



**Economics
& Strategy**

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"For once, a much weaker economy may be needed, if only to put Main Street and Wall Street on the same page."

A Tale of Two Streets

by Jeff Rubin

Damned if they do and damned if they don't. Either way Congress is going to take the rap for whatever happens from America's worst financial crisis since the Great Depression. In acquiescing to a sceptical Main Street, Congress voted thumbs down on the Wall Street bail-out package, leaving the country's, if not the world's financial system exposed to further price declines in the US housing market.

Congress' rejection of the package reflects the still huge and growing chasm between Wall Street and Main Street. Notwithstanding the growing list of banking casualties in the US, and ballooning credit spreads (see pages 8-9), particularly for financial institutions themselves, Wall Street's crisis is yet to make a big splash on Main Street.

To be sure, floating-rate mortgages in the United States are up almost a full percentage point, and car loans are getting harder to come by. Leases for fuel pigs like SUVs are virtually unobtainable, although that may be a good thing in a world of triple-digit oil prices. And while the American economy may be on the threshold of recession, payroll and industrial production losses to date, suggest that has so far been a relatively modest one.

But it is the very benign nature of today's downturn on Main Street that could pose the greatest danger tomorrow. Without a material worsening in the unemployment rate or GDP growth, Main Street could well remain unimpressed with Wall Street's balance sheet ills. And it could still take a quarter or two before average Americans

feel the full impact of what is happening to their financial institutions. Until they do, they are unlikely to become any more tolerant of a bailout package.

The only problem is that the financial system may not be able to tread water long enough before Main Street suffers sufficiently to get on board with a package. That's why it is so pivotal that a package come now, before systemic damage is sustained.

Watching from the sidelines, Canada, and indeed the rest of the world is not immune to what Congress ultimately decides. The international community benefits from any potential package without having to foot the bill for its mammoth cost.

While neither the Canadian economy nor the Canadian housing market (see pages 10-11) are as exposed to the US financial crisis as their American counterparts, ironically the TSX seems far more leveraged to the crisis than either the Dow or the S&P 500. Fears of a financial market meltdown do not bode well for investor sentiment towards commodities. The recent wild ride in oil prices underscores how concern over toxic balance sheets on Wall Street can spill over into other markets, even where there is little to fundamentally connect them. Auto sales and oil demand are still booming in BRIC countries, where SUV sales lead double-digit vehicle sales growth (see pages 4-7).

For once, a much weaker economy may be needed, if only to put Main Street and Wall Street on the same page.

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

MARKET CALL

- Central banks in North America were looking to other measures rather than rate cuts to stem the tightening of conditions in financial markets. These included large scale liquidity injections into short-term funding markets, support for troubled US mortgage borrowers, as well as the TARP program, to boost bank balance sheets. For now, our forecast assumes that some version of the Treasury's plan, or an effective alternative, ends up being adopted by Congress. If so, both the funds rate and the Bank of Canada's overnight target will see no change through at least Q1.
- Government bond markets have seen a huge flight-to-safety bid, and we recently pared back our targets for yields over the next couple of quarters. But the rally in the sovereigns should be partially reversed if current chatter about economic doom proves to be overdone. A larger sell-off will come over the latter half of 2009, when improved global growth makes inflation a meaningful threat once again.
- We reduced our targets for C\$ appreciation by a couple of cents in light of a reduction in our projection for commodity prices over 2008-09. Still, with the current account surplus set to rebound along with resources next year, the C\$ has room to once again break through parity with the US\$.

INTEREST & FOREIGN EXCHANGE RATES

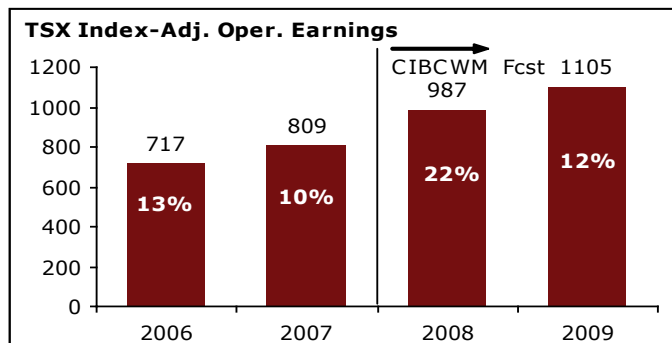
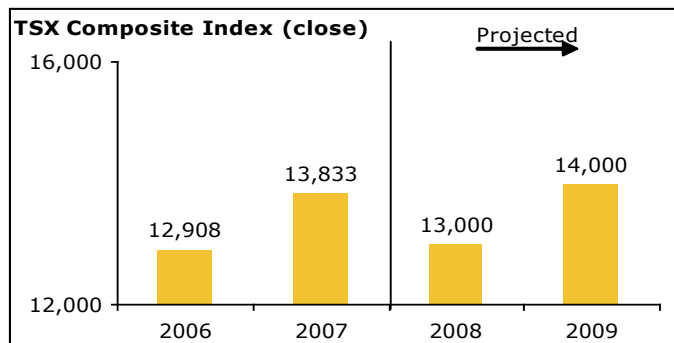
END OF PERIOD:	2008		2009			
	29-Sep	Dec	Mar	Jun	Sep	Dec
CDA Overnight target rate	3.00	3.00	3.00	3.00	3.50	4.00
98-Day Treasury Bills	1.70	2.45	2.75	2.80	3.30	3.70
Chartered Bank Prime	4.75	4.75	4.75	4.75	5.25	5.75
2-Year Gov't Bond (2.75% 12/10)	2.54	3.05	3.35	3.50	4.10	4.35
10-Year Gov't Bond (4.25% 06/18)	3.51	3.80	4.00	4.10	4.30	4.35
30-Year Gov't Bond (5% 06/37)	4.02	4.20	4.30	4.25	4.50	4.65
U.S. Federal Funds Target	2.00	2.00	2.00	2.25	3.25	4.00
91-Day Treasury Bills	0.36	1.50	1.70	2.20	3.00	3.60
2-Year Gov't Note (2% 9/10)	1.67	2.35	2.55	3.20	3.85	4.00
10-Year Gov't Note (4% 08/18)	3.58	4.00	4.35	4.40	4.60	4.65
30-Year Gov't Bond (4.5% 05/38)	4.11	4.55	4.65	4.75	4.80	4.90
Canada - US T-Bill Spread	1.34	0.95	1.05	0.60	0.30	0.10
Canada - US 10-Year Bond Spread	-0.07	-0.20	-0.35	-0.30	-0.30	-0.30
Canada Yield Curve (30-Year — 2-Year)	1.48	1.15	0.95	0.75	0.40	0.30
US Yield Curve (30-Year — 2-Year)	2.44	2.20	2.10	1.55	0.95	0.90
EXCHANGE RATES						
— (US¢/C\$)	95.6	97.6	100.0	99.0	102.0	103.1
— (C\$/US\$)	1.046	1.025	1.000	1.010	0.980	0.970
— (Yen/US\$)	104	108	102	97	96	94
— (US\$/euro)	1.44	1.48	1.48	1.42	1.40	1.39
— (US\$/pound)	1.80	1.84	1.80	1.75	1.75	1.75
— (US¢/A\$)	80.4	88.0	90.0	91.0	92.0	93.0

