2017
Slide Pack on the Outlook for Bond Yields

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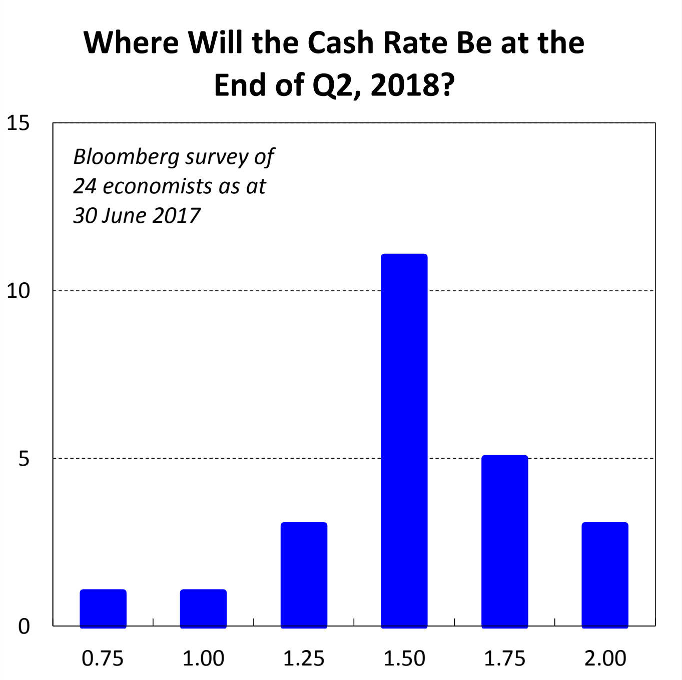
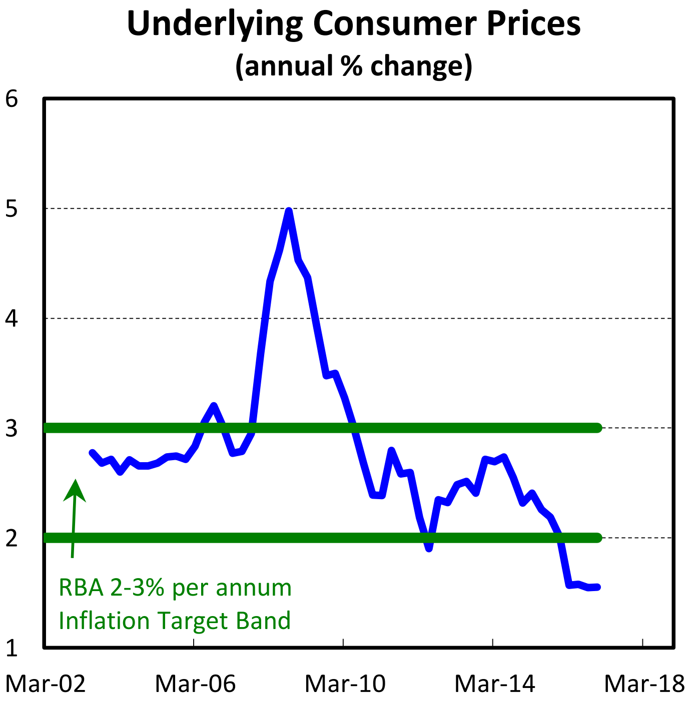
Australian Cash Rate



