Central Bank Watch

October 9, 2014

Note: Unless otherwise indicated all data in this document is sourced from Bloomberg as of 09/10/14

Reserve Bank of Australia

INDICATOR	CURRENT	3-MONTHS AGO	6-MONTHS AGO	12-MONTHS AGO
RBA Target Cash Rate	2.50	2.50	2.50	2.50
2 Year Bond Yield	2.57	2.53	2.81	2.75
10 Year Bond Yield	3.30	3.52	4.07	4.09
Aussie Yield Curve	0.73	0.99	1.26	1.34
CPI	3.00	2.90	2.70	2.40

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.

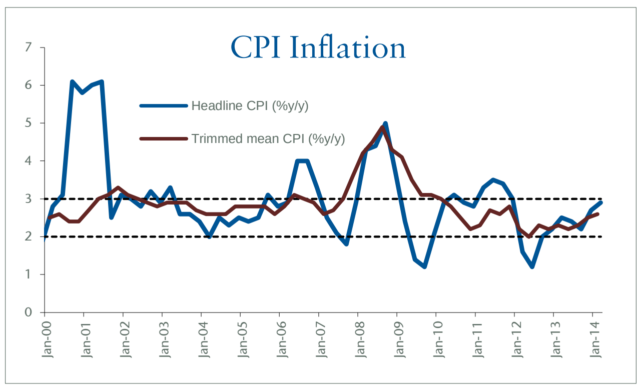
Current Policy

• The Reserve Bank of Australia (RBA) held the cash rate at 2.5% at the 7 October meeting. Rates had previously been cut by 25 basis point at the August 2013 meeting.

• The RBA retained its neutral bias, maintaining the phrase: "most prudent course is likely to be a period of stability in interest rates". Despite the recent weakening in the Australian dollar and rise in house prices, the RBA - if anything - sounded a little dovish. It is slightly more concerned than before about slowing momentum in the Chinese economy and, although commodity prices are high relative to historical averages, the RBA noted that "some of those important to Australia have declined this year". It expects the continued slack in the labour market to "keep inflation consistent with the target even with the lower levels of the exchange rate".

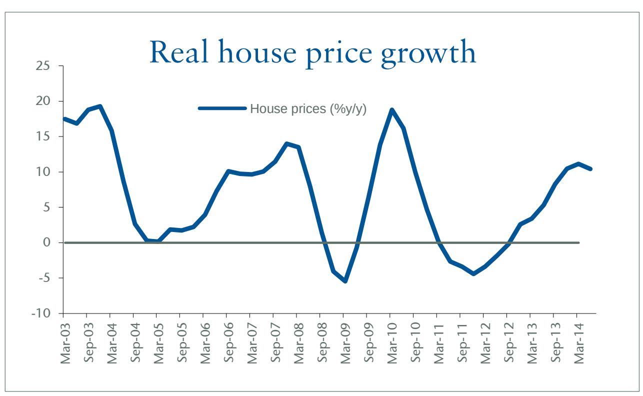
• Following two months of flat outcomes, the TDMI inflation gauge showed inflation of just 0.1% month-on-month in September, suggesting very subdued inflation in Q3.

• After an all-time record of 121,000 jobs were added in August (reversing the July drop), 29,700 jobs were lost in September. The unemployment rate stood at 6.1% (after having fallen from 6.4% in July to 6.1% in August). However, the RBA described labour market data as "unusually volatile of late".



• The August NAB business survey reported a reversal of the strong gains in July, but levels of confidence remained relatively high. Retail sales rose just 0.1% in August and contracted 0.1% on an ex-food basis. Consumer sentiment fell sharply in September, unwinding the tentative recovery of the past couple of months.

• Following a period of solid growth, RP Data-Rismark house prices were flat in September. Recent RBA comments suggested increased anxiety about rising house prices, but the latest RBA statement did not indicate strong concern.



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	0.42	0.48	0.36	0.36
10 Year Treasury Yield	2.31	2.55	2.69	2.66
Treasury Yield curve	1.88	2.07	2.33	2.31
Core PCE	1.47	1.52	1.23	1.33

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

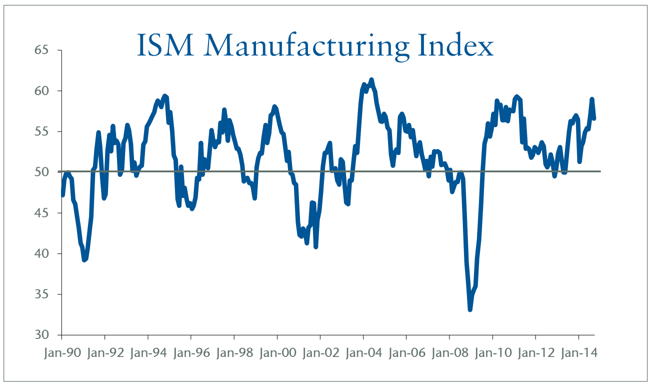
Current Policy

• The Federal Open Market Committee (FOMC) held the target range for the federal funds target rate at 0.0% to 0.25% at its 17 September meeting, while it tapered the pace of asset purchases by another $10 billion to $15 billion per month.

• While the FOMC statement was unchanged, retaining the "considerable time" language, the committee forecasts were hawkish. They showed a noticeable move up in the interest rate projections for 2015 and 2016, and the new 2017 policy-rate projection was at the upper end of forecasts. Minutes to the FOMC meetings showed some concern about slowing global growth and the strength of the dollar. The minutes noted that the current forward guidance "suggested a longer period before lift-off, and perhaps also a more gradual increase in the federal funds rate thereafter, than they believed was likely to be appropriate."

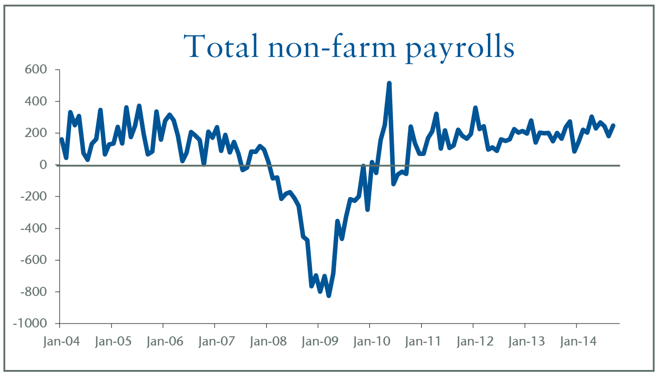
• Recent data paint a strong economic picture. The manufacturing Purchasing Manager Index (PMI) declined modestly from 57.9 in August to 57.5 in September, while the manufacturing Insitute of Supply Management (ISM) weakened from 59 to a still strong 56.6. Durable goods excluding transportation (a volatile category) rose a decent 0.7% in August.

• Personal spending grew 0.5% in August, slightly softer than expected. Meanwhile, consumer confidence fell in September, with expectations for the future also lower.

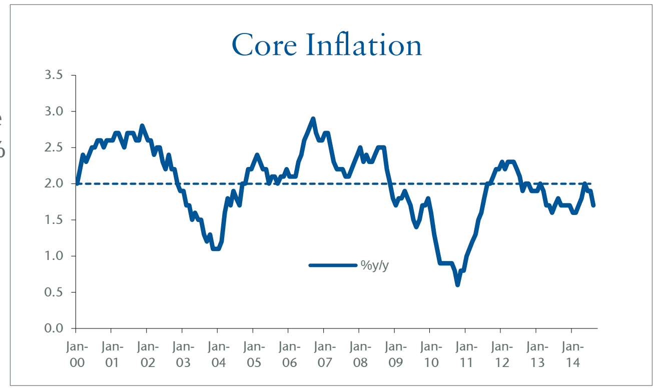


• The September employment report was stronger than expected, with non-farm payrolls rising by 248,000. A decline in labour force participation to a cycle low of 62.7% helped push the unemployment rate below 6%.

