



## The Rally Takes a Summer Holiday

by Avery Shenfeld

### Economics

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*"It would be tempting for aggressive traders to shift funds out of stocks. But for others, riding out the bumps at a benchmark equity weighting is a more realistic option, ..."*

We noted last month that stocks were getting ahead of reality, after a rally that seemed to indicate a recovery was closer at hand than the data really warranted. That was partly evident in price-earnings multiples for equities, which were getting a bit rich. But it was more obvious in the bond market, where the front end of the curve was pricing in a series of rate hikes for early 2010, an outcome that would only make sense in a much sharper economic rebound than appears likely.

What to do, then, as what will prove to be a new bull market in equities takes a summer holiday, keeping stocks flat or in a corrective phase while awaiting the first true signs of growth late this year? It would be tempting for aggressive traders to shift funds out of stocks. But for others, riding out the bumps at a benchmark equity weighting is a more realistic option, given the risks in trying to time the market too precisely when the economy is near a turning point.

After all, as we saw this spring, even a hint of growth can spark a quick rally that would be easy to miss. Consensus earnings figures for Canada this year now appear sufficiently conservative that we could see some modest upside surprises in the second half.

And, more importantly, longer term valuation metrics still show ample headroom for equities, even if the first year of expansion proves to be as tepid as we

suspect. Excess cash holdings in the household sector, and central banks determined to add liquidity, auger for another leg to the equity rally to begin before year end.

That said, we're sticking with underweights in some sectors, like consumer discretionary stocks and industrials, that could struggle as the North American recession lingers over the next few months, and adding weight to telecoms that appear less cyclically exposed. The only highly cyclical sector in which we have an overweight is base metals, where Asia's economic rebound, already well underway, should be a plus.

### Recommended Asset Mix & TSX GICS Sector Weights vs. Current Benchmark

ASSET MIX (%)	Bench- mark	Strategy Recom- mend.	vs Bench- mark	chg vs mon. ago*
Stocks	50	<b>50</b>	0.0	0.0
Bonds	39	<b>37</b>	-2.0	0.0
Cash	11	<b>13</b>	2.0	0.0
<b>GICS SECTORS (%)**</b>				
Cons. Discretionary	4.0	<b>2.0</b>	-2.0	0.0
Cons. Staples	2.9	<b>2.9</b>	0.0	0.0
Energy	28.3	<b>28.3</b>	0.0	0.0
Financials	30.8	<b>30.8</b>	0.0	0.0
-Banks	20.2	<b>20.2</b>	0.0	0.0
-Insur., REITs, other	10.6	<b>10.6</b>	0.0	0.0
Health Care	0.4	<b>0.4</b>	0.0	0.0
Industrials	5.4	<b>2.9</b>	-2.5	0.0
Info Tech	4.4	<b>4.4</b>	0.0	0.0
Materials	17.7	<b>21.7</b>	+4.0	-0.5
-Gold	10.5	<b>11.5</b>	+1.0	0.0
-Other Metals	3.1	<b>5.1</b>	+2.0	0.0
-Fertilizer, Chem	3.7	<b>4.7</b>	+1.0	-0.5
Telecom	4.5	<b>5.0</b>	+0.5	+0.5
Utilities	1.6	<b>1.6</b>	0.0	0.0

Note: Shading indicates recommended overweight.  
\*chg in %-pt underweight/overweight from last month.  
\*\* Benchmark weights are for TSX Composite.

<http://research.cibcwm.com/res/Eco/EcoResearch.html>

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## Sober Second Thoughts—Avery Shenfeld, Peter Buchanan and Meny Grauman

As we warned last month, the spring's run-up in equities, while leaving headroom for further gains longer term (Table 1), had got a bit ahead of the near-term fundamentals. The latest US payrolls data made clear that the ongoing North American recession is still very much with us (Table 2). Reflecting the economic recovery uncertainties, investor sentiment measures have also eased recently after inching up from March to early June (Chart 1) and there are additional jitters about what upcoming earnings reports might hold.

Such doubts about just how near the North American economy and earnings are to a meaningful turnaround should help to keep markets somewhat on the defensive through the summer. Short-term valuation benchmarks, including the TSX's 12-month forward PE that now sits at a slight premium to its historical average, underscore the need for caution.

But only the most nimble market timers should think about going underweight equities at this point in the cycle. There's enough upside over the 18-month horizon to stay benchmark-weighted, and anything more than a 10% further correction would represent a good opportunity to add weight. Metrics based on longer term earnings potential, like the 10-year trailing price-to-earnings ratio pioneered by Robert Shiller, still indicate good value. Policymakers haven't exhausted the options available to provide additional stimulus if necessary, and investors are rightly rejecting the worst case scenarios kicked around earlier this year. Reflecting that shift, the VIX and Libor both eased further in June, and the TED spread is also now back to pre-Lehman levels (Chart 2).

