Central Bank Watch

May 13, 2013

Note: Unless otherwise indicated all data in this document is sourced from Bloomberg as of 5/13/13

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	0.27	0.25	0.26
10 Year Treasury Yield	1.89	2.03	1.59	1.84
Treasury Yield curve	1.66	1.75	1.34	1.58
Core PCE	1.13	1.43	1.54	1.96

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

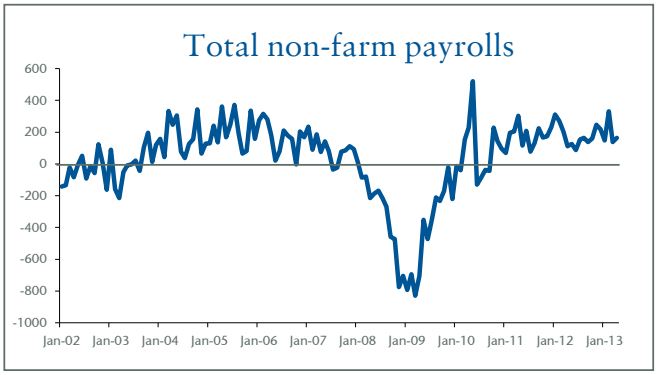
• The Federal Open Market Committee (FOMC) held the Federal Funds Target Rate at 0.25% at its 1 May meeting, while it will continue its asset purchase program of $85 billion per month ($45 billion per month of Treasury purchases and $40 billion of MBS purchases).

• The FOMC's statement accompanying its May policy decision was marginally more dovish than the March statement. The key notable change to the statement was the phrase "the Committee is prepared to increase or reduce the pace of its purchases to maintain appropriate policy accommodation as the outlook for the labour market or inflation changes". This appears to be an admission that the economic activity, labour markets, and inflation have all softened recently. Nonetheless, the FOMC's description of the economy was slightly more hawkish than expected.

• The first estimate of Q1 GDP shows that the economy grew 2.5% (annualised) quarter-on-quarter. Timelier data suggest that the economy slowed towards the end of the quarter.

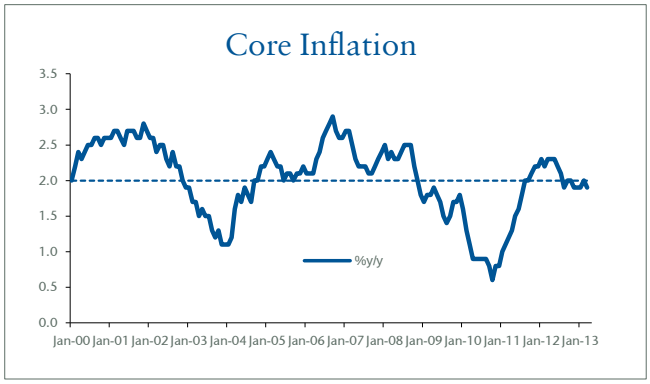
• Durable goods orders fell 5.7% in March. The manufacturing Purchasing Managers Index (PMI) fell from 54.6 to 52.1 in April, while the Institute of Supply Management (ISM) manufacturing index dropped from 51.3 to 50.7 over the same period. Meanwhile, spending growth was stronger than expected in March.

• The April jobs report came in a little better than expected, and a lot better than feared. Non-farm payrolls increased 165,000, with strong upward revisions to prior months. The unemployment rate fell from 7.6% to 7.5%, this time with the participation rate stable.



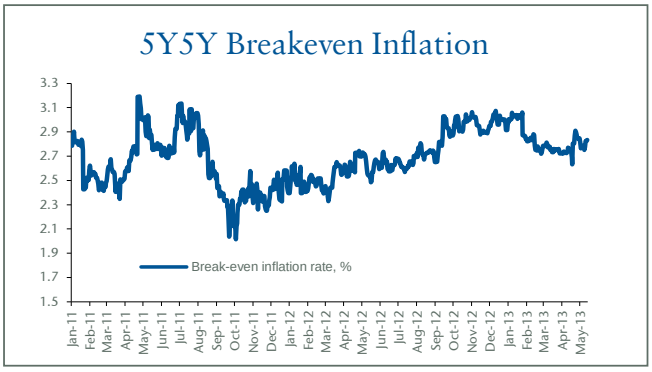
• The FOMC now sees labour markets as having shown signs of improvement only "on balance". Following the solid April payrolls report, jobless claims paint a picture of continuing improvement.

• Annual core Consumer Price Index (CP)I inflation dipped from 2% in February to 1.9% in March. The annual core Personal Consumption Expenditures (PCE) inflation rate, the Fed's preferred measure of inflation, fell further to just 1.1%, well below the Fed's 2% target and near multi-decade lows.
• The FOMC statement still asserted that "the Committee anticipates that inflation over the medium term, likely, will run at or below its 2% objective", choosing not to highlight the recent deflationary trends.



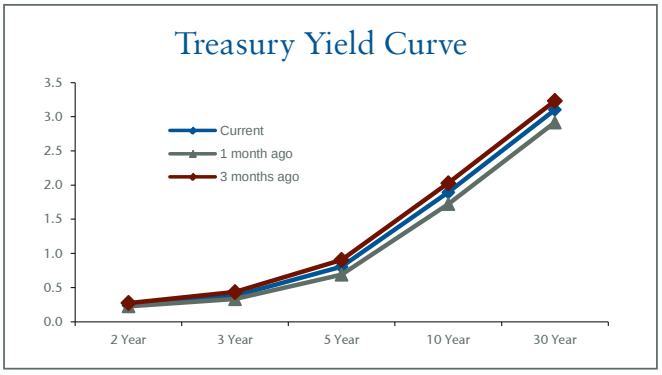
• Yet, the FOMC must be concerned about declining inflation - it specifically noted the possibility of varying the pace of purchases if the "the outlook for the labour market or inflation changes".

• Generally, though, market-based measures of expected inflation do not pose any concern. Five-year breakeven inflation rates, a measure of inflation expectations, have been broadly consistent at around 2.6% to 2.7% since January.



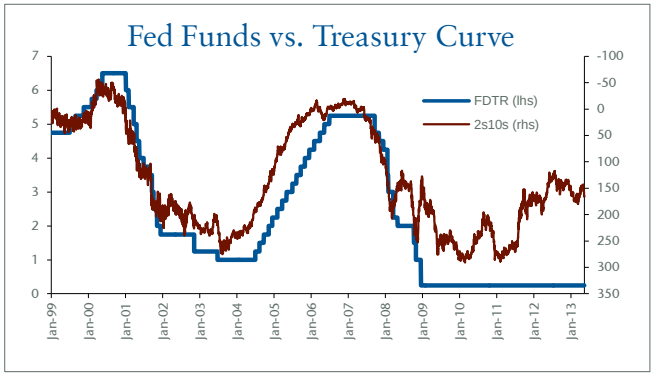
• Over the month, the Treasury yield curve has shifted significantly higher, with much of the upward move taking place in the past week. Ten-year yields reached a 5-month low of 1.62% on 1 May, before surging to 1.92% on 10 May.

• Disappointing U.S. economic data and global central bank easing had driven Treasury yields lower, but stronger labour market data reversed the move. The 10-year rate is 17 basis points higher than a month ago.



