



Economics

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"... the rally in Treasury yields isn't simply a flight to safety from stocks and euros."

Not Just a Safe Haven

by Avery Shenfeld

You might have missed it, but the US inflation rate is now zero. That's right, zero, if you measure the annualized change in prices since the start of the year. We've seen *negative* figures for all-items inflation when oil has come off the boil. But in this case, we also stand at only 0.3% annualized in the core CPI rate from December to May, the tamest five-month annualized rate since the early 1960s (Chart). When it comes to inflation, then, is the US "turning Japanese"?

Some really think so, but the bond market doesn't yet. The TIPS spread still implies longer term inflation of 1.9%. US 10-years trade some 200 bps above Japan's, although perhaps that's helped by new Japanese ads in which women suggest men who own JGBs are sexy.

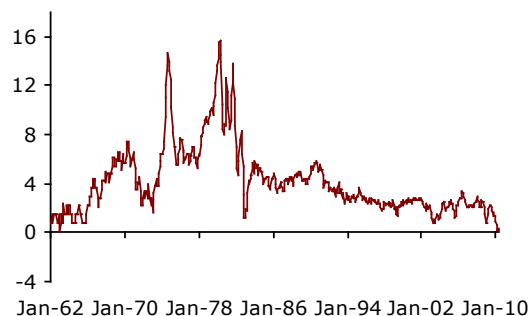
The risks for US inflation in the near term tilt even further to the downside. America's Grand Canyon output gap will only get wider if growth slows. A suddenly hawkish Congress seems bent on fiscal tightening, refusing to pass even a modest bill that would have prevented several million Americans from losing unemployment benefits in the next few months.

Slack is particularly evident in housing, and it's the lack of inflation in rent and owners' equivalent rent that has been key to the soft core rate. Rents seem to have leveled off or started to slowly climb. But strong productivity has had unit labour costs under wraps for made-in-America goods, and retail prices are still adjusting to cheaper imports tied to US dollar gains.

If deflation is the near-term threat, inflation could still be the longer term challenge. That's precisely how countries with America's rising debt profile have historically escaped the mess, using unanticipated inflation to raise nominal GDP and shrink the debt/GDP ratio. But with a massive output gap, and the Fed still (for no good reason) thinking it needs to shrink its balance sheet, any inflation threat is several years off.

As a result, the rally in Treasury yields isn't simply a flight to safety from stocks and euros. New lows in core inflation could keep yields more grounded than we earlier thought, even if, as we expect, equities find a floor soon. Bernanke, a student of deflation, will if necessary turn the money-printing machine on again to prevent a decade like Japan's, so we won't be seeing 1% 10-year yields. But we are trimming our call for a climb in Treasury yields through 2011, with heavy supply and a reduced safe-haven bid not doing as much damage given low inflation expectations. While some of that will spill over into Canadas, our spreads will look generous, particularly out to two years, helping keep the Canadian dollar within shouting distance of parity.

US Core CPI Slowest in Half Century
(five-month % chg, s.a. annualized)



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

MARKET CALL

- US inflation looks to be even lower than we had projected, and with Congress becoming more hawkish fiscally, we see the Fed as waiting even longer for a policy turn. We pushed out the first US rate hike a further quarter, into the second half of 2011. The flight to safety bid in bonds will fade if there are no significant outright sovereign defaults, but we significantly pared back our targets for Treasury yields given the more disinflationary environment ahead.
- The Bank of Canada wants to move from all-out stimulus to a more “subtle” stance, which barring more severe financial market stress, should entail taking the overnight target higher by two or three more quarter point steps. Thereafter, the Bank is likely to stay on hold until US conditions (and thus the external environment for Canada) are healthy enough for the Fed to be close to hiking. But the impact of greater fiscal belt tightening on the global economy has us slightly trimming our target for the overnight rate at the end of 2011.
- The rest of the Canada curve will benefit from market doubts about global growth and just how far Carney can head with a go-it-alone tightening. A slower grind towards higher Treasury yields will also help keep Canadas better bid, and we pared back some of our near term targets for Canadian yields as a result. Mixed global economic news will keep CAD see-sawing, with spikes in volatility, so in any given quarter we could see something through parity (on weeks when global growth looks better) but also levels as weak as \$1.08-1.10 (when bad news hits). Fasten your seatbelts.

INTEREST & FOREIGN EXCHANGE RATES

END OF PERIOD:	2010			2011			
	29-Jun	Sep	Dec	Mar	Jun	Sep	Dec
CDA Overnight target rate	0.50	1.00	1.25	1.25	1.50	1.75	2.25
98-Day Treasury Bills	0.50	1.15	1.05	1.15	1.50	1.80	2.20
2-Year Gov't Bond	1.38	1.75	1.85	1.90	2.35	2.75	3.00
10-Year Gov't Bond	3.09	3.35	3.65	3.85	3.90	3.90	4.00
30-Year Gov't Bond	3.65	3.85	3.90	3.90	4.00	4.10	4.25
U.S. Federal Funds Rate	0.17	0.20	0.20	0.20	0.20	0.75	1.25
91-Day Treasury Bills	0.16	0.10	0.13	0.15	0.15	0.70	1.15
2-Year Gov't Note	0.60	0.75	0.90	1.00	1.45	1.85	2.05
10-Year Gov't Note	2.95	3.30	3.50	3.75	3.90	4.00	4.25
30-Year Gov't Bond	3.93	4.10	4.25	4.45	4.65	4.75	4.80
Canada - US T-Bill Spread	0.34	1.05	0.92	1.00	1.35	1.10	1.05
Canada - US 10-Year Bond Spread	0.14	0.05	0.15	0.10	0.00	-0.10	-0.25
Canada Yield Curve (30-Year — 2-Year)	2.27	2.10	2.05	2.00	1.65	1.35	1.25
US Yield Curve (30-Year — 2-Year)	3.33	3.35	3.35	3.45	3.20	2.90	2.75
EXCHANGE RATES							
CADUSD	0.95	0.99	1.01	0.96	1.00	1.01	1.02
USDCAD	1.06	1.01	0.99	1.04	1.00	0.99	0.98
USDJPY	89	92	91	90	89	87	87
EURUSD	1.22	1.18	1.20	1.22	1.24	1.27	1.30
GBPUSD	1.51	1.46	1.47	1.50	1.51	1.53	1.55
AUDUSD	0.849	0.880	0.900	0.910	0.930	0.940	0.950
USDCHF	1.08	1.13	1.11	1.10	1.09	1.08	1.07
USDBRL	1.81	1.76	1.75	1.73	1.73	1.71	1.70
USDMXN	12.9	12.5	12.5	12.3	12.2	12.0	12.0

Reading China's Tea Leaves

Avery Shenfeld, Meny Grauman, Krishen Rangasamy

Judging the fate of the Chinese economy has become an even more important exercise in light of the downside risks to economic recovery in Europe. Recent jitters in equity and commodity markets owe as much to concerns that Chinese growth is set to melt away as they do to Europe's growth-sapping fiscal malaise.

