Economics

26 October 2011 | 76 pages

Global Economic Outlook and Strategy

October 2011

- Our 2011-13 growth forecasts are little changed this month, a notable contrast to the heavy forecast downgrades of recent months. Overall, we have edged up our 2011 forecast for global growth (at current exchange rates) by 0.1%, while cutting 2012-13 forecasts by 0.1%. Our forecast implies that global GDP growth will slow markedly, from 4.2% in 2010 to 3.1% in 2011 and 2.8% in 2012, while avoiding a global recession (global GDP fell 2.3% in 2009 on this basis). We downgrade our 2011-2013 growth forecasts for the UK, Brazil, Egypt, Hungary, India, Mexico and Romania. PPP-adjusted, our forecasts imply that global growth will slow from 5.0% in 2010 to 3.8% in 2011 and 3.5% in 2012.

- Many advanced economies continue to face sizeable headwinds from high private savings rates as companies and households seek to deleverage, plus poor bank credit availability – and in many cases fiscal restraint as well. In addition, at the time of writing it is unclear if EU policymakers will agree an adequate package to genuinely solve the EMU sovereign crisis. We do expect proposals aimed at three key issues: larger haircuts on Greek sovereign debt; bigger bank recapitalisation; expansion of the EFSF's financial firepower to backstop other solvent but liquidity-strained countries (e.g. Italy and Spain, but conceivably others as well). Nevertheless, we doubt whether the proposals will succeed in restoring sovereign spreads and bank credit availability to anything like normal levels. We continue to expect the Euro Area to slip into renewed recession, with heavy restructuring of Greek government debt likely to be followed by restructuring also in Portugal and Ireland over the next year or two.

- We still expect the ECB to cut rates by 50bp by yearend, most likely at the December meeting. The UK MPC is likely to expand QE further in coming months, while we continue to expect the Fed to keep policy rates low for an extended period. We expect further sovereign ratings downgrades in Europe, including downgrades (by at least one major ratings agency) to Portugal and Greece in the next 3-6 months, with a high risk that France is put on "Negative Outlook" by mid-2012.

Figure 1. Currency and Interest Rate Forecasts (End of Period, Unless Specified), as of 26 Oct 2011

	26 Oct 11	4Q 11 Forecast	1Q 12 Forecast	2Q 12 Forecast	3Q 12 Forecast	4Q 12 Forecast
United States: Federal Funds	0.25	0.25	0.25	0.25	0.25	0.25
10-Yr. Treasuries (Period Ave.)	2.14	2.15	2.05	2.30	2.60	2.90
Euro Area: US$/€	1.39	1.33	1.29	1.27	1.25	1.26
Euro Repo Rate	1.50	1.00	1.00	1.00	1.00	1.00
10-Yr. Bunds (Period Average)	2.06	1.70	1.40	1.50	1.70	1.70
Japan: Yen/US$	76	75	75	76	76	76
Call Money	0.10	0.10	0.10	0.10	0.10	0.10
10-Yr. JGB (Period Average)	1.01	1.10	1.20	1.05	1.10	1.30

Source: Citi Investment Research and Analysis

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With thanks to Jan Maguire

Next issue 28 November 2011

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Figure 2. Forecast Highlights and Changes from Last Month

■ Global	Our 2011-13 growth forecasts are little changed this month, a notable contrast to the heavy forecast downgrades of recent months. Overall, we have edged up our 2011 forecast for global growth (at current exchange rates) by 0.1%, while cutting forecasts for 2012 and 2013 by 0.1%. Our forecast implies that global GDP growth will slow markedly, from 4.2% in 2010 to 3.1% in 2011 and 2.8% in 2012, while avoiding a global recession (global GDP fell 2.3% in 2009 on this basis).
■ United States	The reversal of temporary drags has boosted growth near-term as consumer and business spending have surprised to the upside. However, fragile financial supports suggest the expansion is likely to remain too weak to reduce unemployment meaningfully over the forecast horizon. Enhanced monetary accommodation is likely to focus first on guiding interest rate expectations. New fiscal supports for growth are expected to be very limited.
■ Euro Area	The Euro Area Summit made some progress in dealing with the sovereign debt crisis. However, the Summit outcome probably will not be a "comprehensive package" to end the crisis. We believe the likely sovereign debt restructuring in Greece will probably also lead to debt restructuring in Portugal and Ireland, and is likely to have negative repercussions on the euro area economy. While the ECB is not likely to cut rates in November, we expect a rate reduction of 50bp by year-end. We also expect that the ECB at a later stage will have to increase its support for euro area sovereigns.
■ China	We fine-tune our 2011 growth forecast from 9.0% to 9.1% and revised the average inflation forecast from 5.3% to 5.5%, mainly to reflect stronger-than-expected third quarter activity and elevated inflation. We expect Q4 growth and inflation to fall more significantly on lagged policy impact and external weakness. This would preclude further policy tightening, but a blanket policy loosening is unlikely, although fiscal policy may become more active to forestall downside risks.
■ Japan	The economy will likely grow relatively stably over the forecast period. While exports will probably stall in the first half of 2012 amid the continued slowdown in the global economy, reconstruction demand from the disaster is likely to provide timely offsets. If upward pressures on the yen intensify amid global risk aversion, the BoJ will most likely take additional action.
■ United Kingdom	The UK economy is likely to be near recession in the next two or three quarters. We continue to expect that the MPC will expand QE markedly further, until there are clear signs that the economy is for sustained recovery.
■ Canada	The Canadian outlook remains unspectacular and risks appear tilted to the downside. But hearty domestic economic fundamentals, a stable financial system, elevated inflation and over-indebted consumers provide limited scope for rate cuts. Hence, we maintain our call for a 1.00% policy target through early 2013.
■ Australia	The much lower-than-expected Q3 underlying CPI result makes a slightly restrictive cash rate less relevant in an environment of global downside risks. We expect the RBA to cut 25 bps from official interest rates at the November Board meeting.
■ Emerging Asia (ex China)	EM Asia's growth is slowing, led by exports and inventory de-stocking, but there are limited signs of spillover into labour markets which would dampen consumption, nor is there a significant slowdown in non-tradeable investment. On top of intra-EM demand, Asia's inflation risks have dissipated, paving the way for some monetary easing by Indonesia and Singapore, and this could be followed by some (more fiscal) policy easing by Thailand (post-floods) and a possible rate cut in Malaysia.
■ CEEMEA	Turkey's government has released the much-awaited Medium-Term Plan, which we believe is built, by and large, on reasonable macroeconomic assumptions. In Hungary, the deteriorating global growth environment and announcements of fiscal austerity measures have led us to further downgrade our GDP forecasts for 2011 and 2012. The Bank of Israel kept its rate unchanged at 3% as we expected. Downside growth risks and stable inflation expectations should justify another cut by year-end.
■ Latam	After a series of regional exchange rate depreciations, currencies strengthened in October except for the MXN, which remains relatively undervalued. In one case (Peru), the exchange is, actually, stronger than it was in August. All in all, Latin America appears to be coping well with global instability, though there has been a sharp deceleration in manufacturing and retail activity in some cases, particularly Brazil, where our growth forecasts are corrected downwards to 3.3% in 2011 and 3.5% in 2012 (from 3.7% and 4%, respectively).

Source: Citi Investment Research and Analysis

Overview — Amidst Uncertainties, Growth Prospects Remain Uneven

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Our 2011-13 growth forecasts are little changed this month, a notable contrast to the heavy forecast downgrades of recent months. We are making slight downgrades to our 2011-2012 growth forecasts for the UK, Brazil, Egypt, Hungary, India, Mexico and Romania. In addition, we have made minor increases to our 2011 growth forecasts for the US and China (from 1.7% to 1.8% and from 9.0% to 9.1% respectively), and a minor cut to our 2012 Euro Area forecast (to -0.3% from -0.2%). Overall, we have edged up our 2011 forecast for global growth (at current exchange rates) by 0.1%, while cutting our forecasts for 2012 and 2013 by 0.1%. Our forecasts imply that global GDP growth will slow markedly, from 4.2% in 2010 to 3.1% in 2011 and 2.8% in 2012, while avoiding a global recession (global GDP fell 2.3% in 2009 on this basis). PPP-adjusted, our forecasts imply that global growth will slow from 5.0% in 2010 to 3.8% in 2011 and 3.5% in 2012.

Figure 3. Selected Countries — Industrial Production Data and Forecasts (Pct.), 2011-13F

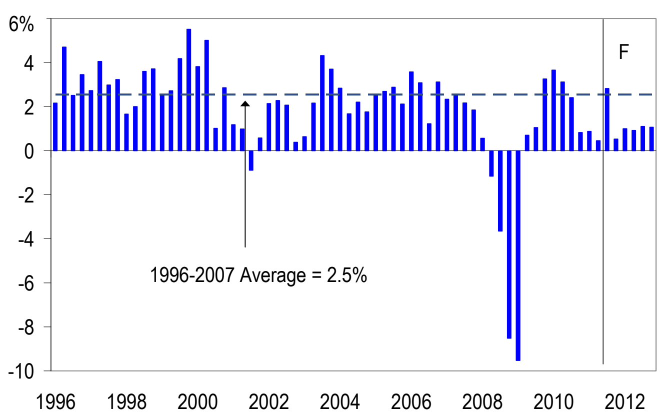
	2011F	2012F	2013F
World	**5.7%**	**3.3%**	**4.1%**
United States	4.0	3.0	3.5
Japan	-3.0	2.3	3.5
Euro Area	4.6	-0.3	1.4
United Kingdom	-0.2	1.0	1.3
Canada	1.5	-0.6	0.7
China	13.8	12.5	11.5
India	6.5	6.8	7.9
Korea	6.5	6.7	7.4
Brazil	1.3	2.5	3.5

Source: Citi Investment Research and Analysis

The previous flow of disappointing economic news has abated a bit recently, and the Citi Economic Surprise Index (ESI) for the US has moved back into positive territory after marked weakness earlier this year, with the decline in the Euro Area ESI also easing. With growth improving in Q3 for both the US and Euro Area, plus the sharp rebound in industrial production in Japan, we estimate that overall G4 GDP growth improved from 0.5% QoQ SAAR in Q2 to about 2.8% in Q3, the highest since Q2-2010.

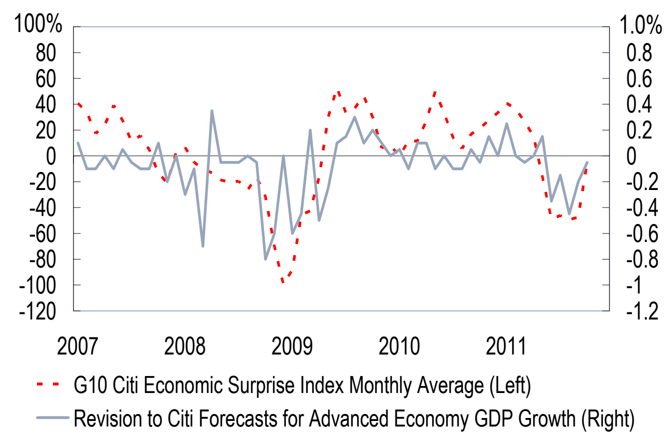
Nevertheless, with the recent deterioration in business surveys in Europe and the US, we doubt the Q3 pick-up will continue. The Euro Area composite PMI has slid to recession levels, hitting 47.2 in October – the weakest since July 2009. The latest level is weaker than Q2-08 (first quarter of recent recession) and similar to Q3-08 (the second recessionary quarter). The EU Commission Economic Sentiment Index is similarly gloomy, with sharp falls in the EMU and UK readings in recent months. In the US, the ISM index is hovering just above 50, while the NFIB survey suggests that optimism among small firms remains about two standard deviations below average. We expect that aggregate GDP growth across the G4 will slow to only about 0.5% QoQ SAAR in Q4, with outright contraction in the Euro Area, growth of close to zero in the UK, and sluggish (but positive) growth in the US and Japan.

Figure 4. G4 — GDP Growth QoQ SAAR, 1996-2012F



F Citi forecast. We show the GDP-weighted average for the US, Euro Area, Japan and UK. Sources : Datastream and Citi Investment Research and Analysis

Figure 5. G10 Citi Economic Surprise Index and Revisions to Citi GDP Forecast for Advanced Economies, 2003-11

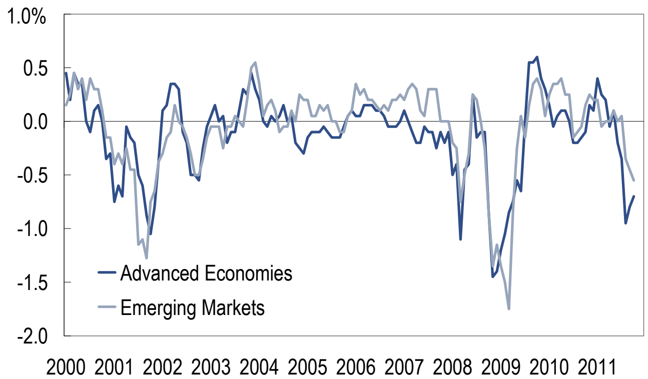


Note: We show revisions to Citi GDP growth forecasts for the current and following year. Source: Citi Investment Research and Analysis

As discussed last month, many advanced economies continue to face sizeable headwinds from high private savings rates as companies and households seek to deleverage, plus poor bank credit availability – and in many cases fiscal restraint as well[1]. These headwinds are unlikely to fade quickly. Even after three-four years of deleveraging, aggregate private debt/GDP ratios have fallen only slightly in the US, Euro Area and UK – and remain far above historic norms.

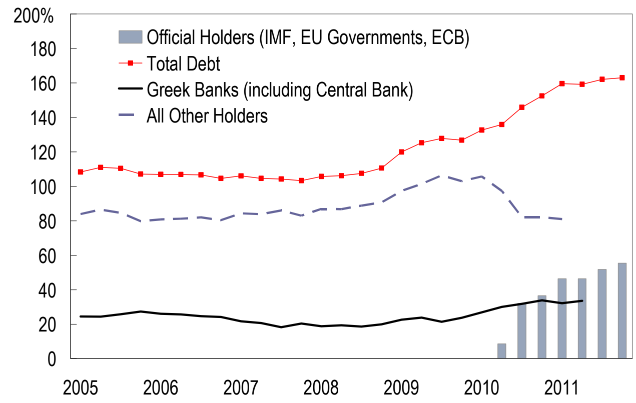
Moreover, at the time of writing, it is unclear if EU policymakers will agree an adequate package to genuinely solve the EMU sovereign debt crisis. We do expect measures soon that aim to tackle three key issues: larger haircuts on Greek sovereign debt; bigger bank recapitalisation; expansion of the EFSF's financial firepower to backstop solvent but liquidity-strained governments (e.g. Italy and Spain, but perhaps others as well). Such announcements may prompt near-term gains in risk assets. Nevertheless, we doubt whether the expected proposals will succeed in restoring sovereign spreads to anything like normal levels.

Figure 6. Global — 3-Month Sum of Revisions to Citi GDP Growth Forecasts, 2000-11



Note: We show revisions to Citi forecasts for the current and following year.
Sources: Citi Investment Research and Analysis

Figure 7. Greece — Split of Government Debt (as Pct of GDP), 2005-11



Note: Figures for official holdings include Citi estimate of ECB purchases.
Sources: ECB, BIS, Datastream and Citi Investment Research and Analysis

Will 50-60% PSI Return Greece to Fiscal Sustainability?

For Greece, a "voluntary" package of 50-60% haircuts under PSI appears to be under discussion. But, even if agreed, we doubt this will restore Greece to fiscal sustainability. One issue is that, given the deteriorating fiscal outlook, even quite deep PSI haircuts will not yield a sufficient drop in Greece's government debt/GDP ratio in our view. Approximately one third of Greek government debt (i.e. about 55% of GDP) is held by official holders (ECB, IMF, loans from other EU countries) and OSI (Official Sector Involvement) appears to be ruled out. In addition, debt equal to about 33% of GDP is held by Greek banks (including the central bank), for which writedowns triggered by larger PSI probably would likely trigger roughly equal recapitalisation needs – to fund which the Greek government would have to borrow more (probably from the EFSF/IMF). Hence, any drop in the debt/GDP ratio from restructuring in effect can only be created through haircuts on government debt not held by official holders or Greek banks (i.e. roughly half of total debt). Moreover, the extent to which "voluntary" PSI will generate a meaningful drop in the debt/GDP ratio is likely to be further diluted if, as with PSI1, the Greek government will take on additional debt to buy zero coupon high-quality assets to guarantee the post-haircut value of government debt.

[1] See "*Global Economic Outlook and Strategy*", September 2011, Willem Buiter et al, Citi.

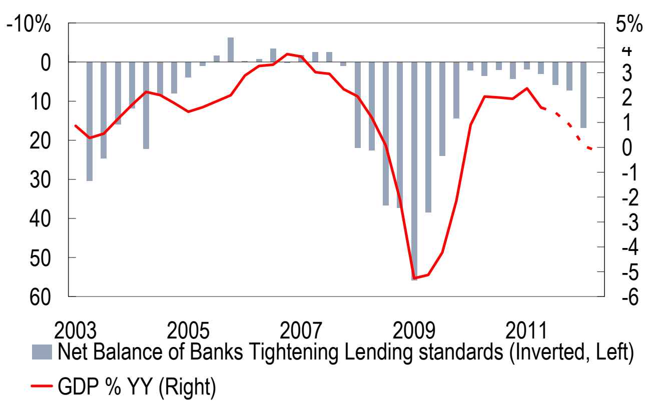
Even after a 50-60% haircut, Greece will probably remain unable to fund itself in markets, in our view. We believe Greece's government debt/GDP ratio will stay far above 100% and leave expectations of further restructuring over time. In our view, the aim of this haircut is really just to limit the scale of further official support for Greece close to the prior plan (€109bn) — a sign that creditor nations are unwilling to bear the burden of funding the ongoing deterioration in Greece's fiscal prospects.

Bank Recapitalisation — Does it Go Far Enough?

We doubt that the new bank recapitalisation plan will end worries over banks' robustness to adverse shocks. In particular, we believe the calculation that roughly €108bn in extra capital will give banks adequate capital is not even a rigorous judgment of banks' probable capital health, let alone a stress test. It appears this calculation simply comes from marking to market banks' sovereign debt holdings against current balance sheets. This calculation has three weaknesses.

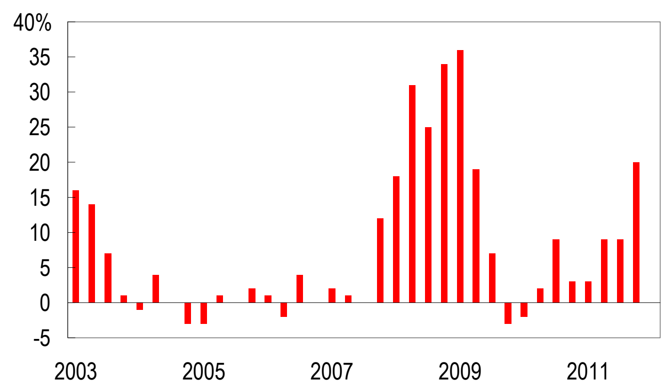
First, it appears that banks have not been forced to reassess whether existing provisions fully reflect probable future losses. Euro area banks' loan loss provisions are notably smaller than those among US and UK banks[2]. Using data from the EBA's mid-11 "Stress Test", we calculate that only 17% of European banks' loan loss provisions are for non-defaulted assets. This leaves further potential legacy losses from financially-weak, but not-yet-insolvent, companies and households. Second, the EBA calculation does not allow for future losses if (as we expect) EMU economies fall into recession. Our base case for the Euro Area (GDP falls 0.3% in 2012) is slightly worse than the EBA's adverse scenario in the July 2011 "Stress Test" (Euro Area GDP falls 0.2% in 2012). Third, it seems that banks have been allowed to count unrealised capital appreciation on non-stressed government bonds (which generally are trading above par) as offsets to potential writedowns on stressed EMU periphery debt. Of course, this calculation does not allow for the future capital losses on non-strained debt, given that these bonds will be redeemed at par. Fourth, some banks may aim to lift capital ratios by shedding assets, hence probably further undermining the economic outlook (and thereby also hitting bank profitability).

Figure 8. Euro Area — Net Balance of Banks Tightening Lending Standards to Businesses, and GDP Growth, 2003-11



Note: Solid line indicates data for GDP, dashed line indicates Citi forecast.
Sources: ECB, Eurostat and Citi Investment Research and Analysis

Figure 9. Euro Area — Net Pct of Banks Citing Bank Funding Conditions as a Factor Hindering Credit Availability to Companies, 2003-11



Sources: ECB and Citi Investment Research and Analysis

2 See BIS Annual Reports.

Worries over bank health already have been reflected in a sharp drop in banks' share prices and funding strains. In turn, this is feeding through to a marked tightening of bank lending standards on business loans and mortgage loans. In particular, there has been a notable rise in the share of banks which cite their own funding conditions as a factor leading to tighter lending standards. If, as we suspect, the recapitalisation plan does not remove worries over banking sector health, these strains may well persist and escalate, intensifying the economic downturn.

Will EFSF Insurance Shield Other EMU Governments?

It is unclear if the proposals for leverage of the EFSF via first-loss insurance plus a Special Purpose Investment Vehicle (SPIV) will adequately backstop other EMU countries, notably Italy and Spain. One problem is that the scale of protection offered by EFSF insurance probably will be insufficient to fully shield investors in the event of sovereign default in our view. Given the other commitments on the EFSF from Ireland and Portugal (€44bn), plus the likelihood of substantial further funding for Greece (perhaps €70-€100bn) and some requirements for bank recapitalisation (perhaps €50bn), funds available for sovereign insurance will probably only amount to about €250bn. This would need to leveraged up roughly 4-5 times (i.e. 20%-25% first loss insurance) to provide firepower of €1000-€1250bn, the minimum needed to fund Italy and Spain for three years. We regard it as unlikely that Italy and Spain will have to default or restructure their government debts. But prior experience suggests that if sovereign debt restructuring does occur, then the scale of writedowns is typically well above 20-25%, more like about 50% in NPV terms[3]. The proposed insurance scheme would provide only modest protection against such losses in our view.

Moreover, investors may reasonably be sceptical about the extent to which any EFSF insurance-type protection can be guaranteed to pay out if investors are subject to further "voluntary" writedowns. For example, the value of CDS as a hedge against writedowns and defaults has been greatly eroded by the emphasis by EU policymakers on persuading investors to accept "voluntary" writedowns on Greek government debt in order to avoid triggering CDS. Investors may suspect that, if restructuring in other EU governments eventually becomes inevitable, then political decisions again will be taken to design restructuring in a way that does not inflict extra losses on other EMU governments – but leaves investors unprotected. In addition, to the extent that governments using EFSF-insurance will have to borrow to buy that insurance, gains in lower debt service payments will to an extent be balanced by a higher debt/GDP ratio. We regard it as unlikely that non-EMU governments will contribute significantly to the proposed SPIV unless offered very generous terms (which may be political as well as financial).

Unaddressed Issues

At the time of writing, it seems unlikely that the EU summit will address other key, but unresolved, aspects of the sovereign debt crisis: Among various issues, these include:

Should the terms of the existing EFSF programmes for Portugal and Ireland be relaxed? Will either or both of these countries also need sovereign debt restructuring? Our base case is that Portugal and Ireland will probably have to restructure sovereign debt as well, and this is likely to occur by end-2012. Portugal's GDP already has fallen for three quarters in a row, the second recession in three years. Indeed, the level of real GDP is only 2-3% up from nine years ago –

[3] See "Haircuts: Estimating Investor Losses in Sovereign Debt Restructurings,1998–2005", Federico Sturzenegger and Jeromin Zettelmeyer, IMF July 2005.

a Japan-like period of stagnation. Portugal's external debt/GDP ratio has risen from 166% in Q1-2006 to 227% of GDP in Q2 this year, well above levels in Italy, Spain and Greece (120%, 167% and 187% respectively). Moreover, business surveys for Portugal have nose-dived since extra fiscal tightening was implemented earlier this year, pointing to further recession in coming quarters. Ireland's economy has picked up recently – albeit not enough to stabilise the jobless rate. But, GDP is still 9-10% below the pre-recession peak (and real GNP is 12-13% down), and more austerity measures are in the pipeline. Recent growth has been heavily dependent on exports, so the Irish economy may be vulnerable to the ongoing slowdown.

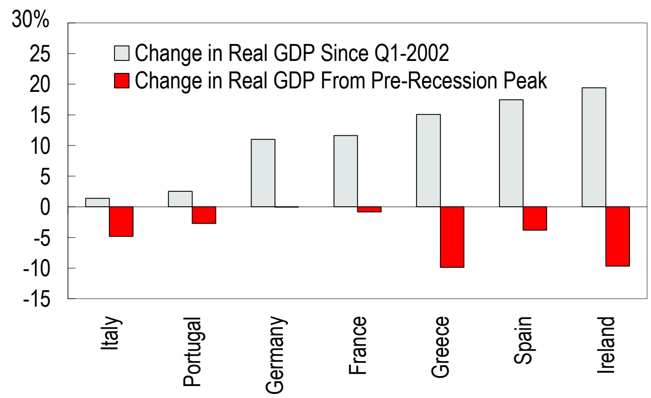
Will supply-side reforms succeed in restoring the peripheral countries to sustained economic growth even after sovereign debt restructuring? This is an issue for a range of countries, including Greece, Portugal, Ireland, Italy and Spain.

Is widespread fiscal tightening in core EMU countries in 2012 still appropriate given the prospect of recession, or should the core countries be expanding domestic demand in order to provide more scope for periphery countries to resume growth?

Will the framework of rescue plans remain viable if France's sovereign debt is downgraded?

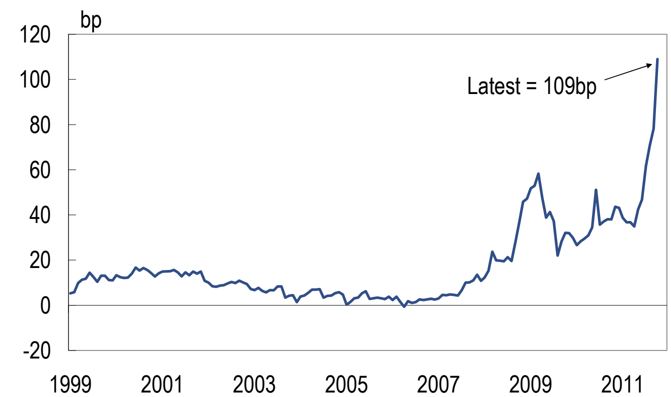
What will be future structure of the euro area? Are the member countries willing to build a fiscal- and economic union?

Figure 10. Selected Euro Area Countries — Change in Real GDP, 2002-11



Note: Latest data are for Q2-2011 apart from Greece, which is for Q1-2011.
Sources: Datastream and Citi Investment Research and Analysis

Figure 11. France — 10-Year Yield Spread Over Germany, 1999-2011



Note: Data are monthly averages apart from the latest point.
Sources: Datastream and Citi Investment Research and Analysis

We do not have the answers to all these questions, but they create vulnerabilities that may well expand as the euro area economies weaken. The Euro Area crisis has deep economic roots, which need to be resolved if a lasting solution is to be found in our view. As a result, we suspect that sovereign strains will not fade anytime soon, creating tight financial and financing conditions that will push the euro area into recession in Q4 and beyond.

Low Interest Rates — and Negative Real Rates — for Extended Period

Against this backdrop, we continue to expect that the ECB will cut rates by 50bp by yearend. In our view, the cut is more likely to come at the December meeting (when new ECB economic forecasts will be released) rather than the November

meeting, given the recent high inflation rates. We then expect the ECB to keep the official policy rates stable for an extended period, with unlimited liquidity keeping overnight rates below the policy rate for a while. The ECB is likely to have to continue its SMP programme. The UK MPC has shown its activist nature by the decision to expand QE to £275bn and, with the UK economy likely to be close to recession, we expect the MPC will expand QE markedly further over coming quarters. The next increase will probably come in February, just after the end of the latest £75bn QE programme, but a further expansion of QE could be announced earlier – for example at the November meeting, if the MPC's updated forecasts suggest that the planned extra £75bn will not be enough to prevent inflation undershooting its target.

We continue to expect the Fed to keep policy rates low for an extended period. Deliberations over deficit reduction have yet to yield any visible progress and although we have assumed temporary tax relief will be extended next year, this issue seems likely to hang over financial markets. Similarly, markets have reacted with appropriate caution in our judgment to suggestions that the Fed might consider stepping up purchases of MBS. We suspect the more likely first set of options for monetary policy remain focused on communications and guiding expectations, and that more expansive measures will remain unlikely barring a significant deterioration in the forecast.

