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FEBRUARY MONTHLY INTEREST RATE OUTLOOK

Bond yields are on the way up ... BEIRs and therefore inflation expectations have played a major role in some markets ... which as Senior Editor/Analyst Marcus Dewsnap suggests is a significant reason for the interest rate expectations shift priced-in by markets via OIS curves [Pages 2-5]

- **Technical Analysis is also supportive of the higher sovereign yield story [Pages 20,21, 22,23] with European FI TA Chief Ed Blake indicating significant moves are afoot in Europe [Page 6]**

- **A major OIS mover is in the Eurozone, but NOT because of an inflation expectations shift for this year at least [Pages 2-5] … maybe it's that growth thing … but as European Fixed Income Manager Alvin Baker writes, 'all told, despite the Euro front-running some further stimulus withdrawal/policy action, 2-10 year yields do *NOT fully reflect a risk premia for quicker normalisation*. Post ECB, the 5-year Bobl reached 0% - an important milestone if that can turn positive and stay above that level' [Pages 8-9].**

- **Meanwhile, the CNB tightened once more in January, and it is almost certain to do so again … although Emerging Markets Managing Analyst Chris Shiells suggests that given current forecasts, only one more hike this year [Pages 6, 13].**

- **In China, the PBoC's removal of the counter-cyclical factor mechanism in January finalises the abolition of measures introduced in August 2015 to defend the Cny. As Tim Cheung, IGM Head of China, writes (Page 16), faded capital outflow pressures combined with improved FX reserves outlook plus a solid recovery of GDP growth not only justifies this, it also suggests *it is time for FX rate normalization*.**

2nd FEBRUARY 2018

The Contributors:

Editorial
Marcus Dewsnap

Fed
Marcus Dewsnap

BoJ
Jian Hui Tan

ECB/BoE
Alvin Baker

RBA/RBNZ
Qi Xiu Tay

BoC/SNB
Mark Mitchell

Riksbank/Norges Bank
Rachel Bex

CEE, CBR, SARB, LatAm
Chris Shiells
Natalie Rivett
Robert Graystone

PBoC
Tim Cheung

BoK/RBI/Bank Indonesia
Freda Yeo

Technicals:
Marnie Owen
Ed Blake
Matthew Sferro

Editor:
Marcus Dewsnap

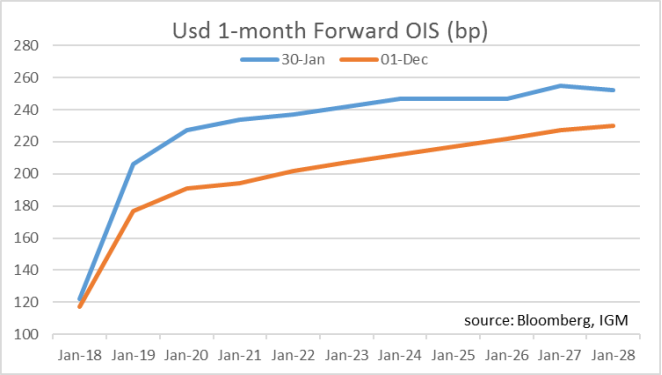
FEBRUARY MONTHLY INTEREST RATE OUTLOOK

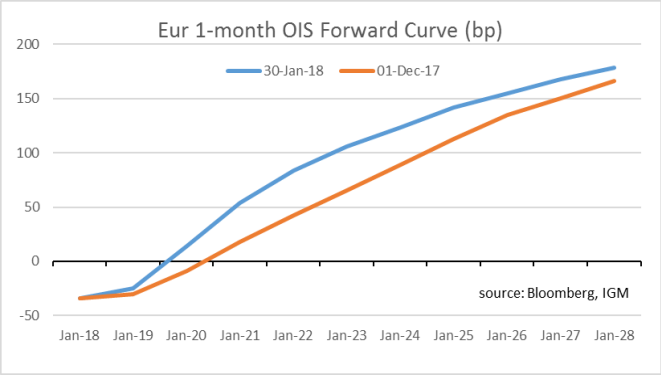
Shifting Rate Expectations

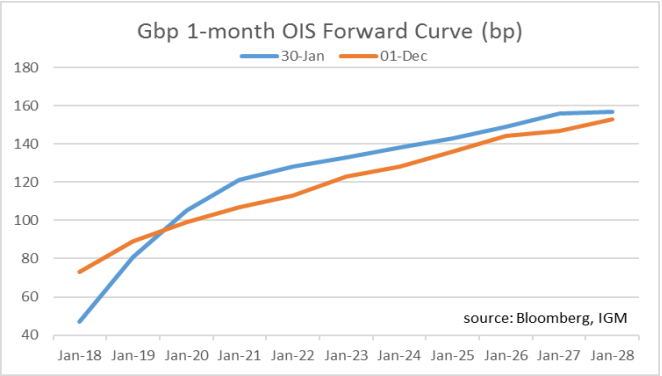
By Marcus Dewsnap, Senior Research Analyst, IFI

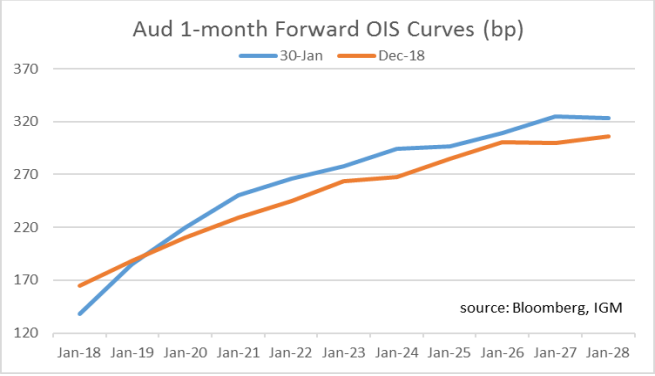
OIS curves have shifted significantly in favour of higher official rates. There is some evidence to suggest BEIR rises might give central banks 'cover' for tightening.

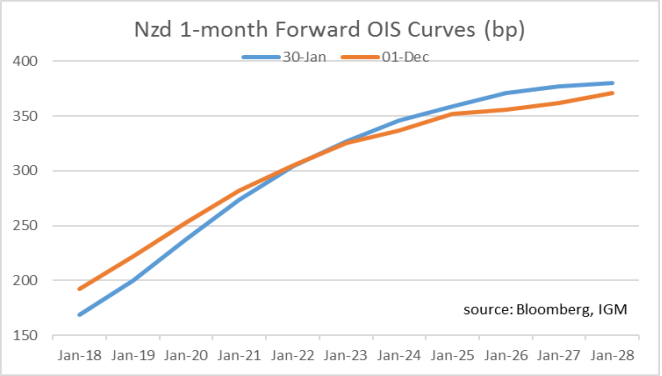
Since early December, market expectations of central bank rate *hikes* have changed dramatically. In particular, 1-month forward OIS curves in the US and Euro have shifted higher and in some parts steeper. Meanwhile, Gbp, Cad, Aud and Nzd have pivoted, steepening at the front-end implying a higher curve farther out … as the graphs below illustrate

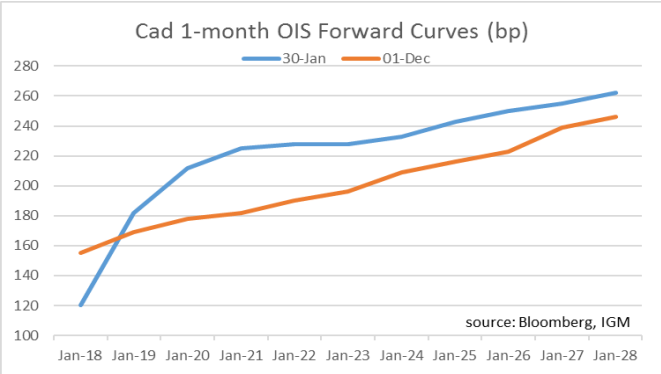












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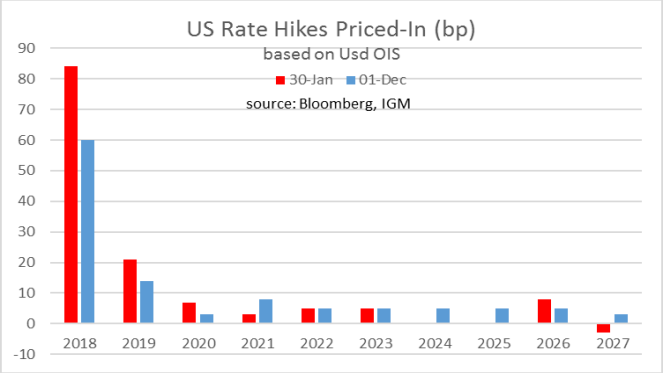
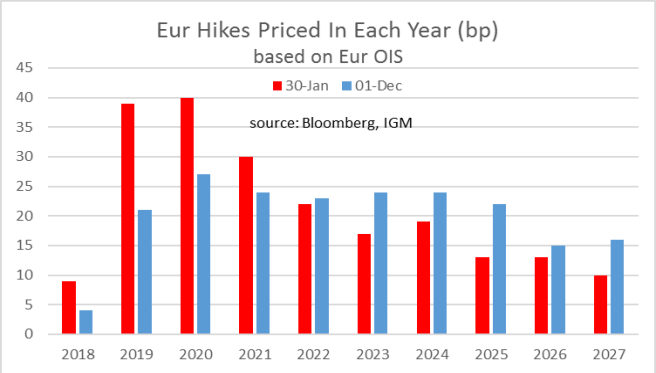
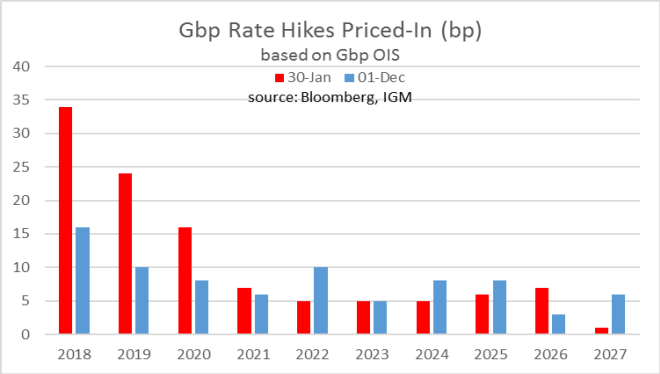
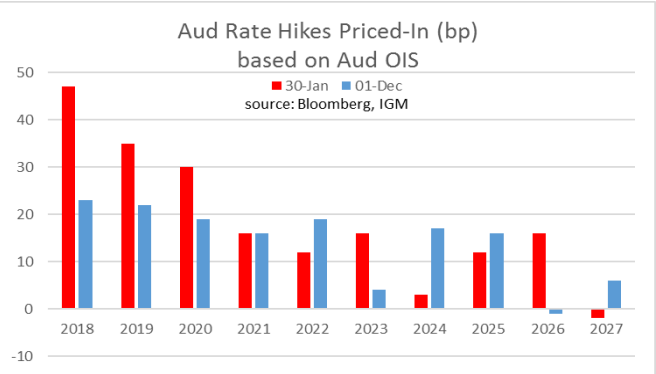
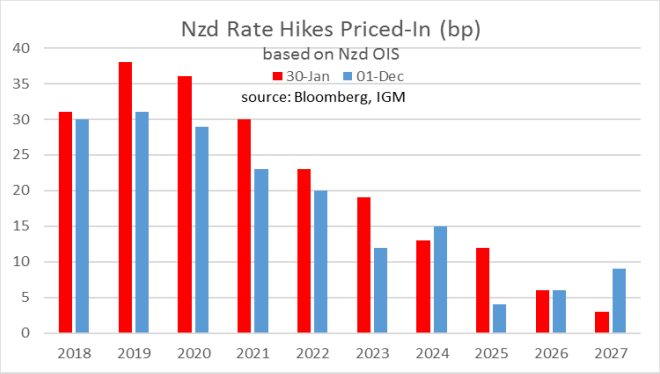
The same point is driven home by these graphics:

