

Global Political Insights

Mid-year Outlook: Rising Geopolitical Risks and the New UltraVox Populi Will Carry On Into 2013

- **Can-Kicking By Elected Officials Will Keep Most Risks Unresolved Into 2013:** Eurozone political risks should remain elevated, while geopolitical risks look set to intensify, especially in the Middle East. US elections are under 100 days away. The first stage of the Chinese political transition will take place in late October/early November, ushering in a new generation of leaders, and the Saudi succession continues. The Netherlands, Venezuela and South Korea, among others, will also hold elections in the months ahead.
- **Beware the Vox Populi:** Our concept of *Vox Populi* risk—volatile public opinion expressed either at the ballot box or protests on the streets—has been much in evidence this year. As the global recovery continues to stagnate, we foresee greater need for leaders to be sensitive to the Vox Populi as political choices expand and discontent with mainstream parties grows. We expect more government collapses, multi-party coalitions, referenda, legal challenges, strikes and demonstrations, with the scope for unelected technocrats and top-down solutions limited.
- **Global Concerns Proliferate:** In the Middle East, the Syrian regime has been weakened, though it could retain power for some months, while risks to the security of its reported stockpile of chemical weapons could prompt international intervention in the weeks or months ahead. Elsewhere in the MENA, the risk of an attack on Iran's nuclear facilities over the next several months is significant in our view, following the failure of UN-led diplomatic efforts, yet not fully priced in.
- **An UltraVox Populi is Emerging in Europe:** Public opposition to austerity measures in the periphery and bailouts in the core has intensified, foreshadowing a European *UltraVox Populi* and undermining a cohesive policy response. The result is not merely a 'two track EU,' but a two-track European electorate. We expect this sentiment will feed into elections in the Netherlands in September, and Italy and Germany expected in 2013. NEAPs (New, Extreme or Alternative Political Parties) should perform better in the next election cycle than in 2011, where mainstream opposition parties prevailed. Eurozone crisis measures could be constrained as a result.
- **A Second Term for Obama Seems Likely Based On Today's Numbers, But Not Guaranteed, While Gridlock Should Continue Into 2013:** In our base-case scenario, Obama is re-elected, bucking an otherwise nearly uniform trend of anti-incumbent outcomes in the mature democracies. But the race isn't over yet, and an adverse shock could reverse his narrow lead. Polls suggest Congress will remain divided, limiting the scope for compromise, with gridlock expected to continue into the next term, and the appetite for European-style austerity measures limited in both of the major parties.

Tina M Fordham

+44-20-7986-9860
tina.fordham@citi.com

Mauro Baragiola
mauro.baragiola@citi.com

Edward L Morse
ed.morse@citi.com

Ebrahim Rahbari
ebrahim.rahbari@citi.com

With thanks to
Jaechul Chang
David Cowan
Matt Dabrowski
Robert DiClemente
Guillaume Menuet
Jürgen Michels

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

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As a solution to the eurozone crisis remains elusive and the Arab Spring has entered a new phase, the political risk outlook is becoming more complex at the same time as economic growth prospects have worsened.

A Long, Hot Summer

We expect political risks will remain elevated in the eurozone, while geopolitical risks look set to intensify in MENA and potentially in Asia. From late summer, the US election campaign will begin in earnest, setting the stage for a contentious autumn.

2012 was always going to be a very political year. Between an exceptionally large concentration of elections and political transitions, including in the "Big Four" (France, Russia, US and China), ongoing instability generated by the 2011 Arab Spring, and the continuing lack of resolution to the sovereign debt crisis, we expected the influence of political risk in the investment environment to be elevated. As we enter the second half of the year, resolution to the eurozone crisis remains elusive and the Arab Spring has entered a new phase. In short, the political risk outlook is becoming more complex at the same time as the global growth outlook has worsened.

In this overview, we assess that political risks will persist into the second half of the year, largely concentrated in EMEA, and continue unresolved into 2013. The new year will feature fewer regular elections than 2012, but will likely include elections in the key eurozone states of Germany and Italy, while the new session of the US Congress will begin amidst looming fiscal challenges. Key risks are the prospect of a disorderly unraveling of the Syrian regime, potentially leading to spillover of civil conflict or insecurity over reported chemical weapons stocks, and the potential for a conflict over Iran's nuclear programme, a risk which may not be priced into markets.

In a July survey of our institutional clients, Citi ICG found that companies and investors are reasonably optimistic when it comes to the potential for resolution of political uncertainty in China and the EU. But our clients are split on a Greek exit from the eurozone and the U.S. 'fiscal cliff.'

Investors are Divided on the Outcome of Key Political Questions

In a July survey of our institutional clients, Citi ICG found that investors are reasonably optimistic when it comes to the potential for resolution of political uncertainty in China and the EU.

Most (76%) expect a smooth transition in China, as Communist Party leadership turns over this fall. Most (59%) also believe European banking union agreement is likely. But our Institutional Clients Group (ICG) clients are split on a Greek exit from the eurozone (50% likely to 47% unlikely, a statistical tie) and the U.S. 'fiscal cliff' (45% likely to 46% unlikely, also a tie).

Figure 1. Citi Clients Confident of Eurozone Solution, Less Secure About Grexit & Fiscal Cliff

In your opinion, how likely do you think each of the following scenarios is to happen?	Likely	Unlikely
"The upcoming change in leadership in China will proceed smoothly."	76%	15%
"An agreement among European leaders on banking union will improve the outlook for resolving the Euro zone crisis."	59%	38%
"Greece will leave the Euro zone within the next 12 months."	50%	47%
"U.S. political leaders will agree on a solution to the so-called 'fiscal cliff' by the end of 2012."	45%	46%
<i>North American clients only</i>	42%	56%

Source: Citi Institutional Clients Group survey of 440 Citi clients, conducted July 3-13, 2012. Margin of error is +/- 5%.

When it comes to the US “fiscal cliff”, however, North American clients were less sanguine, with a majority (56%) saying a solution is unlikely. Except as indicated, there was little other statistical difference in opinion across region or segment.

Beware the Vox Populi – NEAPs, Italy, Russia, France & Greece

In this environment, political honeymoons are short and political capital a commodity in very short supply, while the political cycle runs almost continuously.

Our concept of *Vox Populi* risk—shifting and more volatile public opinion expressed through demand for change at the ballot box, or on the streets—has been much in evidence this year, and shows little sign of abating, even once elections have passed. Seven EU incumbent governments have been defeated at the polls over the past 18 months: Denmark, France, Ireland, Portugal, Slovakia, Slovenia and Spain, while the Dutch coalition government collapsed over strains over passing an austerity budget, and Italy’s technocrat government is now in its second year. This represents a significant political transition, suggesting there could be other government changes in the eurozone after the next round of elections.

Enter the NEAPs—New, Extreme and Alternative Parties

Although small in number, the presence of these new political forces can make passing legislation problematic. Witness the Freedom Party’s opposition to passing an austerity budget, which succeeded in bringing down the government in The Hague.

In this environment, political honeymoons are short and political capital a commodity in very short supply, while the political cycle runs almost continuously. These challenges are most acute in the mature democracies, leading to high rates of anti-incumbent voting patterns and increased political space for what we have called “NEAPs”: new, extreme or alternative political parties. Over the past eighteen months, several NEAPs have either entered parliament or expanded their representation, such as the Pirate Party in Germany, the Freedom Party in the Netherlands, and the True Finns in Finland.

Although small in number, the presence of these parties can make passing legislation problematic. Witness the Freedom Party’s opposition to passing an austerity budget, which succeeded in bringing down the minority government in The Hague. In Greece, the four-year-old anti-austerity Syriza party was able to dramatically increase its share of the vote in the June parliamentary elections, capitalising upon strong anti-establishment sentiment and nearly overtaking the first place winner, New Democracy, despite its relative lack of political experience.

