



December 31, 2006

EXPECTED RETURNS

For the 12 month period ending December 31, 2007	In Canadian Dollars			In Local Currency		
	Economic Rebalancing	Stagflation	Global Slowdown	Economic Rebalancing	Stagflation	Global Slowdown
Probabilities	55.0%	30.0%	15.0%	55.0%	30.0%	15.0%
Canada Money Market	4.1	4.2	3.8	4.1	4.2	3.8
Canada Bond	3.5	-3.8	5.9	3.5	-3.8	5.9
International Bond	2.2	-6.3	11.1	2.1	-1.2	5.9
Canada Equity	10.4	-4.0	-7.1	10.4	-4.0	-7.1
U.S. Equity	8.0	-12.5	-0.3	9.5	-7.2	-3.1
International Equity	10.0	-8.7	-1.0	12.0	-1.8	-4.2
Emerging Market Equity	9.1	-19.4	-8.1	12.3	-5.0	-3.8

In this Issue

Global Environment

We are projecting slightly lower worldwide economic growth and inflation.

Fixed Income vs. Equity

We are staying overweight in global equities and underweight in global fixed income.

Regional Outlook

We expect only modest divergence in regional equity returns due to a more synchronized global economy.

Currency

We will be neutral the U.S. dollar over the next 12 months.

GLOBAL ENVIRONMENT

Our key global projections remain intact:

- The U.S. slowdown will turn out to be milder than generally expected;
- The rest of the world will weather the U.S. storm with little damage;
- The global tightening cycle is not over.

We expect global growth to slow to 4.2% in 2007 from 4.6% in 2006. While growth in the U.S. will cool off significantly to 2.25%, we expect growth in the rest of the world to slow only marginally to 4.4%, down from 4.9%. The slowdown in the rest of the world will be driven by a reduction in growth in China, from 10% in 2006 to 8.5% in 2007, due to tightening monetary conditions in China.

Fears of a global slowdown are overblown. Leading indicators are not signaling a global recession. At first glance, the inversion of the yield curve seems to point towards a recession but the shape of the yield curve is a reflection of inflation expectations, not growth expectations. While interest rates are not high enough to push the economy into recession, the yield curve's inversion is pointing to a deceleration in inflation. This signal is consistent with our forecast of slightly lower global inflation of 3.0% in 2007, down from 3.4% in 2006, owing to cooling global economic activity, weaker commodity price growth and milder cost-push pressures. The performance of equity markets is also inconsistent with a U.S.-led global recession scenario. At the start of the decade, the economic downturn was signaled by a sharp correction in equity markets. In 2006, equity markets around the world were busy setting new highs.

FIXED INCOME VS. EQUITY

Our global rebalancing scenario remains the most probable outcome for 2007. This suggests that selected equity markets remain the favoured asset class relative to fixed income. This strategy worked well in 2006 as international equities and emerging markets substantially outperformed international bonds.

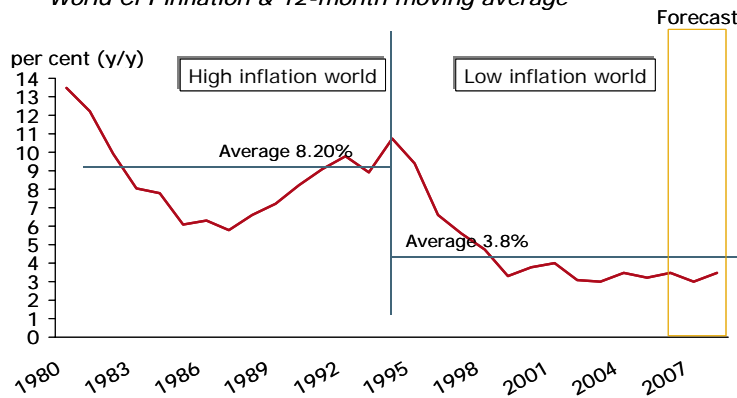
Within U.S. equities, we are establishing a preference for large capitalization stocks versus small capitalization stocks given their relative valuation attractiveness based on year-end relative price to earnings, price to sales, and dividend yields.

The global economy is moving into its fifth year of economic expansion and the bull market in global equities is starting to show its age. At this point in the cycle, inflation typically starts showing its ugly head. While we do think that inflation will continue to gradually rise over the long term it is not likely to happen over the forecast horizon. Global inflation is projected to start reaccelerating in 2008. This implies that central bankers could stay on the sidelines for a while but that the global tightening cycle is not over.

This will come as a major surprise for financial markets. The dominant view now is that the U.S. is experiencing a soft landing and that the Federal Reserve's (the Fed) next move is a rate cut. Equity markets are not likely to react very well to new rate hikes. Increased market volatility doesn't mean that the uptrend in global equities will be broken. It means, however, that equity markets are more likely to experience corrections in 2007. Hence, our overweight position in international equities against international bonds is still in place.

