



Economics & Strategy

Jeffrey Rubin
(416) 594-7357
jeff.rubin@cibc.ca

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

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

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

"The last time we saw 6% inflation in 1990, the federal funds rate was running at around 7½%—over three times today's setting."

The Return of Six Percent Inflation

by Jeff Rubin

We haven't seen a 6% CPI inflation rate posted in the US since 1990 and even then only briefly for four months. You've got to go back to 1982, in the midst of the stagflation that followed the second OPEC oil shock, to see the last time American inflation was clocked at that kind of pace for any sustained period. Yet within the next six months, there is every reason to believe that headline CPI inflation will once again reach that speed.

Coincidence or back to the future? You be the judge. There seems to be at least two major differences between then and now. How long they last remains to be seen.

One huge difference is labor markets. Back in the 1980s they looked quite different than they appear today. For one thing, no one was looking over their shoulder to see if their plant and their job were being moved to China. Not that China wasn't just as cheap as today. It's just that it didn't matter back then because of all the tariff and quota protection around home markets. For another, most collective bargaining agreements of the day had cost of living allowances (COLA) built into the wage scale. Those COLA clauses largely became self-fulfilling prophecies by ensuring that oil price-driven inflation would largely become self-sustaining through a wage-price spiral.

While that may seem light years from today's labor market, soaring energy costs are rapidly turning global cost curves on their

head. As shipping costs soar with triple-digit oil prices, the once omnipotent threat of Chinese competition is growing fainter every day. And the same energy costs that now protect American workers with soaring freight costs are, at the same time, eating their paycheques at the gas pumps.

Both are powerful incentives for COLA to make a triumphant return to North American wage negotiations. Particularly in highly organized industries like steel, where soaring freight rates are the equivalent of double-digit tariff protection. High energy prices give American manufacturing workers bargaining power that they have lacked for over a decade, while at the same time encouraging them to ask for larger pay raises to keep pace with the soaring price of gasoline. And as more and more of OPEC's oil is diverted to meet soaring power demands throughout the Middle East (see pages 4-7), American pump prices will continue to rise.

If labor markets start changing, how high will interest rates have to rise? The last time we saw 6% inflation in 1990, the federal funds rate was running at around 7½%—over three times today's setting. And a 10-year Treasury bond was yielding 8½%—over double what it yields today.

We expect that the Federal Reserve Board will raise interest rates no less than 200 basis points by the end of next year. History says we will be very lucky if they don't have to do more.

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

MARKET CALL

- We've made no changes to our interest rate and major currency outlook this month, in part because both will be largely directionless until a clearer picture emerges on America's economic fate. For now, downside risks to growth preclude any immediate policy tightening by the Fed, while steadily rising inflation risks make an ease similarly implausible.
- Fed fund futures are pricing in a quarter-point post-election rate hike late this year, a view we share. But the bond market isn't fully braced for what lies beyond that in 2009—a fairly aggressive rate hike cycle that will be needed to ward off the spillover from food/energy prices into core inflation.
- In Canada, a flat BA futures curve out to March seems too optimistic. The first Fed hike will be Bernanke's vote of confidence that the worst is over for US growth risks. Carney will then feel compelled to follow suit, recognizing continued above-target Canadian inflation pressures. Relative to what's now priced in, that response will be bearish for Canadian bonds, but bullish for the C\$. These days, rate expectations seem to have a greater impact on the loonie than the ups and downs of crude oil.

INTEREST & FOREIGN EXCHANGE RATES

END OF PERIOD:	2008			2009			
	29-Jul	Sep	Dec	Mar	Jun	Sep	Dec
CDA Overnight target rate	3.00	3.00	3.00	3.25	3.50	4.00	4.00
98-Day Treasury Bills	2.45	2.70	2.80	3.20	3.35	3.75	3.70
Chartered Bank Prime	4.75	4.75	4.75	5.00	5.25	5.75	5.75
2-Year Gov't Bond (3.75% 6/10)	3.06	3.40	3.60	3.85	3.95	4.30	4.35
10-Year Gov't Bond (4.25% 06/18)	3.79	3.85	3.95	4.00	4.10	4.35	4.40
30-Year Gov't Bond (5% 06/37)	4.14	4.20	4.25	4.30	4.30	4.60	4.65
U.S. Federal Funds Target	2.00	2.00	2.25	2.75	3.25	3.75	4.00
91-Day Treasury Bills	1.72	1.95	2.10	2.55	2.95	3.50	3.60
2-Year Gov't Note (2.75% 7/10)	2.64	2.95	3.05	3.10	3.40	3.85	4.00
10-Year Gov't Note (3.875% 05/18)	4.05	4.20	4.30	4.35	4.45	4.60	4.65
30-Year Gov't Bond (4.375% 02/38)	4.63	4.75	4.80	4.80	4.80	4.80	4.90
Canada - US T-Bill Spread	0.73	0.75	0.70	0.65	0.40	0.25	0.10
Canada - US 10-Year Bond Spread	-0.26	-0.35	-0.35	-0.35	-0.35	-0.25	-0.25
Canada Yield Curve (30-Year — 2-Year)	1.08	0.80	0.65	0.45	0.35	0.30	0.30
US Yield Curve (30-Year — 2-Year)	1.99	1.80	1.75	1.70	1.40	0.95	0.90
EXCHANGE RATES							
— (US\$/C\$)	97.8	100.0	103.1	105.3	101.5	102.0	101.5
— (C\$/US\$)	1.023	1.000	0.970	0.950	0.985	0.980	0.985
— (Yen/US\$)	108	105	108	102	97	96	94
— (US\$/euro)	1.56	1.59	1.56	1.50	1.49	1.49	1.50
— (US\$/pound)	1.98	1.99	1.96	1.90	1.90	1.88	1.90
— (US\$/A\$)	95.2	96.5	93.0	92.5	91.0	92.0	93.0

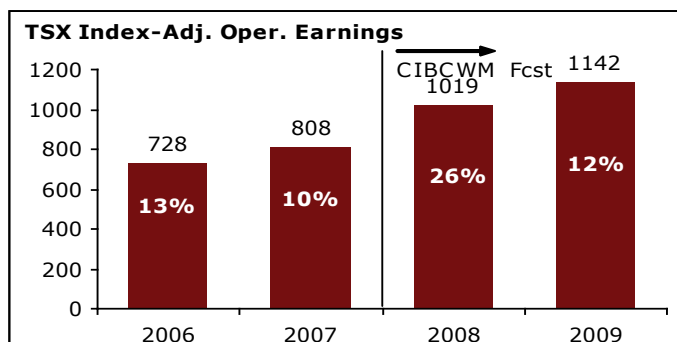
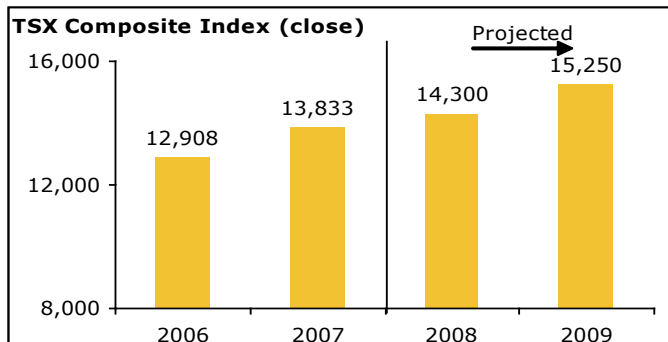
STRATEGY AND EARNINGS OUTLOOK

