



Monthly Indicators

April 17, 2007

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Return of the Nukes

If you can't get coal-fired generating capacity licensed in Texas these days, where can you get new coal plants built? Environmental opposition has forced the state's giant utility TXU to recently scrap some 6,000 megawatts of planned new coal-fired capacity in favour of building as many as five new nuclear facilities. Aside from the refurbished plants in Ontario, they will be the first new nuclear stations started in North America in over a quarter century.

Chances are there will be many more coming. The US economy still relies on coal for nearly half its total power needs. That certainly provides lots of room for future substitution as coal-fired utilities find themselves the primary target of a tidal wave of GHG legislation that is sweeping across state legislatures. Weaning American power consumers off cheap and abundant domestic coal supply is rapidly shaping up to be the frontline battleground of the carbon wars in North America.

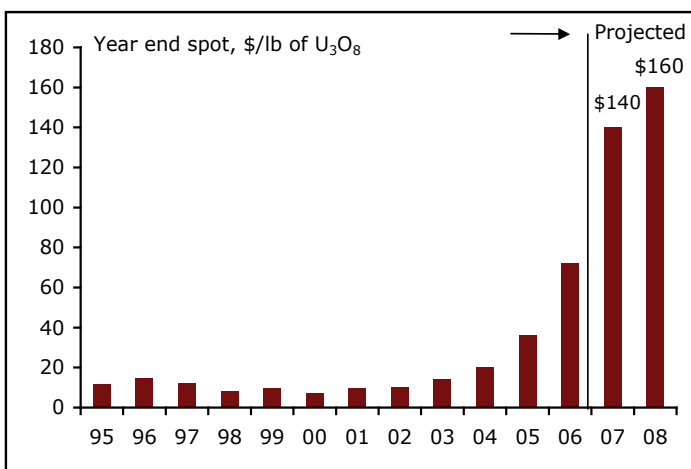
Of course it's a lot easier to say no to coal plants than it is to find the power that they would otherwise

provide. Generation capacity must continue to grow to accommodate an expanding economy and population. With limited untapped hydroelectric capacity to develop, and wind and solar still marginal sources of power, new capacity will increasingly have to be nuclear.

Accounting for only 16% of global power generation today, nuclear power has a huge upside in a carbon constrained world. Unlike other green power alternatives like wind and solar, nuclear facilities provide efficient and reliable base load power at an increasingly competitive price to coal once carbon emissions costs are factored in. While only in the initial stages of rebirth in North America, nuclear power is already riding an expansionary wave from explosive power demand growth in Asia where 21 new reactors will be coming online by the end of the decade and twice that many slated for operation by the end of the next decade.

Finding enough uranium to power all those reactors is already becoming an issue as more and more utilities scramble to lock in supplies. Uranium oxide prices have more than doubled since we last featured the sector in September and are well through our year-end target. With utilities still to contract roughly a third of their uranium fuel requirements over the next five years, we are raising our uranium oxide price target to US\$140/lb this year and US\$160/lb next year (Chart). Mined production won't be able to meet more than its current two-thirds share of global demand until at least the end of the decade (see pages 4-6), and possibly longer depending on when new production begins at the Cigar Lake and Olympic Dam mines. In the meantime, demand for nuclear power continues to grow with every coal plant that doesn't get built.

Uranium Oxide Prices



MARKET CALL

- Decent employment gains and stubborn core inflation have held the Fed to only a modest step away from the hawkish camp. But a collapsing housing market, slowing productivity in Q1, and pessimism reflected in falling capital goods orders point to weaker hiring ahead. We're retaining our call for a total of 75 bps in Fed easing in the second half.
- The Canadian dollar has been on the move, fueled by strong commodity prices, shaky global sentiment on the US greenback, and doubts about whether the Bank of Canada would move rates lower in response to a Fed ease. In the near term, a tight labour market will see the Bank tolerate an appreciation to the 90-cent level as the market rebuilds expectations for a Fed ease, cutting into the negative rate differential at the front end of the curve.
- Further out, the economic conditions that will prompt a Fed ease—slowing consumer spending and hiring—won't go unnoticed north of the border. Given the spillovers to an already-troubled Canadian factory sector, the Bank will likely be forced to put the stop sign on currency markets by matching Fed rate cuts, fueling a bond market rally in the process.

INTEREST & FOREIGN EXCHANGE RATES

END OF PERIOD:	2007				2008	
	16-Apr	June	Sep.	Dec.	June	Dec.
CDA Call loan (mid-point of range)	4.25	4.25	3.75	3.50	3.50	3.75
98-Day Treasury Bills	4.17	4.15	3.50	3.35	3.35	3.70
Chartered Bank Prime	6.00	6.00	5.50	5.25	5.25	5.50
2-Year Gov't Bond (3.75% 06/09)	4.15	4.00	3.50	3.30	3.40	3.70
10-Year Gov't Bond (4% 06/16)	4.22	4.10	3.65	3.45	3.70	3.95
30-Year Gov't Bond (5.75% 06/33)	4.26	4.15	3.75	3.50	3.75	4.00
U.S. Federal Funds Target	5.25	5.25	4.75	4.50	4.50	4.75
91-Day Treasury Bills	4.87	4.85	4.40	4.20	4.25	4.55
2-Year Gov't Note (4.5% 03/09)	4.74	4.55	4.25	4.20	4.40	4.70
10-Year Gov't Note (4.625% 02/17)	4.74	4.60	4.50	4.25	4.55	4.85
30-Year Gov't Bond (4.75% 02/37)	4.89	4.70	4.65	4.50	4.75	4.95
Canada - US T-Bill Spread	-0.70	-0.70	-0.90	-0.85	-0.90	-0.85
Canada - US 10-Year Bond Spread	-0.51	-0.50	-0.85	-0.80	-0.85	-0.90
Canada Yield Curve (30-Year — 2-Year)	0.11	0.15	0.25	0.20	0.35	0.30
US Yield Curve (30-Year — 2-Year)	0.15	0.15	0.40	0.30	0.35	0.25
EXCHANGE RATES						
— (US¢/C\$)	88.4	90.1	88.9	87.0	87.7	87.7
— (C\$/US\$)	1.132	1.110	1.125	1.150	1.14	1.14
— (Yen/US\$)	120	118	112	110	106	105
— (US\$/euro)	1.35	1.34	1.36	1.33	1.33	1.33
— (US\$/pound)	1.99	1.98	1.99	1.93	1.92	1.92
— (US¢/A\$)	83.2	82.0	80.0	78.5	77.0	76.5

