Central Bank Watch

September 20, 2012

Note: Unless otherwise indicated all data in this document is sourced from Bloomberg as of 09/14/12

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	2.85	2.37	3.66	3.44
10 Year Bond Yield	3.28	2.93	4.06	4.09
Aussie Yield Curve	0.43	0.55	0.41	0.65
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.

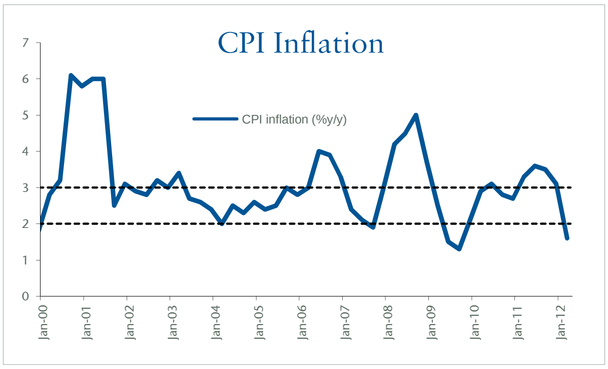
Current Policy

• The Reserve Bank of Australia (RBA) kept the cash rate on hold at 3.5% at the 4 September meeting. Rates had been cut by 75 basis points over two meetings in May and June.

• The RBA's decision was well-anticipated, while the commentary accompanying the decision was largely unchanged from the previous meeting. It still expects growth to remain close to trend and inflation to remain consistent with the target. The RBA did acknowledge the weaker global backdrop, with an "added uncertainty" to the outlook in China. It also displayed some concern about the fall in commodity prices, as well as the surprisingly strong Australian dollar. Once again, it described the current policy rate as "appropriate" and gave little away about the policy outlook.

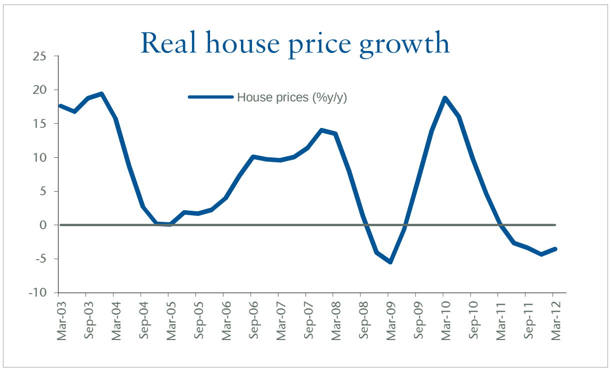
• Annual headline CPI inflation fell from 1.6% in Q1 to 1.2% in Q2, the lowest since June 1999. Annual core inflation fell from 2.2% to 2% - the bottom of the RBA's target band. However, the alternative core measure - the weighted median - came in at 1.9%, slightly higher than expected.

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



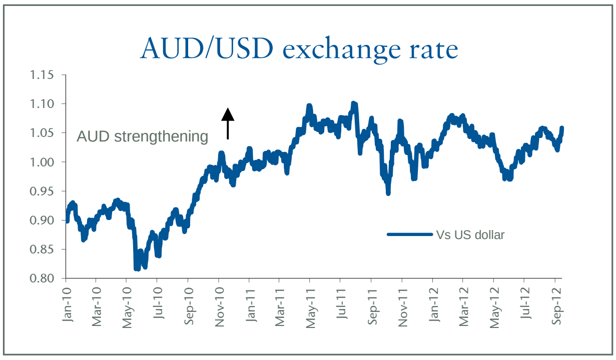
• GDP grew by 0.6% quarter-on-quarter in Q2, down from the 1.4% growth in Q1 and slightly weaker than expected. Timelier data suggest a further fading in momentum. Retail sales fell 0.8% month-on-month in July while employment dropped 9,000 in August.

• The housing finance data disappointed in July, with the total number of new loan commitments declining 1.0% month-on-month. Housing starts rebounded, but the underlying trend in residential investment remains weak. Meanwhile, consumer confidence improved in September.



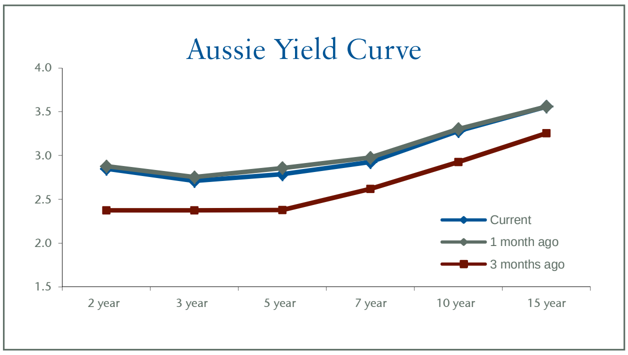
• The Aussie dollar has continued to strengthen very sharply. At $1.06, it is at the highest level since March, although still below the $1.10 levels reached last summer.

• The RBA is concerned about the strength of the Australian dollar and its contrast with the weakening in global growth. The central bank described the AUD as "higher than might be expected", hinting at growing discomfort.



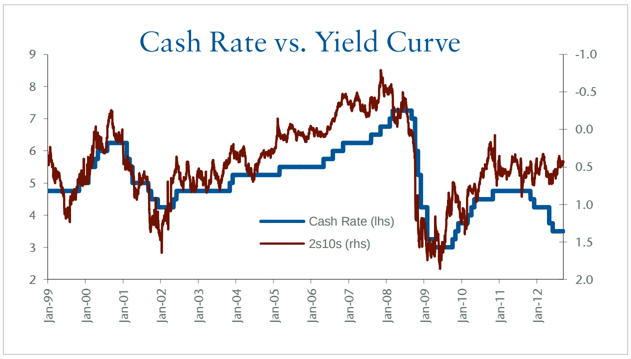
• The Aussie yield curve has shifted lower over the past month, with most of the move in the 3 year to 7 year part of the curve.

• The run of softer domestic data (Q2 GDP, July retail sales, August employment data), as well as signals that the distribution of risks around China have shifted to the downside, have driven the rally.



• If the recent run of weaker domestic economic data is sustained, and the Australian dollar remains elevated, there is a risk of further policy loosening.

• Currently the market is pricing in 50 basis points of further policy rate cuts. That would still keep the Australian cash rate higher than that of most major central banks around the world.



Expectations

• Australian data surprises returned to negative territory in recent weeks. Commodity price developments appear to be having an impact on the real economy, while concerns that Chinese growth may disappoint are another threat for the Australian economy.

