



For the quarter ending
December 31, 2007

EXPECTED RETURNS

| For the 12 month period ending December 31, 2008 | In Canadian Dollars | | | In Local Currency | | |
|--|-------------------------|--------------------|----------------------|-------------------------|--------------------|----------------------|
| | Economic Rebalancing | Growth Surprise | Deflationary Bust | Economic Rebalancing | Growth Surprise | Deflationary Bust |
| Probabilities | 50.0% | 25.0% | 25.0% | 50.0% | 25.0% | 25.0% |
| Canadian Money Market | 4.0% | 4.4% | 3.6% | 4.0% | 4.4% | 3.6% |
| Canadian Bonds | -2.1% | -3.8% | 6.2% | -2.1% | -3.8% | 6.2% |
| International Bonds | -1.2% | -8.5% | 17.0% | 1.5% | -1.2% | 10.4% |
| Canadian Equity | 6.6% | 6.0% | -10.9% | 6.6% | 6.0% | -10.9% |
| U.S. Equity | 7.6% | -4.4% | -0.7% | 10.7% | 2.6% | -9.9% |
| International Equity | 5.2% | -2.1% | 0.7% | 7.2% | 4.0% | -4.1% |
| Emerging Market Equity | 11.5% | 8.2% | -3.4% | 10.4% | 7.9% | -11.1% |

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Global Environment

Monetary policymakers are working hard to alleviate tensions in the financial system.

Fixed Income vs. Equity

We are maintaining our positive bias towards equities and our underweight bias vis-à-vis fixed income.

Regional Outlook

The economic growth decoupling between the U.S. and the rest of the world could abate during the forecasted period as the U.S. slowdown could also be accompanied by a growth slowdown in other parts of the world.

Currency

We believe 2008 may be defined by two distinct trends in the U.S. dollar. The first half of 2008 should see a continuation of the U.S. dollar's cyclical decline followed by a rise in the second half of 2008.

GLOBAL ENVIRONMENT

Dark clouds continue to hang over global financial markets, and investors have good reasons to be nervous. The longer the credit squeeze lasts, the greater the odds of a significant slowdown in economic activity.

However, global monetary policymakers are working hard to alleviate tensions in the financial system. Since August, the U.S. Federal Reserve (the Fed) has led the way by cutting the federal funds rate by 100 basis points. Other central banks, including the Bank of Canada (BoC) and the Bank of England, have followed suit, in an effort to provide liquidity. In a coordinated action with other central banks, the Fed recently announced that it would establish a Term Auction Facility, a program that will offer tens of billions of dollars to banks in short-term loans, in a further attempt to ease the credit crunch and address liquidity problems in the interbank lending market.

The recent acceleration in global inflation, particularly in Asia ex-Japan where it moved from 3% to over 5% in the last year, is making life more difficult for central banks. On the one hand, a failure to alleviate tensions in the financial system could raise the odds of a Japanese-style deflationary bust. On the other hand, persistently high prices could unsettle inflation expectations, leading workers and businesses to factor higher inflation into wage and price-setting decisions.

In the past, central banks had more success in fighting inflation than in dealing with deflation. Accordingly, the priority for policymakers is to ensure that credit availability does not become a problem. Already steps to support the economy and help stabilize credit markets are gaining momentum and interest rates have started to decline – particularly when adjusted for inflation. However, interbank lending rates may remain elevated until the full impact of the credit crunch on the banking system's balance sheet becomes more transparent. If history is any guide, such a crisis is ultimately met by an injection of liquidity from central banks by lowering real interest rates. Moving into the second half of 2008, the global economy could feel the full impact of these reflationary policies and extend the economic cycle.

FIXED INCOME VS. EQUITY

In the U.S. the housing market correction is without doubt a massively deflationary event. As the domestic economy starts cooling down, inflation should continue to move lower, opening the door for additional Fed rate cuts. In many ways, this is reminiscent of the aftermath of the 2001 global recession when, despite the Fed's repeated efforts, the economy remained stuck in the doldrums and inflation decelerated rapidly. Between 2002 and 2003, deflation was perceived as the most serious threat and coincided with the worst equity bear market since the early 1970s.