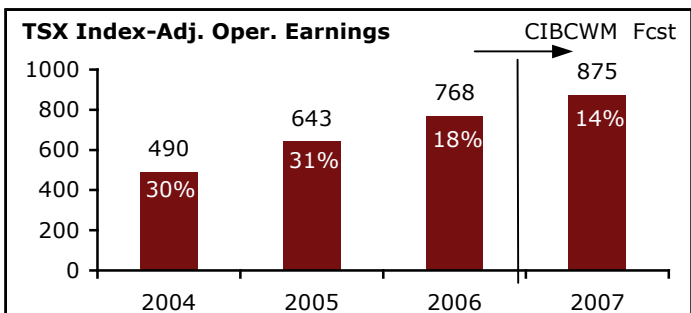
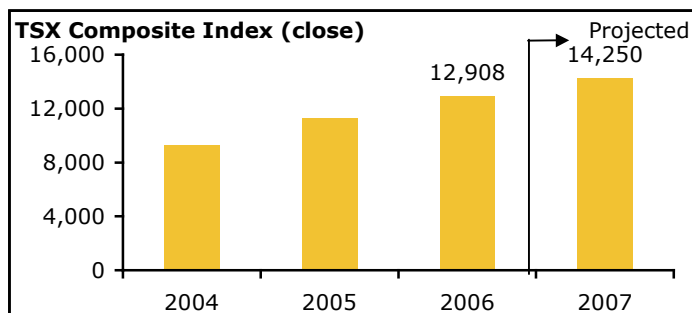
STRATEGY AND EARNINGS OUTLOOK

- The TSX has shrugged off growing concerns about the US subprime mortgage market to set new records recently. While we expect to see further distress in both the US housing market and subprime mortgage market, there is little, if any, evidence of broad contagion effects in financial markets. We remain 10 percentage-points overweight equities in anticipation of a year-end level of 14,250 for the TSX Composite, which is more levered to still hearty global growth than trends nearer home.
- The outlook for the resource sector has brightened with both energy and base metals prices heating up again, warranting continued overweights. Between tensions with Iran, the upcoming Nigerian election, and warnings of another active hurricane season, crude prices should rise to an average US\$75/bbl by Q4. A further increase in uranium prices to US\$140/lb by year end (see pages 4-6) and firmer natural gas prices will also help the energy group set new highs. Base metal stocks are likely to do equally well on the back of strengthening copper and nickel prices while gold shares look undervalued relative to bullish prospects for bullion. We also remain overweight financials, a prime beneficiary of expected second-half rate cuts.
- The primary risk to the outlook is the threat from crumbling real estate values to a housing-wealth levered US consumer. We remain underweight consumer staples and discretionary in view of this risk and info tech sector given overly high valuations. We are moving this month to an underweight in utilities in expectation that privately owned coal-fired power plants may soon have to absorb real costs for carbon emissions.

ASSET MIX (%)	Benchmark	Strategy Recommendation
Stocks	56	66
Bonds	38	34
Cash	6	0
GICS SECTOR EQUITIES (%)		
Consumer Discretionary	5.5	2.5
Consumer Staples	2.6	0.6
Energy	27.0	30.5
Financials	32.5	36.5
-Banks	18.2	21.2
-Insurance, REITs, oth.	14.3	15.3
Healthcare	0.8	0.8
Industrials	5.3	3.3
Info Tech	3.5	1.5
Materials	16.4	18.4
-Gold	6.0	7.0
-Other Metals	7.5	8.5
Telecom	5.2	5.2
Utilities	1.3	0.8

Note: Bold indicates recommended overweight.

TSX - Earnings Outlook & Forward PE					
	Operating Earnings (% chg)			4-qr Fwd PE	
	2005	2006	2007	Latest	Last 10 yrs.
Energy	54.5	4.4	16.0	14.1	13.0
Materials	16.3	97.8	25.6	14.5	27.5
Industrials	19.7	14.3	10.1	15.5	15.6
Consumer Discretionary	6.8	10.7	-9.2	24.0	18.6
Consumer Staples	1.0	-0.9	-8.8	18.5	17.0
Health Care	-6.1	10.7	-5.8	19.1	49.7
Financials	12.8	17.5	15.0	13.7	10.9
Info Tech	260.9	-36.3	25.2	37.6	32.3
Telecom Svcs	1.6	36.7	8.5	15.7	34.7
Utilities	10.4	15.2	10.6	18.4	13.9
TSX Composite	31.2	18.4	14.0	15.1	17.9



Global Warming Heats Up Uranium Market

Jeff Rubin and Peter Buchanan

Lifting Year-End Price Target to \$140/lb

Prospects for the uranium mining industry are as positive as they have been in decades, as climate fears, firm oil & gas prices and exploding power demand growth in China and the rest of developing Asia, re-energize the sector's top customer—the nuclear power industry. Project delays and outages, including flooding at Canada's huge Cigar Lake development and Northern Australia's Ranger Mine have also highlighted the downside risks to production, contributing to a rush by buyers to "lock in" supplies. We have raised our target for uranium oxide to US\$140/lb by this year and US\$160 by late 2008 in recognition of the likelihood that prices will have to rise even higher to narrow the wide gap between current mine capacity and the nuclear power industry's fast-rising requirements.

Secondary supply, a key feature of many resource markets, is particularly important for uranium. Mining production presently meets just 66% of civilian power reactor needs. Secondary sources include inventories held by utilities, mines, other fuel cycle companies, and governments. It also encompasses reprocessed reactor fuels, diluted enriched materials from military programs, and the contents of depleted uranium stockpiles. Secondary sources have been important in recent years, supplying as much as half of the fuel needs of US reactors, but are ultimately finite, and likely to decline, potentially quite rapidly, in coming years.

A key source of secondary supply is the US-Russia Megaton-to-Megawatts Agreement, which converts cold war era arsenals into fuel for US civilian reactors. Some 60% of pledged Russian fuel has already been delivered (Chart 1) under an agreement that expires in 2013. Russia has announced that it will not renew the program, due to its rapidly growing domestic uranium needs. Concern about the resulting supply shortfall has already exerted upward pressure on both spot and long-term uranium contract prices, well in advance of the Agreement's actual expiration. With mined production supplying only two-thirds of uranium demand (Chart 2), any reduction in secondary supplies can have significant price impacts.

