



Economics & Strategy

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“Despite the recent record jump in oil prices, the outlook suggests that oil prices will continue to rise steadily over the next five years, almost doubling from current levels.”

The Age of Scarcity

by Jeff Rubin

Whether we are already at the peak in world oil production remains to be seen, but it is increasingly clear that the outlook for oil supply signals a period of unprecedented scarcity.

Our latest review of probable supply suggests oil production will hardly grow at all, with average daily production between now and 2012 rising by barely more than a million barrels per day (see pages 4-7). Despite the recent record jump in oil prices, the outlook suggests that oil prices will continue to rise steadily over the next five years, almost doubling from current levels.

By recent benchmarks, our supply outlook is moderately optimistic. Widely followed estimates of global oil production, such as those from the International Energy Agency, include millions of barrels per day of other hydrocarbons commonly referred to as natural gas liquids. Crude oil production has not grown at all in the last two-and-a-half years, despite a doubling in world oil prices. All of the supply increase has come from natural gas liquids.

That's fine if you need to refill your lighter, but not so great if your gas tank runs dry. While natural gas liquids such as butane, propane, and hexane are valuable hydrocarbons in their own right, they cannot be used to meet the world's growing appetite for gasoline, diesel, or jet fuel.

Transport fuels now account for half of the world's oil usage, and have driven over 90% of demand growth in recent years. The rise in natural gas liquids found in current oil production is not a technical coincidence that will soon reverse itself. Instead it is a sign of accelerating depletion as declining well pressure releases increasing amounts of trapped natural gas in mature oil fields.

It is also a sign of a growing mismatch between demand and supply. What new car owners in BRIC countries and elsewhere in the developing world will be demanding is gasoline and diesel, not butane.

While global oil supply is not growing, global gasoline demand is, and will continue to grow as cheap cars from Tata and Chery dramatically cut barriers to car ownership in the developing world. Millions of new households will suddenly have straws to start sucking at the world's rapidly shrinking oil reserves.

As they do, world oil prices will continue to rise and kill demand in the more price-sensitive OECD markets. In order to accommodate more drivers on the road in Russia, China and India, there must be fewer drivers in the US and the rest of the OECD. And so there will be. US oil consumption is likely to fall by over 2 mn bbl/day over the next five years as retail gasoline prices rise from the current US\$3.60/gallon mark to almost US\$7/gallon by 2012.

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

MARKET CALL

- A divided Fed is going to be limited to 25-bp rate cuts from here on, and with growth likely to resume in the second half, we've reduced our call for further cuts by a quarter-point, leaving a bit less scope for a rally in Treasuries. Our 1.5% target will still see the funds rate go beyond what's currently priced in, as a string of job losses keep the pressure on the Fed to add to the existing stimulus.
- The Canadian curve is already pricing in our call for one further quarter-point easing by the Bank of Canada, but could rally a bit in sympathy with Treasuries. Look for a second-half sell-off as both the US and Canadian economies gather momentum, and risk aversion that has benefited government bonds begins to abate.
- Although the euro has had a strong run, we're adding a bit more upside to our forecast in the near term, as Fed rate cuts and hawkish talk (but no action) from the ECB keep the dollar under siege. For the C\$, the best days are likely to come later in the year as the US economy shows signs of life, dampening downside risks to the Canadian economy. While we're expecting a smaller yield edge for Canada than earlier, that will be offset by a higher forecast trajectory for energy prices.

INTEREST & FOREIGN EXCHANGE RATES

END OF PERIOD:	2008				2009	
	23-Apr	Jun	Sep	Dec	Mar	Jun
CDA Overnight target rate	3.00	2.75	2.75	2.75	2.75	3.00
98-Day Treasury Bills	2.55	2.30	2.40	2.65	2.70	2.80
Chartered Bank Prime	4.75	4.50	4.50	4.50	4.50	4.75
2-Year Gov't Bond (3.75% 6/10)	2.78	2.45	2.70	3.10	3.35	3.50
10-Year Gov't Bond (4% 06/17)	3.67	3.45	3.50	3.70	3.80	4.00
30-Year Gov't Bond (5% 06/37)	4.16	4.00	4.00	4.10	4.15	4.20
U.S. Federal Funds Target	2.25	1.50	1.50	1.50	1.50	1.75
91-Day Treasury Bills	1.22	0.95	1.00	1.20	1.45	1.65
2-Year Gov't Note (1.75% 3/10)	2.20	1.80	1.85	2.00	2.45	2.80
10-Year Gov't Note (3.5% 02/18)	3.74	3.45	3.50	3.85	3.95	4.20
30-Year Gov't Bond (4.375% 02/38)	4.49	4.20	4.25	4.30	4.35	4.45
Canada - US T-Bill Spread	1.33	1.35	1.40	1.45	1.25	1.15
Canada - US 10-Year Bond Spread	-0.07	0.00	0.00	-0.15	-0.15	-0.20
Canada Yield Curve (30-Year — 2-Year)	1.38	1.55	1.30	1.00	0.80	0.70
US Yield Curve (30-Year — 2-Year)	2.29	2.40	2.40	2.30	1.90	1.65
EXCHANGE RATES						
— (US¢/C\$)	98.4	101.5	104.7	105.0	103.1	102.0
— (C\$/US\$)	1.016	0.985	0.955	0.952	0.970	0.980
— (Yen/US\$)	103	100	103	103	98	96
— (US\$/euro)	1.59	1.62	1.62	1.56	1.50	1.49
— (US\$/pound)	1.98	2.00	1.99	1.96	1.90	1.88
— (US¢/A\$)	94.5	95.0	94.0	93.0	92.5	91.0