Mired in deflation since 1990, Japan serves as the prime example of a deflationary bust. When deflation sets in, the behavior of financial markets changes drastically. In the 1990s, the price of real estate in Japan tumbled and Japanese equities entered their longest bear market ever. Japanese equities are still trading well below the peaks of 1990. At the same time, Japanese bonds have done remarkably well. In this type of deflationary environment, cash becomes a very attractive asset class.

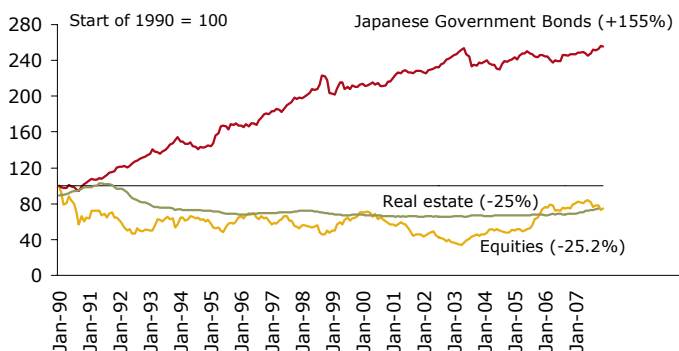
For a deflationary bust scenario to materialize a number of developments are required:

- A multi-year downtrend in real estate prices;
- Consumers who stop spending (i.e. deteriorating balance sheet and weakening fundamentals);
- Inflation turning into deflation;
- A central bank that falls behind the curve as market participants anticipate the Federal funds rate to decline much more than the current level;
- A deflationary global environment.

In our view, these features do not exist in the current environment. The Fed has already lowered short-term interest rates by 100 basis points, lowered the discount rate, and provided liquidity to the financial system via the new Term Auction Facility. In contrast, in early 1990, the Bank of Japan kept interest rates high following the Japanese real estate bust. The decline of long-term interest rates and the U.S. dollar provide additional economic stimulus and reduce the risk of a deflationary scenario. We believe the main economic risk should subside around the middle of 2008. At that point, U.S. fixed income yields should start rising in anticipation of better economic times. With undemanding equity valuation, stock prices should reestablish their uptrend from the current prevailing trading range. As a result, we are maintaining our positive bias towards equities and our underweight bias towards fixed income.

FINANCIAL MARKETS BEHAVIOR IN A DEFLATIONARY BUST

Japanese assets: home prices, equity and bond total returns



Source: Datastream

Risks:

Growth Surprise: As the business cycle matures, it could become increasingly difficult for the Bank of China to contain money growth via credit controls alone. Sooner or later, the Chinese currency will have to appreciate at a much faster pace, exerting inflationary pressures globally.

Deflationary Bust: If the credit squeeze lasts too long, clogging the pipes of the global financial system despite the aggressive easing efforts currently deployed by the central banks, it could mark the start of a deflationary bust. This is the best-case scenario for global bonds but the worst-case scenario for global equities.

Signposts:

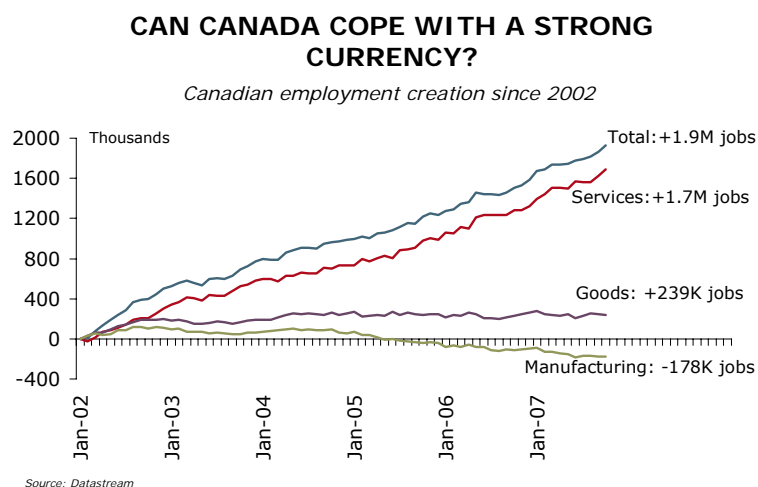
- The speed of ascension of China's currency
- Fed policy
- The relative performance of bank shares
- Interbank lending rates
- The U.S. unemployment rate rising above 5%
- The extent of the U.S. home price correction
- Canadian core inflationary pressures
- Gold's relative performance
- Chinese CPI inflation

