



Economics & Strategy

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"... it's time C\$ short sellers gave up the notion that there is still a manufacturing sector in Canada left to protect."

Give It Up

by Jeff Rubin

Little more than five years ago, when the loonie traded below 62 cents, parity seemed unthinkable. The currency's extinction and subsequent replacement by the US dollar would have been a more likely five-year outlook. What seemed to put parity, or even today's 93-cent value, out of reach was the dire implications those currency levels would pose for the country's manufacturing sector. But what's recently pushed Canadian dollar short sellers so offside hasn't been the lack of pain in manufacturing, but how little difference that pain has meant for the overall Canadian economy.

Like factory sectors in many other OECD economies, the fate of Canadian manufacturing was sealed a long time ago, when the tariff wall fell and import quotas were withdrawn. It's been downhill since. And that includes the crown jewel of Canadian manufacturing—the auto industry, once the source of half of Canada's merchandise trade surplus. Both manufacturing employment and the auto trade surplus are rapidly fading benchmarks of a past age that bear little relevance to today's economy and even less for tomorrow's.

The loss of 275,000 factory jobs since 2002 has turned out to be nothing more than a footnote in a Canadian labour market that has seen the creation of one-and-a-half million jobs in the rest of the economy, and now sports the lowest unemployment rate in over three decades. With the likely loss of another 200,000 factory jobs over the balance of the decade (see pages 4-7),

manufacturing's share of total employment will soon fall to a post-war low of less than 10%, a threshold the US economy is already at. Like agricultural employment that once accounted for a quarter of the labour force, factory jobs are heading down a road from which there is no return.

Manufacturing's decline is equally invisible in the country's trade performance, crucial to an economy where exports are still nearly 40% of GDP. The days of a \$20 billion trade surplus in autos and parts, circa 1999, are long gone, and like the factory payrolls of yesteryear, they're not coming back. Today the trade surplus in vehicles and parts is barely running around a billion dollars.

Ontario may be competitive against Michigan, but neither has the type of economy that will house tomorrow's auto industry. Like most of the rest of manufacturing these days, auto production will be heading for the cheap labour markets of Eastern Europe and China. But the implications of that, even for the Ontario economy, let alone the Canadian one, become less and less over time. And just as the labour market has shrugged off mounting factory job losses, so too has the trade balance all but ignored the loss of its once largest contributor, the post-Auto Pact surplus in vehicles and parts.

How high energy and base metal prices take the loonie is still anyone's guess. But it's time C\$ short sellers gave up the notion that there is still a manufacturing sector in Canada left to protect.

<http://research.cibcwm.com/res/Eco/EcoResearch.html>

MARKET CALL

- Upward revisions to the US Q2 growth outlook, and the lack of any trend towards labour market slack, make any turn towards a dovish Fed policy too distant to be reliably called this far ahead. We've dropped our call for a small mid-cycle ease, and see US overnight rates on hold through 2008. That said, further out the curve, the worst of the damage has likely been done (see pages 8-9).
- The Bank of Canada will likely follow through on its saber rattling with a July quarter-point rate hike. The pain from a strong C\$ hasn't spread as widely as we anticipated through the rest of the economy (see pages 4-7), and more to the point, the Bank wants to see some pain to put downward pressure on growth and core inflation.
- A further spike towards parity in the C\$ might ultimately be a sufficient substitute for rate hikes to keep the Bank on hold after July, prompting a further slide in manufacturing and dampening inflation directly by cheapening the C\$ prices for imports. But it will be some months before that's clear to the bond market, and longer dated Canadas have some catching up to do after the greater steepening sell-off seen in Treasuries.

INTEREST & FOREIGN EXCHANGE RATES

END OF PERIOD:	2007				2008		
	14-Jun	Sep	Dec	Mar	Jun	Sep	Dec
CDA Call loan (mid-point of range)	4.25	4.50	4.50	4.50	4.50	4.50	4.50
98-Day Treasury Bills	4.36	4.55	4.45	4.40	4.40	4.40	4.45
Chartered Bank Prime	6.00	6.25	6.25	6.25	6.25	6.25	6.25
2-Year Gov't Bond (3.75% 06/09)	4.72	4.80	4.70	4.60	4.55	4.55	4.65
10-Year Gov't Bond (4% 06/16)	4.68	4.85	4.85	4.80	4.70	4.65	4.65
30-Year Gov't Bond (5.75% 06/33)	4.60	4.70	4.70	4.65	4.60	4.55	4.55
U.S. Federal Funds Target	5.25	5.25	5.25	5.25	5.25	5.25	5.25
91-Day Treasury Bills	4.63	4.70	4.70	4.65	4.65	4.60	4.70
2-Year Gov't Note (4.875% 05/09)	5.08	5.10	5.10	5.05	5.05	5.00	5.10
10-Year Gov't Note (4.5% 05/17)	5.22	5.30	5.20	5.20	5.20	5.15	5.20
30-Year Gov't Bond (4.75% 02/37)	5.30	5.40	5.35	5.30	5.30	5.25	5.30
Canada - US T-Bill Spread	-0.27	-0.15	-0.25	-0.25	-0.25	-0.20	-0.25
Canada - US 10-Year Bond Spread	-0.54	-0.45	-0.35	-0.40	-0.50	-0.50	-0.55
Canada Yield Curve (30-Year — 2-Year)	-0.12	-0.10	0.00	0.05	0.05	0.00	-0.10
US Yield Curve (30-Year — 2-Year)	0.22	0.30	0.25	0.25	0.25	0.25	0.20
EXCHANGE RATES							
— (US¢/C\$)	93.6	96.2	100.0	100.0	96.2	95.2	94.3
— (C\$/US\$)	1.068	1.040	1.000	1.000	1.040	1.050	1.060
— (Yen/US\$)	123	119	119	115	112	110	110
— (US\$/euro)	1.33	1.40	1.37	1.34	1.33	1.33	1.33
— (US\$/pound)	1.97	2.05	2.01	1.95	1.92	1.92	1.92
— (US¢/A\$)	83.6	84.0	83.0	83.0	82.0	81.0	80.0

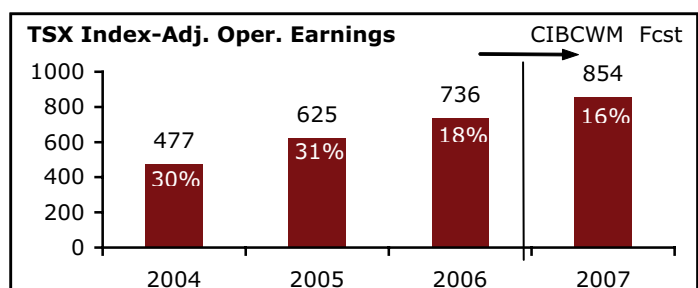
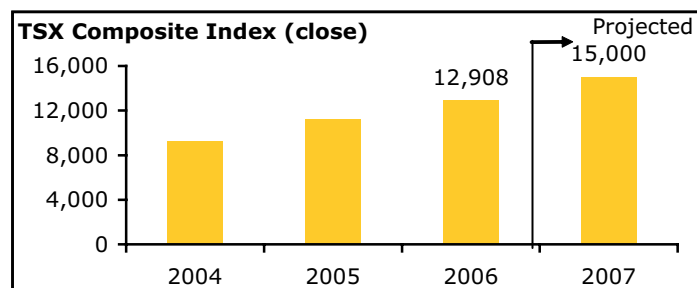
STRATEGY AND EARNINGS OUTLOOK

