

**July 2008****Table of Contents****In this issue...**

- Canada's inflation immunity
- Moving from pooled funds to global segregated funds - a global custody primer
- Why has the Canadian dollar failed to respond to record crude prices?
- A message from our CEO - first anniversary of The Bank of New York Mellon
- Commission recapture - increasing investment returns

This issue by:

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- Tim Rourke, vice president, relationship management
- Shane Enright, currency strategist, CIBC World Markets
- Thomas C. MacMillan, president & chief executive officer at CIBC Mellon
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Canada's inflation immunity

Food consumers are rioting over grain prices in the developing world. Gasoline prices are soaring just about everywhere. Inflation is well above central bank targets in Europe, Mexico, China and Australia, to name only a few such trouble spots. In addition, although the U.S. Federal Reserve has largely averted its eyes to a four per cent inflation rate while it fends off recession, its board members warn of a sterner policy once growth picks up. All of this reflects the impact of several years of strong global growth that has tightened markets for crude oil, metals and grains. Why, then, does Canada seem to have an immunity necklace in terms of price pressures, with both core and all-time Consumer Price Indexes (CPIs) well below the central bank's two per cent target as of March?

A half percentage point of the difference can be chalked up to this year's one per cent point cut in the GST (which does not hit all the components in the CPI), although that is netted out of the Bank of Canada's core CPI measure. However, there is also a nearly unprecedented gap between after-tax goods inflation rates across the Canada-U.S. border.

In part, that captures a recent sharp drop in vehicle prices as carmakers passed on a one-time benefit from the rise in the Canadian dollar into sticker prices. It also reflects a similar one-off savings on imported fruits and vegetables. Food inflation has also been held back by a grocery store price war that has squeezed margins in Canada, and by the role of marketing boards in smoothing out some food price increases.

None of those forces is likely to last into 2009. Grocery store margins will probably rise at some point to restore profitability. Cost increases from the global squeeze on grains and energy will show up in poultry, eggs and milk. There is no further GST cut coming, and the Canadian dollar is highly unlikely to see as big a year-on-year rise, given where it currently sits and the trouble that it



is causing for manufacturers. Add in further increases in gasoline prices, and Canada's CPI will be in the range of three to 3.5 per cent next year.

Assuming the economy is back on a firmer growth path, the Bank of Canada will be doing its duty to wrestle those inflation pressures back down to earth. This year's rate cuts will give way to at least a 100-basis point hike over the course of 2009.

For investors, that puts a note of caution into the prospects for interest-sensitive equities such as financials, residential real estate and utilities. Earnings for financials could be relatively tame, even after the worst of the write downs pass, and Canadian residential real estate prices will slow in the face of rising mortgage rates. Government bonds, which benefited from a flight to safety bid in recent months, will be much less safe by late this year as yields rise in line with higher inflation expectations and upward pressure on the short-term yields from expected 2009 Bank of Canada rate hikes.

Instead, the winners will be in equity market sectors benefiting from the commodities inflation that will underlie the inflation risks - energy, materials and fertilizers - as well as related services in such areas as irrigation and biotechnology.

This will not be stagflation, or at least not a full-blown case of the disease seen in decades past that entailed coinciding double-digit inflation and unemployment rates. Nevertheless, inflation is going to again be a factor for Canadian investment decisions in the year ahead.

May 12, 2008

By Avery Shenfeld, managing director and senior economist, CIBC World Markets

Moving from pooled funds to global segregated funds - a global custody primer

When the foreign content limits were removed in 2005, most Canadian pension funds continued with a gradual increase in their holdings of global pooled funds. As investment strategies continue to evolve, an increasing number of plan sponsors are now considering a move into direct investments of segregated global securities.

When making the move from global pooled funds, plan sponsors must consider a number of variables. Involving your custodian early in these decisions will give you access to a wealth of information and expertise, potentially reducing risks and costs, while increasing revenue opportunities.

The following are a few key areas to consider as you contemplate moving into segregated global securities.

Timing

One of the most critical decisions when moving out of any pooled fund (global or domestic) into a segregated strategy is timing. You'll need to understand the valuation date that the fund manager will use to liquidate your holdings. Of equal importance is the settlement date (when will you receive the proceeds). Often, funds may be liquidated and available for investment, but the global



structure may not be ready to receive funds due to timing and documentation requirements to enter global markets.

If you have significant holdings in a pooled fund, the manager may require that you take your proceeds "in specie," meaning that you will receive your pro rata share of the underlying securities in the pooled fund. This will need to be coordinated with your custodian.

As a plan sponsor, you must ensure your assets stay invested in the market - missing even a day of investment opportunities could create risk for your investment strategy. A transition manager can help you to mitigate this risk.

