CIBC World Markets

STRATEGECON

July 18, 2007

$100 Oil

by Jeff Rubin

Economics & Strategy

Jeffrey Rubin
(416) 594-7357
jeff.rubin@cibc.ca

Avery Shenfeld
(416) 594-7356
avery.shenfeld@cibc.ca

Benjamin Tal
(416) 956-3698
benjamin.tal@cibc.ca

Peter Buchanan
(416) 594-7354
peter.buchanan@cibc.ca

Warren Lovely
(416) 594-7359
warren.lovely@cibc.ca

Leslie Preston
(416) 956-3219
leslie.preston@cibc.ca

"... not only are triple digit oil prices on the horizon, but even more problematic, they will be here to stay."

The two arguments against $100 oil, the ability of technology to raise new supply and the ability of price to limit demand, are falling quickly by the way side. Gone are Big Oil's smug assurances that their technical prowess will untap huge hitherto undiscovered reserves of cheap crude. What we hear instead through the voice of the US National Petroleum Council are warnings of depletion and steadily rising prices.

Meanwhile an equally contrite International Energy Agency (IEA) has finally acknowledged that the demand for oil is a whole lot less price elastic than they have been leading the world to believe. An apparent acceleration in world oil demand this year in the face of a doubling in prices over the last three years has left IEA economists, and most other economists, scratching their heads.

Why haven't soaring prices shackled demand? They actually have in some places like the carbon conscious economies of Western Europe, where crippling gasoline taxes and subsidies for alternatives like biofuels have reduced oil consumption for two years in a row. But such reductions have become a footnote to the world demand curve, which is no longer shaped by energy consumers in the OECD economies, but by the seemingly insatiable appetite of newly empowered consumers in developing countries whose economies are industrializing at breakneck speeds.

Within the next decade, trends predicted by the IEA would have the developing world consume more oil than the developed world. What the IEA hasn't told you is who is driving the surge in demand outside of the OECD. China's highly publicized energy appetite grabs all the headlines, but a no less important factor behind soaring oil prices is the surge in oil consumption in oil producing countries themselves. Together with Mexico and Russia, daily consumption in OPEC countries last year was in excess of 12 million barrels per day, over 60% more than the level of Chinese consumption.

Fill up your tank in the Middle East and you will soon see why. With gasoline selling at as little as a tenth of North American prices, there is no danger of ethanol displacing oil in any of these markets. Unfortunately, production growth in OPEC as well as in producing countries like Mexico and Russia has been far less robust. Soaring internal rates of oil consumption are already eating into export capacity and will actually reduce crude exports from these countries by as much as 2.5 million barrels per day between now and the end of the decade (see pages 4-7).

It's far from obvious who will fill that supply gap. What *is* obvious is that if that gap isn't filled, not only are triple digit oil prices on the horizon, but even more problematic, they will be here to stay.

MARKET CALL

- The Fed's stand pat stance seems well entrenched. Despite slower core inflation, an ease seems improbable as long as labour markets stay reasonably tight. But a return to slower growth in the second half makes a rate hike similarly unlikely, particularly with the housing sector under such pressure. That will leave Treasury markets mostly treading water over the forecast horizon, but the US$ still under downward pressure as overseas central banks tighten.

- The Bank of Canada likely believes it has another rate hike to come, but plans for such a move could be deferred, and ultimately set aside, as the C$ remains stronger than the BoC assumption for a 93-95.5 US cent exchange rate, and US growth disappoints. In the near term, however, the bond market could be troubled by a return to higher core inflation readings.

- The Canadian dollar has, if anything, marched at a faster pace than we expected towards our target of parity by year end. Newly announced M&A transactions are likely a factor, but the loonie has also drawn support from generalized US$ weakness and firming oil prices. With oil prices likely to escalate from here (see pages 4-7), the loonie will retain a lot of that strength even if the Bank of Canada doesn't deliver on expectations for rate hikes.

INTEREST & FOREIGN EXCHANGE RATES

		2007			2008			
END OF PERIOD:		**17-Jul**	**Sep**	**Dec**	**Mar**	**Jun**	**Sep**	**Dec**
CDA	Call loan (mid-point of range)	4.50	4.50	4.50	4.50	4.50	4.50	4.50
	98-Day Treasury Bills	4.50	4.55	4.45	4.40	4.40	4.40	4.45
	Chartered Bank Prime	6.25	6.25	6.25	6.25	6.25	6.25	6.25
	2-Year Gov't Bond (3.75% 06/09)	4.69	4.80	4.70	4.60	4.55	4.55	4.65
	10-Year Gov't Bond (4% 06/16)	4.63	4.80	4.80	4.75	4.65	4.60	4.65
	30-Year Gov't Bond (5.75% 06/33)	4.56	4.65	4.65	4.60	4.55	4.50	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	4.97	4.90	4.80	4.80	4.65	4.60	4.70
	2-Year Gov't Note (4.875% 06/09)	4.90	5.05	5.00	5.00	5.00	4.95	5.05
	10-Year Gov't Note (4.5% 05/17)	5.07	5.25	5.15	5.15	5.15	5.10	5.20
	30-Year Gov't Bond (4.75% 02/37)	5.15	5.30	5.30	5.25	5.25	5.20	5.25
Canada - US T-Bill Spread		-0.46	-0.35	-0.35	-0.40	-0.25	-0.20	-0.25
Canada - US 10-Year Bond Spread		-0.43	-0.45	-0.35	-0.40	-0.50	-0.50	-0.55
Canada Yield Curve (30-Year — 2-Year)		-0.13	-0.15	-0.05	0.00	0.00	-0.05	-0.10
US Yield Curve (30-Year — 2-Year)		0.26	0.25	0.30	0.25	0.25	0.25	0.20
EXCHANGE RATES	— (US¢/C$)	95.8	96.2	100.0	100.0	96.2	95.2	94.3
	— (C$/US$)	1.043	1.040	1.000	1.000	1.040	1.050	1.060
	— (Yen/US$)	122	122	121	118	115	114	113
	— (US$/euro)	1.38	1.37	1.40	1.37	1.33	1.33	1.33
	— (US$/pound)	2.05	2.02	2.00	1.97	1.92	1.92	1.92
	— (US¢/A$)	87.2	85.5	85.0	83.0	82.5	81.0	80.0

STRATEGY AND EARNINGS OUTLOOK

- Aided by more blockbuster resource deals and the bond market's relief rally, the TSX has rebounded from June's selloff, and we remain optimistic on prospects for the second half of the year. Seldom if ever has the global growth outlook looked better, providing solid support for materials and energy stocks, our two principal recommended overweights. While the Bank of Canada raised rates by 25 bps as expected at its July 10th rate setting, the drag from the currency on both growth and inflation mean the Bank's latest move is unlikely to represent the start of full-fledged tightening cycle. The costs of the US subprime debacle are still being assessed, but the troubles on that front should also help to keep the Fed on hold for the foreseeable future.

