



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

"We are hollowing out our industrial base by letting speculative foreign exchange market forces, in effect, dictate the mix of monetary conditions. ..."

Is No Policy the Right Policy?

by Avery Shenfeld

When it comes to foreign exchange rates, even no policy is a policy. Since 1998, Canada has let markets decide where the currency should trade, with the intervention tool left to gather dust in the central bank's basement. The Bank of Canada is quick to remind us that it doesn't target the exchange rate. Instead, it takes any net stimulus or drag associated with an under- or overvalued loonie into account in setting the path for interest rates. In the current environment, that would mean leaving interest rates at rock bottom for longer than would otherwise be the case. But is that the only, or best, option?

Economists generally argue that since the loonie tends to appreciate during resource booms and retreat in resource busts, it acts largely as a valuable cushion against recessions and inflationary periods. History largely bears out that directional linkage.

But anyone who has watched the Canadian dollar's performance in the last 15 years would have a tough time arguing that foreign exchange markets are the perfectly rational, calculating machines that the textbooks suggest. Clearly, it's not simply trade flows and commodity prices, but also wildly fluctuating expectations and the hot money flows they generate, that set the tone for currency movements. The Bank of Canada admits as much when it points out the dangers of recent C\$ appreciation.

If one thinks of GDP as simply an undifferentiated lump of output, then foreign exchange bubbles would not seem to be too consequential for Canada. In the current context, the drag on overall growth and inflation could be largely offset by the Bank of Canada's decision to keep rates on

hold for an extended period. This month's interest rate announcement sent a clear message that to the extent that the C\$ will delay re-attaining the 2% inflation target, it will help keep rates low for longer, giving an offsetting boost to output.

But in the real world, the mix of output also matters. Putting people into larger houses because mortgage rates are lower than otherwise generates economic output in the construction industry, and leaves the economy with a larger stock of housing. But if the loonie is overvalued for a few years, we may be sacrificing business plant and equipment on the altar of a strong currency. Plants that close because they are unprofitable at current exchange rates might permanently relocate elsewhere. They won't suddenly come back if the currency later cheapens. We are hollowing out our industrial base by letting speculative foreign exchange market forces, in effect, dictate the mix of monetary conditions.

What, then, is the alternative? Not a fixed exchange rate, which forever hands over our interest rate policy to the Federal Reserve, and fails to allow any adjustment to longer swings in commodity prices. Instead, Canada could consider what might be called a bounded float. By intervening only at extremes, the central bank could help chase away speculative flows that take the currency, in its considered judgment, beyond fundamentally driven levels. And to those who say intervention never works, China has steered the yuan exactly as it pleases, while Swiss intervention earlier this year stopped the franc's appreciation against the euro dead in its tracks. In short, intervention is a powerful tool for those who opt to use it.

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

MARKET CALL

- As we expected, the Bank of Canada threw down the gauntlet to those doubting its pledge to keep rates on hold through mid-2010, bringing short rates down to earth and weakening the loonie. Still, distaste for the US dollar is likely to limit the scope for a weaker C\$, and we have moved to a stronger average 2010 range for the loonie than our prior forecast. That will leave the Canadian currency persistently overvalued relative to trade fundamentals, until commodity prices begin to close that gap in 2011 and beyond.
- Carney's statements underscore that a strong Canadian dollar can delay the timing of a first rate hike. Less widely discussed is that the coming tightening in fiscal policy, and its drag on growth, also has the same implications (see pages 4-6). We're in a small minority in expecting the Bank to wait until 2011 before pulling the trigger, although the initial run-up in overnight rates in that year could still be a steep one, given the record-low starting point.
- The bond market can hold its ground for now as long as central banks' preach patience on the timing of tightening, and will benefit from slower growth early in 2010. But higher rates are in store for later next year, as investors look ahead to the impacts of rising debt loads (see pages 10-11) and central bank tightening in 2011.

INTEREST & FOREIGN EXCHANGE RATES

END OF PERIOD:	2009		2010				2011	
	26-Oct	Dec	Mar	Jun	Sep	Dec	Mar	Jun
CDA Overnight target rate	0.25	0.25	0.25	0.25	0.25	0.25	1.00	1.75
98-Day Treasury Bills	0.22	0.23	0.25	0.30	0.30	0.30	1.15	1.90
2-Year Gov't Bond	1.54	1.35	1.20	1.30	1.40	1.60	2.10	2.35
10-Year Gov't Bond	3.55	3.45	3.35	3.70	3.85	3.95	4.00	4.05
30-Year Gov't Bond	4.02	3.95	3.90	4.25	4.30	4.35	4.35	4.40
U.S. Federal Funds Rate	0.25	0.25	0.25	0.25	0.25	0.25	1.50	2.25
91-Day Treasury Bills	0.06	0.10	0.15	0.20	0.25	1.00	2.00	2.30
2-Year Gov't Note	1.03	0.95	0.90	1.20	1.45	1.65	2.20	2.45
10-Year Gov't Note	3.56	3.55	3.45	3.75	4.20	4.35	4.45	4.45
30-Year Gov't Bond	4.37	4.30	4.20	4.60	5.00	5.00	5.05	5.05
Canada - US T-Bill Spread	0.16	0.13	0.10	0.10	0.05	-0.70	-0.85	-0.40
Canada - US 10-Year Bond Spread	-0.02	-0.10	-0.10	-0.05	-0.35	-0.40	-0.45	-0.40
Canada Yield Curve (30-Year — 2-Year)	2.48	2.60	2.70	2.95	2.90	2.75	2.25	2.05
US Yield Curve (30-Year — 2-Year)	3.34	3.35	3.30	3.40	3.55	3.35	2.85	2.60
EXCHANGE RATES								
CADUSD	0.936	0.971	0.901	0.943	0.971	1.000	0.976	1.000
USDCAD	1.068	1.030	1.110	1.060	1.030	1.000	1.025	1.000
USDJPY	92	93	97	95	90	87	86	86
EURUSD	1.49	1.49	1.40	1.41	1.44	1.47	1.46	1.50
GBPUSD	1.63	1.66	1.64	1.66	1.70	1.75	1.74	1.78
AUDUSD	0.915	0.940	0.870	0.825	0.855	0.895	0.920	0.940
USDCHF	1.02	1.01	1.07	1.06	1.04	1.02	1.08	1.07
USDBRL	1.73	1.68	1.81	1.82	1.76	1.70	1.69	1.65
USDMXN	13.3	13.6	14.0	13.5	13.0	12.5	12.3	12.3

