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"Rate hikes are coming, but not at the growth-crushing pace that should at this point strike fear in the hearts of equity investors."

Hang in There

by Avery Shenfeld

The rate hikes are coming, the rate hikes are coming. Those words are no friend of the bond market, with brisk selling underway in the front end of the Canadian yield curve as investors price in a tightening cycle beginning this summer. Some months ago, we advised getting out of the way of that selling pressure as the market piles on expectations for even more Bank of Canada tightening than now built into the curve, which at this point, hasn't fully allowed for the 75 bps in hikes we expect in Q3.

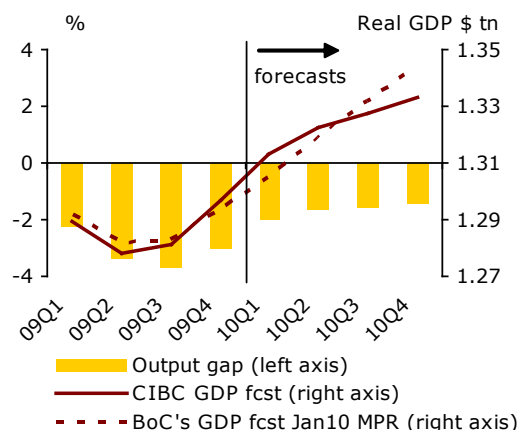
In contrast, for equity investors, higher interest rates are not yet a reason to hit the sell button. History shows that the half-year in the lead-up to the first Bank of Canada rate hike tends to coincide with a very strong run for stocks (see pages 3-5), and stocks still outperform bonds in the early months after that first tightening move.

That makes eminent sense. Equities should be linked to the present value of a future stream of earnings and dividends. Higher rates are bad news for the denominator—the discount rate being applied. But the numerator—the stream of earnings—also counts. Central banks don't start to step on the brake unless they see strong economic momentum. In that regard, we recently lifted our growth outlook for Q1 to just over 5%, marking a second consecutive quarter at that pace. With that economic momentum will be an attendant lift to earnings expectations. That could end up being overdone, but the recognition of any excess optimism about corporate bottom lines will await news of slower quarterly growth late this year and in 2011.

Rate hikes tend to be more damaging later in the cycle, when the central bank is more willing to risk a stall or recession to create anti-inflationary slack. At this point, we are a long way from the demand-driven wage-price spiral that would see the central bank willing to seriously sacrifice growth.

True, economic growth through Q1 appears to have topped the Bank of Canada's last forecast. But that came after a recession whose depth has been made more dramatic in the last set of revisions, and the remaining overshoot will be countered by a second-half slowdown (Chart). Not only do we expect weaker growth in the key US export market by then, but Canadian consumers may also be more temperate in the wake of a debt financed binge (see pages 8-11). As a result, the output gap, using the Bank's estimate for potential (non-inflationary) growth, will still sit at roughly 2% by year end, representing a substantial anti-inflation cushion. Rate hikes are coming, but not at the growth-crushing pace that should at this point strike fear in the hearts of equity investors.

Cdn Real GDP: Overshoot Won't Last



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

MARKET CALL

- Our rate outlook is little changed from a month ago, as markets have generally been moving in line with our forecasts. The Bank of Canada will continue to dampen expectations for an April or June move, and the 25 bp hike we expect for July is fully priced into the Canadian curve. But healthy Canadian data will have the market raising the odds that one of the first two moves will be 50 bps, or will add further hikes to expectations for 2011. Either way, we are not yet done with the bear flattening trend in Canadas.
- Short-term treasury yields, in contrast, look well anchored by a patient Fed, and the US curve could be range-bound for a few months, awaiting a more definitive turn in employment. While the Fed should stay on hold in 2010, the long end will remain pressured by heavy deficit funding requirements.
- While we still see the Canadian dollar shooting stronger than parity after the first Bank of Canada rate hike, we could tread water for a while in the current range. There are already heavy net-long C\$ positions on the IMM, so more buyers have to be brought to the table to get the next leg of this move. We expect the US\$ to start ceding ground against the euro as Greece gets through heavy refi challenges in April and May, even though others (Spain) have financing needs that will keep the eurozone debt issue from moving completely off the front pages.

INTEREST & FOREIGN EXCHANGE RATES

END OF PERIOD:	2010				2011	
	26-Mar	Jun	Sep	Dec	Mar	Jun
CDA Overnight target rate	0.25	0.25	1.00	1.00	1.00	1.50
98-Day Treasury Bills	0.25	0.60	1.15	1.05	1.15	1.75
2-Year Gov't Bond	1.69	1.90	2.35	2.00	2.40	2.70
10-Year Gov't Bond	3.55	3.65	3.80	3.75	4.00	4.05
30-Year Gov't Bond	4.08	4.20	4.40	4.30	4.35	4.40
U.S. Federal Funds Rate	0.18	0.15	0.15	0.25	0.75	1.50
91-Day Treasury Bills	0.14	0.10	0.10	0.20	1.00	1.50
2-Year Gov't Note	1.06	1.10	1.20	1.35	2.20	2.45
10-Year Gov't Note	3.85	3.90	3.95	4.10	4.45	4.45
30-Year Gov't Bond	4.75	4.75	4.95	4.85	5.05	5.05
Canada - US T-Bill Spread	0.11	0.50	1.05	0.85	0.15	0.25
Canada - US 10-Year Bond Spread	-0.30	-0.25	-0.15	-0.35	-0.45	-0.40
Canada Yield Curve (30-Year — 2-Year)	2.39	2.30	2.05	2.30	1.95	1.70
US Yield Curve (30-Year — 2-Year)	3.69	3.65	3.75	3.50	2.85	2.60
EXCHANGE RATES						
CADUSD	0.97	0.99	1.02	0.97	0.96	1.00
USDCAD	1.03	1.01	0.98	1.03	1.04	1.00
USDJPY	93	93	90	87	86	86
EURUSD	1.34	1.35	1.41	1.45	1.47	1.48
GBPUSD	1.49	1.48	1.55	1.61	1.65	1.68
AUDUSD	0.903	0.940	0.960	1.000	0.990	0.995
USDCHF	1.07	1.08	1.05	1.03	1.02	1.03
USDBRL	1.83	1.80	1.75	1.72	1.70	1.69
USDMXN	12.5	13.0	12.7	12.5	12.3	12.3

Will Coming BoC Hikes Derail the Stock Market Rally?