Chart 1 - Investors More Cautious on Equities

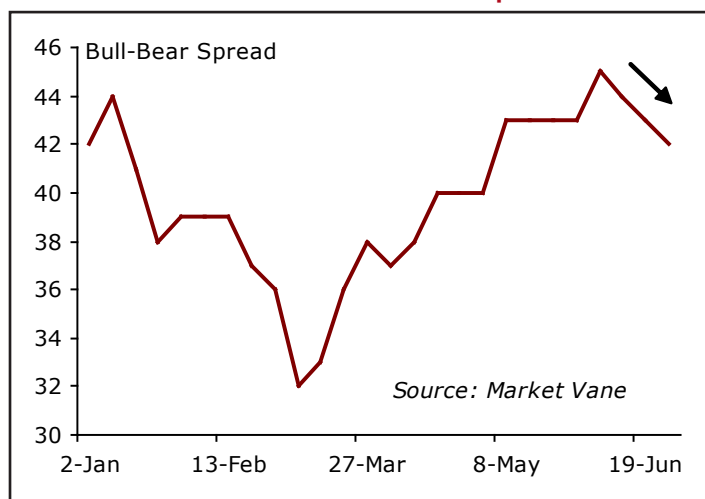


Table 1 - Equity Projections

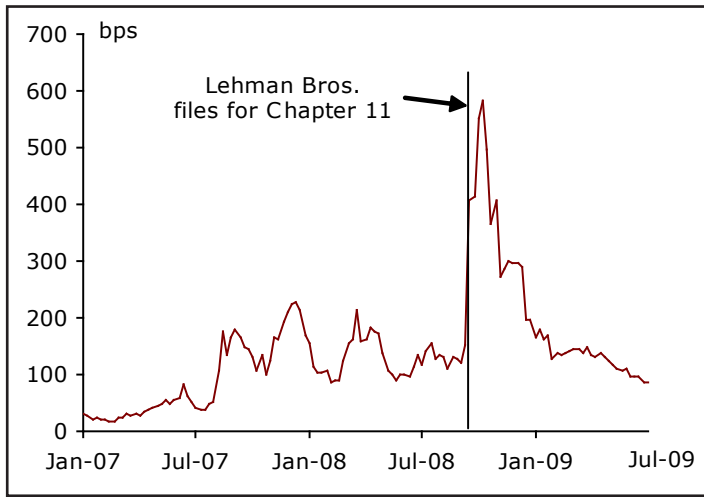
	Latest	Year-end			
		2007	2008	2009	2010
<b>TSX Composite</b>	10,375 (6/30)	13,833	8,988	10,300	12,000
% total return	17.6 YTD	9.8	(33.0)	18.4	19.7
<b>TSX Operating Earnings - index adj</b>	—	838	896	672	753
- yr/yr % chg	(33.3) (09:Q2)	11.4	6.9	(25.0)	12.0
<b>S&amp;P 500</b>	919 (6/30)	1,468	903	930	1,040
-% total return, YTD	3.2	5.5	(37.0)	5.6	14.3

Table 2 - Economic Forecast

	09Q1	09Q2	09Q3	09Q4	2008	2009	2010
<b>Canada</b>							
Real GDP Growth (AR)	-5.4	-3.1	-0.5	2.5	0.4	-2.5	1.5
Real Consumption Growth (AR)	-1.6	0.1	1.7	2.9	3.0	-0.4	1.9
CPI - Headline (y/y)	1.2	0.1	-0.5	0.5	2.4	0.3	1.2
- Core (y/y)	1.9	1.9	1.9	1.5	1.7	1.8	1.4
Unemployment Rate (%)	7.6	8.4	8.7	8.9	6.1	8.4	9.1
<b>US</b>							
Real GDP Growth (AR)	-5.5	-3.2	-0.4	2.1	1.1	-3.0	1.9
Real Consumption Growth (AR)	1.4	-0.5	-0.3	1.5	0.2	-0.9	1.3
CPI - Headline (y/y)	0.0	-1.2	-2.6	0.3	3.8	-0.9	1.6
- Core (y/y)	1.7	1.8	1.4	1.7	2.3	1.7	2.2
Unemployment Rate (%)	8.1	9.3	9.8	10.0	5.8	9.3	9.8
<b>World</b>							
Real GDP Growth (% chg)	-	-	-	-	3.2	-1.5	2.0

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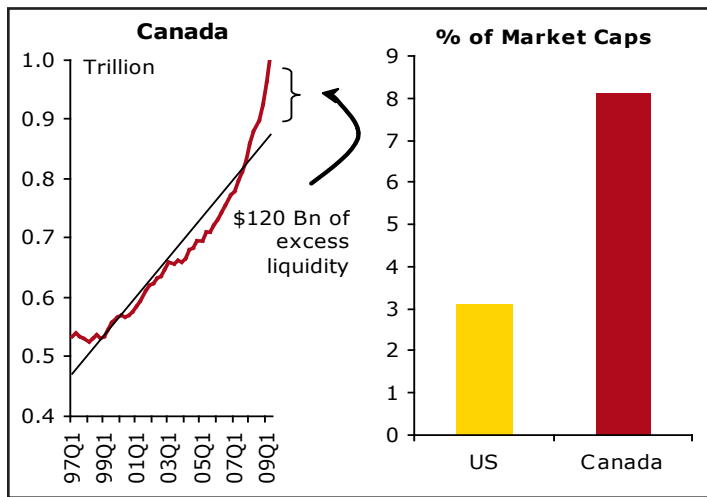
Chart 2 - TED Spread Back to Pre-Lehman Levels



### One Positive for Stocks: The Cash Factor

The spring's market rally was buttressed by added liquidity, and strong money supply growth will be supportive for stocks and related asset classes such as commodities through 2010. Liquidity levels have risen even more rapidly in Canada than in the US. Since the beginning of the crisis in mid-2007, Canadian cash balances have risen by 26%, more than twice the pace seen in the US. Relative to the normal trend, individual Canadians are now holding some \$120 bn in excess cash, a proportionately much larger pool than seen in the US. Canadian investors' holdings now represent about 8% of the TSX total market capitalization, over twice the level stateside (Chart 3).

Chart 3 - Excess Liquidity Among Individual Investors



Canadian firms have also spent the last few years reducing balance sheet leverage, contributing to high liquidity levels in the corporate sector as well. The average liquidity ratio—or value of cash and marketable securities to short-term debt—is currently about 90%. Stateside, the figure is 36%. The materially higher Canadian figure reduces the sensitivity to recessionary financial strains. It also means Canadian firms are well positioned to tap into capital markets to boost sales and profits in the future, when the economy turns.

