



For the quarter ending
March 31, 2007

EXPECTED RETURNS

For the 12 month period ending March 31, 2008	In Canadian Dollars			In Local Currency		
	Economic Rebalancing	Growth Surprise	Global Slowdown	Economic Rebalancing	Growth Surprise	Global Slowdown
Probabilities	55.0%	25.0%	20.0%	55.0%	25.0%	20.0%
Canada Money Market	4.1%	4.3%	3.8%	4.1%	4.3%	3.8%
Canada Bond	4.1%	1.8%	6.4%	4.1%	1.8%	6.4%
International Bond	-1.7%	-9.0%	12.9%	3.4%	0.8%	7.2%
Canada Equity	6.3%	2.1%	-2.9%	6.3%	2.1%	-2.9%
U.S. Equity	5.7%	-10.3%	6.5%	10.9%	-1.5%	4.2%
International Equity	6.6%	-10.1%	6.3%	12.5%	1.0%	0.7%
Emerging Market Equity	10.4%	-0.7%	-1.3%	12.7%	-1.9%	3.2%

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Global Environment

The dominant feature of 2007 is likely to be rising financial market volatility.

Fixed Income vs. Equity

At this point in the cycle, selected equity markets remain our favoured asset class relative to fixed income.

Regional Outlook

We expect economic growth to stabilize in the industrialized world over the next 12 months.

Currency

We expect to see the Canadian dollar back above 90 cents (US) before long.

GLOBAL ENVIRONMENT

When the decade started, the U.S. Federal Reserve (the Fed) lowered interest rates to historical lows to avoid a full-blown recession. This medicine did wonders, keeping U.S. consumer spending robust and vigorous. This shift to a low interest rate environment also marked the start of a number of secular trends:

- Widening trade imbalances between the U.S. and the rest of the world,
- A global real estate bull market;
- A commodity price uptrend;
- Canadian assets outperforming while U.S. assets underperformed;
- Superior performance of riskier assets such as emerging markets;
- The appreciation of cyclical currencies.

For the last few years, our global economic and financial projections have been gravitating around the "economic rebalancing" theme. This theme was essentially based on the assumption that the imbalances between the U.S. and the rest of the world had reached unsustainable proportions and that balance gradually had to be restored. Since the end of 2005 that is exactly what has been happening. The world has now reached the point in the cycle where the end of the rebalancing phase is within reach. When that point is reached, many of the trends enumerated above could be broken. In the meantime, these trends could flatten out as more and more market participants are likely to start challenging the consensus view that these trends will remain in place. In summary, the dominant feature of 2007 is likely to be rising financial market volatility.

FIXED INCOME VS. EQUITY

At this point in the cycle, selected equity markets remain our favoured asset class relative to fixed income. Since 2003, this strategy has been paying off as industrialized equities and emerging markets substantially outperformed fixed income.

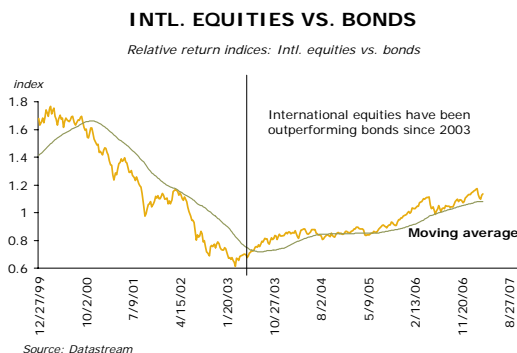
Financial markets are now concerned about the health of the U.S. economy and question if the U.S. economy will experience a soft landing or a hard one.

Many pundits fear that the downturn in the U.S. housing market combined with the sub-prime mortgage market issues will have a domino effect by pushing house prices lower further restraining bank lending, which will reduce consumer spending and result in pushing the U.S. economy into recession. Given that a severe contraction in U.S. economic activity could potentially jeopardize global economic expansion, the rest of the world is keeping a close eye on the U.S. In our view, fears of a severe U.S. consumption contraction are overblown. At this juncture, the danger lies in exaggerating the potential impact of the housing correction and the sub-prime mortgage market on the global economy and hence on financial markets. What we believe is occurring is that the U.S. economy is currently experiencing a mid-cycle slowdown, not a recession. As the economic slowdown unfolds, markets will remain jittery and 2007 could be a year of increased volatility.

