



Vive la Différence

Macro and FX View (Shenfeld): Canada and the US are both headed for shallow recoveries in 2010, but differences in the nature of these rebounds present opportunities for some relative value trades. Canada has better-financed household and federal government sectors, a weaker manufacturing outlook given C\$ strength and barriers to capturing US stimulus impacts, and less inflation risk for 2011.

Rates (Ahmed): 2-year US Treasuries have run out of rally room, but the Canadian curve prices in a rate hike earlier than the Bank of Canada itself suggests. Our analysis finds value in a long 2-yr Canada, short 2-yr Treasury trade.

Government Finance (Lovely): Canada's federal government is facing much less red ink than its US counterpart. Provincial supply, however, will remain a challenge for that sector, and suggests room for corporates to do better than provies.

Credit (Zapior): An analysis of operating leverage in the non-financial corporate sector suggests favouring weighting in Canadian debt issuers over their US counterparts. In the banking sector, operating revenues and expenses have generally been on a more stable trajectory in Canada in terms of the declines and subsequent rebounds.

Commodities (Buchanan): Mean reversion points to nat-gas recovering relative to oil, but inventories will weigh on the pace of that rebound relative to what's priced into the very steep curve. We advocate buying the front end (Oct or Nov 09) nat-gas contract, while selling the Dec 10 contract.

Strategic Risk (Rosborough): Extraordinary UK stimulus, and the FTSE's exposure to emerging markets underlie our bullish call on UK equity futures or ETFs.

FX & Commodity Structuring (Ohayon): A 6-month fade-in range forward allows US\$ buyers to do better than buying forwards if, as we expect, room for further C\$ appreciation is limited over that period. A conditional dual currency note can yield an annualized 7.25% in the next month if CAD doesn't get to 1.009 or better.

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ECONOMICS

AVERY SHENFELD

Relatively Speaking

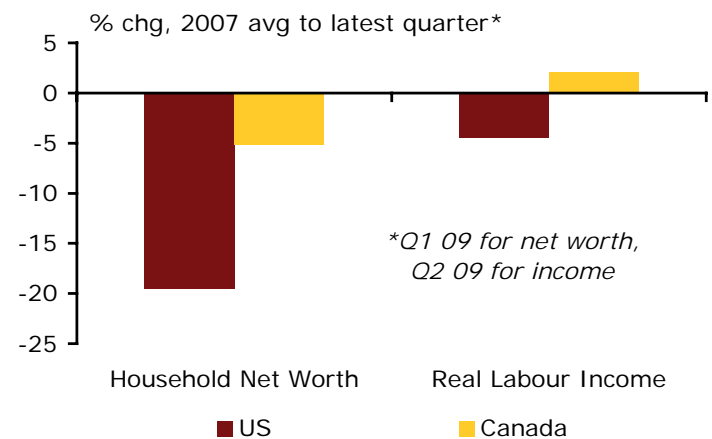
We are out of recessionary waters, but it won't be easy sailing for either the Canadian or US economies over the next year and half. America's frailties are, of course, always a challenge for Canada, with export linkages meaning that GDP growth differentials are likely to be fairly modest (Table 1). US consumer spending will run out of steam when no longer backed by government largesse in tax cuts or vehicle subsidies, and that will spill over into Canadian exports. But on a relative basis, there are some important cross-border differences that could be reflected in investment returns.

Households Not as Battered

For one, the Canadian household sector is not nearly as battered and bruised as its American counterpart. Canadian house prices are only off roughly 6% from their pre-recession peak; US houses tumbled more than 30% as a wave of foreclosed properties hit the market, key to the much deeper wealth loss Americans have suffered (Chart 1).

Labour incomes have also been kinder north of the border. The employment rate is higher, wages firmer, and the average duration of unemployment is much shorter. Canadians are also finding it easier to get credit where credit is due. The mortgage market didn't go from

Chart 1—Canada's Households Less Battered



excessively liquid to tight the way it did in the US, and household credit growth stayed on a stronger course.

For investors, exposures to Canadian-centred retail-related equities, or corporate bonds related to housing, retail products, and retail commercial real estate, may be more promising than those stateside. Relatively better household fundamentals haven't prevented a sharp run-up in personal bankruptcies, but that spike might end sooner north of the border, to the benefit of financial equities and bonds.

Table 1. Economic Forecast

| | 09Q2A | 09Q3F | 09Q4F | 10Q1F | 10Q2F | 2008A | 2009F | 2010F | 2011F |
|----------------------------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| CANADA | | | | | | | | | |
| Real GDP Growth (AR) | -3.4 | 3.1 | 2.9 | 1.8 | 2.1 | 0.4 | -2.3 | 2.0 | 3.8 |
| Real Final Domestic Demand (AR) | 0.4 | 0.8 | 1.7 | 2.1 | 2.7 | 2.6 | -2.0 | 2.1 | 3.5 |
| All Items CPI Inflation (Y/Y) | 0.1 | -0.8 | 0.3 | 0.9 | 1.3 | 2.4 | 0.2 | 1.4 | 2.3 |
| Core CPI Ex Indirect Taxes (Y/Y) | 1.9 | 1.6 | 1.3 | 1.5 | 1.4 | 1.7 | 1.7 | 1.6 | 2.1 |
| Unemployment Rate (%) | 8.4 | 8.7 | 8.8 | 9.0 | 9.1 | 6.1 | 8.4 | 9.0 | 8.2 |
| U.S. | | | | | | | | | |
| Real GDP Growth (AR) | -1.0 | 4.3 | 2.4 | 0.5 | 1.1 | 0.4 | -2.4 | 1.5 | 3.3 |
| Real Final Sales (AR) | 0.4 | 0.2 | 0.7 | 1.1 | 0.9 | 0.8 | -2.0 | 0.9 | 3.0 |
| All Items CPI Inflation (Y/Y) | -1.2 | -1.8 | 0.5 | 1.0 | 1.2 | 3.8 | -0.6 | 1.7 | 3.7 |
| Core CPI Inflation (Y/Y) | 1.8 | 1.5 | 1.9 | 2.1 | 1.9 | 2.3 | 1.7 | 2.2 | 3.1 |
| Unemployment Rate (%) | 9.3 | 9.7 | 10.0 | 10.1 | 10.0 | 5.8 | 9.3 | 10.0 | 9.4 |

It's a Drag

On another key dimension, manufacturing, Canada faces some disadvantages over conditions stateside. The Canadian dollar has been on a trend appreciation, while the greenback is on a multi-year downtrend. Our analysis suggests that the C\$ is some 10 cents overvalued relative to trade and interest differential fundamentals, while the weaker US\$ is giving a lift to US steel, autos and other manufacturers facing competition from Canada or Europe. Much of US growth in 2010 will be generated from government fiscal stimulus on projects where "Buy-America" provisions can shut the door on Canadian suppliers, or in sectors like education that don't benefit Canadian industry.

The weight of near-term current account deficits could see dollar-Canada correct back to the 1.15-1.17 range by year end, but longer term, rising resource prices, or at least optimism about their course beyond 2010, should again see firming levels for the loonie.

That has several implications for asset valuations, beyond the obvious negative pressure on some manufacturing equities. Even with a bit of a sell-off over the next few months, the lagged impacts of earlier C\$ appreciation, and a renewed loonie rally in 2010, will restrain both inflation and the recovery. The Bank of Canada pledged

to maintain overnight rates at current levels through mid-2010 under its forecast scenario, but its outlook assumed a significantly weaker exchange rate. While the Bank of Canada didn't ease as aggressively as the Fed (having eschewed quantitative easing), Carney could end up tightening later than Bernanke given the additional disinflationary drag from a stronger currency, and the prospect for a longer wait could be a factor in relative performance in the bond market (Table 2).