COMMODITIES OUTLOOK

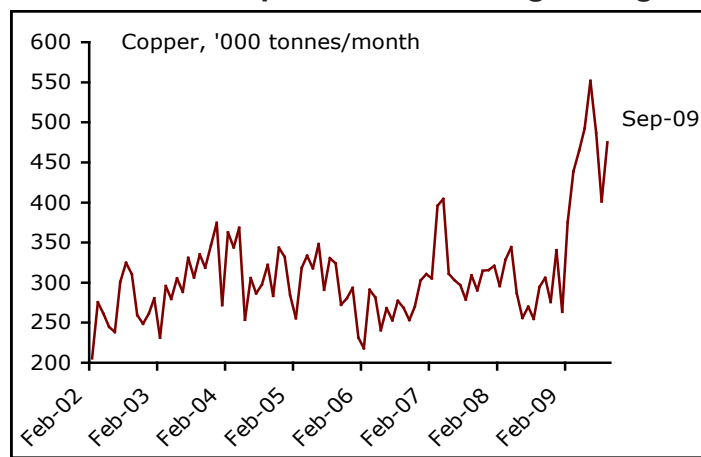
Oil prices have drawn support from the spirited rally in global equity markets and US dollar's rout, which trims prices for non-US\$-denominated consumers. Although we've modestly raised our targets in reaction to recent developments, crude's rise has outrun fundamentals, and we continue to see an appreciable correction risk in the next 6-12 months. Inventories remain high in the US, and at 60.7 days of forward cover, are about 6% above year-ago levels for the industrial countries as a whole. A sub-par recovery in the industrial countries will restrain demand going forward. Demand in US, which is still the world's largest market, remains weak, apart from gasoline. OPEC has also been hinting a supply increase, threatening to spill some of its 6.4 mn barrel per day overhang into the market.

CO₂ abatement efforts could create longer-term opportunities for natural gas-fired power. The economics of shale gas, the dominant source of new North American supply, also don't work at prices as low as those seen recently. While that creates longer-term upside, record inventory levels and a double-digit year-on-year decline in US industrial demand limit the potential, for now, for the market to build significantly on its recent gains. We expect Henry Hub prices to average \$5 next year and \$6.50 in 2011.

Gold has had a good run recently. While we are staying with our bullish longer-term forecast, several factors create some downside risk in the near-term. Speculative long positions are now even higher than they were before early 2008's appreciable sell-off. With the major industrial economies now operating a good 4% or so below capacity, concerns about a material acceleration in inflation are premature. The US dollar's descent is likely to slow and could even reverse itself in the near-term as strains mount on still quite fragile, trade-dependent economies overseas.

The global recovery will not be particularly forceful, but we believe that the composition should be quite favourable for most key industrial metals. Although softness in US non-residential construction will weigh for now, other key North American consuming sectors like autos and homebuilding are stabilizing or on the mend. China's imports of key metals like copper (Chart) have also held up well despite reported cuts in strategic stockpiling. That suggests observers may have underestimated the resilience of underlying demand. The full effect of ambitious infrastructure spending plans there will be felt in the quarters to come. Copper should benefit from grid expansion plans, recent mine interruptions and capacity delays due the financial crisis, making the metal a preferred area for exposure.

China's Metal Imports Still Showing Strength



Spot Commodity Prices

		Average					
		23-Oct	2007	2008	2009 (f)	2010 (f)	2011 (f)
Oil (WTI)	\$/bbl	80	72	100	62	70	80
RBOB gasoline	\$/gal	2.05	2.09	2.49	1.70	1.80	2.00
Heating Oil (NYH)	\$/gal	2.06	2.03	2.86	1.60	1.95	2.10
Natural Gas (Henry)	\$/Mn Btu	4.73	6.97	8.89	4.00	5.00	6.50
Gold	\$/troy oz	1062	695	872	950*	900*	1100*
Copper	\$/lb	3.01	3.24	3.16	2.40	3.25	3.50
Aluminum	\$/lb	0.88	1.20	1.17	0.75	0.85	0.90
Nickel	\$/lb	8.58	16.86	9.57	6.75	8.00	8.50
Zinc	\$/lb	1.02	1.48	0.85	0.75	0.90	0.90

* end of period

The "Other" Exit Strategy

Avery Shenfeld, Warren Lovely and Meny Grauman

These days, when talk turns to an "exit strategy," it's all about monetary policy. The US Fed has gone to extremes in cutting interest rates to the bone and in pumping reserves into the banking system. The Bank of Canada's near-zero overnight rate is also unprecedented, as are the extraordinary liquidity measures still in place. Both central banks will, no doubt, have to move rates significantly higher as normalcy returns.

But there's another exit strategy, one that is more pressing. It's far more important to wean North America off of unsustainable deficit-financed spending than it is to get rid of low interest rates. Large deficits are, all else equal, undesirable, while low interest rates are not. As Canadian federal and provincial governments steer from fiscal largesse to budget belt-tightening, that will act as a major reason to postpone the central bank's own tightening agenda, beyond what is now recognized by markets.

A Little History Lesson

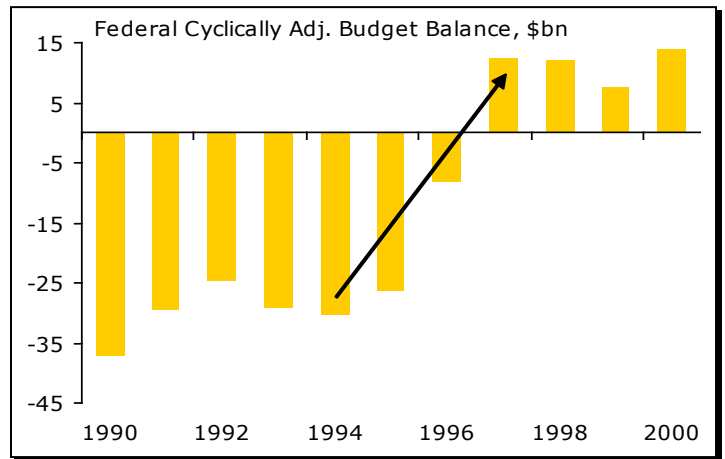
Americans will be learning for the first time since World War II about how to deal with a debt burden equivalent to a year's GDP. While President Clinton tackled deficits, the peak deficit he inherited was only 4.7% of GDP, less than half of the red ink currently spilling out of Washington.

But in the task of stripping a debt mountain down to size, Canadians have been there, done that. And how monetary policy interacted with fiscal measures in that period is quite instructive for what lies ahead.

At its peak, Canada's federal-provincial deficit topped 9% in the aftermath of the early 1990s recession. The subsequent global recovery certainly helped melt Canadian deficits away after 1994. But fiscal belt-tightening was also required, including a major reduction in federal expenditures as a share of GDP, and revenue measures at both the federal and provincial levels of government. Stripping out the benefits of an improved economy, Ottawa's cyclically adjusted budget deficit registered a \$43 bn improvement from 1994 to 1997 (Chart 1). As a share of GDP, that would be equivalent to a \$100 bn fiscal tightening today.

Chart 1

Canada's Fiscal Tightening After 1994...

