

# Monthly Swap Market Update

Interest Rate Risk Management

January 4, 2011



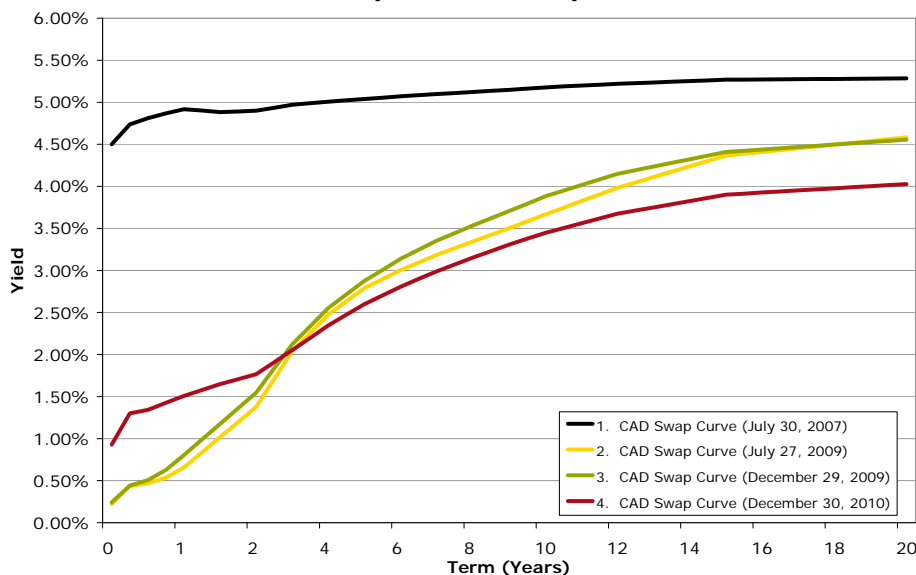
### What's Changed Since Our Last Update on December 1<sup>st</sup>?

- ▲ Financial markets appear to be on more solid ground heading into the New Year despite the bouts of uncertainty provided by Europe's debt overhang
- ▲ Generally better sentiment contributed to higher yields last month as economic reports added to growing evidence of a pick-up in growth during the final quarter of 2010
- ▲ Markets thinned out considerably towards the end of the month, resulting in exaggerated price action as very small flows had a big impact on prices
- ▲ On balance, Canadian swap rates rose last month, from 8 bps in the 2-year sector to 12 bps in the 10-year area. However, the intra-month range is much more telling of recent choppiness with swap rates trading in a 23 to 36 bps range during December
  - Canadian interest rates remain heavily guided by the path of U.S. rates
- ▲ U.S. swap yields drove relentlessly higher again last month, finishing 7 to 48 bps higher. The sell-off in Treasuries was led by the belly of the curve which traded as much as 68 bps higher before retreating. Short-term rates remain anchored by monetary policy
- ▲ QE2 continues to have a strong effect on North American markets. To date, the Fed's bond purchases have failed to bring much stability to the market. In fact, it is contributing to uneasiness about the U.S. government's ability to manage its debt burden which has had the perverse effect of increasing yields
  - The proposed extension of U.S. tax cuts has also raised concerns over inflation and the rising cost of the U.S. government debt load which in turn may impact the country's credit quality
- ▲ While Bernanke said in an interview that the Fed could end up buying more than \$600 billion in bonds, so far it has not made any definitive commitment to increase the size of its program
- ▲ To no surprise, the Bank of Canada left its target overnight rate unchanged at its December meeting. The Bank explicitly mentioned sovereign debt risk as an ongoing challenge