STRATEGY AND EARNINGS OUTLOOK

- We have reduced our targets for the TSX to 13,000 for the end of the current year and 14,000 for the end of 2009. With Europe clearly in recession and Japan and the US looking little healthier, the world growth outlook is the weakest in years. But it's still nowhere near as weak as the recent plunge in resource stocks would suggest. As in the 2001 recession, China's resource-hungry economy has hardly noticed the US slowdown so far. Ditto for most other emerging market giants.
- We added two and a half percentage points of weighting to financials this month, reverting to a full market weight. Hopefully, efforts to enact financial bailout legislation stateside will eventually bear fruit (see pages 8-9). That won't immediately revive the economy but should help contain the downside risks for the battered financial sector. Sluggish growth and rising household default rates will also hamper Canadian institutions. Mortgage markets, however, do not look in quite as bad shape as their US counterparts (see page 10-11). Canadian PEs already appear to price in a moderate rise in charge-offs.
- We have reduced our exposure to energy stocks by 2½%, which still leaves us modestly overweight that sector. Even with near-recessionary conditions in many industrial countries, oil prices at around \$100/bbl remain at levels that would have seemed extraordinarily high not long ago. Demand in China and the Middle East is still rising at a 5-6% annual pace with limited new supply. That sets the stage for a rebound in WTI to an average \$140 in 2009, as a recovering global economy bolsters demand.

ASSET MIX (%)	Benchmark	Strategy Recommendation	TSX - Earnings Outlook & Forward PE						
Stocks	53	53	Operating Earnings (% ch)				4-qtr Fw d PE		
Bonds	38	35							
Cash	9	12							
GICS SECTOR EQUITIES (%)			2005	2006	2007	2008	Latest	Last 10 yrs.	
Consumer Discretionary	4.0	1.0	Energy	44.7	12.3	8.5	45.6	8.8	12.0
Consumer Staples	2.5	2.5	Health Care	27.5	14.2	35.8	-12.9	16.4	14.9
Energy	30.3	35.3	Industrials	40.7	76.9	1.2	69.2	11.8	28.9
Financials	28.2	28.2	Materials	14.0	17.1	14.1	-7.3	14.8	12.0
-Banks	15.9	15.9	Utilities	17.9	-6.5	58.4	2.1	17.4	17.4
-Insur., REITs, other	12.3	12.3	Consumer Staples	3.1	0.3	-2.6	0.4	15.7	17.8
Healthcare	0.4	0.4	Financials	3.7	19.7	-6.1	14.8	11.4	15.7
Industrials	5.7	3.2	Info Tech	-41.4	51.6	155.5	53.7	18.7	44.5
Info Tech	5.3	5.3	Consumer Discretionary	5.3	28.9	-38.7	-23.8	18.8	22.0
Materials	17.1	20.1	Telecom Services	5.9	30.8	28.4	-8.7	16.6	29.8
-Gold	6.5	8.5	TSX Composite	31.2	13.2	10.4	22.0	12.3	16.1
-Other Metals	4.9	4.9							
-Chemicals	5.1	6.1							
Telecom	5.2	2.7							
Utilities	1.6	1.6							

Note: Bold indicates recommended overweight.



Source: Thomson First Call, CIBC WM

Back to the Future: Revisiting 1982 Auto Sales

Jeff Rubin and Meny Grauman

Almost thirty years after the last OPEC shock, US vehicle demand seems no better able to ward off soaring pump prices than it was back then. While the 30% improvement in engine efficiency might suggest some protection from fuel costs, attendant changes in driving habits and in vehicle choice have left today's auto sales every bit as vulnerable to pump prices as they were during past oil shocks.

The Fuel Efficiency Paradox

The failure to translate fuel efficiency gains into actual fuel savings is coming back to haunt us. Vehicles are driven almost 30% more than they were back in the heydays of the OPEC shocks. That increase in annual mileage effectively offset the improvements in engine efficiency. And the proliferation of SUVs and light trucks that, up until now, have absolutely dominated North American auto sales, have left the average vehicle on the road as gas-guzzling as the ones that cruised the interstates in the 1970s and early 1980s (Chart 1).

The dismal statistics speak for themselves. After averaging close to 17 million units over the first half of the decade, US vehicle sales have recently plunged below 14 million for the first time since the early 1990s. And the plunge is far from done, as both a weakening US economy and

pump price hikes point to further declines ahead. Within the next two years, vehicle sales are likely to crash below 12 million units, sinking to levels not seen since the early 1980s.

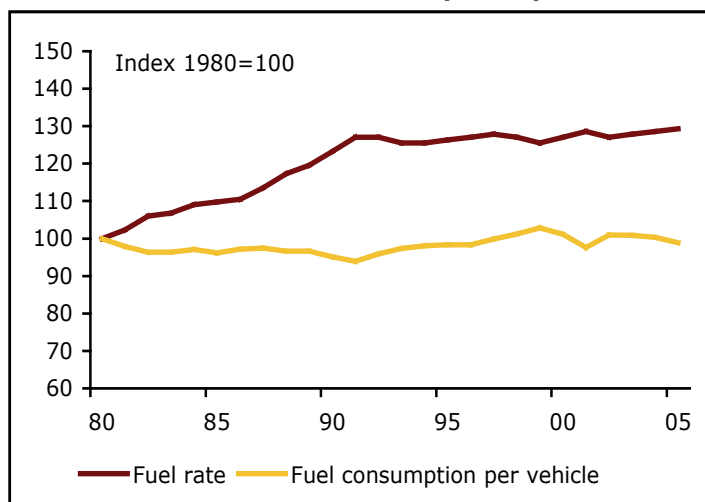
Gasoline prices are already up 35% over the last 12 months, and even with recent pullbacks, that increase is bigger than the massive spikes seen after either of the OPEC oil shocks (Chart 2). Those pump prices are not only putting a huge crimp on sales, but also putting the brakes on Americans' driving habits. Americans are already driving discernibly less this year than last (Chart 3) while mass transit ridership is up by 30% or more in many municipalities around the country.

