



## 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

*"As OECD countries impose large and growing economic costs on their own carbon emitters, their tolerance for those economies who impose no cost on their own emissions will quickly fade."*

## Coming Home

by Jeff Rubin

When oil is cheap and the carbon emissions from burning it are free, global competitiveness is basically a one-variable equation. Find the cheapest labour market and you've found a home for your factory. By this criteria, China, and the rest of the developing world, can still lay claim to what's left of the hollowed-out industrial cores of OECD countries. But the world is changing, and changing rapidly. Not only is crude over US\$100 per barrel and heading higher, but the advanced economies of the world are about to impose punitive costs on their own carbon emissions. And unlike in the Kyoto Accord, this time around they are not going to exempt the carbon-spewing industrial export platforms of the developing world from those costs (see pages 4-8). Having already accounted for a staggering 90% of the increase in global CO<sub>2</sub> emissions since 2000, emissions from the developing world will soon leave those from the OECD in their dust.

In tomorrow's world, energy costs will all be double-sided, including not just the cost of buying hydrocarbons, but the carbon costs of burning them as well. Throw US\$40-\$50 per tonne carbon costs into an environment of triple-digit oil prices and you suddenly redefine the meaning of competitiveness. In a whole swath of manufacturing industries, ranging from chemicals to primary metals, energy costs and their carbon trail, not labour costs, will soon become key.

As OECD countries impose large and growing economic costs on their own carbon emitters, their tolerance for those economies who impose no cost on their

own emissions will quickly fade. Imports from countries that do not play by the same carbon standards will be subject to a carbon tariff that will countervail the implicit trade subsidy that they derive from what goes up their smokestacks. Without such a tariff, the earnest efforts of OECD countries to decarbonize their own economies would become absurdly quixotic in the face of the avalanche of emissions that will come from the rest of the world.

For many industries, what will count is how energy efficient they are, and how carbon efficient they are in their use of energy. On both counts, China and the rest of the developing world, are hugely disadvantaged, in no small measure as a result of huge public subsidies that distort domestic energy prices. Fuel mix is also critical since it largely determines the carbon efficiency of a country's energy system, and hence how much its economy must pay for emissions. With 80% of its power coming from coal, the most carbon intensive of all energy sources, China will once again be seriously disadvantaged.

For the environment, imposing North American energy and carbon efficiency standards on China would have meant an 80% cut in that country's emissions growth over the last seven years—saving the atmosphere 2,700 million tonnes in needless emissions.

And for many energy-intensive industries that joined the exodus to the cheap labour markets of East Asia, imposing a carbon tariff means coming home.

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

## MARKET CALL

- The US economy is now in recession, and its financial system, needs more help. We've lowered our fed funds target by a half point to 1.25%, with the only concession to inflation hawks being that further moves will come in smaller steps. The US\$ will remain out of favour against other majors, particularly versus the euro given Trichet's evident reluctance to cut eurozone rates.
- As we expected, the Bank of Canada looked past the strong jobs figures and delivered a more aggressive rate cut in March. But still-sturdy Canadian domestic demand will see Carney less prone to dramatics than his US counterpart, and we've left our Bank of Canada target at 2.75%, or 150 bps above the funds rate. We'll have to see some weaker jobs figures for the next move to be the 50-bp dose we currently expect.
- Bond markets are running out of room at the short end, but a corrective curve flattening leaves some rally room further out the Canadian yield curve. The flight to safety bid for government bonds isn't over, not with bleak news on the economy and financial writedowns likely to run for another quarter.

## INTEREST & FOREIGN EXCHANGE RATES

END OF PERIOD:	2008				2009
	26-Mar	Jun	Sep	Dec	Mar
<b>CDA</b> Overnight target rate	3.50	2.75	2.75	2.75	2.75
98-Day Treasury Bills	1.74	1.85	2.50	2.65	2.70
Chartered Bank Prime	5.25	4.50	4.50	4.50	4.50
2-Year Gov't Bond (4.25% 12/09)	2.60	2.40	2.70	3.10	3.35
10-Year Gov't Bond (4% 06/17)	3.46	3.30	3.45	3.70	3.80
30-Year Gov't Bond (5% 06/37)	3.96	3.75	3.90	4.10	4.15
<b>U.S.</b> Federal Funds Target	2.25	1.50	1.25	1.25	1.25
91-Day Treasury Bills	1.28	0.80	0.70	0.90	1.20
2-Year Gov't Note (2% 2/10)	1.67	1.30	1.20	1.65	2.00
10-Year Gov't Note (3.5% 02/18)	3.49	3.15	3.10	3.50	3.70
30-Year Gov't Bond (4.375% 02/38)	4.31	4.00	3.95	4.20	4.25
Canada - US T-Bill Spread	0.46	1.05	1.80	1.75	1.50
Canada - US 10-Year Bond Spread	-0.03	0.15	0.35	0.20	0.10
Canada Yield Curve (30-Year — 2-Year)	1.36	1.35	1.20	1.00	0.80
US Yield Curve (30-Year — 2-Year)	2.64	2.70	2.75	2.55	2.25
<b>EXCHANGE RATES</b>					
— (US¢/C\$)	98.3	101.5	104.7	105.0	103.1
— (C\$/US\$)	1.018	0.985	0.955	0.952	0.970
— (Yen/US\$)	99	93	94	100	98
— (US\$/euro)	1.58	1.60	1.58	1.49	1.45
— (US\$/pound)	2.01	2.00	2.01	1.91	1.90
— (US¢/A\$)	92.0	95.0	92.0	90.0	90.0

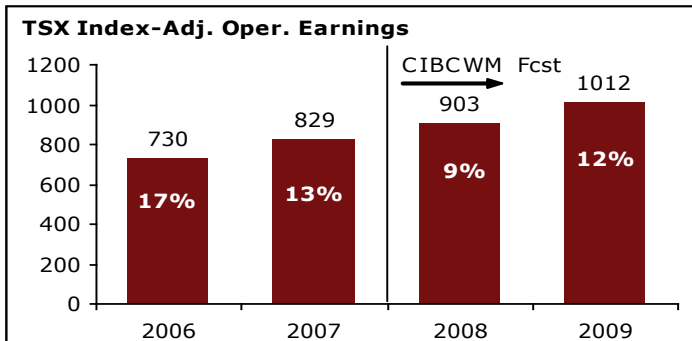
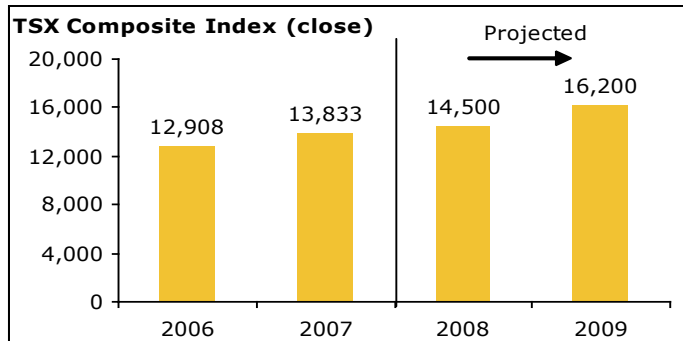
## STRATEGY AND EARNINGS OUTLOOK