Chinese economic reports are neither as comprehensive nor as clear-cut as those in the West. In the absence of as many hard numbers, anecdotes are treated as data. Putting it all together to discern an accurate economic picture is then much like reading tea leaves—the patterns are there, if difficult to read. Despite this complicating factor, at this point the incoming news suggests that China is going through an economic rebalancing, with a tolerable degree of policy-induced moderation to 9% growth in 2011, rather than a now-feared, dramatic slowdown.

Down, But Not for the Count

One way or another, a deceleration in China's growth rate is inevitable. Inflation is running at the upper end of what the central bank can live with, and growth at the 12% clip seen over the past year is increasingly being judged by leading officials as too hot to achieve price stability. But there's a significant difference between a modest deceleration in real GDP growth towards the 8-10% range, and a much steeper fall. Thus far, the fundamental data are more in line with the former, suggesting that the big drag on world economic output next year will come from fiscal austerity in the West, and not a plunge in Chinese economic output in the East.

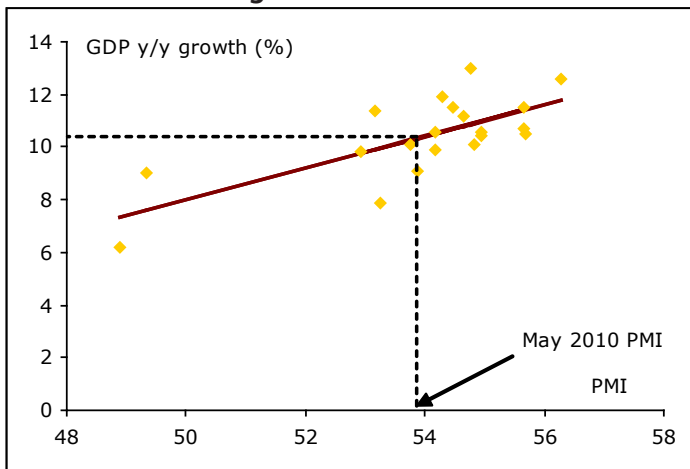
The latest Chinese export numbers, for example, were anything but temperate, with a 49% year-on-year upsurge. The easing in the CFLP purchasing manager's index for May still took it to a level that, over its fairly short history, is consistent with roughly 10% economic growth (Chart 1). It's much the same story for the moderation seen in various Chinese leading indicators.

Overdone Prophets of Doom

Some of the developments in China that are viewed as harbingers of trouble ahead are in fact indicative of

Chart 1

China's Purchasing Index Points to 10% Growth



Source: Bloomberg, CIBC

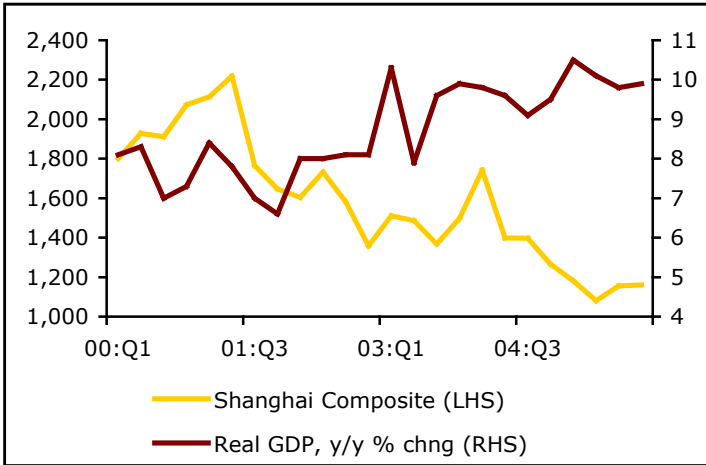
rising economic confidence both among the public and government officials. The move to tighten monetary policy, as well as the recent decision to allow the yuan to gradually appreciate against the greenback, are both just reversals of policies put in place when the global slowdown first hit China in 2008.

The spike in lending growth last year was part of a deliberate effort to boost property and business investment as the country's large export sector was hit hard by plunging global demand. Recent increases in reserve requirements are simply aimed at reversing that process now that global trade volumes have finally improved. Beijing clearly believes the worst of the global recession and its attendant financial crisis is over.

Other, more negative indicators highlighted by China bears have also not proven to be reliable measures of economic performance ahead. Chinese equities have tanked over the past few months, but we saw an over 50% correction in 2001-05 without any visible deceleration in GDP (Chart 2). Furthermore, based on past performance investors appear to be inured to such changes of fortune given how frequently they take place in what is increasingly becoming a casino-like market.

Another ticking economic time bomb that China skeptics consistently point to is the booming property market. However, on a national basis, there appears to be no

Chart 2
Chinese Stocks Don't Always Reflect Economy



Source: Bloomberg, CIBC

evidence that the average Chinese family is facing a squeeze on spending power from higher house prices or rents, as incomes have fully kept pace with rising residence costs (Chart 3). Across the country, property prices are up 20% and real estate development has soared by over 35%. But while money has been flooding into the market, rental rates have not kept pace with purchase prices, as investors continue to snap up units in buildings with high vacancy rates.

Beijing has taken aim at this speculative demand, raising the spread on mortgages, lifting minimum down payments, and eliminating borrowing for anything beyond two residences. These property-specific measures are a clear negative for the sector, but should act as a substitute for more aggressive rate hikes that would have a much wider impact on growth.

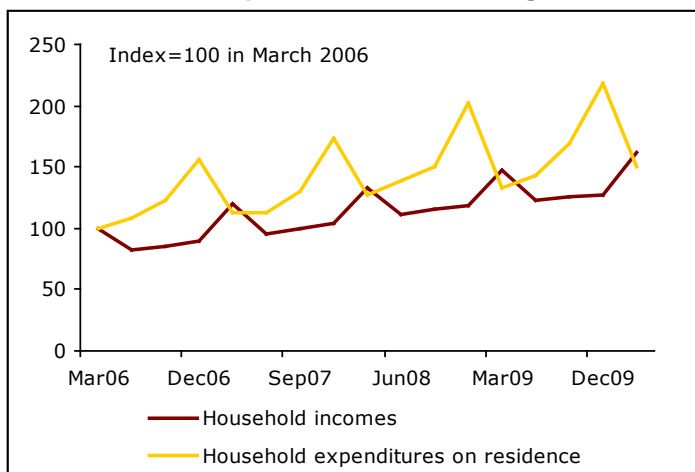
Even with those policy moves, China will likely take further steps to slow broader lending aggregates, reversing the all-out growth in money supply associated with last year's policy ease. However, we don't view Beijing as likely to be turning the screws so tightly as to severely choke off forward economic momentum. For one, while headline inflation has accelerated, most of the momentum is narrowly concentrated in food (Chart 4). In addition, even a 5% strengthening of the yuan will provide a bit of cushion against high inflation, particularly since the Chinese currency has already seen a sharp gain against major non-US currencies like the euro.

