Citi Research
Economics

22 August 2012 | 60 pages

Global

Global Economic Outlook and Strategy

August 2012

- Our global growth forecasts are little changed this month. We continue to look for global growth (at current exchange rates) of about 2.5% this year and 2.8% in 2013 (unchanged from July). Within that, we are lifting our 2012 growth forecast for the industrial countries to 1.3% from 1.1% in July and cutting our 2012 emerging market growth forecast to 4.7% from 4.9%. Nevertheless, we still expect EM growth to exceed the advanced economies by a wide margin. EM outperformance is underpinned by supply-side factors rather than buoyant spending in advanced economies, and the drivers of EM outperformance are intact — industrialisation catch-up, urbanisation, rising south-south trade and high resource prices.

- We continue to expect that the EMU crisis will persist, with prolonged economic weakness — especially in periphery countries — and further periods of intense financial market stress. We again put the probability that Greece will exit the euro area (ie "Grexit") in the next 12-18 months at about 90% and, within that timeframe, we think it is increasingly likely that Grexit will occur in the next 6 months or so, conceivably even as early as September/October depending on the outcome of the September Troika report on Greece. There is a crucial series of meetings and events in coming weeks that may clarify how this plays out. With the ECB's bond purchase programme, together with the EFSF/ESM and some financial repression of banks, European policymakers can now probably construct an adequate firewall to fund Italy and Spain for a couple of years and ensure that Grexit (if it happens) would not cause the euro area as a whole to unravel. Even so, Grexit probably would cause further capital flight out of periphery assets.

- Major central banks are likely to keep policy loose or loosen further in coming months, ready to act promptly if growth disappoints or market strains flare up again. Grexit (if it occurs) probably also would trigger a huge policy response, with liquidity assistance, monetary easing and some deferral of fiscal tightening plans across Europe. We expect a series of further sovereign ratings downgrades in Europe in the next 6-9 months, with a wider range of downgrades over the next 2-3 years.

Figure 1. Currency and Interest Rate Forecasts (End of Period, Unless Specified), as of 22 Aug 2012

	22 Aug 2012	3Q 12 Forecast	4Q 12 Forecast	1Q 13 Forecast	2Q 13 Forecast	3Q 13 Forecast	4Q 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.)	1.78	1.60	1.65	1.80	2.10	2.35	2.60
Euro Area: US$/€	1.23	1.25	1.21	1.17	1.16	1.18	1.20
Euro Repo Rate	0.75	0.50	0.25	0.25	0.25	0.25	0.25
10-Yr. Bunds (Period Ave.)	1.54	1.40	1.20	1.25	1.30	1.50	1.80
Japan: Yen/US$	80	81	81	80	80	81	82
Call Money	0.10	0.10	0.10	0.10	0.10	0.10	0.10
10-Yr. JGB (Period Ave.)	0.83	0.80	0.95	1.10	1.20	1.10	1.30

Source: Citi Research

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With thanks to Jan Maguire

Next issue 19 September 2012

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

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Figure 2. Forecast Highlights and Changes from Last Month

■ Global	Our global growth forecasts are little changed this month, although we are again raising our industrial country forecasts and cutting those for emerging markets. Nevertheless, we still expect EM growth to exceed the advanced economies by a wide margin.
■ United States	Rebounds in consumer spending and payroll growth have relieved earlier concerns but recovery remains subdued. The dual threats of European financial turmoil and large-scale fiscal drag in 2013 will likely keep the Fed focused on easing in coming months.
■ Euro Area	By proposing a Conditional Government Bond Purchase Programme (CGBPP) the ECB effectively increases the euro area rescue facilities and buys more time in dealing with the sovereign debt crisis. However, we expect the crisis to go on with the probability of Greece leaving the euro area in the next 12-18 months at about 90% and Italy and Spain asking for external support. With the economy deteriorating, we expect the ECB to cut rates by 50bp by the end of 2012.
■ China	Our forecasts are little changed this month but we see moderate downside risks. The July data confirmed that inflation is benign and domestic demand improving, but highlighted risks from weaker exports. Industrial production remains weak, accelerating inventory reduction. Further monetary easing is likely over time.
■ Japan	We expect GDP growth of 1.3% in the third quarter and 1.1% in the fourth quarter. Japan's economy likely will hold firm thanks to resilience in domestic demand driven by reconstruction demand, improving labour conditions and stepped-up spending by the older generation. However, we expect the BoJ to take additional easing action in late October amid an increasing downside risk to the BoJ's inflation forecasts.
■ United Kingdom	A technical rebound in GDP is likely in Q3, but the economy's underlying path remains weak. The MPC is likely to loosen monetary policy further via extra QE.
■ Canada	Domestic strength and balanced risks are keeping the BoC slightly hawkish, despite external woes and lingering uncertainties. Hence we retain our call for stable rates in 2012 and modest withdrawal of stimulus in early 2013.
■ Australia	Risks for the Australian economy are beginning to shift from the downside to being more evenly balanced. Some of the high frequency activity data is responding positively to previous cuts in official interest rates.
■ Emerging Asia (ex China)	Growth worries continue to dominate, with forecast downgrades in India, Hong Kong and Taiwan. Malaysia's and Indonesia's growth remained strong — in Indonesia's case this prompted a marked current account deterioration and earlier-than-expected rate hike. For others, benign inflation still leaves a window for some cuts, notably Korea, Thailand and Philippines, but sticky inflation will mean delayed easing room for India.
■ CEEMEA	The only really visible change to our forecasts this month is a bleaker outlook for growth in Poland: not only Citi, but Polish policymakers themselves have become more gloomy about growth prospects there. Over the next few weeks we think one theme to watch is the risk of further escalation in the rhetoric surrounding a conflict in the Middle East. This has already had an impact on asset prices in the region, and further noise is possible.

Source: Citi Research

Figure 3. Global — Summary of Views of Citi's Market Strategists

	Equities	G10 Rates	Credit	Securitized Products	FX	Commodities	Global Macro Strategy
Overall View	Cheap valuations, reasonable EPS, easy monetary policy should provide moderate upside	EMU crisis and supply will come back into focus after summer and drive core yields lower again	Impressive technical support risks being overwhelmed by escalating sovereign crisis	Short, high-quality sectors optimise defensive positioning. Off-the-run sectors offer upside	USD higher medium term	Bearish most industrial commodities although see some short-term seasonal strength in crude and agriculture	Easy money balances negative macro
Most-Favoured Region/Sector	Japan, Asia Pac ex Japan, Australia / IT, Energy, Health Care	10yr Europe	Low-beta core non-fins	US CMBS senior tranches	USD, CAD medium term	Precious Metals, Grains and Oilseeds (due to weather risks)	Gold, Risk Assets
Least-Favoured Region/Sector	Europe ex UK/ Cons. Disc, Industrials, Utilities	>10yr US	Periphery sub-debt	Spanish and Irish RMBS	EUR, AUD	Copper, Zinc, Coffee	Core FI, EUR
Key Risks	Deeper downturn in Continental Europe earnings, profits begin to collapse in the US	Overwhelming central bank policy response	Sovereign crisis; bank runs; global slowdown	Regulation	Short term risk rally extends USD weakness	EMU contagion, oil shock double-dip, risk-off financial outflows China hard landing QE3	EMU breakup, China growth, US fiscal

Source: Citi Research

Overview — Crucial Stage in EMU Crisis Approaching

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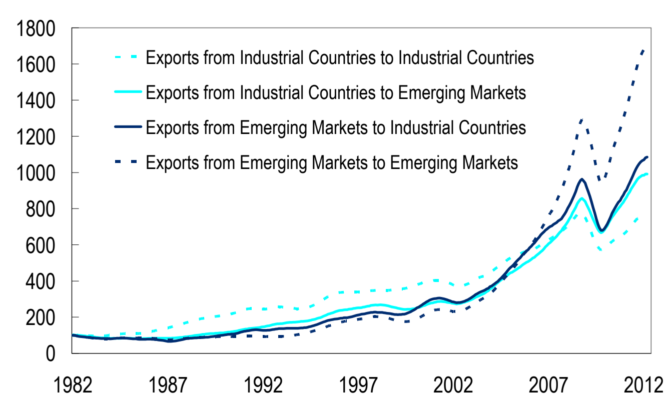
Our global growth forecasts are little changed this month, with continued EM outperformance

Our global growth forecasts are little changed this month. We continue to look for global growth (at current exchange rates) of about 2.5% this year and 2.8% in 2013 (both unchanged from last month). PPP-weighted, we expect growth of 3.0% this year (unchanged from last month) and 3.2% in 2013 (down 0.1%). Within that, we are edging up our 2012 growth forecast for the industrial countries to 1.3% from 1.1% last month and just 0.6% in the January forecast. By contrast, we are trimming our 2012 emerging market growth forecast to 4.7% from 4.9% last month and 5.2% at the start of the year. Nevertheless, as before, we expect emerging market growth in aggregate to outpace the advanced economies by a wide margin. In the short run, sluggish demand growth in advanced economies will cap exports in many emerging markets. However, EM outperformance is underpinned by supply-side factors rather than strong spending growth in advanced economies, and the key drivers of EM outperformance — modernisation, industrialisation catch-up, urbanisation, increasing south-south trade and high resource prices — remain intact.

We continue to expect the EMU crisis will persist, with a 90% probability that Greece will exit EMU in the next 12-18 months

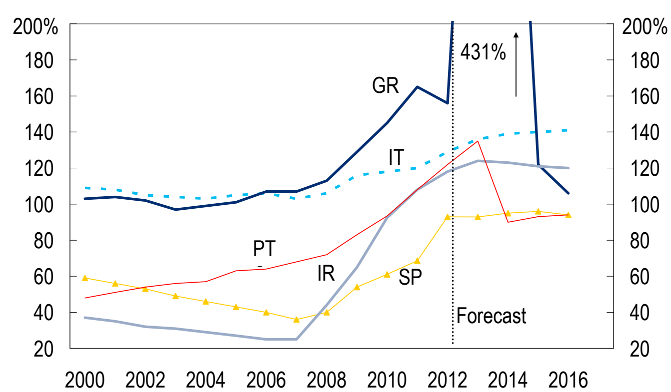
We continue to expect that the EMU crisis will persist, with prolonged economic weakness — especially in periphery countries — and further periods of intense financial market stress. Euro area GDP fell in Q2 and we expect that overall euro GDP will fall in both this year and 2013, with severe falls in most periphery countries. The Citi Economic Surprise Index (CESI) for the US recently has moved close to neutral, but for the euro area it remains firmly negative. We continue to put the probability that Greece will exit the euro area (ie "Grexit") in the next 12-18 months at about 90% and, within that timeframe, we think it is increasingly likely that Grexit will occur in the next 6 months or so, conceivably even as early as September/October depending on the outcome of the September Troika report on Greece.

Figure 4. Global — 12-Month Sum of World Trade Flows, Indexed to Jan 1982 = 100, 1982-2012



Sources: IMF and Citi Research

Figure 5. Selected EMU Countries — General Government Debt/GDP Ratio, 2000-16F



Sources: Eurostat and Citi Research

The CGBPP has helped fill the gap created by the limited size of the EFSF and ESM…

The ECB's decision to introduce the new Conditional Government Bond Purchase Programme (CGBPP)[1] has helped calm markets in recent weeks by creating a plausible framework through which Italy and Spain (and perhaps some other smaller countries) can be funded for an extended period (perhaps two years or so). The

[1] See "Euro Economics Weekly - ECB Ready, Waiting For Spain and Germany", Jürgen Michels, 3 August 2012, Citi.

EFSF/ESM by themselves seem too small to carry this burden. Combined, they would have a maximum lending capacity of €700bn, of which €192bn already has been committed to the existing programmes for Greece, Ireland and Portugal, around €65bn is earmarked to recapitalise Spanish banks (indeed, up to €100bn can be used for the bank support programme), and €10bn may be needed for Cyprus. The remaining EFSF/ESM lending capacity (€433bn or so) looks modest compared to the financing needs of Italy and Spain (about €670bn in 2013-14 combined), let alone the further support that may be needed for Portugal and Ireland (and, indeed Greece), and perhaps also other countries (eg Slovenia).

…and an adequate (but temporary) firewall is now possible for Italy and Spain…

However, a combined structure of EFSF/ESM primary lending, ECB secondary market purchases and financial repression of banks (coupled with the resumption of the ECB's multi-year LTRO programme) probably could cover these countries' borrowing needs for a couple of years. With the ECB's firepower, it would be possible to set up programmes for Italy and Spain without having to rely on IMF financing (although the IMF would probably still provide technical and monitoring assistance). The lack of direct IMF financial assistance would probably make it politically easier for Spain and Italy to ask for external help. Indeed, it is unclear if the IMF will be needed to play a role in funding any further euro area programmes (including second programmes for Portugal and Ireland if required).

…and this could be activated at short notice if necessary

Hence, we believe an adequate (albeit temporary) firewall for the financing of the governments of Italy and Spain (and perhaps some other smaller countries) finally can be constructed. With the governments of Italy and Spain now already more or less implementing the probable conditionality, in our view, this firewall could be activated very quickly, probably in a matter of days — triggered either by country-specific funding strains in Italy or Spain, or as part of a generalised market calming package in the case of Grexit. Of course, to activate ESM/EFSF and ECB support, the countries have to request help and the Eurogroup has to approve a support package.

Nevertheless, the ECB's efforts probably will not resolve worries over the longrun fiscal sustainability of periphery EMU countries

As a result, the tail risk that Grexit or funding problems in Italy or Spain could — via a cascading series of panics in sovereign markets or banks — cause the nearterm disintegration of the euro area has been greatly reduced. This is a considerable achievement. Nevertheless, in our view, this firewall is best viewed as a liquidity provision scheme rather than a sufficient remedy for worries over longrun fiscal solvency for periphery countries. Even with the resultant relatively low funding costs, we doubt that the current mix of fiscal austerity and supply-side reform will return any periphery country to a sustainable fiscal path in coming years. Supply-side measures rarely have big short-term effects on growth (indeed, labour market reforms can produce negative short-term effects), especially if limitations in credit supply limit scope for companies and households to borrow in anticipation of the eventual payoff from reforms. Any such boost probably will be overwhelmed by the drag from fiscal austerity — plus a varying mix of poor external competitiveness, weak banking systems, weak housing markets, high private debts. Hence, we expect that growth in periphery economies will undershoot official forecasts, leading to above-target and generally rising government debt/GDP ratios in coming years.

The likelihood of Grexit is becoming even clearer

Moreover, while the ECB's decisions may help limit the economic and financial market spillovers of Grexit, the likelihood of Grexit itself is coming into even sharper focus, in our view. There appears to be a sizeable — and probably unbridgeable — gap between the Greek government's ability to quickly cut the fiscal deficit and implement major supply-side reforms and privatisations, and the measures that creditor nations would require to extend further funding. Press reports suggest that the Greek government is seeking a two-year extension of the latest austerity

programme, with a slower pace of fiscal tightening[2]. In our view, such a request would suggest that the current programme is unachievable. At the same time, attitudes appear to be hardening among official bodies and especially creditor nations, with a growing reluctance to do "whatever it takes" to keep Greece in EMU and a growing willingness to contemplate the likelihood that one or more countries will exit EMU:

- ECB Executive Board Member Jörg Asmussen argued: "*a Greek exit would be manageable*"[3].
- German Finance Minister Wolfgang Schäuble warned: *"I have always said that we can help the Greeks, but we cannot responsibly throw money into a bottomless pit."*[4]
- Volker Kauder, leader of Ms Merkel's conservative party in the Bundestag, said: *"There is no more latitude, either on the timeframe or the matter itself . . . The Greeks must at some point answer the question: do we perhaps make even more of an effort, or do we leave the euro?"*[5]
- Finland's Foreign Minister, Erkki Tuomioja, advised: "*We have to face openly the possibility of a euro-break up*".[6]

There is a busy timetable of key meetings and events in coming weeks

However, Grexit still is not inevitable. In particular, it appears that no one wants to be blamed for actually causing it. There is a crucial series of meetings and events in coming weeks that may clarify how this dilemma will play out:

- 27 August: Troika officials expected back in Greece, with senior officials expected around 3-5 September.
- 6 September: ECB meeting and press conference, when the ECB is likely to present details of the CGBPP.
- Around September 11: EU Commissioner Michel Barnier will present the proposal for a single bank supervisor (the ECB) in the euro area
- 12 September: German constitutional court will rule on the legality of the ESM. If the court decides in favour, the German president can sign the ESM treaty immediately. Germany is the final signatory needed for the treaty to enter into effect. Once all ESM member states pay their obligations to the first capital tranche, the fund will become operational. However, the court may also require additional information, particularly on the ECB's bond purchase plans under existing ESM programmes, before making a final ruling. Anything other than a positive ruling from the court will prevent Germany ratifying the treaty in the short-term.
- 12 September: Dutch election, with polls pointing to an inconclusive result, which could inhibit approval of further EMU rescue measures[7].

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[2] See the Financial Times, 14 August 2012 and 22 August 2012.

[3] Quote by Reuters from article in the Frankfurter Rundschau, 20 August 2012.

[4] Quote in the Financial Times, 20 August 2012.

[5] Quote in the Financial Times, 20 August 2012, translated from Der Spiegel.

[6] Quote in the Daily Telegraph, 17 August 2012.

[7] See "Global Political Insights - Glorious 12th? Dutch Elections and German Court's ESM Decision, Tina Fordham and Jürgen Michels, 20 August 2012, Citi.

- 13-14 September: Meeting of G20 Finance Ministers and central bank Governors in Mexico.
- 14-15 September: informal meeting of European finance ministers (ECOFIN) with central bank Governors.
- During September: Troika assessment on Greece

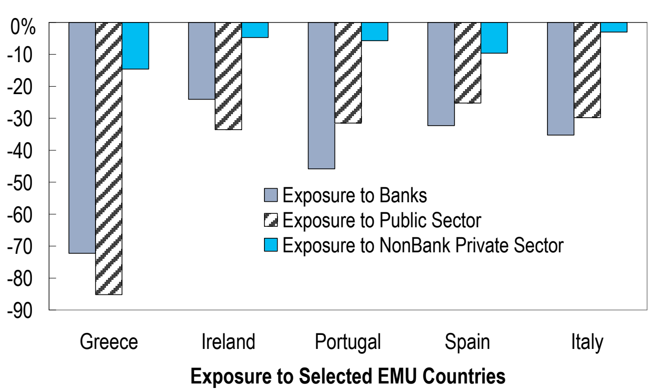
There is a range of factors that may determine the precise timing of Grexit, if it happens

The precise timing of Grexit, if it happens, remains uncertain. It could even occur as soon as September/October, if the upcoming Troika report confirms that Greece's programme is off-track and creditor nations are unwilling to provide Greece any funding extension or extra time. However, creditor nations may provide enough funding to delay Grexit to after the December review, for example to allow plans for common bank supervision to be finalised. This might ensure that if Grexit prompts wider bank recapitalisation needs (in the other euro area countries), these can be mutualised via the ESM (either immediately or at a later stage). A deferral beyond September also would be more likely if the German Constitutional Court causes a delay in ESM ratification. Or, the Greek establishment may accept at some stage that it will be unable (or unwilling) to implement the measures required to stay inside EMU and decide itself that Grexit is inevitable. In our forecasts, we continue to assume, for the sake of argument, that Grexit occurs on 1 January 2013, but we stress that this is an assumption rather than a forecast.

Grexit, if it happens, is likely be accompanied by some form of capital controls in Greece, and we stress that redenomination need not be uniform

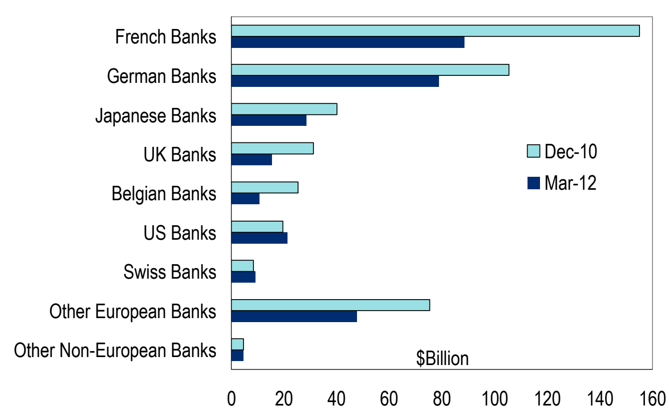
The exact mechanics of Grexit also are uncertain. We envisage an extended bank holiday and some form of capital controls and limits on deposit withdrawals in Greece (and perhaps some temporary restrictions in some other EMU countries as well). Prior examples highlight that currency redenomination need not be uniform: for example, when Argentina abandoned its currency peg to the US$ in 2002, the government decided to apply a 1-to-1 exchange rate for Bank loans and a 1.4-to-1 exchange rate to deposits. Moreover, when East Germany adopted the Deutsche Mark as legal tender on July 1, 1990, just ahead of German unification in October of the same year, the East German mark was converted at par for wages, prices, pensions and savings up to a limit of 4000 East Mark/person. Financial claims, including corporate and housing loans, and savings in excess of 4000 East Mark were converted at a ratio of 2:1 into the Deutsche Mark. We assume that a new Greek currency would fall by about 60%, pushing inflation markedly higher in 2013-16, but the scale of currency decline is highly uncertain.

Figure 6. EMU — Exposure of Foreign Banks to Greece, Portugal, Ireland, Italy and Spain, Pct. Change from Q4-2010 to Q1-2012



Sources: BIS and Citi Research

Figure 7. EMU -- Combined Exposure of Foreign Banks to Public Sectors of Greece, Portugal, Ireland, Italy and Spain, 2010-12,



Note: Data measured on ultimate risk basis. Sources: BIS and Citi Research

Grexit, if it happens, probably would trigger a significant policy response, with central bank liquidity, some easing moves and easing of nearterm fiscal targets for periphery EMU countries

With policymakers aware that Grexit could be a "Lehman" moment — that causes massive unanticipated disruption — Grexit (if it happens) would be likely to prompt a huge policy response, with policymakers using conventional and unconventional tools. The approach would, we expect, be to err on the side of being overly generous rather than emphasise longrun moral hazard or inflation concerns. Greece itself probably would receive financial assistance from the IMF and EU, while the ECB (and other central banks) probably would provide extensive extra liquidity and, in some cases, monetary policy easing as well. In addition, assistance for Italy and Spain would likely be promptly activated (if it is not already in place) with little or no extra conditionality on top of what has already been agreed. Fiscal targets for other periphery EMU countries will probably be eased, at least for 2012 and 2013.

Foreign banks already have sharply cut exposure to Greece and other periphery countries

There are signs that investors already have taken steps to reduce exposure to Greece and other periphery countries. BIS data show that since Q4-10, foreign banks already have cut exposure (on an ultimate risk basis) to Greek banks by 72% and cut exposure to the Greek public sector by 85%, with sharp (but less severe) cuts in exposure to banks and the public sectors in Portugal, Ireland, Italy and Spain. The credit exposure of foreign banks to the Greek public sector in Q1 this year was just $6.9bn. Holdings of Italian public debt among foreign banks have fallen from $262bn in Q4-2010 to $184bn in Q1-2012. In addition, private sector deposits at Greek banks have fallen by 36% from their peak, with declines in deposits of 9% at Spanish banks, 12% at Irish banks and 7% at Portuguese banks.

We do not believe Grexit would be a cathartic event that ends the EMU crisis

Even so, we doubt that potential Grexit and the resultant policy responses would be a cathartic event that ends EMU strains. Indeed, we suspect that Grexit, if it happens, probably would intensify the withdrawal of private sector funds from periphery EMU countries. Grexit would fundamentally change the nature of EMU, establishing that exit can occur. Greece's non-compliance with its programme is unique at present. But, there are echoes of Greece's economic problems — persistent economic weakness, poor external competitiveness, fragile banking system and unsustainable fiscal trends – in a range of other periphery countries.

Figure 8. Selected Countries — Industrial Production Forecasts (Pct.), 2011-13F

	2011	2012F	2013F
World	**3.8%**	**2.2%**	**2.8%**
United States	4.1	4.1	2.8
Japan	-2.4	2.3	3.1
Euro Area	3.5	-2.4	-1.5
United Kingdom	-0.7	-2.5	0.9
Canada	3.5	0.2	0.5
China	13.9	10.5	11.1
India	3.4	3.9	4.4
Korea	6.9	3.7	4.9
Brazil	0.3	-2.5	2.9

Source: Citi Research

We think the EMU end-game is likely to be a mix of EMU exit (Greece), a significant amount of sovereign debt and bank debt restructuring (Portugal and, eventually, perhaps Ireland, Italy and Spain), with only limited official fiscal burden sharing (via the ESM, EFSF and ECB losses) and ongoing liquidity support from the ESM and the ECB. We still expect that Portugal will get a second bailout (or a prolonged extension of the current programme), with no PSI initially but a high chance of PSI and OSI over the next three years or so[8]. Ireland may well also need some external assistance beyond the end of the current programme, although — with the deficit likely to undershoot official forecasts and evidence that the country has some access to markets — this may take the form of partial funding via the EFSF/ESM and the backstop of ECB market purchases if needed.

