

Central Bank Watch

12 August, 2013

Note: Unless otherwise indicated all data in this document is sourced from Bloomberg as of 8/8/13

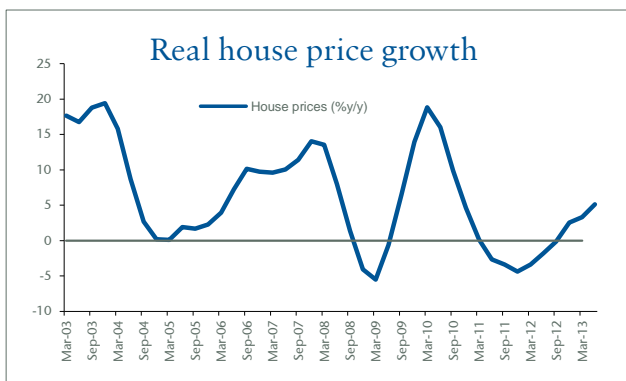
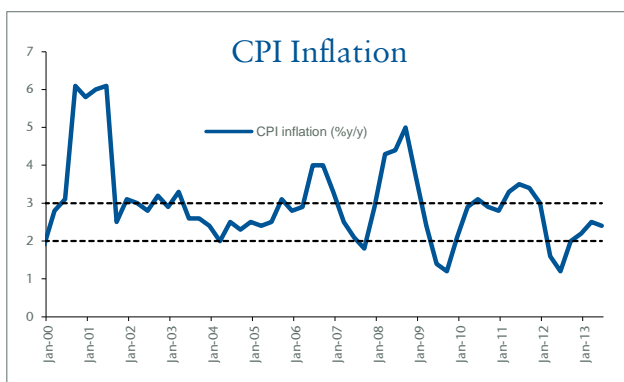
Reserve Bank of Australia (RBA)

| INDICATOR | CURRENT | 3-MONTHS AGO | 6-MONTHS AGO | 12-MONTHS AGO |
|----------------------|---------|--------------|--------------|---------------|
| RBA Target Cash Rate | 2.50 | 3.00 | 3.00 | 3.50 |
| 2 Year Bond Yield | 2.29 | 2.45 | 2.77 | 2.91 |
| 10 Year Bond Yield | 3.67 | 3.12 | 3.48 | 3.32 |
| Aussie Yield Curve | 1.38 | 0.67 | 0.70 | 0.41 |
| CPI | 2.40 | 2.50 | 2.20 | 1.20 |

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 2.75% to a new record low of 2.5% at the 6 August meeting. Rates had previously been cut by 25 basis point at the May meeting.
- Following a speech by Governor Stevens on 30 July, where he had noted that the RBA is not especially concerned with running out of ammunition and that it was not near the zero bound of monetary policy, the RBA's decision to cut the cash rate came as little surprise. He had also said that the normal level for interest rates was lower than it was in the past. While the market had interpreted the Governor's comments as guidance that rates will remain low throughout 2014, the statement accompanying the August decision was brief and gave little hint of what future policy holds.
- Recent data on business conditions, consumer confidence, job vacancies/advertisements, and retail sales have all pointed to the risk that the recovery may be faltering.
- Second quarter inflation came in lower than expected. Headline and core annual inflation both printed at 2.4%, slightly lower than in the first quarter. The RBA's favoured underlying measures, the trimmed mean, was 2.2% - in the lower half of the RBA's 2-3% target band.
- House prices registered their strongest monthly gain in June, and rose by over 5% in the second quarter. Meanwhile, building approvals data fell almost 7% in June alone, while home construction activity continues to respond to the encouraging house price data.
- The economy gained 10,300 jobs in June. However, the unemployment rate rose from 5.6% to 5.7% - the highest level since September 2009. There were also signs of rising underutilization, with weak implications for household income.



- With the RBA displaying no urgency to cut rates at the July meeting, the Australian dollar had strengthened slightly during July. However, RBA Stephens' dovish speech on 30 July pushed the currency back below \$0.90 against the U.S. dollar.

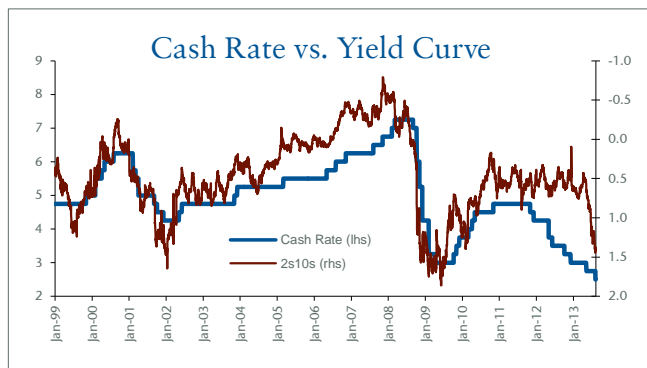
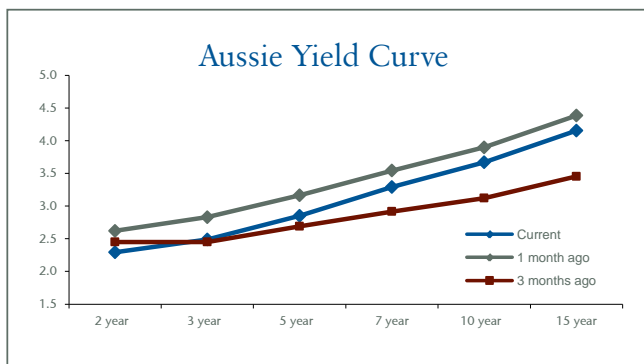
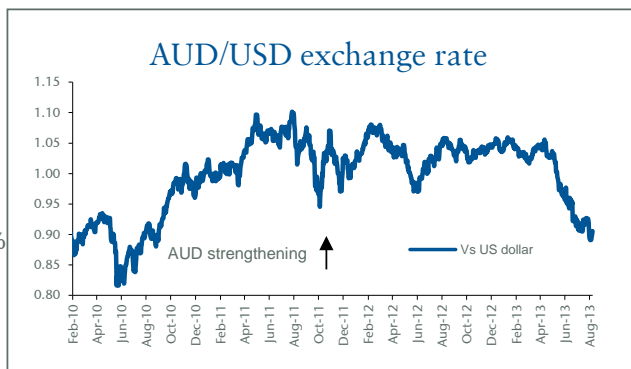
- The trade weighted Australian dollar has fallen 8% since the policy rate cut in May. The RBA expects this depreciation to be supportive of the tradable sector and a key offsetting influence to lower commodity prices.

- The Australian yield curve has bull steepened sharply over the past month. The front end and 5-year part of the curve have fallen 30 basis points over the month as a whole, while the 10-year point has fallen around 20 basis points.

- Prior to Governor Stephens 30 July speech, the market consensus had been that rates would be hiked in 2014. However, after the speech, markets have removed the 2014 rate hikes.

- Although the RBA cut policy rates, the market was disappointed by the lack of rate guidance at the August meeting. However, given the weak economic outlook, a November rate cut is still on the cards.

- Indeed, weaker economic conditions in China will weigh on Australian growth, and the long-awaited transition away from mining investment has disappointed. As such, there remains a strong case for further policy stimulus.



Expectations

- The RBA is one of the few remaining central banks not to have indulged in forward guidance of policy rates. However, in his speech on 30 July, RBA Governor Stephens made some inroads into signalling to markets that rates are likely to remain low throughout 2014. No wonder then that markets reacted sharply to his speech, prompting a sharp depreciation of the Australian dollar and a rally in Australian front-end bond yields.