- While signs of recession in the US are now undeniable, there has been sufficient evidence of market decoupling in recent years that Canadian investors need not seek an entirely defensive posture. Energy and materials stocks led late March's snapback in the TSX. That's further evidence that what matters for increasingly important chunks of the Toronto market is not sickly US but still comparatively firm overseas demand.
- Oil prices remain in triple-digit territory. Natural gas prices have regained US\$9 and power producers preference for a cleaner alternative to coal sets the stage for still-higher levels in the future. These developments prompted us to raise our energy overweight by a point to 5 percentage points. We also remained overweight materials stocks. The gold sector in particular should benefit as a sub-2% funds rate sees bullion hit US\$1,100/oz later in the year.
- The subprime problem has been spreading to fields far removed from low quality mortgages. A further point move out of financials this month was consequently split between banks and non-banks. Rate cuts will not prevent at least one further quarter of subprime-related writedowns. The nominal cost to the insurance industry of the debacle is fast approaching Hurricane Katrina's record US\$41 billion of claims. Alongside this, we remain overweight bonds given the anticipated favourable effect of a further 75 bps of Bank of Canada rate cuts on longer term yields.

ASSET MIX (%)	Benchmark	Strategy Recommendation
<b>Stocks</b>	54	54
<b>Bonds</b>	<b>38</b>	<b>42</b>
Cash	8	4
GICS SECTOR EQUITIES (%)		
Consumer Discretionary	4.3	1.8
<b>Consumer Staples</b>	<b>2.3</b>	<b>2.8</b>
<b>Energy</b>	<b>28.8</b>	<b>33.8</b>
Financials	28.1	25.6
-Banks	15.6	13.6
-Insur., REITs, oth.	12.5	12.0
Healthcare	0.4	0.4
Industrials	5.5	3.5
Info Tech	4.4	3.4
<b>Materials</b>	<b>19.7</b>	<b>21.7</b>
-Gold	<b>8.8</b>	<b>9.8</b>
-Other Metals	<b>5.6</b>	<b>6.6</b>
Telecom	5.0	3.5
<b>Utilities</b>	<b>1.6</b>	<b>3.6</b>

Note: Bold indicates recommended overweight.

TSX - Earnings Outlook & Forward PE						
	Operating Earnings (% ch)				4-qr Fw d PE	
	2005	2006	2007	2008	Latest	Last 10 yrs.
Consumer Staples	1.4	-2.5	11.4	11.4	11.8	17.0
Materials	32.5	89.8	3.1	12.2	24.1	27.5
Energy	54.5	10.8	9.9	13.8	15.4	13.0
Utilities	10.4	15.2	29.3	8.0	16.3	13.9
Consumer Discretionary	5.7	7.6	15.7	-3.0	13.6	18.6
Health Care	1.4	10.4	-35.4	-12.8	15.4	49.7
Financials	12.8	17.3	14.4	4.5	10.8	10.9
Info Tech	260.9	-47.6	25.2	19.1	24.2	32.3
Telecom Svcs	5.0	29.8	20.7	6.0	13.1	34.7
Industrials	18.7	12.2	-10.0	-10.0	15.2	15.6
<b>TSX Composite</b>	<b>31.2</b>	<b>17.4</b>	<b>13.5</b>	<b>9.0</b>	<b>14.5</b>	<b>17.9</b>



Source: Thomson First Call, CIBC WM

# The Carbon Tariff

Jeff Rubin and Benjamin Tal

The world appears to be splitting apart these days, and the new dividing line is carbon. Just as the most advanced and affluent countries of the world are preparing for a long-run commitment toward decarbonizing their economies, the developing nations are carbonizing their own rapidly industrializing economies at breakneck speed. As OECD countries begin to tax their own economies by charging growing fees on CO<sub>2</sub> emissions, their tolerance for the carbon practices of their trading partners will diminish rapidly. Particularly when the painful cuts made by North America, Western Europe and a handful of other OECD economies are dwarfed by the emission trail spewing from China and the rest of the developing world. The response is likely to involve a carbon tariff—an equalizing force that will tax the implicit subsidies on the carbon content of imports that come from carbon non-compliant countries.

## Developing World Now Principal Source of Emissions

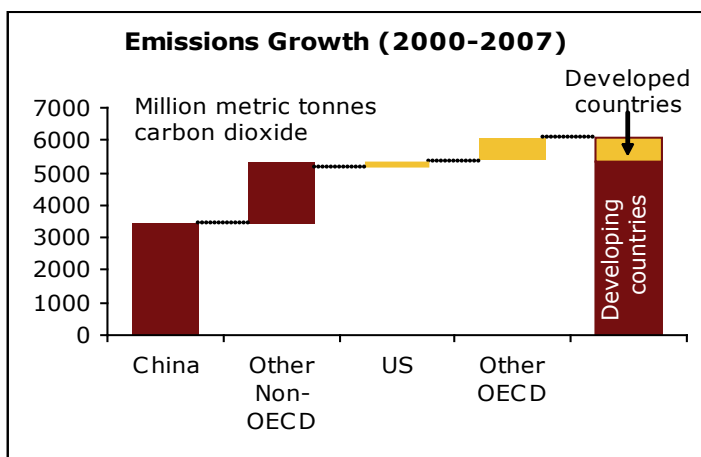
Total global emissions have risen by a cumulative 25% since the beginning of the decade. But only a small fraction of those emissions came from the OECD. In fact, emissions in the most advanced economies of the world have grown by a paltry 5%, one-tenth the 50% increase seen outside of the OECD. In fact, over the last seven years, the non-OECD, largely consisting of developing

economies, contributed 90% of the total increase in global emissions (Chart 1). While North America, Japan and Western Europe are all now trying to decarbonize their economies, the rest of the world is increasingly carbonizing their economies.

So great has the recent rise in emissions growth in the developing world been that as of 2005, it surpassed the OECD in total emissions. And once surpassed, the gap is growing rapidly. Already non-OECD emissions are a massive 2,500 million metric tonnes (mmt) more than the OECD—a gap that is now equal to almost 20% of the latter’s total emissions (Chart 2). Non-OECD countries now account for nearly 55% of global emissions. Within a decade they will account for more than two-thirds.

