Economics

18 January 2012 │ 76 pages

Global Economic Outlook and Strategy

January 2012

- We continue to expect a sizeable slowdown in global economic growth in 2012, with renewed recession in the euro area, growth of roughly 2% in the US, and slowing — albeit still strong — growth in Asia. Within that broad outlook, we again make more forecast downgrades than upgrades, and we expect that overall global growth will slow from 3.0% in 2011 to 2.3% in 2012 (down from 2.5% in our previous forecast).
- We are again cutting our 2012-13 growth forecasts for a range of European economies. With extra fiscal tightening announced or expected, plus drag from the weak banking system, we now expect that euro area real GDP will fall by 1.5% this year and fall by 0.4% in 2013 (prior forecasts were minus 1.2% and minus 0.2% respectively). By contrast, we still look for US growth of about 2% this year, and gradual improvement in the jobs market, and the resilience of activity has introduced upside possibilities. In China, with the domestic property market correction and euro area recession, growth is slowing in early 2012 and may drop to below 8% YoY in Q1.
- Huge ECB liquidity provision may continue to calm markets near term, but the underlying causes of the EMU debt crisis have not been resolved. We continue to expect sizeable further debt restructuring in Greece, as well as debt restructuring in Portugal and possibly Ireland. Italy and Spain are likely to need increasing support, probably including some kind of troika programme.
- We continue to expect a long period of very low interest rates across advanced economies. In addition, elements of financial repression are reemerging, especially in Europe, as governments seek ways to secure low-cost (or at least not high-cost) funding. The Euro is likely to weaken further in response to ECB easing and the wide gap between US and EMU economic growth this year. We expect a string of further ratings downgrades for advanced economy sovereign debt, both in coming months and the longer term. We do not expect any ratings upgrades among advanced economies.

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With thanks to Jan Maguire

Next issue 22 February 2012

Figure 1. Currency and Interest Rate Forecasts (End of Period, Unless Specified), as of 18 Jan 2012

	18 Jan 12	1Q 12 Forecast	2Q 12 Forecast	3Q 12 Forecast	4Q 12 Forecast	1Q 13 Forecast	2Q 13 Forecast
United States: Federal Funds	0.25	0.25	0.25	0.25	0.25	0.25	0.25
10-Yr. Treasuries (Period Ave.)	1.85	1.95	2.05	2.20	2.40	2.50	2.65
Euro Area: US$/€	1.27	1.25	1.24	1.22	1.20	1.22	1.25
Euro Repo Rate	1.00	1.00	0.50	0.50	0.50	0.50	0.50
10-Yr. Bunds (Period Average)	1.77	1.75	1.50	1.25	1.50	1.50	1.50
Japan: Yen/US$	77	77	77	76	76	76	77
Call Money	0.10	0.10	0.10	0.10	0.10	0.10	0.10
10-Yr. JGB (Period Average)	0.97	1.20	1.05	1.10	1.30	1.40	1.50

Source: Citi Investment Research and Analysis

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	We have again cut our global growth forecast, and look for global growth to slow from 3.0% YoY in 2011 to 2.3% in 2012 (revised down from 2.5% previously), with aggregate advanced economy growth below 1% YoY.
■ United States	The reversal of temporary drags has boosted growth but lingering imbalances, financial instability and unresolved policy questions will weigh on expansion. Enhanced monetary accommodation is focusing on extending rate guidance but renewed balance sheet expansion is likely if the outlook worsens. Short-term fiscal support is likely to be renewed but the balance of risks is tilted toward greater medium term restraint.
■ Euro Area	Largely due to additional fiscal tightening measures (mainly in Italy and Spain) we are cutting our GDP forecast for the euro area to -1.5% for 2012 and -0.4% for 2013. After the downgrade of several euro area countries' sovereign ratings, the EFSF's functioning is likely to suffer and the planned introduction of the ESM looks ambitious. We expect the ECB to expand liquidity and to cut rates to 0.5% in 2Q.
■ China	With the domestic property market correction and euro area recession, growth is slowing in early 2012 and may drop to below 8% YoY in Q1. As inflation concerns recede, we expect further policy easing to limit downside risks. Monetary policy will remain prudent with an easing bias. Fiscal policy is likely to be more active than 2011. We do not expect a hard landing and project growth of about 8.4% in 2012.
■ Japan	Debates about the consumption tax hike will be a key focus in 2012. PM Noda plans to propose the consumption tax bill calling for the tax rate hike from 5% now to 8% in April 2014 and to 10% in October 2015. However, there remain significant political hurdles for this bill to be officially approved and implemented, leaving major uncertainties over fiscal prospects.
■ United Kingdom	The UK is near recession, and the MPC are likely to expand QE markedly further in coming months.
■ Canada	The outlook is little changed from before. We continue to project moderate growth and low inflation amid lackluster domestic and external demand. Risks remain elevated, but roughly balanced. Unchanged policy rates are expected through early 2013.
■ Australia	The near-term Australian growth outlook has been lowered, reflecting the impact of global developments on domestic confidence, activity and employment. Nevertheless, we remain confident that aggregate economic activity will return to a trend like growth rate later in the year.
■ Emerging Asia (ex China)	Growth is slowing as exports and investment weaken, but December data saw some positive surprises. Asia is entering a food-led disinflation cycle (after peaking in late 2010-early 2011), but we do not expect this to lead to significant policy easing expectations, except possibly in China and India. Indeed, BI has been less dovish in recent policy meetings while BoT likely to cut a bit more than previously anticipated.
■ CEEMEA	CEE remains at the centre of risks associated with general risk aversion among investors as well as the specific risk of European bank deleveraging. Large external financing requirements in Turkey, Poland, and some others will continue to underpin the region's vulnerability. We have raised by 1bp our 2012 GDP forecast for Russia on higher oil price assumptions.
■ Latin America	We continue to expect slower growth in 2012 with relatively contained inflation. This will provide scope for lower interest rates in some countries, with a series of 0.5% rate cuts expected to bring rates down to 9.5% in Brazil. For Mexico, recent inflation data reinforce our view for stable rates this year. The electoral scene remains uncertain in Venezuela, while Argentina's government has further strengthened exchange rate controls.

Source: Citi Investment Research and Analysis

Figure 3. 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	Long on 6-12 mth view but trade against range near-term or use market dislocations	Short, high-quality sectors optimise defensive positioning. Off-the-run sectors offer upside.	Bullish USD and JPY	A more challenging 1H 12 with potential for sharper rebound in 2H 12	Cautious risk assets medium term
Most-Favoured Region/Sector	EM, Japan, UK, Asia Pac ex Japan/ IT, Financials, Cons. Staples	EUR 5yr and GBP long end	Low-beta core non-fins and senior SIFI; selectively edge down in quality	US CMBS senior tranches	USD, JPY	Precious Metals	Core FI, Gold, cash
Least-Favoured Region/Sector	US/ Healthcare, Utilities, Cons. Disc	EMU non-AAA	French corporates and periphery sub-debt	Spanish and Irish RMBS	EUR, CEEMEA	Coal, Agriculture	Europe, Financials, Base Metals
Key Risks	Major global recession	Credible steps towards ending the EMU crisis could cause large reversal	Sovereign crisis; bank runs; global slowdown	Regulation	More dovish than expected FED	EMU contagion, further US dollar strength	EMU breakup, China growth, US fiscal

Source: Citi Investment Research and Analysis

Overview — Economic Divergence and Financial Repression

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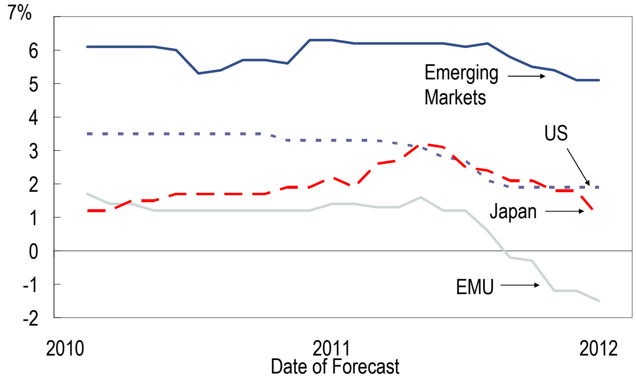
We continue to expect a sizeable slowdown in global economic growth in 2012, with renewed recession in the euro area, growth of roughly 2% in the US, and slowing – albeit still strong – growth in Asia[1]. Within that broad outlook, we again make more forecast downgrades than upgrades, and we expect that overall global growth will slow from 3.0% in 2011 to 2.3% in 2012 (down from 2.5% in our previous forecast).

We continue to expect global growth to slow this year, with wide divergences between countries…

…and we are again cutting our European growth forecasts

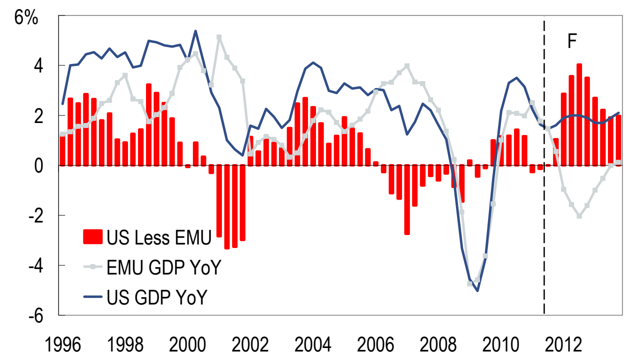
We are again cutting our 2012-13 growth forecasts for a range of European economies, with GDP downgrades for the euro area, UK, Sweden, Switzerland, the Czech Republic, Hungary and Norway[2]. We now expect that euro area real GDP will fall by 1.5% this year and will fall by 0.4% in 2013 (prior forecasts were minus 1.2% and minus 0.2%, respectively). In the euro area, these new downgrades chiefly reflect announced or expected extra fiscal tightening in Italy, Spain and the Netherlands, plus the continued drag from tight financial conditions and the weak banking system. Other European economies are being hit by adverse spillovers from the probable EMU recession and, especially in the UK, internal drag from high private debts. We do not expect that euro area real GDP will regain its pre-recession peak until late 2016. Going the other way, the only significant upgrade is Russia, for which we are raising our 2012 GDP forecast to 3.5% from 2.5%.

Figure 4. US, EMU, Japan and Emerging Markets — Citi Forecasts for Real GDP Growth in 2012, 2010-2012



Source: Citi Investment Research and Analysis

Figure 5. US and EMU — Real GDP YoY, 1996-2013F



Sources: Datastream and Citi Investment Research and Analysis

The US-EMU growth differential is likely to widen sharply in coming quarters…

Our forecasts imply a further marked rise in the GDP growth differentials between the US and Euro Area, with the gap in terms of YoY GDP growth likely to reach 3 ½%-4% in coming quarters, the highest in recent decades – even above the wide late 90s divergence. While the euro area probably already slipped into recession in the final quarter of 2011, we continue to expect sustained economic growth near 2% this year for the US despite unsettled financial conditions. Indeed, for the US, gradual improvement in the labor market and the resilience of activity in the face of negative shocks have introduced upside possibilities. We expect housing investment to rise this year, after six straight years of decline, and we have raised slightly our forecast for payroll employment growth to just shy of 2 million jobs in 2012 with unemployment now expected to dip to 8¼% by yearend[3].

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[1] See "Prospects for Economies and Financial Markets in 2012 and Beyond", Willem Buiter et al, 28 November 2011, Citi.

[2] The UK forecast downgrade was in "2012 Outlook: Deleveraging and Stagnation", *Sterling Weekly*, Michael Saunders, 6 January 2012.

[3] See "Durability Amid Risks", *Comments on Credit*," Robert V DiClemente, Comments on Credit, 13 January 2012, Citi.

…chiefly reflecting the extra drags from fiscal policy and poor credit availability in Europe

Note that our forecast of continued US growth is relatively subdued compared to previous cyclical recoveries. It is consistent with the "Reinhart-Rogoff" (R-R) norm for countries in a post-crisis deleveraging phase, which is not for permanent stagnation, but a deep recession and modest recovery that leaves the actual path of real GDP about 10% below a simple extrapolation of the rising pre-crisis path. By contrast, the euro area and UK are likely to underperform the R-R pattern, mainly because of early fiscal tightening, EMU financial strains and the weaker condition of European banks. Of course, the durability of this wide growth gap rests in part on the US's ability and willingness to defer significant fiscal consolidation near term, while private sector deleveraging is underway. There are risks that US fiscal policy may turn markedly more contractionary in 2013, depending on the outcome of the late-2012 Presidential election and the evolution of Treasury yields.

We expect a long period of ultra-low policy rates in the US and Europe

We continue to expect a long period of ultra-low policy interest rates across the advanced economies. The ECB is likely to cut its main policy rate to 0.5% by midyear and, flooding markets with extra liquidity, this probably will push overnight rates well below 0.5%. For the US, the Fed has signaled that it will pursue all means to support financial conditions with the immediate focus on communications strategies. New support for the mortgage market is possible in coming months but we think full-blown QE would require new signs that the outlook is deteriorating again (which is not our base case). At this stage, we tentatively forecast the first rate hike to come in 2014 for the US, 2015 for the UK and 2016 for the euro area: but the key point for all three is that withdrawal of monetary stimulus is distant.

The policy response in Europe also will probably include elements of financial repression…

We also expect the policy response to the current public and private debt crises will include some elements of financial repression, especially in Europe. Financial repression refers to various measures that seek to constrain the financial sector, in particular '*Financial repression occurs when governments implement policies to channel to themselves funds that in a deregulated market environment would go elsewhere. Policies include directed lending to the government by captive domestic audiences (such as pension funds or domestic banks), explicit or implicit caps on interest rates, regulation of cross-border capital movements, and (generally) a tighter connection between government and banks, either explicitly through public ownership of some of the banks or through heavy "moral suasion." Financial repression is also sometimes associated with relatively high reserve requirements (or liquidity requirements), securities transaction taxes, prohibition of gold purchases, or the placement of significant amounts of government debt that is nonmarketable*'.[4]

…aimed especially at capping yields on government debt

Financial repression was the norm for many advanced economies and emerging markets during the post World War II decades, but diminished in significance in advanced economies with the financial deregulation and liberalization initiated by Thatcher and Reagan. It continues to be a routine instrument of economic policy and government funding tool in many emerging markets and developing countries. A key factor is the desire of governments to secure for themselves relatively cheap and stable funding. In addition, financial repression has been consistent with the general political preference for regulation and quantity restrictions as tools of economic management, a desire to reduce the riskiness of banks and to save consumers from the perils of over-indebtedness, plus the aim of extracting political advantage for the government as the arbiter of credit and financial allocation. And in many cases, the captive investor base then had to accept substantial erosion of the real value of their government debt holdings through negative real interest rates caused by controlled nominal interest rates and high inflation.

[4] Source: "*Financial Repression Redux*", Reinhart, Kirkegaard and Sbrancia, IMF, 2011. See also "*The Liquidation of Government Debt*", Reinhart and Sbrancia, NBER, March 2011.

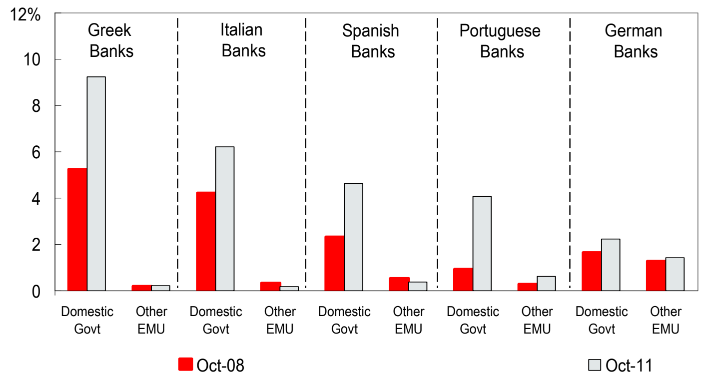
Figure 6. Selected Countries — Industrial Production Forecasts (Pct.), 2011-13F

	2011F	2012F	2013F
World	**3.7%**	**2.4%**	**3.5%**
United States	4.1	3.2	2.9
Japan	-3.5	2.8	2.3
Euro Area	3.6	-3.1	-0.1
United Kingdom	-1.1	-0.3	1.3
Canada	2.8	-0.6	0.7
China	13.9	11.6	12.2
India	5.1	5.3	7.0
Korea	6.8	6.3	8.6
Brazil	0.8	1.8	3.2

Source: Citi Investment Research and Analysis

Elements of financial repression are now reemerging, especially in Europe, partly under the guise of "macro-prudential regulation" and partly in response to the sovereign debt crisis. Examples are (1) the rises in banks' liquid asset and liquidity coverage ratios[5], with even strained sovereign debt counted as a liquid asset, combined with zero capital weightings for sovereign debt (even those of low credit rating)[6]; (2) the ECB's willingness to accept lower-rated sovereign debt as collateral; (3) moral suasion, such as suggestions from Sarkozy and Noyer that banks should use the ECB's 3-year LTRO to finance extra purchases of EMU sovereign debt (as well as hidden arm-twisting). This may be particularly effective in banks which are owned or part-owned by the government; (4) ECB purchases of government debt directed at particular strained governments to cap yields; (5) the general use of government yields to discount liabilities for pension and life insurance funds, creating incentives to hold government debt for asset-liability matching purposes.

Figure 7. Selected EMU Countries — Holdings of EMU Government Debt By EMU Banks, pct of assets, 2008-11



Sources: ECB, national central banks, Haver and Citi Investment Research and Analysis

The sharp rise in holdings of home country sovereign debt in periphery countries may be a symptom of financial repression

An example of the effects is that "home bias" ratios in government bond holdings generally have risen markedly in recent years in EMU periphery countries. For example, since end-08, holdings of Italian government debt by Italian banks have risen by 50%; holdings of Spanish government debt by Spanish banks have risen by 65%, holdings of Greek government debt by Greek banks have risen by 89%; holdings of Portuguese government debt by Portuguese banks have surged by over 400%; and holdings of Irish government debt by Irish domestic banks have surged by over 1100%[7]. For Italy, Spain and Greece, more than 90% of banks' holdings of EMU government debt are in their own country's debt, while for Portuguese banks this ratio is 87%. In our view, if banks truly aimed to hold high quality assets with consistent market liquidity, these "home bias" ratios would be much lower among periphery countries. By contrast, in France and Germany, which are more liquid bond markets, holdings of domestic government debt account for about 60-70% of banks' holdings of EMU debt, while in Belgium this ratio is 44%.

[5] See "*Basel III: International framework for liquidity risk measurement, standards and monitoring*", BIS, December 2010.

[6] The Basel II standards set a zero capital weight only for sovereign debt rated between AAA and AA-, with higher weightings for lower grade debt. However, paragraph 54 of Basel II provides "national discretion" to set a lower risk weighting for sovereign debt, while the EU Capital Requirements Directives set a zero weight for the domestic currency debt of each bank's own government. See "*Sovereign risk in bank regulation and supervision: Where do we stand?*", speech by Hervé Hannoun, Deputy General Manager BIS, October 2011.

[7] The rises among Irish and Portuguese banks are from far lower initial levels and still leave holdings of home country sovereign debt as a lower share of bank assets than in Greece, Italy and Spain.

This expands the vicious circle between weak sovereigns, weak economies and weak banks

Of course, rising home bias can reinforce the vicious circle between weak sovereigns, weak economies and weak banks. Worries over the exposure of periphery country banks to periphery sovereign debt are fuelling worries over the banks' capital health which, in turn, leaves the banks more reliant on ECB funding and the backstop of state recapitalization (perhaps via the EFSF). And this, in turn, may make the banks more susceptible to moral suasion to lift holdings of their home country's government debt.

The drift to financial repression may well continue if, as we expect, EMU economic and financial strains remain high

This bias to financial repression probably will expand this year if, as seems likely, the strains in periphery countries and periphery banks remain high amidst widespread recessions and bank funding difficulties. Possible repression measures might well include greater moral suasion (coupled with further large expansion of ECB LTROs); further easing of ECB collateral norms for lower-grade EMU sovereign debt; a retreat from the use of mark-to-market tests on all holdings of EMU debt in the EBA's tests of bank capital adequacy. These all may be more likely in cases where governments bear part of the burden of recapitalizing banks.

In some other countries, there is a more general retreat from financial liberalisation

In addition, some countries (eg UK, US and Switzerland) have been aiming to establish or re-establish macro-prudential tools to lift capital ratios, regulate credit cycles, or to limit the size of major banks. These policies mainly aim to reduce risks to the economy from credit cycles and to minimize contingent fiscal liabilities from having to bail out overextended banks, rather than to create captive buyers for government debt. We do not regard this as financial repression as defined above, but it is part of a general retreat from financial liberalization.

We do not expect the full postwar array of financial repression and rising inflation

This drift towards financial repression will not, by itself, solve the EMU debt crisis. It is quasi-fiscal policy, and works like a tax on the financially repressed entities; this generates some fiscal gain by cutting the government's interest bill, but not enough in the absence of significant inflation plus tight nominal interest rate caps. In the post-war decades, very extensive financial repression went alongside a greater tolerance of inflation than is the norm today in most advanced economies, with governments in effect deriving substantial fiscal gains from negative real interest rates and the erosion of the real value of outstanding debt. In that sense, financial repression was part of the "solution" for weak fiscal positions. We do not at present expect that financial repression will go so far or will again be reinforced by higher inflation. Unlike earlier periods of financial repression and inflation, we now have operationally independent central banks focused on keeping inflation low over time.

Financial repression can buy time, but ultimately will not prevent widespread debt writedowns and economic strains in the euro area

Rather, we regard the ECB's huge LTRO programme and the drift towards financial repression as an extension of the general emphasis on liquidity-provision policies (in line with the EU treaty), which buy time for strained sovereigns but do not ultimately solve their deep-seated economic and fiscal problems. We continue to envisage further substantial Greek government debt writedowns in 2012-13 (and perhaps a 25%-30% chance that Greece will exit EMU), with sizeable writedowns also on Portuguese and, probably, Irish government debt. We expect that Italy and Spain will be able to fund themselves in the primary markets or through loans from official creditors, once these countries accept some kind of troika programme, at yields below the intolerably high costs likely to available in markets absent repression. But, yields will still be high enough to escalate public debt ratios, and we expect that Italy and Spain (and some other EMU sovereigns) will suffer deep recessions this year, with further sovereign rating downside over time.

Figure 8. Selected Countries — Economic Forecast Overview (Percent), 2011-2016F

	GDP Growth						CPI Inflation						Short-Term Interest Rates					
	2011	**2012**	**2013**	**2014**	**2015**	**2016**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**
Global	**3.0**	**2.3**	**3.0**	**3.5**	**3.8**	**4.1**	**3.8**	**2.9**	**2.8**	**2.9**	**3.0**	**3.0**	**2.67**	**2.63**	**2.74**	**2.93**	**3.20**	**3.55**
Based on PPP weights	*3.6*	*2.9*	*3.5*	*3.8*	*4.1*	*4.3*	*4.4*	*3.4*	*3.3*	*3.2*	*3.3*	*3.2*						
Industrial Countries	**1.3**	**0.6**	**1.1**	**1.9**	**2.3**	**2.7**	**2.6**	**1.6**	**1.4**	**1.4**	**1.5**	**1.6**	**0.77**	**0.55**	**0.57**	**0.69**	**1.07**	**1.62**
United States	1.7	1.9	1.9	2.8	3.5	4.0	3.2	1.7	1.7	2.0	2.3	2.4	0.25	0.25	0.25	0.40	1.15	2.10
Japan	-1.0	1.0	1.3	1.5	1.5	1.2	-0.3	-0.4	-0.2	0.1	0.3	0.5	0.10	0.10	0.10	0.13	0.48	0.75
Euro Area	1.5	-1.5	-0.4	0.6	1.0	1.6	2.7	2.2	1.4	1.0	0.7	0.8	1.20	0.60	0.50	0.50	0.50	0.80
Canada	2.3	1.7	2.3	2.7	3.2	3.5	2.9	1.9	1.7	2.0	2.0	2.0	1.00	1.00	1.63	2.19	2.50	3.00
Australia	1.9	3.4	3.8	4.3	3.8	3.6	3.3	2.2	3.1	2.9	2.7	2.5	4.63	4.00	4.44	5.25	5.25	4.75
New Zealand	1.4	2.6	2.6	3.0	3.2	3.4	4.2	2.1	2.3	2.6	2.9	2.8	2.50	2.81	4.25	5.50	5.50	5.25
Germany	3.0	0.4	1.2	1.4	1.7	1.6	2.3	1.7	2.0	2.1	2.0	1.9						
France	1.6	-0.7	0.5	1.1	1.5	2.0	2.3	2.5	1.8	1.3	1.8	1.5						
Italy	0.4	-2.3	-0.7	-0.5	0.1	1.2	2.9	2.7	1.9	0.9	0.3	1.2						
Spain	0.7	-2.7	-1.3	0.6	0.8	1.9	3.1	2.4	1.8	1.1	1.2	1.8						
Greece	-5.4	-4.9	-3.1	-1.7	-0.4	0.9	3.2	1.5	-0.7	-0.3	-0.4	0.1						
Portugal	-1.8	-5.8	-3.7	-0.6	0.9	1.7	3.6	2.4	1.4	0.3	-0.2	0.0						
Netherlands	1.5	-0.7	0.5	1.1	1.5	1.7	2.3	1.8	1.8	1.6	1.9	1.8						
Belgium	1.8	-0.7	0.8	1.7	2.1	1.8	3.5	2.3	1.7	1.9	2.3	2.3						
Denmark	1.0	0.9	1.2	1.8	1.7	1.9	2.7	2.0	1.4	1.6	1.8	2.0	1.30	0.20	0.30	0.55	0.60	1.05
Norway	2.7	2.5	3.0	2.7	2.7	2.9	1.3	1.8	2.2	2.2	2.5	2.5	2.10	1.56	1.50	1.50	2.00	2.50
Sweden	4.5	0.5	1.9	2.6	2.7	2.7	2.9	1.2	1.9	1.9	2.1	2.0	1.80	1.13	1.00	1.00	1.50	2.00
Switzerland	1.8	0.7	0.9	1.3	1.3	1.3	0.2	-0.6	-0.5	-0.2	0.9	1.2	0.44	0.00	0.00	0.00	0.00	0.00
United Kingdom	0.9	0.2	1.0	1.7	2.5	3.1	4.5	2.6	2.3	2.2	2.1	2.1	0.50	0.50	0.50	0.50	1.04	2.04
Emerging Markets	**6.0**	**5.2**	**5.9**	**5.8**	**5.9**	**5.9**	**6.2**	**5.2**	**5.1**	**5.0**	**5.1**	**4.9**	**6.10**	**6.08**	**6.18**	**6.30**	**6.25**	**6.17**
China	**9.2**	**8.4**	**8.6**	**7.7**	**7.6**	**7.5**	**5.4**	**3.5**	**3.9**	**4.5**	**5.0**	**4.5**	**3.22**	**3.72**	**3.88**	**4.25**	**4.75**	**5.00**
Hong Kong	5.0	3.5	4.2	4.0	4.0	4.0	5.3	3.8	3.1	3.3	3.5	3.5	0.27	0.53	0.81	1.20	2.00	3.00
India	7.1	7.0	7.7	8.2	8.3	8.5	9.0	6.7	6.5	6.0	6.0	6.0	8.13	7.69	7.50	7.50	7.50	7.50
Indonesia	6.5	6.3	6.5	6.7	7.0	6.7	5.4	5.7	5.6	5.5	5.8	6.0	6.60	6.00	6.00	5.63	5.90	6.00
Korea	3.6	3.7	4.4	4.6	4.1	4.2	4.0	3.3	3.2	3.1	3.0	3.2	3.52	3.55	4.15	4.50	5.00	5.19
Singapore	4.8	3.0	5.0	5.0	5.0	5.0	5.3	3.0	3.1	2.5	2.5	2.5	0.44	0.50	0.70	1.70	2.60	3.20
Czech Republic	1.7	-0.5	2.0	2.8	3.6	3.8	1.9	2.6	1.6	2.5	2.0	1.6	2.53	2.80	3.10	3.20	3.50	3.50
Hungary	1.2	0.0	1.5	2.6	2.0	1.8	3.9	5.1	3.4	3.5	3.1	3.3	6.13	7.96	7.13	7.00	6.13	6.00
Poland	4.2	1.9	2.8	3.1	3.4	3.4	4.3	3.5	2.6	2.5	2.5	2.5	5.91	5.60	5.70	5.65	5.50	5.30
Romania	2.5	1.7	3.1	4.2	4.3	4.3	5.6	2.5	2.0	2.5	2.5	2.5	6.19	5.13	5.00	5.00	5.00	5.00
Russia	3.8	3.5	4.0	4.0	4.0	4.3	8.4	6.2	6.1	5.5	5.5	5.5	8.00	7.50	6.00	6.00	5.50	5.00
Turkey	8.2	2.5	4.3	4.4	4.5	4.5	6.5	8.1	6.6	6.2	5.7	5.2	5.75	5.75	7.25	8.00	7.50	7.50
Nigeria	7.1	6.7	6.5	6.9	7.2	7.0	10.9	10.9	10.4	10.3	9.5	9.0	13.00	15.00	12.50	10.50	10.00	9.50
South Africa	3.1	2.9	3.8	4.4	4.4	4.5	5.0	5.8	5.5	5.4	5.5	5.5	5.50	5.83	7.25	8.50	8.75	8.50
Argentina	9.4	5.0	5.0	3.5	3.5	3.5	9.8	9.6	12.2	15.0	15.0	15.0	14.04	19.52	18.24	16.00	14.00	13.00
Brazil	2.9	3.3	4.5	4.5	4.5	4.5	6.6	5.5	5.1	4.5	4.0	4.0	11.71	9.71	10.79	10.25	9.00	8.25
Mexico	3.9	3.0	3.4	3.7	3.8	3.7	3.4	4.3	3.7	3.9	3.8	3.7	4.50	4.50	5.38	7.00	7.00	6.75
Venezuela	4.0	4.0	3.4	4.0	3.0	2.5	27.0	26.3	28.0	25.0	28.0	28.0	14.60	14.50	14.50	14.50	14.50	14.50

