Central Bank Watch

July 14, 2011

Note: Unless otherwise indicated all data in this document is sourced from Bloomberg as of 07/12/11

Reserve Bank of Australia

INDICATOR	CURRENT	3-MONTHS AGO	6-MONTHS AGO	12-MONTHS AGO
RBA Target Cash Rate	4.75	4.75	4.75	4.50
2 Year Bond Yield	4.42	5.02	4.90	4.52
10 Year Bond Yield	4.94	5.62	5.52	5.12
Aussie Yield Curve	0.53	0.60	0.62	0.60
CPI	3.30	2.70	2.80	2.90

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.

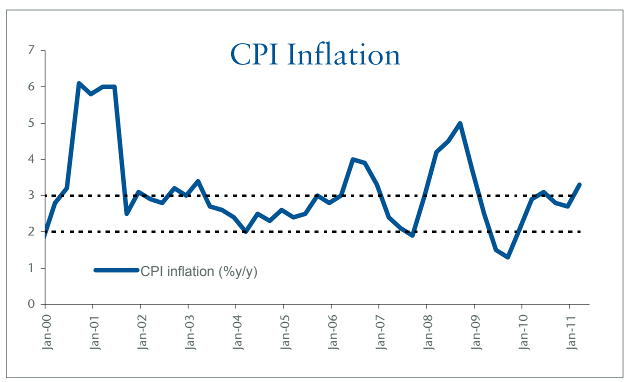
Current Policy

• The Reserve Bank of Australia (RBA) left interest rates on hold at 4.75% at the July 5th meeting. Rates have remained unchanged for eight consecutive months.

• The accompanying statement to the RBA most recent meeting in July was slightly more dovish. The RBA acknowledged the recent weakness in global activity and questioned whether the current "moderate pace of growth will continue". It also noted that the domestic growth forecast is conditional on "if the world economy grows as expected". Nonetheless, recent statements from the RBA have signaled that a further tightening in monetary policy would be necessary at some point.

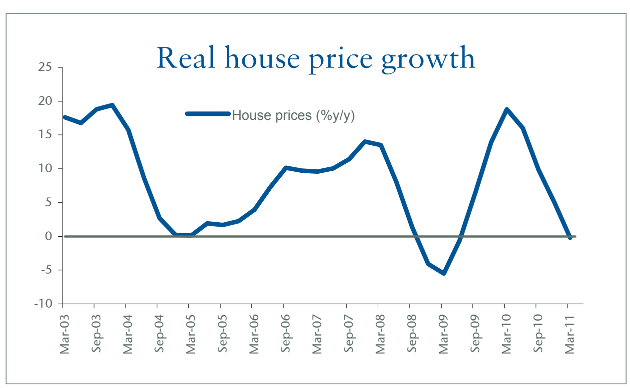
• Annual headline CPI increased from 2.7% in Q4 2010 to 3.3% in Q1 2011, and is now above the RBA's 3% target band ceiling. The RBA recently commented that the decline in underlying inflation looks to have runs its course, and a gradual rise is expected over the next couple of years.

• The RBA's expects underlying inflation to be around the top end of the target band (3%) by the end of 2011.



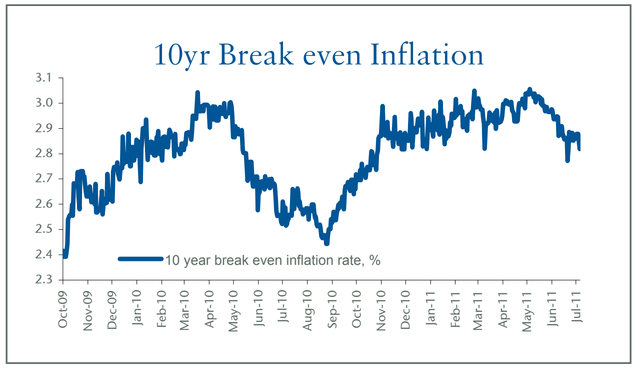
• House prices have continued to fall and there is now a clear downward drift in prices. Auction clearance rates and turnover have been low, while sentiment in the market is weak. Many analysts believe that the housing is still overvalued, indicating further price falls ahead.

• Retail sales fell sharply in May, highlighting the fragility of the consumer.



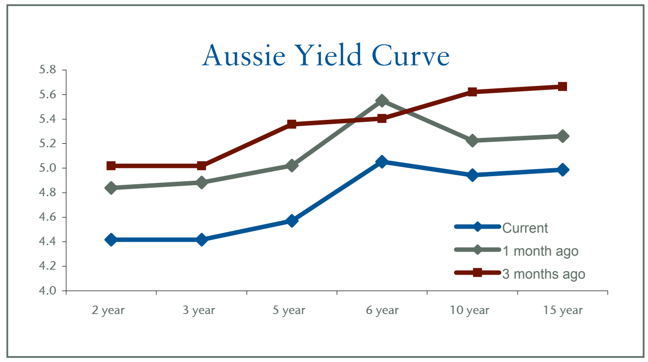
• Financial market measures of inflation expectations - breakevens - have dropped over the past few months.

• Employment rose strongly in June, reversing much of the decline of the previous two months. The unemployment rate remained unchanged at 4.9%. However, momentum in the labor market, and economy overall, is clearly ebbing.

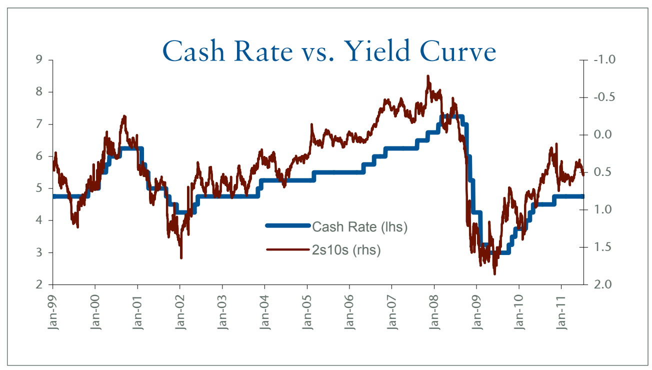


• The weak economic indicators in the past month and the RBA's slightly dovish tone have pushed down the Aussie yield curve. The slight slowing in global economic activity has also played a role.

• Whereas just a month or two ago, financial markets were expecting at least one rate hike this year, futures market pricing now implies an almost 50% probability of a rate cut this year.



• However, we think these expectations are over done. While the RBA may hike rates later than markets were expecting a few months ago, the onus is still on further policy tightening rather than loosening.



