Central Bank Watch

August 9, 2012

Note: Unless otherwise indicated all data in this document is sourced from Bloomberg as of 08/07/12

Reserve Bank of Australia

INDICATOR	CURRENT	3-MONTHS AGO	6-MONTHS AGO	12-MONTHS AGO
RBA Target Cash Rate	3.50	3.75	4.25	4.75
2 Year Bond Yield	2.90	2.70	3.49	3.66
10 Year Bond Yield	3.26	3.41	3.93	4.48
Aussie Yield Curve	0.36	0.70	0.44	0.82
CPI	1.20	1.60	3.10	3.60

The Reserve Bank of Australia has a mandate to maintain price stability.
It has an inflation target band of 2% to 3%, over the medium term.

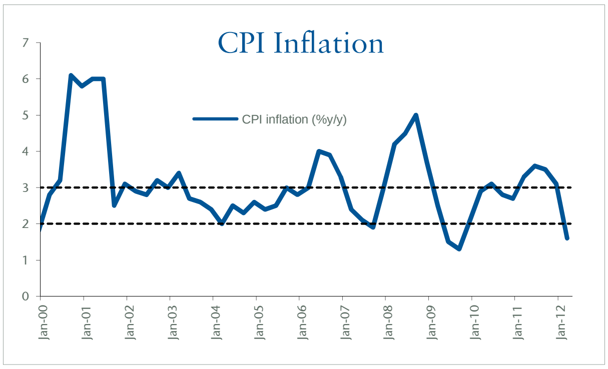
Current Policy

• The Reserve Bank of Australia (RBA) kept the cash rate on hold at 3.5% at the 7 August meeting. Rates had been cut by 75 basis points over two meetings in May and June.

• The RBA's statement gave little away about the future path of policy rates, suggesting that it will be on hold for several months yet. The RBA remains concerned about global growth, commenting that "Europe will remain a potential source of adverse shocks for some time". It also acknowledged the sharp appreciation in the Australian dollar in recent months. Finally, the RBA concluded: "with inflation expected to be consistent with the target and growth close to trend, but with a more subdued international outlook than was the case a few months ago, the stance of monetary policy remained appropriate."

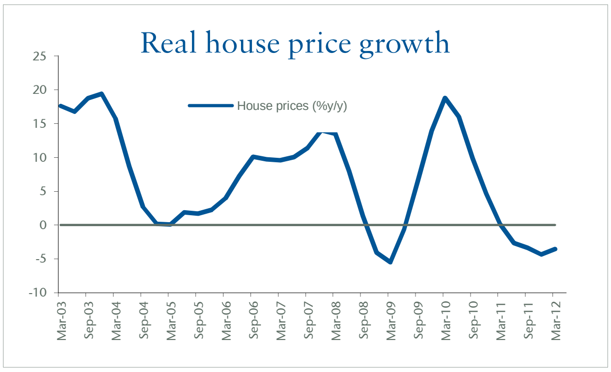
• Annual headline CPI inflation fell from 1.6% in the first quarter to 1.2% in the second quarter, the lowerst since June 1999. Annual core inflation fell from 2.2% to 2% - the bottom of the RBA's target band. However, the alternative core measure - the weighted median - came in at 1.9%, slightly higher than expected.

• With underlying inflation below the RBA's target, there is room for more monetary easing.



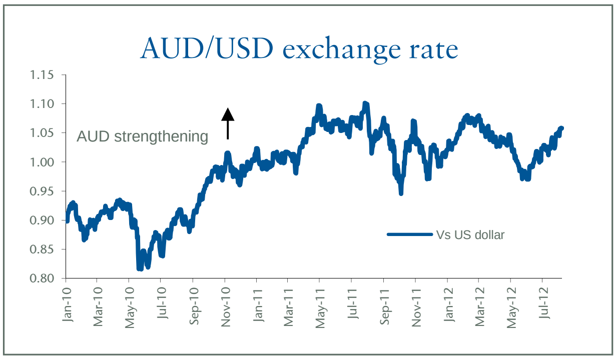
• Australia's manufacturing PMI survey fell to the low 40s in July, the weakest reading since the depths of the financial crisis in mid 2009. In contrast, however, retail spending strengthened in June.

• House prices rose 0.5% quarter-on-quarter in the second quarter, the first increase in five consecutive quarters. While annual house price growth remains in negative territory, the latest data suggest that the recent policy rate cuts are stabilizing the housing market.



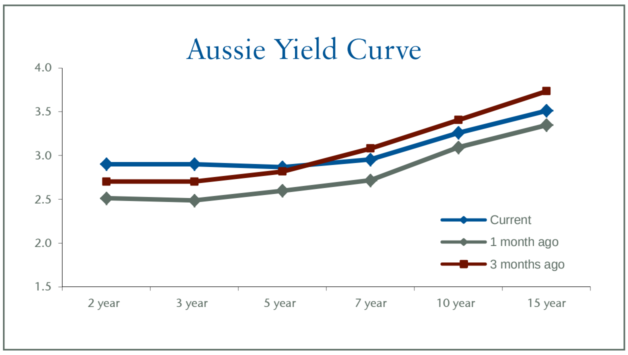
• The Australian dollar has strengthened sharply. At around $1.05, the Australian dollar has appreciated 10% against the U.S. dollar since June and is at its strongest since March. In trade-weighted terms, it is now not far off a historical high.

• This sustained rise is delivering tighter financial conditions, and is posing a concern for RBA officials. The central bank noted that the dollar has appreciated strongly despite the weaker terms of trade.



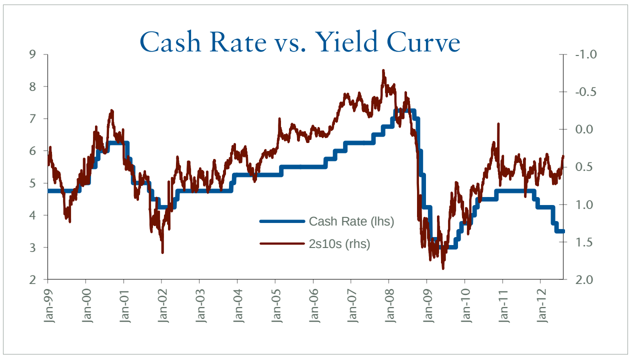
• The Australian yield curve has shifted sharply higher over the past month, with much of the sell-off concentrated on the front end. The 2-year part of the curve has risen almost 40 basis points, while the 10-year point has increased 15 basis points.

• Inconclusive inflation data, coupled with a slight improvement in the European situation, drove the sell-off.



• Markets have moved from effectively pricing in a further 100 basis points of policy rate cuts over the next two years to pricing in a further 50 basis points of cuts.

• The RBA's recent policy rate cuts have largely been in response to concerns about the impact from the euro area crisis. As a result, a sustained improvement in Europe may further reduce policy rate cut expectations.



