



Economics

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"While preventing similar mistakes has underlying merit, the new "war on error" poses the greatest risk to the sustainability of the current expansion."

The War on Error

by Avery Shenfeld

Governments are already shifting from curing the recession to preventing a repeat of the past expansion's fatal flaws. Rightly or not, the blame for the 2008-09 shock has been put on an excessive period of low rates that prompted an asset bubble; a banking system left too unfettered by regulation; a mortgage market over-fed by junk CDOs, Fannie and Freddie; and a debt-financed US government sector that funded itself abroad, pushing up the dollar and exacerbating current account imbalances. While preventing similar mistakes has underlying merit, the new "war on error" poses the greatest risk to the sustainability of the current expansion.

Investors remain jittery about such risks. China took well reasoned steps to tighten credit, with a view to avoiding its own housing and asset bubble. Obama unveiled plans to clamp down on proprietary trading by deposit taking banks. All of that sent a visible shudder through the equity market.

Obama's banking proposals might not survive the inevitable tinkering by Congress, and differentiating risk hedging or prop trading from market-making isn't easy. Washington could instead look north. With no Glass-Steagall walls or prop trading bans, Canada avoided having to make its banks wards of the state, and not only because its mortgage market was better regulated. Canadian institutions also had lower leverage and greater capital to absorb trading hits. However meritorious in the long run, the regulatory steps in that direction that are likely to emerge from Basel pose risks to growth. Implemented too sharply, higher capital and lower leverage requirements

would restrain much needed lending activity in the US and Europe.

Although some blame the US housing bubble (wrongly in our view) on a too-dovish monetary policy in the prior decade, the Fed won't be in a rush to raise rates. But it's already set to withdraw support to housing as its mortgage securities buying program expires. Again, while excessive credit to housing led to grief in the last cycle, for now, a mortgage market still in crisis needs all the help it can get (see pages 8-9). Canada's housing market is booming and prices could be overshooting, but any steps to tighten mortgage insurance policies have to be done gingerly enough to avoid turning boom to bust.

While US fiscal imbalances were also part of the last cycle's problem, there too, a quick cure could be worse than the disease. Obama seems torn between pushing for new job-creation spending, and simultaneously announcing freezes on other budget envelopes that provide someone else's jobs or incomes. Ottawa isn't under as much pressure, and yet while releasing the remaining stimulus, it's also discussing a new spending review. Some provinces will also be leaning against much needed growth given the fiscal challenges ahead.

Fiscal rectitude, normalized interest rates, reduced stimulus to housing, careful regulatory restraints—these will all be needed to avoid the next financial shock. But with the economy still shaky, let's not get too righteous about getting it all done in a hurry. As St Augustine said when confronted by a different sort of temptation, "Lord make me chaste, but not yet."

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

MARKET CALL

- We released an updated interest and exchange rate outlook in our January 14th issue of *Forecast*, and have maintained that outlook here. We didn't see any hints in the Bank of Canada's latest report that it intends to extend the pledge to keep interest rates on hold, and strong first half growth could see overnight rates nudged higher as early as Q3—prematurely in our view, given our less enthusiastic growth projection for the latter half of the year. That slowdown could have the Bank of Canada surprising markets by delaying any follow-up move on rates until well into 2011.
- The bond market's recent rally looks vulnerable, not only due to pressure on two-year yields as we approach the first BoC rate hikes, but also from the impact on global bond yields from heavy deficit financing worldwide. Such pressures should be more evident in the US and some eurozone countries than in Canada, where the fiscal position is less troublesome.
- As we expected, the US dollar managed to find a better footing early in 2010, and that, alongside a dip in oil prices, helped take dollar-Canada towards our 1.07 March-end target. If we're right about the Bank jumping ahead of the Fed on the first rate hikes, Q1 will represent a good opportunity to buy the loonie ahead of its bullish response to a wider short-rate differential.

INTEREST & FOREIGN EXCHANGE RATES

END OF PERIOD:	2010					2011	
	27-Jan	Mar	Jun	Sep	Dec	Mar	Jun
CDA Overnight target rate	0.25	0.25	0.25	1.00	1.00	1.00	1.50
98-Day Treasury Bills	0.16	0.20	0.60	1.15	1.05	1.15	1.75
2-Year Gov't Bond	1.23	1.45	1.90	2.35	2.00	2.40	2.70
10-Year Gov't Bond	3.37	3.65	3.85	3.95	3.75	4.00	4.05
30-Year Gov't Bond	3.97	4.15	4.30	4.45	4.30	4.35	4.40
U.S. Federal Funds Rate	0.15	0.15	0.15	0.15	0.25	0.75	1.50
91-Day Treasury Bills	0.08	0.10	0.10	0.10	0.20	1.00	1.50
2-Year Gov't Note	0.92	1.05	1.10	1.20	1.35	2.20	2.45
10-Year Gov't Note	3.65	3.85	4.00	4.15	4.10	4.45	4.45
30-Year Gov't Bond	4.56	4.70	4.75	4.95	4.85	5.05	5.05
Canada - US T-Bill Spread	0.08	0.10	0.50	1.05	0.85	0.15	0.25
Canada - US 10-Year Bond Spread	-0.28	-0.20	-0.15	-0.20	-0.35	-0.45	-0.40
Canada Yield Curve (30-Year — 2-Year)	2.74	2.70	2.40	2.10	2.30	1.95	1.70
US Yield Curve (30-Year — 2-Year)	3.64	3.65	3.65	3.75	3.50	2.85	2.60
EXCHANGE RATES							
CADUSD	0.94	0.93	0.97	1.02	0.97	0.96	1.00
USDCAD	1.06	1.07	1.03	0.98	1.03	1.04	1.00
USDJPY	90	94	93	90	87	86	86
EURUSD	1.40	1.37	1.38	1.44	1.47	1.48	1.50
GBPUSD	1.62	1.59	1.61	1.67	1.71	1.72	1.73
AUDUSD	0.895	0.920	0.940	0.960	1.000	0.990	0.995
USDCHF	1.05	1.06	1.04	1.01	0.99	1.00	1.01
USDBRL	1.86	1.87	1.82	1.77	1.72	1.70	1.69
USDMXN	12.9	13.5	13.0	12.7	12.5	12.3	12.3

COMMODITIES OUTLOOK

Commodities benefited from the “recovery trade” in 2009 as the global economy emerged from the deepest recession in a generation. Although a slowing in key economies like the US could contribute to a temporary loss of momentum later in the year, the building blocs of last year’s strong resource price rally remain in place. That creates further near term upside in a number of areas. Global GDP is on track for 3.8% growth this year and 3.5% in 2011, surpassing our earlier expectations. Although China is re-tightening, the economy grew solidly for a year after a more dramatic move in 2007 (Chart), and we expect a similar resilience in the coming year.

