



For the quarter ending
June 30, 2007

EXPECTED RETURNS

For the 12 month period ending June 30, 2008	In Canadian Dollars			In Local Currency		
	Economic Rebalancing	Global Slowdown	Growth Surprise	Economic Rebalancing	Global Slowdown	Growth Surprise
Probabilities	55.0%	30.0%	15.0%	55.0%	30.0%	15.0%
Canadian Money Market	4.5%	4.1%	4.7%	4.5%	4.1%	4.7%
Canadian Bonds	3.3%	9.8%	0.3%	3.3%	9.8%	0.3%
International Bonds	0.2%	18.5%	-8.1%	1.1%	10.7%	-1.9%
Canadian Equity	5.8%	-3.5%	2.1%	5.8%	-3.5%	2.1%
U.S. Equity	8.2%	7.5%	-6.9%	9.8%	3.2%	-0.9%
International Equity	9.9%	6.6%	-3.8%	11.9%	0.5%	3.6%
Emerging Market Equity	15.0%	4.3%	2.7%	12.2%	-0.3%	1.6%

In this Issue

Global Environment

Liquidity remains plentiful but central banks are slowly draining it out of the global financial system.

Fixed Income vs. Equity

While the bull market in equities has further to run, bonds are still in the early stages of a bear market. We are staying overweight in equities and underweight in fixed income.

Regional Outlook

We expect increased divergence in regional equity returns. Country selection will play a key role in portfolio returns.

Currency

While the recent rise of the loonie is impressive, the fundamental underpinnings of our currency remain solid.

GLOBAL ENVIRONMENT

The scenario we envisaged in our projections one year ago is slowly materializing. The Federal Reserve (the Fed) has been on hold for 11 consecutive months. But the other major central bankers - the European Central Bank (ECB), the Bank of China, the Bank of Japan, and the Bank of England - have continued to tighten their monetary policy stance. Over the last year, 24 central banks have hiked their short-term interest rates.

Despite all these efforts, it is fascinating to see how slowly global monetary policy is tightening. Adjusted for inflation, global short-term interest rates stood at 1.72% a year ago, and today they average only 2.14%. Moreover, half of this tightening is the direct result of a decline in global inflation. Monetary policy is judged to be restrictive when real interest rates move above the growth potential of an economy. Since for most countries real growth potential is above 2.5%, the current level of real interest rates does not indicate a tight global monetary stance. In short, global monetary policy remains accommodative.

What's even more striking is the sharp contrast between the emerging countries versus the industrialized countries. So far, monetary tightening has been entirely concentrated in the industrialized countries. Not only have interest rates remained unchanged in emerging countries as a whole, nine emerging countries have instituted rate cuts. So while the liquidity tap is slowly closing in the industrialized countries, it remains wide open in the emerging countries - particularly in emerging Asia. For example, China's real interest rates are near zero while real economic activity is powering at around 10%. This accommodative stance continues to be supportive of economic activity as long as global inflation remains within the comfort zone range stated by central banks. For the Fed, that means inflation between 1% and 2%. The global environment remains supportive for capital markets. However, divergences between regions and countries will become increasingly important to monitor.

FIXED INCOME VS. EQUITY

At this point in the cycle, selected equity markets remain favoured relative to fixed income. Price to earnings ratios are not at historically elevated levels despite the strong rise in equity prices because the rise in profits has been exceptionally strong. Levels of corporate profitability are now at historical highs supported by favourable productivity gains and good cost containment. We do not expect these solid fundamentals to deteriorate over the next six to twelve months, lending support to equity prices. On a more technical basis, based on a simple comparison with previous bull markets the uptrend in global equities should remain solidly in place over the coming year, justifying above benchmark exposure to equities during the last stage of the bull market in global equities.

