Central Bank Watch

May 22, 2012

Note: Unless otherwise indicated all data in this document is sourced from Bloomberg as of 05/17/12

Reserve Bank of Australia

INDICATOR	CURRENT	3-MONTHS AGO	6-MONTHS AGO	12-MONTHS AGO
RBA Target Cash Rate	3.75	4.25	4.50	4.75
2 Year Bond Yield	2.67	3.64	3.40	4.97
10 Year Bond Yield	3.26	4.05	4.07	5.39
Aussie Yield Curve	0.59	0.41	0.67	0.42
CPI	1.60	3.10	3.50	3.30

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) lowered the cash rate by 50 basis points, from 4.25% to 3.75%, at the 1 May meeting. Rates had been cut by 50 basis points over two meetings in November and December.

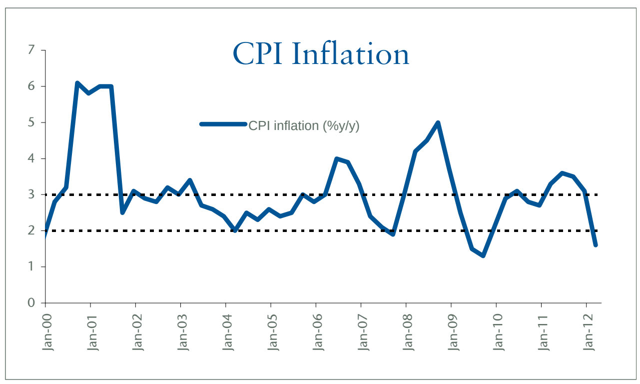
• Prior to the May meeting, market consensus had been for a 25 basis point policy rate cut. Minutes to the meeting revealed that one of the key reasons behind the RBA's decision to cut rates by a larger-than-expected 0.5% was their desire that "rates move below those that prevailed in December". They have been successful on this point - since the meeting, mortgage rates have fallen 25 basis points below their level in December. A further rationale for the decision was material downgrades to the RBA's growth and inflation profiles. Minutes failed to provide any future policy guidance.

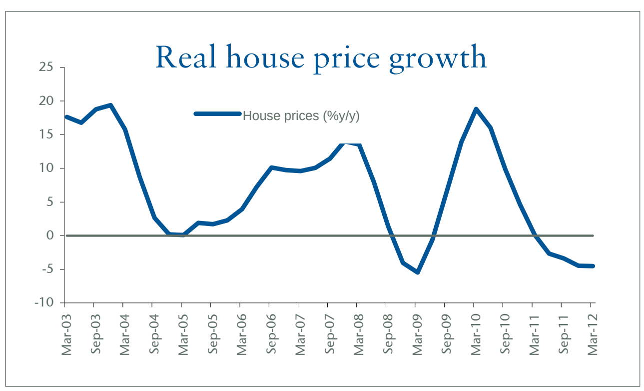
• Headline CPI inflation in Q1 was just 0.1% quarter-on-quarter. The annual inflation rate fell from 3.1% in Q4 to just 1.6%, below the bottom of the RBA's 2-3% target range. This negative surprise was clearly a key driver of the RBA's decision to ease monetary policy in May.

• The RBA now expects inflation to be near the bottom end of the target range until the end of 2012.

• House prices have continued to fall and were 4.5% lower in Q1 than a year earlier. However, housing credit growth has remained broadly stable over the past few months. The RBA policy rate cut should boost credit growth over the coming months.

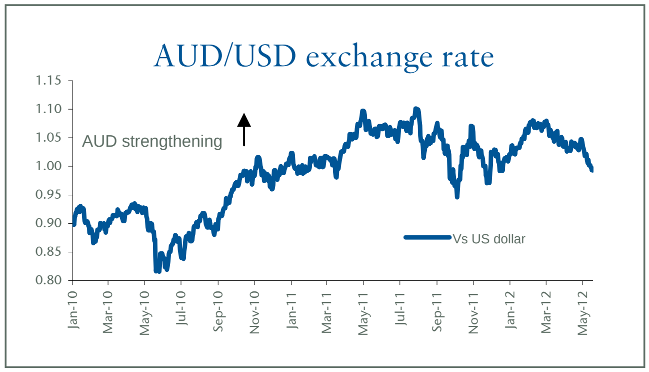
• Economic data flow has been surprisingly robust. After a period of sluggish growth, retail sales rebounded sharply in March. The unemployment rate fell from 5.2% to 4.9% in April, the lowest level in in a year, as employment increased.





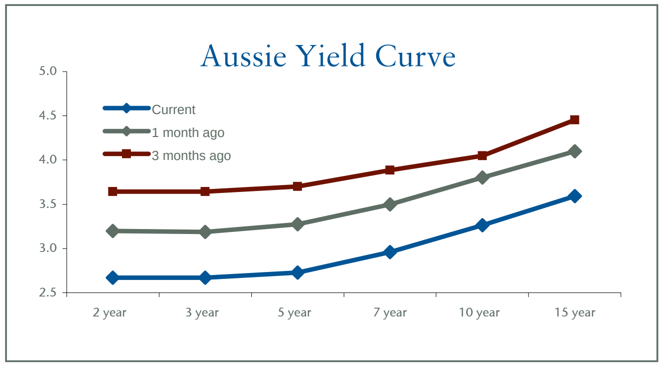
• The RBA's aggressive monetary policy loosening pushed the Aussie dollar lower against the U.S. dollar. It has weakened from a high of around $1.08 in February to around parity in mid-May.

• Continued concerns about China's growth outlook, the European sovereign crisis, as well as anticipation of further policy rate cuts, may put downward pressure on the Aussie dollar in the months ahead.



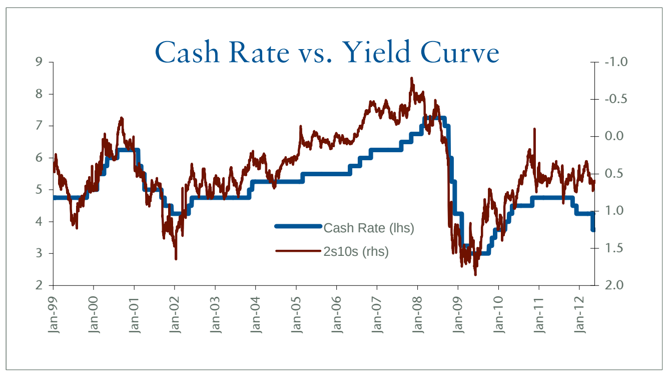
• Australian government bonds have rallied sharply over the past month, with the entire curve shifting downwards. The drop was concentrated on the front-end of the curve, reflecting the surprisingly aggressive RBA policy rate cut.

• Two-year yields have fallen around 55 basis points over the past month and by almost 100 basis point over the past three months.



• Markets are effectively pricing in a further 100 basis points of policy rate cuts over the next two years - a very negative view of Australian, and global, growth. Stronger-than-expected domestic economic news flow may trigger a sharp sell-off, concentrated on the front-end.

• Yet, a deepening of the European sovereign crisis and/or disappointing economic growth in China could push Aussie yields down even further.