Note: For inflation in India, we use the wholesale price index. Source: Citi Investment Research and Analysis

Figure 9. Selected Countries — Economic Forecast Overview (Percent), 2011-2016F

	Current Balance (Pct of GDP)						Fiscal Balance (Pct of GDP)						Government Debt (Pct of GDP)					
	2011	**2012**	**2013**	**2014**	**2015**	**2016**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**
Global	**0.2**	**0.1**	**0.3**	**0.3**	**0.3**	**0.3**	**-5.0**	**-4.4**	**-3.5**	**-3.0**	**-2.6**	**-2.4**	**74**	**75**	**76**	**75**	**74**	**73**
Based on PPP weights	*0.5*	*0.2*	*0.4*	*0.3*	*0.3*	*0.2*	*-4.4*	*-4.1*	*-3.3*	*-2.9*	*-2.6*	*-2.4*						
Industrial Countries	**-0.9**	**-0.7**	**-0.5**	**-0.5**	**-0.4**	**-0.4**	**-6.9**	**-5.9**	**-4.6**	**-4.0**	**-3.4**	**-3.0**	**106**	**111**	**113**	**114**	**115**	**115**
United States	**-3.0**	**-2.4**	**-2.4**	**-2.5**	**-2.7**	**-3.0**	**-9.3**	**-7.3**	**-6.2**	**-5.5**	**-5.0**	**-4.7**	**99**	**104**	**108**	**110**	**111**	**112**
Japan	**1.9**	**1.2**	**1.6**	**1.7**	**1.7**	**1.7**	**-10.7**	**-10.9**	**-8.5**	**-8.2**	**-7.8**	**-7.4**	**233**	**243**	**250**	**254**	**258**	**262**
Euro Area	**-0.5**	**-0.7**	**-0.5**	**-0.4**	**-0.2**	**-0.1**	**-4.4**	**-3.8**	**-2.6**	**-2.0**	**-1.5**	**-1.0**	**89**	**94**	**94**	**93**	**92**	**91**
Canada	-3.1	-3.5	-3.1	-3.3	-3.3	-3.0	-1.8	-1.5	-0.9	-0.4	-0.2	0.0	79	79	79	78	76	75
Australia	-2.2	-3.0	-5.0	-4.9	-3.5	-3.2	-3.4	-2.5	0.1	0.3	1.2	1.7	6	9	9	6	6	5
New Zealand	-3.9	-5.3	-7.2	-6.9	-5.8	-5.5	-8.0	-6.0	-3.0	-0.5	1.0	1.5	21	27	30	29	28	27
Germany	5.2	3.8	3.1	3.4	3.3	3.3	-1.0	-1.7	-1.3	-1.2	-1.1	-1.0	89	93	93	92	91	90
France	-2.6	-2.2	-1.4	-0.6	0.0	0.4	-5.5	-4.5	-3.2	-2.1	-1.1	-0.5	85	92	94	94	93	90
Italy	-3.5	-2.9	-2.4	-2.2	-2.0	-1.7	-4.2	-2.7	-1.2	-1.1	-0.8	0.1	121	129	131	132	132	130
Spain	-3.7	-2.9	-2.3	-2.0	-1.8	-1.5	-8.0	-5.6	-3.0	-1.6	-0.9	-0.2	71	83	90	91	91	89
Greece	-9.2	-4.4	-2.9	-1.9	-1.0	-0.9	-12.6	-10.4	-5.8	-3.4	-0.2	0.5	165	144	152	157	156	154
Portugal	-8.7	-6.4	-4.3	-3.6	-3.0	-0.7	-9.6	-5.1	-3.4	-3.0	-0.7	0.3	113	99	108	112	112	109
Netherlands	8.1	7.1	7.1	7.1	7.0	6.6	-3.6	-3.6	-3.0	-2.3	-1.5	-1.0	65	70	69	69	68	67
Belgium	-0.7	-2.0	-1.4	-0.5	0.5	1.0	-3.7	-2.7	-1.5	-0.6	0.2	0.5	97	109	108	104	100	96
Denmark	6.7	5.7	5.5	3.7	3.3	3.5	-4.0	-5.2	-3.9	-2.6	-2.1	1.0	46	50	53	54	54	51
Norway	14.0	14.3	14.9	15.2	15.8	16.5	12.0	12.5	13.5	15.0	17.0	18.5	NA	NA	NA	NA	NA	NA
Sweden	7.4	7.7	8.0	6.7	6.9	7.3	0.1	-0.4	-0.2	0.5	1.5	1.9	36	36	35	33	30	27
Switzerland	14.4	14.5	15.7	17.1	18.1	19.4	0.3	0.6	0.6	0.9	0.9	0.9	53	51	50	48	47	46
United Kingdom	-2.4	-0.2	1.3	1.8	1.9	1.8	-8.4	-7.9	-7.0	-6.0	-4.7	-3.7	82	87	91	94	96	95
Emerging Markets	**2.2**	**1.5**	**1.7**	**1.4**	**1.3**	**1.2**	**-1.7**	**-2.1**	**-1.7**	**-1.5**	**-1.4**	**-1.5**	**16**	**16**	**16**	**16**	**16**	**15**
China	**3.0**	**2.0**	**1.5**	**1.0**	**1.0**	**1.0**	**-1.0**	**-2.0**	**-1.5**	**-1.0**	**-1.0**	**-1.0**	**15**	**16**	**15**	**15**	**14**	**14**
Hong Kong	7.0	10.3	12.4	10.0	10.0	10.0	2.7	2.2	2.5	1.9	3.4	3.5	1	2	2	3	3	4
India	-3.4	-3.6	-3.0	-2.9	-2.8	-2.5	-8.3	-8.0	-7.5	-6.0	-6.0	-6.0	67	67	66	64	62	62
Indonesia	0.3	-0.3	-0.5	-0.7	-0.6	-0.5	-1.5	-1.0	-0.7	-0.3	-0.5	-0.5	26	25	24	23	23	22
Korea	2.2	1.3	1.0	0.7	-0.3	-0.3	0.5	0.7	1.2	1.5	1.4	2.1	33	33	31	29	28	26
Singapore	16.5	15.0	13.0	13.0	12.0	11.0	1.5	1.0	1.0	1.0	1.0	1.0	110	115	118	120	120	120
Czech Republic	-3.7	-3.6	-3.8	-3.8	-3.3	-3.1	-3.7	-4.0	-3.4	-2.3	-1.5	-0.5	37	40	44	46	46	45
Hungary	1.5	1.2	1.2	2.0	2.2	2.1	3.0	-3.2	-3.0	-3.3	-2.9	-2.5	80	82	81	79	78	76
Poland	-4.3	-3.4	-4.0	-5.7	-6.1	-4.9	-5.2	-3.5	-2.4	-1.8	-1.6	-1.6	53	53	53	51	49	48
Romania	-3.5	-4.5	-4.7	-5.0	-5.0	-5.0	-4.4	-2.0	-2.0	-2.5	-2.3	-2.0	38	39	39	39	39	38
Russia	5.7	3.5	1.4	-1.0	-1.0	-1.0	-1.4	-3.1	-2.7	-2.3	-1.9	-1.7	8	9	11	12	13	13
Turkey	-10.2	-8.4	-5.8	-5.0	-4.4	-3.8	-1.3	-2.2	-2.5	-2.5	-2.7	-3.0	43	40	40	38	38	37
Nigeria	5.9	5.3	6.0	4.7	3.7	3.2	-3.2	-2.8	-2.0	-2.4	-2.8	-2.4	NA	NA	NA	NA	NA	NA
South Africa	-3.4	-4.7	-5.6	-6.6	-6.4	-5.8	-5.0	-4.8	-4.3	-3.6	-3.5	-3.5	35	38	41	42	43	43
Argentina	0.4	0.3	0.2	-0.5	-0.5	-0.5	-0.9	-0.4	0.4	2.0	2.0	2.0	49	49	49	52	53	53
Brazil	-2.1	-2.1	-2.4	-2.7	-3.0	-3.2	-2.7	-2.7	-2.9	-2.7	-2.5	-2.8	63	63	63	63	70	71
Mexico	-1.0	-2.1	-2.1	-2.5	-2.5	-2.7	-2.5	-2.2	-2.0	-1.9	-1.9	-1.8	39	40	39	38	38	38
Venezuela	10.4	8.6	9.9	8.4	9.3	9.1	-5.0	-5.0	-4.0	-5.2	-5.0	-4.8	36	38	33	32	33	33

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 2012-13.
Source: Citi Investment Research and Analysis

Figure 10. 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		-0.2	-0.1	-0.1	-0.1	-0.1		0.1		0.2	0.3	0.2
Based on PPP weights	-1.0	-0.1	-0.1		-0.1		0.1	0.2		0.1	0.3	0.2
Industrial Countries	-0.1	-0.3	-0.1			0.1	-0.1	-0.2	-0.2	0.1	0.1	0.1
United States					-0.1			0.1				
Japan	-0.6	-0.8			-0.1	-0.1	-0.4	-1.3	-1.1	0.1	0.1	
Euro Area		-0.3	-0.2		0.2	0.3	0.2	0.2	0.2	0.1	0.4	0.5
Canada						-0.2	-0.1	0.5	-0.3			
Australia	0.4	-0.3	-0.2	-0.2	-0.2			-1.3	-0.8		-0.7	-0.1
New Zealand												
Germany			-0.1		-0.1				-0.1	0.7	-0.1	
France				0.1	0.7	0.3				0.1	0.5	0.5
Italy		-0.4	0.4		0.3	1.0	0.3	0.3	0.4	-0.2	1.1	1.9
Spain		-0.8	-0.5		1.2	1.7	0.2	0.2	0.2		1.9	2.8
Greece	0.2			0.1	0.1	-0.3						0.1
Portugal	-0.3		0.7	-0.2	1.0	0.2				-1.5	1.9	1.8
Netherlands	0.1	-0.3					-0.4					
Belgium	-0.1	-0.2			0.1		-1.7	-3.1	-3.2		0.7	0.8
Denmark	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Norway		-0.4		-0.1								
Sweden	0.2	-1.6	-0.7	-0.1	-0.8	-0.3	1.0	1.2	1.4	-0.1	-0.8	-1.3
Switzerland	-0.1	-0.3	-0.3	-0.1	-0.2		0.1	2.0	2.9			
United Kingdom		-0.3	-0.2		-0.1	-0.1	-2.2	-1.8	-1.6	0.5	0.7	0.5
Emerging Markets		0.1	-0.1		-0.1	-0.2	0.3	0.6	0.3	0.2	0.5	0.4
China	0.1			-0.1	-0.6	-0.4			-0.5			0.5
Hong Kong												
India				-0.5	-0.8	-0.5	-0.5	-0.6	-0.5			
Indonesia				-0.1						-0.7		
Korea				-0.4			0.5	0.1	0.1			
Singapore	-0.5			0.1		0.1						
Czech Republic	-0.1	-0.5	-0.1		-0.1	-0.4	0.4	-0.3	0.4	0.8		0.1
Hungary		-0.1	-0.2		-0.1		-1.4	-1.4	-1.3	1.1	-0.2	
Poland	0.2			0.1	0.6		0.3	0.1	0.1		0.5	0.5
Romania	0.4		-0.1	-0.2	-0.5	-0.5				0.1	1.3	0.8
Russia	-0.2	1.0	-0.2	-0.2			1.0	1.6				
Turkey	0.5			0.2				0.1	1.6	0.4	-0.4	-0.3
Nigeria												
South Africa			-0.2			-0.3		-0.3	0.6	0.3	0.4	0.4
Argentina	0.9							-0.1				
Brazil	-0.3	-0.2			-0.1	-0.1	0.2	0.8			-0.2	-0.6
Mexico	0.1			0.1	0.7		0.4	0.7	0.4			
Venezuela	0.5	1.0					-1.7	2.7	0.9			

Note: We did not include forecasts for Denmark in the last GEOS. Source: Citi Investment Research and Analysis

Figure 11. Selected Countries — Economic Forecast Overview and Exchange Rate Forecasts (Percent), 2011-2016F

	10-Year Yields						Exchange Rates Versus U.S. Dollar*						Exchange Rate Versus Euro					
	2011	2012	2013	2014	2015	2016	2011	2012	2013	2014	2015	2016	2011	2012	2013	2014	2015	2016
Industrial Countries																		
United States	**2.79**	**2.15**	**2.70**	**3.05**	**3.35**	**3.75**	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**	**1.39**	**1.23**	**1.26**	**1.31**	**1.33**	**1.35**
Japan	**1.12**	**1.16**	**1.50**	**1.50**	**1.75**	**1.75**	**79**	**77**	**77**	**79**	**82**	**85**	**110**	**94**	**97**	**104**	**109**	**115**
Euro Area	**2.71**	**1.50**	**1.70**	**2.10**	**2.40**	**2.70**	**1.39**	**1.23**	**1.26**	**1.31**	**1.33**	**1.35**	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**
Canada	2.78	2.25	3.05	3.40	3.45	3.75	1.01	1.05	1.00	0.95	0.96	0.97	1.39	1.29	1.26	1.25	1.28	1.31
Australia	4.63	4.00	4.90	5.20	5.50	6.00	1.01	0.97	0.91	0.89	0.88	0.87	1.37	1.26	1.38	1.47	1.51	1.56
New Zealand	4.74	4.09	4.95	5.40	6.00	6.30	0.77	0.74	0.66	0.63	0.62	0.62	1.79	1.65	1.91	2.09	2.14	2.18
Germany	2.71	1.50	1.70	2.10	2.40	2.70												
France	3.31	3.04	2.60	2.70	2.90	3.20												
Italy	5.19	6.33	5.45	5.60	5.40	5.20												
Spain	5.43	5.03	4.25	4.40	4.40	4.20												
Netherlands	3.04	1.93	1.88	2.25	2.55	2.85												
Belgium	4.21	3.81	3.08	3.20	3.30	3.40												
Denmark	2.80	1.46	1.80	2.20	2.60	2.95	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Norway	2.97	1.68	2.15	2.70	3.10	3.45	5.66	6.35	6.10	5.78	5.68	5.58	7.84	7.80	7.68	7.59	7.57	7.55
Sweden	2.65	1.36	1.65	2.15	2.50	2.95	6.60	7.29	7.03	6.67	6.57	6.46	9.14	8.95	8.85	8.75	8.75	8.75
Switzerland	1.53	0.75	0.75	0.75	0.95	1.15	0.90	0.99	0.98	0.97	0.99	1.00	1.25	1.21	1.24	1.27	1.31	1.35
United Kingdom	3.71	1.74	1.50	1.75	2.25	3.00	1.59	1.51	1.59	1.66	1.69	1.72	0.87	0.81	0.79	0.79	0.79	0.79
Emerging Markets																		
China	**3.52**	**3.52**	**3.77**	**4.02**	**4.52**	**4.77**	**6.46**	**6.25**	**6.08**	**6.00**	**5.88**	**5.77**	**8.20**	**7.68**	**7.64**	**7.87**	**7.84**	**7.80**
Hong Kong	1.27	1.14	1.58	1.85	2.20	2.60	7.78	7.77	7.75	7.75	7.75	7.75	9.87	9.54	9.75	10.17	10.33	10.49
India	8.25	8.25	8.25	8.25	8.25	8.25	49.68	51.63	49.38	48.50	47.00	46.00	62.99	63.40	62.11	63.63	62.64	62.27
Indonesia	7.20	6.75	7.00	7.13	7.25	7.25	8768	9150	8975	8900	8800	8900	11116	11236	11289	11677	11728	12047
Korea	3.90	3.65	4.54	4.98	5.40	5.70	1108	1129	1053	1010	990	980	1405	1386	1324	1325	1319	1327
Singapore	2.11	2.05	2.80	3.20	3.60	3.60	1.26	1.28	1.21	1.17	1.16	1.15	1.59	1.57	1.52	1.54	1.55	1.56
Czech Republic	0.97	0.95	1.23	1.45	1.75	4.00	17.8	20.9	19.4	18.0	17.3	16.5	22.6	25.6	24.4	23.6	23.0	22.4
Hungary	7.73	8.70	7.91	7.66	6.78	6.60	205	247	230	216	212	207	260	303	289	284	282	281
Poland	NA	NA	NA	NA	NA	NA	2.96	3.61	3.23	2.97	2.93	2.88	3.75	4.43	4.07	3.90	3.90	3.90
Romania	NA	NA	NA	NA	NA	NA	3.06	3.45	3.41	3.13	2.99	2.86	3.87	4.24	4.29	4.10	3.98	3.87
Russia	NA	NA	NA	NA	NA	NA	29.4	33.1	32.9	31.8	31.1	30.4	37.3	40.6	41.4	41.7	41.4	41.2
Turkey	NA	NA	NA	NA	NA	NA	1.68	1.90	1.86	1.76	1.70	1.64	2.12	2.33	2.34	2.31	2.27	2.22
Nigeria	NA	NA	NA	NA	NA	NA	155	160	163	163	165	164	197	197	205	214	220	222
South Africa	NA	NA	NA	NA	NA	NA	7.26	8.55	8.78	9.02	9.40	9.79	9.21	10.49	11.04	11.84	12.53	13.25
Argentina	NA	NA	NA	NA	NA	NA	4.16	5.31	5.97	6.79	7.54	8.36	5.27	6.52	7.51	8.91	10.04	11.32
Brazil	11.45	10.90	11.15	10.07	8.75	8.25	1.67	1.80	1.77	1.76	1.78	1.79	2.12	2.21	2.23	2.31	2.37	2.43
Mexico	6.87	6.52	7.50	8.10	8.00	8.00	12.5	13.5	12.7	12.4	12.6	12.9	15.8	16.6	16.0	16.2	16.8	17.4
Venezuela	13.65	13.55	13.53	13.50	13.50	13.50	4.30	4.30	6.50	6.50	9.75	9.75	5.45	5.28	8.18	8.53	12.99	13.20

*Per USD except Euro Area, Australia, New Zealand, United Kingdom. Note: All foreign exchange forecasts are consistent with the rolling forecasts presented in Figure 73. Source: Citi Investment Research and Analysis

Figure 12. Short Rates (End of Period), as of 18 Jan 2012 (Percent)

	Current	1Q 12	2Q 12	3Q 12	4Q 12	1Q 13	2Q 13
United States	**0.25**	**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**	**0.10**
Euro Area	**1.00**	**1.00**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**
Canada	1.00	1.00	1.00	1.00	1.00	1.25	1.50
Australia	4.25	4.00	4.00	4.00	4.00	4.25	4.50
New Zealand	2.50	2.50	2.50	2.75	3.50	4.25	4.50
Denmark	0.70	0.60	0.10	0.10	0.10	0.10	0.10
Norway	1.75	1.75	1.50	1.50	1.50	1.50	1.50
Sweden	1.75	1.50	1.00	1.00	1.00	1.00	1.00
Switzerland	0.00	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	0.50
China	**3.50**	**3.75**	**3.75**	**3.75**	**3.75**	**4.00**	**4.00**

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 SNBs three-month LIBOR target; and China, where it is the one-year deposit rate. Source: Citi Investment Research and Analysis

Figure 13. 10-Year Yield Forecasts (Period Average), as of 18 Jan 2012 (Percent)

	Current	1Q 12	2Q 12	3Q 12	4Q 12	1Q 13	2Q 13
United States	**1.85**	**1.95**	**2.05**	**2.20**	**2.40**	**2.50**	**2.65**
Japan	**0.97**	**1.20**	**1.05**	**1.10**	**1.30**	**1.40**	**1.50**
Euro area (Germany)	**1.77**	**1.75**	**1.50**	**1.25**	**1.50**	**1.50**	**1.50**
Canada	1.92	2.05	2.15	2.30	2.50	2.85	3.00
Australia	3.86	3.70	3.80	4.10	4.40	4.70	5.00
New Zealand	3.94	3.70	3.90	4.30	4.50	4.75	5.10
Denmark	1.70	1.68	1.45	1.20	1.50	1.55	1.60
Norway	1.92	1.85	1.65	1.40	1.80	1.90	1.95
Sweden	1.61	1.60	1.35	1.10	1.40	1.40	1.45
Switzerland	0.73	0.70	0.65	0.63	0.72	0.72	0.72
United Kingdom	1.94	2.00	1.85	1.50	1.60	1.60	1.60

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 14. 10-Year Yield Spreads (Period Average), as of 18 Jan 2012

	Spread vs. US$						Spread vs. Germany					
	Current	1Q 12	2Q 12	3Q 12	4Q 12	1Q 13	Current	1Q 12	2Q 12	3Q 12	4Q 12	1Q 13
United States	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**	**9**	**21**	**56**	**96**	**91**	**102**
Japan	**-89**	**-76**	**-101**	**-111**	**-111**	**-112**	**-80**	**-55**	**-45**	**-15**	**-20**	**-10**
Euro Area	**-9**	**-21**	**-56**	**-96**	**-91**	**-102**	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**
Canada	7	10	10	10	10	35	16	31	66	106	102	137
Australia	204	177	178	193	203	224	213	198	234	289	295	326
New Zealand	212	177	188	213	214	229	221	198	244	310	305	331
France	124	129	119	54	49	18	139	150	175	150	140	120
Italy	461	479	444	384	359	328	476	500	500	480	450	430
Spain	327	329	324	254	239	198	342	350	380	350	330	300
Netherlands	17	29	-6	-56	-61	-77	32	50	50	40	30	25
Belgium	228	229	194	129	109	73	243	250	250	225	200	175
Denmark	-16	-28	-61	-101	-91	-97	-7	-7	-5	-5	0	5
Norway	5	-11	-41	-81	-61	-62	14	10	15	15	30	40
Sweden	-24	-36	-71	-111	-101	-112	-15	-15	-15	-15	-10	-10
Switzerland	-104	-126	-141	-158	-169	-180	-112	-105	-85	-62	-78	-78
United Kingdom	17	4	-21	-71	-81	-92	17	25	35	25	10	10

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 15. Emerging Market Countries — Short Rates Actual and Forecast of Additional Rate Moves (End of Period), as of 18 Jan 2012

Country	Current Rate (%)	Mar 12	Jun 12	Sep 12	Dec 12	Total Cumulative Rate Moves Expected
South Africa	5.50	0	0	50	50	100
Hungary	7.00	25	0	0	0	25
China	3.50	25	0	0	0	25
Thailand	3.25	-25	0	0	50	25
Czech	0.75	0	0	0	0	0
Indonesia	6.00	0	0	0	0	0
Korea	3.25	0	0	0	0	0
Malaysia	3.00	0	0	0	0	0
Mexico	4.50	0	0	0	0	0
Philippines	4.50	0	0	0	0	0
Turkey	5.75	0	0	0	0	0
Israel	2.75	-25	0	0	0	-25
Russia	8.00	0	0	0	-50	-50
Chile	5.00	-50	-25	0	0	-75
Poland	4.50	-25	-25	-25	0	-75
India	8.50	-25	-25	-25	-25	-100
Brazil	11.00	-100	-50	0	0	-150

Source: Citi Investment Research and Analysis

Figure 16. Foreign Exchange Forecasts (End of Period), as of 18 Jan 2012

	vs. USD						vs. EUR					
	Current	Mar 12	Jun 12	Sep 12	Dec 12	Mar 13	Current	Mar 12	Jun 12	Sep 12	Dec 12	Mar 13
United States	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**	**1.27**	**1.25**	**1.24**	**1.22**	**1.20**	**1.22**
Japan	**77**	**77**	**77**	**76**	**76**	**76**	**97**	**96**	**95**	**93**	**91**	**93**
Euro Area	**1.27**	**1.25**	**1.24**	**1.22**	**1.20**	**1.22**	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**
Canada	1.02	1.03	1.04	1.05	1.07	1.04	1.30	1.29	1.29	1.29	1.28	1.28
Australia	1.03	1.01	0.99	0.96	0.93	0.92	1.23	1.24	1.25	1.27	1.29	1.32
New Zealand	0.79	0.78	0.76	0.73	0.70	0.69	1.60	1.60	1.63	1.67	1.71	1.78
Norway	6.08	6.22	6.31	6.40	6.49	6.35	7.70	7.79	7.80	7.80	7.80	7.76
Sweden	7.02	7.11	7.22	7.35	7.48	7.33	8.90	8.90	8.93	8.96	9.00	8.95
Switzerland	0.95	0.97	0.98	1.00	1.01	1.01	1.21	1.21	1.21	1.22	1.22	1.23
United Kingdom	1.53	1.52	1.52	1.51	1.50	1.53	0.83	0.82	0.81	0.81	0.80	0.80
China	**6.31**	**6.30**	**6.27**	**6.24**	**6.20**	**6.15**	**8.00**	**7.90**	**7.70**	**7.60**	**7.50**	**7.50**
India	51.5	52.0	52.0	51.5	51.0	50.0	65.3	65.1	64.3	62.8	61.3	61.1
Korea	1148	1150	1145	1120	1100	1080	1455	1440	1415	1365	1323	1319
Poland	3.49	3.62	3.62	3.61	3.59	3.45	4.42	4.53	4.48	4.40	4.31	4.22
Russia	31.9	32.3	32.8	33.3	33.9	33.6	40.4	40.4	40.5	40.6	40.7	41.0
South Africa	8.15	8.36	8.50	8.62	8.73	8.76	10.33	10.48	10.50	10.50	10.50	10.70
Turkey	1.86	1.85	1.88	1.91	1.95	1.92	2.36	2.32	2.32	2.33	2.34	2.34
Brazil	1.79	1.80	1.80	1.80	1.80	1.79	2.27	2.25	2.22	2.19	2.16	2.19
Mexico	13.6	13.6	13.5	13.5	13.4	13.1	17.3	17.0	16.7	16.4	16.1	16.1

Note: All foreign exchange forecasts are consistent with the rolling forecasts presented in Figure 72. Source: Citi Investment Research and Analysis

Figure 17. Foreign Exchange Forecasts (End of Period), as of 18 Jan 2012

	vs. JPY					
	Current	Mar 12	Jun 12	Sep 12	Dec 12	Mar 13
United States	**77**	**77**	**77**	**76**	**76**	**76**
Japan	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**
Euro Area	**97**	**96**	**95**	**93**	**91**	**93**
Canada	75	75	74	72	71	73
Australia	79	78	76	73	71	71
New Zealand	60.9	60.2	58.1	55.8	53.5	52.4
Norway	12.6	12.4	12.2	11.9	11.7	12.0
Sweden	11.0	10.8	10.6	10.4	10.2	10.4
Switzerland	81	80	78	77	75	76
United Kingdom	118	117	116	115	114	117
China	**12**	**12**	**12**	**12**	**12**	**12**
India	1.49	1.48	1.48	1.48	1.49	1.53
Korea	14.93	14.94	14.93	14.66	14.46	14.13
Poland	22.1	21.3	21.2	21.2	21.2	22.1
Russia	2.4	2.4	2.3	2.3	2.2	2.3
South Africa	9.4	9.2	9.0	8.9	8.7	8.7
Turkey	41.3	41.6	40.8	40.0	39.1	39.8
Brazil	42.9	42.8	42.6	42.4	42.2	42.7
Mexico	5.6	5.7	5.7	5.7	5.7	5.8

Note: All foreign exchange forecasts are consistent with the rolling forecasts presented in Figure 72. Source: Citi Investment Research and Analysis

Country Commentary

United States

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The recovery from the twin shocks of higher oil prices and factory supply line disruptions has given recent growth a boost, led by reviving auto production and sales. But we continue to expect a return to somewhat disappointing growth this year. Although the expansion's resilience is evident in stronger job gains, policy efforts have been unable to calm financial headwinds completely, while lingering imbalances in some sectors are preventing a broad-based rebound in activity.

The Fed has signaled that policy likely will continue supporting financial conditions with the use of communications strategy. We expect an imminent change in interest rate guidance, pushing out expectations of the first rate hike well beyond 2013. The possible introduction of a formal inflation target could serve as an anchor for credibility in the event a deteriorating outlook warrants renewed balance sheet expansion. Short of that, implementation of OT is continuing and there is a growing chance of additional MBS purchases. Fiscal policy still presents a wild card, but we are anticipating full-year extensions of payroll tax relief and long-term jobless benefits in Q1. Retrenchment among state and local governments remains a drag on income and employment, although its intensity may begin to wane.

Inflation has begun to retreat noticeably in high-frequency headline and core measures as earlier shocks have dissipated. This has buoyed growth, especially where temporary bottlenecks had been a source of price pressure. Business pricing plans have eased and with a slack job market, wage growth remains slow and consumer resistance to higher prices is widely evident. Lower inflation this year could provide an added degree of freedom for Fed policymakers weighing the costs and benefits of additional accommodation.

