



For the quarter ending  
March 31, 2009

## EXPECTED RETURNS

For the 12 month period ending March 31, 2010	In Canadian Dollars			In Local Currency		
	Sluggish Recovery	Deflationary Bust	Economic Expansion	Sluggish Recovery	Deflationary Bust	Economic Expansion
Probabilities	65.0%	20.0%	15.0%	65.0%	20.0%	15.0%
Canada Money Market	0.5%	0.3%	0.6%	0.5%	0.3%	0.6%
Canada Government Bond	-1.7%	4.6%	-8.0%	-1.7%	4.6%	-8.0%
International Government Bond	-3.3%	33.8%	-11.7%	5.2%	9.8%	0.4%
Canada Equity	14.0%	-26.0%	37.3%	14.0%	-26.0%	37.3%
United States Equity	9.2%	7.1%	18.4%	16.7%	-15.8%	35.6%
International Equity	6.8%	-10.4%	26.9%	13.5%	-21.6%	34.7%
Emerging Equity	26.6%	-12.8%	55.5%	21.0%	-20.0%	44.0%

SOURCE: CIBC GLOBAL ASSET MANAGEMENT INC.

## In this Issue

### Global Environment

We believe quantitative easing, which injects liquidity into the system, should jump-start the global economy, allowing for a sluggish recovery in late 2009 or early 2010.

### Fixed Income vs. Equity

Before moving into or increasing equities, investors should consider increasing exposure to corporate bonds as a first step.

### Economic Themes

We believe that equity and currency exposure should shift from the low-growth industrialized world to the high-growth emerging world.

### Regional Outlook

The Canadian equity market could be one of the better-performing equity markets over the next 12 months.

### Currency

The Canadian dollar has not lost as much ground in relation to the U.S. dollar as other commodity currencies.

## FORECAST HIGHLIGHTS

As a result of aggressive intervention by governments and central bankers around the world, we are starting to see signs of economic stabilization, and a sluggish recovery is the scenario that seems most plausible for the forecast period.

With the economy stabilizing, combined with the accompanying public debt burden, we would expect government bonds to become a less-appealing asset class than they have been. The desire for increased risk could gradually shift investor attention to higher-yielding corporate bonds and to equities. The sluggish recovery scenario suggests equities may be the better-performing asset class of the two over the next 12 months.

Our 12-month return expectations for global equity markets have not materially changed. However, due to the significant market correction of the first quarter of 2009, our total return projections are on average 5% higher than they were in December 2008.

For many parts of the world, such as Europe and Japan, it is not clear whether the economic recovery will turn into a full-blown economic expansion. By the end of the 12-month forecast period, worries about the health of the world economy could resurface if government efforts end and the long-term deleveraging of the developed economies continues. For example, deleveraging the balance sheet of the U.S. economy, which currently stands at over 350% debt-to-GDP, is likely to keep that economy growing below potential for a number of years.

World economic growth is likely to remain in a lower gear, which could mean the long-term uptrend in equity prices would be flatter than we have seen historically. It is likely to take years before prices reach their historical highs.

## GLOBAL ENVIRONMENT

The global economic landscape has changed radically over the last 12 months. For many parts of the industrialized world, the present situation is similar to the Japanese experience of the early 1990s – a severe banking crisis, leading to a deep economic recession accompanied by persisting asset price deflation.

The severity of the current global downturn has the potential to plunge the industrialized world into a long-term deflationary environment. To avoid that outcome, central bankers around the world have slashed interest rates aggressively. When their official interest rates reached zero, or close to zero, some central banks turned to quantitative easing by buying up financial assets – government and corporate bonds – to give the struggling banking system new money to lend. The magnitude of the intervention underscores the central banks' determination to keep deflation at bay. The immediate impact has been a significant improvement in credit conditions – a necessary condition for recovery, but the long-term impact is still uncertain.