Increased market volatility does not mean that the uptrend in global equities will be broken. It does mean that equity markets are more likely to experience short-term corrections and rebound in 2007. Hence, our overweight position in international equities against bonds is still in place.

Within U.S. equities, we continue to favour large capitalization stocks versus small capitalization stocks given the relative valuation attractiveness of large caps based on relative price to earnings, price to sales, and dividend yields.

At current levels, the basic forces in the bond markets are roughly balanced and the bond markets are likely to trade in a narrow range. On the one hand, the short-term cyclical backdrop is turning increasingly positive for bonds thanks to abating global inflationary pressures. On the other hand, there are increasing signs that the world economy is relatively unaffected by the U.S. mid-cycle slowdown. In this environment, most central bankers will have no choice but to stay on the sidelines as European and Japanese central banks will continue their slow and gradual monetary policy normalization by nudging short-term policy rates higher. These developments should keep global bond markets in a tight trading range throughout the year. From a long-term valuation viewpoint, bonds are not attractive. Around the world, yield curves are extremely flat, making it very difficult to favour bonds over cash.



Risks:

Growth Surprise: The global economy stays stronger than generally expected. As a result, global inflation resurfaces faster than expected owing to the pass-through of higher commodity 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.

Global Slowdown: More pronounced U.S. consumer slowdown caused by 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.

Signposts:

- The global uptrend in food prices. Food prices have a lot of influence on inflation. A temporary spike in food prices would not be a source of concern for central bankers. However, an uptrend would have an effect.
- 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 economic growth to stabilize in the industrialized world over the next 12 months. The world economy should grow at a 4.8% annual rate. In this scenario, the growth decoupling of the U.S. (3.0%) and the rest of the world (5.1%) intensifies. Meanwhile, global inflation is expected to decelerate from 3.0% in 2006 to 2.7% early in 2008.

Canada

As we projected, the Canadian economy has slowed substantially since 2004. Real GDP growth has declined from 3.6% to 2.3%. In terms of economic growth, Canada now ranks last within the G7 countries. While growth is decelerating in Canada, it is stabilizing in the U.K. and the U.S. and accelerating in Japan and Europe.

In Canada, the slowdown is essentially export-led. Domestic demand remains strong thanks to a low interest rate environment that is encouraging employment growth. But export growth has significantly weakened owing to the strong currency.

Canada still enjoys a wide trade surplus, but that surplus is entirely linked to energy. This imbalance in the contributors to growth makes Canada extremely vulnerable to an unexpected decline in energy prices.

This situation is making life difficult for the Bank of Canada (BoC). While the strength of the domestic economy warrants keeping interest rates at current levels, the weakness of the export sector points in the other direction. For the time being, all the BoC can do is to stay on the sidelines and keep a close eye on inflation.

Over the short term, inflation should not be a problem in Canada. Our forecast calls for a 1.5% rate for both headline and core inflation over the next 12-months. The long-term inflation outlook also looks encouraging.

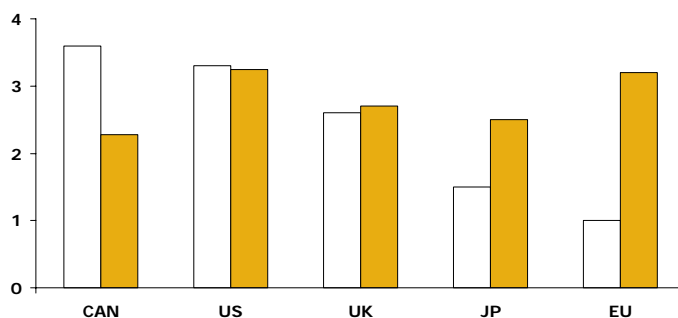
Canada is now experiencing what the rest of the industrialized world has been experiencing since the start of the decade: an expanding service economy but a goods-producing economy in contraction. The contraction in manufacturing employment reflects the fact that more output is produced with less labour – hence boosting productivity and helping to keep a lid on inflation. Since 2003, the Canadian manufacturing sector has lost 202 thousand jobs but 1.2 million jobs have been created in the rest of the economy.

