Economics

28 September 2011 | 76 pages

Global Economic Outlook and Strategy

September 2011

- Global growth prospects continue to deteriorate quickly, both for advanced economies and emerging markets. This month, we are again cutting our 2011-12 GDP growth forecasts for many countries, including the Euro Area, UK, Japan, US and Canada, with a modest downgrade for China and sharper cuts for Eastern Europe, Singapore, Hong Kong and South Africa. We expect early sovereign debt restructuring in the Euro Area, and for the Euro Area overall to slip back into recession in coming quarters.
- We forecast global growth (at current exchange rates) will slow from 4.0% last year to 3.0% this year (revised down from 3.1% last month) and to 2.9% in 2012 (revised down from 3.2% last month and 3.7% two months ago). PPP-weighted, we expect global GDP growth to slow from 5.0% in 2010 to 3.8% this year and 3.6% in 2012 (with our 2012 forecast cut from 3.9% last month and 4.4% two months ago).
- Interest rates are likely to stay low, and negative in real terms, for a long period in the main advanced economies. We expect the ECB to cut its key policy rate back to 1.0% in coming months. For the US, if downside risks intensify, policymakers might turn first toward still-stronger language to guide rate expectations down. Renewed expansion of the Fed's balance sheet is unlikely unless deflation becomes a clear danger. The UK MPC is likely to be more aggressive, and we expect them to restart QE on a big scale in the next month or two. We expect more sovereign ratings downgrades among Euro Area countries in the next 3-6 months, including Italy, Spain, Greece, Portugal and Cyprus. We expect some monetary easing across a range of emerging markets.
- Against this backdrop, Citi's Macro Strategy team are cautious on risk assets and bullish core fixed income. Citi equity strategists believe that markets are oversold, but that stock prices are unlikely to move convincingly higher until there are clearer signs of stability in economic activity and profits growth. Citi rate strategists expect lower yields and flatter curves in core EMU markets and the UK. Citi FX strategists expect the USD and JPY to gain.

Figure 1. Currency and Interest Rate Forecasts (End of Period, Unless Specified), as of 28 Sep 2011

	28 Sep 11	4Q 11 Forecast	1Q 12 Forecast	2Q 12 Forecast	3Q 12 Forecast	4Q 12 Forecast
United States: Federal Funds	0.25	0.25	0.25	0.25	0.25	0.25
10-Yr. Treasuries (Period Ave.)	1.98	2.00	2.00	2.20	2.50	2.75
Euro Area: US$/€	1.35	1.29	1.28	1.26	1.25	1.26
Euro Repo Rate	1.50	1.00	1.00	1.00	1.00	1.00
10-Yr. Bunds (Period Average)	1.93	1.50	1.25	1.35	1.50	1.50
Japan: Yen/US$	76	75	75	76	76	77
Call Money	0.10	0.10	0.10	0.10	0.10	0.10
10-Yr. JGB (Period Average)	1.01	1.20	1.20	1.10	1.05	1.05

Source: Citi Investment Research and Analysis

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With thanks to
Jan Maguire

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	Prospects for global growth continue to deteriorate quickly, both for advanced economies and emerging markets. Based on this, we expect global growth to slow to 3.0% this year from 4.0% last year, and we are cutting our 2012 forecast to 2.9% from 3.2% last month and 3.7% two months ago.
■ United States	Although the reversal of temporary drags has given the latest quarter a solid boost, deteriorating financial conditions and lingering policy uncertainties continue to weigh on business confidence. We have trimmed a bit further already subpar growth estimates through next year, with unemployment expected to remain high over the medium term. Enhanced monetary accommodation is likely to persist through 2013 but new fiscal supports for growth are expected to be limited.
■ Euro Area	With likely multiple debt restructuring in the periphery countries, the Euro Area will probably fall back into recession. While an enlarged and probably leveraged EFSF is likely to limit the repercussions of the defaults, additional austerity measures and tighter financing conditions probably will hit economic activity. In this environment, the ECB is likely to cut rates back to 1.0% by year-end and the ECB is also likely to put in place additional non-standard measures.
■ China	We have cut our 2012 growth forecast from 9.0% to 8.7%, reflecting a deteriorating external outlook as multiple debt restructurings in the Euro Area may push the region into recession. With growth decelerating and inflation falling, we expect no further monetary tightening and fiscal policy to be more proactive to forestall downside risks.
■ Japan	We have revised down our GDP growth forecast for 2012 to 2.1% under the judgment that the European sovereign debt crisis will enter a new phase and the Euro area will fall into a recession in coming quarters. While Japan's direct trade exposure to Europe is modest, dysfunctional financial markets in Europe will likely have a much broader impact on the Japanese economy via indirect channels. We expect additional BoJ easing in October.
■ United Kingdom	The UK economy is likely to be close to recession in the next few quarters. We expect the MPC will restart QE soon and on a large scale.
■ Canada	Eroding confidence, dimming global economic prospects and financial market turmoil necessitate further downgrading of the Canadian outlook. The BoC has softened its policy stance in response to recent developments and probably will keep the overnight rate unchanged until early 2013. Absent significant worsening in the external environment, new fiscal policy stimulus is unlikely.
■ Australia	We have slightly lowered our forecast for economic growth next year to a still-robust 3.7%. The RBA will probably remain on hold in the near term, but there is a growing risk of a shift back to neutral from the current restrictive policy stance.
■ Emerging Asia (ex China)	Asia is showing decelerating growth, with most pronounced weakness in tech exports. Inflation expectations are stabilizing, but sharp FX weakness could be counterproductive. Indonesia cut 50bps from its overnight deposit facility, leading the region. We think MAS could also ease the SGD NEER slope in Oct. Most officials will likely remain cautious in easing given risks to inflation expectations. Nonetheless, the changes are that Asian Central Banks have finished hiking rates.
■ CEEMEA	We cut our 2012 GDP growth forecast for emerging Europe further to 2.3% from 3.4% on deepening fears of sovereign debt and banking risks in the Euro area. The ruble should continue depreciating to 37-38 against the basket, thanks to policy uncertainty and the effect of a fall in the Brent oil price to US$86 pb on average in 2012. The Bank of Israel's rate cut on 26 September has set a precedent for likely easing in other countries.

Source: Citi Investment Research and Analysis

Overview — Cutting Forecasts Again

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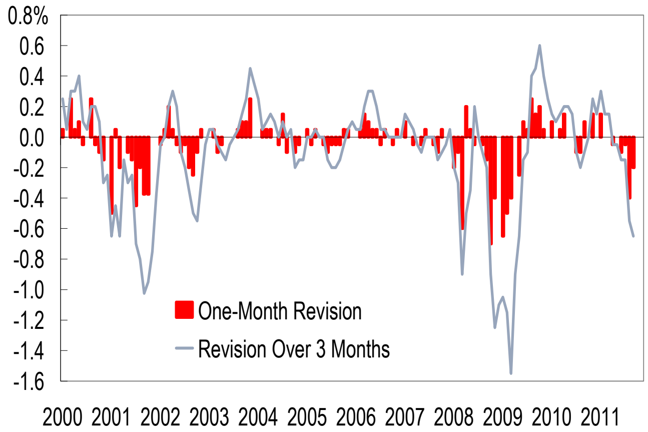
Prospects for global growth continue to deteriorate quickly, both for advanced economies and emerging markets. This month, we are cutting our 2011-12 GDP growth forecasts for a range of countries, including China, Euro Area, Japan, UK and Canada, with sharp downgrades also in Eastern Europe, Singapore, Hong Kong and South Africa. We now expect the Euro Area will slip into recession again, with deep recessions in the periphery economies, and with the UK also close to recession.

We expect global GDP growth will slow below 3% in 2012, markedly lower than expected a few months ago

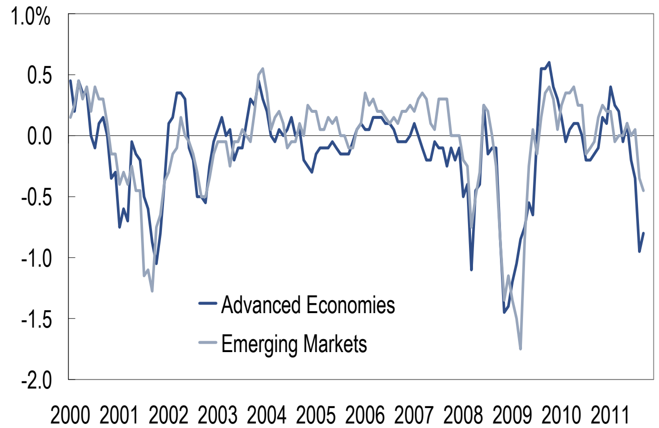
In all, we provide up-to-date forecasts for countries which comprise 97% of global GDP each month in GEOS. Based on this, we expect global growth (at current exchange rates) to slow from 4.0% last year to 3.0% this year (revised down from 3.1% last month) and to 2.9% in 2012 (revised down from 3.2% last month and 3.7% two months ago). PPP-weighted, we expect global GDP growth to slow from 5.0% in 2010 to 3.8% this year and 3.6% in 2012 (with our 2012 forecast cut from 3.9% last month and 4.4% two months ago). We still do not expect a global recession for 2011 or 2012 as a whole (usually defined as global GDP growth of less than 2% YoY), but QoQ industrial country growth probably will be well below average until at least end-2012.

Figure 3. Global — Changes to Citi GDP Growth Forecasts for Current and Following Year, 2000-11



Source: Citi Investment Research and Analysis

Figure 4. Advanced Economies and Emerging Markets — 3-Month Sum of GDP Forecast Revisions (Current and Next Year), 2000-11



Source: Citi Investment Research and Analysis

The recent pace of GDP forecast downgrades is among the greatest of the last ten years…

The recent scale and breadth of our forecast downgrades is unusually large.

- Over the last three months, we have cut our global growth forecasts for the current and following year by 0.65% (from 3.4% to 3.0% for this year, and from 3.8% to 2.9% for 2012). Within the last ten years, this pace of downgrades has been only exceeded in Q4-08 and Q1-09.

…and extends the recent run of lower forecasts

- This is the fourth month in a row in which we have cut our forecasts for advanced economy growth, and the second consecutive month with downgrades to our forecasts for emerging market growth.

We have cut forecasts in a wide range of countries…

- Over the last three months, we have cut our growth forecasts in every single one of 16 major economies (advanced economies and emerging markets), a pattern only seen once in the last 10 years (Q4-08).

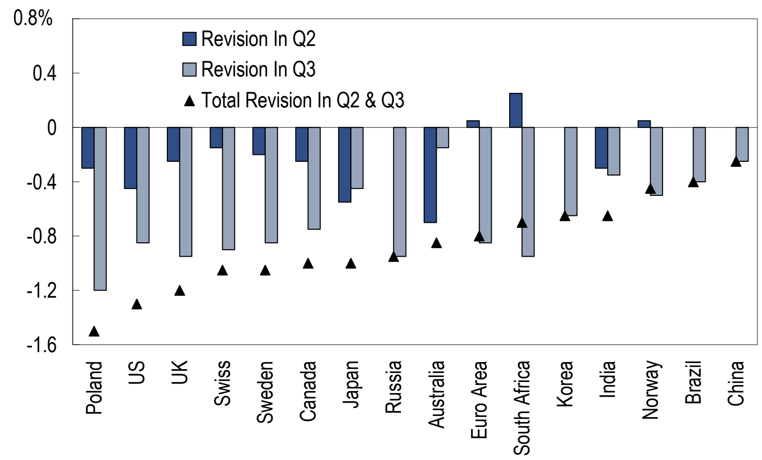
…with another exceptionally large downgrade for the Euro Area

- For the Euro Area, the cut in our growth forecast (down 0.1% for this year, down 0.8% for next year) is the fifth biggest monthly downgrade of the last ten years[1].

In general we are cutting forecasts more for advanced economies than for emerging markets, but this month we have a very large downgrade for Eastern Europe

We expect growth to slow markedly in both the advanced economies and emerging markets. We forecast that GDP growth in advanced economies will slow from 2.6% in 2010 to 1.4% in 2011 and 1.3% in 2012, with emerging market growth slowing from 7.3% in 2010 to 6.0% in 2011 and 5.5% in 2012. But, in general we are cutting our advanced economy growth forecasts faster than our emerging market forecasts. Over the last three months, we have cut our forecasts for 2011-12 GDP growth in advanced economies by 0.8%, roughly twice the downgrade for emerging markets (0.45%). Nevertheless, we are making some exceptionally sharp forecast downgrades in Eastern Europe, with our forecast for aggregate 2012 growth in Emerging Europe cut to 2.3% from 3.4% last month and 4.0% two months ago.

Figure 5. Selected Countries — Recent Revisions to Citi GDP Growth Forecasts for 2011-12



Note: We show revisions to GDP growth averaged across 2011 and 2012.
Source: Citi Investment Research and Analysis

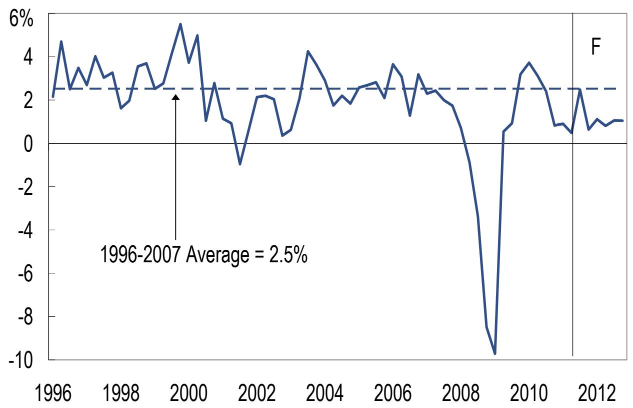
The global economy faces drags from high private debts across advanced economies plus the EMU sovereign debt crisis

The two big questions for the global economy over the last 12-18 months have been: (1) whether we are in a "Reinhart-Rogoff" world of private sector balance-sheet retrenchment and extended weakness in private spending[2], or whether the exceptional monetary stimulus of 2009-10 will prompt a solid recovery; and (2) whether the seemingly-inevitable sovereign debt restructuring of periphery euro countries can be limited or delayed sufficiently to avoid a systemic financial crisis. At the start of this year, we leaned towards relatively optimistic views, but the answer to both questions now seems to be clear — and adverse.

[1] The only months with bigger downgrades to Citi forecasts averaged over the current and next year have been March 2008, November 2008, January 2009 and March 2009.

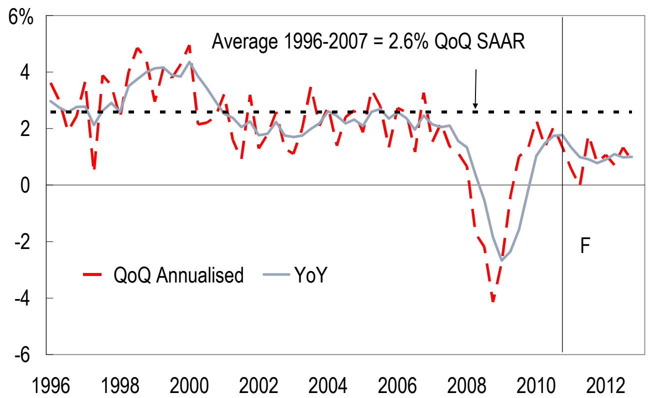
[2] See "*The Aftermath of Financial Crises",* Reinhart and Rogoff, NBER Working Paper no 14656, January 2009.

Figure 6. G4 — Q0Q Annualised GDP Growth, 1996-2012F



F Forecast. Note: The G4 is the GDP-weighted average of the US, Euro Area, Japan and UK. Sources: Datastream and Citi Investment Research and Analysis

Figure 7. G4 — Consumer Spending QoQ and YoY, 1996-2012F



F Forecast. Note: The G4 is the GDP-weighted average of the US, Euro Area, Japan and UK. Sources: Datastream and Citi Investment Research and Analysis

Private savings to stay high for advanced economies

The outlook has been balanced between high private debts and exceptional monetary stimulus…

The Reinhart-Rogoff thesis is that systemic financial crises in advanced economies and emerging markets are usually followed by deep recessions, slow recoveries and an extended rise in unemployment as balance sheet repair dominates. The initial rebound after the 2008-09 recession appeared to suggest that the exceptional monetary stimulus (low interest rates plus unconventional measures) might counter these drags, with a fairly strong recovery in GDP plus a clear pick-up in private consumption and investment across the advanced economies as a whole in H2-09 and through most of 2010.

…but the drag from high private debts seems to be dominating…

However, this initial recovery has petered out. Aggregate GDP growth for the G4 (average of the US, Euro Area, Japan and UK) fell back below average in Q4-2010 and has stayed below average since then. To be sure, specific temporary factors may have played a role in individual countries. But, the widespread evidence of slowdown in recent quarters points to more general headwinds from high private debts and poor credit availability. The unwind of some of these temporary adverse shocks probably has lifted growth in Q3, especially in Japan. But, we expect that G4 growth will slip back close to zero in subsequent quarters. Aggregate real consumer spending for the G4 was roughly flat in Q2 this year, with a marked drop in the Euro Area. Early this year, the jobless rate was falling in the US, EMU, Japan and UK, but these gains have already ended. The jobless rate probably will rise over coming quarters in the US, Euro Area, Japan and UK.

…and is likely to persist over several years

The drag from high private debts is unlikely to fade quickly, leading to an extended period of relatively high private savings and relatively sluggish recovery in private demand. To be sure, corporate liquidity generally is quite strong among large firms, but overall private sector debt burdens remain high in the US, Euro Area and UK, with poor credit availability for small firms in particular. Amidst heightened uncertainties (for example, over medium-term fiscal trends) companies may well remain cautious and continue to repay debt. The ability of the advanced economies to break out from sluggish demand is further hindered by the tight supply/demand balance in many commodity markets, with gains in commodity prices helping to short-circuit the nascent recovery in demand early this year.

EMU crisis to worsen further

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

	2011F	2012F	2013F
World	**5.7%**	**3.3%**	**4.1%**
United States	3.8	2.8	3.5
Japan	-2.5	2.7	3.5
Euro Area	3.9	-0.5	1.4
United Kingdom	0.1	0.0	0.5
Canada	0.8	-1.0	0.4
China	13.8	12.5	11.5
India	6.8	8.0	8.8
Korea	8.1	8.8	8.6
Brazil	2.1	3.0	3.8

Source: Citi Investment Research and Analysis

The intensifying EMU sovereign debt crisis is likely to further hit economic growth, reinforcing the mood of caution among companies and households, especially in Europe but in other regions as well. We have argued for a while that sovereign debt restructuring with large haircuts eventually is likely in Greece, Ireland and Portugal[3]. But, our base case was that restructuring would be delayed until 2013 or even 2014[4]. That delay, we hoped, would allow time for banks to accumulate or raise enough capital to withstand sovereign losses, and for the peripheral countries to achieve sufficient primary budget surpluses so that a sizeable restructuring would return them to a sustainable fiscal path.

However, it now seems likely that sovereign debt restructuring will come much earlier[5]. We now expect the Greek sovereign to engage in substantial and probably coercive debt restructuring by the end of 2012 at the latest and likely much sooner (by the spring of 2012 or even December 2011). We expect Ireland and Portugal to follow Greece into sovereign debt restructuring soon afterwards, mainly because of 'political contagion'.

The slowdown and Greece's fiscal slippage have brought the likely timing for EMU sovereign debt restructuring much closer

First, with weaker growth prospects, the scenario under which banks could build up enough capital to withstand write-downs on periphery exposure has become rather far-fetched. Indeed, the adverse feedbacks from fiscal tightening and worries over banking sector health to lower economic growth, and from lower economic growth to worse fiscal deficits and more worries over the banks, have also become more evident. A strategy of 'buying time' is likely to cause the fiscal problems within the Euro Area to become deeper and broader. Second, Greece has become so clearly non-compliant with the conditionality of its programme that it is becoming increasingly likely that this will be reflected in the results of the quarterly reviews of Greece's performance under the Troika programme. A positive assessment is needed for disbursement of the next installment of the Greek financial support package and for the approval of the second Greek bailout package. Third, opposition in creditor countries to extra bail-outs for the EMU periphery is soaring, and further delay risks simply shifting more of the losses from sovereign debt restructuring to official creditors, including the ECB.

We believe that early and large restructuring is likely…

The scale and timing of Greek sovereign debt restructuring inevitably are uncertain. But, in our view, restructuring is likely to be big, at last 50% in NPV terms. Two plausible targets for post-restructuring debt-to-GDP ratios are either 60% of GDP (the Stability and Growth Pact reference value) or 80% (which is close to the current Euro Area average ex Greece). Assuming uniform haircuts on all creditors bar the IMF, these assumptions would imply haircuts of 67% and 54%, respectively. If we exempt bills, haircuts would rise to 70% and 57%, respectively. Exempting both bills and foreign-issued debt (which we assume currently account for about 10% of the total) would bring the haircut to 79% and 64%, respectively, assuming that the ECB only purchased debt issued under Greek law. With a 50% haircut to coupon payments, Greece would continue to have a budget deficit of about 7% of GDP and still need sizeable funding from the Troika for the sovereign and ECB liquidity assistance for the banks. A failure to agree such continued funding would probably force Greece to exit EMU, and we regard it as unlikely (but not impossible) for that reason.

[3] See *"The Debt of Nations"*, *Global Economics View*, 7 January 2011, Citi

[4] See recent issues of *"Global Economic Outlook and Strategy"*, Willem Buiter et all, Citi.

[5] See *"Debt Restructuring Better Early Than Late"*, Euro Weekly, Juergen Michels et al, 23 September 2011.

…occurring before end-2012 and probably much sooner

The most likely date for restructuring is after the ratification of the EFSF enlargement is complete, which probably will be in late October or early November. At that stage, the existing official facilities could handle the direct implications of an orderly deep sovereign debt restructuring of Greece, Ireland and Portugal, a recapitalisation of the banks of these three countries, and of the banks in the core EA exposed to the outer periphery.

Ireland and Portugal probably also will seek debt relief in order to reduce the need for painful austerity measures

We expect Ireland and Portugal to follow Greece into sovereign debt restructuring soon afterwards, mainly because of 'political contagion'. A Greek default would further raise the market assessment of the likelihood of default by these sovereigns, and undermine the political commitment to austerity in Ireland and Portugal. If Greece gets a deal that offers debt relief and further funding in return for efforts of questionable determination to tighten their belts, then Irish and Portuguese voters and politicians are likely to demand the same lenient treatment, especially given that they have so far stuck to the conditions of their programmes.

Early debt restructuring is likely to affect rest of the Euro Area, and Italy and Spain in particular

Early restructuring is likely to be far more disruptive to economies and financial markets, and we expect the Euro Area to fall into a fresh recession in coming quarters. Nevertheless, there is a huge range of uncertainty, and it is unclear how much contagion will spread to other Euro Area countries, notably Italy and Spain. This is likely to depend on a range of factors. In particular, we assume that (1) Greece will not leave EMU, and nor will any other country; (2) there will be a large backstop facility, via the EFSF and/or ECB, for Euro Area countries other than Greece, Ireland and Portugal, notably Italy and Spain; (3) there will be more widespread recapitalization of European banks. But these are not certain, and adverse outcomes could yet produce a marked intensification of financial market strains and a much bleaker outlook for the EMU economies.

Sluggish growth and negative real interest rates

We expect that real GDP in the Euro Area and UK in 2015 will only be a few percent above the 2007 level…

We do not expect that strains in Euro Area sovereign debt will quickly fade even after 2012. As a result, we expect that near-term recession in the Euro Area will be followed by a modest recovery in later years. In all, our forecasts imply that real GDP in the Euro Area in 2015 will only be 2-3% above the 2007 level. For the UK, we expect the economy will be close to recession near term with only sluggish growth thereafter, leaving GDP in 2015 only 3-4% above the 2007 level.

…and this performance is as bad as anything seen in Japan over recent years

For both the UK and Euro Area, these forecast paths for real GDP growth over 2007-15 are worse than Japan's experience for 1992-00, the first eight years of Japan's 'lost' period, which actually saw Japan's real GDP rise by 5.9%[6]. The UK and Euro Area outlooks from 2007 to 2015 are broadly comparable to the worst 8-year period in Japan's recent history, 2001-09, in which real GDP rose by a cumulative 3.0%. For both the UK and Euro Area, we expect these to be the weakest periods for many decades. For the weaker Euro Area economies (eg Ireland, Greece, Portugal, Italy and Spain), we think the cumulative path for real GDP over this period will be considerably worse than any period in Japan's recent history. By contrast, we still expect that the US recovery will over time be clearly better than Japan's 'lost' decade path.

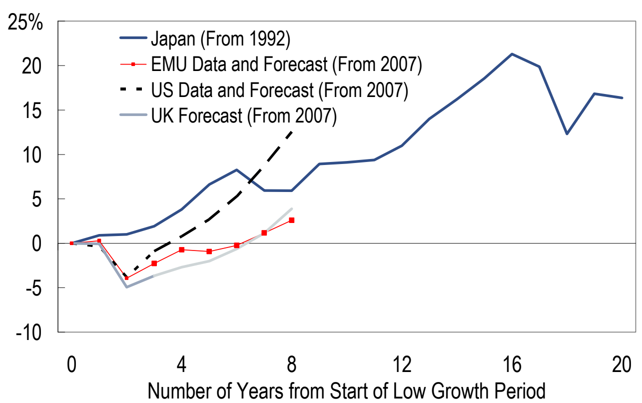
We expect a long period of low or negative real interest rates in the US and Europe

With this backdrop of sluggish growth for the US, Japan and UK, and outright recession in the Euro Area, we expect a long period of low nominal interest rates – and negative real interest rates – for the main advanced economies. Any prospect of rising interest rates in the main advanced economies appears years away. The ECB is likely to cut its key policy rate back to 1.0% in the next few months and, with continued provision of ample liquidity, overnight rates probably will fall well below

[6] From 1997, just before recession, real GDP rose 7.9% in the eight years to 2005.