Figure 18. United States — Economic Forecasts, 2011F-2013F

					2011		2012				2013	
		2011F	2012F	2013F	3Q	4QF	1QF	2QF	3QF	4QF	1QF	2Q
GDP	SAAR				1.8%	2.8%	1.7%	1.7%	2.0%	2.1%	1.0%	1.7%
	YoY	1.7%	1.9%	1.9%	1.5	1.6	1.9	2.0	2.0	1.9	1.7	1.7
Domestic Demand	SAAR				2.7	1.1	1.7	1.3	2.0	2.1	0.6	1.6
	YoY	1.8	1.7	1.7	1.8	1.4	1.7	1.7	1.5	1.8	1.5	1.6
Consumption	SAAR				1.7	2.4	1.9	1.6	2.2	2.4	1.1	1.8
	YoY	2.2	1.9	1.9	2.0	1.7	1.7	1.9	2.0	2.0	1.8	1.9
Business Investment	SAAR				15.7	2.7	6.0	4.0	4.1	4.1	4.7	3.9
	YoY	8.6	6.0	4.3	9.1	7.6	8.6	7.0	4.2	4.6	4.2	4.2
Housing Investment	SAAR				1.3	9.4	9.3	10.9	13.8	15.9	17.4	18.3
	YoY	-1.5	9.3	16.9	1.4	3.0	6.0	7.7	10.8	12.5	14.5	16.3
Government	SAAR				-0.1	-4.8	-1.9	-2.1	-1.5	-1.4	-5.6	-2.9
	YoY	-2.2	-2.1	-2.6	-2.4	-3.0	-1.9	-2.2	-2.6	-1.7	-2.7	-2.9
Exports	SAAR				4.7	6.0	3.8	3.8	4.6	4.9	5.1	5.0
	YoY	6.9	4.5	4.9	6.0	5.5	4.5	4.6	4.5	4.3	4.6	4.9
Imports	SAAR				1.2	2.4	3.0	3.4	4.2	4.0	3.8	4.1
	YoY	4.8	2.9	4.1	2.1	3.3	2.0	2.5	3.2	3.7	3.9	4.0
CPI	YoY	3.2	1.7	1.7	3.8	3.3	2.4	1.6	1.3	1.4	1.5	1.7
Core CPI	YoY	1.7	2.0	1.7	1.9	2.2	2.2	2.1	1.9	1.8	1.7	1.6
Unemployment Rate	%	9.0	8.5	8.4	9.1	8.7	8.6	8.5	8.4	8.3	8.4	8.3
Federal Gov't Balance (Fiscal Year)	$Bn	-1296	-1125	-975								
	% of GDP	-8.7	-7.3	-6.0								
General Gov't Balance (Cal Year)	% of GDP	-9.3	-7.3	-6.2								
Federal Debt	% of GDP	68	74	77								
General Gov't Debt	% of GDP	99	104	108								
Current Account	US$bn	-456	-374	-391	-441	-407	-379	-382	-359	-375	-364	-388
	% of GDP	-3.0	-2.4	-2.4	-2.9	-2.7	-2.5	-2.5	-2.3	-2.4	-2.3	-2.4
S&P 500 Profits (US$ Per Share)	YoY	16.1	1.8	4.5	18.0	15.1	9.4	4.2	-2.6	-3.1	-0.6	4.2

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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Monthly tracking data indicate that real GDP probably contracted in Q4-11, reflecting a decline in exports. Japan's corporate and household sectors do not face as much balance sheet adjustment pressure as their U.S. and European peers, but the economy remains quite vulnerable to external slowdown and the yen's appreciation. We expect economic activity to stay sluggish in H1-2012 before picking up in H2 thanks to moderately faster global growth and reconstruction demand from the earthquake. Deflation likely will persist well in to 2013.

Compared with our last forecasts (as of late November), we revised down our forecasts for private capex in 2012. Recent data suggest that companies are postponing implementation of business investment plans because of the external slowdown (including China), continued strains in global financial markets due to the EMU crisis, the elevated yen and the negative impact from these factors on profits. As a result, we now expect private capex to fall modestly in H1-2012. In contrast, consumer spending is likely to hold up in real terms because of the government's new support program for car purchases as well as enhanced real purchasing power due to falling prices. Moreover, we expect reconstruction spending on infrastructure will start to boost the economy in Q2 although housing reconstruction will be somewhat delayed. Debates about the consumption tax hike will be a key policy issue this year. PM Noda plans to propose the consumption tax bill calling for the tax rate hike to 8% in April 2014 from 5% currently and to 10% in October 2015. In making our economic forecasts, we have yet to reflect the government's plan as there remain significant political hurdles to the tax hike. However, if the plan is implemented, GDP growth in 2013 will probably be pushed up by nearly 2% thanks to frontloaded demand ahead of price hikes but growth in 2014 will worsen thanks to a reactionary decline in spending as well as a permanent negative impact on real household income.

Figure 19. Japan — Economic Forecasts, 2011-13F

					2011		2012				2013	
		2011F	2012F	2013F	3Q	4QF	1QF	2QF	3QF	4QF	1QF	2QF
Real GDP	YoY	-1.0%	1.0%	1.3%	-0.8%	-1.2%	0.6%	1.3%	0.5%	1.4%	1.7%	1.4%
	SAAR				5.6	-1.3	0.3	0.8	2.4	2.0	1.5	-0.2
Domestic Demand	YoY	0.0	1.8	1.1	-0.2	0.2	2.1	2.0	1.7	1.5	1.4	1.1
	SAAR				3.2	2.0	1.2	1.5	2.1	1.0	1.1	0.1
Private Consumption	YoY	-0.1	1.0	0.8	0.1	0.0	1.6	1.2	0.6	0.6	0.8	0.8
	SAAR				3.0	0.9	1.4	-0.4	0.7	0.7	2.2	-0.4
Business Investment	YoY	-0.5	-0.9	3.6	-2.5	-1.4	-1.3	-1.6	-0.7	0.0	2.0	4.1
	SAAR				-1.6	1.8	-3.1	-3.5	2.2	4.4	5.3	4.4
Housing Investment	YoY	5.3	5.6	8.2	7.9	3.2	2.1	6.0	3.6	10.8	13.1	11.7
Public Investment	YoY	-1.9	11.3	-11.3	-0.7	5.3	10.0	11.0	16.3	8.0	-5.0	-15.0
Exports	YoY	-0.1	-0.3	5.1	0.8	-1.8	-2.7	3.0	-3.0	1.8	4.0	5.8
	SAAR				32.7	-10.4	-3.8	-1.6	4.4	8.7	4.8	5.2
Imports	YoY	6.0	4.2	4.2	5.3	6.2	5.6	5.9	2.9	2.5	2.5	3.7
	SAAR				14.9	4.1	2.3	2.7	2.5	2.3	2.6	7.7
CPI	YoY	-0.3	-0.4	-0.2	0.2	-0.3	-0.5	-0.4	-0.4	-0.3	-0.2	-0.2
Core CPI	YoY	-0.3	-0.4	-0.2	0.2	-0.2	-0.3	-0.5	-0.4	-0.3	-0.2	-0.2
Nominal GDP	YoY	-3.0	-0.1	1.0	-2.9	-3.0	-1.1	0.5	-0.3	0.6	1.2	1.1
Current Account	¥ tn	9.1	5.7	7.7	10.4	5.3	4.9	4.9	5.7	7.3	8.3	7.8
	% of GDP	1.9	1.2	1.6	2.2	1.1	1.1	1.0	1.2	1.6	1.8	1.7
Unemployment Rate	%	4.5	4.5	4.4	4.4	4.5	4.6	4.5	4.5	4.4	4.5	4.4
Industrial Production	YoY	-3.5	2.8	2.3	-2.1	-2.4	2.6	5.0	1.0	2.5	0.4	2.9
Corporate Profits (Fiscal Year)	YoY	-12.0	17.5	20.0								
General Govt. Balance (Fiscal Year)	% of GDP	-10.7	-10.9	-8.5								
General Govt Debt	% of GDP	233	243	250								

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

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Euro Area

We are cutting our GDP forecast again by 0.3 points to minus 1.5% for 2012, amid further downward revisions of our GDP forecasts for Italy, Spain and the Netherlands. We also are cutting our 2013 forecast by 0.2 points, now forecasting minus 0.4% YY. At the same time we have revised up our inflation forecasts. We now expect inflation of 2.2% in 2012 and a slowdown to 1.4% in 2013. As with recent GDP forecast cuts, additional austerity measures have played a significant role in the latest GDP revisions. The substantial easing of the ECB's lending conditions, mainly by providing the 3Y LTRO, probably will help to limit the tightening in banks' lending conditions. It also is likely to ease the funding difficulties of periphery country sovereigns to some extent. But, we doubt these effects will offset the fiscal drag from additional austerity measures. The rise in our inflation forecasts reflects bigger-than-expected indirect tax hikes.

With the downgrade of France's and Austria's AAA ratings by S&P, the EFSF has lost around €180bn of AAA-rated guarantees and its AAA rating, which will make financial support of the periphery countries even more difficult. In order to circumvent the EFSF rating problems, officials are now trying to establish the ESM with larger firepower by mid-2012. The introduction of the ESM — which requires a limited change in the EU treaty and ratification by the 17 euro area countries — still faces substantial hurdles, not least over how to provide the required capital in all member countries. In addition, the targeted rise in IMF funding remains uncertain. Regarding the longer term-outlook, there is progress on the new fiscal compact, but the targeted enacting of the framework in 2013 looks ambitious to us. The ECB has announced that it will widen the collateral pool further to pave the way for substantial use of the second 3Y LTRO in February. In addition, we expect that the ECB will take further action to widen the collateral pool to ease banks' funding problems. However, unless there is a dramatic escalation of the crisis, we do not expect the ECB to change its strategy regarding the SMP. On rates, we expect the ECB to cut the main refinancing rate from 1.0% to 0.5% in 2Q, to reduce the deposit rate to 0.1% and to reduce the rate for marginal lending facility to 1.25%.

Figure 20. Euro Area — Economic Forecasts, 2011F-13F

					2011		2012				2013	
		2011F	2012F	2013F	3Q	4QF	1QF	2QF	3QF	4QF	1QF	2QF
Real GDP	YoY	1.5%	-1.5%	-0.4%	1.3%	0.6%	-1.0%	-1.6%	-2.0%	-1.6%	-1.0%	-0.5%
	SAAR				0.5	-2.0	-3.0	-1.8	-1.4	-0.3	-0.5	0.1
Final Domestic Demand	YoY	0.5	-0.8	-0.1	0.3	-0.1	-0.9	-0.6	-0.9	-0.7	-0.3	-0.2
Private Consumption	YoY	0.2	-0.3	0.2	0.0	-0.4	-0.6	-0.1	-0.4	-0.2	0.0	0.0
Government Consumption	YoY	0.1	-0.5	-0.5	0.0	-0.1	-0.4	-0.5	-0.5	-0.5	-0.5	-0.5
Fixed Investment	YoY	1.8	-2.5	-0.4	1.3	1.0	-2.0	-2.5	-2.9	-2.6	-1.3	-0.7
— Business Equipment	YoY	3.5	-3.0	-0.3	3.2	1.7	-1.6	-2.8	-4.0	-3.7	-1.6	-0.7
— Construction	YoY	-0.1	-3.2	-1.3	-1.0	-0.1	-3.3	-3.4	-3.1	-2.8	-2.2	-1.6
Stocks (Contrib. to Y/Y GDP Growth)		0.1	-0.1	-0.1	0.1	0.1	0.0	-0.2	-0.1	0.0	0.0	0.0
Exports	YoY	6.6	-2.3	1.2	5.8	3.6	-0.1	-2.2	-3.8	-3.1	-1.1	0.6
Imports	YoY	4.7	-0.8	1.7	3.7	2.4	0.2	-0.6	-1.5	-1.3	0.4	1.4
CPI	YoY	2.7	2.2	1.4	2.7	2.9	2.4	2.2	2.3	1.8	1.7	1.4
Core CPI	YoY	1.4	1.5	1.0	1.3	1.6	1.5	1.5	1.7	1.2	1.2	0.9
CPI Ex Energy and Food	YoY	1.7	1.6	1.1	1.7	2.0	1.7	1.8	1.7	1.3	1.1	1.0
Unemployment Rate	YoY	10.1	10.5	10.7	10.1	10.3	10.4	10.5	10.6	10.6	10.7	10.7
Current Account Balance	EUR bn	-48.7	-67.7	-52.7								
	% of GDP	-0.5	-0.7	-0.5								
General Government Balance	EUR bn	-410.8	-353.9	-249.0								
	% of GDP	-4.4	-3.8	-2.6								
General Government Debt	EUR bn	8232.6	8586.5	8835.5								
	% of GDP	88.7	94.1	93.8								
Gross Operating Surplus	YoY	2.0	-0.6	0.3								

Sources: Eurostat and Citi Investment Research and Analysis

Germany

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There are clear signs that the boom in Germany is over. GDP fell in 4Q and with the fall in incoming orders at the end-2011, we expect manufacturing activity to fall this year. However, surveys suggest that domestic demand remains resilient and the labour market continues to improve. In February, wage talks will start in key sectors and it seems likely that wage rises will be higher than in 2011. In this environment we expect consumption to hold up, particularly as recent declines in commodity prices are likely to lower inflation. Supported by historical low mortgage rates, construction spending is also likely to support growth.

France

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France is entering recession, and we expect the release of Q4-2011 GDP figures in mid-Feb to show the economy flat or shrinking slightly. The EMU crisis is dampening confidence in the economy's prospects and the unofficial — but intense — campaign for the 2012 presidential and legislative elections is not helping either. There is very limited visibility about the fiscal policy outlook. We believe that further fiscal tightening will be needed if the government is to meet its 4.5% of GDP 2012 budget deficit target, and that about €15bn of extra budgetary tightening will be needed in 2013 to hit the 3% deficit target. Some limited further tightening for 2012 may be announced before the election (April-May) but major decisions will probably be postponed until after the election. Polls suggest that Socialist candidate Francois Hollande will be victorious in May, but 100 days is a very long time in politics.

Italy

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With thanks to Carla Clifton

The Italian economy continues to face serious challenges and we have cut our 2012 growth forecast to -2.3% from -1.9%. The new Monti government has introduced a fiscal consolidation package worth €30bn to hit the 2.7% deficit target for 2012. But, in our view, Italy will have to put in place more austerity measures to reach the 2012 target and to reach a balanced budget by 2013. Even with structural reforms, fiscal drag will hit activity, reinforced by weakness in Italy's main trading partners. We expect the economy will shrink again in 2013, although activity may begin to rise in 2014, as austerity measures ease. Under such a scenario, we expect Italy's debt-to-GDP ratio to rise further to a peak of about 132% in 2015.

Figure 21. Germany, France and Italy — Economic Forecasts, 2011F-13F

		Germany			France			Italy		
		2011F	2012F	2013F	2011F	2012F	2013F	2011F	2012F	2013F
Real GDP	YoY	3.0%	0.4%	1.2%	1.6%	-0.7%	0.5%	0.4%	-2.3%	-0.7%
Final Domestic Demand	YoY	2.4	1.1	1.2	1.0	-0.7	0.4	0.0	-1.2	-1.1
Private Consumption	YoY	1.4	1.0	1.1	0.6	-0.2	0.5	0.5	-0.4	-0.2
Fixed Investment	YoY	7.2	2.1	2.8	2.6	-3.0	0.4	-0.7	-3.3	-2.2
Exports	YoY	8.6	1.6	3.9	4.2	2.3	4.2	6.1	-9.2	-4.6
Imports	YoY	7.8	3.6	4.3	5.1	1.0	3.4	1.1	-6.6	-4.0
CPI	YoY	2.3	1.7	2.0	2.3	2.5	1.8	2.9	2.7	1.9
Unemployment Rate	%	6.0	6.0	6.1	9.2	9.3	9.1	8.3	11.0	13.3
Current Account	€bn	133.2	97.6	83.0	-52.1	-45.7	-29.1	-55.8	-47.4	-40.3
	% of GDP	5.2	3.8	3.1	-2.6	-2.2	-1.4	-3.5	-2.9	-2.4
General Govt. Balance	€bn	-26.6	-43.2	-33.5	-110.6	-91.4	-65.8	-65.9	-42.3	-18.1
	% of GDP	-1.0	-1.7	-1.3	-5.5	-4.5	-3.2	-4.2	-2.7	-1.2
General Govt. Debt	% of GDP	89.2	93.0	93.0	85.2	91.6	94.4	121	129	131
Gross Trading Profits	YoY	3.3	-1.1	1.6	3.0	-2.0	1.0			

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 Carla Clifton

We have cut our forecast for Spanish GDP growth from -1.9% to -2.7% in 2012, and expect continued recession in 2013/14. Spain's new Government has introduced austerity measures worth 1.4% of GDP, which include a mixture of spending cuts and tax hikes. But, the government already acknowledged that the package is unlikely to be enough to allow Spain to shrink its deficit from an estimated 8% of GDP in 2011 to the 2012 target of 4.4% of GDP. The economy already stalled in Q3-2011 and the combination of fiscal tightening and private sector deleveraging is likely to send unemployment rising even further.

Greece

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With thanks to Carla Clifton

The Greek economy is likely to contract sharply again this year amidst deep cuts in Government spending, a further plunge in investment, and weaker foreign demand. In this environment, the 50% PSI debt haircut planned last October appears insufficient to put the country back on a sustainable fiscal path. At the time of writing, it is uncertain if the PSI deal will be agreed and whether Greece will get the second bailout package. If there is no agreement on the two issues, Greece will head to a disorderly debt restructuring in March, when a large bond matures. Political risks are rising as the General Election scheduled for this year approaches and party leaders become increasingly less committed to the reforms required to secure the funding contained in the second bailout deal.

Portugal

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With thanks to Carla Clifton

The economy probably already fell back into recession in H2-2011, and huge fiscal austerity is likely to produce a dramatic drop in GDP in coming years. The 2012 Budget tightened fiscal policy by about 6.0% of annual GDP for 2012-13, and further measures are likely to be required to cut the country's deficit to the 4.5% target for 2012. Without the one-off measures adopted last year, the 2011 deficit would most likely have been around 2 percentage points above the 5.9% target. As fiscal austerity bites, we expect GDP to fall by about 10% in 2012-14 combined (minus 5.8% in 2012, minus 3.7% in 2013, minus 0.6% in 2014). We believe that without a sizeable haircut to its debt stock, Portugal will not be able to move onto a viable fiscal path. We expect a haircut of 35% at the end of 2012 or in 2013.

Figure 22. Spain, Greece and Portugal — Economic Forecasts, 2011F-13F

		Spain			Greece			Portugal		
		2011F	2012F	2013F	2011F	2012F	2013F	2011F	2012F	2013F
Real GDP	YoY	0.7%	-2.7%	-1.3%	-5.4%	-4.9%	-3.1%	-1.8%	-5.8%	-3.7%
Final Domestic Demand	YoY	-1.4	-3.2	-1.7	-7.8	-6.4	-4.5	-5.0	-6.9	-5.0
Private Consumption	YoY	-.01	-1.9	-1.0	-5.6	-5.2	-3.5	-3.7	-5.1	-3.8
Fixed Investment	YoY	-4.8	-7.9	-4.9	-14.5	-10.7	-10.1	-10.8	-13.4	-8.0
Exports	YoY	8.8	-8.5	-3.7	-0.1	0.5	1.3	7.8	2.4	1.9
Imports	YoY	1.4	-9.6	-5.1	-9.4	-6.2	-4.8	-3.4	-1.3	-1.2
CPI	YoY	3.1	2.4	1.8	3.2	1.5	-0.7	3.6	2.4	1.4
Unemployment Rate	%	22.3	26.3	25.9	17.3	20.2	21.0	NA	NA	NA
Current Account	€bn	-39.8	-31.8	-25.3	-20.1	-9.3	-6.1	-14.9	-10.7	-7.4
	% of GDP	-3.7	-2.9	-2.3	-9.2	-4.4	-2.9	-8.7	-6.4	-4.3
General Govt. Balance	€bn	-86.0	-61.0	-33.5	-27.4	-22.0	-12.5	-16.5	-8.6	-5.8
	% of GDP	-8.0	-5.6	-3.0	-12.6	-10.4	-5.8	-9.6	-5.1	-3.4
General Govt. Debt	€bn	757.1	858.4	944.6	354.9	295.1	301.7	193.8	166.4	186.0
	% of GDP	71	83	89	165	144	152	113	99	108

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

Netherlands

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We have cut our GDP forecast for 2012 to -0.7% from -0.4% previously. We expect that, in addition to the existing fiscal consolidation, the government will announce additional austerity measures this year. In addition, consumer spending is vulnerable to the interplay between falling house prises and high household debts, while exports are likely to be hit by the fall in external demand.

Belgium

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The new six-party government has acted to tighten fiscal policy, in response to the European Commission's request to find €1.3bn in the budget to ensure that the country will meet its commitment of reducing its budget deficit to less than 3% of GDP in 2012. This is a clear example of how changes in budget policy oversight and greater transparency introduced in the "European Semester" and subsequent policy initiatives such as the Euro "six pack" and "Euro plus" pact give the executive arm of the EU more power to enforce budgetary objectives. The slowdown in external demand and weak consumer spending (partly caused by rising savings) will cause GDP to fall markedly this year.

Slovakia

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We have cut our 2012 GDP forecast to 0% from 0.5% previously, although some upside risks still remain. Recent monthly data, the economy's cyclical sensitivity, sovereign downgrades and political noise ahead of early elections are the main headwinds. S&P cut the sovereign rating by one notch to A+ with a neutral outlook, which is conditional on economic reforms. The outcome of the March election remains uncertain. With the ongoing EMU crisis, drop in foreign demand and larger government bond issuance this year, we expect Slovak assets to continue to underperform their Czech counterparts.

Slovenia

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After the early-December election, it now seems likely that right-wing parties will try to establish a coalition with some left-wing parties. But this is unlikely to calm the political environment as the economy faces recession, banking sector problems and the structural reforms (including pension reforms) needed for fiscal sustainability. Moreover, there are disputes among the main parties over the scope of privatisation.

Figure 23. Netherlands, Belgium, Slovakia and Slovenia — Economic Forecasts, 2011F-2013F

		Netherlands			Belgium			Slovakia			Slovenia		
		2011F	2012F	2013F	2011F	2012F	2013F	2011F	2012F	2013F	2011F	2012F	2013F
Real GDP	YoY	1.5%	-0.7%	0.5%	1.8%	-0.7%	0.8%	3.0%	0.0%	2.2%	1.1%	-0.6%	1.2%
Final Domestic Demand	YoY	1.1	-0.1	0.6	2.2	-0.6	0.4	1.0	0.1	1.4	-3.7	-1.4	0.8
Public Consumption	YoY	0.5	0.2	0.3	0.5	-0.2	0.0	-1.0	0.0	0.3	0.0	-0.5	0.7
Private Consumption	YoY	-0.6	0.1	0.4	0.8	-0.3	0.4	0.4	-0.5	1.2	0.2	-1.0	0.5
Investment (Ex Stocks)	YoY	6.1	-1.1	1.7	5.0	0.2	0.7	4.0	1.5	2.5	-12.0	-3.4	1.5
Exports	YoY	3.9	0.2	2.3	5.0	-0.7	2.6	8.7	0.2	4.6	7.9	-1.3	2.4
Imports	YoY	3.7	0.3	2.6	5.7	-0.5	2.0	3.7	-1.4	2.3	5.4	-3.0	0.5
CPI (Average)	YoY	2.3	1.8	1.8	3.5	2.3	1.7	3.9	2.7	2.9	2.1	1.8	2.5
Unemployment Rate	%	5.2	5.7	5.8	7.2	7.9	8.3	13.2	15.1	15.3	8.2	8.8	8.6
Current Account	% of GDP	8.1	7.1	7.1	-0.7	-2.0	-1.4	-0.5	-2.7	-3.9	-0.5	0.0	0.5
General Govt Balance	% of GDP	-3.6	-3.6	-3.0	-3.7	-2.7	-1.5	-5.8	-6.2	-3.6	-5.7	-6.0	-4.5
General Govt Debt	% of GDP	65.0	70.3	69.2	96.8	108.8	107.8	44.5	49.5	50.8	45.8	51.7	55.6

F Citi forecast. YoY Year-on-year growth rate. Sources: National sources and Citi Investment Research and Analysis

UK

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We recently cut our UK forecasts again, and now expect GDP growth of only 0.2% in 2012 and 1.0% in 2013, down by 0.3% and 0.2% respectively from our previous forecasts. We expect the economy will be roughly flat in the next few quarters, and indeed partial data suggest that real GDP may even have fallen slightly in Q4-11. Private spending is weak, public spending is falling, while exports are being hit by the euro area slowdown.

The MPC already signaled in November that further QE is likely with their forecast that the current QE programme (which will take QE up to £275bn by early-February) will probably still leave inflation well below target over time. The MPC decided not to expand QE even faster because they (a) want to see confirmation that the forecast drop in inflation will actually occur; and (b) believe the gilt market cannot really absorb significantly more than £75bn per quarter. Hence, the path of monthly inflation data — which we expect will show inflation falling sharply — will be crucial in reinforcing the MPC's willingness to implement further QE. The MPC believe that QE can provide some stimulus to the economy, but that it takes a very large amount of QE to have much effect. Hence, with the economy likely to be weak this year and beyond, we expect that the QE programme will grow to a colossal scale, from the current target of £275bn by end-Jan to reach about £600bn by the end of this year. At that stage, the MPC will hold close to half the overall gilt market, and a rather higher share of liquid conventional issues. The fiscal deficit is falling steadily and if anything may fall a little faster in the current (11/12) fiscal year than the OBR expect. Even with the roughly flat economy, the current fiscal plans will keep the deficit falling in the year ahead and beyond.

Figure 24. United Kingdom — Economic Forecasts, 2011F-2013F

					2011		2012				2013	
		2011F	2012F	2013F	3Q	4QF	1QF	2QF	3QF	4QF	1QF	2QF
Real GDP	YoY	0.9%	0.2%	1.0%	0.5%	0.9%	0.4%	0.3%	0.1%	0.2%	0.7%	1.0%
	SAAR				2.1	0.0	-0.5	-0.3	1.4	0.2	1..4	1.1
Domestic Demand	YoY	-0.7	-1.1	0.0	-1.2	-0.7	-0.5	-0.9	-1.7	-1.2	-0.5	-0.2
(Incl. Inventories)	SAAR				3.2	-3.4	-1.9	-1.2	-0.2	-1.6	1.0	0.0
Consumption	YoY	-0.6	0.5	1.4	-1.0	-0.4	-0.2	0.8	0.9	0.7	1.4	1.3
	SAAR				0.2	1.0	-0.7	2.7	0.7	0.3	2.0	2.1
Investment	YoY	-3.7	-7.5	-8.2	-1.8	-6.5	-4.1	-6.9	-9.5	-9.6	-10.7	-9.8
	SAAR				5.1	-18.1	0.7	-13.5	-6.2	-18.3	-4.1	-9.9
Exports	YoY	5.1	4.2	5.9	3.0	2.5	1.9	4.0	6.6	4.5	5.1	6.3
	SAAR				-3.0	15.2	2.5	2.2	7.0	6.3	5.2	7.0
Imports	YoY	1.5	0.2	2.7	-0.5	-1.0	0.1	0.5	0.5	-0.1	1.3	2.4
	SAAR				1.9	2.8	-1.9	-0.8	2.0	0.4	3.8	3.6
Unemployment Rate	%	8.0	9.2	9.7	8.2	8.4	8.8	9.0	9.4	9.5	9.7	9.7
CPI Inflation	YoY	4.5	2.6	2.3	4.7	4.7	3.3	2.7	2.4	2.1	2.1	2.3
Merch. Trade	£bn	-97.3	-69.0	-49.8								
	% of GDP	-6.4	-4.4	-3.1								
Current Account	£bn	-36.3	-2.7	20.6								
	% of GDP	-2.4	-0.2	1.3								
PSNB	£bn FY	122.7	119.4	108.2								
	% of GDP	-8.0	-7.6	-6.6								
General Govt. Balance	% of GDP	-8.4	-7.9	-7.0								
Public Debt	% of GDP	81.8	87.0	91.4								
Gross Nonoil Trading Profits	YoY	13.2	8.6	7.0								

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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Recent weakness in the PMI and KoF surveys suggests that the economy is close to recession, and we are cutting our 2012 growth forecast to 0.7% from 1.9% last month. Inflation is already negative and we do not expect the change in the SNB's leadership will lead to any change in the SNB's FX policy, because that FX policy is firmly grounded in the SNB's mandate of aiming to keep inflation below 2% (which implies a bias against deflation as well).

Sweden

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We expect the Swedish economy to slow quite markedly this year and are cutting our GDP growth forecasts by 1.6pp to 0.5% for 2012 and by 0.7pp to 1.9% for 2013. Even with this slowdown, Sweden is likely to outperform most other EU economies. In December, the key policy rate was cut by 25bp to 1.75% and the new conditional interest rate path implies a 30% probability of a final cut in February. However, we expect that continued downgrades to the Riksbank's growth outlook will invite further near-term easing, and expect the repo rate to be 1.0% by mid-2012.

Denmark

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GDP growth turned negative in 3Q and we are cutting our GDP growth forecast by 0.7pp this year to 0.9% and only see moderately higher growth in 2013. Without the government's expansionary policy stance this year, economic growth would have been around nil. The euro area debt crisis has led to upward pressures on the DKK and rising currency reserves, prompting the Danish Central Bank to cut deeper than the ECB. If, as we expect, the ECB cuts further and the DKK remains firm, the DNB will probably continue to cut as well.

