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Slim Conservative Minority Means Economic Evolution, Not Revolution

It was close, but Stephen Harper has led Canada's Conservative Party to its first election victory since 1988. With only 124 seats in the House of Commons, pending recounts, the Conservatives were unable to secure a majority government and a clear mandate. This suggests a relatively moderate change in policy orientation since Harper will need the support of at least one other party to implement major changes. It might also mean a return to the polls sooner rather than later.

"Nevertheless, we believe that the Conservative policies that are most likely to find parliamentary favour carry generally positive implications for capital markets," says **Vincent Lépine**, Vice President, Global Asset Allocation, CIBC Asset Management.

In his election platform, Stephen Harper said that he would cut corporate, personal and sales taxes, encourage greater corporate merger and acquisition activity, reduce or abolish capital gains and dividend taxes, and reduce market regulation. As well as general economic and market implications, these measures could have specific influence on Canadian stocks, bonds and currency. It is in the equity markets that the effects might be most immediate. All of this, of course, assumes that the current favourable commodity price-inspired economic backdrop in Canada continues.

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Surpluses were the hallmark of Paul Martin's fiscal policy when he was Finance Minister and then Prime Minister. While the markets may reasonably expect that the Conservatives will continue to maintain balanced budgets, the risk of return to deficit is augmented by the relative inexperience of the Conservative economic team and its potential reliance on the sustainability of revenues from a booming economy.

Macroeconomic implications

Taken as a whole, the fiscal measures proposed by the Conservatives should help improve Canada's productivity over the longer run. No longer enjoying the benefits of a weak currency, Canada has been trailing the U.S. on the productivity front for a number of years.

"The new government could provide extra momentum for a currency that is already in favour," says **Maxime Tessier**, Vice President, Currency Management, CIBC Asset Management. "The possibility for firmer growth, lower inflation and productivity gains is positive for the currency. This opens the door for the Canadian dollar to exceed its 1991 high of 89 U.S. cents."

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The implication for monetary policy is that the Bank of Canada may be given an incentive to curtail its tightening campaign: the goods and service tax (GST) cut and a stronger Canadian dollar will be disinflationary, whereas stronger productivity growth could serve to offset the price pressures that typically come with strong demand.

Lowering the GST by 2% over five years will likely boost consumer spending. In early 1991, the introduction of the GST coincided with a severe contraction in Canadian consumer spending. A very different economic and budgetary context today makes the measurement of the impact difficult.

The initial impact on inflation is more direct. While the GST does not apply to all goods and services, the impact will nevertheless be significant, ranging from 0.6 to 0.8 of a percentage point over the first year. The impact would be a lot smaller over the following years.

Capital market implications

The table below summarizes key changes for Canada's most important financial sectors. The overall impact should be positive.

Equity Market Sectors	Market Impact of a Conservative Minority Government	Comments and Key Factors
Financials	Positive	Better after-tax dividends, possibility of mergers, more M&A fees, steeper yield curve
Energy	Positive	Greater foreign M&A activity, some deregulation
Materials	Negative	Stronger Canadian dollar
Industrials	Uncertain	Stronger Canadian dollar but firm domestic demand
Consumer discretionary	Positive	Income tax and GST cut, lower short-term interest rates
Telecom services	Positive	Market deregulation
Other Capital Market Sectors		
Income Trusts	Uncertain	<u>Positive</u> : less uncertainty for future tax treatment, better corporate/interest rate environment <u>Negative</u> : other sectors/vehicles may be more attractive
T-Bills and short-term Federal government bonds	Positive	Bank of Canada keeps interest rates lower
Long-term Federal government bonds	Uncertain	Supply impact uncertain, investors may substitute equities for bonds, short-term inflation and rate impact positive, steeper yield curve likely.
Real return bonds	Negative	Lower inflation outlook
Provincials and Corporate Bonds	Positive	More provincial revenue, improved corporate cash flow

The fixed income market is likely to benefit from the election results, particularly provincial bonds, and even more specifically Quebec bonds. The spread between Quebec and Ontario long bonds tightened to 13.4 from 18.5 basis points one month ago because of fears that a good showing by the Bloc Quebecois would fuel the Quebec sovereignty sentiment. The BQ's underperformance and Quebec representation in the new government has soothed these concerns. The Conservative promises of increasing transfer payments may also shore up provincial finances.

Investment Conclusions

In light of all of these observations, CIBC Asset Management's Global Asset Allocation team is not changing its asset allocation strategy. This strategy favors stocks over bonds and Canada over U.S. markets. However, increasing active risk, or taking larger positions, is harder to justify because of the uncertainty of a minority government and the unfamiliarity of the Conservatives' new economic team.

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