



Economics

Avery Shenfeld
(416) 594-7356
avery.shenfeld@cibc.ca

Benjamin Tal
(416) 956-3698
benjamin.tal@cibc.ca

Peter Buchanan
(416) 594-7354
peter.buchanan@cibc.ca

Warren Lovely
(416) 594-8041
warren.lovely@cibc.ca

Meny Grauman
(416) 956-6527
meny.grauman@cibc.ca

Krishen Rangasamy
(416) 956-3219
krishen.rangasamy@cibc.ca

"... the number of Canadians truly at risk could be substantially less than the BoC's estimate."

Little Rates, Big Problems?

by Avery Shenfeld

Are low interest rates curing one problem only to set us up for another? Having slashed rates to record lows to forestall a depression, the Bank of Canada is now talking openly about the risks of putting Canadians into mortgages they won't be able to afford when rates rise, and into stocks that could tumble if profits disappoint. It was only in June that the Bank's concerns over household debt were focused on what would happen if unemployment shot higher. Now, after but a quarter of growth, the Bank's fear is about risks when good times arrive and rates move higher (but somehow not good enough times to make today's equity prices a bargain).

The BoC's analysis was a first step in assessing the risks associated with rising household debt and the decisions being taken in a period of ultra-low rates. Our more detailed assessment gets into the guts of the mortgage data rather than simply looking at a single measure, debt service-to-income ratios (see pages 3-6).

While we share the Bank's concerns, make no mistake: Canada is not doomed to see a US-style housing and mortgage blow-up, and not only for the reasons cited by the Bank of Canada, which focused on the protection afforded banks by generous capital cushions and mortgage insurance. There are three lines of defense for those with high debt-service ratios that the BoC analysis ignored: 1) some will have substantial home equity, even allowing for a house price slide, and could downsize, 2) others have high debt payments because they are making accelerated pay-downs of principal, which they could stop, and 3) history suggests that many will jump into fixed mortgages in

time to avoid the full brunt of the variable rate shock. The result is that the number of Canadians truly at risk could be substantially less than the BoC's estimate.

So the issue is less about what has already been underwritten, than about what could build in the quarters ahead as interest rates remain very low. Using the blunt instrument of interest rate hikes would make little sense. The economy still needs help, the Canadian dollar would soar to the detriment of exports if the Bank of Canada moved ahead of the Fed, and premature hikes would expose households to a rate shock before they've seen the recovery's income gains. Instead, while being careful not to unduly harm the important role housing is playing in economic growth, Ottawa and lenders could study whether further steps, akin to the recent shortening in mortgage amortizations, should be adopted to provide a greater degree of prudence in allowing for the impacts of higher rates ahead.

After all, the lessons for the US were not that an extended period of low rates caused a mortgage and housing blow-up. While Greenspan sometimes gets blamed for keeping rates too low for too long, the worst mortgage vintages were actually those dated well after rates had moved higher. It was a massive failure to supervise the worst excess of the American mortgage market that caused the trouble, and fortunately, those excesses are not yet in evidence in Canada.

As for equities, they're not cheap relative to 2010 earnings, but stocks don't discount only one year's results. A multi-year expansion ahead implies that, relative to normalized, mid-cycle earnings and dividends, equities still have upside (see pages 7-10).

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

MARKET CALL

- The US consumer upturn has been more vigorous than we would have expected, a challenge to our view that a rising savings rate would sap growth momentum. But we're still a long way from the big job gains needed to bring unemployment down on a sustained basis, and we're sticking to our view that the Fed will stand pat until early 2011. Long Treasury yields took a big step towards our higher year-end targets for 2010, but that momentum could stall if, as we expect, US growth eases off again moving into 2010.
- Canada's own growth and inflation data has also been slightly firmer than we expected in Q4, but remember, that comes after a disappointing Q3, and some of the strength reflects an inventory swing that will fade next year. If the last three-month average of 25,000 jobs per month is representative of what lies ahead (rather than the more heated November gain), the Bank of Canada could be more patient than the market expects.
- Christmas came early for the US dollar, as the correction we expected to see in its favour in early 2010 already seems to be underway. That's been driven by a return to normalcy in the response of currencies to healthy economic data (see page 11). The loonie will hold in a bit better than some given its own decent growth reports, but we've opened up a bit more room for euro weakening in Q1.

INTEREST & FOREIGN EXCHANGE RATES

END OF PERIOD:	2009	2010	2011				
	17-Dec	Mar	Jun	Sep	Dec	Mar	Jun
CDA Overnight target rate	0.25	0.25	0.25	0.25	0.25	1.00	1.75
98-Day Treasury Bills	0.19	0.25	0.30	0.30	0.30	1.15	1.90
2-Year Gov't Bond	1.29	1.10	1.20	1.40	1.60	2.10	2.35
10-Year Gov't Bond	3.37	3.35	3.40	3.85	3.95	4.00	4.05
30-Year Gov't Bond	3.97	3.95	4.00	4.30	4.35	4.35	4.40
U.S. Federal Funds Rate	0.25	0.25	0.25	0.25	0.25	1.50	2.25
91-Day Treasury Bills	0.05	0.15	0.20	0.25	0.35	1.70	2.25
2-Year Gov't Note	0.76	0.90	1.10	1.30	1.65	2.20	2.45
10-Year Gov't Note	3.49	3.45	3.60	4.20	4.35	4.45	4.45
30-Year Gov't Bond	4.42	4.40	4.65	5.00	5.00	5.05	5.05
Canada - US T-Bill Spread	0.14	0.10	0.10	0.05	-0.05	-0.55	-0.35
Canada - US 10-Year Bond Spread	-0.12	-0.10	-0.20	-0.35	-0.40	-0.45	-0.40
Canada Yield Curve (30-Year — 2-Year)	2.68	2.85	2.80	2.90	2.75	2.25	2.05
US Yield Curve (30-Year — 2-Year)	3.66	3.50	3.55	3.70	3.35	2.85	2.60
EXCHANGE RATES							
CADUSD	0.934	0.901	0.943	0.971	1.000	0.990	1.000
USDCAD	1.070	1.110	1.060	1.030	1.000	1.010	1.000
USDJPY	90	94	93	90	87	86	86
EURUSD	1.43	1.39	1.41	1.44	1.47	1.48	1.50
GBPUSD	1.62	1.58	1.61	1.66	1.69	1.69	1.71
AUDUSD	0.887	0.870	0.925	0.960	1.000	0.990	0.995
USDCHF	1.05	1.08	1.06	1.03	1.02	1.01	1.00
USDBRL	1.78	1.80	1.75	1.70	1.68	1.65	1.64
USDMXN	12.9	14.0	13.5	13.0	12.5	12.3	12.3

Canadian Mortgage Debt—A Closer Look

Benjamin Tal

In a remarkable turnaround the Canadian housing market has swung from a buyers’ market earlier in the year, back into today’s sellers’ market. With cheap credit fueling mortgage activity, the Bank of Canada is now fearing that this might be too much of a good thing. How big is the mortgage debt problem in Canada? Let us take a closer look.

