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WEEKLY COMMENTARY:
Central Banks Holding the Course

Major Developments:

Monday, July 30:

- Eurozone Final Consumer Confidence Indicator increased modestly to -21.5 for July.
- US Dallas Federal Reserve Manufacturing Survey decreased to -13.2 for July.

Tuesday, July 31:

- Eurozone Unemployment Rate increased to 11.2% for June.
- US personal income growth increased to 0.5% and spending growth remained flat m.o.m. for June.
- US Conference Board Consumer Confidence increased to 65.9 for July.

Wednesday, August 1:

- Eurozone Final PMI Manufacturing Survey decreased to 44.0 for July.
- US ISM Manufacturing Survey increased to 49.8 for July.

Thursday, August 2:

- UK PMI Construction increased to 50.9 for July.
- US Factory Orders decreased 0.5% m.o.m. for June.

Friday, August 3:

- US non-farm payrolls increased to 163,000 for July.

This week financial markets received strong statements from both the US Federal Reserve and from the European Central Bank (ECB) but very little in the way of substantive action. Both the Federal Reserve and the ECB outlined plans to step in and to provide additional accommodation if financial and economic conditions did not improve. However, the ECB left rates unchanged, and the Federal Reserve essentially postponed a decision about quantitative easing (QE3) and additional bond purchases for another month.

Last week, ECB President Mario Draghi reminded investors that the ECB remained able and willing to act to defend the euro against disintegration. Draghi reiterated that the euro was irreversible, and noted that "…the ECB is ready to do whatever it takes to preserve the euro. And, believe me, it will be enough." Investors concluded that the ECB would soon act to bring down sovereign yield spreads, probably through renewed bond purchases, and Spanish and Italian bond spreads versus Bunds narrowed sharply.

On Thursday, the ECB had the opportunity to complement its assurances with actual policy measures. Unfortunately, Draghi appears to have either overpromised or investors completely misunderstood him. First, the ECB failed to cut either the deposit rate or the refinance rate, despite acknowledging that risks to both growth and inflation were to the downside. Second, while noting that sovereign risk premia were at "unacceptable" levels, Draghi again repeated the mantra that government progress on fiscal consolidation, structural reforms, and institution-building are the keys to restoring long-term confidence in public finances. Third, Draghi noted that open market operations, if undertaken at all, would be heavily concentrated at shorter maturities, which he clarified as being securities with maturities of 12 months or less. Subordination issues, we were informed, would be addressed at some later point.

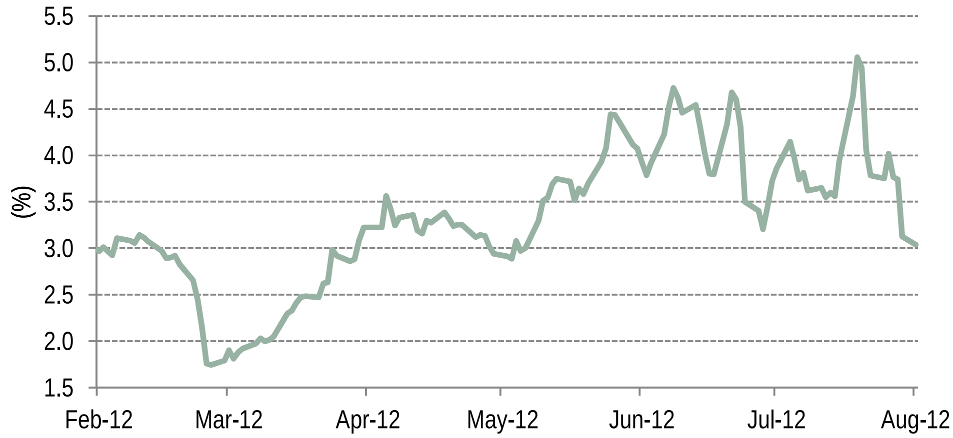
What investors were waiting for, of course, was a declaration of the ECB's willingness to proactively commit its balance sheet to facilitate this reform and austerity process. Instead, Draghi encouraged governments facing funding difficulties to seek assistance from the European Financial Stability Facility (EFSF) and (as yet unratified) European Stability Mechanism (ESM) and submit to an economic reform and austerity program, at which point the ECB might assist with bond purchases in the secondary market.