- The TSX's recent correction is just payback for the market's earlier excessively rapid climb and leaves valuations still up over 8% this year. With a still-hot resource buyout market, above-consensus earnings growth and firm commodity prices signaling a year-end trading level of around 15,000 for the Composite, we remain long equities with a recommended 68% weighting in our model portfolio.
- Stronger-than-expected economic growth and a modest uptick in inflation prompted us to fine tune some of our other asset recommendations. With the Bank of Canada now likely to tighten at least once in coming months, at the start of June we moved a further three points from our already underweight bond position into cash. Returns from the fixed income market will be negligible this year as the Bank hikes rates to tame the economy.
- For much the same reason, we took two percentage points out of the yield-levered financial group, encompassing the banks, major insurers and REITs, reverting to a neutral stance on the sector. At the same time, we added weight to our position in consumer stocks, particularly discretionary. This reflects both a fundamentally stronger consumer and the expected positive impact of C\$ appreciation on profit margins in the retail sector.

ASSET MIX (%)	Benchmark	Strategy Recommendation
Stocks	56	68
Bonds	38	29
Cash	6	3
GICS SECTOR EQUITIES (%)		
Consumer Discretionary	5.2	3.7
Consumer Staples	2.5	1.0
Energy	27.9	31.4
Financials	31.1	31.1
-Banks	17.5	17.5
-Insur., REITs, oth.	13.6	13.6
Healthcare	0.7	0.7
Industrials	5.6	3.6
Info Tech	3.4	1.4
Materials	16.5	19.5
-Gold	5.2	6.2
-Other Metals	8.3	10.3
Telecom	5.6	5.6
Utilities	1.5	2.0

Note: Bold indicates recommended overweight.

TSX - Earnings Outlook & Forward PE					
	Operating Earnings (% chg)			4-qtr Fwd PE	
	2005	2006	2007	Latest	Last 10 yrs.
Energy	54.5	7.3	17.4	15.9	13.0
Telecommunications	2.1	34.7	15.0	17.1	34.7
Industrials	17.0	15.3	9.2	17.6	15.6
Consumer Discretionary	8.5	4.6	3.0	22.1	18.6
Consumer Staples	0.9	-1.3	-3.0	18.0	17.0
Info Tech	260.9	-51.4	25.2	26.0	32.3
Financials	12.8	17.6	17.0	13.8	10.9
Health Care	-5.0	9.8	-29.5	25.0	49.7
Utilities	10.4	15.2	12.4	17.8	13.9
Materials	3.2	80.6	20.5	19.8	27.5
TSX Composite	31.2	17.7	16.0	16.5	17.9



The Vanishing Consequences of a Parity Exchange Rate

Jeff Rubin and Warren Lovely

There's no mystery to the Canadian dollar's unprecedented ascent, but what's fooled many is the resiliency of the economy to that currency strength. After all, this isn't the first time the loonie has taken a serious run against the greenback.

Following the floating of the Canadian dollar in May 1970, the unit went on to rack up a 12% gain over four years, a run arrested by an oil shock that brought the global economy to a crawl. A more dramatic appreciation was witnessed during 1986-91. Then, a roughly 25% surge ultimately ended in tears, as a soaring exchange rate contributed to a deep recession and forced the Bank of Canada to cut rates to stem the tide.

Although significant, those earlier appreciations pale in comparison to what we're now seeing. In the past five-and-a-half years, the Canadian dollar has skyrocketed from an all-time low of 61.8 cents to nearly 94 cents today. Parity with the US dollar—once unthinkable—is not far off, and getting there would imply a cumulative appreciation of over 60% (Chart 1), double the late 1980s/early 1990s gain that spawned so much damage.

For an economy where exports account for nearly 40% of GDP, a supercharged exchange rate should have brought the economy to its knees. Manufacturers are hurting, but the current juxtaposition of the Canadian dollar at a thirty-year high and the national unemployment rate at a three-decade low challenges earlier assumptions

about the broader sensitivity of the Canadian economy to a substantial exchange rate appreciation. Indeed, the apparent ease of adjustment leaves the door open for further appreciation, particularly given that the forces driving the Canadian dollar higher are likely to linger for some time yet.

US\$ Weakness or C\$ Strength?

Of course not all of the 50% rise against the greenback since early 2002 is a C\$ story. Part is a reflection of US dollar weakness and America's record current account deficit, which hit 6½% of GDP last year. Since the loonie's nadir, the US dollar has fallen some 20% on a trade-weighted basis, including a 50% drop against the euro and a near-40% stumble versus sterling (Chart 2, left).

It's been a different story in 2007, however, with the loonie at the head of the class, outperforming other majors (Chart 2, right). Markets are betting that Canada's yield disadvantage—one of the few forces restraining the currency in years gone by—is due to shrink materially in coming months, with BoC tightening.

Merger Wave Sparks Demand for C\$

Meanwhile, elevated commodity prices, and the capital flows they trigger into Canada's resource sector, look to remain firmly behind the loonie. Since 2006, the Canadian dollar has benefited from over \$200 billion in

Chart 1
Previous Periods of C\$ Appreciation

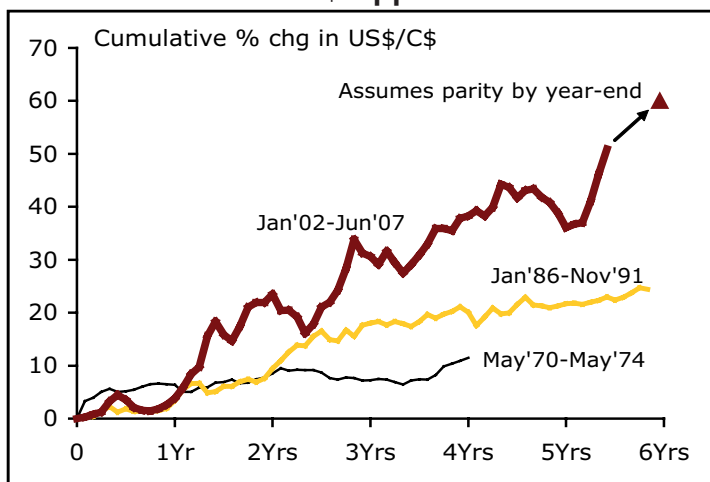
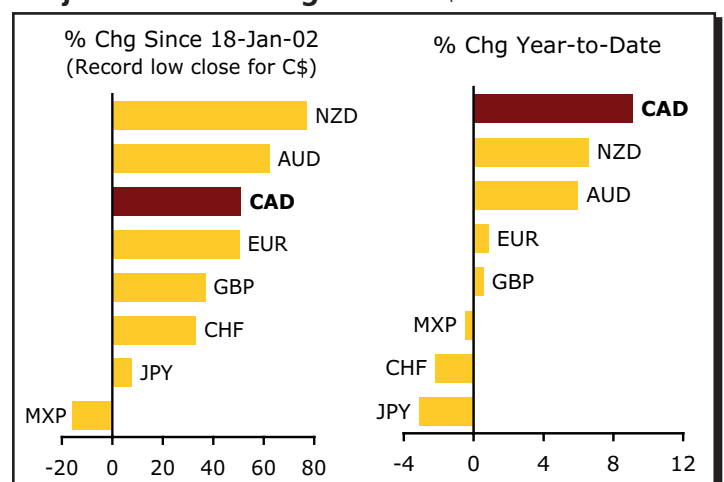


