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JANUARY MONTHLY INTEREST RATE OUTLOOK

In general, central banks are either already tightening policy or veering this way. The aim is not necessarily to dampen inflation, but keep the status quo. There simply is not the need for the volume of economic liquidity currently in the system. How the financial markets react is uncertain given the uncharted waters of a global balance sheet shrinkage.

- **One such issue is the short volatility trade which Senior Editor Marcus Dewsnap considers [Pages 2-4]. There is a risk that the stability of low vol, which is feeding itself, might in the face of a significant shock induce the sort of instability of a decade ago – who didn't read Minsky?**

- **The BoJ is yet to signal any move towards normalizing policy. Governor Kuroda's term ends in April. The latter and YCC tweaks are the focus in the year ahead. Asia FX Analyst Jian Hui Tan suggest the signal for tweaks will be when the BoJ reduces purchases in the 3-5 and 5-10 year segments at the regular bond purchase operations [Pages 5, 8].**

- **Meanwhile, normalization gathers pace at the BoC with FX Analyst Mark Mitchell echoing market sentiment that there is a high probability of an imminent rate hike as the economic outlook improves [Pages 5, 10-11]. This, as Technical Analyst Matthew Sferro suggests, will raise Canadian benchmark yields [Pages 5, 22].**

- **At the Czech National Bank, Emerging Market Managing Analyst Chris Shiells writes, the question heading into the first meeting of 2018, is whether the CNB will hike rates by 25bp having held off in December. Then it is all about the pace of tightening for the rest of the year.**

10th JANUARY 2018

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JANUARY MONTHLY INTEREST RATE OUTLOOK

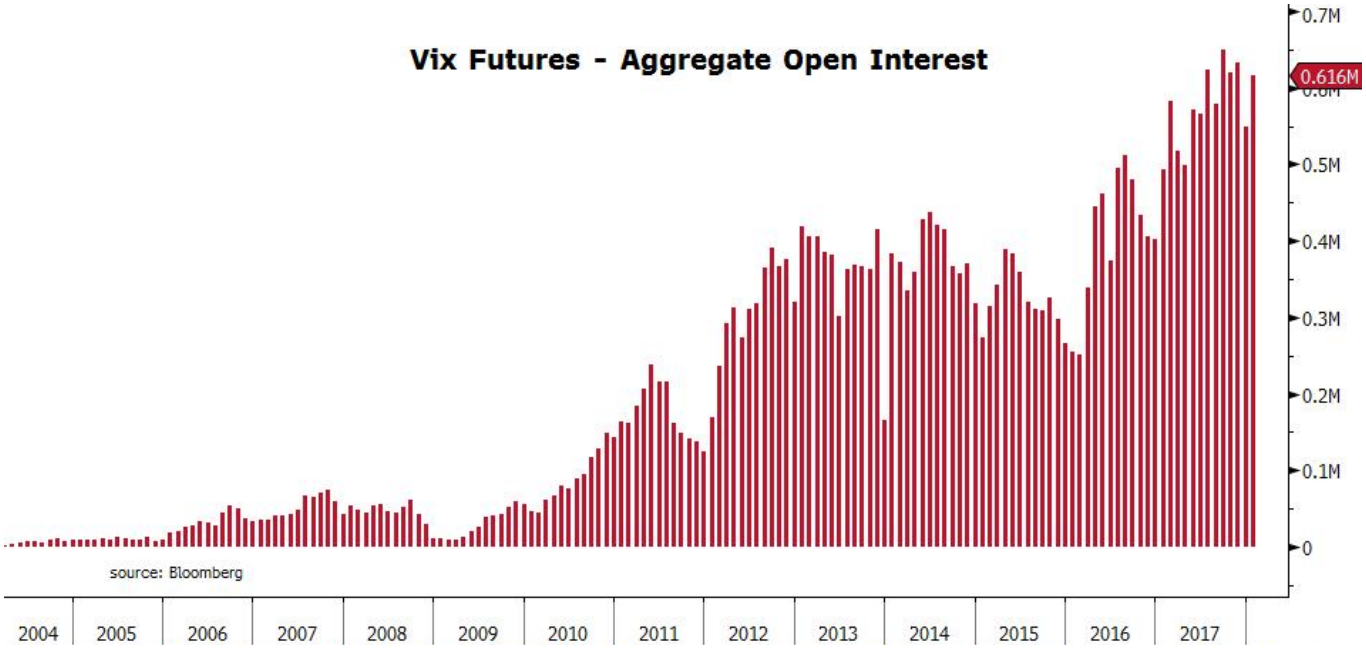
Risk, Uncertainty and (short) Volatility

By Marcus Dewsnap, Senior Research Analyst, IFI

Known-unknowns can be traumatic enough for markets. Unknown-unknowns can be catastrophic. Both are problematic for the short vol trade should a market downturn ensue.

Risk can be measured. Uncertainty can't. The former is a 'known-unknown' and can be priced as there is an attached probability distribution which implies potential outcomes are somehow known (if not necessarily understood)[1]. Uncertainty is an 'unknown-unknown', hence, by definition, it cannot be priced as there is no knowledge of the underlying probability distribution nor potential outcomes.

A favourite method of pricing/trading/measuring risk is via volatility. Underlying the volatility measures are options. There are a great many volatility indices (bespoke or otherwise), especially for equity markets, which allow for futures and therefore options on these *indices* to be traded. For instance, the widely reported VIX Index (called 'The Fear' index) is a measure of the volatility of the S&P500 using options on the S&P500. However, there are also futures and options contracts on the VIX itself. Not surprisingly, there are also ETFs based on the VIX. The increased interest in volatility products can be seen by looking at aggregate open interest in VIX futures, which took-off in 2010 (see graph below).



Aside from the rising interest in volatility products, another trend, which to have not heard about would require one to be on another planet, is the fall in volatility either to record lows or close to. It does not matter which asset class (commodities have evidenced bouts of raised volatility) or measure (implied, realized) or tenor (e.g. via swaptions) or nationality (Germany's VDAX for instance) the trend over the last several years has been of falling vol.

Volatility falls as an asset price rises. If we view vol as the market's view/measure of risk, low vol means low risk (meaning a tendency towards risk-on).

JANUARY MONTHLY INTEREST RATE OUTLOOK

Anything which promotes asset price rises also promotes low volatility – for instance:

- Macroeconomic Stability – lowflation with economic growth and historically low official rates.
- Central Bank liquidity – read asset purchases.
- Loose Financial Conditions – cheap funding (also a function of central bank policy).
- Share buybacks.

All this has induced a generally little discussed trend – the rise of the *short-volatility trade*. Of which two main strands exist – explicit (e.g. short the VIX) or implicit/synthetic (such as share buybacks).

Short volatility trade is any strategy which derives small incremental gains on the assumption of stability in exchange for substantial loss in the event of change. Source: Artemis Capital Management.

Short Volatility Strategies

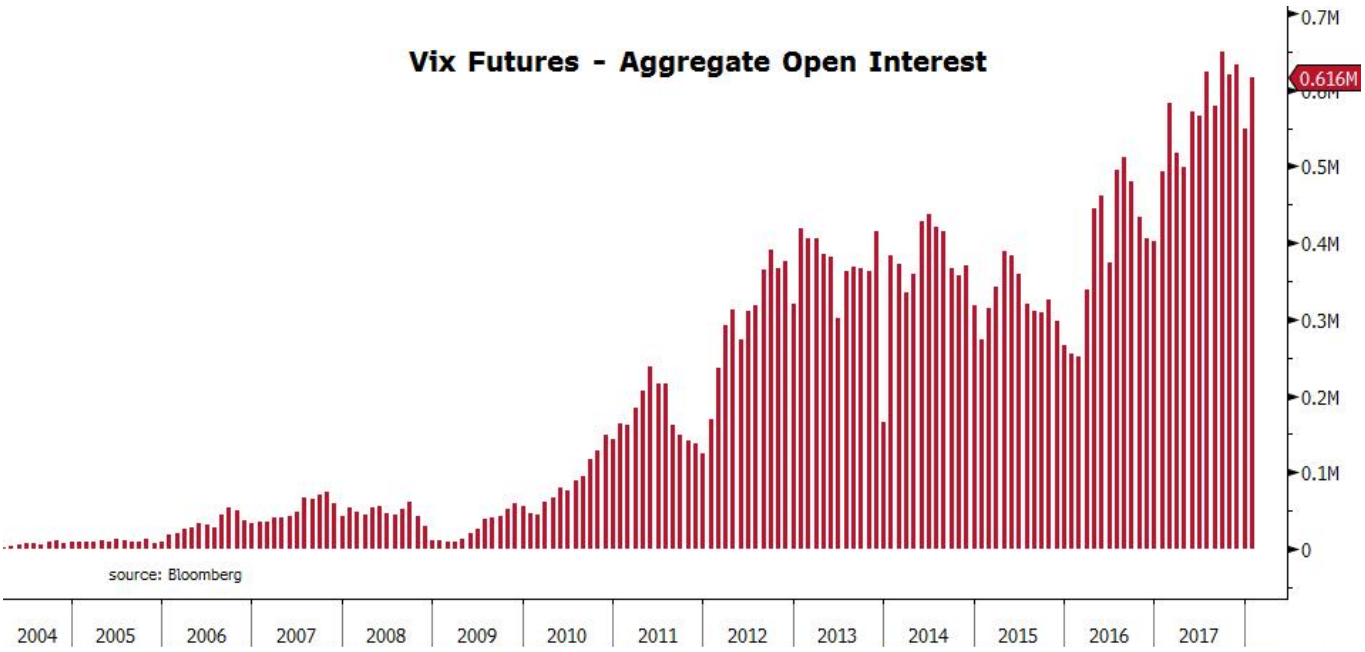
Explicit

- Buy equities/sell calls.
- Sell puts.
- Sell straddles.
- Short a volatility Index (e.g short VIX).
- Short a volatility ETF.
- Buy a short volatility ETF.

Implicit

- Share buybacks.
- Long equity trend following.
- Volatility control funds.
- Risk parity.
- Risk premia.

An example of the increased trade in short vol can be seen via CFTC numbers on the non-commercial short (graph below).



