Global Economic Outlook and Strategy

October 2012

- After a general bias to downgrades in earlier months, our global growth forecasts are little changed this month. We continue to look for global growth (at market exchange rates) of about 2.5% in 2012, while we edge up our 2013 forecast by 0.1% to 2.7% and trim our 2014 forecast by 0.1% to 3.1%. Within that, we now expect the EMU recession to be somewhat shallower but more extended than last month, while we are cutting our 2013 Japan forecast to 0.9% from 1.3% last month — the third consecutive downgrade. Overall, our forecasts are a bit below the consensus and IMF forecasts, mainly reflecting our sub-consensus euro area view.

- We are trimming our 2012 China growth forecast a little further, to 7.7% (from 7.9% last month) while leaving our 2013 forecast at 7.6%. However, there are tentative signs in recent data that China's economy is leveling off and — as well as official monetary and fiscal stimulus — there is ongoing support from ample liquidity and continued urbanisation. In the euro area, the OMT programme and reduced risks of nearterm Grexit have helped calm markets recently, but we expect that periphery economies will face persistent economic weakness and escalating public debt ratios. We still believe that Greece will probably leave EMU, albeit slightly later than we previously expected. Moreover, over the longer term, adverse fiscal trends point to risks of a wider series of debt restructuring in EMU, including Portugal and eventually perhaps Ireland, Spain and Italy.

- We expect Portugal's sovereign rating will be downgraded further over the next 2-3 quarters, with France likely to be put on Negative Watch. Over the longer term (next 2-3 years), we expect a wider series of sovereign debt downgrades, including many EMU countries as well as the US, Japan and the UK. Against this background, the major central banks are likely to keep policy loose or loosen further. We expect that the Fed will continue with unsterilised Treasury purchases after the end of OT, the ECB is likely to cut rates further, the BoJ is likely to resume QE soon, and the UK BoE probably will expand QE well beyond market expectations.

Figure 1. Currency and Interest Rate Forecasts (End of Period, Unless Specified), as of 24 Oct 2012

	24 Oct 2012	4Q 12 Forecast	1Q 13 Forecast	2Q 13 Forecast	3Q 13 Forecast	4Q 13 Forecast	1Q 14 Forecast
United States: Federal Funds	0.25	0.25	0.25	0.25	0.25	0.25	0.25
10-Yr. Treasuries (Period Ave.)	1.79	1.65	1.75	2.00	2.25	2.55	2.75
Euro Area: US$/€	1.31	1.31	1.28	1.25	1.23	1.22	1.21
Euro Repo Rate	0.75	0.50	0.50	0.25	0.25	0.25	0.25
10-Yr. Bunds (Period Ave.)	1.59	1.50	1.75	1.50	1.75	1.50	1.50
Japan: Yen/US$	79	79	79	79	79	79	79
Call Money	0.10	0.10	0.10	0.10	0.10	0.10	0.10
10-Yr. JGB (Period Ave.)	0.78	0.95	1.10	1.20	1.10	1.30	1.30

Source: Citi Research

Chief Economist

Willem Buiter
+44-20-7986-5944
willem.buiter@citi.com

Global Head of International Economics

Nathan Sheets
+1-212-816-9297
nathan.sheets@citi.com

Michael Saunders
+44-20-7986-3299
michael.saunders@citi.com

Kiichi Murashima
+81-3-6270-4981
kiichi.murashima@citi.com

Robert V DiClemente
+1-212-816-7942
robert.diclemente@citi.com

David Lubin
+44-20-7986-3302
david.p.lubin@citi.com

Johanna Chua
+852-2501-2357
johanna.chua@citi.com

Joaquin A Cottani
+1-212-816-2735
joaquin.cottani@citi.com

With thanks to Jan Maguire

Next issue 26 November 2012

Contents

Figure 2. Forecast Highlights and Changes from Last Month

■ Global	After a general bias to downgrades in earlier months, our global growth forecasts are little changed this month. We continue to look for global growth (at market exchange rates) of about 2.5% in 2012, while we edge up our 2013 forecast by 0.1% to 2.7% and trim our 2014 forecast by 0.1% to 3.1%.
■ United States	The Fed's impatience with modest job growth has triggered renewed bond buying and a stronger easing bias that are likely to persist at least well into 2013. But, barring a fiscal policy mistake, recovery's micro-foundations suggest a gradual improvement in the growth outlook.
■ Euro Area	While we revised up our GDP forecast for 2012 and 2013 somewhat, partly due to the likely delay of Grexit, we continue to expect GDP to fall in both years and also now for 2014 GDP to fall slightly as well. We expect the ECB to use the OMT, once Spain and probably Italy are under ESM programmes, and to cut rates further.
■ China	We revise down our annual growth forecast for 2012 from 7.9% to 7.7%, implying a 4Q growth rebound to 7.8%YoY. The revision reflects policy shortfall (especially with regard to RRR cuts) which contributed to weaker-than-expected 3Q growth. We maintain our below-consensus forecast for 2013 at 7.6%.
■ Japan	We expect the BoJ next week to publish core inflation forecasts for fiscal 2014 below the medium to long-term price stability goal of 1% and to expand the asset purchase programme by at least 10 trillion yen accordingly. Moreover, the upcoming change in the BoJ leadership next spring may provide a meaningful shift in policy makers' words and deeds.
■ United Kingdom	The economy probably exited recession in Q3 on a technical bounce, but we expect that growth continued to underperform consensus and BoE expectations.
■ Canada	Moderating global growth and lingering uncertainties probably will postpone the resumption of easy policy removal. As such we now anticipate the next rate hike in July 2013 instead of March.
■ Australia	The RBA is likely to cut interest rates further, but by less than markets are pricing, and probably the RBA will pass next month given the higher than expected Q3 CPI.
■ Emerging Asia (ex China)	Signs are growing of stabilisation to mildly rebound in manufacturing and exports, led by some bottoming signs in China and the favourable impact of central bank policy action in advanced economies to loosen financial conditions. Nonetheless, we expect Asian central banks will continue to focus on downside growth risks versus inflation, with a policy bias to ease marginally or keep rates on prolonged hold, and limit the extent of FX outperformance via intervention.
■ CEEMEA	Tight fiscal policy and weak external demand have led us to cut growth forecasts in Czech, Hungary, Poland, Romania, Turkey and South Africa this month. There is not much evidence of 'green shoots' in CEEMEA. Meanwhile, our inflation forecasts are generally up thanks largely to the effect of rising food prices.
■ Lat Am	With external conditions improving, albeit slightly, and activity performing relatively well in most countries, central banks are likely to remain on hold in the months to come.

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	Global equities to rally modestly to end 2013. Slowing corporate profits suggests the biggest risks are to the downside.	ECB to activate OMT, thus stabilising the front-end of peripheral curves	Diminished tail risk and impressive technicals pushing valuations higher	Short, high-quality sectors optimise defensive positioning. Off-the-run sectors offer upside	USD weaker short term	Crude and product markets should continue to ease and industrial metals should stay under pressure	Continued easy money balances negative macro
Most-Favoured Region/Sector	Asia Pac ex Japan, Australia, US / IT, Materials, Health Care	Front end of the EUR curve	Select Financials; Periphery; Triple-Cs	US CMBS senior tranches	INR, EUR, MXN	LME nickel, grains, soybeans	Gold, Risk Assets
Least-Favoured Region/Sector	Europe ex UK, Japan/ Cons. Disc, Industrials, Telecoms	EUR 5y	Singles names that have run too far, too fast	Spanish and Irish RMBS	ZAR, HUF	US natural gas, cotton	Core FI
Key Risks	Deeper downturn in Continental Europe earnings, profits begin to collapse in the US	Negative surprise on peripheral growth and failure to comply with fiscal targets	Sovereign crisis; bank runs; global slowdown	Regulation	Central banks stop easing. Risk rally loses steam, Intervention	Risk-off financial outflows, Chinese growth rebalancing, US fiscal cliff and nominal US dollar strength	EMU breakup, New Chinese boom, US fiscal cliff

Source: Citi Research

Overview: Some Downside Risks Remain

Michael Saunders
(44 20) 7986-3299
michael.saunders@citi.com

Our global growth forecasts are little changed this month, slightly up for 2013, slightly down for 2014

After a general bias to downgrades in earlier months, our global growth forecasts are little changed this month. We continue to look for global growth (at market exchange rates) of about 2.5% in 2012, while we edge up our 2013 forecast by 0.1% to 2.7% and trim our 2014 forecast by 0.1% to 3.1%. Within that, we now expect the EMU recession to be somewhat shallower but more extended than last month: we are edging up our EMU forecasts for 2012 and 2013 to minus 0.4% and minus 0.7% respectively (from minus 0.6% and minus 0.9% last month) but trimming our 2014 forecast from plus 0.3% to minus 0.1%. Moreover, we are cutting our 2013 Japan forecast to 0.9% from 1.3% last month — the third consecutive downgrade. Overall, our forecasts are a bit below the consensus and IMF forecasts, mainly reflecting our sub-consensus euro area view.

Some of the more extreme downside risks are diminishing, but central banks will keep policy loose

Nevertheless, we are less worried about more extreme downside risks. A few months ago, the global outlook appeared to face three major hurdles around end-2012/early-2013: the likelihood of Grexit and the markets' response to this through exit fear contagion, China slowdown amidst possible policy paralysis related to the leadership transition, as well as the US fiscal cliff. The first two risks have now receded: early Grexit seems much less likely and in any case the OMT makes it much more likely that the wider costs (outside Greece) of exit fear contagion could be contained. Moreover, China's economy shows signs of stabilizing, reducing the need for urgent new stimulus measures during the leadership transition. US fiscal cliff risks remain, but the domestic economy and Fed stimulus provide some offsetting support. Even so, amidst modest growth (and EMU recession), the main central banks are all likely to keep policy loose or to loosen further nearterm.

There are tentative signs that China's economy is now stabilizing after the recent slowdown

China's economy has weakened markedly during this year, and we have already cut our growth forecasts by 0.5% for 2012 and 0.8% for 2013 since January. This month, we are trimming our 2012 growth forecasts a little further, to 7.7% (from 7.9% last month) while leaving our 2013 forecast at 7.6%. However, there are tentative signs in recent data that China's economy is leveling off and perhaps even rebounding a little. For example, credit growth continues to grind higher (16.2% YoY in September), import growth turned positive in September, while some other Asian economies (except Japan) posted stronger exports. As well as official monetary and fiscal stimulus, there is ongoing support from ample liquidity (including the shadow banking system), plus catch-up industrialisation and urbanisation[1].

Figure 4. Selected Countries — Industrial Production Forecasts (Pct.), 2011-13F

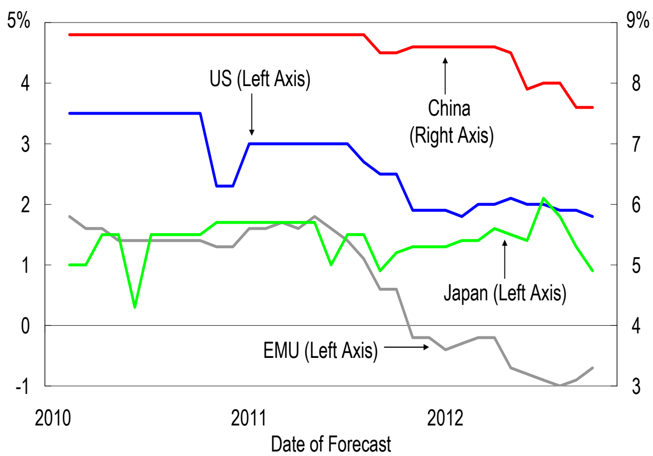
	2011	2012F	2013F
World	4.0%	2.2%	2.6%
United States	4.1	3.8	2.5
Japan	-2.4	-0.7	-1.1
Euro Area	3.5	-1.4	-0.4
United Kingdom	-0.7	-1.4	1.5
Canada	3.5	0.7	-0.2
China	13.9	10.0	9.9
India	3.4	3.2	4.4
Korea	6.9	2.0	3.3
Brazil	0.3	-2.5	3.1

Source: Citi Research

The UN estimates that the share of the World population that lives in urban areas exceeded 50% in 2010 for the first time, and this expansion shows no signs of slackening — the urban population rose by about 74 million people (2.1%) in 2011, a little above the average rise in 2001-10 (70 million people per year). Within that, China's urbanisation rate exceeded 50% for the first time in 2011, having been just 26% in 1990 and 36% in 2000. China's urban population has risen by about 20 million people per year since 2000, rose by 21 million (3.2%) in 2011 and, according to the UN, will keep rising at about this pace to 2015 or so, with further large gains thereafter — rising by a further 34% or so (230 million people) by 2025. Urbanisation will likely be critical to rebalancing China's economy and sustaining the next stage of growth. We do expect that China's growth will slow in coming years but, if urbanisation can be promoted fully and in a timely fashion, China may be able to sustain 6-8% growth in the coming decade. In our forecast, the rise in China's GDP by itself will probably account for about a quarter of global growth over 2012-16. Emerging markets as a whole accounted for about 60% of global growth over the last 10 years (2002-11) and on our forecasts will account for a slightly higher share (66%) of global growth over 2012-16.

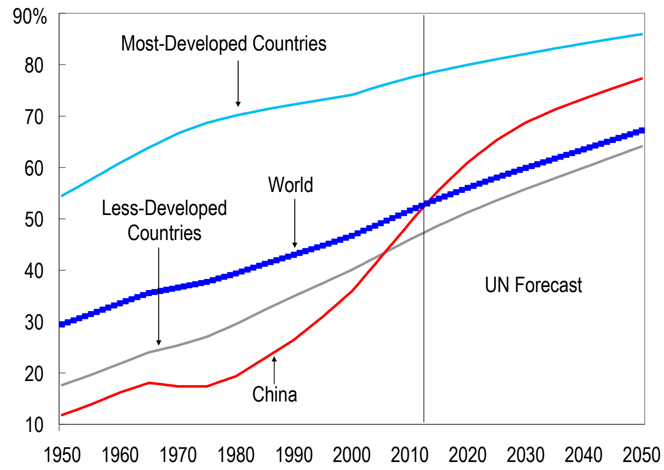
[1] See "*China Macro View: The Urbanization Dividend*", Minggao Shen, Shuang Ding and Enjiang Cheng, 23 October 2012, Citi.

Figure 5. US, China, EMU and Japan — Citi Forecasts for 2013 GDP Growth, 2010-12



Source: Citi Research

Figure 6. Global — Urban Population as Pct Total Population, 1950-2050F



F Forecast. Sources: UN and Citi Research

We are cautiously optimistic on the US growth outlook, provided fiscal cliff uncertainties can be averted

In the US, we are cautiously optimistic on the outlook. Recent data suggest that growth picked up a little in Q3, to about 2.3% QoQ SAAR, while housing is improving and the Citi Financial Conditions Index has reached its most accommodative reading at any time since the Fed began the current easing cycle more than five years ago[2]. Moreover, there probably is considerable pent-up business demand that could be unleashed if the fiscal cliff is safely averted. We expect growth will remain at a modest pace (1-2% QoQ SAAR) in H1-2013, but then rise to 3%+ in H2. Our base case continues to assume that the lame duck session of Congress will produce legislation to avoid the full brunt of the scheduled tightening, leaving roughly a percentage point of drag in 2013. We think there is a fairly wide range of election outcomes consistent with that view, recognizing the components may differ depending on a Romney or Obama victory. We expect that unless there is an unlikely sharp improvement in labour markets over yearend, the Fed is likely to continue buying Treasuries in unsterilised form along with mortgage securities well into 2013 following the completion of Operation Twist (OT).

The OMT programme and reduced risk of nearterm Grexit have helped calm EMU strains for now

In the euro area, policymakers for now have succeeded in calming market strains. First, the ECB's OMT programme is helping to cap short-end yields and underpin market access for Italy and Spain, despite ambiguous signals over whether the ECB would seek to cap yields at current levels, or higher or lower (or indeed, whether they would rigorously cap yields, or merely seek to limit extremes). Second, we believe the nearterm risks of Grexit have receded sharply, and we recently cut our estimate of the probability that Greece will leave EMU in the next 12-18 months to 60% from 90% and delayed the assumed date of Grexit from 1 January 2013 to 1 January 2014[3]. We stress that this date is an assumption, and meant to indicate the most likely approximate timing of Grexit, rather than a view that this precise day is the most likely time for Grexit.

[2] See U.S. Economics Weekly: Market and Policy Comments - Riding Out Yearend, Robert DiClemente, 19 October 2012, Citi.

[3] See Euro Economics Weekly - Grexit — Delayed But Not Cancelled, Giada Giani et al, 12 October 2012, Citi.

Creditor nations now apparently put greater weight on potential costs of nearterm Grexit…

This change in our view of the probability and likely timing of Grexit mainly reflects the change in attitudes among EMU creditor nations — especially Germany — which appear to have decided that the likely economic and electoral costs of nearterm Grexit exceed the likely costs of allowing the Greek government sufficient access to finance to struggle on inside the euro area, for now.

…in both economic and electoral terms

- The German government and other creditors probably fear that they will be blamed if Grexit triggers fresh financial market turmoil and further undermines economic activity in the rest of the euro area in the runup to the late-2013 German elections.
- Moreover, the German government probably fears that, in the event of Grexit, they would have to accept a rapid move towards banking union — with their worries over whether the supervisory framework is adequate likely to be brushed aside in order to provide an adequate “ringfence” for other EMU countries.
- In addition, the Greek government’s recent intense rounds of shuttle diplomacy, together with some recent modest improvements in the Greek deficit data and unit labour cost trends, may also have helped.
- We suspect the additional money needed to keep Greece afloat in 2013 can be made to look relatively small for now and hence can be found without requiring any more parliamentary approvals in core euro countries.

The underlying economic and fiscal problems of the Euro Area have not been solved, and Greece’s program is badly off track

However, we suspect that the current relative calm will prove to be merely the latest of a series of fluctuations between episodes of extreme turbulence — driven by worries over economic and fiscal prospects in periphery countries — and liquidity-induced rallies. The OMT programme and likely deferral of Grexit will not solve the EMU crisis, in our view, which at its heart is a crisis of weak economies and sectoral imbalances (both public and private). Moreover, we stress that our view that early Grexit is less likely mostly reflects changed attitudes among creditor nations over the costs of nearterm Grexit rather than greater optimism over Greece’s medium-term economic and fiscal prospects. We suspect that there is now widespread acceptance that Greece’s second package is badly off track. We continue to expect that Greece will probably leave the Euro Area over the next year or two.

In recent years, no country has exited an IMF GRA program with such a high debt/GDP ratio as Greece is likely to have in coming years…

The second IMF programme agreed early this year projected that Greece’s government debt/GDP ratio would peak at 167% in 2013 and fall to 145% in 2016 (the supposed end of the programme). But, with the ongoing deep recession, the IMF recently raised its forecast for the 2013 debt/GDP ratio to 182% and now (even with relatively optimistic forecasts for Greece’s economic outlook) expects Greece’s debt/GDP ratio will be as high as 164% in 2016[4]. No country in recent years has exited an IMF GRA programme with such a high debt/GDP ratio[5]. Indeed, Ireland and Portugal are both forecast to rank in the top five countries for the debt/GDP ratio at the end of an IMF programme as well (using IMF fiscal projections to the planned end of their current programmes in 2013 and 2014 respectively). Moreover, Greece, Ireland and Portugal have all experienced large rises in their debt/GDP ratios since their IMF programmes began. By contrast, most other high-debt countries cut their debt ratios while in an IMF programme (usually by a mix of debt restructuring and in some cases also high nominal GDP growth in local currency terms).

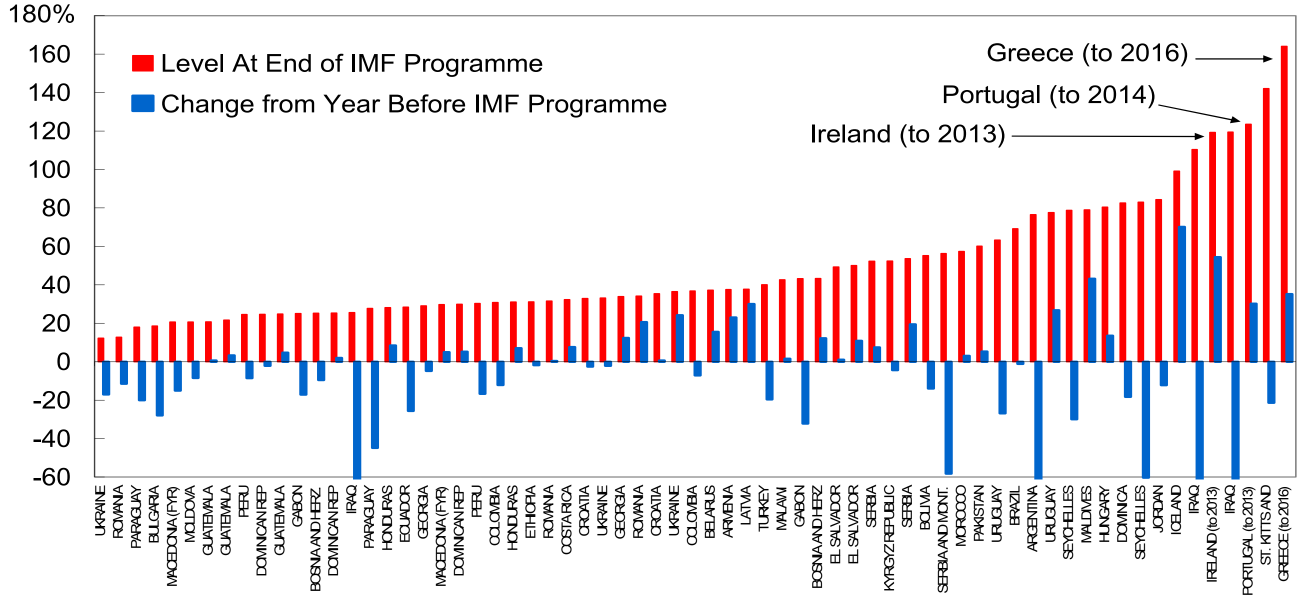
[4] Our own forecasts are that, if Greece stays in EMU without debt restructuring, its government debt/GDP ratio will rise well above 200% by 2016.

[5] We focus on GRA (General Resources Account) programs and exclude PRGT (Poverty Reduction and Growth Trust) programs. See “*2011 Review of Conditionality*”, IMF, June 2012.

…and Greece probably also will suffer one of the biggest collapses in nominal GDP of any country in a GRA program

The failure of Greece's programme to restore the country to fiscal sustainability largely reflects the collapse in economic activity and the absence of any meaningful structural reform since the early success with pension reforms. Greece has implemented the biggest cuts in nominal government spending of any country in an IMF GRA programme in recent years. However, nominal GDP has already fallen by 13% since Greece's first programme began and the IMF expects that even in 2016, nominal GDP will be 12% below the pre-programme (ie 2009) level. This is by far the biggest collapse in nominal GDP seen in any country in an IMF GRA programme in recent years[6]. Portugal probably will fare only a little better.

Figure 7. Selected Countries — Government Debt/GDP Ratio Before and After IMF GRA Programmes, 2002-16



Note: Data from IMF MONA database, updated with latest WEO projections for Greece, Ireland and Spain. Some countries appear more than once if they had more than one programme. We have combined Greece's first program with the current second one. Sources: IMF and Citi Research

The periphery EMU economies face further economic disappointment…

The IMF now acknowledges that fiscal austerity is likely to hit growth heavily especially when, as in many EMU countries, private spending is weak and there is no powerful offsetting monetary loosening[7]. We share these worries. However, the periphery countries remain trapped in an economic vice of fiscal austerity, poor external competitiveness, private sector deleveraging, poor credit availability and tightening monetary conditions. Indeed, fiscal tightening is set to be widespread across Europe in 2013. For example, the IMF judges that in 2013 the structural fiscal stance will tighten by 3-4% in Greece, by 1-2% of GDP in Portugal, Italy and Spain, with similar tightening also in France, the Netherlands and the UK, plus tightening of 0.5-1.0% of GDP in Ireland. Even with modest fiscal easing in Germany (¼% – ½% of GDP), the euro area fiscal stance will tighten by about 1% of GDP in 2013.

[6] There have been more than 70 GRA programmes since 2002, and these are usually of three years duration. Among these, there is only one completed case in which the level of nominal GDP in T+3 was lower than in T-1 (where T denotes the year the IMF programme began), and this was Latvia which recorded a 4% decline in nominal GDP between 2007 (t-1) and 2011 (T+3). Portugal's nominal GDP has fallen by 3.5% since going into a programme and the IMF expects that the country in total will suffer a 1-2% decline in nominal GDP during its current programme.

[7] See "*World Economic Outlook*", IMF, October 2012.

…with domestic weakness exacerbated by poor credit availability

Moreover, with worsening credit quality and worries over capital prompting domestic and foreign banks to retrench, ECB data show bank lending rates on loans up to €1million are at a record low of 3.4% in Germany, but around 6% in Italy, Spain and Ireland and above 7% in Portugal. Supply-side reforms that could yield large longer term benefits, especially for small (and hence potentially more open) economies, though worth doing, are unlikely to alter prospects for demand and growth anytime soon. Lead guides point to signal deepening recessions in most periphery countries.

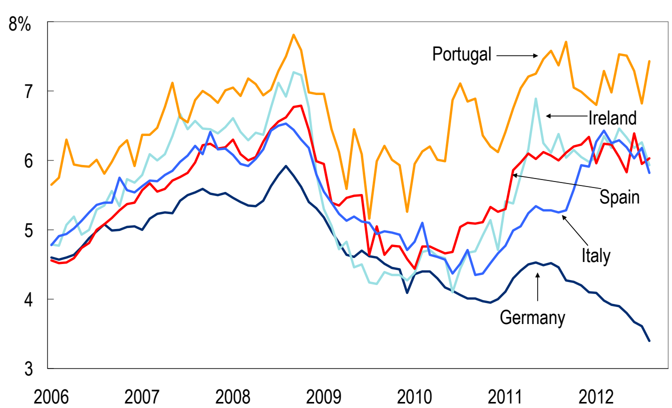
Banking union is being designed to avert future crises rather than solve this one

In addition, the debate over banking union appears aimed at reducing risks of future crises rather than solving the current crisis. The German government appears to have succeeded in ensuring that moves towards a common supervisory system proceed slowly, that existing bank recapitalisation costs will probably not be transferred to the ESM, and that there will be no early move to a joint Deposit Guarantee Scheme — and no move at all to any DGS that might protect against redenomination risk.