- Certainly, the Australian economy could do with additional policy stimulus. The non-mining recovery has shown very sluggish trends recently, while headwinds from the unwinding of the mining boom have been intensifying. Inflation remains at the lower end of the RBA's target band, posing no hurdle to the RBA's "scope to ease" and, with state and commonwealth governments reining in their budget deficits, fiscal drag will weigh on growth. What's more, the slowing Chinese economy poses a meaningful risk to Australia's economic outlook. As a result, despite the sharp weakening of the Australian dollar in recent months, the central bank is likely to cut rates again later in the year.

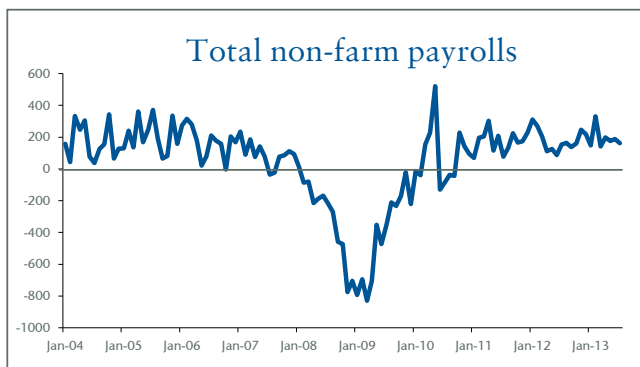
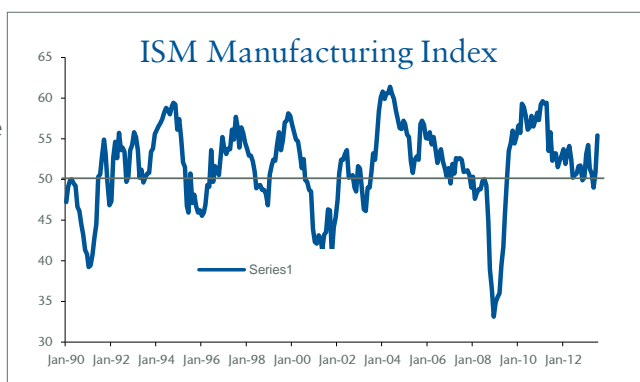
U.S. Federal Reserve (Fed)

| 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 | 0.30 | 0.22 | 0.25 | 0.27 |
| 10 Year Treasury Yield | 2.59 | 1.77 | 1.95 | 1.65 |
| Treasury Yield curve | 2.29 | 1.55 | 1.70 | 1.38 |
| Core PCE | 1.22 | 1.39 | 1.60 | 1.92 |

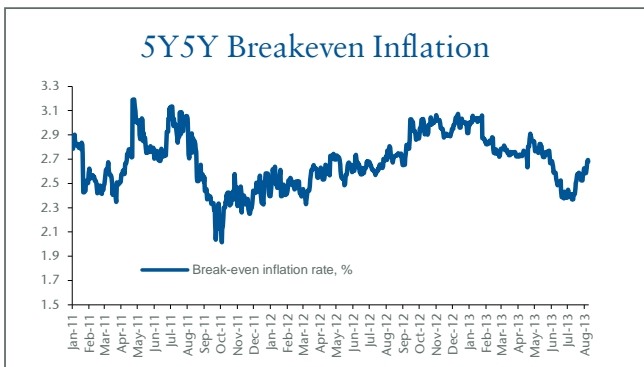
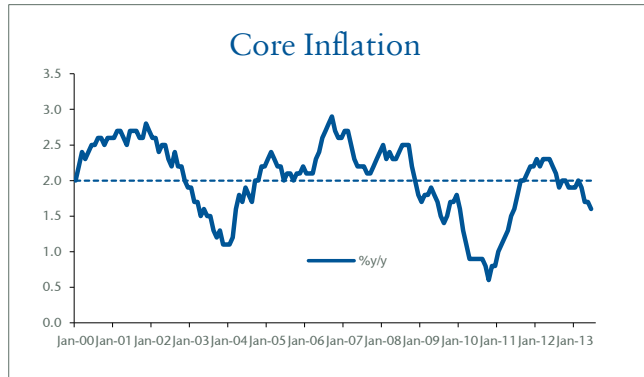
*The Fed has a dual mandate of fostering price stability and employment.
It has an explicit inflation target of 2% on the personal consumption expenditures price index*

Current Policy

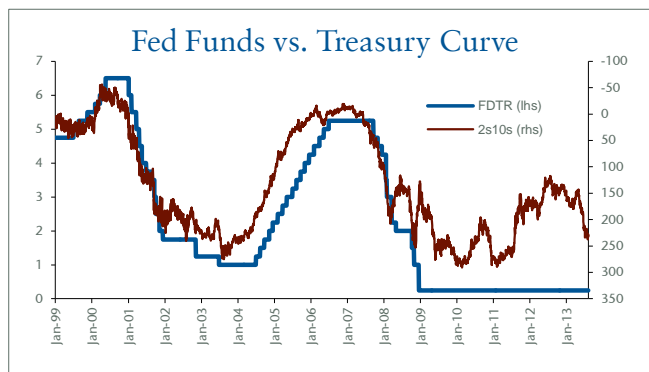
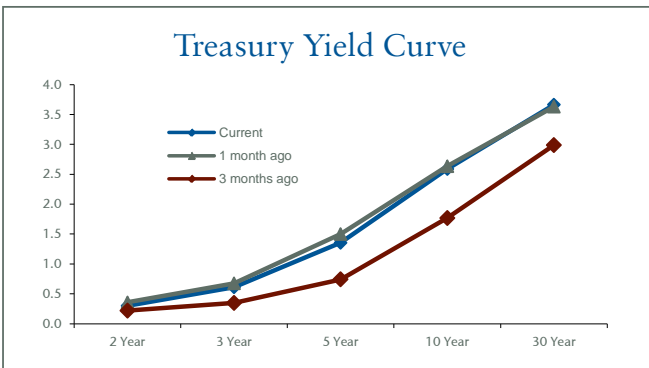
- The Federal Open Market Committee (FOMC) held the Federal Funds Target Rate at 0.25% at its 31 July meeting, while it will continue its asset purchase program of \$85 billion per month.
- At its June meeting, the FOMC took on a more hawkish outlook than the market was anticipating. Chairman Bernanke indicated that if their economic forecast is correct, it will start to taper asset purchases "later this year", with purchases ceasing by the middle of 2014 if the unemployment rate has fallen to 7% or lower. The tone of the July meeting was more dovish - but with the intention of distinguishing the tapering of asset purchases from a rate hike. The widespread view remains that tapering of purchases will begin in September.
- There continues to be good signs of economic improvement. The July Institute of Supply Management (ISM) manufacturing index jumped from 50.9 to 55.4, the biggest one-month increase since 1996. The ISM non-manufacturing index also surged in July, rising from 52.2 to 56.
- Durable goods orders beat expectations in May, consumer confidence hit a new post-recession high in June, while housing market data continue to surprise to the upside with housing starts, building permits, and home sales rising in May.
- The July employment report was slightly disappointing, with non-farm payrolls rising by 162,000, down from the 188,000 increase in June. The unemployment rate fell from 7.6% to 7.4%, but this was driven by a decline in the participation rate. Overall, however, the payrolls data neither makes nor breaks the case for a September tapering.
- The Fed has lowered its unemployment rate forecast for the end of 2013 by 0.15% to 7.25%, for 2014 it lowered it by 0.2% to 6.65%, and for the end of 2015 it was lowered by 0.25% to 6%.