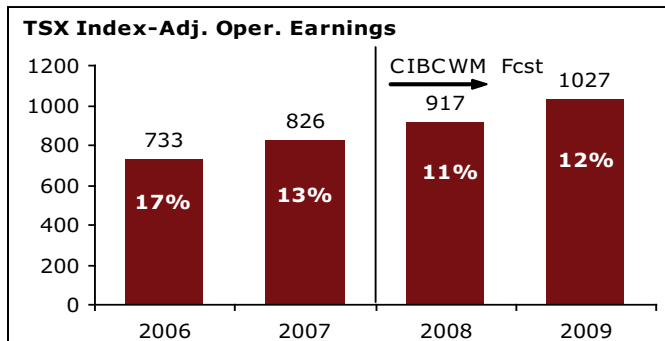
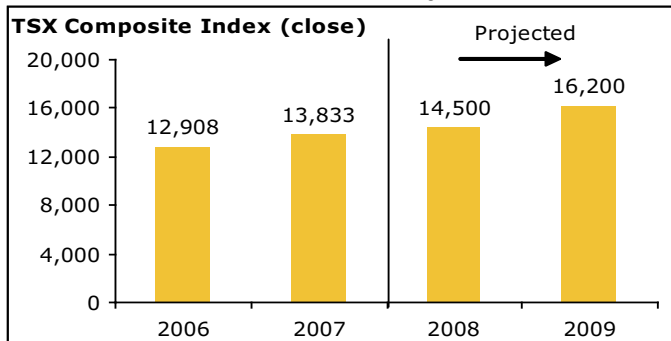
STRATEGY AND EARNINGS OUTLOOK

- With more interest rate cuts expected from both the Federal Reserve Board and the Bank of Canada, we remained overweight bonds at the expense of cash. While further subprime-related writedowns create near-term risks for stocks, prompting us to remain just index-weight that asset group for now, we see the TSX recovering to near record highs later this year. A further leg up to 16,200 is likely over the course of 2009.
- Resource stocks, with their predominantly global demand exposure, remain one of the better places for riding out a housing and financial services-centred US recession. Energy stocks in particular appear to represent good value, given a bullish outlook for natural gas and our updated average WTI price forecast of US\$115/bbl in 2008 and US\$130/bbl in 2009 (see pages 4-7). Material stocks have also contributed to the TSX marked outperformance of the S&P this year. Added greenback selling, alongside Fed cuts and inflation jitters should help gold recoup its recent losses. The continuing lift from the global food crisis to agricultural chemicals valuations is another reason for remaining overweight materials.
- The softer global M&A climate and growing saturation on the highly profitable wireless side contributes to our caution on the telecoms. Offsetting our heightened energy exposure, we consequently lightened up further on that sector. We also remained underweight financial stocks given the two-pronged threat of more asset writedowns and drag on earnings from weakening levels of capital market activity and economic growth.

ASSET MIX (%)	Benchmark	Strategy Recommendation
Stocks	54	54
Bonds	38	42
Cash	8	4
GICS SECTOR EQUITIES (%)		
Consumer Discretionary	4.3	1.8
Consumer Staples	2.4	2.9
Energy	29.0	35.0
Financials	28.3	25.8
-Banks	15.7	13.7
-Insur., REITs, oth.	12.6	12.1
Healthcare	0.4	0.4
Industrials	5.3	3.3
Info Tech	4.8	3.8
Materials	19.0	21.0
-Gold	8.4	9.4
-Other Metals	5.5	6.5
Telecom	4.9	2.4
Utilities	1.6	3.6

TSX - Earnings Outlook & Forward PE						
	Operating Earnings (% ch)				4-qtr Fw d PE	
	2005	2006	2007	2008	Latest	Last 10 yrs.
Consumer Discretionary	1.4	12.1	21.0	7.0	13.1	18.6
Materials	56.6	81.0	1.6	15.0	24.7	27.5
Consumer Staples	1.1	-2.3	-3.6	7.0	13.5	17.0
Health Care	5.0	26.9	-37.3	-11.0	19.0	49.7
Industrials	26.0	12.5	39.3	-3.0	15.2	15.6
Utilities	10.4	15.2	53.7	8.0	9.3	5.4
Financials	12.8	18.1	14.1	4.5	10.7	10.9
Info Tech	260.9	44.2	151.9	17.0	38.8	32.3
Telecom Svcs	6.1	34.2	27.9	6.0	13.2	34.7
Energy	54.5	14.1	7.2	16.0	16.0	13.0
TSX Composite	31.2	17.4	12.7	11.0	14.6	17.9

Note: Bold indicates recommended overweight.



Source: Thomson First Call, CIBC WM

How Much Higher Will Oil Prices Go?

Jeff Rubin and Peter Buchanan

Much smaller net production gains than we previously forecast now point to a more rapid escalation in crude prices over the next several years, with prices likely to soar to an average of US\$150 /bbl by 2010 and continuing to rise to over US\$200/bbl by 2012. We have reduced our estimates for net global supply increases by nearly 1 mn bbl/day for the 2008 through 2010 period, and by over half a million barrels for the two years after that, leading to a discernibly tighter oil market than we had previously projected (Chart 1).

At the same time, there is little evidence to suggest that there is any compensating reduction in global demand growth. Instead, aggregate crude demand remains robust as burgeoning demand for crude oil outside of the OECD, and in major oil-producing countries in particular, has more than offset demand destruction in OECD markets. Juxtaposed against more limited supply gains, the resilience of demand in developing countries points to increasing global competition for increasingly scarce oil resources.

While the International Energy Agency (IEA) estimates continue to peg current oil production at around 86 mn bbl/day, over 9% of this daily production is not oil at all but rather, natural gas liquids (NGL). While natural gas liquids such as propane and butane are valuable hydrocarbons in their own right, they are not a viable substitute for oil. Neither can be economically used as a feedstock for gasoline, or diesel. Propane is used as

a transport fuel, but in less than 2% of all the motor vehicles in the world. Hence, increases in the production of natural gas liquids cannot satisfy steadily growing global demand for gasoline and diesel, as car ownership rates in BRIC countries, and other parts of the developing world take off.

Car purchases in Russia, for example, are exploding as US sales stagnate (Chart 2), while in India the advent of the Tata Nano, a car that will sell for as little as US\$2,500 will allow millions of households in the developing world to own automobiles when they otherwise could not. It is the savings necessary to buy a car, not the price of gasoline that poses the greatest obstacle to fuel demand growth in those countries. But between rapidly rising domestic incomes and rapidly falling car prices, that obstacle is becoming more and more surmountable.

The inability of existing supply sources to meet that demand growth has been highlighted recently by the fact that virtually all of the increase in so-called oil has been in these other hydrocarbons, which come largely from natural gas and are ill-suited for gasoline and diesel production. The ratio of natural gas liquids to total "oil" production has been rising steadily and is likely to continue to rise for the foreseeable future. Whereas these hydrocarbons represented only about 4% of total oil production back in the 1970s, they are likely to account for over 10% of total production by 2012.