We expect that all the peripheral countries will need some form of external financial support or backstop in coming years

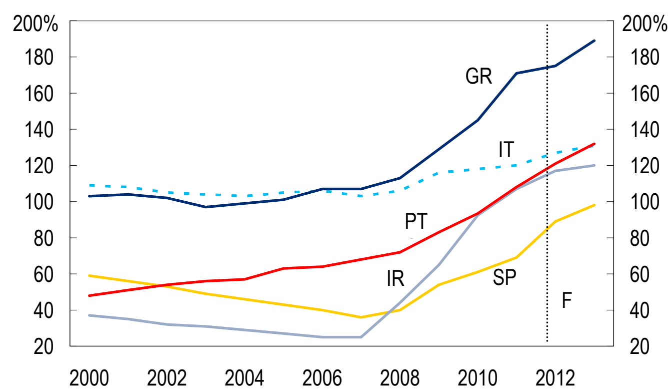
As a result, we expect that in general the periphery economies will continue to undershoot official forecasts, leading to further overshoots in fiscal deficits and public debts in coming years. We forecast continued deep recessions in 2013 in Greece, Portugal, Italy and Spain, with falling domestic demand (but positive GDP growth) in Ireland. A programme for Cyprus is likely to be agreed in coming weeks (perhaps introducing sizeable haircuts for bank creditors prior to access to ESM funding into the EMU policy toolkit), while we think Spain is likely to go into a programme (most likely an ECCL programme) soon, and Italy probably will follow by mid-2013. We expect that in coming years none of the periphery economies will be able to achieve solid economic growth with sustainable fiscal trends, and expect that all of them will need some form of external support or backstop for government financing for many years.

Figure 8. Selected EMU Countries — Average Bank Lending Rates on Longterm Business Loans Up to €1Million, 2006-12



Sources: ECB and Citi Research

Figure 9. Selected EMU Countries — General Government Gross Debt/GDP Ratios, 2000-13F



F Forecast. Sources: Eurostat and Citi Research

We continue to expect a mix of EMU exit (Greece), sovereign debt restructuring (a range of countries) and only limited fiscal burden sharing over time

Over time, therefore, we expect economic weakness and unsustainable fiscal trends in periphery countries to be reflected in a mix of EMU exit (Greece potentially in 2014, once the German election is past), eventual sovereign debt restructuring (Portugal, possibly also Ireland, Spain, Italy, Cyprus), with only a limited move to fiscal burden sharing — probably including some kind of euro area fiscal body, which would be allowed to issuance debt. But this process is likely to be spread over several years, locking the euro area into a long period of economic weakness and uncertainty.

Figure 10. Citi Global Economics Team *For Informational Purposes Only*

	Name	Office Number	Email Address	Responsibilities
NEW YORK	North America			
	Nathan Sheets[3]	(1-212) 816-9297	nathan.sheets@citi.com	Global Head of International Economics
	Robert DiClemente[3]	(1-212) 816-7942	robert.diclemente@citi.com	Head, North America
	Peter D'Antonio[3]	(1-212) 816-9889	peter.dantonio@citi.com	U.S. Forecast
	Steven Wieting[3]	(1-212) 816-7148	steven.wieting@citi.com	Equity Themes
	Dana Peterson[3]	(1-212) 816-3549	dana.peterson@citi.com	U.S. Forecast and Canada
	Matt Dabrowski[3]	(1-716) 730-7407	matt.dabrowski@citi.com	Global Political Analysis
	Emerging Markets			
	Guillermo Mondino[3]	(1-212) 816-6499	guillermo.mondino@citi.com	Head, EM Economics and Strategy Research
	Joaquin Cottani[3]	(1-212) 816-2735	joaquin.cottani@citi.com	Head, Latin America
	Jorge Pastrana[2]	(1-212) 816-5728	jorge.armando.pastranavillegas@citi.com	Caribbean and Central America
	Camilo González García[2]	(1-212) 816-9901	camilo.gonzalezgarcia@citi.com	Argentina, Chile, Peru, Caribbean, Central America
LONDON	Willem Buiter[1]	(44-20) 7986-5944	willem.buiter@citi.com	Chief Economist
	Tina Fordham[1]	(44-20) 7986-9860	tina.fordham@citi.com	Global Political Analysis
	Ebrahim Rahbari[1]	(44-20) 7986-6522	ebrahim.rahbari@citi.com	Global Economics, Spain
	Western Europe			
	Michael Saunders[1]	(44-20) 7986-3299	michael.saunders@citi.com	Head, Western Europe and U.K. Coverage
	Jürgen Michels[1]	(44-20) 7986-3294	juergen.michels@citi.com	Euro Area (Germany) and ECB Specialist
	Guillaume Menuet[1]	(44-20) 7986-1314	guillaume.menuet@citi.com	Euro Area (France, Belgium)
	Giada Giani[1]	(44-20) 7986-3281	giada.giani@citi.com	Euro Area (Italy, Greece, Portugal)
	Tina Mortensen[1]	(44-20) 7986-3284	tina.mortensen@citi.com	Nordics
	Ann O'Kelly[1]	(44-20) 7986-3297	ann.okelly@citi.com	Europe
	Emerging Markets			
	David Lubin[1]	(44-20) 7986-3302	david.p.lubin@citi.com	Head, Emerging Markets and CEEMEA
	David Cowan[1]	(44-20) 7986-3285	david.cowan@citi.com	Africa
	Elina Ribakova[1]			Russia, Kazakhstan, Ukraine
TOKYO	Kiichi Murashima[2]	(813) 6270-4980	kiichi.murashima@citi.com	Head, Japan
	Naoki Iizuka [2]	(813) 6270-4997	naoki.iizuka@citi.com	Japan
SYDNEY	Paul Brennan[15]	(612) 8225-4899	paul.brennan@citi.com	Head, Australia, New Zealand
	Josh Williamson[15]	(612) 8225-4904	josh.williamson@citi.com	Australia, New Zealand
BEIJING	Enjiang Cheng[10]	(86) 10 59376038	enjiang.cheng@citi.com	China
BOGOTA	Munir Jalil[12]	(57) (1) 639-4195	munir.jalil@citi.com	Colombia, Venezuela
BUDAPEST	Eszter Gargyan[7]	(36) 1 374-5559	eszter.gargyan@citi.com	Hungary
DUBAI	Farouk Soussa[1]	(971) (4) 509-9750	farouk.soussa@citi.com	Gulf, Middle East, Levant
HONG KONG	Johanna Chua[4]	(852) 2501-2357	johanna.chua@citi.com	Head, Emerging Asia, Sri Lanka, Vietnam
	Minggao Shen[4]	(852) 2501-2485	minggao.shen@citi.com	China
	Shuang Ding[4]	(852) 2501-2769	shuang.ding@citi.com	China
	Adrienne Lui[4]	(852) 2501-2753	adrienne.lui@citi.com	Hong Kong, Mongolia, Taiwan
ISTANBUL	Ilker Domac[6]	(90) 212 319-4623	ilker.domac@citi.com	Turkey, Romania, Balkans
	Gultekin Isiklar[6]	(90) 212 319-4915	gultekin.isiklar@citi.com	Turkey, Romania, Balkans
JAKARTA	Helmi Arman [21]	62-21-5290-8960	helmi.arman@citi.com	Indonesia
MANILA	Jun Trinidad[17]	(63) (2) 894-7270	jun.trinidad@citi.com	Philippines, Thailand
MEXICO CITY	Sergio Luna Martinez[4]	(52) (55) 2226-6799	sluna@banamex.com	Mexico
MOSCOW	Natalia Novikova[18]			Russia, Kazakhstan, Ukraine
MUMBAI	Rohini Malkani[8]	(91) 22-6631-9876	rohini.malkani@citi.com	India
PRAGUE	Jaromir Sindel[13]	(42) (02) 3306-1485	jaromir.sindel@citi.com	Czech Republic, Slovakia
SAO PAULO	Marcelo Kfoury[19]	(55) (11) 4009-3470	marcelo.kfoury@citi.com	Brazil
SEOUL	Jaechul Chang[16]	(82) 2 2077-4160	jaechul.chang@citi.com	Korea
SINGAPORE	Kit Wei Zheng[20]	(65) 6657-5079	kit.wei.zheng@citi.com	Singapore, Malaysia
WARSAW	Piotr Kalisz[7]	(48) (22) 692-9633	piotr.kalisz@citi.com	Poland
	Cezary Chrapek[7]	(48) (22) 692-9421	cezary.chrapek@citi.com	Poland

1 Citigroup Global Markets Ltd; 2 Citigroup Global Markets Japan Inc.;3 Citigroup Global Markets Inc; 4 Citigroup Global Markets Asia; 5 Citigroup Global Markets (Pty) Ltd; 6 Citibank Anonim Sirketi; 7 Bank Handlowy w Warszawie; 8 Citigroup Global Markets India Private Limited; 9 Citigroup Global Markets India Private Limited; 10 Citibank (China) Co. Ltd; 11 Acciones y Valores Banamex, S.A. de C.V; 12 Citibank Taiwan Ltd; 13Banco Citibank S.A.; 14 Citibank Europe plc Czech Republic; 15 Citigroup Pty Limited; 16 Citigroup Global Markets Korea Securities Ltd; 17 Citibank N.A. Philippines; 18 ZAO Citibank; 19 Banco Citibank S.A.; 20 Citigroup Global Markets Singapore PTE LIMITED; 21 PT Citigroup Securities Indonesia

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Source: Citi Research.

Figure 11. 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	2.7	3.1	3.6	3.9	3.8	2.8	2.9	3.1	2.9	2.9	2.46	2.35	2.26	2.50	2.92	3.40
Based on PPP weights	*3.8*	*3.1*	*3.2*	*3.5*	*3.8*	*4.1*	*4.4*	*3.2*	*3.3*	*3.3*	*3.2*	*3.1*						
Industrial Countries	1.4	1.2	0.9	1.5	2.2	2.6	2.5	1.9	1.8	1.9	1.6	1.7	0.76	0.60	0.43	0.51	0.91	1.52
United States	1.8	2.1	1.8	3.0	3.5	4.0	2.4	1.8	1.9	2.1	2.2	2.2	0.25	0.25	0.25	0.25	1.10	2.10
Japan	-0.8	2.0	0.9	0.2	1.5	1.2	-0.3	0.1	-0.1	2.2	0.3	0.5	0.10	0.10	0.10	0.10	0.10	0.27
Euro Area	1.5	-0.4	-0.7	-0.1	0.7	1.3	2.7	2.6	2.3	1.5	1.4	1.4	1.19	0.81	0.31	0.25	0.25	0.69
Canada	2.6	2.2	2.0	2.8	3.2	3.5	2.9	1.6	1.5	2.0	2.0	2.0	1.00	1.00	1.19	2.13	2.50	3.00
Australia	2.1	3.7	3.2	3.4	3.8	3.6	3.4	1.8	3.0	2.9	2.7	2.5	4.75	3.63	2.75	3.75	4.50	4.75
New Zealand	1.3	2.3	2.8	3.0	3.2	3.4	4.0	1.6	2.2	2.6	2.9	2.8	2.50	2.50	2.69	4.00	4.75	5.00
Germany	3.1	1.1	0.6	0.8	0.9	1.4	2.3	2.0	2.2	2.5	2.3	2.2						
France	1.7	0.0	-0.2	0.5	1.0	1.5	2.1	2.0	1.4	1.4	1.8	1.7						
Italy	0.5	-2.3	-1.4	-1.8	0.2	0.4	2.9	3.4	2.1	1.1	0.3	0.1						
Spain	0.4	-1.5	-2.4	-1.8	0.7	2.0	3.1	2.4	2.1	0.5	0.6	0.6						
Greece	-6.9	-7.2	-7.3	-10.8	-5.0	-0.5	3.1	0.9	2.1	16.9	12.3	1.5						
Ireland	1.4	0.4	0.7	2.8	3.0	3.1	0.2	1.7	1.2	1.4	1.6	1.6						
Portugal	-1.7	-3.3	-4.6	-2.3	0.3	1.1	3.6	2.9	2.3	1.0	0.5	0.6						
Netherlands	1.1	-0.6	-0.9	0.8	1.1	1.2	2.3	2.5	2.7	1.6	1.9	1.8						
Belgium	1.8	-0.1	-0.2	0.5	1.2	1.5	3.5	2.9	1.8	1.9	2.2	2.2						
Denmark	0.8	0.1	1.1	1.6	1.7	1.8	2.8	2.5	2.0	2.1	2.2	2.0	1.30	0.40	0.15	0.75	1.00	1.00
Norway	2.5	3.5	3.2	2.7	2.7	2.9	1.3	0.8	1.7	2.0	2.4	2.5	2.10	1.50	1.90	2.50	3.00	3.30
Sweden	4.0	1.1	1.7	2.3	2.5	2.7	3.0	0.9	1.0	2.1	1.9	2.0	1.80	1.50	0.80	1.30	2.10	2.50
Switzerland	1.9	1.1	0.9	0.6	0.7	0.7	0.2	-0.7	-1.4	-0.9	0.5	0.9	0.22	0.00	0.00	0.00	0.00	0.00
United Kingdom	0.9	-0.3	0.7	0.8	1.3	1.9	4.5	2.7	2.1	1.9	1.5	1.4	0.50	0.50	0.50	0.50	0.50	1.04
Emerging Markets	6.0	4.7	5.3	5.6	5.5	5.6	6.1	4.5	4.7	4.8	4.8	4.6	5.54	5.24	5.10	5.42	5.75	5.93
China	9.3	7.7	7.6	7.3	7.0	6.8	5.4	2.7	3.2	3.8	4.0	4.0	3.22	3.25	3.13	3.50	3.88	4.00
Taiwan	4.0	1.7	3.6	4.5	4.5	4.5	1.4	2.0	2.0	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	6.9	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	6.1	6.3	6.5	6.5	5.4	4.4	4.7	4.7	5.7	5.4	5.42	3.94	4.50	4.50	4.63	5.13
Korea	3.6	2.6	3.4	3.7	4.1	4.2	4.0	2.4	2.8	3.1	3.0	3.2	3.20	3.06	2.56	3.25	4.00	4.38
Czech Republic	1.9	-1.2	0.4	1.1	1.6	2.3	1.9	3.3	2.4	1.5	2.1	1.8	0.75	0.49	0.05	0.24	1.04	2.04
Hungary	1.6	-1.2	0.4	1.5	2.0	1.8	3.9	5.9	5.2	3.8	3.1	3.3	6.04	6.73	5.52	5.50	5.44	5.00
Poland	4.3	2.4	2.2	2.8	3.3	3.3	4.3	3.8	2.6	2.5	2.5	2.5	4.22	4.60	3.88	4.13	4.71	4.75
Romania	2.5	1.3	2.5	3.0	4.3	4.3	5.8	3.5	5.2	3.7	3.3	3.0	6.19	5.25	5.69	5.50	5.50	5.00
Russia	4.3	3.5	4.0	4.1	4.0	4.2	8.4	5.1	6.9	6.0	5.5	5.0	8.12	8.08	8.44	8.10	7.85	7.75
Turkey	8.5	2.5	4.0	4.3	4.5	4.5	6.5	9.2	7.3	6.3	5.9	5.4	6.00	5.75	6.31	8.69	8.88	8.00
Nigeria	7.8	7.4	6.5	7.2	6.9	7.2	10.8	12.2	10.9	10.3	9.5	9.0	8.90	15.00	12.50	10.50	10.00	9.50
South Africa	3.1	2.5	2.6	4.2	4.4	4.2	5.0	5.5	5.1	5.7	5.3	5.4	5.50	5.25	5.00	5.29	5.50	5.50
Argentina	8.9	2.3	3.0	2.0	2.0	3.5	9.8	9.9	11.9	15.0	15.0	18.0	13.47	13.48	17.70	20.00	20.00	20.00
Brazil	2.7	1.4	3.9	4.0	3.5	3.5	6.6	5.4	5.3	5.3	5.3	4.8	11.71	8.46	7.46	8.50	9.50	9.88
Mexico	3.9	3.9	3.8	3.5	3.6	3.7	3.4	4.2	4.0	3.9	3.8	3.7	4.50	4.50	4.50	4.65	5.46	6.42
Venezuela	4.2	5.0	3.0	4.0	3.0	2.5	27.1	21.0	22.5	27.9	26.1	26.1	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 12. 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	0.5	0.2	0.0	-0.1	-0.1	-0.1	-5.0	-4.5	-3.7	-3.0	-2.7	-2.5	82	82	83	82	81	81
Based on PPP weights	*0.3*	*0.0*	*0.0*	*-0.1*	*-0.1*	*-0.1*	*-4.4*	*-4.1*	*-3.5*	*-2.9*	*-2.7*	*-2.5*						
Industrial Countries	-0.6	-0.8	-0.7	-0.6	-0.5	-0.4	-7.0	-6.0	-4.9	-3.8	-3.2	-2.9	108	112	115	117	117	117
United States	-3.1	-3.2	-3.1	-3.1	-3.2	-3.2	-10.0	-8.3	-7.0	-5.0	-4.0	-4.0	103	106	110	112	112	112
Japan	2.1	1.3	1.6	1.5	1.7	1.7	-10.7	-10.7	-8.1	-6.6	-6.2	-5.8	228	237	243	244	248	252
Euro Area	0.0	1.0	1.4	1.5	1.5	1.5	-4.1	-3.3	-2.7	-2.4	-1.9	-1.4	87	93	93	94	93	92
Canada	-3.0	-3.6	-4.0	-3.7	-2.9	-2.5	-1.4	-1.2	-0.5	-0.1	0.2	0.4	85	85	84	83	81	79
Australia	-2.3	-3.8	-4.7	-5.6	-3.5	-3.2	-3.4	-3.0	0.1	0.2	0.4	0.5	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	6.1	5.0	4.8	4.3	4.7	-1.0	-0.2	-0.3	-0.4	-0.2	-0.1	81	84	83	82	80	78
France	-2.0	-1.8	-1.0	-0.2	0.4	0.4	-5.2	-4.3	-3.6	-3.1	-2.5	-1.9	86	92	96	97	97	96
Italy	-3.3	-1.7	-1.3	-1.1	-1.0	-0.9	-3.9	-2.9	-2.6	-2.7	-2.1	-1.5	120	127	130	135	136	136
Spain	-3.5	-1.4	1.5	3.5	3.5	3.5	-9.4	-8.2	-6.4	-5.7	-5.2	-4.0	69	89	98	105	108	109
Greece	-9.8	-6.3	-5.4	-0.1	2.0	3.1	-9.4	-9.1	-7.7	-3.7	-5.6	-24.9	171	175	189	446	471	468
Ireland	1.1	3.2	5.5	7.9	9.4	10.4	-12.8	-8.1	-7.7	-4.9	-2.9	-2.0	107	117	120	118	115	111
Portugal	-8.1	-4.9	-2.8	-1.9	-1.7	-1.2	-4.4	-5.0	-5.0	-5.2	-3.0	-2.5	108	121	132	89	93	94
Netherlands	9.7	10.0	9.6	8.6	7.6	7.2	-4.7	-4.3	-3.8	-3.5	-2.8	-2.3	65	70	73	75	76	76
Belgium	-0.9	-0.7	0.2	0.9	1.8	2.1	-3.7	-2.7	-1.9	-1.8	-1.4	-1.4	98	110	115	114	112	109
Denmark	5.7	5.4	5.4	4.4	3.5	3.7	-2.0	-3.8	-2.0	-1.2	-1.0	0.5	47	49	50	49	48	46
Norway	14.0	14.3	14.9	15.2	15.8	16.5	13.7	13.2	14.0	15.0	17.0	18.5	NA	NA	NA	NA	NA	NA
Sweden	6.4	6.7	6.9	7.3	7.2	7.3	0.1	-0.3	-0.8	-0.3	0.7	1.5	37	37	36	35	33	30
Switzerland	14.3	12.7	13.1	13.0	13.6	14.5	0.7	0.4	0.0	-0.1	-0.6	-1.0	53	51	51	51	51	52
United Kingdom	-1.9	-4.0	-2.9	-2.6	-1.9	-1.2	-8.2	-6.9	-8.0	-7.6	-7.2	-6.1	82	89	97	103	108	112
Emerging Markets	2.3	1.6	1.1	0.6	0.4	0.4	-1.4	-2.0	-1.9	-1.8	-2.0	-2.0	34	33	33	32	31	31
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	-3.2	-2.3	-1.7	-1.2	-0.5	-8.4	-8.5	-8.0	-7.5	-7.0	-6.5	69	69	69	67	65	64
Indonesia	0.2	-2.3	-1.7	-1.1	-1.2	-0.9	-1.2	-2.1	-1.5	-1.4	-1.0	-0.5	24	25	24	23	23	22
Korea	2.4	2.2	1.4	0.8	-0.2	-0.9	1.5	0.8	1.3	1.6	1.5	2.2	33	34	33	31	29	27
Czech Republic	-3.0	-0.8	-1.7	-2.8	-4.3	-2.8	-3.1	-3.2	-3.0	-2.3	-1.5	-0.5	41	45	47	48	48	47
Hungary	1.1	1.3	2.3	2.5	2.2	1.9	4.3	-2.8	-2.9	-3.1	-3.0	-3.0	81	78	78	77	77	76
Poland	-4.3	-3.6	-3.9	-5.2	-5.5	-5.1	-5.1	-3.4	-3.0	-2.5	-2.2	-2.2	54	51	51	50	49	48
Romania	-4.4	-4.0	-4.7	-4.5	-4.7	-5.0	-4.1	-2.4	-2.2	-2.5	-2.3	-2.0	39	40	40	39	38	37
Russia	5.3	5.4	3.9	1.5	0.0	-1.0	2.0	0.3	0.1	-0.1	-1.2	-1.2	8	9	8	8	8	8
Turkey	-10.0	-7.5	-7.0	-6.6	-6.1	-5.5	-1.3	-2.5	-2.7	-2.5	-2.7	-3.0	41	38	37	36	36	36
Nigeria	3.4	2.3	3.4	3.0	1.9	1.3	-3.1	-2.9	-2.1	-2.6	-3.0	-2.6	NA	NA	NA	NA	NA	NA
South Africa	-3.4	-5.7	-5.6	-5.3	-4.6	-3.3	-5.0	-4.8	-4.2	-3.6	-3.5	-3.5	38	41	42	43	43	42
Argentina	0.0	1.0	0.6	-1.0	-1.0	-1.0	-1.7	-2.8	-3.0	-3.0	-3.0	-3.0	40	38	39	40	41	42
Brazil	-2.3	-2.2	-2.5	-2.7	-3.0	-3.3	-2.6	-2.6	-2.4	-2.1	-1.8	-2.0	54	54	55	55	56	56
Mexico	-0.8	-1.0	-1.4	-2.5	-2.4	-2.6	-2.4	-2.2	-2.0	-1.9	-1.9	-1.8	40	40	38	38	38	37
Venezuela	9.1	4.9	4.5	5.8	6.1	5.3	-5.0	-5.0	-4.0	-5.2	-5.0	-4.8	44	40	46	47	47	48

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, for Spain, fiscal deficits include the effect of financial support for banks in 2011 (€5.4bn) and 2012 (€11.6bn). Source: Citi Research

Figure 13. 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					0.3	0.4	-0.1	-0.3	-0.3
Based on PPP weights	*0.1*	*0.2*	*0.1*	*0.1*	*-0.1*			*0.3*	*0.4*	*-0.2*	*-0.2*	*-0.3*
Industrial Countries								0.1	0.3	-0.2	-0.4	-0.5
United States		-0.1	-0.1		-0.1			-0.1	-0.1	-0.6	-0.8	-1.1
Japan		-0.1	-0.4		-0.1			0.3	0.5			
Euro Area		0.2	0.2		0.1	0.1		0.5	1.0			
Canada	0.2	0.2	-0.2		-0.1	-0.4	-0.2	-0.3	-0.3			
Australia									-0.1			
New Zealand					0.1							
Germany		0.1						0.4	1.0		0.1	
France		0.1			-0.1			-0.1	-0.1		0.1	0.1
Italy		0.2	0.7		0.2	-0.2					0.1	0.3
Spain		0.3	0.8			-1.1			-0.3	-0.3	-1.6	-0.9
Greece		0.4	3.4		0.1	-12.8		0.3	-3.3	-0.3	2.1	-1.9
Ireland		1.0	0.1					3.3	3.8		0.3	0.3
Portugal		0.5	1.1			-0.3				-0.2	0.1	-0.1
Netherlands		0.1	-0.1		-0.1	-0.1	1.2	0.4				0.1
Belgium		0.1			0.3	0.3	0.1	-0.6	-0.2			0.2
Denmark						0.1	-0.8	-0.1			-0.3	
Norway										-0.1	-0.4	
Sweden		0.1	-0.2		-0.2	-0.5	-0.1					-0.4
Switzerland		-0.1	-0.1		0.1	-0.1		0.5	1.5			
United Kingdom	0.2	0.2	0.4		0.1			-1.6	-1.5		-0.5	-0.7
Emerging Markets				0.1	-0.1			0.7	0.5		-0.1	-0.1
China		-0.2			-0.2	-0.1						
Taiwan												
India								-0.2	-0.2			
Indonesia												
Korea			0.1					0.1	-0.1			
Czech Republic	0.2	-0.2			-0.1			0.6				0.2
Hungary	-0.1	-0.1	-0.4		0.2	1.0	-0.6	-0.8	-0.7		0.3	1.0
Poland									0.3			
Romania												
Russia								-0.3	1.5			
Turkey												
Nigeria				0.2	0.3	0.7					-0.7	
South Africa		-0.2	-1.0			0.3						
Argentina		0.8						0.1	0.3			
Brazil					0.1	-0.1		0.1	0.2			
Mexico												
Venezuela			-0.5		-0.2	0.2			0.4			