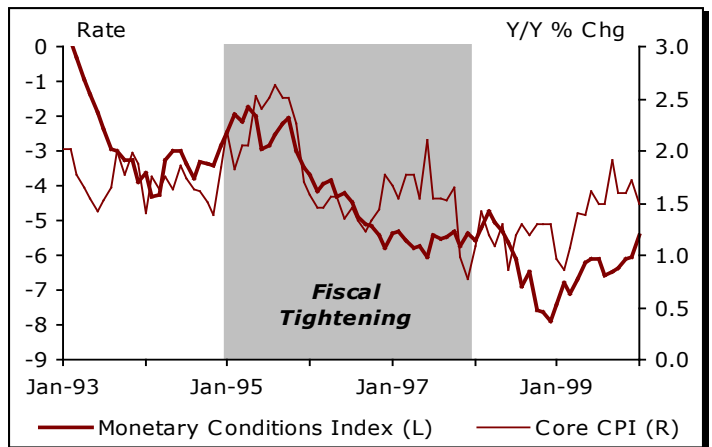


Source: Statistics Canada

What happened to monetary policy in that same expansion? Not only did it not tighten, it eased massively (Chart 2). The Bank of Canada's overnight rate, having spiked above 8% in early 1995, was slashed to 3% by November 1996 and was held at that level through May 1997. That also took Canadian yields below those stateside for the first time in decades, sending the loonie into a tailspin. Capturing the combined impact of lower rates and a weaker currency, the BoC's monetary conditions index eased by the equivalent of 600 bps in little more than three years.

Chart 2

.... Required Huge Easing in Monetary Conditions



Source: Statistics Canada

The logic was clear. With fiscal tightening representing a massive drag, it took an extremely easy monetary policy, in that case a combination of rate cuts and currency devaluation, to keep the Canadian economy afloat. And even with the plunging loonie, slack in the economy meant that inflation stayed well in check in that period, with core CPI averaging a controlled 1.6% during the latter half of the 1990s.

US Belt-Tightening Ahead

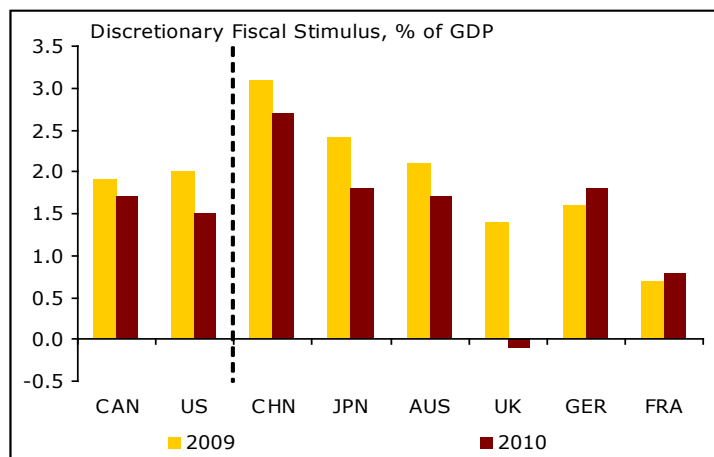
With the world economy teetering on the edge of depression last year, governments across the globe turned on the spending taps to lean against the business cycle (Chart 3). Both the US and Canada passed significant stimulus bills, and although the money has only recently begun to flow, the end of the recession signals that the time for fiscal restraint is fast approaching.

Congress has already enacted a 2010 budget resolution that swings from a huge increase in the 2009 budget deficit to a modest reduction for the 2010 fiscal year which just got underway this month. Last year's \$1.58 tn shortfall represented 11.2% of GDP, unprecedented in the post-War era. The deficit is scheduled to ease to just over \$1.5 tn in fiscal 2010, still some 10½% of GDP. While on the surface that would suggest that the economic pinch will be felt in coming quarters, a more significant downswing in government funding will hit the economy in 2011, with Washington's deficit declining by a full 3%-pts of GDP. It's been 40 years since the US government underwent a fiscal contraction of that magnitude.

Canada's Budget Hole Not as Large ...

In Canada the budgetary outlook is similar, if not quite

Chart 3
Massive Fiscal Stimulus Worldwide in 2009/10



Source: IMF

as severe. Stimulus measures and a contracting economy pushed the federal budget balance deeply in the red—currently projected at \$56 bn. Provinces, succumbing to the same economic flu and delivering their own substantial stimulus packages, have seen their aggregate budgets swing from a roughly balanced position to a \$40 bn deficit in just 12 months time.

Together, federal and provincial budget deficits have soared to within a hair's breadth of \$100 bn—a staggering tally when contrasted to the prior decade of surpluses. While, at 6.4% of GDP, the combined deficit is well shy of the US deficit/GDP ratio or the level Canada racked up in the early 1990s, the year-over-year change in the deficit is off the charts (Chart 4).

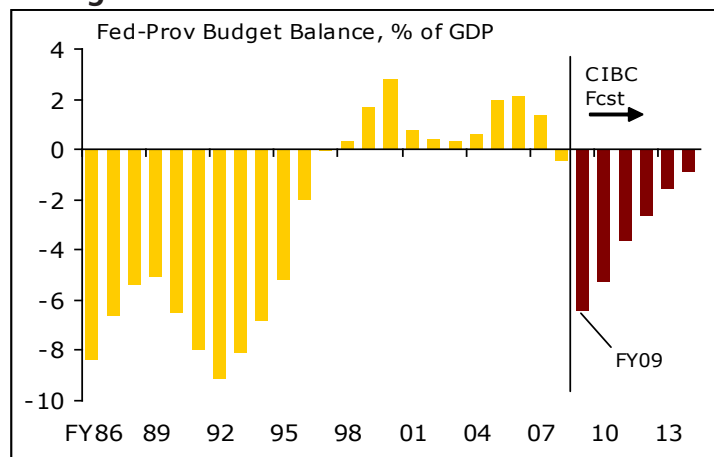
... But Fiscal Tightening Nonetheless Looms

There will be some progress on federal and provincial deficits in fiscal 2010, with the year-over-year change in the aggregate budget balance tightening by an estimated \$15 bn. But a real improvement in budget balances will have to wait for 2011 or later.

Simply looking at the aggregate budget balance obscures the true impact that looming fiscal restraint will have on monetary policy. After all, to the extent that deficit declines are driven by an improvement in the overall economy, they are not a drag on growth. Therefore it's not the overall budget deficit that's most important, but the change in government revenue and spending not tied to the economic cycle.

At the federal level, stimulus spending is pegged at roughly \$50 bn. That has been weighted towards the

Chart 4
Restraint to Follow Record One-Year Fiscal Swing



2009 fiscal year, with the bulk of the stimulus, including infrastructure spending and selective tax cuts, is discretionary, and will be phasing down in future years. In fact, nearly 60% of the federal government stimulus spending is in one-time items that aren't directly tied to the economic cycle, and will therefore dampen growth as the dollars run dry (Chart 5). Overall, that spending is equivalent to 1% of GDP in 2009, easing only slightly in 2010, but then evaporating in fiscal 2011.