This last stage of the bull market is characterized by increased market dispersion between global equity markets, potentially translating into a substantial contribution from relative country strategies to overall portfolio returns. This stage of a bull market in global equities is also typically characterized by a sharp rise in market volatility as the trade-off between growth and inflation becomes increasingly difficult to manage and uncertainty about monetary policy increases. This implies that the odds of a short-term correction exceeding 10% should rise as we move closer to the end of the decade.

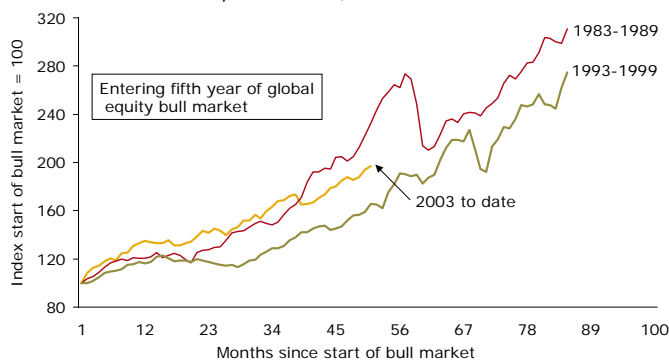
While we have long argued that the secular trend in global bond prices is down, we have also been maintaining that this recent uptrend should remain relatively mild. In our view, while we are still in the early stages of a bear market in bonds, markets have recently retreated too far too fast, opening the door for a counter-trend rally over the coming months. So, the short-term cyclical backdrop is turning increasingly positive for bonds thanks to abating global inflationary pressures.

The longer-term outlook for bonds is not positive. Given the abundance of liquidity we expect that the global tightening cycle is far from over as central banks will continue to slowly drain liquidity out of the system by gradually pushing short-term interest rates higher. From a valuation perspective, bonds still look expensive relative to our fair-value estimate based on short-term interest rates and inflation trends. Yield curves around the world are extremely flat, making it very difficult to favour bonds over cash. We remain underweight bonds.

Given the relatively bullish outlook for equities and bearish outlook for bonds, our overweight position in equities against bonds is still in place. Within U.S. equities, we continue to favour large capitalization stocks versus small capitalization stocks given their relative valuation attractiveness based on relative Price to Earnings, Price to Sales, and dividend yields. Globally-oriented large-cap stocks should outperform their smaller-cap domestically-oriented counterparts as we expect foreign economies to outgrow the U.S. economy over the next 12 months.

GLOBAL EQUITY BULL MARKETS

Global equities: 1983-89, 1993-99 and 2003 to date



Source: Datastream

Risks:

Growth Surprise: Inflation in China accelerates at a faster pace than expected, forcing the Bank of China to take more drastic measures to curb inflationary pressures. The sharp appreciation of the Chinese currency exerts upward pressures on inflation in the industrialized world via imported price inflation. Central bankers are quick to react. The bear market in bonds intensifies and equities show increased volatility.

Global Slowdown: A deeper housing contraction leads to a more pronounced U.S. consumer slowdown. 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.

Signposts:

- The global uptrend in food prices and its pass-through effects.
- Inflation in China and changes in their monetary policy stance.
- The impact of the U.S. housing recession on the American consumer.
- Cost-push pressures in the countries that are the most advanced in the business cycle, such as the U.K., New Zealand, Australia and the U.S.

REGIONAL OUTLOOK

We do not believe the global economic expansion scenario is at risk. World growth is projected to decelerate from 5.4% in 2006 to 4.9% over the next twelve months. In this scenario, the growth decoupling between the U.S. (2.8%) and the rest of the world (5.7%) intensifies. Meanwhile, global inflation is not expected to accelerate significantly.

Canada

In many ways, whether the Bank of Canada (BoC) hikes interest rates over the coming months is not particularly relevant for the domestic economic outlook. Higher short-term rates would fuel the rise of the Canadian currency, but the impact on long-term interest rates would likely be negligible. In recent years, it has become clear that it is global forces, not domestic ones that drive fluctuations in the Canadian bond market. So what happens to global bond markets is more relevant than what happens to the BoC intervention rate.