Source: Citi Research

Figure 14. 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	1.80	2.15	2.90	3.40	3.75	NA	NA	NA	NA	NA	NA	1.39	1.30	1.24	1.20	1.25	1.32
Japan	1.12	0.90	1.18	1.25	1.75	1.75	79	80	79	80	81	81	110	104	98	96	100	107
Euro Area	2.71	1.59	1.63	2.25	2.50	3.00	1.39	1.30	1.24	1.20	1.25	1.32	NA	NA	NA	NA	NA	NA
Canada	2.78	1.88	2.46	3.30	3.50	3.75	1.01	0.99	0.98	0.97	0.97	0.96	1.39	1.29	1.22	1.17	1.20	1.26
Australia	4.63	3.25	3.23	3.70	4.20	5.00	1.01	1.03	0.95	0.93	0.93	0.92	1.37	1.26	1.31	1.29	1.35	1.43
New Zealand	4.74	3.61	3.83	4.20	4.60	5.30	0.77	0.82	0.78	0.71	0.68	0.67	1.79	1.59	1.59	1.70	1.83	1.96
Germany	2.71	1.59	1.63	2.25	2.50	3.00												
France	3.31	2.57	2.43	2.85	3.05	3.50												
Italy	5.19	5.44	5.25	4.75	5.00	5.50												
Spain	5.43	5.96	5.38	5.00	5.00	5.50												
Netherlands	3.04	1.98	2.03	2.50	2.70	3.20												
Belgium	4.21	3.11	2.78	3.05	3.25	3.70												
Denmark	2.70	1.49	1.53	2.30	2.65	3.25	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Norway	2.90	2.14	2.28	2.90	3.20	3.75	5.66	5.76	5.82	6.04	5.84	5.54	7.84	7.48	7.24	7.27	7.28	7.28
Sweden	2.60	1.59	1.66	2.30	2.60	3.25	6.60	6.68	6.75	6.95	6.72	6.40	9.14	8.68	8.40	8.35	8.38	8.41
Switzerland	1.53	0.63	0.80	1.05	1.50	2.10	0.90	0.93	0.96	1.00	0.99	0.96	1.25	1.20	1.20	1.20	1.23	1.27
United Kingdom	3.00	1.85	1.80	2.35	2.50	3.00	1.59	1.60	1.58	1.53	1.58	1.66	0.87	0.81	0.79	0.79	0.79	0.79
Emerging Markets																		
China	3.52	3.14	3.37	3.74	4.12	4.24	6.46	6.30	6.27	6.18	6.13	6.10	9.00	8.18	7.80	7.43	7.63	8.02
Taiwan	1.38	1.35	1.50	1.60	1.70	1.80	29.40	29.49	29.36	28.45	28.20	28.20	40.93	38.29	36.53	34.22	35.15	37.09
India	8.40	8.25	8.25	8.25	8.25	8.25	46.63	52.14	51.94	52.30	51.67	50.90	64.92	67.69	64.62	62.89	64.40	66.95
Indonesia	7.41	6.07	6.45	6.80	7.00	7.25	8763	9464	9799	9692	9616	9563	12201	12286	12191	11655	11986	12577
Korea	3.90	3.22	2.89	3.70	4.63	5.00	1108	1123	1102	1022	997	993	1542	1458	1371	1228	1242	1306
Czech Republic	3.68	2.85	2.88	3.42	3.82	4.00	17.7	19.4	20.4	20.6	19.2	17.6	24.6	25.1	25.4	24.8	24.0	23.1
Hungary	7.63	7.98	7.26	7.16	6.94	6.65	201	223	239	243	230	216	279	289	297	292	287	284
Poland	5.99	5.17	5.36	5.38	5.40	5.34	2.96	3.20	3.34	3.29	3.13	2.97	4.12	4.16	4.15	3.95	3.90	3.90
Romania	NA	NA	NA	NA	NA	NA	3.04	3.44	3.72	3.45	3.22	3.01	4.23	4.47	4.62	4.15	4.01	3.97
Russia	NA	NA	NA	NA	NA	NA	29.4	31.0	33.1	34.3	33.3	31.9	41.0	40.2	41.2	41.2	41.5	41.9
Turkey	NA	NA	NA	NA	NA	NA	1.68	1.80	1.84	1.90	1.91	1.91	2.34	2.34	2.29	2.28	2.38	2.51
Nigeria	NA	NA	NA	NA	NA	NA	156	158	161	164	168	171	217	205	201	197	209	225
South Africa	8.24	8.21	8.90	9.15	9.20	9.20	7.26	8.29	9.18	9.44	9.62	9.77	10.11	10.77	11.42	11.36	11.99	12.85
Argentina	NA	NA	NA	NA	NA	NA	4.13	4.58	5.46	6.90	7.94	9.36	5.74	5.94	6.79	8.30	9.89	12.31
Brazil	11.45	9.98	9.31	9.15	8.75	8.25	1.67	1.97	2.04	2.05	1.98	1.90	2.33	2.55	2.54	2.46	2.47	2.50
Mexico	6.83	5.80	6.44	6.84	6.99	7.29	12.4	12.9	12.8	12.6	12.6	12.8	17.3	16.7	15.9	15.1	15.8	16.8
Venezuela	13.65	11.42	11.45	13.90	13.80	13.70	4.29	4.30	6.50	6.50	9.75	9.75	5.98	5.58	8.09	7.82	12.15	12.82

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

Figure 15. Short Rates (End of Period), as of 24 Oct 2012 (Percent)

	Current	4Q 12	1Q 13	2Q 13	3Q 13	4Q 13	1Q 14
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	0.50	0.25	0.25	0.25	0.25
Canada	1.00	1.00	1.00	1.00	1.25	1.50	1.75
Australia	3.25	3.25	3.00	3.00	3.00	3.00	3.00
New Zealand	2.50	2.50	2.50	2.50	2.75	3.00	3.50
Denmark	0.20	0.05	0.05	0.05	0.15	0.25	0.25
Norway	1.50	1.50	1.50	1.75	1.75	2.00	2.25
Sweden	1.25	1.00	0.75	0.75	0.75	0.75	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	3.00	3.00	3.00	3.25	3.25	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 16. 10-Year Yield Forecasts (Period Average), as of 24 Oct 2012 (Percent)

	Current	4Q 12	1Q 13	2Q 13	3Q 13	4Q 13	1Q 14
United States	1.79	1.65	1.75	2.00	2.25	2.55	2.75
Japan	0.78	0.95	1.10	1.20	1.10	1.30	1.30
Euro area (Germany)	1.59	1.50	1.75	1.50	1.75	1.50	1.50
Canada	1.87	1.80	2.00	2.25	2.65	2.95	3.15
Australia	3.20	3.10	3.00	3.10	3.30	3.50	3.75
New Zealand	3.57	3.50	3.70	3.75	3.85	4.00	4.20
Denmark	1.61	1.35	1.60	1.40	1.65	1.45	1.45
Norway	2.12	2.10	2.35	2.15	2.40	2.20	2.25
Sweden	1.63	1.50	1.75	1.50	1.80	1.55	1.65
Switzerland	0.49	0.58	0.66	0.58	0.66	0.58	0.58
United Kingdom	1.84	1.80	1.80	1.70	2.00	1.75	1.85

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 17. 10-Year Yield Spreads (Period Average), as of 24 Oct 2012

	Spread vs. US$						Spread vs. Germany					
	Current	4Q 12	1Q 13	2Q 13	3Q 13	4Q 13	Current	4Q 12	1Q 13	2Q 13	3Q 13	4Q 13
United States	NA	NA	NA	NA	NA	NA	21	16	1	51	51	107
Japan	-102	-71	-66	-81	-116	-127	-81	-55	-65	-30	-65	-20
Euro Area	-21	-16	-1	-51	-51	-107	NA	NA	NA	NA	NA	NA
Canada	8	15	25	25	40	41	29	31	26	76	92	147
Australia	142	147	126	111	106	96	163	162	127	162	158	203
New Zealand	181	187	198	178	162	147	201	203	198	229	214	254
France	46	49	69	19	29	-7	66	65	70	70	80	100
Italy	309	259	349	299	299	293	329	275	350	350	350	400
Spain	383	384	374	299	299	318	403	400	375	350	350	425
Netherlands	3	9	29	-21	-11	-47	23	25	30	30	40	60
Belgium	68	84	104	54	64	28	88	100	105	105	115	135
Denmark	-18	-31	-16	-61	-61	-112	2	-15	-15	-10	-10	-5
Norway	33	44	59	14	14	-37	53	60	60	65	65	70
Sweden	-16	-16	-1	-51	-46	-102	4	0	0	0	5	5
Switzerland	-130	-108	-110	-143	-160	-199	-110	-92	-109	-92	-109	-92
United Kingdom	5	15	5	-30	-25	-81	25	31	6	21	26	26

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 18. Emerging Market Countries — Short Rates Actual and Forecast of Additional Rate Moves (End of Period), as of 24 Oct 2012

Country	Current Rate (%)	Dec 12	Mar 13	Jun 13	Sep 13	Dec 13	Total Cumulative Rate Moves Expected
Turkey	5.75	0	0	0	75	75	150
Brazil	7.25	0	0	0	0	100	100
Romania	5.25	0	25	25	0	0	50
Indonesia	4.00	25	25	0	0	0	50
China	3.00	0	0	0	25	0	25
Korea	2.75	0	-25	0	0	25	0
Mexico	4.50	0	0	0	0	0	0
South Africa	5.00	0	0	0	0	0	0
Czech	0.25	-20	0	0	0	0	-20
Philippines	3.75	-25	0	0	0	0	-25
Israel	2.25	-25	0	0	0	0	-25
Thailand	2.75	0	-25	0	0	0	-25
Russia	8.25	0	25	0	0	-50	-25
India	8.00	-25	-25	0	0	0	-50
Chile	5.00	0	-50	0	0	0	-50
Hungary	6.50	-50	-50	0	0	0	-100
Poland	4.75	-25	-50	-25	0	0	-100

Source: Citi Research

Figure 19. Foreign Exchange Forecasts (End of Period), as of 24 Oct 2012

	vs. USD						vs. EUR					
	Current	Dec 12	Mar 13	Jun 13	Sep 13	Dec 13	Current	Dec 12	Mar 13	Jun 13	Sep 13	Dec 13
United States	NA	NA	NA	NA	NA	NA	1.31	1.31	1.28	1.25	1.23	1.22
Japan	79	79	79	79	79	79	104	103	101	98	98	97
Euro Area	1.31	1.31	1.28	1.25	1.23	1.22	NA	NA	NA	NA	NA	NA
Canada	0.99	0.97	0.98	0.98	0.98	0.98	1.29	1.27	1.25	1.22	1.21	1.19
Australia	1.04	1.01	0.98	0.95	0.94	0.94	1.26	1.29	1.30	1.32	1.31	1.30
New Zealand	0.82	0.81	0.80	0.79	0.77	0.75	1.59	1.60	1.59	1.57	1.59	1.62
Norway	5.64	5.67	5.73	5.79	5.85	5.92	7.36	7.41	7.31	7.22	7.21	7.23
Sweden	6.56	6.65	6.68	6.73	6.78	6.83	8.56	8.68	8.53	8.38	8.35	8.35
Switzerland	0.93	0.92	0.94	0.96	0.97	0.98	1.21	1.20	1.20	1.20	1.20	1.20
United Kingdom	1.60	1.61	1.60	1.59	1.58	1.56	0.81	0.81	0.80	0.78	0.78	0.78
China	6.25	6.25	6.27	6.30	6.28	6.25	8.20	8.20	8.00	7.80	7.70	7.60
India	53.9	49.2	50.7	52.2	52.5	52.4	70.4	64.3	64.7	65.0	64.6	64.1
Korea	1103	1103	1111	1118	1101	1077	1441	1441	1418	1394	1356	1316
Poland	3.15	3.17	3.26	3.36	3.37	3.35	4.11	4.13	4.16	4.19	4.15	4.09
Russia	30.8	30.9	32.0	33.2	33.6	33.8	40.2	40.4	40.9	41.3	41.4	41.3
South Africa	8.65	9.03	9.08	9.14	9.21	9.28	11.30	11.79	11.59	11.39	11.34	11.34
Turkey	1.80	1.81	1.82	1.84	1.85	1.87	2.35	2.36	2.33	2.29	2.28	2.28
Brazil	2.03	2.01	2.03	2.05	2.05	2.05	2.65	2.62	2.59	2.55	2.53	2.50
Mexico	12.9	12.6	12.7	12.9	12.8	12.8	16.8	16.4	16.2	16.0	15.8	15.6

Source: Citi Research

Figure 20. Foreign Exchange Forecasts (End of Period), as of 24 Oct 2012

	vs. JPY					
	Current	Dec 12	Mar 13	Jun 13	Sep 13	Dec 13
United States	79	79	79	79	79	79
Japan	NA	NA	NA	NA	NA	NA
Euro Area	104	103	101	98	98	97
Canada	80	81	81	81	81	81
Australia	82	80	77	75	74	74
New Zealand	65.0	64.4	63.5	62.6	61.3	59.8
Norway	14.1	13.9	13.8	13.6	13.5	13.4
Sweden	12.1	11.9	11.8	11.7	11.7	11.6
Switzerland	86	86	84	82	81	81
United Kingdom	127	127	126	126	125	124
China	13	13	13	13	13	13
India	1.47	1.61	1.56	1.51	1.51	1.51
Korea	13.91	13.97	14.06	14.16	13.91	13.57
Poland	25.2	25.0	24.2	23.5	23.5	23.7
Russia	2.6	2.6	2.5	2.4	2.4	2.3
South Africa	9.2	8.8	8.7	8.6	8.6	8.6
Turkey	44.1	43.7	43.4	43.0	42.8	42.5
Brazil	39.1	39.3	39.0	38.6	38.6	38.7
Mexico	6.2	6.3	6.2	6.1	6.2	6.2

Source: Citi Research

Country Commentary

United States

Robert V. DiClemente
(1-212) 816-7942
robert.diclemente@citi.com

Peter D'Antonio
(1-212) 816-9889
peter.dantonio@citi.com

Steven Wieting
(1-212) 816-7148
steven.wieting@citi.com

Reassuring strength in retail sales and housing data have buoyed growth prospects somewhat but the uncertainties surrounding the election and fiscal policy have stalled business spending. An abrupt drop in capital goods orders and slower inventory accumulation is expected to pull growth down in Q4 to 1% or less. Consumer confidence has been rising in part on growing perceptions that housing markets are recovering, while job growth has been steady if unspectacular. Fiscal drag is likely to remain a headwind, with downside risks if scheduled tax increases and spending restraint cannot be recast over yearend. Our projections assume that the U.S. will avoid the "fiscal cliff" in 2013 but drag near 1% is still likely.

The Federal Reserve's aggressive new easing bias and open-ended bond-buying program have helped bolster financial conditions for the moment. Policymakers' patience with gradual labour market improvement has run out and the outlook that inflation is likely to remain low has elevated a bias to continue supporting financial conditions through QE or other means until there is substantial strengthening in labour markets. We expect that unsterilised Treasury purchases will follow the end of OT, with a focus on medium- and longer-term securities, and officials are weighing enhanced forward guidance as well.

Despite some recent firming in consumer energy costs, more persistent inflation trends remain relatively muted and are expected to remain contained. Gasoline markets already show signs of steadying. Wage and compensation measures have been range bound near 2% and surveys of longer-term inflation expectations have been stable, providing an element of monetary policy flexibility.

Figure 21. United States — Economic Forecasts, 2011-2013F

					2012				2013			
		2011	2012F	2013F	1Q	2Q	3QF	4QF	1QF	2QF	3QF	4QF
GDP	SAAR				2.0%	1.3%	2.3%	0.7%	1.3%	1.9%	3.1%	3.2%
	YoY	1.8%	2.1%	1.8%	2.4	2.1	2.4	1.6	1.4	1.5	1.7	2.4
Domestic Demand	SAAR				2.2	1.4	1.6	1.3	0.9	2.0	2.9	3.2
	YoY	1.8	1.9	1.7	2.1	2.0	1.8	1.6	1.3	1.5	1.8	2.3
Consumption	SAAR				2.4	1.5	2.1	2.0	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	3.6	-1.3	-1.3	2.2	4.9	6.3	7.2
	YoY	8.6	7.1	2.5	12.5	9.7	4.7	2.0	0.8	1.1	3.0	5.1
Housing Investment	SAAR				20.5	8.5	9.1	11.2	18.6	18.7	18.7	17.1
	YoY	-1.4	11.1	15.4	9.3	10.4	12.4	12.2	11.8	14.3	16.8	18.3
Government	SAAR				-3.0	-0.7	0.0	-1.0	-2.9	-1.8	-1.3	-1.3
	YoY	-3.1	-1.8	-1.5	-2.2	-2.2	-1.5	-1.2	-1.1	-1.4	-1.8	-1.8
Exports	SAAR				4.4	5.3	-1.7	2.0	3.1	4.2	4.9	5.4
	YoY	6.7	3.3	3.0	4.0	4.3	2.3	2.4	2.1	1.9	3.5	4.4
Imports	SAAR				3.1	2.8	0.6	1.9	2.3	3.2	3.8	4.4
	YoY	4.8	3.0	2.5	3.2	3.9	2.8	2.1	1.9	2.0	2.8	3.4
PCE Deflator	YoY	2.4	1.8	1.9	2.4	1.6	1.5	1.9	1.7	2.0	2.1	1.9
Core PCE Deflator	YoY	1.4	1.8	1.6	1.9	1.8	1.6	1.7	1.5	1.5	1.6	1.7
Unemployment Rate	%	9.0	8.1	7.7	8.3	8.2	8.1	7.9	7.8	7.8	7.7	7.5
Federal Gov't Balance (Fiscal Year)	$Bn	-1297	-1089	-830								
	% of GDP	-8.7	-7.0	-5.0								
General Gov't Balance (Cal Year)	% of GDP	-10.0	-8.3	-7.0								
Federal Debt	% of GDP	68	72	75								
General Gov't Debt	% of GDP	103	106	110								
Current Account	US$bn	-466	-493	-499	-534	-470	-481	-488	-477	-501	-495	-525
	% of GDP	-3.1	-3.2	-3.1	-3.5	-3.0	-3.1	-3.1	-3.0	-3.1	-3.1	-3.2
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

Kiichi Murashima
(81-3) 6270 4980
kiichi.murashima@citi.com

We are revising down our growth forecasts again, primarily because of developments in China. We had expected a technical recession in H2 this year even before the escalation of the Japan-China dispute, but we have now cut 4Q GDP projections even deeper into negative territory. Sales of Japanese cars in China plunged 40%YoY in September. Given that a full-scale deterioration in the Japan-China relationship began in mid-September, car sales most likely fell more sharply in the latter half of the month. China-bound exports of motor vehicles and parts account for 1.9% of total exports. Assuming that exports of motor vehicles and parts to China halve in the fourth quarter, this alone would depress overall exports by 1%. Moreover, the China factor likely will strengthen the corporate tendency to postpone business investment amid a worsening outlook for Chinese demand.

The BoJ also will likely downgrade its growth and inflation forecasts for fiscal 2012 and 2013 at its policy meeting on October 30th. But most importantly, the BoJ's core inflation forecasts for fiscal 2014, which will be newly presented this time, are likely to be below the BoJ's price stability goal of +1%. The BoJ has held the view that that core inflation will reach 1% in the not-too-distant future. But if core inflation forecasts for fiscal 2014 stay below 1%, the BoJ likely will have to introduce additional easing measures. The most likely option is another expansion of the asset purchase program, including higher ceilings for T-bills, JGBs and ETFs.

In coming months, there will likely be a change in the political leadership while the BoJ Governor's term will end in next April. While a concrete timing of the general elections has become more uncertain as PM Noda tries to delay the elections, there is a consensus that the LDP (Liberal Democratic Party) will defeat the DPJ (Democratic Party of Japan). In that case, the LDP Chief Shinzo Abe would become PM and the basic thrust of economic policies may shift meaningfully. Moreover, the BoJ's deeds and words might well become much more dovish under the new leadership. These personnel changes may increase market volatility.

Figure 22. Japan — Economic Forecasts, 2011-13F

					2012				2013			
		2011	2012F	2013F	1Q	2Q	3QF	4QF	1QF	2QF	3QF	4QF
Real GDP	YoY	-0.8%	2.0%	0.9%	2.8%	3.3%	1.3%	0.8%	-0.2%	0.3%	1.2%	2.2%
	SAAR				5.3	0.7	-1.0	-1.6	1.3	2.8	2.5	2.4
Domestic Demand	YoY	0.2	2.6	1.2	3.6	3.3	2.3	1.3	0.5	0.8	1.4	2.2
	SAAR				4.6	1.0	0.2	-0.4	1.1	2.4	2.8	2.7
Private Consumption	YoY	0.1	2.3	0.8	3.7	3.2	1.6	0.8	-0.2	0.2	1.2	2.0
	SAAR				5.0	0.5	-1.8	-0.5	1.2	2.2	1.8	3.1
Business Investment	YoY	1.2	2.9	1.1	3.1	5.5	4.7	-1.7	-0.2	-0.7	1.4	4.0
	SAAR				-6.3	5.6	-1.9	-3.7	-0.5	3.4	6.9	6.2
Housing Investment	YoY	5.7	1.6	9.8	0.2	4.3	0.5	1.6	6.8	9.2	11.6	11.5
Public Investment	YoY	-2.8	7.9	-0.6	8.9	3.3	8.6	10.8	5.5	1.8	-3.2	-5.8
Exports	YoY	-0.1	2.3	1.0	1.2	8.7	-1.2	1.0	-1.3	-1.1	1.8	4.6
	SAAR				14.3	5.0	-7.8	-5.9	4.2	5.8	3.5	4.9
Imports	YoY	6.3	6.1	3.3	6.8	8.5	4.9	4.3	2.9	2.1	3.5	4.8
	SAAR				9.1	6.7	-0.1	1.8	3.2	3.5	5.6	7.0
CPI	YoY	-0.3	0.1	-0.1	0.3	0.2	-0.1	0.1	-0.4	-0.1	0.1	0.1
Core CPI	YoY	-0.3	-0.1	0.0	0.1	0.0	-0.2	-0.1	-0.2	-0.1	0.1	0.1
Nominal GDP	YoY	-2.8	1.1	0.5	1.5	2.2	0.4	0.1	-0.8	-0.1	0.9	2.0
Current Account	¥ tn	9.6	6.2	7.8	5.9	5.4	6.8	6.5	7.1	8.2	8.1	7.9
	% of GDP	2.1	1.3	1.6	1.2	1.1	1.4	1.4	1.5	1.7	1.7	1.7
Unemployment Rate	%	4.6	4.4	4.2	4.5	4.4	4.3	4.3	4.3	4.3	4.1	4.2
Industrial Production	YoY	-2.4	-0.7	-1.1	4.8	5.3	-3.8	-6.6	-6.1	-3.3	0.9	4.7
Corporate Profits (Fiscal Year)	YoY	-16.3	3.0	15.0								
General Govt. Balance (Fiscal Year)	% of GDP	-10.7	-10.7	-8.1								
General Govt Debt	% of GDP	228	237	243								

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

Jürgen Michels
(44-20) 7986-3294
juergen.michels@citi.com

Giada Giani
(44-20) 7986-3281
giada.giani@citi.com

Guillaume Menuet
(44-20) 7986-1314
guillaume.menuet@citi.com

We continue to forecast negative GDP growth, reflecting ongoing private sector deleveraging, tight financing conditions and fiscal drag. We have lowered our view on the probability of Grexit in the next 12-18 months to 60% from 90% previously, and put the most likely date as early 2014 instead of early 2013. Nevertheless, the prospects of eventual Grexit are likely to prolong uncertainty about the stability of the euro and undermine growth in the periphery countries. However, with better-than-expected 3Q data, plus the likelihood of delayed Grexit and less fiscal drag than previously expected in 2013, we revise up our GDP forecast for 2012 from -0.6% to -0.4% and for 2013 from -0.9% to -0.7%. But, with the possibility of Grexit and ongoing fiscal drag in 2014, we cut our 2014 GDP forecast from +0.3% to -0.1%.

Similar to recent agreements for Spain or Portugal, where the EU delayed the targets of reducing the deficit-to-GDP ratios, we expect that other countries under the excessive deficit procedure will also get more time to bring down their deficits. We still expect that deficit-to-GDP ratios will fall in 2013 on a broad-basis. Nevertheless, the euro area debt-to GDP ratio is likely to rise further in 2013, even with our more benign assumption on the smaller use of the EFSF amid the OMT. We expect now that the EFSF will only fund the agreed programmes for Ireland, Portugal and Greece with a total volume of €248bn instead of our prior view that the total EFSF lending capacity of €440bn will be tapped. This helps to improve the euro area debt profile because there is less impact of the EFSF lending on the non-step-out countries' debt-to GDP ratios. We expect the ECB will start purchases under the OMT programme quite promptly after a country is under a precautionary ESM programme. We expect the ECB to cut the refi rate by 25bp to 0.5% in December, but postpone the expected timing of the next cut from 1Q 2013 to 2Q. At that stage the ECB probably will also cut the deposit rate from zero now to -0.25%.