New mine capacity is unlikely to change market reliance on secondary supply any time soon. It now takes as long as two decades to bring on a new mine in major producing countries like Canada and Australia due to protracted time requirements for environmental assessment and public hearings. Mined uranium production is fairly concentrated, with just seven companies accounting for three fourths of global output. The same generally holds for new capacity. Our analysis of 14 large new mine capacity projects in seven countries suggests that even in the best case scenario, where all these proceed on schedule, primary production will grow by about 9% or 4,000 tonnes per year. That latter amount is only modestly more-than-expected demand growth, hardly denting the

Chart 1
Russian-US Megaton to Megawatts Program

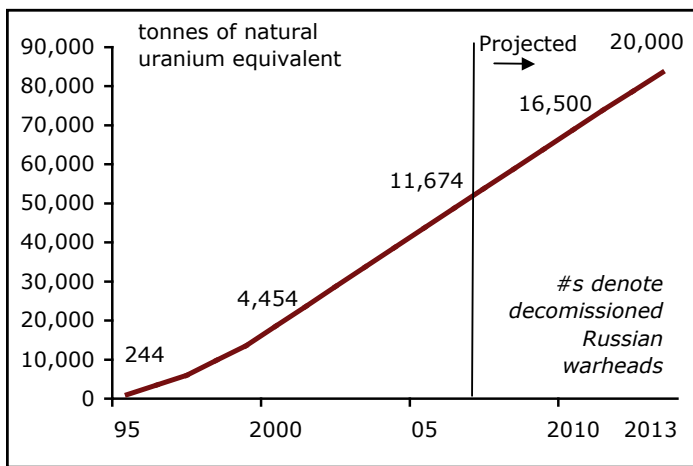


Chart 2
Total Demand, Mined Production & Military/Govt Supply Even with New Mines

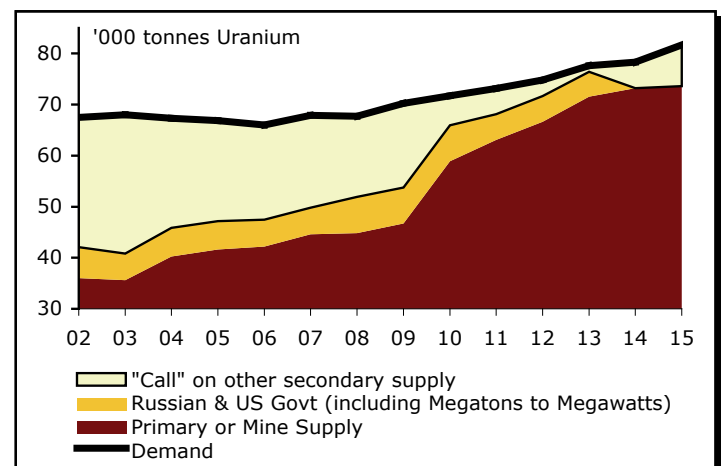


Table 1
Projected Additions to Mined Supply

Mine Supply vs Demand, 2002-2010									
000 tonnes Uranium *	2002	2003	2004	2005	2006	2007	2008	2009	2010
Mine Production	36.0	35.6	40.2	41.6	42.2	44.6	44.8	46.7	58.9
Demand	67.5	68.0	67.3	66.8	66.0	67.9	67.7	70.2	71.7
Primary Supply Gap	31.5	32.4	27.1	25.2	23.8	23.3	22.9	23.5	12.8
-% of Demand	47	48	40	38	36	34	34	33	18
Secondary Supply	31.5	32.4	27.1	25.2	23.8	23.3	22.9	23.5	12.8
-Megatons-to-Megawatts	5.0	5.1	5.1	5.0	5.0	5.0	5.0	5.0	5.0
-Diluted US Weapons Uranium*	1.0	0.1	0.6	0.6	0.3	0.20	0.10	0.00	0.00
-US DOE Stockpiles*	0.0	0.0	0.0	0.0	0.0	0.0	2.0	2.0	2.0
-Inventories, other	25.4	27.2	21.4	19.7	18.5	18.1	15.8	16.5	5.8

na=not available

Source: World Nuclear Association, US Enrichment Corporation, UxC, CIBC WM

*1 tonne of uranium is equivalent to 1.18 tonnes of uranium oxide (U₃O₈)

24,000 tonne gap between demand and mine production until the end of the decade. Hence utilities will remain heavily dependent on secondary supplies.

As noted in Table 1, mined production is likely to expand from 42,000 tonnes per year to 59,000 tonnes per year by 2010. Note that the big jump in mined production in 2010 is largely dependent on the timely completion of the currently flooded Cigar Lake mine in Saskatchewan (Table 2). Any slippage on that date would leave future uranium markets significantly tighter than they already appear.

The potential reduction in secondary supply and delays and disruptions at the key Cigar Lake and Ranger mines in Canada and Australia come precisely when demand for uranium oxide is accelerating. Currently there are 435 nuclear reactors operating in 30 countries around the world, meeting 16% of global power demand. Seven more are slated for commissioning in 2007, with Asia, the focal point of reactor construction globally, leading the way. Four more will commence operations in 2008, and another three in 2009, rising in years beyond that (Chart 3). Each gigawatt-hour (GWh) of increased capacity requires about 195 tonnes of uranium per year of extra mine production on a sustained basis, and roughly three times this amount for the initial fuel load needed to start new reactors. Based on those parameters, we estimate that the 17 GWh of new and refurbished capacity slated for completion in the next four years will lift uranium demand by a cumulative 3,000 tonnes, or 4½%.

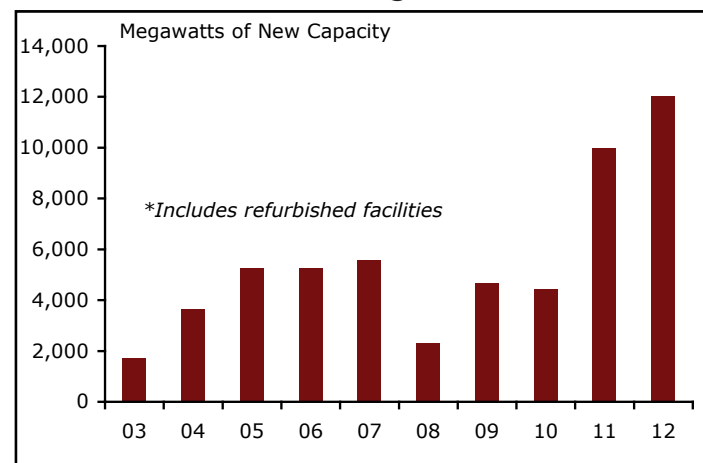
In addition to new reactors, license upratings and improved load factors also drive demand growth. In fact, these factors have accounted for all of the growth

in nuclear generation in recent years in the US. At the global level, we estimate that these factors will add a further 1% annually to consumption, helping to lift demand from an estimated 66,000 tonnes in 2006 to around 72,000 tonnes per year by 2010.