Chart 2
Major Currencies Against US\$



inbound merger and acquisition activity. Action has been frenzied in the resource sector, where former giants like Inco and Falconbridge were taken out, and where Alcan, LionOre and others are now targets.

While many of the big names in the mining and metal processing industry have been spoken for, there are even larger capital inflows potentially still ahead in the energy sector. Thanks to the oil sands, and a still laissez-faire attitude towards ownership of those resources, Canada represents anywhere from 50-60% of the investable oil reserves in the world, depending on whether you consider Nigeria and Kazakhstan open for private investment.

Canada's vast and accessible oil sands are poised to become the final frontier for private energy investment, contrasting mightily with its geological competitor, the Orinoco oil sands in the effectively nationalized Venezuelan oil patch. As the Alberta oil sands become one of the premiere locations in the globe to increase privately owned oil production, its ownership will increasingly be dominated by the world's largest oil companies—entailing significant acquisitions of existing Canadian producers. Consider that the combined market cap for four of the largest domestic oil sands producers, at roughly \$180 billion, is more than double that paid or offered for the four mining firms noted above (Chart 3). Future acquisitions of Canadian energy firms should not only sustain, but increase already heightened global demand for Canadian dollars.

Decline in Manufacturing Hasn't Derailed Economy

Global demand for energy and base metals may be driving the loonie higher, but the Canadian dollar wouldn't have

Chart 3
Potentially Large Capital Flows into Energy Sector

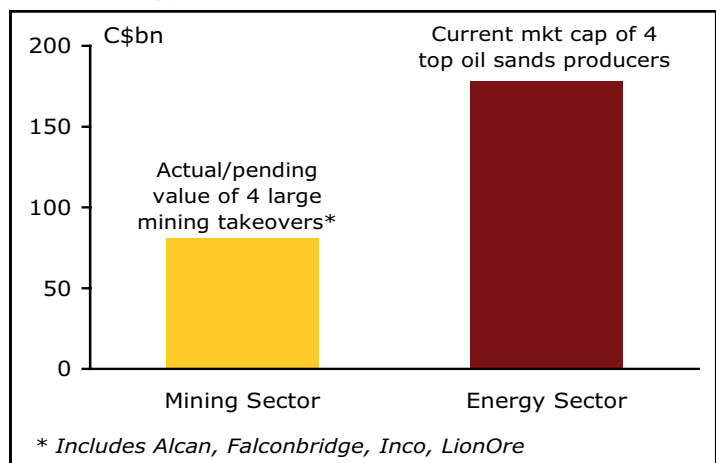
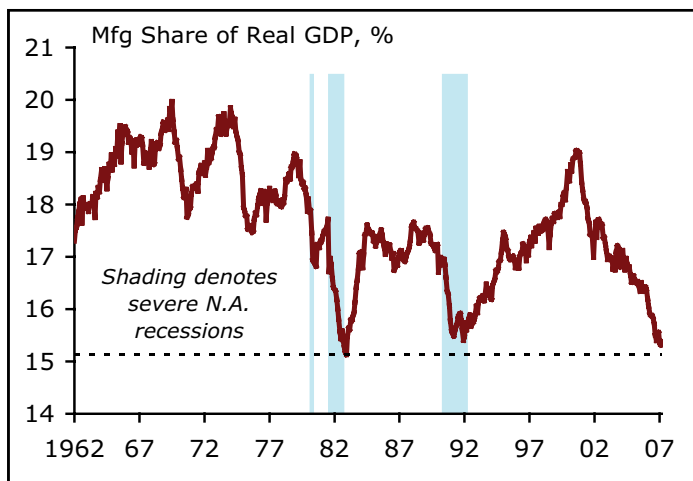


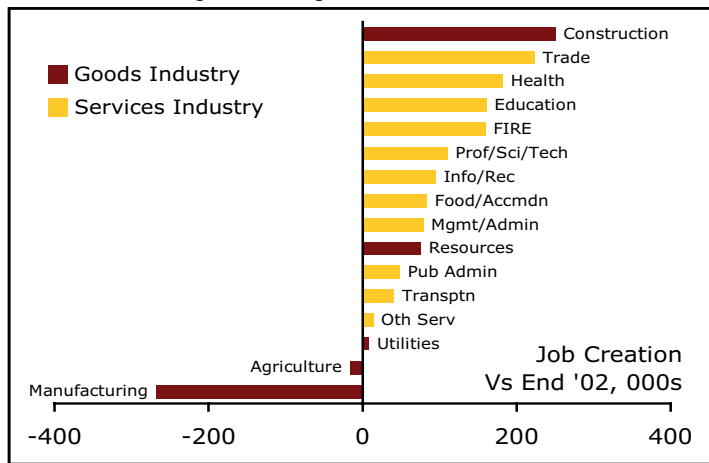
Chart 4
Factory Share of GDP Hitting Past Recession Lows



gone nearly as far if not for the economy's ability to weather a currency storm. The manufacturing sector is far and away the most threatened by the rising currency, since so much of the sector's output is exported to the US market, where competitiveness has always been an issue for Canadian producers. Manufacturing's share of real GDP is now plumbing the lows seen during the two deepest recessions of the last half century (Chart 4). This erosion would have been more severe were it not for deep cuts in factory employment, as Canadian producers, feeling the heat from low-cost centres overseas, scrambled to bolster productivity and maintain some level of competitiveness.

The sector has shed some 275,000 jobs since the currency began its run in 2002, with all of those job losses in Ontario and Québec. But the decline in Canadian

Chart 5
Even Goods Employment Unscathed by Factory Job Losses



manufacturing employment hasn't made much of an impression on the labour market.

