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World Markets

STRATEGECON

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Fueling Inflation

by Jeff Rubin

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

Warren Lovely
(416) 594-7359
warren.lovely@cibc.ca

"With food carrying more than twice the weight in the CPI than energy, the policy response to record oil prices may become more inflationary than oil prices themselves."

The Fed may still be cutting interest rates, but markets should brace themselves for some of the hottest inflation numbers seen this cycle. If energy prices haven't gotten your attention then surely food prices have, where inflation is already running well above 4%. The coincident surges in food and energy price inflation are not unrelated. The massive policy-mandated diversion of the American corn crop from animal feed and human consumption to ethanol production has already led to huge distortions in agricultural prices, and threatens even greater distortions as land use patterns continue to change.

The tandem soaring of energy and food prices will soon be in evidence as US headline CPI inflation next month climbs above 3% and continues to rise next year. During that time the consumer price level will be subject to a steady barrage of food and energy price shocks that will see headline inflation take a run toward 4% by the end of 2008.

Still to come is not only the rise in crude prices to $100/bbl oil but, equally menacing to gasoline prices, a potential recovery in refinery margins. The twin impacts could push gasoline prices over $3.50 per gallon by next year. An even bigger push to headline inflation will come from another year of soaring food prices, as more of the US corn crop is devoted to the production of highly subsidized and trade-protected ethanol. Soaring corn prices not only pass directly into animal feed costs and corn-based food prices like tortillas, but they are spilling over to other grain prices as farmers scramble to expand corn production at the expense of other crops. Grain prices are the strongest they have been in memory while global inventories continue to shrink to record lows.

Will wages respond to soaring food and energy costs, boosting core inflation as well? If they don't and the demand for food and energy is price-inelastic, then higher consumer spending on food and energy means lower spending on everything else. That's contractionary unless you are an Iowa corn farmer or an Alberta oil sands operator. So far, wages have not responded as evidenced by the nearly full percentage-point gap between the US headline and core rate of inflation. But can wage demands remain tame when they will be constantly provoked by a seemingly never ending series of food and energy price shocks?

While the verdict is still out on the labor market's response, one thing is already clear. The bond market can say good-bye to 2% inflation rates, thanks to food and energy prices. Converting corn from food to fuel has, at best, dubious net energy benefits (see pages 4-7), but its impact on food prices, already significant, can only grow over time. With food carrying more than twice the weight in the CPI than energy, the policy response to record oil prices may become more inflationary than oil prices themselves.

MARKET CALL

- We presented this revised FX and interest rate outlook in our October 15th issue of Forecast, with the most notable feature being the stronger projection for the Canadian dollar. A solid trade surplus in resources, and the coming end of the Canada-US short-rate differential, spell sustained strength in the C$ through 2008, with any dip as the US economy begins to recover likely to prove temporary.
- Markets are tempted to price in a Bank of Canada rate cut in response to the strong C$, but the Bank will welcome the drag from the currency, given tight labour markets and a still-hot domestic economy. The Fed, in contrast, faces a crunch in domestic activity rooted in America's housing crash, and a further 50 bps in cuts lies ahead, keeping the pressure on the US dollar against other majors in the near term.
- Treasury yields have already priced in further easing, and will therefore see only modest benefit when the Fed moves. A sell-off is likely in 2008, with bonds coming under pressure as energy price hikes are joined by escalating food inflation (see pages 4-7). A persistant and growing gap between headline and core inflation will likely prompt markets to question the relevance of inflation measures that exclude food and energy prices.

INTEREST & FOREIGN EXCHANGE RATES

		2007		2008			
END OF PERIOD:		**19-Oct**	**Dec**	**Mar**	**Jun**	**Sep**	**Dec**
CDA	Call loan (mid-point of range)	4.50	4.50	4.50	4.50	4.50	4.50
	98-Day Treasury Bills	3.88	4.25	4.30	4.40	4.40	4.45
	Chartered Bank Prime	6.25	6.25	6.25	6.25	6.25	6.25
	2-Year Gov't Bond (4.25% 12/09)	4.14	4.30	4.25	4.40	4.45	4.50
	10-Year Gov't Bond (4% 06/17)	4.30	4.40	4.35	4.40	4.50	4.80
	30-Year Gov't Bond (5.75% 06/33)	4.36	4.65	4.55	4.60	4.65	4.90
U.S.	Federal Funds Target	4.75	4.50	4.25	4.25	4.25	4.50
	91-Day Treasury Bills	3.82	3.95	3.90	4.05	4.20	4.40
	2-Year Gov't Note (4% 09/09)	3.78	3.95	3.85	4.00	4.55	4.60
	10-Year Gov't Note (4.75% 08/17)	4.38	4.50	4.40	4.55	4.70	4.95
	30-Year Gov't Bond (5% 05/37)	4.68	4.75	4.70	4.80	4.95	5.00
Canada - US T-Bill Spread		0.06	0.30	0.40	0.35	0.20	0.05
Canada - US 10-Year Bond Spread		-0.08	-0.10	-0.05	-0.15	-0.20	-0.15
Canada Yield Curve (30-Year — 2-Year)		0.22	0.35	0.30	0.20	0.20	0.40
US Yield Curve (30-Year — 2-Year)		0.90	0.80	0.85	0.80	0.40	0.40
EXCHANGE RATES	— (US¢/C$)	103.5	103.7	103.0	100.2	105.0	105.0
	— (C$/US$)	0.966	0.964	0.971	0.998	0.952	0.952
	— (Yen/US$)	115	115	114	115	114	110
	— (US$/euro)	1.43	1.45	1.42	1.40	1.37	1.37
	— (US$/pound)	2.05	2.03	2.03	2.00	1.98	1.98
	— (US¢/A$)	89.1	90.0	89.0	85.0	82.0	87.0

STRATEGY AND EARNINGS OUTLOOK

- While some problems remain in the asset backed commercial paper market, we are becoming more confident that the worst in credit markets is over. Our 16,200 end of 2008 target for the TSX Composite points to another year of double-digit total returns for stocks. Based on that view and expected further gains in the TSX through the end of this year, we continued to recommend a 12%-pts overweight of Canadian equities. Even with the past month's advance, bonds have lagged equities this year. The expected boost to inflation stateside from food and energy price pressures warranted a continued underweight of that asset class.

- In what proved to be a prescient move, we added weight to the then-heavily oversold base metal group back in September. This month we added a half-point of weighting to the other large component of the material sector, gold mining. The anticipated further toll on the ailing greenback from deeper Fed rate cuts and a US current account deficit of over 5% of GDP leaves bullion prices still a one-way positive bet.