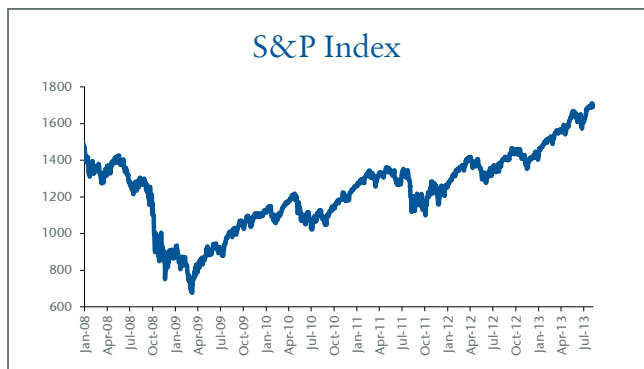
- Annual core Consumer Price Index (CPI) inflation dipped from 1.7% in May to 1.6% in June, consistent with subdued overall price pressures. The annual core Personal Consumption Expenditures (PCE) inflation rate - the Fed's preferred measure of inflation - stood at 1.1% in May, meaningfully lower than the Fed's 2% target and its own inflation projection.
- Although the FOMC has been largely dismissive of the recent softening of inflation, it said "the Committee recognises that inflation persistently below its 2% objective could pose risks to economic performance".
- The FOMC continues to characterise inflation expectations as stable. Five-year breakeven inflation rates, a measure of inflation expectations, have risen from around 2.4% to almost 2.7% over the past month.
- The FOMC has lowered its 2013 year end core inflation forecast by 0.3% to 1.25%, its year end 2014 forecast by 0.2% to 1.65%, and its 2015 year end forecast by 0.1% to 1.85%.



- A sharp sell-off following the hawkish FOMC June meeting and a strong June employment report saw 10-year Treasury yields push above 2.75% on 5 July - a full 55 basis point swing in one month.
- However, more dovish commentary from the July meeting, suggesting that there is still limited upward pressure on policy rates, has seen bonds rally. As a result, 2-year and 10-year UST yields are down around five basis points on the month.
- Quantitative easing tapering in September is the FOMC's baseline and this now appears to be priced into the market. However, given that tapering will still be dependent on the evolution of economic data, U.S. Treasury yields will continue to be subject to volatility.
- In addition, the Fed is attempting to draw a dividing line between tapering (which impacts long-end yields) and eventual rate hikes (which impact front-end yields). If successful, we would expect a further steepening of the Treasury curve.



- U.S. equities have reached new historic highs in recent weeks, helped by a relatively healthy U.S. corporate earnings picture, which has boosted equity investors' confidence.
- Confidence that the U.S. economy is strong enough to justify tapering of asset purchases, coupled with reassurance from the Fed that policy rates are to stay close to zero for the foreseeable future, is strongly positive for equities.



Expectations

- In one fell swoop, the Federal Reserve has gone from being arguably the most dovish major central bank, to being the relatively most hawkish central bank at the moment. The FOMC's signal that tapering is likely to start as early as September 2013 and end by mid-2014 came as a shock to the market. However, the Fed believes that the economic outlook has strengthened sufficiently to warrant a tapering of asset purchases later this year, and also believes that purchases should be terminated when the unemployment rate reaches 7%.
- With non-farm payroll growth of around 200,000 per month over the past six months, a firming housing market, improved household confidence and spending, as well as the likelihood that the drag from fiscal policy will wane later this year, growth prospects have improved. The Fed has made it abundantly clear that the labour market is the key indicator they are interested in and stronger job growth should feed into more robust economic growth in the second half of the year.
- Even so, Fed Chairman Ben Bernanke is clearly aware of the scepticism about the perceived strength of the economy. While his recent remarks in Boston did little to counter the notion that tapering of asset purchases will start relatively soon, his comments were notably dovish. Bernanke noted that underemployment may be a reason why the Fed could keep rates on hold well after the 6.5% unemployment threshold has been attained.
- Specifically, he stated "if a substantial part of the reductions in measured unemployment were judged to reflect cyclical declines in labour force participation rather than gains in employment, the Committee would be unlikely to view a decline in unemployment to 6.5% as a sufficient reason to raise its target for the federal funds rate". This point is important - the most recent FOMC forecasts indicate that they expect the unemployment rate to reach 6.5% around the end of 2014 or in early 2015 - sooner than had been previously projected. So without Bernanke's assurances, market expectations for the first rate hike would rise sharply.
- Over the past fortnight, there have been signs of stabilization in risk markets, suggesting that the most disorderly part of the sell off is now behind us. Over the next few weeks we expect the Fed to take every available opportunity to convey to markets their rationale behind tapering, as well as signalling to markets that tapering does not necessarily imply tightening. If they are successful, market moves following the eventual official tapering announcement should be less volatile than the ones we saw last month.

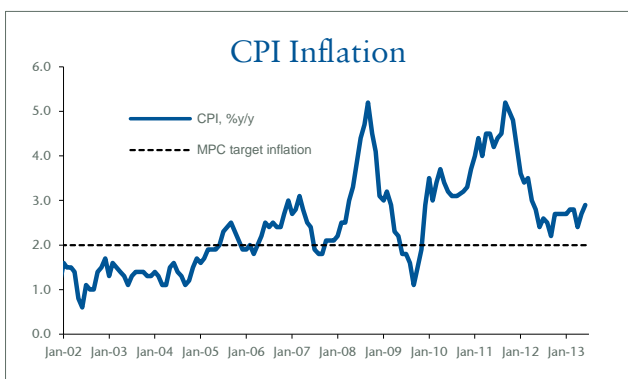
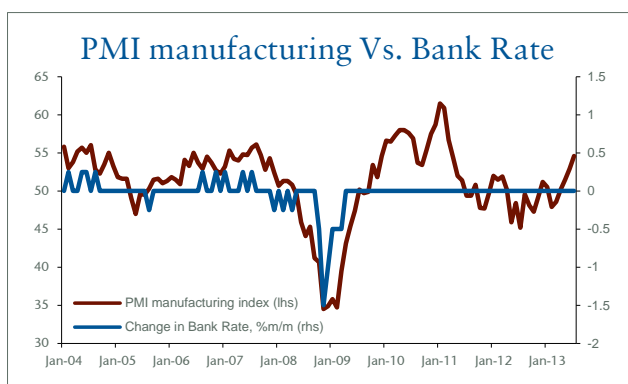
Bank of England

| 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 | 0.39 | 0.28 | 0.32 | 0.13 |
| 10 Year Gilt Yield | 2.47 | 1.77 | 2.10 | 1.57 |
| Gilt Yield Curve | 2.08 | 1.49 | 1.78 | 1.44 |
| CPI | 2.90 | 2.80 | 2.70 | 2.40 |

*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 1 August meeting, and also chose to keep the size of its bond purchase plan unchanged at £375 billion.
- At the August Inflation Report press conference, the MPC laid out its new forward-rate guidance. The MPC will not raise the Bank Rate until unemployment falls to a threshold level of 7%, subject to three "knockout clauses": inflation is expected to be higher than 2.5% at the 18-24 month horizon; medium-term inflation expectations are not well contained; or, the Financial Policy Committee judges that monetary policy poses risks to financial stability. The MPC's own forecast shows that unemployment is not expected to fall to 7% until the second half of 2016, suggesting that rates will remain at current levels for the next three years.
- The UK grew 0.6% quarter-on-quarter in the second quarter according to preliminary estimates, and is showing further signs of a broad-based strengthening. The manufacturing PMI rose to 54.6 in July - the highest level since March 2011, while the services PMI rose from 56.9 to 60.2 - the second strongest reading in 15 years. Retail sales rose 0.2% in June, while industrial production was up 1.1%.
- The latest labour market data showed that the headline unemployment rate remained at 7.8% in the three months to May.
- Annual CPI inflation rose from 2.7% in May to 2.9% in June, remaining significantly higher than the Bank of England's 2% inflation target. The MPC revised down its annual CPI inflation forecast for 2013 from 2.9% to 2.8%, but kept its 2014 forecast unchanged at 2.5% - just within the MPC's new rules for its rate guidance to hold.
- If the MPC's forecast is correct, by 2014 annual CPI inflation will have been above the 2% target for most of the decade.