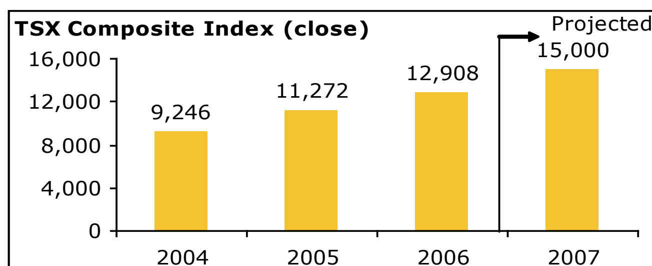
- Within our long equity position, we maintained our 3.5%-point overweight in the energy sector. Soaring demand for oil in the developing world (see pages 4-7) has helped push crude prices above $70/bbl, en route to expected new record highs later this year. While also remaining overweight base metals, we took a half point out of gold stocks, which have failed to draw strength from rising bullion prices and the utilities group, which is vulnerable not only to interest rates but pending carbon emission restrictions. Offsetting those weighting reductions, we added a percentage point of exposure to the industrial sector. Key segments of that group, like the rails and rolling stock manufacturers, continue to benefit from soaring energy prices and growing concerns about CO_2 emissions. Rail is nine times more energy efficient than other freight modes and well positioned to benefit from developments on both of these fronts.

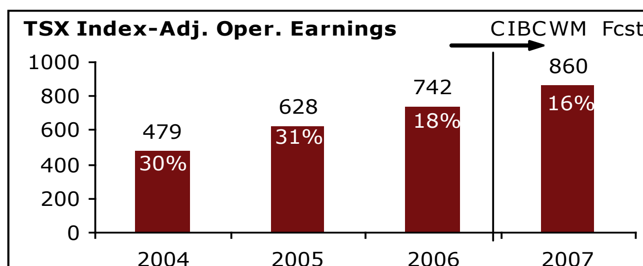
ASSET MIX (%)	Benchmark	Strategy Recommendation
Stocks	**56**	**68**
Bonds	38	29
Cash	6	3
GICS SECTOR EQUITIES (%)		
Consumer Discretionary	5.3	3.8
Consumer Staples	2.5	1.0
Energy	**27.9**	**31.4**
Financials	30.5	30.5
-Banks	17.0	17.0
-Insur., REITs, oth.	13.5	13.5
Healthcare	0.7	0.7
Industrials	5.6	4.6
Info Tech	3.8	1.8
Materials	**16.7**	**19.2**
-Gold	**5.2**	**5.7**
-Other Metals	**8.4**	**10.4**
Telecom	5.7	5.7
Utilities	1.4	1.4

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	4.7	21.5	15.5	13.0
Materials	19.0	95.9	19.2	17.9	27.5
Industrials	23.6	6.5	14.4	17.2	15.6
Consumer Discretionary	9.3	6.1	8.2	21.0	18.6
Consumer Staples	0.7	-1.4	0.8	18.7	17.0
Health Care	-1.0	12.8	-30.7	23.2	49.7
Financials	12.8	18.2	13.5	13.8	10.9
Info Tech	260.9	-52.1	61.7	27.5	32.3
Telecom Svcs	2.1	34.7	12.6	17.8	34.7
Utilities	10.4	15.2	22.6	16.5	13.9
TSX Composite	**31.2**	**18.0**	**16.0**	**16.2**	**17.9**





Cheap Gasoline in Producing Countries Will Have The Rest of the World Paying More

Jeff Rubin and Peter Buchanan

Global oil demand growth is headed for a rise of close to 2% in 2007, double last year's pace. Unfortunately, supply growth will be hard pressed to keep pace, with conventional production having recently fallen for a third year in a row, and many projects like the Thunderhorse Gulf platform or the Kashagan project in the Caspian Sea mired in delays. As a result, West Texas Intermediate should set a new record high of US$80 per barrel this year as markets become discernibly tighter. WTI is expected to rise further to an average of US$90 in 2008 with either it, or its European price equivalent Brent, likely to touch triple-digit levels towards the end of next year (Chart 1).

The arrival of US$100 oil is likely to come earlier than first predicted back in 2005 (April *Monthly Indicators*) when we pegged the end of the decade as the likely period. We subsequently brought that forward to the fourth quarter of 2007, with the advent of the hurricane damage in the Gulf of Mexico in 2005, in what ultimately proved to be a head-fake for oil prices. Last year's surprisingly benign hurricane season saw WTI prices fall back, but a subsequent tightening in global oil markets has pushed prices within striking distance of earlier all time highs.

Faltering supply growth has certainly been a key factor behind today's near-record oil prices, but robust demand growth has been an even larger one. The resilience of world crude demand to the doubling in prices in the last three years has economists scratching their heads about the apparent lack of price sensitivity in world crude demand.

Demand Soaring in Oil Producing Countries…..

Higher prices may be keeping a lid on crude demand growth in much of the OECD but these economies are no longer driving the bus when it comes to global crude demand. Demand outside the OECD is expected to grow at over a 3.5% pace in 2007, four times the expected growth in demand in the OECD countries. Indeed, the most recent forecast from the International Energy Agency calls for consumption declines in jurisdictions like Japan and Western Europe, the second straight drop in demand in those areas. At current growth rates, non-OECD demand, currently about 40% of world consumption, will overtake the OECD within the next decade.

While the recent IEA report highlights the strong growth in crude demand in the developing (non-OECD) world, consumption has been particularly strong in oil-producing countries themselves. All of a sudden, major oil-producing countries are becoming major oil-consuming countries. Russia, Mexico, and the OPEC