Peter Buchanan

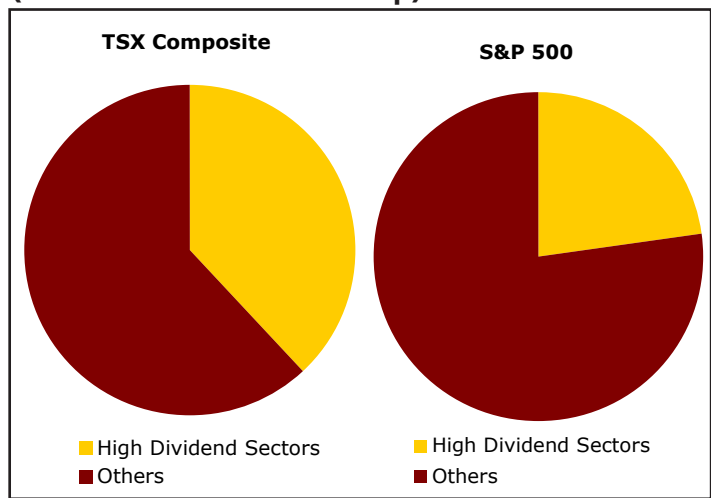
Finance 101 tells us the price of a stock depends on expected dividends (and thus earnings) and the interest rate at which these are time discounted. With interest rates, or at least bill yields, hovering near zero, investors haven't had to think hard about the interest rate side of the valuation equation lately, but that could soon change. Above-target core inflation readings and prospects that Q1 GDP growth will match or surpass Q4's hot pace make it a good bet that the Bank of Canada will soon abandon its comfortable seat on the policy fence. That's most likely to occur at its July 20th meeting, right after its conditional pledge to keep rates steady expires.

At first glance, some concern over the onset of a Bank tightening cycle would appear to be warranted. Given their bond-like characteristics, dividend stocks are often seen (though not always with complete justification as noted in our discussion of the telecoms below), as being ultra-sensitive to interest rates. The TSX's weighting in the financials and other high-dividend yielding sectors readily surpasses the S&P 500 (Chart 1). That's in addition to the rate sensitivity resulting from the Canadian market's inherently larger stable of cyclical resource issues.

Stocks Did Well Around First Rate Hike Dates

Should investors react to the prospect of a less accommodative Bank by battening down the hatches

Chart 1
TSX More Weighted to High Dividend Sectors* (Share of Total Market Cap)



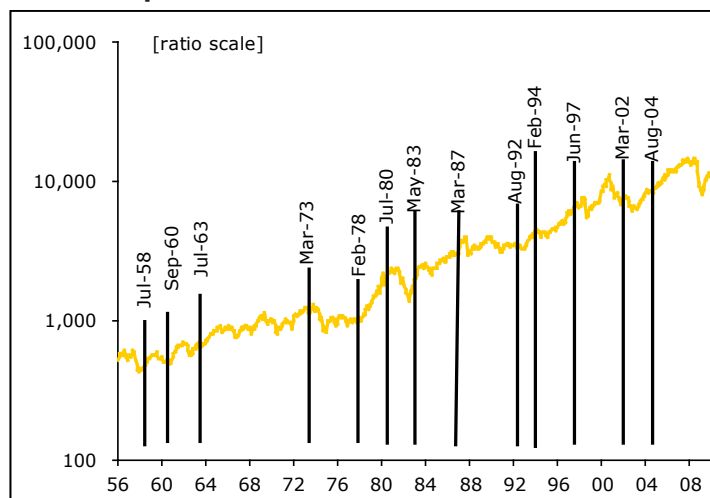
* Financials, Utilities, Telecoms

and cutting their weighting in Canadian stocks? The answer from history would appear to be no. Stock prices respond to a variety of factors, including earnings and growth prospects—not just interest rates. Muddying what would otherwise be a clear inverse correlation between rates and valuations, central bankers historically have tended to take away the punchbowl as these other signals turn from a flashing red to a steady green. It also takes time for the economy—and by extension, sales and corporate revenues—to respond to higher rates, further complicating matters.

In examining past Bank of Canada tightening cycles for useful guidance, the question then is whether these other positives typically offset the direct bad news from higher rates. History suggests they have in a majority of cases (Chart 2). That's true of the period immediately before a decision by the Bank to get off the policy fence, and also, though not quite so forcefully, of the months following such action.

To get a better handle on Bank policy shifts and market performance, we looked at how the TSX fared in the run-up to, and early stages of, the last 13 tightening cycles. That covers the period from 1956 to mid-2004, when rates began to rise in step with those stateside, as the Fed became confident that the economy was emerging from the weak spell caused by the tech wreck and September 11th attacks.

Chart 2
Start of Bank of Canada Tightening Cycles and TSX Composite



The results show that in the six months before the Bank started to lean into the wind, Canadian stocks historically provided, on average, a 22% annualized return (dividends plus capital gains) measured by the total return index for the TSX Composite (Table 1). The best was a 34% return (unannualized) in the six months leading up to May 1983, when the Bank began to reverse gears after the early 1980s double dip. The worst was a 4% decline (unannualized) in the half-year period prior to August 2004. In only one other case was performance measurably negative.

In the 6 months after a rate trough, Canadian stocks in comparison returned 8.3% in annualized terms. That's less, on average, than in the pre-hike period, but within a per cent of the TSX's longer term performance. Total returns were significantly negative in only one of the thirteen half-year periods after a rate trough. Stocks outshone bonds, the main competing asset class, about 70% of the time in the half year before the trough in rates and over 85% of the time in the half year after.

Banking, Metals, Transportation Performed Well Before Past Rate Troughs

Consistent detailed TSX total return data extend back only to late 1987. Among the best performers in the 6-month lead-up to the low point in rates in that interlude were the banking, base metals and transportation groups. They did better than the market as a whole 80% of the

Table 2

Sectors That Have Done Well Historically in 6 Months

<i>Before first rate hike</i>	<i>After first rate increase</i>
Banks 4/5	Transportation 5/5
Diversified Financials 4/5	Telecom Services 5/5
Autos & Components 4/5	Consumer Durables 4/5
Diversified Metals 4/5	Chemicals 4/5
Transportation 4/5	

Note: Figures show proportion of time group has topped market

time—or in four of the five tightening episodes that occurred during that period.