Expectations

• Australian economic data, like many other major developed markets recently, is showing signs of a slowdown. Indeed, with Japan one of Australia's key trading partners, it is little surprise that Australia has felt the impact of the earthquake related supply constraints. In addition, the housing market is slowed down significantly and is showing consistently falling house prices. The unemployment rate remains below 5%, but employment growth over the past quarter has been relatively weak.

• Yet, the Australian economy still appears to need tighter monetary policy. Underlying inflation is likely to rise in the coming years. While external developments in the U.S. and in the euro area may well take a toll on Aussie growth, policy tightening may still be required. In other words, while the urgency to raise interest rates further may have eased, it has not disappeared entirely.

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	0.36	0.74	0.60	0.65
10 Year Treasury Yield	2.88	3.49	3.37	3.06
Treasury Yield curve	2.52	2.75	2.76	2.41
Core PCE	1.20	0.90	0.80	1.50

The Fed has a dual mandate of fostering price stability and employment.
It has an informal inflation target of around 2%.

Current Policy

• The Federal Open Market Committee (FOMC) held the Federal Funds Target Rate at 0.25% at its 22 June meeting. The purchases of $600 billion of long-term Treasury securities was completed in June.

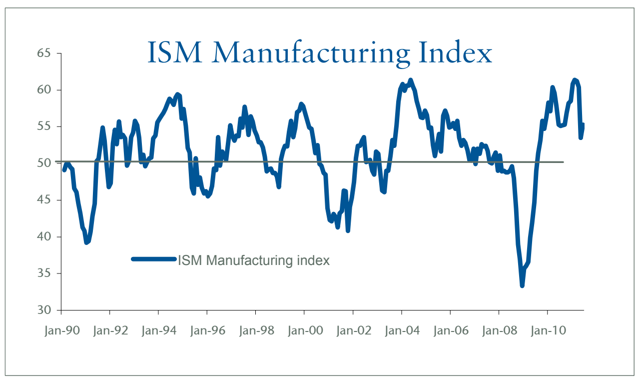
• The FOMC's post-meeting statement and press conference revealed that they believe there has been a deterioration in the growth/inflation trade-off. The Fed has revised down its expectations for GDP growth, whilst its inflation assessment is slightly more hawkish. During the post-meeting conference, when questioned on the possibility of QE3, Fed Governor Ben Bernanke commented that it is unlikely given the reduced deflationary risks. However, he also noted that, if required, other easing options exist.

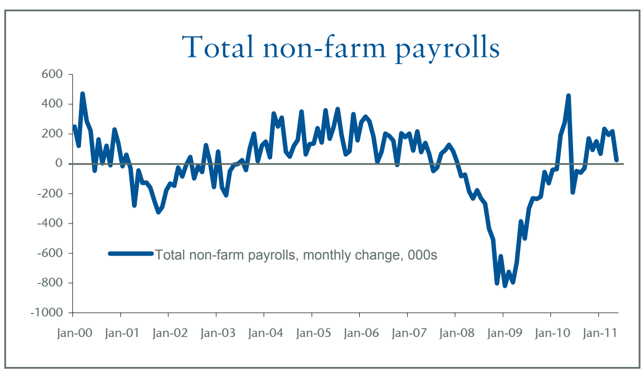
• There are tentative signs that some of the temporary negative economic forces are beginning to reverse. The ISM manufacturing survey rose unexpectedly in June, from 53.5 to 55.3. Durable goods growth also beat expectations, while the housing market is showing signs that a floor could be near.

• Indicators on the consumer side remain weak but may start picking up soon as the fall in gasoline prices boosts spending power.

• However, labor market data has been severely disappointing. Non-farm payrolls increased by just 18,000 in June, the lowest since September 2010, while previous months were downwardly revised. The unemployment rate rose to 9.2%.

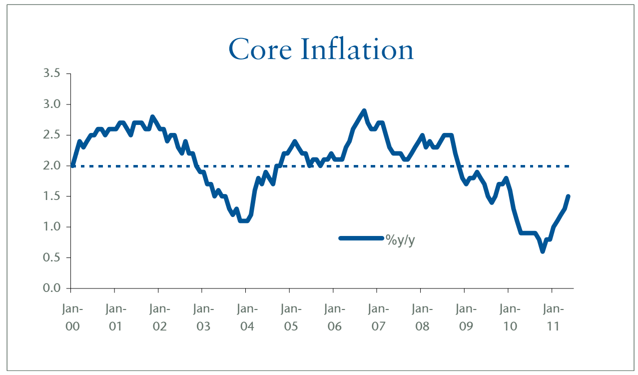
• The FOMC has become more pessimistic about labor market developments recently. In its statement following the June meeting, it said that indicators "have been weaker than anticipated".





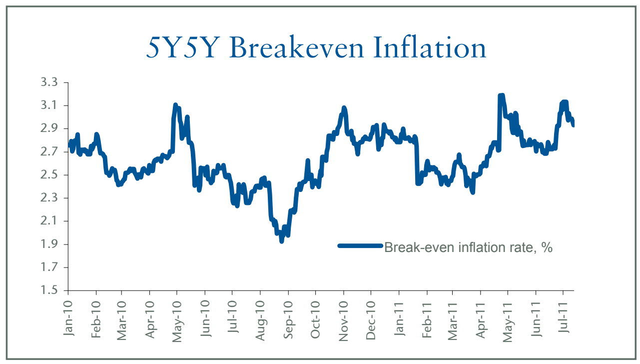
• Headline inflation moderated in May as energy costs fell. However, core inflation registered its largest monthly increase since May 2006, pushing the annual inflation rate up to 1.5%. The three-month annualized CPI rate is now 2.5% - suggesting that inflation is soon to exceed the Fed's implicit 2% target.

• However, the Fed expects inflation to "subside to levels at or below those consistent with the Committee's dual mandate".



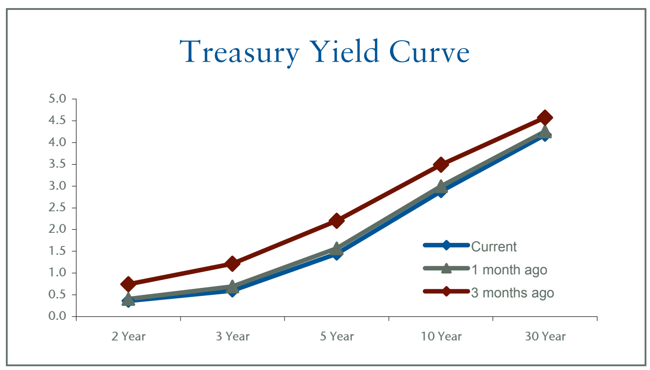
• Breakeven inflation rates had eased significantly during May and the first half of June. Following the Fed meeting on 22 June when its appraisal of current inflation trends became more hawkish, breakevens rose very sharply.