Longer term, risks remain of more widespread sovereign debt restructuring in EMU

Nevertheless, for Portugal, Ireland, Italy and Spain, the crisis looks set to leave a legacy of high unemployment and very high government debt/GDP ratios (90%+, and, in most cases, well above that level). We doubt that any of these countries will be able to sustain normal market access at a tolerable yield without the backstop of official support in coming years. There are arguments in favour of implementing widespread debt restructuring early, to limit the extent to which restructuring risks hang over the system and paralyse decision-making. However, in practice we suspect the process will be lengthy and drawn-out over several years, because of hopes that periphery countries can grow their way back to fiscal sustainability and widespread reluctance to inflict early losses on the already-weak banking system.

[8] See "Euro Economics Weekly - Focus on Portugal", Jürgen Michels, 17 August 2012, Citi

Figure 9. Citi Global Economics Team *For Informational Purposes Only*

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Source: Citi Research.

Figure 10. Selected Countries — Economic Forecast Overview (Percent), 2011-2016F

	GDP Growth						CPI Inflation						Short-Term Interest Rates					
	2011	2012F	2013F	2014F	2015F	2016F	2011	2012F	2013F	2014F	2015F	2016F	2011	2012F	2013F	2014F	2015F	2016F
Global	**3.0**	**2.5**	**2.8**	**3.4**	**3.6**	**3.9**	**3.6**	**2.8**	**2.8**	**3.0**	**2.8**	**2.8**	**2.45**	**2.29**	**2.22**	**2.50**	**2.84**	**3.23**
Based on PPP weights	*3.7*	*3.0*	*3.2*	*3.8*	*3.9*	*4.2*	*4.1*	*3.2*	*3.2*	*3.3*	*3.1*	*3.1*						
Industrial Countries	**1.3**	**1.3**	**1.0**	**1.8**	**2.2**	**2.6**	**2.3**	**1.7**	**1.6**	**1.9**	**1.5**	**1.5**	**0.76**	**0.57**	**0.47**	**0.58**	**0.93**	**1.51**
United States	**1.8**	**2.2**	**1.9**	**3.5**	**3.5**	**4.0**	**2.4**	**1.8**	**1.9**	**2.1**	**2.2**	**2.2**	**0.25**	**0.25**	**0.25**	**0.40**	**1.15**	**2.10**
Japan	**-0.8**	**2.7**	**1.8**	**0.2**	**1.5**	**1.2**	**-0.3**	**0.2**	**-0.1**	**2.6**	**0.3**	**0.5**	**0.10**	**0.10**	**0.10**	**0.10**	**0.10**	**0.27**
Euro Area	**1.5**	**-0.6**	**-1.0**	**0.3**	**0.7**	**1.4**	**2.7**	**2.4**	**2.0**	**1.4**	**1.0**	**0.9**	**1.19**	**0.69**	**0.25**	**0.25**	**0.31**	**0.69**
Canada	2.4	2.0	2.2	2.8	3.2	3.5	2.9	1.7	1.9	2.0	2.0	2.0	1.00	1.00	1.63	2.19	2.50	3.00
Australia	2.1	3.7	3.4	3.8	3.8	3.6	3.4	1.8	3.2	2.9	2.7	2.5	4.75	3.69	3.69	4.10	4.60	4.75
New Zealand	1.3	2.3	2.8	3.0	3.2	3.4	4.0	1.5	2.2	2.6	2.9	2.8	2.50	2.50	2.94	3.60	4.20	4.80
Germany	3.1	1.1	0.6	0.4	0.8	1.5	2.3	2.0	2.2	2.6	2.3	2.3						
France	1.7	-0.1	-0.2	0.9	1.2	1.8	2.1	2.0	1.2	1.3	1.7	1.5						
Italy	0.5	-2.5	-2.2	-0.3	0.4	0.4	2.9	3.2	2.3	0.3	-0.1	0.9						
Spain	0.7	-1.7	-3.3	-0.9	0.7	2.2	3.1	2.1	3.0	0.8	0.8	1.3						
Greece	-6.9	-7.6	-10.2	-0.9	4.1	4.4	3.1	0.8	14.9	18.9	6.2	5.9						
Ireland	1.4	-0.5	0.6	2.7	2.3	2.7	0.2	1.4	1.0	1.3	1.4	1.4						
Portugal	-1.6	-3.9	-6.1	-0.9	1.3	1.6	3.6	2.8	2.3	0.8	0.1	0.1						
Netherlands	1.1	-0.7	-1.0	0.8	1.0	1.1	2.3	2.7	2.7	1.6	1.9	1.8						
Belgium	1.8	-0.2	-0.2	0.7	1.4	1.8	3.5	2.6	1.5	1.9	2.2	2.2						
Denmark	0.8	0.7	1.4	1.6	1.7	1.8	2.8	2.5	1.7	1.5	1.6	1.8	1.30	0.94	0.25	0.30	0.41	0.94
Norway	2.5	3.0	2.9	2.7	2.7	2.9	1.3	0.8	1.6	2.0	2.4	2.5	2.10	1.50	1.90	2.30	2.90	3.30
Sweden	4.0	1.1	1.9	2.3	2.5	2.7	3.0	1.0	1.5	2.3	2.1	2.0	1.80	1.20	1.10	1.60	2.10	2.50
Switzerland	2.1	1.9	1.0	0.8	0.9	0.9	0.2	-0.8	-1.3	-0.9	0.4	0.6	0.22	0.00	0.00	0.00	0.00	0.00
United Kingdom	0.7	-0.6	0.5	0.8	1.2	1.9	4.5	2.6	1.7	1.7	1.8	1.8	0.50	0.50	0.50	0.50	0.50	1.04
Emerging Markets	**6.0**	**4.7**	**5.5**	**5.7**	**5.7**	**5.7**	**6.0**	**4.6**	**4.7**	**4.7**	**4.7**	**4.6**	**5.51**	**5.16**	**4.97**	**5.38**	**5.60**	**5.61**
China	**9.2**	**7.9**	**8.0**	**7.6**	**7.3**	**7.0**	**5.4**	**2.7**	**2.9**	**3.8**	**4.0**	**4.0**	**3.22**	**3.16**	**3.00**	**3.63**	**4.00**	**4.00**
Taiwan	4.0	2.4	3.6	4.5	4.5	4.5	1.4	1.9	2.1	1.8	1.8	1.8	0.82	0.87	0.87	0.98	1.17	1.40
India	6.5	5.4	6.2	7.0	7.3	7.4	8.9	8.0	7.0	6.0	6.0	6.0	8.20	7.80	7.50	7.50	7.50	7.50
Indonesia	6.5	6.2	6.3	6.6	6.5	6.5	5.4	4.4	4.7	5.3	5.8	5.4	5.43	4.03	4.25	4.50	4.63	5.13
Korea	3.6	2.8	3.6	3.9	4.1	4.2	4.0	2.4	2.8	3.1	3.0	3.2	3.20	3.00	2.56	3.25	4.00	4.38
Czech Republic	1.7	-1.2	0.6	1.8	2.2	2.8	1.9	3.3	2.5	1.4	2.0	1.8	0.75	0.49	0.05	0.55	1.50	2.25
Hungary	1.7	-0.9	0.8	2.0	2.0	1.8	3.9	5.6	3.9	3.5	3.1	3.3	6.04	6.94	5.75	5.50	5.44	5.00
Poland	4.3	2.6	2.2	2.8	3.3	3.3	4.3	3.9	2.7	2.5	2.5	2.5	4.22	4.67	3.88	4.13	4.71	4.75
Romania	2.5	1.3	3.0	4.2	4.3	4.3	5.8	2.8	2.7	2.5	2.5	2.5	6.19	5.25	5.00	5.00	5.00	5.00
Russia	4.3	3.5	4.0	4.1	4.0	4.2	8.4	5.1	6.9	5.8	5.5	5.0	8.12	8.00	7.08	6.00	5.96	5.42
Turkey	8.5	2.5	4.3	4.6	4.6	4.6	6.5	9.1	7.0	6.0	5.9	5.4	6.00	5.75	6.31	8.00	7.56	7.50
Nigeria	7.8	7.4	6.8	7.2	6.9	7.2	10.8	12.4	9.8	10.3	9.5	9.0	8.90	15.00	12.50	10.50	10.00	9.50
South Africa	3.1	2.7	3.6	4.2	4.4	4.2	5.0	5.8	5.0	5.2	5.3	5.3	5.50	5.25	5.00	5.29	5.50	5.50
Argentina	8.9	1.5	3.0	2.0	2.0	3.5	9.8	9.8	11.8	15.0	15.0	18.0	13.47	13.27	17.70	22.50	25.00	25.00
Brazil	2.7	1.4	3.9	4.5	4.5	4.5	6.6	5.3	5.4	4.5	4.0	4.0	11.71	8.46	7.92	9.38	9.00	8.25
Mexico	3.9	3.9	3.8	3.5	3.6	3.7	3.4	4.0	3.9	3.9	3.8	3.7	4.50	4.50	4.50	4.65	5.46	6.42
Venezuela	4.2	5.5	3.5	4.0	3.0	2.5	27.1	23.3	27.8	31.9	29.9	29.9	13.30	14.40	14.40	13.00	12.90	12.70

Note: For inflation, we use the PCE deflator in the US, wholesale price index in India, GDP deflator in Ireland. For Indonesia we refer to the FasB1 rate to reflect actual money market rates. Source: Citi Research

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

	Current Balance (Pct of GDP)						Fiscal Balance (Pct of GDP)						Government Debt (Pct of GDP)					
	2011	2012F	2013F	2014F	2015F	2016F	2011	2012F	2013F	2014F	2015F	2016F	2011	2012F	2013F	2014F	2015F	2016F
Global	**0.3**	**0.1**	**-0.1**	**-0.2**	**-0.2**	**-0.1**	**-4.9**	**-4.3**	**-3.5**	**-3.0**	**-2.6**	**-2.4**	**81**	**83**	**83**	**82**	**81**	**80**
Based on PPP weights	*0.6*	*0.3*	*0.0*	*-0.2*	*-0.2*	*-0.1*	*-4.2*	*-3.9*	*-3.3*	*-2.9*	*-2.6*	*-2.5*						
Industrial Countries	**-0.7**	**-0.9**	**-0.9**	**-0.8**	**-0.6**	**-0.5**	**-6.8**	**-5.7**	**-4.5**	**-3.8**	**-3.1**	**-2.9**	**108**	**113**	**115**	**116**	**117**	**117**
United States	**-3.1**	**-3.2**	**-3.2**	**-3.1**	**-3.2**	**-3.2**	**-9.4**	**-7.8**	**-5.9**	**-4.9**	**-4.0**	**-4.0**	**103**	**107**	**110**	**112**	**112**	**112**
Japan	**2.1**	**1.2**	**1.3**	**1.7**	**1.7**	**1.7**	**-10.7**	**-10.5**	**-8.0**	**-6.6**	**-6.2**	**-5.8**	**228**	**235**	**241**	**242**	**246**	**250**
Euro Area	**0.0**	**0.3**	**0.2**	**0.3**	**0.5**	**0.6**	**-4.1**	**-3.3**	**-2.8**	**-2.4**	**-1.9**	**-1.4**	**87**	**96**	**96**	**96**	**96**	**95**
Canada	-2.8	-3.2	-3.0	-2.5	-1.8	-1.2	-1.4	-1.2	-0.5	-0.1	0.2	0.4	85	85	84	83	81	79
Australia	-2.3	-4.1	-5.3	-4.9	-3.5	-3.2	-3.4	-3.0	0.1	0.1	0.3	0.4	26	29	28	27	25	23
New Zealand	-4.2	-5.0	-7.0	-6.4	-5.8	-5.5	-9.2	-4.1	-3.6	-0.9	0.1	0.9	36	39	39	43	42	44
Germany	5.7	5.7	4.0	3.4	3.2	3.7	-1.0	-0.3	-0.3	-0.6	-0.5	-0.4	81	83	83	82	80	79
France	-2.2	-1.9	-1.1	-0.3	0.3	0.4	-5.2	-4.3	-3.8	-3.4	-2.5	-1.7	86	93	98	100	99	98
Italy	-3.3	-1.7	-1.3	-1.1	-1.0	-0.9	-3.9	-3.0	-3.0	-2.8	-2.5	-2.1	120	129	136	139	140	141
Spain	-3.5	-2.2	0.1	2.3	1.9	1.6	-8.9	-6.5	-5.5	-3.7	-3.2	-1.8	69	93	93	95	96	94
Greece	-9.8	-6.6	-2.1	1.8	3.5	4.1	-9.1	-11.2	-5.5	-4.9	-3.5	-6.9	165	156	431	425	122	106
Ireland	1.1	-0.2	1.4	3.6	4.9	6.2	-12.8	-7.9	-7.8	-5.0	-3.6	-3.3	108	118	124	123	121	120
Portugal	-8.1	-4.5	-2.5	-1.5	-1.4	-1.0	-4.2	-4.7	-5.7	-5.7	-3.3	-2.4	108	122	135	90	93	94
Netherlands	8.5	9.6	9.6	8.6	7.6	7.2	-4.7	-4.3	-3.7	-3.6	-2.8	-2.3	65	72	75	78	78	78
Belgium	-1.0	-0.1	0.4	1.2	2.1	2.5	-3.7	-2.7	-2.2	-2.2	-1.6	-1.3	98	112	118	117	115	112
Denmark	6.7	5.5	5.4	4.0	3.5	3.7	-1.9	-3.5	-2.0	-1.9	-1.7	0.5	47	49	49	50	50	48
Norway	14.0	14.3	14.9	15.2	15.8	16.5	13.8	13.6	14.0	15.0	17.0	18.5	NA	NA	NA	NA	NA	NA
Sweden	7.0	7.0	7.2	7.3	7.2	7.3	0.1	-0.1	-0.2	0.5	1.2	1.5	37	36	35	33	31	28
Switzerland	14.8	12.9	11.7	10.6	10.6	11.0	0.7	0.8	0.4	0.3	0.0	-0.4	52	51	50	50	49	49
United Kingdom	-1.9	-2.7	-2.2	-1.5	-0.5	0.2	-8.2	-6.9	-8.2	-7.8	-7.4	-6.6	82	88	96	103	109	112
Emerging Markets	**2.1**	**1.7**	**1.1**	**0.6**	**0.5**	**0.5**	**-1.4**	**-1.9**	**-1.8**	**-1.7**	**-1.8**	**-1.9**	**33**	**32**	**32**	**31**	**30**	**29**
China	**2.8**	**2.0**	**1.5**	**1.0**	**1.0**	**1.0**	**-1.3**	**-2.4**	**-1.5**	**-1.0**	**-1.0**	**-1.0**	**15**	**16**	**16**	**16**	**15**	**15**
Taiwan	8.8	8.7	8.4	8.0	8.0	8.0	-1.9	-1.6	-1.6	-1.3	-1.0	-0.7	39	39	40	42	43	44
India	-4.2	-3.0	-2.1	-1.5	-1.0	-0.3	-8.4	-8.5	-8.0	-7.5	-7.0	-6.5	69	69	68	66	64	63
Indonesia	0.2	-2.3	-1.5	-1.2	-1.3	-0.9	-1.2	-2.1	-0.7	-1.0	-0.5	-0.5	26	25	24	23	23	22
Korea	2.4	2.1	1.9	1.2	0.2	-0.7	1.5	0.8	1.3	1.6	1.5	2.2	33	34	33	31	29	27
Czech Republic	-3.0	-3.0	-1.9	-2.2	-1.7	-1.3	-3.1	-3.2	-3.1	-2.3	-1.5	-0.5	41	45	47	47	46	45
Hungary	1.7	1.9	2.7	2.5	2.2	2.0	4.3	-3.1	-3.7	-3.0	-3.0	-3.0	81	78	79	78	78	78
Poland	-4.3	-3.6	-4.2	-5.0	-5.2	-5.1	-5.1	-3.3	-2.9	-2.4	-2.1	-2.1	54	52	51	50	49	48
Romania	-4.4	-4.5	-4.7	-5.0	-5.0	-5.0	-4.1	-2.4	-2.2	-2.5	-2.3	-2.0	39	39	39	39	38	37
Russia	5.3	5.7	2.4	-1.0	-1.0	-1.0	2.0	0.3	0.1	-0.1	-1.1	-1.1	8	9	8	8	8	8
Turkey	-10.0	-7.5	-7.1	-6.6	-6.1	-5.7	-1.3	-2.2	-2.5	-2.5	-2.7	-3.0	41	41	39	39	38	36
Nigeria	3.4	2.3	3.5	3.0	1.9	1.3	-3.1	-2.2	-2.1	-2.6	-3.0	-2.6	NA	NA	NA	NA	NA	NA
South Africa	-3.4	-4.7	-5.6	-6.6	-6.3	-5.8	-5.0	-4.8	-4.2	-3.6	-3.5	-3.5	38	41	42	43	43	42
Argentina	0.0	0.3	-0.8	-1.0	-1.0	-1.0	-1.7	-2.8	-3.0	-3.0	-3.0	-3.0	40	38	40	41	42	43
Brazil	-2.3	-2.3	-2.7	-3.0	-3.3	-3.6	-2.6	-1.9	-2.7	-2.5	-2.3	-2.6	54	54	55	55	56	56
Mexico	-0.8	-1.0	-1.4	-2.5	-2.4	-2.6	-2.5	-2.2	-2.0	-1.9	-1.9	-1.8	40	40	38	38	38	37
Venezuela	9.1	4.8	3.7	5.6	5.8	5.0	-5.0	-5.0	-4.0	-5.2	-5.0	-4.8	43	34	34	35	35	36

Note: Fiscal deficit and debt figures for all countries are general government debt and deficits. We assume sovereign debt restructuring in Portugal in 2014 and Greece in 2015. Source: Citi Research

Figure 12. 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	2012F	2013F	2011	2012F	2013F	2011	2012F	2013F	2011	2012F	2013F
Global					**0.1**	**0.1**				**0.5**	**0.4**	**0.4**
Based on PPP weights	*0.1*		*-0.1*	*-0.1*	*0.1*	*0.2*	*0.1*	*0.1*		*0.7*	*0.6*	*0.6*
Industrial Countries		**0.2**	**-0.1**			**0.1**				**0.1**	**0.2**	
United States	**0.1**	**0.3**	**-0.1**	**-0.1**	**0.1**	**0.3**				**0.2**	**0.3**	
Japan	**-0.1**		**-0.3**				**0.1**	**0.2**	**0.1**			**-0.1**
Euro Area			**-0.1**		**0.1**	**0.2**		**0.1**				
Canada						0.1		-0.5	-0.8			
Australia												
New Zealand												
Germany		-0.1	-0.2					0.5	0.3			-0.1
France		0.1				-0.1					0.1	
Italy					0.2	0.5	-0.1	0.6	0.5		-0.1	-0.1
Spain		0.1			0.3	0.9		0.7	2.4			0.4
Greece		-0.1	-0.1		-0.2	-0.2		1.1	1.3		-0.2	-0.3
Ireland		0.2			0.6	0.8		-0.3	-1.1		0.4	0.8
Portugal		0.7	-0.5		0.3	0.8					0.3	0.1
Netherlands		0.7	-0.4		-0.1	0.2		-0.1			0.3	
Belgium	-0.2	-0.4			0.1	0.2		1.2	1.2		0.1	0.4
Denmark	-0.2		0.1				0.1					
Norway					-0.1	-0.1						
Sweden		0.7			-0.2	-0.1						
Switzerland		0.5	0.2		0.1	0.1		0.5	0.6		0.3	0.3
United Kingdom		-0.1	0.2		0.1	-0.1		-0.1	-0.8	0.2		
Emerging Markets		**-0.2**			**0.1**	**0.1**					**-0.1**	
China												
Taiwan												
India		-1.0	-0.7		0.6	0.5	-0.2	0.5	0.5		-0.5	-0.3
Indonesia		0.1						-0.4	-0.3		-0.3	
Korea					-0.4	-0.2		0.3			-0.4	-0.2
Czech Republic		-0.1			-0.2	-0.1		-0.1				
Hungary												
Poland		-0.1	-0.2			0.1		0.2	0.3		-0.2	-0.4
Romania												
Russia												
Turkey									-0.1			
Nigeria												
South Africa												
Argentina												
Brazil		-0.4	-0.6		0.2	0.2						
Mexico												
Venezuela		0.5						-2.4	-0.4			

Source: Citi Research

Figure 13. 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	2012F	2013F	2014F	2015F	2016F	2011	2012F	2013F	2014F	2015F	2016F	2011	2012F	2013F	2014F	2015F	2016F
Industrial Countries																		
United States	**2.80**	**1.75**	**2.20**	**3.00**	**3.40**	**3.75**	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**	**1.39**	**1.26**	**1.18**	**1.24**	**1.29**	**1.33**
Japan	**1.12**	**0.90**	**1.18**	**1.25**	**1.75**	**1.75**	**79**	**81**	**81**	**84**	**84**	**84**	**110**	**102**	**95**	**104**	**109**	**112**
Euro Area	**2.71**	**1.50**	**1.45**	**2.00**	**2.50**	**3.00**	**1.39**	**1.26**	**1.18**	**1.24**	**1.29**	**1.33**	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**
Canada	2.78	1.85	2.59	3.40	3.50	3.75	1.01	1.00	0.99	0.97	0.96	0.96	1.39	1.26	1.17	1.21	1.25	1.28
Australia	4.63	3.25	3.70	4.40	4.90	5.30	1.01	1.03	0.98	0.95	0.93	0.91	1.37	1.23	1.20	1.31	1.38	1.46
New Zealand	4.74	3.58	3.94	4.60	5.25	5.75	0.77	0.81	0.74	0.69	0.68	0.66	1.79	1.57	1.59	1.79	1.91	2.02
Germany	2.71	1.50	1.45	2.00	2.50	3.00												
France	3.31	2.53	2.18	2.70	3.15	3.60												
Italy	5.19	6.18	6.95	7.00	7.00	6.50												
Spain	5.43	6.41	6.95	6.80	6.70	6.20												
Netherlands	3.04	1.99	1.99	2.40	2.85	3.30												
Belgium	4.21	3.06	2.50	2.90	3.35	3.80												
Denmark	2.80	1.30	1.29	2.05	2.65	3.25	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Norway	3.07	2.06	2.04	2.60	3.20	3.75	5.66	5.92	6.12	5.85	5.66	5.48	7.84	7.48	7.20	7.28	7.30	7.31
Sweden	2.66	1.51	1.50	2.05	2.60	3.25	6.60	6.75	6.86	6.62	6.45	6.31	9.14	8.53	8.07	8.23	8.33	8.41
Switzerland	1.53	0.70	0.64	0.80	1.50	2.10	0.90	0.95	1.02	0.97	0.96	0.95	1.25	1.20	1.20	1.20	1.23	1.27
United Kingdom	3.00	1.70	1.68	1.70	2.50	3.00	1.59	1.58	1.53	1.58	1.63	1.68	0.87	0.80	0.77	0.79	0.79	0.79
Emerging Markets																		
China	**3.52**	**2.72**	**2.61**	**3.30**	**3.67**	**3.67**	**6.46**	**6.35**	**6.31**	**6.16**	**6.12**	**6.09**	**9.00**	**7.97**	**7.47**	**7.95**	**8.12**	**8.23**
Taiwan	1.38	1.35	1.50	1.60	1.70	1.80	29.40	29.99	30.15	28.66	28.39	28.29	40.93	37.66	35.66	36.99	37.66	38.23
India	8.40	8.25	8.25	8.25	8.25	8.25	46.63	53.79	54.66	52.45	51.48	50.71	64.92	67.54	64.64	67.68	68.29	68.53
Indonesia	7.20	6.06	6.45	6.80	7.00	7.25	8763	9383	9625	9641	9596	9546	12201	11782	11383	12442	12729	12900
Korea	3.90	3.15	2.86	3.75	4.63	5.00	1108	1143	1163	1085	1049	1020	1542	1435	1375	1400	1391	1378
Czech Republic	3.68	3.04	3.16	3.46	3.82	4.00	17.7	20.1	21.7	19.1	17.9	16.9	24.6	25.3	25.7	24.6	23.7	22.9
Hungary	7.63	8.05	6.63	6.41	6.19	5.90	201	232	243	224	216	209	279	291	287	289	286	283
Poland	5.99	5.29	5.22	5.38	5.40	5.34	2.96	3.35	3.63	3.06	2.94	2.89	4.12	4.21	4.30	3.94	3.90	3.90
Romania	NA	NA	NA	NA	NA	NA	3.04	3.48	3.65	3.37	3.15	2.98	4.23	4.36	4.32	4.35	4.18	4.03
Russia	NA	NA	NA	NA	NA	NA	29.4	32.2	34.8	33.1	32.0	31.0	41.0	40.4	41.1	42.7	42.4	41.9
Turkey	NA	NA	NA	NA	NA	NA	1.68	1.80	1.86	1.86	1.88	1.91	2.34	2.25	2.20	2.40	2.50	2.58
Nigeria	NA	NA	NA	NA	NA	NA	156	161	165	163	165	164	217	202	195	210	219	222
South Africa	8.24	8.21	8.90	9.15	9.20	9.20	7.26	8.11	8.65	8.78	9.16	9.57	10.11	10.19	10.23	11.34	12.15	12.93
Argentina	NA	NA	NA	NA	NA	NA	4.13	4.58	5.46	6.90	7.94	9.36	5.74	5.75	6.45	8.90	10.53	12.65
Brazil	11.45	10.07	9.48	9.24	8.75	8.25	1.67	1.96	2.04	1.95	1.90	1.85	2.33	2.46	2.40	2.52	2.52	2.50
Mexico	6.83	5.77	6.17	6.72	6.99	7.29	12.4	13.0	13.1	12.4	12.5	12.8	17.3	16.5	15.8	16.0	16.6	17.2
Venezuela	13.65	12.44	12.64	13.90	13.80	13.70	4.29	4.30	6.50	6.50	9.75	9.75	5.98	5.40	7.69	8.39	12.93	13.18

