



Economics

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

Warren Lovely
(416) 594-8041
warren.lovely@cibc.ca

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

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

"But what's of more import is the extent to which ... the world excluding the PIGS are also fated for tough times."

Just How Contagious are the PIGS?

by Avery Shenfeld

The investor world has its eyes glued on developments in Europe's most fiscally fragile states, almost to the exclusion of everything else. There's little doubt that PIGS (Portugal, Ireland, Greece and Spain) face a prolonged recession and for Greece if not others, an eventual debt restructuring and even an exit from the euro itself. Heightened correlations, particularly evident when equity markets are on a slower-than-average track, mean that at least in the near term, there are fewer ways to diversify out of that risk than there were decades ago (see pages 7-9). Everything from the price of a barrel of oil, to a Canadian utilities stock, is somehow tied up in the latest news about Greek protesters. But what's of more import is the extent to which the kosher economies—the world excluding the PIGS—are also fated for tough times.

There are three transmission mechanisms for the rest of the world to suffer from the PIGS' contagion. First, Europe will see slower growth as it puts its fiscal house in order, decelerating to less than 1% growth in 2011. For Canada, that will hit a modest portion of exports (see pages 10-11), but a soft Europe will dampen some commodities. Furthermore, corporate America derives roughly 15% of its earnings through subsidiary operations in Europe. And both Asian and US industries have been placed at a competitive disadvantage to Europeans given the now weaker euro.

The second contagion impact—a credit market shock—seems less likely to take hold, at least not in the next year or so. Europe will use its collective borrowing power to refinance the debt of its weakest players if necessary. Greece could still end up in default, but losses on its debt will be

mostly felt overseas, and given how much has already been spent to shore up financial systems, we doubt that Europe will let related losses take down its major institutions, some of which are already government-owned. Central banks have also learned a lot about enhancing liquidity through various term funding arrangements, and the ECB could go back to that well if interbank funding dries up.

The third transmission mechanism is the one to really fear, even if it is mostly a 2011 story. Having seen where Greece ended up, governments will speed up efforts to avoid going there.

The bond market isn't going to cut the US off and force it into recession-creating budget slashing (bond yields are showing no fear of default or the use of inflation to pay off America's huge debt). But Washington is set to wind down stimulus on a fairly steep path next year, and the UK will be speeding up its own restraint efforts. For most major economies, fiscal tightening will take a 1-2% haircut off economic growth next year, enough to turn a more typical 4% pace coming out of a recession into a 2% world for the developed economies on average. Canada's only advantage is that with a smaller deficit, the pain will be over earlier, leaving more space for growth after 2011 (see pages 3-6).

That leaves equity markets with room to recover this year if the first two transmission mechanisms fail to do much damage. But even those not dining out on PIGS will be exposed to another challenge as earnings and growth results don't measure up in 2011.

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

MARKET CALL

- The Bank of Canada *wants* to raise rates, but it doesn't have a crystal ball. It can't be certain that the recent financial market downturn isn't going to morph into something more severe that would make a rate hike look out of place. Waiting until July is, therefore, still an option, but at this point the damage to equities and commodities isn't severe enough, so the odds still lean in favour of a June hike, with further 25-bp hikes at each meeting through October, followed by a pause until Q2 of next year as growth falls short of the Bank's forecast.
- Bond markets in both the US and Canada have benefited from a huge flight-to-safety bid. Both are vulnerable to sharp corrections if the sense of crisis fades. In particular, Canadas will see a fairly sharp bear market steepening on any calming in markets that refocuses attention on the potential for further central bank tightening.
- The Canadian dollar will rally sharply on the first Bank of Canada rate hike. But dampened growth expectations have taken a bit of shine off oil and metals, and even with a likely recovery in those markets, we might not have enough drama to take the C\$ through parity until year end. We've, therefore, shaved a bit off our near target for the loonie.

INTEREST & FOREIGN EXCHANGE RATES

END OF PERIOD:	2010			2011			
	27-May	Sep	Dec	Mar	Jun	Sep	Dec
CDA Overnight target rate	0.25	1.00	1.25	1.25	1.75	2.25	2.50
98-Day Treasury Bills	0.46	1.15	1.05	1.15	1.75	2.35	2.55
2-Year Gov't Bond	1.79	1.95	2.15	2.40	2.85	3.00	3.25
10-Year Gov't Bond	3.38	3.50	3.75	4.00	4.05	4.00	4.10
30-Year Gov't Bond	3.76	3.90	4.00	4.20	4.25	4.15	4.20
U.S. Federal Funds Rate	0.23	0.20	0.20	0.50	1.00	1.50	2.25
91-Day Treasury Bills	0.17	0.10	0.15	0.40	0.85	1.30	2.05
2-Year Gov't Note	0.88	1.00	1.20	1.75	2.20	2.60	3.00
10-Year Gov't Note	3.36	3.60	4.00	4.15	4.30	4.35	4.45
30-Year Gov't Bond	4.26	4.50	4.75	4.75	4.95	5.00	5.05
Canada - US T-Bill Spread	0.29	1.05	0.90	0.75	0.90	1.05	0.50
Canada - US 10-Year Bond Spread	0.02	-0.10	-0.25	-0.15	-0.25	-0.35	-0.35
Canada Yield Curve (30-Year — 2-Year)	1.97	1.95	1.85	1.80	1.40	1.15	0.95
US Yield Curve (30-Year — 2-Year)	3.38	3.50	3.55	3.00	2.75	2.40	2.05
EXCHANGE RATES							
CADUSD	0.95	0.99	1.01	0.96	1.00	1.01	1.02
USDCAD	1.05	1.01	0.99	1.04	1.00	0.99	0.98
USDJPY	91	92	91	90	89	87	87
EURUSD	1.24	1.18	1.20	1.22	1.24	1.27	1.30
GBPUSD	1.46	1.40	1.43	1.44	1.46	1.48	1.49
AUDUSD	0.850	0.870	0.890	0.910	0.930	0.940	0.950
USDCHF	1.15	1.19	1.18	1.16	1.15	1.13	1.12
USDBRL	1.82	1.77	1.75	1.73	1.73	1.71	1.70
USDMXN	12.8	12.5	12.5	12.3	12.2	12.0	12.0

Canada Shines Through the Long Lens

Avery Shenfeld and Peter Buchanan

It was some 106 years ago that Wilfred Laurier opined that while the US dominated the 19th century, the 20th century would belong to Canada. It didn't, of course, quite work out that way, as forecasts with a 100-year horizon rarely pan out. But it might well be that, if not the 21st century as a whole, its second decade could be Canada's to shine, at least among the industrialized economies of the West.