- One of the MPC's three rules ("knockouts") is that inflation expectations must be anchored. However, this rule is difficult to pin down - there are several measures of inflation expectations, including breakeven inflation, and it is not obvious what defines "anchored".

- Ten-year breakeven inflation rates are currently just above 3% - higher than the Bank of England's 2% inflation target and above the MPC's new rule that inflation at the 2-year horizon should not exceed 2.5%.

- The immediate market reaction to the announcement of forward guidance must have been a disappointment for the MPC. Gilt yields across the curve failed to fall, even rising a few basis points. Over the month as a whole, the yield curve is broadly unchanged.

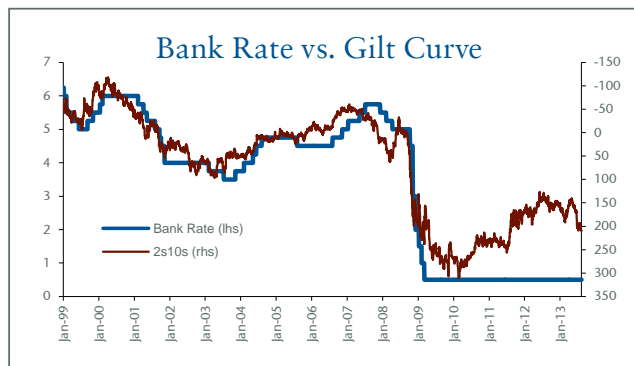
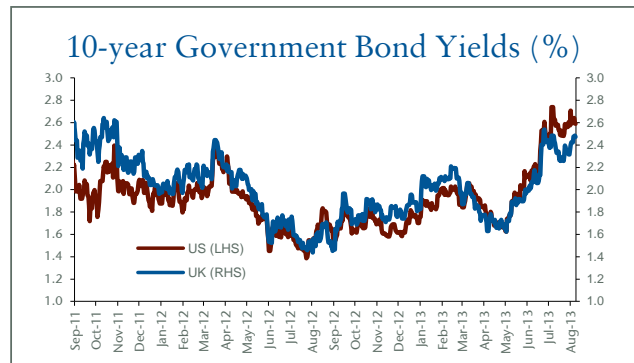
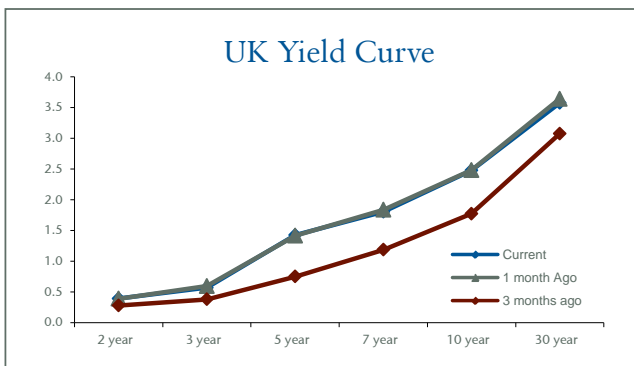
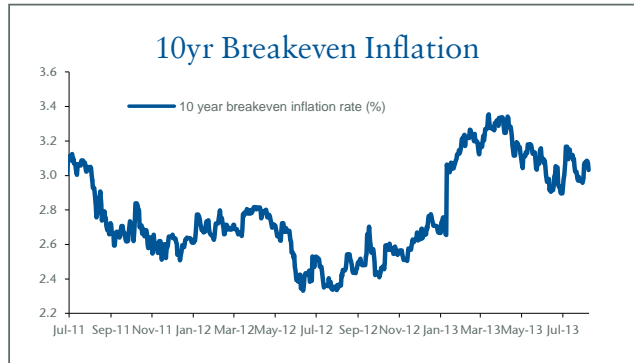
- The Bank of England's move towards forward guidance on rates appears to have been an attempt to counteract the past few months' increase in gilt yields.

- The increase in gilt yields over recent months has not only been driven by stronger UK economic data, but also by the more hawkish commentary from the U.S. Federal Reserve. In the week following the FOMC meeting where the Fed indicated that tapering of asset purchases would begin later this year, 10-year gilt yields rose 40 basis points.

- As a result, by introducing forward guidance, it seems that the Bank of England is trying to divorce rate dynamics from the United States.

- Ahead of the announcement on forward guidance, the market was pricing in the first tightening by the Bank of England in the second half of 2015. The MPC is hoping that forward guidance will push market rate expectations further out.

- The Bank of England revised up its growth forecasts. It now expects GDP to grow 1.4% in 2013 (previously 1.2%) and by 2.4% in 2014 (previously 1.7%).



- Contrary to the Bank of England's hopes, sterling appreciated sharply following the release of the Inflation Report. Sterling appreciated from around \$1.53 to \$1.55 as markets raised their growth expectations on the back of the lower for longer rate guidance.
- Ultimately, however, the relatively dovish monetary stance from the Bank of England compared to the Fed should put downward pressure on sterling. After all, while the UK guidance precludes the tightening of policy, it does not rule out further stimulus via asset purchases or even a cut in the policy rate.



Expectations

- Mark Carney has really put his stamp of authority on the Bank of England. After just one month as the new Governor, he has already shaken things up, introducing new forward rate guidance: the MPC intends not to raise the Bank Rate from 0.5% until the unemployment rate falls to a threshold level of 7%, subject to the likelihood that inflation is no higher than 0.5% above the 2% inflation target at the 18-24 month horizon, medium-term inflation expectations are contained, and the Financial Policy Committee (FPC) believes that accommodative stance of monetary policy does not pose a risk to financial stability. However, the MPC will not necessarily raise rates when the threshold is met - rather, it is then that the guidance will be "reassessed".
- The Bank of England's aim is obvious. In recent months, the strengthening in economic activity, coupled with clear signals from the U.S. Federal Reserve that tapering of asset purchases will begin this year, have triggered a rise in UK interest rate expectations. The MPC believes this rise is unwarranted: "short-term rates have risen since May implying a faster withdrawal of monetary stimulus than appears likely given the current economic outlook". But time will tell whether its bid to anchor short-term rates is successful. The immediate market reaction was a very mild sell off of gilts, suggesting that the market may be attaching more weight to the recent stronger economic data than to the guidance.
- In addition, the market may be questioning the three rules which are tied to the forward guidance. After all, the rules are open to interpretation. For example, how will inflation expectations be judged? - the rule is not tied to any particular measure of inflation expectations. How will the FPC judge whether or not monetary policy is posing a risk to financial stability? In other words, the rules could be used as a "get out clause" should the MPC wish to raise policy rates without the unemployment rate having been breached. More significantly, with inflation having been above target for much of the past decade and the Bank of England's own 2014 forecast showing inflation only just on the cusp of the 2.5% rule, it would not be impossible to see inflation forecasts drifting above 2.5% over the coming months.
- Attention is also likely to quickly turn to the question of how fast unemployment will fall. For the first time, the Bank of England published its ILO unemployment rate forecast which showed that it expects the 7% threshold will not be met until the third quarter of 2016. The path for unemployment will depend heavily on labour participation and productivity.
- The Bank of England's concern that, as the recovery gathers pace, there will be an unwarranted change in expectations about the timing of the first rate hike is unlikely to disappear. As a result, if markets do not push out their rate expectations, it is possible that the MPC - and particularly Carney - will do more to convince the market that rates will stay lower for longer.

