0 | -11 bp | 29 |
| 2 11-Aug-09 | Long Canada 5s vs. 2s/10s | 59.5 bp | 30 bp | 65 bp | 0.5 bp | 56.5 bp | +3 bp | 58 |

Notes:

- (a): Note that we rolled the US 2s benchmark post-auction at a spread 6 bps. 'Entry', 'Target' and 'Stop' levels have been adjusted accordingly.

GOVERNMENT FINANCE

WARREN LOVELY

Credit Fundamentals Come Home to Roost

With dealer and calendar year-ends looming, liquidity will undoubtedly remain a near-term focus for debt capital markets. Still, market healing means liquidity doesn't command the same premium it did during the darkest hours of the 2008-09 financial crisis.

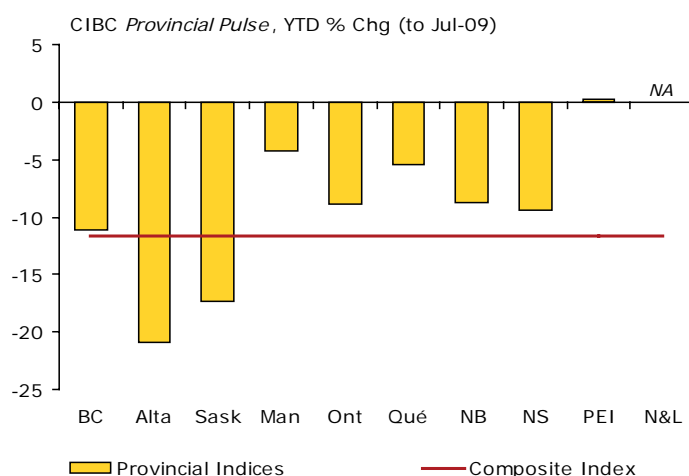
More than a perceived lack or abundance of liquidity, relative value and name diversification hold merit once more. And with government issuers charting divergent paths through troubled fiscal waters, credit fundamentals are reasserting their influence, with material implications for relative spreads in the weeks and months ahead.

Putting Economic Weakness into Perspective

Recent developments in economic fundamentals, budget balances, borrowing requirements, debt service burdens and relative indebtedness highlight eroding government credit quality, but to varying degrees for Canada's provinces.

CIBC's *Provincial Pulse*—our new current economic indicator—highlights commodities-related weakness in Western Canada (Chart 1). But that same leverage leaves the West better positioned to benefit from now-

Chart 1. **Nominal Economic Output Pressured Out West**



recovering global growth, and recent *Provincial Pulse* readings have signaled a restoration of positive economic momentum there.

For its part, Ontario stands to benefit from North American inventory restocking, while its large financial services sector has regained strength. Still, an appreciating currency creates obvious headaches, and as with other US-centric centres, a lukewarm American expansion limits growth prospects for 2010. Current year economic outperformance in Manitoba and Québec remains noteworthy, extending a theme from 2008. A complete *Provincial Forecast*, examining prospects through 2011, will be published later this month.

In general, softness in our *Provincial Pulse* indicator is consistent with declining nominal GDP, which itself translates into pressure on key own-source revenue streams. And recent announcements, such as Ontario's 2008/09 public accounts, show risks remain skewed to larger deficits and heavier funding requirements.

Collectively, the provinces are set to roll out negative adjustments to revenue and budget balances in mid-year updates. Associated headlines could keep provincial spreads on the defensive this Fall. For now, Manitoba and Saskatchewan are the only provinces projecting a 2009/10 surplus, with the latter achieving its target via a larger draw on its stabilization fund. Nova Scotia is working towards a return to balance for 2010/11, but in some other jurisdictions, structural deficits are at risk of emerging.

In general, enlarged deficits and elevated debt levels mean a heavier financial burden ahead for provincial issuers, with debt servicing a medium term threat. All this has not gone unnoticed. Setting aside rating action on Prince Edward Island, the provincial sector recently suffered this decade's first downgrade. Positive outlooks are coming off; negative outlooks are being put on.

A New Measure of Credit Health

We've compiled credit rating developments into a new *Credit Rating Score (CRS)*, which depicts absolute credit strength on a scale from 0 to 10, based on long-term ratings and outlooks from S&P, Moody's and DBRS. Individual scores provide a 20-year perspective on underlying credit quality and are directly comparable across the provincial landscape.

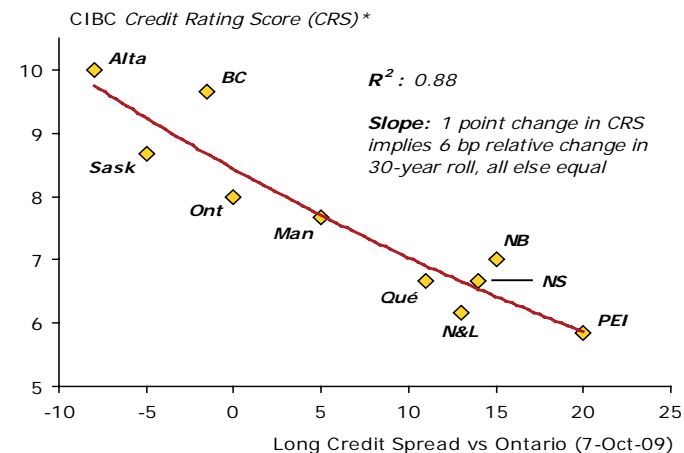
Our composite *CRS* turned the corner in June, when flags were raised on Ontario's rating in the wake of its auto-sector bailout. Overall credit rating strength is now in the early stages of decline (Chart 2), with ratings likely to remain under pressure during the first two-plus years of recovery.

More positively, the magnitude of the expected erosion should pale in comparison to the early 1990s fallout, where a 20% decline in our composite *CRS* was equivalent to an average two-notch downgrade for the sector as a whole. Today, financial flexibility is much greater and relative debt levels notably lighter, with Canada's provinces having entered this downturn with unprecedented ratings health.