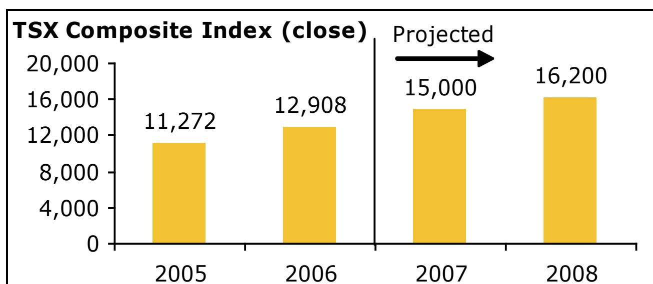
- Oil prices have pierced the $90 per barrel level, outpacing even our earlier well above consensus projections. The likelihood of royalty increases in Alberta does not alter the fact that the Canadian oil sands represent over 50% of the world's oil reserves open to private investment. Two-pronged support for valuations from M&A activity and also firmer oil and natural gas prices warrants a continued 4% overweight of TSX energy stocks.

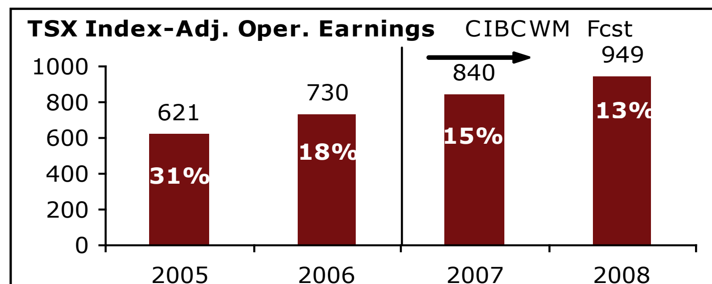
ASSET MIX (%)	Benchmark	Strategy Recommendation
Stocks	**56**	**68**
Bonds	38	29
Cash	6	3
GICS SECTOR EQUITIES (%)		
Consumer Discretionary	5.0	3.5
Consumer Staples	2.6	1.6
Energy	**27.1**	**31.1**
Financials	**30.2**	**30.7**
-Banks	16.9	16.9
-Insur., REITs, oth.	**13.3**	**13.8**
Healthcare	0.6	0.6
Industrials	5.5	4.0
Info Tech	4.4	2.4
Materials	**17.6**	**20.1**
-Gold	**6.1**	**7.1**
-Other Metals	**7.8**	**9.3**
Telecom	5.5	4.5
Utilities	1.5	1.5

Note: Bold indicates recommended overweight.

TSX - Earnings Outlook & Forward PE

	Operating Earnings (% ch)				4-qtr Fwd PE	
	2005	2006	2007	2008	Latest	Last 10 yrs.
Energy	54.5	3.7	20.7	16.8	14.6	13.0
Materials	21.3	93.3	19.4	9.4	18.9	27.5
Industrials	23.6	6.6	13.4	13.7	15.8	15.6
Consumer Discretionary	4.5	8.2	7.0	8.7	19.3	18.6
Consumer Staples	1.3	-1.9	1.5	2.9	16.7	17.0
Health Care	-0.7	12.6	-31.3	-9.8	19.3	49.7
Financials	12.8	18.3	13.4	9.4	12.9	10.9
Info Tech	260.9	-52.1	25.2	26.2	36.6	32.3
Telecom Svcs	2.1	34.7	12.7	14.8	15.6	34.7
Utilities	10.4	15.2	-10.0	3.5	17.0	13.9
TSX Composite	**31.2**	**17.6**	**15.0**	**13.0**	**15.5**	**17.9**





Corn For Ethanol: An Inflation Crop

Jeff Rubin and Benjamin Tal

Boosted by legislated demand, heavy subsidies and tariffs, ethanol production will continue to rise strongly in the near term. Going yellow will make only a negligible contribution to both meeting US energy demand and reducing GHG emissions. But it will make a much larger contribution to inflation over the next several years.

Surging Ethanol Production

Ethanol is produced by distilling simple sugar into alcohol. While ethanol can be derived from many biological sources, 95% of the ethanol produced in the United States is distilled from corn. Ethanol is used as an additive to gasoline, where it can comprise as much as 10% of the fuel mixture. Cars that have refitted engines can run on 85% ethanol, which is now sold in selected locations across the US as E85. While interest in ethanol has been recently piqued by record oil prices, the technology is by no means new. Henry Ford's first car ran on 100% ethanol and the first flex fuel car (mixed ethanol and gasoline) was built in 1905. What is new is the notion that a widespread substitution of ethanol for gasoline is economically viable.

Ethanol production around the world has been surging, particularly in the US, where huge increases in national production have now been policy-mandated by Washington. Ethanol production has soared from around one billion gallons per year in 2000 to six billion gallons by mid-2007. At this rate, President Bush's target of 35 billion gallons a year by 2017 would be met five years earlier, by 2012.

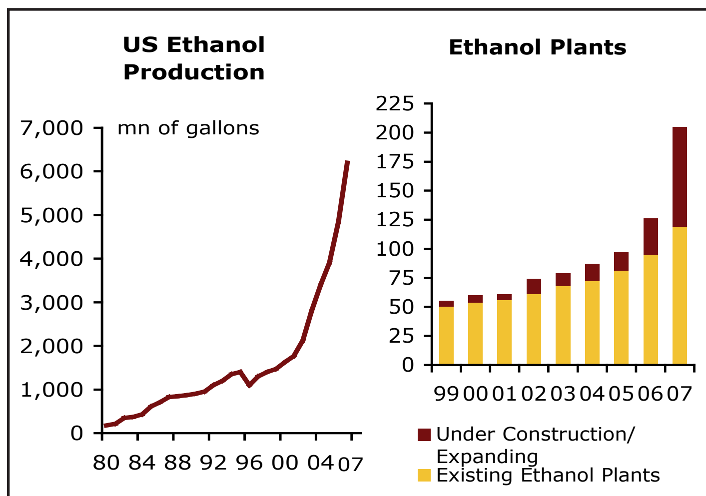
Currently there are just over 120 operational distillery plants in operation in the US, with another 77 under construction and eight planned expansions of existing plants. In total, production capacity will rise to over 12 billion gallons by 2009 (Chart 1).

The Subsidy

At the heart of President Bush's plan to rapidly expand domestic ethanol production to 35 billion gallons per year are huge federal and state subsidies directed toward both corn farmers and ethanol producers. Without such subsidies, corn-based ethanol production is simply not economic—not even with $100 per barrel oil. The key reason for that is the huge amount of energy that is required in first growing and harvesting the corn, and then in distilling the ground cornmeal into ethanol.