Norway

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Although cushioned by high oil receipts, the Norwegian economy will also suffer from the external slowdown. That said, GDP growth is set to outpace most other European economies this and next year. We are cutting our GDP forecast by 0.4pp to 2.5% this year and by 0.2pp to 3.0% for 2013. The Norges Bank cut rates by 50bp to 1.75% in December and against a backdrop of recession and credit crunch in the euro area plus additional ECB policy easing this year, we forecast the Norwegian policy rate will drop to 1.50% by mid-2012.

Figure 25. Switzerland, Sweden, Denmark and Norway — Economic Forecasts, 2011-2013F

		Switzerland			Sweden			Denmark			Norway		
		2011F	2012F	2013F	2011F	2012F	2013F	2011F	2012F	2013F	2011F	2012F	2013F
Real GDP	YoY	1.8%	0.7%	0.9%	4.5%	0.5%	1.9%	1.0%	0.9%	1.2%	2.7%	2.5%	3.0%
Final Domestic Demand	YoY	1.5	0.6	-0.6	2.4	0.3	1.8	-0.5	1.0	1.0	3.0	2.6	3.0
Public Consumption	YoY	1.5	1.7	1.2	1.8	0.6	1.1	-0.5	0.8	0.1	1.4	2.3	2.2
Private Consumption	YoY	0.8	0.4	0.6	1.3	0.6	2.0	-0.6	0.8	1.2	2.3	2.0	2.4
Investment (Ex Stocks)	YoY	3.4	0.5	-4.6	6.2	-0.6	2.5	-0.2	2.2	2.1	7.6	4.8	6.0
Exports	YoY	3.3	0.0	2.0	8.9	0.8	3.9	7.4	0.1	2.2	0.9	3.0	4.8
Imports	YoY	1.8	-0.9	-0.7	6.4	0.6	4.1	5.7	0.8	2.0	1.5	3.3	3.6
CPI (Average)	YoY	0.2	-0.6	-0.5	2.9	1.2	1.9	2.7	2.0	1.4	1.3	1.8	2.2
Unemployment Rate	%	3.1	3.3	3.7	7.5	7.8	8.0	7.5	7.7	7.4	3.3	3.4	3.3
Current Account	% of GDP	14.4	14.5	15.7	7.4	7.7	8.0	6.7	5.7	5.5	14.0	14.3	14.9
General Govt Balance	% of GDP	0.3	0.6	0.6	0.1	-0.4	-0.2	-4.0	-5.2	-3.9	12.0	12.5	13.5
General Govt Debt	% of GDP	53.0	51.0	50.0	36.3	35.9	34.8	46.1	50.0	52.7	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 outlook is little changed from the previous update. We continue to project a moderate expansion and low inflation amid lackluster domestic and external demand. Softer Asian growth will temper commodity price appreciation, while tighter fiscal policy in the US will dampen domestic activity and subsequently Canadian exports. The business investment revival will be less robust, and modest income growth and reduced housing wealth will keep household consumption subdued.

Risks remain two-sided. Contagion and reduced risk appetite stemming from the EA sovereign debt and banking crises are the premier threat to the outlook. Other downside risks include the possibility of a US recession as fiscal restraint weakens demand; and Canadian consumer retrenchment under the weight of massive debt obligations and/or on account of a disorderly unwind in housing market activity.

Meanwhile, upside risks include faster-than-expected EM growth and higher global commodity price inflation; debt-driven Canadian consumer spending; and an upswing in global business and consumer sentiment as EA uncertainties fade. The potential for policy missteps in Asia and rising political tension among oil exporting nations in the Middle East and Africa are reemerging risks to the inflation outlook.

In this environment, the BoC is likely to maintain its dovish stance, keeping the overnight rate target at 1.00% through early 2013. Policy normalization likely will be protracted thereafter. Rate cuts remain unconstructive in our view for several reasons: deflation is not a risk as key consumer inflation gauges are poised to return to 2% over the medium term; the domestic financial system is well functioning; economic fundamentals are relatively sound; the overnight rate target is extraordinarily accommodative; and policymakers view risks as roughly balanced.

Figure 26. Canada — Economic Forecast, 2011F-2013F

					2011		2012				2013	
		2011F	2012F	2013F	3Q	4QF	1QF	2QF	3QF	4QF	1QF	2QF
Real GDP	YoY	2.3%	1.7%	2.3%	2.4%	2.0%	1.4%	2.0%	1.7%	1.9%	2.0%	2.2%
	SAAR				3.5	1.5	1.3	1.6	2.3	2.5	1.8	2.4
Final Domestic Demand	YoY	2.9	2.2	2.7	2.6	2.2	2.3	2.0	2.3	2.2	2.4	2.7
	SAAR				0.9	3.2	1.8	1.8	2.3	2.7	2.9	2.9
Private Consumption	YoY	2.0	2.1	2.4	1.9	1.5	2.0	2.0	2.3	2.2	2.3	2.4
	SAAR				1.2	3.0	2.0	2.0	2.3	2.5	2.4	2.4
Government Spending	YoY	1.2	0.1	1.4	0.8	-0.1	0.1	-0.1	0.0	0.3	0.7	1.2
	SAAR				-0.1	-0.3	0.0	0.0	0.2	1.0	1.8	1.8
Private Fixed Investment	YoY	8.4	4.3	5.6	7.3	6.6	5.0	3.6	4.3	4.3	4.8	5.4
	SAAR				1.6	5.4	3.8	3.5	4.7	5.4	5.8	5.8
Exports	YoY	4.0	3.1	3.6	5.5	2.8	2.0	4.6	2.2	3.7	3.3	3.3
	SAAR				14.4	-1.9	3.2	3.3	4.1	4.1	1.8	3.3
Imports	YoY	6.5	3.3	4.6	4.4	5.1	4.0	1.7	3.6	4.1	4.2	4.4
	SAAR				-3.2	2.3	4.0	4.0	4.0	4.5	4.5	4.5
CPI	YoY	2.9	1.9	1.7	3.0	2.8	2.4	1.9	1.8	1.6	1.6	1.2
Core CPI	YoY	1.7	1.8	2.0	1.9	2.1	2.0	1.8	1.7	1.5	1.8	1.9
Unemployment Rate	%	7.5	7.3	7.0	7.2	7.4	7.6	7.4	7.0	7.2	7.3	7.1
Current Account Balance	C$bn	-53.7	-61.3	-58.3	-48.5	-60.6	-57.8	-59.1	-62.9	-65.4	-58.8	-60.4
	% of GDP	-3.1	-3.5	-3.1	-2.8	-3.5	-3.3	-3.3	-3.5	-3.6	-3.2	-3.3
Net Exports (Pct. Contrib.)		-1.4	-0.4	-0.8	5.3	-1.7	-0.7	-0.6	-0.4	-0.6	-1.4	-0.9
Inventories (Pct. Contrib.)		0.4	0.1	0.1	-2.6	1.0	0.0	0.2	0.2	0.1	0.1	0.1
Budget Balance (Fiscal Year)	% of GDP	-1.8	-1.5	-0.9								
Federal Budget Debt	% of GDP	33.9	34.1	33.5								
General Govt. Debt	% of GDP	79.0	79.2	78.6								

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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We have lowered our economic growth forecast from 3.7% to 3.4% for 2012. The slowdown in China, a small retreat in domestic confidence and softer commodity prices are being reflected through ongoing softness in high frequency expenditure data and more moderate employment and income growth. Nevertheless, we still believe that economic activity remains on-track for a return to trend growth in the H2-2012. Previous cuts to official interest rates have provided some insurance to parts of the non-mining economy. With inflation moderating, room remains for monetary policy to move into accommodative territory should global conditions worsen. Our central forecast remains for one further 25 bp cut to the cash rate on February 7. Households have gained around 1% to disposable income from cuts to date and the long pipeline of minerals and energy related infrastructure investment is showing no signs of being downwardly revised because of events in Europe.

New Zealand

The better-than-expected influence of the Rugby World Cup on Q3 GDP growth is likely to be partly unwound in Q4. As a small open economy in an environment of slower global growth, any hangover could extend into Q1 2012. On balance, we leave our economic forecasts unchanged. However, there is some downside risk to our 2012 growth forecast as more earthquakes in the Christchurch area over the past month place a larger question mark over the extent and timing of reconstruction efforts this year. In combination with inflation that is set to fall, the RBNZ will feel even more comfortable with an accommodative policy stance and keeping the forward guidance on interest rates neutral in the policy statement following the next OCR Review on January 26.

Figure 27. Australia and New Zealand — Economic Forecast, 2011F-2013F

	Australia			New Zealand		
	2011F	2012F	2013F	2011F	2012F	2013F
Real GDP[a]	1.9%	3.4%	3.8%	1.4%	2.6%	2.6%
Real GDP (4Q versus 4Q)	2.3	3.7	3.7	1.9	3.1	2.2
Real Final Domestic Demand	4.0	4.8	4.3	2.3	3.1	3.3
Consumption	3.6	3.4	3.0	1.6	2.9	2.1
Govt. Current & Capital Spending[b]	-0.4	1.9	4.0	3.2	1.6	1.5
Housing Investment	-1.9	3.6	5.8	-15.7	13.9	23.5
Business Investment[c]	16.2	14.1	8.2	6.8	3.6	5.5
Exports of Goods & Services	-1.7	11.5	8.6	3.6	1.5	3.3
Imports of Goods & Services	11.5	11.4	8.7	4.3	3.7	5.2
CPI	3.3	2.2	3.1	4.2	2.1	2.3
CPI (4Q versus 4Q)	2.9	3.2	3.3	2.6	2.2	2.3
Unemployment	5.3	5.1	4.9	6.5	6.2	5.5
Merch. Trade, BOP (Local Currency, bn)	30.3	19.8	-0.1	4.1	3.4	-0.1
Current Account, (Local Currency, bn)	-31.5	-45.5	-80.6	-7.9	-11.1	-15.8
Percent of GDP	-2.2	-3.0	-5.0	-3.9	-5.3	-7.2
Budget Balance[d] (Local Currency, bn)	-47.7	-37.1	1.5	-16.0	-12.0	-6.0
Percent of GDP	-3.4	-2.5	0.1	-8.0	-6.0	-3.0
General Govt. Debt (% of GDP)[e]	5.9	8.9	8.5	20.9	26.8	30
Gross Trading Profits[f]	6.2	5.0	6.5	1.4	2.6	2.6

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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China

Growing signs of slowdown despite upside surprise from Q4 GDP – GDP grew 8.9% YoY in Q4 2011 (8.2% saar), beating market expectations. Annual GDP expanded by 9.2%, down from 10.4% in 2010. The upside surprise can be partially attributed to a year-end spike in home appliance purchase before the expiration of trade-in subsidies. On the other hand, reflecting waning external demand, especially from EU, China's export growth slowed to 14% YoY in Q4 from 26% in Q1 2011, reducing the annual trade surplus by 15%. Property investment slowed sharply from 20.1% YoY in November to 12.3% in December. With property market correction accelerating and euro area sliding into recession, growth may hit a soft patch and drop to around 8% YoY in Q1.

Inflation concern shifted to the back burner – CPI inflation has eased consistently since reaching the peak of 6.5% YoY in July, and reached a 15-month low of 4.1% in December. The main driver of inflation in this cycle, pork prices, has declined for three months in a row. Non-food prices appeared to be well contained against growth moderation. PPI inflation dropped even more, reducing price pressures in the pipeline. CPI inflation may stay close to 4% for a couple of months due to holiday effects, but the risk of a general inflation rebound is low this year. We expect annual average inflation to fall from 5.4% in 2011 to 3.5% in 2012.

Policy easing reduces hard landing risks – The government has shifted policy focus from fighting inflation to stabilizing growth, starting from a reserve requirement cut in December. Broad money growth and new lending rebounded in December. With inflationary pressures abating, the government would have more room to ease policies to reduce downside risks. However, policies will likely be reactive pending further deterioration of macro indicators. We expect monetary policy to remain prudent, but with an easing bias. We forecast M2 growth of 14% and new RMB lending of about 8tn in 2012, which would require multiple RRR cuts due to narrowing trade surplus and slowing capital inflows. Fiscal policy is likely to be more active, entailing structural tax cuts and higher spending on social housing, social safety net, and agriculture. Property policy will likely be loosened following adequate market correction. These policies should facilitate a growth rebound from Q2.

Figure 28. China — Economic Forecasts, 2011F-2013F

					2011		2012				2013	
		2011F	2012F	2013F	3Q	4QF	1QF	2QF	3QF	4QF	1QF	2QF
Real GDP	YoY	9.2%	8.4%	8.6%	9.1%	8.9%	8.0%	8.2%	8.8%	8.6%	8.7%	9.3%
Real Final Domestic Demand	YoY	10.4	9.3	9.2								
Consumption	YoY	10.0	9.7	9.7								
Fixed Capital Formation	YoY	10.8	8.8	8.8								
Industrial Production	YoY	13.9	11.6	12.2	13.8	12.8	11.6	11.0	11.9	12.0	12.3	12.5
Exports	YoY	20.3	7.2	12.9	20.6	14.3	9.0	5.0	6.0	9.0	10.0	12.0
Imports	YoY	24.8	10.2	15.8	24.9	20.1	12.0	8.0	9.0	12.0	13.0	15.0
Merchandise Trade Balance	$bn	155.1	113.1	71.5	62.6	48.3	-14.4	35.9	52.7	38.9	-29.3	26.4
FX Reserves	$bn	3181	3347	3515	3,202	3,181	3,167	3,223	3,295	3,347	3,343	3,395
Current Account	% of GDP	3.0	2.0	1.5								
Fiscal Balance	% of GDP	-1.0	-2.0	-1.5								
General Govt. Debt	% of GDP	15.3	15.6	15.4								
Urban Unemployment Rate	%	4.1	4.2	4.1	4.1	4.2	4.2	4.2	4.2	4.2	4.1	4.1
CPI	YoY	5.4	3.5	3.9	6.3	4.6	3.9	3.4	3.0	3.7	4.0	3.9
Exchange Rate (end period)	CNY/$	6.29	6.20	6.01	6.38	6.29	6.30	6.27	6.24	6.20	6.15	6.10
1-Yr Deposit Rate (end period)	%	3.50	3.75	4.00	3.50	3.50	3.75	3.75	3.75	3.75	4.00	4.00

Note: F Citi forecast. E Citi estimate. YoY Year-to-year percent change. SAAR Seasonally adjusted annual rate. *Based on official data, not including the local government debt as audited by the National Auditing Office in summer 2011. Sources: Haver Analytics and Citi Investment Research and Analysis

India

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2011 has proven to be an unfortunate cocktail of domestic policy issues (high interest rates, infrastructure constraints) and a slowing global environment. As a result, we have seen growth expectations for India come off from 9% levels to 7%, with doubts on whether even a 7% number can hold. As mentioned, we believe that India is not beyond repair and a number of measures are key to keep growth at even 7% levels. Key among them include incentivizing investments, attracting FX flows, addressing structural issues on inflation, executing proposed fiscal reform, re-vamping the current model of governance, and battling corruption along with electoral reform.

Inflation as measured by the WPI was stuck in a 9-11% range for 22 months from Feb-10 to Nov-11. This resulted in the RBI raising rates 13 times, with effective tightening at 525bps. But WPI inflation already slowed sharply in December (to 7.5% YoY) and is likely to stay around 7-7.5% YoY in coming months, allowing the RBI to begin its easing cycle in 1Q12. At this stage we expect the RBI to cut rates by 100bps. A key data point to watch is 'non-food manufactured product inflation' — the RBI's proxy for core inflation. This has been sticky at about 7.5% YoY, with the November reading inching higher to 8%.

On the external front, while India posted a marginal Balance of Payments surplus in 2QFY12, trends are likely to reverse in the coming quarters. Taking into account higher oil prices, a deceleration in exports and lower capital flows, we now expect a marginal drawdown of forex reserves in FY12/FY13 to the tune of US$2bn vs. an accretion of US$4bn expected earlier. This will likely limit the bounce-back in the currency. Enhancing capital flows will likely to be a key theme in 2012 and we expect that the RBI will continue relaxing both price and quantum restrictions on the capital account.

The latest trends in government finances during Apr-Nov remain a bit disappointing, with revenues running below official forecasts while expenditure continues to overshoot. We thus maintain our view of the deficit coming in at 5.6%-5.8% of GDP vs. budget estimates of 4.6%. The outlook for FY13 also appears bleak, with key pressure points being (1) the implementation of the food security bill and (2) mounting losses of state electricity boards. With the timelines for GST likely to be delayed, fiscal consolidation is likely to be on the back burner.

Figure 29. India — Economic Forecasts, FY2011/12-2011-2013F

		FY 11/12F	FY 12/13F	FY 13/14F
Real GDP	YoY	7.1%	7.0%	7.7%
Final Domestic Demand	YoY	5.7	6.1	7.6
Private Consumption	YoY	6.6	6.8	7.5
Fixed Investment	YoY	4.0	4.0	8.0
Exports	YoY	16.0	13.5	15.0
Imports	YoY	11.0	8.3	10.8
Wholesale Price Index*	YoY	9.0	6.7	6.5
Consumer Price Index	YoY	8.0	7.0	5.0
Unemployment Rate	%	NA	NA	NA
Current Account	US$ bn	-64.2	-73.6	-76.8
	% of GDP	-3.4	-3.6	-3.0
Consolidated Fiscal Balance	% of GDP	-8.3	-8.0	-7.5
Centre Fiscal Balance	% of GDP	-5.8	-5.5	-5.0
US Dollar Exchange Rate	Average	49.7	51.1	47.8

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

Korea

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Production and consumption continued to moderate in November. Industrial production growth declined to 5.6%YoY in Nov from 6.3% in Oct, while retail sales growth slowed to 0.5%YoY from 2.2%. Meanwhile, headline inflation stayed at 4.2%YoY during the last two months of 2011 on the back of increases of prices for agricultural products and public services. We expect real GDP growth to slow from about 3.5%YoY in 3Q-11 to about 3.3%YoY in 4Q-11 and to about 3.0% in 1Q-12 as exports and domestic demand contract. Although Dec export growth was better-than-expected at 10.8%YoY, it is likely to fall to about 6.6%YoY in 1Q-12. Facilities investment will continue to decrease by 1.8%YoY in 1Q-12 on the back of weakening growth prospects for the economy. Meanwhile, the government announced that it will frontload 70% of 2012 spending in 1H-12 to provide support for the economy, as it did in 2009 after the GFC. As hinted in the direction of 2012 monetary policy, BoK is expected to raise the reserve requirement ratios, instead of raising the policy rate, amid elevated inflationary pressures.

Indonesia

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Some of Indonesia's key export commodity prices (e.g. rubber) have eased since October, however this has not led to a significant decline in rural purchasing power. The farmers' terms of trade index increased 0.12% MoM in Nov, helped by favorable crop food prices. Meanwhile Indonesia's consumer confidence index, which is surveyed in the cities, still managed to increase to 116.6 from 114.3. This is still consistent with our scenario for a mild slowdown in growth to 6.3%YoY this year (from possibly 6.5% in 2011). Inflation was benign in 2011 (i.e. 3.8%YoY, from nearly 7.0% in 2010) due to disinflation in food prices and also the absence of energy price increases. This year energy subsidy adjustments appear to be forthcoming and could push up inflation to 5.7% on average in 2012, on our forecasts. Meanwhile we expect the IDR will see volatile swings in 1H11, with a low of 9,000 in 1Q12 and high of 9,300 by end 2Q. The FX market has been plagued by an imbalance, with BI apparently the main single supplier of USD. Foreign reserves fell to $110.1bn in December from $111.3bn in the previous month. Following the recent widening of the BI rate lower corridor, we no longer expect a 50bps cut in the 'BI rate' this year (YE12 fcast: 6.00pct).

Figure 30. Korea and Indonesia — Economic Forecasts, 2011F-2013F

		Korea			Indonesia		
		2011F	2012F	2013F	2011F	2012F	2013F
Real GDP	YoY	3.6%	3.7%	4.4%	6.5%	6.3%	6.5%
Final Domestic Demand	YoY	1.3	2.9	4.2	7.2	7.7	7.5
Private Consumption	YoY	2.4	2.3	4.0	5.0	4.9	5.4
Fixed Investment	YoY	-1.6	4.4	5.2	9.0	11.1	10.8
Exports	YoY	10.8	8.2	10.1	11.0	7.6	9.5
Imports	YoY	7.6	7.7	11.8	13.3	11.3	10.5
Consumer Price Index	YoY	4.0	3.3	3.2	5.4	5.7	5.6
Unemployment Rate	%	3.4	3.3	3.2	6.6	6.3	6.0
Current Account	US$ bn	24.8	15.0	12.9	2.5	-2.7	-5.1
	% of GDP	2.2	1.3	1.0	0.3	-0.3	-0.5
Fiscal Balance	% of GDP	0.5	0.7	1.2	-1.5	-1.0	-0.7
US Dollar Exchange Rate	Average	1108	1129	1053	8768	9150	8975

Sources: Haver Analytics and Citi Investment Research and Analysis

Hong Kong

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Data thus far (available up until November) suggest three clear economic trends: (1) inflation lingers at elevated levels, (2) resilient domestic consumption. (3) export weakness. We believe these trends are continuing over the festive seasons of Christmas and the Chinese New Year. GDP momentum likely stayed weak in 4Q11 and will only bottom in 1Q12, in our view. Home prices have weakened somewhat since Oct-11 on policy tightening and weaker confidence, but we do not expect any reversal of that policy tightening yet. The political scene is heating up as we draw close to the Mar-12 Chief Executive Election, with the four potential candidates debating their election manifestoes. The HKD will likely continue to gyrate near the middle of its trading band, reflecting ongoing EU/US debt news. Albeit with delay, the 3M HIBOR is following its USD Libor counterpart's recent rise.

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The 16.4% MoM surge in Dec NODX indicates that exports have bottomed and a modest upward revision to the 4Q11 GDP Advance Estimate of a 4.9% QoQ SAAR decline is likely. Nonetheless, risk of a mild technical recession remains in 1Q12, though this will likely mark the bottom of the GDP cycle. With immigration tightening unlikely to be reversed, and productivity unlikely to catch up with wages in the near term, rising unit business costs will likely keep core CPI inflation elevated in 2012 even as headline inflation slows on base effects. We thus do not expect the MAS to ease policy in April. Counter-cyclical support, if any, may come via cost reduction measures in the Feb 17th Budget, though these will be modest in scale. The Additional Buyer Stamp Duty (ABSD) in Dec is likely a structural response to demand-supply imbalance in housing, and is thus unlikely to be reversed soon

Taiwan

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GDP growth turned negative in 3Q and likely in 4Q11 as well to form a technical recession. We expect growth momentum to bottom in 1Q-12. CPI inflation surprisingly went up to 2.0% YoY in December on surging vegetable prices, but that was likely a short-term phenomenon. We are more concerned about the rise in crude oil prices on geopolitical risks. Coupled with a recovery in consumer spending, we expect CPI inflation to be still on a gradual uptrend. Housing prices remained stubbornly high and this is one of main reasons we expect the CBC to keep rates unchanged for an extended period despite the current economic downturn. KMT's victory in both presidential and legislative elections has reduced one uncertainty in politics, and the resumption of cross-strait ties with Mainland China will likely provide some downside protection for this year's economic outlook.

Figure 31. Hong Kong, Singapore and Taiwan — Economic Forecasts, 2011F-2013F

		Hong Kong			Singapore			Taiwan		
		2011F	2012F	2013F	2011F	2012F	2013F	2011F	2012F	2013F
Real GDP	YoY	5.0%	3.5%	4.2%	4.8%	3.0%	5.0%	4.2%	3.7%	4.2%
Final Domestic Demand	YoY	6.9	3.1	1.9	3.5	2.7	5.3	1.5	1.7	3.0
Private Consumption	YoY	8.2	2.9	2.0	5.3	2.3	5.1	3.4	3.1	3.3
Fixed Investment	YoY	4.8	4.0	2.0	1.4	2.7	6.9	-4.2	-1.8	4.3
Exports	YoY	3.9	3.1	7.0	2.4	3.1	6.4	4.8	4.5	6.0
Imports	YoY	4.0	2.7	6.1	2.6	3.8	6.7	0.0	1.3	5.1
CPI	YoY	5.3	3.8	3.1	5.3	3.0	3.1	1.4	1.4	1.7
Unemployment Rate	%	3.4	3.7	3.6	2.1	2.3	2.0	4.4	4.3	4.2
Current Account	US$ bn	16.9	26.6	34.6	43.8	41.7	41.2	39.4	41.6	43.8
	% of GDP	7.0	10.3	12.4	16.5	15.0	13.0	8.3	8.7	8.4
Fiscal Balance	% of GDP	2.7	2.2	2.5	1.5	1.0	1.0	-2.5	-2.0	-1.8
US Dollar Exchange Rate	Average	7.78	7.77	7.75	1.26	1.28	1.21	29.47	30.18	29.50

Sources: Haver Analytics and Citi Investment Research and Analysis

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The CBR estimated that in 2011 most of Russia's current account (CA) surplus of US$100bn was absorbed by US$88bn of capital outflows. The exceptionally high negative capital account in our view reflects political uncertainty and lack of external borrowing owing to both lack of investment projects and poor access to the international markets. We do not expect capital outflows to slow substantially before the March 4 presidential elections. We expect the CA surplus to narrow and the capital account to remain negative in 2012. Under our base case (oil price at US$110/bbl on average in 2012), we expect the CA surplus to fall to about US$60bn in 2012 from about US$100bn in 2011 and to be mainly absorbed by continuous capital outflows. As a result of the political uncertainty, global financial turmoil and a potential decrease in the oil price we expect the ruble basket to average about 36-37 in 2012.

Turkey

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The wide current account gap continues to be the weakest link in the Turkish economy, overshadowing stability. In our view, the current policy mix remains unambitious in terms of promoting a soft landing. On the fiscal front, it is true that headline budget figures look impressive. However, this robust performance is largely due to transient factors associated with the economy's cyclical position and one-off revenues stemming from the tax amnesty (around TRY 13bn through November 2011). In addition, a tighter fiscal stance would have been more appropriate in terms of containing the current account deficit. On the monetary policy front, the CBT continues to resist policy normalization. Nonetheless, we believe that the current monetary policy framework is not sustainable due to the CBT's limited firepower to support the lira and the high cost of aggressive interest rate defense policy, among other things. This backdrop, coupled with the country's less favorable initial conditions, may amplify the adverse impact of a capital account shock, thereby further complicating the outlook for Turkish assets — particularly in the first half of 2012.

Figure 32. Russia and Turkey — Economic Forecasts, 2011F-2013F

		Russia			Turkey		
		2011F	2012F	2013F	2011F	2012F	2013F
Real GDP	YoY	3.8%	3.5%	4.0%	8.2%	2.5%	4.3%
Final Domestic Demand	YoY	8.2	4.1	5.5	10.3	1.6	4.5
Private Consumption	YoY	5.3	4.5	5.3	7.9	1.0	4.5
Fixed Investment	YoY	7.5	5.0	9.0	18.2	2.3	5.0
Exports	YoY	3.3	2.7	2.7	6.6	1.8	5.5
Imports	YoY	17.0	3.5	10.0	13.5	-1.4	6.2
CPI	YoY	8.4	6.2	6.1	6.5	8.1	6.6
Unemployment Rate	%	7.3	7.5	7.5	10.0	10.2	10.2
Current Account	US$ bn	100.0	60.0	27.6	-77.3	-62.5	-48.7
	% of GDP	5.7	3.5	1.4	-10.2	-8.4	-5.8
Fiscal Balance	% of GDP	-1.4	-3.1	-2.7	-1.3	-2.2	-2.5
US Dollar Exchange Rate	Average	29.4	33.1	32.9	1.68	1.90	1.86

Sources: Haver Analytics and Citi Investment Research and Analysis

Hungary

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At the heart of the economic and market outlook will be the outcome of IMF negotiations that are due to start this month. Changes to the institutional system and constitution aimed at strengthening the governing party's position led to a sharp deterioration in political credibility, credit rating downgrades and the drying up of available market funding. We expect more political noise in the short term, however our baseline scenario is the government is likely to accept conditionality due to increased market pressure and potential sanctions from the EU. We expect an IMF deal by March or 2Q12 at the latest, which is likely to deliver a narrowing in the risk premium and firming in EURHUF. The deterioration in political credibility and the government rhetoric suggests political risks are unlikely to be eliminated even if a stand-by arrangement is put in place. Therefore we expect further rate hikes will be needed in the coming months to shore up the currency and the NBH is unlikely to reverse the current hikes before early 2013. While the FX mortgage aid program mutes the immediate impact of currency weakness on households, private sector FX deleveraging and fiscal austerity measures will likely deliver ongoing contraction in domestic demand over the medium term and keep economic growth prospects low in the coming years.