Expectations

• Despite a rate cut being fully anticipated by markets, the Reserve Bank of Australia still managed to deliver a surprise. The 50 basis point cut takes the RBA's cumulative easing since November 2011 to 100 basis points. What's more, although the RBA did not provide any policy guidance in their statement, markets are effectively pricing in a further 100 basis points of rate cuts over the next two years.

• Certainly, it is easy to imagine the RBA becoming even more dovish at its next meeting. It had raised slightly its forecasts for global growth - but, since their meeting, there has been a marked deterioration in the global outlook, with negative developments in Europe and weaker-than-expected economic data in China. Furthermore, last week's Commonwealth Budget announced a (much-anticipated) budget surplus target for 2012/13. This task is not much less than the fiscal challenges facing several highly indebted European countries. The fiscal drag will be front-loaded and is set to be one of the most severe.

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	0.29	0.29	0.26	0.52
10 Year Treasury Yield	1.78	2.00	1.96	3.12
Treasury Yield curve	1.49	1.71	1.70	2.60
Core PCE	2.00	1.90	1.60	1.00

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 25 April meeting, and maintained existing asset purchase programs.

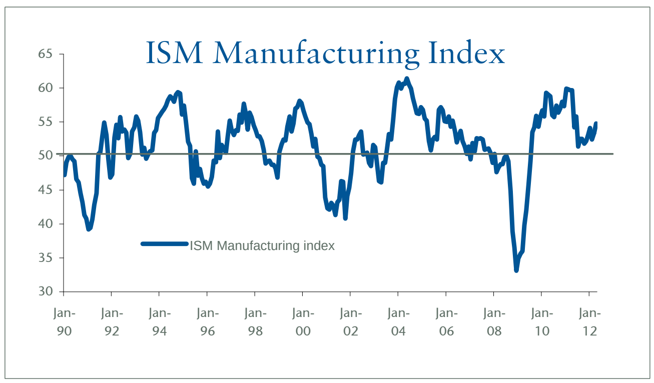
• The FOMC statement suggested no change in its interest rate or balance sheet guidance. Its growth outlook was slightly more upbeat, and several FOMC members brought forward their forecast for the first policy rate hike, suggesting that they see less need for further monetary easing now. Despite this, in his press conference, the Fed Chairman was slightly more dovish. He was careful not to rule out further easing if needed, although he did not give any signal that it should be expected. He repeated the guidance on keeping policy rates "exceptionally low" to late-2014, but admitted that "extremely low means different things to different people in the committee".

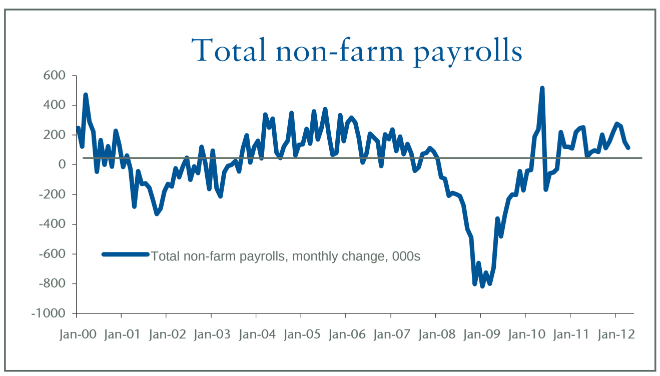
• Gross domestic product (GDP) grew by 2.2% quarter-on-quarter in Q1, less than in Q4. Consumer spending was healthy, but growth was largely driven by inventories, while business fixed investment contributed negatively.

• Timelier data have been mixed. Durable goods orders fell 4.2% in March, industrial production was flat in February and March, and the non-manufacturing Institute of Supply Management (ISM) index fell to 53.5 in April. By contrast, the ISM manufacturing index rose to 54.8 in April, the highest reading since June.

• Non-farm payrolls increased by 115,000 in April, down from 154,000 in March and an average of 252,000 between December and February. The unemployment rate fell from 8.2% to 8.1%, but the drop was due to reduced labor force participation.

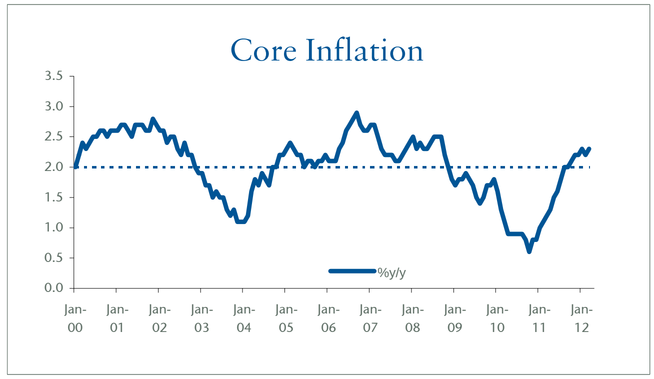
• At the post-FOMC meeting press conference, Ben Bernanke pointed out that only 100,00 jobs per month are now needed to keep the unemployment rate stable. Unsurprisingly then, their unemployment rate forecast was lowered.





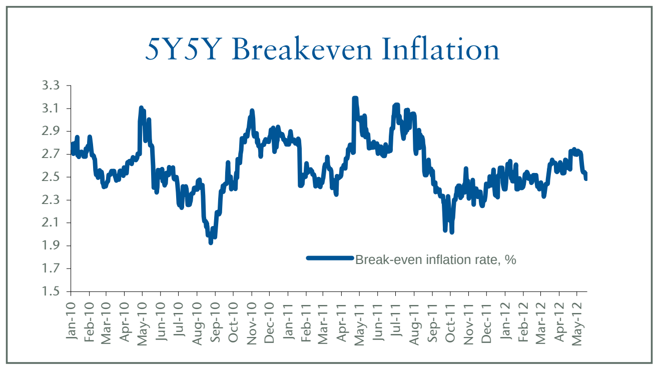
• Annual core Consumer Price Index (CPI) inflation rose from 2.2% in February to 2.3% in March. The annual core PCE price inflation rate, the Fed's preferred measure of inflation, rose from 1.9% to 2%.

• The Fed raised its inflation forecast for 2012 from 1.7% to 1.9%. Overall, the Fed should be comfortable with the inflation outlook given current and expected readings are running close to its 2% target.



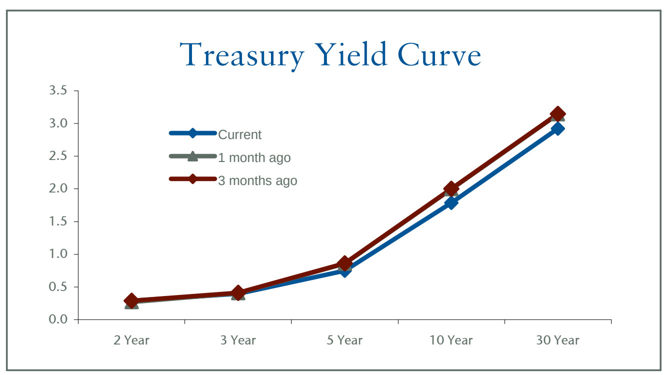
• Nonetheless, the Fed seems to be slightly concerned about maintaining its inflation credibility. Bernanke commented that it would be "very reckless" to actively seek higher inflation in order to achieve a lower unemployment rate.