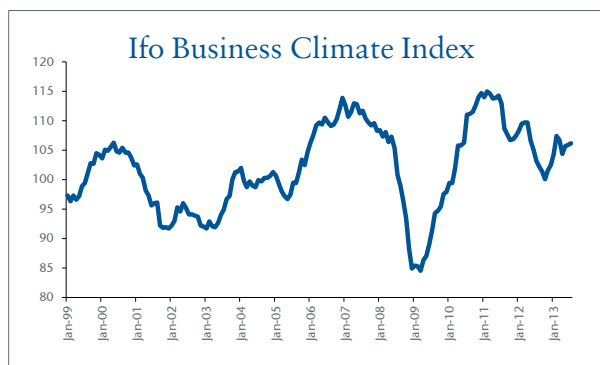
European Central Bank (ECB)

| INDICATOR | CURRENT | 3-MONTHS AGO | 6-MONTHS AGO | 12-MONTHS AGO |
|----------------------|---------|--------------|--------------|---------------|
| ECB Refi Rate | 0.50 | 0.75 | 0.75 | 0.75 |
| 2 Year Yield | 0.17 | 0.01 | 0.18 | -0.05 |
| 10 Year Yield | 1.67 | 1.27 | 1.61 | 1.42 |
| Eurozone Yield Curve | 1.50 | 1.26 | 1.43 | 1.47 |
| HICP | 2.40 | 1.20 | 2.00 | 2.40 |

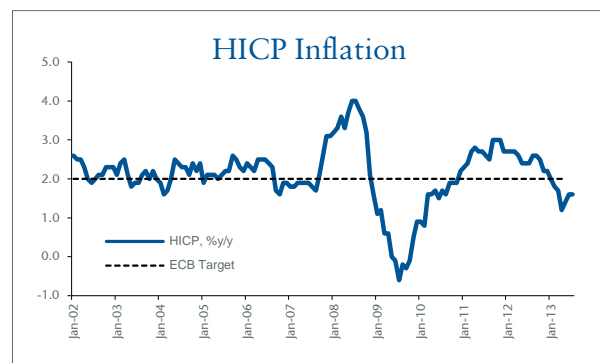
The ECB has a mandate to maintain price stability and has an asymmetric inflation target of below but close to 2% over the medium term. The ECB also has a reference value for the growth of M3.

Current Policy

- The ECB kept the official policy rate unchanged at 0.5% at the 1 August meeting. The marginal lending facility was kept on hold at 1% and the deposit rate left unchanged at zero.
- Having departed from its sacred "no pre-commitment policy" by introducing more explicit forward guidance on policy rates at the July meeting, the ECB offered no further specification on forward guidance, simply reconfirming that rates will remain "at present or lower levels for an extended period of time". ECB President Draghi also re-emphasised the downward bias to rates despite acknowledging the continued improvement in economic conditions. Indeed, it was noted that "market expectations of rate hikes are unwarranted". The decision to repeat the forward guidance had the unanimous backing of the entire Governing Council, but President Draghi resisted commenting whether or not a rate cut was discussed.
- The euro area economy has made an encouraging start to the third quarter. In July, the euro area composite PMI broke above the all-important 50 threshold for the first time since January 2012, rising to 50.4. Within this number, German, French, Italian, and Spanish composite PMIs all improved markedly.
- The German Ifo Business Climate Index rose from 105.9 to 106.2 in July. In addition, the ECB lending survey showed banks tightening their lending standards at a slower pace.



- According to the flash estimate, annual headline Harmonised Index of Consumer Prices (HICP) inflation remained at 1.6% in July. The recent rise appears to be driven by developments in energy prices.
- The ECB believes that underlying price pressures will remain subdued and is projecting inflation to fall further in the near term as a result of base effects and one-off measures. Inflation is then expected to significantly undershoot its target at 1.3% next year.



- However, ECB President Draghi noted that he is not worried about the risk of deflation. Breakeven inflation rates, a financial measure of inflation expectations, have declined from 1.9% in February to around 1.6% in late July.

- Certainly, in the context of its price stability mandate, the move to forward guidance suggests that the ECB views the inflation risk distribution as sufficiently skewed to the downside to enable it to make a reasonably solid forward commitment.

- Peripheral political developments over the past month have been generally negative, although not enough to result in major spillovers to other parts of the euro area.

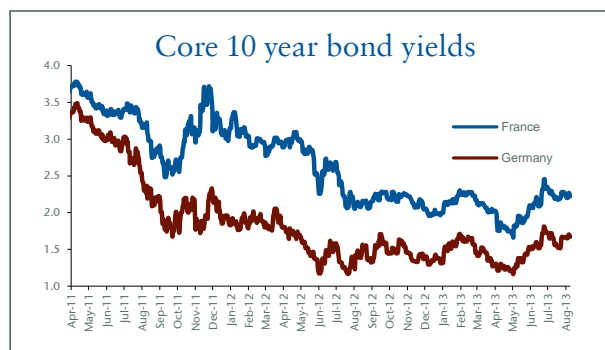
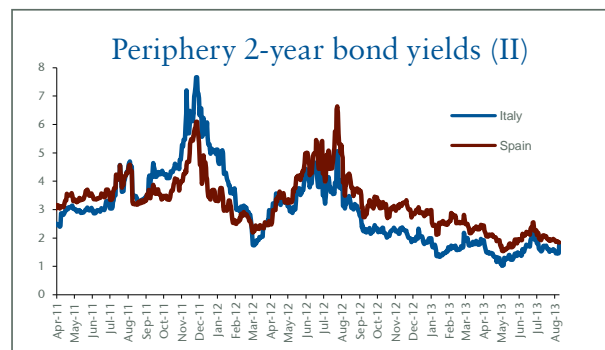
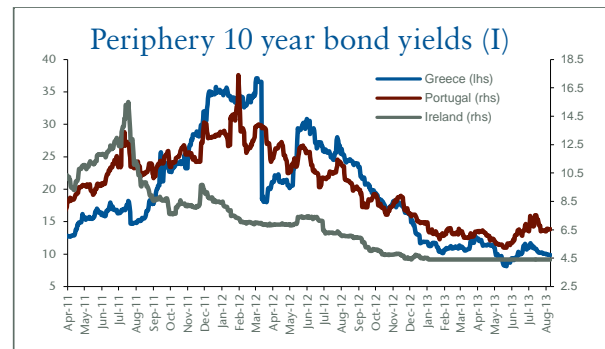
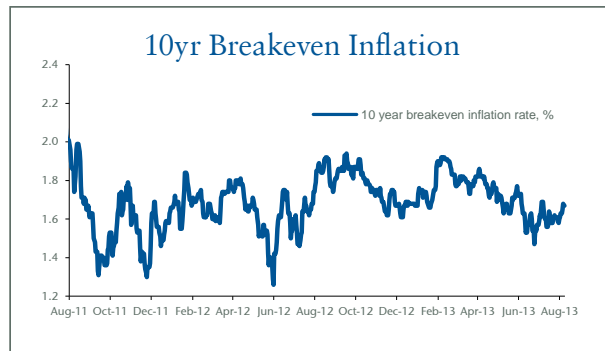
- Portuguese bond yields rose sharply in July following the resignation of the finance minister and concerns that early elections would be called. While the situation now appears to have been resolved and yields have since rallied, the episode highlights the effects of austerity fatigue.