JANUARY MONTHLY INTEREST RATE OUTLOOK

Implicit volatility involves a fair bit of financial engineering and implies *leverage*. The 'hunt for yield' is a major driver in this and it has been suggested short vol has become the alternative to fixed income as the yield on the former is now at least as competitive. Some numbers from *Artemis Capital Management* in October 2017 suggested the explicit short vol trade totaled $60bn, the implicit $1.4tn and share buybacks equal $3.8tn. The 'buy the dip' mentality in equities is aided by share buybacks.

An issue which has been noted by several institutions is that short vol strategies are compounding low volatility. This from Natixis for instance (Strategic Daily, December 19th 2017):

> *'In the absence of significant shocks, performances by these strategies even contribute to maintaining volatility range trading. In the face of option sellers, buyers hedge their long option positions (selling underlyings if prices weaken, buying underlyings if prices rise) compressing actual volatility, hence implied volatility, encouraging a touch more short volatility carry trades.'*

A concern is that the stability implied by low volatility, which is feeding itself helped along by a decent dose of leverage, is actually masking a growing instability – sounds very similar to another 'Minsky Moment' in the making?!?!?! The increase in passive investing compounds the issue in two ways. This from Artemis once more:

> *'Passive investing is now just a momentum play on liquidity. Large flows into stocks occur for no reason other than the fact they are highly liquid members of an index. … In effect, the volatility of an entire stock market can become dominated by a small number of companies and correlation relationships.'*

And,

> *'Active managers serve as a volatility buffer, willing to step in and buy undervalued stocks when the market is falling and sell overvalued stocks when the market is rising too much. Remove that buffer and there is no incremental seller to control overvalue on the way up, and no incremental buyer on the way down.'*

In other words, in a falling market, passive investing *amplifies volatility* and if anyone thought the appearance of the *odd air pocket* during the several market crises of the last 10-years was an abnormality, there is currently a much higher probability of such events (AI/algos might further amplify). Air pockets severely impair price discovery.

Significant shocks to the system might include interest rate rises (especially if faster than market pricing) and/or central bank balance sheet shrinkage - recall, Q3 this year is when the total global central bank balance sheet (ex-PBoC) is expected to start shrinking on a sustainable basis (within the Jeremy Grantham's, of GMO, potential 'near-term melt-up' timeframe – see HERE). The market reaction to this is *uncertain*. Uncertainty is typically ignored by the market – which is why nasty surprises occur.

IF equities *and* bonds are vulnerable to the same impulses (e.g. interest rate rises, central bank balance shrinkage) then portfolio diversification isn't necessarily the answer to reducing, let alone eliminating, *correlation risk* should the short-volatility trade unwind. Critical here is the magnitude of the initial reaction. The larger the move, the more intense the liquidation which can quickly spiral out of control. A painful experience – as anyone short Eur/Chf vol just before the SNB lifted the pair's floor will testify.

Endnote

1. We'll leave aside the important issue as to whether a distribution is 'correct' – for instance see the many discussions on 'fat tails' verses the thin tailed normal distribution over the last 10-years or so.

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JANUARY MONTHLY INTEREST RATE OUTLOOK

FORECASTS AT A GLANCE: MAJORS

G3	CURRENT (%)	DIRECTION OF NEXT POLICY MOVE*	UPCOMING CB MEETINGS	RISK OF MOVE AT NEXT MEETING	THREE-MONTH F/C (%)	SIX-MONTH F/C (%)	TWELVE-MONTH F/C (%)
Fed Funds	1.25-1.50	↑	January 30-31	100% steady	1.50-1.75	1.75-2.00	2.00-2.25
T-Note (10 Yr)	2.59				2.65	2.90	2.85
ECB refi/depo	0.0/-0.40	↑	January 25	100% steady on all fronts	0.00/-0.40	0.00/-0.40	0.10/-0.20
Euro 10 Yr	0.54				0.60	0.70	0.80
Japan o/night Call	-0.10	↑	January 22-23	100% steady	-0.10	-0.10	0.00
JGB b/mark 10 Yr	0.08				0.05	0.09	0.14
Europe							
BoE Repo	0.50	↑	February 8	100% steady	0.50	0.75	1.00
Gilts 10 Yr	1.28				1.40	1.55	1.75
Swiss 3 mth Libor	-0.75	↑	March 15	100% steady	-0.75	-0.75	-0.75
Conf 10 Yr	-0.11				0.00	0.05	0.20
Swedish Repo	-0.50	↑	February 14	100% steady	-0.50	-0.50	-0.25
SGB 10 Yr	0.79				0.90	1.00	1.15
Norges Bank depo	0.50	↑	January 25	100% steady	0.50	0.50	0.75
NGB 10 Yr	1.57				1.70	1.80	2.00
Dollar Bloc							
BoC o/n Target	1.00	↑	January 17	85% hike 25bp 15% steady	1.25	1.50	1.75
Canada 10 Yr	2.23				2.30	2.10	2.40
RBA OCR	1.50	↑	February 6	100% steady	1.50	1.50	1.50
Australia 10 Yr	2.72				2.75	2.85	3.00
RBNZ	1.75	↑	February 8	100% steady	1.75	1.75	2.00
NZ 10 Yr	2.83				3.00	3.15	3.40

JANUARY MONTHLY INTEREST RATE OUTLOOK

FORECASTS AT A GLANCE: EMERGING MARKETS

Emerging Markets	CURRENT (%)	DIRECTION OF NEXT POLICY MOVE*	UPCOMING CB MEETINGS	RISK OF MOVE AT NEXT MEETING	THREE-MONTH F/C (%)	SIX-MONTH F/C (%)	TWELVE-MONTH F/C (%)
NBH base rate	0.90	↑	January 30	100% steady	0.90	0.90	1.15
CNB 2 wk repo	0.50	↑	February 1	55% hike 25bp 45% steady	0.75	1.00	1.25
NBP reference rate	1.50	↑	February 7	90% steady 10% hike 25 bp	1.50	1.50	1.75
CBT 1 wk repo	8.00	↑	January 18	70% steady 30% hike 25 bp	8.00	8.00	8.00
SARB repo	6.75	↓	January 18	60% steady 40% cut 25 bp	6.50	6.50	6.50
Bank of Russia key policy rate	7.75	↓	February 9	60% cut 25bp 40 % steady	7.50	7.25	7.00
BC do Brasil selic	6.75	↓	February 7	90% cut 25 bp 10% cut 50 bp	6.50	7.00	7.00
BC de Chile o/n	2.50	↑	February 1	80% steady 20% cut 25bp	2.50	2.50	2.75
Banco de Mexico o/n	7.25	↑	February 8	65% hike 25 bp 35% steady	7.50	7.50	7.25
PBoC 1 year depo	1.50	↑	n/a	n/a	1.50	1.50	1.50
RBI repo	6.00	↑	February 7	90% steady 10% cut 25 bp	6.00	6.00	6.25
BoK Base rate	1.50	↑	January 18	100% steady	1.50	1.50	1.75
Bank Indonesia Reverse Repo	4.25	↓	January 18	90% steady 10% cut 25 bp	4.25	4.25	4.25

Current yields as of 1 January 2018

N/a = not applicable

* Note: The IGM view of the next monetary policy move, whenever it occurs. Tightening = ↑ Easing = ↓

Boxes in red denote significant changes to our outlook.

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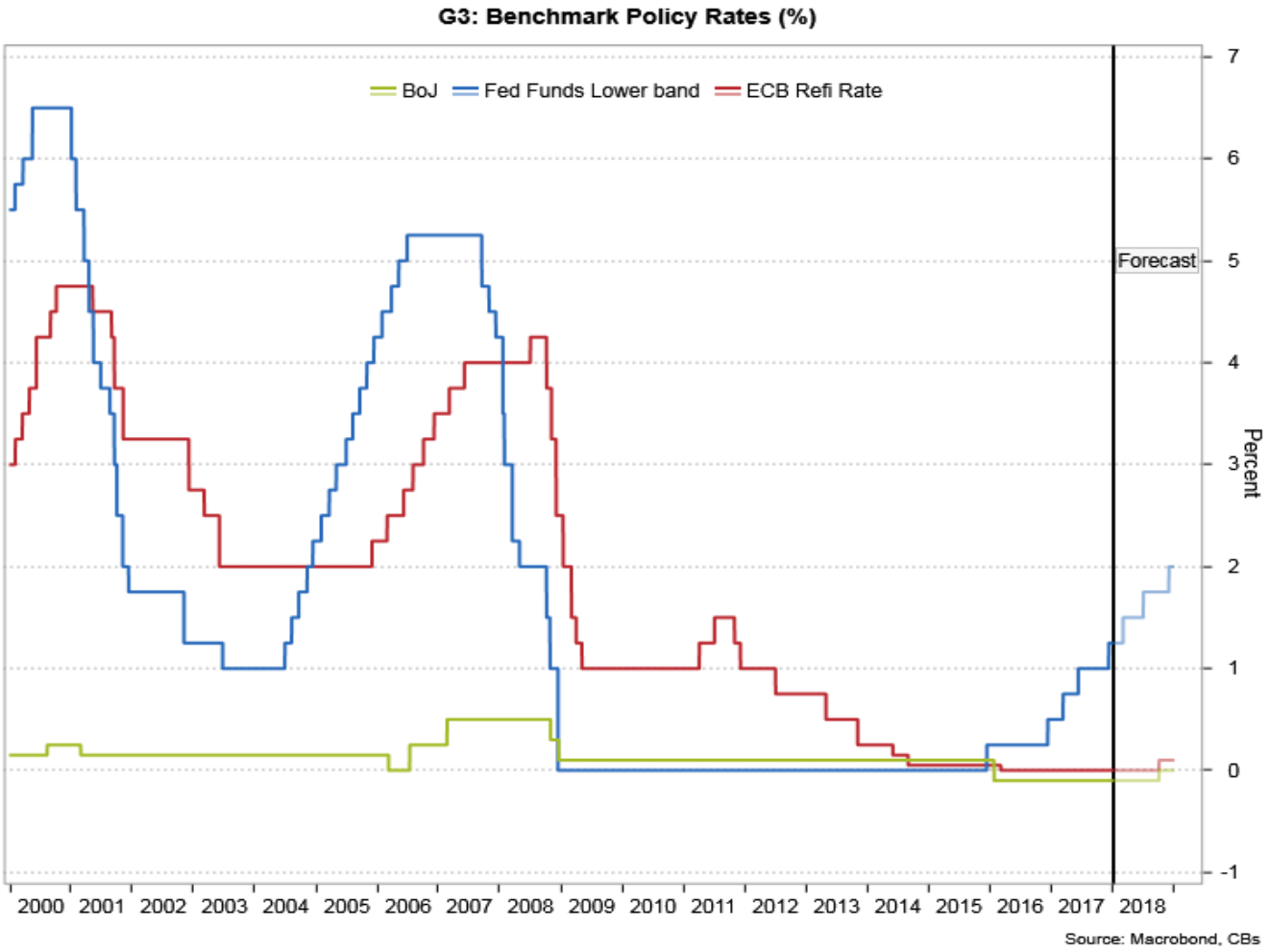
CENTRAL BANK OUTLOOKS



FED: The markets says 2 rate hikes this year. The dot plot implies 3. And some think 4. However, a great deal about the FOMC outlook will depend on the Committee make-up. Hence there is much uncertainty.