Rebalancing: Tricky, But Achievable

Shifting activity away from speculative residential property development is a near term policy objective. But a longer term goal, and indeed a requirement for sustained growth, will be a much broader, and certainly farther reaching, rebalancing of China's economic mix.

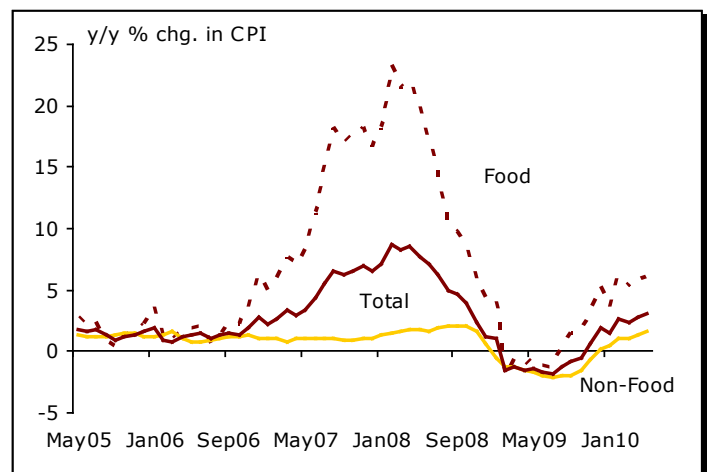
Infrastructure is one sector that won't see a diminished role for some time. What supports near double-digit growth in China isn't just exports, but the build up of power plants, rail lines and other facilities necessary for a modern economy to function. Here we can take comfort from the fact that China still has miles to go, despite very rapid industrialization over the last 20 years. To take just one measure, Chinese power consumption is still light-years away from where it is on a per-capita basis in the major western economies, or other East Asian success stories such as South Korea (Chart 5). China's overall capital-to-labour ratio is also still a mere fraction of that of more developed economies.

Chart 3
Incomes Have Kept Pace With Housing Costs



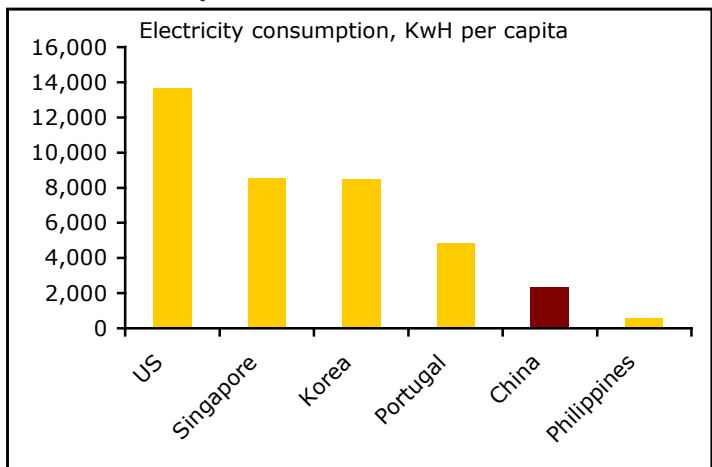
Source: Bloomberg, CIBC

Chart 4
Little Inflation Outside of Food



Source: Bloomberg, CIBC

Chart 5
Power Development Still Has Lots of Headroom



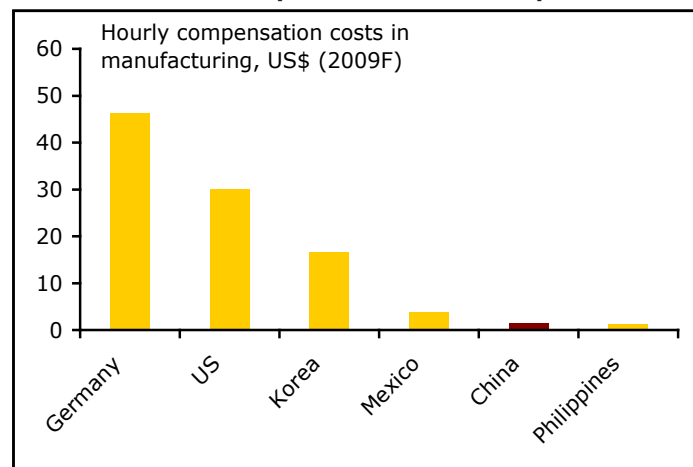
Source: World Bank, CIBC

In addition to China's still immense infrastructure needs, rapid growth should continue to be fueled by the country's still abundant supply of human capital. A *Businessweek* headline screamed about the risks to growth from a diminished supply of cheap labour. Except that the story in question ran in March 2006, and subsequent years have clearly illustrated that there are still hundreds of millions of workers in the countryside that are ready and willing to take more productive factory jobs in China's major industrial cities.

While some wages may be jumping as much as 20% this year, that comes after minimum-wage freezes and downward pressure on other wages during the global recession. The gap between urban and rural pay, while no longer widening as sharply from year to year, is still at a new all-time high, leaving plenty of incentive to draw workers into the coastal factory heartland. True, China's wages are no longer rock bottom, with greater bargains in Bangladesh, Vietnam and their kin. But we estimate that current Chinese hourly factory wage costs are still far below many other competitors (Chart 6).

A gradual appreciation of the yuan, rising education levels, and general economic progress will quicken the process, but the resulting adjustment in China's industry mix is already underway. Low-skill, low-tech sectors like toys and clothing have been shifting to those lower cost locations for more than 10 years now, and are giving way to increased production in higher value-added sectors. In fact, high-tech goods have more than doubled their share of China's exports since 1995 (Chart 7), and China is also shifting its trade orientation geographically, with other Asian economies becoming more important target markets.

Chart 6
China Not the Cheapest, But Still Cheap

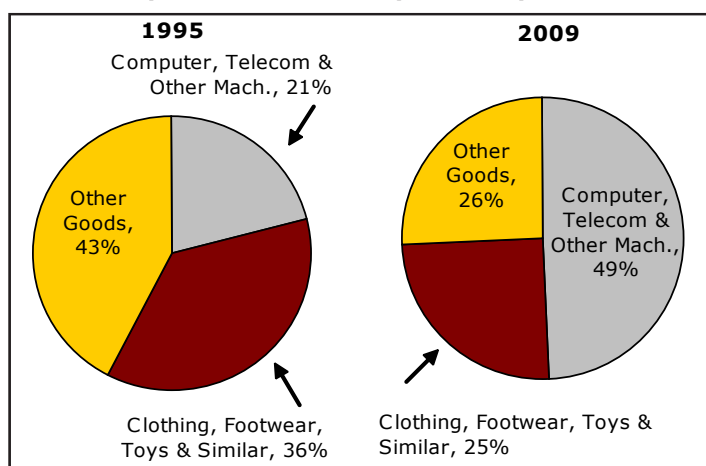


Source: BLS, CIBC

As wages rise, and the Chinese yuan appreciates, household consumption and service sectors can begin to assume a larger role in driving growth forward. That process is now underway, with consumption growth firming since 2008. More needs to be done, including the establishment of a social safety net that reduces the need for precautionary savings. But confidence among Chinese households that their recent income gains are here to stay is already changing consumer behaviour. In that regard, China is following the well-trodden development path of other East Asian economies such as Japan, Taiwan and Korea.