Our econometric analysis suggests that stock market performance historically in Canada has been most strongly tied to broader measures of money supply growth, namely M2, a metric that includes currency outside the banks and most term deposits. A 10%

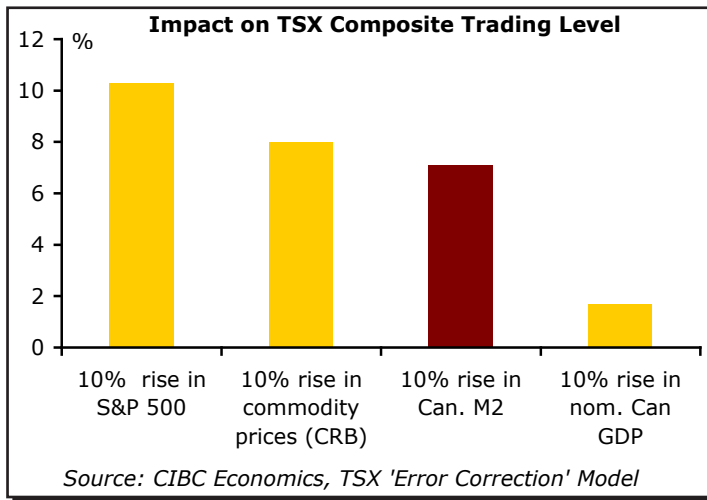
Table 3 — Valuations & Earnings Growth by Sector

	4-Qtr Fwd	Index Level	Forward PE		TSX Op. Earnings (% chg)			
	Earnings		Current	Last Decade	2007	2008	2009 (f)	2010 (f)
Energy	131.0	2522	19.3	12.0	7.4	49.8	-54.8	15.5
Health Care	20.6	276	13.4	22.0	-37.1	-16.8	18.6	0.4
Financials	103.9	1390	13.4	12.0	13.9	-18.2	-8.8	8.3
Consumer Discretionary	63.8	812	12.7	15.7	27.6	0.6	-16.9	3.3
Consumer Staples	127.5	1483	11.6	17.8	0.8	6.0	16.3	9.0
Telecommunications	77.0	642	8.3	29.8	33.1	-6.6	13.5	-3.0
Materials	121.4	2537	20.9	28.9	24.8	14.1	-19.9	36.3
Utilities	101.2	1489	14.7	17.4	25.9	-65.3	143.6	10.0
Industrials	63.7	950	14.9	14.9	9.7	24.8	-30.8	0.4
Info Tech	24.7	282	11.4	44.5	82.7	28.2	32.3	19.5
<b>TSX Composite</b>	<b>685.6</b>	<b>10375</b>	<b>15.1</b>	<b>16.1</b>	<b>11.7</b>	<b>6.9</b>	<b>-25.0</b>	<b>12.0</b>

Note: Indexes as of June 30th close; 4-qtr fwd earnings are proj. 09:Q2 thru 10:Q1

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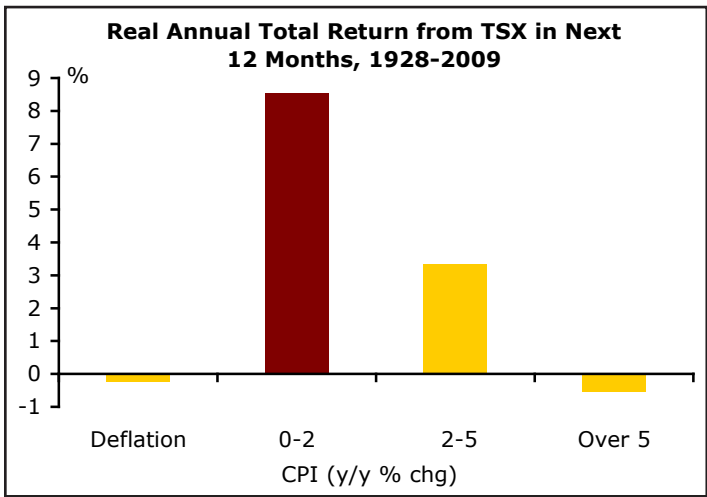
**Chart 4 - TSX Sensitivity to Money Supply And Other Factors**



rise in M2, typically lifts the equilibrium target level for the TSX by over 7% (Chart 4), with the full effect taking a bit over two years to achieve. By that line of reckoning, the 23% rise in M2 money supply since the crisis intensified in mid-2007 has accounted for nearly 1,000 points of the TSX's recent climb, with potential room for more as central bankers keep their foot on the gas.

Inflation is a further critical variable for both bonds and equities. The meltdown in the CPI in Canada and the US has been narrowly based on energy and food prices. There is no sign of broadly based deflationary pressures in the more critical core component. We expect headline inflation in both countries to begin to edge back up this fall, as growth turns and sky-high year-ago gas prices drop out of the measurement base.

**Chart 5 - Low, But Positive Inflation Boosts Real Returns**

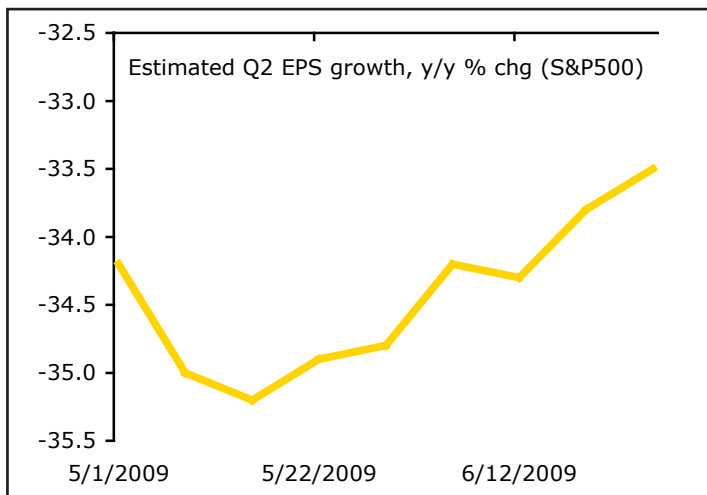


When it comes to inflation, the Goldilocks rule applies: not too hot, and not too cold, ends up being just right for real returns on stocks (Chart 5). In particular, a gradual re-inflation from low levels has provided the ideal climate for expanded production and positive margin effects, since wages tend to lag behind rising product prices. That's the scenario we believe is likely over the next 12-18 months.