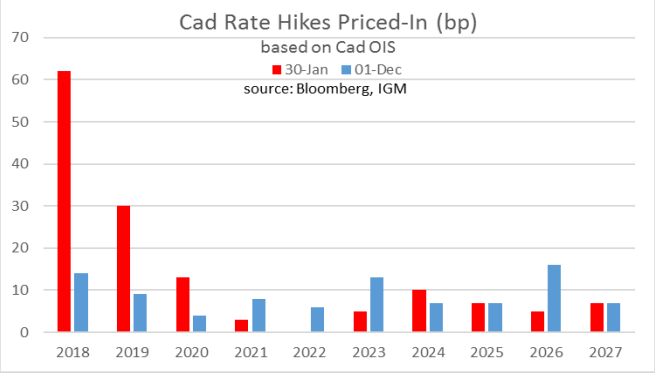








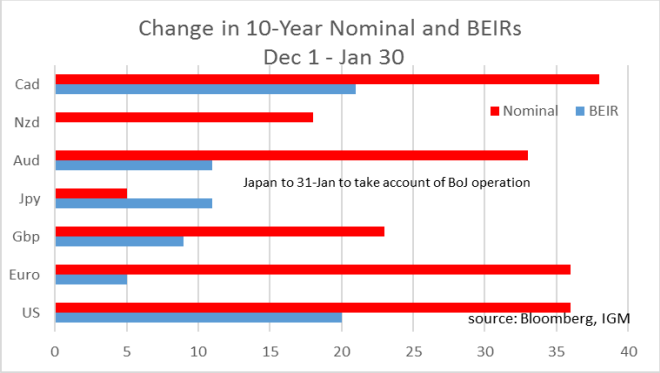


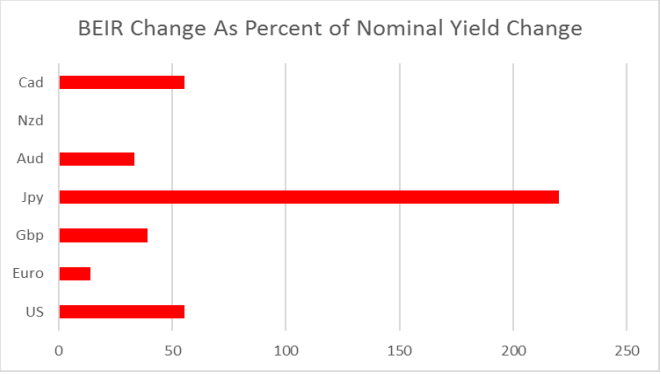


The result is that sovereign yields have universally risen as markets price in faster than originally expected rate rises, resulting in bear flattening in some but not all jurisdictions. What underlies this dynamic? The simple answer is better global economic growth prospects, which given central bank inflation targeting mandates, implies accelerated inflation and therefore a higher probability (expectation) assigned to faster official rate hikes.

If the market believes faster inflation is on the way, this should reveal itself in higher Breakeven Rates (BEIRs). The graphic below shows the move in the nominal yield and that in the Breakeven rate (a nominal yield can be decomposed into an inflation element – the BEIR – and a real yield. They do not always move in the same direction or magnitude).

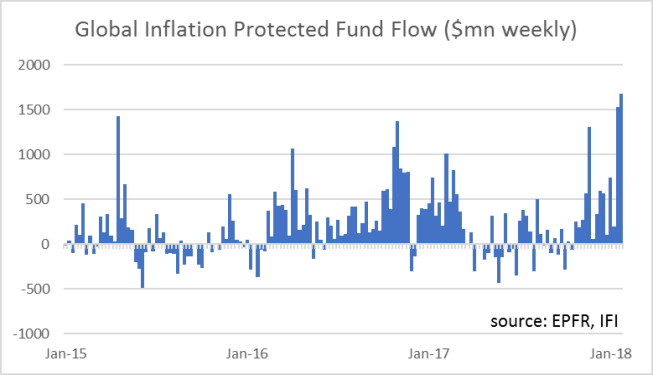
FEBRUARY MONTHLY INTEREST RATE OUTLOOK

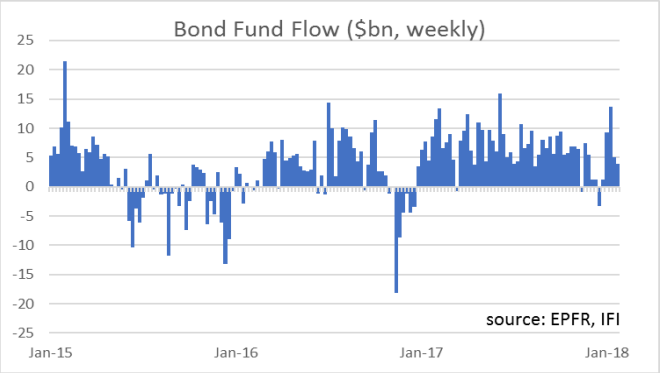




Alongside is a graphic showing the BEIR change as a percent of the nominal yield change. Japan is the obvious outlier here with 220%, but in the US and Canada, over 50% of the nominal yield move is down to the change in market-based inflation expectations. The JGB market is of course subject to the BoJ's Yield Curve Control, part of the reason for the 220% figure as the CB suppresses the 10-year nominal yield. Interestingly, the rise in the Euro yield has occurred with *stable* inflation expectations. The UK and Australia see less than 50% contribution from BEIRs and New Zealand 0%. An issue with using BEIR is their sensitivity (positive correlation) to commodity prices, oil especially. However, using 10-year BEIRs mitigates, but does not necessarily eliminate, this impact somewhat as commodity price changes tend to impact inflation in the more immediate term.

Still, if investors are concerned about rising inflation, there should be flow into inflation protected funds. The next graphic shows a large increase this year in such inflows. The accompanying graph also indicates flows into bond funds remain positive despite the inflation concerns.





The majority of the inflation protected inflow has been US-fund related. The UK and Australia have witnessed inflow, but Canada a (small) outflow, in Europe ex-UK a much larger outflow. This suggests there is demand for inflation protection, but it isn't universal. Indeed, this fits with the ECB's inflation isn't likely to pick-up speed soon and the relatively small change in EMU BEIR's (large amount of surplus capacity?). The Fed in contrast has talked up inflation prospects much more (up to the recent meeting). There are no Japanese inflation protected funds, but within the market there has been more intense talk of an inflation pick-up which might account for the BEIR reaction. The UK is FX impacted via Brexit (which might be inflationary), Canada does have NAFTA related issues as well (that might be inflationary).

The significance of BEIR changes in relation to nominal yield moves is twofold.

1. The greater the BEIR move the more the market believes inflation is likely to accelerate as opposed to higher yields coming from CBs saying they are going to buy less government debt or because there is more issuance. The former is more likely to bring to about a *material* change in interest rate expectations and probably faster rate hikes.

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2. The greater the BEIR change in relation to the nominal yield change, the looser credit conditions remain. So, referring to the 'BEIR Change as a Percentage of Nominal Yield' graphic above, Japan for instance has seen a *reduction* in the real yield (nominal yield = BEIR + real yield). New Zealand has experienced a pure real yield increase given there has been no change in its BEIR whilst the nominal yield has risen. The important point here is the real yields are a proxy for real borrowing costs. Thus, the lower a BEIR contribution to a nominal yield rise, the more significant the tightening in credit markets … which reduces the probability of central bank tightening action (the market is doing the job for the central bank).

The US and Canada have seen sizable increases in the magnitude of priced-in rate hikes for 2018 alongside 50%-plus contributions to nominal yield increases from BEIRs. At the opposite end of the spectrum, New Zealand where the OIS curve hasn't changed that much in the face of no BEIR change. For the Euro Area, a small BEIR contribution results in a minor upswing in priced-in rate hikes for this year (the ECB has talked down the chances of a Depo Rate rise this year). The major change occurs in 2019/2020, but for now higher real yields (alongside a stronger Euro) are tightening credit markets but not choking off the recovery. Perhaps Euro BEIRs will contribute more as growth eats into Eurozone spare capacity. Or perhaps the Eur OIS curve is over sensitive to any talk approaching the start of normalization. Gbp and Aud markets are somewhere in between, the OIS curves don't imply an additional 25bp since the start of December with BEIR contributions of 39% and 33% of respective nominal yield moves. The Japan OIS curve (not shown) hasn't budged … but there has been a lot of talk about raising the policy balance rate from -0.10% and reining QE. But talk is all so far.

Meanwhile, when bond yields rise equities are supposed to fall. At the time of writing, this is happening. This is hardly a meltdown and may just be related to month-end shenanigans/minor correction after the heady start to the year. Indeed there is a theory that although yields are rising, that they are still historically low implies any bout of increased actual inflation or rising inflation expectations make equities *more attractive* than bonds as equities offer significantly better inflation protection (see Equitile Investment's George Cooper for more HERE). Producer Price Inflation (what company's charge each other) are at or above long-term averages after all. If all this fits, there is more life in the equity bull market.

This raises the issue of what might cause a termination of the equity bull market, specifically at what yield level? With this in mind, we came across the next graphic to suggest 3% in US 10s is a critical juncture.