House Prices—Some Overshooting

Over the past two years the degree of volatility observed in the Canadian housing market has been unprecedented. Within this short time frame, house prices fell by almost 13%, only to rebound by an impressive 21%¹. Meanwhile, resale activity is now rising by close to 67% on a year-over-year basis after falling by close to 40% in 2008. Housing starts are presently 33% higher than in April 2009 despite dropping by more than 50% earlier in the recession. In fact, no other segment of the economy has rebounded as fast as the housing market, making it one of the real surprises of this recession.

This rapid uptick in housing activity, in the face of recessionary conditions elsewhere in the economy, raises concerns about its sustainability, and is causing some to wonder whether house prices are in fact rising too quickly given current economic fundamentals. Using a recent IMF housing valuation model² as a base, and updating

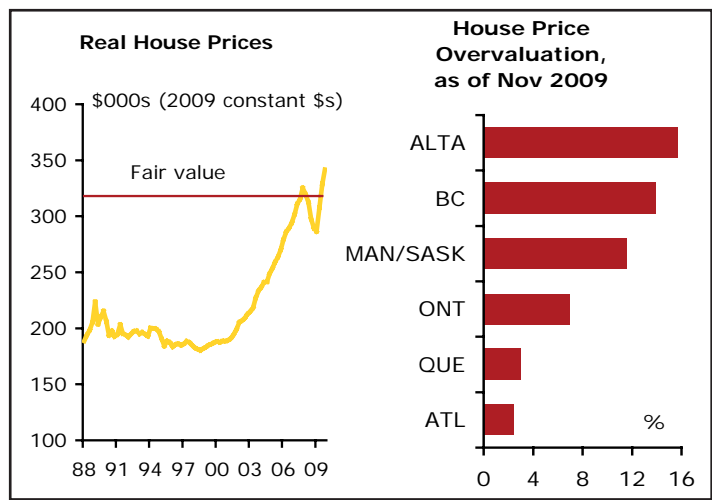
it to reflect the most recently available Canadian data (November 2009), we estimate that the Canadian housing market as a whole is indeed beginning to overshoot its “fair value”. At just under \$350,000, the current average price of a home is estimated to be roughly 7% over what would be consistent with current housing market fundamentals such as interest rates, income growth, rents and demographics. However, that modest overshooting is far from uniform across the country. Those figures are skewed to western Canada, which has seen the most dramatic swings in house prices over the past 24 months. That market now appears to be overvalued by roughly 10-15%, suggesting that the imbalance in the rest of the country is much more modest (Chart 1).

Note, however, that overvaluation does not necessarily mean a bubble or a dramatic price correction. Given that the current overvaluation is occurring in a context of historically low interest rates, what we are most likely witnessing is a temporary period of exuberance that is “borrowing” activity from the future, as households take advantage of lower rates and accelerate their borrowing and home purchasing activities.

To the extent that current activity is simply a redistribution of sales from the future to the present, the housing market of tomorrow may be in store for a more muted level of activity. Housing starts will also catch up with the sudden spurt in demand, with the increase in supply helping to moderate price trends. Rather than plunging, house prices are more likely to stagnate in coming years (or fall modestly in the most overheated markets) as fundamentals catch up with a market that has gotten ahead of itself.

Chart 1

Canadian House Prices Starting to Overshoot

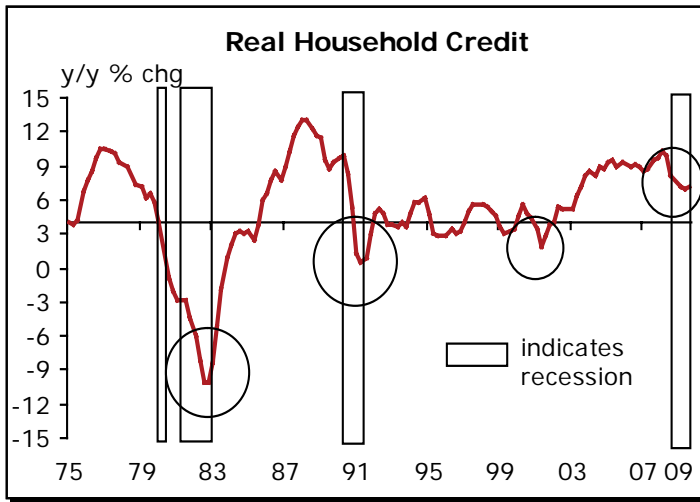


Source: CREA, IMF, CIBC

What Worries the Bank?

Rather than house prices, it is the accelerated pace of borrowing at very low rates that is beginning to raise some concerns at the Bank of Canada. For the first time in the post-war era, real household credit³ continued to expand through a recession (Chart 2). In fact, mortgage credit is now rising at a year-over-year rate of more than 7%. This strong performance is a clear reflection of an extremely effective monetary policy in Canada. With Canadian consumer confidence only ten points below

Chart 2
Credit Continued To Expand During the Recession



Source: Statistics Canada, CIBC

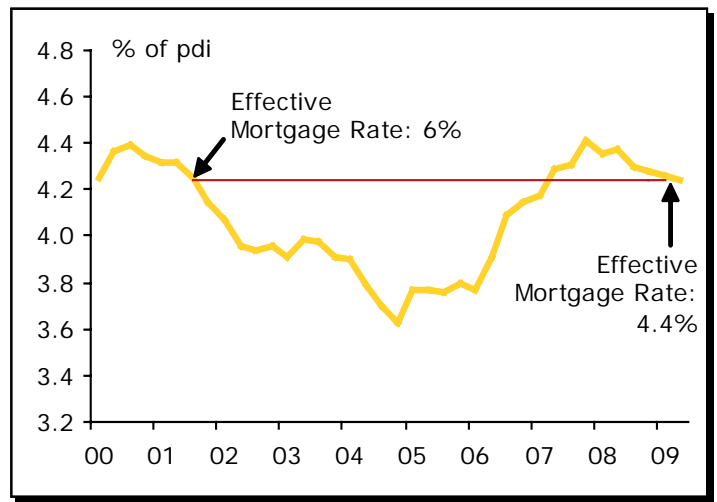
its pre-recession level (versus a 50% decline in the US), Canada is benefiting not only from properly functioning credit channels, but also from a household sector that is able and willing to take on new credit. Remember, low rates only work as an economic stimulus if Canadians take advantage of them.

The wave of borrowing does, however, have consequences in terms of consumer debt levels. The household debt-to-income ratio is now at a new all-time high of more than 140%. Despite a record low 4.4% effective mortgage rate, overall mortgage interest payments as a share of after tax income, are now at levels that in the past were consistent with a 6% effective mortgage rate (Chart 3). Since rates will no doubt at some point return to those higher levels, the Bank of Canada is worried that Canadians are making themselves increasingly more vulnerable in terms of their ability to continue to service these new, higher debt loads.

How Big is the Problem?

The relevant question, however, is just how serious a problem it is becoming, and here we have to dig a bit deeper to get the answers. Aside from an unlikely scenario of a 1970s-type stagflation, any future increase in interest rates will be in response to an improving economy. Thus any analysis of the potential impact of higher rates on the household sector in general, and the housing market in particular, should be done with tomorrow's healthier economy in mind.