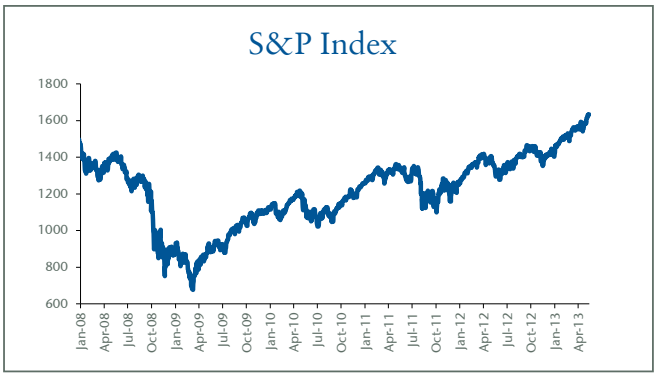
• Although the FOMC's latest statement was fairly neutral on its assessment of the economy, it did indicate that it is willing to vary the pace of purchases if the labour market outlook or inflation outlook deteriorate.

• However, the strong April payroll numbers have prompted perceptions of a stronger U.S. labour market, triggering a large one-week sell-off. If this improvement is maintained, the Fed may announce a tapering off of Fed asset purchases before the end of the year.



• Equity markets have continued to rise, posting new cycle highs. Better economic data (mainly U.S. payroll numbers) induced a sharp rise in equities in the first half of May. Cyclical sectors have performed the best, feeding off the perception that global growth is picking up.

• To continue this outperformance, a sustained run of stronger economic data, particularly in manufacturing, will be required.



Expectations

• U.S. economic data have been mixed over the past month. First quarter GDP growth came in weaker than expected, the ISM and PMI manufacturing surveys disappointed, durable goods orders declined sharply, retail sales slowed, and inflation continued to move further below the Fed's 2% target. On the other hand, the labour market report for April surprised strongly to the upside, and was further supported by better than expected jobless claims numbers. Meanwhile, the housing market continues to be a positive spot for the U.S. economy, .

• Unsurprisingly then, the earlier softness in data (characterised by the weaker manufacturing reports and disappointing March jobs report) did not trigger a meaningful change in the FOMC's characterisation of the economic outlook. The FOMC described the jobs report as having "shown some improvement, on balance". Similarly, although inflation has fallen close to multi-decade lows and Fed officials have expressed some concern about the risks of an inflation undershoot, the FOMC simply noted that it "anticipates that inflation over the medium term, likely, will run at or below its 2% objective" - the same phrase it used in both the January and March statements. The Committee was, however, more definitive in its description of fiscal policy, saying that it was "restraining growth".

• The FOMC did show some caution in its latest statement. It indicated that it is prepared to increase or reduce the pace of purchases depending on the state of the labour market and inflation. While this does not suggest a near-term policy bias in either direction, the inclusion of this new sentence does suggest that the FOMC recognises the deflationary risks facing the U.S. economy.

• The earlier fall in U.S. Treasury yields to the low 1.60s reflected the apparent softness in the economy and reinforced expectations that the Fed will maintain its asset purchases through the entire remainder of 2013. Arguably, then, the latest surge in yields is built on somewhat fragile ground. After all, it was just the strong April labour market report, coupled with slightly stronger German data and hawkish comments from a typically dovish FOMC member, that pushed 10-year yields from 1.62% to 1.92% in the space of 10 days. Certainly, if the stronger run of data is sustained, indicating a recovery in global growth, U.S. Treasury yields may rise higher. What's more, if the FOMC responds by tapering off Fed asset purchases well before the end of the year, Treasury yields are likely to surge sharply higher.

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	0.31	0.36	0.26	0.40
10 Year Gilt Yield	1.88	2.21	1.71	1.96
Gilt Yield Curve	1.57	1.85	1.45	1.56
CPI	2.80	2.70	2.20	3.50

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%.

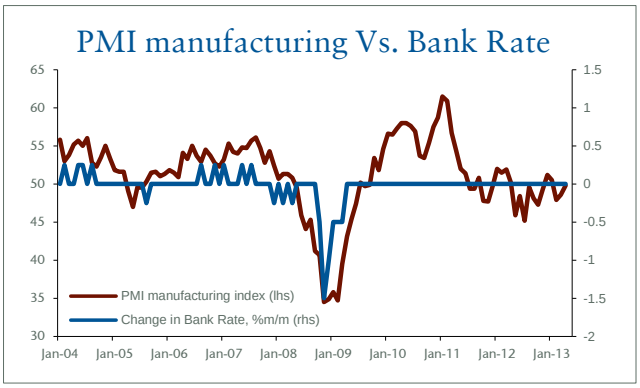
Current Policy

• The Monetary Policy Committee (MPC) decided to hold the Bank Rate at 50 basis points at its 9 May meeting, and also chose to keep the size of its bond purchase plan unchanged at £375 billion.

• The minutes of the April MPC meeting showed a 6-3 vote to keep quantitative easing unchanged, with the three dissenters voting for a £25 billion expansion in the asset purchase program. Several members of the MPC do think that further quantitative easing is the correct tool to use given that "policy was highly stimulatory and the benefit of past actions would continue to be felt". As a result, at the May meeting, the MPC was likely divided over the need for further stimulus. In the end, however, the better run of economic data recently persuaded the majority of the MPC to remain on 'wait and see' mode.

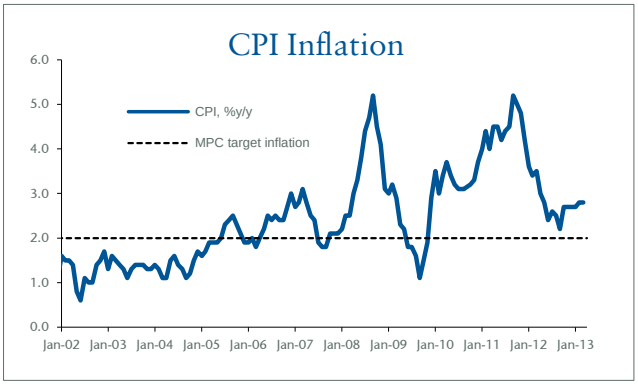
• According to the preliminary estimate, UK GDP rose 0.3% quarter-on-quarter in Q1, beating expectations for stagnation or even a mild contraction. Services were the key driver of growth, rising 0.6% over the quarter.

• Timelier data also suggest an upturn in activity recently. Industrial production rose 0.7% month-on-month in March, up 1.7% since January. The manufacturing PMI rose 1.2 points to 49.8 in April, while the services PMI rose from 52.4 in March to 52.9, the fourth consecutive monthly increase.

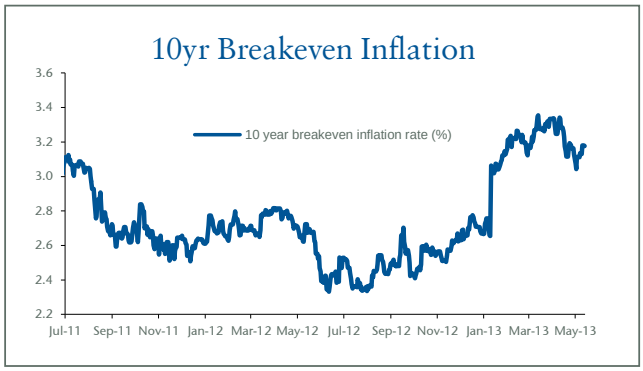


• Annual headline CPI inflation remained unchanged at 2.8% in March, its highest level for nine months and above the Bank of England's 2% inflation target. Core CPI rose from 2.3% to 2.4%.