We believe quantitative easing, which injects liquidity into the system, should jump-start the global economy, allowing for a sluggish recovery in late 2009 or early 2010. However, any rebound in economic activity is likely to be tepid and accompanied by falling inflation rates – potentially leading to a deflation scare in many parts of the world that could be more intense than the one at the beginning of the 2001 global recession. We believe this economic slump, unlike any previous, is driven by reduced access to credit and a need to trim the level of debt on the balance sheet of the financial system and consumers. Household indebtedness relative to income is historically elevated, and the process of deleveraging could take time.

## FIXED INCOME VERSUS EQUITY

Conventional valuation indicates equities are cheap and government bonds are expensive. However, the recent events are without precedent and investors should remain prudent in their interpretation of traditional valuation metrics. For example, the inflation/deflation outlook has an influence on the forecasted price to earnings ratio and the expectations of future corporate profits. That outlook is uncertain considering the potential for long-term deleveraging, higher taxes (to repay mounting government debt) and lower GDP growth.

To put things in perspective, it can be useful to examine past episodes of extreme financial turbulence. Two episodes come to mind: the Great Depression of the 1930s and the implosion of the Japanese economy in the early 1990s. In both cases, the equity bear market was well-entrenched with severe collateral damage to the economy.

What can we learn from history?

The first lesson is that the cyclical highs hit in late 2007 could remain out of reach over the short to medium term, one to five years. It took more than 12 years for U.S. equities to recover all the ground lost in the 1930s. Japanese equities never revisited the highs reached of 1989. History has shown that once equity prices hit rock bottom, it can take years – if ever – for markets to reach their previous highs.

The second lesson is that the speed of the equity market's initial recovery could take investors by surprise. Equity markets typically have their best yearly performance at the start of the recovery phase. Between the summer of 1932 and the middle of 1933, U.S. equities rebounded solidly. The same thing happened in Japan between 1992 and 1993. However, both equity rallies petered out over subsequent years.

A third lesson is that when markets move into their multi-year recovery phase, high volatility typically continues to prevail. Despite potentially attractive short-term returns, equities remain a risky proposition in this type of environment and portfolio risk has to be carefully managed.

Before moving into or increasing equities, investors should consider increasing exposure to corporate bonds as a first step. Last year, the exceptional widening of credit spreads led to a sharp underperformance of corporate bonds relative to government bonds. With corporate bond spreads at historically high levels, potential returns for corporate bonds appear very attractive, over a one year short-term, and over a three to five year medium-term, time period. Corporate bonds are less volatile than equities and can be used to reduce portfolio risk. While we project equities will outperform corporate bonds, our forecast currently shows a 5% one-year total returns for the Canadian corporate bond universe. However, it is not clear to us whether equities will continue to outperform bonds over the next three to five years.

# ECONOMIC THEMES

## World economy: Growing apart

With the global economy in recession, it appears that the world is split into two distinct segments. Most of the developed world countries are characterized by: unsustainably high leverage ratios; heavily-indebted, overstretched consumers with virtually no savings; and rapidly aging populations. For these countries, the long-term outlook is for low growth and intensifying deflationary pressures. Owing to the significant efforts deployed by the U.S. Federal Reserve, we project that any recovery in 2010 will be led by the U.S.

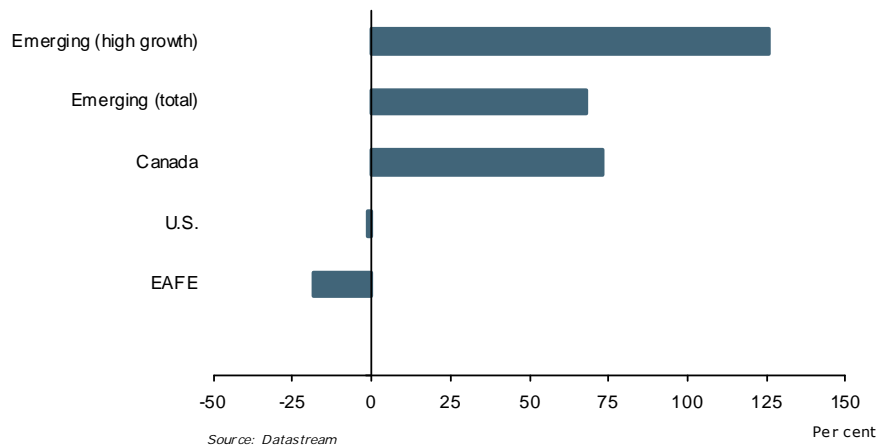
while continental Europe and Japan will lag. The most likely scenario is that the industrialized world could be shifting into an investment regime characterized by higher financial market volatility and potentially lower domestic portfolio returns.