This shows the trend line, along with one and two standard deviations, since the yield peak in 1981. One standard deviation has been touched a few times and broken just twice over the 30-year bond bull market (began roughly 1987). The first saw a quick return below. The second saw a return to and then a bounce off the 1-standard deviation. The suggestion here is that a breach of two standard deviations will be critical and this currently resides at just over 3%.

Meanwhile, Deutsche Bank suggest 3.5% is the important level to watch (HERE) and the post financial crisis peak of 4% is oft mentioned as a gamechanger.

If BEIRs are a significant driver of nominal yields this provides central banks 'cover' for rate hikes by keeping a cap on the speed of tightening in credit markets. It could make this 1-standard deviation mentioned above more of a support rather than resistance to higher rates and this would represent a change to the long-term downtrend.

marcus.dewsnap@informagm.com

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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	↑	March 20-21	95% hike 25bp 5% steady	1.50-1.75	1.75-2.00	2.00-2.25
T-Note (10 Yr)	2.80				2.75	3.00	3.00
ECB refi/depo	0.0/-0.40	↑	March 8	100% steady on all fronts	0.00/-0.40	0.00/-0.40	0.25/-0.00
Euro 10 Yr	0.74				0.80	0.90	1.10
Japan o/night Call	-0.10	↑	March 8-9	100% steady	-0.10	-0.10	0.00
JGB b/mark 10 Yr	0.07				0.07	0.11	0.14
Europe							
BoE Repo	0.50	↑	February 8	100% steady	0.50	0.75	1.25
Gilts 10 Yr	1.57				1.60	1.75	1.90
Swiss 3 mth Libor	-0.75	↑	March 15	100% steady	-0.75	-0.75	-0.75
Conf 10 Yr	0.11				0.20	0.30	0.45
Swedish Repo	-0.50	↑	February 14	100% steady	-0.50	-0.50	-0.25
SGB 10 Yr	0.95				1.10	1.20	1.35
Norges Bank depo	0.50	↑	March 15	100% steady	0.50	0.50	0.75
NGB 10 Yr	1.84				2.00	2.15	2.25
Dollar Bloc							
BoC o/n Target	1.25	↑	March 7	85% hike 25bp 15% steady	1.25	1.50	1.75
Canada 10 Yr	2.36				2.30	2.10	2.40
RBA OCR	1.50	↑	February 6	100% steady	1.50	1.50	1.50
Australia 10 Yr	2.83				2.85	2.95	3.00
RBNZ	1.75	↑	February 8	100% steady	1.75	1.75	2.00
NZ 10 Yr	2.93				3.00	3.15	3.25

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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	↑	February 27	100% steady	0.90	0.90	1.15
CNB **2 wk repo**	0.75	↑	March 29	50% hike 25bp 50% steady	1.00	1.00	1.25
NBP reference rate	1.50	↑	February 7	90% steady 10% hike 25bp	1.50	1.50	1.75
CBT **1 wk repo**	8.00	↑	March 7	70% steady 30% hike 100bp	8.00	8.00	8.00
SARB repo	6.75	↓	March 28	90% steady 10% cut 25 bp	6.50	6.50	6.50
Bank of Russia key policy rate	7.75	↓	February 9	70% cut 25bp 15% cut 50bp 15% steady	7.50	7.25	7.00
BC do Brasil selic	6.75	↓	February 7	95% cut 25bp 5% cut 50bp	6.75	7.00	7.00
BC de Chile o/n	2.50	↑	March 20	80% steady 20% cut 25bp	2.50	2.50	2.75
Banco de Mexico **o/n**	7.25	↑	February 8	40% hike 25bp 60% 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 25bp	6.00	6.00	6.25
BoK Base rate	1.50	↑	February 27	100% steady	1.50	1.50	1.75
Bank Indonesia **Reverse Repo**	4.25	↓	February 15	90% steady 10% cut 25bp	4.25	4.25	4.25

Current yields as of 2 February 2018

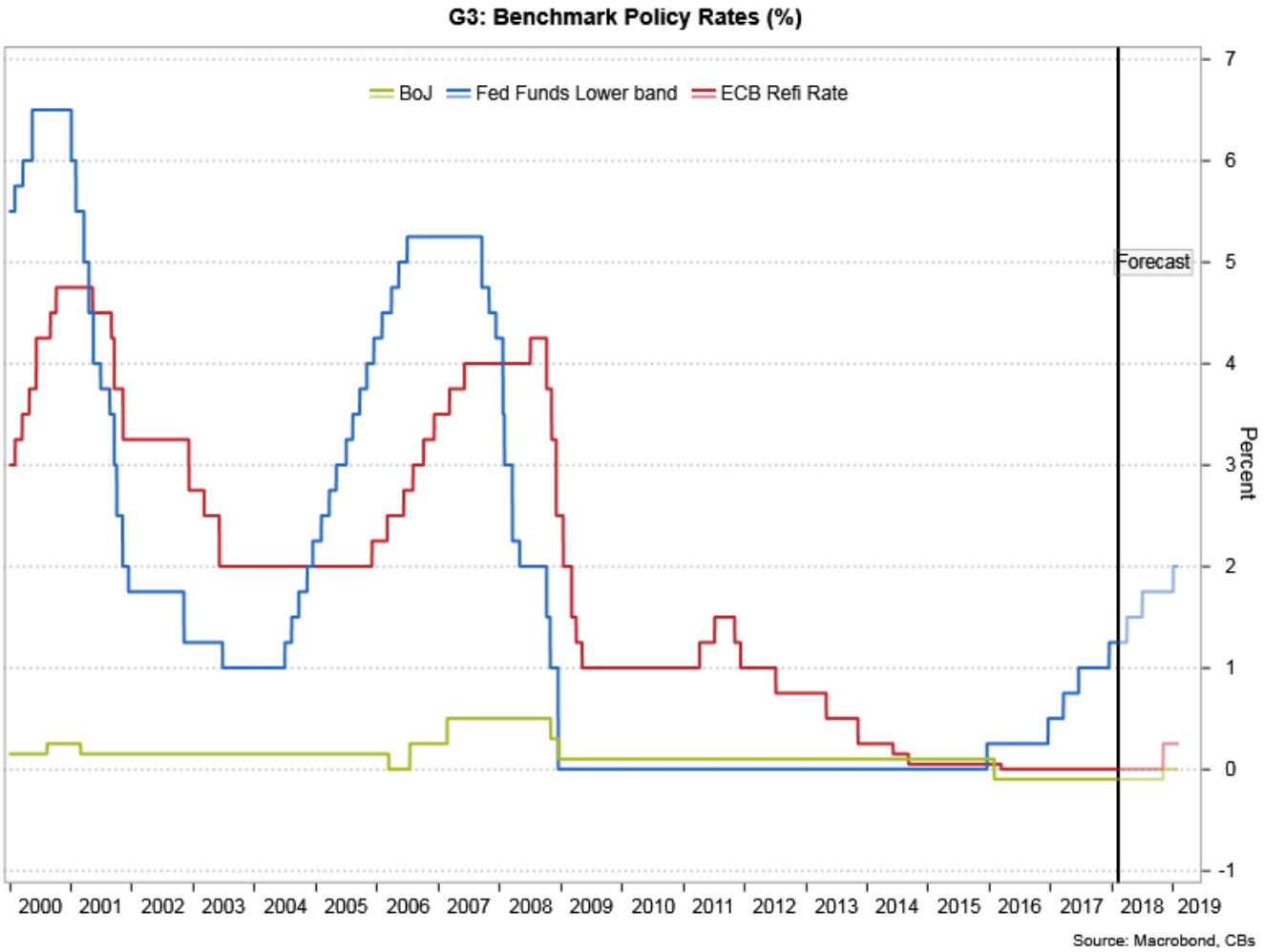
N/a = not applicable

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

Boxes in red denote significant changes to our outlook.

FEBRUARY MONTHLY INTEREST RATE OUTLOOK

CENTRAL BANK OUTLOOKS



FED: The market via Fed Funds fully prices 2 hikes this year, the OIS curve implies 3. The former is now at least beginning to entertain 3, which remains our preferred scenario, the first 25bp of which is as dead-a-cert in March as it can be after the last FOMC. The more hawkish leaning Committee supports. Financial conditions are still historically loose and BEIR rate rises give the Fed some cover for March, keeping real yields capped meaning credit markets are not tightening as quick as nominal yields might suggest.
marcus.dewsnap@informagm.com

10-year US yield technical analysis HERE

EUROZONE: While the January meeting undelivered in some respects versus the pre-convene hawkish hype, the presser and Q&A still left many contemplating a more feisty convene behind the scenes - we have long suspected growing GC tension. Even Draghi (a self-confessed dove) acknowledged a tight labour market, and the risk for higher wages threatens Staff Forecasts (for the March meeting) to release revised higher inflation and growth in 2018/19 – to the, latter GDP can't keep going at this rate and not eat up dwindling spare capacity, and not stoke inflation.

We therefore remain steadfast bears on the entire curve (as we have been since at least October 2017). While we hold OTM Bund option puts (well in the money now as instigated when March Bunds at/above 161) we would rather add to positions on market rebounds. For the ascent in the 10-year German yield, the pace has quickened, 0.75% looks on the cards, and therefore we affirm our end-2018 target of 1%, or higher.

Indeed, since the affirmed forward guidance statement, CB's Knot asserted that QE 'must end soon', and sooner the better the clear inference. The

FEBRUARY MONTHLY INTEREST RATE OUTLOOK

ECB was said to have reviewed the situation (on inflation) and the message was not much had changed (versus December). That said we/many noted a less dovish tone (on the Euro) and inferred QE can end without reference to the single currency's volatility, unwelcome as it is.

Draghi also acknowledged the rise in market-based inflation expectations, (5-year/5-year forward inflation swap to almost 1.80%) but that is not enough to change tact as asset purchases will still run to September 2018, or beyond, and rather strangely can still be 'increased'. The only rationale: no significant, convincing signs of a sustained rise in inflation (yet) which is still required, meaning an ample degree of stimulus is needed to get it (the CPI) there, to just under 2%. To counter this, the statement also noted that the core inflation rate is seen rising over medium-term, with more conviction about reaching remit, despite inflation hovering at current levels (1.4%).

All told, despite the Euro front-running some further stimulus withdrawal/policy action, 2-10 year yields do not fully reflect a risk premia for quicker normalisation. Post ECB, the 5-year Bobl reached 0% - an important milestone if that can turn positive and stay above that level. alvin.baker@informagm.com

10-year Euro yield technical analysis HERE

JAPAN: No changes are expected at the March BoJ. Looking at things from a broader perspective, the general narrative is that the BOJ will retain its ultra-loose monetary policy. To be perfectly accurate, the BoJ isn't about to exit QQE anytime soon (possibly not before 2020 owing to overhanging concerns of the proposed October 2019 sales tax hike) but the truth is that the BOJ has already started "stealth tapering" in 2017 under the guise of its YCC strategy.