Ottawa's Edge

While growth rates may not differ much in 2010, Canada's bond curve could be in better shape beyond next year given its much lighter load on the fiscal front. The US is headed right where Canada stood in the early 1990s, with Washington's debt approaching 70% of GDP. That has a flood of supply hitting the Treasuries market, one that will be even more apparent as the Fed completes its QE buying later this year. There will be relatively lighter pressure from supply in the Canada bond market (Table 2, and see also pages 4-5 and 6-7).

All told, there's a Canadian advantage that could play out in the bond market, and down the road, in economic growth as Canada faces a lesser fiscal tightening post-2010. While there are challenges for Canadian non-resource exporters, both debt and equity assets linked to domestic demand could outperform their US equivalents.

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

| | | 2009 | | 2010 | | | |
|-----------------------|---------------------------------------|-------|-------|-------|-------|-------|-------|
| END OF PERIOD: | | 9-Sep | 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 | 0.21 | 0.23 | 0.25 | 0.30 | 0.30 | 0.30 |
| | 2-Year Gov't Bond | 1.27 | 1.15 | 1.25 | 1.30 | 1.40 | 1.60 |
| | 10-Year Gov't Bond | 3.46 | 3.30 | 3.50 | 3.70 | 3.85 | 3.95 |
| | 30-Year Gov't Bond | 3.96 | 3.90 | 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 | 0.15 | 0.15 | 0.15 | 0.20 | 0.25 | 0.25 |
| | 2-Year Gov't Note | 0.95 | 0.95 | 1.20 | 1.30 | 1.45 | 1.65 |
| | 10-Year Gov't Note | 3.50 | 3.50 | 3.85 | 4.05 | 4.20 | 4.35 |
| | 30-Year Gov't Bond | 4.35 | 4.50 | 4.70 | 4.95 | 5.00 | 5.00 |
| | Canada - US T-Bill Spread | 0.06 | 0.08 | 0.10 | 0.10 | 0.05 | 0.05 |
| | Canada - US 10-Year Bond Spread | -0.05 | -0.20 | -0.35 | -0.35 | -0.35 | -0.40 |
| | Canada Yield Curve (30-Year — 2-Year) | 2.69 | 2.75 | 2.85 | 2.95 | 2.90 | 2.75 |
| | US Yield Curve (30-Year — 2-Year) | 3.40 | 3.55 | 3.50 | 3.65 | 3.55 | 3.35 |
| EXCHANGE RATES | CADUSD | 0.929 | 0.855 | 0.877 | 0.909 | 0.926 | 0.943 |
| | USDCAD | 1.076 | 1.170 | 1.140 | 1.100 | 1.080 | 1.060 |
| | USDJPY | 92 | 97 | 95 | 90 | 89 | 87 |
| | EURUSD | 1.46 | 1.35 | 1.35 | 1.37 | 1.39 | 1.40 |
| | GBPUSD | 1.65 | 1.58 | 1.59 | 1.62 | 1.64 | 1.67 |
| | AUDUSD | 0.865 | 0.795 | 0.825 | 0.855 | 0.875 | 0.895 |
| | USDCHF | 1.04 | 1.11 | 1.11 | 1.09 | 1.08 | 1.08 |
| | USDBRL | 1.82 | 1.95 | 1.89 | 1.82 | 1.79 | 1.75 |
| | USDMXN | 13.3 | 14.0 | 13.0 | 12.7 | 12.5 | 12.5 |

RATES

MOHAMMED AHMED

The Not-So-Terrible 2s

The short end of the Canadian bond market reflects an expectation that Governor Carney will not keep his conditional promise to maintain the overnight rate at the effective lower bound until mid-2010. Meanwhile, south of the border Treasury yields have rallied significantly, and somewhat counter-intuitively, since early August. The result is a Canadian front end that is fundamentally and technically undervalued relative to that of the US.

Adjusted for the CDOR-O/N basis, March 2010 BAX futures imply a quarter-point hike by the Bank of Canada as early as June. Though this expectation has diminished since early August, it remains in conflict with the Bank's "conditional commitment" to leave rates unchanged until the end of the second quarter of 2010 (Chart 1). Moreover, a stronger-than-forecast Canadian dollar could very likely push back the Bank's timeline for tightening, from mid-2010 to early-2011 (see pages 2-3). Under that scenario, not only are BAX futures attractive, but so too are Canada 2s at a yield of 1.275%.

In the US, yields have moved dramatically lower across the curve since the beginning of August. Of note during this period has been a breakdown of the positive correlation between yields and equities. While there are many potential explanations for this performance, the key takeaway is that there will be limited scope for Treasuries to rally on a flight-to-quality bid in the event equities head lower. That applies, in particular, to US 2s, which have rallied 45 bps since the beginning of August. Indeed, as the Fed concludes its QE buying of Treasuries, there is upside risk to yields in the near term.

As we have shown in the past, Canadas tend to underperform Treasuries in a rallying rate environment, and vice versa. Hence, it was not surprising to see Canada-US spreads widen over the past month. However, note that this directional relationship strengthens proportionally with term to maturity, which makes the extent of recent underperformance in Canada 2s of particular interest (Chart 2).

Chart 1. **BAX Futures Implying a Rate Hike as Early as June**

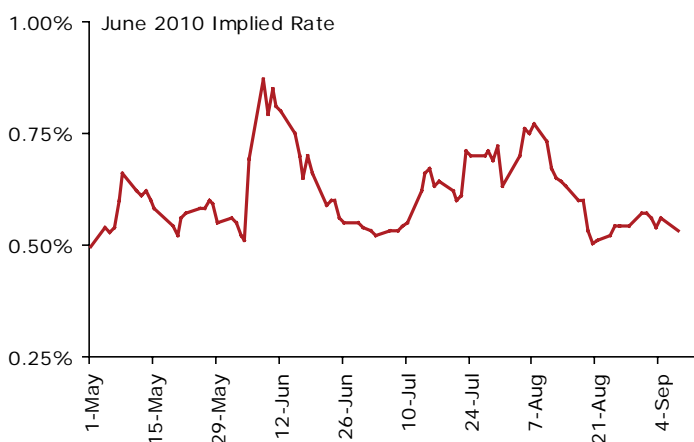
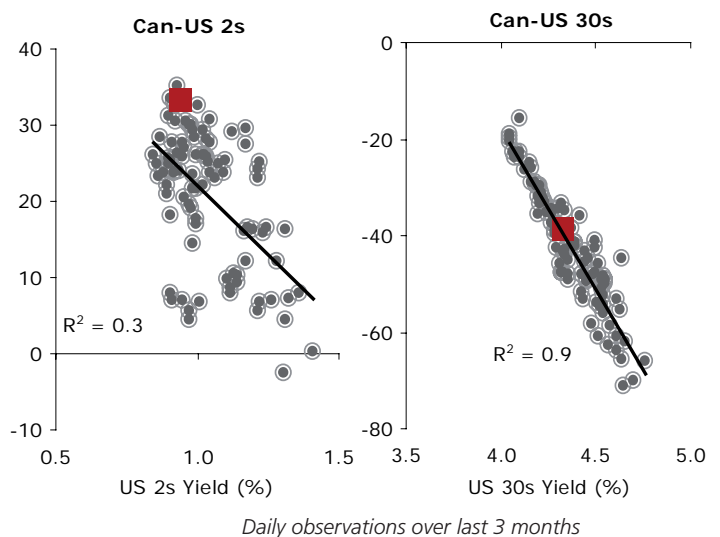


Chart 2. **Underperformance of 2s Has Been the Most Pronounced**



A multi-factor model of the Canada-US spread suggests that Canada 2s are fundamentally underpriced. We model the bond spread as a function of the differentials in overnight targets, inflation rates and budget balances, with a one-quarter lag. As expected, differences in overnight rates and CPI have a positive contribution to the spread. That is to say, quarters in which the Bank of Canada's target for the overnight rate is greater than the Fed Funds rate are followed by wider Canada-US spreads. Likewise, given each central bank's mandate to contain inflation, the difference in current headline CPI is also positively correlated with the direction of the spread in the next period. In contrast, the budget balance differential, a proxy for government supply, has a negative impact on relative performance.