It is also becoming clear that the global environment is changing. As the global business cycle starts showing its age, upward pressures on global real interest rates are intensifying. Canada is not exempt. Assuming that long-run inflation expectations stay well anchored at 2.5% and real yields at 2.3%, nominal Canadian 10-year bond yields should reach 4.8% by the middle of 2008.

Our Canadian GDP growth forecast calls for the continuation of the current export-led slowdown, with GDP growth modestly accelerating from 2.3% to 2.5% in 2008. Domestic demand should stay relatively strong.

Our forecast calls for a rise in headline CPI inflation to 2.8% but slightly milder core inflation at 1.8%.

United States

The U.S. economy is bottoming out, but we believe the recovery will be softer than generally expected. Real GDP growth should reach only 2.8% by the end of the forecast horizon.

Housing is at the heart of the problem for the U.S. economy. Activity in the housing sector has contracted by 30% since the summer of 2005. The U.S. housing recession, as exemplified by continued price declines and high inventories is now in its last stretch. The recent rise in bond yields will further delay the recovery in housing, particularly due to an increasing amount of variable rate mortgages coming due. This will offset the improvement in affordability as a result of the recent decline in residential home prices.

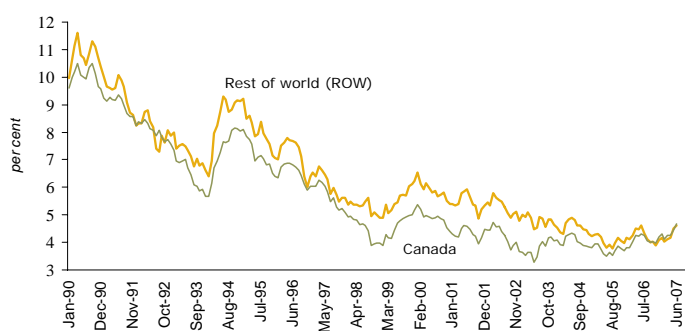
However, given the historically high levels of home inventories, construction activity will remain depressed. Employment in the construction sector could be the next spanner in the works. Only 28,000 construction jobs have been lost so far in the U.S., however, when viewed based on previous cycles, construction employment should be down by 400,000.

All in all, economic growth in the U.S. should remain below average, resulting into a widening output gap, which should translate into decelerating core CPI inflation. CPI inflation is projected to drop to 1.9% over the next twelve months. Core CPI inflation should fall to 2.0% over the same period.

In this scenario, the Fed should remain on the sidelines, but our 12-month target for U.S. 10-year bond yields now stands at 5.50% owing to rising global real yields.

GLOBAL FORCES PREDOMINATING

Canadian 10-year bond yields vs. Rest Of The World 10-year bond yields



Source: Datastream

Europe

Over the last year, the European economy has been a top performer. In the industrialized countries, only Australia, and the U.K. as distinct from the European Union, have grown at a faster clip. This pick-up in growth momentum has been accompanied by a reacceleration in inflation. The EU GDP deflator is revealing that inflation is reaching new highs. This is being reflected in headline CPI inflation which is now exceeding 2.0% in seven European countries and inflation is strongly accelerating in nine European countries.

The acceleration of inflation is not surprising. Liquidity is too abundant in Europe. Since the ECB began raising short-term interest rates, longer-term market rates have been offsetting the tightening efforts. Since the end of 2005, administered short-term rates have been increased by 175 basis points but longer-term rates are only up by 104 basis points. More importantly, most of the increase in these longer-term rates has taken place over recent months. To have a slowing impact on the economy, yields will have to stay higher for a longer period.

Our forecast calls for a modest slowdown of Europe's economy next year. Real GDP growth should stabilize at around 2.5% in early 2008 when European headline inflation could reach 3.0% while core inflation should rise to 2.1%. This forecast implies that the ECB tightening campaign is not over. More rate hikes are projected. Trading at around 4.48%, 10-year European bond yields are still a long way from fair value.

