Economics

22 June 2011 │ 76 pages

Global Economic Outlook and Strategy

June 2011

- Recent economic data for advanced economies generally have remained soft, and this month we are downgrading our growth forecasts for 2011-12 combined in the US, euro area, UK, Switzerland, Sweden, Australia, Denmark and Canada. Even so, markets may be extrapolating the recent soft patch too far and we expect stronger growth in the US and Japan in Q3 this year. Moreover, despite the modest outlook for advanced economies, we stress that the strong EM growth should keep global growth buoyant, at 3%-4% this year and 2012 — and even higher thereafter — well above the longrun norm of just below 3% YoY (PPP-weighted, we expect growth of 4%-5% YoY). We still expect the ECB to hike at the upcoming July meeting, but have postponed the expected start of Fed hiking to Q3-2012 (Q1-2012 previously) and scaled back our forecasts for tightening by the ECB and UK MPC.

- For Greece, we expect extra liquidity assistance and some form of semi-coercive rollover to ensure there is no near-term “hard restructuring” (ie haircuts to principal or coupon). Nevertheless, we believe the chance of eventual debt restructuring (with haircuts) is high in Greece, Portugal and Ireland. Spain’s medium-term economic and fiscal prospects are weaker than markets currently price in.

- Global Economics Essay (see page 14): World trade will both expand markedly and be transformed by 2050. World trade is set to rise from \$37trn in 2010 to about \$150trn in 2030 (in constant USD) and to about \$370trn by 2050. Intra-emerging markets (EM) trade is set to overtake trade within advanced economies (AEs) by 2015 and AE-EM trade by 2030.

- Against this backdrop, Citi strategists stress near-term uncertainties to a range of risk assets, especially commodities. However, Citi equity strategists expect higher earnings to lift global equities by about 15% by year end, while Citi rate strategists believe government bond yields in the US, core EMU and Japan will all rise in H2.

Figure 1. Currency and Interest Rate Forecasts (End of Period, Unless Specified), as of 22 Jun 2011

	22 Jun 2011	3Q 11 Forecast	4Q 11 Forecast	1Q 12 Forecast	2Q 12 Forecast	3Q 12 Forecast
United States: Federal Funds	0.25	0.25	0.25	0.25	0.25	0.75
10-Yr. Treasuries (Period Ave.)	2.98	3.15	3.35	3.40	3.50	3.60
Euro Area: US$/€	1.43	1.37	1.41	1.44	1.47	1.44
Euro Repo Rate	1.25	1.50	1.75	2.00	2.00	2.25
10-Yr. Bunds (Period Average)	2.99	2.95	3.35	3.65	3.80	3.90
Japan: Yen/US$	80	79	81	82	83	84
Call Money	0.10	0.10	0.10	0.10	0.10	0.10
10-Yr. JGB (Period Average)	1.12	1.30	1.40	1.40	1.30	1.50

Source: Citi Investment Research and Analysis

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

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Figure 2. Forecast Highlights and Changes from Last Month

■ Global	Recent economic data for advanced economies generally have remained soft, and we are further downgrading our growth forecasts across a range of advanced economies. Even so, markets may be extrapolating the recent soft patch too far and we expect stronger growth in the UE and Japan. Moreover, despite the modest outlook for advanced economies, we stress that strong EM growth should keep global growth buoyant, at 3%-4% this year and 2012 — and even higher thereafter
United States	We have pushed back the start of Fed rate hikes to the third quarter of 2012. A reviving auto sector and a boost to consumers from steadying energy prices should lift near-term growth. But the first-half slowing has stalled the decline in unemployment and, along with a chance of greater fiscal tightening, that may keep monetary policy on hold longer.
■ Euro Area	We have revised down our GDP forecast for 2011 and 2012 somewhat to 2.0% and 1.4% respectively, partly due to lower global demand. However, the impact of fiscal and monetary tightening is the main driver for the growth moderation in coming quarters. Despite a likely second Greek package and the extension of the EFSF, the sovereign debt crisis continues and we expect debt haircuts in coming years. The ECB is likely to continue with rate hikes, but we now expect only 2 hikes in 2012.
■ China	Monetary conditions have tightened meaningfully in recent months, with notable increases in borrowing costs despite the lack of benchmark rate hikes. However, inflation risks remain and investment growth continues to accelerate. Power shortages and supply chain disruptions seem to have passed their worst. As such, we continue to expect two more rate hikes by yearend.
■ Japan	We expect the economy to rebound sharply in the second half of 2011 after negative growth in 1Q and 2Q, as supply chains normalize and reconstruction demand materializes. Depending upon policy developments, however, potentially large burden hikes for the household sector, including income tax hikes to fund reconstruction, may slow consumer spending meaningfully in 2012.
■ United Kingdom	We have again downgraded our growth forecasts amidst high inflation, and now expect a more gradual path of MPC tightening — with a continued inflation overshoot.
■ Canada	The Bank of Canada's trajectory for inflation and closure of the output gap continues to suggest some modest tightening later this year and early next. However, we now anticipate resumption of interest rate normalization in October instead of July, given the temporary lull in near-term activity and lingering concerns about the Euro Area sovereign debt woes.
■ Australia	Softer activity data and some moderation in activity in Australia's largest trading partner China have pushed out the forecast for the next RBA rate rise until November.
■ Emerging Asia (ex China)	Asia's growth is proving resilient, but we worry about inflation, especially if central banks use the growth slowdown to delay much monetary policy normalization. We have pushed back the timetable for rate hikes in the Philippines, and Indonesia continues to sound relatively more dovish. However, Korea's recent hike was a surprise, and India and Thailand remain hawkish. Asia FX has been relatively resilient to the risk off environment, suggesting central banks are still worried about inflation.
■ CEEMEA	On the whole, events this month unfolded with very little surprise. Poland's MPC hiked rates by 25bps as expected, but issued a more balanced statement than in previous months. We think that going forward, though the MPC is likely to continue to tighten monetary policy, it will probably do so at a slower pace. In Turkey, the widening current account remains a top concern and we will closely watch the measures the new government will table to address this issue. We think recent concerns about the capital outflows in Russia are overdone.
■ Latin America	While we believe the deceleration in Latin America's growth pace is the result of tighter fiscal and monetary policies in the region, we acknowledge that the external backdrop is introducing a source of downward risk, albeit a limited one. We identify two main contagion channels from the sequel of peripheral Europe's fiscal woes, if the situation were to worsen. The first and most important is the effect on commodity prices, of which the region is a net exporter. The second source of vulnerability is financial in nature, as lower asset prices and higher volatility could have an impact on growth. Unsurprisingly, the most vulnerable countries are Argentina and Venezuela, as they are the most reliant on commodity exports to keep their economies on track.

Source: Citi Investment Research and Analysis

Overview — Assessing the Downside Risks

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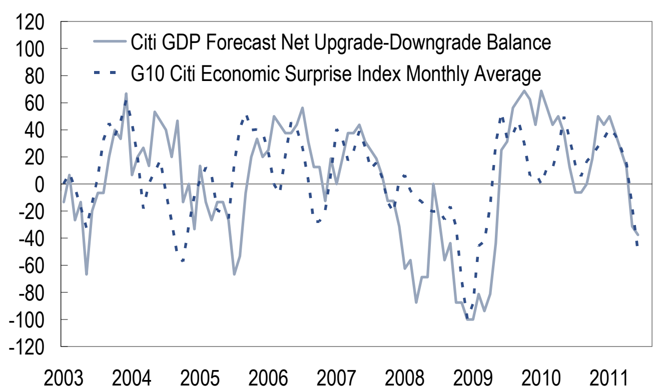
We continue to expect strong global growth this year and the next, but we are again downgrading growth forecasts in a range of advanced economies, and the divide between winners and losers in the growth outlook is becoming even more pronounced. The ECB remains likely to hike by 25bp at the upcoming July meeting and, despite the worsening sovereign crisis, the ECB will probably hike again later this year and again in early 2012 (to 2.00%). But, we now expect a slower pace of tightening thereafter. By contrast, we have postponed the start of the expected Fed hiking cycle, and now anticipate this will not occur until Q3-2012.

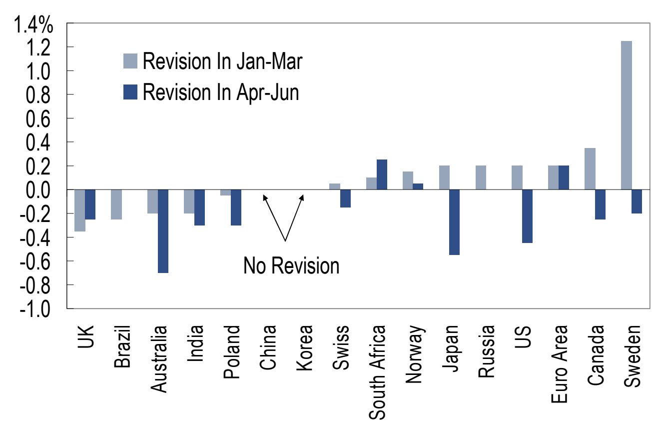
Recent economic data for advanced economies generally have remained soft, with the Citi G10 Economic Surprise Index (CESI) in June at its most negative since Nov-Dec 2008. In turn, we are further downgrading our growth forecasts across a range of advanced economies, with downgrades this month to our GDP growth forecasts for 2011-12 combined in the US, euro area, UK, Switzerland, Sweden, Australia, Denmark and Canada. We also have trimmed our growth forecasts for Romania and Singapore, but are not revising down growth forecasts in the major emerging markets. We noted last month that the 3-month average of our GDP revisions across 16 major economies had turned markedly negative. June sees the biggest downward bias to our growth forecasts of any month since March 2009, pushing the 3-month average for the direction of revisions further into negative territory.

Figure 3. Global — Balance Between Citi Growth Forecast Upgrades and Downgrades, and Citi Economic Surprise Index, 2003-11



Note: We compare revisions to our growth forecasts for the current and next year in the US, Euro, Japan, UK, Australia, Brazil, Canada, China, India, Korea, Norway, Poland, Russia, Sweden, South Africa, Switzerland.
Source: Citi Investment Research and Analysis

Figure 4. Global — Changes in 2011-12 GDP Growth Forecasts Since January 2011



Sources: IMF and Citi Investment Research and Analysis

A key issue for the outlook is whether the recent dive in these cyclical guides is just a soft patch or the start of a more protracted slowdown. We lean more to the first, but do expect that economic growth in major advanced economies — while not disastrous — will remain relatively lacklustre overall.

Part of the recent slowdown is probably temporary, with the unusually heavy snow in the US in Q1, erosion of real incomes by high oil prices in February-April and then supply-chain disruptions stemming from Japan since March. These supply chain effects appear to be more pronounced in the UK and US than the euro area, consistent with the fact

that car output by Japanese-owned companies is a higher share of the total in the US and UK. In the US, output of autos and light trucks (seasonally adjusted) fell 7.0% below the Q1 average in April-May. In the UK, car output rose 13% YoY in Q1 but then fell 8.5% YoY in April-May. However, these effects are likely to prove temporary. Japanese nameplate car and truck production jumped 33.5% in the U.S. last week and has nearly doubled (+95%) in the past two weeks. The latest week's production level was 79% of the end-of-March level. Japanese manufacturing companies expect that output rose 8% MoM in May, with output of transport machinery up 35.7% MoM. Even if those hopes prove slightly premature, we expect Japan's GDP to rebound by about 7.0% QoQ SAAR in Q3, with rebounds in other countries where supply-chain effects have been severe.

Figure 5. Selected Countries — Industrial Production Data and Forecasts (Pct.), 2010-12F

	2010	2011F	2012F
World	**9.4%**	**4.8%**	**5.4%**
United States	5.3	4.1	3.8
Japan	16.6	-0.5	7.2
Euro Area	7.4	4.7	2.9
United Kingdom	2.0	0.5	1.3
Canada	4.6	1.9	0.7
China	15.5	13.6	12.5
India	7.9	7.5	8.3
Korea	16.2	10.0	9.6
Brazil	10.5	3.5	4.5

Source: Citi Investment Research and Analysis

However, the drop in our growth forecasts does not just reflect weakness in Q1 and Q2, but we have also trimmed future growth expectations. First, confidence in recovery is sufficiently fragile that even disruptions that prove temporary can have a more lasting effect on growth, by interrupting the path to improving financial conditions and reinforcing the lingering mood of caution among businesses.

Second, uncertainties from the euro area sovereign crisis are unlikely to fade quickly. We continue to expect that Greece, Portugal and Ireland (GPI) will all have to implement sovereign debt restructuring (including haircuts) in coming years, perhaps even several phases of restructuring. But, we assume there will be only a "soft restructuring" this year, with some form of semi-coercive rollover of debt by some banks. However, the ability of these governments, in combination with the EU/IMF/ECB troika, to "kick the can down the road" to eventual "hard restructuring" (ie with haircuts to principal) without considerable near-term disruption looks increasingly doubtful.

At the time of writing, the Greek government has won its parliamentary confidence vote, and we assume the government will also win the vote on approval for further austerity measures, hence unlocking further near-term assistance from the troika. But the key problem is that all of the rescue packages are essentially liquidity assistance (ie loans at interest rates above those for core country debt) although Greece (and probably also Ireland and Portugal) is manifestly insolvent from a long-term perspective[1]. Fiscal tightening on the necessary scale will probably be economically unsustainable (it would crush the economy and hence fail to cut the deficit as far as needed) or would be politically unsustainable. Even if aggressive supply-side reforms could be implemented, debt/GDP ratios will have spiralled by the time the benefits start to emerge.

So the current rescue packages buy time, but also leave the GPI countries on a path that appears to point to eventual debt restructuring. However, the anticipation of the future losses and disruption from future restructuring tightens financial conditions for the euro area as a whole now. This caps growth prospects for the euro area as a whole, and other fiscally-weak countries, making it harder to break out of the current impasse of fiscally-weak sovereigns and capital-short banks. For example, investors may well assume that any significant rise in euro area bank profits will simply increase the willingness of European policymakers to accept greater private sector burden sharing, hence further impeding banks' ability to attain the necessary rise in capital ratios. The current approach of liquidity assistance for the GPI countries — without confidence that they can ever return to fiscal sustainability — may simply lead to zombie economies and zombie banks in the GPI countries, with a prolonged restraint on overall euro area growth from cautious banks and non-supportive financial conditions. In order to break out of this, what would be needed (in our view) is either; (1) policy measures and assistance that makes restructuring unlikely; or (2) a framework within which sovereign debt restructuring can occur without causing a systemic crisis. Neither is likely near-term.

[1] See "The Debt of Nations", *Global Economics View,* Willem Buiter et al, 7 January 2011, Citi.

Third, the strong demand for commodities related to EM industrialization and urbanization imparts an upward bias to global commodity prices that will probably cap the upside in GDP growth for advanced economies. To be sure, the recent signs of slowdown in advanced economies have brought commodity prices a bit lower, but — with strong EM demand — oil prices are still higher than six months ago. Conversely, recent experience suggests that if advanced economies start to grow meaningfully above trend, then (unless EM countries slow very sharply) prices of oil and other commodities will probably surge. This would erode real incomes and (via higher headline inflation) probably would induce some central banks (eg the ECB) to accelerate monetary tightening, hence capping growth in advanced economies.

Even so, markets may be extrapolating the recent softer patch too far, especially for the US and core euro area countries. We expect US growth to rise from about 1.5% QoQ SAAR in Q2 to 3%-3½% QoQ SAAR in H2, with the jobless rate heading below 9% by yearend. Moreover, despite the modest outlook for industrial country growth, we stress that the outlook for global growth remains strong, at 3%-4% this year and 2012 — and even higher thereafter — well above the longrun norm of just below 3% YoY (PPP-weighted, we expect growth of 4%-5% YoY). But, as we noted last month, the current global boom is unique, in that the countries that are growing strongly sum to only about 40% of global GDP. By contrast, in the global booms of the mid 80s, mid 90s and mid 2000s, the countries that were growing strongly summed to comfortably more than half of global GDP — and usually amounted to 70%-80% of global GDP[2].

With softer growth, we have scaled back our rate forecasts for the US, euro area and UK in recent weeks. The ECB remains likely to hike again at the July meeting (to 1.5%), given the "strong vigilance" emphasised at the June meeting. We believe the ECB is virtually on auto-pilot near-term, and intends to hike rates to about 2.0% by mid-2012 unless the economy weakens sharply. The ECB believes that keeping ultra-low rates now the recession is over is risky because of risks of fuelling a future credit boom or lifting inflation expectations. But, beyond about 2.0%, we expect that policy will be more sensitive to economic conditions, and — with lower growth prospects — we have slightly scaled back our expected tightening in 2012, and forecast 2.0% rates in Q3-2012 (2.25% previously). By contrast, the US Fed remains likely to keep rates low for an extended period before normalizing rates and, with the recent soft patch and uncertain financial conditions, we recently delayed our forecast for the first hike from Q1 2012 to Q3-2012[3]. For the UK, we now expect just one hike in H2 this year (two hikes previously), with rates at end-2012 forecast at 1.50% (2.0% previously)[4]. By contrast, we still expect further tightening across many emerging markets in coming months, but also believe this tightening will probably not be sufficient to derail growth or seriously restrain inflation in 2012-13.

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

[3] See "*Resetting the Policy Clock*", Bob DiClemente, Comments on Credit, 10 June 2011, Citi.

[4] See "*The Good, The Bad and the Ugly*", Michael Saunders, Sterling Weekly, 17 June 2010, Citi.

Figure 6. Global — Summary of Views of Citi's Market Strategists

	Equities	G10 Rates	Credit	Securitized Products	FX	Global Macro Strategy
Overall View	Constructive, 15% upside to the end of 2011	Recent rally has broken bear-trend but higher yields still expected in H2	Slowly getting less bearish but correction wider in spreads has further to run	Market weight	Bullish $ short term. Bearish medium to long term	Cautious risk assets short term, commodities especially vulnerable
Most-Favoured Region/Sector	EM, Japan/ IT, Materials, Industrials	30yr GBP	Core BB and BBBs, prefer CDS to bonds	US CMBS senior tranches	AUD, EUR, GBP, EM in long term	Short Oil, S&P 500, EUR/USD and long implied equity vol
Least-Favoured Region/Sector	Eur x UK/ Financials, Cons. Staples, Telecoms	3yr EUR	Undiversified periphery corporates	Spanish & Irish RMBS	USD, JPY, CHF	European financials
Key Risks	Sharp rise in bond yields, global profits recovery is a false dawn	EMU default, US fiscal crisis, sharp decline in risk assets	Sovereign contagion, early corporate releveraging	Regulation	$ rally, which we expect short term, extends for longer	EMU periphery, US fiscal policy, reduced liquidity support to markets, slower than expected growth

Source: Citi Investment Research and Analysis

Figure 7. Selected Countries — Economic Forecast Overview (Percent) 2010-2015F

	GDP Growth						CPI Inflation						Short-Term Interest Rates					
	2010	2011	2012	2013	2014	2015	2010	2011	2012	2013	2014	2015	2010	2011	2012	2013	2014	2015
Global	**4.1**	**3.4**	**3.8**	**3.8**	**4.2**	**4.1**	**2.7**	**4.0**	**3.3**	**3.3**	**3.1**	**3.3**	**2.07**	**2.71**	**3.28**	**3.75**	**4.13**	**4.32**
Based on PPP weights	*4.9*	*4.2*	*4.4*	*4.5*	*4.9*	*4.7*	*3.4*	*4.6*	*3.8*	*3.8*	*3.5*	*3.6*						
Industrial Countries	**2.5**	**1.9**	**2.4**	**2.3**	**2.9**	**2.7**	**1.4**	**2.7**	**1.8**	**2.2**	**2.0**	**2.3**	**0.65**	**0.82**	**1.34**	**2.09**	**2.79**	**3.23**
United States	**2.9**	**2.5**	**2.8**	**3.0**	**4.5**	**4.0**	**1.6**	**3.1**	**1.7**	**2.0**	**2.0**	**2.2**	**0.25**	**0.25**	**0.55**	**1.85**	**2.85**	**3.50**
Japan	**4.0**	**-0.5**	**3.1**	**1.0**	**1.5**	**0.7**	**-0.7**	**0.5**	**0.5**	**2.5**	**0.5**	**3.5**	**0.10**	**0.10**	**0.10**	**0.13**	**0.48**	**0.83**
Euro Area	**1.6**	**2.0**	**1.4**	**1.6**	**1.7**	**1.7**	**1.6**	**2.7**	**2.1**	**2.1**	**2.3**	**1.9**	**1.00**	**1.40**	**2.15**	**2.75**	**3.30**	**3.60**
Canada	3.2	2.8	2.6	2.5	2.9	3.3	1.8	2.9	2.1	2.0	2.0	2.0	0.69	1.13	2.19	2.25	2.75	3.25
Australia	2.7	1.4	4.0	4.4	4.1	3.8	2.8	3.1	2.7	3.1	3.0	2.6	4.44	4.81	5.25	5.50	6.00	5.50
New Zealand	1.4	1.5	3.4	2.5	2.8	3.0	2.3	4.3	2.9	2.5	2.4	2.6	2.81	2.56	3.50	4.50	6.00	5.50
Germany	3.5	3.5	2.5	2.2	2.1	2.0	1.1	2.4	2.1	2.1	2.2	2.3						
France	1.4	2.0	1.6	1.6	1.8	1.8	1.7	2.2	2.0	2.8	1.6	1.6						
Italy	1.2	0.8	1.0	0.9	0.9	0.9	1.6	2.9	2.7	1.9	1.9	1.9						
Spain	-0.1	0.3	0.2	0.9	1.2	1.3	2.0	3.1	1.5	1.5	1.7	1.7						
Greece	-4.4	-4.1	-2.5	0.0	0.5	1.0	4.7	3.4	1.8	1.3	1.4	1.5						
Portugal	1.3	-2.1	-1.9	-0.5	0.6	1.0	1.4	3.7	0.9	0.7	1.1	1.0						
Netherlands	1.8	2.5	1.5	2.1	1.7	1.9	1.3	2.1	1.8	1.9	1.8	2.0						
Denmark	2.1	1.7	2.1	2.0	2.4	2.3	2.3	2.4	2.1	2.1	2.2	2.0	1.05	1.45	2.30	3.00	3.55	3.85
Norway	2.1	3.1	3.5	3.0	2.7	2.7	2.4	1.8	2.2	2.3	2.5	2.5	1.91	2.24	3.42	4.48	4.80	4.80
Sweden	5.4	4.8	3.3	3.0	2.6	2.5	1.2	3.2	2.4	2.4	2.0	2.0	0.50	1.88	3.06	3.91	4.00	4.00
Switzerland	2.6	2.5	2.6	2.2	1.9	1.7	0.7	1.5	1.2	0.7	0.6	0.8	0.22	0.25	0.63	1.13	1.63	2.13
United Kingdom	1.3	1.4	2.2	2.2	2.5	2.9	3.3	4.5	3.3	2.7	3.0	2.9	0.50	0.54	1.13	1.77	2.44	3.29
Emerging Markets	**7.2**	**6.3**	**6.1**	**6.3**	**6.3**	**6.2**	**5.3**	**6.4**	**5.8**	**5.2**	**4.7**	**4.7**	**5.02**	**6.15**	**6.57**	**6.42**	**6.19**	**5.92**
China	**10.3**	**9.2**	**9.0**	**8.8**	**8.5**	**8.0**	**3.3**	**5.0**	**4.0**	**3.8**	**3.5**	**3.5**	**2.30**	**3.38**	**3.75**	**3.75**	**3.75**	**3.75**
Hong Kong	7.0	5.8	5.5	4.0	4.0	4.0	2.4	5.5	3.3	3.0	3.5	3.5	0.25	0.27	0.51	2.00	3.50	4.00
India	8.5	8.1	8.4	8.8	8.8	8.9	8.6	8.6	7.5	6.0	6.0	6.0	5.96	8.00	7.50	7.50	7.50	7.50
Indonesia	6.1	6.5	6.6	6.7	6.9	7.0	5.1	5.8	6.4	6.8	6.8	6.8	6.50	6.81	7.44	7.50	7.75	7.75
Korea	6.2	4.3	4.6	4.4	5.0	4.2	3.0	4.0	3.4	2.8	3.2	3.0	2.68	3.72	4.46	4.75	5.00	5.15
Singapore	14.5	7.0	5.0	7.1	7.1	7.1	2.8	4.3	3.2	2.5	2.5	2.5	0.56	0.40	0.75	2.30	2.80	3.20
Czech Republic	2.3	2.2	2.6	4.0	4.2	3.8	1.5	2.0	2.6	1.8	2.2	2.0	0.83	0.90	1.69	2.54	3.33	3.50
Hungary	1.2	3.0	3.4	2.9	2.9	2.9	4.7	4.6	3.9	3.1	3.0	3.1	5.48	6.00	6.50	6.60	6.02	6.00
Poland	3.8	4.2	3.9	3.7	3.4	3.4	2.7	4.2	2.9	2.6	2.5	2.5	3.50	4.31	5.00	5.00	5.00	4.63
Romania	-1.3	2.0	3.8	4.7	4.8	4.8	6.1	6.7	4.0	3.0	3.0	3.0	6.54	6.25	5.13	5.00	5.00	5.00
Russia	4.0	4.3	4.1	4.1	4.2	4.3	6.9	8.8	7.3	5.9	5.5	5.5	7.75	8.25	7.50	6.00	6.00	5.50
Turkey	8.9	5.6	3.8	5.2	5.0	5.0	8.6	5.9	6.8	5.8	5.3	5.0	6.50	7.75	9.00	8.00	7.50	7.50
Nigeria	7.2	6.8	6.5	6.5	6.9	7.2	13.7	11.1	10.9	10.5	10.3	9.5	6.08	7.96	9.00	10.00	10.50	10.00
South Africa	2.8	3.9	3.8	4.1	4.2	4.3	4.1	4.8	5.7	6.0	5.7	5.5	6.41	5.75	7.25	8.50	8.75	8.50
Argentina	9.2	7.0	4.0	3.0	3.0	3.0	18.4	27.5	25.0	25.0	15.0	15.0	10.19	11.70	13.68	13.39	11.00	9.00
Brazil	7.5	4.0	4.5	4.5	4.5	4.5	5.0	6.6	5.5	4.5	4.0	4.0	9.80	11.63	12.50	11.75	10.25	9.00
Mexico	5.4	4.8	3.8	3.5	3.2	3.2	4.2	3.5	4.0	3.9	3.9	3.8	4.40	4.50	5.54	6.81	7.00	7.00
Venezuela	-1.4	3.5	3.9	2.3	2.5	2.4	28.2	26.8	26.5	28.0	26.0	29.0	14.52	19.40	20.40	21.00	21.00	21.00

Source: Citi Investment Research and Analysis

Figure 8. Selected Countries — Economic Forecast Overview (Percent) 2010-2015F

	Current Balance (Pct of GDP)						Fiscal Balance (Pct of GDP)						Government Debt (Pct of GDP)					
	2010	2011	2012	2013	2014	2015	2010	2011	2012	2013	2014	2015	2010	2011	2012	2013	2014	2015
Global	0.3	0.2	0.1	0.1	0.1	0.1	-5.7	-5.1	-3.9	-3.2	-2.7	-2.4	69	71	70	70	69	68
Based on PPP weights	0.6	0.3	0.1	-0.1	-0.2	-0.2	-5.2	-4.8	-3.9	-3.2	-2.8	-2.6						
Industrial Countries	-0.8	-0.7	-0.6	-0.6	-0.5	-0.3	-7.3	-6.7	-5.1	-4.0	-3.3	-3.0	88	94	95	96	96	96
United States	-3.2	-3.1	-3.0	-3.0	-3.0	-3.0	-8.9	-8.8	-7.0	-5.4	-4.3	-4.3	62	70	73	76	76	76
Japan	3.6	2.3	2.5	3.0	3.2	3.3	-9.8	-10.3	-8.8	-8.5	-8.2	-7.7	225	237	239	244	248	252
Euro Area	-0.4	-0.4	-0.4	-0.4	-0.4	-0.3	-6.0	-4.3	-3.2	-2.5	-2.2	-1.8	85	87	87	87	87	86
Canada	-3.1	-2.1	-1.2	-0.6	0.2	1.2	-2.2	-1.8	-1.1	-0.5	0.0	0.2	34	33	33	32	30	29
Australia	-2.6	-1.8	-2.8	-6.3	-6.0	-5.5	-4.2	-3.6	-1.5	0.2	0.2	0.3	3	6	7	7	6	6
New Zealand	-2.3	-0.7	-5.5	-5.0	-5.5	-5.7	-3.3	-8.4	-4.7	-1.8	-0.3	0.5	14	21	26	29	30	30
Germany	5.7	5.4	5.2	5.1	5.2	5.5	-3.3	-1.8	-0.7	0.1	0.5	0.5	88	87	85	82	79	76
France	-1.8	-0.8	-0.7	-0.4	-0.2	0.0	-7.0	-5.8	-4.3	-3.3	-3.0	-2.5	82	85	86	86	86	86
Italy	-3.5	-4.3	-4.4	-4.5	-4.6	-4.7	-4.6	-4.1	-3.7	-3.9	-3.8	-3.9	119	121	121	122	123	124
Spain	-4.5	-3.7	-2.0	-1.6	-1.4	-1.3	-9.3	-6.9	-5.2	-4.5	-4.1	-3.9	60	69	74	77	80	82
Greece	-10.4	-7.3	-4.4	-2.6	-2.6	-3.4	-10.5	-10.0	-9.7	-8.4	-8.2	-7.5	143	161	174	181	187	191
Portugal	-10.5	-8.3	-6.2	-4.7	-3.5	-2.3	-9.1	-6.4	-5.8	-5.8	-5.5	-5.1	93	104	114	119	122	124
Netherlands	7.7	7.3	6.9	6.8	6.7	6.7	-5.4	-2.9	-2.3	-2.0	-1.2	0.0	64	64	65	64	63	61
Denmark	5.1	5.0	4.2	3.3	2.8	2.6	-2.7	-2.8	-2.5	-2.0	-1.3	0.0	44	46	47	46	45	43
Norway	12.4	13.5	15.0	15.5	16.0	16.0	9.7	9.6	12.5	13.0	15.0	19.0	NA	NA	NA	NA	NA	NA
Sweden	6.3	6.4	6.4	6.5	6.7	6.9	0.0	0.4	1.6	2.6	2.6	3.9	39	36	32	30	30	29
Switzerland	14.6	14.5	12.4	12.8	14.1	15.4	0.2	0.3	0.6	0.6	0.9	0.9	55	53	51	50	48	47
United Kingdom	-2.5	-0.5	-0.1	0.5	1.2	1.8	-9.7	-8.4	-6.5	-4.8	-3.3	-2.0	75	80	83	84	83	80
Emerging Markets	2.5	1.7	1.2	1.1	0.9	0.8	-2.5	-2.3	-2.0	-1.8	-1.7	-1.6	29	29	28	28	28	28
China	5.3	4.2	3.5	2.9	2.3	1.7	-1.6	-2.0	-2.0	-2.0	-2.0	-2.0	21	20	21	21	21	21
Hong Kong	6.6	9.1	10.0	10.0	10.0	10.0	4.2	2.9	3.0	2.5	2.0	2.0	1	1	2	2	3	3
India	-2.0	-2.7	-2.2	-1.8	-1.3	-0.7	-7.2	-7.9	-7.1	-7.0	-6.0	-6.0	67	66	64	63	60	58
Indonesia	0.9	0.5	0.1	-0.5	-0.7	-0.7	-0.6	-1.5	-1.5	-1.5	-1.3	-1.0	26	26	25	24	23	23
Korea	2.8	1.7	1.1	0.4	-0.4	-0.3	1.4	0.8	1.0	1.4	1.6	1.4	35	35	34	33	31	30
Singapore	22.2	16.5	15.0	13.0	13.0	12.0	0.5	0.0	2.0	2.0	1.0	1.0	107	110	115	118	120	120
Czech Republic	-3.7	-4.9	-4.2	-3.9	-4.1	-3.9	-4.7	-4.4	-3.4	-3.1	-2.3	-1.5	39	41	43	43	43	42
Hungary	2.1	1.3	-0.6	-1.5	-2.7	-3.8	-4.2	2.5	-3.0	-3.3	-3.4	-3.4	80	73	72	69	67	65
Poland	-3.4	-5.8	-5.7	-5.3	-5.5	-5.3	-7.9	-5.6	-4.0	-3.0	-2.3	-2.1	53	51	51	50	49	48
Romania	-4.2	-5.2	-5.4	-5.5	-5.5	-5.0	-6.7	-4.5	-3.0	-2.5	-2.0	-1.5	33	35	35	35	34	32
Russia	4.8	4.7	1.6	-0.6	-2.0	-2.8	-4.0	-2.2	-2.1	-2.0	-0.6	-0.6	8	8	9	10	9	9
Turkey	-6.5	-8.9	-8.9	-6.0	-5.0	-4.5	-3.6	-2.6	-2.9	-3.0	-3.0	-3.0	43	41	39	37	37	36
Nigeria	6.1	8.7	8.1	6.0	4.7	3.8	-5.3	-2.3	-2.0	-1.9	-2.3	-2.8	NA	NA	NA	NA	NA	NA
South Africa	-2.7	-3.0	-5.3	-6.1	-6.5	-6.2	-5.2	-5.0	-4.7	-4.0	-3.8	-3.5	34	37	41	39	36	34
Argentina	1.0	-0.1	0.8	0.3	-0.1	-0.1	0.2	-0.6	1.0	1.5	2.1	2.3	49	49	49	50	52	53
Brazil	-2.3	-2.2	-2.7	-2.5	-2.2	-2.0	-2.5	-2.5	-2.5	-2.2	-2.8	-1.8	63	63	63	70	70	71
Mexico	-0.5	-2.0	-2.4	-2.6	-2.7	-2.7	-2.8	-2.5	-2.0	-1.9	-1.9	-1.9	42	41	41	41	41	40
Venezuela	3.7	11.0	8.3	5.0	4.9	4.7	-6.6	-5.0	-5.0	-5.5	-5.9	-5.8	38	37	31	39	41	40