### Earnings: Less Ugly

The good news south of the border is that the earnings picture is looking a bit less ugly (Chart 6). Analysts have been lifting their estimates for both the present year and upcoming quarter. That comes after the slightly better-than-expected performance of S&P 500-member earnings in Q1.

**Chart 6 - US Earnings Projections Are Improving**



The same trend in revisions isn't, as yet, in evidence in Canada. The "bottoms-up" analysts' consensus now expects TSX earnings to fall by 27% this year. That's a sobering number, as we've noted previously, but less severe than the 80% drop incurred in the debilitating 1990-91 recession, when a runaway currency slammed exporters, a risk that looks less likely after the recent cooling off in the C\$. The consensus is also now slightly more pessimistic than our own "top-down" call. While year-on-year earnings growth for the TSX Composite is unlikely to show a positive handle until Q4, matching the consensus call for a 33% dropoff in Q2 would

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nonetheless represent an improvement over Q1's 43% year-on-year decline, the probable low point for the current cycle.

### Where the Growth Lies

Canadian stocks tied to American economic performance got a slap in the face from June's larger-than-expected 467,000 US non-farm payrolls decline, and the even more dire picture for total hours worked. That was consistent with our view that subsequent data will show that the consensus was overly optimistic in expecting a drop of 2% or less in US Q2 GDP, and that the third quarter could still see a marginal further dip. While the latest S&P Case Shiller numbers suggest the housing sector's drag on household wealth is starting to ease a bit, June's quarter-century-high jobless rate is yet another sign that consumers are unlikely to return to their earlier free-spending ways any time soon. That will limit the initial pace of recovery when the economy does turn, crimping consumer stocks, including TSX-listed firms with US retail exposure.

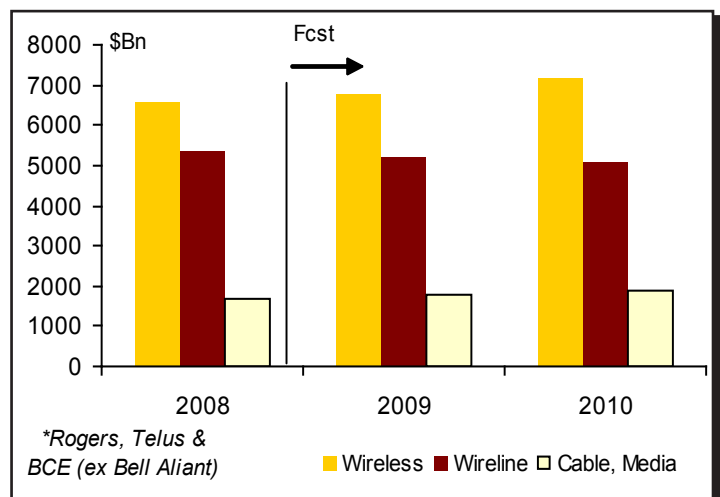
Instead, it's East Asia that still looks to us to have the greatest potential to surprise to the upside. Given the heavy commodity use associated with that region's growth, its turn is a clear plus for highly resource-levered stock markets such as the TSX. After deep cuts over the fall and winter, growth expectations for 2009 and 2010 for many countries have been upgraded recently, in the wake of recent strong gains in industrial production.

All countries have been impacted by the recent crisis, but what the proponents of a tightly coupled world economy may be overlooking is the varying capacity of different countries for remedial action. China's stimulus program, at some \$585 billion, is the largest in terms of economic size of any leading industrial power. Although recession elsewhere has cut exports, strong gains in both retail sales and fixed asset investment suggest that policies to encourage domestic demand to counter trade-centred slack are achieving some success. That's helped lift year-on-year industrial growth from a cyclical low of 5% to almost 9% recently, and suggests that GDP growth could attain the official 8% target in 2009. Japan's economic prospects are by no means as bright as China's, but expectations there are now for 2-3% GDP growth in Q2 after a precipitous retreat the quarter before. While that still leaves production far below year-ago levels, factory activity in other economies like Korea and Taiwan has reclaimed most of the earlier decline.

### Adding Weight to Telecoms, Paring Fertilizer Exposure

While our broad equity weighting is unchanged from last month, we've upgraded the telecom services group to a modest overweight. Multiples in the sector remain relatively affordable in historical terms and the four largest players all surprised to the upside in the latest earnings reporting quarter. Wireless data represents the largest area of growth (Chart 7). While it's not immune to the recession, the sharper-than-warranted decline in wireless valuations on such concerns has created a buying opportunity. Changes in industry structure, including already high levels of saturation in major urban markets, will at the same time help to limit the challenge to incumbents' growth from newly licensed AWS carriers.