Still, unless there is a sudden and unexpected (sustained rather than transitory) inflation surge, forward guidance is unlikely to change from 'gradual' rate hikes, which suggests no more than one hike per quarter starting at the March meeting. The policy mix is important though. Tighter quantitative policy might offset regulatory easing for instance. Or, maybe, a combination of quantitative and faster interest rate rises will be required (unlikely we add!). Unless inflation decelerates, we expect three 25bp hikes this year. A question also arises as to whether the range will be abandoned.

As the year progresses, focus will turn to Terminal Funds. Currently the best guesstimate is somewhere north of 2%. One year rates 5-years forward have recently jumped 10bp or so to over 2.6%. Part of this is down to the markets' sensitivity to oil price moves (as can be seen in Breakevens). This does not necessarily mean inflation is going to take off. A sustained 50bp+ real yield rally will be more meaningful. marcus.dewsnap@informagm.com

10-year US yield technical analysis HERE

EUROZONE: The CB has had a 'slowish' start to 2018, with a smattering of GC members updating, but influential members Draghi and Praet keeping their thoughts close to their chest . Instead, GC colleague foot-soldiers have voiced concerns that the current PSPP regime looks out of kilter with growth dynamics and evidence that the EZ economy is rapidly going from strength to strength. NIRP/ZIRP has been set

JANUARY MONTHLY INTEREST RATE OUTLOOK

with inflation not projected to REACH target until 2020. This looks too reliant on benchmark oil staying low, well below $60/brl, Brent is now almost $70/brl!

As we have mentioned before, Draghi has been guiding and perhaps blindsiding many by throwing away the textbook to believe inflation can stay soft indefinitely with oil and consumer demand showing signs of taking off. Next stop higher wages, (January 11th cited as a key round for German metal workers) and if 3% or above, a red-faced ECB? Currently, asset purchases are expected to run until September 2018, with guidance in place that PSPP could be extended. Hawks such as Buba's Weidmann, others; Nowotny, Hansson, Coeure and Mersch have increasingly questioned this 'wisdom'.

Bears, (such as ourselves) have seen several false dawns, but because of the delayed start to policy normalisation, there grows the risk of a tantrum backlash, where yields snap into line. Witness the 200 bp+ spread versus counterpart US yields. Now is the time to buy incredibly cheap Bund OTM puts. For the 10-year German yield, we affirm our 2018 outlook: 0.50%+ in Q1, 0.65-0.75% in Q2, with an end-2018 target of 1%, or even higher.

To re-affirm, the ECB has to un-box itself out of a corner of its own making. Initially, this via nuances to soften sequencing. Perhaps Draghi at an EU Parliament address or another 'Sintra event' (by declaring that ample accommodation is NO longer required, and PSPP will end in Sep 2018). This could be a pre-cursor for more hawkish language to revise when policy should normalise.
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10-year Euro yield technical analysis HERE

JAPAN: No policy change is expected at the January meet given core-CPI remains less than halfway to the 2% target. Traditionally, attention is on the CB's quarterly outlook. That said, we do not expect any revisions to growth/inflation forecasts this time.

The take on growth is likely to remain balanced, with an upbeat external outlook offset by warnings of a drag from a probable decline in public investments in 2018 and the 2019 sales tax hike.

On inflation, a reiteration to hit the 2% target "around FY2019" is expected with risks still skewed to the downside.

The 2018 focus will be on whether Governor Kuroda, who's term ends in April, is reappointed and potential YCC tweaks. At this stage, most signs point to Kuroda being asked to stay-on, thus, no radical policy shifts and a becalmed JGB market.

The window to tweak YCC will open from Q2 as that is when we'll get a clearer indication of whether Japan's core CPI (currently at 0.9% y/y) will start to trend higher and towards the 2% target. While stealth tapering has already been facilitated by YCC (2017's monetary base expansion well below the soft annual Jpy 80tn target), we think it's inevitable tweaks will happen and a more objective discussion of policy normalization towards 2019 will ensue.

So, when do we need to materially price in a YCC tweak? When the BoJ reduces purchases in the 3-5 and 5-10 year segments at the regular bond purchase operations

As to the tweaks - we suspect the initial move will come via lifting the 10-year JGB yield target to 0.10% from 0% (and subsequently to 0.15% and 0.20%) whilst keeping the short-term rate target around -0.10%. jianhui.tan@informagm.com

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EUROPE

UK: For many/most, BoE policy is in limbo for the foreseeable future. With inflation said to be topping out soon at just over 3%, Carney has convinced most investors/market participants to believe that rate rises will not only be gradual and limited, but will be semi-conditional on a 1-2 year Brexit transitional arrangement in place, all before an UK/EU trade deal. This idea has been backed-up by foreign inflows into Gilts which in November, went through the roof.

Therefore, the BoE seemingly has no hidden agenda to push rates up to where they should realistically be. However, this guidance, which accompanied the first rate rise in a decade, now appears somewhat stale (guidance was also affirmed in December). It was all before an aggressive spike in oil prices, obviously prior to the latest (and above inflation) train fare rises, and prices looking to firm up across the board on skill shortages, utility firms/services' providers chomping at the bit to lift prices – latter seen in latest CBI and hiring surveys. Aside from base effects, all this points to elevated, or more, but not less inflation.

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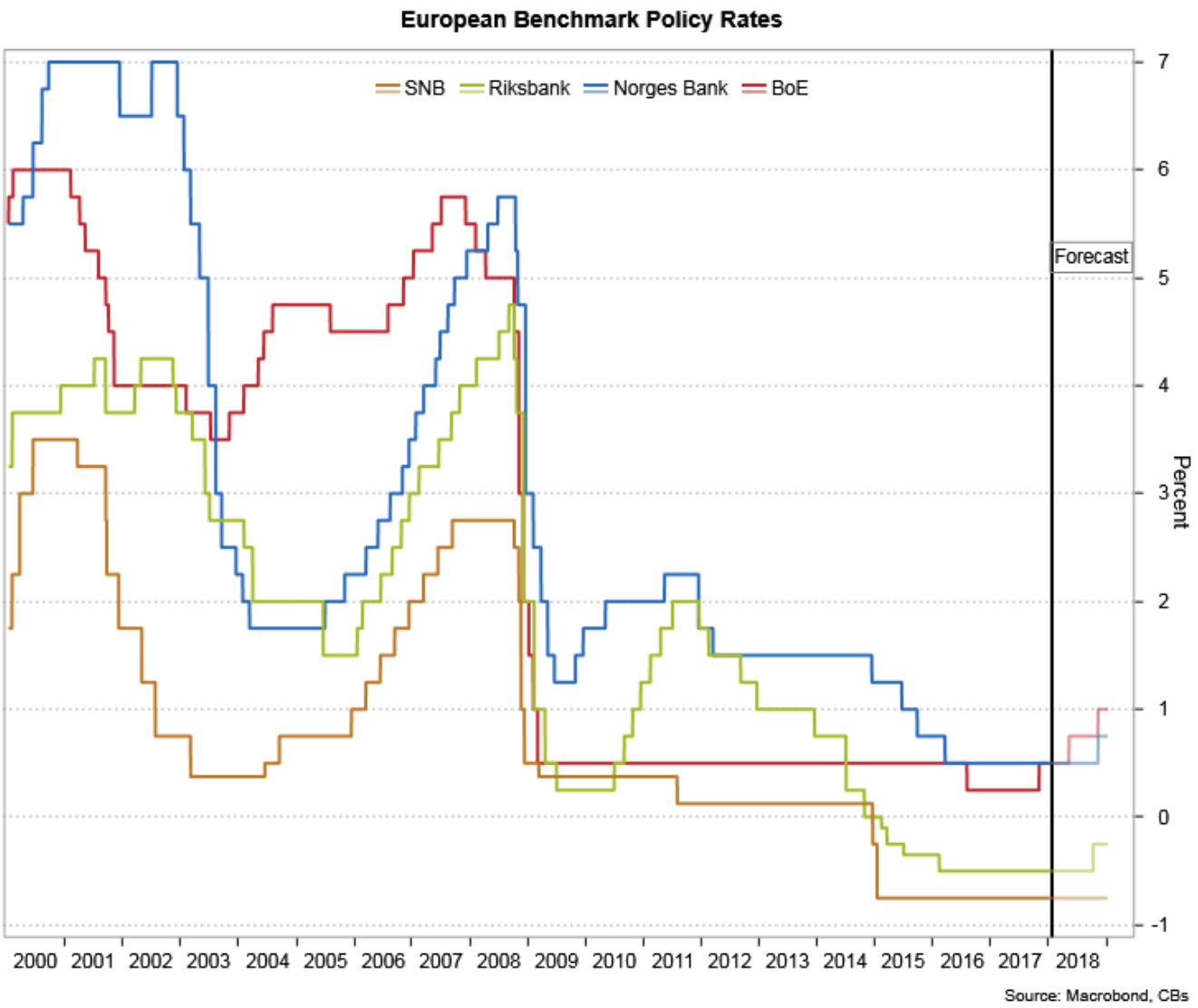
Assuming Bank Rate will be held at 0.50% until H2, and only 2 hikes priced in to the strip in the next 3 years, we think the 10-year Gilt yield should stay relatively range bound between 1.20-1.40%. If a break were to transpire, it should be to the upside. We stand ready to revisit this 10-year yield view and adjust significantly higher if there is another surprising Brexit development. This could be via a 'softer' still deal, such as a bespoke arrangement that will allow some single market access after the transition period (assuming that this is also speedily agreed). alvin.baker@informagm.com

Gilt yield technical analysis HERE.