*Per USD except Euro Area, Australia, New Zealand, United Kingdom. Source: Citi Research

Figure 14. Short Rates (End of Period), as of 22 Aug 2012 (Percent)

	Current	3Q 12	4Q 12	1Q 13	2Q 13	3Q 13	4Q 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	**0.75**	**0.50**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**
Canada	1.00	1.00	1.00	1.25	1.50	1.75	2.00
Australia	3.50	3.50	3.50	3.50	3.50	3.75	4.00
New Zealand	2.50	2.50	2.50	2.50	2.75	3.00	3.50
Denmark	0.20	0.05	0.00	0.00	0.00	0.00	0.00
Norway	1.50	1.50	1.50	1.75	1.75	2.00	2.00
Sweden	1.50	1.25	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	**3.00**	**2.75**	**2.75**	**2.75**	**2.75**	**3.00**	**3.25**

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

Figure 15. 10-Year Yield Forecasts (Period Average), as of 22 Aug 2012 (Percent)

	Current	3Q 12	4Q 12	1Q 13	2Q 13	3Q 13	4Q 13
United States	**1.78**	**1.60**	**1.65**	**1.80**	**2.10**	**2.35**	**2.60**
Japan	**0.83**	**0.80**	**0.95**	**1.10**	**1.20**	**1.10**	**1.30**
Euro area (Germany)	**1.54**	**1.40**	**1.20**	**1.25**	**1.30**	**1.50**	**1.80**
Canada	1.91	1.70	1.75	2.10	2.50	2.75	3.00
Australia	3.30	3.20	3.10	3.30	3.60	3.80	4.10
New Zealand	3.78	3.30	3.50	3.70	4.00	4.40	4.75
Denmark	1.24	1.15	0.90	0.95	1.10	1.40	1.70
Norway	2.13	2.00	1.80	1.85	1.90	2.05	2.35
Sweden	1.52	1.40	1.20	1.25	1.35	1.55	1.85
Switzerland	0.57	0.55	0.50	0.55	0.60	0.70	0.70
United Kingdom	1.68	1.50	1.40	1.40	1.50	1.75	2.05

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 Research

Figure 16. 10-Year Yield Spreads (Period Average), as of 22 Aug 2012

	Spread vs. US$						Spread vs. Germany					
	Current	3Q 12	4Q 12	1Q 13	2Q 13	3Q 13	Current	3Q 12	4Q 12	1Q 13	2Q 13	3Q 13
United States	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**	**25**	**16**	**46**	**56**	**81**	**86**
Japan	**-96**	**-76**	**-71**	**-71**	**-91**	**-126**	**-71**	**-60**	**-25**	**-15**	**-10**	**-40**
Euro Area	**-25**	**-16**	**-46**	**-56**	**-81**	**-86**	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**
Canada	13	15	10	30	40	41	38	31	56	86	122	127
Australia	154	167	147	152	152	147	179	183	192	208	233	234
New Zealand	203	177	187	193	193	208	228	193	233	248	274	295
France	36	74	34	24	-6	-16	63	90	80	80	75	70
Italy	389	454	554	544	469	464	416	470	600	600	550	550
Spain	444	544	554	544	469	464	471	560	600	600	550	550
Netherlands	8	24	14	4	-26	-36	35	40	60	60	55	50
Belgium	79	114	69	59	29	14	106	130	115	115	110	100
Denmark	-54	-41	-76	-86	-101	-96	-27	-25	-30	-30	-20	-10
Norway	35	44	14	4	-21	-31	62	60	60	60	60	55
Sweden	-26	-16	-46	-56	-76	-81	1	0	0	0	5	5
Switzerland	-121	-101	-116	-126	-151	-166	-94	-85	-70	-70	-70	-80
United Kingdom	-12	-6	-26	-41	-61	-61	14	10	20	15	20	25

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 Research

Figure 17. Emerging Market Countries — Short Rates Actual and Forecast of Additional Rate Moves (End of Period), as of 22 Aug 2012

Country	Current Rate (%)	Sep 12	Dec 12	Mar 13	Jun 13	Sep 13	Total Cumulative Rate Moves Expected
Turkey	5.75	0	0	0	0	75	75
Brazil	8.00	-50	-25	0	0	100	25
Indonesia	4.00	0	25	0	0	0	25
Mexico	4.50	0	0	0	0	0	0
South Africa	5.00	0	0	0	0	0	0
China	3.00	-25	0	0	0	25	0
Israel	2.25	-25	0	0	0	0	-25
Philippines	3.75	0	-25	0	0	0	-25
Czech	0.50	-25	-20	0	0	0	-45
Chile	5.00	0	-50	0	0	0	-50
Colombia	5.00	-50	-25	0	25	0	-50
India	8.00	0	-25	-25	0	0	-50
Korea	3.00	0	-25	-25	0	0	-50
Thailand	3.00	-25	-25	0	0	0	-50
Russia	8.00	0	0	-25	-25	-25	-75
Poland	4.75	0	0	-75	-25	0	-100
Hungary	7.00	0	-50	-50	-25	-25	-150

Source: Citi Research

Figure 18. Foreign Exchange Forecasts (End of Period), as of 22 Aug 2012

	vs. USD						vs. EUR					
	Current	Sep 12	Dec 12	Mar 13	Jun 13	Sep 13	Current	Sep 12	Dec 12	Mar 13	Jun 13	Sep 13
United States	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**	**1.23**	**1.25**	**1.21**	**1.17**	**1.16**	**1.18**
Japan	**80**	**81**	**81**	**80**	**80**	**81**	**98**	**101**	**97**	**94**	**93**	**96**
Euro Area	**1.23**	**1.25**	**1.21**	**1.17**	**1.16**	**1.18**	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**
Canada	0.99	0.98	0.99	1.00	1.00	0.99	1.22	1.22	1.19	1.17	1.16	1.17
Australia	1.05	1.05	1.02	0.99	0.98	0.97	1.18	1.19	1.18	1.18	1.19	1.21
New Zealand	0.81	0.82	0.79	0.76	0.74	0.73	1.52	1.52	1.53	1.53	1.56	1.61
Norway	5.94	5.97	6.06	6.16	6.18	6.10	7.31	7.44	7.32	7.21	7.16	7.19
Sweden	6.67	6.69	6.79	6.90	6.92	6.85	8.22	8.34	8.20	8.07	8.02	8.07
Switzerland	0.97	0.96	1.00	1.03	1.04	1.02	1.20	1.20	1.20	1.20	1.20	1.20
United Kingdom	1.57	1.58	1.55	1.52	1.51	1.53	0.79	0.79	0.78	0.77	0.77	0.77
China	**6.36**	**6.36**	**6.33**	**6.31**	**6.29**	**6.26**	**7.8**	**7.9**	**7.7**	**7.4**	**7.3**	**7.4**
India	55.7	55.0	55.4	55.8	55.7	54.9	68.7	68.6	66.9	65.3	64.5	64.8
Korea	1136	1121	1128	1136	1135	1123	1399	1396	1363	1330	1315	1324
Poland	3.30	3.22	3.45	3.69	3.76	3.61	4.07	4.02	4.17	4.32	4.36	4.25
Russia	32.1	31.6	33.1	34.6	35.3	34.9	39.5	39.4	40.0	40.5	40.9	41.2
South Africa	8.31	8.27	8.44	8.61	8.70	8.71	10.24	10.30	10.19	10.08	10.09	10.27
Turkey	1.80	1.77	1.82	1.86	1.88	1.87	2.22	2.21	2.19	2.17	2.18	2.21
Brazil	2.02	1.99	2.02	2.05	2.05	2.04	2.48	2.48	2.44	2.39	2.38	2.41
Mexico	13.1	12.7	13.0	13.3	13.3	13.1	16.1	15.9	15.7	15.5	15.4	15.4

Source: Citi Research

Figure 19. Foreign Exchange Forecasts (End of Period), as of 22 Aug 2012

	vs. JPY					
	Current	Sep 12	Dec 12	Mar 13	Jun 13	Sep 13
United States	**80**	**81**	**81**	**80**	**80**	**81**
Japan	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**
Euro Area	**98**	**101**	**97**	**94**	**93**	**96**
Canada	80	83	82	81	81	82
Australia	83	85	82	80	79	79
New Zealand	64.3	66.2	63.7	61.3	59.8	59.5
Norway	13.4	13.6	13.3	13.0	13.0	13.3
Sweden	11.9	12.1	11.9	11.6	11.6	11.9
Switzerland	82	84	81	78	78	80
United Kingdom	125	128	125	122	121	124
China	**13**	**13**	**13**	**13**	**13**	**13**
India	1.43	1.47	1.45	1.44	1.44	1.48
Korea	14.28	13.84	14.00	14.16	14.12	13.83
Poland	24.1	25.1	23.3	21.7	21.4	22.5
Russia	2.5	2.6	2.4	2.3	2.3	2.3
South Africa	9.6	9.8	9.5	9.3	9.2	9.3
Turkey	44.2	45.6	44.4	43.2	42.8	43.4
Brazil	39.4	40.6	39.9	39.2	39.1	39.7
Mexico	6.1	6.4	6.2	6.1	6.0	6.2

Source: Citi Research

Country Commentary

United States

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Rebounds in employment and consumer spending in July have eased fears that the expansion might be at risk. Although major downside threats remain due to scheduled fiscal tightening next year and the ongoing financial crisis in Europe, the U.S. recovery is proceeding on a modest 2% track. Consumer finances have benefited from faster income growth, slowing inflation and easier credit, while signs of a modest housing rebound have become more widespread. Still, the upside appears checked by ongoing fiscal drag and economic policy uncertainty holding back businesses. The forecast assumes that the U.S. will avoid the "fiscal cliff" in 2013 but modest restraint from the public sector is still likely next year and beyond.

Worries about downside risks have pushed the Fed closer to another major easing step. Our base case gives a slight nod to further eventual accommodation but this vigil is likely to extend well beyond the next few months and into 2013. For now, the improvement in key early Q3 data is likely to forestall action at their next meeting. In the meantime, Operation Twist has been extended and officials are likely to use public statements to underscore their readiness to buoy financial conditions, most likely through MBS purchases or a new lending program. Action remains contingent on either a serious financial shock or more credible evidence that economic momentum, particularly in labour markets, is stalling.

Despite prospective food crop shortfalls, we do not anticipate a change in relatively muted underlying inflation patterns. Wage and compensation measures have been range bound near 2% and longer-term inflation expectations have been stable, providing an element of monetary policy flexibility.

Figure 20. United States — Economic Forecasts, 2011-2013F

					2012				2013			
		2011	2012F	2013F	1Q	2QF	3QF	4QF	1QF	2QF	3QF	4QF
GDP	SAAR				2.0%	1.6%	2.2%	1.9%	1.0%	2.0%	3.0%	3.3%
	YoY	1.8%	2.2%	1.9%	2.4	2.2	2.5	1.9	1.7	1.8	2.0	2.3
Domestic Demand	SAAR				2.2	1.5	1.8	2.1	1.1	2.3	3.1	3.3
	YoY	1.8	2.0	2.0	2.1	2.0	1.9	1.9	1.6	1.8	2.1	2.4
Consumption	SAAR				2.4	1.5	2.0	2.3	1.2	2.1	3.0	3.3
	YoY	2.5	1.9	2.0	1.8	1.9	2.0	2.0	1.7	1.9	2.1	2.4
Business Investment	SAAR				7.5	5.6	4.8	4.3	4.3	5.8	6.8	7.7
	YoY	8.6	8.7	5.3	12.5	10.3	6.8	5.5	4.7	4.8	5.3	6.2
Housing Investment	SAAR				20.5	11.0	10.2	13.5	19.3	23.2	21.8	17.5
	YoY	-1.4	11.9	17.5	9.3	11.0	13.4	13.7	13.4	16.4	19.4	20.4
Government	SAAR				-3.0	-1.0	-1.1	-1.2	-2.9	-1.7	-1.2	-1.1
	YoY	-3.1	-2.0	-1.7	-2.2	-2.3	-1.8	-1.6	-1.6	-1.7	-1.8	-1.7
Exports	SAAR				4.4	6.5	4.0	3.7	4.3	5.0	5.9	6.9
	YoY	6.7	4.3	4.8	4.0	4.6	4.1	4.6	4.6	4.2	4.7	5.5
Imports	SAAR				3.1	4.0	2.4	3.2	4.5	4.8	6.0	5.9
	YoY	4.8	3.5	4.3	3.2	4.2	3.6	3.2	3.5	3.7	4.6	5.3
PCE Deflator	YoY	2.4	1.8	1.9	2.4	1.6	1.5	1.8	1.6	1.9	2.0	2.0
Core PCE Deflator	YoY	1.4	1.8	1.6	1.9	1.8	1.7	1.8	1.6	1.6	1.6	1.7
Unemployment Rate	%	9.0	8.2	8.0	8.3	8.2	8.2	8.1	7.9	8.0	8.0	7.9
Federal Gov't Balance (Fiscal Year)	$Bn	-1297	-1175	-875								
	% of GDP	-8.7	-7.6	-5.5								
General Gov't Balance (Cal Year)	% of GDP	-9.4	-7.8	-5.9								
Federal Debt	% of GDP	68	74	78								
General Gov't Debt	% of GDP	103	107	110								
Current Account	US$bn	-466	-505	-510	-549	-517	-473	-481	-479	-508	-509	-542
	% of GDP	-3.1	-3.2	-3.2	-3.5	-3.3	-3.0	-3.0	-3.0	-3.2	-3.1	-3.3
S&P 500 Profits (US$ Per Share)	YoY	14.7	5.3	4.9	8.9	6.5	1.0	5.1	2.7	5.3	4.6	6.8

Notes: F Citi forecast. E Citi Estimate. 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 Research

Japan

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We expect real GDP growth of 1.3% QoQ SAAR in the third quarter and 1.1% in the fourth quarter. Some observers expect the economy to lose steam in the second half as a tailwind from exogenous demand (i.e. car sales driven by eco-car subsidies and reconstruction demand from the earthquake) will taper off while exports remain lacklustre amid tepid growth in Japan's major trading partners. We, however, do not share this view and expect Japan's economy to hold firm thanks to resilience in domestic demand driven by reconstruction demand, improving labour conditions and stepped-up spending by the older generation.

Economic activity in 2013 likely will enjoy a strong tailwind of frontloaded spending ahead of the 3% point consumption tax rate hike scheduled in April 2014. Thanks to this factor, GDP will probably grow by about 1.8% in 2013 even though export growth is expected to be modest. However, we expect a sharp slowdown to meagre 0.2% growth in 2014, because 1) household spending likely will decline as rush demand drops out, and 2) real disposable income decreases as prices increase due to the tax hike. In our view, there is a real risk that an economic downturn in 2014 might affect political decisions on the second stage of the consumption tax hike to 10%, scheduled for October 2015.

We expect the BoJ to take additional easing action in late October when policymakers publish a semiannual economic outlook report. We anticipate that the BoJ's inflation forecasts will be revised down somewhat and that this will lead to additional easing action. However, the most likely option is probably to increase purchases of short-term and long-term JGBs under the asset purchase program. Its impact on financial conditions and activity will likely be limited. The government plans to introduce a supplementary budget including public works spending this autumn and this would exert moderate upward pressures on JGB yields.

Figure 21. Japan — Economic Forecasts, 2011-13F

					2012				2013			
		2011	2012F	2013F	1Q	2QF	3QF	4QF	1QF	2QF	3QF	4QF
Real GDP	YoY	-0.8%	2.7%	1.8%	2.8%	3.6%	2.1%	2.3%	1.3%	1.6%	2.0%	2.4%
	SAAR				5.5	1.4	1.3	1.1	1.7	2.6	2.6	2.7
Domestic Demand	YoY	0.2	3.1	1.9	3.6	3.6	2.9	2.3	1.5	1.7	1.9	2.4
	SAAR				4.7	1.6	1.9	1.1	1.5	2.4	2.7	3.0
Private Consumption	YoY	0.1	2.6	1.1	3.7	3.3	2.3	1.4	0.4	0.8	1.1	2.1
	SAAR				5.0	0.6	0.6	-0.3	0.8	2.2	1.8	3.8
Business Investment	YoY	1.2	4.1	4.1	3.1	5.7	6.2	1.5	3.9	3.4	4.3	4.8
	SAAR				-6.2	6.3	3.0	3.2	3.2	4.0	6.9	5.2
Housing Investment	YoY	5.7	1.7	12.6	0.2	4.1	0.3	2.4	8.7	12.0	15.2	14.5
Public Investment	YoY	-2.8	7.6	-1.0	8.9	3.2	8.0	10.5	5.0	0.3	-3.0	-6.0
Exports	YoY	-0.1	4.0	3.4	1.2	8.7	1.0	5.5	3.0	3.0	3.8	3.8
	SAAR				14.3	4.8	0.9	2.4	4.0	4.8	3.8	2.4
Imports	YoY	6.3	6.7	4.0	6.8	8.4	6.0	5.8	4.4	3.8	3.7	4.0
	SAAR				9.1	6.4	4.8	3.0	3.3	4.0	4.6	4.3
CPI	YoY	-0.3	0.2	-0.1	0.3	0.2	0.0	0.2	-0.3	-0.1	0.1	0.0
Core CPI	YoY	-0.3	0.0	0.0	0.1	0.0	-0.1	0.0	-0.2	-0.1	0.1	0.0
Nominal GDP	YoY	-2.8	1.8	1.7	1.5	2.4	1.3	1.8	1.0	1.5	1.8	2.2
Current Account	¥ tn	9.6	5.8	6.4	5.9	5.4	5.8	5.9	6.2	6.3	6.6	6.5
	% of GDP	2.1	1.2	1.3	1.2	1.1	1.2	1.2	1.3	1.3	1.4	1.3
Unemployment Rate	%	4.6	4.4	4.3	4.5	4.4	4.4	4.3	4.3	4.3	4.2	4.2
Industrial Production	YoY	-2.4	2.3	3.1	4.8	5.3	0.8	1.0	1.2	4.0	3.2	4.0
Corporate Profits (Fiscal Year)	YoY	-16.3	17.5	20.0								
General Govt. Balance (Fiscal Year)	% of GDP	-10.7	-10.5	-8.0								
General Govt Debt	% of GDP	228.0	235.0	241.0								

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 Research

Euro Area

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We leave our 2012 GDP forecast for the euro area unchanged at -0.6%, but we are cutting our GDP forecasts for 2013 (from -0.9% to -1.0%) and for 2014 (from +0.6% to +0.3%), the latter in particular reflecting additional austerity measures in Spain. Greece might manage to get some more months of funding from Troika. However, the increasing unwillingness of some creditor countries to expand support for Greece suggests that “Grexit” — to which we attach a probability of about 90% — could happen as early as September/October, potentially triggered by the end of Troika funding. In particular, if the German constitutional court approves Germany’s ESM participation, this would increase the probability of Grexit soon, in our view.

The ECB’s early-August decision to launch the Conditional Government Bond Purchase Programme (CGBPP) shows its willingness to take far-reaching measures to support EMU countries within its mandate. However, member states have to get into at least a light form of EFSF/ESM programme to benefit from ECB purchases in the secondary market. Purchases will focus on the short end of the curve and we expect that, in practice, purchases will be concentrated on treasury bills. This would allow the ECB to claim that it will not have a seniority position to existing holders of bills, although the ECB de-facto probably would gain a seniority position versus existing bond holders. We also expect that the ECB will continue to absorb the extra liquidity, probably through bill issuance. We do not expect that the ECB will introduce upper limits for periphery-bond spreads relative to Germany, because this would be likely to lead to conflicts with the required conditions. Regarding the other non-standard measures, we expect that there will be a further easing of collateral rules in September, probably including the cancellation of the extra 5% haircut for sovereign bonds below A- and also smaller haircuts for below A- private sector collateral. If and when Spain or Italy has sought support from the ESFS/ESM, we expect also the ECB to resume its multi-year LTRO programme. Likely backed by a weaker growth outlook, we expect the ECB to cut the refi rate to 0.5% in September and the deposit rate to -0.25%. During 4Q, we expect a reduction of the main refi and the deposit rate to 0.25% and -0.5%, respectively.

We publish further details of our European forecasts monthly in European Economic Forecast Highlights

Figure 22. Euro Area — Economic Forecasts, 2011-13F

					2012F				2013F			
		2011	**2012F**	**2013F**	**1Q**	**2QF**	**3QF**	**4QF**	**1QF**	**2QF**	**3QF**	**4QF**
Real GDP	YoY	1.5%	-0.6%	-1.0%	0.0%	-0.4%	-0.9%	-1.1%	-1.4%	-1.2%	-0.9%	-0.3%
	SAAR				0.1	-0.7	-1.7	-2.2	-1.0	0.1	-0.4	0.3
Final Domestic Demand	YoY	0.3	-1.3	-1.2	-0.9	-1.0	-1.6	-1.6	-1.7	-1.3	-1.2	-0.8
Private Consumption	YoY	0.2	-1.0	-1.0	-0.7	-0.6	-1.4	-1.4	-1.5	-1.1	-0.9	-0.5
Government Consumption	YoY	-0.3	-0.1	-1.0	0.0	0.0	-0.2	-0.2	-0.9	-1.0	-1.1	-1.2
Fixed Investment	YoY	1.6	-3.4	-2.2	-2.6	-3.4	-3.7	-3.9	-3.2	-2.3	-2.0	-1.3
— Business Equipment	YoY	3.7	-4.5	-3.1	-2.5	-4.1	-5.5	-5.9	-4.9	-3.4	-2.6	-1.4
— Construction	YoY	-0.8	-2.8	-1.5	-3.1	-3.1	-2.3	-2.6	-1.9	-1.5	-1.5	-1.2
Stocks (Contrib. to Y/Y GDP Growth)		0.2	-0.5	-0.1	-0.5	-0.8	-0.4	-0.2	0.0	-0.1	-0.1	-0.1
Exports	YoY	6.3	2.3	1.4	3.0	2.6	1.4	2.1	1.4	1.1	1.4	1.9
Imports	YoY	4.1	-0.5	0.7	-0.7	-0.8	-1.2	0.9	1.0	0.8	0.5	0.6
CPI	YoY	2.7	2.4	2.0	2.7	2.5	2.4	2.2	1.8	1.8	2.2	2.0
Core CPI	YoY	1.4	1.5	1.4	1.5	1.6	1.5	1.4	1.3	1.2	1.6	1.4
CPI Ex Energy and Food	YoY	1.7	1.8	1.5	1.9	1.8	1.6	1.6	1.4	1.5	1.7	1.5
Unemployment Rate	YoY	10.2	11.2	11.5	10.9	11.1	11.2	11.3	11.4	11.4	11.4	11.4
Current Account Balance	EUR bn	-3.2	30.4	15.3								
	% of GDP	0.0	0.3	0.2								
General Government Balance	EUR bn	-387.6	-311.5	-261.3								
	% of GDP	-4.1	-3.3	-2.8								
Primary Balance	% of GDP	-1.1	0.0	0.6								
General Government Debt	EUR bn	8,215.3	9,095.4	9,131.8								
	% of GDP	87.2	96.1	96.1								
Gross Operating Surplus	YoY	2.5	-0.5	0.3								

Sources: Eurostat and Citi Research

Germany

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With weakness in 2Q GDP and declines in lead guides, we are trimming our GDP forecast for 2012 to 1.1% from 1.2% last month and for 2013 to 0.6% from 0.8%. However, we expect that Germany will avoid slipping into recession as exports to non-EMU countries probably will offset weakness in intra-EMU exports. Recent comments from politicians suggest that the EMU crisis will play an important role in the campaigns for the 2013 state elections (which start as early as January) and the autumn 2013 general election. In this environment, it will probably become more difficult to get approval in the German parliament for additional euro area support measures, and risks are rising that the current government coalition will break up.