In contrast, most of the emerging world countries have much stronger fundamentals. Households still have clean balance sheets and high saving rates. More importantly, their labour force is projected to continue growing. For these countries, the outlook is for strong growth and mild inflation.

In the emerging world, China, with a GDP increase of 8.3%, and India, with a GDP increase of 7.8%, are expected to be the growth engines. Emerging Asia, as a whole, is projected to experience a solid recovery. As a result, we believe that equity and currency exposure should shift from the low-growth industrialized world to the high-growth emerging world.

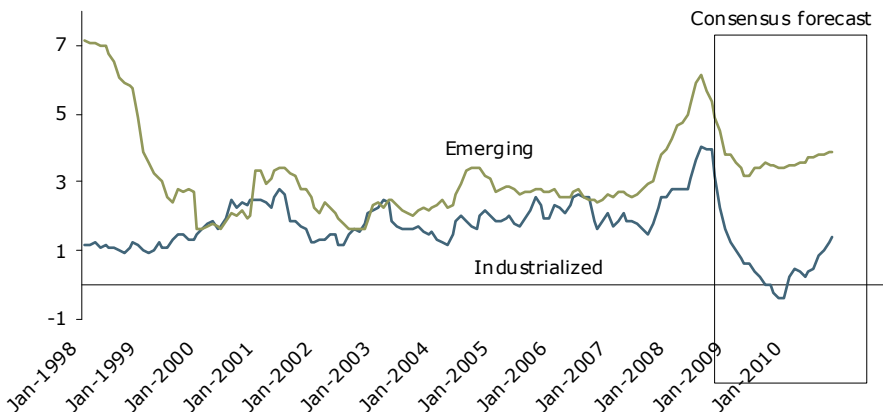
### WHERE TO DIVERSIFY

Performance of equity markets around the world since 1997 (local currency)



## GLOBAL INFLATION: TWO WORLDS

Aggregate CPI inflation rates: industrialized versus emerging countries



Source: Datastream

### A global deflation scare

In light of the severe slowdown in global economic activity, the deceleration in global CPI inflation has remained surprisingly mild so far. In most countries, high food prices are the biggest source of inflation.

However, a sharp deceleration in food inflation likely lies ahead. Food prices have been rising rapidly since 2007 because of climbing transportation costs and strong global demand. Global transportation costs have dropped, suggesting that a global food disinflation could follow. Also, as the global economy experiences its first contraction since World War II the global demand for food is likely to slow substantially. A collapse in international agricultural prices also points to food deflation.

## REGIONAL OUTLOOK

### Canada

The recession in Canada began 9 months ago in June 2008. However, the worst may be yet to come. During the last global recession in 2001, the Canadian economy was saved by a weak currency. When the 2001 recession started, the Canadian dollar was undervalued by more than 20%. When the U.S. recession started in late 2007, the Canadian dollar was overvalued by 20%. This likely means net exports won't be able to cushion the economic downturn the same way they did in 2001.

We are projecting a rebound in energy prices. Supply from OPEC continues to be curtailed as member states respect their production quotas and supply from non-OPEC countries, particularly Russia and Mexico continues to decline. Energy demand should also stabilize as economic activity stabilizes. In this case, the Canadian equity market should be one of the better-performing equity markets over the next 12 months, supported by improved performance by the cyclical sectors and a recovery in the Canadian currency. In recent years, Canadian earnings have grown spectacularly because of booming commodity prices. Despite recent weakness, Canadian earnings are still above the long-term trend line. Canadian earnings tend to be highly cyclical, so further declines are possible.