SWITZERLAND: The Swiss National Bank meeting on December 14th came and went with little fanfare and even less market reaction. The SNB Chairman Jordan played a straight bat, reinforcing the message that it is 'too soon to be talking about policy normalisation'. Inflation pressures remain benign with December CPI figure matching the November number at 0.8% y/y, while the Swiss manufacturing PMI for December registered its second booming 65 plus read. Eur/Chf has been inching higher, with 1.1778 the new three year high and we expect divergent policy paths from the ECB and the SNB to keep the Franc on the back foot. mark.mitchell@informagm.com

SWEDEN: The final Riksbank meeting of 2017 saw the central bank keep the repo rate unchanged with a unanimous vote, but they signalled that they would end their bond purchase programme at the end of

the year. At any other time the Riksbank would have feared that this first move to policy normalisation could lead to unwanted Krona strength, but with the Scandinavian housing market worries a major factor, the currency has remained under pressure. The all important Swedish November CPI report released before the Riksbank meeting revealed an upside surprise, with both headline and core readings coming in 0.2% higher than consensus on a y/y basis. The Riksbank rate path continued to point to a first rate hike in mid 2018.

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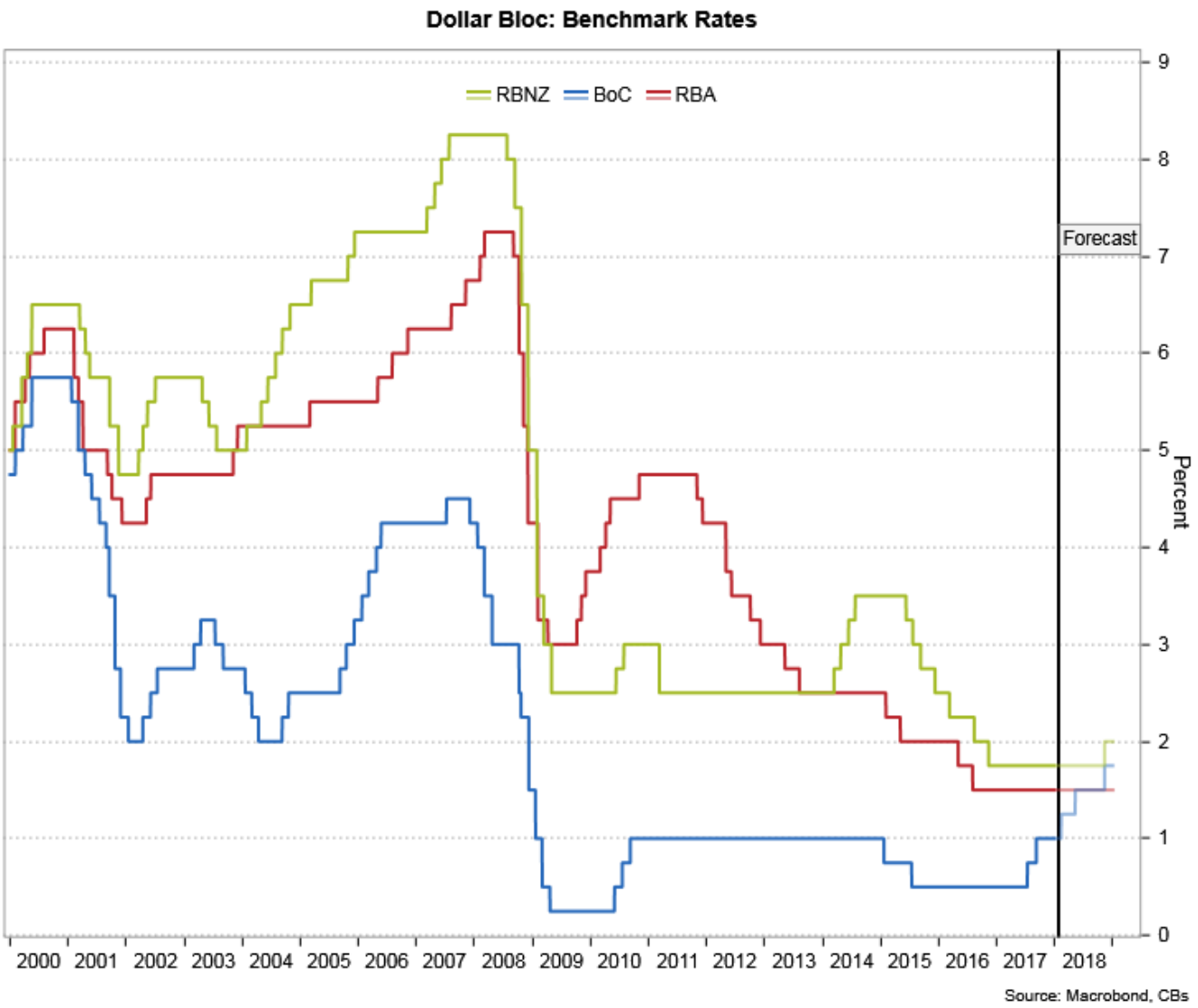
NORWAY: The final Norges Bank meeting of 2017 on December 14 resulted in a minor change in the rate path, with the first rate hike now being signalled for the end of 2018, replacing the previous 'summer of 2019' in September. The more hawkish than expected verdict gave the Krone a brief respite from the selling inspired by Scandinavian house price worries. The respite did not last long, with Eur/Nok roaring to a nine year high up at 9.9939 just a week after the Norges Bank decision. Fears over the health of Scandinavian housing markets have died down at start the year, giving the Krone a sizeable boost, but we feel that the house price issue will remain a major influence. mark.mitchell@informagm.com

DOLLAR BLOC



CANADA: The BoC duly kept interest rates on hold at their final 2017 meeting on December 6th. Their cautious accompanying statement gave no indication that they were looking to raise rates soon, but economic data since the decision has seen the chances of a hike at the January 17th meeting, rise

considerably. The December jobs report was a blockbuster. Job creation came in above 78k for the second month in a row, sending the unemployment rate down 5.7%, its lowest level since the mid-1970s. Wages for permanent employees, the metric favoured by the BoC, rose by 2.9% y/y, its highest level since April 2016. Meanwhile the Canadian trade data for November revealed a 4.1% rise in non-energy exports, which is another piece of data high on the BoC watch list. The upbeat BoC Business Outlook survey pushed the odds of a January rate hike up to 85%. We also expect a 25 bp BoC rate hike, taking rates to 1.25%, but look out for Poloz to try and remain cautious, so as not to flame the Loonie rally even further. mark.mitchell@informagm.com

10-year Cad yield technical analysis HERE.

AUSTRALIA: No policy change is expected at the February gathering. Although inflation expectations are rising and the macro outlook improving alongside a tightening labour market, still lackluster wage growth and the prevailing issue of high household debt remain obstacles towards higher rates. We expect the first hike to occur in late Q4 '18 and possibly even Q1 '19, which is in line with the Bloomberg survey but slightly behind market pricing of roughly 2/3 odds of a hike by October 18.

Along with global expectations, Australia's 10-year breakeven rate has risen approximately. 25bp over H2 2017. This comes amidst overall improving fundamentals as the Citi Economic Surprise Index rebounded off a 6-month decline and to above 0 for the first time since early October 17. Real GDP has also been on the ascendency and combined with a pick-up in infrastructure spending/non-mining investments, improving business conditions and a tightening labour market, Australia's macro outlook does indeed seem have a few bright spots.

That said, there are still areas of concerns that form obstacles towards higher rates. Although there are signs of a bottom, wage growth remains lackluster and will remain a drag on consumer spending until a sustainable uptrend is intact. The household savings ratio remains low, indicating the need for households to draw on savings to finance expenditure, which explains the sluggish retail sales as essentials are prioritized (retail sales have been on a 4-year decline with no signs yet of a bottom). Consumer confidence is thus also unsurprisingly gloomy.

In addition, external demand is also expected to take a hit in 2018 as iron ore prices are forecast to decline (some 20% according the Government) on supply glut and a drop in Chinese demand. While China's anti-pollution clampdown has meant a shift towards the higher-grade ore that Australia produces, the corresponding decline in steel smelter activity and the broader decline in infrastructure spending mean that iron ore needs on the mainland will overall decline. Combined with reduced infrastructure spending, the outlook ahead sees a trend of reduced Chinese demand for base metal, which will continue to weigh on Australia's exports and external growth. QiXiu.Tay@informagm.com

NEW ZEALAND: The RBNZ will see an arguably more exciting year in 2018 as the themes of tightening labour conditions, central bank reform and firming inflationary pressures dominate. Regardless, the RBNZ is still expected to stand pat on its Official Cash Rate (OCR) for most of this year. The next OCR move likely to be 25bp hike and likely to take place earliest in November this year.

An extension of 2017's positive labour market trends which ultimately feed through to inflationary pressures will likely stoke increasingly hawkish market expectations of the RBNZ as the year trudges on.

The appointment of former NZ Super fund head Adrian Orr's as the new CB Governor and positive developments seen in New Zealand's labour market have been allayed fears of a significant dovish turn. However, uncertainties abound. Much is still unknown with regards changes/implementation to the RBNZ mandate. Incoming Governor Orr's policy tilt is largely unknown, despite some speculation of a supposedly more hawkish stance. It seems any potential mandate reforms are unlikely steer the CB materially away from its current OCR trajectory as many proposed additions (e.g. full employment mandate) have been implicitly taken into account during past economic assessments/OCR decisions.