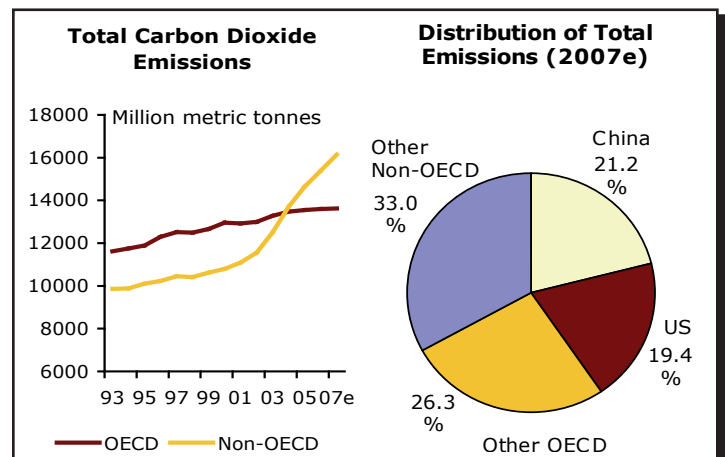
Within the developing world, China stands out as the home of most of the recent emissions growth. Since the beginning of the decade, the country’s GHG emissions have increased by close to 120%. By contrast, the level of US emissions has hardly changed over the last seven years. And last year for example, the annual increase in emissions in China was equal to the total GHG emissions of a Canada or a United Kingdom, no carbon slouches in their own right. In fact, the cumulative increase in CO<sub>2</sub> emissions in China since the beginning of the decade is equivalent to the total current level of emissions of Canada, India, Spain and Japan combined (Chart 3).

Chart 1  
**90% of Emissions Growth Came From Outside of the OECD**



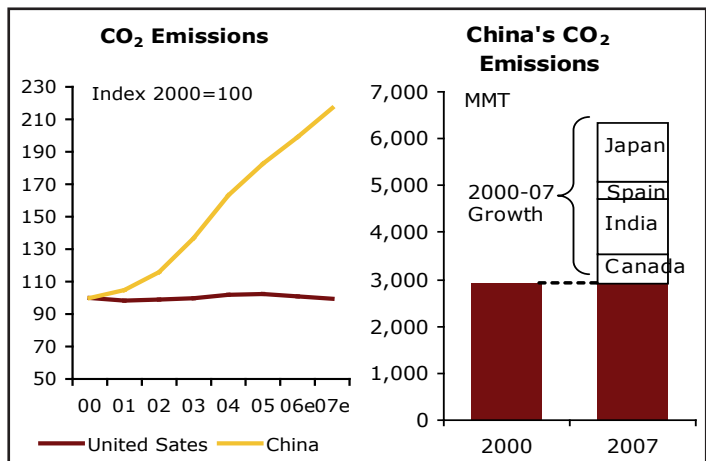
Source: EIA, CIBCWM

Chart 2  
**Emissions Outside of the OECD Already Exceeded OECD Levels**



Source: EIA, NEAA, CIBCWM

Chart 3  
**China's Growing GHG Emissions**



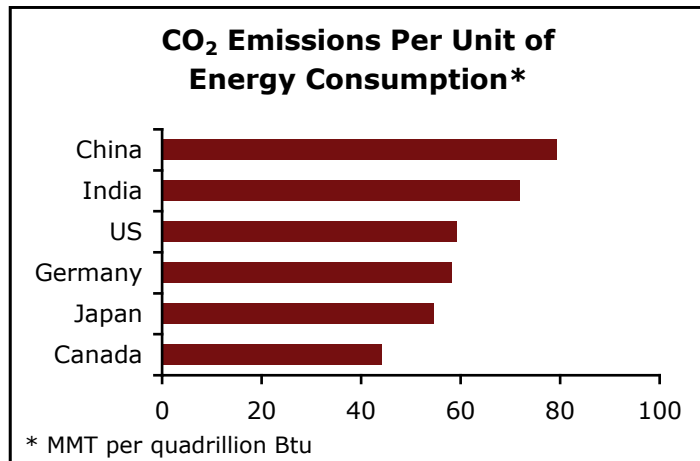
Source: EIA, CIBCWM

As of 2006, China even surpassed the US as the single largest emitter country in the world. Today, it already emits 9% more than the US, and it now accounts for over a fifth of total global emissions.

Certainly the growth of emissions over the last decade has exposed a fatal flaw with the old Kyoto framework for managing global carbon emissions. By exempting China and other developing economies from GHG emission requirements, Kyoto effectively exempts the principal source of new emissions from any carbon restraint. As such, Kyoto is a framework for redistributing emissions from the developed to the developing world—not a framework for reducing the global aggregate.

Why are emissions growing so rapidly in the Chinese economy? Certainly, the sheer pace of economic growth and the absence of enforceable and meaningful environmental regulations are commonly cited factors. But a more vital factor has been the emissions intensity of the Chinese economy. Energy use in the manufacturing-intensive Chinese economy as a share of GDP is four times greater than in the largely services-based US economy. To make matters worse, China is not particularly carbon efficient. It produces a third more CO<sub>2</sub> emissions per unit of energy than does the US economy, and almost double that of Canada (Chart 4). Combine the energy intensity of the Chinese economy with the poor carbon efficiency of its energy use and you have a powerful cocktail for exploding emissions growth.

Chart 4  
**Emissions Intensity is Much Higher in Developing Countries**



Source: EIA, CIBCWM

If China had the same energy intensity and carbon efficiency as the American economy, its emissions growth since the beginning of the decade would have been only a fifth of the 120% increase it has been since 2000. That, in turn, would have saved the atmosphere 2,700 million metric tonnes in needless CO<sub>2</sub> emissions.

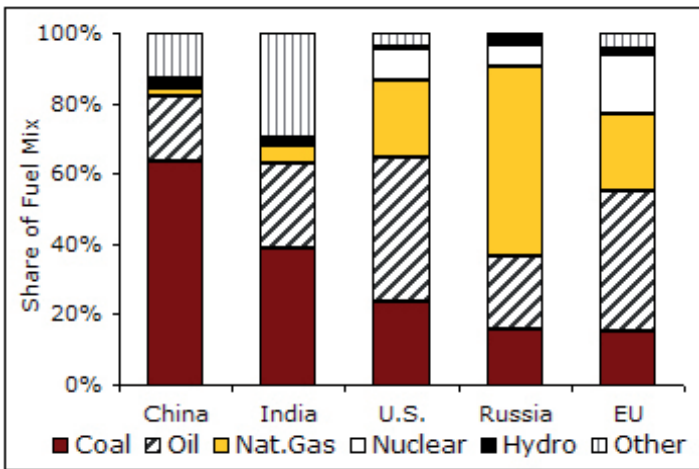
Why is China's energy consumption so emissions intensive? While an economy's energy intensity (energy per unit of GDP) reflects its industrial make-up, emissions efficiency (emissions per unit of energy) is more a story about fuel mix than the economic weight of its manufacturing sector.