- Growing stagflation risks prompted us to trim our TSX target to 14,300 for the end of 2008 and 15,250 for the end of 2009. We also reduced our equity exposure to neutral, by shifting four points of weighting to cash. The combination of 1% US real GDP growth, 5%-plus inflation, and tightening by both the Fed and Bank of Canada will be challenging to large swaths of the stock market. That's particularly true of anything connected to the energy-exposed transportation sector.
- Consistent with our more aggressive oil price target of \$150/bbl for 2009, we added half a point to our seven points overweight in the energy sector. We also added a half percentage point of exposure to the fertilizer group. Soaring meat demand in China and India, which is sending world fertilizer demand through the roof, creates more upside for the sector. The materials sector, which contains agricultural chemicals producers, and the energy sector have been the TSX's two top performers year to date.
- We also reduced our exposure to both the consumer discretionary and the industrial sectors, particularly airlines. The auto component of the consumer discretionary looks vulnerable to an anticipated further collapse in US vehicle sales to an anemic 11 million pace over the next two years. Jet fuel prices have risen even more dramatically than gasoline prices in the last year, adding to the airline sector's profit woes.

ASSET MIX (%)	Benchmark	Strategy Recommendation
Stocks	53	53
Bonds	38	36
Cash	9	11
GICS SECTOR EQUITIES (%)		
Consumer Discretionary	3.8	0.8
Consumer Staples	2.3	2.3
Energy	29.9	37.4
Financials	27.9	25.4
-Banks	15.7	13.7
-Insur., REITs, other	12.2	11.7
Healthcare	0.4	0.4
Industrials	5.5	3.0
Info Tech	5.0	5.0
Materials	18.6	21.6
-Gold	7.7	8.7
-Other Metals	4.9	5.9
-Chemicals	5.6	6.6
Telecom	5.0	2.5
Utilities	1.6	1.6

Note: Bold indicates recommended overweight.

TSX - Earnings Outlook & Forward PE						
	Operating Earnings (% ch)				4-qr Fwd PE	
	2005	2006	2007	2008	Latest	Last 10 yrs.
Energy	44.7	12.3	8.5	72.4	9.3	12.0
Health Care	5.3	28.9	-38.7	-23.8	20.4	22.0
Industrials	27.5	14.2	35.8	-12.9	18.4	14.9
Materials	40.7	76.9	1.2	84.3	14.0	28.9
Utilities	17.9	-6.5	58.4	2.1	19.8	17.4
Consumer Staples	3.1	0.3	-2.6	0.4	15.4	17.8
Financials	14.0	17.1	14.1	-7.3	14.6	12.0
Info Tech	-41.4	51.6	155.5	53.7	28.0	44.5
Consumer Discretionary	3.7	19.7	-6.1	14.8	11.6	15.7
Telecom Services	5.9	30.8	28.4	-8.7	17.6	29.8
TSX Composite	31.2	13.2	10.4	26.1	12.7	16.1



Source: Thomson First Call, CIBC WM

OPEC: Solution or Part of the Problem?

Jeff Rubin and Peter Buchanan

Shady speculators. The sagging dollar. Global tensions. The only factor that OPEC’s leaders don’t blame for triple-digit oil prices is their own energy subsidies, that are fuelling runaway demand, and cannibalizing their oil and gas exports. That includes not only ultra-low prices for products like gasoline (see *Occasional Report #62, “OPEC’s Growing Call on Itself”*)—for which motorists typically pay a tenth or so the prevailing global rate—but even more egregious subsidies for oil- and gas-fired electricity.

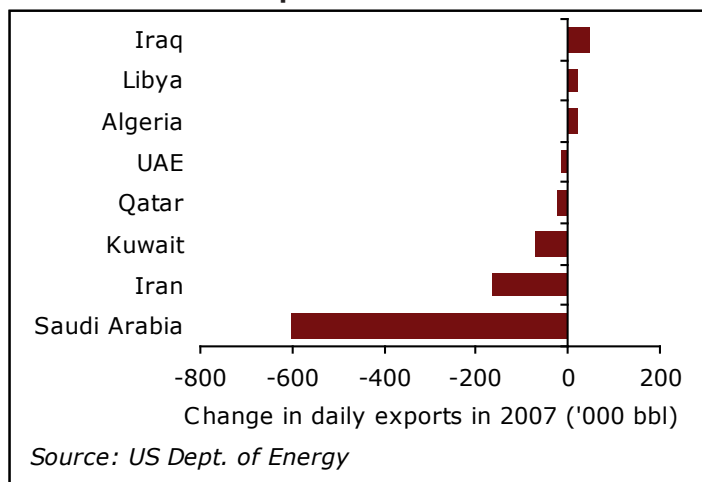
From the world’s largest indoor ski hill in Dubai, to the world’s largest desalination plants in Saudi Arabia, dirt cheap energy makes anything possible in the Middle East today. No surprise then that North America’s claim to the most energy-intensive lifestyles is being challenged by what’s going on in the Middle East these days, with sweeping implications for global energy markets. The clash between the region’s exploding thirst for oil and waning production growth was the main reason why crude exports from the region fell by over 700,000 barrels per day in 2007 (Chart 1). Although producers now claim they will boost exports from that level, our analysis points to a further one million barrel per day decline over the next half decade.

Middle East Oil Demand Growing as Fast as China’s

While exports fell in 2007, daily oil consumption in the Middle East itself climbed by some 300,000 barrels,

Chart 1

Middle East Oil Exports Fell in 2007



offsetting much of the decline in OECD consumption. The increase in the Middle East’s own consumption matched the increase recorded by China, a country with quadruple its population.

Nor is the threat to the region’s export capacity limited to oil. The Middle East is home to two of the world’s top four liquefied natural gas (LNG) exporters, Algeria and Qatar. Near double-digit gas demand growth in many countries (Chart 2) calls into question American hopes for greatly expanded imports of LNG to stave off higher natural gas prices.

