



For the quarter ending  
March 31, 2008

## EXPECTED RETURNS

For the 12 month period ending March 31, 2009	In Canadian Dollars			In Local Currency		
	Economic Rebalancing	Deflationary Bust	Growth Surprise	Economic Rebalancing	Deflationary Bust	Growth Surprise
Probabilities	50.0%	30.0%	20.0%	50.0%	30.0%	20.0%
Canadian Money Market	3.3%	2.8%	4.1%	3.3%	2.8%	4.1%
Canadian Bonds	1.1%	4.3%	-5.3%	1.1%	4.3%	-5.3%
International Bonds	-0.5%	7.7%	-9.0%	2.8%	8.2%	-1.5%
Canadian Equity	8.4%	-10.4%	24.8%	8.4%	-10.4%	24.8%
U.S. Equity	9.5%	-1.7%	16.7%	13.5%	-4.0%	26.0%
International Equity	7.1%	-4.5%	11.1%	10.6%	-3.2%	18.9%
Emerging Market Equity	15.8%	-13.2%	25.7%	14.7%	-14.6%	25.3%

Source: CIBC Global Asset Management Inc.

## GLOBAL ENVIRONMENT

The credit-driven boom/bust cycle that the U.S. economy is currently experiencing has been repeated many times before, most recently in the early 1990s and early 1980s. While each cycle has its own particularities, key features are constant. The initial boom phase is normally characterized by an uptrend in real estate prices fueled by a very easy monetary policy stance. As home prices appreciate, home equity grows and households can take on more debt. Meanwhile, banks and other lenders, with a misplaced sense of security, loosen their lending standards well beyond what may be considered prudent. This easy credit perpetuates the cycle, pushing real estate prices even further beyond a reasonable level.

Inevitably, the bubble bursts and the fall in real estate prices interacts negatively with depreciating balance sheets as deleveraging hits lenders and borrowers alike. Deleveraging, or the reduction of borrowed capital previously used to increase the potential return of an investment, is a sign of slowing growth. As risk aversion increases, the distress rapidly spreads to financial markets. As capital becomes scarcer, banks tighten their lending standards substantially and the credit crunch amplifies the economic downturn. Ultimately, a very aggressive monetary policy response is needed to end the financial crisis.

The U.S. financial system appears to be in the late stages of the credit crisis. The U.S. Federal Reserve (the Fed), has taken extraordinary measures to pump liquidity into the financial system and we expect these reflationary efforts will soon have an impact on global financial markets. However, history shows that the unwinding of bubbles can be long and painful, and deleveraging has taken several years. The current episode shouldn't be any different, so we see the U.S. economy heading for a prolonged period of below-trend growth. This period of subdued U.S. consumption should help reduce the U.S. current account deficit, one of the great imbalances of the global economy.

The good news is that risky asset classes typically stabilize and begin to rally long before real estate prices stop falling. Thus, we do not necessarily have to wait for U.S. house prices to hit bottom before there is some relief in the credit markets. More importantly, the Fed has learned from Japan's deflationary bust and is working to mitigate the negative impact on financial markets and the economy. In our view, while the economy is not yet out of the woods, there is a path towards daylight for global equities.

### In this Issue

#### Global Environment

The U.S. financial system appears to be in the late stages of the credit crisis.

#### Fixed Income vs. Equity

Inflation in the emerging world now exceeds inflation in the industrialized world, indicating to us that other macro policies have to be put to work.

#### Regional Outlook

The concerted efforts deployed by central bankers over the recent months are reassuring.

#### Currency

Following a stellar rally during 2007, the Canadian dollar has stabilized in the 0.98 to 1.02 range for most of this year.

## FIXED INCOME VS. EQUITY

The tug-of-war between economic weakness and reflationary efforts on the part of central banks is expected to continue for a few more months, resulting in continued volatility. The economic impact of the U.S. housing downturn is not fully digested by the economy while the medicine of lower interest rates, financial liquidity and fiscal stimulus have not yet worked their way into the economy.

Looking further down the road, however, the outlook seems to be brightening for global equities. Financial markets have already priced in a lot of bad news and should remain in their recent trading range until the stimulus provided works its way into the economy.