The domestic economy saw stronger price pressures in 2017 with its Q3 2017 y/y CPI reading coming in at 1.9%, near the 2% midpoint of the RBNZ's y/y CPI target of "between 1 and 3 percent". We may still have to see inflation creep towards the upper bound of the target range before we hear discussion on any prospective tightening by the CB. tianyong.woon@informagm.com

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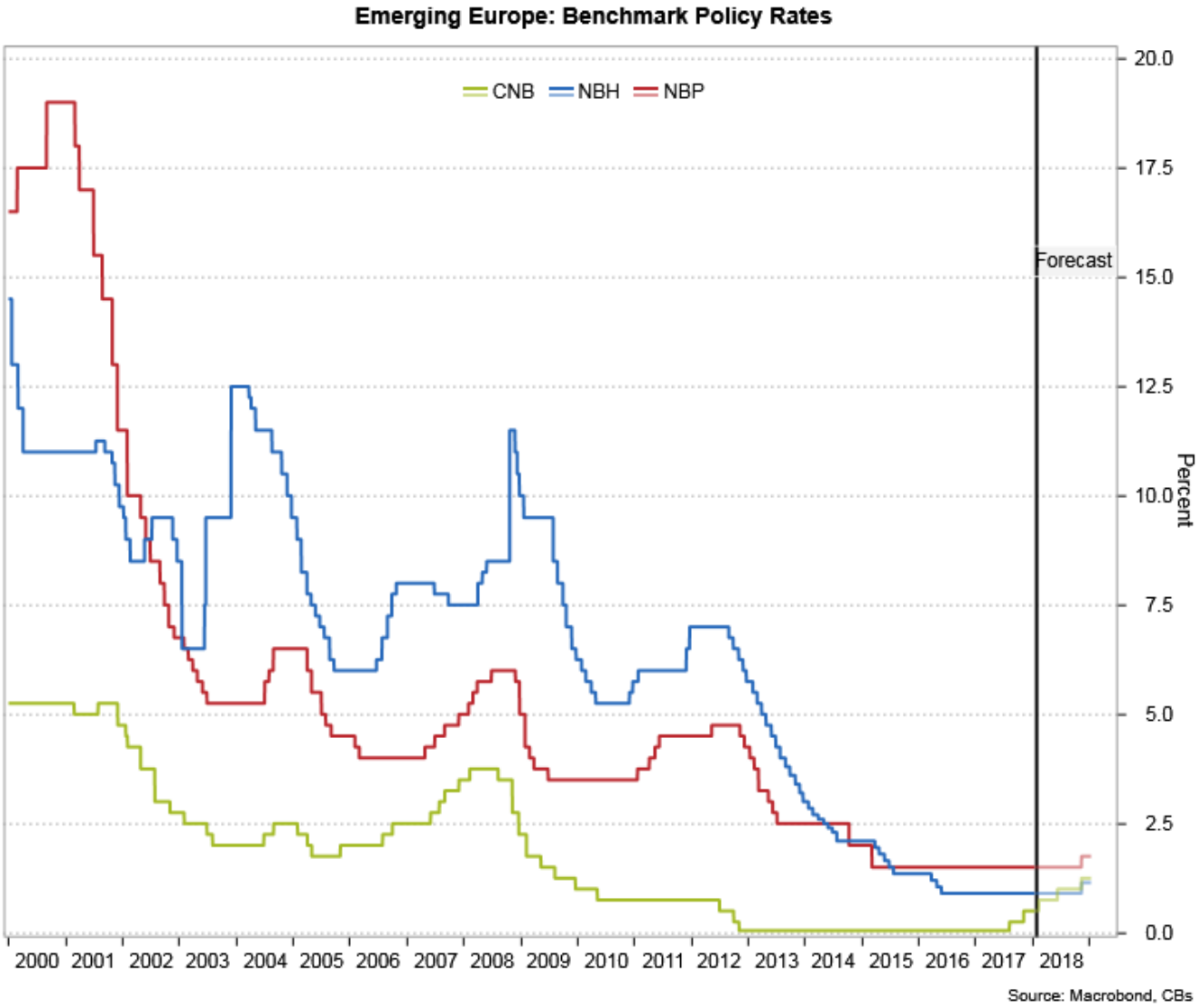
EMERGING MARKETS: EUROPE, RUSSIA & SOUTH AFRICA



CZECH REPUBLIC: The question heading into the first meeting of 2018, is whether the CNB will hike rates by 25bp having held off in December. Then it is all about the pace of tightening for the rest of the year. Governor Rusnok has said that Czech rates should be at "a normal state" around 3.00% in "one to two years"; this is significantly higher than the forward implied policy rate for 2 years which is at less than 1.50%.

Thus it would seem that there are few obstacles to further hikes at upcoming meetings. However, the CNB minutes show that most rate setters favour gradual policy tightening, with the economy considered to be developing in line with the central bank's forecasts. Rusnok has said that there is nothing wrong with CPI staying above 2% for some time after years of undershooting, and this has curbed some of the recent rate hike speculation, especially with CPI slowing at the end of 2017.

A lack of political risk means that fundamentals and monetary policy will remain the key drivers for Eur/Czk and CZGB yields in 2018. The continued strength of the Czech economy and gradual interest rate increases will see the Czk appreciate CZGB yields rise in 2018, but to a smaller extent than in 2017. We expect to see Eur/Czk down at 25 (-2.0% from current levels) and the 10-year CZGB yield up at 2.00% (+40-50bp from current levels) by 2018-end. christopher.shiells@informagm.com

HUNGARY: Having previously introduced additional unconventional easing measures, due to come into force at the beginning of 2018, at their final meeting of 2017, the NBH predictably repeated a commitment

too loose monetary conditions over a prolonged period with its expanded tools. Hence, it appears that the central bank intends to remain staunchly dovish for the foreseeable future.

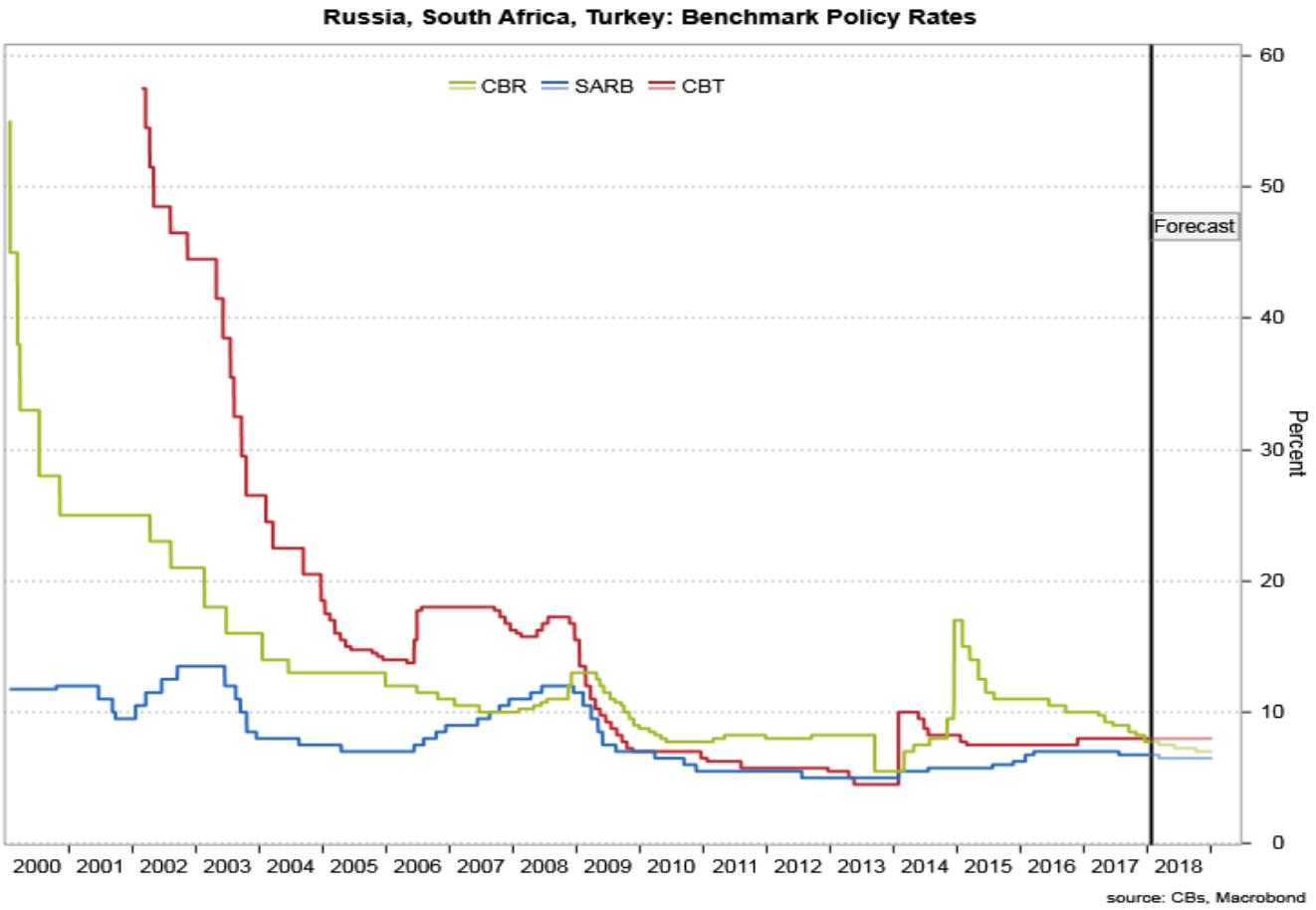
However, Hungarian GDP growth has been heading higher in line with other economies in the CEE region, and is expected to hold around the 4.0% y/y mark throughout 2018. This strong growth and rapidly climbing wages (around 13% y/y) also bring about the question of how long the NBH can cling to its dovish outlook. The CB does not expect CPI to reach the 3% target until mid-2019, and the market implied policy rate now points to less than a 20bp, though they may well resist calls to begin tightening.

Ultimately, it remains to be seen whether or not the central bank's hand will be forced, but it is clear that the path of monetary policy is a key risk for Hungarian assets in 2018. robert.graystone@informagm.com

POLAND: With most of the ten-person rate setting council, including Governor Glapinski, expecting inflation to stay close to the 2.5% target through 2019, the NBP looks set to extend the record long rate pause in the coming months. The central bank has made it clear that it is a lack of conviction over the strength of inflationary pressures (notably core inflation) and the assumption that growth will lose momentum that is preventing any deviation away from the official neutral stance to a more hawkish one.

Traders have been doubting the central bank's guidance and this was a key driver of Zloty strength in 2017 (second best EM performer against both the Euro and the US Dollar). However, with inflation having moderated from its five-year high of 2.5% y/y in November, tightening bets are not getting carried away – the market implied policy curve is still pricing in 25bp of hikes within twelve months.