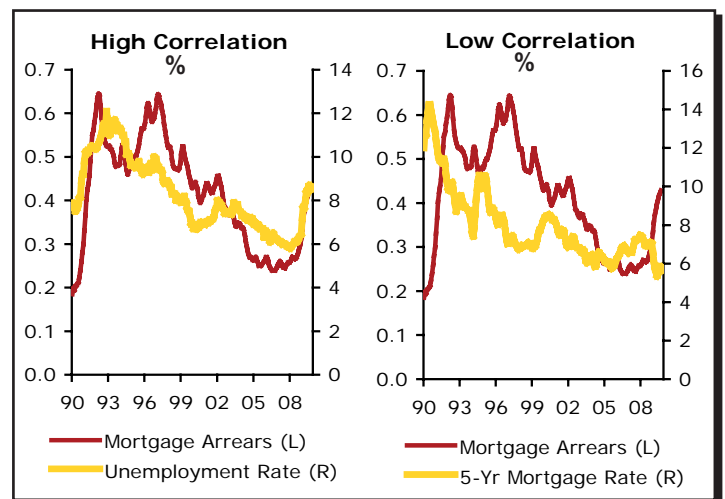
Chart 3
High Debt Service Ratio Despite Record Low Mortgage Rates



Source: Statistics Canada, CIBC

After all, the reality is that in the past, interest rates have played only a minor role in driving mortgage default rates. Historically, it's clear that mortgage arrears rates are highly correlated with the unemployment rate, with little or no correlation with changes in interest rates (Chart 4). The same goes for the economy in general. Over the past three decades, personal bankruptcies have risen twice as fast in an environment of falling interest rates than in an environment of rising rates (Chart 5). And the logic here is obvious. Interest rates rise when the economy

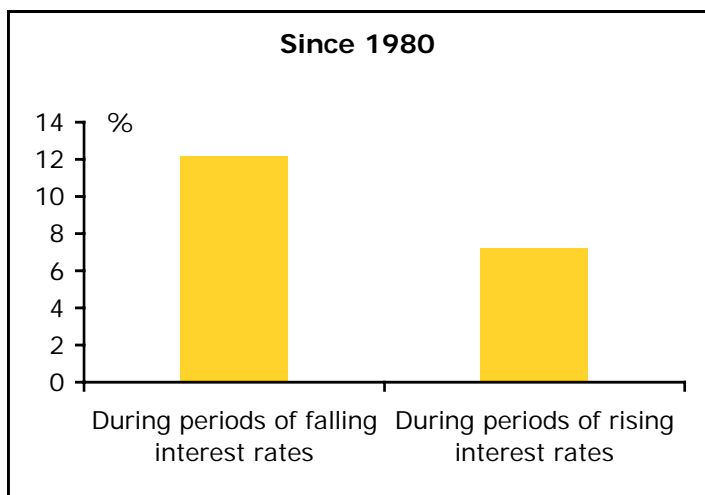
Chart 4
Mortgage Arrears Influenced Mostly by Unemployment, Not by Interest Rates



Source: Statistics Canada, CIBC

Chart 5

Average Annual Chg in Consumer Bankruptcies



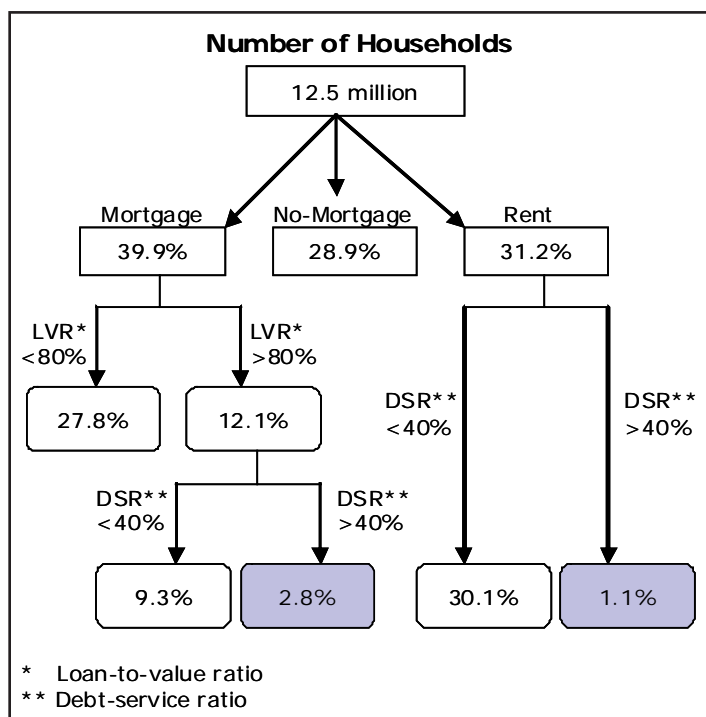
Source: Statistics Canada, CIBC

recovers, and the benefits to employment and incomes of an improving economy easily offset the sting of higher interest rates on debt service costs.

But the line of defense goes well beyond an improving economy. In its latest "Financial System Review" the Bank of Canada estimated that at present, 5.9% of all

Chart 6

A Closer Look at the CDN Mortgage Market



Source: CMHC, Ipsos Reid's CFM, Statistics Canada, CIBC

Canadian households are vulnerable to rising interest rates since their debt-service ratio (DSR) exceeds 40% (i.e. debt payments account for more than 40% of their household gross income). The Bank also estimated that the share of households with a 40%+ DSR would climb to 8.5% by 2012 if interest rates rise by 300 basis points.

However, focusing on a borrowers' debt-service ratio with no reference to the underlying asset that they hold can be misleading. In fact, many households with a DSR greater than 40% have already accumulated a significant amount of equity in their house, and therefore have the option to downsize and reduce their debt overhang if their mortgage payments stop becoming manageable. Out of the five million Canadian households who hold a mortgage, only an estimated 350,000 have a mortgage with a loan-to-value (LTV) ratio greater than 80% and a DSR greater than 40%. Add this number to the small number of renters with DSRs over 40% and the share of Canadian households that are "vulnerable" to a rate shock is less than 4.0%, notably below the 5.9% starting point estimated by the Bank of Canada (Chart 6)⁴.

A Few More Buffers

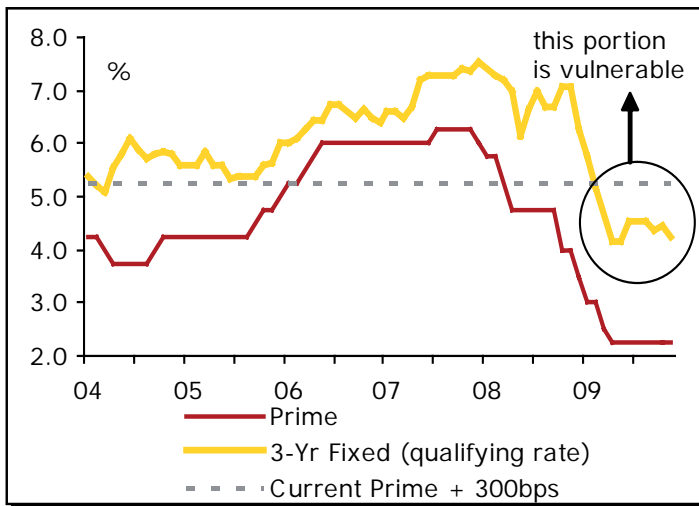
Another potential buffer is the fact that most Canadian financial institutions limit their variable rate customers to a mortgage that they would qualify for at today's 3-year fixed-term rate, well above current variable rates. While all borrowers will face the impact of higher rates, most of them will therefore be able to absorb a 300 basis point rate hike and still remain within the qualification threshold. Only mortgages that were underwritten since early 2009 are vulnerable in this sense, as their new mortgage rate (prime + 300 basis points) will end up being higher than their qualifying rate (Chart 7).