• Wage growth remains sluggish. Average hourly earnings were flat on the month, and up 2% compared to a year earlier. Yellen has stated that "to my mind, the very slow pace of wage increases does reflect slack in the labour market". Wage growth will be key to Fed policy and the progress of the U.S. economy.

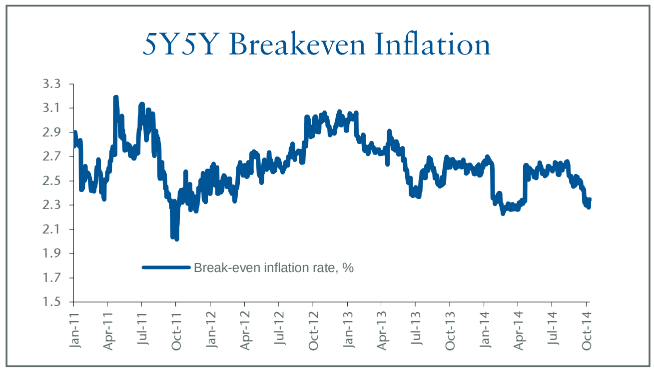


• Inflation was weaker than expected in August. Headline Consumer Price Index (CPI) fell 0.2% month-on-month, pushing the annual measure down from 2% to 1.7%. Core CPI rose 0.1% on the month, also pushing the annual rate down to 1.7% (from 1.9% in July). The annual core Personal Consumption Expenditure (PCE) inflation rate - the Fed's preferred measure of inflation - was stronger than expected, standing unchanged at 1.5% in August.
• The September FOMC statement described inflation as "running below" the Fed's target rather than moving "somewhat closer".



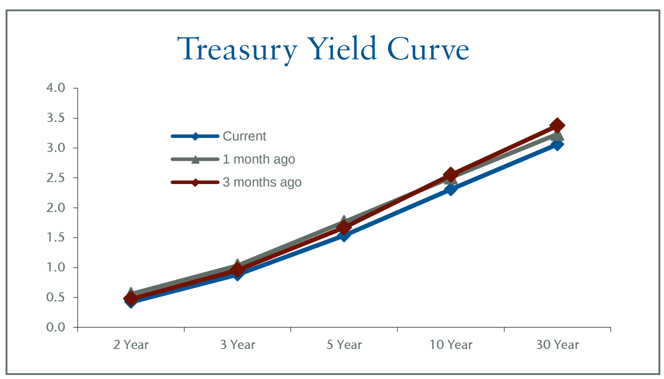
• Five-year breakeven inflation rates, a financial market measure of inflation expectations, have declined in the past couple of months, falling from around 2.65% to 2.3%.

• The Fed has become more concerned about inflation expectations, with Chicago Fed President Evans recently focusing on the drop in breakevens. On the other hand, survey-based measures of inflation expectations have generally remained range-bound, providing some relief.



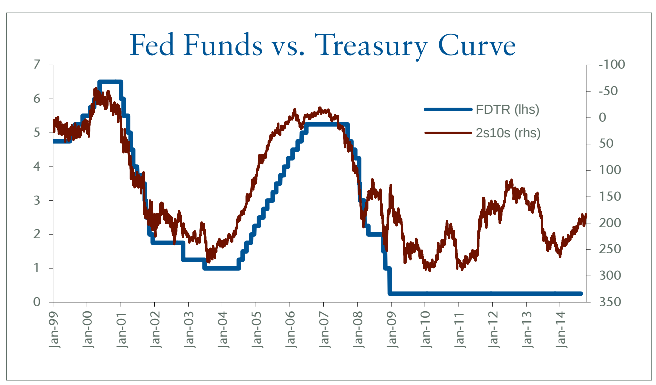
• Ten-year Treasury yields have had another volatile month, swinging from a high of 2.65% on 19 September (as USTs sold off in response to a move up in FOMC committee forecasts), then down to 2.28% on 9 October. The sharp rally in USTs has been driven by more dovish-than-expected FOMC minutes, as well as concerns about a global slowdown and geopolitical risks.

• Over the past month as a whole, the entire yield curve has shifted lower, led by the belly.



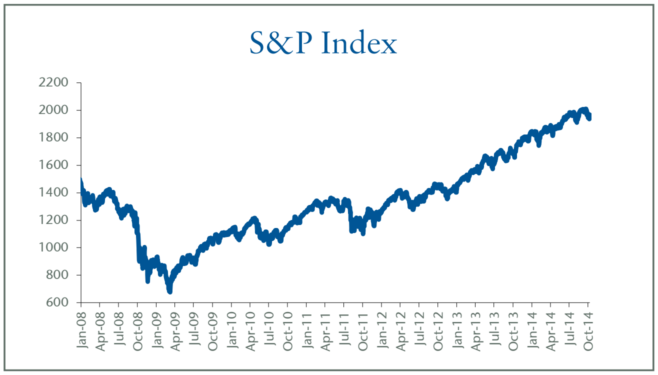
• Downside risks for global growth are growing, with associated concerns about the impact of the strong dollar on the inflation outlook.

• We think the FOMC will start to raise rates next year but, going into 2016 and 2017, the magnitude of the new normal rate is likely to be much lower than the FOMC median projection would suggest. There are considerable global deflationary pressures and they will continue to suppress rates in the United States even as the Fed moves to normalize policy.



• Global equities reached a new high in late September, before tracing back down slightly.

• Markets have alternated between concerns about a more hawkish Fed (following release of the FOMC meeting statement) to concerns about a global slowdown and the strong dollar. Credit spreads have widened further on similar concerns, with high yield and emerging markets underperforming. Central bank policy divergence between the Fed and the European Central Bank (ECB) may see European credit spreads outperforming U.S. credit spreads.



Expectations

• The latest incoming U.S. economic data paint a picture of a strong recovery, with low inflation and a strengthening labour market. Business surveys have been at elevated levels, with the ISM and PMI surveys signalling solid industrial production growth in the third quarter. Labour market data have also been encouraging, with robust employment growth pointing to employer confidence. The unemployment rate has continued to decline - admittedly helped along by a falling participation rate - and is now below 6%. Consumer confidence slipped in September, but the August number was revised higher. Housing data remain slightly soft, with house price growth moderating slightly.

• Given the broad improvement in data, there was some market surprise that the Fed had not dropped the "considerable time" guidance in its September policy statement. However, the Federal Reserve still has reason to be patient. First, wage growth remains sluggish and is only just starting to pick up speed. Without a recovery in average earnings growth, consumer spending will struggle to pick up meaningfully. As such, it is no wonder that evolution of wage growth will be key to Fed policy going forward.

• Second is concern over the state of the global economy. There are growing signs that China's economy is slowing - domestic demand remains soft and the pace of property price declines has intensified. In addition, the euro area economy has continued to lose momentum, with Germany suffering a slowdown in manufacturing and Italy and France both struggling to post any positive economic numbers. While the ECB is pursuing a significantly expansionary monetary policy - with its asset-backed securities/covered bond purchase programs set to start in the coming weeks - there are wide concerns that it will not be enough to arrest the slide in euro area inflation and inflation expectations.