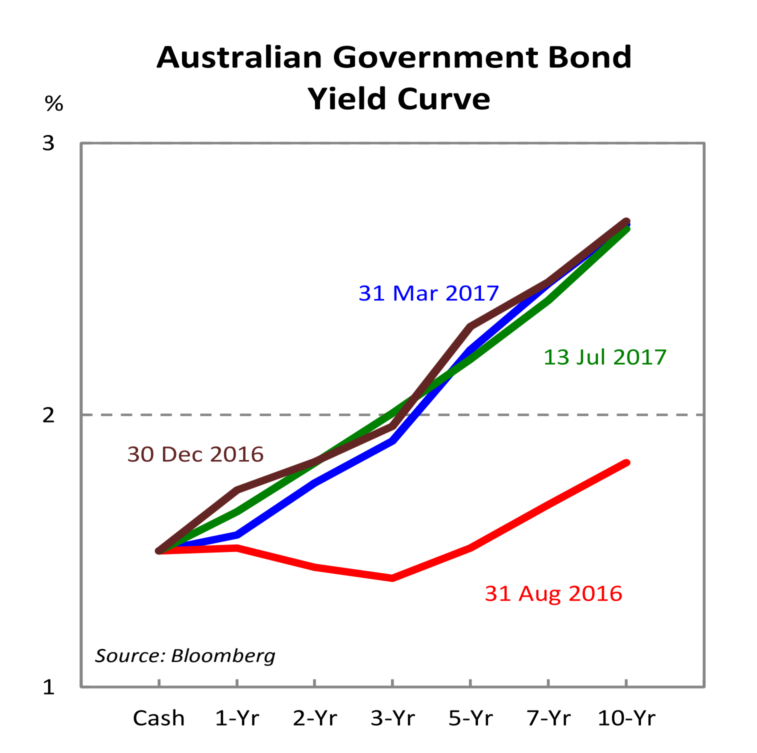
- The cash rate is at a record low of 1.50%.
- Reserve Bank faces a juggling act.
- In recent months, more economists have moved away from calling more rate cuts.

Inflation Outlook in Australia



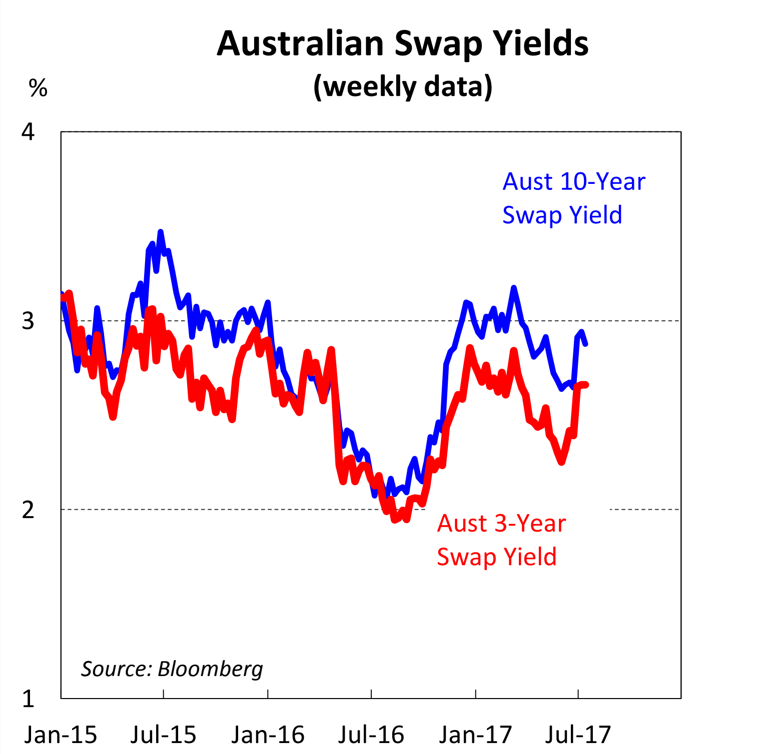
- We expect the RBA to leave the cash rate steady this year and next year.
- Household indebtedness and soft inflation supports our view.

Australian Bond Yield Curve



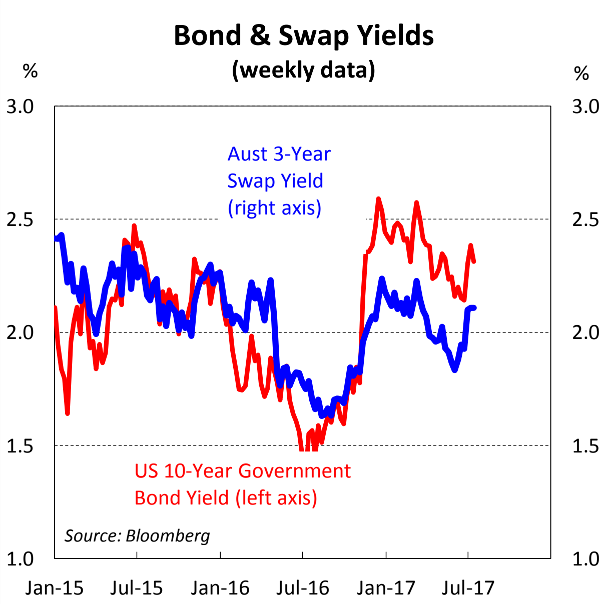
- We expect further modest steepening by end of 2018.
- Consensus is expecting more substantial steeping than our forecasts. Consensus expects the 10-year bond yield will rise more sharply next year (from 2.88% expected at end of 2017 to 3.50% at end of 2018).