The transportation sectors and durables sectors, in contrast, were among the best places for exposure in the half-year after the rate trough (Table 2). As confirmed by our regression analysis, looking at sensitivity to rate movements over the full course of the cycle, those sectors are not as strongly sensitive to higher bond yields as others (Table 3), but still key beneficiaries of an economic upturn. Given the importance of interest arbitrage income, banking industry earnings also depend, of course, on the slope of the yield curve. The energy sector's sensitivity to finance costs is higher than one might expect, but it tallies with the increasingly capital intensive nature of that business and lengthening payoff horizons, particularly in the upstream end.

Table 1

TSX Total Return Around Cdn Rate Trough, %

Rate Trough	6-months before		6-months after	
	TSX Comp.	Bonds*	TSX Comp.	Bond*
Jul-58	15.3	2.0	12.5	-0.8
Sep-60	-0.5	10.4	23.2	-0.6
Jul-63	1.1	1.8	11.8	1.9
Mar-73	7.6	7.2	2.4	0.5
Feb-78	2.7	1.5	25.4	5.8
Jul-80	10.7	3.4	3.2	2.4
May-83	34.3	12.4	7.1	4.5
Mar-87	27.3	8.3	5.7	-5.5
Aug-92	-3.4	10.7	3.0	2.7
Feb-94	8.2	3.8	-0.5	-4.3
Jun-97	9.6	3.4	4.9	6.1
Mar-02	15.7	1.0	-20.6	7.4
Aug-04	-3.8	0.9	16.4	2.1
Avg, % (simple)	10.3	3.9	4.1	2.7
Avg, % (ann.)	21.7	8.0	8.3	5.5

*SC Universe Bond Index, 1956-89, CIBC BIGAR Broad Composite, 1990-2004, DEX Universe Bond Index, 2004-present

Note: geometric averages, data for individual time periods is unannualized.

Table 3

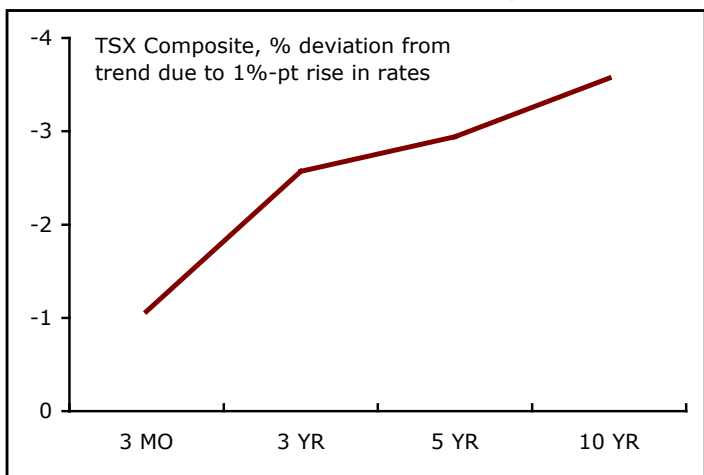
Relative Sensitivity to 10-Year Yields (TSX Average = 100)

Diversified Financials	200 *
Banks	197 *
Capital Goods	149 *
Utilities	149 *
Real Estate	128 *
Food Bev & Tobacco	127 *
Insurance	107 *
Materials	104 *
Energy	103 *
Media	103 *
Hotels, Rest & Leisure	86 *
Retailing	86 *
Transportation	79 *
Telecom Services	77 *
Autos & Components	69
Commercial Services	64
Health Care Equip & Svcs	39
Technology Hardware	30
Apparel, Consumer Durables	—

* statistically significant at 10% level, based on monthly data, 1987-2010, — = negligible

Chart 3

Stocks Are More Sensitive to Long-Term Rates



While higher dividend sectors tend to be more impacted by rising rates, the telecom group is an exception. It appears that investors have come to see the sector increasingly as a growth play, due to the rapid proliferation of a range of new media services. That has reduced its traditional “bond-like” behaviour.

As notable as the effect of overnight rate changes may be, our analysis confirms the widely held view that long term rates have much more of an impact on equity valuations than short-term rates do (Chart 3). That is not all that surprising, since what matters for investors is not earnings this year or quarter, but over a longer time frame. They are, consequently, more likely to compare the return with those from other long-lived assets. Although we expect the Bank of Canada to start tightening before the Fed, Canada’s low inflation and better fiscal fundamentals leave somewhat more room for the curve to flatten and that could, in turn, help to cushion bonds and equities from an overly rough ride.

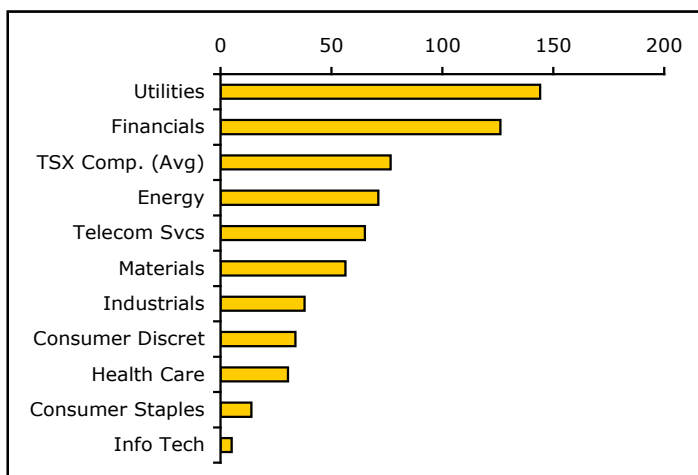
Other things being equal, higher yields are less welcome news for companies that are more highly levered. Debt-to-revenue ratios are the highest currently in the utilities and financials sectors and lowest in info-tech (Chart 4).