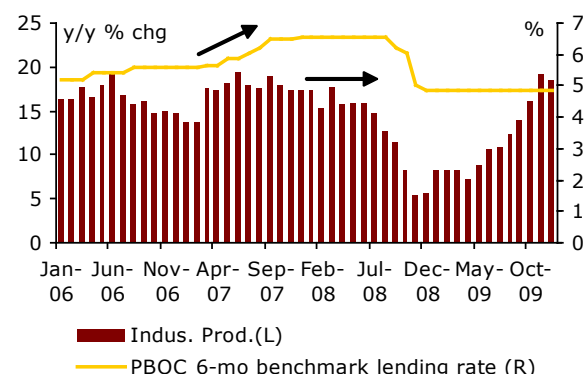
Renewed selling pressure against the US dollar later this year, as attention refocuses on the current account and fiscal deficits, should help to put a shine back on gold. Supporting non-interest bearing assets, a sub-par recovery will also keep the Fed on hold through year-end, longer than generally expected. We expect gold prices to back off in 2011, however, when monetary policy in the US finally tilts back to restraint.

Base metals prices doubled in 2009, as the pick-up in emerging market consuming nations outgunned expectations. While China’s imports of key metals like copper have eased in recent months, they remain well above historical levels, suggesting some resilience in demand. Copper remains our favourite area for exposure within the metals space, based on supply and demand fundamentals.

Although a continuing recovery and rising supply curve are longer term pluses, any further run-up in oil is unwarranted on several counts. OPEC spare capacity remains at an unusually high 5 mn barrels or more per day. Demand in China grew by 6% last year but in what is still the world’s largest market, the US, it remains nearly 10% below its pre-recession peaks. Based on this, WTI should average \$75/bbl this year and \$80 in 2011, a bit below consensus.

Henry Hub natural gas spot prices have risen from 8-year lows last fall to around \$5.60/Mn Btu recently. As the economy recovers, we expect prices to benefit from improving demand, particularly from industrial users and power generators. But unless temperatures are atypically cold, US inventories are likely to enter the Spring shoulder season on the high side. US dry gas production, moreover, rose by nearly 4% last year even with drilling cutbacks. We expect price increases, but not dramatic ones, over the next 12-18 months given this. Henry Hub prices should average \$6.50/Mn Btu in 2011, compared to \$5.50/Mn Btu this year.

China's Economy Grew Solidly for Year After Last Rate Hike Cycle



Spot Commodity Prices

		Average					
		26-Jan	2007	2008	2009	2010 (f)	2011 (f)
Oil (WTI)	\$/bbl	75	72	100	62	75	80
RBOB gasoline	\$/gal	1.96	2.09	2.49	1.69	1.80	2.10
Heating Oil (NYH)	\$/gal	1.94	2.03	2.86	1.65	1.95	2.15
Natural Gas (Henry)	\$/Mn Btu	5.61	6.97	8.89	3.82	5.50	6.50
Gold	\$/troy oz	1093	695	872	1088*	1250*	1150*
Copper	\$/lb	3.34	3.24	3.16	2.35	3.50	3.30
Aluminum	\$/lb	0.99	1.20	1.17	0.76	0.85	0.80
Nickel	\$/lb	8.22	16.86	9.57	6.69	7.80	6.50
Zinc	\$/lb	1.04	1.48	0.85	0.76	1.10	0.90

* end of period

Provincial Forecast: Picking Up & Dusting Off

Warren Lovely

The dawn of a new decade is a natural time to reflect and project. Consider the decade that was “the zeros”, a period of generally robust growth that gave way to a 9th inning collapse, characterized by a broad-based recession and severe job loss.

Recent weakness cut average real GDP growth for the decade to a rather pedestrian 2.1%, although the country still outperformed the US across a host of indicators (Table 1). But what is Canada, if not a collection of ten increasingly varied provinces? Regional divergence will remain a telling story in the years ahead, if less dramatically so in 2010. As provinces pick themselves up and dust themselves off, the march back to economic health will be at varied speeds.

Resource provinces, in the West and East, will make their way back to the top of the growth charts this year and next. For 2010, inventory restocking will see Ontario beat the national average for the first time since the Canadian dollar began its appreciation in earnest. That resurgence risks proving temporary, however, as an overvalued C\$ and a reversion to slower US growth weighs. Recent outperformance in Québec and the Maritimes likely won't be repeated, with solid, if unspectacular gains due in 2010-11.

Table 1
**The Decade That Was;
 Resource Provinces Were Leaders in 2000s**

Y/Y %	Real GDP	Nominal GDP	Employment	Retail Sales
BC	2.4	4.5	1.8	4.0
Alta	2.9	8.4	2.6	6.6
Sask	1.9	6.2	1.0	5.9
Man	2.1	4.5	1.1	5.2
Ont	1.8	3.3	1.5	3.5
Qué	1.8	3.6	1.5	4.3
NB	1.7	3.5	1.2	3.6
NS	1.7	4.0	1.1	3.5
PEI	1.7	3.7	1.4	3.7
N&L	3.8	9.4	0.7	5.1
CDA	2.1	4.5	1.6	4.3
US	1.9	4.3	0.2	3.0

Notes: Compound annual growth rate, 2009 vs 1999; shading denotes growth rate above national average
 Source: Statistics Canada

Roller Coaster Ride for Resource Provinces

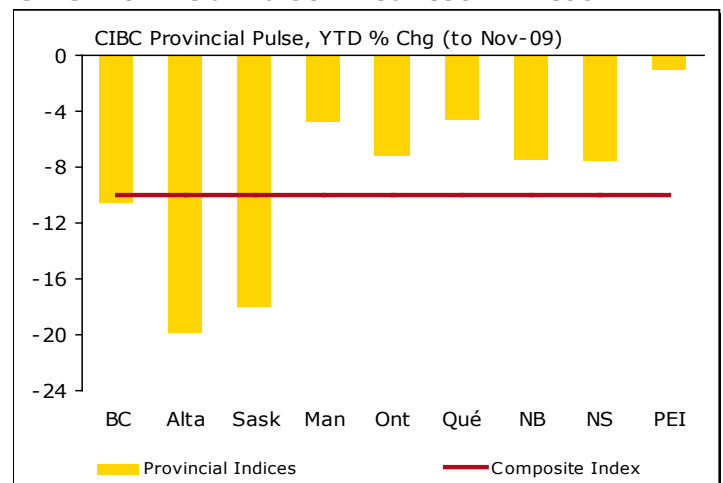
When it comes to economic growth, the “haves” and “have nots” can be defined by natural resource wealth. The resource rich provinces generally spent the last decade at the top of the growth charts. With the notable exception of Manitoba, those less levered to commodities chalked up below-average growth (Table 1).