Spread Adjustment to Come

Individual *Credit Rating Scores* account for almost 90% of the current deviation in provincial rolls vs. Ontario. And a one point drop in our *CRS*, equivalent to a one notch downgrade, currently implies a 6 basis point relative widening, all else equal (Chart 3).

Chart 3. **Credit Strength, Spreads Go Hand-in-Hand**

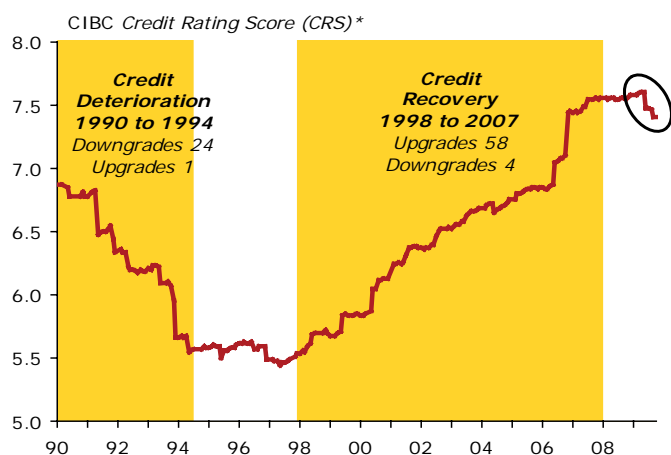


*CRS based on S&P, Moody's & DBRS ratings/outlooks

Consider Manitoba, whose underlying credit ratings strength is converging with Ontario. On its own, that would signal a further tightening in Manitoba's roll to Ontario. While new issue spread indications for long Manitoba are already near the tight end of the range observed since September 2008 (Table 1), credit fundamentals support a move towards flat or small through Ontario. Liquidity remains a consideration, but recall that the province routinely traded through Ontario in the years leading up to the 2008-09 financial crisis.

Notwithstanding a revised fiscal plan and a delayed return to a balanced budget, British Columbia also looks cheap to Ontario given its inherent credit strengths. BC's *CRS* is second only to Alberta, anchored by a relatively low level of indebtedness. The government's fiscal track record—more specifically, past successes on deficit elimination—is also noteworthy.

Chart 2. **Composite CRS in Early Stages of Deterioration**



*CRS based on S&P, Moody's & DBRS ratings/outlooks

Table 1. **Provincial Rolls: A Historical Perspective**

| 30Yr bps | Current 7-Oct | Since Sep-08 | | | Prior 5 Years | | |
|---------------------------|------------------|--------------|-------|------|---------------|-------|------|
| | | Avg | Tight | Wide | Avg | Tight | Wide |
| Spread to Canadas: | | | | | | | |
| Ont | 70.0 | 100 | 69 | 131 | 49 | 37 | 70 |
| Roll to Ontario: | | | | | | | |
| Alta | -8.0 | -5 | -8 | -2 | -12 | -18 | -4 |
| Sask | -5.0 | -3 | -7 | 0 | -4 | -9 | 0 |
| BC | -1.5 | -3 | -6 | 2 | -8 | -14 | -3 |
| Man | 5.0 | 10 | 3 | 22 | -2 | -8 | 6 |
| Qué | 11.0 | 19 | 11 | 30 | 11 | 5 | 17 |
| N&L | 13.0 | 16 | 6 | 30 | 8 | 4 | 15 |
| NS | 14.0 | 16 | 7 | 26 | 3 | -4 | 9 |
| NB | 15.0 | 17 | 8 | 27 | 1 | -4 | 8 |
| PEI | 20.0 | 21 | 8 | 33 | 8 | 5 | 14 |

Note: Based on CIBC new issue spread indications

Québec spreads, meanwhile, have recovered much ground, hovering at the tight end of the range observed since last Fall. At +11 basis points in the long end, Québec's roll to Ontario is similarly in-line with its longer-term average. Relatively heavily indebted by provincial standards, Québec has yet to identify all the measures needed to close its budget gap. But for accounts focused on liquidity, Québec continues to offer relative economic outperformance, yield pick-up to Ontario and, most critically, an expectation of relatively lighter supply.

A Look at Future Bond Supply

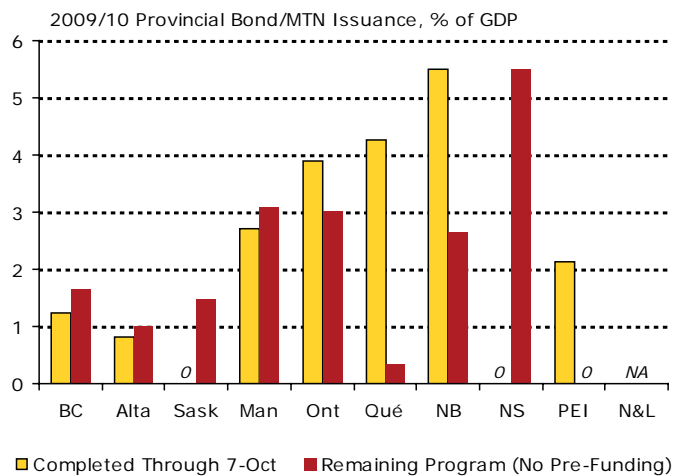
Québec and Hydro-Québec, having earlier achieved their fiscal 2009 funding targets, are already pre-funding for the coming year's requirement on an opportunistic basis. Québec could be more than \$5 billion pre-funded by the close of the current fiscal year. As a result, CIBC fully expects the theme of proportionately lighter supply from Québec government issuers to carry over into fiscal 2010/11, where Ontario's term funding requirement is likely to be at least one and a half times that of Québec.

A closer look at 2009/10 funding requirements—what's been done, what's still to come—points to relatively lighter supply from British Columbia, Alberta and Saskatchewan through March 2010 (Chart 4). Overlaid with underlying credit strengths, relatively lighter bond supply would argue for increasingly negative rolls to Ontario for these provinces.