Our model, using Q2 data, forecasts a zero Canada-US spread in 2s by the end of Q3. Moreover, examining the outlook for the independent variables in the model reinforces the conclusion that Canada bonds should outperform Treasuries over the next quarter. In particular, a firm Canadian dollar will be a drag to both growth and inflation, which will in turn keep the Bank of Canada on hold for longer than the market has currently priced in. Even assuming that neither central bank acts to tighten in the near future, Canada 2s at a spread of 35 bps over US 2s are undervalued. Moreover, as the US budget deficit reaches new records, relatively less supply in Canada should also argue for Canada outperformance (see pages 6-7).

Short-term technicals corroborate the view that there is scope for Canada outperformance. The rally in Treasury yields has pushed the Canada-US 2s spread 20 bps wider in the last month and as a result, the spread is at the high end of 2009's trading range. The spread's current level places it in the middle of a consolidative range that has been in place since 2008, previously acting as resistance for the spread and currently acting as support (Chart 3). However, recent price action is not indicative of the initiation of a new trend of Canada underperformance. Rather, we recommend this as a strategic opportunity to establish long Canada, short US positions.

Chart 3. **Canada-US 2s at Support**



Current Recommended Strategies

| Proposed Date | Recommendation | Entry | Target | Stop | 1-Mth Carry | Current | Gain/Loss | Duration (Days) |
|---------------|---------------------------|----------------------|--------|-------|-------------|---------|-----------|-----------------|
| 1 *NEW* | Long Canada 2s vs. US 2s | 35 bp | 5 bp | 45 bp | 1 bp | 35 bp | - | - |
| 2 11-Aug-09 | Long Canada 5s vs. 2s/10s | 59.5 ^a bp | 30 bp | 65 bp | 0.5 bp | 56.5 bp | +3 bp | 28 |

Notes:

- (a) Note that we rolled the 5s benchmark from the 3%/Jun-14 bond to the 2%/Jun-14 issue at a spread of 11 bps. 'Entry', 'Target' and 'Stop' levels have been adjusted accordingly.

GOVERNMENT FINANCE

WARREN LOVELY

Not All Government Created Equal

Look no further than recent labour market data for evidence of Canada's superior economic performance relative to the US. Having entered the recession with a structurally balanced budget and requiring relatively less fiscal stimulus, Canada's federal fiscal edge over the US is striking (Chart 1).

Canada has earned credibility for its record of fiscal management, and a focus on fiscal stewardship (more specifically, the commitment to deficit eradication) resonates from both of the main federal parties. Tackling America's yawning gap is a more monumental task, and the fiscal tools available are diminished relative to the flexibility Canada possesses.

The Obama administration's recent budget update sees publically held debt—mainly T-Bills and marketable bonds—soaring fully \$10 trillion come 2019, including a \$1.7 trillion jump (equivalent to 12% of GDP) in the coming fiscal year. True, there's been little shortage of Canadas, with a record \$100 billion delivered in the past 12 months alone. While that's three-and-a-half times the steady state that prevailed before the global financial calamity hit, gross Canada issuance is proportionately half that of Treasuries (Chart 2, left). And the July-September quarter could, in all likelihood, represent the high water mark for Canada issuance, with supply expected to recede much faster than in the US.

Even so, there are some uncertainties in the Canada space. A looming parliamentary showdown could set the stage for the country's fourth election in five years. Notwithstanding the medium term focus on fiscal restoration, there's potential for another round of temporary stimulus—less to bolster growth and more to appease opposition parties in a minority parliament. Still, weaker recovery prospects make an even stronger argument for additional stimulus in the US.

Ottawa's support for financial markets could manifest itself in a third extension of Canada's insured mortgage purchase program (IMPP). That program triggered a seismic shift in Canada issuance (Chart 2, right), but the size and frequency of these operations has now dried up. Barring a material change in pricing, another extension would have only a modest impact on issuance. The introduction of a 3-year maturity further altered the profile of supply. Notwithstanding a commitment to this tenor, a planned increase in the fixed share of debt could partially restore the portion of issuance out the curve. (Treasuries never saw the relative spike in 5 years, with a disproportionate share issued in longer tenors.) As-yet-unutilized, quantitative easing, meanwhile, remains in the Bank of Canada's policy tool kit, with potential implications for the Canadian curve.

Chart 1. Economic & Fiscal Edge for Canada

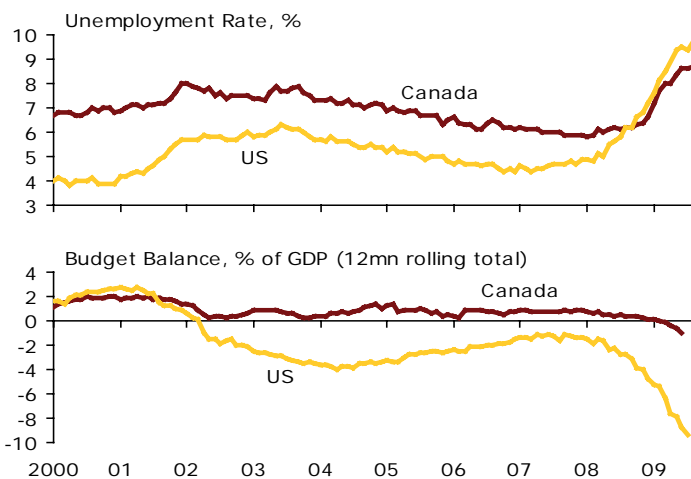
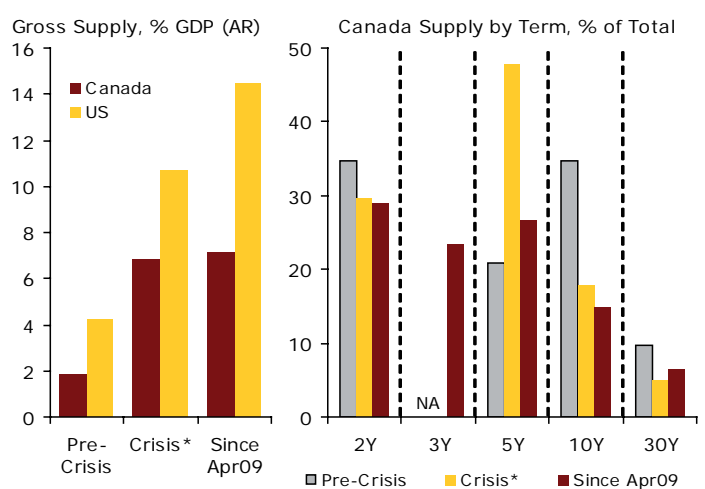


Chart 2. Relative Size and Profile of Canada Supply



* Crisis defined as 6 months from Oct-08 to Mar-09

Provincials vs States: Should We Care?