Chart 1
The Supply Crunch is Here

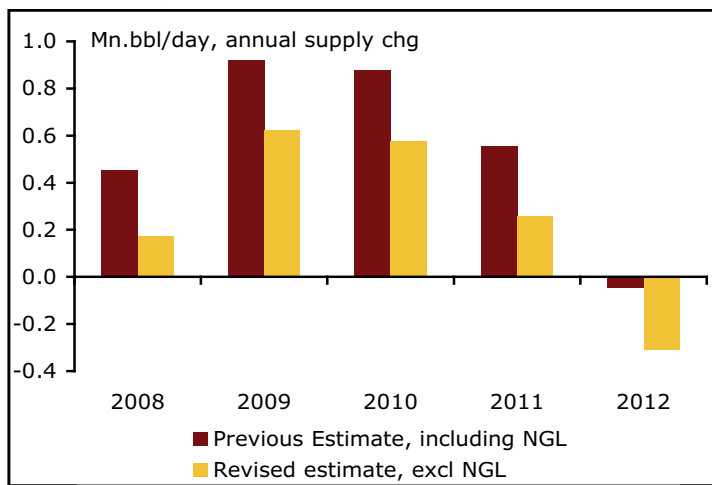
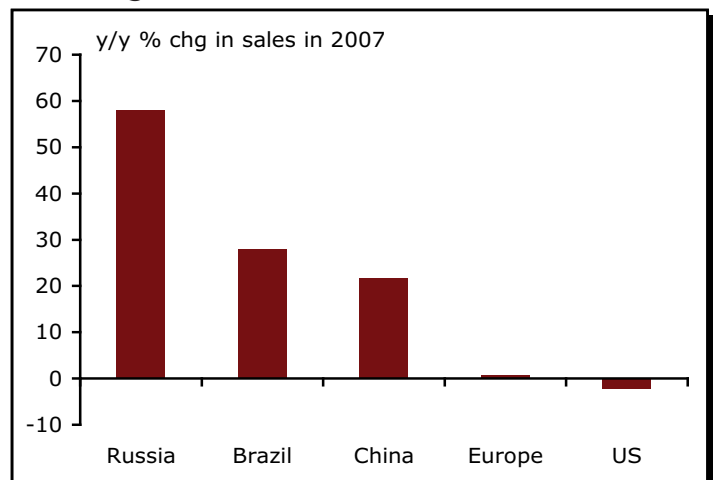


Chart 2
Booming Car Sales in BRIC Countries



The increasing ratio is coincident with accelerating depletion rates in many of the world's largest and most mature oil fields. Beyond methane which is what the home consumer burns, natural gas at the wellhead contains a range of readily liquefiable gases, which agencies like the IEA have traditionally included in total oil supply. These products—propane and butane, along with smaller amounts of pentanes, hexanes and heptanes—are removed at specialized upstream processing facilities, in part to expedite movement of the treated gas through the pipeline distribution network.

While natural gas can occur on its own, much of the world's natural gas is "associated" gas—found together with oil. As an oil field matures, the resulting loss of reservoir pressure releases dissolved natural gas. The released gas forms an expanding cap over many mature oil fields, resulting in a rising ratio of natural gas to oil and hence, a rising ratio of natural gas liquids to oil production. This is precisely what is occurring in rapidly depleting fields like Mexico's Cantarell.

While the steady, but very gradual rise in the ratio of natural gas liquids to total petroleum liquids production may not, in itself, trigger particular alarm, recent developments do. What counts in terms of meeting future transportation fuel demand growth is what percentage of new supply that is coming on-stream will be oil and what percentage will be natural gas liquids? While natural gas liquids only account for 10% of total supply, they account for virtually all of the increase in petroleum liquids production since 2005 (Chart 3). Stripping out natural gas

liquids, oil production has not grown for over two-and-a-half years, which certainly goes a long way to explaining why oil prices have doubled over that period.

In light of these developments we have re-examined our projected supply increases, stripping out the expected increases in actual petroleum production as opposed to natural gas liquids. The distinction turns out to be critical. Roughly 50% of the increase in expected production is likely to come from natural gas liquids, leaving only small marginal gains in petroleum supply over the next two years.

Indeed, stripping out natural gas liquids, underlying world oil supply will rise from 78 mn bbl/day (equivalent of 86 mn barrels today with natural gas liquids) to only 79 mn barrels by 2010. And looking beyond, it is unclear whether that level can be much exceeded in the following years, at least through the end of our forecast horizon in 2012.

Our new estimates suggest that we are likely to see barely more than a million-barrel increase in global production between now and the end of the decade. Oil production edges up another 200,000 bbl/day in 2011 but then falls again in 2012.

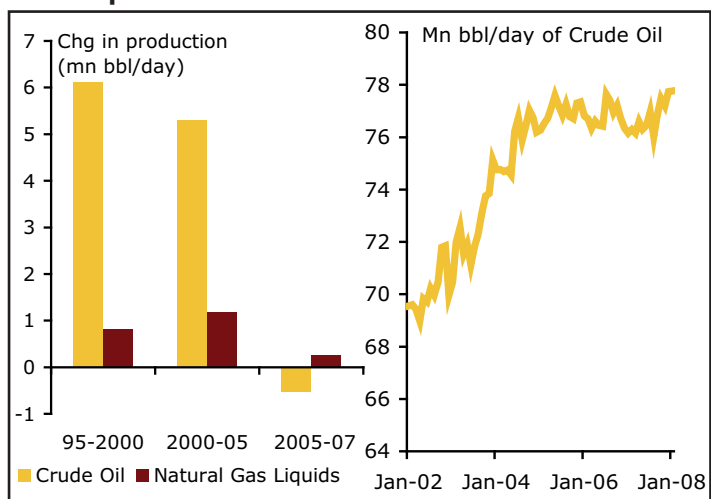
Whether in fact, these levels will define ultimate production peaks or not, cannot of course be known at this time, but whether they do or do not define such peaks, they indicate at a minimum that world oil markets will remain as tight over the next five years as they have over the last two years.

Rationing Demand: How High Must Prices Rise?

Demand must ultimately be constrained by supply so the price equation, given a fixed supply, depends on how price-sensitive demand is. As we have argued before (see *Occasional Report #62, "OPEC's Growing Call on Itself"*), there are essentially two world oil markets, one fairly price-sensitive and one not at all. In the still-senior oil market, the OECD, consumers are not only expected to bear the full costs of world oil prices, but also pay substantial excise taxes as well. This is where the rubber meets the road insofar as price rationing global demand. The virtual doubling in world oil prices since 2005 has led to back-to-back reductions in OECD consumption (Chart 4) for the first time since the early 1980s.