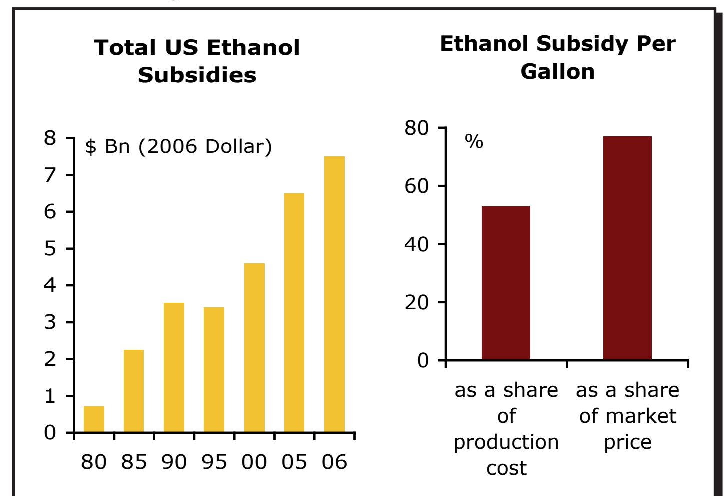
The single most important subsidy for US ethanol production is the volumetric Ethanol Excise Tax Credit, which gives a tax credit of 51 cents for every gallon of ethanol blended into gasoline. In addition, many states reduce their own motor fuel taxes on gasoline with

Chart 1
US Ethanol: Production & Processing Capacity



Source: RFA, USDA

Chart 2
Subsidizing Ethanol



Source: GSI, IISD, Earth Track, CIBCWM

higher ethanol content, in an effort to promote greater consumption of mixed ethanol fuels. Then there are direct subsidies paid to farmers to induce them to grow corn for the purposes of ethanol fuel production. Those include feedstock's subsidies, property-tax abatements and reduced business and occupation tax. Last, but by no means least, is the trade protection provided to US corn farmers and ethanol distillers. A crippling 54 cents per gallon tariff on much more economically efficient Brazilian ethanol, made from sugar cane, effectively keeps that product out of the American market place. As American ethanol production has exploded, so has the cost of those subsidies (Chart 2). Last year it approached the $8 billion mark, as subsidies accounted for as much as 50% of production costs and 75% of market prices. It is estimated that subsidies will rise to a staggering level of more than $25 billion when production reaches President Bush's 35 billion gallon target by 2017 or sooner.

And for What?

While subsidized ethanol may be cheaper to motorists, those who rely on this fuel will be making more trips to fill up their tanks. A gallon of pure ethanol holds about 30 per less energy than a gallon of gasoline (80,000 Btu versus 119,000).

Even more damaging to the economic viability of ethanol is the huge amount of energy required to produce it. Producing ethanol for fuel is the same as producing ethanol for liquor. Yeast eats sugar and gives off alcohol and CO_2. The output is distilled, vaporizing the alcohol, which is then captured and reconstituted as ethanol. All of this requires a fair amount of heat, which is normally supplied through burning natural gas. In addition to the natural gas used in the distillation process, other fossil fuels must be burned over the course of ethanol's full production and transportation cycle. For example, growing and harvesting the corn initially requires diesel fuel to drive the tractors. Then the corn must be hauled to the processing plant by truck, again requiring the burning of either diesel fuel or gasoline. And lastly, the refinished product, ethanol, must be transported by truck and trains all across the country, since ethanol cannot be transported in conventional pipelines.

Add it all up and the net energy benefits begin to look pretty marginal relative to the huge subsides directed towards ethanol production. Most recent studies suggest that corn-based ethanol in the US provides only a 25% net energy benefit compared to the energy required in its production. By comparison, Brazilian ethanol, made from sugar cane, provides a 90% increase in energy (Chart 3, left).

Just as corn-based ethanol's net energy benefits are suspect, so too are its GHG emission properties. Because so much of the energy in corn-based ethanol comes from burning hydrocarbons, there is little GHG emission benefit compared to conventional gasoline (Chart 3, right). In fact, there could even be a slight negative emission differential if coal instead of natural gas is used to generate the heat required in the distillation process for ethanol.

Chart 3

Corn Based Ethanol: Limited Energy and GHG Emission Benefits

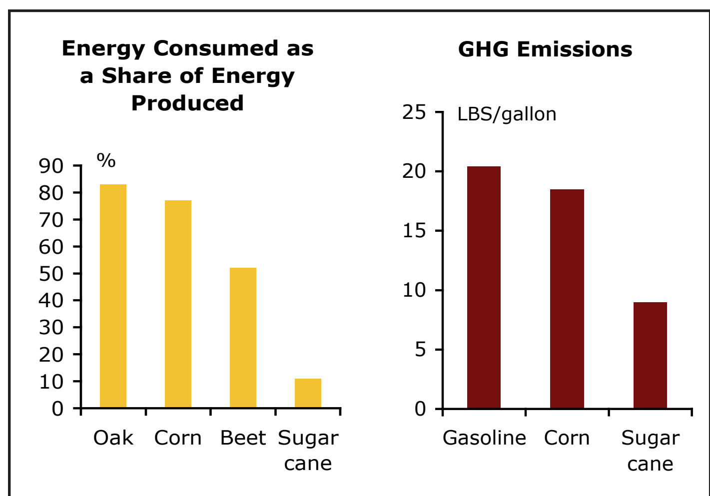
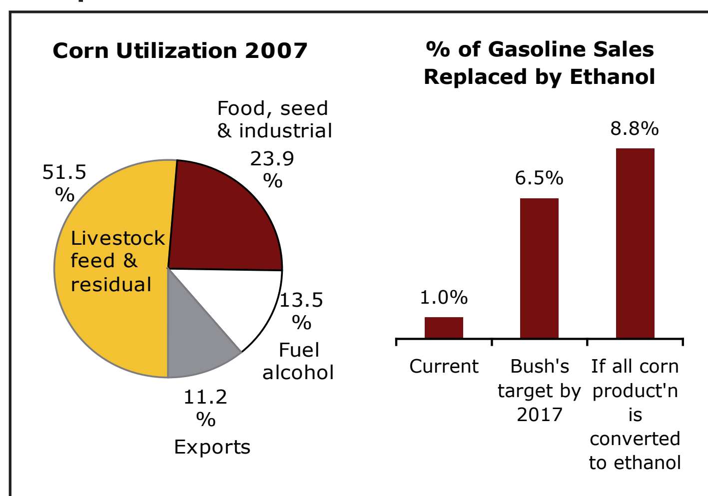