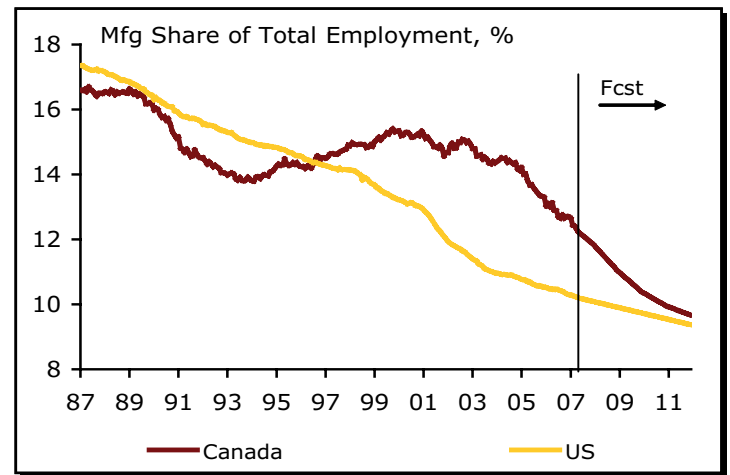
Simply put, a half decade of job losses in manufacturing have been dwarfed by job creation in the rest of the economy. Even in the goods sector itself, manufacturing layoffs have been more than compensated for by hiring in construction and resources (Chart 5). Throw in well over a million new service positions, and resource utilization in Canada's labour market, measured by the employment rate, has never been tighter.

A parity exchange rate would necessitate further declines in manufacturing employment. The earlier C\$ weakness had protected Canadian payrolls from the more aggressive factory job shedding seen in the US and other G-7 countries (Chart 6). But currency-induced cost cutting suggests Canadian factory job losses over the balance of the decade could match that seen since 2002. If so, manufacturing employment would likely dip below 10% of total employment (Chart 7), a threshold about to be crossed in the US economy. As manufacturing's footprint continues to shrink, further job losses in the sector will pose much less of an obstacle to exchange rate appreciation in the future.

Trade Surplus Has Also Weathered Currency's Rise

Not only has a soaring exchange rate failed to jeopardize job creation, but neither has it blown up Canadian trade. The trade surplus is today as large as it was back when the C\$ was trading below 62 cents. While non-resource manufacturing exports have suffered, exports of energy and mining and metal processing have more than compensated, soaring from \$120 billion to \$200 billion

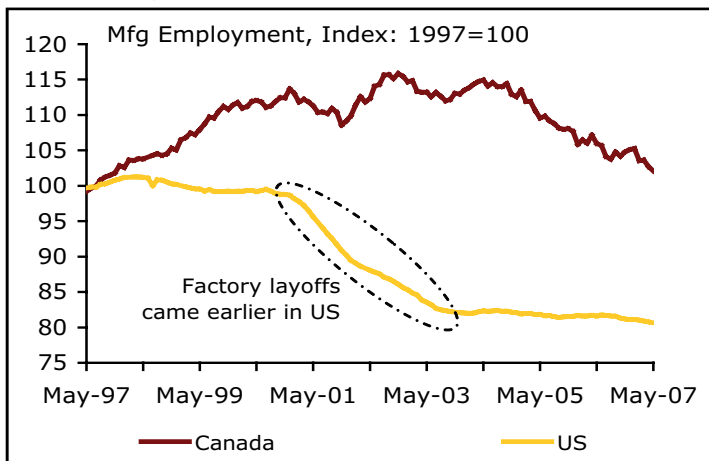
**Chart 7
Declining Importance of Manufacturing in the Labour Force**



(at annual rates) since 2002. A ballooning commodity surplus here has more than offset eroding net trade positions for other goods (Chart 8). The ascendancy of the energy, metals and minerals trade balance coincides with the decline of the country's once huge surplus in autos and parts, which had long been the backbone of Canada's merchandise trade surplus (Chart 9).

While the auto sector in Canada has done better than it has stateside, thanks to the proportionately larger presence of Asian manufacturers in Canada, the industry will be hard pressed to grow on either side of the border. European producers will shift more and more of their value added to Eastern European factories where labour is cheap, while Asian producers look to move production to cheap labour markets like China. The same can more or less be said of the rest of the manufacturing sector, except for that which is directly linked to resource processing,

**Chart 6
US Factory Sector Has Shed More Jobs**



**Chart 8
Sources of Canada's Trade Surplus**

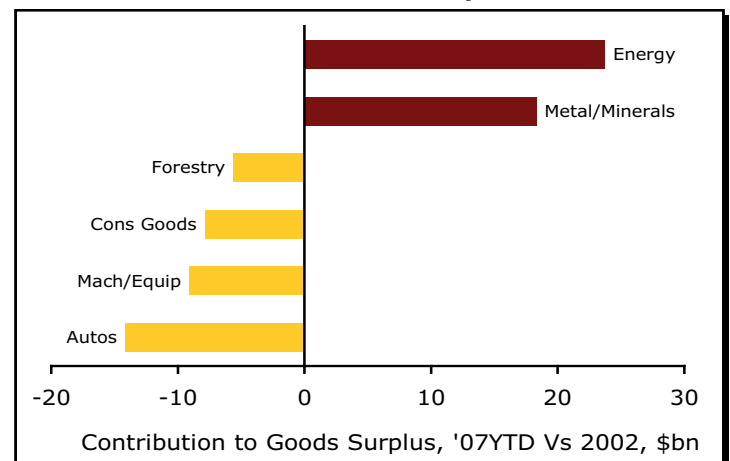


Chart 9
Faltering Auto Trade Surplus

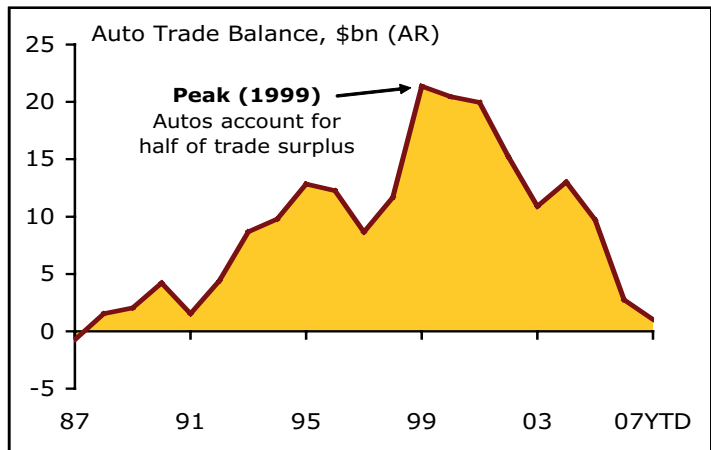
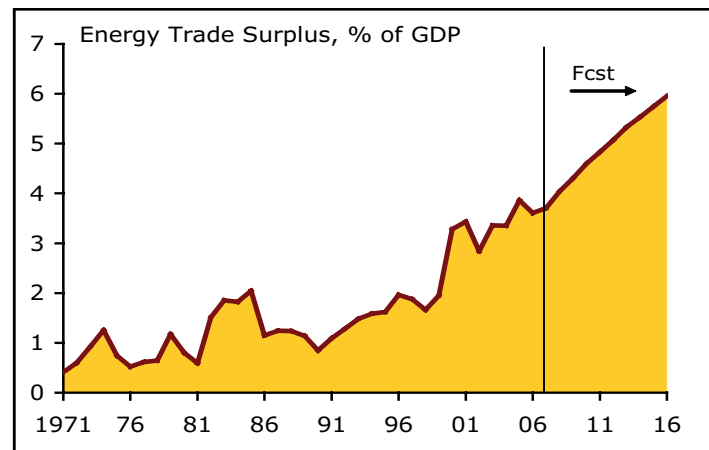


Chart 10
Growing Dominance of Energy Trade Surplus



where Canada's resource endowments give it a natural comparative advantage.