### United States

The first quarter of 2009 was difficult for all global equity markets including the U.S. However, there are reasons to believe U.S. equities could outperform the rest of the developed world over the 12-month forecast horizon. In order to restore profitability, U.S. businesses have been aggressively reducing production, thinning inventories and cutting jobs. As a result, U.S. productivity is already improving.

We believe the U.S. economy is well ahead of the rest of the world in the business cycle. The U.S. recession, which started in late 2007, is already 15 months old. Since the start of the recession, total employment in the U.S. has dropped by -3.28% for a cumulative job loss of 4.3 million. With the exception of the Great Depression, total job losses for this recession now exceed the aggregate losses from previous recessions.

However, as a percentage of the total workforce unemployment now matches the recession of the early 1980s. A replay of the 1980s recession would suggest that employment could start stabilizing over the second half of 2009. A close examination of recent developments in the U.S. housing market also point in that direction. The U.S. housing recession is already three years old – which is the longest housing contraction phase of the past decades:

- Employment in construction has dropped by 1.1 million and is now back to pre-housing bubble levels;
- Housing starts are running at 583,000 units – which is well below the annual trend of 1.5 million units;
- Because of a 30% drop in home prices and the lowest mortgage rates in years, housing is as affordable as it has ever been.

We expect an improvement in existing home sales will be the first sign that home prices will stabilize, which would help restore some confidence in the financial system.

### Europe

The economic downturn in Europe already lags the U.S. and Japan by at least six months. Because of Europe's structural issues, and slower monetary policy easing by the European Central Bank (ECB), the European economic downturn will probably last longer than anywhere else. We project real GDP growth to stay in negative territory in 2009 at -2.5%, recovering to 0.8% in 2010 - a mild recovery by historical standards. If the economy contracts by -2.5% in 2009 but grows only 0.8% in 2010 (from very depressed levels), European economic activity will still be 1.72% below its pre-recession levels of activity which qualifies as a modest recovery.

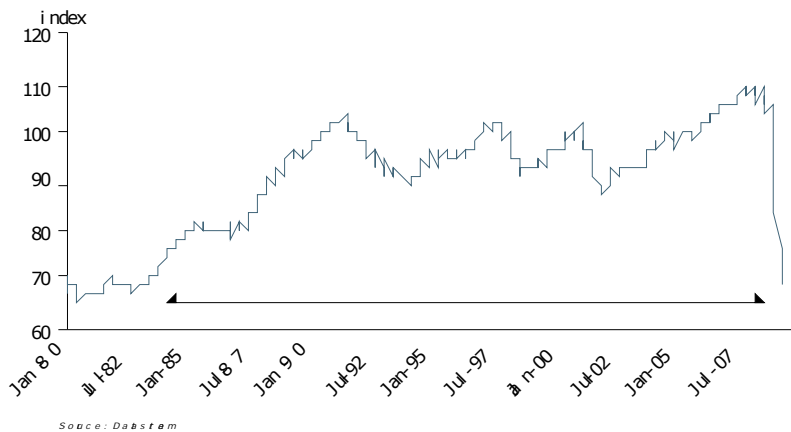
Demographic trends are not helping Europe's situation. The European labour force is shrinking at a pace of -0.25% or 250,000 workers per year, and we expect the rate of decline to accelerate over the years ahead. If nothing changes on the productivity front, potential GDP growth is set to decelerate from 1.5% to 0% in the next 10 years. Potential GDP growth corresponds to long-term secular growth. In the long term, GDP growth reflects labour force growth and productivity. Of course, there are cycles around GDP potential. GDP growth will exceed potential in periods of expansion and fall below it in periods of contraction. To avoid this potential decline in long-term GDP, productivity will have to improve substantially – which means a stubbornly high unemployment rate. We believe Europe is slowly, but surely, slipping into a Japanese-style deflationary/low growth environment.