And when it comes to fuel mix—old king coal is the absolute worst. As a carbon-intensive fuel, coal contains twice the amount of carbon per unit of energy compared to natural gas, and about 20% more than oil. Hence, no other form of power generation gives off as large a carbon trail as coal-fired power. And when it comes to coal use, China is king.

China relies on coal for close to two-thirds of its total energy needs and for approximately 80% of its electricity needs (Chart 5). There are more coal plants in China today than there are in the United States, the UK and India combined. But whereas in the US and other jurisdictions it is becoming increasingly difficult to get new coal-fired capacity licensed environmentally, China is adding new coal capacity at breakneck speed. At the current rate of a new coal plant per week, the country will see thirty more coal plants built before the "green" Olympic games

Chart 5

**Fuel Mix in Energy Supply**



Source: IEA

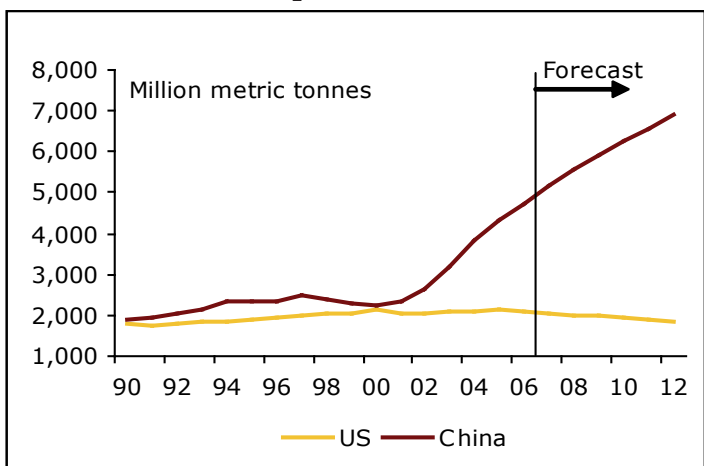
begin. Between now and 2012, expansion plans call for some 560 new coal-fired generating plants. The emissions from those plants will effectively nullify all emission cuts required by the industrialized countries under the Kyoto Protocol.

Already, coal-based CO<sub>2</sub> emissions in China are more than double those in the United States. But between now and 2012, the increase in Chinese coal-fired emissions alone will exceed the entire level of coal-fired emissions in the US. In fact, coal will contribute 80% of the expected total emissions growth in China over the next five years (Chart 6).

The implications for environmental policies in North America are staggering. Efforts in the United States to restrict the growth of new coal-fired generating capacity

Chart 6

**Coal Generated CO<sub>2</sub> Emissions**



Source: EIA, NEAA, CIBCWM

seem absurdly quixotic when juxtaposed against this rate of carbon expansion in the Chinese and other developing economies. Whatever reduction in CO<sub>2</sub> emissions comes from North America coal action will simply be dwarfed by the rate of growth in emissions in China.

At the same time, it is clear why China will naturally be recalcitrant when it comes to signing on to any global commitments in carbon reduction. Given the carbon intensity of its economy, it would be a death warrant for economic growth. Instead, we are likely to see more propaganda about “green energy” which according to government targets should account for 10% of the nation’s power supply bill by 2010. So far the progress is unimpressive, with the 2007 target being missed by a wide margin. And even if the 2010 commitments are met, they would still imply a huge increase in hydrocarbon consumption and a similarly huge jump in CO<sub>2</sub> emissions.

**A Carbon Tariff**

The rapid if not exponential growth of emissions in China and the rest of the developing world is a lethal challenge to burgeoning efforts in the OECD to restrict its own carbon usage. As OECD countries begin to impose greater economic sacrifices on its own economies as part of decarbonization efforts, tolerance for the carbon practices of its trading partners, or more precisely the lack thereof, will diminish dramatically.

For example, a cap and trade system for gradually reducing carbon emissions in the US economy by only 10% will shave off an estimated 0.6 percentage points of real GDP growth per year for the next five years. A similar macroeconomic sacrifice can be expected for Western Europe, Canada, Australia, Japan and other OECD member states.

Efforts at decarbonizing the OECD are only meaningful if they are done in concert with other countries. Otherwise, global emissions will continue to rise as more and more are shifted to unregulated jurisdictions as has been the case under the Kyoto Protocol.

The challenge of course is to induce change in carbon practices in the developing world. And other than moral suasion, which is likely to fall on deaf ears, the OECD’s only leverage is through trade access. Already Europe, which is well ahead of North America in terms of domestic carbon pricing, is talking about a carbon tariff that it can apply to imports from countries that don’t

play by the same carbon rules. The concept is likely to gain popularity in North America as it too moves to price carbon emissions, somewhere likely in the \$40-\$50 per tonne range.

In effect, a carbon tariff is a countervail against unfair energy subsidies that Chinese (and other developing world) exporters reap from either their direct carbon emissions or indirect emissions such as those generated from the coal plants that supply them with power. But how big should the tariff be? That depends on two factors: the price of carbon emissions in our own economy, and the amount of emissions that come from China's export sector.

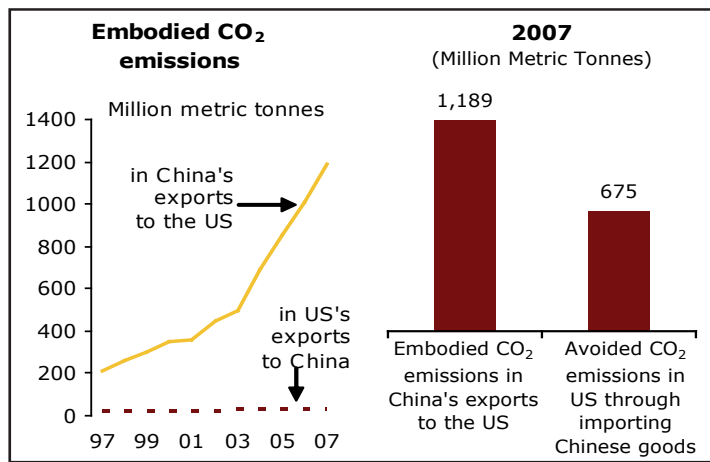
In order to answer that we first have to establish that China's export sector is in fact a significant source of that country's GHG emissions. As of 2007, China's export-related emissions stood at an estimated 1,700 mmt. This is 27% of the country's total emissions. In fact, aside from the US, China's export sector alone is the largest emitter globally, producing more emissions than the entire Russian, or German, or Japanese economy (Chart 7).