• In fact, inflation expectations have fallen slightly. Five-year breakeven inflation rates, a measure of inflation expectations, have moved lower over the past month.



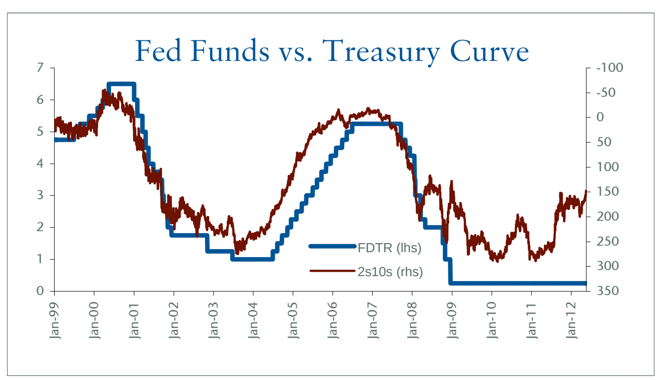
• Despite indications from the Fed that Operation Twist will neither be extended nor followed by an additional stimulus program, U.S. 10-year Treasury yields have remained stubbornly below 2%.

• Indeed bond markets remain hostage to European developments. Following the market-unfriendly results of the Greek elections, 10-year Treasurys fell below 1.80%. The belly of the curve has fallen around 20 basis points, while the long end is down some 25 basis points.



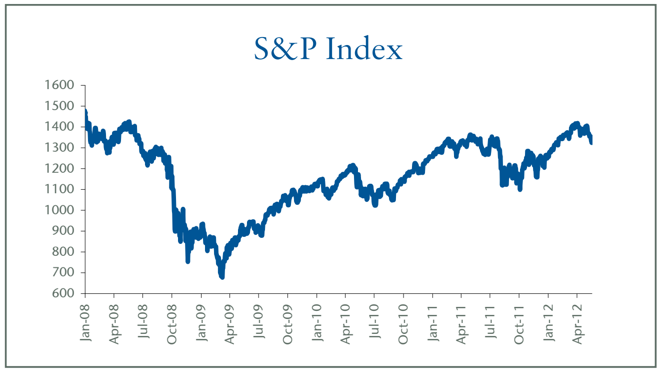
• Mixed economic data have done little to resolve uncertainty about the outlook. Many analysts expect the Fed to provide further stimulus later in the year. This speculation has contributed to the fall in yields.

• If, however, the Fed ends Operation Twist in June as planned (and does not follow it up with further stimulus), and European risks diminish, there is considerable upside potential for Treasury yields.



• A slowdown in U.S. growth, coupled with renewed stress in Europe and continued worries about China have stalled the rally in risky markets.

• Over the past two weeks, equity markets have given back all their gains from the previous fortnight. Indeed, the Standard & Poors (S&P) index is broadly unchanged over the past month, but has fallen around 4% in the past fortnight.



Expectations

• Recent U.S. economic data has been mixed. While the ISM manufacturing index surprised to the upside, the ISM non-manufacturing index was weaker than expected. While the increase in non-farm payrolls in April was around 45,000 lower than consensus expectations, backward revisions saw a total increase in payrolls of 53,000. So the economic backdrop remains muddled. Yet market reaction has been overwhelming negative - 10-year U.S. Treasurys have remained stubbornly below 2% for the past month.

• The pessimistic view of U.S. growth has also prompted markets to ignore the Fed's less dovish stance. Indeed, minutes to the latest FOMC meeting were slightly more upbeat about the economic outlook. In the committee's mind, the recent economic newsflow suggested that "economic growth would remain moderate over coming quarters and then pick up gradually", and had led some participants to become more confident about the durability of the recovery. The FOMC's forecast changes showed stronger near-term GDP growth, a faster drop in the unemployment rate, and higher inflation. Furthermore, several FOMC members brought forward their forecast for the first policy rate hike.

• Yet, despite the noticeable absence of quantitative easing (QE) three hints, markets continue to price in further Fed action. Perhaps this was prompted by Fed Chairman Ben Bernanke's care in indicating that further easing is not off the table if conditions warrant it. Certainly, although in most likelihood Operation Twist will neither be extended nor followed by an additional stimulus programme, a deterioration in the economic outlook would surely give the Fed cause for consideration. FOMC minutes noted that "several members indicated that additional monetary policy accommodation could be necessary if the economic recovery lost momentum or the downside risks to the forecast became great enough".

• But it seems that the key downward driver of U.S. Treasury yields (and, indeed, other core market yields) has been the worsening in the European crisis and the resulting flight-to-quality. Until European political risk diminishes, U.S. Treasury yields are likely to remain under pressure.

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	0.36	0.43	0.50	0.99
10 Year Gilt Yield	1.87	2.19	2.23	3.37
Gilt Yield Curve	1.51	1.75	1.73	2.38
CPI	3.50	4.20	5.20	4.00

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%.

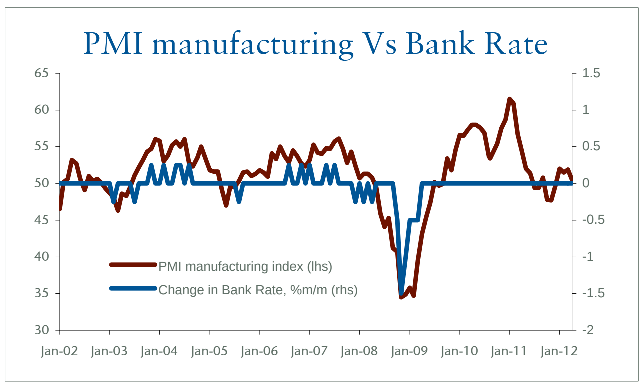
Current Policy

• The Monetary Policy Committee (MPC) decided to hold the Bank Rate at 50 basis points at its May 10th meeting, and also chose to keep the size of its bond purchase plan unchanged at £325 billion (having increased it from £275 billion at the February meeting).

• The MPC is trying to find an appropriate policy response to higher-than-expected inflation and weaker-than-expected growth. In its May Inflation Report (released on May 16), the MPC revised its inflation forecast over the next 18 months significantly higher. However, inflation is then expected to undershoot the 2% target by a greater margin than it had previously forecast. The GDP growth forecast was lowered, mainly reflecting weaker activity news and a reassessment of trend growth. On balance, the MPC has a slightly dovish bias.

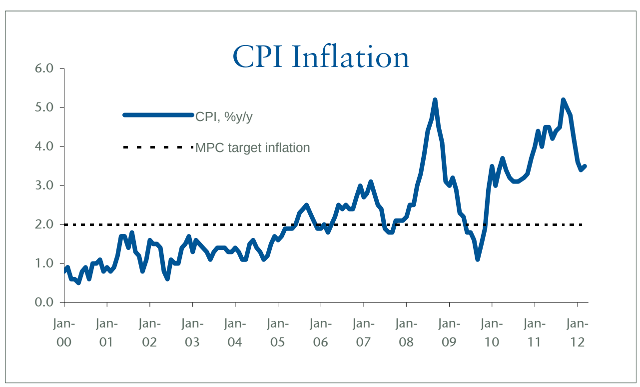
• GDP fell by 0.2% quarter-on-quarter in Q1, the second consecutive quarter of contraction. Although the UK is now technically in recession, the MPC believes that the underlying growth of the economy is slightly stronger. It considers the sharp drop in construction "perplexing".