Despite the growing number and popularity of political alternatives, we reject comparisons to the extremism of the 1930’s, and note that 20th Century revolutionary ideologies such as fascism and communism have not succeeded despite growing questions about capitalism and discontent with mainstream political parties. Instead, the new political battleground is public debt—who should pay, and who should bear the cost of cuts.

We see such developments as the beginning of a change in trend that will likely accelerate if the economic outlook worsens, and expect to see more support for NEAPs in future elections. We caution however that it takes years for support to build for new parties to overtake established mainstream parties, and the growing popularity of NEAPs is most likely at this juncture to lead to more unwieldy multi-party coalitions rather than outright victories in our view. Despite the growing number and popularity of political alternatives, we reject comparisons to the extremism of the 1930’s, and note that 20th Century revolutionary ideologies such as fascism and communism have not succeeded despite growing questions about capitalism and discontent with mainstream political parties. Instead, the new political battleground is public debt—who should pay, and who should bear the cost of cuts.

The confluence of anti-establishment sentiment and the emergence of a new political party could have a pronounced impact in Italy, where elections are due by spring 2013, but pre-election positioning will begin in the autumn. (Early elections can’t be ruled out, but would require a change to the electoral law and thus are not our base-case scenario.) Following former Prime Minister Silvio Berlusconi’s departure from the political scene in 2011 and a raft of corruption prosecutions into political party financing, Italian public support for political parties has dropped to historic lows. A new political party, the Five Star Movement, led by a former

comedian, proved a surprise in May's Italian local elections, winning some key seats. Currently polling third according to some polls, Italy's newest party could prove a challenge to the country's political party establishment for the 2013 elections despite its unclear policy platform, capitalising upon anti-establishment sentiment.

Russia: Putin's Return Has Not Ended Opposition Sentiment

The run-up to March presidential elections in Russia featured public protests of a scale unprecedented since the *perestroika* demonstrations of the 1990's. Most observers expected protest activity would subside once Putin won re-election. Instead, protests drew crowds as large as 30,000 continued even after Putin's inauguration, and some actors have continued their activism at the local/municipal level. Softening oil prices and plans for restrictions on free speech signal the possibility of a sustained period of tensions ahead, as Russia's newly-energised middle class may seek to continue its challenges to the regime.

In our view, prospects for modernisation and reform are limited in this environment, as is the potential that the leadership will be able to return to its once-high approval ratings. We believe further demand for political change is highly likely in the years ahead.

France: Hollande the Centrist

In France, the outcome of presidential and parliamentary elections in May and June was largely consistent with the European political trend of the past 12 months: a victory for a candidate from the mainstream opposition, with slightly increased showing in the legislature for non-mainstream parties.

In France, the outcome of presidential and parliamentary elections in May and June was largely consistent with the European political trend of the past 12 months: a victory for a candidate from the mainstream opposition, with slightly increased showing in the legislature for non-mainstream parties, in this case the return of the far-right National Front to the assembly for the first time in decades, albeit with just two MPs.

Figure 2. Anti-Incumbent Elections a Nearly Uniform Trend in Eurozone, While Non-Euro Countries Have Re-Elected Incumbents Over Past 18 Months

EU Member State	Real GDP Growth, 2011	Election	Result for Government
Estonia	7.6%	March 2011	Re-elected
Latvia	5.5%	September 2011	Re-elected with coalition
Poland	4.3%	October 2011	Re-elected
Slovakia	3.3%	March 2012	Defeated
Finland	2.9%	April 2011	Coalition shuffled
France	1.7%	April-June 2012	Defeated
Denmark	1.0%	September 2011	Defeated
Ireland	0.7%	February 2011	Defeated
Spain	0.7%	November 2011	Defeated
Cyprus	0.5%	May 2011	Loses majority in parliament
Slovenia	-0.2%	December 2011	Defeated
Portugal	-1.6%	June 2011	Defeated
Greece	-6.9%	May, June 2012	Failure to form gov't in first round

Source: EuroStat, Citi Research

President Hollande can govern with a comfortable majority in the legislature, and we expect that with his majority established, he will govern from the centre, with the occasional Socialist-party flourish. What is more significant perhaps than how Hollande will govern France is the message his winning election strategy will send to other European political parties.

We think that the success of Hollande's pro-growth/anti-austerity sentiment has markedly accelerated the erosion of the eurozone's fragile pro-austerity consensus, a key component in what we have termed the "New Eurozone Political Geometry." Hollande has been joined by Italian technocratic PM Mario Monti and Spanish PM Mariano Rajoy in demanding a shift in policy, pressuring Germany and the Troika. To date their efforts have borne little fruit, but as pro-austerity and pro-bailout sentiment in the "soft core" also weakens, we believe tensions between Germany and other eurozone member states could increase. (Please see [The New Eurozone Political Geometry: What Economic and Market Implications?](#) and [France: Hard Choices Lie Ahead.](#))

Greece & the Potential for New, Formerly Rich "Critical Fragile" States

We believe that the difficulty in Greece's implementation of the degree of fiscal austerity needed to meet programme requirements will ultimately strain coalition tensions to the breaking point.

Of all the elections to date this year, perhaps none captured as intense a level of market interest as the two parliamentary elections over a six week period in Greece, with a second ballot scheduled after the first ended in stalemate. Within three days of the June 17th ballot, a new coalition government was formed with the pro-MoU New Democracy the largest party. We believe that the difficulty in implementing the degree of fiscal austerity needed to meet programme requirements will ultimately strain coalition tensions to the breaking point.

Thus, our probability for "Grexit," a Greek exit from the euro area, remains elevated at 90% over the next 12-18 months, and could happen in the next 2-3 quarters. We previously argued that the probability of Grexit over the next 12-18 months was 50-75%. However, we raised this probability to about 90% over the next 12-18 months, and believe the most likely date is in the next 2-3 quarters, possibly as early as following a September Troika assessment. (Please see our [Global Economic Outlook and Strategy](#) report for July.)

This reflects two main factors. First, earlier this year before the Greek election, the Troika members were willing to be patient while Greece slipped off-programme in the hope that the election might produce a government that was able and willing to get the programme back on track, and to have the time to make the European Stability Mechanism (ESM) operational. It is now fairly clear that these hopes will not be fulfilled. There still looks to be a considerable, and probably unbridgeable, gap between the reform measures and fiscal improvements insisted upon by the creditors and those that are politically and economically achievable in Greece. Second, with possible bailouts for Spain and Italy looming, comments from the Troika and various European politicians suggest they are becoming less patient with Greece, because of the need to reassure creditor nations that countries which persistently miss their programmes will not be financed.

More broadly, amid the sharp reversal of living standards, growing evidence of social dislocation, including hunger, homelessness and the risk of violent disruption in Greece is also a cause for concern, raising the possibility of what the World Economic Forum has called "critical fragile states."

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¹ World Economic Forum. *Global Risks 2012*, 7th edition. [<http://reports.weforum.org/global-risks-2012/>]

Public Sentiment is Becoming More Negative Across the European Union

Fiscal stress, austerity and bailouts have shaken the Vox Populi across Europe. The result is not merely a 'two track EU,' but a two-track European electorate.

Fiscal stress, austerity and bailouts have shaken the Vox Populi across Europe. The result is not merely a 'two track EU,' but a two-track European electorate, with divisions accelerating between the core and the periphery that could undermine future policy action.