With the good comes the bad, and the greater variability of resource provinces was on full display in 2009. CIBC's *Provincial Pulse*, a comprehensive indicator that mimics *nominal* GDP, shows 2009's weakness concentrated in the West (Chart 1). As for *real* GDP, commodity-based provinces occupied four of the bottom five growth spots in 2009.

But more than others, the West will reap the benefits of reinvigorated Asia-Pacific growth. Its edge may be marginal in 2010 (Chart 2), with CIBC forecasts residing at the lower end of the current consensus due to a more conservative call for Canada as a whole. Come 2011, commodity-based provinces will be flying even higher (Table 2).

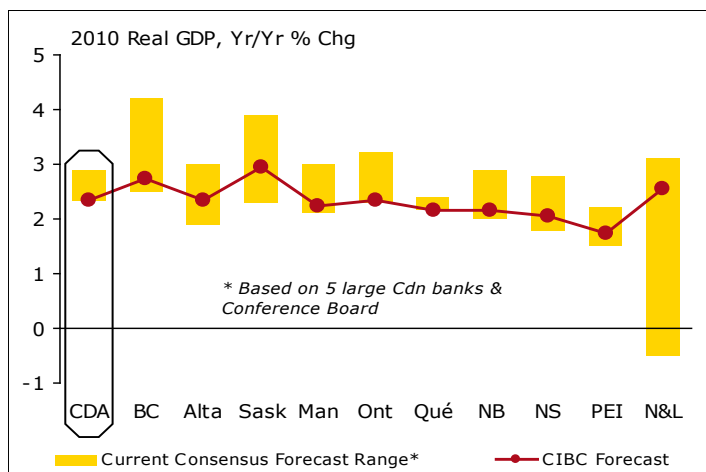
If anything, a cooling in once-overheated housing markets, wages and material costs has set the stage for renewal. It was the West, after all, that earlier sparked concerns of a housing bubble and labour shortages. A global financial crisis and resource price skid put an end

Chart 1
CIBC Provincial Pulse: Weakest in West



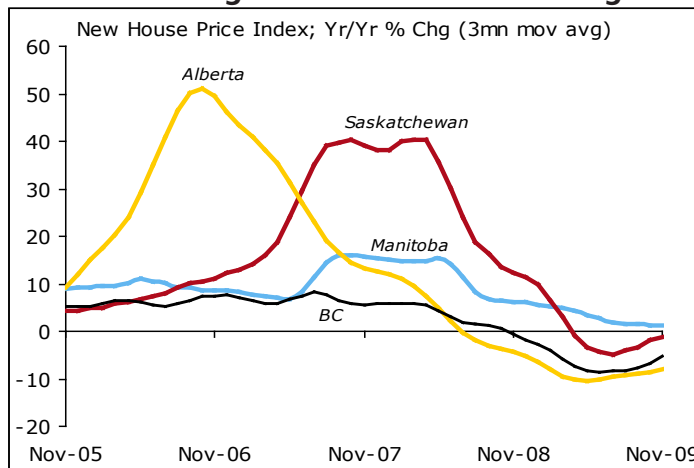
Source: CIBC

Chart 2
2010 Real GDP Forecasts



Source: CIBC

Chart 3
West's Housing Boom Saw Hard Landing



Source: Statistics Canada

to Western Canada's housing boom (Chart 3), but in recent months, housing activity has re-accelerated (Chart 4). Business investment is likewise returning. The stage is again set for economic outperformance.

British Columbia will be among the leaders in 2010-11. Incited by an attractive royalty regime, shale gas deposits are being pursued aggressively, complementing an upturn in other mining activity. Muted US home construction clouds the outlook for forestry products. Still, we anticipate success in broadening and deepening BC's export base, with expanded transportation infrastructure allowing the province to lever its Gateway to Asia status. We don't see the end of Olympics spending as a significant drag. The adoption of a harmonized sales tax should spur investment—an avenue for enhancing a relatively poor productivity record.

A still-tentative consumer suggests Alberta will be slower to re-accelerate in 2010. But the newfound availability of cost-effective inputs, alongside a recovery in commodity prices, is sparking re-investment. Expansion of the oil sands compensates for uncertainty in conventional natural gas, which faces competition from abundant shale gas elsewhere. A revised royalty regime could be an important offset here. Political momentum towards tough carbon standards appears to have faded, reducing the near term uncertainties to Alberta's carbon-intensive economy.

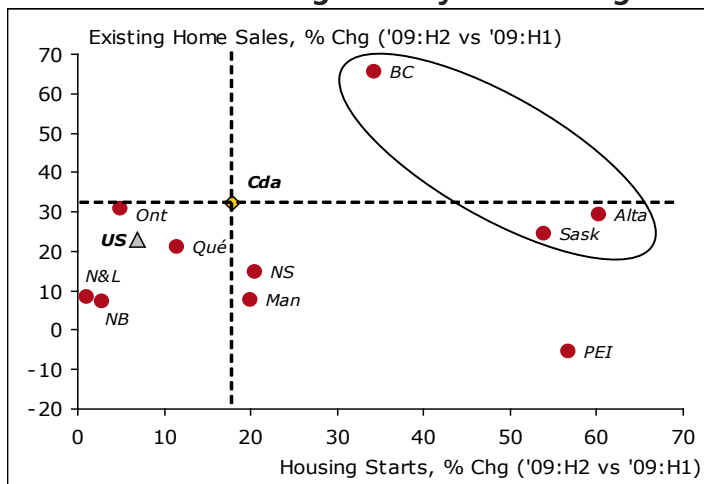
Saskatchewan entered 2010 with considerable potential. In stark contrast to others, total employment advanced 1.5% last year. Being closer to full employment (Chart 5), wage growth leads the nation, auguring well for future consumer demand. Solid job prospects will continue to spur in-migration, with population growth stronger than

Table 2
Real GDP Performance: 2008-2011

Y/Y %	Actual 2008	CIBC Forecasts		
		2009	2010	2011
BC	0.0	-2.2	2.8	3.4
Alta	0.0	-2.6	2.4	4.2
Sask	4.2	-1.7	3.0	4.1
Man	2.0	-0.2	2.3	3.1
Ont	-0.5	-3.5	2.4	2.8
Qué	1.0	-1.4	2.2	2.7
NB	0.0	-0.7	2.2	2.8
NS	2.2	-0.4	2.1	2.6
PEI	0.5	-0.5	1.8	2.4
N&L	0.5	-3.5	2.6	3.3
CDA	0.4	-2.5	2.3	3.0
US	0.4	-2.5	2.8	2.4