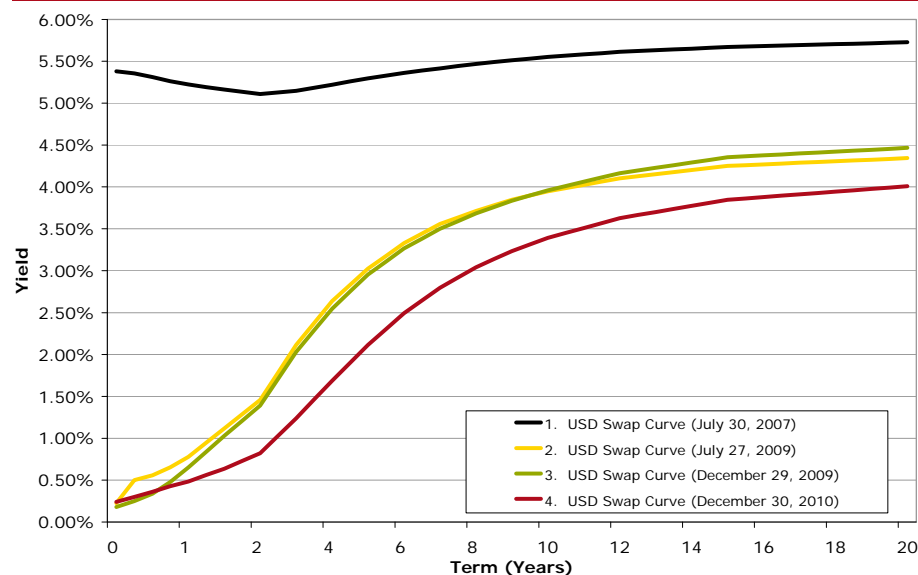
## Curve Comparisons

- ▲ The Bank of Canada held its target rate steady, as expected, on December 7<sup>th</sup> and issued a statement focusing on the downside risks to the global and domestic economies, particularly from financial turmoil in the euro zone. At the same time, it said current policy “leaves considerable monetary stimulus in place”
- ▲ The Fed’s most recent statement offered a cautious assessment on economic progress and showed no signs of altering the terms of its stimulus measures

CAD Swap Curve Comparison



USD Swap Curve Comparison

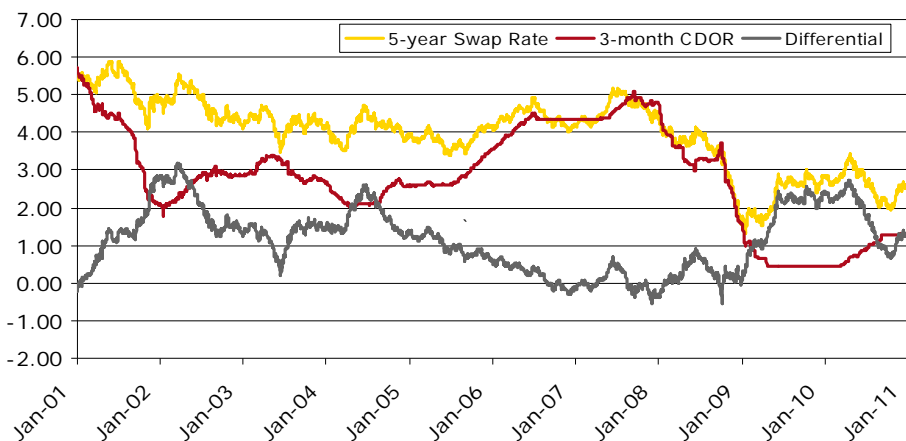


## Swap Environment

- ▲ After narrowing for the better part of a year, the differential between fixed and floating rates has normalized
  - Floating rates have remained static since the fall in line with central bank actions, while term swap rates have continued to rise
- ▲ Despite the recent increases, 5-year swap rates remain low on an historical basis

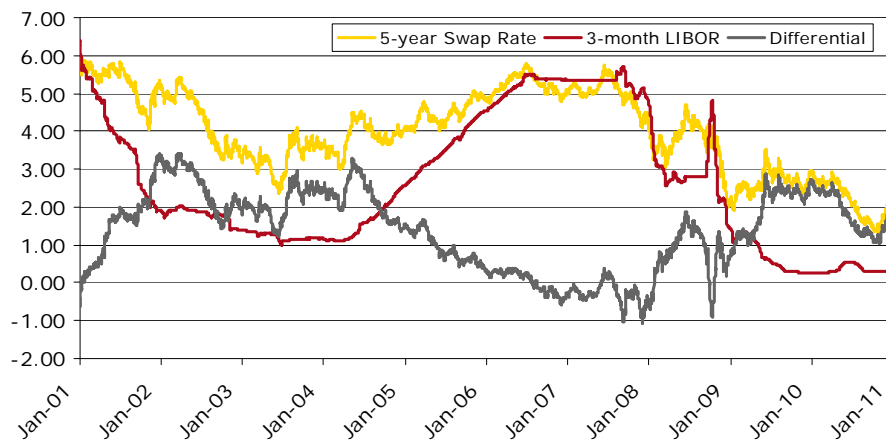
Historic 3-month CDOR vs. 5-year CAD Swap Rates