But even this small group will not have to face the full magnitude of the tightening by the Bank of Canada, as they will have the option to switch to fixed rates in the early stages of the monetary tightening by the Bank of Canada. And if history is a guide, they will do it very quickly. Although fixed rates might also have risen by that point, they would still typically have sheltered themselves from the full rise in variable rates ahead.

Others in the supposedly "at risk" group have afforded themselves some protection from the initial impact of rising rates by having already locked in a fixed rate mortgage. Based on information obtained from CMHC, no less than 80% of households who took a mortgage in 2009 with an LTV greater than 80% and a DSR greater

Chart 7

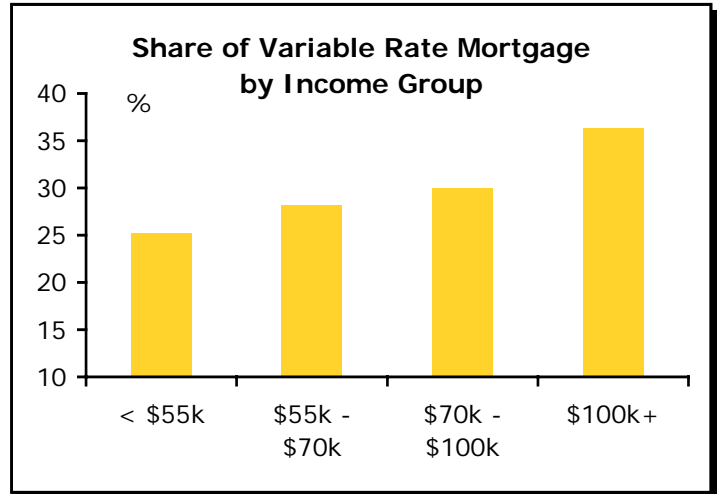
Impact of 300 Basis Points Rate Hike on VRM



Source: Bank of Canada, CIBC

Chart 8

Low Income Canadians Rely Less on VRM



Source: Ipsos Reid's CFM, CIBC

than 40% have a fixed rate mortgage. Also note that in general, low income Canadians tend to rely more heavily on fixed-rate mortgages (Chart 8)—the complete opposite of the situation south of the border where low income Americans were heavy users of variable-rate mortgages. While even fixed-term mortgages will eventually be reset, the longer time frame for any hikes in their borrowing rates leaves them with more time to pay down principal and benefit from rising incomes before that hits.

Moreover, many Canadians have taken advantage of low mortgage rates to accelerate their mortgage payments. No less than 40% of mortgage holders now accelerate their payments by adding a full-month of extra interest payments each year⁵. On a \$250,000 mortgage with 5% rate amortized over 30 years, that works out to a *de facto* shortening of the mortgage amortization period by 5 years. Translating years into basis points means that by simply switching from an accelerated payment plan to a regular one, these same borrowers can absorb the first 75 basis points on any rate increase by simply exercising their right to cease these prepayments.

Add it all up, the level of vulnerability in the mortgage market is not as high as suggested by the Bank of Canada, and even the most vulnerable borrowers have some flexibility to absorb higher interest rates. There is nothing in Canada akin to the huge excesses in lending that led up to the housing and mortgage crisis experienced in the US in the past few years.

That said, we share the Bank's view that it is time for both borrowers and lenders to exercise prudence in continuing to build up household debt loads to the point where they are overly reliant on today's low rates. Existing debt burdens appear to be manageable for the vast majority of Canadians given the buffers noted above, but care should be taken on how far these are extended in the next couple of years. An accelerated pace of credit growth, and the resulting upward pressure on home valuations could lead to adjustment problems down the road. Clearly, the current magnitude of the problem is not big enough to justify a premature tightening move by the Bank of Canada. While other adjustments to practices by participants in the mortgage market could be examined as a means of enhancing prudence, one should be careful to avoid excessively denting the health and flexibility of the housing market as a whole.

Notes:

1. Note that when house prices are weighted by market size, the swings in house prices during this cycle were not as dramatic. For example, while in January 2009 the unweighted measure fell by 11% on a year-over-year basis, the weighted measure fell by only 6.2%. And as of November 2009, the unweighted measure rose by almost 20% (year-over-year) vs. a much more modest increase of 13% seen in the weighted measure.
2. IMF working paper 09/235 October 2009.
3. Using PCE deflator.
4. CIBC's calculations based on data obtained from CMHC's estimates regarding the homeowners population as well as Ipsos Reid's CFM for the six months ending October 2009.
5. Source: CMHC

Is the TSX Rally Overdone?

Avery Shenfeld and Peter Buchanan

The decade now ending, although not as bad as stateside, has been a forgettable one for Canadian stockholders. Stung by two crashes since 2000, investors tend to get nervous whenever equities have rallied. Is the TSX, then, in dangerous territory because it looks to be ending 2009 with a 30% gain? Or are investors still safe in the knowledge that it's still a good 20-25% below where it was just 18 months ago—falling a bit short of the pace of past bear market rebounds, when things are viewed from the surrounding hilltops rather than the valley floor (Chart 1)?

Buy low, sell high is an investment cliché, so much of the story of the coming year, or even the coming decade, will depend on whether today's levels are the product of another bout of "irrational exuberance" or, instead, a reasonable entry point. While some point to the scale of the run-up in both equity prices and earnings expectations as danger signals, a careful look at TSX fundamentals suggests that valuations are not overdone.

Which E in the PE?

Earnings are the bedrock of stock market performance, but which "E" is the right one? While it's forward earnings that you're buying, some argue for avoiding the messiness of analysts' "scrubbed" forecasts that are purged of myriad non-recurring items. Investors are

advised instead to look at the "hard" earnings of the year gone by. But while current trailing PEs look rich against what's gone before, such measures lose some of their usefulness, coming out of a recession as deep as the recent one. PE ratios based on 12-month trailing or forward earnings tend to rise at the end of recessions, as investors factor in better times in the next year and subsequent ones. That can make the market look unwarrantedly expensive (Chart 2).

To get around that issue, one could look at the prospects for earnings for the full cycle ahead, but that involves even less certain, longer-term forecasting. Instead, economist Robert Shiller proposed judging valuations against 10 years of trailing earnings, which presumably captures a complete business cycle. By that benchmark, Canadian equities aren't screaming bargains, but aren't at the overblown trailing PE levels that prevailed in the last decade (Chart 3).