Note: US debt and deficit figures are for the Federal government only. All other countries are general government debt and deficits. Source: Citi Investment Research and Analysis

Figure 9. Selected Countries — Changes in Economic Forecast from the Previous Month (Percent) 2011-2013F

	GDP Growth			CPI Inflation			Current Balance (Pct of GDP)			Fiscal Balance (Pct of GDP)		
	2011	2012	2013	2011	2012	2013	2011	2012	2013	2011	2012	2013
Global	**-0.1**	**-0.1**	**-0.1**	**0.1**		**0.1**	**0.1**	**0.1**	**0.0**	**0.1**		
Based on PPP weights	-0.1	-0.2	-0.1		-0.1	0.1	0.1	0.1		0.1		
Industrial Countries	**-0.1**	**-0.2**	**-0.1**	**0.1**	**-0.1**	**0.3**	**0.1**	**0.1**	**0.1**	**0.1**		
United States	**-0.2**	**-0.3**		**0.2**			**0.2**	**0.1**	**0.1**	**0.4**		
Japan	**0.1**	**-0.1**	**-0.7**			**2.0**						
Euro Area	**-0.1**	**-0.2**	**-0.2**		**-0.1**							
Canada	-0.1						-0.9	-1.1	-1.0	-0.1	-0.1	
Australia	-1.1	-0.3	0.1				0.2	0.6	-0.8			
New Zealand												
Germany			-0.1	-0.2		0.3	-0.1	-0.7	-0.8			-0.2
France		-0.1		-0.1		0.6	0.1					
Italy							-0.1	-0.2	-0.1			
Spain			-0.1	-0.2	-0.1		-0.4	0.1	0.1			
Greece	-0.4	-0.3		0.1	0.3		0.7	1.1	1.1	-0.1	-0.1	-0.3
Portugal												
Netherlands	-0.2	-0.3						0.1	0.1			-0.1
Denmark	-0.4		-0.2				0.1	0.2		-0.3	-0.2	
Norway	-0.1	0.2					-1.0	-1.0	-1.0			
Sweden	-0.2			0.1	0.1	0.1		-0.1	-0.1			
Switzerland	-0.6	0.2					2.5	2.0	2.5		0.1	0.1
United Kingdom	-0.4	-0.4	-0.6	-0.1	-0.1	0.1	1.1	1.6	1.5	0.1	-0.1	-0.3
Emerging Markets		**-0.1**				**-0.1**						
China												
Hong Kong												
India				0.6	1.0							
Indonesia				-0.2	-0.2					-0.1		
Korea												
Singapore		-0.5		0.1	0.4							
Czech Republic	0.2	-0.2		-0.1	-0.2	-0.1		0.1		0.1		
Hungary				0.3	0.5							
Poland		-0.1			0.1		-0.2	0.6	0.6	0.1		0.1
Romania		-0.4					-0.1					
Russia												
Turkey			0.2	0.2	0.4		-0.4	-0.6	-0.5	0.6	0.3	
Nigeria				0.6	0.2		-0.1	-0.1		0.1		
South Africa	0.1						-0.1	0.6				
Argentina					-7.5	-7.5						
Brazil										0.1		
Mexico				-0.2	0.1	-0.1						
Venezuela				0.7	-0.5							

Source: Citi Investment Research and Analysis

Figure 10. Selected Countries — Economic Forecast Overview and Exchange Rate Forecasts(Percent) 2010-2015F

	10-Year Yields						Exchange Rates Versus U.S. Dollar*						Exchange Rate Versus Euro					
	2010	2011	2012	2013	2014	2015	2010	2011	2012	2013	2014	2015	2010	2011	2012	2013	2014	2015
Industrial Countries																		
United States	**3.21**	**3.30**	**3.60**	**4.30**	**5.10**	**5.00**	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**	**1.32**	**1.41**	**1.44**	**1.38**	**1.37**	**1.37**
Japan	**1.18**	**1.29**	**1.43**	**1.50**	**1.75**	**1.75**	**87**	**81**	**84**	**87**	**87**	**87**	**114**	**113**	**121**	**120**	**119**	**118**
Euro Area	**2.78**	**3.20**	**3.85**	**4.00**	**4.10**	**4.20**	**1.32**	**1.41**	**1.44**	**1.38**	**1.37**	**1.37**	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**
Canada	3.24	3.30	4.00	4.45	5.00	4.90	1.03	0.98	0.95	0.95	0.96	0.97	1.35	1.38	1.38	1.32	1.32	1.33
Australia	5.55	5.36	5.90	6.50	7.00	6.60	0.94	1.04	1.05	0.95	0.92	0.89	1.41	1.35	1.37	1.45	1.50	1.54
New Zealand	5.87	5.31	6.10	6.80	7.40	7.00	0.73	0.79	0.76	0.64	0.63	0.62	1.81	1.77	1.89	2.17	2.19	2.19
Germany	2.78	3.20	3.85	4.00	4.10	4.20												
France	3.12	3.60	4.20	4.30	4.35	4.45												
Italy	4.00	4.00	4.80	5.00	5.00	5.00												
Spain	4.30	4.30	5.50	5.60	5.20	5.30												
Greece	9.20	9.20	16.50	17.80	13.00	12.60												
Portugal	5.40	5.40	9.80	10.20	8.50	8.10												
Netherlands	3.00	3.50	4.10	4.20	4.25	4.35												
Denmark	2.95	3.28	4.05	4.25	4.35	4.45												
Norway	3.41	4.31	4.46	4.70	4.80	4.85	6.02	5.60	5.37	5.57	5.60	5.62	7.95	7.87	7.75	7.70	7.69	7.68
Sweden	2.89	3.30	4.08	4.28	4.43	4.55	7.09	6.51	6.20	6.37	6.41	6.44	9.36	9.15	8.94	8.81	8.79	8.79
Switzerland	1.57	1.80	2.75	2.90	3.00	3.10	1.01	0.87	0.88	1.01	1.02	1.03	1.33	1.22	1.28	1.39	1.40	1.40
United Kingdom	3.58	3.50	4.40	4.55	4.65	4.75	1.54	1.62	1.72	1.74	1.74	1.73	0.86	0.87	0.84	0.79	0.79	0.79
Emerging Markets																		
China	**2.91**	**3.78**	**4.15**	**4.50**	**4.40**	**4.50**	**6.77**	**6.45**	**6.18**	**6.00**	**5.80**	**5.60**	**9.67**	**9.07**	**8.92**	**8.30**	**7.96**	**7.65**
Hong Kong	1.54	1.66	2.10	2.80	3.60	4.50	7.77	7.77	7.75	7.75	7.75	7.75	11.10	10.92	11.19	10.72	10.64	10.58
India	8.00	8.00	8.00	8.00	8.00	8.00	45.60	44.83	44.75	44.75	44.40	44.00	65.10	63.01	64.60	61.91	60.93	60.09
Indonesia	8.49	7.89	8.35	8.25	8.50	8.50	9092	8540	8325	8250	8150	8050	12985	12002	12017	11413	11184	10993
Korea	4.08	4.12	4.66	5.35	5.45	5.60	1156	1069	1023	1000	975	970	1651	1503	1476	1383	1338	1325
Singapore	2.41	2.79	3.11	2.80	3.20	3.60	1.36	1.23	1.20	1.17	1.16	1.15	1.95	1.73	1.73	1.62	1.59	1.57
Czech Republic	3.71	4.09	4.33	4.40	4.40	4.40	19.10	17.32	16.24	16.77	16.85	16.88	27.28	24.34	23.44	23.20	23.12	23.06
Hungary	7.97	7.36	7.60	7.36	6.58	6.77	208	191	190	201	203	205	297	269	274	278	279	279
Poland	5.35	5.82	6.08	5.93	5.66	5.35	3.02	2.83	2.64	2.61	2.60	2.58	4.31	3.98	3.8	3.61	3.56	3.53
Romania	NA	NA	NA	NA	NA	NA	3.18	2.95	2.80	2.85	2.81	2.76	4.54	4.14	4.04	3.95	3.86	3.77
Russia	7.27	7.33	7.57	7.59	7.60	7.60	30.4	28.5	28.9	30.2	30.2	30.2	43	40	42	42	41.50	41.21
Turkey	NA	NA	NA	NA	NA	NA	1.50	1.61	1.65	1.66	1.64	1.62	2.15	2.27	2.37	2.29	2.25	2.22
Nigeria	NA	NA	NA	NA	NA	NA	151	154	153	150	148	150	216	217	221	208	203	205
South Africa	8.38	8.67	9.10	9.50	9.25	9.20	7.32	6.86	7.40	8.32	8.91	9.47	10.50	9.64	10.68	11.50	12.22	12.94
Argentina	16.96	13.92	15.68	16.58	15.19	13.00	3.90	4.16	5.31	6.27	6.77	7.27	5.56	5.85	7.66	8.68	9.29	9.93
Brazil	12.05	12.55	12.63	11.90	10.20	8.75	1.76	1.61	1.61	1.66	1.71	1.76	2.51	2.26	2.33	2.29	2.34	2.40
Mexico	6.93	7.37	8.32	7.50	8.10	8.00	12.6	11.93	11.90	12.24	12.51	12.78	18.00	16.77	17.18	16.93	17.17	17.45
Venezuela	13.78	13.00	14.00	15.00	15.00	15.00	2.59	4.30	4.30	4.80	4.80	5.30	3.70	6.04	6.21	6.64	6.59	7.24

*Per USD except Euro Area, Australia, New Zealand, United Kingdom. Note: All foreign exchange forecasts are consistent with the rolling forecasts presented in Figure 82. Source: Citi Investment Research and Analysis

Figure 11. Short Rates (End of Period), as of 22 Jun 2011 (Percent)

	Current	3Q 11	4Q 11	1Q 12	2Q 12	3Q 12
United States	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.75**
Japan	**0.10**	**0.10**	**0.10**	**0.10**	**0.10**	**0.10**
Euro Area	**1.25**	**1.50**	**1.75**	**2.00**	**2.00**	**2.25**
Canada	1.00	1.00	1.50	2.00	2.25	2.25
Australia	4.75	4.75	5.00	5.00	5.25	5.25
New Zealand	2.50	2.50	2.75	3.00	3.25	3.50
Denmark	1.30	1.55	1.80	2.10	2.15	2.40
Norway	2.25	2.50	2.75	3.00	3.25	3.75
Sweden	1.75	2.25	2.50	2.75	3.00	3.25
Switzerland	0.25	0.25	0.25	0.50	0.50	0.75
United Kingdom	0.50	0.50	0.75	1.00	1.00	1.25
China	**3.25**	**3.75**	**3.75**	**3.75**	**3.75**	**3.75**

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

Figure 12. 10-Year Yield Forecasts (Period Average), as of 22 Jun 2011 (Percent)

	Current	3Q 11	4Q 11	1Q 12	2Q 12	3Q 12
United States	**2.98**	**3.15**	**3.35**	**3.40**	**3.50**	**3.60**
Japan	**1.12**	**1.30**	**1.40**	**1.40**	**1.30**	**1.50**
Euro Area (Germany)	**2.99**	**2.95**	**3.35**	**3.65**	**3.80**	**3.90**
Canada	2.98	3.15	3.60	3.65	4.00	4.05
Australia	5.13	5.30	5.50	5.60	5.80	5.80
New Zealand	5.04	5.20	5.40	5.70	6.00	6.40
Denmark	2.98	3.10	3.50	3.80	4.00	4.10
Norway	3.45	3.40	3.95	4.20	4.40	4.50
Sweden	2.90	3.00	3.45	3.85	4.05	4.15
Switzerland	1.69	1.80	2.25	2.60	2.75	2.85
United Kingdom	3.23	3.25	3.50	3.75	3.90	4.25

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

Figure 13. 10-Year Yield Spreads (Period Average), as of 22 Jun 2011

	Spread vs. US$					Spread vs. Germany				
	Current	3Q 11	4Q 11	1Q 12	2Q 12	Current	3Q 11	4Q 11	1Q 12	2Q 12
United States	**NA**	**NA**	**NA**	**NA**	**NA**	**1**	**22**	**3**	**-22**	**-27**
Japan	**-188**	**-187**	**-198**	**-203**	**-223**	**-187**	**-165**	**-195**	**-225**	**-250**
Euro Area	**-1**	**-22**	**-3**	**22**	**27**	**NA**	**NA**	**NA**	**NA**	**NA**
Canada	0	0	25	25	51	1	22	28	3	24
Australia	219	220	220	225	235	221	242	223	203	208
New Zealand	210	209	209	235	256	211	232	212	213	229
France	49	28	37	57	62	50	50	40	35	35
Italy	183	158	157	142	137	184	180	160	120	110
Spain	250	238	237	232	187	251	260	240	210	160
Netherlands	30	13	27	47	47	31	35	30	25	20
Belgium	117	108	117	132	127	118	130	120	110	100
Denmark	-2	-7	12	37	47	-1	15	15	15	20
Norway	45	23	57	77	87	46	45	60	55	60
Sweden	-10	-17	7	42	52	-9	5	10	20	25
Switzerland	-130	-137	-113	-83	-78	-129	-115	-110	-105	-105
United Kingdom	24	8	12	32	37	25	30	15	10	10

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

Figure 14. Emerging Market Countries — Short Rates Actual and Forecast of Additional Rate Moves (End of Period), as of 22 Jun 2011

Country	Current Rate (%)	By Sep 11	Dec 11	Mar 12	Jun 12	Total Cumulative Rate Moves Expected
Turkey	6.25	50	100	100	25	275
South Africa	5.50	50	50	50	0	150
Colombia	4.25	0	75	25	25	125
Israel	3.25	25	50	50	0	125
Czech	0.75	25	25	25	25	100
Mexico	4.50	0	0	50	50	100
Chile	5.25	75	0	0	0	75
Indonesia	6.75	0	25	25	25	75
Korea	3.25	25	25	0	25	75
China	3.25	50	0	0	0	50
Hungary	6.00	0	0	25	25	50
India	7.50	25	25	0	0	50
Philippines	4.50	25	25	0	0	50
Poland	4.50	0	25	25	0	50
Thailand	3.00	50	0	0	0	50
Brazil	12.25	25	0	0	0	25
Russia	8.25	0	0	-25	0	-25

Source: Citi Investment Research and Analysis

Figure 15. Foreign Exchange Forecasts (End of Period), as of 22 Jun 2011

	vs USD						vs EUR					
	Current	Sep 11	Dec 11	Mar 12	Jun 12	Sep 12	Current	Sep 11	Dec 11	Mar 12	Jun 12	Sep 12
United States	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**	**1.43**	**1.37**	**1.41**	**1.44**	**1.47**	**1.44**
Japan	**80**	**79**	**81**	**82**	**83**	**84**	**115**	**109**	**113**	**118**	**122**	**122**
Euro Area	**1.43**	**1.37**	**1.41**	**1.44**	**1.47**	**1.44**	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**
Canada	0.98	1.00	0.98	0.96	0.95	0.95	1.40	1.37	1.38	1.39	1.39	1.37
Australia	1.06	1.02	1.05	1.07	1.09	1.05	1.35	1.34	1.35	1.35	1.35	1.38
New Zealand	0.81	0.80	0.80	0.80	0.79	0.75	1.76	1.72	1.76	1.80	1.85	1.92
Norway	5.52	5.74	5.57	5.41	5.28	5.36	7.88	7.89	7.84	7.79	7.75	7.74
Sweden	6.43	6.75	6.51	6.28	6.10	6.17	9.18	9.28	9.17	9.05	8.94	8.91
Switzerland	0.85	0.85	0.85	0.85	0.86	0.90	1.21	1.17	1.20	1.23	1.26	1.29
United Kingdom	1.62	1.60	1.65	1.69	1.73	1.73	0.88	0.86	0.86	0.85	0.85	0.83
China	**6.48**	**6.43**	**6.35**	**6.28**	**6.20**	**6.15**	**9.20**	**8.80**	**8.90**	**9.10**	**9.10**	**8.90**
India	44.9	45.0	45.3	45.5	45.0	44.5	64.1	61.9	63.7	65.6	66.0	64.3
Korea	1086	1060	1040	1030	1030	1020	1551	1457	1465	1485	1511	1473
Poland	2.78	2.89	2.79	2.70	2.62	2.62	3.98	3.97	3.93	3.89	3.84	3.78
Russia	28.1	28.9	28.7	28.6	28.5	29.0	40.1	39.7	40.5	41.2	41.9	41.9
South Africa	6.79	6.87	6.98	7.10	7.24	7.50	9.70	9.44	9.84	10.24	10.62	10.83
Turkey	1.60	1.65	1.65	1.64	1.64	1.65	2.28	2.27	2.32	2.37	2.41	2.38
Brazil	471	475	473	471	470	471	672	653	666	680	690	681
Mexico	11.9	12.0	11.9	11.9	11.8	11.9	17.0	16.5	16.8	17.1	17.3	17.2

Note: All foreign exchange forecasts are consistent with the rolling forecasts presented in Figure 81 Source: Citi Investment Research and Analysis

Figure 16. Foreign Exchange Forecasts (End of Period), as of 22 Jun 2011

	vs JPY					
	Current	Sep 11	Dec 11	Mar 12	Jun 12	Sep 12
United States	**80**	**79**	**81**	**82**	**83**	**84**
Japan	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**
Euro Area	**115**	**109**	**113**	**118**	**122**	**122**
Canada	82	79	82	85	88	89
Australia	85	81	84	88	90	88
New Zealand	65.0	63.4	64.4	65.5	66.0	63.2
Norway	14.5	13.8	14.5	15.1	15.7	15.7
Sweden	12.5	11.7	12.4	13.0	13.6	13.6
Switzerland	95	93	94	96	97	94
United Kingdom	130	127	132	138	144	146
China	**12**	**12**	**13**	**13**	**13**	**14**
India	1.79	1.76	1.78	1.80	1.85	1.89
Korea	13.54	13.39	12.91	12.58	12.39	12.12
Poland	28.8	27.4	28.9	30.4	31.7	32.2
Russia	2.9	2.7	2.8	2.9	2.9	2.9
South Africa	11.8	11.5	11.5	11.5	11.5	11.2
Turkey	50.2	48.0	48.9	49.8	50.7	51.1
Brazil	0.2	0.2	0.2	0.2	0.2	0.2
Mexico	6.7	6.6	6.8	6.9	7.0	7.1

Note: All foreign exchange forecasts are consistent with the rolling forecasts presented in Figure 81. Source: Citi Investment Research and Analysis

Global Economics Essay

Trade Transformed — Following the Rise of EM Trade until 2050

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World trade is set to rise from 61% of world GDP in 2010 to 84% in 2030 and 86% in 2050, with the bulk of growth in trade occurring in EMs

World trade is set for both a prolonged boom and a marked transformation, according to our research. We expect world trade (defined as the sum of world exports and imports of goods and services) to expand at an average rate of 7.1%pa between 2010 and 2030, measured in constant 2010 USD, and to expand by 4.7%pa between 2030 and 2050.[5] World trade would be equivalent to 84% of world GDP by 2030 and 86% by 2050, up from 39% in 1990 and 61% in 2010. Fast growth of world trade is thus not new — the average growth rate of world trade in goods was 6.0%pa between 1960 and 2010 and of trade in goods and services 5.4% pa between 1990 and 2010 — but what will be new, at least in recent history, is the prominence of today's emerging market economies (EMs) in world trade.[6] We expect intra-EM trade to overtake trade within the advanced economies (AEs) by 2015 and to exceed trade between AEs and EMs by 2030. The definition of EMs used throughout this report includes Hong Kong, Singapore, Korea, Israel, and Slovenia, while, for example, the IMF includes these countries in the AE category. Using the IMF definition, we expect intra-EM trade to overtake trade within AEs by 2025 and to overtake AE-EM trade by 2050.

The growth and transformation of world trade have implications for investment in trade-related infrastructure, trade-related service industries and the location of economic activities

We also expect China to become the largest economy by trade and for Developing Asia to become the largest region by trade by 2015.

These changes in the volume, value and composition of world trade will likely drive public and private investment in trade-related infrastructure (ports, docks, airports, roads, storage facilities, inter-modal freight transport and transshipment facilities), investment in trade-related service industries and the location of economic activities, with coastal regions with decent port facilities the obvious winners.

World trade grew by 18.7% in 2010, after a fall of more than 20% during the recent economic and financial crisis — the largest fall on record

In 2010, world trade grew by 18.7% in current USD (17.5% in constant USD). After collapsing during the recent economic and financial crisis — world trade fell by over 20% in 2009 — world trade therefore reverted to its pre-recession pattern of almost uninterrupted growth over the past decades. Between 1980 and 2008, world trade in goods and services grew by a factor of 3.6, from $11.3trn to $40.1trn or 4.7%pa, according to the WTO. During the same time, world GDP more than doubled, from $25.5trn to $61.4trn. The fall in world trade in 2009 was much sharper than the fall in world GDP — which, at 5%, was the largest recorded fall in world GDP since WWII — but historically average trade growth was higher than average GDP growth, too.

We expect the long-run growth story of world trade to continue over the next four decades. According to our projections, world trade in goods and services will grow from $37trn in 2010 to 149trn in 2030 and $371trn in 2050. This corresponds to an average growth rate of 7.1%pa between 2010 and 2030 and 5.9%pa between 2010 and 2050. Relative to world GDP, world trade would grow from 61% in 2010 to 84% in 2030 and 86% in 2050.

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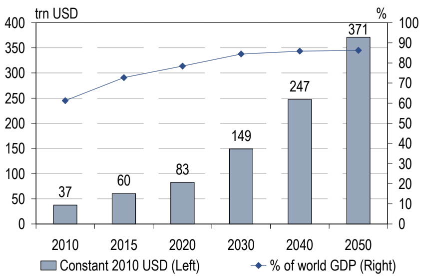
[5] Data in current USD and constant USD are converted at market exchange rates throughout this report. All data are quoted in constant 2010 USD, unless otherwise noted. In current USD, we expect world trade to expand by 9.0%pa between 2010 and 2030 and 6.8%pa between 2030 and 2050.

[6] There are at least two differences between the coverage of the IMF data and the coverage of the data quoted in our projections. First, the IMF data only includes trade in goods, while our projections cover both trade in goods and in services. Second, the IMF's definition of the AE aggregate is different from the one used in the text, as noted in the first paragraph.

Figure 17. World trade — Level (Constant USD trn) and Share of World GDP (%), 2010-2050



Source: CIRA

We expect intra-EM trade to overtake intra-AE trade by 2015 and AE-EM trade by 2030

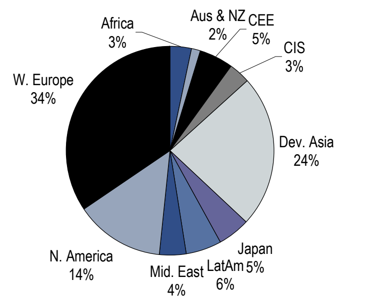
The shift of world trade to EMs will also have large regional implications — Developing Asia forecast to be the largest trading region and China the largest trading country by 2015

The share of Africa in world trade is set to more than triple from 3% in 2010 to 10% in 2050

But at least as interesting as the growth in world trade that we forecast are the changes in its composition that we expect over the course of the next four decades, with today's EMs set to gain much more prominence in world trade relative to AEs. Today, Intra-EM trade of goods and services accounts for just under a quarter of total world trade, while intra-AE trade is just under a third, and trade between AEs and EMs accounts for 42%. We expect intra-EM trade to overtake within-AE trade by 2015, to exceed AE-EM trade by 2030, and to account for 48% of world trade by 2030 and 58% by 2050. Trade between today's AEs meanwhile is projected to fall from 33% of world trade in 2010 to 14% in 2030 and below 10% by 2050. In fact, the transformation of world trade has already begun. Between 1990 and 2010, the share of intra-AE trade of goods fell from 76% to 51% of total EM and AE trade, according to IMF DOTS data.[7] Intra-EM trade almost quadrupled its share from 5% in 1990 to almost 20% in 2010, while AE-EM trade rose from 19% to 29%.

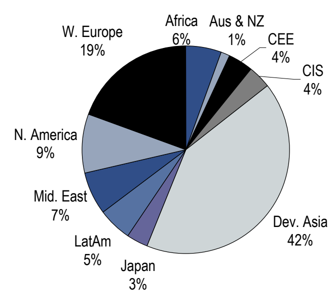
The shift of world trade from today's AEs to EMs will also likely manifest itself in a large regional shift in the composition of trade (see Figure 18, Figure 19 and Figure 20). Developing Asia (DA) accounted for 24% of world trade in 2010, but its share is expected to reach 42% by 2030 and 46% by 2050. This constitutes a rather dramatic change from the mere 11% of world trade the region accounted for in 1990, but is in line with the shares of world GDP (47%) or world population (50%) that we expect this region to account for in 2050. We expect Africa's share of world trade to more than double from 3% in 2010 to 6% by 2030, and to rise to 10% by 2050 — to be compared with GDP and population shares of 15% and 22%, respectively by 2050. Western Europe (WE) on the other hand, in 2010 by far the largest region in terms of trade with 34% of world trade — already down from 48% in 1990 — is expected to account for 19% of world trade by 2030 and 15% by 2050. Nevertheless, we expect WE to continue to punch above its weight in world trade, as its share of world GDP and population are forecast to be 8% and 5%, respectively, in 2050. Similar declines in relative trade shares as for WE are projected for North America and Japan, despite healthy increases in *absolute* levels of trade projected for each one of these regions.[8]

Figure 18. Selected Regions — Share of World Trade, 2010



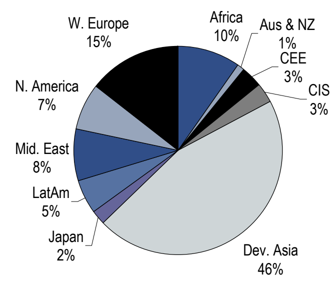
Source: WTO and CIRA

Figure 19. Selected Regions — Share of World Trade, 2030



Source: CIRA

Figure 20. Selected Regions — Share of World Trade, 2050



Source: CIRA

In terms of the largest countries by trade, we expect China to overtake the US to become the world's largest trader by 2015 and to remain in the top spot for the rest of our forecast horizon (Figure 21). India, which does not even feature in the top 10

[7] There are at least two differences between the coverage of the IMF data and the one for our projections. First, the IMF data only includes trade in goods, while our projections cover both trade in goods and in services. Second, the IMF AE aggregate include Korea, Hong Kong and Singapore, while they are included in the EM category in our classification.

[8] For long-run projections of GDP and population, please see Global Growth Generators: Moving Beyond 'Emerging Markets' and 'BRIC'

of the world's largest traders in 2010, is expected to be the world's second-largest trader by 2050, with the US in third place. In 2010, only two countries from Developing Asia featured in the top 10 (China and Korea), while five European countries were among the ten largest traders in the world. In 2050, we expect seven out of the ten largest traders in the world to hail from Developing Asia, with Germany the only remaining European constituent.