Figure 12. Global — Summary of Views of Citi's Market Strategists

	Equities	G10 Rates	Credit	Securitized Products	FX	Commodities	Global Macro Strategy
Overall View	Markets cheap, but need a catalyst	Slowing growth and falling confidence means lower yields and flatter curves	Positioning has improved but market likely to widen further on negative headlines	Market weight	Bullish USD and JPY	Markets could stabilise after harsh 3Q'11. Macro headlines on EU, USD strength and aggregate flows the catalyst in uncertain environment	Cautious risk assets, bullish core FI
Most-Favoured Region/Sector	EM, Japan, UK, Asia Pac ex Japan/ IT, Materials, Cons. Staples	EUR 5yr and GBP long end	Low-beta core non-fins and senior SIFI	US CMBS senior tranches	USD	Gold, Crude oil (due to tight physical market), Agriculture	Core FI
Least-Favoured Region/Sector	US, Australia / Industrials, Utilities, Cons. Disc	EMU non-AAA	French corporates and periphery sub-debt	Spanish and Irish RMBS	EUR, CEEMEA	Base metals, US Natural Gas	Europe, Financials, Commodities and other cyclicals
Key Risks	Major global recession	EMU resolution would trigger dramatic reversal	Policy disappointment; recession; wider sovereign spreads	Regulation	Early QE3 in US	EMU contagion, harsh landing in China, US slowdown, USD rally	EMU periphery, global growth, QE3 in US

Source: Citi Investment Research and Analysis

Figure 13. Selected Countries — Economic Forecast Overview (Percent), 2010-2015F

	GDP Growth						CPI Inflation						Short-Term Interest Rates					
	2010	2011	2012	2013	2014	2015	2010	2011	2012	2013	2014	2015	2010	2011	2012	2013	2014	2015
Global	**4.2**	**3.1**	**2.8**	**3.3**	**3.8**	**3.9**	**2.7**	**4.0**	**3.2**	**3.1**	**3.1**	**3.1**	**2.08**	**2.61**	**2.75**	**2.88**	**3.28**	**3.69**
Based on PPP weights	*5.0*	*3.8*	*3.5*	*4.0*	*4.4*	*4.5*	*3.4*	*4.7*	*3.8*	*3.7*	*3.6*	*3.5*						
Industrial Countries	**2.7**	**1.4**	**1.2**	**1.7**	**2.3**	**2.4**	**1.4**	**2.6**	**1.7**	**1.6**	**1.7**	**1.8**	**0.65**	**0.76**	**0.74**	**0.79**	**1.27**	**2.04**
United States	3.0	1.8	1.9	2.5	3.3	3.5	1.6	3.2	2.0	2.1	2.2	2.2	0.25	0.25	0.25	0.25	1.10	2.65
Japan	4.0	-0.4	2.1	1.2	1.5	1.5	-0.7	0.0	-0.1	-0.2	0.1	0.3	0.10	0.10	0.10	0.10	0.13	0.48
Euro Area	1.8	1.6	-0.3	0.6	1.2	1.3	1.6	2.7	1.9	1.4	1.7	1.8	1.00	1.19	1.00	1.00	1.25	1.5
Canada	3.2	2.2	1.8	2.3	2.5	2.8	1.8	3.0	2.0	2.0	2.0	2.0	0.69	1.00	1.00	1.63	2.19	2.50
Australia	2.7	1.4	3.7	4.1	4.3	3.8	2.8	3.3	2.5	3.3	2.9	2.6	4.44	4.75	4.88	5.19	5.19	5.00
New Zealand	1.7	1.4	2.6	2.9	3.2	3.1	2.3	4.2	2.1	2.3	2.6	2.9	2.81	2.50	3.25	4.25	5.50	5.50
Germany	3.6	3.0	1.0	1.3	1.6	1.8	1.1	2.3	2.0	2.4	2.2	2.2						
France	1.4	1.6	0.1	1.3	1.7	1.5	1.7	2.2	1.8	2.3	1.5	1.6						
Italy	1.5	0.5	-1.0	0.0	0.8	0.9	1.6	2.9	2.6	1.9	1.9	1.9						
Spain	-0.1	0.6	-0.8	0.0	0.8	0.9	2.0	3.0	0.8	1.5	1.7	1.7						
Greece	-4.4	-5.6	-4.9	-2.0	-1.0	-0.5	4.7	3.1	1.3	1.3	1.4	1.5						
Portugal	1.3	-2.0	-5.7	-3.8	-0.4	1.2	1.4	3.5	0.8	0.5	1.0	0.8						
Netherlands	1.6	1.3	0.4	1.0	1.7	1.8	1.3	2.3	1.8	1.9	1.8	2.0						
Belgium	2.3	2.3	0.8	1.8	2.3	2.1	2.2	3.5	2.5	2.0	1.9	2.3						
Norway	2.1	2.7	2.9	3.0	2.7	2.7	2.4	1.4	1.8	2.2	2.3	2.4	1.91	2.18	2.30	2.82	3.53	4.25
Sweden	5.4	4.3	2.1	2.6	2.7	2.6	1.2	3.0	2.0	2.2	2.3	2.1	0.50	1.76	2.00	2.30	3.25	4.00
Switzerland	2.7	2.1	1.2	1.2	1.2	1.2	0.7	0.3	-0.2	-0.6	-0.2	0.1	0.22	0.44	0.00	0.00	0.00	0.00
United Kingdom	1.8	0.9	0.7	1.1	1.9	2.5	3.3	4.5	3.0	2.5	2.5	2.3	0.50	0.50	0.50	0.50	1.06	2.04
Emerging Markets	**7.3**	**6.0**	**5.3**	**5.9**	**6.1**	**6.1**	**5.3**	**6.5**	**5.6**	**5.4**	**5.0**	**4.9**	**5.02**	**5.90**	**6.06**	**6.17**	**6.27**	**6.04**
China	**10.4**	**9.1**	**8.7**	**8.5**	**8.3**	**8.1**	**3.3**	**5.5**	**4.1**	**4.0**	**4.0**	**4.0**	**2.31**	**3.22**	**3.50**	**3.75**	**4.00**	**4.00**
Hong Kong	7.0	5.6	4.5	4.0	4.0	4.0	2.4	5.3	4.0	3.0	3.5	3.5	0.25	0.93	0.54	0.80	1.30	2.50
India	8.5	7.6	7.5	8.1	8.4	8.5	8.6	9.5	7.5	7.0	6.0	6.0	5.96	8.19	8.06	7.50	7.50	7.50
Indonesia	6.1	6.5	6.3	6.5	6.7	7.0	5.1	5.0	6.2	6.5	6.5	6.5	6.50	6.63	6.00	6.50	6.75	7.00
Korea	6.2	3.7	3.9	4.1	4.5	4.0	3.0	4.5	3.5	3.2	3.1	3.0	2.68	3.53	3.58	3.90	4.50	5.00
Singapore	14.5	5.3	3.3	5.0	5.0	5.0	2.8	5.1	3.0	2.5	2.5	2.5	0.56	0.44	0.50	2.30	2.80	3.20
Czech Republic	2.3	1.9	0.6	2.4	3.3	3.8	1.5	1.9	2.7	2.2	2.6	2.0	0.83	0.75	0.75	1.19	2.04	2.90
Hungary	1.2	1.1	0.5	2.3	2.6	2.9	4.7	3.9	5.0	3.4	3.0	3.1	5.48	6.02	6.73	6.13	5.69	5.50
Poland	3.8	3.8	1.9	3.4	3.5	3.4	2.7	4.2	3.0	2.6	2.5	2.5	3.50	4.25	4.15	4.00	4.65	5.00
Romania	-1.3	1.5	1.7	4.0	4.5	4.6	6.1	5.8	3.4	3.0	3.0	3.0	6.54	6.25	5.13	5.00	5.00	5.00
Russia	4.0	4.0	2.5	4.2	4.0	4.0	6.9	8.6	6.3	6.1	5.5	5.5	7.75	8.25	7.50	6.00	6.00	5.50
Turkey	9.0	7.3	2.5	4.9	4.4	4.5	8.6	6.4	8.5	6.7	6.2	5.7	6.50	5.75	6.75	8.00	8.00	7.50
Nigeria	7.2	7.1	6.7	6.5	6.9	7.2	13.7	11.3	13.8	9.4	10.3	9.5	6.08	8.98	14.00	12.50	10.50	10.00
South Africa	2.8	3.0	2.9	3.9	4.4	4.3	4.1	4.9	5.6	5.8	5.6	5.5	6.41	5.50	5.83	7.25	8.50	8.75
Argentina	9.2	8.5	5.0	3.5	3.5	3.5	18.4	25.0	20.0	25.0	22.5	15.0	10.19	14.04	19.52	18.85	16.50	14.00
Brazil	7.5	3.3	3.5	4.5	4.5	4.5	5.0	6.6	5.7	4.5	4.0	4.0	9.80	10.88	10.75	10.75	10.25	9.00
Mexico	5.4	3.8	3.0	3.4	3.7	3.8	4.2	3.3	3.6	3.7	3.9	3.8	4.40	4.50	4.50	5.38	7.00	7.00
Venezuela	-1.4	3.5	3.9	2.3	2.5	2.4	28.2	26.8	26.5	28.0	26.0	29.0	14.52	14.80	13.90	21.00	21.00	21.00

Source: Citi Investment Research and Analysis

Figure 14. Selected Countries — Economic Forecast Overview (Percent), 2010-2015F

	Current Balance (Pct of GDP)						Fiscal Balance (Pct of GDP)						Government Debt (Pct of GDP)					
	2010	2011	2012	2013	2014	2015	2010	2011	2012	2013	2014	2015	2010	2011	2012	2013	2014	2015
Global	**0.2**	**0.1**	**0.0**	**0.2**	**0.2**	**0.1**	**-5.8**	**-5.0**	**-4.1**	**-3.2**	**-2.7**	**-2.4**	**73**	**74**	**74**	**74**	**73**	**72**
Based on PPP weights	*0.6*	*0.3*	*1.9*	*2.2*	*2.3*	*2.2*	*-5.3*	*-4.7*	*-4.0*	*-3.2*	*-2.8*	*-2.6*						
Industrial Countries	**-0.8**	**-1.0**	**-0.7**	**-0.6**	**-0.6**	**-0.8**	**-7.4**	**-6.7**	**-5.2**	**-3.9**	**-3.1**	**-2.7**	**101**	**106**	**109**	**110**	**110**	**111**
United States	**-3.2**	**-3.1**	**-2.8**	**-2.7**	**-2.9**	**-3.2**	**-9.7**	**-9.3**	**-6.9**	**-5.8**	**-4.9**	**-4.9**	**94**	**99**	**104**	**105**	**105**	**106**
Japan	**3.6**	**2.1**	**2.0**	**2.5**	**2.8**	**2.8**	**-9.8**	**-10.3**	**-9.2**	**-8.5**	**-8.2**	**-7.8**	**225**	**239**	**245**	**251**	**255**	**259**
Euro Area	**-0.5**	**-0.8**	**-0.9**	**-0.9**	**-0.8**	**-0.8**	**-6.2**	**-4.4**	**-3.6**	**-2.8**	**-2.1**	**-1.5**	**85**	**89**	**91**	**91**	**91**	**90**
Canada	-3.1	-3.4	-3.9	-3.1	-3.1	-2.7	-2.5	-1.9	-1.1	-0.5	0.0	0.2	34	34	34	33	32	30
Australia	-2.7	-2.3	-2.0	-4.7	-5.4	-5.5	-4.2	-3.4	-1.8	0.2	0.2	0.3	3	6	7	7	6	6
New Zealand	-4.1	-3.9	-5.3	-6.3	-7.7	-8.4	-4.0	-8.0	-6.0	-3.0	-0.5	0.0	14	21	27	30	32	32
Germany	5.7	5.0	4.0	4.0	4.5	4.7	-4.3	-1.7	-1.3	-0.6	-0.1	0.2	84	85	88	89	87	84
France	-1.7	-2.7	-2.4	-1.5	-0.8	0.0	-7.1	-5.6	-4.7	-4.0	-3.0	-2.0	82	85	93	96	96	95
Italy	-3.5	-3.8	-3.3	-3.0	-2.9	-2.8	-4.6	-4.0	-2.8	-1.5	-1.2	-0.7	119	121	123	123	121	120
Spain	-4.6	-3.8	-3.0	-2.7	-2.4	-2.2	-9.3	-8.2	-7.6	-5.8	-5.6	-5.6	61	71	79	83	89	93
Greece	-10.4	-9.2	-4.5	-2.9	-2.9	-1.9	-10.6	-10.5	-6.8	-4.1	1.3	0.5	145	114	127	128	129	128
Portugal	-10.5	-8.7	-6.3	-3.4	-2.0	-1.9	-9.8	-6.7	-6.3	-2.5	-2.7	-2.3	93	110	92	94	99	102
Netherlands	7.2	8.0	7.1	7.0	6.9	7.0	-5.1	-3.0	-2.4	-2.0	-1.2	0.0	63	65	68	69	68	66
Belgium	1.5	1.0	1.1	1.8	2.7	3.7	-4.1	-3.5	-2.9	-2.0	-1.0	0.0	96	95	103	101	98	95
Norway	12.4	14.0	14.3	14.9	15.2	15.8	10.6	12.0	12.5	13.5	15.0	19.0	NA	NA	NA	NA	NA	NA
Sweden	6.6	6.4	6.5	6.6	6.7	6.9	-0.2	0.2	0.4	1.1	2.0	3.1	39	36	34	31	28	27
Switzerland	14.5	14.7	13.2	13.4	14.5	15.5	0.2	0.3	0.6	0.6	0.9	0.9	55	53	51	50	48	47
United Kingdom	-2.5	-0.2	1.8	3.2	3.7	3.8	-9.3	-8.2	-7.2	-5.6	-4.0	-2.5	76	82	86	89	90	88
Emerging Markets	**2.4**	**2.0**	**1.2**	**1.4**	**1.4**	**1.3**	**-2.6**	**-2.1**	**-2.3**	**-2.1**	**-2.0**	**-2.0**	**16**	**16**	**16**	**17**	**17**	**16**
China	**5.2**	**4.0**	**3.2**	**2.8**	**2.5**	**2.0**	**-1.6**	**-2.0**	**-2.0**	**-2.0**	**-2.0**	**-2.0**	**21**	**20**	**21**	**21**	**21**	**21**
Hong Kong	6.2	7.0	6.3	10.0	10.0	10.0	4.2	2.9	3.0	2.5	2.0	2.0	1	1	2	2	3	3
India	-2.6	-2.9	-2.3	-1.4	-0.7	-0.3	-8.1	-8.3	-7.1	-7.0	-6.0	-6.0	69	67	65	62	60	58
Indonesia	0.9	0.1	-0.3	-0.5	-0.7	-0.7	-0.6	-1.5	-1.5	-1.5	-1.3	-1.0	26	26	25	24	23	23
Korea	2.8	1.3	1.1	0.8	0.5	-0.5	1.4	0.5	0.7	1.2	1.5	1.4	35	35	34	33	31	30
Singapore	22.2	16.5	15.0	13.0	13.0	12.0	0.5	0.0	2.0	2.0	1.0	1.0	107	110	115	118	120	120
Czech Republic	-3.7	-4.1	-3.5	-4.2	-4.7	-5.7	-4.7	-4.5	-4.0	-3.4	-2.3	-1.5	39	41	44	45	45	44
Hungary	2.1	2.6	2.6	3.2	-2.0	-2.6	-4.2	1.9	-3.0	-3.0	-2.9	-2.9	80	74	75	73	72	71
Poland	-3.4	-4.3	-3.4	-4.0	-5.2	-5.7	-7.9	-5.3	-4.5	-3.2	-2.3	-2.2	53	53	53	52	50	50
Romania	-4.2	-3.5	-4.5	-5.5	-5.5	-5.0	-6.7	-4.5	-3.3	-2.5	-2.0	-1.5	35	37	37	37	36	36
Russia	4.8	4.8	1.9	1.4	-1.3	-1.8	-4.0	-1.4	-3.1	-2.7	-2.3	-1.9	8	9	11	12	13	13
Turkey	-6.5	-9.6	-8.4	-7.4	-6.5	-5.8	-3.6	-1.9	-2.7	-3.0	-3.0	-3.0	43	40	38	36	36	36
Nigeria	6.1	5.9	5.1	5.8	4.5	3.6	-2.3	-3.2	-2.7	-2.0	-2.4	-2.8	NA	NA	NA	NA	NA	NA
South Africa	-2.7	-3.4	-4.0	-6.2	-6.6	-6.4	-5.2	-5.5	-5.5	-5.2	-4.7	-4.3	34	39	42	44	45	46
Argentina	1.0	-0.2	-0.6	0.3	-0.1	-0.1	0.2	-0.6	1.0	1.5	2.1	2.3	49	49	49	50	52	53
Brazil	-2.3	-2.4	-3.0	-2.5	-2.2	-2.0	-2.5	-2.5	-2.5	-2.2	-2.4	-2.4	63	63	63	70	70	71
Mexico	-0.5	-1.1	-2.6	-2.6	-2.7	-2.7	-2.8	-2.5	-2.0	-1.9	-1.9	-1.9	43	42	42	42	42	42
Venezuela	3.7	11.6	11.0	5.0	4.9	4.7	-6.6	-5.0	-5.0	-5.5	-5.9	-5.8	38	40	33	39	41	40

Note: Fiscal deficit and debt figures for all countries are general government debt and deficits. We assume sovereign debt restructuring in Greece, Ireland and Portugal in 2011-12.
Source: Citi Investment Research and Analysis

Figure 15. Selected Countries — Changes in Economic Forecast from the Previous Month (Percentage Points), 2011-2013F

	GDP Growth			CPI Inflation			Current Balance (Pct of GDP)			Fiscal Balance (Pct of GDP)		
	2011	2012	2013	2011	2012	2013	2011	2012	2013	2011	2012	2013
Global	**0.1**	**-0.1**	**-0.1**			**-0.1**	**0.1**	**0.1**	**0.2**		**-0.2**	
Based on PPP weights		-0.1	-0.1			-0.1	0.1		0.1		-0.2	0.1
Industrial Countries		**-0.1**				**-0.1**		**0.2**	**0.2**	**-0.2**	**-0.4**	
United States	**0.1**				**0.1**					**-0.2**	**-0.5**	**-0.4**
Japan			**0.3**		**0.2**	**-0.1**		**-0.1**			**-0.2**	
Euro Area		**-0.1**				**-0.4**	**-0.1**	**0.2**	**0.2**	**-0.1**	**-0.2**	**-0.4**
Canada	0.1			0.2			-0.1	-0.4	-0.6			
Australia										0.2		
New Zealand												
Germany						0.2	0.1	0.2	0.2		0.2	0.3
France		-0.1	0.1					-0.1				
Italy				-0.1	-0.1							
Spain		-0.1		0.1	0.1					-1.4	-1.4	
Greece				-0.1	0.1					-0.1		
Portugal				0.1	0.1					-0.7	-1.6	
Netherlands												
Belgium												
Norway												
Sweden												
Switzerland								0.2	0.2			
United Kingdom	-0.1		-0.3	0.1	0.1		1.2	1.7	2.1	0.1		0.9
Emerging Markets	**-0.1**	**-0.3**	**-0.1**		**-0.1**	**-0.1**	**0.2**	**-0.1**	**0.2**	**0.2**	**0.1**	**0.2**
China	**0.1**			**0.2**	**-0.1**							
Hong Kong							-1.3	-3.0				
India		-0.7	-0.7				0.1		0.1			
Indonesia												
Korea							-0.1					
Singapore												
Czech Republic				0.1	0.2							
Hungary	-0.3	-0.6	0.3		0.2	0.3	-0.4	-1.7	4.0			
Poland							0.1					
Romania	-0.1	-0.3	-0.3	-0.4	-0.3		0.7	0.5			-0.3	
Russia				-0.2	-0.9	-0.4						
Turkey				0.4	1.0							
Nigeria				0.4	0.8	-1.1	-2.9	-1.3	-0.1	-0.9	-0.3	-0.2
South Africa		0.1		-0.1	-0.2		-0.1	0.7		0.1	0.1	
Argentina					-2.5	-2.5	-0.1	-1.5				
Brazil	-0.4	-0.5					-0.2	-0.3				
Mexico	-0.3	-0.5		-0.1	-0.2	-0.1						
Venezuela				-0.2	0.2							

Source: Citi Investment Research and Analysis

Figure 16. Selected Countries — Economic Forecast Overview and Exchange Rate Forecasts (Percent), 2010-2015F

	10-Year Yields						Exchange Rates Versus U.S. Dollar*						Exchange Rate Versus Euro					
	2010	2011	2012	2013	2014	2015	2010	2011	2012	2013	2014	2015	2010	2011	2012	2013	2014	2015
Industrial Countries																		
United States	**3.21**	**2.80**	**2.35**	**3.45**	**4.00**	**4.00**	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**	**1.32**	**1.38**	**1.27**	**1.29**	**1.32**	**1.34**
Japan	**1.18**	**1.18**	**1.15**	**1.04**	**1.50**	**1.75**	**87**	**79**	**76**	**78**	**80**	**83**	**114**	**109**	**96**	**100**	**106**	**111**
Euro Area	**2.78**	**2.55**	**1.60**	**1.90**	**2.20**	**2.70**	**1.32**	**1.38**	**1.27**	**1.29**	**1.32**	**1.34**	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**
Canada	3.24	2.90	2.85	3.85	4.00	3.90	1.03	1.01	1.02	0.96	0.96	0.97	1.35	1.40	1.29	1.24	1.26	1.29
Australia	5.55	4.80	4.76	5.50	6.00	6.30	0.94	1.01	1.00	0.96	0.93	0.90	1.41	1.37	1.27	1.34	1.42	1.49
New Zealand	5.87	4.96	4.96	5.70	6.40	6.80	0.73	0.77	0.76	0.67	0.63	0.62	1.81	1.79	1.66	1.93	2.10	2.14
Germany	2.78	2.55	1.60	1.90	2.20	2.70												
France	3.12	3.70	2.85	2.90	3.00	3.30												
Italy	4.00	5.40	5.95	5.90	5.70	5.70												
Spain	4.30	5.45	5.65	5.60	5.30	5.20												
Greece	9.20	19.00	19.10	17.90	14.20	10.70												
Portugal	5.40	11.30	17.60	17.90	14.20	10.70												
Netherlands	3.00	2.95	2.01	2.25	2.50	2.95												
Belgium	3.46	4.85	4.10	3.90	3.80	3.90												
Norway	3.41	2.83	1.91	2.40	2.90	3.35	6.02	5.67	6.13	5.98	5.85	5.75	7.95	7.85	7.79	7.71	7.70	7.69
Sweden	2.89	2.51	1.54	2.05	2.50	3.05	7.09	6.61	7.16	6.86	6.69	6.58	9.36	9.16	9.10	8.85	8.80	8.80
Switzerland	1.57	1.28	0.67	0.70	1.00	1.50	1.01	0.90	0.95	1.02	1.03	1.03	1.33	1.24	1.21	1.31	1.36	1.37
United Kingdom	3.58	1.98	1.95	3.25	3.80	4.00	1.54	1.58	1.52	1.61	1.67	1.70	0.86	0.88	0.83	0.80	0.79	0.79
Emerging Markets																		
China	**2.96**	**3.69**	**3.80**	**4.05**	**4.30**	**4.30**	**6.77**	**6.42**	**6.15**	**5.90**	**5.80**	**5.60**	**9.39**	**8.89**	**7.81**	**7.61**	**7.63**	**7.48**
Hong Kong	1.54	1.20	1.13	2.15	2.75	2.75	7.77	7.78	7.77	7.75	7.75	7.75	10.78	10.77	9.87	9.99	10.20	10.36
India	8.00	8.25	8.25	8.25	8.25	8.25	45.58	46.94	47.50	46.13	45.13	44.13	63.27	64.97	60.37	59.47	59.40	58.96
Indonesia	8.49	7.44	7.00	7.25	7.25	7.25	9092	8884	8975	8675	8650	8625	12621	12298	11407	11186	11386	11526
Korea	4.08	3.87	3.82	5.20	5.45	5.60	1156	1123	1108	1048	1005	980	1605	1555	1408	1351	1323	1310
Singapore	2.41	2.05	2.05	2.80	3.20	3.60	1.36	1.27	1.24	1.19	1.17	1.16	1.89	1.76	1.58	1.53	1.54	1.55
Czech Republic	3.71	3.65	3.67	4.17	4.40	4.40	19.1	17.8	19.5	18.5	17.7	17.0	26.5	24.7	24.8	23.9	23.3	22.7
Hungary	7.97	7.32	7.79	7.61	7.10	6.09	208	208	252	226	215	211	289	288	320	292	284	282
Poland	NA	NA	NA	NA	NA	NA	3.18	3.06	3.43	3.10	2.96	2.92	4.19	4.24	4.36	3.99	3.90	3.90
Romania	NA	NA	NA	NA	NA	NA	3.18	3.06	3.29	3.17	3.04	2.93	4.41	4.23	4.19	4.09	4.00	3.91
Russia	7.27	8.24	7.57	7.59	7.60	7.60	30.4	30.2	33.7	32.3	31.3	30.8	42.2	41.9	42.8	41.6	41.2	41.1
Turkey	NA	NA	NA	NA	NA	NA	1.50	1.74	1.89	1.81	1.74	1.68	2.08	2.40	2.41	2.33	2.29	2.25
Nigeria	NA	NA	NA	NA	NA	NA	151	155	158	160	158	163	210	215	201	207	208	218
South Africa	NA	NA	NA	NA	NA	NA	7.32	7.43	8.40	8.75	9.11	9.50	10.16	10.29	10.67	11.28	12.00	12.69
Argentina	NA	NA	NA	NA	NA	NA	3.90	4.16	5.31	6.08	7.19	8.14	5.41	5.76	6.75	7.84	9.46	10.88
Brazil	12.05	11.97	11.59	10.98	9.74	8.75	1.76	1.72	1.73	1.70	1.73	1.76	2.44	2.38	2.20	2.19	2.27	2.35
Mexico	6.93	6.87	6.45	7.50	8.10	8.00	12.6	12.7	12.9	12.4	12.4	12.7	17.5	17.6	16.4	15.9	16.3	16.9
Venezuela	13.78	12.36	12.00	15.00	15.00	15.00	2.59	4.30	4.30	4.80	4.80	5.30	3.59	5.95	5.47	6.19	6.32	7.08

*Per USD except Euro Area, Australia, New Zealand, United Kingdom. Note: All foreign exchange forecasts are consistent with the rolling forecasts presented in Figure 79. Source: Citi Investment Research and Analysis

Figure 17. Short Rates (End of Period), as of 26 Oct 2011 (Percent)

	Current	4Q 11	1Q 12	2Q 12	3Q 12	4Q 12
United States	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**
Japan	**0.10**	**0.10**	**0.10**	**0.10**	**0.10**	**0.10**
Euro Area	**1.50**	**1.00**	**1.00**	**1.00**	**1.00**	**1.00**
Canada	1.00	1.00	1.00	1.00	1.00	1.00
Australia	4.75	4.50	4.50	4.50	4.50	4.50
New Zealand	2.50	2.50	2.75	3.00	3.50	3.75
Norway	2.25	2.25	2.25	2.25	2.25	2.50
Sweden	2.00	2.00	2.00	2.00	2.00	2.00
Switzerland	0.00	0.00	0.00	0.00	0.00	0.00
United Kingdom	0.50	0.50	0.50	0.50	0.50	0.50
China	**3.50**	**3.50**	**3.50**	**3.50**	**3.50**	**3.50**

Note: The rates shown are overnight rates, except for Denmark, where it is the central bank's seven-day repo rate; Switzerland, where it is the SNB's three-month LIBOR target; and China, where it is the one-year deposit rate. Source: Citi Investment Research and Analysis

Figure 18. 10-Year Yield Forecasts (Period Average), as of 26 Oct 2011 (Percent)

	Current	4Q 11	1Q 12	2Q 12	3Q 12	4Q 12
United States	**2.14**	**2.15**	**2.05**	**2.30**	**2.60**	**2.90**
Japan	**1.01**	**1.10**	**1.20**	**1.05**	**1.10**	**1.30**
Euro Area (Germany)	**2.06**	**1.70**	**1.40**	**1.50**	**1.70**	**1.70**
Canada	2.26	2.55	2.45	2.70	3.00	3.30
Australia	4.38	4.30	4.45	4.60	4.90	5.10
New Zealand	4.44	4.60	4.75	4.90	5.00	5.20
Norway	2.53	2.05	1.80	1.95	2.25	2.35
Sweden	1.85	1.70	1.50	1.60	1.85	1.90
Switzerland	1.02	0.73	0.53	0.66	0.68	0.68
United Kingdom	2.49	2.20	1.85	1.85	2.00	2.00

Note: Bond yields measured on local market basis (semi-annual for the United States, United Kingdom, Canada, Australia, and New Zealand; annual for the rest). The 10-year yield for the Euro Area is the Bund yield.
Source: Citi Investment Research and Analysis

Figure 19. 10-Year Yield Spreads (Period Average), as of 26 Oct 2011

	Spread vs. US$						Spread vs. Germany					
	Current	4Q 11	1Q 12	2Q 12	3Q 12	4Q 12	Current	4Q 11	1Q 12	2Q 12	3Q 12	4Q 12
United States	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**	**9**	**46**	**66**	**81**	**92**	**122**
Japan	**-114**	**-106**	**-86**	**-126**	**-152**	**-162**	**-105**	**-60**	**-20**	**-45**	**-60**	**-40**
Euro Area	**-9**	**-46**	**-66**	**-81**	**-92**	**-122**	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**
Canada	12	40	40	40	41	41	21	87	107	122	132	163
Australia	228	218	244	234	234	224	237	265	310	315	326	347
New Zealand	234	249	275	265	245	235	243	295	341	346	336	357
France	104	69	64	49	28	-22	111	115	130	130	120	100
Italy	402	404	384	369	338	288	409	450	450	450	430	410
Spain	338	374	354	339	308	258	345	420	420	420	400	380
Netherlands	35	-1	-21	-36	-52	-87	42	45	45	45	40	35
Belgium	217	184	184	159	138	78	224	230	250	240	230	200
Norway	38	-11	-26	-36	-37	-57	47	35	40	45	55	65
Sweden	-30	-46	-56	-71	-77	-102	-21	0	10	10	15	20
Switzerland	-111	-143	-153	-165	-194	-224	-112	-97	-87	-84	-102	-102
United Kingdom	36	4	-21	-46	-62	-92	35	50	45	35	30	30

NA Not applicable. Note: Spreads calculated on annual basis (except those of the United Kingdom, Canada, Australia and New Zealand over the United States).
Source: Citi Investment Research and Analysis

Figure 20. Emerging Market Countries — Short Rates Actual and Forecast of Additional Rate Moves (End of Period), as of 26 Oct 2011

Country	Current Rate (%)	by Dec 11	Mar 12	Jun 12	Sep 12	Dec 12	Total Cumulative Rate Moves Expected
South Africa	5.50	0	0	0	50	50	100.00
Turkey	5.75	0	75	25	0	0	100.00
Colombia	4.50	0	50	0	0	25	75.00
Hungary	6.00	25	50	0	0	0	75.00
China	3.50	0	0	0	0	0	0.00
Czech	0.75	0	0	0	0	0	0.00
Korea	3.25	0	0	0	0	0	0.00
Mexico	4.50	0	0	0	0	0	0.00
Philippines	4.50	0	0	0	0	0	0.00
Thailand	3.50	-50	25	25	0	0	0.00
Israel	3.00	-25	0	0	0	0	-25.00
India	8.50	0	0	-25	-25	0	-50.00
Indonesia	6.50	-25	-25	0	0	0	-50.00
Poland	4.50	0	0	-50	0	0	-50.00
Russia	8.25	0	-25	0	0	-50	-75.00
Brazil	11.50	-50	-50	0	0	0	-100.00
Chile	5.25	0	-75	-25	0	0	-100.00

Source: Citi Investment Research and Analysis

Figure 21. Foreign Exchange Forecasts (End of Period), as of 26 Oct 2011

	vs. USD						vs. EUR					
	Current	Dec 11	Mar 12	Jun 12	Sep 12	Dec 12	Current	Dec 11	Mar 12	Jun 12	Sep 12	Dec 12
United States	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**	**1.39**	**1.33**	**1.29**	**1.27**	**1.25**	**1.26**
Japan	**76**	**75**	**75**	**76**	**76**	**76**	**106**	**100**	**97**	**96**	**95**	**96**
Euro Area	**1.39**	**1.33**	**1.29**	**1.27**	**1.25**	**1.26**	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**
Canada	1.01	1.05	1.04	1.02	1.00	0.99	1.41	1.39	1.35	1.31	1.26	1.25
Australia	1.04	0.98	0.98	1.00	1.02	1.01	1.34	1.36	1.33	1.28	1.24	1.25
New Zealand	0.80	0.75	0.75	0.77	0.79	0.76	1.75	1.78	1.74	1.67	1.60	1.66
Norway	5.52	5.92	6.07	6.13	6.19	6.14	7.69	7.86	7.86	7.81	7.76	7.74
Sweden	6.53	7.00	7.15	7.17	7.19	7.11	9.10	9.30	9.26	9.14	9.03	8.96
Switzerland	0.88	0.93	0.95	0.95	0.95	0.97	1.22	1.24	1.23	1.21	1.19	1.22
United Kingdom	1.60	1.55	1.53	1.52	1.51	1.53	0.87	0.85	0.84	0.84	0.83	0.82
China	**6.35**	**6.30**	**6.24**	**6.18**	**6.12**	**6.05**	**8.9**	**8.4**	**8.1**	**7.9**	**7.7**	**7.6**
India	49.5	49.5	48.0	47.5	47.5	47.0	69.0	65.7	62.1	60.6	59.6	59.2
Korea	1132	1150	1130	1120	1100	1080	1578	1527	1463	1428	1380	1361
Poland	3.14	3.40	3.47	3.45	3.44	3.35	4.38	4.51	4.49	4.40	4.32	4.22
Russia	30.6	32.5	33.2	33.6	34.1	33.7	42.6	43.1	43.0	42.9	42.7	42.4
South Africa	7.96	8.11	8.22	8.35	8.47	8.56	11.09	10.77	10.64	10.64	10.63	10.78
Turkey	1.77	1.92	1.92	1.90	1.88	1.86	2.46	2.54	2.49	2.43	2.36	2.35
Brazil	1.77	1.79	1.77	1.74	1.71	1.70	2.46	2.38	2.30	2.22	2.14	2.14
Mexico	13.5	13.3	13.1	13.0	12.8	12.7	18.8	17.6	17.0	16.5	16.1	16.0

Note: All foreign exchange forecasts are consistent with the rolling forecasts presented in Figure 78. Source: Citi Investment Research and Analysis

Figure 22. Foreign Exchange Forecasts (End of Period), as of 26 Oct 2011

	vs. JPY					
	Current	Dec 11	Mar 12	Jun 12	Sep 12	Dec 12
United States	**76**	**75**	**75**	**76**	**76**	**76**
Japan	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**
Euro Area	**106**	**100**	**97**	**96**	**95**	**96**
Canada	75	72	72	74	76	77
Australia	79	74	73	75	77	77
New Zealand	60.4	56.2	56.1	57.8	59.6	58.0
Norway	13.8	12.7	12.4	12.3	12.3	12.4
Sweden	11.6	10.8	10.5	10.5	10.6	10.7
Switzerland	87	81	79	80	80	79
United Kingdom	121	117	115	115	115	117
China	**12**	**12**	**12**	**12**	**12**	**13**
India	1.53	1.52	1.57	1.59	1.60	1.63
Korea	14.92	15.28	15.02	14.82	14.49	14.14
Poland	24.2	22.1	21.7	21.9	22.1	22.8
Russia	2.5	2.3	2.3	2.2	2.2	2.3
South Africa	9.5	9.3	9.2	9.1	9.0	8.9
Turkey	43.0	39.3	39.1	39.7	40.3	41.0
Brazil	43.0	42.0	42.4	43.4	44.5	44.9
Mexico	5.6	5.7	5.7	5.8	5.9	6.0

Note: All foreign exchange forecasts are consistent with the rolling forecasts presented in Figure 78. Source: Citi Investment Research and Analysis

Country Commentary

United States

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The reversal of some temporary drags from the first half has given near-term growth a boost as consumer and business spending have surprised. But we continue to expect below-trend growth on average through next year, with the jobless rate likely to edge up slightly from already elevated levels. Fragile financial supports for growth and continued deleveraging still are important headwinds. Recurring bouts of heightened risk aversion have been a feature of early recovery, and despite the better tone in credit and equities for much of this past month, domestic policy uncertainties still weigh on confidence, posing risks of disappointment.