(January 2001 to January 2011)



Historic 3-month LIBOR vs. 5-year USD Swap Rates

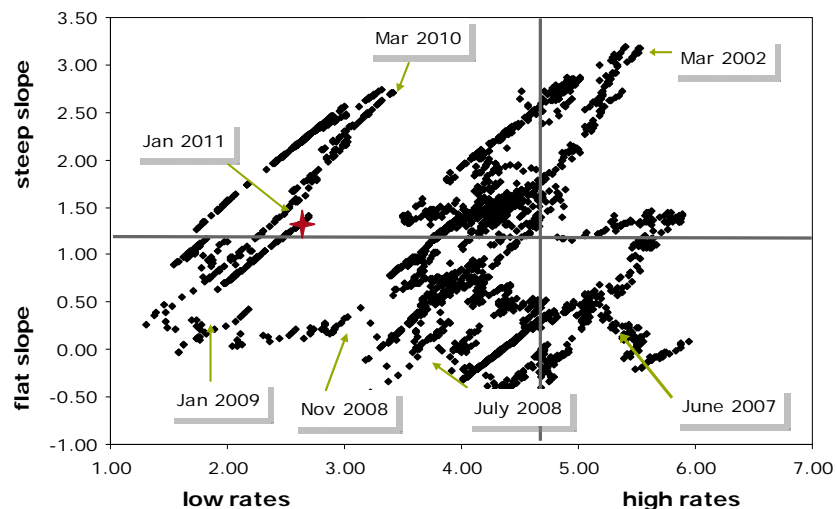
(January 2001 to January 2011)



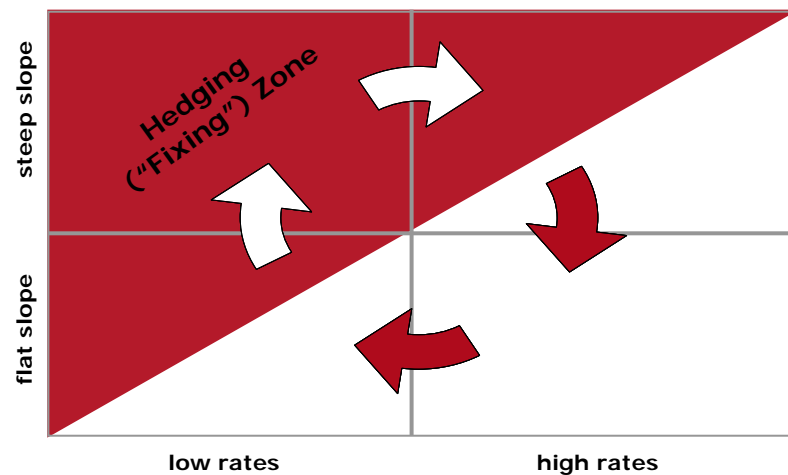
## Swap Environment

- ▲ Plotting the combination of the slope of the swap curve against the absolute level of rates helps to put market conditions into the context of the relative and the absolute cost/benefit of fixed versus floating
- ▲ The diagram on the right demonstrates the prospective movement of interest rates (i.e. clockwise movement through the quadrants)
- ▲ The current point continues to suggest a bias for fixing rates
  - It is bordering the flat/steep slope line, which means the average “premium” for converting from floating to fixed rates is very near the historic 10-year average
  - The low absolute level of rates is also supportive of converting from floating to fixed rates