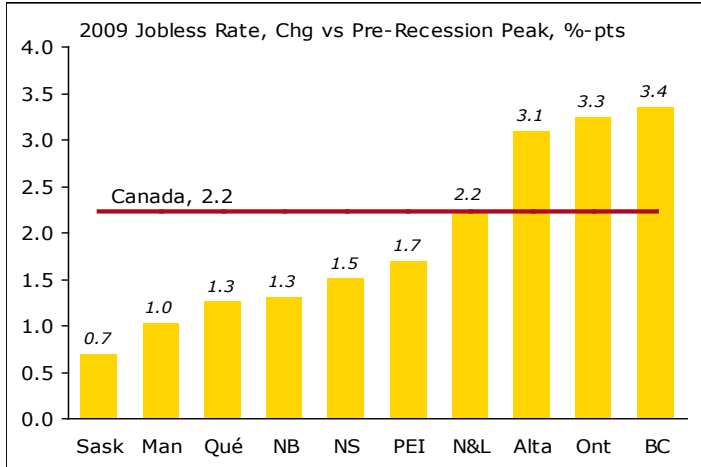
Note: Shading denotes annual decline in provincial real GDP
Source: CIBC, Statistics Canada

Chart 4
But Western Housing Activity Recovering



Source: CMHC, CREA

Chart 5
Less Slack in Saskatchewan's Labour Market

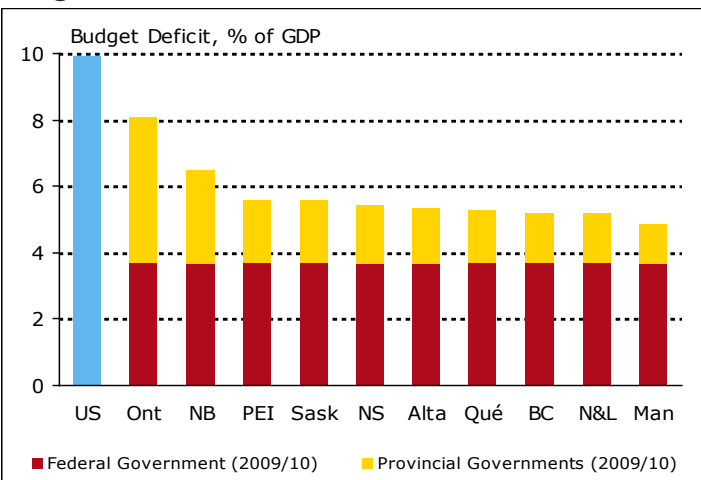


Source: Statistics Canada

at any time in the past thirty years. Oil, potash, agriculture and uranium sectors are again in demand, with ongoing development paving the way for production increases. Expect Saskatchewan to lead all provinces in 2010, and to battle Alberta for top spot in 2011.

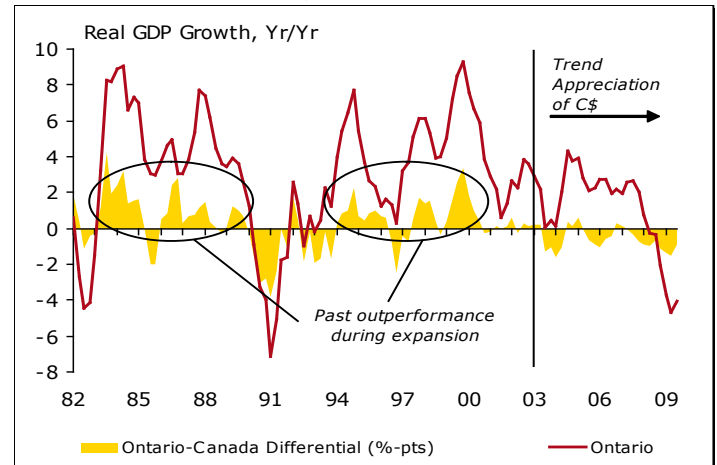
Manitoba escaped recession relatively unscathed, tabling a fourth straight year of above-average growth in 2009. With less ground to be made up, growth should run just in line with the national average in 2010. Unemployment has been contained, personal finances are in better shape than most and housing market demand hasn't materially wavered. A diverse manufacturing base is a strength. Meanwhile, transportation infrastructure is being enhanced and vast hydro potential is being developed. Over the medium term, fiscal policy will be less of a drag, given a budget deficit that is the smallest in the country (Chart 6).

Chart 6
Manitoba's Deficit the Smallest, Ontario's the Largest



Source: Federal/Provincial Governments, CIBC

Chart 7
Ontario Led Country Out of Past Recessions



Source: Statistics Canada

Ontario Picks Up the Pieces

For Ontario, 2009 was a year to forget. But as growth returns, how will Ontario stack up? It was once the case that Ontario outperformed in expansion, at least until the C\$ began its trend appreciation (Chart 7). Since that time, Ontario has lagged the national average.

That makes recent developments all the more notable. Ontario outpaced the national average by a significant margin in Q3, and with momentum carried into the first half of this year, Ontario's full-year growth rate should exceed the national average for the first time in eight years.

This year's growth rate captures comparisons to depressed levels of activity in 2009. That's particularly true in manufacturing, where shipments slumped and factory job losses lopped more than 1.5% off total employment (Chart 8). Once an inventory restocking has run its course, growth could be harder to sustain.

While its weight is diminished, the factory sector must contend with an overvalued exchange rate. Lower US costs and heightened competition from emerging Asia pose a threat to Ontario, North America's largest auto producer. And as a net-energy importer, higher oil and gas prices won't do producers any favours. Future years will also feel the drag from government belt tightening.

A harmonized sales tax, alongside cuts to corporate taxes, will boost competitiveness and help lure jobs. A focus on emerging sectors, such as green power, also looks to pay dividends. Finally, growth in Canada's banking sector stands to benefit Ontario disproportionately.

Chart 8
Factory Layoffs Weighed Heaviest on Ontario



Source: Statistics Canada

Québec's 2009 real GDP decline was less acute than that of its Central Canada cousin. In fact, Québec's growth edge vs Ontario was the largest in nearly two decades. But having sustained less damage, Québec looks to relinquish its edge in the initial stages of recovery.

Fiscal stimulus has been timely and effective, with public sector projects driving investment and job creation. As in other parts of the country, government will lend support in 2010. Absent a heavy reliance on autos, Québec's diverse manufacturing base suffered less damage. Still, forestry remains an industry in decline, aluminium is challenged by new global capacity, and refining output has been scaled back. Aerospace demand has also softened.