WORLD INFLATION

World CPI inflation & 12-month moving average



Source: Datastream

At current levels, global bond markets are very vulnerable to an unexpected reacceleration of inflation.

The outlook isn't as rosy for bond markets. At current levels, global bond markets are vulnerable to an unexpected reacceleration of inflation that would eventually convince central bankers to start hiking rates again. Bond market fluctuations are driven by expectations about future inflation not by what happens to current inflation. Prospects of a reacceleration in inflation in 2008 will hit

bond markets this year. With U.S. markets now discounting significant rate cuts, bond returns are likely to be very disappointing in 2007. However, the outlook is somewhat rosier for Canadian bonds. The fact that the Bank of Canada (BoC) is the only central bank expected to lower interest rates implies that Canadian bonds are likely to outperform non-Canadian bonds. Nonetheless, we are likely to consider eliminating our overweight Canadian bonds position if the yield curve inversion becomes more pronounced in the weeks to come.

Risks:

Global Slowdown: More pronounced U.S. consumer slowdown is caused by the lagged impact of high energy costs and a deeper housing contraction. Weakening U.S. demand eventually pulls the global economy down. This is the best case scenario for bonds but the worst case scenario for equities.

Stagflation: The global economy shifts into lower gear but global inflation resurfaces faster than expected owing to the pass-through of high energy prices and building cost-push pressures. Renewed inflation fears force central banks to resume their tightening campaign. The bear market in global bonds resumes and global equities are in for increased volatility.

Signposts:

- The global uptrend in food prices
- Global real estate prices
- Cost push pressures in the countries that are the most advanced in the business cycle such as the U.K. and Australia
- Japanese inflation

REGIONAL OUTLOOK

We expect slightly slower economic growth in all the world's major economic regions except Europe in 2007, and inflation will not be a major factor anywhere. However, due to the more synchronized nature of the economic slowdown, regional equity performance disparity will be modest.

Canada

Canada is now experiencing what the rest of the industrialized world has been experiencing since the start of the decade: an expanding service economy and a declining manufacturing economy. Since 2003, the Canadian manufacturing sector lost 202,000 jobs and the rest of the economy added 1.2 million jobs. The structural adjustments taking place in the manufacturing sector are increasing productivity and keeping a lid on inflation in the short term.

Our Canadian economic forecast calls for slower growth owing to a sizeable drag from net exports. Our 12-month projection stands at 2.0% - well below the consensus projection of 2.8%. However, we expect domestic demand to slow marginally from 4.2% to 3.8%, owing to slightly slower growth in consumer spending.

Our forecast calls for higher headline CPI inflation of 2.4% but stabilizing core inflation of 2.0%. However, even if core inflation stays in line with the BoC's implicit 2% target, the BoC still faces a dilemma. While the short-term inflation outlook remains benign, long-term capacity pressures are slowly building as unit labour cost inflation is running above core inflation - that is, at approximately 2.6%. In our view, the projected slowdown in domestic demand won't be sufficient to curb wage inflation.

Having said this, capacity pressures won't be strong enough to influence long-term inflation expectations. Long-term inflation expectations will remain well anchored. This means that the Canadian yield curve will stay flat and could continue to flatten - albeit modestly. Canadian bond returns will be very disappointing, possibly underperforming cash for the first time since 1999.

The BoC has a lot of leeway regarding its interest rates. If the economy slows more than expected, the BoC could choose to lower its interest rate a notch or two. In our main scenario, we expect the BoC to cut its rate to 4.00% in the middle of the year. However, this would not mark the start of a full-blown easing cycle. Eventually rate hikes will be back on the BoC's agenda, but at this juncture, there is a risk of going overboard in the amount of easing required in 2007.

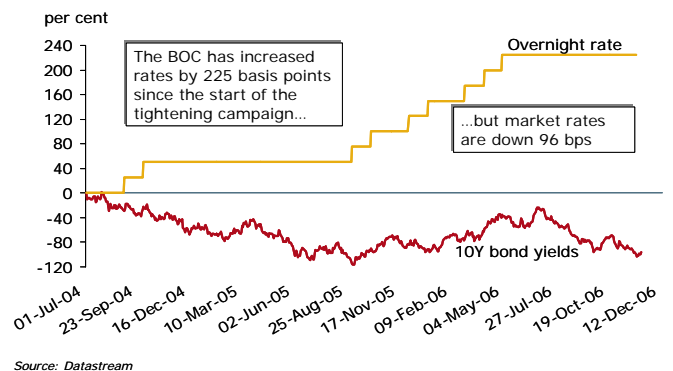
United States

Overall, our U.S. real GDP growth forecast for 2007 calls for a slowdown from 3.20% to 2.25% - the slowest pace since 2003. We project below-trend growth for U.S. consumer spending of approximately 2.0%, owing to slowing employment growth and the consumer's desire to start saving more. The slowdown in consumer spending will translate into weaker import growth. Exports should benefit from the depreciation of the currency and solid foreign demand. Residential spending will shave 0.27% off GDP growth and inventories will reduce the GDP by 0.34%. We expect core inflation to stay at around 2.8% in 2007, while overall inflation will rise to 2.8% due to an increase in energy prices.