Of course by shifting manufacturing production to China and then subsequently importing Chinese-made goods, the US has exported what used to be its own GHG emissions to other countries. In short, some of China's emissions used to be America's emissions. From a global perspective, does it really make a difference?

The short answer is yes—largely due to the huge differences in energy usage and in emissions intensity between the two countries. In other words, had the

Chart 8

**Embodied CO<sub>2</sub> Emissions in Exports: China vs. US**



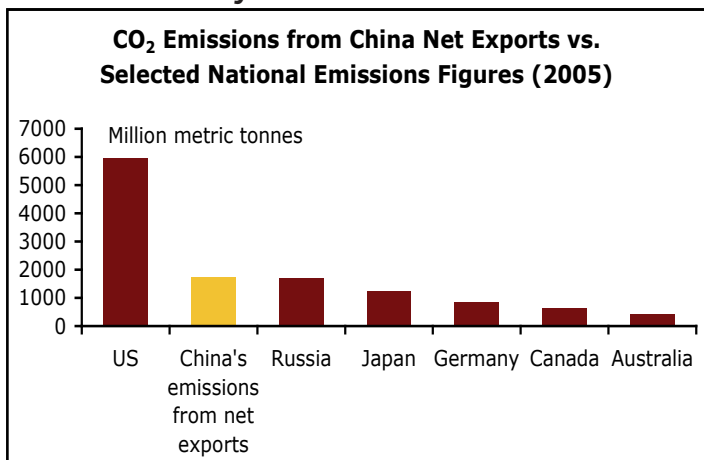
Source: Shui & Harriss (2005), CIBCWM

manufacturing production that was shifted from North American to China, stayed in North America, it would have generated much less GHG emissions for the same level of output (Chart 8). The reasons are twofold. First, as noted previously, North American power is a lot less coal intensive than Chinese power. Secondly, energy efficiency in North American plants is 30% higher than in Chinese plants. Together, the difference adds up to 500 mmt for 2007 alone—hardly a trivial sum. The savings in CO<sub>2</sub> emissions is almost half the total emissions from China's exports to the US.

The other variable aside from the CO<sub>2</sub> embedded in Chinese exports is the price of carbon emissions itself. Assuming a \$45 per tonne cost of CO<sub>2</sub> in the US

Chart 7

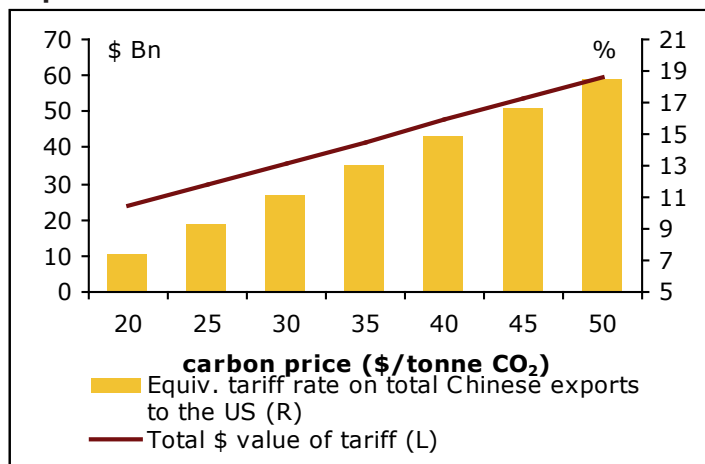
**China's Export Sector: The Second Largest Emitter Globally**



Source: EIA, Tyndall, CIBCWM

Chart 9

**Tariff on Emissions Embodied in Chinese Exports to the US**



marketplace, the tariff would raise roughly \$55 billion a year from Chinese exports to the US or the equivalent of a 17% tariff on total Chinese exports (Chart 9). To put these numbers in perspective, such tariff is almost six times larger than the current 3% effective tariff rate on Chinese exports, and it is 60% of the size of the tariff proposed by Senators Schumer and Graham, when they were advocating a full-scale trade war against China.

Of course, it's not just Chinese exporters who will have to pay. At least initially, before other carbon compliant sourcing can be found, it will be US consumers who will have to bear the bulk of the tariff burden in higher import prices. Based on China's share of US imports, a \$45 per tonne tariff would raise annual US consumer price inflation by more than 0.6 percentage points (Chart 10). At some point, however, the inflationary impact might be mitigated as either domestic production replaces some Chinese imports or sourcing is shifted to a less egregious emitter than China. Longer term, the tariff could induce changes in China's own energy and carbon practices.

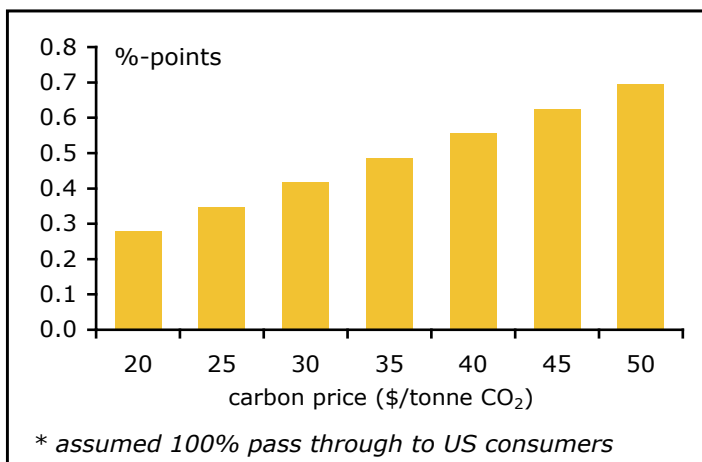
Equally important, a carbon tariff, coupled with triple-digit oil prices could reverse the migration of certain manufacturing industries that have left North America for much cheaper labour markets in China. Wage advantages may no longer be as decisive in determining overall competitiveness for energy-intensive industries in today's energy-starved world economy. All the more so if exports from those industries will be assessed relatively punitive tariffs for their carbon content upon entering North American or Western European markets.

In fact, with energy costs mounting rapidly, this process has already begun. For the first time in six years, growth in Chinese exports of high energy/emission products is now lagging growth in exports of low-mid energy/emission products. In 2007, energy and emissions-intensive industries have seen their shipments rising by only 6%—only a third of the annual average seen since the beginning of the decade (Chart 11, left). And this process will only accelerate once the carbon tariff is added to those industries' cost function.