New Brunswick, having aggressively tackled its large 2009/10 requirement, finds itself two-thirds funded towards its current target. A slower pace of supply could lend support to New Brunswick's roll, which trades back of the level implied solely by the province's *Credit Rating Score*. New Brunswick's Maritime cousin, Nova Scotia, was sidelined during the first half of the fiscal year. On a relative basis, that province has the largest funding program remaining, although capacity exists in money market to offset term funding requirements.

As financial updates roll out and credit fundamentals come home to roost, relative provincial spreads will be recast. Don't let liquidity be your only guide.

Chart 4. **What's Left to Come from Provincial Issuers?**



Note: Alta incl. ACFA & ATB; Qué incl. Fin-Q & HQ

CREDIT
JOANNA ZAPIOR

Can Credit Default Swaps Tell Hot from Cold?

They can, given how liquid and therefore sensitive this instrument is. However, at this juncture, across three main regions, North America, Europe and Asia, across several industry sectors, and along the spectrum of investment grade through high yield, the CDS market does not send clear signals about inter-sector investment opportunities.

CDS sector spreads started rallying between December 2008 and March 2009, depending on the sector (see the side bar), and by now have undone 70-80% of the peak spread widening. In North America, both investment grade and high yield spreads are less than three times the tiny number of basis points they were sporting in June 2007 (and more than four times in Europe and Asia).

Arguably, if most of the extraordinary illiquidity of 2008 has already been priced out of spreads, and if for a moment we ignore all other components of spreads, this level of spreads incorporates three times higher default rates than those the market anticipated in June 2007.

In investment grade, this is likely enough of a cushion, but S&P projects that speculative grade default rates will escalate to 13.9% by August 2010 and could reach as high as 18% if economic conditions worsen from current expectations (based on an S&P report dated October 2, 2009). For comparison, in a July 31, 2007 report, S&P analyzed two default scenarios: in the baseline scenario, default rates were to escalate to 4.9%, and in the pessimistic scenario to 8.5%, “nearly double the long-term average of 4.4% but still below the peak of 10.8% in 2001-02”. Spreads at three times the June 2007 level merely incorporate default rates that are three times those contemplated in the base line scenario at that time.

This makes us think that sector valuation in the CDS market may actually be sending a signal after all—that at the sector level risk is fully priced in, and value needs to be carefully sought through security selection. The low-hanging fruit of sector play in credit has been harvested before autumn came this year.

Two Patterns in Sector Spreads

Chart 1. **North American IG Bank CDS Spreads**



Chart 2. **North American IG Retail CDS Spreads**



There has been quite a bit of herd-instinct in sector spreads. One typical pattern is the double-peaked North American bank spread that first reflected the fall-out from the Lehman bankruptcy in late September 2008, and then the Fed stress-test uncertainties in February 2009, the resolution of which in March appears to have been the catalyst for a more confident spread rally. And then, there is the single-peak spread pattern, such as the one for North American telecoms that have been rallying, somewhat haltingly at times, but rallying, since the inflection point in December 2008.

A Comment on Our Sources and Metrics

Five-year CDS spreads are sourced through Bloomberg (provided by CMA Datavision, a CDS pricing and price verification service, which ultimately sources from 30 firms, including investment banks, hedge funds and asset managers). We did not use sector averages provided by Bloomberg. Instead we recalibrated to ensure that only truly investment grade companies by agency rating are included in our investment grade sectors. In high yield we rejected distressed companies, which we defined as recently trading at spreads wider than one thousand basis points.

We have used simple but practical metrics. 1) the timing of the peak in spreads to differentiate “later bloomers” from the rest of the universe on the assumption that the sooner the spread started tightening, the less uncertainty the market had about its condition. 2) degree of tightening from the widest spread to the current spread, on the assumption that the “harder” the spread rallies, the better the perception of its fundamentals. 3) pre-crunch comparison: how much wider the current spread still is from the level on June 30, 2007, before the liquidity squeeze started in the summer of 2007.

Table 1. **Early and Late Bloomers—North America**

| | Degree of tightening from peak | Current spread (bps) | Date of peak in spread | Times wider than the spread in 06/07 |
|-----------------------|--------------------------------|----------------------|------------------------|--------------------------------------|
| Banks | -72% | 129 | 9-Mar-09 | 5.4 |
| Insurance | -77% | 154 | 7-Apr-09 | 6.7 |
| Lenders | -80% | 157 | 9-Mar-09 | 5.4 |
| Telecom/cable | -69% | 58 | 5-Dec-08 | 1.7 |
| Technology | -77% | 65 | 15-Dec-08 | 2.7 |
| Consumer goods | -58% | 79 | 9-Mar-09 | 2.1 |
| Restaurants | -69% | 77 | 21-Nov-08 | 2.1 |
| Food & beverage | -69% | 52 | 5-Dec-08 | 2.5 |
| Retail | -72% | 75 | 21-Nov-08 | 1.1 |
| Consumer services | -78% | 93 | 10-Mar-09 | 3.5 |
| Utilities | -66% | 102 | 2-Jan-09 | 2.6 |
| Pipelines | -74% | 108 | 18-Dec-08 | 2.4 |
| Transportation | -70% | 76 | 9-Mar-09 | 1.6 |
| Bldg mat/construction | -67% | 170 | 28-Nov-08 | 5.5 |
| Home builders | -72% | 147 | 21-Nov-08 | 1.1 |
| REITs | -81% | 212 | 5-Dec-08 | 5.3 |
| Oil&gas | -70% | 98 | 22-Jan-09 | 3.4 |
| Metals & mining | -79% | 97 | 8-Dec-08 | 3.1 |
| Manufacturing | -69% | 70 | 5-Mar-09 | 2.6 |
| Machinery/Industrial | -74% | 54 | 3-Mar-09 | 2.3 |
| Chemicals | -70% | 82 | 9-Mar-09 | 2.6 |
| Aerospace/defence | -69% | 78 | 9-Mar-09 | 6.0 |
| Autoparts | -83% | 104 | 3-Mar-09 | 2.9 |

Judging by the timing of the CDS spread cycle,

- Not surprisingly, “late bloomer” sectors across all regions (those where the CDS spreads started tightening from the widest level the latest) are financials (Tables 1 through 3; late bloomers are boxed).
- We argue that the CDS market has shown most conviction about telecom/cable, technology, and, except in North America, utilities, as across most regions these sectors peaked once, and started tightening early.