The Fed's back-to-back easing efforts have given a modest lift to financial conditions, which still remain weaker than norms. Although some officials have kept alive the chances of new support for housing, we think enhanced accommodation is more likely to be in the form of communications strategies to alter rate expectations. Fiscal policy presents a continuing wild card. We think the scheduled expiration of payroll tax relief will be extended but prospects for more substantive longer-term fiscal consolidation remain in limbo, with possible financial market repercussions. Retrenchment among state and local governments is likely to remain a drag on income and employment. Inflation has remained elevated with high-frequency core measures of 2%-2½% running above desired ranges. This has narrowed policy options but also undercut growth. Easing bottlenecks in autos are beginning to ease up one source of price pressure while business pricing intentions have also rolled over. With only limited labour market improvement, wage growth remains anaemic and consumer resistance to higher prices is widely evident. Easing in inflation ahead represents a key prerequisite for sustaining modest recovery in our view.

Figure 23. United States — Economic Forecasts, 2010-12F

					2011				2012			
		2010	**2011F**	**2012F**	**1Q**	**2Q**	**3QF**	**4QF**	**1QF**	**2QF**	**3QF**	**4QF**
GDP	SAAR				0.4%	1.3%	2.8%	1.9%	1.6%	2.0%	2.2%	2.0%
	YoY	3.0%	1.8%	1.9%	2.2	1.6	1.7	1.6	1.9	2.1	1.9	1.9
Domestic Demand	SAAR				0.4	1.3	2.3	1.6	1.6	1.4	2.1	2.0
	YoY	1.8	1.8	1.7	2.5	1.7	1.7	1.4	1.7	1.7	1.7	1.8
Consumption	SAAR				2.1	0.7	2.3	1.9	1.8	1.6	2.1	2.1
	YoY	2.0	2.2	1.8	2.8	2.2	2.1	1.7	1.7	1.9	1.9	1.9
Business Investment	SAAR				2.1	10.3	10.0	5.4	5.3	5.3	7.4	5.1
	YoY	4.4	8.1	6.5	10.0	8.0	7.7	6.9	7.7	6.5	5.9	5.8
Housing Investment	SAAR				-2.4	4.2	-8.4	1.9	7.5	9.0	11.5	12.6
	YoY	-4.3	-3.1	5.2	-2.9	-6.9	-1.2	-1.3	1.1	2.3	7.4	10.2
Government	SAAR				-5.9	-0.9	0.2	-1.5	-1.5	-1.9	-1.6	-1.4
	YoY	0.7	-1.9	-1.4	-1.1	-2.2	-2.4	-2.1	-0.9	-1.2	-1.6	-1.6
Exports	SAAR				7.9	3.6	5.4	5.4	7.0	7.4	7.0	6.7
	YoY	11.3	6.9	6.3	8.9	7.3	6.1	5.5	5.3	6.3	6.7	7.0
Imports	SAAR				8.3	1.4	1.0	3.8	5.8	5.2	5.0	5.0
	YoY	12.5	4.9	4.3	9.6	4.7	2.0	3.6	3.0	4.0	4.9	5.2
CPI	YoY	1.6	3.2	2.0	2.2	3.3	3.8	3.5	2.7	1.9	1.6	1.5
Core CPI	YoY	1.0	1.7	1.9	1.1	1.5	1.9	2.1	2.1	2.1	1.7	1.7
Unemployment Rate	%	9.6	9.0	9.3	8.9	9.1	9.1	9.1	9.2	9.2	9.4	9.4
Federal Gov't Balance (Fiscal Year)	$Bn	-1294	-1299	-1035								
	% of GDP	-9.0	-8.7	-6.7								
General Gov't Balance (Cal Year)	% of GDP	-9.7	-9.3	-6.9								
Federal Debt	% of GDP	63	69	74								
General Gov't Debt	% of GDP	94	99	104								
Assumed WTI Spot Price	US$	79.4	93.6	88.0	94.0	102.6	90.2	87.5	87.8	87.8	88.1	88.4
Current Account	US$bn	-471	-468	-439	-478	-472	-466	-458	-430	-444	-427	-456
	% of GDP	-3.2	-3.1	-2.8	-3.2	-3.1	-3.1	-3.0	-2.8	-2.8	-2.7	-2.9
S&P 500 Profits (US$ Per Share)	YoY	37.8	13.5	4.1	19.2	12.4	12.0	10.9	5.3	4.6	3.7	3.0

Notes: F Citi forecast. YoY Year-to-year percent change. SAAR Seasonally adjusted annual rate
Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, I/B/E/S, Treasury Department, *Wall Street Journal* and Citi Investment Research and Analysis

Japan

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We expect the Japanese economy to grow relatively stably over the forecast period. While exports will probably stall in the first half of 2012 amid the continued slowdown in the global economy, reconstruction demand from the disaster is likely to provide timely offsets. As a result, we expect above-trend growth of 2.1% for 2012. Exports already show signs of slowing, after a sharp rebound driven by the normalisation from the earthquake, reflecting demand weakness in the major trading partners. If, as we anticipate, the EMU crisis will persist in a way that leads to a euro area recession, Japan's exports – to the EU but also to other regions – will likely slow, reflecting higher risk aversion. Moreover, temporary factors that lifted consumer spending in recent months are tapering off. We expect that after likely strong growth in the third quarter, the economy will slow in following quarters.

Meanwhile, reconstruction demand – in both public and private sectors – will likely support economic activity in quarters to come. The Administration plans to propose the third supplementary budget of roughly ¥12tn late October. We estimate that reconstruction demand, including public and housing investment, will be ¥5.5tn in fiscal 2012 following ¥2.1tn in FY2011. This would push up GDP growth in 2012 by around 0.7% points. On the other hand, temporary individual income tax hikes to fund reconstruction are delayed until 2013. Thus, a basic thrust of Japan's fiscal policy is quite different from that in the U.S. and Europe. The BoJ may take additional easing measures depending on external developments. In particular, if upward pressures on the yen intensify amid global risk aversion, the BoJ will most likely take additional actions. Possible policy options include: 1) reducing the interest paid on excess reserves; 2) strengthening its commitment to keep rates low for an extended period; and 3) extending the maximum maturity of JGBs that the BoJ buys under the asset purchase programme, from two years currently. In our view, the third option is most likely. However, as has often been the case in the past, the BoJ's action will likely be passive rather than proactive.

Figure 24. Japan — Economic Forecasts, 2010-12F

					2011				2012			
		2010	2011F	2012F	1Q	2Q	3QF	4QF	1QF	2QF	3QF	4QF
Real GDP	YoY	4.0%	-0.4%	2.1%	-0.7%	-1.1%	-0.2%	0.7%	2.3%	3.0%	1.5%	1.5%
	SAAR				-3.7	-2.1	8.0	1.0	2.7	0.6	1.5	1.2
Domestic Demand	YoY	2.2	0.3	2.5	-0.5	0.2	0.3	1.1	2.8	3.1	2.1	2.1
	SAAR				-2.9	0.8	5.7	1.0	3.8	2.0	1.5	1.0
Private Consumption	YoY	1.9	-0.6	1.1	-0.9	-0.5	-0.8	-0.1	0.9	1.2	0.8	1.4
	SAAR				-2.5	-0.1	3.0	-0.7	1.5	1.2	1.5	1.4
Business Investment	YoY	2.5	0.5	3.7	2.2	-1.3	-0.1	1.4	3.5	4.7	3.4	3.1
	SAAR				-5.5	-3.6	9.5	6.0	2.6	1.0	4.1	4.8
Housing Investment	YoY	-6.5	3.2	5.9	5.1	3.2	4.1	0.3	1.3	4.9	5.4	12.0
Public Investment	YoY	-3.5	-3.2	15.0	-13.5	-4.0	0.8	5.5	19.0	22.0	13.5	6.0
Exports	YoY	24.1	0.7	2.0	6.4	-5.1	0.0	2.0	1.3	5.3	0.5	1.0
	SAAR				0.0	-18.1	27.0	4.1	-2.9	-4.4	5.6	6.2
Imports	YoY	9.8	5.3	5.6	8.5	3.3	3.7	5.7	5.1	6.6	5.3	5.5
	SAAR				5.8	-0.2	12.4	5.2	3.6	5.5	6.9	6.2
CPI	YoY	-0.7	0.0	-0.1	0.0	0.1	0.0	0.0	0.1	-0.1	-0.2	-0.3
Core CPI	YoY	-1.0	-0.2	-0.1	-0.8	-0.3	0.2	0.1	0.1	-0.1	-0.2	-0.3
Nominal GDP	YoY	1.7	-2.3	1.1	-2.9	-3.3	-2.1	-0.8	1.1	2.2	0.6	0.7
Current Account	¥ tn	17.2	9.9	9.4	13.0	7.4	9.0	10.2	9.8	8.8	9.3	9.9
	% of GDP	3.6	2.1	2.0	2.8	1.6	1.9	2.2	2.1	1.9	2.0	2.1
Unemployment Rate	%	5.1	4.7	4.6	4.9	4.6	4.7	4.6	4.7	4.6	4.6	4.6
Industrial Production	YoY	16.6	-3.0	2.3	-2.5	-6.8	-1.7	-0.9	1.0	4.9	1.3	2.0
Corporate Profits (Fiscal Year)	YoY	50.0	2.0	13.5								
General Govt. Balance (Fiscal Year)	% of GDP	-9.8	-10.3	-9.2								
General Govt Debt	% of GDP	225	239	245								

F Citigroup forecast. SAAR Seasonally adjusted annual rate. YoY Year-to-year percent change. Corporate profits are TSE-I nonfinancials consolidated recurring profits.
Source: Citi Investment Research and Analysis

Euro Area

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The details of the European Summit are not available at the time of writing. While we do not expect a bold “comprehensive package”, some steps will be taken, probably including a debt restructuring of between 50% and 60% as part of the PSI of the second Greece package. In order to limit the negative impact of debt restructuring on the European financial sector, banks have to increase their Core Tier 1 to 9% by summer 2012. For those unable to raise funding in the market, governments will provide the requested capital, if necessary with support from the EFSF. Moreover, the EFSF is likely to get an increase of its firepower to support bond markets in Spain and Italy. However, we expect that Ireland and Portugal will follow Greece into sovereign debt restructuring in 2012, mainly because of ‘political contagion’.

Even if it comes in a relatively orderly way through PSI, we expect that the Greek debt restructuring will have negative repercussions on euro area GDP and we have revised down our 2012 forecast again slightly to -0.3%. Despite the support measures for the banking sector, we expect that tighter financing conditions will be a headwind for the economy. In addition we expect that the financial support from the EFSF will come only in combination with additional austerity measures, which are likely to dampen growth as well. We do not expect that the ECB will react positively to the Council decisions by announcing ongoing purchases under the SMP. However, we expect that the ECB will have to increase its support for euro area bond markets at a later stage. After providing liquidity support measures in October – the last meeting of President Jean-Claude Trichet – we expect no additional non-standard measures in the first ECB Council meeting chaired by Mario Draghi in November. With inflation probably around 3.0% in October, the ECB is likely to leave rates unchanged in November. However, with more signs of a contraction in GDP, we expect the ECB to cut interest rates by 50bp before year-end.

Figure 25. Euro Area — Economic Forecasts, 2010-12F

					2011				2012			
		2010	2011F	2012F	1Q	2Q	3QF	4QF	1QF	2QF	3QF	4QF
Real GDP	YoY	1.8%	1.6%	-0.3%	2.4%	1.6%	1.4%	0.8%	-0.1%	-0.3%	-0.5%	-0.2%
	SAAR				3.1	0.7	0.7	-1.2	-0.4	-0.2	-0.3	0.0
Final Domestic Demand	YoY	0.4	0.8	-0.4	1.4	0.7	0.7	0.4	-0.3	-0.3	-0.6	-0.5
Private Consumption	YoY	0.9	0.5	-0.2	0.9	0.5	0.5	0.2	-0.1	0.1	-0.3	-0.3
Government Consumption	YoY	0.4	0.2	-0.8	0.7	0.3	0.1	-0.2	-0.7	-0.8	-0.8	-0.7
Fixed Investment	YoY	-0.9	2.3	-0.7	3.8	1.7	1.9	1.8	-0.4	-0.8	-1.1	-0.6
— Business Equipment	YoY	2.1	3.6	-1.4	5.4	3.6	3.3	2.0	-0.2	-1.6	-2.1	-1.7
— Construction	YoY	-4.3	0.4	-1.4	1.8	-0.5	-0.4	0.5	-2.1	-1.7	-1.3	-0.7
Stocks (Contrib. to Y/Y GDP Growth)		0.7	0.3	-0.1	0.5	0.4	0.2	0.1	-0.1	-0.2	-0.1	0.0
Exports	YoY	10.1	5.0	0.7	8.8	5.3	3.9	2.2	0.8	0.5	0.3	1.2
Imports	YoY	9.2	4.4	0.4	8.3	4.5	3.1	1.9	0.1	0.2	0.3	0.9
CPI	YoY	1.6	2.7	1.9	2.5	2.8	2.7	3.0	2.3	2.1	1.9	1.4
Core CPI	YoY	1.0	1.4	1.1	1.1	1.6	1.3	1.8	1.4	1.3	1.2	0.6
CPI Ex Energy and Food	YoY	1.0	1.7	1.3	1.3	1.8	1.7	2.1	1.6	1.7	1.3	0.7
Unemployment Rate	YoY	10.1	10.0	10.3	10.0	10.0	10.0	10.1	10.2	10.2	10.3	10.3
Current Account Balance	EUR bn	-43.2	-75.9	-83.1								
	% of GDP	-0.5	-0.8	-0.9								
General Government Balance	EUR bn	-571.5	-413.8	-343.3								
	% of GDP	-6.2	-4.4	-3.6								
General Government Debt	EUR bn	7822.4	8371.2	8664.5								
	% of GDP	85.4	88.6	90.5								
Gross Operating Surplus	YoY	3.7	2.4	-0.6								

Sources: Eurostat and Citi Investment Research and Analysis

Germany

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Available data suggest that GDP growth in 3Q rebounded to around 0.7% QQ after the soft patch in 2Q (0.1% QQ). However, the substantial fall in sentiment indicators and the drop in incoming orders point to a contraction in GDP in 4Q. In 2012 we expect the German economy to expand at a modest pace. The likely negative repercussions of multiple defaults in the euro area and weaker global demand should cap expansion, mainly through lower export growth. The expected slowdown in exports will probably also lead to higher unemployment, but we expect that with higher wage growth and some moderation in inflation, private consumption will expand next year. After getting an “own-majority” for the extension of the EFSF, Angela Merkel’s coalition looks somewhat more settled. However, the coalition remains fragile in our view.

France

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We believe that the French government could cut its 2012 GDP forecast only three weeks after announcing a 1.75% baseline for the budget currently being debated in Parliament. It appears that the combination of the lower 0.9% consensus forecast (Citi 0.1%) and Moody’s warning that it would re-assess France’s Aaa stable outlook in three months' time has finally been heeded. A supplementary budget is probably necessary before year-end in order to convince the rating agencies and investors that its public finance strategy is sound. We believe that a rating downgrade remains unlikely at this stage, but the risks of a negative outlook have increased significantly. The onus will be on the main contenders for the French presidential election to present credible medium-term fiscal consolidation programmes.

Italy

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With thanks to Alessandra Gaia

Available coincident and leading indicators suggest that Italian GDP fell back into recession in 3Q. We still expect weak economic growth in 2011 overall and we expect the country to stay in recession in 2012. Recent austerity packages will help to reduce the fiscal deficit but at the expense of economic growth. Therefore we do not expect the general government deficit to reach the government target of “close-to-zero” by 2013. The new fiscal package may be partly offset by significantly higher funding costs amid the escalation of the sovereign debt crisis. We expect the debt-to-GDP ratio to stabilise just above 120%, but a near-term reduction looks unlikely to us. Recent political turmoil has increased the likelihood of early elections being called before the scheduled date of spring 2013.

Figure 26. Germany, France and Italy — Economic Forecasts, 2010-12F

		Germany			France			Italy		
		2010	2011F	2012F	2010	2011F	2012F	2010	2011F	2012F
Real GDP	YoY	3.6%	3.0%	1.0%	1.4%	1.7%	0.1%	1.5%	0.5%	-1.0%
Final Domestic Demand	YoY	1.7	2.3	1.6	0.8	1.2	-0.1	0.9	0.4	-1.5
Private Consumption	YoY	0.6	1.1	1.4	1.3	0.8	0.0	1.0	0.7	-0.9
Fixed Investment	YoY	5.4	7.9	3.5	-1.3	3.1	-0.8	2.4	0.0	-2.5
Exports	YoY	13.4	8.3	3.5	9.3	4.4	3.1	8.9	3.5	0.2
Imports	YoY	11.5	7.9	4.3	8.3	5.8	2.1	10.3	1.8	-2.4
CPI	YoY	1.1	2.3	2.0	1.7	2.2	1.8	1.6	2.9	2.6
Unemployment Rate	%	7.1	6.1	6.2	9.4	9.2	9.3	8.4	8.1	8.5
Current Account	€bn	141.1	128.1	105.8	-33.9	-55.1	-48.7	-53.5	-60.8	-54.7
	% of GDP	5.7	5.0	4.0	-1.7	-2.7	-2.4	-3.5	-3.8	-3.3
General Govt. Balance	€bn	-106.0	-43.9	-34.6	-136.5	-113	-96.5	-71.2	-63.7	-44.8
	% of GDP	-4.3	-1.7	-1.3	-7.1	-5.6	-4.7	-4.6	-4.0	-2.8
General Govt. Debt	% of GDP	84.0	84.7	87.7	81.7	84.7	92.6	119.0	121.0	123.0
Gross Trading Profits	YoY	10.5	0.8	-2.3	5.3	3.0	1.0	NA	NA	NA

F Citi forecast. YoY Year-to-year growth rate. Note: The German annual figures are derived from quarterly Bundesbank data and adjusted for working days. Forecasts for GDP and its components are calendar adjusted. Sources: Deutsche Bundesbank, Statistisches Bundesamt, INSEE, and Citi Investment Research and Analysis

Spain

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With thanks to Alessandra Gaia

We expect stagnation in GDP in 3Q and a new recession to start in 4Q. The country is suffering from the recent escalation of the sovereign debt crisis. Furthermore the downgrade of the sovereign rating by the main rating agencies earlier this month has contributed to a further tightening in financing conditions. We have revised our 2011 deficit forecast from 6.8% to 8.2% of GDP, more than 2% above the 2011 government target of 6%. In our opinion, a reduction of the fiscal deficit to 3.0% of GDP by 2013 looks difficult to achieve. On the political scene, according to opinion polls it seems the main centre-right opposition party (PP) is likely to get an absolute majority in general elections on November 20. In our view, as a new government comes to power, slippages on the fiscal front are quite likely to emerge.

Greece

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With thanks to Alessandra Gaia

While the Eurogroup has already approved the next tranche of the first Greek programme, the latest Troika report highlights that there is need of a larger haircut. We expect a Greek debt restructuring with haircuts of 50%-60% as part of the PSI before year-end. In our view, the second Greek programme may include the requirement that the Troika has more control of the implementation of the austerity measures. In the meantime, continued fiscal austerity, and tighter financing conditions will likely keep the economy in recession. We forecast a sharp contraction of GDP in 2011 (-5.6%) and an ongoing deep recession in 2012/2013. With lower interest payments we expect a smaller fiscal deficit from 2012 onwards, but we do not expect that Greece will achieve a primary surplus before 2014.

Portugal

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With thanks to Alessandra Gaia

We think that the debt restructuring in Greece will quickly spread through political contagion to Portugal, where we see haircuts of around 35%-40% likely to occur in 2012. We expect a deep recession in 2012 (-5.7%), a much sharper contraction than the recently-updated government estimate of -2.8%. We see the general government deficit-to-GDP ratio at end of 2011 at 6.7%, not achieving the government target of 5.9%.

Figure 27. Spain, Greece and Portugal — Economic Forecasts, 2010-12F

		Spain			Greece			Portugal		
		2010	2011F	2012F	2010	2011F	2012F	2010	2011F	2012F
Real GDP	YoY	-0.1%	0.6%	-0.8%	-4.4%	-5.6%	-4.9%	1.3%	-2.0%	-5.7%
Final Domestic Demand	YoY	-1.2	-1.0	-2.2	-5.9	-7.8	-6.4	NA	NA	NA
Private Consumption	YoY	1.3	0.5	-0.8	-4.6	-5.6	-5.2	NA	NA	NA
Fixed Investment	YoY	-7.5	-6.1	-5.8	-8.2	-14.5	-10.7	NA	NA	NA
Exports	YoY	10.3	7.7	-0.2	3.9	-0.1	0.5	NA	NA	NA
Imports	YoY	5.5	1.7	-3.9	-4.8	-9.4	-6.2	NA	NA	NA
CPI	YoY	2.0	3.0	0.8	4.7	3.1	1.3	1.4	3.5	0.8
Unemployment Rate	%	20.1	21.0	21.6	12.5	17.2	20.1	NA	NA	NA
Current Account	€bn	-48.4	-41.3	-33.0	-24.1	-20.2	-9.4	-18.1	-14.8	-10.8
	% of GDP	-4.6	-3.8	-3.0	-10.4	-9.2	-4.5	-10.5	-8.7	-6.3
General Govt. Balance	€bn	-98.2	-90.7	-68.3	-24.1	-23.4	-14.5	-17.0	-11.0	-10.7
	% of GDP	-9.3	-8.2	-7.6	-10.6	-10.5	-6.8	-9.8	-6.7	-6.3
General Govt. Debt	€bn	641.8	730.6	830.1	329	253	272	161	187	157
	% of GDP	61.0	70.6	79.4	144.9	113.7	126.8	93.3	109.5	92.2

F Citi forecast. YoY Year-to-year growth rate. Sources: ISTAT, INE, Haver Analytics, Eurostat, and Citi Investment Research and Analysis

UK

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With gloomy business surveys and – at the time of writing – still major uncertainties stemming from the Euro Area crisis, our growth forecasts on balance are a little weaker than last month. We are trimming this year's GDP growth forecast to 0.9% from 1.0% last month, keeping our 2012 forecast at 0.7% and trimming our 2013 forecast from 1.4% to 1.1%. Within that, recent data suggest that Q3 growth was about 0.5% QoQ, but this may have included a sizeable contribution from inventories, with final domestic demand remaining sluggish. We expect that renewed inventory cutbacks will bring GDP growth close to zero in Q4 and Q1, and there must be a decent chance of one or two negative quarters over the coming year. We assume that the Chancellor will increase planned capital spending by about £4bn in both 2012/13 and 2013/14. The jobless total recently has started to rise again and looks likely to reach 2.9-3 million people (9¼%-9½%) by end-2012.

We expect an unusually slow recovery, so that GDP will not exceed the pre-recession peak (Q1-2008) until Q4-2014, 27 quarters later. This is a far slower recovery path than after the major recessions of the last 50 years. It took 13 quarters for GDP to regain the pre-recession level in the recession/recovery cycles of the early 80s and early 90s, and 14 quarters in the mid-70s. Our forecast even implies a much weaker path than in the 1930s. GDP fell 6.9% from the peak in 1930Q1 to the trough in 1932 Q3 (similar to the drop in the current cycle, which was 7.0%), but then recovered quite quickly, regaining the pre-recession peak in Q1-1934 (16 quarters later) and rising well above that level in 1935 and 1936. In these terms, this recession/recovery cycle will, we expect, be the worst of the last 100 years outside wartime. We continue to expect the MPC will expand QE markedly further, to a total of about £500bn (£275bn announced so far), but do not hold out great hopes that this will generate a significant recovery in demand.

Figure 28. United Kingdom — Economic Forecasts, 2010-2012F

					2011				2012			
		2010	2011F	2012F	1Q	2QF	3QF	4QF	1QF	2QF	3QF	4QF
Real GDP	YoY	1.8%	0.9%	0.7%	1.6%	0.6%	0.5%	1.0%	0.8%	0.9%	0.6%	0.7%
	SAAR				1.7	0.4	1.9	0.2	0.5	1.1	0.5	0.8
Domestic Demand	YoY	2.7	-0.7	0.2	0.0	-0.6	-1.4	-0.7	0.5	0.3	-0.2	0.2
(Incl. Inventories)	SAAR				-4.3	1.2	1.9	-1.4	0.2	0.7	-0.1	-0.1
Consumption	YoY	1.0	-1.1	0.2	-0.4	-1.7	-1.1	-1.0	-0.6	0.5	0.3	0.6
	SAAR				-2.5	-3.1	1.6	0.0	-1.0	1.5	0.7	1.3
Investment	YoY	2.6	-2.2	-1.3	-4.3	-0.6	-2.1	-1.7	1.0	-1.1	-2.0	-2.9
	SAAR				-10.6	6.9	-1.7	-0.5	-0.3	-2.0	-5.1	-4.3
Exports	YoY	6.2	5.7	5.1	9.5	4.3	5.6	3.5	3.0	6.0	5.8	5.6
	SAAR				6.2	-5.2	5.9	7.6	4.2	6.1	5.3	6.6
Imports	YoY	8.5	0.8	3.3	4.1	0.9	-0.3	-1.4	2.4	3.9	3.3	0.0
	SAAR				-11.3	-1.3	5.7	2.2	3.0	4.7	3.3	3.6
Unemployment Rate	%	7.9	8.2	9.1	7.7	7.9	8.3	8.9	9.0	9.1	9.1	9.2
CPI Inflation	YoY	3.3	4.4	4.4	4.1	4.4	4.6	4.6	3.4	2.9	2.7	2.4
Merch. Trade	£bn	-98.5	-90.2	-73.6								
	% of GDP	-6.8	-5.9	-4.6								
Current Account	£bn	-36.7	-3.2	27.8								
	% of GDP	-2.5	-0.2	1.8								
PSNB	£bn FY	136.7	127.7	114.3								
	% of GDP	-9.3	-8.3	-7.1								
General Govt. Balance	% of GDP	-10.2	-9.2	-7.9								
Public Debt	% of GDP	76.0	82.0	85.8								
Gross Nonoil Trading Profits	YoY	4.5	14.8	12.8								

Note: Fiscal deficit shown excluding financial interventions. F Citi forecast. YoY Year-to-year growth rate. Sources: ONS and Citi Investment Research and Analysis

Switzerland

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Business surveys have weakened sharply in recent months as the adverse effects of the very strong CHF and euro slowdown start to hit. We estimate that Q3 growth slowed to about 0.3% QoQ, the weakest since H1-2009, and growth in Q4 may well be similar or a bit softer given the recent slide in surveys. We do not currently expect outright recession but sluggish growth and the likelihood of negative inflation should ensure that the SNB will strongly resist any CHF appreciation and will opportunistically look for chances to weaken the CHF.

Belgium

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Belgium is on track to form a coalition government after clearing some important hurdles on the reform of the state at the start of October. Six parties are holding talks to identify some €10bn of structural savings for the 2012 budget, with an objective of closing the deficit gap by 2015. After more than 16 months without government, Belgium (Aa1/AA+, on review for possible downgrade from Moody's and negative outlooks from S&P and Fitch) is under pressure after the Dexia problems. GDP growth looks set to weaken to around 0.8% in 2012 after 2.3% in 2011.

Sweden

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We expect the slowdown in Swedish growth to be fairly pronounced but are leaving our GDP growth forecast at 4.3% this year and 2.1% in 2012. Even with this slowdown, Sweden should outperform most other EU economies. With underlying inflation well-contained, the Riksbank remains likely to keep the key policy rate unchanged at 2.0% for the rest of this and next year, before slowly continuing its hiking cycle again in 2013.