Shiller found that when US stocks were expensive relative to the prior decade's earnings, the process of reversion to the mean didn't entail a period of strong earnings growth ahead, but rather, a fairly protracted period of sub-par performance for stocks. That result appears to hold reasonably well for the 10-year performance of the TSX Composite. Today's 10-year trailing PE (or

Chart 1
Not Such a Different Trajectory After All

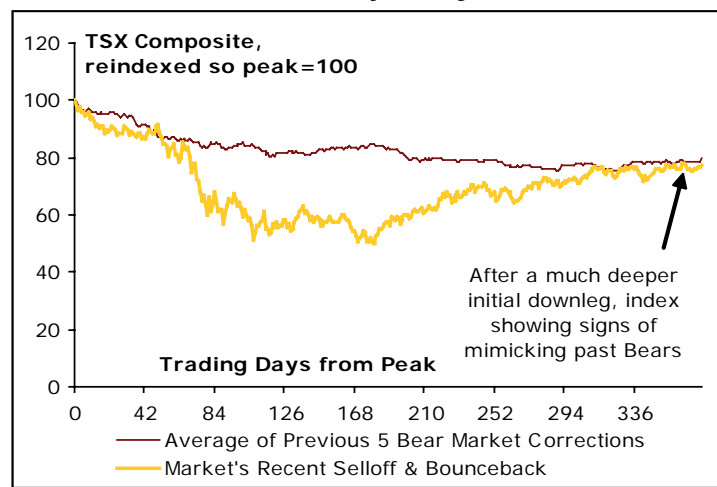


Chart 2
Normal for PE to Rise During Recovery's Early Stages

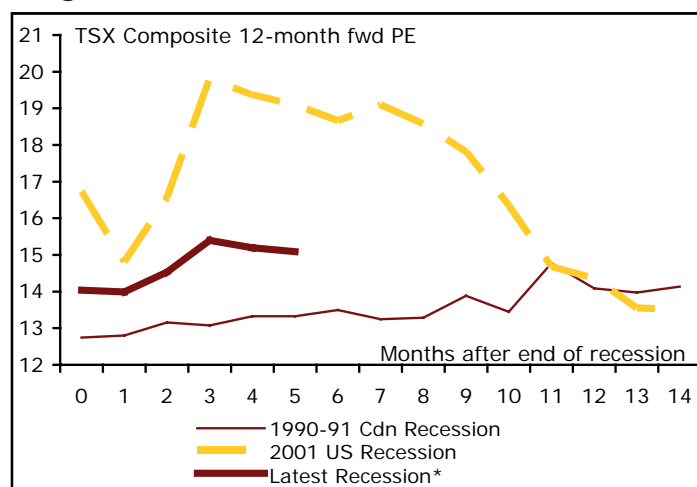
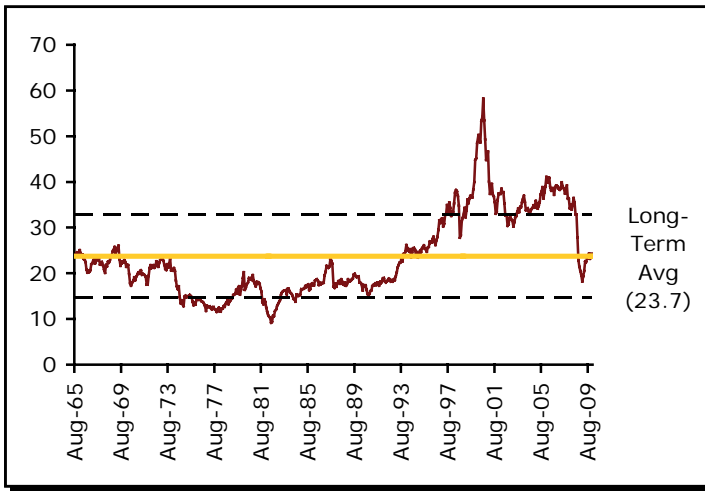


Chart 3

10-Year Lagged Cyclically Adjusted TSX PE Ratio

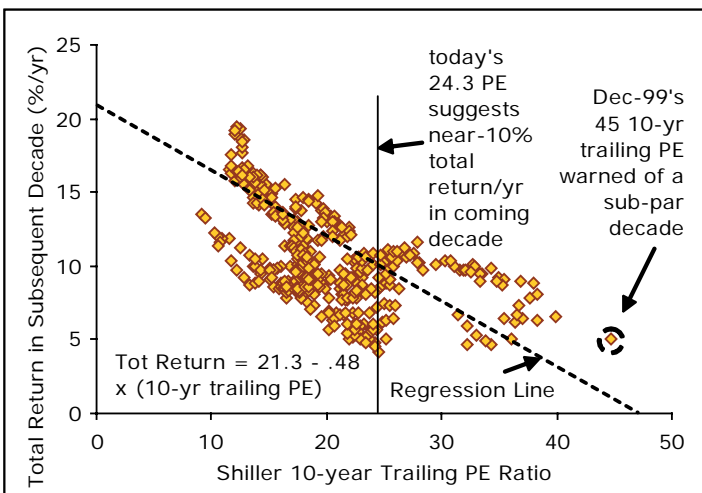


Note: Dotted lines denote plus or minus one standard deviation from average

“cyclically adjusted” PE, as it is sometimes called by market practitioners) would typically be associated with a nearly 10% annual rate of return in the next decade (Chart 4). An investor looking at ultra-high readings a decade ago would have been forewarned of lean pickings ahead. The 10-year trailing PE in December 1999 stood at a stratospheric 45. The TSX’s scant 5% return in the next decade was, if anything, more than the historical relationship between lagged PE and returns would have justified.

Chart 4

Lower 10-year trailing PE Hints at a Better Decade for Canadian Stocks



Ten years is a long time for many investors. Nevertheless, our analysis suggests that the 10-year lagged PE popularized by Shiller also offers a better guidepost to market performance over a one-year horizon than several other popular valuation metrics (Chart 5). The weakest link was to trailing earnings which had the wrong sign. Ten years of earnings data, in other words, provides a good deal of information about where the market should be trading. As with any comparably noisy series, just a year doesn’t tell you much.

Valuations Relative to Past Economic Turning Points

We can also compare current conditions with where key valuation metrics stood at similar points in past business cycles (Table 1). If the recession is judged to have come to an end after Q2 (the point at which GDP stopped falling and employment began to turn higher), the TSX one-year and 10-year trailing PE levels were not far out of line with historical norms. The subsequent rally has taken the one-year trailing PE to a lofty 32, but that’s after quite a deep recession and its correspondingly large hit to trailing earnings. Remember that after the 2001 recession, trailing earnings were actually trailing losses, so the PE was infinite at times.