With no inflation coming down the pipeline, the BoC has a lot of leeway. If the economy slows more than expected, it could choose to lower its intervention rate a notch or two. In our baseline scenario, the BoC cuts its overnight rate by 25 basis points to 4.00% in consideration of the low level of expected inflation. However, this would not mark the start of a full-blown easing cycle. Eventually, rate hikes could be back on the BoC's agenda because of increasing global inflation, but not over the forecast horizon.

The Canadian yield curve should stay inverted owing to well-anchored long-run inflationary expectations. With a policy gap forecast of 125 basis points, Canada-U.S. spreads will stay deep in negative territory. Our 12-month forecast calls for Canadian 10-year bonds at 4.16% in Canada vs. 4.75% in the United States.

CANADA: FROM FIRST TO LAST POSITION

G7 Real GDP growth: 2004 (white) vs. 2006 (dark)



Source: Datastream

United States

As widely expected, the U.S. economy is shifting into lower gear. Weakness is widespread. Previously confined to residential spending this weakness is now becoming apparent in consumer spending and non-residential investment. However, net exports are no longer acting as a drag. In short, the U.S. economy is in the midst of a mid-cycle slowdown.

At this juncture, the danger is of exaggerating the potential impact of the housing correction on the overall economy. The U.S. housing sector is entering the final stages of the correction implying:

- Continued price declines;
- Inventories drawdown;
- Improving affordability;
- An eventual rebound in activity.

A U-shape recovery is projected with real GDP growth bottoming at close to 2.0% but reaching 3.0% by the end of the forecast horizon.

However, the housing inventory overhang is likely to have important consequences on the inflation outlook.

Homebuilders are turning to the rental market to liquidate inventories – turning houses for sale into houses/apartments for rent. The sharp rise in homeowner vacancy rates is in turn pushing rental vacancy rates higher. After declining for two consecutive years (i.e. between 2004 and 2005), rental vacancy rates are rising again and are projected to rise further over the coming months. Currently, there are 3.8 million housing units for rent – accounting for 9.8% of all rented homes – this is close to a record high.

While the relationship between rental vacancy rates and inflation in the rents component of the U.S. CPI is a rather loose one, one finds that *rents* inflation tends to be low when rental vacancy rates are high and vice versa. Right now, rental vacancy rates are close to historical highs reached in early 2004, indicating that excess supply conditions already prevail. Needless to say, if a significant amount of unsold homes turn to the rental market the rental vacancy rate will rise substantially. However, even at current levels, rental vacancy rates are consistent with a drop in *shelter* inflation. Our research shows that *rents* inflation typically starts decelerating 10 months into the home price correction and intensifies afterwards. Headline CPI inflation is projected to drop to 1.9% over the next twelve months as year-over-year gains if energy prices moderate. Core CPI inflation could fall to 2.0% over the same period as the large inventory of unsold homes puts downward pressure on shelter and rents, the dominant component of core CPI in the U.S.

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 the forecast horizon.