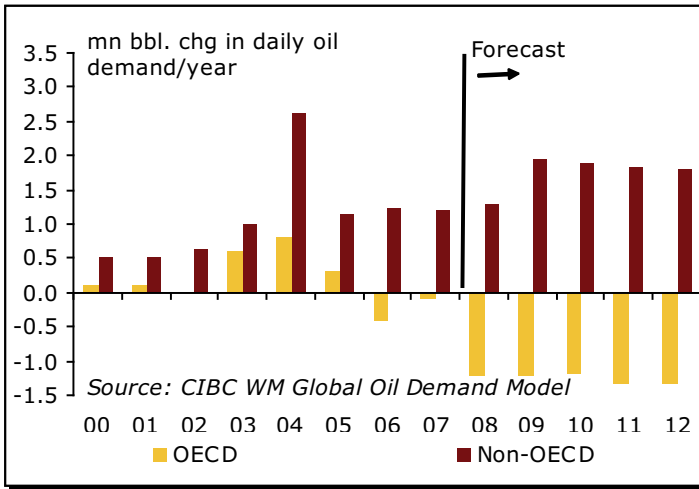
Chart 3

New Oil Supply Over the Last 3 Years—Natural Gas Liquids or Oil



Source: US Dept. of Energy

Chart 4
**Declining Consumption in OECD,
 Rising Consumption Outside of OECD**

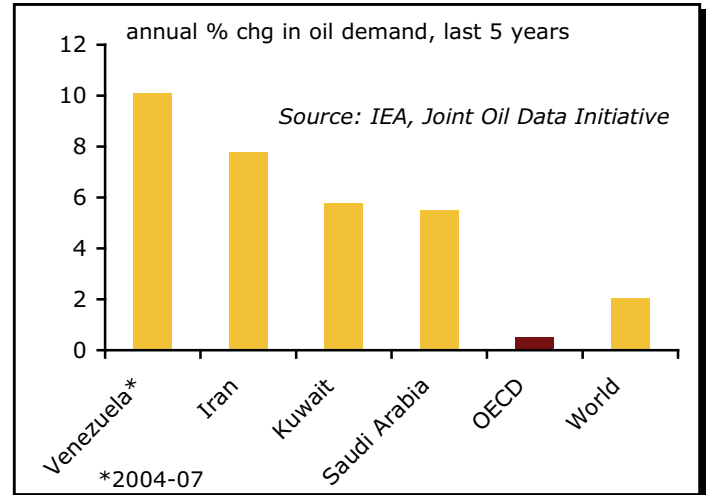


In the rest of the world, however, soaring oil prices have had little traction on demand. In many countries outside of the OECD, first time car buyers have no memory of past gasoline prices, and by virtue of car ownership, now have a claim on the world's rapidly shrinking oil reserves.

The extent to which prices ration limited supply over the next five years depends to a significant degree on how much oil will be diverted from world oil markets to meet the consumption needs of major oil exporters themselves. Last year, OPEC together with independent producers Russia and Mexico, consumed over 13 mn bbl/day of oil, constituting, next to the US, the second-largest oil market in the world. Unlike the US however, where total crude demand has been basically flat over the last three years, domestic oil consumption is soaring in those other markets. Over the last three years, consumption inside of OPEC has grown at an astounding over-5% average annual rate (Chart 5), while domestic consumption growth in Russia and Mexico is not very far behind.

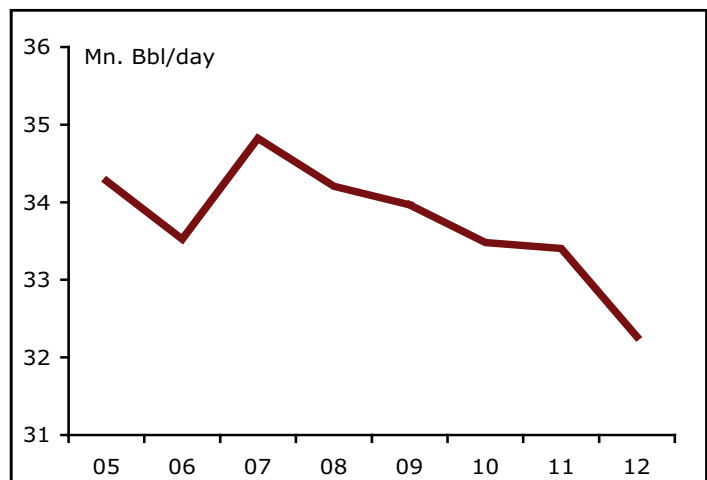
For the most part, soaring rates of domestic fuel consumption, particularly in OPEC countries, can be traced to egregiously low pump prices. Gasoline in the 25-cents/gal range in Venezuela and in the 50-60 cents/gal range in Saudi Arabia, Kuwait and Iran, have not, surprisingly, spurred enormous fuel appetites in those countries. Not only is the demand for fuel there price-inelastic but the elasticity has the wrong sign. In other words, higher world oil prices only serves to boost demand, because they bring even more money chasing massively subsidized fuel.

Chart 5
**Oil Consumption Surging in Key
 Oil-Exporting Countries**



With production faltering, soaring rates of domestic fuel consumption will soon cannibalize export capacity. Exports from OPEC, Russia and Mexico are expected to decline by 2.5 mn bbl/day in the next five years (Chart 6). To a large extent, that has already happened in OPEC, whose export growth has slowed dramatically in recent years. Soaring Russian exports had effectively filled the void created by OPEC, but now, as we recently heard from Russia's resources minister, both Russian production and exports are set to decline. Instead of offsetting what's happened in OPEC countries, Russia is soon to add to the problem. But markets will soon see an even more spectacular drop in exports from Mexico, home to roughly 1.5 mn bbl/day of supply to the US market. The

Chart 6
Declining Exports from OPEC, Russia, & Mexico



tandem of strong domestic gasoline demand growth and plummeting production at its massive Cantarell field will see Mexico's exports virtually disappear within five years (Chart 6).

The more oil is consumed in oil-producing countries, the less oil will be consumed in the OECD. Since oil-producing countries effectively have first call on their own oil, the balance is the residual which the price mechanism must ration. Boosted by the explosive growth in oil consumption in oil-producing countries, we expect that by 2012, consumption in the rest of the world will exceed OECD consumption, a virtually unthinkable prospect a little over a decade ago, when consumption outside of the OECD measured little more than half of the OECD's annual oil intake (Chart 7).