• The RBA has kept policy rates on hold for three consecutive months, giving little away about the near-term path for rates. It continues to describe growth as close to trend and inflation close to target, but surely the downside risks to the economic outlook are growing. As a result, further policy easing seems likely in the coming months. Remember, with policy rates at 3.5%, the RBA has more room than any other major central bank to provide stimulus, putting it in a relatively comfortable position.

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	0.29	0.39	0.19
10 Year Treasury Yield	1.82	1.64	2.27	1.98
Treasury Yield curve	1.58	1.35	1.88	1.80
Core PCE	1.60	1.90	1.90	1.50

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 13 September meeting. New policy measures were announced, while Operation Twist will continue until year-end.

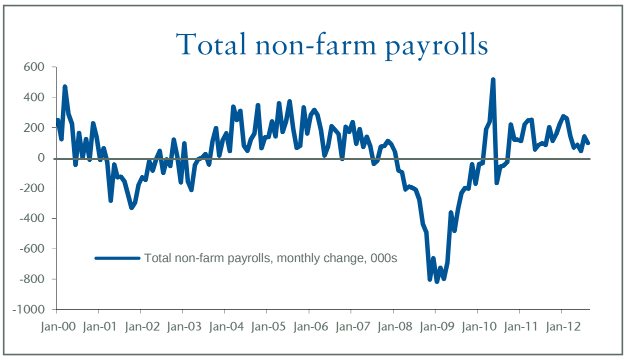
• The FOMC has taken extremely aggressive action. It extended its low-rate guidance through mid-2015, and highlighted that "a highly accommodative stance of monetary policy will remain appropriate for a considerable time **after** the economy strengthens". The Fed also announced that it will begin purchasing $40 billion of agency mortgage-backed securities (MBS) per month, and that "if the outlook for the labour market does not improve substantially, the Committee will continue its purchases of MBS, undertake additional asset purchases, and employ its other tools as appropriate until such improvement is achieved".

• The recent modest improvement in activity appeared to stall in August. The ISM manufacturing index edged down slightly from 49.8 to 49.6 in August. The underlying details of the report suggest weak final demand and excessive inventory building.

• The ISM non-manufacturing index rose from 52.6 to 53.7 in August, but again the details were disappointing. Consumer confidence declined unexpectedly in August. The Case-Shiller index showed year-on-year gains in house prices, beating expectations.

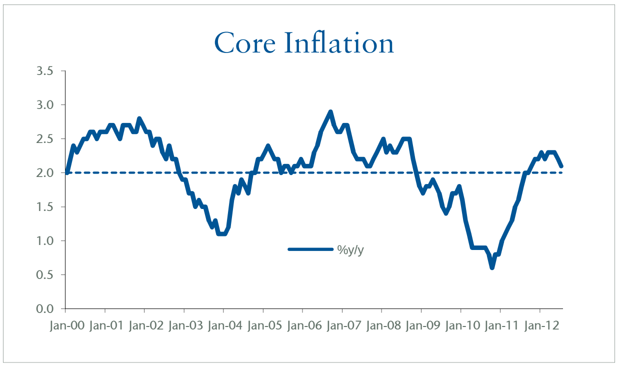
• The August labour market report was disappointing. Non-farm payrolls rose just 96,000, far less than expected. The unemployment rate fell from 8.3% to 8.1%, however, this reflected a drop in labour force participation.

• In the post-FOMC meeting, Chairman Bernanke emphasized that the employment situation remains a "grave concern" and is a threat to economic potential. It seems that the clear target of Fed policymakers is the labour market.



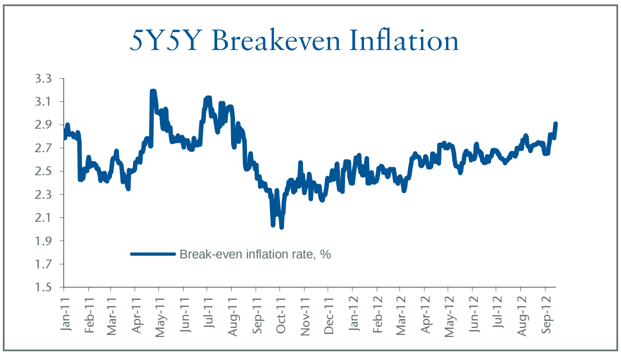
• Annual core inflation weakened from 2.2% in June to 2.1% in July. The annual core PCE inflation rate - the Fed's preferred measure of inflation - fell from 1.8% in June to 1.6% in July, below the Fed's 2% target.

• The Fed's focus on the labour market means that monetary policy may be less sensitive to changes in inflation. The Fed may accept some inflation above its target so long as the rise is viewed as temporary and coincides with progress on reducing unemployment.



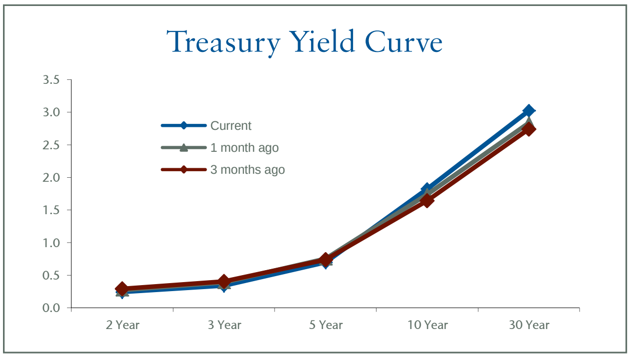
• Five-year breakeven inflation rates, a measure of inflation expectations, rose from 2.7% in August to 2.9% in September.

• Anticipation of a further increase in the Fed's balance sheet may have driven inflation expectations higher. Now, with the Fed suggesting that its reaction function - with regards to inflation - has changed, it is possible that inflation expectations will rise further in the coming months.



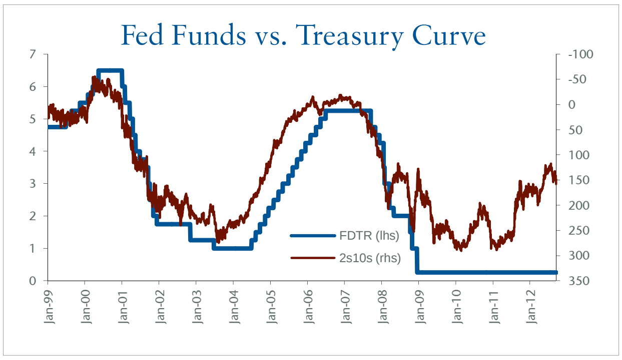
• Ten-year Treasury yields are 8 basis points higher over the month. They reached a three-month high of 1.83% on 16 August as investors speculated that the Fed may not introduce further monetary stimulus, before dropping some 30 basis points.