REGIONAL OUTLOOK

The world is moving into the last stage of the global rebalancing theme we have been forecasting. A weaker U.S. consumer, an improving U.S. current account surplus, the awakening of the Chinese consumer, and a stronger Chinese currency, characterizes this stage. The economic growth decoupling between the U.S. and the rest of the world could abate during the forecast period as the U.S. slowdown could also be accompanied by a slowdown in growth in other parts of the world. While the U.S. hasn't felt the full impact of the recession in housing activity yet nor its resulting impact on slowing the U.S. economy, the sharp appreciation of the euro seems to be putting a damper on consumer and business confidence in Europe, which could be pointing towards a European growth slowdown. Japan continues to experience disappointing consumer demand, while more aggressive tightening measures in China are aimed at cooling its red-hot economy.

Canada

Since the Canadian dollar started its appreciation in 2002, consensus projections turned gloomy every time the currency's climb intensified. Canada previously experienced two such "growth scares" – once in late 2003 and again in early 2006. The BoC lost conviction both times, cutting rates the first time and moving on the sidelines the second.



So far, the current episode hasn't been much different. Tight credit conditions, an intensifying manufacturing slowdown and short-term inflation deceleration have convinced the BoC to ease policy, keeping interest rates at low levels.

In turn, low interest rates are fueling Canada's red-hot service economy leading to an exceptional economic expansion. Since 2002, 178,000 jobs have been lost in the manufacturing sector, while 1.7 million jobs have been created in the service sector. Given the relative importance of services in the Canadian economy and the strength of the employment market, we do not project that GDP growth will cool significantly. Both headline and core inflation

could decelerate below 1.0% over the coming months, and reaccelerate later.

The longer-term picture is unchanged. The Canadian economy is overheating and inflation concerns could resurface at some point next year, forcing the BoC to resume its tightening campaign.

United States

Given the intensity of the credit squeeze, recession fears have increased substantially in the U.S. However, the odds that the U.S. economy will actually experience a severe contraction have dropped owing to the pronounced easing in monetary conditions. The Fed has been aggressively cutting interest rates since September by lowering the Fed Funds rate by 100 basis points. Typically, an economic downturn is nearly over by the time the central bank starts seriously cutting interest rates.

We believe that weaker home prices combined with lower mortgage interest rates should allow for an improvement in housing affordability in the first half of 2008 providing support to consumer spending. A weaker U.S. dollar should benefit net exports thereby providing a boost to the U.S. economy while a low level of inventories supports industrial production.

Europe

Over recent months, Europe's financial sector has been under severe pressure, with the stock prices of many European banks getting hit just as hard as U.S. ones. However, in sharp contrast with the Fed, the European Central Bank (ECB) has kept interest rates unchanged since June 2007. The current ECB policy is adequate for most European Union members, but way too tight for the weaker economies, specifically those of Southern Europe. This policy is causing a rising divergence in economic performance between southern and northern Europe. This problem is likely to persist with Italy, France and Portugal looking particularly vulnerable.

The Italian economy is in especially bad shape, particularly its fiscal situation. Its deficit accounts for nearly 4.0% of GDP and accumulated debt represents more than 100% of GDP. Unfortunately, the weakness of the Italian economy isn't helping. Italian leading indicators have been contracting since the start of the decade, and since 1998 Italy has been trailing the rest of Europe. Past tightening by the ECB is hurting the Italian economy and real rates are too high for Italy's fragile economy.

With European inflation still above the ECB target of 3.1%, and with money supply still growing at a strong level, we expect the central bank to keep its tightening bias. A change in its stance will require further weakness in economic activity. However with unemployment at historical lows supporting the consumer, we don't expect interest rates to be cut in the near term.

Japan

Leading indicators are signaling a slowdown in Japanese economic activity. Recent business sentiment surveys indicate a decline in optimism as prices of oil and raw materials continue to climb, putting downward pressure on profit margins. Consumer sentiment has declined, partly due to the recent deterioration of the employment market and the stagnant growth in wages. Prices of some consumer goods, such as food and gas, have also increased, translating into lower purchasing power for consumers.