The rise in world oil prices to over US\$200/bbl should translate into steadily rising retail gas pump prices. US gasoline prices, already averaging US\$3.60/gal nationally, should peak at well over US\$4/gal this summer, rising to as much as US\$7/gal by 2012 (Table 1).

Small declines in OECD consumption in 2006 and 2007 are likely to be followed by a 2.6% annual decline for the next three years, with declines averaging 3% per year after 2010 (Table 1). Referenced off its 2006 peak, oil consumption will fall by almost six million barrels per day in the OECD by 2012, with roughly half of the decline occurring in the US, the world's largest oil market.

Chart 7

Shifting Pattern of World Oil Consumption (OECD vs Rest of World)

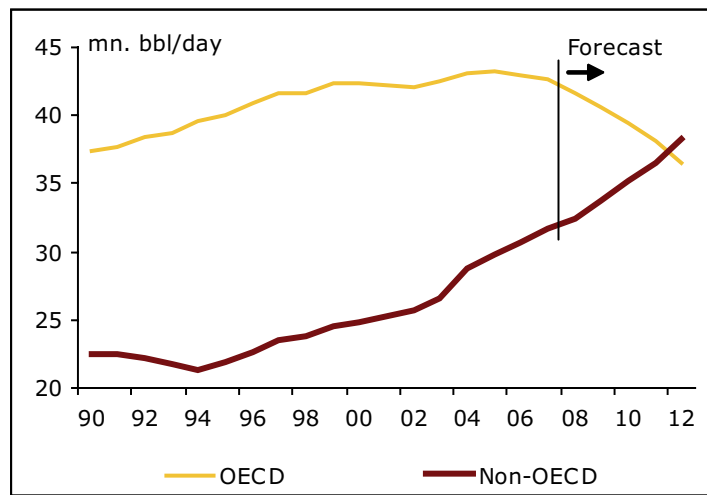


Table 1

Global Oil Supply Forecast

	2008	2009	2010	2011	2012
<i>All Petroleum Liquids Production (Jan. Forecast)</i>	86.1	87.0	87.9	88.4	88.4
Minus: Natural Gas Liquids Production	8.2	8.5	8.8	9.1	9.4
Latest Global Supply Forecast (ex NGL)	77.9	78.5	79.1	79.3	79.0
World Oil Demand	77.8	78.0	78.4	78.7	79.0
- % ch.	-0.3	0.3	0.5	0.4	0.4
OECD	43.8	42.7	41.6	40.3	39.0
- % ch.	-2.5	-2.6	-2.6	-3.0	-3.1
non-OECD	34.0	35.4	36.8	38.4	40.0
- % ch.	2.7	4.1	4.2	4.3	4.1
Prices					
West Texas Crude	115	130	150	190	225
Retail Gasoline (annual avg) (US\$)	3.90	4.50	5.00	5.75	6.50
(summer peak) (US\$)	4.25	4.80	5.50	6.00	7.00

Source: Oil Megaprojects Task Force/The Oil Drum, company, industry & govt. reports. Field start-up dates have been adjusted by CIBC World Markets where appropriate to reflect expected delays due to political, technological and other factors.

Food Inflation: Coming to a Grocery Store Near You

Avery Shenfeld

Worldwide crop shortages, soaring retail food prices, riots over the cost of feeding the poor—these have been the headlines on food inflation in recent months. Adverse weather in major grain growing regions, rising incomes and calorie consumption in developing Asia, energy costs in transport, tractors and fertilizer, and the diversion of crops to biofuels are behind those headlines. Seemingly everywhere, that is, except Canada. Even relative to our closest neighbour, food prices have been remarkably tame in the last year (Chart 1). But after looking at what’s behind that exceptional gap, it’s clear that Canada’s good luck on food prices is likely to run out in 2009.

As is the case globally, retail consumers are seeing the pass-through of record grain prices into related food items, such as bakery products, pasta and flour (Chart 2). But that’s been offset by tame or, in some cases, sharply lower prices on other food products, both in absolute terms and relative to the US.

Part of the difference reflects the one-time benefits of a much stronger Canadian dollar. The share of imports in Canadian consumption is over 90% for fruit and nearly 50% for vegetables. Since, in many cases, these products turn over quickly, foreign exchange movements don’t take long to translate into Canadian retail prices.

Chart 1
Food CPI: Largest Cdn Advantage in 38 Years

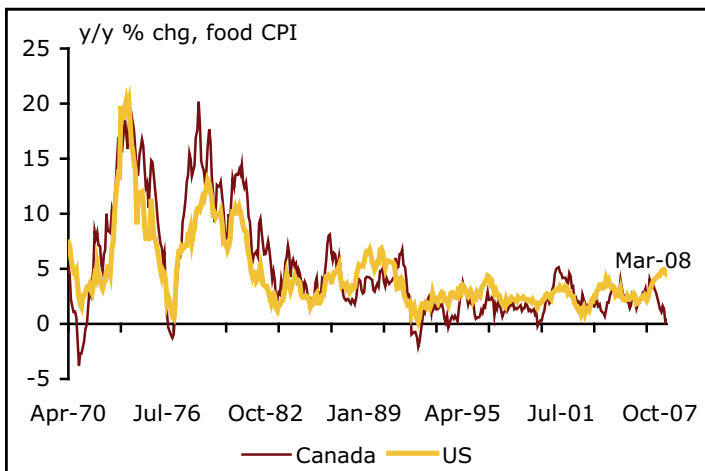
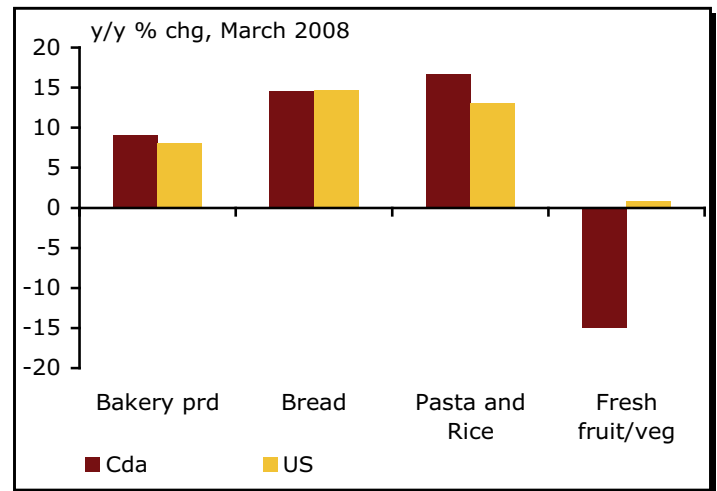