• The purchasing managers' index (PMI) manufacturing index fell from 51.9 in March to 50.5 in April, while the PMI services index fell from 55.3 to 53.3. Although they declined they are consistent with weak expansion, not recession.



• Annual CPI inflation was higher-than-expected in March, rising from 3.4% to 3.5%. It was the first increase in annual inflation since it peaked at 5.2% in September 2011.

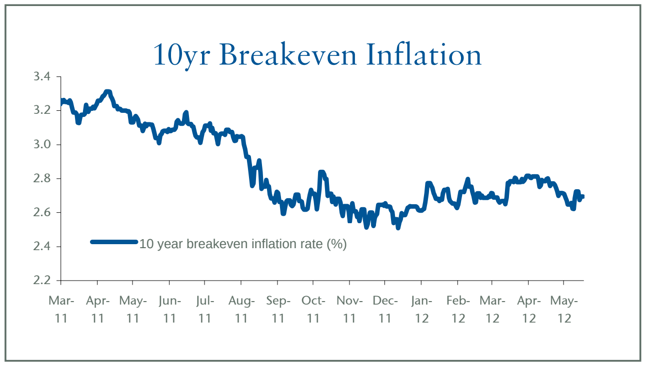
• The MPC raised its official end-2012 inflation forecast significantly, from 1.9% to 2.9%. However, its inflation forecast for two years' time was lowered from 1.8% to 1.6%, implying a greater undershoot of the MPC's 2% medium-term inflation target.



Principal Global Investors

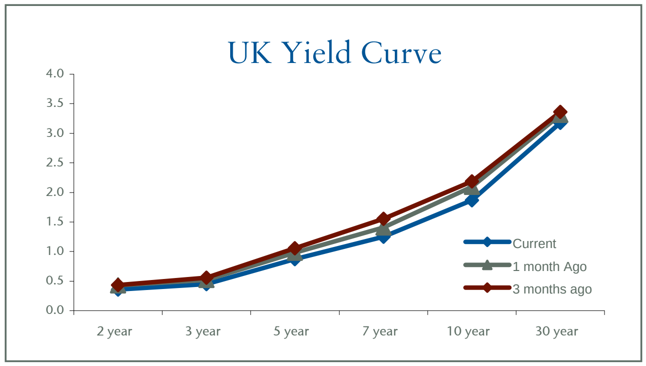
• Inflation has almost consistently overshot the 2% target in the past few years. Since October 2007, it has been at or below 2% for just six months. The MPC is concerned that it is losing credibility and that higher inflation is becoming anchored in expectations.

• Breakeven inflation, a financial measure of inflation expectations, has fallen from around 2.8% to 2.7% over the past month and from about 3.2% a year ago. However, it remains above the MPC's 2% inflation target.



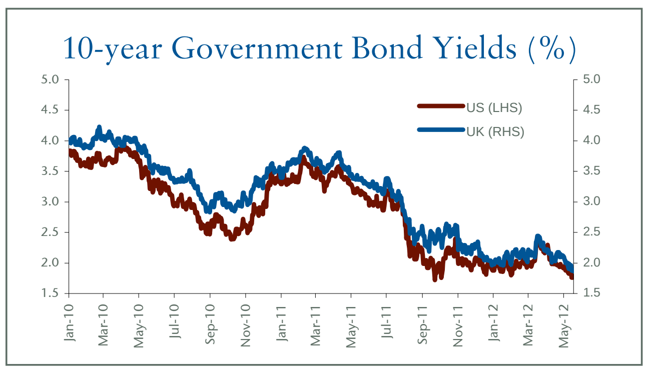
• The belly of the UK gilt curve has shifted down over the past month, falling almost 25 basis points. In contrast, the front end is broadly unchanged on the month, while the long-end has fallen by almost 15 basis points.

• Ten-year gilt yields have fallen back below 2%, reaching a low of 1.87% on 17 May.



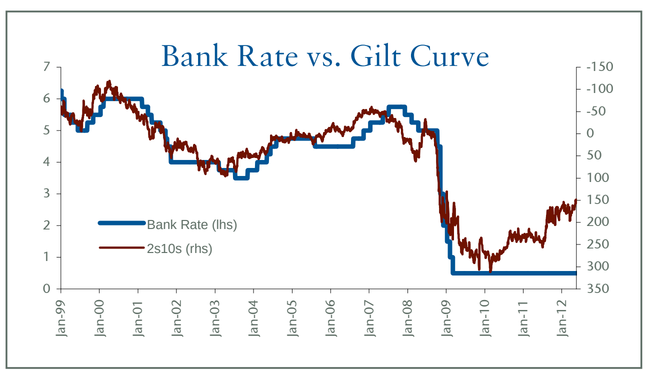
• Flight to quality flows - in response to the renewed crisis in Europe - were also key drivers of the drop in gilt yields. The decline in U.S. Treasury yields over the past month has matched the decline in UK gilts.

• Higher-than-expected inflation and the MPC's decision not to extend the asset purchase program initially triggered a sell-off, with 10-year gilts rising above 2%. However, worsening conditions in Europe then caused gilts to drop back below 1.9%.

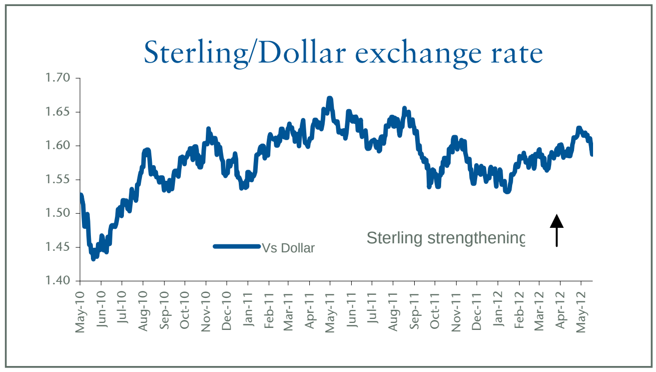


• With inflation expected to undershoot the 2% target in the medium-term and the MPC judging underlying growth to be weaker than it had previously expected, the door to further QE may not be entirely shut.

• Indeed, with the MPC judging the Euro area crisis to "pose the greatest threat to the UK recovery", a materialization of some of the downside risks may be sufficient to trigger further monetary easing.



• Sterling had strengthened at the end of April, almost reaching $1.63 against the U.S. dollar. However, worries about the UK's exposure to the Euro area has pushed sterling lower since the start of May. The Bank of England's slightly dovish Inflation Report pushed sterling back below $1.60.



Expectations

• With inflation still significantly above the Bank of England's 2% target and falling slower than the MPC had envisaged, the Bank of England chose not to provide further stimulus in May. However, the possibility of additional asset purchases later in the year cannot be dismissed. Indeed, economic weakness has been persistent and renewed tensions in the Euro area are likely to weigh on the UK economy. Furthermore, although inflation will remain above the 2% target through to end-2012, it is then expected to undershoot the target.