China's economy isn't immune to global forces. It will feel the impact of a deceleration in world growth next year, but will not be its cause. It's in the West, where fiscal austerity will hit hardest, where the real growth risks lie.

Chart 7
China's Export Mix Moves Up Development Scale



Source: UN Comtrade, CIBC

Analysts Doing Better, But Still Wide at Turning Points

Peter Buchanan

Time marches on and investors, while they might sometimes prefer otherwise, end up paying for future performance. Many stockholders consequently attempt to ascertain whether the market is reasonably priced by consulting the ratio of equity prices to analysts' forward earnings estimates. Based on the averages for the last quarter-century, a look at that forward oriented metric in isolation would suggest stocks are not currently overvalued—even a bit inexpensive stateside after the recent market decline (Chart 1).

The so-called "Fed model" (though neither created nor endorsed by that institution) brings another dynamic variable—interest rates—into the equation, assuming effectively that investors always have the choice of investing either in equities or fixed income instruments. The approach compares the inverse of the projected price/earnings ratio with the 10-year bond yield, assuming that in "equilibrium" the two should be roughly equal.

Accurate Market Prediction Requires Good Earnings Projections

Whether these or other forward-looking approaches provide a useful answer to the valuation question depends, in no small part, on the quality of the analysts' earnings estimates. Investors are now bracing for the deluge of Q2 earnings reports, making the issue all

the more important. Smoldering eurozone debt woes and domestic growth uncertainties mean, moreover, that investors will be looking even more closely, not just at past earnings performance, but what analysts and companies themselves, via their guidance, have to say about the future. While Canadian and US earnings expectations rose more or less together in the recovery's early stages, the gains stateside have been much more aggressive recently. That would seem to suggest a greater disappointment risk for stocks there, if the recovery trails estimates due to fiscal restraint, consumer fragility, or overseas developments.

The assertion in a recent *Bloomberg Businessweek*¹ article that "things are always looking up" for analysts captures one element of ingrained skepticism about consensus earnings expectations fairly well. But is such blanket criticism in fact warranted? And is it more or less justified today than in the past—a central issue in assessing the medium-term outlook for earnings and valuations?

Analysts Glasses Not as Rose Tinted as in the Past

Analysts typically adjust their EPS estimates as more information becomes available, resulting in a better approximation—but never a perfect one—to the final numbers (Charts 2 & 3). The revisions data for the S&P 500 support the notion that investors were well advised

Chart 1
Markets Not Expensive Based on Projected Earnings After Recent Sell-Off

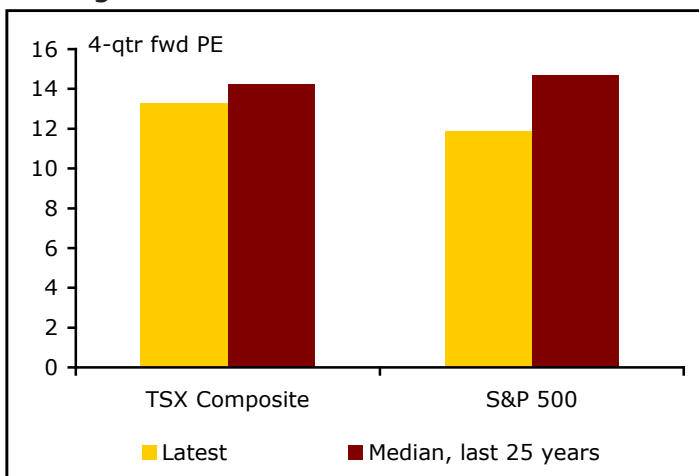
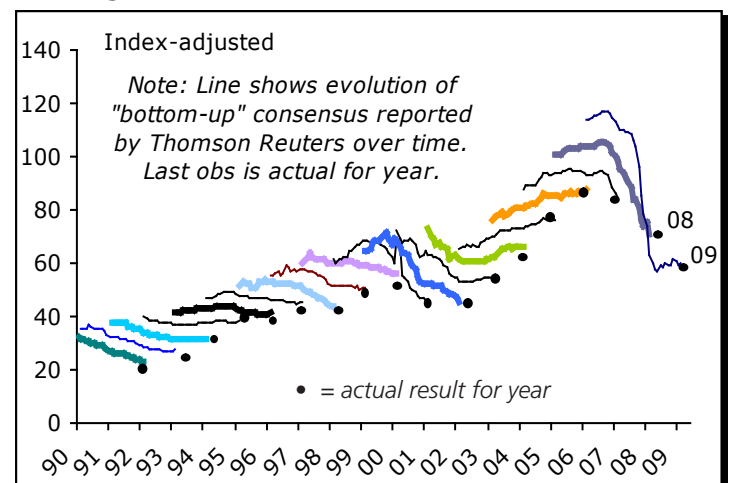
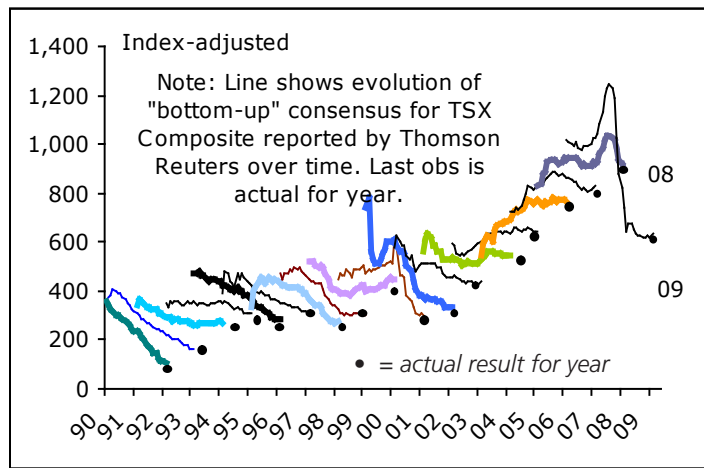


Chart 2
Analysts' Track Record in Predicting S&P 500 Earnings



¹ "For Analysts, Things are Always Looking Up", *Bloomberg Businessweek*, June 10, 2010, pages 39-40