• While CPI inflation may continue to rise and exceed 3% in the coming months as a result of the fall in sterling earlier this year, the recent drop in commodities and sluggishness in regular pay growth may have created more room for the MPC to manoeuvre.

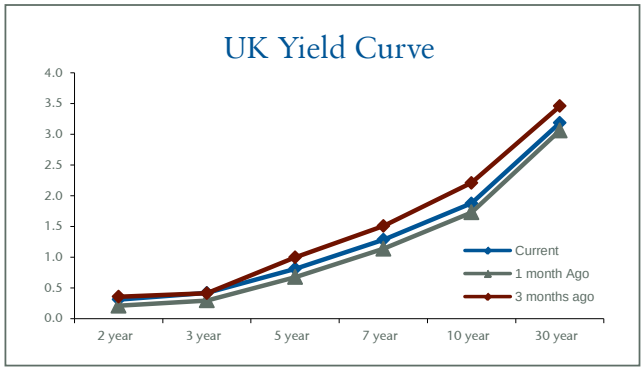


• Despite talk of further asset purchases and greater flexibility in the MPC's inflation remit, Inflation expectations have eased slightly over the past few months. Breakeven inflation, a financial market measure of inflation expectations, has fallen from 3.3% in mid-March to around 3.1% in early May. However, that is still above the 2% inflation target, suggesting that the MPC will still be cautious with regards to introducing more monetary stimulus.



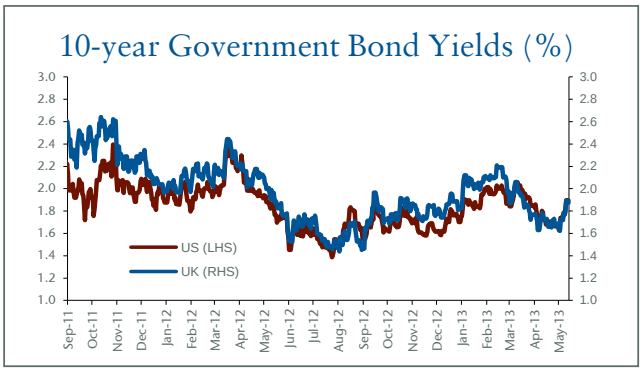
• The gilt yield curve has shifted higher over the past month. Ten-year gilt yields rose almost 15 basis points over the month. Both the short end and long end rose by around 10 basis points.

• The past month has seen significant volatility in yields. Ten-year gilt yields fell to a low of 1.62% on 2 May, before rising sharply to almost 1.9% on 10 May. The stronger run of UK economic data is putting upward pressure on yields.



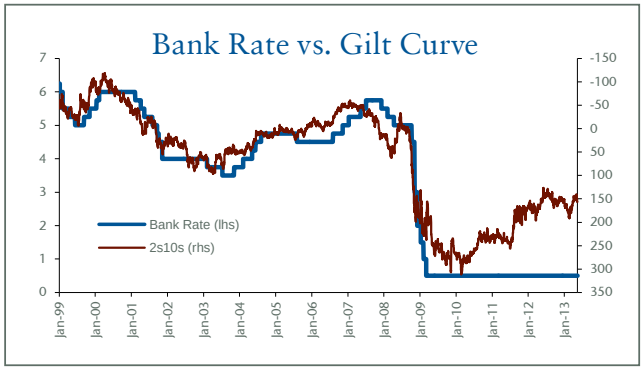
• However, the sharp upward correction in gilt yields in early May stemmed from stronger U.S. labour market data. Indeed, U.S. Treasury and UK gilt yields have moved in lock-step in recent weeks.

• Looking ahead, the evolution of the global economy is likely to determine the strength and sustainability of the UK's economic recovery. As a result, gilt yields are likely to remain strongly correlated to U.S. Treasury yields.



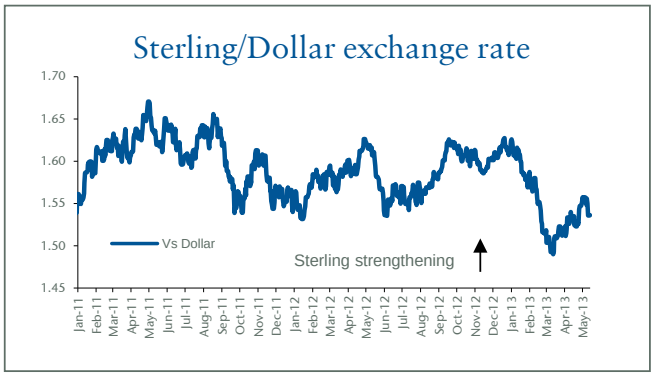
• The improved recent data flow has convinced the MPC to keep policy on hold - for now. However, the recovery is not well established and a return to weakness could yet see further asset purchases ahead.

• By contrast, a firming of the global recovery would see the UK strengthening. With 10-year gilt yields still below 2%, there is strong upward pressure and a continued improvement in economic activity would likely result in a sharp shift higher in yields.



• Since falling below $1.50 in March, sterling has resumed a strengthening trend, rising to $1.55 in early May as it became clear that the Cyprus crisis had failed to trigger significant contagion to other peripheral banking systems.

• A sustained run of stronger economic data and expectation that policy will not be eased further should serve to strengthen sterling further, or at least keep it broadly stable.



Expectations

• The UK is enjoying an upturn in activity. GDP growth in Q1 surprised to the upside, while the important PMI surveys suggest that the recovery has continued into the second quarter. In addition, bank funding conditions have improved materially, particularly for households and consumers. Unsurprisingly then, the MPC decided to remain in wait and see mode, keeping monetary policy unchanged at the latest meeting in May.

• Recent meetings had suggested that the MPC was strongly considering introducing further stimulus, and certainly the update to the MPC's remit had given it a green light to tolerate above-target inflation for longer. It is possible that several members of the MPC are cautious of the recent upturn and could yet vote for further asset purchases in the coming months if momentum in economic activity fails to gather pace.

• Certainly, there is likely to be a significant shift in the Bank of England's policy stance once Mark Carney arrives in July as the new Bank of England Governor. Carney is in favour of introducing Fed-style intermediate thresholds to strengthen policy guidance and the MPC will be providing an assessment of the merits of such a policy. Either way, there is likely to be greater "activism" under Carney, so additional unconventional policy measures could be on their way later this year.

•One unconventional policy measure that the Bank of England has already introduced and hopes to be a success is the Funding for Lending Scheme (FLS). The Bank of England announced an extension to the FLS in April. The drawdown period has been increased to the end of January 2015 and the scheme is more targeted towards increased lending to small and medium-sized enterprises (SMEs). With the FLS now designed to offer more incentives for lenders to ease credit conditions to SMEs, its success will depend on the demand for credit from SMEs. The impact on the real economy may be slow and take some considerable time to work through. In terms of monetary policy action, the MPC may decide that the extension to the FLS is sufficient for now, reducing the need for further asset purchases in the coming months.