Chart 1

West Texas Intermediate Price Forecast

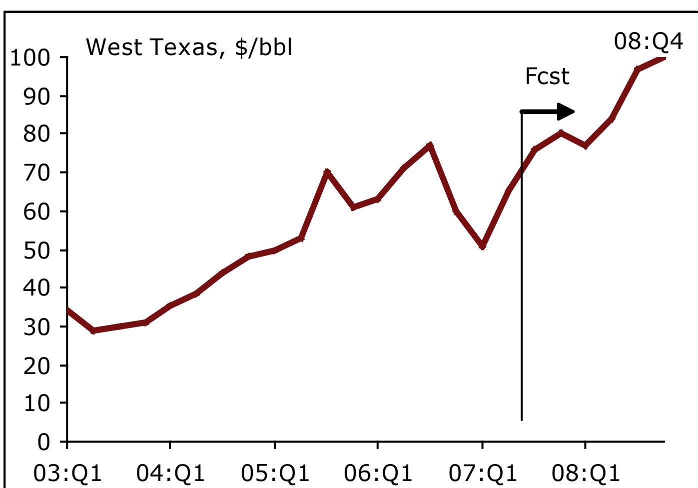
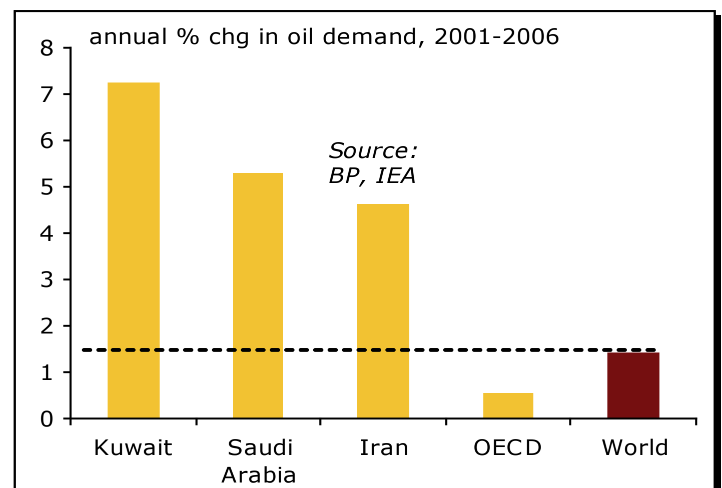


Chart 2

Oil Consumption in Oil-Producing Countries



countries last year consumed over 12 million barrels of oil per day—over 60% more than China, which next to the US, is the largest oil consuming country in the world. Not surprisingly, many of these countries posted some of the fastest growth in domestic demand anywhere in the world (Chart 2). For example, in both Saudi Arabia and Kuwait, domestic oil demand has grown at a well-over-5% annual pace in the last half-decade.

And those countries are by no means alone. Comparably strong demand growth in Iran over the last five years has sent that country turning to gasoline rationing earlier this year.

Why is oil consumption so strong in oil-producing countries? Even by the standards of developing countries, it is still well above normal. One has to look no further than prices to see why. In most oil-producing countries in the world, conspicuous consumption of cheap and abundant gasoline is considered a political birthright, and one which regimes tamper with at their peril. Gasoline prices in Venezuela, Iran and other Middle Eastern countries are a fraction of the world price. Average gasoline prices of 20-80 cents a gallon are as little as a tenth of US domestic prices (Chart 3).

.....Cutting Into OPEC Export Capacity

With consumption growth in the Middle East quintuple the advanced economies' pace, OPEC's future export capacity must be increasingly called into question. Particularly now that the cartel no longer seems to be able to raise production. Saudi Arabia, by far the largest OPEC supplier, seems struggling to maintain a daily production rate much above 9 million barrels per day. Increasingly it looks like OPEC production is approaching a peak at somewhere around 34 million barrels per day and, further out, will edge down from that level as a result of ongoing depletion. Production in some of its largest fields like the Burgan field in Kuwait are already well in decline and there is widespread speculation that Saudi's mammoth Ghawar field may be next.

While OPEC production may be close to a peak, domestic demand for oil in OPEC member countries has nowhere to go but up. At current internal consumption rates, the cartel's exportable surplus will decline steadily over the balance of the decade—even if new production offsets the mounting toll taken from depletion. With domestic production more or less constant over the balance of the decade, internal demand growth will reduce exports by about 1 million barrels per day between now and the end of the decade (Chart 4).

Neither Russia Nor Mexico Able to Fill the Gap

In recent years, Russia, now the world's largest oil producer, has filled the supply gap. But Russia is increasingly subject to the same trends seen in other major oil-producing countries. Growth in Russian oil production has slowed from nearly 10% per year a decade ago to around 2% annual growth. At the same time, domestic oil demand is growing briskly, buoyed by both very strong economic growth and cheap domestic prices. Real GDP has averaged 6.8% over the last three years and gasoline prices are, on average, 15% cheaper than in the US. Throw in a booming domestic car market and you have all the ingredients for 4%-plus annual growth

Chart 3
Most Oil Exporters Give Their Consumers A Break

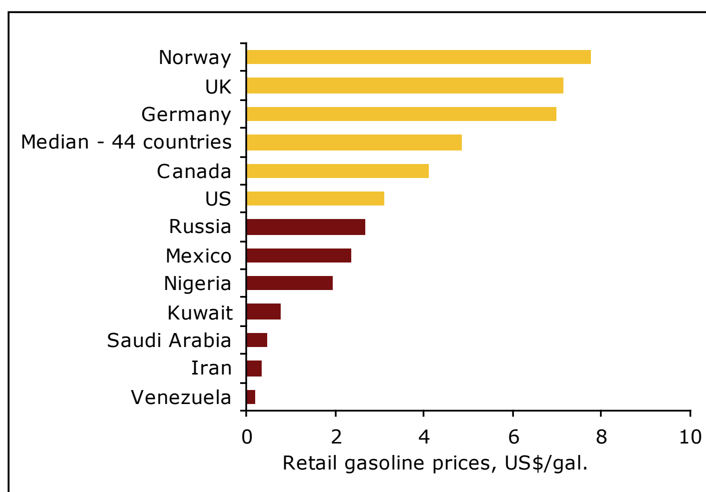


Chart 4
OPEC's Own Consumption Will Cut Into its Exports

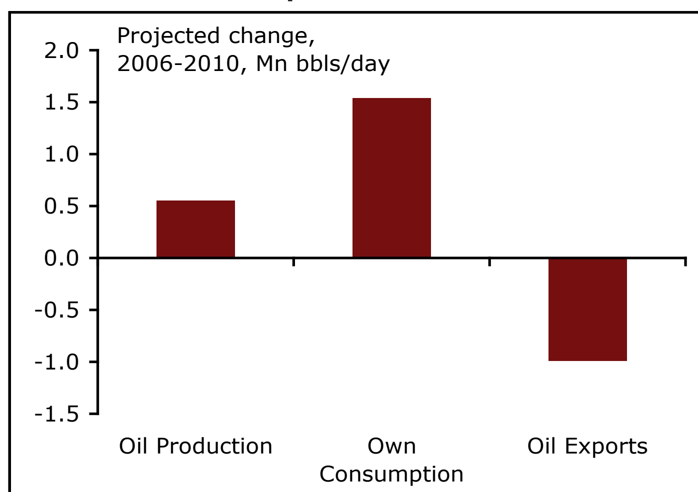
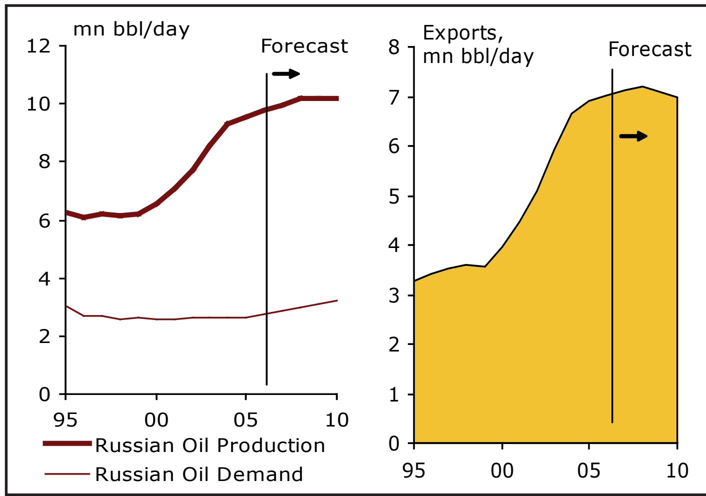


Chart 5

Russian Production, Domestic Consumption (L) and Exports (R)



in domestic fuel consumption. With still only one-quarter of the per capita oil consumption of America, there is lots of head room for Russian oil consumption to grow.