Alongside impressive GDP growth, subsidies for a range of fuel types—including fossil fuel-fired electricity—are serving to boost petroleum demand in the Middle East, limiting the region’s exports and threatening to tighten global markets even further. Half of the world’s population pays less than the prevailing market rate for oil products, a key reason why triple-digit world oil prices have yet to quash global demand. Nowhere are users more shielded from those prices than in major oil-producing countries in the Middle East itself. The belief that ultra-cheap energy is a birthright extends beyond gasoline to electric power. With no coal or nuclear and very limited hydro capacity, electricity in the region is predominately either natural gas- or oil-fired. Surging demand for subsidized electricity (Chart 3) could even overtake motor fuel demand as the primary driver of the region’s insatiable appetite for burning hydrocarbons.

Chart 2

Middle East Demand for Oil & Natural Gas is Booming

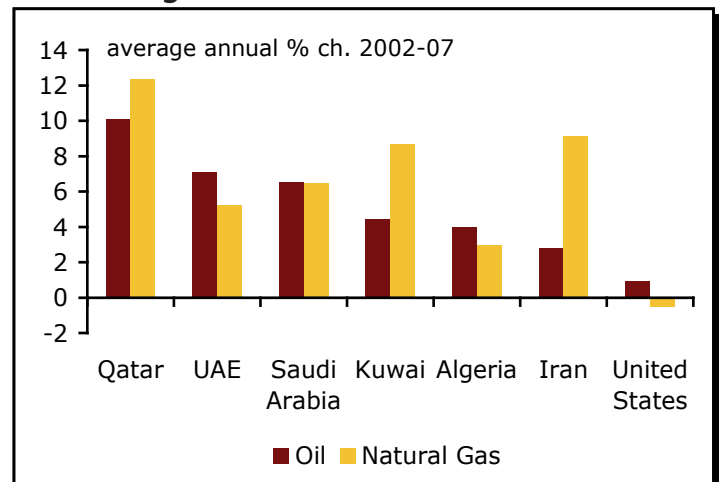
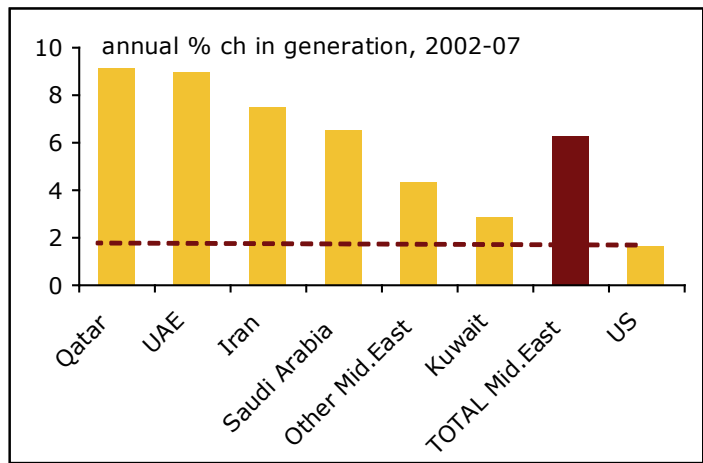


Chart 3

Middle East Power Demand Also Rocketing



Subsidized Electricity Boosting Hydrocarbon Demand

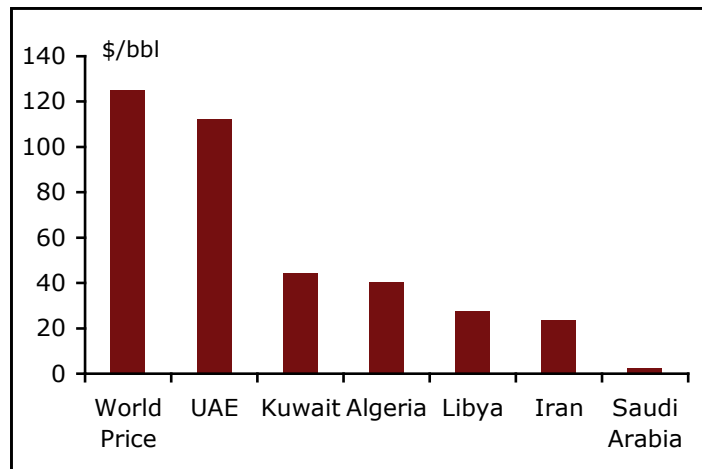
Saudi motorists pay an enviable 45 cents per gallon, or around \$20/bbl to gas up. Incredible as it may seem, the desert kingdom’s power plants get an even better deal, paying just \$0.46/mn Btu by royal decree, or less than \$3/bbl—what oil cost back in the mid-1960s (Chart 4). Power generators in other nearby countries get similar price breaks, as do other heavy industrial users like petrochemicals. In the power sector, those prodigious savings are passed along to the final customers, stimulating both power demand and associated fuel demand for oil- or natural gas-fired generators. Saudi households pay about 1 cent per kilowatt-hour, roughly a tenth of prevailing rates in the US. In nearby countries, end power users also receive generous discounts leaving them paying anywhere from half to just a 14th of what North American households would typically pay per kilowatt-hour (Chart 5).

Today, the largest per capita power users are increasingly found in the Middle East. Per capita power use in Kuwait now surpasses the US, while in Dubai, one of the region’s key economic engines, the level is now nearly twice what it is in the US. Even in countries which still lag the US, demand is fast catching up. Saudi power consumption, for example, has grown at an average 7% annual rate in the last half decade, four times as fast as in the US (Chart 3). And its huge expansion plans for water desalination plants are about to raise power consumption growth rates higher still.

Rising electricity demand would have little impact on oil consumption in the US, where only a negligible amount of power is still produced from oil-burning generators.

Chart 4

Cost of Oil to Power Generation Sector



Not so, however, in many OPEC countries, particularly in the Middle East. Counting conventional steam, diesel turbine and smaller-sized internal combustion units, oil makes up 50% of all power generated in Saudi Arabia and over 80% of Kuwait’s power (Chart 6).

The world’s single largest oil-fired power plant, operated by Saudi Electricity Company, produces 3,000 megawatts of power (equivalent to the output of three nuclear reactors). Pending additions will lift that amount to nearly 5,000 megawatts, part of an ambitious plan to triple the desert kingdom’s electricity production by 2020. Central to those plans is the construction of three massive new oil-fired generation facilities.