On the one hand, countries like Germany and Poland have seen economic stability, even modest growth, over the crisis years, and electorates have rewarded their governments. Polish Prime Minister Donald Tusk's Civic Platform party won the presidency in 2010 and was re-elected to parliament in 2011. In Germany, Angela Merkel's personal popularity is at its highest level since 2009. Merkel's CDU party remains strong, making their continued presence in government likely, despite the weakness of their FDP coalition partners and the potential for a grand coalition featuring additional parties such as the centre-left SPD. In the Baltic region, Estonia and Finland, both euro countries, as well as Latvia, have re-elected their governments since the beginning of 2011. In sum, the electorates in non-eurozone EU member states and Germany have not experienced the same degree of anti-incumbent sentiment as elsewhere.

Meanwhile, public support for the European Union as an entity appears to be diverging. According to new data from the Pew Foundation, two-thirds of Germans (68%) and Poles (69%) have a favorable view of the EU. Fifty-nine percent (59%) of Germans say the EU has strengthened their economy.

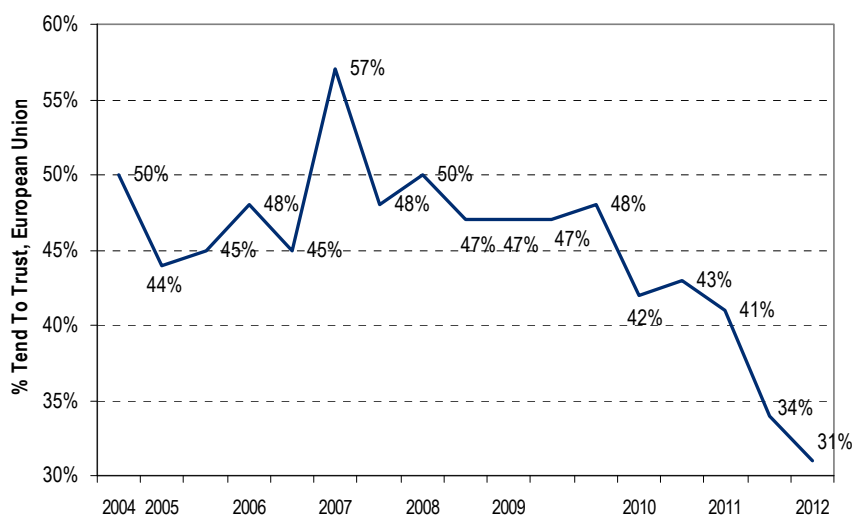
In Greece, only 37% say they have a favorable view of the EU and 70% say EU integration as weakened their economy. Sixty-one percent (61%) of Italians say integration has weakened the economy there.²

Europe's declining credibility could constrain national leaders as they try to negotiate the gap between EU institutions and their own constituents in a struggle to keep their governments afloat.

The declining credibility of the European Union project could constrain national leaders as they try to negotiate the gap between EU institutions and their own constituents in a struggle to keep their governments afloat. The latest Eurobarometer polls reported the lowest level of trust in European institutions in eight years, at only 31%.

² Pew Global Attitudes Project, surveys conducted March-April 2012
[<http://www.pewglobal.org/2012/05/29/european-unity-on-the-rocks/>]

Figure 3. Trust in European Union as an Institution at Six-Year Low

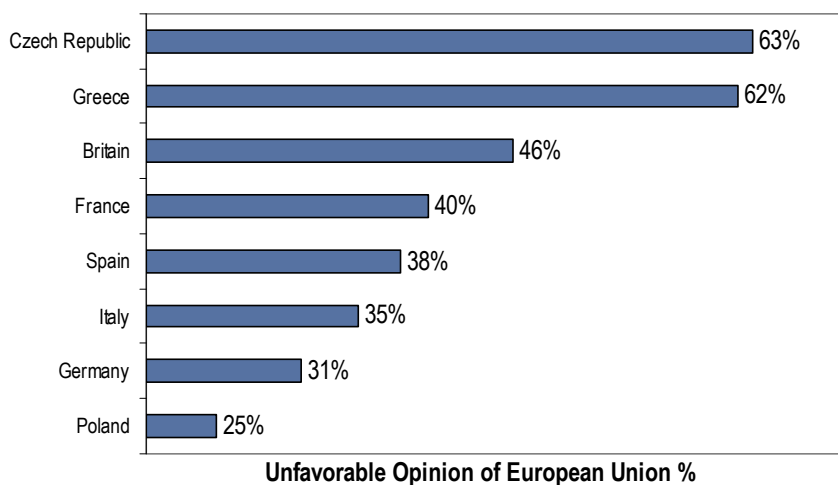


Source: Eurobarometer, latest survey conducted May 5-27, 2012.
[http://ec.europa.eu/public_opinion/archives/eb/eb77/eb77_first_en.pdf]

Over the long-term, the interaction between worsening views of the European Union and of mainstream political parties, compounded by weak growth and competitiveness, could create a negative feedback loop that impedes implementing crisis measures just when they are needed most.

The rise of Syriza in Greece on the back of anti-European message will likely be a model for opposition groups in a number of debtor countries over time, though we expect the current peripheral country governments (with the exception of Greece) to last at least this year, and many the full term. Over the long-term, the interaction between worsening views of the European Union and of mainstream political parties, compounded by weak growth and competitiveness, could create a negative feedback loop that impedes implementing crisis measures just when they are needed most.

Figure 4. Unfavorable Opinions of the European Union are on the Rise



Source: Pew Global Attitudes Project, surveys conducted March-April 2012
[<http://www.pewglobal.org/2012/05/29/european-unity-on-the-rocks/>]

In another sign of public sentiment trending toward a future challenge to globalization, another Pew survey highlighted support for capitalism on the decline in Europe. Only 58% said that most people are better off in a free market economy,

down from 67% in 2007, a substantial reversal, compared to the US (67%) and even China, where public support for a free market economy has increased to (74%).³

Fast Forward: Election Outlook in the Netherlands & Italy

In the Netherlands, Rutte's Liberal Party has run neck & neck in the polls with the anti-austerity Socialists. Either party could win, but the fluid nature of Dutch coalition politics make the composition & program of the incoming government difficult to predict.

The Dutch elections September 12th will be a key signpost for public sentiment in one of the eurozone's most important creditor countries. Dutch Prime Minister Mark Rutte resigned in April after the populist right-wing Freedom Party abandoned support for an austerity package designed to meet EU targets. Over the course of the election campaign, Rutte's Liberal Party (VVD) has run neck & neck in the polls with the anti-austerity Socialists (SP).

The fluid nature of Dutch coalition politics make the composition and programme of any incoming government difficult to predict, whether the VVD or the SP come out on top. Austerity and bailout deals have underscored the traditional flexibility of the Dutch political spectrum, as both left- and right-wing parties have lined up for and against developments in Europe, and different coalitions have formed each time a major European development has come before parliament this year.

Figure 5. Issue Coalitions in the Dutch Tweede Kamer

Party		Post-Election Seat Projection, August 1	Supported Austerity Package?	Supported ESM Bailout Fund?
SP	Socialist Party	32	No	No
PvdA	Labour Party	20	No	Yes
GL	Green Left	4	Yes	Yes
CU	Christian Union	7	Yes	No
D66	Democrats 66	15	Yes	Yes
CDA	Christian Democrats	14	Yes	Yes
VVD	Liberals	33	Yes	Yes
PVV	Freedom Party	18	No	No
Minor Parties				
PvdD	Animal Rights Activists	3		
SGP	Calvinists	3		
50 Plus	Pensioners	1		

Source: Amsterdam Herald, The Economist, Citi Research. Seat projections from Quirksmode.org, based on rolling average of Ipsos, Politieke Barometer, and Peil.nl surveys, accessed August 1, 2012.

Dutch politics can confound observers. Governments contain as many as four parties, the threshold for parties to enter parliament is low, and there is a longstanding tradition both of left-right "purple" coalitions and of centrist parties open to governments of all political stripes.