Poland

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So far, Poland has been relatively resilient to the economic slowdown in the euro area but forward looking indicators, in particular the PMI, suggest substantially weaker growth in 2012. We expect more slowdown in private consumption and a gradual weakening of fixed investment spending in the coming quarters. Despite the deterioration in the labour market, consumer price inflation rose substantially in 4Q 2011, but mainly on fuel and drug price hikes, i.e. factors that remain outside central bank control. Given the high statistical base, lower drug price dynamics and rising unemployment in early 2012, we expect CPI inflation to fall in the coming months towards 2.5-3.0% in 4Q 2012. For the time being the central bank will remain cautious and will not be in a hurry to cut rates, but its rhetoric is likely to evolve towards a more dovish tone if economic data continue to point towards weaker GDP. Although the central bank and Finance Ministry intensified foreign currency intervention in December we expect them to be more passive in early 2012. Taking this into account, we expect EUR/PLN to follow changes in global risk sentiment in the near term but we also believe the zloty is likely to strengthen in the longer term thanks to a gradual improvement in the current account balance.

Figure 33. Hungary and Poland — Economic Forecasts, 2011-2013F

		Hungary			Poland		
		2011F	2012F	2013F	2011F	2012F	2013F
Real GDP	YoY	1.2%	0.0%	1.5%	4.2%	1.9%	2.8%
Final Domestic Demand	YoY	-1.4	-2.5	-1.3	3.5	1.5	2.7
Private Consumption	YoY	-0.7	-2.5	-1.5	3.2	2.1	3.0
Fixed Investment	YoY	-6.0	-3.0	0.5	7.6	1.5	2.0
Exports	YoY	8.5	3.5	5.9	5.9	0.8	8.5
Imports	YoY	6.5	2.2	4.7	4.8	-1.1	8.2
CPI	YoY	3.9	5.1	3.4	4.3	3.5	2.6
Unemployment Rate	%	11.5	11.8	11.0	12.5	12.9	11.7
Current Account	US$ bn	1.7	1.4	1.6	-22.5	-15.2	-21.3
	% of GDP	1.5	1.2	1.2	-4.3	-3.4	-4.0
Fiscal Balance	% of GDP	3.0	-3.2	-3.0	-5.2	-3.5	-2.4
US Dollar Exchange Rate	Average	205	247	230	3.0	3.6	3.2

Sources: Haver Analytics and Citi Investment Research and Analysis

Czech Republic

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Czech 3Q11 GDP fell 0.1%QoQ and we expect a further deceleration to 0.6%YoY in 4Q11 from 1.2% in 3Q11 owing to another mild quarterly fall, although industrial performance and export activity were supportive in November with the trade surplus at historical highs. However, we cut our 2012 GDP forecast to -0.5%YoY from -0.1% previously, reflecting downside risks to foreign demand and labour market weakness in late-2011, We think the recession could be more pronounced (with GDP falling about 1% YoY), if the government sticks to its 2012 fiscal target. However, with the economy deteriorating, we expect the government will allow the fiscal deficit to rise slightly. Nevertheless, the MinFin is likely to propose a cut in expenditures by CZK8-9bn accompanied with the freezing of CZK10bn of expenditure until 4Q12. The latter measure is not likely to be actually implemented unless we see a larger sell-off of Czech bonds or the CNB hikes rates to about 2% this year (from 0.75% currently) . We expect this ultra-low policy rate to stay in place until 1Q13, when we expect a 25bp hike to 1%. Inflation is above the CNB's forecast, but it is still within the CNB's target. Inflation is likely to accelerate to average 2.5%YoY in 2012, but this will be not driven by core measures, in our view. The dovish ECB is likely to ease the pressure on the hawks but, with a cut as per our EURCZK forecast to 25.7 in 2012, we do not expect the CNB will cut rates.

Romania

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The NBR started 2012 with a 25bp rate cut, bringing the policy rate to 5.75%. The move was motivated by the improved inflation outlook and the ongoing concerns about the economic recovery. The NBR will likely maintain its easing bias for the rest of 2012 so long as currency stability is not at risk. Thus, the new Inflation Report (to be approved by the Board on February 2, 2012) will provide additional insight into the monetary policy outlook. Currently, the ongoing European debt crisis continues to overshadow the Romanian economy, raising downside risks to our 2012 growth projection of 1.7%. Despite the stronger-than-expected 3Q GDP reading (thanks to a bumper harvest), the two key drivers of growth on the supply side — services and industry — have so far failed to gain traction. This, coupled with the absence of a meaningful improvement in sentiment indicators, doesn't paint a comforting picture for growth this year. Although the presence of a precautionary EU-IMF program and other favorable factors, such as relatively low sensitivity to the euro zone and the improvement in the external performance, provide some cushion against the fall-out from the euro crisis, deleveraging risks by European banks pose a serious threat to the fragile economic recovery and macroeconomic stability.

Figure 34. Czech Republic and Romania — Economic Forecasts, 2011-2013F

		Czech Republic			Romania		
		2011F	2012F	2013F	2011F	2012F	2013F
Real GDP	YoY	1.7%	-0.5%	2.0%	2.5%	1.7%	3.1%
Final Domestic Demand	YoY	-0.8	0.0	0.5	1.2	1.1	2.9
Private Consumption	YoY	-0.2	-0.1	0.2	1.0	1.0	2.9
Fixed Investment	YoY	-0.5	-0.7	1.6	4.0	1.5	3.5
Exports	YoY	12.0	0.5	2.8	13.0	5.4	4.2
Imports	YoY	9.8	-1.1	3.1	10.8	4.8	3.2
CPI	YoY	1.9	2.6	1.6	5.6	2.5	2.0
Unemployment Rate	%	8.5	9.5	9.7	5.4	5.2	5.2
Current Account	US$ bn	-8.0	-6.6	-7.9	-6.7	-7.5	-8.9
	% of GDP	-3.7	-3.6	-3.8	-3.5	-4.5	-4.7
Fiscal Balance	% of GDP	-3.7	-4.0	-3.4	-4.4	-2.0	-2.0
US Dollar Exchange Rate	Average	17.8	20.9	19.4	3.1	3.5	3.3

Sources: Haver Analytics and Citi Investment Research and Analysis

Brazil

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Stagnant 3Q11 GDP and the outlook for a gradual acceleration in economic growth drive our 2011 and 2012 GDP growth forecasts to 2.9% and 3.3%, respectively. On the inflation front, lower commodity prices amid mild economic growth should help reduce CPI inflation thereafter, although not enough to bring it back to the mid point target of 4.5% YoY. We forecast inflation to be about 5.3% YoY at year-end 2012 and 5.0% at 2013. Under both conditions, the central bank should keep reducing the Selic rate, at the pace of 50bp per meeting, down to 9.5% in April 2012. Given our view of improving activity outlook and upward risk for inflation in the medium term, the central bank should start a tightening cycle in the beginning of 2013, hiking the Selic rate up to 11.0%. On the FX front, the perspective of commodity price stabilization at high levels and our favorable assessment about trade balance/current account performances supports a scenario of some BRL appreciation. In terms of fiscal policy, the 2012 primary surplus is likely to be slightly below the target (2.8% against 3.1% of GDP), but it should still be enough to keep the net public debt-GDP ratio trending down.

Mexico

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We performed several slight adjustments in our outlook. Recent indicators point to activity growth in 4Q11 being slightly above what we had previously anticipated: accordingly, we now think GDP growth in 2011 stood at 3.9% YoY up from 3.8% in our previous forecast. We nonetheless keep our GDP forecast for this year at 3.0%, as we still see elements of uncertainty in the global growth outlook. Inflation closed 2011 at 3.8% YoY, above expectations mostly as a result of the materialization of some FX pass-through. Although we do not see a significant departure from ongoing inflation trends, we now believe inflation will end this year at 3.8%, up from the 3.7% rate previously expected. Thus, when it comes to our rate outlook, we are actually more confident on our existing forecast that Banxico will remain on hold at 4.5% throughout 2012, as the risk of an alternative scenario of rate cuts fades away. In the political arena, presidential elections to be held July the 1st will be the theme to follow.

Figure 35. Brazil and Mexico — Economic Forecasts, 2011F-2013F

		Brazil			Mexico		
		2011F	2012F	2013F	2011F	2012F	2013F
Real GDP	YoY	2.9%	3.3%	4.5%	3.9%	3.0%	3.4%
Final Domestic Demand	YoY	3.9	3.7	5.2	4.8	3.8	4.3
Private Consumption	YoY	4.0	3.5	4.8	4.5	3.4	3.7
Fixed Investment	YoY	5.0	4.3	6.4	8.0	6.4	7.7
Exports	YoY	4.0	4.6	7.3	7.9	6.7	7.9
Imports	YoY	9.1	6.6	10.7	7.7	8.4	9.6
CPI	YoY	6.6	5.5	5.1	3.4	4.3	3.7
Unemployment Rate	%	6.1	6.3	6.5	5.3	5.2	5.3
Current Account	US$ bn	-48.6	-51.4	-65.4	-11.2	-24.7	-27.8
	% of GDP	-2.1	-2.1	-2.4	-1.0	-2.1	-2.1
Fiscal Balance	% of GDP	-2.7	-2.7	-2.9	-2.5	-2.2	-2.0
US Dollar Exchange Rate	Average	1.67	1.82	1.75	12.5	13.5	12.8

Sources: Haver Analytics and Citi Investment Research and Analysis

Argentina

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Additional exchange controls, introduced in November of last year, stopped the drain in reserves that began in September due to capital flight acceleration and dollar deposit withdrawal from domestic banks. For the time being, the controls are effective not only at preventing reserve losses, but also at repressing parallel FX market activity. And, since monetary expansion continues unabated, real GDP continues to outperform despite the Euro crisis. There are, however, various reasons to be concerned. First, a prolonged drought in the fertile pampean region has damaged crops, particularly of corn, hence presaging a decline in FX supply. Second, limits on convertibililty constrain the importation of essential inputs for domestic production. Third, monetary expansion will soon have to decelerate sharply, lest the fragile exchange rate regime be allowed to collapse. For all these reasons, we maintain our 2012 forecasts of official and unofficial growth at 5% and 3%, respectively.

Venezuela

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Politics has taken center stage as the date of the primaries to elect the opposition presidential candidate draws near (they are scheduled for February 12) and President Chávez reshuffles his cabinet and the list of close allies. The latest polls for the opposition primaries show that Henry Capriles, Pablo Pérez and Leopoldo López hold the highest vote intention among those who are planning to vote in the primaries. At the same time, the government strategy has been to downplay the primaries by making public comments saying that it expects a low turnout while President Chávez has announced that current Vicepresident Elías Jaua and Foreign Relations' Minister Nicolás Maduro, would be replaced in order to allow them to run for the key governorships of Miranda and Carabobo. In addition, Mr. Chávez has appointed Diosdado Cabello, a former Vicepresident, as the PSUV Vicepresident and President of the National Assembly, and Henry Rangel-Vivas as the new Defense Minister. We view the movements by President Chávez as a way of getting a tighter grip on the military, as both Mr. Cabello and Mr. Rangel-Vivas represent the faction of the military closer to the government. Although presidential elections will take place in October 7, there is no doubt that the political race for the seat in Casa de Miraflores has begun, and both the incumbent PSUV and the opposition are putting up the best players they have for this battle.

Figure 36. Argentina and Venezuela — Economic Forecasts, 2011-2013F

		Argentina			Venezuela		
		2011F	2012F	2013F	2011F	2012F	2013F
Real GDP	YoY	9.4%	5.0%	5.0%	4.0%	4.0%	3.4%
Final Domestic Demand	YoY	12.7	5.6	5.4	6.6	3.5	1.8
Private Consumption	YoY	10.7	4.9	4.7	4.8	7.9	0.8
Fixed Investment	YoY	9.0	3.6	8.0	-2.6	-7.2	2.2
Exports	YoY	4.4	5.4	4.6	6.8	8.1	5.1
Imports	YoY	22.4	13.4	12.1	13.4	3.7	-0.9
CPI	YoY	9.8	9.6	12.2	27.0	26.3	28.0
Unemployment Rate	%	8.1	7.8	8.2	6.5	6.4	6.6
Current Account	US$ bn	1.8	1.5	1.1	31.2	31.6	36.6
	% of GDP	0.4	0.3	0.2	10.4	8.6	9.9
Fiscal Balance	% of GDP	-0.9	-0.4	0.4	-5.0	-5.0	-4.0
US Dollar Exchange Rate	Average	4.2	5.3	6.0	4.3	4.3	6.5

Sources: Haver Analytics and Citi Investment Research and Analysis

Saudi Arabia

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At year-end, the Ministry of Finance issued a statement on the 2012 budget, as well as fiscal and economic outturns for 2011. According to the Ministry, total revenues for 2011 were projected at SR1.110bn (US$296bn) and total expenditures SR804bn (US$214bn). This implies a budget surplus of 12% of GDP, despite a 23% rise in expenditures. This number is almost double our expectation of a 6.1% surplus in 2012, mainly due to the higher oil price and lower actual spend. The ministry expects economic growth to come in at 6.7% in 2011, in line with our view of 6.8%. For 2012, the budget is based on oil revenues of SR702bn (US$187.2bn), consistent with a 5% drop in production and an average price of $68 per barrel. Expenditures are projected at SR690bn (US$184bn). In our view, oil prices are likely to average US$110 per barrel in 2012, bringing in revenues similar to those seen in 2011, while expenditures will once again overshoot budget (although will remain lower than 2011 levels due to the one-off nature of many such expenditures). The net result is that we expect a budget surplus of around 11.5% in 2012. We believe growth in the non-oil economy will remain strong, around 7%, but overall growth will fall back to 3.8% owing to a scaling back in oil production of about 5% from 2011 levels. We continue to expect progress on passing of the mortgage law in 2012, which we believe will create a significant boost to the local housing sector and domestic demand.

United Arab Emirates

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Latest monthly data show a continued contraction in bank deposits through November, and quarterly data for Q3 report a decline in deposits of 5.3% during the quarter. This is being driven mainly by residents (-5.8% in Q3), particularly government and the public sector. Liquidity conditions are thus apparently tightening, in our view. In Abu Dhabi, the slowdown in public sector spending in the non-oil sector continues, but the Abu Dhabi government's commitment to limit the financial fallout on local government related entities (GREs) and the Emirate at large was demonstrated with an effective US$4.6bn cash injection into Aldar in December, one of the Emirates' largest real estate developers. In Dubai, meanwhile, the continued economic recovery is likely to run into headwinds in 2012 due to a softening in global economic growth. The Emirate's debt challenges received attention in December, but a statement by Sheikh Ahmed al Maktoum, head of Dubai's Supreme Fiscal Committee, that categorically excluded any plans to restructure debt in 2012 reinforces Dubai's willingness to support this year's 3 upcoming bond maturities, in our view.

Figure 37. Saudi Arabia and United Arab Emirates — Economic Forecasts, 2011F-2013F

		Saudi Arabia			United Arab Emirates		
		2011F	2012F	2013F	2011F	2012F	2013F
Real GDP	YoY	6.7%	3.8%	8.5%	2.5%	4.5%	1.3%
Final Domestic Demand	YoY	9.9	7.8	7.9	3.1	3.5	3.5
Private Consumption	YoY	10.0	5.0	5.0	1.0	2.0	2.0
Fixed Investment	YoY	15.0	10.0	10.0	5.0	5.0	5.0
Exports	YoY	10.5	8.0	8.0	13.0	13.0	13.0
Imports	YoY	15.0	12.0	12.0	15.0	15.0	15.0
CPI	YoY	5.2	7.0	8.0	2.0	2.4	2.9
Current Account	US$ bn	154.4	143.6	160.9	15.4	3.5	5.7
	% of GDP	34.9	23.0	22.3	4.8	1.0	1.6
Fiscal Balance	% of GDP	12.1	11.5	9.6	NA	NA	NA
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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We now expect that the Faith And Justice Party (F&J) will secure around half the seats in the country's new parliament and the political headlines will now focus on the presidential elections with the polls to be held in mid June. However, arguably the real political activity in the coming months will be between the F&J party and the military, and how they agree to form a new government and set the limits for re-writing the constitution. This will largely determine the extent, and stability, of the proposed democratic transition. Meanwhile, for much of 1H 2012, the government will try to maintain current economic policy, seeking to retain popularity by maintaining spending on subsidies, at the cost of running a major fiscal deficit, while attempting to curtail inflation and maintaining a stable exchange rate. The reality, however, is that with foreign exchange reserves continuing to fall sharply, this is looking increasingly difficult without significant external support. Therefore, unless there is a major inflow of foreign aid, which still seems unlikely, we expect that at some point in the next six months a major decision will have to be made on whether to devalue the Egyptian pound. This in turn will have wider policy implications.

South Africa

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SA economic growth will probably remain subpar in 2012 with the output gap only beginning to close again in 2H12 and 2013. An unfavourable global environment and recent declines in commodity prices are delaying the cyclical recovery, despite ongoing monetary stimulus and a resilient consumer. Housing remains in the doldrums, and rising inflation erodes household purchasing power. That said, monetary policy will remain stimulative, corporate finances are healthy and there are signs of an upturn in private investment. Thus, we remain confident that growth will accelerate back to nearer 4% in 2013. Inflation will probably hover around the top end of the 3%-6% target range in the next 15 months or so but no lasting breach is likely, although rand fragility and wage stickiness pose upside risks. Poor export performance and the high import content of capital spending suggest that the current account deficit will gradually widen, after being kept low by favourable terms of trade. Mixed risks to the inflation outlook make additional monetary easing unlikely, but rates look set to stay on hold for a long while, with no hikes before 2H12 and only gradual normalisation afterwards. The Treasury remains committed to budget deficit reduction and debt stabilisation — focusing more on micro policy steps to foster stronger growth — yet it may struggle to contain the public wage bill. Still, the 2011/12 deficit should be less than last October's official forecast.

Figure 38. Egypt, Nigeria and South Africa — Economic Forecast, 2011-2013F

		Egypt			Nigeria			South Africa		
		2011F	2012F	2013F	2011F	2012F	2013F	2011F	2012F	2013F
Real GDP	YoY	1.5%	3.3%	3.9%	7.1%	6.7%	6.5%	3.1%	2.9%	3.8%
Final Domestic Demand	YoY	2.5	4.0	3.8	NA	NA	NA	4.6	3.2	4.0
Private Consumption	YoY	3.6	1.5	1.5	NA	NA	NA	4.9	2.8	3.3
Fixed Investment	YoY	-3.2	7.2	3.4	NA	NA	NA	4.3	4.4	5.7
Exports	YoY	-2.3	2.1	6.3	NA	NA	NA	5.9	5.3	6.2
Imports	YoY	0.2	5.4	5.5	NA	NA	NA	9.1	6.7	7.0
CPI	YoY	10.2	12.4	11.4	10.9	10.9	10.4	5.0	5.8	5.5
Unemployment Rate	%	9.7	10.2	11.0	NA	NA	NA	26.0	25.7	25.2
Current Account	US$ bn	-5.5	-6.8	-8.0	15.9	16.5	21.9	-13.6	-17.2	-22.0
	% of GDP	-2.4	-2.7	-3.2	5.9	5.3	6.0	-3.4	-4.7	-5.6
Fiscal Balance	% of GDP	-8.2	-7.7	-6.2	-3.2	-2.8	-2.0	-5.0	-4.8	-4.3
US Dollar Exchange Rate	Average	5.94	6.27	7.22	155	160	163	7.26	8.55	8.78

Source: Citi Investment Research and Analysis

Figure 39. Selected Emerging Market Countries — Economic Forecast Overview, 2011F-2013F

	GDP Growth			CPI Inflation			Current Balance (% of GDP)			Fiscal Balance (% of GDP)		
	2011F	2012F	2013F	2011F	2012F	2013F	2011F	2012F	2013F	2011F	2012F	2013F
Asia	**7.3%**	**6.9%**	**7.3%**	**5.8%**	**4.2%**	**4.3%**	**4.0%**	**2.4%**	**1.6%**	**-2.1%**	**-2.6%**	**-2.1%**
China	9.2	8.4	8.6	5.4	3.5	3.9	3.0	2.0	1.5	-1.0	-2.0	-1.5
Hong Kong	5.0	3.5	4.2	5.3	3.8	3.1	7.0	10.3	12.4	2.7	2.2	2.5
India*	7.1	7.0	7.7	9.0	6.7	6.5	-3.4	-3.6	-3.0	-8.3	-8.0	-7.5
Indonesia	6.5	6.3	6.5	5.4	5.7	5.6	0.3	-0.3	-0.5	-1.5	-1.0	-0.7
Korea	3.6	3.7	4.4	4.0	3.3	3.2	2.2	1.3	1.0	0.5	0.7	1.2
Malaysia	4.8	5.0	5.3	3.2	2.5	2.8	11.5	10.5	9.0	-5.4	-5.0	-4.7
Pakistan	2.8	3.1	4.2	10.5	11.0	11.0	-2.2	-2.7	-2.5	-6.0	-6.0	-5.0
Philippines	3.7	4.0	4.5	4.8	3.5	4.5	2.6	2.1	1.4	-1.6	-2.0	-1.3
Singapore	4.8	3.0	5.0	5.3	3.0	3.1	16.5	15.0	13.0	1.5	1.0	1.0
Sri Lanka	8.0	7.8	7.6	6.8	6.0	6.0	-4.4	-4.8	-5.7	-7.0	-6.4	-6.0
Taiwan	4.2	3.7	4.2	1.4	1.4	1.7	8.3	8.7	8.4	-2.5	-2.0	-1.8
Thailand	1.7	3.0	5.0	3.8	3.4	3.5	3.1	-0.2	0.1	-1.5	-3.8	-2.6
Vietnam	5.9	6.0	6.3	18.6	10.4	8.1	-3.7	-3.7	-2.8	-5.0	-4.8	-4.5
Latin America	**4.2%**	**3.7%**	**4.4%**	**7.0%**	**6.6%**	**6.5%**	**-1.0%**	**-0.9%**	**-1.2%**	**-2.4%**	**-2.3%**	**-2.2%**
Argentina	9.4	5.0	5.0	9.8	9.6	12.2	0.4	0.3	0.2	-0.9	-0.4	0.4
Brazil	2.9	3.3	4.5	6.6	5.5	5.1	-2.1	-2.1	-2.4	-2.7	-2.7	-2.9
Chile	6.2	4.0	5.0	3.3	3.6	3.1	-1.2	-1.9	-1.9	0.8	0.7	0.6
Colombia	5.8	5.1	5.2	3.4	3.9	4.2	-2.8	-2.6	-2.9	-2.9	-3.0	-2.5
Mexico	3.9	3.0	3.4	3.4	4.3	3.7	-1.0	-2.1	-2.1	-2.5	-2.2	-2.0
Panama	10.0	7.0	7.0	5.9	5.6	3.2	-13.5	-11.5	-9.9	-2.4	-2.0	-1.5
Peru	6.8	5.0	6.5	3.4	3.6	2.9	-1.6	-2.4	-2.8	1.5	1.2	-0.3
Venezuela	4.0	4.0	3.4	27.0	26.3	28.0	10.4	8.6	9.9	-5.0	-5.0	-4.0
Europe	**4.7%**	**2.7%**	**3.8%**	**6.7%**	**5.8%**	**5.3%**	**-0.4%**	**-0.3%**	**-1.1%**	**-2.2%**	**-3.1%**	**-2.7%**
Czech Republic	1.7	-0.5	2.0	1.9	2.6	1.6	-3.7	-3.6	-3.8	-3.7	-4.0	-3.4
Hungary	1.2	0.0	1.5	3.9	5.1	3.4	1.5	1.2	1.2	3.0	-3.2	-3.0
Kazakhstan	7.1	6.3	6.3	8.4	6.3	6.8	5.1	1.7	2.6	-1.9	-2.7	-1.5
Poland	4.2	1.9	2.8	4.3	3.5	2.6	-4.3	-3.4	-4.0	-5.2	-3.5	-2.4
Romania	2.5	1.7	3.1	5.6	2.5	2.0	-3.5	-4.5	-4.7	-4.4	-2.0	-2.0
Russia	3.8	3.5	4.0	8.4	6.2	6.1	5.7	3.5	1.4	-1.4	-3.1	-2.7
Slovakia	3.0	0.0	2.2	3.9	2.7	2.9	-0.5	-2.7	-3.9	-5.8	-6.2	-3.6
Turkey	8.2	2.5	4.3	6.5	8.1	6.6	-10.2	-8.4	-5.8	-1.3	-2.2	-2.5
Ukraine	5.0	3.0	4.5	8.8	8.4	7.2	-4.5	-7.6	-4.2	-4.0	-3.4	-4.7
Africa/Mideast	**5.3%**	**4.1%**	**5.2%**	**5.6%**	**6.1%**	**6.2%**	**4.9%**	**11.0%**	**10.0%**	**2.7%**	**2.0%**	**2.7%**
Bahrain	4.5	-4.4	4.7	1.9	2.0	3.0	2.7	16.7	1.2	-5.6	-3.4	-7.0
Egypt	1.5	3.3	3.9	10.2	12.4	11.4	-2.4	-2.7	-3.2	-8.2	-7.7	-6.2
Ghana	13.5	7.5	6.5	8.7	6.5	8.3	-7.1	-5.9	-3.8	-5.1	-5.5	-5.8
Iraq	9.4	12.4	11.2	4.0	5.0	6.0	-7.0	35.3	72.8	21.7	10.5	32.9
Israel	4.4	2.0	2.9	3.5	2.6	2.6	-0.8	-2.2	-0.8	-2.0	-2.5	-2.7
Jordan	1.6	2.5	3.0	5.0	5.0	5.0	-11.4	-6.0	-5.2	-3.1	-7.2	-8.7
Kenya	4.4	5.1	5.8	12.1	12.8	8.8	-8.2	-7.5	-6.5	-6.2	-6.5	-5.5
Kuwait	4.3	0.2	2.5	4.2	5.0	5.0	47.5	41.9	46.6	26.7	20.4	23.1
Lebanon	2.8	3.5	4.3	5.3	5.0	5.0	-15.1	-11.4	-12.3	-6.6	-7.8	-8.8
Nigeria	7.1	6.7	6.5	10.9	10.9	10.4	5.9	5.3	6.0	-3.2	-2.8	-2.0
Oman	1.4	3.0	4.5	3.5	3.0	3.0	3.4	2.9	21.8	6.1	2.8	4.6
Qatar	18.1	6.0	8.3	3.0	3.0	3.0	38.7	33.5	29.5	8.1	4.9	2.9
Saudi Arabia	6.7	3.8	8.5	5.2	7.0	8.0	34.9	23.0	22.3	12.1	11.5	9.6
South Africa	3.1	2.9	3.8	5.0	5.8	5.5	-3.4	-4.7	-5.6	-5.0	-4.8	-4.3
Tanzania	6.5	6.9	7.2	12.3	9.5	6.7	-8.5	-7.8	-9.1	-7.8	-6.2	-5.8
UAE	2.5	4.5	1.3	2.0	2.4	2.9	4.8	1.0	1.6	0.0	0.0	0.0
Uganda	6.0	6.2	7.0	18.8	17.4	6.3	-4.0	-8.9	-8.0	-7.2	-6.0	-5.2
Zambia	6.6	6.5	6.9	8.7	7.5	8.0	4.2	1.5	-2.5	-3.2	-4.2	-5.2
Total	**6.0%**	**5.2%**	**5.9%**	**6.2%**	**5.3%**	**5.2%**	**2.3%**	**2.2%**	**1.5%**	**-1.7%**	**-2.2%**	**-1.8%**

* 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.

Figure 41. Citi Global Strategy and Macro Team *For Informational Purposes Only*

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Figure 41. (Continued) Citi Global Strategy and Macro Team *For Informational Purposes Only*

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Source: Citi Investment Research and Analysis.

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Sovereign Ratings Outlook

This publication is a joint product between the Citi economics and rate strategy teams, with input from various other research teams. We aim to forecast the direction and scale of sovereign debt ratings (local currency), as well as any changes in the ratings outlook, for a range of countries. These are our judgments over the ratings outlook, rather than model-determined recommendations. All economic and fiscal forecasts are consistent with those published in Citi's monthly "*Global Economic Outlook and Strategy*" or other research. This publication does not aim to make a judgment on the financial market implications of ratings changes, except in so far as we expect any such market implications to affect other sovereign ratings. The full publication is released roughly once per quarter, with a briefer monthly summary in the "*Global Economic Outlook and Strategy*".