Expectations

• The RBA has taken strong action over the past few months. Its rate cuts appear to be stabilizing the housing market, steering it to a soft landing. There is also a strengthening trend in credit growth, particularly for housing credit. Inflationary pressures remain subdued, but the second quarter inflation print was not as weak as many were expecting. Furthermore, the new carbon tax is likely to boost inflation in the third and fourth quarters. However, downward pressures remain: the strength of the Australian dollar represents a major headwind, particularly for the manufacturing sector, while the unemployment rate is likely to keep rising over the coming months.

• The outlook for the Australian economy is unclear and, as a result, the RBA is likely to remain on the sidelines for several months as it assesses how much traction it has gained with its policy rate cuts. Unlike other major central banks, the RBA has the comfort of knowing it still has some firepower left if the Australian economy continues to weaken.

U.S. Federal Reserve (Fed)

INDICATOR	CURRENT	3-MONTHS AGO	6-MONTHS AGO	12-MONTHS AGO
Fed Funds Target Rate	0.25	0.25	0.25	0.25
2 Year Treasury Yield	0.24	0.25	0.25	0.29
10 Year Treasury Yield	1.57	1.87	1.97	2.56
Treasury Yield curve	1.33	1.62	1.73	2.27
Core PCE	1.80	2.00	1.90	1.40

The Fed has a dual mandate of fostering price stability and employment.
It has an explicit inflation target of 2% on the personal consumption expenditures price index

Current Policy

• The Federal Open Market Committee (FOMC) held the Federal Funds Target Rate at 0.25% at its 1 August meeting. The FOMC decided in June to extend Operation Twist through to the end of the year.

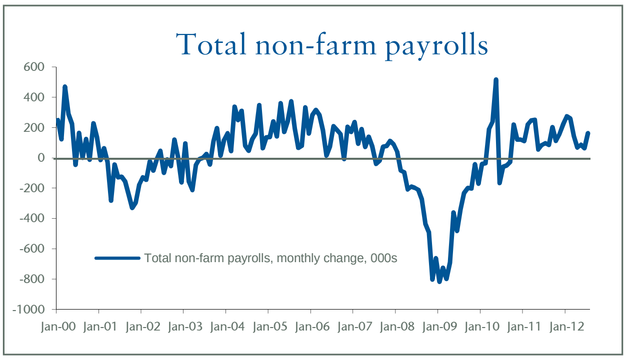
• Although the FOMC took no action at the latest meeting, it did strengthen its easing bias. Whereas the statement from the previous meeting said the Fed was "prepared to take further action as appropriate", the statement from the August meeting said that they "will closely monitor incoming information on economic and financial developments and will provide additional accommodation as needed". This more forceful statement indicates that the FOMC is likely to ease monetary policy further if the labor market fails to improve or if the European situation deteriorates.

• GDP growth for the second quarter came in at 1.5% quarter-on-quarter, down from 1.9% in the first quarter. Timelier U.S. economic data have been mixed over the past month.

• At 49.8, the Institute of Supply Management (ISM) manufacturing index was essentially . unchanged in July. Personal spending data in June was slightly weaker than expected, while personal income data was better than expected. Consumer confidence improved, and housing market data point to a stabilization in the sector.

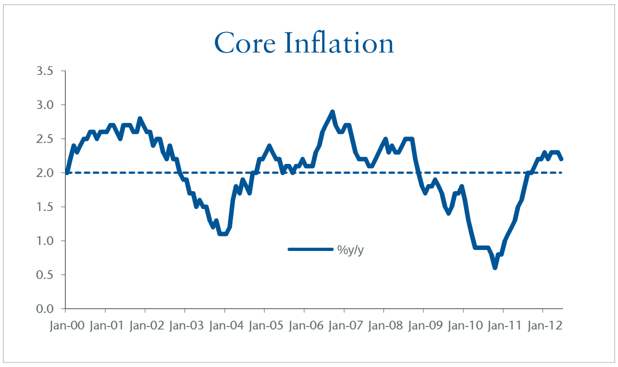
• The July employment report was better than expected. Non-farm payrolls rose 163,000 - a significant improvement on the 73,000 average monthly gain in the second quarter.

• The FOMC described employment growth as "slow" in its latest statement. It appears to be growing impatient with the sluggish pace of the labor market recovery. While the stronger payroll growth in July was a positive sign for growth, it probably does not meet the FOMC's criteria of a sustained improvement.



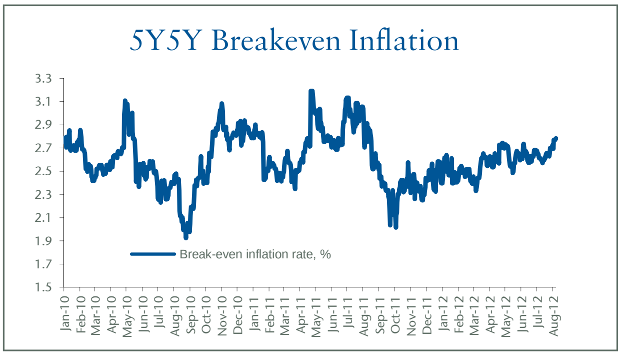
• Annual core inflation weakened from 2.3% in May to 2.2% in June. The annual core personal consumption expenditures (PCE) inflation rate - the Fed's preferred measure of inflation - remained unchanged at 1.8% in June, below the 2% target.

• The macroeconomic backdrop is currently unsupportive of inflation. With the economy growing below trend, inflationary pressures are subdued. The FOMC expects core PCE inflation to be around 1.7-2.0% at the end of 2012, undershooting its target.



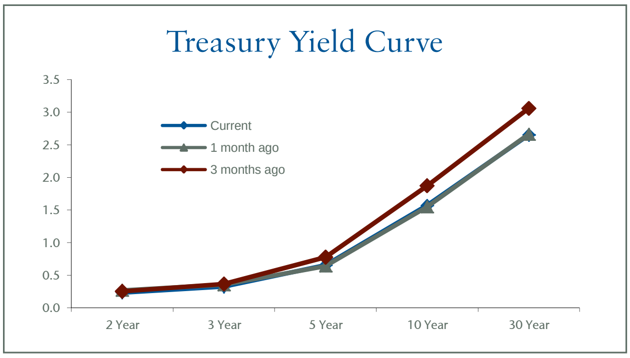
• With the FOMC forecasting inflation to fall further below 2% through 2012 and 2013, it suggests that the central bank may be moving further away from its mandate.

• Inflation expectations, however, suggest growing price pressures. Five-year breakeven inflation rates, a measure of inflation expectations, have gradually moved up from around 2% in September 2011 to 2.7% in August 2012.