Chart 3
Analysts' Track Record in Predicting TSX Earnings



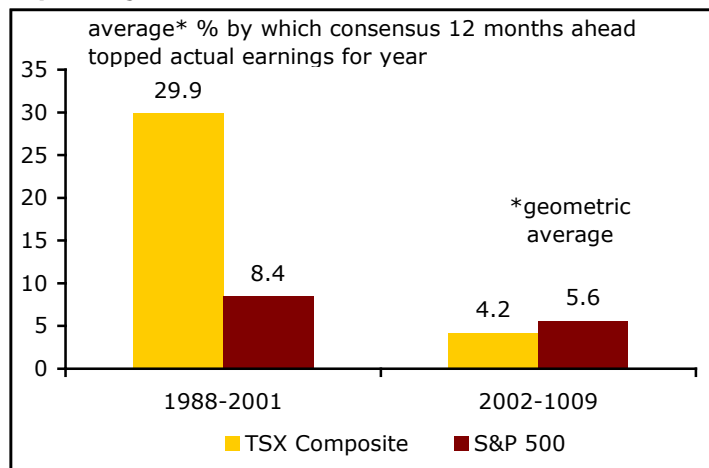
Source: Thomson Reuters, CIBC

to treat the consensus view on earnings, even for forecast periods as short as a year, with healthy skepticism in the years prior to 2002. That's when the North American economy and financial system began their long and arduous recovery from the dot-com derailment, itself a product of excessive confidence over the profit potential of a new technology.

The year-ahead bottom-up consensus for TSX earnings in that 1988-2001 period was too high by 30% on average. That surprisingly large deviation is, in part, due to the unexpectedly heavy toll on the corporate sector of the Bank of Canada's very taut stance during the 1991 recession. The combination of a soaring currency and yields socked corporations with the worst of all possible worlds. Moreover, nearly half of the TSX's weight is in resources, and the inherent volatility of prices in those segments makes profits harder to forecast. In comparison, estimates for the S&P 500 were in the ballpark—but just barely. The "optimistic bias" built into the year-ahead bottom-up consensus over that 15-year interval was 8.4% on average. It's interesting to note that stocks nevertheless did reasonably well in a number of years in that period, perhaps due to the "buy side's" use of more cautious assumptions.

The dot-com implosion resulted in a number of changes in the legislative environment. The Sarbanes-Oxley Act, passed by Congress in mid-2002, contained provisions to encourage greater analyst independence. Whether for that or other reasons, the forecasting error for US analysts has improved, falling to a bit under 6% since the end of that recession for the year-ahead consensus. While too much arguably should not be read into modest

Chart 4
Analysts Estimates Closer to the Mark After 2001 Especially in Canada



Source: CIBC Calculations based on annual Thomson Reuters data

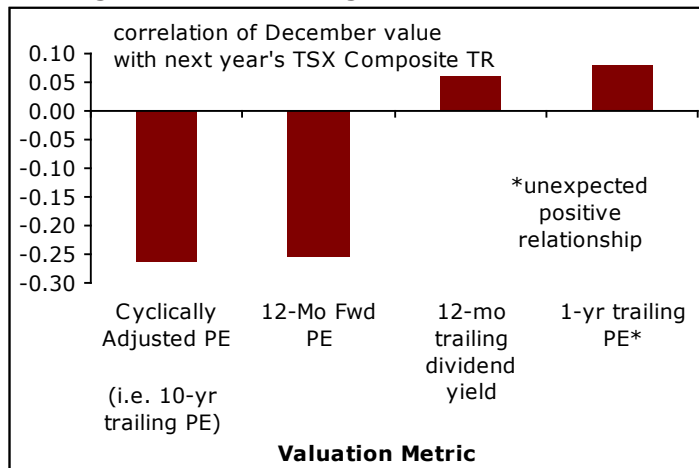
differences, the precision of Canadian analysts' projections since 2002 has actually been 1-2%-points better than US analysts' projections (Chart 4).

The proof of any recipe is in the pudding. Correlations for the TSX show that the forward PE has been just as good a predictor of subsequent market performance as the lagged 10-year cyclically adjusted PE, and appreciably better than the simple one-year lagged PE. The latter can give misleading signals, especially after deep, protracted recessions (Chart 5).

Still Trouble When Growth Turns or Disappoints

Beyond an obvious trend component, earnings have a cyclical dimension. That's not so surprising, since

Chart 5
Forward Earnings Better Predictor of Returns Than Trailing One-Year Earnings, 1957 to Date



corporate profits mimic the economy's rhythms far more closely than either wages or salaries. The mean annual growth rate for TSX earnings in the last 24 years has been just over 5%, a point or two above the rate for the S&P 500. That's the average effectively of a 14% rate of increase in recoveries, and 25% average decline in years in which either Canada or the US was in recession.

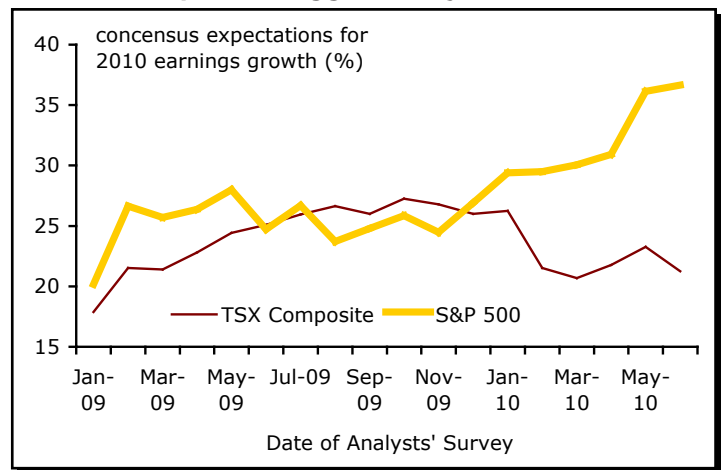
Given that cyclical sensitivity, and the likelihood of a bumpy economic road ahead, it's worth looking at how analysts have performed over the cycle. While consensus expectations may provide a fairly good road map to the profit outlook in years when growth is trending, analysts like economists have greater difficulty around turning points. The evidence from the latest downturn suggests that continues to be the case. Though not quite as far off as in some previous episodes, annual earnings estimates were as much as 14% above the mark for the TSX, and 28% too strong for the S&P 500 (Chart 6).

US Earnings Revisions Aggressive, Canadian Estimates Not as "Pumped Up"

What sort of picture does this paint for North American equities, looking ahead a year or two? Departing notably from patterns north of the border, earnings expectations for S&P 500 members have surged recently, increasing by 6-7% in the last 3-4 months alone (Chart 7). While we don't expect the economy's recent unevenness to morph into another recession, the exuberance in analysts' current profit outlooks sits oddly with a number of impediments to a vigorously paced recovery. One of these is a still far-from-fully-healed consumer. Fiscal tightening will take a larger bite out of the US economy's performance than a number of other countries, including Canada, in

Chart 7

US Earnings Growth Expectations Have Been Ratcheted Up More Aggressively Than in Canada



Source: Thomson Reuters, CIBC

coming years (Chart 8). Valuations are less well supported given these facts, than a quick glance at the S&P 500's "relatively cheap" 11-12 PE, based on the consensus' ambitious assumptions about earnings, might suggest.