Entering the decade with fewer fragilities after a lighter recession than others in 2009 will help. But there's more to the story than simply a better starting point. The country's relative resource abundance, lighter government deficit burden, and demographic options could collectively play out in superior performance for equity investors.

A Milder Hangover

They're dangerous words, but in terms of the first few years of economic recovery globally, 'this time will be different'. Economist Ken Rogoff has convincing evidence that economic rebounds from recessions linked to financial crises face greater headwinds than the typical up-cycles.

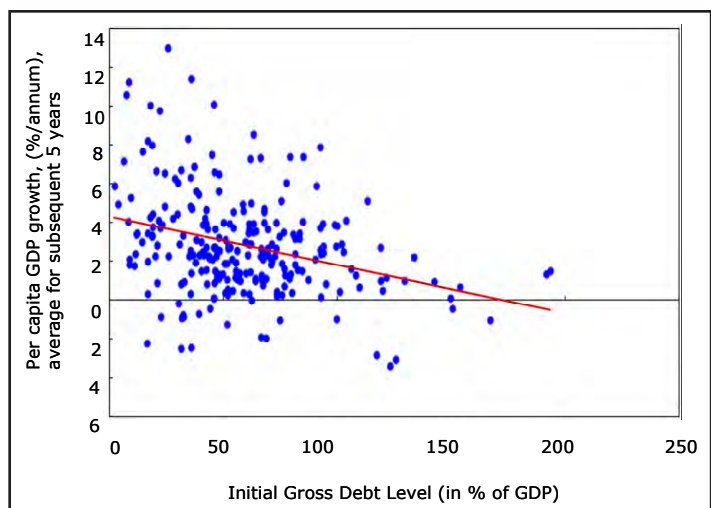
Government debt and the need to tighten fiscal policy in the aftermath of crisis rescue efforts appear to be the key transmission mechanism for this relationship. The IMF

found that more indebted countries typically have slower rates of real per capita GDP growth in the subsequent five years (Chart 1). As a result, Canada is well-positioned to outpace the typical major industrialized economy in the coming half decade, having less gross debt, and much less net debt, than most others (Chart 2).

While an earlier rate hike cycle could prevent such a growth differential from showing through in 2010-11, Canada will have a longer-term advantage in dealing with a much lighter burden from fiscal restraint. Canada's current federal deficit of 3% of GDP (or 5% including the provinces) pales next to double-digit deficit-to-GDP ratios for national governments in the US and the UK. The result is that if each country aimed to stabilize its debt-to-GDP ratio at 45%, Canada would require a retrenchment of less than 3% of GDP, while others would need fiscal cuts several times larger (Chart 3).

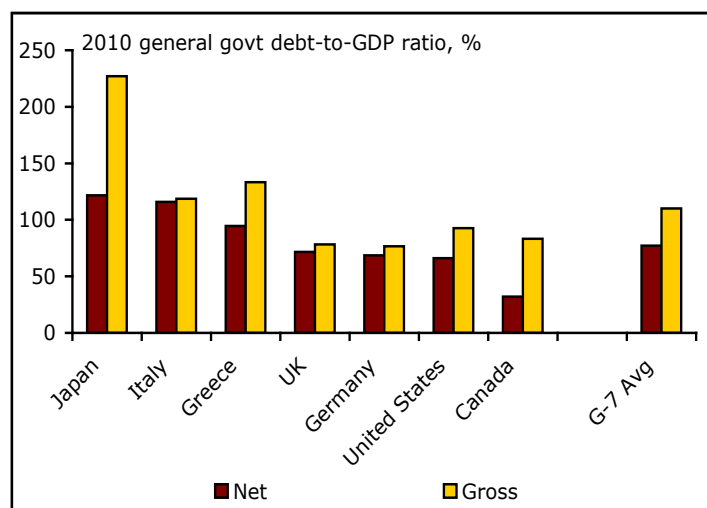
That doesn't mean that Canada won't see a huge fiscal drag in 2011—we estimate that the swing from stimulus to restraint represents a 2%-of-GDP drag in that year. But thereafter, the pain will be much lighter here than elsewhere. Moreover, while Canada's short rates will top those of other countries in the near term, long-bond yields could be lower than elsewhere, given the country's unquestioned AAA rating.

Chart 1
Government Debt and Per Capita GDP Growth



Source: IMF, "Navigating the Fiscal Challenges Ahead", May 2010

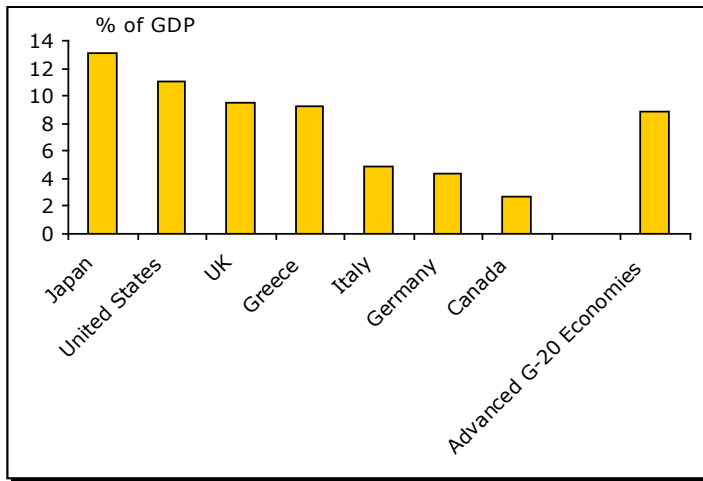
Chart 2
Canada's Government Debt Burden the Least Onerous



Note: Based on IMF projections

Chart 3

Size of Fiscal Cuts Needed to Stabilize Net Debt-to-GDP Ratio



The other hangover from the 2008-09 recession is the need to address what that shock revealed about the lack of a sufficient cushion in the global banking industry. But Canada's banks are already better capitalized (Chart 4), and have long lived with limits on leverage. While details are still forthcoming, and definitions used to calculate capital adequacy could change, the upcoming regulatory regime change should impose fewer restraints on lending growth in Canada than elsewhere given that stronger starting point.