Chart 4

Negligible Contribution to Energy Independence



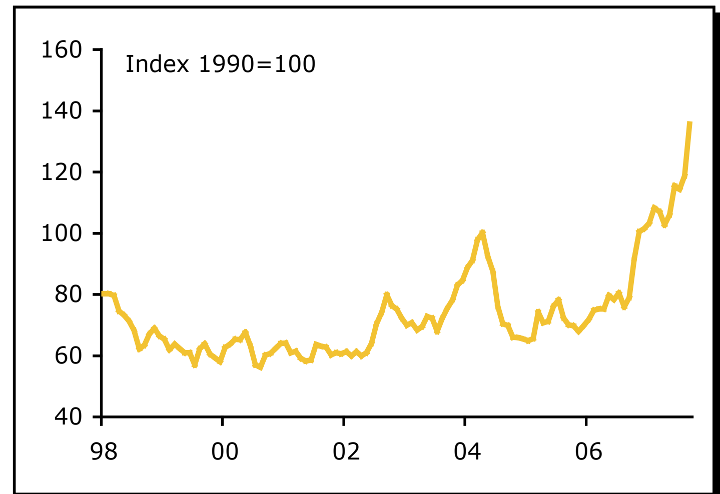
Source: USDA, CIBCWM

Those energy inefficiencies consign ethanol to a relatively minor role in replacing gasoline. Currently, corn for ethanol accounts for 13.5% of all corn production in the US, yielding roughly 6.2 billion gallons of ethanol which is equivalent to only one percentage point reduction in US gasoline consumption. Even if the US achieved President Bush's 2017 target of 35 billion gallons per year that would only reduce gasoline consumption by an estimated 6.5%. And if tomorrow we convert the entire US corn crop to ethanol production, it would only replace less than 9% of gasoline consumption. Even if achieved, President Bush's plan would result in a negligible measure of US energy independence (Chart 4).

Food Inflation

While corn-based ethanol will make a negligible contribution to meeting US energy demand, it will make a major contribution to US inflation over the next several years. Diverting an ever increasing share of the American corn crop from human consumption and livestock feed to energy production is putting unrelenting pressure on food inflation. And we are seeing that not only in the US, but around the world, given the key role the US plays in world corn markets. The ethanol bandwagon is contributing to the most significant bull market for grain prices in generations. Global grain supply, currently at only 53 days of consumption, has plunged to its lowest level in almost 50 years, as production cannot keep up with surging demand (Chart 5). Not surprisingly, grain prices have soared—up by a dazzling 70% in the past year alone (Chart 6).

Chart 6
Grain Prices

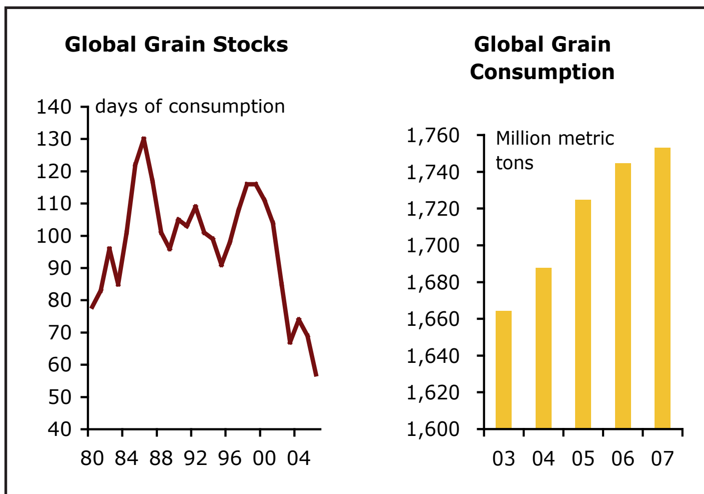


Source: CRB

Corn prices have risen by 60% over the past two years, as ethanol production claims an ever increasing share of US corn production. But, the impact of ethanol on food prices is by no means restricted to corn. As ethanol pushes up the price of corn, farmers respond by switching crops. As more and more acres are connected to the production of corn, fewer acres are available for other crops that compete for the same land use. Hence the prices of those crops rise as well.

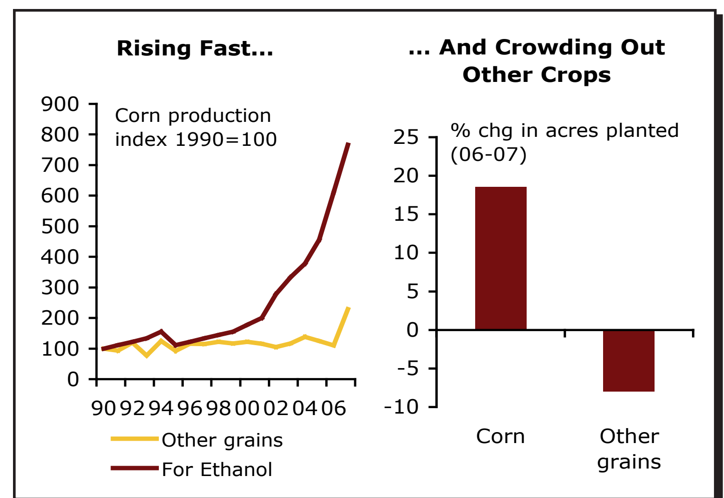
For example, this year corn cultivation in the US rose by 20%, while planned cultivation of other crops fell 7%. Out of the eight largest grain crops in the US, corn's share has

Chart 5
Record Low Grain Stocks & Rising Consumption



Source: USDA

Chart 7
Corn for Ethanol



Source: USDA

already risen from 30% to 40% between 2000 and 2007. The first casualty is soybeans since corn and soybeans are typically planted in rotation (Chart 7).

The issues are by no means America's alone. The production of ethanol from corn is crowding out other claims on corn production around the world, For example, tortilla prices shot up 30% recently in Mexico, forcing the government to come in with a price cap, as concerns have risen that corn imports form the US will fall short due to growing demand for ethanol in the US marketplace.

Corn prices, of course, are transmitted through the food chain, given that 50% of all the corn grown in the US is used for animal feed. As corn prices soar, so does the price of cattle feed and ultimately the price of meat itself.

Not surprisingly, food inflation is suddenly on the rise both globally and especially in the US, where the push for ethanol-based fuels is the greatest. In the US, food inflation in the Consumer Price Index is running at 4.4%, the highest rate in more than 15 years—contributing more than 0.3 percentage points to overall inflation—the second largest contribution in 15 years.

As more and more of America's corn is diverted towards fuel production, food inflation will continue to soar. By the end of next year we predict that food inflation will be running well over 5% and as ethanol production rises to nine billion gallons in 2009, food inflation will approach 7%, its highest level in more than 25 years (Chart 8, left).

While accounting for less than 15% of the consumer price index, food represents one of the least substitutable areas of consumer demand. Inflation rates this high in the food component suggest that the all-items CPI inflation rate will probably move and stay well above the 3% level that many believe is the Fed's effective policy intervention ceiling (Chart 8, right).