France

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French GDP growth was flat in Q2 according to INSEE's flash estimate. However, with downward revisions to earlier quarters, GDP rose only 0.3% YY: the economy had stalled. We are slightly raising our 2012 GDP growth forecast by 0.1ppt to -0.1% but leave the 2013 forecast unchanged at -0.2%. The recent supplementary budget probably will be enough to hit the 2012 budget deficit target of 4.5% of GDP. However, the lack of growth will likely pose problems for the 2013 Budget due in September. President Francois Hollande may have to ignore some dissent from the left wing of the Socialist Party as parliament gears up to ratify the fiscal compact treaty in the autumn. He will also need to instruct Prime Minister Jean-Marc Ayrault to find some sizeable supplementary savings with respect to government outlays.

Italy

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With thanks to Carla Clifton

We are keeping our forecast for Italy's GDP growth unchanged at -2.5% and -2.2% for 2012 and 2013. The 2Q data were roughly in line with our forecasts, but there is uncertainty over what kind of extra fiscal measures the government will announce in September. While the Finance Minster signalled larger asset sales to reduce the country's debt burden, we doubt such sales can generate substantial receipts in the near term. With the economy likely to remain weak, the government's fiscal targets are unlikely to be met and political uncertainty ahead of the April 2013 election is likely to rise. We believe that Italy will follow Spain in asking ESM/EFSF aid (supported by the ECB) before the year is over.

Figure 23. Germany, France and Italy — Economic Forecasts, 2011-13F

		Germany			France			Italy		
		2011	2012F	2013F	2011	2012F	2013F	2011	2012F	2013F
Real GDP	YoY	3.1%	1.1%	0.6%	1.7%	-0.1%	-0.2%	0.5%	-2.5%	-2.2%
Final Domestic Demand	YoY	2.3	1.0	1.5	0.9	0.2	0.2	-0.3	-3.9	-3.3
Private Consumption	YoY	1.4	1.0	1.3	0.3	-0.2	0.2	0.2	-2.7	-2.3
Fixed Investment	YoY	6.6	0.5	3.2	3.6	0.3	-0.3	-1.2	-10.3	-9.0
Exports	YoY	8.4	3.8	1.8	5.5	2.4	1.8	6.4	-0.1	-1.8
Imports	YoY	7.9	2.7	3.6	5.2	1.2	1.9	1.3	-8.4	-5.7
CPI	YoY	2.3	2.0	2.2	2.1	2.0	1.2	2.9	3.2	2.3
Unemployment Rate	%	6.0	5.5	5.5	9.2	9.6	9.4	8.5	10.6	11.9
Current Account	€bn	146.6	150.0	108.3	-43.4	-38.3	-21.7	-51.5	-26.8	-20.1
	% of GDP	5.7	5.7	4.0	-2.2	-1.9	-1.1	-3.3	-1.7	-1.3
General Govt. Balance	€bn	-26.6	-7.6	-8.9	-103.1	-88.4	-77.6	-62.4	-45.9	-45.6
	% of GDP	-1.0	-0.3	-0.3	-5.2	-4.3	-3.8	-3.9	-3.0	-3.0
Primary Balance	% of GDP	1.6	2.0	1.8	-2.6	-2.2	-1.5	1.0	2.5	3.0
General Govt. Debt	% of GDP	81.2	83.0	82.7	86.0	93.1	98.2	120.1	129.5	135.9
Gross Trading Profits	YoY	2.7	4.0	-0.5	3.0	0.0	1.0	NA	NA	NA

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

Spain

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With thanks to Deimante Kupciuniene

On August 3, PM Rajoy presented the medium-term budget guideline, including €102bn of budget cuts for 2012-14, but the new cuts mostly apply to 2014. We therefore keep our 2012 and 2013 growth forecasts mostly unchanged, but now expect Spain's GDP to fall by 0.9% in 2014 (July: +0.2%). We still expect general-government deficit overshoots in 2012-14 (but by less than before in 2014) and expect Spain to request a sovereign bail-out from the EFSF/ESM in the next few months, likely supported by the ECB with secondary market purchases.

Greece

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With thanks to Carla Clifton

Although the Q2 GDP figure shows a smaller contraction on a YY comparison than in Q1, we believe that the outlook for the rest of the year remains very weak. The delay of the Troika disbursements to the Government will likely add to other headwinds facing the Greek economy. Looking ahead, we continue to put the probability of Greece leaving the euro in the next 12-18 months at 90%. One scenario is that the Government will acknowledge that the country cannot deliver the planned fiscal savings over the currently agreed two-year period, and yet creditor nations will be unwilling to agree the two-year extension sought by the Greek government. Such an outcome could see Troika funding ended in coming months.

Ireland

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Our growth forecasts for Ireland are little changed this month, with GDP falling 0.5% in 2012 and rising 0.6% in 2013 (down 0.7% and up 0.6% respectively last month). With the recent upward revisions to nominal GDP growth and solid revenue gains in the monthly fiscal data, we have cut our 2012 deficit forecast to 7.9% of GDP from 8.3% last month, hence forecasting a modest undershoot versus the government's forecast (8.3% of GDP). But, with the economy recently weakening, we expect that future deficit figures will probably overshoot official forecasts, keeping Ireland's debt/GDP ratio at about 120% even in 2016.

Portugal

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With thanks to Carla Clifton

We revised our forecast for Portugal's GDP for 2012, up from a contraction of 4.6%, to a contraction of 3.9% to reflect the Q2 GDP growth figure, which although worse than the consensus, was not as bad as we feared. However, we revised down our forecast for 2013, from a contraction of 5.6% to a contraction of 6.1%. We expect Portugal could suffer from the joint impacts of a potential Grexit, recession in Spain and the continuation of widespread deleveraging at home. We expect Portugal to continue to stay on an unsustainable fiscal path and that debt restructuring will take place sometime in 2013-15, although the country is likely to stay in the euro area.

Figure 24. Spain, Greece, Ireland and Portugal — Economic Forecasts, 2011-13F

		Spain			Greece			Ireland			Portugal		
		2011	2012F	2013F	2011	2012F	2013F	2011	2012F	2013F	2011	2012F	2013F
Real GDP	YoY	0.7%	-1.7%	-3.3%	-6.9%	-7.6%	-10.2%	1.4%	-0.5%	0.6%	-1.6%	-3.9%	-6.1%
Final Domestic Demand	YoY	-1.7	-4.2	-5.5	-9.6	-11.7	-12.3	-4.3	-1.4	-3.6	-5.3	-7.6	-6.7
Private Consumption	YoY	-0.1	-1.9	-3.6	-7.1	-10.2	-12.1	-2.4	-2.6	-2.9	-4.0	-7.8	-5.8
Fixed Investment	YoY	-5.1	-9.5	-8.4	-20.6	-21.9	-19.2	-12.8	1.8	-9.5	-11.4	-12.0	-12.4
Exports	YoY	9.1	0.2	2.5	-0.8	-3.3	-1.3	5.0	5.4	4.3	7.6	4.1	-0.2
Imports	YoY	-0.1	-6.6	-4.7	-8.0	-17.9	-10.4	-0.3	4.8	1.9	-5.2	-5.6	-2.2
CPI	YoY	3.1	2.1	3.0	3.1	0.8	14.9	0.2	1.4	1.0	3.6	2.8	2.3
Unemployment Rate	%	21.7	24.9	26.7	17.4	23.8	29.3	14.4	15.6	17.5	12.7	15.7	18.8
Current Account	€bn	-37.5	-23.5	1.0	-21.1	-13.2	-3.7	1.8	-0.3	2.3	-13.9	-7.5	-3.9
	% of GDP	-3.5	-2.2	0.1	-9.8	-6.6	-2.1	1.1	-0.2	1.4	-8.1	-4.5	-2.5
General Govt. Balance	€bn	-95.3	-68.3	-57.2	-19.6	-22.4	-4.4	-20.4	-12.7	-12.8	-7.3	-7.7	-9.0
	% of GDP	-8.9	-6.5	-5.5	-9.1	-11.2	-5.5	-12.8	-7.9	-7.8	-4.2	-4.7	-5.7
Primary Balance	% of GDP	-6.5	-3.5	-1.0	-2.2	-3.4	-5.3	-5.4	-3.9	-2.2	-0.4	-0.7	-1.5
General Govt. Debt	% of GDP	68.6	93.4	92.7	165.3	156.4	431.5	108.2	118.3	124.0	107.8	121.6	135.2

F Citi forecast. YoY Year-to-year growth rate. For Ireland we show the GDP deflator rather than the CPI. Sources: ISTAT, INE, Haver Analytics, Eurostat, and Citi Research

Netherlands

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GDP data for 2Q surprised on the upside with an increase of 0.2% QQ. However, as a substantial increase in inventories was a major driver for the GDP expansion, we expect the country to slip back into recession in 2H. Increasing unemployment and a VAT rate hike are likely to undermine consumption. Recent polls show a lead for the Socialist party in the September 12 early elections. We expect that an inconclusive election outcome will lead to lengthy coalition talks, making the implementation of the fiscal package uncertain.

Belgium

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Belgium's 0.6% QQ contraction in Q2 GDP compares unfavourably with the 0.2% fall in the euro area average. Business surveys had not pointed to such a sizeable contraction, suggesting that some one-off factors could be at play. Despite our forecast of a likely technical rebound in Q3 (0.1% QQ), we lower our 2012 GDP forecast by 0.3ppt to -0.2%, with no prospect of improvement in 2013 (-0.2%, same as July). A key issue for 2012 and 2013 remains the continued uncertainty surrounding the recapitalisation of a large cross-border financial institution, which could still add to the guarantees that the government has already extended.

Slovakia

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Slovak GDP increased by 0.7% QoQ in 2Q12 driven by the car industry and thus we expect the key contribution from foreign demand (but there are larger "Errors and Omissions" in the balance of payments) with a limited pass-through into domestic demand. Reflecting a stronger GDP outturn, we revised upward our 2012 GDP forecast to 2.4%, while we cut the 2013 growth to 1.3%. This is below MinFin's forecast of 2.6% in 2013 that is likely to be a test for the government's commitment to narrow the deficit below 3% of GDP in 2013 — we expect -3.3%.

Slovenia

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2Q GDP has not yet been published, but the monthly indicators remain weak with another large drop in construction activity and poor retail sales. While unemployment has increased less than we expected since late 2011 (11.5% in June 2012), it reflects a larger fall of the labour force rather than better employment (-1.6%YoY in June). Deficit of the state budget has narrowed to 4.3% of GDP in June 2012 from 5% in January owing to a drop in expenditures. There are negative risks to the fiscal deficit given a possible capital injection into the banking sector and poor overall confidence that points to a fall in GDP of around 3% YoY in mid-2012.

Figure 25. Netherlands, Belgium, Slovakia and Slovenia — Economic Forecasts, 2011-2013F

		Netherlands			Belgium			Slovakia			Slovenia		
		2011	2012F	2013F	2011	2012F	2013F	2011	2012F	2013F	2011	2012F	2013F
Real GDP	YoY	1.1%	-0.7%	-1.0%	1.8%	-0.2%	-0.2%	3.3%	2.4%	1.3%	0.2%	-0.9%	0.1%
Final Domestic Demand	YoY	0.6	-1.0	-1.2	1.9	-0.3	0.2	0.6	0.5	0.5	-2.6	-1.5	-0.7
Public Consumption	YoY	0.1	0.6	-0.4	0.8	0.2	-0.1	-3.5	1.1	-2.1	-0.9	0.8	-0.9
Private Consumption	YoY	-1.0	-1.1	-1.5	0.2	-0.4	0.2	-0.4	-0.2	0.2	-0.1	0.1	0.0
Investment (Ex Stocks)	YoY	5.7	-3.4	-1.5	4.1	-0.3	0.6	5.7	1.5	2.7	-10.2	-7.8	-2.3
Exports	YoY	3.9	3.2	1.2	5.5	0.5	2.0	10.8	3.7	2.2	7.8	-1.7	0.5
Imports	YoY	3.6	2.7	0.7	5.7	0.5	2.0	4.5	2.9	3.7	4.7	-2.4	-0.5
CPI (Average)	YoY	2.3	2.7	2.7	3.5	2.6	1.5	3.9	3.6	2.8	1.8	2.5	2.6
Unemployment Rate	%	5.3	6.3	6.9	7.2	7.2	7.6	13.2	13.4	13.6	8.2	8.3	9.2
Current Account	% of GDP	8.5	9.6	9.6	-1.0	-0.1	0.4	0.1	1.2	-1.0	-1.5	-0.9	-0.2
General Govt Balance	% of GDP	-4.7	-4.3	-3.7	-3.7	-2.7	-2.2	-4.8	-4.9	-3.3	-6.4	-4.2	-3.3
Primary Balance	% of GDP	-2.6	-2.5	-2.1	-0.4	0.3	0.9	-3.5	-3.5	-1.9	-4.5	-2.1	-1.1
General Govt Debt	% of GDP	65.2	71.6	75.4	97.8	111.6	117.8	43.4	46.7	49.4	47.6	51.3	53.3

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

UK

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Our economic forecasts are little changed from last month, and we still expect continued economic weakness with undershooting inflation and an overshooting fiscal deficit. The revised Q2 GDP data, to be released just after this publication, may well show a smaller drop in GDP than the 0.7% QoQ decline in the provisional data. Nevertheless, the big picture is that the economy has been flat for the last couple of years, since the EMU crisis and UK fiscal tightening began. Technical factors (Olympic ticket sales plus unwind of adverse effect of Queen's Jubilee on 2Q growth) probably will cause GDP to rebound in Q3, but -- with ongoing headwinds from high household debts, poor credit availability, the EMU crisis and fiscal drag – we do not expect a significant recovery in coming quarters.

Inflation in Q2 undershot the MPC's forecasts and inflation is likely to fall further in coming months, dropping below the 2% target before yearend. The inflation boost from the sharp drop in sterling in 2007-09 is now fading, and the economy has ample slack. We do not regard the weakness of productivity as a threat to this low inflation outlook, because it is accompanied by very low wage growth. The share of the workforce that is in full-time non-temporary employment continues to fall, capping pay deals. Moreover, some of the workers displaced from core employment are "pricing themselves back into work" and re-entering work via self-employment, part-time work and temporary jobs -- all of which on average have lower pay levels than full-time non-temporary employment. The MPC is likely to loosen the monetary policy further via extra QE later this year but to remain reluctant to cut the official Bank Rate below the current low of 0.5%.

Figure 26. United Kingdom — Economic Forecasts, 2011-2013F

					2012				2013			
		2011	2012F	2013F	1Q	2QF	3QF	4QF	1QF	2QF	3QF	4QF
Real GDP	YoY	0.7%	-0.6%	0.5%	-0.2%	-0.8%	-0.8%	-0.7%	0.0%	0.8%	0.4%	0.6%
	SAAR				-1.6	-2.7	2.5	-0.8	1.2	0.5	0.8	0.0
Domestic Demand	YoY	-0.5	-0.2	-0.1	0.3	0.0	-0.7	-0.2	0.1	-0.4	-0.1	0.2
(Incl. Inventories)	SAAR				0.3	0.9	-0.7	-1.3	1.5	-1.2	0.7	-0.2
Consumption	YoY	-1.1	0.0	1.4	-0.9	-0.2	0.7	0.5	1.1	1.4	1.6	1.7
	SAAR				-0.4	0.6	0.8	0.7	2.1	2.0	1.4	1.2
Investment	YoY	-1.4	-1.3	-7.3	1.9	0.4	-2.5	-5.1	-5.4	-9.3	-7.7	-6.6
	SAAR				7.9	-6.1	-8.9	-12.2	6.4	-20.6	-2.4	-7.6
Exports	YoY	4.4	1.9	5.9	-1.0	0.5	5.2	2.8	5.5	9.0	4.6	4.7
	SAAR				-6.6	-5.8	23.1	3.1	3.6	7.4	4.4	3.3
Imports	YoY	0.5	3.0	4.0	0.7	2.6	5.1	3.7	5.2	4.6	2.9	3.2
	SAAR				-1.3	4.5	10.8	1.3	4.6	2.1	3.8	2.5
Unemployment Rate	%	8.1	8.1	7.6	8.2	8.0	8.1	7.9	7.9	7.7	7.6	7.4
CPI Inflation	YoY	4.5	2.6	1.7	3.5	2.7	2.3	1.8	1.5	1.7	1.8	1.8
Merch. Trade	£bn	-100.3	-103.6	-98.8								
	% of GDP	-6.6	-6.8	-6.4								
Current Account	£bn	-29.0	-40.7	-34.8								
	% of GDP	-1.9	-2.7	-2.2								
PSNB	£bn FY	-126.0	-108.6	-131.1								
	% of GDP	-8.3	-7.1	-8.4								
General Govt. Balance	% of GDP	-8.2	-6.9	-8.2								
Government Primary Balance	% of GDP	-5.1	-4.1	-5.4								
Public Debt	% of GDP	82.5	88.5	96.5								
Gross Nonoil Trading Profits	YoY	6.3	-4.3	-1.2								

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

Switzerland

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A very large boost from inventories (adding 1.8% to domestic demand) helped lift GDP growth in Q1, which was 0.7% QoQ. However, consumer spending also is holding up well, rising 0.6% QoQ and 1.8% YoY (highest YoY growth since Q1-2010). Moreover, the drag on growth from weakness in exports (down 0.3% YoY in Q1) is limited by the simultaneous slowdown in imports (up just 0.6% YoY in Q1), with little overall effect from net trade. Hence, while growth probably slowed in Q2 as the inventory effect fades, the Swiss economy probably continued to avoid recession. With inflation still negative, the SNB will continue to defend the currency peg.

Sweden

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We raise our 2012 GDP growth forecast to 1.1% Y/Y (from previously 0.4%) following the strong 2Q GDP flash estimate. A marked jump in the Swedish economic surprise indicator in August (two first weeks) suggests upside risks to this forecast; however, both sentiment indicators and labour market data imply markedly weaker growth than implied by 1H GDP data. We regard expectations of sub-trend growth this and next year as very likely and expect the flash GDP estimate to be revised down. Very subdued inflation, low resource use and slower credit growth are important reasons why we expect the Riksbank to cut rates further during autumn.

Denmark

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Although escaping recession in 1Q 2012 (GDP was up 0.4% Q/Q), economic activity indicators continue to point to a prolonged period of limited economic expansion in Denmark, with below-trend GDP growth in coming years. In July, the DNB entered uncharted territory by cutting the CD-rate to a negative 0.2%. Given sustained stress in the euro area, demand for DKK is likely to stay strong near-term, adding to pressures for more policy action. We expect the lending rate to be cut to zero (currently 0.2%) in the near term.

Norway

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The Norwegian economy has so far been largely unaffected by the global slowdown. Momentum in the Norwegian economy is strong and the latest regional network report suggests that economic activity only will slow marginally near-term. Main growth drivers are high activity in the oil sector and a recovery in private consumption — fuelled by strong labour market and income growth. Fiscal policy is also supportive (0.75% of mainland trend-GDP). Given strong domestic fundamentals, Norges Bank now signals a 25bp rate hike in 2Q ’13 with 50/50 probability of even earlier tightening.

Figure 27. Switzerland, Sweden, Denmark and Norway — Economic Forecasts, 2011-2013F

		Switzerland			Sweden			Denmark			Norway		
		2011	2012F	2013F	2011	2012F	2013F	2011	2012F	2013F	2011	2012F	2013F
Real GDP	YoY	2.1%	1.9%	1.0%	4.0%	1.1%	1.9%	0.8%	0.7%	1.4%	2.5%	3.0%	2.9%
Final Domestic Demand	YoY	1.8	2.1	1.7	2.9	1.4	1.4	-0.7	1.5	1.4	3.2	2.7	3.4
Public Consumption	YoY	2.6	3.3	1.8	2.0	0.9	1.0	-1.3	0.5	0.6	1.6	1.9	2.2
Private Consumption	YoY	0.9	1.9	0.9	2.1	1.4	1.5	-0.8	1.0	1.2	2.4	2.9	2.9
Investment (Ex Stocks)	YoY	3.9	1.9	3.7	7.1	1.9	2.0	0.2	4.6	2.9	8.1	3.4	6.6
Exports	YoY	3.6	2.6	2.9	7.4	2.3	2.9	7.0	0.5	2.8	1.0	2.5	4.9
Imports	YoY	2.1	5.4	4.5	6.5	-0.3	2.7	5.3	1.9	2.9	2.9	2.5	4.3
CPI (Average)	YoY	0.2	-0.8	-1.3	3.0	1.0	1.5	2.8	2.5	1.7	1.3	0.8	1.6
Unemployment Rate	%	3.1	3.1	3.2	7.5	7.6	7.8	7.6	7.7	7.6	3.3	3.1	3.0
Current Account	% of GDP	14.8	12.9	11.7	7.0	7.0	7.2	6.7	5.5	5.4	14.0	14.3	14.9
General Govt Balance	% of GDP	0.7	0.8	0.4	0.1	-0.1	-0.2	-1.9	-3.5	-2.0	13.8	13.6	14.0
General Govt Debt	% of GDP	52.0	51.0	50.0	37.0	36.3	35.4	46.5	48.6	49.1	NA	NA	NA

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

Canada

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The Canadian expansion is progressing as expected, with material support from consumers in the form of home buying, and from business investment in capital, labour and inventories. Fiscal consolidation is underway and net exports are weighing on growth. Employment growth is slowing presently in reaction to softer GDP in the second quarter. Nonetheless, job gains remain substantial among full-time workers, and wages and hours suggest faster earned income growth in tow — all critical for debt-free spending and deleveraging. Financial conditions are improving after a swoon, the TSX is rising and stock market volatility is ebbing.

Risks to the inflation outlook are two-sided, but remain roughly in balance. Upside risks include (1) increased global inflationary pressures linked to higher commodity prices or lower than anticipated potential growth; (2) greater Canadian housing momentum; and (3) stronger Canadian exports with reduced competitiveness impediments. Downside risks include (1) failure to contain the Euro Area crisis resulting in contagion to Canada via financial, confidence and trade channels; (2) realisation of the US Fiscal Cliff or hard landings among key Emerging Market trading partners; and (3) Canadian consumer retrenchment related to outsized household debt levels and/or disorderly correction of the domestic housing market.

Output and inflation are tracking a hair below the BoC's base-case. Nonetheless, the economy is still poised to expand by about 2% this year and next, and pick-up slightly in 2014. Key consumer inflation gauges should return to the Bank's 2% target by mid-2013. Externally focused downside risks and lingering uncertainties should keep the central bank on the sidelines through yearend. However, underlying domestic strength, a fully functioning financial system, balanced risks, and ongoing concern about household debt accumulation amid low interest rates should prompt the bank to retain its slightly hawkish policy tack. Barring the realisation of a confluence of downside risks, we maintain our call for a first rate hike in 1Q 2013.

Figure 28. Canada — Economic Forecast, 2011-2013F

					2012F				2013F			
		2011	2012F	2013F	1Q	2QF	3QF	4QF	1QF	2QF	3QF	4QF
Real GDP	YoY	2.4%	2.0%	2.2%	1.8%	2.4%	1.7%	1.9%	1.9%	2.1%	2.4%	2.5%
	SAAR				1.9	1.5	1.7	2.3	1.9	2.4	2.8	2.9
Final Domestic Demand	YoY	3.0	1.7	2.5	1.7	1.7	1.7	1.9	2.2	2.4	2.7	2.8
	SAAR				1.3	2.1	1.6	2.6	2.7	2.6	2.9	2.9
Private Consumption	YoY	2.4	1.8	2.3	1.9	1.7	1.9	1.8	2.1	2.5	2.4	2.4
	SAAR				0.9	0.9	2.9	2.4	2.3	2.4	2.4	2.5
Government Spending	YoY	0.1	-1.5	0.7	-2.3	-1.9	-1.4	-0.4	0.4	0.7	0.9	0.8
	SAAR				-2.3	-0.6	0.1	1.0	0.8	0.8	0.9	0.9
Private Fixed Investment	YoY	8.9	6.3	5.3	6.5	7.3	5.7	5.9	5.5	3.8	5.7	6.1
	SAAR				7.6	12.4	-0.9	4.9	6.1	5.3	6.6	6.3
Exports	YoY	4.6	4.4	3.8	4.8	6.4	3.7	2.8	2.7	3.5	4.0	4.8
	SAAR				2.5	1.1	4.0	3.7	2.2	4.1	6.2	6.5
Imports	YoY	7.0	3.8	4.7	4.1	2.1	4.2	4.7	4.7	4.4	4.7	5.0
	SAAR				4.4	6.0	4.0	4.5	4.5	4.5	5.5	5.5
CPI	YoY	2.9	1.7	1.9	2.3	1.6	1.3	1.5	1.6	1.5	2.1	2.4
Core CPI	YoY	1.7	1.8	2.1	2.1	2.0	1.5	1.6	1.8	2.0	2.4	2.2
Unemployment Rate	%	7.5	7.3	7.0	7.4	7.3	7.2	7.3	7.2	7.0	6.9	6.9
Current Account Balance	C$bn	-48.4	-56.8	-55.4	-41.1	-64.5	-54.4	-66.2	-58.2	-56.4	-53.4	-53.6
	% of GDP	-2.8	-3.2	-3.0	-2.3	-3.6	-3.1	-3.7	-3.2	-3.1	-2.9	-2.8
Net Exports (Pct. Contrib.)		-1.5	-0.2	-0.8	-0.6	-2.3	-0.4	-0.8	-1.3	-0.6	-0.4	-0.3
Inventories (Pct. Contrib.)		0.3	0.1	0.3	1.0	1.5	0.4	0.3	0.2	0.2	0.0	0.0
Budget Balance (Fiscal Year)	% of GDP	-1.4	-1.2	-0.5								
Federal Budget Debt	% of GDP	33.4	33.6	32.6								
General Govt. Debt	% of GDP	85.0	84.9	83.9								

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

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Australia

Better-than-expected domestic economic data and signs of stabilisation in China suggest the risks to the Australian economy are shifting from the downside to being more evenly balanced. More support for the maintenance of trend economic growth resulted in the early-August removal of our forecast for one further RBA interest rate cut this year. Monetary policy should now remain unchanged until the end of Q3 2013, at which time we expect the hiking cycle to begin. Global events still mean that for the remainder of this year there is some residual risk that official interest rates are cut further. However, the trigger point for rate cuts requires the delivery of a severe negative economic shock from Europe or China rather than just the possibility of one. Australian monetary policy is now mildly stimulative and the high frequency activity data shows an improvement in some non-mining interest rate sensitive sectors. Furthermore, Australian fiscal policy is unlikely to have the large contractionary influence on the economy assumed at the time of the May Federal Budget. The FY13 fiscal drag from the government's attempt to force the Budget back into surplus is likely to be close to the indifference level of the RBA.