## Japan

Japan is coping with its worst recession ever. To make things worse, the yen reached its highest levels since the mid 1990s just as Japanese industrial production has dropped to lows it has not seen since the late 1980s.

### JAPAN: THAT SINKING FEELING

*Japanese industrial production*



The Japanese equity market has been one of the hardest hit since the credit crisis started in the middle of 2008. Considering the current economic situation, the underperformance of Japanese equities does not seem particularly surprising.

This situation is not sustainable. We believe heavy foreign exchange intervention and the reintroduction of Japan's quantitative easing policy is imminent. While a monetary policy shift would increase the odds of a recovery in global equity and global credit markets, the recovery is likely to be characterized by the underperformance of the Japanese equity market.

## China

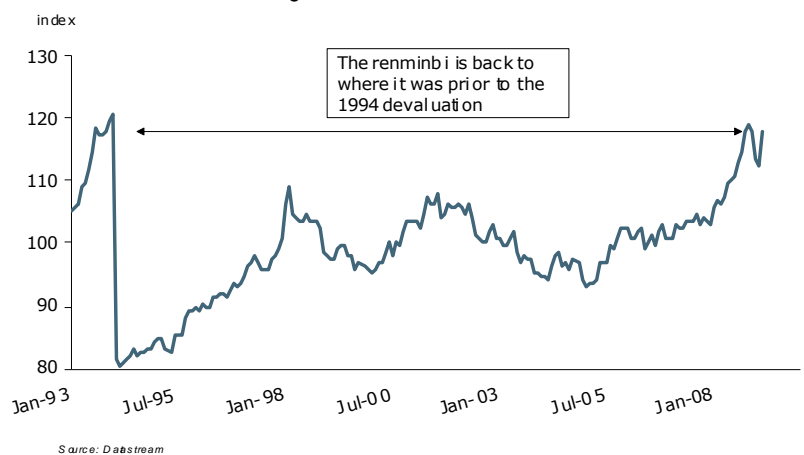
The world imports a lot of goods from China, so inflation in China has a big influence on the rest of the world. The last time deflation hit China – from 2002 to 2003 – it delayed the recovery in global equities and prolonged the rally in global bonds. More important, it allowed central bankers to keep interest rates lower for a longer period, fueling the bubble in real estate.

Deflation is back in China. Total CPI inflation is currently at -1.5%, and we project it will drop 3.0% over the 12-month forecast horizon.

To defeat deflation, the Chinese economy would need to grow quickly. However, shifting back to high gear won't be easy. China is not as competitive as it used to be. On a real basis, the Chinese renminbi is back to where it was prior to its devaluation by -40% in 1994. That means a Chinese economic recovery will likely have to be driven by the domestic economy and the Chinese consumer.

### CHINA: BACK TO SQUARE ONE?

*China real effective exchange rate index*



#### Risks:

**Deflationary Bust:** Despite the aggressive rescue efforts by the central banks, if the credit squeeze lasts too long it could impede the global financial system. A deflationary mentality could take root, which would be very difficult to break. Such a scenario would support government bonds, and all riskier assets would continue to deflate.

**Economic Expansion:** With the extreme pessimism still plaguing the financial markets, a major surprise would be for the global economy to experience a milder recession – helped by effective and coordinated monetary and fiscal policy intervention. At currently depressed prices, credit spreads could narrow and equities could stage a strong rally relative to government bonds.

#### Signposts:

- Inflation expectations
- U.S. initial claims
- U.S. existing home sales
- U.S. loan officer surveys
- Purchasing Managers Index
- Equity and currency volatility index
- Cyclical versus defensive stocks performance
- Chinese retail sales
- Chinese money growth

## CURRENCY

The turmoil in the financial markets has been accompanied by deleveraging pressures and massive moves in currency markets. As investors left cyclical currencies for safe haven currencies, valuations were pushed to extreme levels.