Dividend yields look generous relative to similar points in past business cycles, when contrasted to the available yields on 10-year bonds. Typically, bonds have carried a nearly 600-bp yield advantage over equity dividend yields early in recoveries (since only the latter promise rising

Chart 5

Cyclically Adjusted PE Also Good Predictor of Short-Term TSX Performance

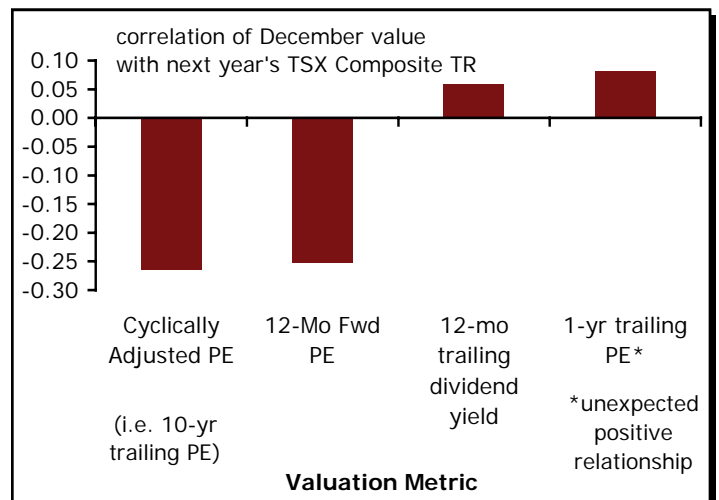


Table 1

TSX Valuation Metrics During Previous and Current Recoveries

Last Month of Recession	Trailing PE	Forward PE	Cyclically Adj PE**	Div. Yield (%)	10-Yr Bond Minus Div Yield (bps)
Mar-61	18.2	-	-	3.1	198
Mar-75	7.8	-	14.7	4.8	358
Sep-80	9.0	-	19.0	3.6	896
Dec-82	19.1	-	12.9	4.0	768
Mar-91	19.8	12.7	17.4	3.5	598
Sep-01 *	∞	16.7	33.0	1.8	364
Average, Past Cycles	14.8	12.7	19.4	3.5	597
Jun-09	17.0	13.5	22.5	3.1	28
Latest	32.2	14.8	24.3	2.8	61

* Not a Cdn recession, but an official US one. ** 10-year trailing PE. Source: CIBC, TSX, Thomson Reuters

payouts over time). While the gap was a bit wider back in June than at present, 10-year bonds offer a leaner-than-normal 60-bp pick-up over TSX dividend yields. Moreover, dividends are miles above the near-zero yields on short-term money market instruments.

Analysts May Be Erring ...

Where the comparison gets more murky is against forward PEs, which are based on analysts' expectations. While the TSX rally has been partly about a multiple expansion as risk aversion faded, it has also been supported by rising consensus expectations for forward earnings, which have moved up almost 15%-pts since April (Chart 6).

Chart 6

TSX Rally Driven by Strong Multiples Rebound, Better Earnings Expectations

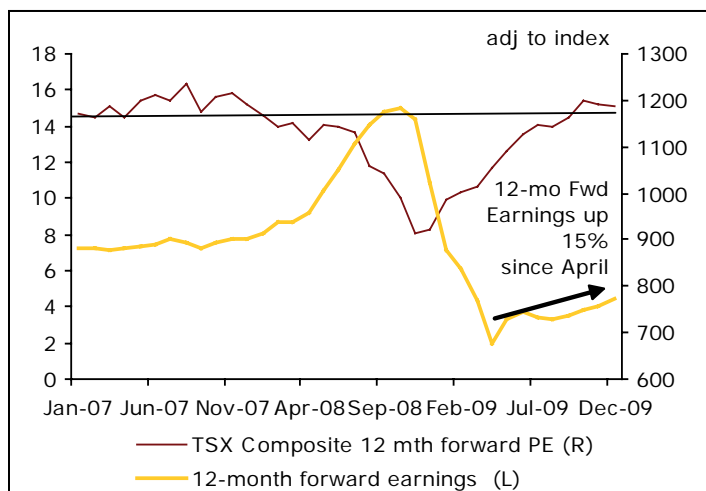
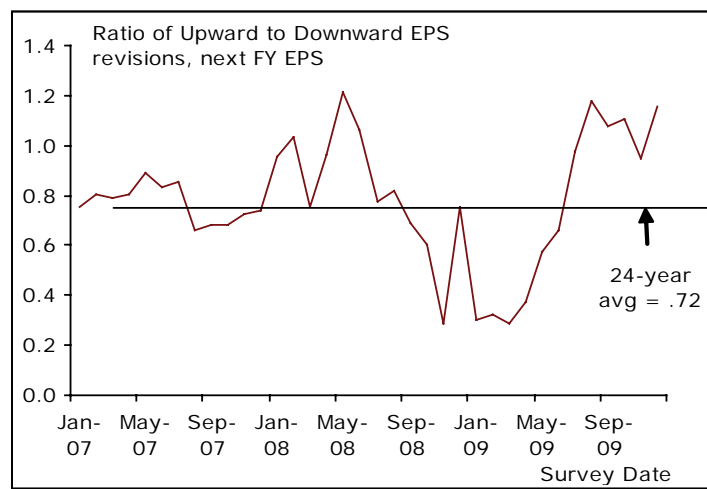


Chart 7

Analysts Still Ratcheting Up 2010 EPS Estimates



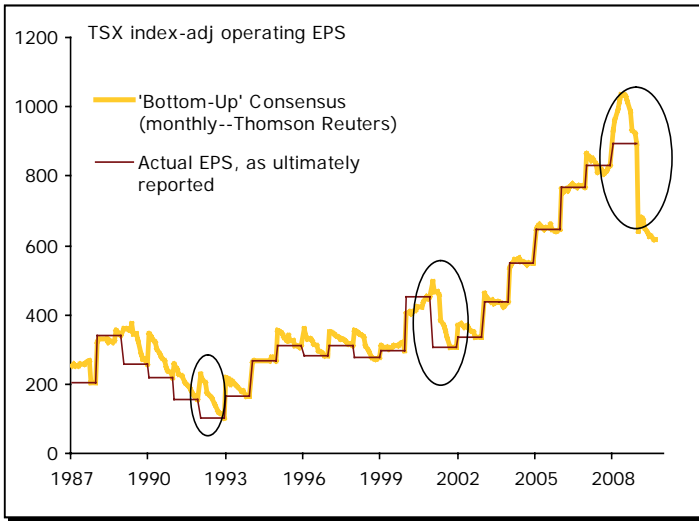
Source: Thomson Reuters

Nothing in the approach of next year, or in Q3 earnings reports, has shaken analysts' convictions, as the ratio of upwards to downwards revisions has run well above the average of the past 24 years (Chart 7). Historically, while analysts have typically been wide of the mark in terms of their ability to predict recessionary declines in earnings, their calls have been materially closer during upswings (Chart 8).

But the bottom-up consensus expectation for more than a 25% advance in earnings does look to be on the high side, implying that nearly all of 2009's decline will be reversed in the first year of recovery. CIBC's top-down

Chart 8

Earnings: Consensus Typically Misses Downswings, Better in Recoveries



equity strategist, Peter Gibson, has an appreciably more conservative target, perhaps more in line with a moderate year of growth ahead.