The consequences are likely to be twofold. It will be more difficult for the Fed to deal with the economic impacts of $100 oil, if food inflation is at the same time running at a near-record pace.

Secondly, the substitution of land use from food growing to fuel will have some profoundly negative income distribution effects. While food may account for less than 15% of the US consumer price index, it represents nearly 40% of the monthly budget of low income Americans—two and a half times the percentage the average American household would spend on food (Chart 9).

Ethanol indeed has certain benefits, but only for those who grow corn and distill it into alcohol. The cost of this endeavor however, is enormous, and is rising with every gallon of ethanol produced. While the impact of rising grain prices on the half of the world population that is malnourished will probably not persuade Washington to rethink its pro-ethanol policy, surging food inflation at home will. Until then, however, the only thing Bush's renewable energy policy will fuel is inflation.

Chart 8
Food Inflation is on the Rise

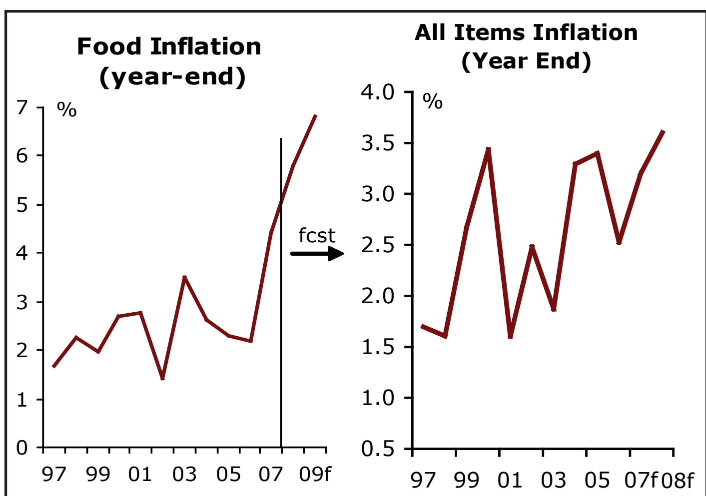
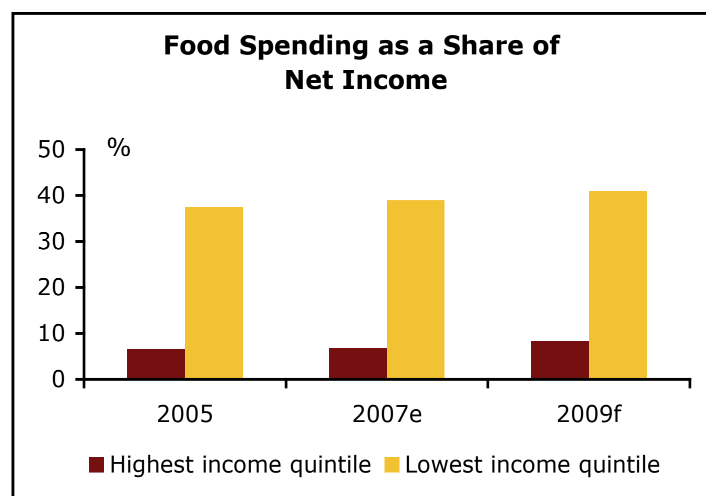


Chart 9
The Poor Spend More on Food



Source: BLS, CIBCWM

Canada's Contemporary Class Struggle

Warren Lovely

Back in the mid-19th century, Karl Marx popularized the notion of a class struggle, one pitting capital against labour. Fast forward to 2007, and Canada is putting a distinctive and contemporary twist on this 150-year-old concept.

Canada's struggle isn't about being a capitalist or a labourer. Rather, it's a conflict delineated along industry lines, one that's about industry *classification* as much as anything. At its most basic, Canada's struggle pits resource producers against non-resource manufacturers; the former capitalizing on a global economic boom, the latter victim to a premium exchange rate, a slumping US, and competition from overseas players (whose very success, in a cruel twist of irony, is behind so much of the demand for Canada's resources).

Given resource concentration and the orientation of production/trade, Canada's industry struggle is easily translated along provincial boundaries. Discord is evident between an Alberta oil producer and an Ontario automaker, between a Saskatchewan miner and a Québec clothing maker. Prospects also vary materially depending on whether you're a construction worker or a logger, a farmer or a fisherperson.

Resource Producers Remain in the Driver's Seat

Today's global economy is not an equal opportunity playing field for Canada's provinces, with success or peril a function of the industries in which they ply their trade. Those with outsized resource sectors, oriented towards fast-growing Asia, are clustered at the top of the provincial growth charts (Charts 1 and 2).

Newfoundland & Labrador will lead the provinces in 2007, with an 8%-plus real GDP surge powered by expanding oil and mineral production. No province has a more volatile growth record, and a 2007 spike is due to give way to more restrained growth in 2008. Throughout Atlantic Canada, large energy projects hold the key to current and future growth, be it development of offshore fields, expanded refining and pipeline capacity or the construction of liquefied natural gas terminals.

Western Canadian resource players are cashing in on unrelenting global demand, with real GDP growth in Alberta and Saskatchewan set to run at 4½-5% this year and next. As for British Columbia, 2008 should mark the seventh straight year in which growth outstrips the national average.

Notwithstanding weakness in natural gas, the development of Alberta's vast oil sands remains a vital source of growth, with facility construction giving way to increased production. Compared to nationalization in other parts of the world, a moderate increase in Alberta royalty rates would maintain an attractive investment climate. Incremental resource royalties would only accentuate Alberta's fiscal edge.

Chart 1
Growth Rates: Softer in the Middle

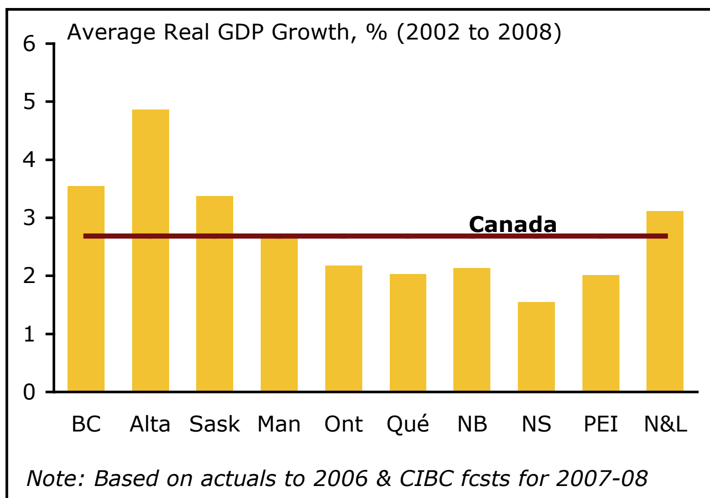


Chart 2
Provincial Real GDP Growth

Y/Y % Chg	06A	07F	08F
British Columbia	3.6	3.3	3.3
Alberta	6.8	4.8	4.7
Saskatchewan	0.4	5.0	4.5
Manitoba	3.3	3.1	3.0
Ontario	1.9	1.9	2.0
Québec	1.7	2.0	2.3
New Brunswick	2.6	2.4	2.5
Nova Scotia	1.1	2.3	2.4
Prince Edward Island	2.0	1.9	1.8
Newfoundland & Lab.	2.8	8.3	2.2
Canada	**2.8**	**2.6**	**2.7**