The market will ultimately continue to look for signs of increased hawkish thinking amongst the MPC that could lead to a discussion of rate hikes in the coming months, but at some point, there will need to be a convergence of reality and expectations, one way or another. The Zloty's performance will play a part in how the rate hike debate within the MPC develops, together with the path of core inflation, which has yet to take off in the same fashion as the headline (sub-1% y/y for all but one month in 2017). At present, we continue to look for one quarter point hike in the second half of 2018. natalie.rivett@informagm.com



JANUARY MONTHLY INTEREST RATE OUTLOOK

SOUTH AFRICA: The slow rate of pick-up shown in both GDP growth and inflation forecasts for the South African economy in 2018 give the SARB limited scope for tightening monetary policy. The headline CPI figure has been inside the SARB's 3%-6% target range since April 2017 and the CB expects inflation to stay inside this range until at least 2019-end. Hence, market expectations point to a front-loading of rate cuts by the SARB in H1 this year, bringing the key repo rate down to 6.50% as inflationary pressures remain subdued.

This outlook represents a pivot away from the consensus view towards the end of 2017 which suggested that the door was closing to further monetary policy easing. The SARB's new forecast model implies three 25bp hikes by the end of 2019, but the country's growth challenges will leave the SARB reluctant to hike rates prematurely. That being said, the central bank has warned that there remain upside risks to the inflation outlook on the back of higher oil prices and a weaker Rand. robert.graystone@informagm.com

RUSSIA: Russian inflation ended 2017 at a record low of 2.5% y/y, well below the CBR's 4% target for the year, which should keep the door open to further easing in 2018. However, after 225bp of cuts over the last twelve months, the pace of further rate reductions will likely slow going forward, with inflation seen returning to target in H2 2018.

The deal between OPEC and its allies to maintain oil production cuts until the end of 2018 was cited by the CBR as a key factor in the decision to deliver the greater than anticipated 50bp rate deduction in December, by helping to lower inflationary risks over a one year horizon. Yet, Governor Nabiullina emphasised the move was consistent with plans to gradually transition from a moderately tight to neutral monetary policy stance.

In fact, Nabiullina said that it would take approximately two years for the key rate to reach a nominal equilibrium level of circa a 6–7.00%. This leaves us anticipating more pauses between small 25bp moves in 2018, for a combined 75bp of cuts in the key rate, possibly 100bp. However, the threat of US sanctions on OFZs lingers and should this come into force, the CBR may have no choice but to raise rates to try and curb Rouble weakness, and potentially to the tune of 200-250bp. natalie.rivett@informagm.com

TURKEY: At the start of 2018 pressure remains on the CBRT to take further action to curb inflation, as the December CPI print slowed, but not as much as forecast, whilst core-CPI accelerated, highlighting the CB's risky strategy of waiting for disinflation to kick in and turn real yields positive in Q1 2018 to reduce the pressure on the Lira.

The currency's performance over the past couple of weeks has taken the pressure off the CB - the currency has rallied some 3% since the underwhelming 50bp hike to the Late Liquidity Window (LLW) on December 14, but we maintain that the CBRT needs to restore some credibility and hike rates again in early 2018 or the Lira will remain vulnerable to renewed speculation.

This year, CPI will slow on base affects, but the weaker Try, rising administered prices and the minimum wage are expected to keep expectations elevated and inflation in double-digits for most of the year. It would take a significant shift lower in food/oil prices or a steady and appreciating Lira to see CPI decelerate below 10%, which is where the CB could help with some strong and clear policy action. However, President Erdogan has rallied against rate hikes, as he can ill-afford an economic slowdown ahead of the twin parliamentary and presidential elections in 2019, the final obstacle to his aim of ruling Turkey as an executive president.

If the CB can restore some confidence, then Turkish markets could be primed for a strong 2018. The Lira is at decade low levels versus its trade weighted basket, local bonds boast some of the highest nominal yields among major economies and have some catching up to do with peers, whilst stocks are trading near the widest discount to other EMs indices in more than eight years.
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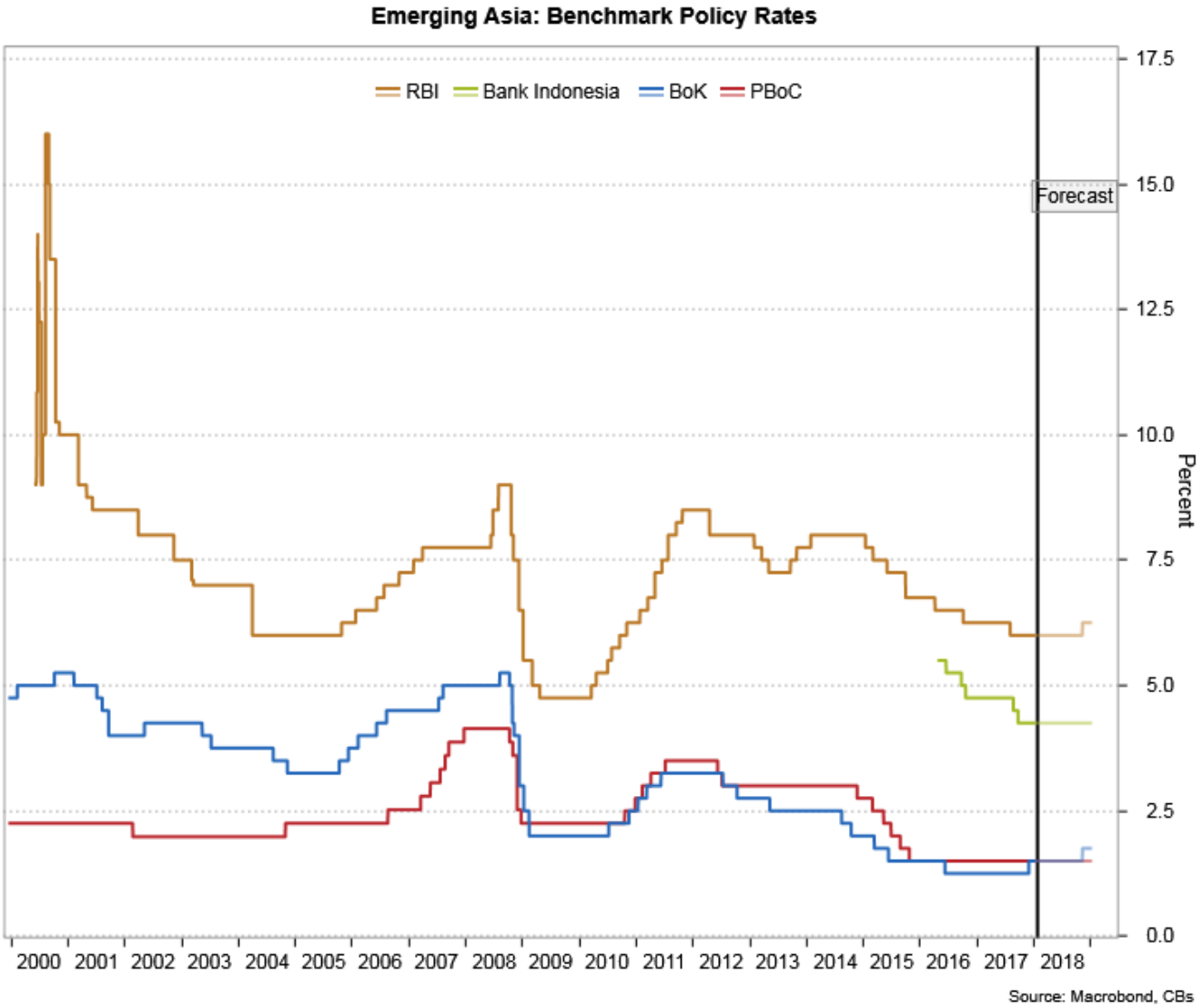
EMERGING MARKETS: ASIA

INDIA: The RBI had been under pressure for a large part of 2017 to cut rates to boost an economy beset by problems caused by reform such as demonetization and the implementation of GST. The fallout from the reforms has caused the vast cash economy to grind to a halt, and this has had a muting effect on inflation in the middle of 2017, with the index falling below 2% in June, an unheard-off phenomenon. Still, the RBI had stood its ground despite criticism aimed at its inflation modelling, as it

focused on the potential for government wage hikes and increases in housing allowance as well as volatile weather-driven fresh food prices and resurgent oil price. In the New Year, with plans to recapitalize banks to jumpstart lending, as well as the fading of the ill effects of the reform, the potential for inflation has increased. To reflect this, the RBI boosted inflation estimates modestly to 4.3-4.7% at their last meeting for the second half of FY2018, which is still well within the central bank's 4% (+/- 2%) target range. However, the lower than expected estimate for FY2018 GDP at 6.5% means that the voices calling for the RBI to do more for the economy won't be silenced just yet. As such, the RBI will only be able to act when they have firm data to support their actions, possibly only in the latter half of 2018. freda.yeo@informagm.com



CHINA: The Chinese top policymakers concluded the Central Economic Work Conference (CEWC) on 20th December 2017. Every signal delivered there suggested that the central government will focus more on reform implementations than economic growth in 2018.

Unlike previous years, CEWC in 2017 emphasized that monetary is required to safeguard the liquidity floodgate. We are inclined to interpret "safeguarding the liquidity floodgate" as a hint towards PBOC's preference for a tighter monetary stance in 2018 as the top policymakers appear to be speeding up financial deleveraging even at a cost of a slightly slower growth. Removal of the phrase "expanding aggregate demand" by CEWC also reflected the central government's willingness to accept slower growth if necessary.

Actions speak louder than words. Immediately after CEWC was finished, China Banking Regulatory Commission (CBRC) on 29 December introduced a

new capital regulation on distressed asset management company's capital and leverage on a consolidated basis. Before this new regulation was introduced, companies in this industry could set up multiple subsidiaries to invest without eroding parent companies' capital. Apparently, these companies in the new regulatory framework now have to slow the growth pace or even deleverage by shrinking the balance sheet.

In order to prevent potential liquidity shocks as a result of the above-said new regulation from spilling over to the banking sector, the PBoC on the same day announced a special RRR arrangement, under which all commercial banks are allowed to temporarily withdraw 2% of their legal reserve deposit for a 30-day period in the Spring festival period. The PBoC did make special liquidity arrangements for the festival seasons in both 2016 and 2017. However, the 2018 arrangement obviously is more generous in the sense that it covers all commercial banks, not only the large ones.

In our view, we are likely to see more new regulatory measures aimed at deleveraging and/or reducing financial risk over the next 3-4 quarters. While these measures are implemented, special liquidity arrangement(s) on temporary basis might be introduced as a buffer against any potential liquidity shocks.