... But Forgiveness is Divine

So the issue comes down to just how forgiving the market will be if the bottom-up earnings calls get downgraded as the year progresses. There are clearly times in the cycle when such adjustments can see a harsh response, but a first year of recovery, with very low interest rates as a backdrop, may not be one of them.

For one, investors are used to analysts being a bit too optimistic before the year begins, as estimates at that point are typically on the high side of ultimate reality (Chart 8, again). The equity market consistently gained ground during the economy's last upswing, despite at least a modest downward revision to earnings estimates in many years.

Second, the huge expectational misses tend to be when recessions hit. And if, as we expect, the economy avoids the dreaded double-dip, an overestimate of earnings for 2010 can still leave investors in a mood to say "wait until

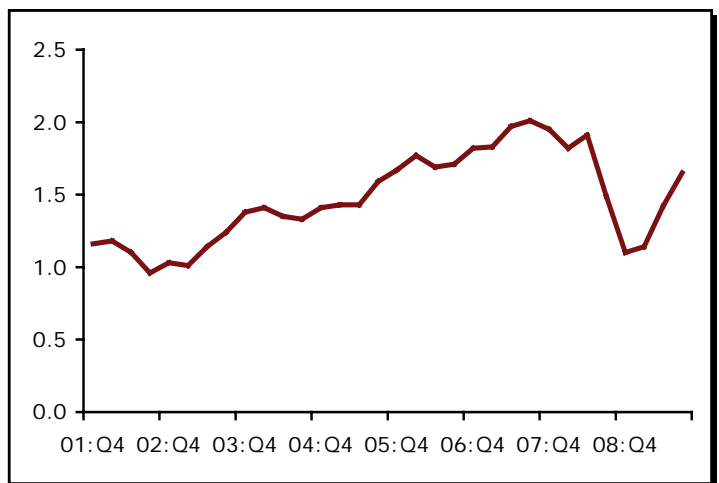
next year". The market is, in effect, a time-discounting mechanism, synthesizing the views of many players. Although analysts may be hasty in expecting earnings to recoup nearly all of the lost ground next year, a multi-year expansion will leave plenty of time for further profit gains. TSX valuations now stand at only 12.6 times 2011 earnings forecasts. Relative to normalized, mid-cycle earnings, based on the average of the last 10 years, stocks don't look out of line.

Another metric also lends view to the support that stocks are not grossly overvalued. After misses early in the year, revenue growth is very much on investors' minds these days. Despite concerns that firms stateside are sacrificing revenues and hence future growth by slashing costs excessively, the Canadian market appears to be somewhat cheaper on a price-to-sales basis than it was a year or so back (Chart 9).

Bookended by two deep sell-offs, the decade now ending will not go down as one of the better ones on record for investors. A barn-burner recovery doesn't look like it's in the cards at this point. But even without one, there are reasons for thinking the year ahead may turn out to be a reasonable one for equity markets.

Chart 9

TSX Price-to-Sales Ratio Down From Recent Highs



Source: Bloomberg

Good News is Now Good News in FX

Avery Shenfeld and Krishen Rangasamy

Over the past year, good economic news has been bad news for the greenback and vice versa. But that odd correlation has broken down in the last couple of weeks, as the US\$ strengthened against most other majors after consensus-topping reports on US jobs and retail sales (Chart 1). While those two instances aren't solid proof of a regime change, the dollar's vulnerability to strong economic reports had to come to an end, or else the US recovery would have eventually entailed unsustainable overvaluations for many other major currencies.

The dollar was helped against the euro by adverse news from the common currency region. Weighing on the euro were less than stellar data on eurozone industrial production, and concerns over credit issues in Greece, and for a while, exposures to Dubai. Speculative net long positions in the common currency were scaled back significantly as markets woke up to eurozone troubles (Chart 2).

If, as we expect, we are back to normalcy, when strong data helps your currency, that opens up room for a further correction in favour of the US\$ in the next month or so. Data rolling out over this period will pertain to Q4, a quarter in which we expect healthy growth for the US. Longer term, we expect the US growth picture to be more disappointing in 2010, putting the dollar back on a depreciating trend as the timeframe for the first Fed hike is pushed off into 2011, and the dollar feels the weight of America's current account and trade deficits.

Another, somewhat looser rule of thumb also looks to be breaking down, as dollar-Canada didn't move in sync with dollar-euro in recent weeks. Canada's own impressive jobs and trade reports allowed the loonie to stand its ground in a period of US\$ strength (Chart 3). The C\$ could continue to trade sideways into early next year, and we see it averaging 1.05 C\$/US\$ in 2010.

As a result, the C\$ will remain overvalued despite improvements in resource price fundamentals. Our error-correction model, which takes into account latest data on commodity prices and interest rate differentials, suggests that the "fair value" for the C\$/US\$ exchange rate is around 1.1450, or nearly 10 cents weaker for the C\$ than our target for 2010.

Chart 1
Trade-Weighted US\$ Now Reacts Positively to Good US Economic News

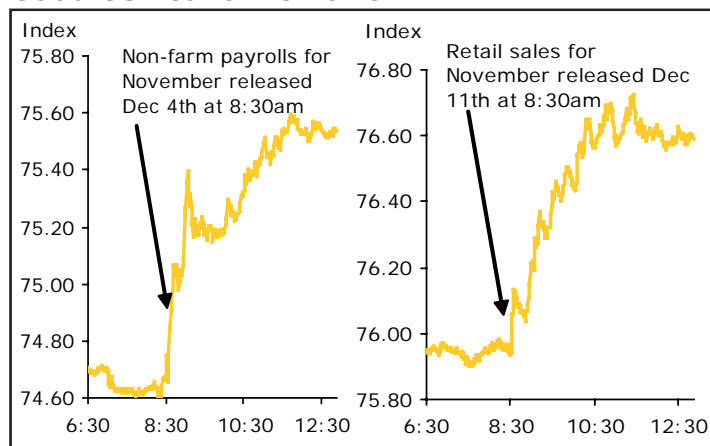


Chart 2
Speculators Dump Euro

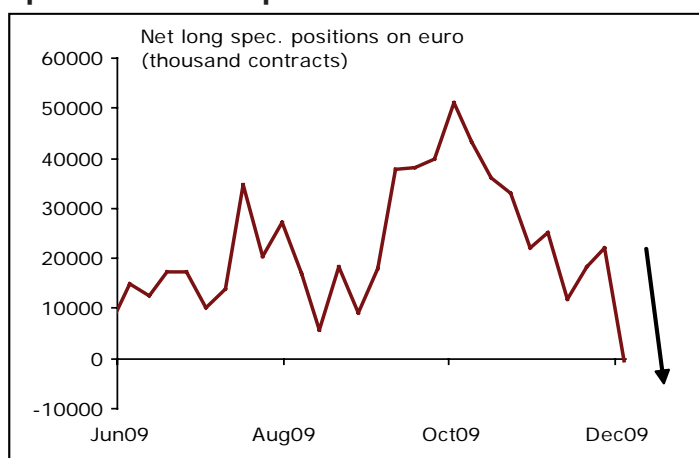
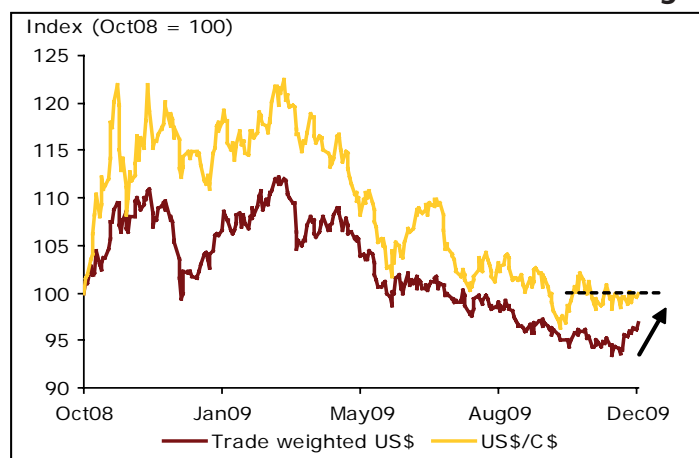