Getting off the Road for Good

At today's prices, or even higher pump prices in the future, the longer-term prognosis for the world's largest auto market is not encouraging. Not only are US auto sales likely to continue to slump, even after the broad economy gets on a sounder footing, but sales are soon likely to fall below the scrappage rate. This means that current oil prices are going to do what the previous oil shocks of the 1970s and early 1980s were not able to, namely reduce the total number of cars on US roads.

Chart 1

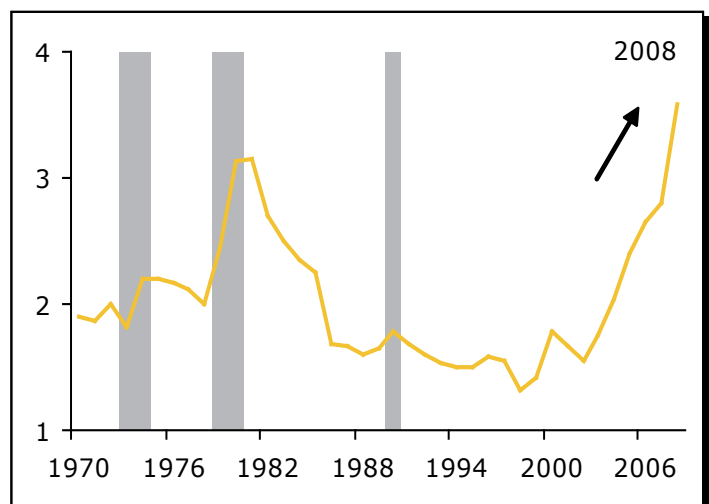
Improved Fuel Rate for a Given Vehicle Type Failed to Lower Fuel Consumption per Vehicle



Source: EIA

Chart 2

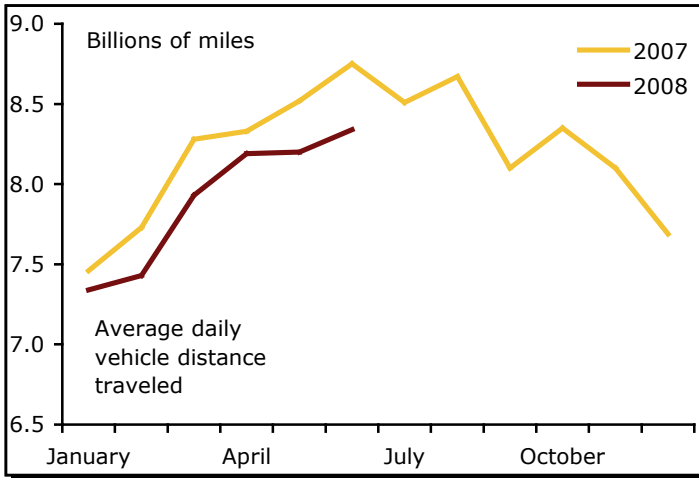
Real Gasoline Prices at Record Levels



Note: Shading denotes previous oil shocks

Chart 3

Americans Already Driving Less



The scrappage rate, which is the rate at which cars are taken out of service, is currently 5%, but it has always risen in response to large increases in gasoline prices. By 2010, a 1%-point increase in the current scrappage rate will take close to 14 million vehicles off America’s highways (Table 1). With vehicle sales plunging below 12 million, that implies a cumulative loss of just over 3 million vehicles from American roadways by 2010 (Chart 4). That would not be totally unprecedented; after all the US economy saw its total vehicle stock shrink in both 1991 and 2002. But in each of those cases a temporary recession-induced slide was quickly reversed the following year. The decline that we are projecting this time around is different because it is not just a reaction to a temporary dip in the economic cycle, but a much more deliberate response to a fundamental change in fuel costs.

Chart 4

US Auto Sales Projected to Continue Falling

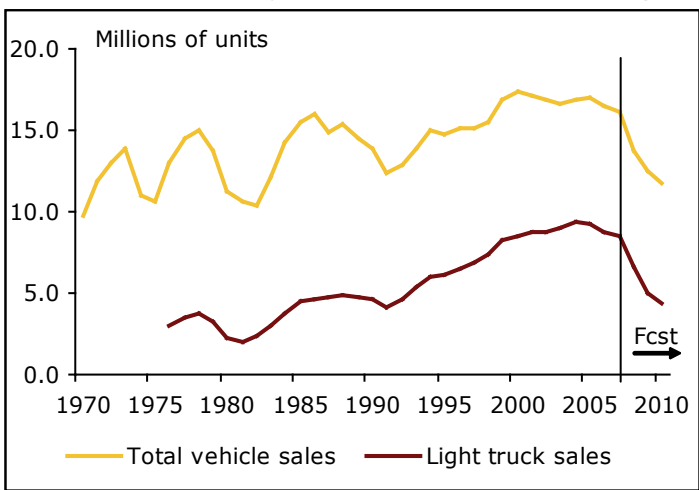


Table 1

The Shrinking US Auto Market

US Sales and Scrappage Statistics				
	1974 Oil Shock	1979 Oil Shock	2009f	2010f
Vehicle Sales (mn)	11.0	13.8	12.5	11.7
% chg in sales (yr/yr)	-2.9	-1.2	-1.0	-1.1
Scrapped Cars (mn)	6.9	10.4	13.6	14.0
Net Change to Total Vehicle Stock (mn)	4.1	3.4	-1.1	-2.3