• That brings us to the Fed's third concern: the strength of the dollar. With the euro having dropped below $1.30 and likely to decline to at least the low $1.20s, there is likely to be some spillover for the U.S. economy from foreign demand weakness. Unsurprisingly then, the FOMC minutes noted that staff had revised down their medium-term outlook, partly due to dollar strength.

• FOMC minutes also revealed that the Committee is uncertain about the risks associated with changing the statement language. They stress that "considerable time" (referring to the FOMC's forward-rate guidance) has no "mechanical" interpretation, and that the Fed's rate decision is data-dependent. Either way, they have concerns that excluding the "considerable time" phrase would be "misinterpreted as a fundamental shift". For now, then, the phrase remains.

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	0.69	0.87	0.65	0.42
10 Year Gilt Yield	2.21	2.66	2.69	2.68
Gilt Yield Curve	1.52	1.79	2.04	2.26
CPI	1.50	1.50	1.70	2.70

The Bank has a mandate to maintain price stability.

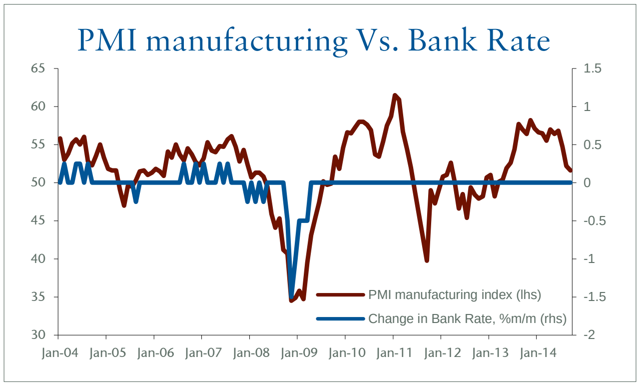
The MPC has a symmetric inflation target of 2% on the Consumer Price Index, plus or minus 1%.

Current Policy

• The Monetary Policy Committee (MPC) decided to hold the bank rate at 50 basis points at its 4 September meeting, and also chose to keep the size of its bond purchase plan unchanged at £375 billion.

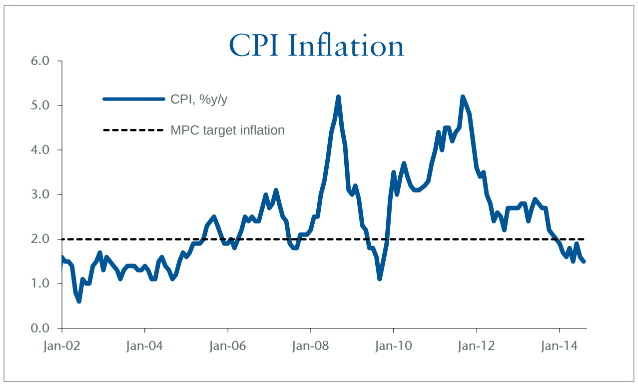
• Minutes to the September meeting showed that the MPC voted 7-2 in favour of unchanged policy, with the same two members as in August voting for a 25 basis point increase. The MPC appears not in any hurry to tighten policy given concerns about the "accumulating evidence" that growth in the euro area has weakened, as well as signs that UK economic growth will soften from fourth quarter. It also noted that "inflation was below the target", with " few signs of inflationary pressures". Most of the MPC is waiting to see a pick up in wage growth, although in a recent speech, Governor Carney said that "we need to see the *prospect* of wage growth".

• UK Q2 GDP growth was upwardly revised from 0.8% quarter-on-quarter to 0.9%. Timelier data tentatively suggests a moderation in activity in Q3. The manufacturing PMI fell further in September, from 52.2 to 51.6 - the lowest level since Q2 2013 and a sharp drop from 57 in April. The services PMI fell from 60.5 in August to a still-high 58.7.



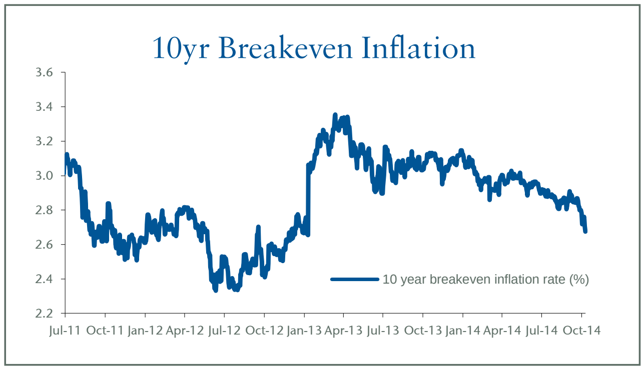
• The unemployment rate fell from 6.4% to 6.2% in the three months to July. However, the drop was driven by a fall in participation, with employment growth weaker than expected.

• Annual earnings growth rose from -0.2% to 0.6% in July - but the increase was attributable to base effects from last year's tax changes. The level of the average earnings index is unchanged from where it stood last December.



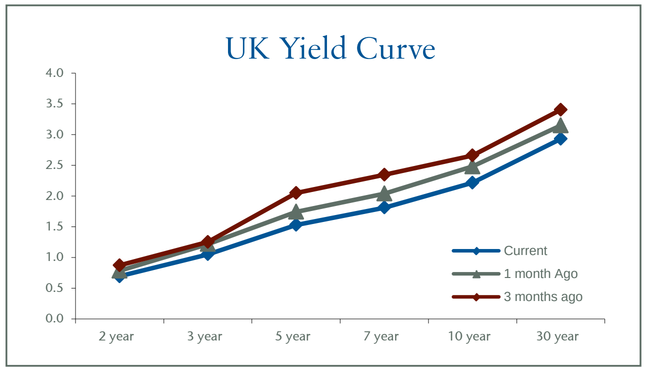
• Annual CPI inflation fell from 1.6% in July to 1.5% in August, further below the BoE's 2% target. Core CPI inflation rose from 1.8% to 1.9%. The September MPC minutes noted that "unit labour costs were currently growing at a rate well below that consistent with meeting the inflation target in the medium term".

• The MPC minutes noted that there are "few signs of inflationary pressures". Certainly, just as in other advanced economies, UK inflation expectations have been declining. Ten-year breakeven inflation rates - a financial market measure of inflation expectations - have continued to decline and are now at 2.7%.



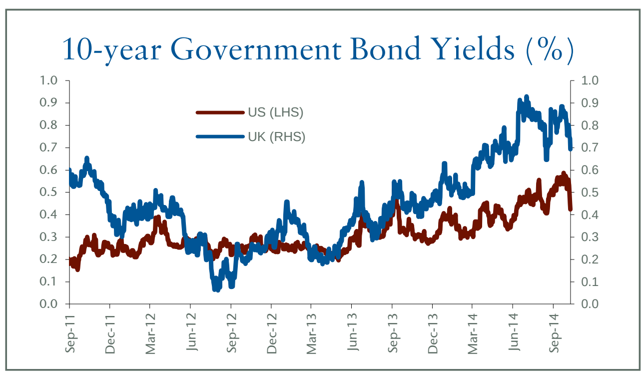
• The MPC expects inflation at the two-year horizon to reach 1.8%, and on the three-year horizon, inflation is expected to be in line with the 2% target.

• The gilt curve has fallen sharply over the past month. The front end of the curve has fallen around 7 basis points over the past month, while the belly and long end have fallen more than 20 basis points.