New Zealand

RBNZ Governor Alan Bollard retires on September 25, to be replaced by former World Bank Managing Director Graeme Wheeler. With policy remaining unchanged despite the global challenges of the last few months, Dr Bollard is unlikely to surprise with his final policy decision being a change in the OCR. Monetary policy is likely to remain anchored at 2.50% until economic activity narrows the output gap next year. As part of the new governor's appointment, another Policy Targets Agreement needs to be negotiated between the RBNZ Governor and New Zealand Minister of Finance. The current PTA that emphasises price stability as the objective of monetary policy is unlikely to be altered in any meaningful way.

Figure 29. Australia and New Zealand — Economic Forecast, 2011-2013F

	Australia			New Zealand		
	2011	2012F	2013F	2011F	2012F	2013F
Real GDP[a]	2.1%	3.7%	3.4%	1.3%	2.3%	2.8%
Real GDP (4Q versus 4Q)	2.5	3.5	3.6	1.9	2.6	3.0
Real Final Domestic Demand	4.0	3.8	3.6	2.3	1.7	2.8
Consumption	3.3	3.7	3.2	2.5	2.3	2.1
Govt. Current & Capital Spending[b]	-0.8	-0.1	0.6	1.8	1.3	1.3
Housing Investment	1.1	-5.0	3.0	-12.0	7.4	12.6
Business Investment[c]	16.9	12.8	8.5	6.9	2.0	5.0
Exports of Goods & Services	-1.3	6.0	8.2	2.4	4.0	3.0
Imports of Goods & Services	11.4	7.3	7.9	6.0	2.7	3.7
CPI	3.4	1.8	3.2	4.0	1.5	2.2
CPI (4Q versus 4Q)	3.1	2.5	2.9	1.8	1.8	2.3
Unemployment	5.1	5.3	5.1	6.5	6.4	5.6
Merch. Trade, BOP (Local Currency, bn)	17.9	-14.2	-31.3	3.3	2.4	-0.4
Current Account, (Local Currency, bn)	-33.2	-61.4	-84.1	-8.3	-10.8	-16.3
Percent of GDP	-2.3	-4.1	-5.3	-4.2	-5.0	-7.0
Budget Balance[d] (Local Currency, bn)	-47.7	-44.4	1.5	-15.9	-12.1	-6.5
Percent of GDP	-3.4	-3.0	0.1	-9.2	-4.1	-3.6
General Govt. Debt (% of GDP)[e]	25.5	28.9	28.4	36.2	38.9	38.9
Gross Trading Profits[f]	6.2	-1.4	6.1	NA	NA	NA

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. Sources: NZIER and Citi Research

China

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Domestic demand continues to improve but external risks have increased. Nominal FAI grew by 20.4% YoY in the first seven months, and accelerated in real terms. The growth of planned investment under new projects picked up, supported by budget funding and domestic loans. Property investment growth slowed from 16.6% YoY in 1H to 15.4% YoY in the first seven months. Nominal retail sales growth decelerated from 13.7 YoY in June to 13.1% in July, but real growth improved slightly to 12.2% YoY due to the continued fall in inflation. However, export growth tumbled from 11.3% YoY in June to 1.0% in July, way below expectations. The weakness was most striking for exports to EU, which contracted by 16% YoY in July.

Industrial production remained sluggish amid accelerating destocking. Industrial value-added decelerated from 9.5% YoY in June to 9.2% in July, and seasonally-adjusted MoM growth has slowed for two months in a row. Electricity production growth, while rebounding from 0% in June to 2.1%, remained weak relative to periods before 2Q. The destocking process is confirmed by the PMI inventory index for finished goods, which dropped by 4.3ppts in July to 48. On the positive side, the destocking of raw materials appeared to be running its course, and the ratio of industrial sales improved, boding well for production going forward.

Our forecast for main macro indicators are little changed this month, although we see moderate risks on the downside. CPI inflation fell to 1.8% YoY and PPI deflation widened in July. Inflation will likely remain subdued in the near term, leaving ample room for further policy easing. The recent high-level meetings indicate the government is ready to step up policy fine-tuning in 2H, although a large-scale stimulus is currently not on the cards. We continue to expect one more rate cut (25bps) and two more RRR cuts (total 100bps) for the rest of the year, with the first RRR cut likely this month. If the policy space under a proactive fiscal policy and accommodative monetary policy is fully utilised, we expect growth to rebound mildly in 2H. A further deterioration of exports and policy delay would justify reassessment of growth prospects.

Figure 30. China — Economic Forecasts, 2011-2013F

					2012F				2013F			
		2011	2012F	2013F	1Q	2Q	3QF	4QF	1QF	2QF	3QF	4QF
Real GDP	YoY	9.2%	7.9%	8.0%	8.1%	7.6%	7.8%	8.1%	8.3%	8.1%	7.9%	7.8%
Real Final Domestic Demand	YoY	10.2	9.1	8.8								
Consumption	YoY	9.7	9.4	9.2								
Fixed Capital Formation	YoY	10.7	8.7	8.5								
Industrial Production	YoY	13.9	10.5	11.1	11.6	9.5	9.9	11.0	11.2	11.5	11.0	10.5
Exports	YoY	20.3	8.1	9.2	7.6	10.6	8.7	5.5	6.0	8.0	10.0	12.0
Imports	YoY	24.9	8.1	11.4	6.9	6.5	7.8	11.0	9.0	10.0	12.0	14.0
Merchandise Trade Balance	$bn	155	167	141	1	69	72	26	-12	65	70	19
FX Reserves	$bn	3,181	3,301	3,461	3,305	3,240	3,302	3,301	3,289	3,355	3,439	3,461
Current Account	% of GDP	2.8	2.0	1.5								
Fiscal Balance	% of GDP	-1.3	-2.4	-1.5								
General Govt. Debt	% of GDP	15.3	16.2	16.1								
Urban Unemployment Rate	%	4.1	4.2	4.1	4.1	4.2	4.2	4.2	4.1	4.1	4.1	4.1
CPI	YoY	5.4	2.7	2.9	3.8	2.9	1.8	2.3	2.4	2.6	3.1	3.4
Exchange Rate (end period)	CNY/$	6.29	6.37	6.25	6.30	6.35	6.38	6.37	6.36	6.34	6.30	6.25
1-Yr Deposit Rate (end period)	%	3.50	2.75	3.25	3.50	3.25	2.75	2.75	2.75	2.75	3.00	3.25

Note: F Citi forecast. E Citi estimate. YoY Year-to-year percent change. SAAR Seasonally adjusted annual rate. *Based on official data. The ratio was roughly 50% in 2010 if the debt of Ministry of Railway and local government debt as audited by the National Auditing Office are included. Sources: Haver Analytics and Citi Research

India

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The stars just don't seem to be aligning for India with almost all the growth drivers being hit and GDP growth likely to skid to a ten year low. (1) Drought fears are coming true; (2) Politics and policies are still not conducive for investments; (3) Power outages are taking their toll on growth; (4) Confidence is low and consumption has begun to splutter; (5) Exports are more sensitive to global demand than the weaker INR. (See India Macroscope - Murphy's Law at Play?). While we have been highlighting risks that sub-par monsoons could shave 40-80bps off our earlier 6.4% GDP estimate for FY13, the macro -- both domestic and global -- has become grimmer. Consequently, we recently cut our FY13 and FY14 GDP growth estimates to 5.4% and 6.2%, respectively, from 6.4% and 6.9%. We stress that if drought/global conditions worsen, growth could even fall to about 4.9% YoY.

A weak monsoon spells concern for primary articles and manufactured food products (~30% of the WPI basket). We raised our average WPI estimates to 8% from 7.5% earlier. Given the growth slowdown, we are holding on to our rate cut call, but with inflation likely to edge higher, we have lowered our call from 50-75bps to 50bps for FY13. While we maintain our view of a fiscal slippage, we now expect the overshoot to be higher, taking the centre's deficit to 5.9% v/s budget estimates of 5.1%. This is due to (1) expenditure overruns on account of higher subsidy outlay due to food/fuel and drought-relief measures; and (2) revenue shortfalls because slowing growth is impacting tax collections and market conditions are not conducive for divestments. As highlighted earlier, this could take a toll on India's sovereign ratings.

The one bright spot is on the external account. Despite a contraction in exports, the sharper fall in imports (due to the slowing economy) coupled with lower oil/gold imports is likely to result in the current account deficit (CAD) coming in at US$55bn (3% of GDP) in FY13 from US$78bn or 4.2% in FY12. The lower CAD bodes well for the INR stabilising in the Rs54-56 range over the 12 month horizon. Despite growth skidding to a ten year low, we maintain our view that the India story is 'dented' but not 'broken'. The structural drivers still exist — domestic-driven economy, demographics and relatively high saving rates. However, the government needs to stem a further deceleration in growth. We re-iterate our view that while a change in guard in the Finance Ministry is positive, actions may be less than words given the continuation of the dual leadership model and all eyes on the next polls.

Figure 31. India — Economic Forecasts, FY2012/13-2014/5F

		FY 12/13F	FY 13/14F	FY 14/15F
Real GDP	YoY	5.4%	6.2%	7.0%
Final Domestic Demand	YoY	5.0	5.8	7.4
Private Consumption	YoY	5.0	5.5	6.7
Fixed Investment	YoY	5.0	6.0	9.0
Exports	YoY	8.0	15.0	11.0
Imports	YoY	6.0	10.8	9.5
Wholesale Price Index*	YoY	8.0	7.0	6.0
Consumer Price Index	YoY	7.0	6.5	6.0
Current Account	US$ bn	-55	-46	-40
	% of GDP	-3.0	-2.1	-1.5
Consolidated Fiscal Balance	% of GDP	-8.5	-8.0	-7.5
Centre Fiscal Balance	% of GDP	-5.5	-5.0	-4.5
US Dollar Exchange Rate	Average	55.4	54.2	52.0

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

Korea

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Exports in July decreased 8.8%YoY as exports to China (-7.3%YoY) and euro zone (-27.0%) continued to contract. Most major export goods, except auto parts and LCD, registered negative YoY growth and in particular shipbuilding plunged by 48.3% as the impact of reduced orders after the GFC in 2008 began to materialise. Reflecting the sharper-than-expected contraction of exports in July, we are cutting our forecast for 2012 export growth to 1.4% from 2.2%, previously. Recently-released data for service activities and retail sales in June also showed downward trends, falling 0.4% MoM and 0.5%, respectively. Meanwhile, the moderation of agricultural inflation due to favourable weather has led to two months of MoM deflation, resulting in YoY inflation reaching its lowest in a decade at 1.5%YoY. Notwithstanding the recent rise in international grain prices as well as an electricity fee hike of 4.9% in August (with another hike expected later this year), the government's price controls and negative output gap are likely to maintain headline inflation at about 2.2% in 2H. With economic growth likely to stay weak in coming quarters, we expect another policy rate cut in September at the earliest and the government's supplementary budget of around KRW6trn to support domestic demand.

Indonesia

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Up to 2Q, GDP growth had held up better than expected amid robust domestic demand. The recent rise in inventories may signal a forthcoming slowdown, although it still appears that FY12 GDP growth will be around 6.2% YoY. With domestic demand relatively strong, while exports slid faster than expected, we have raised our current account deficit forecasts to 2.3% of GDP in FY12 and 1.5% of GDP in FY13 from 1.9% of GDP and 1.2%, respectively, last month. The size of the CA deficit in 2Q was far higher compared with foreign direct investment inflows (i.e. $6.9bn vs. $3.8bn). BI has tried to curb cyclical demand pressures by raising the O/N FasBI rate by 25bps, while also signalling tighter macroprudential regulations to curb auto/motorcycle loans and hinting at possible tolerance for IDR depreciation. BI's next move will likely be data dependent, but we expect them to raise the FasBI rate again by 25bps in December. Although import growth may further moderate in coming months, we think the 3Q12 CA deficit will likely still be wide, at around 2.5% of GDP (annualised). As for 2013, however, we expect BI to stop raising rates as the CA deficit probably will have come down to more sustainable levels. However, we still expect the IDR to remain on a weakening trend (6-12M forecast: $9,750).

Figure 32. Korea and Indonesia — Economic Forecasts, 2011-2013F

		Korea			Indonesia		
		2011	2012F	2013F	2011	2012F	2013F
Real GDP	YoY	3.6%	2.8%	3.6%	6.5%	6.2%	6.3%
Final Domestic Demand	YoY	1.3	1.8	3.0	5.7	6.5	7.0
Private Consumption	YoY	2.3	1.6	2.0	4.7	5.1	4.5
Fixed Investment	YoY	-1.1	1.4	4.4	8.8	11.4	10.6
Exports	YoY	9.5	4.9	4.1	13.6	4.3	11.7
Imports	YoY	6.5	3.7	2.7	13.3	7.1	14.2
Consumer Price Index	YoY	4.0	2.4	2.8	5.4	4.4	4.7
Unemployment Rate	%	3.4	3.3	3.3	6.6	6.1	5.9
Current Account	US$ bn	26.5	23.4	22.4	1.7	-20.4	-14.8
	% of GDP	2.4	2.1	1.9	0.2	-2.3	-1.5
Fiscal Balance	% of GDP	1.5	0.8	1.3	-1.2	-2.1	-0.7
US Dollar Exchange Rate	Average	1108	1143	1163	8763	9383	9625

Sources: Haver Analytics and Citi Research

Hong Kong

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We are cutting our 2012 GDP growth to 2.2% YoY from 2.5% YoY previously, following the disappointing 2Q GDP data (1.1% YoY) and persistent export weakness. However, lead guides still point to moderate growth in 2H. We expect a continued disparity between weak external trade but resilience in domestic demand. In line with the expected economic slowdown, we are also trimming our 2012 CPI forecast to (3.8% YoY from 4% YoY). The drop in the July CPI print was mainly due to an earlier-than-usual public housing rental waiver, and should not be read as a new trend. The upcoming Legislative Council election (9 Sept) is generating more political noise. The HKD is likely to remain near the strong end of the trading band amidst global headwinds. Domestic interest rates are likely to stay low.

Singapore

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Following the smaller-than-expected upward revision in 2Q GDP, lead indicators point to a risk of technical recession in 3Q. While technical recession is not our base case, our 2.6% YoY GDP growth forecast for the year anticipates activity will stagnate in 3Q, before a short-lived rebound in activity later in the year. The mid-point of the narrowed official GDP forecast of 1.5-2.5% is below MAS's implicit expectations of 2-3% from April. With headline inflation moderating to around 4% in July as MAS expected, this should give MAS more confidence that its forecast of core inflation falling to around 2% by year end will be met. Thus the tilt in the balance of risks should give MAS some leeway to reduce the slope of the policy band slightly in October, though this is a close call and depends on incoming data.

Taiwan

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July exports plunged further to suggest additional downside risks to the 3Q12 growth outlook. However, we believe exports will improve in August on higher shipments of tech products. CPI inflation increased to a near four-year high of 2.5% YoY in July and we expect CPI inflation to stay above 2% until mid-2013, driven by food inflation and another utility price hike in December. On balance, the lower growth outlook but higher inflation concern will likely keep the CBC on hold in its September policy rate decision. The desire to protect banks' profit margin and curb further rises in housing prices also will count against a CBC rate cut. The eighth cross-strait meeting between Taiwan and China has finally inked the long-awaited investment protection agreement and we expect the coming current settlement agreement and service trade agreement at yearend to be catalysts to 2H12 growth.

Figure 33. Hong Kong, Singapore and Taiwan — Economic Forecasts, 2011-2013F

		Hong Kong			Singapore			Taiwan		
		2011	2012F	2013F	2011	2012F	2013F	2011	2012F	2013F
Real GDP	YoY	5.0%	2.2%	3.8%	4.9%	2.6%	3.5%	4.0%	2.4%	3.6%
Final Domestic Demand	YoY	7.5	4.8	1.9	3.4	3.6	3.0	1.3	0.7	2.8
Private Consumption	YoY	8.4	4.4	2.0	4.1	3.2	3.4	3.0	1.9	2.7
Fixed Investment	YoY	7.3	6.6	2.0	3.3	6.8	2.6	-3.8	-2.6	5.2
Exports	YoY	4.2	-0.4	6.0	2.6	2.6	3.9	4.5	1.7	5.3
Imports	YoY	4.6	0.4	5.1	2.4	4.2	4.6	-0.6	-0.7	4.8
CPI	YoY	5.3	3.8	3.2	5.2	4.4	3.3	1.4	1.9	2.1
Unemployment Rate	%	3.4	3.5	3.7	2.0	2.2	2.1	4.4	4.3	4.2
Current Account	US$ bn	12.4	12.8	15.2	57.1	41.7	41.2	41.3	41.9	42.6
	% of GDP	5.1	5.0	5.5	21.9	15.0	14.0	8.8	8.7	8.4
Fiscal Balance	% of GDP	3.9	0.8	1.1	1.5	1.0	1.0	-1.9	-1.6	-1.6
US Dollar Exchange Rate	Average	7.78	7.76	7.76	1.26	1.26	1.27	29.40	29.99	30.15

Sources: Haver Analytics and Citi Research

Russia

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GDP growth slowed to 4%YoY in 2Q from 4.9% in 1Q12. Consumer spending remains strong, while production growth is a humble 2-3% YoY. We keep our GDP growth forecast at 3-3.5% for 2012 as a whole (in the base case of oil at US$95-100/bbl in 4Q). As of mid-August, inflation was running at 5.6%YoY, still within the 5-6% target range of the Central bank, but is poised to exceed 6.5% at yearend. At the last meeting, the CBR remained on hold, but it indicated that tightening was possible due to signs that higher agricultural prices will lift inflation expectations. We believe that the regulator might hike the floor rates in September. The 2Q current account fell to US$19bn, while capital flight was near zero due to increased borrowings. We expect that in H2, capital outflows will absorb most of the current account surplus, given high debt repayments and liquidity infusions from the budget. The CBR widened the ruble band and decreased the accumulated volume of interventions that shifts the band. This means the ruble will be more responsive to shocks, and we believe global growth uncertainty, weaker oil and looser liquidity will bring the ruble to 37.5 versus the basket by 4Q. In the short-term, the lingering risk-on momentum and a possible rate hike may provide some support to the ruble.

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Following a rebound in 2Q, recent developments lead us to believe that economic activity is likely to lose momentum in 3Q. In particular, capacity utilisation stood at 73% in July compared with the second quarter average of 74.3%. Similarly, the manufacturing PMI fell to 49.4 in July from 51.4 in June, signaling further weakness going forward. These readings, coupled with the recent lower-than-expected inflation readings and encouraging signals regarding re-balancing in 1H, should strengthen the CBT's hand in relaxing its stance. The CBT has in fact brought its effective funding rate below 7% in mid-August from 8% (pa) in July and 9.2% (pa) in June. We believe that the CBT's ability to carry out further easing will be constrained by at least two factors. First, we believe that the re-balancing process is likely to lose steam in 2H. Second, even under fairly optimistic assumptions, year-end inflation is likely to be in the range of 6.5%-7.0%—above the 5% target. Against this backdrop, we believe that there is not much room for the CBT to ease without hurting the performance of Turkish assets, as the Bank struggles to target both the exchange rate and inflation.

Figure 34. Russia and Turkey — Economic Forecast, 2011-13F

		Russia			Turkey		
		2011	2012F	2013F	2011	2012F	2013F
Real GDP	YoY	4.3%	3.5%	4.0%	8.5%	2.5%	4.3%
Final Domestic Demand	YoY	1.7	1.5	2.0	9.8	1.6	4.5
Private Consumption	YoY	6.3	5.9	5.3	7.7	1.0	4.5
Fixed Investment	YoY	8.0	6.7	9.0	18.3	2.3	4.9
Exports	YoY	0.4	1.0	2.7	6.5	1.8	5.5
Imports	YoY	20.3	4.3	5.8	10.6	-1.4	6.2
CPI	YoY	8.4	5.1	6.9	6.5	9.1	7.0
Unemployment Rate	%	6.6	7.5	7.5	9.8	9.4	9.7
Current Account	US$ bn	98.8	107.1	46.6	-77.1	-60.4	-62.1
	% of GDP	5.3	5.7	2.4	-10.0	-7.5	-7.1
Fiscal Balance	% of GDP	2.0	0.3	0.1	-1.3	-2.2	-2.5
US Dollar Exchange Rate	Average	29.4	32.2	34.8	1.68	1.80	1.86

Sources: Haver Analytics and Citi Research

Hungary

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The 2Q12 GDP data confirmed broad-based weakness in the economy, while inflation — partly driven by food prices and tax hikes — remains stubbornly high. The absence of any positive growth momentum may complicate the agreement with the IMF/EU, in our view, given the government's overly-optimistic underlying growth assumptions in the 2012-2013 budget plans. The government has signalled that it may remove the financial transaction tax levied on the Central Bank due to the opposition of the Troika, which may remove one big hurdle from a loan agreement. Still it remains unclear how the government would fill the fiscal gap (about 1.5-2% of GDP) in the 2013 budget related to the transaction tax shortfall and weaker growth outlook. Given the government's reluctance to increase the progressivity of the flat personal income tax or impose new wealth taxes or cut social expenditures further, we expect more political noise during the second round of loan negotiations, which is expected to resume in September. The recent correction in risk premiums may encourage external MPC members to initiate rate cuts earlier. Nevertheless, given the fragile external risk environment and the remaining uncertainties related to the pace of loan aid talks, we expect rates to remain on hold until late 2012, when we expect the IMF/EU loan negotiations to near a successful conclusion.

Poland

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Recent monthly data releases reinforce our long-held view that 2012/2013 will see a deeper economic slowdown than the consensus expects. We estimate 2012 GDP growth could slow to about 2.6% YoY, while in 2013 GDP is likely to grow by only about 2.2%, well below the country's economic potential. Deteriorating GDP prospects have already contributed to a substantial reduction in consensus forecasts of 2013 GDP growth (to 2.6% vs. 3.3% in June, according to Reuters) and triggered more dovish comments from Polish central bankers. We expect the MPC to move towards a "neutral bias" in September and then it probably will signal an "easing bias" sometime in 4Q. We believe the first interest rate cut is likely in January 2013 and expect the overall easing cycle will bring the reference rate to 3.75% from the current level of 4.75%. We continue to expect the pace of fiscal deficit reduction will be slower than the Finance Ministry assumed. But, we believe the government will stick to a cautious fiscal stance and will refrain from substantial stimulus packages. All in all, we expect that fears over the fiscal outlook will intensify in the coming months, possibly putting upward pressure on government bond yields and leading to some further correction on the bond market.