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

Figure 23. Euro Area — Economic Forecasts, 2011-13F

					2012F				2013F			
		2011	2012F	2013F	1Q	2Q	3QF	4QF	1QF	2QF	3QF	4QF
Real GDP	YoY	1.5%	-0.4%	-0.7%	0.0%	-0.4%	-0.7%	-0.7%	-0.9%	-0.8%	-0.6%	-0.3%
	SAAR				0.0	-0.7	-0.9	-1.4	-0.8	-0.2	0.0	-0.1
Final Domestic Demand	YoY	0.3	-1.4	-1.2	-1.0	-1.2	-1.7	-1.7	-1.7	-1.3	-1.1	-0.8
Private Consumption	YoY	0.1	-1.1	-0.9	-1.0	-0.9	-1.4	-1.2	-1.2	-1.0	-0.7	-0.5
Government Consumption	YoY	-0.1	-0.3	-1.3	0.0	-0.1	-0.2	-0.9	-1.3	-1.5	-1.3	-1.1
Fixed Investment	YoY	1.6	-3.6	-2.3	-2.4	-3.6	-4.0	-4.3	-3.4	-2.3	-1.9	-1.4
— Business Equipment	YoY	3.7	-3.1	-1.9	-2.0	-3.2	-3.5	-3.5	-2.5	-1.7	-2.1	-1.5
— Construction	YoY	-0.8	-3.9	-2.0	-3.2	-4.3	-3.8	-4.2	-3.1	-1.6	-1.6	-1.5
Stocks (Contrib. to Y/Y GDP Growth)		0.1	-0.4	-0.1	-0.4	-0.7	-0.5	-0.1	-0.1	-0.2	0.0	-0.1
Exports	YoY	6.4	2.8	2.1	2.6	3.3	2.3	2.8	2.6	1.9	1.9	2.0
Imports	YoY	4.2	-0.4	0.8	-0.9	-0.6	-0.9	0.6	1.0	0.7	0.7	0.7
CPI	YoY	2.7	2.6	2.3	2.7	2.5	2.5	2.7	2.3	2.4	2.4	2.0
Core CPI	YoY	1.4	1.7	1.8	1.5	1.6	1.6	2.0	1.8	1.8	2.0	1.5
CPI Ex Energy and Food	YoY	1.7	1.9	1.9	1.9	1.8	1.7	2.1	1.8	2.1	2.1	1.6
Unemployment Rate	YoY	10.2	11.3	11.6	10.9	11.3	11.4	11.5	11.6	11.6	11.6	11.6
Current Account Balance	EUR bn	-3.2	92.3	137.3								
	% of GDP	0.0	1.0	1.4								
General Government Balance	EUR bn	-387.6	-311.8	-254.4								
	% of GDP	-4.1	-3.3	-2.7								
Primary Balance	% of GDP	-1.1	0.1	0.7								
General Government Debt	EUR bn	8,211.6	8,834.6	8,892.7								
	% of GDP	87.2	93.1	92.8								
Gross Operating Surplus	YoY	2.3	-0.4	0.3								

Sources: Eurostat and Citi Research

Germany

Jürgen Michels
(44-20) 7986-3294
juergen.michels@citi.com

Available data suggest that 3Q GDP growth was about 0.3% QQ, similar to 2Q There are signs of slowdown in 4Q, but 2H probably will be somewhat stronger than we expected before. As a result, we edge up our 2012 growth forecast from 1.0% to 1.1%. We leave the 2013 forecast unchanged at 0.6%. Exports should benefit from the likelihood of delayed Grexit and less severe weakness in other EMU countries, but the euro's appreciation is likely to take its toll. Unlike many other EMU countries, fiscal policy is likely to loosen in 2013 (by ¼%-½% of GDP), through slightly lower income tax rates, reduced contributions to public health schemes — probably via the cancellation of the fee for visiting a GP — and lower pension contribution rates.

France

Guillaume Menuet
(44-20) 7986-1314
guillaume.menuet@citi.com

France's 2013 budget will be austere, with the greater share of the €30bn fiscal adjustment (2/3) to be extracted from an increase in taxation, equally split between corporates and households, in both instances relying on the larger and wealthier groups. We continue to believe that the 0.8% GDP baseline on which the budget is constructed will need to be revised down, probably in early 2013 when a supplementary budget will be required to reflect some of the likely reforms to reduce the cost of labour. At this stage, it appears very unlikely that the government will present some budgetary savings on the expenditure side. The environment remains fragile, as shown by the challenging labour market picture, making the government redouble its efforts on the European scene to lower the uncertainty.

Italy

Giada Giani
(44-20) 7986-3281
giada.giani@citi.com

We expect the recession will continue in 2013 and 2014, although our 2013 growth forecasts are less negative than before due to our change in the timing for Grexit. The size of the fiscal drag in 2013 is likely to be less than half that in 2012, but still substantial at around 1½ pp of GDP. Uncertainty stemming from the euro crisis will likely continue to weigh on investment decisions. Economic weakness means we think the government will likely miss its fiscal deficit targets (-1.8% of GDP in 2013; -1.5% in 2014) due to revenue shortfalls, but we doubt more austerity on top of the already-approved measures will be forced upon Italy in 2013. Political uncertainty will likely rise in Q1 13 ahead of the elections with fears that the current technical government is succeeded by an elected one which may lack the sense of urgency and/or the ability to implement the agreed austerity plans and structural reforms.

Figure 24. 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%	0.0%	-0.2%	0.5%	-2.3%	-1.4%
Final Domestic Demand	YoY	2.4	0.7	1.2	0.9	0.3	-0.2	-0.3	-4.0	-2.9
Private Consumption	YoY	1.7	0.9	1.1	0.3	-0.1	-0.2	0.2	-3.7	-2.4
Fixed Investment	YoY	6.4	-0.1	2.5	3.6	0.6	-0.5	-1.2	-8.6	-6.1
Exports	YoY	7.9	4.4	2.1	5.5	2.4	1.7	6.4	1.0	1.5
Imports	YoY	7.5	2.9	3.0	5.2	1.1	1.3	1.3	-7.8	-3.6
CPI	YoY	2.3	2.0	2.2	2.1	2.0	1.4	2.9	3.4	2.1
Unemployment Rate	%	6.0	5.6	5.9	9.2	9.8	10.3	8.4	10.6	11.6
Current Account	€bn	146.6	160.9	135.3	-39.1	-37.1	-20.5	-51.5	-26.8	-20.1
	% of GDP	5.7	6.1	5.0	-2.0	-1.8	-1.0	-3.3	-1.7	-1.3
General Govt. Balance	€bn	-26.6	-6.6	-7.8	-103.1	-88.4	-74.6	-61.8	-45.5	-40.1
	% of GDP	-1.0	-0.2	-0.3	-5.2	-4.3	-3.6	-3.9	-2.9	-2.6
Primary Balance	% of GDP	1.6	2.0	1.7	-2.6	-2.2	-1.4	1.0	2.6	3.3
General Govt. Debt	% of GDP	81.2	84.1	83.3	86.0	91.8	95.8	120.1	126.6	130.1
Gross Trading Profits	YoY	1.3	2.1	-0.7	-2.2	1.0	2.0	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

Ebrahim Rahbari
(44-20) 7986-6522
ebrahim.rahbari@citi.com

With thanks to Deimante Kupciuniene

Spain

We continue to expect Spain generally to underperform official and consensus growth and fiscal forecasts. Nevertheless, better-than-expected recent macro data and a possible later Grexit lead us this month to revise up our growth expectations for 2012 to -1.5% (from -1.8% previously) and to -2.4% (-3.2%) for 2013. For 2014, we cut our forecast to -1.8% (from -0.8%). We still expect that Spain will request a precautionary EFSF/ESM sovereign programme soon, allowing the ECB to activate its OMT programme — although a lack of market pressure could delay this move.

Giada Giani
(44-20) 7986-3281
giada.giani@citi.com

Greece

We still expect Greece will exit the euro (Grexit) in the next 12-18 months (with 60% probability, recently revised down from 90%), with the most likely timing in H1 2014. We believe that the change in attitude from core euro countries towards Grexit and the recent better cooperative stance from Greece will help keep Greece afloat longer than we expected. Unless there is early write-off of official debt (unlikely in our view), we believe that Greece's fiscal position will remain unsustainable and eventual Grexit will remain likely. We expect GDP in 2013 will continue to shrink at about the same pace as in 2012, with probably an even faster decline in 2014.

Michael Saunders
(44-20) 7986-3299
michael.saunders@citi.com

Ireland

We are raising our 2012 GDP forecast to +0.4% (minus 0.6% previously) and edging up our 2013 forecast to 0.7% from 0.6% last month. The economy was (as expected) weak in Q2, with flat GDP, but recent data point to growth of about 0.9% QoQ in Q3. Industrial orders rose about 6.0% QoQ while exports surged in August. Nevertheless, we doubt the recent momentum will be maintained given euro area weakness. Hopes that Ireland will be able to shift the costs of previous bank recapitalisations onto the ESM have receded given the insistence of creditor nations that this would only be available for future bailouts.

Giada Giani
(44-20) 7986-3281
giada.giani@citi.com

Portugal

Recent data suggest the economy in H2 may not be as weak as we expected, hence calling for a slight upward revision for 2012 average. However, large tax increases envisaged by the 2013 budget and social unrest suggest the recession will intensify in 2013, underperforming government projections (of -1%). As a result, we expect the 2013 fiscal deficit target to be overshot. Although 2013 financing needs have been reduced by a recent debt swap, we still expect Portugal will require additional bailout money in 2013 and will have sovereign debt restructuring — perhaps in 2014 or soon thereafter.

Figure 25. 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	0.4%	-1.5%	-2.4%	-6.9%	-7.2%	-7.3%	1.4%	0.4%	0.7%	-1.7%	-3.3%	-4.6%
Final Domestic Demand	YoY	-1.8	-4.2	-4.5	-6.5	-8.2	-8.6	-4.3	-3.6	-4.2	-5.3	-7.1	-6.3
Private Consumption	YoY	-0.9	-2.0	-2.4	-7.1	-8.2	-7.4	-2.4	-2.5	-2.3	-4.0	-6.2	-5.5
Fixed Investment	YoY	-5.3	-9.3	-7.6	-9.8	-11.3	-15.4	-12.7	-7.4	-14.3	-11.4	-15.2	-10.7
Exports	YoY	7.7	3.6	5.6	11.9	-0.3	-3.8	5.0	3.7	3.7	7.5	4.5	1.2
Imports	YoY	-0.8	-4.8	-1.0	-3.1	-7.9	-9.2	-0.3	-0.2	0.5	-5.2	-6.3	-2.9
CPI	YoY	3.1	2.4	2.1	3.1	0.9	2.1	0.2	1.7	1.2	3.6	2.9	2.3
Unemployment Rate	%	21.7	24.8	25.9	17.4	23.8	27.9	14.4	15.1	16.1	12.7	15.5	18.1
Current Account	€bn	-37.5	-14.5	15.8	-21.1	-12.7	-10.2	1.8	5.1	9.1	-13.9	-8.1	-4.5
	% of GDP	-3.5	-1.4	1.5	-9.8	-6.3	-5.4	1.1	3.2	5.5	-8.1	-4.9	-2.8
General Govt. Balance	€bn	-100.4	-86.3	-66.5	-19.6	-18.2	-15.4	-20.4	-13.1	-12.8	-7.5	-8.3	-8.1
	% of GDP	-9.4	-8.2	-6.4	-9.4	-9.1	-7.7	-12.8	-8.1	-7.7	-4.4	-5.0	-5.0
Primary Balance	% of GDP	-7.0	-4.0	-2.3	-2.2	-2.9	-2.0	-4.9	-4.1	-2.3	-0.4	-0.9	-0.3
General Govt. Debt	% of GDP	69.4	89.0	98.2	170.6	174.6	188.7	106.5	117.0	119.5	108.1	121.3	132.2

F Citi forecast. YoY Year-to-year growth rate. For Ireland we show the GDP deflator rather than the CPI, for Spain, fiscal deficits include the effect of financial support for banks in 2011 (€5.4bn) and 2012 (€11.6bn). Sources: ISTAT, INE, Haver Analytics, Eurostat and Citi Research

Netherlands

Jürgen Michels
(44-20) 7986-3294
juergen.michels@citi.com

Consumer spending continues to fall, hit by rising unemployment (jobless rate up to 6.6% in September — highest since May 2005) and falling house prices (down 9.1% YY in 3Q). The 2-point VAT rate hike to 21% in October will probably hit spending further in 4Q. Coalition talks between caretaker PM Mark Rutte's VVD and the centre-left PvdA continue and they have already agreed to amend the earlier-agreed fiscal package for 2013 — but without providing details. There probably will be less tightening than previously planned and, together with ongoing recession, we expect the public deficit to clearly exceed the 3% of GDP target under the EDP.

Belgium

Guillaume Menuet
(44-20) 7986-1314
guillaume.menuet@citi.com

Although sentiment surveys have remained weak, the hard data appears to have held up a bit better than we had anticipated earlier, requiring a very slight 0.1ppt upward revision in our 2012 GDP forecast to a contraction of 0.1%. While 2013 should benefit slightly from the one-year delay of our baseline Grexit scenario to 2014, the government still has to deliver an extra €3.7bn of budgetary savings in 2013 in order to hit the 2.15% of GDP budget deficit target. We therefore maintain our 2013 forecast of a 0.2% drop in GDP, but lower our 2014 estimate by 0.2ppt to show a modest gain of 0.5%, the first increase since 2011.

Slovakia

Jaromir Sindel
+42 0 233 061 485
jaromir.sindel@citi.com

Strong industrial data, slightly better confidence and likely later "Grexit" led us to revise our 2H12 GDP forecast up slightly, while keeping our 2013 and cutting our 2014 forecasts. The central government deficit improved slightly in September. Key however remains the outlook for the automotive sector that is the only driver of industrial activity and GDP growth. Later "Grexit" is likely to support Slovak assets, unless there is larger than expected deceleration of economic activity that would in our view make it tougher to strengthen fiscal consolidation.

Slovenia

Jaromir Sindel
+42 0 233 061 485
jaromir.sindel@citi.com

Although the MinFin's recent tapping of the market for USD2.25bn has provided some relief, gross borrowing needs are around €4-€4.5bn for 2013 including resources for the stabilisation of banking sector (likely around €1-1.5bn in 2013). The banking sector remains a critical weakness. Given larger issuance and current risk-on period, we would expect Slovenia not to ask for a bailout unless a deepening recession brought political costs. However, a proposal for direct recapitalisation of the banking sector from the ESM would be positive for Slovenia as the creation of a "Bad Bank" would have a gradual negative impact on Slovene debt.

Figure 26. 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%	-0.6%	-0.9%	1.8%	-0.1%	-0.2%	3.2%	2.8%	1.3%	1.0%	-2.0%	-1.6%
Final Domestic Demand	YoY	0.6	-1.0	-1.0	1.9	-0.3	0.2	2.2	-0.2	0.6	-1.4	-2.6	-3.0
Public Consumption	YoY	0.1	0.6	-0.1	0.8	0.2	0.0	-4.3	-0.5	-0.8	-1.2	-2.9	-5.7
Private Consumption	YoY	-1.0	-1.0	-1.4	0.2	-0.5	0.1	-0.5	-0.2	0.2	1.0	-1.9	-2.7
Investment (Ex Stocks)	YoY	5.7	-3.4	-1.5	4.1	-0.1	0.5	14.2	-0.3	2.3	-8.3	-8.2	-3.6
Exports	YoY	3.9	3.2	1.2	5.5	-0.4	1.7	12.7	8.0	2.2	8.0	1.1	-0.4
Imports	YoY	3.6	2.7	0.7	5.7	-0.6	1.7	10.1	4.5	1.6	5.2	-2.9	-3.3
CPI (Average)	YoY	2.3	2.5	2.7	3.5	2.9	1.8	3.9	3.6	2.9	1.8	2.7	3.0
Unemployment Rate	%	5.3	6.2	6.9	7.2	7.4	7.8	13.2	13.4	13.6	8.2	8.5	9.4
Current Account	% of GDP	9.7	10.0	9.6	-0.9	-0.7	0.2	-2.1	2.6	2.2	0.0	1.6	3.4
General Govt Balance	% of GDP	-4.7	-4.3	-3.8	-3.7	-2.7	-1.9	-4.9	-4.9	-3.0	-6.4	-4.2	-3.3
Primary Balance	% of GDP	-2.6	-2.4	-2.2	-0.4	0.3	1.0	-3.2	-3.4	-1.5	-4.5	-2.1	-1.1
General Govt Debt	% of GDP	65.2	69.8	72.9	97.8	109.8	115.0	43.3	52.1	54.4	46.9	53.1	57.4

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

UK

Michael Saunders
(44-20) 7986-3299
michael.saunders@citi.com

The economy probably exited recession in Q3 (we expect growth of 0.4% QoQ, 1.7% SAAR), after three negative quarters. However, this rebound is largely or totally accounted for by technical factors, with a boost of about ½% to Q3 GDP from the unwind of the adverse effect on Q2 of the Queen's Jubilee plus an extra 0.2% from the Olympics ticket sales. Excluding these effects, the underlying path of the economy is roughly flat, as it has been all year. There is certainly no sign at all in business and consumer surveys that a sustained recovery is underway. The economy faces powerful ongoing headwinds from private deleveraging, fiscal drag, poor credit availability and the EMU crisis. Hence, as these technical effects fade, we expect that GDP will be roughly flat again in Q4. We expect that GDP will not regain the pre-recession peak (Q1-08) until 2016. Inflation is likely to remain close to the 2% target in coming months, with increases in energy prices balanced by the disinflationary effects of the weak economy plus the pound's rise this year.

The authorities face two key policy challenges: first, how to react to this year's marked undershoot in economic growth; second, how to react to the resultant significant undershoot in tax revenues and resultant overshoot in the fiscal deficit (about £10bn) caused by the weak economy. The MPC already has provided extra stimulus through QE and credit easing, and we expect it will expand QE further soon (at the November meeting or soon after), given that QE is a more flexible nearterm tool for stimulus than the FLS. At the same time, the Chancellor will probably tolerate the overshoot in the fiscal deficit, and not seek to reverse it with even more fiscal tightening for 2013/14 on top of the heavy drag (about 1½% of GDP) than already is planned. To accommodate the deficit overshoot, we estimate the Chancellor will need to change or scrap his self-imposed target to achieve a falling debt/GDP ratio in 2015/16, and we expect this change probably will be announced in the early-December Autumn Statement.

Figure 27. United Kingdom — Economic Forecasts, 2011-2013F

					2012				2013			
		2011	2012F	2013F	1Q	2Q	3QF	4QF	1QF	2QF	3QF	4QF
Real GDP	YoY	0.9%	-0.3%	0.7%	-0.1%	-0.5%	-0.6%	-0.1%	0.5%	1.1%	0.7%	0.5%
	SAAR				-1.2	-1.6	1.7	0.7	1.2	0.7	0.2	-0.2
Domestic Demand	YoY	-0.4	0.3	0.3	0.5	0.4	-0.3	0.6	0.6	0.2	0.3	0.1
(Incl. Inventories)	SAAR				0.7	1.6	-0.5	0.8	0.4	-0.2	0.2	0.0
Consumption	YoY	-1.1	0.6	0.9	0.2	0.2	0.9	1.3	1.0	1.4	0.9	0.5
	SAAR				1.4	-1.0	2.4	2.2	0.2	0.6	0.5	0.6
Investment	YoY	-2.4	-0.1	-2.6	3.1	0.3	-3.0	-0.9	-2.3	-4.0	-1.1	-2.8
	SAAR				13.6	-10.5	-10.5	5.8	7.2	-16.2	0.7	-1.3
Exports	YoY	4.5	0.3	3.1	-0.9	0.3	2.2	-0.2	2.3	4.3	2.9	2.7
	SAAR				-6.3	-4.1	7.9	2.2	3.7	3.4	2.5	1.1
Imports	YoY	0.5	2.4	1.8	1.3	3.2	3.1	2.1	2.6	1.3	1.7	1.5
	SAAR				-0.5	5.6	0.7	2.6	1.3	0.6	2.4	1.7
Unemployment Rate	%	8.1	8.2	8.2	8.2	8.0	8.1	8.4	8.4	8.2	8.2	8.1
CPI Inflation	YoY	4.5	2.7	2.1	3.5	2.7	2.4	2.1	2.1	2.2	2.2	2.1
Merch. Trade	£bn	-100.1	-101.2	-93.3								
	% of GDP	-6.6	-6.5	-5.9								
Current Account	£bn	-29.0	-61.8	-46.8								
	% of GDP	-1.9	-4.0	-2.9								
PSNB	£bn FY	-119.3	-101.0	-121.1								
	% of GDP	-7.8	-6.5	-7.6								
General Govt. Balance	% of GDP	-8.2	-6.9	-8.0								
Government Primary Balance		-4.7	-3.4	-4.6								
Public Debt	% of GDP	82.3	89.2	96.7								
Gross Nonoil Trading Profits	YoY	7.7	5.3	8.7								

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

Switzerland

Michael Saunders
(44-20) 7986-3299
michael.saunders@citi.com

The evidence on Q3 growth has been mixed, with weak PMIs but a marked gain in the KOF indicator. On balance we suspect that the economy grew by about 0.5% QoQ, but attach considerable uncertainty to this — with a risk that the PMI is correct and GDP will prove much weaker than we expect. With this caveat, we leave our forecasts roughly unchanged, and expect low but positive growth with continued deflation in 2013 and 2014. Against this backdrop, the SNB will continue to strongly defend the CHF1.20/€ level and keep rates ultra low for an extended period.

Sweden

Tina Mortensen
(44-20) 7986-3284
tina.mortensen@citi.com

While indicators point to a slowdown in economic activity in 2H, supportive economic policies suggest that a recession should be avoided. The government presented a budget bill for 2013, adding stimulus equivalent to 0.6% of GDP and the Riksbank cut the repo rate by 25bp to 1.25% in September. The deteriorating labour market plus low inflation will probably prompt the Riksbank to cut rates again in 4Q-2012 and 1Q-2013, with the key policy rate likely to trough at 0.75%.

Denmark

Tina Mortensen
(44-20) 7986-3284
tina.mortensen@citi.com

Q2 GDP was revised to show a smaller decline than previously, but even so Denmark has experienced negative GDP growth in three out of the last four quarters. We expect continued weakness, with below-trend GDP growth in coming years. Following the cut of the CD-rate to minus 0.2%, the DKK has weakened versus the Euro. In September, DNB had to buy Danish kroner to support the currency, whereas in earlier months the Bank had sought to weaken the DKK in response to heavy capital inflows. Should the krone weaken further ahead, DNB is likely to intervene again and an interest rate hike could even become a reality.

Norway

Tina Mortensen
(44-20) 7986-3284
tina.mortensen@citi.com

Although private spending has moderated in recent months, mainland GDP growth is set to outpace trend this and next year. With a domestic economy operating at full capacity, historically-low interest rates and surging investment in the petroleum sector, fiscal policy will be about neutral next year and Norges Bank signals a tighter policy stance in the first half of 2013. However, absent any clear upward trend in core inflation combined with a strong krone and weaker-than-expected consumption growth in recent months, the Bank is likely to lower its conditional interest rate path in October. In turn, we have postponed the first rate hike from 1Q 2013 to 2Q.

Figure 28. 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	1.9%	1.1%	0.9%	4.0%	1.1%	1.7%	0.8%	0.1%	1.1%	2.5%	3.5%	3.2%
Final Domestic Demand	YoY	2.0	2.2	0.7	2.9	1.8	1.7	-0.7	0.8	1.3	3.2	3.2	3.4
Public Consumption	YoY	2.0	2.1	1.5	1.9	0.9	1.1	-1.3	0.2	0.8	1.5	2.0	2.5
Private Consumption	YoY	1.2	2.3	0.5	2.2	1.5	1.8	-0.8	0.7	1.2	2.4	3.6	3.5
Investment (Ex Stocks)	YoY	4.0	1.9	0.9	7.0	4.2	2.2	0.2	2.2	2.4	8.1	3.7	4.4
Exports	YoY	3.8	0.7	2.5	7.5	0.5	2.4	7.0	2.3	2.8	0.9	2.3	5.0
Imports	YoY	4.2	1.9	1.4	6.4	0.2	2.3	5.3	2.7	3.0	2.8	2.5	3.3
CPI (Average)	YoY	0.2	-0.7	-1.4	3.0	0.9	1.0	2.8	2.5	2.0	1.3	0.8	1.7
Unemployment Rate	%	3.1	3.2	3.5	7.5	7.6	7.8	7.6	7.8	7.8	3.3	3.0	3.0
Current Account	% of GDP	14.3	12.7	13.1	6.4	6.7	6.9	5.7	5.4	5.4	14.0	14.3	14.9
General Govt Balance	% of GDP	0.7	0.4	0.0	0.1	-0.3	-0.8	-2.0	-3.8	-2.0	13.7	13.2	14.0
General Govt Debt	% of GDP	52.5	51.5	50.8	37.0	36.5	36.3	46.5	49.0	49.6	NA	NA	NA

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

Canada

Dana M. Peterson
(1-212) 816-3549
dana.peterson@citi.com

Canada remains embroiled in a tug-of-war between domestic strength and external weakness. The expansion continues to be fueled by household spending, business investment and inventories. However, fiscal consolidation is still underway and net exports are weighing on growth. Moreover, increasing business caution, as modest US growth, the European recession, and rebalancing EM growth weigh, and cooling housing activity probably will likely continue to cap output and employment near-term.

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 amid a revival in sentiment with resolution of key uncertainties. Downside risks include (1) failure to contain the EA 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.

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 BoC's 2% target in 2H 2013. Externally focused downside risks and lingering uncertainties will keep the central bank on the sidelines for some time. Moreover, policymakers' increasing angst about moderating global growth prompted us to anticipate a delay in the resumption of easy policy removal from March 2013 to July 2013. 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 some measure of hawkishness in its policy tack.