But while the manufacturing sector continues to shrink, energy exports will rise even more dramatically in the future, as oil sands production is scheduled to double or perhaps even triple within a decade, with virtually all of the incremental production slated for the American market.

Even at today's oil prices, soaring oil sands production would boost crude exports by some \$50 billion over the next decade, dwarfing any growth in energy imports into Central and Eastern Canada. Additional support from non-petroleum exports, added to the likelihood of higher prices, should ultimately produce an energy trade surplus double what it is today, rising to 6% or more of GDP (Chart 10). In the aftermath of past oil shocks, such as following the Iranian Revolution in 1978, the energy trade surplus barely touched 2% of the country's GDP. While parity for the C\$ will undoubtedly lead to some plant closures and a further loss of manufacturing exports, the trade balance won't be materially affected thanks to soaring energy exports.

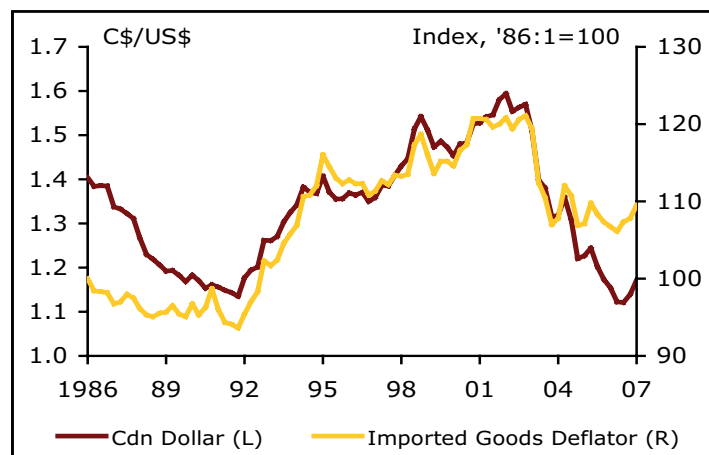
BoC Gives Currency Green Light

The Bank of Canada, eying an economy operating above its non-inflationary speed limit, will welcome the dampening influence of an even stronger currency on both economic growth and inflation. A couple hundred thousand additional factory job losses, while far from derailing domestic economic growth, might be a route to opening up a bit of slack in today's ultra-tight labour market, forestalling a more serious wage threat.

Core inflation, currently 2.5%, has proven surprisingly stubborn, and a resilient housing market suggests a long-standing source of upward pressure isn't yet prepared to fade from view. But the loonie's ascent will, with a lag, tame today's too-hot inflation rate.

A stronger C\$ has seen imported goods prices ease significantly relative to the currency's low point in 2002, echoing results from the 1986-91 appreciation (Chart 11). Our earlier research on dollar-inflation sensitivities implies that a move from 87 cents at the end of 2006 to parity should chop off a half percentage point from underlying core inflation. That's enough of a correction to bring down today's inflation rate to the Bank of Canada's 2% comfort zone over the coming quarters. When it comes to monetary policy in Canada, the C\$ will continue to do the heavy braking for the country's central bank.

Chart 11
Move to Parity Will Bring Down Core Inflation



After the Spike: US Treasuries

Avery Shenfeld

In the financial market, old news is no news. Numerous signs that the US economy has picked up, likely to a 3½% pace for real GDP in the second quarter, has the bond market fearing that the growth party has started. How quickly have investors forgotten that America's 0.6% first quarter was decidedly weaker than just about any forecast made six months ago. Adding in the firmer second quarter would leave first-half growth of barely over 2%, not much different than what those with a dovish view on the Fed expected six months ago, and consistent with the pace that put the Fed on hold (Chart 1).

What made growth so anemic in Q1 was a sharp drawdown in inventories, as automakers and others adjusted output after a few quarters of soft demand. Excluding inventories, real output was up 1.6%, feeding off a stronger consumer sector that had been sluggish in Q4.

Second-quarter output, then, could be nearly 3½% without final sales (GDP excluding inventories) running above 2½% (Chart 2), merely capturing the one-quarter benefit from a return to normal inventory levels. The latest inventory data showed a strong pick-up to start Q2. Strength in factory orders and the ISM index could be, in part, a reflection of the need for inventory restocking. Consumer spending, even with a brisk May, is still tracking slower than in Q1, which benefited from a temporary drop in gasoline prices.

Chart 1
US Real GDP and Two-Quarter Trend

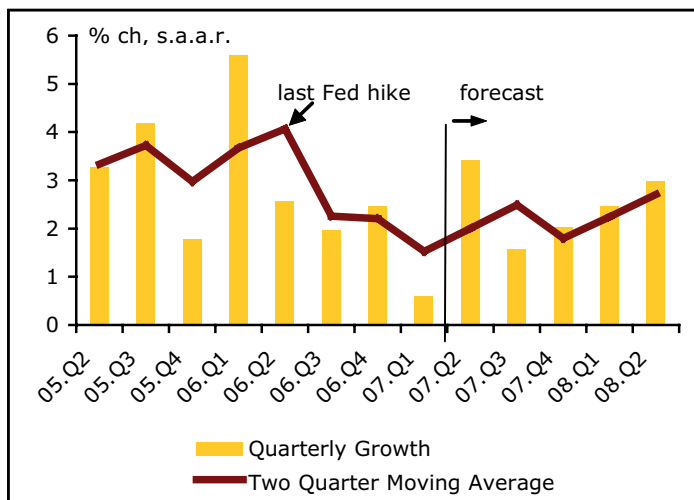
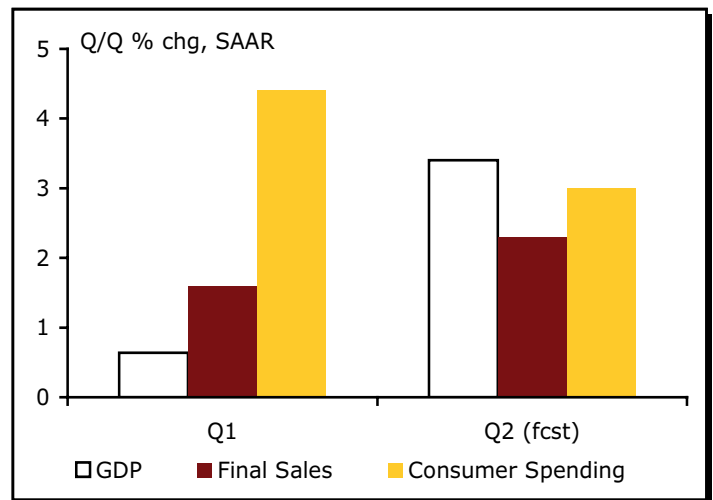