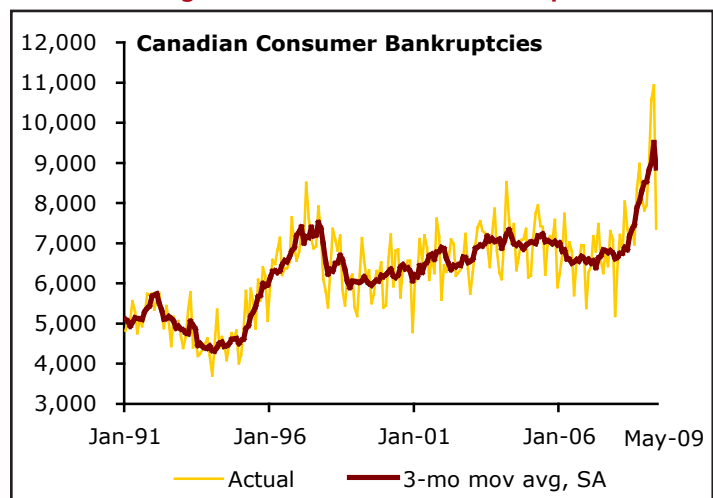
**Chart 7 - Wireless/Media Will Continue to Drive Telecom EBITDA Growth\***



Source: CIBC Equity Research

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Chart 8 - Rising Canadian Consumer Bankruptcies



Offsetting that move, we are trimming our weighting in the agricultural chemicals group by a half-point. Longer term fundamentals remain positive, including changing emerging market diets and the general pressure for higher crop yields due to arable land constraints. Declining volumes are, however, continuing to weigh on nearer-term earnings and revenue prospects for key Canadian producers. The potential for ongoing negotiations to settle at a contract price for potash below last year's US\$625/tonne, heightens nearer-term revenue risks.

Although the financial sector has modestly outperformed the TSX to date in 2009, we are staying with our market weighting of the sector. Aided by lower leverage levels, more conservative attitudes toward risk taking and differing regulatory

framework, Canada's financial system has by all accounts weathered some exceptionally difficult times relatively well, in contrast to the extraordinary upheavals south of the border and in some European markets. But even here, banks face higher loan loss provisions tied to the deteriorating credit environment. Momentum for Canadian financials could also be stalled by a correction in their US counterparts, as surprising resilient Q1 earnings reports from American financials may have built in too much optimism about the sector's ability to rapidly turn the page on recent troubles. US regional banks are also exposed to the spillovers from the commercial real estate sector's deepening troubles, which could restrain valuations placed on the US-retail subsidiaries of Canadian banks.

Given the changes in global resource consumption patterns, we continue to believe that selected resource stocks, like the base metals segment, will offer the best vehicle for playing an Asian-led global recovery. Some of the recent rise in China's metals imports reflects restocking. Not all of those supplies, however, are likely to find their way back onto global markets soon and other factors point to firm underlying demand. That includes the recent solid snapbacks in auto sales and real estate sectors, in addition to infrastructure spending plans focused on grid and rail networks.

We are also retaining our previous neutral recommended weighting for the energy group. The recent narrowing in heavy-light crude differentials is a notable plus for Canadian producers given that nearly half of Canada's conventional production is heavy. We also believe that a strong resilient market for upstream properties, tied to efforts by emerging markets to lock in supplies, will continue to support valuations. Oil and gas M&A activity is one of the few areas that is presently up on year-earlier levels (Chart 9). Tempering these prospects is the potential for a further correction in crude prices on demand-related weakness and heavy inventories. OECD industry

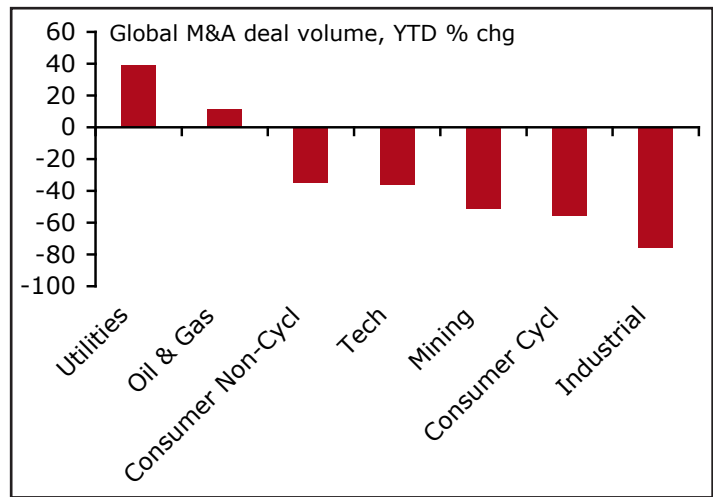
Table 4 — Commodity Price Forecast

		Average					
		30-Jun	2006	2007	2008	2009 (f)	2010 (f)
Oil (WTI)	\$/bbl	70	66	72	100	60	70
Natural Gas (Henry)	\$/Mn Btu	3.70	6.73	6.97	8.89	4.00	5.00
Gold	\$/troy oz.	935	604	695	872	1000*	1100*
Copper	\$/lb	2.25	3.06	3.24	3.16	2.40	2.85
Aluminum	\$/lb	0.73	1.17	1.20	1.17	0.75	0.85
Nickel	\$/lb	6.95	10.98	16.86	9.57	6.75	7.50
Zinc	\$/lb	0.69	1.48	1.48	0.85	0.75	0.90