Further complicating the outlook, the process of forming a government in the Netherlands is time-consuming. Rutte took office four months after the 2010 election and eight months after the collapse of the previous government. The absence of a government thus far hasn't prevented the Dutch from signing off on key eurozone policy proposals, but the September election outcome will be an important indicator of one of Germany's most important pro-austerity allies'

³ Pew Research Center. "Support For Capitalism Declines in Europe." Median percentages of Britain, France, Germany, Spain and Poland.
[<http://pewresearch.org/databank/dailynumber/?NumberID=1546>]

In our view, the continuation of political stability in Italy is critical to the stability of the wider eurozone.

Figure 6. Seat Projections in the Italian Chamber of Deputies

Based on a rolling average of the latest polls

Right	150	↓ 194 (from 344)
Left	346	↑ 100 (from 246)
Center	52	
Five Star Movement	79	
Others	3	

Source: Termometro Politico.it, July 29, 2012.

As the politicians position themselves in advance of elections and the population reacts to tough reform packages, Monti's ability to get things done will be further constrained in our view.

Yet while Berlusconi's party may wish to see him return in the hopes of boosting their chances, one poll suggested that 71% of Italian voters would not vote for Berlusconi again "under any circumstances".

willingness to continue to support eurozone rescue measures. The victory of an anti-austerity party would be a potentially significant blow.

Italy's Political Future is Key to the Eurozone

Italian elections are scheduled no later than April 2013, and will be closely-watched. Prime Minister Mario Monti has brought a welcome degree of stability to Italian politics during his tenure as an unelected, but popular technocrat, as well as considerable credibility in negotiations with Europe. This period of relative political calm could be complicated by the outcome of elections, given the state of flux in Italian public opinion and low ratings for most mainstream political parties.

In our view, the continuation of political stability in Italy is critical to the stability of the wider eurozone. This is all the more important given Italy's economic outlook, where Citi Economists expect a recession over the next year deeper than most analysts anticipate. (Please see [Focus on Italy](#).)

Anti-establishment and opposition parties, including former comedian Beppe Grillo's Five Star Movement, have made gains in local races across the country this year, surprising Italy's political establishment. As the politicians position themselves in advance of elections and the people react to tough reform packages, Monti's ability to effect further reforms will be significantly constrained in our view.

After eight months in office, reports suggest that the popularity of his government has faded. Monti has stated that he will step down after next year's election. Nonetheless, Monti remains the most popular politician in Italy by a significant margin, albeit as an unelected technocrat rather than a party-aligned politician in the traditional sense. For this reason, his continued presence on the political scene in some capacity should not be ruled out in our view.

In July, former premier Silvio Berlusconi hinted in remarks to the media that he would return to active politics as the right-wing candidate for prime minister. This may not be surprising, considering latest projections show the Right, led by his Popolo della Libertà party (PDL), losing almost 200 seats in the Chamber of Deputies, a significant decline since his departure. The possibility of such a substantial loss of seats would prompt any political party look for a game changer, and this calculation might explain Berlusconi's possible return.

Yet while Berlusconi's party may wish to see him return in the hopes of boosting their chances, one poll suggested that 71% of Italian voters would not vote for Berlusconi again "under any circumstances".⁴ These surveys suggest that his return to politics would not markedly affect the Right's chances for victory. Yet this may be fine for Berlusconi; perhaps it's enough for him to remain as a player on the national scene.

Another key factor is the negotiation over a new electoral law. The current system, where the voters cast their ballots for party lists and not individual candidates, has been much criticised as promoting party loyalty over performance. Mocked as the 'porcellum' or 'piggy' law in the press, it also boosted the prospects of the front-running party. Berlusconi proposed the law during his tenure, and his coalition did benefit under its terms. Now, however, his PdL party is one of many seeking to make changes. Ultimately, changing the rules of the game in politics becomes a matter of political party survival and can be fiercely fought.

⁴ Termometro Politico survey, published July 9, 2012. http://www.termometropolitico.it/19237_il-ritorno-di-berlusconi.html

Early elections in November have also been floated in the media; these would require changes to Italy's electoral law to be agreed in the next few weeks. While greater political clarity would be welcomed by markets, given the weak showing in current opinion polls for most of Italy's parties, we think early elections this autumn are less likely than spring elections that would coincide with presidential elections for outgoing President Giorgio Napolitano, who must depart due to term limits. Spring 2013 timing would allow parties more time to refine their platforms, and we also suspect that additional new political parties could be formed to fill the vacuum.

MENA in the Wake of the Arab Spring – Egypt & Libya

While post-revolutionary transitions are never linear, these developments suggest that Egypt's political transition is likely to be slow and feature continued military intervention.

Egypt's first democratic presidential elections in June produced a narrow victory from Muslim Brotherhood candidate Mohammed Morsi, in a contest that pitted him against a former Mubarak-era prime minister, Ahmed Shafiq. With a margin of 52% supporting Morsi versus 48% favouring Shafiq, Egypt's post-Mubarak divisions are evident, suggesting Morsi faces significant challenges in unifying the country. Meanwhile, the interim military authority (SCAF) also continues to wield the lion's share of political influence, as evidenced by recent moves to dissolve parliament and other decisions.

We regard the election result as positive for Egypt's short-term stability in that a return to street violence is reduced due to the victory of the Brotherhood candidate. Nevertheless, moves by Egypt's Supreme Constitutional Court to dissolve the newly-elected parliament and curtail the powers of the president underscore the military's intention to continue a strong role in running the country and an unclear path for its political and legal institutions.

While post-revolutionary transitions are often multi-decade and never linear, these developments suggest that Egypt's political transition is likely to be slow and feature continued military intervention. But in our view, a return to the pre-crisis status quo is impossible; the events in Tahrir Square were a galvanising experience for many in the country, with the deaths of 900 protestors bearing witness to the human cost.

We expect that episodic street violence will continue alongside moves toward participatory democracy, with Israel closely watching the newly-elected president's pledge to respect previously signed agreements. It remains to be seen if Morsi's evident willingness to challenge the military leadership will have a positive or negative effect on the transition.

In all likelihood, both sides will continue testing the other's resolve in a continued political tug-of-war. As the new constitution takes shape and elections proceed to replace the dissolved parliament, this back-and-forth will likely continue through the end of 2012 and into 2013.

In Libya, secular liberal parties had some success in the elections on July 9th, but independents won a majority of the 200 seats in the Grand National Council.

In Libya, secular liberal parties had modest success in the July 9 elections, but independents outside the nascent political party structures won a majority of the 200 seats in the Grand National Council. Many of the key figures are former Gaddafi officials who defected to the rebels. In one such example, Mahmoud Jibril, the key figure of the opposition and a leader of the secular liberals, was himself Gaddafi's top economic planner before becoming an early defector.

Again, history shows that democratic transitions are not linear; setbacks and even reversals are common, as is score-settling between rival groups. It will take years or even decades for the full implications of regime change in Libya to become clear.

The risks will persist as the process continues. But Libya's possession of significant energy resources and links to the international community provide it with some stabilizers that could cushion the transition.

State Collapse in Syria?

The civil conflict in Syria has become a cycle of escalating violence, where the rebels grow in their ability to strike at the heart of the regime, as evidenced by the July 18 assassination at the heart of the regime's command centre. Meanwhile, the Assad government has intensified its crackdown in response, retaining significant military capabilities. According to media sources, as many as 19,000 civilians have been killed in the conflict. Senior Syrian civil and military officials have begun to defect in growing numbers in recent weeks. State collapse is an increasingly possible scenario, and the prospects for a Yemen-style negotiated solution have declined as divisions have deepened, raising the risk of greater conflict and regional contagion in our view.