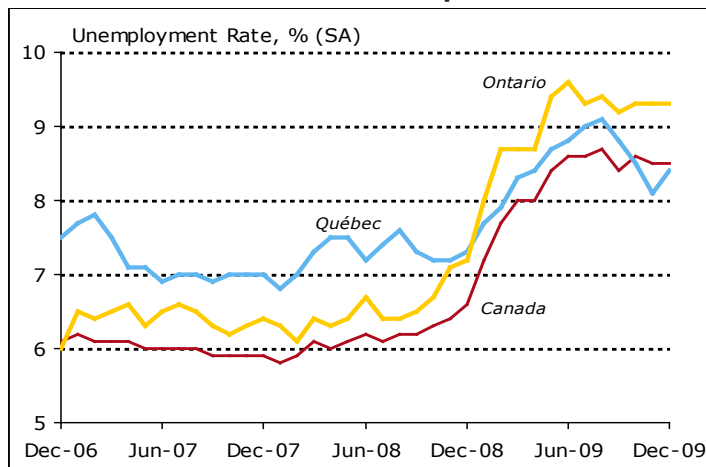
Overall, the province has seen a significantly smaller rise in joblessness (Chart 9). This relatively stronger labour market supports consumer demand and housing, although past outperformance means there's less easy ground to be regained.

Atlantic Canada Weathered Storm Well

Save Newfoundland & Labrador, the Atlantic provinces suffered a less severe economic hit during 2009. Consumer fundamentals are in relatively better shape (Chart 10), but with a leaner roster of major capital projects, growth in much of the region is likely to trail the national average in 2010-11.

Tax cuts and lower power rates will make New Brunswick a more attractive destination for industry. Less positively, traditional sectors like forestry and business services

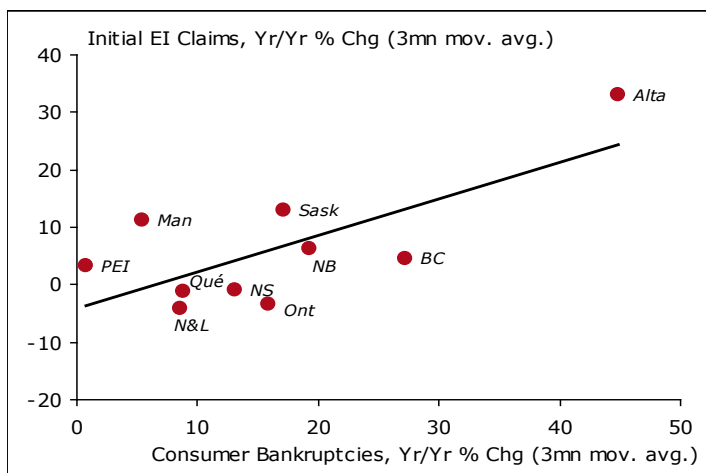
Chart 9
Québec's Labour Market Outperforms



Source: Statistics Canada

face headwinds. And in some cases, capital investment has been put off. For Nova Scotia, first gas from Deep Panuke will flow in 2010, helping to offset depletion in more mature fields. The province boasts a vibrant finance industry and its transportation sector stands to benefit from an upturn in global demand. Prince Edward Island will see a limited bounce in 2010, and despite diversifying its economy, the agriculture sector has been under stress. Output in Newfoundland & Labrador slumped in 2009, as energy and mineral production declined. Confidence remains high, however, with consumer spending and business investment expected to lend meaningful support in the years ahead. Once a labour dispute is resolved, nickel production is poised to shoot higher, with a strong price backdrop supportive. Barring disruptions, growth in 2011 should strengthen further, with large energy projects having the potential to deliver strong growth longer-term.

Chart 10
Stronger Consumer Fundamentals in Atlantic Canada



Source: Statistics Canada, Industry Canada

US Housing—A Double Dip

Benjamin Tal and Meny Grauman

The US economy may be on the mend, but a full-fledged recovery in the residential real estate market is still years away. After an unprecedented multi-year collapse most housing indicators have stabilized, but whatever signs of improvement do exist are more a function of a badly damaged market, and the distorting effect of temporary tax incentives, than evidence of a sustainable rebound. Starts, sales and prices are ended 2009 higher than they were earlier in the year, but we anticipate further weakness ahead as supply continues to outpace demand, mortgage rates head higher, and the government’s generous home-buyers tax credit finally expires. That has significant implications for related equities which have already priced in a steady recovery in the US housing market.

Short-Lived Remedies

Just how strong an impact recent tax policy has had is clearly visible in the flood of purchases of existing homes, where foreclosures beat down prices to levels tempting to the first time buyers who initially qualified for the program. During the past year in which the program has been in effect, sales of existing homes have climbed by 15%, while new home sales have actually dropped by 5%. In fact, the usually stable sales ratio between the two has more than tripled, recently hitting a record high 18 (Chart 1). But after being extended once by the Obama Administration, this tax credit will expire at the end of April—putting

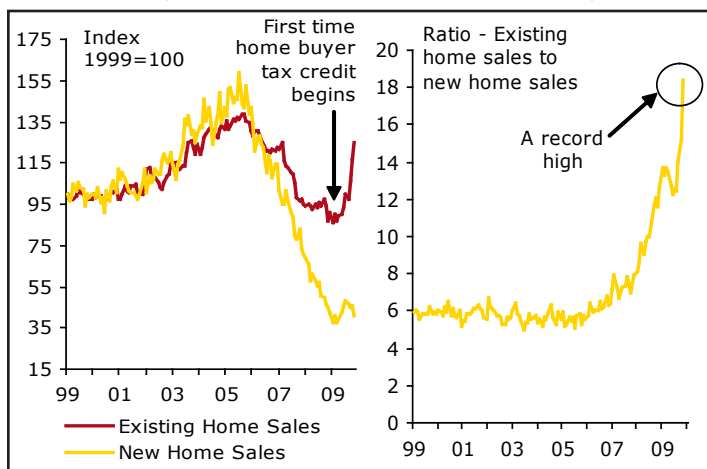
downward pressure on demand for existing home sales. That prospect will make it more difficult to clear out the next wave of foreclosures, prompting another down leg in US house prices.

Shadow Inventory

But the risk of a double dip in US home prices is not simply the result of properties being sold at “fire-sale” valuations, but also due to a deluge of shadow inventory coming onto the market. Although conventional inventories are trending lower, shadow inventories, capturing seriously delinquent and bank-owned properties, are just as large.