Figure 21. Top 10 Countries by Trade (in bn 2010 USD), 2010 – 2050

Rank	Country	Trade in 2010	% of World Trade	Rank	Country	Trade in 2015	% of World Trade	Rank	Country	Trade in 2030	% of World Trade	Rank	Country	Trade in 2050	% of World Trade
1	US	4,024	10.7%	1	China	7,754	12.8%	1	China	24,879	16.7%	1	China	63,009	17.0%%
2	China	3,579	9.5	2	US	5,794	9.6	2	US	11,290	7.6	2	India	31,074	8.4%
3	Germany	2,865	7.6	3	Germany	3,819	6.3	3	India	7,957	5.3	3	US	21,974	5.9%
4	Japan	1,783	4.8	4	Japan	2,508	4.2	4	Germany	6,367	4.3	4	Korea	11,523	3.1%
5	France	1,433	3.8	5	Korea	2,091	3.5	5	Korea	5,506	3.7	5	Germany	11,174	3.0%
6	UK	1,357	3.6	6	UK	1,861	3.1	6	Japan	4,850	3.3	6	Indonesia	10,581	2.9%
7	Neths	1,310	3.5	7	France	1,840	3.0	7	Singapore	4,121	2.8	7	Thailand	9,064	2.4%
8	Italy	1,146	3.1	8	Neths	1,765	2.9	8	HK	4,102	2.8	8	Japan	8,762	2.4%
9	Korea	1,047	2.8	9	India	1,651	2.7	9	Russia	3,558	2.4	9	Singapore	8,652	2.3%
10	Canada	976	2.6	10	Singapore	1,627	2.7	10	UK	3,439	2.3	10	HK	8,523	2.3%

Source: CIRA

We expect trade within Developing Asia to become the world's largest regional trade corridor by 2015, accounting for 15% of world trade in 2015 and 24% by 2050

In our study, we projected bilateral trading relationships for a large number of countries and then aggregated these into country and regional aggregates. However, bilateral trading relationships or 'trading corridors' remain a focus of our study. Figure 22 shows that the growth in EM trade manifests itself both in growing intra-regional trade as well as in growth of trade between regions. In 2010, trade within Western Europe was by far the largest trade corridor, accounting for just under 20% of world trade, almost twice as much as the next largest trade corridor (within-DA trade), with DA-WE trade at number three. We expect within-DA trade to just exceed intra-WE trade by 2015 and to account for almost a quarter of world trade by 2050. By 2050, we expect DA to feature in all five of the five largest regional trading corridors in the world. Africa, which was not part of any of the ten largest trade relationships in 2010, is expected to be a part of two such corridors by 2050, while the CEE, which featured once in 2010, is expected to disappear from this list altogether.

Figure 22. Largest Trade Corridors (in bn 2010 USD), 2010 – 2050

Rank	Trade Corridor	Trade, 2010	% of World Trade	Rank	Trade Corridor	Trade, 2015	% of World Trade	Rank	Trade Corridor	Trade, 2020	% of World Trade	Rank	Trade Corridor	Trade, 2050	% of World Trade
1	W. Europe - W. Europe	7,461	19.91%	1	Dev. Asia - Dev. Asia	9,087	15.05	1	Dev. Asia - Dev. Asia	14,703	17.79%	1	Dev. Asia - Dev. Asia	88,364	23.82%
2	Dev. Asia - Dev. Asia	3,991	10.65	2	W. Europe - W. Europe	8,846	14.65	2	W. Europe - W. Europe	9,739	11.79	2	Dev. Asia - Mid. East	31,383	8.46
3	Dev. Asia - W. Europe	3,165	8.44	3	Dev. Asia - W. Europe	5,667	9.38	3	Dev. Asia - W. Europe	7,937	9.61	3	Dev. Asia - W. Europe	30,971	8.35
4	Dev. Asia - N. America	2,480	6.62	4	Dev. Asia - N. America	4,331	7.17	4	Dev. Asia - N. America	6,083	7.36	4	Africa - Dev. Asia	30,055	8.10
5	N. America - W. Europe	2,188	5.84	5	Dev. Asia - Japan	2,767	4.58	5	Dev. Asia - Mid. East	4,360	5.28	5	Dev. Asia - N. America	21,519	5.80
6	Dev. Asia - Japan	1,737	4.64	6	N. America - W. Europe	2,714	4.49	6	Dev. Asia - Japan	3,723	4.51	6	W. Europe - W. Europe	18,457	4.98
7	LatAm - N. America	1,552	4.14	7	Dev. Asia - Mid. East	2,605	4.31	7	N. America - W. Europe	3,122	3.78	7	Dev. Asia - LatAm	14,035	3.78
8	Dev. Asia - Mid. East	1,131	3.02	8	LatAm - N. America	2,187	3.62	8	LatAm - N. America	2,660	3.22	8	Africa - W. Europe	12,048	3.25
9	N. America - N. America	1,093	2.92	9	Dev. Asia - LatAm	1,594	2.64	9	Dev. Asia - LatAm	2,432	2.94	9	Dev. Asia - Japan	11,276	3.04
10	CEE - W. Europe	986	2.63	10	N. America - N. America	1,408	2.33	10	Africa - Dev. Asia	2,036	2.46	10	CIS - Dev. Asia	9,124	2.46

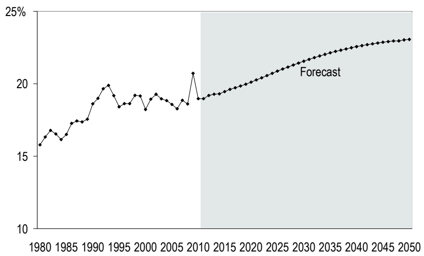
Source: CIRA

Trading what?

Manufacturing goods are by far the largest product category in world trade, but regional variations are large — more than 70% of exports in the CIS, the Middle East and Africa are fuel products. We expect the share of commercial services in total trade to rise from 19% in 2010 to 23% in 2050

Figure 23 indicates the share of some selected product categories in total exports and imports of goods in 2009. Regional variations are substantial. In the CIS, Africa and the Middle East, fuel products alone accounted for over half of total exports. In North America, Europe and Asia, on the other hand, manufactures account for over 70% of exports, while manufactures account for over 60% of imports in each of the regions. The most important categories for commercial services exports were information and communications services (45% of total services exports), travel services (26%), transport services (20%) and insurance and financial services (8%).

Figure 23. World — Share of Services Trade in Total Goods and Services Trade (in %), 1980–2050F



Note: Forecast is Citi forecast. Source: CIRA

We do not produce trade forecasts at the commodity level. We do, however, forecast trade in goods separately from trade in commercial services. The share of services in total trade grew from 15.8% in 1980 to just under 20% in 1994, but has moved sideways since. This is despite the fact that the share of services in world GDP rose from 64.6% in 1994 to 70.2% in 2008, the latest year for which data are available. Traditional services are often cited as the quintessential 'nontradable' goods — despite the fact that transportation, shipping and trade are themselves traditional services. With the ascent of financial services and information and communication technology, any association of services with non-tradability is clearly inappropriate if indeed it ever was. We therefore expect the share of services in total trade to rise over the next four decades, from just under 19% of total trade in 2010 to 22% in 2030 and 23% in 2050. Recently, the decline in the share of commodities in world exports has also halted and to some extent reversed. We expect this reversal to continue for some time. In addition, we also expect the decades-long fall in the share of agricultural products to just 1.5% of total world exports in 2009 to halt and possibly reverse over the next decades.

Figure 24. Selected Regions — Shares of Selected Product Categories in Total Exports and Imports (in %), 2009

	Exports										Imports	
	Agricultural Products	Fuels + Mining Products		Manufactures								
		Total	Fuels	Total	Iron + Steel	Chemicals	Office and Telecom Equipment	Automotive Products	Textiles	Clothing	Fuels	Manufactures
World	9.6	18.6	14.8	68.6	2.7	11.9	10.9	7.0	1.7	2.6	14.8	68.6
N America	11.2	13.6	9.8	70.5	1.3	12.3	10.8	8.9	0.8	0.6	15.1	73.0
Latin America	30.5	38.9	23.9	27.4	2.7	6.3	1.1	3.3	0.7	2.2	16.5	68.8
Europe	10.5	9.6	6.9	77.3	2.9	17.2	6.7	9.4	1.4	2.2	12.3	70.9
CIS	8.7	62.9	56.3	24.1	8.1	5.9	0.4	0.8	0.4	0.3	10.1	72.6
Africa	10.2	64.0	55.3	19.2	1.8	3.7	0.6	1.4	0.6	2.5	11.5	69.5
Middle East	2.6	68.0	66.8	27.3	0.7	6.3	2.9	2.7	1.1	0.8	7.2	77.0
Asia	6.3	10.8	7.4	79.7	2.7	7.7	22.0	5.3	3.1	4.7	19.6	62.8

Source: Citi Investment Research and Analysis

Drivers of trade growth

The main drivers of trade are general levels of economic activity and the evolution of natural and man-made barriers to trade

There is a vast literature on the drivers of trade.[9] Among the empirically most prominent are growth in GDP and GDP per capita. As economies grow larger and more affluent, the number of product varieties and preferences for variety increase, leading to increases in both imports and exports. The causation, of course, runs the other way, too, with openness to trade, ideas, FDI and migration, an important catalyst for technology transfer and catch-up in productivity. The list of countries and regions for which we predict the highest rates of trade growth is therefore very similar to the list of countries with the best prospects of high GDP growth.[10]

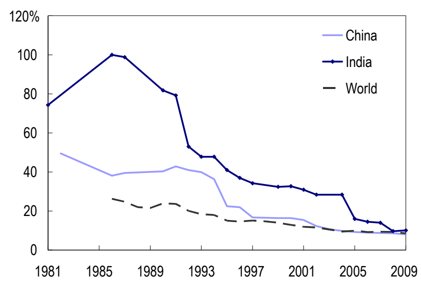
[9] See Anderson, J (2010), "The Gravity Model", NBER Working Paper, December 2010, Bergstrand, J and P Egger (2010), "Gravity Equations and Economic Frictions in the World Economy", June 2010, and Anderson, J and E van Wincoop (2004), "Trade Costs," Journal of Economic Literature, September 2004 for excellent surveys of the theory and empirics of trade.

[10] Global Growth Generators: Moving Beyond 'Emerging Markets' and 'BRIC'

Both natural and man-made barriers to trade have tended to fall over time, but the reductions are neither automatic nor irreversible

However, trade has also grown relative to GDP for decades and this increase can be related to a reduction in trade barriers over time, both natural/technological and man-made. Natural barriers to trade include the time and expense needed to overcome the distance between the point of production and the point of consumption. The variation in transport costs across countries and across goods within countries is very large. In general, natural/technological barriers to trade have tended to fall over time, but recent increases in the prices of fuel products and security-related increases in cross-border transport costs serve as a useful reminder that such reductions should not be taken for granted. Man-made barriers to trade include tariffs on the import and export of goods as well as the myriad non-tariff barriers to trade, including quotas, licences, standards, and a number of other administrative measures to reduce trade. Man-made barriers to trade have also fallen over the past few decades in all but a handful of countries (Figure 25), but are also not irreversible. Geography, language, culture, common borders and common historical roots are other factors that have been found to have significant and usually persistent effects on the levels of trade between countries.

Figure 25. Selected countries — Average MFN Applied Tariff Rates (% of Value) 1981-2009



Note: All tariff rates are based on unweighted averages for all goods in ad valorem rates, or applied rates, or MFN rates whichever data is available in a longer period. Missing values interpolated. MFN stands for Most Favored Nation.

Sources: World Bank Data on Trade and Import Barriers and CIRA

Limits to trade

The limits to trade have not been reached nor are they likely to be reached over the next few decades

Fast growth of world trade in the past and the forecast of strong future growth we present in this note raise the question of whether we may soon reach the limits of trade growth, in absolute terms or relative to GDP. In our view, that day is still far off, for at least two reasons. The first one has to do with the measurement of trade, while the second relies on a theoretical measure of 'frictionless' or maximum trade.

First, note that trade is measured on a gross basis, while GDP is measured in value-added terms. Data on the share of value-added in trade is notoriously difficult to obtain, but estimates of the import content of exports of between 20 — 30% in G7 countries circulate, implying that trade measured in value-added terms would be up to a third smaller than the gross measures.[11] In countries that are heavily involved in processing trade or in re-exporting, the share of value-added can be much lower still, as should be clear from the fact that trade in places such as Singapore or Hong Kong already accounts for multiples of GDP today — there is thus no reason for measured imports, exports or total trade in a country, a region or the world as a whole to be smaller than, say, 100% of the GDP of that country, region or the world.

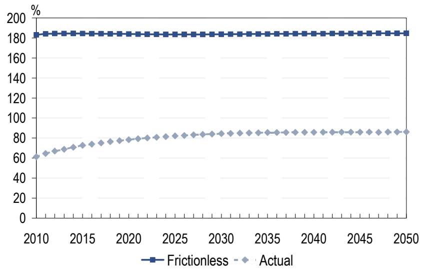
Second, we can obtain a simple theoretical measure of the 'frictionless' level of trade which can be interpreted as a natural upper bound for trade in the absence of any trade barriers – natural or man-made. Assume that the proportion of spending of any country *i* on its own (final) goods and services is the same as the proportion of world (final goods and services) spending on country *i*. This assumption implies that the share of imports in country *i*'s GDP equals the rest of the world's share in world GDP.[12] For the US which accounted for 23% of world GDP in 2010, this measure implies a frictionless level of imports of 77% of GDP. Assuming balanced trade in equilibrium, exports would be of the same size and imply an equilibrium frictionless level of trade, measured in value-added terms, of 154% of GDP for the US in 2010 – compared to an actual value of gross (not value-added!) trade of 28%. Applying the same approach to all other countries in the world, we arrive at a measure of 'frictionless' world trade of 183% of world GDP in 2010. This compares to an actual (gross) value of world trade of around 61% in 2010, and 86% in 2050.[13]

[11] See Johnson, R. and G. Noguera, "The value-added content of trade", voxEU.org, 7 June 2011

[12] For a detailed exposition of this approach see Anderson, J (2011), op.cit.

[13] The frictionless value of world trade is in principle time-varying, but quantitatively virtually unchanged between 2010 in 2050 in our projections.

Figure 26. Frictionless and Actual World Trade (% of GDP), 2010 — 2050F



Source: CIRA

Risks to our forecasts include lower-than expected levels of general economic activity, increases in protectionism and more inward orientation around the world

What could go wrong?

Long-term forecasts are naturally to be treated with caution, and our trade forecasts are no exception. Here, we point out a number of key caveats. First, GDP growth and catch-up in productivity and incomes by many of today's EM economies are a key driver of trade in our forecasts. In our view, the causation clearly runs both ways here, as openness to trade, FDI and migration is likely to be a key condition to allow today's poorer economies to import best practices from abroad and start to close the productivity and income gap with the richer world — notably, trade barriers are much higher in EMs today than in AEs. Lower than expected GDP growth is likely to be associated with lower growth in world trade.

A second relevant risk is a prolonged return to a more protectionist environment. The current trade-negotiation round of the WTO, the Doha Development Round, has stalled since 2009 and is unlikely to be concluded anytime soon. Despite a current lack of enthusiasm for further trade liberalization in much of the world, we expect the long-term trend for a slow reduction in both natural and man-made trade barriers to be resumed in the future. Should this resumption fail to materialise, our trade projections will likely turn out to be too optimistic. Stopping short of erecting new barriers to trade, a more inward orientation in many countries would also markedly reduce the prospects for an expansion of world trade. Large supply-driven increases in commodity prices or in security-related costs of trade would also endanger the predicted expansion and do not form part of our central scenario.

Conclusion

'The World is Flat' was the name of a best-selling book published in 2005 by Thomas Friedman on the forces and dynamics of globalization. According to our research, the world is set to become a lot flatter over the next forty years. We expect world trade in constant USD to expand from around \$37trn in 2010 to \$149trn in 2030 and \$371trn in 2050. Along with a sustained expansion of trade, we forecast a marked reorientation of world trade towards EMs in general, and Developing Asia in particular.

New trade corridors between and within EMs will come into existence and existing ones will become both deeper and wider. As industrialising EMs become richer, they will import fewer capital goods and commodities and more consumption goods. Exporters of non-renewable natural resources need to diversify their economies to prepare for the eventual depletion of their natural resource endowment, even if that eventuality is still some decades off. Many of the new trade corridors require investment in trade-related infrastructure, including ports, docks, airports, roads, storage facilities, inter-modal freight transport and transshipment facilities. Trade-related service industries, including the financing and insurance of trade, transport and tourism, will blossom. The new trade routes have the potential to create new winners, be they products, services, cities, companies, industries, or economies

Country Commentary

United States

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The drag on growth from higher energy costs and supply chain disruptions has been larger than we anticipated, while flagging business confidence hints that recovery's underlying momentum may have faded a bit for now. We continue to expect a second half pickup to 3%-plus growth as the auto sector revives and moderating inflation buoys real incomes. Despite recent setbacks in markets, financial conditions remain supportive of healthy demand and faster job growth beyond the next couple of months.

Uncertainties created by the first-half slowing and the increased focus on possible fiscal policy tightening suggest a longer monetary policy interlude. The Fed is expected to keep overnight rates unchanged at least through mid-2012 and public discussion of exit strategies could be downplayed near term. Officials have signalled that reinvestment of MBS redemptions will continue beyond the announced June end of net new asset purchases. The hurdles to new easing measures — especially asset purchases — are very high because policymakers expect stronger growth ahead and now see inflation risks as more balanced.

Forecasts for inflation have peaked for the time being, now showing some near-term relief from rising costs for energy and commodities. Importantly, the earlier decline in unemployment has stalled with wage growth still anemic. Ample resource slack and wide profit margins do not support a forecast of spreading price pressures. This setting is expected to extend the period of low bond yields despite the end of Fed purchases and background concerns about fiscal sustainability. This update assumes brinkmanship over the debt ceiling will be resolved on time.

Figure 27. United States — Economic Forecast, 2010-12F

					2010	2011				2012		
		2010	2011F	2012F	4Q	1Q	2QF	3QF	4QF	1QF	2QF	3QF
GDP	SAAR				3.1%	2.3%	1.5%	3.1%	3.4%	2.1%	2.9%	3.0%
	YoY	2.9%	2.5%	2.8%	2.8	2.4	2.4	2.5	2.6	2.5	2.9	2.9
Consumption	SAAR				4.0	2.2	1.0	3.0	3.3	1.3	2.5	2.8
	YoY	1.7	2.5	2.4	2.6	2.7	2.4	2.5	2.3	2.1	2.5	2.5
Business Investment	SAAR				7.7	4.5	4.8	6.6	8.1	6.9	8.5	9.0
	YoY	5.7	7.0	7.7	10.6	9.8	6.7	5.9	6.0	6.6	7.5	8.1
Housing Investment	SAAR				3.3	-3.0	3.0	4.8	5.2	9.3	15.6	17.5
	YoY	-3.0	-1.3	10.1	-4.6	-2.2	-6.9	2.0	2.4	5.6	8.6	11.8
Government	SAAR				-1.7	-5.5	0.7	-1.2	-1.1	-1.8	-1.7	-2.2
	YoY	1.0	-1.1	-1.5	1.1	0.1	-0.7	-2.0	-1.8	-0.9	-1.5	-1.7
Exports	SAAR				8.6	7.8	9.5	6.2	6.7	6.6	6.9	7.2
	YoY	11.7	7.9	6.9	9.0	8.1	8.2	8.0	7.5	7.2	6.6	6.8
Imports	SAAR				-12.6	5.2	3.4	3.8	4.8	1.6	3.3	4.5
	YoY	12.6	3.9	3.5	11.0	9.4	2.7	-0.3	4.3	3.4	3.4	3.5
CPI	YoY	1.6	3.1	1.7	1.2	2.2	3.4	3.6	3.2	2.3	1.5	1.5
Core CPI	YoY	1.0	1.5	1.6	0.6	1.1	1.5	1.6	1.7	1.7	1.5	1.5
Unemployment Rate	%	9.6	8.9	8.6	9.6	8.9	9.1	9.0	8.8	8.8	8.6	8.5
Gov't Balance (Fiscal Year)	% of GDP	-8.9	-9.2	-7.0								
Assumed WTI Spot Price	US$	79.4	100.6	104.5	85.0	94.0	103.6	101.8	103.0	103.9	104.5	104.7
Current Account	US$bn	-471	-467	-470	-449	-477	-478	-448	-463	-456	-462	-471
	% of GDP	-3.2	-3.1	-3.0	-3.0	-3.2	-3.2	-2.9	-3.0	-2.9	-2.9	-3.0
S&P 500 Profits (US$ Per Share)	YoY	37.8	14.6	7.1	34.2	19.0	15.2	13.3	11.5	8.5	6.9	7.1

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

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Japan

We continue to expect a sharp rebound in activity in the second half of this year after negative growth caused by the quake in the first half. Disruption in supply chains, mostly at the auto sector, has been resolved much faster than companies expected earlier. For example, reportedly Toyota's domestic auto production will return to normal in July. The government's survey also indicates that companies plan to increase production of transport machinery by 36% MoM in May and 37% in June after 48% declines in March and April. Meanwhile, the negative impact from power shortages this summer on production is probably limited: first, because TEPCO has revised up its estimate of supply capacity this summer significantly; and second, because manufacturers plan to implement thorough rotating operations and operation at nights and weekends.

However, medium-term uncertainties surrounding the economic outlook are significant. First, nuclear power plants that are temporarily shut down for regular inspection may not be able to restart for an extended period because of concerns over the safety in the wake of the Fukushima tragedy. Assuming all nuclear reactors which will be shutdown for regular inspection will remain non-operational, all 54 reactors in Japan will be suspended in May 2012 and the country will lose 47.7mkW in power supply. The uncertainty regarding power may encourage manufacturers to shift their production bases overseas. Second, consumers may suffer income tax hikes that are intended to finance reconstruction and higher electricity charges in 2012. Thus, we are inclined to view the economy in 2012 relatively cautiously.

Whatever the political developments in months to come, the upcoming supplementary budget(s) for reconstruction, which is likely to amount to 10-15 trillion yen, will probably be approved this summer and this would start to push up the economy in the fourth quarter. Meanwhile, the BoJ appears unlikely to take additional easing measure in order to support the economy given that policymakers upgraded their economic assessment last week. However, if the supplementary budget(s) should exert upward pressures on the JGB yields, the BoJ might expand the size of the asset purchase program again to keep interest rates stable.

Figure 28. Japan — Economic Forecast, 2010-12F

					2010	2011				2012		
		2010	2011F	2012F	4Q	1Q	2QF	3QF	4QF	1QF	2QF	3QF
Real GDP	YoY	4.0%	-0.5%	3.1%	2.4%	-0.7%	-1.5%	-0.7%	1.1%	3.0%	4.5%	3.0%
	SAAR				-2.9	-3.5	-3.0	7.0	4.5	3.7	3.0	0.7
Domestic Demand	YoY	2.2	0.7	2.9	2.0	-0.5	0.4	0.6	2.1	3.7	3.7	2.5
	SAAR				-2.5	-2.8	2.6	5.3	3.6	3.3	2.6	0.5
Private Consumption	YoY	1.9	-1.0	1.6	0.6	-0.9	-1.1	-1.5	-0.2	1.0	2.0	1.8
	SAAR				-4.0	-2.2	-1.4	1.6	1.2	2.6	2.6	0.8
Business Investment	YoY	2.4	1.5	5.8	5.3	2.4	-0.1	1.0	2.6	5.6	6.9	5.7
	SAAR				0.1	-4.9	0.6	8.8	6.5	6.5	6.0	3.7
Housing Investment	YoY	-6.6	4.3	12.3	6.1	5.3	3.8	3.7	4.2	6.9	13.5	16.2
Public Investment	YoY	-3.5	0.3	9.5	-13.0	-13.7	-5.5	4.7	18.1	23.3	19.0	4.0
Exports	YoY	24.1	-1.3	5.4	13.1	6.7	-6.2	-4.3	-1.1	-0.2	9.3	6.7
	SAAR				-3.3	2.8	-27.0	15.5	10.3	6.6	4.9	5.3
Imports	YoY	9.8	6.1	4.1	9.9	8.9	6.1	4.0	5.5	4.5	3.7	4.1
	SAAR				-1.2	8.0	5.7	3.7	4.7	3.9	2.6	5.2
CPI	YoY	-0.7	0.5	0.5	0.1	0.0	0.7	0.8	0.6	0.7	0.5	0.5
Core CPI	YoY	-1.0	0.5	0.5	-0.5	-0.2	0.6	1.0	0.8	0.7	0.5	0.5
Nominal GDP	YoY	1.7	-1.8	2.6	0.5	-2.9	-2.7	-1.9	0.3	2.3	4.0	2.6
Current Account	¥ tn	17.2	10.8	11.9	17.3	13.6	7.8	10.3	11.6	11.4	11.8	11.9
	% of GDP	3.6	2.3	2.5	3.6	2.9	1.7	2.2	2.4	2.4	2.4	2.5
Unemployment Rate	%	5.1	4.8	4.4	5.0	4.9	4.8	4.7	4.6	4.5	4.5	4.4
Industrial Production	YoY	16.6	-0.5	7.2	5.9	-2.4	-6.0	1.4	5.0	8.2	12.1	5.8
Corporate Profits (Fiscal Year)	YoY	50.0	-5.0	25.0								
General Govt. Balance (Fiscal Year)	% of GDP	-9.8	-10.3	-8.8								

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

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Euro Area

We have revised down our GDP forecast for 2011 by 0.1 points to 2.0% and the 2012 forecast by 0.2 points to 1.4%. After the decent gain in 1Q (0.8% QQ, 3.3% SAAR) we expect growth rates around 0.3% QQ/ 0.4% QQ in coming quarters. Lower export growth, reflecting smaller gains in global demand, partly explain the downward revision. Overall, the slowdown in the economy takes into account lower domestic demand, which is due to fiscal and monetary tightening.

The controversial discussion regarding the involvement of the private sector in a second Greek support package highlights the conflicting interest between the euro area countries. The debate suggest that political risks in the periphery countries — where the population is increasingly unwilling to accept austerity measures — but also in the core countries — where the population is increasingly unwilling to accept support measures — are mounting. For the time being, the likely losses of a Greek default are too high for all involved parties. But with the proposed debt roll over, the first step towards a debt restructuring is done and we expect haircuts in coming years, if the euro area economy and its banking sector are in better shape. The ECB participated actively in the public debate regarding the private sector involvement. Its aim was probably to prevent a renewed banking crisis, which could emerge from a Greek default in an environment in which a big rescue facility is not available — even after increasing the lending power of the rescue facilities to EUR 750bn. But, with its comments, the ECB created even more uncertainty in the markets.

After using “strong vigilance” in June we expect the ECB to go ahead with the second 25bp rate hike (to 1.5% in the refi rate) in July. Unless the economic slowdown is much sharper than we expect or inflation falls substantially in coming months, we forecast further rate hikes in 4Q and 1Q 2012. Then we expect the ECB to reduce the pace of rate hikes and we only expect one more rate hike in 2H 2012. Hence, our rate forecast for mid 2012 of 2.0% and end 2012 of 2.25% are 25bp lower than last month

Figure 29. Euro Area — Economic Forecast, 2010-12F

					2010	2011				2012		
		2010	2011F	2012F	4Q	1Q	2QF	3QF	4QF	1QF	2QF	3QF
Real GDP	YoY	1.6%	2.0%	1.4%	2.0%	2.5%	1.7%	1.7%	1.7%	1.3%	1.4%	1.4%
	SAAR				1.1	3.3	1.1	1.2	1.2	1.6	1.4	1.5
Final Domestic Demand	YoY	0.4	1.4	1.2	1.0	1.8	1.2	1.3	1.3	0.8	1.2	1.3
Private Consumption	YoY	0.8	1.2	1.3	1.1	1.1	1.2	1.3	1.2	1.2	1.2	1.3
Government Consumption	YoY	0.7	0.6	-0.7	0.6	1.4	0.8	0.2	-0.1	-1.0	-0.7	-0.6
Fixed Investment	YoY	-1.0	2.9	2.8	1.1	4.0	1.7	2.5	3.5	1.7	2.9	3.1
— Business Equipment	YoY	2.5	4.7	4.8	4.9	5.3	4.0	4.6	4.9	4.4	5.0	4.9
— Construction	YoY	-4.2	1.1	1.5	-2.5	2.0	-0.6	0.6	2.5	0.2	1.6	1.9
Stocks (Contrib. to Y/Y GDP Growth)		0.5	0.0	0.0	0.5	0.2	-0.1	-0.1	0.1	0.0	0.0	0.0
Exports	YoY	11.0	7.9	5.7	11.6	10.3	7.5	7.0	7.0	6.4	5.7	5.4
Imports	YoY	9.1	6.3	5.0	10.7	8.7	5.6	5.4	5.8	5.2	5.1	5.0
CPI	YoY	1.6	2.7	2.1	2.0	2.5	2.8	2.6	2.7	2.2	2.0	2.2
Core CPI	YoY	1.0	1.3	1.4	1.1	1.1	1.6	1.2	1.3	1.3	1.3	1.3
CPI Ex Energy and Food	YoY	1.0	1.5	1.6	1.1	1.3	1.8	1.3	1.5	1.4	1.4	1.8
Unemployment Rate	YoY	10.1	9.8	9.6	10.1	9.9	9.9	9.8	9.7	9.7	9.6	9.5
Current Account Balance	EUR bn	-36.6	-35.3	-41.3								
	% of GDP	-0.4	-0.4	-0.4								
General Government Balance	EUR bn	-550.5	-405.3	-314.0								
	% of GDP	-6.0	-4.3	-3.2								
General Government Debt	EUR bn	7837.2	8262.5	8596.6								
	% of GDP	85.1	86.8	87.4								
Gross Operating Surplus	YoY	3.4	3.1	3.2								

Sources: Eurostat and Citi Investment Research and Analysis

Germany

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Sentiment indicators dropped in recent months, but most of them remained substantially above their long-term averages and many are close to historical highs. This suggests that the recovery continues at a decent pace. However, after a temporarily upwardly distorted GDP gain by 1.5% QQ in 1Q we expect smaller GDP gains in coming quarters. With ongoing buoyant gains in capital expenditure and consumption — the latter supported by ongoing employment and wage gains — domestic demand is likely to play a key role in the recovery. Indeed, for 2011 we expect the largest contribution from final domestic demand to GDP growth (3.1%) since 1992. Although unemployment rates are around the lowest readings since unification, wage gains have been modest so far, keeping underlying inflationary pressure in check. Despite this "goldilocks" economy, Angela Merkel's centre-right government is struggling. In addition to the intra-coalition controversy regarding the exit from using nuclear energy, there is also an intra-coalition row regarding additional support measures for Greece. While we expect that Germany will agree to the second Greece package and to the planned extension of the guarantees of the EFSF, these measures might lead to a break up of the coalition. In that case early elections would be likely.