• However, the Fed commented in the post-meeting statement that longer-run inflation expectations remain stable.

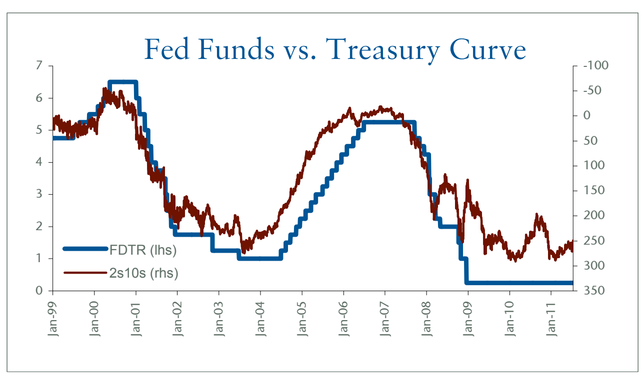


• Ten-year Treasury yields fell to a seven-month low of 2.85% on 27 June. While weak U.S. economic data had initially pushed yields lower in May, it was the focus on Greece that caused them to plummet below 2.9% in June.

• Yields had risen back above 3.10% on the back of progress towards an additional funding package for Greece and better U.S. economic data. But the disappointing jobs data has pushed yields back below 3%.

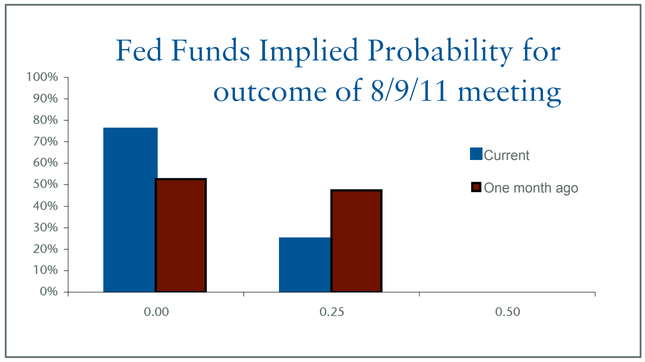


• Treasury yields are almost 70 basis points lower than they were three months ago, and markedly below most measures of fair-value. Assuming the Euro area sovereign crisis does not spiral out of control, Treasury yields should rise over the coming months. Signs that Japanese earthquake-related supply disruptions are now easing should feed through to better U.S. data, while the end of QE2 will also remove a significant source of demand from the Treasury market.



• Nonetheless, it seems that at least part of the recent economic weakness is due to more persistent factors. Market expectations for interest rates reflect these concerns. According to Fed Fund futures, markets now assign a significantly greater probability to further monetary policy stimulus than they did a month ago.

• However, we suspect that there will be no policy changes for some time to come.



Expectations

• The U.S. Federal Reserve appears to be stuck between a rock and hard place. With inflation running above the Fed's estimates, and likely to exceed the implicit 2% target, that on its own would likely trigger a hawkish shift in the Fed's rhetoric. However, the slowdown in economic activity and resulting downgrades in its economic forecasts mean that the Fed is likely to stay on middle growth - that is, no action for several months at least. The question of a third round of quantitative easing has been raised. However, the Fed's leanings are clear - with deflation risks significantly reduced and the labor market in better health than last year (at least that was the view at the time of the last Fed meeting), QE3 is unlikely.

• Recent weeks have brought tentative signs that the supply constraints resulting from the Japanese earthquake are easing. Furthermore, energy prices have come down meaningfully - providing a boost to spending power - while a plateau in the housing market downturn may be near. As a result, the second half of the year may bring an improvement in economic growth, although the recent jobs report suggests that the risks remain clearly on the downside. The European sovereign crisis also poses a significant risk to U.S. economic growth via its impact on financial conditions and general market sentiment. Either way, the next market focus is set to be the issue of an extension to the U.S. debt ceiling. The potential impact on Treasury yields is unclear, but could certainly be significant.

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	0.70	1.25	1.36	0.74
10 Year Gilt Yield	3.03	3.70	3.64	3.34
Gilt Yield Curve	2.33	2.45	2.29	2.59
CPI	4.20	4.00	3.70	3.20

The Bank has a mandate to maintain price stability.
The MPC has a symmetric inflation target of 2% on the Consumer Price Index, plus or minus 1%.

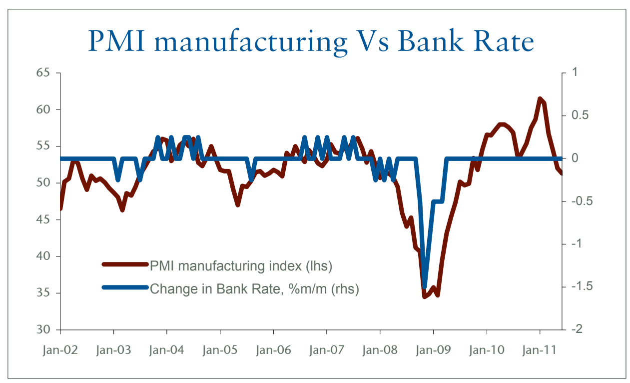
Current Policy

• The Monetary Policy Committee (MPC) decided to hold the Bank Rate at 50 basis points at its July 7th meeting, and also chose to keep its bond purchase plan at £200 billion.

• Although no MPC member changed his vote in the June meeting, there was a distinctly more dovish tone to the minutes. They revealed that the MPC "judged that the downside risks to the prospects for medium-term inflation had increased over the month". Indeed, although only one member voted for additional quantitative easing, "some" of those members who voted for no change in policy believe that "further asset purchases might become warranted ". Even so, there clearly remains a split in the MPC with several members continuing to believe that there is a substantial risk from rising inflation expectations.

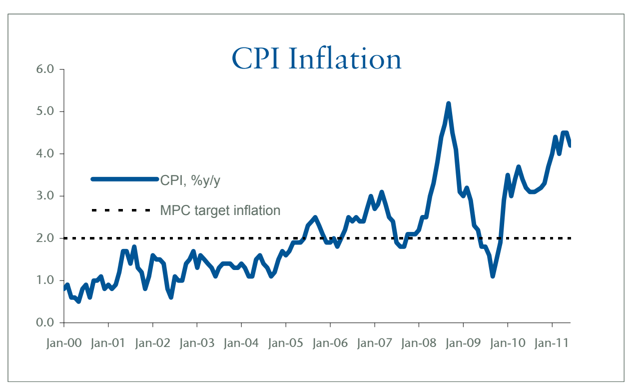
• There has been limited positive economic news over the past month. The PMI manufacturing index fell in June for the fifth consecutive month, reaching a 22-month low of 51.3. Retail sales growth fell 1.6% in May, mortgage lending growth remains subdued, and consumer confidence continues to deteriorate.