The US non-farm payroll report released Friday showed the addition of 163,000 jobs, which was slightly better than anticipated, with an unemployment rate of 8.3%. The US economy is managing slow-but-positive economic growth but not enough to meaningfully impact the jobs market. There remains a strong likelihood the Federal Reserve will provide for additional stimulus measures at its September meeting.

For now, financial markets seem content with what they have heard. Spreads for risk assets are tightening, and short-end maturities in Italian and Spanish government bond markets are sharply tighter. The S&P 500 Index is at its highest level since early May and close to the high for the year. Longer term, we wonder if words are sufficient.

The ECB's strategy of forcing troubled issuers to seek assistance from the EFSF and ESM (vehicles that are either too small or not even ratified) prior to offering central bank support seems a particularly dangerous one in the long term. It is hard to avoid the conclusion that market conditions will become more stressed before they improve.

Chart of the Week: Italy 2-year Yields 2/6/12 – 8/6/12



Data Source: Bloomberg, as at end August 6, 2012

Next Week:

Monday, August 6:

- UK House Prices are expected to decrease 0.5% m.o.m. for July.

Tuesday, August 7:

- UK Industrial and Manufacturing Production are expected to decrease 3.5% and 4.3%, respectively, m.o.m. for June.
- Germany Factory Orders are expected to decrease 0.8% m.o.m. for June.

Wednesday, August 8:

- Germany Industrial Production is expected to decrease 0.8% m.o.m. for June.
- Japan Machine Orders are expected to increase 11.0% m.o.m. for June.

Thursday, August 9:

- US Trade Deficit is expected to decrease to US$47.5 billion for June.
- US Wholesale Inventory growth is expected to remain at 0.3% m.o.m. for June.

Friday, August 10:

- Germany Final CPI is expected to remain at 1.7% y.o.y. for July.
- UK PPI is expected to decrease to 2.0% y.o.y. for July.

Source: Bloomberg, as at end August 3, 2012

Central Bank Watch:

	Last Move	Date of Move	Current Policy Rate	Implied 3-Month Rate on Sept. 2012 Interest Rate Futures Contract	Next Meeting
Fed	-75 bps	December 16, 2008	0% - 0.25%	0.14%	September 13
ECB	-25 bps	July 5, 2012	0.75%	0.08%	September 6
BoJ	-20 bps	October 5, 2010	0% - 0.10%	0.31%	August 9
BoE	-50 bps	March 5, 2009	0.50%	0.63%	September 6

Source: Bloomberg, as at end August 3, 2012

Market Review: Sovereign Bond Markets

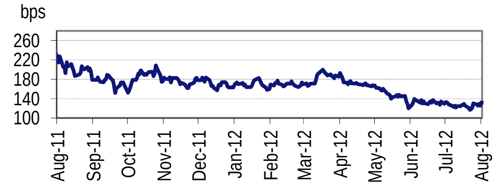
United States

US Treasuries saw a volatile week amid central bank meetings across the world and the US non-farm payroll report. The Federal Open Market Committee (FOMC) statement on Wednesday spelled out nothing materially different from the previous message except for acknowledging weaker economic activity. The reaction of Treasury markets to the statement was relatively muted. However, on Thursday, Draghi disappointed markets with talk of possible monetary action but failed to take decisive measures. This resulted in a rally in Treasuries as peripheral spreads widened, with the current 10-year Treasury yield reaching 1.45%. Friday was a different day though, as front-dated peripheral spreads narrowed significantly and Treasuries sold off following a better-than-expected headline US non-farm payroll report. The 10-year yield ended the week at 1.56%.

In economic data, the US non-farm payroll report for the month of July came in at a higher-than-expected 163,000, with net downward revisions of only 6,000. However, unemployment rose from 8.2% to 8.3% as household jobs were down 195,000, offsetting a 150,000 drop in the labor force. Average hourly earnings were up 0.1%, following a 0.3% gain last month. In manufacturing data, ISM Manufacturing for the month of July came in at a lower-than-expected 49.8, indicating a continuing decline in the US manufacturing sector.