Chart 3
Saskatchewan Tops in Job Quality

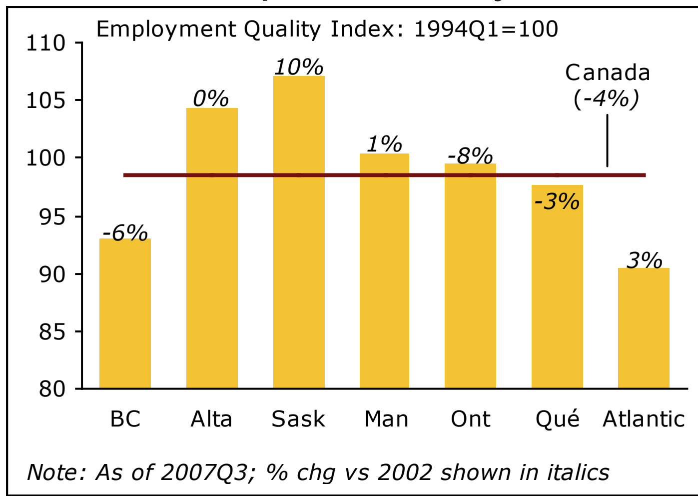
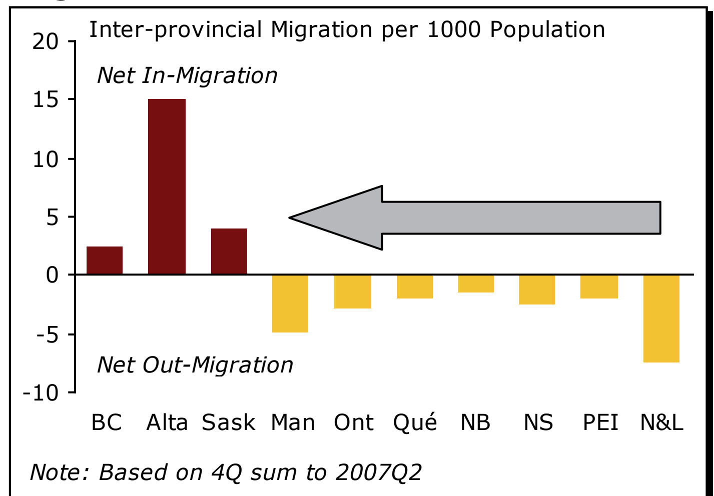


Chart 5
Migration Flows East to West



Mining exploration and development remains vibrant in Saskatchewan, covering oil, potash, uranium and other minerals. As in other parts of the West, private sector paid employment is growing rapidly, and adding workers in energy extraction or mining—where weekly earnings run anywhere from 50% to 125% above the industrial aggregate—is a boon for employment quality (Chart 3). Reflecting stellar wage growth and a hearty business backdrop, bankruptcies are in decline in Alberta and Saskatchewan, contrasting with Central Canada (Chart 4).

Despite below-average employment quality in British Columbia, no province has enjoyed a steeper decline in joblessness in the past five years. Mining is on fire, helping to overcome weakness in an outsized forestry sector crimped by a US homebuilding recession and faltering lumber prices. Taxes are being cut and infrastructure works abound, with expanded transportation networks allowing BC to profit from its position as the gateway to fast-growing Asia.

Canadians Vote with Their Feet

Canadians are moving to arbitrage regional labour market opportunities. Inter-provincial migration maintains a decidedly East-to-West flavour (Chart 5). While off its peak, net inter-provincial migration to Alberta remains brisk, although insufficient to alleviate worker shortages. An expanding population is straining infrastructure, and projects are moving forward, while commercial building is also catching up to torrid provincial growth.

Chart 4
Bankruptcies Growing in the Centre

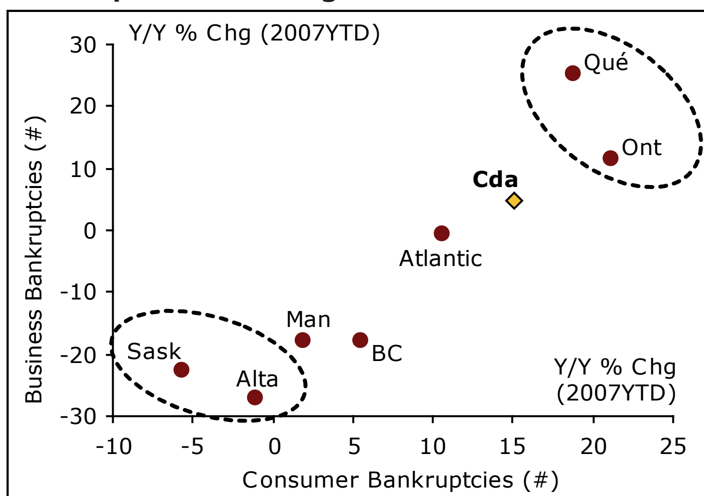
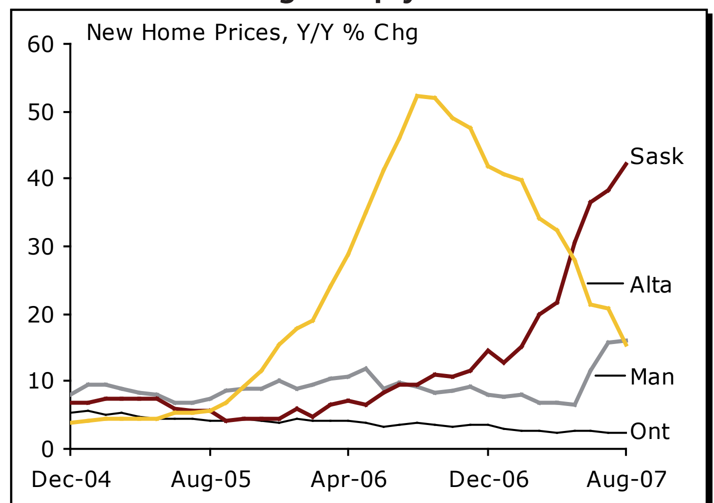


Chart 6
House Prices Rising Sharply in West



BC remains a draw, but again, it's in Saskatchewan where the situation has evolved most favourably. Drawn by high paying jobs and relative housing affordability, an influx of migrants from other provinces has seen Saskatchewan population growth top Ontario for the first time in a generation. In Newfoundland & Labrador, net out-migration has contributed to a near-13% population decline in less than a decade and a half, although a new incentive aims to reverse the tide.