Driving Less and Driving Different

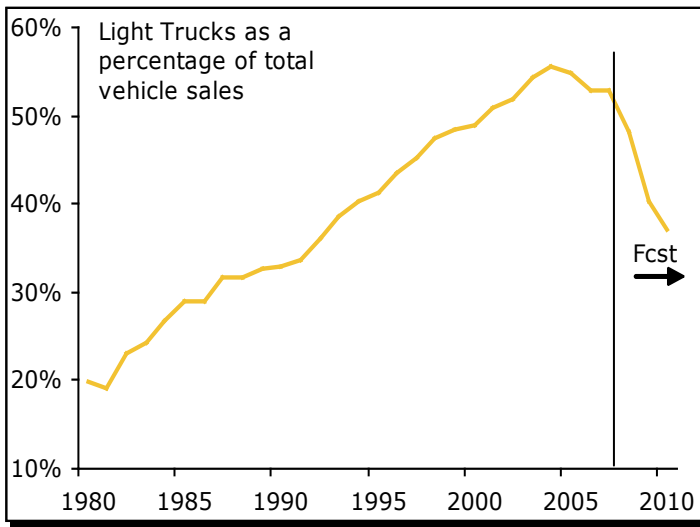
Despite ongoing volatility, real oil prices are higher than in any prior year in history, and will continue to climb over the next few years, permanently changing the economics of owning and operating a car both in the US and around the world. The implications for Detroit are clear. Not only do the “Big-Three” car makers face a shrinking domestic vehicle market as large numbers of Americans opt for mass transit or give up on a second vehicle, but just as huge a shift is brewing in the type of vehicle Americans are willing to buy. After rising consistently over the last 25 years, the share of SUVs and other light trucks being sold in America is falling. Between 2005 and the beginning of this year, annual sales of light trucks have fallen by 30% compared to a 1% decline in passenger cars. During this time gasoline prices have almost doubled from \$2 per gallon.

Light trucks have already lost about 5%-points of total vehicle market share in what is likely to be a protracted decline as fuel prices trend higher. By 2010, the light truck segment of the US auto market should shed another 10%-points of market share (Chart 5), falling to under 40% of total vehicle sales. That decline will reverse virtually all the gains since the mid-1990s.

The SUV market has been further undermined by the fact that the residual values assumed by most SUV lease agreements over the past few years have been grossly overstated in view of the huge decline in the resale value of these vehicles. Falling resale values mean higher lease rates because lease payments now have to cover a greater

Chart 5

Americans Starting to Choose Smaller Cars



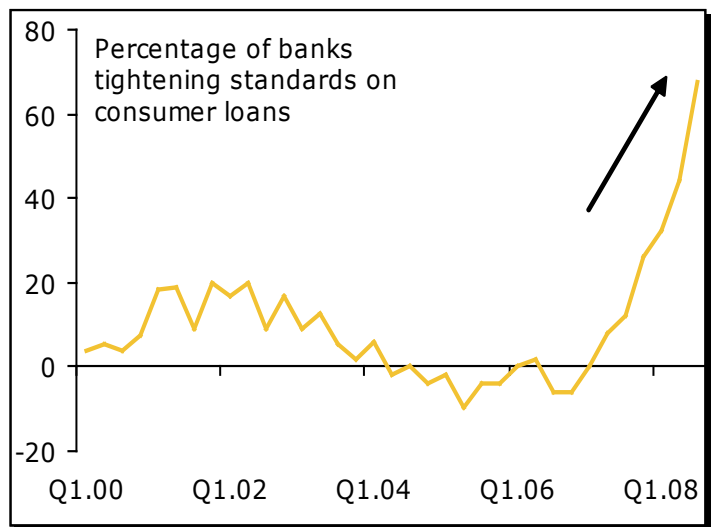
amount of depreciated value than ever before. Some estimates point to increases of as much as 40% on a typical 3-year SUV lease.

Lower resale prices for light trucks has forced major automakers and their related financing arms to take large losses to write down the value of leases that were issued at significantly higher vehicle values. As a result of these writedowns, Chrysler has stopped leasing cars in North America altogether, while both Ford and General Motors are raising lease rates and significantly cutting back on the number of leases that they will offer. The effective withdrawal of financing for SUVs will only hasten the plunge in their market share.

Financing difficulties are not just relegated to the leasing market. Car buyers are also finding it more difficult than ever to get a car loan even though interest rates are lower than they were a year ago. According to the Federal Reserve's quarterly Senior Loan Officer Survey, the number of banks reporting tighter lending standards for consumer loans has ballooned to 67%, while a recent survey by Automotive News suggests that a majority of car dealers are having a hard time securing loans, even for customers with good credit (Chart 6). Meanwhile, Chrysler Financial recently informed its own dealers that it would be raising the rates it charges when dealers borrow to finance their own inventories.

Chart 6

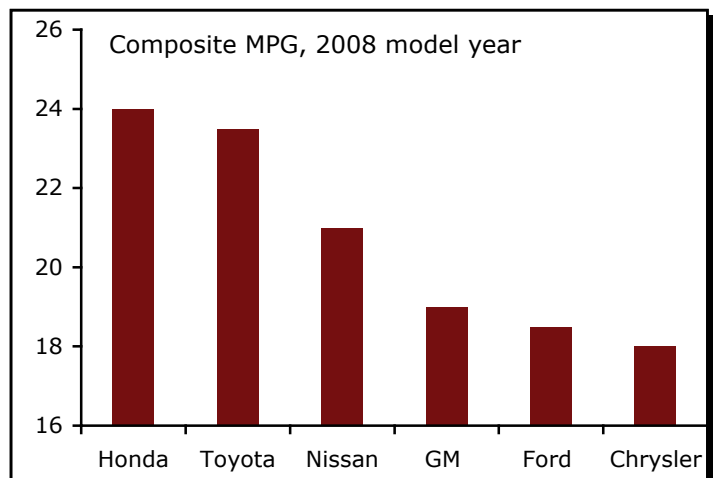
Consumer Credit Getting Tighter



The huge shift in consumer preferences away from gas-guzzling SUVs and other light trucks has enormous implications for an auto industry that was ill prepared for triple-digit oil prices. Ford, for example, has lowered its offering of trucks from 70% of its model line-up in 2004 to 40% this year. General Motors and Chrysler have similarly scaled back production and announced a number of plant closures as both scrap some of their light truck models. The American automakers are in a desperate rush to replace product offerings that are on average 25% less fuel efficient than leading imports like Honda and Toyota (Chart 7).

Chart 7

Big 3 Fuel Efficiency at the Bottom of the Pack



Detroit knows it must wean itself off SUVs and switch to making hybrids and other fuel efficient vehicles, but what it doesn't know is whether it can afford to do so. Its entire margin comes from selling the very SUVs, vans and other light trucks that consumers are eschewing in the face of \$4-per-gallon gasoline. At the same time, none of the traditional "Big-Three" US auto companies have yet to demonstrate that they can make any money producing a hybrid vehicle. In fact, most car makers other than Toyota are assumed to currently be losing money on their hybrid product lines, and even Toyota's margin is likely paper-thin.