Norway

Our growth and inflation forecasts are unchanged from last month. Norway will suffer a bit from the slowdown across advanced economies, but the cushion of high oil receipts should ensure that the economy continues to outpace most other European economies. Underlying inflation remains low and, with the currency still strong, the Norges Bank can afford to keep interest rates stable to see how the EMU crisis unfolds.

Figure 29. Switzerland, Belgium, Sweden and Norway — Economic Forecasts, 2010-2012F

		Switzerland			Belgium			Sweden			Norway		
		2010	2011F	2012F	2010	2011F	2012F	2010	2011F	2012F	2010	2011F	2012F
Real GDP	YoY	2.7%	2.1%	1.2%	2.3%	2.3%	0.8%	5.4%	4.3%	2.1%	2.1%	2.7%	2.9%
Final Domestic Demand	YoY	2.2	1.4	2.4	1.1	2.2	0.6	3.8	3.4	2.2	1.9	3.3	3.4
Public Consumption	YoY	1.9	1.6	2.2	0.2	0.2	0.0	1.8	1.1	0.1	2.2	1.8	2.3
Private Consumption	YoY	2.0	1.2	1.5	2.3	1.1	1.0	3.6	2.5	1.9	3.6	2.7	3.2
Investment (Ex Stocks)	YoY	7.2	4.0	4.1	-0.7	5.4	1.2	5.7	9.5	6.1	-3.1	7.6	5.1
Exports	YoY	8.8	5.1	2.3	9.9	5.3	1.9	10.0	8.0	4.4	2.8	2.9	4.5
Imports	YoY	7.4	3.6	5.9	8.7	5.4	1.8	12.1	7.6	4.6	8.1	5.1	4.2
CPI (Average)	YoY	0.7	0.3	-0.2	2.2	3.5	2.5	1.2	3.0	2.0	2.4	1.4	1.8
Unemployment Rate	%	3.9	3.1	3.1	8.3	6.9	7.2	8.4	7.5	7.4	3.6	3.3	3.2
Current Account	% of GDP	14.5	14.7	13.2	1.5	1.0	1.1	6.6	6.4	6.5	12.4	14.0	14.3
General Govt Balance	% of GDP	0.2	0.3	0.6	-4.1	-3.4	-2.9	-0.2	0.2	0.4	10.6	12.0	12.5
General Govt Debt	% of GDP	55	53	51	96.2	95.4	102.7	39.3	36.3	34.2	NA	NA	NA

[a] For Norway, mainland GDP. F Citi forecast. YoY Year-on-year growth rate. Sources: National sources and Citi Investment Research and Analysis

Canada

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The Canadian economic outlook remains unspectacular. The threat of a European recession, a tepid U.S. expansion, and a weaker profile for commodity prices all suggest sub-trend domestic growth through 2013. Near-term depreciation of the Canadian dollar should create some offset, but ongoing competitiveness issues should continue to weigh on exports. Narrower job gains, government layoffs and increased joblessness are likely given moderate growth prospects and downside risks. Lacklustre wage growth, cooling housing activity and outsized financial market losses will probably squeeze incomes, and subsequently consumer spending. The capex revival could falter on flagging business sentiment. CPI inflation is elevated currently, but should wane on reduced energy costs and limited pricing power.

Downside risks include contagion and reduced risk appetite amid the EA sovereign and banking crises; persistent CAD strength; and consumer retrenchment. The first risk has been realised, the second has intensified and the third could occur as household income growth moderates further. Meanwhile, headwinds from the currency and soft U.S. demand have increased, and U.S. political risks will likely become a greater influence over the next few months. While upside risks remain, they have lessened in degree as slower global economic momentum should dampen domestic resource utilisation and inflationary pressures. Risks look tilted to the downside.

In response to recent developments, the BoC eliminated rhetoric in reference to accommodation removal and is likely to keep rates unchanged until early 2013. Absent significant worsening in the external environment, new fiscal stimulus is unlikely. Bank of Canada rate cuts also have limited scope, given Canada's still relatively strong economic fundamentals and stable financial system, as well as ongoing concern about exacerbating wanton consumer debt accumulation, and lingering upside inflation risks. Alternatively, the BoC may apply additional stimulus by signalling a lengthy period of low interest rates, should conditions warrant it.

Figure 30. Canada — Economic Forecast, 2010-2012F

					2011				2012			
		2010	2011F	2012F	1Q	2Q	3QF	4QF	1QF	2QF	3QF	4QF
Real GDP	YoY	3.2%	2.2%	1.8%	2.9%	2.2%	1.9%	1.7%	1.2%	1.8%	2.1%	2.2%
	SAAR				3.6	-0.4	1.5	2.1	1.6	2.1	2.6	2.5
Final Domestic Demand	YoY	4.5	3.0	2.1	3.7	3.5	2.9	2.2	2.2	2.0	2.1	2.2
	SAAR				1.8	3.0	1.8	2.2	1.8	2.0	2.4	2.4
Private Consumption	YoY	3.3	1.9	2.2	2.1	2.2	2.0	1.4	2.0	2.2	2.3	2.3
	SAAR				-0.1	1.6	2.0	2.2	2.2	2.3	2.4	2.2
Government Spending	YoY	4.7	1.0	-1.6	2.9	2.0	0.5	-1.3	-1.8	-2.4	-1.7	-0.6
	SAAR				0.2	1.5	-2.8	-4.1	-1.7	-0.8	-0.2	0.2
Private Fixed Investment	YoY	8.4	9.3	6.1	10.1	10.0	8.2	8.8	7.3	6.0	6.2	5.1
	SAAR				10.8	9.7	4.6	10.2	4.7	4.4	5.6	5.7
Exports	YoY	6.4	4.2	2.5	6.7	1.5	5.2	3.5	2.0	4.7	1.8	1.8
	SAAR				7.7	-8.3	14.1	1.7	1.6	1.8	2.0	1.9
Imports	YoY	13.1	7.0	2.6	9.5	6.8	5.5	6.2	4.3	2.3	2.0	2.0
	SAAR				9.5	10.0	3.5	2.0	2.0	1.9	2.1	1.9
CPI	YoY	1.8	3.0	2.0	2.6	3.4	3.0	2.9	2.6	2.0	1.9	1.7
Core CPI	YoY	1.7	1.7	2.1	1.3	1.6	1.9	2.1	2.3	2.1	2.0	2.0
Unemployment Rate	%	8.0	7.5	7.3	7.8	7.5	7.2	7.4	7.6	7.6	7.0	7.1
Current Account Balance	C$bn	-50.9	-58.0	-68.5	-40.3	-61.3	-60.6	-69.7	-67.8	-72.6	-69.1	-64.5
	% of GDP	-3.1	-3.4	-3.9	-2.4	-3.6	-3.5	-4.1	-3.9	-4.1	-3.9	-3.6
Net Exports (Pct. Contrib.)		-3.1	-1.6	-0.3	-0.6	-5.7	3.0	-0.3	-0.4	-0.2	-0.3	-0.2
Inventories (Pct. Contrib.)		0.7	0.3	0.0	2.2	2.5	-2.0	0.0	0.0	0.2	0.2	0.1
Budget Balance (Fiscal Year)	% of GDP	-2.5	-1.9	-1.1								
Federal Budget Debt	% of GDP	33.8	34.1	34.1								

F Citi forecast. YoY Year-to-year percent change. SAAR Seasonally adjusted annual rate. Sources: Statistics Canada, and Citi Investment Research and Analysis

Australia

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Recent readings on the economy have been surprisingly resilient, suggesting growth is around trend. The unemployment rate fell slightly to a relatively healthy 5.2%, retail sales, business confidence and consumer sentiment improved and the outlook for business investment continued to build momentum with the approval of another very large gas project. That said, the uncertain global economic outlook has seen a sharp fall in major commodity prices extend to iron ore in recent weeks. This will likely see Australia's terms of trade fall within the next few months, albeit from record levels. The weak Q3 underlying CPI result will likely result in the RBA Board removing 25 bps from the cash rate target at the November meeting. With underlying inflation at the middle of the RBA's target band, monetary policy should be fine-tuned to a more neutral setting around 4.50%. The move would also provide some insurance against downside risks emanating from weaker global economic prospects.

New Zealand

Growth appears to have remained soft in recent months. Business surveys in Q3 were little changed from their flat Q2 readings and the expected boost to activity from the Rugby World Cup was disappointing. More positively, commodity prices in general have held up and inflation expectations have remained contained. The Q3 CPI showed price pressures eased by more than was expected. Consequently, given the uncertain global backdrop, there is no immediate pressure for the RBNZ to reverse the March emergency 50bp rate cut. We continue to see no change in the OCR until the end of Q1 2012.

Figure 31. Australia and New Zealand — Economic Forecast, 2010-2012F

	Australia			New Zealand		
	2010	2011F	2012F	2010	2011F	2012F
Real GDP[a]	2.7%	1.4%	3.7%	1.7%	1.4%	2.6%
Real GDP (4Q versus 4Q)	2.7	1.7	4.1	1.1	1.9	3.1
Real Final Domestic Demand	3.8	3.8	4.3	2.6	2.3	3.1
Consumption	2.8	3.2	3.2	2.3	1.6	2.9
Govt. Current & Capital Spending[b]	9.1	1.4	1.7	2.6	3.2	1.6
Housing Investment	4.2	2.8	3.2	2.7	-15.7	13.9
Business Investment[c]	0.0	11.5	12.4	3.5	6.8	3.6
Exports of Goods & Services	5.7	-2.0	10.0	2.8	3.6	1.5
Imports of Goods & Services	13.7	10.5	7.7	9.9	4.3	3.7
CPI	2.8	3.3	2.5	2.3	4.2	2.1
CPI (4Q versus 4Q)	2.7	3.2	2.9	4.0	2.6	2.2
Unemployment	5.2	5.2	5.0	6.5	6.5	6.2
Merch. Trade, BOP (Local Currency, bn)	16.2	20.1	22.7	3.4	4.1	3.4
Current Account, (Local Currency, bn)	-36.0	-32.9	-31.0	-8.0	-7.9	-11.1
Percent of GDP	-2.7	-2.3	-2.0	-4.1	-3.9	-5.3
Budget Balance[d] (Local Currency, bn)	-54.8	-47.7	-22.6	-8	-16	-12
Percent of GDP	-4.2	-3.4	-1.8	-4	-8	-6
General Govt. Debt (% of GDP)[e]	3.3	5.9	7.2	14.1	20.9	26.8
Gross Trading Profits[f]	12.2	5.8	7.4	NA	NA	NA

Source: Citi Investment Research and Analysis

BOP Balance of payments basis. CPI Consumer Price Index. F Citigroup forecast. NA Not available. [a]Averaged-based GDP in Australia and New Zealand. [b] In New Zealand excludes capital spending. [c] In New Zealand includes government capital spending. [d] Fiscal year ending June. Australia's underlying cash balance. [e]Australia and New Zealand Budget definition and forecasts. [f]Company gross operating surplus. Source: Citi Investment Research and Analysis.

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We have fine-tuned our growth and inflation forecast for 2011 to reflect recent developments. GDP grew by 9.1% in Q3 relative to our forecast of 9.0%. YoY growth of industrial production and retail sales rebounded in September compared with August, and fixed asset investment growth decelerated only slightly. In the meantime, CPI inflation fell slightly to 6.1% YoY in September, confirming the peak of inflation is behind us. However, sticky food inflation slowed the pace of disinflation. Therefore, we revise our 2011 growth forecast up slightly, from 9.0% to 9.1% and also slightly raise our average inflation forecast, from 5.3% to 5.5%.

The economy will likely decelerate more significantly in the next two quarters, but the risk of a hard landing is low. External trade already is feeling the adverse impact of the sluggish global recovery, with export growth falling markedly in September. The EMU sovereign debt crisis and modest US growth will continue to weigh on external demand, while China's monetary and property tightening has yet to show the full impact. We expect that YoY GDP growth will slow further to 8.4% and 8.1% in Q4 2011 and Q1 2012 respectively. The shrinking output gap, weak commodity price, strengthened currency and favourable base effect will likely bring down 12-month inflation from 6.3% in Q3 to 5.0% in Q4. However, leading indicators – such as the manufacturing and non-manufacturing PMIs – do not indicate a hard landing, and the government should have sufficient room to boost domestic demand if there is a threat of sharp slowdown.

While further tightening is unlikely, we do not expect general policy loosening. With the economy expected to cool down and inflation to ease, we think policy tightening has run its course. However, since inflation is still high and the labour market remains tight, the likelihood of policy loosening is limited unless the economy slows a lot further. The government has adopted targeted policies to alleviate the difficulties facing small enterprises, but an outright policy reversal is unlikely. We expect monetary policy will remain prudent, with money and credit growth kept below the PBOC's targets. We continue to expect that policy makers will make more use of the flexibility on the fiscal side to forestall downside risks. Given substantial revenue outperformance so far in the year, the government may choose to increase spending on social housing programmes, the social safety net, and infrastructure (such as irrigation projects).

Figure 32. China — Economic Forecasts, 2010-2012F

					2011				2012			
		2010	2011F	2012F	1Q	2Q	3QF	4QF	1QF	2QF	3QF	4QF
Real GDP	YoY	10.4%	9.1%	8.7%	9.7%	9.5%	9.1%	8.4%	8.1%	8.7%	8.9%	8.9%
Real Final Domestic Demand	YoY	9.8	9.9	9.7								
Consumption	YoY	8.0	9.2	9.6								
Fixed Capital Formation	YoY	11.9	10.7	9.9								
Industrial Production	YoY	15.7	13.8	12.5	14.9	13.9	13.8	13.0	13.0	12.5	12.3	12.0
Exports	YoY	31.3	20.9	11.6	26.4	22.0	20.5	16.0	14.0	12.0	11.0	10.0
Imports	YoY	38.7	24.4	14.4	32.8	23.1	24.8	19.0	16.0	15.0	14.0	13.0
Merchandise Trade Balance	$bn	183.1	171.6	142.2	-0.7	46.7	63.8	61.8	-8.8	39.5	57.1	54.4
FX Reserves	$bn	2,847	3,313	3,656	3,045	3,197	3,202	3,313	3,355	3,444	3,551	3,656
Current Account	% of GDP	5.2	4.0	3.2								
Fiscal Balance	% of GDP	-1.6	-2.0	-2.0								
General Govt. Debt	% of GDP	20.5	20.4	20.6								
Urban Unemployment Rate	%	4.1	4.1	4.0	4.1	4.1	4.0	4.0	4.0	4.0	4.0	4.0
CPI	YoY	3.3	5.5	4.1	5.1	5.7	6.3	5.0	4.6	4.2	3.7	3.9
Exchange Rate (end period)	CNY/$	6.62	6.30	6.05	6.56	6.47	6.35	6.30	6.24	6.18	6.12	6.05
1-Yr Deposit Rate (end period)	%	2.75	3.50	3.50	3.00	3.25	3.50	3.50	3.50	3.50	3.50	3.50

Note: F Citi forecast. E Citi estimate. YoY Year-to-year percent change. SAAR Seasonally adjusted annual rate. Sources: Haver Analytics and Citi Investment Research and Analysis

India

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The 2011 playbook of the exceptional stimulus aiding growth and Euro debt restructuring being pushed to 2013-14 have not played out. This has resulted in further cuts in GDP estimates across the world. While a low exports/GDP ratio, a domestically-financed fiscal deficit, and a healthy banking system insulates India to some extent; in times of risk aversion, India immediately comes on the radar due to its twin deficits and reliance on external capital. Moreover, we believe that India has less manoeuvrability relative to the 2008 pullback given its increased fiscal constraints, elevated levels of inflation and government decision-making. In effect, if the current environment were to deteriorate sharply, India's response could be less effective than in 2008. To reflect recessionary conditions in the advanced economies as well as growth cuts to major EMs such as China, coupled with the continuation of domestic structural policy issues and the lagged impact of ~500bps of tightening, we recently cut our FY13 GDP forecasts from 8.2% to 7.5%.

Following the 9.78% reading in August, inflation in September slowed marginally to 9.72%. More importantly non-food manufactured products came in at 7.5% – a four-month low. We expect primary product inflation to remain elevated due to structural factors at play (rising incomes, rural wages and higher support prices of agri crops). However, we expect the fuel/manufactured product index to come off due to lower commodity prices. (~60% of the inflation basket is linked to commodities). Key would be the extent of decline in commodities being offset by INR weakness. Despite expressing significant concerns on growth and a consequent cut in official GDP estimates from 8% to 7.6%, high inflation levels have resulted in the RBI raising rates by 25bps at its 25 October policy meeting. The RBI has said that the likelihood of a rate action in the Dec review is relatively low.

On the fiscal side, trends in government finances remain unchanged, with the April-August deficit at 66% of budget estimates. We maintain our view of a fiscal slippage due to both lower revenues and higher expenditures. Depending on the timing of the payout to oil companies, the headline FY12 deficit number could come in the 5.1% to 5.8% v/s budget estimates of 4.6% of GDP. The recently announced 2H borrowing calendar was Rs530bn higher than expected. Yields which have crossed 8.7% levels could edge higher, but the rise could be limited to the extent the RBI resorts to open market operations.

Figure 33. India — Economic Forecasts, FY2010/11-2012/13F

		FY 10/11F	FY 11/12F	FY 12/13F
Real GDP	YoY	8.5%	7.6%	7.5%
Final Domestic Demand	YoY	8.1	5.7	6.7
Private Consumption	YoY	8.6	6.6	7.0
Fixed Investment	YoY	8.4	4.0	6.0
Exports	YoY	12.0	16.5	13.0
Imports	YoY	6.3	11.0	8.3
Wholesale Price Index*	YoY	8.6	9.5	7.5
Consumer Price Index	YoY	9.5	8.0	7.0
Unemployment Rate	%	NA	NA	NA
Current Account	US$ bn	-44.3	-55.4	-51.1
	% of GDP	-2.6	-2.9	-2.3
Consolidated Fiscal Balance	% of GDP	-8.1	-8.3	-7.1
Centre Fiscal Balance	% of GDP	-5.1	-5.8	-4.6
US Dollar Exchange Rate	Average	45.6	47.8	47.1

Note: * In India, policymakers look at the wholesale price index. Sources: Haver Analytics and Citi Investment Research and Analysis

Korea

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Amidst financial market turmoil and lower global growth forecasts, production growth in 3Q has showed signs of slowdown. Industrial production (IP) in July-August rose 4.4%YoY, 2.8%p lower than in 2Q11. The reduced growth momentum came from the softer electronic sectors, due to the decline in overseas demand. Meanwhile, service activities and retail sales maintained robust growth, 4.3%YoY and 5.3%YoY in Jul-Aug following 3.3%YoY and 5.7%YoY in 2Q11, on the back of steady job growth (more than 400K from a year ago). With the rapid fall of agricultural goods prices, headline inflation in September stepped down to 4.3%YoY from 5.3%YoY in August and core-inflation also eased to 3.9%YoY, 0.1%p lower than a month ago. We expect IP growth to slow further as exports weaken, reflecting the deceleration of economic growth in advanced economies. The anaemic pace of wage growth, with headline inflation exceeding 4%, is going to be a downside risk to service sector activity and retail sales in coming months. Facing increased uncertainties in global financial markets and economic growth, the BoK will likely continue to hold the policy rate at 3.25% for a while, at least to the end of 1H12 to secure economic growth even if currency weakness keeps inflation pressures high.

Indonesia

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Coincident indicators suggest the economy is still performing well. Consumer confidence reached a two year high in September, while retail sales growth rose to 33% YoY in August. On the external front; exports (using data up to August) were supported by raw commodity shipments, although exports may soften given the decline in prices of many hard and soft commodities in September. Fortunately, domestic demand is more sensitive to inflation than export growth. And so far inflation has been kept at bay, with the September headline reading at 4.6% YoY. Core inflation has indeed been nudging higher, reaching 4.9% YoY, but almost 1ppt of this is due to distortions from gold jewelry prices (which is linked to global commodity prices). On the rates side, Bank Indonesia has cut the BI policy rate by 25bps to 6.50% in October, following a 50bps cut in the rate on the overnight standing deposit facility in September. We believe it will cut further towards 6.00% by Jan 12. The currency has stabilised amid BI intervention, and market liquidity is gradually improving after drying up severely in September. However, given the still-hefty foreign penetration in the bond market (30% of outstanding bonds), the risk of further turbulence is not off the table just yet.

Figure 34. Korea and Indonesia — Economic Forecasts, 2010-12F

		Korea			Indonesia		
		2010	2011F	2012F	2010	2011F	2012F
Real GDP	YoY	6.2%	3.7%	3.9%	6.1%	6.5%	6.3%
Final Domestic Demand	YoY	4.8	1.7	3.9	5.2	7.2	7.7
Private Consumption	YoY	4.1	2.7	3.3	4.6	5.0	4.9
Fixed Investment	YoY	7.0	-0.8	5.6	8.5	9.0	11.1
Exports	YoY	14.5	9.9	6.8	14.9	11.0	7.6
Imports	YoY	16.9	7.8	7.5	17.3	13.3	11.3
Consumer Price Index	YoY	3.0	4.5	3.5	5.1	5.0	6.2
Unemployment Rate	%	3.7	3.5	3.3	7.1	6.8	6.5
Current Account	US$ bn	28.2	14.4	13.1	6.3	0.8	-2.7
	% of GDP	2.8	1.3	1.1	0.9	0.1	-0.3
Fiscal Balance	% of GDP	1.4	0.5	0.7	-0.6	-1.5	-1.5
US Dollar Exchange Rate	Average	1156	1123	1108	9092	8884	8975

Sources: Haver Analytics and Citi Investment Research and Analysis

Hong Kong

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Robust domestic demand and tight labour market conditions, along with the lagged pass-through of rising rental costs, are sustaining near-term inflation pressures. To help alleviate this, the government announced more relief measures (rental and welfare subsidies), targeting the lower-income groups. However, HK remains exposed to external contagion worries, in terms of financial and trade linkages, and these will probably take their toll on HK's economic growth in 2012. Rising risk aversion has began to slow loan growth, but banks continued making loans faster than the growth in deposits, taking the overall Loan/Deposit ratio to a worrying level for HK policymakers (85.9% in Aug). A recent HKMA study warns that tightening liquidity conditions (setting 90% LDR as the benchmark) would raise the different type of interest rates in HK (including HIBORs). Higher funding costs would act as another obstacle for economic growth. The newly-announced guidelines for RMB FDI will likely facilitate more RMB lending, allowing banks to tap the idle RMB deposit pool. The government has committed to increase provision of subsidised housing in response to popular demand by middle income groups. The HKD edged slightly stronger away from the mid-trading band on slightly higher risk appetite; however, gyrations likely to continue in 4Q as capital flows are likely to be influenced by news of US/EU debt issues.

Singapore

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The MAS eased policy modestly by reducing the slope of the band in tandem with initial GDP data showing the economy narrowly escaped technical recession in 3Q. The smaller-than-expected decline in Sep IP suggests upward revisions are possible when the final GDP estimates are released in November, although the Shell refinery fire and spillovers on global technology supply chains from floods in Thailand may impact IP and exports in October. While financial market volatility has hit sentiment-sensitive consumer purchases, the resilience in the labour market should provide a base of support. Electronics restocking will likely drive a small QoQ expansion in 4Q, although this will not be sustained if final demand remains tepid. Our below-consensus 3.3% GDP forecast for 2012 anticipates a trough in 1Q12, and implies a smaller, but still positive output gap in 2012. This, together with a further reduction in COE quotas, should keep inflation elevated at 3% in 2012. Even though the MAS's growth forecast is more cautious than ours, its inflation forecasts of 2.5-3.5% for 2012 is similar to ours. This suggests some recognition that the growth-inflation trade off has worsened, because of reduced immigration, as part of the shift towards more inclusive growth. Policymakers hope the growth slowdown will cool the property market. But, with tight supply and low interest rates lifting private home sales in September, the risk of further property tightening, including restrictions on foreign ownership, remains.

Figure 35. Hong Kong and Singapore — Economic Forecasts, 2010-12F

		Hong Kong			Singapore		
		2010	2011F	2012F	2010	2011F	2012F
Real GDP	YoY	7.0%	5.6%	4.5%	14.5%	5.3%	3.3%
Final Domestic Demand	YoY	6.2	6.5	3.9	5.5	3.6	3.7
Private Consumption	YoY	6.2	8.2	3.7	4.2	4.7	3.4
Fixed Investment	YoY	7.8	2.7	4.7	5.1	2.5	3.6
Exports	YoY	16.8	4.9	5.2	19.2	4.2	4.8
Imports	YoY	17.3	4.7	4.8	16.6	4.0	6.0
CPI	YoY	2.4	5.3	4.0	2.8	5.1	3.0
Unemployment Rate	%	4.4	3.4	3.5	2.2	2.1	2.3
Current Account	US$ bn	13.9	16.9	16.5	49.5	43.5	43.0
	% of GDP	6.2	7.0	6.3	22.2	16.5	15.0
Fiscal Balance	% of GDP	4.2	2.9	3.0	0.5	0.0	2.0
US Dollar Exchange Rate	Average	7.77	7.78	7.77	1.36	1.27	1.24

Sources: Haver Analytics and Citi Investment Research and Analysis

Russia

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The ruble has re-traced some of its steps owing to the stabilisation of global financial markets, the high oil price and tight domestic liquidity. In 2012, we expect the ruble to be 37-38 against the basket, assuming Brent oil price falls to US$86 per barrel on average in 2012, as our commodity team expects. Depreciation pressures over the last month stemmed largely from contagion. We expect tight domestic liquidity and weaker global growth to slow Russia's GDP growth to about 2.5% in 2012 from about 4.0% this year. This is already evident in the marked slowdown in September IP growth. While the 2Q GDP number – 3.4%YoY – came well below expectations, we believe domestic demand will remain robust in the coming one or two quarters. Private consumption rose about 6%YoY in 2Q, while investment and construction activity have recently accelerated significantly. We expect a fiscal deficit of about 1-1.5% of GDP in 2011, allowing for higher social spending and the indexation of public wages in 2H11. We expect the fiscal deficit will rise to 3-4% of GDP in the next three years and public debt will grow by about US$50bn per annum. Falling food prices may bring headline inflation below 7% at end-2011, but core inflation remains persistent. We do not expect the CBR to alter its rate policy. However, the CBR may change access to its facilities to provide more liquidity to the market; for example by increasing the volume of liquidity at the lower repo rate and persuading the MoF to roll-over its deposits with banks through year-end.

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The government has released the much-awaited Medium-Term Plan (MTP). By and large, we believe the MTP is built on reasonable macroeconomic assumptions. However, those who were expecting a noticeable improvement in the current account balance would have been disappointed, as the government expects a current account gap of 8.0% of GDP in 2012. In the fiscal sphere, the budget deficit (central government) targets for 2011 (1.7% of GDP) and 2012 (1.5% of GDP) look impressive when compared with many countries. In the context of the wide current account gap, however, the size and the nature of the envisaged adjustment, which seems to rely largely on revenues (particularly for 2012 and 2013), does not seem to be particularly ambitious in our view. Rising inflationary pressures and weaker lira cast further doubt on the current policy mix. In particular, we remain sceptical about the effectiveness of the CBT's current approach. In our view, FX sales alone – without hiking rates and tightening domestic liquidity – are not likely to be successful in containing depreciation pressures. Moreover, we believe the CBT's ability to prop up the lira will be constrained by Turkey's large external financing needs in relation to the bank's international reserves.

Figure 36. Russia and Turkey — Economic Forecasts, 2010-12F

		Russia			Turkey		
		2010	2011F	2012F	2010	2011F	2012F
Real GDP	YoY	4.0%	4.0%	2.5%	9.0%	7.3%	2.5%
Final Domestic Demand	YoY	3.3	8.2	3.3	10.7	10.0	1.6
Private Consumption	YoY	3.0	5.3	3.0	6.7	6.5	0.8
Fixed Investment	YoY	6.1	7.5	5.0	29.9	22.1	2.9
Exports	YoY	7.1	3.3	2.7	3.4	3.8	1.8
Imports	YoY	25.6	17.0	3.6	20.7	13.2	-1.4
CPI	YoY	6.9	8.6	6.3	8.6	6.4	8.5
Unemployment Rate	%	7.5	7.3	7.5	11.9	10.2	10.4
Current Account	US$ bn	71.1	81.3	31.4	-47.7	-69.7	-62.0
	% of GDP	4.8	4.8	1.9	-6.5	-9.6	-8.4
Fiscal Balance	% of GDP	-4.0	-1.4	-3.1	-3.6	-1.9	-2.7
US Dollar Exchange Rate	Average	30.4	30.2	33.7	1.50	1.74	1.89

Sources: Haver Analytics and Citi Investment Research and Analysis

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The deteriorating global growth environment and announcements of fiscal austerity measures have contributed to further downward revisions to our GDP forecasts. We believe the announced tax hikes and expenditure cuts will extend the decline in domestic demand. Consumption is likely to suffer an additional burden from currency weakness. In our view, the 2012 budget deficit target may still be at risk from disappointing growth and adverse one-off items. Tax hikes will likely lift CPI close to 5% next year while core inflation measures may remain close to the 3% target. Since currency weakness may pass through into higher medium-term inflation, we expect monetary policy will turn increasingly hawkish. Risks of potential sovereign credit rating downgrades and additional government measures boosting household FX debt conversion have increased, which may intensify HUF sell-off in the short term. Our view is that, given the relatively low ratio of FX reserves to FX debt, the central bank will only smooth currency pressures by limited interventions (equal to EU inflows) and may have to rely on rate hikes to defend financial stability and preserve its credibility. Our base case scenario is for a cumulative 75bp total of rate hikes, starting at end-2011. However the size and timing of future rate hikes is dependent on external conditions and economic policy moves.

Poland

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Current economic data are still relatively positive. Although corporate sector job growth continued to decelerate in September, wage growth remains relatively high, at around 5%YoY. Moreover industrial output data for the last two months surprised to the upside (rising around 8%YoY). However, leading indicators signal that a significant deceleration of economic activity lies ahead, with the PMI only marginally above 50 pts. The PMI components show declines in new export orders, slower output growth and weakening labour demand. We expect the recession in the euro zone – and especially the slowdown in Germany – along with fiscal policy tightening will slow GDP growth significantly. Although inflation is still significantly above the central bank's target, we expect a gradual decline of CPI growth toward the target in 1H 12. Assuming the economic slowdown, decline in inflation, and ECB easing all occur, the MPC may start to cut rates in late 1Q or 2Q in 2012. We expect a total of 50bp of rate cuts. However, if pressure on the zloty declines, interest rates may fall even further (up to 75-100bp). The NBP showed it can be an active player in the FX market, intervening to limit zloty depreciation. Therefore any rate cuts this year would go against its previous activity. At the year-end, the Ministry of Finance may intensify intervention to support the zloty in order to keep the debt-to-GDP ratio below 55%.