The Japanese economic downturn in construction activity has also intensified. Housing starts are down 58% from the levels of a year ago – the sharpest annual drop on record. This drop was triggered by the enactment of a revised building standards law. It is estimated that the introduction of the new regulations under this law could lower GDP growth by as much as one percentage point in the short term. However, if

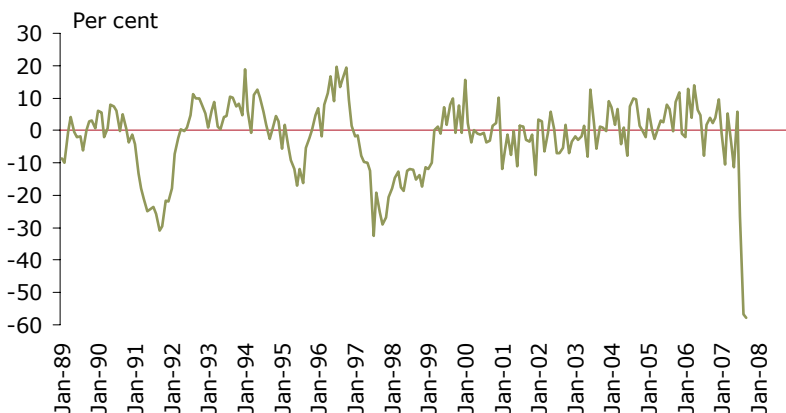
housing starts return to normal early in 2008 as projected, the drag from housing won't last long.

Downside risks to the Japanese economy should be concentrated at the start of 2008. Equity markets have already priced in the slowdown in growth.

For 2008 as a whole, our forecast calls for 2.7% real GDP growth in Japan. Our forecast also calls for 0.4% headline and core inflation over the year. With inflation returning positive, the Bank Of Japan might feel the need to continue to raise short term interest rates in order to bring monetary policy to a more normal stance away from the zero interest rates policy of the past decade.

SHARP FALLOFF IN HOUSING STARTS

Japanese housing starts (y/y, %)



Source: Datastream

China

Our baseline growth outlook for China has moderated from our last forecast mainly because of slower export growth caused by slowing global growth. Solid Chinese domestic demand and investment growth should continue despite recent measures to raise short-term interest rates. Real interest rates are still quite low. Until now, China has chosen to keep its currency undervalued in order to support its export sector. This choice has made China vulnerable to a global slowdown in growth since export growth has been a strong contributor to its growth over the last few years. With Chinese inflation at more than 6.0%, the Bank of China faces a daunting task. As the business cycle ages, it is becoming increasingly difficult for the Bank of China to curb inflationary pressures via credit controls alone.

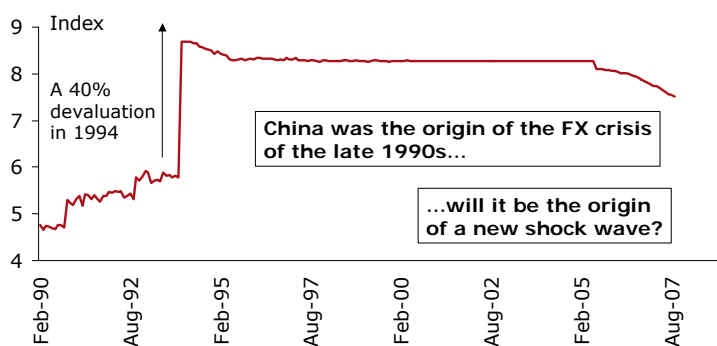
There are controls placed on lending by commercial banks. While direct rationing of commercial lending by commercial banks could continue to be an important part of China's tightening package, other more macro policies also need to be put to work, such as raising short-term interest rates and letting the Chinese currency float more freely from a very undervalued level. However, too many interest rate hikes could slow down the purchasing power of Chinese consumers counter to China's objective to get a stronger contribution to growth from the consumer sector.

In our view, the only alternative is to let the Chinese currency appreciate at a faster pace.

There are signs that this process may already have begun, as the rate of appreciation of the yuan shows signs of acceleration versus the U.S. dollar. This process could translate into higher U.S. import prices and complicate the Fed's attempts to manage the U.S. economy out of its real estate slump.

CHINA: ANOTHER FX SHOCK?

Chinese bilateral exchange rate



Source: Datastream

Risks:

Deflationary Bust: The potential failure of the Fed to alleviate financial tensions, created by the sub-prime market fallout, could create a more deflationary environment. In turn, weakening U.S. demand could drag down the economies of the rest of the world, triggering a trend reversal in commodity prices while seriously challenging the bull market in emerging market equities.