While Russian crude production may continue to grow modestly over the short-run, Russian oil export growth has slowed dramatically, and an actual decline is likely as early as 2008 as domestic consumption begins to eat more deeply into production (Chart 5). At the same time the effective nationalization of the Russian oil industry has cast a pall over the pace of the development of new reserves.

Soaring Russian exports were instrumental in averting even higher oil prices earlier in this decade when export growth from OPEC slowed to a crawl. From 2000-2006, Russia accounted for fully 70% of the increase in exports from the traditional oil exporting countries. A 3 million barrel rise in daily output, aided by improved recovery techniques at the country's Soviet-era oil fields, also accounted for just under half of the rise in global crude production (Chart 6). Both its now faltering production growth and soaring domestic consumption preclude the country from playing a similar role in the world oil market over the balance of the decade.

Mexico faces even greater obstacles than Russia in maintaining production with Cantarell, the source of 60% of the country's production, in irreversible decline and foreign oil investment limited by the 1917 Constitution. Depletion at Cantarell has turned out to be more rapid than initially thought. Already production has dropped by half a million barrels per day and seems to be tracking Pemex's worst case scenario, where production is projected to drop by another million barrels per day over the next couple of years (Chart 7). Should that happen, strong domestic consumption could actually render Mexico an oil importer much in the same way as OPEC member Indonesia became one in 2005.

Iraq's neglected oil fields seemed to offer great promise not so long ago. But even keeping production there steady, as foreign troops are withdrawn down the road, looks like a difficult challenge. While any post-American

Chart 6

Russia Has Offset Weak OPEC Export Growth in Recent Years

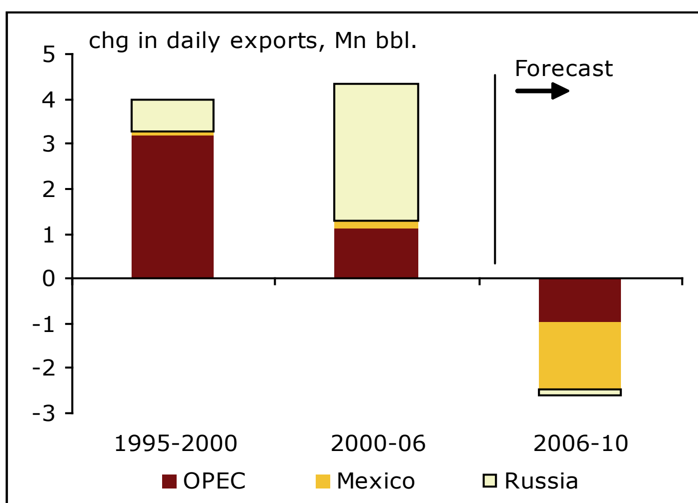
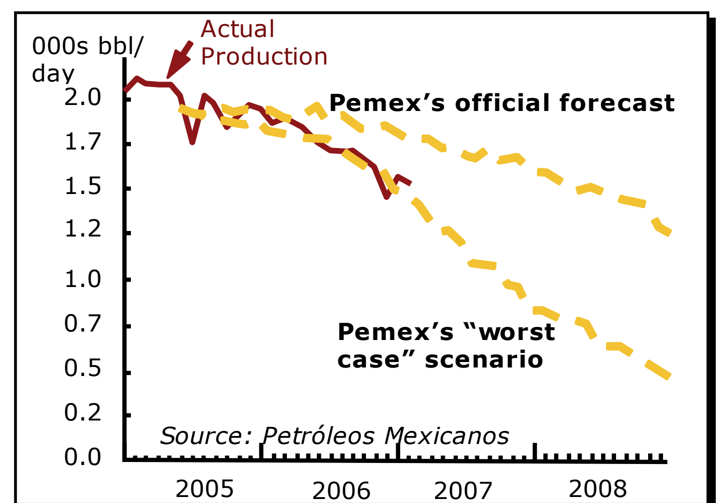


Chart 7

Mexico's Cantarell Field Depletion Faster Than Originally Thought



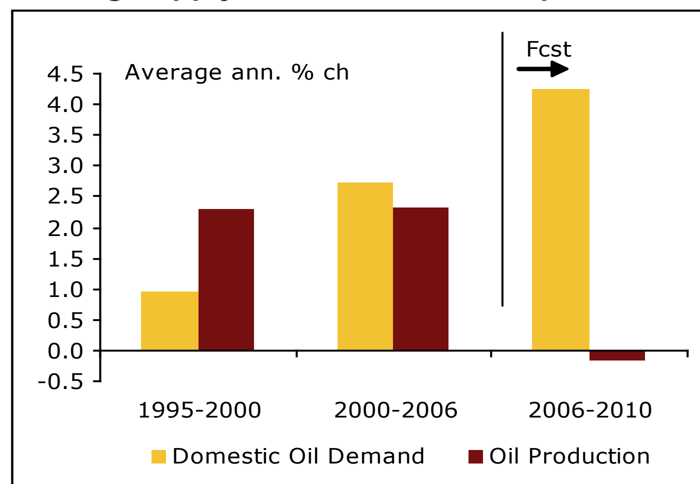
regime will want to maximize oil revenue, the prospect of a protracted civil war in the country raises the risk of a major disruption in this country's supply. Civil strife on a much smaller scale in the Niger delta region has already shut in over half a million barrels per day of Nigerian production.

Collectively OPEC, Russia and Mexico account for almost 60% of the world's production of oil, with output of just over 47 million barrels per day. While we expect the group's crude production will more or less hold near that level, crude exports from the region are likely to drop by as much as 2.5 million barrels per day over the balance of the decade (Table 1). Exports will effectively be crowded out by soaring domestic oil consumption; dual charged by both rapidly rising incomes and highly subsidized oil prices (Chart 8).