• The UK economy has clearly slowed, but is it in recession? The official GDP data would suggest so, but survey data indicate that the UK is (only just) keeping its head above water. Activity in Q1 was dragged down by a "perplexing" 3% contraction in construction. In the Bank of England's view, "underlying aggregate activity growth was likely... to have picked up in the second half of 2011".

• On balance, we think there would have to be a sustained and significant deterioration in the economic outlook before the MPC chooses to extend the asset purchase program again. More importantly, the MPC would need to be convinced that if inflation does remain above 2% over the coming year, its credibility is not called into question. Of course, if the euro area crisis were to worsen significantly, the Bank of England would likely announce further policy action.

European Central Bank (ECB)

INDICATOR	CURRENT	3-MONTHS AGO	6-MONTHS AGO	12-MONTHS AGO
ECB Refi Rate	1.00	1.00	1.25	1.25
2 Year Yield	0.07	0.25	0.45	1.79
10 Year Yield	1.46	1.93	1.89	3.09
Eurozone Yield Curve	1.40	1.67	1.45	1.30
HICP	2.40	2.70	3.00	2.80

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 1% at the May 3rd meeting. The ECB had previously cut the policy rate from 1.5% to 1% over two meetings in November and December.

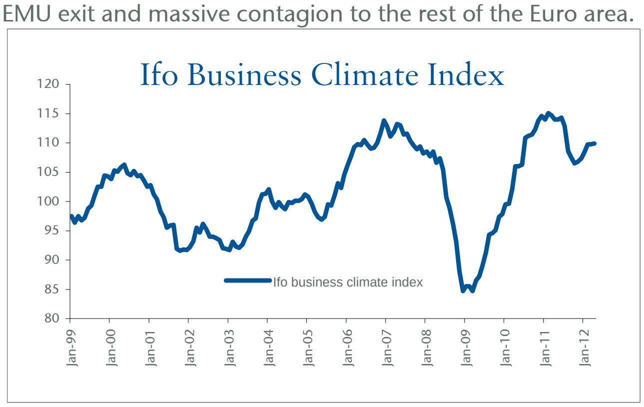
• Prior to the May ECB meeting, markets were expecting a decisively dovish shift and had priced in a 25% chance of a policy rate cut. The ECB disappointed on both counts - the Council did not materially change its statement from the previous month, not did it even discuss a change in policy rates. However, if anything, it seems that the ECB is in a "wait and see mode" - a sustained weakening in economic data may indeed trigger a dovish shift. Peripheral yields have surged once again as investors become increasingly conscious of the vicious cycle between growth and austerity, while political stress reared its ugly head once again as the failure of the Greek elections to produce a pro-European Monetary Union (EMU) coalition has raised the risk of eventual EMU exit and massive contagion to the rest of the Euro area.

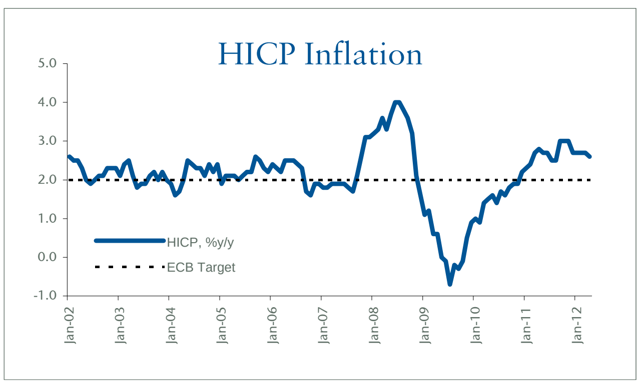
• Contrary to expectations, the euro area economy did not shrink in Q1 - indicating that the region did not enter technical recession. A strong upside surprise from Germany helped to keep Euro area GDP growth marginally in positive territory.

• Yet, recent data hint that the slowdown may be deepening. The Euro area composite PMI fell in April, from 49.1 to 46.7, as both manufacturing and services indices declined, with particularly weak readings in France, Italy and Spain.

• Annual headline Harmonized Index Consumer Prices (HICP) inflation declined to 2.6% in April.

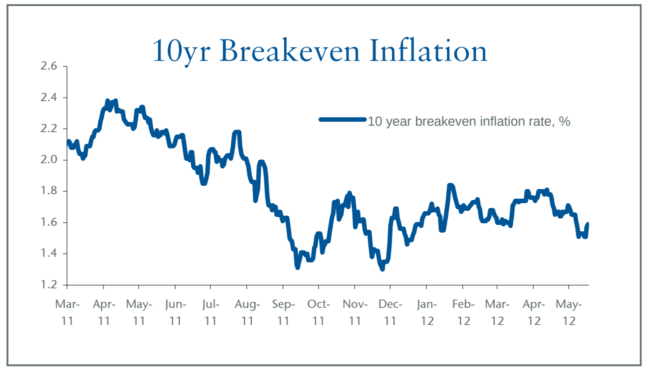
• The ECB expects inflation to remain above 2% this year, mainly as a result of "increases in energy prices, as well as rises in indirect taxes". The ECB then expects inflation to decline below 2% in early 2013. It considers risks to the inflation outlook to be broadly balanced, with upside risks stemming from higher energy prices and downside risks stemming from weak economic activity.





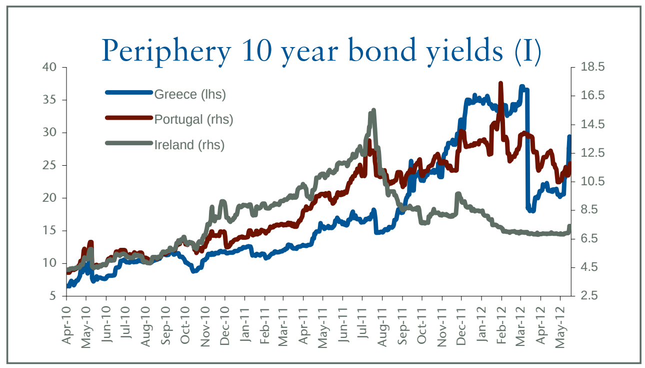
• At its latest meeting, the ECB said "looking ahead, in an environment of modest growth in the euro area and well-anchored inflation expectations, underlying price pressures should remain limited".

• Inflation expectations do not pose a serious concern. Breakeven inflation rates, a financial measure of inflation expectations, have declined sharply in the past month, falling from around 1.8% to around 1.6%.



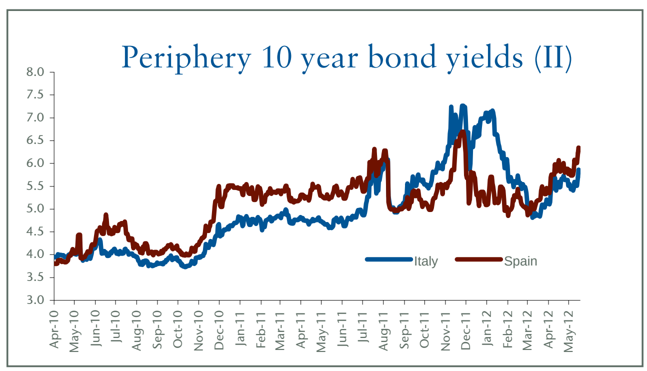
• The Greek electorate did not vote as the pre-election polls had indicated. Instead, elections in early May saw support for pro-bailout parties decline sharply while support for more radical, anti-austerity parties increased.