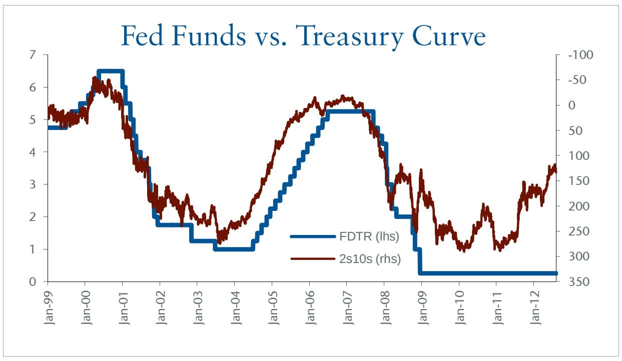
• Once again, volatility was a theme as U.S. 10-year Treasury yields moved in a 25 basis point range over the month amid large swings in sentiment in Europe. Ten-year U.S. Treasury yields dropped to a record low of 1.38% on 24 July before selling off as European Central Bank (ECB) President Draghi pledged "to do whatever it takes to preserve the euro".

• Over the month as a whole, 10-year and 30-year Treasury yields were broadly unchanged, while 2-year yields fell slightly.



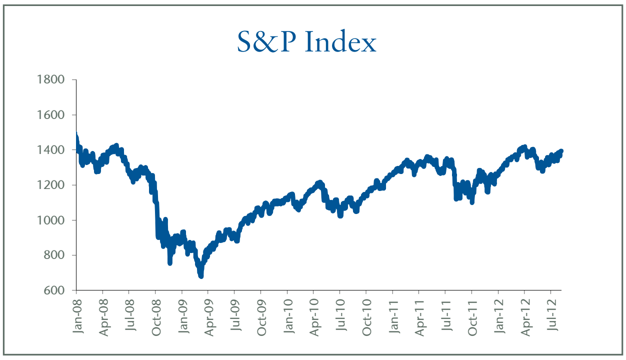
• Prior to the August FOMC meeting, many analysts had speculated that the Fed would extend its guidance on "exceptionally low interest rates" from late-2014 to mid-2015. The market was disappointed that the Fed kept its guidance unchanged.

• However, as the press statement signalled a strong willingness to ease in the coming months, the disappointment was short-lived. Indeed, some form of monetary easing is widely expected in September.



• Following strong gains in June, global equities were broadly flat in July. Mixed economic data, coupled with limited major market events helped keep equity markets afloat in July.

• The coming month's performance is likely to be dependent on the ECB. Strong intervention by the ECB, warding off Spanish and Italian tail risk, would serve to strengthen equity markets, while failure to act could undo much of the positive gains of the past few months.



Expectations

• The U.S. economy continues to perform well below potential. The disappointing pace of the U.S. expansion has been exacerbated by an intensification of worries about Europe. The Federal Reserve clearly recognizes this. It commented that "economic activity decelerated somewhat over the first half of this year", a significant change from their previous month's comment that "the economy has been expanding moderately this year". The Federal Reserve projects that progress in achieving its dual mandate of maximum employment and stable prices will be "frustratingly slow".

• Despite this, the Federal Reserve took no policy action at its August meeting. It delivered no new asset purchase program, no cut to the interest rate paid on excess reserve balance (IOER), and not even an extension to their late-2014 interest rate guidance. The case for pushing back the rate guidance was strong. The Fed's forecast for unemployment and core inflation has deteriorated relative to where it was in January, yet the rate guidance - which was introduced in January - is unchanged.

• However, while clearly actions speak louder than words, the Fed's words were quite powerful. With the phrase "will provide additional accommodation as needed", the FOMC indicated a clear willingness to ease policy further in the future. As a result, the Fed is widely expected to announce some form of monetary easing at the September meeting.

• What form any further monetary easing may take is unclear. With the Bank of England introducing new credit easing measures; the European Central Bank having taken the deposit rate to zero and signalling that further monetary measures will be introduced in the coming weeks, there is some speculation that the Federal Reserve may be exploring the possibility of developing some new tools. Chairman Bernanke may take the opportunity to discuss the policy options at the annual Jackson Hole Symposium on 31 August.

Bank of England

INDICATOR	CURRENT	3-MONTHS AGO	6-MONTHS AGO	12-MONTHS AGO
Official Bank Rate	0.50	0.50	0.50	0.50
2 Year Gilt Yield	0.08	0.42	0.46	0.55
10 Year Gilt Yield	1.51	2.01	2.22	2.69
Gilt Yield Curve	1.43	1.59	1.76	2.14
CPI	2.40	3.50	4.20	4.20

The Bank has a mandate to maintain price stability.

The MPC has a symmetric inflation target of 2% on the Consumer Price Index, plus or minus 1%.

Current Policy

• The Monetary Policy Committee (MPC) decided to hold the Bank Rate at 50 basis points at its 2 August meeting, and also chose to keep the size of its bond purchase plan unchanged at £375 billion (having increased it from £325 billion at the July meeting).

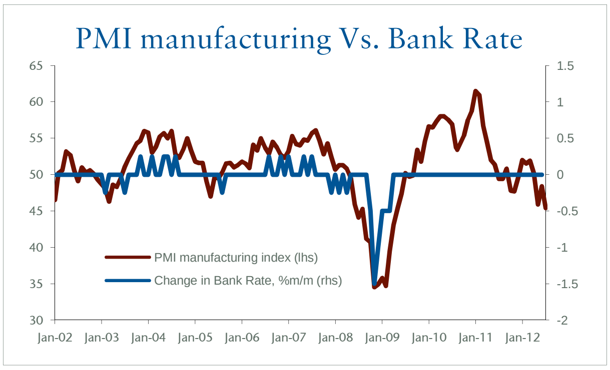
• Minutes to the July meeting (August meeting minutes will be released on 15 August) revealed that the MPC voted 7-2 in favor of further quantitative easing (QE), with the debate primarily between whether they should increase the asset purchase plan by £50 billion or £75 billion. The MPC also revisited the possibility of cutting the Bank Rate below 0.5%. While they noted that the Funding for Lending Scheme may improve the effectiveness of a reduction in the policy rate, they decided to reassess the policy rate "in time".

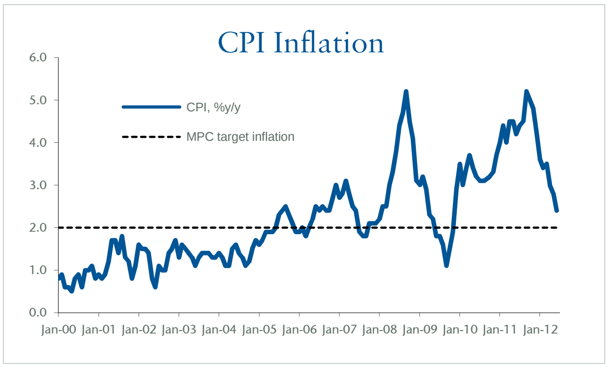
• The UK economy contracted by a worse-than-expected 0.7% quarter-on-quarter in the second quarter. While the preliminary estimate is subject to significant revisions, monthly survey data also suggest a very weak start to the third quarter.