2- to 10-Year Treasury Yield Spread

US	Current	Change in Level (bp) 1wk	MTD	YTD
Fed	0.25	0	0	0
3 Mo	0.08	-3	-1	7
2 Yr	0.24	0	-6	0
5 Yr	0.67	1	-5	-17
10 Yr	1.56	2	-8	-31
30 Yr	2.64	2	-11	-25
2 - Fed	-0.01	0	-6	0
5 - 2	0.43	1	1	-17
10 - 5	0.90	0	-3	-15
30 - 10	1.08	0	-3	6



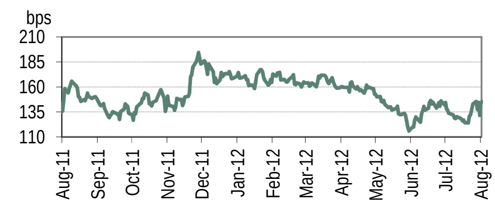
Source: Bloomberg, as at end August 3, 2012

Europe & Japan

This week the focus was on the ECB meeting on Thursday. Following Draghi's comments at the end of last week about doing "whatever it takes" to preserve the euro, there was hope that he would use the ECB meeting to announce measures to combat the ongoing crisis. In the end, the statement and Q&A session were fairly disappointing with the ECB ready to intervene only once an EFSF/ESM program with strict conditionality was enacted. The comment that purchases would be focused on the front-end was also not what the market wanted to hear. Initial reactions were a sharp retracement of last week's rally in Spanish and Italian yields and a strong rally in core bonds. Surprisingly though, the sentiment on Friday turned a lot more positive, no doubt helped by better-than-expected US jobs data, and the market took some reassurance that while the ECB was not going to act now, they would stand behind the euro in size should action become necessary. Ten-year Bund yields finished the week three basis points higher at 1.42%.

2- to 10-Year Bund Yield Spread

Europe	Current	Change in Level (bp) 1wk	MTD	YTD
ECB	0.75	0	-25	-25
1 Yr	0.02	3	-6	9
2 Yr	-0.02	1	-15	-17
5 Yr	0.43	1	-18	-33
10 Yr	1.42	3	-16	-41
30 Yr	2.25	-2	-8	-12
2 - ECB	-0.77	1	10	8
5 - 2	0.45	0	-4	-17
10 - 5	1.00	2	3	-7
30 - 10	0.82	-5	7	28

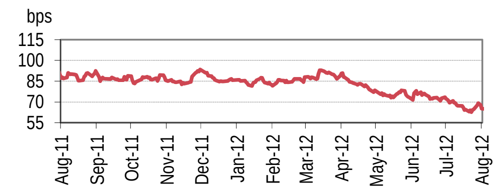


Source: Bloomberg, as at end August 3, 2012

In the UK, the Bank of England (BoE) meeting on Thursday produced no changes to either rates or QE. July PMI data was mixed. Manufacturing unexpectedly fell three points to 45.4, however construction rose from 48.2 to 50.9. The Services survey was slightly off, falling 0.3 to 51.0, whereas consensus was for a small improvement. Gilts were slightly weaker, closing up two basis points, at 1.56%.

2- to 10-Year JGB Yield Spread

Japan	Current	Change in Level (bp) 1wk	MTD	YTD
BOJ	0.10	0	0	0
1 Yr	0.10	0	0	-2
2 Yr	0.09	-1	-2	-4
5 Yr	0.16	-3	-6	-19
10 Yr	0.74	0	-10	-25
20 Yr	1.57	1	-10	-18
30 Yr	1.82	1	-9	-11
2 - BOJ	-0.01	-1	-2	-4
5 - 2	0.07	-2	-4	-14
10 - 5	0.58	2	-4	-6
30 - 10	1.08	1	1	14



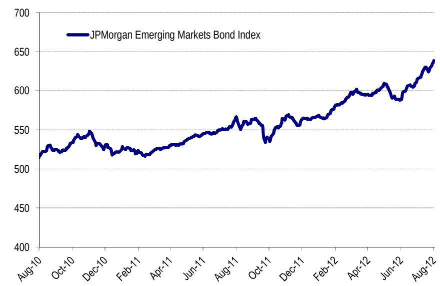
Source: Bloomberg, as at end August 3, 2012

In Japan, industrial production failed to bounce back from a disappointing May, recording -0.1% for June, 1.6% below consensus expectations. Jobs data was more encouraging with the jobless rate falling to 4.3% from 4.4%. Ten-year Japanese Government Bonds were unchanged on the week, at a yield of 0.74%.