The issue for the Bank is that their policy guidance will become increasingly challenging, and there is the historical evidence of the BoJ doing a poor job of this. It's a fine line that needs to be trod in so far as to sound upbeat on growth/prices but not excessively such that it leads to the market speculating a policy shift and potentially undoing much of its good work. This is the source of the fudged inflation outlook after the latest policy meeting and Governor Kuroda's Davos speech, and how there was clarification *both* times that it wasn't a material policy shift and that QQE will remain in place.

What is clear though is the official stance that inflation remains far from the 2% target (to be met in FY2019) and that "risks to prices are skewed to the downside". However, there is tangible optimism within the BoJ that it is finally making headway to the 2% target. Clearest of all being Kuroda's Davos speech. Recent chatter also shows that while all Bank members still favour continued easing, a few are starting to see the need for discussions on YCC tweaks in the belief that the economic recovery will spur inflation, while there is an inherent concern on how best to maintain the sustainability of the huge QQE program and to contain its negative impacts.

Our view remains that a YCC tweak in 2018 will be seen to aid QQE sustainability, with the window opening in Q2. Given most in the market still aren't pricing this in, the abiding risk is of a market pivot that intensifies a strong Yen bias.

The BOJ has kept JGB purchases unchanged in its Feb bond operation plans. Unsurprising given they won't want to further inflame policy tweak speculation and stoke Yen strength. This could perpetuate more yield curve flattening, which is not what is wanted as a long-term trend, but it's a short-term trade-off to minimize Yen strength which could complicate reflation efforts. jianhui.tan@informagm.com

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EUROPE

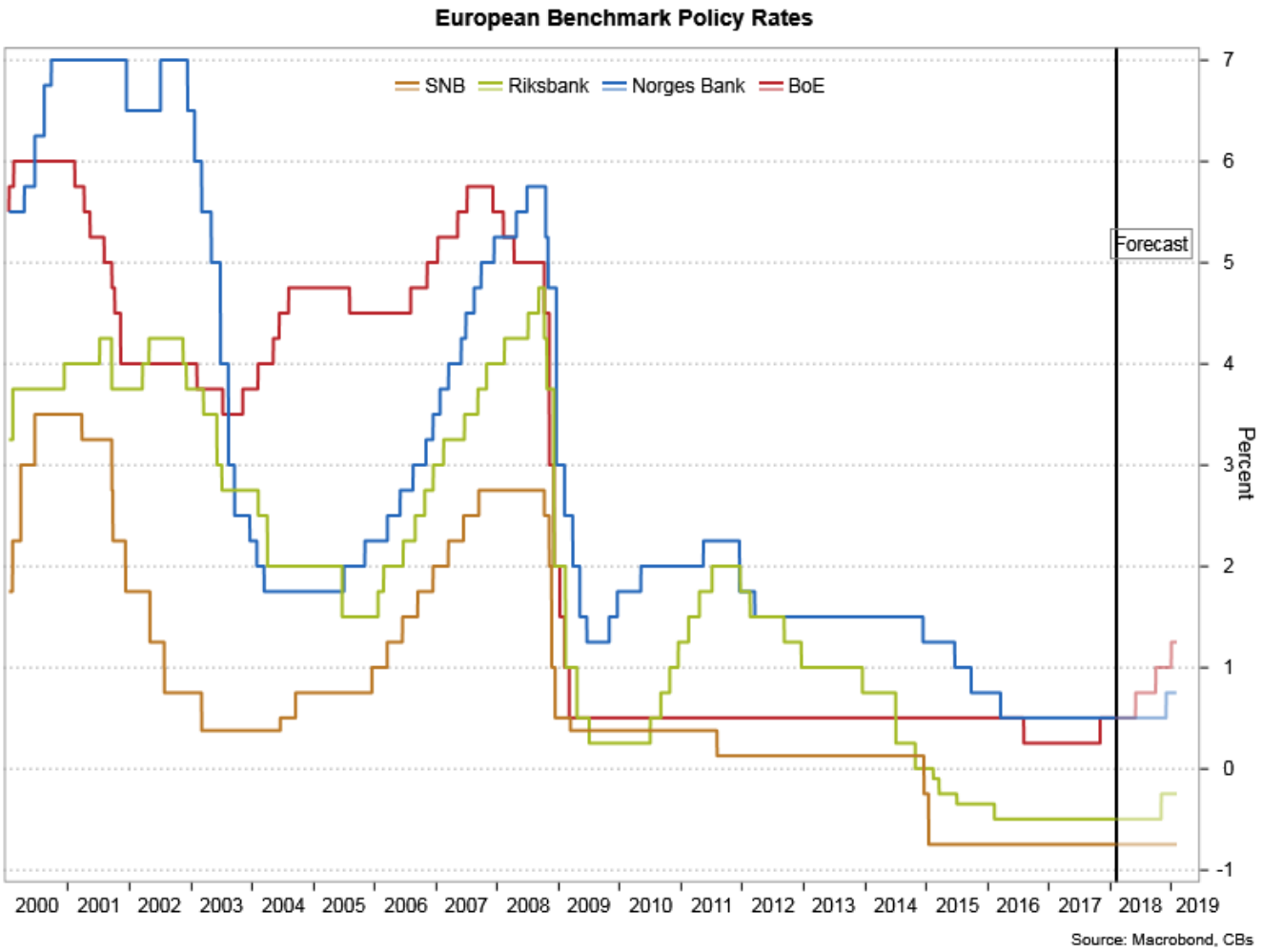
UK: The UK rates' curve has essentially done some pre-emptive tightening for the BoE having responded to better than expected GDP in Q4 last year. That set the ball rolling to allow the strip and 10-year Gilt yield to follow the lightning speed of rising US yields - the latter also taking some by surprise as the US economy appears to be firing on all cylinders. Inflation worries/reflation (via US tax) policy has stoked the fear of aggressive CB (Fed) tightening. This looks the main, but not only reason behind the 25 bp rise in the UK 10-year bond yield (from 1.20 to 1.45%). The Short Sterling rate strip has squeezed in expectations of 3 hikes in the next 3 years (vs guidance 2 before) and pricing 25 bp in H22018 - the Mar/Dec18 Short Stg spread 99.43 vs 99.09 resp. We have long viewed the 10-year Gilt yield as artificially low considering CPI, inflation expectations and vs equity yield. A 2% handle would be more reasonable if it were not for Brexit uncertainty.

The joker-in-the-pack therefore remains how inflation pans out along with Brexit clarity - both

probably needed at the same/similar time to warrant an official BoE/MPC response. We suspect the Feb 8th QIR will sound out a more hawkish message compared to Nov's - back then a transition deal was still up in the air, and inflation had only just reached 3.1% (3% in Dec, Jan's to come post QIR). Carney had convinced most investors/market participants to believe that rate rises will not only be gradual and limited, but will be semi-conditional on an up to 2-year Brexit transitional arrangement in place - still some work to be done as EU says conditional on what kind of deal the UK wants post 2019.

While consumer confidence and business investment stays patchy, the BoE is unlikely to pull the trigger in H1, but if the EU/London can get down to rubber-stamping something the parties can stick to, the market could bear-steepen a lot more - the Gilt yield to 1.50-1.65% perhaps. The latest talk of some kind of Customs Union arrangement seems a half-way house and to the dismay of 'Brexiteers' seeing the UK inside the EU in all but name. Such a perceived agreement outcome could herald a period of heightened political uncertainty, and see yields capped alvin.baker@informagm.com

Gilt yield technical analysis HERE.



SWITZERLAND: The third-year anniversary of the SNB's decision to abandon the Franc cap was marked by a rise in Eur/Chf to its highest level since then, up at 1.1833. That has proved to be the high of 2018 so far, as fears over trade tariffs have weighed. With the next SNB meeting not due until March 15th, there has been precious few developments on the macro-economic front. Inflation remained at just 0.8% y/y for December, while the manufacturing economy is continuing to be the envy of many, as the PMI for January was once again above 65. There was no change of tune from the SNB's Jordan either, as he reiterated that negative rates are still needed to tame

the Swiss Franc, which remains 'highly valued'. mark.mitchell@informagm.com

SWEDEN: The Riksbank continues to project its first rate rise to come mid-2018, and has conceded of late that tightening will likely begin before the ECB starts hiking. CB members continue to exercise caution over policy however, warning that housing would become a worry if it affects inflation, while low wages pressure are also envisaged going forward. The inflation developments have been broadly in line with estimates, but members want to see inflation stabilize around 2% before tightening can begin. CPIF for December came in at 1.9% y/y as forecast. rachel.bex@informagm.com

NORWAY: The Norges Bank kept rates unchanged on January 25th, and the accompanying statement provided little new in the way of thinking, stating the outlook and the balance of risks for the Norwegian economy do not appear to have changed substantially since the December report. The Krone rate and inflation have both been in line with CB expectations, but the Norges Bank optimistically noted that growth prospects for trading partners appear to be better than assumed in December. It also acknowledged that new statistics indicate a somewhat less pronounced drop in house prices over the past 12 months than projected. There is now a long wait until the next decision on March 15, but as the ECB moves ever closer to normalization, so scope is there for markets to start pricing in Norges Bank tightening later this year. The rate path indicates such a move late-2018. rachel.bex@informagm.com