We estimate that power production alone in major Middle East oil producers uses about a third of a million barrels of oil each day (Chart 7). And that amount is likely to grow

Chart 5

Cheap Fuel Costs Mean Low Power Prices

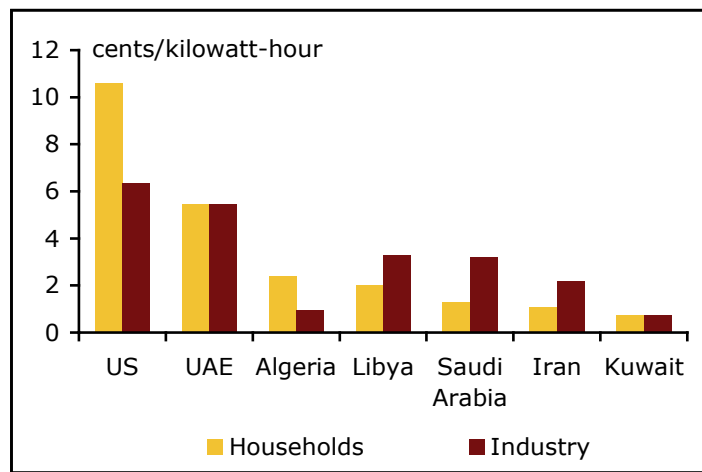
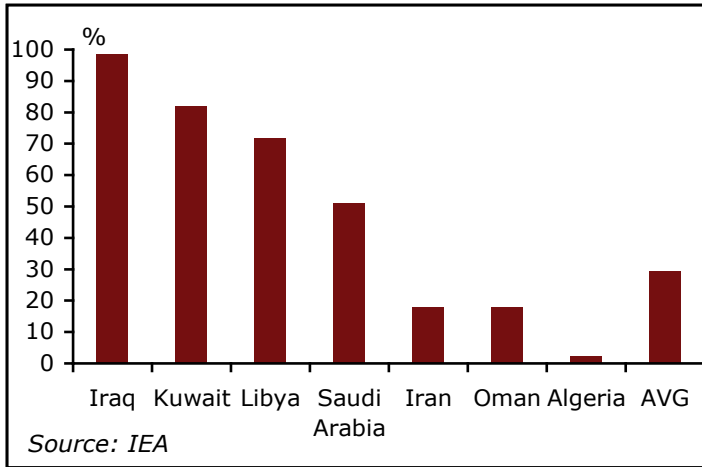


Chart 6

Oil's Share in the Power Generation Mix, 2005

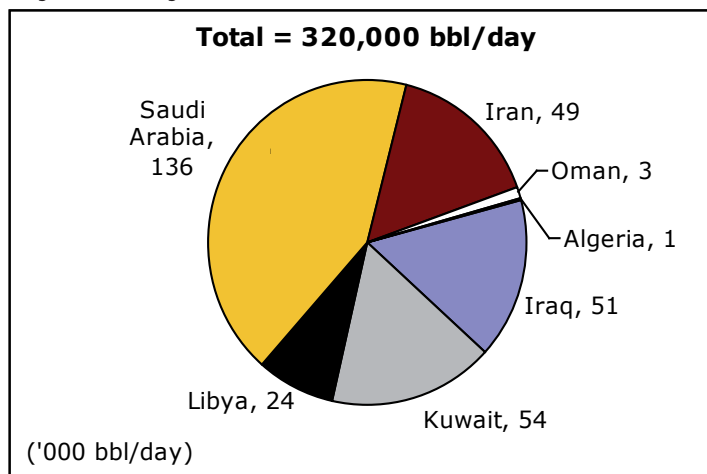


from here, due to economic and demographic factors, as well as fuel mix changes. Population growth rates of up to 2% in some countries are among the world's highest. Even before triple-digit oil prices boosted the Middle East's economic prospects, the US Department of Energy predicted that the region would see one of the fastest rates of power consumption growth in the world—double to triple the OECD countries' pace.

Moreover, a number of countries in the region previously reliant on gas-fired power are switching generation capacity to oil, which should significantly add to the power sector's petroleum demand. A particularly striking shift is occurring in the United Arab Emirates. Despite having the world's fifth largest natural gas reserves, the UAE actually faces a shortage of available gas due

Chart 7

Oil Consumed for Power Generation (by Country)



to long-term export contract commitments. Dubai, the second wealthiest and most dynamic of the Emirate states, has the highest electricity demand growth in the region, 15% annually. To conserve scarce natural gas, the country's state-owned power generator, DEWA, began switching its turbine-powered generators to diesel fuel three years ago.

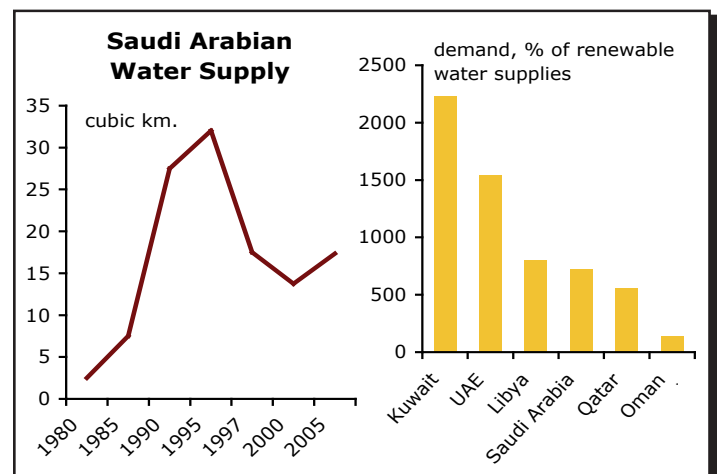
Even if Middle East governments cut back on retail price subsidies for gasoline and power, they may find it difficult to restrain overall energy demand, for a couple of reasons. One is the obvious pressure to nurture industrial development in a region where population pressures mean job growth and political stability have historically been intertwined. That has invariably meant encouraging heavy gas and oil consumers, like the petrochemical sector via cheap feedstock prices. The Middle East has accounted for half of all global petrochemical investment in recent years.

Fast-Rising Desalination Needs Will Boost Oil & Gas Consumption

But there is yet another factor driving rising power demand and that is the region's growing water crisis and the attendant demand for more hugely energy-intensive desalination plants, particularly in places like Saudi Arabia. Production of natural water—which, like oil was laid down eons ago in underground aquifers, and cannot therefore easily be replaced—is already down 50% from its mid-1990s peak (Chart 8, left). Agriculture accounts for around two-thirds of water use in the Middle East. Growing shortages consequently raise the uncomfortable spectre of an even greater dependence

Chart 8

Peak Water in Saudi Arabia (L); Unsustainably High Demand Elsewhere (R)



on food imports. That's true not just in Saudi Arabia, but of many neighbouring countries, some of which are running through their legacy of historical water at an even more alarming rate (Chart 8, right). While water use is seven times the sustainable levels in Saudi Arabia, consumption levels in the UAE and Kuwait, are 15 and 22 times the natural rate of replenishment from rivers and rainfall.