Which industries will be most affected? Naturally those with high capital-to-labour ratios, as well as high energy/emission intensity factors embodied in their production process. Chinese exporters of chemical products, with their astronomical energy intensity factor (Chart 11, right), will be the first to see their businesses migrating back to the US. In fact, chemical exports from China to the US are already slowing down notably, with shipments in the past two years rising by only half the pace seen in the first half of the decade. Non-metallic mineral products (cement, glass, lime, etc), with energy intensity 130% higher than the Chinese industrial average, along with printing, primary metal manufacturing and machinery industries are other candidates for such realignment.

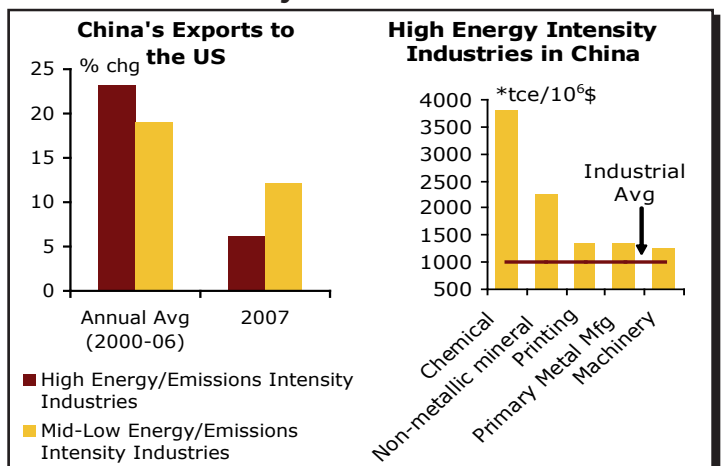
With the OECD's carbon tolerance diminishing with every tonne of CO<sub>2</sub> spread into the atmosphere by non-OECD countries, environmentalism will soon become a significant barrier to trade. A carbon tariff imposed by the US on emissions embodied in Chinese exports would not only abolish the implicit subsidies on the carbon content currently enjoyed by Chinese exports, but it would be large enough to start reversing current trade and off-shoring patterns.

Chart 10  
Impact of Carbon Tariff on US CPI Inflation\*



Source: EIA, NEAA, CIBCWM

Chart 11  
Exports & Industrial Breakdown by Energy/Emissions Intensity



Source: Ma (2005), US Census Bureau

\*tonne coal equivalent



# Fighting the US Recession: Bring Out the Big Guns

Avery Shenfeld and Meny Grauman

In an election year, Washington will spare no quarter in fighting off what is now a recession. The latest data dispelled any doubts. Non-farm payrolls dropped for two successive months, and the 3-month average of the Chicago Fed's National Activity Index sits below the -0.7 level that has, infallibly, marked a recession onset. With the Fed and the Treasury eventually using all of the weapons at their disposal, GDP could be held to a modest two-quarter decline (Chart 1), although the early stages of recovery will be anemic.

A lot of stimulus has already been offered up. Coefficients from the Fed's macro model imply that the 300 bps of rate cuts to date would boost real GDP growth by 2% over the coming year, although that assumes that other rates follow suit, which isn't yet happening in today's credit crunch. Fiscal stimulus could add another 1%. The Fed stepped in to avoid another hazard, a run on the banks and investment banks. Discount window funding is being offered at a mere 25-bp penalty over the funds rate, and the Fed is auctioning off billions in term funding through a specially created lending facility. The result has been a rush to tap into that funding at unprecedented levels (Chart 2).

But house prices are still dropping at more than 2% per month, extending a mortgage crisis that represents the greatest challenge to the financial system in decades. Another roughly US\$150 bn of losses on mortgage

Chart 1

## US Economy In Recession

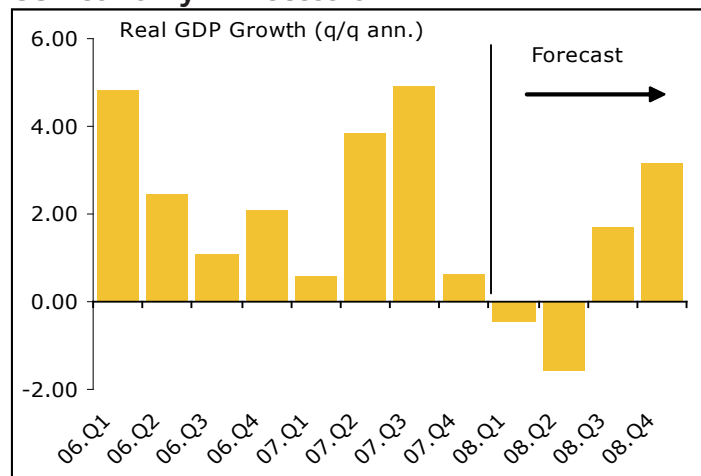
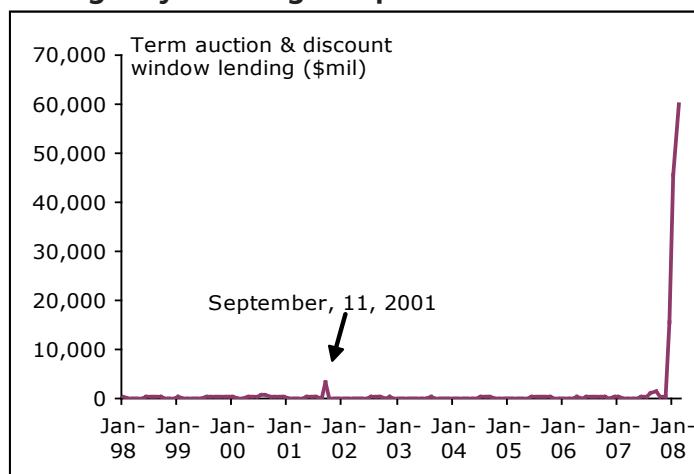


Chart 2

## Emergency Lending Jumps Off the Chart



securities lies ahead, and that estimate would worsen if house prices fail to bottom-out this summer. Writedowns on LBO debt and the usual cyclical run-up in loan loss provisions on non-mortgage loans to businesses and households have only just begun. In short, we're barely more than half way through this financial crisis.

## Interest Rate Cuts Lose Relevance

Just what weaponry is left to deploy? Interest rates still have room to fall to our target of 1.25%, if likely in smaller steps after two FOMC members objected to March's 75-bp slashing. Financial markets are giving the green light to use the available room. True, investors have turned thumbs down on the US dollar, but that sell-off hasn't hit where it would hurt, in the bond market. As long as the cheapening dollar isn't forcing up yields, it's providing a net boost to the economy through its links to trade competitiveness. The dollar's drop adds to import inflation, but the spread between TIPs and Treasuries—a benchmark of inflation expectations—is below where it was at the beginning of the year.