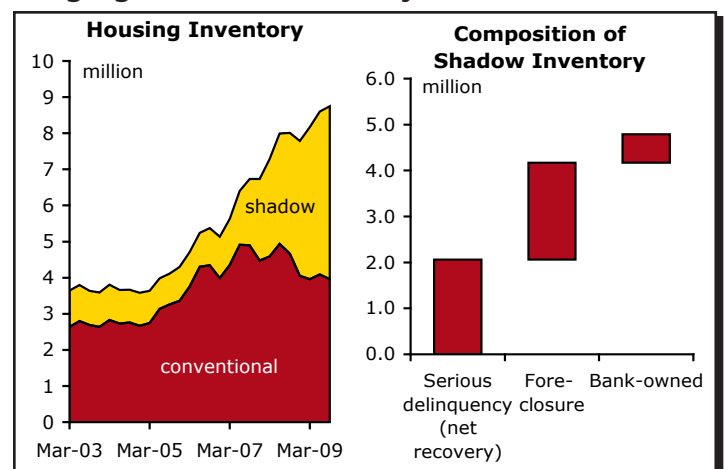
There are close to two million mortgages that are more than 90 days delinquent, and nearly all of these will end up in foreclosure, given that over the past three years the “cure rate” of this category fell from 40% to less than one percent. Add to that the 2.3 million properties that are in foreclosure or already seized by banks, and total inventories (conventional and shadow) are now running at over 8 million units (Chart 2). At current sales rates, that adds up to a record high 16 months of supply. True, this “shadow” stock will not hit the market all at the same time as banks manage their supply of seized properties, but this constant flow is likely to keep markets depressed for a while.

Chart 1
US Housing—Tax Credit Helped Existing Homes



Source: MBA, CIBC

Chart 2
Surging Shadow Inventory



Source: MBA, NAR, CIBC

Note that default and foreclosure rates continue to rise despite a slowly improving economy and government efforts to stem the tide. Out of the nearly 730,000 mortgages in trial loan modification just 31,000 have been made permanent. And according to recent figures, despite managing to reduce monthly payments, the vast majority of modifications have actually raised loan balances—an important contributor in itself to the probability of foreclosure.

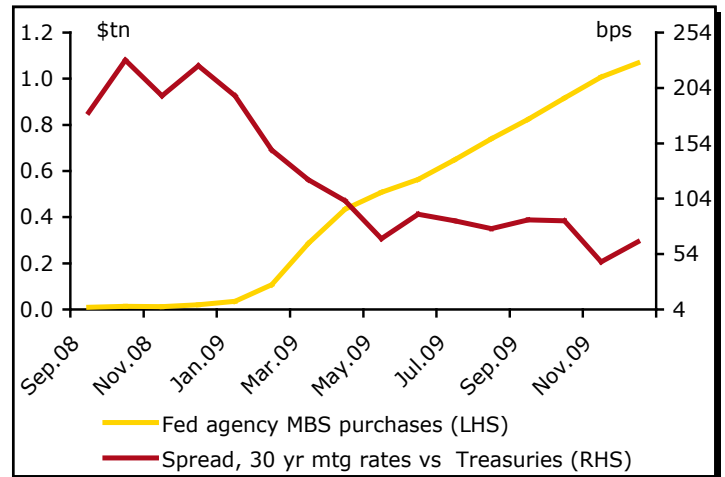
A big part of the problem is a still weak labour market, which has left a record 15 million Americans unemployed and another 9 million underemployed for economic reasons. However, just as significant is the roughly 10 million households in a negative home equity position of worse than -20%, for whom strategic default - failing to pay when one could - is a very real option. While negative equity is a necessary but not sufficient condition for default, it's a clear risk; out of the 2 million or so foreclosures in 2009, roughly 25% were strategic (Chart 3).

Fed About to Halt Purchases of Agency MBSs

It's not just inventories and tax credits that are looming large over the housing market, but also interest rates. Aggressive central banks' rate cuts along with large amounts of agency MBS purchases by the Federal Reserve have lowered mortgage rates by over 100 bps since the height of the financial crisis. That spurred a refinancing boom, which, according to First American Corelogic, saved \$2.3 billion in mortgage payments—a roughly 10% reduction—in 2009 alone. Although we don't expect policymakers to raise the fed funds rate until 2011, mortgage rates have

Chart 4

Fed MBS Purchases Held Down Mortgage Rates

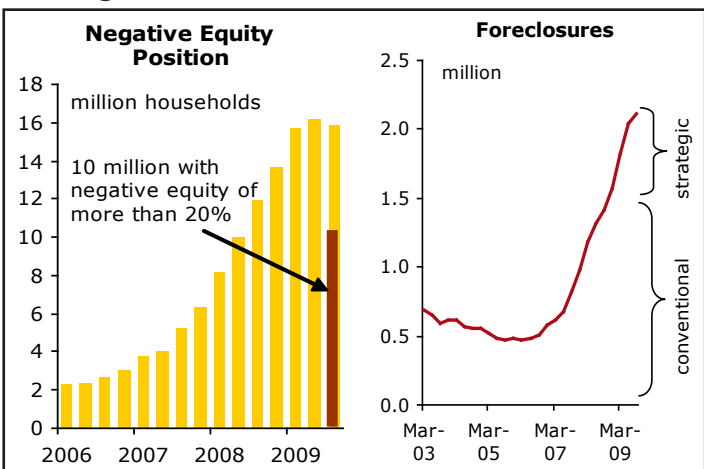


already started to head higher, and could keep climbing towards the end of the first quarter when the Fed's \$1.25 trillion agency MBS purchase program is completed. Those purchases made up almost 50% of all MBS issuance last year, and despite the improvements in the securitization market, their absence will likely have a material impact on rates (Chart 4).

In the final analysis, the end of unprecedented government tax support for housing, along with the looming overhang of supply and a higher cost of borrowing will keep new home building activity trudging along at historic lows over the next two years and could see prices drop again by 5-10% (Chart 5).

Chart 3

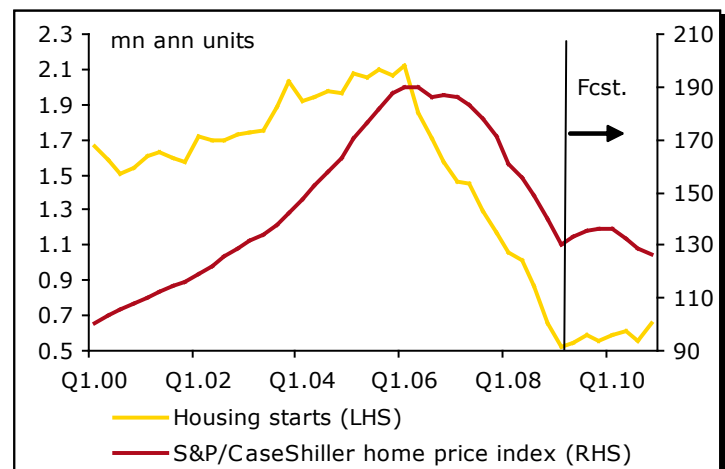
Strategic Defaults on the Rise



Source: Loan Performance, Equifax, CIBC

Chart 5

Housing Prices Head for a Double Dip



The TSX Earnings Recession Ends with a Bounce

Peter Buchanan

Last year was the best in nearly three decades for Canadian stocks. How much of that momentum may carry over into 2010 will become clearer in coming days as the TSX Q4 reporting season shifts into full gear

As in the US, the forthcoming reports will mark the end of the earnings recession, after four down quarters. "Bottom-up" expectations are for an increase of 43% in TSX operating earnings on the year (Chart 1). That's the first positive print since 08:Q3 and compares with an expected 189% increase for S&P 500 stocks. The gain for the TSX looks like a tough wall to climb, but will in fact benefit hugely from an easy comparison with a year earlier, when both the Canadian and global economies sank into recession, dragging commodity prices and profits down. In sequential terms, TSX earnings will have to rise by only 5-6% from the previous quarter to meet expectations.