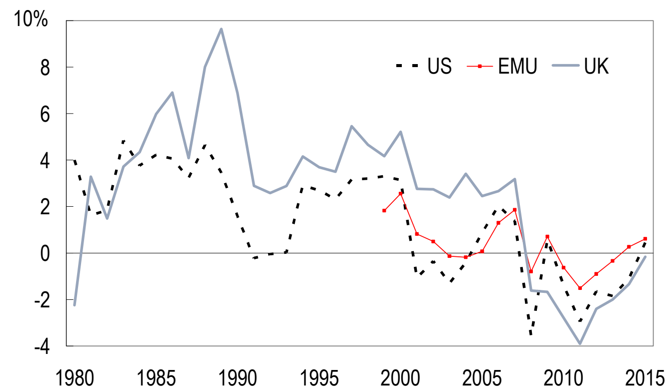
1.0%. For Federal Reserve policy, our base case does not anticipate that economic and financial developments will press officials to enhance accommodation efforts further before the scheduled end of the current maturity extension (Operation Twist) campaign next June. If downside risks become more threatening, policymakers might turn first toward still stronger accommodation language guiding rate expectations. Beyond that, the Committee could be forced to consider more creative options of targeting nominal GDP or inflation. However, unless deflation scenarios become a clear danger, renewed expansion of the balance sheet will likely remain off the table. The UK MPC is likely to be more aggressive, and we expect them to implement extra QE on a large scale in coming months, with perhaps to a further £300bn or so (about 20% of GDP) over the next few quarters unless growth prospects improve markedly.

Figure 9. US, Euro Area, UK and Japan — Cumulative Change in Real GDP In Low-Growth Periods, 1991-2015F



Sources: Datastream and Citi Investment Research and Analysis

Figure 10. US, EMU and UK — Real Short-Term Interest Rates (Versus CPI Inflation), 1980-2015F



F Citi Forecast. Note: for the UK, we use the consumer spending deflator before 1988.
Sources: Datastream and Citi Investment Research and Analysis

Figure 11. Global — Summary of Views of Citi's Market Strategists

	Equities	G10 Rates	Credit	Securitized Products	FX	Commodities	Global Macro Strategy
Overall View	Markets cheap, but need a catalyst	Slowing growth and falling confidence means lower yields and flatter curves	Positioning has improved but market likely to widen further on negative headlines	Market weight	Bullish USD and JPY	More bearish short-term from weaker growth and risk herding. Dispersion across energy/ags. Continued interest in precious metals	Cautious risk assets, bullish core FI
Most-Favoured Region/Sector	EM, Japan/ IT, Materials, Industrials	EUR 5yr and GBP long end	Low-beta core non-fins & senior SIFI	US CMBS senior tranches	USD	Gold, Precious Metals, Grains	Core FI
Least-Favoured Region/Sector	UK/Telecoms, Health Care, Cons. Staples	EMU non AAA	French corporates & periphery sub-debt	Spanish & Irish RMBS	EUR, CEEMEA	Crude Oil, Gasoline	Europe, Financials, Commodities and other Cyclicals
Key Risks	Major global recession	EMU resolution would trigger dramatic reversal	Policy disappointment; recession; wider sovereign spreads	Regulation	Early QE3 in US	Policy stimulus, economic recovery, geopolitical risk/Downside: double-dip, eurozone contagion	EMU periphery, global growth, QE3 in US

Source: Citi Investment Research and Analysis

Figure 12. 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**	**3.0**	**2.9**	**3.4**	**3.8**	**3.9**	**2.7**	**4.0**	**3.2**	**3.2**	**3.1**	**3.1**	**2.07**	**2.60**	**2.78**	**2.84**	**3.29**	**3.72**
Based on PPP weights	*5.0*	*3.8*	*3.6*	*4.1*	*4.5*	*4.5*	*3.4*	*4.7*	*3.8*	*3.8*	*3.6*	*3.5*						
Industrial Countries	**2.6**	**1.4**	**1.3**	**1.7**	**2.3**	**2.4**	**1.4**	**2.6**	**1.7**	**1.7**	**1.8**	**1.8**	**0.65**	**0.76**	**0.73**	**0.80**	**1.36**	**2.14**
United States	**3.0**	**1.7**	**1.9**	**2.5**	**3.3**	**3.5**	**1.6**	**3.2**	**1.9**	**2.1**	**2.2**	**2.2**	**0.25**	**0.25**	**0.25**	**0.25**	**1.10**	**2.65**
Japan	**4.0**	**-0.4**	**2.1**	**0.9**	**1.5**	**1.5**	**-0.7**	**0.0**	**-0.3**	**-0.1**	**0.1**	**0.3**	**0.10**	**0.10**	**0.10**	**0.10**	**0.13**	**0.48**
Euro Area	**1.7**	**1.6**	**-0.2**	**0.6**	**1.2**	**1.2**	**1.6**	**2.7**	**1.9**	**1.8**	**1.9**	**1.9**	**1.00**	**1.19**	**1.00**	**1.06**	**1.57**	**1.81**
Canada	3.2	2.1	1.8	2.3	2.5	2.8	1.8	2.8	2.0	2.0	2.0	2.0	0.69	1.00	1.00	1.63	2.19	2.50
Australia	2.7	1.4	3.7	4.1	4.3	3.8	2.8	3.3	2.5	3.3	2.9	2.6	4.44	4.75	4.88	5.19	5.19	5.00
New Zealand	1.7	1.4	2.6	2.9	3.2	3.1	2.3	4.2	2.1	2.3	2.6	2.9	2.81	2.50	3.25	4.25	5.50	5.50
Germany	3.6	3.0	1.0	1.3	1.7	1.8	1.1	2.3	2.0	2.2	2.1	2.3						
France	1.4	1.6	0.2	1.2	1.7	1.5	1.7	2.2	1.8	2.3	1.5	1.5						
Italy	1.2	0.5	-1.0	0.0	0.8	0.9	1.6	3.0	2.7	1.9	1.9	1.9						
Spain	-0.1	0.6	-0.7	0.0	0.8	0.9	2.0	2.9	0.7	1.5	1.7	1.7						
Greece	-4.4	-5.6	-4.9	-2.0	-1.0	-0.5	4.7	3.2	1.2	1.3	1.4	1.5						
Portugal	1.3	-2.0	-5.7	-3.8	-0.4	1.2	1.4	3.4	0.7	0.5	1.0	0.8						
Netherlands	1.6	1.3	0.4	1.0	1.7	1.8	1.3	2.3	1.8	1.9	1.8	2.0						
Denmark	1.8	1.5	1.6	1.7	1.8	1.7	2.3	2.7	2.0	1.9	2.1	2.0	1.05	1.24	1.05	1.13	1.68	1.99
Norway	2.1	2.7	2.9	3.0	2.7	2.7	2.4	1.4	1.8	2.2	2.3	2.4	1.91	2.18	2.30	2.82	3.53	4.25
Sweden	5.4	4.3	2.1	2.6	2.7	2.6	1.2	3.0	2.0	2.2	2.3	2.1	0.50	1.76	2.00	2.30	3.25	4.00
Switzerland	2.7	2.1	1.2	1.2	1.2	1.2	0.7	0.3	-0.2	-0.6	-0.2	0.1	0.22	0.44	0.00	0.00	0.00	0.00
United Kingdom	1.4	1.0	0.7	1.4	1.8	2.7	3.3	4.4	2.9	2.5	2.4	2.2	0.50	0.50	0.50	0.50	1.06	2.04
Emerging Markets	**7.3**	**6.1**	**5.6**	**6.0**	**6.1**	**6.1**	**5.3**	**6.5**	**5.7**	**5.5**	**5.0**	**4.9**	**5.02**	**5.92**	**6.16**	**6.04**	**6.17**	**5.96**
China	**10.4**	**9.0**	**8.7**	**8.5**	**8.3**	**8.1**	**3.3**	**5.3**	**4.2**	**4.0**	**4.0**	**4.0**	**2.31**	**3.22**	**3.50**	**3.75**	**4.00**	**4.00**
Hong Kong	7.0	5.6	4.5	4.0	4.0	4.0	2.4	5.3	4.0	3.0	3.5	3.5	0.25	0.28	0.44	0.80	1.30	2.50
India	8.5	7.6	8.2	8.8	8.8	8.9	8.6	9.5	7.5	7.0	6.0	6.0	5.96	8.19	8.50	7.50	7.50	7.50
Indonesia	6.1	6.5	6.3	6.5	6.7	7.0	5.1	5.0	6.2	6.5	6.5	6.5	6.50	6.69	6.50	6.50	6.75	7.00
Korea	6.2	3.7	3.9	4.1	4.5	4.0	3.0	4.5	3.5	3.2	3.1	3.0	2.68	3.53	3.58	3.90	4.50	5.00
Singapore	14.5	5.3	3.3	5.0	5.0	5.0	2.8	5.1	3.0	2.5	2.5	2.5	0.56	0.42	0.40	2.30	2.80	3.20
Czech Republic	2.3	1.9	0.6	2.4	3.3	3.8	1.5	1.8	2.5	2.2	2.3	2.0	0.83	0.75	0.75	1.23	2.29	3.25
Hungary	1.2	1.4	1.1	2.0	2.5	2.9	4.7	3.9	4.8	3.1	3.0	3.1	5.48	6.00	6.00	6.00	5.69	5.50
Poland	3.8	3.8	1.9	3.4	3.5	3.4	2.7	4.2	3.0	2.6	2.5	2.5	3.50	4.25	4.15	4.00	4.65	5.00
Romania	-1.3	1.6	2.0	4.3	4.5	4.6	6.1	6.2	3.7	3.0	3.0	3.0	6.54	6.25	5.13	5.00	5.00	5.00
Russia	4.0	4.0	2.5	4.2	4.0	4.0	6.9	8.8	7.2	6.5	5.5	5.5	7.75	8.25	7.50	6.00	6.00	5.50
Turkey	9.0	7.3	2.5	4.9	4.4	4.5	8.6	6.0	7.5	6.7	6.2	5.7	6.50	5.75	6.75	8.00	8.00	7.50
Nigeria	7.2	7.1	6.7	6.5	6.9	7.2	13.7	10.9	13.0	10.5	10.3	9.5	6.08	8.23	10.00	10.00	10.50	10.00
South Africa	2.8	3.0	2.8	3.9	4.4	4.3	4.1	5.0	5.8	5.8	5.6	5.5	6.41	5.50	5.83	7.25	8.50	8.75
Argentina	9.2	8.5	5.0	3.5	3.5	3.5	18.4	25.0	22.5	27.5	22.5	15.0	10.19	12.18	19.12	13.39	11.00	9.00
Brazil	7.5	3.7	4.0	4.5	4.5	4.5	5.0	6.6	5.7	4.5	4.0	4.0	9.80	10.88	10.75	10.75	10.25	9.00
Mexico	5.4	4.1	3.5	3.4	3.7	3.4	4.2	3.4	3.8	3.8	3.9	3.8	4.40	4.50	4.50	5.38	7.00	7.00
Venezuela	-1.4	3.5	3.9	2.3	2.5	2.4	28.2	27.0	26.3	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 13. 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	**0.2**	**0.0**	**-0.1**	**0.0**	**0.0**	**-0.1**	**-5.7**	**-5.0**	**-3.9**	**-3.2**	**-2.8**	**-2.5**	**65**	**66**	**66**	**66**	**65**	**64**
Based on PPP weights	*0.6*	*0.2*	*1.9*	*2.1*	*2.1*	*2.1*	*-5.2*	*-4.7*	*-3.8*	*-3.3*	*-2.9*	*-2.6*						
Industrial Countries	**-0.8**	**-1.0**	**-0.9**	**-0.8**	**-0.8**	**-0.8**	**-7.2**	**-6.5**	**-4.8**	**-3.9**	**-3.2**	**-2.7**	**89**	**94**	**96**	**98**	**97**	**97**
United States	**-3.2**	**-3.1**	**-2.8**	**-2.7**	**-2.9**	**-3.2**	**-9.0**	**-8.5**	**-6.2**	**-5.0**	**-4.0**	**-3.5**	**63**	**68**	**72**	**75**	**76**	**77**
Japan	**3.6**	**2.1**	**2.1**	**2.5**	**2.8**	**2.8**	**-9.8**	**-10.3**	**-9.0**	**-8.5**	**-8.2**	**-7.7**	**225**	**238**	**240**	**245**	**249**	**253**
Euro Area	**-0.5**	**-0.7**	**-1.1**	**-1.1**	**-1.1**	**-1.0**	**-6.0**	**-4.3**	**-3.5**	**-2.4**	**-2.0**	**-1.6**	**85**	**89**	**91**	**91**	**90**	**89**
Canada	-3.1	-3.3	-3.5	-2.5	-2.4	-1.9	-2.2	-1.9	-1.1	-0.5	0.0	0.2	34	34	34	33	32	30
Australia	-2.7	-2.3	-2.0	-4.7	-5.4	-5.5	-4.2	-3.6	-1.8	0.2	0.2	0.3	4	6	6	7	6	6
New Zealand	-4.1	-3.9	-5.3	-6.3	-7.7	-8.4	-4.0	-8.0	-6.0	-3.0	-0.5	0.0	14	21	27	30	32	32
Germany	5.7	4.9	3.8	3.8	4.1	4.2	-3.3	-1.7	-1.5	-0.9	-0.5	-0.3	83	84	85	89	87	85
France	-1.7	-2.7	-2.3	-1.5	-0.7	0.0	-7.1	-5.6	-4.7	-4.0	-3.0	-2.0	82	85	93	96	96	95
Italy	-3.5	-3.8	-3.3	-3.0	-2.9	-2.8	-4.6	-4.0	-2.8	-1.5	-1.2	-0.7	119	121	123	123	121	120
Spain	-4.6	-3.8	-3.0	-2.7	-2.4	-2.2	-9.2	-6.8	-6.2	-5.8	-5.6	-5.6	60	68	76	83	89	93
Greece	-10.4	-9.2	-4.5	-2.9	-2.9	-1.9	-10.5	-10.4	-6.8	-2.3	0.6	1.5	143	165	91	92	90	88
Portugal	-10.5	-8.7	-6.3	-3.4	-2.0	-1.9	-9.1	-6.0	-4.7	-2.5	-2.7	-2.3	93	108	87	94	99	102
Netherlands	7.2	8.0	7.1	7.0	6.9	7.0	-5.4	-3.0	-2.4	-2.0	-1.2	0.0	63	65	68	69	69	66
Denmark	5.3	5.6	5.0	4.3	3.5	3.1	-2.8	-3.8	-4.6	-3.9	-2.6	-2.1	44	46	49	51	52	52
Norway	12.4	14.0	14.3	14.9	15.2	15.8	10.6	12.0	12.5	13.5	15.0	19.0	NA	NA	NA	NA	NA	NA
Sweden	6.6	6.4	6.5	6.6	6.7	6.9	-0.2	0.2	0.4	1.1	2.0	3.1	39	36	34	31	28	27
Switzerland	14.5	14.7	13.0	13.2	14.3	15.4	0.2	0.3	0.6	0.6	0.9	0.9	55	53	51	50	48	47
United Kingdom	-3.2	-2.2	-0.6	0.5	1.2	1.7	-9.7	-8.3	-7.4	-6.5	-5.5	-4.6	76	82	87	90	93	94
Emerging Markets	**2.5**	**1.8**	**1.3**	**1.2**	**1.1**	**0.9**	**-2.6**	**-2.3**	**-2.4**	**-2.3**	**-2.2**	**-2.1**	**16**	**16**	**16**	**17**	**17**	**16**
China	**5.2**	**4.0**	**3.2**	**2.8**	**2.5**	**2.0**	**-1.6**	**-2.0**	**-2.0**	**-2.0**	**-2.0**	**-2.0**	**21**	**20**	**21**	**21**	**21**	**21**
Hong Kong	6.2	8.3	9.3	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	-2.6	-3.0	-2.3	-1.5	-0.8	-0.4	-8.1	-8.3	-7.1	-7.0	-6.0	-6.0	68	66	64	62	60	58
Indonesia	0.9	0.1	-0.3	-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	1.4	1.1	0.8	0.5	-0.5	1.4	0.5	0.7	1.2	1.5	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	-3.8	-3.5	-4.1	-4.7	-5.7	-4.7	-4.5	-4.0	-3.4	-2.3	-1.5	39	41	44	45	45	44
Hungary	2.1	3.0	4.3	-0.8	-2.0	-2.6	-4.2	1.9	-3.0	-3.0	-2.9	-2.9	80	74	73	71	69	67
Poland	-3.4	-4.4	-3.4	-4.0	-5.0	-5.4	-7.9	-5.3	-4.5	-3.2	-2.3	-2.2	53	53	53	52	50	50
Romania	-4.2	-4.2	-5.0	-5.5	-5.5	-5.0	-6.7	-4.5	-3.0	-2.5	-2.0	-1.5	35	37	37	36	34	32
Russia	4.8	4.8	1.9	1.4	-1.3	-1.8	-4.0	-1.4	-3.1	-2.7	-2.3	-1.9	8	9	11	12	13	13
Turkey	-6.5	-9.6	-8.4	-7.4	-6.6	-5.8	-3.6	-1.9	-2.7	-3.0	-3.0	-3.0	43	40	38	36	36	36
Nigeria	6.1	8.8	6.4	5.9	4.6	3.7	-4.9	-2.3	-2.4	-1.8	-2.3	-2.8	NA	NA	NA	NA	NA	NA
South Africa	-2.7	-3.3	-4.7	-6.2	-6.6	-6.4	-5.2	-5.6	-5.6	-5.2	-4.7	-4.3	34	38	43	40	37	35
Argentina	1.0	-0.1	0.9	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	-2.4	-2.4	63	63	63	70	70	71
Mexico	-0.5	-1.1	-2.6	-2.6	-2.7	-2.7	-2.8	-2.5	-2.0	-1.9	-1.9	-1.9	43	42	42	42	42	42
Venezuela	3.7	11.6	11.0	5.0	4.9	4.7	-6.6	-5.0	-5.0	-5.5	-5.9	-5.8	38	40	33	39	41	40

Note: US debt and deficit figures are for the Federal government only. All other countries are general government debt and deficits. We assume sovereign debt restructuring in Greece, Ireland and Portugal in 2014.
Source: Citi Investment Research and Analysis

Figure 14. Selected Countries — Changes in Economic Forecast from the Previous Month (Percentage Points), 2011-2013F

	GDP Growth			CPI Inflation			Current Balance (Pct of GDP)			Fiscal Balance (Pct of GDP)		
	2011	2012	2013	2011	2012	2013	2011	2012	2013	2011	2012	2013
Global	**-0.1**	**-0.3**	**-0.2**	**0.1**				**-0.1**			**0.1**	
Based on PPP weights		-0.4	-0.2	0.1		0.1		-0.1	0.1		0.1	-0.1
Industrial Countries		**-0.4**	**-0.3**	**0.1**	**0.1**	**-0.1**	**-0.1**	**-0.2**			**0.2**	
United States	**0.1**	**-0.2**	**-0.2**	**0.2**	**0.3**	**-0.1**	**-0.1**	**-0.1**	**0.3**		**0.6**	
Japan	**-0.2**	**-0.3**	**-0.6**		**-0.2**		**-0.2**	**-0.5**	**-0.5**		**-0.2**	
Euro Area	**-0.1**	**-0.8**	**-0.5**	**0.1**	**-0.1**	**-0.1**		**-0.4**	**-0.4**	**-0.2**	**-0.4**	**-0.2**
Canada	-0.3	-0.4	0.1				0.3	0.9	-0.1			
Australia		-0.3	-0.3	0.2	-0.2	0.2	-0.5	0.8	1.6		-0.3	
New Zealand	-1.0	-0.8	0.4	-0.1	-0.8	-0.2	-3.2	0.2	-1.3	0.4	-1.3	-1.2
Germany		-0.9	-0.7			0.1	-0.3	-1.0	-0.7	0.2	-0.5	-0.6
France		-0.7	-0.1	0.1		-1.1			-0.1	0.4	-0.2	-0.7
Italy	-0.1	-0.7	-0.2	0.2	0.2		0.5	1.1	1.5	0.1	-0.3	-0.2
Spain		-0.4	-0.4	-0.1	-0.3		-0.4	-1.4	-1.5			0.1
Greece	-1.3	-1.9		-0.1	-0.6		-1.7	-0.5	-0.8	-0.6	0.7	3.5
Portugal	-0.1	-1.9	-1.1	-0.1	-0.1	-0.2	-0.4	-0.6	-0.3	0.3		1.4
Netherlands	-0.2	-0.7	-0.5					0.1	0.1	-0.1		
Denmark	-0.1	-0.3	-0.3		-0.1	-0.2	0.5	0.7	1.0	-0.8		-0.1
Norway	-0.2	-0.3		-0.2		0.1	1.0	-0.2	-0.1			
Sweden	-0.4	-0.7	-0.2		-0.3	-0.2		-0.1		-0.3	-0.8	-1.5
Switzerland	-0.1	-0.2	-0.1	-0.2	-0.8	-0.9	1.1	2.9	3.3			
United Kingdom	-0.1	-0.6	-0.2		-0.3	-0.2	-0.2	-0.3	-0.2	-0.1	-0.5	-0.7
Emerging Markets	**0.1**	**-0.2**	**-0.1**	**0.1**			**0.1**	**0.1**			**-0.2**	**-0.2**
China		-0.3	-0.3					-0.3	-0.2			
Hong Kong		-0.5		0.1	0.7							
India				0.5		1.0	-0.2	-0.1	0.3			
Indonesia												
Korea				0.2	0.3	0.2	-0.2	-0.1	-0.1	-0.3	-0.2	-0.2
Singapore	-0.4	-0.7	0.3	0.2	0.2							
Czech Republic	-0.2	-0.9	-0.8		0.2	0.1	0.3		-0.7		-0.1	
Hungary	-0.4	-0.5	-0.9	0.1	1.5		1.4	4.0		-0.1	0.8	0.7
Poland		-1.0	-0.1		0.2		0.4	1.0	0.2	0.4	-0.4	-0.4
Romania		-1.0	-0.2	-0.1			0.1					
Russia		-1.0	0.1				0.3	1.0	1.0		-0.4	
Turkey	1.0	-1.4	-0.3	0.2	0.4		0.3	0.7	0.8			
Nigeria	0.3			0.9	1.2			-1.7	-0.1	0.1	-0.4	0.1
South Africa	-0.4	-0.7		0.2	0.3		0.5	0.5		-0.2	-0.5	-0.8
Argentina	0.7	1.0										
Brazil					0.2		0.1					
Mexico					0.2			-0.2				
Venezuela				0.2	-0.2		0.6	0.4				