Figure 37. Hungary and Poland — Economic Forecasts, 2010-12F

		Hungary			Poland		
		2010	2011F	2012F	2010	2011F	2012F
Real GDP	YoY	1.2%	1.1%	0.5%	3.8%	3.8%	1.9%
Final Domestic Demand	YoY	-2.8	-1.7	-2.0	2.1	3.3	1.0
Private Consumption	YoY	-2.1	-0.5	-2.5	3.2	3.2	2.0
Fixed Investment	YoY	-5.6	-6.0	-0.9	-2.0	5.7	-0.8
Exports	YoY	14.1	8.1	5.4	10.1	5.2	1.4
Imports	YoY	12.0	6.9	4.3	11.5	4.8	-1.8
CPI	YoY	4.7	3.9	5.0	2.7	4.2	3.0
Unemployment Rate	%	11.2	11.5	11.8	12.1	11.1	10.0
Current Account	US$ bn	2.7	3.1	3.1	-15.9	-21.4	-15.7
	% of GDP	2.1	2.6	2.6	-3.4	-4.3	-3.4
Fiscal Balance	% of GDP	-4.2	1.9	-3.0	-7.9	-5.3	-4.5
US Dollar Exchange Rate	Average	208	208	252	3.0	3.1	3.4

Sources: Haver Analytics and Citi Investment Research and Analysis

Czech Republic

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We have slightly cut our forecast for 3Q growth, given the slowdown in economic activity. Industrial output is likely to drop by more than 2%QoQ in 3Q11, but this mainly reflects the temporary halt in refinery production, which should be reversed in 4Q11. We now expect unchanged 3Q GDP, while we previously expected a mild 0.2%QoQ rise, after the gain of just 0.1% in 2Q11. Moreover, the outlook is not at all supportive. We expect mild growth in 4Q, reflecting an offset in industrial production and possible forward buying before the hike in the lower VAT rate in January next year. The weakness in foreign demand and EMU sovereign debt crisis will shape the economic environment in coming quarters. The Czech economy is highly export-dependent and so we expect zero growth in industrial production in 2012 after an expected 6.5%YoY rise in 2011, with a resulting negative labour market impact. However, we do not expect a large drop in the trade surplus, because export growth will probably still outpace imports, because of the weak jobs market, limited investment activity and lower commodity prices. We think the policy rate will stay unchanged at 0.75% until 1Q13 as our forecast for a weaker koruna will compensate for disinflationary factors. The CNB would probably only intervene to weaken the koruna if the koruna has appreciated first. However, any action will likely be preceded by a cut in policy rate and verbal comments.

Romania

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Recent data suggests that economic recovery is losing momentum. The absence of a meaningful pick-up in domestic demand paints a difficult picture for the recovery process. Consequently, we downgrade our growth outlook as we now forecast GDP growth of 1.5% and 1.7% in 2011 and 2012, respectively. Looking ahead, the deleveraging process will remain a significant constraint on households' consumption and investment in the coming years given the considerable unhedged FX loans of households. The near-term inflation outlook has improved considerably thanks to good crop yields domestically and softer commodity prices. We see year-end inflation at 3.9%, though a lower reading is possible if the favourable trend in food prices continues. Despite the improvement in the near-term inflation outlook, we believe that the NBR will opt for prudence and keep rates at 6.25% through the reminder of the year. In our view, the NBR is likely to continue to mop up excess liquidity and bring money market rates closer to the policy rate. Barring unforeseen shocks, we expect a 75bp rate cut in 1Q 12. Turning to the currency, despite the presence of a number of leu-supportive factors, the Eurozone debt crisis complicates the currency outlook. With this caveat in mind, we expect EUR/RON to be around 4.35 by the end of 2011.

Figure 38. Czech Republic and Romania — Economic Forecasts, 2010-12F

		Czech Republic			Romania		
		2010	2011F	2012F	2010	2011F	2012F
Real GDP	YoY	2.3%	1.9%	0.6%	-1.3%	1.5%	1.7%
Final Domestic Demand	YoY	-0.9	-0.2	-0.3	-4.3	-0.2	1.0
Private Consumption	YoY	0.0	-0.3	-0.1	-1.5	0.3	1.0
Fixed Investment	YoY	-3.1	1.6	-2.1	-13.1	-0.7	1.0
Exports	YoY	18.0	9.2	1.5	14.3	16.2	5.0
Imports	YoY	18.0	7.2	0.7	12.4	10.8	2.8
CPI	YoY	1.5	1.9	2.7	6.1	5.8	3.4
Unemployment Rate	%	9.0	8.5	8.6	6.9	5.4	5.2
Current Account	US$ bn	-7.2	-8.5	-6.9	-6.8	-6.6	-8.0
	% of GDP	-3.7	-4.1	-3.5	-4.2	-3.5	-4.5
Fiscal Balance	% of GDP	-4.7	-4.5	-4.0	-6.7	-4.5	-3.3
US Dollar Exchange Rate	Average	19.1	17.8	19.5	3.2	3.0	3.3

Sources: Haver Analytics and Citi Investment Research and Analysis

Brazil

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Recent data suggest that the economic slowdown is sharper than expected, motivating us to downgrade our 2011 and 2012 GDP growth forecasts to 3.3% and 3.5%, respectively (from 3.7% and 4.0% previously). Despite the softer expansion, the labour market remains very tight (unemployment rate at lowest ever level), providing no relief to our 2011 and 2012 year-end inflation forecasts of 6.5% and 5.7% respectively, both above the mid-point target of 4.5%. The evidence of softer economic growth reinforced the central bank's easing stance, which cut the policy rate by 50bp, and a more aggressive pace of easing cannot be ruled out depending on the impacts of global turmoil on domestic activity data. On the FX front, commodity prices have weakened recently, and developments in the EMU debt crises – and consequent effects on global risk aversion – will probably be the main driver of USD/BRL movements in the near term. Finally, we keep our view that the public sector will accomplish its primary fiscal target this year, reinforcing the slight downward trend of net public debt currently estimated at around 40% of GDP.

Mexico

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Our assessment of activity early in 4Q shows both good news and bad news. Among the latter, export-related manufacturing is decelerating at a slightly sharper pace than we had assumed. Among the former, services and the primary sector are still gaining momentum, although they are unlikely to wholly offset the industrial slowdown. Therefore, we are cutting our 2011 GDP growth forecast to 3.8% from 4.1% previously. Moreover, the statistical carry-over from this revision, along with an assumption of only modest US growth in 2012, lead us to revise our GDP growth estimate for 2012 to 3.0% from 3.5%. Weaker demand is likely to be disinflationary, but factors such as public pricing policy and an increase in corn prices – water scarcity will likely affect the harvest of early 2012 – are likely to generate a slight upward pressure on inflation. Therefore, we only make marginal changes to our end-year inflation forecast, to 3.3% and 3.6% for 2011 and 2012 respectively. Accordingly, we still believe Banxico will stay on hold during its last monetary policy meeting of the year (2 December) but also acknowledge that a slightly more dovish communiqué accompanying its 14 October decision to keep rates at 4.5% implies that this is becoming a close call. The upcoming minutes as well as the quarterly inflation report could prove important for monetary policy prospects.

Figure 39. Brazil and Mexico — Economic Forecasts, 2010-12F

		Brazil			Mexico		
		2010	2011F	2012F	2010	2011F	2012F
Real GDP	YoY	7.5%	3.3%	3.5%	5.4%	3.8%	3.0%
Final Domestic Demand	YoY	8.3	4.6	4.1	4.2	4.7	3.7
Private Consumption	YoY	7.0	4.7	3.5	5.0	4.3	3.3
Fixed Investment	YoY	21.9	5.4	4.6	2.3	8.4	6.5
Exports	YoY	11.5	3.2	4.8	24.3	9.4	6.5
Imports	YoY	36.2	10.4	7.8	22.1	9.9	9.4
CPI	YoY	5.0	6.6	5.7	4.2	3.3	3.6
Unemployment Rate	%	6.7	6.1	6.3	5.4	5.2	4.7
Current Account	US$ bn	-47.4	-54.1	-70.8	-5.6	-13.0	-30.7
	% of GDP	-2.3	-2.4	-3.0	-0.5	-1.1	-2.6
Fiscal Balance	% of GDP	-2.5	-2.5	-2.5	-2.8	-2.5	-2.0
US Dollar Exchange Rate	Average	1.76	1.67	1.72	12.6	12.4	13.0

Sources: Haver Analytics and Citi Investment Research and Analysis

Argentina

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Cristina Fernández de Kirchner (CFK) was re-elected in the 23 October elections, obtaining 54% of the votes, followed by socialist Hermes Binner with 17% of the suffrage. The next political question is who will take over the Ministry of Finance, as the current Minister of Finance, Amado Boudou, is to be CFK's Vice-President. Recent speculation suggests Mr Boudou would support Hernan Lorenzino, current Secretary of Finance. If this appointment is confirmed, markets should react positively since most other candidates are less market friendly. Regarding the current economic outlook, capital flight continues, causing the central bank to lose reserves. During the last three months, the central bank has lost roughly US$5bn of reserves, despite the fact that it has received loans for approximately US$3 billion. In addition, local interest rates have begun to increase. For instance, the private Badlar has soared more than 500bp during the last month and a half, surpassing 18%.

Venezuela

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Recent information published by local media have pointed out President Chávez's health condition might be worse than initially expected, which has brought back to the political arena the question of whether he would be able to run as candidate during next year's presidential election. The evolution of President Chávez should be the main driver behind the final outcome of the October 2012 presidential elections. From a macroeconomic perspective, the outlook in Venezuela has not changed significantly, with the economy showing some mild recovery along with internal supply constraints which maintain annual inflation close to 27%. It is worth noting that this performance has not affected the capacity of both the Venezuelan Government and PDVSA to honour its debts and that Venezuela's debt service profile continues to look manageable. The latter being the case even though the sovereign surprisingly increased USD-denominated debt issuance this month by US$3bn. Thus, we continue to claim that oil prices are the main variable to assess Venezuela's credit. In our view, the Venezuelan basket oil price for the government to keep fiscal accounts and the balance of payments on a sustainable path ranges between US$83-95/barrel for both 2011 and 2012. While we acknowledge Venezuela should not have a problem honouring its debt obligations in the short term, pending arbitration cases against Venezuela in international arbitration bodies could have a negative impact on the credit.

Figure 40. Argentina and Venezuela — Economic Forecasts, 2010-12F

		Argentina			Venezuela		
		2010	2011F	2012F	2010	2011F	2012F
Real GDP	YoY	9.2%	8.5%	5.0%	-1.4%	3.5%	3.9%
Final Domestic Demand	YoY	11.6	11.9	6.7	-2.1	5.6	5.1
Private Consumption	YoY	9.0	10.1	5.1	-2.3	5.5	7.8
Fixed Investment	YoY	21.2	9.0	3.6	-4.4	-5.9	-2.4
Exports	YoY	14.6	-0.2	5.2	-12.4	5.5	-0.7
Imports	YoY	34.0	21.7	12.9	-4.6	10.9	6.0
CPI	YoY	18.4	25.0	20.0	28.2	26.8	26.5
Unemployment Rate	%	9.3	8.1	7.8	8.5	6.3	6.2
Current Account	US$ bn	3.6	-1.0	-2.2	14.4	34.4	43.3
	% of GDP	1.0	-0.2	-0.6	3.7	11.6	11.0
Fiscal Balance	% of GDP	0.2	-0.6	1.0	-6.6	-5.0	-5.0
US Dollar Exchange Rate	Average	3.9	4.2	5.3	2.6	4.3	4.3

Sources: Haver Analytics and Citi Investment Research and Analysis

Saudi Arabia

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The annual rate of inflation rose to 5.3% in September, from 4.8% in August, but remains well below our expectations given the surge in government spending this year. GDP numbers out this month show that private consumption rose sharply in the second quarter of 2011, by 7% in real terms according to our estimates (deflating by the CPI). We expect inflation to rise, but now anticipate a year end rate of around 6.5% (previously 8%). Saudi Crude, like the rest of the OPEC basket, has been trading closer to Brent than WTI, so we have revised our fiscal projections to reflect this. Assuming oil production remains around 10% above the level last year, the Kingdom should enjoy a surplus of around 7.5% of GDP, despite a 40% rise in expenditure. We forecast that the surplus will narrow sharply in 2012, turning to deficit in 2013 and beyond. This is due to a likely step down in production as global crude supply is bolstered from other sources (e.g. Libya) and demand weakens, as well as a forecast softening in prices. Economic growth will remain robust, in our view. We do not expect the government to curtail expenditure in future years, as priority is being given to social stability and diversification of the economy for the purpose of creating employment. Non-oil growth is thus likely to remain strong on the back of high government expenditure, and will be given a further boost by the passing of the mortgage law (which we expect imminently) and the increase in local employment under the Nitaqat programme.

United Arab Emirates

Latest figures show a deterioration in UAE banking liquidity, after a marked improvement earlier this year. Bank deposits contracted over the past two months, pushing the loan/deposit ration to 98%, from 93% in May. Detailed statistics are yet to be published, but we expect that this is probably a partial reversal of inflows from Arab countries that occurred when the unrest was at its height in the spring. Generally, we believe the deteriorating global outlook spells risks for the UAE on three fronts, and we now consider risks to our economic forecasts to be on the downside. First, the fall in recent months in global oil prices will squeeze revenues at the Abu Dhabi level, and we have already seen that emirate begin to pull back from some previously anticipated investments, particularly in the non-oil sector. Second, slower growth in global demand may impact Dubai's ongoing recovery, dependent as it is on global trade, tourism and transportation. Finally, the retrenchment in global risk appetite will likely expose entities in the UAE to heightened refinancing risks if financial conditions remain tight in the medium term.

Figure 41. Saudi Arabia and United Arab Emirates — Economic Forecasts, 2010-12F

		Saudi Arabia			United Arab Emirates		
		2010	2011F	2012F	2010	2011F	2012F
Real GDP	YoY	4.1%	6.7%	3.8%	1.4%	4.9%	0.7%
Final Domestic Demand	YoY	-0.8	9.9	7.8	1.9	3.1	3.5
Private Consumption	YoY	2.3	10.0	5.0	1.0	1.0	2.0
Fixed Investment	YoY	-5.6	15.0	10.0	5.0	5.0	5.0
Exports	YoY	5.0	10.5	8.0	10.0	13.0	13.0
Imports	YoY	-8.0	15.0	12.0	10.0	15.0	15.0
CPI	YoY	5.4	5.2	7.0	1.5	2.0	2.4
Current Account	US$ bn	66.8	147.3	95.7	24.3	48.7	11.9
	% of GDP	14.9	33.3	15.7	8.2	15.0	3.5
Fiscal Balance	% of GDP	6.5	7.5	3.1	0.0	0.0	0.0
US Dollar Exchange Rate	Average	3.8	3.8	3.8	3.7	3.7	3.7

Sources: Haver Analytics and Citi Investment Research and Analysis

Egypt

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Parliamentary elections, due to be held from 28 November 2011, are quickly becoming the main focus of political activity. However, it now looks as if presidential polls will be delayed until late 2012 or into 2013, effectively leaving the military as a major political power for some time to come. The outcome of the elections is very unclear, and we expect the vote to be heavily fragmented. We believe the key to understanding its outcome will be to understand the political alliances that emerge and the ongoing relationship of the alliances with the military. Meanwhile, for the rest of 2011 and for 1H 2012, the government will likely be in a position of policy hold, while seeking to ensure that it remains popular by maintaining spending on subsidies, at the cost of running a major fiscal deficit, and attempting to curtail inflation and maintaining a stable exchange rate. This should just about be possible with regional Arab support. As well as writing a new constitution, the new government will also have to outline more coherent economic policies in 2012, notably on the exchange rate, although its policy choices will be curtailed by the fiscal and balance of payments deficits and substantial outstanding debt stock.

South Africa

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High-frequency economic data have been on the high side of consensus and our expectations of late, so for the first time in three months we see no reason to further downgrade our real GDP growth forecasts for 2011 and 2012. Consumer spending is continuing to expand despite rising inflation, as are investment projects in some sectors, including mining. Probable resilience in prices of gold and bulk commodities (all major SA exports) should also help incomes. Nonetheless, the economy remains highly vulnerable to a fragile global environment, many businesses are reluctant to hire or invest, and housing remains in the doldrums. Consequently, growth is likely to average a sub-par 3% both this year and next. Inflation continued to rise in September and may breach the top end of the 3%-6% target range before year-end, but should retreat back below 6% next year. While the weaker rand should raise core inflation, the contribution of oil and food to inflation is likely to taper off next year. That said, inflation remains high given the sluggish growth performance. Resilience in the terms of trade is likely to limit current account deficit widening, despite soft real export growth. Mixed risks to the inflation outlook still make additional monetary easing unlikely but rates look set to stay on hold for a long while, with no hikes expected before 2H12. Discretionary fiscal policy easing looks unlikely, but the deficit will probably widen temporarily as growth slows.

Figure 42. Egypt, Nigeria and South Africa — Economic Forecast, 2009F-11F

		Egypt			Nigeria			South Africa		
		2009F	2010F	2011F	2009F	2010F	2011F	2009F	2010F	2011F
Real GDP	YoY	5.1%	1.4%	3.1%	7.2%	7.1%	6.7%	2.8%	3.0%	2.9%
Final Domestic Demand	YoY	4.8	2.5	4.0	NA	NA	NA	2.8	4.0	3.4
Private Consumption	YoY	5.1	2.6	1.5	NA	NA	NA	4.4	4.5	3.3
Fixed Investment	YoY	3.9	0.4	7.2	NA	NA	NA	-3.7	2.2	3.1
Exports	YoY	-3.0	-2.3	2.1	NA	NA	NA	4.7	3.3	4.4
Imports	YoY	-3.2	0.2	5.4	NA	NA	NA	9.6	7.4	5.3
CPI	YoY	11.1	9.9	9.7	13.7	11.3	13.8	4.1	4.9	5.6
Unemployment Rate	%	9.0	9.7	10.2	NA	NA	NA	25.5	26.0	25.7
Current Account	US$ bn	-4.4	-7.2	-8.3	14.2	15.9	16.5	-10.0	-13.0	-15.0
	% of GDP	-2.1	-3.5	-3.8	6.1	5.9	5.1	-2.7	-3.4	-4.0
Fiscal Balance	% of GDP	-8.1	-9.0	-8.8	-2.3	-3.2	-2.7	-5.2	-5.5	-5.5
US Dollar Exchange Rate	Average	5.63	5.94	6.26	151	155	158	7.32	7.43	8.40

Source: Citi Investment Research and Analysis

Figure 43. Selected Emerging Market Countries — Economic Forecast Overview, 2010-12F

	GDP Growth			CPI Inflation			Current Balance (% of GDP)			Fiscal Balance (% of GDP)		
	2010	2011F	2012F	2010	2011F	2012F	2010	2011F	2012F	2010	2011F	2012F
Asia	**9.2%**	**7.4%**	**7.2%**	**4.2%**	**5.9%**	**4.6%**	**4.0%**	**2.9%**	**2.3%**	**-2.4%**	**-2.7%**	**-2.4%**
China	10.4	9.1	8.7	3.3	5.5	4.1	5.2	4.0	3.2	-1.6	-2.0	-2.0
Hong Kong	7.0	5.6	4.5	2.4	5.3	4.0	6.2	7.0	6.3	4.2	2.9	3.0
India*	8.5	7.6	7.5	8.6	9.5	7.5	-2.6	-2.9	-2.3	-8.1	-8.3	-7.1
Indonesia	6.1	6.5	6.3	5.1	5.0	6.2	0.9	0.1	-0.3	-0.6	-1.5	-1.5
Korea	6.2	3.7	3.9	3.0	4.5	3.5	2.8	1.3	1.1	1.4	0.5	0.7
Malaysia	7.2	4.7	5.0	1.7	3.2	2.7	11.8	10.5	9.0	-5.6	-5.4	-5.0
Pakistan	2.4	3.5	5.0	13.9	11.0	8.0	0.2	-1.7	-1.6	-6.2	-4.0	-3.9
Philippines	7.6	3.7	3.9	3.8	4.3	3.5	4.2	3.5	3.0	-3.5	-1.6	-2.1
Singapore	14.5	5.3	3.3	2.8	5.1	3.0	22.2	16.5	15.0	0.5	0.0	2.0
Sri Lanka	8.0	7.9	8.0	6.0	7.2	6.5	-2.9	-4.0	-4.1	-8.0	-6.8	-6.2
Taiwan	10.8	4.5	4.0	1.0	1.3	1.5	9.4	8.0	8.0	-3.2	-2.5	-2.4
Thailand	7.8	2.2	3.7	3.3	3.8	3.5	4.7	4.0	2.2	-2.0	-4.0	-2.8
Vietnam	6.8	5.7	6.4	9.2	18.8	12.2	-4.7	-6.8	-6.2	-7.9	-5.0	-4.8
Latin America	**6.1%**	**4.3%**	**3.8%**	**7.5%**	**8.2%**	**7.3%**	**-1.0%**	**-1.1%**	**-1.6%**	**-2.6%**	**-2.3%**	**-2.0%**
Argentina	9.2	8.5	5.0	18.4	25.0	20.0	1.0	-0.2	-0.6	0.2	-0.6	1.0
Brazil	7.5	3.3	3.5	5.0	6.6	5.7	-2.3	-2.4	-3.0	-2.5	-2.5	-2.5
Chile	5.2	6.3	4.5	1.4	3.2	2.9	1.9	-1.3	-1.9	-0.3	0.8	0.7
Colombia	4.3	5.0	4.8	2.3	3.3	3.5	-3.1	-2.8	-2.5	-3.6	-3.5	-3.2
Ecuador	2.0	3.5	3.5	3.4	2.8	3.0	-4.7	-3.2	0.0	-3.5	-3.2	-3.3
Mexico	5.4	3.8	3.0	4.2	3.3	3.6	-0.5	-1.1	-2.6	-2.8	-2.5	-2.0
Panama	7.5	10.0	7.5	3.5	6.3	7.0	-11.0	-13.5	-12.1	-1.9	-3.0	-2.0
Peru	8.8	6.5	5.5	1.5	3.2	3.2	-1.5	-3.0	-3.6	-0.8	1.5	1.2
Uruguay	7.8	5.8	4.7	6.7	7.4	6.6	1.0	0.4	-1.9	-1.2	-1.1	-1.0
Venezuela	-1.4	3.5	3.9	28.2	26.8	26.5	3.7	11.6	11.0	-6.6	-5.0	-5.0
Europe	**4.6%**	**4.4%**	**2.3%**	**6.1%**	**6.8%**	**6.0%**	**-0.1%**	**-0.6%**	**-1.7%**	**-4.8%**	**-2.4%**	**-3.3%**
Czech Republic	2.3	1.9	0.6	1.5	1.9	2.7	-3.7	-4.1	-3.5	-4.7	-4.5	-4.0
Hungary	1.2	1.1	0.5	4.7	3.9	5.0	2.1	2.6	2.6	-4.2	1.9	-3.0
Kazakhstan	7.0	6.4	4.5	7.1	8.6	7.3	3.1	4.7	2.4	-2.6	-1.9	-2.1
Poland	3.8	3.8	1.9	2.7	4.2	3.0	-3.4	-4.3	-3.4	-7.9	-5.3	-4.5
Romania	-1.3	1.5	1.7	6.1	5.8	3.4	-4.2	-3.5	-4.5	-6.7	-4.5	-3.3
Russia	4.0	4.0	2.5	6.9	8.6	6.3	4.8	4.8	1.9	-4.0	-1.4	-3.1
Slovakia	4.0	2.9	1.0	1.0	3.8	2.4	-3.4	-4.8	-3.9	-7.5	-5.4	-4.3
Turkey	9.0	7.3	2.5	8.6	6.4	8.5	-6.5	-9.6	-8.4	-3.6	-1.9	-2.7
Ukraine	4.2	4.6	3.9	9.4	9.3	9.2	-2.1	-3.1	-4.9	-5.9	-3.9	-3.2
Africa/Mideast	**4.6%**	**5.4%**	**4.0%**	**5.0%**	**5.6%**	**6.1%**	**5.9%**	**7.8%**	**4.5%**	**-0.6%**	**1.8%**	**-0.5%**
Bahrain	4.1	-3.8	4.7	1.9	2.0	3.0	2.8	6.8	6.8	-5.8	-6.9	-10.7
Egypt	5.1	1.4	3.1	11.1	9.9	9.7	-2.1	-3.5	-3.8	-8.1	-9.0	-8.8
Ghana	6.6	15.5	7.3	10.7	8.7	6.4	-7.2	-7.0	-5.8	-7.5	-6.9	-7.1
Iraq	5.9	10.4	10.4	0.0	4.0	5.0	2.7	0.9	0.7	-10.4	15.4	-3.6
Israel	4.8	4.3	2.5	2.7	3.4	2.3	2.9	-0.4	-1.2	-3.0	-2.0	-2.5
Jordan	2.3	1.6	2.5	5.0	5.0	5.0	-5.0	-10.7	-5.4	-5.6	-3.1	-7.2
Kenya	5.6	4.8	5.3	4.4	14.4	11.3	-7.9	-8.2	-7.5	-6.5	-6.9	-6.7
Kuwait	6.4	6.7	3.2	4.4	4.2	5.0	39.0	39.6	43.1	16.3	29.2	13.0
Lebanon	6.0	2.8	3.5	4.0	3.4	4.0	-13.0	-15.1	-11.4	-7.4	-6.6	-7.8
Nigeria	7.2	7.1	6.7	13.7	11.3	13.8	6.1	5.9	5.1	-2.3	-3.2	-2.7
Oman	6.7	1.4	3.0	3.5	3.5	3.0	2.6	3.4	3.0	-0.2	2.6	-1.1
Qatar	9.3	12.8	9.4	-2.4	3.0	3.0	19.1	-19.5	-17.9	3.3	15.0	14.6
Saudi Arabia	4.1	6.7	3.8	5.4	5.2	7.0	14.9	33.3	15.7	6.5	7.5	3.1
South Africa	2.8	3.0	2.9	4.1	4.9	5.6	-2.7	-3.4	-4.0	-5.2	-5.5	-5.5
Tanzania	6.9	6.5	6.9	6.2	12.3	9.5	-8.6	-8.5	-7.8	-7.0	-7.8	-6.2
UAE	1.4	4.9	0.7	1.5	2.0	2.4	8.2	15.0	3.5	0.0	0.0	0.0
Uganda	5.2	6.0	6.2	4.0	16.4	10.7	-9.9	-10.6	-9.2	-5.0	-7.2	-6.0
Zambia	7.6	7.2	6.8	8.5	9.0	8.3	3.8	4.2	2.0	-3.1	-3.5	-4.2
Total	**7.3%**	**6.0%**	**5.3%**	**5.3%**	**6.5%**	**5.6%**	**2.4%**	**2.0%**	**1.2%**	**-2.6%**	**-2.1%**	**-2.3%**

* Note: In India, policymakers look at the wholesale price index. Sources: National sources and Citi Investment Research and Analysis

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Source: Citi Investment Research and Analysis.

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Figure 45. (Continued) Citi Global Strategy and Macro Team *For Informational Purposes Only*

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Rates Strategy

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The dominant driver of rates – if not all asset classes – remains risk appetite, with a high degree of correlation across markets. Focus remains firmly on developments in Europe and what may or may not emerge in terms of policy to help rectify the deterioration in both economic fundamentals and market confidence. In this context, we outline our core views on curves, EMU spreads and US Treasuries.

Curve dynamics remain in tact

The Fed's Operation Twist and the BoE's re-opening of the Asset Purchase Facility have flattened yield curves dramatically. However, we still believe that the dollar and sterling curves are too steep for the policies to have a sustainable impact on risk assets. Both central banks have also hinted at the possibility of larger actions if sentiment fails to improve. We thus continue to favour flatteners in US Treasuries (10s30s) and UK gilts (5s30s). With the ECB more likely to act via monetary policy than asset purchases, we think the EUR curve should re-steepen in 5s10s.

EMU spreads under pressure

EMU spreads remain at the mercy of events and the delicate constellation of European politics. Within the AAA space, amidst the extraordinary volatility pervading bond markets, a new dynamic is emerging. Three groupings seem to have developed: Germany, Finland & the Netherlands and Austria & France. Traditional spread relationships are consequently under strain, especially as some weaker AAA spreads widen in both Bund rallies *and* sell offs. Although it might appear prudent to trim shorts in these markets, where we go from here will largely be determined by risk appetite given developments in European policy. In our view, dynamics seem to suggest that core spreads have entered a new set of higher trading ranges.

In the context of Tier2 markets, spreads continue to test the top end of recent trading ranges. Falling liquidity is also exacerbating the price action. Our view is clear: we believe risks are still skewed to higher EMU yields and further spread widening in coming months. This is predicated on the view that fundamental problems at the heart of the crisis will unlikely be adequately addressed in the near term. Trading EMU spreads is difficult (and costly) in this environment. We prefer to express our broader views with simple directional trades. The strategy remains to buy Germany on dips.

Longer Term Impact on US Rates

This environment in Europe is likely to continue to have a dramatic impact on US Treasury yields. In the long term, a full resolution of the EMU crisis would likely drive 10yr US rates closer to 3% as the flight-to-quality bid dissipates, financial conditions improve and eventually, expectations for economic growth follow. On the other hand, a sovereign or bank default could drive 10yr rates below the recent lows seen in the last month. We think the most likely outcome in the near term is for 10yr yields to trade in a range of 2%-2.5%. However, some time in 2012, Europe will likely be in a similar position seen at present and US Treasuries should again be driven by the next policy solution that is offered.