• The manufacturing Purchasing Managers Index (PMI) fell from 48.4 to 45.4 in July, its lowest level since May 2009. The services PMI declined from 51.3 to 51, only marginally above the all-important 50 level. By contrast, employment has been more resilient - rising 181,000 in the three months leading up to May.

• Annual headline Consumer Price Index (CPI) inflation fell from 2.8% to 2.4% in June, the third month in a row that inflation has been materially lower than expected.

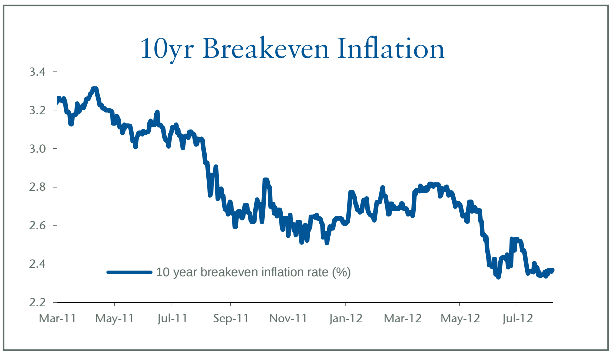
• July MPC minutes revealed that a couple of members were concerned that the recent decline in inflation was "very largely a consequence of temporary price-level effects resulting from the reduction in oil prices". Others considered the medium-term inflation risk to be lower and, therefore, less of a hurdle to easing policy.





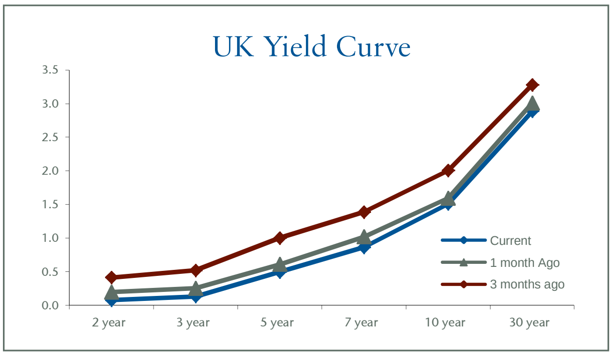
• With inflation having fallen from 4.2% at the start of the year to 2.4% in June, the MPC's concerns about higher inflation expectations have also eased. MPC minutes showed that several members hoped that the fall in inflation made it less likely that the MPC's credibility in targeting inflation would be called into question.

• Breakeven inflation, a financial measure of inflation expectations, has fallen from 2.5% in late June to below 2.4% in early August.



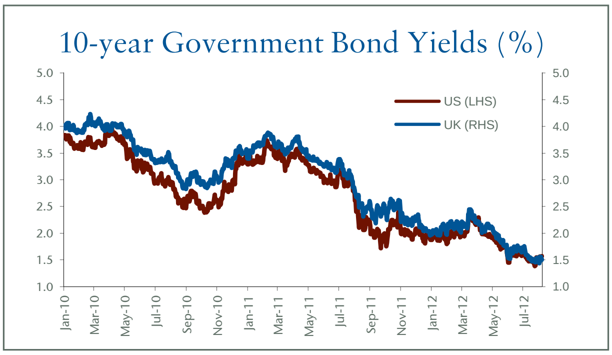
• Ten-year UK gilt yields fell to a record low of 1.41% on 23 July, before recovering slightly to around 1.50% in early August. Over the month as a whole, 2-year yields are 12 basis point lower, while 10-year yields are 8 basis points lower.

• Expectations for a further reduction in the policy rate has seen the front end of the UK gilt curve fall more than 30 basis points over the past three months.



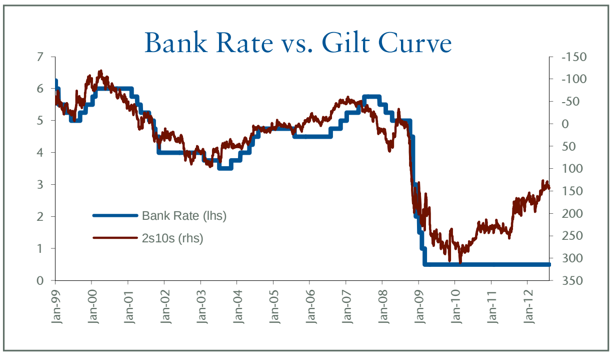
• UK gilt, U.S. Treasury, and German bund yields have all fallen to record lows recently as demand for safe havens has risen.

• However, the August ECB meeting, in which President Draghi indicated imminent policy action, relieved tensions in bond markets and triggered a sell off in the safe havens. Ten-year gilt yields and Treasury yields rose some 10 basis points following the ECB meeting, while bund yields rose 15 basis points.



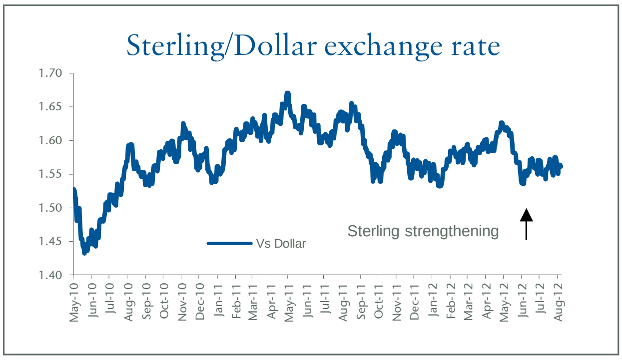
• The Bank of England has become more pessimistic about the UK growth outlook, and believes that economy may not see any growth in 2012. It also sees increasing signs that the euro area crisis is harming domestic confidence and credit conditions.

• The market is pricing in a 25 basis point cut in the Bank Rate by the second quarter of next year. The MPC has stated that it will review this option again in a few months. Additional asset purchases are another possibility.



• Sterling has remained broadly stable at around $1.55 against the U.S. dollar. However, on a trade-weighted basis sterling has strengthened by around 2% over the past two months, putting downward pressure on the UK's export performance.

• The pound's strength, despite the UK's weak economy, suggests that its appeal lies in its status as being a safe haven. By implication, however, an improvement in the euro area may dampen the UK's appeal.



Expectations

• UK GDP has contracted for three consecutive quarters, the manufacturing PMI is signalling a sharp decline in activity, while the services PMI suggests that the services sector is just keeping its head above water. Although the Bank of England continues to believe that official data is being muddied by the additional bank holidays and unseasonably cold weather, it is in agreement that the economic outlook has worsened. Furthermore, the MPC is concerned about the euro area crisis' impact on UK confidence and credit conditions.

• The MPC has responded to these concerns by increasing the asset purchase plan and introducing three measures to support bank lending (the activation of the Extended Collateral Term Repo (ECTR) facility, the Financial Policy Committee's guidance on banks' liquidity buffers, and the Funding for Lending scheme). Even with these additional expansionary tools in place, the MPC has been debating a further policy rate cut which would take the Bank Rate to a new record low of 0.25%.