Valuations are compelling. In our view, equities are still very attractive and bonds are very expensive. To think otherwise, one needs to strongly believe that the world is heading for a Japanese-style deflationary bust. Given the easing efforts deployed so far by world central bankers, this isn't a likely outcome. In short, the bull market in global equities should convincingly resume as soon as credit concerns start abating.

The credit turmoil has been more pronounced and has lasted longer than most market participants were expecting. As a result, long term government bond yields revisited historical lows as investors fled to this safe haven asset class in fear of a worsening credit debacle.

Meanwhile a number of initiatives by the Fed and the U.S. government have been implemented to mitigate the impact of the credit crunch. It will still take a number of months for these measures to take effect but we think that a worst-case scenario can be avoided for the U.S. economy.

At current low levels, it is hard to be positive on the outlook for international bonds. Given the worldwide acceleration in both energy and food price inflation, such an outcome is hard to envisage. Indeed, outside the U.S., the inflation backdrop is deteriorating. In fact, once credit tensions start dissipating, central banks, except for the Fed, are expected resume their tightening campaign and the Fed is projected to move to the sidelines. This should allow for the bear market in global bonds to resume.

### Risks:

**Deflationary Bust:** The credit squeeze lasts too long, choking the global financial system despite the aggressive easing efforts currently deployed by central bankers. This would mark the start of a deflationary bust. This is the best-case scenario for global bonds but the worst-case scenario for global equities.

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

### Signposts:

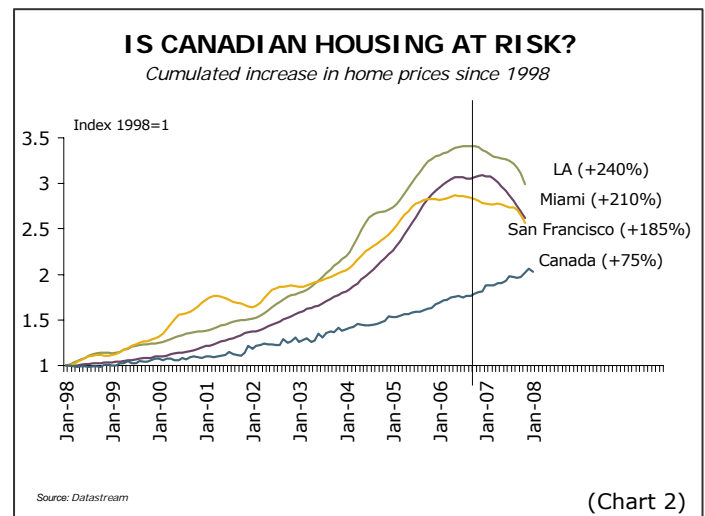
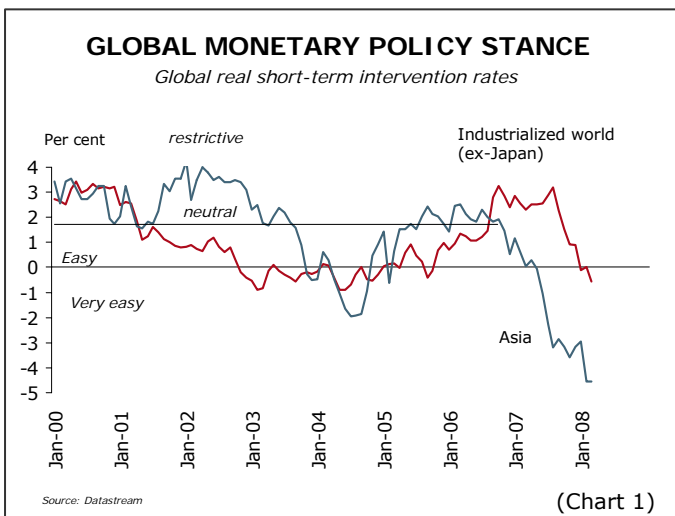
- Credit conditions
- Bottoming out of U.S. housing prices
- Energy vs. non-energy commodity prices
- The relative performance of bank shares
- The U.S. unemployment rate rising above 5%
- U.S. employment growth slowdown
- Canadian core inflationary pressures
- Gold's relative performance
- Chinese CPI inflation

## REGIONAL OUTLOOK

In the U.S., the balance is clearly tipping towards weakness. At this stage, the question is whether the rest of the world will be able to decouple itself from the weak U.S. economy. Prior to the credit crisis, the risk of a U.S.-led global slowdown was very low, with the global economy outside the U.S. in tip-top shape. However, the tightening credit conditions, while originating in the U.S., are affecting nearly all economies. The longer this situation prevails, the greater the odds that the global economy gets knocked down.