As far as the interest rate policy is concerned, we see there is room for the PBoC to raise the benchmark interest rates in 2018. The very wide spread between government bond 1-year yield and 7-day repo rate (currently at 95p) suggests the PBoC has been lagging behind the curve. Historically, such a wide spread is unsustainable, which eventually will correct inward. In the course of financial deleveraging in 2017, it was difficult for the small banks to fund themselves due to tightening of interbank lending. As a result, NCD rates increased by 250bp and WMP by 100bp. Thus, rate hiking in 2018 as a recognition of the deleverage is likely to happen at some point in 2018. tim.cheung@informagm.com

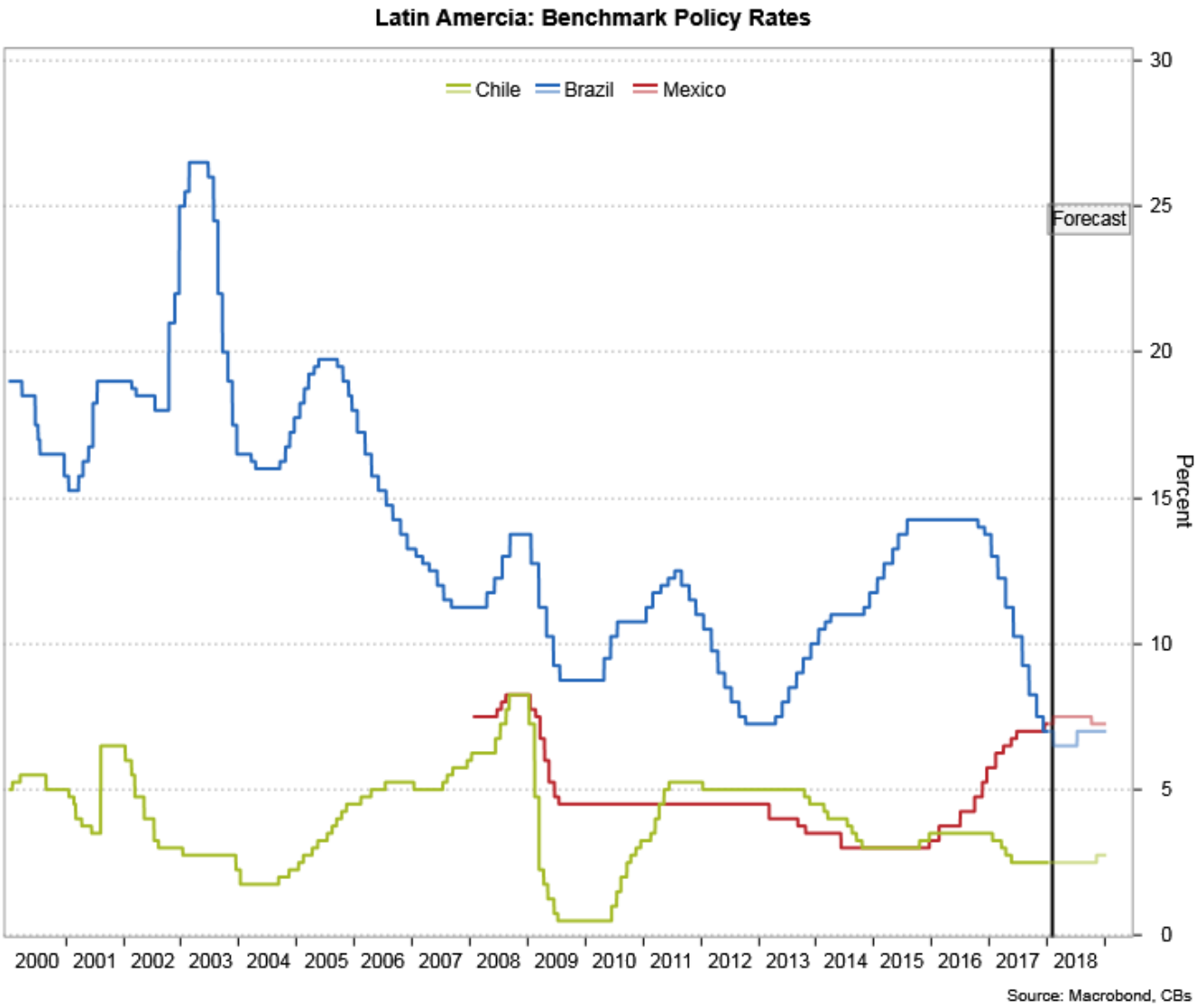
INDONESIA: Bank Indonesia is likely to stay on hold for an extended period after pushing through 8 rate cuts since 2016 and a change in benchmark in mid-2016, as the BI had already warned that the scope for further rate cuts are limited by the Fed's rate hike outlook. However, that no longer represents the end of the road for lower rates and interest by bond investors as the government and central bank has another card up its sleeve: following the upgrade by Fitch in mid-December of 2017 of the country's sovereign rating from BBB- to BBB, the focus will be on improving their fiscal profile. This will provide the benefit of keeping investors onshore and lowering yield that the BI has so far not totally managed despite the lowering of the benchmark rate. Already there are positive developments in this respect, with the IDR, the region's laggard, making strong gains since the New Year while the 10-year bond yield has dived towards 6% from around 6.6% before the upgrade. Improving fiscal matrices including preliminary budget deficit guidance of under 2.6% for 2017 (estimated in July at 2.92%) is raising hopes that there could be a crucial second upgrade within the year as Moody's has the country on 'Positive' watch while S&P was previously reported as being constructive on the country after its upgrade to lowest investment level in May 2017. Inflation seems to have found a bottom in the low 3% and averaging 3.81% for 2017, but due to the shift in focus, is likely to become less important as an indicator going forward. freda.yeo@informagm.com

SOUTH KOREA: South Korea's central bank tightened first in the region with a 25bp hike in a relatively sudden but well-signaled move (following a surprise dissent at the October meeting) at the end of November 2017. However, markets should expect a rather long holding pattern following this hike. The BoK will likely back-pedal from further hints of tightening before other regional peers due to the KRW's almost 6.5% appreciation since it was revealed the CB was biased towards a hike in mid-October. While there are other reasons present for the performance of the KRW, its strength will depress imported inflation even as oil prices firm noticeably.

The BoK will keep in mind that further hints of rate rises will add to the pressure in a vicious cycle. Core inflation lost the 2% handle in the last quarter of 2017, which removes the pressure to act anytime soon. Other uncertainties include stubbornly high youth unemployment and household debt, and the Bank will try to not get in the way of the President's economic agenda. 2017's high base has raised risk of export-driven economic growth and this is undoubtedly on the government's and BoK's radar. The BoK had already hedged the rate hike with a dissenting on-hold vote. Additionally, the Bank is on a hunt for a new Governor as the four-year term for current chief Lee ends in March. All this points to the likelihood of a delay (and justifiably so) to any further rate moves during the first half of 2018. freda.yeo@informagm.com

JANUARY MONTHLY INTEREST RATE OUTLOOK

EMERGING MARKETS: LATIN AMERICA



BRAZIL: The BCB is seen creeping closer to the end of its most aggressive easing cycle in a decade, having cut the benchmark Selic rate by a more modest 50bp to a record low of 7.00%, as expected, at their final meeting of 2017. This is supported by the ongoing inflation rebound to 2.80% y/y in November.

In their most recent statement, the Copom indicated that the next meeting would likely see another "moderate reduction" in the pace of cuts; this points to a smaller 25bp move in February. After that, in the absence of any unexpected shocks that might prompt the BCB to ease policy further, we expect the central bank to turn neutral and eventually begin tightening. DI swaps indicate that the key rate could be back up at 7.00% by the end of 2018, though the BCB may decide to drag their heels by holding a neutral stance.

It is worth noting though that data from our partners at EPFR shows little reaction to BCB policy in net Brazilian bond fund flows, hence, political headwinds such as pension reform and the upcoming election will remain the key focus of Brazilian investors this year. robert.graystone@informagm.com

CHILE: The backdrop for Chilean rates has turned hawkish at the start of 2018, as inflation accelerated back within the central bank's target range (3% +/- 1%) in December, for the first time in 7 months, following on from the release of the stronger than expected economic activity figures for November (3.2% y/y, a 21-month high).

Before this the BCCh had maintained a dovish bias amidst ongoing concerns over below target inflation, and said they would be prepared to adjust monetary

policy further "if deemed necessary", but investors have not quite been buying this narrative, as markets are only marginally pricing in a chance of a rate cut in 6-months. After this the BCCh is expected to start raising rates. Overall, we maintain our view that cuts will not materialise in 2018 so long as activity data shows an improvement and inflation expectations resume an upward trend.

For the February meeting, everything is pointing to an unchanged decision, as the CB will need time to assess if the recent increase in inflation is something temporary or more permanent. As-long-as the economy is on a strengthening path, there is no need for the BCCh to rush a decision.
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MEXICO: Mexico's overnight rate now stands at 7.25%, the highest in almost nine years, after the 25bp hike from the central bank at the final meeting of 2017, and it may well have to be lifted further this year to contain inflation, which has been running at more than double the 3% target for the past eight months (reached 6.77% y/y in December).

The central bank has made it clear there has been a deterioration in the inflation outlook, with the 3% remit now seen taking longer than anticipated to reach and for this reason, we are expecting another 25bp, possibly 50bp, of rate hikes over the coming six months, and with the next increase perhaps as soon as the February meeting. Much depends on the path of the Peso, which could depreciate on any unfavourable developments from NAFTA renegotiations as well as concerns over Mexico's presidential election in July.