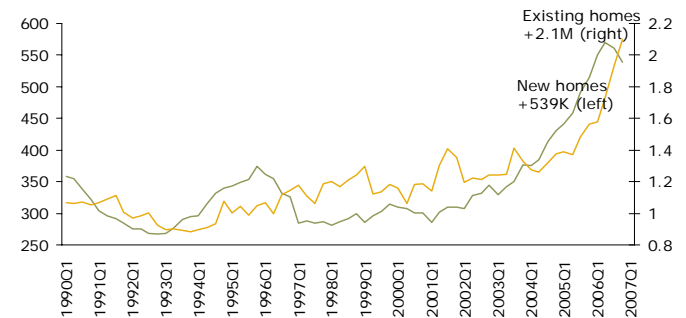
Europe

In contrast with the consensus view, our forecast does not call for a slowdown of Europe's economy next year. Real GDP growth should stabilize at around 2.8% in 2007. Despite tightening efforts by the European Central Bank (ECB), financial conditions have continued to ease in Europe. While the ECB is hiking short-term interest rates, long-term rates are not rising, money growth remains strong and equity prices are trending higher. Hence, financial conditions are easing. Liquidity, as measured by the growth in monetary aggregate, remains plentiful. Equity prices have gained substantial ground, market rates remain historically low and home prices are still trending up. In such an environment, it is not surprising that domestic demand growth has been gaining momentum. Next year, domestic demand should remain strong, growing at 2.5% supported by continued growth in job creation.

So far, the ECB's tightening efforts are aimed at bringing policy back in neutral territory. A year ago, European short-term real interest rates were still negative. Real rates are now at 1.7% - that is, within a neutral range. In our baseline forecast, the ECB is projected to increase its overnight rate to 4.0% from 3.75% by the middle of 2007 but to stay on the sidelines for the rest of the year.

HOUSING: INVENTORY OVERHANG

U.S. inventories of new & existing homes



Source: Datastream

Japan

Thanks to drastic measures, Japan finally completed its economic recovery in late 2005. It is now in the middle of its second year of expansion. This is quite a contrast to the rest of the industrialized world. North America is already in its fourth year of expansion. The fact that Japan has been trailing the rest of the world in the business cycle has had huge implications on the dynamics at work in the global economy: Japanese interest rates have served as an anchor for global rates. In turn, low global interest rates are fueling all interest-sensitive asset classes. Efforts deployed by other central bankers to drain liquidity out of the system have been offset by actions taken by the Bank of Japan (BoJ).

However, the economic landscape has definitively been changing over the last year or two:

- The Japanese economy is expanding thanks to gradually improving consumer fundamentals.
- The banking system is improving. Bank lending has been growing for nearly two years.
- The excess liquidity injected by the BoJ between 2001 and 2004 (quantitative easing policy) has been completely drained out from the financial system.
- The BoJ tightening campaign has started with two 25 basis points shifts.
- Inflation appears to be staging a comeback, mainly based on the price of real estate which has posted a 0.4% rise, the first positive increase in prices in at least 10 years.

As long as the Japanese economy stays in an expansion mode, these trends should continue to intensify. Over the last year, real GDP in Japan has been growing at a 2.5% annual pace, fueled by export and capital spending. In our view, a slowdown is not in the cards. At this juncture, the most relevant question for financial markets concerns the timing of inflation's return to Japan. In our view, it is too early to envisage a significant deterioration on the inflation front. As a consequence, the BoJ is expected to continue to tighten at a very slow pace. Our forecast calls for interest rate increase of another 50 basis points over the next 12 months

The most relevant question for financial markets concerns the timing of inflation's return to Japan.

Our 12-month target for 10-year Japanese government bonds stands at 1.9%, implying that the yield curve will continue to flatten at a snail's pace. Our forecast calls for better equity performance in 2007 than in the disappointing year we just witnessed.

China

In late February, Chinese equities experienced their worst correction in a long time. Global financial markets initially reacted very negatively to this turn of events: Was this equity correction an early warning signal for China's economy? The short answer is no, as the Chinese stock market does not qualify as a leading indicator of economic activity.

Tighter monetary conditions will eventually slow the Chinese economy. However, over the short term, the tightening is not likely to be significant enough to jeopardize economic expansion. We have revised our Chinese GDP growth forecast from 8.5% to 9.0%. Growth contributions from business investment and trade will decline in 2007, but will be partially offset by a pick-up in consumer spending growth. Headline CPI inflation is likely to moderate to approximately 2.3% while core inflation should reach only 0.6% by the end of the year.

Risks:

Growth Surprise: In this scenario, the better-than-expected-growth outlook brings deterioration into the inflation outlook and the monetary policy response. Interest-sensitive assets such as stocks and long bonds will experience a correction, as higher uncertainty regarding inflation would push risk premiums higher to protect the investors against an uncertain inflation outcome. Higher commodity prices could support cyclical sectors.