But further rate cuts will deliver much less bang for the buck. One-month T-bill rates were as low as 0.6% in mid-March. With the risk-free rate having little room to fall further, what's really needed to lower other market rates is both a flatter yield curve, and more critically, a narrowing in credit spreads, as the gap between Eurodollar and bill yields remains cavernous (Chart 3).

Chart 3  
Eurodollar Spread Still Very Wide

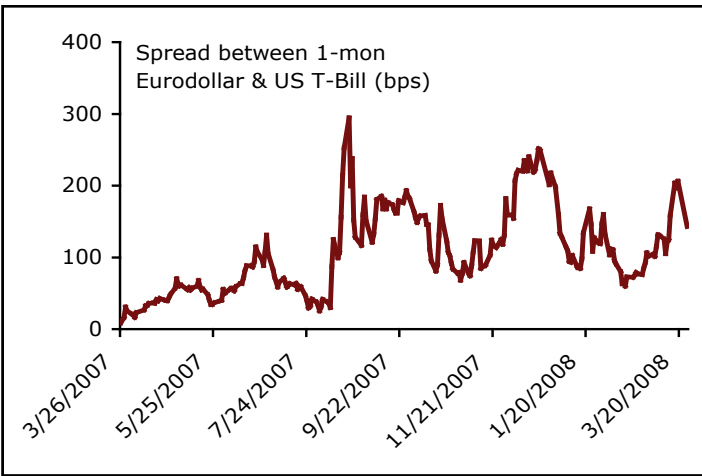
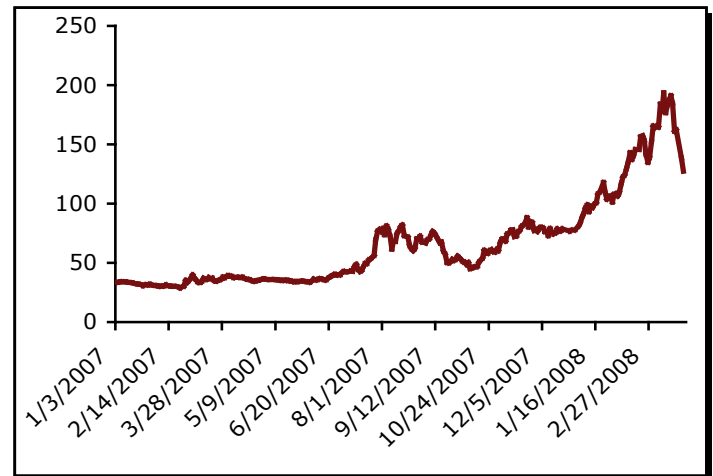


Chart 5  
CDS Spreads on Investment Grade Corps



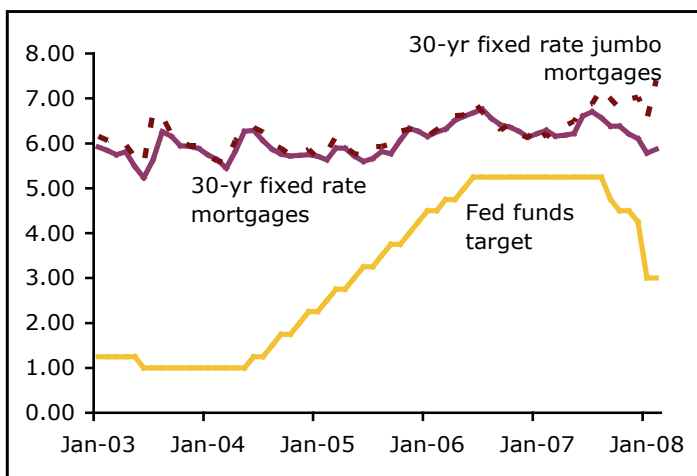
Source: Markit

As a result, fears over financial and non-financial corporate risks have kept private sector borrowing costs from following government yields downward. For example, dramatic rate cuts have not translated into significant declines in mortgage rates (Chart 4). Spreads on the CDX default swap indexes, a measure of the market's appetite for high-grade corporate risk, remain in the stratosphere (Chart 5). The solidity of bond insurers' credit ratings is still at issue as long as markets remain pessimistic about CDO defaults.

**Bailouts by Any Other Name**

At its roots, this crisis is about a collapse in the mortgage market and the resulting risk that lending activity, house prices, and therefore household spending, would dry up. One need only look at Japan in the 1990s for an example

Chart 4  
Mortgage Rates High Relative to Last Easing Cycle



of what is at stake. By the time the Bank of Japan brought short-term rates to zero, several years after the initial real estate meltdown, banks were so overwhelmed by bad debt that they were in no position to expand their lending activity, constrained by their lack of capital to do so.

A direct bailout of banks and brokers would be political suicide. But aiding struggling mortgage borrowers and propping up the mortgage market could be cast in a more favourable light, with the same financial system benefits. There is ample precedent for such action. Washington ended up eating some US\$200 bn in losses in today's dollars when it assumed the assets of failing S&Ls in the 1990s. Mexican debt was guaranteed by the US Treasury in a controversial Clinton administration move, ultimately at no cost to the taxpayer. Chrysler was also judged worthy of a bailout.

Bush and Paulson have preached a free market gospel, but are under pressure from both Democrats and Republicans to intervene more directly. Indeed, in terms of entering the battle to bail out mortgage borrowers and investors, the administration has already crossed the Rubicon.

The White House dropped earlier-imposed restraints on government sponsored agencies, and encouraged expansions by Fannie Mae and Freddie Mac that could see them buy an additional US\$200 bn in mortgages. While the debt of these agencies isn't government guaranteed, the market treats them as being too big to fail, and their financing costs have always assumed some odds of a government bailout. Regional Federal Home Loan

Banks were also permitted to buy more than US\$100 bn in Freddie and Fannie securities. FHA guarantees were also extended to refinancing larger mortgages under temporarily elevated size limits.

The Fed will then be soaking up illiquid MBS assets from the market through its alphabet soup of new term auction, securities lending and term repurchase facilities (Chart 6). Should their bank or dealer counterparty go bust in any 28-day window, the Fed would have to absorb the losses on the collateral value. The extension of the discount window to primary dealers helped ensure that illiquid mortgage securities would not end up being dumped on the market as brokerage firms scrambled for cash.