Sub-sovereign comparisons of financial performance in Canada and the US are less relevant to debt capital markets. In dollars, provincial credits trade in the SSA space, and prints for the likes of KfW, EIB and IADB are more relevant than State of California GO bonds. Indeed, the requirement for States to set aside reserves and strive for an annual balance is more akin to the financial constraints in Canada's municipal sector. For Canada's provinces, balanced budget legislation did little to prevent the emergence of broad based deficits—the by-product of economic weakness and their own stimulus efforts.

Recent provincial updates have tacked nearly \$10 billion onto the aggregate provincial deficit, which now stands at \$33 billion. Borrowing requirements have moved in lockstep (Chart 3). But critically, formal transfer arrangements give investors more comfort that Canada's federal government would, in the extreme, come to the aid of a troubled province.

On either score—budget balance or funding requirements—a meaningful near-term improvement seems unlikely, as fiscal recoveries generally lag the upturn in the broader economy. As a result, expect rating agencies to scrutinize mid-year reports, on alert for evidence of emerging structural deficits. Notwithstanding past fiscal management and enhanced flexibility relative to the last major recession, provincial credit ratings could remain under pressure during at least the first year of economic recovery.

Together, increased borrowing requirements and the potential for negative rating actions could leave the provincial sector on a defensive stance relative

to competing domestic spread product: CHTs and corporates.

Net of maturities, CHT issuance has begun to top out. With large issues maturing and/or rolling out of the index, and with fewer constraints in terms of sector exposure limits, upcoming CHT offerings should attract strong demand. In light of the overhang of provincial supply, the provi-CMB roll—having ground tighter in recent months—risks giving up ground.

Canadian corporates, particularly those levered to domestic demand, will generally be quicker to record improving credit metrics relative to most provincials. And a relatively light Fall maturity calendar affords corporates a degree of patience that many provincial issuers do not currently possess. Finally, despite a substantial tightening, corporate spreads remain at recessionary levels, with incremental yield attractive vs provincials. (Refer to pages 8-9 for a more detailed examination of corporate fundamentals.)

The stage then appears set for relative underperformance on the part of provincials vs CHTs and corporates during this early stage of economic recovery. In an effort to mitigate pressure on domestic spreads, and to advance a sizeable borrowing program, provincial issuers will remain keenly focused on international markets, issuing opportunistically in order to access deeper pools of liquidity in the US and abroad (Chart 4). The short-term market remains an important outlet for provincial issuers. Filling a void left by other traditional sectors, provinces have driven their outstanding bills to record levels (\$40 billion as of July). There is still capacity for further bills issuance, although a desire to term out can make this a less preferred avenue for net financings.

Chart 3. Provincial Deficits, Funding Needs Mount

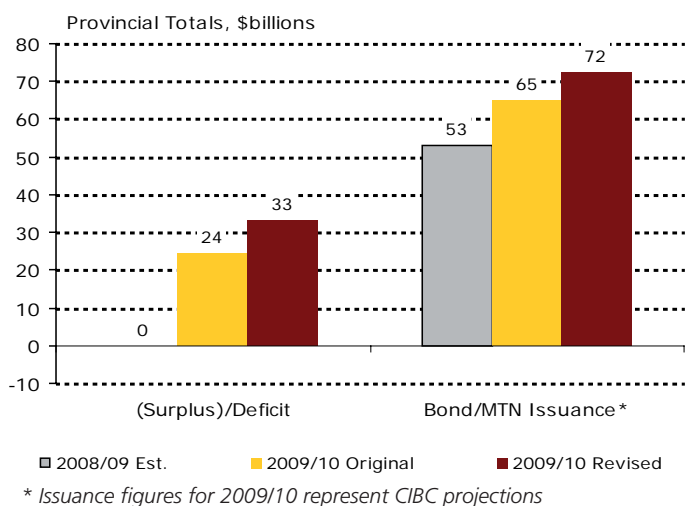
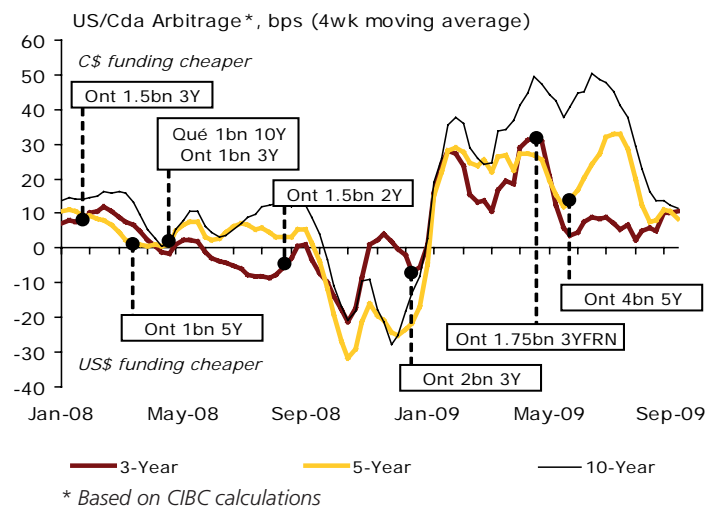


Chart 4. Foreign Markets Important Outlet for Provincials



CREDIT
JOANNA ZAPIOR

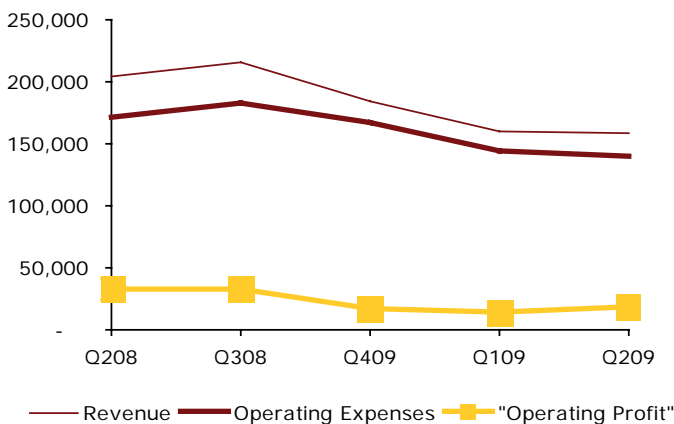
Of Leverage and Cholesterol

Leverage is just like cholesterol—there is the “good” one, and the “bad” one. It is the “bad” leverage that credit analysts usually get excited about. This is certainly the case when the going is too good to be true and the day of reckoning is sure to come and wreck the credit fundamentals for us. However, at this point of the credit cycle, at a possible—but not certain—edge of recovery, it is important to know whether the “good”, operating leverage is being created. Operating profitability and cash-flow generation are ultimately necessary to pay interest charges, and companies that create operating leverage bounce back faster.

The latest series of quarterly calls in Canada was all about the “good” operating leverage created by cost cutting. Many reporting companies claimed that cost cutting is now more aggressive than the pace of decline in revenues. We actually have done a few measurements so that we can quantify the “story” we heard loud and clear during almost 80 Canadian conference calls by debt issuers that we listened to this quarter.

True to their words, non-financial debt issuers in Canada have created quite a bit of operating leverage (Chart 1).

Chart 1. Canadian Corporate Debt Issuers Get an A for Effort in 2009



The downtrend in revenues has almost flattened, and cost cutting exceeded revenue declines. As a result, after the initial shock in the second half of 2008, the impact on operating profits was dampened, and by the second quarter of 2009 operating profits for our universe of Canadian debt issuers recovered nicely. Make no mistake, this is still 43% down from the peak level in 3Q08, but our numbers certainly provide evidence of stabilization.