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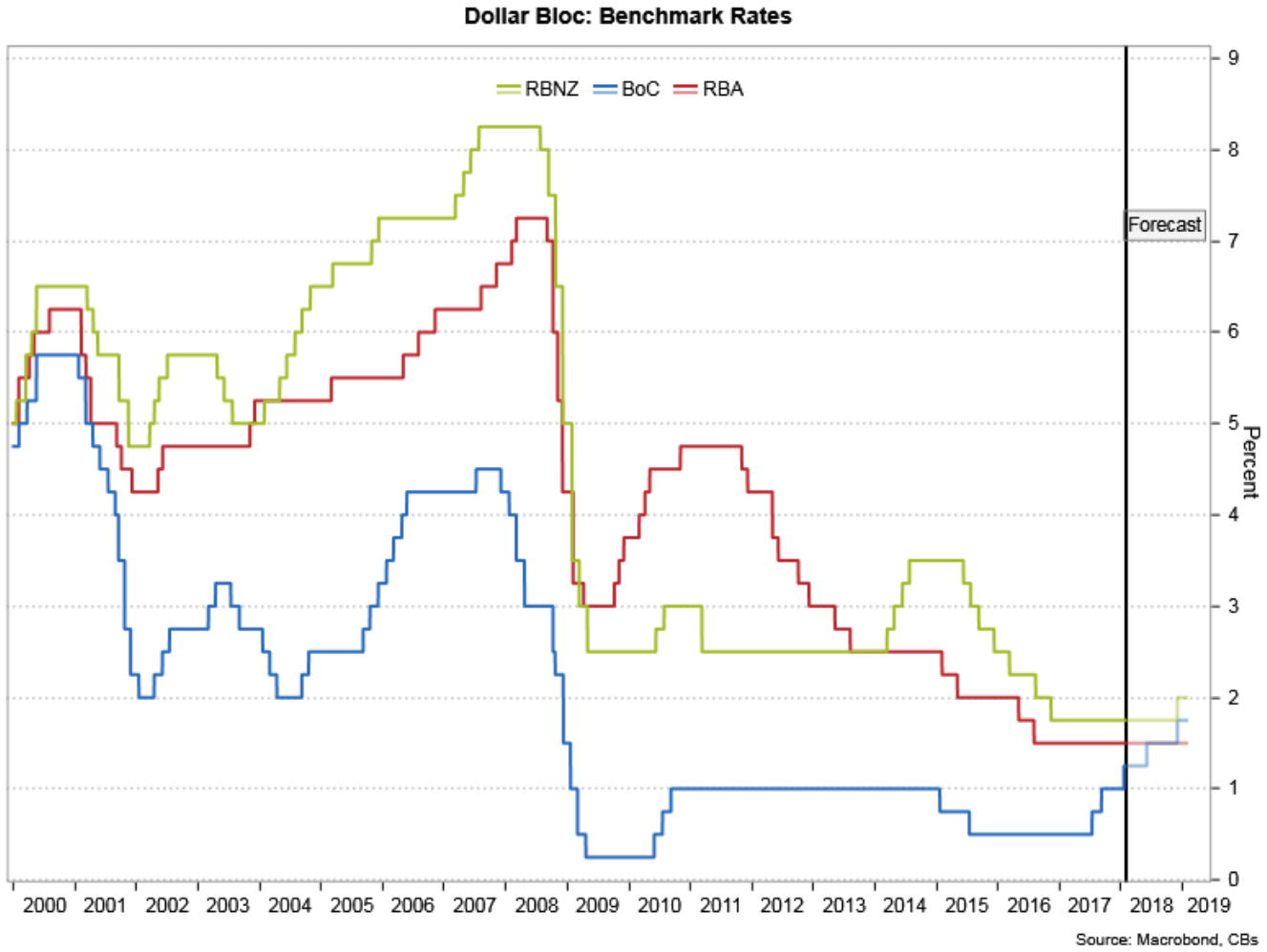


FEBRUARY MONTHLY INTEREST RATE OUTLOOK

CANADA: A 'dovish' hike was duly delivered by the Bank of Canada on January 17th, taking the key rate to 1.25%, its highest level since January 2009. The data proved to be too strong to ignore and the rise followed similar 0.25% hikes in July and September 2017. The BoC revised its growth forecasts for 2018 and 2019 slightly higher, in the accompanying monetary policy report, but the whole tone of the release and the following Press Conference from Governor Poloz, was dominated by their worries over the uncertainty in regards to NAFTA talks. Trade frictions are now the main issue for the BoC, but they will be pleased to see growth rising by 0.4% in November, its best result since May. The NAFTA uncertainty should keep the BoC on the side-lines until the talks conclude.

mark.mitchell@informagm.com

10-year Cad yield technical analysis HERE.

AUSTRALIA: The RBA is expected to leave rates unchanged at 1.50% at the next meeting. Although Australia's fundamentals have been improving - the Citi Economic Surprise Index on a strong rebound to 47 after hitting bottom at -46 in December - the issue of sluggish wage growth and high household debt will continue to remain obstacles towards higher rates.

Having said that, there is a growing expectation of a gradual hawkish tweak in language. The December gathering was noteworthy for dropping a reference that inflation would remain low for some time. However, Q4's sub forecast CPI might be cause for a rethink – the markets did wind back hike expectations.

After the January hiatus, communication will resume in February and markets may perhaps be able to gain some early insights into the officials' positions on rising inflation expectations (10-year breakeven holding above 1.95% after 4-months of mainly upside and despite the CPI outturn). In our view, we still expect the RBA to only raise rates late in Q4 2018, possibly delaying until Q1 2019 with a change in language likely to only manifest in Q3 this year. QiXiu.Tay@informagm.com

NEW ZEALAND: The RBNZ isn't expected to change policy at its next gathering. While economic statistics released during much of H2 2017 were encouraging, the year seems to have ended on a soft note with a 5-year low in manufacturing PMI and misses in Q4 inflation. CPI at 1.60% has been on a descending trend since peaking at 2.2% in Q1 17 and any discussions of prospective tightening would first require inflation to exhibit a sustainable trend towards the upper bound of the 1-3% target range. In addition, core inflation also fell from 1.5% to 1.1%, effectively erasing all the upsides made since mid-2016.

There are however a few bright spots in the economy with external demand robust, current account deficit low (< 3%) and the labour market tightening, although until such developments translate into better price pressure, the RBNZ would not be expected to tighten anytime soon with the window only realistically opening in Q1 2019. In addition, incoming Governor Orr's bias is still not yet known and for the February meeting at least, he is unlikely to intentionally rock the boat with rhetoric likely to tilt towards the cautionary side.

QiXiu.Tay@informagm.com

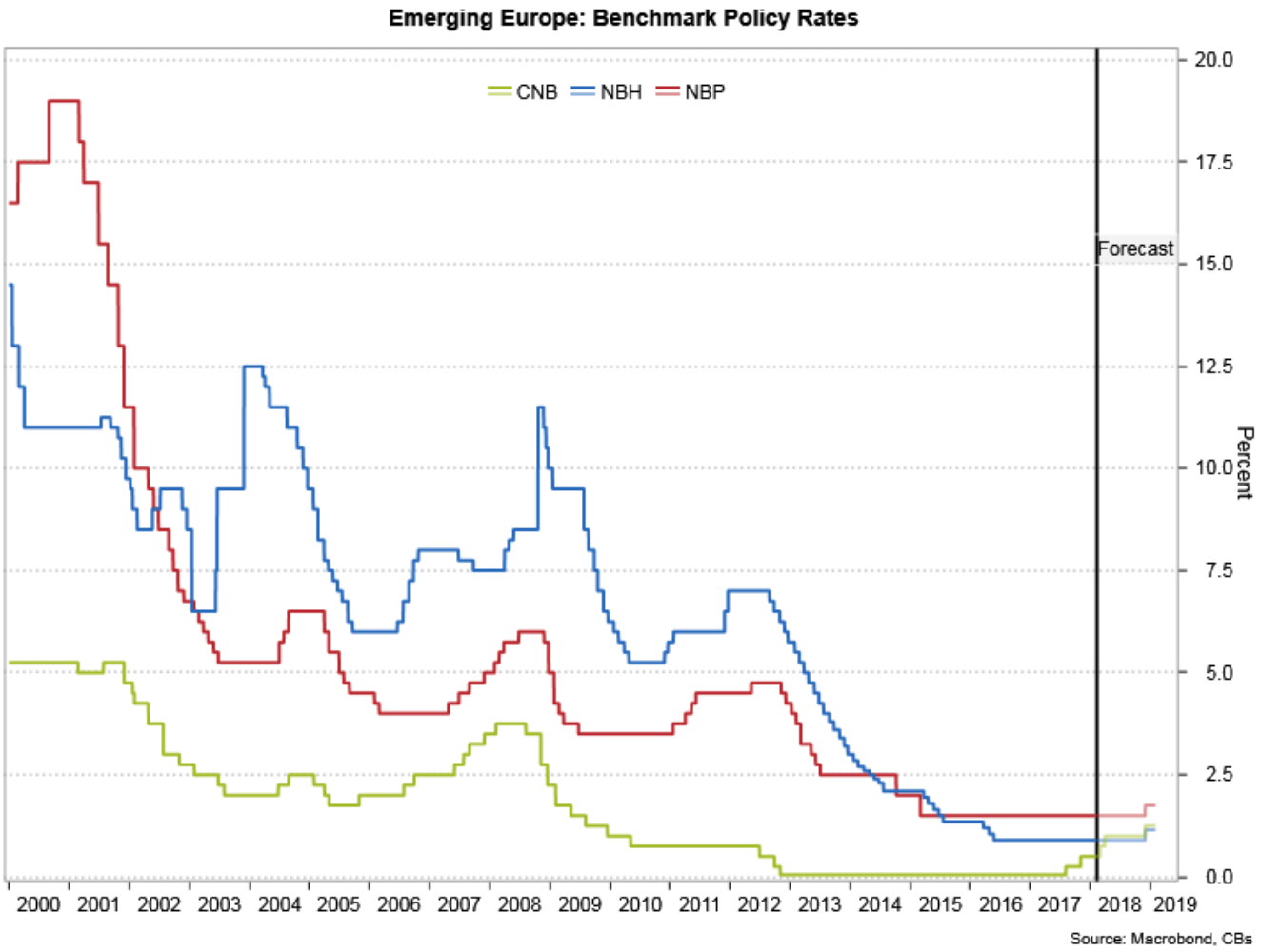
EMERGING MARKETS: EUROPE, RUSSIA & SOUTH AFRICA

CZECH REPUBLIC: The CNB is almost certain to hike again, but only once more in 2018 given its current forecasts. The CB's updated forecasts showed an upwards revision to GDP growth for 2018 to 3.6% (versus 3.4% previously), but crucially lowered the Q1 2019 CPI outlook to 1.9% from 2.0%. Coupled with only a mild appreciation outlook for the Czk, the CNB is under little pressure to accelerate rate hikes. Note the CNB sees Eur/Czk averaging 24.9 in 2018 and 24.50 in 2019, which is a 1.2% and 2.78% decline from current levels, a smaller percentage change from when it last published the FX projection and faced CPI at 2% (May 2012).

Thus, there has been no change in the market pricing for rate hikes, which were looking for two 25bp moves in 2018, before the February meeting, and it is now all about the timing. Rusnok stated in February that the exact timing of future hikes is uncertain, with a faster pace of Czk appreciation potentially curbing room for action. However, Governor Rusnok had previously 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 remains at less than 1.50%.