Figure 29. Canada — Economic Forecast, 2011-2013F

					2012F				2013F			
		2011	2012F	2013F	1Q	2Q	3QF	4QF	1QF	2QF	3QF	4QF
Real GDP	YoY	2.6%	2.2%	2.0%	2.2%	2.9%	1.9%	1.7%	1.7%	1.8%	2.0%	2.3%
	SAAR				1.8	1.9	1.7	1.5	1.8	2.1	2.7	2.9
Final Domestic Demand	YoY	2.7	1.7	2.1	1.7	1.8	1.8	1.7	1.8	2.0	2.2	2.4
	SAAR				1.7	1.6	1.7	1.7	2.4	2.1	2.7	2.7
Private Consumption	YoY	2.4	1.8	2.3	1.8	1.5	1.8	1.9	2.1	2.5	2.4	2.4
	SAAR				1.5	0.8	2.7	2.5	2.3	2.4	2.4	2.5
Government Spending	YoY	0.3	-1.0	0.7	-1.7	-1.2	-1.0	-0.1	0.6	0.7	0.9	0.8
	SAAR				-1.6	0.3	0.2	1.0	0.8	0.8	0.8	0.8
Private Fixed Investment	YoY	7.1	5.4	3.3	6.1	6.6	5.6	3.5	2.8	2.2	3.3	4.6
	SAAR				7.3	5.4	1.4	0.2	4.5	2.9	5.8	5.5
Exports	YoY	4.6	2.0	2.1	4.6	6.0	-0.7	-1.5	0.2	0.2	3.3	4.6
	SAAR				-4.4	4.0	-6.5	1.4	2.4	3.7	5.9	6.3
Imports	YoY	5.8	2.0	3.6	3.3	1.8	1.3	1.5	2.0	2.5	4.7	5.0
	SAAR				2.9	3.6	-3.1	4.5	4.5	4.5	5.5	5.5
CPI	YoY	2.9	1.6	1.5	2.3	1.6	1.2	1.4	1.3	1.0	1.7	2.1
Core CPI	YoY	1.7	1.8	1.9	2.1	2.0	1.5	1.6	1.7	1.7	2.2	2.0
Unemployment Rate	%	7.5	7.3	7.1	7.4	7.3	7.3	7.3	7.2	7.1	7.1	7.0
Current Account Balance	C$bn	-52.3	-65.3	-74.5	-59.8	-73.5	-60.0	-76.0	-71.2	-74.4	-76.0	-76.3
	% of GDP	-3.0	-3.6	-4.0	-3.3	-4.1	-3.3	-4.2	-3.9	-4.0	-4.0	-4.0
Net Exports (Pct. Contrib.)		-0.5	0.0	-0.5	-2.2	0.4	-1.0	-1.0	-0.7	-0.4	0.0	0.1
Inventories (Pct. Contrib.)		0.1	0.4	0.4	2.1	0.5	1.0	0.8	0.1	0.3	0.0	0.1
Budget Balance (Fiscal Year)	% of GDP	-1.4	-1.2	-0.5								
Federal Budget Debt	% of GDP	32.6	33.0	32.2								
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 Research

Paul Brennan
(61-2) 8225-4899
paul.brennan@citi.com

Joshua Williamson
(61-2) 8225-4904
josh.williamson@citi.com

Australia

The economy is slowing, broadly in line with our forecasts. The slowdown reflects the impact on national income of the lower terms of trade against the backdrop of a still strong AUD. Profits remains weak and growth in business investment has peaked, and likely will slow. Soft hiring intentions suggest employment growth will be too slow to prevent a further rise in the unemployment rate to around 5.75% by year end. More positively, signs of stabilisation in China's economy have been accompanied by a partial recovery in iron ore prices and no further slippage on the viability of potential mining projects. Lower rates have seen a tentative turnaround in the housing market which should be followed by a moderate upswing in housing construction before the end of this year. Lower rates should also support consumer spending. Overall, we have not changed our economic forecasts this month and expect moderately below trend growth in 2013. We had expected the RBA to ease monetary policy further next month, but the uncomfortably high Q3 CPI report will probably give the RBA Board reason to temporarily pause and assess the fall-out for price and wage expectations.

New Zealand

The New Zealand economy remains on a moderate growth path. Consumption growth remains below trend and is unlikely to increase without a break lower in the unemployment rate. The currency continues to encourage import substitution and hamper exports. One trade exposed industry that has benefited from global developments is farming. Soft commodity prices have lifted, including for the important dairy sector. Domestically, demand should receive more support from the construction sector as residential activity accelerates in Canterbury. The combination of a lift in domestic activity and appointment of a new RBNZ Governor leaves our interest rate forecasts unchanged, despite the surprise October interest rate cut by New Zealand's largest trading partner Australia.

Figure 30. Australia and New Zealand — Economic Forecast, 2011-2013F

	Australia			New Zealand		
	2011	2012F	2013F	2011	2012F	2013F
Real GDP[a]	2.1%	3.7%	3.2%	1.3%	2.3%	2.8%
Real GDP (4Q versus 4Q)	2.6	3.6	3.2	1.9	2.6	3.0
Real Final Domestic Demand	4.2	5.0	3.4	2.3	1.7	2.8
Consumption	3.3	3.9	2.8	2.5	2.3	2.1
Govt. Current & Capital Spending[b]	0.1	2.3	1.8	1.8	1.3	1.3
Housing Investment	1.3	-4.9	2.8	-12.0	7.4	12.6
Business Investment[c]	17.0	15.8	7.5	6.9	2.0	5.0
Exports of Goods & Services	-1.3	6.4	8.0	2.4	4.0	3.0
Imports of Goods & Services	11.5	7.8	6.6	6.0	2.7	3.7
CPI	3.4	1.8	3.0	4.0	1.6	2.2
CPI (4Q versus 4Q)	3.1	2.6	2.5	1.8	1.8	2.3
Unemployment	5.1	5.2	5.5	6.5	6.6	5.8
Merch. Trade, BOP (Local Currency, bn)	18.0	-14.1	-28.5	3.3	2.4	-0.4
Current Account, (Local Currency, bn)	-33.2	-55.9	-72.6	-8.3	-10.8	-16.3
Percent of GDP	-2.3	-3.8	-4.7	-4.2	-5.0	-7.0
Budget Balance[d] (Local Currency, bn)	-47.7	-43.7	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	29	28.9	36.2	38.9	38.9
Gross Trading Profits[f]	6.1	-3.9	3.9	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

Minggao Shen
(852) 2501-2485
minggao.shen@citi.com

Shuang Ding
(852) 2501-2769
shuang.ding@citi.com

Enjiang Cheng
(86) 10 5937 6038
enjiang.cheng@citi.com

Despite a further slowdown in 3Q, conditions appear ripe for a rebound. Growth slowed from 7.6%YoY in 2Q to 7.4%YoY in 3Q, and our estimates show the seasonally adjusted annualised QoQ rate of growth accelerated from 7.7% to 8.2%. Monthly data for Sep — including PMI, exports, FAI, retail sales and liquidity conditions — were overwhelmingly positive, and broadly point to an upward momentum. The data also suggest destocking is gradually giving way to restocking.

We expect policies to remain supportive but rule out a fresh stimulus. The Premier's recent remarks indicate that growth stabilisation will continue to be the priority in 4Q, but the emphasis is putting into effect policies already introduced. We think there is little incentive for the government to introduce new stimulus around the time of the upcoming leadership transition, especially when the growth target is within reach and the employment situation is acceptable. We continue to think the government will instead make full use of the room under the current policy mix. New RMB loans are on track to reach 8.5tn this year. PBOC appears to be guiding broad money growth to 14%. This policy stance implies about 600bn new RMB loan per month in 4Q. The window for an interest rate cut probably is closed. The chance for RRR cuts by year-end has diminished, and we now expect only one more cut. We expect fiscal policy to remain active, within the budget envelope. The accommodative monetary policy and expansionary fiscal policy will support a growth uptick in our view.

We revise down our 2012 growth forecast to 7.7% and maintain our below-consensus forecast for 2013 at 7.6%. 3Q growth was lower than our estimate of 7.6%YoY due to policy shortfall (especially with regard to RRR cut). Based on our assumption of supportive policies without new stimulus, we revise down our annual growth forecast for 2012 from 7.9% to 7.7%, implying a 4Q growth rebound to 7.8%YoY from 7.4%YoY in 3Q. According to our estimate, QoQ SAAR growth will increase slightly from 8.2% in 3Q to 8.3% in 4Q. It is our expectation that the incoming leadership will pursue reforms to rebalance the economy, including cost normalisation. The growth target may be downgraded from 7.5% in 2012 to 7.0% in 2013. As inflation starts to rise and downside risk eases, the government may return to a neutral policy stance.

Figure 31. China — Economic Forecasts, 2011-2013F

					2012F				2013F			
		2011	2012F	2013F	1Q	2Q	3QF	4QF	1QF	2QF	3QF	4QF
Real GDP	YoY	9.3%	7.7%	7.6%	8.1%	7.6%	7.4%	7.8%	8.0%	7.8%	7.5%	7.3%
Real Final Domestic Demand	YoY	10.3	8.4	8.3								
Consumption	YoY	9.8	8.6	8.7								
Fixed Capital Formation	YoY	10.8	8.3	7.9								
Industrial Production	YoY	13.9	10.0	9.9	11.6	9.5	9.1	10.0	10.5	10.2	9.6	9.1
Exports	YoY	20.3	7.3	8.2	7.6	10.6	4.5	6.8	5.0	8.0	9.0	10.0
Imports	YoY	24.9	5.3	11.1	6.9	6.5	1.4	6.5	8.0	11.0	12.0	13.0
Merchandise Trade Balance	$bn	155	202	165	1	69	79	53	-12	61	73	43
FX Reserves	$bn	3,181	3,360	3,450	3,305	3,240	3,290	3,360	3,328	3,368	3,421	3,450
Current Account	% of GDP	2.8	2.0	1.5								
Fiscal Balance	% of GDP	-1.3	-2.4	-1.5								
General Govt. Debt	% of GDP	15.2	16.2	16.2								
Urban Unemployment Rate	%	4.1	4.2	4.1	4.1	4.1	4.2	4.2	4.1	4.1	4.1	4.1
CPI	YoY	5.4	2.7	3.2	3.8	2.9	1.9	2.4	2.7	3.1	3.5	3.5
Exchange Rate (end period)	CNY/$	6.29	6.25	6.25	6.30	6.35	6.28	6.25	6.27	6.30	6.28	6.25
1-Yr Deposit Rate (end period)	%	3.50	3.00	3.25	3.50	3.25	3.00	3.00	3.00	3.00	3.25	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

Rohini Malkani
+91 22 6631 9876
rohini.malkani@citi.com

Following the first phase of reforms last month (fuel prices, FDI and divestments) which broke the ~2 year policy log-jam, the government announced a second slew of reforms. These include FDI in Insurance and Pension, amendments to the Companies Bill, and Forward Contract Regulation Act. However, it is important to note that most of the second set of reforms requires parliamentary approval. Given the current political situation where the government is in a "minority" due to withdrawal of support from one of the coalition partners, the road ahead is far from easy. While the current reforms have led to a revival in investor sentiment and "bought" India time to avoid a rating downgrade, key pending measures that will help accelerate growth and avert a downgrade include those on (a) Fiscal consolidation, (b) Incentivising investments. This includes addressing execution-related obstacles in power, coal, gas, land and environment. Until there is further action on the above, we are maintaining our 5.4% GDP estimate for FY13 and 6.2% in FY14.

On the fiscal side, accounting for expenditure and revenue slippages, we maintain our view that the FY 12/13 deficit will come in at 5.9% of GDP vs. the government's target of 5.1%. However, if the government goes ahead with the proposal on the UTI stake sale in select stocks and raises excess telecom revenues, the deficit could be capped at 5.3%. Recent positive initiatives towards fiscal consolidation are (1) Setting up a platform for cash transfers and (2) Focusing on implementing GST by March 13. On rates, given sub-par growth and both inflation numbers (WPI and CPI) remaining well over targets at 7.8% and 9.7% respectively, our base case is that of 50bps easing in the latter half of 2HFY13. However, given the recent slew of reforms, there remains an outside chance of rate action at the Oct 30th RBI policy meeting. On the INR, reforms, QE and lower commodity prices have helped the rupee retrace about 5% since its lows to Rs52.9/US$ levels. Going forward, taking into account the above, but given that (1) reforms are yet to be fully implemented (2) India's current growth-inflation mix, (3) The declining fx import cover and (4) rating agencies still on the vigil, we expect the INR to likely be range-bound at Rs51.50-53.50 over the next 12 months.

Figure 32. India — Economic Forecasts, FY2012/13-2014/5F

		FY 12/13F	FY 13/14F	FY 14/15F
Real GDP	YoY	5.4%	6.2%	6.9%
Final Domestic Demand	YoY	4.8	5.8	7.3
Private Consumption	YoY	5.0	5.5	6.7
Fixed Investment	YoY	4.5	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	-59	-50	-44
	% of GDP	-3.2	-2.3	-1.7
Consolidated Fiscal Balance	% of GDP	-8.5	-8.0	-7.5
Centre Fiscal Balance	% of GDP	-5.9	-5.5	-5.0
US Dollar Exchange Rate	Average	49.2	52.4	52.1

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

Korea

Jaechul Chang
+82 2 2077 4160
jaechul.chang@citi.com

The contraction of exports eased in September, as YoY growth rose to -2.0% from -6.0% in August, and daily average exports rebounded to US$2.1bn from US$1.8trn. We expect exports to expand slowly, by about 3.2%YoY in 4Q12, after falling 5.6%YoY in 3Q, on the back of a mild recovery in China. However, domestic demand is set to remain lukewarm as household debt and sluggish housing market will likely weigh on consumption and construction investment. Meanwhile, headline CPI inflation in Sep bottomed out by reversing up to 2.0%YoY from a decade low of 1.2% in Aug. We expect inflation to rise going forward as base effects dissipate, but to stay below 3% for a while because of below-potential economic growth until 2H13. On macro policy front, we think the BoK will leave the policy rate at current 2.75% to the end of this year but cut another 25bps early next year — when the economy will likely contract on QoQ terms. After two rounds of fiscal enforcements in 3Q12, the government is unlikely to implement extra spending in 2013 but probably will frontload more than 60% of the budget in 1H13 to support economic growth.

Indonesia

Helmi Arman
+65-21-5290-8960
helmi.arman@citi.com

The trade balance tipped into surplus in August after four months of deficits. Moreover, FX market pressure also eased lately, as indicated by the slight increase in foreign reserves in September to $110.2bn, from $108.9bn in August. Mining and heavy equipment related imports have fallen and non-oil and gas imports usually show seasonal weakness in the months after Ramadan. The BI accordingly has toned down its concerns over the external imbalance. On a quarterly basis, the CA deficit has probably peaked in 2Q12 (Citi forecast for 3Q CA deficit: 2.5pct of GDP vs. 3.1 in 2Q). But we think the monthly trade numbers will probably still exhibit some volatility, especially as palm oil prices have softened. Coal prices have also weakened further, which will be a drag on exports and negative IDR. Overall, we still see some upside risk on the IDR (Citi 6-12M forecast: 9,850). As for rates, any move will likely be data-dependent. Our baseline forecast remains for a 25bps hike in the FasBI rate in Dec-12; however, BI may delay any move if portfolio inflows suffice to avoid significant balance of payments deficits.

Figure 33. Korea and Indonesia — Economic Forecasts, 2011-2013F

		Korea			Indonesia		
		2011	2012F	2013F	2011	2012F	2013F
Real GDP	YoY	3.6%	2.6%	3.4%	6.5%	6.2%	6.1%
Final Domestic Demand	YoY	1.3	1.6	2.5	5.7	6.5	7.0
Private Consumption	YoY	2.3	1.5	1.6	4.7	5.1	4.5
Fixed Investment	YoY	-1.1	0.7	3.8	8.8	11.4	10.6
Exports	YoY	9.5	2.6	3.4	13.6	4.3	6.0
Imports	YoY	6.5	1.0	1.8	13.3	7.1	7.9
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	24.9	17.8	1.7	-20.4	-15.9
	% of GDP	2.4	2.2	1.4	0.2	-2.3	-1.7
Fiscal Balance	% of GDP	1.5	0.8	1.3	-1.2	-2.1	-1.5
US Dollar Exchange Rate	Average	1108	1123	1102	8763	9464	9799

Sources: Haver Analytics and Citi Research

Hong Kong

Adrienne Lui
+852 2501 2753
adrienne.lui@citi.com

3Q probably saw a tepid economic recovery. External headwinds kept August trade growth near zero, and we expect modest favourable base effects will start to lift exports from September. The jobless rate began to edge up in September, and could climb modestly in coming months to reflect the recent economic moderation. The consumer slowdown will likely continue, with falling local consumer confidence and reduced spending per tourist. Disinflation is ongoing, but property prices are making new highs and continue to put policymakers on high alert — with warnings that more property cooling measures could come. With stronger regional FX trends, HKMA was forced to intervene as the HKD touched the strong end of the trading band on 19 October, with officials reiterating that the dollar peg is to stay.

Singapore

Kit Wei Zheng
+65 6657 50779
wei.zheng.kit@citi.com

Although GDP fell 1.5% QoQ SAAR in 3Q GDP, a technical recession was narrowly averted on the upward revision in 2Q GDP. We expect a modest, short-lived restocking-driven 4Q rebound. With a still-tight labour market, elevated COE premiums, and rising home prices, headline inflation will likely stay above 4% for the rest of 2012, not far off from September 4.7% reading, while the core may also stay near the September level of 2.4%. MAS's 2013 headline and core forecasts of 3.5-4.5% and 2-3% hint at a pick up in 2013. MAS's surprise decision to stand pat implies it views the cyclical drag as not sufficiently large to offset the structural need to accommodate faster medium-term REER appreciation and anchor inflation expectations. We see modest room for SOR fixings to nudge lower, but the stimulatory effect on housing demand may be neutralised by measures to cap mortgage tenors at 35 years.

Taiwan

Adrienne Lui
+852 2501 2753
adrienne.lui@citi.com

A few green shoots were spotted in the September data, with double-digit gains in exports and export orders after six months of contraction — both thanks to recent tech product launches. We expect favourable base effects will also help support a modest recovery in 4Q, but have yet to see improvement in Mainland China's demand for Taiwanese products. Headline inflation remains elevated, with food prices lifted by the typhoon, and this will likely prolong CBC's neutral stance. We expect the TWD to stay flat in the near term, after it has recently appreciated along with regional FX trends on overall better risk appetite. Strengthening cross-strait linkage with Mainland China remains one important support to our growth outlook. We expect 3Q real GDP to grow 1.9% YoY, recovering from 2Q's -0.2% YoY.

Figure 34. 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	4.9%	2.2%	3.8%	4.9	2.3	3.2	4.0%	1.7%	3.6%
Final Domestic Demand	YoY	7.5	4.8	1.9	3.4	3.3	2.9	1.3	0.7	2.8
Private Consumption	YoY	8.2	4.4	2.0	4.1	2.6	3.3	3.0	1.9	2.7
Fixed Investment	YoY	7.5	6.6	2.0	3.3	7.0	2.4	-3.8	-2.6	5.2
Exports	YoY	4.1	-0.4	6.0	2.6	2.6	3.8	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	4.6	3.5	1.4	2.0	2.0
Unemployment Rate	%	3.4	3.4	3.7	2.0	2.2	2.1	4.4	4.3	4.2
Current Account	US$ bn	16.2	13.1	15.5	57.0	41.7	41.2	41.3	41.9	42.6
	% of GDP	6.5	5.0	5.5	21.9	15.0	14.0	8.8	8.7	8.4
Fiscal Balance	% of GDP	3.8	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	1.24	1.23	29.40	29.49	29.36

Sources: Haver Analytics and Citi Research

Russia

David Lubin
+44-20-7986-3302
david.p.lubin@citi.com

Olga Ponomarenko
+7 (495) 643 1549
olga.ponomarenko@citi.com

Elina Ribakova on leave
Natalia Novikova on leave

Preliminary data suggest growth was 2.5-3%YoY in 3Q. Retail sales reached a 2.5 year low of 4.3%YoY, and passenger car production slowed to 5.6% YoY after 15% average growth in 1H12. Inflation is running at 6.6%YoY — above the central bank's forecast of 6.4%. The high inflation rate and slowing growth increase the uncertainty over the CBR rate-setting policy. We believe the CBR will hike the deposit rate in November followed by a pause. Even though rates were hiked recently, overall there is no effective tightening as fiscal spending remains high and the CBR expects to double liquidity provision to the banks over the next three years. Foreign borrowing of banks and corporates at US$26bn in 3Q helped keep net outflows low at US$11.5bn. On the other hand, the current account surprised negatively, at just US$13bn, on the back of a weaker trade balance. The global risk-on and positive perception of Russia after the Sberbank privatisation should support inflows; however outflows will likely accelerate as the budget will be running deficits. We expect marginal ruble weakening by year-end. However, in our base case, we expect the ability to use Euroclear for Russian bonds to be introduced in 1Q13, and coupled with the seasonally strong current account, this should drive the ruble to 34.8/BASK.

Turkey

Ilker Domac
+90 212 319 4623
ilker.domac@citi.com

Gultekin Isiklar
+90 212 319 4915
gultekin.isiklar@citi.com

Expectations of Fitch Ratings upgrading Turkey to investment grade (IG) as early as this year have become one of the key drivers of Turkish assets recently. Specifically, the markets were buoyed by statements suggesting Fitch is quite close to reviewing Turkey's sovereign rating (Bloomberg, October 10, 2012). Although we would not rule out an upgrade to IG perhaps as soon as this year, it is not the most likely outcome in our baseline scenario. On the monetary policy front, despite the underperformance of the lira with respect to its peers, the CBT continues to maintain its dovish stance, which led to a marked rally in the short-end of the yield curve. Looking ahead, we believe the CBT is likely to maintain its pro-growth posture so long as the lira remains within the Bank's comfort zone. This, coupled with the likely slowdown in the pace of the external adjustment, rising geopolitical risks and the low likelihood of a revival of structural reforms aimed at addressing Turkey's competitiveness gap, paints a challenging picture for the lira. As a result, we believe the lira will remain vulnerable to sudden shifts in investor sentiment. Despite this difficult backdrop, we believe the lira is likely to hold up well in the near-term on the back of rising expectations of IG and the likely near-term risk-on mood.

Figure 35. 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%	4.0%
Final Domestic Demand	YoY	1.7	1.5	2.0	9.9	-0.5	3.4
Private Consumption	YoY	6.3	5.9	5.3	7.8	-0.6	3.2
Fixed Investment	YoY	8.0	6.7	9.0	18.5	-2.1	4.1
Exports	YoY	0.4	1.0	2.7	6.4	16.0	4.5
Imports	YoY	20.3	4.3	5.8	10.9	-2.4	2.5
CPI	YoY	8.4	5.1	6.9	6.5	9.2	7.3
Unemployment Rate	%	6.6	7.5	7.5	9.8	9.2	9.5
Current Account	US$ bn	98.8	101.2	75.9	-77.1	-60.6	-61.3
	% of GDP	5.3	5.4	3.9	-10.0	-7.5	-7.0
Fiscal Balance	% of GDP	2.0	0.3	0.1	-1.3	-2.5	-2.7
US Dollar Exchange Rate	Average	29.4	31.0	33.1	1.68	1.80	1.84

Sources: Haver Analytics and Citi Research

Hungary

Eszter Gargyan
+36 (1) 374-5559
eszter.gargyan@citi.com

We have lowered our growth forecast for 2013 from 0.8% previously to 0.4% on the back of the heavily revenue-based fiscal measures that have been revealed in two steps during October. The measures may be sufficient to keep the deficit below 3% of GDP and avoid a suspension of Cohesion Funds. But, the increased burden on banks and mostly foreign owned retailers, utility and energy companies could hold bank investment activity further and continue to erode Hungary's weak potential growth rate. We believe the measures will be unwelcome to the EU and the IMF which are urging structural expenditure cuts and a lower tax wedge for low wage earners to improve Hungary's competitiveness. The global hunt for yield has created a supportive environment for Hungarian assets, eliminating pressure on the government to compromise on a multilateral deal. We expect gradual rate cuts to continue as long as Hungary's risk premiums remain contained. Hungary's growth problems, a significant reduction in interest rates and increasing concerns in the runup to the spring 2014 general elections may trigger a correction in local asset prices if global factors turn less supportive.

Poland

Piotr Kalisz
48 (22) 692 9633
piotr.kalisz@citi.com

Cezary Chrapek
+48 (22) 692 9421
cezary.chrapek@citi.com

Recently released data confirm the Polish economy is slowing rapidly and GDP growth in 3Q probably fell to around 1.5%YoY from 2.4% in 2Q. Falling real wages, the high jobless rate and stagnant employment do not bode well for any recovery in private consumption. In turn, double-digit declines in construction output suggest further weakening in fixed investment is likely, especially in the face of a reduction of spending on infrastructure projects. In October the government presented a program that is supposed to constitute a response to the deteriorating growth outlook. The program includes a plan to increase the capital of the state-owned BGK bank that would help to generate funding for investment projects worth PLN 40bn in the coming years. Given the scarcity of details, it is difficult however to assess whether this will prove successful in boosting growth. Despite dovish comments, the MPC left rates on hold in October as several policymakers wanted to delay any potential rate adjustment until the new inflation projection is published in November. Taking this into account, as well as most recent comments of even hawkish MPC members, we expect interest rates to be cut by 25bps in early November and we expect the easing cycle will comprise a total of 100bps by mid-2013.