Modest Tightening, Healthier Balance Sheets Should Limit Market Impact

While the effect will vary significantly across sectors, several factors may help to temper the adverse effects of Bank hikes at the broad brush level. The first is that balance sheets in corporate Canada are in appreciably better shape than in the past. The debt-to-equity ratio

Chart 4

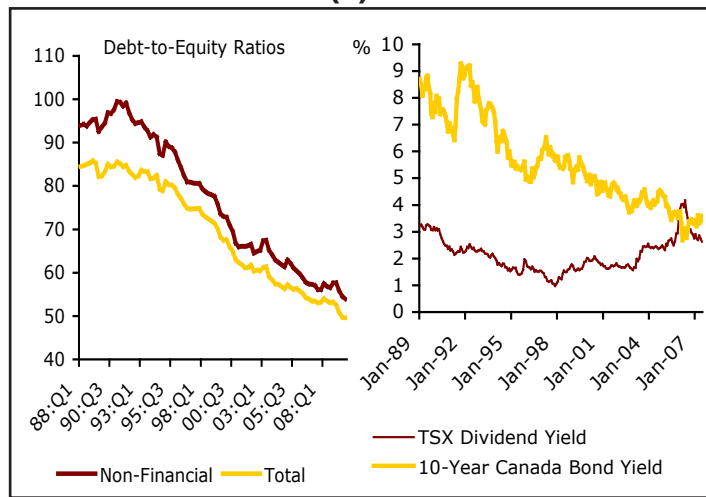
Debt-to-Sales Ratios



for the non-financial sector stands at just over 50%, a little over half its level 15 years ago (Chart 5, left). With a higher dollar and fiscal tightening doing some of the Bank’s work and still ample slack limiting prospects for a truly serious deterioration in inflation, we expect short-term rates to rise by only about 75 bps from today’s comparatively low levels through year-end. In absolute terms, that means rates at both the long and short end will remain low, relative to their historical averages for some time. That’s a plus for corporate cash flows and it also means that the payouts on dividend-yielding equities will remain attractive compared to fixed income vehicles (Chart 5, right). Those forces suggest higher rates may well be an annoyance but are unlikely to deliver a knockout blow to equity markets.

Chart 5

Debt-to-Equity Ratio (L), Stock vs Bond Yields (R)



US GDP: Too Good to be True?

Avery Shenfeld and Meny Grauman

Is the sharp rebound in US economic output and productivity too good to be true? While Wall Street trumpets the economic recovery in climbing stock prices, many people on Main Street cannot help but wonder what all the fuss is about as the unemployment rate continues to hover near 10%. The most watched data suggest that output is soaring, and that businesses are churning out a lot more output per worker than anyone realized would be possible. However, other less watched indicators are telling a different story, hinting that the unfolding economic miracle may not be quite as miraculous as it initially appears.

In fact, there is evidence that the favourite measure of activity, real GDP, may have persistently understated the depth of the most recent recession and is now overstating the pace of the current rebound. That argument goes to the heart of how economic output is computed.

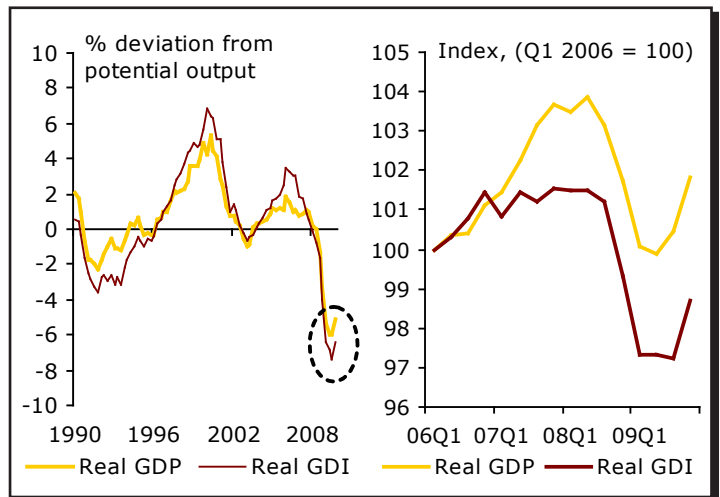
As is the case in the familiar GDP measure, one can calculate real output by adding up all of the sources of demand in the economy (consumption, business spending, exports, etc). Alternatively though, one can also measure output via income flows (wages, profits, interest and other income sources) as captured by Gross Domestic Income (GDI). Since every dollar spent is also a dollar earned by someone (after stripping out profit flows to foreign owners), economic output as measured by GDP should in theory be identical to the result obtained through the equivalent GDI measure. In practice though, the two series can and have diverged, sometimes quite significantly. Recent decades have seen larger gaps, but rarely as striking as now, where in real terms GDI shows a much deeper recession and slower rebound than the theoretically equivalent GDP numbers (Chart 1).

So Who's Right?

While there's no hard and fast proof, we have reasons to believe that the less vigorous GDI picture is closest to the truth. For one, the GDI figures do a better job of capturing activity from the smallest businesses in the economy since they rely on more comprehensive tax rolls. That is in contrast to the GDP numbers, which come from survey data that include nearly complete samples of large business establishments, but only partial reports

Chart 1

GDI Hints That the US Recession Was Deeper



from smaller firms. That is significant because there is growing evidence that this cycle has been particularly hard on small business relative to larger companies due to capital constraints. While credit availability rebounded sharply last year for large corporates as the bond market opened its arms to new issues, small firms, who are largely dependent on bank loans, have continued to see a sharp retreat in financing (Chart 2), as banks have cut lending capacity and failed to loosen historically tight lending standards.

Chart 2

Credit Growth Favours Large Corporates

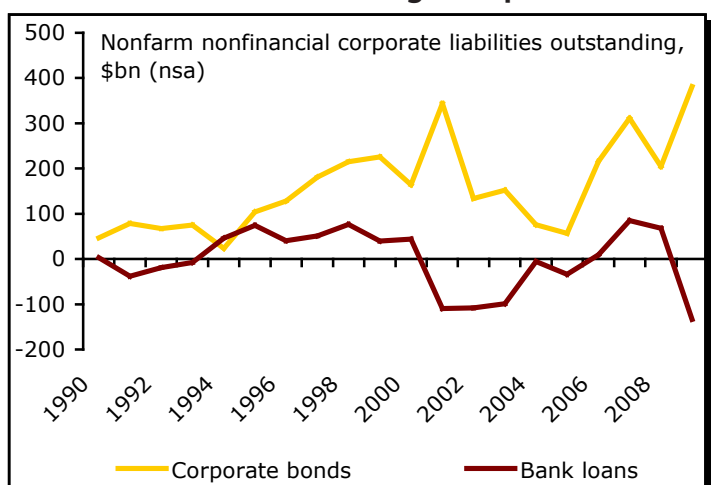
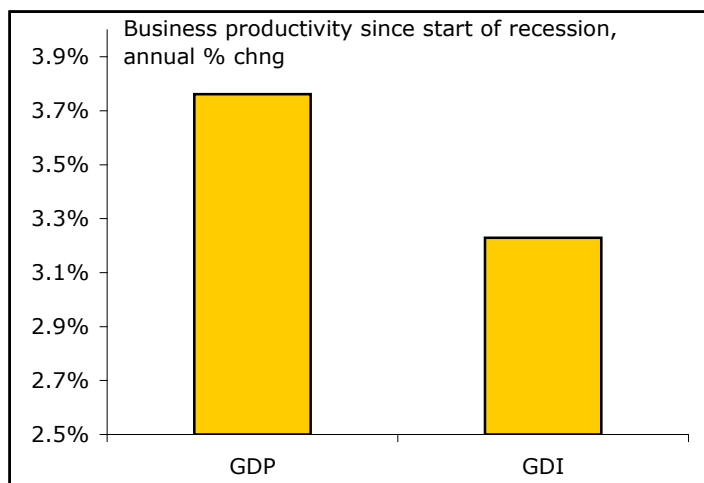