• Fed action, however, has seen the Treasury yield curve steepen. The front-end of the curve has fallen as a result of looser monetary policy conditions, while the long-end has risen due to higher inflation expectations.



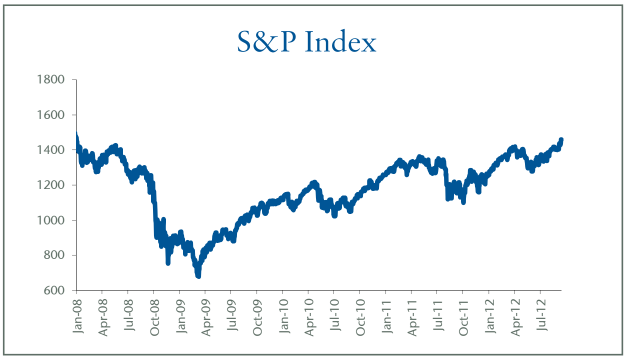
• The Fed's latest monetary policy action came even as FOMC participants' economic forecasts were upgraded, indicating that the committee's reaction function has become significantly more dovish.

• The additional $40 billion MBS purchases per month, combined with the on-going Operation Twist, will increase the Fed's holdings of longer-term securities by about $85 billion a month through the end of the year.



• Global equity markets have responded very strongly to the new policy responses in the U.S. and Europe over the past week. The S&P 500 index has recovered to levels unseen since Lehman.

• Although most market participants were expecting a significant easing move from the Fed, the eventual announcement was more aggressive than expected, with equity markets rallying sharply following the release of the FOMC's statement.



Expectations

• The Fed's latest policy announcement provides further monetary stimulus in order to generate a stronger recovery and, most particularly, to improve conditions in the labour market. Although the Federal Reserve has a dual mandate - fostering price stability and employment - from now on, monetary policy may be less reactive to higher inflation while unemployment is well away from target.

• The Fed's decision was heavily anticipated. At the annual Jackson Hole Symposium in August, Federal Reserve Chairman Ben Bernanke made the case for unconventional monetary easing policies at the same time as noting the "grave concern" posed by the labour market. Speculation of further monetary stimulus heated up following the release of the weak August employment report which can hardly have given the Fed much comfort that labour market conditions are improving to the degree they desire.

• As it happened, the Federal Reserve fired from all fronts. As well as vowing to maintain near-zero policy rates for a considerable time even **after** the recover strengthens, new asset purchases will be open-ended and may even increase if the outlook for the labour market does not improve substantially. And while the Fed did not announce new purchases of Treasuries in addition to purchases of MBS, the door to future purchases of Treasuries is certainly not closed with the FOMC noting that, in the absence of an improvement in the labour market, they may "undertake additional asset purchases, and employ other policies as appropriate".

• How long asset purchases go on for is unclear. Fiscal policy risks suggest that they may well extend beyond the end of 2012. Indeed, if the government's fiscal stance is much tighter than expected, the Federal Reserve is likely to compensate by extending purchases of MBS, and throwing in Treasury purchases too.

• The FOMC's forecasts GDP growth in 2012 to be in a range of 1.7% to 2%, and growth in 2013 to range between 2.5% and 3%. It expects unemployment to remain above 7% in 2013, falling only to around 7.7%. If the U.S. outlook deteriorates from there, further asset purchases are certainly possible.

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	0.26	0.29	0.51	0.57
10 Year Gilt Yield	1.93	1.73	2.34	2.44
Gilt Yield Curve	1.67	1.44	1.83	1.87
CPI	2.60	3.00	3.60	4.40

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 September 6th 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 August meeting (September meeting minutes will be released on 19 September) revealed that the MPC voted unanimously to hold policy unchanged. However, while for most members the decision was "relatively straightforward", for others the decision was more "finely balanced", as a "good case could be made at this meeting for more asset purchases". Unlike the July meeting, the minutes to the August meeting showed that there was no discussion of the issue of whether to cut Bank Rate to 0.25%.

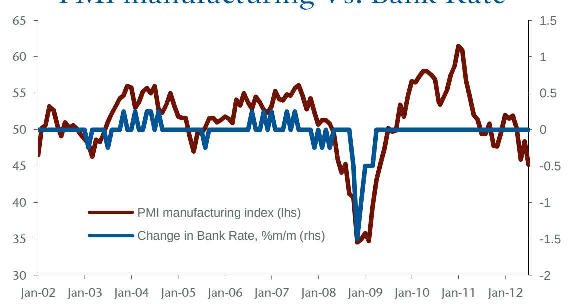
• The second estimate of Q2 GDP growth was revised upwards, from -0.7% quarter-on-quarter to -0.5%. Consumer spending deducted 0.3% from growth in Q2, while inventory accumulation was the sole source of support to growth.

• The PMI manufacturing index rose significantly, from 45.2 to 49.5 in August, reversing last month's sharp decline. The PMI services index rose from 51 to 53.7, leaving the composite output reading consistent with modest GDP growth.

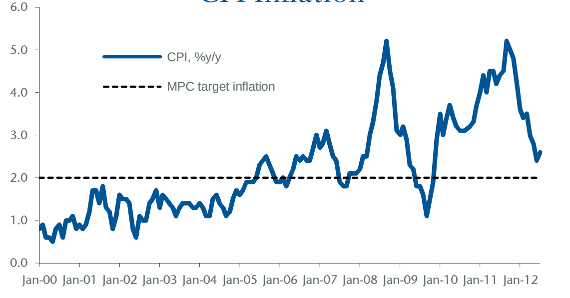
• Annual headline CPI inflation rose from 2.4% in June to 2.6% in July, the first increase in annual inflation since March.

• The August Inflation Report revealed the MPC's revised inflation forecast. In the medium-term inflation is expected to reach about 1.8%, marginally higher than the 1.7% expectation in the May report, but still below the MPC's 2% inflation target. The MPC believes that risks to inflation around the target were "broadly balanced".