Figure 36. Hungary and Poland — Economic Forecasts, 2011-2013F

		Hungary			Poland		
		2011	2012F	2013F	2011	2012F	2013F
Real GDP	YoY	1.6%	-1.2%	0.4%	4.3%	2.4%	2.2%
Final Domestic Demand	YoY	-1.3	-2.0	-1.4	3.5	1.3	1.8
Private Consumption	YoY	0.0	-1.1	-0.6	3.1	1.7	2.2
Fixed Investment	YoY	-5.5	-5.6	-4.0	8.3	1.2	1.2
Exports	YoY	8.4	1.8	4.4	7.5	2.0	2.3
Imports	YoY	6.3	0.5	3.1	5.8	-1.3	0.1
CPI	YoY	3.9	5.9	5.2	4.3	3.8	2.6
Unemployment Rate	%	11.6	11.0	10.8	12.2	13.1	13.5
Current Account	US$ bn	1.3	1.7	2.9	-22.2	-18.0	-19.6
	% of GDP	1.1	1.3	2.3	-4.3	-3.6	-3.9
Fiscal Balance	% of GDP	4.3	-2.8	-2.9	-5.1	-3.4	-3.0
Euro Exchange Rate	Average	279	289	297	4.12	4.16	4.15

Sources: Haver Analytics and Citi Research

Czech Republic

Jaromir Sindel
+ 42 0 233 061 485
jaromir.sindel@citi.com

We have made only a mild downward change to our 2012 GDP forecast reflecting positive revisions to the 2011 numbers. While we expect a less negative outlook for foreign demand in 2013, it will likely be offset to the downside by revisions scheduled to take place in 2014. This has actually led to a later inventory recovery, which we previously expected in 2013. However, we have not revised our 2013 GDP forecast due to the slightly improved foreign demand outlook and what would likely be milder fiscal consolidation in 2013. This reflects the tensions facing the coalition in regional and Senate elections in October, which means significant uncertainty, particularly over the expected VAT change in 2013 and pension reform that is supposed to start in two months. All in all, we cannot exclude the possibility of an early election in 1H13 though we still expect the CNB to ease monetary policy further due to weak domestic demand, until politicians commit to the fiscal consolidation effort. While the CNB policy rate was cut to 0.25% in September, we expect it to reach 0.05% by year-end, with cuts likely coming in two steps, accompanied with comments favouring a weaker koruna as the only other channel to ease the monetary conditions. However, we would also expect the CNB to use other tools (liquidity volumes, 3M PRIBOR), before any FX intervention, which we would expect to be accompanied by no more selling yields from CNB reserves.

Romania

Ilker Domac
+90 212 319 4623
ilker.domac@citi.com

Gultekin Isiklar
+90 212 319 4915
gultekin.isiklar@citi.com

Higher food prices continue to complicate inflation dynamics. At 5.3%YoY, the inflation outturn in September came in considerably higher than the consensus (4.7%) on the back of a sharp pick up in food prices, which rose by about 2.3%MoM — well above its seasonal average of about 0.2%. The August and September inflation readings confirm that a sharp reversal in food prices is underway. These data, coupled with the deterioration in forward looking inflation expectations and the lue depreciation, point to more difficult short-term inflation dynamics. This backdrop, in turn, provides an additional reason for the NBR to keep liquidity conditions tight. With year-end inflation on track to exceed the upper uncertainty band for the inflation target (3% ±1pp), the pressure to tighten the monetary policy stance is rising, in our view. We believe that heightened political uncertainty and contagion from the euro area crisis are likely to keep depreciation pressures at elevated levels. This, coupled with a more challenging inflation outlook, suggests that upward pressures on interest rates are likely to remain elevated in the near term, which may, in turn, lead the NBR to consider tightening.

Figure 37. Czech Republic and Romania — Economic Forecasts, 2011-2013F

		Czech Republic			Romania		
		2011	2012F	2013F	2011	2012F	2013F
Real GDP	YoY	1.9%	-1.2%	0.4%	2.5%	1.3%	2.5%
Final Domestic Demand	YoY	-0.9	-2.2	-0.2	1.9	1.8	2.4
Private Consumption	YoY	-0.6	-3.2	0.2	1.3	0.8	2.3
Fixed Investment	YoY	-0.9	-1.4	0.8	6.2	6.5	3.0
Exports	YoY	11.0	4.3	1.7	10.5	-1.4	4.2
Imports	YoY	7.5	-0.8	0.7	11.5	-0.2	3.2
CPI	YoY	1.9	3.3	2.4	5.8	3.5	5.2
Unemployment Rate	%	8.5	8.6	9.0	5.4	5.0	5.2
Current Account	US$ bn	-6.3	-1.6	-3.2	-8.3	-7.0	-8.6
	% of GDP	-3.0	-0.8	-1.7	-4.4	-4.0	-4.7
Fiscal Balance	% of GDP	-3.1	-3.2	-3.0	-4.1	-2.4	-2.2
EURCZK, USDRON	Average	24.6	25.1	25.4	3.0	3.5	3.6

Sources: Haver Analytics and Citi Research

Brazil

Marcelo Kfoury
+55 11 4009 3470
marcelo.kfoury@citi.com

The stronger performance of activity indicators in August led us to raise our 3Q12 GDP growth forecast to 1.1% QoQ (from 1.0% QoQ), although we are keeping our 2012 and 2013 annual estimates at 1.4% and 3.9%, respectively. Our more pessimistic GDP forecasts (compared to the consensus) are based on the view that the unfavourable global scenario will continue to constrain the recovery in domestic activity. On the inflation front, upward pressures on food prices support an increase in our 2012 CPI inflation forecast to 5.4% (from 5.2%), while the likely drop in energy prices next year implied a reduction in our 2013 CPI inflation estimate to 5.2% (from 5.6%). In terms of monetary policy, the central bank clearly signaled that the easing cycle has ended with the Selic rate at 7.25%. Given our view that the real interest rate is below its neutral level, we expect the central bank to initiate a normalisation of monetary policy in October 2013, hiking the Selic rate to 8.25% at 2013 year end. On the FX front, government/CB interventions will likely keep USD/BRL hovering around the range between 2.0 to 2.10. Finally, given the frustrating performance of tax revenues, we continue to believe that the primary fiscal surplus will reach 2.5% of GDP this year, below the 3.1% of GDP target.

Mexico

Sergio Luna Martinez
+52 55 2226 6799
sergio1.luna@banamex.com

Economic activity continued to grow at a reasonable pace in 3Q12. Industrial production grew by 3.6%YoY in August, reflecting solid manufacturing growth (4.5% YoY). In particular, auto sector activity remains remarkably strong, with output growing by 12.5%YoY in September. These results are in line with our 3Q12 3.5% YoY GDP growth forecast. Thus, we continue to expect 3.9% GDP growth for 3012 as a whole and 3.8% for 2013. Meanwhile, inflation remains virtually our only worry. Annual headline inflation increased again, reaching 4.77% in September — boosted by food prices (10.7%YoY). More positively, however, core inflation was 3.61%YoY, down from 3.70%YoY in August. We think food price pressures will gradually start to ease in coming months, so we keep our year-end forecast at 4.0% for the headline figure. As of today, we expect limited impact from second-round effects, so we forecast that Banxico will keep the reference rate unchanged for a prolonged period and start raising rates until 3Q14. Thus, we are focusing on MXN, where we see potential for short-term peso strength. We therefore revise down our year-end 2012 USD/MXN estimate to 12.6 from 12.70.

Figure 38. 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	2.4	4.7	5.0	4.2	4.4
Private Consumption	YoY	4.1	3.1	4.6	4.5	3.7	4.0
Fixed Investment	YoY	4.7	-0.9	8.5	8.9	7.3	7.4
Exports	YoY	4.5	1.5	21.3	6.7	7.1	7.8
Imports	YoY	9.7	5.3	20.8	6.7	6.4	7.4
CPI	YoY	6.6	5.4	5.3	3.4	4.2	4.0
Unemployment Rate	%	6.1	6.3	6.5	5.2	4.8	4.8
Current Account	US$ bn	-52.5	-52.8	-64.7	-9.0	-11.5	-17.8
	% of GDP	-2.3	-2.2	-2.5	-0.8	-1.0	-1.4
Fiscal Balance	% of GDP	-2.6	-2.6	-2.4	-2.4	-2.2	-2.0
US Dollar Exchange Rate	Average	1.67	1.97	2.04	12.44	12.90	12.79

Sources: Haver Analytics and Citi Research

Argentina

Joaquin A Cottani
+1 212 816 2735
joaquin.cottani@citi.com

We have raised our forecasts for non-official real GDP growth to 0% in 2012 and 3% in 2013. Regarding official GDP growth, we expect it to stand at 2.3% in 2012 and 3% in 2013. Our more optimistic forecast for non-official growth in 2013 is mostly based on positive exogenous shocks, namely better weather and stronger growth in Brazil. Naturally, improving weather conditions and the resulting harvest should boost agricultural exports, and consequently relax Argentina's external constraint. Yet, we are less optimistic than other market participants about this second-round effect. We expect agricultural exports to increase by USD4.3bn during 2013. Given this expected increase in agricultural exports, we would expect the government to relax the administrative controls on imports, but the restrictions on foreign currency purchases are likely to remain fully in place. We also reaffirm our 25% and 30% non-official inflation forecasts for 2012 and 2013, respectively. Lastly, we continue to expect the USDARS to be 4.9 and 6 by the end of 2012 and 2013.

Venezuela

Munir Jalil
+57 1 639 4195
munir.jalil@citi.com

With the uncertainty regarding the election behind us, the focus of attention is turning back to oil price dynamics, and expectations regarding December's regional elections, which can be read as a signal of the opposition's cohesion after the presidential elections. On the economic front, we expect the economy to decelerate next year, with GDP growth standing at 3% in 2013 after an expected 5% print this year. Also, we expect a devaluation of the VEF by late 2012 or early 2013, and a reopening of the parallel exchange rate market as a way to ease pressure on the current two-tier FX regime. In that sense, it is important to note that the external accounts in Venezuela could stay in check if the average Venezuelan oil basket manages to be above USD82 per barrel on average next year. Despite a more fragile economic outlook expected for next year, the debt profile remains manageable through 2013, in our view.

Figure 39. Argentina and Venezuela — Economic Forecasts, 2011-2013F

		Argentina			Venezuela		
		2011	2012F	2013F	2011	2012F	2013F
Real GDP	YoY	8.9%	2.3%	3.0%	4.2%	5.0%	3.0%
Final Domestic Demand	YoY	12.0	2.3	3.3	7.6	8.4	1.4
Private Consumption	YoY	10.7	4.9	3.5	4.0	6.2	0.3
Fixed Investment	YoY	NA	NA	NA	4.4	7.5	2.2
Exports	YoY	4.3	-4.4	2.2	4.7	1.8	4.9
Imports	YoY	17.8	-6.6	4.4	15.4	14.3	-0.9
CPI	YoY	9.8	9.9	11.9	27.1	21.0	22.5
Unemployment Rate	%	7.2	7.5	8.3	6.5	6.0	6.3
Current Account	US$ bn	0.0	4.9	2.7	27.3	18.2	14.5
	% of GDP	0.0	1.0	0.6	9.1	4.9	4.5
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

Farouk Soussa
+971 (4) 509 9750
farouk.soussa@citi.com

Sustained high oil prices have meant that Saudi production continues at a record high of close to 10 million barrels per day in September. Saudi officials continue to reassure markets that they are willing and capable of providing further output, despite what they see as a balanced physical market in terms of supply and demand. State oil producer Aramco has also said it plans to invest US$35bn over the next 5 years in order to maintain current excess capacity levels, although Minister of Oil Naimi recently stated that it is unclear whether Saudi will need to increase its overall production capacity, given uncertainty in global supply and demand in the long term. Meanwhile, domestic oil consumption (mainly for electricity generation) continues to rise strongly, threatening to erode Saudi's export capacity in the long term. As a result, authorities have responded with a redoubling of efforts to increase gas production and reduce reliance on crude oil. In recent months, sizeable discoveries have been made. Production at the Karan and Wasit gas fields are expected to add 40% to total gas production (Reuters, October 16), and there are expectations of sizeable commercially exploitable shale gas reserves in the north and west of the Kingdom, which Baker Hughes Inc (the oil and gas services company) estimates could be the world's fifth largest. Meantime, we continue to expect robust growth in the non-oil economy (7.5% in 2012) 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 a surge in housing demand could introduce.

United Arab Emirates

Farouk Soussa
+971 (4) 509 9750
farouk.soussa@citi.com

We have upgraded our growth projections for Dubai, mainly on the back of a reassessment of the growth prospects in the construction and real estate sectors. Dubai has seen a steady recovery in the property market through the year, with villa prices rising by over 20%YoY in the first half of 2012, according to research by Jones Lang Lasalle, the property services company. While the recovery is mainly in the prime market, there is strong anecdotal evidence of an increase in general construction activity in the Emirate, with stalled projects being completed and new projects being announced. While we had previously expected a continued contraction of the construction and real estate sectors in 2012, we now expect modest growth of 2%-3% in real terms, with the net effect of lifting overall real GDP growth to 5.1% in 2012 (previously 1.9%).

Figure 40. 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%	7.0%	5.2%	4.2%	0.6%	3.4%
Final Domestic Demand	YoY	6.8	7.8	7.9	0.0	3.4	3.4
Private Consumption	YoY	4.7	5.0	5.0	4.0	2.0	2.0
Fixed Investment	YoY	10.1	10.0	10.0	-0.5	5.0	5.0
Exports	YoY	18.7	7.0	-5.1	14.3	13.0	13.0
Imports	YoY	13.7	15.0	15.0	6.5	15.0	15.0
CPI	YoY	5.0	4.8	6.0	0.9	1.1	1.3
Current Account	US$ bn	159.2	163.1	114.3	48.7	12.0	20.7
	% of GDP	26.7	25.5	17.9	15.9	3.7	6.0
Fiscal Balance	% of GDP	13.6	14.6	4.9	NA	NA	NA
US Dollar Exchange Rate	Average	3.75	3.75	3.75	3.67	3.67	3.67

Sources: Haver Analytics and Citi Research

Nigeria

David Cowan
+44 (20) 7986 3285
david.cowan@citi.com

One way to think about Nigeria's recent economic history is having built up savings, most visibly in the accumulation of foreign reserves, in 2003-08, these have been drawn down in the 2009-11 period. While there has been a rebuilding of foreign exchange reserves in 2012, the naira has still come under periodic pressure such as in May this year when the oil price fell below US$100/bbl. This continues to highlight that with only limited savings the government's room for policy manoeuvre is 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 and rising payments into the SWF.

South Africa

David Cowan
+44 (20) 7986 3285
david.cowan@citi.com

Despite the rebound in real GDP growth in Q2, driven by a recovery in the mining sector, we expect growth to remain weak in 2H following events at Marikana which will negatively impact on mining production and business confidence. In addition, there are some signs that the more solid consumer demand growth seen in 2011 also seems to be losing steam in 2012. Finally, the prices of South African commodity exports have declined of late although the weaker rand is cushioning local producer margins giving some boost to competitiveness. Nonetheless, real export performance remains poor and is further undermined by the Euro Zone debt crisis. The combination of these trends means that while the current account deficit was moderate in 2011, we expect it to widen sharply in 2012-13. With concerns about weak growth dominant, monetary policy has remained accommodative for a sustained period. In fact, given the lack of fiscal space, the SARB seems convinced that the only support to the economy in the short term will come from monetary policy, hence the surprise 50 basis point cut in the Repo rate to 5% in July. But the reality remains that despite efforts at more micro-focused policy intervention, structural obstacles to stronger growth will not dissipate soon and continue to limit the economy's ability to generate sufficient employment. With political uncertainty set to rise around the ANC's Elective Conference in December, all this continues to point to a weaker rand going forward.

Figure 41. 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%	6.5%	3.1%	2.5%	2.6%
Final Domestic Demand	YoY	2.9	2.7	2.6	NA	NA	NA	4.6	2.9	2.8
Private Consumption	YoY	5.0	0.9	0.8	NA	NA	NA	4.9	2.3	2.0
Fixed Investment	YoY	-5.6	3.7	6.5	NA	NA	NA	4.3	3.9	3.8
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	7.2	10.5	10.8	12.2	10.9	5.0	5.5	5.1
Unemployment Rate	%	12.1	13.0	14.5	NA	NA	NA	26.0	25.7	26.5
Current Account	US$ bn	-5.4	-7.1	-7.2	8.8	6.9	11.9	-13.6	-21.4	-21.0
	% of GDP	-2.3	-2.9	-2.8	3.4	2.3	3.4	-3.4	-5.7	-5.6
Fiscal Balance	% of GDP	-10.1	-9.4	-7.7	-3.1	-2.9	-2.1	-5.0	-4.8	-4.2
US Dollar Exchange Rate	Average	5.94	6.09	6.63	155.9	158.11	161.42	7.26	8.29	9.18

Sources: Haver Analytics and Citi Research

Figure 42. 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	6.2	6.5	5.7	3.5	3.7	2.4	1.5	1.2	-2.1	-2.9	-2.2
China	9.3	7.7	7.6	5.4	2.7	3.2	2.8	2.0	1.5	-1.3	-2.4	-1.5
Hong Kong	4.9	2.2	3.8	5.3	3.8	3.2	6.5	5.0	5.5	3.8	0.8	1.1
India*	6.5	5.4	6.2	8.9	8.0	7.0	-4.2	-3.2	-2.3	-8.4	-8.5	-8.0
Indonesia	6.5	6.2	6.1	5.4	4.4	4.7	0.2	-2.3	-1.7	-1.2	-2.1	-1.5
Korea	3.6	2.6	3.4	4.0	2.4	2.8	2.4	2.2	1.4	1.5	0.8	1.3
Malaysia	5.1	5.0	5.3	3.2	1.8	2.1	11.0	5.0	4.0	-4.8	-4.5	-4.0
Mongolia	17.3	12.0	13.8	9.2	13.8	12.0	-31.7	-25.6	-10.9	-3.5	-3.7	-1.5
Philippines	3.9	5.0	5.3	4.8	3.1	3.5	3.1	2.8	2.3	-2.0	-2.4	-2.1
Singapore	4.9	2.3	3.2	5.2	4.6	3.5	21.9	15.0	14.0	1.5	1.0	1.0
Sri Lanka	8.3	6.7	7.3	6.8	7.4	7.6	-7.8	-4.4	-3.8	-6.9	-6.7	-6.0
Taiwan	4.0	1.7	3.6	1.4	2.0	2.0	8.8	8.7	8.4	-1.9	-1.6	-1.6
Thailand	0.1	4.8	4.6	3.8	3.0	3.3	3.4	-2.9	-2.2	-1.5	-4.7	-3.9
Vietnam	5.9	5.0	5.4	18.6	9.4	8.1	-0.6	0.3	-0.6	-2.9	-4.5	-4.3
Latin America	3.9	2.6	3.9	6.8	5.8	5.8	-1.1	-1.3	-1.6	-2.3	-2.4	-2.3
Argentina	8.9	2.3	3.0	9.8	9.9	11.9	0.0	1.0	0.6	-1.7	-2.8	-3.0
Brazil	2.7	1.4	3.9	6.6	5.4	5.3	-2.3	-2.2	-2.5	-2.6	-2.6	-2.4
Chile	6.0	4.9	4.5	3.3	3.1	3.1	-1.3	-3.4	-2.4	1.4	0.7	0.6
Colombia	5.9	4.4	4.5	3.4	3.2	3.2	-3.0	-3.0	-2.9	-2.9	-1.8	-1.6
Mexico	3.9	3.9	3.8	3.4	4.2	4.0	-0.8	-1.0	-1.4	-2.4	-2.2	-2.0
Panama	10.6	10.2	8.5	5.9	5.6	3.2	-12.7	-8.5	-7.8	-2.3	-2.5	-3.0
Peru	6.9	6.1	5.8	3.4	3.8	3.2	-1.9	-3.3	-2.6	1.8	0.5	-0.6
Venezuela	4.2	5.0	3.0	27.1	21.0	22.5	9.1	4.9	4.5	-5.0	-5.0	-4.0
Europe	5.1	2.7	3.5	6.8	5.4	6.2	-0.2	0.4	-0.3	-0.2	-1.2	-1.1
Czech Republic	1.9	-1.2	0.4	1.9	3.3	2.4	-3.0	-0.8	-1.7	-3.1	-3.2	-3.0
Hungary	1.6	-1.2	0.4	3.9	5.9	5.2	1.1	1.3	2.3	4.3	-2.8	-2.9
Kazakhstan	7.5	5.5	5.3	8.3	5.1	6.8	7.6	7.0	4.2	5.9	1.7	3.0
Poland	4.3	2.4	2.2	4.3	3.8	2.6	-4.3	-3.6	-3.9	-5.1	-3.4	-3.0
Romania	2.5	1.3	2.5	5.8	3.5	5.2	-4.4	-4.0	-4.7	-4.1	-2.4	-2.2
Russia	4.3	3.5	4.0	8.4	5.1	6.9	5.3	5.4	3.9	2.0	0.3	0.1
Slovakia	3.2	2.8	1.3	3.9	3.6	2.9	-2.1	2.6	2.2	-4.9	-4.9	-3.0
Turkey	8.5	2.5	4.0	6.5	9.2	7.3	-10.0	-7.5	-7.0	-1.3	-2.5	-2.7
Ukraine	5.1	2.1	3.5	8.0	1.2	8.1	-5.2	-7.3	-5.4	-3.8	-3.6	-2.6
Africa/Mideast	5.6	4.2	4.8	5.5	5.2	5.5	12.1	9.2	7.1	1.8	2.4	-0.4
Bahrain	1.9	2.8	3.6	-0.4	3.0	3.5	10.3	11.4	3.3	-1.1	0.4	-0.3
Egypt	1.8	2.0	2.7	10.2	7.2	10.5	-2.3	-2.9	-2.8	-10.1	-9.4	-7.7
Ghana	14.4	7.4	7.0	8.7	10.2	8.4	-9.4	-7.3	-4.9	-5.4	-6.8	-5.5
Iraq	1.1	9.0	12.1	5.6	5.0	6.0	22.5	23.0	19.9	7.5	5.7	1.9
Israel	4.9	3.1	3.5	3.4	1.8	2.3	0.1	-1.5	-2.2	-2.7	-3.9	-3.5
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	5.8	5.0	5.8	14.0	9.7	5.8	-9.9	-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	42.2	41.0	17.1	10.7	4.3
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	6.5	10.8	12.2	10.9	3.4	2.3	3.4	-3.1	-2.9	-2.1
Oman	3.5	3.0	4.4	4.0	3.0	3.0	16.4	2.7	8.3	0.7	6.0	3.0
Qatar	18.1	6.0	8.3	1.9	3.0	3.0	34.2	23.5	16.8	9.8	9.8	5.0
Saudi Arabia	7.1	7.0	5.2	5.0	4.8	6.0	26.7	25.5	17.9	13.6	14.6	4.9
South Africa	3.1	2.5	2.6	5.0	5.5	5.1	-3.4	-5.7	-5.6	-5.0	-4.8	-4.2
Tanzania	6.3	6.4	6.8	12.7	15.4	7.7	-20.1	-11.9	-10.2	-6.0	-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	14.7	5.7	-13.2	-12.5	-10.7	-7.2	-5.5	-5.2
Zambia	6.6	6.5	6.9	6.4	6.7	7.1	0.4	-3.4	0.5	-3.4	-3.5	-2.5
Total	6.0	4.7	5.3	6.1	4.5	4.7	2.3	1.6	1.1	-1.4	-2.0	-1.9

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

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Figure 43. Citi Global Strategy and Macro Team *For Informational Purposes Only*

	Name	Office Number	Email Address	Responsibilities
Global Macro Strategy				
London	Jeremy Hale[1]	(44-20) 7986-9465	jeremy.hale@citi.com	Head Macro Strategy
	Maya Bhandari[1]	(44-20) 7986-1013	maya.bhandari@citi.com	Macro Strategy
	Michael Hampden-Turner[1]	(44-20 7986-3445	michael.hampdenturner@citi.com	Macro Strategy
	Maximilian Moldaschl[1]	(44-20) 7986-8753	maximilian.moldaschl@citi.com	Macro Strategy
Rates Strategy Research				
London	Alessandro Tentori[1]	(44-20) 7986-9224	alessandro.tentori@citi.com	Head European Rates Strategy
	Robert Crossley[1]	(44-20) 7986-9255	robert.crossley@citi.com	European Rates Strategy
	Jamie Searle[1]	(44-20) 7986-9493	jamie.searle@citi.com	European Rates Strategy
	Nishay Patel[1]	(44-20) 7986-1007	nishay.patel@citi.com	European Rates Strategy
	Peter Goves[1]	(44-20) 7986-3215	peter.goves@citi.com	European Rates Strategy
New York	Brett Rose[3]	(1-212) 723-6439	brett.rose@citi.com	Head US Rates and MBS Strategy
	Neela Gollapudi[3]	(1-212) 723-3075	neela.gollapudi@citi.com	US Rates and MBS Strategy
	Jabaz Matha[3]	(1-212) 723-1839	jabaz.mathai@citi.com	US Rates and MBS Strategy
	Ankur Mehta[3]	(1-212) 723-1833	ankur.mehta@citi.com	US Rates and MBS Strategy
Asia Pac	Steven Mansell[21]	(61-2) 8225-4351	steven.mansell@citi.com	Head Asia Pac Rates Strategy
	Carl Ang[21]	(61-2) 8225-4832	carl.ang@citi.com	Asia Pac Rates Strategy
	Jacy Sun[21]	(61-2) 8225-1197	jacy.sun@citi.com	Asia Pac Rates Strategy
	Eiji Dohke[3]	(813-6) 270-7245	eiji.dohke@citi.com	Japan Rates Strategy
	Maki Shimizu[3]	(813-6) 270-7246	maki.shimizu@citi.com	Japan Rates Strategy
Equity Strategy Research				
Global	Robert Buckland[1]	(44-20) 7986-3947	robert.buckland@citi.com	Chief Global Strategist
	Geoffrey Dennis[3]	(1-212) 816-8391	geoffrey.dennis@citi.com	
	Hasan S Tevfik, CFA[1]	(44-20) 7986-4110	hasan.tevfik@citi.com	
	Beata Manthey, PhD[1]			
	Mert Genc[1]	(44-20) 7986-4087	mert.genc@citi.com	
Pan-Europe	Jonathan Stubbs[1]	(44-20) 7986-4218	jonathan.stubbs@citi.com	Regional Head
	Adrian Cattley[1]	(44-20) 7986-4454	adrian.cattley@citi.com	
US	Tobias M Levkovich[3]	(1-212) 816-1623	tobias.levkovich@citi.com	Regional Head
US Small & Mid Cap	Scott T Chronert[3]	(1-415) 951-1771	scott.t.chronert@citi.com	
Japan	Kenji Abe PhD[12]	(81-3) 6270-4890	kenji.abe@citi.com	Regional Head
Australia & New Zealand	Tony Brennan[15]	(61-2) 8225-4890	tony.brennan@citi.com	Regional Head
Asia ex Japan	Markus Rosgen[4]	(852) 2501-2752	markus.rosgen@citi.com	Regional Head
Credit Strategy Research				
London	Matt King[1]	(44-20) 7986-3228	matt.king@citi.com	Global Head
	Hans Lorenzen[1]	(44-20) 7986-3568	hans.lorenzen@citi.com	European Flow Credit
	Teresa Cascino[1]	(44-20) 7986-9580	teresa.cascino@citi.com	Single Name Strategy
New York	Stephen Antczak[3]	(1-212) 723-6267	stephen.antczak@citi.com	US Head Flow Credit
	Ratul Roy[3]	(1-212) 723-6043	ratul.roy@citi.com	Structured Credit
	Jason Shoup[3]	(1-212) 723-6147	jason.b.shoup@citi.com	US HG Flow Credit
	Michael Anderson[3]	(1-212) 723-3819	michael.henry.anderson@citi.com	US HY Flow Credit
	Erin Lyons[3]	(1-212) 723-1102-	erin.lyons@citi.com	Single Name Strategy
Securitized Products Strategy Research				
New York	Mary Kane[3]	(1-212) 816-8409	mary.e.kane@citi.com	Global Head
	Stav Gaon[3]	(1-212) 816-3233	stav.gaon@citi.com	CMBS
	Jeff Berenbaum[3]	(1-212) 816-8399	jeffrey.s.berenbaum@citi.com	CMBS
London	Gordon Kerr[1]	(44-20) 7986-1998	gordon.kerr@citi.com	European RMBS/ABS

1 Citigroup Global Markets Ltd; 2 Citigroup Global Markets Japan Inc.; 3 Citigroup Global Markets Inc; 4 Citigroup Global Markets Asia; 5 Citigroup Global Markets (Pty) Ltd; 6 Citibank Anonim Sirketi; 7 Bank Handlowy w Warszawie; 8 Citigroup Global Markets India Private Limited; 9 Citigroup Global Markets India Private Limited; 10 Citibank (China) Co. Ltd; 11 Acciones y Valores Banamex, S.A. de C.V; 12 Citibank Taiwan Ltd; 13 Banco Citibank S.A.; 14 Citibank Europe plc Czech Republic; 15 Citigroup Pty Limited; 16 Citigroup Global Markets Korea Securities Ltd; 17 Citibank N.A. Philippines; 18 ZAO Citibank; 19 Banco Citibank S.A.; 20 Citigroup Global Markets Singapore PTE LIMITED

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Source: Citi Research.