• The labor market was the single bright spot, with the ILO unemployment rate falling from 7.9% to 7.7%.



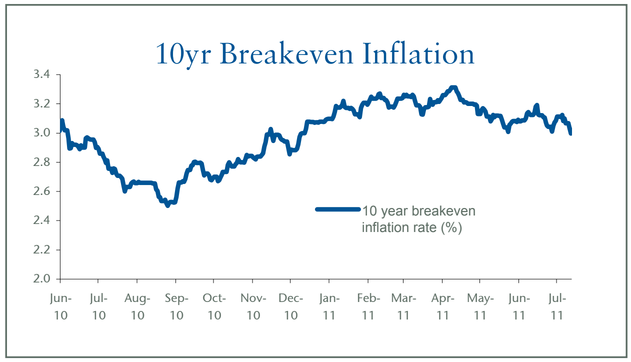
• Annual headline CPI inflation unexpectedly dropped from 4.5% in May to 4.2% in June. Even so, inflation has been above the MPC's 2% target for sixteen consecutive months. Core inflation has fallen from a record high of 3.7% in April to 2.8% in June.

• Despite the fall in June, headline inflation is still likely to rise above 5% in the coming months before declining at the end of the year.

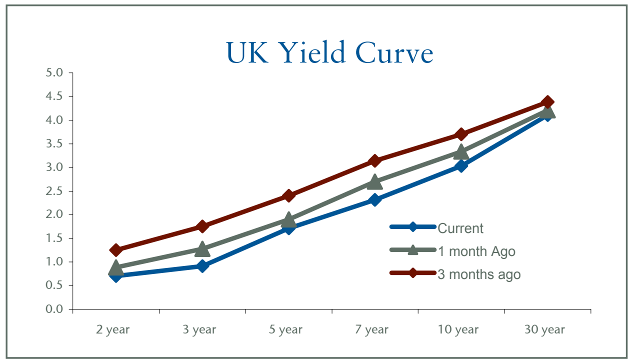


• Breakeven inflation rates have eased recently, falling below 3.1% in early July. However, the Bank of England's inflation expectations survey showed that there has recently been an upward drift in both short-term and long-term expectations.

• Yet, a key reason why the MPC has not hiked rates, despite the rise in inflation and elevated expectations, is the continued sluggishness of pay growth.

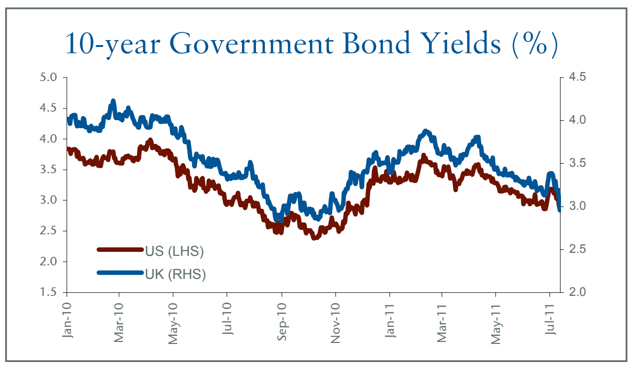


• The front and long ends of the UK yield curve are broadly unmoved from a month ago. However, the belly of the curve has dropped. There has been considerable volatility over the past month, with the ten-year gilt yield swinging from 3.13% on 24 June to 3.39% on 2 July and down to 2.98% on 12th June.



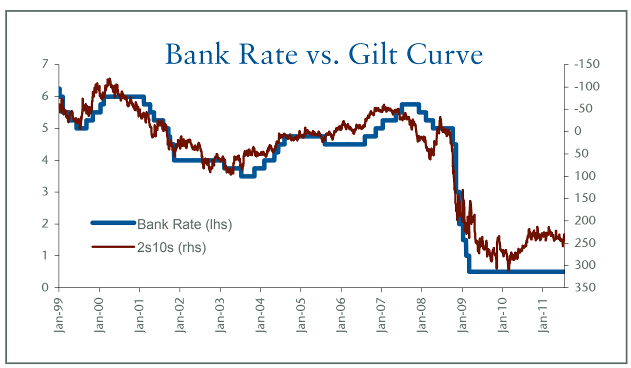
• Weak risk appetite, as a result of the continuing Greek sovereign debt crisis, and downbeat economic data have conspired to keep gilt yields close to their end-2010 levels. The same factors have also caused U.S. Treasury yields to move in a similar fashion in the past month.

• However, sterling has weakened against the U.S. dollar, falling from $1.64 a month ago to $1.58 in early July.



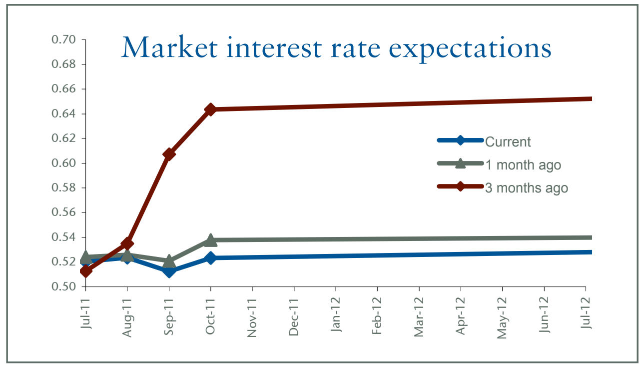
• The balance of opinion in the MPC appears to be shifting towards the doves, with more weight being placed on the downside risks to demand with attendant easing of inflation

• Although much of the shift appears to be driven by concerns over external developments, the deflationary impact of the fiscal austerity programme does itself warrant domestic growth concerns.



• Reflecting the softening of activity indicators and the dovish tone of the minutes to the June MPC meeting, market interest rate expectations have continued to ease over the last month. Whereas previously a rate hike was expected in Q4 2011, a slight easing in policy is now being priced in.

• In fact, the obstacles to further QE are extremely high. We place greater likelihood on there being no change to policy for the remainder of this year.



Expectations

• Whereas the key UK discussion in recent months has been the timing of the MPC's first interest rate increase, recent signs of renewed softness in the UK economy have raised speculation that the MPC's next move will not be an interest rate hike, but rather a further loosening of policy - through an extension to the asset purchase program. In fact, we suspect that the threshold for MPC members to vote for further quantitative easing is very high given ongoing concerns about the MPC's credibility. With inflation set to remain above the 2% target till at least the end of 2012, the growth outlook would need to deteriorate meaningfully further for a second round of asset purchases to be implemented.

• Yet the UK economy does face some challenging headwinds. For a start, although most tax increases have now been implemented, the full effect of the fiscal tightening measures is yet to be felt. The housing market is showing signs of renewed slowdown, unemployment is vulnerable to a sharp increase if firms start to follow their U.S. counterparts and increase productivity, and household spending power continues to be squeezed by high inflation.