• The Bank of England had previously considered and then decided not to cut the policy rate. This was due to concerns that lenders would not be able to substantially reduce the rates they pay on their deposit liabilities even if the Bank Rate was cut. With some mortgages tracking the Bank of England's official policy rate and therefore, obliged to pass on cuts in the Bank Rate, there could be a compression of profitability for lenders. In turn, this could further reduce lending. However, in the wake of the Funding for Lending scheme - which would lower the funding cost for banks - the option of cutting Bank Rate below 0.5% has been revisited.

• Once again, this option has been rejected. With the MPC optimistic that the extension to the asset purchase program will have a strong positive impact, it has decided that policy support would be overdone. In addition, it will be several months yet before the success of the Funding for Lending scheme and the other bank lending measures becomes clear. In the meantime, if the UK economy continues to weaken, further QE in November may be the preferred option. Next week's Inflation Report, which is likely to be very dovish, should provide us with a better insight into the MPC's thinking. Nonetheless, if QE turns out to be less effective than it hoped, the MPC may once again consider the possibility of taking Bank Rate below 50 basis points.

European Central Bank (ECB)

INDICATOR	CURRENT	3-MONTHS AGO	6-MONTHS AGO	12-MONTHS AGO
ECB Refi Rate	0.75	1.00	1.00	1.50
2 Year Yield	-0.06	0.10	0.22	0.77
10 Year Yield	1.41	1.61	1.96	2.35
Eurozone Yield Curve	1.46	1.50	1.74	1.58
HICP	2.40	2.70	2.70	2.70

The ECB has a mandate to maintain price stability and has an asymmetric inflation target of below but close to 2% over the medium term. The ECB also has a reference value for the growth of M3.

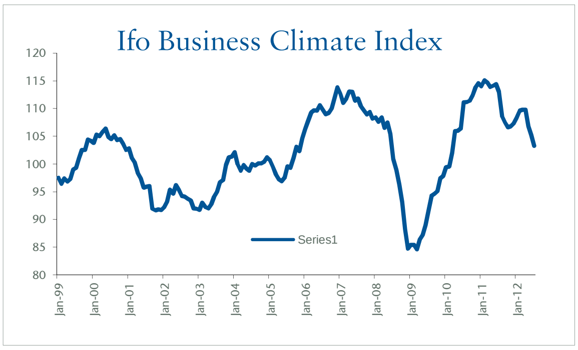
Current Policy

• The ECB kept the official policy rate unchanged at a record low of 0.75% at the 2 August meeting and also kept the deposit rate on hold at zero, having reduced both by 25 basis points at the July meeting.

• Following on from ECB President Draghi's comments on 26 July where he pledged "the ECB is ready to do whatever it takes to preserve the euro", the ECB's failure to announce concrete actions at their August meeting was a disappointment. Even so, the ECB did indicate a willingness to "undertake outright open market operations " - but only once the relevant country had requested support from the European Financial Stability Facility/ European Stability Mechanism (EFSF/ESM) and accepted the conditionality required. The ECB also said it would address "the concerns of private investors about seniority", and it "may consider undertaking further non-standard monetary policy measures", hinting that it may involve a revised collateral framework and more LTROs.

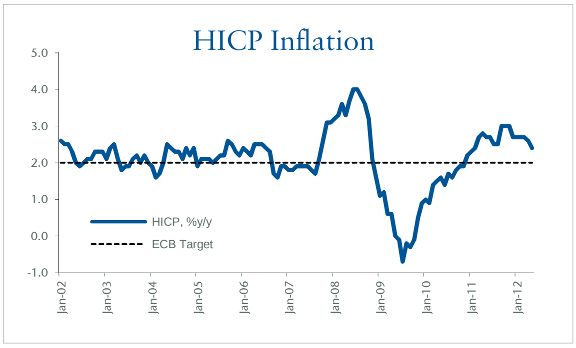
• Euro area growth remains subdued, with worrying signs that the German economy is slowing. While the euro area composite PMI edged up marginally in July, from 46.4 to 46.5, the German composite PMI fell 0.6 to 47.5, its lowest level since June 2009. By contrast, the French composite PMI rose 0.6.

• Meanwhile, the German Ifo business climate index fell for a third consecutive month in July, pointing to a weak economic outlook for Germany in the third quarter.



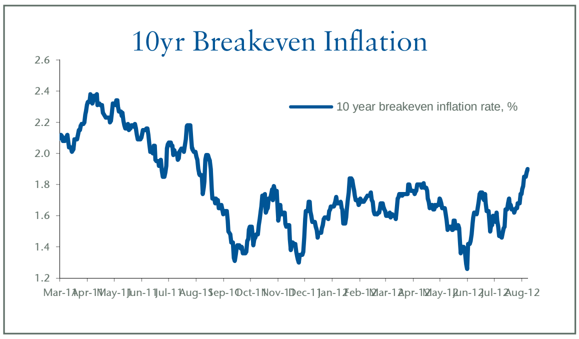
• Annual headline Harmonized Index of Consumer Prices (HICP) inflation remained unchanged at 2.4% in July for a third consecutive month, according to the flash esitimate. Although it remains above the ECB's 2% target, headline inflation is 0.6% lower than its November peak and the central bank expects it to fall below 2% in 2013.

• The ECB noted at their press conference that inflation is "decreasing to some extent faster than expected". Even so, it considers risks to the outlook to be broadly balanced.



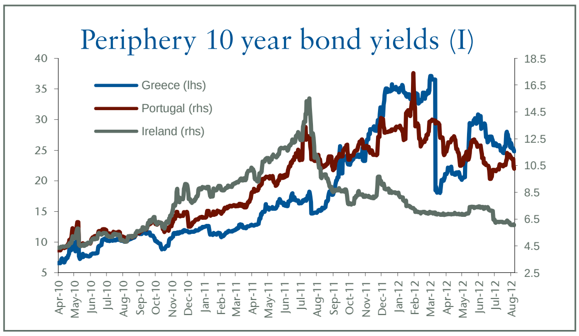
• The ECB still considers inflation expectations to be "well-anchored" and, as a result, it expects underlying price pressures to remain moderate.

• Breakeven inflation rates, a financial measure of inflation expectations, have actually risen quite sharply over the past two months, increasing from 1.3% in early June to 1.7% in early August. Yet, this is still below the 2% target.



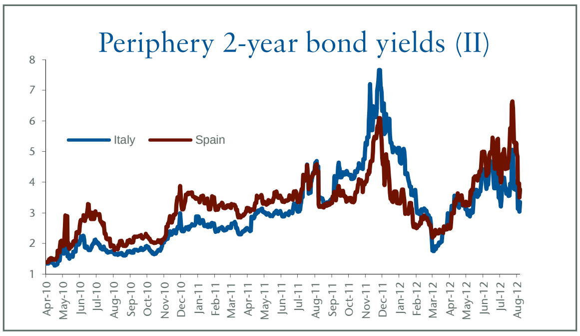
• The Greek crisis re-emerged in July as the Troika's return unveiled a host of missed fiscal targets and deeper-than-expected recession. Given renewed concerns about Greece's debt sustainability, there is growing speculation that the official sector will take a haircut on its holdings of Greek bonds.