But most directly, it was in the Bear Stearns deal that the Fed moved from lending against higher quality MBS assets to outright equity ownership of some US\$30 bn in lower grade securities. The Fed termed its actions as a loan, but in reality, it became the purchaser of these securities, since the "loan" is to a new entity that has no assets other than these shaky securities. In so doing, the Fed assumed all but US\$1 bn of the risk on any drop in their value, but like an equity investor, will get any upside. That not only cleared the way for the acquisition of the rest of Bear Stearns, but also prevented a quick fire sale of these assets that would have dented mark-to-market valuations used by other Wall Street players.

**What's Next?**

Having stepped its toes into the waters, the Bush Administration may be only months away from even more direct action for mortgage borrowers to help put a cap on defaults and a floor under house prices. Such an intervention now has support from both sides of the political aisle. Proponents include Republicans like Reagan advisor Martin Feldstein and Senator Kit Bond, and Democrats like Clinton Treasury Secretary Robert Rubin and Congressional leaders Barney Frank and Christopher Dodd. Clinton and Obama have offered up suggestions in the US\$10-30 bn range, too little to matter, but other proposals are in the hundreds of billions. Clinton also suggests having the FHA guarantee more mortgages and temporarily hold some negative-equity mortgages.

All of these schemes involve direct government lending or guarantees for subprime mortgage borrowers. Financial institutions will in some cases be asked to take a haircut on the original principal, but given the need for their approval, one that would be less than their expected losses on likely defaults.

None of the steps taken by the Treasury or the Fed has yet created a lasting turn in sentiment. But we had a whiff of the potential reaction of a larger bailout when stocks rallied last week, and mortgage-related ABX indexes rebounded (Chart 7) on talk that governments in the US and UK were looking at buying more MBS. Look for a more lasting equity rally when, as seems inevitable, the US government wades deeper into the mortgage mess and assumes more of the risk, a step we expect to see before the summer is done.

Chart 6  
**Upcoming Moves Take Liquidity Addition to US\$530 Billion**

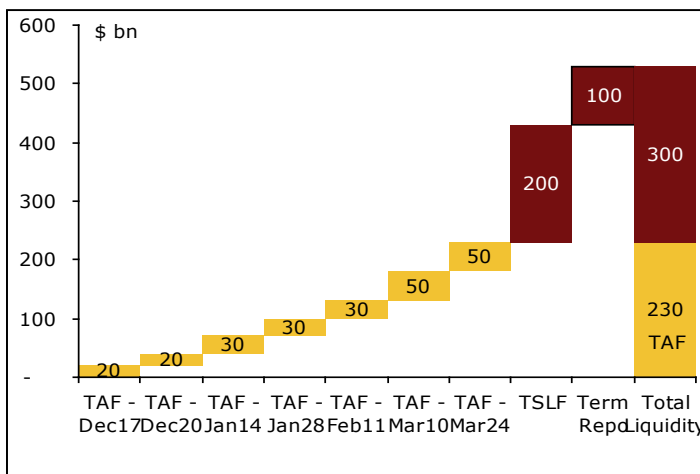
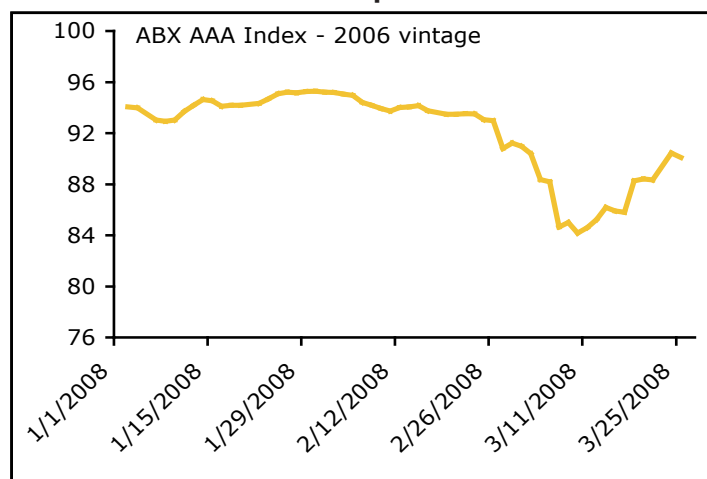


Chart 7  
**ABX Index Rallies on Hopes of Bailout**



**ECONOMIC UPDATE**

<b>CANADA</b>	<b>07Q4A</b>	<b>08Q1F</b>	<b>08Q2F</b>	<b>08Q3F</b>	<b>08Q4F</b>	<b>2007F</b>	<b>2008F</b>	<b>2009F</b>
Real GDP Growth (AR)	0.8	0.4	0.7	1.8	3.8	2.7	1.4	2.2
Real Final Domestic Demand (AR)	6.9	4.2	3.5	3.0	3.0	4.3	4.5	3.0
All Items CPI Inflation (Y/Y)	2.4	1.9	1.8	2.5	2.9	2.1	2.3	2.4
Core CPI Ex Indirect Taxes (Y/Y)	1.6	1.4	1.4	1.5	2.0	2.1	1.6	1.8
Unemployment Rate (%)	5.9	5.8	6.2	6.4	6.4	6.0	6.2	6.3
Merchandise Trade Balance (C\$ Bn)	37.4	35.0	34.0	37.7	46.9	49.6	38.4	47.9
<b>U.S.</b>								
Real GDP Growth (AR)	0.6	-0.5	-1.6	1.7	3.2	2.2	0.9	2.1
Real Final Sales (AR)	1.9	-1.1	-1.5	1.1	3.1	2.9	0.8	2.0
All Items CPI Inflation (Y/Y)	4.0	4.2	3.5	4.2	4.0	2.9	4.0	3.5
Core CPI Inflation (Y/Y)	2.3	2.6	2.3	2.2	2.5	2.3	2.5	2.2
Unemployment Rate (%)	4.8	5.0	5.2	5.3	5.3	4.6	5.2	5.3

**CANADA**

January got 2008 off to a good start on gains in manufacturing, wholesaling and retailing. But we will need a healthy 0.5% gain in real GDP that month just to claw back a chunk of the 0.7% December decline, leaving the quarter barely on track for a positive gain. We weakened our call for the subsequent two quarters in line with our US downgrade.

**UNITED STATES**

With the preponderance of fundamental indicators rolling in worse than expected, the question is no longer whether the US economy is in recession, but how long it will last. Although we continue to see a recovery taking shape in the third-quarter as the Fed's aggressive monetary action takes hold and the President's economic stimulus package makes its way to Main Street, both the first and second quarters of 2008 should be worse than we had previously forecast. The good news is that this downturn should be relatively mild, following closer to the 2001 contraction rather than those in either the 1980s or 1990s.

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