Figure 46. Interest Rate and Bond Market Forecasts (End of Period), as of 26 Oct 2011

		Forecast End Period				
	Current	4Q 11	1Q 12	2Q 12	3Q 12	4Q 12
US						
Policy Rate (Fed Funds) End Quarter	0.25	0.25	0.25	0.25	0.25	0.25
3-Month Libor	0.42	0.45	0.50	0.55	0.60	0.70
2 Year Treasury Yield	0.28	0.27	0.30	0.35	0.40	0.65
5 Year Treasury Yield	1.08	1.00	1.00	1.25	1.35	1.60
10 Year Treasury Yield	2.21	2.15	2.05	2.30	2.60	2.90
30 Year Treasury Yield	3.23	3.15	3.05	3.35	3.60	3.90
2-10 Year Treasury Curve	193	188	175	195	220	225
2 Year Swap Spread (Swap Less Govt.), bp	37	34	34	35	35	35
10 Year Swap Spread (Swap Less Govt.), bp	19	20	20	20	22	25
30 Year Swap Spread (Swap Less Govt.), bp	-22	-35	-35	-35	-40	-45
30 Year Mortgage Yield	4.17	4.15	4.15	4.30	4.40	4.70
10 Year Breakeven Inflation	203	205	205	215	225	240
Euro Area						
Policy Rate	1.50	1.00	1.00	1.00	1.00	1.00
Overnight Rate (EONIA)	0.93	0.60	0.40	0.40	0.40	0.40
3-Month Libor	1.58	1.10	0.70	0.70	0.80	0.90
2 Year Treasury Yield	0.65	0.50	0.50	0.50	0.55	0.60
5 Year Treasury Yield	1.30	1.20	1.15	1.05	1.10	1.15
10 Year Treasury Yield	2.06	1.70	1.40	1.50	1.70	1.70
30 Year Treasury Yield	2.80	2.70	2.45	2.40	2.55	2.50
2-10 Year Treasury Curve	141	120	90	100	115	110
10 Year BTP-Bund Spread	379	450	475	450	425	400
10 Year Swap Spread (Swap Less Govt.), bp	53	67	62	57	52	42
10 Year Breakeven Inflation	165	155	135	120	110	105
Japan						
Policy Rate	0.10	0.10	0.10	0.10	0.10	0.10
3-Month Libor	0.20	0.20	0.20	0.20	0.20	0.20
2 Year Treasury Yield	0.15	0.15	0.15	0.10	0.15	0.20
5 Year Treasury Yield	0.38	0.40	0.45	0.35	0.40	0.55
10 Year Treasury Yield	1.01	1.10	1.20	1.05	1.10	1.30
30 Year Treasury Yield	1.98	2.05	2.10	2.00	2.05	2.20
2-10 Year Treasury Curve	86	95	105	95	95	110
2 Year Swap Spread (Swap Less Govt.), bp	21	23	25	22	23	25
10 Year Swap Spread (Swap Less Govt.), bp	1	3	5	1	3	7
10 Year Breakeven Inflation	NA	NA	NA	NA	NA	NA
UK						
Policy Rate	0.50	0.50	0.50	0.50	0.50	0.50
3-Month Libor	0.98	1.00	0.90	0.85	0.85	0.85
2 Year Treasury Yield	0.58	0.45	0.40	0.30	0.35	0.45
5 Year Treasury Yield	1.40	1.35	1.30	1.20	1.25	1.40
10 Year Treasury Yield	2.49	2.20	1.85	1.85	2.00	2.00
30 Year Treasury Yield	3.46	3.20	3.00	2.90	2.90	2.90
2-10 Year Treasury Curve	191	175	145	155	165	155
10 Year Swap Spread (Swap Less Govt.), bp	36	50	65	65	65	65
10 Year Breakeven Inflation	268	250	230	240	255	270
Australia						
Policy Rate	4.75	4.50	4.50	4.50	4.50	4.50
3-Month Libor	4.63	4.75	4.90	5.10	5.30	5.40
2 Year Treasury Yield	3.84	3.60	3.75	4.00	4.25	4.55
5 Year Treasury Yield	3.89	3.80	3.95	4.20	4.45	4.70
10 Year Treasury Yield	4.38	4.30	4.45	4.60	4.90	5.10
2-10 Year Treasury Curve	54	70	70	60	65	55
10 Year Swap Spread (Swap Less Govt.), bp	67	65	60	60	55	50

Source: Citi Investment Research and Analysis

Sovereign Ratings Outlook

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- We expect a series of sovereign ratings downgrades among euro area countries in the next 3-6 months, including Greece, Portugal and Cyprus. We also expect Italy, Spain, Portugal and Ireland to be downgraded further over the longer term (next 2-3 years). We believe there is a high risk that at least one of the major ratings agencies will put France on negative outlook by mid-2012, depending in part on prospects for fiscal policy after the Presidential Election. Over time, we also expect that Austria will be put on negative outlook, with Belgium at risk of a single notch downgrade.

- In the US, it is uncertain at this stage whether the Super Committee will lead to agreement on extra early fiscal tightening, or whether the alternative of spending cuts post-2013 will kick in. If the latter occurs, there would likely be some fiscal tightening in the years ahead, but the chance of an adverse ratings decision from one of the major agencies (either downgrade or negative outlook) in the following 3-6 months appears sizeable. Barring a substantial breakthrough from the committee, we still expect that the sovereign rating of the US will be downgraded over the longer term (next 2-3 years), in response to adverse medium-term fiscal trends. We also continue to assume a downgrade for Japan over the next 2-3 years.

- We do not currently expect the UK to be downgraded or put on negative outlook in the next few months or the longer term. But we believe the UK is a relatively weak “AAA”, given the sharp rise in the fiscal deficit over recent years, surging public debts, large banking system, weak economic outlook and prospect that the deficit will overshoot official forecasts. The UK’s rating could be at risk if the coalition falls apart or eases up on the fiscal consolidation programme.

- We regard the smaller European countries (Switzerland, Sweden, Denmark and Norway) as fairly solid AAAs for now, albeit with some concerns over the rising fiscal deficit, sluggish housing market and poor export performance in Denmark.

- We do not expect any ratings upgrades among advanced economies, either over the next few months or the next 2-3 years.

Figure 47. Advanced Economies — Sovereign Long-Term Debt Ratings and Citi Ratings Forecasts

	S&P Ratings				Moody's Ratings			
Country	Current Rating	Current Outlook	Citi Nearterm (3-6 months) Forecast Rating	Citi Longterm (2-3 Years) Forecast Rating & Outlook	Current Rating	Current Outlook	Citi Nearterm (3-6 months) Forecast Rating	Citi Longterm (2-3 Years) Forecast Rating & Outlook
US	AA+	Neg	AA+	AA↓	Aaa	Neg	Aaa	Aa1↓
Canada	AAA	Stable	AAA	AAA	Aaa	Stable	Aaa	Aaa
Japan	AA-	Neg	AA-	A+↓	Aa3	Stable	Aa3	A1↓
Germany	AAA	Stable	AAA	AAA	Aaa	Stable	Aaa	Aaa
France	AAA	Stable	AAA	AAA Neg	Aaa	Stable	Aaa	AAA Stab
Italy	A	Neg	A	A- ↓	A2	Neg	A2	A3↓
Spain	AA-	Neg	AA-	A- ↓↓↓	A1	NEG	A1	A3 ↓↓
Austria	AAA	Stable	AAA	AAA Neg	Aaa	Neg	Aaa	AAA Stab
Belgium	AA+	Neg	AA+	AA↓	Aa1	Stable	Aa1	Aa1 (Neg)
Finland	AAA	Stable	AAA	AAA	Aaa	Stable	Aaa	Aaa
Greece	CC	Neg	SD ↓↓	CC/C ↓	Ca	Developing	C ↓	Ca
Ireland	BBB+	Stable	BBB+	BBB↓	Ba1	Neg	Ba1	Ba2 ↓
Netherlands	AAA	Stable	AAA	AAA	Aaa	Stable	Aaa	Aaa
Portugal	BBB-	Neg	BB ↓↓	CC/C ↓↓↓↓↓	Ba2	Neg	Ba3 ↓	Ca ↓↓↓↓↓
Denmark	AAA	Stable	AAA	AAA	Aaa	Stable	Aaa	Aaa
Norway	AAA	Stable	AAA	AAA	Aaa	Stable	Aaa	Aaa
Sweden	AAA	Stable	AAA	AAA	Aaa	Stable	Aaa	Aaa
Switzerland	AAA	Stable	AAA	AAA	Aaa	Stable	Aaa	Aaa
UK	AAA	Stable	AAA	AAA	Aaa	Stable	Aaa	Aaa

Note: Arrows denote expected ratings changes. (Neg) denotes negative outlook. (Neg W) denotes negative watch. SD means Selective Default. The number of arrows denotes the expected change in ratings notches from the current level. We show a maximum of five arrows even for countries where we expect more than five notches of ratings change. In the outlook we have not included an extension of the actual EFSF lending beyond the now targeted €440bn maximum capacity. In the event that a substantial extension of the EFSF takes place and is likely to incur sizeable fiscal costs, the six AAA-rated Euro Area countries may be at risk of downgrade. NA Not available.
Sources: Moody's, S&P and Citi Investment Research and Analysis

Credit Outlook

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Spare a thought for your humble credit investor here. He/she is hardly in a very comfortable position right now. The reasons to buy are increasingly hard to ignore:

Current non-financial corporate fundamentals are healthy — profit margins are strong, debt levels have barely risen much since the deleveraging of 2009-10 and corporates retain conservative cash levels with much of their debt termed out.

Nearly all models and past relationships with fundamentals suggest credit spreads have widened disproportionately, especially in Europe. In IG and crossover credit, investors are already being compensated for a default rate scenario that normally only arises in fairly sharp recession.

In fact, credit spreads have spent less than 10% of the time at current levels historically (see Figure 48). When spreads have been here in the past, 24-month forward returns have nearly always been positive, at least in investment-grade credit.

Figure 48. Current spreads, position in historical ranges

Index	Daily Since	% Of Obs. Tighter Than Current	Current Percentile Of Range
iTraxx Main	Oct-03	97%	81%
Xover	Dec-03	91%	60%
CDX USD	Oct-03	85%	41%
CDX HY	Nov-03	86%	31%
€ iBoxx Non-Fins	Nov-03	94%	53%
€ iBoxx Sen-Fins	Jan-09	92%	65%
US BIG Non-Fins	Jan-95	74%	23%
US BIG Fins	Jan-95	93%	36%

Sources: CIRA, Markit, Yieldbook

What's more there is an unusually high amount of cash at real money funds – many investors that would normally hold 4-7% in cash are currently holding much more – in some cases 20% or more. Most credit hedge funds are also defensively positioned. In that regard, the current situation is much better than in the immediate post-Lehman environment. Back then, real money investors facing fund outflows were competing with banks and hedge funds to sell funded assets like corporate bonds at the same time. This time round the outflows have been much smaller – not least due to low interest rates on deposits. If anything, many funds have overliquidated in anticipation of outflows that haven't materialised. As a consequence, the new bond issues from non-financials have generally been heavily oversubscribed. It seems pretty easy to construct an argument for a big rally. Indeed, the retracement in the first couple of weeks of October illustrates that many investors are as a worried about missing that rally as they are about further widening.

Spreads not at the summit yet

We don't dismiss any of that. Indeed on a longer-term basis we tend to agree that there is value in the credit market. However, although spreads don't tend to stay at these wide levels for very long, Figure 48 also demonstrates that when they are here, they can go much, much wider for a short period of time. Many of the main credit indices are still not even mid-way in their historical ranges.

Insurance companies and other investors less sensitive to mark-to-market fluctuations are starting to look through near-term issues and buying credit risk. But the vast majority of the market is subject to frequent valuations and potentially constraining risk limits, so we doubt a rally can persist until the macro uncertainty has been resolutely addressed. Lots of cash is no use if there is no risk appetite.

In some sense, the latest European summit is a step in the right direction. At least the right issues are now on the table. Will it work though? It remains to be seen how the rates markets will receive the insurance scheme, but our initial take is sceptical.

And unless sovereign spreads come in substantially there will be no sustained rally in corporate credit in our view. We have seen over the last year that corporates can trade inside the sovereign where they are domiciled, especially when they are internationally diversified. However, average corporate spreads in Europe are now historically tight in CDS to the average sovereign spreads weighted the same way. At the European level, the diversification argument is much weaker, so we think it will be much harder for corporate credit to trade sustainably inside sovereign credit generically. This isn't just a question of periphery spreads. We are very mindful of the recent widening in OAT versus Bunds spreads. In *When Sovereigns Dominate Corporates* we highlighted that French corporates look vulnerable if risk premia on the French sovereign rise any further.

Worse, from a credit perspective we reckon the open-ended bank recapitalisation could end up creating more risks than no recapitalisation at all – at least until it is done. We are dubious about the amount of new equity that can be raised in the open market. While there may still be some sovereign wealth money, the experience from the last few years is likely to make many funds more hesitant.

And if the credit market can't see where the equity will come from, then it will start fretting about increasingly aggressive liability management exercises or even bail-ins. National governments, backed by the EFSF, might still end up providing much of the capital. But state involvement at the very least increases the likelihood of coupon deferrals and maturity extensions on the subordinated debt. Without clarity, investing in subordinated debt more than ever becomes a question of faith in policy – that faith has taken a few knocks recently, not least from the Greek PSI.

We fear elevated funding costs combined with a drive by European banks to improve their capital ratios through balance sheet shrinkage may have much more negative implications for growth than the current consensus factors in.

Taken together, this still leaves us distinctly negative on European credit in the near-term, despite the ostensible long-term value. US credit should be less affected but would not be immune to a renewed spike in European spreads in our view. Moreover, we remain sceptical that the supercommittee will be able to reach a compromise on the US budget that would actually be a positive for spreads.

Generically, we prefer investment-grade to high-yield and distressed, where we think there are more trapped longs and where outflows have been more sizeable. At a time where both the top-down and the bottom-up consensus for growth remain much higher than our economists' forecasts, we use spread compression during rallies to switch from higher-beta cyclicals into more defensive names.

In recent weeks, credit spreads may have appeared numb to a deteriorating macro environment, periphery sovereign spread widening and the gradual watering down of prospective policy actions. But we reckon this has largely been a correction in positions. At the end of the day, credit is still sitting in the back seat with the government bond market at the wheel. As long as sovereigns are heading in the wrong direction, credit will follow, uncomfortable as that may be.

Global Equity Strategy

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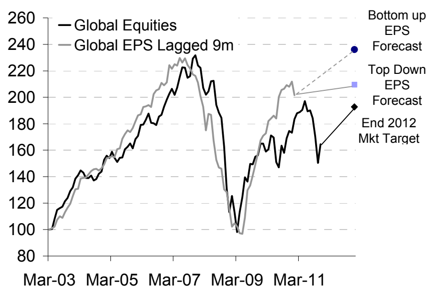
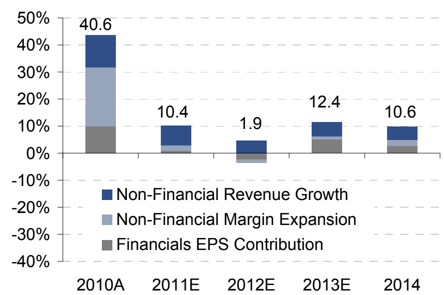
After the recent rally which pushed the global stock prices up by 10% from their lows, global equities are down -10% ytd. This rally occurred within less than two weeks and caught many investors by surprise. Expectations of European policy makers coming up with a comprehensive solution to the sovereign crisis, above-consensus macro data from US and positioning in the market are all possible explanations for this recent move. We think markets have moved much faster to price in an EPS recession than they did last time round and any improvement in investors' risk appetite can cause this kind of quick rally. We revised down our EPS growth forecasts to reflect the GDP downgrades by our economists. We now forecast global EPS to grow by 2% in 2012 and 12% in 2013. We cut our end-2012 target for the MSCI AC World from 390 to 360, still suggesting 20% gains from current levels. This should allow some recoupling of global equities and global EPS, but does not imply a re-rating back to levels seen earlier this year. At current levels, we think stock markets are implying global EPS to contract by 10-15% for 2012. We disagree and expect global EPS growth to stall, not reverse. The main risks to our outlook stem from Europe and potential secondary consequences for global growth.

Figure 49. MSCI AC World Price vs EPS (9m Lagged)



Source: MSCI, CIRA

Figure 50. Top-down Global EPS Growth Forecasts



Source: Company reports, Citi Investment Research and Analysis

At the start of the year, our top-down 2012 EPS growth forecast was in line with the analysts' consensus. Our current forecasts are well below consensus, but the close lead/lag relationship between global share prices and EPS (see Figure 49) suggests that market is now pricing in something worse. We think that the outlook for global EPS has worsened over recent months but not as much as the market is now discounting.

Our global EPS growth forecast of 2% for 2012 includes global Financials EPS falling by 15% and Non-Financials growing by 5% (see Figure 50). We believe corporate profit margins will level out over the next two years. In a wholesale global recession, global profit margins tend to fall sharply, magnifying the impact upon EPS. But in a more localised slowdown, as we are expecting now, profit margins should hold. This is what happened in 1998 around the Asian financial crisis.

Our expectation of 20% gains for global equities is in line with our regional strategists' targets. CIRA strategists around the world forecast their regions to deliver double-digit returns by the end of 2012 (see Figure 51). They are most optimistic on Emerging Markets and Japan, forecasting around 30% gains, while less optimistic on the US, UK and Australia expecting returns of around 15%.

Figure 51. **CIRA Equity Index Targets For End-2012**

Index	Current Level (on 19 Oct 2011)	Index Target 2012	Expected Gain (%)
MSCI ACWI	298	360	21%
S&P500	1210	1375	14%
DJ STOXX	237	280	18%
FTSE 100	5450	6200	14%
TOPIX	751	980	30%
S&P/ASX 200	4214	4900	16%
MSCI EM	933	1225	31%

Source: Citi Investment Research and Analysis

With the economic outlook unclear, investors are understandably wary of current/forecast EPS-based valuation metrics. CIRA equity strategists are increasingly looking at more stable valuation metrics such as P/BV or price to trend earnings. Global equities are trading at 1.5x P/BV, 25% higher than the low seen at the very worst of the last bear market. Europe ex-UK equities are trading only 15% above their 2009 low. While cheap valuations alone may not be enough to sustainably turn the markets, it should help to limit the downside.

Our key regional and global sector recommendations are summarised in Figure 52. Emerging Markets remain our preferred structural growth play. EM economies offer premium GDP growth which should translate into premium EPS growth. We stay Overweight. We are also Overweight Japan, which is our recovery play. The post-earthquake EPS downgrades have reversed and we believe Japan can benefit from positive earnings trends from this point. We favour EM plays in the developed world. We upgraded UK to Overweight as UK has a heavy weighting of commodity companies where the end market is driven by EM demand. Also, defensive companies in the UK such as the Consumer Staples generate much of their sales in EM. We remain neutral on Europe ex UK. The region is the epicentre of current concerns. However, valuations look very cheap. We suspect the region will enjoy considerable outperformance if authorities take credible steps to address sovereign concerns. We lowered the US to Underweight as it looks expensive relative to other equity markets where we see better opportunities. We remain underweight Australia as we think UK is a cheaper place to play the “EM in DM” theme.

Our global sector strategy also has an Emerging Market tilt. We are Overweight sectors with some of the largest EM end market exposure such as Materials, IT and Consumer Staples. These sectors have solid earnings and reasonable valuations, in our view. Despite dismal earnings momentum, we keep Financials at Neutral as we think short-term performance may be strong if there is an improvement in investors’ risk appetites. Our Underweight sectors include a mix of global cyclicals and defensives. We lowered Industrials and Consumer Discretionary to Underweight as earnings momentum is moderating for these Sectors. We also downgraded Utilities as we believe unique headwinds for the sector will persist for some time to come.

Figure 52. **Regional And Global Sector Recommendations**

Overweight	Neutral	Underweight
Global Emerging Markets	Europe ex-UK	US
Japan		Australia
UK		
Asia Pac ex Japan		

Overweight	Neutral	Underweight
IT	Health Care	Industrials
Materials	Energy	Utilities
Consumer Staples	Financials	Consumer Disc.
	Telecoms	

Source: CIRA

Securitised Products Strategy

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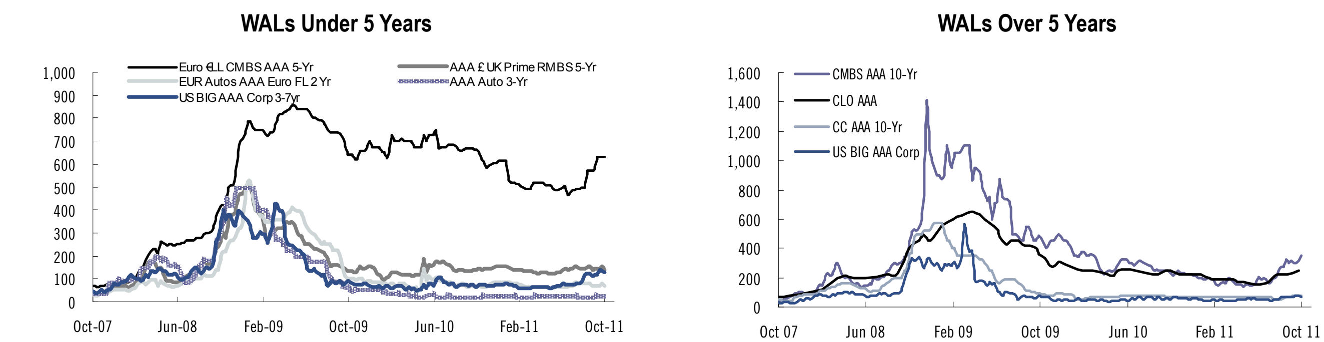
The value of a perfected security interest became apparent during the last few tempestuous months, and we project select securitised products sectors to remain a good foil for volatility. We expect certain defensive sectors to maintain their resiliency during the fourth quarter. We reiterate our market weight recommendation for core classes such as senior US credit cards and autos, senior-most CMBS, and various European ABS sectors. US Agencies, although they look expensive to structured credit products, should also be a source of good stability.

In turn, the more credit-sensitive sectors, such as subordinate CMBS and European RMBS, still show elevated correlation to the broad market negative sentiment. But if the market gradually becomes convinced that a credible resolution to the broader issues is in the works (especially for the European sovereign debt challenge), we would expect to see securitised products' sensitivity to headline risk subsiding, and a renewed focus on close fundamental analysis.

Figure 53. Selected Securitised Products Sectors — Spread Performance, Oct 07-Oct 11



Source: Citi Investment Research and Analysis

Policy Analysis Becomes Key for Investment Decisions…

Still, the factors which roiled markets in August and September remain largely unresolved. Uncertainty is the only certainty in this market. The global landscape, **including Europe, the United States, and Asia, faces significant challenges** in the months to come. These hurdles should keep markets on edge and yet are the reasons why defensive securitised products should offer relatively good protection.

Key to addressing the global challenges would be policymakers' actions. The recent swing from market pessimism to optimism over the European debt situation underscores this. The brewing plan for bank recapitalisation, the greater likelihood of Greece getting a sixth tranche of aid, and the prospects for bolstering up the EFSF, have sharply improved market sentiment, leading to a strong rally. But the fact that a confidence vote in Slovakia commanded rapt market focus, demonstrates how unpredictable and diverse the factors determining market sentiment have become.

…Especially As the Economic Outlook Remains Cloudy

Several securitised products sectors remain sensitive to broad market themes because there are also hanging uncertainties over the fundamentals that have more direct impact on ABS performance. On balance, the economic outlook

remains challenging. But our economics team takes consolation from data which continues to show evidence of reasonable strength in the face of strong headwinds.[4]

- **Autos are a bright spot** — September auto sales reported strongly at 13.04 million SAAR. This prognosticates good auto ABS supply into the fourth quarter. Another strong measure is the durable goods advance report, which revealed surprising gains in core business investment in new equipment. Orders rose by 1.1% and July was revised higher.

- **Lacklustre growth** — Citi's economists expect tepid economic growth to continue through year-end 2012, unemployment to remain above 9% and inflation to float below 2%. Fed's Operation Twist shows measurable effects to rates, but the economy continues to be bogged down by sovereign and political uncertainty.

- **Consumer convalescence** — Consumers remain focused on saving, deleveraging, and rebuilding household balance sheets. Weak labour markets are putting downward pressure on wage growth, restraining real disposable income. However, real consumer spending is on track to accelerate slightly in the third quarter.

Securitisation Emerges As Attractive Funding Alternative

Interestingly, the choppy market environment has made securitisation attractive compared to unsecured funding. For example, financial unsecured debt widened at a pace that is nearly five times that of comparable credit card ABS during the last month. Therefore, we think banks ought to reconsider new issuance in the credit card ABS markets. Similarly, UK Prime RMBS is tight versus senior unsecured and covered bonds spreads as investors flock to the safety of secured collateral. As such, we were not surprised to see a pick-up in European ABS new issue supply.

We expect renewed interest in securitisation funding to intensify especially as the existing supply run off far exceeds new issuance. For example, roughly $55 billion of credit card ABS supply runs off during 2011, matched against only roughly $10 billion of new YTD supply.

Sector Relative Value and Allocation Recommendations

Our securitised products strategists have mixed views on the market, ranging from bullish to neutral, and Figure 54 shows Citi strategists' recommendations for major structured products sectors on a scale of -3 (maximally bearish) to +3 (maximally bullish). The table also incorporates the strategists' most current thinking about value and presents one or two trade ideas.

Figure 54. Sector Relative Value and Asset Allocation Recommendations — Selected Sectors, October 2011

Sector	Strategist Recommendation	Spreads Relative to Long-Term Averages	Comments
CABS	0	Fair	Remain market weighted. Senior cards and auto are our core picks. We also like certain off-the-run senior sectors, including dealer floorplan, private label credit cards, equipment and auto lease ABS.
CMBS	+1	Cheap	Our long-term view remains for further tightening, but the current environment suggests waiting a bit longer to step in with new investments. We still feel that buying stronger AMs opportunistically in a market dislocation will ultimately reward investors in the long run.
Agency MBS	-1	Fair to Rich	Relative to regression based fair value, 30yr MBS nominal spreads appear roughly 10bps rich. Richness is likely due to the market's anticipation strong support by the Fed in coming months.
European Securitised Products	+	Cheap to Fair	Short duration autos offer strong cash alternative. We also like UK Credit Cards, UK prime RMBS, UK BTL, CMBS. Look for spreads to outperform

Source: Citi Investment Research and Analysis

[4] See *US: Economic Forecast Highlights: September 2011*, by Robert DiClemente et al, 29 Sep 11 and *Comments on Credit: Defining Recovery Down*, by Robert DiClemente et al, 30 Sep 11.

Commodity Outlook and Forecast

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After a precipitous 11% decline in 3Q11 (and the steepest drop since 2H08) on the back of heightened EMU tail-risk, retrenchment in global growth forecasts, elevated cross-asset volatility and a surging US dollar – commodities have rebounded markedly during the month of October, up ~6%. But uncertainty abounds and it is still not clear whether the commodity 'bull-run cycle' that has been on hold since mid-August is experiencing an extended relief rally or if the current market reprieve predicates a transition to a new phase in the cycle. In our view, it is premature to call any definitive change in trend. Rather, it might be more appropriate to acknowledge commodity risk sentiment has stabilised, and that the market appears to be better balanced between buyers and sellers, at least for now.

Figure 55. Commodity Price Forecasts*

Commodity Price Forecasts		Spot	Forecasts 0-3M	6-12M	5Y Cyclical	2011E	2012E	2013E
Energy								
NYMEX WTI	USD/bbl	91.3	85.0	72.5	81.0	90.0	72.0	92.5
ICE Brent	USD/bbl	111.2	110.0	91.0	85.0	106.0	86.0	102.0
Henry Hub Natural Gas	USD/MMBtu	3.6	3.8	4.0	N/A	4.1	4.1	N/A
Base Metals								
LME Aluminum	USD/MT	2,205	2,150	2,325	2,500	2,443	2,300	2,566
LME Copper	USD/MT	7,637	7,000	8,500	7,500	8,763	8,113	8,534
LME Lead	USD/MT	2,002	1,975	2,275	2,200	2,423	2,244	2,356
LME Nickel	USD/MT	19,976	17,500	21,750	18,500	24,309	21,063	23,419
LME Tin	USD/MT	22,516	22,000	23,000	18,000	26,400	21,750	23,938
LME Zinc	USD/MT	1,862	1,850	2,125	2,300	2,204	2,075	2,256
Precious Metals								
Gold	USD/T. oz	1,652	2,000	1,650	1,050	1,575	1,950	1,744
Silver	USD/T. oz	32	33	32	20	35	33	27
Platinum	USD/T. oz	1,537	1,550	1,630	1,500	1,725	1,630	1,675
Palladium	USD/T. oz	639	620	870	550	731	830	870
Bulk Commodities								
Hard Coking Coal (benchmark Asia)	USD/MT	225	N/A	N/A	200	289	275	248
Thermal Coal (API2)	USD/MT	117	123	125	105	122	139	148
Iron Ore Spot (TSI)	USD/MT	142	160	175	81	174	160	135
Agriculture								
Corn	USD/bu	651	675	699	700	688	676	N/A
Soybeans	USD/bu	1,227	1,247	1,342	1,350	1,289	1,363	N/A
Wheat	USD/bu	643	700	716	675	713	710	N/A
Rice	USD/cwt	17	15.6	16.0	14	15.3	15.5	N/A
Cotton	USD/lb	98	104	98	125	150	100	N/A
Sugar	USD/lb	27	29	26	25	28	25	N/A
Coffee	USD/lb	251	245	249	180	250	250	N/A
Cocoa	USD/MT	2,627	2,850	3,000	3,100	3,100	3,095	N/A

Sources: Bloomberg and Citi Investment Research and Analysis, *subject to change

Commodity index investments experienced an estimated $6.5bn in net inflows for the two consecutive weeks ending 18 October. This most recent data reverses a five week trend of steadily rising net index swap outflows through the beginning of 4Q11, during which time risk assets underwent a period of outright capitulation. The current market is buttressed by four primary factors.

First, and perhaps most importantly, sovereign risk has shown some signs of improvement. While the EU remains under duress and the situation removed from immediate resolution, EMU policymakers appear more focused in finding scalable solutions for sovereign restructuring and bank recapitalisations, which has aided risk sentiment. On macro growth, China is still growing at over 9% and has been buying grain and base commodities on bouts of price weakness, and indications

argue for a rebound in its manufacturing. US data also point to potentially stronger growth than visualised during the third-quarter retrenchment. The macro outlook has correlated to a third point, which is the declining USD, helping commodities appreciate on a nominal basis. At the beginning of October, the asset class was on edge as the US dollar index had rallied to nearly 80 (EURUSD at nine-month lows). Since then, the US dollar has steadily weakened; USDJPY printing a post-WWII record low and the Euro gaining 5% month-to-date. Dollar weakness has helped stabilise long LME/short DXY structures that unwound substantially in September, in addition to supporting prices for petroleum markets and gold. Lastly, managed money net length and paper-market conviction appear to be improving on the margins, having recently sharpened for WTI and for the agriculture complex.

Figure 56. Near Term Outlook

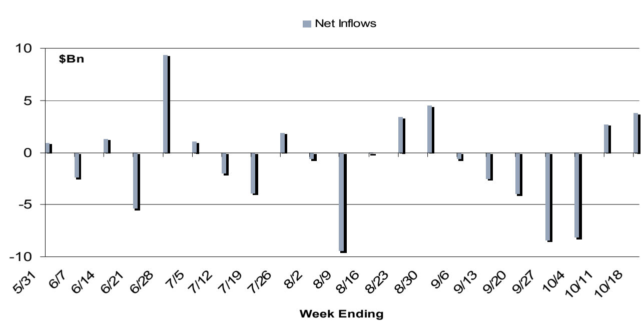
	Current	Prior Month	Beginning of Year
Energy	Slightly Bullish	Bearish	Bullish
Precious Metals	Slightly Bullish	Slightly Bullish/Neutral	Slightly Bullish
Base Metals	Neutral	Slightly Bearish	Bullish
Bulk Commodities	Neutral	Slightly Bearish	Bullish
Agriculture	Neutral	Slightly Bullish	Neutral

Source: Citi Investment Research and Analysis

On the whole, macro headlines should be the catalyst for commodities, albeit tail-risks remain prevalent and volatility remains well above 1H'11 levels. As such, we expect there to be heightened differentiation among key sectors and temporary factors that will help certain commodities outperform its peers.