Half of the world's desalination capacity is in the Middle East. Saudi Arabia alone accounts for about 60% of the region's share, including the world's largest single facility, Shuaibah III. The oil-fired power station and associated desalination plant will produce 900 megawatts of power and 880,000 cubic meters of water per day when it reaches capacity early next year. The commissioning of the plant and two other integrated power facilities will boost the country's desalination capacity by 80% over the next two years (Table 1).

Producing fresh water from brine or other low-grade sources is invariably an energy-intensive process, even using efficient techniques. In reverse osmosis, brackish or saline water is forced through a semi-permeable membrane under high pressure to remove any impurities. Flash distillation, an alternate process which is popular in the Middle East, uses reduced air pressure to help vaporize and purify seawater.

Desalinating a thousand cubic metres of water in today's most efficient plants uses about 3-5 megawatt-hours of electricity (Table 2)—the power that can be generated from burning 6 barrels of oil or about 23 mn Btu of gas. Fully offsetting the 20 bn cubic metre/year decline

Table 2

Energy Needed to Desalinate 1,000 cubic metres of Seawater

<i>Technology</i>	<i>Megawatt Hrs</i>
Multi-stage Flash	3-6
Vapour Compression	8-12
Reverse Osmosis	5-10

Source: Californian Coastal Commission, CIBC World Markets

in Saudi Arabia's natural water over the last decade could consequently add roughly 300,000 barrels to the country's daily crude oil consumption. According to the World Bank, over the next 10-15 years, the Middle East will need an extra 50-60 bn cubic feet of water annually due to rapidly escalating demand, driven by population and economic growth, and declining natural water availability. Desalinating that immense volume of water could ultimately use 1 million barrels of oil per day, or the energy equivalent in natural gas.

Add to that, other factors driving soaring power demand, and an equally voracious appetite for motor vehicle fuel, and we expect crude exports from the Middle East to fall by another million barrels per day through 2012 (Chart 9). Rising energy needs for desalination alone could account for as much as a third of that expected decline.

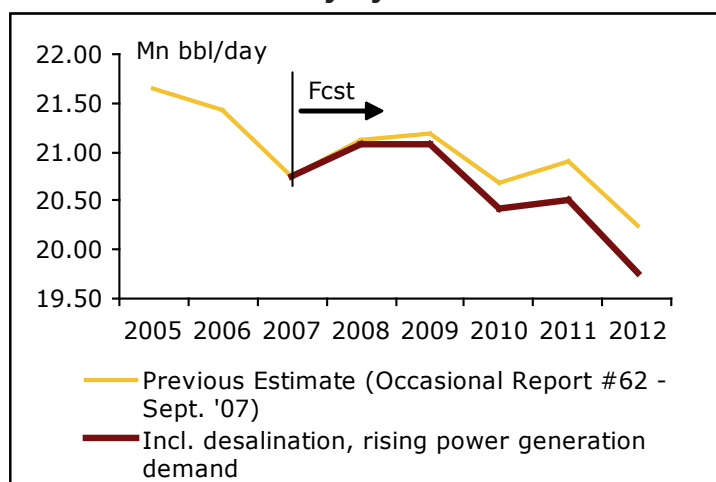
If world oil markets are to see future supply growth, it won't be coming from OPEC.

Table 1
Desalination Plants

World Rank	Country	Name	Capacity ('000 cu m. /day)	Startup	Fuel
1	Saudi Arabia	Shuaibah III	880	2009	Oil
2	Saudi Arabia	Ras Al-Zour	800	2009	Nat. Gas
3	Saudi Arabia	Al Jubail II Ex	730	2009	Nat Gas
4	UAE	Jebel Ali M	600	2011	Nat Gas
5	Kuwait	Al-Zour North	567	2007	Oil
6	UAE	Shuweihat	455	2004	Nat Gas/Oil
7	UAE	Shuweihat 2	455	2006	Nat Gas/Oil
8	USA	San Francisco	454	2008	Nat. Gas
9	UAE	Fujairah II	454	2007	Nat Gas/Oil
10	UAE	Qidfa	454	2004	Nat Gas/Oil

Chart 9

Middle East Oil Exports To Decline 1 Million Barrels Daily By 2012



Electricity Prices To Surge

Benjamin Tal and Krishen Rangasamy

While natural gas prices have dipped in recent weeks, the longer-term outlook for the commodity remains bullish. Natural gas prices are up 50% in the past year and should continue to rise alongside oil prices. This will cause electricity bills to surge in North American centers that use natural gas to run their generating stations.

Natural Gas Prices Will Rise

The relationship between oil prices and natural gas prices is complex, being a substitute and complement in consumption and a rival in production, but as illustrated in Chart 1, oil prices clearly drive natural gas prices. Even with domestic production staging a modest rebound, the latest surge in WTI prices led to a 50% rise in benchmark Henry Hub natural gas prices from \$6/mn Btu in late 2007 to the current \$9. And it's far from over. As oil moves towards the \$150 mark, and given that the full impact of higher oil prices on natural gas prices usually works with a 12-month lag, look for natural gas prices to reach a record high of \$15/mn Btu next year. And the fundamentals suggest that natural gas prices will not stop there. Simply put, global warming is bullish for natural gas. Demand for natural gas is sensitive to rising temperatures. Many coal-fired generation capacity plans are likely to be canceled all over North America and to be

replaced by nuclear and natural gas facilities. And given that half of the energy content of ethanol comes from natural gas, demand for natural gas will rise alongside ethanol production.

Rising Electricity Bills

With natural gas now representing one-fifth of total power generation in the US, up from 15% ten years ago, and gas-fired generation accounting for the lion's share of planned increased capacity in the coming five years, natural gas prices are increasingly becoming an important driver of US electricity prices. Average electricity prices in the US have already risen by 20% over the past three years (Chart 2). And with gas prices continuing to rise, look for US electricity prices to rise by an additional 20% by 2010, with regions that rely heavily on gas-fired generation such as New England seeing the largest increases.