Chart 3

Productivity Using Alternative Output Measure



Secondly, taking the latest GDP reports at face value increasingly requires one to accept that the United States has achieved a truly unbelievable jump in productivity since the recession began. Output per worker expanded at a roughly 7% annualized rate in the last three quarters. True, output can rebound sharply without much hiring at economic troughs as semi-idle employees are finally put to full use again.

But this recovery's productivity gains have vastly outstripped the norm. Most cycles would have seen at least some growth in hours worked at an equivalent stage of output growth. Jobless recoveries are rare, let alone ones in which GDP is moving up at more than a 5% annualized rate while layoffs are still in evidence.

To a modest degree, productivity gains since the onset of recession don't look quite far as out of line if real GDI is used to measure economic output (Chart 3). That might be taken, then, as further evidence that the standard GDP measures of the economy may be overstating the recovery.

Indeed, even without directly addressing the advantages of the GDI figures, there are other reasons to question both real output and productivity measures as they are typically reported. Due to the rise in off-shoring, an ever more important step in the government's GDP calculation is the subtraction of the imported components in American production when assessing domestic

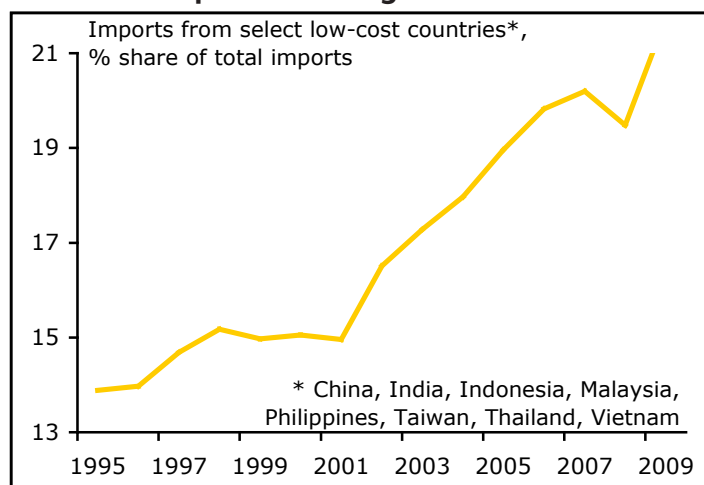
value added. Due to the rise of low cost production opportunities in China and other countries, imported content has clearly been increasing over the past few decades (Chart 4). That appears to be introducing significant bias into the official growth figures as import prices get overstated, since it takes time for them to fully capture the savings associated with the shift in sourcing towards lower wage developing countries. In turn, that implies that real imports have been actually been stronger than reported and therefore that real GDP (i.e., the US content) has been systematically overstated.

It's even more evident that quarterly manufacturing productivity growth has been less than meets the eye in the official data. The published data are based on real shipments per hour worked, rather than real domestic value added. As import content in the basket of US made goods grows, the data will fail to strip that out from the productivity of the American workers.

A critical look at the standard US economic statistics is not to suggest that there isn't a recovery underway, or that productivity is not improving from its recession lows. But if the GDI figures are on the mark, the economy could be as much as 1.5%-points further below its non-inflationary potential than estimates based on GDP. As a result, it will be an even longer road to either inflation pressures or the need for a significant monetary policy tightening.

Chart 4

Low Cost Imports Gaining Share



Canadian Consumers: More Confident But Less Capable

Benjamin Tal

The Canadian consumer turned in another strong performance in the fourth quarter, as real personal spending climbed by nearly 4% annualized. But a closer look at the data reveals that the recent surge in spending is not backed up by rising consumer fundamentals. In fact, the “V-shaped” recovery in consumer confidence that we have seen throughout the second half of 2009, has actually coincided with a drop in the ability of households to spend.

Measuring Consumer Capability

After reaching a 15-year low in late 2008, consumer confidence, as measured by the Conference Board’s Consumer Confidence Index, has improved by 60%, and is now back to its long-term average. Although still almost 20% below its 2007 peak, it is in a much better position than the corresponding measure south of the border, where consumer confidence is now almost 60% below the level seen in late 2007 (Chart 1).

The improving mood of Canadian shoppers over the past few months led to a jump in real consumer spending over the second half of 2009. But while improved sentiment can provide a short-term lift to household spending, a sustainable boost in activity must eventually be backed up by improving consumer fundamentals such

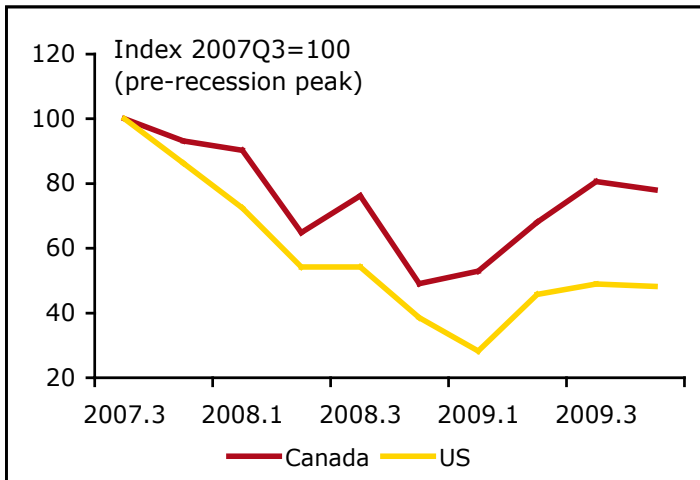
as income growth, falling unemployment and reduced debt burdens.

To get a better sense of the trajectory of these household fundamentals, we looked at seven key macro-economic factors to construct a proprietary **Consumer Capability Index** (Table 1). Unlike a confidence survey which is based on the results of a subjective survey, this measure does not address the self-reported mood of Canadians, but rather their objective capacity to continue spending. The goal of this indicator is to shed light on consumers’ *ability* to spend as opposed to their *willingness* to spend.