PEs north of the border appear to be less affordable, but only because analysts have not been as aggressive in their near-term projections. Moreover, stocks are not simply a short term bet, discounting several years of earnings. In that regard, one thing investors should be cheering this Canada Day is our shelter from the tax hikes looming elsewhere, thanks to sounder fiscal fundamentals. Another is the TSX's leverage to vigorous, resource-hungry emerging markets.

Chart 6

Still Difficulty Around Economic Turning Points

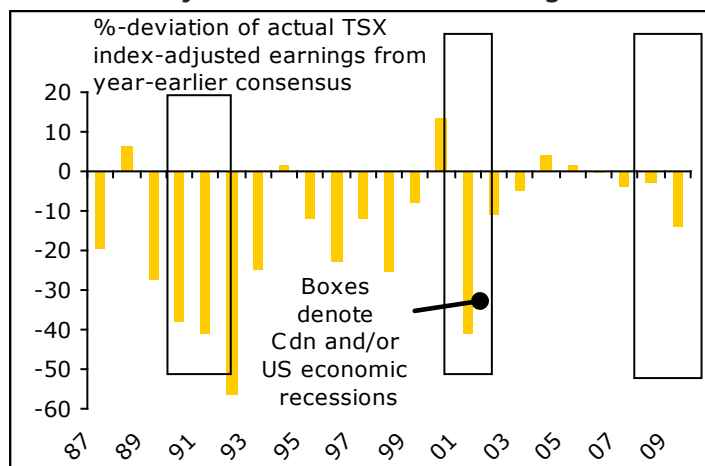
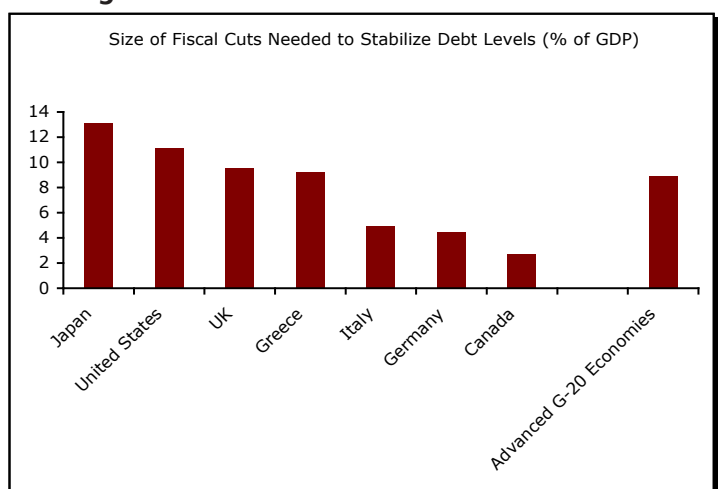


Chart 8

Stiffer Fiscal Headwinds Stateside to Economic and Earnings Growth



Source: IMF

Beating the Budget

Warren Lovely

A lot can change in a few months. Just ask Canadian finance ministers, who have presided over a notable upgrade to their collective economic fortunes since budgets were struck in the Spring. The median forecast for 2010 real GDP growth for Canada has risen a full percentage point in the past half-year to a healthy 3.5% (Chart 1).

While CIBC remains at the cautious end of the spectrum, other notable prognosticators are decidedly upbeat, with the Bank of Canada and the OECD foreseeing an above-consensus expansion this year. All this stands in stark contrast to 2009, when budgets were drawn up before the full extent of the global recession's impact on Canada was evident.

Risks of a second half slowdown linger, with a potential loss of economic altitude meaning 2011 growth won't be flying as high as some now hope. But in the here and now, economic growth for 2010 will better official government projections by a nice margin, triggering above-plan revenue and faster progress on deficit elimination. And importantly for the bond market, stronger growth should mean lighter borrowing requirements for a Canadian government sector that already is the envy of the developed world.

Rising Tide Lifts All Boats

A better-than-expected economic performance is a story for the federal and provincial government sectors

alike. The provinces will benefit, to varying degrees, from the more buoyant economic tone. That is evident in the current median forecast for Canada's ten provinces relative to the growth outlook assumed in the budgets (Chart 2).

While the preferred yardstick for economic vitality, governments don't tax real GDP. In the end, it's prospects for nominal GDP that exert greater influence on fiscal performance. Happily, the expected improvement vs. plan is even more pronounced than with real GDP. CIBC expects nominal GDP to outstrip very conservative budget forecasts in all but one jurisdiction (Table 1), with the national rate of increase, at 6.3%, standing nearly 1½%pts above the weighted provincial average.

Other indicators of government revenue also tell an improving story. Job creation has come roaring back to life, keying an improvement in the single largest tax base there is—personal income. Commodities, while susceptible to an uncertain global economic outlook, have generally recovered ground. Crude oil has averaged US\$78/bbl since the start of the fiscal year (April 1st), a 30%-plus improvement vs. the corresponding year-earlier period. Natural gas has also regained some form. The improved price/demand backdrop means companies are paying handsomely for drilling rights, a development that has echoed from British Columbia, Alberta and Saskatchewan in recent weeks. This bonus bid revenue