Chart 2
Selected Food CPI Components

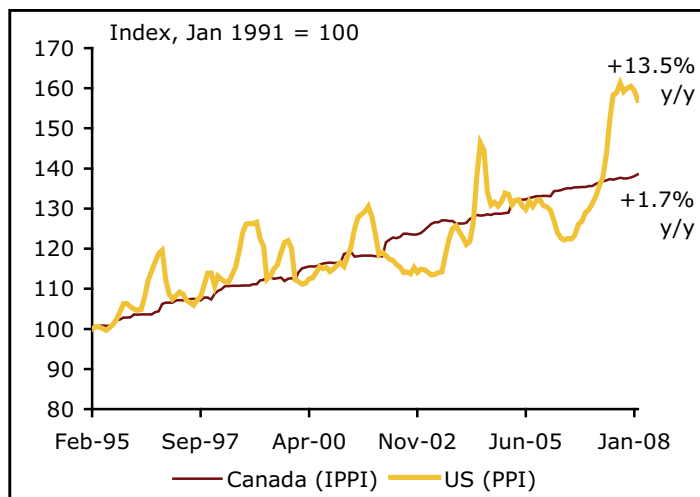


That explains why Canadian fresh produce prices are down roughly 15%, while the same items (often sourced at this time of year from the same growing regions) are up slightly stateside. But even with our call for the Canadian dollar to reach US\$1.05 by year-end, the loonie will not come close to matching the 17% year-on-year appreciation that is currently cushioning retail produce prices. As well, on both sides of the border, fresh produce costs look lighter because the prior year saw elevated prices after a California frost hit supply.

For most other items, the import share of the Canadian market is 20% or less, too light to account for the huge differences in inflation rates. Here there are other forces at work, most of which will be less powerful come 2009. For dairy products, the enormous gap in retail inflation with the US reflects differences further upstream at the wholesale and farm gate level. US PPI prices for dairy products soared in the past year, in line with a global supply-demand crunch. Adverse weather in New Zealand and the earlier loss of producers in Europe during a period of soft prices hit supply, while demand captured East Asia’s new taste for dairy products.

Chart 3

**Wholesale Dairy Product Prices
Less Volatile in Canada**



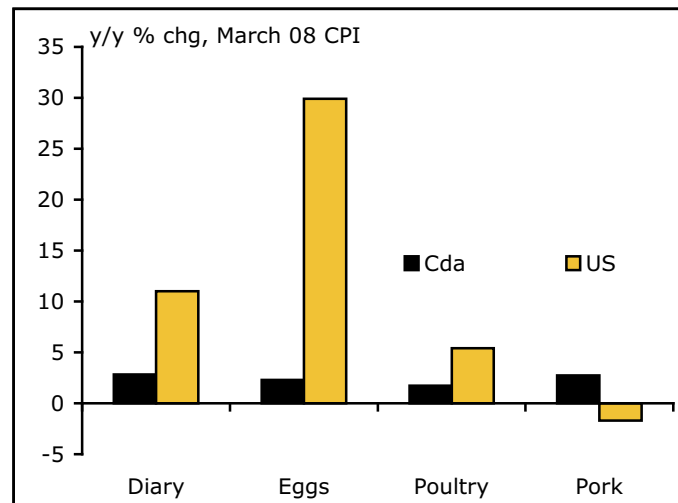
Canadian milk and cheese prices tend to be much more stable, as they are the product of a marketing board system that controls both production and prices and limits imports. The result is that wholesale dairy product prices in Canada ultimately rise in line with those stateside, but in a much smoother trend (Chart 3). Rising feed grain and energy prices could see dairies paying more for fluid milk and transportation next year, and we look for wholesale prices to retailers to rise at a 3% clip next year, up from 1.7% year-on-year in March, according to the Industrial Product Price Index (IPPI).

Similarly, other products sold through marketing boards have lower year-on-year CPI readings in Canada than in the US (Chart 4). But cost increases for energy and feed will be added to the poultry pricing formula. To help pork producers struggling with those costs, Ottawa is paying for a 10% cull of the hog population (with the meat diverted mostly to pet food, and to a lesser extent to food banks) in order to help lift prices next year.

Developments at the retail level have also temporarily put a damper on food inflation on the north side of the Canada-US border. The entry of new US-based competitors, and the response by Canadian chains, left the sector with excess capacity and a fight for market share. The resulting price war has depressed margins (Chart 5) to levels that are resulting in outright losses in some cases. Unless margins keep falling, which seems unlikely given the need for profits to stay in business, the year-on-year inflation rate will lose this benefit in

Chart 4

CPI Inflation in Marketing Board Foods

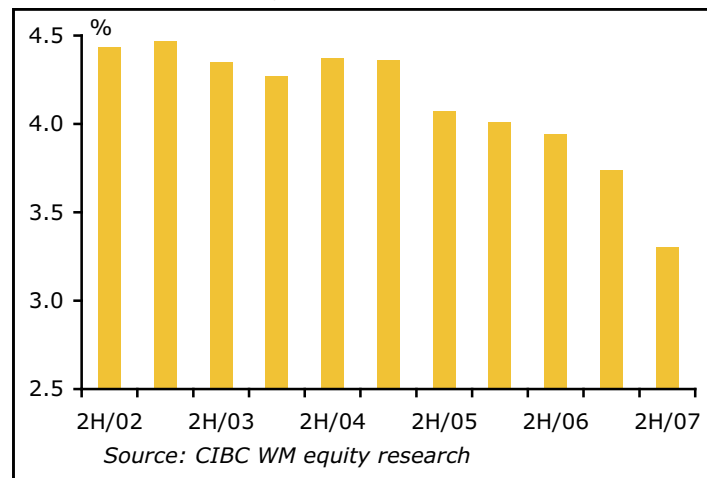


2009, tacking on about half a percent to food inflation if margins stabilize, and more if margins climb.