• Overall, given the unique voting system of the UK MPC - one member, one vote - it is doubtful that either camp - dovish or hawkish - will gain enough votes to sway policy one way or the other. As a result, it seems likely that UK interest rates are set to remain on hold for the remainder of 2011.

European Central Bank (ECB)

INDICATOR	CURRENT	3-MONTHS AGO	6-MONTHS AGO	12-MONTHS AGO
ECB Refi Rate	1.50	1.25	1.00	1.00
2 Year Yield	1.25	1.85	0.98	0.70
10 Year Yield	2.65	3.44	3.05	2.59
Eurozone Yield Curve	1.40	1.59	2.07	1.89
HICP	2.40	2.40	1.90	1.60

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.

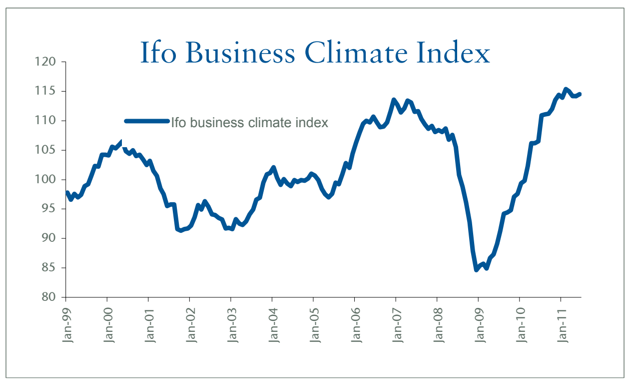
Current Policy

• The ECB raised the official policy rate by 25 basis points to 1.50% at the July 7th meeting. In April, the ECB had raised the policy rate for the first time since July 2009.

• After hiking policy rates as expected, the ECB took a hard line today on both conventional policy and the prospect of Greek debt restructuring. At the post-meeting press conference, ECB President Trichet hinted that further interest rate rises lie in the pipeline, noting that medium term inflation risks "remain on the upside" and that the Bank will "monitor risks to price stability very closely". When questioned about its position on the eligibility of sovereign collateral, the ECB President stated only that the Bank "says no to selective credit default". He also suggested that no kind of debt restructuring in Greece would be acceptable to the ECB.

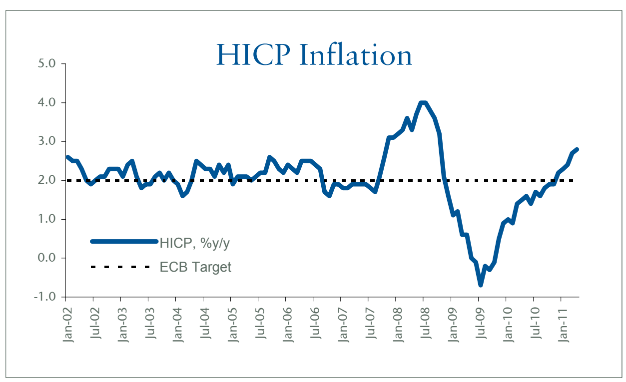
• The Eurozone composite PMI fell from 55.4 in May to 53.3 in June (with much of the weakness concentrated in the peripheries).

• There has been some positive data though. German industrial production rebounded by 1.2% in May following a contraction the previous month. The Ifo index edged higher in June - although the expectations component declined.



• The flash estimate of headline HICP inflation was unchanged at 2.7% in June, although for the sixth consecutive month inflation remains above the ECB's 2% target.

• Even taking into account the latest policy rate increase and the recently slowdown in economic activity, the ECB believes that upside risks to price stability remain.



• Inflation expectations are yet to pose a serious concern to the ECB. Market based measures of inflation expectations, such as breakeven inflation, have fallen over the past four months. At 2% in early July, breakeven inflation rates are consistent with the ECB's inflation target.

• Nonetheless, ECB President Trichet reiterated that it is very important to keep inflation expectations anchored.

• After several weeks of extreme volatility and negotiations, details of a new bailout package for Greece still remain unclear - most pertinently with regards to the possibility of achieving private sector participation without triggering a downgrade of the Greek sovereign to selective default by the rating agencies.

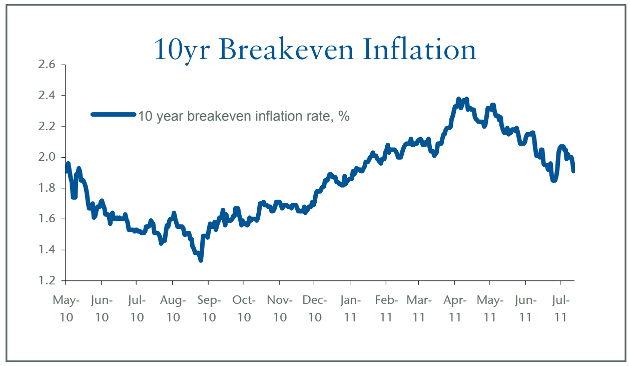
• Pressure on Portugal re-emerged on the back of rating downgrades by Moody's, driving yields up to new record highs.

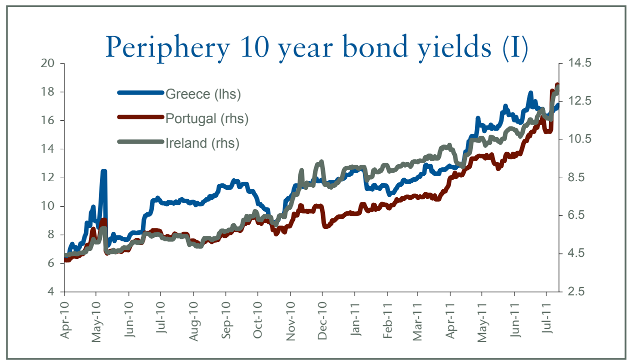
• Spanish and Italian yields have certainly not escaped unscathed. Although the Italian government presented a €40 billion fiscal plan last week, Italy's progress on fiscal reforms has been slow. Political uncertainty has also helped push Italy into the market spotlight.

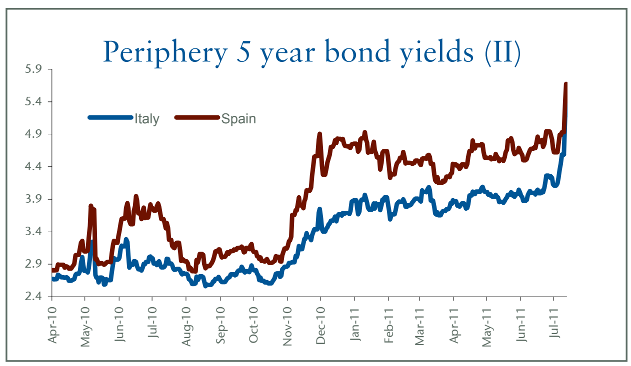
• The increase in Eurozone systemic risk has raised speculation that Italy and Spain may be engulfed by the crisis, pushing yields to euro-time record highs.