The negative impact on China would be felt through its export sectors which are strong contributor to job growth. Slower job growth could be very destabilizing to the existing government.

Growth Surprise: A quick resolution of the credit crunch would leave current monetary policy extremely stimulative leading to stronger-than expected economic growth. This scenario would put additional pressure on Chinese authorities to let their currency appreciate faster to alleviate potential domestic inflationary pressures. Fears of spreading inflation would have the most detrimental impact on fixed income investments as the current level of interest rates do not price in any risk of inflationary pressures.

Signposts:

- U.S. retail sales
- U.S. initial claims / employment reports
- Bank of China tightening policy
- Chinese loan growth restrictions
- Oil prices
- Agricultural prices

CURRENCY

The defining feature of 2007 was the steady decline in the U.S. dollar, with only short-lived rallies. We do not foresee such a straight-line trend in 2008. Rather, we believe 2008 may be defined by two distinct trends in the U.S. dollar. The first half of 2008 should see a continuation of the U.S. dollar's cyclical decline followed by a rise in the second half of 2008.

The Fed has not yet finished easing. Meanwhile, other major central banks are lagging the Fed's reflationary efforts. While the Bank of England and the BoC have eased rates by 25 basis points, they have not kept pace with the Fed's 100 basis point reduction. Moreover, other central banks, such as Australia's and Norway's, have continued to tighten and the ECB is on hold.

A divergence in monetary policies should continue in the first half of 2008 and keep the U.S. dollar under pressure. In fact, a classic U.S. dollar "undershoot" may be about to unfold which could see the euro soar towards 1.60(US). In 2000/2001 the euro collapsed towards 0.80, during a dollar "undershoot", the exact reversal of what we anticipate. The second half of 2008 could see the U.S. dollar stage a recovery as the cyclical downturn in the U.S. is discounted by financial markets and the Fed's easing cycle nears an end. Investors should be looking beyond the valley of the cyclical downturn to an eventual recovery in the U.S. economy, which as usual will lag the Fed's reflationary efforts.

It should be another good year for the Canadian currency in 2008. The Canadian economy is strong. Consumer spending should continue to grow at an encouraging pace, given favourable employment and earnings conditions. Investment spending should also remain a key engine of growth. This year's 25 basis points interest rate cut by the BoC, as insurance against a significant U.S. economic slowdown and as a response to a benign domestic inflation backdrop, will only add fuel to already encouraging domestic demand growth. In addition, our forecast calls for a U.S. economic recovery in the second half of 2008. This will support Canada's beleaguered export sector and sustain the uptrend in commodity prices.

We remain positive on emerging market currencies, especially those of Asia. As living standards in Asia rise towards Western levels, there is enormous upside pressure on Asia's real exchange rates. It is becoming evident that Asian policymakers cannot indefinitely forestall an appreciation in their real exchange rates. With inflation moving to uncomfortably high levels, they will need to allow a greater appreciation in their nominal exchange rates. China could take the lead in the appreciating trend. China's inflation rate has accelerated to an eleven year high of 6.9% year-to-year. After allowing for an almost 6% appreciation in the renminbi in 2007, we expect the inflation rate pace to quicken to 10% in 2008.

Risks:

Growth Surprise: In this scenario, risk-aversion remains low and the trading between currencies based on interest rates continue to be a major underlying theme. The U.S. dollar could underperform relative to commodity-sensitive currencies and remain fairly neutral versus the euro. Asian currencies could continue to see upward pressure to cool inflationary pressures.

Deflationary bust: The biggest risk to our core view is a slow-moving Fed that pushes the U.S. economy into recession, leading to sub-par global growth or even a global recession. This could lead to the following developments:

1. Rising U.S. real interest rates (as inflation falls in a recession), narrowing current account deficit (as U.S. imports contract), and increasing risk aversion should see the U.S. dollar strengthen broadly.
2. Commodities and commodity currencies could decline sharply with a U.S.-led global downturn.

Signposts:

- Energy and non-energy commodity prices
- Bank of China policy
- Divergence/convergence of central bank policies
- Domestic demand in China
- U.S. interbank lending rate
- The U.S. current account balance
- U.S. existing home prices
- U.S. employment growth

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