FEBRUARY MONTHLY INTEREST RATE OUTLOOK

The continued strength of the Czech economy and gradual interest rate increases will see the Czk and CZGB yields appreciate in 2018, but to a smaller extent than in 2017. We still expect to see Eur/Czk down at 25 and 10-year CZGB yield up at 2.00% by 2018 year-end. christopher.shiells@informagm.com



HUNGARY: The NBH still don't expect their 3% (+/- 1 ppt) inflation target to be achieved in a sustainable manner until the middle of 2019; hence the commitment to maintaining loose monetary conditions at both short and long ends for an extended period by using unconventional policy tools. The central bank left the base rate and overnight deposit rate on hold at 0.90% & -0.15% at the first meeting of 2018 as expected. The statement noted that the upward pressure on prices from a tight labour market and wage growth is being offset by the reduction in employers' social contributions and in the corporate income tax rate. The only deviation of note from previous decisions was the concession that yield spreads have narrowed versus Euro Area and regional counterparts.

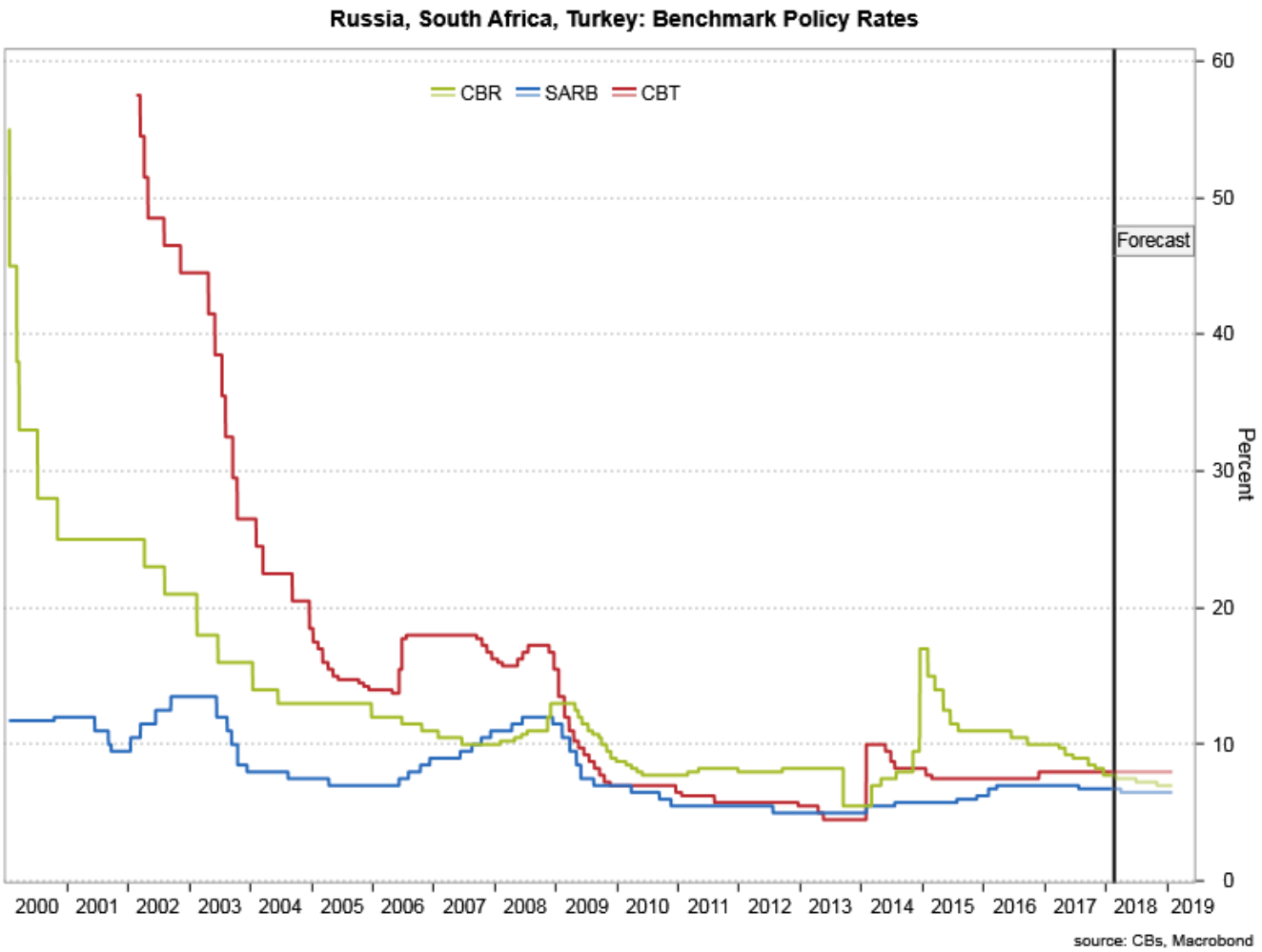
Hence, the NBH's determination in sticking to a dovish stance suggests that there is little significant downside potential for EUR/HUF over the short-term. Looking further ahead though, we maintain that the Bank could be forced to tighten policy before the end of 2018, and the implied policy rate suggests that the market consensus is strengthening (now pricing in a 25bp hike to key policy rate over the next 12 months versus less than 20bp in early-January). robert.graystone@informagm.com

POLAND: Inflation slowed to 2.1% y/y in December from the 5 year 2.5% peak the prior month, while the Zloty has been among the top best performing EM currencies ytd, reaching its highest level against the Euro since mid-2015 and its best versus the Dollar since late 2014. These factors should continue to support the neutral/dovish majority within the central bank's MPC at the next policy meeting February 7th.

FEBRUARY MONTHLY INTEREST RATE OUTLOOK

Recall, at the press conference preceding January's (steady) rate decision, Governor Glapinksi flagged the strong Zloty as a substitute for monetary tightening and opined that the period of stable rates could potentially extend into mid-2019, a view that he has since repeated. Meanwhile, rate setter Lon, recently commented that further Zloty gains could lead him to vote for additional monetary easing, which is the most dovish verbiage we have seen for some time.

It would, therefore, seem the bar is high for policy tightening and it will likely be some time before the hawks gain enough traction on the board to debate a rate hike. The market implied policy curve is still pricing in a 25bp increase in 12 months, but there is a risk these tightening expectations will be wound in, particularly should inflation look to be staying within the NBP's target band. natalie.rivett@informagm.com



SOUTH AFRICA: The South African Reserve Bank aren't scheduled to make a rate decision again until the end of March, giving rate setters and investors alike plenty more economic releases and developments to digest.

For the time being though, there was little to sway the central bank one way or the other in December inflation metrics, with the headline figure at 4.7% y/y. It is worth noting that the SARB sees CPI averaging 4.9% in 2018 (versus 5.2% previous estimate) though rapid wage increases should continue driving inflationary pressure, and there remains an upside risk to this forecast. Given the improving inflation outlook and the stronger Rand, which is trading at its highest level against the Dollar since 2015, the implied policy curve is in fact indicating over 25bp of further easing over the next 12 months.

Crucially, the potential for further ratings downgrades remains a key talking point for the central bank. On that note - SARB Governor Kganyago struck an optimistic tone in an interview with Bloomberg in Davos, stating that the sovereign is likely to fare better at credit rating reviews now than it did in November on the back institutional strength and potential for reduced corruption. However, ratings agencies will be looking for the

sovereign to present a credible fiscal consolidation plan in February.

Overall, we maintain that there is room for rate cuts over the coming meetings, but this is likely to be dependent on the fallout from any ratings downgrades and any further moderation in inflation expectations. robert.graystone@informagm.com

RUSSIA: Heading into year-end and in early 2018, the broad consensus was that the CBR would slow the pace of rate cuts to 25bp this year, after Governor Nabiullina had previously said that it would take approximately 2 years for the key rate to reach a nominal equilibrium level of ca 6-7% (vs current 7.75%). However, she has changed her language, stating this week that the CB may shift to neutral policy slightly faster than planned, as risks for a weaker Rub have decreased.

Nabiullina added that this means a rate cut in February is an option with the pace open to debate, echoing the comments of CB policy head Dmitriev, who said earlier this month that a 50bp cut and a pause will also be discussed at the February meeting.

It had also been speculated that if the US decides to move forward with sanctions on Russian sovereign bonds that this could lead to a 50-150bp surge in yields and together with a slump in the Rub, could force the CBR to raise rates by as much as 250bp. This risk has now seemingly passed, but there remains some uncertainty over further sanctions, and these remain a tail risk to our outlook on CBR policy. christopher.shiells@informagm.com

TURKEY: The pick-up in the Lira and a deceleration in headline CPI in December had taken some of the pressure off the central bank to tighten monetary policy further at the first meeting of 2018. As expected, the CBRT deemed its current tight policy stance as sufficient and thus avoided taking any additional action, following the 50bp hike to the Late Liquidity Window the prior month.

There was some concern the central bank would take a more relaxed tone on inflation, possibly signalling a loosening of policy over the coming months, but this was not the case. Indeed, the CBRT repeated guidance that the tight monetary policy stance will be maintained decisively until the inflation outlook displays a significant improvement, and with further tightening to be delivered if needed. This, against the backdrop of still elevated inflation and inflation expectations, that the central bank noted continues to pose risks to pricing behaviour, and all told, suggests any policy reversal is unlikely for some months to come.