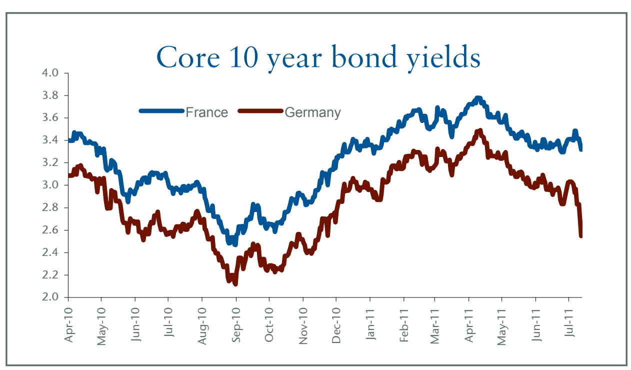
• German bund yields have benefited from the flight-to-quality in recent weeks. Furthermore, with industrial production and consumer confidence strong, and unemployment continuing to fall, the German economy continues to stand out as the main driver of Euro area growth.

• Yet, as Germany and France have the highest exposure to Greece, it is unsurprising that yields have not fallen as far as they did last September.







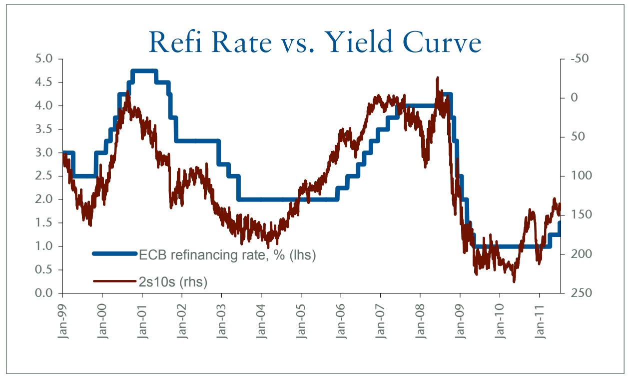


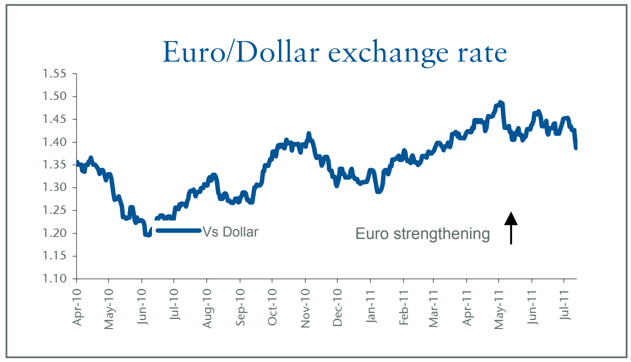
• In the July meeting, the ECB clearly demonstrated that sovereign developments will not prevent them from tightening monetary policy.

• The ECB has signaled that it retains a hawkish bias. Its intention to monitor price risks very closely, and its assessment that underlying growth momentum is positive, did nothing to alter markets' belief that another hike is still in the pipeline for this year.

• Downward pressure on the euro from concerns about Greece outweighed upward pressures resulting from the ECB's monetary policy tightening. The euro weakened from $1.46 on 4th July to just $1.38 on 12th July.

• Even so, it remains meaningfully stronger than in May 2010 when the Greek sovereign crisis first hit. That largely reflects the comparatively weaker U.S. outlook and interest rate differential.





Expectations

• Once again, economic activity and interest rate decisions have taken a backseat in terms of market attention in the past month. The Greek sovereign debt saga has threaten to spiral out of control, with the sovereign on the brink of default in June. However, the passing of fiscal austerity measures managed to ward off default (for the time being at least), and by September a new bailout package for Greece, which will run through to 2014, should be in place. Yet, the role of private sector participation remains the key question. Some burden sharing between bondholders and official creditors would help to limit contagion, whilst also appeasing some of the Euro area countries. However, whether or not any proposals for burden sharing will avoid triggering a downgrade of the Greek sovereign to selective default by the rating agencies, and a credit event, remains to be seen.

• Contagion remains the main risk for the euro area. At the time of writing, there is speculation that Italy will be engulfed by the crisis. With the largest bond market in Europe, Italy must be defended at all costs and, if Euro area policy makers do not deal with it efficiently and promptly, the latest twist to this Euro area sovereign debt saga may be the most threatening yet. Given the potentially enormous fall-out, we think that policymakers will do whatever it takes to avert such an event - even if that means reducing private sector participation in the Greek bail-out to minimum. Already, the Eurogroup has stated its intentions to restructure offical loans to Greece, Ireland and Portugal. Allowing the European Financial Stability Facility (EFSF) to purchase sovereign debt on the secondary market is one of the proposals which will surely be seriously considered now.

• Meanwhile, we do not think that the sovereign debt crisis will prevent further interest rate hikes. The ECB has signaled that inflation is its **only** focus and, as a result, it retains its hawkish bias. In the absence of a real and significant deterioration in the sovereign debt saga (for example, where Italy is engulfed in the crisis), another interest rate hike is likely this year, with several more to follow in 2012.

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	0.16	0.21	0.18	0.15
10 Year Govt. Bond	1.11	1.34	1.18	1.13
JGB Yield Curve	0.95	1.13	1.00	0.98
CPI	0.30	0.00	0.10	-0.90

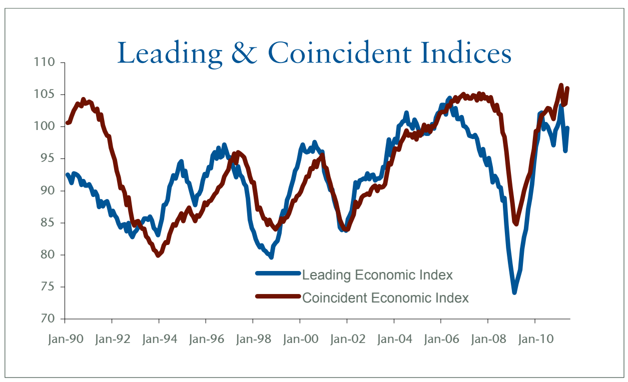
The BOJ does not have a formal target, but its objective is to maintain price stability. Since December 2009, the Board has defined this as being "in a positive range of 2% or lower".