Rising electricity prices south of the border are clearly bullish for the Canadian provinces that supply the US with power (Chart 3). By far the largest winner here is Québec with over C\$1 billion of net power exports to the US. Based on the average price of the province's main electricity export destinations (New England, New York

Chart 1
Nat. Gas Prices Will Rise Alongside Oil Prices

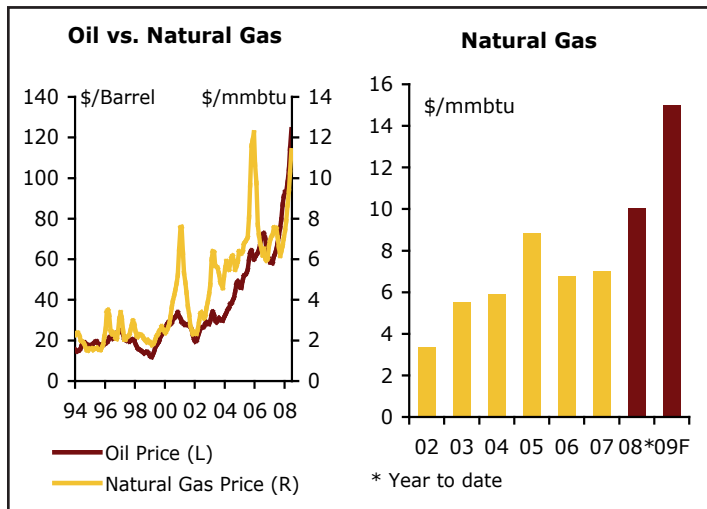
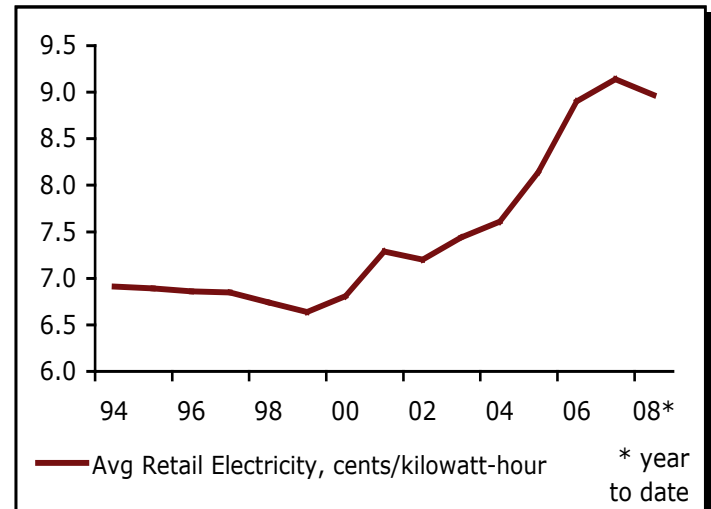


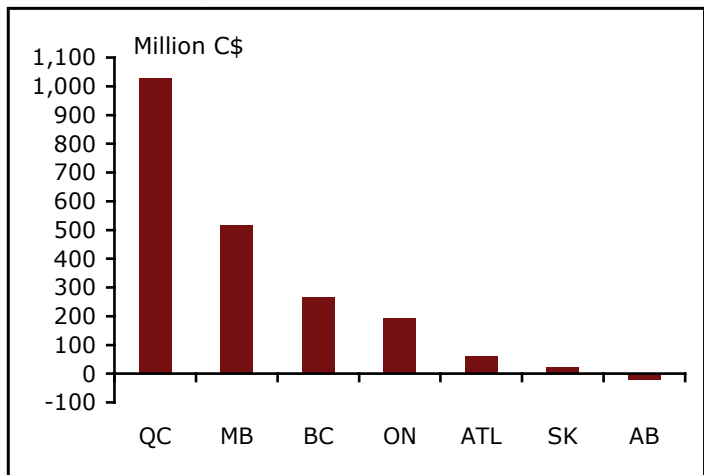
Chart 2
US Electricity Prices



Source: EIA, CIBCWM

Chart 3

Net Electricity Exports to the US (2007)



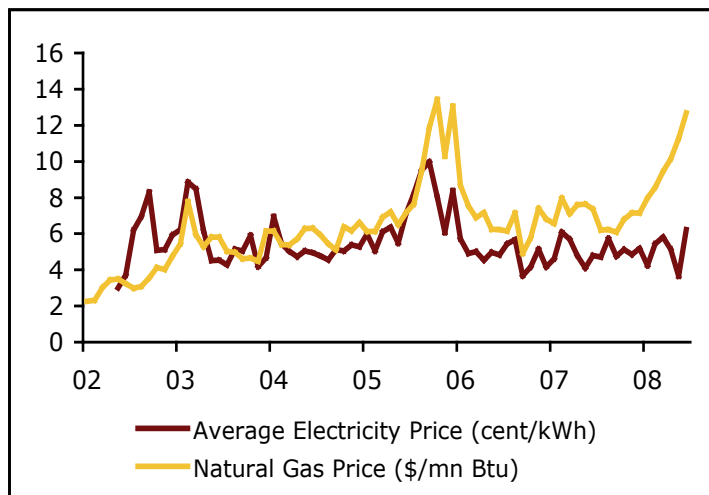
Source: National Energy Board, CIBCWM

and Vermont) we estimate that the upcoming rise in electricity prices in North America will add some C\$300 million to the province's electricity revenues.

Ontario is also a net exporter of electricity, but its growing reliance on gas-fired generation makes it increasingly sensitive to rising natural gas prices. As illustrated in Chart 4, electricity prices in Ontario dance very closely to the tune of natural gas. The surge in natural gas prices in the aftermath of hurricane Katrina led to a 40% increase in electricity prices in Ontario. On average, a one percentage point increase in natural gas prices in the province leads to a 0.6% rise in electricity prices in Ontario.

Chart 4

Natural Gas Drives Electricity Prices in Ontario



Source: IESO, CIBCWM

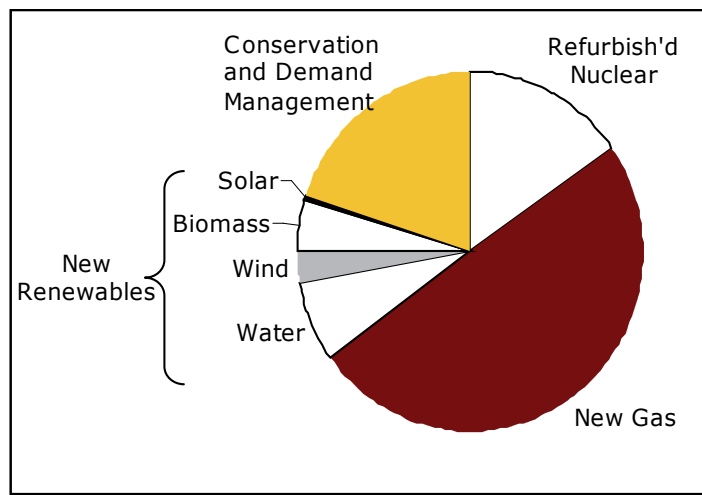
And electricity prices in the province are already rising—up from just over 4 cents per kWh earlier in the year to 6.2 cents per kWh in June. But a second glance at Chart 4 clearly reveals that this adjustment is still too small given the average level of natural gas prices this year. In fact, electricity prices in Ontario will have to rise an additional 25% to 7.8 cents per kWh just to catch up with natural gas prices, and by an additional 15% (to roughly 9 cents per kWh) as natural gas prices climb further to an average \$15 next year.