France

Available information on 2Q GDP has been mixed. Some business surveys, like the PMI's, were up compared to 1Q, but the INSEE business and consumer surveys edged down and hard economic data, like industrial production, were down. Overall we continue to expect a slowdown in GDP in 2Q and modest growth rates thereafter. While we are pretty much in line with the government and IMF view on GDP growth for 2011, we remain less upbeat for 2012 than the government and the IMF and actually revised down our GDP forecast by 0.1% to 1.6% this month. As the IMF stressed in its recent Article IV consultation report, additional austerity measures would be required to meet the medium-term deficit targets. In that respect, we expect an increase in VAT after the 2012 spring elections. This hike would be a drag on growth and would boost headline inflation. With the nomination of the Presidential candidates, the election campaign is likely to start soon. Most interesting will be the choice of the candidate of the Socialist Party, whereas we have little doubt that President Sarkozy will decide to run for a second term.

Figure 30. Germany and France — Economic Forecast, 2010-12F

		Germany			France		
		2010	2011F	2012F	2010	2011F	2012F
Real GDP	YoY	3.5%	3.5%	2.5%	1.4%	2.0%	1.6%
Final Domestic Demand	YoY	1.8	3.2	2.3	0.8	1.8	1.5
Private Consumption	YoY	0.4	1.9	2.1	1.4	1.8	1.5
Fixed Investment	YoY	6.2	9.1	5.3	-1.3	3.4	3.1
Exports	YoY	14.4	10.1	8.9	9.4	5.2	5.1
Imports	YoY	12.8	8.2	9.4	8.3	6.5	3.9
CPI	YoY	1.1	2.4	2.1	1.7	2.2	2.0
Unemployment Rate	%	7.1	6.1	5.7	9.3	8.9	8.7
Current Account	€bn	141.4	141.2	140.0	-34.3	-17.1	-15.0
	% of GDP	5.7	5.4	5.2	-1.8	-0.8	-0.7
General Govt. Balance	€bn	-82.0	-46.7	-18.2	-136.5	-117.5	-90.1
	% of GDP	-3.3	-1.8	-0.7	-7.0	-5.8	-4.3
General Govt. Debt	% of GDP	1946.3	2003.1	2029.3	81.7	84.6	86.1
Gross Trading Profits	YoY	87.6	87.1	85.0	1.1	3.5	4.0

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

Italy

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Weakness in Q1 GDP growth is likely to be reversed in Q2, leaving the annual average unchanged. However, overall growth remains subdued due to the ongoing deterioration of the private sector's ability to spend. Rating agencies have recently started to raise concerns that weak growth could jeopardize medium-term sustainability of still-high public debt. Despite recent efforts to keep the deficit low, a sizable improvement in the primary balance (of at least 3pp of GDP) is needed in order to start seeing meaningful declines in the debt-to-GDP ratio. Given the current fragility of the government after its political defeat in recent local elections, policy commitment towards a severe fiscal consolidation path may not be as strong as it has been in the recent past.

Spain

GDP growth in Q1 was slightly stronger than we expected, but recent data indicate a slowdown for Q2, led mainly by domestic demand, while exports remain buoyant. Housing indicators have recently shown renewed weakness, after a temporary pause in 2010. The housing correction will keep weighing on investment activity and on private consumption via wealth effects. The central government budget deficit continues to shrink, but this may not be enough to offset the likely slippages at the regional level. We still expect the deficit targets to be missed by some, but not huge, extent this year and the next. The news flow on banks recapitalisation plans — either via private or public funds — will likely be key for Spanish sovereign risks in coming months.

Greece

With still very few details on the new austerity plans, it is very difficult to compute their impact on growth at this stage. We have revised down our GDP forecast for this year and the next once again this month, incorporating new data revisions for 2010 and recent monthly data suggesting negative growth in Q2, after a surprisingly positive Q1 reading. Central government budget data up to May suggest the fiscal deficit by year-end may be even wider than last year, unless a major fiscal shift is operated in H2 11. We think this is unlikely, given the ongoing political turmoil and increased chances of early elections, perhaps even before year-end.

Figure 31. Italy, Spain and Greece — Economic Forecast, 2010-12F

		Italy			Spain			Greece		
		2010	2011F	2012F	2010	2011F	2012F	2010	2011F	2012F
Real GDP	YoY	1.2%	0.8%	1.0%	-0.1%	0.3%	0.2%	-4.4%	-4.1%	-2.5%
Final Domestic Demand	YoY	0.9	0.5	0.7	-1.2	-1.6	-1.3	-5.9	-7.4	-4.6
Private Consumption	YoY	1.0	0.7	0.4	1.3	-0.3	-1.0	-4.6	-4.0	-3.3
Fixed Investment	YoY	2.4	0.7	3.2	-7.5	-6.7	-1.7	-8.2	-23.0	-6.3
Exports	YOY	8.9	5.2	2.9	10.3	9.4	0.5	3.9	3.6	2.8
Imports	YOY	10.3	5.6	1.6	5.5	2.3	-3.8	-4.8	-10.4	-6.0
CPI	YOY	1.6	2.9	2.7	2.0	3.1	1.5	4.7	3.4	1.8
Unemployment Rate	%	8.4	8.7	8.5	20.1	21.2	21.1	12.5	16.5	17.9
Current Account	€bn	-53.5	-68.1	-71.5	-47.9	-40.1	-22.7	-24.1	-16.6	-9.8
	% of GDP	-3.5	-4.3	-4.4	-4.5	-3.7	-2.0	-10.4	-7.3	-4.4
General Govt. Balance	€bn	-71.2	-64.2	-59.3	-98.6	-74.5	-57.7	-24.2	-22.4	-21.9
	% of GDP	-4.6	-4.1	-3.7	-9.3	-6.9	-5.2	-10.5	-10.0	-9.7
General Govt. Debt	€bn	1843	1907	1966	638.0	745.5	820.5	329	358	393
	% of GDP	119.0	121.0	121.5	60.0	69.0	73.6	142.8	160.7	173.9

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

UK

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The economy continues to show sluggish growth with high inflation. We are trimming our GDP forecasts to 1.4% for 2011 and 2.2% for 2012 this month from 1.8% and 2.6% respectively, because of the weakness in Q1 domestic demand, signs that Q2 growth is softer than expected and the likelihood that headwinds from high private debts and poor credit availability will persist. We are not wholly convinced that the economy really is as subdued as recent activity data imply: business surveys and labour market data, for example, paint a less gloomy picture. Nevertheless, the ONS GDP figures have been soft recently and hence our forecast reflects that (although the GDP data will be revised later this year). Behind the short-term trends, the strategic trend is that the UK is undergoing a major multi-year rebalancing, or rather a three-sided rebalancing: from the public sector to the private sector; from consumption to investment; and from domestic demand to exports. This adjustment is in its early stages, but we suspect that — unless recovery is derailed by fiscal slippage, surging inflation expectations or currency turmoil — the UK economy will achieve sustained and well-balanced growth in coming years.

We continue to expect an extended inflation overshoot, caused by external cost pressures from the low pound plus global inflation, supply-side deterioration, and loose monetary policy. The recession appears to have created less disinflationary slack than expected. Surveys suggest that capacity use among manufacturing and service sector firms is close to its longrun average, in contrast to output gap estimates which imply ample slack. Private sector job growth is the highest since the late 90s and pay deals are picking up. Nevertheless, the Governor and majority of MPC members seem determined to keep rates low, and hence we have scaled back our rate forecast: we now anticipate just one 25bp hike by end-2011 (two hikes previously) with rates expected to be 1.5% at end-2012 (2.0% previously) and 2.0% at end-2013 (3.0% previously).

Figure 32. United Kingdom — Economic Forecast, 2010-2012F

					2010	2011				2012		
		2010	2011F	2012F	4Q	1Q	2QF	3QF	4QF	1QF	2QF	3QF
Real GDP	YoY	1.3%	1.4%	2.2%	1.5%	1.8%	0.8%	0.9%	2.1%	2.0%	2.5%	2.2%
	SAAR				-2.0	2.0	0.3	3.4	2.8	1.6	2.2	2.2
Domestic Demand	YoY	2.4	-0.3	1.6	2.8	0.5	-0.3	-0.8	-0.3	1.3	1.6	1.9
(Incl. Inventories)	SAAR				0.1	-5.1	0.6	1.1	2.2	1.4	1.8	2.1
Consumption	YoY	0.8	0.0	1.2	0.2	-0.3	-0.4	0.1	0.7	1.5	1.2	1.1
	SAAR				-1.1	-2.3	2.1	1.7	1.4	0.7	0.9	1.4
Investment	YoY	3.0	-3.3	7.3	5.8	-2.7	-3.5	-5.4	-1.4	5.5	8.3	8.6
	SAAR				-7.2	-16.5	-2.9	6.2	9.8	9.5	7.7	7.2
Exports	YoY	5.3	6.9	6.8	5.4	10.4	4.7	6.3	6.4	3.9	8.6	7.1
	SAAR				7.1	15.6	-9.2	13.8	7.2	5.3	8.1	7.8
Imports	YoY	8.5	0.8	4.7	9.4	4.9	0.6	-0.1	-2.0	1.4	5.2	5.8
	SAAR				13.5	-9.0	-7.8	4.6	5.1	4.5	6.6	7.2
Unemployment Rate	%	7.9	7.6	7.1	7.9	7.7	7.5	7.6	7.4	7.3	7.2	7.0
CPI Inflation	YoY	3.3	4.5	3.3	3.4	4.1	4.5	4.8	4.7	3.9	3.4	3.2
Merch. Trade	£bn	-99.2	-78.7	-68.5								
	% of GDP	-6.8	-5.2	-4.3								
Current Account	£bn	-36.2	-8.0	-1.3								
	% of GDP	-2.5	-0.5	-0.1								
PSNB	£bn FY	-139.4	-111.7	-85.6								
	% of GDP	-9.5	-7.2	-5.3								
General Govt. Balance	% of GDP	-9.7	-8.4	-6.5								
Public Debt	% of GDP	75.1	79.9	82.5								
Gross Nonoil Trading Profits	YoY	4.3	10.0	7.7								

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

Switzerland

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We have revised down our 2011 growth forecast from 3.1% to 2.5% following the weaker-than-expected Q1 data, when GDP rose by just 0.3% QoQ — whereas surveys had pointed to growth of 0.7%-0.8% QoQ. We regard the weakness in GDP as being somewhat erratic, given that there was a massive drop in inventories in that quarter — the biggest drop since data began 30 years ago — cutting 2.5% off domestic demand in Q1. For Q2, we expect less destocking and a rebound in growth to 0.7%-0.8% QoQ, in line with business surveys. The super-strong CHF will cap growth and inflation in 2012-13, and we now expect the SNB to stay on hold to the end of this year.

Sweden

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With thanks to Frida Sellberg

Consumption growth seems to be slowing faster than we had previously expected. This together with the fact that import growth was above our forecast in 1Q is behind our downwards revision of growth this year, to 4.8% YY compared to the previous 5.0% YY. The main driver behind growth, which still is at a historically very high level, is hence continued growth in exports and investment. We still expect the Riksbank's key policy rate to be at 2.5% end-2011 and to reach 3.5%-end 2012.

Denmark

An unexpected drop in 1Q GDP, following the 4Q 2010 drop, officially put Denmark back into recession. Consumption as well as investment were much weaker than we had expected and we have revised down our growth forecast rather markedly to 1.7% YY this year (2.1% YY previously). Exports showed a fair pickup in 1Q and are expected to be the main driver for growth also for the rest of the year. Nationalbanken is most likely to continue peg the ECB in terms of rate hikes this year, hence we expect a 25bp hike in July, putting the key policy rate at 1.55%.

Norway

Surveys continue to signal a fair pickup in growth this year while "real" data are not as encouraging. We still expect a fair pickup in growth, driven by investments and private consumption. Even so, our forecast for mainland GDP is revised down slightly this month (0.1pp), following weaker than expected export figures in the first part of the year. Hence, we now expect a larger pickup in exports in 2012, and we have revised up our GDP growth forecast by 0.2pp that year. Norges Bank is expected to hike two more times this year, in 3Q and 4Q, putting the key policy rate at 2.75% year-end. For next year, the policy rate is likely to reach 4.0%.

Figure 33. Switzerland, Sweden, Denmark and Norway — Economic Forecast, 2010-2012F

		Switzerland			Sweden			Denmark			Norway		
		2010	2011F	2012F	2010	2011F	2012F	2010	2011F	2012F	2010	2011F	2012F
Real GDP[a]	YoY	2.6%	2.5%	2.6%	5.4%	4.8%	3.3%	2.1%	1.7%	2.1%	2.1%	3.1%	3.5%
Final Domestic Demand	YoY	1.3	2.2	3.2	3.7	3.3	3.0	0.7	1.0	2.1	1.9	3.7	3.3
Public Consumption	YoY	-1.6	1.0	1.4	2.0	1.0	0.7	1.1	-0.3	0.8	2.2	2.0	2.0
Private Consumption	YoY	1.7	1.2	1.8	3.4	2.5	2.6	2.2	1.3	2.5	3.6	2.8	3.4
Investment (Ex Stocks)	YoY	4.6	7.5	7.5	6.0	9.1	7.4	-3.4	1.9	3.6	-3.0	9.4	5.1
Exports	YoY	9.3	8.9	6.8	10.6	9.6	5.6	3.7	6.3	2.5	2.9	5.6	7.3
Imports	YoY	6.8	9.7	12.2	12.4	9.7	4.7	2.9	5.8	2.6	8.1	7.9	4.9
CPI (Average)	YoY	0.7	1.5	1.2	1.2	3.2	2.4	2.3	2.4	2.1	2.4	1.8	2.2
Unemployment Rate	%	3.9	3.2	2.4	8.4	7.3	6.5	4.2	3.9	3.7	3.6	3.1	2.9
Current Account	% of GDP	14.6	14.5	12.4	6.3	6.4	6.4	5.1	5.0	4.2	12.4	13.5	15.0
General Govt Balance	% of GDP	0.2	0.3	0.6	0.0	0.4	1.6	-2.7	-2.8	-2.5	9.7	9.6	12.5
General Govt Debt	% of GDP	55.0	52.7	51.2	39.4	35.9	31.9	43.6	45.6	46.5	NA	NA	NA

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

Canada

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We continue to anticipate trend-like growth for 2011 as lost 2Q output should be recouped in the second half. The economy is still poised to moderate over the medium term reflecting drag from fiscal consolidation; capped consumer spending as income growth softens and deleveraging takes hold; and limited exports capacity amid ongoing competitiveness constraints. Key upside risks to the inflation outlook remain higher commodity prices and global inflation, as well as a stronger profile for Canadian debt and consumer spending. The main downside risks include the persistent strength of the Canadian dollar and consumer retrenchment.

Given the severity of auto sector supply chain disruptions and production cuts, the Canadian economy should expand at a more tepid pace in the second quarter than first anticipated. However, the Bank of Canada's seemingly unchanged trajectory for inflation and closure of the output gap, suggests some modest tightening later this year and early next. Moreover, we posit that there is a narrow window within which the central bank must unwind some extraordinarily accommodative monetary policy before the economy slows over the 2012-13 span. Hence, we continue to expect the policy rate target to rise from 1.00% to 2.25% over the next twelve months, followed by an extended pause.

The temporary lull in near-term activity and lingering concerns about Euro Area sovereign debt woes have, however, prompted us to push back our projection for resumption of interest rate normalization from July to October. By the final quarter of this year, there should be strong evidence that the global economy has recovered from first-half energy price and Japanese earthquake shocks. In Canada, overall inflation will remain near 3%, and underlying prices may briefly exceed 2% on elevated food costs and waning of dampening HST effects. Moreover, Canadian output will have reaccelerated and the absorption of excess supply resumed — both central bank conditions for the eventual removal of easy policy.

Figure 34. Canada — Economic Forecast, 2010-2012F

					2010	2011				2012		
		2010	2011F	2012F	4Q	1Q	2QF	3QF	4QF	1QF	2QF	3QF
Real GDP	YoY	3.2%	2.8%	2.6%	3.3%	2.9%	2.6%	2.8%	2.8%	2.4%	2.7%	2.6%
	SAAR				3.1	3.9	1.0	3.4	3.0	2.2	2.3	2.7
Final Domestic Demand	YoY	4.5	3.4	2.4	4.6	3.8	3.7	3.3	2.7	2.6	2.3	2.3
	SAAR				4.8	2.3	3.3	2.8	2.2	2.2	2.2	2.4
Private Consumption	YoY	3.3	2.0	2.5	3.2	2.2	2.0	2.0	1.6	2.2	2.7	2.5
	SAAR				4.4	0.2	0.5	3.2	2.8	2.5	2.4	2.3
Government Spending	YoY	4.7	0.5	-2.3	3.3	3.0	1.5	-0.3	-2.3	-3.0	-3.0	-2.1
	SAAR				3.4	0.6	-0.8	-4.2	-4.7	-2.1	-0.8	-0.7
Private Fixed Investment	YoY	8.4	11.4	7.7	11.1	10.4	11.8	11.5	11.9	10.5	7.8	6.7
	SAAR				7.8	12.0	15.8	10.6	9.3	6.3	5.0	6.4
Exports	YoY	6.4	4.8	4.6	7.0	6.4	3.3	5.1	4.5	3.6	4.9	4.9
	SAAR				8.8	6.4	-0.3	5.7	6.3	2.8	4.9	5.4
Imports	YoY	13.1	5.7	3.9	10.2	9.4	5.0	3.8	4.9	3.5	3.7	4.0
	SAAR				-0.5	9.1	3.5	3.5	3.5	3.5	4.5	4.5
CPI	YoY	1.8	2.9	2.1	2.3	2.6	3.3	3.0	2.9	2.5	2.0	2.0
Core CPI	YoY	1.7	1.8	2.1	1.6	1.3	1.6	1.9	2.2	2.3	2.0	1.9
Unemployment Rate	%	8.0	7.5	7.1	7.7	7.8	7.5	7.7	7.2	7.3	7.2	7.3
Current Account Balance	C$bn	-50.9	-36.4	-21.4	-41.1	-35.7	-36.9	-36.9	-36.0	-28.5	-20.0	-19.3
	% of GDP	-3.1	-2.1	-1.2	-2.5	-2.1	-2.1	-2.1	-2.0	-1.6	-1.1	-1.1
Net Exports (Pct. Contrib.)		-3.1	-0.9	-0.1	2.7	-0.9	-1.6	0.4	0.6	-0.6	-0.3	-0.1
Inventories (Pct. Contrib.)		0.7	0.2	0.2	-3.8	2.6	0.3	0.0	0.0	0.4	0.2	0.2
Budget Balance (Fiscal Year)	% of GDP	-2.2	-1.8	-1.1								
Federal Budget Debt	% of GDP	33.6	33.4	32.8								

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

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Australia

Weaker-than-expected employment data, a decline in business and consumer sentiment and some slowing in Australia's largest trading partner, China, have raised the hurdle rate for a near term increase in official interest rates. We also have lowered our GDP growth forecast for 2011. Barring a substantial upside shock to the Q2 CPI result in late July, we do not expect the RBA to further increase monetary policy until November. We expect additional monetary policy measures in 2012, given the expectation of a return to above-trend economic growth and the underlying structural demand for commodities that will see a large increase in business investment probably through to the middle of the decade. These developments will reinforce Australia's "two-speed" nature of economic growth. But spillovers from mining into other sectors will contribute to solid aggregate income growth and point to upside inflation risks at a time when Australia's productivity growth is likely to remain relatively low.

New Zealand

An upbeat assessment of the economy by the RBNZ Governor and an improvement in some economic indicators, including confidence and retail spending, created some risk that the emergency rate cuts of March could be removed this year. In response, we brought forward the forecast for the start of the monetary tightening cycle from Q1 2012 to Q4 2011. But we believe that the removal of the emergency policy accommodation will begin with a 25bp increase in the OCR rather than anything larger. More seismic activity in the Christchurch region is likely to further delay the reconstruction effort while the high NZD continues to hamper exports outside of the dairy sector.

Figure 35. Australia and New Zealand — Economic Forecast, 2010-2012F

	Australia			New Zealand		
	2010	2011F	2012F	2010	2011F	2012F
Real GDP[a]	2.7%	1.4%	4.0%	1.4%	1.5%	3.4%
Real GDP (4Q versus 4Q)	2.7	2.1	4.2	0.6	2.9	3.8
Real Final Domestic Demand	3.6	3.6	4.4	2.2	2.3	2.8
Consumption	2.7	3.1	3.3	1.9	1.1	1.9
Govt. Current & Capital Spending	9.1	1.2	1.0	-2.1	0.3	-1.0
Housing Investment	4.8	4.5	3.6	4.4	3.5	8.8
Business Investment	-0.9	10.8	7.5	0.1	6.8	6.4
Exports of Goods & Services	5.3	-0.5	12.0	2.7	1.3	4.2
Imports of Goods & Services	13.2	8.4	10.6	7.9	5.9	3.7
CPI	2.8	3.1	2.7	2.3	4.3	2.9
CPI (4Q versus 4Q)	2.7	3.1	2.8	4.0	3.1	2.6
Unemployment	5.2	4.6	3.9	6.8	6.8	5.8
Merch. Trade, BOP (Local Currency, bn)	16.7	36.9	32.0	-0.61	-1.07	-0.86
Current Account, (Local Currency, bn)	-34.5	-25.5	-43.3	-2.8	-1.3	-11.2
Percent of GDP	-2.6	-1.8	-2.8	-2.3	-0.7	-5.5
Budget Balance[b] (Local Currency, bn)	-57.1	-41.5	-12.3	-6.3	-16.7	-9.7
Percent of GDP	-4.2	-3.6	-1.5	-3.3	-8.4	-4.7
General Govt. Debt (% of GDP)[c]	3.3	5.9	7.2	14.1	20.8	26.2
Gross Trading Profits[d]	12.5	4.0	8.8	NA	NA	NA

BOP Balance of payments basis. CPI Consumer Price Index. F Citigroup forecast. NA Not available. [a]Averaged-based GDP in Australia; Production in New Zealand. [b]Fiscal year ending June. Australia's underlying cash balance. [c]Australia and New Zealand Budget definition and forecasts — debt equals an asset. [d]Company gross operating surplus.
Source: Citi Investment Research and Analysis

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China

China's economy continues to follow a path of moderate slowdown. Monetary conditions have tightened more notably than real indicators of activity, which is likely to show further softening in coming periods. Inflation stayed on an upward climb, but there is some evidence of a return to more normal seasonal patterns. The mixed signs in current activity keep the doors open for further rate hikes, while reserve requirement hikes may have run their course amid tight liquidity.

Monetary aggregates have been kept below central bank targets. Slower than expected M2 growth suggests that PBOC is building a cushion in meeting its monetary targets. Credit extension in the first five month was notably below past years, and has underperformed deposit growth markedly, bringing down the loan-to-deposit ratio. As such, we see little odds for additional RRR hikes, especially since maturing PBOC bills would narrow to more manageable levels in 2H. We expect no immediate loosening in monetary policy since inflation remains a challenge. But the cushion built in over the past several months would increase policy flexibility later, if needed, to respond to new developments while still meeting the monetary targets.

Investment growth continues to boom, while destocking weighed on industrial production (IP). Fixed investment growth sped up to 25.8% in the first five months from 24.4% in 2010. Other than social housing driven property development, resources and manufacturing investment also showed strong numbers. Some of this strength came from a statistical change that excluded smaller projects and included rural ones. Power shortages and supply chain disruptions appear to have had only a minor impact on industrial activity. But IP growth has slowed due to firms' trying to clear inventories given softening orders, both domestic and external.

Inflation risks remain, but there are signs of ebbing momentum. Food prices have come down, especially after the droughts were doused by heavy rainfall, though floods are raising new risks. The negative gap between M1 and M2 growth continues to point at falling momentum in inflation. And broadly slower global growth will likely limit additional imported inflation in the near term. These reinforce our view that CPI will likely peak in mid-year, with gradual softening in 2H. Thus, we maintain our view that authorities may still raise interest rates to compensate depositors, but refrain from much additional administrative tightening.

Figure 36. China — Economic Forecast, 2010-2012F

					2010	2011				2012		
		2010	2011F	2012F	4Q	1Q	2QF	3QF	4QF	1QF	2QF	3QF
Real GDP	YoY	10.3%	9.2%	9.0%	9.8%	9.7%	9.5%	9.1%	8.8%	9.2%	9.0%	9.0%
Real Final Domestic Demand	YoY	10.3	9.7	9.7								
Consumption	YoY	8.0	8.3	8.8								
Fixed Capital Formation	YoY	12.8	11.2	10.5								
Industrial Production	YoY	15.5	13.6	12.5	13.2	14.4	13.0	13.5	14.0	13.0	12.5	12.3
Exports	YoY	31.3	17.7	13.4	24.9	26.4	19.0	15.0	13.0	12.0	12.0	13.0
Imports	YoY	38.9	22.3	15.9	29.5	32.8	23.5	19.0	16.0	14.0	13.0	15.0
Merchandise Trade Balance	$bn	184.5	153.3	138.7	63.1	-1.0	33.5	60.9	59.9	-9.2	33.2	60.1
FX Reserves	$bn	2,847	3,300	3,600	2,847	3,045	3,150	3,200	3,300	3,400	3,500	3,575
Current Account	% of GDP	5.3	4.2	3.5								
Fiscal Balance (trailing 4-qtr sum)	% of GDP	-1.6	-2.0	-2.0	-1.6	-1.7	-1.7	-1.5	-2.0	-1.7	-1.5	-1.5
General Govt. Debt	% of GDP	21	20	21								
Urban Unemployment Rate	%	4.1	4.1	4.1	4.1	4.1	4.1	4.0	4.0	4.0	4.0	4.0
CPI	YoY	3.3	5.0	4.0	4.7	5.1	5.4	5.1	4.3	3.9	4.1	3.8
Exchange Rate (end period)	CNY/$	6.60	6.35	6.00	6.60	6.56	6.48	6.43	6.35	6.28	6.20	6.15
1-Yr Deposit Rate (end period)	%	2.75	3.75	3.75	2.75	3.00	3.50	3.75	3.75	3.75	3.75	3.75

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

India

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We maintain our view that FY12 will likely be a year of two halves, with 1H GDP in the 7.5%-7.8% YY range; and 2H GDP in the 8.2%-8.5% range. However, in addition to consumption and exports being relatively buoyant, a key assumption behind our full-year 8.1% GDP estimate is a pick-up in investment in 2HFY12.

A quick re-cap: over the last year the impact of policy uncertainty was reflected in diverging trends in 1HFY11 — where investment growth came in at 14.7% and 2HFY11 where growth slowed to 4.1%. Looking ahead, while trends in 1HFY12 are likely to remain weak, we expect a recovery in 2HFY12, thus resulting in overall investment growth coming at 5.4% v/s 8.4% in FY11. This is based on (1) Incremental policy momentum being positive, as reflected in conditional clearances and bills being tabled; (2) Bunching up of projects in the last year of the plan; and (3) Deferred projects being taken up. If we don't see an investment recovery in 2HFY12, overall investment growth could slow to 2.5% levels, resulting in headline GDP growth at 7.2%.

Similar to the May reading which saw a headline print of 9.1%, inflation is expected to remain elevated at 8%+ through the year. With inflation remaining a priority over growth, in addition to the recent 25bps hike in policy rates, we maintain our view that the RBI will hike rates by a further 50bps through 2011. The clouds on the fiscal horizon remain, with slippages likely both due to higher subsidies as well as on the revenue account due to lower growth. Depending on the timing of the subsidy pay-out, the deficit could touch 5.1%-5.5% of GDP this year.

On the external front, while exports in April and May have got off to a good start, up 34% and 57% respectively, we maintain our view of growth moderating to 19%. This is due to (1) a high base (2) external factors (global growth + MENA risks); and (3) domestic constraints (infrastructure + rates). Despite relatively robust exports, given India's dependence on resources, we maintain our view of the trade deficit widening to US$155bn in FY12 from US$119bn in FY11. While India's overall trade deficit will likely remain in the 7%-8% of GDP range, the current account deficit (CAD) is likely to print much lower at 2%-3% of GDP levels. This is due to the continued buoyancy in invisible earnings. As mentioned earlier, this is due to: (1) software exports, which are likely to register growth of 25%, and (2) continued buoyancy in remittances. This bodes well for our medium-term rupee view of a marginal appreciation.

Figure 37. India — Economic Forecast, FY2010/11-2012/13F

		FY 10/11F	FY 11/12F	FY 12/13F
Real GDP	YoY	8.5%	8.1%	8.4%
Final Domestic Demand	YoY	8.1	6.6	8.3
Private Consumption	YoY	8.6	7.1	8.0
Fixed Investment	YoY	8.4	5.4	9.0
Exports	YoY	12.0	16.5	13.0
Imports	YoY	6.3	11.0	8.3
Wholesale Price Index*	YoY	8.6	8.6	7.5
Consumer Price Index	YoY	9.5	7.0	6.5
Unemployment Rate	%	NA	NA	NA
Current Account	US$ bn	-34.4	-54.3	-51.5
	% of GDP	-2.0	-2.7	-2.2
Consolidated Fiscal Balance	% of GDP	-7.2	-7.9	-7.1
Centre Fiscal Balance	% of GDP	-4.7	-5.1	-4.6
US Dollar Exchange Rate	Average	45.6	44.8	44.8

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

Korea

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Job growth continues, while inflationary pressures remain high. With resilient exports and steady consumption, the number of new jobs in May increased by 112k from the previous month and the seasonally-adjusted unemployment rate declined sharply to 3.3% from 3.6% in April. Headline CPI inflation in May was 4.1% YoY, above the BoK's inflation target range, but continuing to moderate from the peak of 4.7% in Mar due to the slowdown of agricultural and import price inflation. Meanwhile, core CPI inflation rose to 3.5% YoY from 3.2% in Apr as processed foods and services inflation picked up. As inflation pressures are expected to stay high in 2H11, both from cost-push and demand-pull, the government recently shifted its policy priority to price stabilization from economic recovery. Following the shift in policy stance, BoK turned hawkish on inflation and raised the policy rate by 25bps to 3.25% at the June MPC meeting. There had been widespread expectations of stable rates given that the external and domestic uncertainties that had led BoK to hold the rate in May have not improved. Considering the stance of the government and BoK on inflation, we expect BoK to raise the policy rate twice in 2H11, each by 25bps, to 3.75% at the end of this year.