PMI manufacturing Vs. Bank Rate

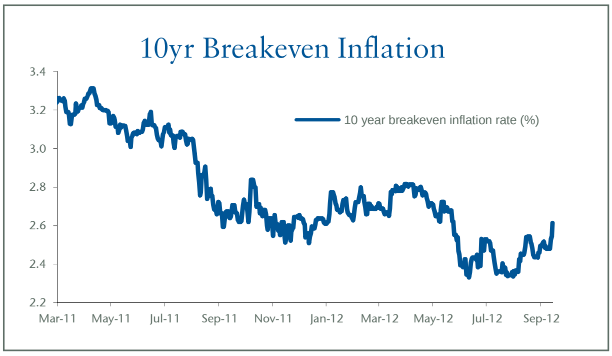


CPI Inflation



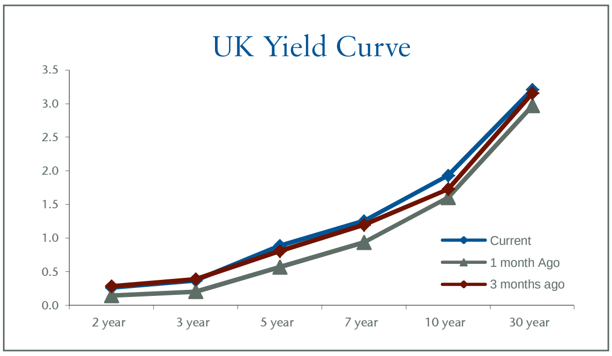
• Inflation expectations appear to remain well-anchored, despite the increase in annual headline inflation from 2.4% to 2.6% in August.

• Breakeven inflation, a financial measure of inflation expectations, has risen from 2.38% in August to 2.6% in mid-September, but still remains below than the 2.8% rate recorded in April. The prospect of higher petrol and utility prices may push up inflation expectations in the coming months.



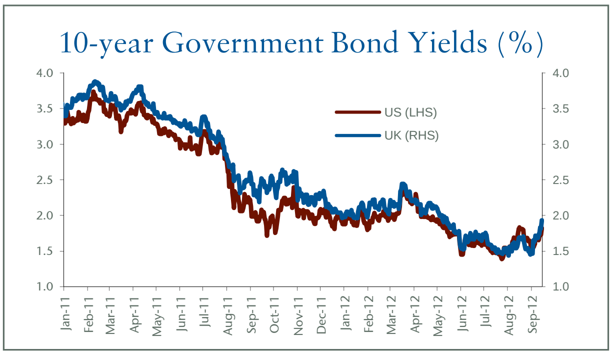
• Ten-year gilt yields have risen almost 35 basis points in the past month as a result of stronger-than-expected UK economic data and diminishing risk aversion.

• The sell-off has been largely focused on the belly of the curve. Two-year and 30-year yields have risen 13 basis points and 25 basis points respectively. However, with market still expecting the BoE to maintain its easy monetary policy stance, upward pressure on yields will be limited.



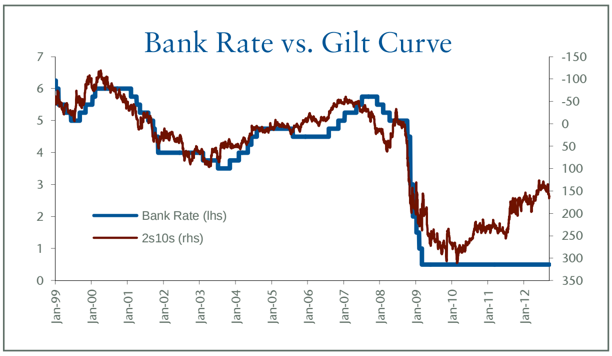
• Stronger economic data in the U.S. in the first half of August prompted U.S. Treasuries to sell-off sharply, pulling away from UK gilts. With the exception of occasional days here and there, it was the first time 10-year U.S. Treasury yields have exceeded UK Gilt yields for a sustained period since 2006.

• Weak U.S. payroll data in early September, however, reignited expectations for monetary easing in the U.S, pushing 10-year Treasury yields back below UK gilt yields.



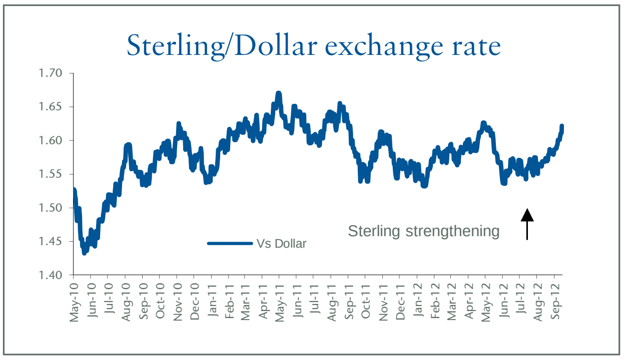
• Although there was no policy change at the September meeting, there is likely to be significant discussion within the MPC about options for further monetary easing.

• The market widely expects additional stimulus to be announced at the November meeting. By then, the MPC will have lending data to end-September, providing it with an early indication of the Funding for Lending's scheme impact on lending activity. A further cut to Bank Rate is also possible.



• The MPC earlier identified the euro area crisis as the main threat to the UK economy. Following the ECB's announcement of a new bond purchase program, European risk has diminished and the euro has strengthened against sterling. If sustained, this should provide a much-needed boost to UK exports.

• On the other hand, the pound has strengthened against the U.S. dollar, reaching $1.63 in early September.



Expectations

• UK economic data has generally surprised to the upside recently. The PMI manufacturing and services indices improved in August, while the labour market continues to defy expectations. Indeed, the level of employment currently stands at 29.5 million, and is not far off the 29.6 million peak seen prior to the crisis.

• However, the underlying economy remains weak and the improvements in economic data are from a low base. As a result, although the August MPC meeting contained limited discussion of further policy stimulus and the September meeting resulted in no change to policy, the Bank of England is likely to maintain its monetary policy easing bias in the coming months.

• Given that the Bank of England has identified the euro area crisis as the most potent risk to the UK economy, recent ECB action may lift the pressure on the MPC to take action in November. Furthermore, the coalition government has indicated that it will be refocusing its efforts on boosting economic growth rather than fiscal tightening, suggesting less urgency for the Bank of England to fill in the stimulus gap. In addition, the new Funding for Lending Scheme provides additional policy easing. Yet, there remains a strong contingent within the Monetary Policy Committee that is erring on the side of further policy easing.

• Indeed, several members believe that a "good case could be made for more asset purchases". The MPC expects medium-term inflation to undershoot the 2% target by a fairly comfortable margin, suggesting that further policy stimulus could be easily justified. However, the MPC would like to take time to judge how effective the Funding for Lending Scheme is at boosting credit creation and aggregate demand. By the November MPC meeting, the members will have lending data to end-September, providing it within an early indication of the FLS' success. A further interest rate cut is an option - several members have been rethinking their original hostility to the idea of cutting Bank Rate to 0.25%. If the FLS is successful, it may enable a policy rate cut to be transmitted to households.