Johnny Canuck Shows Potential

Attaining full employment faster will colour the near-term outlook, but for the decade as a whole, the other key is

the trend growth rate in the economy's longer-term non-inflationary potential. That sets the speed limit on how fast the Bank of Canada will let the Canadian economy advance without judging it as excessively inflationary.

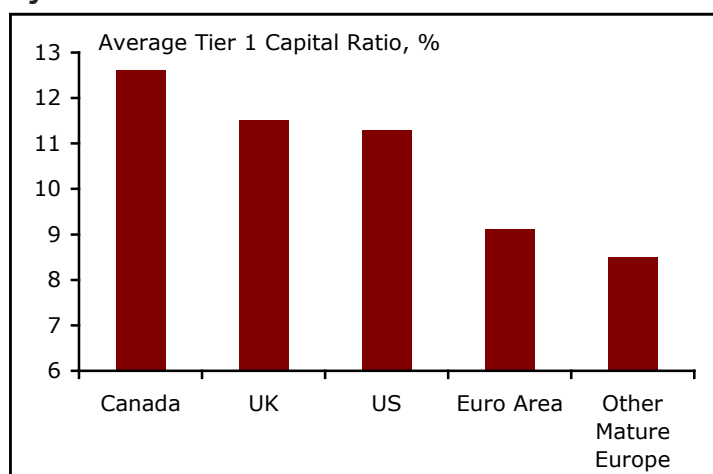
In that regard, the Bank's current estimate of the elbow room for non-inflationary growth is likely to prove too conservative. The IMF puts the country's initial output gap at about a half-point wider than the Bank's estimate. If inflation doesn't heat up, the Bank is always willing to adjust its output gap estimate to be in line with that evidence.

Potential growth will come down to medium-term trends in population and productivity. And the terms of trade matters as well, for living standards. Demographers here and elsewhere are concerned about an ageing work force that will slow growth ahead, but Canada is still well-positioned relative to other mature economies. Japan is already seeing labour force shrinkage, and is ill-positioned to attract immigrants given language barriers and cultural homogeneity in its existing population. Fueled by immigration to a multi-cultural society, Canada's economically active population is still set to grow faster than that of the US or Europe (Chart 5).

Immigration also has a side benefit, in terms of helping Canada make inroads into some of the world's faster growing developing-economy markets. Research across countries has identified that bilateral trade tends to be enhanced between countries in response to the movement of people from one to the other. Business and cultural ties to the home country can facilitate the movement of goods, a trend that appears evident in the

Chart 4

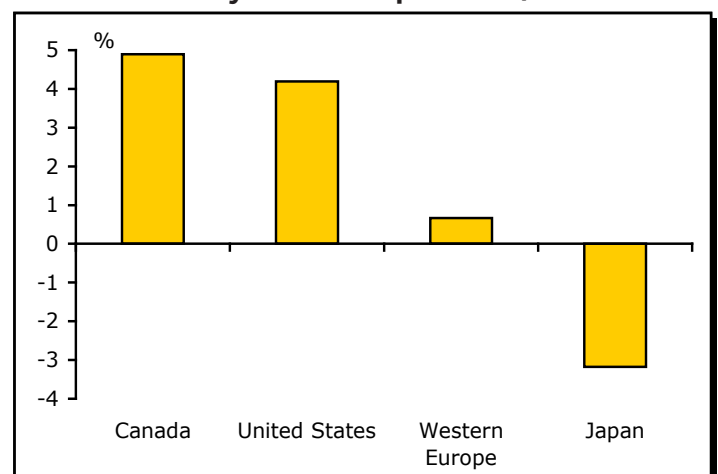
Canada's Banks Well Capitalized by International Standards



Source: CIBC, IMF

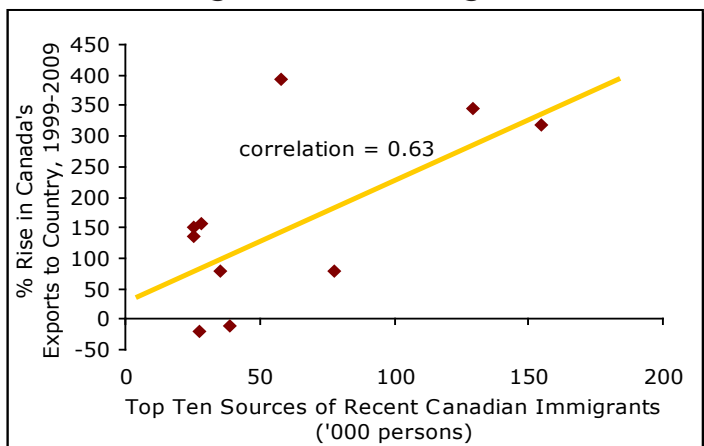
Chart 5

Projected Growth in Economically Active Population, 2010-2015



Source: International Labour Organization

Chart 6
Trade-Creating Effects of Immigration

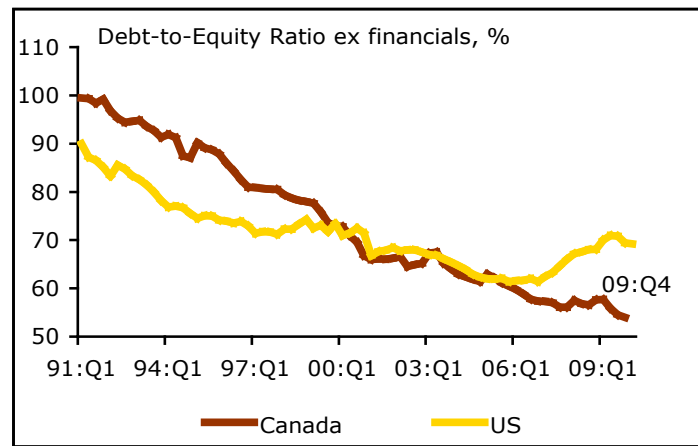


Source: Statistics Canada, CIBC

Canadian data (Chart 6). Continued in-migration from East Asia and South Asia should help build Canada's export prospects in these fast growing markets.

Where Canada's report card has suffered is on squeezing out more output per worker, a trend chalked up, in part, to sub-par business investment in productivity-enhancing capital equipment. On that score, there are at least some reasons to expect improvement ahead. Capital spending plans are recovering from their recessionary malaise (Chart 7), and corporate Canada is carrying less debt than its US counterpart (Chart 8), leaving more room to add leverage to finance those plans. Governments have done their part to encourage such spending, with corporate

Chart 8
Canadian Companies Less Leveraged Than US Ones



Source: Statistics Canada, Federal Reserve

tax rates headed below those in all of the nation's major developed-economy competitors (Chart 9).