What will the Fed do in the scenario? The projected stabilization of core inflation over the next year means that the Fed could stay on the sidelines for a very long time, leaving the impression that the tightening cycle is over. Our forecast calls for the Fed Funds rate to remain unchanged for most of the forecast horizon. However, we expect the Fed to resume its tightening campaign in the second half of 2007, hiking the Fed Funds rate by 25 basis points to 5.50%.

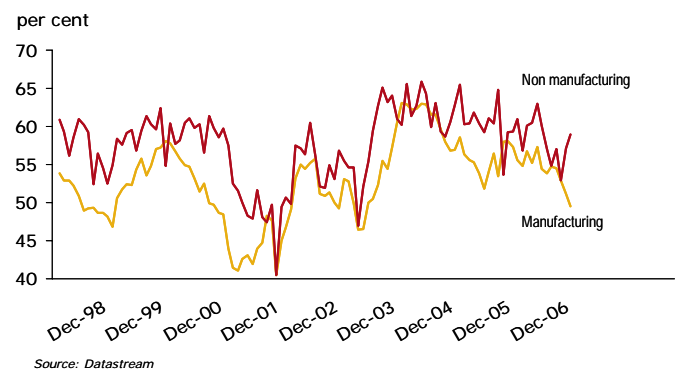
BOC: NO IMPACT ON MARKET RATES

Cumulative increase in the overnight rate vs. 10-yr bond yields



U.S.: MIXED SIGNALS?

U.S. ISM business conditions: manufacturing vs. non manufacturing



Europe

In contrast with the consensus view, our forecast does not call for a pronounced slowdown of Europe's economy next year. Real GDP growth should stay at around 2.0% in 2007. Despite the European Central Bank's (ECB) tightening efforts, financial conditions have continued to ease in Europe. Equity prices have climbed roughly 20%, government 10-year bond yields remain historically low and home prices are still increasing. In such an environment, it is not surprising that domestic demand growth has been gaining momentum. The only uncertainty is the impact of the 3% rise of the value-added tax (VAT) in Germany at the start of 2007. Our view remains that domestic demand in Europe should remain strong, growing at 2.1% in 2007. On the other hand, net exports will act as a significant drag on Europe's GDP growth.

Japan

The Japanese economy seems to be on more solid footing compared to the last 10 years. Real GDP is still growing at a 2.65% yearly pace, fueled by export and capital spending. Our forecast calls for 2.5% real GDP growth in 2007 compared with a consensus forecast of 2.2%

Thanks to the continued depreciation of its currency, Japan has gained market share against most of its trading partners. Japan's trade surplus is widening against the U.S., Europe, and most of Asia, particularly Korea but has a small trade deficit with China. Fundamentals for the yen are sound. On top of the trade surplus, Japan has a huge income surplus. Yet the currency continues to weaken owing to unfavourable short-term interest rate differentials with the other major trading blocks of North America and continental Europe.

At this juncture, what the Bank of Japan (BoJ) does next will play a crucial role. The Bank of Japan will only increase short-term interest rates if inflation returns. In our opinion, Japanese inflation is indeed heading higher. Our forecast calls for 1.5% headline inflation and core inflation at 0.5%. As a result, the BOJ will gradually hike rates by 75 basis points but this will be a very slow process.

The behaviour of Japanese bonds and stocks in 2006, particularly the 4% correction in stock prices, was consistent with the modest deceleration in economic activity and the deceleration in inflation. Our forecast calls for better equity performance in 2007, as employment conditions continue to improve supporting domestic consumption. Meanwhile, a competitive currency will support the large exporting companies that form an important component of the Tokyo Stock Exchange.