Short of bringing on more high cost unconventional products like Canadian bitumen, there are no obvious sources of new supply that are going to offset the decline in exports from major oil-producing countries. That will leave the onus of adjustment falling squarely on the shoulders of soaring world oil prices, which will have to bring the rest of the world's demand curve in line with what oil-producing countries will be able to sell them.

Chart 8

Traditional Oil Exporters*: Cooling Supply as Demand Heats Up



** OPEC, Russia and Mexico*

Table 1

Traditional Suppliers Export Capacity Will Decline

		1995	2000	2006	2008(f)	2010 (f)
OPEC	**Oil Production**	27.7	31.5	34.2	34.4	34.8
	Own Consumption	5.2	5.9	7.5	8.2	9.0
	Oil Exports	22.5	25.6	26.7	26.2	25.7
-Saudi Arabia	*Oil Production**	*7.9*	*8.0*	*9.2*	*9.9*	*10.2*
	Own Consumption	*1.3*	*1.5*	*2.0*	*2.3*	*2.5*
	Oil Exports	*6.7*	*6.5*	*7.1*	*7.6*	*7.7*
-Iran	*Oil Production*	*3.7*	*3.8*	*4.3*	*4.3*	*4.1*
	Own Consumption	*1.2*	*1.3*	*1.7*	*1.8*	*2.0*
	Oil Exports	*2.5*	*2.5*	*2.7*	*2.5*	*2.1*
Mexico	**Oil Production**	3.1	3.5	3.7	3.0	2.4
	Own Consumption	1.7	1.9	2.0	2.1	2.2
	Oil Exports	1.4	1.5	1.7	0.9	0.2
Russia	**Oil Production**	6.3	6.5	9.8	10.2	10.2
	Own Consumption	3.0	2.6	2.7	3.0	3.2
	Oil Exports	3.3	4.0	7.0	7.2	7.0
Total	**Oil Production**	**37.0**	**41.5**	**47.7**	**47.6**	**47.3**
	Own Consumption	**9.9**	**10.4**	**12.2**	**13.2**	**14.4**
	Oil Exports	**27.1**	**31.1**	**35.5**	**34.4**	**32.9**

** Excludes Natural Gas liquids*

Source: 2006 and prior years, BP Statistical Review of World Energy and IEA; more recent data are CIBC WM estimates/forecasts

Can Ontario Shutdown Coal and Keep the Lights On?

Benjamin Tal

The pledge to phase out Ontario's four coal-fired generation plants is the centerpiece of the provincial government's goal to slash greenhouse gases to 6% below 1990 levels by 2014. And to demonstrate that it's serious, the government is enshrining the 2014 plant closing in law. Is it doable? The short answer is yes. But electricity prices will have to rise. And even then, it will be important to avoid any glitches in the projected flow of new power-generating sources.

Coal — Still an Important Energy Source

Despite the successful closing of the Lakeview coal-fired generation station in 2005, coal still accounts for no less than a fifth of Ontario's electricity generating capacity, with Nanticoke, the largest coal-fired plant in North America, responsible for more than 60% of that capacity (Chart 1).

Regardless of how you look at it, Ontario government's plan to phase out coal plants and completely close them down by 2014, is ambitious. In fact, the plan will make Ontario the only jurisdiction in North America to be phasing-out coal.

And the challenge is not only to replace the nearly 6,500 megawatts (MW) of coal-fired generation, but also to deal with the fact that the generating capacity of the province's geriatric nuclear reactors is on a declining trajectory. In fact, the deadline for a complete shutdown of the four coal plants roughly coincides with the potential shutdown for refurbishment of the four 500 MW reactors at the Pickering B nuclear station (Chart 2).

Demand is Rising

In the background, demand for electricity in the province is rising by more than 1% a year — well above its long-term average. But more importantly, to phase-out coal-fired electricity generation and keep the lights on, electricity resources must exceed not only average demand throughout the year, but also *peak* electricity demand. Ontario, unlike all other provinces, is a summer-peaking region, as summer peak electricity consumption outpaces winter peak loads. And as illustrated in Chart 3, the difference can be significant. In summer 2005, Ontario demand exceeded domestic generating capacity for no less than 593 hours, with the province being forced to import the missing power. By the time the coal plants are completely shut down, normal weather peak demand will be 7% higher than today's levels. That means at least 3,100 MW in additional required resources.

So all other things being equal, the net outcome of phasing-out coal, diminishing existing nuclear capacity and rising electricity demand would lead to a power gap of roughly 14,000 MW by 2015. Put differently, in the coming eight years Ontario must develop more

Chart 1

Ontario's Electricity Supply

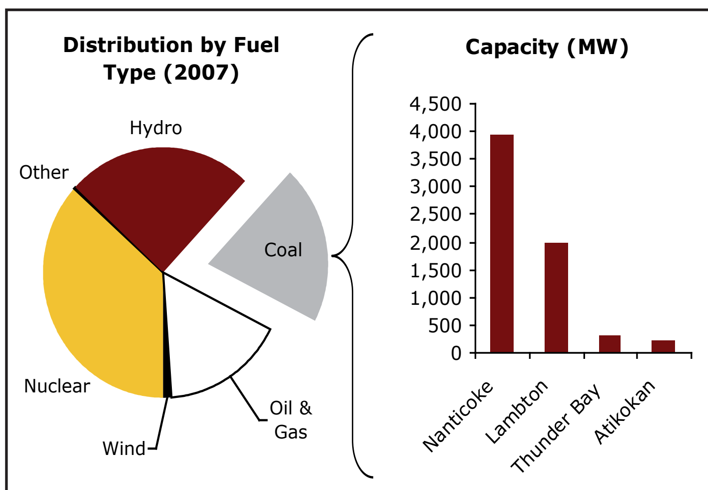
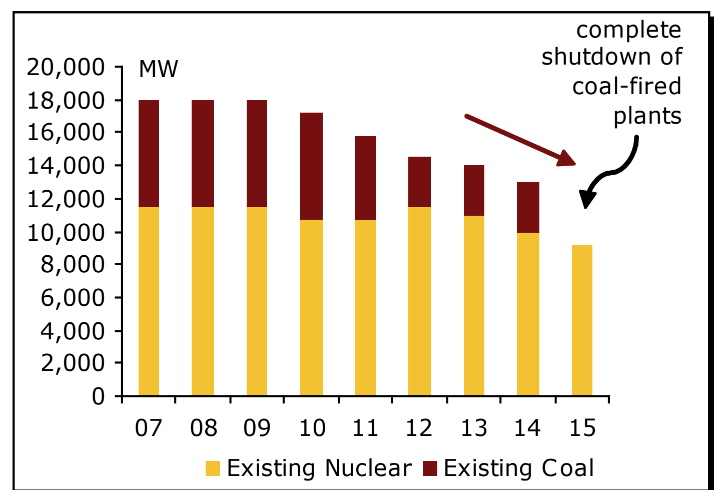