Chart 3
C\$ Stands its Ground in Period of US\$ Strength



ECONOMIC UPDATE

CANADA	09Q2A	09Q3A	09Q4F	10Q1F	10Q2F	10Q3F	10Q4F	2008A	2009F	2010F	2011F
Real GDP Growth (AR)	-3.1	0.4	4.3	2.4	2.2	2.4	2.6	0.4	-2.5	2.1	3.8
Real Final Domestic Demand (AR)	0.6	4.7	1.7	2.2	2.7	3.3	3.2	2.6	-1.6	2.6	3.5
All Items CPI Inflation (Y/Y)	0.1	-0.9	0.8	1.4	1.6	1.9	1.6	2.4	0.3	1.6	2.3
Core CPI Ex Indirect Taxes (Y/Y)	1.9	1.6	1.6	1.7	1.5	1.6	1.6	1.7	1.8	1.6	2.0
Unemployment Rate (%)	8.4	8.6	8.6	8.5	8.5	8.6	8.5	6.1	8.3	8.5	8.1
U.S.											
Real GDP Growth (AR)	-0.7	2.8	3.5	1.5	0.9	2.3	1.7	0.4	-2.5	1.9	3.4
Real Final Sales (AR)	0.7	1.9	2.7	0.9	1.2	1.6	0.8	0.8	-1.6	1.5	2.8
All Items CPI Inflation (Y/Y)	-1.2	-1.6	1.4	2.1	1.6	1.7	1.9	3.8	-0.3	1.8	3.0
Core CPI Inflation (Y/Y)	1.8	1.5	1.7	1.6	1.5	1.7	2.0	2.3	1.7	1.7	2.3
Unemployment Rate (%)	9.3	9.6	10.1	10.4	10.6	10.5	10.3	5.8	9.3	10.5	9.9

CANADA

The final quarter of the year is off to a good start with a strong showing from exports, warranting an upgrade to our Q4 GDP forecasts, and a corresponding improvement in our unemployment rate projections. The jobless rate looks to have peaked, but we don't see the economy moving quickly enough in 2010 to make any further improvement. While we have raised our CPI forecasts marginally in light of latest data, both core and headline inflation should remain close to the Bank of Canada's 2% target next year, as tepid economic growth and excess capacity anchor prices.

UNITED STATES

We have raised our forecast for fourth quarter real GDP growth to 3.5% on stronger than expected consumer spending and a better inventory picture, but continue to believe that the pace of US economic recovery will slow down significantly in early 2010. American consumers are shopping again, but high unemployment and tighter access to credit should weigh on activity over the coming quarters. Year-over-year inflation finally moved back into positive territory as last year's steep drop in energy prices finally fell out of the index, but core inflation should continue to be weighed down by significant economic slack through next year.

Conflicts of Interest: CIBC World Markets' analysts and economists are compensated from revenues generated by various CIBC World Markets businesses, including CIBC World Markets' Investment Banking Department. CIBC World Markets may have a long or short position or deal as principal in the securities discussed herein, related securities or in options, futures or other derivative instruments based thereon. The reader should not rely solely on this report in evaluating whether or not to buy or sell the securities of the subject company.

Legal Matters: This report is issued and approved for distribution by (i) in Canada by CIBC World Markets Inc., a member of the IIROC and CIPF, (ii) in the UK, CIBC World Markets plc, which is regulated by the FSA, and (iii) in Australia, CIBC World Markets Australia Limited, a member of the Australian Stock Exchange and regulated by the ASIC (collectively, "CIBC World Markets"). This report is distributed in the United States by CIBC World Markets Inc. and has not been reviewed or approved by CIBC World Markets Corp., a member of the New York Stock Exchange ("NYSE"), NASD and SIPC. This report is intended for distribution in the United States only to Major Institutional Investors (as such term is defined in SEC 15a-6 and Section 15 of the Securities Exchange Act of 1934, as amended) and is not intended for the use of any person or entity that is not a major institutional investor. Major Institutional Investors receiving this report should effect transactions in securities discussed in the report through CIBC World Markets Corp. This report is provided, for informational purposes only, to institutional investor and retail clients of CIBC World Markets in Canada, and does not constitute an offer or solicitation to buy or sell any securities discussed herein in any jurisdiction where such offer or solicitation would be prohibited. This document and any of the products and information contained herein are not intended for the use of private investors in the United Kingdom. Such investors will not be able to enter into agreements or purchase products mentioned herein from CIBC World Markets plc. The comments and views expressed in this document are meant for the general interests of clients of CIBC World Markets Australia Limited.

This report does not take into account the investment objectives, financial situation or specific needs of any particular client of CIBC World Markets Inc. Before making an investment decision on the basis of any information contained in this report, the recipient should consider whether such information is appropriate given the recipient's particular investment needs, objectives and financial circumstances. CIBC World Markets Inc. suggests that, prior to acting on any information contained herein, you contact one of our client advisers in your jurisdiction to discuss your particular circumstances. Since the levels and bases of taxation can change, any reference in this report to the impact of taxation should not be construed as offering tax advice; as with any transaction having potential tax implications, clients should consult with their own tax advisors. Past performance is not a guarantee of future results.

The information and any statistical data contained herein were obtained from sources that we believe to be reliable, but we do not represent that they are accurate or complete, and they should not be relied upon as such. All estimates and opinions expressed herein constitute judgments as of the date of this report and are subject to change without notice.

Although each company issuing this report is a wholly owned subsidiary of Canadian Imperial Bank of Commerce ("CIBC"), each is solely responsible for its contractual obligations and commitments, and any securities products offered or recommended to or purchased or sold in any client accounts (i) will not be insured by the Federal Deposit Insurance Corporation ("FDIC"), the Canada Deposit Insurance Corporation or other similar deposit insurance, (ii) will not be deposits or other obligations of CIBC, (iii) will not be endorsed or guaranteed by CIBC, and (iv) will be subject to investment risks, including possible loss of the principal invested. The CIBC trademark is used under license.

© 2009 CIBC World Markets Inc. All rights reserved. Unauthorized use, distribution, duplication or disclosure without the prior written permission of CIBC World Markets Inc. is prohibited by law and may result in prosecution.