Insurers, Mining Expected to Drive Q4 Earnings Gain

Performance in two TSX segments in particular is expected to show striking year-to-year improvement (Chart 2). Insurers lost over \$1 billion in the year-earlier quarter as a result of adjustments on segregated funds and some of their other assets and liabilities. That sector is expected to see a well-over \$3 billion positive swing in profitability. The diversified mining group, meanwhile, is expected to

Chart 1
TSX Earnings Recession Ends

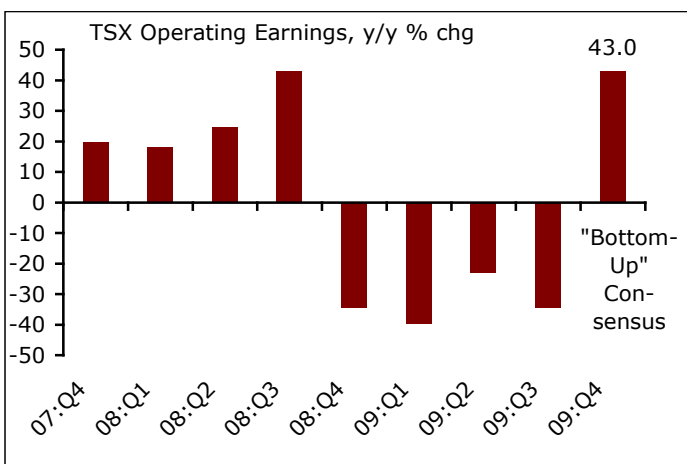
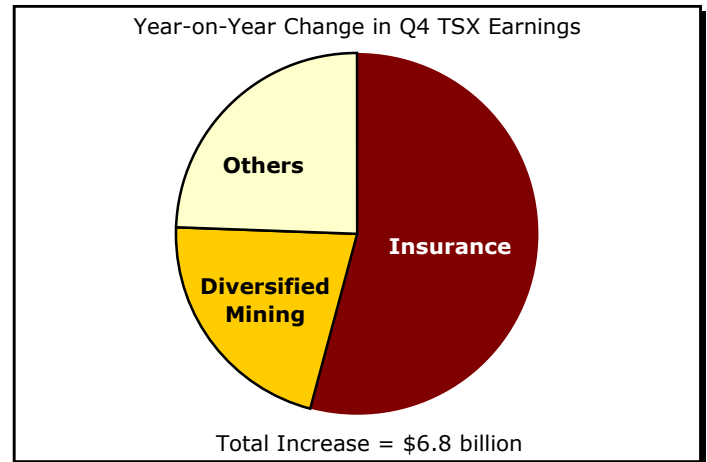


Chart 2
Better Results From Insurers, Metal Miners to Drive Q4 Results



see a \$1.5 billion improvement on a year earlier. Gains in those two segments will account for about three quarters of the total year-on-year rise in earnings.

Earnings in seven of ten major TSX market sectors are expected to show improvement on the year (Table 1). Next to the two areas identified above, health care, info tech and utilities stocks are expected to show the largest increases. Q4 expected 43% rise would nevertheless

Table 1

yr/yr % change	TSX Composite			S&P 500
	2009:Q3	2009:Q4	2009	2009:Q4
	Actual	Consensus	Consensus	Consensus
Cons. Discr.	-19.4	-2.7	-18.3	67.4
Cons. Staples	11.9	7.6	12.2	3.6
Energy	-68.3	-3.6	-49.9	-29.1
-E&P Firms	-68.8	-32.5	-57.1	19.8
Financials	-4.4	101.5	2.2	NM
-Banks	13.8	-2.9	2.6	NM
-Insurance	-24.8	NM	-1.3	NM
Health Care	-11.8	105.0	13.8	-7.3
Industrials	-10.0	-18.1	-22.3	-12.7
Info Tech	15.5	23.7	19.7	32.4
Materials	-48.6	4015.4	-27.9	136.9
-Gold	12.8	13.1	7.0	205.0
-Diversified Mining	-21.8	NM	-0.7	NM
-Chemicals	-83.6	-66.4	-72.6	99.8
Telecom	16.4	5.6	7.6	-70.2
Utilities	-154.2	58.6	160.5	-15.4
Total, All Sectors	-34.4	43.0	-26.0	188.5

NM=not meaningful, -ve yr ago

translate into a 26% drop for the year as a whole. That's a sizeable setback, although still better than the 80% decline in earnings in the early 1990s recession, when commodity prices sank even lower.

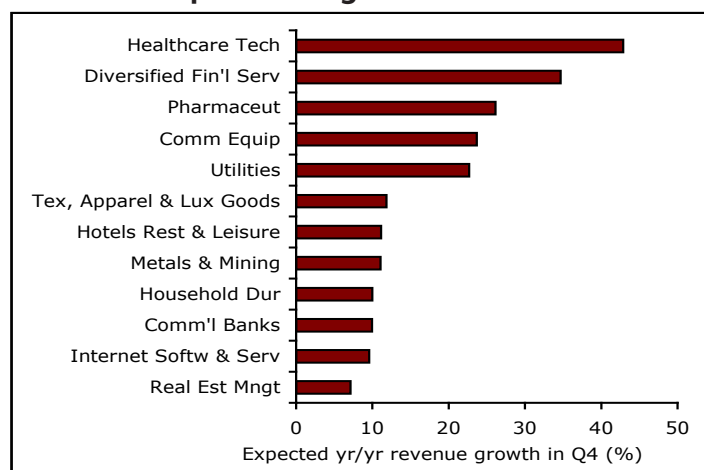
Analysts on both sides of the border have been ratcheting up their near-term expectations for earnings, in response to improvements in the economy and commodity prices. In Canada, positive revisions have accounted for 53% of all revisions for the quarter ahead recently, compared to a normal ratio of 42%. South of the border the ratio is an even loftier 73%. That suggests more of the positive news may already be priced into stock valuations than a few quarters ago, limiting the potential for stocks to rally strongly on the upcoming reports (Chart 3).