Indonesia

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Growth remains robust, with Bank Indonesia expecting 2Q2011 growth to be better than previously expected. Meanwhile, May inflation has gone below BI's inflation target for the first time in 7 months largely because of the third consecutive month of food deflation. However, we still view this inflation reprieve as temporary. The underlying strength of domestic demand and strong external flows going into 2Q 2011, alongside an increasingly more dovish central bank, underpins upward risks to core inflation. With foreign inflows into IDR government bonds rising by about $1.8bn in 2Q2011 (up to mid-June), equivalent to about 34% of outstandings, there is a risk that the market is increasingly under-pricing inflation risks later on, and we expect that some market volatility will prompt BI to hike rates one more time towards year-end. Meanwhile, we sense growing risk that BI may resort to another hike in reserve requirement to manage excess liquidity, and will resist rate hikes for as long as possible. We also believe, despite the recent bout of FX weakness, the BI will continue to manage volatility and will tolerate more appreciation when risk appetite improves. Indonesia remains on a clear path towards investment grade rating — probably by year-end.

Figure 38. Korea and Indonesia — Economic Forecast, 2010-12F

		Korea			Indonesia		
		2010	2011F	2012F	2010	2011F	2012F
Real GDP	YoY	6.2%	4.3%	4.6%	6.1%	6.5%	6.6%
Final Domestic Demand	YoY	4.8	3.0	4.2	5.2	7.2	7.2
Private Consumption	YoY	4.1	3.5	4.5	4.6	5.4	5.4
Fixed Investment	YoY	7.0	2.8	4.1	8.5	10.7	11.0
Exports	YoY	14.5	11.3	11.5	14.9	11.1	7.3
Imports	YoY	16.9	10.8	13.1	17.3	13.5	9.5
Consumer Price Index	YoY	3.0	4.0	3.4	5.1	5.8	6.4
Unemployment Rate	%	3.7	3.5	3.2	7.1	6.8	6.5
Current Account	US$ bn	28.2	19.5	14.3	6.3	4.1	0.6
	% of GDP	2.8	1.7	1.1	0.9	0.5	0.1
Fiscal Balance	% of GDP	1.4	0.8	1.0	-0.6	-1.5	-1.5
US Dollar Exchange Rate	Average	1156	1069	1023	9092	8540	8325

Sources: Haver Analytics and Citi Investment Research and Analysis

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HK is likely to enter into a soft patch in 2Q, as previewed by two consecutive declines in the PMI data. We forecast 2Q real GDP could fall to 5% YY from the strong growth of 7.2% YY in 1Q, affected by Japanese supply chain disruptions, still feeble demand recovery of the US and EU, plus inflation-related tightening in Asian neighbours. Domestic demand, however, remains resilient thus far as indicated by strong retail sales and labor data. We expect inflationary pressures will only peak in 3Q, driven by private rental pass-through and unfavorable base effects. The unabated rise in property prices has led HKMA to further lower the loan-to-value ratio of mortgages. Although the US may delay exit strategies till early next year and only start to raise the Fed Fund rates in Q3-2012, HK banks may raise lending rates earlier as HKMA enforces more prudential measures to curb excessive lending. We reiterate our view that the HKD peg will prevail status quo, despite our high inflation scenario and market worries of marginalization of the HKD. The HKD has again weakened and has recently been edging towards the mid of the convertibility band; we see the currency could strengthen in 2H if the stock market recovers after China's inflation and tightening peak.

Singapore

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The economy is weathering the Q2 soft patch better than expected, with May exports unexpectedly rebounding, while services are holding up well. Growth will probably regain momentum in the second half, and we maintain our 2011 GDP forecast of 7%. Into 2012 however, supply constraints from the tightening of foreign worker inflows may become more binding, and growth will likely moderate to around 5%. The labour market is now near the tightest levels in the last decade, and higher wages are lifting domestic retail sales. With domestic demand staying resilient, higher wages are more likely to be passed on to consumer prices, offsetting much of the relief to inflation from the plateau in COE premiums and commodity prices. The structural catch-up in wages will keep inflation elevated, above the long term average of 2% over the next few years. We thus cannot rule out a further round of monetary tightening in October, even though the bar for tightening is probably higher now. An expected delay in the Fed's rate hiking timetable to Q3-2012 will keep SIBOR rates low for longer. Property market sentiment has already softened after the announcement of a sizeable increase in supply of public and private housing post elections, although given the significant shortfall over the past few years, this represents more of a catch-up at this stage rather than a supply glut.

Figure 39. Hong Kong and Singapore — Economic Forecast, 2010-12F

		Hong Kong			Singapore		
		2010	2011F	2012F	2010	2011F	2012F
Real GDP	YoY	7.0%	5.8%	5.5%	14.5%	7.0%	5.0%
Final Domestic Demand	YoY	6.2	4.0	4.0	5.5	6.0	6.1
Private Consumption	YoY	6.2	5.2	3.8	4.2	4.9	5.3
Fixed Investment	YoY	7.8	0.8	4.9	5.1	10.1	7.8
Exports	YoY	16.8	10.0	6.3	19.2	5.8	4.4
Imports	YoY	17.3	8.7	5.6	16.6	5.3	4.7
CPI	YoY	2.4	5.5	3.3	2.8	4.3	3.2
Unemployment Rate	%	4.4	3.5	3.3	2.2	2.0	2.0
Current Account	US$ bn	14.8	22.4	26.8	49.5	45.2	45.8
	% of GDP	6.6	9.1	10.0	22.2	16.5	15.0
Fiscal Balance	% of GDP	4.2	2.9	3.0	0.5	0.0	2.0
US Dollar Exchange Rate	Average	7.77	7.77	7.75	1.36	1.23	1.20

Sources: Haver Analytics and Citi Investment Research and Analysis

Russia

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We are increasing our capital outflow forecast this year to between US$40bn-US$50bn, out of which US$35bn has already taken place. However, we are not changing our ruble forecast, but expect the CBR to accumulate fewer reserves for the year as a whole. Should pressure on the capital and financial accounts increase in 4Q11, including due to the higher budget spending, we expect the CBR to hike deposit rates by more than our current forecast of 50bps. During the election period the authorities are not likely to allow significant ruble appreciation as imports account for a large share of the consumer basket. We think the forthcoming elections (2011 parliamentary and 2012 presidential) will shape major policy decisions this year. According to the proposed amendments to the budget, Russia will receive RUB1.13tr extra oil revenues in 2011. We believe the deficit is likely to be closer to 2% of GDP this year allowing for higher indexation of public wages in 2H 11. Inflation is also likely to start coming off in 2H owing to ruble appreciation, lower administered price increases, and low real wage growth in 1H. Given this and uneven growth statistics in 1Q, we expect the CBR to pause with rate hikes. However, we remain concerned about inflation in 2012. The basket may weaken moderately to 34.5 in 2H 11 on the back of declining current account surpluses, uncertainty related to the elections, and the higher budget spending.

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The results of the June general election turned out to be close to the most market friendly outcome in which the AKP is widely envisaged to gain a comfortable majority, but falling short of 330 deputies — the required number in Parliament to amend or rewrite the Constitution through a referendum. With the general election behind us, whether or not the new AKP government will put forward measures to alleviate rising concerns over the current account deficit emerges as the most pressing issue. In our view, maintaining the status quo in the management of the economy after the June election is not a viable option. As a result, we believe the new government is likely to take certain measures to alleviate these concerns, which may include: (i) fiscal actions in the form of administrative price adjustments and a commitment to restrain primary spending; and (ii) involvement of the BRSA through macro-prudential measures to help the CBT's efforts to bolster financial stability. Minister Babacan's recent comments seem to corroborate this view. According to him, the government's new Medium-Term Plan, which is reportedly to be released a few months after the new government is formed, will concentrate on the country's wide current account gap, including adjusting the fiscal stance as needed.

Figure 40. Russia and Turkey — Economic Forecast, 2010-12F

		Russia			Turkey		
		2010	2011F	2012F	2010	2011F	2012F
Real GDP	YoY	4.0%	4.3%	4.1%	8.9%	5.6%	3.8%
Final Domestic Demand	YoY	3.3	8.5	5.7	10.6	6.4	4.4
Private Consumption	YoY	3.0	5.1	5.3	6.6	5.3	4.0
Fixed Investment	YoY	6.1	10.0	10.3	29.9	10.1	6.1
Exports	YoY	7.1	3.5	3.1	3.4	6.8	7.5
Imports	YoY	25.6	18.0	10.0	20.7	9.6	9.0
CPI	YoY	6.9	8.8	7.3	8.6	5.9	6.8
Unemployment Rate	%	7.5	7.5	7.5	11.9	10.1	10.3
Current Account	US$ bn	71.1	84.6	32.9	-47.6	-68.1	-73.8
	% of GDP	4.8	4.7	1.6	-6.5	-8.9	-8.9
Fiscal Balance	% of GDP	-4.0	-2.2	-2.1	-3.6	-2.6	-2.9
US Dollar Exchange Rate	Average	30.4	28.5	28.9	1.50	1.61	1.65

Sources: Haver Analytics and Citi Investment Research and Analysis

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The final breakdown of 1Q GDP showed the Hungarian economy expanded by 2.5% YY. Domestic demand accelerated to 1.4% YY from 0.3% in 4Q, thanks to a smaller decline in fixed investment and private consumption. We expect a recovery in private consumption will be recorded only later this year, especially after the payout of real returns from pension savings. We expect wage demands to rise gradually, reflecting somewhat improved (albeit still challenging) labour market conditions as well as very high CPI fuelling inflation and wage expectations. After a large drop in inflation in May to 3.9% YY from 4.5% YY in April resulting mostly from lower food prices growth, we still expect inflation going up to 4.5%-4.7%, although our inflation profile for the coming months was lowered. At the same time this may be accompanied by a slow increase in core inflation on an expected gradual increase of demand-side pressures. Since the economic recovery is still very fragile and dependent on external demand, we don't expect changes in interest rates anytime soon. However, the improved inflation outlook will probably make the central bank soften its rhetoric and will probably delay discussions about rate hikes. We see little room for forint appreciation as fiscal tightening was already discounted by markets, while the interest rate disparity against the euro zone will likely decline.

Poland

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GDP growth decelerated slightly in 1Q to 4.4% YY and was driven by domestic demand (4.5% YY) with still very strong private consumption growth (3.9% YY) and gradual recovery in investment (6% YY). In May, inflation jumped further to 5% YY, substantially above market expectations and the central bank's target at 2.5%. This should lead to a further increase in net inflation, close to CPI target, and other core inflation measures, which are at elevated levels. Inflation should stay above 4% till the year end, while core inflation may be fuelled by accelerating wage pressures and unit labour cost growth. The labour market situation is improving further, along with recovery of economic growth, increased inflation and good financial results of Polish enterprises. The MPC raised interest rates in June by 25bp for the third month in a row to 4.50% and now has decided on a pause in monetary policy tightening. We expect the next rate hikes in September-October and in early 2012. The fiscal tightening planned by the government may accelerate the reduction of the general government deficit to about 4% GDP in 2012, i.e. still higher than 2.9% of GDP deficit assumed by the government. We expect fiscal tightening will result in a growth slowdown in 2012-2013. The current account deficit will likely be revised upwards in the next few weeks, although pressure on the zloty should be offset by privatization flows and the sale of EU funds by the Finance Ministry in the market.

Figure 41. Hungary and Poland — Economic Forecast, 2010-12F

		Hungary			Poland		
		2010	2011F	2012F	2010	2011F	2012F
Real GDP	YoY	1.2%	3.0%	3.4%	3.8%	4.2%	3.9%
Final Domestic Demand	YoY	-2.8	1.3	3.1	2.1	4.4	4.2
Private Consumption	YoY	-2.1	2.6	3.3	3.2	3.6	3.9
Fixed Investment	YoY	-5.6	1.7	5.0	-2.0	8.6	7.7
Exports	YoY	14.1	10.1	8.1	10.1	7.1	8.0
Imports	YoY	12.0	9.8	8.4	11.5	7.8	10.0
CPI	YoY	4.7	4.6	3.9	2.7	4.2	2.9
Unemployment Rate	%	11.2	10.0	9.5	12.1	11.1	10.0
Current Account	US$ bn	2.7	1.9	-0.9	-15.9	-31.1	-35.4
	% of GDP	2.1	1.3	-0.6	-3.4	-5.8	-5.7
Fiscal Balance	% of GDP	-4.2	2.5	-3.0	-7.9	-5.6	-4.0
US Dollar Exchange Rate	Average	208	191	190	3.0	2.8	2.6

Sources: Haver Analytics and Citi Investment Research and Analysis

Czech Republic

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First quarter GDP increased by 0.9% QQ, stronger than the flash estimate (0.6%). GDP increased by 2.8% YY which suggests an upside risk to our 2011 forecast of 2%, which is above the CNB's expectation for 1.5% YY. As result we have made a small upward revision to 2011's GDP forecast to 2.2%, while we cut 2012's forecast to 2.6% from 2.8% previously. We retain our view that more widespread and stronger growth in Germany this year is beneficial for the Czech recovery, but is limited by fiscal consolidation. The main downside risk to our 2012 forecast would be a stronger impact from the approved hike in the lower VAT rate in January 2012 (by 4%pt) that could hit real disposable incomes. The gradual recovery is likely to ease the contraction of the adjusted core CPI that is, in our view, the best indicator for the tightening in the CNB's policy rate. It was just a tick higher than CNB forecasts in May (-0.8% YY vs. -0.9%). In addition, the May CPI surpassed the CNB forecast (2% vs. 1.7%). Having said this, we expect the CNB to keep its policy rate unchanged on 23 June while we forecast it to increase to 1% in 3Q11 if the ECB keeps its hawkish stance and the koruna eases from its recent strengthening which we expect in the short-term.

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The release of the detailed 1Q GDP reading has led us to become more cautious about the recovery. While we still think that our forecast of 2% GDP growth looks reasonable, the outlook for the recovery looks less comforting than the stronger-than-expected headline 1Q GDP print (1.7% YY) suggests. In particular, the 1Q GDP reading is largely driven by inventory building, while the contribution of domestic demand to GDP growth remains in negative territory. This, coupled with the rising risks on the inflation front, places the NBR in a difficult position. On the one hand, a more difficult inflation outlook, including the deterioration in forward-looking inflation expectations, may require policy tightening. On the other hand, there is a need to pursue an accommodative monetary policy to support the fragile recovery. Against this backdrop, barring major deviations from our inflation trajectory, we believe that the NBR will pursue a more cautious approach and keep rates on hold at 6.25% during the remainder of the year. We recognize that there are risks to our rate outlook. Large deviations from our inflation trajectory and a further deterioration in forward-looking inflation expectations could lead the NBR to consider hiking rates.

Figure 42. Czech Republic and Romania — Economic Forecast, 2010-12F

		Czech Republic			Romania		
		2010	2011F	2012F	2010	2011F	2012F
Real GDP	YoY	2.3%	2.2%	2.6%	-1.3%	2.0%	3.8%
Final Domestic Demand	YoY	-0.9	0.3	2.3	-4.3	0.1	5.4
Private Consumption	YoY	0.0	0.7	1.2	-1.5	0.6	5.5
Fixed Investment	YoY	-3.1	0.5	4.6	-13.1	-0.5	6.3
Exports	YoY	18.0	13.6	10.9	14.3	16.5	5.1
Imports	YoY	18.0	14.1	10.3	12.4	11.0	6.6
CPI	YoY	1.5	2.0	2.6	6.1	6.7	4.0
Unemployment Rate	%	9.0	8.8	8.2	6.9	6.6	6.1
Current Account	US$ bn	-7.2	-10.6	-10.1	-6.8	-9.8	-11.6
	% of GDP	-3.7	-4.9	-4.2	-4.2	-5.2	-5.4
Fiscal Balance	% of GDP	-4.7	-4.4	-3.4	-6.7	-4.5	-3.0
US Dollar Exchange Rate	Average	19.1	17.3	16.2	3.2	2.9	2.8

Sources: Haver Analytics and Citi Investment Research and Analysis

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Copom kept its strategy and hiked interest rates by 25bp in June. We expect a final increase of this same amount in July, driving the Selic rate to 12.50%. On the activity front, although 1Q11 GDP had confirmed the strong growth of 1.3% QQ, several fundamentals (labor, credit, confidence, fiscal and monetary stimuli) are suggesting a slowdown ahead, a trend already embedded in our 2011 GDP growth forecast of 4%. Regarding the inflation outlook, some factors (fuel, apparel, foods and health prices) should contribute to reduce inflation in the near term, although high figures of core measures suggest this benefit should be short lived. In all, we maintain our end-year 2011 and 2012 CPI inflation forecasts at 6.5% and 5.3%, respectively, both above the mid point target of 4.5%. On external accounts, we set improving biases in our already optimistic view about trade balance/current account performances this year, given the still elevated commodity prices amid a relative stable real exchange rate. Finally, tax revenues continue to surpass expectations, which together with softer than expected public spending growth motivated us to increase our 2011 primary surplus forecast to 2.9% of GDP (from 2.7%), now reaching the annual fiscal target.

Mexico

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Industrial output growth slowed to 1.4% YY in April. The print should not surprise anyone, given the temporary presence of combined negative effects for Easter week and the supply-chain disruptions associated with Japan's disaster. We firmly believe in the temporary nature of these factors and, although we do not deny that downside risks exist for growth in the U.S., we expect activity to keep growing at a relatively fast pace in 2011, supported by better performance of domestic demand and stable growth for exports. Therefore, we stand by our 4.8% GDP growth forecast for 2011. Meanwhile, inflation is moving better than expected, standing at 3.25% YY in May, so we have revised our year-end 2011 and 2012 headline inflation estimates to 3.7% and 3.9%, respectively, from 3.8% and 4.0% before. Better inflation prospects together with dovish rhetoric from the CB have led us to postpone our call for its first 25bp rate hike to January 2012 from October 2011. For 2012, however, we think policymakers will broadly try to match rate hikes by the Fed in the US, so we continue to see the local funding rate closing the year at 6%.

Figure 43. Brazil and Mexico — Economic Forecast, 2010-12F

		Brazil			Mexico		
		2010	2011F	2012F	2010	2011F	2012F
Real GDP	YoY	7.5%	4.0%	4.5%	5.4%	4.8%	3.8%
Final Domestic Demand	YoY	8.3	5.0	5.0	4.2	5.2	4.4
Private Consumption	YoY	7.0	5.1	4.1	5.0	4.8	3.8
Fixed Investment	YoY	21.9	5.8	5.7	2.3	8.4	7.7
Exports	YoY	11.5	2.6	6.4	24.3	13.9	11.1
Imports	YoY	36.2	9.0	9.4	22.1	15.0	11.9
CPI	YoY	5.0	6.6	5.5	4.2	3.5	4.0
Unemployment Rate	%	6.7	6.3	6.3	5.4	4.6	4.8
Current Account	US$ bn	-47.4	-52.9	-70.1	-5.6	-24.2	-30.2
	% of GDP	-2.3	-2.2	-2.7	-0.5	-2.0	-2.4
Fiscal Balance	% of GDP	-2.5	-2.5	-2.5	-2.8	-2.5	-2.0
US Dollar Exchange Rate	Average	1.76	1.61	1.62	12.6	11.9	11.9

Sources: Haver Analytics and Citi Investment Research and Analysis

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Economic growth remains strong, with activity indicators expanding robustly on a yearly basis. We expect real GDP to post an annual 7.7% improvement in 1Q11, and we maintain our real annual GDP growth forecast for 2011 at 7%. Inflation remains high at 21.4% YY in May according to FIEL (we expect it at 30% by yearend) and, along with a stable exchange rate vis-à-vis the USD, it is eating away Argentine competitiveness. Moreover, as per our fair value effective exchange rate model, we believe that Argentina's peso is already overvalued by about 10%. This is why, although a return to voluntary markets in 2012 (as recent speculation suggests) would diminish the fiscal needs for devaluation, we maintain our USD/ARS4.5 and USD/ARS6 forecasts for 2011 and 2012, respectively. On the political front, Cristina Fernández de Kirchner (CFK) has now confirmed her candidacy for the 2011 Presidential elections. In recent weeks, several politicians from the opposition also have confirmed their candidacies. Without a unified endeavor to go up against CFK, we believe her reelection has become much more likely.

Venezuela

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Economic activity in Venezuela throughout 1Q11 showed signs that a recovery was underway, although internal factors that could threaten this resurgence of economic growth still linger. In particular, energy shortages, and the measures taken by the government to regulate energy demand, could affect both the retail and industrial sectors. We continue to expect fiscal spending to be the main driver for growth going forward. In order to guarantee financing for an expected spending spree on social projects, the government has anounced an increase in the amount of debt it plans to issue in 2011, after the National Assembly approved a VEF45 billion increase in the debt ceiling. We consider that even though most of the new issuance would take place locally (VEF25 billion), the sovereign will need to issue close to US$5 billion in dollar denominated debt throughout 2H11. Finally, stable oil production (between 2.3 and 2.4 million of barrels per day) and favorable oil prices imply that Venezuela should not have any trouble to fulfill payment obligations in 2011 and 2012, as amortization and coupons represent less than 10% of oil revenues. Going forward, fiscal sustainability concerns, capital account outflows and policies against private entrepreneurship probably will adversely affect Venezuela's credit over the medium term.

Figure 44. Argentina and Venezuela — Economic Forecast, 2010-12F

		Argentina			Venezuela		
		2010	2011F	2012F	2010	2011F	2012F
Real GDP	YoY	9.2%	7.0%	4.0%	-1.4%	3.5%	3.9%
Final Domestic Demand	YoY	11.6	8.6	4.5	-2.1	5.3	5.4
Private Consumption	YoY	9.0	8.0	4.6	-2.3	5.9	7.4
Fixed Investment	YoY	21.2	9.0	3.6	-4.4	-7.3	-0.9
Exports	YoY	14.6	8.5	5.0	-12.4	5.7	-0.9
Imports	YoY	34.0	20.5	8.0	-4.6	10.1	6.8
CPI	YoY	18.4	27.5	25.0	28.2	26.8	26.5
Unemployment Rate	%	9.3	8.1	7.8	8.5	8.8	6.7
Current Account	US$ bn	3.6	-0.6	3.8	14.4	31.0	30.5
	% of GDP	1.0	-0.1	0.8	3.7	11.0	8.3
Fiscal Balance	% of GDP	0.2	-0.6	1.0	-6.6	-5.0	-5.0
US Dollar Exchange Rate	Average	3.9	4.2	5.3	2.6	4.3	4.3

Sources: Haver Analytics and Citi Investment Research and Analysis

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Plans to limit expat residency to six years as part of a package of reforms, called Nitaqat, were unveiled this month. The reforms build on existing Saudization rules, giving the policy some teeth. We have previously argued that it is time for the private sector to wean itself off cheap foreign labour, and believe these reforms are necessary given the demographic imbalances in the Kingdom. However, we recognise the potential impact on the economy, including: (i) potential failure of a number of private sector companies, (ii) potential productivity loss, (iiI) economic cost of training locals for jobs, and (iv) rising labour costs.

We maintain our macro forecasts on the basis of an average oil price of US$105 per barrel in 2011. However, the production outlook is quite uncertain. The latest OPEC meeting failed to sanction a rise in quotas, despite Saudi pressure to do so. That said, we believe Saudi Arabia remains willing and able to raise production to meet demand and maintain our assumption of a 10% rise in production. The risk of lower production to our growth forecast is balanced against the potential for higher non-oil GDP driven by strong government expenditure.

United Arab Emirates

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We believe that the economic recovery in the UAE remains underpinned by strong global growth and perceptions of it being a safe haven during recent regional unrest. The external sector is the main driver of the recovery, but there are indications that domestic demand is picking up. Inflows into the banking sector are showing a modest uptick, and money supply (M2) increased 13% in April, the fastest rate of growth since February 2009. Dubai continues to make progress on its debt overhang, refinancing the US$4bn ICD maturity coming due in August. Yields on its external sovereign debt have fallen to pre-Dubai World standstill levels, prompting Dubai to seek financing through a new Eurobond issue. We expect 2011 growth in Dubai will be close to 5%, rising to over 6% in 2012. In Abu Dhabi, government spending and ongoing megaprojects continue to drive activity, although we think real estate will be a drag on growth for the next 2-3 years due to contagion and substitution effects from Dubai.

Figure 45. Saudi Arabia and United Arab Emirates — Economic Forecast, 2010-12F

		Saudi Arabia			United Arab Emirates		
		2010	2011F	2012F	2010	2011F	2012F
Real GDP	YoY	3.8%	7.5%	6.3%	4.4%	4.7%	5.1%
Final Domestic Demand	YoY	-0.8	6.4	7.8	1.5	2.5	3.1
Private Consumption	YoY	2.3	5.0	5.0	1.0	1.0	2.0
Fixed Investment	YoY	-5.6	10.0	10.0	5.0	5.0	5.0
Exports	YoY	5.0	13.0	8.0	10.0	13.0	13.0
Imports	YoY	-8.0	10.0	12.0	10.0	15.0	15.0
CPI	YoY	5.4	7.0	8.0	1.5	2.0	2.4
Current Account	US$ bn	66.8	44.6	45.6	21.6	9.5	8.4
	% of GDP	16.5	10.1	7.5	7.8	3.2	2.6
Fiscal Balance	% of GDP	6.7	8.5	8.2	0.0	0.0	0.0
US Dollar Exchange Rate	Average	3.8	3.8	3.8	3.7	3.7	3.7

Sources: Haver Analytics and Citi Investment Research and Analysis

Egypt

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We still expect presidential and parliamentary elections will be held in 2H 2011, and that a new government will be able to outline a more coherent economic policy in 2012. Meanwhile, the incumbent government will continue to try and buy time with a more expansionary fiscal policy. Rising inflation, driven by the large fiscal deficit against the background of rising world food and fuel prices and the political uncertainty, will weigh heavily on private consumption and growth in 2011 and only modestly ease in 2012. While the Central Bank of Egypt (CBE) has allowed a modest depreciation of the EGP this year, recent efforts to secure external funds, notably the US$3bn agreement with the IMF, means that it may well be able to maintain a degree of exchange rate stability in 2H 2011, and limit the sharp fall in reserves seen in early 2011. However, the substantial current account deficit is likely to mean pressure on the currency continues to grow into 2012.

South Africa

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We continue to expect GDP growth of nearly 4% in 2011, but only revised our forecast marginally upwards despite a strong performance in Q1 — as the pace of growth is likely to moderate somewhat in the remainder of the year. Household spending continues to outperform GDP, helped by partial consumer re-leveraging, while improving business confidence suggests greater corporate willingness to re-stock, hire and boost fixed investment than in 2010. Strong commodity prices also provide a windfall to the local economy. However, rising inflation and (eventually) interest rate hikes should trim growth in household spending power, while the housing sector remains in the doldrums and the strong rand keeps weighing on export competitiveness. For those reasons, we do not see a further acceleration in growth in 2012. Inflation probably will rise to about 6% by year-end, as the impact of oil and food prices feed through the CPI, but it should stabilize somewhat in 2012. Commodity price gains should keep the current account deficit moderate in 2011, but it should widen again next year as capital spending recovers and net dividend outflows resume their trend rise. We still expect the SARB to start normalizing policy rates upwards in September 2011, but the pace of tightening afterwards should be relatively gradual.