Investing in new markets

Working with your global segregated fund manager, your custodian will give you the required documentation for the markets where you choose to invest. A power of attorney in favour of your custodian is required for all markets as well as a certificate of residency from the Canada Revenue Agency to allow the custodian to deal with regulators and tax authorities.

Certain countries, including Germany and the United Kingdom, do not require extensive documentation, so investment can begin as soon as the accounts are opened. However, India is an example of a country where there are multiple filing requirements.

Monthly statements, taxes and accounting

Previously, your statement would have shown the value and number of pooled fund units held. Your new statement will include:

- Securities held, sorted by market, in both the foreign and base currency
- Tax reclaims shown as interest or dividends receivable
- Foreign exchange transactions

Withholding tax rates vary depending on the country and by the tax treaties in place with Canada. Tax amounts to be reclaimed will be reflected on your statements until they are paid, the timing of which is dependent on the country's tax practices - it may take months or even years.

Additional considerations

Some additional considerations are as follows:

- Review your pension fund's trust or custodial agreement to ensure that the language allows for investment in global markets.
- Complete documentation and tax forms before entering into specific markets.
- Remember that entering a global securities lending program can provide additional income opportunities to offset some of the costs relating to foreign markets.
- Ensure that you understand the foreign exchange services required by your plan.

Your global custodian will play an important part in the implementation of your segregated global strategy. Early consultation will help ensure that you experience a smooth transition with reduced risks and costs and increased revenue opportunities.



Adapted with permission from an article in the Winter 2008 Pension Investment Association of Canada's Communiqué newsletter.

By Tim Rourke, vice president, relationship management

Why has the Canadian dollar failed to respond to record crude prices?

Since Jan. 1, 2008, an environment of broad commodity price strength has driven a 7.5 per cent appreciation in the Australian dollar versus the U.S. dollar, while Norway's "petro-currency," the krone, has risen by a similar 7.4 per cent versus the greenback. Over this same period, despite a roughly 30 per cent jump in light crude prices, the Canadian dollar has actually lost ground versus the U.S. dollar - down almost one per cent in the first four months of 2008 - and it is more than 10 per cent off its strong point from last November.

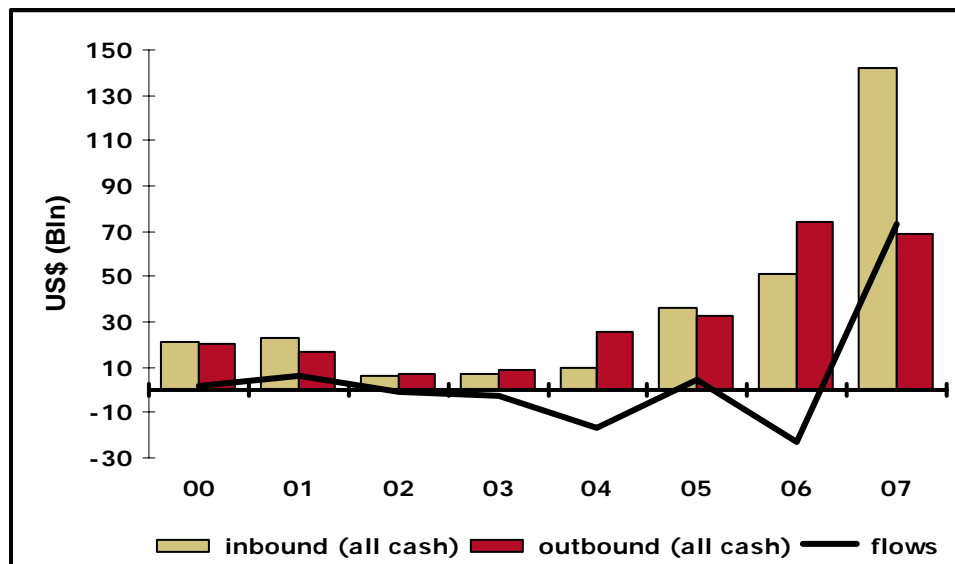
Geography plays a part in explaining the loonie's lacklustre performance in recent months; Australian exports are primarily bound to Asian markets, and the majority of Norway's exports are sent to European nations. Both these regions are presently viewed as more robust than the United States, the end destination for the majority of Canada's exports. However, geography is far from being the sole factor in our domestic currency's lack of responsiveness to soaring energy prices. Two other material factors for the loonie's current malaise exist: a more currency neutral merger and acquisition pipeline thus far in 2008 and weakening interest rate differentials.