Indeed, translating fiscal-year figures into regular calendar years only serves to emphasize how big 2010 will be for spending, and how large the drop-off will be in 2011. According to this alternate breakdown, federal non-cyclical stimulus spending in Canada will peak at 2.5% of GDP in 2010, before falling to only 0.2% during the 2011 calendar year (Chart 6). Meanwhile, in the US fiscal stimulus will have a longer tail, but should follow a similar trajectory, peaking at 2.3% of GDP next year, before heading down to 0.7% in 2011 and then closer to 0.4% in subsequent years.

Ottawa's infrastructure program requires projects to be completed by March 2011. The inevitable delays in getting stimulus out the door means that a material share of the money booked into fiscal 2009/10 will end up being condensed into the 2010 construction season. Come 2011, Canada's army of construction workers will need the private sector to pick up the slack. Provincial and municipal governments, required to match Ottawa's timetable in cost-shared projects, will see the stimulus programs expire at roughly the same time.

But provinces will need to do more than simply turn off the stimulus tap. More than Ottawa, some provinces face a structural imbalance, necessitating a serious belt-

Chart 5
Two-Year Federal Stimulus Plan

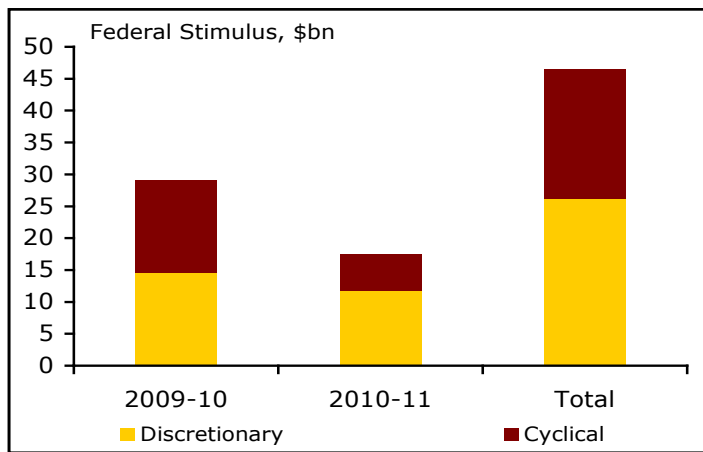
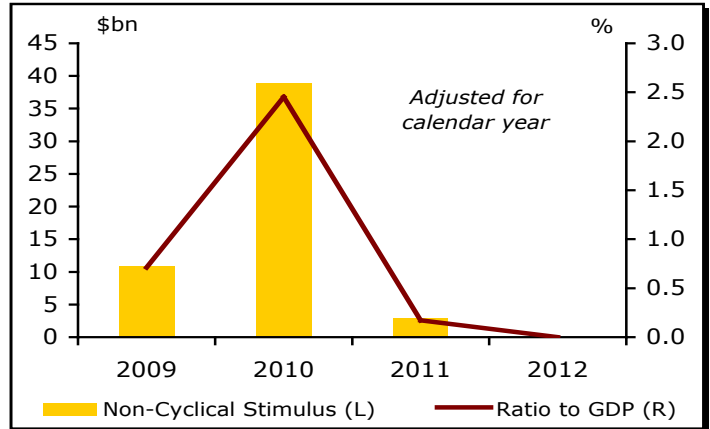


Chart 6
Federal Discretionary Stimulus Dives in 2011



tightening to put finances on a more sustainable footing. In Ontario, for example, the 2009/10 deficit exceeds that witnessed in the early 1990s. A critical review of government services and agencies is set to begin, but we expect that any serious retrenchment won't commence until 2011/12. Other provinces will also be enacting program restraint or tax increases to cut their deficits.

Canadian municipalities are precluded from running operating deficits and will therefore be the first to tighten. But since municipalities have been equal partners in a federal-provincial-municipal infrastructure blitz, local infrastructure spending will remain elevated next year. Come 2011, when capital programs wind down, local governments will be contributing their own fiscal drag.

Carney Will Be Listening

The combined effect of fiscal tightening at all levels of government will blunt what is today the primary driver of growth. Easing public sector employment and a smaller contribution to growth from direct spending will require the private sector to step up in a major way, offsetting what could be more than a 2%-of-GDP retrenchment by governments in 2011.

Both Governor Carney and Fed Chair Bernanke will have to see more than mere talk about fiscal restraint to alter their interest rate plans. But the more credible are plans for belt-tightening, the gentler the path will have to be towards higher interest rates if private sector demand is to counter a downscaling by governments. With interest rates already so low, it would be hard to engineer a repeat of the monetary easing that accompanied budget cutting in the 1990s. But fiscal tightening will be one more reason, on top of a strong loonie, for Carney to wait until 2011 before launching the rate hike cycle.

US Business Investment Will Disappoint

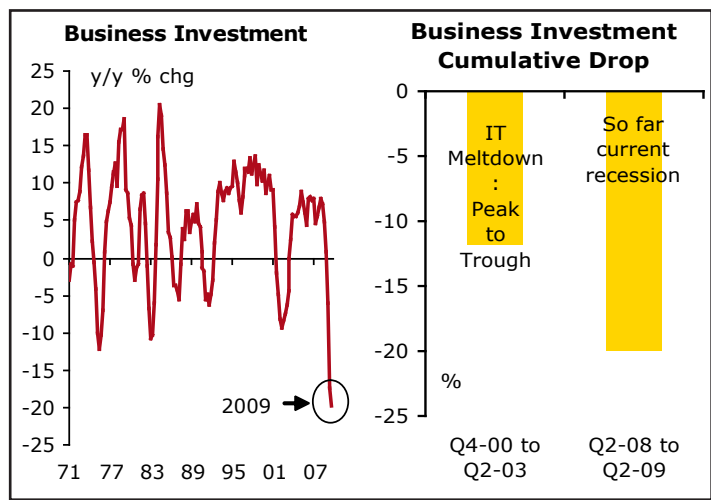
Benjamin Tal

An integral element in formatting the market's current view that the Fed will start hiking rates in the second half of 2010 is that by that time, business capital spending in the US will be rising by no less than 5% on an annual basis. Given that business spending has been a huge contributor to the US GDP recession, the timing of its rebound will be critical to the timing of a turn to monetary tightening. But a closer look suggests that consensus expectations are way too optimistic. A subdued commercial real estate market, reduced motivation to invest due to low utilization rates and historically low returns on capital investment, along with a secular decline in non-IT investment suggest that growth in US capital spending will still be in negative territory well into the second half of 2010.