• With the ECB ready to provide further extraordinary measures to deal with the euro area crisis and the U.S. Federal Reserve introducing aggressive monetary policy measures, the Bank of England may soon follow suit.

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	0.09	0.08	0.25	0.56
10 Year Yield	1.66	1.49	1.95	1.88
Eurozone Yield Curve	1.57	1.40	1.71	1.32
HICP	2.40	2.40	2.70	2.50

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 September 6th meeting and also kept the deposit rate on hold at zero, having reduced both by 25 basis points at the July meeting.

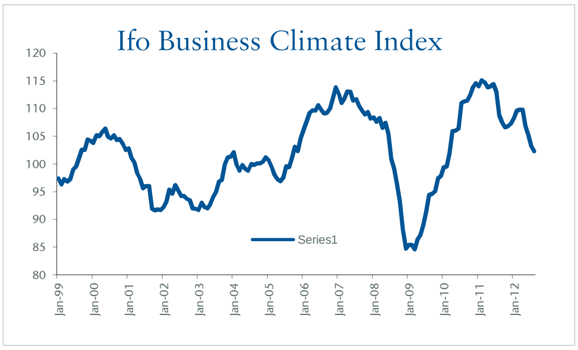
• The ECB introduced its new and improved bond purchase program, Outright Monetary Transactions (OMT). The intention is to repair the monetary transmission mechanism by reducing convertibility risk (the risk that a country could leave the euro and re-denominate its bonds into a weaker currency), and it will do this by purchasing peripheral sovereign bonds (1-year to 3-year maturity). Intervention will be on an unlimited basis, holdings will be pari passu to other creditors and will be fully sterilized. The key feature of the program is conditionality: in order to qualify for bond purchases countries will need to be participating in either a full or precautionary EFSF/ESM programme and accept conditionality.

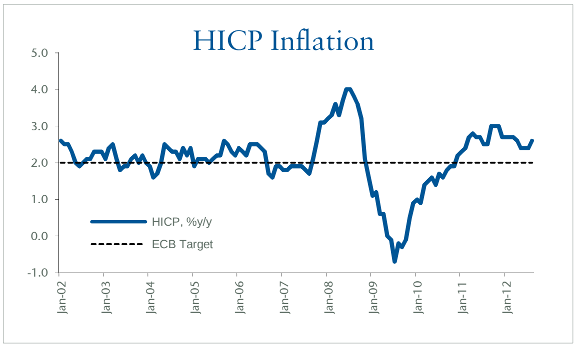
• Euro area GDP fell 0.7% quarter-on-quarter in Q2. Industrial production rose 0.6% m/m in July, while the Euro-area composite PMI fell marginally, from 46.5 to 46.3 in August. However, it remains broadly unchanged over the past three months.

• In Germany, the composite PMI fell from 47.5 to 47, while it rose very slightly in France, Italy, and Spain (remaining below 45 in the latter two countries). The German Ifo business climate index fell again in August, from 103.2 to 102.3.

• Annual headline HICP inflation jumped from 2.4% to 2.6% in August, largely driven by tax increases. By contrast, core inflation was unchanged at 1.9%. Headline inflation remains above the 2% target, and is expected to remain so for the remainder of 2012. However, the ECB expects inflation to fall to 1.9% in 2013.

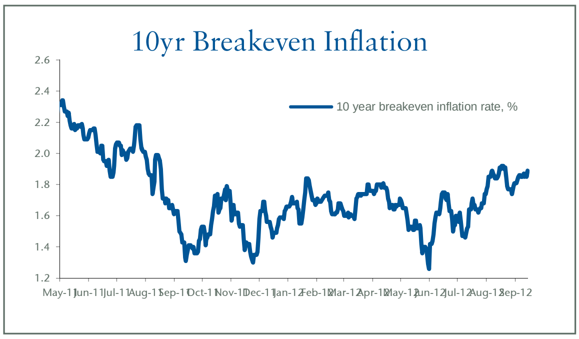
• The ECB has chosen to sterilize all its bond purchases under the OMT in order to prevent it from having an inflationary impact.





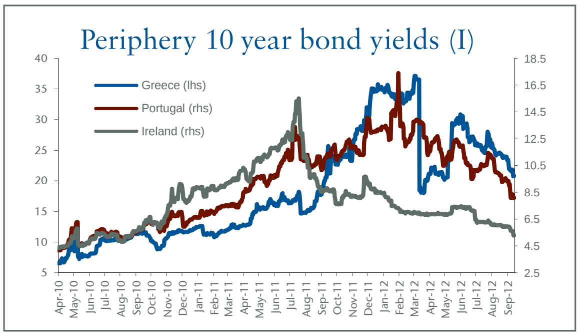
• The announcement of OMT has resulted in an increase in inflation expectations, despite it being fully sterilized.

• Breakeven inflation rates, a financial measure of inflation expectations, have risen to around 1.8% in September. However, as this remains below the 2% target, it should not pose a significant concern to the ECB. Nevertheless, we expect the ECB to be extra vigilant of rising inflationary expectations in the coming months.



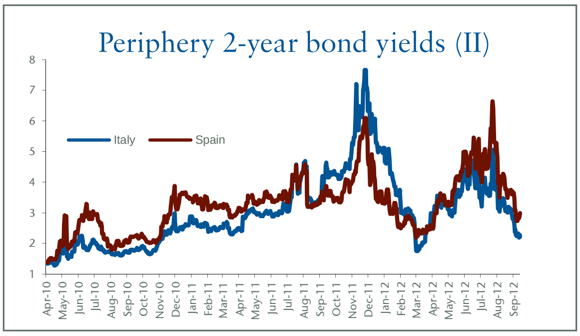
• Greece has requested a 2-year extension to its bail-out program. Germany has indicated that it may accept this request providing it does not entail more bailout funds. However, no decision will be made until the Troika has completed a full assessment of Greece (likely in early October).

• Portugal's programme remains broadly on track and the Troika is ready to disburse the next tranche of the bail-out. Ireland continues its successful return to the markets.