Market Review: Emerging Markets

Positive momentum resumed in emerging markets (EM) this week with the JP Morgan Emerging Market Bond Index Global (JP Morgan EMBIG) gaining 1.46% over the week and spreads tightening 28 basis points. EM currencies also appreciated against the US dollar due to strong expectations of impending liquidity, likely driven by high expectations earlier in the week ahead of the FOMC and ECB meetings. Asian currencies outperformed (i.e., the Malaysian ringgit, the South Korean won, and the Philippine peso). The central bank meetings delivered little new guidance to EM but, after the initial disappointment and market correction, markets were quick to resume a more positive tone. There was little data or policy action within emerging markets themselves. There was a strong rebound in flows to EM bond funds with the asset class registering US$0.94 billion of inflows over the week.

JP Morgan Emerging Markets Bond Index Global



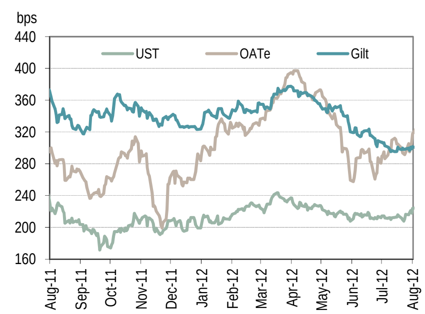
Source: Bloomberg, as at end August 3, 2012

Market Review: Global Inflation-Linked Bonds

In the Eurozone inflation-linked bond (ILB) market, French and German breakeven inflation (BEI) continued to be well supported by flows from index rebalancing and BEI in the 10-year sector widened 12-to-15 basis points over the week. At the same time, the index selling of Italian ILBs was less than expected, and instead, Italian BEI performed well on the back of strong risk-on sentiment. Italian BEI widened by more than 20 basis points in the 10-year sector.

TIPS BEI widened 7-to-12 basis points across the curve, as stronger-than-expected employment data, rising gasoline prices, improving market-risk sentiment, and sizeable month-end TIPS index-duration extension all helped TIPS outperform nominal Treasuries.

GILBs - 10-Year Breakeven Spreads



OATe - French sovereign indexed to EU harmonized CPI

Source: Bloomberg, performance in percentage points (%), as at end August 3, 2012

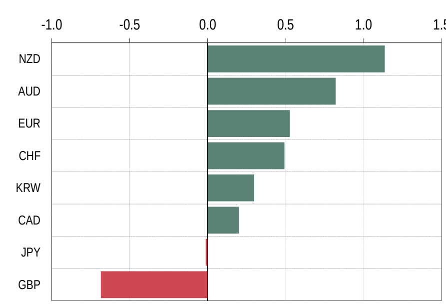
In the UK, index-duration extension flows helped the BEI curve to steepen marginally over the week. BEI levels in general, however, remained in a tight range amid thin trading flows during the Olympics/summer holiday. Meanwhile, the market awaits recommendations on RPI calculation methodologies from the Consumer Prices Advisory Committee, which will be released by the Committee in September.

Market Review: Currency Markets

G10

For the week, risky currencies outperformed the safe-haven currencies while the UK sterling was at the bottom of the pack. Following Draghi's upbeat comments, there was a lot of expectations built heading into the ECB meeting. Although Draghi signaled a potential change of policy in September, the lack of immediate action or any details initially weighed on risk appetite. However, the potential for ECB policy action helped the market end the week on firmer footing. The euro rallied 1% on the week and triggered a lot of short-covering on extreme short positioning.

US Dollar's WTD Performance Against Other Majors



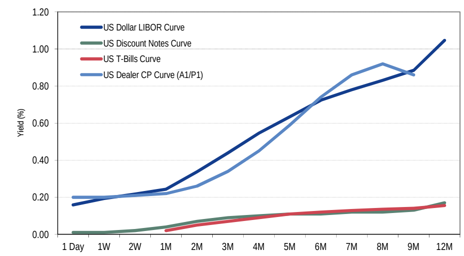
Source: Bloomberg, performance in percentage points (%), as at end August 3, 2012

Meanwhile, Federal Reserve Chairman Ben Bernanke did not take any action at the FOMC meeting. The Committee's statement reiterated its easing bias, but the bar for QE3 remains high. Additionally, the subsequent release of a stronger employment report on Friday has substantially pared back any expectations of easing by the Federal Reserve. The US dollar outperformed the Japanese yen marginally while underperforming most other currencies on better risk appetite.