Source: Citi Investment Research and Analysis

Figure 15. 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**	**2.75**	**2.35**	**3.45**	**4.00**	**4.00**	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**	**1.32**	**1.38**	**1.26**	**1.29**	**1.32**	**1.34**
Japan	**1.18**	**1.17**	**1.10**	**1.50**	**1.75**	**1.75**	**87**	**79**	**76**	**78**	**81**	**83**	**114**	**108**	**96**	**101**	**106**	**111**
Euro Area	**2.78**	**2.50**	**1.40**	**1.80**	**2.20**	**2.70**	**1.32**	**1.38**	**1.26**	**1.29**	**1.32**	**1.34**	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**
Canada	3.24	2.85	2.76	3.85	4.00	3.90	1.03	1.01	1.01	0.96	0.96	0.97	1.35	1.38	1.28	1.24	1.26	1.30
Australia	5.55	4.80	4.76	5.50	6.00	6.30	0.94	1.01	1.00	0.96	0.92	0.89	1.41	1.36	1.27	1.35	1.43	1.50
New Zealand	5.87	4.96	4.96	5.70	6.40	6.80	0.73	0.78	0.80	0.67	0.63	0.62	1.81	1.76	1.58	1.94	2.10	2.15
Germany	2.78	2.50	1.40	1.80	2.20	2.70												
France	3.12	3.20	2.30	2.50	2.80	3.20												
Italy	4.00	5.30	6.20	4.80	4.50	4.20												
Spain	4.30	5.40	6.20	5.00	4.70	4.40												
Greece	9.20	19.00	18.90	16.80	12.20	7.70												
Portugal	5.40	11.20	16.90	16.80	12.20	7.70												
Netherlands	3.00	2.90	1.90	2.10	2.50	3.00												
Denmark	2.95	2.60	1.56	1.99	2.43	2.95												
Norway	3.41	2.83	1.91	2.40	2.90	3.35	6.02	5.71	6.16	5.96	5.84	5.75	7.95	7.86	7.78	7.71	7.70	7.69
Sweden	2.89	2.51	1.54	2.05	2.50	3.05	7.09	6.68	7.18	6.84	6.68	6.58	9.36	9.19	9.07	8.84	8.80	8.80
Switzerland	1.57	1.28	0.67	0.60	1.00	1.50	1.01	0.90	0.96	1.02	1.03	1.03	1.33	1.24	1.21	1.32	1.36	1.37
United Kingdom	3.58	1.78	1.75	2.05	2.60	2.90	1.54	1.57	1.52	1.62	1.67	1.70	0.86	0.88	0.83	0.80	0.79	0.79
Emerging Markets																		
China	**2.96**	**3.65**	**3.80**	**4.05**	**4.30**	**4.30**	**6.77**	**6.42**	**6.15**	**5.90**	**5.80**	**5.60**	**9.15**	**8.82**	**7.77**	**7.63**	**7.64**	**7.49**
Hong Kong	1.54	1.20	1.20	2.15	2.75	2.75	7.77	7.78	7.77	7.75	7.75	7.75	10.50	10.70	9.81	10.02	10.21	10.37
India	8.00	8.25	8.25	8.25	8.25	8.25	45.58	47.00	47.50	46.13	45.13	44.13	61.62	64.64	60.00	59.62	59.47	59.03
Indonesia	8.49	7.71	7.69	7.25	7.25	7.25	9092	8922	8975	8675	8650	8625	12291	12272	11337	11213	11399	11539
Korea	4.08	3.87	3.82	5.20	5.45	5.60	1156	1134	1148	1053	1010	980	1563	1559	1449	1361	1331	1311
Singapore	2.41	2.05	2.05	2.80	3.20	3.60	1.36	1.27	1.24	1.19	1.17	1.16	1.84	1.75	1.57	1.54	1.54	1.55
Czech Republic	3.71	3.65	3.67	4.17	4.40	4.40	19.1	18.0	19.7	18.5	1.7	17.0	25.8	24.7	24.8	23.9	23.3	22.7
Hungary	7.97	7.32	7.74	7.61	7.10	6.09	208	211	260	236	223	215	281	290	329	305	294	287
Poland	5.35	5.63	5.58	5.45	5.55	5.34	3.02	3.10	3.45	3.07	2.87	2.73	4.08	4.27	4.35	3.96	3.78	3.65
Romania	NA	NA	NA	NA	NA	NA	3.18	3.06	3.21	3.07	2.94	2.83	4.30	4.21	4.06	3.96	3.87	3.79
Russia	7.27	7.99	7.57	7.59	7.60	7.60	30.4	30.3	33.7	31.8	30.9	30.5	41.1	41.7	42.5	41.1	40.8	40.9
Turkey	NA	NA	NA	NA	NA	NA	1.50	1.72	1.87	1.80	1.74	1.68	2.03	2.36	2.36	2.33	2.29	2.24
Nigeria	NA	NA	NA	NA	NA	NA	151	154	153	150	148	150	204	212	193	194	195	201
South Africa	8.38	8.28	8.33	9.50	9.25	9.20	7.32	7.45	8.40	8.73	9.11	9.51	9.90	10.25	10.61	11.29	12.00	12.72
Argentina	NA	NA	NA	NA	NA	NA	3.90	4.16	5.31	6.08	7.19	8.14	5.27	5.72	6.71	7.86	9.47	10.90
Brazil	12.05	11.97	11.59	10.98	9.74	8.75	1.76	1.72	1.80	1.72	1.73	1.76	2.38	2.36	2.27	2.22	2.28	2.36
Mexico	6.93	6.89	7.25	7.50	8.10	8.00	12.6	12.6	13.0	12.4	12.4	12.7	17.1	17.4	16.4	16.0	16.4	17.0
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	3.50	5.91	5.43	6.20	6.33	7.09

*Per USD except Euro Area, Australia, New Zealand, United Kingdom. Note: All foreign exchange forecasts are consistent with the rolling forecasts presented in Figure 84. Source: Citi Investment Research and Analysis

Figure 16. Short Rates (End of Period), as of 28 Sep 2011 (Percent)

	Current	4Q 11	1Q 12	2Q 12	3Q 12	4Q 12
United States	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**
Japan	**0.10**	**0.10**	**0.10**	**0.10**	**0.10**	**0.10**
Euro Area	**1.50**	**1.00**	**1.00**	**1.00**	**1.00**	**1.00**
Canada	1.00	1.00	1.00	1.00	1.00	1.00
Australia	4.75	4.75	4.75	4.75	5.00	5.00
New Zealand	2.50	2.50	2.75	3.00	3.50	3.75
Denmark	1.55	1.30	1.05	1.05	1.05	1.05
Norway	2.25	2.25	2.25	2.25	2.25	2.50
Sweden	2.00	2.00	2.00	2.00	2.00	2.00
Switzerland	0.0	0.00	0.00	0.00	0.00	0.00
United Kingdom	0.50	0.50	0.50	0.50	0.50	0.50
China	**3.50**	**3.50**	**3.50**	**3.50**	**3.50**	**3.50**

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 17. 10-Year Yield Forecasts (Period Average), as of 28 Sep 2011 (Percent)

	Current	4Q 11	1Q 12	2Q 12	3Q 12	4Q 12
United States	**1.98**	**2.00**	**2.00**	**2.20**	**2.50**	**2.75**
Japan	**1.01**	**1.20**	**1.20**	**1.10**	**1.05**	**1.05**
Euro Area (Germany)	**1.93**	**1.50**	**1.25**	**1.35**	**1.50**	**1.50**
Canada	2.19	2.40	2.40	2.60	2.90	3.15
Australia	4.31	4.30	4.45	4.60	4.90	5.10
New Zealand	4.35	4.60	4.75	4.90	5.00	5.20
Denmark	2.13	1.70	1.45	1.50	1.65	1.65
Norway	2.42	1.85	1.65	1.80	2.05	2.15
Sweden	1.84	1.50	1.35	1.45	1.65	1.70
Switzerland	0.90	0.73	0.53	0.66	0.68	0.68
United Kingdom	2.34	2.00	1.65	1.65	1.80	1.80

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 18. 10-Year Yield Spreads (Period Average), as of 28 Sep 2011

	Spread vs. US$						Spread vs. Germany					
	Current	4Q 11	1Q 12	2Q 12	3Q 12	4Q 12	Current	4Q 11	1Q 12	2Q 12	3Q 12	4Q 12
United States	NA	NA	NA	NA	NA	NA	6	51	76	86	102	127
Japan	-98	-81	-81	-111	-147	-172	-92	-30	-5	-25	-45	-45
Euro Area	-6	-51	-76	-86	-102	-127	NA	NA	NA	NA	NA	NA
Canada	21	40	40	40	41	41	27	91	116	127	142	167
Australia	237	234	249	244	244	240	243	285	325	330	346	367
New Zealand	241	264	280	275	255	250	247	315	356	361	356	377
France	69	34	24	14	-12	-47	74	85	100	100	90	80
Italy	366	399	424	394	378	323	371	450	500	480	480	450
Spain	309	329	404	394	378	353	314	380	480	480	480	480
Netherlands	36	-6	-31	-46	-67	-97	41	45	45	40	35	30
Belgium	180	149	144	124	98	63	185	200	220	210	200	190
Denmark	14	-31	-56	-71	-87	-112	20	20	20	15	15	15
Norway	43	-16	-36	-41	-47	-62	49	35	40	45	55	65
Sweden	-15	-51	-66	-76	-87	-107	-9	0	10	10	15	20
Switzerland	-114	-128	-148	-155	-184	-209	-108	-77	-72	-69	-82	-82
United Kingdom	30	-1	-36	-56	-72	-97	36	50	40	30	30	30

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 19. Emerging Market Countries — Short Rates Actual and Forecast of Additional Rate Moves (End of Period), as of 28 Sep 2011

Country	Current Rate (%)	by Dec 11	Mar 12	Jun 12	Sep 12	Dec 12	Total Cumulative Rate Moves Expected
South Africa	5.50	0	0	0	50	50	100
Turkey	5.75	0	75	25	0	0	100
Colombia	4.50	0	50	0	0	25	75
China	3.50	0	0	0	0	0	0
Czech	0.75	0	0	0	0	0	0
Hungary	6.00	0	0	0	0	0	0
Korea	3.25	0	0	0	0	0	0
Mexico	4.50	0	0	0	0	0	0
Philippines	4.50	0	0	0	0	0	0
Thailand	3.50	0	0	0	0	0	0
Indonesia	6.75	-25	0	0	0	0	-25
Israel	3.00	-25	0	0	0	0	-25
India	8.25	0	0	-25	-25	0	-50
Poland	4.50	0	0	-50	0	0	-50
Russia	8.25	0	-25	0	0	-50	-75
Chile	5.25	0	-75	-25	0	0	-100
Brazil	12.00	-100	-50	0	0	0	-150

Source: Citi Investment Research and Analysis

Figure 20. Foreign Exchange Forecasts (End of Period), as of 28 Sep 2011

	vs. USD						vs. EUR					
	Current	Dec 11	Mar 12	Jun 12	Sep 12	Dec 12	Current	Dec 11	Mar 12	Jun 12	Sep 12	Dec 12
United States	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**	**1.35**	**1.29**	**1.28**	**1.26**	**1.25**	**1.26**
Japan	**76**	**75**	**75**	**76**	**76**	**77**	**103**	**97**	**96**	**96**	**95**	**97**
Euro Area	**1.35**	**1.29**	**1.28**	**1.26**	**1.25**	**1.26**	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**
Canada	1.03	1.06	1.04	1.02	1.00	0.99	1.39	1.36	1.32	1.29	1.25	1.25
Australia	0.98	0.95	0.98	1.00	1.02	1.00	1.38	1.35	1.31	1.26	1.23	1.26
New Zealand	0.78	0.76	0.79	0.81	0.83	0.78	1.74	1.69	1.62	1.56	1.51	1.63
Norway	5.83	6.13	6.15	6.18	6.19	6.12	7.88	7.90	7.85	7.80	7.75	7.74
Sweden	6.88	7.25	7.23	7.22	7.19	7.08	9.30	9.34	9.22	9.11	9.00	8.95
Switzerland	0.90	0.95	0.95	0.95	0.95	0.98	1.22	1.23	1.22	1.20	1.19	1.23
United Kingdom	1.55	1.52	1.51	1.51	1.51	1.54	0.87	0.85	0.84	0.84	0.83	0.82
China	**6.39**	**6.30**	**6.24**	**6.18**	**6.12**	**6.05**	**8.6**	**8.1**	**8.0**	**7.8**	**7.7**	**7.6**
India	49.4	49.5	48.0	47.5	47.5	47.0	66.8	63.8	61.2	60.0	59.4	59.4
Korea	1167	1200	1180	1160	1140	1110	1578	1547	1505	1464	1426	1403
Poland	3.26	3.60	3.55	3.49	3.43	3.32	4.41	4.64	4.52	4.41	4.29	4.19
Russia	32.0	32.9	33.4	33.8	34.1	33.4	43.3	42.5	42.5	42.6	42.7	42.2
South Africa	8.27	8.01	8.18	8.35	8.50	8.57	11.18	10.33	10.43	10.53	10.64	10.83
Turkey	1.84	1.86	1.87	1.87	1.88	1.86	2.49	2.40	2.38	2.37	2.35	2.34
Brazil	1.86	1.82	1.81	1.81	1.80	1.77	2.51	2.34	2.31	2.28	2.25	2.24
Mexico	13.8	13.2	13.1	13.1	13.0	12.8	18.6	17.0	16.7	16.5	16.2	16.2

Note: All foreign exchange forecasts are consistent with the rolling forecasts presented in Figure 83. Source: Citi Investment Research and Analysis

Figure 21. Foreign Exchange Forecasts (End of Period), as of 28 Sep 2011

	vs. JPY					
	Current	Dec 11	Mar 12	Jun 12	Sep 12	Dec 12
United States	**76**	**75**	**75**	**76**	**76**	**77**
Japan	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**
Euro Area	**103**	**97**	**96**	**96**	**95**	**97**
Canada	74	71	73	74	76	78
Australia	75	71	73	76	77	77
New Zealand	59.4	57.2	59.2	61.2	62.8	59.4
Norway	13.1	12.2	12.3	12.3	12.3	12.5
Sweden	11.1	10.4	10.4	10.5	10.6	10.8
Switzerland	85	79	79	79	80	78
United Kingdom	118	114	114	114	115	118
China	12	12	12	12	12	13
India	1.54	1.52	1.57	1.59	1.60	1.63
Korea	15.30	15.99	15.66	15.33	14.99	14.50
Poland	23.4	20.8	21.2	21.7	22.2	23.1
Russia	2.4	2.3	2.3	2.2	2.2	2.3
South Africa	9.2	9.4	9.2	9.1	8.9	8.9
Turkey	41.5	40.3	40.4	40.4	40.5	41.2
Brazil	41.0	41.2	41.6	41.9	42.3	43.2
Mexico	5.5	5.7	5.7	5.8	5.9	6.0

Note: All foreign exchange forecasts are consistent with the rolling forecasts presented in Figure 83. Source: Citi Investment Research and Analysis

Country Commentary

United States

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Although the reversal of some temporary drags gave a boost to economic growth at the start of the third quarter, the outlook has deteriorated a bit further this month. We continue to expect below-trend growth on average through next year, with the jobless rate likely to edge up slightly from already elevated levels. But the latest forecast also incorporates the possibility that recurring bouts of heightened risk aversion that have been a feature of early recovery may persist still longer, reflecting domestic policy uncertainties as well as contagion effects from an unresolved European debt crisis.

The Fed's back-to-back easing efforts in the form of stronger guidance and Operation Twist were already part of the August forecast and the outlook assumes these measures will yield modest support for financial conditions. Along with lower oil prices, this buffers some of the downside risks to expansion. The previous assumption that the scheduled expiration of payroll tax relief will be extended now adds some further enhancement in line with the Administration's proposed stimulus package. Retrenchment among state and local governments is likely to remain a drag on income and employment.

Inflation has remained elevated with high-frequency core measures of 2%-2½% running above desired ranges. This has narrowed policy options but also undercut growth. Easing bottlenecks in autos should hasten some moderation while business pricing intentions and some pipeline measures have started to crest. With labor market improvement stalled, wage growth remains anemic and consumer resistance to higher prices is widely evident. Easing in price pressures should help stabilize recovery.

Figure 22. United States — Economic Forecasts, 2010-12F

					2011				2012			
		2010	2011F	2012F	1Q	2Q	3QF	4QF	1QF	2QF	3QF	4QF
GDP	SAAR				0.4%	1.4%	2.0%	1.6%	1.8%	2.0%	2.2%	2.0%
	YoY	3.0%	1.7%	1.9%	2.2	1.7	1.5	1.3	1.7	1.8	1.9	2.0
Consumption	SAAR				2.1	0.4	1.8	1.7	1.9	1.5	2.2	2.1
	YoY	2.0	2.1	1.7	2.8	2.2	2.0	1.5	1.4	1.7	1.8	1.9
Business Investment	SAAR				2.1	11.9	2.0	4.4	4.2	4.5	6.9	4.6
	YoY	4.4	7.3	4.8	10.1	8.4	6.1	5.0	5.6	3.8	5.0	5.0
Housing Investment	SAAR				-2.5	3.8	4.6	7.0	7.1	9.9	12.3	13.0
	YoY	-4.3	-1.3	8.1	-2.9	-6.9	2.1	3.2	5.6	7.1	9.1	10.6
Government	SAAR				-5.9	-0.9	-2.1	-1.3	-1.5	-1.9	-1.6	-1.4
	YoY	0.7	-2.2	-1.6	-1.0	-2.2	-2.9	-2.6	-1.5	-1.7	-1.6	-1.6
Exports	SAAR				7.9	3.7	5.2	5.7	7.1	7.5	6.9	6.8
	YoY	11.3	7.0	6.4	8.9	7.3	6.1	5.6	5.4	6.4	6.8	7.1
Imports	SAAR				8.3	0.4	-0.1	4.2	5.0	4.7	4.4	4.4
	YoY	12.5	4.6	3.7	9.6	4.5	1.5	3.1	2.4	3.4	4.6	4.6
CPI	YoY	1.6	3.2	1.9	2.2	3.3	3.7	3.5	2.5	1.9	1.5	1.6
Core CPI	YoY	1.0	1.7	1.9	1.1	1.5	1.9	2.1	2.1	2.0	1.7	1.7
Unemployment Rate	%	9.6	9.1	9.5	8.9	9.1	9.1	9.2	9.4	9.4	9.5	9.5
Gov't Balance (Fiscal Year)	% of GDP	-9.0	-8.5	-6.2								
Assumed WTI Spot Price	US$	79.4	91.5	81.1	94.0	102.6	90.2	79.3	80.1	80.5	80.9	82.9
Current Account	US$bn	-471	-471	-430	-477	-489	-462	-456	-425	-437	-417	-441
	% of GDP	-3.2	-3.1	-2.8	-3.2	-3.3	-3.0	-3.0	-2.8	-2.8	-2.7	-2.8
S&P 500 Profits (US$ Per Share)	YoY	37.8	13.5	4.1	19.2	12.4	12.0	10.9	5.3	4.6	3.7	3.0

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

Japan

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We have revised down our GDP growth forecast for 2012 to 2.1% from 2.5% last month, mostly reflecting developments in Europe. Under the judgment that the European sovereign debt and banking crisis will intensify in a way that leads to a Euro area recession, Japan's exports — not only to the EU but also to other regions — will likely slow reflecting higher risk aversion. We expect that after likely strong growth (driven by normalization in supply chains) in the third quarter, the economy will slow to a modest pace because of the strong yen and export weakness. Moreover, temporary factors that lifted consumer spending in recent months are tapering off.

Meanwhile, reconstruction demand from the earthquake — on both public and private sectors — will likely support economic activity in quarters to come. The Administration is currently finalizing the third supplementary budget, which is reported to reach ¥12tn. We estimate that reconstruction demand including public and housing investment will be ¥5.5tn in fiscal 2012 following ¥2.1tn in FY2011. This would push up GDP growth in 2012 by around 0.7% points. On the other hand, temporary individual income tax hikes to fund reconstruction will likely be delayed until 2013.

We expect an additional easing measure from Bank of Japan in October. In particular, if upward pressures on the yen intensify amid global risk aversion, the BoJ will most likely take additional actions. Possible policy options include: 1) reducing the interest paid on excess reserves (0.1%); 2) strengthening its commitment to keep rates low for an extended period, as the Fed did in August; and 3) extending the maximum maturity of JGBs that the BoJ buys under the asset purchase program, from two years currently. However, as has often been the case in the past, the BoJ's action will likely be passive rather than proactive. Finally, we expect the BoJ's rate hike will start as late as the fourth quarter of 2014, most likely later than the Fed's first rate hike.

Figure 23. Japan — Economic Forecasts, 2010-12F

					2011				2012			
		2010	2011F	2012F	1Q	2Q	3QF	4QF	1Q	2QF	3QF	4QF
Real GDP	YoY	4.0%	-0.4%	2.1%	-0.7%	-1.1%	-0.1%	0.8%	2.5%	3.1%	1.4%	1.4%
	SAAR				-3.7	-2.1	8.1	1.5	2.7	0.1	1.3	1.3
Domestic Demand	YoY	2.2	0.3	2.4	-0.5	0.2	0.3	1.1	2.9	3.1	1.9	1.8
	SAAR				-2.9	0.8	5.8	1.2	4.0	1.4	1.3	0.8
Private Consumption	YoY	1.9	-0.6	1.0	-0.9	-0.5	-0.8	0.0	1.0	1.2	0.8	1.2
	SAAR				-2.5	-0.1	3.0	-0.3	1.3	1.0	1.5	0.8
Business Investment	YoY	2.5	0.6	3.5	2.2	-1.3	0.1	1.6	3.8	4.7	3.0	2.6
	SAAR				-5.5	-3.6	10.4	6.1	2.6	-0.1	3.6	4.5
Housing Investment	YoY	-6.5	2.7	5.2	5.1	3.2	3.4	-0.8	0.1	3.6	5.0	12.0
Public Investment	YoY	-3.5	-3.1	14.6	-13.5	-4.0	1.2	5.5	21.0	20.0	12.0	6.0
Exports	YoY	24.1	0.9	2.0	6.4	-5.1	0.0	2.5	1.5	5.3	0.5	1.0
	SAAR				0.0	-18.1	27.0	6.1	-3.8	-5.3	5.6	8.3
Imports	YoY	9.8	5.3	5.2	8.5	3.3	3.7	5.7	5.2	6.0	4.6	5.0
	SAAR				5.8	-0.2	12.4	5.2	3.6	3.2	6.5	6.7
CPI	YoY	-0.7	0.0	-0.3	0.0	0.1	0.0	-0.3	-0.2	-0.3	-0.4	-0.4
Core CPI	YoY	-1.0	-0.2	-0.3	-0.8	-0.3	0.2	-0.1	-0.2	-0.3	-0.4	-0.4
Nominal GDP	YoY	1.7	-2.4	0.7	-2.9	-3.3	-2.3	-1.0	0.8	1.9	0.3	0.1
Current Account	¥ tn	17.2	10.0	9.9	13.0	7.4	9.0	10.5	9.9	9.2	9.7	10.6
	% of GDP	3.6	2.1	2.1	2.8	1.6	1.9	2.2	2.1	2.0	2.1	2.3
Unemployment Rate	%	5.1	4.7	4.6	4.9	4.6	4.7	4.6	4.7	4.6	4.6	4.6
Industrial Production	YoY	16.6	-2.5	2.7	-2.5	-6.8	-0.6	0.3	2.2	6.0	1.2	1.7
Corporate Profits (Fiscal Year)	YoY	50.0	2.0	13.5								
General Govt. Balance (Fiscal Year)	% of GDP	-9.8	-10.3	-9.0								

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

Euro Area

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With lower global growth, Greece's non-compliance with the programme conditions and increasing opposition in creditor countries to further bail-outs, we now expect a substantial and probably coercive debt restructuring of the Greek sovereign by the end of 2012 at the latest and likely much sooner (by the spring of 2012 or even December 2011). We expect Ireland and Portugal to follow Greece into sovereign debt restructuring soon afterwards, mainly because of 'political contagion'. We expect haircuts to all non-IMF debt (so including the European official lending) of around 55% for Greece and 35% for Portugal and Ireland, which will likely bring their debt ratios close to the Euro Area average.

In order to prevent spillovers from these sovereign defaults to other strained Euro Area countries, there are now plans to leverage the amended version of the EFSF. However, before going ahead, the amended framework of the EFSF (with a lending capacity of €440bn) has to be approved by all 17 EU member countries in the first place, which is likely to happen by mid-October. Furthermore, it depends on the willingness of the ECB and the creditor countries to support the leverage of the EFSF. They probably will request additional austerity measures from fiscally unsound countries and a tightening of the Stability and Growth Pact including automatic penalties.

Even with a leveraged EFSF, additional fiscal tightening and tighter financial conditions are likely to be sizeable drags for Euro Area growth. Taking this into account, we revise down our Euro Area 2012 GDP growth forecast from +0.6% to -0.2%, now expecting a mild recession to start in 4Q 2011. In this scenario, the ECB is likely to reduce rates back to 1.0% by year-end. With reasonable GDP growth in 3Q and inflation likely to increase in September, we expect that the ECB will leave the policy rate unchanged in October, although the probability of a rate cut has risen recently. The ECB is likely to expand its non-standard measures by providing a series of 12M LTROs and probably to resume purchases of covered bonds.

Figure 24. Euro Area — Economic Forecasts, 2010-12F

					2011				2012			
		2010	**2011F**	**2012F**	**1Q**	**2Q**	**3QF**	**4QF**	**1QF**	**2QF**	**3QF**	**4QF**
Real GDP	YoY	1.7%	1.6%	-0.2%	2.4%	1.6%	1.4%	0.9%	0.1%	-0.2%	-0.4%	-0.3%
	SAAR				3.1	0.6	0.8	-0.8	-0.4	-0.3	-0.3	-0.1
Final Domestic Demand	YoY	0.4	0.9	-0.3	1.4	0.7	0.7	0.6	-0.1	-0.1	-0.4	-0.5
Private Consumption	YoY	0.8	0.6	0.0	0.9	0.5	0.6	0.3	0.1	0.2	-0.1	-0.3
Government Consumption	YoY	0.5	0.2	-0.8	0.8	0.3	0.0	-0.2	-0.8	-0.8	-0.8	-0.7
Fixed Investment	YoY	-1.0	2.4	-0.5	3.7	1.7	2.0	2.3	0.1	-0.5	-0.8	-0.8
— Business Equipment	YoY	2.1	4.8	-0.9	6.2	4.7	4.6	3.7	0.8	-0.9	-1.7	-1.9
— Construction	YoY	-3.8	-0.5	-1.4	1.3	-1.6	-1.5	-0.4	-2.2	-1.5	-1.1	-0.7
Stocks (Contrib. to Y/Y GDP Growth)		0.6	0.1	-0.1	0.3	0.2	0.0	-0.1	-0.2	-0.2	-0.1	0.0
Exports	YoY	10.6	6.2	2.0	9.6	6.3	5.3	3.7	2.1	1.8	1.6	2.4
Imports	YoY	8.9	4.8	1.5	8.2	4.7	3.8	2.8	1.3	1.2	1.4	1.9
CPI	YoY	1.6	2.7	1.9	2.5	2.8	2.6	2.9	2.2	2.0	2.0	1.4
Core CPI	YoY	1.0	1.4	1.1	1.1	1.6	1.2	1.6	1.3	1.3	1.2	0.6
CPI Ex Energy and Food	YoY	1.0	1.7	1.4	1.3	1.8	1.6	2.1	1.7	1.7	1.4	0.8
Unemployment Rate	YoY	10.1	10.0	10.3	10.0	10.0	10.0	10.1	10.2	10.3	10.3	10.3
Current Account Balance	EUR bn	-43.2	-63.0	-105.7								
	% of GDP	-0.5	-0.7	-1.1								
General Government Balance	EUR bn	-550.5	-406.0	-331.5								
	% of GDP	-6.0	-4.3	-3.5								
General Government Debt	EUR bn	7837.2	8378.2	8659.8								
	% of GDP	85.1	88.7	90.5								
Gross Operating Surplus	YoY	3.7	3.5	-0.5								

Sources: Eurostat and Citi Investment Research and Analysis

Germany

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With likely negative repercussions of the multiple defaults in the Euro Area and weaker global demand we have revised down our forecast for 2012 German exports and GDP substantially for a second consecutive month. However, with indications of stronger-than-expected 3Q GDP and despite the new forecast of a contraction in GDP in 4Q, we have left our 2011 GDP forecast unchanged. We expect that domestic demand will be more resilient than during the 2008 recession. Even with the recent environment of sharply falling sentiment, companies continue to plan an increase in employment suggesting that households' disposable income will continue to support private consumption. Although the government is likely to achieve approval of the extended version of the EFSF, Angela Merkel's coalition remains fragile, particularly in Europe-related questions.