Figure 46. Nigeria and South Africa — Economic Forecast, 2010-12F

		Egypt			South Africa		
		2010	2011F	2012F	2010	2011F	2012F
Real GDP	YoY	5.1%	1.4%	3.6%	2.8%	3.9%	3.8%
Final Domestic Demand	YoY	4.8	2.5	4.0	2.8	4.2	4.1
Private Consumption	YoY	5.1	2.6	1.5	4.4	4.7	3.7
Fixed Investment	YoY	3.9	0.4	7.2	-3.7	2.8	5.3
Exports	YoY	-3.0	-2.3	2.1	4.7	9.1	7.7
Imports	YoY	-3.2	0.2	3.8	9.6	11.1	8.8
CPI	YoY	11.1	12.2	12.5	4.1	4.8	5.7
Unemployment Rate	%	9.0	9.7	10.2	25.5	25.7	25.3
Current Account	US$ bn	-4.4	-11.0	-6.2	-10.0	-12.8	-22.8
	% of GDP	-2.1	-5.4	-3.0	-2.7	-3.0	-5.3
Fiscal Balance	% of GDP	-8.1	-12.3	-9.5	-5.2	-5.0	-4.7
US Dollar Exchange Rate	Average	5.63	5.96	6.49	7.32	6.86	7.40

Sources: Haver Analytics and Citi Investment Research and Analysis

Figure 47. Selected Emerging Market Countries — Economic Forecast Overview, 2010-12F

	GDP Growth			CPI Inflation			Current Balance (% of GDP)			Fiscal Balance (% of GDP)		
	2010	2011F	2012F	2010	2011F	2012F	2010	2011F	2012F	2010	2011F	2012F
Asia	9.1%	7.7%	7.7%	4.2%	5.5%	4.7%	4.0%	3.0%	2.6%	-11.1%	-2.7%	-2.4%
China	10.3	9.2	9.0	3.3	5.0	4.0	5.3	4.2	3.5	-1.6	-2.0	-2.0
Hong Kong	7.0	5.8	5.5	2.4	5.5	3.3	6.6	9.1	10.0	4.2	2.9	3.0
India*	8.5	8.1	8.4	8.6	8.6	7.5	-2.0	-2.7	-2.2	-7.2	-7.9	-7.1
Indonesia	6.1	6.5	6.6	5.1	5.8	6.4	0.9	0.5	0.1	-0.6	-1.5	-1.5
Korea	6.2	4.3	4.6	3.0	4.0	3.4	2.8	1.7	1.1	1.4	0.8	1.0
Malaysia	7.2	5.7	6.1	1.7	2.8	3.5	11.8	10.5	9.0	-5.6	-5.5	-5.3
Pakistan	2.5	3.5	5.0	14.0	13.5	12.5	-1.0	-2.7	-3.1	-6.4	-6.1	-5.8
Philippines	7.6	4.8	5.3	3.8	4.8	3.8	4.2	2.8	2.3	-3.5	-3.1	-2.7
Singapore	14.5	7.0	5.0	2.8	4.3	3.2	22.2	16.5	15.0	0.5	0.0	2.0
Sri Lanka	8.0	7.9	7.5	6.0	8.0	6.5	-2.9	-3.8	-4.0	-8.0	-6.8	-5.2
Taiwan	10.8	4.9	5.0	0.9	1.8	2.0	9.4	8.0	8.0	-3.2	-2.5	-2.0
Thailand	7.8	3.6	5.0	3.3	3.8	3.7	4.6	4.0	3.8	-2.0	-2.9	-2.0
Vietnam	6.8	6.0	6.5	9.2	17.3	10.2	-4.7	-5.6	-5.1	-5.6	-5.0	-4.5
Latin America	**6.0%**	**4.7%**	**4.4%**	**7.5%**	**8.4%**	**7.8%**	**-1.0%**	**-1.2%**	**-1.4%**	**-2.6%**	**-2.4%**	**-2.1%**
Argentina	9.2	7.0	4.0	18.4	27.5	25.0	1.0	-0.1	0.8	0.2	-0.6	1.0
Brazil	7.5	4.0	4.5	5.0	6.6	5.5	-2.3	-2.2	-2.7	-2.5	-2.5	-2.5
Chile	5.2	6.3	5.3	1.4	3.4	3.3	1.9	0.2	0.0	-0.3	0.9	1.0
Colombia	4.3	4.7	5.0	2.3	3.4	3.9	-3.1	-2.1	-2.0	-3.6	-3.5	-3.2
Ecuador	2.0	3.5	3.5	3.4	2.8	3.0	-4.7	-3.2	0.0	-3.5	-3.2	-3.3
Mexico	5.4	4.8	3.8	4.2	3.5	4.0	-0.5	-2.0	-2.4	-2.8	-2.5	-2.0
Panama	7.5	9.5	8.5	3.5	6.6	7.2	-11.0	-13.5	-12.0	-1.9	-3.0	-2.0
Peru	8.8	7.1	6.5	1.5	3.2	3.1	-1.5	-2.7	-2.2	-0.8	-0.5	-0.6
Uruguay	7.8	5.8	4.7	6.7	7.4	6.6	1.0	0.4	-1.9	-1.2	-1.1	-1.0
Venezuela	-1.4	3.5	3.9	28.2	26.8	26.5	3.7	11.0	8.3	-6.6	-5.0	-5.0
Europe	**4.6%**	**4.4%**	**4.0%**	**6.1%**	**6.8%**	**6.1%**	**-0.1%**	**-0.8%**	**-2.3%**	**-4.8%**	**-2.9%**	**-2.8%**
Czech Republic	2.3	2.2	2.6	1.5	2.0	2.6	-3.7	-4.9	-4.2	-4.7	-4.4	-3.4
Hungary	1.2	3.0	3.4	4.7	4.6	3.9	2.1	1.3	-0.6	-4.2	2.5	-3.0
Kazakhstan	7.0	6.5	5.2	7.1	8.3	7.0	3.1	4.0	1.9	-2.6	-1.9	-2.1
Poland	3.8	4.2	3.9	2.7	4.2	2.9	-3.4	-5.8	-5.7	-7.9	-5.6	-4.0
Romania	-1.3	2.0	3.8	6.1	6.7	4.0	-4.2	-5.2	-5.4	-6.7	-4.5	-3.0
Russia	4.0	4.3	4.1	6.9	8.8	7.3	4.8	4.7	1.6	-4.0	-2.2	-2.1
Slovakia	4.0	3.4	4.1	1.0	3.8	2.7	-3.4	-4.8	-2.7	-7.5	-5.4	-4.2
Turkey	8.9	5.6	3.8	8.6	5.9	6.8	-6.5	-8.9	-8.9	-3.6	-2.6	-2.9
Ukraine	4.2	4.8	4.8	9.4	8.8	9.0	-2.1	-2.1	-3.6	-5.9	-4.0	-6.2
Africa/Mideast	**4.9%**	**5.7%**	**5.6%**	**5.0%**	**6.1%**	**6.3%**	**6.2%**	**4.9%**	**4.3%**	**0.2%**	**0.7%**	**1.5%**
Bahrain	4.1	1.0	6.0	1.9	2.0	3.0	6.3	6.2	6.3	-1.5	-4.0	-4.1
Egypt	5.1	1.4	3.6	11.1	12.2	12.5	-2.1	-5.4	-3.0	-8.1	-12.3	-9.5
Ghana	6.6	11.9	7.3	10.7	8.6	6.9	-7.2	-7.0	-5.4	-7.5	-6.9	-7.1
Iraq	5.9	10.4	10.4	0.0	4.0	5.0	2.7	0.9	0.7	-6.1	3.3	4.3
Israel	4.7	4.3	4.0	2.7	3.8	3.0	3.1	0.9	0.7	-3.0	-2.0	-1.1
Jordan	3.1	3.5	4.6	5.0	5.0	5.0	-4.3	-7.4	-7.0	-5.4	-7.2	-6.8
Kenya	5.3	5.7	6.1	3.9	13.1	10.5	-7.9	-8.2	-7.5	-6.5	-6.9	-6.7
Kuwait	6.2	4.4	4.7	4.4	4.2	5.0	38.1	38.8	39.1	21.7	18.4	14.1
Lebanon	6.0	2.8	3.5	4.0	3.4	4.0	-13.0	-16.7	-11.7	-7.4	-10.8	-8.9
Nigeria	7.2	6.8	6.5	13.7	11.1	10.9	6.1	8.7	8.1	-5.3	-2.3	-2.0
Oman	7.0	4.4	4.1	3.5	3.5	3.0	2.6	3.4	2.9	-1.6	1.0	0.3
Qatar	8.7	13.9	10.0	-2.4	3.0	3.0	17.3	16.5	12.9	15.2	14.9	14.4
Saudi Arabia	3.8	7.5	6.3	5.4	7.0	8.0	16.5	10.1	7.5	6.7	8.5	8.2
South Africa	2.8	3.9	3.8	4.1	4.8	5.7	-2.7	-3.0	-5.3	-5.2	-5.0	-4.7
Tanzania	6.9	7.2	7.6	6.2	10.0	7.6	-9.5	-10.1	-9.6	-6.4	-5.5	-5.0
UAE	4.4	4.7	5.1	1.5	2.0	2.4	7.8	3.2	2.6	0.0	0.0	0.0
Uganda	6.9	7.2	7.6	4.1	13.9	8.8	-9.9	-10.6	-9.2	-4.5	-5.0	-5.1
Zambia	7.6	7.2	6.8	8.5	9.3	8.0	3.5	4.7	3.0	-3.3	-3.9	-3.5
Total	**7.2%**	**6.3%**	**6.1%**	**5.3%**	**6.4%**	**5.8%**	**2.5%**	**1.7%**	**1.2%**	**-2.5%**	**-2.3%**	**-2.0%**

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

Figure 48. Citi Global Economics Team *For informational purposes only*

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Source: Citi Investment Research and Analysis.

Figure 49. Citi Global Strategy and Macro Team

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Rates Strategy

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As we approach the middle of the year it is worth reflecting on some of the moves that we have seen over the past six months. 10yr US Treasury yields are almost unchanged from their Q4 2010 average, while 10yr Bund yields have risen by 25bp. Such divergence reflects, we believe, a noticeable shift in the market dynamic; in the face of a dramatic shock to the financial sector, multi-faceted economic policies have served to reduce the volatility of underlying economic growth (it is frequently observed that slope of recovery from a financial recession is likely to be shallower than that of non-financial recessions). With this lower volatility surrounding growth expectations, we have seen a commensurate reduction in real yields. At the same time, the severity of the shock and the accompanying drastic policy response has raised the volatility of inflation data and expectations, and thus raised the term premium in inflation breakevens. As a result of these two factors, policy risk and along with it the fair value level for bond yields in inflation sensitive markets (the Eurozone and the UK) has probably risen relative to the markets in which monetary policy is determined by a more balanced mandate (such as the US).

We do not expect any significant change in the environment in the next few months. As the ECB continues to raise rates to head-off the threat of rising price pressures and the Fed remains cautious over the sustainability of the recovery, the policy rate differential between the two markets is likely to continue to widen and with it the fair value level for the yield spread between US Treasuries and Bunds should also remain under pressure.

Fiscal concerns in the US may temporarily put upwards pressure on Treasury yields. We do think that supply in the coming months will be a significant challenge for the market with the Fed no longer the marginal buyer and the negotiations on the debt ceiling becoming increasingly fraught, however the significantly greater carry and roll in the US market relative to the Euro market will go some way to offsetting the negative impact of issuance on returns from Treasuries. Overall, our expectations for bond yields have not changed much this month; we still see fair value for 10yr US Treasuries rising to around 3.6% by year-end, for Bunds we see 3.65% and for 10yr Gilts we expect 3.75%.

We also expect JGB yields to rise modestly over coming months. The correlation between JGBs and US Treasuries remains extremely high and thus modestly higher Treasury yields should put upwards pressure on JGBs. Fiscal concerns are a further worry for JGB investors as the combination of a huge supplementary budget and a fragile political backdrop weigh on the market.

The outlook for yield curves is somewhat mixed. Broadly speaking we look for flatter curves everywhere except Japan, where there appears to be no chance of a rate hike. The point from which the flattening is driven in the other markets will depend on the expected timing of policy tightening. In the US, where the Fed is expected to hold rates steady until well into 2012, we think the belly of the curve is likely to continue to lead the way, whereas in the Euro area and the UK the front-end of the curve should see yields rise further than the long-end.

The EMU crisis continues to deepen. Even at current levels, however, we do not think that a sufficient reduction in debt burdens is yet priced into the markets. We continue to look for further deterioration unless there is a concerted political action to deal with the root causes of the problem.

Figure 50. Interest Rate and Bond Market Forecast (End of Period), as of 22 June 2011

		Forecast End Period				
	Current	3Q 11	4Q 11	1Q 12	2Q 12	3Q 12
US						
Policy Rate (Fed Funds) End Quarter	0.25	0.25	0.25	0.25	0.25	0.75
3-Month Libor	0.25	0.30	0.35	0.40	0.60	1.00
2 Year Treasury Yield	0.38	0.65	0.90	1.10	1.35	1.60
10 Year Treasury Yield	2.98	3.15	3.35	3.40	3.50	3.60
30 Year Treasury Yield	4.18	4.35	4.50	4.55	4.60	4.65
2-10 Year Treasury Curve	260	250	245	230	215	200
2 Year Swap Spread (Swap Less Govt.), bp	26	28	30	32	34	36
10 Year Swap Spread (Swap Less Govt.), bp	15	15	16	18	20	22
30 Year Swap Spread (Swap Less Govt.), bp	-26	-30	-35	-40	-45	-50
30 Year Mortgage Yield	4.49	4.70	4.90	5.05	5.20	5.40
10 Year Breakeven Inflation	220	230	240	245	245	245
Euro Area						
Policy Rate	1.25	1.50	1.75	2.00	2.00	2.25
3-Month Libor	1.45	1.45	1.60	1.85	2.10	2.35
2 Year Treasury Yield	1.46	1.50	1.90	2.25	2.50	2.70
10 Year Treasury Yield	2.99	2.95	3.35	3.65	3.80	3.90
30 Year Treasury Yield	3.55	3.60	3.85	4.00	4.07	4.25
2-10 Year Treasury Curve	153	145	145	140	130	120
10 Year BTP-Bund Spread	195	200	225	200	150	85
2 Year Swap Spread (Swap Less Govt.), bp	60	55	50	50	45	40
10 Year Swap Spread (Swap Less Govt.), bp	39	30	32	35	37	40
30 Year Swap Spread (Swap Less Govt.), bp	11	11	12	15	20	20
10 Year Breakeven Inflation	192	195	215	225	225	220
Japan						
Policy Rate	0.10	0.10	0.10	0.10	0.10	0.10
3-Month Libor	0.20	0.20	0.20	0.20	0.20	0.20
2 Year Treasury Yield	0.17	0.20	0.25	0.25	0.25	0.25
10 Year Treasury Yield	1.12	1.30	1.40	1.40	1.30	1.50
30 Year Treasury Yield	2.05	2.20	2.25	2.25	2.15	2.30
2-10 Year Treasury Curve	95	110	115	115	105	125
2 Year Swap Spread (Swap Less Govt.), bp	20	20	22	22	20	25
10 Year Swap Spread (Swap Less Govt.), bp	2	4	7	7	5	9
30 Year Swap Spread (Swap Less Govt.), bp	-5	-3	0	0	0	3
10 Year Breakeven Inflation	NA	NA	NA	NA	NA	NA
UK						
Policy Rate	0.50	0.50	0.75	1.00	1.00	1.25
3-Month Libor	0.82	0.80	0.80	0.90	1.00	1.25
2 Year Treasury Yield	0.74	0.80	0.90	1.00	1.15	1.50
10 Year Treasury Yield	3.23	3.25	3.50	3.75	3.90	4.25
30 Year Treasury Yield	4.13	4.10	4.25	4.35	4.40	4.50
2-10 Year Treasury Curve	249	245	260	275	275	275
2 Year Swap Spread (Swap Less Govt.), bp	64	60	55	50	45	40
10 Year Swap Spread (Swap Less Govt.), bp	17	15	10	15	20	25
30 Year Swap Spread (Swap Less Govt.), bp	-19	-19	-15	-10	0	10
10 Year Breakeven Inflation	311	320	330	345	360	365
Australia						
Policy Rate	4.75	4.75	5.00	5.00	5.25	5.25
3-Month Libor	4.97	5.00	5.20	5.10	5.40	5.30
2 Year Treasury Yield	4.71	4.80	5.00	5.10	5.40	5.50
10 Year Treasury Yield	5.13	5.30	5.50	5.60	5.80	5.80
2-10 Year Treasury Curve	42	50	50	50	40	30
10 Year Swap Spread (Swap Less Govt.), bp	50	55	60	55	55	50

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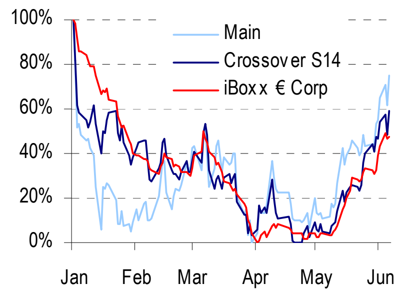
Credit Outlook — Macro and Credit Still Joined at the Hip

Changing drivers

The credit market has been putting on a brave face but the sense of invulnerability has faded. Since early May, iBoxx € corporate spreads have widened about 20bp, and are now all the way back to the middle of their YTD trading range, while Crossover and the iTraxx Main have fared worse still (see Figure 51). US spreads display a similar pattern.

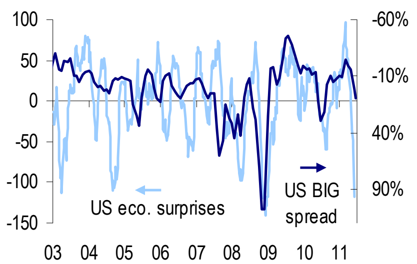
Greece and the European sovereign story have obviously been making the headlines and many European investors cite the situation as their top concern. However, that isn't really consistent with the numerous days when the SovX was rallying and yet credit carried on selling off regardless. As we have argued for some time now, we reckon the negative surprises in recent US data and uncertainty about the end of quantitative easing have been as important, if not more important, in driving recent risk aversion — not just in credit, but also in equity markets.

Figure 51. Credit indices: Percentiles in YTD trading ranges



Source: CIRA, Markit

Figure 52. 3m %chg in credit spreads vs US economic surprises



Source: Citi Investment Research and Analysis

Does macro matter any more?

Even with the latest sell-off, the reaction in risk assets has been less than proportional to the very large negative surprise the US economy has produced in recent weeks. From a 10-year high in early March, Citi's US economic surprises index has fallen around 200 points. Over the last nine years the index has only been lower than currently on one occasion — in the aftermath of the collapse of Lehman.

The current reading is so extreme that there is a very high likelihood of a turn in the surprises index soon — quite simply it is difficult for it to fall much further. But frankly, we're skeptical that economic expectations have been revised fully yet — we think the adjustment will continue over the coming weeks, albeit the misses are likely to get progressively smaller. Even if there were no more negative surprises in any of the upcoming data, the index would still have a reading of -100 at the end of June due to past misses.

Both credit (see Figure 52) and equity (see Figure 53) have been doing their best to ignore the massive drop in surprises. But since 2008, the correlations have tended to be quite strong. US Treasury yields and commodity prices have maintained a much stronger link with economic surprises, and reacted more proportionately.

The central question is therefore whether we have now we reached the point in the cycle where markets have enough confidence in the recovery that any period of weak data is just temporary and can be ignored.

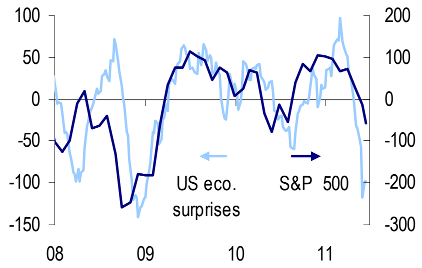
Markets are trying, but the intense intraday volatility we've seen in recent sessions suggests they are not very comfortable about it. And given the lack of volume it won't take very much selling to move levels significantly.

To reiterate, we don't believe the US recovery is really collapsing — indeed our economists expect a rebound in growth in H2 2011. But until the end to the negative surprises is apparent, we reckon it will be very difficult for markets to ignore the downside risks of what is still in many respects a deeply unbalanced recovery in the Western economies. As we have highlighted previously[14], the end of QE2 this month adds to the uncertainty.

[14] See 'Do rate hikes matter for credit?', Hans Lorenzen, 23 March 2011

The upcoming earnings season will be very important. Despite the weakening top-down data, the US remains the only major region globally where analyst net earnings revisions are positive (see Figure 54). In Europe analyst revisions are already the most negative since mid-2009.

Figure 53. 3m % chg in equities vs US economic surprises

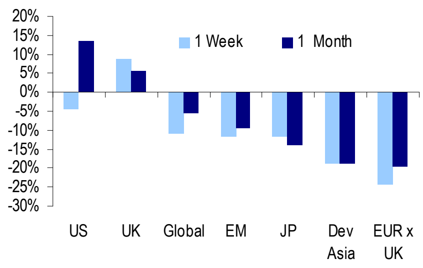


Source: Citi Investment Research and Analysis

If pre-announcements for Q2 over the next couple of weeks disappoint or company guidance in July is more cautious, we'd expect further widening in markets on both sides of the Atlantic. Recent statements from the likes of McDonalds in the US, many of the UK retailers (Tesco, Sainsbury, Argos), and even some commodity companies suggest that this is exactly what is in store.

The comparative resilience in spreads to date is a strong indication to us that positions in the Street and among leveraged accounts are less long than they were just over 12 months ago, when European sovereign concerns first took off in earnest. The principal vulnerability lies with real money accounts, where our survey indicates that positions remain very long.
Whilst they are still getting inflows and not expecting a large amount of supply it will take something to change their long-term assumptions for them to start selling out. Yet if inflows were to fall, they could easily become more nervous. The last few trading sessions suggest that this may be happening, and that they are not finding very much depth to the bid.

Figure 54. Net positive earnings revisions, %



Source: Citi Investment Research and Analysis

German Finance Minister Wolfgang Schaeuble's insistence on private sector participation in a second bailout for Greece, and Michael Noonan's renewed suggestion that senior bondholders at Anglo Irish should face losses, are also unnerving markets. We suspect that the ECB's insistence that anything resembling a default must be avoided will win out in both cases, and at this point a relatively modest Greek rollover might even prove a positive. But the prolonged uncertainty — with some chance that EU ministers do not agree a new Greek package even until July — seems to be contributing to exactly the sort of contagion to Spain and Italy that we think the ECB is so anxious to avoid.

With the widening, risk/reward is gradually becoming less poor than it was six weeks ago. If you are worried that the 'turn' will come soon, then other asset classes which have responded more proportionately to the weakness in the economic data offer better opportunities here. A bullish view on growth is surely better expressed through a short position in US Treasuries (where our duration survey shows that net shorts have fallen by half) or Bunds than in credit.

However, for credit all of the above suggests to us that the bias remains skewed to the downside from here. If spreads widen further, we would start adding very gradually from our current neutral position. But at the current pace of widening — and with the current lack of shift in the consensus — we'd only want to be fully scaled in by perhaps late July: by then we should also have a better idea of Q2 earnings and the momentum the economy is carrying into Q3.

Global Equity Strategy

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We are now midway through 2011 and major stock market indices are broadly flat on the year. Despite the lack of progress in 1H we remain constructive on equity markets. Our optimistic outlook is based on reasonable valuations, low interest rates and positive earnings trends. Our view is that global stock indices will Grind Higher with EPS. We expect global EPS to grow 18%, 11% and 9% for 2011-13. Figure 55 illustrates our forecast of the global price index. Our MSCI ACWI 2011 year-end target is 380 (currently 329). The strategy during the Grind Higher phase of the cycle is to not chase rallies too hard but be prepared to buy into dips. The Grind Higher is also a time when stock indices lack a clear direction, like we saw in 2008 (downside direction) or 2009 (upside). We think investors will have to get used to the more trendless nature of markets.

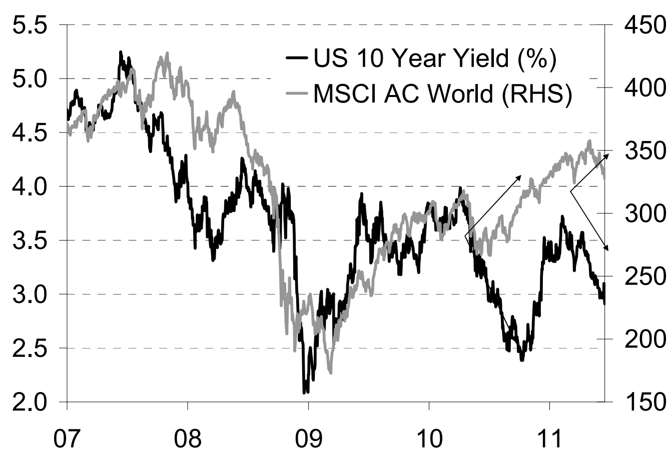
The ongoing sovereign crisis in Eurozone, worse than expected macroeconomic data and roll over of some lead indicators, have added to investors' worries and risk aversion more recently. In response, like last August, benchmark government bond yields have fallen sharply around the world. Global investors are facing another conundrum. Falling bond yields seem to be indicating that the global economy is slowing, while more resilient equity markets (despite the recent correction), suggest that the economic cycle is on track to deliver decent growth in EPS (see Figure 56). The bears call this complacency, the bulls call it resilience. Who will be proven right this time round? Last summer, equities won the debate. The conundrum was resolved through bond yields rising rather than equities falling. We suspect the end result this time round may be similar.

Over the past 11 years, there have been 11 occasions when government bond yields and stock prices have diverged. Equities have been proven 'right' seven times versus bonds twice (undecided twice). It seems that the bond market calls it right towards the end of a cycle (like 2001-02 and 2007), whereas the equity market has a better track record during recovery. We believe we are still in a recovery. Citi rate strategists forecast bond yields to rise over the rest of the year. Citi equity strategists expect global indices to end the year higher, not lower.

Figure 55. MSCI AC World (US$) and Citi Target

Source: Factset, MSCI, CIRA

Figure 56. Another Conundrum: Global Equities And 10 Year US Treasury Yields (%)



Source: CIRA, Datastream

While we forecast a moderating global economic backdrop, the slowdown in GDP growth is not enough to undermine the global profits outlook. We believe investors are underestimating two factors which should ensure solid EPS growth for the next few years. First the corporate revenue leverage to a growing economy has risen. This means companies can now generate faster revenue growth, per unit of GDP growth, than they did a decade ago. Second, companies are still successfully containing costs. This has been an outstanding feature of the current earnings cycle. And has meant profit margins are now approaching previous highs. There is little to suggest margins will retrace in the medium term.

As the global EPS recovery has developed, we have progressively shifted our preferences towards those stocks, sectors or regions that are generating the best earnings growth and momentum. Earnings momentum strategies tend to outperform in mid-cycle years and underperform around major economic turning points[15]. Given that we do not see another economic turning point soon, we think that an earnings momentum strategy is appropriate right now.

Our key regional and global sector recommendations are summarised in Figure 57. Recent rotation against EM equities has moved valuations back to a discount relative to DM. EM economic and EPS momentum remain robust. We stay Overweight. While EM remains our structural growth play, Japan is our recovery play. We are Overweight Japan, where valuations at last look competitive. The post-earthquake EPS downgrades seem to be moderating, but we think that the prospect of reconstruction and a weaker yen should support Japanese equities.

We recently downgraded the UK to Neutral. Although valuations look attractive, earnings momentum is fading. Poor EPS growth prospects mean that Europe ex-UK remains Underweight. We stay Underweight Developed Asia (mostly Australia) as a hedge against our EM Overweight. EPS prospects remain good in the US although valuations look slightly expensive. We stay Neutral.

Our belief in the ongoing economic recovery means that our global sector strategy still has a cyclical tilt. We think it is still too early to give up on the recovery trade. Our Overweights (IT, Materials, Industrials) should benefit from a continued recovery in the global economy.

Our Underweights look more mixed. We are Underweight Financials given lacklustre earnings momentum, balance sheet uncertainties and ongoing dilutive equitisation. Telecoms may be cheap but earnings momentum is disappointing. Consumer Staples look relatively expensive and are vulnerable to higher commodity prices and slower consumer spending in the developed markets.

Figure 57. Regional And Global Sector Recommendations

Overweight	Neutral	Underweight
Global Emerging Markets	US	Europe ex-UK
Japan	UK	Developed Asia
Overweight	**Neutral**	**Underweight**
IT	Utilities	Financials
Materials	Consumer Disc.	Consumer Staples
Industrials	Health Care	Telecoms
	Energy	

Source: CIRA

[15] *Global Equity Strategist: Earnings Momentum Strategies*, 16 September 2009

Securitized Products Strategy

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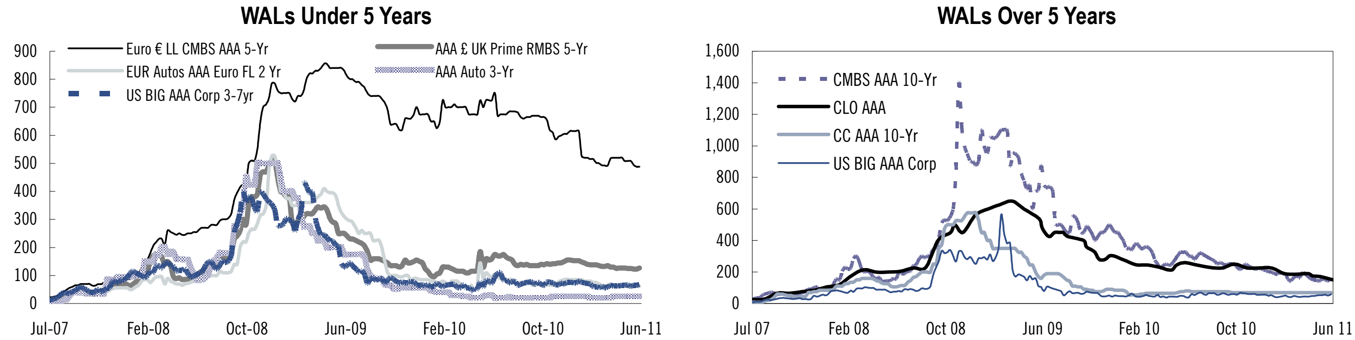
With the backdrop of weak economic data, defensive investment strategies in securitized markets continue to best address the lingering market indecision about the future. Investors and dealers are cautious over ongoing macro concerns and a slowing domestic recovery. May's jobs reports could suggest this weak economic environment may persist for a bit longer. Defensive sectors like US consumer ABS, European non-mortgage sectors and US CMBS duper classes (even given its recent softness) should fare best.

Market Indecision Opens Up Good Entry Point

The market's lack of conviction favors defensive sectors

Still, investors who have more confidence in our view that the current weakness is temporary would find attractive entry points in the current selloff. Indeed, all the broad market negative headlines simply overshadow the recent positive, sector-specific developments. The CMBS market, for example, continues to experience fairly robust and oversubscribed new issuance, an improving lending environment (even on floating-rate loans) and stabilizing CRE fundamentals. More broadly, US household wealth has risen, while credit conditions (outside of mortgages) have loosened. The Fed's April Senior Loan Officer survey indicated that bank lending standards and terms eased somewhat further during Q1 2011. Demand for commercial and industrial loans (C&I) and for commercial mortgages increased, while demand for residential mortgages continued to decrease. Outstanding consumer revolving credit continues to drop, while non-revolving credit (mainly auto loans) shows a modest increase and is available at attractive terms.

Figure 58. Selected Securitized Products Sectors — Spread Performance, July 07-Jun 11



Source: Citi Investment Research and Analysis

Off-the-Run Trades Axed to Recovery Could Fare Well

From this perspective, off-the-run trades correlated to recovery could be worth a look. In consumer ABS, for example, we favor short-WAL off-the-run assets, including auto lease, dealer floorplan, equipment and certain subprime auto ABS. Longer-term and more deeply off-the-run ABS, including container lease, franchise and timeshare ABS, offers more spread. Investors willing to look across the pond would find attractive spreads for UK credit cards and prime RMBS, and European auto loan ABS.

Economic Concerns Might be Overstated

We reckon that, in the face of recent economic data, it is difficult to focus on recovery-driven or bullish-view trades. Citi's Economic Surprise Index provides a vivid illustration of the recent shock to the market (see Figure 59). Yet our economic team points out that concerns prompted by the combination of energy's squeeze, supply chain disruptions and the inherent variability of employment surveys overstate the risks.[16]

[16] "Comments on Credit – Twister", Citi, June 3, 2011.

Many Potential Catalysts for Rate Reversal

In turn, the uncertain timing of eventual interest rate rises is also keeping market players cautiously short-term in their investment strategy. Citi's rates strategists expect that Treasury yields are likely to rise by more than the forward curve implies in the medium term.[17] However, the 60bp drop in 10-YR Treasury yields in the last eight weeks presents a strong momentum hurdle. Duration surveys that suggest investors remain short versus their benchmarks also provide a significant positioning hurdle.

Figure 59. Recent Economic Data Have Indeed Been Surprising

Source: Citi Investment Research and Analysis

The existence of several potential catalysts, such as the debt ceiling negotiations, QE2 termination and the possibility (remote as it may be) of QE3, exacerbates the uncertainty about the reversal timing. But currently, as overall market yields continue to fall, some investors simply may be staying out of some securitized sectors, as all-in yields are not adequate to achieve their yield targets.