Both Chrysler and GM are scrambling to get a fully electric car to market, but even these moves will not be game changers in the short run. Chrysler for example has not even settled on a battery supplier, while the much-hyped Chevy Volt will be both relatively expensive at a list price of over \$30,000, and in very short supply, with an initial production run of only 10,000 in 2010 before ramping up to just 60,000 units by 2012. To put this number in perspective it amounts to just 1½% of GM's total North American vehicle production last year and less than 0.5% of annual auto sales.

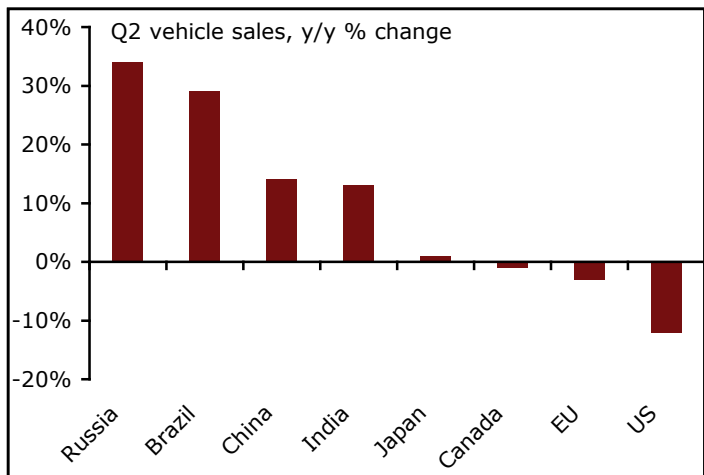
World Auto Sales to Hit Record High on Soaring Demand from BRIC Countries

Despite the systemic problems facing the US auto market, the world market has seldom been better. This year should mark the seventh consecutive record for annual vehicle sales, led by continued strength in Brazil, Russia, India, China (BRIC) and the rest of the developing world. While vehicle sales in the second quarter fell a combined 7% in the United States, Canada, the European Union and Japan, they were up 20% in BRIC countries (Chart 8). In fact, total annual sales in these countries are expected to overtake the US next year for the first time ever.

Moreover, the very models that American motorists are shunning, motorists overseas are snapping up. SUV sales, which already make up roughly 8% of the red-hot Chinese car market, are up 40% since the beginning of the year, and demand for such vehicles is similarly strong in Russia as well. So great is the demand for SUVs in the Chinese

Chart 8

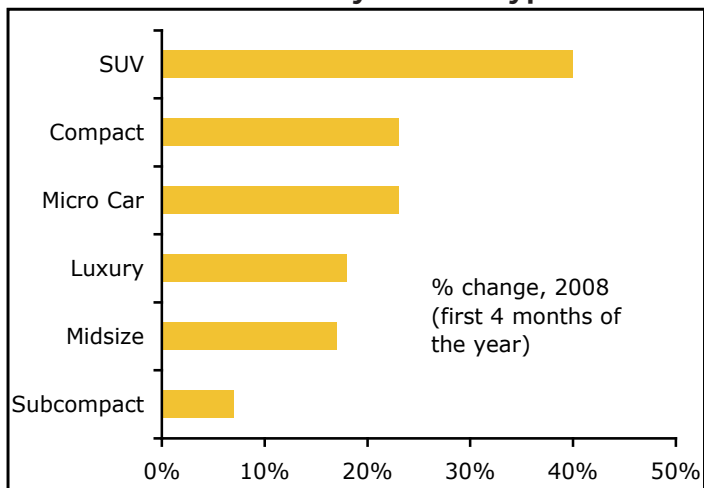
Vehicle Sales Soaring in BRIC Countries



market that General Motors plans to start shipping the Michigan-made Buick Enclave, a seven-passenger vehicle, to China. SUV demand is growing at double the rate of any other class of vehicle in the Chinese market and four times the pace of sales of fuel-efficient subcompact cars (Chart 9). As their own domestic auto market shrinks, American car companies better look overseas if they hope to be able to see sales growth in the future.

Chart 9

Chinese Vehicle Sales by Vehicle Type



Treasury Bailout: Deal or No Deal?

Avery Shenfeld

Washington's now-jeopardized effort to unfreeze the financial system matched the drama of the events that made it a necessity. Historic names vanished in a moment's notice, sending the spread being paid for even 1-3 month money soaring (Chart 1). A 2% fed funds rate means nothing when 3-month Libor, the base for floating rate loans, sits at nearly 4%. Even when it looked as if the bill might gain passage, its benefits were being overlooked as markets focused on new names moving into collapse or rescue.

Lessons from Japan on the consequences of a poorly addressed financial system crisis after a bursting of a property bubble aren't pretty. Japan spent the 1990s in and out of recession as its banks were left hanging with bad loans and, as a result, a constrained ability to lend and finance growth.

If the stock market keeps diving, it won't be too late for the House to reconsider its initial thumbs down. Members of Congress feared the wrath of voters, dismayed that Wall Street would get any form of rescue from what they perceived as a crisis it helped create. But voters' wrath could also fall on members if they were seen as the cause of a financial meltdown.

If not exactly the Troubled Asset Relief Program (TARP), then what? There are two problems that any plan has to address. First, the absence of sufficiently funded arbitrageurs, and the costly information necessary to sort out the wheat from the chaff, has meant that mortgage-related assets are being marked at far below their true hold-to-maturity value. We reached that conclusion as far back as a year ago (see September 2007 *StrategEcon*). The Treasury hoped to design a mechanism that would allow them to identify undervalued assets and remark them by their purchases, boosting bank balance sheets in the process.

A \$100 bn upward remark would, given 20-times leverage, allow banks to expand lending by \$2 trillion, a major improvement in a \$14 trillion economy. And that doesn't include other multiplier effects, such as those generated by raising the credit ratings of financial institutions, which then raises the capital position of others who have them as counterparty risks.

To accomplish that feat, any plan has to be large enough to entail purchases across the full spectrum of outstanding securities. At, say, a 50-cent discount to face value, TARP might have had a bit of overkill, allowing the Treasury to buy \$1.4 trillion in mortgages, roughly two-thirds of all US outstanding residential MBS that are not already Fannie/Freddie owned or insured (Chart 2).