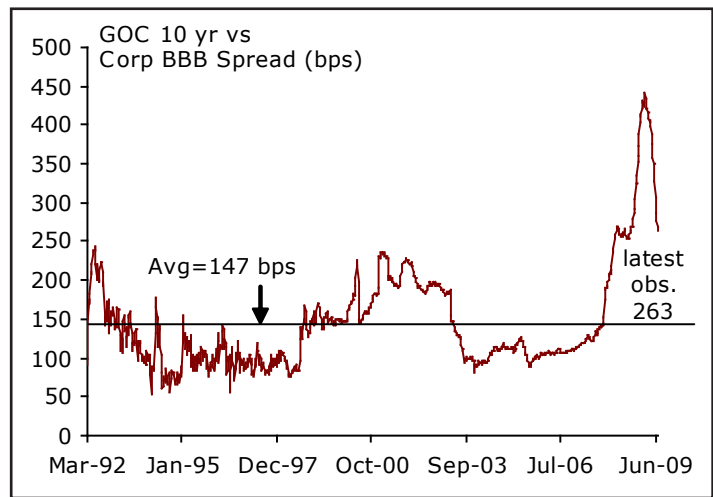
\* end of period

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**Chart 9 - Oil and Gas a Rare Area of Increased M&A Action**



**Chart 10 - Corporates Could Have More Room to Rally**



stocks are up 7.5% from year-ago levels. Natural gas prices have fallen by over 70% in the last year, and continuing high inventories heighten the risk that fuel will continue to trade at an unusually hefty Btu discount. Oil-centred equities may therefore be a better medium-term bet.

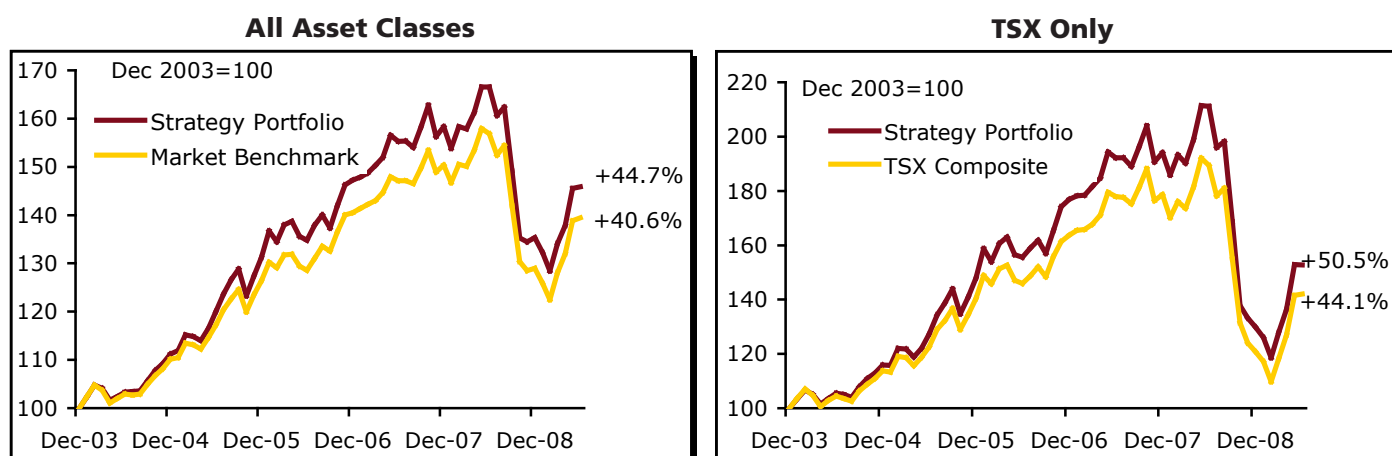
We added weight to bonds last month at the expense of cash, viewing the front end of the curve as having priced in a sequence of rate hikes well ahead of reality. As markets pushed back rate hikes until much further into 2010, oversold two-year government bonds staged a fairly impressive relief rally in the last three weeks of June. Mid-term bond yields could be dragged lower as investors shift from the now-lean 1- to 2-year part of the curve, but again, only the nimblest of market timers would go overweight bonds to catch what could be a one-quarter move for government bonds. Corporate bonds may have more enduring upside (Chart 10), even if spreads never return to unreasonably tight pre-recession levels. Although the narrowing trend could temporarily stall in view of economic concerns, spreads have room to narrow in 2010 as the economy recovers, and Canadian corporate balances sheets are in better shape than a decade ago. Moreover, some of the excess retail investor cash looking for better yields is beginning to shift into the corporate debt space.

**Table 5 - Fixed Income & Exchange Rate Projections**

	Jun 30/09	Sep 30/09	Year-End		
			2007	2008	2009
B of C Overnight Target (%)	0.25	0.25	4.25	0.25	0.25
2-Year GOC	1.21	1.05	3.75	1.21	1.15
10 Year GOC	3.36	3.05	3.99	3.36	3.35
30-Year GOC	3.86	3.70	4.10	3.86	4.00
S&P TSX Cdn Bond Index (% YTD total return)	-1.8	0.8	3.8	11.8	0.3
<i>Fed Funds</i>	0.25	0.25	4.25	0.13	0.25
<i>10-Year US Note</i>	3.54	3.35	4.03	2.10	3.65
<i>C\$ in US cents</i>	86.0	84.0	100.2	78.7	87.0
<i>US\$/EUR</i>	1.40	1.32	1.46	1.29	1.35
<i>Yen/US\$</i>	96	98	112	93	97

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**PERFORMANCE OF STRATEGY PORTFOLIO VS BENCHMARK**



<sup>(1)</sup> Total return for the recommended portfolio is the index return multiplied by the individual asset mix or sector weight recommended by Economics & Strategy. Recommended portfolio weights for the current month appear in the front table.