Current Slump Worst Than IT Meltdown

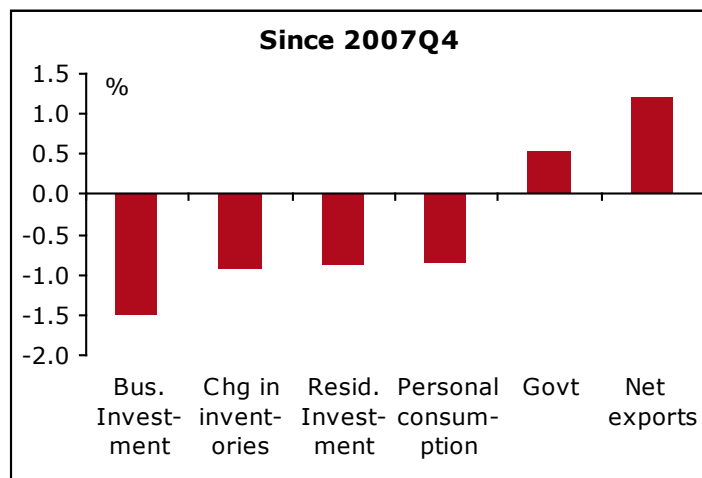
The conventional wisdom is that the past year's US recession was consumer-led, as opposed to the investment-led recession of 2001. But the reality is that the current slump in capital spending is, in fact, steeper than the IT meltdown. Back then, the burst of the bubble meant a 12% drop in real capital spending over a two-year period. Currently, as of the second quarter of 2009, and only a year removed from its peak, capital spending is already down by no less than 20%, qualifying it as the steepest slump in business spending in the post-war

Chart 1
Mega Bust in US Business Spending



Source: BEA, CIBC

Chart 2
Contribution to % Change in US Real GDP

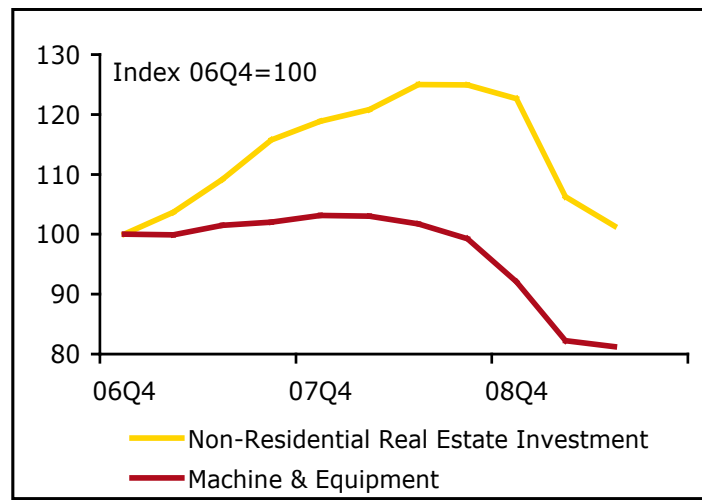


Source: BEA, CIBC

era (Chart 1). Even as a share of GDP, capital spending is already down to the level seen at the trough of the IT meltdown and it has been by far, the largest contributor to the overall decline in GDP since the beginning of the recession (Chart 2).

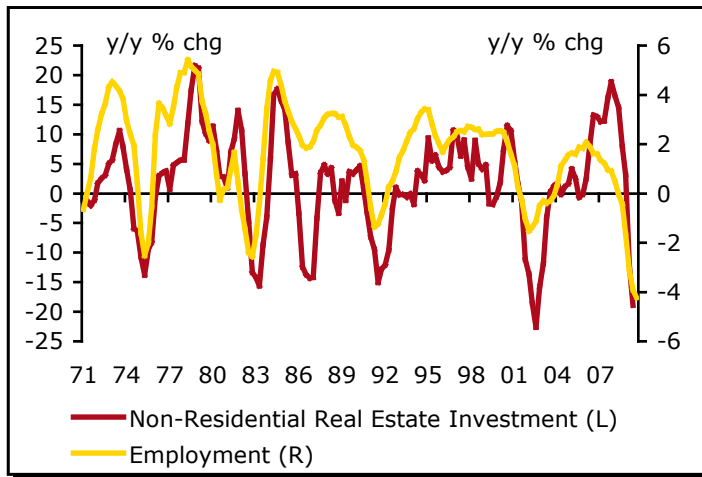
Another misconception is that the current decline in business spending is largely due to the weak state of the American commercial real estate market. But the reality

Chart 3
US M&E Investment Fell Faster Than Non-Residential Real Estate



Source: BEA, CIBC

Chart 4
**Non-Residential Real Estate Investment
 Highly Correlated with Employment**



Source: BEA, CIBC

is that, so far, the largest slump in spending was in the machinery and equipment category, which is now down by 21% since the beginning of the recession, compared to a 15% decline in the non-residential real estate component (Chart 3). Note that the descent in non-residential investment began 6-8 months after spending on machinery and equipment started its nosedive. This suggests that the adjustment in non-residential real estate investment is still in its early stages. Add to it the high correlation of this business investment category with employment growth (Chart 4) and the fact that

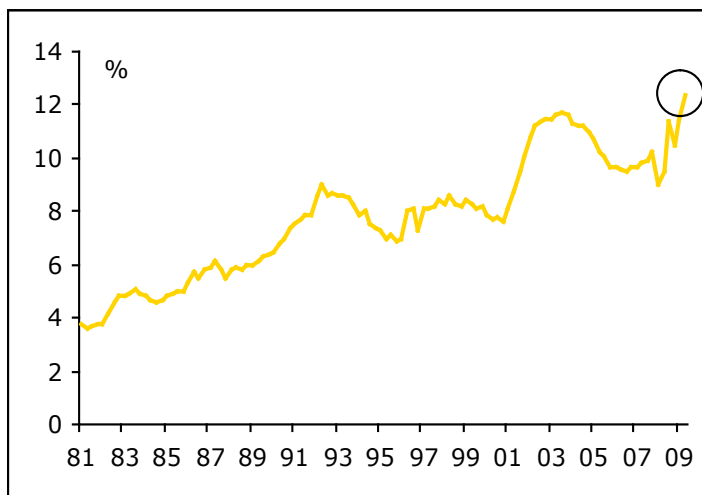
the industrial vacancy rate is now at a dazzling 12%—a record high and a full five percentage points above levels that in the past signalled a recovery (Chart 5), and it becomes painfully clear that any hopes of a turnaround in non-residential real estate investment by mid-2010 are nothing more than wishful thinking.

Low ROI and Spare Capacity Weight on Investment

If non-residential real estate investment cannot carry the freight, what about capital spending on machinery and equipment, which accounts for roughly 70% of total business spending? Ultimately, spending on machinery and equipment cannot recover and grow on a sustained basis without evidence of higher return on new investment. Some argue that the recent increase in productivity suggests higher returns from new capital. But this logic is flawed; the improvement in productivity reflects the ability of firms to squeeze more effort out of fewer workers. Economists call it increased productivity, workers call it shorter breaks. This temporary gain in the level of productivity is clearly not an indication of a sustained rise in the underlining trend.