France

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Sentiment surveys are weakening markedly, reflecting an economy that is getting dangerously close to stalling speed. Pressure on French financial institutions, if it continues, will impact credit availability and leave the economy more vulnerable to shocks. We argue that the government's projection of 1.75% GDP growth in 2012 is not achievable. Our new baseline scenario of an early Greek default would impact France's macroeconomic performance and could lead to a technical recession if not managed with an overwhelming policy response. We are lowering our 2012 GDP forecast from 0.9% to 0.2%, implying a 1.2ppt reduction since the July GEOS. We doubt the government will tighten fiscal policy aggressively ahead of the May 2012 elections, preferring to rely on automatic stabilisers to cushion the blow.

Italy

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We have cut back once again our GDP forecasts, as the deterioration of the euro debt crisis will likely cause further tightening in financing conditions, especially in a high-debt country like Italy. Recent austerity packages imply sizable fiscal tightening already in 2012, focused mainly on tax increases which are likely to hit spending. The fiscal deficit should keep falling, but with a negative growth environment preventing it reaching the government's target of close-to-zero by 2013. The debt ratio should stabilise just above 120%, but, barring major privatizations, it is unlikely to start falling any time soon. Political uncertainty is bound to stay high, with early elections or a major government reshuffle as likely developments in the near term.

Figure 25. Germany, France and Italy — Economic Forecasts, 2010-12F

		Germany			France			Italy		
		2010	2011F	2012F	2010	2011F	2012F	2010	2011F	2012F
Real GDP	YoY	3.6%	3.0%	1.0%	1.4%	1.6%	0.2%	1.2%	0.5%	-1.0%
Final Domestic Demand	YoY	1.7	2.3	1.6	0.8	1.3	-0.1	0.9	0.4	-1.5
Private Consumption	YoY	0.6	1.1	1.4	1.3	0.8	0.0	1.0	0.7	-0.9
Fixed Investment	YoY	5.4	7.9	3.4	-1.3	3.6	-0.5	2.4	0.0	-2.5
Exports	YoY	13.4	8.3	3.6	9.4	4.4	3.2	8.9	3.5	0.2
Imports	YoY	11.5	7.9	4.4	8.3	5.8	2.1	10.3	1.8	-2.4
CPI	YoY	1.1	2.3	2.0	1.7	2.2	1.8	1.6	3.0	2.7
Unemployment Rate	%	7.1	6.1	6.2	9.3	9.2	9.3	8.4	8.1	8.5
Current Account	€bn	141.1	126.3	100.8	-33.9	-54.2	-47.8	-53.5	-60.8	-54.7
	% of GDP	5.7	4.9	3.8	-1.7	-2.7	-2.3	-3.5	-3.8	-3.3
General Govt. Balance	€bn	-82.0	-43.5	-38.2	-136.5	-112.9	-96.5	-71.2	-63.7	-44.8
	% of GDP	-3.3	-1.7	-1.5	-7.1	-5.6	-4.7	-4.6	-4.0	-2.8
General Govt. Debt	% of GDP	83.2	84.0	85.1	81.7	84.8	92.7	119	121	123
Gross Trading Profits	YoY	10.5	0.6	-2.5	1.1	3.5	2.0	NA	NA	NA

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

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Spain

We expect 2011-H2 and 2012 GDP growth to suffer from the worsening of the euro debt crisis and further tightening in financing conditions. The downward adjustment in the construction sector has re-accelerated recently, and further house price declines are likely to hit private sector balance sheets. Fiscal restraint is the other major drag on private spending, although probably not large enough to ensure the deficit will fall in line with the government's targets (6.0% of GDP in 2011 and 4.4% in 2012). More fiscal austerity is likely to be implemented after the elections (on 20 Nov). The debt ratio remains below the Euro Area's, but likely slippages in the fiscal consolidation path and additional capital needs from the banks keep the uncertainty around the future debt-to-GDP trajectory elevated.

Greece

With the targets of the EU/IMF Greek program looking increasingly unattainable and rising political fatigue in donor countries, we now expect a Greek debt restructuring soon (with haircuts of at least 50-55% on non-IMF debt), possibly even before year-end. We expect the likely very negative effects on confidence, on Greek banks and on overall financing conditions to cause an even deeper recession in 2012/2013. The fiscal deficit should be much smaller, but a primary surplus is unlikely before 2013. A post-default second bail-out package would still be necessary to fill the primary balance gap and bank recapitalizations, keeping the pressure for fiscal discipline still high.

Portugal

We think early debt restructuring in Greece would quickly spread contagion to Portugal, making the implementation of the EU/IMF adjustment program economically and politically more difficult. Also, upward revisions to the public deficit/debt numbers are likely in coming months. We expect a debt restructuring to happen sometime before end-2012 in Portugal too, with haircuts of around 35%-40%, to bring the debt ratio down to around the Euro Area average of 80%. The recession will likely get deeper in 2012-13, but it may be shorter than in a scenario of delayed restructuring to 2014.

Figure 26. Spain, Greece and Portugal — Economic Forecasts, 2010-12F

		Spain			Greece			Portugal		
		2010	2011F	2012F	2010	2011F	2012F	2010	2011F	2012F
Real GDP	YoY	-0.1%	0.6%	-0.7%	-4.4%	-5.6%	-4.9%	1.3%	-2.0%	-5.7%
Final Domestic Demand	YoY	-1.2	-1.0	-2.2	-5.9	-7.8	-6.4	NA	NA	NA
Private Consumption	YoY	1.3	0.5	-0.9	-4.6	-5.6	-5.2	NA	NA	NA
Fixed Investment	YoY	-7.5	-6.1	-5.8	-8.2	-14.5	-10.7	NA	NA	NA
Exports	YoY	10.3	7.7	-0.2	3.9	-0.1	0.5	NA	NA	NA
Imports	YoY	5.5	1.7	-4.0	-4.8	-9.4	-6.2	NA	NA	NA
CPI	YoY	2.0	2.9	0.7	4.7	3.2	1.2	1.4	3.4	0.7
Unemployment Rate	%	20.1	21.0	21.6	12.5	17.2	20.1	NA	NA	NA
Current Account	€bn	-48.4	-41.3	-33.0	-24.1	-20.2	-9.4	-18.1	-14.8	-10.8
	% of GDP	-4.6	-3.8	-3.0	-10.4	-9.2	-4.5	-10.5	-8.7	-6.3
General Govt. Balance	€bn	-98.2	-74.1	-67.5	-24.2	-22.8	-14.1	-16	-10	-7.9
	% of GDP	-9.2	-6.8	-6.2	-10.5	-10.4	-6.8	-9.1	-6.0	-4.7
General Govt. Debt	€bn	638.8	742.2	820.8	329	360	190	160	185	1488
	% of GDP	60.1	68.3	75.6	142.8	164.6	91.1	93.0	108.4	87.2

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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Signs of slowdown are accumulating: unemployment has been rising for several months, corporate liquidity is worsening and business surveys have nose-dived. We now expect that the UK economy is likely to slow close to recession in the next few quarters, with consumer spending remaining sluggish and weakness in business investment and exports — the previous engines of recovery.

Although inflation is far above the 2.0% target this year, it is likely to slow sharply next year as the VAT hike drops out and the slowdown takes hold. We do not currently expect that inflation will fall back to the 2.0% target next year, but the MPC believe it will fall back to target even if the economy picks up significantly. Since prospects for recovery are now very much in doubt, the MPC probably now believe that inflation will fall below target by end-2012.

As a result, the MPC are likely to restart QE soon and indeed are already softening up market opinion for the relaunch of QE. The political obstacles to QE evident in the US do not exist in the UK. The BoE believe that QE is effective in boosting nominal GDP, but that it takes a lot of QE to have much effect: they believe the QE programme of 2009-10 – £200bn (14% of GDP) – lifted nominal GDP by about 2¼%-3½%, a far smaller effect than they expected when QE was implemented. It follows that the MPC now are likely to use QE in bigger scale, relative to any given shortfall in expected economic growth, than previously. We expect they will begin with £50bn-100bn of QE in October or at the latest in November, with a total of about £300bn over the next few quarters. At that point, the BoE will own roughly half the gilt market. If necessary, we would expect them to buy the whole gilt market.

Figure 27. United Kingdom — Economic Forecasts, 2010-2012F

					2011				2012			
		2010	2011F	2012F	1Q	2QF	3QF	4QF	1QF	2QF	3QF	4QF
Real GDP	YoY	1.4%	1.0%	0.7%	1.6%	0.8%	0.5%	1.0%	0.8%	0.8%	0.7%	0.8%
	SAAR				2.0	0.8	1.0	0.2	1.0	0.9	0.5	0.6
Domestic Demand	YoY	2.7	0.0	0.3	0.5	0.3	-0.2	-0.4	0.8	0.2	-0.1	0.2
(Incl. Inventories)	SAAR				-3.6	2.8	1.0	-1.5	1.2	0.4	-0.3	-0.4
Consumption	YoY	0.9	-0.1	1.5	-0.5	-0.4	-0.1	0.5	1.4	1.3	1.5	1.6
	SAAR				-2.3	1.8	0.8	1.5	1.4	1.6	1.6	1.7
Investment	YoY	3.7	-1.1	-2.4	-0.2	1.8	-1.9	-4.1	-0.9	-1.5	-3.9	-3.5
	SAAR				-7.7	2.6	0.9	-11.4	5.2	0.2	-8.7	-9.9
Exports	YoY	5.2	4.8	5.4	9.3	3.3	3.3	3.6	2.2	6.7	6.8	6.1
	SAAR				9.8	-10.0	5.9	9.9	4.2	6.8	6.2	7.2
Imports	YoY	8.8	1.3	3.6	4.2	1.4	0.9	-1.1	2.4	4.3	3.7	3.9
	SAAR				-9.1	-2.9	5.4	2.9	4.6	4.4	3.1	3.6
Unemployment Rate	%	7.9	8.0	8.6	7.7	7.9	8.0	8.1	8.4	8.6	8.7	8.8
CPI Inflation	YoY	3.3	4.4	2.9	4.1	4.4	4.6	4.6	3.4	2.9	2.7	2.4
Merch. Trade	£bn	-54.8	-90.7	-75.2								
	% of GDP	-3.8	-6.0	-4.8								
Current Account	£bn	-46.3	-33.0	-9.1								
	% of GDP	-3.2	-2.2	-0.6								
PSNB	£bn FY	142.1	127.3	117.5								
	% of GDP	-9.7	-8.3	-7.4								
General Govt. Balance	% of GDP	-10.2	-8.8	-7.9								
Public Debt	% of GDP	76.0	81.7	86.5								
Gross Nonoil Trading Profits	YoY	4.5	10.5	8.3								

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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The Swiss economy is likely to slow sharply in coming quarters, probably already in Q3, as the super-strong CHF hits exports and investment. Signs of a sharp slowdown already are evident in recent business surveys, and these are likely to weaken markedly further in coming months. CPI inflation is likely to turn negative as import prices fall, staying well below the SNB's 2% target ceiling throughout the next few years. We expect the SNB to keep the policy rate at zero for several years. They will strongly resist FX appreciation.

Sweden

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With thanks to Frida Sellberg

We expect the slowdown in Swedish growth to be more pronounced than we thought previously, and now forecast GDP growth of 4.3% this year and 2.1% in 2012 (compared to 4.7% and 2.8% respectively). Moreover, we now expect the Riksbank to keep their key policy rate unchanged at 2.0% for the rest of this and next year, before slowly continuing their hiking cycle again in 2013. As a result of a postponement in the projected rate hikes, our forecast for headline CPI is lowered to 2.0% next year and 2.2% in 2013 (from 2.3% and 2.4% respectively).

Denmark

Following softer-than-expected private consumption and investment in 2Q, we have trimmed our 2011 growth forecast to 1.5% (from 1.6% last month). We have also cut our forecasts for 2012-13, and expect GDP growth of 1.6% in 2012 and 1.7% in 2013 (versus 1.9% and 2.0% previously), mainly reflecting weaker investment. The central bank will probably keep a stable spread (5bp) between their lending rate and the ECB policy rate in the coming years, and hence match expected ECB easing. In addition, the Central Bank is likely to take any chance of currency strength to further cut the current account rate (which is the anchor for money market rates) in the near term.

Norway

We have revised down our growth forecast for Norway slightly for this and next year mainly based on downward revisions of mainland exports. Given a large downside surprise in inflation in August, we have also revised down our forecasts for CPI this year to 1.4% YY (from 1.6%). Headline inflation is likely to stay below Norges Bank's 2.5% target in the coming years. Following a dovish tone at the September meeting, we now expect the Norges Bank to stay on hold until the end of 2012.

Figure 28. Switzerland, Sweden, Denmark and Norway — Economic Forecasts, 2010-2012F

		Switzerland			Sweden			Denmark			Norway		
		2010	2011F	2012F	2010	2011F	2012F	2010	2011F	2012F	2010	2011F	2012F
Real GDP	YoY	2.7%	2.1%	1.2%	5.4%	4.3%	2.1%	1.8%	1.5%	1.6%	2.1%	2.7%	2.9%
Final Domestic Demand	YoY	2.2	1.5	2.6	3.8	3.4	2.2	0.7	-0.4	1.5	1.9	3.3	3.4
Public Consumption	YoY	1.9	1.6	2.2	1.8	1.1	0.1	0.7	0.4	0.8	2.2	1.8	2.3
Private Consumption	YoY	2.0	1.2	1.4	3.6	2.5	1.9	2.3	-0.4	1.6	3.6	2.7	3.2
Investment (Ex Stocks)	YoY	7.2	4.7	5.1	5.7	9.5	6.1	-2.7	-1.2	2.5	-3.1	7.6	5.1
Exports	YoY	8.8	5.2	2.6	10.0	8.0	4.4	3.9	7.4	3.0	2.8	2.9	4.5
Imports	YoY	7.4	4.0	6.4	12.1	7.6	4.6	3.9	5.8	2.8	8.1	5.1	4.2
CPI (Average)	YoY	0.7	0.3	-0.2	1.2	3.0	2.0	2.3	2.7	2.0	2.4	1.4	1.8
Unemployment Rate	%	3.9	3.1	3.1	8.4	7.5	7.4	7.4	7.2	7.1	3.6	3.3	3.2
Current Account	% of GDP	14.5	14.7	13.0	6.6	6.4	6.5	5.3	5.6	5.0	12.4	14.0	14.3
General Govt Balance	% of GDP	0.2	0.3	0.6	-0.2	0.2	0.4	-2.8	-3.8	-4.6	10.6	12.0	12.5
General Govt Debt	% of GDP	55	53	51	39.3	36.3	34.2	43.6	45.7	48.7	NA	NA	NA

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

Canada

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Eroding confidence, dimming global economic prospects and financial market turmoil necessitate further downgrading of the Canadian outlook. The threat of a European recession, a tepid US expansion, and a weaker profile for commodity prices all suggest sub-trend domestic growth through 2013. Near-term depreciation of the Canadian dollar will create some offset, but ongoing competitiveness woes will continue to weigh on exports. Narrower job gains, government layoffs and increased joblessness are likely given moderate growth prospects and downside risks. Lackluster wage growth, cooling housing activity and outsized financial market losses probably will squeeze incomes and subsequently consumer spending. The capex revival could falter on flagging business sentiment.

Downside risks include contagion and reduced risk appetite amid the EA sovereign and banking crises; persistent CAD strength; and consumer retrenchment. The first risk has been realized, the second has intensified and the third could occur as household income growth moderates further. Meanwhile, headwinds from the currency and soft US demand have increased, and US political risks will become a greater influence over the next few months. While upside risks remain, they have lessened in degree as slower global economic momentum should dampen domestic resource utilization and inflationary pressures. Risks look tilted to the downside.

In response to recent developments, the BoC softened its stance at the September monetary policy meeting and is likely to keep rates unchanged until early 2013. Absent significant worsening in the external environment, new fiscal stimulus is unlikely. Bank of Canada rate cuts also have limited scope, given Canada's still relatively strong economic fundamentals and stable financial system, as well as ongoing concern about exacerbating wanton consumer debt accumulation, and lingering upside inflation risks. Alternatively, the BoC may apply additional stimulus by signaling a lengthy period of low interest rates, should conditions warrant it.

Figure 29. Canada — Economic Forecasts, 2010-2012F

					2011				2012			
		2010	2011F	2012F	1Q	2Q	3QF	4QF	1QF	2QF	3QF	4QF
Real GDP	YoY	3.2%	2.1%	1.8%	2.9%	2.2%	1.8%	1.5%	1.1%	1.7%	2.1%	2.2%
	SAAR				3.6	-0.4	1.0	2.0	1.9	2.0	2.5	2.3
Final Domestic Demand	YoY	4.5	2.9	1.8	3.7	3.5	2.6	1.8	1.8	1.5	1.9	2.1
	SAAR				1.8	3.0	0.9	1.5	1.8	1.9	2.4	2.4
Private Consumption	YoY	3.3	1.8	2.0	2.1	2.2	1.8	1.2	1.8	1.9	2.1	2.2
	SAAR				-0.1	1.6	1.5	1.8	2.2	2.1	2.4	2.2
Government Spending	YoY	4.7	0.9	-1.6	2.9	2.0	0.2	-1.4	-1.9	-2.5	-1.5	-0.6
	SAAR				0.2	1.5	-4.2	-3.1	-1.7	-0.8	-0.2	0.2
Private Fixed Investment	YoY	8.4	8.8	5.3	10.1	10.0	7.8	7.5	6.0	4.7	5.4	5.1
	SAAR				10.8	9.7	3.1	6.6	4.8	4.4	5.6	5.7
Exports	YoY	6.4	3.8	4.0	6.7	1.5	4.3	3.0	2.0	5.4	4.1	4.4
	SAAR				7.7	-8.3	10.1	3.5	3.8	4.4	4.8	4.7
Imports	YoY	13.1	6.5	3.3	9.5	6.8	4.6	5.2	3.6	2.2	3.4	4.0
	SAAR				9.5	10.0	-0.3	2.0	3.0	4.0	4.5	4.5
CPI	YoY	1.8	2.8	2.0	2.6	3.4	2.8	2.5	2.3	1.8	2.0	2.0
Core CPI	YoY	1.7	1.7	2.0	1.3	1.6	1.7	2.0	2.2	2.0	2.0	1.9
Unemployment Rate	%	8.0	7.5	7.3	7.8	7.5	7.3	7.4	7.6	7.4	7.1	7.1
Current Account Balance	C$bn	-50.9	-56.8	-61.2	-40.3	-61.3	-60.5	-65.2	-61.3	-65.4	-61.4	-56.6
	% of GDP	-3.1	-3.3	-3.5	-2.4	-3.6	-3.6	-3.8	-3.5	-3.7	-3.5	-3.2
Net Exports (Pct. Contrib.)		-3.1	-1.5	-0.1	-0.6	-5.7	3.4	0.3	0.0	-0.3	-0.4	-0.4
Inventories (Pct. Contrib.)		0.7	0.3	0.0	2.2	2.5	-2.0	0.0	0.0	0.2	0.2	0.1
Budget Balance (Fiscal Year)	% of GDP	-2.2	-1.9	-1.1								
Federal Budget Debt	% of GDP	33.6	34.2	34.0								

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

We have lowered slightly our forecasts for Australian economic growth in 2012 to a still robust 3.7% from 4.0% last month. The downgrade reflects a slightly weaker outlook for exports given the more uncertain global backdrop and slower employment growth as companies respond to a range of financial pressures. That said, we continue to expect stronger growth next year after the impact of the summer floods passes and as mining and energy projects drive an acceleration in business investment growth. We expect fairly steady, but below trend, growth in household demand. A key risk to this outlook is that prospects in Europe and the US continue to deteriorate, eventually undercutting growth in China significantly. Should this occur, the RBA would likely respond by cutting interest rates back into the neutral zone, but for now we see no near-term change to rates.

New Zealand

The recovery from the recession remains slow and as a result we have lowered our growth forecasts and pushed back the timing of the normalization of monetary policy. Economic activity in Q2 grew by just 0.1% and yearly growth remains below potential despite the maintenance of a low policy rate. The strong currency is dampening services exports and domestic activity has yet to receive a meaningful boost from reconstruction-related expenditure in the Canterbury region. Household expenditure is unable to accelerate on a sustained basis and improvements in business confidence have yet to appear in actual investment activity. However, prices of soft commodities remain robust and we expect the RBNZ to anchor the OCR at 2.50% for at least another six months because of downside risks from international developments.

Figure 30. Australia and New Zealand — Economic Forecasts, 2010-2012F

	Australia			New Zealand		
	2010	2011F	2012F	2010	2011F	2012F
Real GDP[a]	2.7%	1.4%	3.7%	1.7%	1.4%	2.6%
Real GDP (4Q versus 4Q)	2.7	1.7	4.1	1.1	1.9	3.1
Real Final Domestic Demand	3.8	3.8	4.3	2.6	2.3	3.1
Consumption	2.8	3.2	3.2	2.3	1.6	2.9
Govt. Current & Capital Spending	9.1	1.4	1.7	2.6	3.2	1.6
Housing Investment	4.2	2.8	3.2	2.7	-15.7	13.9
Business Investment	0.0	11.5	12.4	3.5	6.8	3.6
Exports of Goods & Services	5.7	-2.0	10.0	2.8	3.6	1.5
Imports of Goods & Services	13.7	10.5	7.7	9.9	4.3	3.7
CPI	2.8	3.3	2.5	2.3	4.2	2.1
CPI (4Q versus 4Q)	2.7	3.2	2.9	4.0	2.6	2.2
Unemployment	5.2	5.2	5.0	6.5	6.5	6.2
Merch. Trade, BOP (Local Currency, bn)	16.2	20.1	22.7	3.4	4.1	3.4
Current Account, (Local Currency, bn)	-36.0	-32.9	-31.0	-8.0	-7.9	-11.1
Percent of GDP	-2.7	-2.3	-2.0	-4.1	-3.9	-5.3
Budget Balance[b] (Local Currency, bn)	-57.1	-41.5	-12.3	-8.0	-16.0	-12.0
Percent of GDP	-4.2	-3.6	-1.8	-4.0	-8.0	-6.0
General Govt. Debt (% of GDP)[c]	3.7	5.7	6.4	14.1	20.9	26.8
Gross Trading Profits[d]	12.2	5.8	7.4	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: National sources and Citi Investment Research and Analysis

China

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We cut our growth forecast for 2012 to reflect the worsening outlook in Europe. Sovereign debt restructuring is expected to take place in Greece by end-2012 at the latest, to be followed probably by Ireland and Portugal. Multiple restructurings may lead to new recession in the Euro Area, significantly reducing demand from China's biggest export market. We therefore reduced our 2012 growth projection to 8.7% from 9.0% last month, due mainly to a negative contribution from net exports. Quarterly growth in early 2012 may fall to around 8%, likely increasing calls for more accommodative policies.

Growth has held up well so far, but is expected to slow more tangibly. All real economy data – including on industrial production, fixed asset investment and retail sales – in August pointed to further moderation of economic expansion, but there was little sign of hard landing. The PMI also confirmed the economic slowdown. We expect weakness in export orders will weigh on China's exports in coming months. This, together with accumulated impact from monetary and property tightening, will likely bring down growth more significantly in the next couple of quarters.

Inflation may have peaked, and will likely fall more markedly in 4Q. YoY CPI inflation fell from 6.5% in July to 6.2% in August, reflecting more favorable base effects. Overall inflation may stay close to 6% YoY in September on seasonally high food inflation, but we expect it to ease more substantially in 4Q due to the economic slowdown and lower base effects.

No further tightening is likely, and fiscal policy may become more proactive. With the economy cooling and inflation easing, further policy tightening is unlikely. Although external headwinds may strengthen calls for policy loosening, we think speculation of an outright policy reversal is premature as the inflation target is set to be exceeded by a big margin this year. We expect policy makers to make more use of the flexibility under the current policy mix to forestall downside risks. In particular, given substantial revenue outperformance so far in the year, fiscal policy is likely to be more active in the remainder of the year, with more spending on social housing and possibly on social safety net. The Central Economic Work Conference in late November or early December will probably shed light on the policy stance for 2012.