Table 2. **A More Muddied Picture in Europe**

| | Degree of tightening from peak | Current spread (bps) | Date of peak in spread | Times wider than the spread in 06/07 |
|-----------------------|--------------------------------|----------------------|------------------------|--------------------------------------|
| Banks | -65% | 101 | 13-Mar-09 | 7.8 |
| Insurance | -80% | 109 | 9-Mar-09 | 8.4 |
| Telecom/cable | -58% | 80 | 5-Dec-08 | 2.7 |
| Technology | -72% | 75 | 5-Dec-08 | |
| Consumer goods | | | | |
| Restaurants | | | | 2.7 |
| Food & beverage | -59% | 76 | 5-Dec-08 | 2.5 |
| Retail | -67% | 105 | 5-Dec-08 | 2.2 |
| Consumer services | -70% | 89 | 5-Dec-08 | 5.1 |
| Utilities | -61% | 76 | 15-Dec-08 | |
| Pipelines | | | | 3.0 |
| Transportation | -58% | 57 | 5-Dec-08 | 2.4 |
| Bldg mat/construction | -62% | 87 | 5-Dec-08 | 3.5 |
| Home builders | | | | |
| REITs | -82% | 161 | 17-Dec-08 | 6.7 |
| Oil&gas | -67% | 74 | 12-Dec-08 | 5.7 |
| Metals & mining | -88% | 176 | 5-Dec-08 | 5.0 |
| Manufacturing | -63% | 145 | 5-Dec-08 | 5.6 |
| Machinery/Industrial | -56% | 152 | 16-Dec-08 | 5.6 |
| Chemicals | -66% | 53 | 22-Sep-08 | 1.8 |
| Aerospace/defence | -80% | 73 | 15-Dec-08 | 4.1 |
| Autoparts | -63% | 195 | 6-Mar-09 | 6.3 |

Judging by how hard the spreads rallied from the peak,

- The dispersion in the strength of the rallies among the sectors and regions is relatively low, with generally Europe lagging somewhat both North America and Asia (Tables 1 through 3; the column entitled “Degree of tightening from peak”).
- The CDS market showed the strongest conviction about metals and mining, and North American and European real estate. The latter, we suspect, is due to an exaggerated widening in the first place.

Table 3. *Asia is a Different Story Altogether*

| | Degree of tightening from peak | Current spread (bps) | Date of peak in spread | Times wider than the spread in 06/07 |
|-----------------------|--------------------------------|----------------------|------------------------|--------------------------------------|
| Banks | -75% | 108 | 10-Mar-09 | 3.7 |
| Insurance Lenders | -77% | 99 | 11-Mar-09 | 11.0 |
| Telecom/cable | -76% | 57 | 4-Mar-09 | 3.2 |
| Technology | -79% | 90 | 12-Mar-09 | |
| Consumer goods | | | | |
| Restaurants | | | | 3.0 |
| Food & beverage | -74% | 59 | 9-Mar-09 | 2.7 |
| Retail | -71% | 74 | 3-Oct-08 | |
| Consumer services | | | | 2.9 |
| Utilities | -87% | 50 | 27-Oct-08 | |
| Pipelines | | | | 5.3 |
| Transportation | -72% | 64 | 13-Mar-09 | 3.9 |
| Bldg mat/construction | -82% | 98 | 16-Mar-09 | 6.1 |
| Home builders | -85% | 58 | 10-Mar-09 | 5.8 |
| Oil&gas | -76% | 109 | 10-Mar-09 | 3.8 |
| Metals & mining | -81% | 65 | 26-Feb-09 | 4.3 |
| Manufacturing | | | | |
| Machinery/Industrial | -81% | 69 | 17-Mar-09 | 4.9 |
| Chemicals | | | | |
| Aerospace/defence | | | | |
| Autoparts | -76% | 110 | 3-Mar-09 | 6.9 |

Table 4. *North American High Yield: Rallies Late But Rallies Well*

| | Degree of tightening from peak | Current spread (bps) | Date of peak in spread | Times wider than the spread in 06/07 |
|------------------|--------------------------------|----------------------|------------------------|--------------------------------------|
| Telecom/cable | -59% | 432 | 16-Dec-08 | 2.1 |
| Tech | -60% | 557 | 9-Mar-09 | 1.8 |
| Food & beverage | -52% | 517 | 4-Dec-08 | 2.0 |
| Retail | -73% | 516 | 9-Mar-09 | 2.8 |
| Consumer svcs | -85% | 614 | 9-Mar-09 | 2.5 |
| Leisure | -72% | 705 | 5-Mar-09 | 4.9 |
| Utilities | -39% | 579 | 9-Mar-09 | 2.9 |
| Bldg materials | -64% | 301 | 6-Mar-09 | 3.0 |
| Home builders | -83% | 499 | 9-Mar-09 | 1.7 |
| Oil & gas | -44% | 417 | 5-Dec-08 | 2.2 |
| Metals mining | -66% | 377 | 8-Dec-08 | 2.8 |
| Machinery | -86% | 278 | 20-Apr-09 | 8.7 |
| Chemicals | -83% | 449 | 3-Feb-09 | 1.6 |
| Aerospace defenc | -75% | 235 | 1-Apr-09 | 1.5 |
| Autoparts | -87% | 695 | 2-Feb-09 | 2.3 |

Judging by how close the current spread got to the levels from before the credit crisis,

- Outperforming sectors in North America have been consumer, telecom and building materials, in Europe — consumer and telecoms, but also some industrials, and in Asia, again the consumer (Tables 1 through 3; the column entitled “Times wider than 06/07”).
- Farthest away from pre-crisis spreads is the insurance sector, across all regions. European banks are also lagging other regions. Building materials, and certain other real estate sectors have also been underperformers on this metric. And then, there are a few other regional under-performers, such as auto-parts in Asia, and telecom in North America.