- Spanish yields rose during July as a result of alleged evidence suggesting the Partido Popular and some of its members benefited from illegal funding. In addition, the Italian high court's decision to uphold a tax fraud ruling, which may lead to the expulsion of Mr. Berlusconi from parliament and snap elections early next year, unsettled Italian markets.

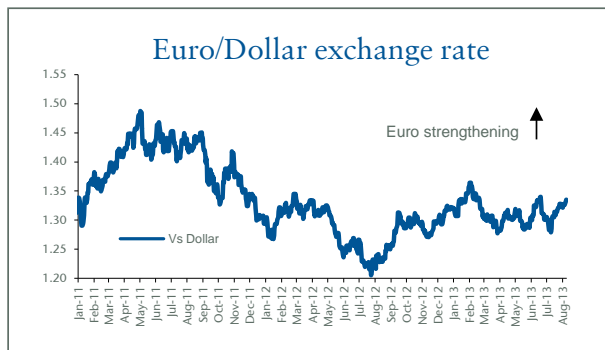
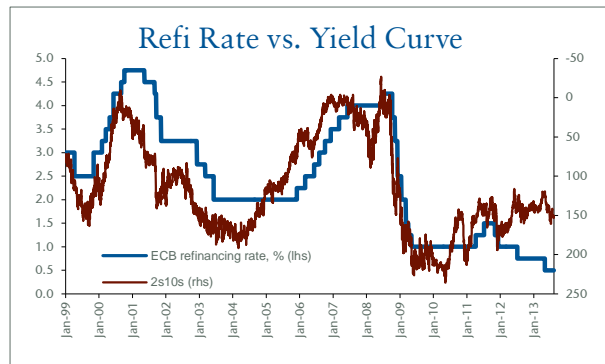
- While headlines have been negative, business surveys in the periphery have been improving, albeit from very weak levels, and hard data is also starting to reflect this stabilisation.

- Core bond yields rose sharply in the second half of June, in line with U.S. Treasuries as the Federal Reserve indicated it would soon start tapering asset purchases. However, the ECB's decision in early July to provide forward guidance, with a clear downward bias to policy rates, helped core bond yields rally, partially offsetting the prior sell off.

- However, there is now upward pressure on rates as the ECB is unlikely to loosen policy further given the improving macro outlook.



- Indeed, although the ECB has provided forward guidance, it is unlikely to offer further details of this guidance unless the economy re-weakens. In addition, in the absence of a deterioration in the economic outlook, policy rates are unlikely to be cut further.
- While the provision of forward guidance will support low front-end rates, the strengthening economy should put upward pressure on the belly and longer end of the euro yield curve. Political upheaval is likely to have limited impact on yields (at least in the run up to Germany's elections in September).
- Having weakened in early July as a result of ECB forward guidance, the euro regained its former strength in the second half of the month, appreciating to \$1.33 in early August.
- The outlook for the euro is mixed. On the one hand, ECB forward guidance (particularly in relation to the Fed's likely tapering of asset purchases) should put downward pressure on the euro. However, the strengthening euro area economy should limit any weakness.



Expectations

- The ECB's decision to introduce forward guidance is noteworthy, even if the details are not. After all, the ECB had steadfastly stuck to its "no pre-commitment" policy during the past few years, even as the market has screamed out for some signal that the ECB would soon take monetary action. In addition, the decision to provide forward guidance had the unanimous approval from the Governing Council. This means that representatives from the notoriously hawkish Bundesbank were also on board. That should hopefully imply little of the disagreements and disapproval that have tainted previous ECB announcements.
- What's more, the ECB's decision to keep rates "at present or lower levels for an extended period of time" came against a backdrop of an improving economy. Activity indicators suggest that a recovery is in motion - not only in the core countries, but also the peripheries. The rise in the euro area composite PMI above the all-important 50 threshold was supported by stronger readings from not only Germany and France, but also Italy and Spain.
- Given the improving economic outlook, what was the driving force behind the ECB's decision to provide forward guidance? It seems to us that the ECB's decision was caused by a desire to regain closer control over the euro area yield curve. After all, the increase in interest rate expectations in the United States had spilled over into the euro area. Hence, to insulate the euro area from externally driven increases in interest rates, the ECB likely felt that it needed to intervene early and ensure that the yield curve in the Eurozone more closely reflects economic conditions in the region, rather than those elsewhere.
- From our point of view, however, the scope for further policy stimulus from the ECB is limited. After all, if the ECB successfully divorces rate expectations in the euro area from those in the United States and if the economic data continue to evolve as expected, there will be little need for further policy rate cuts or guidance. If there is disappointment on those two fronts, however, it is possible that the ECB will deliver.
- Political developments in the periphery have been generally negative over the past month. Portugal, Spain, and Italy have suffered negative news flow and political upheaval. However, much of the news has been simple near-term headline noise, with no significant impact on the region as a whole. Strengthening economic data, coupled with enforced pre-German election calm has kept spillovers to a minimum. Overall, while volatility is likely, economic recovery in the Southern European economies should dictate most yield movements, supported by the ECB's more dovish stance.

Bank of Japan (BOJ)

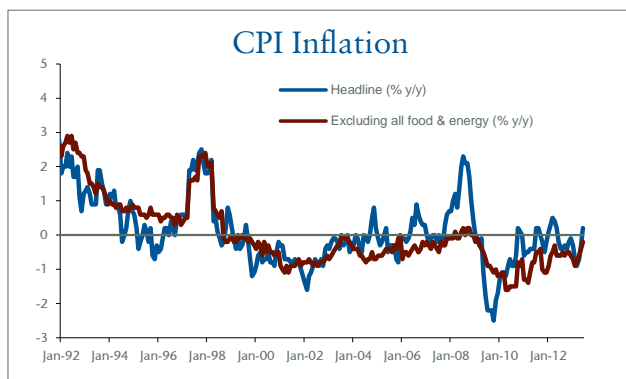
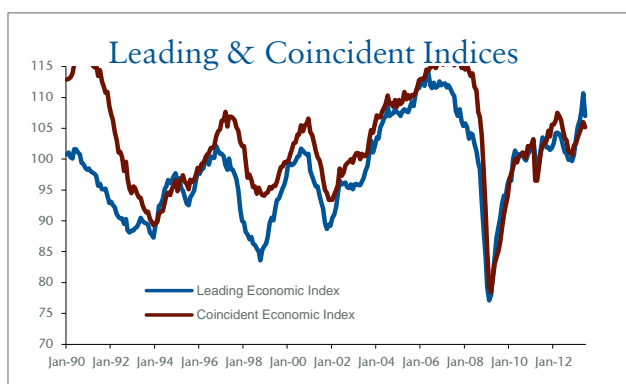
| INDICATOR | CURRENT | 3-MONTHS AGO | 6-MONTHS AGO | 12-MONTHS AGO |
|--------------------|---------|--------------|--------------|---------------|
| BOJ Target Rate | 0.10 | 0.10 | 0.10 | 0.10 |
| 2 Year Govt. Bond | 0.11 | 0.11 | 0.03 | 0.09 |
| 10 Year Govt. Bond | 0.76 | 0.60 | 0.77 | 0.80 |
| JGB Yield Curve | 0.64 | 0.48 | 0.74 | 0.72 |
| CPI | 0.20 | -0.90 | -0.10 | -0.20 |

The BOJ has a mandate to maintain price stability.