European Central Bank (ECB)

INDICATOR	CURRENT	3-MONTHS AGO	6-MONTHS AGO	12-MONTHS AGO
ECB Refi Rate	0.50	0.75	0.75	1.00
2 Year Yield	0.02	0.22	-0.03	0.09
10 Year Yield	1.35	1.67	1.34	1.52
Eurozone Yield Curve	1.33	1.45	1.37	1.43
HICP	2.40	2.20	2.60	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.

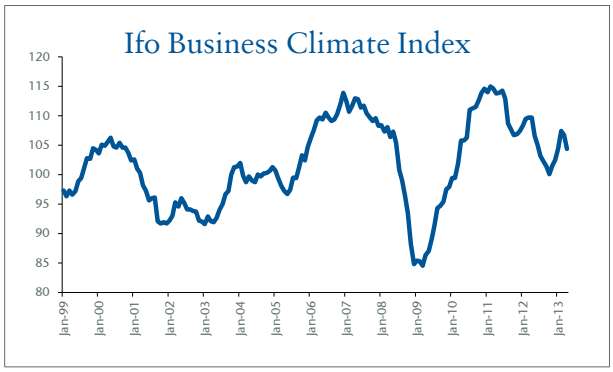
Current Policy

• The ECB lowered the official policy rate from 0.75% to a record low of 0.50% at the 2 May meeting. The marginal lending facility was cut by 50 basis points to 1%, but the deposit rate was left unchanged at zero. The ECB also extended the full allotment of liquidity to banks at its regular refinancing operations until at least mid-2014. Finally, the ECB announced that it would start consultations with other European insitutions on initatives to kick-start the market for asset-backed securities.

• ECB President Draghi noted that there was a "prevailing consensus" for cutting rates by 25 basis points, indicating that there were some members who preferred a larger rate cut. Significantly, Draghi also opened the door to cutting the deposit rate into negative territory, saying that the Governing Council would look at this with "an open mind" and that the ECB was now in a position to cope with any potential negative side effects.

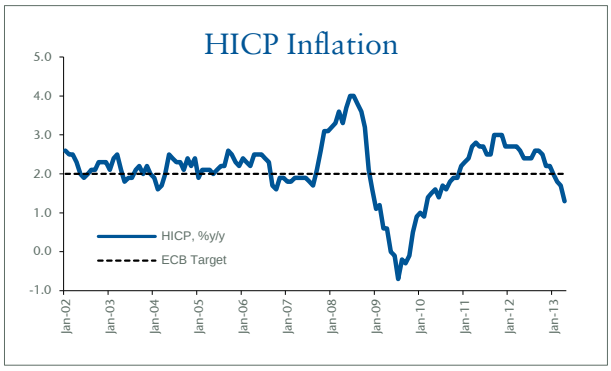
• Concerns have continued to build that peripheral weakness is spreading to the core. While the euro area composite PMI rose marginally from 46.5 to 46.9 in April, the German composite PMI dropped from 50.7 to 49.2. The French PMI remained under 45, albeit slightly higher than in the previous month, while the Italian and Spanish PMIs remained below 50 (46.6 and 44 respectively).

• The German Ifo Business Climate Index fell from 106.7 in March to 104.4 in April.



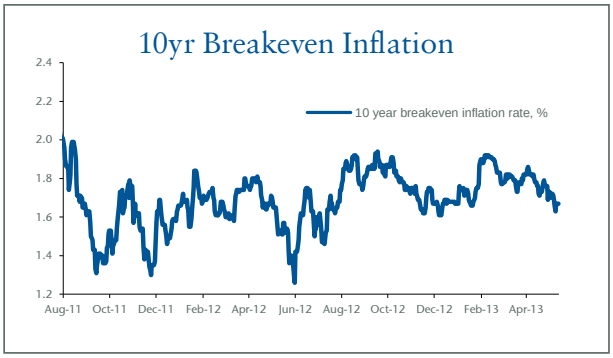
• According to the flash estimate, annual headline Harmonized Index of Consumer Prices (HICP) inflation fell sharply from 1.7% in March to 1.2% in April. It appears that part of this move down is temporary and related to a seasonal factor in Germany.

• However, euro area core inflation appears to have an underlying downward trend and inflation is likely to end the year well below the ECB's 2% target. This inflation undershoot was a key driver behind the ECB's decision to cut the main refinancing rate.



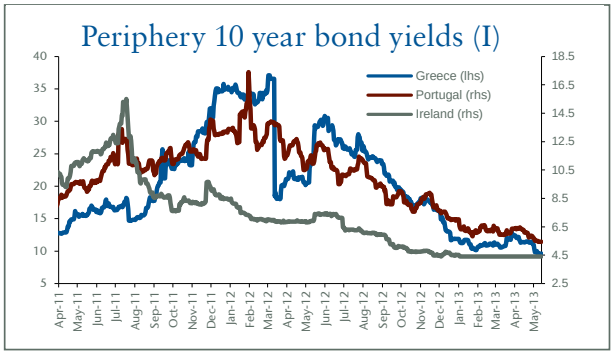
• Further deflationary pressures may need to be seen before the ECB cuts rates further. The ECB continues to believe that inflationary expectations are firmly anchored at rates consistent with the ECB's objective.

• In fact, breakeven inflation rates, a financial measure of inflation expectations, have fallen from 1.9% in February to around 1.7% in early May. If economic activity continues to soften, infaltionary expectations may weaken further.



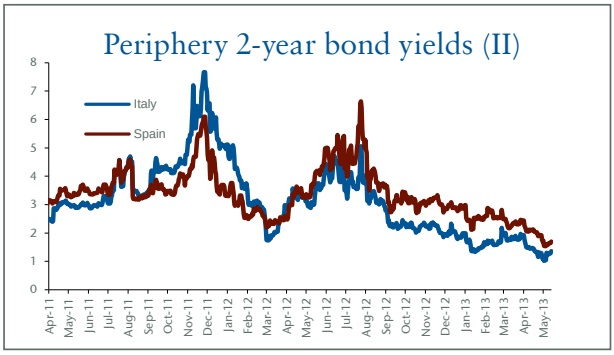
• Market calm returned as Cyprus was granted a bailout. Peripheral yields declined, aided by a loosening of fiscal targets for many euro area countries.

• Portugal sold €3 billion of 10-year bonds in its first issuance since it requested European Financial Stability Facility (EFSF) aid two years ago. The issuance was several times over-subscribed, with foreign investors representing 86% of the demand. It was an important step forward in Portugal's attempt to return to the market.



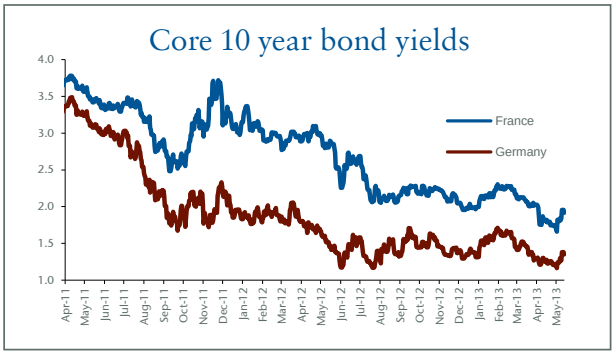
• Peripheral yields continued to rally sharply, largely driven by positive political progress and expectations of monetary easing.