And finally, moving to the high yield sector (we use North American CDS spreads so Table 4 can also be directly compared with Table 1),

- All high yield sectors rallied late, except for telecoms, oil and gas and metals/mining, which started a confident spread tightening as early as December 2009.
- As we would expect in high yield, there is a high degree of idiosyncrasy among high yield industry sectors, and significant dispersion in terms of how strong the rally was. A few sectors show residual value relative to where they traded pre-crisis, notably leisure, building materials, and machinery. Aerospace/defense, chemicals, home builders and technology have come closest to their pre-crisis levels, perhaps leaving the least value on the table.

FX STRUCTURING

ZAFAR BHATTI

Brazil Fundamentals Provide a Currency Opportunity

The 2016 Olympics in Rio de Janeiro have put a spotlight on Brazil but this is just the latest in a series of positive stories for this economy. The good news for Brazil started in early September with the release of the Q2 GDP data which showed the economy growing at a 1.9% rate quarter over quarter. This allowed Brazil to declare an end to their recession after only six months. In fact, the Brazilian economy may actual post year over year growth when the final numbers are tallied for 2009. The good news did not stop there. Moody's finally upgraded Brazilian sovereign debt to Baa3, the lowest investment grade rating. This removed the split ratings on Brazilian debt and pushed them solidly into the investment grade category. S&P and Fitch upgraded Brazil last year.

All of this good news could cause the Real to appreciate simply on a sentiment change, but in the case of Brazil there are also capital flows into the economy supporting the currency. The government is running deficits to stimulate the economy. As a result, the Brazil Treasury took advantage of the rating upgrade to announce plans to sell US\$ 1.25 billion worth of 2041 bonds in the European and US markets. This is the first time that Brazil has done a 30+ year international issue. From a hard asset perspective, Brazilian and international companies will invest billions of dollars this year to bring offshore oil discoveries closer to production. From an investment perspective, foreigners have started to take notice of the Brazilian equity market which is up 110% from its 2009 lows. For all these reasons, Brazil continues to be a magnet for capital which has boosted the Real 40% from its 2009 lows (Chart 1).

These capital flows are already putting upward pressure on the Real. Just like every other central bank, Brazil's Central Bank is concerned about its currency's appreciation. Unlike Canada, Brazil is doing more than just talking about it. Since April, the Brazilian Central Bank has been buying up roughly US\$ 2.5 billion per month in foreign exchange operations to slow down the Real's appreciation versus the US dollar. These purchases have slowed the rate of appreciation but have not been able to reverse it.

Investment Opportunities

Investing in Brazil is not without risks for foreign investors. The equity market is inherently volatile and there is a tendency for the USD/BRL exchange rate to follow the equity market. So when equity weakens the currency turns bad at the same time leading to a compounding of the losses. Investing in Brazilian denominated debt also has a similar issue. If foreign investors are exiting debt en masse, it is likely that the currency will weaken as well.

For investors who like the fundamentals of the Brazilian economy the currency provides a direct way to express a view. A Brazilian currency note can be structured to meet an investor's risk tolerance, time horizon, and view. By taking the currency exposure without linking it to a debt or equity instrument, the investor has reduced the number of variables impacting the overall investment return. Investing in a currency provides a return linked to the broad economy; it avoids sector, credit, or name specific risks that can occur when investing in Brazilian debt and equities.

The following strategy is suitable for an investor who has a view that the Brazilian Real will continue to strengthen over the next month. The investor will get a high coupon if her view is correct, and has a limited amount of principal at risk if her view is incorrect.

Chart 1. Spot Chart (BRL per CAD)



As priced on September 6, 2009

| | |
|---|---|
| Strategy: | Trend Continuation |
| Client View: | The Brazilian Real will continue to strengthen versus the Canadian dollar over the next month. |
| Underlying Asset: | BRL per CAD exchange rate |
| Term: | 1 month |
| Notional Investment: | C\$ 1,000,000 |
| Spot Reference: | 1.6450 BRL per CAD |
| Note Coupon: | 10% per annum |
| Payoff: | Coupon is guaranteed at maturity |
| Principal returned based on following formula: | Principal Redemption Amount = C\$1,000,000 x Foreign Exchange Adjustment (FXA) |
| | ⇒ If spot ever trades below 1.57 BRL per CAD over the term, FXA =1 |
| | ⇒ If spot at expiry fixes below 1.66 BRL per CAD, FXA =1 |
| | ⇒ If spot at expiry fixes above 1.66 BRL per CAD, FXA = $\text{Max}[(1.66/\text{Spot}_{\text{mat}}), .9567]$, Maximum principal at risk 4.33% |
| Analysis: | If the BRL strengthening trend continues, or doesn't weaken by more than 1.5 cents over the next month then the investor benefits from the coupon. In addition if the BRL surges stronger and touches 1.57 at anytime over the month, then the full principal return gets guaranteed. However, if the BRL weakens (above 1.66) then the investor will still get the coupon but a portion of the capital will not be returned. The maximum loss of principal is 4.33%. |