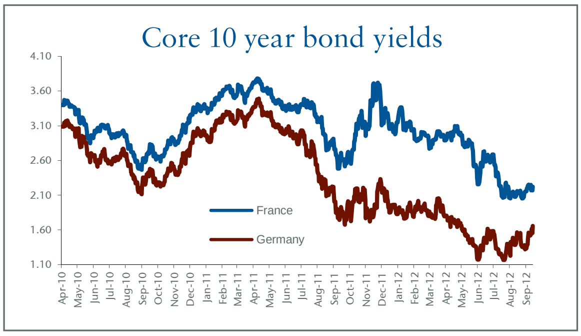
• Anticipation of the ECB's new bond purchase plan drove Spanish and Italian front-end yields sharply lower, with the rally extending beyond the official announcement. Since 26 July, when Draghi pledged to do "whatever it takes", Spanish 2-year yields have halved.

• However, the OMT will only be activated if and when Spain officially requests support. It is possible that Spain will delay its request for assistance until after the regional elections in late-October, but markets may force the issue before then.



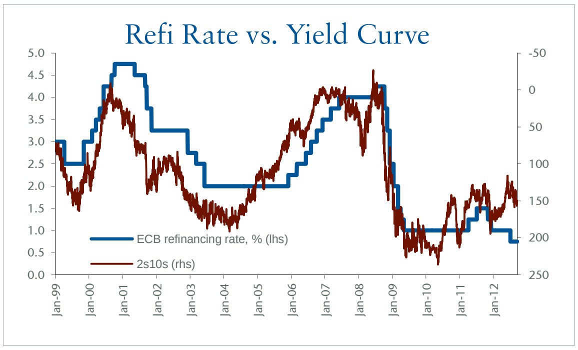
• The German Constitutional Court ruled not to stop the ratification of the European Stability Mechanism (ESM) and Fiscal Compact. The ESM should be operational by early October. Core yields have sold off in the past month as tail risk has diminished.

• Early indications suggest that the Dutch election (12 September) resulted in a victory for centrist, pro-European parties - a positive result from the market's perspective.



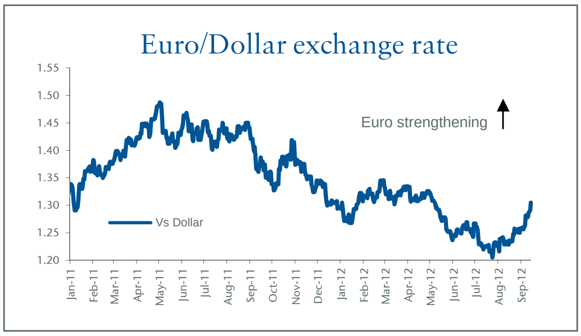
• The ECB's decision to purchase bonds to keep risk premia low has induced a meaningful rally in peripheral bonds. To sustain this risk rally in the near-term, we think Spain will need to request assistance soon. In the medium-term, market focus will likely return to Spain/Italy's ability to meet their fiscal targets.

• The ECB expects GDP growth of -0.4% in 2012 and +0.5% in 2013, suggesting that further policy stimulus may still be required. This may involve an additional LTRO and a policy rate cut.



• With the OMT having reduced tail risks in Europe, coupled with the German Constitutional Court's positive verdict on the ESM, the euro has strengthened very sharply over the past month. The U.S. Federal Reserve's decision to expand the balance sheet has also seen the euro strengthen against the U.S. dollar.

• At $1.31, the euro is at its strongest level since May 2012.



Expectations

• The OMT is a much improved version of the SMP - there is no expiry date and resources are potentially unlimited. Furthermore, the necessary condition of strict conditionality should mean that, while the ECB is trying to deliver low short-term financing rates for sovereigns, it is also providing a strong incentive to those sovereigns to comply with their fiscal commitment. Indeed, the ECB has explicitly stated that their support will be withdrawn if fiscal commitments slip. Conditionality should mean countries maintain ownership of the economic problem.

• The ECB has chosen to concentrate purchases on the front-end of the yield curve. This is because it keeps their operations closer to traditional monetary policy, and - it is hoped - that such purchases will also affect the medium-term yield curve. Certainly, if investors believe that sovereigns will stick to the conditionality terms and that the ECB will continue to purchase debt when necessary, the longer-end of the yield curve should also rally. One potential drawback of having short-end purchases, however, is if it results in a steep yield curve those countries are likely to issue debt at ever-shorter durations, implying greater rollover risk.

• Assuming Spain requests assistance in the coming weeks, we believe that the ECB has made significant inroads to resolving the euro area crisis. However, there is a material risk that Spain will delay. Improving market conditions have reduced the incentive for Spain to request help, while it has also indicated that it may not request assistance if conditionality goes substantially beyond what they have already committed to. If Spain resists for too long, markets conditions are likely to deteriorate, eventually forcing Spain to seek support. In the medium-term Spain's ability to meet its deficit targets (a minimum standard) is a clear risk. Currently, Spain has fallen behind and will need a significant improvement in the coming months if it is to achieve its target. Indeed, the OMT cannot diminish the fact that the economic adjustment paths are extremely challenging.

• Ultimately, the OMT should provide a useful 'kick the can down the road' operation to buy the euro area more time to continue pushing through necessary reforms to provide fundamentals consistent with continued Euro participation. Furthermore, hopefully these adjustments can take place in a much less financially stressful environment. This week's action should alter the course of the crisis for the better.

• The economic outlook suggests that further monetary easing may be necessary. A further cut in the policy rate and the deposit rate (taking it into negative territory) may still lie on the horizon.

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	0.10	0.11	0.14
10 Year Govt. Bond	0.80	0.86	1.01	1.00
JGB Yield Curve	0.71	0.76	0.90	0.86
CPI	-0.40	0.40	0.10	0.20

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 August 9th meeting. It also kept its asset purchase program unchanged at ¥70 trillion (having last increased it in April).

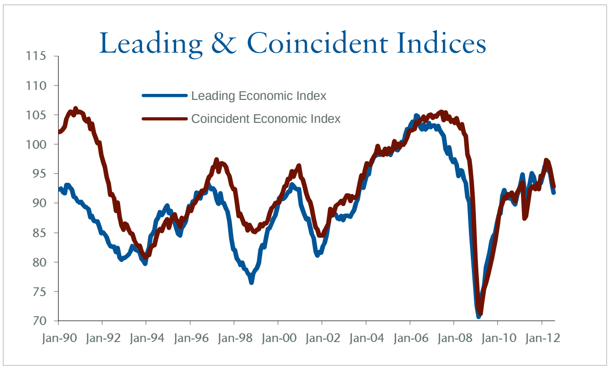
• The latest meeting was uneventful. The BOJ noted that it "will proceed with monetary easing in a continuous manner by steadily increasing the amount outstanding of the Asset Purchase Program". It also kept its assessment of the economy unchanged: it continues to expect a moderate pickup in growth, with firm domestic demand supported by reconstruction, and it once again cited the Euro area debt crisis and the weak U.S. recovery as risks to Japan's economic outlook. However, political pressure for further easing remains and, if it starts to mount, could trigger further policy action.