• Meanwhile, Ireland made a successful return to the markets for medium-term issuance, raising hopes that it will not need an extension of EU/IMF financial assistance.



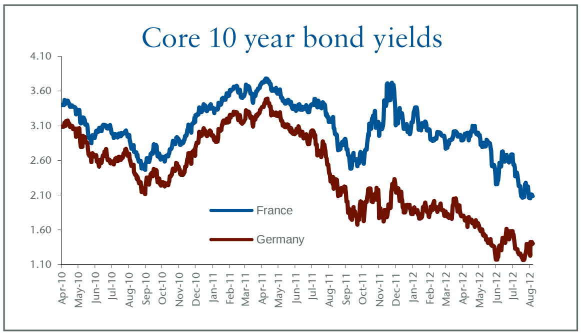
• The ECB signalled that it may purchase Italian and Spanish sovereign debt in the coming weeks - but only after the country had approached the EFSF/ESM for support and accepted the conditionality required in return for that support.

• Having openly recognised that current intra-EMU short-end spreads are too high, the ECB indicated interventions "would be focused on the short term part of the yield curve", triggering a sharp decline in two and three-year Italian and Spanish bond yields.



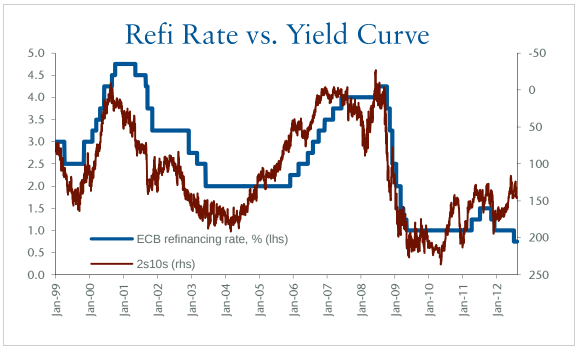
• Moody's changed the outlook for Germany from stable to negative - based on the increased chance that Germany would have to increase support for Spain and Italy.

• Core countries were the main beneficiaries of the July ECB interest rate cut, as yields on their short-dated bonds dipped into negative territory. However, the ECB's August signal that it may soon mobilise its balance sheet then triggered a sell-off in German bunds.



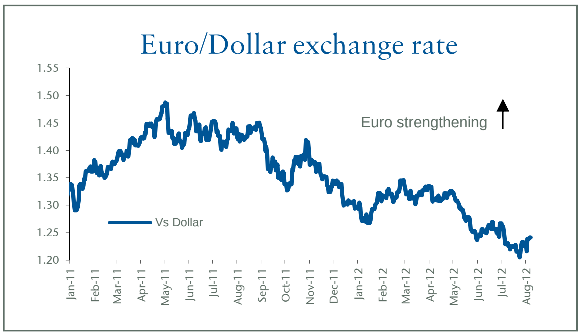
• The technical details of how the proposed measures would be carried out needs to be discussed in the euro system committees. The Bundesbank president is the only dissenter and, as such the measures are very likely to be approved. However, it is unsettling for markets in their present state to see central bank decisions having to be referred to a committee for discussion.

• The ECB also discussed the possibility of a further rate cut, but decided that this was not the time.



• The euro weakened during the past month, falling to $1.20 in late July. However, the ECB's signal that it will soon provide new monetary stimulus drove the euro slightly higher in early August.

• Overall, if the ECB's policy action is sufficiently aggressive and produces sustained improvement in the region, it should provide strong support for the single currency.



Expectations

• After President Draghi's extremely bold comments a week earlier, the ECB failed to follow up with any immediate actions. Although the ECB is clearly willing to mobilize its balance sheet to lower peripheral bond yields, the country in question would first need to formally request EFSF/ESM bond-buying support. It would then need to go through the normal approval processes (for example, parliamentary approval, Eurogroup finance ministers approval, etc), and have the appropriate conditionality negotiated. Only then would the ECB *consider* sovereign debt purchases for that country.

• Nonetheless, the ECB's intention is clear - it is willing and able to help resolve this crisis. In addition, in the context of the long-term survival of the euro area, their insistence on conditionality is important and correct. By preventing governments the opportunity to disregard their fiscal targets, the ECB is hoping to prevent the deterioration of fiscal and structural fundamentals.

• As it stands, the Spanish and Italian governments have not offered any signal of imminent EFSF activation. Certainly, they are not in any rush - their relatively light issuance programmes in the coming weeks suggests that there is no urgency for them to request assistance. However, with the ECB clearly indicating that countries must officially activate the EFSF before the ECB can provide any support, Spain and Italy may soon decide it is in their interest to turn to apply for the EFSF.

• Despite these uncertainties, and with ECB President Draghi forcefully recommending that "it is pointless to bet against the euro... because the euro will stay and it is going to be irreversible", the euro area appears to have taken a significant step forward in resolving this crisis. It has always been the case that the ECB is the one institution that has the ability to make a meaningful improvement to the situation. Now, with Spain and Italy both having introduced and implemented necessary fiscal and structural reforms, it seems the ECB is finally prepared to put its resources to use. In the coming weeks/months, we are likely to see some effective policy action from the ECB.

• Peripheral bond purchases, a relaxation of collateral requirements and new LTROs are likely. A commitment from the ECB that its future Securities Markets Programme (SMP) purchases of Spain and Italy will be treated on par with private bond holders is possible. Quantitative easing and another policy rate cut could be seen in the coming months. Encouragingly, the ECB is back in the game.

Bank of Japan

INDICATOR	CURRENT	3-MONTHS AGO	6-MONTHS AGO	12-MONTHS AGO
BOJ Target Rate	0.10	0.10	0.10	0.10
2 Year Govt. Bond	0.10	0.11	0.13	0.14
10 Year Govt. Bond	0.77	0.86	0.97	1.01
JGB Yield Curve	0.67	0.75	0.84	0.87
CPI	-0.20	0.50	-0.20	-0.40

The BOJ has a mandate to maintain price stability.
It has an explicit inflation goal of 2% or less, with a goal of 1% for "the time being"

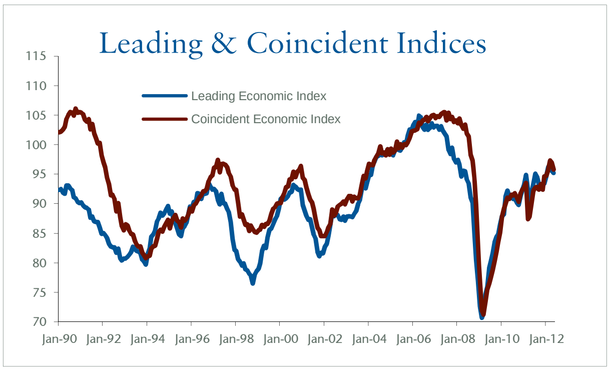
Current Policy

• The Bank of Japan (BOJ) maintained its overnight target rate at 0.1% at its 12 July meeting. It also kept its asset purchase program unchanged at ¥70 trillion (having last increased it in April).