Productivity, which focuses on the volume of goods produced per hour, doesn't, moreover, tell the whole story in terms of income and wealth. In the past decade, volume gains were supplemented by an improvement in the global market value of the goods that Canada sells to the rest of the world (particularly commodities), relative to what it imports (consumer goods) (Chart 10, left). Even including the setback from softer energy and metal prices during the recent global recession, those terms-of-trade gains accounted for about a third of Canada's domestic income growth (Chart 10, right) since 2002. That trend

Chart 7
Canadian Firms Upgrade M&E Investment Plans



Source: Bank of Canada

Chart 9
Competitive Corporate Taxes Should Support Investment & Productivity Growth

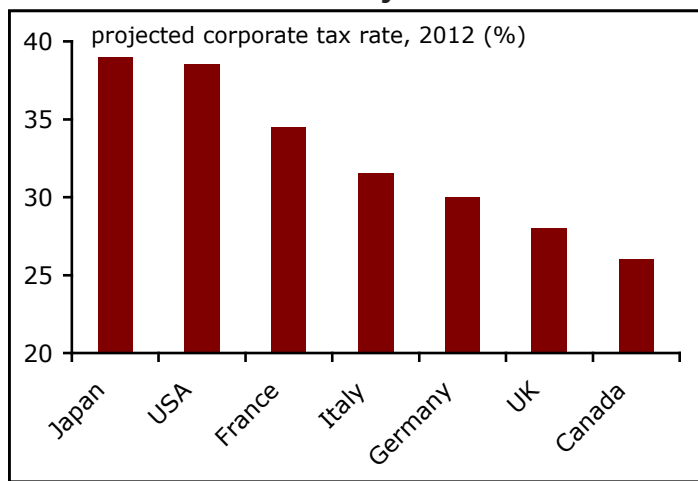
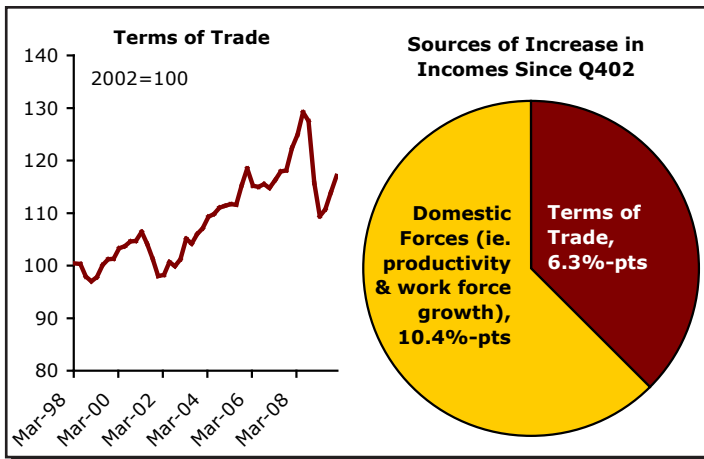


Chart 10

Canada's Terms of Trade an Important Source of Income Growth



Source: Statistics Canada, CIBC

almost certainly has further to run given the rising needs of dynamic resource-hungry emerging markets.

The Bottom Line

Investors have been climbing the proverbial wall of worry due to eurozone debt woes. Geopolitical tensions in Asia have also amplified volatility. While all this, not surprisingly, has overshadowed longer-term fundamentals, Canada's resource endowments, resilient financial system and favourable demographics relative to other G-7 nations make it an economic contender looking out over the next 5-10 years. Another notable positive is in the healthier state of public and corporate sector balance sheets. These factors are no iron-clad recipe for national success in the near term, but do mean Canada is better-positioned than many of its competitors to deal with the challenges of the upcoming teen years. And where economic growth goes, corporate earnings, dividends and other rewards for investors are likely to follow (Table 1).

Table 1

Canadian Long-Term Forecast

	Units	2008A	2009A	2010F	2011F	2012-2015F average
Real GDP	% ch	0.4	-2.6	3.2	2.5	3.0
Consumer Spending	"	3.0	0.2	3.2	2.6	3.4
Business Investment	"	-0.8	-14.1	2.7	2.5	3.1
Government Expenditures	"	4.8	4.5	6.8	1.1	2.4
Exports	"	-4.7	-14.0	8.0	6.4	4.2
Imports	"	0.8	-13.4	10.1	7.1	3.5
CPI (All Items)	"	2.4	0.3	1.9	2.1	2.2
BoC Core	"	1.7	1.8	1.9	2.0	2.0
GDP Deflator	"	3.9	-1.9	2.8	2.9	3.6
Employment	"	1.5	-1.6	1.5	1.9	1.9
Unemployment Rate	%	6.2	8.3	8.2	8.1	6.9
Housing Starts	'000	212	149	205	200	205
TSX Operating Earnings	% ch	3.5	-27.2	20.0	15.0	10.0
C\$/US\$ (average)		1.07	1.14	1.03	1.00	0.98

Source: Statistics Canada, CIBC

Looking For a Place To Hide

Benjamin Tal and Meny Grauman

The focus of global markets is now shifting from liquidity and financing concerns to deteriorating macro fundamentals, which will worsen in the coming twelve months largely due to massive fiscal belt tightening in over 60% of the world economy. If history is any guide, the next few months should see global stock markets dance to the tune of a slowing global economy, and Canadian equities will see increased correlation with softening world markets. In this environment of reduced diversification opportunities, sector selection within the equity market and proper allocation across a range of asset classes will become increasingly important as investors search for cover in a world in which returns are increasingly connected.