CAD 5-year swap rate vs. 3m 5yr slope



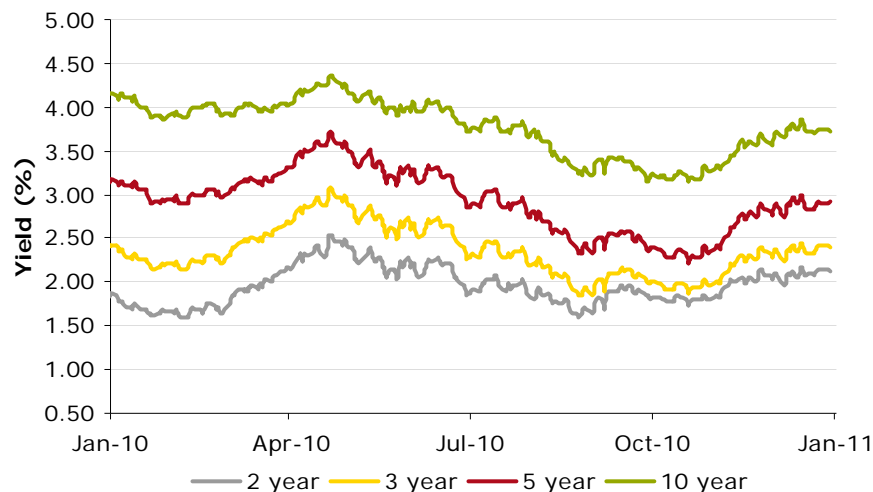
Interest Rate Cycle



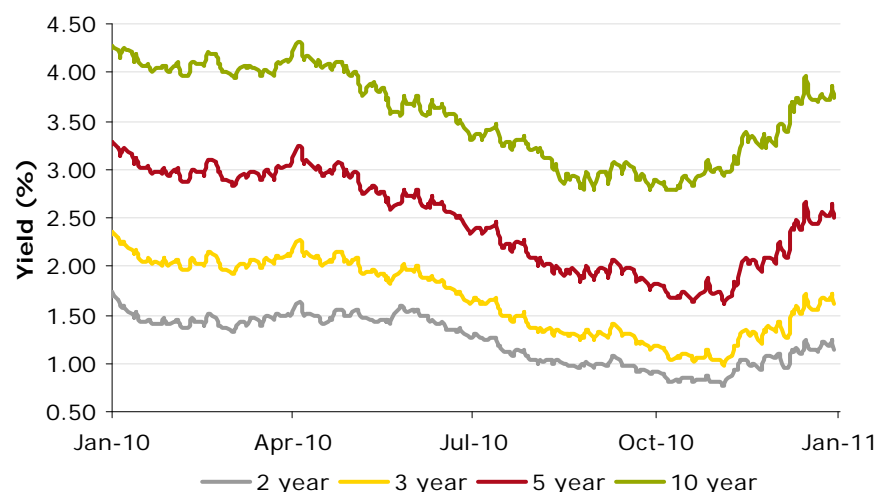
## Swap Rates Over the Past Year

- ▲ Fixed income markets experienced another sell-off last month, sending yields higher and continuing the recent trend of rising term rates
- ▲ What makes the recent rise in yields especially notable is that it is taking place amid the Fed's quantitative easing, a program intended to lower borrowing costs
- ▲ The expiry of the Fed's bond purchase plan in the middle of this year, if not extended, will remove a large support to the market which could send interest rates higher