• In Italy, the election process has finally come to a close. The re-election of Napolitano as President opened the door to the formation of a grand coalition government, with former centre-left deputy leader Enrico Letta being invited to form a government. This newly formed government, made up of both the Left and the Right, has won the necessary confidence votes.



• French bond yields declined further over the past month, falling to new record lows. Speculation of a Japanese investor shift to foreign bonds following the Bank of Japan's announcement of a massive monetary stimulus plan has driven French yields (and Spanish and Irish yields) lower.

• Ten-year German yields fell below 1.20% following the ECB's decision to cut its official policy rate (before rising to almost 1.40% by 10 May).

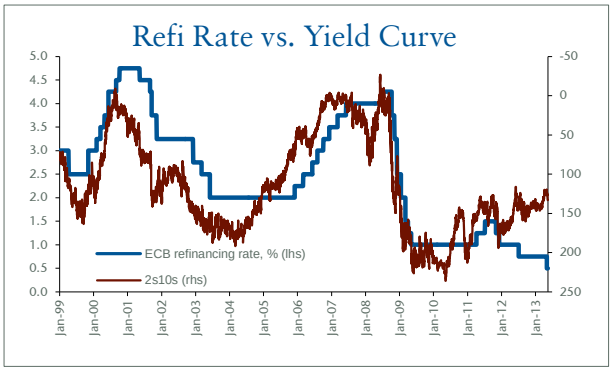


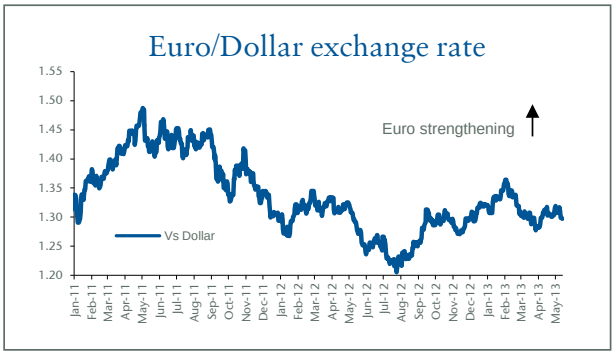
• The ECB's decision to cut its main refinancing rate to 0.5% has set a lower ceiling on the effective overnight interest rate (Eonia). As a result, Eonia will rise less as banks repay their longer-term refinancing operation borrowings and the level of excess liquidity diminishes. It will also lower the cost of ECB borrowings for peripheral banks.

• The ECB continues to expect an economic recovery later this year, but if this does not materialise, the ECB may need to provide more stimulus to the economy. A further cut in the official policy rate is unlikely, but a cut to the deposit rate is certainly an option.

• After falling below $1.30 in early April, the euro made a slight recovery, reaching $1.32 in early May (before falling back below $1.30).

• While it is questionable what the impact of a negative deposit rate would have on the behaviour of core banks, the impact on currency markets would likely be more significant. Indeed, the ECB's original decision to cut the deposit rate to zero produced a sharp depreciation of the euro.





Expectations

• Against the backdrop of low growth and a significant inflation undershoot, the ECB finally decided to introduce more monetary stimulus. It is easy to argue that the ECB's policy stance was inappropriate. Over the past year, the ECB has revised down its GDP growth forecast by 2% and it has questioned the speed of recovery. Furthermore, the ECB now expects inflation of just 1.3% in 2014, well below its 2% target. Unlike other central banks around the world which are willing to take on more inflation risk in order to boost growth, the ECB has been taking on more growth risk to bring down inflation.

• It is questionable whether the 0.25% cut in the official policy rate will improve the euro area's economic outlook. Although it has improved, fragmentation continues to plague the region so peripheral countries are unlikely to feel the full benefit of the policy cut. As a result, further policy measures are still necessary.

• One possibility is a negative deposit rate. ECB President Draghi indicated that the door to this option is open, sounding more enthusiastic than he had previously. Such action would bring market rates down, easing funding conditions for some banks, although it is unlikely to lead to a significant revival of the interbank lending market. Perhaps the greatest impact would be on the currency market. As the ECB would be showing that it is willing to introduce extraordinary measures if necessary, it could be viewed as one of the more aggressive and pro-active central banks and this would weaken the euro.

• However, Draghi also reiterated that there could be several unintended consequences and in the last few days, other ECB Governing Council members have voiced their concerns about a cut in the deposit rate. As a result, the ECB is unlikely to embrace this option easily and the economy needs to deteriorate significantly from here before this option is seriously considrered. Meanwhile, the ECB is also beginning consultations for dealing with the problem of lackluster lending to SMEs. However, it has asked governments and the European Investment Bank to take the lead, suggesting that the ECB is reluctant to get too involved.

• Finally, this month has seen a signifant shift in the austerity versus growth argument. New Italian Prime Minister Letta pushed the discussion forward, arguing for an end to the focus on austerity. Market reaction to this discussion was positive. Italian yields have fallen over the past month, suggesting that the market is finally more focused on the growth outlook rather than on the fiscal outlook.

Bank of Japan (BOJ)

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	0.12	0.03	0.10	0.11
10 Year Govt. Bond	0.75	0.75	0.74	0.85
JGB Yield Curve	0.64	0.72	0.64	0.75
CPI	-0.90	-0.10	-0.30	0.50

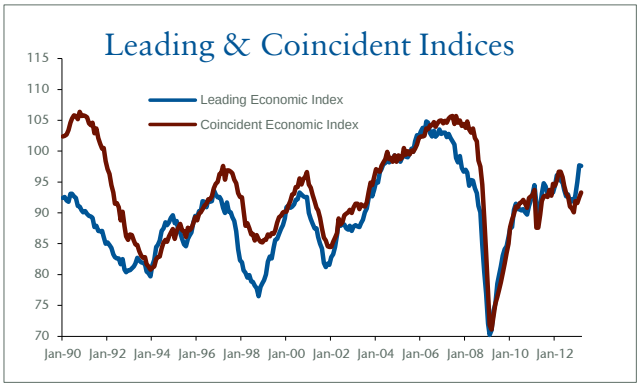
The BOJ has a mandate to maintain price stability.
It has an explicit inflation goal of 2% , to be achieved "at the earliest possible time"

Current Policy

• The BOJ kept policy unchanged at its 26 April meeting, having announced significant new policy measures at its 4 April meeting.

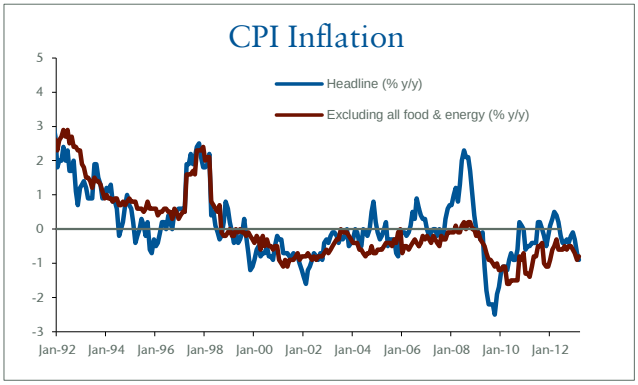
• After having introduced a new 2% inflation target to be reached within two years and a decision to double the monetary base by the end of 2014, the BOJ was not expected to take any action at the latest meeting. Instead, the focus of this meeting was the semi-annual Outlook Report which showed the consensus outlook of the board members for the economy and inflation. The BOJ expects inflation to reach 1.9% in fiscal year 2015, however there were two members that expect inflation to be below 1%. The BOJ also expects GDP growth of 2.2% in financial years 2014 and 2015 - considerably more optimistic than the market consensus forecast of 1.3%.