Global Growth Will Soften in the Coming Year

Incoming economic data suggest that the global economy has been improving faster than expected, but as investors are now beginning to fear, that pace is likely to slow down significantly later this year. World growth is still on track to expand at a respectable 4% for 2010 as a whole, but this headline number masks two diverging trajectories as healthy gains early in the year, are followed by a much slower path later on. That outlook does not just rest on dimming prospects for Europe, where significant

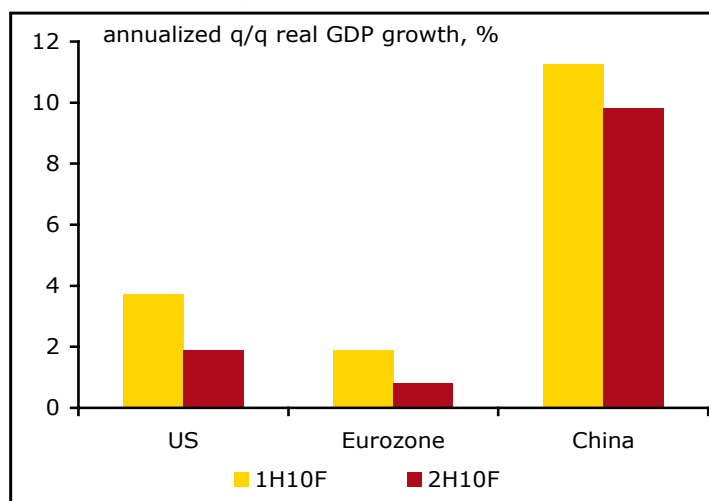
fiscal tightening is expected to keep real GDP growth below 1% this year and next. In fact, most other major economies are also set to slow significantly, regardless of their ties to the Continent (Chart 1).

Although only about 15% of American exports go to Europe, a significant pullback in US government spending, coupled with a peaking in the inventory restocking cycle is likely to hold real GDP growth to just below an annualized 2% for the second half of the year after growing by close to 4% over the first six months of 2010. Meanwhile, China is still likely to post growth rates for both 2010 and 2011 that would be the envy of any member of the G-7, but the government there has already taken steps to cool an overheating economy sparking fears of a hard landing.

Global Growth Influences Global Equities

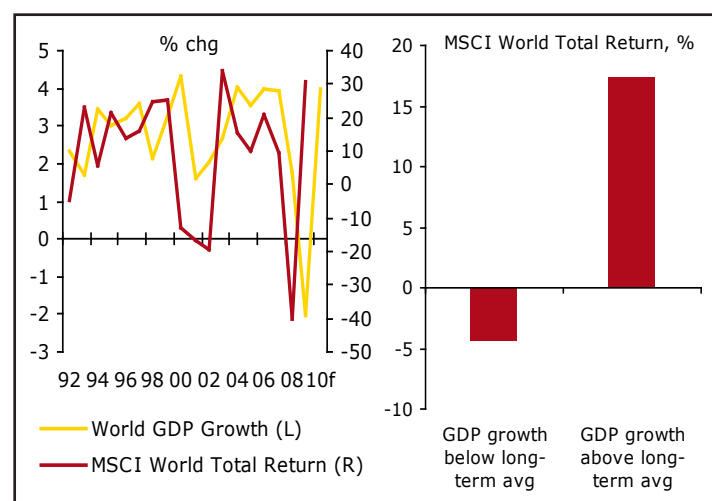
While some doubt that global real economic activity plays any significant role in determining global equity valuations, the reality is that the correlation between the two is very tight (although forward-looking markets tend to move ahead of actual changes in real GDP). Over the past 30 years the average annual return on the MSCI global equity index has been well over 15% when the

Chart 1
Global Economy to Slow in the Second Half



Source: CIBC

Chart 2
Global Stock Returns in Sync with GDP Growth



Source: MSCI/Barra Total Return Index, CIBC

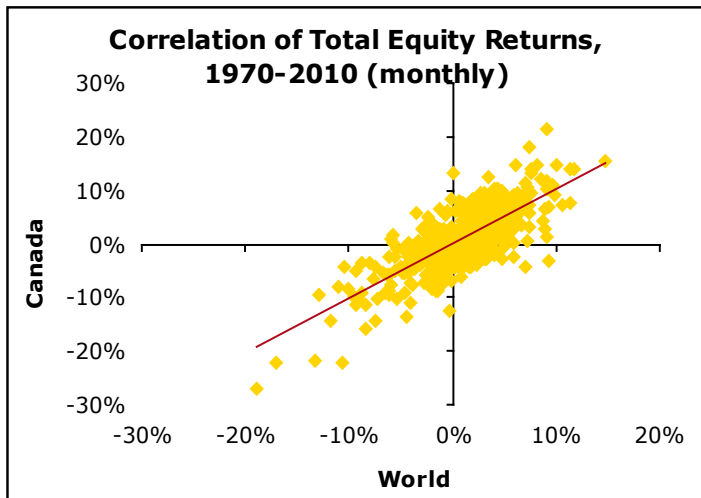
global economy is expanding at a rate above its long-term average. This is in sharp contrast to the 5% decline in total global equity returns when the global economy is growing at a rate below its long-term average (Chart 2). Accordingly, the souring world economic outlook holds significant implications for global equity returns over the coming months.

Canadian vs. Global Markets

The fact that Canadian stocks are tightly correlated with global markets (Chart 3) should not come as a total surprise considering the growing inter-connectedness of global trade and financial markets. During the long expansionary period between 2001 and 2007, those linkages helped reinforce world growth, but as was made clear during the past recession, those same connections can also amplify local crises and quickly spread them from one edge of the globe to the other.

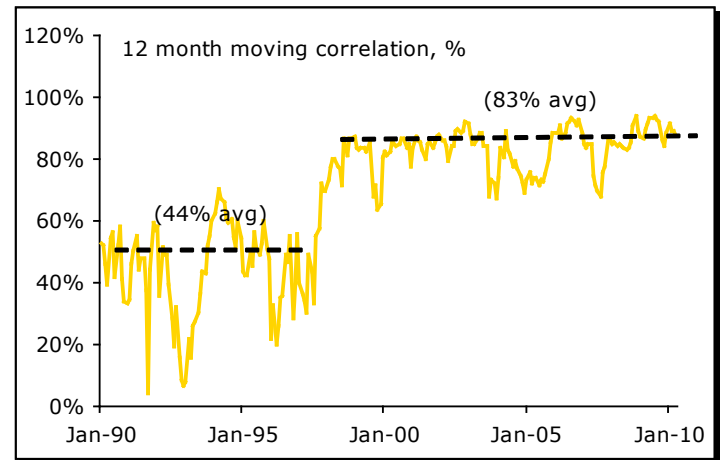
While the average correlation between Canadian and US stocks has risen somewhat over the past two decades, the more impressive increase in correlation has been against non-US markets where it more than doubled since the early 1990s (Chart 4) as demand for Canadian raw materials, particularly in the developing world, took off. Note that Canadian equity returns are still less sensitive to global markets than stocks in either Europe or the US, but not by a very wide margin.