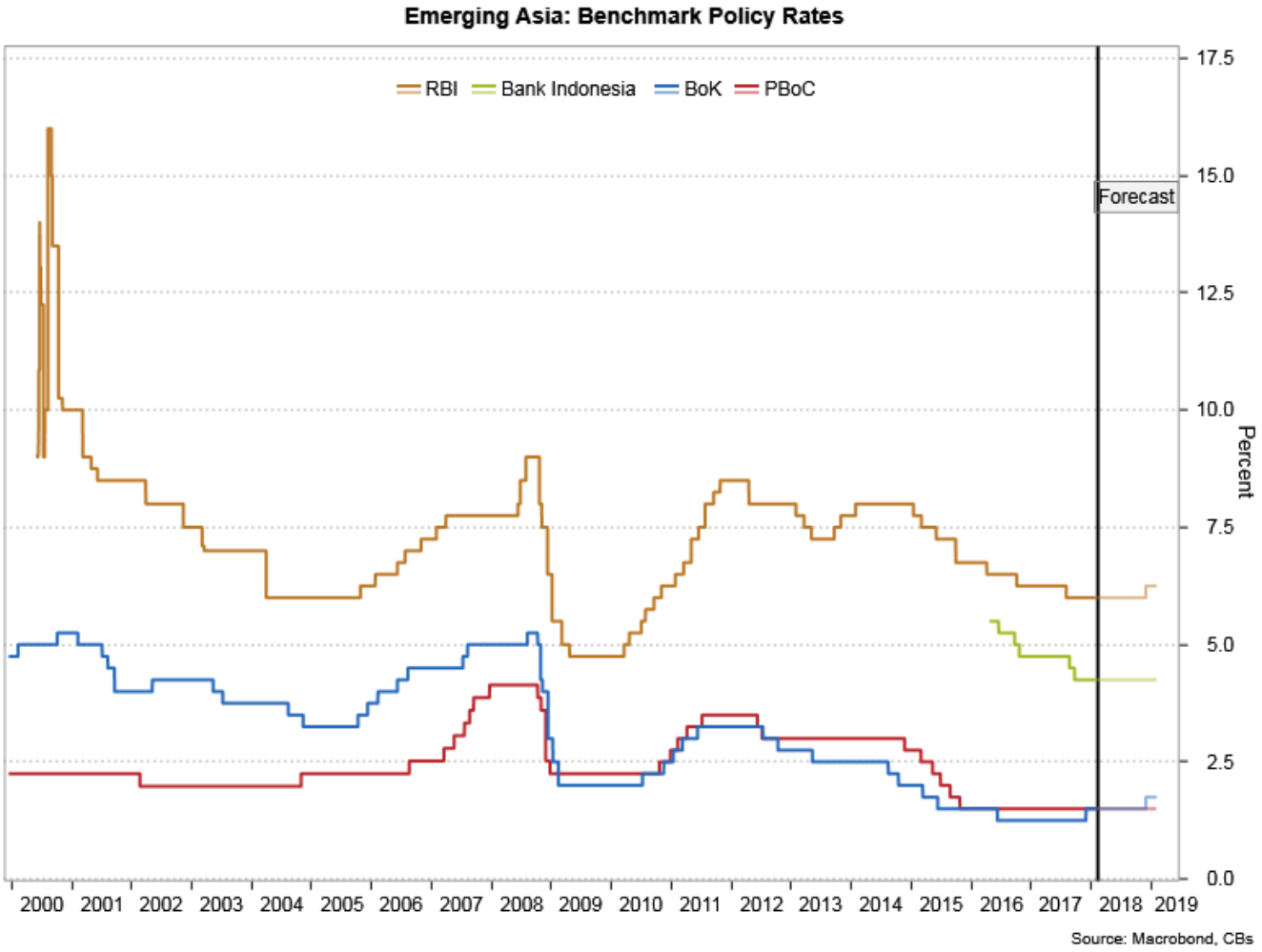
The CBRT recently lifted its inflation forecast for the end of 2018 to 7.9%, almost a percentage point above its prior estimate, albeit still well below the current rate of almost 12.0% y/y in December, while the 2019 estimate was raised to 6.5% from 6.0% three months ago. We suspect these are still too optimistic and will likely need to be revised higher in due course, though we do not see the CBRT tightening policy again, unless forced to by renewed currency weakness.

natalie.rivett@informagm.com

EMERGING MARKETS: ASIA

INDIA: For most of 2017, the RBI had been under pressure from the government and business groups to cut interest rates as the economy was roiled by demonetization and GST implementation effects. The RBI stood its ground even when the CPI fell below 2% in June, and they have been proven right as the index has climbed steadily higher since then, on account of food inflation and fading effect of the reforms undertaken, closing out 2017 strongly at 5.21%. Accordingly, the RBI has slightly adjusted upwards their inflation estimate to 4.3-4.7% at their last meeting in November. Since then, the focus has fallen on worries that the fiscal deficit may balloon and get out of control. With the government earlier seeking to issue more bonds, and then backtracking on the additional issuance by 60%, yield has been steadily climbing higher anyway, with the 10Y yield making a try for 7.5% in recent days, a level not seen since mid-2016. The expected supply of bonds continues to be problematic, not only driven by expectation of widening fiscal deficit due to teething problems with GST collection, but also for a plan to recapitalize banks, part of which is expected to be financed by issuance. With India expected to become the top economic performer in 2018 in the region, even famous dove Subramanian of the CEA admits that the time for a rate cut has passed, especially with oil prices rising and growth expected to fuel demand inflation. As such, the RBI is likely to remain unchanged at its next meeting scheduled for Feb7th and beyond, with incoming data watched for a more hawkish change in tone later in the year. freda.yeo@informagm.com

FEBRUARY MONTHLY INTEREST RATE OUTLOOK



CHINA: After abolishing the 20% forex risk reserve requirement in September last year, the PBoC on 9 January announced a removal of counter-cyclical factor (CCF) from the USD/CNY daily fixing mechanism. By now, the two major administrative measures that were introduced to defend CNY FX rate in the aftermath of the 11 August 2015 FX regime change have been removed. Faded capital outflow pressures combined with improved FX reserves outlook plus solid recovery of GDP growth not only justifies the said policy changes but also suggests it's time for a normalisation of FX rates, i.e. an appreciation of CNY FX rate back to the levels seen before 11 August 2015.

Thanks to sustained weakness of greenback, USD/CNY FX rate normalisation has been going faster than expected since CCF was removed. USD/CNY has dropped by an impressive 3% so far. The pair finally reached as low as 6.30. Net-net, this represents a CNY depreciation of only 1.6% against the USD from where it was *before* 11 Aug 2015.

With capital outflow pressures easing and USD weakness intensifying, strict enforcement of FX controls may no longer be necessary. For example, outbound investment approvals could be relaxed on a case by case basis, more QDII quota and similar programs could be allowed, the investment restrictions on the USD50k/year individual FX quota could be eased, and cross-border borrowing repatriation could be made easier. tim.cheung@informagm.com

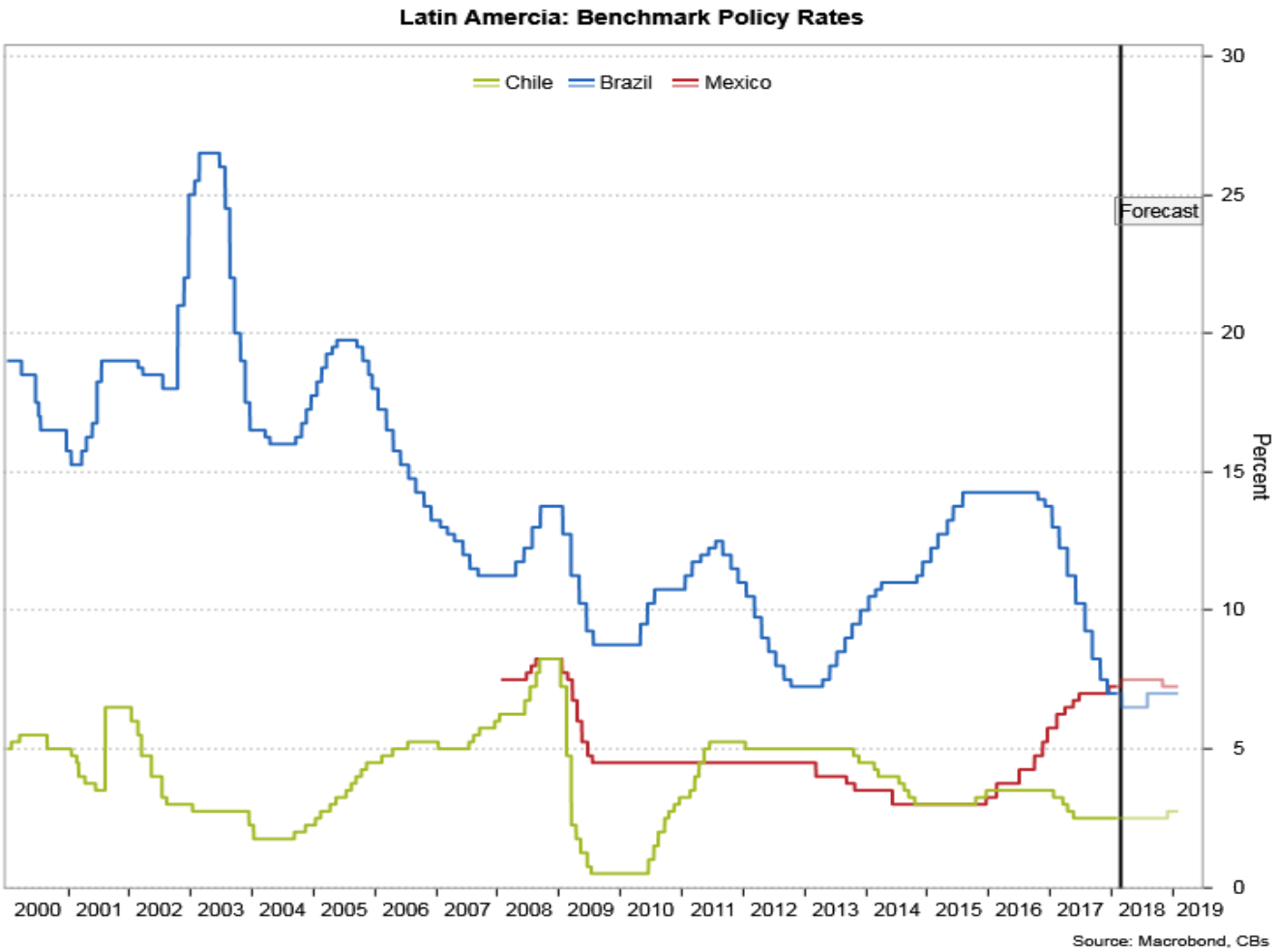
INDONESIA: Bank Indonesia has been saying for about half a year that the window for rate cuts is closing. However, inflation continues to remain muted and despite some blips along the way, still headed downwards. The latest January CPI print was slightly softer than 2017's low of 3.3% seen in November. However as had been discussed earlier, the BI and the government is unlikely to rely as much on monetary policy going forward as they recently have. The reality is that monetary policy globally is

on a tightening path. And while Indonesia's fiscal position has improved, the country still runs a budget deficit that has to be financed. A recent surprising upgrade by Fitch from BBB- to BBB late last year has provided the opening the government needed, with focus now on improving the matrices to gain another important upgrade. This is crucial, with the central bank unlikely to go against the regional monetary policy grain (S. Korea and Malaysia hiked in recent months). But, that leaves the government's goal of spurring loan growth to 10% and above per year hanging, with bank lending rates above 10% seen as a large factor. If the change of benchmark and 8 rate cuts in 2 years is ineffective towards this goal, the BI is likely to keep its powder dry for now, while continuing to cooperate with the government to keep prices within the target 2.5-4.5% range. freda.yeo@informagm.com

SOUTH KOREA: At its most recent meeting the BoK as expected kept rates on hold, as CPI continues to miss expectations after the first hike in years back in November. January's CPI reading came in at 1% while the core printed at 1.1% to match the December 2012 cyclical low. Amid upgrades in growth (2018 slightly higher to 3% from 2.9% in October, with more upgrades possible), and exports remaining strong, muted prices point to the continued softness in consumer demand, hamstrung by ever-higher household debt, as well as the offsetting effect of the strong KRW on imports including oil. As such, there is literally no chance for the BoK to seek a rate hike in this environment.