COMMODITIES

PETER BUCHANAN

All That Glitters Isn't Golden

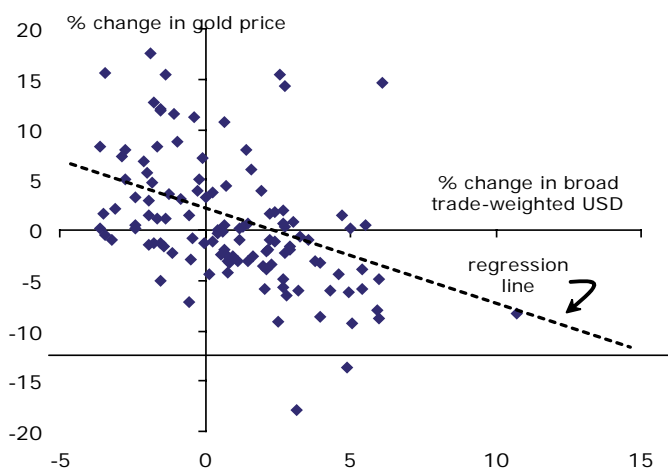
Gold has set new highs this month. Although renewed selling pressure against the US dollar could rekindle support a year or two out, prices for the metal are likely at or near their peak given the prospective reversal of some recent props. That has led us to replace our previous recommended overweight with an underweight.

One reason for caution on gold's immediate prospects is the outlook for the US dollar. Gold has long been considered a super-currency of sorts. True to that reputation, our analysis of quarterly data for the last three decades shows that a 1% rise in the dollar's value, measured by the Fed's broad weighted trade weighted index, has typically triggered a 1% opposing move in gold (Chart 1).

Weaker Dollar Key Factor Driving Gold's Rise

Currency influences have been particularly important for gold recently, accounting for half to three quarters of the metal's near-vertiginous climb since late winter by our reckoning. But support on this front may not continue much longer. The recent improvement in the US current account deficit has been largely transitory in nature, tied to the recession's negative effect on imports. While further dollar depreciation may consequently be needed

Chart 1. **Gold Price and the Dollar**



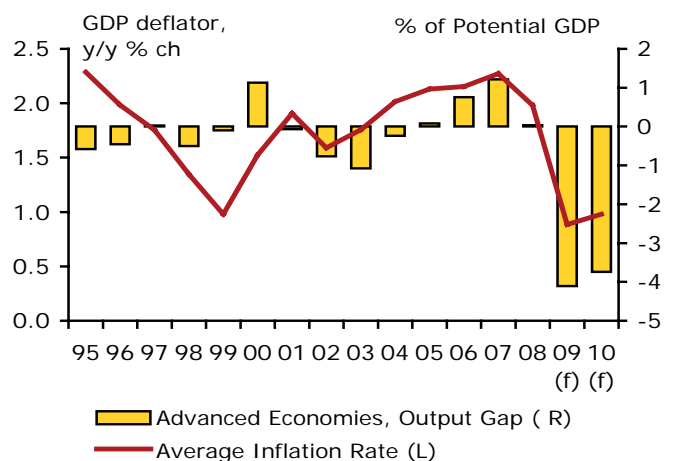
over a 2-3 year horizon for payments sustainability, we believe that the dollar has overshot to the downside. A 6-8% relief rally in the next 2 or 3 quarters could deprive gold of some of its lustre.

Rising financial jitters after the Lehman debacle helped fuel gold's incandescent rally over \$200/ounce last fall and winter. Those anxieties have subsided recently. Given the potential for even a modestly paced recovery to ease investors lingering anxieties, we believe that a further reduction is possible, crimping investors' appetite for a range of traditional safe harbours. Even with its recent decline, the VIX remains about 50% above historical levels and has only surpassed present levels in a few instances, like the 1990 Gulf War and LTCM crisis.

An Easing of Overdone Inflation Anxieties Could Also Weigh

Gold has performed better as a dollar than inflation haven in recent years, actually exhibiting a negative correlation with European and Japanese price measures. Despite that somewhat chequered history, we see an unwinding of present exaggerated near-term market inflation fears as posing a third risk for the metal's prospects. The IMF projects that inflation in the industrial countries will fall

Chart 2. **Unprecedented Slack Limits Near-Term Inflation Risk**



below 1% for the first time in a quarter century this year. A 4% average output gap should keep the rate near that low level for some time even with faster money supply growth (Chart 2).

Price Historically High Relative to Oil and Other Commodities

In terms of other critical market influences, central banks became net buyers of gold for the first time in a decade in the second quarter of 2009 (Chart 3), as European countries trimmed their purchases and non-traditional buyers stepped in. The central banks of cash rich emerging markets remain potentially important sources of buy-side interest. Gold still accounts for only about 2% of China's holdings even with net purchases of over 500 tonnes since 2003. We expect agency sales, including the IMF's upcoming disposition of 403 tonnes, to help meet some of these requirements and also offset a 100 tonne

per year cut in annual sales by major European banks under revisions to the 1999 Washington Agreement. Total official net sales will still be modestly positive this year according to GFMS, even with China's purchases. Turning to another prop, producer de-hedging added the equivalent of 360 tonnes to world gold demand in 2008. Dehedging has plummeted however so far this year and the limited size of remaining books will continue to restrain activity.

Gold's trading ratio to other commodity prices is also sometimes used as a buy-sell indicator. As indicated (Chart 4), gold has traded at near record levels in recent months against a general basket of commodities. Prices for the metal also remain unusually high compared to oil, a longstanding traveling companion, also suggesting some downside risk. Gold's ratio to oil and other resources typically falls during periods of economic stabilization, meaning common, industrially-sensitive commodities may offer greater returns at this point in the cycle.