• GDP growth picked up strongly in Q1, although data for March and April were slightly softer than expected. Industrial production disappointed in March and the manufacturers' output projection looks for a contraction in May after a decent gain in April. The manufacturing PMI rose to 51.1 in April, its highest level since March last year. Retail sales and core household spending fell in March, indicating some cooling in consumption.



• Labour markets show some improvement, although wages remained subdued in Q1.

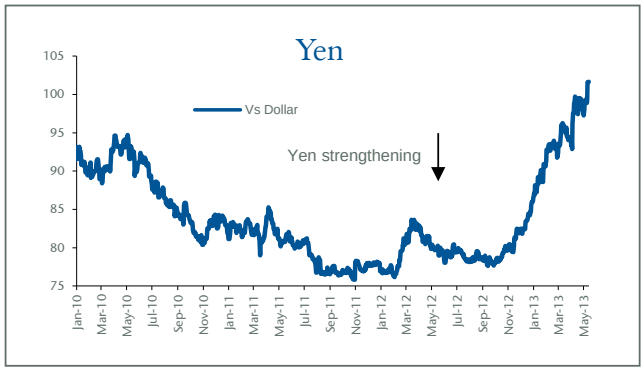
• Headline CPI inflation fell from -0.7% year-on-year in February to -0.9% in March. The core annual inflation rate (excluding food and energy) rose marginally from -0.9% to -0.8% over the same period.



• The BOJ expects inflation to hit 0.7% in 2013 and 1.4% in 2014 - more optimistic than the market consensus, which expects inflation of 0.3% and 0.5% in 2013 and 2014, respectively. Furthermore, the market does not expect the 2% target to be met in the two-year timeframe (i.e. by early 2015).

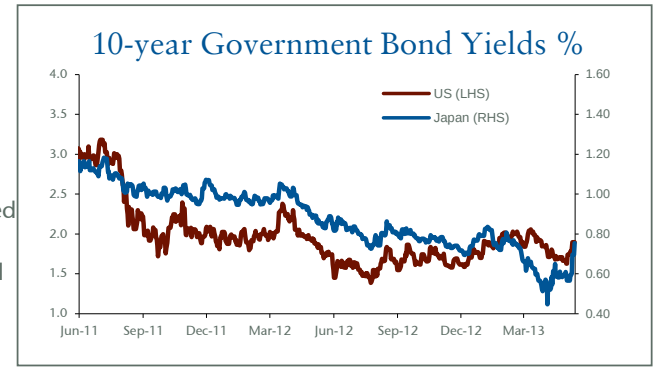
• The yen has continued to strengthen since the 4 April BOJ meeting, pushing above ¥100 against the U.S. dollar on 10 May for the first time since April 2009. Japan's Ministry of Finance weekly portfolio data showed Japanese investors were net buyers of foreign bonds in the two-week period from 22 April to 3 May, with a total of JPY510 billion.

• Expectations of further monetary stimulus later this year should serve to weaken the yen further.



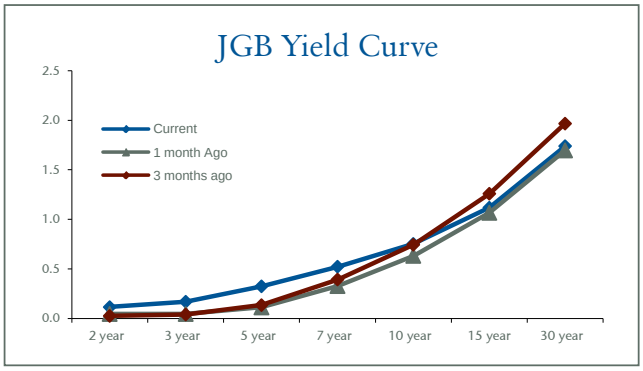
• Japanese government bond yields have risen sharply over the past month. While 10-year Japanese government bonds have risen 14 basis points, 10-year U.S. Treasurys have risen 17 basis points.

• The rise in Japanese government bond yields has come despite the heavy BOJ purchases and subdued inflation, suggesting that the economic rebound may have some part to play. In addition, the global economic recovery has driven global bond yields higher in the past week, adding further upward pressure to Japanese government bonds.



• While 10-year Japanese government bond yields have risen 14 basis points, 30-year yields haven risen a tremendous 20 basis points over the past month. Two-year yields are broadly unchanged but slightly lower.

• Short-term to medium-term yields may decline in the coming months if the BOJ decides to introduce more monetary stimulus. However, yields at the longer end may rise further if inflation expectations increase (as BOJ Governor Kuroda expects).



Expectations

• The BOJ's growth and inflation projections are more optimistic than the market consensus. For example, while the market consensus expects growth of 1.3% over the next two years, the central bank expects GDP growth of 2.2%. More significantly, while the BOJ expects to meet its 2% inflation target within a two-year horizon, the market consensus is notably more skeptical. The main difference between the BOJ and market consensus is that the consensus expects the hit from the 3% increase in consumption tax (scheduled to take place in April 2014) to be greater than the BOJ has assumed. In addition, the consensus believes that wage and price inflation will rise more slowly as expectations are slow to adjust.

• BOJ Governor Kuroda believes that the central bank has done "everything it can" to achieve the 2% target. However, if the consensus is correct, the recently introduced monetary stimulus is still not sufficient. The BOJ revises its forecast every quarter, suggesting that there could be forecast downgrades in October and even further monetary easing.

Bank of Canada (BoC)

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	1.01	1.11	1.08	1.24
10 Year Bond Yield	1.89	1.96	1.72	1.99
Canada Yield Curve	0.88	0.85	0.63	0.75
Core CPI	1.40	1.10	1.30	1.90

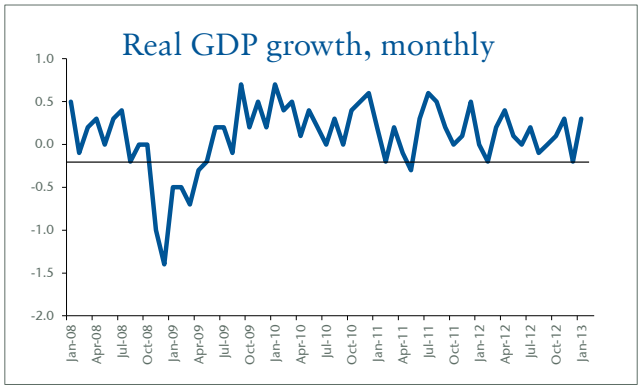
The Bank of Canada has a mandate to maintain price stability.
It has a symmetric inflation target of 2%, plus or minus 1%.

Current Policy

• The BoC left its key policy rate unchanged at 1% at its 17 April meeting. Rates have remained on hold since October 2010.