Chart 1

Libor Spreads Boost Business Borrowing Costs

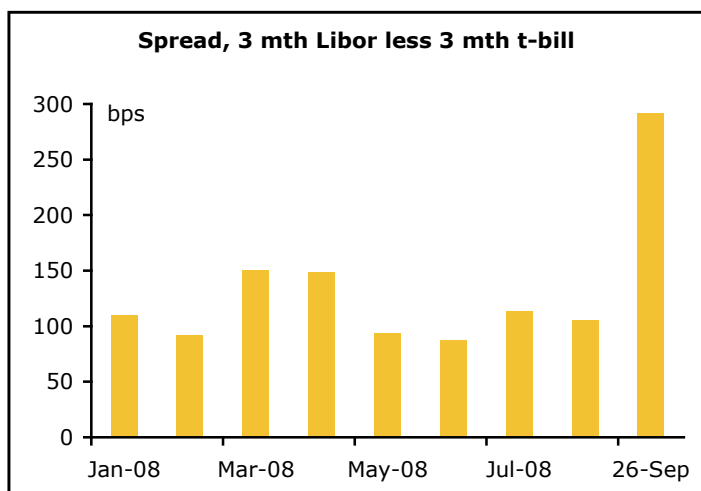


Chart 2

TARP Will Be a Significant Market Player

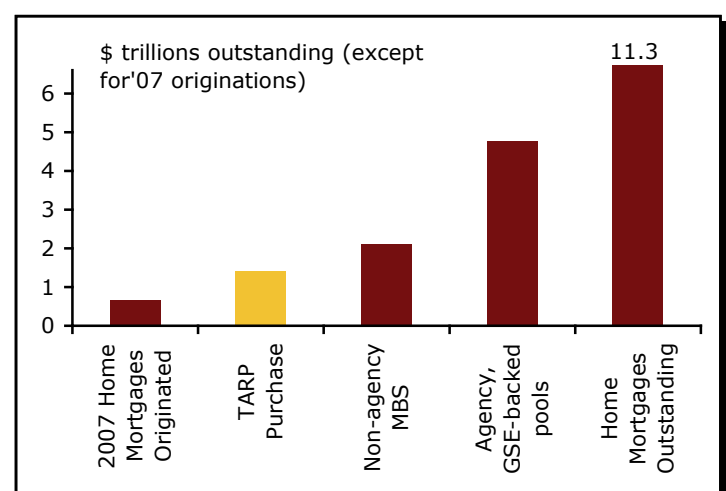
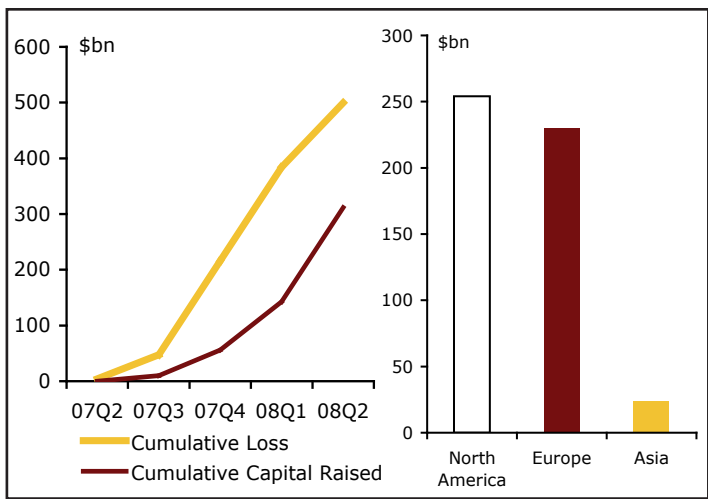


Chart 3

Writedowns Outpacing Replacement Capital



Second, losses not only on these illiquid securities, but also on credit default swaps and securities associated with failed counterparties, have left an undercapitalized financial system, the same ill that plagued Japan in the 1990s. Global financials have taken huge hits to capital, and have been struggling to keep pace in terms of new issuance (Chart 3). Falling share prices make it difficult to further dilute existing shareholders through the new equity or preferred issues necessary to raise tier-one capital. Going to the market, particularly in a second round, is seen as an admission of weakness, and risks sending nervous counterparties fleeing in the process. Paulson likely hoped that the upward revaluations created by TARP purchases would not only reduce the strain on capital, but support a rebound in share prices and enable some banks to go back to the market for funding.

While TARP could still be resuscitated with amendments before this week is done, there are alternatives to meeting both of its objectives. Harvard's Lucian Bebchuk suggested that the Treasury help co-finance privately run distressed asset funds that could go into the market and bid for these distressed assets, with managers incented by the profit motive to buy only what has been unduly marked down. Separately, financials could be mandated to raise additional equity capital—with the requirement to do so eliminating the stigma.

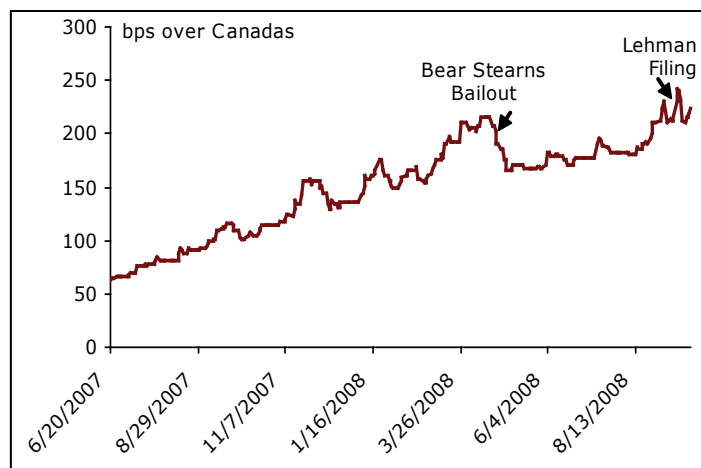
Sweden addressed its 1992 property collapse by forcing quick writedowns and injecting public capital into banks, essentially nationalizing a large chunk of its banking system while wiping out the shareholders of those banks that could not fend for themselves by raising private capital. While Sweden recovered most, if not all, of its investments and shareholders took the pain, such a neo-socialist approach would seem to be an anathema to free-market Republicans in the House.

A risky alternative would be to provide enhanced government-funded deposit insurance to help restore some confidence, and let the run of bank failures continue. The FDIC would seize assets, and a Resolution Trust-style institution would dispose of them slowly and help recover depositors' funds, while letting time and those sales establish better market prices on the assets. Risky because given the linkages across banks, each failure raises the odds of follow-up collapses.

For Canadian equities, the ultimate beneficiaries of any successful rescue effort will be financials, those with US operations that potentially might let them participate directly, and those that will re-price assets as the higher valuations are established. Counterparty risks to US financials will ultimately be reduced if Congress and the White House can agree on an effective alternative plan. Canadian banks have seen widening funding costs during the current crunch (Chart 4) and stresses on counterparty risks, and these should ease as financial system confidence is restored. But all of that will take time, even if TARP is approved and the Treasury starts to cobble together its procedures for its first purchase. Until then, sentiment will remain soured by the likelihood of further financial failures and rescues outside Canada's borders.