How much does all this matter to the overall inflation outlook? A lot as it turns out. For one, Canada's core CPI measure includes all foods except fresh fruits and vegetables. And food has a large weight in the CPI as a whole. If, as we expect, food inflation is running at 3.5% in 2009, as opposed to only 0.4% today, that will add about half a percent to the CPI. Tack on fast-rising gasoline prices and the end of the one-year benefit of the GST cut and Canadian inflation will average 3% in 2009.

Chart 5

**Canadian Grocery Store Operating Margins
Are Unsustainably Low**



Has the Global Credit Crunch Hit a Bottom?

Meny Grauman

With the S&P 500 down by over 6% since the start of the year and inter-bank lending spreads still over four times their historical averages, these are hardly heady times for global financial markets. Yet despite the constant stream of bad news coming out of Wall Street, in some aspects, the worst of the credit crunch appears to be over.

Financial markets are unlikely to return to normal over the next few months, but there is a sense that, at the very least, the credit situation won't get any worse. Despite the fall of Bear Stearns, investors' deepest fears have not been realized and the global financial system is hit but not hobbled. Financial firms have seen their capital ratios bruised, but have been able to handily access global equity markets in order to recapitalize. Meanwhile, the Fed has also done its part through a series of well-timed targeted liquidity measures, including opening up the discount window to securities dealers.

Getting Used to Bad News

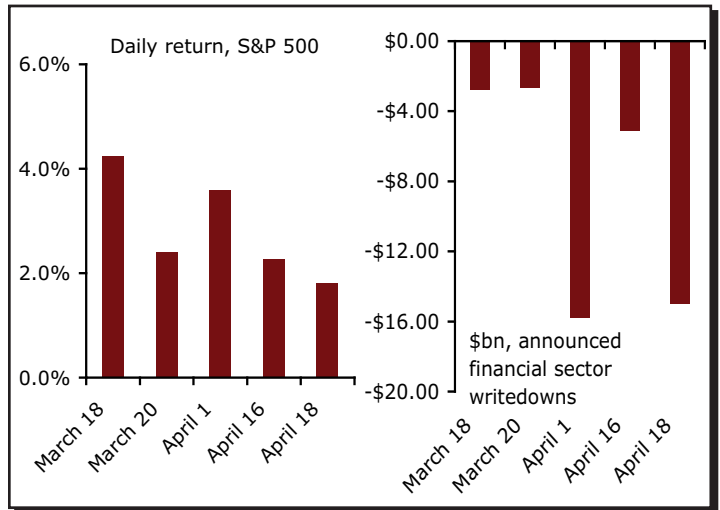
To be sure, the fundamental economic data will certainly get worse before they get better, but investors appear to be willing to look past that, even if they are not yet willing to bet on a full blown US economic recovery. There is clear evidence that expectations have hit a bottom and that markets are learning to live with significantly higher risk premiums and ongoing market losses.

Just how inured investors have gotten to the ongoing stream of billion dollar writedowns from global banks and brokerage firms can clearly be seen in the equity market's performance in the wake of these announcements. Over the past 30 days, five of the fifteen winning S&P 500 trading sessions came on days during which major financial institutions reported at least \$2 bn in writedowns (Chart 1).

Signs of market stress are still clearly visible, but have certainly moderated since spiking in mid-March. Spreads on highly rated corporate bonds are still close to the highest they have been since this latest crisis started (Chart 2), but after blowing out to record levels, spreads on both the investment-grade and high-yield CDX indices are the lowest that they have been since the start of the year (Chart 3).

Chart 1

US Stocks Rose on Days with Big Writedowns



Equity market volatility has also dropped off significantly, and although financial stocks have certainly not rallied very much, they have managed to level off. Furthermore, if credit conditions continue to modestly improve, these same firms may even be able to avoid further mark-to-market writedowns next quarter as the value of the related assets bounces back from their March lows.

Chart 2

Corporate Spreads May Have Plateaued

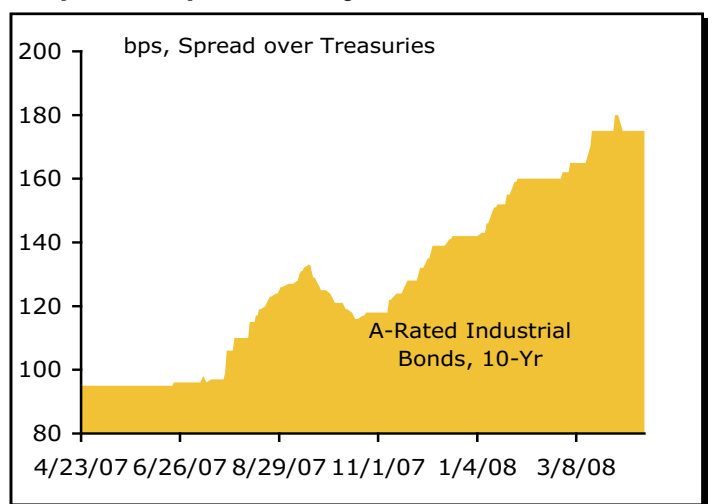
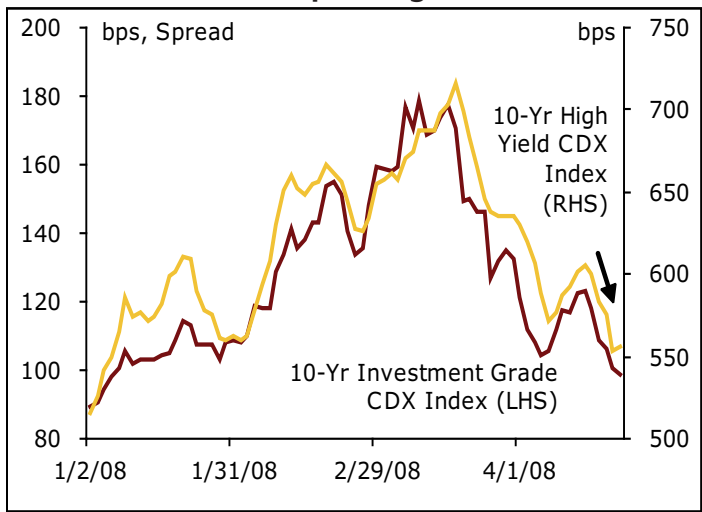


Chart 3

Credit Conditions Improving



The implications for Treasuries are significant. Bonds have sold off across the curve and the spread between 2s and 10s has narrowed by 50 bps over the last four weeks. There are those who would like to attribute this move to soaring inflation concerns as crude oil nears US\$120/bbl and rising food prices spark riots across the globe. However, although inflation is certainly a persistent and global problem, the recent moves in the yield curve have more to do with scaled-back risk intolerance than rising prices. After all, inflation expectations as measured by the TIPS market are low by historical standards, and even lower than they were in March (Chart 4).