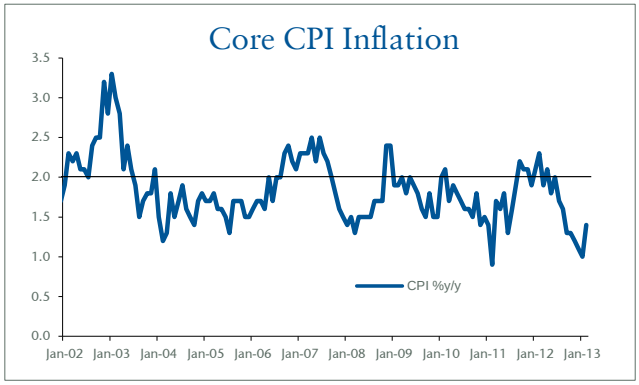
• In its latest statement, the BoC noted that global tail risks have diminished and global financial conditions have eased. Although it made only minor adjustments to its global GDP outlook, the BoC downgraded its Canadian GDP growth for 2013 from 2% to a sub-par 1.5%. It also expects inflation to remain below the 2% target until mid 2015, longer than it previously forecasted. Given the weaker economic outlook, the BoC repeated its comment that "the considerable monetary policy stimulus currently in place will likely remain appropriate for a period of time".

• The Canadian economy grew 0.3% month-on-month in February, the same growth rate as January. Retail sales posted a stronger-than-expected gain in February. Employment disappointed in April, rising just 12,500 after a sharp loss of 54,500 in March. The unemployment rate remained unchanged at 7.2%.



• The BoC's weaker 2013 growth forecast is driven by subdued performance in the first three quarters of the year - it continues to expect GDP growth of 2.8% in Q4 of this year.

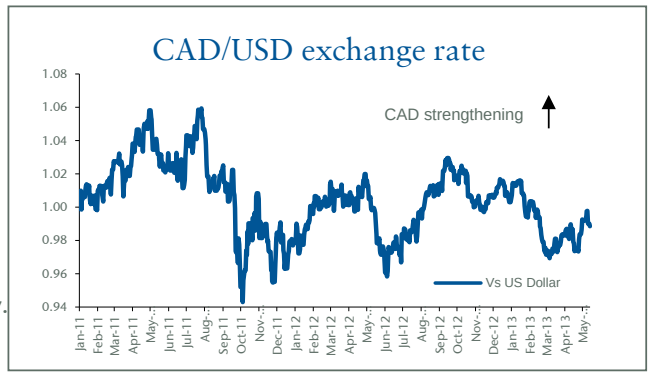
• Annual headline CPI inflation slowed from 1.2% in February to 1% in March. By contrast, core annual CPI was unchanged at 1.4%. Inflation remains at the lower end of the target band.



• The BoC now estimates that the economy will not return to full capacity until mid 2015, more than two quarters later than it had estimated in January. Accordingly, it sees inflation remaining below the 2% target for longer, not returning to target until mid 2015.

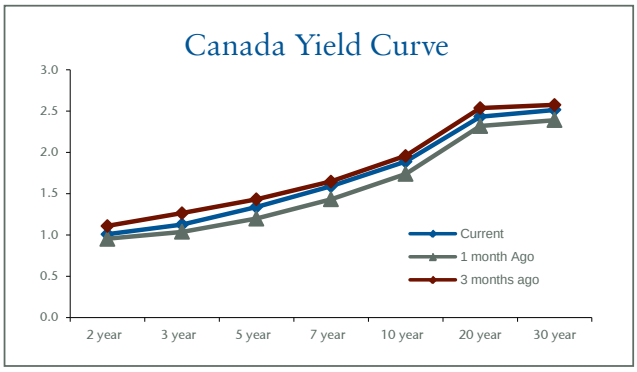
• The Canadian dollar has strengthened in recent weeks as firmer economic data surprised to the upside - but it remains below parity.

• Currently, the market is pricing in a small probability of a rate cut this year, putting downward pressure on the loonie. However, a strengthening U.S. economy should push rate expectations back up toward the end of the year, supporting the Canadian dollar to cross parity.



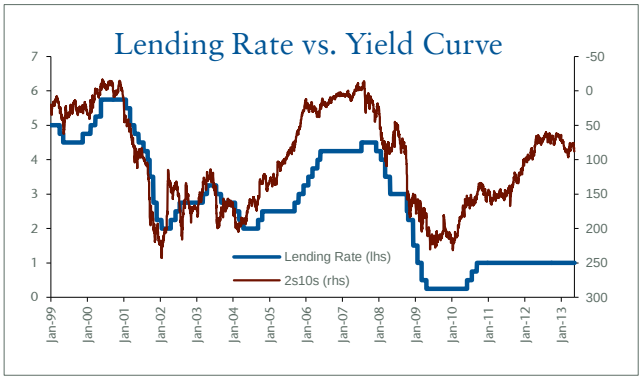
• The Canadian yield curve has shifted higher over the past month. While 2-year yields have increased 5 basis points, 10-year and 30-year yields have risen almost 15 basis points.

• Canadian government bonds have slightly outperformed U.S. Treasurys. The spread between Canada and the United States is close to zero currently, but if Treasurys continue to rise through the rest of the year, we would expect spreads to move into negative territory (U.S. yields higher than Canadian yields).



• The Bank of Canada seems a ways from hiking policy rates. Below-trend growth and an undershoot of the inflation target mean that current stimulus is considered "appropriate".

• However, the BoC has given no indication that it will be cutting rates. Despite the market pricing in a small probability of rate cuts this year, the central bank still believes that current stimulus is "considerable" and that "some modest withdrawal will likely to be required" eventually.



Expectations

• In an interview a few weeks ago, the outgoing BoC Governor Mark Carney said that three conditions need to be fulfilled before interest rates would be raised. First, the economy would need to grow at a rate faster than 2%, second, there would need to be a positive evolution of household debt and "aspects of the housing market", and finally, inflation would need to pick up "a little bit". With that in mind, rate hikes remain a ways off - but at least rate cuts do not seem likely in the foreseeable future.

• Stephen Poloz, President and Chief Executive Officer of Export Development Canada, who previously spent 14 years at the Bank of Canada, has been announced the successor to Mark Carney as BoC Governor. His views on monetary policy are little known, so there is some uncertainty with regards to how policy will move once he joins. Nonetheless, as BoC monetary policy tends to be consensus driven, his appointment may not have a significant impact on future policy. He has, however, commented several times on the adverse impact the strong Canadian dollar has had on Canadian exporters. On that basis, it is possible that he could add a more dovish angle to the central bank.

Reserve Bank of Australia (RBA)

INDICATOR	CURRENT	3-MONTHS AGO	6-MONTHS AGO	12-MONTHS AGO
RBA Target Cash Rate	2.75	3.00	3.25	3.75
2 Year Bond Yield	2.53	2.79	2.64	2.69
10 Year Bond Yield	3.25	3.51	3.06	3.29
Aussie Yield Curve	0.72	0.72	0.42	0.60
CPI	2.50	2.20	2.00	1.60

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.