Our sample of some 140 US peers of Canadian corporate debt issuers demonstrates they are not much different in terms of how they have coped with the blows rendered to their top line by this downturn. Except for this past quarter. While Canadian issuers have stabilized the upper part of their income statement, US companies’ revenues are still reeling from the impact. See Chart 2 and refer to Table 1 on next page for details.

These numbers corroborate the view from our Economics Group that Canada is emerging from the recession a bit less scathed than the US. They support our constructive view on Canadian investment grade credit, and a preference for domestic exposure.

Chart 2. Their US Peers Continue to Fight the Headwinds

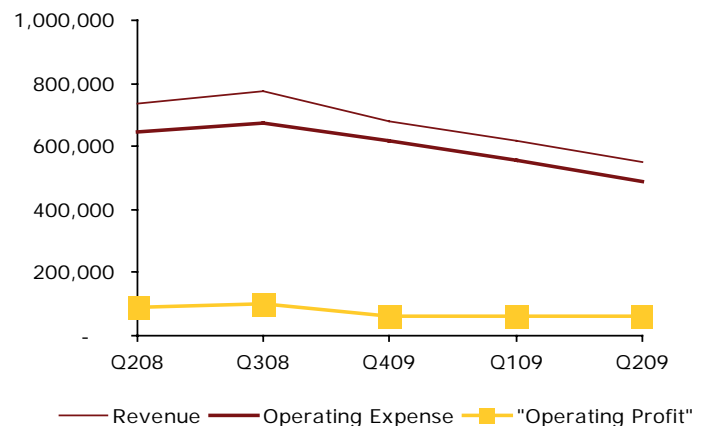


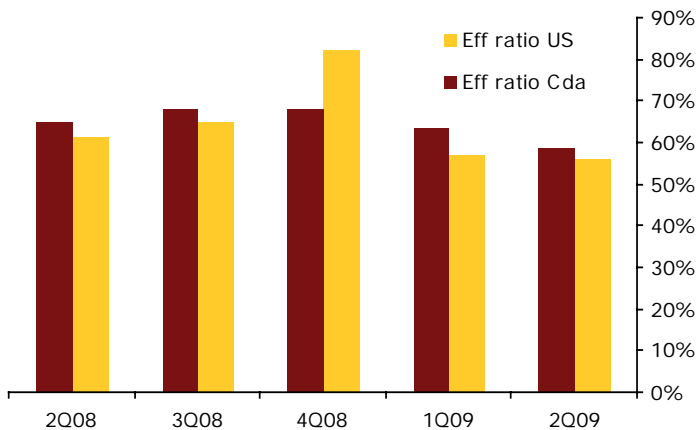
Table 1. Operating Leverage in Corporates

| | CANADA | | | U.S. | | |
|------------------|-------------|-------------|-------------------|-------------|-------------|-------------------|
| | 2Q09 effort | 1Q09 effort | From peak in 3Q08 | 2Q09 effort | 1Q09 effort | From peak in 3Q08 |
| Revenue | -1% | -13% | -27% | -11% | -9% | -29% |
| Operating cost | -3% | -14% | -24% | -12% | -10% | -28% |
| Operating income | 25% | -10% | -43% | 2% | 2% | -39% |

The banks obviously march to a different drummer. For banks, we have looked at the efficiency ratio (non-interest expenses divided by revenues, i.e. the smaller it is, the better).

At first blush (Chart 3), the banks have worked hard in 1H09 on bringing the efficiency ratio down. Not surprisingly, this is the case for US banks, whose efficiency ratio rose rapidly to unsustainable levels in 4Q08, and was worked down to the lowest level in the five quarters shown. Canadian banks have certainly been less pressured, but even they worked down the efficiency ratios in 1H09 from the highest level in 4Q08.

Chart 3. Average Efficiency Ratios of Canadian and US Banks



But when we dig into the components of the efficiency ratio, it certainly looks like a page from a different tale than what we observed in non-financials. In Chart 4 we plot the revenues and operating expenses, which are components of the efficiency ratio. In the US, in the aggregate, bank operating costs declined in the latter half of 2008 (not keeping up with the decline in revenues). They actually moved up sharply with the bounce-back in revenues, though not with the same force as revenues. Canada has been a much more subdued story, both on the revenue and operating expense lines.

Chart 4. Components of Efficiency—Revenues and Operating Expenses

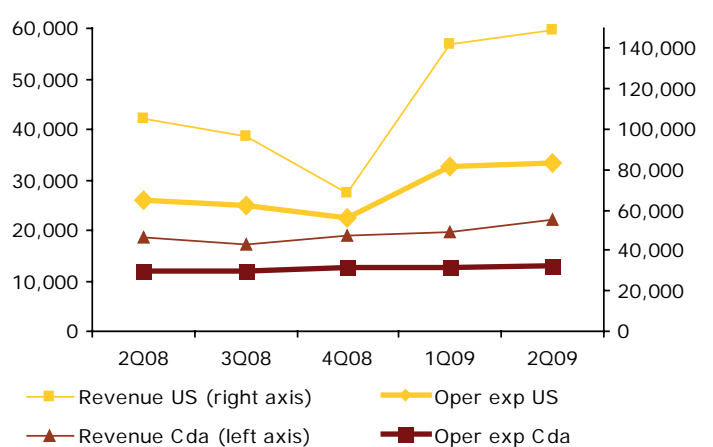


Table 2. Operating Efficiency in Banks

| | Change 1H09 | Change 2H08 (from the peak) |
|---------------------------|-------------|-----------------------------|
| US revenue | 117.20% | -35.10% |
| US operating expenses | 47.80% | -13.00% |
| Canada revenue | 17.10% | 0.90% |
| Canada operating expenses | 1.10% | 6.10% |

COMMODITIES
PETER BUCHANAN

Natural Gas vs Oil: A Tale of Two Markets

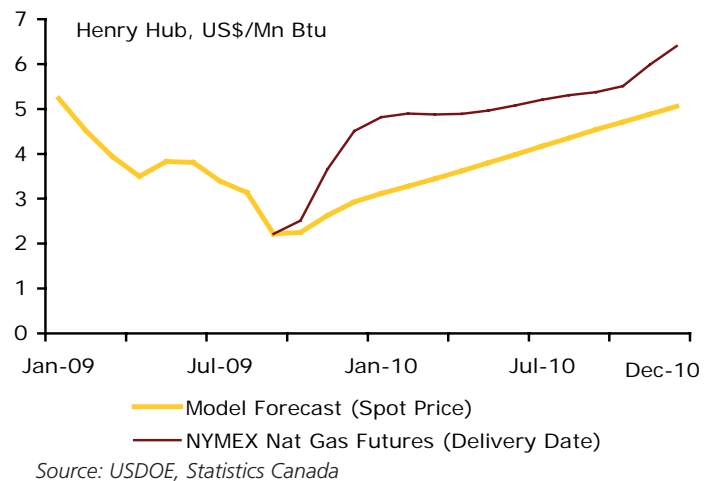
A Measured Recovery Likely After a Steep Sell-Off

Natural gas, oil's "weak cousin", has seldom been cheaper relative to its principal fossil fuel competitor, pointing to "mean reversion" if history is a guide. The recession's toll on demand, combined with a cool summer, limited tropical storm activity and rising non-conventional production have helped push gas prices down to just 25% of crude in Btu-equivalent terms, the lowest level since 1981 (Chart 1).