Large Primary Gap Will Persist

Bringing the demand and supply side of the market together, it immediately becomes apparent that the gap between demand and mined production (primary gap) will continue to be very substantial for at least the rest of the decade if not longer. We expect that mined supply still fall well short of expected demand by a good 20% or about 13,000 tonnes in 2010. While that's a smaller gap than exists today, it is still a substantial enough one to put further upward pressure on uranium prices. And, any slippage on the Cigar Lake start date could keep the primary gap at decade-end as large as it is today.

Chart 3
More Nuclear Plants Being Commissioned*



**Table 2
New Capacity**

New Mining Projects, tonnes U				
Corporation	Mine	Country	Start Date	Eventual Capacity
Cameco	Cigar Lake	Canada	2010	7,650
BHP Billiton	Olympic Dam	Australia	2010	4,900
Rossing Uranium	Rossing	Namibia	2010	2,900
Cogema	Midwest (McClean)	Canada	2010	1,500
Kazatomprom	Kharasan	Kazakhstan	2009	1,450
SXR Uranium One	Dominion	South Africa	2007	1,300
Paladin	Langer Heinrich	Namibia	2006	850
Paladin	Kayalekera	Malawi	2009	700
SXR Uranium One	Honeymoon	Australia	2009	600
IUC	White Mesa	USA	2006	330
Others				425
Total				22,605

Instead there are good fundamental reasons for thinking that prices could climb further in the quarters ahead. No other factor arguably has contributed more to revived interest in nuclear power than global climate change worries. On a full cycle basis nuclear power emits the least greenhouse gas emissions per kilowatt-hour of any power source (Chart 4), which takes account not only of direct emissions, but also those released in producing key inputs or components such as steel or concrete. In the near term, prices should also draw support from heightened purchases by power producers both to rebuild inventories and meet appreciable levels of future uncontracted demand.

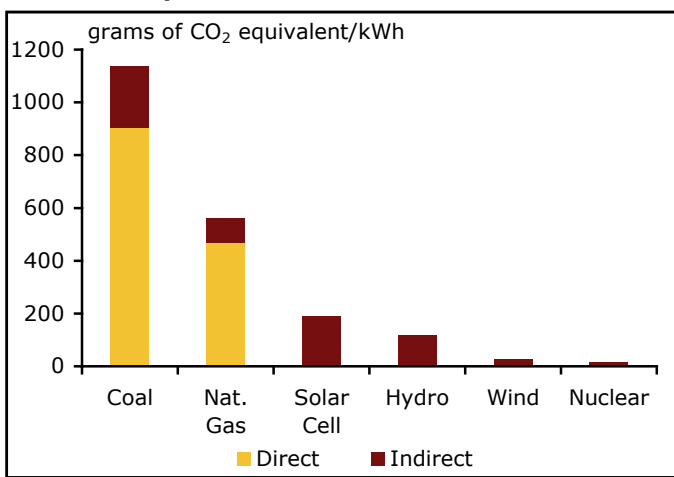
Constructive Fundamentals, Not Speculation Will Drive Uranium Prices Higher

Speculation, while undeniably having some influence, has not in our view been as large or as pervasive a factor in the market for uranium as some observers claim. Identifiable investor-held stocks of uranium are modest, at around 15 million lbs. or about a tenth of annual world demand. Uranium, unlike other metals, also does not trade in a centralized market, limiting liquidity. Nor is there any futures market for uranium, a critical ingredient for speculative activity in base metals markets. In addition, heavy regulation of the product by both national and international agencies would also appear to limit, to at least some degree, opportunities for profitable speculation.

Surging long-term contract volumes suggest utilities have re-entered the market in a major way in the last year or two, after sitting out the rally's early stages. Nevertheless fully half of the uranium fuel needs of nuclear power stations over the next decade remain to be contracted (Chart 5). Hence, we expect utilities to continue to bid aggressively for future supply at upcoming auctions.

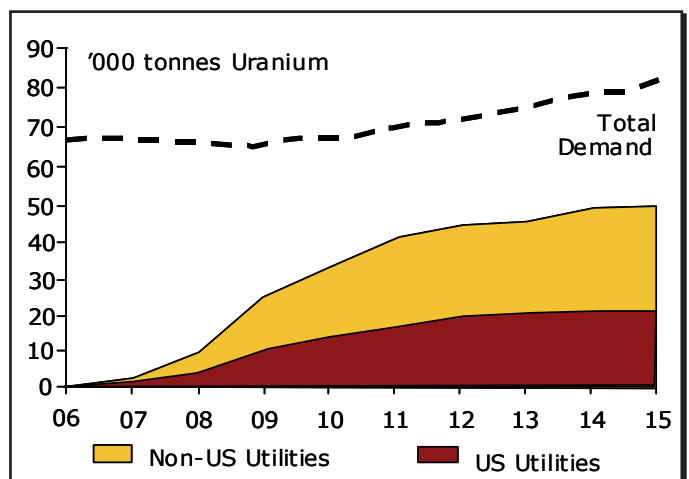
Global warming fears, rising fossil fuel prices and surging power demand in the Far East are fueling a new wave of nuclear plant construction. Along with declining commercial inventories and a heavy reliance on non-mine supply, that has helped turn a buyer's market for uranium into a seller's market. Uranium stocks have been among the TSX's best performers in the last year. Our target prices of US\$140/lb for year-end 2007 for uranium oxide and US\$160/lb for the end of 2008 suggest the sector continues to offer good value.

**Chart 4
Emissions per Kilowatt Hour**



Source: International Atomic Energy Agency (2000); Note: Values are an average of Agency's low and high scenarios; indirect emissions include those from purchased inputs

**Chart 5
Uncontracted Future Utilities Demand**



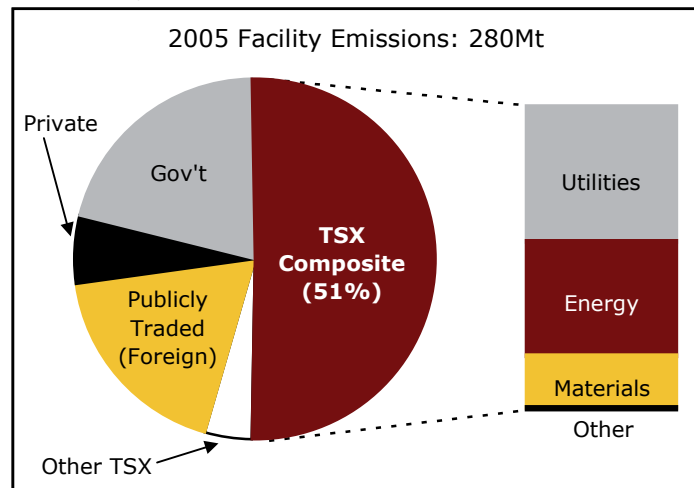
Canada: Tracking Corporate Emissions

Warren Lovely

Canada's Greenhouse Gas Emissions Reporting Program details the country's dirtiest facilities. Covering everything from coal-fired generation plants to oil sands upgraders, steel mills to municipal landfills, 336 facilities reported 280 Mt of CO₂-equivalent emissions in 2005. That's effectively one half of the country's *total* emissions, excluding non-stationary sources tied to transportation. Some 170 companies hold full or partial ownership of reporting facilities, but a core group "owns" the majority of related emissions. The top 12 companies were responsible for 159 Mt of GHG emissions, a 57% share of total facility emissions, qualifying this group as a veritable "dirty dozen" (Table 1).