CAD Swap Rates

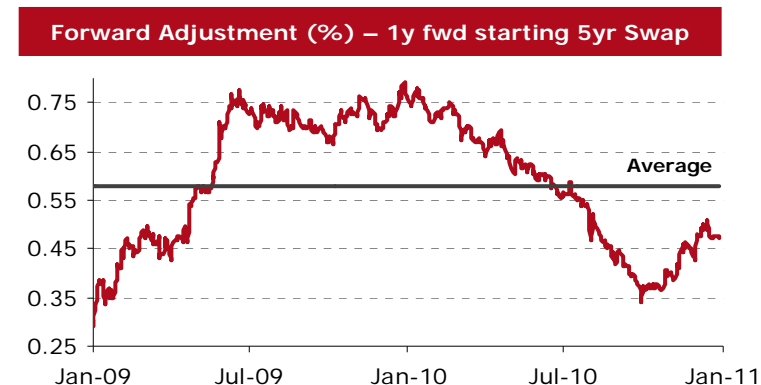
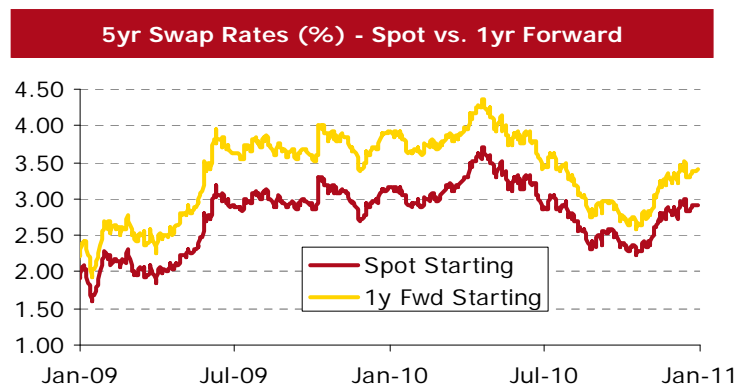
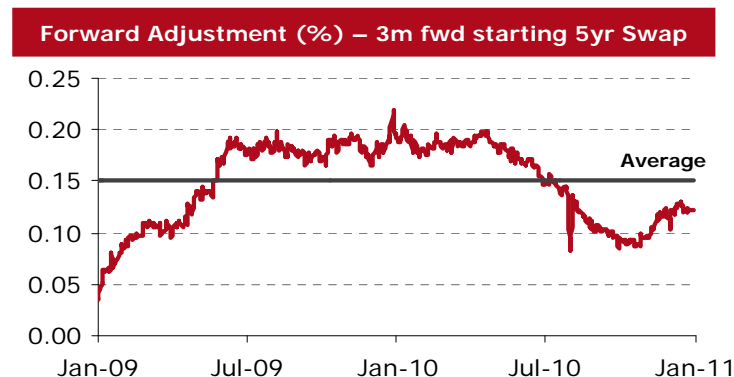
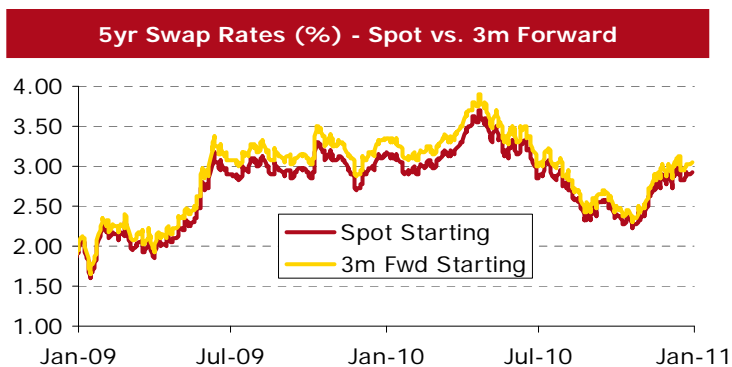