How soon, and aggressively prices realign themselves is a more difficult call. But our forecasting model, which predicts changes in spot gas prices from the lagged price differential to oil and de-seasonalized US DOE forecast inventory levels, projects \$5/mn Btu Henry Hub for the end of 2010. That is based on an average WTI spot price of \$70/bbl next year, unchanged from our previous estimate, and is about \$1.30 less than is presently priced in by the futures strip (Chart 2).

With US gas hub prices at multi-year lows, even as WTI hangs on to an over-100% gain from February's lows, the two fuels have effectively de-linked in recent months. The front-end NYMEX gas contract skidded to a 7-year low of \$2.40 in early September, still searching for a cyclical bottom. Even with recent deep cuts in drilling activity (Chart 3), added shale gas production means total US

Chart 2. **NYMEX Strip Curve vs Our Natural Price Forecast**



marketable gas production will still be up a good 7% this year from the level two years ago.

Weighing on the overall gas demand picture and prices, US industrial demand slid by 11% on the year in Q2. Reflecting the recession's toll on customers like the metals and chemicals sectors, gas-weighted production fell by nearly 17% from pre-recession peaks, about 2-3%-pts more than the pullback in the factory sector as a whole.

Reduced gas-fired power needs, as a temperate summer limits air conditioner use, have also contributed to

Chart 1. **Natural Gas Prices, % Energy Equivalence of Oil**

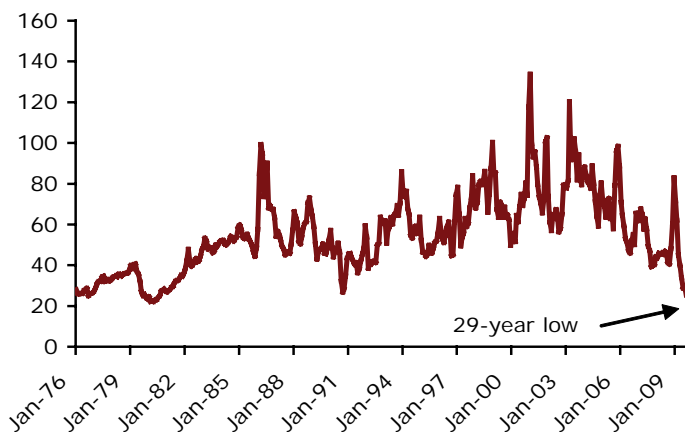


Chart 3. **Natural Gas Rig Count, Canada and US**

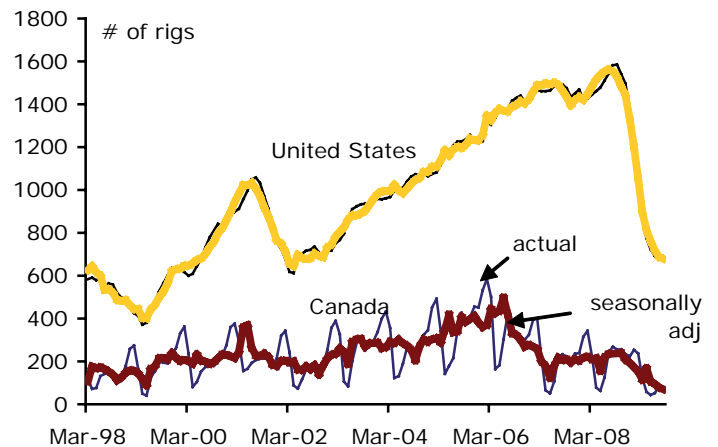


Table 1. North American Natural Gas Indicators

| | | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 |
|---|-------------------|-------|-------|-------|-------|-------|-------|
| US. Natural Gas Consumption | bn cu ft/day | 60.3 | 59.4 | 63.1 | 63.4 | 61.8 | 62.1 |
| US Marketed Production | bn cu ft/day | 51.9 | 53.2 | 54.9 | 58.6 | 58.7 | 57.0 |
| LNG & Pipeline Imports | bn cu ft/day | 11.89 | 11.47 | 12.62 | 10.88 | 10.46 | 10.98 |
| US Working Storage | bn cu ft | 2,635 | 3,070 | 2,879 | 2,840 | 3,246 | 3,139 |
| Henry Hub Spot Price | US\$/Mn. Btu | 8.89 | 6.73 | 6.97 | 8.89 | 3.30 | 4.10 |
| AECO C Hub | C\$/gigajoule | 8.31 | 5.97 | 6.16 | 7.71 | 2.50 | 3.15 |
| Addendum: | | | | | | | |
| -Cdn Marketable Gas Production | bn cu ft/day | 16.5 | 16.6 | 16.2 | 15.2 | 14.5* | - |
| -US Natural Gas Wtd Industrial Production | (index, 2002=100) | 108.3 | 110.2 | 109.7 | 104 | 90.5 | 90.2 |

Source: US DOE, Statistics Canada

*Average, Jan-Jun '09

abnormally high injection rates, lifting inventories nearly 20% above seasonal norms. While gas prices are now cheap in both historical and relative terms, we don't expect inventories to decline much before mid-2010, as supply outpaces demand (Table 1). That limits, for now, prospects of a strong price snapback.

Coinciding with the softer demand picture, non-conventional natural gas production—shale and tight gas plus coal bed methane—have helped lift US marketable gas production by 13% since 2005, reversing the previous secular decline. Non-conventional gas production topped conventional for the first time in 2008 and could provide 75% to 90% of new gas supply over the next several years according to some estimates—effectively defining the industry's marginal cost curve. The economics of shale gas, the prime driver of recent conventional supply

growth, are contentious. Longer-term forward curve prices are sufficiently elevated, however, to warrant continuing high levels of project investment even under more pessimistic assumptions of a breakeven cost in the \$7-8/ mn Btu range.

Lagging North American Recovery A Larger Negative for Gas Prices Than Oil

Macroeconomic trends have contributed to oil's recent outperformance against gas. We expect these will continue to favour the former fuel in the next year or two. While rising LNG volumes have bound national markets more closely in the last decade, natural gas remains much more than oil, a regionally traded commodity, dependent on local rather than global conditions. A lagging North American recovery thus presents a larger obstacle for gas prices than oil.

US LNG imports are expected to rise by about 30% in 2009. Growth there is likely however to just offset weaker pipeline imports from Canada. LNG's share of the US market remains modest at 2%, limiting the fallout for prices. Proposed US climate change legislation could have sizeable longer-term implications for demand but under current proposals will only take effect in 2012, limiting the near-term effect.

The long-standing relationship between oil and gas prices reflects a number of factors—some demand- and others supply-related. Changes in relative oil and natural gas prices may encourage firms to look for one fuel at the expense of the other. Another factor helping to align prices is the potential for fuel substitution in the

Table 2. Spot Commodity Prices

| | | 4-Sep | 2006 | 2007 | Average 2008 | 2009 (f) | 2010 (f) |
|---------------------|------------|-------|-------|-------|--------------|----------|----------|
| Oil (WTI) | \$/bbl | 68 | 66 | 72 | 100 | 60 | 70 |
| RBOB gasoline | \$/gal | 1.98 | 1.88 | 2.09 | 2.49 | 1.70 | 2.00 |
| Heating Oil (NYH) | \$/gal | 1.69 | 1.80 | 2.03 | 2.86 | 1.60 | 2.05 |
| Natural Gas (Henry) | \$/Mn Btu | 1.88 | 6.73 | 6.97 | 8.89 | 3.30 | 4.10 |
| Gold | \$/troy oz | 989 | 604 | 695 | 872 | 1000* | 1100* |
| Copper | \$/lb | 2.84 | 3.06 | 3.24 | 3.16 | 2.40 | 3.25 |
| Aluminum | \$/lb | 0.82 | 1.17 | 1.20 | 1.17 | 0.75 | 0.85 |
| Nickel | \$/lb | 7.97 | 10.98 | 16.86 | 9.57 | 6.75 | 8.25 |
| Zinc | \$/lb | 0.86 | 1.48 | 1.48 | 0.85 | 0.75 | 0.95 |