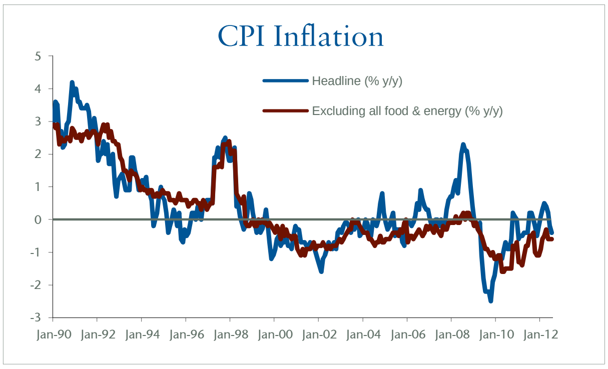
• Q2 GDP growth was revised down to 0.7% quarter-on-quarter from 1.4%. The revision mainly reflected a larger negative contribution from a change in inventories.

• Timelier survey data were also largely negative. The Cabinet Office's consumption index – the most reliable monthly indicator to track GDP-based consumption – fell in July with a large downward revision in June too.
Meanwhile, the PMI services index in August recovered part of the total 6.2 drop of the previous four months and now stands at 49.3.

• Headline CPI inflation weakened from -0.2% year-on-year in June to -0.3% in July, the third consecutive monthly decline. The core annual inflation rate (excluding food and energy) was unchanged at -0.6% in June.

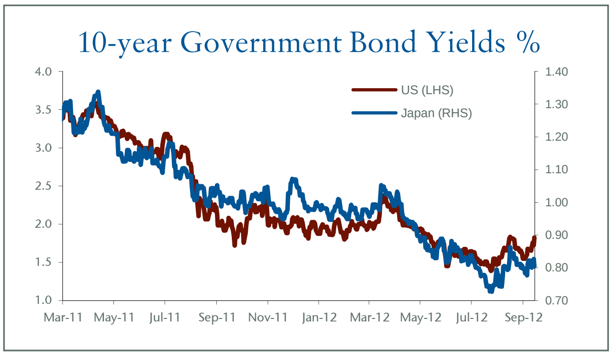
• The BOJ expects inflation to rise to 0.7% by end-2013 and then to reach the BOJ's 1% target shortly after. Household inflation expectations have fallen back after rising for a time in 2012.





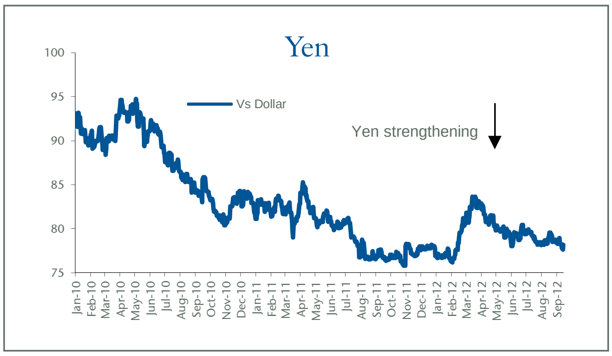
• Japanese government bond yields are broadly unchanged on the month, but that conceals the drop in the past few weeks.

• Ten-year JGBs had reached 0.86% in mid-August, but then rallied in the second half of August in line with U.S. Treasury yields following the release of the unexpectedly dovish FOMC minutes. In the past week, the announcement of the ECB's bond purchase programme has seen most safe havens sell-off slightly, with JGBs no exception.



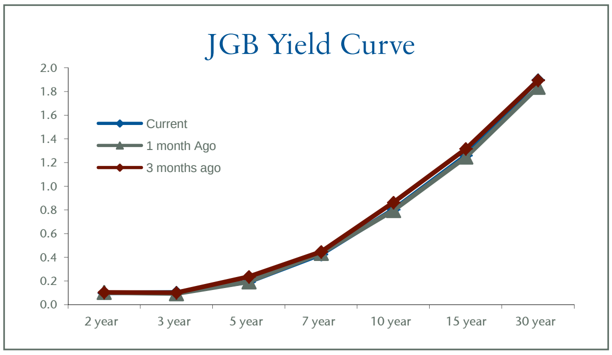
• The Japanese yen has continued to strengthen in recent weeks, reaching ¥78 in mid-September as the U.S. Federal Reserve announced new policy stimulus.

• It is possible that the yen could surge further following the FOMC's decision to expand the balance sheet. In this scenario, if the currency starts to weigh heavily on growth, the BOJ may increase the Asset Purchase Program further.



• The JGB curve is broadly unchanged on the month. However, while the steepness of the 2-year-10-year section of the curve has not changed, the 30-year part of the JGB curve has sold off more than any other part of the curve.

• If the Japanese yen continues to strengthen, prompting action from the BOJ, we would expect to see JGBs rally across the curve.



Expectations

• Recent economic data in Japan has been disappointing. As such, it is likely that the BOJ will lower its economic assessment at the next monetary policy meeting on 18/19 September. In recent months, the central bank has appeared to be comfortable with its policy stance, providing little indication of forthcoming action. However, the U.S. Federal Reserve's decision to add monetary stimulus via further expansion of the balance sheet raises the risk that the BOJ will act sooner rather than later. After all, with the yen currently at ¥78, it is already bordering the BOJ's comfort limit and further appreciation of the yen against the U.S. dollar will constrict Japanese growth.

• The recent release of the Cabinet Office's Economic and Fiscal projections showed that the 5% hike in the consumption tax rate in 2014/15 is still insufficient to meet the government's goal of achieving a primary budget balance by 2020. Fiscal deficits are estimated to increase again after 2017, and could even increase in earlier years if the government's optimistic economic assumptions are not met.

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	1.17	1.03	1.21	0.94
10 Year Bond Yield	1.88	1.77	2.07	2.20
Canada Yield Curve	0.71	0.74	0.87	1.26
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%.