USD Swap Rates



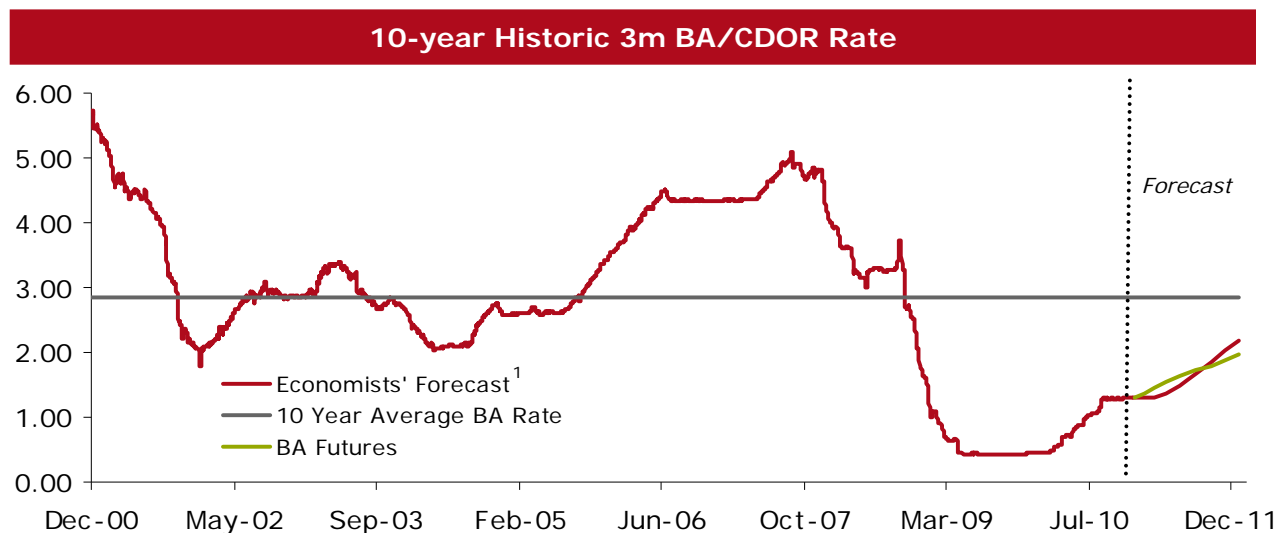
## Pre-Hedging Costs

- ▲ Interest rate swaps can be structured to accommodate a delay or forward effective date, meaning the fixed rate can be established well in advance of the actual funding requirement
- ▲ Forward-starting swaps are generally priced at a premium to immediate (or spot) starting swaps (called the 'forward adjustment'), reflective of the typically "positive" slope of the yield curve
- ▲ The premium for locking in on a forward basis is now below the average over the last two years, suggesting it may be an opportune time to consider establishing a fixed rate on future obligations



## Banker's Acceptance Rates

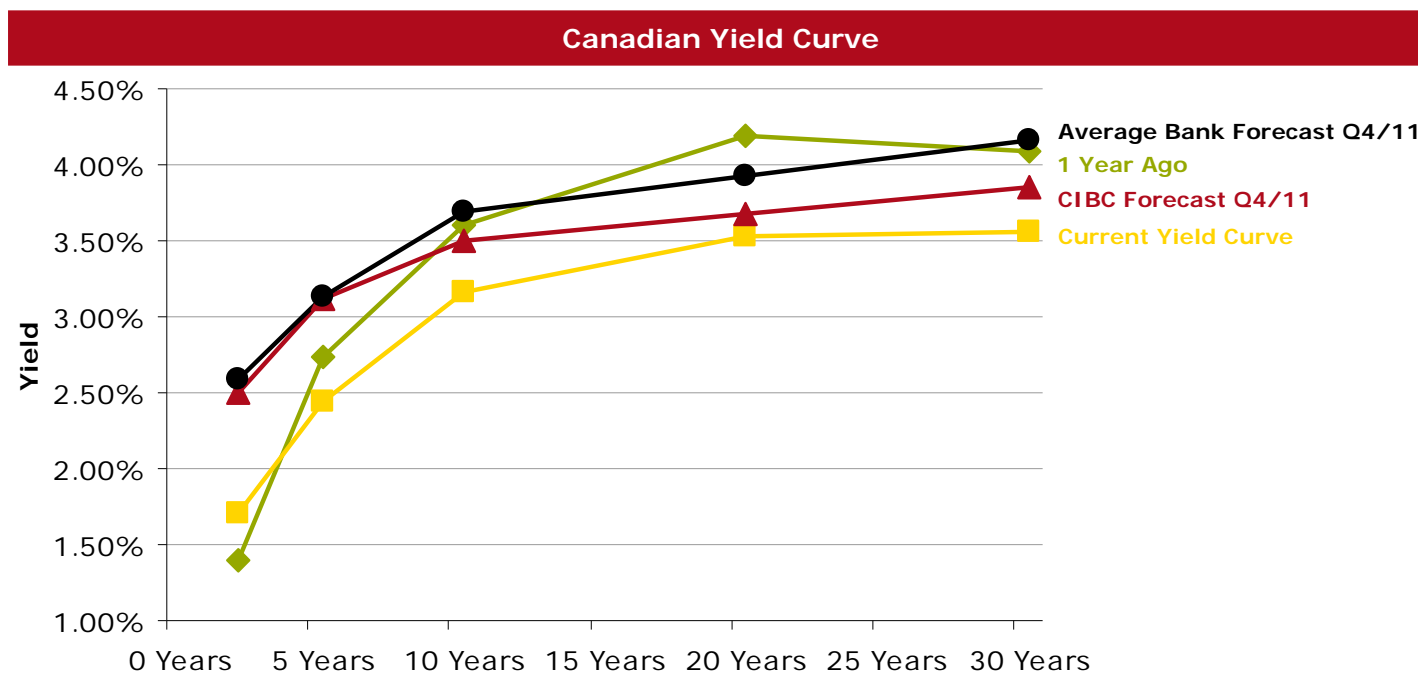
- ▲ B.A. rates plummeted during the financial crisis as central banks cut their overnight rates to unprecedented lows and a flight to quality ensued
- ▲ After remaining virtually unchanged for almost an entire year, B.A. rates began to shift higher in conjunction with central bank activity
- ▲ The market has pulled forward its expectations for the resumption of Bank of Canada rate hikes, resulting in re-priced expectations for floating rates (as implied by B.A. futures) which are now more in line with economists' forecasts