**HISTORICAL PERFORMANCE: CIBC WM BENCHMARK AND ASSET CLASSES**

Asset Classes	Total Return (%)*		
	2008	2009 YTD	Last 3 Mos.
Stocks (TSX Composite Total Return Index)	-33.00	17.56	19.97
<b>-Strategy Equity Portfolio</b>	<b>-32.44</b>	<b>17.57</b>	<b>19.37</b>
Bonds (Bloomberg Cda Bond Index)	11.77	-1.78	-2.29
Cash (1-Month Bills)	2.27	0.19	0.05
Total Market Benchmark(2)	-13.79	8.14	-3.99
<b>-Total Strategy Portfolio</b>	<b>-14.17</b>	<b>7.75</b>	<b>8.71</b>
<b>TSX Stocks by Sector (Total Return) (3)</b>	<b>2008</b>	<b>2009 YTD</b>	<b>Last 3 Mos.</b>
Consumer Discretionary	-35.41	2.41	10.72
Consumer Staples	-6.08	2.69	9.45
Energy	-33.88	21.39	21.62
Financials	-36.45	26.29	34.54
-Banks	-31.43	38.70	34.47
-Insurance, REITS, others	-42.37	8.21	12.69
Health Care	-30.15	12.60	8.00
Industrials	-25.06	5.19	17.21
Info Tech	-54.18	55.92	43.31
Materials	-26.48	12.43	4.27
-Gold	4.32	-1.64	3.72
-Other Metals	-63.19	94.61	28.20
-Chemicals	-40.63	19.14	4.70
Telecom	-24.85	-8.34	-0.97
Utilities	-20.46	1.37	15.04

\*as of June 30/09

<sup>(2)</sup> Market benchmark weight is the actual mix for stocks, bonds and cash held by the broad base of pension funds, segregated funds, mutual funds and insurance companies. This totals about \$1 trillion of which pension and mutual funds are the biggest (45% & 37%) with life insurance and segregated funds at 11% & 7% respectively. The cash, stock and bond breakdown varies significantly among the 3 basic components such that the benchmark for any of the 4 categories may vary significantly from the published aggregate (eg. equities can vary from 10% for life companies to 75% for the other 3 categories). Data is Statistics Canada/Bank of Canada published data updated to current based on correlation analysis from the most recent partial actuals. The total return for the index will differ slightly from the summed weighted return for the sectors due to the weight shifts on a day-to-day basis.

<sup>(3)</sup> Equities by GICS sector benchmark weights are TSX data. Sector index levels are total returns.

## EQUITY RESEARCH

## TSX SECTORAL VIEWS BY FUNDAMENTAL EQUITY RESEARCH ANALYSTS FOR JULY 2009

**Consumer Discretionary – B. Bek**

The potential for cyclical upside in an advertising recovery is significant, especially from historically low valuation levels (**Bek: Communications & Media – Market Weight**). We believe data growth can more than absorb the pressures from the legacy components of the story, such as voice ARPU declines, slower subscriber growth, and increased low-end competition (**Bek: Telecommunication & Cable – Market Weight**).

**Consumer Staples – P. Caicco**

The discount food segment is benefitting from the current economic weakness and consumer trade-down effect. But if execution slips, performance could suffer when consumers regain confidence (**Caicco: Merchandising & Consumer Products – Market Weight**).

**Energy – W. Lee, M. Bridges, B. Borggard, J. Fetterly & R. Pare**

While valuations will likely be range-bound in 2009, we remain positive from a long-term perspective given market optimism for a commodity recovery in H2/2009 or early 2010. In addition, we have been seeing indications that declines in global oil demand are bottoming. US demand destruction has slowed considerably and has likely seen its lows. In addition, we have seen early industrial improvements in China, prompting the Energy Information Administration (EIA) to increase its demand outlook for the first time since August 2008 (**Lee: Oil & Gas – Large Cap- Market Weight**). We believe the significant weakness in commodity prices (especially natural gas) combined with the reduced access to external capital have created one of the most challenging operating environments for E&P companies in recent memory. As a result, we believe 2009 is poised to be one of the weakest years on record for the oilfield services sector, with the pullback in activity surpassing the downturns of 2007, 2002 and 1999 and approaching levels not seen since the early 1990s (**Fetterly: Energy Equipment Services – Market Weight**). At current levels, we believe the junior group is discounting WTI oil prices of US\$63.50/Bbl and AECO gas prices of \$4.25/Mcf today—approximately 13% below the 12-month futures strip price. We remain cautious on near-term AECO gas prices until clearer signs of improvement in demand emerge (likely in 2010). We continue to expect a fundamental supply/demand imbalance in the US, upwards of 2 Bcf/d year over year. In addition, with declining demand in Asia, the risk of increasing US LNG imports remains a threat to North American natural gas prices. On the oil side, the recent rally in WTI prices is partially explained by the weakness in the US dollar, along with the sharp decline in crude inventories since peaking in early May (**Bridges, and Borggard: Oil & Gas Junior E&P – Market Weight**). Trading at a 2010E EV/DACF multiple of 3.7x (vs. cycle peak >6.0x and compared to the junior E&P group at 4.6x and the royalty trusts at 6.5x) and a P/NAV multiple of 0.9x (cycle peak >1.0x, junior E&P group at 0.7x and royalty trusts at 0.8x), we continue to believe that the value proposition offered by the international group is compelling, particularly factoring in the relative risk/reward growth proposition and free option on exploration upside (**Pare: International E&P – Market Weight**).

**Financials – D. Mihelic, R. O'Reilly, A. Avery**

Canadian banks have reported better-than-expected Q2/09 results, which were driven by very strong trading revenues. Though we do not expect these spectacular trading revenues to be sustainable in the long run, we believe they will remain strong going into the second half of the year, due to market volatility and certain structural changes in Canada. Core earnings, on the other hand, were dented by higher-than-expected Provisions for Credit Losses (PCLs) and lower other income, in general (**Mihelic: Banks & Lifecos – Market Weight**). Shopping center and apartment REITs will benefit from the inherent strengths of their property asset classes, which have sustained them through past economic recessions with relative stability. Canadian

## EQUITY RESEARCH

## TSX SECTORAL VIEWS BY FUNDAMENTAL EQUITY RESEARCH ANALYSTS FOR JULY 2009

shopping center REITs' high degree of concentration in unenclosed and community power centers afford them a high degree of protection since these centers: 1) tend to sell basic necessities (groceries, hardware, fast food, discount items) rather than fashion and other discretionary merchandise, which are sold in regional malls (now mostly owned by pension funds); and, 2) collect contractual fixed rents rather than rents based on tenant sales **(O'Reilly and Avery: Real Estate – Overweight)**.