Syria's substantial chemical weapons stockpile, regarded as the largest in the world, is a considerable worry, and as in last year's Libya intervention, has forced the attention of the international community.⁵ Previously, it was clear that the internationalisation of the conflict was unlikely given staunch Russian and Chinese opposition at the United Nations' Security Council. Now, however, the potential use of chemical weapons by the regime, or in the event of substantiated fears that they may fall into the hands of rogue actors, would dramatically increase the prospects of the conflict becoming internationalised and possibly spilling over into neighbouring countries.

Although the use of chemical weapons would prompt an international outcry and escalate support for regime change, the WMD experience in the Iraq war means that building international support would be far from straightforward, with many likely to question the intelligence information.

⁵ Barnes, Julian et al. "US Concerned as Syria Moves Chemical Stockpile." *The Wall Street Journal*. July 13, 2012.
[<http://online.wsj.com/article/SB10001424052702303644004577523251596963194.html>]

Figure 7. Syria's Geo-strategic Position in the Middle East



Source: Citi Research

The July 18th assassination of three senior Assad regime figures by car bomb in Damascus underscores the increasingly fragile nature of the regime. But the end could still take weeks or even months.

The July 18th assassination of three senior Assad regime figures by car bomb in Damascus underscores the increasingly fragile nature of the regime. But the end could still take weeks or even months. At this writing, it appears that the next stage of the conflict is the battle over Syria's major cities, including Damascus and Aleppo. Thus far, the conflict has largely avoided major population centres; heightened conflict in the cities could accelerate the ultimate outcome in the conflict.

While Syria is a relatively small country without significant natural resources, its geostrategic position in the heart of a volatile region means that the Syrian crisis could create geopolitical risks for a number of actors. Aleppo sits only 45 kilometres from the Turkish border, and the June downing of a Turkish jet, reportedly by Syrian forces, brought a strong response from the leadership in Ankara. To the east, the Maliki government in Iraq is also concerned about destabilisation, while for Iran, the continued rule of its ally in Damascus is a key source of support.

Tensions Between Iran & Israel Continue

Our view is that the risk of an Israeli unilateral attack is substantial, and we remain more hawkish than consensus in this respect.

The July 17th departure of Kadima from the government coalition in Israel could alter Israeli Prime Minister Benjamin Netanyahu's political calculus, and recent polling has suggested low support for an attack on Iran among the Israeli public. Some actors from Israel's military and security establishment have also voiced concerns, often in remarks to the press, about the risks of an attack relative to its limited potential success in reversing Iran's progress on its nuclear programme. In the abstract, these factors could constrain Netanyahu's ability to act unilaterally. But the July 18th terrorist attack on Israeli tourists in Bulgaria has given an added impetus to the government's rhetoric.⁶

⁶ "PM: All signs point to Iran in Bulgaria attack." *The Jerusalem Post*. July 18, 2012. [<http://www.jpost.com/DiplomacyAndPolitics/Article.aspx?id=278001>]

Netanyahu still commands a majority in the Knesset, but with elections due by October 2013, campaign priorities may take precedence in the months to come.

The risk of military action against Iran's nuclear sites ahead of US elections is as high as 25% in our view, and will increase in the 1H of 2013 if no action takes place ahead of elections. We expect to see headline risks only increase as the year progresses.

Policy change comes slowly in the Kingdom and usually accompanies changes in leadership. For example last winter when Prince Nayef succeeded his brother as Crown Prince a new targeted oil price of \$100 was announced. Recent policy has called for prices under \$100 per barrel.

A further variable in the Israeli calculation is the notion of a "zone of immunity," as described by Defense minister Ehud Barak— a point beyond which the Iranian nuclear program cannot be stopped, even after military action. Our view is that the risk of a unilateral attack is substantial, and we remain more hawkish than consensus in this respect.

Kadima broke with the government over a military conscription bill opposed by the Orthodox parties on the right of Netanyahu's coalition. Netanyahu still commands a majority in the Knesset, but with elections due by October 2013 and regarded as likely to take place as early as January, domestic political priorities may take precedence in the months to come.

On the Iranian side, diplomats left a second round of talks with the P5+1 Group in Moscow in June without agreement, even on the date for their next meeting. EU oil sanctions come online in July, and the threat of a collapse in diplomatic negotiations is likely to increase tensions.

The risk of military action against Iran's nuclear sites ahead of US elections is as high as 25% in our view, and could increase in the first half of 2013 if no action takes place ahead of US elections. We expect to see headline risks increase as the year progresses.

The End of a Generation in Saudi Arabia?

Leadership change in Saudi Arabia, where the average age of senior princes is in the high 70's, has been steady and orderly. Over the past year the country has had three crown princes, and King Abdullah has been in poor health throughout that period. With each personnel move has come changes in the government positions of senior princes from each of the major family groups, including changes at the very top of the defense, interior and intelligence organizations, as well as in other ministries including foreign affairs at senior levels.

Policy change comes slowly in the kingdom and usually accompanies changes in leadership. For example, new targeted oil price of \$100 was announced last winter when Prince Nayef succeeded his brother as Crown Prince. Recent policy has called for prices under \$100 per barrel.

According to Citi Commodities analysis, the kingdom has raised production by more than two million barrels a day over the past 18 months and is now averaging daily flows of between 9.5 and 10 million b/d, enabling the country and the world as a whole to build inventory. Citi calculates that inland inventories of crude oil and petroleum products have increased by more than 130 million barrels since 2008 and overseas stocks have grown by another 50 million barrels.

The kingdom has offered four explanations for its increased output: to meet customers needs, to help keep prices low enough to spur global economic growth, to make sure that buyers affected by sanctions against Iran are well supplied, and to make up for any disruptions, including from Libya last year and Yemen, Syria and Sudan more recently.

Leadership change and oil policy may well be interconnected in Riyadh. It is well known at Iran has a need for some \$100 billion in revenue to balance its budget, that last year it earned over \$86 billion from oil sales, and that current sales due to sanctions are averaging closer to \$40 billion on an annualized basis. This is geopolitically convenient for the kingdom. The country said that it intends to keep production above 9.5 million b/d through year-end at least, and meanwhile prices

remain relatively soft. If oil prices fall to \$90 or below (Brent basis) for any length of time, markets will focus on whether the kingdom raise its production or whether it will continue to pump oil at a rate that pushes prices down.

Venezuela and 'Key Man' Risk

Venezuelan president Hugo Chavez is favored to win re-election in that country's polls on October 7. Even with the inconsistent nature of political polling in Venezuela, the consensus has Chavez with a solid lead over Henrique Capriles, the opposition candidate. Based on current trends, all signs point to a continuation of the 'Bolivarian Revolution' for another six-year term, but a change in his health could signal changes in energy policy.

Venezuelan president Hugo Chavez is favored to win re-election in that country's polls on October 7. Even with the inconsistent nature of political polling in Venezuela, the consensus has Chavez with a solid lead over Henrique Capriles, the opposition candidate. A June poll from Datanalisis gave him a 15-point lead over Capriles.⁷ Based on current trends, all signs point to a continuation of Chavez's 'Bolivarian Revolution' for another six-year term, but a change in his health could signal changes in energy policy.

Chavez's policy of steering Venezuela's petrochemical windfall into generous social programs has been the basis of his popular support through three campaigns, two coup attempts and a recall election. The basis of this policy has been state control of the oil sector. Chavez has aggressively pursued greater influence over Petroleos de Venezuela and has expanded its holdings through nationalization. Now the Venezuelan public budget is more dependent on oil prices than ever, a situation which may not be sustainable even with the country's vast production reserves.

But Chavez has been ill from an undisclosed cancer for at least two years, and has visited Cuba for medical treatment. Published reports suggest that Chavez's re-election campaign has choreographed his public events to downplay his illness. Though Chavez has said he's fully recovered, it's difficult to know the state of his health and prospects for staying in office.