Japan

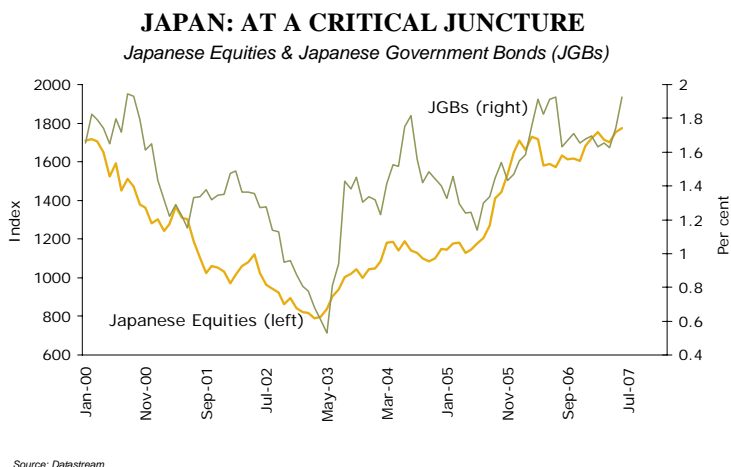
Since the start of the year, the performance of the Japanese economy has been disappointing. However, one needs to put things in perspective. Since 2005, the economic landscape in Japan has significantly changed:

- The expansion of the economy is now in its second year.
- Excluding a few pockets of severe deflation, inflation is back into the system.
- The Japanese yen is depreciating against the Chinese yuan.
- Real yields are slowly increasing.
- Japanese equities appear to be in the first phase of a bull market.

While the structural backdrop is slowly improving, Japan remains a very cyclical economy. This implies that fluctuations around the economic uptrend can be wide. Japan has recently experienced a cyclical downturn. In our view, a cyclical rebound is just around the corner.

As the global economic cycle matures, the convergence between Japan and the rest of the world will intensify, and it is just a matter of time before inflation becomes apparent in Japan's CPI. Over the next 12 months, headline inflation should range between 0.25% and 0.5% but core inflation, excluding food and energy, will remain flat.

The Bank of Japan's tightening campaign will be particularly slow and our forecast calls for an increase of 0.75% over the next 12 months. Since 2005, real yields have started moving up. The secular trend in real yields points to 1.5% inflation by the end of 2008. While long-term inflation expectations are expected to stay well-anchored at roughly 0.5% to 0.75%, this points to a fair value for Japanese Government Bonds (JGBs) ranging between 2.0% and 2.25%. There is very little upside for JGBs at current levels. Our 12-month target stands at 2.25% for 10-year JGBs. The tightening at the short end could translate into a continued but gradual flattening of the Japanese yield curve.

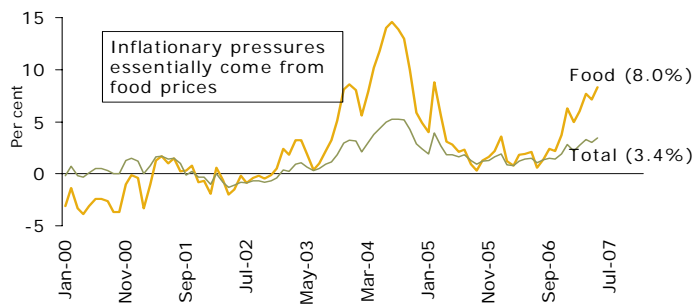


China

Sizzling equity prices, accelerating money supply growth and a ballooning trade surplus indicate one thing: Chinese monetary conditions are still too accommodative. With real interest rates close to historical lows, the Bank of China has a lot more work to do. The bulk of the adjustment is likely to be made via the exchange rate. The Chinese yuan will continue to gradually appreciate.