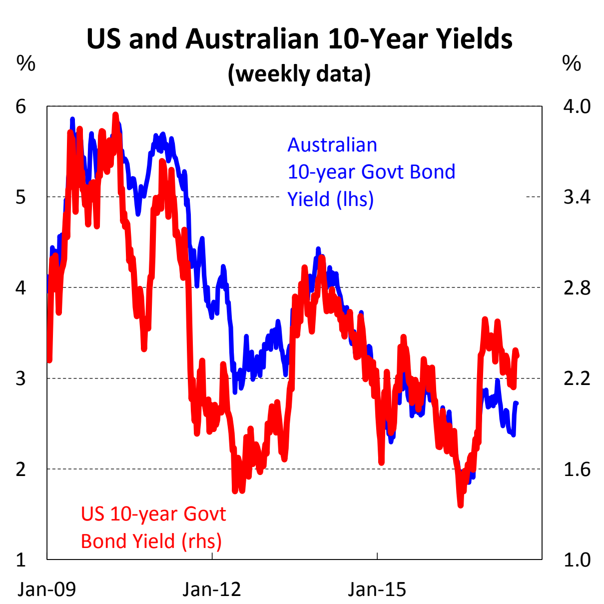
Australian Swap Rates Outlook



- Australian swap rates bottomed in August 2016.
- Australian 3-year swap yields are up 49 basis points and Australian 10-year swap yields are up 84 basis points from their lows.

Australian Swap Rates Outlook





- Australian yields are being heavily influenced by US yields, more so since mid 2015.
- This correlation should continue over the year ahead.

US 10-Year Bond Yields Outlook

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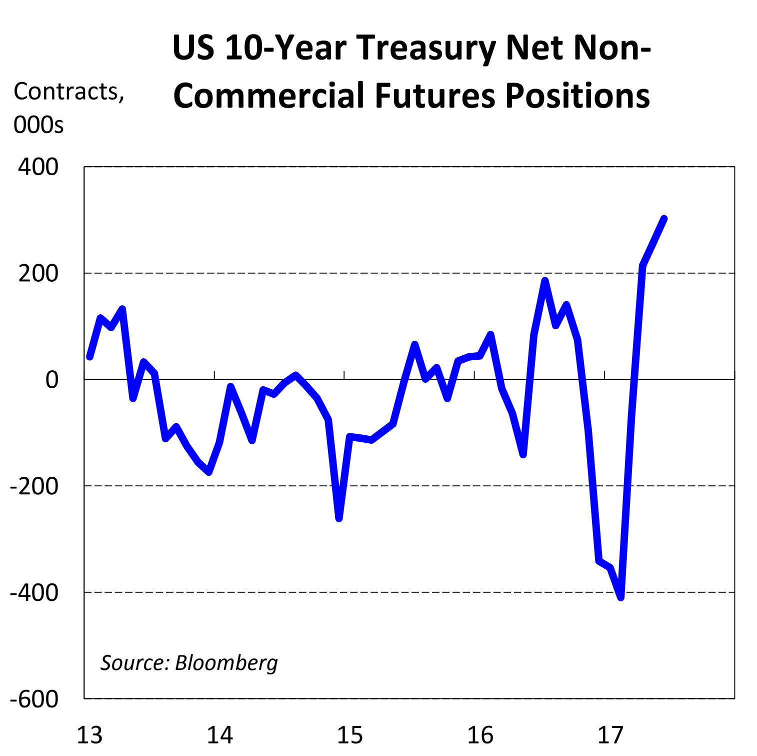
- A synchronised global economic recovery is in play. Economic data is improving in key advanced economies, including Europe and Japan.
- The recent gyrations in US Treasuries is in part a function of what the market expects US President Trump will do with fiscal policy (and how successful he will be). US economic data has not substantially altered in recent months.
- The US Federal Reserve has assured the market that the impending balance sheet shrinkage will be gradual, minimising the risks of another tantrum.
- The Fed intends to increase the balance sheet run off cap every three months until a fully phased-in level is hit.