Chart 2

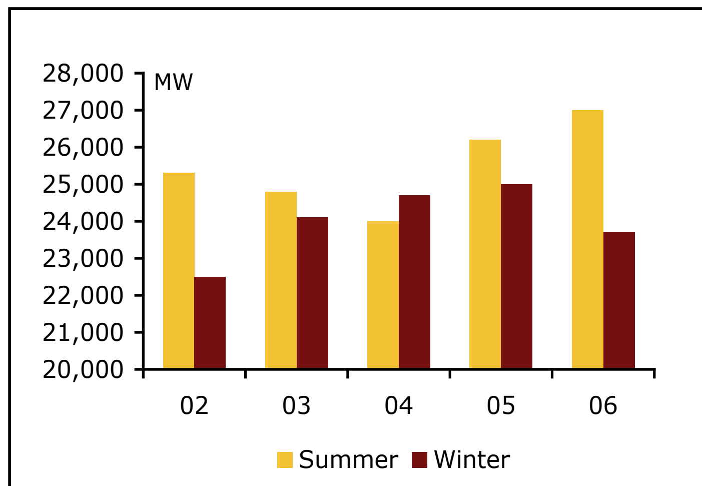
Phasing-Out Coal Alongside Falling Existing Nuclear Capacity



Sources: OPA, CIBCWM

Chart 3

Ontario's Peak Electricity Demand



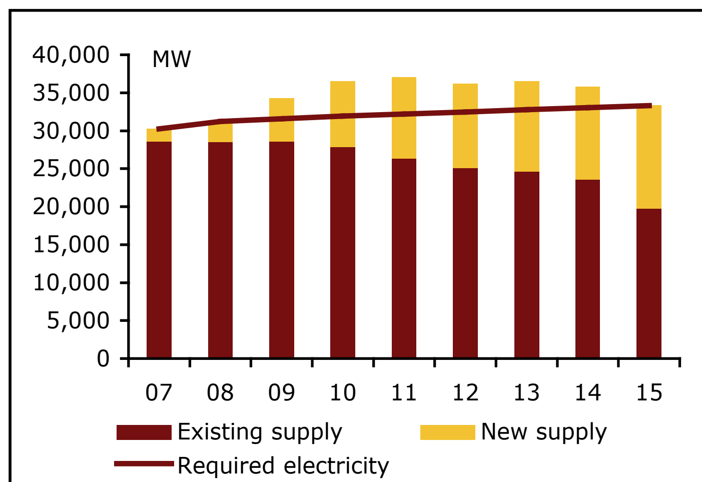
Source: IESO

new electricity-generating sources than currently exist in Alberta as a whole.

The timetable used by the Ontario government to close the coal plants is based on an analysis done by The Ontario Power Authority (OPA). And the numbers do add up. However, as illustrated in Chart 4, even according to the OPA's projections, the situation by 2015 (following the closing of all coal plants) will be tight. Any glitches to the flow of new-electricity generating capacity will jeopardize the plan. Thus, it's hardly a surprise that the OPA itself describes the phasing-out of coal in Ontario as a *"significant challenge"* and the Ontario Independent Electricity System Operator (IESO) views it as *"the most significant undertaking in the Ontario electricity sector's 100 history".*

Chart 4

Electricity Demand vs. Supply



Sources: OPA, CIBCWM

New Power and Higher Prices

Where will all this new electricity-generating capacity come from? To be sure, some of this new supply is already in the pipeline. Table 1 lists all the projects that were approved or are already underway. Those projects are expected to add close to 7,000 MW of new capacity to the province's electricity system by 2010. Most notably, the Bruce A Unit 1 and 2 nuclear reactors are expected to return to service in 2009 and 2010 respectively, and the Greenfield and Goreway combined cycle natural gas power plants will together provide close to 1,900 MW by 2008.

Another glance at the table reveals that a significant portion of the new electricity is based on energy coming from natural gas. And the OPA plans more of the same for the period 2010-2015. In fact, almost half of the projected new sources of power between now and 2015 will be based on natural gas (Chart 5). Natural gas is 50% greener than coal. But natural gas prices are also more volatile. Chart 6 shows that electricity prices in Ontario dance very closely to the tune of natural gas. The surge in natural gas prices during Katrina led to a

Table 1

Committed Supply Resources in Ontario By 2010

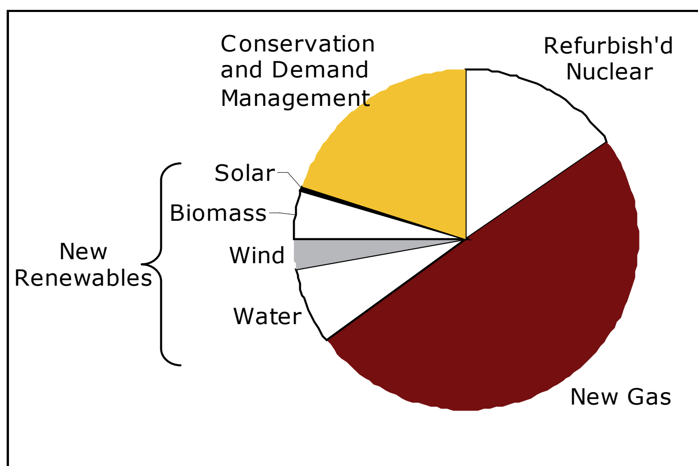
Source of Project	Committed Supply Resources	Installed MW
Gas-fired	Goreway	860
	Halton Hills (GTA West)	600
	Portlands Energy	550
	Greenfield Energy	1,005
	Greenfield South Power	280
	St. Clair Energy	570
	Great Northern Tri-Gen	12
	East Windsor Cogeneration	84
	Durham College District	2
	Thorold Cogeneration	236
	Countryside London Cogeneration	12
	Algoma Energy Cogeneration	63
	Warden Energy	5
Wind	Wolfe Island	198
	Leader A & B	200
	Kingsbridge II	159
	Ripley	76
	Kruger Energy Port Alma (KEPA)	101
	Melanchton II	132
	Prince 2	90
Hydro-electric	Island Falls	20
	Hydro Umbata Falls	23
Nuclear	Bruce Power Unit 1 & 2 Refurbishment	1,500
TOTAL		**6,778**

40% increase in electricity prices in Ontario. On average, a one percentage point increase in natural gas prices leads to 0.5 percentage point increase in electricity prices in Ontario. And that's in an environment in which natural gas accounts for only 15% of Ontario's electricity supply. The heavy reliance on natural gas as the dominant source of new supply will bring this share to 30% by 2015 — doubling Ontario's electricity price sensitivity to swings in natural gas prices.