• New elections have been called for June 17. Polls suggest that support for the Radical Left party (anti-bailout) is increasing. Its victory would put the Troika rescue deal, and even Greece's membership in the monetary union, in doubt. Tail risk is elevated and risk aversion is likely to remain a theme.



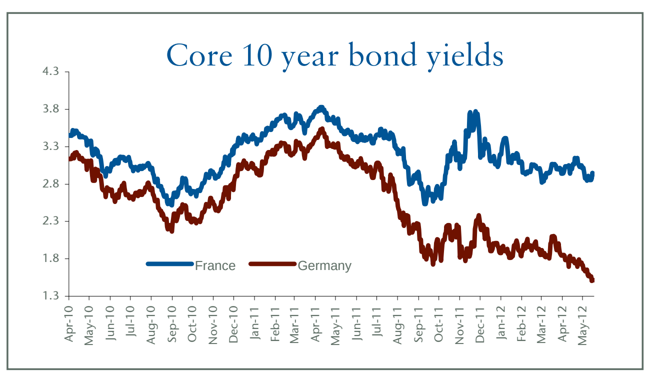
• Contagion has already hit the peripherals, with Spanish yields soaring (Italian yields rose too, but to a lesser extent).

• In fact, Spanish yields had already surged before the Greek elections as investors became increasingly conscious of Spain's high unemployment, potential real estate losses, coupled with the challenges of very aggressive fiscal adjustment. Recently announced banking sector reforms failed to soothe market fears.



• Greek political uncertainty, along with worries about Spain's banking sector, pushed German bund yields below 1.50%, a record low. In the absence of a resolution in the Greek political crisis, core bond yields may fall further.

• In the French presidential elections, Socialist candidate Francois Hollande ran on a pro-growth platform. His victory was expected and is likely to add to the growing pushback against fiscal austerity in favor of growth.

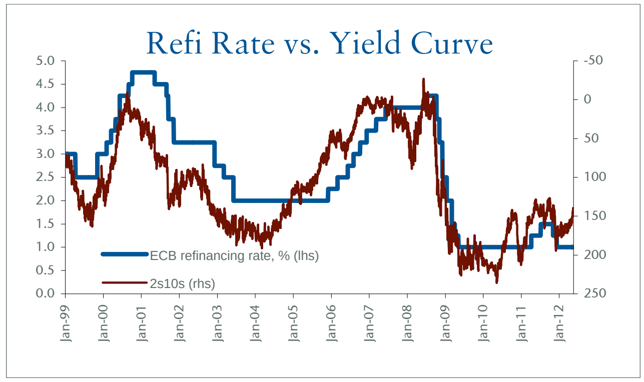


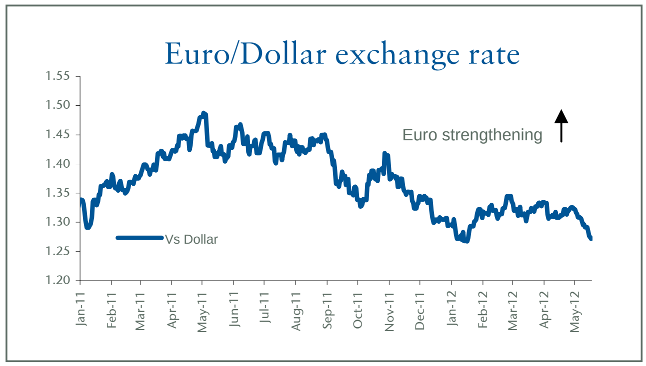
• The ECB needs to see clearer signs that the Euro area recession is deepening before it takes on a more dovish stance. A further set of extremely weak PMI numbers may be the trigger. In the meantime, the ECB will be keeping a close eye on Greek developments, discussions on the use of external funds for Spanish bank recapitalization, as well as the growth versus austerity debate.

• In the latter case, ECB President Draghi has focused on the need for structural reforms to boost growth, rather than fiscal stimulus.

• The results of the Greek elections on 6 May, potentially putting it on an EMU exit path, has triggered declines in European equity markets and a sharp decline in the euro.

• The euro fell below $1.29 on 14 May, and remains only marginally stronger than the January low of around $1.26. However, if the Greek political risks continue to worsen, the euro may feasibly weaken to the low $1.20s.





Expectations

• Once again, Europe is the focus of global concerns. Risk aversion is a dominant theme again, with safe haven assets in heavy demand. Having failed to form a coalition government, new Greek elections will be held on 17 June and the results could have serious market implications - not only for the Euro area, but globally.

• New elections mean another month of political uncertainty, speculation, and anti-austerity rhetoric. The current front-runner is anti-bailout Radical Left party, Syriza. Among Syriza's most memorable propositions is bank nationalization and unilateral debt moratorium. Markets will be closely watching out for a loosening of rhetoric - either from the Troika in regards to Greece's austerity programme, or from the anti-bailout parties with regards to their call for a unilateral repudiation of financing agreements. Either of these developments would ease market panic. But in their absence, a victory for an anti-bailout party with such a hardline stance could trigger a suspension of bail-out related payments from the Troika, bank runs, and even a Greek euro exit.

• Meanwhile, Spain is also back in the spotlight as investors are increasingly conscious of the dangers arising from ongoing rapid falls in real estate prices and related banking sector fragilities, near-record (and rapidly rising) unemployment, an erosion of fiscal credibility, and the challenges of very aggressive fiscal adjustment while in recession (as well as Greek contagion). Although the Spanish government attempted to address the banking sector's woes by announcing a second round of bank reform on 11 May, they failed to soothe investor concerns. There is growing speculation that Spain will ultimately need to tap European Union (EU) funds for wide scale recapitalization.

• Another European theme over the past month has been the growing pushback against fiscal austerity in favor of growth. The weakness of the euro area's growth outlook is undermining the efforts of many sovereigns to rein in budget deficits, thereby highlighting the self-defeating nature of the existing austerity plans. The debate may result in some minor amendments to the fiscal compact and greater use of the European structural funds. However, these measures are unlikely to have a meaningful impact in the short-term. On the other hand, an ECB policy rate cut or even quantitative easing, would likely have a greater impact. If economic data continue to deteriorate, the ECB may take on a more dovish tilt in the months ahead.

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	0.11	0.11	0.12	0.19
10 Year Govt. Bond	0.85	0.95	0.96	1.16
JGB Yield Curve	0.74	0.84	0.84	0.98
CPI	0.50	-0.20	0.00	-0.50

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 27 April meeting. However, it expanded its asset purchase program by ¥5 trillion to ¥70 trillion (having last increased it in February).