Revenues in Some Sectors Should Do Well

Revenue growth continues to be a key focus on both sides of the border. Canada's inflation rate cooled to 1.3% in the 12 months through December. That suggests a lack of pricing power, and by extension revenue performance remains a concern for some firms. Steep job cuts, especially in the US, have led to fears that recent profit growth is being fueled excessively by cost cutting rather than "organic" revenue growth, and that companies are effectively improving today's performance at the expense of tomorrow's. While such concerns remain, some sectors should show fairly good top-line momentum. That includes resource industries like mining, leveraged to hot emerging-market demand, as well as high-tech firms and others selling differentiated products, limiting their sensitivity to priced-based competition. It also includes firms facing favourable sales demographics like health

Chart 4

Some Sectors Could See Good Revenue Growth Despite Pricing Headwinds



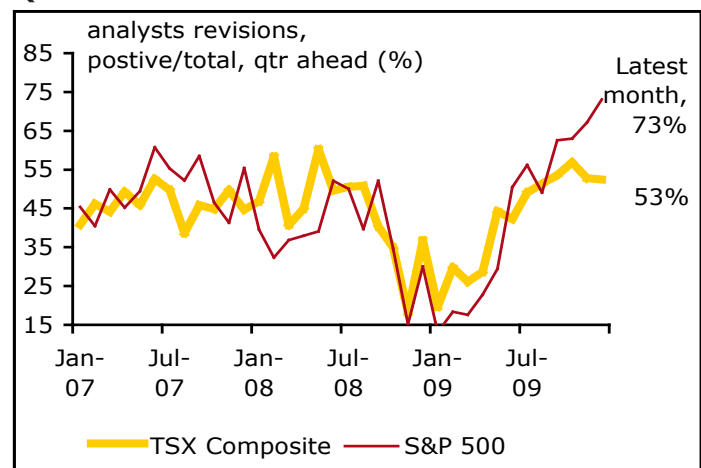
equipment and services (Chart 4).

Pressure on Firms to Meet 2010 Expectations

While meeting expectations this quarter may not prove in the end to be overly difficult for many firms, Composite members could have a greater challenge validating expectations for a 26% rise in 2010 (Chart 5). Although such increases have occurred after past recessions, that has generally been in the context of stronger economic recoveries than we expect this time, given the drag from a scaling back of fiscal stimulus programs in both Canada and the US. The currency, moreover, has seldom been as large a drag as it is at present. Commodity prices, another recent profit driver, are unlikely to advance quite as much this year as they did in 2009, when prices rose by the most in three decades.

Chart 3

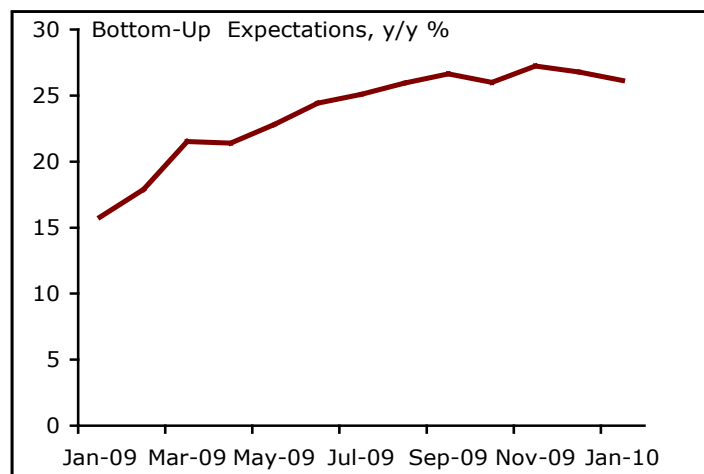
Less Room for Upside Surprises Than in Quarters Past?



Source: Thomson Reuters, CIBC

Chart 5

2010 TSX Earnings Growth Expectations



Source: Thomson Reuters, CIBC

ECONOMIC UPDATE

CANADA	09Q3A	09Q4F	10Q1F	10Q2F	10Q3F	10Q4F	2008A	2009F	2010F	2011F
Real GDP Growth (AR)	0.4	3.5	3.8	3.1	1.5	1.9	0.4	-2.5	2.3	3.0
Real Final Domestic Demand (AR)	4.7	2.5	3.5	3.0	2.7	2.4	2.6	-1.5	3.0	2.5
All Items CPI Inflation (Y/Y)	-0.9	0.8	1.5	1.8	2.1	1.7	2.4	0.3	1.8	2.0
Core CPI Ex Indirect Taxes (Y/Y)	1.6	1.6	1.7	1.7	1.7	1.6	1.7	1.8	1.7	2.0
Unemployment Rate (%)	8.6	8.6	8.3	8.2	8.3	8.4	6.1	8.3	8.3	8.1
U.S.										
Real GDP Growth (AR)	2.2	4.0	4.0	3.3	1.4	0.7	0.4	-2.5	2.8	2.4
Real Final Sales (AR)	1.5	3.0	2.1	1.8	1.2	0.7	0.8	-1.6	1.8	2.2
All Items CPI Inflation (Y/Y)	-1.6	1.4	2.1	1.3	1.7	1.8	3.8	-0.4	1.7	3.0
Core CPI Inflation (Y/Y)	1.5	1.7	1.5	1.2	1.1	1.2	2.3	1.7	1.3	2.0
Unemployment Rate (%)	9.6	10.0	10.3	9.9	10.2	10.5	5.8	9.3	10.2	9.5

CANADA

After a slow start to Q4, it's going to take a strong December to meet our call for a 3.5% annualized pace for the quarter. We revamped our outlook in January's edition of "Forecast" and are now expecting a stronger first half of the year in line with the trade-related gains from the upswing stateside. While we took down a notch our inflation forecasts for 2010 after the latest below-consensus CPI report, we anticipate that strong first half growth will prompt the Bank of Canada to start the tightening cycle in Q3. But second half growth will disappoint as the impacts of US fiscal stimulus, inventory restocking and housing wealth's boost to Canadian consumption collectively fade.

UNITED STATES

Although US economic growth has returned after its deepest post-war recession, the pace of recovery will slow down significantly in the second half of 2010. We expect nonfarm payrolls to begin to head higher over the next couple of months, but that will not be enough to bring the unemployment rate down materially below 10% until late in 2011. Year-over-year inflation finally moved back into positive territory as last year's steep drop in energy prices fell out of the index, but core inflation should remain weighed down by significant economic slack until next year.

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