An increased influence of natural gas prices on electricity prices can be a blessing when natural gas prices fall. But the likelihood is that, in the medium term, natural gas prices will rise. And what will drive natural gas prices higher are the same forces that are behind Ontario's decision to scrap coal. Simply put, global warming is bullish for natural gas. Demand for natural gas is extremely sensitive to rising temperatures. Many coal-fired generating capacity plans are likely to be canceled all over North America and to be replaced by nuclear and natural gas facilities; and given that over half of the energy content of ethanol comes from natural gas, demand for natural gas will rise alongside ethanol production.

Chart 5

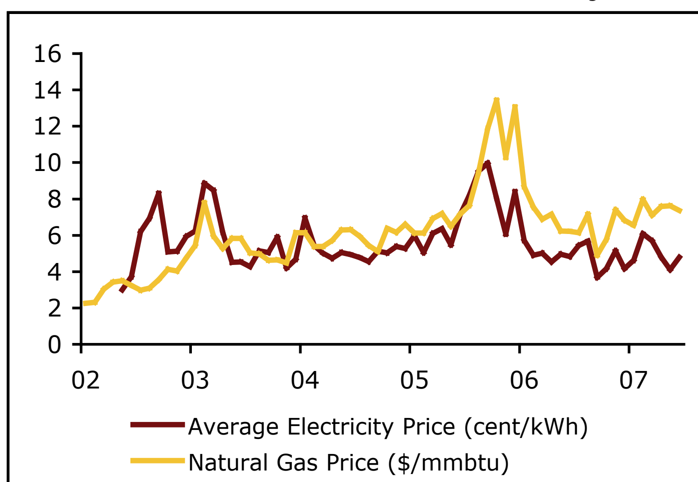
Distribution of Planned New Power Resources (2007-2015)



Sources: OPA, CIBCWM

Chart 6

Natural Gas Drives Wholesale Electricity Prices



So the combination of increased reliance on natural gas as a source of new electricity and higher natural gas prices is a sure recipe for higher electricity prices in Ontario. In fact, based on our assumption that natural gas prices will reach $12-$14/mnBtu by 2015, and assuming natural gas-electricity price elasticity of 0.7-0.8, we estimate that by the time the last coal-fired plant is closed, electricity prices in Ontario will be 60%-70% higher than they are now, or roughly 6.5% per year.

That kind of price increase will be needed in order to meet the government's goal of a nine-fold increase in energy savings from Conservation and Demand Management (CDM) between now and 2015. In fact, CDM is projected to be the second largest resource of "new electricity" in the coming years (Chart 5)[1]. Achieving those savings will require consumers to face the conservation incentives inherent in higher prices.

The OPA also counts on renewable energy sources to rise by 50% by 2015 and to constitute 25% of the solution. The problem here is that not all megawatts were created equal. Coal-fired generated electricity is much more flexible than most renewable resources in terms of its ability to rapidly react to changing demand. For example, by 2015 the province is projected to install close to 2,200 MW of wind power capacity, but only a mere 400 MW will be dispatchable during peak demand periods.

Phasing-out coal in Ontario by 2015 will be challenging, but it's feasible. The math behind the plan however suggests that in order to close the power gap, electricity prices in the province will have to rise from the recent average market price of 4.8 cent/kWh to around 8 cent/kWh by 2015.

Note 1: Based on the methodology used by the OPA, reduced demand due to CDM is counted as new supply. CDM consists mainly of conservation, efficiency, time of use pricing, demand response and fuel switching.

Credit Spreads: Is Risk Now a Four Letter Word?

Avery Shenfeld

Bond markets have been hit with a sharp sell-off in government yields, and more recently, wider credit spreads. But this looks to be merely a return to normalcy than the start of a blow-out that would threaten either global growth or the M&A and equities boom. Real government yields are still only near their 10-year average (Chart 1). Nor is there a reason to expect an aggressive tightening stance, as core inflation is too low to justify taking excessive risks to growth.

In spread markets, there's been a huge hit to CDOs comprised of US subprime mortgages. The spread widening also extended to other credits, and some LBO financings were put off until cooler heads prevail. But reports of a dramatic squeeze have been exaggerated by looking at credit default swap indexes that have a limited history. Longer series for both generic B-rated corporate bonds and institutional loans show that by historical standards, spreads are still moderate (Chart 2).

That makes sense, as analogies between subprime mortgages and corporate debt are misguided. Some US mortgage originators rushed to get poorly backed assets on the books and out the door in securitizations, and targeted unsophisticated retail borrowers. In contrast, sophisticated corporate and private equity borrowers take pains to avoid debt they won't be able to service, since that would wipe out their equity stake no matter how the debt has been distributed.

Corporate profits continue to show the healthy growth needed for debt servicing, with G7 earnings seeing double-digit gains. Indeed, recent developments don't show the hallmarks of a rush to safety. Not only have North American stocks set new highs, but high-yield issuance volumes have been brisk, emerging market currencies and equities have appreciated, and their bond spreads have remained lean. A liquid global supply of investment funds still has an appetite for risk. China's central bank's current move into equities is only part of a pattern that has seen US capital inflows tilt towards riskier assets in the past two years (Chart 3). Deals may be done at a higher cost and under tighter covenants, and spreads could see some further widening from still tight levels, but corporate risk concerns aren't going to derail financial markets or the economy.