Risk Retention Comment Period Extended, but Rules May Not be Re-Proposed

Regulatory changes are the third principal factor driving current securitized markets (beyond economics and rates). We have been following developments closely during the past few weeks, and regulation continues to foster uncertainty. Notably, recently the regulators have extended the comment period on the Dodd-Frank risk retention rules proposal to August 1, from the original June 10 date. As such, it may signal that regulators may not plan to re-propose the rules as we and other market participants have been suggesting. This would leave the market fretting whether the regulators will incorporate the industry's input in the final rules. Nonetheless, many market participants were prepared for the earlier comment deadline and plan to submit comments ahead of the revised new schedule. Regulators plan to focus on comments as soon as they are submitted.

Sector Relative Value and Allocation Recommendations

Our securitized products strategists have mixed views on the market, ranging from bullish to neutral, and Figure 60 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 60. Sector Relative Value and Asset Allocation Recommendations — Selected Sectors, June 2011

Sector	Strategist Recommendation	Spreads Relative to Long-Term Averages	Comments
CABS	0	Fair	Remain market weighted. To outperform, buy subordinate credit cards and autos. We also like certain off-the-run senior sectors, including dealer floorplan, private label credit card, equipment, auto lease and first cash flow private student loans.
CMBS	+1	Cheap	Our long-term view remains for further tightening from levels at the start of the year, but the current environment suggests waiting a bit longer to step in with new investments. We still feel buying stronger AMs opportunistically in a market dislocation will ultimately reward investors in the long run.
CLO	+1	Cheap	CLOs remain cheap compared to other securitized products, as well as to corporates.
Agency MBS	0	Cheap to Fair	We continue to view the 30-YR mortgage basis as cheap, but we recommend maintaining neutral basis positions due to strong momentum within the Treasury market and the possibility of a notable increase in refinancing activity.
European Securitized Products	+1	Cheap to Fair	Recommend overweighting core country sectors. Short cards and autos are defensive and have more tightening potential. We also like UK BTL, CMBS and UK prime RMBS. Look for spreads to outperform.

Source: Citi Investment Research and Analysis

[17] "Rates & Curve Overview: Rate Reversal Catalysts," Citi, June 3, 2011.

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

Citi Foreign Exchange Forecasts

Market Commentary

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

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

- Risk aversion, the end of QE2 and a correction in commodity prices may extend a short term USD rally over 0-3 months. "Risk on", carry and commodity backed currencies would correct and USD, CHF and JPY outperform
- Assuming current events represent a mid cycle slowdown rather than a double dip, however, we forecast a resumed USD downtrend over 6-12 months as reserve managers continue to diversify away from the greenback. AUD and GBP are the G10 outperformers
- In the EM world, we also expect broad appreciation vs. forwards in the medium term. High carry, strong macro fundamentals, ongoing inflationary pressures and a rebound in commodity prices over 6-12m are likely to be key drivers. PLN, BRL, IDR, KRW, and MYR are the biggest EM winners
- In EM Asia, CNY appreciation should continue as part of policy efforts to stem rising inflation, at least in the medium term, subsequently also boosting other currencies in the region

Citi Foreign Exchange Forecasts

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

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

Figure 61. 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	1.43	1.43	1.41	1.37	1.47	1.38	-3.9%	4.0%
Japanese yen	USDJPY	80	80	80	79	83	87	-1.5%	3.9%
British Pound	GBPUSD	1.62	1.61	1.61	1.59	1.73	1.75	-1.4%	7.5%
Swiss Franc	USDCHF	0.85	0.85	0.84	0.85	0.85	1.01	0.8%	0.7%
Australian Dollar	AUDUSD	1.06	1.05	1.01	1.02	1.09	0.95	-2.8%	7.5%
New Zealand Dollar	NZDUSD	0.81	0.81	0.79	0.80	0.80	0.63	-0.7%	1.3%
Canadian Dollar	USDCAD	0.98	0.98	0.99	1.00	0.95	0.95	1.8%	-3.9%
Dollar Index*	DXY	75.13	75.25	75.69	77.26	73.27	77.02	2.7%	-3.2%
G10 Crosses									
Japanese yen	EURJPY	115	114	113	108	122	120	-5.3%	8.1%
Swiss Franc	EURCHF	1.21	1.21	1.19	1.17	1.25	1.40	-3.0%	4.7%
British Pound	EURGBP	0.88	0.88	0.88	0.86	0.85	0.79	-2.5%	-3.3%
Swedish Krona	EURSEK	9.18	9.20	9.28	9.30	8.95	8.80	1.1%	-3.6%
Norwegian Krone	EURNOK	7.88	7.91	7.99	7.90	7.75	7.70	-0.1%	-3.0%
Norwegian Krone	NOKSEK	1.17	1.16	1.16	1.18	1.15	1.14	1.2%	-0.5%
Australian Dollar	AUDNZD	1.31	1.30	1.28	1.28	1.36	1.51	-2.1%	6.1%
Australian Dollar	AUDJPY	85	84	81	81	90	83	-4.2%	11.7%
Asia									
Chinese Renminbi	USDCNY	6.48	6.44	6.38	6.43	6.20	6.05	-0.2%	-2.8%
Hong Kong Dollar	USDHKD	7.79	7.79	7.78	7.77	7.75	7.75	-0.3%	-0.3%
Indonesian Rupiah	USDIDR	8608	8700	9035	8500	8350	8200	-2.3%	-7.6%
Indian Rupee	USDINR	44.9	45.5	47.3	45.0	45.0	44.0	-1.1%	-4.9%
Korean Won	USDKRW	1086	1087	1100	1080	1030	1000	-0.7%	-6.4%
Malaysian Ringgit	USDMYR	3.04	3.07	3.12	3.03	2.94	2.83	-1.2%	-5.9%
Philippine Peso	USDPHP	44.0	43.9	44.1	43.0	41.9	41.4	-2.0%	-5.1%
Singapore Dollar	USDSGD	1.24	1.24	1.23	1.22	1.21	1.17	-1.2%	-2.0%
Thai Baht	USDTHB	30.6	30.8	31.3	30.3	29.8	29.4	-1.8%	-4.9%
Taiwan Dollar	USDTWD	29.0	28.8	28.3	28.5	28.5	27.8	-1.1%	0.8%
EMEA									
Czech Koruna	EURCZK	24.1	24.1	24.0	24.6	23.4	23.2	2.2%	-2.3%
Hungarian Forint	EURHUF	268	271	276	270	273	278	-0.2%	-1.1%
Polish Zloty	EURPLN	3.98	4.00	4.07	3.98	3.85	3.60	-0.6%	-5.4%
Israeli Shekel	USDILS	3.44	3.45	3.50	3.50	3.40	3.35	1.3%	-2.9%
Russian Ruble	USDRUB	28.1	28.3	29.2	28.9	28.5	30.3	2.0%	-2.6%
Russian Ruble Basket		33.5	33.7	34.7	33.7	34.5	35.5	-0.1%	-0.5%
Turkish Lira	USDTRY	1.60	1.63	1.71	1.65	1.64	1.66	1.5%	-4.3%
South African Rand	USDZAR	6.79	6.89	7.19	6.85	7.20	8.25	-0.6%	0.1%
LATAM									
Brazilian Real	USDBRL	1.60	1.63	1.74	1.60	1.60	1.65	-2.0%	-7.8%
Chilean Peso	USDCLP	471	476	491	475	470	475	-0.3%	-4.2%
Mexican Peso	USDMXN	11.9	12.0	12.4	12.0	11.8	12.2	-0.1%	-4.6%
Colombian Peso	USDCOP	1786	1794	1818	1800	1800	1850	0.3%	-1.0%

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

Source: Citi Investment Research and Analysis

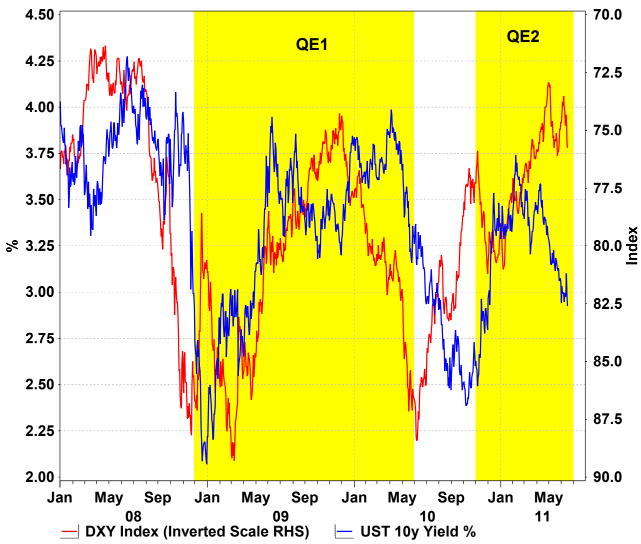
Overview

We continue to expect short term USD appreciation as a result of higher risk aversion and a correction in commodity prices and other risk assets. Risk appetite is vulnerable because it remains elevated (implied volatilities and credit spreads low) despite clearly slowing growth expectations and the continued withdrawal of monetary stimulus and liquidity support to asset markets. In the context of a notable fall in bond yields already across major currencies, we are surprised that implied volatility in other asset markets is rising only slowly and expect some acceleration. As this occurs, we see more upside for the DXY over 0-3 months (see Figure 62). Meanwhile, speculative and fast money positioning appears to remain short which also gives scope for short covering to drive a DXY rally. Finally, as QE2 ends this month, the Fed effectively is “on hold” for the first time in a while, neither easing nor tightening. Typically, the USD rallies a little in this part of the cycle though it often gives back the gains once the Fed starts to raise rates.

Longer term, though, we think that the bear market in the USD remains intact. Reserve managers remain structurally long USD and keen to diversify where they can and these flows into other currencies (EUR mainly) probably dominate traditional investor flows driven by policy and cyclical indicators. We think a more sustained correction in the cycle is unlikely because lower commodity prices will tend to re-kick start the economy at some point. Absent such a double dip, or maybe a new tax measure (HIA2), we see USD weakness returning over the 6-12 months horizon. The 40 year trend is your friend.

According to our 6-12 months forecasts, AUD and GBP are the big winners in the G10 arena. JPY and to a lesser extent CHF remain significant funding currencies and underperform, aided in the case of CHF (but not JPY) by significant overvaluation. In the EM world, high carry currencies are expected to do well, with PLN outperforming others including BRL. Best in Asia are IDR, KRW and MYR.

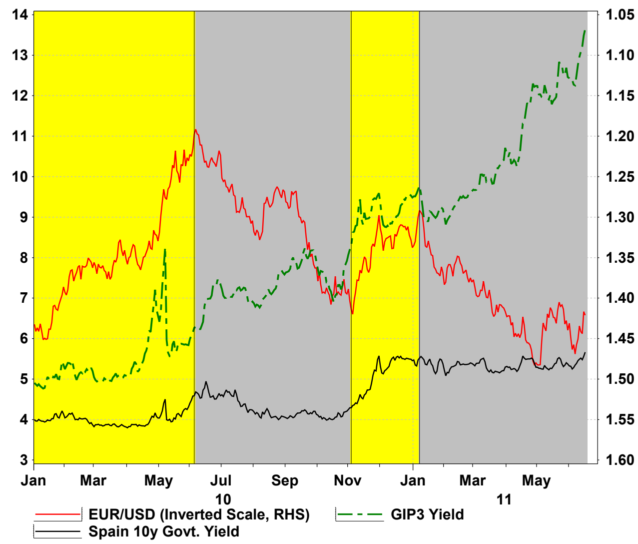
Figure 62. DXY Lagging UST Yields As Liquidity Support Wanes



Copy Chart/Table, then double click to insert

Source: Reuters EcoWin

Figure 63. EUR/USD vs. Greece, Ireland, Portugal Average 10y Yield and Spanish 10y Yield



Source: Reuters EcoWin

G10 Exchange Rates

EUR/USD — Running out of steam

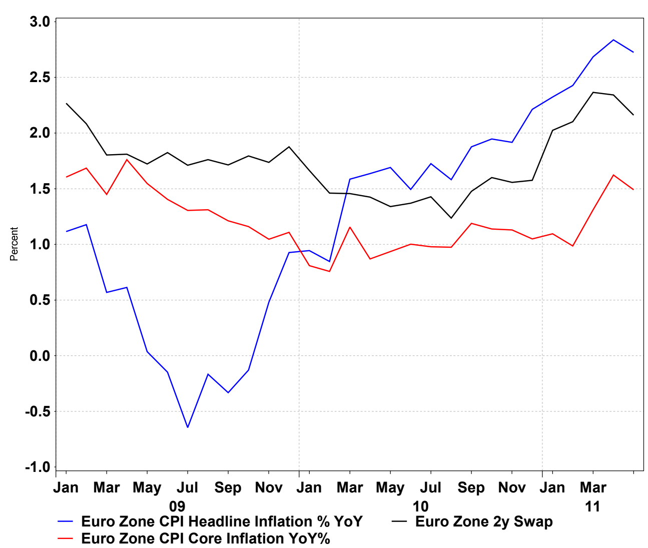
Having reached almost 1.50 in early May, EUR/USD subsequently corrected back to a low so far just above 1.40 in late May before bouncing. The recent local June high was below 1.47 so the short term uptrend of higher highs and lows seems definitively broken. Furthermore, the EUR high in 2008 was 1.604, in 2009 was 1.514 and in 2011 so far less than 1.50 whereas lows in 2010 were lower than in 2008/2009. Short and medium term, therefore, EUR strength seems to have run out of steam and there is a pattern of lower highs and lower lows emerging.

Medium term, events in the periphery bond market crisis will be critical. As Figure 63 highlights, EUR/USD has been able to withstand rising yields in Greece/Ireland/Portugal but not higher yields in Spain. An important factor here has been the separation of policy towards the periphery countries' debt problems (liquidity and bail out funds) from policy rate expectations. So long as this separation seems sustainable, and ECB tightening is expected and credible, the EUR will remain supported. In that context, we note that 2y EUR swap yields have been falling since mid April and even the "strong vigilance" comments at the June ECB meeting (signalling a July policy rate hike) have not interrupted this trend. While the front end rally is more about weak global data than periphery concerns at this point, lower rate differentials are still having an impact on the EUR. Should Spain get dragged into the periphery crisis, we think the market would very rapidly price in a less restrictive ECB stance and, as a result a lower EUR.

Short term anyway we think lower commodity prices, reduced risk appetite, some easing in EUR less US rate differentials and ongoing periphery concerns may yet see EUR/USD pull back to around 1.37 over 0-3 months. Oil prices and EUR have been correlated for some time and oil prices are now in mid-correction. We think the drivers for the oil price/ EUR/USD correlation are mainly reserve diversification (higher oil price, higher reserves of oil producers, more EUR buying) and asymmetric rate expectations. As Figure 64 highlights, EUR 2y swap rates tend to track headline inflation (but US 2y rates track core). As a result, lower oil prices tend to generate lower headline inflation and a sharper drop in 2y rates in Europe than in the US. Over the next couple of months, we expect somewhat impaired risk appetite to persist as QE2 comes to an end. This could mean lower commodity prices, increased financial volatility and, most likely, some more downside in EUR/USD.

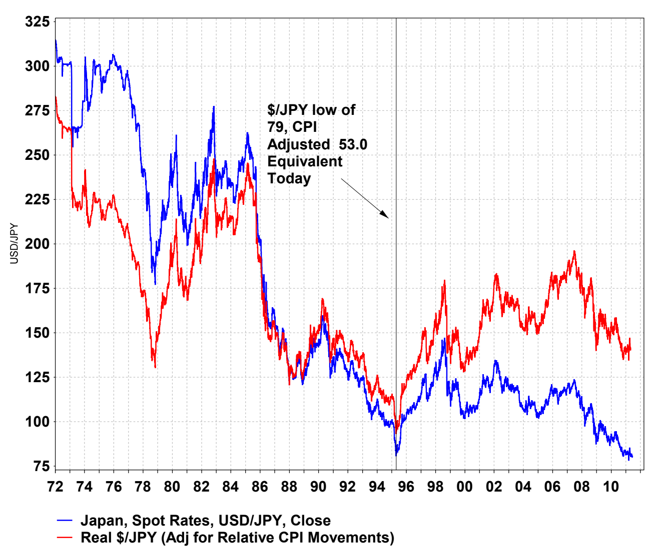
Since this seems more mid cycle correction than double dip, however, it is periphery pressure and Spain's position that remains the bigger risk to our bullish medium term EUR/USD forecast. Our projections foresee a moderate rebound to around 1.40 over the next 6-12 months but this is clearly subject to huge uncertainty.

Figure 64. EUR 2y Swap Rates vs. Headline and Core Inflation



Source: Reuters EcoWin

Figure 65. Real and Nominal USD/JPY



Source: Reuters EcoWin and Citi

Yen — USD/JPY range bound short to medium term

USD/JPY has been effectively range bound for around eight months (except immediately after the earthquake in March) and our forecasts anticipate this continuing short term. In reality, the real USD/JPY level looks pretty reasonable and investors focusing on the low nominal exchange rate are missing the impact of differential inflation over many years (Figure 65).

On the downside, the market may well continue to believe that selling below 80 is risky given the risk of (further) official intervention to sell JPY against an unfavourable macro background in the Japanese economy. On the upside, the drivers of a trend rise in USD/JPY, particularly a bear flattening in the US yield curve, continue to be absent. In fact, Citi economists have further pushed back expectations of the first Fed hike in this cycle to mid 2012 from the beginning of next year and this will likely further delay any upside in USD/JPY. According to our regressions, current rate differentials and USD/JPY are exactly in line.

Over the 0-3 months horizon, JPY positive include weaker risk appetite, no Fed action on flattening the curve and exporters' hedging being slightly behind schedule as output recovers after the March earthquake. This should keep USD/JPY close to current levels.

Over 6-12 months, Citi forecasts show the Fed just about beginning to raise rates and this could generate some upside in USD/JPY over 12 months. Our long term fair value WERM estimate is now around 87 and for the "long term" horizon we forecast, we think that this level is a reasonable target.

Dollar Bloc — AUD correction was overdue, NZD performs

In a recent joint research note between Citi's Australian economists and Macro Strategy Group[18], the four main drivers of AUD strength over the past year were identified as: (i) commodity price gains/ terms of trade; (ii) Australia's links with EM Asia, especially China; (iii) carry/ RBA policy; and (iv) risk appetite and easy money/ liquidity.

These drivers pushed spot AUD/USD all the way to 1.1 by early May. On our calculations, at that point AUD was around 30% overvalued relative to Citi's WERM fair value level. However, it is extremely unlikely that AUD returns to this long term real exchange rate equilibrium anytime soon. Boosted by terms of trade gains, positive carry and links to Asia's economic boom, the AUD will likely remain overvalued in this sense for a significant time in the same way that it was undervalued for a long time in the late 1990's when resource sectors in general were out of vogue.

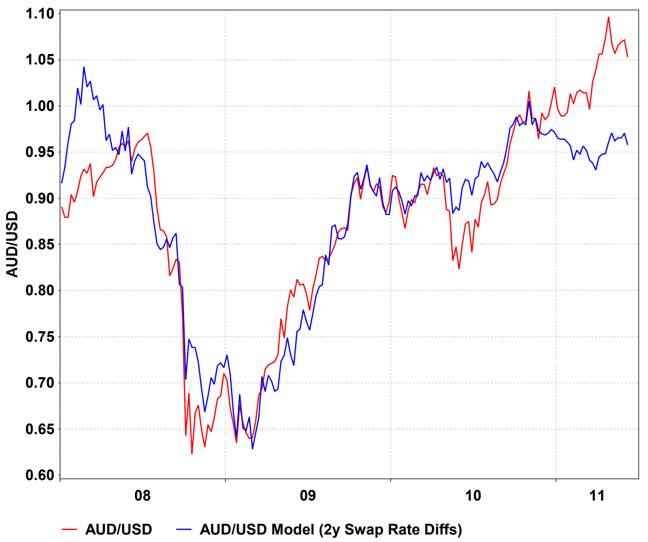
That said, even relative to the underlying drivers, AUD seemed a bit frothy by early May. Regressing spot on the underlying drivers listed above, we still find AUD to be around 3-4% too high, even after the correction since then. While AUD is trading mainly a 1.05-1.08 range for now, we think the currency is vulnerable to a further pull back to about 1.02 over the 0-3 months horizon.

Longer term, too, AUD appreciation may be a bit more limited. Citi has downgraded its 2011 GDP forecast to 1.5% given the impact of floods, slower global growth, consumer caution and a weaker labour market. As a result, any further RBA tightening is unlikely before late 2011 or 2012, when growth should be stronger. Yet,

[18] See Unstoppable? AUD Outlook and Implications, 3 May 2011

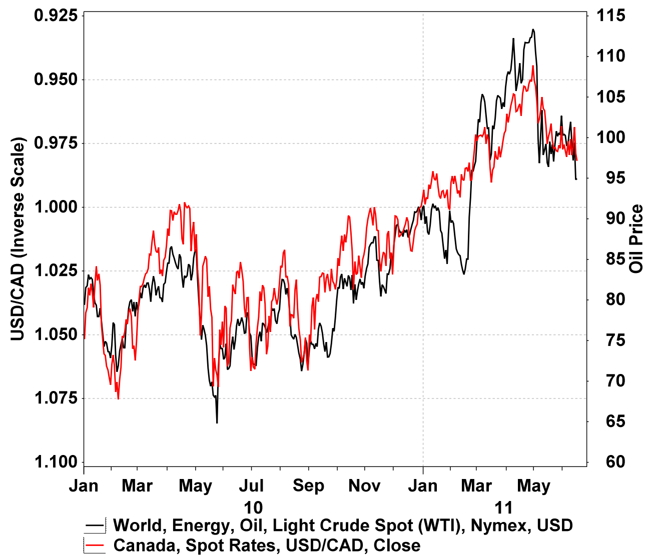
as Figure 66 highlights, AUD is substantially adrift of levels associated with past rate differentials at current levels. Nonetheless, Australia is in the middle of a multi year investment boom in resource extraction with nearly full employment and excess capacity very limited. This should mean that Australian economic growth and real interest rates remain higher than the average of other G10 countries over the long term, terms of trade remain robust and the link between Asian economic growth and the AUD remains strong. Our longer term forecasts reflect this.

Figure 66. AUD/USD Regressed on 2y Swap Differentials



Source: Reuters EcoWin

Figure 67. Oil Prices vs. CAD



Source: Reuters EcoWin

USD/CAD has been trending steadily lower since a year ago. Corrections along the way have been limited and have never threatened the main downtrend, even including the latest correction from a low around 0.95 to a recent high just below 0.99. This might change if oil prices continue to correct lower, as we expect at least short term, since the CAD- oil price link remains close (Figure 67). Our forecasts suggest some further limited near term upside in USD/CAD over 0-3 months and a return to parity should not be ruled out.

Longer term, though, we remain constructive CAD and think a new range of 0.93-0.95 can be reached and sustained. For now, there is little signal from rate differentials with the US, however, Citi economists still think the Bank of Canada could hike rates before year end and just 15bp is currently priced in given recent soft data. This will surely be faster than in the US as well as faster than what is currently priced in markets- both positive for CAD over the 6-12 months horizon if commodity prices are then recovering again.

Finally, the NZD has been a star FX performer over the past month, appreciating back to the highs vs. the USD at around 80c. A turnaround in underlying economic performance in the face of continued seismic shocks in various centres has generated a pick up in rate expectations and NZD has benefited in spite of rising risk aversion that has affected other commodity/carry backed currencies. We now think that this may continue for a while and that NZD may hold close to recent highs even in he USD rallies more generally. This implies some outperformance by the kiwi relative to CAD and AUD over 0-3 months though this may be given back over the next 6-12 months.

European Crosses

GBP — Real appreciation coming but via nominal or inflation?

Sterling is still trading mainly sideways against the average of the USD and EUR (Figure 68). In some ways GBP has been off the market's radar screen compared with the USD (weak data, debt ceiling), JPY (earthquake, long term fundamentals) and EUR (periphery concerns).

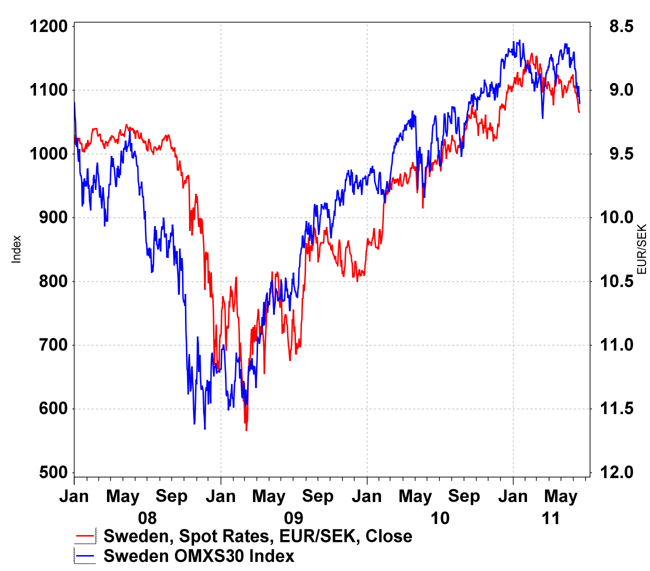
A positive for the GBP is that it is cheap. Our WERM fair value estimates are GBP/USD 1.74 and EUR/GBP 0.71. This cheapness shows up in a general perception that the UK is now a lower cost centre than historically. One or all of several phenomena usually follow from this. Exports rise, the currency appreciates or the inflation rate accelerates. For now, we are getting more of the first and last mainly because the MPC continue to allow above target inflation to persist without raising interest rates. We think that real appreciation is inevitable in the medium term as the UK economy emerges "re-balanced" in the long term with a lower fiscal deficit, current account surplus and lower consumption/ higher exports investment. But the danger for our mildly bullish GBP view and forecasts is that the MPC will allow all this real appreciation to come via inflation.

For now, we assume that policymakers don't blow inflation credibility completely and forecast a rather flat medium to long term path for EUR/GBP meaning that sterling first loses and then regains ground against the USD in line with our EUR/USD view.

Figure 68. GBP vs. Average of USD and EUR

Source: Bloomberg

Figure 69. EUR/SEK vs. VIX



Source: Reuters EcoWin

Scandis — NOK/SEK higher

EUR/SEK bottomed out in February/ March and has risen quite sharply in recent weeks as risk aversion has picked up. In part this probably reflects position unwinds (SEK has been a popular long) but also the relatively high beta nature of Swedish stocks. Given the way Swedish equities trade, when risk is off, SEK suffers (Figure 69). Short term, we doubt this spike is over and our 0-3 months forecast is 9.30 which means SEK probably further underperforms NOK — see below.

However, longer term our forecast assumes that this correction is reversed and the cross should move lower again in line with medium term value around 8.80. Sweden's economy still seems reasonably robust, and inflation expectations rose a bit in Q2. As a result, Citi economists expect a further gradual normalisation of monetary policy with policy rates reaching 2.5% by end 2011 and 3.5%+ by the end of next year.

In Norway, EUR/NOK has been in a relatively volatile sideways trading range this year. The 7.70-8.15 range has actually contained an awful lot of the EUR/NOK price action since 2005, with the exception of the sharp move higher in 2008 that was probably driven by a similarly sharp fall in oil prices that year. Since we think risk appetite pulls back near term, oil prices could pull back too. There may be mild upside for EUR/NOK over 0-3 months.

Over 6-12 months, assuming better risk appetite and a commodity price recovery, EUR/NOK may move lower again, aided by higher rates from the Norges Bank (Citi expects two 25bp hikes this year following the hike announced in May). However, we see the downside for the cross as limited. Our WERM fair value estimate for the cross is 7.67.

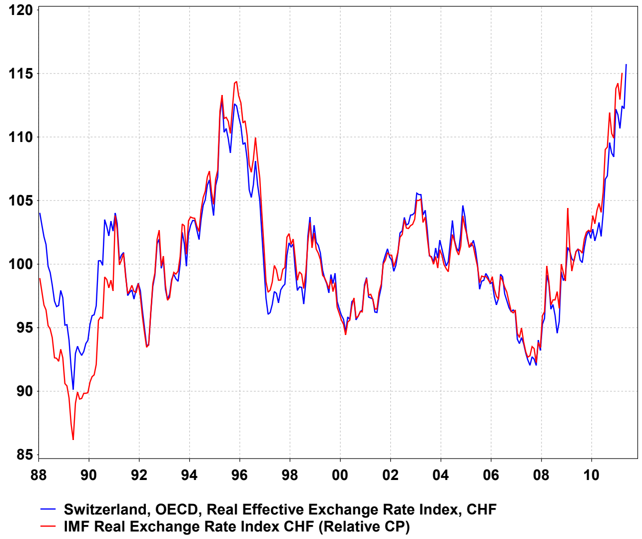
CHF — Overvalued but could strengthen more short term

In contrast to SEK and NOK, we think CHF is hugely overvalued longer term vs. the EUR. Figure 70 and Figure 71 make the point. The former shows the real effective exchange rate is off the charts to the strong side (our WERM EUR/CHF estimate is 1.41). The latter suggests that on a rate differential basis, EUR/CHF could be above 1.50. As a result, our longer term EUR/CHF forecasts are higher.

That said, the Swiss economy is doing surprisingly well given the currency strength. Although Swiss business surveys lag those in Germany, Switzerland is probably outperforming the EMU average. SNB President Hildebrand recently suggested that the currency was lowering their inflation projections and, by implication, delaying rate normalisation. But he also said that exports were holding up more than he would have expected.

We have to admit that this economic strength is surprising given the apparently penal level that the exchange rate has reached. Furthermore, another surprise is that the CHF continued to trade strongly in the "risk on" period from August to April. We suspect, but cannot prove in the data, that capital flight both from MENA and EMU periphery countries may be a factor behind the CHF strength. (Another factor is the ongoing problem related to CHF denominated mortgages in Hungary.) Whatever the cause, the trading pattern suggests there is a serious risk that EUR/CHF takes another leg lower short term, especially in a "risk off" environment. We forecast 1.17 over 0-3 months.