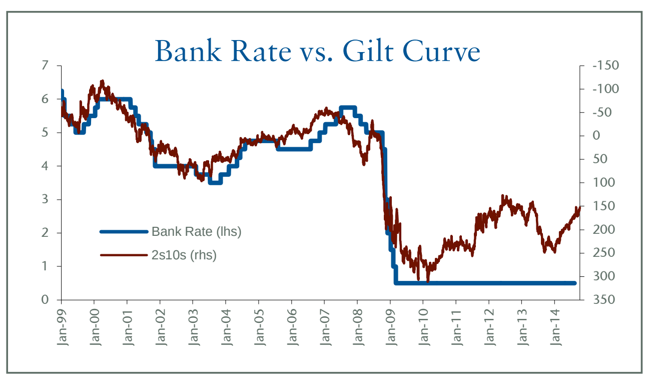
• There has been considerable volatility over the past month. Ten-year gilt yields rose to 2.61% in the run-up to the Scottish independence vote on 19 September. The resulting "no" vote saw a sharp relief rally, with gilt yields falling to 2.23% in October.

• Much of the rally in the past week has reflected similar moves in U.S. Treasury yields. Concerns about global growth as a result of weak euro area growth and a slowing Chinese economy have weighed on traditional safe havens, such as U.S. Treasurys.



• Specific to the UK gilt market, domestic economic data suggest a slight moderation in momentum, while recent speeches by MPC members have struck a relatively neutral tone. As a result, there has been speculation that the UK's first policy rate hike will be pushed back.

• For the moment, consensus expectation is still for the first rate hike in Q12015, with gradual tightening thereafter. Forwards are pricing in a bank rate of 1.2% at end-2015 (equivalent to 75 basis points of hikes next year).

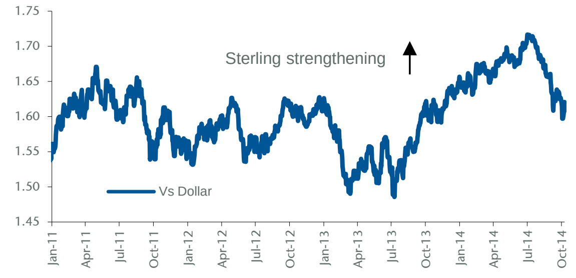


• Wage growth over the next few months is going to play a key role for BoE policymakers. While official average earnings growth is subdued, survey data suggest strong wage pressures. Rate hike expectations will be pushed out if wage growth does not materialise.

• Sterling weakened to almost $1.60 in the run-up to the September Scotland independence vote as markets worried about the implications of a surprise "yes" vote. Although sterling strengthened following the "no" vote, news that the UK current account deficit widened pushed sterling back lower.

• With the UK still likely to be the first central bank to raise rates, sterling may strengthen modestly against the U.S. dollar. With the ECB set to ease monetary policy significantly over the coming months, sterling should strengthen meaningfully against the euro.

Sterling/Dollar exchange rate



Expectations

• The UK economy is showing signs of moderation as we move into the final quarter of 2014. However, this should not pose a meaningful concern to policymakers, as a modest slowdown has been anticipated and is to be expected following a sharp recovery from a deep downturn. Indeed, recent revisions from the Office of National Statistics show that the UK economic recovery was stronger than initially believed - real GDP is estimated to have surpassed the pre-crisis peak in 2013Q3 (previously believed to be 2014Q2) and in 2014Q2, GDP is estimated to have already been 2.7% above the pre-crisis peak.

• The manufacturing PMI declined further in September and is now consistent with broadly stagnant manufacturing output. Growth within the sector has lost significant momentum through the summer, and will weigh on Q4 growth. In addition, there are growing signs that the UK housing market is losing steam once again; the Financial Policy Committee's macroprudential measures are probably weighing on demand. With growth in the euro area - the UK's main export trading partner - weakening, there are some downside risks to UK growth.

• Most important from the Bank of England's perspective is the evolution of wage growth. While unemployment has been falling faster than expected, earnings growth have continued to disappoint and official numbers generally remain flat. However, there are strong hopes that the tight labour market conditions will eventually push up wage costs. Certainly, recent surveys show a gap between actual wages and wage pressures for new hiring, fuelling concerns in the MPC that wages growth "may pick up quite sharply as slack is absorbed". With Governor Carney indicating (albeit then instantly confusing his message) that the MPC just needs to see the "prospect" of wage growth, we think the first rate hike is only a couple of quarters away.

• In other news, the Scottish independence vote was (thankfully) a non-event. The implications of a surprise "yes" vote would have been significant - the ensuing uncertainty and deterioration in the UK's government and external imbalances could have been detrimental to UK equity, bond, and currency markets. There will now be constitutional reform for the rest of the UK, hopefully implemented before the new government is formed in May 2015. On a similar note, with the General Election now in sight, the party conference season is underway and the main parties are pencilling their fiscal strategies. Electoral polls suggest there is a fair chance of a change in government - from the current Conservative/Liberal Democrat coalition to a Labour government.

European Central Bank (ECB)

INDICATOR	CURRENT	3-MONTHS AGO	6-MONTHS AGO	12-MONTHS AGO
ECB Refi Rate	0.05	0.15	0.25	0.50
2 Year Yield	-0.07	0.02	0.18	0.17
10 Year Yield	0.88	1.23	1.58	1.81
Eurozone Yield Curve	0.95	1.21	1.39	1.64
HICP	2.40	0.50	0.50	1.10

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.

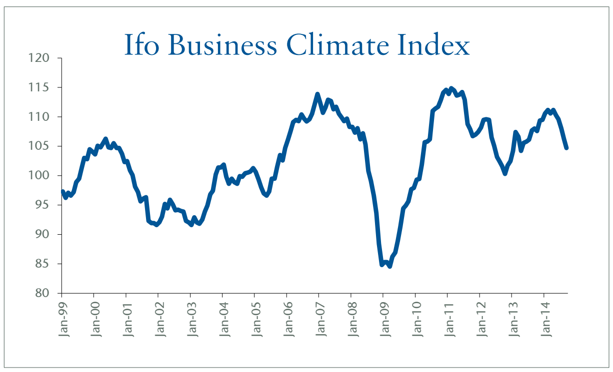
Current Policy

• The ECB kept the official policy rate at 0.05% at the 2 October meeting. The marginal lending facility was left unchanged at 0.3% and the deposit rate kept on hold at -0.2%. Previously, all three policy rates had been lowered at the June and September meetings.

• The ECB announced no new policy measures at the October meeting, although it did provide operational details on its previously announced ABS and covered bond (CB) purchase programs. ECB Governor Draghi gave the impression that those asset purchase programs and the up-coming TLTROs will be sufficient to reactivate markets and to bring inflation back into line with the "below, but close to 2%" target - although he also repeated that the ECB was unanimous that it would use "other unconventional instruments within its mandate" if necessary.

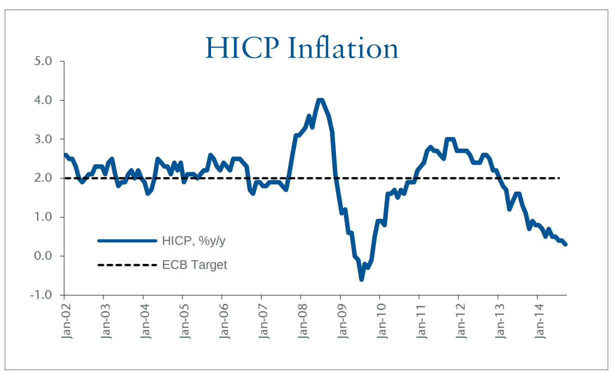
• Survey data has been pointing to further moderation in activity.