Chart 2

Credit Spreads Still Tame

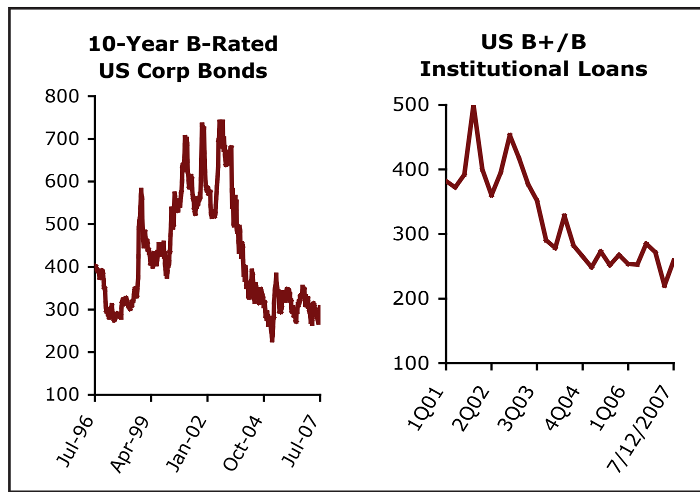


Chart 1

Real 10-Year Rates Are Merely Near Averages

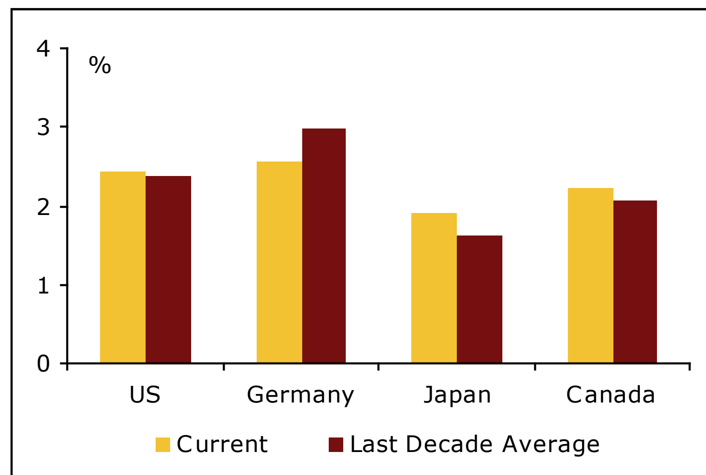
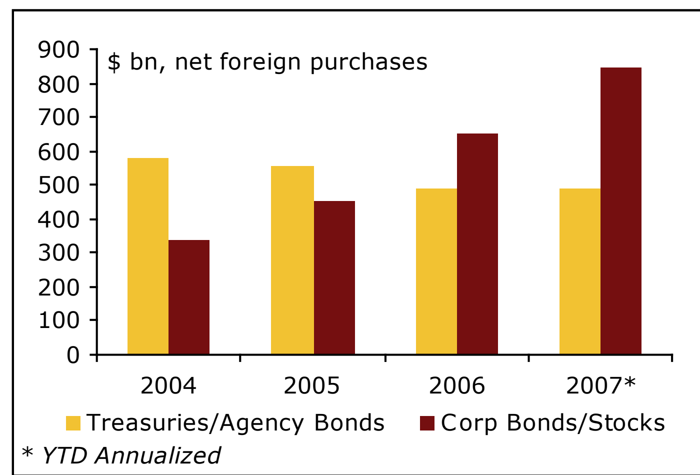


Chart 3

Foreigners Buy Riskier US Asset Mix



ECONOMIC UPDATE

CANADA	07Q1A	07Q2A/F	07Q3F	07Q4F	08Q1F	2006A	2007F	2008F
Real GDP Growth (AR)	3.7	2.4	2.4	2.1	2.6	2.8	2.3	2.6
Real Final Domestic Demand (AR)	3.2	3.2	3.2	3.2	3.3	4.7	3.4	3.2
All Items CPI Inflation (Y/Y)	1.8	2.2	2.7	3.1	2.6	2.0	2.5	2.4
Core CPI Ex Indirect Taxes (Y/Y)	2.3	2.4	2.3	2.3	2.2	1.9	2.3	2.2
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	69.2	67.4	65.6	66.0	51.3	65.5	65.0
U.S.								
Real GDP Growth (AR)	0.7	3.0	1.7	2.0	2.5	3.3	1.9	2.6
Real Final Sales (AR)	1.7	2.0	1.8	2.3	2.3	3.1	2.2	2.5
All Items CPI Inflation (Y/Y)	2.4	2.6	2.4	3.4	3.0	3.2	2.7	2.4
Core CPI Inflation (Y/Y)	2.6	2.2	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

First half growth looks solid and core inflation has turned heads, refusing to retreat to the Bank of Canada's prescribed 2% target. An ultra-tight labour market looks to keep upward pressure on wages, so even with the C$ dampening imported goods inflation, it will take longer than we (or the BoC) projected to tame core CPI. Nationally at least, job creation and the trade surplus reveal an economy that has weathered the C$'s sharp appreciation surprisingly well. Factory jobs losses continue to be offset by strong gains in a host of other industries, with housing resilience contrasting with an imploding stateside market. An elevated currency will take some sheen off the growth outlook, but that's being seen as a necessary cooling for today's overheated economy.

UNITED STATES

We've weakened our forecast for Q2 growth over the past month as reports revealed a larger-than-expected deceleration in consumer spending. A 3% growth rate will depend heavily on inventories and net exports, but the slow pace to final sales foretells a weaker second half. Watch for headline CPI to surge late this year, as crude oil and gasoline will then be compared to a prior year price dip that we don't see repeated.

Conflicts of Interest: CIBC World Markets' analysts and economists are compensated from revenues generated by various CIBC World Markets businesses, including CIBC World Markets' Investment Banking Department. CIBC World Markets may have a long or short position or deal as principal in the securities discussed herein, related securities or in options, futures or other derivative instruments based thereon. The reader should not rely solely on this report in evaluating whether or not to buy or sell the securities of the subject company.

Legal Matters: This report is issued and approved for distribution by (i) in Canada by CIBC World Markets Inc., a member of the IDA and CIPF, (ii) in the UK, CIBC World Markets plc, which is regulated by the FSA, and (iii) in Australia, CIBC World Markets Australia Limited, a member of the Australian Stock Exchange and regulated by the ASIC (collectively, "CIBC World Markets"). This report has not been reviewed or approved by CIBC World Markets Corp., a member of the NYSE and SIPC, and is intended for distribution in the United States only to Major Institutional Investors (as such term is defined in SEC Rule 15a-6 and Section 15 of the Securities Act of 1934, as amended). This document and any information contained herein are not intended for the use of private investors in the UK. The comments and views expressed in this document are meant for the general interests of clients of CIBC World Markets Australia Limited. This report is provided for informational purposes only.

This report does not take into account the investment objectives, financial situation or specific needs of any particular client of CIBC World Markets Inc. Before making an investment decision on the basis of any information contained in this report, the recipient should consider whether such information is appropriate given the recipient's particular investment needs, objectives and financial circumstances. CIBC World Markets Inc. suggests that, prior to acting on any information contained herein, you contact one of our client advisers in your jurisdiction to discuss your particular circumstances. Since the levels and bases of taxation can change, any reference in this report to the impact of taxation should not be construed as offering tax advice; as with any transaction having potential tax implications, clients should consult with their own tax advisors. Past performance is not a guarantee of future results.

The information and any statistical data contained herein were obtained from sources that we believe to be reliable, but we do not represent that they are accurate or complete, and they should not be relied upon as such. All estimates and opinions expressed herein constitute judgements as of the date of this report and are subject to change without notice.

Although each company issuing this report is a wholly owned subsidiary of Canadian Imperial Bank of Commerce ("CIBC"), each is solely responsible for its contractual obligations and commitments, and any securities products offered or recommended to or purchased or sold in any client accounts (i) will not be insured by the Federal Deposit Insurance Corporation ("FDIC"), the Canada Deposit Insurance Corporation or other similar deposit insurance, (ii) will not be deposits or other obligations of CIBC, (iii) will not be endorsed or guaranteed by CIBC, and (iv) will be subject to investment risks, including possible loss of the principal invested. The CIBC trademark is used under license.

(c) 2007 CIBC World Markets Inc. All rights reserved. Unauthorized use, distribution, duplication or disclosure without the prior written permission of CIBC World Markets Inc. is prohibited by law and may result in prosecution.