Chart 2
Final Sales Shows Smaller Pick-Up

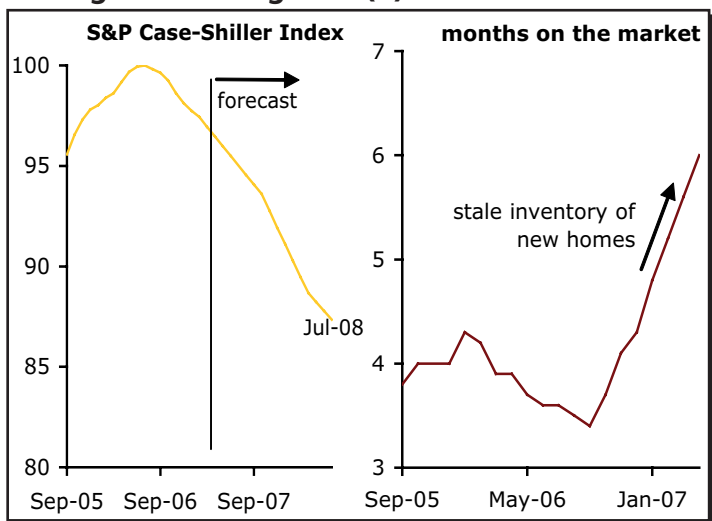


Taking that first half trend of 2.0-2.5% in final sales as the starting point, there does not appear to be a clear directional bias for the second half to be materially better or worse. True, the direct hit to GDP from a drop in housing construction could diminish if starts begin to level off. But against that, we still have most of the job losses from the lower pace of home building lying ahead.

Moreover, house prices, which only started to decline in mid-2006 (using the S&P Case-Shiller index), look to have a long way to go to the downside, and could end up off 15% from their peak. Every measure of the supply overhang—such as the lengthening time that new homes have been sitting on the market—shows that price cuts will be needed to clear the market (Chart 3). It will only take a modest spillover impact from declining housing wealth on the savings rate to eat into consumer spending growth.

So if the economy's underlying real growth trend is still no better than 2½%, where does that leave the bond market? At the front end, the Fed is in the driver's seat. While it hasn't dropped the upward tilt to its inflation risk assessment, it has to be encouraged by the deceleration in core inflation in recent months, taking the core PCE

Chart 3
House Prices Still Falling (L),
Selling Times Lengthen (R)



to 2.0%, and the core CPI to 2.3%. Tame rent inflation should keep core prices on a gradually decelerating track. But our earlier call that growth would dip enough below the non-inflationary trend to compel an ease looks, at a minimum, premature given the upward revisions to the Q2 outlook. That points to a sustained 5.25% funds rate for the foreseeable future.

Further out the curve, we've seen a rapid steepening over the past month, one not easily attributable to inflation fears given the roughly parallel move in inflation-indexed bonds (Chart 4), and the absence of rate hikes priced into the short end. Instead, real rates have risen, and the

most likely suspects lie in the very sources that had earlier inverted the curve to a greater extent than rate cut hopes would have justified: global capital flows.

Central bank tightening is paring back excess liquidity in Europe. But the pools of capital in oil exporters (OPEC, Russia) and China are still growing rapidly, given their trade surpluses. China has to maintain a tilt to US dollar buying if it wants to manage the yuan-dollar pace. But it has announced a policy shift to taking greater risk with what is now a US\$ 1.2 trillion reserve portfolio, shifting some assets into equities, and China has also allowed domestic institutions to put clients into foreign stocks. If bonds are suffering as a result, there should still be winners in stocks as they react to the additional buying power. Some Middle East countries have broken their US\$ peg, while Russia is also thought to be looking at diversifying currency risks.

If the curve is therefore simply reverting to a "normal" slope, how far are we from normalcy? History—at least during a period of similarly contained inflation—suggests that today's 5¼% 10-year yield isn't far off. While the average slope from overnight to tens is steeper, that includes periods where short-term rates are near cycle lows and expected to rise. The average real ten-year yield in the past decade, a period in which core inflation has averaged roughly the same pace as it is today, stands just below the current yield (Chart 5). Add it all up, and Treasuries aren't a screaming buy, particularly while the better news from Q2 GDP is still rolling out, but we've likely seen the worst of the selling. Canadian bonds, in contrast, still face pressure from rate hike expectations.

Chart 4
Nominal & Inflation-Indexed Yields

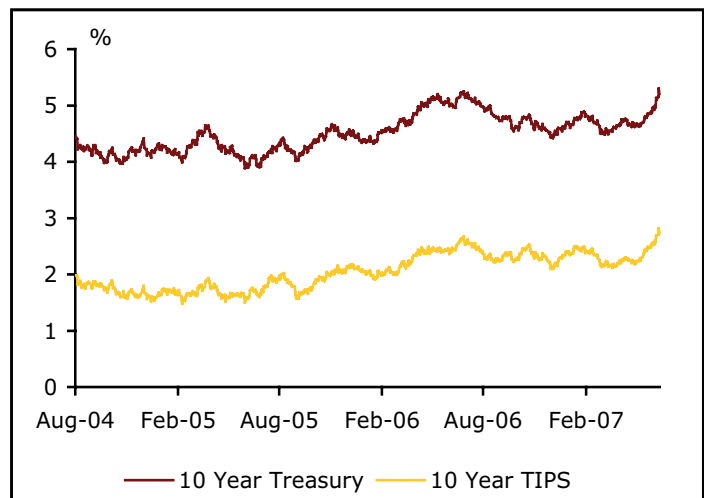
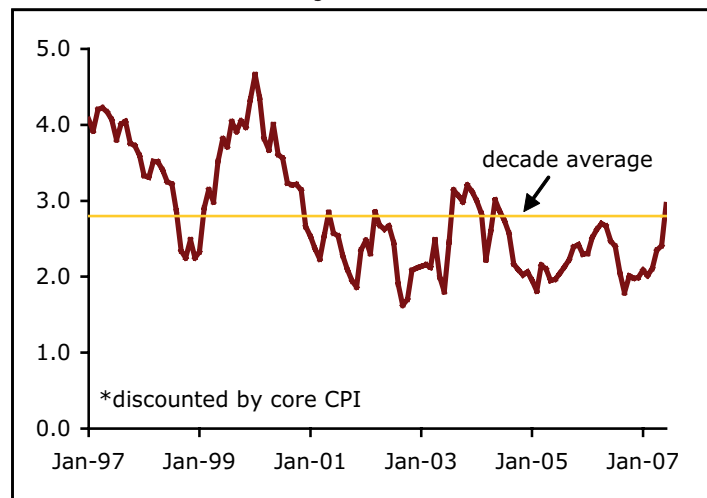