Chart 3
Canadian and Global Stocks Positively Correlated



Source: MSCI/Barra Total Return Index, CIBC

Chart 4
Rising Canadian Equity Market Correlation with Non-US Stocks

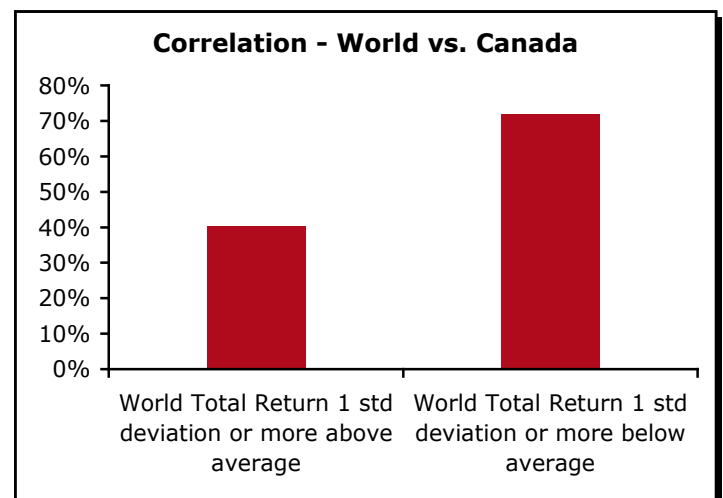


Source: MSCI/Barra Total Return Index, CIBC

Correlation Goes Up When Markets Go Down

Digging deeper into the correlation between Canadian and global equities, we find that not only do Canadian stocks increasingly move in sync with stocks on the other side of the globe, but that this relationship tends to increase during periods of increased financial market stress. Canadian equities are almost twice as correlated with global stock moves during months when international markets underperform their long-run average than during periods when stocks are doing well (Chart 5). Put differently, there are many more diversification opportunities when markets advance at an above-average pace compared to periods when markets are underperforming.

Chart 5
Canadian Equities More Correlated with Global Stocks in Bad Times



Source: MSCI/Barra Total Return Index, CIBC

That is a particularly important insight at this stage of the global economic cycle since, as mentioned above, we are forecasting a notable slowdown in the pace of economic recovery by the end of the year. Based on historical correlations this outlook is not only a negative for global stocks as a whole, but also suggests below-average performance for Canadian equities specifically.

True, there have been periods when the co-movement between Canadian stocks and major global markets has broken down. In fact the most recent example occurred in mid-2008 when the TSX hit a new record high a full eight months after the S&P 500 began a steep decline. However, that divergence was driven by the market's erroneous assumption that fallout from the US housing crash would not impact growth in the rest of the world, and was reversed when it became clear that the recession and attendant financial crisis was much more global in nature. Investors do not appear to be making the same mistake twice, as this time around commodities have actually moved in step with the current slide in equities.

Where Should Investors Go For Cover?

Having established that the outlook for global growth is unlikely to be constructive for equities, the key question for Canadian investors then is, where can they head for cover in a world in which equity returns are increasingly correlated across borders? The good news is that there are some options. First of all, it is worth noting that not all

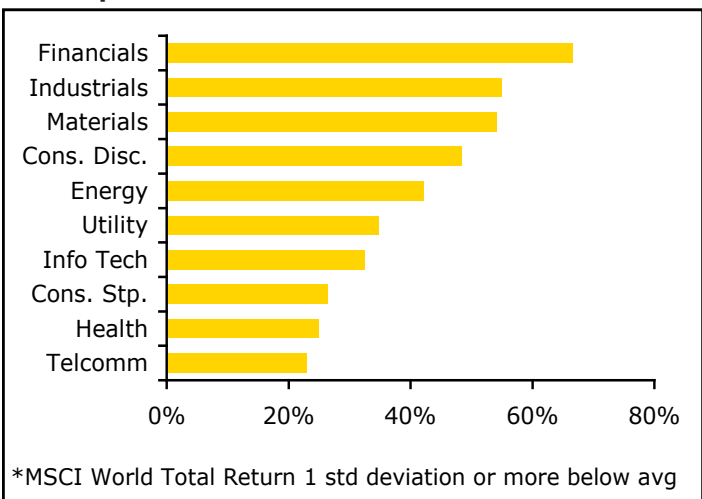
TSX sectors are equally levered to world markets, which suggests that sector selection should become increasingly important during this period. While sectors like financials, industrials and materials are highly correlated to global returns, other areas such as telecoms, health and consumer staples actually tend to be much less sensitive (Chart 6).

Secondly, looking beyond equities across a broader range of asset classes we find a number of additional pockets of protection that tend to provide some shelter to investors during periods when global stocks are under pressure. Among the assets that we looked at, an equally weighted basket of major currencies (US dollar, yen, euro and Australian dollar) appears to provide the best hedge against declines in global equities with a negative correlation of nearly 40% (Chart 7).

Canadian bonds also exhibited a negative correlation with global stocks, but we would tend to be cautious of fixed income in an environment when the Bank of Canada is poised to raise rates. Additionally, commodity futures also appear to be less sensitive to global developments than Canadian stocks, but that correlation is still positive, and raw material prices appear to be increasingly vulnerable to any weakening in global demand. In any event, while the next few months will present investors with reduced opportunities for diversification, our analysis suggests that there are still opportunities to capitalize on the ongoing deceleration in global equities.

Chart 6

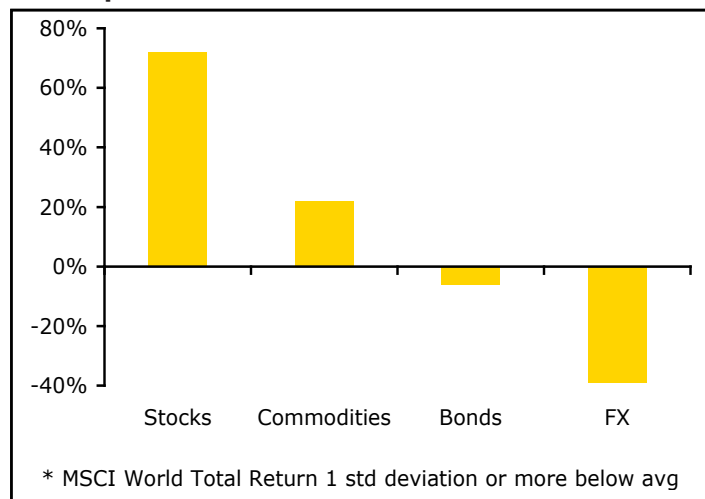
Correlation of TSX Sector Returns to World Equities During Periods of Global Underperformance*



Source: MSCI/Barra Total Return Index, CIBC

Chart 7

Correlation of Various Asset Classes with World Equities During Periods of Underperformance*



Source: MSCI/Barra Total Return Index, CIBC

European Slowdown Not Material to Canadian Trade

Krishen Rangasamy

It's not just about Greece anymore. Slow-moving European authorities have allowed a Greek problem to snowball into a full blown European crisis, and now the very survival of the eurozone and its currency is being questioned. With dimming growth prospects in Europe, nations exporting to it will clearly be affected. But Canada should do better than most given its relatively weak trade linkages with the old continent.