Chart 4

Typical Mid-Term Cdn Bank Sub-Debt Spread



Where's the Trigger for a Canadian House Price Crash?

Benjamin Tal

Every dollar drop in the value of Canadian real estate elevates the level of anxiety about a US-style housing meltdown in Canada. To be sure, house prices in Canada will continue to ease in the coming months. But the triggers that led to a freefall in Canadian real estate markets in the early 1990s and today in US markets are nowhere to be found.

Buyer's Market?

In six short months, the Canadian real estate market was transformed from a confident seller's market to a more muted balanced market. And at this rate of growth in unit sales and new listings, by early next year the Canadian housing market will turn, for the first time since 1995, to a buyer's market (Chart 1).

Direction is important, but so is magnitude. A quick glance at Chart 2 reveals that when measured against income, the Canadian real estate market has indeed overshot. But a mere 5-7% drop in prices from current levels should bring the national average back to equilibrium. That's a fraction of the 25% overshooting seen in the US by mid-2006.

Location, Location, Location

While the national housing market is still in a balanced position, the overall picture is far from uniform. Calgary

and Edmonton, where until recently homeowners doubled the value of their real estate during the course of breakfast, are now seeing close to two and a half new house listings for every unit sold (Chart 3). Consequently, average home prices in these markets fell by 8.5% and 4.6%, respectively, during the year-ending July 2008.

The trigger for the current slowing in these markets is a sharp deterioration in affordability. With house prices in Alberta doubling since 2004, housing affordability has deteriorated to levels not seen since the early 1990s (Chart 4).

But a second glance at Chart 4 also reveals that affordability in other key markets such as Ontario and Québec did not worsen so rapidly. In fact, from a national perspective, it is now 20% more affordable to carry a house than it was after Governor Crow took interest rates to double-digit territory in 1990. Put differently, to bring national affordability back to the levels that triggered the real estate correction of 1990, current mortgage rates would have to double.

US Minus Subprime = Canada

US housing prices have been falling for two years with a cumulative decline of 18% to date—on their way to an eventual correction of 25%. Having started the housing boom roughly at the same time (around 1997), the Canadian housing market is now lagging the US market by roughly two years.

Chart 1

Cdn Real Estate: Getting Closer to a Buyers' Market

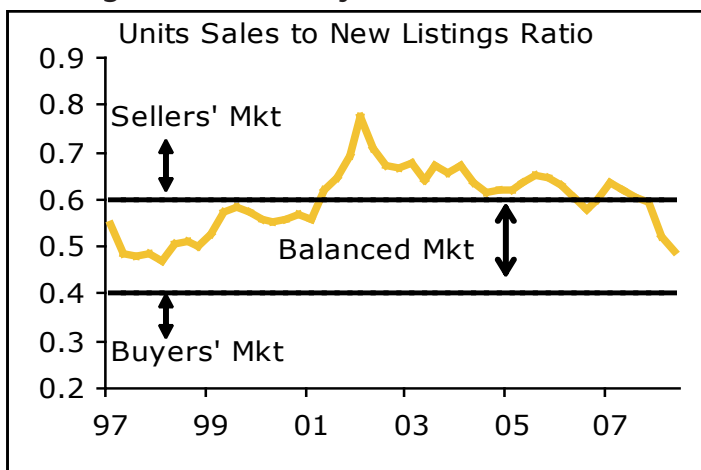


Chart 2

Cdn House Prices—Some Overshooting

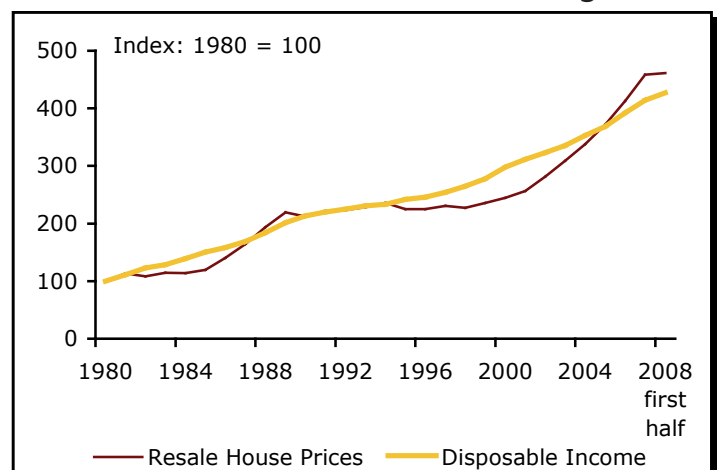


Chart 3

Unit Sales Per New Listing

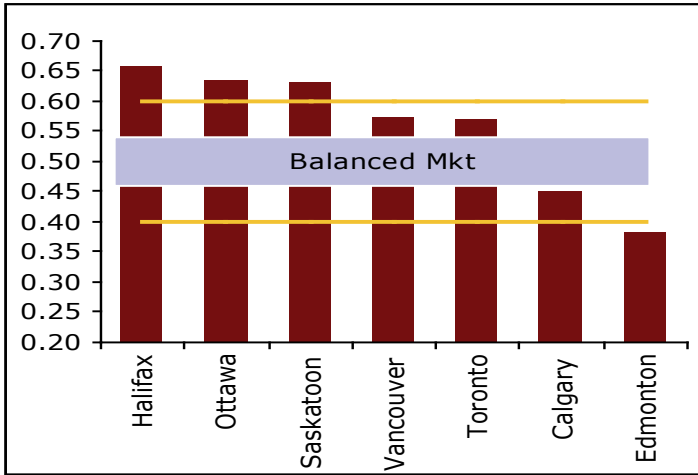
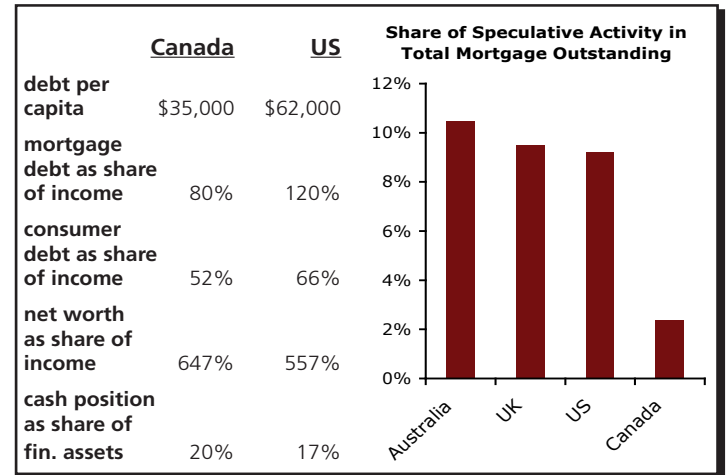