However, a reversal of the recent hike is also highly improbable, seeing as how monetary policy globally has taken a clear tightening bias and the kicking-in of the minimum wage increase this year. Also note the end of the BoK chair's term in March, which will forestall any rocking of the boat. In light of a number of risks faced by the economy including trade tensions with 2 of its largest trade partners and an unfriendly northern neighbor, the BoK is likely to hold on to its options for now. freda.yeo@informagm.com

EMERGING MARKETS: LATIN AMERICA



FEBRUARY MONTHLY INTEREST RATE OUTLOOK

BRAZIL: There has been very little change in the pricing of BCB rate cuts since the start of 2018, which has seen the Brl rally some 5% vs the USD, despite the S&P credit rating downgrade, and markets are still expecting just one further 25bp cut in February before rates begin to rise again in H2. DI swaps indicate that the key rate could be back up at 8.00% in 12-months, although the economists survey has it remaining at 6.75% until year-end.

The BCB made it clear in December that there would be a "moderate reduction" in the pace of cuts, and that is all the guidance the market needed given that inflation has slowly been rebounding in Brazil (Jan IPCA-15 print at 3.02% y/y), albeit still below the BCB's 4.5%, +/- 1.5ppt target.

The strength of the tightening cycle will depend on the progress of fiscal reforms, which now look as though they will be delayed until after the Presidential election in October, the result of which itself remains a big unknown. Any failure by the new government to implement reforms and keep fiscal policy under control is likely to add to inflationary pressure and bring forward the start of BCB tightening. christopher.shiells@informagm.com

CHILE: Chile's economy appears to have taken a turn for the better, with economic activity reaching a near 2 year high of 3.2% y/y in November, industrial production advancing for the past six months and copper production hitting the second highest on record in December. This, together with the acceleration of inflation back within the BCCh's target range in December, for the first time since May, has further narrowed the scope for interest rate cuts.

Given the above, the central bank kept its benchmark rate at 2.50% for the eighth successive month at the February 1st policy meeting. The Bank also moved to a neutral stance from a moderately expansionary bias on monetary policy, acknowledging more favourable external and domestic conditions. With regards to inflation, the BCCh said risks that inflation would fail to converge on target had eased, though with CPI expected to remain low in the short-term, it kept the door open to further easing and will remain attentive to any signs of a delay in the convergence of inflation that may warrant additional monetary stimulus.

We maintain that further easing will not materialise, so long as the economy remains on a strengthening path and there is no sharp deterioration in inflation, while traders and economists (per the BCCh bi-weekly surveys) already consider Chile to have reached the end of its easing cycle and are looking for a 25bp hike to 2.75% in 12 months. natalie.rivett@informagm.com

MEXICO: Having raised rates at their final meeting of 2017, it remains to be seen whether or not the Mexican central bank will tighten monetary policy further in February at Alejandro Diaz de Leon's second rate decision as governor.

Headline CPI hit its highest level since 2001 at 6.77% y/y in December, though the core figure rose by less than forecast and remains below 5%. Broadly speaking, these inflation metrics leave the door open for Banxico to raise rates in February, but Mexico's market implied policy rate only points to two 25bp hikes over the next 6 months, so the CB could well decide to drag its heels.

Supporting the case for holding rates steady in February is the Peso's recent strength which has seen USD/MXN trading around 3-month lows, sub-18.500. Additionally, the Fed's decision to stand pat in January has likely removed some of the pressure for other CBs to hike. That being said, Banxico does have a track record of surpassing market expectations with policy action in terms of both the timing & size of rate hikes.

Overall, we see the balance of probability as narrowly in favour of steady policy this month, though there is a significant risk of a 25bp hike. Looking ahead, we maintain that the path of monetary policy will be heavily dependent on Peso strength which will in turn be at the mercy of both NAFTA negotiations and Mexico's presidential election in July. robert.graystone@informagm.com

FEBRUARY MONTHLY INTEREST RATE OUTLOOK

TECHNICAL ANALYSIS

US 10-Year Treasury Note Yield – Focus remains on the upper bounds of 29-year falling channel

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	3.247	12 May 2011 peak near 3.221, 7 July 2011 peak
R3	3.052	2014 peak – 2 January
R2	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)
R1	2.833	2.000x 1.318/1.877 from 1.714 near 2.819 (7 March 2014 range high) and 2.848 (38.2% 5.323/1.318)
Support Levels		
S1	2.302	8/7 November 2017 lows
S2	1.990	10 November 2016 low, near 1.997 (16 March 2016 prior peak) /2.014 (2017 low - 8 September)
S3	1.877	1 November/28 October 2016 8-day range highs
S4	1.714	9 November 2016 low
S5	1.517	7 September 2016 reaction low

Key Points

- Broke above 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) to confirm a higher low at 2.014 (8 September low) near the congested 1.990 area
- The weekly and monthly RSI and MACD studies trend higher, offering scope for a test of the key 2.819/48 area (houses 2.831, 0.618x 1.318/2.639 from 2.014 and 2.833, 2.000x 1.318/1.877 from 1.714) near the upper bounds of a 29-year falling channel
- Extended daily studies (not shown) may soon unwind, prompting consolidation near the falling channel upper bounds
- However, ranging should develop over the 2.302 area, enabling yields to break out of the 29-year channel/2.848 area eventually for the 2.981/3.052 region
- Below 2.302 would suggest a higher platform had not yet completed and shift the focus back to 2.014/1.990

marnie.owen@informagm.com

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FEBRUARY MONTHLY INTEREST RATE OUTLOOK

EU 10 Year Yield – Yield bulls are resuming the broader recovery for 0.822/0.910

EU 10 Year Yield – Weekly Chart

Resistance Levels		
R5	1.057	2015 peak – 10 June
R4	0.986	13 July 2015 lower high
R3	0.910	.764 projection of -0.205/0.619 off 0.280
R2	0.822	1 September 2015 lower high, near .618 projection of -0.205/0.619 off 0.280 (0.789)
R1	0.737	4 December 2015 high, nr a 21 month rising trendline at 0.745 and 76.4% of 1.057/-0.205 fall at 0.760
Support Levels		
S1	0.540	23 January 2018 minor higher low, near a 9½ year falling trendline
S2	0.466	9 January 2018 high, gap low
S3	0.380	27 December 2017 low
S4	0.280	11 December 2017 low, also the base of the recent five-month bullish consolidation
S5	0.225	14 June 2017 minor higher low

Key Points

- Yield bulls extend the long term recovery from -0.205 (record low) through 0.619 (2017 top - 12 Jul) to post new 25½ month highs
- Firming daily-monthly studies signal further tests of strong clustered resistance between 0.737-0.760
- This marks 4 Dec 15 high (0.737), recent 0.280/0.518 range target (0.756), 21mth rising trendline & 76.4% of 1.057/-0.205 (0.760)
- A clearance would initially expose 0.822 (1 Sep 15 lower high) then 0.910 (.764x -0.205/0.619 off 0.280)
- Some daily studies are highly over-extended, but any corrective dips should hold 0.540 (23 Jan low, near a 9½yr falling trendline)

ed.blake@informagm.com

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FEBRUARY MONTHLY INTEREST RATE OUTLOOK

UK 10 Year Yield – Looking to resolve higher from year-long base

UK 10 Year Yield – Weekly Chart

Resistance Levels		
R5	2.088	9 November 2015 high
R4	2.000	30 December 2015 high
R3	1.808	76.4% of the June 2015 – August 2016 (2.212-0.501) fall
R2	1.670	26 April 2016 high
R1	1.558	61.8% of the June 2015 – August 2016 (2.212-0.501) fall, near the 15 December 2016 high at 1.536
Support Levels		
S1	1.283	16 January 2018 low
S2	1.137	15 December 2017 low, near a 16-month rising trendline drawn off the Aug 2016 and Sep 2017 lows
S3	0.923	2017 low – 14 June, near 8 September 2017 low at 0.951
S4	0.745	76.4% of the August 2016 – December 2016 (0.501-1.536) rally
S5	0.641	27 September 2016 low

Key Points

- Structure growing increasingly bullish as the market looks to resolve higher from a year-long base
- A significant low formed at 1.137 in September, near the former upper boundary of a prior multi-month bear channel
- Immediate focus is on the Dec 1.536 high/61.8% retrace at 1.536/1.558, near the 200-Week MA (approx. 1.60)
- Above opens further targets at 1.670 and 1.808
- Bears need to breach the 16 January 1.283 low to stall the advance
- Only below the September/June 2017 double bottom at 0.951/0.923 threatens the wider basing scenario

andrew.dowdell@informagm.com

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FEBRUARY MONTHLY INTEREST RATE OUTLOOK

CAN 10-YEAR YIELD – Extends off 1.806 higher low towards 76.4% retracement/4+ year falling trendline

CAN 10-YEAR YIELD – Weekly Chart

Resistance Levels		
R5	3.278	11 May 2011 minor lower high
R4	3.141	30 June 2011 reaction high
R3	2.830	2013 high - 11 September
R2	2.572	21/20 February 2014 lower high/3-month range top
R1	2.376	76.4% retracement of the 2.830/0.908 fall near 2.374, 4+ year falling trendline off 2.830
Support Levels		
S1	2.137	10 January 2018 minor platform
S2	1.977	27 December 2018 minor higher low
S3	1.806	29 August 2017 1.806 higher low, near 1.816/26 reaction lows (28 November/15 December 2017)
S4	1.639	10 May 2017 former lower peak
S5	1.373	6 June 2017 low/reaction low

Key Points

- Extends strength off the 1.816/26 reaction lows to post fresh 3.5-year highs over the 2.203 2017 peak (27 September)
- Eyes an immediate test of the key 2.374/6 area (4+ year 2.830/2.798 falling trendline, 76.4% retracement of the broad September 2013 – February 2016 2.830/0.908 decline)
- That said, the weekly RSI is approaching 80, over 2 standard deviations above the average reading over the past 5 years, though the recent weekly MACD bull cross suggests any corrective dips should be modest
- Strength over 2.376 offers scope for the 2.572 range top, and only a weekly close under 2.137 warns of a more protracted consolidation

matthew.sferro@informagm.com

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FEBRUARY MONTHLY INTEREST RATE OUTLOOK