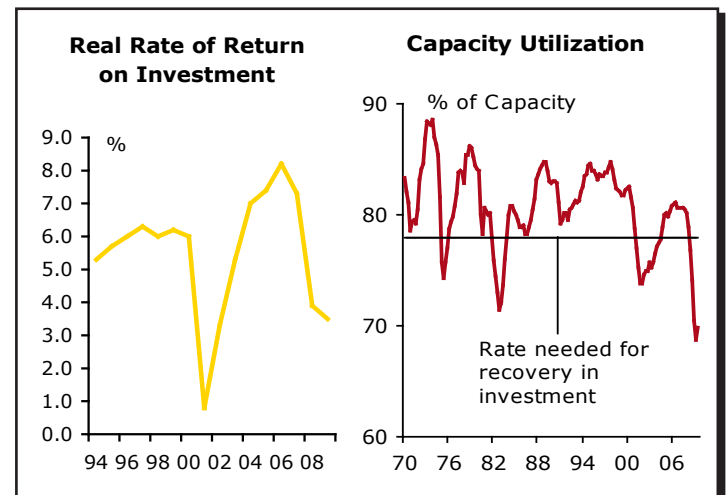
More direct measures of the motivation to invest suggest that the current environment is still inconsistent with a return to positive investment. The rate of return on investment, currently at an inflation-adjusted 3.5%, is still more than two full percentage points below its long-term average (Chart 6, left). An alternative measure—the capacity utilization rate, is currently at a record low of roughly 70%. During every expansion of the past 40

Chart 5
Record High Industrial Vacancy Rate



Source: CB Richard Ellis

Chart 6
Low Motivation To Expand



Source: FRB, CIBC

years, a return to sustained real investment spending growth did not occur until the capacity utilization rate reached at least 78% (Chart 6, right).

And for those firms that still want to invest, financing, while improving, can still be a challenge for firms too small to tap the public markets. The market for lease financing in the US has materially dried up. Financing a necessary rebuilding of inventories will also drain cash and use up credit limits, depleting the capacity for financing business capital spending. Bank credit to US businesses is now falling by no less than 10% on a year-over-year basis, and while equity markets are improving, and corporate issuance of securities is down materially from its peak (Chart 7).

Replacement, Not Expansion

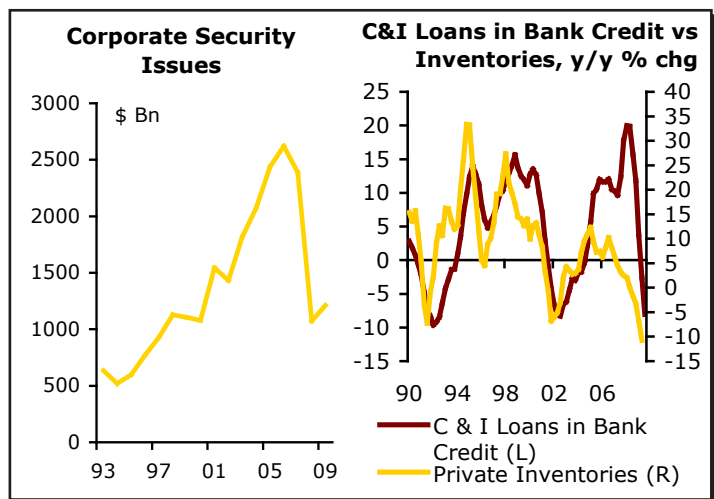
Granted, there are clear signs of improved activity in IT investment, with overall spending starting to rise in the second quarter. This trend will continue in the immediate future, helped by some temporary provisions aimed at inducing businesses to front-load new investment. But this early investment is not for expansion. It's for essential equipment replacement. A quick glance at Chart 8 reveals that we saw a similar temporary bounceback in

replacement IT investment in 2003. Back then the head fake lasted two quarters. The current situation is very similar. Look for IT investment to turn south after the pent-up demand for replacement investment is tapped.

Excluding IT investment, there actually never was any capital spending boom in the past twenty years. The non-IT capital stock has been declining both as a share of total capital stock and as a share of GDP in the past two decades, reflecting the exodus of manufacturing activity in the US to lower-cost offshore producers. As this ratio shrinks, so does the ability of non-IT investment to drive an economy-wide rebound. While a weaker dollar will, with a long lag, help America stem the bleeding of manufacturing to offshore locations, current consensus expectations for an 8% annualized pace for business spending in the second half of 2010 look to be a tall order.

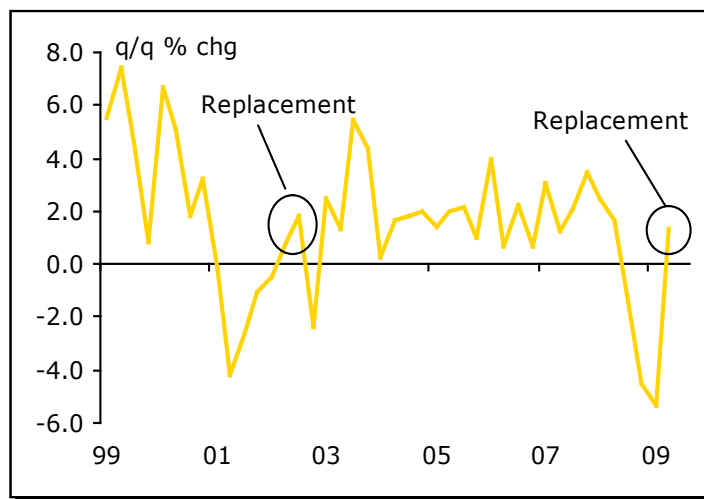
The continuing decline in business investment next year will leave the market's overall US economic growth expectations light on fuel. While talk in some quarters of a double-dip recession looks to be too gloomy given the huge stimulus still flowing next year, the long wait for a capital spending turn will keep overnight rates at highly stimulative levels for longer than the market now thinks.

Chart 7
US Financing Is Difficult



Source: BEA, CIBC

Chart 8
IT Investment



Source: BEA, CIBC

Fiscal Policy and Bond Yields: The International Evidence

Peter Buchanan

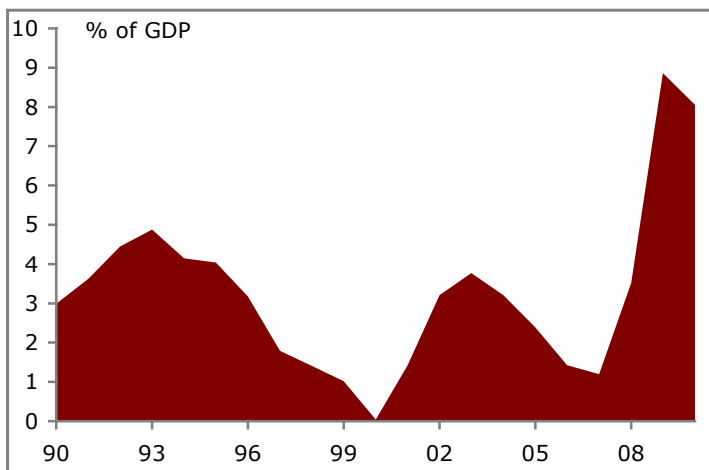
Pump-priming to revive an ailing global economy has rekindled interest in the degree to which—and even whether—government deficits and debt levels impact bond yields. With the fiscal throttle in many countries wide open and revenues under heavy pressure, public sector deficits in the advanced economies are expected to treble to 9% of GDP this year, falling only gradually thereafter (Chart 1). The US will see greater fiscal deterioration than most nations. But balances north of the border are also under pressure, as indicated by recent announcements at the federal level and in some key provinces (see p. 4-6). To the degree that they do respond, a key question is whether rates react more to deficits, or debt levels. The latter case would suggest a greater sensitivity to longer-term rather than short-term prospects and policy changes.