Risk of Sharp Sell off in US Treasuries

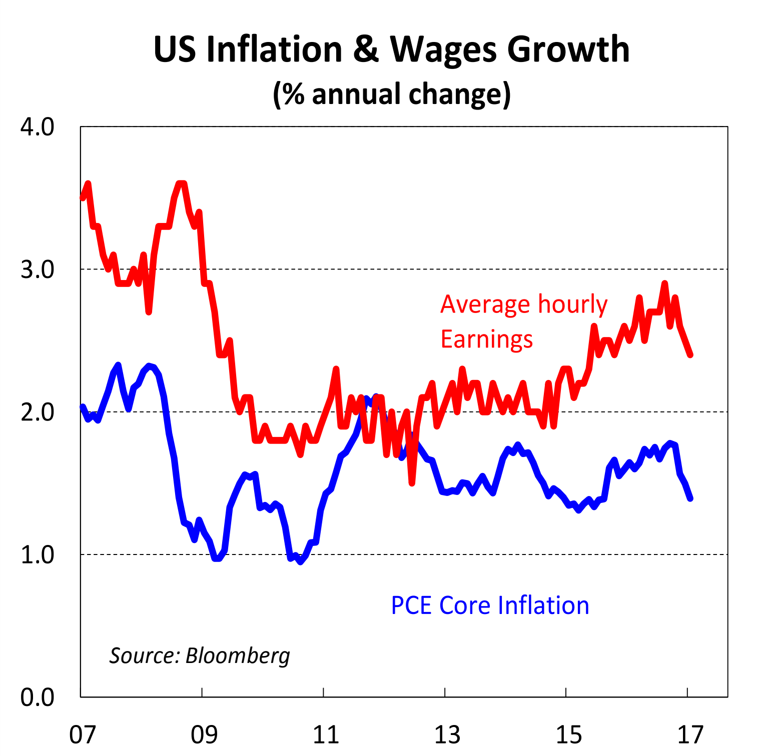


- Net long positions in 10-year US Treasuries have built up.
- The market is now net long 302,000 in 10-year US Treasury futures contracts; these are levels last witnessed in late 2007.
- It leaves US 10-year bond yields vulnerable to a sharp spike if inflation and/or economic growth surprises to the high side.

US Inflation Expectations

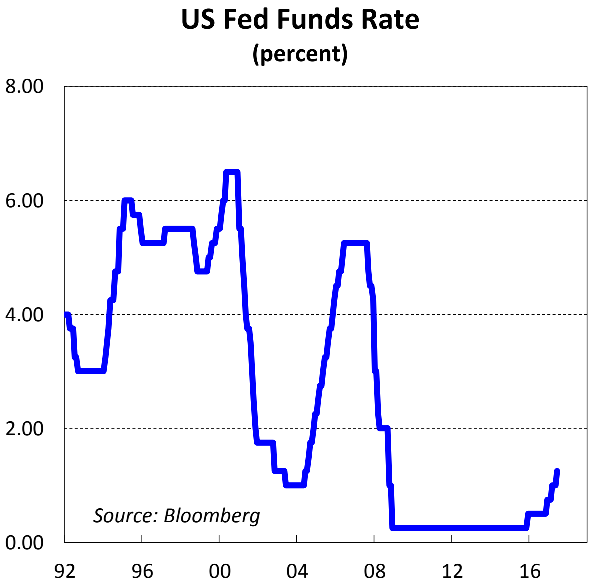
- Markets are not convinced that US inflation will push sharply higher over the next few quarters.
- It is reflected in the 5-year, 5-year forward inflation expectation rate, which is a measure of expected inflation (on average) over the next five years.