* end of period

Recommendation Summary:

- Buy Oct-09 Nat Gas (approx. 270)
OR Nov-09 Nat Gas (approx. 375) (Time Horizon 1-2 mths)
- Sell Dec-10 Nat Gas (approx. 645) (Time Horizon 1-2 mths)

STRATEGIC RISK

MICHAEL ROSBOROUGH

Three Degrees of Stimulation

As a trader of a proprietary macro portfolio I have a very diverse menu of choices across the universe of equities, fixed income and currencies. Within that universe there is only one country in which I am currently running an outright long position in its broad equity market and that is in the UK, where I have a stake in the FTSE 100. While it has been the poorest performer of the major G7 markets year to date, the "Footsie" is beginning to show signs of life relative to its peers. In fact, it has smartly outpaced the S&P 500, the Nikkei, the Euro Stoxx 50 and the S&P/TSX so far this quarter.

Working in London, as I have for the past five years, it's easy to be pessimistic on Britain's prospects. The meltdown in global finance might have its epicentre in the US housing market, but in no G7 country are financial services as important to the overall economy as they are in the UK. Before the sub-prime crisis erupted into a global credit crunch, the assets of the UK banking sector were a fivefold multiple of the country's GDP. In Canada the big five banks' assets are less than twice GDP and in the very dis-intermediated US assets of the entire banking system are less than 100% of GDP. If any country was vulnerable to the shocks and aftershocks of the credit crunch it was the UK.

From five big banks pre-crunch the UK is now down to four, and of those four the government owns an over-40% stake in one and a 70% stake in another. In terms of the rise in household debt and the pre-crunch boom in house prices, Britain was arguably even more vulnerable than the US to the sort of de-leveraging a financial crisis engenders. Against these impediments the recent outperformance of the FTSE 100 seems out of place, but the counterweight to all this gloom is the extraordinary degree of stimulus now feeding through the British economy.

Keynes Comes Home

In terms of resurrection, the UK government and the Bank of England have done more than their counterparts in the G7 to pursue the prescriptions of England's most famous economist—John Maynard Keynes. The most striking manifestation is in the projected size of the UK's budget deficit (Table 1).

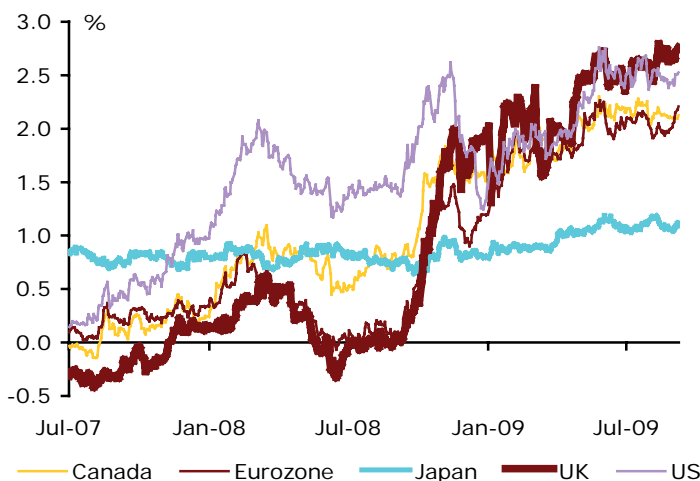
Table 1. Soaring Deficit Shows Massive UK Stimulus

| Country | Budget Balance (% of GDP) | | |
|----------------|---------------------------|-------|-------|
| | 2008 | 2009 | 2010 |
| Canada | 0.1 | -2.8 | -2.4 |
| France | -3.0 | -6.5 | -7.2 |
| Germany | 0.0 | -4.2 | -5.4 |
| Italy | -3.0 | -5.2 | NA |
| Japan | -2.7 | -7.4 | NA |
| United Kingdom | -2.7 | -12.9 | -13.2 |
| United States | -4.7 | -11.9 | -9.0 |

(Consensus forecasts from page ECFC on Bloomberg and where not available from the Economist magazine)

On the monetary side the Bank of England surprised the markets by voting to increase the size of its quantitative easing program from £125 to £175 billion. The increase would have been even larger had BOE Governor Mervyn King's views prevailed, which suggests we may yet see a further QE rise while the central banks of the rest of the G7 hold steady. In response to these degrees of fiscal and monetary stimulation, the UK now boasts the steepest yield curve after having the flattest when the crunch began (Chart 1).

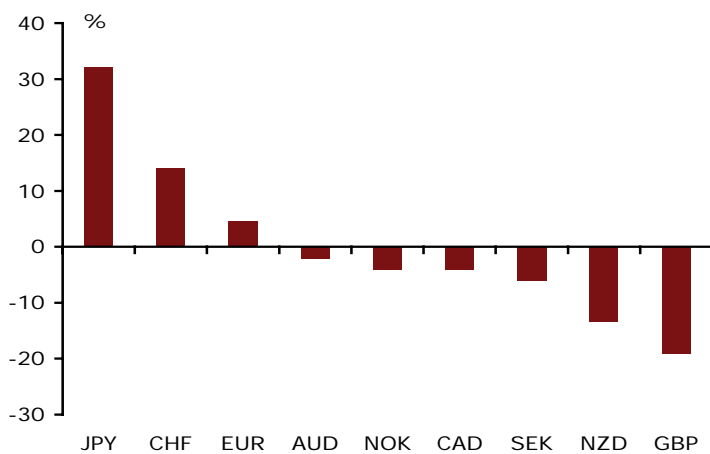
Chart 1. **Ten-Year — Two-Year Government Bond Yields**



The third degree of stimulus for the UK has been the exchange rate. Since the global credit crunch erupted in the summer of 2007 no currency amongst the world's majors has fallen further than the British pound (Chart 2).

So while arriving late to the party, the UK is now experiencing an aggressive degree of stimulus relative to the rest of the developed world. Interestingly, rather than

Chart 2. **Change versus the US Dollar Since July 2007**



being spooked by the unanticipated increase in the size of quantitative easing at the Bank of England's August MPC meeting, the equity market digested it well and clearly took it as a positive. My own view is that the biggest risk to global equity markets is a too early exit from both the fiscal, but especially the monetary stimulus policymakers have enacted. By increasing the size of their program the Bank of England clearly signaled that they would be one of the last to head for the exit in that respect.

Turning to the UK equity market itself, one of its great attractions is that of the major markets its forward multiple is currently the lowest relative to the level of the past five years amongst its peers. Moreover the beaten down UK financial sector no longer dominates the index as it once did (although that said, there is plenty of room for upside from that group when it recovers).

Table 2. **PE Multiples and Financial Sector Weights**

| Index (Country) | Five Year Average P/E | Current Forward P/E | Financial Sector Weight |
|-----------------------------|-----------------------|---------------------|-------------------------|
| S&P/TSX (Canada) | 16.7 | 17.6 | 32.2% |
| DJ Euro Stoxx 50 (Eurozone) | 13.0 | 13.2 | 32.6% |
| DAX (Germany) | 16.1 | 15.7 | 21.5% |
| Nikkei 225 (Japan) | 20.8 | 41.0 | 6.9% |
| FTSE 100 (UK) | 16.7 | 14.2 | 22.8% |
| S&P 500 (US) | 16.0 | 17.0 | 15.2% |

(All estimates from Bloomberg)

The trajectory of the UK economy is clearly important to the performance of the FTSE, and Britain's high relative exposure to the credit crunch may be the reason for the discount relative to the other major markets. That said, there is more to the Footsie than a play on the UK's recovery. The index is home to a significant number of global players in a variety of sectors including oil and gas and metals and mining (both of which lever off of global and particularly emerging market growth) and healthcare.