Figure 35. Hungary and Poland — Economic Forecasts, 2011-2013F

		Hungary			Poland		
		2011	2012F	2013F	2011	2012F	2013F
Real GDP	YoY	1.7%	-0.9%	0.8%	4.3%	2.6%	2.2%
Final Domestic Demand	YoY	-1.2	-1.9	-1.1	3.5	1.7	1.8
Private Consumption	YoY	0.0	-1.1	-0.8	3.1	2.0	2.2
Fixed Investment	YoY	-5.4	-5.6	-2.0	8.3	2.5	1.2
Exports	YoY	8.4	2.1	5.3	7.5	2.4	2.3
Imports	YoY	6.3	1.0	4.0	5.8	-0.5	0.1
CPI	YoY	3.9	5.6	3.9	4.3	3.9	2.7
Unemployment Rate	%	11.6	11.5	11.0	12.5	13.1	13.0
Current Account	US$ bn	2.0	2.3	3.5	-22.2	-17.5	-19.7
	% of GDP	1.7	1.9	2.7	-4.3	-3.6	-4.2
Fiscal Balance	% of GDP	4.3	-3.1	-3.7	-5.1	-3.3	-2.9
Euro Exchange Rate	Average	279	291	287	4.12	4.21	4.30

Sources: Haver Analytics and Citi Research

Czech Republic

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Although the CZSO will publish details on 7 September, poor domestic demand represents a downside risk to our GDP forecast, which we slightly cut to -1.2%YoY in 2012 from -1.1% previously. However, our forecast is still accompanied by downside risk if the Czech economy does not benefit from German growth, as the July confidence reading points to a 2%YoY GDP fall. We expect a recovery of 0.6% in 2013, although this also is accompanied by downside risks from adverse base effects. The 2Q GDP outturn supports our view of a 25bp cut in the CNB's policy rate to 0.25% on 27 September from 0.5% currently. Additionally, we believe ongoing koruna strength increases the likelihood of another cut close to zero before year-end and might lead to the CNB starting to think about non-standard measures to narrow the spread between 3M PRIBOR and the policy rate and to weaken the koruna. Conversely, if the koruna weakens, we would not expect pressure to hike as soft domestic demand will likely limit any inflationary impact from currency weakness. However, implications on the fiscal front are less clear as we are close to the autumn regional and Upper House elections. Therefore we do not expect the government will introduce more fiscal austerity beyond that already approved, in line with recent comments of policymakers to allow a slightly wider fiscal deficit.

Romania

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The authorities reached a staff-level agreement with the IMF team, which was recently in Bucharest for the sixth review of the EU-IMF supported program. Based on the conclusion of the mission, it looks like policy implementation remains broadly on track. In particular, the June fiscal deficit target was met and, according to the IMF, the ambitious objective for the year as a whole (below 3% of GDP in accrual terms) looks achievable with continued spending restraint. Nonetheless, subdued economic activity — with GDP growth projected by the Fund at 1% this year — and overdue structural reforms remain causes for concern. Where do we go from here? We believe that the political backdrop is likely to remain complicated, which will probably lead to delays in the implementation of a number of structural reform measures (in the privatisation sphere and energy sector, among other things). However, we believe that there is genuine commitment to the EU-IMF supported program. In fact, the USL has already revealed that they will go for another 2-year IMF arrangement once the current one expires in April 2013. Against this backdrop, we believe that the markets will get used to this new equilibrium in the political sphere so long as the EU-IMF supported program remains broadly on track.

Figure 36. Czech Republic and Romania — Economic Forecasts, 2011-2013F

		Czech Republic			Romania		
		2011	2012F	2013F	2011	2012F	2013F
Real GDP	YoY	1.7%	-1.2%	0.6%	2.5%	1.3%	3.0%
Final Domestic Demand	YoY	-0.9	-1.6	0.5	1.9	0.9	2.7
Private Consumption	YoY	-0.6	-2.5	0.2	1.3	0.9	2.7
Fixed Investment	YoY	-0.9	-1.4	1.5	6.2	1.2	3.5
Exports	YoY	11.0	3.8	-0.1	10.5	5.5	4.2
Imports	YoY	7.5	-0.6	-1.4	11.5	3.9	3.2
CPI	YoY	1.9	3.3	2.5	5.8	2.8	2.7
Unemployment Rate	%	8.5	8.5	8.7	5.4	5.2	5.2
Current Account	US$ bn	-6.3	-5.6	-3.4	-8.3	-7.8	-8.2
	% of GDP	-3.0	-3.0	-1.9	-4.4	-4.5	-4.7
Fiscal Balance	% of GDP	-3.1	-3.2	-3.1	-4.1	-2.4	-2.2
EURCZK, USDRON	Average	24.6	25.3	25.7	3.0	3.5	3.7

Sources: Haver Analytics and Citi Research

Brazil

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Although June's activity indicators support our 2Q12 GDP growth forecast of 0.4% QoQ, we identify some global and domestic fundamentals that are likely to restrain a more robust growth recovery in the coming quarters. Consequently, we downgrade our 2012 and 2013 annual GDP growth forecasts to 1.4% and to 3.9% (from 1.8% and 4.5% respectively last month). On the inflation front, the upward pressure coming from food prices has led us to increase our end-year 2012 CPI inflation forecast to 5.3% (from 5.1% last month). In terms of monetary policy, the Selic rate will likely decline to 7.25% this year, while an outlook of rising inflationary pressures next year will likely motivate the central bank to hike interest rates by 200bp through 2H13, driving it to 9.25%. We maintain our stronger-than-consensus view on the trade and current account balances for this year. Finally, we maintain our view that the government will likely accomplish the primary fiscal target of 3.0% of GDP this year, despite recognising that risks around the issue are increasing as sluggish economic activity may hit government revenues.

Mexico

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Economic activity grew satisfactorily in 2Q12, with GDP up by 4.1% YoY. For the second half, we are anticipating a deceleration in external demand on the back of weaker global conditions, but the internal market should help to mitigate the slowdown. We reiterate our GDP growth forecast of 3.9% for the whole of 2012. Annual headline inflation rose to 4.4% in July from 4.3% in June, mostly driven by non-core inflation. We think annual headline inflation peaked in July, but we expect it will remain above 4% for the next few months, and start declining by year-end: our 2012 year-end annual inflation forecast now stands at 3.8% from 3.7% previously. On the FX front, we expect peso strength vs. the USD in the short-term, driven by ample global liquidity and a risk-on mood. The new Congress will begin activities on September 1st. On the same date, President Calderón will submit to Congress his sixth and last annual report on the state of the Nation. Both the PRI and the PAN are expected to submit legislative initiatives dealing with structural economic and political reforms in September. Political conditions after the election may not allow for a swift approval of structural issues, but we nonetheless believe meaningful Congressional activity — understood as approval of relevant legislation — will take place before year end.

Figure 37. Brazil and Mexico — Economic Forecasts, 2011-2013F

		Brazil			Mexico		
		2011	2012F	2013F	2011	2012F	2013F
Real GDP	YoY	2.7%	1.4%	3.9%	3.9%	3.9%	3.8%
Final Domestic Demand	YoY	3.8	2.2	4.7	5.0	4.7	4.4
Private Consumption	YoY	4.1	3.0	4.6	4.5	4.1	4.0
Fixed Investment	YoY	4.7	-0.3	8.5	8.9	7.7	7.4
Exports	YoY	4.5	4.5	21.5	6.7	8.6	7.8
Imports	YoY	9.7	7.1	20.9	6.7	9.0	6.1
CPI	YoY	6.6	5.3	5.4	3.4	4.0	3.9
Unemployment Rate	%	6.1	6.3	6.5	5.3	5.2	5.3
Current Account	US$ bn	-52.5	-54.0	-71.6	-9.0	-11.5	-17.8
	% of GDP	-2.3	-2.3	-2.7	-0.8	-1.0	-1.4
Fiscal Balance	% of GDP	-2.6	-1.9	-2.7	-2.5	-2.2	-2.0
US Dollar Exchange Rate	Average	1.67	1.96	2.04	12.44	13.00	13.10

Sources: Haver Analytics and Citi Research

Argentina

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Business and consumer confidence is still weak, as a consequence of the local authorities' poor economic management, in our view. For instance, 5-year CDS are being traded at around 1,100bps, while the gap between the official and the parallel exchange rates remains high (30% in the retail "blue" market, and 40% in the blue chip swap market). Additionally, consumer confidence posted a 25% YoY drop in July, according to Universidad Torcuato Di Tella. In line with these figures, investment in machinery and equipment shrank 31% YoY in June (according to OJF), while July retail sales dropped 6% YoY (according to the Argentina Association of Medium Enterprises, CAME). On the back of these results, our call is for non-official real GDP to drop 1.7% this year. For 2013, we expect a slight uptick and non-official real GDP growth of about 2%. Yet, despite the gloomy growth outlook, inflation probably will not fall significantly. We expect non-official consumer inflation to stand at about 25% during this year and at 30% in 2013. Finally, we expect the official USDARS to stand at 4.9 and 6 by the end of 2012 and 2013, respectively.

Venezuela

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August is the peak of summer time for Venezuelans, but these days are anything but summer for presidential candidates. President Chávez has increased the number of public appearances and attacks on his opponents, a strategy that is also being followed by Mr. Henrique Capriles. Polls continue to favour Mr. Chávez although some are showing a closing gap between the two. Nevertheless, our base case continues to be a victory for President Chávez over Mr. Capriles. In the meantime, the economy is booming thanks to fiscal spending aimed mostly towards the building of housing projects. That is the reason why this year it is likely that GDP growth will be above 5%. In the meantime, the main surprise has been the favourable inflation results, as it now stands around 20% in annual terms. The deceleration in price increases is due to better-than-expected results for foodstuffs, which are being directly imported by the government. On the FX front, we see that the idea of legalising the parallel exchange rate is gaining ground and could come sooner than expected.

Figure 38. Argentina and Venezuela — Economic Forecasts, 2011-2013F

		Argentina			Venezuela		
		2011	2012F	2013F	2011	2012F	2013F
Real GDP	YoY	8.9%	1.5%	3.0%	4.2%	5.5%	3.5%
Final Domestic Demand	YoY	12.0	1.7	3.2	7.6	6.4	1.8
Private Consumption	YoY	10.7	3.1	3.4	4.0	6.4	0.7
Fixed Investment	YoY	NA	NA	NA	4.4	4.1	2.2
Exports	YoY	4.3	-2.8	3.6	4.7	6.8	5.2
Imports	YoY	17.8	-3.3	5.0	15.4	8.5	-0.9
CPI	YoY	9.8	9.8	11.8	27.1	23.3	27.8
Unemployment Rate	%	7.2	7.5	8.3	6.5	6.0	6.3
Current Account	US$ bn	0.0	1.6	-3.9	27.2	17.7	13.4
	% of GDP	0.0	0.3	-0.8	9.1	4.8	3.7
Fiscal Balance	% of GDP	-1.7	-2.8	-3.0	-5.0	-5.0	-4.0
US Dollar Exchange Rate	Average	4.13	4.58	5.46	4.29	4.30	6.50

Sources: Haver Analytics and Citi Research

Saudi Arabia

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We edged down our price forecasts for Brent for 2012 to US$113 per barrel while the 2013 forecast of US$99/bbl was left unchanged. Although June data shows sustained oil production at just below the 10mbpd mark, meaning an average oil production of 9.75mbpd so far this year, we see average Saudi production at around 9.6mbpd for the full year, given our view that over-supply risks for the rest of the year will likely lead to production cuts. Our GDP growth forecasts are unchanged from last month, at 6.1% for both 2012 and 2013, and we expect the government's budget surplus will come in at around 15.4% of GDP in 2012. We have not revised our forecast for growth in the non-oil economy, which probably will remain strong, around 8.5%, this year on the back of continued high government expenditure and increased domestic demand. At the beginning of July, the Saudi Council of Ministers finally approved the long-awaited mortgage law and we believe it will transform the stagnant mortgage market, though some caution is merited given the likely challenges if housing demand does surge. June inflation eased to 4.9% YoY on the back of weaker food prices, although over the medium term we think the drive to hire Saudis in place of cheap foreign labour and rising demand for housing, given chronic supply shortages, are likely to add to medium-term inflationary pressure.

United Arab Emirates

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The Abu Dhabi Tourism Authority (ADTA) announced strong figures for the hotel sector so far this year. According to the ADTA, the number of hotel guests rose 14% in the first half of 2012, compared with the same period last year, with guest nights rising 9%. Occupancy numbers, however, were down 7 percentage points to 65%, owing to the large number of hotel rooms that have come onto the market in the past year. The supply overhang in the hotel sector is likely to be significant in the medium term, even though the government has scaled back development plans as part of the recently-concluded spending review. The Abu Dhabi Crude Oil Pipeline (ADCOP) has been inaugurated with a shipment of crude oil to a Pakistani refinery in July. The pipeline has a maximum capacity of 1.8mbpd, the majority of Abu Dhabi's 2.5mbpd production, and runs directly from Abu Dhabi to Fujairah on the UAE's east coast. In Dubai, the repayment of the DIFC Sukuk and continued progress on debt restructuring at some high-profile Dubai-based government related entities, such as Dubai Drydocks and Limitless, continue to boost investor confidence in the Emirate.

Figure 39. Saudi Arabia and United Arab Emirates — Economic Forecasts, 2011-2013F

		Saudi Arabia			United Arab Emirates		
		2011	2012F	2013F	2011	2012F	2013F
Real GDP	YoY	7.1%	6.1%	6.1%	5.3%	0.5%	3.4%
Final Domestic Demand	YoY	6.8	7.8	7.9	3.0	3.4	3.4
Private Consumption	YoY	4.7	5.0	5.0	1.0	2.0	2.0
Fixed Investment	YoY	10.1	10.0	10.0	5.0	5.0	5.0
Exports	YoY	18.7	5.2	-5.6	13.0	13.0	13.0
Imports	YoY	13.7	15.0	15.0	15.0	15.0	15.0
CPI	YoY	5.0	7.0	8.0	0.9	1.1	1.3
Current Account	US$ bn	142.7	136.2	87.7	48.7	11.9	20.7
	% of GDP	23.9	21.4	14.0	15.0	3.5	5.7
Fiscal Balance	% of GDP	15.3	15.4	3.8	-	-	-
US Dollar Exchange Rate	Average	3.75	3.75	3.75	3.67	3.67	3.67

Sources: Haver Analytics and Citi Research

Nigeria

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One way to think about Nigeria's recent economic history is that the country built up savings, especially the buildup of foreign reserves, in 2003-08, and these have been drawn down in the 2009-11 period. While there has been some rebuilding of foreign exchange reserves in 1H 12, this came under pressure as the price of Brent crude fell below US$100/bbl in May and global economic uncertainty has increased demand for foreign exchange. Even with the recovery in the oil price back to levels of around US$100/bbl, with only limited savings the government's room for policy manoeuvre seems limited. The fragile position has been compounded by the ongoing political crisis in the north, as a result of the activities of Boko Haram. But the impetus is now moving back in favour of reform and with Ngozi Okonjo-Iweala as finance minister, alongside incumbent central bank governor Lamido Sanusi, we think Nigeria has a respected economic team committed to improving fiscal discipline, driving a return to more orthodox monetary policies and much needed structural reforms. But the key barometer of progress, and their ability to maintain naira stability, will be the re-building of foreign exchange reserves in 2H 2012.

South Africa

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Growth is set to remain weak in 2012 at under 3% but should start to rebound in 2013 as uncertainty about domestic policy eases following the ANC's elective conference in Mangaung in December and the unfavourable external environment facing the country slowly improves. Meanwhile, the Treasury remains committed to budget deficit reduction and debt stabilisation, focusing on micro policy steps to foster stronger growth and boost employment, although the reality is that weak revenue growth and pressure from the public wage bill mean that a significant reduction in the deficit is unlikely until 2014/15. Monetary policy is also expected to remain supportive of growth, especially with the surprise cut in the Repo rate to 5% in July. Consumer spending remains resilient and that recent monetary stimulus should give some support. But we expect no further cuts in 2012 and early 2013 as inflationary pressures still remain relatively robust, unless there is a sharp deterioration in the growth outlook. Given the rand's sensitivity to global risk aversion, the recent fall in interest rates may not be sustained in 2012-13, especially if the crisis in the Euro Zone were to escalate. This risk is heightened because poor export performance and the high import content of capital spending suggests that the current account deficit will widen gradually after being kept low by favourable terms of trade. A sudden and sharp weakening in the rand potentially could complicate thinking about monetary policy.

Figure 40. Egypt, Nigeria and South Africa — Economic Forecast, 2011-2013F

		Egypt			Nigeria			South Africa		
		2011	2012F	2013F	2011	2012F	2013F	2011	2012F	2013F
Real GDP	YoY	1.8%	2.0%	2.7%	7.8%	7.4%	6.8%	3.1%	2.7%	3.6%
Final Domestic Demand	YoY	2.9	2.7	2.6	NA	NA	NA	4.6	3.1	3.7
Private Consumption	YoY	5.0	0.9	0.8	NA	NA	NA	4.9	2.5	2.9
Fixed Investment	YoY	-5.6	3.7	6.5	NA	NA	NA	4.3	4.4	5.7
Exports	YoY	3.7	-3.8	6.3	NA	NA	NA	5.9	5.3	6.2
Imports	YoY	8.1	-2.3	5.5	NA	NA	NA	9.1	6.7	7.0
CPI	YoY	10.2	7.5	10.8	10.8	12.4	9.8	5.0	5.8	5.0
Unemployment Rate	%	12.1	13.0	14.5	NA	NA	NA	26.0	25.7	25.2
Current Account	US$ bn	-5.4	-7.2	-9.0	8.8	6.9	11.9	-13.6	-18.1	-22.3
	% of GDP	-2.3	-2.9	-3.5	3.4	2.3	3.5	-3.4	-4.7	-5.6
Fiscal Balance	% of GDP	-10.1	-9.3	-7.7	-3.1	-2.2	-2.1	-5.0	-4.8	-4.2
US Dollar Exchange Rate	Average	5.94	6.08	6.63	155.9	160.79	165.17	7.26	8.11	8.65

Sources: Haver Analytics and Citi Research

Figure 41. Selected Emerging Market Countries — Economic Forecast Overview, 2011-2013F

	GDP Growth			CPI Inflation			Current Balance (% of GDP)			Fiscal Balance (% of GDP)		
	2011	2012F	2013F	2011	2012F	2013F	2011	2012F	2013F	2011	2012F	2013F
Asia	**7.3%**	**6.4%**	**6.8%**	**5.7%**	**3.4%**	**3.5%**	**2.3%**	**1.7%**	**1.4%**	**-2.1%**	**-2.9%**	**-2.1%**
China	9.2	7.9	8.0	5.4	2.7	2.9	2.8	2.0	1.5	-1.3	-2.4	-1.5
Hong Kong	5.0	2.2	3.8	5.3	3.8	3.2	5.1	5.0	5.5	3.9	0.8	1.1
India*	6.5	5.4	6.2	8.9	8.0	7.0	-4.2	-3.0	-2.1	-8.4	-8.5	-8.0
Indonesia	6.5	6.2	6.3	5.4	4.4	4.7	0.2	-2.3	-1.5	-1.2	-2.1	-0.7
Korea	3.6	2.8	3.6	4.0	2.4	2.8	2.4	2.1	1.9	1.5	0.8	1.3
Malaysia	5.1	5.0	5.3	3.2	2.0	2.4	11.0	7.0	6.7	-5.0	-5.0	-4.7
Mongolia	17.3	16.0	17.5	9.2	12.9	14.0	-32.4	-25.5	-10.4	-3.6	-7.3	-0.9
Philippines	3.9	4.9	5.3	4.8	3.1	3.5	3.1	3.1	2.6	-2.0	-2.4	-2.1
Singapore	4.9	2.6	3.5	5.2	4.4	3.3	21.9	15.0	14.0	1.5	1.0	1.0
Sri Lanka	8.3	6.9	7.4	6.8	7.0	6.8	-7.8	-5.5	-4.9	-6.9	-6.5	-6.0
Taiwan	4.0	2.4	3.6	1.4	1.9	2.1	8.8	8.7	8.4	-1.9	-1.6	-1.6
Thailand	0.1	4.8	4.6	3.8	2.7	2.9	3.4	1.1	0.2	-1.5	-4.7	-3.9
Vietnam	5.9	5.2	5.6	18.6	8.8	6.9	-0.6	0.3	-0.6	-2.9	-4.5	-4.3
Latin America	**3.9**	**2.5**	**3.8**	**6.8**	**5.9**	**6.2**	**-1.1**	**-1.4**	**-1.9**	**-2.3**	**-2.0**	**-2.3**
Argentina	8.9	1.5	3.0	9.8	9.8	11.8	0.0	0.3	-0.8	-1.7	-2.8	-3.0
Brazil	2.7	1.4	3.9	6.6	5.3	5.4	-2.3	-2.3	-2.7	-2.6	-1.9	-2.7
Chile	6.0	4.9	4.5	3.3	3.0	3.1	-1.3	-2.3	-1.9	1.4	0.7	0.6
Colombia	5.9	4.0	4.5	3.4	3.2	3.2	-3.0	-2.9	-2.9	-2.9	-1.8	-1.6
Mexico	3.9	3.9	3.8	3.4	4.0	3.9	-0.8	-1.0	-1.4	-2.5	-2.2	-2.0
Panama	10.6	9.2	7.0	5.9	5.6	3.2	-12.7	-11.6	-10.0	-2.3	-3.0	-3.0
Peru	6.9	5.7	6.5	3.4	3.6	2.9	-1.9	-2.4	-2.8	1.7	1.2	-0.3
Venezuela	4.2	5.5	3.5	27.1	23.3	27.8	9.1	4.8	3.7	-5.0	-5.0	-4.0
Europe	**5.0**	**2.7**	**3.6**	**6.7**	**5.3**	**5.8**	**-0.2**	**0.3**	**-1.1**	**-0.3**	**-1.3**	**-1.2**
Czech Republic	1.7	-1.2	0.6	1.9	3.3	2.5	-3.0	-3.0	-1.9	-3.1	-3.2	-3.1
Hungary	1.7	-0.9	0.8	3.9	5.6	3.9	1.7	1.9	2.8	4.3	-3.1	-3.7
Kazakhstan	7.5	5.5	6.0	8.3	5.1	5.7	7.6	1.9	2.4	5.9	1.7	3.0
Poland	4.3	2.6	2.2	4.3	3.9	2.7	-4.3	-3.6	-4.2	-5.1	-3.3	-2.9
Romania	2.5	1.3	3.0	5.8	2.8	2.7	-4.4	-4.5	-4.7	-4.1	-2.4	-2.2
Russia	4.3	3.5	4.0	8.4	5.1	6.9	5.3	5.7	2.4	2.0	0.3	0.1
Slovakia	3.3	2.4	1.3	3.9	3.6	2.8	0.1	1.2	-1.1	-4.8	-4.9	-3.3
Turkey	8.5	2.5	4.3	6.5	9.1	7.0	-10.0	-7.5	-7.1	-1.3	-2.2	-2.5
Ukraine	5.1	2.8	4.5	8.0	1.7	7.1	-5.2	-6.6	-4.3	-3.8	-3.5	-2.9
Africa/Mideast	**5.8**	**4.0**	**5.0**	**5.5**	**5.7**	**5.8**	**10.3**	**9.5**	**8.4**	**2.6**	**3.0**	**-0.1**
Bahrain	3.2	3.0	3.9	-0.4	3.0	3.5	11.6	24.8	11.3	-1.2	2.6	0.2
Egypt	1.8	2.0	2.7	10.2	7.5	10.8	-2.3	-2.9	-3.5	-10.1	-9.3	-7.7
Ghana	14.4	7.5	6.5	8.7	11.4	9.9	-8.2	-7.3	-4.8	-5.4	-6.8	-6.2
Iraq	9.4	9.3	11.5	5.6	5.0	6.0	-5.1	28.1	50.7	15.8	11.8	14.3
Israel	4.9	2.7	3.0	3.4	2.0	2.2	0.1	-1.5	-1.1	-2.7	-3.7	-3.2
Jordan	2.6	2.5	3.0	4.4	5.0	5.0	-12.4	-14.2	-13.5	-7.0	-11.0	-12.5
Kenya	4.5	5.0	5.8	14.0	10.5	6.6	-11.8	-10.5	-9.5	-5.5	-5.0	-4.9
Kuwait	4.0	0.9	2.8	4.7	5.0	5.0	44.1	43.9	41.1	17.1	13.4	4.4
Lebanon	6.0	3.5	4.3	5.1	6.0	5.0	-22.9	-24.2	-25.1	-5.7	-6.9	-8.1
Nigeria	7.8	7.4	6.8	10.8	12.4	9.8	3.4	2.3	3.5	-3.1	-2.2	-2.1
Oman	3.5	3.0	4.4	4.0	3.0	3.0	16.4	2.7	8.3	5.6	6.0	3.0
Qatar	18.1	6.0	8.3	3.0	3.0	3.0	31.6	31.0	24.2	8.1	7.1	3.3
Saudi Arabia	7.1	6.1	6.1	5.0	7.0	8.0	23.9	21.4	14.0	15.3	15.4	3.8
South Africa	3.1	2.7	3.6	5.0	5.8	5.0	-3.4	-4.7	-5.6	-5.0	-4.8	-4.2
Tanzania	6.3	6.2	6.8	12.7	15.7	7.4	-20.1	-11.9	0.0	-7.8	-6.2	-5.8
UAE	4.2	0.6	3.4	0.9	1.1	1.3	15.9	3.7	6.0	NA	NA	NA
Uganda	5.7	4.5	5.5	18.7	14.3	5.1	-13.2	-12.5	-10.7	-7.2	-5.5	-5.2
Zambia	6.6	6.5	6.9	6.4	6.8	6.9	0.4	2.6	2.4	-3.2	-3.5	-3.7
Total	**6.0**	**4.7**	**5.5**	**6.0**	**4.5**	**4.6**	**2.1**	**1.7**	**1.1**	**-1.4**	**-1.9**	**-1.8**

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

Figure 42. Citi Global Strategy and Macro Team *For Informational Purposes Only*

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Source: Citi Research.