Government claims responsibility for three of the top 12, including the single largest emitter. The rest are publicly traded companies, and most are TSX Composite members. All told, fully one half of the emissions reported in 2005 could be traced back to TSX Composite companies (Chart 1), which together hold a 27% weight in the index. A further 4% of emissions were linked to other TSX listed firms. Publicly traded firms headquartered in the US or overseas held a roughly 20% share of domestic facility emissions, with a similar portion residing in the public sector. Privately owned firms accounted for the rest.

Chart 1
Company Ownership of GHG Emissions



The domain of the TSX's large emitters is almost exclusively the utilities, energy and materials GICs. While utilities firms hold a mere 1% weight in the index, they account for 45% of emissions linked to TSX firms. That captures a reliance on coal-fired power generation, one of the most carbon vulnerable activities there is, and supports our recommended underweight for the utilities sector. Carbon vulnerability is not limited to those with ownership interests in high emission facilities. But reporting facilities are some of the most easily identifiable emitters in the country, and represent likely targets when it comes to combating climate change.

Table 1
GHG Emissions from Reporting Facilities

Rank	Company Name	GHG Emissions, Facility Based (2005)				Company Ownership		
		Facilities #	Emissions Mt	Share %	Largest Emissions Source Facility Name (Mt)	Publicly Traded		Gov't
						TSX	Other Exch	Enterprise
From 1-12	Parent Company with Whole/Part Facility Ownership							
1	Ontario Power Generation	1	0.0	0.0	Nanticoke Gen. Stn. (17.6)			X
2	TransAlta	1	0.1	0.0	Sundance Gen. Plant (16.2)	X		
3	Canadian Utilities / ATCO ^a	2	4.1	1.5	Sheerness Gen. Stn. (6.5)	X		
4	SaskPower	3	0.4	0.1	Boundary Dam Power Stn. (6.8)			X
5	Imperial Oil	6	1.1	0.4	Cold Lake Oil Sands (4.1)	X		
6	Emera	4	1.1	0.4	Lingan Gen. Stn. (4.4)	X		
7	TransCanada	2	9.0	3.2	Ontario Pipeline System (3.0)	X		
8	EPCOR	5	10.6	3.8	Genesee Thermal Gen. Stn. (8.9)	X		
9	Suncor Energy	7	14.1	5.0	Suncor Oil Sands (7.7)	X		
10	NB Power	6	26.4	9.4	Belledune Gen. Stn. (3.2)			X
11	Shell Canada ^b	1	0.0	0.0	Scotford Upgrader/Cogen. (1.9)		X	
12	Stelco ^c	1	0.0	0.0	Lake Erie Steel (3.6)	X		
SUB-TOTAL: Top 12 Companies		39	66.9	23.9				
TOTAL: All Facilities Reporting		336	279.8	100.0				

^a Combines emissions for Canadian Utilities (member of ATCO Group) with other ATCO companies; both companies are TSX Composite members

^b Shell Canada acquired by Royal Dutch Shell, which trades on NYSE and European exchanges

^c Stelco is TSX listed, but is not a Composite member

Canadian Budgets: Stimulating Reading?

Avery Shenfeld and Warren Lovely

With the budgets from Ottawa and eight provinces now in the books, what does it all mean for the economy and financial markets? Certainly, on the surface, we're headed for more of the same in terms of the budgetary bottom line: another year in an unprecedented string of surpluses—unprecedented for Canada, and without equal among other G-7 jurisdictions.

Timing is Everything

But you can't judge a budget by its cover. For one, the economy is boosted when the government buys capital goods, but the charge in the budget balance measures only the depreciation of existing assets. There are also timing differences between when programs and revenues are booked and when cash is received or disbursed.

In terms of when the cash is actually being spent, Ottawa's net financial requirements are a better guide to the fiscal impetus. On that score, 2007/08 will see a swing back into deficit (Chart 1), for only the second time in the past decade. The one-year change, at \$13 bn, is much larger than anything we've seen in recent non-recession years.

Provincial budgets carry a similar flavour. The provinces that have announced budgets (all except Alberta, N&L) target a \$2 bn surplus, and it wouldn't take much of a surprise to match the 2006/07 results. But on a cash basis (leaving out flows to sinking funds, pension funds, etc. where the cash doesn't flow into the economy),

the budgets also point to increased stimulus (Chart 2), with the cash deficit growing by \$3.5 bn. (Still to come is Alberta, which will show a huge financial surplus for 2006/07, and which due to the need to adopt conservative resource pricing assumptions, has in recent years tended to understate the coming year's surplus.)

Taken together, then, the federal and provincial plans would seem to imply a dose of fiscal stimulus, as measured by the increase in net financial requirements on the order of 1% of GDP. Fodder for rate hikes? Not so fast. For one, the federal budget was no surprise for either the Bank of Canada (or our prior macroeconomic outlook). Dodge is on record as saying that the budget was in line with his expectations in terms of its economic growth implications, and by implication, his currently stuck-in-neutral stance on the direction of interest rates.

Moreover, we have heard this story before. Last year, Ottawa's fiscal bottom line ended up with an extra \$6 bn going to debt reduction relative to the plan, even though the economy wasn't particularly impressive. Indeed, only once in the last nine years has the federal government not dramatically overshot its target for debt pay-downs (Chart 3). Above-plan debt reduction and consequently lower net financing needs, would mean that the budget plan delivers less stimulus than meets the eye, perhaps as little as 0.5% of GDP. And if the economy slows from already conservative budget assumptions for growth, we'll be looking at interest rate cuts, not hikes.