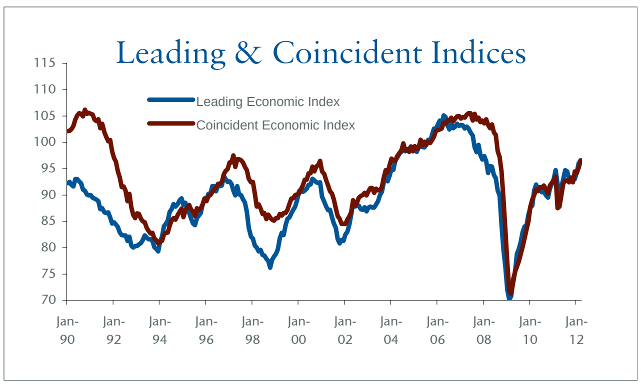
• Despite upwardly revising its economic outlook, the BOJ decided unanimously that additional monetary easing was required. It chose to increase its Japanese Government Bonds (JGB) purchases by ¥10 trillion, exchange-traded funds by ¥200 billion, and real estate investment trusts by ¥10 billion. The duration of eligible bonds was also extended from two years to three years, while the asset purchase program itself was extended by six months to June 2013. While this was quite aggressive action, as the BOJ's decision was widely anticipated, the market response was muted.

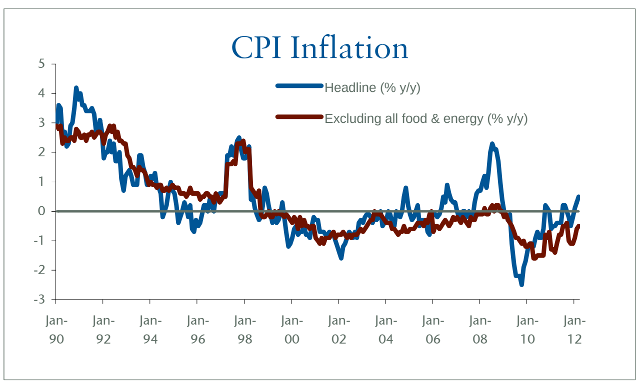
• Japan's GDP grew by 4.1% quarter-on-quarter in Q1. Recent data suggest that GDP growth momentum has slowed slightly in Q2. The services PMI index fell from 53.7 to 51 in April, reversing the gain in the previous month, although it remained relatively upbeat. The PMI manufacturing index weakened and indicated that industrial activity could slow sharply due to an inventory correction.

• The BOJ has upwardly revised its 2012 GDP growth outlook from 2.1% to 2.3%, and its 2013 GDP growth forecast from 1.6% to 1.7%.

• Headline CPI inflation rose from 0.3% year-on-year in February to 0.5% in March. The core core inflation measure (excluding food and energy) also moved upward in the month, with deflation easing from 0.6% in February to 0.5% in March.

• The BOJ revised its 2013 inflation forecast up from 0.5% to 0.7%. This is still below the BOJ's recently announced 1% CPI inflation goal, suggesting that further monetary stimulus may lie in the pipeline.





• The BOJ's monetary easing measures have played a significant role in the atypically large downward shift in JGB yields over the past month.

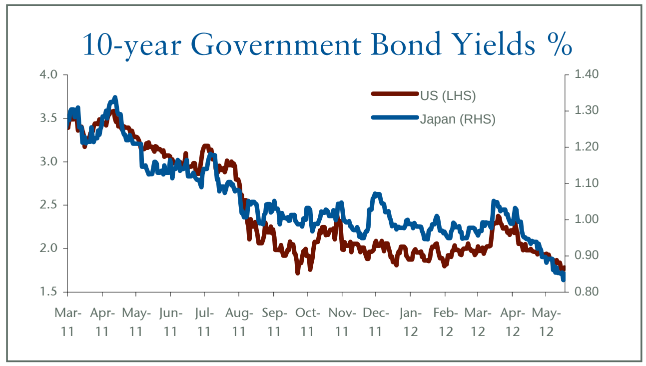
• Global factors are also likely to have played a part. Indeed, bond yields in other safe havens have also moved sharply lower. U.S. Treasury yields have fallen below 1.80%, while German bund yields have reached new record lows as European sovereign risks have re-escalated.

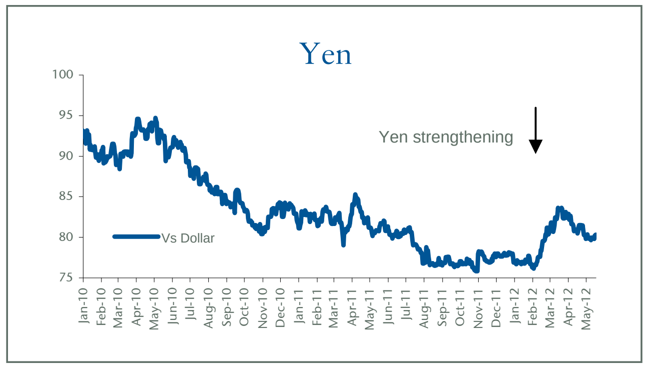
• The yen has strengthened against the U.S. dollar, despite the BOJ's aggressive monetary easing in April. At around ¥80 against the U.S. dollar, the yen has regained much of its strength since mid-February.

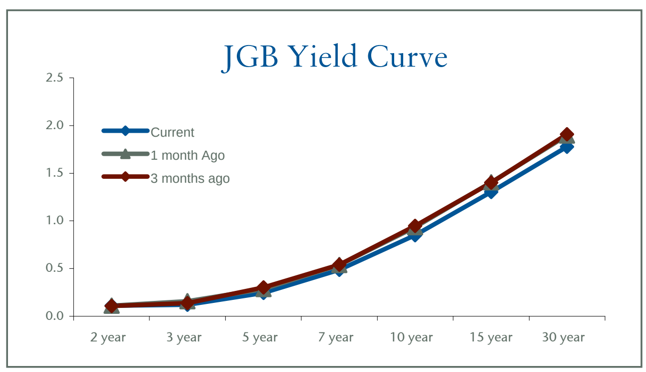
•This suggests that non-BOJ factors are also driving the yen stronger - most likely European developments. Indeed, the yen has appreciated sharply against the euro over the past fortnight, strengthening from around ¥108 to around ¥102.

• Most of the fall in JGB yields has been concentrated in the belly and long end of the curve. Ten-year JGB yields dropped below 0.85% last week to the lowest levels since October 2010, and are down almost 10 basis points on the month. The 5-year and 30-year segments of the curve are down 5 and 12 basis points respectively.

• Further monetary easing or market upheaval in Europe could see JGB yields fall even further.







Expectations

• Despite the upgrade of its economic outlook, the Bank of Japan decided unanimously that additional monetary easing was required at their latest meeting, confirming that the BOJ has taken on a more aggressive policy stance. However, the BOJ's forward looking message is less clear and, if anything, it seems that the yen continues to play a key role in policy decision making. If the yen remains below ¥80 against the U.S. dollar, the BOJ may ease policy again in June. The inflation outlook has also gained in significance since the BOJ announced its 1% inflation goal in February.

• JGB yields have fallen back close to their October 2011 lows. Continued upheaval in Europe could put additional downward pressure on JGB yields. Similarly, the yen has re-strengthened over the past month as a result of strong safe haven flows. Continued appreciation of the yen may trigger further monetary easing, which would likely see a slight correction in the yen.

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	1.28	1.07	0.89	1.67
10 Year Bond Yield	1.92	2.03	2.10	3.19
Canada Yield Curve	0.65	0.96	1.21	1.52
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 April meeting. Rates have remained on hold since October 2010.