Rescue Package Not a Panacea

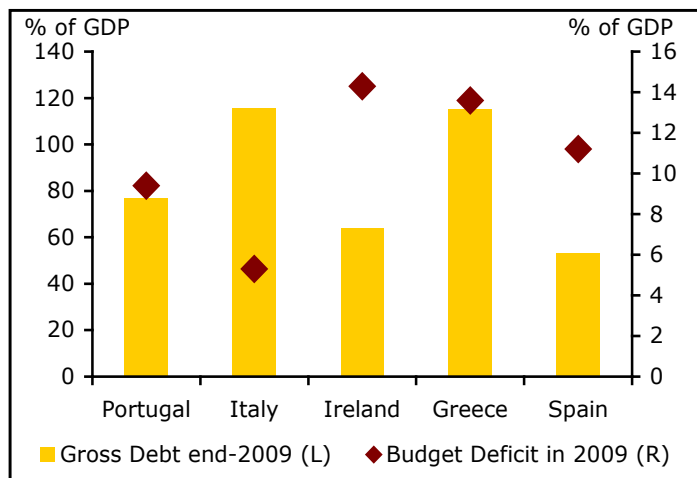
While the belated joint EU/IMF €750 billion rescue package and the European Central Bank's decision to inject additional liquidity helped lower spreads on sovereigns, it did not provide a lasting benefit for the euro. That's because markets are aware that, no matter how large a bailout package, or how much cash is pumped into markets, the necessary sharp fiscal restraint in member nations will subdue growth on the old continent for several years.

Slow Eurozone Growth Ahead

In addition to the obvious fiscal challenges (Chart 1), the eurozone will have to address a more complex structural problem. Savers like Germany will have to spend more and chronic borrowers like Portugal, Ireland, Greece and Spain (PIGS) will have to save more. For years, the latter economies have indulged in running current account

Chart 1

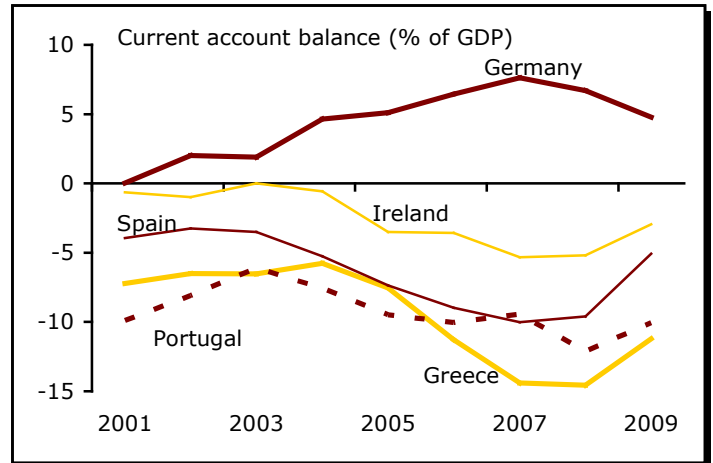
The Eurozone's Weakest Fiscal Links



Source: EuroStat, CIBC

Chart 2

Eurozone: Many Borrowers, Few Savers



Source: IMF, CIBC

deficits (Chart 2), helped by easy credit from lenders such as France and Germany. The consumption binge helped push up prices and wages, so much so that the PIGS gradually lost their export competitiveness. To make the PIGS competitive again, labour costs will have to come down relative to the more competitive Germany. Without the option of currency devaluation, it will take the slack of an extended recession to realign prices and wages.

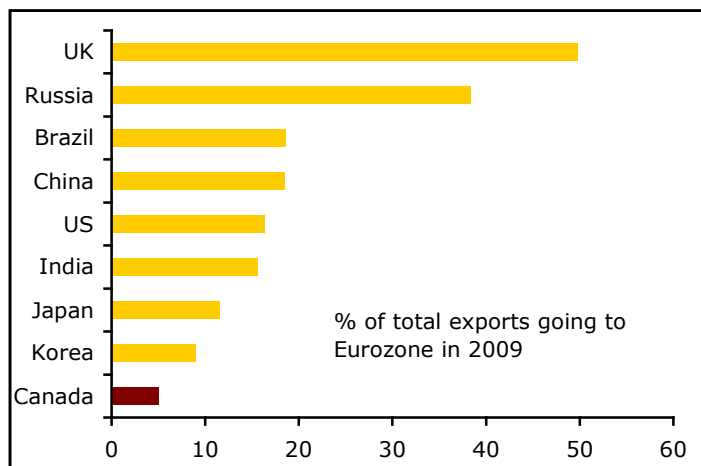
All told, there are no palatable options for the eurozone. Taking action to correct for internal fiscal and trade imbalances will at best have benefits only over the longer term, with guaranteed hardships and weak economic growth over the near to medium term. Look for growth in the European Monetary Union (EMU) to fall below 1% this year and next.

How's Canada Affected?

A stagnating eurozone will clearly hurt European countries, even those outside of the EMU, such as the UK and Russia. But looking beyond Europe, the damage should be less dramatic (Chart 3). For instance, less than a fifth of exports from leading emerging markets such as China, India and Brazil go to the eurozone. How about Canada? Unlike the tie to the US, when Europe sneezes, Canada does not necessarily catch a cold. That's because trade linkages between Canada and the old continent are not as vital as the ones we have with the US. The eurozone's 16 member nations account for 4%

Chart 3

Exposure of Exporting Nations to the Eurozone



Source: EuroStat, CIBC

of total Canadian exports (or 8% for the EMU and the UK combined). Arguably, slower demand from Europe could be more than made up by higher demand from elsewhere.