To avoid this outcome, economic policymakers had to take decisive action to restore trust and confidence for creditors and the concerted efforts deployed by central bankers over recent months are reassuring. Since the start of the easing campaign by the Fed, U.S. short-term interest rates have tumbled, by over 300 basis points. As a result, in real terms (after inflation), global interest rates are now deeply negative (see chart 1). Negative real rates act as a powerful subsidy to profits, income and growth, so the Fed's actions have significantly reduced the odds of a U.S. financial meltdown.

The world economy is projected to shift into lower gear, from 5.0% real GDP growth in 2007 to 4.4% over the next twelve months. Excluding the U.S., we expect global growth to decelerate from 6.0% to 5.2%.



## Canada

In the past, confidence in the Canadian economy has always been determined by developments south of the border. While Canada is not immune to the current U.S. economic slowdown, we believe that the consensus opinion may be overestimating Canada's vulnerability for the following reasons:

- The housing market in Canada is in better shape than it is in the U.S. Canadian housing prices have not climbed as high as in the U.S. At their peak in late 2006, housing prices in the U.S. had increased two times faster than in Canada, which means there is a lot less downside for Canadian housing prices. In addition, over the past 10 years, Canadian home prices have been appreciating at a slower pace than household incomes. Chart 2 compares the cumulative increase in home prices over the last ten years for big cities.
- Canadian households are not as leveraged as American households.
- The impact of the U.S. slowdown would be partially offset by the sharp improvement in the Canadian terms of trade. Over the last year oil prices have climbed +63%, natural gas prices +20%, and wheat prices +144%. Overall, this amounts to 1.5% of Canadian GDP.
- To cushion the potential impact of a U.S. slowdown, Canada is also relying on a heavy dose of fiscal stimulus through a combination of GST cuts and lower personal and corporate income taxes that exceeds the efforts deployed by the U.S. administration to rescue the U.S. economy.
- As inflation (headline and core) is expected to decelerate to 0.5% year over year in the coming months, the Bank Of Canada (BoC) has a lot of leeway in setting monetary policy.

## United States

Fueled by fears of a full-blown recession, U.S. equities have broken below the cyclical lows reached in late February. From its peak in October 2007, the S&P 500 has lost more than 15% in U.S. dollar terms.

Since 1960, the U.S. economy has experienced seven official recessions. These recessions have lasted on average about a year, with a contraction in activity averaging approximately -2.55%. This time around, economic activity has so far contracted by only -0.15% since the peak in October 2007.

What happens to the equity market during recessions? The conclusions reached can widely differ depending on whether secular equity bear markets are included in the calculations or not. The S&P 500 experienced two severe bear markets: one in the mid 1970s and one at the start of this decade (2000-2002). During secular bear markets, cyclical developments are not the driving force. The dominant feature is a structural downtrend and including these episodes in the calculations can be misleading. When the two bear market episodes are excluded from the calculations, the average downturn in U.S. equities amounts to -17% from peak to trough. At its March trough, the S&P 500 had lost more than -18% from its October 2007 cyclical peak.

Equities typically rebound five to six months before the rebound in economic activity becomes apparent. Given the efforts deployed by the Fed since September, and the depreciation of the U.S. dollar, economic activity is likely to rebound in the second half of 2008. If that is the case, U.S. equities would now be in a bottoming process.

## Europe

In Europe, like in the U.S., financial distress has intensified over recent months. Since mid-July many European bank stocks have been hit harder than those in the U.S. Intervention by the the European Central Bank (ECB) is at its highest level since the start of the decade. So far, the ECB seems to believe that inflation remains a greater risk than potential economic weakness. In our opinion, inflation concerns are warranted in Europe where total CPI inflation is running at more than 3.0% owing to strong inflation acceleration in the food (+5.2%) and housing (+3.9%) segments of the CPI.