Fiscal Policy Changes Can Affect Rates Through Several Channels

In principal, varying fiscal performance can affect yields for sovereign and private sector credits through several channels. One is the perception—whether warranted or not—that a higher deficit entails heightened default risks. Another, though arguably less of a concern with economies today operating well short of full capacity, is the potential for any induced GDP boost to stoke inflation. The third, and potentially more significant as numerous countries hit the fiscal accelerator, is supply pressures and roll-over risks.

Chart 1

Average Government Deficit — Advanced Industrial Countries



Governments are not the only participant in credit markets. To accurately gauge the effects of their borrowing, account must also be taken of the potential response of other players. In an extreme but perhaps not so realistic case, known as Ricardian equivalence, households simply save more to fully offset their future tax liabilities, and the rise in private savings effectively just offsets public dis-savings.

The effect on borrowing costs is also likely to be limited if capital flows are highly mobile, and foreign lenders rush in to fill any financing gap. Global capital markets have become more integrated over time. Half of US Treasury securities have been held offshore in recent years, ten times the share back in 1970. The decline in the dispersion in real interest rates across countries (Chart 2) has been taken by some to mean that rates are less sensitive today to country-specific factors, like debt levels, as a result of this development. Empirical research suggests that oil shocks and central bank bond purchases can also impact real long-term public debt yields. Of note given recent developments, Engen and Hubbard¹ concluded that a rise in Federal Reserve Treasury purchases equal to 1% of GDP reduced average 10-year Treasury yields by 100 bps in any year.

¹E.M. Engen and R.G. Hubbard, "Federal Government Debt and Interest Rates", NBER Working Paper No. W10681, August 2004.

Chart 2

Reduced Dispersion in Real 10-Year Yields

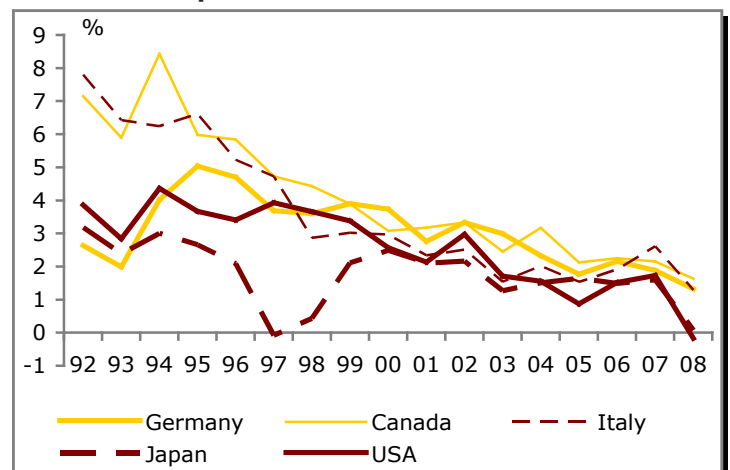
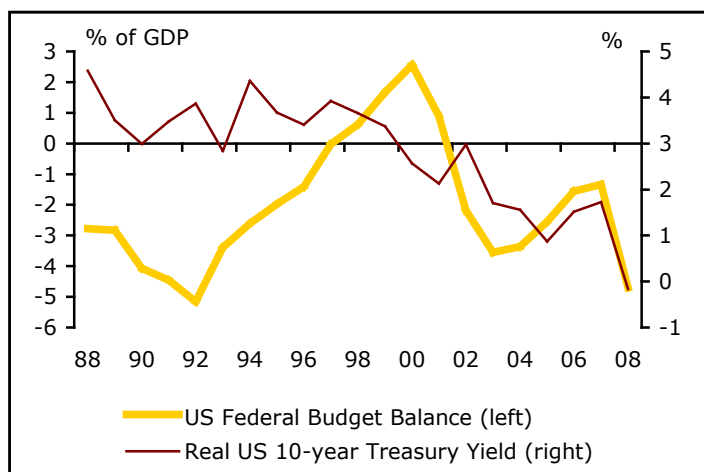


Chart 3

US Bond Yields Only Modestly Correlated with Deficit



Given the variety of factors affecting bond yields, some studies have, not surprisingly, concluded that though fiscal variables do in fact matter to some degree, the proportion of the historic variation accounted for by changes in fiscal performance by itself is modest. Engen and Hubbard were able to explain only a little over 30% of the year-on-year variation in US 10-year Treasury yields between 1976 and 2003, looking at debt and deficit levels and several other factors. A glance at the historical patterns in the US also suggests a loose, rather than tight, relationship between the federal deficit and real long-term interest rates (Chart 3).

Less Crowding-Out Risk Due to Weak Economy

A key concern historically has been potential for budget deficits to “crowd out” private sector investment, by increasing borrowing costs for groups like businesses and homebuyers. The jump in investment spending in late 1990s, after the Clinton administration cut the US

deficit, is seen by some as an argument for running a tight fiscal ship. Others argue, however, that crowding-out risks are low or non-existent today, with the economy operating far below potential. If anything, the argument goes, stimulus measures may increase private investment in today’s climate, by inspiring confidence about the economy’s future performance.

Debt Levels, Not Just Deficits, Are Important

To evaluate the effect of fiscal policy on borrowing costs, we regressed the level of real long-term government bond yields in individual G-7 countries on overall public sector deficits and net debt levels as a share of GDP, changes in real GDP growth, and real oil prices. The time period studied extended from 1961 through 2008. Inflation rates and bond yields tracked each other to a considerable extent over this period. As with most other studies, real rather than nominal rates were analyzed, to provide a better measure of the true costs of policy changes.

Our results (Table 1) suggest that while deficits have an influence, the most statistically significant relationship historically has been between long-term yields and debt levels. In the larger industrial countries, a 20%-point rise in debt-GDP levels has historically been associated with a rise of about 100 bps in real longer-term interest rates. While investors may look at short-term fiscal performance parameters, this suggests they have historically also given a good deal of weight to long-term changes in performance.