Sovereign Ratings Outlook

Michael Saunders
(44-20) 7986-3299
michael.saunders@citi.com

Robert Crossley
+44 20 7986 9255
robert.crossley@citi.com

Peter Goves
(44-20) 7986-3215
peter.goves@citi.com

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

Over the near-term (next 2-3 quarters), Citi economists and strategists expect most sovereign ratings to be relatively stable. Our views reflect recent policy initiatives from the ECB and the likelihood that Greece will not leave EMU in the near-term. Furthermore, S&P recently acted to markedly downgrade Spain, while Moody's has ended its recent ratings review, leaving Spain at Baa3. However, due to our longer-term view on Grexti and various sovereign-specific factors, we continue to expect a wide series of downgrades over the next 2-3 years (see Figure 44). The pool of stable AAAs is likely to be largely restricted to Canada and the Nordic countries (among those covered in our *Sovereign Rating Outlook*).

Figure 44. 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	AA+ ↓	Aaa	Neg	Aaa (Neg)	Aa1 ↓
France	AA+	Neg	AA+ (Neg)	AA ↓	Aaa	Neg	Aaa (Neg W)	Aa1 ↓
Italy	BBB+	Neg	BBB+ (Neg)	BBB ↓	Baa2	Neg	Baa2 (Neg)	Baa3 ↓
Spain	BBB-	Neg	BBB- (Neg)	BB+ ↓	Baa3	Neg	Baa3 (Neg)	Ba1 ↓
Austria	AA+	Neg	AA+ (Neg)	AA ↓	Aaa	Neg	Aaa (Neg)	Aa1 ↓
Belgium	AA	Neg	AA (Neg)	AA- ↓	Aa3	Neg	Aa3 (Neg)	A1 ↓
Finland	AAA	Neg	AAA (Neg)	AA+ ↓	Aaa	Stable	Aaa	Aaa (Neg)
Greece	CCC	Stable	CCC	D ↓↓	C		C	C
Ireland	BBB+	Neg	BBB+ (Neg)	BBB ↓	Ba1	Neg	Ba1 (Neg)	Ba2 ↓
Netherlands	AAA	Neg	AAA (Neg)	AA+ ↓	Aaa	Neg	Aaa (Neg)	Aa1 ↓
Portugal	BB	Neg	BB- ↓	D ↓↓↓↓↓	Ba3	Neg	B1 ↓	C ↓↓↓↓↓
UK	AAA	Stable	AAA (Neg)	AA+ ↓	Aaa	Neg	Aaa (Neg)	Aa1 ↓
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. NA Not available. Sources: Moody's, S&P and Citi Research

Key Expected Ratings Issues

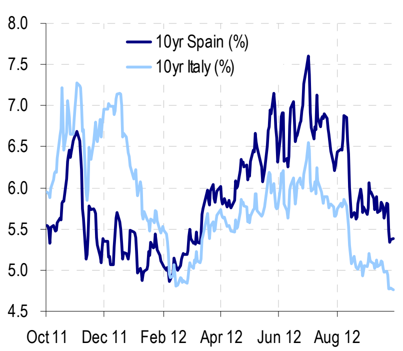
Peter Goves
(44-20) 7986-3215
peter.goves@citi.com

A respite in downgrade pressure in the near-term

Two core reasons underpin our expectation that ratings across EMU sovereigns are likely to remain relatively stable in the near-term:

- **The ECB's OMT programme** has successfully bought time for policy action and has provided a degree of market stability which has alleviated some near-term rating pressure. This was a specific driver in Moody's recent confirmation of Spain's Baa3 rating (which was assessed largely in the context of market access[8]). Given this recent ECB initiative (although yet to be activated), risks that Spain or Italy lose market access have (as Moody's note) decreased at least for the near-term, and Bono and BTP yields continue to benefit from the improved market sentiment (Figure 45).
- **The reduced likelihood of Grexit in the near-term** also removes the prospect of a systemic shock to the euro area system in coming quarters. Rating agencies had alluded to the fact that most EMU sovereigns would probably be placed on review for downgrade in the event that any sovereign leaves monetary union. Those currently within a Troika programme would be more vulnerable to downward ratings pressure, but the AAA sovereigns would also not be completely immune. Postponing Grexit from our near-term horizon therefore means such rating actions are now unlikely in the next 2-3 quarters.

Figure 45. 10yr Spain and Italy (%)



Source: Citi Research

Although we expect most sovereigns will have stable ratings in the near-term, there are a few notable exceptions. We expect that Moody's will place France on a ratings review for a possible downgrade (ie Negative Watch) in the next 2-3 quarters, largely because of the fiscal program and weak economy. Moreover, we also expect that S&P will likely place the UK on Negative Outlook in the next 2-3 quarters (in line with Moody's Aaa Negative Outlook). We also expect that Portugal will be downgraded over the next 2-3 quarters due to continued recession plus the probable need to extend its Troika programme.

Longer term ratings pressure remain

Over the long-term, we still believe that ultimately, it will become evident that the Greek programme remains off track and that Greece's debt is still unsustainable. The likely stalemate between Greece and its international creditors will eventually be resolved by Grexit, we believe. Citi's base case is that this most likely happens in H1 2014 (*Grexit — Delayed But Not Cancelled*).

Other longer-term issues concern prospects for banking union and the euro area policy framework more generally. For example, Moody's has recently stated (22nd October) that "*continuing dissonance among EU leaders on a banking union will continue to undermine sovereign creditworthiness within the euro area*[9]". Together with such rating agency comments, Citi's Grexit expectation in 2014, general economic weakness, and various sovereign-specific factors, we believe many EMU countries will ultimately face at least one downgrade over the next 2-3 years. Separately, we also continue to expect downgrades of the US, Japan and UK over the next 2-3 years, largely predicted on longer-term debt sustainability trends.

[8] Moody's Special Comment, 17 October 2012

[9] Moody's Special Comment, 22 October 2012

European Interest Rate Strategy

Alessandro Tentori
alessandro.tentori@citi.com
+44-207-986-9493

Jamie Searle
jamie.searle@citi.com
+44-207-986-3568

A rather benign sovereign credit environment continues to drive flows into Eurozone's peripheral markets, thus fuelling a solid performance in the second-half of 2012. ECB's "threat-to-shorts" together with the receding probability of Grexit and small, but key steps towards the implementation of EMU2.0 are convincing even traditionally risk-averse investors to move back into the non-core EGB markets. However, expensive valuations, market positioning and persistent macroeconomic risks for Spain make us think that the peripheral rally may be overdone at this stage.

Running Behind Benchmark

ECB is a major contribution to the performance of EGB periphery

Year-to-date, Italy has delivered a total return of 17% with the 3y LTRO and the OMT-announcement contributing roughly 13% and 9%, respectively. By comparison, France is up 9.4% and Germany 2.9% in 2012. ECB's contribution to non-core performance is tangible and underlines the fragility of the EGB markets in the absence of support from monetary policy. In our view, the thin line between monetary financing and price stability has been — de facto — crossed several times during the past three years.

Optional value in the front-end of the Bono curve

We believe that Spain is likely to ask for ESM support before the end of this year, but that the ECB will activate OMT mainly as a function of the level of yields. While OMT seems to be very successful even without activation, we think that the Spanish macroeconomic environment remains very fragile and that deteriorating market conditions will be the trigger for ECB's intervention in the Bono market. At the same time, BTP's performance should remain rather insulated from Iberian market risk. Therefore, we expect the Bono 2/10s curve to outperform the BTP 2/10s curve as investors realise the optionality at the front-end of the Bono curve and "arbitrage" away the 2y Bono/BTP spread.

The selloff in Euribor is a good opportunity to reload on carry trades

In pure rates space, the market is pricing out the probability of rate cuts by the ECB. While excess liquidity conditions bias our perception of the probability of changes in the refinancing rate, a negative discount rate seem highly unlikely until year end. Positioning and anticipation of a potential large exercise of the January 2013 early repayment option are the main factors behind the recent-selloff in Euribor futures. We think investors should fade this move and position for a "low for longer" carry trade scenario in 2013.

Bund: Range trading and directional yield curve

As far as Bunds are concerned, we expect the 1.50/1.75% range to hold in the near term. This is especially true in our scenario of Madrid asking for ESM support. The volatility differential between the 2y and the 10y sector should continue to deliver a strong directionality into the yield curve, i.e. we expect the bear steepening / bull flattening theme to persist into year end.

Gilt yields are likely to be stuck in a historical low range for a sustained period

In the UK, we continue to expect gilt yields to remain stable around current levels for a sustained period. The front-end is likely to remain anchored by stable policy rates while long-end yields are likely to be depressed by ongoing QE. The market has recently reduced expectations for further QE in November allowing gilts to underperform Bunds. However, the dire economic outlook is likely to warrant an extension of QE in the coming months and we see scope for gilts to outperform on a cross-market basis in the near-term. Curves are likely to remain directional; bull flattening/bear steepening in 2s10s and the opposite in 10s30s. We prefer to trade 10s30s with a flattening bias in the near-term, however, as supply pressure subsides and given the usual seasonal support for Long gilts in Q4. There is also room for gilts to outperform swaps in the near-term. Swap spreads have narrowed sharply in recent months and are likely to attract interest around current levels.

Figure 46. Interest Rate and Bond Market Forecasts as of 24 Oct 2012

		Quarterly Average					
	Current	4Q 12	1Q 13	2Q 13	3Q 13	4Q 13	1Q 14
US							
Policy Rate (Fed Funds) End Quarter	0.25	0.25	0.25	0.25	0.25	0.25	0.25
3-Month Libor	0.32	0.30	0.35	0.45	0.60	0.70	0.80
2 Year Treasury Yield	0.31	0.21	0.30	0.50	0.60	0.75	0.90
5 Year Treasury Yield	0.78	0.65	0.75	0.95	1.10	1.35	1.60
10 Year Treasury Yield	1.79	1.65	1.75	2.00	2.25	2.55	2.75
30 Year Treasury Yield	2.97	2.85	2.95	3.20	3.45	3.80	3.95
2-10 Year Treasury Curve	148	144	145	150	165	180	185
2 Year Swap Spread (Swap Less Govt.), bp	10	15	20	25	30	35	35
10 Year Swap Spread (Swap Less Govt.), bp	3	5	15	25	25	25	25
30 Year Swap Spread (Swap Less Govt.), bp	-25	-30	-35	-40	-45	-50	-50
30 Year Mortgage Yield	3.47	3.40	3.45	3.75	3.90	4.15	4.35
10 Year Breakeven Inflation	251	250	250	250	245	240	240
Euro Area							
Policy Rate	0.75	0.50	0.50	0.25	0.25	0.25	0.25
Overnight Rate (EONIA)	0.08	0.08	0.08	-0.15	-0.15	-0.15	-0.15
3-Month Libor	0.21	0.15	0.15	0.05	0.05	0.00	0.00
2 Year Treasury Yield	0.11	0.00	0.05	-0.05	0.00	-0.05	0.05
5 Year Treasury Yield	0.62	0.50	0.70	0.50	0.75	0.50	0.55
10 Year Treasury Yield	1.59	1.50	1.75	1.50	1.75	1.50	1.50
30 Year Treasury Yield	2.42	2.30	2.35	2.30	2.40	2.20	2.20
2-10 Year Treasury Curve	148	150	170	155	175	155	145
10 Year BTP-Bund Spread	318	275	350	350	350	400	400
10 Year Bono-Bund Spread	382	400	375	350	350	425	425
2 Year BTP-Schatz Spread	199	175	200	250	250	250	250
2 Year Bono Schatz Spread	267	215	250	250	250	250	250
10 Year Swap Spread (Swap Less Govt.), bp	24	40	25	20	15	40	30
10 Year Breakeven Inflation	188	180	180	185	195	180	180
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	0.15	0.10	0.15	0.15
5 Year Treasury Yield	0.19	0.25	0.35	0.40	0.35	0.50	0.50
10 Year Treasury Yield	0.77	0.95	1.10	1.20	1.10	1.30	1.30
30 Year Treasury Yield	1.93	2.00	2.10	2.20	2.10	2.25	2.25
2-10 Year Treasury Curve	67	85	100	105	100	115	115
2 Year Swap Spread (Swap Less Govt.), bp	16	17	20	22	20	24	24
10 Year Swap Spread (Swap Less Govt.), bp	1	3	4	6	4	8	8
UK							
Policy Rate	0.50	0.50	0.50	0.50	0.50	0.50	0.50
3-Month Libor	0.53	0.55	0.55	0.55	0.55	0.55	0.55
2 Year Treasury Yield	0.26	0.30	0.35	0.30	0.45	0.30	0.35
5 Year Treasury Yield	0.85	0.75	0.75	0.65	0.85	0.65	0.75
10 Year Treasury Yield	1.89	1.80	1.80	1.70	2.00	1.75	1.85
30 Year Treasury Yield	3.21	3.10	3.05	3.00	3.20	3.05	3.10
2-10 Year Treasury Curve	163	150	145	140	155	145	150
10 Year Swap Spread (Swap Less Govt.), bp	10	20	25	30	20	25	20
10 Year Breakeven Inflation	239	225	215	225	230	230	235
Australia							
Policy Rate	3.25	3.25	3.00	3.00	3.00	3.00	3.00
3-Month Libor	3.14	3.15	2.95	3.00	3.05	3.05	3.10
2 Year Treasury Yield	2.57	2.50	2.25	2.25	2.35	2.45	2.50
5 Year Treasury Yield	2.66	2.60	2.40	2.40	2.55	2.70	2.90
10 Year Treasury Yield	3.20	3.10	3.00	3.10	3.30	3.50	3.75
2-10 Year Treasury Curve	63	60	75	85	95	105	125
10 Year Swap Spread (Swap Less Govt.), bp	56	50	55	60	65	65	70

Source: Citi Research

Credit Strategy Outlook

Matt King
matt.king@citi.com
+ 44 (20) 7986-3228

The risk on trade has obviously pushed valuations dramatically higher in recent months but, to put the richening into perspective, consider current levels relative to those in June when the rally began. In equity space, the SPX index is up 14% and EURO STOXX has rallied +24%, and in credit CDX.IG has tightened almost 40 bp, CDX.HY is more than 225 richer, and iTraxx has improved about 70 bp. That said, as dramatic as these moves are, the reality is that current levels are still much, much wider than the tights we reached in previous credit cycles (e.g., ’07; Figure 47).

We would argue, however, that the current environment is unique and one can’t blindly rely on the past as a guide. This time around there are extenuating circumstances such as extraordinarily high dollar prices, systemic risk that is higher than normal, among other factors. And after considering these factors, we would argue that, on the whole, valuations are probably pretty close to fair value.

Figure 47. Room to run? Credit spreads are still well north of the ’07 tights

	Current	Jun '07	Spread Diff
US HG	129 bp	93 bp	36 bp
Eur HG	137 bp	43 bp	94 bp
CDX.IG	90 bp	34 bp	56 bp
iTraxx Eur	116 bp	20 bp	95 bp

Note: As of October 17, 2012; index eligible bonds only for cash spreads
Source: Citi Research

Our view: moderate spread tightening in the near-term

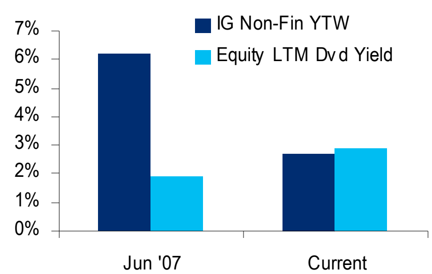
In terms of where we go from here, our base case expectation is modestly tighter spread levels. While we believe that the majority of the rally in absolute terms is done, until investors can see an identifiable negative catalyst, we expect little resistance to liquidity injected by central banks and as such over the coming months there will likely be times when the liquidity lure will push spreads tighter.

That said, risky assets in markets that central banks do not directly participate in should, to some extent, be viewed as substitutes for each other, and in this context credit is beginning to look full. Consider some of these relationships, and use ’07 (previous tights) as a reference point:

- **Bond vs. dividend yields:** Back in ’07 the average HG non-financial bond in the US was yielding 6.2%, while stocks for the same issuers offered a dividend yield of 1.9%. The difference has gone from 4.3% to *negative* 0.2% now (2.7% vs. 2.9%), even before adjusting for factors such as high dollar prices (Figure 48). At some point, the marginal dollar should flow from credit into equities, and we seem fairly close now.

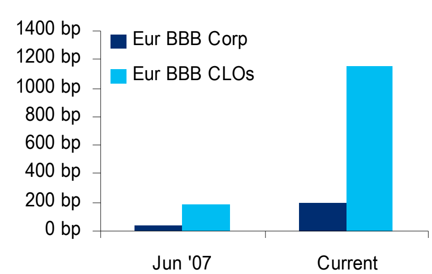
- **Cash bonds vs. CLOs:** Another example is cash corporates vs. structured products. Back in ’07 the BBB tranche of the typical CLO traded at a spread of 182 bp, while comparably rated bonds in Europe were at 39 bp. Now the spread difference is about 950 bp (201 bp vs. 1150 bp, Figure 49).

Figure 48. US HG non-fin issuers now yield less than the equity market



Note: As of 6/1/07 and 10/9/12; based on 166 issuers
Sources: Citi Research, Bloomberg

Figure 49. Triple-B CLO vs. corp spreads suggest that corp valuations are full



Note: As of October 1, 2012
Sources: Citi Research

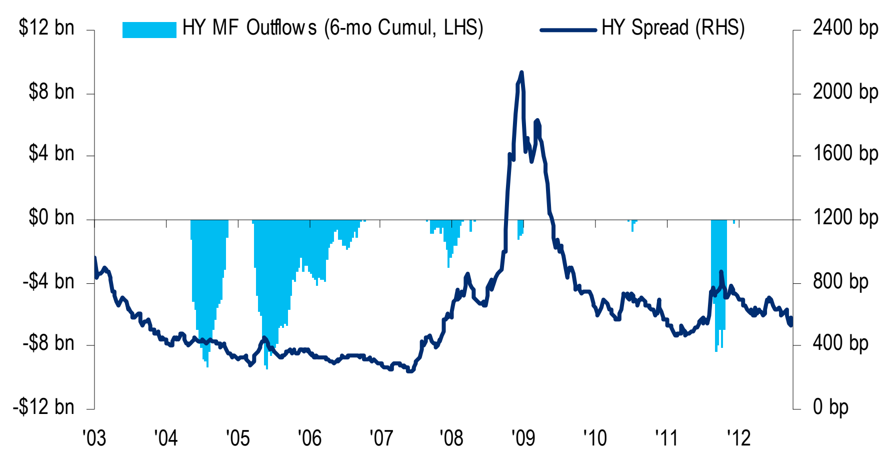
These tight relationships do not mean that credit spreads will face selling pressure per se, but just that the marginal buyers may look elsewhere before long, thereby limiting upside.

But meaningful widening more likely than some expect

While status quo is our base case expectation, we are willing to go out on a limb and assign a higher-than-consensus probability to meaningful widening as well. There may not be all that many new negative catalysts, but we believe that tail risks — be it Grexit, Catalan independence, or Italian elections — are bound to resurface. Given the marketplace's complacency, the crowded risk-on trade, and with the Street unwilling to take risk, the long trade could turn sharply at the first sign of trouble and cause credit spreads to gap dramatically wider.

As an example, consider the market response to a decent sized mutual fund outflow. Last summer / fall, we saw total outflows of $7 bn in the U.S. high-yield market (0.9% of market outstandings). This was more or less the same magnitude as the outflow in the first half of '05 (over $8 bn; 1.8% of '05 market). But in '05 spreads widened 75 bp, relative to more than 300 bp last fall. We acknowledge the apples-to-oranges comparison, but we would argue that the Street's inability to take risk and the crowded nature of positions was a key reason for disproportionate spread widening last year.

Figure 50. Outflows in the high-yield market caused a disproportionate spread widening last year vs. in 05



Note: As of October 3, 2012
Sources: Citi Research, EPFR

Global Equity Strategy

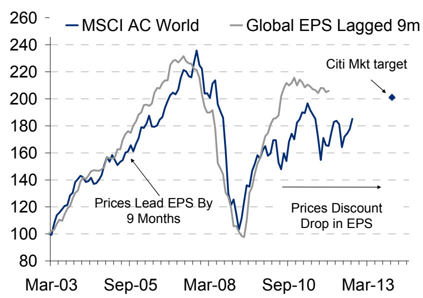
Robert Buckland
+44-207-986-3947
robert.buckland@citi.com

Hasan Tevfik
+44-207-986-4110
hasan.tevfik@citi.com

Global equities are up 12% YTD. From here Citi Equity Strategists believe the combination of even easier central bank policy and cheap valuations should ensure global markets rally a further 8% to the end of 2013. We target the MSCI AC World index to finish 2013 at 360. It is currently 334. However the global corporate earnings cycle is clearly rolling over and is not helped by a slowing world economy. This means that the risks to our market target are probably to the downside.

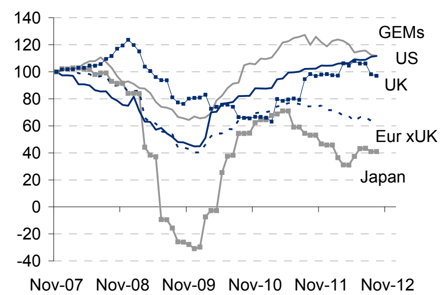
Figure 51 shows the relationship between global share prices and the trailing EPS index lagged by 9 months. Between 2003 and 2010, prices led EPS. Since then, this relationship suggests that prices have started to discount a contraction in global EPS. Bottom-up consensus forecasts for 2012 have been cut during last few months and now stand at 5% for 2012 and 13% for 2013. An aggregation of Citi strategists' top-down forecasts suggests 7% global EPS growth in 2013. This means that Citi strategists are not forecasting a contraction in global profits, but they are less optimistic than bottom-up consensus.

Figure 51. MSCI AC World Price vs EPS (9m Lagged)



Sources: MSCI, Citi Research

Figure 52. Trailing EPS Since November 2007



Sources: Citi Research, Factset

A slowing global economy is reflected in slowing global EPS. Figure 52 shows trailing EPS since the global peak in November 2007. Only the US and EM have regained their previous highs. EPS in EM has since begun to fade with weaker commodity prices and GDP growth. UK EPS has been surprisingly strong given the weakness of the domestic economy. However, more recently resource sector profits have succumbed to commodity price weakness. The earthquake clearly hit Japan's EPS hard, but the rebound in profits has been more subdued than originally thought. Overall, we suspect that the downside risks to global EPS have been rising. However, there appears to be a lot of bad news already priced in. Cheap valuations help limit the downside when pullbacks occur. Global equities are trading at 18x Cyclically Adjusted PE (CAPE) while the long-term average is 25x.

Our key regional and sector recommendations are summarised in Figure 54. The combination of relatively weak price performance and still strong EPS momentum provides us with an opportunity to upgrade the US to Overweight from Neutral. EPS trends here remain the strongest in the world. While there are obvious risks to profits in the US, we are not convinced an EPS recession will mean that other equity markets outperform given the low beta characteristics of the US. Within the US, our strategists like Diversified Financials and Tech Hardware as EPS momentum is strong and Utilities as valuations are appealing.

The upgrade of the US comes at the expense of Japan, which we downgrade from Overweight to Underweight. Our concerns on Japan focus around the profits rebound following the earthquake of 2011, which is proving to be drawn-out and

disappointing. The outlook for profits is not helped by our economists' forecast of a 2H 2012 recession and a strong Yen. Within Japan, our strategists are most cautious in Consumer Staples, Tech and Utilities.