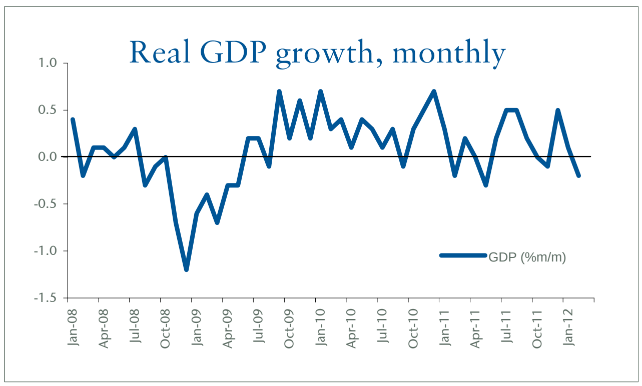
• The BoC took on a more hawkish tone at the latest meeting in April, noting that "some modest withdrawal of the present considerable monetary policy stimulus may become appropriate". The BoC expects a slightly more favorable global backdrop. In addition, it expects stronger Canadian growth, with the economy to reach full capacity in early-2013 - two quarters earlier than it previously expected - and, therefore, for inflation to be at or slightly above the 2% target over the forecast horizon. The BoC, however, downplayed the chances of a near-term rate hike, noting that "the timing and degree of any such withdrawal will be weighed carefully".

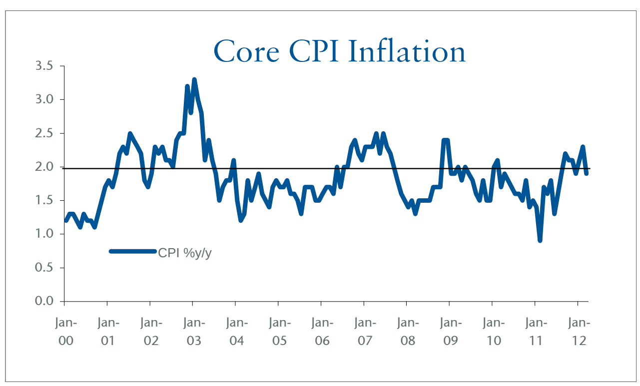
• After growing just 0.1% month-on-month in January, Canadian GDP contracted by 0.2% in February. Most of the decline was attributed to temporary closures in mining and other goods-producing industries.

• Canada had a second surprisingly strong employment report. After rising 82,300 in March, Canada added a further 58,200 jobs in April - the largest two-month increase in jobs since 1981. However, an increase in the participation rate pushed the unemployment rate up from 7.2% to 7.3%.

• Annual headline CPI inflation dropped from 2.6% in February to 1.9% in March. Core annual CPI inflation slipped from 2.3% to 1.9% in March, just below the BoC's 2% inflation target.

• At its latest meeting, the BoC noted that "as a result of reduced slack and higher gasoline prices, the profile for inflation is expected to be somewhat firmer than anticipated in January".





• The Canadian dollar (CAD) strengthened following the hawkish tone to the BoC's monetary policy meeting. However, it has weakened over the past fortnight and has fallen below parity against the U.S. dollar.

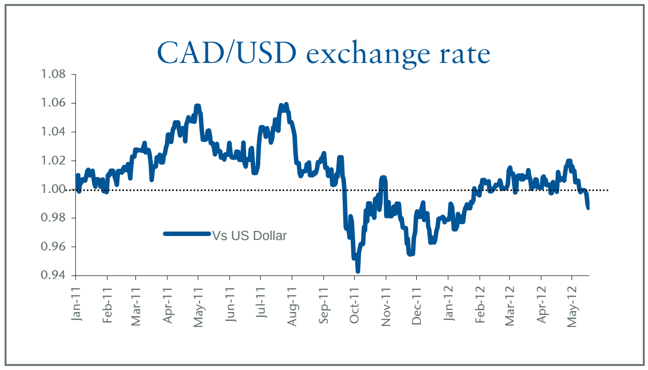
• The loonie's fluctuations suggest that the CAD is not yet a safe haven currency in the face of sovereign risk. Indeed, the currency has depreciated as market risk - related to the European sovereign crisis - has soared.

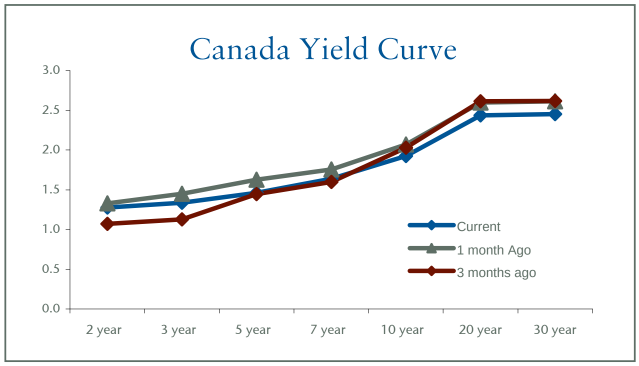
• In the week following the BoC's April meeting, the front-end of the Canadian yield curve shifted up some 10 basis points. However, growing concerns about global growth have pushed yields back down. Two-year yields are 5 basis points lower than a month ago, while the belly and long-end have fallen some 15 basis points.

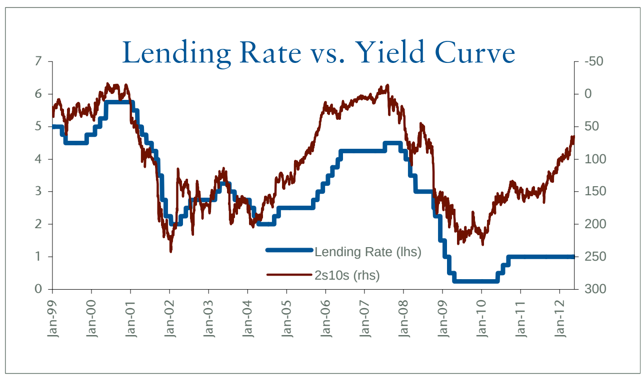
• Canadian bonds have underperformed U.S. Treasurys. Canada tends to underperform in a falling rate environment and outperform in a rising rate environment.

• The overnight index swaps (OIS) market is pricing in aggressive policy rate hikes, especially since the strong employment report. It now puts the odds at about 50:50 of a 25 basis point hike in July.

• However, given how conscious the BoC has been of European risks, the escalation of the sovereign crisis may see the BoC wait a bit longer before it increases rates.







Expectations

• The Bank of Canada has turned clearly hawkish, signaling that it will soon raise interest rates providing domestic and global economic developments do not deteriorate. It no longer expects a period of slightly below-target core inflation given the "diminishing economic slack" and higher gasoline prices. In addition, a slight change in its economic outlook, with a more front-loaded growth profile, suggests an earlier need for monetary tightening.

• The Bank of Canada remains concerned about household debt and housing market imbalances. It emphasized that "Canadian household spending is expected to remain high relative to GDP as households add to their debt burden, which remains the biggest domestic risk". This also suggests that the need for tighter policy is growing, although it does imply that policy rate hikes will be only gradual. While the commentary from the BoC was decidedly more hawkish, it does not seem to be in a rush to hike rates. As a result, while policy rates are likely to increase this year, the timing of the hikes will depend on the incoming economic data.

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