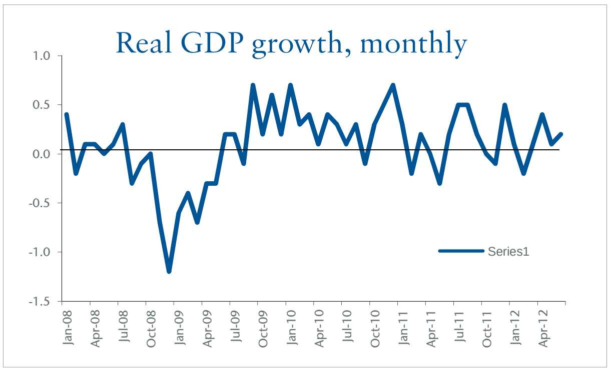
Current Policy

• The Bank of Canada (BoC) left its key policy rate unchanged at 1% at its September 5th meeting. Rates have remained on hold since October 2010.

• The BoC showed no change in their outlook. It described the Canadian economy as performing around its productive potential, while "global growth prospects are unfolding largely as the Bank projected in its July Monetary Policy report". It continues to see external developments as the key risk to the outlook while domestic demand continues to be the main driver of growth. The BoC once again repeated the phrase "some modest withdrawal of the present considerable monetary policy stimulus may become appropriate", suggesting that the central bank maintains a slight tightening bias.

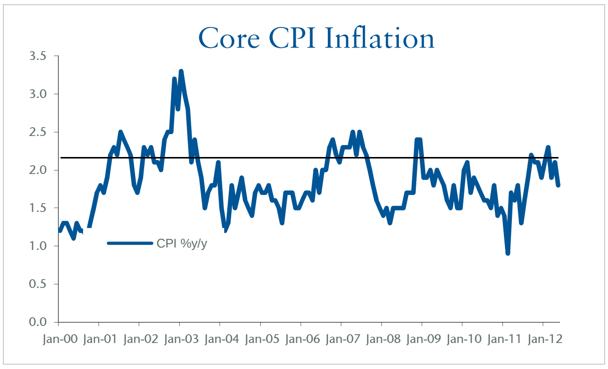
• GDP grew 1.8% quarter-on-quarter in Q2, a similar pace to the previous two quarters. Business investment was the only source of strength, while net exports were weak.

• The economy gained 34,300 jobs in August, fully offsetting the 30,400 jobs lost in July. However, all of the gains came in part-time employment, while full-time jobs were down 12,500 on the month. The unemployment rate held steady at 7.3% because of a slight rise in the participation rate.



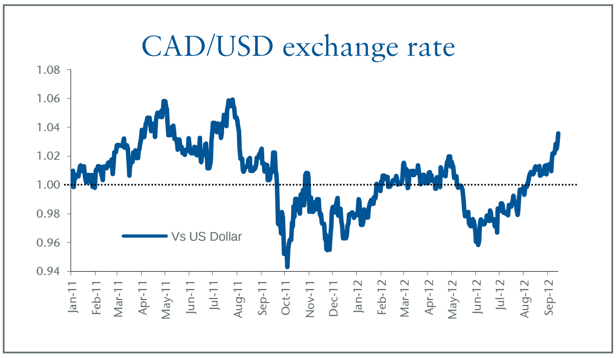
• Inflationary pressures remain benign. Annual headline CPI inflation fell from 1.5% in June to 1.3% in July. Core annual CPI inflation declined from 2% to 1.7% in July, below the BoC's 2% inflation target.

• At its September meeting, the BoC noted that core CPI inflation has been a "little softer than expected in recent months". Even so, the central banks expects core inflation to return to the 2% target around mid-2013.



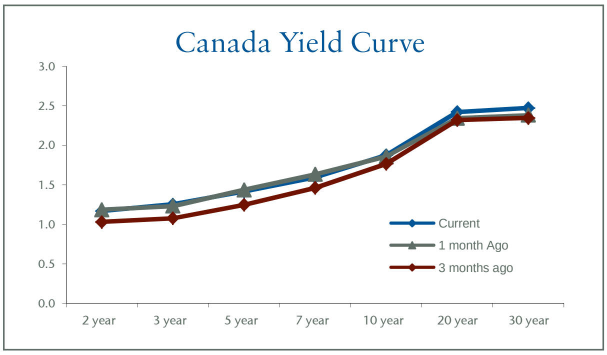
• The loonie has appreciated sharply in the past few months, especially in the first two weeks of September. At $1.036, the loonie is at its strongest level in more than a year.

• The combination of U.S. Federal Reserve monetary easing and the BoC's tightening bias has been the key upward driver of the loonie. Declining commodity prices, however, would present some downside risk to the Canadian dollar.



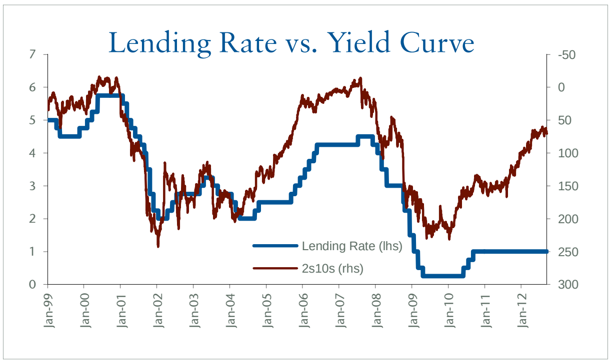
• Part of the Canadian yield curve has shifted slightly higher over the past month. The curve has steepened as the long-end has risen the most. Indeed, while 2-year yields have fallen a couple of basis points, 10-year yields have risen 2 basis points and 30-year yields are up almost 10 basis points.

• In a rising rate environment, Canadian bonds tend to outperform U.S. Treasuries - this month is no exception to that rule.



• While the BoC appears happy to rest on the side-lines for the time being, their next move for policy rates is likely to be up. The OIS market is currently pricing in nearly a 40% chance of a 25 basis point hike by next spring.

• Certainly, providing external risk factors continue to ease in the months ahead, the domestic economy may soon justify monetary tightening.



Expectations

• The Bank of Canada has decided not to jump on the central bank easing bandwagon. While the U.S. Federal Reserve and European Central Bank are providing more monetary support, and the Bank of England looks posed to add further stimulus in the coming months, the BoC has steadfastly kept policy unchanged. Furthermore, it has maintained a tightening bias.

• Of course, a deterioration in the external environment - tensions in Europe and a renewed slowdown in the U.S. - could change the policy rate outlook. Ultimately, however, the level of policy accommodation is still very high. Therefore, a stabilisation in external risk may be sufficient to prompt the Bank of Canada to start hiking policy rates gradually.