Chart 5

Canada vs US: Spot the Difference



But that's where the similarity ends. By almost any measure, American households entered the current housing crisis from a more vulnerable position relative to their Canadian counterparts— carrying a heavier debt load and a much lighter net worth position (Chart 5, left). And when it comes to real estate speculation, Canada was not really a player (Chart 5, right).

in cities with above-average subprime exposure fell by more than 25% from the June 2006 peak—notably more than the 10% decline in cities with below average exposure (Chart 6, left). And in today's US market, below-average subprime exposure does not necessarily mean low exposure, as this category includes cities such as Dallas and San Diego with well over 20% in subprime exposure. In fact, house prices in cities with 10-19% subprime exposure fell by only 8% since the 2006 peak, and markets with single-digit exposure fell by an inconsequential 5% (Chart 6, right).

But even more important than the absolute and relative level of debt is the distribution of debt. At the peak of the cycle, subprime and Alt-A mortgages accounted for no less than 33% of originations in the US market. In Canada we estimate that at the peak, non-conforming mortgages reached 5.4% of originations.

Eradicate subprime from the US housing market and, instead of the most severe house price meltdown since the great depression, you get a trivial moderate cyclical slowing—something along the line of what we are currently experiencing in Canada.

And at its core, the US meltdown is a subprime story. A glance at Chart 6 tells the tale. Average house prices

Chart 4

Affordability: West vs the Rest

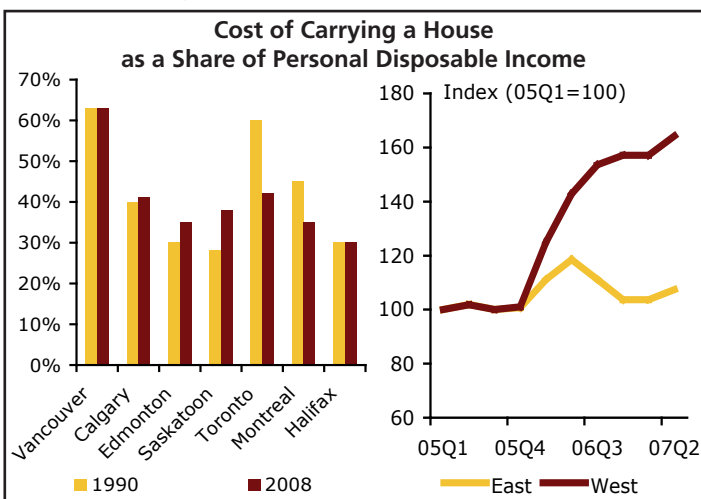
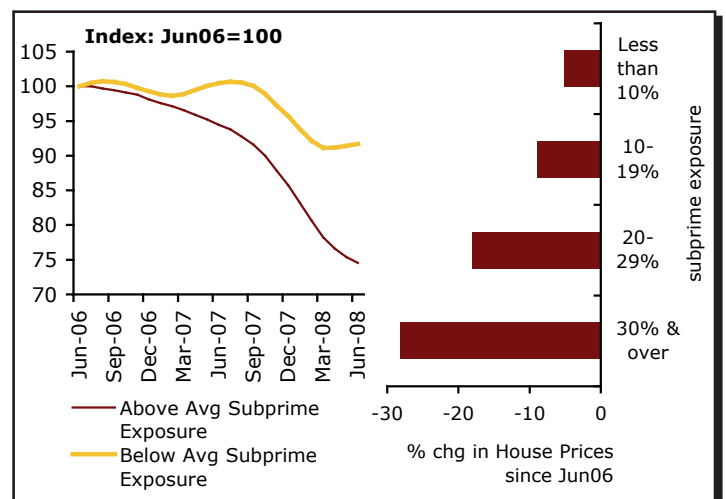


Chart 6

US House Prices by Subprime Exposure



ECONOMIC UPDATE

CANADA	08Q2A	08Q3F	08Q4F	09Q1F	09Q2F	2007A	2008F	2009F
Real GDP Growth (AR)	0.3	0.8	-0.5	1.0	2.6	2.7	0.6	1.3
Real Final Domestic Demand (AR)	2.0	2.6	1.7	2.1	2.5	4.2	3.5	2.3
All Items CPI Inflation (Y/Y)	2.4	3.4	2.6	2.5	2.6	2.1	2.5	3.3
Core CPI Ex Indirect Taxes (Y/Y)	1.5	1.7	2.4	2.5	2.5	2.1	1.7	2.8
Unemployment Rate (%)	6.1	6.1	6.4	6.5	6.6	6.0	6.1	6.4
U.S.								
Real GDP Growth (AR)	3.3	0.3	-1.8	1.8	2.8	2.0	1.6	1.9
Real Final Sales (AR)	4.8	-1.1	-2.0	1.3	2.4	2.4	1.8	1.5
All Items CPI Inflation (Y/Y)	4.4	5.4	5.1	5.2	4.5	2.9	4.8	5.1
Core CPI Inflation (Y/Y)	2.3	2.5	2.8	2.9	3.1	2.3	2.5	3.1
Unemployment Rate (%)	5.3	5.9	6.2	6.4	6.2	4.6	5.6	6.2

CANADA

In our recent issue of Forecast, we pared back our outlook for Canada, with little real GDP growth expected through Q1 2009. Headline CPI will also be more moderate during that period given the pullback in oil. Thereafter, we still see an improved global backdrop and rising commodity prices providing a substantial lift to growth and inflation.

UNITED STATES

The official growth numbers may not yet show it, but the US economy is in recession. Third quarter real GDP growth may still manage to come in flat, but the fourth quarter will see a big decline. A large scale government bailout of the US financial system is necessary to mitigate the downside risks to the economy, but remains highly uncertain. Regardless of any legislative life-line, expect another few quarters of intensifying job losses and contracting consumer demand. Lower energy prices should help take some of the heat off headline inflation, but year-over-year CPI remains elevated, and core inflation could still move higher as firms continue to push through earlier costs increases.

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