• The euro area composite PMI fell from 52.5 in August to 52 in September, led by the forward-looking orders index. The German composite PMI rose from 53.7 to 54.1, with an increase in services offsetting a fall in manufacturing. The composite PMI fell to 48.4 in France, 49.5 in Italy, and 55.3 in Spain. The German Ifo Business Climate Index fell again in September, to 104.7 to 106.3 in August.



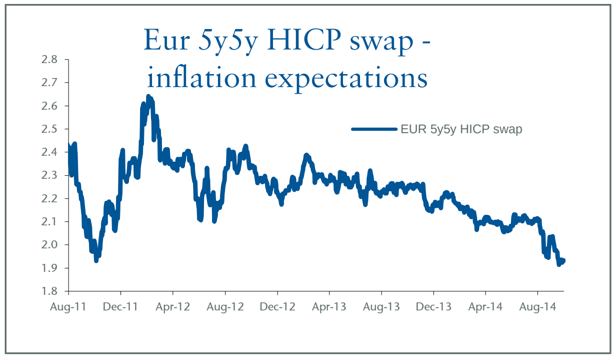
• Annual headline Harmonised Index of Consumer Prices (HICP) inflation moved lower, falling from 0.4% in August to 0.3% in September and further below the ECB's inflation target of "below, but close to, 2%". Core inflation fell from 0.9% to 0.7%.

• Draghi highlighted that the most recent inflation data reflected an easing in price components beyond the energy component on the back of weakness of the economy. The ECB expects inflation "to remain at low levels over the coming months, before increasing gradually during 2015 and 2016".



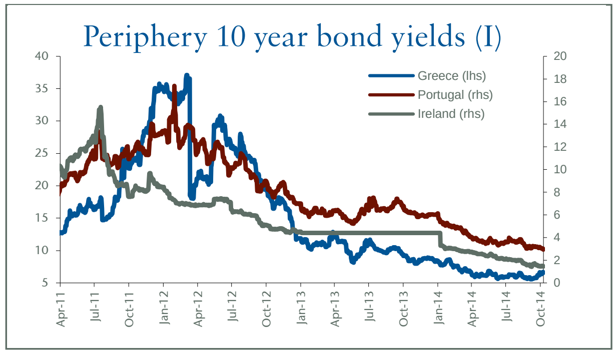
• At the Jackson Hole symposium in late August, Draghi drew attention to the sharp drop in inflation expectations, noting that inflation expectations appear to have become unanchored. Indeed, 10-year breakeven inflation and 5y5y HICP swaps - financial market measures of inflation expectations - have dropped sharply over the past couple of months.

• If inflation expectations fail to recover, there is a meaningful prospect of sovereign quantitative easing (QE).



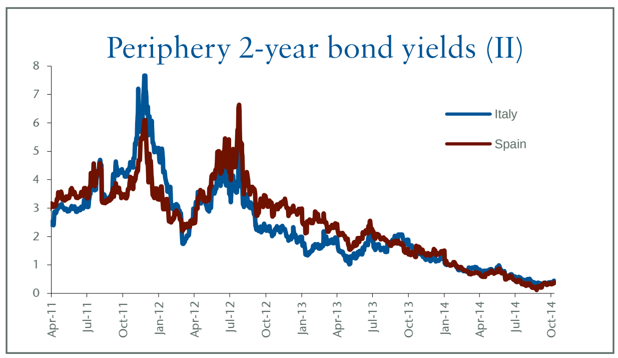
• Peripheral bond yields have continued to rally, driven by expectations that the ECB is aiming to increase the size of its balance sheet significantly.

• Greek bonds, in particular, will receive a boost by the news that the ECB is considering purchasing senior Greek bonds. With the Troika set to conduct its fifth review on reforms made by Greece so far, the Greek PM has indicated that the country will not be looking for a third bail-out program.



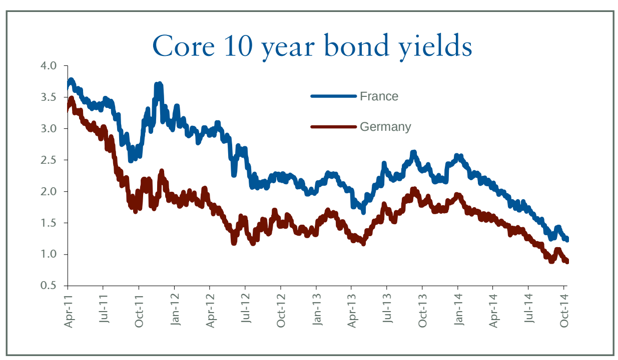
• Whilst the Spanish economy has continued to perform strongly, the Italian economy has disappointed. Industrial production declined in July, and survey indicators suggest that the weakness continued through the whole of September.

• Italy is falling behind once again with its fiscal austerity commitments, while structural reforms are also being delayed. In Spain, political stress has increased as a result of Catalan's plans for a referendum on independence.



• Core bond yields have continued to fall, driven by expectations for further ECB easing. German bund yields are negative up to the 5-year point, while 10-year German bund yields have fallen below 0.9%. With the German economy increasingly frail, there is limited prospect for a near-term rise in yields.

• France has continued to disappoint in its plans for structural reforms and fiscal austerity. Political instability recently has also weighed on the plans to reduce the budget deficit.

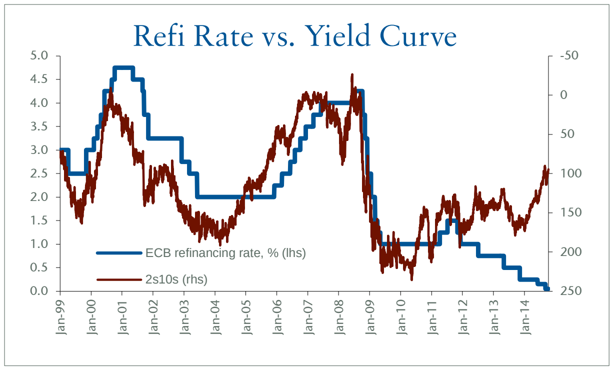


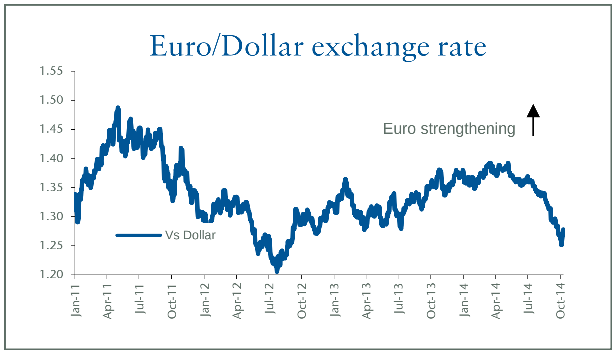
• With economic activity numbers continuing to disappoint and inflation expectations failing to recover, there are growing expectations that the ECB will need to do more than the TLTROs and ABS and covered bond purchase programs it has already announced.

• The ECB will be closely watching how economic sentiment evolves, if economic momentum picks up, and, most importantly, if inflation expectations recover. If any of those factors fail, there will be significant pressure for the ECB to follow-up with large scale sovereign debt purchases.

• At least some of the ECB's measures are working through their impact on the euro. The currency has weakened sharply in recent months, falling to almost $1.25 in early October, and the ECB has maintained verbal pressure on the euro.

• We think the euro needs to fall substantively further. If it does not weaken sufficiently, the ECB may need stronger action to push it down further.