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 labour cost inflation moving into positive territory
- European employment growth
- Chinese domestic retail sales

CURRENCY

Cyclical forces remain the dominant theme underpinning major currency trends. Against the backdrop of global economic rebalancing and moderating growth and inflation, current cyclical trends and risk-seeking behavior will persist. This has three key implications for the currency outlook:

- The U.S. dollar will continue to weaken, albeit moderately.
- Commodity-sensitive currencies such as the Australian and Canadian dollars will do well.
- Emerging market currencies on average will continue to outperform, although by less than in previous years.

The U.S. dollar is approaching cyclical lows against most major currencies with the notable exception of the Japanese yen. This reflects the fact that the U.S. economy is slowing and the Fed's next move is expected to be a policy rate cut, whereas other economies remain relatively strong and central banks are pondering tighter policy settings. In our view, this cyclical divergence will persist for a while, but will end and possibly reverse by late 2007 or early 2008. After several years of weakness, the U.S. dollar is no longer overvalued, and is now primarily driven by cyclical forces. The external and fiscal imbalances are rapidly correcting and interest rates are now sufficiently high to attract long-term capital. As a result, we forecast a new cyclical low for the greenback in the next six months, followed by stabilization if not a rebound. The timing of this trend change largely rests on the Fed. A rate cut would likely extend the dollar's downside, and tougher talk in the face of resilient inflation would help put an early floor underneath the U.S. currency.

From a valuation standpoint, four currencies stand to benefit from a weak U.S. dollar: the euro and the Australian, New Zealand and Canadian dollar. For the latter three, high commodity prices and strong fiscal balances are key elements sustaining value. In addition, these four currencies have cyclical factors in common: strong domestic demand, uncompromising inflation-targeting central banks and high or rising interest rates. We expect to see the Canadian dollar back above 90 cents (U.S.) before long and our long term forecast of parity before 2010 remains unchanged.

Other major currencies will have more difficulty strengthening versus the U.S. dollar. Several European currencies, like Norway's and Sweden's, are already overvalued against both the euro and the greenback. And this is especially true for the British pound. For the Japanese yen, key concerns are that the economy is slowing, in line with the U.S., and interest rates are expected to remain very low. A mixture of valuation and cyclical concerns means that the best-case scenario for these other currencies is flat performance versus the U.S. dollar.

Emerging market currencies have consistently strengthened since 2002. In its early stages, this was primarily a valuation story which has now run its course. According to our analysis, about half of emerging market currencies are now expensive and trading above their equilibrium value. However, that does not portend an immediate end to the uptrend. External cyclical forces remain positive, with strong demand in Europe taking the baton from a weaker U.S. economy. A good indicator of buoyant global demand is the overall level of commodity prices, which remains elevated and expected to stay so. Domestic forces are also generally supportive for currencies in many emerging markets: domestic demand continues to accelerate, liquidity is plentiful and nominal interest rates are, in most cases, falling.

Risks:

Growth Surprise: Under this assumption, the moderate trends we see in our baseline scenario would get amplified. This implies, among other things, a new cyclical high for the Canadian dollar of 95 cents (US). However, this scenario also raises the likelihood of a more volatile 2008 as a result of the inevitable monetary tightening effort it would trigger. Emerging market currencies typically do very well in this scenario, but the odds of a financial accident or crisis rise toward the end of the forecast horizon.

Global Slowdown: This scenario has negative implications for the U.S. dollar, but only against less growth-sensitive currencies like the euro. In fact, dollar downside could be cushioned by "safe haven" capital inflows as a number of emerging market and commodity-sensitive currencies could run into trouble. One such casualty could be the Canadian dollar, which we would see falling back to recent lows in this scenario.

Signposts:

- Measures of U.S. capacity and underlying inflation
- Global commodity prices (energy, metals and agricultural)
- China's monetary and exchange rate policy
- Exchange rate volatility and risk-aversion indicators
- Geopolitical tensions in the emerging economies
- U.S. and European trade policy

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