One could argue that high headline inflation did not stop the ECB from cutting interest rates in May 2001 just as headline inflation was peaking at more than 3.0%. However the economic backdrop is very different this time:

- The unemployment rate in the European Union stands at a cyclical low of 7.1% compared to 7.8% at the time of the first rate cut in 2001. Since 2004, 7.7 million jobs have been created in Europe whereas only 3 million jobs had been created at the same point in the last cycle .
- Money supply growth is running at nearly 12.% today compared to approximately 5.0% in early 2001.
- Composite leading indicators were clearly negative in 2001 whereas the story is very different this time, with the exception of Italy which is facing structural headwinds.
- Europe does not suffer from the overvalued housing market and high household leverage that have been at the core of weaker growth in the U.S.
- More importantly, inflation was trending lower during the ECB's 2001-2002 easing cycle. Looking forward, inflation is expected to remain high. Our forecast calls for 3.35% headline inflation and 2.0% for the core CPI.

Given these differences, the ECB will probably not be in a hurry to cut rates. However, given the weakening in economic conditions, a pause in the ECB's tightening cycle seems justified.

## Japan

The Japanese equity market delivered negative returns for 2007, ranking as one of the worst global equity performers. Consumer confidence dipped again in February, to hit its lowest level in nearly five years while business confidence stands at a four year low. The last time consumer confidence was this weak was in early 2001, when the last global recession began. However, over that period, growth in consumer spending did not dip in negative territory. It is not clear whether this ongoing drop in confidence will translate into further weakness in domestic demand. However, for turnaround this time, Japan's cyclical outlook would have to start improving.

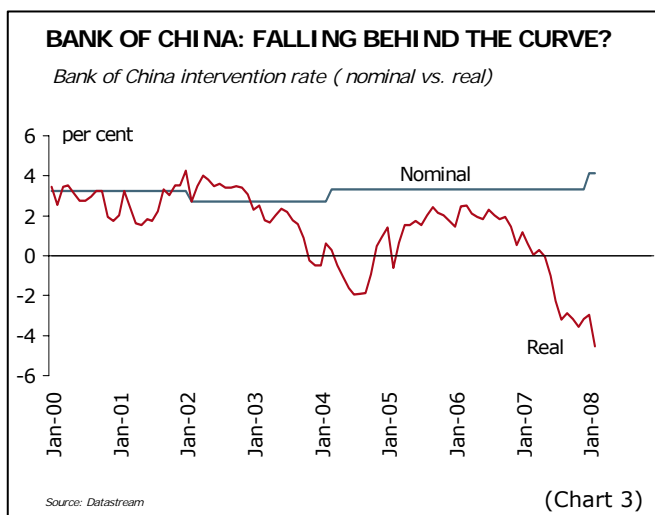
Another recent negative indicator is that the yen has gained more than 14% on a trade-weighted basis, which could hurt Japan's competitiveness. Japan has been growing steadily less sensitive to the U.S. economy. At the time of the last consumer-led U.S. recession in the early 1990s, Japanese exports to the U.S. were almost 10 times the size of Japanese exports to China. Today, both export markets are about equal.

On the bright side, Japan's index of leading indicators bottomed out in September 2007. The downtrend in the unemployment rate in Japan remains intact despite a brief increase last fall. Real GDP growth is running at +1.7% (i.e. no contraction), with the weakness concentrated in business investment spending. Even this business downturn has been concentrated in construction activity. Last fall, housing starts were down 58% on a yearly basis – the sharpest drop on record - triggered for the most part by the enactment of the revised Building Standards Law. Housing starts are returning to normal, implying that the drag from housing should prove to be short-lived.

Our forecast calls for a pronounced economic slowdown but with downside risks concentrated over the next three to six months. We project GDP growth to slow to +1.5% over the next 12 months. With inflation moving into positive territory, the Bank of Japan is expected to move to the sidelines.

## China

Recently, Chinese equities have taken a severe beating. At first glance, this might come as a surprise, given the strength of the Chinese economy. However, the current situation is reminiscent of 2004 to 2006 when Chinese authorities were getting increasingly uncomfortable with the acceleration in inflation and sizzling money supply growth. The action resulted in a tightening monetary policy via higher interest rates, tighter credit control and a faster appreciation of the currency. These actions, in turn, act as a negative for equity markets.



One needs to keep a close eye on inflation and money supply growth to determine how long the pain will last. Both have to convincingly decelerate over the coming months. For the time being, Chinese food inflation is running at 23.3%, up from 5.0% in early 2007. At the same time, the money supply is still growing at more than 15% on a yearly basis.