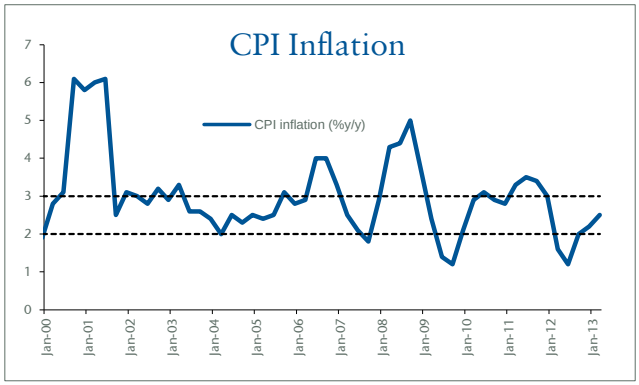
Current Policy

• The RBA cut the cash rate from 3% to a new record low of 2.75% at the 7 May meeting. Rates had previously been cut by 25 basis points at the December meeting.

• The RBA retained its easing bias at the latest meeting, assessing that lower-than-expected inflation had afforded it the flexibility to lower policy rates. It noted that "the inflation outlook would afford scope to ease further, should that be necessary to support demand. At today's meeting the Board decided to use some of that scope". Indeed, the RBA downgraded its inflation forecast, now expecting it to lie in the lower half of the target band over 2013. By contrast, its forecasts for global and domestic growth were little changed, even going so far as to say that "signs have emerged that the economy is responding" to low rates.

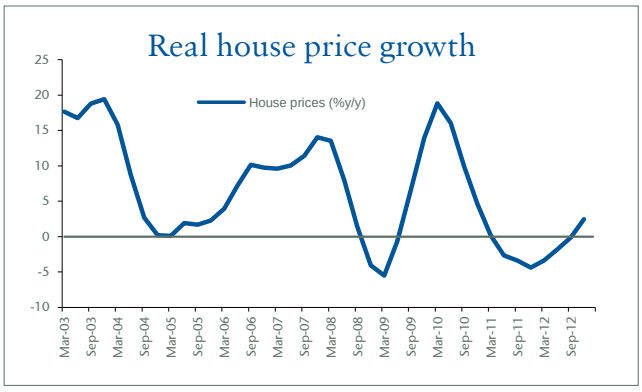
• The recent run of economic data has been weak. The manufacturing PMI dropped sharply in April, while growth in retail sales lost momentum through Q1. The RBA expects GDP growth of 3.25% in 2013.

• Headline CPI inflation rose just 0.4% quarter-on-quarter in Q1, and by 2.5% year-on-year, surprising to the downside. The RBA now expects CPI inflation of 2.25% in Q4 2013 - in the lower half of the RBA's target band over this period.



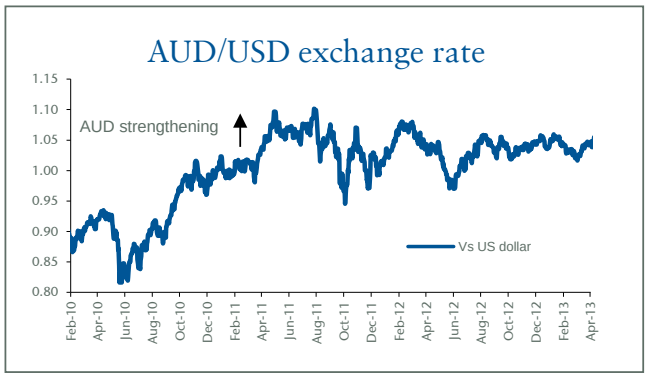
• Housing credit growth remains at multi-decade lows, with only modest price increases being recorded. House prices remain below their previous peak, while March building approvals data continue to disappoint.

• Job creation was much stronger than expected in April. The 50,100 gain more than offset the 30,000 loss in the previous month. Jobs growth was skewed to full-time positions. The unemployment rate fell from 5.6% to 5.5%, even with an increase in the participation rate.



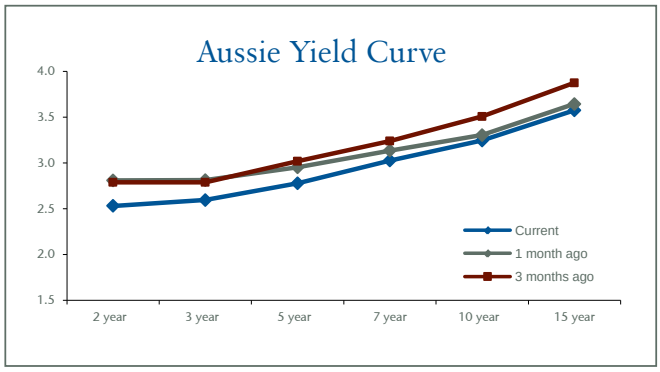
• The Australian dollar has remained broadly unchanged over the past few months, hovering between $1.02 and $1.04. The latest decision to cut policy rates failed to weaken the currency meaningfully.

• Even so, the Australian dollar was a key consideration for the policy outlook. Its strength has been weighing on economic activity and exacerbating deflationary pressures.



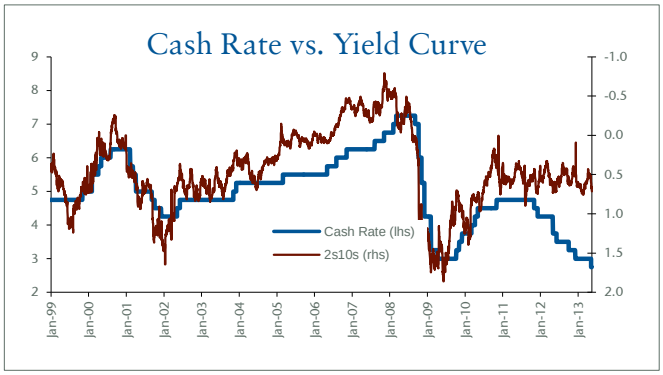
• In contrast to most other global bond curves, the Australian yield curve has shifted lower over the past month. Front-end yields have fallen some 25 basis points, while the 10-year point is down 6 basis points.

• The sharp rally at the front-end of the curve is down to the RBA's decision to lower policy rates, although downside economic surprises had already put significant downward pressure on yields.



• The market is pricing in a further 25 basis points of rate cuts. The RBA's latest statement suggests that while it retains an easing bias, there is no hurry to loosen monetary policy any further.

• Further downgrades to the inflation outlook later this year may be enough to convince the RBA to cut rates to 2.5%, although there appear to be no obvious data triggers that would motivate such a move.



Expectations

• The latest month has delivered downside surprises on the Australian economic data front. However, the RBA has barely changed its growth forecasts. Domestic GDP growth is still expected to remain below trend, at 2.75% in 2013, before accelerating in 2014. The RBA expects unemployment to move higher given that "employment has continued to grow more slowly than the labour force". Global growth forecasts are also little changed, although the composition of growth has shifted very slightly towards Japan and away from China.

• By contrast, the RBA lowered its inflation forecast notably. With inflation set to remain in the lower half of the RBA's target band over the horizon period, the RBA has retained an easing bias. Weak inflation motivated the latest cut in policy rates, and with growth struggling to pick up pace as mining-related activity slows and deflationary pressures are still a concern, the RBA may cut rates again later this year. However, there is no sense of urgency to ease policy again in the near term.

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