Expectations

• With euro area growth momentum slowing and inflation dangerously close to negative territory, the ECB has cause to be concerned. The ECB will be watching developments very closely to see if its announced measures (TLTROs, ABS purchase program, and covered bond purchase program) have the desired effect.

• The first of these announced measures came in below expectations. Take-up of the September TLTRO - the first of eight - was disappointingly low: 255 banks borrowed a total of €82.6 billion of liquidity (compared to a consensus expectation of around €120billion). However, take-up at the next TLTRO in December should be higher as the ECB's Asset Quality Review (AQR) and stress tests will have been released and banks will have a clearer idea of their funding needs and real economy lending strategy.

• At the October meeting, the ECB announced details of its ABS and CB purchase programs. The ECB will start purchases of CB later this month while ABS purchases will start in Q4 2014. Purchases will last "at least" two years. In both ABS and CBs, the ECB will buy both distributed and retained issues, giving it a larger pool of assets to buy (Draghi mentioned €1 trillion as the "universe"). Purchases of fully retained ABS securities will be possible, subject to some participation by other market investors. The ECB will buy up to 70% of individual ABS and CBs, a significantly larger percentage than in the previous CB purchase programs. The minimum rating for purchased assets has been set at BBB- (a potential point of tension with Germany), and additional limits will apply for Greece and Cyprus, who will also need to be in an European Union assistance programme.

• How big will these programs be? Draghi had indicated at the September meeting that the ECB was trying to expand its balance sheet back to early-2012 levels (€2.7 - €3 trillion). However, at the October meeting, Draghi downplayed this target, instead emphasizing that measures were an instrument to reactivate credit markets and to return inflation back to the ECB's "below, but close to, 2%" inflation target. The size of purchases will depend on the progress of economic activity and, in particular, inflation and inflation expectations.

• However, the market has a slightly more pessimistic view of these measures, believing that the ECB will also have to introduce large scale purchases of sovereign debt. We are in partial agreement. The ECB seems to have a strong determination to meet its inflation target and, we think, will do whatever it takes. However, QE is still a last option - the ECB will likely wait until it can assess the effects of the TLTROS, ABS, and CB purchase programs before it decides if this next step is needed - assuming, of course, inflation expectations don't take another dive...

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	0.05	0.06	0.09	0.10
10 Year Govt. Bond	0.49	0.55	0.62	0.66
JGB Yield Curve	0.44	0.49	0.53	0.56
CPI	3.30	3.70	1.50	0.90

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"

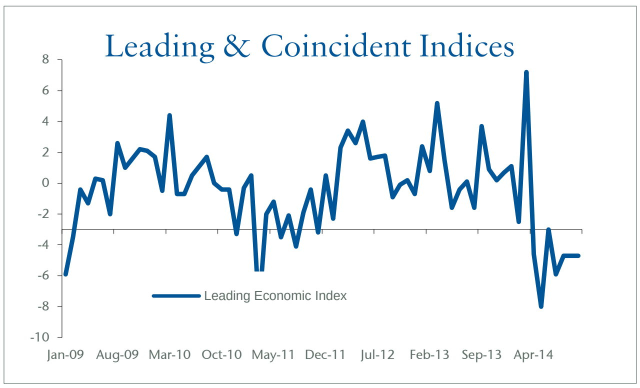
Current Policy

• The Bank of Japan (BOJ) kept policy unchanged at its 7 October meeting, increasing the monetary base at an annual pace of 60-70 trillion yen via the asset purchasing program and the loan support program.

• The BOJ maintained its overall assessment that "Japan's economy has continued to recover moderately as a trend", although it did acknowledge that industrial production has been slowing. Its outlook for inflation was unchanged and it expects to meet the 2% inflation target in the middle of its forecast period (FY2014-16). Governor Kuroda said that the current quantitative easing policy is not a calendar-based policy and that the BOJ will continue to ease until the inflation target is achieved. In response to questioning, Governor Kuroda commented that recent depreciation of the yen is "natural, reflecting different policies".

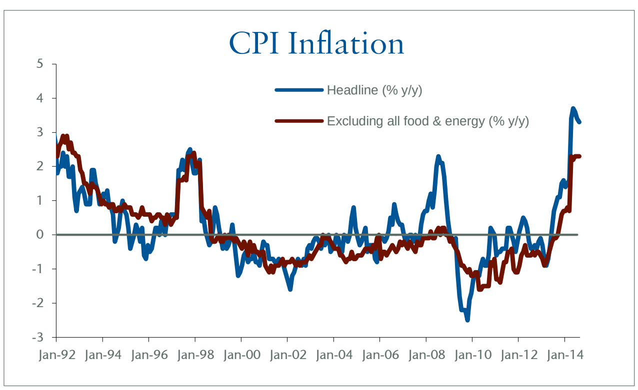
• The Japanese economy continues to reel from the April consumption tax hike. Industrial production fell 1.5% month-on-month in August, a particularly weak number given the sharp plunge in Q2 and very small gain in July. Consumer spending dropped 4.7% year-on-year in August following a 5.9% fall in July. Auto registrations dropped 8.4% in August.

• The September BOJ Tankan survey showed improving business conditions for manufacturers, but deteriorating conditions for non-manufacturers.



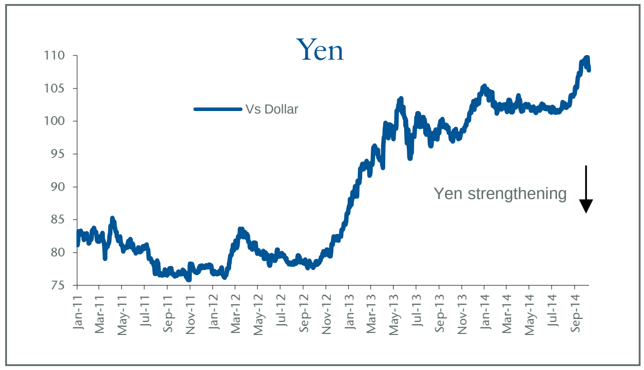
• The national annual core CPI (excluding fresh foods) came in at 3.1% in August, down from 3.3% in July. Excluding the impact from the VAT hike, core CPI fell from 1.3% in July to 1.1% in August - below the BOJ's 2% inflation target. The core measure (excluding the VAT hike) stood at 0.6% in August.

• The BOJ expects inflation (excluding the VAT hike) to remain around 1.25% for the time being, before accelerating to reach 2% in FY 2015.



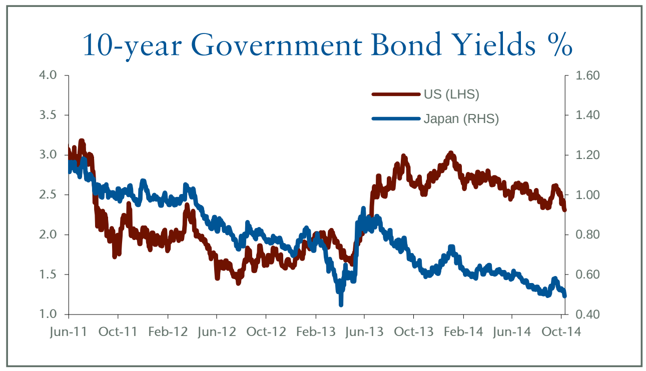
• The yen has weakened sharply over the past two months, moving from around ¥102 in early August to almost ¥110 in early October.