Without clear successors waiting in the wings, 'key man' risk is high, with the implications for Venezuelan political stability unclear. There is considerable speculation about what might happen politically depending on whether President Chavez dies before or after an election campaign that he is otherwise overwhelmingly likely to win. It may be the case that the death of the leader before an election could trigger a postponement, opening up the possibility of a change in policy direction. It is less clear whether the death of the leader soon after the elections would be as orderly, with the more likely scenario being outcries over the fairness of the electoral process and a vying for positions among the ruling elites.

Either way there are likely to be calls for changes in how the state oil monopoly is run, given dwindling oil revenues and the need for foreign capital to trigger an expansion of the country's vast oil resources. The recently published Statistical Review of World Energy 2012 dramatically increased its estimates of Venezuelan oil reserves to a level higher than that of Saudi Arabia, yet the kingdom is currently producing about 400% more than Venezuela.

⁷ "Datanalisis gives Chávez 15.3 points ahead of Capriles Radonski." *El Universal*. July 16, 2012. [<http://www.eluniversal.com/nacional-y-politica/120716/datanalisis-gives-chavez-153-points-ahead-of-capriles-radonski>]

Leadership Changes on the Korean Peninsula

South Koreans elect a new president on December 19. Outgoing president Lee Myung-bak is term-limited. His Saenuri Party has taken a hard line on Pyongyang. Lee's popularity has suffered, however, thanks to scandals affecting members of his own family, and a new free trade agreement with the United States that proved to be controversial.

The widely popular Park Geun-hye represents the centrist wing of Saenuri, and has proven a foil to Lee on a number of issues. Park is expected to win the December election, but businessman Ahn Choel-soo may draw support as an outsider should he choose to run.

In North Korea, observers agree that Kim Jong-un has consolidated control. This summer, Kim was secure enough to shuffle aside potential rivals like the army chief Ri Yong Ho.

Regardless, new blood in Pyongyang and a move towards the center in Seoul should point to a reduction in internal tensions on the peninsula going into next year.

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The leading Saenuri party candidate is Park Geun-hye, the daughter of former military dictator Park Chung-hee. Park ran for president in 2007, but lost the Saenuri primary to Lee. Since then, her supporters have taken control of the party apparatus. The widely popular Park represents the centrist wing of the party, and has proven a foil to Lee on a number of issues. Saenuri won this past April's legislative elections under her stewardship.

Based on the current data, Park is likely to win the December election. The opposition Democratic United Party is likely to nominate Moon Jae-in, a close supporter of former president Roh Moo-hyun. But the opposition trails in the polls after changing positions on free trade and on the creation of the Jeju naval base, a development that has seen both as pro-American and provocative to China, and that has drawn popular protests.

A potential wild card is the potential entry into the race of technology entrepreneur Ahn Choel-soo. Ahn has made waves as an outsider figure, and recently published a book on his political views. Some polling suggests he'll do better than other opposition candidates against Park, but Ahn portrays himself as a reluctant politician and has backed out of throwing his hat into the ring on prior occasions.

In North Korea, observers agree that Kim Jong-un has consolidated control since being elevated to power at the end of 2011. After his father Kim Jong-il passed away in December, some North Korea watchers worried that the younger Kim, only 28 years old, might lack the experience to run a system as closed and as military-driven as North Korea. But Kim quickly succeeded to all the civil, military and party offices held by North Korea's paramount leader. This summer, Kim was sufficiently secure in his position to remove potential rivals, such as army chief Ri Yong Ho. In April, the international media was allowed to cover the failed launch of a satellite rocket; this was the first time that the North Korean government had officially acknowledged such a failure.

Are the winds of change blowing in North Korea, or is this the creation of another personality cult? Kim is often photographed smiling and shaking hands, or attending light-hearted events like plays, concerts, and the opening of amusement parks. In July, Kim announced suddenly that he was married. We do not think that a North Korean form of *glasnost* is emerging, but it may be that the younger Kim is seeking to differentiate himself from his father.

Regardless, new leadership in Pyongyang and a potential move towards the political center in Seoul provide scope for optimism over a reduction in tensions on the peninsula going into next year.

Hu Jintao's departure from the scene is part of a wider turnover in leadership at the top of the Communist Party of China (CPC) which will affect party-controlled institutions across the country.

All Eyes on Leadership Transition in China

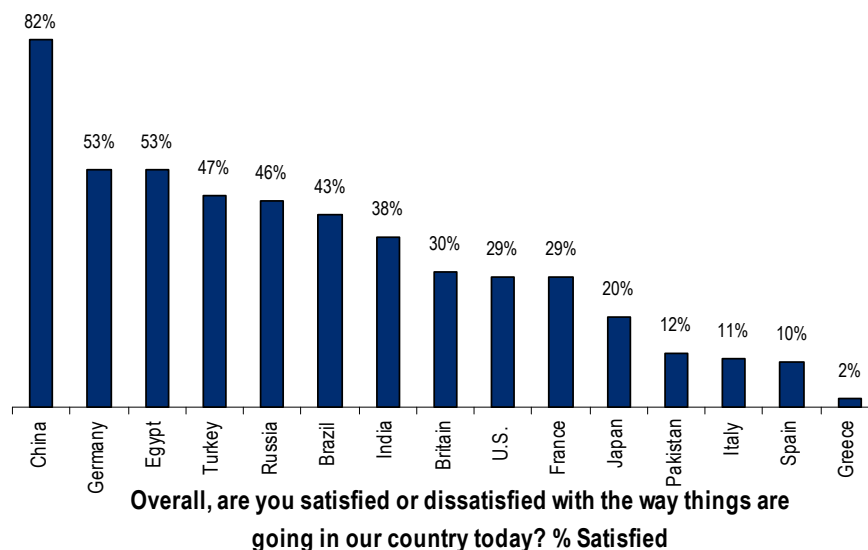
Chinese President Hu Jintao is stepping down after ten years as paramount leader. His departure from the scene is part of a wider turnover in leadership at the top of the Communist Party of China (CPC) which will affect party-controlled institutions across the country, including banks and other key state-owned enterprises (SOEs).

The first step in the process is the CPC National Party Congress. Held this fall, the next party congress will select a new CPC party leader and a new Politburo. Delegate selection in the provinces is ongoing through the summer. In the spring, the Chinese parliament will elect a new President, almost certainly the CPC chief. The third leg of the paramount leadership – the chair of the Central Military Commission – will also be named in the new year.

Vice President Xi Jinping is expected to take over the leadership from Hu in all three roles. Yet the fall of Chongqing party chief and 'princeling' Bo Xilai in March in the midst of a widely reported corruption & murder scandal reminds observers that even in a highly centralised system, full top-down control is elusive. Regardless, of the incident, the CPC will maintain control of the levels of power in Chinese society. This includes the Chinese private sector as it navigates the 'soft landing.'

Even with slowing growth, evidence exists that the Chinese people are largely satisfied with the state of the nation. A Pew poll reported that China had a higher level of citizen satisfaction than any other country surveyed, to the tune of 82%.

Figure 8. Satisfaction in China Head & Shoulders Above The Rest



Source: Pew Global Attitudes Project. "Pervasive Gloom About the World Economy." Surveys conducted spring 2012. [<http://www.pewglobal.org/2012/07/12/pervasive-gloom-about-the-world-economy/>]

As China continues its economic rise, geopolitical and regional tensions could also increase. Relations with China will also figure prominently in the US presidential campaign, with Republican challenger Mitt Romney having stated an intention to name China a currency manipulator "on day one" of his presidency if elected.