The second most significant relationship has been between real rates and GDP growth, in line with conventional wisdom that government bonds are a counter-cyclical investment. In today’s circumstances, that suggests that an only tepid initial economic recovery will help cushion borrowing costs from some of the impacts of weaker fiscal performance.

Table 1

Results for Regression of Long Term Real Bond Yields, 1961-2008							
	Net Debt/ GDP	Deficit /GDP	Real GDP Growth Rate	Real Oil Price (2008=100)	Constant	R2	Observations
Coefficient	0.045*	0.206*	0.383*	-0.020*	0.127	0.27	329
Standard Error	0.007	0.057	0.071	0.007	0.565		

* statistically significant at 1% level.

Note: varying country intercepts, rho=.662

ECONOMIC UPDATE

CANADA	09Q2A	09Q3F	09Q4F	10Q1F	10Q2F	10Q3F	10Q4F	2008A	2009F	2010F	2011F
Real GDP Growth (AR)	-3.4	1.5	4.0	1.8	2.1	2.4	2.6	0.4	-2.4	2.0	3.8
Real Final Domestic Demand (AR)	0.4	5.1	1.6	2.0	2.7	3.2	3.1	2.6	-1.5	2.6	3.5
All Items CPI Inflation (Y/Y)	0.1	-0.9	0.3	1.0	1.4	1.5	1.6	2.4	0.2	1.4	2.2
Core CPI Ex Indirect Taxes (Y/Y)	1.9	1.6	1.3	1.5	1.4	1.5	1.6	1.7	1.7	1.5	1.9
Unemployment Rate (%)	8.4	8.6	8.6	8.7	8.6	8.7	8.7	6.1	8.3	8.7	8.2
U.S.											
Real GDP Growth (AR)	-0.7	3.8	2.4	0.5	1.2	2.0	1.4	0.4	-2.4	1.6	3.3
Real Final Sales (AR)	0.7	0.2	0.7	1.1	0.9	1.9	1.0	0.8	-2.0	0.9	3.0
All Items CPI Inflation (Y/Y)	-1.2	-1.6	0.6	1.1	1.2	1.7	2.3	3.8	-0.5	1.6	3.6
Core CPI Inflation (Y/Y)	1.8	1.5	1.7	1.8	1.6	2.0	2.5	2.3	1.7	2.0	3.1
Unemployment Rate (%)	9.3	9.6	10.0	10.1	10.0	9.9	9.8	5.8	9.3	10.0	9.4

CANADA

Canada is out of recession but not convincingly so. Unspectacular data for July and August prompted us to lower our call for Q3 GDP growth, while pushing the bulk of second-half growth to the final quarter of the year. The weakness in Q3 stems from a slower than expected ramp up in factory activity. As inventory replenishment fades after Q4, growth will likely revert to below-trend as Canada grapples with the twin blows of an overvalued C\$ and a weak US economy. Exports will, as a result, take a backseat to government and consumption spending in 2010. While we expect the unemployment rate to drift higher in the months ahead, we've shaved our forecast jobless rates by a few ticks after last month's pleasant surprise. Strong growth in 2011 will be contingent on the lagged impacts of keeping interest rates very stimulative over the forecast horizon.

UNITED STATES

After four consecutive quarters of contraction the US economy likely turned a corner in Q3. After an initial two-quarter bounce, the pace of recovery is expected to be long and slow. The labour market is showing signs the worst is over, but monthly job losses remain in the triple digits. At the same time, the unemployment rate continues to head higher, and is expected to cross the 10% mark before the end of the year. Year-over-year inflation appears to have troughed, but pricing pressure is expected to remain very soft well into next year.

Conflicts of Interest: CIBC World Markets' analysts and economists are compensated from revenues generated by various CIBC World Markets businesses, including CIBC World Markets' Investment Banking Department. CIBC World Markets may have a long or short position or deal as principal in the securities discussed herein, related securities or in options, futures or other derivative instruments based thereon. The reader should not rely solely on this report in evaluating whether or not to buy or sell the securities of the subject company.

Legal Matters: This report is issued and approved for distribution by (i) in Canada by CIBC World Markets Inc., a member of the IIROC and CIPF, (ii) in the UK, CIBC World Markets plc, which is regulated by the FSA, and (iii) in Australia, CIBC World Markets Australia Limited, a member of the Australian Stock Exchange and regulated by the ASIC (collectively, "CIBC World Markets"). This report is distributed in the United States by CIBC World Markets Inc. and has not been reviewed or approved by CIBC World Markets Corp., a member of the New York Stock Exchange ("NYSE"), NASD and SIPC. This report is intended for distribution in the United States only to Major Institutional Investors (as such term is defined in SEC 15a-6 and Section 15 of the Securities Exchange Act of 1934, as amended) and is not intended for the use of any person or entity that is not a major institutional investor. Major Institutional Investors receiving this report should effect transactions in securities discussed in the report through CIBC World Markets Corp. This report is provided, for informational purposes only, to institutional investor and retail clients of CIBC World Markets in Canada, and does not constitute an offer or solicitation to buy or sell any securities discussed herein in any jurisdiction where such offer or solicitation would be prohibited. This document and any of the products and information contained herein are not intended for the use of private investors in the United Kingdom. Such investors will not be able to enter into agreements or purchase products mentioned herein from CIBC World Markets plc. The comments and views expressed in this document are meant for the general interests of clients of CIBC World Markets Australia Limited.

This report does not take into account the investment objectives, financial situation or specific needs of any particular client of CIBC World Markets Inc. Before making an investment decision on the basis of any information contained in this report, the recipient should consider whether such information is appropriate given the recipient's particular investment needs, objectives and financial circumstances. CIBC World Markets Inc. suggests that, prior to acting on any information contained herein, you contact one of our client advisers in your jurisdiction to discuss your particular circumstances. Since the levels and bases of taxation can change, any reference in this report to the impact of taxation should not be construed as offering tax advice; as with any transaction having potential tax implications, clients should consult with their own tax advisors. Past performance is not a guarantee of future results.

The information and any statistical data contained herein were obtained from sources that we believe to be reliable, but we do not represent that they are accurate or complete, and they should not be relied upon as such. All estimates and opinions expressed herein constitute judgments as of the date of this report and are subject to change without notice.

Although each company issuing this report is a wholly owned subsidiary of Canadian Imperial Bank of Commerce ("CIBC"), each is solely responsible for its contractual obligations and commitments, and any securities products offered or recommended to or purchased or sold in any client accounts (i) will not be insured by the Federal Deposit Insurance Corporation ("FDIC"), the Canada Deposit Insurance Corporation or other similar deposit insurance, (ii) will not be deposits or other obligations of CIBC, (iii) will not be endorsed or guaranteed by CIBC, and (iv) will be subject to investment risks, including possible loss of the principal invested. The CIBC trademark is used under license.

© 2009 CIBC World Markets Inc. All rights reserved. Unauthorized use, distribution, duplication or disclosure without the prior written permission of CIBC World Markets Inc. is prohibited by law and may result in prosecution.