Chart 3. **Central Bank Gold Reserves (L); Holdings by Country (R)**

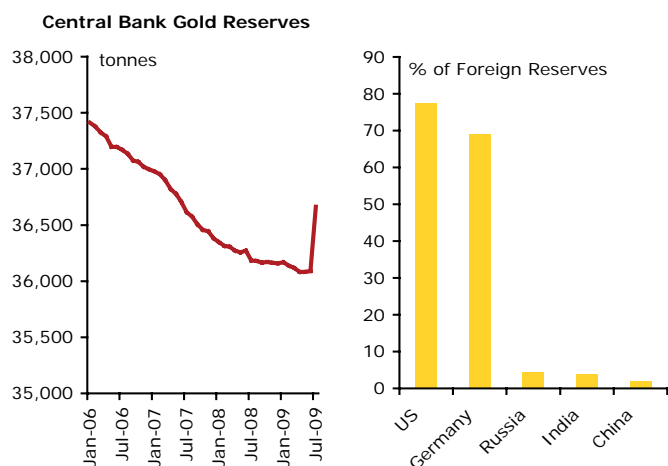


Chart 4. **Ratio of Gold to Oil and CRB**

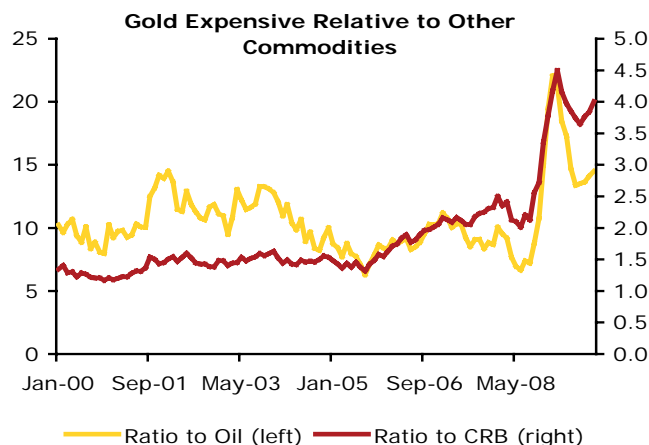


Table 1. **Spot Commodity Prices**

| | | Average | | | | | |
|---------------------|------------|---------|-------|------|----------|----------|----------|
| | | 6-Oct | 2007 | 2008 | 2009 (f) | 2010 (f) | 2011 (f) |
| Oil (WTI) | \$/bbl | 71 | 72 | 100 | 60 | 70 | 75 |
| RBOB gasoline | \$/gal | 1.76 | 2.09 | 2.49 | 1.70 | 1.80 | 2.00 |
| Heating Oil (NYH) | \$/gal | 1.79 | 2.03 | 2.86 | 1.60 | 1.95 | 2.10 |
| Natural Gas (Henry) | \$/Mn Btu | 3.20 | 6.97 | 8.89 | 3.50 | 4.50 | 6.50 |
| Gold | \$/troy oz | 1039 | 695 | 872 | 950* | 900* | 1100* |
| Copper | \$/lb | 2.76 | 3.24 | 3.16 | 2.40 | 3.00 | 3.25 |
| Aluminum | \$/lb | 0.81 | 1.20 | 1.17 | 0.75 | 0.85 | 0.90 |
| Nickel | \$/lb | 8.18 | 16.86 | 9.57 | 6.75 | 7.80 | 8.00 |
| Zinc | \$/lb | 0.86 | 1.48 | 0.85 | 0.75 | 0.80 | 0.90 |

* end of period

STRATEGIC RISK

MICHAEL ROSBOROUGH

A Year in a Quarter and a Half

When trying to divine what's hot and what's not from a macro viewpoint it's important to put in perspective just how extraordinary a year this has been. Using the S&P 500 as a point of reference the market has risen 17% on the year—a very tidy return versus historical norms. What makes the year so extraordinary is that this total return encompasses both a vicious bear and a heroic bull market

Chart 1. Top 5 Equity Markets (US Dollar Terms) Year-to-Date 2009

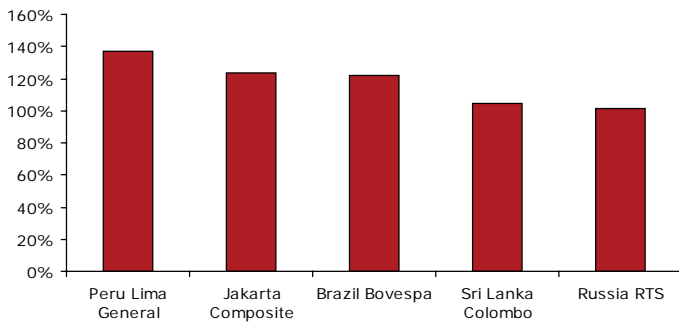


Chart 2. Top 5 Bond Index Returns Year-to-Date 2009

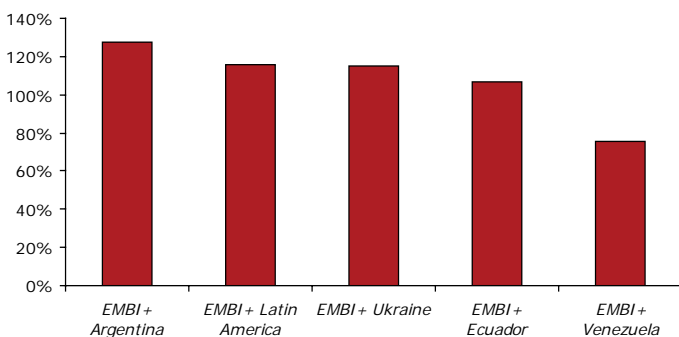
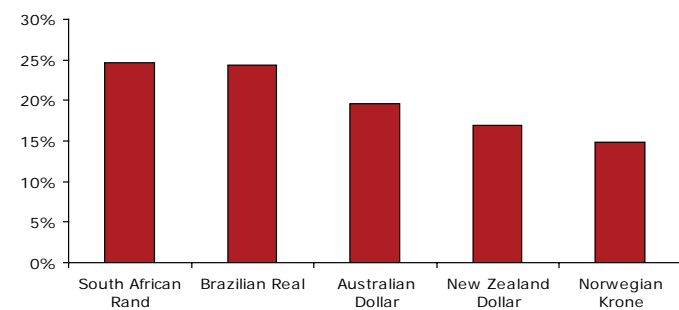


Chart 3. Top 5 Major Currencies (versus the US Dollar) Year-to-Date 2009



in a little over nine months. The market experienced a 25% decline to start the year till March 9th and has surged 56% since. Leadership in these bull and bear phases has rotated with amazing alacrity making a review of what has been hot not necessarily a good indicator of what is likely to be hot as we go forward.