One likely theatre for emerging power dynamics is the South China Sea, where tensions have increased over the past several months. Neighbouring Vietnam and the Philippines, in the midst of an offshore oil & gas boom, may seek to challenge

China given the higher economic stakes. Both sides have invoked Washington's support to their advantage in territorial disputes.⁸

US Elections to Take Centre Stage With Under 100 Days To Go

In our base-case scenario, President Barack Obama wins re-election, though the anemic economy should keep his advantage modest, even within the margin of error. At the same time, the possibility of further economic slowdown creates significant downside risk for Obama's chances of re-election.

The economy, while still struggling, has risen off its peak lows from 2009. Likewise, Obama's hit their low points during last year's debt ceiling crisis and have improved on the margins.

At around 48%, Obama's job approval remains weak and strongly influenced by the US economic outlook.

Traditionally, US presidential campaigns begin in earnest following the September party conventions. This year, however, President Barack Obama and Mitt Romney are off to a fast start, reflecting a divided electorate anxious about the sluggish economic recovery and pervasive high unemployment. August 1 marks 97 days till the election, and the final fourteen weeks of the campaign should be eventful.

In our base-case scenario, President Barack Obama wins re-election, though the anemic economy should keep his advantage modest, even within the margin of error. Obama led Romney in the Pollster.com rolling early in the year, and has maintained that lead through mid-July.

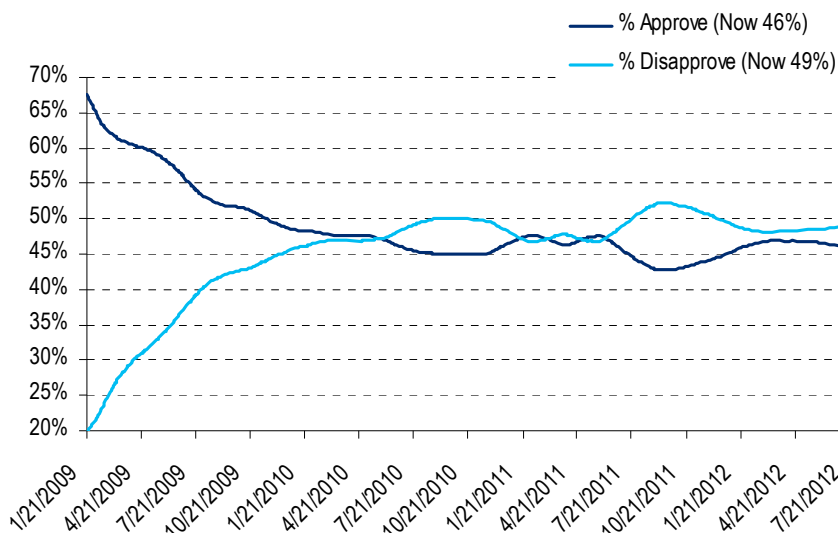
The US economy, while still struggling, has risen off its peak lows from 2009. Likewise, Obama's poll numbers hit their low points during last year's debt ceiling crisis and have since improved marginally. And even though European governments are falling in the midst of economic crisis, US voters have already taken the opportunity to hire new leadership on two occasions: the 'wave elections' of 2008 and 2010.

Obama remains strong on a whole host of issues. It is notable that the consensus of US political pundits and forecasters has Obama ahead, even if slightly. Survey data highlights Obama's strong "likability" and American voters' trust on issues such as terrorism and foreign policy.

Yet the possibility of further economic slowdown creates significant downside risk for Obama's chances of re-election. A significant negative economic shock would imperil his chances. According to polling data, the number one issue for US voters is the state of the economy, and it is here that Mitt Romney sees his strongest success. At only 46%, Obama's job approval remains weak and strongly influenced by the US economic outlook.

⁸ International Crisis Group. "Stirring Up The South China Sea."
[<http://www.crisisgroup.org/en/regions/asia/north-east-asia/china/223-stirring-up-the-south-china-sea-i.aspx>]

Figure 9. Barack Obama's Job Approval Stagnates, But Is Off Peak Lows



Source: Pollster.com rolling average, accessed July 28, 2012.

One venerable trend in political science research is to use econometric indicators in an attempt to forecast elections. Using this approach, many of this year's forecasts give the edge to Obama by a nose. But the more a forecasting approach emphasizes economic indicators over political ones, the lower Obama's vote share.

Figure 10. Many Top Econometric Prognosticators Favour Obama's Chances, By A Nose

Forecaster	Basis for Prediction	Prediction
Intrade	Prediction market	57% probability of victory for Obama
Iowa Electronic Markets	Prediction market	52% probability of victory for Obama
Wlezien & Erikson	National ballot, job approval, experts' predictions, voters' predictions from polling data, prediction markets, economic indicators	"Obama leads in five areas but splits on economic indicators..."
Graefe, Armstrong, Jones & Cuzan, "PollyVote" model	Combination of 13 forecasting models, only 5 are econometric	52% Obama vote
Alan Abramowitz, "Time For Change" model	Approval rating, GDP growth, incumbency	51% Obama vote
New York Times' Nate Silver	Polling data, nonfarm payrolls, personal income, industrial production, consumption, Consumer Price Index, S&P, GDP forecast	51% Obama vote
Douglas Hibbs, "Bread & Peace" model	Disposable income, U.S. military fatalities	50% Obama vote
Ray Fair	GDP growth, GDP deflator, quarters of GDP growth	49.5% Obama vote
Lewis-Beck & Tien, "Jobs Model"	National Business Index	48% Obama vote

Source: Citi Research. Predictions come from published sources. Less recent publications are updated using Citi Research economic indicators. Web sources accessed July 26-31, 2012.

While the relationship between economic performance and the success of ruling parties at the ballot box is taken as a given, we caution that it is not the only variable in voters' calculations. Even with the economy as the overarching issue, other intangibles have an effect. Noted US elections prognosticator Nate Silver has explored the weak relationship between economic indicators and electoral

outcomes.⁹ This suggests to us that observers dismiss Obama's chances by looking for specific red lines in the economic indicators. Here we note that the US economy is growing, albeit sluggishly, and while fiscal pressures are considerable, they are not nearly as acute as in the eurozone. While no candidate would seek out running for election in today's current economic conditions, the modest improvement to the US economy compared to 2009 lows may be sufficient for the US public to support four more years of Barack Obama.

Obama's chances for re-election depend less on his own campaign or Mitt Romney's, than on the European policy-makers, the Chinese and the Iranians.

Substantial downside risks to the outcome of the US election come from abroad: the Eurozone crisis, a hard landing in China, and an Iranian war in the Gulf. Any of these events would have a dramatic impact on US politics. Seen this way, Obama's chances for re-election depend less on his own campaign or Mitt Romney's, than on the European policy-makers, the Chinese and the Iranians. We re-iterate that the base-case scenario today is an Obama re-election, but any number of negative economic developments from abroad may change this trajectory.

Campaign spending is highly dependent on the ever-rising prices of television advertising and postage rates in the US. But on the supply side, more and more Americans, especially wealthy ones, perceive political risk and have become willing to support the candidate that defends their interests. By July, candidates Obama and Romney have raised more than \$450 million.

The 2012 US presidential election is on track to be the most expensive in world history, with costs higher in the US than any other democracy. Campaign spending is highly dependent on the ever-rising prices of television advertising and postage rates. First-class postage alone has increased 6% since the 2008 election – significant inflation when one considers that the amount of mail that will be sent to an electorate of over 110 million voters.

But on the supply side, more and more Americans, especially wealthy ones, perceive political risks and have become more willing to involve themselves in the funding of politics. By July, candidates Obama and Romney have raised more than \$450 million. So-called 'Super-PACs,' the latest form of independent activity, have spent more than \$105 million, and are largely funded by the wealthy.¹⁰

After their long and contested primary season, Republicans trailed Democrats in fundraising, but they are likely to catch up with Democrats. One important note: no incumbent president has ever been out-raised by a challenger, and consequently, Romney will be competitive but is not expected to out-raise Obama. In 2008, challenger Obama out-raised John McCain by almost 2-to-1, underscoring the president's significant fundraising prowess, especially at the grassroots level.