Figure 42. Advanced Economies — Sovereign Long-Term Debt Ratings and Citi Ratings Forecasts

	S&P Ratings				Moody's Ratings			
Country	Current Rating	Current Outlook	Citi Nearterm (Up to 6 Months) Forecast Rating	Citi Longterm (Next 2-3 Years) Forecast Rating & Outlook	Current Rating	Current Outlook	Citi Nearterm (Up to 6 Months) Forecast Rating	Citi Longterm (Next 2-3 Years) Forecast Rating & Outlook
US	AA+	Neg	AA+ (Neg)	AA ↓	Aaa	Neg	Aaa (Neg)	Aa1 ↓
Canada	AAA	Stable	AAA	AAA	Aaa	Stable	Aaa	Aaa
Japan	AA-	Neg	AA- (Neg)	A+ ↓	Aa3	Stable	Aa3	A1 ↓
Germany	AAA	Stable	AAA	AAA (Neg)	Aaa	Stable	Aaa	Aaa (Neg)
France	AA+	Neg	AA+ (Neg)	AA ↓	Aaa	Stable	Aaa (Neg)	Aa1 ↓
Italy	BBB+	Neg	BBB+ (Neg)	BBB- ↓↓	A2	Neg	Baa1 ↓↓	Baa3 ↓↓↓↓
Spain	A	Neg	A (Neg)	BBB+ ↓↓	A1	Neg	A2 ↓	Baa1 ↓↓↓
Austria	AA+	Neg	AA+ (Neg)	AA ↓	Aaa	Stable	Aaa (Neg)	Aa1 ↓
Belgium	AA	Neg	AA (Neg)	AA- ↓	Aa3	Neg	Aa3 (Neg)	Aa3
Finland	AAA	Neg	AAA (Neg)	AA+ ↓	Aaa	Stable	Aaa	Aaa (Neg)
Greece	CC	Neg	SD ↓↓	CC/C	Ca	Developing	C ↓	Ca
Ireland	BBB+	Neg	BBB+ (Neg)	BBB- ↓↓	Ba1	Neg	Ba1	Ba2 ↓
Netherlands	AAA	Neg	AAA (Neg)	AA+ ↓	Aaa	Stable	Aaa	Aaa (Neg)
Portugal	BB	Neg	BB (Neg)	CC/C ↓↓↓↓↓	Ba2	Neg	Ba3 ↓	Ca ↓↓↓↓↓
UK	AAA	Stable	AAA	AAA (Neg)	Aaa	Stable	Aaa	Aaa (Neg)
Switzerland	AAA	Stable	AAA	AAA	Aaa	Stable	Aaa	Aaa
Sweden	AAA	Stable	AAA	AAA	Aaa	Stable	Aaa	Aaa
Denmark	AAA	Stable	AAA	AAA	Aaa	Stable	Aaa	Aaa
Norway	AAA	Stable	AAA	AAA	Aaa	Stable	Aaa	Aaa
EFSF	AA+	Developing	AA+	AA+	(P) Aaa	Stable	Aa1 ↓	Aa1 ↓

Note: Arrows denote expected ratings changes from the current rating. (Neg) denotes negative outlook. (Neg W) denotes negative watch. SD means Selective Default. (P) means Provisional. 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, various Euro Area countries may be at risk of downgrade. NA Not available. Sources: Moody's, S&P and Citi Investment Research and Analysis

- We expect a string of further ratings downgrades for advanced economy sovereign debt, and do not expect any ratings upgrades.

- In the near term (next 6 months), we expect Moody's to downgrade the sovereign ratings for Italy, Spain, Portugal and Greece, as well as the EFSF. We expect that Moody's will place France and Austria on "negative outlook". In addition, we expect S&P to further downgrade Greece into either "selective default" or outright default.

- In the longer term (next 2-3 years), we expect a wide range of sovereign debt downgrades, including (by at least one major agency) the US, Japan, France, Italy, Spain, Austria, Belgium, Finland, Ireland, the Netherlands and Portugal.

- In addition, we see risks that the UK and Germany will both be put on "negative outlook" over the next 2-3 years. For Germany, ratings pressure comes from the slowing economy and the potential burdens of supporting domestic banks and other EMU countries. For the UK, the main issue is the prospect that extended economic weakness will limit the pace of fiscal improvement. The UK's AAA rating could be at risk if the coalition falls apart or eases up on the fiscal consolidation programme.

- We regard the smaller EMU-outs (Switzerland, Denmark, Norway, Sweden) as fairly solid AAAs and expect them all to retain that rating in coming years. Among these, Denmark's rating is perhaps the least secure, reflecting the deteriorating fiscal trend, high private debts and sluggish housing market. Our projection implies that in a few years, there may well be very few pure AAAs (ie top rated with stable outlook and ratings watch), just Canada, some smaller European economies, and the Antipodean countries.

Rates Strategy

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There is a sense of déjà-vu as 2012 gets going; equity markets have begun the year on a solid footing and US data has been surprising on the upside. Meanwhile central banks remain on hold for the foreseeable future and the EMU crisis is far from being resolved. This environment feels very similar to the start of 2011. There is, however, one very significant difference from last year in that bond yields are now near their all-time lows.

This apparent dislocation between the bond and the equity markets leads us to suspect that the fair-value level for bond yields may have changed. This is not just about QE, however, which should have been in the price throughout 2011. We think that there are two other factors driving this move: first, Operation Twist is likely act more slowly on the real economy than full-on QE or traditional monetary policy, and secondly there is a developing shortage of collateral in the system that has been increasing the demand for high grade assets and simultaneously limiting credit availability.

The result of this is that money-market curves are likely to remain flatter than normal, reducing term premia. So long as central banks give guidance that policy rates are going to stay low for a long time, bond yields can remain low or even decline further and yield curves should retain a flattening bias.

Bond yields to unwind recent convergence

The outperformance of US Treasuries against Bunds in 2011 can be attributed partly to QE and partly to flight to quality flows out of Europe. Recently, however, we have begun to see the correlation between Treasuries and EMU spreads weaken and the relationship between US bonds and the domestic data reassert itself. We expect this trend to continue in 2012 and this should lead to underperformance of US Treasuries against Bunds as the ECB continues to cut rates and add liquidity. We also see scope for some tightening in the spread between UK and Euro money-market curves, but any putative Bund outperformance against Gilts is likely to be offset by large-scale QE in the UK.

Japan and Australia remain highly correlated to the US market and this seems likely to persist, albeit with JGBs outperforming US Treasuries and Australian government bonds in periods of rising yields, owing to the much lower volatility of the market. Indeed, while there is no doubt that concerns over the very high levels of debt refinancing in Japan will persist, JGBs still look more attractive on a volatility adjusted carry basis than the other markets.

Sovereign credit spreads to remain volatile

Sovereign credit is likely to remain very much in the headlines in 2012 although given the immense volatility in spreads it is debatable whether or not spreads are a viable yield enhancement tool.

Ratings actions are likely to continue to play a significant part, particularly once the AAA issuers begin to be downgraded. While it is true that the loss of AAA ratings in the US and Japan has not had a meaningful impact on yields in those countries, the experience of Spain suggests that countries constrained by the shackles of monetary union may not be quite so fortunate.

Mitigating this, the markets may now be pricing excess risk premium for fx risk in the event of an EMU break-up. We think this is a relatively low probability event but the risk has risen. It is certainly not negligible but we doubt, however, that it is as high as the 25% probability implied by our Fiscal Risk Index and this may limit the upside for spread widening.

Figure 43. Interest Rate and Bond Market Forecasts (End of Period), as of 18 January 2012

		Forecast End Period					
	Current	1Q 12	2Q 12	3Q 12	4Q 12	1Q 13	2Q 13
US							
Policy Rate (Fed Funds) End Quarter	0.25	0.25	0.25	0.25	0.25	0.25	0.25
3-Month Libor	0.57	0.57	0.60	0.65	0.70	0.75	0.80
2 Year Treasury Yield	0.22	0.27	0.30	0.35	0.45	0.55	0.70
5 Year Treasury Yield	0.79	0.90	1.00	1.10	1.25	1.40	1.55
10 Year Treasury Yield	1.85	2.00	2.10	2.25	2.45	2.55	2.70
30 Year Treasury Yield	2.91	3.10	3.25	3.40	3.55	3.65	3.70
2-10 Year Treasury Curve	163	173	180	190	200	200	200
2 Year Swap Spread (Swap Less Govt.), bp	35	40	45	40	35	35	35
10 Year Swap Spread (Swap Less Govt.), bp	15	18	20	22	25	25	25
30 Year Swap Spread (Swap Less Govt.), bp	-5	-30	-35	-40	-50	-50	-50
30 Year Mortgage Yield	3.91	4.00	4.05	4.10	4.25	4.50	4.70
10 Year Breakeven Inflation	202	210	220	230	235	240	240
Euro Area							
Policy Rate	1.00	1.00	0.50	0.50	0.50	0.50	0.50
Overnight Rate (EONIA)	0.38	0.32	0.15	0.15	0.15	0.15	0.15
3-Month Libor	1.17	1.25	1.00	0.50	0.50	0.50	0.50
2 Year Treasury Yield	0.16	0.25	0.25	0.25	0.35	0.35	0.35
5 Year Treasury Yield	0.78	0.80	0.70	0.60	0.75	0.75	0.75
10 Year Treasury Yield	1.77	1.75	1.50	1.25	1.50	1.50	1.50
30 Year Treasury Yield	2.39	2.50	2.40	2.25	2.40	2.40	2.35
2-10 Year Treasury Curve	161	150	125	100	115	115	115
10 Year BTP-Bund Spread	479	550	600	550	450	400	350
10 Year Swap Spread (Swap Less Govt.), bp	44	50	65	65	50	45	35
10 Year Breakeven Inflation	158	150	125	125	150	165	175
Japan							
Policy Rate	0.10	0.10	0.10	0.10	0.10	0.10	0.10
3-Month CD	0.15	0.15	0.15	0.15	0.15	0.15	0.15
2 Year Treasury Yield	0.13	0.15	0.10	0.15	0.20	0.20	0.25
5 Year Treasury Yield	0.34	0.45	0.35	0.40	0.55	0.60	0.70
10 Year Treasury Yield	0.97	1.20	1.05	1.10	1.30	1.40	1.50
30 Year Treasury Yield	1.92	2.10	2.00	2.05	2.20	2.25	2.35
2-10 Year Treasury Curve	84	105	95	95	110	120	125
2 Year Swap Spread (Swap Less Govt.), bp	25	25	22	23	25	25	27
10 Year Swap Spread (Swap Less Govt.), bp	2	5	1	3	7	8	10
10 Year Breakeven Inflation	NA	NA	NA	NA	NA	NA	NA
UK							
Policy Rate	0.50	0.50	0.50	0.50	0.50	0.50	0.50
3-Month Libor	1.09	1.00	0.90	0.75	0.75	0.75	0.75
2 Year Treasury Yield	0.39	0.40	0.35	0.35	0.35	0.35	0.35
5 Year Treasury Yield	1.01	1.00	0.90	0.65	0.75	0.75	0.75
10 Year Treasury Yield	1.94	2.00	1.85	1.50	1.60	1.60	1.60
30 Year Treasury Yield	3.05	2.85	2.65	2.35	2.35	2.30	2.20
2-10 Year Treasury Curve	155	160	150	115	125	125	125
10 Year Swap Spread (Swap Less Govt.), bp	26	35	40	50	55	55	55
10 Year Breakeven Inflation	270	250	240	220	230	235	240
Australia							
Policy Rate	4.25	4.00	4.00	4.00	4.00	4.25	4.50
3-Month Libor	4.41	4.20	4.25	4.30	4.40	4.60	4.80
2 Year Treasury Yield	3.28	3.00	3.10	3.30	3.60	3.80	4.15
5 Year Treasury Yield	3.44	3.30	3.45	3.60	3.80	4.10	4.40
10 Year Treasury Yield	3.86	3.70	3.60	3.90	4.20	4.50	4.80
2-10 Year Treasury Curve	58	70	50	60	60	70	65
10 Year Swap Spread (Swap Less Govt.), bp	86	80	75	65	60	55	50

Source: Citi Investment Research and Analysis

Credit Outlook

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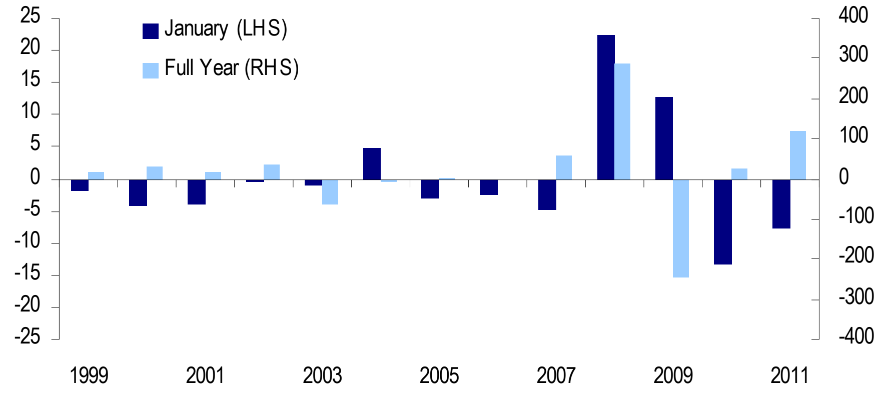
In credit, January isn't normally the best month on which to judge trends for the year. If anything, it is a bit of a reverse indicator. In Europe, spreads have tightened during January in 10 out of the last 13 years. But only in three years has the spread direction in January matched the spread direction for that year. So in more than three out of four years, January has sent the wrong signal.

It remains to be seen whether the spread tightening we have seen in the first couple of weeks of the year turns out to be another head fake. However, at least in making the struggle between liquidity and European fundamentals apparent, we reckon January has set the scene for 2012 correctly.

Figure 44. iBoxx EUR spread change in January and full year, 1999-2011 (basis points)



Sources: Mark-It, CIRA

All the conventional requisites for a strong rally in credit are in place — (non-financial) fundamentals are strong, valuations are attractive and investors have above-normal cash holdings and relatively defensive positioning.

Indeed, recent sessions have illustrated that it will take a substantial negative bias in the headlines to prevent the credit market from tightening.

Headlines out of the US are supportive — economic surprises remain very positive and although Q4 is unlikely to deliver anything like the earnings growth predicted a few months ago, it shouldn't see meaningful deterioration in credit metrics either.

But we expect the credit market will continue to follow the ebb and flow of the European sovereign crisis — not just in Europe. Although European credit now has a much higher beta than it used to against US credit, it is important to emphasize that correlations between investment-grade indices across the Atlantic remain high. US credit will also be impacted by systemic issues, such as funding for Italy and Spain.

As things stand key high sovereign funding requirements in Q1, rating agency actions, a European summit and uncertainty on Greek PSI could quickly derail any liquidity-led rally at a time where investor conviction is low.

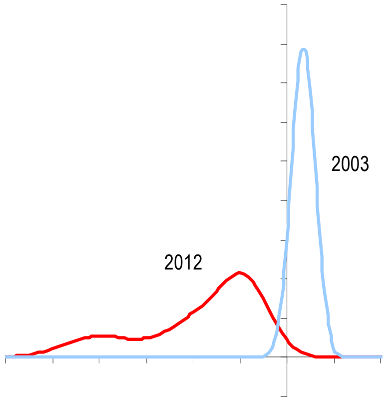
What will make 2012 frustrating for many credit investors is the natural inclination to trade pro-cyclically — reduce exposure on a stream of bad news and increase on a stream of good news. But if the year sees the market oscillate frequently between liquidity and fundamental drivers, as we expect, then it will be very easy to get whip-sawed. When things look bleak and market volatility is high, the chances of concerted policy intervention increase. When things look fine and market pressure has subsided, time and time again we have seen the policy resolve flake.

As such, our preferred strategy is to try to take advantage of the turning points. Where these are too difficult to identify, or liquidity is too poor outside of the indices, a simple strategy of scaling in and scaling out ought to help[8].

But when spreads are somewhere in the middle of the perceived range as currently, we would emphasise the relative value between assets — between debt and equity, between securitized and unsecuritized assets, on the curve, between banks and their sovereigns, between IG and HY and between CLOs and loans.

If there is a silver lining, then it is that unlike in 2011, which we traded from the short side, in 2012 we would look to be long in our long-term, core positions, using indices as short-term overlays.

Figure 45. Stylised distribution of possible growth outcomes in 2012 compared to a 'normal' year



Source: CIRA

In Europe, our 'modal' scenario (to which we assign a 45% probability) is for a 25% rally in IG spreads and a 10% rally in HY spreads. Our main alternative scenario (45%) has flat spreads in IG, but a 15% widening in HY. Both cases imply positive returns for the year, when the carry is factored in.

In the US, our main scenarios see IG credit spreads trading in a range of 160-220bp, again implying positive credit returns for the year.

However, both politically and economically the range of range of possible outcomes is very wide this year. So given the very apparent tail risks we would seek to hedge long exposures from the worst of the systemic risks.

At the moment we see two obvious ways of doing this: One is to buy equity vol — judging by historical relationships, current low levels of equity vol imply a much more benign outlook than current credit spreads. Equally, we believe the steepness of European curves at the front end provide a good hedging opportunity. When systemic stress rises, curves tend to invert as the market front-loads default expectations.

In uncertain times, the best opportunities usually lie in the dislocations between markets.

[8] See 'A simple Add-on-Weakness Trading Rule' Stephen Antczak, 19 December 2011

Global Equity Strategy

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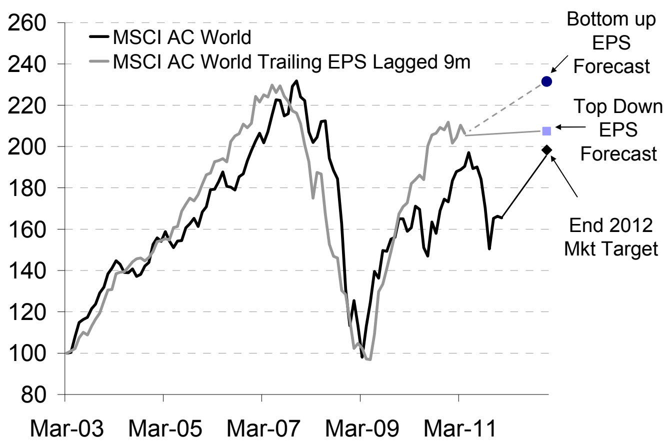
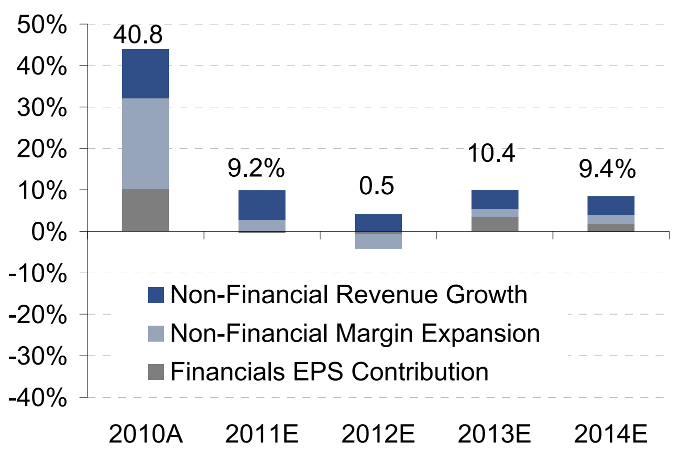
In 2011, global markets moved to price in an EPS recession. We think this is unlikely to happen. We forecast flat EPS growth over the next 12 months. Our end-2012 target for the MSCI AC World is 360, suggesting 20% gains from current levels. This implies a recoupling of global share prices and EPS over the year, but more through rising prices than falling EPS (see Figure 46). The main risks to our outlook stem from Europe and potential secondary consequences for global growth.

Figure 46. MSCI AC World Price vs EPS (9m Lagged)



Sources: MSCI, CIRA

Figure 47. Top-down Global EPS Growth Forecasts



Source: Citi Investment Research and Analysis

Figure 47 factors our economists' forecasts into our global EPS model. This produces 0.5% growth for 2012, followed by a 10.4% increase in 2013. The worsening macro backdrop means that our top-down EPS growth forecasts are now well below the bottom-up consensus, which still suggests global EPS growing by 10.5% in 2012. This would suggest plenty more downgrades to come. But, the close lead/lag relationship between global share prices and trailing EPS suggests that the market is pricing in something much worse, more like a 20% contraction over the next 12 months (see Figure 46). Our regional strategists also suggest that their markets are already pricing in double-digit falls in EPS. Our expectation of 15-20% gains for global equities is in line with our regional strategists' targets (Figure 48). They are most optimistic on Emerging Markets and Japan, forecasting around 20-25% gains, whereas less optimistic on the Europe, US and UK expecting returns of around 10-15%.

Peaking global margins have caused concerns for investors. Our forecasts suggest that global 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, a mid-cycle slowdown should be less damaging. And, while economic theory might suggest that profit margins are mean-reverting over time (excess profits attract capital that eventually drive down profits), continued capex and cost discipline mean that global margin mean-reversion is not imminent, in our view.

Investors are understandably worried about how the Eurozone crisis will progress, but the early-year rally we have seen so far suggests that global equity investors are becoming more willing to focus on reasonable corporate fundamentals rather than daily newsflow coming out of Eurozone. This is perhaps due to equity markets

believing that European policy makers will eventually sort out the issues. Strong macro data in the US have also helped offset the uncertainties coming out of Eurozone. In addition, cheap valuations may not be a catalyst for market rallies, but certainly limit the downside risk when setbacks occur. Global equities are trading at 1.6x P/BV which is close to the lowest level in 30 years. The long-term average P/BV is 2.1.

Figure 48. CIRA Equity Index Targets For End-2012

Index	Current Level (on 12 Jan 2012	Index Target 2012	Expected Gain (%)
MSCI ACWI	307	360	17%
S&P500	1296	1425	10%
DJ STOXX	249	285	14%
FTSE 100	5662	6200	9%
TOPIX	727	870	20%
S&P/ASX 200	4181	4750	14%
MSCI EM	953	1225	28%

Source: Citi Investment Research and Analysis

Our key regional and global sector recommendations are summarised in Figure 49. We remain Overweight Global Emerging Markets. The tightening cycle in Emerging Markets has ended with real rates still very low. In 2012, our economists are forecasting rate cuts in Brazil, Russia and India and a lower reserve requirement in China. EM equities should be supported by this easier policy. We are also Overweight Japan. Japanese stocks are trading at valuations last seen during the 2008/09 bear market at less than 1x book value. We think Japanese equities can make solid gains as the effect from temporary factors like the earthquake and Thai floods dissipates. We favor EM plays in the developed world. We are Overweight the UK as companies have a heavy exposure to emerging markets. Another reason to be positive on UK equities is that Bank of England is currently one of the most aggressive major central banks in the world in terms of policy easing. This should be a positive for risky assets like equities. We remain neutral on Europe ex UK. The region is the epicenter 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 have upgraded Australia to Neutral due to the prospect of further monetary easing, relatively resilient earnings, solid commodity prices and cheaper valuations. We are Underweight the US as it is expensive relative to other equity markets where we see better opportunities.

Our global sector strategy has taken on a more cyclical tilt. This is driven by our positive view on markets, which keeps us Overweight higher-beta sectors. We have upgraded Financials to Overweight. We are aware that it is too early to call an end to the sovereign issues in the Eurozone. However, globally the sector trades at less than book value and all we need is some respite in the deluge of bad news for the sector to rally, in our view. We remain Overweight IT and Consumer Staples. These sectors have solid earnings momentum and they are strong de-equitisers. Consumer Staples companies generate much of their growth in emerging economies, which makes the sector attractive. We keep Consumer Discretionary at Underweight as we have a preference for Staples within consumer sectors. We have cut Healthcare to Underweight as valuations look unattractive after the strong performance in 2011. We are also Underweight Utilities as we believe unique headwinds for the sector will persist for some time to come.

Figure 49. Regional And Global Sector Recommendations

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

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

Source: CIRA

Securitized Products Strategy

A Fresh Start for 2012

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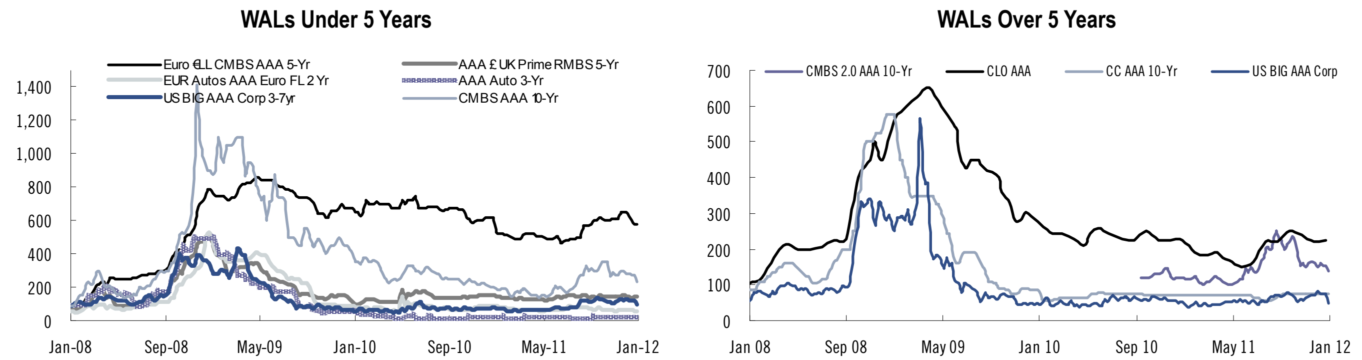
Incoming economic data indicate that the new year is beginning on a positive note, yet financial conditions remain tighter than normal and unresolved US fiscal and banking issues in Europe present threats to global financial stability. These perils are likely to keep financial markets on edge, and fixed income portfolios should prepare for persistent volatility. A good defense is to invest in short and high quality securitized products sectors, which have demonstrated good resilience compared to other fixed income sectors. These sectors offer good pickups to high quality alternatives, and are attractive because they are short and roll down the curve. Few other fixed income sectors offer comparable flexibility.

Figure 50. Selected Securitized Products Sectors — Spread Performance, Jan 07-Jan 12



Source: Citi Investment Research and Analysis

Notably, on a total rate of return basis, European securitized products sectors outperformed European equities by 8-20% and even outperformed comparable covered bonds by 0.6%. Likewise, the US ABS index outperformed mortgages, Agencies, high quality corporates and the BIG index itself. CMBS also performed well. In early 2012 new issue trading, investors seem to be finding ABS more attractive than the volatile unsecured financials sector. Our various securitized products research professionals recommend certain trades for the new year as follows:

- **30-YR Mortgage Basis.** We remain neutral on the mortgage basis. Regression based techniques show nominal current coupon mortgage spreads to be roughly 55bps rich to fair value. We refrain from initiating a short position as the basis is currently supported by several factors.
- **15-YR MBS versus 30-YR MBS.** We expect 15 year performance to strengthen going forward.
- **Favor the Mortgage Belly.** On the coupon stack, we favor the belly (4.5s and 5.0s) versus higher coupons. Belly coupons avoid HARP prepay risk and benefit most strongly from any increase in guarantee fees in the coming year.
- **FFELP ABS Positive Catalyst.** Changes in the SAP benchmark setting for FFELP student loans should remove much of the basis risk inherent in FFELP student loan ABS, and we expect this development to positively affect spreads and credit ratings.

- **Buy Early.** We think it would be sensible to take advantage of early-year ABS new issue supply. The robust ABS new issue calendar belies the strong ABS technicals, which should keep pressure on spreads during 2012. We project ABS runoff to exceed new issue supply by roughly $30 billion in 2012.[9] Roughly $63 billion of credit card ABS supply is scheduled to run off. Moreover, HARP II refinancing and large TLGP maturities add up to abundant cash needing reinvestment.
- **European Outperformance** — Impressively, European securitized products outperformed volatile competing credit sectors by 0.6-2.0% for 2011. We like sectors with a short duration bias — autos, credit cards, and senior UK prime RMBS. To enhance returns, we also recommend the fundamentally strong UK BTL sector, and select CMBS transactions.
- **CMBS Sector Opportunities.** Agency multifamily classes offer superior spread stability and are an attractive stabilizing asset. The 2.0 triple-As (including the 30%-enhanced super-seniors) could come in 5-15bp. Legacy dupers, including GG10s, could tighten around 50bp under our most likely scenario. The AMs and 2.0 triple-Bs could come in around 200bp.
- **CLO 2012 Trading Ideas**. We think CLO senior debt represents an attractive risk-adjusted opportunity. New Issue CLO AAA have 33-35% of structured support compared to 22-25% prior to crisis and offer spread of 150bp. Also, one should not shun European CLO opportunities, which are wider than their US counterparts and the exposure to peripherals is quite limited. Vintage CLO mezz, with the possibility of being called, looks appealing.
- **CLO Hedging Ideas.** CLO hedges will be very important in 2012. The combination of low defaults but possible spread blow-outs draws us to index tranche and option hedges. Such hedges were partially effective last summer in reducing CLO price volatility. Using options as a hedge, one can capitalize on the changes in credit vol. Historically, super seniors can provide tail-risk protection.
- **Prime and Alt-A Fixed Rate.** The prime fixed-rate non-agency RMBS sector offers good carry and higher cash flows from prepayments and recoveries from liquidations. There is a greater cash flow certainty in these bonds due to better collateral performance, lower delinquencies and lower modification / servicer risk.
- **Subprime Servicer Front Pay Picks.** For the front pay tranche, we look for servicers that have a high actual cash flow (as a percentage of scheduled cash flow) and higher than average cash flow from voluntary prepayments and recoveries. We would recommend Wells Fargo and Option One for front pays.

Figure 51. Sector Relative Value and Asset Allocation Recommendations — Selected Sectors, January 2012

Sector	Strategist Recommendation	Spreads Relative to Long-Term Averages	Comments
CABS	0	Fair	Remain market weighted. Subordinate auto ABS is our top pick. We also like certain off-the-run senior sectors, including dealer floorplan, private label credit cards, equipment and auto lease ABS.
CMBS	+1	Cheap	CMBS provides a compelling risk/reward tradeoff among a limited set of high yielding alternatives. Spreads should gradually tighten in the coming year, but spread compression will be limited by the excess volatility the asset class has experienced.
Agency MBS	+0	Rich	We remain neutral on the mortgage basis. Regression based techniques show nominal current coupon mortgage spreads to be roughly 55bps rich to fair value. We expect 15 year performance to strengthen going forward.
European Securitized Products	+	Cheap to Fair	Market weighted. Like stable, short sectors, combined with select off-the-run opportunities. We like autos, UK Credit Cards, UK prime RMBS, with higher yielding UK BTL, CMBS seniors and off-the-run opportunities in first pay short WAL UK NCRMBS, and older vintage Spanish RMBS. We expect stable performance from core sectors in volatile markets.
CLO		Cheap	CLO senior debt represents an attractive risk-adjusted opportunity. New Issue CLO AAA have 33-35% of structured support compared to 22-25% prior to crisis and offer spread of 150bp. Secondary CLOs offer an even wider spreads.