Current Policy

• The Bank of Japan (BOJ) maintained its overnight target rate at 0.1% at its July 12th meeting. It also kept unchanged its credit program and asset-purchase fund at ¥10 trillion (increased from ¥5 trillion in the immediate aftermath of the devastating March 11 earthquake and tsunami).

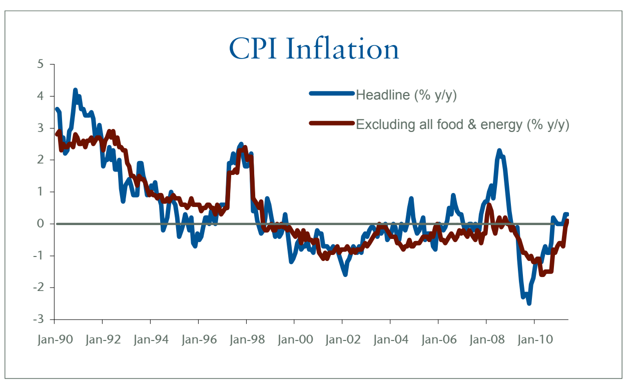
• Several economic indicators point to a V-shaped recovery for Japan. The BOJ's assessment of the economy at its latest policy meeting in July was more positive, commenting that "after declining sharply following the earthquake, production has recently shown clear signs of picking up". The economy "is expected to return to a moderate recovery path from the second half of fiscal year 2011".

• Industrial production rose 5.7% in May and is expected to growth a further 5% in June. The latest BOJ Tankan survey showed that large manufacturers expect business conditions to improve sharply by September. Although the PMI manufacturing index unexpectedly fell in June, the survey did suggest that the supply-chain disruptions are mostly over.



• Private consumption also recovered solidly in May, with retail sales rising 2.4%.

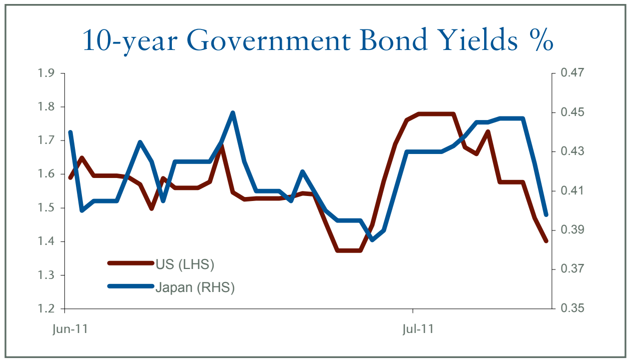
• The annual change in core CPI, which excludes food and energy, rose from -0.1% in April to +0.1% in May. However, the Tokyo preliminary June report indicated that inflation remained unchanged in June.



• The labor market has also started to recover from March's earthquake. Having risen to 4.7% in April, the unemployment rate dropped back to 4.5% in May.

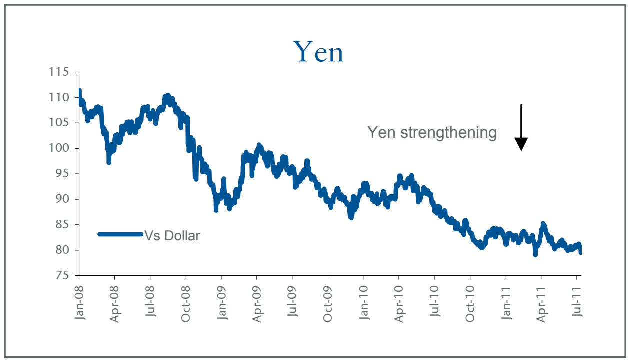
• Despite all the uncertainty and volatility of the past fortnight - confidence and austerity measures votes in Greece - JGB yields have fallen only moderately.

• By contrast, U.S. Treasury yields and German bund yields have fallen sharply as a result of a flight-to quality rally. It seems that positive domestic economic data gave investors a more positive bias for Japan.



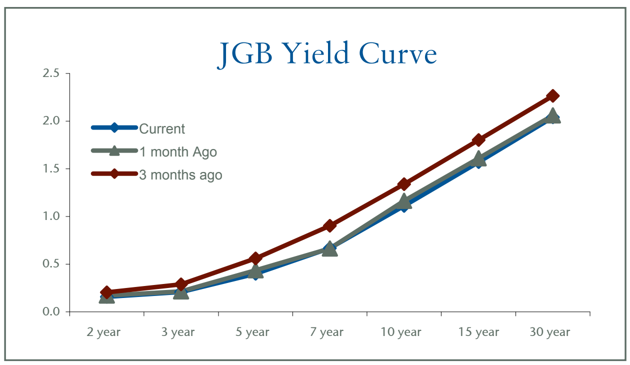
• In the past month, the yen has remained at historically strong levels of around ¥80. This reflects optimism about a recovery from the earthquake-related downturn.

• The Japanese yen may appreciate slightly in the short term if the global recovery decelerates. However, a global economic rebound later in the year may see the yen weaken once more.



• The JGB curve has been broadly unchanged for the past month, although the belly of the curve has fallen slightly.

• Given the potential for more positive sentiment to return to the market, JGB yields may rise over the coming month. Indeed, improving data in the U.S., the end of U.S. QE2, as well as growing evidence of a V-shaped recovery in Japan should put upward pressure on yields.



Expectations

• Following the extreme slowdown experienced in March and April, Japan's economy is now experiencing a sharp rebound. Industrial production is bouncing back, and there are indications that the supply chain disruptions are mostly over. Furthermore, demand is also recovering. Consumer spending appears to have risen solidly in May and employment conditions have started to improve.

• However, it remains to be seen if the recovery seen so far is sustained through the second half of the year. Although the central bank did not provide additional monetary stimulus at its last meeting, at its June meeting it did introduce a new lending scheme whereby the central bank will provide loans, at a rate of 0.1%, to banks which extend asset based loans and equity investments. This latest scheme is hoped to lift risk appetite, whilst also aiding recent liquidity injections to feed through to businesses via bank lending, and thereby bringing an end to deflation. In fact, financial markets have not welcomed this new scheme with open arms and remain skeptical that BOJ policy can improve Japan's notoriously lackluster risk appetite.