In reaction to developments on the inflation front, the Bank of China (BOC) has introduced tighter credit controls. However, it is becoming increasingly difficult for the BOC to curb inflationary pressures via credit controls alone. The BOC has also been hiking interest rates, but modestly, to say the least. Given the sharp rise in inflation, real interest rates have dropped deep into negative territory, signaling that the monetary policy stance remains very accommodative (see chart).

The only alternative is to allow for a faster pace of currency appreciation, which would translate into downward pressures on inflation in China but upward pressures on global inflation.

## Risks:

**Deflationary Bust:** Ongoing U.S. housing price decline would continue to have a negative impact on the financial system and restrain access to credit. Weakening U.S. consumer demand would spread outside the U.S. triggering a more pronounced global slowdown. Demand for commodities would slow with a negative impact on resource-based economies like Canada's. Fixed income and other defensive assets would outperform risky assets such as equities and commodities.

**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 domestic inflationary pressures. Fears of spreading inflation would have the most detrimental effect on fixed income investments as the current level of interest rates does not price in any risk of inflationary pressures.

## Signposts:

- Bank of China tightening policy
- Chinese loan growth restrictions
- Chinese CPI inflation
- Oil and agricultural prices
- U.S. employment reports
- Chinese retail sales

## CURRENCY

The U.S. dollar resumed its down-trend in early 2008, falling to a record post-Bretton Woods low on a trade-weighted basis. The relative cyclical outlook remains negative for the U.S. currency, but valuation could limit further weakness against several major currencies, particularly the euro.

While the U.S. economy is still decelerating, European growth has held firm. As a consequence, the ECB has refrained from easing monetary policy. With the Fed aggressively lowering rates in 2008, U.S. short-term interest rates are now 175 basis points below Europe. This cyclical divergence in economies and monetary policies pushed the euro to a record high of 1.59 versus the U.S. dollar. At this level we believe that the euro is reaching an extreme overvaluation. Simple purchasing power parity (PPP) models place fair value for the euro near 1.26. Historically, euro over/undershoots from PPP tend to be in the neighbourhood of 30%. Today, that will translate to 1.638U.S.. On balance, while the cyclical backdrop remains negative for the U.S. dollar, further significant weakness against the euro may be limited on valuation grounds.

Where we expect to see further weakness in the U.S. dollar is against emerging market currencies. In particular, we favour a further appreciation in Asian currencies. Inflation continues to accelerate across Asia and we calculate that inflation across the ten major Asian economies has accelerated to over 6%. In part this is the result of the Asian policymakers' decision to link their currencies to the U.S. dollar. We believe easy U.S. monetary policy is inappropriate for Asia's red-hot economies because it will only end up stoking the inflation fires. Tightening monetary policy independently of the Fed in order to rein in inflation will require Asian policymakers to allow a further appreciation in their currencies. We favour the Chinese renminbi, Singapore dollar, and Indian rupee.

Following a stellar rally during 2007, the Canadian dollar has stabilized in the 0.98 to 1.02 range for the first quarter of 2008. We believe this stability reflects several opposing factors at play for the loonie. On the positive side is the strength in commodity prices and Canada's domestic economy. On the negative side is the U.S. slowdown/recession that poses a risk to Canadian growth and the BoC easing monetary policy. A resolution to this tug-of-war should determine which way the Canadian dollar will ultimately break out. We have a bias towards strength rather than weakness. Strength in the Asian economies, the high level of commodity prices, and strong domestic demand should buffer the Canadian economy from the U.S. slowdown. Moreover, aggressive policy reflation by U.S. policymakers will eventually place a floor under U.S. growth.

### Risks:

**Deflationary Bust:** In this scenario growth in the rest of the world converges downward towards the U.S. This should result in increased risk aversion and sharp correction in cyclical assets. The U.S. dollar should rally in this environment and commodity currencies, such as the Canadian dollar, should suffer. Emerging Asian currencies should remain weak, as the global downturn will help contain Asian inflation and lead Asian policymakers to once again pursue cheap currencies.

**Growth Surprise:** In this scenario the U.S. economy rebounds quickly from its housing downturn. This will push global growth to above-trend levels and commodities to new highs. In this scenario commodity currencies will strengthen to new cyclical highs. Asian policymakers will also face increased pressure to allow an appreciation in their currencies.

### Signposts:

- US housing/employment data
- Interest rate differentials
- Commodity prices
- Asian inflation

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