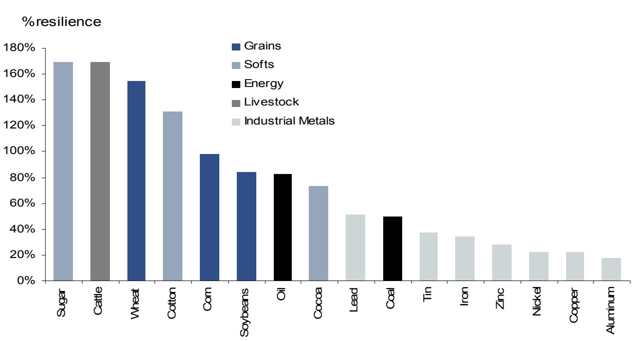
As to particular sectors, the petroleum complex remains favourable in the short-term, as even the WTI forward curve has shifted into backwardation. Despite Libya's return to market at a robust pace, we are the peak of global refinery turnarounds and crude demand should be better positioned into the end of 4Q11, with the larger question of demand-destruction in 2012 looming on meaningful global growth slowdown (and thus keeping us more bearish in the medium-term). We increase our 2012 gold forecast to $1,950/t. oz on continued fiat-currency depreciation, loose monetary policy and macro risk aversion. We initiate US natural gas coverage with a flat price outlook in 2012 on a likely cold winter and strong supply. Copper is likely to be underpinned by Chinese buying but the market likely to be capped at the $9,000/t mark although supply problems provide upside risk. We remain neutral-to-bullish in the agriculture complex as historically low global inventory levels in key grains still need to be rebuilt and emerging markets look to support prices to curb food-price inflation, favouring corn and soy prices.

Figure 57. Weekly Commodity Index Flow Estimates



Source: CFTC, Citi Investment Research and Analysis estimates

Figure 58. Resilience to World Economic Downturn*



Source: Citi Investment Research and Analysis, *1 / short-term 'real' income elasticity

Citi Foreign Exchange Forecasts

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† This author is not an independent research analyst and may have knowledge of the Firm's positions and/or the Firm's interest in one or more of the securities referenced herein.

Market Commentary

This market commentary has been prepared by a member of the Institutional Clients Group of Citi. The information in this communication is not intended to constitute "research" as that term is defined by applicable regulations.

** For specific trade ideas associated with this sector review, please contact the contributors listed at the end of this piece

- We still expect elevated risk aversion and weaker global growth expectations to drive USD gains over the short to medium term across the board.
- We forecast 3-6% USD gains on a DXY basis over the short to medium term with EUR/USD likely to drop into a 1.25-1.30 range. There should be further near-term USD gains vs. commodity backed G10 currencies as commodity prices ease, with NZD the worst performing.
- Only JPY is likely to be strong enough to resist the USD advance.
- Within Europe, EUR relative strength is likely short term vs. the Scandis and CHF but downside is expected for EUR/GBP.
- Within EM, CEEMEA is expected to come under the most pressure, with Latam outperforming. Asia runs a middle course.

Citi Foreign Exchange Forecasts

These forecasts are a joint venture between Citi's foreign exchange, global macro and technical strategy groups and our developed and emerging markets economists. Under normal circumstances, we expect to present *Forecasts* on a monthly schedule although we may offer intra month updates if circumstances dictate.

While these forecasts should be considered the best guide to Citi's short to medium-term views on the outlook for the exchange rates covered, individual analysts within various strategy teams may offer separate trade ideas in spot, forward, options or futures when this seems appropriate for technical, tactical or strategic reasons.

Figure 59. Citi Foreign Exchange Forecasts

		Market data			Forecasts			Returns**	
		spot	3m Fwd	12m Fwd	0-3 mos	6-12 mos	long-term	3 mos rtn	12 mos rtn
G10									
Euro	EURUSD	1.39	1.39	1.39	1.31	1.25	1.30	-5.6%	-9.9%
Japanese yen	USDJPY	76	76	76	75	76	78	-1.3%	0.6%
British Pound	GBPUSD	1.59	1.59	1.59	1.54	1.51	1.65	-3.3%	-5.2%
Swiss Franc	USDCHF	0.88	0.88	0.87	0.95	0.95	1.04	7.3%	8.9%
Australian Dollar	AUDUSD	1.03	1.02	1.00	0.96	1.02	0.95	-6.1%	2.5%
New Zealand Dollar	NZDUSD	0.80	0.80	0.78	0.73	0.79	0.63	-8.5%	0.9%
Canadian Dollar	USDCAD	1.01	1.01	1.02	1.06	1.00	0.95	4.8%	-1.5%
Dollar Index*	DXY	76.33	76.36	76.37	79.91	82.08	79.36	4.7%	7.5%
G10 Crosses									
Japanese yen	EURJPY	106	105	105	98	95	101	-6.9%	-9.4%
Swiss Franc	EURCHF	1.23	1.22	1.21	1.24	1.19	1.35	1.3%	-1.9%
British Pound	EURGBP	0.87	0.87	0.87	0.85	0.83	0.79	-2.4%	-4.9%
Swedish Krona	EURSEK	9.11	9.15	9.24	9.35	9.00	8.80	2.2%	-2.6%
Norwegian Krone	EURNOK	7.72	7.76	7.85	7.90	7.75	7.70	1.9%	-1.3%
Norwegian Krone	NOKSEK	1.18	1.18	1.18	1.18	1.16	1.14	0.3%	-1.4%
Australian Dollar	AUDNZD	1.29	1.28	1.27	1.32	1.29	1.51	2.6%	1.6%
Australian Dollar	AUDJPY	79	78	75	72	78	74	-7.4%	3.1%
Asia									
Chinese Renminbi	USDCNY	6.38	6.39	6.41	6.29	6.11	5.87	-1.6%	-4.8%
Hong Kong Dollar	USDHKD	7.78	7.78	7.75	7.78	7.76	7.75	0.0%	0.1%
Indonesian Rupiah	USDIDR	8908	9050	9478	9279	8879	8650	2.5%	-6.3%
Indian Rupee	USDINR	50.0	50.8	51.9	50.0	47.4	46.0	-1.7%	-8.8%
Korean Won	USDKRW	1148	1151	1157	1146	1096	1030	-0.5%	-5.3%
Malaysian Ringgit	USDMYR	3.15	3.16	3.18	3.18	3.05	2.89	0.6%	-4.0%
Philippine Peso	USDPHP	43.5	43.5	43.5	43.7	42.6	41.5	0.4%	-2.2%
Singapore Dollar	USDSGD	1.27	1.27	1.27	1.28	1.24	1.17	0.8%	-2.6%
Thai Baht	USDTHB	31.0	31.2	31.7	30.8	30.0	29.5	-1.4%	-5.3%
Taiwan Dollar	USDTWD	30.3	30.1	29.8	30.2	29.4	28.2	0.3%	-1.2%
EMEA									
Czech Koruna	EURCZK	25.0	25.0	24.8	25.3	24.7	23.7	1.3%	-0.6%
Hungarian Forint	EURHUF	298	301	310	335	315	285	11.1%	1.8%
Polish Zloty	EURPLN	4.38	4.42	4.51	4.55	4.30	3.90	2.8%	-4.6%
Israeli Shekel	USDILS	3.63	3.65	3.67	3.80	3.70	3.70	4.1%	0.8%
Russian Ruble	USDRUB	31.1	31.6	33.0	32.9	34.2	31.7	4.2%	3.4%
Russian Ruble Basket		36.5	37.1	38.8	37.2	38.0	36.0	0.3%	-2.1%
Turkish Lira	USDTRY	1.83	1.87	1.97	1.94	1.88	1.79	3.6%	-4.6%
South African Rand	USDZAR	8.05	8.16	8.45	8.13	8.50	8.80	-0.4%	0.6%
LATAM									
Brazilian Real	USDBRL	1.77	1.81	1.89	1.80	1.70	1.70	-0.5%	-10.2%
Chilean Peso	USDCLP	512	519	531	520	530	490	0.2%	-0.2%
Mexican Peso	USDMXN	13.6	13.7	14.0	13.2	12.8	12.2	-3.5%	-8.4%
Colombian Peso	USDCOP	1897	1908	1939	1850	1850	1900	-3.0%	-4.6%

* The DXY forecasts are implied from the forecasts of the constituent crosses.
** Returns are relative to forwards

Source: Citi Investment Research and Analysis

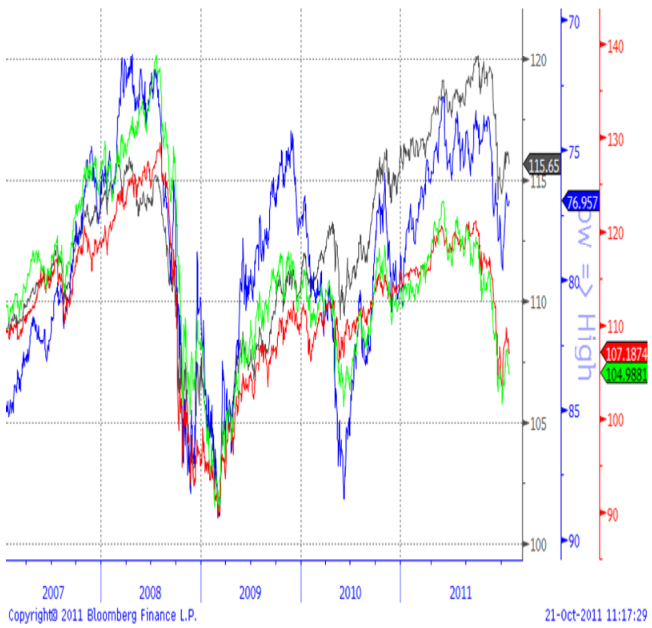
Overview

Our FX forecasts are not significantly different from last month. With risk aversion likely to remain elevated (see Figure 61) and global growth expectations still ratcheting lower, we expect broad based USD strength to resume over the short to medium term. In developed markets, key barometer exchange rates are EUR/USD (expected to drop to around 1.30) and AUD/USD (forecast at 0.96), both over 0-3 months.

As Figure 60 highlights, it is unlikely that USD gains vs. developed currencies will not feed gains vs. EM FX too. In each recent period of USD strength on a DXY basis, there have also been gains vs. ADXY and LATAM/ CEEMEA currencies. The scale of US/EM upside depends on the source of the shock. If the only relevant factor is European stress then May 2010 tells us that upside for the USD will be limited outside CEEMEA. But if weak global growth is the driver, 2008 suggests much broader USD gains. We think both factors are currently relevant and therefore think the risks are to the upside for most USD exchange rates.

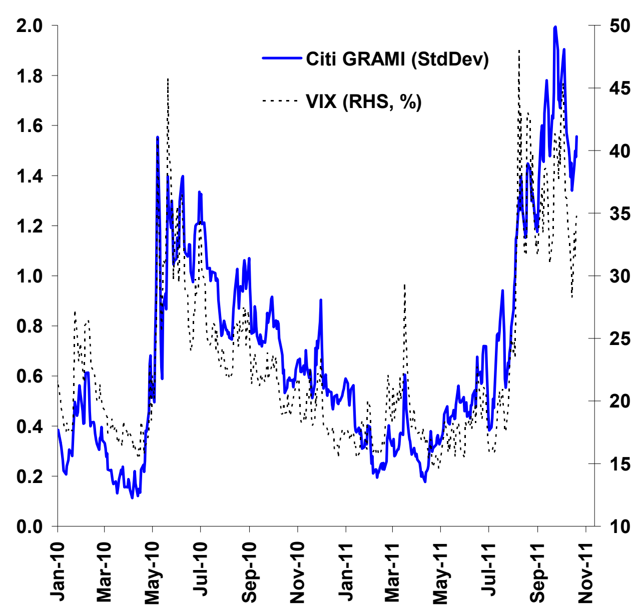
A key question for Asia though will be CNY. Since Greater China is nearly half the ADXY index, it is unlikely that ADXY has so much downside as other currency blocs vs the USD unless CNY depreciates. While spot moves in USD/CNY are likely to be small with the USD strong more broadly, we do not expect CNY spot depreciation. As such, ADXY should be low volatility compared with LATAM and CEEMEA currencies.

Figure 60. DXY (Blue), ADXY (Black), LACI (Red) CEEMEA FX (Green)



Source: Citi and Bloomberg * CEEMEAXY is an equally weighted index of CZK, HUF, PLN, ILS, RUB, TRY, ZAR (all vs. USD), rebased to Jan2010=100. Higher CEMEAXY = CEEMEA FX appreciation

Figure 61. Risk Aversion Higher – Citi GRAMI



Source: Citi and Bloomberg

EUR/USD – Further Downside

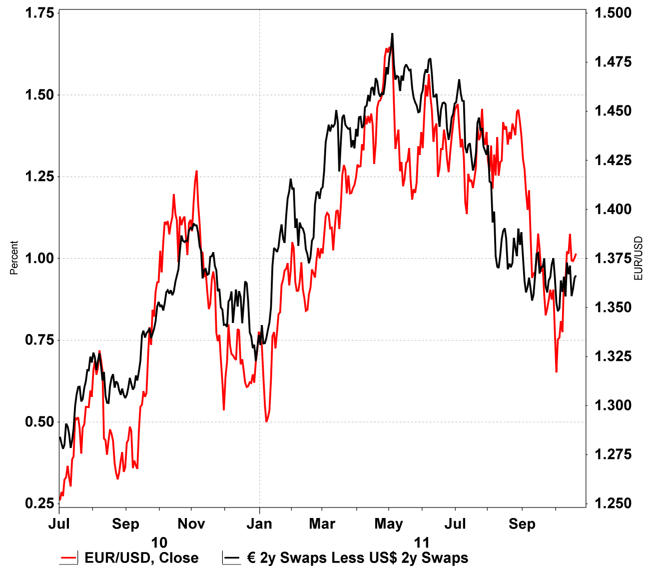
After a sharp sell off in September, that saw EUR/USD fall from just over 1.45 to a low of below 1.32 by early October, the single currency then retraced over half its losses by mid month. This latter recovery seems to have been based on optimism that the package of measures, which will be announced after the European Summits on 23 and 26 October, will change sentiment regarding the EMU crisis. While we are not privy to the details as we write, we remain sceptical that this will be the case. Meanwhile, rate differentials and relative economic performance seem to point to a somewhat weaker EUR (see Figure 62).

Key elements of the deal will likely include a new PSI agreement to haircut Greek debt and the leveraging of the EFSF as an insurer of first losses on sovereign

issuance plus recapitalisation of Euro Area banks. We doubt this is the "big bazooka" that may be needed unless the Greek haircut is in the 60-70% range, banks raise €300bn in new capital and the size of the EFSF is expanded even allowing for leverage. We also think an aggressive intervention from the ECB would be helpful, to include both lower rates and expanded and persistent purchases of T2 debt by the SMP, but also doubt this will occur.

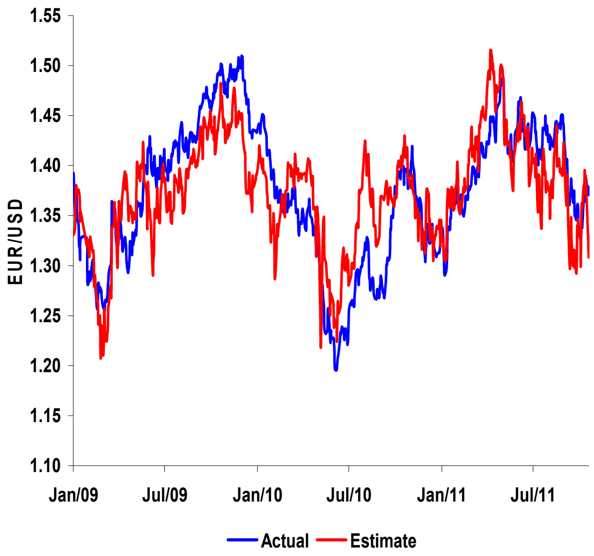
As a result, we think markets may "buy the rumour and sell the fact". With global growth expectations still weak/falling and risk aversion high, we see further EUR weakness over time and our 0-3 and 6-12 months forecasts are unchanged this month at 1.31 and 1.25 respectively.

Figure 62. EUR/USD (Red) vs. 2y Swap Rate Differentials (Black)



Source: Reuters EcoWin

Figure 63. Markets Based EUR/USD Fair Value Model



Source: Bloomberg and Citi

To be fair, EUR/USD trading around 1.37 is fair value relative to long term fundamentals (our augmented PPP World Exchange Rate Model (WERM)) albeit slightly high relative to market drivers such as rates, relative equity market performance, oil prices and periphery stress. Our markets-based fair value model (see Figure 63) has neutral at around 1.31. Much will depend on investor confidence from here. If investors believe that European policymakers are finally delivering the goods, confidence will improve, risk assets will rally and the EUR/USD will likely follow. But, more likely, we think the return of concern about the EMU crisis, rising risk aversion and lower rate differentials will most likely lead market drivers to push EUR/USD below the WERM long run FV level over the next 12 months.

Yen – USD/JPY Broadly Stable Medium Term

USD/JPY has traded in a tight range of 76-78 since the intervention induced spike to over 80 in early August. However, there is little evidence that the trend lower in this exchange rate since mid-2007 is over. Instead, with global growth expectations falling and risk aversion rising, we expect further moderate downside for the rate near term absent further intervention. With institutional Japanese investors like Life Insurers fairly heavily hedged against JPY strength already, they are unlikely to be big players. Retail investors may look to go back into higher yielding FX like AUD if

confidence stabilises but, against this, corporates seem under-hedged and could cap upside in USD/JPY between 78 and 80 even if retail capital outflows pick up.

Japanese fundamentals are mixed. The current account surplus of around 2% of GDP remains a positive and unemployment remains low by international standards. On the other hand, Japanese economic growth remains fragile and supported by a large, and probably unsustainable, fiscal deficit. A new supplementary budget is due by end-October, with additional spending to support reconstruction after the earthquake likely to total around Y12trn. Tax hikes to pay for this seem likely to be delayed to 2013 giving a possible net boost to real GDP in 2012 of 0.7ppt. But the underlying economy remains weak and the BoJ will likely downgrade its economic growth forecast later this month mainly as a result of weaker external demand. As a result, further monetary stimulus is also likely including an extension on the duration of JGB purchases.

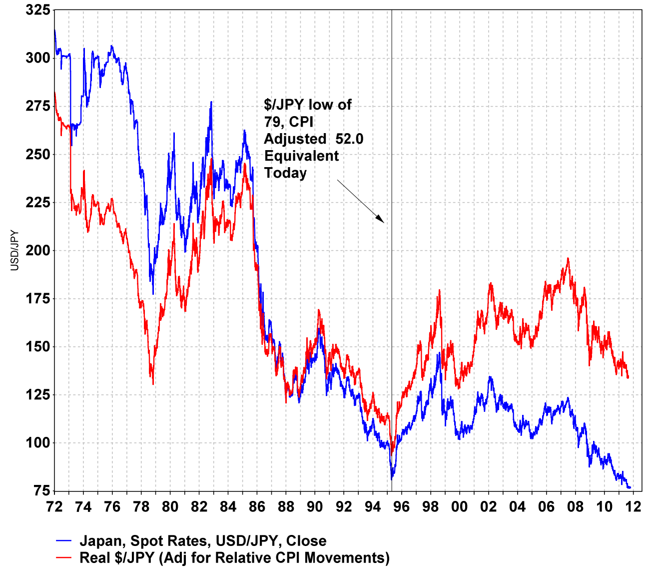
Overall, we doubt that these domestic policy changes matter much for USD/JPY. Instead, a key driver remains the path of US and European short rates. Figure 64 does suggest that USD/JPY is low to existing rate differentials. However, since yields in neither bloc seems likely to rise much in the current environment, we think USD/JPY will have upside only on occasions when MoF/ BoJ intervene, and our guess is that this will not happen unless spot falls through 75 (even then we do not consider this justified since the real USD/JPY rate is not stretched - Figure 65).

Our forecast is for a broad stability in the USD/JPY rate in the face of USD strength elsewhere.

Figure 64. USD/JPY vs. 2y Swap Rate Differentials

Source: Reuters EcoWin and Citi

Figure 65. USD/JPY: Nominal and Real Levels



Source: Reuters EcoWin and Citi

Dollar Bloc – USD Higher Across the Board

AUD/USD peaked at over 1.10 in late July, fell around 15% by early October but then retraced around 60% of the down move later in the month. At the time of writing, spot is still around 7% off the peak. Our bias is still lower for AUD. In part, this reflects the overall view expressed here that the USD will do well as global growth weakens and risk aversion remains elevated. But there are also AUD-specific factors to consider.

Relative to traditional valuation metrics, such as our WERM fair value estimate of 0.86, the currency remains very rich. Supports to AUD that have allowed this degree of longer-term overvaluation have included relatively high Australian rates/carry, terms of trade gains and the related strength of EM economies, especially China. Now all these supports are being questioned.

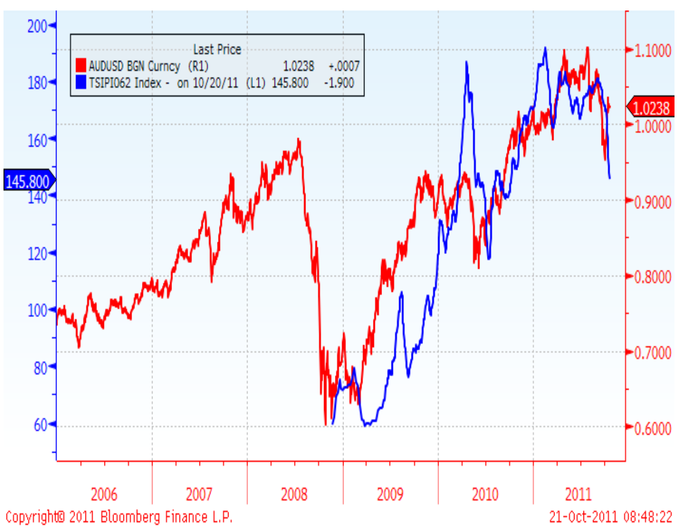
On rates/carry, the AUD should now be trading below 0.90 based on simple regressions on 2y rate differentials. Markets still price in significant rate cuts from the RBA over the next 6-12 months and this has reduced the positive carry for the currency. While these cuts are far from assured, Australia's economy is slowing and our economists have recently reduced growth forecasts somewhat. For some time, the economy has been two-speed. Robust external demand and investment in resources, but more subdued household spending. As external risks mount, the danger that the balance shifts towards rate cuts being needed has increased.

Meanwhile, commodity prices have been falling since early May with industrial metals and aggregates leading the way. Some of Australia's key exports like iron ores have held up thus far, but spot ore prices are now catching up to the downside (see Figure 66) suggesting that the commodity price rug is being pulled from AUD. Our commodity analysts are bearish on most prices over the medium term, a view that fits with a possible stronger USD, weaker growth and investor uncertainty.

Related to this, EM growth is also now faltering and, importantly, China looks vulnerable (see EM section below). Recent data there have been soft, leading indicators such as PMIs and money growth look worrying and exports are softening. It also appears that stockpiled inventories of commodities are high. All this suggests downside risks remain for AUD.

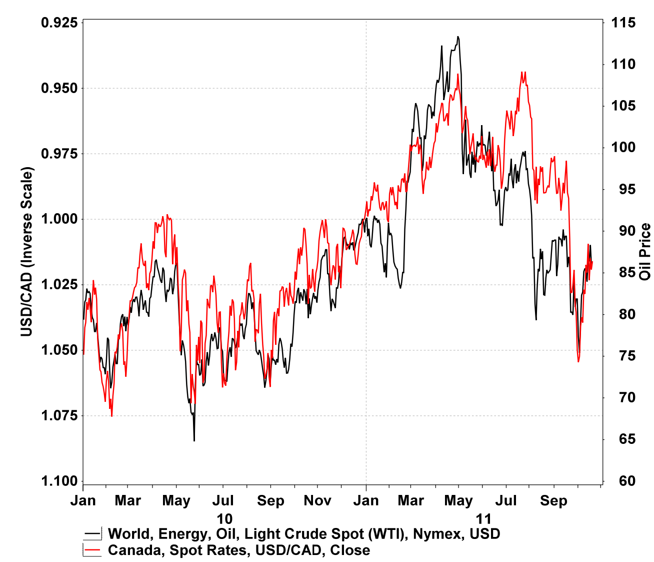
Taking all these factors into account, we feel that AUD has probably peaked, at least for the medium term, and may trade a rather lower range over the short term. We predict 0.96 over 0-3 months and look for around 1.02 over 6-12 months.

Figure 66. AUD/USD vs. Iron Ore Spot Prices



Source: Bloomberg

Figure 67. USD/CAD vs. Oil Prices



Source: Reuters EcoWin

NZD has traded similarly to AUD, depreciating since early August by around 15% and then rallying back somewhat this month. As with AUD, we expect further downside in NZD. Indeed, we expect NZD to underperform AUD in this period. NZ economic growth remains anaemic and soft commodity prices have weakened more than hard commodity prices this year. With household and corporate demand weak, RBNZ policy will likely remain very accommodative. With existing policy rates little more than half AUD levels, carry is much less supportive for NZD and all the more so if very moderate rate hikes now priced into the forward curve drop out.

All in all, in the context of a stronger USD, we forecast NZD at 0.73 over 0-3 months and then 0.79 over 6-12 months.

Turning to CAD, spot USD/CAD bottomed at around 0.94 in May and July and has been trending higher since then, albeit with a 5-6% peak to trough correction in October. We think the move back above parity is warranted by a combination of rate differentials and oil price movements (see Figure 67) and expect moderate further upside for the exchange rate as oil prices are expected to fall further and the USD may be generally stronger.

Some modest upside in USD/CAD would please policymakers, especially the Bank of Canada which sees currency strength as a downside risk to growth. With US growth still vulnerable to the downside and Canadian labour market developments disappointing, Bank of Canada policy seems unlikely to tighten anytime soon and further easing measures are possible.

Overall, we expect USD/CAD to return to 1.06 over 0-3 months and to remain at/ above parity over the medium term.

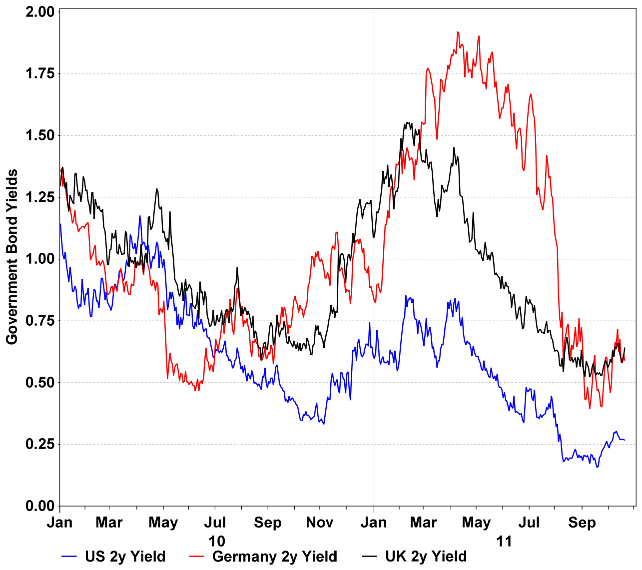
European Crosses

GBP – Cheap But Slow Progress Stronger Likely. Up vs. EUR, Down Vs. USD

Sterling continues to be pulled in different directions by valuation (cheap) and by UK economic and monetary conditions (not helpful). On the valuation side, GBP continues to look cheap on our long-term WERM valuation models (FV at EUR/GBP 0.79 and GBP/USD 1.73). But further weakness in the UK economy has led to increased asset purchases by the Bank of England despite further surprises to the upside on CPI inflation. Our economists expect this second round of QE to be extended further in coming months as the economy remains weak and base effects generate lower levels of headline inflation. In the recent past, BoE QE has been probably the most aggressive of the major Central Banks, partly because it has been fighting the effects of a severe fiscal policy tightening. This mix of easy money and tight fiscal policy is not helpful for currencies and policymakers will lose little sleep over a weak pound as they attempt to re-balance the economy towards net exports and investment and away from consumer demand.

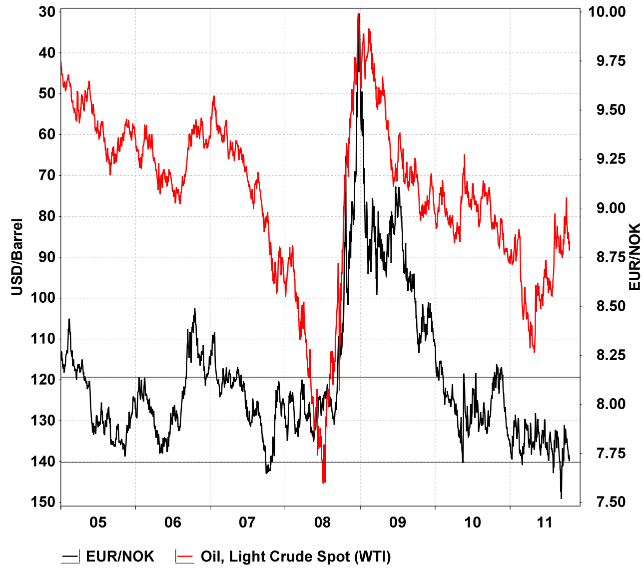
The net result of these conflicting forces has been to keep GBP remarkably stable on a basket basis against the EUR and USD combined. Aside from valuation, one reason GBP has held up despite the new QE measures is that carry has been stable vs. USD and less adverse relative to the EUR recently (see Figure 68). Our forecasts show losses for GBP/USD as the USD rallies more generally but downside for EUR/GBP in line with expected downside in EUR/USD.

Figure 68. 2y Yield Moves Help GBP



Source: Reuters EcoWin

Figure 69. EUR/NOK vs. Crude Oil Price



Source: Reuters EcoWin

Scandis – Weaker Given High Risk Aversion

EUR/SEK bottomed out in February/March and then trended higher through to August. Since then, the cross has traded in a volatile fashion but with a rather flat trend around 9.15. SEK tends to be a currency that is vulnerable in risk off periods both because Swedish stocks tend to be high beta to the overall equity market trend and because the underlying economy also remains sensitive to trends in the European/global cycle. This is evident in the current slowdown too. Our Swedish forecasts show real GDP growth more than halving from 2010 to 2012. This means that the Riksbank is now unlikely to change rates for the foreseeable future which leaves SEK less supported from current, and expected future, carry. Hence, while static fundamentals such as Sweden's zero government deficit and large current account surplus are helpful, we still expect some moderate upside in EUR/SEK over 0-3 months as global risk aversion remains elevated. Medium to longer term, the currency probably offers better value given our WERM fair value estimate of 8.80.

In Norway, EUR/NOK remains in a mainly sideways trading range (see Figure 69). After a sharp spike lower in early September, the cross is again back in a 7.70-7.90 band that has prevailed this year. We expect this to continue in our forecasts. As in Sweden, a strong external account and an even stronger government balance sheet are positives, while the equity market beta is less than for Sweden. However, NOK remains correlated with oil prices which Citi forecasts to fall. Our WERM fair value estimate is 7.68, again not really a major factor relative to the prevailing range.