Figure 31. China — Economic Forecasts, 2010-2012F

					2011				2012			
		2010	2011F	2012F	1Q	2Q	3QF	4QF	1QF	2QF	3QF	4QF
Real GDP	YoY	10.4%	9.0%	8.7%	9.7%	9.5%	8.9%	8.4%	8.0%	8.6%	8.9%	8.9%
Real Final Domestic Demand	YoY	9.8	9.9	9.7								
Consumption	YoY	8.0	9.1	9.6								
Fixed Capital Formation	YoY	11.9	10.7	9.8								
Industrial Production	YoY	15.7	13.8	12.5	14.9	13.9	13.6	13.0	13.0	12.5	12.3	12.0
Exports	YoY	31.3	21.0	11.6	26.4	22.0	21.0	16.0	14.0	12.0	11.0	10.0
Imports	YoY	38.7	24.5	14.4	32.8	23.1	25.0	19.0	16.0	15.0	14.0	13.0
Merchandise Trade Balance	$bn	183.1	172.7	143.4	-0.7	46.7	64.9	61.8	-8.8	39.5	58.3	54.4
FX Reserves	$bn	2,847	3,401	3,679	3,045	3,197	3,307	3,401	3,427	3,502	3,592	3,679
Current Account	% of GDP	5.2	4.0	3.2								
Fiscal Balance (trailing 4-qtr sum)	% of GDP	-1.6	-2.0	-2.0	1.8	1.0	-1.8	-3.0	1.8	1.0	-1.8	-3.0
General Govt. Debt	% of GDP	20.5	20.4	20.6								
Urban Unemployment Rate	%	4.1	4.1	4.0	4.1	4.1	4.0	4.0	4.0	4.0	4.0	4.0
CPI	YoY	3.3	5.3	4.2	5.1	5.7	6.0	4.6	4.5	4.2	4.0	4.0
Exchange Rate (end period)	CNY/$	6.62	6.30	6.05	6.56	6.47	6.35	6.30	6.24	6.18	6.12	6.05
1-Yr Deposit Rate (end period)	%	2.75	3.50	3.50	3.00	3.25	3.50	3.50	3.50	3.50	3.50	3.50

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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Recently released macro and sectoral data indicate a clear slowdown in economic activity with GDP growth coming in at sub 8% for the second consecutive quarter. We expect this trend to continue due to (1) lagged effect of 500bps of tightening, (2) structural policy issues, and (3) worsening prospects on the global front, and thus maintain our FY11/12 GDP estimate of 7.6%.

Inflationary pressures continued unabated in August, with the WPI rising 9.8% YoY. While we have been expecting inflation to remain elevated due to higher minimum support prices of agri crops and continued upward revisions to past data, two further price pressures have emerged over recent weeks: (1) commodity prices have showed no sign of abating despite slowing global demand. This has a strong bearing on the WPI given that ~60% of the inflation basket is linked to commodities and (2) over the last month; the INR has weakened by 8%, which adds to inflationary woes. Thus, key to watch would be if a decline in commodity prices occurs; and the extent to which this is offset by exchange-rate depreciation.

On the fiscal side, trends in government finances remain unchanged with the April-July fiscal deficit coming in at Rs2,288bn or 55% of budget estimates of Rs4,128bn. Despite austerity measures, we expect the government to miss its deficit target due to both lower revenues and higher expenditures. Depending on the timing of the pay-out to oil companies, the headline deficit number could come in at 5.1% to 5.8% vs. budget estimates of 4.6% of GDP.

The further deterioration seen on the global front has taken its toll on risk assets – EM currencies, equities and bonds. While India's low exports/GDP, domestically financed fiscal deficit, limited exposure to foreign liabilities and healthy banking system are positive, in times of risk aversion, India immediately comes on the radar due to its twin deficits and reliance on external capital. As mentioned earlier, though India is relatively better placed, the worries this time are (1) a slowing economy and (2) limited ammunition vs. 2008 that Indian policy makers have in the event of a crisis. This is on both the fiscal and monetary front, where higher deficits and stickier inflation limit space for conventional policy responses.

Figure 32. India — Economic Forecasts, FY2010/11-2012/13F

		FY 10/11F	FY 11/12F	FY 12/13F
Real GDP	YoY	8.5%	7.6%	8.2%
Final Domestic Demand	YoY	8.1	5.7	8.3
Private Consumption	YoY	8.6	7.0	8.0
Fixed Investment	YoY	8.4	3.0	9.0
Exports	YoY	12.0	16.5	13.0
Imports	YoY	6.3	11.0	8.3
Wholesale Price Index*	YoY	8.6	9.5	7.5
Consumer Price Index	YoY	9.5	8.0	7.0
Unemployment Rate	%	NA	NA	NA
Current Account	US$ bn	-44.3	-57.5	-50.8
	% of GDP	-2.6	-3.0	-2.3
Consolidated Fiscal Balance	% of GDP	-8.1	-8.3	-7.1
Centre Fiscal Balance	% of GDP	-5.1	-5.8	-4.6
US Dollar Exchange Rate	Average	45.6	47.6	47.5

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

Korea

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Aug headline CPI rose to a year-high level of 5.3%YoY from 4.7%YoY in July as prices of fresh foods and oils rose by 13.8%YoY and 15.2%YoY, respectively. Core inflation also rose to 4.0% YoY and is expected to rise further to 4.6%YoY in 4Q11 as the second-round effects of previous raw material and foods price hikes materialize. Headline inflation, however, will probably gradually decline due to increased supply of agricultural goods and high base effects from a year ago. Exports grew 25.9%YoY in August, reaching US$45.9bn, led by petro products (up 82.7% YoY), shipbuilding (79.9%), auto (33.7%) and steel & iron (28.0%). Labor market conditions also continued to improve in Aug. The seasonally adjusted jobless rate fell to a three-year low level of 3.1% from 3.3% in July as the number of employed increased by 490K YoY, on the back of job growth in service sector (572K YoY). Meanwhile, job growth in the manufacturing sector decreased by 28K YoY, suggesting a slowdown of production in the sector. Industrial production has already slowed to 3.8%YoY in July from 6.5% in June. Facing financial market turmoil and weaker prospects for the global economy, the BoK kept the policy rate at 3.25% at the Sep MPC meeting. We reiterate our call of no policy rate hike in the remainder of 2011.

Indonesia

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The IDR depreciated by around 7 percent against the dollar in the first three weeks of September, following increased worries over the US and EU debt crisis. This came as a surprise to many who have become accustomed to seeing BI keep the exchange rate in a tight range. Market liquidity has dried up amid foreign unwinding, despite intervention by the BI in both the bond and FX markets (using for the first time its dollar-settled bond buying auction facility). Domestic fundamentals, however, should not be affected significantly yet. The IDR is merely close to where it was in the beginning of the year. As a result, we do not expect the depreciation to spawn a broad-based rise in the inflation rate. However exchange-rate sensitive items (e.g. gold jewelry prices) could trigger a moderate one-off jump in the inflation rate. Our outlook on the BI rate remains unchanged, expecting a cut of 25bps by YE11. We think BI's recently dovish stance reflects a rethink on their approach to monetary policy and not just short-term growth and inflation considerations. Adhering to traditional 'policy rules' is being viewed as a costly strategy, given the current backdrop of low global interest rates and capital inflows which add to excess liquidity in the domestic banking system.

Figure 33. Korea and Indonesia — Economic Forecasts, 2010-12F

		Korea			Indonesia		
		2010	2011F	2012F	2010	2011F	2012F
Real GDP	YoY	6.2%	3.7%	3.9%	6.1%	6.5%	6.3%
Final Domestic Demand	YoY	4.8	1.7	3.9	5.2	7.2	7.7
Private Consumption	YoY	4.1	2.7	3.3	4.6	5.0	4.9
Fixed Investment	YoY	7.0	-0.8	5.6	8.5	9.0	11.1
Exports	YoY	14.5	9.9	6.8	14.9	11.0	7.6
Imports	YoY	16.9	7.8	7.5	17.3	13.3	11.3
Consumer Price Index	YoY	3.0	4.5	3.5	5.1	5.0	6.2
Unemployment Rate	%	3.7	3.5	3.3	7.1	6.8	6.5
Current Account	US$ bn	28.2	15.5	13.1	6.3	0.8	-2.7
	% of GDP	2.8	1.4	1.1	0.9	0.1	-0.3
Fiscal Balance	% of GDP	1.4	0.5	0.7	-0.6	-1.5	-1.5
US Dollar Exchange Rate	Average	1156	1134	1148	9092	8922	8975

Sources: Haver Analytics and Citi Investment Research and Analysis

Hong Kong

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Inflation concerns linger despite expected the growth moderation. Domestic strength so far provides some buffer to further external trade weakness, especially when the jobless rate unexpectedly fell to a 13-year low of 3.2%sa in Aug, indicating a tight labor market that could tolerate some headcount adjustments. We forecast GDP will slow to 4.9%YoY in 2H11 from the strong 1H of 6.3% YoY. We are lowering our 2012 forecast to 4.5% from 5.0% last month. This expected slowdown could alleviate inflation pressures. However, some sources of HK's inflation are likely to remain persistent, especially rising rentals (for both retail and residential) and labor costs (as demands for wage rises usually lag). It is widely expected that the government will launch more inflation relief measures for lower income groups in the upcoming Policy Address in October. Although HIBOR remained low alongside its US counterparts, consecutive quarters of increases in loan-to-deposit ratios have tightened banks' liquidity positions. The trend is for higher funding costs to be passed onto borrowers (e.g. there have been several hikes to new mortgage rates and lending rates for other loan types have also risen). The HKD gyrated around the middle of the convertibility band in the past month, reflecting large financial market volatility. We think this will continue in 4Q, with the USD peg to stay.

Singapore

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Upside surprises in Aug NODX and IP have reduced but not eliminated odds of a 3Q technical recession. With ex-biomed manufacturing already in contraction for 7 months, our forecasts currently anticipate a short-lived restocking-driven stabilization in 4Q, YoY growth bottoming in 1Q12, and a reversion to the lower end of the official 3-5% trend growth rate for 2012. The deteriorating situation in Europe, however, poses downside risks to 2012 growth, which could fall below trend under alternative scenarios of a protracted recession extending into 1Q12. Inflation reached a new yearly high of 5.7% in Aug, but will likely moderate from here on. However, policy-induced supply side constraints, a tight labour market, record job vacancies, and low interest rates, all suggest that inflation is unlikely to moderate as sharply as in past slowdowns. With aggressive labour cost reduction policies less feasible in the current political climate, a more activist approach to FX policy setting may be needed to arrest the erosion of cost competitiveness from REER appreciation. The expected return to trend growth in 2012 warrants a calibrated easing or 'normalization' of the monetary policy stance with the MAS shifting to a gentler slope of 1-2% p.a. of the SGD NEER policy band in mid-Oct. But, the possibility of below-trend growth in 2012 suggests that an outright easing to 'neutral' remains a significant risk.

Figure 34. Hong Kong and Singapore — Economic Forecasts, 2010-12F

		Hong Kong			Singapore		
		2010	2011F	2012F	2010	2011F	2012F
Real GDP	YoY	7.0%	5.6%	4.5%	14.5%	5.3%	3.3%
Final Domestic Demand	YoY	6.2	5.8	3.9	5.5	3.6	3.7
Private Consumption	YoY	6.2	7.2	3.7	4.2	4.7	3.4
Fixed Investment	YoY	7.8	3.0	4.7	5.1	2.5	3.6
Exports	YoY	16.8	5.6	6.4	19.2	4.2	4.8
Imports	YoY	17.3	5.1	6.0	16.6	4.0	6.0
CPI	YoY	2.4	5.3	4.0	2.8	5.1	3.0
Unemployment Rate	%	4.4	3.4	3.5	2.2	2.1	2.3
Current Account	US$ bn	13.9	20.0	24.4	49.5	43.5	42.9
	% of GDP	6.2	8.3	9.3	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	7.78	7.77	1.36	1.27	1.24

Sources: Haver Analytics and Citi Investment Research and Analysis

Russia

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We expect the ruble to continue depreciating to 37-38 against the basket, provided the global financial turbulence continues and the Brent oil price falls to US$86 pb on average in 2012 as our commodity team expects. For now, depreciation pressure is stemming largely from contagion, but it could accelerate should the CBR start providing liquidity aggressively, thus giving domestic banks ammunition to position against the ruble. Should markets stabilize and oil prices hold up at US$100, we believe the ruble could regain some of its losses. We are also cutting our economic growth forecast: down this year (by 0.2pp to 4.0%) and next (by 1.5pp to 2.5%) given an anticipated slowdown in the global economy, volatility in the financial market and our expectation for lower oil prices. While the 2Q GDP number – 3.4% YoY – came well below expectations, internal demand looks robust. Private consumption rose about 5% YoY and investment and construction activity have accelerated significantly recently. We expect a fiscal deficit of about 1.5% of GDP in 2011, allowing for higher social spending and the indexation of public wages in 2H11. We expect the fiscal deficit will widen to 3-4% of GDP in the next three years and public debt to grow by about US$50bn per annum.

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At 8.8% YoY, Turkey's 2Q GDP came in stronger-than-expected (6.4%) on the back of robust domestic demand. Standing at 1.3%QoQ (SWA), the pace of economic activity remained strong in the second quarter, though the momentum seems to be softening compared with the last quarter of 2010 (3.6% QoQ, SWA) and the first quarter of 2011 (1.7%QoQ, SWA). Despite our expectations of a softer 2H, we don't think the CBT is facing a struggling economy. This, coupled with the deterioration in underlying inflation dynamics, reduces the likelihood of a rate cut during the remainder of the year, in our view. Concerning our FX outlook, despite the envisaged improvement in the current account balance going forward, the country's external financing needs will remain large, which prevents us from becoming constructive about the secular outlook for the lira. The S&P's recent decision to upgrade Turkey's local currency credit rating, while keeping FC rating unchanged, suggests that an upgrade to IG on FC debt remains a challenge requiring major policy efforts. In this regard, the government's new Medium-Term Plan (to be announced in early October) will have an important signaling effect, which may in turn have implications for the trajectory of the lira.

Figure 35. Russia and Turkey — Economic Forecasts, 2010-12F

		Russia			Turkey		
		2010	2011F	2012F	2010	2011F	2012F
Real GDP	YoY	4.0%	4.0%	2.5%	9.0%	7.3%	2.5%
Final Domestic Demand	YoY	3.3	8.2	3.3	10.7	10.0	1.6
Private Consumption	YoY	3.0	5.3	3.0	6.7	6.5	0.8
Fixed Investment	YoY	6.1	7.5	5.0	29.9	22.1	2.9
Exports	YoY	7.1	3.3	2.7	3.4	3.8	1.8
Imports	YoY	25.6	17.0	3.6	20.7	13.2	-1.4
CPI	YoY	6.9	8.8	7.2	8.6	6.0	7.5
Unemployment Rate	%	7.5	7.3	7.5	11.9	10.2	10.4
Current Account	US$ bn	71.1	81.3	31.4	-47.7	-70.4	-62.0
	% of GDP	4.8	4.8	1.9	-6.5	-9.6	-8.4
Fiscal Balance	% of GDP	-4.0	-1.4	-3.1	-3.6	-1.9	-2.7
US Dollar Exchange Rate	Average	30.4	30.3	33.7	1.50	1.72	1.87

Sources: Haver Analytics and Citi Investment Research and Analysis

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A deteriorating global growth environment and fears of contagion have contributed to a substantial revision of our GDP forecasts for Hungary. In response to weaker growth prospects, the government reiterated its commitment to keep the fiscal deficit below 3% of GDP in 2012 and presented a set of fiscal measures that are to help achieve that target. We see a risk that the new fiscal measures may not be sufficient to keep the general government deficit below 3% of GDP, especially in the event of a deeper-than-expected economic slowdown. The Hungarian Parliament adopted also a new law that allows households to repay foreign currency-denominated mortgages in a single step at an off-market exchange rate of CHF/HUF 180. The FX loss related to such repayments will be borne by Hungarian banks, and assuming that 25% of clients will have access to refinancing loans or sufficient savings to take advantage of the repayment option, the cost to banks could reach 1% of GDP. The resulting demand for foreign currencies could put downward pressure on the forint; however, the central bank is ready to provide FX from its official reserves to limit market pressures, partly reducing the risk of a disruptive depreciation. We expect interest rates to remain on hold in the coming months with some risk of rate hikes in the event of substantial currency depreciation.

Poland

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2Q GDP growth decelerated to 4.3% YoY from 4.4% YoY in 1Q, which comprised: deceleration in private consumption to 3.5% YoY from 3.9% YoY in 1Q, acceleration of investments growth to 7.8% YoY from 6% YoY, and high stock-building. The deterioration of global economic growth prospects, especially in the euro zone, should negatively affect the Polish economy in the next quarters. Consumption may be negatively affected by probable deterioration in labour market conditions and weaker zloty versus the Swiss franc. At the same time, public consumption may be reduced due to fiscal tightening. Increased uncertainty and lower confidence may negatively affect private investments. All in all we revise down our forecasts for Poland in 2012. We also revise upwards the path of inflation for the next 3-6 months due mainly to a weaker zloty, which is under pressure in the current risk-off environment. Further zloty weakening to above 4.70 would increase the risk of Poland's debt-to-GDP ratio exceeding the 55% threshold level, which would require substantial fiscal tightening. Therefore, the Ministry of Finance may decide to intensify its interventions to the end of this year to secure a stronger zloty. We think attempts to stabilize the zloty will stop the central bank from immediate rate cuts. However, given the prospect of monetary easing in the Euro Area, we now believe the Polish MPC will vote to cut rates in 2Q 2012.

Figure 36. Hungary and Poland — Economic Forecasts, 2010-12F

		Hungary			Poland		
		2010	2011F	2012F	2010	2011F	2012F
Real GDP	YoY	1.2%	1.4%	1.1%	3.8%	3.8%	1.9%
Final Domestic Demand	YoY	-2.8	-0.8	-0.4	2.1	3.3	1.0
Private Consumption	YoY	-2.1	0.2	-0.2	3.2	3.2	2.0
Fixed Investment	YoY	-5.6	-4.4	-0.9	-2.0	5.7	-0.8
Exports	YoY	14.1	8.5	5.0	10.1	5.2	1.4
Imports	YoY	12.0	7.0	3.8	11.5	4.8	-1.8
CPI	YoY	4.7	3.9	4.8	2.7	4.2	3.0
Unemployment Rate	%	11.2	11.5	11.8	12.1	11.1	10.0
Current Account	US$ bn	2.7	4.0	4.9	-15.9	-21.4	-15.7
	% of GDP	2.1	3.0	4.3	-3.4	-4.4	-3.4
Fiscal Balance	% of GDP	-4.2	1.9	-3.0	-7.9	-5.3	-4.5
US Dollar Exchange Rate	Average	208	211	260	3.0	3.1	3.4

Sources: Haver Analytics and Citi Investment Research and Analysis

Czech Republic

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We have cut our GDP growth forecast to 0.6% YoY in 2012 (from 1.5%) and 1.9% in 2011 (from 2.1%) as foreign demand is likely to slow below the forecasts of the CNB (2.2% YoY in 2012) and MoF (2.5%). Industrial production growth eased in July and we expect it to drop to 2% YoY in September because of a regular temporary stoppage at a refinery industry. We expect little or no growth in industrial production in 2012. The main downside risk to our forecasts is the slowdown in export activity. Domestic demand remains weak, with retail sales still falling in July, although 2Q wage data and the August unemployment rate improved. CPI growth undershot again in August and we expect the CPI to undershoot the CNB's forecast in the remainder of the year. The economic slowdown is likely to lead to some pressure for tighter fiscal policy, but we believe the fiscal deficit is manageable unless the economy starts to contract. The koruna has been weaker compared to the CNB forecast and we expect this to persist. In spite of this, we expect the CNB to keep the main policy rate unchanged at 0.75% also in 2012 with the koruna to be an inflationary risk, and the external environment a key disinflationary risk. But a weaker koruna is likely to be welcomed later by the CNB to ease monetary conditions and to offset the pressure to cut its policy rate, unless we see EURCZK above 25 (which is our forecast) accompanied by stronger-than-expected GDP.

Romania

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Contagion effects from the ongoing Greek crisis continue to play on investors' minds due to the relatively high presence of Greek-owned banks in Romania (about 16% of total bank assets). It is true that there are several mitigating factors: (i) despite the rising concerns about Greece, there are so far no visible signs of stress in the form of a run on subsidiaries of euro zone periphery banks or capital outflows; (ii) the Greek-owned banks in Romania don't hold a significant amount of Greek sovereign debt and have low exposures to other Greek entities; and (iii) the NBR, which can draw on external assistance if needed, appears to be in a strong position to contain the situation in the event of such a shock. Nonetheless, we believe that investors' appetite for Romanian assets will remain subdued until there is more clarity on Greek sovereign debt woes. On the monetary policy front, while the improvement in the near-term inflation outlook and difficult growth prospects have raised the probability of a rate cut, we think that the NBR will keep rates on hold at 6.25% during the remainder of the year. The NBR officials remain cautious, since a rate cut this year may not be a prudent move due to rising concerns about the Greek crisis and the elevated level of risk aversion.

Figure 37. Czech Republic and Romania — Economic Forecasts, 2010-12F

		Czech Republic			Romania		
		2010	2011F	2012F	2010	2011F	2012F
Real GDP	YoY	2.3%	1.9%	0.6%	-1.3%	1.6%	2.0%
Final Domestic Demand	YoY	-0.9	-0.2	-0.3	-4.3	-0.1	3.4
Private Consumption	YoY	0.0	-0.3	-0.1	-1.5	0.4	3.5
Fixed Investment	YoY	-3.1	1.6	-2.1	-13.1	-0.7	3.0
Exports	YoY	18.0	9.2	1.5	14.3	16.2	4.2
Imports	YoY	18.0	7.2	0.7	12.4	10.8	5.2
CPI	YoY	1.5	1.8	2.5	6.1	6.2	3.7
Unemployment Rate	%	9.0	8.6	9.2	6.9	6.6	6.1
Current Account	US$ bn	-7.2	-8.0	-6.9	-6.8	-7.8	-9.2
	% of GDP	-3.7	-3.8	-3.5	-4.2	-4.2	-5.0
Fiscal Balance	% of GDP	-4.7	-4.5	-4.0	-6.7	-4.5	-3.0
US Dollar Exchange Rate	Average	19.1	18.0	19.7	3.2	3.1	3.2

Sources: Haver Analytics and Citi Investment Research and Analysis

Brazil

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Copom's surprising decision to cut the Selic rate in August (to 12% from 12.50%) and the consequent decline in real interest rates should increase inflation risks in coming months, raising the likelihood it will surpass the target band this year. Simultaneously, the decision also indicated that monetary policy probably will be looser in 2012 than we previously expected. This stimulus, together with the likely more expansionary fiscal policy, suggests that 2012 GDP growth may be stronger than the market currently forecasts. On the FX front, the recent deterioration in the global outlook, reflected in lower commodity prices, higher risk aversion and a more dovish stance in monetary policy, suggests that part of the recent BRL depreciation should persist. We maintain our more constructive view regarding trade balance/current account performances this year, while in terms of fiscal policy we keep our view that the public sector will accomplish its primary fiscal target this year.

Mexico

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Economic activity began the second half with reasonable results. Industrial production growth in July at 3.2% YY was below our expectation, but internal demand indicators, such as retail sales, employment and bank lending, are still gaining momentum. We therefore keep our 2011 GDP growth forecast at 4.1%. For 2012, our projection also remains unchanged at 3.5% but we reiterate that forecast risks appear tilted to the downside, albeit limited by the fact that US manufacturing is still performing better than the rest of the economy. In any case, Banxico has made clear that a shift in current prospects – given inflation closing at around the 3.5% level this year and next – could lead policy makers to consider rate cuts. For the moment, however, we stick to the central scenario that Banxico will keep the policy rate at 4.5% throughout 2011-12. This is particularly the case since peso weakness vs. the USD during the recent episode of global volatility already implies looser monetary conditions. We think the USD/MXN has overshot relative to fundamentals and therefore we see space for the MXN to explore stronger levels towards year-end (partially reversing from current levels), in tandem with an expected partial easing in risk aversion abroad.