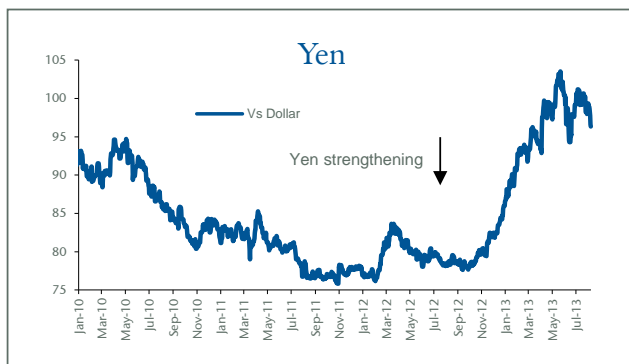
It has an explicit inflation goal of 2% , to be achieved "at the earliest possible time"

Current Policy

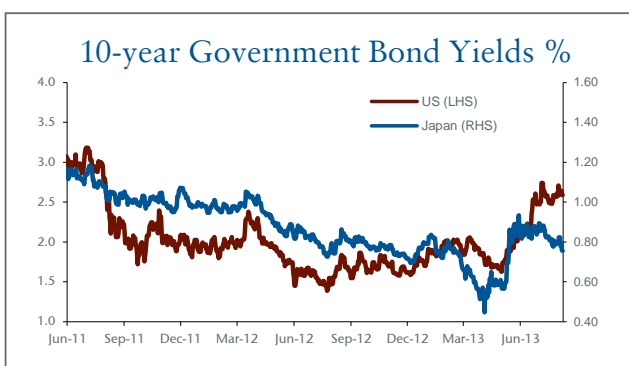
- The BOJ kept policy unchanged at its 8 August meeting, having announced significant new policy measures at its 4 April meeting.
- The BOJ appeared to be content with the development of the economy, prices, and market. At the July meeting, it revised up its assessment of the economy on an improvement in exports and corporate earnings, although its growth forecasts were lowered marginally. The CPI inflation forecast for 2013 and 2014 was trimmed slightly, but was left unchanged at 1.9% for 2015. The BOJ remains confident that it will meet its 2% inflation target in two years. The BOJ also noted that "inflation expectations appear to be rising on the whole", and made no mention of any concern about the stronger yen.
- After having accelerated in the first half of the year, the economy appears to be decelerating. Consumer spending fell 0.7% in June, with retail sales edging down and auto registrations posting a third consecutive drop in July. The services PMI fell from 52.1 in June to 50.6 in July, while the manufacturing PMI fell from 52.3 to 50.7.
- However employment data continued to improve in June, with the job offer to application ratio rising and the unemployment rate falling from 4.1% to 3.9% in June.
- The robust economy and rising inflation expectations are pushing up inflation. The national core CPI (excluding fresh foods) rose 0.4% year-on-year in June - the first annual rise since April. The core measure slowed its pace of decline to -0.2% year-on-year, from -0.4% in May.
- The BOJ trimmed its core CPI forecast down from 0.7% to 0.6% for 2013, and from 1.4% to 1.3% for 2014. The 2015 forecast was left unchanged at 1.9%. The BOJ is confident that it will meet its 2% inflation target.



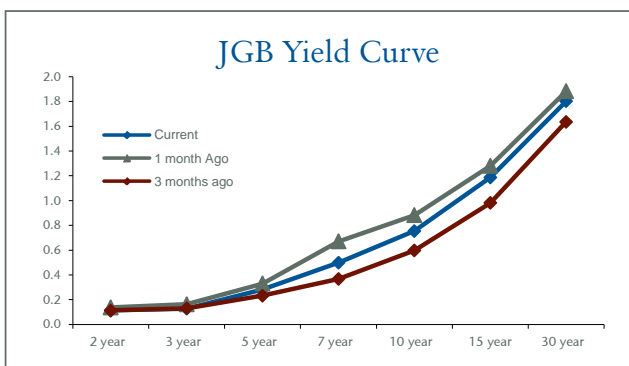
- The yen weakened through the month of July but fell back below ¥100 in early August. Robust economic growth in the first half of the year, coupled with stronger-than-expected inflation, as well as the LDP-NKP's landslide victory in the upper house elections, which is now paving the way for a more aggressive reform initiative, have reduced expectations of further BOJ monetary stimulus. This is positive for the yen and, as a result, there is pressure on the yen to strengthen.



- A slight easing of concerns about an imminent U.S. tapering of asset purchases has also contributed to the re-strengthening of the yen. Similarly, Japanese government bond (JGB) yields continue to be strongly influenced by U.S. Treasury yields.
- A spike in U.S. Treasuries following stronger-than-expected U.S. jobless claims and ISM manufacturing data triggered a rise in JGB yields in early August. If upward momentum is sustained in the U.S. Treasury market, JGB yields could continue to rise.



- Over the month as a whole, however, 10-year JGB yields have fallen 13 basis points, while 10-year USTs have fallen just 5 basis points. On the other hand, two-year JGBs have underperformed two-year USTs.



- Our overall view remains that, in the near term, JGB yields will be under downward pressure from BOJ buying. However, over the longer term, JGB yields should gradually shift upwards, driven by stronger Japanese growth and inflation and also by higher U.S. Treasury yields.

Expectations

- As expected, the LDP won a landslide victory in the Upper House election on 21 July. Together, the two ruling parties now hold a majority in the Upper House. The result of the election suggests that Prime Minister Abe will likely run a stable administration for the next three years. In October, a decision to go forward with a hike in the consumption tax will likely be made (with the hike set to occur in April 2014). In addition, the second phase of Abe's growth strategy will be announced in Autumn.

- Overall, the success of Abenomics will require the BOJ to support growth through all the difficult fiscal and structural adjustments that lie ahead. But in the near term, at least, the BOJ's behaviour is likely to be strongly driven by deviations from its 2% inflation target. As a result, although economic activity appears to be now decelerating, the recent rise in inflation suggests that the BOJ may defer additional monetary easing until next year. Its Outlook Report will be released at the October monetary policy meeting and will provide useful insight into the BOJ's plans. Notably, comparing the BOJ's own inflation forecasts to the consensus, the BOJ is more optimistic that it will meet its 2% inflation target over the two-year horizon.