Chart 4

Inflation Expectations Tame in the TIPS Market

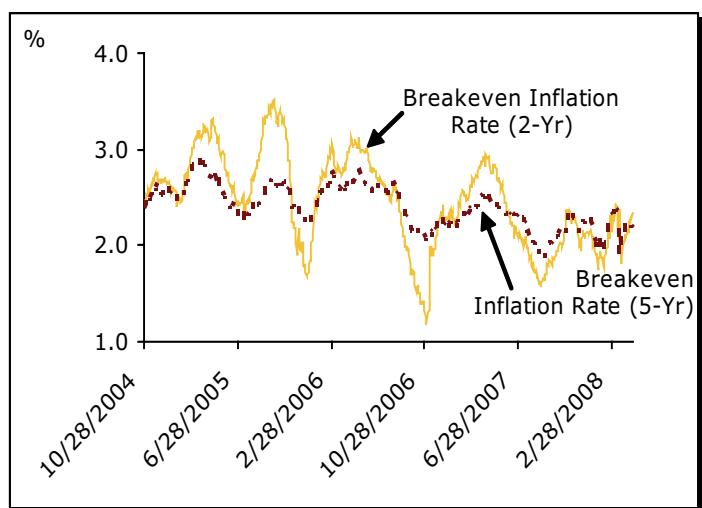
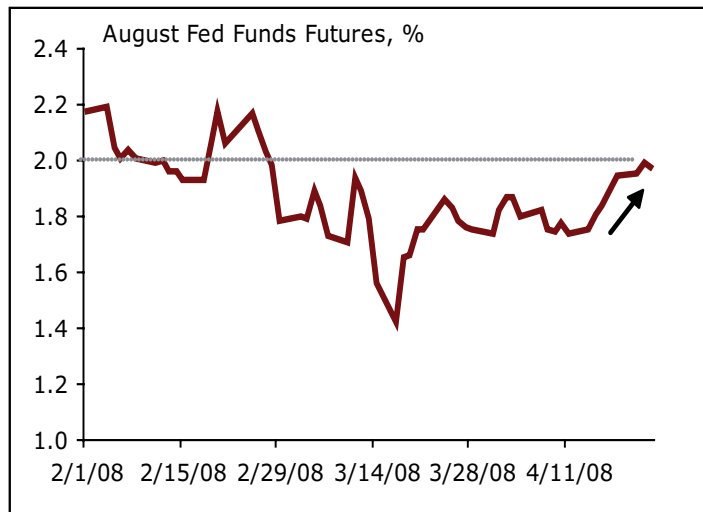


Chart 5

Market Now Believes Fed to Stop at 2%



Easing Will Surpass Expectations

Turning to monetary policy, only a month ago the fed fund futures market was pricing in a better-than-50% probability of sub-2% Fed funds rate by August, but that prediction has now slipped to around 20% (Chart 5).

Considering the financial and economic risks still ahead of us, our view on administered rates is a little more circumspect, but is also more optimistic than it was a month ago. We continue to call for rates to drop below 2%, but there is no doubt that a calmer market environment will make it harder for the Federal Reserve to drive its target rate below 1.50%, especially as the voices of the FOMC's inflation hawks get even louder.

Still, despite meager market expectations, more significant monetary easing is still par for the course, in no small part because the economy demands it. Policy makers will likely have to move in smaller 25-bp increments, but they will still need to continue to ease the pressure on floating rate borrowers, especially homeowners. Defaults continue to rise and according to the Case-Shiller home price index home values are not just continuing to decline, but are dropping faster with each passing month.

When all is said and done, the second-quarter will likely bring a significant decline in real GDP growth in the US, and be the low point of the current recession. However, it appears that it will also mark a stabilization-point, if not yet the turning-point, for the nine-month old credit crunch. Both the markets and the economy will take some time to fully recover, but an end is finally in sight.

ECONOMIC UPDATE

CANADA	07Q4A	08Q1F	08Q2F	08Q3F	08Q4F	2007F	2008F	2009F
Real GDP Growth (AR)	0.8	1.0	0.7	1.8	3.8	2.7	1.6	3.0
Real Final Domestic Demand (AR)	6.9	4.5	3.6	3.0	3.0	4.3	4.6	3.4
All Items CPI Inflation (Y/Y)	2.4	1.8	1.9	2.6	3.1	2.1	2.4	3.0
Core CPI Ex Indirect Taxes (Y/Y)	1.6	1.4	1.2	1.4	2.1	2.1	1.5	2.1
Unemployment Rate (%)	5.9	5.8	6.2	6.5	6.4	6.0	6.2	6.2
Merchandise Trade Balance (C\$ Bn)	37.1	46.4	42.7	37.8	40.1	49.4	41.8	43.1
U.S.								
Real GDP Growth (AR)	0.6	-0.2	-1.9	1.7	3.2	2.2	0.9	2.3
Real Final Sales (AR)	2.4	-0.5	-2.3	1.0	2.5	2.5	0.9	2.3
All Items CPI Inflation (Y/Y)	4.0	4.2	4.3	4.5	4.0	2.9	4.4	3.6
Core CPI Inflation (Y/Y)	2.3	2.4	2.4	2.3	2.3	2.3	2.4	2.3
Unemployment Rate (%)	4.8	4.9	5.3	5.5	5.5	4.6	5.3	5.3

CANADA

Our macroeconomic outlook is little changed from the detailed presentation in our April 14th issue of *Forecast*. We made offsetting adjustments within our CPI forecast, lowering the near-term core outlook in response to softer-than-expected March data and a cooling in new home prices, but making that up in the headline rate given the steeper climb now built into our oil forecast.

UNITED STATES

The resiliency of the US economy is apparent even in recession. Although first-quarter real GDP growth will still be the weakest result since Q4 2002, it will be very close to flat, due to sluggish, but still better than expected consumer spending and industrial production. It is unlikely, however, that the second quarter will also be so fortunate, and we continue to expect an annualized decline of 1.9%. On the inflation front, we do not expect a mild and short slowdown to have a significant impact on CPI, which will likely be stuck at over 4% until the end of the year.

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