Bank of Canada

INDICATOR	CURRENT	3-MONTHS AGO	6-MONTHS AGO	12-MONTHS AGO
BOC Lending Rate	1.00	1.00	1.00	0.50
2 Year Bond Yield	1.43	1.94	1.73	1.72
10 Year Bond Yield	2.89	3.49	3.23	3.23
Canada Yield Curve	1.47	1.55	1.49	1.51
Core CPI	2.10	1.10	1.10	1.40

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

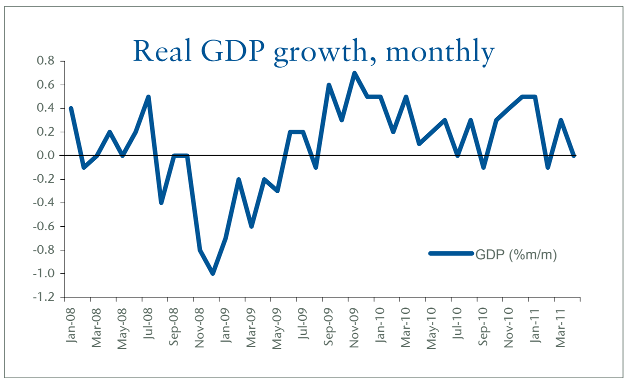
Current Policy

• The Bank of Canada (BoC) left its key policy rate unchanged at 1% at its May 31st meeting. Rates were last increased at the September meeting.

• At the latest meeting in May, the BoC commented that "some of the considerable monetary stimulus currently in place will be eventually withdrawn, consistent with achieving the 2% inflation target". However, they also stated that tightening policy was conditional: "to the extent that the expansion continues and the current material excess supply in the economy is gradually absorbed". In fact, recent developments in Europe and U.S. are likely to take a toll on the Canadian economy, pushing out the likely date for policy tightening.

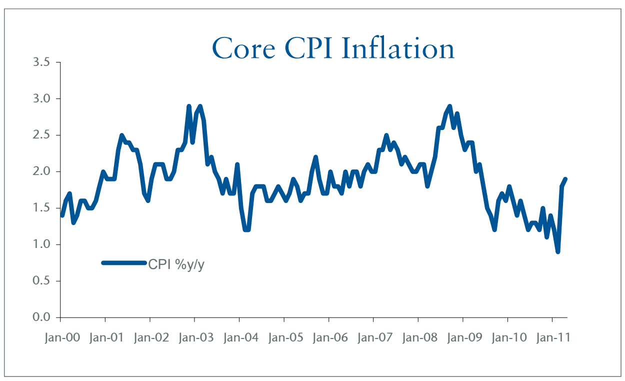
• After growth of 0.3% in March, Canada's monthly GDP was unchanged in April, held back by a 6.9% drop in motor vehicle production. However, growth should pick up again in the coming months as the Japan earthquake related supply disruptions ease.

• The slow start to the second quarter suggests that growth may fall short of the BoC's 2% quarter-on-quarter forecast.

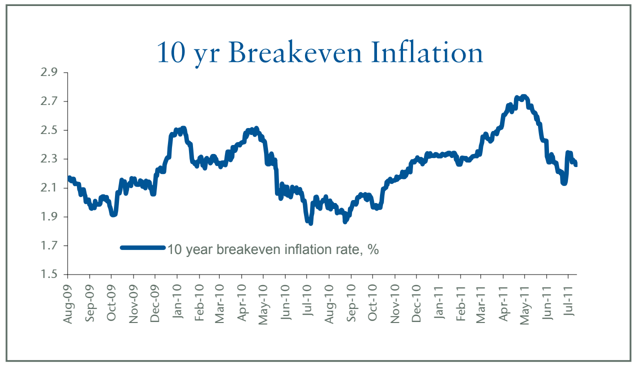


• Headline CPI inflation rose from 3.3% to an eight-year high of 3.7% in May. Core inflation rose from 1.6% to a seven-month high of 1.8%.

• However, the recent drop back in energy prices suggests that headline inflation has now peaked. Inflation is expected to remain benign this year and next due to the disinflationary output gap, which the BoC projects will not be closed until mid-2012.

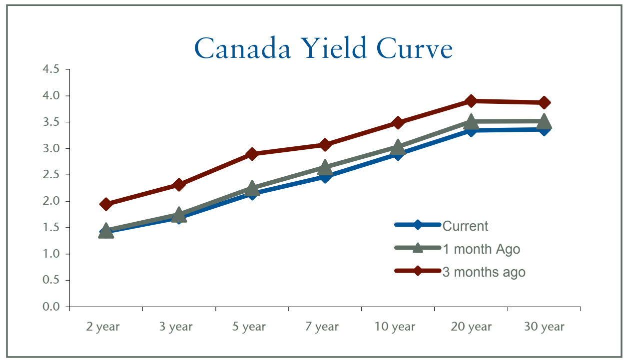


• According to the BoC Q2 2011 surveys, inflation expectations have risen further as capacity has tightened. The percentage of respondents expecting inflation to exceed the 2% target over the next 24 months rose its highest reading since Q2 2008. Breakeven inflation rates fell from around 2.7% in April to 2.1% in early June, before rising to 2.3% in July.

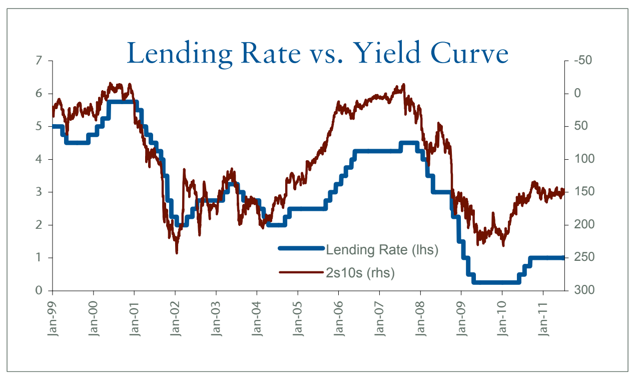


• The Canadian yield curve has fallen slightly in the past month. The front-end has risen marginally, while the long-end is slightly lower than it was a month ago. Yields across the curve are lower than they were three months ago.

• Canadian bond yields were around 15 to 20 basis points lower at the end of June, before rising on the back of stronger Canadian and U.S. economic data.



• The BoC is widely expected to raise policy rates in Q3. However, if growth in the U.S. struggles to improve, interest rate expectations may be pushed further out. After all, not only will weak growth feed through to the Canadian economy, but a weakening dollar will put upward pressure on the loonie - a key concern for the BoC.



Expectations

• The Canadian economy appears to be performing relatively robustly. While growth has weakened in Q2, the easing of Japanese earthquake related supply disruptions should lift growth in the second half of the year. However, a sustained slowdown in the U.S. would certainly take a toll on the Canadian economy - while a stronger loonie against the dollar would surely delay the BoC even longer in resuming their policy tightening.

• Currently, however, the Canadian economy is looking healthy. As the central bank has previously commented, the economy no longer requires policy rates to be at emergency levels. We expect, providing the U.S. does not undergo a significant slowdown, that the BoC will hike rates in Q3 or early Q4. This should send the Canadian dollar sharply higher, eliciting another policy pause until the global recovery looks like it is back on its feet.

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