In the aggregate what has been hot has been emerging markets and markets that have high exposure to them, and this holds true whether one looks at equities, fixed income or currencies as the charts on the left show.

Given the nature of this year all comparisons are very time sensitive. Much of the outperformance of emerging markets was a first half of the year phenomenon. Chinese equities, which serve as an important barometer for the rest of the emerging world, bottomed last November and rallied all through the first half of this year, but peaked in early August and have been in something of a bear market since.

Viewing the market stylistically is perhaps the best way to evaluate the sequencing and the relative performance of the various sectors of the global market, and in that way to get a better sense of what should outperform and underperform from here. As the credit crunch began to unfold, interest rates fell (i.e. bonds rallied) fairly steadily for about six months while other markets (credit and equities) went more or less sideways, presumably on the assumption that central bank policy would be enough to contain the crunch. The US dollar meanwhile remained in what had been a long term bear market.

About six months into the crunch credit spreads began to widen ahead of the broader sell-off in developed and emerging equity markets, while interest rates entered a range trade at their new lower levels. By mid-2008 the deleveraging trade began in earnest—the dollar rallied while emerging equities and credit entered a second and steeper bear market that did not spread fully to G7 equities and particularly the US until Lehman's collapse. Emerging market equities found their bottom first, right around the time of China's massive (13% of GDP) fiscal

stimulus in early November. Credit spreads hit their widest levels and interest rates their lows in the late November, early December time frame. The dollar and G7 equities meanwhile did not find their respective highs and lows until March of this year.

The ensuing recovery trade has been led by credit spreads narrowing, followed by rates rising, then by emerging equities, and at the last stage by developed equities and a turn lower in the US dollar. Investment grade credit spreads, while not yet quite back to their pre crunch levels, have made a fairly full recovery, and emerging market equities appear on track to do the same though over a longer time frame. Despite their impressive recovery since March G7 stocks remain well below pre crunch levels. In terms of trend the decline of the dollar falls between emerging and developed equity markets in its relative performance and the timing thereof.

This sequencing makes intuitive sense given that what we have been through is at its core a credit problem in the US and UK financial systems, and hence it began with widening spreads and falling interest rates that snowballed into deleveraging. This deleveraging manifested itself in a strengthening dollar and the early stage sell-off in emerging markets. Ultimately the shock spread to G7 equity markets and economies, and crystallized in Lehman's collapse as the decline of financial intermediation and ongoing deleveraging claimed its biggest systemic victim.

It was not until after that shock that the fiscal and particularly monetary policy measures were sufficient to turn the tide in the credit markets, thereby building the base from which other markets and, with a lag, the economy could heal. Hence the phasing of the recovery, with credit leading and interest rates then rising, followed by emerging equities (which were further from the epicentre of the crisis and more of a portfolio than a direct victim) rallying before G7 equities could begin to recover.

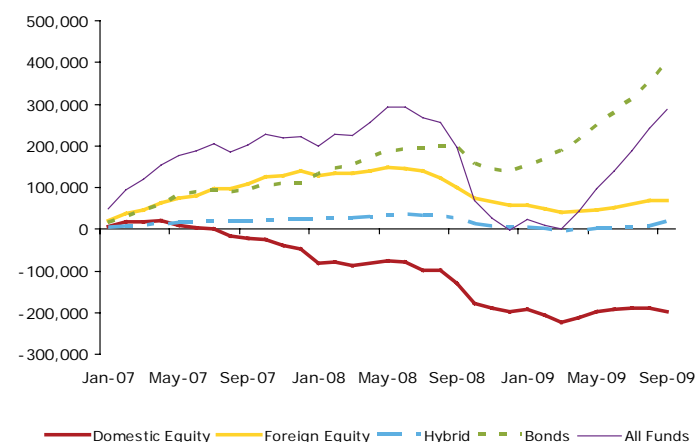
From here this sequencing suggests that to get us back to where we were pre crunch G7 equities, and particularly those of the US and the UK, have the best potential upside. In my own trading portfolio I am long the UK equity market outright (via ISF, the FTSE 100 ETF) with the view that those in greatest distress are also those with the greatest recovery potential. In a similar vein I am long those sectors of the US equity market (financials via XLF and homebuilders via XHB) that have, because of their central position in the credit crunch, had the deepest

troughs, with the view a deeper trough ultimately bodes for the best returns in an ongoing recovery. In the past quarter this strategy has worked particularly well and I continue to believe it will.

The obvious objection to my view of what's hot is the counterpoint that the world we are returning to is not the one we left, that what is distressed may remain so for a long time and that the best investments are where the greatest growth is likely to lie—i.e. emerging markets. In principle I agree with the view that recovery will be slower in the G7 than the emerging world but at the end of the day it is a matter of pricing. Chinese equities, as emerging market stocks often do, went parabolic earlier this year only to come back to earth with a thud. One has to be cognizant that these stories get quickly oversubscribed and perhaps it is the things that people are still shying away from that ultimately offer better potential.

Which brings me to my final point. The worst performing of all fixed income markets this year has been longer dated US treasury bonds as rates rose from the crisis induced 60 year lows of last year. Couple that with the fact that investment grade credit spreads are now almost back to pre crunch levels and the potential upside for bond funds seems very constrained. And yet that is where the tide of US retail investor money continues to flow—out of US equities, marginally into foreign equities and heavily into bond funds. At 4% long rates and normalizing spreads an investment grade bond fund is the antithesis of "hot" in my mind, but perhaps it is perceived safety rather than return potential that is what is truly hot with the investing public right now as seen in the chart below.

Chart 4—Cumulative Flows into US Long-Term Mutual Funds (\$ Millions)



Source: Investment Company Institute

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