Chart 1
Budgets Swing to Stimulus in 07/08

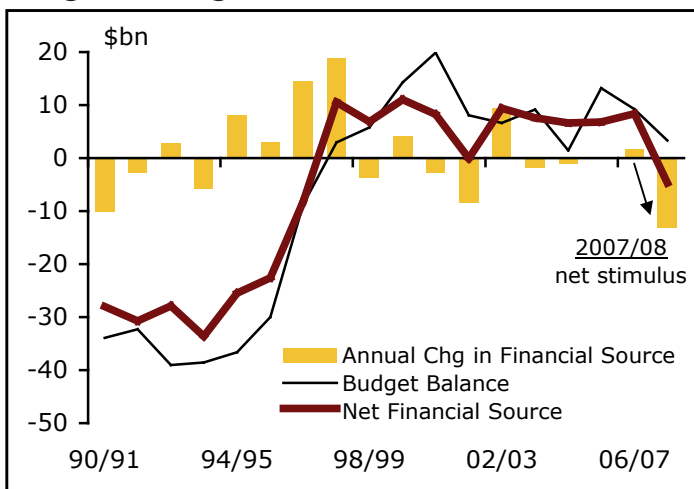


Chart 2
Budgets Balanced, But Cash Requirements Up

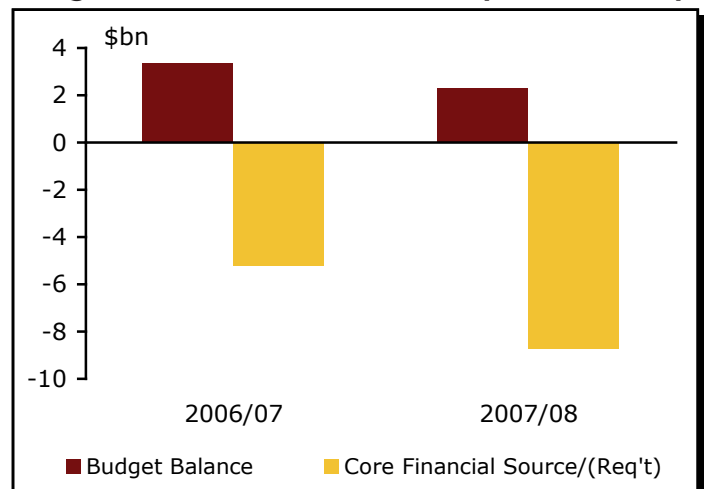


Chart 3
Are We Overdoing Debt Paydown?

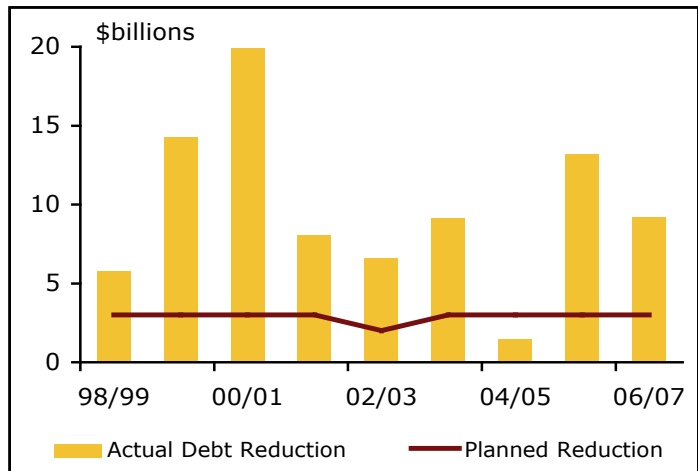
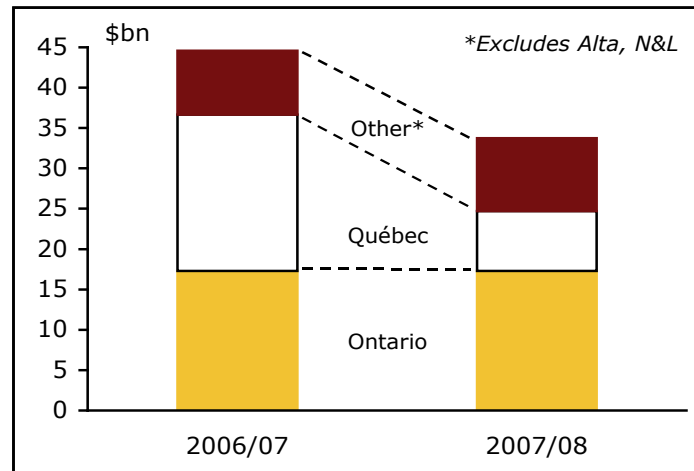


Chart 4
Limited Bond Issuance Planned



Note: 2007/08 issuance based on budgets and CIBCWM estimates; includes direct/guaranteed issuance by provincial authorities

Bonds Still Scarce

Cash needs for government operations are one thing, bond issuance can be quite another. For one, debt-financed pension payments boost requirements for some provinces. These payments are debt-neutral overall, as the unfunded liability is cut by the equivalent amount added to marketable debt. And to the extent pension funds invested in a balanced portfolio earn a superior return than the interest rate on government debt, special pension payments can trim the costs of meeting pension obligations (albeit by taking on some market risk).

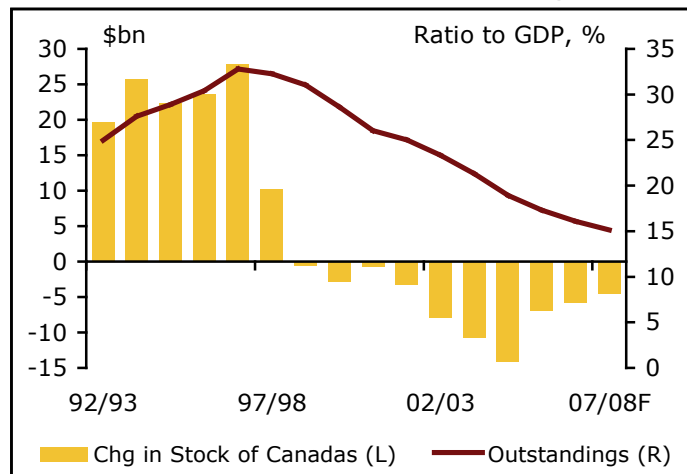
Québec has made regular deposits to its retirement fund, on a path to see unfunded liabilities erased by 2020. For 2007/08, Québec’s pension deposits add \$5 bn in borrowing requirements. Manitoba announced a \$1.5 bn investment to fund its teachers’ plan, lifting borrowing requirements in 2007/08 as a result. Newfoundland & Labrador has yet to table its budget, but recent borrowing there has been linked to special plan payments, with a further contribution expected for 2007/08.

Higher cash deficits and borrowing for pensions would seem to imply a wave of bond issues. But several provinces took advantage of the past year’s low rates to pre-borrow. Excluding retail savings bonds and notes, short-term bills and CPP funding, some \$33 bn of provincial bond/MTN issues is planned for 2006/07, more than \$10 bn below last year’s pace (Chart 4). While we could again see some pre-funding that would add to that total, supply doesn’t look likely to be a negative for provincial spreads.