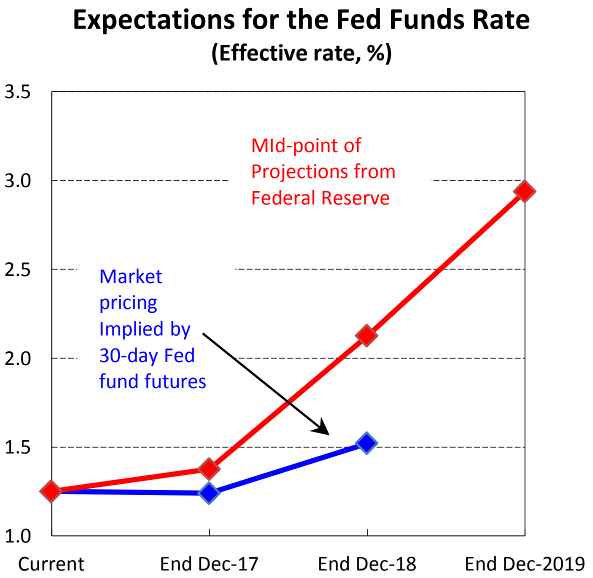
Fed Looking Through Soft Inflation



- Fed appears willing to look through weaker inflation outcomes, for now.
- US Federal Reserve Chair still believes in the Phillips Curve – the notion that lower unemployment will generate stronger wages growth in time.

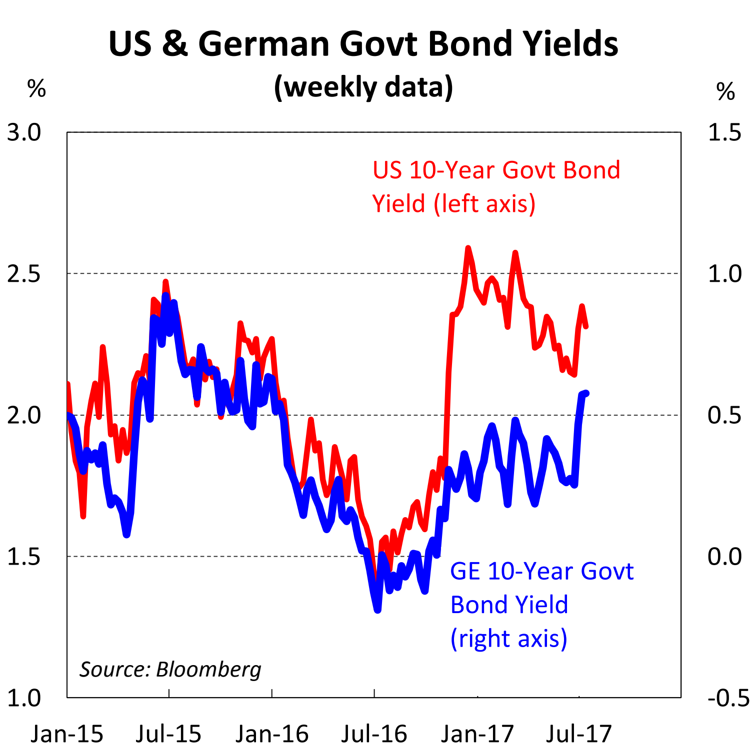
More Rate Hikes to Come in the US





- Financial markets expect one more rate hike this year and one more next year. We think markets are not pricing in enough tightening.

Europe



- Europe is at a turning point with European Central Bank (ECB) President Draghi recently stating that the "threat of deflation is gone and reflationary forces are at play". German long-end yields are, therefore, likely to nudge higher over the coming year.
- With higher inflation expectations lacking domestically, data and event developments in Europe and Japan will be important.

More on Europe

- The European Central Bank's (ECB) asset purchase program runs out by the end of the year. Financial markets are speculating that the ECB may taper the current program for 2018.
- The market is likely to look for greater clarity in the next few ECB policy meetings.
- Any change in outlook or hint of a reduction in asset purchases would likely push German 10-year yields higher and thereby prod US 10-year bond yields higher.
- In other developments, Bank of Canada recently raised their benchmark rate, making it the first major central bank to follow in the footsteps of the US Federal Reserve.

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