As safe haven currencies, the U.S. dollar, the Japanese yen and the Swiss franc reached such high levels that their countries' exports became uncompetitive. Meanwhile, the cyclical commodity-based currencies – the Canadian dollar, the Australian dollar and the British pound – have sold off, facilitating the adjustment to a downturn in economic activity and the future recovery in these countries. That leaves the euro in the middle. We believe the euro's decline has been insufficient to support the eurozone economy. Our view is that the effects of the extraordinary reflationary measures that have been undertaken on a global scale should gain traction as the year progresses.

Over the next 12 months, we believe the U.S. dollar will likely decline for the following reasons:

- The deleveraging process and the flight-to-quality panic should end, which may stop and then reverse some of the capital flow into U.S. assets;
- Higher interest rates and/or a weaker U.S. dollar could be needed to finance the worsening U.S. fiscal deficit;
- With domestic demand tepid, the U.S. needs a weaker currency to support its export sector;
- The U.S. terms-of-trade could deteriorate relative to those of commodity-based currencies as commodity prices improve.

The global reflationary environment we are expecting should underpin commodities and commodity-based currencies. Because of its stronger fundamentals, the Canadian dollar has not lost as much ground in relation to the U.S. dollar as other commodity currencies. Therefore, as the global economy stabilizes, we do not expect the rebound in the Canadian dollar to be as strong as the rebound in the Australian dollar and Norwegian kroner.

Our positive view on the Canadian dollar/U.S. dollar exchange rate is based on the following:

- Canada/U.S. relative terms-of-trade should improve with the expected rebound in energy prices;
- The banking sector in Canada is in much better shape than in the U.S.;
- Canada is in a better fiscal position than the U.S.

The financial conditions in the eurozone, Japan and Switzerland have tightened to extreme levels, and their economies and currencies should fare even worse than the U.S. in the year ahead. Exports represent close to 50% of GDP in the eurozone. The lack of ECB action and a reliance on emerging Europe for its export markets could lead to downward pressures on the euro in the medium term.

In our view, the Japanese yen and the Swiss franc are both safe haven currencies. The risk aversion that took hold during the financial crisis has led to impressive rallies in both currencies. Since interest rates in Japan and Switzerland have reached near zero, we believe the only tool left for their central banks is quantitative easing. The Swiss National Bank has already started intervening in foreign exchange markets to weaken the Swiss franc. Therefore, we expect the Japanese yen and the Swiss franc to weaken.

We expect the currency market to be driven by valuation. We appreciate that valuation is not a timing tool and that currencies can remain over or undervalued for long periods of time. However, we believe this investment style could be an excellent guide for finding currency opportunities in the year ahead. As sentiment shifts between optimism regarding policy stimulus and the bleak reality of economic news and doubts about the effectiveness of the various policy initiatives, the management of risk exposure will be paramount.

### Risks:

**Deflationary Bust:** In this scenario, global growth contracts as the deleveraging forces are more powerful than the reflationary efforts. This would result in increased risk aversion and a sharp correction in cyclical assets. In this scenario, the U.S. dollar and the safe haven currencies, such as the yen and Swiss franc, would rally, and commodity currencies, such as the Canadian dollar, as well as some emerging market currencies, would suffer.

**Economic Expansion:** Policy efforts throughout the world would likely be more effective than currently expected by financial markets. The housing market could stabilize and the credit markets improve, which would potentially lead to a stronger recovery in demand and investments. Combined with a strong fiscal package, the U.S. economy could rebound quickly from its housing downturn and risky assets regain part of their lost ground. Commodity and emerging market currencies could outperform the U.S. dollar significantly.

### Signposts:

- U.S. housing
- U.S. employment data
- Central bank balance sheets
- Long-term interest rate differentials
- Gold, iron ore and copper prices
- Chinese retail sales
- Chinese money growth

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