M&A flow: Canadian dollar positive in 2007 but neutral in 2008

The volume of M&A was a major catalyst for Canadian dollar gains in 2007, but so far in 2008 it has been neutral. As illustrated in Figure 1, the net balance of cash inbound flows versus outbound flows in 2007 was far more distorted than in any of the previous years this decade. While the data captured in this figure do not account for the method of financing and are therefore not a direct reflection of foreign exchange conversion flows, it is worth noting that the next largest net inflow behind the US\$73.2 billion evidenced in 2007 was a comparatively meagre US\$6 billion inflow back in 2002.



Figure 1 – M&A: annual cash inbound versus outbound flows (2000-2007)

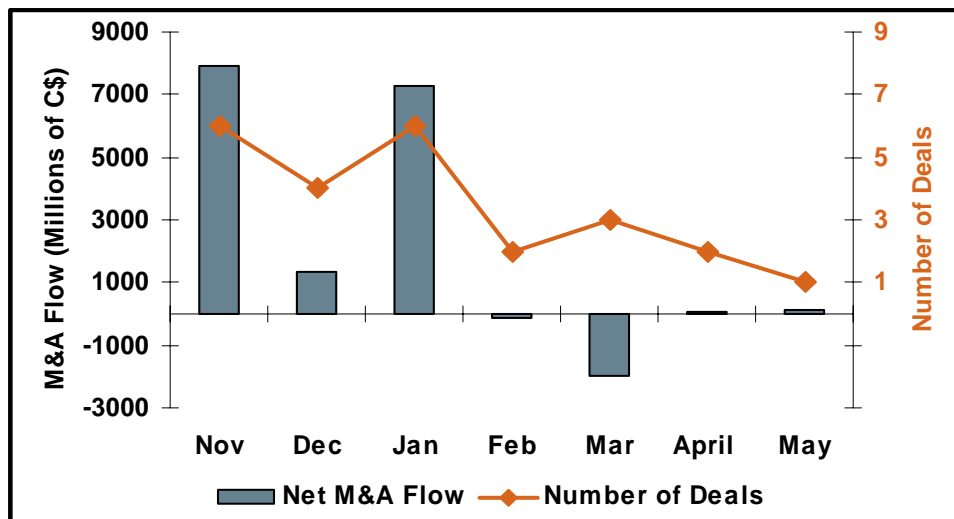


Of all the cross-border deals closed during 2007, none was more significant than Rio Tinto's US\$38.1 billion acquisition of Alcan. This deal captured the attention of the speculative community, both because of its sheer size and the fact that all shareholders were paid in U.S. dollars (raising the likelihood of material conversion flows). Net speculative bets against the Canadian dollar, as measured by non-commercial positioning on the Chicago Mercantile Exchange (CME), pushed net speculative bets in favour of the Canadian dollar to record highs. Given that Canadian dollar futures first started trading in 1972, this shift from record net short bets to record long bets in a nine-month window was quite astounding, and represented a massive US\$15.7 billion swing in speculative sentiment in favour of the loonie.

Similar data for early 2008 paint a very different story so far (Figure 2). Tighter credit conditions reducing the number of deals in recent months and a near-parity currency have encouraged many domestic firms to grow their operations through U.S. acquisitions. These conditions have allowed for a more balanced mix of inbound versus outbound deals, and with the absence of a positive M&A profile, speculative investors finding better opportunities elsewhere have, for the most part, shunned the loonie.



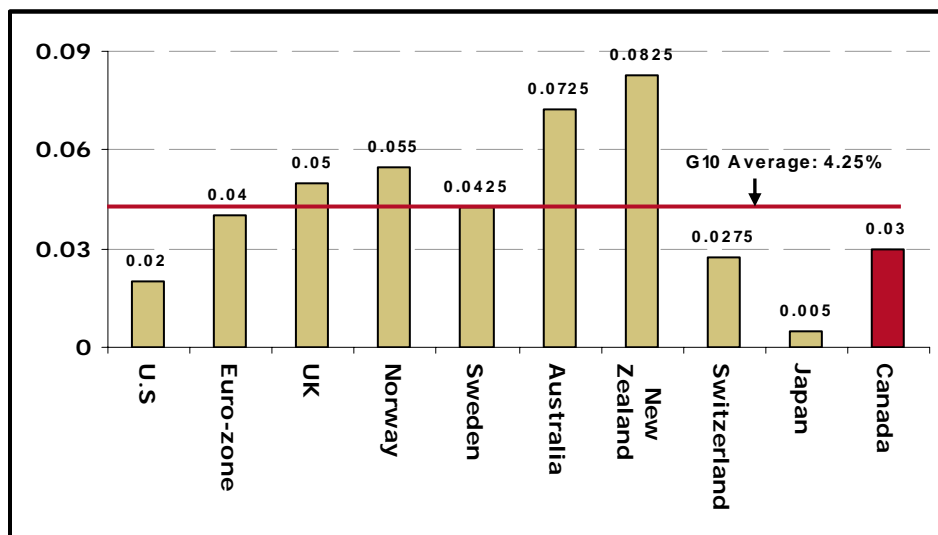
Figure 2 – Net M&A flow data since November 2007



Falling domestic yields reduce Canadian dollar's appeal to speculators

Comparatively low domestic interest rates have encouraged speculators to play the commodity cycle through other currencies. While the importance of yield may lessen during bouts of extreme market risk aversion, it does always remain a variable that factors into investment decisions. Note also that while Bank of Canada cumulative rate cuts have fallen well shy of those witnessed south of the border so far in 2008, they are still far greater than those seen in any other G10 countries (Figure 3).