In constructing this index, we focused on both the level of our selected macro-economic indicators in relation to their long-term average (*Level Variables*), as well as their most recent trend (*Trend Variables*). Based on this methodology, each variable received five different scores based on its deviation from its mean. For example, at a given point in time, if the long-term unemployment rate was above its long-term average and/or was rising faster than its historical trend, then it received a low capability score. Conversely, if the long-term unemployment was below its long-term average and/or was rising slower than its historical trend, then it received a high capability score. The rationale here is that a relatively high and/or accelerating rate of long-term unemployment suggests

Chart 1

Canadian Consumers More Confident Than Americans



Source: Conference Board, CIBC

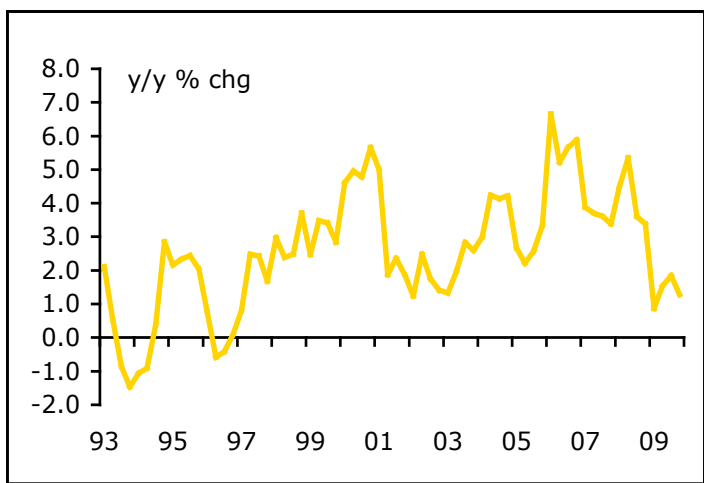
Table 1

Components of Consumer Capability Index

1. Debt-to-income ratio
2. Debt-to-asset ratio
3. Real income growth
4. Long-term unemployment rate
5. House price to income ratio
6. Personal saving rate
7. Personal bankruptcies

Chart 2

Real Disposable Income Growth



Source: Statistics Canada, CIBC

increased consumer vulnerability down the road, while the opposite points to relatively less consumer vulnerability.

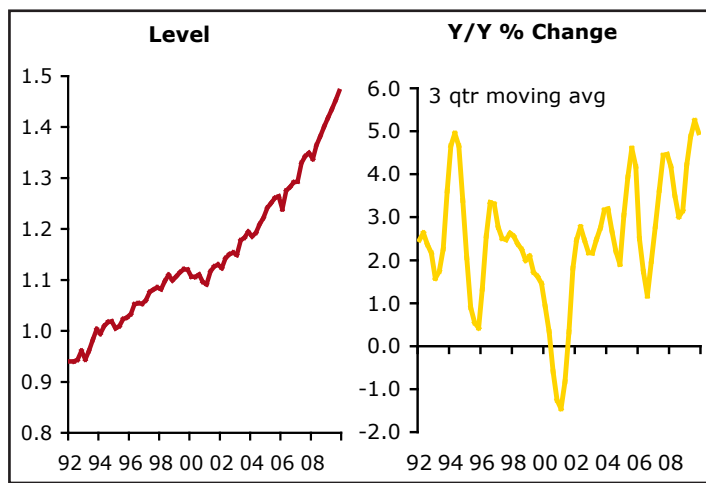
Despite Canadian consumers' high spirits, their recent consumption pattern has not been supported by an equivalent increase in income. In fact, growth in real disposable income has been trending downward over the past year (Chart 2), and to a certain extent debt is replacing income as a major driver of consumer purchases. The rising importance of debt as a determinant of consumption can be seen in the fact that the 2008-09 recession was the first economic contraction on record to show overall expansion in real household credit. As of February, overall household credit was up by more than 7% on a year-over-year basis—more than three times faster than income growth.

Consequently, the household debt-to-income ratio in Canada has continued to head higher, and as of December 2009 stood at a new all-time record of 147% (Chart 3, left). More troubling is the fact that this ratio is accelerating at a rate not seen since the mid-1990s (Chart 3, right).

That said, households are not relying much on credit for day-to-day consumption. After all, roughly 70% of the increase in household debt over the past year has been mortgage debt due to a strong revival in housing activity. Of the other 30%, only roughly one-fifth of the increase in non-mortgage consumer credit is used to finance daily purchases. Furthermore, despite rising debt loads, ultra-low interest rates kept the Canadian debt-service ratio

Chart 3

Debt-to-Income Ratio



Source: Statistics Canada, CIBC

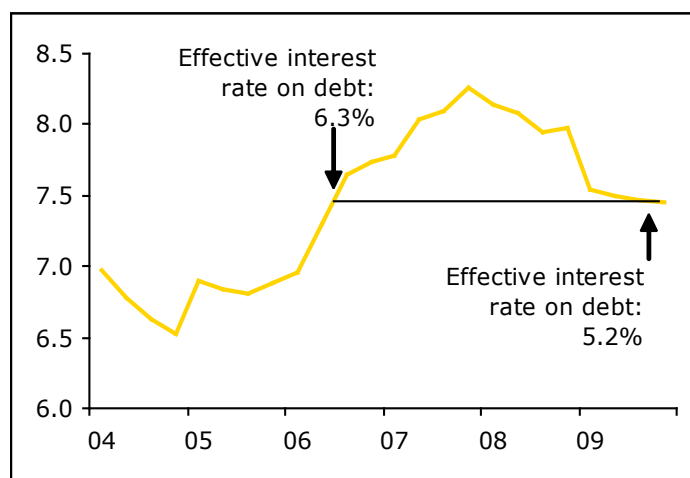
falling throughout this latest recession—a factor that is a clear positive for our index.

While this ratio is only back to the level seen in 2006 Q3, back then the effective interest rate on household debt was 1.1 %-points higher than it is now (Chart 4). With interest rates most likely to rise in the near future, this relatively elevated debt service ratio suggests an earlier debt-service squeeze and a quick response by households to any monetary tightening.