I like the FTSE therefore both as a bet on the recovery of the UK economy and its financial sector and because of its leverage to the faster growing emerging world. Exposure to the index can be gained either through the FTSE 100 Index futures contract (Z U9 for the September contract, Z Z9 for December) or through the ISF ETF on the London exchange. A similar UK equity ETF, EWU, trades on the New York exchange and tracks the MSCI United Kingdom index.

FX AND COMMODITY STRUCTURING

ERIC OHAYON

USD/CAD Outlook and Trading Strategies

USD/CAD Outlook

Commodity currencies, following in the footsteps of commodity prices, have had a strong performance year to date. AUD, CAD, NZD, Oil and Gold prices continue to perform despite the seemingly inflated prices and needed correction. The Canadian dollar has traded with strong momentum over the past 6 months with spot USD/CAD moving over 20 big figures lower from the 1.3000 highs back in early March to trade below 1.0700 in recent weeks—a 17% appreciation of the loonie against the greenback. The increasing strength of the currency is undermining Canada's growth prospects in the short term, drawing strong comments from the Bank of Canada. With the threat of an "intervention" and/or quantitative easing, the Bank of Canada seems to have drawn a line in the sand around the 1.0700 CAD per USD level. However, looking into 2010, a revival of the global economy and demand for commodities is likely to attract foreign money into Canada and hence increase export revenue, which is likely to provide support for a stronger Canadian Dollar.

Despite the strong performance of the Canadian dollar, a move to parity seems premature. It would require the USD to be under significant pressure combined with strong equity and commodity gains. Longer term, the US is likely to support a weaker US Dollar as a means of boosting exports. However, we would need a global recovery to be underway for other economies to carry the load of further currency appreciations.

Spot USD/CAD continues to trade sideways within the 1.0630 - 1.1130 range. The outlook remains neutral with more choppy sideways trading looming in the horizon.

Fade-In Range Forward

A client looking to buy USD against CAD over the next 6 months could enter into forward contracts. The client would be obligated to buy USD/CAD at an exchange rate close to the current 1.0700 spot exchange rate.

The following alternative allows the client to potentially buy USD/CAD over the next 6 months (26 weeks) at the rate of 1.0300 CAD per USD, outperforming the outright forward by over 400 pips:

Indicative terms & conditions as of Sep 8th 2009

| | |
|--------------------------------|--|
| Client: | Buys USD / Sells CAD forward |
| Expiry Dates: | Weekly from Sep 15 th to Mar 9 th 2010 (26 weeks) |
| Exchange Rate: | 1.0300 CAD per USD |
| Weekly Notional Amount: | US\$ 1,000,000 |
| Fade-In Level: | below 1.0300 CAD per USD On a weekly basis if Spot USD/CAD fixes below 1.0300, the client buys USD 1,000,000 against CAD at the rate of 1.0300 for that week. |
| Weekly Bonus Payout: | C\$ 15,000 |
| Bonus Range: | 1.0300 – 1.1700 On a weekly basis if Spot USD/CAD fixes above 1.0300 and below 1.1700, the client receives a CAD 15,000 payout for that week. |
| Observation Period: | weekly (26 fixings) |
| Analysis: | On a weekly basis if Spot USD/CAD fixes below 1.0300, the client buys USD 1,000,000 against CAD at the rate of 1.0300 for that week, a 400 CAD pips advantage relative to the outright forward. On a weekly basis if Spot USD/CAD fixes above 1.0300 and below 1.1700, the client receives a CAD 15,000 payout for that week. On a weekly basis if Spot USD/CAD fixes above 1.1700, nothing happens for that week. |
| Spot Ref.: | 1.0700 CAD per USD |

The above strategy allows the client to buy USD/CAD, in the event that spot fixes below 1.0300, on a weekly basis over the next 6 months at the advantageous rate

of 1.0300 relative to the 1.0700 outright forward. In the event that USD/CAD continues to trade sideways inside the 1.0300 – 1.1700 range, the client will receive C\$15,000 each week, which the investor can utilize to improve their USD buying rate. In the event that spot fixes above 1.1700 CAD per USD, nothing happens for that week.

The strategy is best suited for clients that have a recurring need to buy USD/CAD at a boosted rate and would benefit from a weekly payout if spot continues to range trade.

Conditional Dual Currency Note (CAD Denominated)

Clients viewing a quick move to parity as unlikely can also use that view to earn higher short-term yields. The following FX-linked note allows the client to benefit from an enhanced yield of 7.25% p.a. over the next month—a pick up in excess of 6.50% relative to the C\$ BA. At maturity, the note can be redeemed, at CIBC discretion, either in CAD or in USD at a pre-agreed conversion rate. However, only in the event that spot USD/CAD has ever traded at or below 1.0090 CAD per USD, can CIBC exercise its right to convert Principal and Interest in USD at the pre-agreed rate of 1.0700.

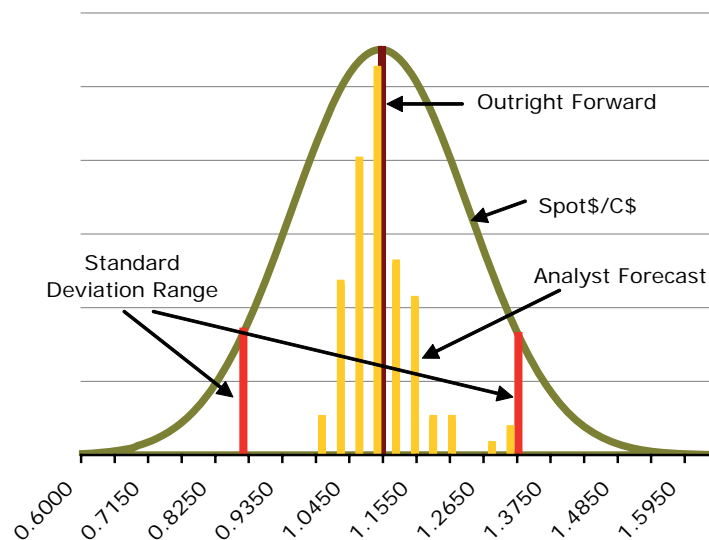
Indicative terms & Conditions as of Sep 8th 2009

| | |
|------------------------------|--|
| Instrument: | CAD Denominated Note |
| Issuer: | CIBC |
| Principal Protection: | n.a. |
| Principal: | C\$ 10,000,000 |
| Tenor: | 1 month |
| Coupon Rate: | 7.25% p.a. (C\$ 61,575) |
| Coupon Payment Date: | Maturity Date |
| Redemption Amount: | In the event that 1.0090 CAD per USD has never traded; CAD 10,061,575 |
| | In the event that spot USD/CAD ever trades at or below 1.0090 and spot USD/CAD fixes above 1.0700 at Maturity; CAD 10,061,575 |
| | In the event that spot USD/CAD ever trades at or below 1.0090 and spot USD/CAD fixes below 1.0700 at Maturity; USD 9,403,341.10 (CAD 10,061,575 ÷ 1.0700) |

Chart 1. Spot USD/CAD Exchange Rate



Chart 2. Spot Analysis & Distribution



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