And that's in an environment in which natural gas accounts for less than 15% of Ontario's electricity supply. But given that 50% of projected new sources of power between now and 2015 will be based on natural gas (Chart 5), the province's sensitivity to swings in natural gas prices will double.

The other casualty of higher electricity prices is Alberta. Not only is the province a net importer of electricity, but its reliance on gas-fired generation is the largest in the nation. Roughly 20% of the province's electricity generation comes from burning natural gas, and as is the case in Ontario, a one percentage point increase in the price of natural gas leads to an electricity price increase of about 0.6%. And this elasticity will increase given that the share of natural gas in electricity generation will be rising in the coming years with new gas-fired plant additions to capacity. Overall, look for electricity prices in Alberta to rise by 15% by 2010—just in time for the regulated rate, which was implemented in 2006, to have completely expired, and expose Albertans to the full impact of a rising free market price.

Chart 5

Distribution of Planned New Power Resources in Ontario (2007-2015)



Source: OPA, CIBCWM

Stagflation, Stocks and Sector Selection

Avery Shenfeld and Meny Grauman

The debate is open as to which individual economic problem is more pressing, but taken together North America's sluggish growth outlook and rising inflationary trend signal challenging times ahead for investors on both sides of the border. Stocks have typically underperformed during periods of stagflation. And since both the US and Canada are unlikely to see above-potential growth or low CPI readings in either 2008 or 2009, prospects for both countries are a far cry from the "nirvana nineties" when the combination of strong US growth and low inflation helped push equity markets to record highs (Chart 1).

TSX No Longer Beholden to the US Economy

Over the past 60 years, the worst episodes of global stagflation have come in the aftermath of major oil supply shocks. The combination of rapidly rising inflation as a result of soaring energy prices, and plunging economic growth as a result of the accompanying monetary policy response, almost invariably led to a collapse in world growth and commodity prices. As can be expected, that confluence of events hit the TSX particularly hard because of its heavy resource weighting.

However, these historical episodes are a poor model for today's world, in which soaring energy prices are largely being driven by strong global demand and not by a temporary supply shock. Led by the developing world

and oil exporters, global economic growth is expected to remain near 4% even in 2009, which should keep commodity prices high for the foreseeable future. At the same time, many years of very low inflation is also allowing central bankers to respond to current inflationary challenges much less aggressively than they have in the past, tempering the resulting impact on GDP.

In this still favorable global environment, the resource-laden TSX should still be able to continue to post solid returns even under the threat of weak real GDP growth and rising inflation in both Canada and the United States. Global growth is much more closely correlated to the Toronto market than New York (Chart 2) as a result of the key role that the developing world has played in driving up prices for natural resources.

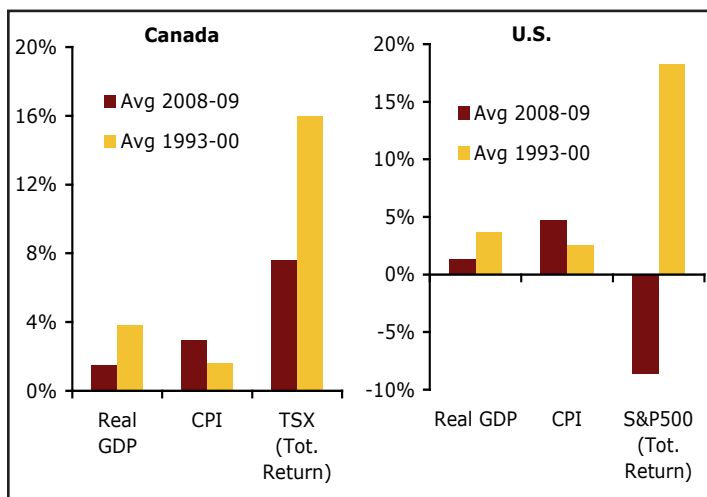
Indeed, looking at individual TSX sectors, the correlations to developing economy performance are most notable for materials and industrials (Chart 3). In contrast, sectors like consumer staples are more tuned to the North American economy and, more broadly, G-7 growth, which should remain soft well into 2009.

Equities and Inflation

Of course, stagflation brings with it not just slow growth but also high inflation, as can be seen in the fact that

Chart 1

GDP, CPI and Stocks



2008-09 is CIBCWM Forecasts.

Chart 2

TSX Has Greater Global GDP Link

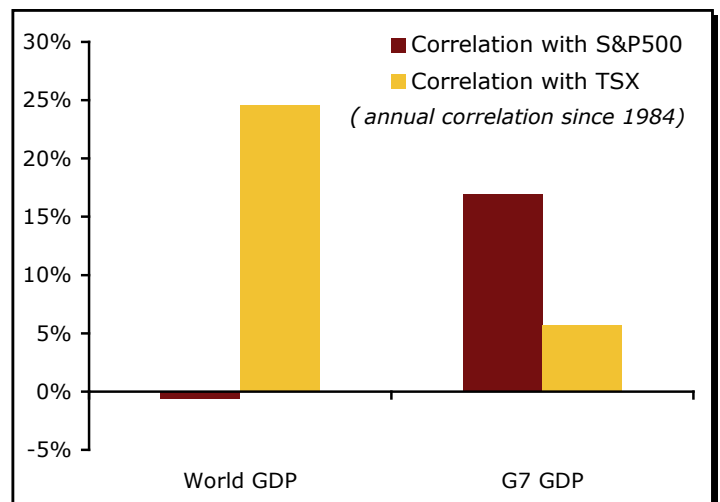
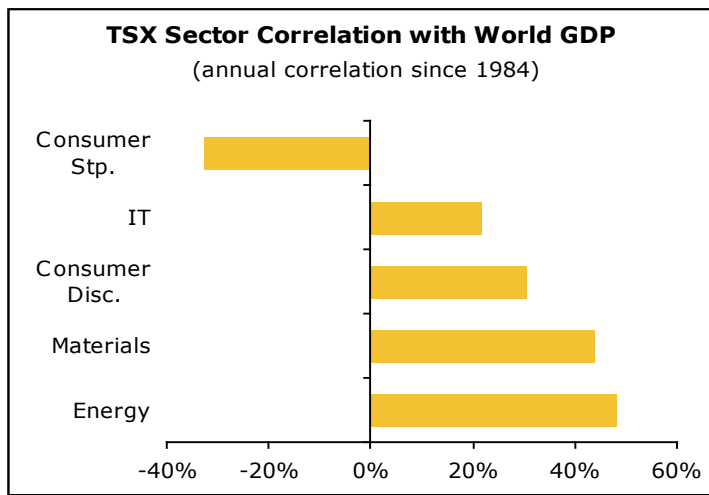


Chart 3

Where to Win From Global Growth



US CPI is already running at 5% a year and its Canadian equivalent is poised to move above 4% by the first quarter of 2009. At first glance, stocks would seem to be an ideal hedge against inflation, since earnings and underlying asset values should also move up with higher prices, unlike bonds which make fixed coupon payments that don't move with inflation.