<sup>1</sup> Average forecasts of five Canadian chartered banks as of December 29, 2010 based on information obtained from publicly available websites. Derived from Prime rate forecasts. Assuming Prime-BA differential of 170 basis points in line with historic average.

## Underlying Government of Canada Benchmark Bond Yields

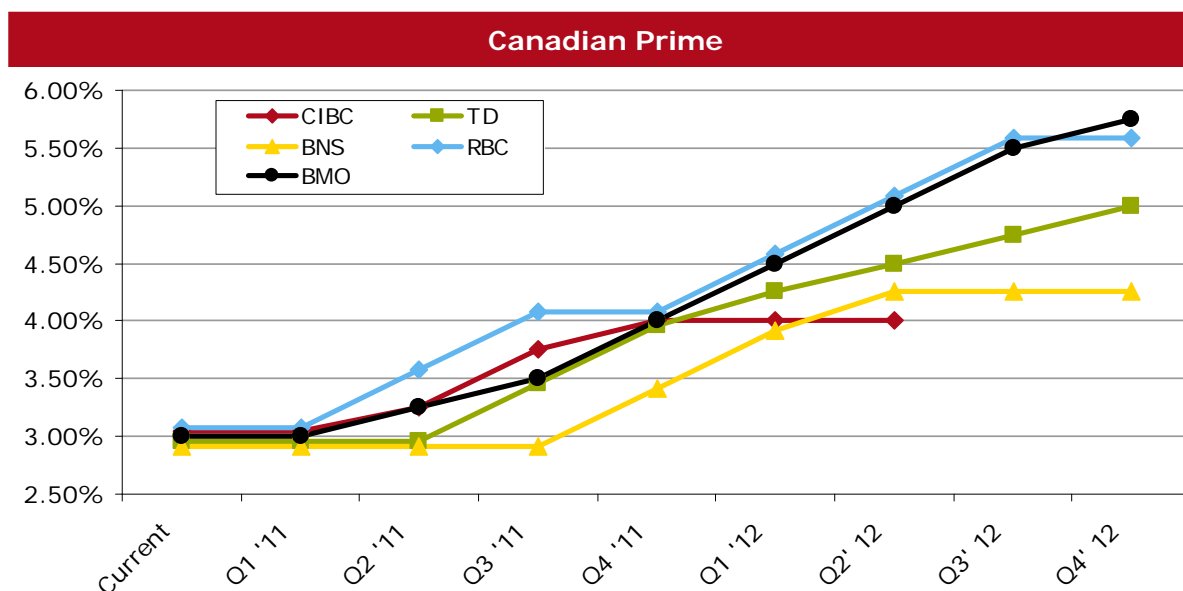
- ▲ Based on the consensus forecast, the risk for bond yields is to the upside
- ▲ Economists are expecting yields to trudge higher over the medium-term as the economic recovery becomes more entrenched
- ▲ Gradual economic improvement in 2011 is expected to cause yields to rise and the curve to flatten
  - The change is forecast to be most pronounced in short- and medium-term yields



Note: Average of the 4 other major Canadian Banks, excluding CIBC as surveyed from publicly available information on December 29, 2010.

## Forecast of Canadian Prime

- ▲ Economists expect the Bank of Canada to resume its rate hiking campaign as early as Q2 2011
- ▲ Once initiated, the rate hikes are anticipated to be largely uninterrupted until monetary policy returns to a more neutral stance
- ▲ Additional interest rate increases are expected to push Prime materially higher over the next two years
  - Prime rate was 6.25% before the credit crisis began in the fall of 2007
- ▲ If short-term rates return to pre-credit crunch levels, this likely implies a much higher profile for rates across all terms



Note: Canadian Prime forecasts as of December 29, 2010 based on information obtained from publicly available websites.