• As well as keeping policy on hold, the BOJ indicated that it has no intention of returning to their zero interest rate policy (ZIRP). It noted that the negative side effects of the ZIRP - drying up of liquidity and a disfunctioning market - outweighed the benefits. Notably, the BOJ considers its current policy stance as expansionary. The BOJ governor said that, as the central bank was persistently purchasing assets - and, therefore, the size of the asset purchase program is growing to meet its target - the central bank is intensifying the monetary easing every month.

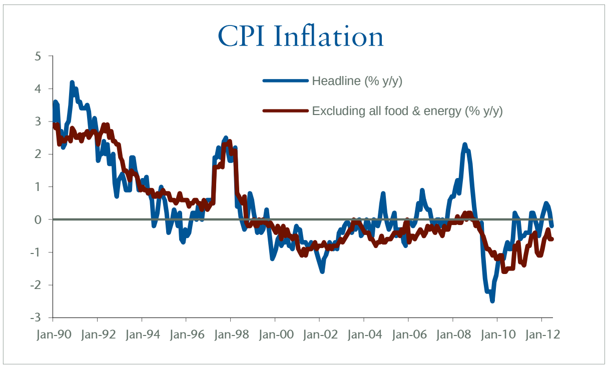
• The latest data suggest that the softer global backdrop is taking its toll on Japanese growth. Industrial production fell 0.1% month-on-month in June, following a 3.4% decline in May. The manufacturing PMI fell from 49.9 in June to 47.9 in July, the lowest reading since April last year - after the Tohoku earthquake. The services index also declined further below 50 in July.

• The unemployment rate fell from 4.4% in May to 4.3% in June. By contrast, total monthly wages fell in June.

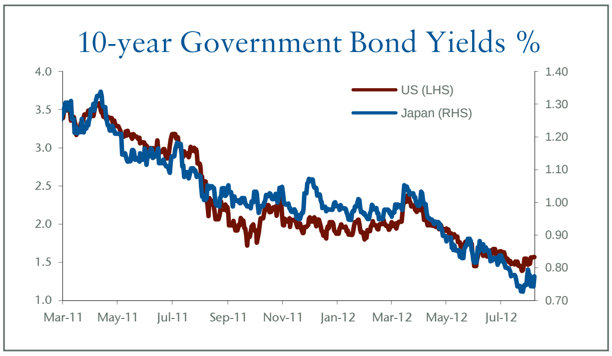


• Headline CPI inflation weakened from 0.2% year-on-year in May to -0.2% in June. The core annual inflation rate (excluding food and energy) was unchanged at 0.6% in June.

• The BOJ lowered its 2012 inflation forecast marginally from 0.3% to 0.2%. However, it continues to expect inflation to rise to 0.7% by end-2013 and then to reach the BOJ's 1% target shortly after.

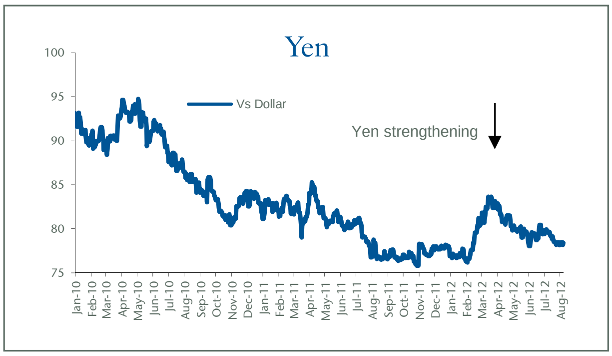


• Japanese government bonds (JGBs) have generally rallied over the past month. They recorded a similar performance to U.S. Treasurys and a slight underperformance to UK gilts and German bunds.



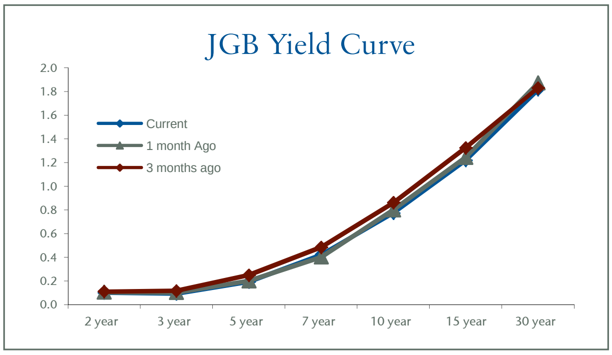
• JGBs reached new record lows over the past month following the deterioration in the euro area crisis, as did U.S. Treasurys and UK gilts. However, positive comments from the ECB triggered a mild sell-off in the traditional safe havens.

• The yen has been trending lower since March. It is currently below ¥80 and is approaching levels where the Ministry of Finance and Bank of Japan intervened in the market in the past. Current yen strength is largely a product of external factors, such as the euro area crisis.



• The BOJ has two new board members that have recently suggested their support for more explicit and active foreign exchange policies, involving foreign bond purchases.

• The JGB curve has flattened slightly over the past month. While the front-end of the curve is unchanged, 10-year JGB yields have fallen a couple of basis points and 30-year yields have fallen by around 5 basis points.



• The two-year yield is now around 0.09% - below the interest on excess reserves balance (IOER) at 0.1%. There has been some speculation that the BOJ will cut the IOER. However, with neither the ECB nor the Federal Reserve choosing to lower the IOER, it is unlikely that the BOJ will do so.

Expectations

• The Japanese economy seems to be slowing from its robust performance in the first half of 2012. Global weakness is starting to weigh on Japan's manufacturing sector. Indeed, in the July manufacturing PMI, the export orders component declined sharply. Meanwhile, although domestic demand has remained quite resilient, there are signs that is softening. The planned end to the auto incentives in August will put further downward pressure on consumption.

• Recent comments from BOJ board members indicate that they are expecting an improvement in the global backdrop as well as firm growth in domestic demand. As a result, the BOJ is widely expected to keep policy on hold this week before resorting to further expansionary measures in September - most likely via another increase in the Asset Purchase Program. With two new BOJ board members supporting more aggressive currency action, a further appreciation of the yen would be likely to trigger some type of policy action.

Bank of Canada

INDICATOR	CURRENT	3-MONTHS AGO	6-MONTHS AGO	12-MONTHS AGO
BOC Lending Rate	1.00	1.00	1.00	1.00
2 Year Bond Yield	1.12	1.27	1.04	1.08
10 Year Bond Yield	1.75	2.02	2.04	2.64
Canada Yield Curve	0.63	0.75	1.00	1.56
Core CPI	2.10	2.20	1.30	1.50

The Bank of Canada has a mandate to maintain price stability.
It has a symmetric inflation target of 2%, plus or minus 1%.