Similarly, despite Ottawa’s swing to a net financial requirement, gross issuance of nominal Canadas will rise by a mere \$1 bn from last year’s 15-year low, to \$33 bn in 2007/08. After maturities and buybacks, the outstanding stock of Canadas will continue to evaporate. A net retirement of \$4½ bn this fiscal year would take outstandings to little more than 15% of GDP—less than half the peak set a decade ago (Chart 5) and further below the corresponding ratio for US Treasuries. Federally backed CHT issues are filling the gap, but are not equivalent to net borrowing because Ottawa also buys the equivalent in mortgage debt.

A combined cash deficit leaves the economy due to receive a bit of fiscal lift in 2007/08, but with issuance being held in check, light supply continues to provide an edge for the Canadian government bond market.

Chart 5
Stock of Federal Bonds Still Shrinking



Inflation: A Lagging Indicator

Benjamin Tal

Following the October 13th 2000 decision to keep rates unchanged, the FOMC stated: *“The Committee remains concerned about the risk of a continuing gap between the growth of demand and potential supply at a time when the utilization of the pool of available workers remains at an unusually high level..... the Committee believes the risks continue to be weighted mainly toward conditions that may generate heightened inflation pressures in the foreseeable future.”* Three months after making that statement, the Fed cut rates by 50 basis points.

Chances are that history will repeat itself. Yes, the Fed is still talking about inflationary risk, as it did in 2000, but mounting evidence of a slowing economy in the coming six months will outweigh any residual inflationary concerns—paving the way to a rate cut.

Cutting Rates in the Face of Rising Inflation

Despite many monetary policy slips over the decades, the Fed deserves some credit for realizing (albeit a bit late) that as opposed to media headlines, its job description really entails focusing on medium-term inflation risks and not on the CPI du jour. In mid-1989, the Fed started cutting rates while still facing a relatively high rate of inflation. Between mid-1989 and early 1991, the Fed eased policy by no less than 200 basis points. During that period, core inflation accelerated by 0.7 percentage points. Similarly

in late 2000, the Fed initiated an easing cycle despite the fact that inflation was not showing any signs of softening (Chart 1). Lately, while many point to the increase in unit labour costs as a reason for the Fed to stay put or even hike rates, the reality is that in December 2000, the Fed cut rates while still observing a cyclically high 5% year-over-year surge in unit labour costs (Chart 2).

What triggered that courageous monetary act was the realization that inflation is essentially a lagging indicator, and it would be much more prudent to pay closer attention to the fact that, in both 1989 and 2000, the economy was quickly losing momentum.

Fast-forward to today’s situation. The likelihood is that core inflation in the US will remain high for a few more months. A quick look at the source of today’s inflation however, suggests that price pressures in the US will not last. Owner’s equivalent rent (OER)—the component that helped keep US core inflation tame during the recent housing boom—is the one that is keeping core inflation elevated these days. But a glance at Chart 3 suggests that the 30% contribution of OER to the year-over-year growth in core inflation is clearly abnormal. Mean reversion of the OER trajectory would single-handedly eliminate the entire gap between existing and desired inflation.

Chart 1
Cutting Rates in the Face of Rising Inflation

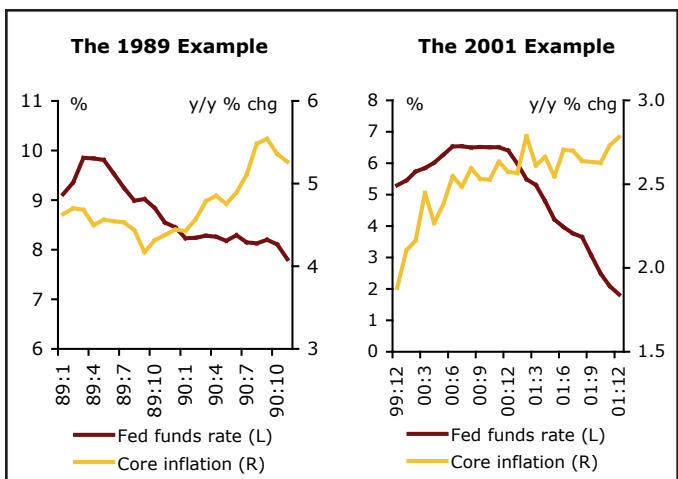


Chart 5
Unit Labour Costs

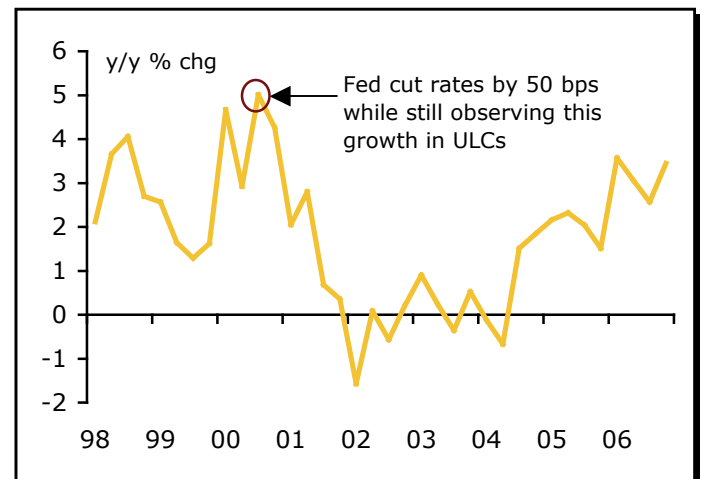
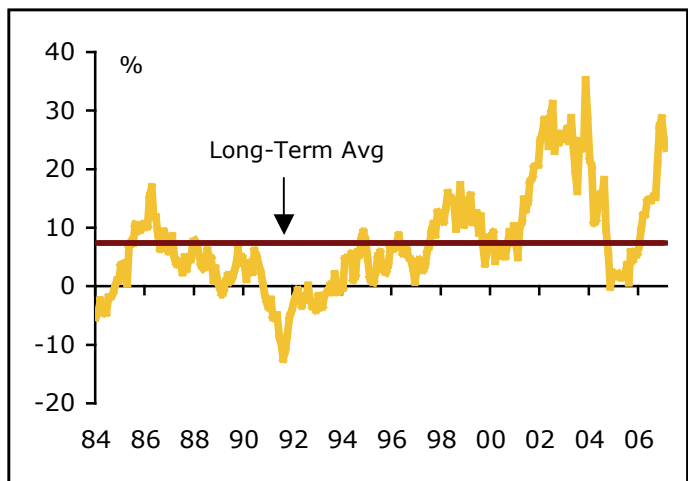