It is possible that Banxico could start trimming rates before the year is out – we forecast the key rate back at 7.25% by year-end – but the central bank will first need to see both a significant moderation in inflation and sustained stabilisation of the Peso at firmer levels. Note, the market is taking a more hawkish stance, with the implied policy rate curve pricing the benchmark rate at almost 7.80% in six months, easing to circa 7.60% by year-end.
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JANUARY MONTHLY INTEREST RATE OUTLOOK

TECHNICAL ANALYSIS

US 10-Year Treasury Note Yield – Consolidates ahead of the next upswing

US 10 Year Yield – Monthly Chart

Resistance Levels		
R5	3.336	Equality of 1.318/2.639, 2.014 near 3.320 - 2 May 2011 high and 50% 5.323/1.318
R4	3.052	2014 peak – 2 January
R3	2.981	61.8% 4.009/1.318, near 2.961 (2.75-year falling channel target)/ 2.965 (2.236x 1.318/1.877, 1.714)
R2	2.833	2.000x 1.318/1.877 from 1.714 near 2.819 (7 March 2014 range high)
R1	2.687	3 July 2014 peak, near 2.639 (2016 high – 15 December), 2.653 (19 September 2014 peak)
Support Levels		
S1	1.990	10 November 2016 low, near 1.997 (16 March 2016 prior peak) /2.014 (8 September 2017 YTD low)
S2	1.877	1 November/28 October 2016 8-day range highs
S3	1.714	9 November 2016 low
S4	1.517	7 September 2016 reaction low
S5	1.318	6 July 2016 record low

Key Points

- Ranges between 2.639/2.628 (2016/2017 peaks), just shy of congested lower highs at 2.653 and 2.687 (houses 50.0% 4.009/1.318 at 2.664 and 0.500x 1.318/2.639, 2.014 at 2.675) and 2.014 (8 September low) near the congested 1.990 area
- The weekly and monthly RSI and MACD studies trend higher, suggesting yields will retest the 2.639/2.687 zone, possibly in Q1
- Whether or not there is a concerted range break early in the year hinges on the daily studies (not shown) which may attempt to unwind from extended levels, prompting consolidation prior to the next push higher
- While 2.014/1.990 holds, yields should attempt to break out of the 29-year channel/2.848 area for the 2.981/3.052 region
- Yields may stall in or around this congested zone and settle back into a range; however, a strong push through 3.052 would stage an extension towards the equality target at 3.336, possibly in the middle or latter part of the year

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JANUARY MONTHLY INTEREST RATE OUTLOOK

EU 10 Year Yield – Yield bulls are resuming the broader recovery for 0.619/0.822

EU 10 Year Yield – Weekly Chart

Resistance Levels		
R5	1.057	2015 peak – 10 June
R4	0.986	13 July 2015 lower high
R3	0.822	1 September 2015 lower high
R2	0.737	4 December 2015 high, nr a 20 month rising trendline at 0.745 and 76.4% of 1.057/-0.205 fall at 0.760
R1	0.619	2017 peak - 12 July (highest for two years)
Support Levels		
S1	0.380	27 December 2017 low
S2	0.280	11 December 2017 low, also the base of the recent five-month range bullish consolidation
S3	0.191	1x 0.619-0.292 fall from 0.518, near 14 June 2017 low (0.225) and 50% of -0.205/0.619 fall (0.207)
S4	0.156	2017 low – 18 April, near 2 January 2017 low at 0.157
S5	0.092	9 November 2016 minor higher low, near 61.8% retrace of -0.205/0.619 recovery at 0.110

Key Points

- Recovered from -0.205 (record low) to 0.619 (2017 top - 12 Jul), before easing to range within the five-month, 0.280-0.518 band
- Yield bulls have now broken up out of this range and are currently probing a 9½ year tentative falling trendline at 0.546
- Constructive daily/weekly studies suggest a sustained trendline break to extend the broader recovery for the 2017 peak at 0.619
- Beyond would confirm 0.280 as a major higher low and target lower highs from 2015 at 0.737/0.822, perhaps 0.986
- Only below 0.280 would damage current recovery potential and signal extended consolidation over higher lows at 0.156/0.225

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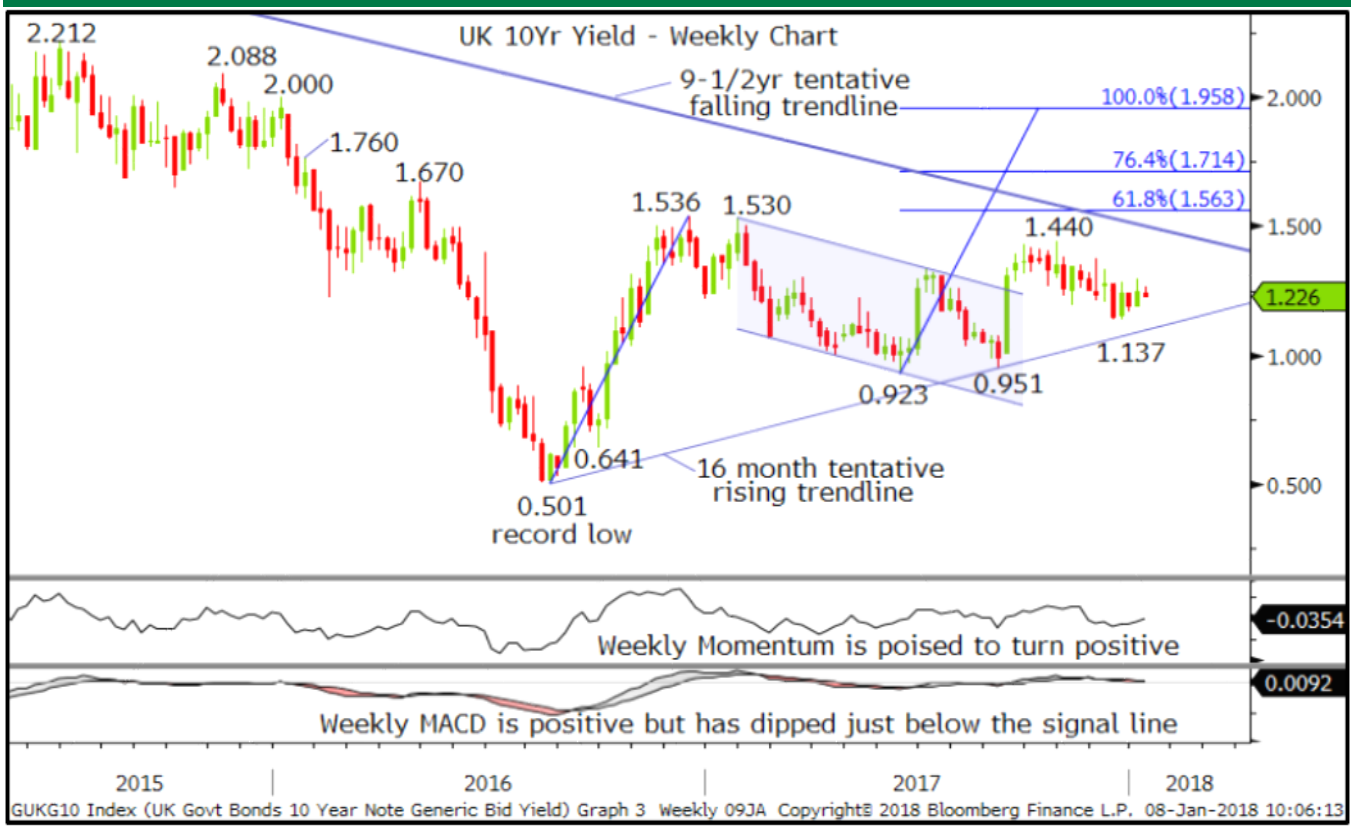
JANUARY MONTHLY INTEREST RATE OUTLOOK

UK 10 Year Yield – Broader recovery to resume while dips hold 1.089/1.137

UK 10 Year Yield – Weekly Chart



Resistance Levels		
R5	1.958	Equality projection of 0.501/1.536 rally from 0.923
R4	1.760	19 January 2016 high, near .764 projection of the 0.501/1.536 rally from 0.923 at 1.714
R3	1.670	26 April 2016 lower high, near the current 1.195/1.440 range target at 1.685
R2	1.536	15 December 2016 high, near 26 January YTD high (1.530), .618x 0.501/1.536 off 0.923 (1.563)
R1	1.440	25 October 2017 high, near a 9½ year tentative falling trendline at 1.490
Support Levels		
S1	1.137	15 December 2017 low, near a 16-month tentative rising trendline at 1.089
S2	0.923	2017 low – 16 June, near 8 September 2017 higher low at 0.951 and 61.8% of 0.501/1.536 at 0.896
S3	0.745	76.4% retrace of 0.501/1.536 rally
S4	0.641	27 September 2016 higher low
S5	0.501	15 August 2016 record low

Key Points

- Gains from last year's 0.501 record low reached 1.536 before easing to consolidate this recovery above 0.923 (2017 low – 16 June)
- Daily-monthly studies are reasonably constructive and while 1.089/1.137 limits near term dips, watch for the recovery to resume
- Above 1.440 then the 1.530/1.563 zone would confirm 0.923 as a major higher low and mark a resumption of the broader recovery
- Potential would then be seen to 1.670/1.760 (26 Apr/19 Jan 16 lower highs), perhaps an equality projection at 1.958 on extension
- Only below the 1.089/1.137 zone would caution and re-open the key 0.923 consolidation base – which should hold

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JANUARY MONTHLY INTEREST RATE OUTLOOK

CAN 10-YEAR YIELD – Extends off 1.806 higher low for anticipated multi-year highs over 2.203

CAN 10-YEAR YIELD – Monthly Chart

Resistance Levels		
R5	3.141	30 June 2011 reaction high
R4	2.830	2013 high - 11 September
R3	2.572	21/20 February 2014 lower high/3-month range top
R2	2.376	76.4% retracement of the 2.830/0.908 fall near 2.375, 5 June 2014 range top
R1	2.203	2017/3-year high – 27 September
Support Levels		
S1	1.806	29 August 2017 1.806 higher low, near 1.816/26 reaction lows (28 November/15 December 2017)
S2	1.639	10 May 2017 former lower peak
S3	1.373	6 June 2017 low/reaction low
S4	1.260	28 October 2016 former range high
S5	1.113	24 October 2016 minor higher low

Key Points

- Recent strength off the 29 August 2017 1.806 higher low probed 18-yr falling channel upper bounds at 2.087 and is now pressuring the 27 September 2.203 3-year high. An anticipated push through here will open a test of the 76.4% retracement of the 2.830/0.908 decline at 2.376, likely before Q2 2018
- The monthly MACD crossed above the signal line in late 2016 and has held there since while the monthly RSI, currently in the mid-60's, shows room for perhaps 1-2 additional near-term legs higher before periodic weakness might ensue
- Q2 and Q3 2018 are thus likely to see a period of corrective consolidation with the 1.806/26 area supporting dips, before a Q4 2018 push back towards 2.376 and potentially the 21/20 February 2014 2.572 lower high on continued strength

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JANUARY MONTHLY INTEREST RATE OUTLOOK