Chart 1
2010 Growth Forecasts Have Brightened

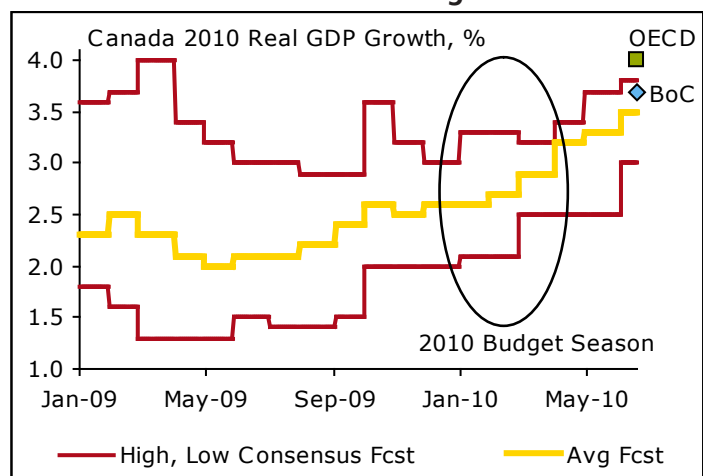


Chart 2
Budget Forecasts Now Look Too Low

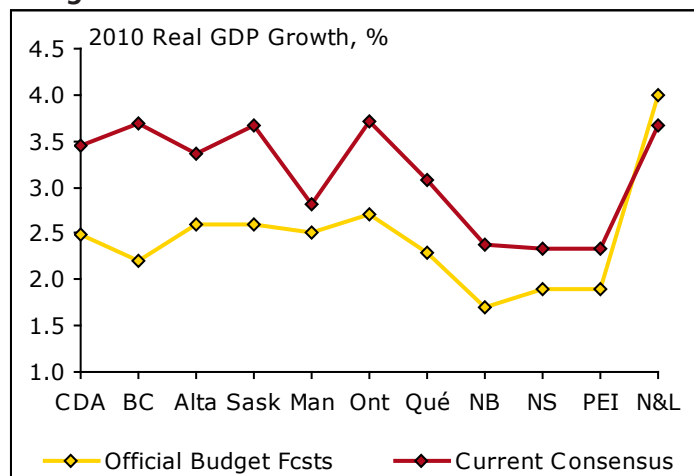


Table 1

CIBC vs Budget Growth Forecasts

Y/Y % Chg	Real GDP			Nominal GDP		
	Govt	CIBC	Diff	Govt	CIBC	Diff
Provincial Forecasts						
BC	2.2	3.5	1.3	4.5	6.8	2.3
Alta	2.6	3.3	0.7	7.9	8.3	0.4
Sask	2.6	3.6	1.0	3.8	6.5	2.7
Man	2.5	3.0	0.5	4.0	4.9	0.9
Ont	2.7	3.7	1.0	4.4	6.0	1.6
Qué	2.3	2.9	0.6	4.0	5.5	1.5
NB	1.7	2.5	0.8	3.9	4.2	0.3
NS	1.9	2.4	0.5	4.4	4.5	0.1
PEI	1.9	2.2	0.3	2.8	3.8	1.0
N&L	4.0	4.0	0.0	10.9	10.0	-0.9
Canada Forecasts						
Provincial ¹	2.5	3.3	0.8	4.9	6.3	1.3
Federal	2.6	3.3	0.7	4.9	6.3	1.4

1. Weighted average of individual provincial forecasts

Source: Provincial budgets, CIBC

is an important driver of fiscal performance for these energy-focused provinces.

Gauging Sensitivities

So what does all this mean for government revenue and budget balances in Canada? In a number of cases, fiscal sensitivities published in the budgets provide clues as to how government revenue is impacted by a given change in economic growth or other key metrics like energy prices. Table 2 summarizes selected sensitivities for the federal government and the provinces.

On the surface, changes in the economic outlook have more of a bearing on Ottawa's finances than provincial results. Ottawa calculates that a one percentage point increase in real GDP growth boosts its bottom line by

Table 2

Selected Fiscal Sensitivities

	Real GDP	GDP Deflator	Nominal GDP	Natural Gas	Crude (WTI)
	Increase by:				
C\$bn	1%-pt	1%-pt	1%-pt	C\$/GJ	US\$/bbl
Federal	3.10	1.60			
BC			0.20	0.28	
Alta				0.93	1.86
Sask			0.09	0.01	0.18
Ont	0.75		0.53		
Qué			0.50		
NS			0.04		
N&L					0.24

Note: Figures represent change to budget balance or revenue; In some cases, average sensitivities are displayed

\$3.1 billion. Ontario pegs the benefit from that same percentage point increase in real GDP growth at just \$750 million, proportionately less as a share of GDP.

More muted sensitivities at the provincial level owe to the fact that Canada's provinces collect significant revenue from the federal government that is not subject to the vagaries of a one-year surge or slide in economic performance. On average, federal transfers for health, education and social services, and in many cases additional dollars via the equalization program account for more than 20% of total provincial revenue (Chart 3). Net results for large Crown Corporations—an important driver in some provinces—may be more a function of US demand or specific prices for benchmark commodities than domestic economic performance. Finally, changes in interest rates and the value of the Canadian dollar can dilute the revenue impact of a given change in economic growth or commodity prices.

Adding It All Up

Official sensitivities suggest that the federal government is in a position to make more significant progress on its deficit than was envisioned back in March. The combination of stronger real GDP growth, a larger GDP deflator and somewhat lower interest rates, would work out to an extra \$4 billion for Ottawa this year. At the provincial level, our economic and commodity price forecasts would collectively imply some \$3 billion of incremental revenue.

If history is any guide, these fiscal sensitivities risk understating the looming improvement. Ontario for one, has witnessed greater amplitude in own-source revenue for a given surprise in real GDP growth than that implied

Chart 3

Federal Transfers Add Stability to Revenue

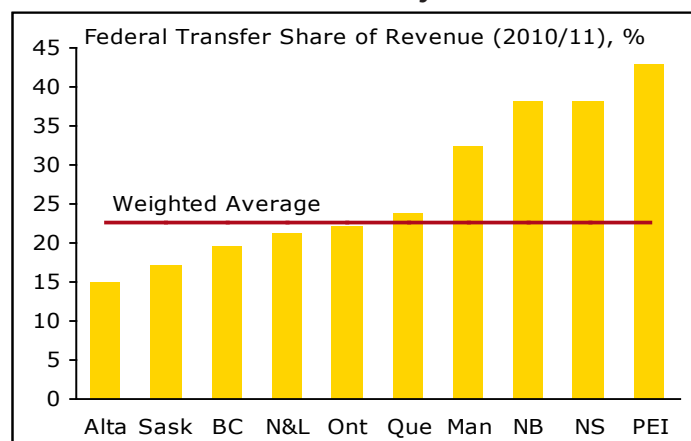
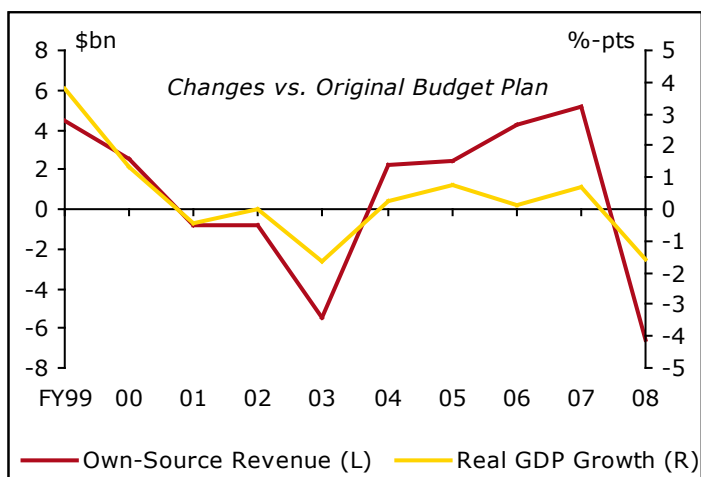


Chart 4
Small GDP Deviations from Forecast Led to Large Deviations in Ontario Revenues