Mitt Romney is expected to announce his pick for vice president before his party's August convention. Vice presidential candidates rarely have a demonstrable effect at the ballot box, even in their own home states, but the process provides grist for the media cycle.

Mitt Romney is expected to announce his pick for vice president before his party's August convention. Vice presidential candidates rarely have a demonstrable effect at the ballot box, and even then typically only in their own home states. But the process provides grist for the media cycle, and may provide indications about candidate Romney and his expectations for the race.

⁹ Silver, Nate. "Which Economic Indicators Best Predict Presidential Elections?" *Five Thirty Eight. The New York Times online*. November 18, 2011. [<http://fivethirtyeight.blogs.nytimes.com/2011/11/18/which-economic-indicators-best-predict-presidential-elections/>]

¹⁰ Center for Responsive Politics. [<http://www.opensecrets.org>]

Figure 11. Potential Candidates for Republican Vice President

Condoleeza Rice	Former Secretary of State	Foreign policy leader
Tim Pawlenty	Former governor of Minnesota	Working class roots
Rob Portman	Senator from Ohio	Budget hawk, D.C. veteran
Haley Barbour	Former governor of Mississippi	Popular party leader, but a former lobbyist
Jeb Bush	Former governor of Florida	From a swing state, education expert, brother of George W. Bush
Chris Christie	Governor of New Jersey	Straight-talking budget cutter, but has denied interest in the job
Bobby Jindal	Governor of Louisiana	Policy wonk

Source: Politico Veep Watch [<http://www.politico.com/2012-election/vp-watch/>]

US Congressional Outlook: Gridlock & Polarisation Ahead

Our base-case scenario is that Democrats gain a handful of seats in the US House, but not enough to challenge the Republicans' majority. In the US Senate, Republicans have a good chance of winning the four seats needed to take control.

Policy gridlock has intensified during Obama's presidency, and the November elections are unlikely to bring a meaningful resolution to this state of affairs.

Looking forward to the elections, our base-case scenario is that Democrats gain a handful of seats in the US House, but not enough to challenge the Republicans' majority. In the US Senate, Republicans have a good chance of winning the four seats needed to take control, but neither party will have the 60 seats required to avoid the filibuster.

Figure 12. Seat Projections in the US House

		112th Congress (Today)	113th Congress (Projected)
Senate	Republican caucus	47	46-53
	Democratic caucus	53	47-54
House	Republican caucus	242	234-249
	Democratic caucus	193	186-201

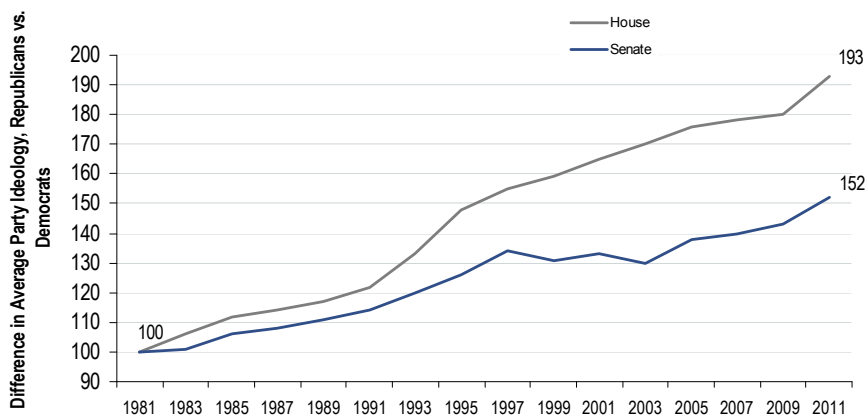
Source: Rothenburg Political Report, Larry Sabato's Crystal Ball/University of Virginia Center for Politics

If these projections are correct, the likelihood of the new Congress being able to overcome divisions to address a wide range of fiscal challenges that loom, including automatic "sequestration" cuts due to take effect at the end of January, will be limited in our view.

There will be no resolution to the "fiscal cliff" before the elections in our view. In the meantime, though negotiations will be daunting, highly-charged rhetoric from the major players should be understood in the context of the campaign season. (For a view of the implications for markets, please see [Washington Watch - Three Months to Go and to Know.](#))

Polarisation, both between the two mainstream parties and within them, explains much of this outlook. Political polarization in the US Congress is at its highest levels since the beginning of the 20th Century according to some measures. The ideological gulf between the average Republican and the average Democrat has increased by half in the Senate since the beginning of the 1980's, and has effectively doubled (92%) in the House, with rapid increases over the past decade.

Figure 13. US Political Polarization is at an All-Time High. Compare Polarization in the US Congress, from 1981 Levels.



Source: Keith Poole & Howard Rosenthal/VoteView.com.

Parting Thoughts

History suggests that the collapse of the political center is a common feature of the aftermath of financial crises; in that sense, the political outlook for the mature democracies appears to be a case of history repeating itself.

As in Europe, divisions between US political parties and rising anti-establishment sentiment are contributing to turnover at the polls, voter frustration and difficulty in finding policy-based solutions to the crisis. The US Tea Party movement could be seen in the context of rising anti-bailout sentiment in the eurozone core.

History suggests that the collapse of the political center is a common feature of the aftermath of financial crises; in that sense, the political outlook for the mature democracies may not be a case of history repeating itself, but as has been famously said, it “rhymes.”

Political Signposts for 2012 & 2013

Figure 14. Key Dates Upcoming

First Friday of each month	U.S. Bureau of Labor Statistics releases monthly jobs report
August 30	U.S.: Mitt Romney accepts nomination at Republican National Convention
September 6	U.S.: President Obama accepts nomination at Democratic National Convention
September 12	Dutch parliamentary elections, German Constitutional Court rules on ESM
September 13-15	Eurogroup, finance ministers, central bankers meet in Cyprus
September 30	U.S.: End of government FY12, must pass budget or continuing resolutions
October	U.S.: 112th Congress adjourns for election season
October 7	Venezuela presidential election
October 8	Eurogroup meeting in Luxembourg
October 12-14	IMF meeting in Tokyo
October 14	Lithuanian parliamentary elections
October 18-19	E.U. summit in Brussels
October/November	Communist Party of China (CPC) congress, Chinese leadership handover
Early November	G20 finance ministers & central bankers meet in Mexico
November 6	U.S. general election
November 12	Eurogroup meeting, discuss banking & fiscal unions
December	'Lame duck' session of U.S. Congress
December 3	Eurogroup meeting, discuss banking & fiscal unions
December 13-14	E.U. summit in Brussels
December 19	South Korea presidential election
December 31	U.S. tax rates expire ("fiscal cliff")
January 1	Ireland begins EU presidency
January 2	U.S. Office of Management & Budget begins sequestration ("fiscal cliff")
January 3	U.S.: 113th Congress convenes
January 20	U.S. presidential inauguration
February	Cyprus presidential election
March	Chinese parliament (National People's Congress) meets
April	Last date for Italian parliamentary elections
June	Iranian presidential election
July 1	Lithuania begins EU presidency
August	Last date for Japanese parliamentary elections
September	Norwegian parliamentary elections
September	Austrian parliamentary elections
October	Last date for German parliamentary elections
October	Last date for Israeli parliamentary elections
November	Last date for Austrian parliamentary elections
December	Chilean presidential election
(undetermined)	Qatar Consultative Assembly elections

Source: Citi Research

Appendix A-1

Analyst Certification

The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

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