Figure 38. Brazil and Mexico — Economic Forecasts, 2010-12F

		Brazil			Mexico		
		2010	2011F	2012F	2010	2011F	2012F
Real GDP	YoY	7.5%	3.7%	4.0%	5.4%	4.1%	3.5%
Final Domestic Demand	YoY	8.3	4.8	4.4	4.2	4.8	4.2
Private Consumption	YoY	7.0	4.9	3.5	5.0	4.4	3.6
Fixed Investment	YoY	21.9	5.5	4.7	2.3	8.6	7.3
Exports	YoY	11.5	3.3	6.4	24.3	9.4	8.0
Imports	YoY	36.2	10.0	8.8	22.1	10.4	10.3
CPI	YoY	5.0	6.6	5.7	4.2	3.4	3.8
Unemployment Rate	%	6.7	6.3	6.3	5.4	5.2	4.7
Current Account	US$ bn	-47.4	-54.1	-70.8	-5.6	-13.0	-30.7
	% of GDP	-2.3	-2.2	-2.7	-0.5	-1.1	-2.6
Fiscal Balance	% of GDP	-2.5	-2.5	-2.5	-2.8	-2.5	-2.0
US Dollar Exchange Rate	Average	1.76	1.72	1.80	12.6	12.6	13.0

Sources: Haver Analytics and Citi Investment Research and Analysis

Argentina

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There have been no major changes in the political outlook. Cristina Fernández de Kirchner's victory in the first round in the October 23 presidential elections seems likely, as the opposition remains highly fragmented, even after the strong blow its candidates suffered in the August 14 open primaries. Regarding the economic outlook, activity indicators continue to show momentum, especially those produced by the National Statistical Institute (INDEC). According to the INDEC, GDP grew 9.1% YY in real terms during 2Q11 and 9.5% YY in 1H11. In our view, those figures seem overestimated, and we think that real economic expansion during 1H11 was around 7% y/y. Not everything is going well on the economic front, as capital flight has risen and in September it probably has been above US$3 billion, the highest level since October 2008. The big question is if capital flight is likely to continue after the October presidential elections or not. If capital flight does not dwindle after the presidential elections, the chances of the economy marching towards stagnation are far from negligible, we believe.

Venezuela

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The Venezuelan economy expanded 3.6% year over year in 1H11, driven mostly by growth in the communications and retail sectors. Construction showed overall weakness, falling for a second consecutive quarter. This poses a challenge for the administration as it is using the housing construction program as the flagship of its social agenda. Prices continue to rise at a pace roughly consistent with annual inflation of 26-28%, although, as with many emerging economies, the biggest risk is that the adverse effects of the global slowdown could overwhelm the burgeoning domestic activity recovery. In this regard, it is worth noting that the Venezuelan economy suffered the most among its LatAm peers back in 2009, as the slump in oil prices sent the economy into seven continuous quarters of negative growth. This is the reason why we consider Venezuela to be the economy with the highest risks in the region if the global outlook deteriorates further.

Figure 39. Argentina and Venezuela — Economic Forecasts, 2010-12F

		Argentina			Venezuela		
		2010	2011F	2012F	2010	2011F	2012F
Real GDP	YoY	9.2%	8.5%	5.0%	-1.4%	3.5%	3.9%
Final Domestic Demand	YoY	11.6	11.9	6.7	-2.1	5.6	5.1
Private Consumption	YoY	9.0	10.1	5.1	-2.3	5.5	7.8
Fixed Investment	YoY	21.2	9.0	3.6	-4.4	-5.9	-2.4
Exports	YoY	14.6	-0.2	5.2	-12.4	5.5	-0.7
Imports	YoY	34.0	21.7	12.9	-4.6	10.9	6.0
CPI	YoY	18.4	25.0	22.5	28.2	27.0	26.3
Unemployment Rate	%	9.3	8.1	7.8	8.5	8.8	6.7
Current Account	US$ bn	3.6	-0.5	-2.0	14.4	34.4	43.3
	% of GDP	1.0	-0.1	-0.5	3.7	11.6	11.0
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

Saudi Arabia

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We expect an average WTI oil price of $89 per barrel this year, down from $98 YTD, but believe government revenues are likely to remain buoyed by an increase in production. Saudi Arabia could cut back to 9 million barrels per day (from 9.9mbpd in August) for the remainder of the year and overall production would still register a 10% increase. Such a cutback is unlikely, in our view, leaving risks to production forecasts firmly to the upside. Assuming stable non-oil revenues and expenditure growth of 40% this year (reflecting the slew of social expenditures announced earlier this year), we continue to expect a small fiscal surplus (1% of GDP) in 2011. Going forward, it is likely that Saudi Arabia will begin to accumulate fiscal deficits given our projected oil price of around $75 per barrel of WTI, and a fiscal breakeven that will hover in the mid to high $80s per barrel WTI mark. However, we remain confident that Saudi Arabia has the fiscal space to absorb these deficits, either through resorting to its considerable fiscal assets (government deposits at SAMA stood just shy of $290bn in July, or 65% of projected 2011 GDP) or through borrowing. Economic growth will remain robust, in our view. We do not expect the government to curtail expenditure despite slowing revenues, as priority is being given to social stability and diversification of the economy for the purpose of creating employment. Non-oil growth is thus likely to remain strong on the back of high government expenditure, and will be given a further boost by the passing of the mortgage law (which we expect imminently) and the increase in local employment.

United Arab Emirates

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The deteriorating global outlook spells risks for the UAE on three fronts, and we now consider risks to our economic forecasts to be to the downside. First, the fall in global oil prices in recent months will squeeze revenues at the Abu Dhabi level, and we have already seen that emirate begin to pull back from some previously anticipated investments, particularly in the non-oil sector. Second, slower growth in global demand may impact Dubai's ongoing recovery, dependent as it is on global trade, tourism and transportation. Finally, the retrenchment in global risk appetite will expose entities in the UAE to heightened refinancing risks if financial conditions remain tight in the medium term. That said, we believe that Dubai in particular will continue to benefit from its safe-haven status at a time of continued Middle East unrest, providing significant tailwinds to its tourism and banking industries. The latest figures show a surge in domestic deposits in the UAE, easing previous liquidity constraints in the banking sector and creating conditions for a renewal of growth in bank lending.

Figure 40. Saudi Arabia and United Arab Emirates — Economic Forecasts, 2010-12F

		Saudi Arabia			United Arab Emirates		
		2010	2011F	2012F	2010	2011F	2012F
Real GDP	YoY	3.8%	7.2%	6.2%	2.1%	2.2%	2.3%
Final Domestic Demand	YoY	-0.8	9.9	7.8	1.9	3.1	3.5
Private Consumption	YoY	2.3	10.0	5.0	1.0	1.0	2.0
Fixed Investment	YoY	-5.6	15.0	10.0	5.0	5.0	5.0
Exports	YoY	5.0	10.5	8.0	10.0	13.0	13.0
Imports	YoY	-8.0	15.0	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	21.7	9.6	8.5
	% of GDP	16.5	10.1	7.5	7.9	3.3	2.7
Fiscal Balance	% of GDP	6.7	0.8	-3.7	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

Nigeria

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GDP data shows that growth slowed marginally in 1H 2011, because of the political uncertainty around the elections and lower government spending. But growth is still quite robust; we forecast 7.1% for the year. Inflation fell into single digits in July and August, but we think that further significant falls are unlikely and that it will remain in high single/low double digits levels into 2012. The appointment of Ngozi Okonjo-Iweala as finance minister, alongside incumbent central bank governor, Lamido Sanusi, creates a respected economic team committed to improving fiscal discipline and driving a return to more orthodox monetary policies. However, the focus will now be the speed with which the new government makes progress with structural reforms which have been in the pipeline for some time, led by reforms of the power sector and the oil industry. But, the combination of improved fiscal discipline, higher interest rates and recovering oil production should allow the central bank to maintain naira stability unless there is a significant fall in the oil price.

South Africa

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We are again downgrading our real GDP growth forecasts for 2011 and 2012, and now expect only 3.0% average growth this year and 2.8% in 2012. Ongoing global financial tensions and their negative impact on local business sentiment are the key reasons behind this revision. In addition, widespread strikes in early Q3 probably forced companies to reduce inventories, resulting in a poor Q3 GDP performance. We see a rebound from Q4 onwards, but private consumption growth – so far the main driver of expansion – will probably suffer from eroding real wage growth. Job prospects remain flat, fixed investment projects may be delayed by the current drop in business confidence and housing has not yet bottomed, despite very low real interest rates. Inflation is likely to be higher by 0.3 percentage point on average in 2012 compared with our earlier forecast – because of a weaker rand and despite slower GDP growth – but we still do not see a sustained breach of the 3-6% target. We still expect the current account deficit to widen in 2012 amid less-supportive commodity prices, but by less than we previously projected because the rand is weaker and the recovery in domestic fixed investment is delayed. Mixed risks to the inflation outlook probably will preclude additional monetary easing but rates look set to stay on hold for a long while, with no hikes before 2H12. Discretionary fiscal policy easing looks unlikely, but the deficit probably will widen temporarily as growth slows.

Figure 41. Nigeria and South Africa — Economic Forecasts, 2010-12F

		Nigeria			South Africa		
		2010	2011F	2012F	2010	2011F	2012F
Real GDP	YoY	7.2%	7.1%	6.7%	2.8%	3.0%	2.8%
Final Domestic Demand	YoY	NA	NA	NA	2.8	4.0	3.4
Private Consumption	YoY	NA	NA	NA	4.4	4.5	3.4
Fixed Investment	YoY	NA	NA	NA	-3.7	2.2	3.0
Exports	YoY	NA	NA	NA	4.7	3.0	2.7
Imports	YoY	NA	NA	NA	9.6	7.4	4.7
CPI	YoY	13.7	10.9	13.0	4.1	5.0	5.8
Unemployment Rate	%	NA	NA	NA	25.5	26.0	25.7
Current Account	US$ bn	14.2	23.7	21.4	-10.0	-12.7	-17.5
	% of GDP	6.1	8.8	6.4	-2.7	-3.3	-4.7
Fiscal Balance	% of GDP	-4.9	-2.3	-2.4	-5.2	-5.6	-5.6
US Dollar Exchange Rate	Average	151	154	153	7.32	7.45	8.40

Sources: Haver Analytics and Citi Investment Research and Analysis

Figure 42. 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	**9.2%**	**7.4%**	**7.3%**	**4.2%**	**5.8%**	**4.7%**	**4.0%**	**2.9%**	**2.4%**	**-2.4%**	**-2.7%**	**-2.4%**
China	10.4	9.0	8.7	3.3	5.3	4.2	5.2	4.0	3.2	-1.6	-2.0	-2.0
Hong Kong	7.0	5.6	4.5	2.4	5.3	4.0	6.2	8.3	9.3	4.2	2.9	3.0
India*	8.5	7.6	8.2	8.6	9.5	7.5	-2.6	-3.0	-2.3	-8.1	-8.3	-7.1
Indonesia	6.1	6.5	6.3	5.1	5.0	6.2	0.9	0.1	-0.3	-0.6	-1.5	-1.5
Korea	6.2	3.7	3.9	3.0	4.5	3.5	2.8	1.4	1.1	1.4	0.5	0.7
Malaysia	7.2	4.7	5.0	1.7	3.2	2.7	11.8	10.5	9.0	-5.6	-5.4	-5.0
Pakistan	2.4	3.5	5.0	13.9	12.0	12.0	0.2	-1.7	-1.6	-6.2	-4.0	-3.9
Philippines	7.6	3.7	3.9	3.8	4.3	3.5	4.2	3.5	3.0	-3.5	-1.6	-1.2
Singapore	14.5	5.3	3.3	2.8	5.1	3.0	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	-4.1	-4.0	-8.0	-6.8	-5.2
Taiwan	10.8	4.8	4.6	1.0	1.3	1.5	9.4	8.0	8.0	-3.2	-2.5	-2.4
Thailand	7.8	2.7	3.4	3.3	3.8	3.5	4.6	5.1	3.0	-2.0	-2.9	-2.0
Vietnam	6.8	5.7	6.4	9.2	18.7	11.8	-4.7	-6.8	-6.2	-7.9	-5.0	-4.8
Latin America	**6.1%**	**4.5%**	**4.1%**	**7.5%**	**8.2%**	**7.5%**	**-1.0%**	**-1.0%**	**-1.4%**	**-2.6%**	**-2.3%**	**-2.0%**
Argentina	9.2	8.5	5.0	18.4	25.0	22.5	1.0	-0.1	0.9	0.2	-0.6	1.0
Brazil	7.5	3.7	4.0	5.0	6.6	5.7	-2.3	-2.2	-2.7	-2.5	-2.5	-2.5
Chile	5.2	6.3	4.5	1.4	3.2	2.9	1.9	-0.8	-1.8	-0.3	0.9	1.0
Colombia	4.3	5.0	4.8	2.3	3.3	3.5	-3.1	-2.2	-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	4.1	3.5	4.2	3.4	3.8	-0.5	-1.1	-2.6	-2.8	-2.5	-2.0
Panama	7.5	10.0	7.5	3.5	6.3	7.0	-11.0	-13.5	-12.1	-1.9	-3.0	-2.0
Peru	8.8	6.5	5.5	1.5	3.2	3.1	-1.5	-3.0	-3.6	-0.8	1.4	1.1
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	27.0	26.3	3.7	11.6	11.0	-6.6	-5.0	-5.0
Europe	**4.6%**	**4.4%**	**2.3%**	**6.1%**	**6.8%**	**6.2%**	**-0.1%**	**-0.5%**	**-1.6%**	**-4.8%**	**-2.4%**	**-3.2%**
Czech Republic	2.3	1.9	0.6	1.5	1.8	2.5	-3.7	-3.8	-3.5	-4.7	-4.5	-4.0
Hungary	1.2	1.4	1.1	4.7	3.9	4.8	2.1	3.0	4.3	-4.2	1.9	-3.0
Kazakhstan	7.0	6.4	4.5	7.1	8.6	7.3	3.1	7.6	5.3	-2.6	-1.9	-2.1
Poland	3.8	3.8	1.9	2.7	4.2	3.0	-3.4	-4.4	-3.4	-7.9	-5.3	-4.5
Romania	-1.3	1.6	2.0	6.1	6.2	3.7	-4.2	-4.2	-5.0	-6.7	-4.5	-3.0
Russia	4.0	4.0	2.5	6.9	8.8	7.2	4.8	4.8	1.9	-4.0	-1.4	-3.1
Slovakia	4.0	2.9	1.0	1.0	3.8	2.1	-3.4	-4.8	-3.9	-7.5	-5.4	-4.3
Turkey	9.0	7.3	2.5	8.6	6.0	7.5	-6.5	-9.6	-8.4	-3.6	-1.9	-2.7
Ukraine	4.2	4.7	4.0	9.4	9.3	9.2	-2.1	-2.5	-5.0	-5.9	-3.8	-3.1
Africa/Mideast	**4.7%**	**5.2%**	**4.9%**	**5.0%**	**5.9%**	**6.2%**	**6.3%**	**5.2%**	**4.4%**	**0.1%**	**-0.5%**	**-1.9%**
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	9.8	9.5	-2.1	-3.5	-3.0	-8.1	-9.0	-8.8
Ghana	6.6	15.5	7.3	10.7	9.5	8.0	-7.2	-6.9	-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	-11.1	2.2	-11.7
Israel	4.7	4.3	2.5	2.7	3.4	2.3	3.1	-0.4	-1.2	-3.0	-2.0	-2.5
Jordan	5.0	3.5	4.6	5.0	5.0	5.0	-5.0	-8.3	-8.0	-5.6	-3.0	-2.7
Kenya	5.3	5.7	6.1	4.4	14.4	11.3	-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	-8.4	-8.9
Nigeria	7.2	7.1	6.7	13.7	10.9	13.0	6.1	8.8	6.4	-4.9	-2.3	-2.4
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	9.3	12.8	9.4	-2.4	3.0	3.0	19.3	18.9	15.2	15.2	15.0	14.6
Saudi Arabia	3.8	7.2	6.2	5.4	7.0	8.0	16.5	10.1	7.5	6.7	0.8	-3.7
South Africa	2.8	3.0	2.8	4.1	5.0	5.8	-2.7	-3.3	-4.7	-5.2	-5.6	-5.6
Tanzania	6.9	7.2	7.6	6.2	11.4	9.3	-9.5	-10.1	-9.6	-6.4	-5.5	-5.0
UAE	2.1	2.2	2.3	1.5	2.0	2.4	7.9	3.3	2.7	0.0	0.0	0.0
Uganda	6.9	7.2	7.6	4.1	16.4	10.7	-9.9	-10.6	-9.2	-4.5	-5.0	-5.1
Zambia	7.6	7.2	6.8	8.5	9.0	8.3	3.8	6.6	3.0	-3.1	-3.9	-3.5
Total	**7.3%**	**6.0%**	**5.5%**	**5.3%**	**6.5%**	**5.7%**	**2.5%**	**1.8%**	**1.3%**	**-2.6%**	**-2.3%**	**-2.4%**

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

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Source: Citi Investment Research and Analysis.

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

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Rates Strategy

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The highlight of the last few weeks in terms of news headlines was probably the FOMC meeting but the business end of the proceedings is undoubtedly still the deteriorating situation in EMU. The average of tier two spreads has widened 70bp versus tier one spreads and our blended tier three measure has widened 250bp against tier two. The Euro crisis now threatens to derail confidence across the system and is having a detrimental effect on global growth expectations.

The Fed's flattening trade

The Fed announced a USD 400 billion duration extension trade last week, selling sub 3yr paper to buy 6-30yr paper. The longer than expected maturity switch has triggered a dramatic flattening of the US Treasury yield curve but it has failed to boost risk assets.

We suspect that there will need to be a significant further flattening of the curve before equity markets can really respond, thus while we think the impact on the level of yields may be muted compared to QE2, given the different structure of the package, we think the yield curve flattening move potentially has a lot further to run.

Tier 2 EMU spreads likely to remain under pressure

Despite Italy's latest, less outdated, growth forecasts, and their second austerity package in as many months, we remain pessimistic on the prospects for sustained spread compression in tier two markets in the immediate future. Considerable uncertainties surround Italy's package, which require clarification, but it is the politics and implementation risks that pose the main threats to the targets being met, and to future growth.

We expect sovereign ratings in EMU to come under further pressure in coming months and with the market now implying a very high probability of a Greek default it seems that tier two may be where the next wave of pressure comes from. That said, we note that CDS spreads in the core markets are also heading sharply higher. Germany and the Netherlands were, at the time of writing, flirting with the 100bp level, which is where Japan traded at the start of the month. The market is fast losing patience with the apparent political impasse and we believe that this will continue to drive risk premia higher.

Forecasts revised lower

With growth expectations declining fast and an increasing sense that the sovereign debt crisis and the global slowdown in growth are inextricably linked, we have revised down many of our yield forecasts this month. Forecasting beyond a few weeks is very difficult at the present time because the policy response from central banks will inevitably change depending on how the economies react to new and unusual measures. Our forecasts are therefore based on a central scenario with the caveat that extreme scenario probabilities are rising. The central scenario is one of positive but weak growth, modest price pressures and low and stable policy rates throughout 2012. We expect continued downward pressure on yields from central bank bond purchases in the US and the UK too. This is likely to mean low and stable bond yields, flatter curves and probably decreasing realized volatility. We do, however, urge investors to consider tail-risk hedges in such an uncertain environment.

Figure 45. Interest Rate and Bond Market Forecasts (End of Period), as of 28 Sep 2011

	Forecast End Period					
	Current	4Q 11	1Q 12	2Q 12	3Q 12	4Q 12
US						
Policy Rate (Fed Funds) End Quarter	0.25	0.25	0.25	0.25	0.25	0.25
3-Month Libor	0.37	0.38	0.40	0.45	0.50	0.60
2 Year Treasury Yield	0.24	0.25	0.25	0.35	0.40	0.65
5 Year Treasury Yield	0.95	0.95	0.95	1.25	1.35	1.60
10 Year Treasury Yield	1.98	2.00	2.00	2.30	2.60	2.90
30 Year Treasury Yield	3.09	3.10	3.10	3.35	3.60	3.90
2-10 Year Treasury Curve	174	175	175	195	220	225
2 Year Swap Spread (Swap Less Govt.), bp	28	34	34	35	35	35
10 Year Swap Spread (Swap Less Govt.), bp	18	20	20	20	22	25
30 Year Mortgage Yield	4.05	4.1	4.1	4.3	4.4	4.7
10 Year Breakeven Inflation	188	195	205	215	225	240
Euro Area						
Policy Rate	1.50	1.00	1.00	1.00	1.00	1.00
Overnight Rate (EONIA)	1.05	0.60	0.40	0.40	0.40	0.40
3-Month Libor	1.50	1.10	0.70	0.70	0.80	0.90
2 Year Treasury Yield	0.40	0.25	0.25	0.25	0.30	0.35
5 Year Treasury Yield	0.90	0.80	0.75	0.65	0.70	0.75
10 Year Treasury Yield	1.93	1.50	1.25	1.35	1.50	1.50
30 Year Treasury Yield	2.49	2.35	2.15	2.10	2.25	2.20
2-10 Year Treasury Curve	153	125	100	110	120	115
10 Year BTP-Bund Spread	390	450	475	450	425	400
10 Year Swap Spread (Swap Less Govt.), bp	71	85	80	75	70	60
10 Year Breakeven Inflation	135	125	115	120	125	130
Japan						
Policy Rate	0.10	0.10	0.10	0.10	0.10	0.10
3-Month Libor	0.19	0.19	0.17	0.15	0.15	0.15
2 Year Treasury Yield	0.13	0.15	0.15	0.15	0.10	0.10
5 Year Treasury Yield	0.34	0.35	0.45	0.45	0.40	0.35
10 Year Treasury Yield	1.01	1.20	1.20	1.10	1.05	1.05
30 Year Treasury Yield	1.92	2.00	2.10	2.10	2.05	2.00
2-10 Year Treasury Curve	88	105	105	95	95	95
2 Year Swap Spread (Swap Less Govt.), bp	21	20	24	24	22	20
10 Year Swap Spread (Swap Less Govt.), bp	-1	1	5	5	3	1
10 Year Breakeven Inflation	NA	NA.	NA	NA	NA	NA
UK						
Policy Rate	0.50	0.50	0.50	0.50	0.50	0.50
3-Month Libor	0.93	1.00	0.90	0.85	0.85	0.85
2 Year Treasury Yield	0.54	0.45	0.40	0.30	0.35	0.45
5 Year Treasury Yield	1.29	1.25	1.20	1.10	1.15	1.30
10 Year Treasury Yield	2.34	2.00	1.65	1.65	1.80	1.80
30 Year Treasury Yield	3.54	3.30	3.10	3.00	3.00	3.00
2-10 Year Treasury Curve	180	155	125	135	145	135
10 Year Swap Spread (Swap Less Govt.), bp	32	45	60	60	60	60
10 Year Breakeven Inflation	263	245	225	235	250	265
Australia						
Policy Rate	4.75	4.75	4.75	4.75	5.00	5.00
3-Month Libor	4.74	5.00	5.10	5.20	5.30	5.40
2 Year Treasury Yield	3.47	3.60	3.75	4.00	4.25	4.50
5 Year Treasury Yield	3.66	3.80	3.95	4.20	4.45	4.70
10 Year Treasury Yield	4.31	4.30	4.45	4.60	4.90	5.10
2-10 Year Treasury Curve	84	70	70	60	65	60
10 Year Swap Spread (Swap Less Govt.), bp	72	65	60	60	55	50

Source: Citi Investment Research and Analysis

Sovereign Ratings Outlook

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- We expect a series of sovereign ratings downgrades among Euro Area countries in the next 3-6 months, including Italy, Spain, Greece, Portugal and Cyprus. We also expect Italy, Spain, Portugal and Ireland to be downgraded further over the longer term (next 2-3 years). Over the next 2-3 years, we also expect that France and Austria are likely to be put on negative outlook, with Belgium at risk of a single notch downgrade.

- Over the longer term (next 2-3 years), we also expect that the sovereign ratings of the US and Japan will be downgraded in response to adverse medium-term fiscal trends.

- We do not currently expect the UK to be downgraded or put on negative outlook in the next few months or the longer term. But the UK is a relatively weak 'AAA', given the sharp rise in the fiscal deficit over recent years, surging public debts, large banking system, weak economic outlook and prospect that the deficit will overshoot official forecasts. The UK's rating could be at risk if the coalition falls apart or eases up on the fiscal consolidation programme.

- We regard the smaller European countries (Switzerland, Sweden, Denmark and Norway) as fairly solid AAAs for now, albeit with some concerns over the rising fiscal deficit, sluggish housing market and poor export performance in Denmark.