CHINA: FOOD INFLATION

Chinese CPI inflation: total vs. food



Source: Datastream

However, thanks to a very tame inflation outlook monetary adjustments are likely to be very gradual. Now at 3.4%, headline CPI inflation in China is likely to moderate somewhat over the coming months, reaccelerating to 4.0% by 2008.

As long as the adjustment on the monetary policy front remain gradual, China's economic expansion won't be in jeopardy. Our GDP growth forecast stands at 9.0% for the next twelve months.

At this point in the cycle, inflation is the main risk. An unexpected acceleration in Chinese inflation would have important implications for global financial markets:

- Faced with intensifying inflationary pressures, China's policymakers could decide to let their currency appreciate at a faster rate. India is a recent example of accelerated currency appreciation addressing domestic inflationary pressures.
- In turn, this could mean less forced buying of U.S. and European bonds from Asian central banks, implying rising real yields everywhere.
- This turn of events would accelerate inflation's return in Japan. This is a strong negative for JGBs in particular and global bond markets in general.
- In this context, it is not obvious that the U.S. bond market would be the hardest hit. Excluding China, the rest of the world could even become hungrier for U.S. Treasuries, leading to a superior performance of U.S. bonds.

Risks:

Growth Surprise: Europe, Japan and the rest of Asia could continue to grow at a stronger pace than currently expected. This outcome could force central banks to accelerate their tightening campaign, which would continue to push interest rates higher. This in turn would provoke increased equity volatility with a risk of a 10% + correction during the year.

Global Slowdown: If weakening U.S. demand knocks down the economies in the rest of the world, 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 labour cost inflation moving into positive territory
- European employment growth
- Chinese domestic retail sales

CURRENCY

The Canadian dollar remains in a long-term uptrend versus the U.S. dollar. The loonie is trading slightly above our long-term fair valuation calculation. Although on the expensive side, the currency is still far from its previous overvaluation extremes but is not far out of line when compared to the encouraging fundamental backdrop. Canada's current account and fiscal budget surpluses should continue to support the currency. In addition, the uptrend in energy prices remains in place which should continue to favour the currency over the next 12 months. On a shorter-term basis, the Canadian dollar could be subject to profit taking due to its strong recent advance. This would be consistent with the shorter-term technical picture which is over extended in terms of price movement. We would view such correction as temporary and not the start of a negative reversal of the currency's long term positive trend.

We are modestly negative on the trade-weighted U.S. dollar over the next twelve months, as U.S. economic growth continues to disappoint. 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 most of Europe, economic growth is encouraging as most leading economic indicators remain in an uptrend. The implication is that interest rate differential will continue to move in favour of Europe which does not bode well for the U.S. currency.

Global imbalance adjustment should also continue to weigh on the U.S. dollar. The deterioration in the U.S. current account deficit is unlikely to worsen given booming exports, slowing imports and improving fiscal conditions. Domestic demand growth in the euro area should remain encouraging due to favourable 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 sooner rather than later. A stable to weaker U.S. dollar is necessary for this adjustment process to continue.

Technical conditions should cushion a decline in the U.S. dollar. Momentum for the currency is positive and investor sentiment, usually a good contrarian indicator, is excessively pessimistic. Even indicators from the options market suggest that speculators and money managers are not concerned about a falling U.S. dollar. This tends to be bullish for the currency.

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 should underperform relative to commodity-sensitive currencies and remain fairly neutral versus the euro.

Global Slowdown: In this scenario, slowing economic growth in the U.S. and the rest of the world should, on average, undermine the U.S. dollar. The U.S. dollar should do well versus cyclical sensitive currencies like the Canadian, Australian and New Zealand dollars. However, we expect the U.S. dollar to underperform versus most European currencies, such as the euro and the Norwegian krone, as European central banks will be slow to ease monetary conditions. Asian currencies will be less affected because valuation remains attractive and the Chinese economy will continue to provide a firm anchor.

Signposts:

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

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