### Who to Contact

**Allan Levitt**, Managing Director

Corporate Solutions Group

Tel: (416) 594-7328

E-mail: [allan.levitt@cibc.ca](mailto:allan.levitt@cibc.ca)

**Doug Jones**, Executive Director

Corporate Solutions Group

Tel: (416) 956-6193

E-mail: [doug.jones@cibc.ca](mailto:doug.jones@cibc.ca)

**Martin Peichl**, Executive Director

Corporate Solutions Group

Tel: (416) 594-7223

E-mail: [martin.peichl@cibc.ca](mailto:martin.peichl@cibc.ca)

**Lindsay Sinclair**, Associate

Corporate Solutions Group

Tel: (416) 594-7562

E-mail: [lindsay.sinclair@cibc.ca](mailto:lindsay.sinclair@cibc.ca)



## Legal Disclaimer

---

This publication is being distributed by (i) in Canada, CIBC World Markets Inc., a member of the Investment Industry Regulatory Organization of Canada, the Toronto Stock Exchange, the TSX Venture Exchange and CIPF, (ii) in the European Union, CIBC World Markets plc, which is regulated in the United Kingdom by the Financial Services Authority, (iii) by CIBC World Markets Inc. affiliates in other jurisdictions in compliance with local rules and regulations (collectively, "CIBC World Markets Inc."). This publication is provided for general informational purposes only to institutional and professional investors and does not constitute an offer or solicitation to buy or sell any specific securities or other investments discussed herein.

The information, opinions and statistical data contained herein has been prepared by CIBC World Markets Inc. solely for informational purposes based upon sources believed to be reliable, however, CIBC World Markets Inc. does not represent or warrant the completeness or accuracy of any such information, opinions and statistical data. Any opinions, estimates and projections contained herein are subject to change without notice, and are provided by CIBC World Markets Inc. in good faith but with no legal responsibility or liability whatsoever. Changes in assumptions may have a material impact on any returns detailed. The securities and other investments listed reflect indicative terms only and may change in price and yield and market conditions.

The securities and investments mentioned in this publication may not be suitable for all types of investors. This publication does not take into account the investment objectives, financial situation or specific needs of any recipient or particular client of CIBC World Markets Inc.. Recipients should consider this publication as only a single factor in making an investment decision and should not rely solely on investment recommendations contained herein, if any, as a substitution for the exercise of independent judgment of the merits and risks of investments. Nothing in this publication constitutes legal, accounting or tax advice, and recipients should independently evaluate the financial, market, legal, regulatory, credit, tax and accounting risks and consequences involved, and specific to the recipient's situation, before entering into a transaction.

Past performance is not a guarantee of future results, and no representation or warranty, express or implied, is made regarding the future performance of any security or investment mentioned in this publication. The price of the securities and other investment mentioned in this publication and the income they produce may fluctuate and/or be adversely affected by exchange rates, and investors may realize losses on investments in such securities, including the loss of investment principal. CIBC World Markets Inc. accepts no liability for any loss arising from the use of information contained in this publication, except to the extent that liability may arise under specific statutes or regulations applicable to CIBC World Markets Inc..

CIBC World Markets Inc. and its affiliates may have an investment banking or other relationship with some or all of the issuers mentioned herein and may trade in any of the securities and investments mentioned herein either for their own account or the accounts of their customers. CIBC World Markets Inc. and its affiliates may at any time deal as principal in or have a long or short position in any security or investment mentioned herein, or any option, future or other derivative based thereon. Any products or services mentioned herein are made available only in accordance with local legal and regulatory requirements. As a result, the securities and investments discussed herein may not be eligible for sale in some jurisdictions.

CIBC World Markets Inc., and CIBC World Markets plc are wholly owned subsidiaries of Canadian Imperial Bank of Commerce, ("CIBC"), but each is solely responsible for its contractual obligations and commitments. 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, 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.

This report may provide addresses of, or contain hyperlinks to, Internet web sites. CIBC World Markets Inc. has not reviewed the linked Internet web site of any third party and takes no responsibility for the contents thereof. Each such address or hyperlink is provided solely for the recipient's convenience and information, and the content of linked third party web sites is not in any way incorporated into this document. Recipients who choose to access such third-party web sites or follow such hyperlinks do so at their own risk.