Market Review: Money Markets

Data this week continued to point to a sluggish economy but with some positives such as the growth of 163,000 in US non-farm payrolls kept the Federal Reserve on hold. Also, markets were disappointed by more talk and no policy action after Thursday's ECB meeting. The short-term markets were quiet ahead of month end, but investors aggressively returned to the markets after the central bank meetings, extending out to three- to six-month fixed and six-month to one-year floating rate in high-quality names. For the week, total volume for maturities three-months out was 13%, significantly higher than the average volume of 9.3% for 2012 YTD.

Money Market Yield Curves



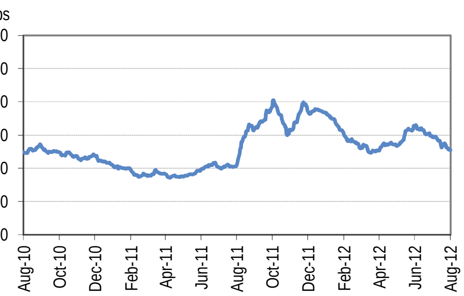
Source: Bloomberg, as at end August 3, 2012

Market Review: Spread Sectors

Sector Rotation: Corporate Credit

Both US and European corporate bonds outperformed government bonds again this week. Draghi's follow-through after his bold comments last week was initially taken as a disappointment, and risk assets sold off mid-week. Then on Thursday something changed. Frankly, there is no clear agreement in the markets what that change was, but corporate bond spreads ended tighter for the week. The constructive view of the ECB's action is that it has committed to support peripheral sovereign bond yields with conditionality, which squarely puts the burden on politicians to act and EU officials have become increasingly more willing to accept fiscal transfers. Under these conditions, it would appear much of the tail risk has been removed from the markets. US high-grade bond inflows slowed to US$733 million (after three consecutive US$1 billion-plus weeks). High-yield bond inflows also slowed to US$401 million from US$2 billion last week. US corporate bonds outperformed Treasuries by 0.32% for the period and closed the week at 177 basis points (five basis points tighter). European corporate bonds outperformed government bonds by 0.34% and ended the week at 219 basis points (13 basis points tighter).

Investment-Grade Corporate Bond Index OAS

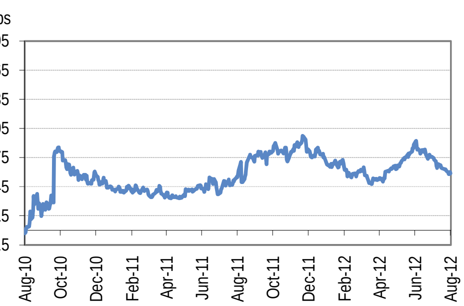


Source: Barclays Capital, as at end August 3, 2012

Mortgage-Backed Securities

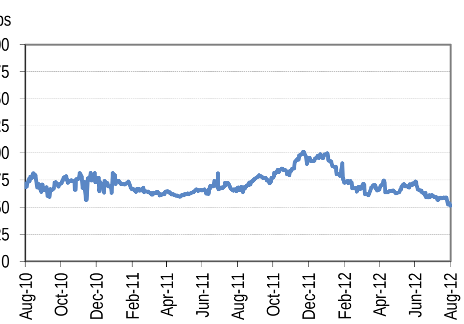
The mortgage sector outperformed duration-matched Treasuries by six basis points this week. For July, the sector outperformed duration-matched Treasuries by 28 basis points. Draghi's commitment to preserving the euro and the recent surge in the REIT market fared well for MBS this past month. This past week, Federal Housing Finance Agency (FHFA) Acting Director Edward DeMarco, announced that the GSEs will not adopt principal forgiveness as a method to help borrowers, but have proposed ideas to improve financing. Moreover, the FHFA has announced increased government fees this past week, which should impact MBS valuations. The refinance-index has increased 0.8% w.o.w. and conventional primary rates have increased six basis points from the previous week. In light of the recent employment data, the likeliness that the Federal Reserve will implement QE3 before the September meeting has been slightly reduced. We are positive on structured products, including MBS, CMBS, and non-agency RMBS.

Agency MBS Current-Coupon Fixed-Rate OAS



Source: Barclays Capital, as at end August 3, 2012

Barclays Capital ABS Index OAS



Source: Barclays Capital, as at end August 3, 2012

Asset-Backed Securities

The ABS market continued to grind tighter on light supply and continued investor demand for spread products. Esoteric ABS spreads tightened by 5-to-10 basis points. The new issue pipeline slowed down going into August (only US$2.36 billion priced last week) and may remain quiet for the remainder of the month.

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