Note that in Manitoba, where economic growth has proven solid and stable, a hearty inflow of *international* migrants is offsetting outflows to other provinces. Economic diversity has allowed Manitoba to weather currency appreciation and weakness in key trading partners. Major capital projects are underway or planned, mining activity has ramped up, and Prairie farmers generally are benefiting from a surge in world crop prices linked to soaring ethanol production (see pages 4-7).

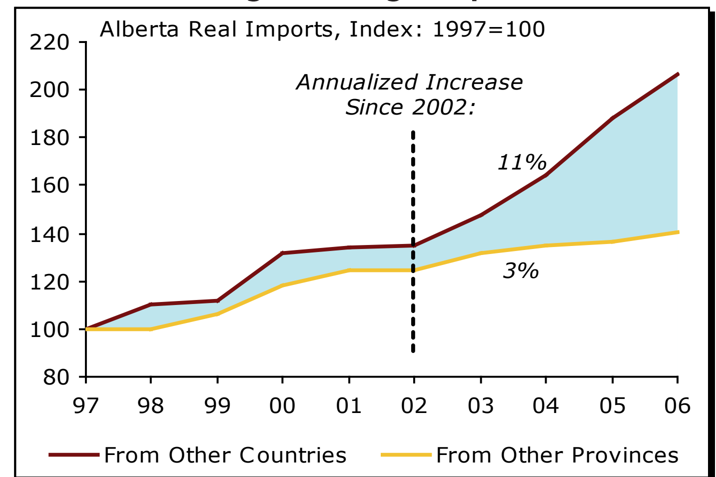
Migration patterns are leaving a notable impression on the housing market. Home prices have more recently ignited in Saskatchewan, and to a lesser extent, in Manitoba (Chart 6). Following Alberta's lead, explosive price gains are eliciting a supply response, with Saskatchewan and Manitoba seeing hefty increases in housing starts. Alongside strong wage growth, housing prices remain a key source of inflation west of Ontario (Chart 7).

Alberta Demand No Substitute for US

Western Canada's expansion creates opportunities for other provinces, and with US growth anemic, there's no better time to promote internal trade. However, foreign exporters are benefiting more than other Canadian provinces from Alberta's supercharged economy. Alberta's real imports from other countries have soared at a double-digit annualized clip since 2002, while imports from other provinces have seen only muted growth (Chart 8).

Chart 8

Alberta Drawing in Foreign Imports



As impressive as Alberta's performance has been, it is equivalent to but 2% of US GDP, making external demand developments vital for many. That's particularly true in Central Canada, where large and externally focused factory sectors mean growth rates are closely linked with US trends (Chart 9). Exacerbating the challenge posed by a stateside slowdown, the Canadian dollar has savaged relative competitiveness. For a growing number of once proud factory sectors, survival is now dependent upon extraordinary cost cutting.

Chart 7

Inflation is Regionally Concentrated

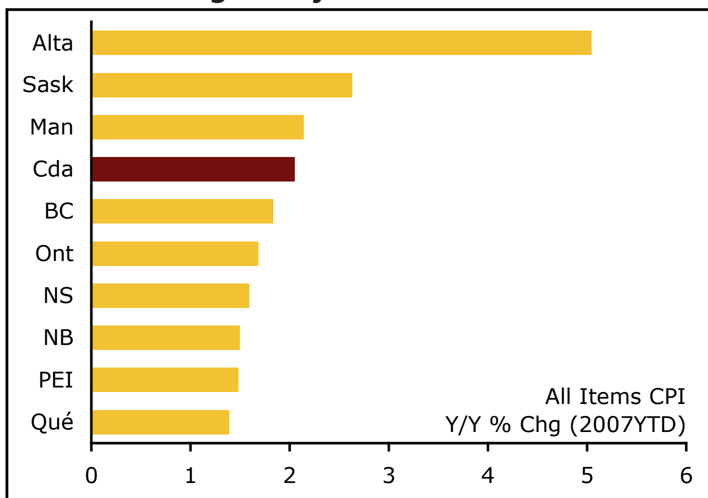


Chart 9

Factory-Oriented Central Canada Still US-LInked

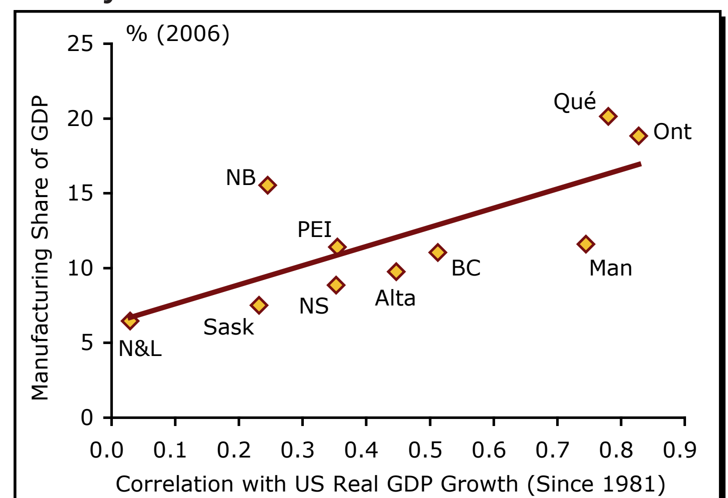
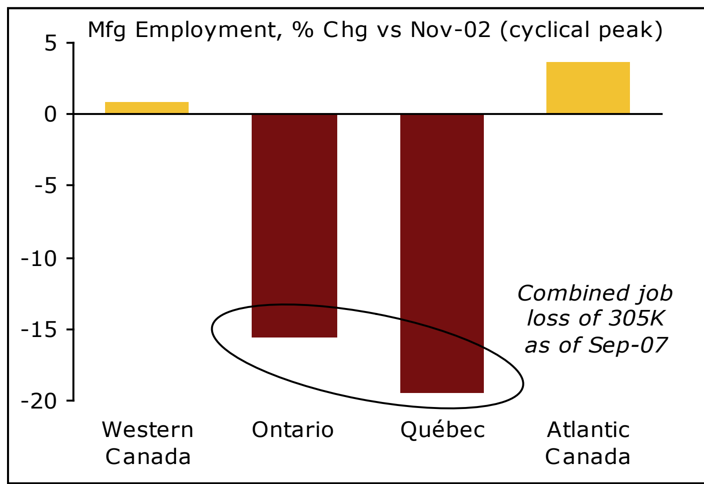


Chart 10

Factory Jobs Melting Away in Central Canada



Premium C$, $100 Oil Weigh on Central Canada

With the C$ and oil heading higher, simply extracting greater productivity from the existing manufacturing workforce won't be enough. Having already slashed more than 300,000 factory jobs in a little less than five years (Chart 10), a further 200,000 factory jobs remain at risk in Central Canada, with the industry's share of total employment heading ever lower (Chart 11).