Source: Citi Investment Research and Analysis

[9] *"Thinking Ahead to 2012"*, by Mary Kane and Eugene Belostotsky, Citi Consumer ABS Outlook, 9 Dec 11.

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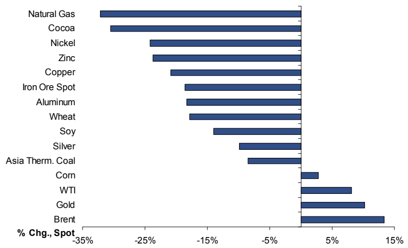
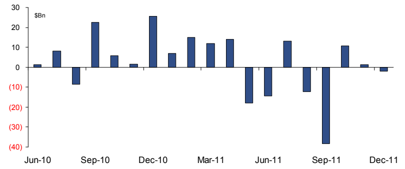
Figure 52. Key Commodity Price Moves, 2011



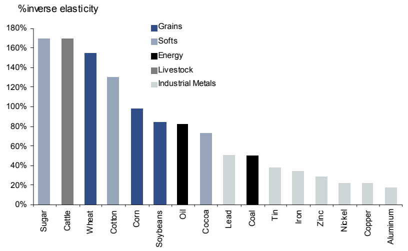
Source: Bloomberg, Citi Investment Research and Analysis

Figure 53. Net Aggregate Commodity Monthly Flows*: Index, ETPs



Source: Citi Investment Research and Analysis est.
*biased to US market flows

Figure 54. Inverse Elasticities of Global Commodity Demand to Income



Source: Citi Investment Research and Analysis

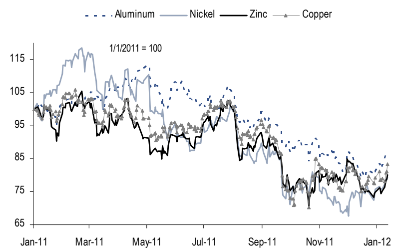
Commodity Outlook and Forecast

2011 was supposed to be a banner year for commodities, subsequent the global economic recovery of 2010. It was also a period of unfolding tail-risks. During the early part of the year, such events largely buttressed the commodity bull-run cycle. A sizable quantitative easing program in the US and geopolitical risk to crude oil supply—most visibly channeled through the ‘Arab Spring’ and most visibly observed through the overnight shutdown of Libya’s 1.5-m b/d of light, sweet crude oil production—lifted commodity prices across the board. To be sure, the benchmark Dow-Jones UBS Total Return Index had a CAGR of 27% for the four months ending 30th April 2011 as commodity assets under management peaked to nearly $380Bn. But the evolution of prices in the latter half of the year ended on a fillip; retrenchment in global growth outlooks and a steady worsening of the euro zone crisis plagued risk asset sentiment as the US dollar rallied and cross asset volatilities flared. Following a sharp sell-off in May, commodities experienced an estimated $11.4Bn of net outflows for the calendar year. The Dow-Jones Total Return Index finished the year down 13.3% as only gold, crude oil and petroleum products finished the year with measurable gains.

We expect commodity prices in 2012 will continue to wrestle with similar market forces that led to such a bifurcating year for commodities in 2011, with the sector increasingly susceptible to a flippant macro ‘risk-on’/’risk-off’ cycle. Benchmark trading levels are expected to be range-bound but subject to both ‘downside demand’ and ‘upside supply’ tail-events. At the fore are recession risks and austerity in the EU and a slowdown in Chinese growth; key commodity consumption drivers that look soft as the year begins. Further weak economic sentiment should weigh down commodities closely tied to the business cycle such as industrial metals and energies and favor defensive commodities such as soft commodities and livestock whose demand are less exposed to lower incomes. Exacerbating the bearish tone is the expectation of continued US dollar appreciation against the Euro, a cross that has plunged below the 1.30 mark and could stabilize in the 1.20-25 range according to our FX team.

But in a dynamic policy environment, it also appears probable that there will be accelerating and reinforcing stimulus measures in (either one or both) the monetary and fiscal realm in Europe, China and other emerging economies and quite possibly the US. These responses would generally prove bullish for commodity prices, potentially making 2012 a mirror image of 2011; the year starting quite negative for commodities but ending on a more optimistic and firmer tone. China remains the focal point for demand in regards to industrial commodities, precious metals and perhaps even crude oil as well, depending on its decisions to fill the strategic reserve. But tail risks—especially to supply—loom large with La Nina weather patterns on Southern hemisphere agriculture production and geopolitical tensions ratcheting up for key OPEC producer states, including Iran (2.6-m b/d net exporter) and Nigeria (1.85-m b/d producer because of 200-k b/d force majeure in December as the state is typically a 2-m b/d producer).

Figure 55. LME Base Metals



Source: Bloomberg, Citi Investment Research and Analysis

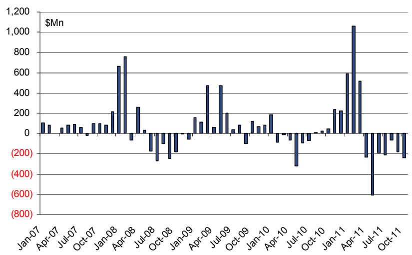
Precious metals are a favored sector in this environment based upon average price targets this year vis-à-vis current trading levels. The most meaningful revision was to the 2012 gold outlook revised down 10% from our prior publication to $1,710/t oz. While still constructive for the yellow metal, we expect the traditional 15-20% CAGR to stabilize this year to about 8-10% as investors cash out of their positions for dollar liquidity despite record low interest rates. Furthermore, EMU periphery governments may be forced to sell as a means to reduce its debt burden, partially reversing the record 2011 trend in official sector purchases after some 30 years of net selling. Meanwhile, even though lackluster sentiment and net sales in ETFs weighed on the palladium price during 2H’11, we expect a strong recovery for prices in 2012 and continue to forecast a rising deficit market for the PGM metal, targeting $775/t oz. On the other hand, industrial metals remain challenged given the current macroeconomic environment. But possible policy stimulus makes the sector prone to rebound in 2H’12 with Chinese demand being the key catalyst. The LMEX has started the year off with a bang, spot prices up about 6%. Copper is expected to set the tone for the complex. We estimate the market was in deficit by 296,000 tons in 2011 but could be roughly balanced this year before moving into modest surplus in 2013 with demand in developed economies—particularly Europe, expected to be subdued. LME aluminum and zinc prices are expected to outperform LME nickel.

Figure 56. Commodity Price Forecasts*

		Recent Spot	Forecasts 0-3M	6-12M	5Y Cyclical	2012E	2013E
Energy							
NYMEX WTI	USD/bbl	99.2	95.0	100.0	81.0	100.0	113.0
ICE Brent	USD/bbl	111.1	105.0	110.0	85.0	110.0	120.0
Henry Hub Natural Gas	USD/MMBtu	2.6	3.3	3.1	N/A	3.3	3.6
Base Metals							
LME Aluminum	USD/MT	2,114	2,100	2,350	2,500	2,275	2,525
LME Copper	USD/MT	7,991	7,000	8,300	7,500	7,825	8,525
LME Lead	USD/MT	1,987	1,950	2,325	2,300	2,150	2,400
LME Nickel	USD/MT	19,561	20,000	19,750	22,000	19,500	22,820
LME Tin	USD/MT	21,044	19,500	23,250	24,500	22,125	25,700
LME Zinc	USD/MT	1,954	1,900	2,125	2,300	2,050	2,295
Precious Metals							
Gold	USD/T. oz	1,640	1,675	1,750	1,050	1,710	1,910
Silver	USD/T. oz	29	31	29	15	30	27
Platinum	USD/T. oz	1,482	1,555	1,665	1,500	1,610	1,675
Palladium	USD/T. oz	639	720	830	600	775	925
Bulk Commodities							
Hard Coking Coal (benchmark Asia)	USD/MT	285	235	270	220	256	248
Thermal Coal (API2)	USD/MT	107	118	130	105	120	139
Iron Ore Spot (TSI)	USD/MT	142	125	165	100	149	135
Agriculture							
Corn	USD/bu	600	620	628	N/A	635	N/A
Soybeans	USD/bu	1,160	1,200	1,265	N/A	1,240	N/A
Wheat	USD/bu	602	610	621	N/A	625	N/A
Rice	USD/cwt	14	14.9	15.1	N/A	15.1	N/A
Cotton	USD/lb	95	95	85	N/A	90	N/A
Sugar	USD/lb	24	23	22	N/A	22	N/A
Coffee	USD/lb	225	210	200	N/A	210	N/A
Cocoa	USD/MT	2,269	2,200	2,400	N/A	2,375	N/A

Source: Citi Investment Research and Analysis
*Subject to change and revision. Forecasts updated as of 8 Jan 2012

Figure 57. 'Ag' Sector ETF Fund Flows



Source: Citi Investment Research and Analysis

Brent crude oil prices are expected to range between $100 and $120, averaging $110/bbl this year. Our global supply and demand balances are moderately bearish for 1Q'12, as is our price outlook, but from then on we expect stronger balances and prices. We are not optimistic on oil demand growth, modeling just 800-k b/d in 2012 and 1-m b/d in 2013, based on Citi's GDP growth expectations of 3.0% and 3.6% (PPP-adjusted) respectively (as of December 2011). We are optimistic on supply, projecting 1.1-m b/d of non-OPEC supply growth; coupled with the return of Libya, this requires an OPEC cut of some 500-k b/d to keep the market tight and prevent a return to inventory builds. Tail risks to supply remain elevated, however, particularly for waterborne crude markets with the potential for embargos on Iranian crude and protests in Nigeria. Agriculture commodities are likely to underperform as record Southern hemisphere and projected global output for the key grains reduces the burden on US exports and pressures CBOT prices. USDA 'surprises' to the market via volatile WASDE reports that have in recent months included sharp upside revisions to 11/12 inventory stocks has only exacerbated a sector that has seen fund shorts ride down prices in 4Q'11 and net outflows in the ETF space. Cocoa and rice were forecast as the most favorable crops at the start of this calendar year.

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

- ECB easing has helped EMU risk premia move lower but hurt the EUR. We think the latter will continue but the former may not
- Our forecasts assume further USD gains over the short to medium term absent a much more aggressive Fed
- We forecast that EUR/USD will drop into a 1.20-1.25 range. There should be further 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
- The forecasts for EMs are nuanced at the start of 2012. Within EM, CEEMEA is expected to come under the most pressure near term, but then broadly recover 6-12 months out. Asian outlooks are very mixed near term, with Chinese developments staying key. Latam flat-lines at current spot.

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 frecasts 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 58. 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	1.27	1.27	1.27	1.25	1.20	1.30	-1.4%	-5.7%
Japanese yen	USDJPY	77	77	76	77	76	78	0.2%	-0.5%
British Pound	GBPUSD	1.53	1.53	1.52	1.52	1.50	1.65	-0.2%	-1.5%
Swiss Franc	USDCHF	0.95	0.95	0.95	0.97	1.02	0.96	1.6%	7.6%
Australian Dollar	AUDUSD	1.03	1.02	0.99	1.01	0.93	0.90	-0.8%	-6.4%
New Zealand Dollar	NZDUSD	0.79	0.79	0.77	0.78	0.70	0.63	-0.9%	-9.5%
Canadian Dollar	USDCAD	1.02	1.03	1.03	1.03	1.07	0.95	0.3%	3.7%
Dollar Index*	DXY	81.54	81.53	81.38	82.34	84.94	79.12	1.0%	4.4%
G10 Crosses									
Japanese yen	EURJPY	97	97	97	96	91	101	-1.1%	-6.2%
Swiss Franc	EURCHF	1.21	1.21	1.20	1.21	1.22	1.25	0.2%	1.5%
British Pound	EURGBP	0.83	0.83	0.84	0.82	0.80	0.79	-1.2%	-4.2%
Swedish Krona	EURSEK	8.90	8.94	9.05	8.90	9.00	8.75	-0.5%	-0.5%
Norwegian Krone	EURNOK	7.70	7.73	7.82	7.80	7.80	7.60	0.8%	-0.3%
Norwegian Krone	NOKSEK	1.15	1.16	1.16	1.14	1.15	1.15	-1.3%	-0.2%
Australian Dollar	AUDNZD	1.30	1.29	1.28	1.29	1.33	1.43	0.1%	3.4%
Australian Dollar	AUDJPY	79	78	76	78	71	70	-0.6%	-6.9%
Asia									
Chinese Renminbi	USDCNY	6.31	6.31	6.32	6.32	6.19	6.01	0.1%	-2.0%
Hong Kong Dollar	USDHKD	7.77	7.77	7.77	7.78	7.76	7.75	0.2%	-0.1%
Indonesian Rupiah	USDIDR	9180	9329	9723	9000	9100	8900	-3.5%	-6.4%
Indian Rupee	USDINR	51.5	52.7	54.7	52.0	50.9	49.0	-1.3%	-6.9%
Korean Won	USDKRW	1148	1159	1167	1150	1120	1020	-0.8%	-4.0%
Malaysian Ringgit	USDMYR	3.13	3.15	3.17	3.18	3.07	2.94	1.0%	-3.3%
Philippine Peso	USDPHP	43.8	44.1	44.3	44.5	43.0	42.3	0.8%	-3.0%
Singapore Dollar	USDSGD	1.29	1.29	1.29	1.30	1.25	1.19	0.5%	-2.9%
Thai Baht	USDTHB	31.6	31.9	32.3	31.8	31.2	30.3	-0.2%	-3.3%
Taiwan Dollar	USDTWD	30.0	29.8	29.5	30.2	29.8	29.2	1.3%	1.0%
EMEA									
Czech Koruna	EURCZK	25.6	25.6	25.6	26.2	25.0	24.0	2.3%	-2.4%
Hungarian Forint	EURHUF	311	314	324	310	295	285	-1.3%	-9.0%
Polish Zloty	EURPLN	4.42	4.46	4.57	4.55	4.30	3.90	1.9%	-5.9%
Israeli Shekel	USDILS	3.84	3.86	3.88	3.90	4.00	3.90	1.0%	3.1%
Russian Ruble	USDRUB	31.9	32.3	33.6	32.4	33.9	32.2	0.2%	1.0%
Russian Ruble Baske	RUB	35.7	36.2	37.7	36.0	37.0	36.5	-0.5%	-2.0%
Turkish Lira	USDTRY	1.86	1.91	2.03	1.85	1.95	1.80	-3.0%	-4.0%
South African Rand	USDZAR	8.15	8.27	8.62	8.40	8.75	8.80	1.5%	1.6%
LATAM									
Brazilian Real	USDBRL	1.79	1.83	1.93	1.80	1.80	1.75	-1.8%	-6.6%
Chilean Peso	USDCLP	503	509	520	506	520	490	-0.6%	0.0%
Mexican Peso	USDMXN	13.6	13.7	14.1	13.6	13.4	12.2	-1.0%	-4.9%
Colombian Peso	USDCOP	1843	1853	1886	1850	1850	1850	-0.1%	-1.9%

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

Source: Citi Investment Research and Analysis

Overview

The USD has started the year with mixed performance, gaining versus the EUR and CEEMEA currencies, broadly stable vs Asian currencies and weakening against LATAM. This is interesting. We have pointed out in recent *Forecasts* that the USD generally tends to do better either when the US economy falls into recession or if growth is very strong. Middling performance, however, tends to leave USD outcomes also rather mixed.

The ECB's actions in cutting rates and providing liquidity via 3y LTROs has probably helped both to boost risk appetite and weaken the EUR. We think the latter effect will last longer than the former. If so, and with Chinese economic slowdown an underestimated risk for some LATAM currencies and the AUD in G10, we expect broad based USD strength to resume unless the Fed's new operating transparency is perceived to be hugely dovish when announced towards the end of the month.

Overall, our FX forecasts show USD gains against G10 currencies over the medium term with the EUR still particularly weak and JPY relatively strong.

In the EM world, CEEMEA is most exposed to Western Europe, and as such, is forecast to remain under the most pressure in the next three months. In Asia, some currencies look particularly oversold, but others should stay under pressure as real data weakens and inflation comes off the boil. Latam broadly flat-lines around current spot levels.

G10 Exchange Rates

EUR/USD – Short term bounce possible but, medium term, further downside

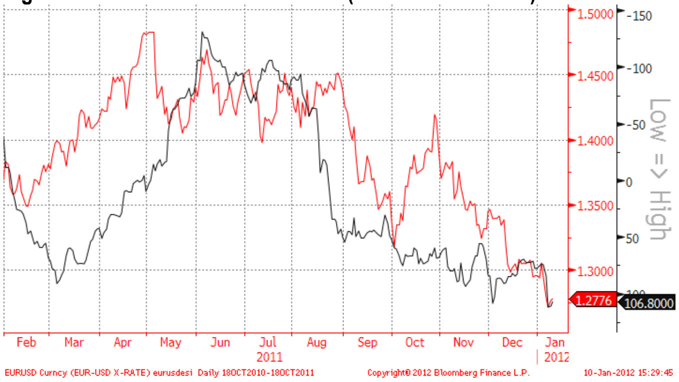
Over the turn of the year, a number of indicators suggested that EMU related risk premia had fallen back, reflecting early investor optimism that December ECB policy initiatives would "work." For example, the 25delta risk reversal, essentially the volatility price of EUR puts relative to calls, has retraced all the way back to mid year levels (see Figure 59) while other indicators of reduced stress included the reduced cost for Euro Area Banks seeking USD funding (the basis) and a better tone to European equities.

On the other hand, EUR/USD continued to fall, even in the face of improved risk appetite elsewhere. This seems to have been the result of the market perception that what might be good for EMU in general was not good for the single currency specifically i.e. much easier money resulting from the 3y LTRO and rate cuts in November and December.

Figure 59. EUR/USD (Red) vs. 25d 3mRisk Reversal (Black)

Source: Bloomberg

Figure 60. EUR/USD vs. Relative ESI (Euro Area Less US)



Sources: Bloomberg and Citi Investment Research and Analysis

Essentially, risk premia on EMU fell, but so did the return on the currency as rate differentials continued to contract. While current rate differentials suggest the very recent mini bounce in the currency could persist short term, relative cyclical performance continues to favour the US over Europe as Figure 60 – comparing Economic Surprise Indices (ESIs) - highlights.

On the US side of the equation, we do need to take into account the impact of more Fed transparency including at the forthcoming January FOMC the likelihood of a shock to market expectations on the Fed's expected path for Funds, the balance sheet and inflation. If such projections are interpreted as dovish, relative monetary sentiment may swing back to the EUR for a bit though we doubt that this will last long.

Furthermore, we think the risks surrounding risk premia on EMU related events are heavily biased to the upside too. Uncertainties abound including on the Greek March package, related PSI and the risks of failed bond auctions elsewhere as supply picks up and banks show signs of hoarding LTRO cash rather than re-investing.

Overall, our 0-3 and 6-12 months forecasts are unchanged from our December forecast at 1.25 and 1.20 respectively.

Yen – USD/JPY flat to slightly lower

Our bias is still flat to modestly lower in USD/JPY. While intervention may, from time to time, interrupt this trend, we still see such actions as designed to smooth the trend and to limit volatility rather than to draw a line in the sand at particular levels. We do not expect further official JPY sales until USD/JPY breaches 75 not least because the US Treasury semi annual FX report recently criticised previous actions.

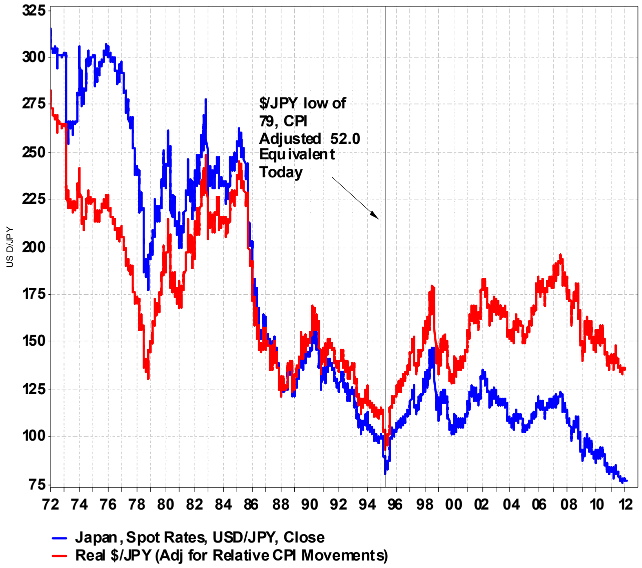
Amongst the major domestics players, retail investors are still repatriating investments from EM markets but this flow has slowed. Margin traders are quiet and reluctant to re-set JPY shorts after being hurt by the surge in risk aversion in mid 2011. Institutional investors are considering lowering UST weightings overall as the flatter US curve has reduced hedged returns. Meanwhile, corporates are comfortable with existing USD/JPY hedges but may have work to do on EUR/JPY where internal rates are believed to be around 105-110. However, with exports to the recessionary EA weak, this is not pressing. Overall, local investors are not really pushing the currency materially one way or the other.

In valuation terms, USD/JPY is somewhat below medium term averages but not hugely stretched as we have also pointed out many times. For example, as Figure 61 shows, the previous nominal low in April 1995 at 79 compares to around 52 today after adjusting for CPI differences between Japan and the US since then.

Japanese fundamentals are mixed. The current account surplus of around 2.5-3.0% of GDP remains a positive and unemployment is low by international standards. On the other hand, Japanese economic growth remains fragile and supported by a large, and very probably unsustainable, fiscal deficit. The Noda Administration apparently want to raise Japan's sales tax from 5% and this will require as accommodative a monetary stance (rates, QE and FX) as possible. That said, Japanese policy is rarely proactive so we doubt BoJ actions will have a major impact on JPY and we need to remember that BoJ/ MoF monetary policy actions in recent years have been extremely timid compared to Fed ones (see Figure 62).

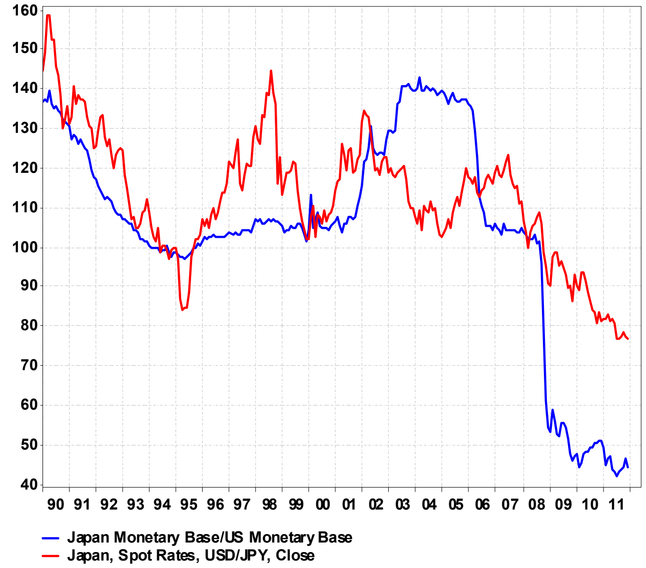
Overall, our forecast is for a broad stability, or a slight decline, in the USD/JPY rate over the medium term.

Figure 61. USD/JPY: Nominal and Real Levels



Sources: Reuters EcoWin and Citi

Figure 62. Relative Monetary Policy Much Looser in the US Than Japan



Source: Reuters EcoWin and Citi

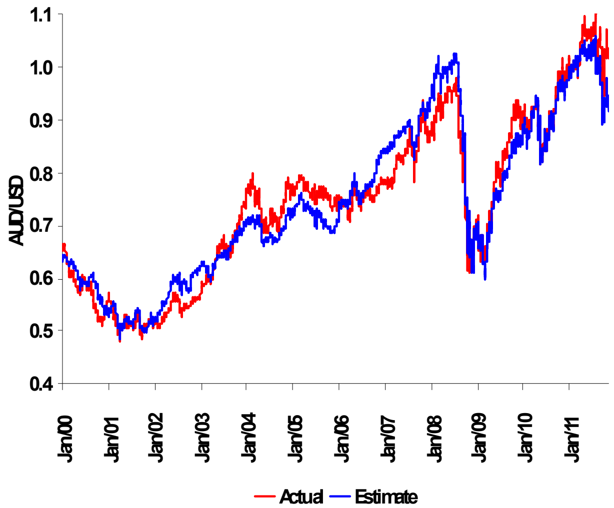
Dollar Bloc – CAD Low Beta

AUD/USD peaked at over 1.10 in late July and is now trading within a range of about 1.00-1.05, a consolidation characterised by lower highs and higher lows. Within this band, we think AUD remains hugely overvalued. For example, our WERM estimate of long run fair value is 0.86 and some PPP estimates are even lower.

Furthermore, we find it hard to explain this overvaluation by reference to market drivers such as commodity prices/ terms of trade, carry and rate differentials, risk appetite globally and so on. A further demonstration of this can be seen by comparing the downtrend in the trend in economic data surprises in Australia compared with those in the US. While US data continue to surprise to the upside, Australian news is much less positive yet AUD has held up pretty well. Taking several market drivers together, Figure 63 shows our short term fair value estimate is around 0.92. This model uses the levels of other Asian currencies, risk appetite, terms of trade and rate differentials.

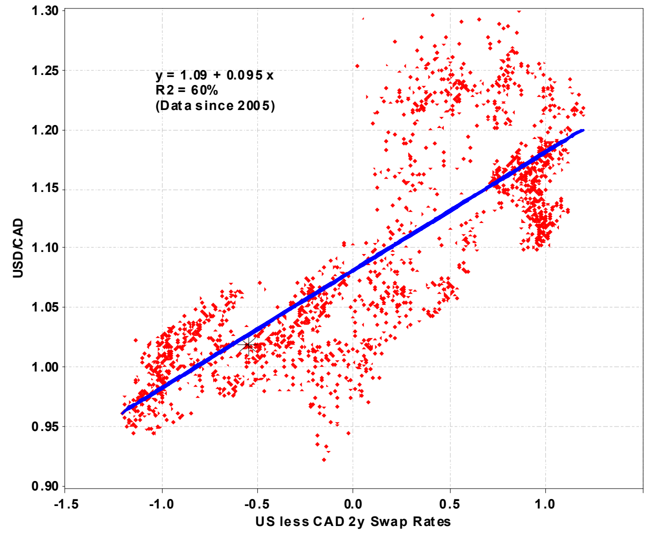
Europe remains a risk to AUD based on a more general rebound in risk aversion though the recent decoupling of market sentiment from the EUR performance could continue short term. Much more importantly, however, concerns about the end game in the Chinese property bubble are a huge threat to AUD. Since we remain worried about the latter, we forecast AUD downside medium term, with 0.93 expected over 6-12 months.

Figure 63. AUD/USD vs. Estimate Modelled on Market Drivers



Sources: Bloomberg and Citi

Figure 64. USD/CAD vs. 2y Rate Differentials



Sources: Reuters EcoWin

In directional terms, NZD has traded similarly to AUD, coming off July highs and then moving sideways since September. However, in this period, and until recently, NZD as underperformed AUD. This underperformance seems to be coming to an end and our NZD forecasts over 0-3 months broadly match those for AUD. Nonetheless, ongoing negatives for NZD include large twin fiscal and current account deficits and relative terms of trade developments, notably weak agricultural prices. We forecast NZD falling to 0.70 over 6-12 months and even further long term.

Turning to CAD, the pattern in the exchange rate is similar to that of AUD and NZD i.e. CAD weaker from late July to late September and then trading sideways. Domestic economic developments are unlikely to be critical. The economy likely slowed in the fourth quarter after exports prompted a spike in activity in the third quarter. Both domestic and external forces portend below-trend growth of about 2¼% over the medium-term which means that, with inflation risks reasonably balanced, the Bank of Canada will keep interest rates fixed until early 2013. Cuts remain unlikely given the nation's stable financial system and an already highly accommodative policy rate target of 1.00%. Importantly, the central bank appears to view risks as roughly in balance, and believes that the current degree of monetary stimulus, aided by low risk-free treasury yields, is sufficient to achieve the 2% inflation target over the medium-term. With rates in both the US and Canada on hold, we doubt there will be sharp moves in USD/CAD (see Figure 64).

As for the currency, the Canadian Dollar likely still is too strong for the central bank. Policymakers will probably say in the imminent January quarterly forecast update that the currency's persistent strength will continue to erode exports ahead. This will tend to limit upside in the event of a period of increased risk appetite relative to the higher carry AUD or NZD but support from relatively strong oil prices may also reduce the beta of CAD relative to the others in sell offs too. But oil prices remain a wild card. Since September, WTI prices have been rising strongly but Brent prices falling, leaving the direction for oil backed currencies unclear. However, very recently both have been moving higher, possibly underpinning CAD going forward.

Overall, we forecast USD/CAD at 1.03 in 0-3 months and 1.07 at 6-12 months.