• At the latest BOJ meeting, Governor Kuroda was questioned on the pace of yen weakening. He responded that he does not think that anything "abnormal" is happening in the FX market. He also noted that the yen rate reflects fundamentals and that is not a negative for the economy. His stance indicates that the BOJ would be content with further depreciation.



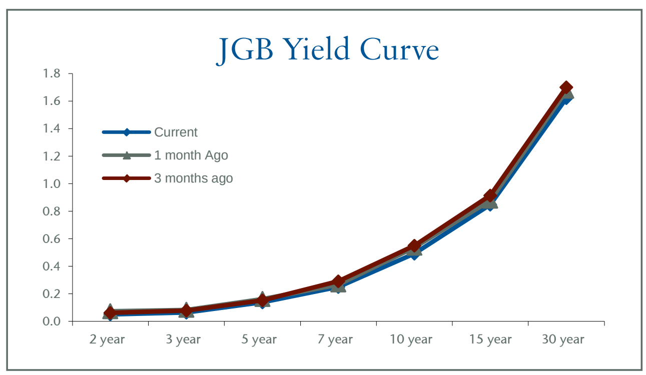
• The divergence in monetary policies between the United States and Japan next year is likely to be significant for the currency, with further yen weakness likely.

• The moves in JGBs continues to mirror movements in USTs. However, tightening of U.S. monetary policy (likely next year) could push USTs and JGBs in different directions. Although it is also possible that global yields will move higher, taking JGB yields with them - unless the BOJ decides to expand its balance sheet further.



• For now, with USTs struggling to rise convincingly, there is limited upward pressure on JGBs. Over the past month, the JGB yield curve has fallen slightly. The front end and belly have declined by around two and four basis points respectively, while the long end has fallen five basis points.

• As the BOJ is increasingly successful at breaking the deflationary cycle, longer-dated JGBs will see upward pressure on yields as the market inevitably prices in an inflation premium.



Expectations

• The Bank of Japan appears to be confident that the economy will recover from the April consumption tax hike and that it will achieve its 2% inflation target by financial-year 2015. While it acknowledged that production has shown some weakness due to the tax hike and bad weather, the BOJ believes that household income and employment have been improving and that Q3 GDP will turn positive (after a large decline in Q2). The BOJ also noted that the labour market has been tightening and the output gap has narrowed. In this environment, it expects wages and prices will be in an uptrend and inflation expectations to increase.

• Against such an assessment, it seems unlikely that the BOJ will increase the balance sheet further this year. However, the BOJ is more optimistic than the market in its economic and inflation assessment, suggesting that it could provide further monetary stimulus next year. If inflation fails to move decisively back towards the 2% target by mid-2015, we think there is certainly a possibility that the BOJ will expand the balance sheet again.

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	1.05	1.11	1.08	1.19
10 Year Bond Yield	2.02	2.25	2.46	2.56
Canada Yield Curve	0.96	1.14	1.39	1.37
Core CPI	2.10	1.70	1.20	1.30

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

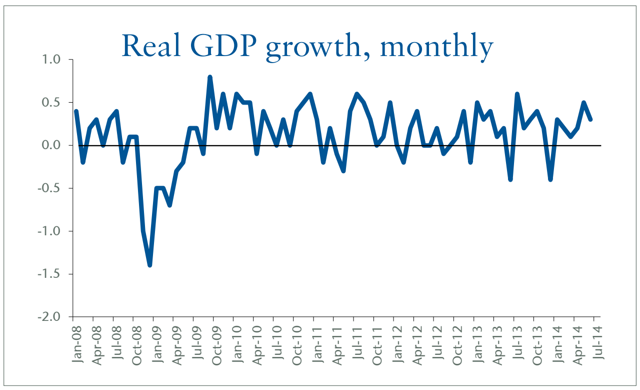
Current Policy

• The Bank of Canada (BoC) left its key policy rate unchanged at 1% at its 3 September meeting. Rates have remained on hold since October 2010.

• The BoC kept its policy guidance unchanged at the last meeting, indicating that the timing and direction of the next policy move will be dependent on the incoming data. Certainly, the central bank gave little indication that a change in policy is imminent. There was a renewed concern about the housing market and the risks associated with stretched housing finances. In another later speech, the BoC noted that "it is possible that persistent headwinds will mean that some degree of stimulus will be required even after the output gap is closed to keep inflation at target".

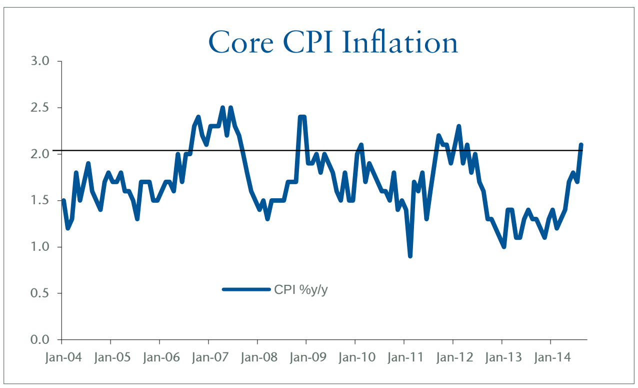
• After strong growth of 3.1% in Q2, GDP growth was flat in July as a 0.2% month-on-month increase in services output was fully offset by a drop in goods-producing activity. The September manufacturing PMI fell to 53.5 from 54.8 in August - taking the index back to its June level. New orders decreased, suggesting further weakness ahead.

• Employment fell 11,000 in August after a 42,000 increase in July. However, a drop in participation left the unemployment rate unchanged at 7%.



• Annual headline CPI inflation remained at 2.1% in August, still above the BoC's 2% inflation target. Core annual CPI was also at 2.1%. Headline and core inflation for Q3 are both tracking above the Bank of Canada's projections from the July Monetary Policy Report (MPR).

• However, the BoC considers the latest pick-up in inflation as temporary and unrelated to economic fundamentals. Their outlook for inflation remains roughly balanced and it is not presenting pressure for a change in policy.



• The Canadian dollar has weakened from around $0.94 in July to below $0.90 in early October.

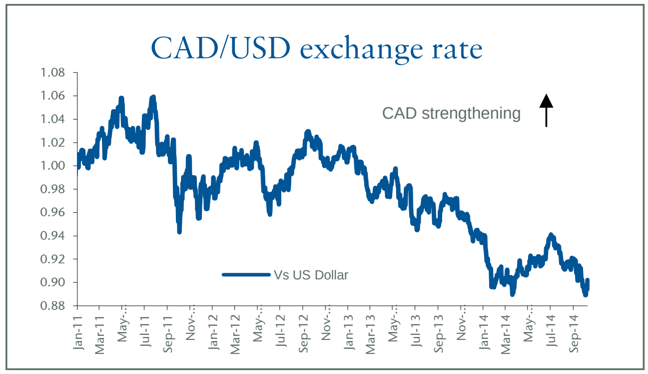
• At a recent speech, the BoC explained why it has done little to intervene in the currency market, describing that the bank cannot target both inflation and hold the exchange rate constant. However, the value of the currency is still important to the BoC as it believes that a key element of Canada's recovery will be a substantial recovery in non-energy exports.