China

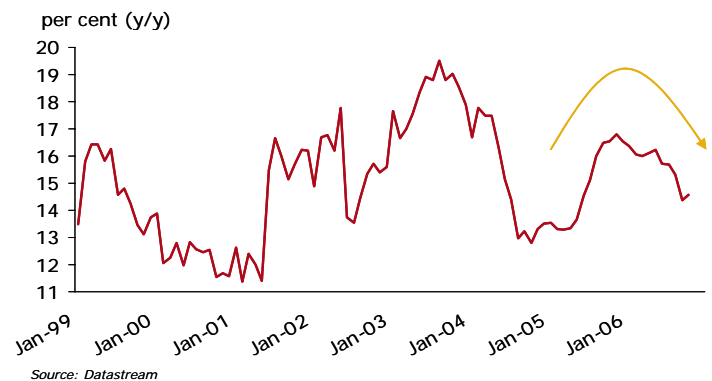
China's monetary conditions will continue to tighten, slowing the Chinese economy to 8.5% in 2007 from 10% in 2006. Contributions to growth from business investment and trade will decline in 2007, but will be partially offset by an increase in consumer spending and improvement in China's terms of trade due to weaker energy prices.

Cost-push pressures won't become apparent in China. Per capita disposable incomes have been rising consistently at 10% annually. However, rising wages are not translating into rising prices because wage inflation is more than offset by the rise in productivity. In fact, Chinese unit labor costs are still declining. As long as this trend continues, a sharp rise in inflation will be hard to foresee.

Chinese CPI inflation is likely to gradually rise from 1.2% to 2.5% at the end of 2007, with core inflation reaching 1.7% in 2007. Inflation will essentially be concentrated in non-tradable goods and services.

CHINA: CLOSING THE LIQUIDITY TAP?

Chinese money supply growth (year over year)



Risks:

Global Slowdown: If weakening U.S. demand knocks the rest of the world down, a trend reversal in commodity prices will unfold, leaving emerging markets in a vulnerable position. On the other hand, net energy importers (Asia and Europe) will experience a positive term of trade shock.

Signposts:

- U.S. unemployment rate rising above 5%
- U.S. non-manufacturing index falling below 50%
- U.S. core goods deflation
- Japanese unit labor cost inflation moving into positive territory
- European employment growth
- Chinese domestic retail sales

CURRENCY

We have a neutral outlook on the trade-weighted U.S. dollar over the next twelve months as global imbalance adjustments continue to unfold at a snail's pace.

The deterioration in the U.S. current account deficit is unlikely to worsen much more given booming exports, slowing imports and improving fiscal conditions. Domestic demand growth in the euro area should remain encouraging on the back of favorable employment conditions. In addition, while the pace of Japanese domestic economic growth remains disappointing, there are early signs that consumer spending is about to pick up later in 2007. A stable U.S. dollar is necessary for this adjustment process to continue. In the first quarter of 2007, the U.S. dollar should continue to grind higher versus the euro and the British pound as the worst of the U.S. economic slowdown is over.

In our analysis of currencies, we look at domestic demand to try to predict central bank policies since future interest rate differentials between countries are key drivers of relative currency performance. In the U.S., the housing downturn appears to be stabilizing as mortgage applications are rising and existing home sales have hit bottom. In addition, retail sales are softening but the pace of the decline is not worrisome given robust employment conditions and stable consumer confidence.

In most of Europe, economic growth should decelerate somewhat as most leading economic indicators appear to have peaked. The implication is that interest rate expectations in Europe will need to be revised lower over the next three to six months. At the same time, we expect interest rate expectations in the U.S. to remain firm supporting a stronger U.S. dollar.

Technical conditions also point towards a near-term rally in the U.S. dollar: momentum for the currency is positive and investor sentiment is excessively pessimistic. Even indicators from the options market suggest that speculators and money managers are becoming too complacent about a falling U.S. dollar. This tends to be bullish for the currency.

Risks:

Global Slowdown: Slowing economic activity in the U.S. will not, on average, undermine the U.S. dollar. First, it is already largely discounted, with the Fed expected to lower interest rates by 0.5 percentage points. Second, abundant global liquidity will help sustain capital inflows. Finally, the U.S. trade imbalance will continue to correct. Commodity-sensitive currencies will depreciate in this environment. Asian currencies will be less affected because valuation remains attractive and the Chinese economy will continue to provide a firm anchor. The euro should outperform in this scenario. The European economy will be less impacted by a global slowdown and the ECB will be slow to ease monetary conditions.

Stagflation: In this scenario, risk aversion rises to a new cyclical high and capital flows become more volatile. Countries with large current account deficits will experience funding issues. These include the U.S., the U.K., Australia, and New Zealand. Tightening liquidity will also undermine the Japanese yen because the interest rate gap will widen. Asian currencies will be more volatile because China may rethink its policy of gradual appreciation against the backdrop of a weaker economy. European currencies tied to the euro remain a good bet. Most European central banks have indicated plans to further raise interest rates in 2007.

Signposts:

- Energy and non-energy commodity prices
- Divergence/convergence of central bank policies
- Domestic demand in China
- The U.S. current account balance

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