Current Policy

• The Bank of Canada (BoC) left its key policy rate unchanged at 1% at its 17 July meeting. Rates have remained on hold since October 2010.

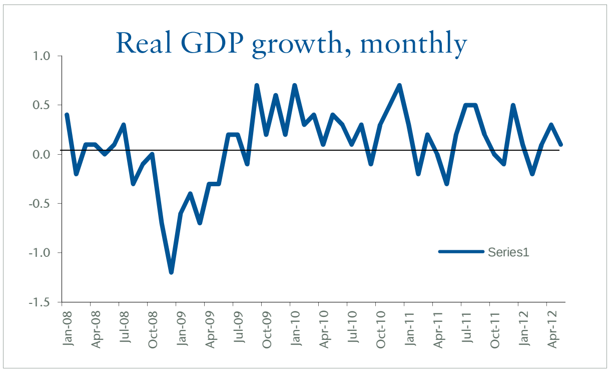
• The BoC continued to keep policy rates on hold as external headwinds constrain growth, prompting the central bank to lower its 2012 and 2013 GDP growth forecasts. As a result, it now expects the economy to reach full capacity in the second half of 2013 - slightly longer than it previously anticipated. Yet, despite its weaker growth expectations, the BoC once again said that "some modest withdrawal of the present considerable monetary policy stimulus may become appropriate". However, the timing of any future policy tightening is dependent on events outside Canada.

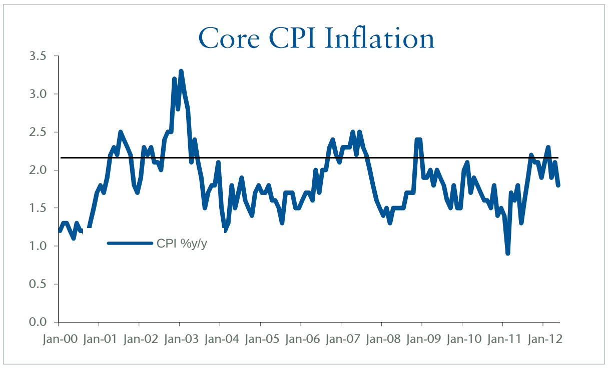
• Following growth of 0.3% month-on-month in April, GDP rose just 0.1% in May. Weak manufacturing activity was the main factor behind the poor performance, with the services sector driving growth. The BoC's Business Outlook Survey showed a more cautious outlook than previously.

• Employment continued to grow in May and June, although at a slightly more modest pace than in the previous two months. The unemployment rate declined marginally to 7.2%.

• Annual headline CPI inflation rose from 1.2% in May to 1.5% in June. Core annual CPI inflation rose from 1.8% to 2.0% in June, in line with the BoC's 2% inflation target.

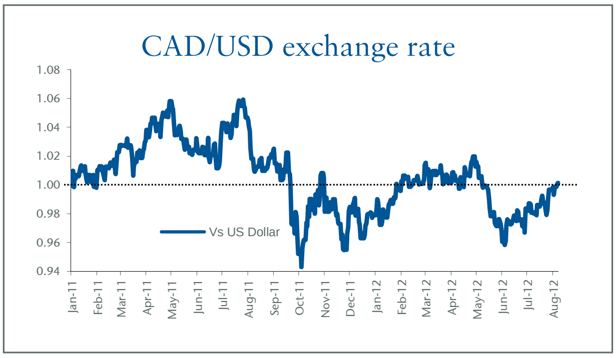
• The BoC expects core CPI to remain around the 2% target over the forecast horizon and for inflation expectations to stay well anchored. The economy "is expected to reach full capacity in the second half of 2013, thus operating with a small amount of slack for somewhat longer than previously anticipated".





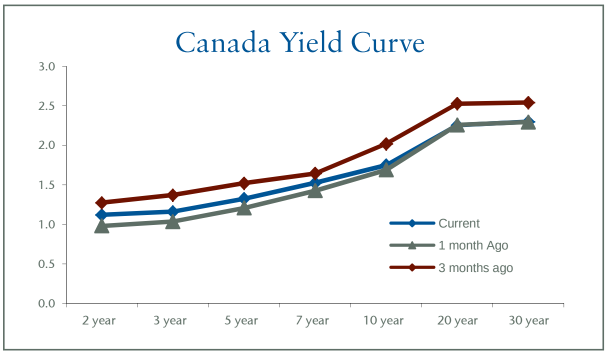
• Fading expectations for a BoC policy rate cut, plus safe-haven inflows helped push the loonie back up almost to parity against the U.S. dollar, its highest level since May.

• Europe remains the primary risk facing the Canadian dollar. However, assuming European risks abate, the BoC seems eager to start normalizing policy. As such, the loonie is likely to strengthen against the U.S. dollar over the medium term.



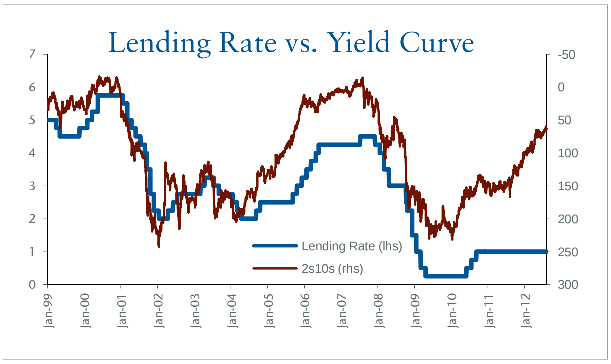
• Similar to U.S. Treasurys, medium and longer-term Canadas hit record lows in late July. Ten-year yields dropped below 1.60%, while 30-year yields fell below 2.20%, before selling off slightly. The yield difference between 10-year Treasurys and 10-year Canadas has remained stable at around 20 basis points.

• Over the month as a whole, the short end of the Canadian yield curve has moved almost 15 basis points higher, while 10-year yields have risen 5 basis points.



• The overnight index swaps (OIS) market continues to price in a strong probability of a rate cut by year-end. with the economy set to operate below potential over the next few quarters, and without any inflationary pressures building, there is little urgency to hike rates.

• However, the BoC's most recent Monetary Policy report suggested that it is keen to normalize policy once global headwinds subside.



Expectations

• As expected, the BoC has downgraded its growth expectations in its latest Monetary Policy report. While the domestic economy will provide support to growth, the "failure to contain the crisis in Europe is the most serious risk facing the global and Canadian economies". The BoC has downgraded its 2012 GDP growth forecast from 2.4% to 2.1% and its 2013 GDP forecast from 2.4% to 2.3%. However, it has raised its 2014 forecast from 2.2% to 2.5%.

•Overall, despite the downgrade to its growth forecasts, the BoC continues to think that a policy rate of 1% is inconsistent with the strength of the Canadian economy. So, while external factors - namely, the euro area crisis - will guide policy over the near term, keeping rates on hold through the remainder of 2012, over the medium term the BoC's next policy move is likely to be a hike in rates.

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