- We do not expect any ratings upgrades among advanced economies, either over the next few months or the next 2-3 years.[7]

[7] See "Sovereign Ratings Outlook", Michael Saunders and Mark Schofield, 12 September 2011, Citi

Figure 46. Advanced Economies — Sovereign Long-Term Debt Ratings and Citi Ratings Forecasts

	S&P Ratings				Moody's Ratings			
Country	Current Rating	Current Outlook	Citi Nearterm (3-6 months) Forecast Rating	Citi Longterm (2-3 Years) Forecast Rating and Outlook	Current Rating	Current Outlook	Citi Nearterm (3-6 months) Forecast Rating	Citi Longterm (2-3 Years) Forecast Rating and Outlook
US	AA+	Neg	AA+	AA ↓	Aaa	Neg	Aaa	Aa1 ↓
Canada	AAA	Stable	AAA	AAA	Aaa	Stable	Aaa	Aaa
Japan	AA-	Neg	AA-	A+ ↓	Aa3	Stable	Aa3	A1 ↓
Germany	AAA	Stable	AAA	AA	Aaa	Stable	Aaa	Aaa
France	AAA	Stable	AAA	AAA (Neg)	Aaa	Stable	Aaa	Aaa
Italy	A	Neg	A	A- ↓	Aa2 (Neg W)	NA	Aa3 ↓	A3 ↓↓↓↓
Spain	AA	Neg	AA- ↓	A- ↓↓↓↓	Aa2 (Neg W)	NA	Aa3 ↓	A3 ↓↓↓↓
Austria	AAA	Stable	AAA	AAA (Neg)	Aaa	Stable	Aa	Aaa
Belgium	AA+	Neg	AA+	AA ↓	Aa1	Stable	Aa1	Aa1 (Neg)
Finland	AAA	Stable	AAA	AAA	Aaa	Stable	Aaa	Aaa
Greece	CC	Neg	SD ↓	CC/C ↓	Ca	Developing	C ↓	Ca
Ireland	BBB+	Stable	BBB+	BBB ↓	Ba1	Neg	Ba1	Ba2 ↓
Netherlands	AAA	Stable	AAA	AAA	Aa	Stable	Aaa	Aaa
Portugal	BBB-	Neg	BB ↓↓	CC/C ↓↓↓↓↓	Ba2	Neg	Ba3 ↓	Ca ↓↓↓↓↓
Denmark	AAA	Stable	AAA	AAA	Aaa	Stable	Aaa	Aaa
Norway	AAA	Stable	AAA	AAA	Aaa	Stable	Aaa	Aaa
Sweden	AAA	Stable	AAA	AAA	Aaa	Stable	Aaa	Aaa
Switzerland	AAA	Stable	A A	AAA	Aaa	Stable	Aaa	Aaa
UK	AAA	Stable	AAA	AAA	Aaa	Stable	Aaa	Aaa

Note: Arrows denote expected ratings changes. (Neg) denotes negative outlook. (Neg W) denotes negative watch. Spain and Italy currently do not have a ratings outlook from Moodys, both are on negative watch. SD means Selective Default. The number of arrows denotes the expected change in ratings notches from the current level. We show a maximum of five arrows even for countries where we expect more than five notches of ratings change. In the outlook we have not included an extension of the actual EFSF lending beyond the now targeted €440bn maximum capacity. In the event that a substantial extension of the EFSF takes place and is likely to incur sizeable fiscal costs, the six AAA-rated Euro Area countries may be at risk of downgrade. NA Not available. Sources: Moody's, S&P and Citi Investment Research and Analysis

Credit Outlook

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The renewed sell-off in markets has left many investors struggling to find suitable comparisons. A 2001-style recession is virtually priced in, and at first sight seems a worse prospect than warranted either by the state of corporate balance sheets, or by most economists' main scenarios.

In many respects, though, we think 2008 is a better comparison.[8] As was the case then, the economic outlook depends as much upon markets as vice versa. And while banks' liquidity position is less of a concern than then, in other respects the current situation feels worse: policy makers on both sides of the Atlantic have less credibility, and the solutions are less obvious.

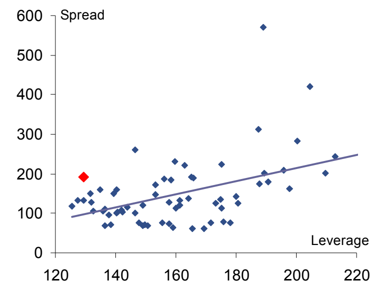
Growth prospects – forecast cutting to continue

Whilst Euro Area woes are the obvious culprit for the current sell-off, to our minds the sharp fall in economic indicators that began in August is almost as important. That fall was not confined to the euro periphery, but present in the US, in Germany and in emerging markets as well. And regardless of whether the cause of that fall was the policy tightening in EM, the US debt ceiling debacle or Euro Area woes spreading, feedback loops suggest to us that the process has further to run.

Market values – paradigm lost?

If it were just a case of the need to price in a renewed recession, we would feel more relaxed. After all, on most measures, we are already there. Spreads on non-financials in both the US and core Europe are already very close to 2001 levels. Net debt/EBITDA relationships suggest that credit market valuations already discount something like a 30% decline in non-financial earnings next year (see Figure 47).

Figure 47. -30% Earnings Already in the Price?
Net debt/EBITDA vs spreads, bp

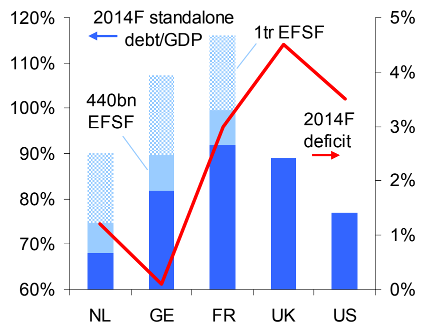


Source: CIRA, Yieldbook, Markit

The trouble is, investor after investor tells us that they do not know what the right paradigm is. The parallel they all fear is 2007-08. Then too, corporate balance sheets were not particularly stretched – yet a crisis in the banking sector sparked a collapse in growth and earnings which led to a rise in defaults and a surge in spreads in any case. When the threats on the macro side are so large, balance sheet and profit metrics are rendered little more than a historical curiosity.

Nowhere is this more obvious than in the banking sector. European bank CDS and cash bond spreads are at, or near, 2008 levels. As we see it, it is not simply a question of raising more capital. No amount of capital raising is likely to allow the European banking sector to withstand the impact of an Italian default, in our view. On the other hand, if it is just Greece, Ireland and Portugal we are talking about, and Italy and Spain can be ring-fenced, the losses would be small enough that most banks would barely need any capital at all (see Figure 48).

Figure 48. Why Italy and Spain Must Be Saved
Sovereign exposures vs bank capital



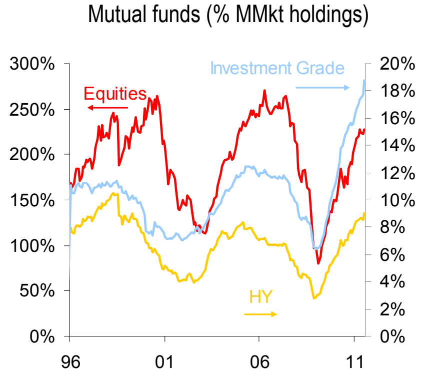
Source: Citi Investment Research and Analysis

Even in non-financials, it is not difficult to conjure up a scenario where spreads would widen to 2008 levels. Over the past two years, retail investors in the US alone have taken around $1tn out of money market funds and deposited it in credit and equity funds, spurred on by zero interest rates and the need to pick up yield. If the outlook continues to deteriorate, part of this flow may be reversed. After all, if the US is re-entering recession, equities are falling sharply and Europe is on the brink of multiple sovereign defaults, zero might not be such a bad return after all. Yet given current levels of liquidity in credit, forced selling in cash would send spreads gapping wider, regardless of fundamentals. Even after August's outflows, holdings

[8] Fundamentally, of course, the similarities are stronger with, say, the Latin American debt crises, given that the root of the immediate problem is sovereign debt. But in terms of magnitude, familiarity and scope for contagion, 2008 still seems the obvious comparison.

of risky assets relative to money market funds are still extremely elevated (see Figure 49). And, while our client survey shows that net long positions have fallen considerably in recent months, it also suggests that much of this has been through index hedging, rather than cash sales – hence the periodic sharp squeezes in CDS and steady widening of the basis.

Figure 49. Still Fully Invested, for Now



Source: Citi Investment Research and Analysis

Waiting for the cavalry

What could be done to avert such a nightmare scenario? Quite a lot, actually – but little of it feels very likely until things become much worse. It is not that policy makers are running out of ammunition – it is that the political will to use it is lacking. The ECB, for example, has the means to stop the widening in Italian and Spanish government bond spreads by either stepping up its purchases via the SMP or by drawing an SNB-style line in the sand – but the repeated references to the sole purpose of the SMP being to "ensure the orderly transmission of monetary policy", and the steady reduction in the scale of purchases, demonstrate that it does not consider it its job to do so.

The Fed, too, has plenty more ammunition in principle. QE1 and QE2 were remarkably effective in propping up markets while they lasted. But elevated levels of inflation and the growing political opposition to further balance sheet expansion have limited their room for manoeuvre.

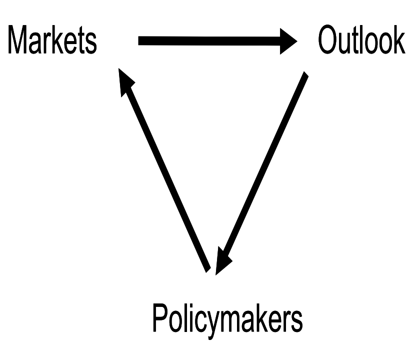
Politicians, too, could stop the sell-off in its tracks – but seem unlikely to do so. If Europe were actually to adopt a plan to restructure Greece, Ireland and Portugal but to effectively ring-fence Italy and Spain through a gigantically expanded EFSF-style liquidity cushion, as is beginning to be discussed, the outlook would improve in an instant. But political opposition makes such action unlikely.

Likewise in the US, if the supercommittee were to exceed its mandate, coming up with a long-term proposal for a return to budget surplus coupled with near-term stimulus, both markets and the rating agencies would be appeased. But, as with Europe, there needs to be greater recognition of just how desperate the situation is before the necessary will can be mustered to address it.

Next steps

Despite the vaguely encouraging signs from the IMF meetings over the weekend, we suspect that decisive measures will only be implemented if markets continue to push hard enough, and if the global economic outlook deteriorates enough, that policy makers realize they have little choice. Until that point we expect only brief short squeezes promptly followed by bigger sell-offs as markets and policy makers alike come to appreciate the magnitude of the hurdles confronting them.

Figure 50. Down and Round We Go



Source: Citi Investment Research and Analysis

And so we go from markets, to the outlook, to policy makers – and back to markets again. Because until these policy problems are addressed, the steady erosion of confidence seems likely to cause markets to sell off, and a sell-off in markets is a major driver of the economic outlook. It is no use firms and investors having cash if a crisis of confidence means they are not prepared to use it (Figure 50).

To sum up, it feels like in terms of time, the point of wanting to be outright long is beginning to be within sight: value is there, and it might only be a matter of months, or even weeks, before things are bad enough that policy makers start to take more decisive action. In terms of spread levels, though, those weeks or months could easily see a very significant move wider. With investors sounding bearish but not yet obviously short, and liquidity in cash minimal at best, it is hard to do more than to say we fear the collapse in confidence is not yet over, and to recommend strapping yourself in for the ride.

Global Equity Strategy

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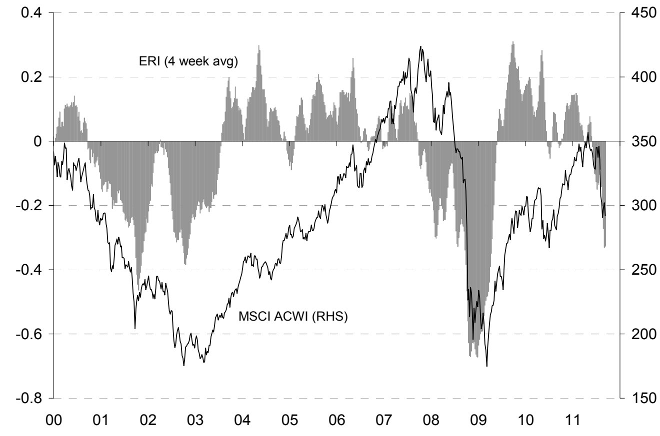
The ongoing sovereign crisis in Eurozone, lack of strong action from policy makers around the world and worries about global growth have all been drivers of weaker stock prices. Global equities are down 20% from their 2011 peaks. At current levels, we think stock markets are implying global EPS to contract by 10-15% for 2012. This is unlikely to happen, in our view. Our forecasts for global EPS growth are 12% for 2011 and 9% in 2012. As such, we believe markets are oversold and global stock indices will move higher with EPS. Figure 51 illustrates our forecasts.

Figure 51. MSCI ACWI and Citi Forecasts

Sources: MSCI, Citi Investment Research and Analysis

Figure 52. Global ERI and MSCI ACWI



Sources: CIRA, Factset

Valuations for global equities are approaching the lows that we saw during the 2008-09 bear market. Global equities trade on 1.5x price to book whereas the long-term average has been 2.1x. The global price to trend (10-year average) earnings ratio is 15.8x while the long-term average is 25x. Outside of the recent bear market, both these measures suggest equities are as cheap as they were in the early/mid 1980s or close to recession levels already.

However, our economists' forecasts are consistent with sluggish global GDP growth, not a recession. Although the risks to corporate profits have risen, especially in Europe, we do not believe they are consistent with a contraction in global EPS. While we remain constructive on equities, stock prices are unlikely to move convincingly higher until there are clearer signs of stability in economic activity and profits growth. So, which indicators have been helpful in the past to help confirm a market bottom? One has been the Citigroup Economic Surprise Index (CESI), which is a measure of economic data releases relative to expectations over the last 3 months. In the Euro Zone the CESI is hovering around its recent lows — consistent with economic data missing expectations by a considerable margin. In the US the CESI has been rising since June, but remains negative. We also find economists' forecasts can help confirm market lows. In the past the period of the biggest GDP downgrades has usually been around the time markets made bottoms. GDP downgrades have accelerated over last few months.

Timely indicators of corporate profits like our earnings revision index (ERI)[9] have also helped confirm a market bottom. ERI is a measure of EPS forecast changes made by bottom-up analysts. As shown in Figure 52, our global measure of ERI tends to be a coincident indicator of stock prices. Previous rebounds in stock prices have been confirmed by slowing in the pace of downgrades (i.e. analysts are still putting through more downgrades than upgrades, but less so than previously). We have just had the weakest 6 weeks for global earnings revisions since 2009. There are at least 2 downgrades for every upgrade. It is still too early to say earnings revisions have stabilized.

While our global measure of earning revisions is a coincident indicator of stock prices, earning revisions for the 'problem child' have at times led a bottom in stock prices. The 'problem child' is the part of the equity market that is at the epicentre of the pull-back or bear market. This region or sector usually suffers the biggest declines in earnings and prices. The problem child in the late 1990s was Asian Financials, in the early 2000s it was US Tech and in 2009 it was US Financials. In 2010 (and now) we think it is Continental European Financials. On average the pace of earnings downgrades for the problem child begins to slow 40-50 days before the market finds an eventual bottom. We are yet to see this happening, but we think we are getting closer after already big downgrades in European Financials over the last few weeks.

Our key regional and global sector recommendations are summarised in Figure 53. Emerging Markets remain our preferred structural growth play. EM economic and EPS momentum remain robust compared to DM. Balance sheets are strong for corporates, banks and governments. We stay Overweight. We are also Overweight Japan, which is our recovery play. The post-earthquake EPS downgrades have reversed and we believe Japan can benefit from positive earnings trends from this point. We are Neutral on the US. Although the US has its own fiscal problems, corporates in the US are buying back their shares at a rapid rate and EPS momentum remains solid. Europe ex UK has been one of the worst performers recently due to ongoing sovereign concerns. Although we see more serious risk to earnings in Continental Europe, cheap valuations and expectations of a market rebound keep us Neutral. We are Underweight UK and Developed Asia.

Our global sector strategy keeps a cyclical tilt. While these sectors have underperformed, our positive view on global corporate profits should be most beneficial for these sectors. We prefer to buy operational leverage rather than financial leverage. Our Overweights include IT, Materials and Industrials. We think these sectors are likely to benefit from a market rebound. Despite dismal earnings momentum, we keep Financials at Neutral as we think short-term performance may be strong if there is an improvement in investors' risk appetites. Our Underweights have a clear defensive tilt and include Telecoms, Health Care and Consumer Staples. Other than being defensive, these sectors should underperform as earnings revisions stabilize. Their valuations do not look particularly attractive either.

Figure 53. Regional And Global Sector Recommendations

Overweight	Neutral	Underweight
Global Emerging Markets	US	UK
Japan	Europe ex-UK	Developed Asia

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

Source: CIRA

[9] ERI is calculated as upgrades less downgrades divided by total number of estimates changed for period. ERI is available on Bloomberg CGQI <Go> Option 3 (ERI)

Securitized Products Strategy

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We expect securitized products spreads to remain fairly stable, as most sectors have performed well during the recent volatile market period. Moreover, securitization markets also outperformed competing high quality fixed income sectors, and we think this trend is sustainable for the near future. With an investors' stance that is decisively risk averse at this juncture, defensive positioning and spread stability remain key ingredients to deal with the ongoing market turmoil. Securitized products sectors have managed to finesse the market's strong credit de-risking trend and vicious volatility. We recommend remaining market weighted.

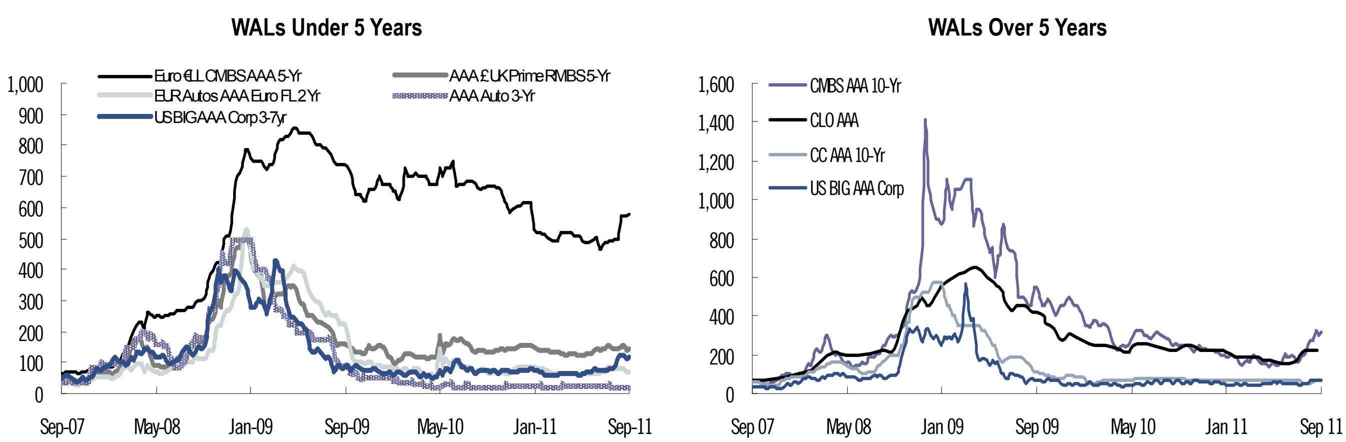
Still, to complement a focus on defense and stability, certain sectors offer interesting positioning opportunities in securitized markets.

- **Up in Credit.** We would use spread widening to go up in credit. Tiering is likely to become more prevalent as year-end approaches, and maintaining quality is a key defensive strategy.

- **"Operation Twist" Trades.** Long duration bonds could maximize any benefit deriving from the Fed "twist" operation. Longer securitized products sectors, such as 7-10YR credit cards or long triple-A CMBS classes would benefit the most. "Operation Twist" involved the Fed legging out of shorter-term coupon investments to extend maturities. This duration-extending mechanism would drive down longer-term yields.

- **Cross-sector Reallocation.** CMBS is likely to benefit from year-end sector re-allocation by money managers shifting from RMBS to CMBS for more yield pickup. This trend is in the early stage, in our view. The most recent PPIP quarterly performance report also shows that PPIP portfolio managers increased their CMBS allocation at the expense of non-Agency RMBS.[10] CMBS yields are very attractive, perhaps being oversold at this stage, in our view.

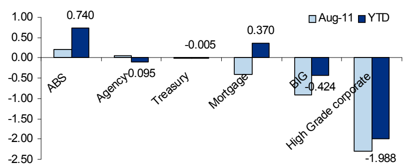
Figure 54. Selected Securitized Products Sectors — Spread Performance, Sep 07-Sep 11



Source: Citi Investment Research and Analysis

[10] See "PPIP Still Positive Technical for AMs and AJs," Citi, July 29, 2011.

Figure 55. Duration-Adjusted Total Rate of Return for Selected Citi Broad Investment Grade Indexes, August 2011 (%)



Source: Citi Investment Research and Analysis

Focus on Stability in the Face of Weaker Economic Outlook…

Our expectation for continued spread stability is supported by the recent performance of securitized markets. European ABS, for example, outperformed other markets during the recent market rout. Similarly, the consumer ABS index duration-adjusted returns lead alternative high-quality indexes' performances for the month of August, and also for the year to date (Figure 55).

Challenging broad market headwinds underscore our focus on stability. Combined effects from 1) a softer pace of first-half growth and 2) last month's financial shock, suggest weaker economic prospects for the coming year. Our economists cut their full-year 2011 GDP estimates to 1.6%, including shaving about three-fourths of a point relating to the early August financial shock alone.[11]

But while evidence shows that fundamentals have in fact weakened, data also shows the economy is not falling off a cliff. For example, consumer spending showed momentum improving prior to the financial shock. Consumer spending increased by a solid 0.8% (0.5% in real terms) in July, mainly on a bounce back in motor vehicle purchases. In the same vein, some CMBS fundamental performance metrics appear to have stabilized. The fixed-rate CMBS 30-plus day delinquency rate, for example, fell 14bp in August.

…But Active Primary Market Signals a Constructive View

A robust new issuance pipeline also suggests many market participants maintain a constructive view. In CMBS, the market is gearing up for a relatively heavy new issue calendar. There is an $8 billion new issue pipeline through October, across seven deals. A robust new issue calendar also kicked off a busy post-holiday week in consumer ABS. The first two weeks of September experienced $8-10 billion of supply, spread across various sectors, including credit cards, auto, equipment and stranded assets.

Sector Relative Value and Allocation Recommendations

Our securitized products strategists have mixed views on the market, ranging from bullish to neutral, and Figure 56 shows Citi strategists' recommendations for major structured products sectors on a scale of -3 (maximally bearish) to +3 (maximally bullish). The table also incorporates the strategists' most current thinking about value and presents one or two trade ideas.

Figure 56. Sector Relative Value and Asset Allocation Recommendations — Selected Sectors, September 2011

Sector	Strategist Recommendation	Spreads Relative to Long-Term Averages	Comments
CABS	0	Fair	Remain market weighted. Senior cards and auto are our core picks. We also like certain off-the-run senior sectors, including dealer floorplan, private label credit cards, equipment and auto lease ABS.
CMBS	+1	Cheap	Our long-term view remains for further tightening, but the current environment suggests waiting a bit longer to step in with new investments. We still feel that buying stronger AMs opportunistically in a market dislocation will ultimately reward investors in the long run.
CLO	0	Cheap to Fair	We remain neutral on the mortgage basis in the short term, as policy risk and spread volatility are elevated. Valuations continue to look attractive.
Agency MBS	0	Fair	European products look fair value relative to credit markets. Move to an underweight in Italian RMBS. Overweight core country sectors. Short duration credit cards and autos are defensive plays and outperform. We also like UK prime RMBS, CMBS and UK BTL.
European Securitized Products	0	Fair	Remain market weighted. Senior cards and auto are our core picks. We also like certain off-the-run senior sectors, including dealer floorplan, private label credit cards, equipment and auto lease ABS.

Source: Citi Investment Research and Analysis

[11] See "US: Economic Forecast Highlights: August 2011" by Robert DiClemente et. al. Citi Fixed Income Research. 24 Aug 11 and "Comments on Credit", by Robert DiClemente et al., Citi Fixed Income Research, 2 Sep 11.

Commodity Outlook and Forecast

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Commodities remain pressured in a choppy 'risk-off' environment that has permeated capital markets since the August sell-off. Macro uncertainty in Europe's banking sector, sovereign solvency and funding issues across both core and periphery EMU entities as well as retrenchment in the US and Chinese economies (both of which also have bank-credit problems coming to the fore, as seen in financial sector ratings downgrades and recent IMF reports) have not spared commodity returns or flows as investors look to reposition portfolios from both a fundamental and liquidity purview. As such, it is becoming more and more evident that the commodity 'bull-run cycle' that began in late 2010 will remain on hold in the absence of meaningful policy stimulus from the ECB and US Federal Reserve Bank (beyond an 'Operation Twist'), or a global growth turnaround, even though some key commodity markets (including copper and oil) remain tightly balanced.

Figure 57. Commodity Price Forecasts*

			Forecasts					
		Spot	0-3M	6-12M	5Y Cyclical	2011E	2012E	2013E
Energy								
NYMEX WTI	USD/bbl	79.9	82.0	72.5	81.0**	89.7	71.8	92.5
ICE Brent	USD/bbl	104.0	95.0	91.0	85.0**	106.0	86.3	102.0
Base Metals								
LME Aluminum	USD/MT	2,183	2,325	2,300	2,500	2,462	2,319	2,566
LME Copper	USD/MT	7,355	7,000	7,500	7,500	9,099	8,375	8,534
LME Lead	USD/MT	1,956	2,250	2,200	2,200	2,477	2,263	2,356
LME Nickel	USD/MT	18,264	21,000	20,000	18,500	23,649	20,938	23,419
LME Tin	USD/MT	20,195	22,500	21,000	18,000	N/A	N/A	N/A
LME Zinc	USD/MT	1,896	2,125	2,000	2,300	2,260	2,075	2,256
Precious Metals								
Gold	USD/T. oz	1,638	2,000	1,650	1,050	1,590	1,650	1,500
Silver	USD/T. oz	30	33	32	12	33	26	22
Platinum	USD/T. oz	1,633	1,850	1,850	1,500	1,827	1,900	1,775
Palladium	USD/T. oz	641	795	823	550	801	950	850
Bulk Commodities								
Hard Coking Coal (benchmark Asia)		302	305	280	220	289	275	248
Thermal Coal (API2)	USD/MT	125	123	125	105	122	139	148
Iron Ore Spot (TSI)	USD/MT	176	165	175	100	173	160	135
Agriculture								
Corn	USD/bu	639	675	700	700	688	671	N/A
Soybeans	USD/bu	1,258	1,247	1,343	1,350	1,289	1,369	N/A
Wheat	USD/bu	641	700	725	675	713	710	N/A
Rice	USD/cwt	16	15.6	15.6	14	15.3	15.5	N/A
Cotton	USD/lb	100	104	98	125	150	100	N/A
Sugar	USD/lb	25	27	26	25	28	25	N/A
Coffee	USD/lb	231	245	249	250	253	250	N/A
Cocoa	USD/MT	2,634	3,000	3,050	3,100	3,080	3,095	N/A

*As of September 2011, **Real-Adjusted
Source: Citi Investment Research and Analysis

The benchmark Dow-Jones UBS Total Return Index is down 11.8% year-to-date and has lost 10% month-over-month on a flat-price basis. This compares to a CAGR of positive 0.5% from January-July of this year. To be sure, volatility across key markets has returned to the late summer peaks and commodity markets have not been immune – the metals complex, agriculture and energy sectors being most adversely affected. Index and fund flows once again are exiting the commodity space, following the August nadir and will likely stay challenged for the time being. Sentiment since mid-August has thus far lacked conviction. For the week ending September 20th, commodity index outflows totaled $4Bn, marking the third consecutive week of flows leaving the sector. Institutional and retail (real money) investment via ETFs has also been muted in September, driven largely by flows into precious metal funds that have been in part offset by outflows in the energy space. The mixed trend in commodity flows is something we expect to continue until the market is proffered a new catalyst to firm up sentiment for risk.