Figure 44. (Continued) Citi Global Strategy and Macro Team *For Informational Purposes Only*

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Source: Citi Research.

Sovereign Ratings Outlook

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The *Sovereign Ratings Outlook* 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. We do 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.

Given economic updates in this publication and based on rating agency criteria, we highlight our economists' and strategists' main expectations for sovereign ratings over the near (2-3 quarters) and longer (2-3 years) term. Citi economists and strategists continue to expect further downgrades over the near-term in the euro area, and a broader range of downgrades over the longer term.

Figure 43. Advanced Economies — Sovereign Long-Term Debt Ratings and Citi Ratings Forecasts

	S&P Ratings				Moody's Ratings			
Country	Current Rating	Current Outlook	Citi Near-term (Up to 9 Months) Forecast Rating	Citi Longterm (Next 2-3 Years) Forecast Rating & Outlook	Current Rating	Current Outlook	Citi Near-term (Up to 9 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 (Neg W)	AA+ ↓	Aaa	Neg	Aa1 ↓	Aa1 ↓
France	AA+	Neg	AA+ (Neg W)	AA (Neg) ↓	Aaa	Neg	Aa1 ↓	Aa1 (Neg) ↓
Italy	BBB+	Neg	BBB ↓	BBB- ↓↓	Baa2	Neg	Ba1 (Neg) ↓↓	Ba2 ↓↓↓
Spain	BBB+	Neg	BBB ↓	BBB - ↓↓	Baa3	Neg W	Ba1 (Neg) ↓	Ba2 ↓↓
Austria	AA+	Neg	AA+ (Neg W)	AA (Neg) ↓	Aaa	Neg	Aa1 ↓	Aa1 (Neg) ↓
Belgium	AA	Neg	AA (Neg W)	AA- ↓	Aa3	Neg	A1 ↓	A1 ↓
Finland	AAA	Neg	AAA (Neg W)	AA+ (Neg) ↓	Aaa	Stable	Aaa (Neg)	Aaa (Neg)
Greece	CCC	Neg	D ↓↓↓↓	CCC ↑↑↑↑	C		C	Caa2 ↑↑↑↑
Ireland	BBB+	Neg	BBB ↓	BBB- ↓↓	Ba1	Neg	Ba2 ↓	Ba2 ↓
Netherlands	AAA	Neg	AAA (Neg W)	AA+ (Neg) ↓	Aaa	Neg	Aa1 ↓	Aa1 (Neg) ↓
Portugal	BB	Neg	B+ ↓↓	CCC ↓↓↓↓↓	Ba3	Neg	B1 ↓	Caa2 ↓↓↓↓↓
UK	AAA	Stable	AAA (Neg)	AAA (Neg)	Aaa	Neg	Aaa (Neg)	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

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 Research

Key Expected Ratings Issues

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Overview: The EMU core is not immune from downgrades

Given Citi's view of the probability of a Greek exit in the near term (next 2-3 quarters) and recent comments by Moody's, we continue to expect the ratings of many core EMU sovereigns to be downgraded some time in the next 2-3 quarters, including Germany. These moves reflect the weak economic backdrop, broad-based fiscal slippage and bank stresses compound by Greek exit. Our views also reflect the fact that Moody's and S&P already have many EMU countries on Negative Outlook. Full details can be found in our latest *Sovereign Ratings Outlook*.

Few changes since last month, except Ireland

We continue to incorporate revised economic forecasts, new information and updates from the rating agencies into our view on how sovereign ratings might evolve. Below we list the major changes in ratings and our forecasts since we last published:

- **Improving Ratings Outlook for Ireland:** Since last month, we have revised our ratings forecasts up for Ireland. This reflects an improvement in the fiscal outlook and a demonstration of market access (Ireland held a bond switch and outright auction on 26 July, which raised €4.19bn of new money). We now expect Ireland to retain an investment grade rating with S&P over the longer-term (and therefore remain eligible for benchmark indices), whereas previously we envisaged an eventual downgrade to BB. Moody's already rate Ireland as sub investment grade. We expect one further downgrade from Moody's in the near-term but then expect the rating to stabilise. As a result of these modifications, our ratings outlook for Ireland is much more closely aligned with those for Italy and Spain.

- **Rating Affirmations:** Since the last *Global Economic Outlook and Strategy*, both Moody's and S&P have affirmed the ratings of several sovereigns (Figure 44). The affirmations have come with few significant changes to the rating agencies' economic forecasts, which in general are more optimistic than Citi's base cases.

- **S&P places Greece on Negative Outlook:** The only change to a sovereign rating since we last published came from S&P when on 7th August, the agency revised its Outlook on Greece's CCC rating to Negative. They stated[9] that this "*reflects the potential for a downgrade if shortfalls in Greece's 2012 deficit and arrears targets established under the current EU/IMF program are not met by new funding or other relief from members of the Troika.*" The rating agency also highlighted delays in implementing budgetary consolidation measures and the worsening economic outlook.

Figure 44. Recent Rating Affirmations

Moody's			S&P		
Date	Sovereign	Affirmed	Date	Sovereign	Affirmed
30th July	UK	Aaa Neg	25th July	Finland	AAA
31st July	Greece	C	27th July	UK	AAA
8th Aug	Ireland	Ba1 Neg	1st Aug	Spain	BBB+ Neg
9th Aug	Norway	Aaa	2nd Aug	Ireland	BBB+ Neg
10th Aug	Sweden	Aaa	2nd Aug	Portugal	BB Neg
16th Aug	Canada	Aaa			

Source: Citi Research

Global outlook: only Canada and the Scandinavian counties are likely to retain a AAA-rating over the long-term

Over the longer-term, given Citi's global economic projections and fundamentally weak backdrop, we continue to expect downwards rating pressure. The US is currently on Negative Outlook by both Moody's and S&P and we continue to expect a one-notch downgrade over the next 2-3 years. We also envisage downwards ratings pressure for Japan over the next 2-3 years, predicated on longer-term debt sustainability trends. Canada and the Scandinavian countries are the only countries covered in our Sovereign Ratings Outlook that we believe rating agencies will maintain a "AAA Stable" status both in the near- and longer-term.

[9] S&P RatingsDirect Research Update: "*Greece Outlook Revised to Negative on Likely Financing Shortfalls for 2012*" 7 August 2012.

Rates Strategy

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There have been three salient features of recent weeks: the sell-off in Bunds, the outperformance of France (and the UK vs the US), and underperformance of the long end in Europe. All have been helped by positioning, compounded by summer liquidity, and met little opposition. We think all three moves will reverse as we go into September.

The Bund sell-off has been extended by positioning but there is significant event risk in September

The sell-off in Bunds has extended further than we, and many others, expected. Bunds are now close to the top of their three-month range and we are starting to see buying interest. Positioning remains all important in these thin markets, but we expect there to be greater resistance to higher yields at these levels and with all the event risk approaching in September. We expect another risk-off Bund rally towards 1.20% once markets return from holiday to focus on how much there remains to do in Europe: for example, the increasing possibility of Greek exit or request for even more aid, the likely eventual request from Spain for assistance, the size of the financial firepower available to the authorities relative to the breadth and depth of the potential calls on it, the divergences in opinion amongst the main players on the European stage, the resumption of heavy supply in September… the (depressingly familiar) list goes on. For choice, we would express this bullish view conditionally with 6m expiries as, amongst other events, this would encompass the September and December Troika reports on Greece, the Dutch elections, the German Constitutional Court Ruling, and the events outlined above.

With a lot of positioning painfully unwound, we think the balance of risks is skewed towards bouts of risk-off in the coming month

The ‘good news’ that could theoretically come from Europe and derail this view, e.g., ECB bond buying capping peripheral yields, sharp increase in deployable financial resources, a common deposit insurance scheme, submission to conditionality and relinquishing of sovereignty, etc, is either likely to be very slow in materialising, or unlikely. With a lot of positioning painfully unwound, we think the balance of risks is skewed towards bouts of risk-off in the coming month.

We are still positive gilts vs US Treasuries spreads in the medium term, and Europe vs the US

While Bunds have sold off recently, gilts have been relatively resilient. The short term risk-reward for long gilts vs Treasuries is much more balanced than it was following recent moves, but we remain very constructive gilts in the medium term. US Treasury vs Bund spreads remain correlated to forward short rate differentials but a Discount Rate cut from the ECB could remove the cap on these spreads. We like using dips to buy 5yr Bobls against US Treasuries or consider 2s5s EUR flatteners vs USD steepeners.

Fading the richness of France

The other salient feature of recent moves is the strong outperformance of France in the hunt for yield and as the only liquid alternative to Germany. As outlined above, we expect the EMU crisis to re-intensify and for Germany to take back a lot of its recent risk-on inspired sell-off. We think 2s5s steepeners in France are a good proxy for selling France/Germany and 2s5s is at the bottom of the range which has contained it in recent years.

Steepening of 10s30s in Europe has lost momentum

10s30s curves in Europe have drifted steeper still after steepening significantly as anticipation of regulatory pressures weighed on the long end. While we see further scope for steepening in the absence of demand to drive long end yields lower, the short term risk/reward is much less attractive than it was, and we have recently seen a variety of accounts lightening up on steepeners in swaps. However, rather than fade the steepening directly, we would recommend looking at buying 30yr Germany vs 30yr Netherlands which is at historically very attractive levels.

Figure 45. Interest Rate and Bond Market Forecasts as of 22 Aug 2012

		Quarterly Average					
	Current	3Q 12	4Q 12	1Q 13	2Q 13	3Q 13	4Q 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	0.43	0.42	0.40	0.40	0.55	0.65	0.75
2 Year Treasury Yield	0.28	0.27	0.25	0.35	0.55	0.70	0.85
5 Year Treasury Yield	0.79	0.70	0.75	0.85	1.10	1.25	1.40
10 Year Treasury Yield	1.78	1.60	1.65	1.80	2.10	2.35	2.60
30 Year Treasury Yield	2.92	2.70	2.75	2.90	3.20	3.50	3.80
2-10 Year Treasury Curve	150	133	140	145	155	165	175
2 Year Swap Spread (Swap Less Govt.), bp	21	25	30	30	30	35	35
10 Year Swap Spread (Swap Less Govt.), bp	11	20	24	22	25	25	25
30 Year Swap Spread (Swap Less Govt.), bp	-23	-25	-35	-45	-50	-50	-50
30 Year Mortgage Yield	3.68	3.60	3.65	3.80	4.05	4.25	4.45
10 Year Breakeven Inflation	225	215	215	220	230	235	240
Euro Area							
Policy Rate	0.75	0.50	0.25	0.25	0.25	0.25	0.25
Overnight Rate (EONIA)	0.10	-0.10	-0.30	-0.30	-0.30	-0.30	-0.30
3-Month Libor	0.33	0.10	-0.10	-0.20	-0.20	-0.20	-0.20
2 Year Treasury Yield	-0.01	-0.05	-0.10	-0.10	-0.05	0.00	0.05
5 Year Treasury Yield	0.46	0.35	0.20	0.25	0.30	0.55	0.75
10 Year Treasury Yield	1.54	1.40	1.20	1.25	1.30	1.50	1.80
30 Year Treasury Yield	2.35	2.25	2.00	2.00	2.05	2.20	2.35
2-10 Year Treasury Curve	155	145	130	135	135	150	175
10 Year BTP-Bund Spread	420	440	600	600	550	550	500
10 Year Swap Spread (Swap Less Govt.), bp	33	40	50	45	40	25	25
10 Year Breakeven Inflation	199	180	170	180	185	195	200
Japan							
Policy Rate	0.10	0.10	0.10	0.10	0.10	0.10	0.10
3-Month Libor	0.19	0.20	0.20	0.20	0.20	0.20	0.20
2 Year Treasury Yield	0.10	0.10	0.10	0.10	0.15	0.10	0.15
5 Year Treasury Yield	0.24	0.20	0.25	0.35	0.40	0.35	0.50
10 Year Treasury Yield	0.83	0.80	0.95	1.10	1.20	1.10	1.30
30 Year Treasury Yield	1.90	1.85	1.95	2.05	2.15	2.05	2.20
2-10 Year Treasury Curve	73	70	85	100	105	100	115
2 Year Swap Spread (Swap Less Govt.), bp	21	21	22	23	25	23	27
10 Year Swap Spread (Swap Less Govt.), bp	2	2	4	6	8	6	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	0.70	0.75	0.75	0.75	0.75	0.75	0.75
2 Year Treasury Yield	0.17	0.15	0.10	0.10	0.20	0.40	0.60
5 Year Treasury Yield	0.64	0.55	0.45	0.45	0.60	0.85	1.10
10 Year Treasury Yield	1.68	1.50	1.40	1.40	1.50	1.75	2.05
30 Year Treasury Yield	3.05	2.90	2.60	2.65	2.70	2.80	2.90
2-10 Year Treasury Curve	151	135	130	130	130	135	145
10 Year Swap Spread (Swap Less Govt.), bp	41	40	45	45	40	35	30
10 Year Breakeven Inflation	235	230	230	235	250	265	275
Australia							
Policy Rate	3.50	3.50	3.50	3.50	3.50	3.75	4.00
3-Month Libor	3.61	3.55	3.60	3.60	3.60	3.90	4.20
2 Year Treasury Yield	2.83	2.70	2.60	2.60	2.80	3.10	3.40
5 Year Treasury Yield	2.94	2.80	2.75	2.75	2.90	3.25	3.55
10 Year Treasury Yield	3.30	3.20	3.10	3.30	3.60	3.80	4.10
2-10 Year Treasury Curve	47	50	50	70	80	70	70
10 Year Swap Spread (Swap Less Govt.), bp	74	80	80	75	70	65	60

Source: Citi Research

Credit Outlook

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For credit, 2012 has been all about the battle between strong technicals created by deleveraging corporates and liquidity-infused investors on the one hand and all the fundamental uncertainty on the other. The past couple of months have been no different.

Compared to last year, policymakers have managed to prevent a weak macro backdrop from causing further market turmoil during the illiquid summer period. In the US, the perception that the Fed was ready to act took the sting out of comparatively weak macro data. In Europe, Draghi's reassurances that the ECB would do what was required have not only kept a lid on Spanish and Italian yields, but also prompted a significant rally at the front end. A very defensively positioned and extremely cash-rich credit market was invariably very prone to a squeeze in such a period of comparative macro stability.

However, with spreads in many parts of the credit market at or near 12-month tights, we see renewed pressure, given the likely return of macro volatility in September.

The bear case

As discussed elsewhere in this publication, September is in many ways a crucial month from a macro perspective. Credit investors have lots to worry about:

Spain and Italy, in particular, have a large gross funding requirement until year end. As Draghi made amply clear, until Spain and Italy request support, they will have to find that funding in the open market. Moody's rating decision on Spain is likely in the coming weeks. A downgrade would likely be followed by rating action on a number of corporates also. Spanish corporate debt represents some 65% of existing € HY market outstandings. Although it would take downgrades from the other rating agencies to force ejection from most bond indices, some segregated fund mandates are based on the lowest rating. Separately, the bottom-up assessment of Spanish banks is due towards the end of the month. We believe further problems are likely to emerge and expect bail-ins, at least at the sub-debt level.

On 1 September, the Troika is set to return to Athens for what still look like very discordant negotiations. Our economists see a growing risk that the outcome could be an accelerated departure from the euro.

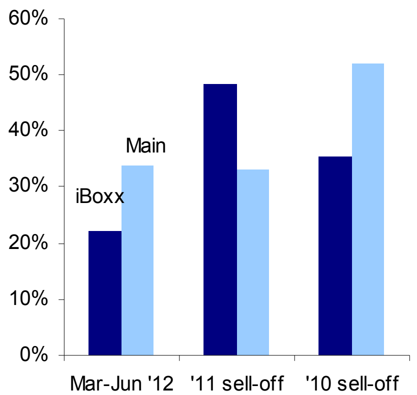
On the 12th, the German Constitutional Court's ruling on the ESM and fiscal compact, although expected to be favourable, could also add more checks on Germany's ability to shoulder further bailouts. Equally, the Dutch general election on the same day could result in a Parliament composition that would put constraints on Dutch participation.

Our G10 economic surprises index has been recovering from the June low in recent weeks, suggesting the adjustment to expectations has progressed, but the data out of the US and China is likely to remain comparatively soft and very weak in Europe. Equally, although it is probably to some extent already discounted by the market, we think bottom-up earnings expectations remain too high both in Europe and the US, implying that earnings revisions are likely to retain a very negative bias.

It won't be a deluge of supply, but the credit market is likely to head into these headlines whilst also having to absorb a substantial pick up in new issuance.

The bull case

Figure 46. Widening in corporate credit indices relative to Spain 5yr CDS



Sources: Citi Research and Markit

All that ought to make even the most sanguine credit investor wary, though the impact may be muted. The cash credit market has become much less sensitive to the macro uncertainty lately, judging by the lower responsiveness of corporate credit spreads to widening in Italy and Spain in Q2 than in previous sell-offs (Figure 46).

Technicals play an important role. Our latest credit survey shows that longs in credit are near a three-year low, whilst reported inflows are currently near a two-year high. In a broader study of technicals in the US market, we show that IG credit has seen more than $430bn of inflows since 2009 — 15 times the amount from 2003-08. The lack of supply over the summer will only have added to cash balances. But equally, the credit market has now been "schooled" to expect last-minute intervention. Too many times, fund managers have found themselves struggling to find the bonds they had sold in the widening, in the post-intervention contrarian rally.

As a result, many are just sticking to core holdings, riding out the volatility. We expect they will do the same in September given the perception that a Spanish, and potentially an Italian, bailout request could come very rapidly if market pressure picks up. Draghi's plan might not be a lasting solution, but we suspect the defensive position of the credit market implies that it would, at least initially, give the plan the benefit of the doubt.

What could upset the apple cart is a potential rapid Greek exit from monetary union — we do not believe that this is a central scenario in credit currently. Against the lack of progress on creating pan-European deposit guarantees, we still believe the downside systemic risks posed by that scenario would be difficult for corporate credit to ignore — especially in financials.

Too tight to chase

Our sense remains that credit still wants to rally and the prospect of central bank intervention will probably prevent most from underweighting / shorting the market aggressively. Yet the likelihood is that nothing will happen on the policy front without market pressure, and the downside risk regarding Greece, coupled with the fact that spreads are at their recent lows, should prompt some accounts to lighten up going into September. Risk/reward in € cash, in particular, looks poor with spreads at one-year lows, having outperformed US peers and spreads in the CDS market. We would use the remainder of August to position more defensively:

- Short financials to non-financials — Whether, with respect to the growing likelihood of widespread bail-in in Europe, or the headline risks associated with regulators' investigations, we are surprised at the extent to which the market reaction has thus far been idiosyncratic. It is true that, unlike last year, there is no liquidity crisis in the banking system currently. However, financials are more exposed to systemic risk than other sectors.
- Long US versus European banks — The widening in Spanish and Italian spreads was barely reflected in spreads on core banks in Europe. However, given the large exposures — both direct and indirect — we believe the increase in systemic risk should be reflected much more in their spreads than for US counterparts.
- Long covered/ABS and hybrid debt selectively versus underweight senior — The effective subordination of unsecured bank debt makes investment in bank bonds a more binary proposition. That speaks for barbelling between bonds with security or hybrid capital, where the subordination risk is already priced in.

Overweight IG to HY — While high yield has benefited from the low-interest rate environment, a deteriorating economic outlook, coupled with the negative effects of potential benchmark changes, to our minds favours IG, especially in Europe.

Global Equity Strategy

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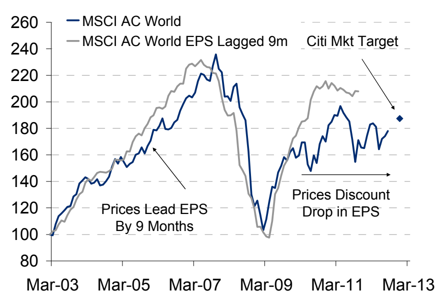
Global equities are up 9% YTD and 12% from the lows reached in early June. Expectations of policy easing from major central banks and a reasonable earnings season seem to have helped global equity markets. We forecast a further 5% gain for global equities by year-end which would imply the MSCI AC World index ending the year at 340. This represents a healthy gain for the entire year.

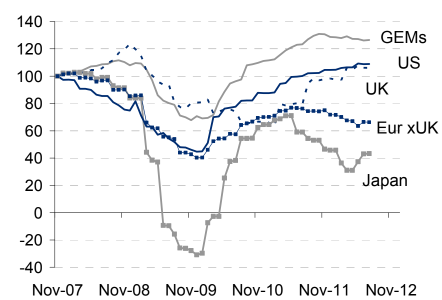
Figure 47 shows the relationship between global share prices and the trailing EPS index lagged by 9 months. Between 2003 and 2010, prices led EPS. Since then, this relationship suggests that prices have started to discount a contraction in global EPS. Bottom-up consensus forecasts for 2012 have been cut during last few months and now stand at 6% for 2012 and 13% for 2013. An aggregation of Citi strategists' top-down forecasts suggests 6% EPS growth in 2012 followed by 6% in 2013. This suggests that Citi strategists are not forecasting a contraction in global profits, but they are less optimistic than bottom-up consensus for 2013.

Figure 47. MSCI AC World Price vs EPS (9m Lagged)



Source: MSCI, Citi Research

Figure 48. Trailing EPS Since November 2007



Source: Citi Research, Factset

A slowing global economy is reflected in slowing global EPS. Figure 48 shows trailing EPS since the global peak in November 2007. Only the US and EM have regained their previous highs. The scope for further EPS growth in the US is limited by already-high margins and a slowing economy, in our view. UK EPS has been surprisingly strong given the weakness of the domestic economy, but we think the UK is vulnerable to lower commodity prices with its heavy weightings in the Energy and Materials sectors. The Eurozone crisis has dragged Europe ex UK EPS back down to 30% below highs of 2007 and EMU recession is likely to prove a continued drag here. Overall, we suspect that the risks to global EPS have been rising. However, there appears to be a lot of bad news already priced in. Global equities look cheap, especially against artificially low core government bond yields. Cheap valuations help limit the downside when pullbacks occur. Global equities are trading at an estimated 17x Cyclically Adjusted PE (CAPE) while the long-term average is 25x.

Our key regional and sector recommendations are summarised in Figure 50. Lower global GDP forecasts mean that those areas generating some growth should be valued more highly. In line with this view, we have increased our exposure to those regions with solid EPS and GDP trends, while at the same time lowered the importance of valuation in our allocation. We are Neutral on the US. GDP growth in the US, while not stellar, has remained stable over the last 18 months while other regions have fallen back into recession. Although US equity valuations appear to be amongst the most expensive in the world, they are not extreme enough to offset the positives of superior EPS and GDP, in our view. Within the US, our strategists like IT as earnings remain solid and Telecoms as valuations are appealing.

By comparison, the Eurozone economy is only part way through a contraction, which continues to be a considerable drag on corporate profits. Although Continental European equities trade on relatively low valuations, we are Underweight the region given the uninspiring EPS outlook. Within Europe, our strategists are most cautious on some of the domestic-focused sectors such as Construction.

We are Neutral on the UK. The UK economy is also contracting but 70-80% of FTSE 100 sales come from outside of the UK, much of this directly from Emerging Markets. Large international exposure means that UK profits are very sensitive to moves in a currency which is now being depressed by unconventional monetary policy. We are also Neutral on Emerging Markets. EM companies have struggled to turn premium GDP growth into premium EPS growth and we don't see this changing soon.

Our preferred equity markets right now are all in Asia. This includes Japan, Asia Pac ex Japan and Australia where we are Overweight. Unlike Europe, Asia is not suffering a recession. By contrast, Japan is experiencing a rebound in GDP and EPS following the earthquake last year. Within Japan, our strategists prefer Autos and Financials. Japanese Financials trade close to European Bank valuations but without the intertwined sovereign risks. Within Asia Pac ex Japan, our strategists like Energy, which trades on depressed valuations and IT, which benefits from solid EPS momentum. We like Australia which benefits from easy monetary policy and attractive valuations. The dividend yield is amongst the highest in the world at more than 5%. Within Australia, our strategists are buyers of the Energy sector.