CHF – Peg Holds for a While At Least

EUR/CHF had effectively bottomed even before the SNB shocked markets with the announcement of an asymmetric peg on EUR/CHF at 1.20 (or higher) on 6 September. Since the peg announcement, spot has been gently ratcheting higher in a 1.20-1.22 range, then rising to 1.21-1.235 and most recently trading 1.23-1.245. It is not completely clear what is behind these recent moves but it seems that the "bid" for EUR/CHF from the SNB that has been communicated to FX desks has been creeping higher. No doubt the SNB is keen to avoid a sense of one way risk to the

1.20 target level as the flows into CHF could potentially be very large if only downside risk is perceived for the cross.

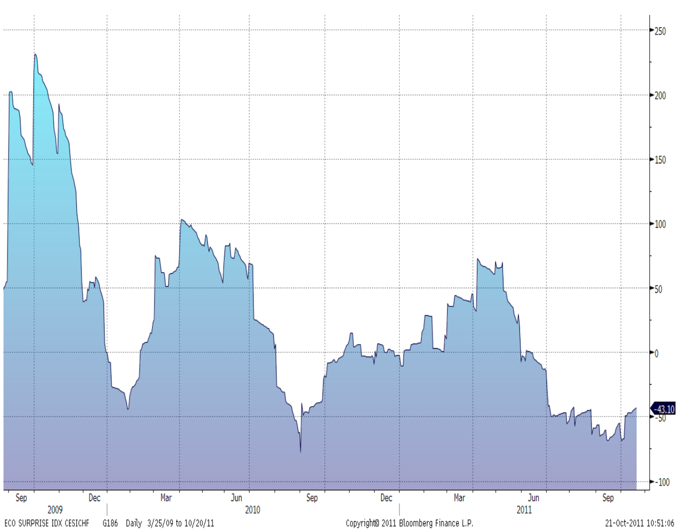
For now, we expect the peg to hold. One of the key issues is that this is effectively an easing of monetary policy by the SNB, but it is one that is justified and therefore credible in our view. For example, easier money is warranted by the current zero core inflation in Switzerland (6m annualised rates are running at -1 to -1.5%) and by the sharp weakening in Swiss economic activity (see Figure 70 on our Citi ESI). For so long as this weak growth/low or negative inflation background persists, the market is unlikely to really test the SNB's resolve.

But, setting a currency peg effectively makes the domestic money supply endogenous. In 2009, base money growth in Switzerland rose to over 150% pa as the SNB intervened at various levels to stem EUR/CHF losses (see Figure 71). But with an unlimited commitment to sell CHF at 1.20 (or higher), domestic money growth rates have already exploded to even higher levels. We have calculated that if all bondholders in the periphery 3 (Greece, Ireland, Portugal) sold out to the SMP or EFSF and then gave their EUR to the SNB, Swiss base money growth would be circa 800%. If we throw in Spain and Italy, this might rise to 2000-4000%. This may seem an extreme scenario but, on the other hand, it does not allow for other liabilities such as bank deposits making their way into CHF.

So a key medium-term question becomes this: Will the SNB tolerate such large domestic money growth? For sure, there is no reason not to now. But what if we see some signs of economic recovery and a sharp rise in local real estate prices and other asset markets? Alternatively, or additionally, assuming that over 6-12 months the EMU crisis continues and a weak EUR generally persists, the longer-term sustainability of this peg remains in doubt.

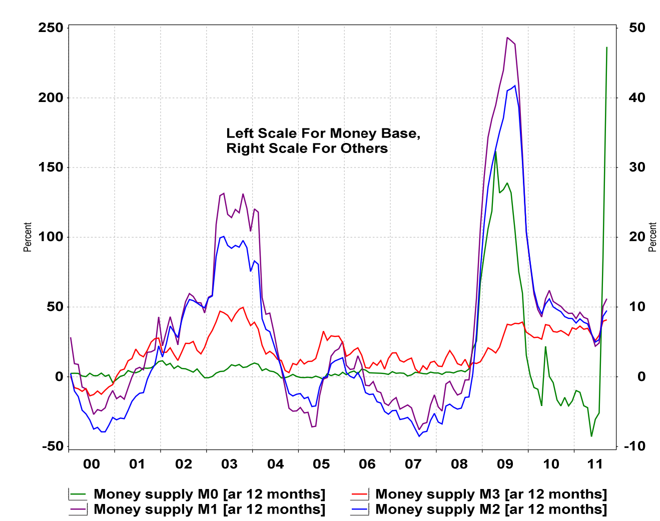
Our forecast is for 1.20-1.25 to hold over 0-3 months. Over 12 months, we are not so sure. We show 1.19 as a point forecast. This implies the peg is stressed at this horizon though we recognise that if it does break it will probably break by more than 0.01. Our forecast reflects our uncertainty on the time horizon over which this may occur.

Figure 70. Swiss Economic Surprise Index (ESI)



Source: Bloomberg and Citi

Figure 71. Swiss Money Growth



Source: Reuters EcoWin

EM Exchange Rates

Last month, intensifying downside risks to global growth, reduced risk appetite and no sign of an effective palliative for the European fiscal and banking crises led us to lower our expectations for EM FX, particularly in the near term. Not much has changed. Spates of "risk on", and forceful official intervention, have benefitted some of the more vulnerable EM FX rates since – particularly in Asia. An (equally weighted) Asian FX basket has performed best since our last forecast round, down only 1% against USD. Comparable CEEMEA and Latam aggregates fell by roughly 2% each, and the broader DXY rallied up 3.3% until early October, and, at the time of writing, was flat versus levels a month ago. Taking the SPX peak on 7/7 as the starting point, however, produces a much sharper downtrend: CEEMEA has plummeted by 12.6%; Latam by 8.7% and Asia by 4%; the broader DXY is up 3%.

However, the relief rally continues to lack "legs", in our view. As such, we expect positive returns on several USD and EUR crosses vs. EM by year-end, barring chiefly those where sell-offs seem to have overshot to the downside.

Over a longer time period, USD/EM crosses remain positively (and tightly) correlated with DXY (see Figure 60) – so our expectations of EUR/USD to grind choppily lower, to 1.31 in the next three months and 1.25 in the next six to twelve months, are a strong influence on our EM forecasts.

Aside from dollar strength, three other themes are expected to be important drivers of EM FX for the next six months or so. First, falling food prices, which should soon start to dampen (high) inflation pressures in food-intensive EM, granting central banks room for FX depreciation as part of monetary stimulus. Food prices are down anywhere between 9% and 14% since August, and, given typical time lags involved, should soon feed into (lower) headline inflation. Second, and acting in the opposite direction, is the scope for intervention should inflation not develop as expected, and/or if central bank concerns on FX volatility build further. On our assessment, Asian central banks have probably intervened more than most others, when their forward books are factored in – and might be expected to continue to do so, given their considerably greater "firepower". And finally, what happens both in the Chinese economy (i.e. further stimulus measures), and with the heavily managed yuan, is key – in particular for Asia, but also for EM FX/economies more generally.

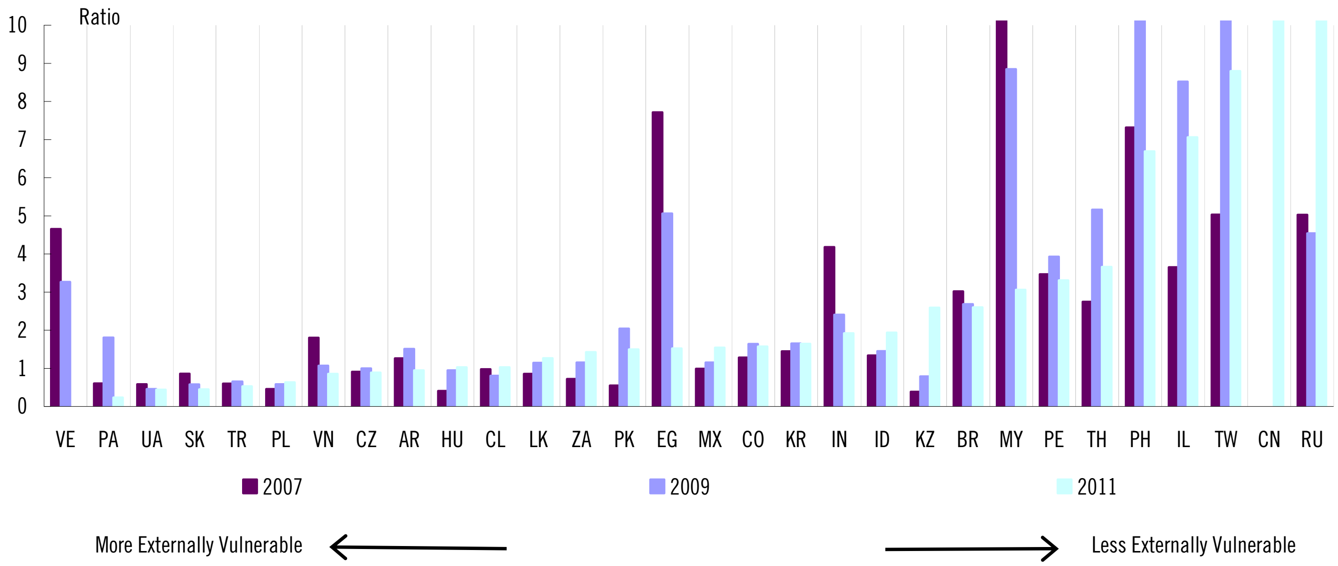
EM Asia – Reserves Matter

We keep our October forecasts for EM Asia broadly unchanged, expecting depreciation of 0.5% on average against the USD for the region as a whole in the next three months (China remains the important exception). For the medium to long term, we continue to expect broad-based appreciation.

One consequence of central bank intervention amidst sharp shifts in risk perceptions is that the three Asian exchange rates with greatest external financing needs – the IDR, KRW and INR – have performed very differently. IDR is the best performer in Asia in the last month, INR is the worst, and KRW falls somewhere in between. We don't think that this can be sustained, however. Our forecasts show IDR expected to reverse some of these gains, falling by just over 4% in the next three months, to 9279 against USD. The INR falls much less, to 50 against the USD, and KRW ends the year at 1146.

Bank Indonesia has proven to be quite aggressive in its efforts to stabilise both its exchange rate and bond market. After last month's capital flight, outflows from the IDR bond market subsided in October, and as noted above, the currency was the best performer in its region. However, foreign positioning is still high, and, alongside lower FX cover relative to short term debt, leaves IDR the most vulnerable in its region for the next three months.

Figure 72. FX Reserve Cover (ST Debt by Remaining Maturity plus C/A Deficit)



Source: Citi Investment Research and Analysis

Korea has been similarly "interventionist" in shoring up its currency and keeping volatility low. The fivefold increase in the Korean-Japanese currency swap line, to $70bn, in addition to the $28.2bn already secured with China, should help alleviate some of the near term pressure from foreign outflows that have sapped KRW strength in recent months. As such, we raise our 0-3m forecast to 1146 vs. USD, to be followed by gradual strengthening of 1.6% per quarter on average for the following four quarters.

INR stands out for having to contend with sizeable twin deficits, and in an increasingly "stag-flationary" setting. Further central bank tightening – money markets are pricing in 25bps of tightening in the next three months – is unlikely to provide much support at this stage, coming as it does at the worst point in the cycle; the allure of carry is also generally diminished. That said, the currency has already weakened substantially, and our forecasts now anticipate USD/INR at around 50, 0-3 months forward. Further out, strong fundamentals are forecast to reassert themselves: our forecasts show INR delivering the highest 12 month total return in the region, and the second highest in EM (after only BRL).

Meanwhile, *Realpolitik*, not market forces, have been the chief driver of the USD/CNY cross which, unusually, moved up even with a broadly weak dollar. The US Currency Bill, which threatens to punish China for alleged currency manipulation, may have been an important driver of recent price action, and creates some uncertainty about the path of CNY in the immediate future. Our view remains that gradual CNY *appreciation* is needed for China to achieve its own objectives, including curbing inflation, narrowing the trade surplus and paring back wasteful reserve accumulation in the longer run. Our current forecasts have USD/CNY at 6.29 in 0-3 months, and 6.11 in 6-12 months.

We have nudged our year-end THB forecasts slightly lower: the baht is expected to end the year at 30.8 against USD, although this too implies modest appreciation relative to spot. THB has been the second worst performer in its region in the last month – only INR did worse. Unlike India, Thailand runs a current account surplus, but, as Figure 72 shows, FX reserve "cover" is no longer as robust. The recent

floods, which are estimated to shave at least 1% off GDP, should help keep THB relatively low.

TWD, SGD and MYR are now forecast to be a touch stronger than last month, against USD, mainly reflecting recent market action. It is worth noting that "intervention risk" is running high for the CBC, ahead of the Presidential Election.

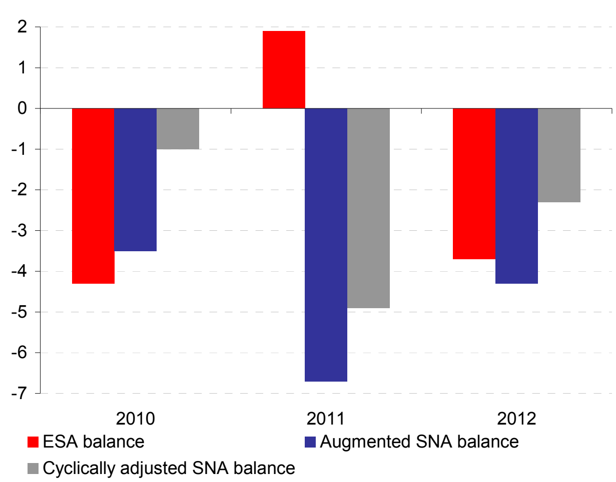
CEEMEA – (Still) In The Eye Of The Storm

With all eyes on the twin fiscal and banking crises in Europe, CEEMEA is the most exposed of the three EM regions covered. Many, if not most countries in the region are heavily export/Germany reliant (Hungary, Czech Republic), directly sensitive to the unfolding Western European banking crisis (Poland, Hungary), grappling with large local distortions (Turkey, Russia), and have strikingly lower reserve cover relative to short-term external debt and current account positions (Russia and Israel are the only two outliers, see Figure 72).

Reflecting this potent combination of risks, our 0-3 month forecasts have CEEMEA FX underperforming both Asia and Latam, by a significant margin. Although variations within the group are large – HUF is forecast to slump 11% by year-end versus the EUR, and ZAR is expected to rally (vs. USD), by 1.5% – the regional average FX rate is expected to weaken by nearly 4% in the next three months. Further out, with EUR/USD expected to grind down to 1.25 in the next 6-12 months, risks for CEEMEA FX as a whole also run high.

The HUF remains the most vulnerable by far, with a toxic cocktail of heavily forex levered households and corporations, a very weak domestic economy and an underlying fiscal situation that is far less sturdy than it might seem (see Figure 73). It also has a low reserve cover ratio of under 1; i.e. the scope to meaningfully defend the currency is very limited. With growth-hobbling rate rises the only feasible defence option, our forecasts remain for broad-based HUF weakness, with EUR/HUF at 335 and 315 in 0-3m and 6-12 months respectively.

Figure 73. Hungary's Underlying Fiscal Ratio, % of GDP



Source: Citi and Central Bank September Inflation Report

Figure 74. RUB and GRAMI Risk Aversion Index

Source: Citi and Bloomberg. Black=GRAMI, Orange=USD/RUB

The beleaguered ZAR stands at the opposite end of the spectrum, as the only CEEMEA currency that is forecast to strengthen against the USD by year-end. USD/ZAR is expected to fall to 8.13 in 0-3 months, and then rise to 8.50 6-12

months out. Citi's relatively bullish outlook for the commodities that South Africa exports – bulk minerals and gold – is a significant support, although we acknowledge that if the next few months fall into our "worst case" risk scenario, then ZAR could be weaker.

PLN has choppily strengthened against the EUR since our last FX forecast. But its high-beta qualities, alongside hefty private sector forex loans, mostly West European-owned banking system and poor fiscal position are forecast to lean against it in coming months. The path implied by our forecasts remains roughly the same: EUR/PLN is expected to rise to 4.55 in the next three months, and fall to 4.30 in 6-12 months' time. That said, it is important to note that the political incentive to keep EUR/PLN low at year-end is high: with debt/GDP dangerously close to the upper threshold of Polish law (53% of GDP vs. 55% permitted), and a quarter of public debt in FX, a coordinated year-end "defence" by the NBP and MOF could temporarily lower EUR/PLN below our presented projection.

We also keep our forecast of weaker CZK against the euro in the near-term, at 25.3 for 0-3 months. The central bank is likely to welcome a weaker koruna – given the economy's overt export reliance any boost to competitiveness would presumably be welcome. Containing the sell off are a healthy trade surplus that is likely to remain in place (unlike, e.g. Hungary, where this is the result of recession), a relatively good fiscal position, and no exposure to FX loans.

ILS/USD has been the only cross in the region that was able to hold its ground in the last four weeks, but we keep our forecast for a 3.4% correction by year-end unchanged this month. We have cut our long term forecasts for ILS/USD, however, to reflect two developments. First, the direction of Israel's current account balance: the current account surplus has been an important element in holding shekel confidence together, so its disappearance in Q2 could undermine that confidence. The second is the probable rise in the regional risk premium, with Israel's CDS of 160bp looking too low in this context.

Our short-run forecasts for Russia also stand pat: the current level of 36.3 for the rouble basket means that tight liquidity and stable oil prices dominate, and a lot of downside is already priced in (Figure 15). We lower our long-run forecast to 36-36.5, noting that while Russia stands out in the wider EM space for its large FX cover of 23 times the sum of short term external debt, amortizations and the current account, this ratio gyrates wildly with oil prices (the six year average is 9.9 – Figure 72).

Notwithstanding continued heavy-handed intervention by the Turkish central bank, our forecasts encompass continued depreciation of TRY. While an external adjustment is underway, the current account deficit is likely to remain considerably wider than its norm. This, coupled with the CBT's radical monetary policy stance, sets a difficult backdrop for TRY, which is expected to fall to 1.94 in 0-3 months against the USD, and stay weak at 1.88 6-12 months out.

Latam – Can It Buck Global Forces?

Our forecasts show Latam FX outperforming other regional aggregates in the near term, by some margin. For the next three months, much of this rests on our forecasts for MXN and COP, which are expected to rally by roughly 3% each. We expect Latam to shrug off global forces partly because of the fundamental strengths of individual countries/currencies: generally balanced economies, without, e.g. the current account deficits of Eastern Europe, reasonable fiscal balance sheets; and importantly, because we believe much of the downside risks are already priced in.

That said, the main risk to our forecast is that three of the four Latam currencies (BRL, CLP, MXN) are backed by increasingly vulnerable commodities, and so may be confronted with a "double-whammy": a weaker global growth environment and risk appetite, plus sliding metals and oil.

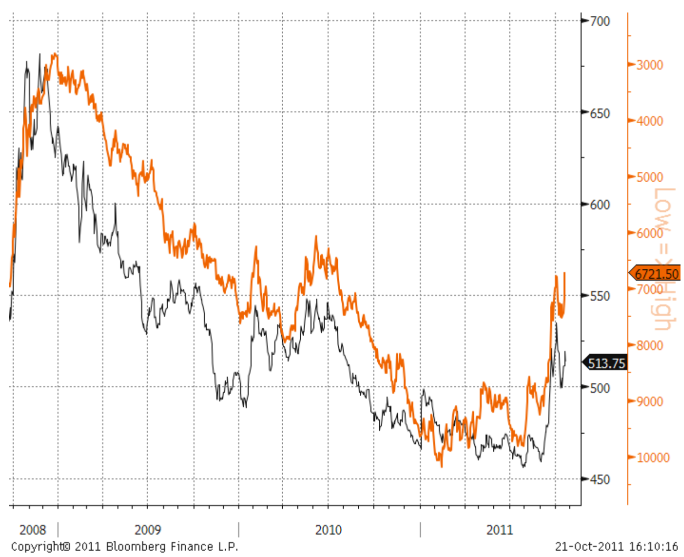
Our 0-3 month forecast for the BRL at 1.80 still leaves it around current spot, and roughly in line with its average in the last four years. It is striking that, in both a Latam and broader EM context, Brazil stands out for having a solid FX cover: total external financing requirements as a percentage of FX reserves are estimated at just 40% this year; the ratio of reserves to short term debt, amortisations and the current account deficit is 2.6 times. The main threats to our forecasts are sharp price declines in metals and oil, which comprise half of all exports, and a slowing Chinese economy, which is Brazil's chief trading partner.

For MXN, which is high beta to the US outlook, our forecasts are driven by two forces: the better outlook for the US economy relative to other developed markets, and Mexico's own robust fundamentals. These include a more balanced contribution of external and internal demand to growth, robust fiscal profile, record high reserves, and two years of "cover" for the government's external financial needs. Overall competitiveness is also much better now than in past crisis periods.

Figure 75. COP and Brent Oil Prices

Source: Citi and Bloomberg. Orange=Brent(COA); Black=USD/COP

Figure 76. CLP and Copper Prices



Source: Citi and Bloomberg. Orange=copper spot; Black=USD/CLP

CLP meanwhile is copper-backed, so in this aspect remains the most exposed of the four regional crosses. As such, it is the only one its region forecast to depreciate in both the 0-3 and 6-12 month time frames. Based on historical relationships, if copper falls to the 6500-7000 range, CLP should weaken to 550 (see Figure 76). A possible front-loading of rate cuts – i.e. the central bank bringing forward some of the rate cuts we expect next year – is an added risk in this scenario. Over the longer term, however, we expect Chile's sturdy fundamentals to reassert themselves, supporting CLP.

The basic foundation for our COP view meanwhile is strong FDI inflows with a balance of payments surplus, both of which are expected to stay firm in the near term. As long as the price of Brent holds above US$70 sizeable FDI inflows are forecast to continue (see Figure 75). Moreover, like Brazil, Colombia has low external financing requirements, relative to reserves; unlike Brazil, it is also undervalued in real effective terms, relative to its long-run history (see Figure 72).

Contributors

*** Citi Foreign Exchange: Forecasts is a joint venture between Citi's foreign exchange, global macro and technical strategy groups and our developed and emerging markets economists. The analysts listed below have contributed to these forecasts in one form or another.*

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Figure 78. Citi Quarterly Interpolated Forecasts

Quarterly Interpolated Forecasts

	Currency	Spot	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13
G10-US Dollar											
Euro	EURUSD	1.39	1.33	1.29	1.27	1.25	1.26	1.27	1.28	1.30	1.30
Japanese yen	USDJPY	76	75	75	76	76	76	77	77	78	79
British Pound	GBPUSD	1.59	1.55	1.53	1.52	1.51	1.53	1.57	1.60	1.64	1.65
Swiss Franc	USDCHF	0.88	0.93	0.95	0.95	0.95	0.97	0.99	1.01	1.03	1.04
Australian Dollar	AUDUSD	1.03	0.98	0.98	1.00	1.02	1.01	0.99	0.97	0.95	0.94
New Zealand Dollar	NZDUSD	0.80	0.75	0.75	0.77	0.79	0.76	0.72	0.68	0.64	0.63
Canadian Dollar	USDCAD	1.01	1.05	1.04	1.02	1.00	0.99	0.98	0.97	0.95	0.95
Dollar Index*	DXY	76.33	79.07	80.45	81.17	81.91	81.54	80.86	80.18	79.51	79.27
G10 Crosses											
Japanese yen	EURJPY	106	100	97	96	95	96	98	99	101	102
Swiss Franc	EURCHF	1.23	1.24	1.23	1.21	1.19	1.22	1.26	1.30	1.34	1.35
British Pound	EURGBP	0.87	0.85	0.84	0.84	0.83	0.82	0.81	0.80	0.79	0.79
Swedish Krona	EURSEK	9.11	9.30	9.26	9.14	9.03	8.96	8.91	8.86	8.81	8.80
Norwegian Krone	EURNOK	7.72	7.86	7.86	7.81	7.76	7.74	7.73	7.72	7.70	7.70
Norwegian Krone	NOKSEK	1.18	1.18	1.18	1.17	1.16	1.16	1.15	1.15	1.14	1.14
Australian Dollar	AUDNZD	1.29	1.31	1.31	1.30	1.29	1.33	1.39	1.44	1.50	1.50
Australian Dollar	AUDJPY	78.7	73.5	73.4	75.2	77.1	76.9	76.0	75.2	74.3	74.1
EM Asia											
Chinese Renminbi	USDCNY	6.38	6.30	6.24	6.18	6.12	6.05	6.00	5.93	5.87	5.80
Hong Kong Dollar	USDHKD	7.78	7.78	7.77	7.77	7.76	7.76	7.75	7.75	7.75	7.75
Indonesian Rupiah	USDIDR	8908	9300	9200	9000	8900	8800	8750	8700	8650	8600
Indian Rupee	USDINR	50.0	49.5	48.0	47.5	47.5	47.0	46.5	46.3	46.0	45.8
Korean Won	USDKRW	1148	1150	1130	1120	1100	1080	1060	1050	1030	1022
Malaysian Ringgit	USDMYR	3.15	3.20	3.11	3.09	3.06	3.00	2.96	2.94	2.89	2.93
Philippine Peso	USDPHP	43.5	43.7	43.5	43.0	42.8	42.0	41.7	41.6	41.5	41.5
Singapore Dollar	USDSGD	1.27	1.29	1.26	1.25	1.24	1.22	1.21	1.19	1.17	1.19
Thai Baht	USDTHB	31.0	30.9	30.6	30.5	30.0	30.0	29.9	29.8	29.5	26.5
Taiwan Dollar	USDTWD	30.3	30.2	30.2	29.8	29.5	29.2	28.8	28.5	28.2	27.8
EM Europe											
Czech Koruna	EURCZK	24.98	25.23	25.15	24.95	24.75	24.51	24.26	24.01	23.76	23.60
Hungarian Forint	EURHUF	298	327	330	323	317	309	302	294	287	285
Polish Zloty	EURPLN	4.38	4.51	4.49	4.40	4.32	4.22	4.12	4.02	3.92	3.90
Israeli Shekel	USDILS	3.63	3.76	3.77	3.74	3.71	3.70	3.70	3.70	3.70	3.68
Russian Ruble	USDRUB	31.1	32.5	33.2	33.6	34.1	33.7	33.1	32.5	31.9	31.6
Russian Ruble Basket	RUB	36.5	37.0	37.4	37.7	37.9	37.6	37.1	36.6	36.1	35.9
Turkish Lira	USDTRY	1.83	1.92	1.92	1.90	1.88	1.86	1.84	1.82	1.80	1.78
South African Rand	USDZAR	8.05	8.11	8.22	8.35	8.47	8.56	8.63	8.71	8.78	8.87
EM Latam											
Brazilian Real	USDBRL	1.77	1.79	1.77	1.74	1.71	1.70	1.70	1.70	1.70	1.71
Chilean Peso	USDCLP	512	518	523	526	529	522	512	502	492	494
Mexican Peso	USDMXN	13.6	13.3	13.1	13.0	12.8	12.7	12.5	12.4	12.2	12.3
Colombian Peso	USDCOP	1897	1861	1850	1850	1850	1860	1872	1885	1897	1903

* The DXY forecasts are implied from the forecasts of the constituent crosses.

Source: Citi Investment Research and Analysis

Figure 79. Citi FX Annual Forecasts

Annual Forecasts

	Currency	Spot	2011*	2012*	2013*	2014*	2015*
G10-US Dollar							
Euro	EURUSD	1.39	1.38	1.27	1.29	1.32	1.34
Japanese yen	USDJPY	76	79	76	78	80	83
British Pound	GBPUSD	1.59	1.58	1.52	1.61	1.67	1.70
Swiss Franc	USDCHF	0.88	0.90	0.95	1.02	1.03	1.03
Australian Dollar	AUDUSD	1.03	1.01	1.00	0.96	0.93	0.90
New Zealand Dollar	NZDUSD	0.80	0.77	0.76	0.67	0.63	0.62
Canadian Dollar	USDCAD	1.01	1.01	1.02	0.96	0.96	0.97
Dollar Index**	DXY	76.33	76.97	81.27	79.95	78.98	78.51
G10 Crosses							
Japanese yen	EURJPY	106	109	96	100	106	111
Swiss Franc	EURCHF	1.23	1.24	1.21	1.31	1.36	1.37
British Pound	EURGBP	0.87	0.88	0.83	0.80	0.79	0.79
Swedish Krona	EURSEK	9.11	9.16	9.10	8.85	8.80	8.80
Norwegian Krone	EURNOK	7.72	7.85	7.79	7.71	7.70	7.69
Norwegian Krone	NOKSEK	1.18	1.17	1.17	1.15	1.14	1.14
Australian Dollar	AUDNZD	1.29	1.31	1.31	1.46	1.48	1.43
Australian Dollar	AUDJPY	78.7	80.0	75.7	74.9	74.2	74.2
EM Asia							
Chinese Renminbi	USDCNY	6.38	6.42	6.15	5.90	5.80	5.60
Hong Kong Dollar	USDHKD	7.78	7.78	7.77	7.75	7.75	7.75
Indonesian Rupiah	USDIDR	8908	8884	8975	8675	8650	8625
Indian Rupee	USDINR	50.0	46.9	47.5	46.1	45.1	44.1
Korean Won	USDKRW	1148	1123	1108	1048	1005	980
Malaysian Ringgit	USDMYR	3.15	3.11	3.07	2.93	2.88	2.85
Philippine Peso	USDPHP	43.5	43.6	42.8	41.5	41.0	41.0
Singapore Dollar	USDSGD	1.27	1.27	1.24	1.19	1.17	1.16
Thai Baht	USDTHB	31.0	30.8	30.3	28.9	28.9	28.9
Taiwan Dollar	USDTWD	30.3	29.7	29.7	28.3	27.8	27.8
EM Europe							
Czech Koruna	EURCZK	24.98	24.69	24.84	23.91	23.26	22.73
Hungarian Forint	EURHUF	298	288	320	292	284	282
Polish Zloty	EURPLN	4.38	4.24	4.36	3.99	3.90	3.90
Israeli Shekel	USDILS	3.63	3.60	3.73	3.70	3.62	3.52
Russian Ruble	USDRUB	31.1	30.2	33.7	32.3	31.3	30.8
Russian Ruble Baske	RUB	36.5	35.4	37.7	36.4	35.7	35.4
Turkish Lira	USDTRY	1.83	1.74	1.89	1.81	1.74	1.68
South African Rand	USDZAR	8.05	7.43	8.40	8.75	9.11	9.50
EM Latam							
Brazilian Real	USDBRL	1.77	1.72	1.73	1.70	1.73	1.76
Chilean Peso	USDCLP	512	496	525	500	506	526
Mexican Peso	USDMXN	13.6	12.7	12.9	12.4	12.4	12.7
Colombian Peso	USDCOP	1897	1859	1852	1889	1914	1930

*Averages of end-quarter data shown in quarterly interpolation table.
** The DXY forecasts are implied from the forecasts of the constituent crosses.

Source: Citi Investment Research and Analysis

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