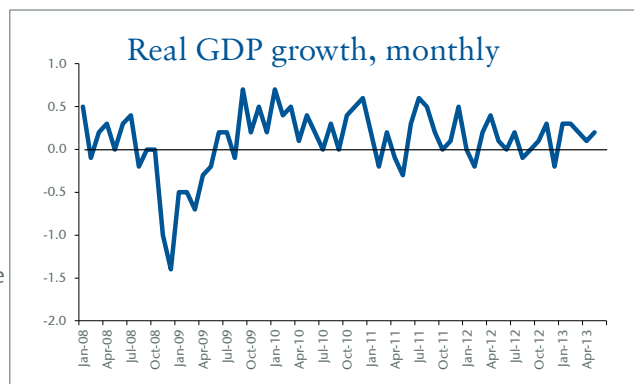
Bank of Canada

| 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 | 1.14 | 0.98 | 1.15 | 1.17 |
| 10 Year Bond Yield | 2.50 | 1.82 | 2.00 | 1.84 |
| Canada Yield Curve | 1.36 | 0.85 | 0.84 | 0.67 |
| Core CPI | 1.30 | 1.40 | 1.10 | 2.00 |

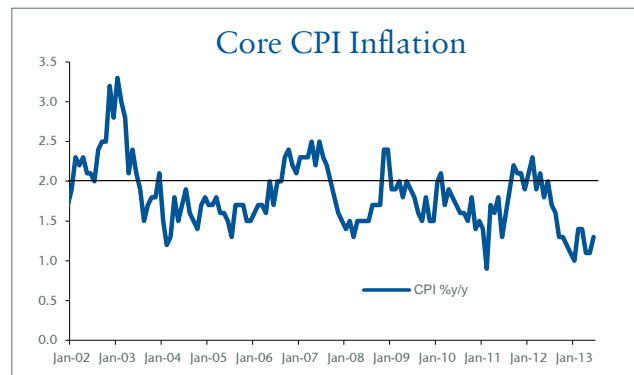
*The Bank of Canada has a mandate to maintain price stability.
It has a symmetric inflation target of 2%, plus or minus 1%.*

Current Policy

- The Bank of Canada (BoC) left its key policy rate unchanged at 1% at its 17 July meeting. Rates have remained on hold since October 2010.
- In new Governor Stephen Poloz's first rate announcement, the language was slightly more dovish than previously. Although the BoC continued to signal that the next policy move would be upwards, it also noted that "as long as there is significant slack in the Canadian economy, the inflation outlook remains muted, and imbalances in the household sector continue to evolve constructively, the considerable monetary policy stimulus currently in place will remain appropriate". The BoC slightly lowered its forecast for global GDP growth, but boosted its 2013 forecast for the Canadian economy from 1.5% to 1.8%.
- The Canadian economy grew 0.2% month-on-month in May, the fifth consecutive increase. The service industry led the gain, increasing 0.5%. Retail sales growth surged in May to 1.9% month-on-month, the largest increase since March 2010.
- After a 95,000 surge in May, Canadian employment was essentially unchanged in June, with jobs edging down 400. On average, during the second quarter employment has averaged 35,700 per month. The unemployment rate was unchanged at 7.1%.

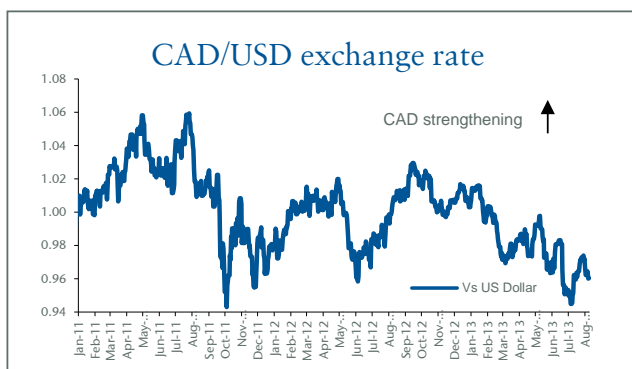


- Annual headline CPI inflation rose further in June, from 0.7% to 1.2%, boosted by a jump in gasoline prices and favourable base effects. Core annual CPI rose from 1.1% in May to 1.3% in June, remaining within the lower end of the BoC's inflation target band.

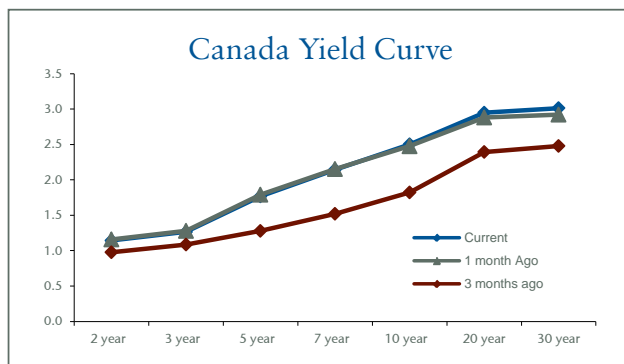


- In its latest quarterly Monetary Policy Report, the BoC noted that low core inflation "continues to reflect persistent material excess capacity in the economy" and expects it to gradually return to the 2% target by the middle of 2015.

- The Canadian dollar weakened to almost \$0.94 against the U.S. dollar in early July, reflecting more strength in the U.S. dollar than weakness in the loonie. In addition, concerns about China's economic prospects weighed on global commodity prices, putting downward pressure on the Canadian dollar.
- New Governor Poloz's slightly more dovish comments also weighed on the currency - particularly as the U.S. Federal Reserve has been signalling a near-term tapering of quantitative easing.

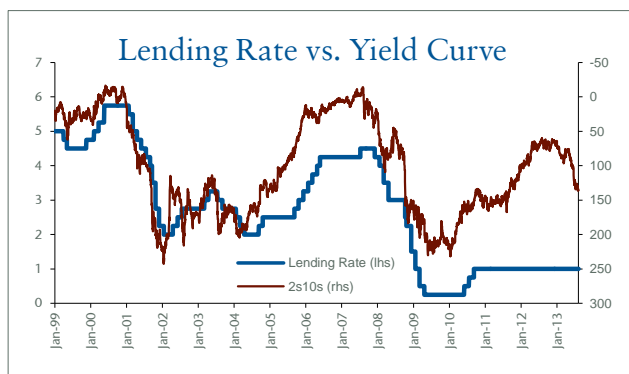


- Canadian bonds have slightly underperformed U.S. Treasuries. Ten-year Canadian yields rose three basis points over the month as a whole, while 10-year Treasuries fell five basis points. The front end of the Canadian curve fell marginally.



- The comparably more dovish BoC should mean that Canada's outperform U.S. Treasuries. However, as Canadian growth strengthens, it is possible that short-end Canada's will underperform.

- Although the new BoC Governor appears to be slightly more dovish than ex-Governor Carney, the strengthening U.S. economy is likely to spill over to the Canadian economy. In turn, this is likely to re-ignite rate hike expectations and lead to a re-strengthening of the Canadian dollar.



- As a result, while Canadian policy rates are likely to be kept on hold for the remainder of this year, 2014 may bring policy rate hikes.

Expectations

- In its latest quarterly Monetary Policy Report, the Bank of Canada lowered its near-term outlook for global GDP growth (mainly due to a downward revision to Chinese GDP growth and other emerging market economies), while stronger-than-expected growth in the first quarter has pulled up its 2013 Canadian GDP growth forecast. The BoC lowered its 2014 Canadian forecast slightly (from 2.8% to 2.7%), and left its 2015 forecast unchanged at 2.7%. It continues to expect the economy to return to full capacity around the middle of 2015, with inflation returning to trend around that time.

- While its wording was slightly more dovish than in recent meetings, the BoC has maintained its bias that the next rate change - whenever it eventually comes - will be in the upward direction. With the U.S. economic recovery gathering momentum now and the Federal Reserve preparing to taper asset purchases, Canada is likely to feel the benefits of stronger U.S. growth. In early 2014, we expect Canadian growth to pick up, re-igniting expectations for a rate hike - although that may not come until the second half of next year.

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