Figure 70. Real Effective CHF at Multi Year Highs



Source: Reuters EcoWin

Figure 71. EUR/CHF (Red) vs. Regression on 2y Swap Rate Differentials

Sources: Reuters EcoWin and Citi

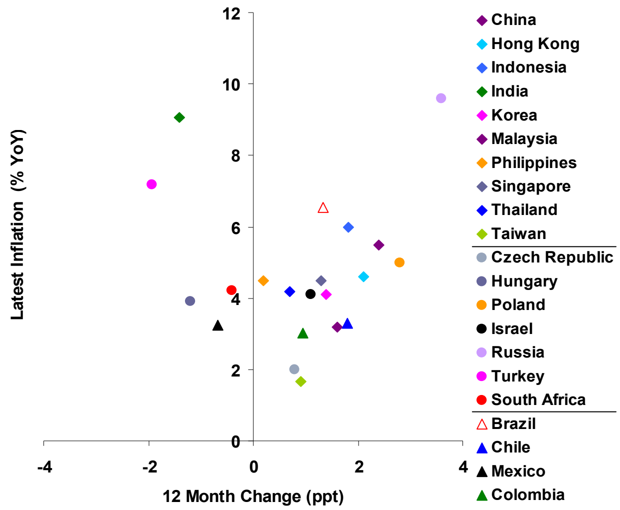
EM Exchange Rates

Since our last forecast round, broadly speaking, EM currencies appreciated as the DXY gave back some of the gains acquired during the May mini-rally. However, macro data have surprised on the downside in EM too over the last few weeks and reduced liquidity support will likely not bode well for risk assets. We thus expect weaker risk appetite coupled with a rebound in the DXY Index in the short term. These broad risk-off dollar movements are likely to impact EM FX also, and, as a result, we don't expect much upside in spot EM currencies in the next 0-3 months.

In the medium to longer term, EM Asian currencies should continue their trend spot appreciation against the USD. High carry, means that in some cases, returns vs. forwards over 6-12m are likely to be in the high single digits. The picture is perhaps more mixed in CEEMEA and Latam, but in these regions as well we generally expect good medium term performance vs. forwards, especially for PLN and BRL.

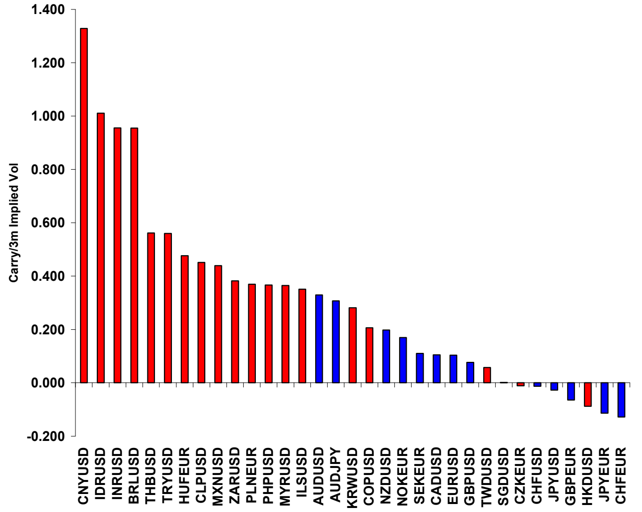
A significant factor in the EM world today is the attitude of policymakers towards tolerating greater exchange rate appreciation to tame inflation. Inflationary pressures remain strong in many EM countries, with high agricultural commodity prices not helping. In fact, only 5 out of the 21 countries we cover in this report are experiencing *declines* in CPI inflation over the past year, with the other countries seeing strong (1-4ppt) increases in inflation (Figure 72). In reality, countries with a strong external balance are those most able or most likely to tolerate nominal appreciation as a means to fighting inflation. Indonesia, Malaysia and Singapore fall into this category for example. Limited effectiveness of other inflation fighting tools is also a factor. In that respect, China recently hiked its reserve requirements yet again, but inflation continues to increase — the latest print is a near-3-year high. This is one reason why we continue to expect CNY appreciation in the medium term.

Figure 72. Inflationary Pressures Still High in Most EM Countries



Sources: Citi and Bloomberg

Figure 73. "Quality" of Carry High In EM



Sources: Citi and Bloomberg

In an environment where short term rates are likely to stay low in the major G10 countries for the rest of this year (and possibly beyond), another key factor impacting the outlook for several EM currencies is the appeal of high carry. Even when we adjust for the "quality of carry", i.e. the carry relative to expected FX volatilities[19], EM currencies clearly stand out (Figure 73). Obvious beneficiaries are BRL, MXN, ZAR, HUF, PLN and TRY. Thus, while we continue to hold reservations about the underlying fundamentals in some of these countries, high carry currencies are likely to post good performance vs. forwards over a 6-12m horizon. Of course, a much sharper correction in global risk appetite is the main risk to these forecasts.

EM Asia — Robust growth & inflationary pressures support appreciation in 6-12m

High ongoing economic growth and related inflationary pressures in EM Asia remain key underlying supports for the longer term appreciation of many currencies in the region. In the bigger picture, broad USD dynamics and commodity price inflation will likely be key too. In that respect, our expectation for medium term USD depreciation and commodity price gains also support trend nominal appreciation of Asian currencies over that horizon.

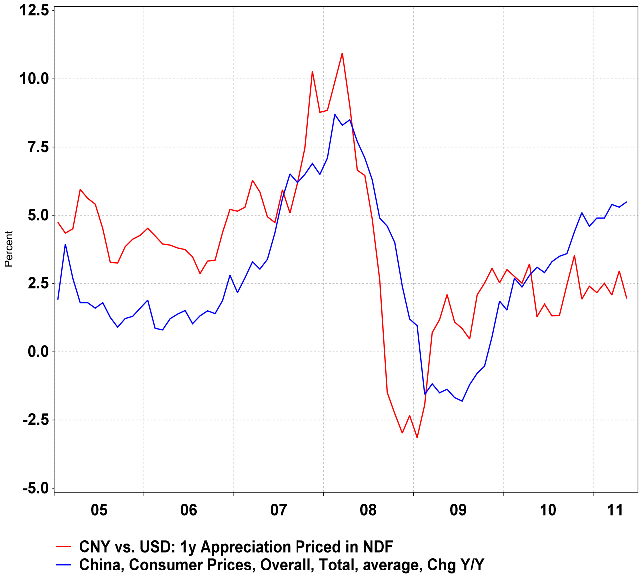
In the short term however, many EM Asian currencies could struggle to make gains in a backdrop of higher risk aversion and our bullish DXY forecast. Such a situation poses the main risk to our 0-3m forecasts for EM Asia, particularly for the higher beta currencies. Nevertheless, we note that the ADXY Index held up fairly well during the DXY rally in May and also very recently.

In China, renminbi appreciation versus the dollar has effectively paused since the soft patch to risk assets began in early May. As a result, market expectations for year ahead CNY appreciation (in the 12m NDF) are at lows not seen since September of last year. Nonetheless, upward inflation pressures remain high, the latest CPI print of 5.5% YoY is a near-3 year-high, and continue to be a principal driver of CNY appreciation expectations (Figure 74).

[19] We define the carry/vol ratio as the 2y swap rate spread to the US divided by the 3m implied FX volatility.

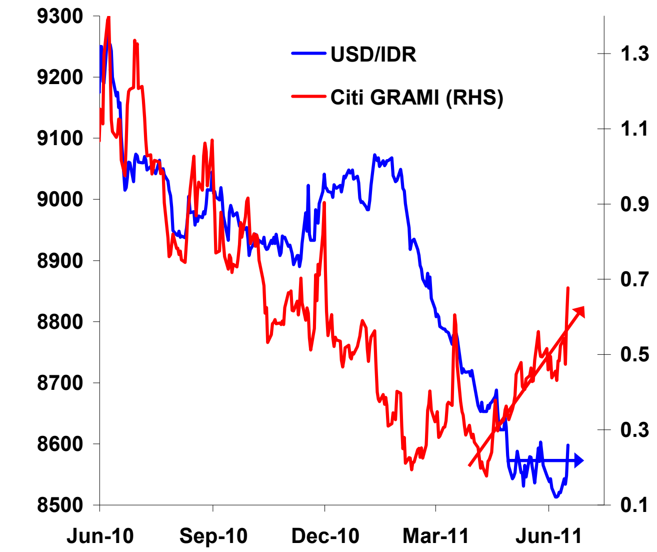
Furthermore, Citi is still bullish on many commodities complexes over the medium term and our forecasts have DXY resuming its downward trend after the current retreat from risk runs its course. As such, our forecast of around 3% appreciation in 6-12m is above consensus, even as we expect inflation to likely moderate slightly in the second half of the year. In contrast, shorter term risk aversion and our expectation of a stronger USD in coming months, will likely restrain renminbi appreciation over 0-3m.

Figure 74. China: CPI Inflation (yoy) and CNY 1y Appreciation in NDF



Source: Reuters EcoWin

Figure 75. IDR Resilient in light of higher Risk Aversion



Sources: Citi and Bloomberg

Since our last forecast round, capital outflows and a stronger USD have caused the HKD to continue to depreciate, edging towards the middle of the convertibility band. Our forecasts see the currency trading sideways from here, both in the short and medium term. If China's inflation peaks in H2 as expected, a stock market recovery and still high inflation provide downside risks to our USD/HKD medium term forecast.

The rupiah has remained resilient in light of the recent environment of higher risk aversion (Figure 75). Bank Indonesia seems more tolerant on using FX appreciation as a means for disinflation and furthermore offshore inflows into Indonesian fixed income instruments remain supportive. As such, we expect IDR to outperform its peers in 0-3m, although a short term USD rally could make it difficult for the IDR to pierce through the 8500 level. In the medium term, we expect this resistance level to be broken eventually, supported by structural allocation into EM debt likely persisting alongside resilient FDI and current account flows. Of course, carry supports IDR, resulting in it likely posting one of the strongest returns vs. forwards in EM.

In India, inflationary pressures remain elevated but we think INR is most likely to continue its side ways trading pattern rather than resuming the gradual downtrend begun in 2009. The country continues to run a current account deficit and a large fiscal deficit. Citi economists don't expect a lot of improvement on either front before end 2012. High carry is a positive, though, and so we still predict decent gains vs. the forwards in 6-12m.

Turning to Korea, we expect the won to be one of the top performers in the region in the next 6-12m. A current account surplus, continued inflows to the Korean bond market and MoSF's recent shift to prioritising inflation stabilisation should be key supports. With regards to the latter point, MoSF recently declared to engage in every possible measure to contain inflation. In the near term however, the currency is probably unlikely to make big gains, like elsewhere in the region given our bullish dollar forecast. Nonetheless we expect it to continue to trade in its recent downward sloping channel with not a lot upside in USD/KRW from current spot.

Broad USD strength will likely also cause the appreciation of SGD and MYR to stall in the short term. Further out, central bank tolerance for SGD and MYR appreciation will likely resume in an effort to counter inflation pressures. In particular, stubbornly high structural inflation pressures in Singapore, may raise market expectation for a further tightening of MAS policy, further increasing capital inflows supporting SGD in the medium term. Apart from being a proxy play for SGD appreciation, the MYR may also benefit from further rate hikes this year as inflation continues to nudge higher on strengthening domestic demand.

As for other countries, THB and PHP gains are likely limited in the short term. Elections in early July in Thailand will likely heighten near-term political uncertainty, possibly leading to offshore portfolio outflows, further undermining the currency. That said, we do not expect much upside in USD/THB beyond 30.50. As external concerns fade, we expect trend appreciation to resume in the medium term, with both crosses posting decent single digit gains vs. forwards.

We also don't see much upside in TWD. Inflation has been less of a problem in Taiwan and the government seems keen for TWD to stabilize going forward following the trend lower in USD/TWD since September last year. A stronger DXY and lower risk appetite should alleviate appreciation pressures in the short run. The risk to our medium term forecast is probably to the downside in the cross based on a rebound in growth momentum in 2H and particularly if other currencies in the region such as KRW post strong gains.

CEEMEA — Softer near term in line with higher risk aversion

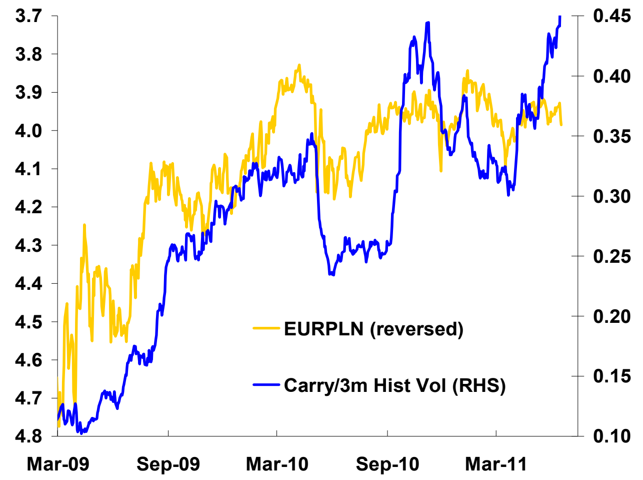
We expect CEEMEA fx to trade softer in the short term, in line with higher risk aversion and a backdrop of broader USD strength. As we expect commodity prices to be vulnerable during a period of risk aversion, appreciation pressures on RUB and ZAR will likely be limited. In the medium term, high carry is a positive in most cases and provides the basis for decent single digit returns in 6-12m.

PLN is one example of a high carry beneficiary — we expect it to be the best performing CEE3 currency over 6-12m (vs. forwards). Indeed, the quality of carry (carry/3m implied vols) is near multi-year highs and clearly a driver for the zloty (Figure 76). Furthermore, accelerated privatization flows, relatively strong economic growth and an improvement is risk appetite will likely be supportive over this horizon. However, the fiscal deficit remains at a high level, political risks may increase ahead of the parliamentary elections later this year and we see a further widening of the current account deficit in late June. Combined with our expectation of increasing global risk aversion and a weaker EUR, we thus also expect the zloty to weaken in the short term.

We also expect CZK to weaken in 0-3m as higher risk aversion, continued coalition tensions and a wider interest rate spread versus the euro zone will likely weigh on the currency. In 6-12m we expect the koruna to resume appreciation driven by continued foreign demand, a solid trade surplus, a robust fiscal stance and the likely start in CNB's normalisation in 3Q11.

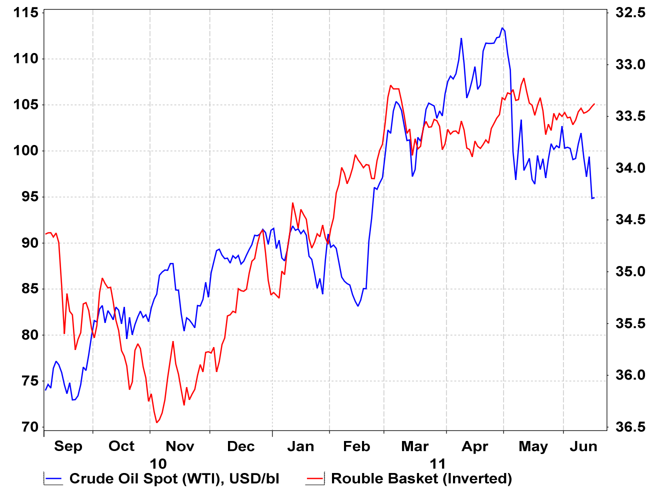
We continue to expect HUF to underperform its CEE3 peers in the medium term. In our view, most of the planned fiscal tightening seems to be discounted by the market by now. As such, the forint will likely suffer short term corrections along with a DXY rally and higher risk aversion globally. Further out, even if risk appetite rebounds, a further decreasing interest rate differential vs. the euro zone and other CEE economies should to weigh on the currency. That said, high carry is likely to roughly offset the expected depreciation in spot in 6-12m.

Figure 76. Carry a driver for PLN



Source: Citi and Bloomberg

Figure 77. RUB and Oil Prices



Source: Reuters EcoWin

We expect TRY to continue to perform poorly in the short term against a backdrop of broader USD strength and risk appetite being pared back. The lira also continues to be vulnerable to the noticeable widening in the current account deficit and the deterioration in the quality of external financing. With the general election behind us, all eyes will be on the nature of the likely policy response by the new government to alleviate rising concerns about the current account deficit. We are sceptical about the political will of the new government to press ahead with any comprehensive reform packages and hence expect the countries' structural weakness to persist for some time. Nonetheless, high carry is especially positive for the lira and we thus expect TRY to muddle through later this year, thereby posting decent returns vs. forwards.

Although we expect the ruble to depreciate versus the dollar in the short term, our weaker EUR/USD forecasts has the ruble basket trading roughly sideways over the same horizon (Figure 77). A bout of risk aversion would likely cause commodities (including energy/oil) to underperform other risk assets as positioning still points to stretched net long positioning in the asset class. As such, together with our expectation of a falling current account surplus, capital outflows and increased uncertainty around December elections, the rouble is likely to post no significant gains in the short and medium term. Of course, the main risk to our RUB forecasts is a sharp rebound in oil prices.

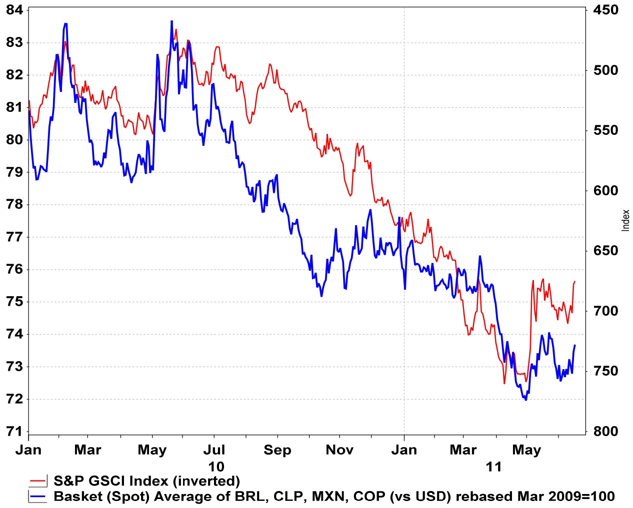
Aggressive monetary tightening by the Bank of Israel should provide support to ILS over the medium term, although USD/ILS is likely to rise near term in line with our higher DXY forecast. The market has gone too far, we think, in moderating its view about how many rate hikes will be needed. Further evidence of inflationary pressures in the next couple of months, which we think likely, will bring the market back towards pricing in more rate hikes.

ZAR remains to be one of the biggest underperformers in EM FX this year, stuck in a 6.55-7.30 range since October of last year. We expect this side-ways trend to continue in the short term, although the risks are skewed to the higher end of its recent range given our expectation of broad dollar strength and higher risk aversion. Over the medium to longer term, however, ZAR needs to weaken considerably to reflect inflation and productivity differentials. High carry means that ZAR may, however, still beat forwards.

Latam — BRL outperformance due to high carry

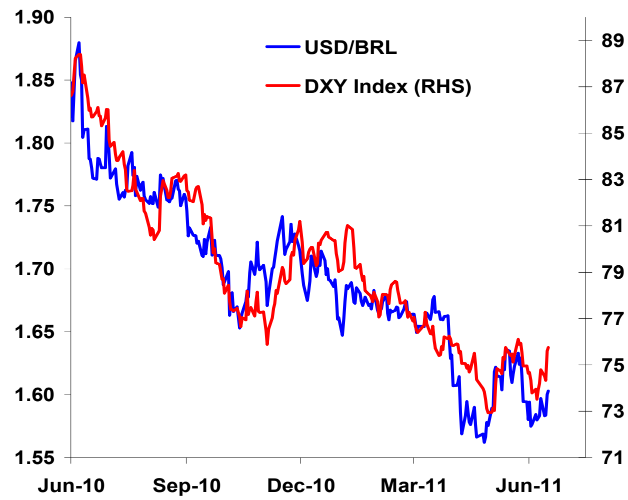
The recent correction to commodity prices has also exerted downward pressures on the main Latam currencies since our last forecast round in May (Figure 78). We expect risk assets to continue to sell-off in the short term and in particular, we think commodities could be vulnerable during further bouts of risk aversion. As for the other EM regions, we hence expect Latam currencies to trade mostly sideways in 0-3m, although we think the very short-term risks are skewed to the downside. Longer term gains in spot also seem limited by twin current account and fiscal deficits in Brazil, Colombia and Mexico. Nonetheless, due to high carry, returns versus forwards remain attractive in 6-12m.

Figure 78. Latam Currencies vs. S&P GSCI Index



Source: Reuters Ecowin

Figure 79. BRL Likely Vulnerable During Broad USD Strength



Source: Bloomberg

Especially for Brazil, high carry means the real should be one of the top performer in EM (vs. forwards) in both the short and medium term. Moreover, inflation also remains stubbornly high and our economist see it increasing even further in H2 11. In the short term however, broad USD strength coupled with risk aversion means the BRL will likely trade roughly sideways, although risks seem skewed to the downside (Figure 79). In the medium term, a rebound to commodity prices should support the BRL, but increasing current account deficits and the ongoing poor fiscal position should act as a constraint on spot BRL upside in 6-12m.

In Mexico, the peso sold off recently, trading at levels not seen since late March of this year. Pressures will likely remain given higher risk aversion in the short term, we expect to see USD/MXN around the 12.0 level in 0-3m. Further out, strong fundamentals will likely cause the peso to strengthen slightly. Indeed, Mexico continues to grow at a relatively fast pace, the local authorities have continuously reiterated their commitment to a free-floating exchange rate, fiscal fundamentals are robust and carry is attractive.

Although CLP has been fairly resilient recently, continued risk aversion will likely cause the peso to revisit recent lows around the 475 level in 0-3m. Although we do not expect the central bank to increase direct purchases, with CLP trading near previous intervention levels, we do not rule out further measures on the fx front if USD/CLP were to come under much further pressure. In the medium term, the peso should find support from supportive terms of trade as copper prices are likely to rebound.

USD/COP has been relatively immune during the latest bout of risk aversion and we think it will continue to trade around current levels in 0-3m. Foreign investment inflows should also lend support to COP, especially as Moody's recently granted investment grade status (making it two out of the large tree rating agencies). Medium term, carry remains supportive, resulting in decent single digit returns vs. forwards.

Citi Foreign Exchange: Forecasts

Contributors

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

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Source: Citi Investment Research and Analysis

Figure 81. Citi Quarterly Interpolated Forecasts

Quarterly Interpolated Forecasts

	Currency	Spot	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13
G10-US Dollar											
Euro	EURUSD	1.43	1.42	1.37	1.41	1.44	1.47	1.44	1.42	1.40	1.38
Japanese yen	USDJPY	80	80	79	81	82	83	84	85	86	87
British Pound	GBPUSD	1.62	1.61	1.60	1.65	1.69	1.73	1.73	1.74	1.74	1.75
Swiss Franc	USDCHF	0.85	0.85	0.85	0.85	0.85	0.86	0.90	0.94	0.98	1.01
Australian Dollar	AUDUSD	1.06	1.06	1.02	1.05	1.07	1.09	1.05	1.01	0.98	0.95
New Zealand Dollar	NZDUSD	0.81	0.81	0.80	0.80	0.80	0.79	0.75	0.71	0.67	0.63
Canadian Dollar	USDCAD	0.98	0.98	1.00	0.98	0.96	0.95	0.95	0.95	0.95	0.95
Dollar Index*	DXY	75.13	75.42	77.06	75.67	74.36	73.40	74.32	75.26	76.19	77.03
G10 Crosses											
Japanese yen	EURJPY	115	114	109	114	118	122	121	121	120	120
Swiss Franc	EURCHF	1.21	1.20	1.17	1.20	1.23	1.26	1.29	1.33	1.37	1.40
British Pound	EURGBP	0.88	0.88	0.86	0.86	0.85	0.85	0.83	0.82	0.80	0.79
Swedish Krona	EURSEK	9.18	9.20	9.28	9.17	9.05	8.94	8.91	8.87	8.83	8.80
Norwegian Krone	EURNOK	7.88	7.88	7.89	7.84	7.79	7.75	7.74	7.72	7.71	7.70
Norwegian Krone	NOKSEK	1.17	1.17	1.18	1.17	1.16	1.15	1.15	1.15	1.15	1.14
Australian Dollar	AUDNZD	1.31	1.31	1.28	1.31	1.34	1.37	1.40	1.44	1.48	1.51
Australian Dollar	AUDJPY	85.1	84.5	81.0	84.4	87.7	90.2	88.2	86.2	84.3	82.6
EM Asia											
Chinese Renminbi	USDCNY	6.48	6.48	6.43	6.35	6.28	6.20	6.15	6.10	6.05	6.05
Hong Kong Dollar	USDHKD	7.79	7.78	7.77	7.76	7.75	7.75	7.75	7.75	7.75	7.75
Indonesian Rupiah	USDIDR	8608	8550	8500	8400	8350	8350	8300	8300	8250	8200
Indian Rupee	USDINR	44.9	44.5	45.0	45.3	45.5	45.0	44.5	44.0	44.0	44.0
Korean Won	USDKRW	1086	1080	1060	1040	1030	1030	1020	1010	1000	1000
Malaysian Ringgit	USDMYR	3.04	3.03	2.99	2.94	2.92	2.94	2.90	2.87	2.80	2.83
Philippine Peso	USDPHP	44.0	43.5	43.0	42.5	42.3	41.9	41.5	41.0	41.4	41.4
Singapore Dollar	USDSGD	1.24	1.24	1.22	1.21	1.20	1.21	1.20	1.18	1.17	1.17
Thai Baht	USDTHB	30.6	30.5	30.3	29.9	29.9	29.8	29.5	29.4	29.4	29.4
Taiwan Dollar	USDTWD	29.0	28.8	28.5	28.2	28.5	28.5	28.2	28.2	27.8	27.8
EM Europe											
Czech Koruna	EURCZK	24.10	24.17	24.54	24.14	23.74	23.39	23.34	23.29	23.24	23.20
Hungarian Forint	EURHUF	268	269	270	271	272	273	274	276	277	278
Polish Zloty	EURPLN	3.98	3.98	3.97	3.93	3.89	3.84	3.78	3.72	3.65	3.60
Israeli Shekel	USDILS	3.44	3.44	3.50	3.46	3.43	3.40	3.39	3.37	3.36	3.35
Russian Ruble	USDRUB	28.1	28.2	28.9	28.7	28.6	28.5	29.0	29.5	29.9	30.3
Russian Ruble Basket	RUB	33.5	33.5	33.7	34.0	34.3	34.5	34.8	35.0	35.3	35.5
Turkish Lira	USDTRY	1.60	1.61	1.65	1.65	1.64	1.64	1.65	1.65	1.66	1.66
South African Rand	USDZAR	6.79	6.80	6.87	6.98	7.10	7.24	7.50	7.77	8.03	8.27
EM Latam											
Brazilian Real	USDBRL	1.60	1.60	1.60	1.60	1.60	1.60	1.61	1.63	1.64	1.65
Chilean Peso	USDCLP	471	471	475	473	471	470	471	473	474	476
Mexican Peso	USDMXN	11.9	11.9	12.0	11.9	11.9	11.8	11.9	12.0	12.1	12.2
Colombian Peso	USDCOP	1786	1788	1800	1800	1800	1802	1814	1827	1839	1851

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

Source: Citi Investment Research and Analysis

Figure 82. Citi Annual Forecasts

Annual Forecasts

	Currency	Spot	2011*	2012*	2013*	2014*	2015*
G10-US Dollar							
Euro	EURUSD	1.43	1.41	1.44	1.38	1.37	1.37
Japanese yen	USDJPY	80	81	84	87	87	87
British Pound	GBPUSD	1.62	1.62	1.72	1.74	1.74	1.73
Swiss Franc	USDCHF	0.85	0.87	0.89	1.01	1.02	1.03
Australian Dollar	AUDUSD	1.06	1.04	1.05	0.95	0.92	0.89
New Zealand Dollar	NZDUSD	0.81	0.79	0.76	0.64	0.63	0.62
Canadian Dollar	USDCAD	0.98	0.98	0.95	0.95	0.96	0.97
Dollar Index**	DXY	75.12	76.00	74.33	76.88	77.40	77.73
G10 Crosses							
Japanese yen	EURJPY	115	113	121	120	119	118
Swiss Franc	EURCHF	1.21	1.22	1.28	1.39	1.40	1.40
British Pound	EURGBP	0.88	0.87	0.84	0.79	0.79	0.79
Swedish Krona	EURSEK	9.18	9.15	8.94	8.81	8.79	8.79
Norwegian Krone	EURNOK	7.88	7.87	7.75	7.70	7.69	7.68
Norwegian Krone	NOKSEK	1.17	1.16	1.15	1.14	1.14	1.14
Australian Dollar	AUDNZD	1.31	1.31	1.39	1.49	1.46	1.42
Australian Dollar	AUDJPY	85.1	83.9	88.1	82.5	79.5	76.8
EM Asia							
Chinese Renminbi	USDCNY	6.48	6.45	6.18	6.00	5.80	5.60
Hong Kong Dollar	USDHKD	7.79	7.77	7.75	7.75	7.75	7.75
Indonesian Rupiah	USDIDR	8608	8540	8325	8250	8150	8050
Indian Rupee	USDINR	44.9	44.8	44.8	44.8	44.4	44.0
Korean Won	USDKRW	1086	1069	1023	1000	975	970
Malaysian Ringgit	USDMYR	3.04	3.00	2.91	2.80	2.74	2.64
Philippine Peso	USDPHP	44.0	43.1	41.7	41.0	41.0	41.3
Singapore Dollar	USDSGD	1.24	1.23	1.20	1.17	1.16	1.15
Thai Baht	USDTHB	30.6	30.2	29.6	29.5	29.3	29.7
Taiwan Dollar	USDTWD	29.0	28.7	28.4	28.0	28.0	28.0
EM Europe							
Czech Koruna	EURCZK	24.10	24.34	23.44	23.20	23.12	23.06
Hungarian Forint	EURHUF	268	269	274	278	279	279
Polish Zloty	EURPLN	3.98	3.98	3.81	3.61	3.56	3.53
Israeli Shekel	USDILS	3.44	3.47	3.40	3.36	3.37	3.39
Russian Ruble	USDRUB	28.1	28.5	28.9	30.2	30.2	30.2
Russian Ruble Bask	RUB	33.5	33.8	34.7	35.4	35.3	35.1
Turkish Lira	USDTRY	1.60	1.61	1.65	1.66	1.64	1.62
South African Rand	USDZAR	6.79	6.86	7.40	8.32	8.91	9.47
EM Latam							
Brazilian Real	USDBRL	1.60	1.61	1.61	1.66	1.71	1.76
Chilean Peso	USDCLP	471	474	471	480	504	529
Mexican Peso	USDMXN	11.9	11.9	11.9	12.2	12.5	12.8
Colombian Peso	USDCOP	1786	1815	1811	1855	1889	1922

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

Source: Citi Investment Research and Analysis

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