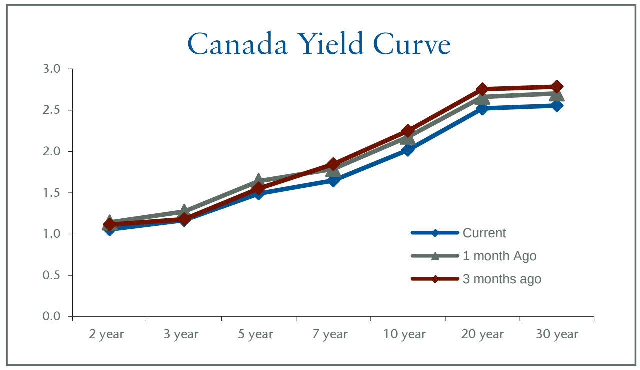
• After dropping to 2% in late August - the lowest level since May 2013 - Canadas sold off in line with U.S. Treasurys, before rallying again. The 10-year spread between Canada and the United States has remained relatively stable at around 30-35 basis points, but this is still wider than it has been for the past five years.

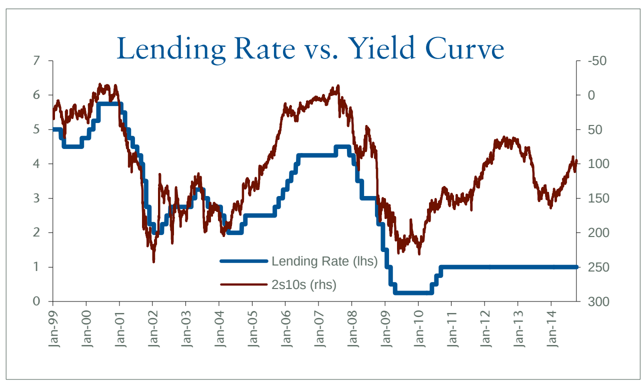
• Over the past month as a whole, the front end of the Canadian curve has fallen almost 10 basis points, while the belly and long end have fallen by around 15 basis points.

• A recent speech by the BoC Deputy Governor noted that U.S. monetary policy has an important impact in Canada . However, he also stressed that BoC policy must be independent and can diverge from Fed policy to keep inflation low, stable, and predictable.

• Whilst that may be true, in this instance, BoC policy rates are unlikely to diverge too far from the Fed's. Despite inflation moving above the 2% target, the BoC will resist raising rates until after the U.S. Fed has moved first so as to avoid upward pressure on the loonie.





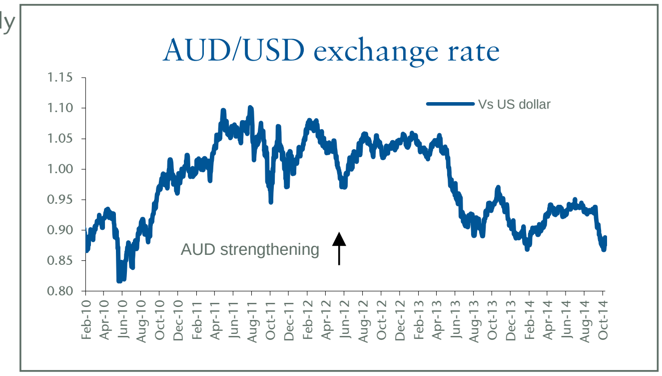


Expectations

• The Bank of Canada has described the recovery as "underwhelming". Certainly, growth has failed to accelerate sharply and job creation has been disappointing. Inflation has moved above the central bank's own forecasts and above the 2% target - yet, in his Jackson Hole interview, Governor Poloz emphasized that the bank was in no hurry to raise rates - even if the Federal Reserve starts hiking. He noted that "right now, inflation, at most, is at the middle of that target zone and is probably going to drift lower unless we get that rotation (from household spending to exports and business investment)... we're more pro-growth than anti-inflation in that situation". He also added "we are at 1%. In this world, that's a high number when everything is starting at zero". This surely indicates no rush to start tightening monetary policy.

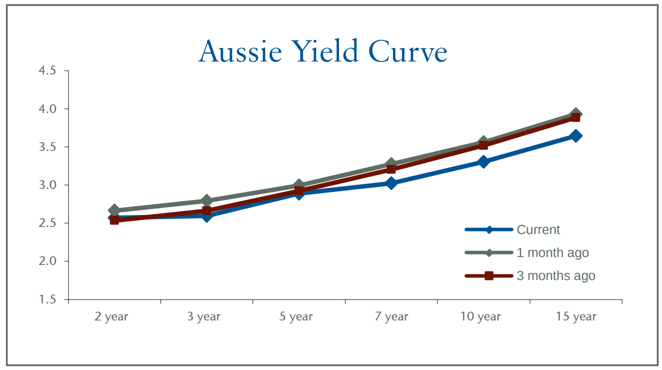
• We think the Bank of Canada is waiting until the U.S. economic recovery is clearly evident in Canada's export performance and business investment. It is unlikely to raise rates until the second half of next year, and only once the Federal Reserve has done so first - that should put further downward pressure on the Canadian dollar, something that the BoC will be very content with.

• The Australian dollar (AUD) has weakened sharply over the past month. It has fallen from almost $0.94 in early September to under $0.88 in early October.



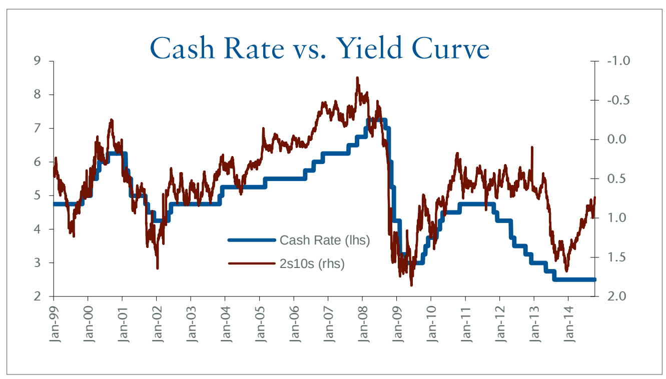
• The RBA had been sounding uncomfortable with the strength of the AUD in recent months. However, it has signalled little relief about the AUD's recent decline, instead noting that it still "remains high by historical standards, particularly given the further declines in key commodity prices".

• The front end of the Australian yield curve has shifted 10 basis points lower over the past month, while the 10-year yield has fallen by around 25 basis points - with much of that move taking place immediately after the release of the RBA's October policy rate decision and statement. Markets had been expecting a slightly more hawkish tone.



• With the Chinese economy appearing to slow and inflationary pressures subdued, we think Australian yields will struggle to rise.

• While there are some tentative signs that the Australian economy is strengthening (e.g. strong employment data, rising house prices), mounting external risks (e.g. falling commodity prices, slowing Chinese economy) mean that the RBA is likely to keep rates on hold well into 2015.



• Financial markets are pricing in no change in the policy rate over the next year. Even then, with other global policy rates still low, the yield advantage of Australian assets will likely persist.

Expectations

• The Reserve Bank of Australia has maintained its forward guidance of a period of stability in rates. The cash rate has been steady at a record low of 2.5% for well over a year, and there is little indication that this is about to change. Certainly, the slightly more robust domestic economy appears to be offsetting greater external risks.

• Our central case is that the RBA will keep policy rates steady at 2.5% through 2014 and into 2015. As the domestic economy continues to strengthen, there may be more pressure on the RBA to raise rates - but, given China's critical importance to Australian exports, the timing of the first hike will depend heavily on the strength of the Chinese economy. Of course, one way in which these concerns can be cushioned is via a weaker Australian dollar. That, in turn, will be strongly influenced by the timing and speed of U.S. Federal Reserve monetary policy tightening. Overall, we think the RBA is unlikely to raise policy rates until the second half of 2014 - but its recent ability to wrong-foot markets means that an earlier hike cannot be discounted.

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