Figure 3 – G10 benchmark interest rates (as of May 14, 2008)



Therefore, while Canada still retains its "petro-currency" status, speculators currently view Norway's krone as the better currency play for the expression of a bullish crude view. Not only is



Norway's 5.50 per cent yield more attractive, but in addition Norway maintains a much larger current account surplus (an important metric when risk aversion rises) and has a more robust export base.

Recent CME data (for the reporting period ending May 6) confirm the importance of yield to speculators, with the two largest positive currency bets being the Australian dollar and Mexican peso (Australia has a 7.25 per cent benchmark rate, while Mexico has a 7.50 per cent benchmark rate). Both currencies are viewed as commodity plays, and the fact that positive bets on the Mexican peso sit near two-year highs illustrates that geography alone does not explain the lack of investor appetite for the Canadian dollar. With Mexico having even stronger trading ties to the United States, it is clear that investors are willing to look beyond geography if they are paid enough (in terms of yield).

While domestic inflation is showing signs of building, this will be more a story for 2009. In the interim, a Canadian dollar stronger than parity will be dependant on renewed foreign investor appetite for domestic resource assets – a condition that will surely draw speculators back to the loonie once again.

June 20, 2008

By Shane Enright, currency strategist, CIBC World Markets

A message from our CEO - first anniversary of The Bank of New York Mellon

On July 1, we celebrated the first anniversary of The Bank of New York Mellon Corporation - the world's largest asset servicing provider, with more than US\$23 trillion in assets under custody and administration.

Asset servicing is a business where scale, combined with effective local delivery, creates a powerful combination. The Bank of New York Mellon merger gives us the opportunity to provide you - our clients - with the best products, technology and service to enhance the management, administration and oversight of your investment process.

I'm pleased to inform you that The Bank of New York Mellon's thoughtfully paced integration is well on track. The ultimate objective is to strengthen product and service offerings, and enrich your overall client experience.

In the near future, we look forward to further leveraging the strength of The Bank of New York Mellon, to deliver the next generation of products you need to evolve and grow. I'm confident these enhanced products and services - combined with our solid knowledge of your business - will position you for further success.

By Thomas C. MacMillan, president & chief executive officer at CIBC Mellon

Commission recapture - increasing investment returns

In today's uncertain economic environment, managing your fund expenses, controlling costs and helping to bring investors greater returns can be challenging. One highly effective way to control transaction costs is to implement a commission recapture program.

**How does commission recapture work?**

A commission recapture program returns a portion of trading commissions directly back to your fund. Typically, a portion of the commissions generated by a fund is usually used to pay for fund research. Under a commission recapture program, the portion normally used to pay for research is instead rebated (recaptured) directly to the fund. This direct benefit preserves fund assets and, by lowering the operating expenses, increases the fund's cash flow and its net investment returns.

Features of a commission recapture program

Commission recapture programs are designed to enable your investment managers to process trades in a manner that is completely consistent with your normal trading process. It is easy to start and maintain a commission recapture program. The program has no fees, volume requirements or time limits.

Clients have a dedicated, highly skilled client services professional assigned to ensure the smooth implementation, operation and management of commission recapture programs. Clients also benefit from online access to your records and a proprietary accounting system designed specifically for commission recapture.

How can CIBC Mellon help you?

CIBC Mellon has selected BNY ConvergEx to be the preferred provider of commission recapture services for our clients. BNY ConvergEx Group, an affiliate of The Bank of New York Mellon, is a premier global agency trading and investment technology firm. BNY ConvergEx Group's LJR Recapture Services (LJR) unit is a pioneer in commission recapture, having originated the first commission recapture program in 1986. With a growing list of over 2,000 client funds worldwide - whose assets total more than \$3 trillion - LJR specializes in helping clients save on commissions, conserve assets and benefit participants. Clients include annuities, pension plans, pension schemes, endowments, mutual funds and more.

If you are looking for ways to reduce fund costs, pass on the savings to your clients and increase the returns to your fund, please contact your relationship manager.

By Christian Kraus, vice president, sales, LJR Recapture Services