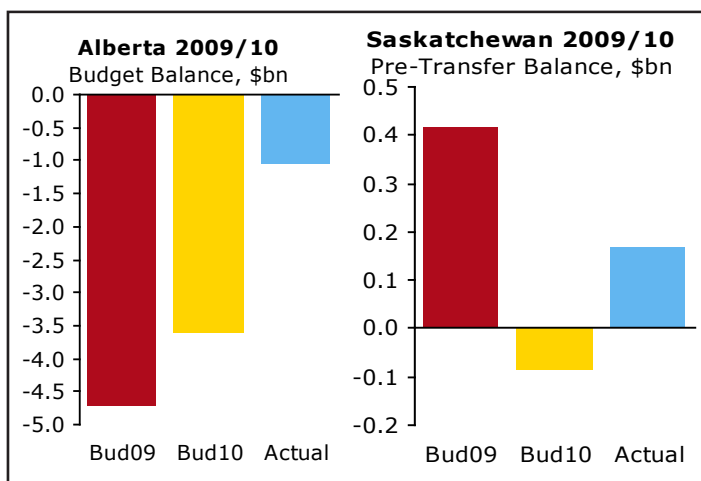
by official sensitivities (Chart 4), hinting at the potential for a greater increase in revenue in 2010. Recall that auto sector relief and financial sector carnage contributed to a larger economic downturn in Ontario and relatively more damage to the budget balance. But a reversal of fortune could lead to a quicker recovery in corporate profits and provincial finances. There's also the potential for an earlier-than-planned repayment of an auto bailout, which will be subject to the timing and success of a prospective GM IPO.

Finally, there's reason to believe that prior-year results will produce a positive base effect for many governments—a stronger starting point for revenue than originally forecast. In recent months, 2009/10 federal revenue has come in above the level estimated in March. And at the provincial level, the first two sets of public accounts (from Alberta and Saskatchewan) revealed extra revenue and stronger 2009/10 budget balances than were estimated only a few months ago (Chart 5). Given all this, we peg the combined improvement in 2010/11 federal/provincial revenue at roughly \$15 billion vs. the current budget plan.

Where Will Extra Revenue Go?

How much of that makes its way to the budget balance could be open to debate. While remaining committed to fiscal stimulus programs, many governments have moved to tighten their belts in other areas, which could create pressure to use extra revenue to fund spending priorities. That will be a theme for many years, as governments face the tall order of wrestling spending growth to the ground despite an aging demographic and demands for other

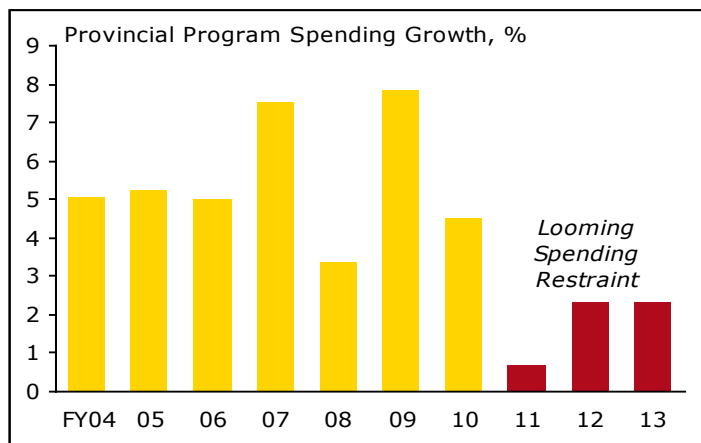
Chart 5
Recent Upward Revisions to 2009/10 Results Give a Better Base for 2010/11



social services (Chart 6). Channeling some extra money to spending would dampen the impact on the budget balance and borrowing, but we believe that a focus on deficit elimination will see a healthy portion of revenue windfalls applied to the bottom line.

Federally, an improving fiscal picture will translate into lighter Canada issuance, further enhancing a supply dynamic that favours long Canadas over US Treasuries. Provincially, expect smaller deficits in British Columbia, Ontario and some others to reduce underlying borrowing requirements. While cyclical in nature, a looming fiscal improvement and easing in funding needs will slow the growth in provincial debt and get provinces further down the road to deficit elimination than many thought possible only a few short months ago.

Chart 6
Lean Spending Plans Could Tempt Use of Extra Revenues



ECONOMIC UPDATE

CANADA	10Q1A	10Q2F	10Q3F	10Q4F	11Q1F	11Q2F	2009A	2010F	2011F
Real GDP Growth (AR)	6.1	3.5	2.0	1.5	2.1	2.5	-2.5	3.3	2.5
Real Final Domestic Demand (AR)	4.7	3.5	2.6	2.0	1.6	1.7	-1.8	3.8	2.1
All Items CPI Inflation (Y/Y)	1.6	1.5	2.2	1.8	1.9	2.3	0.3	1.8	2.1
Core CPI Ex Indirect Taxes (Y/Y)	1.9	1.8	2.0	1.9	1.8	2.0	1.8	1.9	2.0
Unemployment Rate (%)	8.2	8.1	8.1	8.2	8.2	8.1	8.3	8.2	8.1
U.S.									
Real GDP Growth (AR)	2.7	4.0	2.5	1.3	1.6	2.7	-2.4	3.1	2.5
Real Final Sales (AR)	0.8	3.9	2.5	1.5	1.7	2.4	-1.7	1.9	2.5
All Items CPI Inflation (Y/Y)	2.4	1.8	1.1	0.9	0.8	1.2	-0.4	1.6	1.5
Core CPI Inflation (Y/Y)	1.3	0.9	0.8	0.5	0.8	0.9	1.7	0.9	1.1
Unemployment Rate (%)	9.7	9.8	9.9	9.8	9.8	9.5	9.3	9.8	9.4

CANADA

Despite the slow start to the second quarter, as suggested by the soft April data, Canadian Q2 GDP growth remains on track for a healthy 3 1/2% annualized print, thanks to the excellent handoff from March. The softer-than-expected inflation data for May has us trimming our call for Q2, which lowers by one tick our forecast for the 2010 headline inflation rate. We're maintaining our call for below-trend growth over the second half of the year which should translate into a sticky unemployment rate near current levels.

UNITED STATES

While US macro-economic fundamentals continued to improve in the second quarter, real GDP growth should slow down significantly in the second half of the year as fiscal stimulus and inventory contributions to growth begin to fade. Developments in Europe have rattled financial markets, but it's too soon to see the consequences of that on US growth indicators. Wages and hours-worked are heading higher again, but monthly job gains are not expected to be large enough to bring the unemployment rate down materially until late in 2011. Meanwhile, consumer inflation continues to head lower led by outright declines in the large shelter category. There are signs that this component has begun to stabilize, but we still expect year-over-year core CPI to stay below 1% until late next year.

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