Figure 49. Strategists Forecast

Region	Index	Current Level*	End 2012 Target	Exp Gain (%)
US	S&P 500	1416	1425	1
Pan Euro	DJ Stoxx600	271	275	1
UK	FTSE 100	5835	6000	3
Japan	Topix	759	800	5
Asia x Jp	MSCI AsiaxJ	497	585	18
Australia	S&P/ASX 200	4330	4450	3
GEMs	MSCI EM	976	1100	13
LATAM	MSCI Latam	3687	4000	8
CEEMEA	MSCI EM EMEA	334	350	5
Global	**MSCI ACWI**	**325**	**340**	**5**

* 16/Aug/2012.
Source: Citi Research

Figure 50. Regional And Global Sector Recommendations (Arrows show latest changes)

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

Global Sectors		
Overweight	**Neutral**	**Underweight**
Energy	Consumer Staples	Consumer Discretionary
Health Care	Financials	Industrials
IT	Materials	Utilities
	Telecoms	

Sectors		
Overweight		**Underweight**
Japan - Autos		US - Capital Goods
Australia - Energy		Europe - Construction
CEEMEA - Energy		GEMs - Consumer Staples
Asia ex Japan - Energy		US - Materials
GEMs - Financials		Europe - Media
Japan - Financials		US - Retailing
US - Telecoms		Europe - Telecoms
Asia ex Japan - IT		GEMs - Telecoms
US - IT		Europe - Utilities
Europe - Pharmaceuticals		Japan - Utilities

Source: Citi Research

Securitized Products Strategy

The Central Bank Effect

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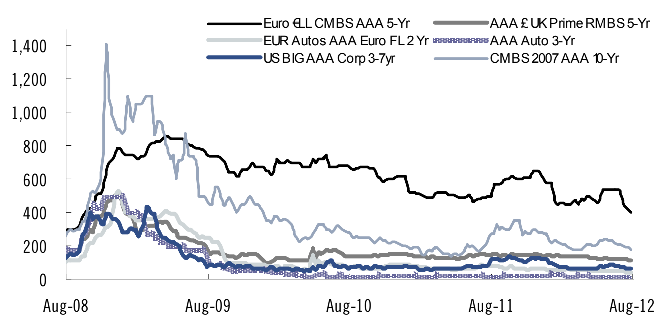
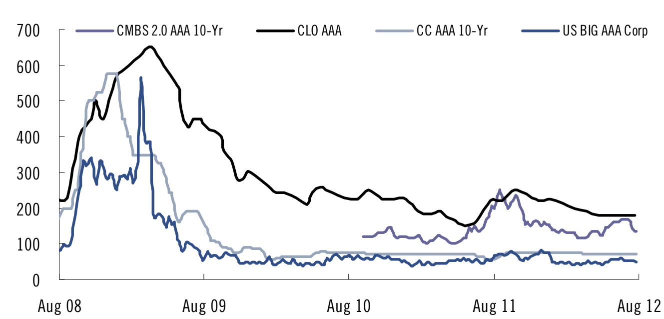
The securitized products markets broadly exhibit measurable strength, reacting to the quantitative easing enacted to date and the likelihood that rates will remain accommodative for an extended period. We expect the rally has some legs as markets express optimism about possible additional global monetary accommodation and also slowly improving US labour and economic conditions.

Longer WAL and off-the-run sectors likely have more tightening potential, in our view, as short-end trades have outperformed and spreads are tight to historical levels. In US consumer ABS, auto subordinates remain our top pick. At swaps + 100-175bp, single-A and triple-B auto ABS, respectively, are attractive to historical levels and pick up 35-105bp to comparable credit card subordinates. Nonagency RMBS bids lists continues to trade well, with evidence of robust demand from non-dealer buyers.

Figure 51. Selected Securitized Products Sectors — Spread Performance, Aug 08-Aug 12





Source: Citi Research

In Europe, UK Prime RMBS experienced its strongest rally of the year, and short WAL UK Prime spreads range in the LIBOR + 55–100bp area, tightening from the LIBOR + 120bp earlier in the year. The UK central bank's new "funding for lending" scheme encourages banks to borrow cheaply if they grant new consumer and commercial loans. This action could discourage new issue UK RMBS supply, causing spreads to tighten further. The market is beginning to appreciate the ramifications of the new central bank scheme. This awareness is driving spreads tighter, and we think this trend is sustainable.

Job Count Does Not Tell All[10]

For all the market angst over the wide monthly swings in US payrolls, the underlying trend has been remarkably steady at a modest pace.[11] The average employment gain in the past six months was 150,000, which was almost identical to the average in the prior six months and the six months before that. The issue is that payroll gains have oscillated between waves of strength and weakness. Importantly, these

[10] *"July Non-Farm Jobs +163K as Seasonal Distortions Wash Out; Other Components Very Modest; Fed Outlook Unresolved"*, by Steven Wieting, August 3, 2012, Citi Economics Research US Macro Flash.

[11] Excerpt from *"Back to the Well — Market and Policy Comments"*, Citi US Economics Weekly, by Robert V. DiClemente et al, 27 July 2012.

strings of strong/weak payroll increases have been poor signals for the wider economic outlook. Actually, the very visible swings in payrolls have not corresponded well to demand in the past year and a half. Demand growth has generally advanced at a moderate pace in the 2% range consistent with the trend in payrolls. As long as demand growth remains steady, we expect that hiring will once again bounce back closer to its modest trend pace.

Selected Securitized Products Recommendations

- **Possible upgradeable FFELP ABS.** We identified four Stafford FFELP classes in last week's report[12] which appear to be on the cusp of being upgradeable from double-A+ to triple-A, either because of elevated parity, and/or short WAL. All the transactions we have cited as possible upgrade candidates represent current cash flow Stafford classes with large parity ratios.

- **Euro Core Focus.** Core country collateral is the focal point for our recommended barbell strategy. We recommend that investors continue to treat peripheral regions with caution despite recent positive sentiment. We recommend investors look to core country high yield sectors such as UK BTL, UK NCRMBS, and CMBS for extra yield.

- **Non-agency current recommendation.** While the market has shown resilience in the face of large supply, we remain cautious about entering the market at current levels. Although dealer inventory declined slightly last week, inventory levels are still significantly high. Yields are at the richest levels in the past two years, and the prices could pull back if dealers are unable to place their increased inventory. We recommend waiting for a pullback in prices before adding to positions.

- **Attractive CMBS vintage differentials.** Vol-risk-adjusted duper differentials currently imply compelling relative value in the later-vintage dupers even though nominal spreads are near their year-to-date averages.

Sector Relative Value and Allocation Recommendations

Our securitized products strategists have mixed views on the market, ranging from bullish to neutral, and Figure 52 shows Citi strategists' recommendations for major structured products sectors on a scale of -3 (maximally bearish) to +3 (maximally bullish). The table also incorporates the strategists' most current thinking about value and presents one or two trade ideas.

Figure 52. Sector Relative Value and Asset Allocation Recommendations — Selected Sectors, August 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 senior auto lease, private label credit card and dealer floorplan ABS.
CMBS	0	Fair	Vol-risk-adjusted duper differentials currently imply compelling relative value in the later-vintage dupers even though nominal spreads are near their year-to-date averages.
Agency MBS	0	Fair	OAS levels are tight, however convexity-adjusted carry is in upper end of range
European Securitized Products	0	Cheap to Fair	We prefer a core country focus in our barbell strategy with stable, short sectors, combined with select off-the-run opportunities. We prefer yield opportunities in UK BTL, UK NCRMBS and select CMBS.

Source: Citi Research

[12] For more extensive analysis, refer to *"A Guide to Navigating FFELP Rating Pitfalls"*, by Mary Kane and Eugene Belostotsky, Citi Consumer ABS Weekly, August 2, 2012.

Commodity Outlook and Forecast

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Commodity returns have been surprisingly resilient this quarter (+5.8%) buoyed by a myriad of idiosyncratic factors. To be sure, macro sentiment has also been buttressed by a general 'risk-on' rally across asset markets this month and an ongoing trend of volatility compression since June. Indeed, aggressive statements from policymakers in Europe and modest improvement in economic data prints in the US and emerging markets in recent weeks have been well-received by investors, helping push benchmark equity indices to multiyear highs. But that has provided little relief to base metals (-4.8% q-t-d) that continue to struggle amid economic growth concerns and tepid industrial activity in China. Meanwhile, their metals brethren in the precious complex have also shown underwhelming returns this quarter (+0.8%) with markets weighing hopes of further stimulus from the ECB and FOMC. Rather it has been the weather-related 'supply-shock' in US grain markets and seasonal tightness and geopolitical tension in the petroleum complex that have given the commodity rally legs this quarter albeit it seems unlikely to last.

Figure 53. Citi Commodity Price Forecasts*

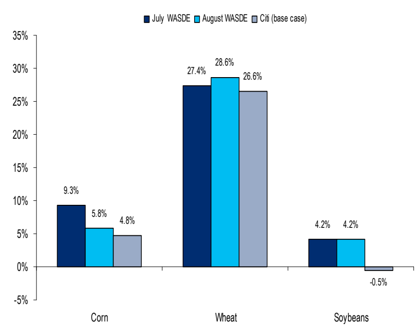
		Point Prices												
		0-3M	6-12M	5Y Cyclical	Q1 2012	Q2 2012	Q3 2012E	Q4 2012E	2012E	Q1 2013E	Q2 2013E	Q3 2013E	Q4 2013E	2013E
Energy														
NYMEX WTI	USD/bbl	90.0	80.0	81.0	103.0	93.3	100.0	80.0	94.0	85.0	85.0	85.0	85.0	85.0
ICE Brent	USD/bbl	105.0	100.0	85.0	118.4	108.8	120.0	105.0	113.0	105.0	95.0	100.0	95.0	99.0
Henry Hub Natural Gas	USD/MMBtu	2.5	2.7	N/A	2.5	2.4	2.5	2.3	2.4	3.1	3.5	3.8	3.7	3.6
Base Metals														
LME Aluminum	USD/MT	1,900	2,065	2,300	2,216	2,019	1,900	2,000	2,035	2,050	2,080	2,120	2,200	2,115
LME Copper	USD/MT	7,550	8,180	7,300	8,314	7,833	7,550	7,900	7,900	8,100	8,260	8,240	8,200	8,200
LME Lead	USD/MT	1,850	2,075	2,300	2,118	1,987	1,850	1,950	1,975	2,100	2,050	2,000	2,150	2,075
LME Nickel	USD/MT	16,800	22,513	22,000	19,721	17,228	16,800	20,500	18,560	22,550	22,475	23,000	23,250	22,820
LME Tin	USD/MT	18,700	22,500	24,500	22,986	20,619	18,700	21,500	20,950	22,000	23,000	23,500	22,000	22,625
LME Zinc	USD/MT	1,830	1,988	2,300	2,040	1,933	1,830	1,900	1,925	1,975	2,000	2,080	2,100	2,040
Precious Metals														
COMEX Gold	USD/T. oz	1,610	1,680	1,350	1,691	1,613	1,610	1,660	1645.0	1670	1690	1700	1720	1695
Silver	USD/T. oz	29	30	21	32.6	29.6	28.6	29.5	30.0	29.7	29.8	30.0	30.0	29.9
Platinum	USD/T. oz	1,475	1,565	1,750	1,604	1,505	1,475	1,550	1535.0	1565.0	1565.0	1565.0	1565.0	1565.0
Palladium	USD/T. oz	650	700	775	683	630	650	675	660.0	700.0	700.0	700.0	700.0	700.0
Bulk Commodities														
Hard Coking Coal (benchmark Asia)	USD/MT	215	220	200	235	215	225	220	224	225	230	225	225	226
Thermal Coal Asia (NEWC)	USD/MT	90	115	105	113	88	94	98	98	110	115	115	120	115
Iron Ore Spot (TSI)	USD/MT	130	135	100	142	139	135	140	139	140	138	130	130	135
Agriculture														
CBOT Corn	USd/bu	850	693	N/A	641	618	730	710	675	675	660	635	610	645
CBOT Wheat	USd/bu	925	750	N/A	643	641	765	750	700	750	725	730	715	730
CBOT Soybeans	USd/bu	1,875	1,488	N/A	1,272	1,426	1,550	1,525	1,443	1450	1375	1375	1300	1,375
CBOT Rice	USD/cwt	15.0	15.1	N/A	14.31	14.82	15.00	15.10	14.81	15.15	15.20	15.25	15.00	15.15
NYB-ICE Cotton	USd/lb	67	80	N/A	93	81	83	83	85	N/A	N/A	N/A	N/A	85
Sugar#11	USd/lb	23	24	N/A	24.5	21.2	23.5	23.5	23.2	N/A	N/A	N/A	N/A	23.0
ICE Coffee	USd/lb	180	185	N/A	205	171	185	180	186	N/A	N/A	N/A	N/A	190
ICE Cocoa	USD/MT	2,315	2,315	N/A	2,308	2,221	2,315	2,300	2,290	N/A	N/A	N/A	N/A	2,400

Source: Citi Research, *subject to revision. Originally published 16th July 2012 (agriculture price forecast published 11th July 2012)

To be sure, oil markets are looking strong *for now*, driven by macro, geopolitics and fundamental factors. The energy complex as a whole looks surprisingly firm; aided by a one of the hottest US summers on record which has helped US natural gas and slowed coal exports. Meanwhile Brent has been supported by seasonal maintenance of North Sea production along with a host of other geopolitical issues. Looking into 4Q'12 however, crude supplies look more plentiful, while US natural gas should resume its bearish influence on the global energy complex. JODI data from last week confirmed oil production in Saudi Arabia at 10.1-m b/d in June and it appears the Kingdom is likely to maintain a high level of output for the foreseeable future. These data arrive just as the IEA continues to reduce its 2012/13 global oil demand outlook. Certainly US sanctions on Iran are ratcheting tighter. Citi estimates

Iranian exports in July fell to just 830-k b/d, down 1.5-m b/d y/y and the heightened regional tension in recent weeks (Syria, Russia, Iran, Israel) have been price supportive although, fundamentally, s/d balances look healthy as market reports indicate the possibility of an SPR release and weighing on a move higher.

Figure 54. Projected US Stocks to Use (%) for Key Grains and Oilseeds

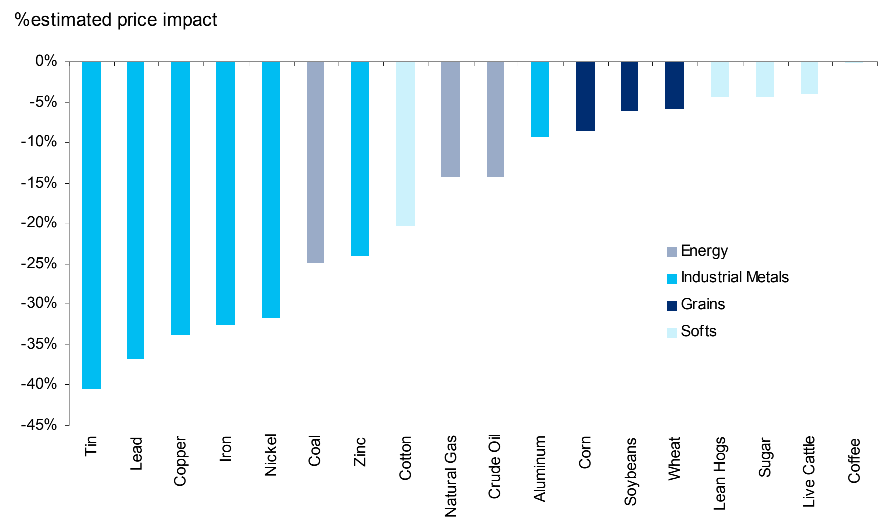


Source: USDA, Citi Research

Agriculture appears poised to continue outperforming other commodity sectors with benchmark grain and oilseed prices likely to remain at elevated levels until the potential for a LatAm bumper crop comes online to ease balances in late 1H'13. With the US the global swing producer of corn (~35% of world) and soybeans (~30% or world) as well as swing exporter of wheat (~25% of world), the impacts of the worst US drought in over a half-century are clearly being felt in 'ag' markets globally, just as weather risks in other key producing blocs including the Black Sea, Australia and India emerge. The USDA August report affirmed the bullish tinge with the availability of these key crops—particularly corn and beans—alarmingly tight.

Over the longer-term, the current slowdown and expected rebalancing in the Chinese economy promises to have dramatic repercussions for commodity markets and prices. Since 1998, investment in fixed capital such as real estate and infrastructure has contributed to about half of Chinese real GDP growth, peaking at a remarkable 91% in 2009.

Figure 55. Estimated Price Impact from China Rebalancing by Commodity



Source: Citi Research

This fixed capital investment has been strongly raw materials-intensive, particularly for base metals and energy commodities, and Chinese appetite has been one of the if not the most significant driver of the decade-long rally in commodity prices since the late 1990s. Conversely, the restructuring of Chinese economy would have equally dramatic negative impact on commodity prices across the spectrum.

Figure 55 presents our estimates as to the potential price impact (in real terms) of a halving of the commodity-intensity of the Chinese economy. As expected, base metals should be the hardest-hit, with tin, lead, copper, iron, and nickel all seeing 30% depreciation. Coal is also strongly hit, though crude oil somewhat less so (given the oil-linked nature of natural gas contracts prevalent in East Asia, we assumed natural gas prices should fall in tandem with crude oil). Meanwhile, the grain and soft commodities are relatively immune from the China rebalancing, with the exception of raw cotton, whose price may fall over -20%.

Citi Foreign Exchange Forecasts

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To see this piece in full please refer to *"Foreign Exchange Forecasts"*, 22 August 2012, Citi.

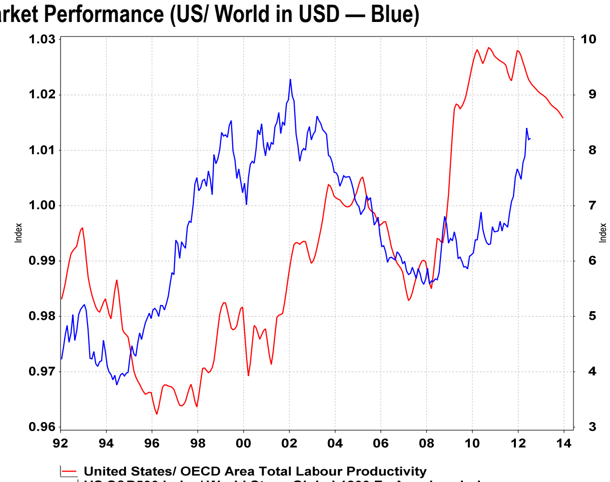
Medium term, our forecasts remain resolutely USD bullish, with an appreciation of around 5% priced vs. other G10 currencies over 6-12m and 4% globally. This in turn reflects likely US cyclical outperformance. FX investors are likely to believe that the US economy may be sub-par but that it is still likely to better other regions. Equity market outperformance, and bond market underperformance on trend suggest similar expectations are in other asset markets. These factors are likely to drive USD appreciation over the medium term, absent US policy disasters. As such, investors in US asset markets will likely outperform via either asset market or currency (see Figure 56).

The EUR is expected to be the weakest major currency over the same medium term horizon, undermined by high risk premia, relatively aggressive ECB monetary easing/ balance sheet expansion and tight fiscal policies/ subdued cyclical performance. In the EM world, we expect USD/ CNY to be broadly stable implying some Chinese appreciation against other blocs. LATAM currencies may perform relatively well short term but give back some gains medium term. CEEMEA performance will likely be varied but generally weak, held back by association with EUR weakness.

Short term, however, the correction weaker in USD since early June may extend further and this is reflected in our 0-3m forecasts. For one thing, USD remains a risk-on/ risk off currency however much we may all wish it was not so (Figure 57). Given the extent of current Central Bank liquidity support to markets, and receding concerns about tail risks in Europe, this points to some scope for the USD to fall near term. For another, apparent speculative positioning in USD based on CFTC and Citi platform indicators suggests that markets are positioned for USD upside and some unwind may need to occur near term, again pushing USD lower.

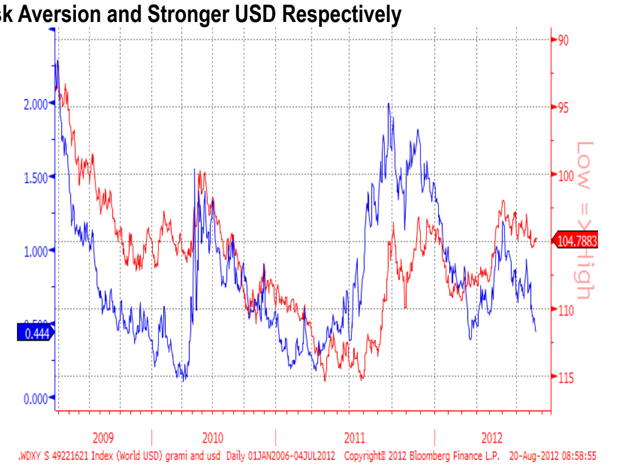
All in all, while Citi forecasts anticipate further USD gains medium term, especially relative to G10 majors with EUR/USD falling towards 1.15, our near term outlook sees some USD weakness for so long as risk appetite remains robust.

Figure 56. US / Total OECD Area Productivity (Red) and Relative Equity Market Performance (US/ World in USD — Blue)



Sources: Citi Research and Reuters EcoWin

Figure 57. GRAMI (Blue) vs. World USD Index (Red) — Higher = Greater Risk Aversion and Stronger USD Respectively



World USD = Average of 4 evenly weighted regional indices (Higher = USD Weaker)
Source: Citi Research and Bloomberg

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	1.23	1.23	1.24	1.25	1.15	1.25	1.4%	-7.2%
Japanese yen	USDJPY	80	79	79	81	80	84	2.0%	1.2%
British Pound	GBPUSD	1.57	1.57	1.57	1.58	1.50	1.58	0.9%	-4.1%
Swiss Franc	USDCHF	0.97	0.97	0.97	0.96	1.04	0.96	-1.4%	8.1%
Australian Dollar	AUDUSD	1.05	1.04	1.01	1.05	0.98	0.95	1.3%	-3.2%
New Zealand Dollar	NZDUSD	0.81	0.80	0.79	0.82	0.75	0.69	2.0%	-5.0%
Canadian Dollar	USDCAD	0.99	0.99	1.00	0.98	1.00	0.97	-1.0%	0.2%
Dollar Index*	DXY	82.57	82.57	82.37	81.93	86.91	82.22	-0.8%	5.5%
G10 Crosses									
Japanese yen	EURJPY	98	98	98	101	92	105	3.4%	-6.1%
Swiss Franc	EURCHF	1.20	1.20	1.20	1.20	1.20	1.20	0.0%	0.3%
British Pound	EURGBP	0.79	0.79	0.79	0.79	0.77	0.79	0.5%	-3.2%
Swedish Krona	EURSEK	8.22	8.26	8.37	8.35	8.00	8.25	1.1%	-4.4%
Norwegian Krone	EURNOK	7.31	7.35	7.45	7.45	7.15	7.30	1.4%	-4.0%
Norwegian Krone	NOKSEK	1.12	1.12	1.12	1.12	1.12	1.13	-0.3%	-0.4%
Australian Dollar	AUDNZD	1.29	1.29	1.28	1.28	1.31	1.38	-0.6%	1.9%
Australian Dollar	AUDJPY	83	82	80	85	78	80	3.3%	-2.1%
Asia									
Chinese Renminbi	USDCNY	6.36	6.38	6.45	6.36	6.30	6.15	-0.3%	-2.4%
Hong Kong Dollar	USDHKD	7.76	7.75	7.75	7.76	7.76	7.75	0.1%	0.1%
Indonesian Rupiah	USDIDR	9517	9669	10122	9450	9750	9649	-2.3%	-3.7%
Indian Rupee	USDINR	55.7	56.8	59.4	55.0	56.0	52.3	-3.2%	-5.7%
Korean Won	USDKRW	1136	1142	1154	1120	1140	1080	-1.9%	-1.2%
Malaysian Ringgit	USDMYR	3.13	3.15	3.19	3.10	3.23	3.11	-1.6%	1.4%
Philippine Peso	USDPHP	42.4	42.6	42.9	42.5	43.0	40.8	-0.2%	0.3%
Singapore Dollar	USDSGD	1.25	1.25	1.25	1.25	1.28	1.23	-0.3%	2.3%
Thai Baht	USDTHB	31.5	31.7	32.1	31.4	32.0	29.9	-0.9%	-0.4%
Taiwan Dollar	USDTWD	30.0	30.0	29.7	29.7	30.5	28.5	-1.0%	2.5%
EMEA									
Czech Koruna	EURCZK	24.9	25.0	25.0	24.7	26.0	24.5	-1.0%	3.8%
Hungarian Forint	EURHUF	278	282	292	275	290	290	-2.5%	-0.7%
Polish Zloty	EURPLN	4.07	4.12	4.25	4.00	4.40	3.90	-2.9%	3.5%
Israeli Shekel	USDILS	4.03	4.05	4.08	4.00	4.20	4.00	-1.2%	3.0%
Russian Ruble	USDRUB	32.1	32.6	34.1	31.5	35.4	33.7	-3.5%	3.9%
Russian Ruble Basket		35.4	36.0	37.8	35.0	37.8	37.5	-2.8%	0.1%
Turkish Lira	USDTRY	1.80	1.83	1.90	1.77	1.88	1.85	-3.1%	-1.3%
South African Rand	USDZAR	8.31	8.43	8.73	8.25	8.70	8.72	-2.1%	-0.3%
LATAM									
Brazilian Real	USDBRL	2.02	2.05	2.13	1.99	2.06	2.00	-2.8%	-3.1%
Chilean Peso	USDCLP	483	490	505	495	510	490	1.0%	1.0%
Mexican Peso	USDMXN	13.1	13.2	13.5	12.7	13.4	12.2	-3.9%	-0.9%
Colombian Peso	USDCOP	1820	1847	1893	1820	1865	1850	-1.5%	-1.5%

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

Source: Citi Research

Notes

Notes

Notes

Appendix A-1

Analyst Certification

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