A further negative for household spending is the fact that household debt is also rising faster than assets. As illustrated in Chart 5, the debt-to-asset ratio (as reported

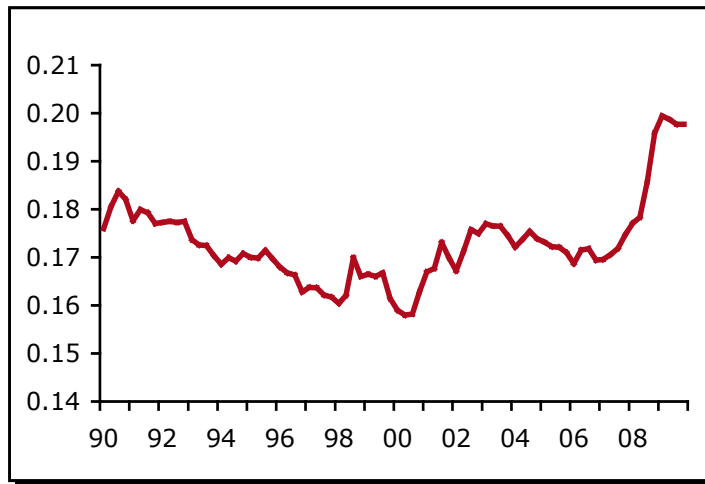
Chart 4

Debt Service Ratio (% of disposable income)



Source: Statistics Canada, CIBC

Chart 5
Debt-to-Asset Ratio



Source: Statistics Canada, CIBC

in Statistics Canada’s National Balance Sheet Account) has trended upwards during the recession. Despite the rebound in stock valuations and the recent surge in home prices, over the past two years Canadians have seen their liabilities rising twice as fast as their assets. Recent quarters have seen some stabilization in this ratio but its level remains relatively elevated.

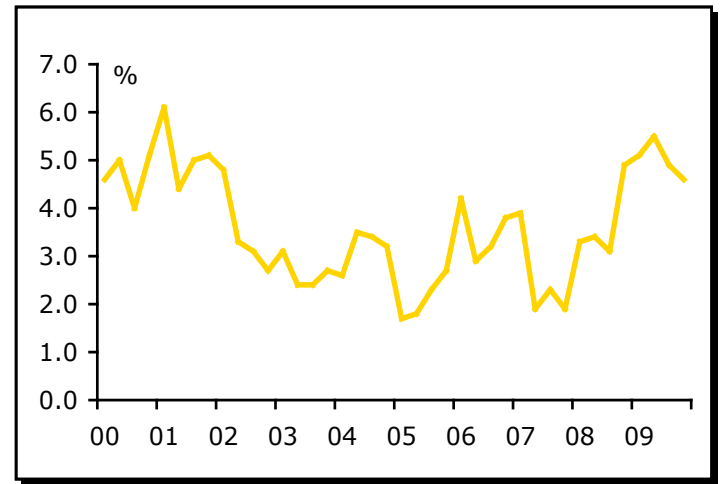
In addition, with growth in personal income softening up over the past few years, the gap between real estate gains and income growth is also widening, with the ratio of house prices to income hovering at a 20-year high (Chart 6). From a consumer resiliency perspective this is also negative, since it implies either stagnating or falling

Chart 6
Ratio of House Prices to Income



Source: Statistics Canada, CIBC

Chart 7
Personal Saving Rate

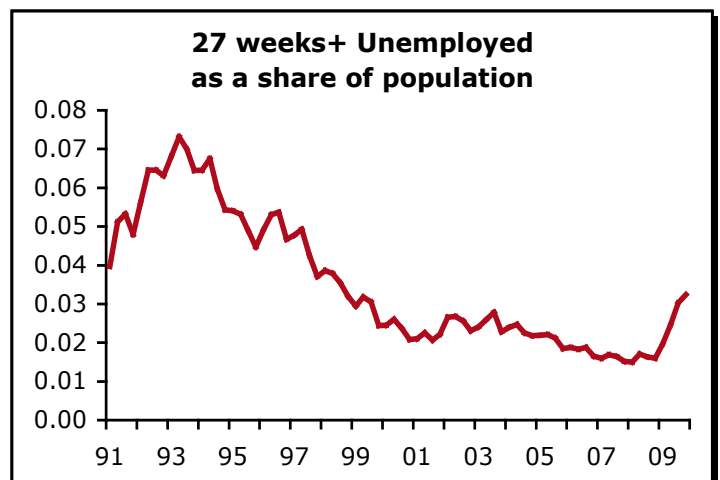


Source: Statistics Canada, CIBC

real estate markets over the coming years, particularly given now-higher housing starts creating supply pressures and higher mortgage rates ahead.

On the other side of the equation, the rise in the saving rate since 2008 (Chart 7) is a positive development, since savings can act as a buffer between the economic downturns and individual finances. Likewise, the long-term unemployment rate is also an important ingredient in our resiliency index. While this measure has trended upwards over the past year, it is still relatively low in relation to past cycles (Chart 8). Also, of note is the recent slowdown in the pace of consumer bankruptcies in Canada. However, that measure is still well above its 15-year average (Chart 9).