Low Export Sensitivity

Moreover, the expected drop in exports to Europe may not be significant for two reasons. The bulk of Canada's exports go to the large economies (UK, Germany, France, Italy) which are faring much better than their smaller counterparts. Also, Canada's export sensitivity to Europe seems to be diminished by the fact that the industries with the largest exposure are goods that are not necessarily linked to the economic cycle. For instance, Canadian exporters of precious metals have the largest exposure to Europe, with more than half of their total exports, i.e. roughly \$7.5 bn going to the old continent last year. The EMU and the UK also account for 27% of Canada's exports of armament (Chart 4).

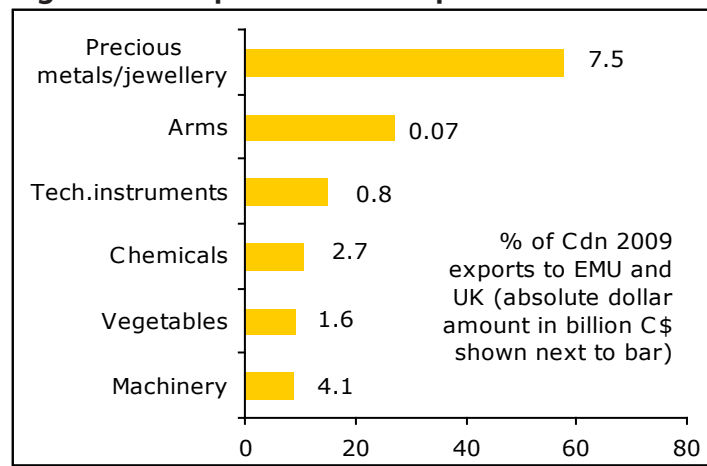
So the two sectors that are the most export dependent on Europe, produce goods that are fairly non-cyclical. That will provide some offset to lower exports in other categories, meaning that the overall impact resulting from softer growth in Europe or a weaker euro, is unlikely to do much to derail Canada's recovery.

Productivity Boost From Hi-Tech Imports

Imports from Europe are dominated by hi-tech products e.g. machinery, instruments, transportation equipment, which accounted in 2009 for roughly 40% of total

Chart 4

Canadian Goods-Producing Sectors That Have Significant Exposure to Europe



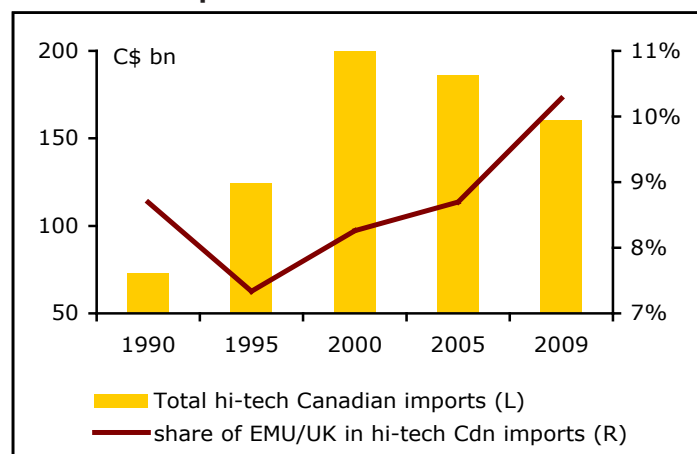
Source: Statistics Canada, CIBC

Canadian imports from the EMU and the UK. Canada's hi-tech import dependence on Europe has risen in the last decade, and last year over 10% of Canada's hi-tech imports came from Europe (Chart 5). A weaker eurozone and hence a weaker euro should support the continuation of that trend, helping Canada address its productivity problems.

That said, a slow moving Europe could have larger indirect effects on Canada. For instance, economies with bigger exposures to Europe, such as Asia will be somewhat slower as a result, cutting into volumes and prices for Canada's exports. But direct effects won't be as dramatic, with minimal export sensitivity to Europe being countered by the productivity benefits associated with increased imports of cheaper hi-tech goods.

Chart 5

Canadian Imports of Hi-Tech Products



Source: Statistics Canada, CIBC

ECONOMIC UPDATE

CANADA	09Q4A	10Q1F	10Q2F	10Q3F	10Q4F	2009A	2010F	2011F
Real GDP Growth (AR)	5.0	5.9	2.9	2.3	1.7	-2.6	3.2	2.5
Real Final Domestic Demand (AR)	4.6	5.1	3.3	2.7	2.4	-1.7	4.0	2.2
All Items CPI Inflation (Y/Y)	0.8	1.6	1.8	2.4	1.9	0.3	1.9	2.1
Core CPI Ex Indirect Taxes (Y/Y)	1.6	1.9	1.8	2.0	1.9	1.8	1.9	2.0
Unemployment Rate (%)	8.4	8.2	8.1	8.1	8.2	8.3	8.2	8.1
U.S.								
Real GDP Growth (AR)	5.6	3.0	4.3	2.5	1.3	-2.4	3.2	2.6
Real Final Sales (AR)	1.7	1.4	4.0	2.5	1.5	-1.7	2.0	2.5
All Items CPI Inflation (Y/Y)	1.4	2.4	1.9	1.5	1.3	-0.4	1.8	2.1
Core CPI Inflation (Y/Y)	1.7	1.3	0.9	0.9	0.8	1.7	1.0	1.6
Unemployment Rate (%)	10.0	9.7	9.8	9.9	9.8	9.3	9.8	9.4

CANADA

While we've upgraded our GDP growth forecast for the first quarter to 5.9% based on stronger than expected consumption data, which incidentally raises our forecast for 2010 growth to 3.2%, we're maintaining our call for below-trend growth over the second half of the year and early 2011. A US-led slowdown, fading fiscal stimulus and tighter monetary policy by the Bank of Canada will impose a speed limit on Canada's growth, and as a result we do not expect major improvements in the unemployment rate. The large negative output gap means that core and headline inflation will remain unthreatening near the BoC's 2% target, warranting a go-slow approach to forthcoming interest rate hikes.

UNITED STATES

Although US macro-economic fundamentals are steadily improving, we continue to expect real GDP growth to slow down significantly in the second half of the year. Developments in Europe have helped rattle financial markets, but the impact on the American economy should be minor. Nonfarm payrolls have been climbing now for four consecutive months, but monthly job gains are not expected to be large enough to bring the unemployment rate down materially until later in 2011. Year-over-year headline inflation continues to hold above 2%, but core inflation dropped below 1% in April, and should stay below that mark until next year. Growth concerns continue to trump inflation worries in the US, giving the Fed all the room it needs to keep rates on hold through the end of 2010.

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