Chart 5
Real 10-Year Treasury Yield



GHG Emissions in Canada—A Temporary Pause

Benjamin Tal

By now every man, woman and child knows that Canada is miles behind its Kyoto commitment to cut greenhouse gas (GHG) emissions. And recently revised data from Environment Canada did not change this reality. But the new and improved measurements reveal that despite a strong economy in recent years, the absolute level of emissions is no longer rising. Unfortunately, a closer look suggests that we have not turned a corner yet, and the recent improvement is due largely to one-off factors. The long-term trend of rising emissions in Canada is intact.

Emissions Leveling Off

The recently released National Greenhouse Inventory Report confirmed that GHG emissions in Canada are still almost 33% above the Kyoto target. But the more interesting finding was that the level of emissions, after rising by an annual average of almost 2% a year since 1990, was virtually flat between 2003 and 2005 (Chart 1). And this improvement occurred in an environment of a healthy economy, as opposed to previous periods of improvements, which were largely the result of economic recessions.

Chart 2 uncovers the dynamics behind the near-zero growth in emissions between 2003 and 2005, with growing emissions from transportation, agriculture and industrial activities being fully offset by falling emissions in the electricity, manufacturing and residential sectors.

Chart 1
Canada's Greenhouse Gas Emissions

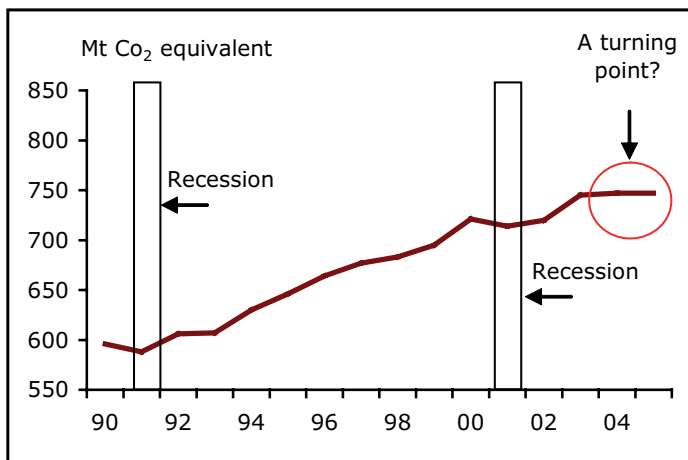
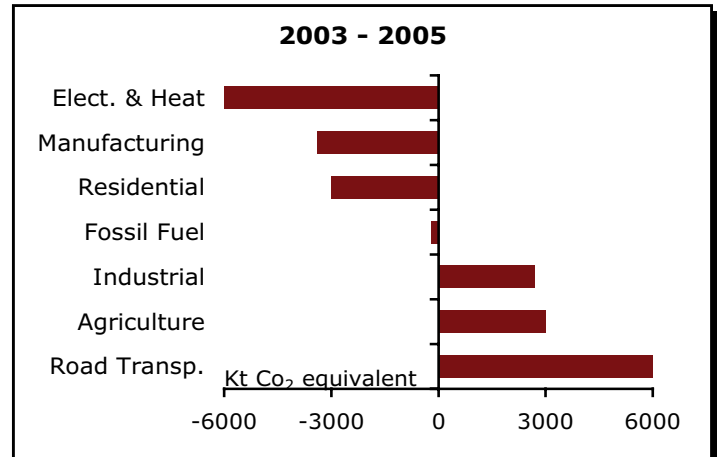


Chart 2
Canadian GHG Growth



Too Good To Be True?

The significant jump in road transportation emissions during that period is definite proof that, at least in the short-term, high gasoline prices provide little protection from rising emissions. Despite a 13% jump in gasoline prices in 2005, the number of vehicles on the road rose by almost 3%—and virtually all of that growth came from SUVs, which on average, emit 40% more than light-duty vehicles (Chart 3).

The notable drop in manufacturing emissions between 2003 and 2005 is a reflection of the fact that a strong dollar is good for the environment. As illustrated in Chart 4, emissions and output growth in manufacturing

Chart 3
SUV Sales Rising Despite High Gasoline Prices

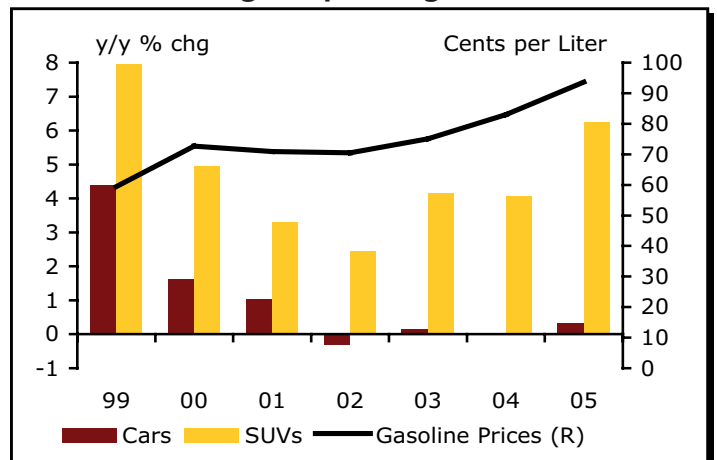
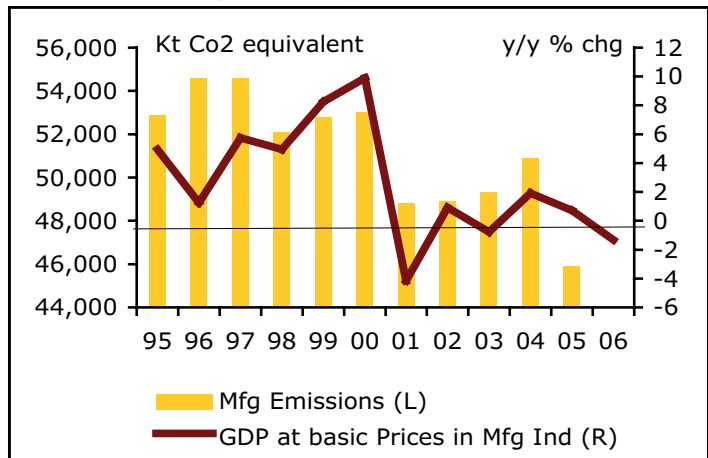