Figure 53. Strategists' Forecast

Region	Index	Current Level*	End 2013 Target	Exp Gain (%)
US	S&P 500	1433	1615	13%
Pan Euro	DJ Stoxx600	274	285	4%
UK	FTSE 100	5896	6200	5%
Japan	Topix	754	920	22%
Asia x Jp	MSCI AsiaxJ	520	600	15%
Australia	S&P/ASX 200	4571	4900	7%
GEMs	MSCI EM	1006	1150	14%
Global	MSCI ACWI	334	360	8%

* 19/Oct/2012.
Source: Citi Research

Continental Europe is also one of our least favoured equity regions at the moment. The economic recession in the Eurozone is only part way through and our economists don't forecast growth to return for some time yet. This should continue to be a drag on EPS for some time to come. While Continental European equities are amongst the cheapest in the world, we don't think the valuation gap will close until we get nearer to the end of the economic and profits recession. Within Europe, our strategists are most cautious on some of the domestic-focused sectors such as Construction and Retailing.

Weakness in mining sector profits means that the UK too has entered an EPS recession (peak to trough fall of more than 10% in EPS). However, our forecasts of stability in China economic activity might mean this recession is relatively short-lived, compared to the rest of Europe. Meanwhile, UK equities are just as cheap as the rest of Europe. The Bank of England has been amongst the most aggressive of the central banks in expanding their balance sheet. 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.

In addition to the US, our favoured equity markets include Asia Pac ex Japan and Australia. Both markets should perform well as Chinese GDP growth stabilises, as our economists expect. Within Asia Pac ex Japan, our strategists like cyclical sectors such as Tech and Banks. We like Australia which benefits from easier 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 Mining sector.

Figure 54. 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
Health Care	Consumer Staples	Consumer Discretionary
IT	Energy ↓	Industrials
Materials ↑	Financials	Telecoms ↓
	Utilities ↑	
Sectors		
Overweight		Underweight
US - Div Fins		US - Capital Goods
Asia ex Japan - Banks		Europe - Construction
Japan - Banks		GEMs - Consumer Staples
Asia ex Japan - IT		Japan - Consumer Staples
Europe - Media		US - Media
GEMs - Materials		Japan - IT
Australia/UK - Mining		Europe - Retailing
Europe - Pharmaceuticals		Asia ex Japan - Telecoms
US - Tech Hardware		GEMs - Utilities
US - Utilities		Japan - Utilities

Source: Citi Research

Securitized Products Strategy

Mary Kane
+1 (212) 816-8409
mary.e.kane@citi.com

Stav Gaon
+1 (212) 816-3233
stav.gaon@citi.com

Jeff Berenbaum
+1 (212) 816-8399
jeffrey.s.berenbaum@citi.com

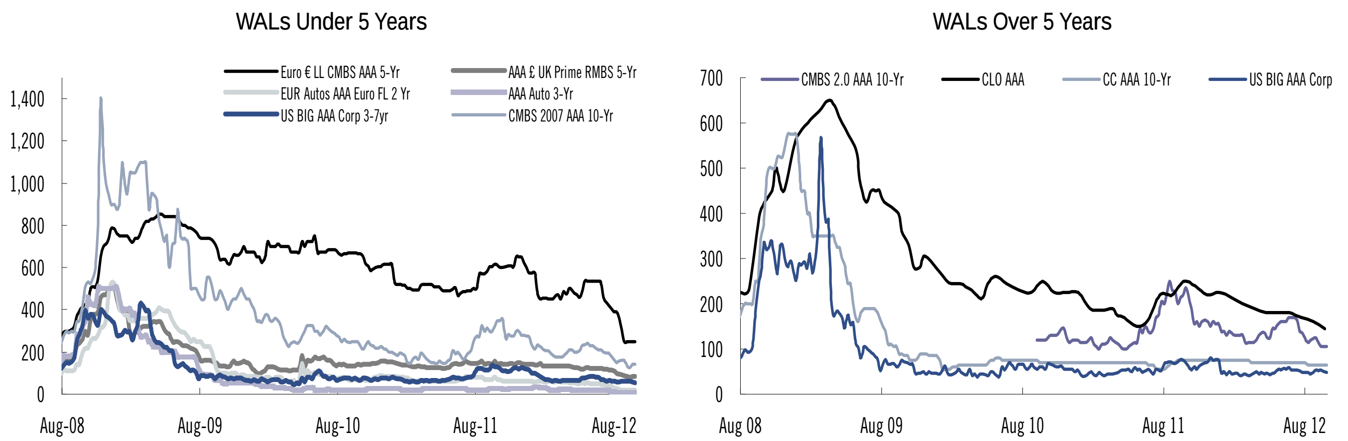
Counterintuitive Perhaps, but Rally Has More Life

Central Bank Policies to Sustain Technical Bid

Although currently tight senior securitized products spreads make us question how much further spreads could narrow, we think powerful technicals will stoke the generic markets with a bit more room to run. Off-the-run sectors are likely to have more tightening potential than the generics as the relentless search for yield continues to drive market activity. The power of central bank policy has been impressive in 2012, and its influence is likely to persist. Low interest rates have impelled the market to buy riskier assets. Moreover, investable mortgage and ABS assets have contracted, eliciting a significant technical bid for securities in the United States. It is the same story in Europe, where the ECB repo scheme and the Bank of England's FLS arrangement have also deprived the market of supply, driving spreads decisively tighter. The 5YR UK prime RMBS spreads tightened from roughly LIBOR + 120bp earlier in the year to LIBOR + 90bp.

The upcoming expiration of the FDIC's TAG insurance program will also likely sustain the technical rally for a while longer, and clearly, it will be very difficult to predict the market turning point. Investing in short, high quality securitized products is a strong defence against the not insignificant uncertainties the market still faces.

Figure 55. Selected Securitized Products Sectors — Spread Performance, Aug 08-Sept 12



Source: Citi Research

Choose "Security" as Further Rallying Potential Diminishes

While investing at current levels may feel like a painful trade to some, there are few short and high quality credit alternatives, and we recommend market weighting or slightly overweighting the ABS index. Low spread, low volatility sectors should present little downside risk when the market finally turns. In non-agency, for example, we continue to recommend a slight overweight sector; while the improvements in technical and fundamental assumptions have been partially priced in, we expect additional upside as investors assign higher probabilities to more optimistic housing scenarios.

Potential fulcrums for change include the upcoming US elections, lack of resolution of the looming US “fiscal cliff”, and the persistent European debt crisis. Faced with these uncertainties and relatively tight spread levels, there are several steps we recommend:

- **Calculated risk-taking**. We think there is genuine relative value in ‘secured’ assets compared to unsecured assets. For example, the 10YR triple-A credit card ABS picks up 43bp to 9YR Freddie Mac benchmark bonds, 51bp to 5YR Canadian covered bonds, 25bp to 7—10YR triple-As and 17bp to comparable 10YR DUS CMBS. At 65bp over swaps, triple-A credit cards also offer significant spread versus 30 YR Agency MBS (-35bp OAS). Comparable WAL credit card ABS is 15bp tighter than the CMBS 2.0 triple-As.
- **Trade “up in credit”**. In periods when credit spreads are converging towards all-time tight levels, the cost of buying top tier, prime names is insignificant when little to no market tiering is evident. This is a conservative and defensive strategy. For example, CMBS dupers’ tiering slopes have all flattened since August, when the 2007-vintage slope was still quite steep. As such, we recommend moving to top tier 2007 dupers in that sector.
- **Credit barbell**. We recommend combining a mix of generic, triple-A sectors with selected off-the-run ABS. The generic sectors have a bit more tightening potential, in our view, benefitting from central bank liquidity policies. Off-the-run sectors should outperform the generics, based on the enduring risk-on trade still prevalent in the market.

Sector Relative Value and Allocation Recommendations

Our securitized products strategists have mixed views on the market, ranging from bullish to neutral, and Figure 56 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 56. Sector Relative Value and Asset Allocation Recommendations — Selected Sectors, October 2012

Sector	Strategist Recommendation	Spreads Relative to Long-Term Averages	Comments
CABS	0+	Fair-to-expensive	Remain market weighted. Subordinate credit card and auto ABS are our top picks. We also like senior auto lease, private label credit card and dealer floorplan ABS.
CMBS	0	Fair	We recommend that investors consider moving back up in quality. In the absence of more spread pickup on the higher mark-to-market risk bonds, it makes sense to opt for cleaner paper.
Agency MBS	0	Tight	Fed is absorbing major portion of origination as part of open ended Agency MBS purchases, this should continue to support MBS basis.
European Securitized Products	+1	Cheap to Fair	We see further upside potential to European securitized product spreads, based on positive market technicals. Our top pick remains UK prime RMBS on this basis, but we expect other alternative high quality sectors to also benefit such as credit cards and UK BTL. We remain cautious on peripheral RMBS due to ongoing sovereign concerns.

Source: Citi Research

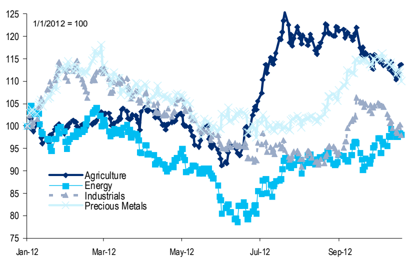
Commodity Outlook and Forecast

Daniel P. Ahn
(212) 723-3612
daniel.p.ahn@citi.com

Aakash Doshi
(212) 723-3872
aakash.doshi@citi.com

Commodities have failed to measurably appreciate in the past month despite the onset of a third round of quantitative easing in the US and loose monetary policy from major central banks globally. Notably, traded levels of the benchmark DJ-UBS index peaked year-to-date on September 14th—the day immediately following the announcement of QE3—having struggled since. Not surprisingly, the main benefactor has been the precious metals complex driven by gold which has also been aided by geopolitical disruptions in South Africa. After posting net redemptions of $1.3Bn in July, precious metal ETFs had nearly $5.3Bn in net inflows during August and September on expectations and fruition of further Fed accommodation. And preliminary estimates for October likely point to another large net inflow into the sector of more than $1Bn despite the recent retrenchment in prices.

Figure 57. Sector Performance, YTD



Sources: Bloomberg, Citi Research

Although economic data across the US, China and Eurozone have been improving in the fourth quarter, macro headwinds abound. Particularly daunting for industrial commodities is the risk of a deeper slowdown to global growth which the IMF highlighted as 'alarmingly high' in its October WEO. Similar to Citi, the official agency noted sovereign and bank credit issues in Europe, deceleration of Chinese growth and the looming fiscal cliff in the US as significant tail risks that could derail a modest global recovery. Accordingly, expectations are for commodity prices to remain tempered this quarter and into 2013.

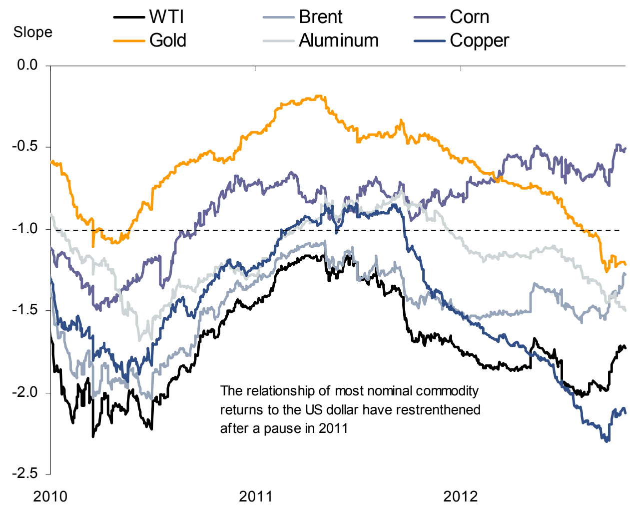
This renewal of attention on macroeconomic concerns not only contributed to risk-on/risk-off flows but also re-strengthened the relationship between nominal commodity prices with the US dollar exchange rate. Industrial metals such as copper and aluminum have seen its correlation to the US dollar reach historic lows, as concerns over Chinese growth have dominated the fundamental picture.

Figure 58. 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	2.8	3.4	N/A	2.5	2.3	2.8	2.7	2.6	3.2	3.3	3.4	3.5	3.4
Base Metals														
LME Aluminum	USD/MT	2,050	2,075	2,200	2,216	2,019	1,950	2,050	2,060	2,100	2,050	2,100	2,150	2,100
LME Copper	USD/MT	8,000	7,900	6,200	8,314	7,833	7,720	8,000	7,965	8,160	8,000	7,800	7,900	7,965
LME Lead	USD/MT	2,150	2,025	2,200	2,118	1,987	1,980	2,150	2,060	2,150	2,050	2,000	2,150	2,090
LME Nickel	USD/MT	20,000	21,740	20,000	19,721	17,228	16,500	20,000	18,360	21,050	22,475	21,000	22,550	21,770
LME Tin	USD/MT	22,000	23,250	18,600	22,986	20,619	19,450	22,000	21,265	22,500	23,000	23,500	22,000	22,750
LME Zinc	USD/MT	1,950	2,040	2,100	2,040	1,933	1,900	1,950	1,955	1,975	2,000	2,080	2,100	2,040
Precious Metals														
COMEX Gold	USD/T. oz	1,770	1,770	1,050	1,691	1,613	1,650	1,770	1680.0	1790	1750	1735	1720	1749
Silver	USD/T. oz	33	32	16.5	32.6	29.6	31.1	33.0	31.6	32.5	31.5	30.0	30.0	31.0
Platinum	USD/T. oz	1,650	1,675	1,775	1,604	1,505	1,468	1,650	1557.0	1650.0	1650.0	1700.0	1700.0	1675.0
Palladium	USD/T. oz	680	744	700	683	630	603	680	649.0	700.0	725.0	750.0	800.0	744.0
Bulk Commodities														
Hard Coking Coal (benchmark Asia)	USD/MT	170	205	200	235	215	225	170	211	190	200	210	210	203
Thermal Coal Asia (NEWC)	USD/MT	98	105	105	113	88	94	98	98	105	105	105	105	105
Iron Ore Spot (TSI)	USD/MT	105	122	81	142	139	113	105	125	115	122	122	120	120
Agriculture														
CBOT Corn	USd/bu	850	788	N/A	641	618	790	850	725	800	775	665	620	715
CBOT Wheat	USd/bu	925	953	N/A	643	641	870	925	770	975	930	850	850	900
CBOT Soybeans	USd/bu	1,875	1,645	N/A	1,272	1,426	1,690	1,810	1,550	1700	1590	1430	1400	1,530
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	78	N/A	93	81	75	71	80	N/A	N/A	N/A	N/A	85
Sugar#11	USd/lb	23	24	N/A	24.5	21.2	21.0	22.0	22.2	N/A	N/A	N/A	N/A	23.0
ICE Coffee	USd/lb	180	185	N/A	205	171	175	180	186	N/A	N/A	N/A	N/A	190
ICE Cocoa	USD/MT	2,800	2,600	N/A	2,308	2,221	2,450	2,700	2,420	N/A	N/A	N/A	N/A	2,500

Source: Citi Research, *subject to revision. These price targets were initially released for the 4Q'12 Commodity Update issued in mid-September

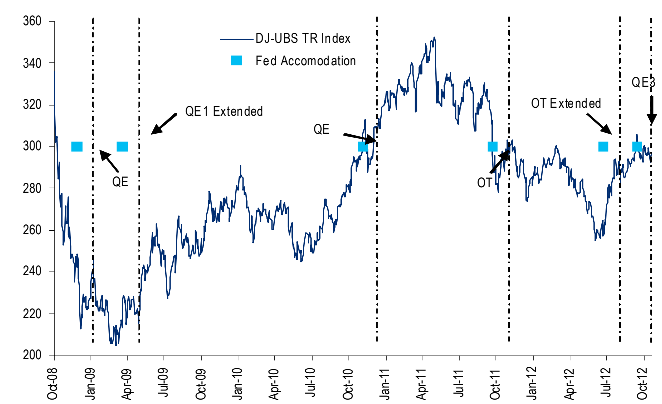
Figure 59. Regression slopes of nominal commodity prices to the US dollar



Source: Citi Research

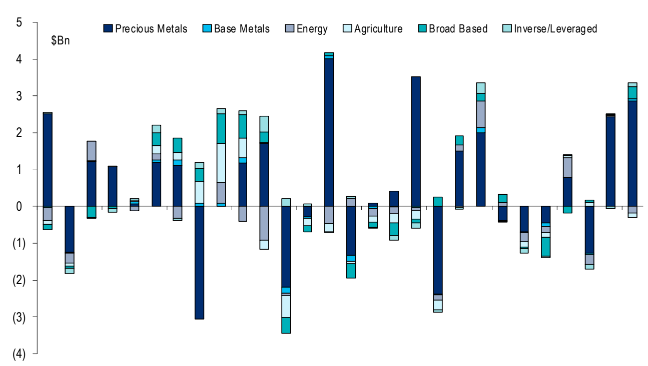
To be sure, supply disruptions in the petroleum market and low inventories in the grains complex remain an upside price risk. But for the major grains prices are likely to peak either later this quarter or the beginning of 1Q'13 prior to a bumper Latin American harvest that should ease global corn and bean balances. For crude oil, fundamentals point to looser balances and weaker prices despite the geopolitical heat in the Middle East. Oil consumption growth of just 1-m b/d in 2013 in Citi's outlook (driven almost entirely from non-OECD demand growth) arrives just as new non-OPEC output comes online from record North American supply as well as Black Sea sources after what was a relatively tight 3Q. World supply is further buttressed by high output levels of ~10-m b/d from Saudi Arabia and the Kingdom's overt support for prices at below $100/bbl.

Figure 60. Commodity Index and US Central Bank Easing



Sources: Bloomberg, FOMC, Citi Research

Figure 61. Commodity Exchange Traded Fund (ETF) Net Flows



Source: Citi Research

Citi Foreign Exchange Forecasts

Jeremy Hale
(44-20) 7986-9465
jeremy.hale@citi.com

Maya Bhandari
(44-20) 7986-1013
maya.bhandari@citi.com

Maximilian Moldaschl
(44-20) 7986-8753
maximilian.moldashl@citi.com

To see this piece in full please refer to Citi Foreign Exchange Forecasts - October 2012

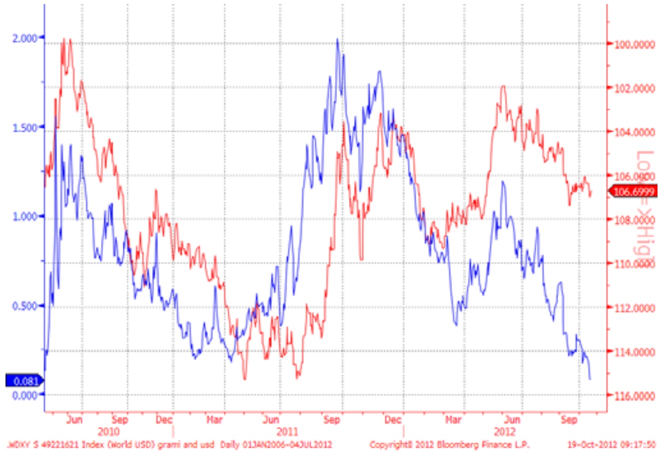
We see a number of key themes as important for all asset markets, including FX. An important one is the continuation of easy money from major Central Banks, led by the Fed's QE3 announcement in mid September but with support from several European Central Banks. QE is usually risk friendly, and USD negative, though a caveat is that the USD was already weak in the run up to Jackson Hole at the end of August and then through to the FOMC meeting in mid September. Since then, risk assets have range traded somewhat and the USD has seen similarly mixed performance, rallying against CEEMEA and G10 but losing ground to an average of EM Asian and Latam. We expect USD weakness to resume in the context of continued high levels of risk appetite over the 0-3m horizon, though other factors will likely muddy the waters.

One factor is the reluctance amongst major EM policy makers to allow QE to translate into significant USD downside. Via rates, intervention and capital controls, we see less room for USD declines than in the prior QE episode when inflation was more of a concern. On the other hand, the same China weakness that is translating into less upside for commodity prices than during QE2 will tend to undermine commodity centric currencies like AUD.

European tail risks seem to be subsiding fast and the rally in the EUR from July lows reflects this. Citi economists have reduced the probability they put on GREXIT and extended the timeline. There is a feeling that, ahead of German elections in September/ October 2013, even the core country policymakers do not want to risk rocking the boat. This will likely take EUR higher near term though the impact is likely to be partly reversed as the ECB continues to cut rates and expand its balance sheet even faster than the Fed. We have raised our medium term EUR/USD forecasts but the trend is still lower.

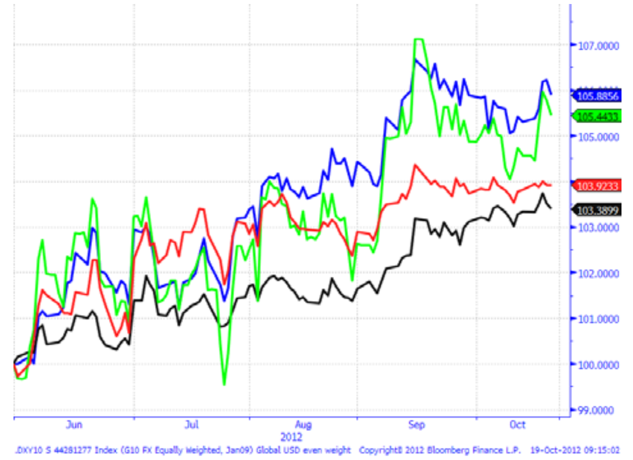
Overall, our forecasts show USD gains vs. global currencies over 6-12m of 2-3% though the near term trend is likely for USD weakness.

Figure 62. 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)
Sources: Citi Research and Bloomberg

Figure 63. USD vs. Regions, Normalised to 1 June=100. Blue=G10, Green=CEEMEA, Red=LATAM, Black=Asia



Sources: Citi Research and Bloomberg

Figure 64. 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	1.31	1.31	1.31	1.32	1.24	1.19	1.0%	-5.4%
Japanese yen	USDJPY	79	79	79	79	79	80	-0.3%	0.0%
British Pound	GBPUSD	1.60	1.60	1.60	1.61	1.59	1.51	0.3%	-0.8%
Swiss Franc	USDCHF	0.93	0.92	0.92	0.91	0.97	1.01	-1.7%	5.2%
Australian Dollar	AUDUSD	1.04	1.03	1.01	1.03	0.94	0.93	0.2%	-6.8%
New Zealand Dollar	NZDUSD	0.82	0.81	0.80	0.82	0.79	0.69	0.7%	-1.3%
Canadian Dollar	USDCAD	0.99	0.99	1.00	0.97	0.98	0.97	-2.0%	-1.7%
Dollar Index**	DXY	79.43	79.41	79.31	78.71	82.03	84.88	-0.9%	3.4%
G10 Crosses									
Japanese yen	EURJPY	104	104	104	104	98	95	0.7%	-5.4%
Swiss Franc	EURCHF	1.21	1.21	1.21	1.20	1.20	1.20	-0.7%	-0.5%
British Pound	EURGBP	0.81	0.81	0.82	0.82	0.78	0.79	0.7%	-4.6%
Swedish Krona	EURSEK	8.56	8.59	8.67	8.75	8.35	8.35	1.8%	-3.7%
Norwegian Krone	EURNOK	7.36	7.40	7.50	7.45	7.20	7.28	0.7%	-4.0%
Norwegian Krone	NOKSEK	1.16	1.16	1.16	1.17	1.16	1.15	1.1%	0.2%
Australian Dollar	AUDNZD	1.26	1.26	1.26	1.26	1.19	1.35	-0.5%	-5.5%
Australian Dollar	AUDJPY	82	81	80	81	74	74	-0.1%	-6.8%
Asia									
Chinese Renminbi	USDCNY	6.25	6.32	6.37	6.24	6.30	6.15	-1.2%	-1.1%
Hong Kong Dollar	USDHKD	7.75	7.75	7.75	7.75	7.76	7.75	0.0%	0.1%
Indonesian Rupiah	USDIDR	9629	9770	10162	9650	9850	9660	-1.2%	-3.1%
Indian Rupee	USDINR	53.9	54.8	57.0	48.5	52.5	52.3	-11.5%	-8.0%
Korean Won	USDKRW	1103	1109	1122	1100	1120	1000	-0.8%	-0.1%
Malaysian Ringgit	USDMYR	3.05	3.07	3.12	3.04	3.15	3.11	-1.1%	0.9%
Philippine Peso	USDPHP	41.4	41.4	41.4	41.1	42.0	40.8	-0.8%	1.3%
Singapore Dollar	USDSGD	1.22	1.22	1.22	1.21	1.23	1.24	-0.8%	0.9%
Thai Baht	USDTHB	30.7	30.9	31.3	30.4	31.5	29.9	-1.5%	0.8%
Taiwan Dollar	USDTWD	29.2	29.2	28.9	29.2	29.6	28.2	0.0%	2.3%
EMEA									
Czech Koruna	EURCZK	24.8	24.8	24.9	25.0	25.6	24.7	0.6%	2.8%
Hungarian Forint	EURHUF	279	282	291	290	300	290	2.7%	3.1%
Polish Zloty	EURPLN	4.11	4.16	4.27	4.12	4.20	3.90	-0.9%	-1.6%
Israeli Shekel	USDILS	3.82	3.84	3.87	3.90	4.00	4.00	1.6%	3.3%
Russian Ruble	USDRUB	30.8	31.3	32.7	30.4	33.4	34.5	-2.8%	2.3%
Russian Ruble Basket		35.1	35.6	37.2	34.8	37.0	37.5	-2.3%	-0.6%
Turkish Lira	USDTRY	1.80	1.82	1.90	1.80	1.84	1.91	-1.1%	-2.9%
South African Rand	USDZAR	8.65	8.77	9.09	9.00	9.15	9.50	2.6%	0.7%
LATAM									
Brazilian Real	USDBRL	2.03	2.05	2.13	2.00	2.05	2.05	-2.6%	-3.8%
Chilean Peso	USDCLP	473	480	496	470	490	490	-2.0%	-1.2%
Mexican Peso	USDMXN	12.9	13.0	13.4	12.5	12.9	12.5	-3.7%	-3.4%
Colombian Peso	USDCOP	1796	1822	1880	1800	1850	1850	-1.2%	-1.6%

* market data including spot as of 10:05 AM London time on 19-Oct-2012
** 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

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