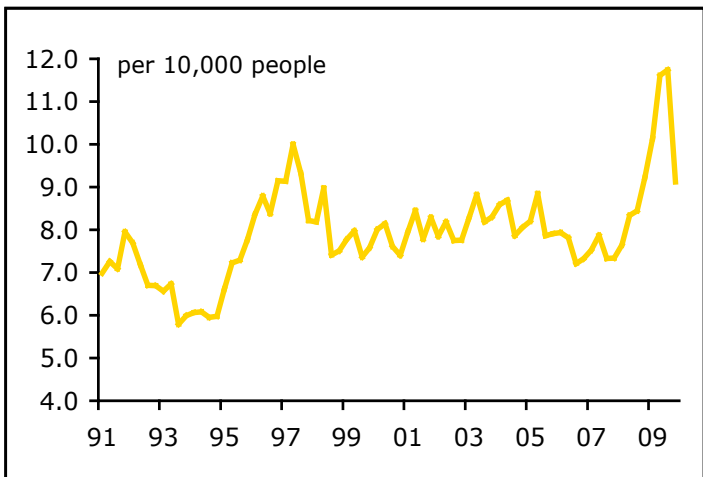
Chart 8
Long-Term Unemployment Rate



Source: Statistics Canada, CIBC

Chart 9

Personal Bankruptcies



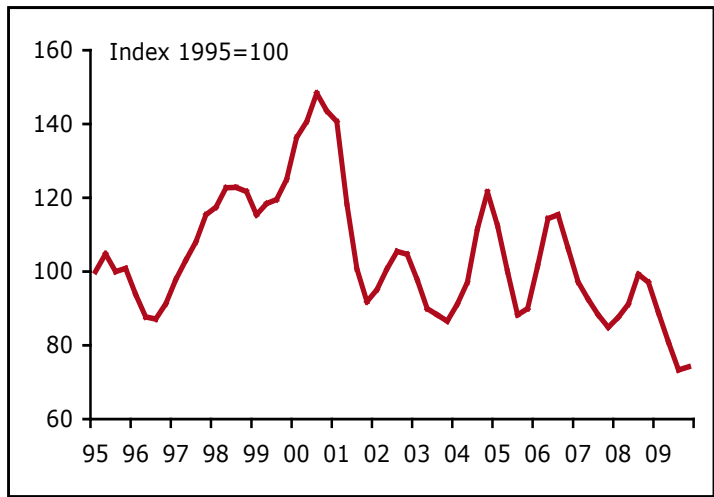
Source: Statistics Canada, CIBC

Confidence vs. Capability

Combining all of the above information into one index reveals that Canadian consumer fundamentals are weaker than they have been in almost 15 years (Chart 10). The rapid acceleration in the household debt ratio, the loss of net worth, the softening in income growth, and a relatively high bankruptcy rate are definite negatives. Those minuses are moderated by the recent increase in the saving rate, and a low long-term unemployment rate, but overall the balance is still weighted to the downside.

Chart 10

Consumer Capability Index



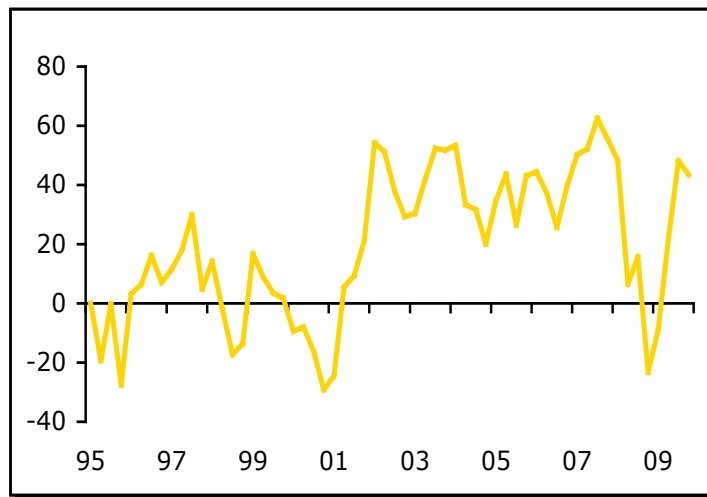
Source: CIBC calculation

Interestingly, when we zoom in on the gap between the Conference Board's Confidence Index and our Consumer Capability Index (Chart 11), we find that during the 1990s the average gap between the two measures was minimal, suggesting no deviation between sentiment and capability. However, for most of the past decade increased reliance on credit and surging real estate prices have materially widened that gap. That changed during the recession as confidence plunged to match capability, but recently headed back once again to pre-recession levels.

The practical implication of the reduced consumer capability as measured by our index is that consumer spending will disappoint in the coming twelve months. Our capability index has historically been some 20%-points better correlated with spending than the widely watched confidence index. While most of the recent focus of the potential impact of higher interest rates has been on the risk that this move will trigger a new wave of debt defaults, our analysis suggests that the focus should be on the overall impact of these rate hikes on consumer spending. And given the vulnerable starting point of the consumer, the Bank of Canada will soon find that even a moderate monetary squeeze will be sufficient to drive a material deceleration in consumer spending.

Chart 11

Gap Between Consumer Confidence and Consumer Capability



Source: Conference Board, CIBC calculation

ECONOMIC UPDATE

CANADA	09Q4A	10Q1F	10Q2F	10Q3F	10Q4F	11Q1F	11Q2F	2009A	2010F	2011F
Real GDP Growth (AR)	5.0	5.1	2.8	1.5	1.7	2.5	2.9	-2.6	2.9	2.5
Real Final Domestic Demand (AR)	4.6	4.3	3.0	2.7	2.4	1.5	1.5	-1.7	3.7	2.1
All Items CPI Inflation (Y/Y)	0.8	1.8	1.8	2.1	1.7	1.5	2.1	0.3	1.9	2.1
Core CPI Ex Indirect Taxes (Y/Y)	1.6	2.0	1.9	1.9	1.9	1.9	2.0	1.8	1.9	2.0
Unemployment Rate (%)	8.4	8.2	8.0	8.2	8.3	8.3	8.2	8.3	8.2	8.2
U.S.										
Real GDP Growth (AR)	5.6	2.5	4.6	1.3	0.7	2.4	2.6	-2.4	3.0	2.5
Real Final Sales (AR)	1.7	1.9	3.6	1.7	0.7	2.0	2.1	-1.7	1.9	2.3
All Items CPI Inflation (Y/Y)	1.4	2.3	1.5	1.2	0.9	0.9	1.8	-0.4	1.5	2.0
Core CPI Inflation (Y/Y)	1.7	1.4	1.0	1.0	0.9	1.2	1.4	1.7	1.1	1.6
Unemployment Rate (%)	10.0	9.8	9.9	10.1	10.1	10.2	9.6	9.3	10.0	9.5

CANADA

The new year started just like its predecessor ended, with January's output surge putting Canada in a great position to repeat Q409's impressive 5% annualized GDP print. While upgrading our growth forecast for Q1 lifts our call for the year as a whole, we've pared down our outlook for 2011, fearing a slower pace for consumption (see pages 8-11). Soft US growth, fading fiscal stimulus and monetary tightening by the Bank of Canada will also put a speed limit on Canadian GDP next year. Core and headline inflation will not stray too far away from the BoC's 2% target throughout 2010-2011 as excess capacity keep prices under wraps, something that will give the Bank the opportunity to follow a slow course of tightening in 2011 as it gauges the effects of the strong Canadian dollar and softer growth.

UNITED STATES

A stronger-than-expected turn in inventories in Q4, coupled with unusually bad weather, has led us to once again scale back our call for Q1 growth to 2.5%. Despite this downward revision we continue to believe that the pace of recovery will remain generally healthy in the first half of 2010 before easing up later in the year. Non-farm payrolls should begin to grow again in March, but that will not be enough to bring the unemployment rate down materially until later in 2011. Year-over-year inflation is still above 2%, but is trending lower, and continues to be weighed down by outright deflation in the housing component of the CPI.

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