**Industrials – M. Willemse, J. Bout, C. Murray**

Investors should keep in mind that North American light vehicle production volumes at the Big Three have been trending well below North American light vehicle sales since November 2008 (by approximately 30% on average). We estimate North American light vehicle production in Q2/2009 will trend approximately 38% below North American light vehicle sales, suggesting inventories should decline significantly in Q2/2009 and that inventory destocking should be ending in Q2/2009 or Q3/2009. As a result, vehicle production volumes should begin to ramp up again in Q4/2009 **(Willemse: Automotive – Market Weight)**. While the steel sector is currently in the midst of the worst industry downturn in decades, some initial signs of stabilization may emerge over the next few months. The steel industry will likely remain challenging into 2010; however, we expect end-market demand will at least improve over 2009 **(Willemse: Steel – Market Weight)**. Global PV installations are expected to decline 32% to 3.5 GW in 2009 versus 5.2 GW in 2008. In addition, average selling prices are expected to decrease 12%, negatively impacting industry revenues, which are expected to fall 40.2% to \$18.2 billion versus \$30.5 billion in 2008 **(Willemse: Solar – Market Weight)**. The collapse in commodity prices, particularly oil and base metals, has been a drag on the heavy equipment sector with large capital budget projects now being put on hold indefinitely or cancelled. Greenfield mining projects (especially in the Alberta oil sands) are no longer economic and brownfield projects are hovering near cash-cost levels. Government stimulus packages, including large infrastructure spend components, remain the bright spot for the heavy equipment group **(Bout: Capital Equipment – Market Weight)**. There may be signs that railroad volumes have bottomed, with the rate of decline moderating over the past three to four weeks, but we do not expect carloads to recover from current levels until later in H2/2009 **(Bout: Railroads – Market Weight)**. Our sector weighting reflects weak consumer spending but lower fuel costs continue to help preserve margins. Aggressive capacity management strategies by airlines help offset falling demand. We expect traffic and revenue trends to continue to be constrained by the weak economy and now also by concerns over the swine flu outbreak **(Murray: Airlines – Market Weight)**.

**Information Technology – P. Lechem, T. Coupland**

With organic growth likely under pressure due to the macro environment and with valuations declining to attractive levels, we expect consolidation in the sector to accelerate. Valuations appear reasonable, with the sector trading towards the lower end of the trailing five-year average **(Lechem: Technology-Software – Market Weight)**. Our Market Weight sector weighting reflects the balance between economic/financial/commodity risks and ongoing infrastructure spending. We remain cautious on this latest recovery leg. The sector appears vulnerable to further sell-offs **(Lechem: Business and Professional Services – Market Weight)**. 2009 will be a difficult year for most segments, with pockets of growth in wireless backhaul, MSO capex for analog reclamation and HDTV services, and intelligent networking. The technology sector is cash rich with no debt. Many valuations are attractive in spite of robust growth prospects for 2009 **(Coupland: Technology Hardware – Market Weight)**.

## EQUITY RESEARCH

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**Materials – J. Bout, B. Cooper, J. Lethbridge, I. Parkinson**

Multiples for gold companies have been rebounding following the precipitous drop to historical lows in Q4/2008. Evidence points to rising multiples for general markets and we expect that this will apply to gold shares as well (**Cooper: Mining, Precious Metals – Overweight**). Market Weight sector weighting is based on a belief that metals are already pricing in a cyclical trough. The supply adjustments and low inventories should offset slower demand (**Parkinson: Mining, Metals and Minerals – Market Weight**). As chemicals demand is typically more economically sensitive, we expect a rebound in buying to be pushed out until 2010. We expect demand for fertilizers to pick up by mid-2009 (**Bout: Chemicals & Fertilizers – Market Weight**). We rate the paper & forest products sector as Underweight because most pulp, paper and packaging prices continue to trend lower as the global economy slows. However, weakening energy, fiber and chemicals prices and the lower Canadian dollar are mitigating, to some extent, lower selling prices and weakening demand. We think building materials prices will hover around cash costs until mid-2010 until excess inventories in the US housing market are depleted. Although most solidwood companies have strong balance sheets, the cash burn rate for most of them remains high. Given declining demand, we expect that rationalization throughout the forest products sector will continue (**Lethbridge: Paper & Forest Products – Underweight**).

**Pipeline, Utilities & Power – P. Panarites**

Relative strength has returned to the pipelines/utilities in recent days, following, in weeks prior, the collapse of credit spreads and a strong (perhaps too strong) run in higher beta areas of the market. Nevertheless, valuations in the group remain extraordinarily low from a historical standpoint and we continue to see exceptional risk/reward (**Panarites: Pipeline, Utilities & Power – Overweight**).

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\* "We have compiled our analysts' views in accordance with the TSX sectoral breakdowns. We would note, however, that an analyst's coverage universe might not correspond exactly with the constituents of the TSX sectors noted above. As such, we refer readers to **CIBC World Markets "Canadian Research Review and Common Stock Universe"** publication where each analysts' specific universe is broken out. Analyst weightings are based solely on the specific constituents of that analyst's universe and might not correspond with the constituent in the TSX sector breakdowns."