Québec has seen pronounced weakness in forestry products, with other traditional sectors (e.g., clothing, paper/printing) facing stiff competition or softening demand. Meanwhile, Canada's high profile auto industry, overwhelming located in Ontario, remains under siege. The country's once enormous trade surplus in autos has been wiped out, and while plant retooling and the growing presence of better-selling foreign models are pluses, cutbacks at established assembly lines and parts producers are an ever-present threat.

That Ontario and Québec are seeing roughly 2% real growth at today's level for the currency is itself impressive. Notwithstanding manufacturing's formidable drag, construction and a host of service sectors, oriented to a still-sturdy domestic economy, are hiring. Although carrying a smaller economic weight, mining activity is robust. While autos and forestry have created pockets of weakness, many large urban areas boast healthy labour markets (Chart 12), with commercial building activity solid.

As housing activity moderates, consumer resilience will be tested. Fiscal policy should lend a hand, however. An earlier pay equity settlement, announced provincial tax cuts and infrastructure developments are supportive in Québec, allowing growth to edge out Ontario this year and next. Ontario, meanwhile, awaits the broad-based tax relief and support for manufacturers promised in the recent federal Throne Speech, and public sector hiring has a role to play in offsetting factory layoffs.

At any given time, there's always a host of industries or provinces in relative ascendancy whilst others decline, but the growing chasm between growth leaders and laggards is striking. Global economic dynamics mean inter-provincial growth gaps aren't going anywhere. Convergence, while tempting to forecast, remains elusive, complicating federal policy making (from both a fiscal and monetary perspective). Canada's contemporary class struggle rages on.

Chart 11

Manufacturing Footprint is Shrinking

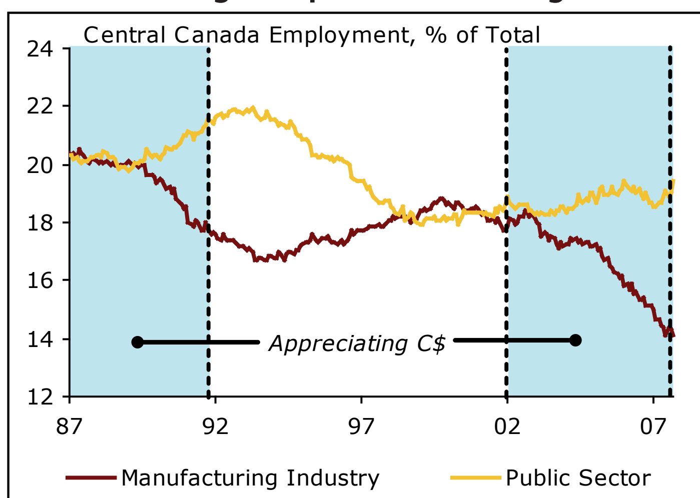
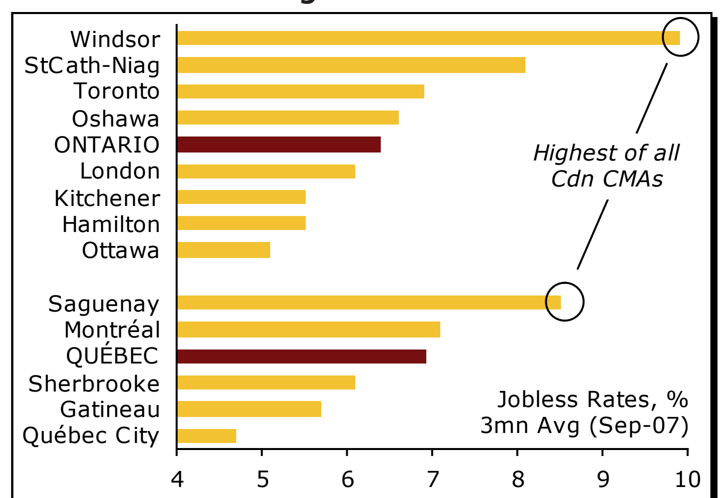


Chart 12

Jobless Rates Diverge Across Cities



ECONOMIC UPDATE

CANADA	07Q2A	07Q3A/F	07Q4F	08Q1F	08Q2F	2006A	2007F	2008F
Real GDP Growth (AR)	3.4	2.4	2.0	2.4	3.0	2.8	2.6	2.7
Real Final Domestic Demand (AR)	4.3	3.4	3.4	3.2	3.4	4.7	3.5	3.4
All Items CPI Inflation (Y/Y)	2.2	2.1	2.6	2.2	2.0	2.0	2.2	2.4
Core CPI Ex Indirect Taxes (Y/Y)	2.4	2.2	2.2	2.1	2.0	1.9	2.3	2.0
Unemployment Rate (%)	6.1	6.0	5.9	5.9	6.0	6.3	6.0	6.0
Merchandise Trade Balance (C$ Bn)	63.9	51.5	53.8	56.4	57.4	51.3	56.8	58.8
U.S.								
Real GDP Growth (AR)	3.8	2.9	0.4	1.5	2.0	2.9	1.9	1.9
Real Final Sales (AR)	3.6	2.7	0.6	1.4	2.1	2.8	2.2	1.8
All Items CPI Inflation (Y/Y)	2.7	2.4	3.4	3.1	2.1	3.2	2.7	3.0
Core CPI Inflation (Y/Y)	2.3	2.2	2.0	2.0	2.0	2.5	2.3	2.2
Unemployment Rate (%)	4.5	4.6	4.7	4.7	4.9	4.6	4.6	4.9

CANADA

Although August results to date have been a bit disappointing, the Canadian economy should see no more than a modest slowdown from the headwinds blowing from the US, as it draws on a healthy domestic economy, ongoing and potential fiscal stimulus, and globally driven strength in resource prices. Our forecast is on the high side of the Bank of Canada's outlook, consistent with our view that the Bank won't be tempted to match Fed rate cuts. Canadian inflation will run below the US, in part, due to the cushion of a stronger currency.

UNITED STATES

As we detailed in our October 15th issue of *Forecast*, we raised our Q3 growth outlook with an offsetting reduction in Q4, expecting consumer spending to decelerate in the face of tumbling house prices, rising gasoline costs, and tighter credit standards. New in this report is an upward adjustment to our late-2008 CPI outlook, rooted in the spark from rising food inflation tied in part to ethanol production (see pages 4-7).

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