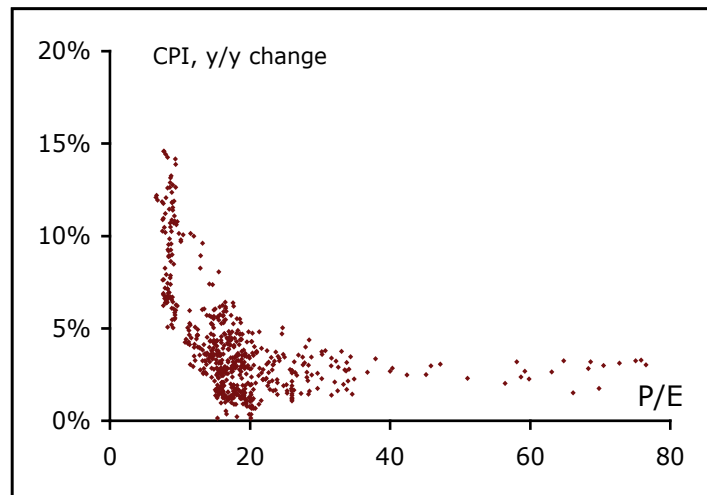
But tax policies that set depreciation rates based on historic rather than replacement values understate the latter when inflation is higher. Furthermore, investors may also worry that higher inflation will mean higher interest rates which threaten earnings growth. While causation between inflation and stock prices is hard to prove, US studies have generally concluded that periods of rising inflation don't see full compensation in higher equity returns, and see weaker real returns. Similarly, in Canada, higher inflation rates have typically led to less generous valuations for stocks, as shown in the negative relationship between the 12-month trailing TSX P/E ratio and the inflation rate (Chart 4).

The Importance of Sector Selection

Indeed, looking back to the late 1950s, higher inflation has been associated with weaker real returns in the Canadian equity market overall, as nominal returns fail to fully compensate for inflation. But that's not true for all sectors. Precious metals are thought of as good hedges against inflation, and what has been true for the metal has been true for the related equities as well (Chart 5). According to our analysis, real equity returns for gold and silver companies actually improve during periods of higher inflation. In contrast, financials and

Chart 4

TSX Trailing P/E Ratios versus CPI

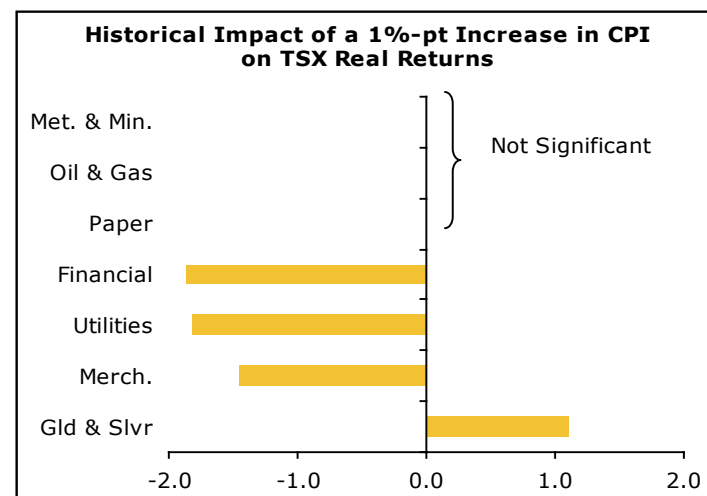


merchandising stocks show weakening real returns as inflation rises. Meanwhile, there is no statistically significant relationship between real returns and inflation for either energy or materials stocks, implying that nominal returns have tended to roughly compensate for inflation.

Overall then, weak US growth and high inflation appear to pose some risks for overall equity performance, particularly outside the resource sector. Precious metals stocks look attractive in that environment, while energy and materials are neutral with respect to overall inflation, but have a favorable link to healthy global economic growth. The strong growth and low inflation environment made equities an easy winner in the 1990s, but stagflation makes sector selection increasingly critical to portfolio performance from here.

Chart 5

TSX Real Returns and Inflation



ECONOMIC UPDATE

CANADA	08Q1A	08Q2F	08Q3F	08Q4F	2007	2008F	2009F
Real GDP Growth (AR)	-0.3	1.0	0.9	3.0	2.7	1.1	2.1
Real Final Domestic Demand (AR)	2.3	2.5	3.1	3.0	4.2	3.7	3.0
All Items CPI Inflation (Y/Y)	1.8	2.4	3.3	3.9	2.1	2.9	3.9
Core CPI Ex Indirect Taxes (Y/Y)	1.4	1.5	1.7	2.4	2.1	1.7	2.2
Unemployment Rate (%)	5.9	6.1	6.3	6.4	6.0	6.2	6.3
Merchandise Trade Balance (C\$ Bn)	52.9	63.2	42.6	49.5	48.0	52.0	56.5
U.S.							
Real GDP Growth (AR)	1.0	2.3	-1.8	2.1	2.2	1.5	1.2
Real Final Sales (AR)	0.9	2.3	-2.8	1.4	2.5	1.6	1.1
All Items CPI Inflation (Y/Y)	4.1	4.4	5.6	6.0	2.9	5.0	4.5
Core CPI Inflation (Y/Y)	2.4	2.3	2.5	2.6	2.3	2.5	3.0
Unemployment Rate (%)	4.9	5.3	5.8	6.0	4.6	5.5	5.6

CANADA

Canada is barely skirting recession in real GDP terms, but is still doing much better in nominal growth, domestic spending and incomes. We've lifted our CPI forecast for 2008-09, as our call for food price escalation is coming even earlier than expected, and there are even signs, in a 2.9% annualized rate (seasonally adjusted) over the last three months, that core prices are heating up. If, as we expect, oil prices don't cool off, growth will have to be held below potential through rate hikes in 2009 in order to get inflation back down by 2010.

UNITED STATES

With June's headline inflation rate the highest that it has been in 17 years and both food and energy prices continuing to post impressive gains, we have once again materially boosted our CPI forecast for both 2008 and 2009. Look for the headline number to hit 6% by the fall and average 5% this year, followed by 4.5% next year. We've also further raised our Q2 growth forecast to reflect the outsized impact of the federal government's \$150 bn economic stimulus package. At the same time, we have taken down our growth calls for both Q3 and Q4, and believe that the US economy will be significantly weaker once this temporary fiscal support fades.

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