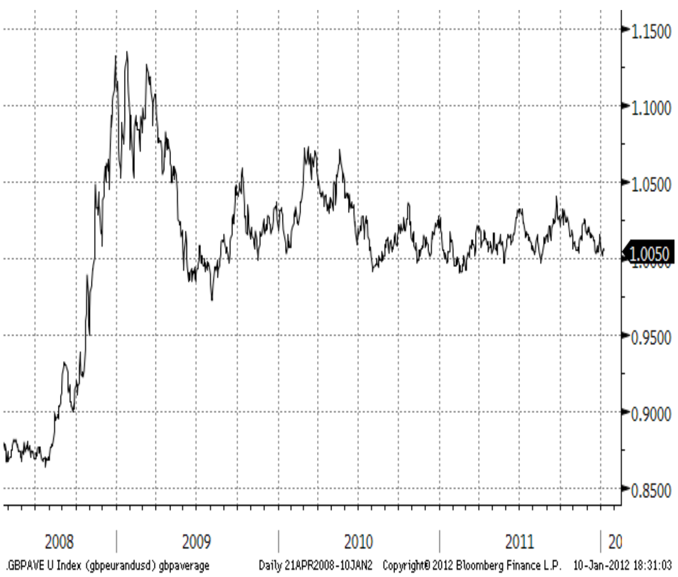
European Crosses

GBP – Up vs. EUR, down vs. USD

Sterling continues to be pulled in different directions by valuation (cheap, WERM estimates of fair value at 0.79 and 1.73) and by UK economic and monetary conditions (not helpful). The net effect of these conflicting forces has been a remarkable stability in the GBP when measured against a 50:50 EUR and USD basket (see Figure 65). We expect more of the same. We see EUR/GBP falling to 0.79-0.80 medium term and GBP/USD also moving lower, probably to around 1.50. Policymakers will likely be happy to keep the basket roughly stable at competitive levels as part of the overall recovery strategy.

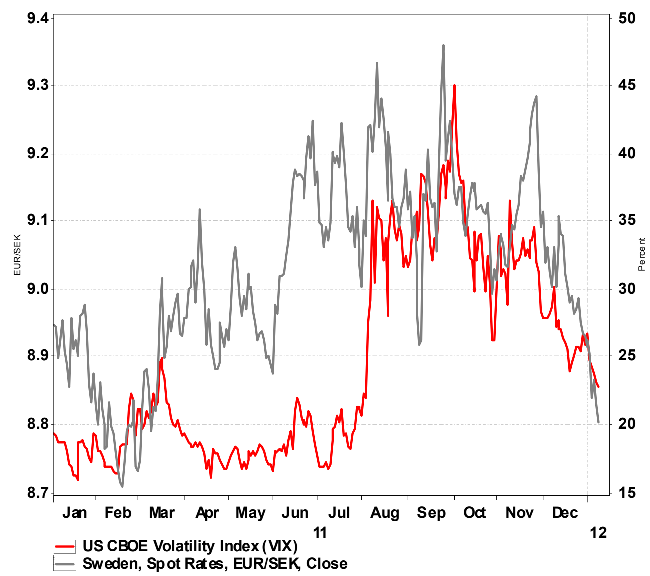
The outlook for the UK economy continues to look poor with the Euro Area recession unhelpful and domestic deleveraging by households and tighter fiscal policy adding to downwards pressure on growth. Citi has steadily downgraded growth forecasts for the UK to near zero in 2012 and has commensurately raised the estimate of the total size of the Bank of England's QE2 programme as a result. Tight fiscal and easy monetary policy are not normally currency friendly but since this is also likely to be the state of affairs in the Euro Area, we still expect further EUR/GBP downside. In practice, carry has quietly been getting a little more favourable for GBP in recent weeks.

Figure 65. GBP vs. Average of USD and EUR (Lower In Chart=Stronger GBP)



Sources: Bloomberg, Citi

Figure 66. EUR/SEK vs. VIX



Source: Reuters EcoWin

Scandis – Softer with levels near fair value and risk aversion possibly set to rise

EUR/SEK had a sharp move lower from late November to the time of writing, falling from 9.30 to around 8.80. As is often the case, increased risk appetite was associated with the sharp SEK rally. For example, Figure 66 shows that VIX implied equity volatility fell sharply over the same period. As we highlight above, the ECB actions to provide 3y LTROs and cut rates may both have boosted risk appetite globally, at least for a bit, but also weakened the EUR, In this context, a sharp fall in EUR/SEK is not surprising.

However, in making the forecast, we need to be aware that risk aversion may return if the LTRO is not successful in increasing banks' purchases of sovereign bonds. Furthermore, the level of EUR/SEK is now close to our long term WERM estimate of fair value at 8.75. As such, the risks of a partial retracement of the recent move lower in EUR/SEK are relatively high and our short to medium term forecasts reflect this.

EUR/NOK also moved lower over the past couple of months but less noticeably than for EUR/SEK. As a result, NOK/SEK declined. With SEK more sensitive to risk appetite than NOK this is not surprising. If risk aversion moves higher in the range as we expect, NOK will eventually regain some ground. Meanwhile, in 2012, we do not really expect EUR/NOK to break out of the 7.60-7.90 range for long since this has contained most trading since December 2010. Our bias is lower long term but our WERM fair value estimate is 7.54, less than 2% below spot.

CHF – Personnel changes reduce risk of high EUR/CHF peg

The resignation of SNB Chairman Hildebrand from the SNB probably reduces the immediate chances of the SNB ramping up the policy to weaken the CHF by increasing the level of the EUR/CHF peg. While we expect a continued robust defence of the existing 1.20 floor, not least because Swiss growth and deflation risks remain significant, it seems less probable now that the peg is raised.

As a result, we have lowered our EUR/CHF forecasts which had, in December, put some weight on a higher peg being announced. According to many metrics, the CHF remains highly overvalued against long term criteria (e.g. see our EUR/CHF WERM estimate of 1.37). Furthermore, with inflation having gone negative in Switzerland, it is unlikely that the SNB will baulk anytime soon at the explosive base money growth that results from making the money supply endogenous to the FX market. This makes policy more credible and therefore unlikely to fail.

Our forecasts see EUR/CHF in a 1.20-1.25 range over the short to medium term.

EM Exchange Rates

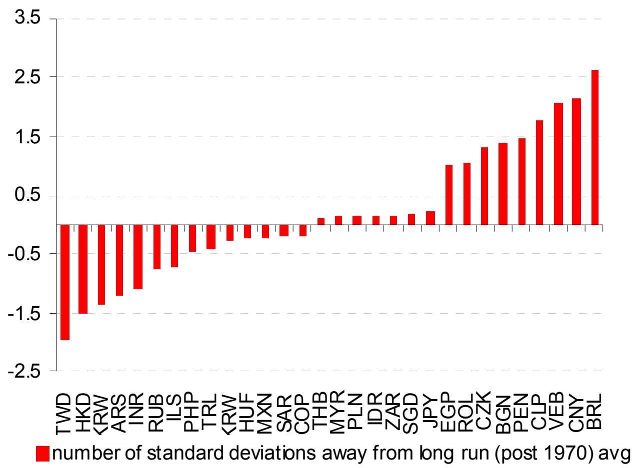
So far this year, better risk appetite has had very mixed results for Emerging Markets FX. In Latin America, our basket of equally weighted regional crosses rallied strongly from the late December low-point, by over 3%. Our Asian basket has essentially stabilized, anchored by the yuan and in keeping with the broader trend of less violent swings in beta-adjusted terms. Our comparable CEEMEA basket, however, has lurched lower and then partially recouped, ending around 2% lower at the time of writing. Of the three broad EM regions, DXY has thus had the greatest bearing on CEEMEA FX moves, as might be expected given recent moves in EUR/USD that in turn dominate DXY.

Against this setting, and as the Europe-US economic split grows increasingly apparent alongside a slowing Chinese growth engine, the implications for EM FX are complex. Many in CEEMEA have significant domestic problems as well as the closest economic and banking sector ties to a global heavy-weight that is already clearly in recession – Europe. The forecasts presented here split the outlook for CEEMEA in 2012 into two distinct halves: local currency weakness in the very near term, followed by recovery in some further out.

Latin America is mixed, both in terms of economic exposures, and indeed relative attractiveness of currencies in real effective terms (see Figure 67). Our short run forecast is for the individual crosses broadly to flat-line around current spot levels, implying negative returns on most USD longs in 6-12 months' time.

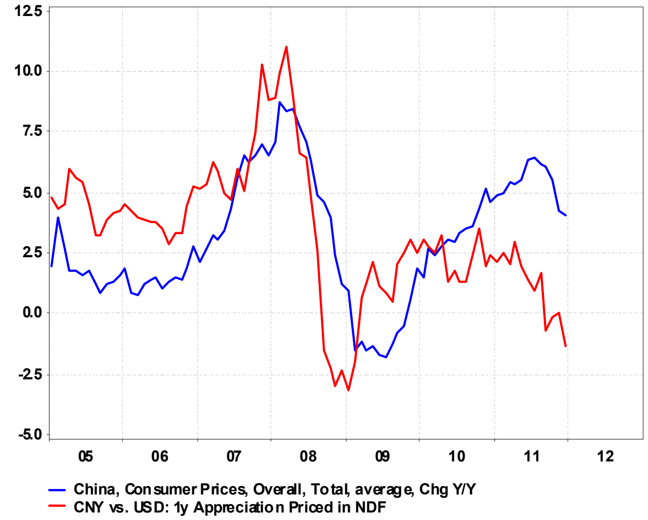
Asian FX is evenly split. We expect more near-term downside for currencies that have intimate China ties and where domestic data have also softened, so several USD longs here should generate good returns in the next three months. For a handful that are both oversold and fundamentally well-supported, the inverse holds, and we expect negative long USD returns throughout the forecast horizon.

Figure 67. Real Effective Exchange Rates Compared



Sources: Citi and Bloomberg

Figure 68. China CPI and 12 Month Appreciation Priced in by NDF



Sources: Citi and Reuters Ecowin

EM Asia – Mixed Performance

CNY stays central as the chief anchor for Asian FX, and, with mounting Chinese macro risks in a generally firm dollar environment, we have pared back our expectations for meaningful USD/CNY depreciation over the next 12 months. The near term (0-3 month) outlook for the regional crosses, however, is more nuanced. Having depreciated significantly, IDR, INR and KRW are now forecast to recoup more against USD than is presently priced by forwards. By contrast, MYR, PHP, and TWD are forecast to depreciate further than the markets currently anticipate.

For CNY, which is to some extent a policy tool, the short-term incentive to appreciate the currency and contain imported inflation has weakened considerably over the last year. With inflation eased (note the December CPI was at a 15-month low – Figure 68), and helped lower by the continued economic slowdown and reduced global food prices, we see USD/CNY broadly flat over the medium term. Despite some uptick in December data, the overall trend of the data, both real and leading, points to a weakening growth cycle.

The disconnect, meanwhile, between equity markets and some Asian FX rates has been striking, with the latter underperforming by some margin. Three currencies in particular stand out: IDR, INR and KRW. Each looks oversold against the USD to us in the near term; is relatively cheap in real effective terms; and at least the first two are insulated from global forces by the dominance of domestic demand in their respective economies. As such, USD/INR and USD/IDR are expected to weaken steadily throughout the forecast period, relative to forwards.

For USD/INR, it is worth pointing out three separate “structural” developments in the last fortnight that should provide important support to the INR: the foreign currency ratings upgrade, looser rules for portfolio inflows and the opening up of the retail sector for foreign firms. It could also, unusually, gain from expected interest rate cuts near-term, if activity recovers from this monetary stimulus.

IDR is also forecast to outperform near term, as it catches up with stock market. The disconnect between the IDR and CDS spreads, which have historically tended to move in tandem, is also apparent. Further out, domestic dollar liquidity is expected to improve, and that the yield curve should have bear steepened by enough to re-attract inflows into the bond market. As such, IDR strengthens throughout our forecast period, relative to forwards.

KRW of course has one key support that IDR and INR lack – a cushioning current account surplus – that is expected to stay around 1% of GDP this year and next. Inflows of foreign funds into both equity and bond markets add to our near term optimism, which is tempered mainly by Korea's sensitivity to global trade and especially China in the medium term. Policy makers' concerns about the downtrend of Korean growth are also rising, leaving the outlook for KRW more mixed. We see USD/KRW at 1150 in the 0-3 month period, and 1120 6-12 months out.

TWD, PHP and MYR meanwhile, are forecast to underperform the dollar in the next three months vs forwards, but, barring TWD, to outperform thereafter as fundamentals, including solid reserves, reassert themselves. The near term outlook is driven by weaker prospects for China, which is vital for these largely export-driven economies. Trade balances have deteriorated perceptibly in both Malaysia and the Philippines, and real activity has weakened. It is notable that the Philippines' current account position has worsened despite strong end-year remittances. USD/SGD is also expected to firm up a little ahead of forwards in the near term, and modestly weaken 6-12 months out.

CEEMEA – A Tale of Two Halves

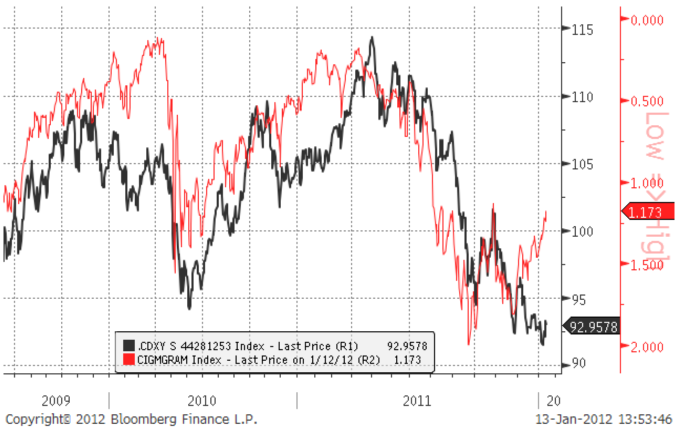
Our forecasts for CEEMEA FX in the coming twelve months are divided neatly into two halves. Except for TRY, which we continue to see as a policy tool for the central bank to tame domestic price pressures in the very near term, local currencies in the rest of the region is expected to weaken or at best stay flat in the 0-3 month period, relative to forwards. With formidable challenges facing European policymakers, limited scope for quick agreement given the issues and countries in question, and powerful feed-through channels to CEEMEA, downward pressures on regional FX stays intact (see Figure 69). This switches in the second half, with generally strengthening local currency vs. forwards, with a few exceptions.

Of course, as Hungarian developments have demonstrated, CEEMEA currencies carry deep economic and policy imbalances of their own, and tend to have weak reserve firepower. Hungary has a particularly nasty mix of high government debt, high short term external debt, very high forex borrowing by the domestic private sector, banking system concerns and deep export vulnerability to the European recession. So why do we see EUR/HUF at 310 and 295, 0-3 and 6-12 months respectively? Essentially, because HUF weakness in recent weeks has raised the chances of an early supportive standby deal with the IMF/EU, by March or at the latest in Q2. EUR/HUF is expected to stay volatile in the interim, however.

PLN shares one crucial weakness with Hungary: heavily forex levered households. Our EUR/PLN 4.55 forecast for 0-3 months thus implies near term positive returns on EUR/PLN, reflecting both this balance sheet risk and the fact that, notwithstanding its better economic "fundamentals", PLN stays high beta to developments in Europe. We have revised our 6-12 month EUR/PLN forecasts slightly lower, however, to 4.30, to reflect the positive combination of: an expected improvement in Poland's current account; resilient growth (Poland is the least export-reliant in its region).

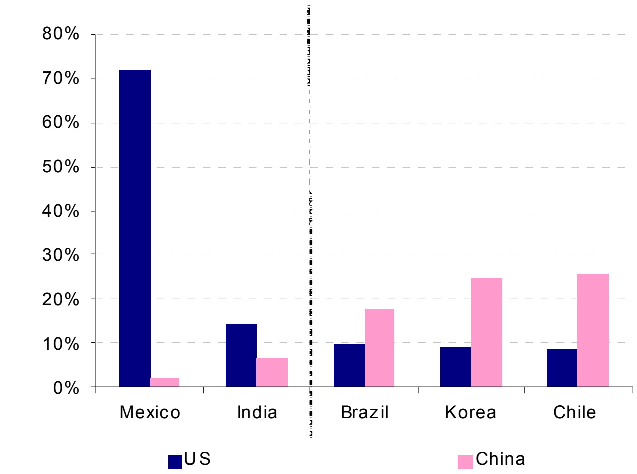
Our EUR/CZK forecasts stay as before, at 26.2 and 25.0 for 0-3 and 6-12 months out. Our forecasts balance two forces. The Czech Republic stands out for having negligible private sector forex loans, and good debt ratios, which should be CZK supportive. But the economy is also one of the most export-intensive its cohort, which acts in the opposite direction.

Figure 69. CEEMEA FX and GRAMI



Red - Citi GRAMI risk index, Black - CDXY, an equally weighted basket of CEEMEA FX
Source: Citi and Bloomberg

Figure 70. Export Shares – the US vs. China



Black - EUR/PLN, Red – Poland 5Y CDS
Source: Citi, Ecowin and IMF DOTS

Projections for RUB and ILS remain unchanged too. The RUB basket seems likely to range trade between 36 and 37, with supportive oil prices offset by continued capital outflows and indeed, mounting political risks around the presidential elections in March. (Geo)political risks also feature in our USD/ILS forecasts, with ILS expected to be the worst performing EM currency in the 6-12 month window, relative to forwards. A slipping current account position, and dovish sounding central bank, should keep USD/ILS at between 3.90 and 4.00 over the forecast period.

The ZAR follows close at the heels of ILS, with a considerably worse near term outlook than other CEEMEA exchange rates. We see USD/ZAR at 8.40 and 8.75 in 0-3 and 6-12 months respectively. This is driven by the combination of a soft domestic outlook, volatile inflows, weaker external/commodity outlook and widening trade deficit.

Finally, TRY, which is the only CEEMEA currency that does well in a strong USD setting in the next three months, chiefly because of the central bank's radical policies. Partly as a result of these policies, inflation is high, at 10.4% y/y, and expected to stay above-target for the rest of this year. The central bank has clearly indicated that it will keep TRY strong – and below 1.90 against USD – to dampen price pressures. We think that this works in the near term, but are less confident further out, for two reasons. First, because of Turkey's large external financing needs, which should weigh against TRY. The current account deficit is expected at 8.5% of GDP this year, which although lower than last year's estimated 10.2%, is elevated. And second, ultimately, maintaining a huge, 6.5%, *spread* between overnight lending and borrowing rates seems likely to have consequences.

Latam – Flat-lining

Our Latam forecasts basically flat-line relative to spot rates over the next twelve months, with Chile the notable exception. As equity market strength offsets valuation and/or China concerns, Latam FX should be fairly supported. Moreover, in a world where large domestic, external and banking sector imbalances are the focus of markets' attention, currencies like MXN and BRL look relatively sturdy. Relative to forwards, our point forecasts mean that USD/BRL and USD/MXN deliver negative returns both 0-3 and 3-6 months out, with USD/BRL the most negative. USD/COP returns also turn slightly negative in the medium term. China and commodity sensitive USD/CLP returns, however, are flat to slightly positive compared with respective forwards.

Encouraging US data and MXN's relative "cheapness" in real effective terms may justify lower USD/MXN in the short term from current spot. Exports to the US are both the dominant component and growth driver of the Mexican economy (see Figure 70) and, as such, should benefit MXN that has badly underperformed its peers. High sensitivity to the Euro crisis and to swings in global risk appetite, however, lead us to temper our optimism for the next twelve months, and our forecasts show MXN oscillating around 13.5 in this period, ie, USD/MXN returns stay negative relative to forwards.

For Brazil, meanwhile, carry stays attractive in the near-term even with lower SELIC rates, and recent cheapening its real effective exchange rate means it looks less overvalued. A sharper Chinese growth correction is a risk to our forecasts, given that Brazil's economy is already in "industrial recession". Both hard commodities and China have a weighty role in Brazil's export basket. A "China shock" is not Citi's central forecast, however, and it follows that BRL should gain against the dollar from a confluence of positive factors including a robust trade surplus and good foreign inflows, helping the overall current account position. We have USD/BRL at 1.80 for the next twelve months, and 1.75 in the long run.

In Colombia, meanwhile, we are broadly neutral following the latest price action: the currency has gained nearly 6% in the last two weeks, outperforming the broader region. The oil and mining sector has attracted very strong FDI inflows, which have been an important driver. Fundamentals, including rate differentials, terms of trade and solid FDI are also supportive – and we have USD/COP at 1850 throughout the forecast period.

Chile, however, is the outlier: USD/CLP is the only cross that is expected to generate positive returns in the next twelve months relative to forwards. Chile is essentially a "copper currency" with strong links to China to boot. Copper is 92% of total mineral exports and 52% of total exports; exports oscillate to between 40 and 45% of GDP. So copper exports alone are around 20% of GDP – an important distinction with Brazil where exports are 15% of GDP – and a quarter of all exports head to China (see Figure 70). We have USD/COP at 506 and 520 in 0-3 and 6-12 months respectively.

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 72. Citi Quarterly Interpolated Forecasts

Quarterly Interpolated Forecasts

	Currency	Spot	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14
G10-US Dollar											
Euro	EURUSD	1.27	1.25	1.24	1.22	1.20	1.22	1.25	1.27	1.30	1.30
Japanese yen	USDJPY	77	77	77	76	76	76	77	77	78	79
British Pound	GBPUSD	1.53	1.52	1.52	1.51	1.50	1.53	1.57	1.60	1.64	1.65
Swiss Franc	USDCHF	0.95	0.97	0.98	1.00	1.01	1.01	0.99	0.98	0.96	0.96
Australian Dollar	AUDUSD	1.03	1.01	0.99	0.96	0.93	0.92	0.92	0.91	0.90	0.90
New Zealand Dollar	NZDUSD	0.79	0.78	0.76	0.73	0.70	0.69	0.67	0.65	0.63	0.63
Canadian Dollar	USDCAD	1.02	1.03	1.04	1.05	1.07	1.04	1.01	0.98	0.95	0.95
Dollar Index*	DXY	81.54	82.23	83.07	83.93	84.82	83.66	82.18	80.73	79.32	79.02
G10 Crosses											
Japanese yen	EURJPY	97	96	95	93	91	93	96	98	101	102
Swiss Franc	EURCHF	1.21	1.21	1.21	1.22	1.22	1.23	1.23	1.24	1.25	1.26
British Pound	EURGBP	0.83	0.82	0.81	0.81	0.80	0.80	0.80	0.79	0.79	0.79
Swedish Krona	EURSEK	8.90	8.90	8.93	8.96	9.00	8.95	8.88	8.82	8.76	8.75
Norwegian Krone	EURNOK	7.70	7.79	7.80	7.80	7.80	7.76	7.71	7.66	7.61	7.60
Norwegian Krone	NOKSEK	1.15	1.14	1.14	1.15	1.15	1.15	1.15	1.15	1.15	1.15
Australian Dollar	AUDNZD	1.30	1.30	1.30	1.32	1.33	1.35	1.37	1.40	1.43	1.43
Australian Dollar	AUDJPY	79.1	78.0	75.8	73.4	71.0	70.6	70.5	70.3	70.2	70.5
EM Asia											
Chinese Renminbi	USDCNY	6.31	6.30	6.27	6.24	6.20	6.15	6.10	6.05	6.01	6.01
Hong Kong Dollar	USDHKD	7.77	7.78	7.77	7.77	7.76	7.76	7.75	7.75	7.75	7.75
Indonesian Rupiah	USDIDR	9180	9000	9300	9200	9100	9050	9000	8950	8900	8900
Indian Rupee	USDINR	51.5	52.0	52.0	51.5	51.0	50.0	49.5	49.0	49.0	49.0
Korean Won	USDKRW	1148	1150	1145	1120	1100	1080	1070	1040	1020	1020
Malaysian Ringgit	USDMYR	3.13	3.18	3.12	3.11	3.08	3.04	3.01	2.96	2.94	2.94
Philippine Peso	USDPHP	43.8	44.5	43.8	43.3	43.0	42.9	42.7	42.5	42.3	42.3
Singapore Dollar	USDSGD	1.29	1.30	1.28	1.27	1.25	1.23	1.22	1.20	1.19	1.19
Thai Baht	USDTHB	31.6	31.8	31.6	31.4	31.2	31.0	30.8	30.5	30.3	30.3
Taiwan Dollar	USDTWD	30.0	30.2	30.5	30.2	29.8	29.8	29.5	29.5	29.2	29.2
EM Europe											
Czech Koruna	EURCZK	25.58	26.11	25.86	25.46	25.06	24.79	24.54	24.29	24.04	23.87
Hungarian Forint	EURHUF	311	310	306	301	296	293	290	288	285	285
Polish Zloty	EURPLN	4.42	4.53	4.48	4.40	4.31	4.22	4.12	4.02	3.91	3.90
Israeli Shekel	USDILS	3.84	3.89	3.93	3.96	4.00	3.98	3.95	3.93	3.90	3.86
Russian Ruble	USDRUB	31.9	32.3	32.8	33.3	33.9	33.6	33.1	32.7	32.2	32.0
Russian Ruble Basket	RUB	35.7	36.0	36.3	36.6	37.0	36.9	36.8	36.6	36.5	36.5
Turkish Lira	USDTRY	1.86	1.85	1.88	1.91	1.95	1.92	1.88	1.84	1.81	1.79
South African Rand	USDZAR	8.15	8.36	8.50	8.62	8.73	8.76	8.77	8.79	8.80	8.88
EM Latam											
Brazilian Real	USDBRL	1.79	1.80	1.80	1.80	1.80	1.79	1.78	1.76	1.75	1.75
Chilean Peso	USDCLP	503	506	510	515	519	514	506	499	491	494
Mexican Peso	USDMXN	13.6	13.6	13.5	13.5	13.4	13.1	12.8	12.5	12.2	12.3
Colombian Peso	USDCOP	1843	1849	1850	1850	1850	1850	1850	1850	1850	1857

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

Source: Citi Investment Research and Analysis

Figure 73. Citi Annual Forecasts

Annual Forecasts

	Currency	Spot	2012*	2013*	2014*	2015*	2016*
G10-US Dollar							
Euro	EURUSD	1.27	1.23	1.26	1.31	1.33	1.35
Japanese yen	USDJPY	77	77	77	79	82	85
British Pound	GBPUSD	1.53	1.51	1.59	1.66	1.69	1.72
Swiss Franc	USDCHF	0.95	0.99	0.98	0.97	0.98	1.00
Australian Dollar	AUDUSD	1.03	0.97	0.91	0.89	0.88	0.87
New Zealand Dollar	NZDUSD	0.79	0.74	0.66	0.63	0.62	0.62
Canadian Dollar	USDCAD	1.02	1.05	1.00	0.95	0.96	0.97
Dollar Index**	DXY	81.54	83.50	81.44	78.84	78.36	77.88
G10 Crosses							
Japanese yen	EURJPY	97	94	97	104	109	115
Swiss Franc	EURCHF	1.21	1.21	1.24	1.27	1.31	1.35
British Pound	EURGBP	0.83	0.81	0.79	0.79	0.79	0.79
Swedish Krona	EURSEK	8.90	8.95	8.85	8.75	8.75	8.75
Norwegian Krone	EURNOK	7.70	7.80	7.68	7.59	7.57	7.55
Norwegian Krone	NOKSEK	1.15	1.15	1.15	1.15	1.16	1.16
Australian Dollar	AUDNZD	1.30	1.31	1.39	1.42	1.41	1.40
Australian Dollar	AUDJPY	79.1	74.5	70.4	71.0	72.3	73.6
EM Asia							
Chinese Renminbi	USDCNY	6.31	6.25	6.08	6.00	5.88	5.77
Hong Kong Dollar	USDHKD	7.77	7.77	7.75	7.75	7.75	7.75
Indonesian Rupiah	USDIDR	9180	9150	8975	8900	8800	8900
Indian Rupee	USDINR	51.5	51.6	49.4	48.5	47.0	46.0
Korean Won	USDKRW	1148	1129	1053	1010	990	980
Malaysian Ringgit	USDMYR	3.13	3.12	2.99	2.88	2.85	2.85
Philippine Peso	USDPHP	43.8	43.6	42.6	41.0	41.0	41.0
Singapore Dollar	USDSGD	1.29	1.28	1.21	1.17	1.16	1.15
Thai Baht	USDTHB	31.6	31.5	30.6	28.9	28.9	28.9
Taiwan Dollar	USDTWD	30.0	30.2	29.5	28.2	28.2	28.2
EM Europe							
Czech Koruna	EURCZK	25.58	25.62	24.41	23.63	23.00	22.36
Hungarian Forint	EURHUF	311	303	289	284	282	281
Polish Zloty	EURPLN	4.42	4.43	4.07	3.90	3.90	3.90
Israeli Shekel	USDILS	3.84	3.94	3.94	3.80	3.64	3.47
Russian Ruble	USDRUB	31.9	33.1	32.9	31.8	31.1	30.4
Russian Ruble Baske	RUB	35.7	36.5	36.7	36.6	36.8	36.9
Turkish Lira	USDTRY	1.86	1.90	1.86	1.76	1.70	1.64
South African Rand	USDZAR	8.15	8.55	8.78	9.02	9.41	9.79
EM Latam							
Brazilian Real	USDBRL	1.79	1.80	1.77	1.76	1.78	1.79
Chilean Peso	USDCLP	503	512	502	502	522	542
Mexican Peso	USDMXN	13.6	13.5	12.7	12.4	12.6	12.9
Colombian Peso	USDCOP	1843	1850	1850	1870	1903	1936

*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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