Chart 3
Contribution of Owner's Equivalent Rent to Core Inflation



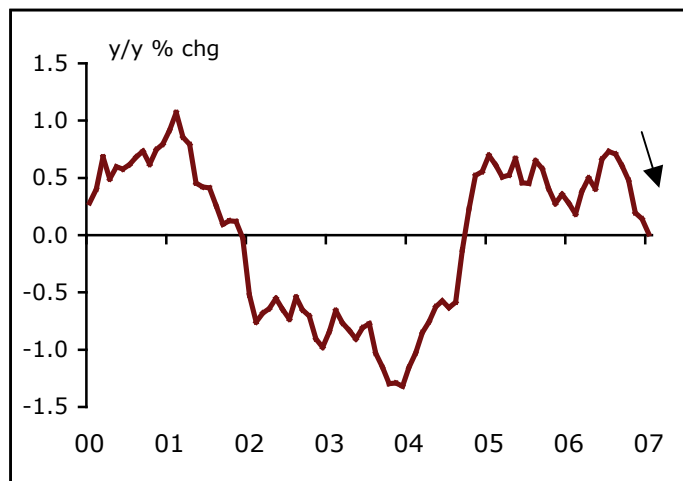
What's more, from a monetary policy perspective, what really counts are those inflation components that are directly linked to the economic cycle. The prices of education or health services are not particularly sensitive to swings in the economy. But the cost of items such as furnishing, apparel or recreation, usually dance much more closely to the tune of the economy. And when zooming in on those cyclically sensitive components of core CPI, we find that they are, in fact, on the verge of deflating (Chart 4)¹.

A robotic Fed would ignore all that and keep rates unchanged until core inflation falls below 2%. But past experience suggests that the Fed possesses the wisdom to deliver a rate cut even before the price adjustment process is completed. The temporary nature of the current up-tick in inflation, deflating cyclically sensitive core inflation, and the inevitable slowing in economic activity would provide the Fed with ample ammunition to justify a rate cut.

The Bank Will Have To Match

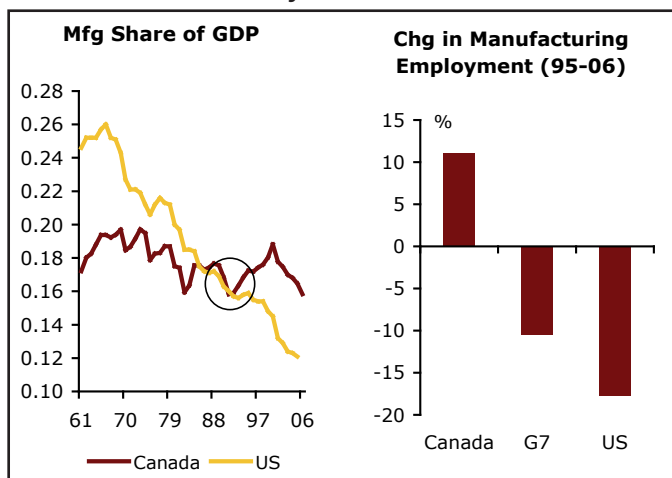
The Bank of Canada has been moderately successful in divorcing itself from the Fed in recent years. But it would be extremely difficult for Dodge to maintain such independence at this point of the cycle. A Fed rate cut with no matching move by the Bank will no doubt boost the value of the Canadian dollar—the last thing Canadian manufacturers need. Despite the 175,000 manufacturing jobs lost over the past three years, the adjustment process in the manufacturing sector in

Chart 4
Cyclically Sensitive Core Inflation is About to Deflate



Canada is still significantly behind that observed in the US, or in any other G-7 country (Chart 5). This means that even without any change to the value of the dollar, the Canadian manufacturing sector will continue to shrink. But a spread-driven boost to the dollar will unnecessarily accelerate that process and exacerbate the pain—taking a sector that is already in recession, into darker places.

Chart 5
CDN Manufacturing Still Behind the Adjustment Curve



Note: (1) Weighted average of Household Furniture & Operation; Apparel; New and Used Motor Vehicles; Recreation; Technology and Personal care.

ECONOMIC UPDATE

CANADA	06Q4A	07Q1F	07Q2F	07Q3F	07Q4F	2006A	2007F	2008F
Real GDP Growth (AR)	1.4	2.5	2.4	2.2	2.5	2.7	2.2	2.7
Real Final Domestic Demand (AR)	3.0	2.3	2.4	2.8	2.9	4.5	2.9	3.0
All Items CPI Inflation (Y/Y)	1.3	1.9	2.1	2.4	3.0	2.0	2.3	2.3
Core CPI Ex Indirect Taxes (Y/Y)	2.2	2.2	2.2	2.0	1.9	1.9	2.1	1.9
Unemployment Rate (%)	6.2	6.1	6.2	6.3	6.3	6.3	6.2	6.3
Merchandise Trade Balance (C\$ Bn)	52.1	63.1	60.6	61.9	63.2	53.6	62.2	62.0
U.S.								
Real GDP Growth (AR)	2.5	2.5	1.8	1.7	2.4	3.3	2.2	3.0
Real Final Sales (AR)	3.7	2.3	1.8	2.2	2.4	3.1	2.4	2.9
All Items CPI Inflation (Y/Y)	1.9	2.3	1.8	1.9	3.3	3.2	2.3	2.6
Core CPI Inflation (Y/Y)	2.6	2.6	2.3	2.0	1.9	2.5	2.2	2.0
Unemployment Rate (%)	4.5	4.5	4.6	5.0	5.1	4.6	4.8	4.9

CANADA

Notwithstanding what looks to be a disappointing (albeit distorted) February growth performance, Q1 GDP should still improve nicely on the lackluster growth pace set in the second half of 2006. Employment remains unequivocally strong, and relative to the US, housing market activity and business capital spending instill greater confidence in future domestic demand. But with exporters seeing only modest growth in their largest market, future GDP gains should be no faster than the economy's non-inflationary speedlimit. And as growth in housing prices settles back, notably tamer core inflation will return.

UNITED STATES

The housing/mortgage crunch is unfolding right on schedule, but we're only in the first inning of seeing the spillovers on other activity. Consumption has been stronger, but capital spending weaker than our last forecast, leaving Q1 growth looking roughly steady from the "final" Q4 pace. But poor capital spending and slower productivity suggest a fall-off in job gains in the next two quarters. Both headline and core inflation outlooks look a bit warmer than last projected, the former seeing a push from food costs, and the latter a more stubborn trajectory for a moderation in rent inflation.

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