Chart 4
Manufacturing: Activity vs Emissions

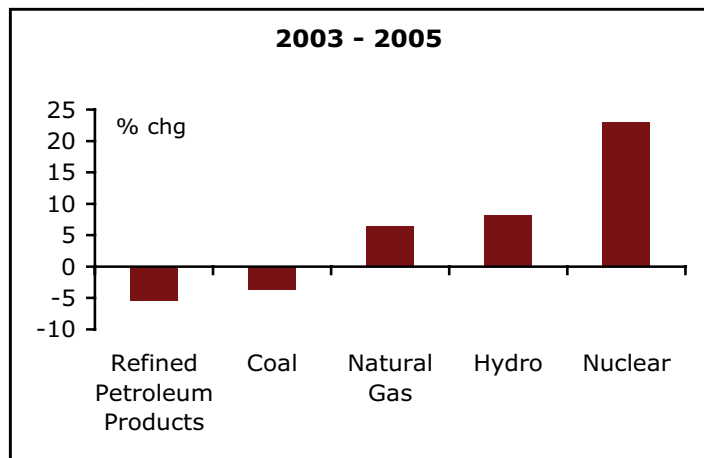


are highly correlated, with the near-10% decline in GHG emitted by Canadian manufacturers in 2005 coinciding with a significant (dollar-induced) softening in overall manufacturing activity. We do not have emissions data for 2006 but we do know that last year was a recessionary year for the manufacturing sector—a fact that almost certainly worked to further reduce emissions in that sector. But even the greenest of the environmentalists would agree that losing 275,000 manufacturing jobs is not an optimal way to cut GHG emissions.

It is well documented that the oil patch is one of the largest emitters in Canada. But the reality is that between 2003 and 2005 emissions from the fossil fuel sector hardly changed. This improvement, however, does not reflect a sudden greening of oil producers. Rather, it reflects a series of outages in late 2004 and most of 2005 in three major oil sands plants that resulted in lost production. At Suncor, a fire in January 2005 at one of its oil sands facilities reduced production by 50% for no less than eight months. As well, at the Scotford Upgrader, operated by Shell Canada, throughput was reduced by 60% for five months due to operational issues, and Syncrude also experienced some lost production due to the unsuccessful start-up of Hydrogen Plant 9-3 in early 2005. The end result of all these outages was that overall oil production in Canada fell by 2.2% in 2005—the first decline in production since 1999. Since then oil production rebounded drastically, to rise by 5.6% in 2006—leading to an estimated 6% jump in associated emissions in that sector.

But by far, the most significant contributor to the leveling off in emissions growth in 2003-2005 was a notable shift in the way the nation's electricity was generated. A naïve glance at Chart 5 reveals a seemingly optimal outcome of an effective environmental policy: Coal- and oil-fired

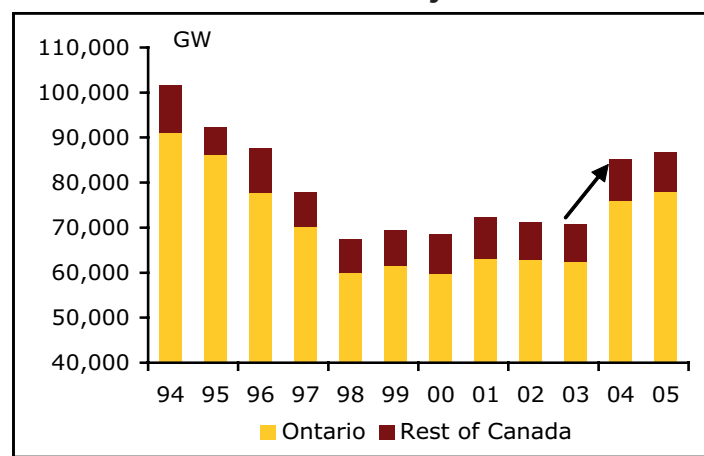
Chart 5
Electricity Generation



electricity generation fell almost 4% between 2003 and 2005, while electricity generated from natural gas, hydro and nuclear energy rose by close to 11%. And the nearly 5Mt of GHG emissions reduction due to the 16,000-GW increase in nuclear generated electricity, is a hint of the enormous prospects of nuclear energy as a potential solution to Canada's emission problems.

But here again, the details spoil an otherwise rosy picture. With 80% of Canadian nuclear capacity located in Ontario, a Canadian nuclear policy is essentially an Ontario nuclear policy (Chart 6). And the recent increase in nuclear generated electricity was entirely due to the return to service of the refurbished nuclear reactors in the Pickering A station. While the Ontario government appears determined to proceed with an increase in the province's nuclear capacity, at the moment there is no new capacity in the pipeline—suggesting that in the near and medium term, nuclear power will be only a marginal offset to rising emissions in the rest of the economy.

Chart 6
Nuclear Generated Electricity



ECONOMIC UPDATE

CANADA	07Q1A	07Q2F	07Q3F	07Q4F	08Q1F	2006A	2007F	2008F
Real GDP Growth (AR)	3.7	2.9	2.3	2.1	2.6	2.8	2.4	2.6
Real Final Domestic Demand (AR)	3.2	3.3	3.2	3.2	3.3	4.7	3.4	3.2
All Items CPI Inflation (Y/Y)	1.8	2.3	2.6	2.9	2.4	2.0	2.4	2.3
Core CPI Ex Indirect Taxes (Y/Y)	2.3	2.4	2.3	2.2	2.1	1.9	2.3	2.0
Unemployment Rate (%)	6.1	6.1	6.1	6.2	6.2	6.3	6.1	6.2
Merchandise Trade Balance (C\$ Bn)	59.7	66.8	65.0	62.4	64.4	51.3	63.5	64.0
U.S.								
Real GDP Growth (AR)	0.6	3.4	1.6	2.0	2.5	3.3	2.0	2.6
Real Final Sales (AR)	1.6	2.2	1.9	2.2	2.3	3.1	2.3	2.5
All Items CPI Inflation (Y/Y)	2.4	2.4	2.2	3.4	3.0	3.2	2.6	2.4
Core CPI Inflation (Y/Y)	2.6	2.3	2.0	1.9	1.9	2.5	2.2	2.0
Unemployment Rate (%)	4.5	4.5	4.6	4.7	4.7	4.6	4.6	4.8

CANADA

After topping BoC expectations by more than percentage point in Q1, Canadian growth looks to retain a decent pace in Q2, where a near-3% advance is eyed. A second-half deceleration reflects weaker demand from south of the border, with domestic sectors likely to hold up well. Labour market slack is largely nonexistent, but a strong C\$ will once again be working to dampen inflation pressure, even if energy and food keep headline CPI running above target.

UNITED STATES

Second-quarter growth now looks decidedly stronger after upside surprises in both May retail sales and April international trade. Still, this all comes off a similar downside surprise in Q1 growth, and is helped by a full-point boost from inventories. Core inflation remains unthreatening, and the moderate medium term growth trend, and easing rent inflation, should keep it so.

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