Figure 58. Near-Term Outlook

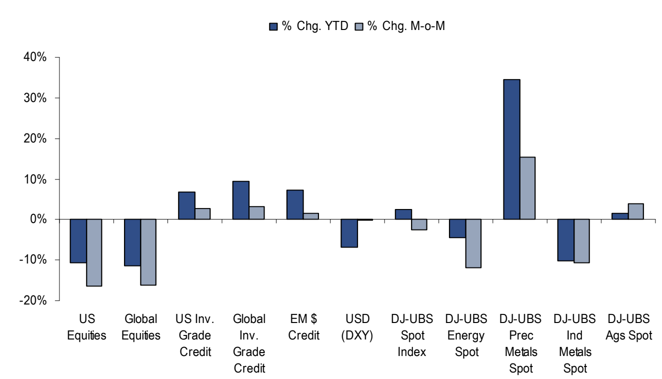
	Current	Prior Month	Beginning of Year
Energy	Bearish	Bearish	Bullish
Precious Metals	Slightly Bullish/Neutral	Bullish	Slightly Bullish
Base Metals	Slightly Bearish	Neutral	Bullish
Bulk Commodities	Slightly Bearish	Neutral	Bullish
Agriculture	Slightly Bullish	Slightly Bullish	Neutral

Source: Citi Investment Research and Analysis

In light of these macro headwinds, we have most recently revised down our base metal and bulk commodity outlook in early September. Base metal 2011 prices were revised down 6-14% ex-zinc, and 2012 prices down anywhere from 11-23% across the board. The largest revisions came in for nickel, which we perceive to be most susceptible to economic slowdown on the back of surging Chinese nickel-pig-iron production. Bulk commodities could remain more buffered since emerging markets represent 50-70% of global demand for coal, iron ore and steel, placing a floor on prices as Asian countries look to buy on bouts of weakness. As such, our revised forecasts for 2012 are still up 5% for iron ore and unchanged for thermal coal. Our forecast for gold remains unchanged as it 'settles' after the recent correction on long metals/short DXY unwinds with a 2011 average price forecast of $1,591/t oz.

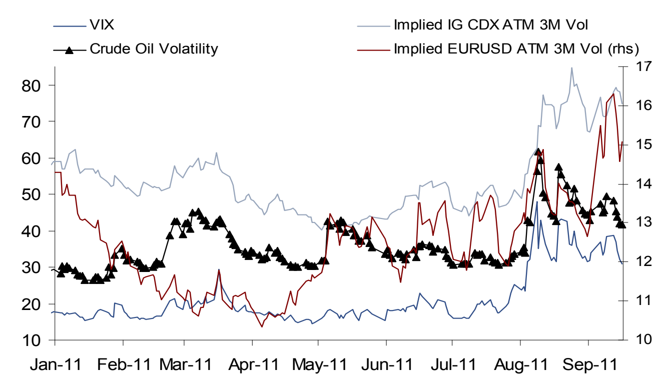
We remain bearish the energy sector, which has seen downward shifts in the forward curve term structures for both WTI and Brent. The WTI-Brent spread should also stay volatile in the short term as traders sort physical tightness in North Sea loading delays and the resumption of Libyan supply, which we estimate to be 200-k b/d in October, up to 500-k b/d in Dec'11 and 900-k b/d in 2012. WTI should remain weak despite new rail evacuation routes in the US mid-continent. Agriculture commodities have softened sharply in early September but inventories still need to be rebuilt and demographic shifts in developing markets should provide support into 2012. We thus expect heightened differentiation among commodity sectors to resume into 4Q'11 and overall note that the 'bull-cycle' is temporarily on pause.

Figure 59. Market Movements: Equities, Credit, Dollar and Commodities*



Source: Bloomberg, Citi Investment Research and Analysis
*Note: Reflects nominal spot price change from 1 January 2011 – 21 September 2011

Figure 60. Equity, Corporate Credit, Petroleum Market and FX Volatility



Source: CBOE, Citi Investment Research and Analysis

Citi Foreign Exchange Forecasts

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

Market Commentary

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

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

- Rising and elevated risk aversion, resulting from weaker growth expectations and the ongoing fiscal crisis in the Euro Area, seems likely to extend the rally in the USD where downside in ADXY and in EUR have caught up in recent weeks with already depreciated LATAM and CEEMEA currencies
- We forecast 3-5% USD gains on a DXY basis over the short to medium term with EUR/USD likely to drop into a 1.25-1.30 range. There should be further near term USD gains vs. commodity backed G10 currencies as commodity prices ease, including AUD and CAD
- Only JPY is likely to be strong enough to resist the USD advance
- Within Europe, we expect the 1.20 EUR/CHF peg to hold for some time but warn that this implies potentially explosive domestic money growth which could unravel the currency fix in the medium term if the Euro Area crisis persists
- Within EM, CEEMEA is expected to come under the most pressure, with Latam outperforming. Asia runs a middle course

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	1.35	1.35	1.35	1.29	1.25	1.30	-4.5%	-7.6%
Japanese yen	USDJPY	76	76	76	75	76	78	-1.6%	0.3%
British Pound	GBPUSD	1.55	1.54	1.54	1.52	1.51	1.65	-1.7%	-2.2%
Swiss Franc	USDCHF	0.90	0.90	0.89	0.95	0.95	1.04	5.6%	6.4%
Australian Dollar	AUDUSD	0.98	0.97	0.95	0.95	1.02	0.95	-2.0%	7.8%
New Zealand Dollar	NZDUSD	0.78	0.77	0.76	0.76	0.83	0.63	-1.8%	9.2%
Canadian Dollar	USDCAD	1.03	1.03	1.03	1.06	1.00	0.95	3.0%	-3.0%
Dollar Index*	DXY	78.10	78.19	78.10	80.84	82.08	79.36	3.4%	5.1%
G10 Crosses									
Japanese yen	EURJPY	103	103	103	97	95	101	-6.0%	-7.4%
Swiss Franc	EURCHF	1.22	1.22	1.21	1.23	1.19	1.35	0.8%	-1.7%
British Pound	EURGBP	0.87	0.88	0.88	0.85	0.83	0.79	-2.9%	-5.5%
Swedish Krona	EURSEK	9.30	9.31	9.39	9.35	9.00	8.80	0.4%	-4.1%
Norwegian Krone	EURNOK	7.88	7.90	8.00	7.90	7.75	7.70	0.0%	-3.1%
Norwegian Krone	NOKSEK	1.18	1.18	1.17	1.18	1.16	1.14	0.4%	-1.0%
Australian Dollar	AUDNZD	1.26	1.25	1.24	1.25	1.23	1.51	-0.2%	-1.3%
Australian Dollar	AUDJPY	75	74	72	71	78	74	-3.5%	8.1%
Asia									
Chinese Renminbi	USDCNY	6.39	6.42	6.43	6.30	6.12	5.87	-1.9%	-4.8%
Hong Kong Dollar	USDHKD	7.80	7.79	7.77	7.78	7.76	7.75	-0.1%	-0.1%
Indonesian Rupiah	USDIDR	8941	9460	9749	9300	8900	8650	-1.7%	-8.7%
Indian Rupee	USDINR	49.4	50.3	51.4	49.5	47.5	46.0	-1.6%	-7.6%
Korean Won	USDKRW	1167	1189	1189	1200	1140	1050	1.0%	-4.1%
Malaysian Ringgit	USDMYR	3.17	3.18	3.20	3.20	3.06	2.89	0.6%	-4.4%
Philippine Peso	USDPHP	43.6	44.0	44.1	43.7	42.8	41.5	-0.6%	-3.2%
Singapore Dollar	USDSGD	1.30	1.30	1.30	1.30	1.24	1.17	0.1%	-4.3%
Thai Baht	USDTHB	30.9	31.1	31.7	30.7	30.0	29.5	-1.4%	-5.3%
Taiwan Dollar	USDTWD	30.4	30.3	29.9	30.8	29.5	28.2	1.5%	-1.5%
EMEA									
Czech Koruna	EURCZK	24.7	24.7	24.7	25.3	24.8	23.8	2.2%	0.6%
Hungarian Forint	EURHUF	291	292	299	335	330	300	14.7%	10.3%
Polish Zloty	EURPLN	4.41	4.43	4.50	4.65	4.30	3.90	4.9%	-4.4%
Israeli Shekel	USDILS	3.70	3.72	3.75	3.80	3.60	3.40	2.0%	-3.9%
Russian Ruble	USDRUB	32.0	32.6	34.2	32.9	34.2	31.3	1.0%	0.0%
Russian Ruble Basket		37.1	37.7	39.6	37.2	38.0	35.5	-1.4%	-4.0%
Turkish Lira	USDTRY	1.84	1.87	1.94	1.86	1.88	1.79	-0.3%	-3.0%
South African Rand	USDZAR	8.29	8.38	8.68	8.00	8.50	8.75	-4.6%	-2.1%
LATAM									
Brazilian Real	USDBRL	1.86	1.91	2.00	1.82	1.80	1.70	-4.7%	-9.8%
Chilean Peso	USDCLP	518	526	539	520	530	490	-1.1%	-1.7%
Mexican Peso	USDMXN	13.8	14.0	14.3	13.2	13.0	12.2	-5.4%	-9.1%
Colombian Peso	USDCOP	1901	1920	1955	1850	1850	1850	-3.6%	-5.4%

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

Source: Citi Investment Research and Analysis

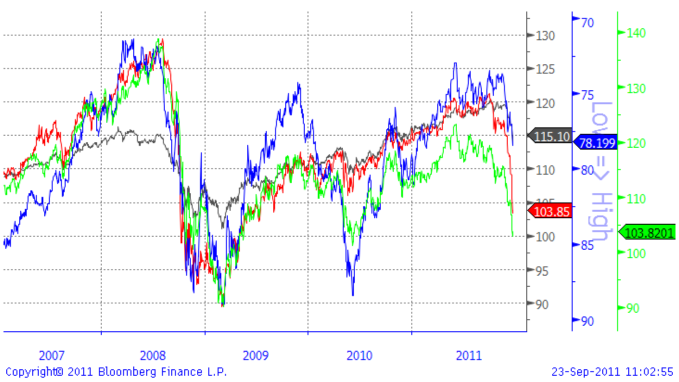
Overview

Last month, we pointed to higher risk aversion, lower growth expectations and rallying core bond markets and noted that, in recent times, such a background would have generated a strong USD rally. This month, the USD rally has finally started (see Figure 62). Initially, the move has been led by weakness in LATAM and CEEMEA currencies. The drop in USD/CNY in the first half of August that coincided with the visit of US VP Biden to China stemmed initial ADXY declines while Asian CB buying of EUR also delayed the move higher in DXY. But these indices are now catching up as fundamentals have overwhelmed the EUR and ADXY has finally responded to global events.

In our September forecasts, we expect further upside in DXY over 0-3 and 6-12 months. Relative to DXY weighted forwards, we think long USD will outperform by about 5% over the next year. Key drivers are much weaker growth expectations and continued elevated levels of risk aversion (see Figure 63).

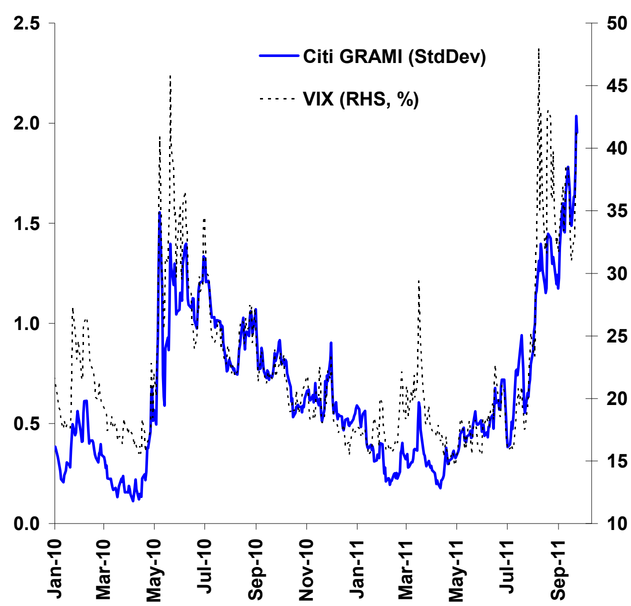
As we have seen both recently and in 2008, a USD rally against G10 currencies implies a rally against EM FX too.

Figure 62. DXY (Blue), ADXY (Black), LACI (Red) CEEMEA FX (Green)



Source: Citi and Bloomberg *
CEMEAXY is a equally weighted index of CZK, HUF, PLN, ILS, RUB, TRY, ZAR (all vs. USD), rebased to Jan2010=100. Higher CEMEAXY = CEEMEA FX appreciation

Figure 63. Risk Aversion Higher – Citi GRAMI



Source: Citi and Bloomberg

G10 Exchange Rates

EUR/USD – Further downside

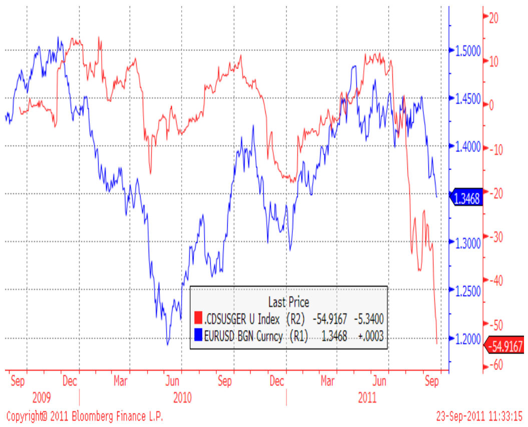
Last month, we pointed to three key cross trends affecting EUR/USD. First, we felt that the EMU crisis was not expected to subside soon. Second, despite ECB stubbornness on official rates, short term rate differentials were already less helpful for the EUR than before. But third, official EUR buying, mainly by Asian CBs, was buoying the EUR relative to levels that seemed unsustainable based on the first two and other fundamental factors.

Overall, we thought that the EUR was rather near to the top end of the short term trading range with a pullback to the low 1.40s likely short term and to 1.37 longer term. This, we felt, would continue the medium term pattern of lower highs and lows since the 2008 peak at over 1.60.

In general terms, the path of EUR/USD since our last forecast is as expected. Spot fell a little faster than we predicted partly because the sudden apparent withdrawal of the Asian Central Bank bid after the end of August coincided with further bad news on the periphery crisis. In particular, there were the signs that Greece is failing the conditionality needed for Troika support. This has resulted in a further sharp underperformance of German CDS relative to the US equivalent (see Figure 64) a trend that might well generate a much lower EUR/USD rate if sustained.

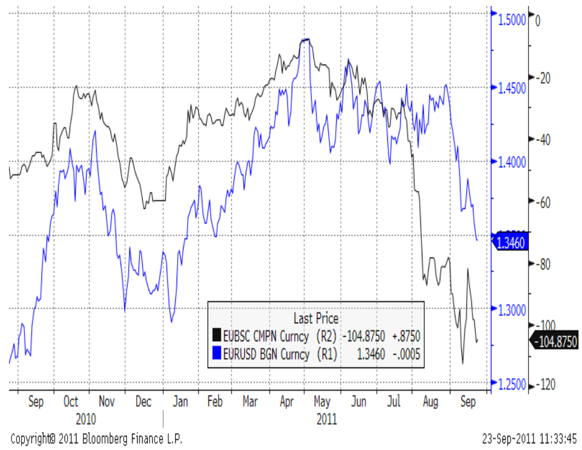
A related concern to the periphery sovereign crisis is the strain on the Euro Area banks. USD funding costs have skyrocketed as US investors are increasingly reluctant to lend even short term. As a result, even with expanded swap lines and a coordinated supply of USD liquidity involving the Fed, ECB, SNB and BoE, the EUR-USD basis swap remains wide and is another factor potentially driving EUR lower as European banks try to access USD however they can (see Figure 65).

Figure 64. CDS Spreads Remain Elevated (Red –US Less Germany), A Risk for the EUR (Blue)



Source: Citi Investment Research and Analysis

Figure 65. EUR-USD Basis Swap (Black) vs. EUR/USD FX Spot (Blue)



Source: Citi Investment Research and Analysis

On the other hand, however, the recent fall in EUR spot has restored a more normal relationship with short term rate differentials. Our bias is still to see some scope for front end EUR rates to fall more than USD equivalents given more rapidly receding core inflation, growth expectations and simply that the level is higher. So there may still be juice in the rate differential to drive EUR/USD a bit lower.

Overall, our market based models see EUR fair value at around 1.29 and this is now our new 0-3 months forecast. Over 6-12 months, our 1.25 forecast is driven by two further factors. First, in this time horizon we see a realistic chance of realised default by sovereigns in the EMU periphery. Second, we expect the USD to rally as is the norm in a US recessionary environment.

Yen – USD/JPY lower on risk aversion, weaker growth

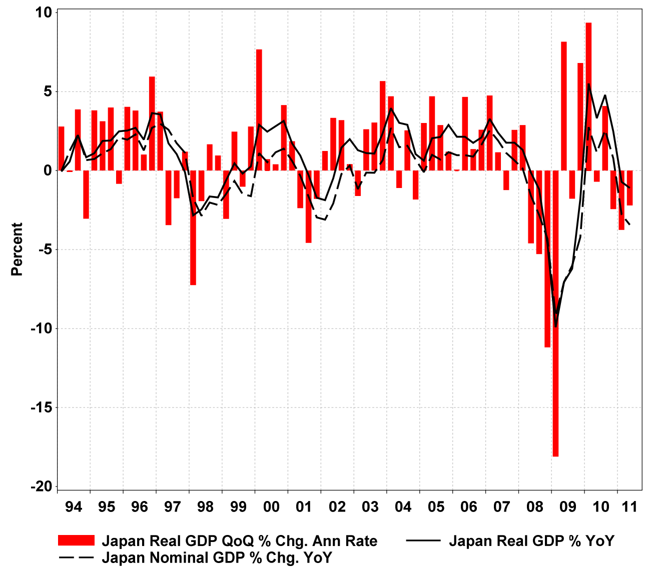
USD/JPY has drifted in a 76-78 range since the intervention induced spike to over 80 in early August. However, there is little evidence that the trend lower in this exchange rate since mid-2007 is over. Instead, with global growth expectations falling and risk aversion rising, we expect further downside for the rate.

This has little to do with Japanese fundamentals. Japan's economy is probably growing strongly in Q3 given a bounce in exports, more consumer spending and reconstruction demand. However, while the reconstruction will persist in Q4, other supports may diminish. In any event, in the three quarters prior to the current one, the economy contracted in what was essentially the seventh recession since the asset bubble burst just over 20 years ago (see Figure 66).

Japanese economic factors rarely impact the exchange rate directly. For example, the correlation between the trade balance and the currency is inverse (see Figure 67) because capital flows drive JPY and the currency then drives the economy and the trade balance. Nonetheless, economic factors will have an influence on official policy towards the JPY. At Citi, we have never really been convinced that JPY was overvalued vs. USD. But Japanese officials remain obsessed with this and will most likely try to stem USD/JPY downside below 75 if they can. Possible initiatives include (i) reducing the rate on excess reserves – now 0.1%; (ii) announcing/ strengthening the commitment to extended low rates; (iii) buying JGBs beyond 2y maturities under the asset purchase programme. And of course, further FX intervention is also possible/ likely.

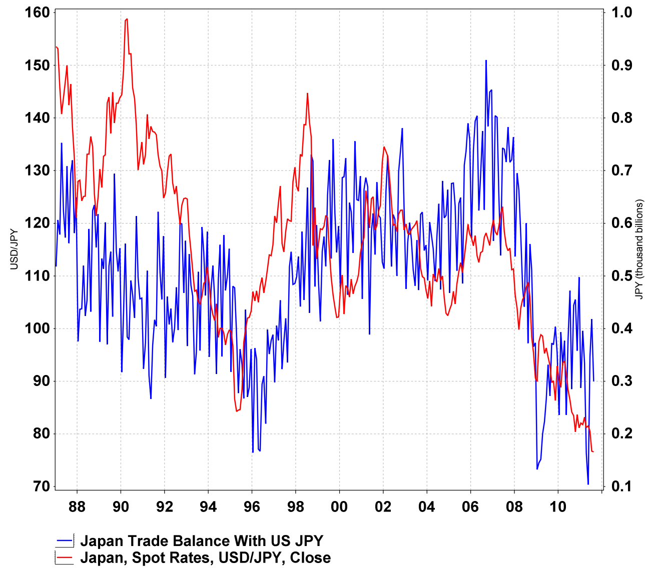
If growth expectations in developed, and even EM, economies indeed continue to weaken, we are sceptical that any lines in the sand will last long as the winds of risk aversion blow in. So our forecast bias is still USD/JPY down over the year ahead although a generalised USD rally (and a possible pause in any downside USD/CNY moves) plus official actions may slow the move.

Figure 66. Nominal and Real GDP Growth Rates in Japan



Source: Reuters EcoWin and Citi

Figure 67. USD/JPY vs. The Bilateral Japanese Trade Balance With the US



Source: Reuters EcoWin and Citi

Dollar Bloc – USD higher across the board

AUD is currently approximately 11% below late July cyclical highs at just over 1.10. While a decent correction, we think it will extend further since the setback in May/ June 2010 was more like 15% while the 2008 AUD drop reached almost 40%.

We have felt for a while that AUD was living a bit on borrowed time. Clearly, relative to traditional valuation metrics, such as our WERM fair value estimate of 0.86, the currency remains very rich. In response to this kind of observation, AUD bulls typically refer to one of three main supports: (i) rates/ carry; (ii) China and EM growth; and (iii) the terms of trade/ commodity prices. Let's consider these in turn.

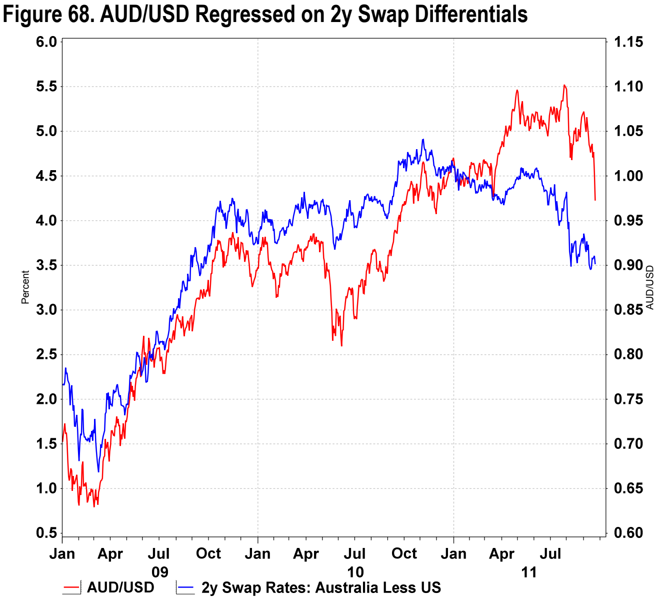
On rates/ carry, the AUD should now be trading around 0.90, close to the WERM fair value level of 0.86 – see Figure 68. Since the start of the year, and especially since late July, there has been a huge rally in front end rates in Australia as rate hikes were priced out and cuts priced in. While our economists in Sydney are cautious relative to the more than 100bp of cuts price in for the next 6-12 months, the currency seems recently to have decoupled from rate differentials and we doubt that this lasts. With the RBA on hold for the immediate future, a sharp back up in rate differentials seems unlikely so AUD probably has to fall further.

On the China EM story, we are getting more cautious there too. We expect even EM growth expectations to move lower and note that many EM FX markets are now under pressure reflecting this and, in some cases, the lower rates that go with weaker activity (see EM section below). AUD has also tended to ignore a weak trend for some time in Chinese equities, weak Chinese money growth and softer nominal GDP growth in China. We are not sure that the China/ EM story prevents further downside in AUD/USD.

Finally, on commodities, as we pointed out in the last *Forecasts,* commodity prices are generally trending lower now and we expect further downside especially for energy prices and base metals. Some Australian exports to be fair, like iron ore and coal, are set in longer term contracts and prices are so far resilient. Nonetheless, even relative to Australia's actual terms of trade, we think AUD also looks a bit rich.

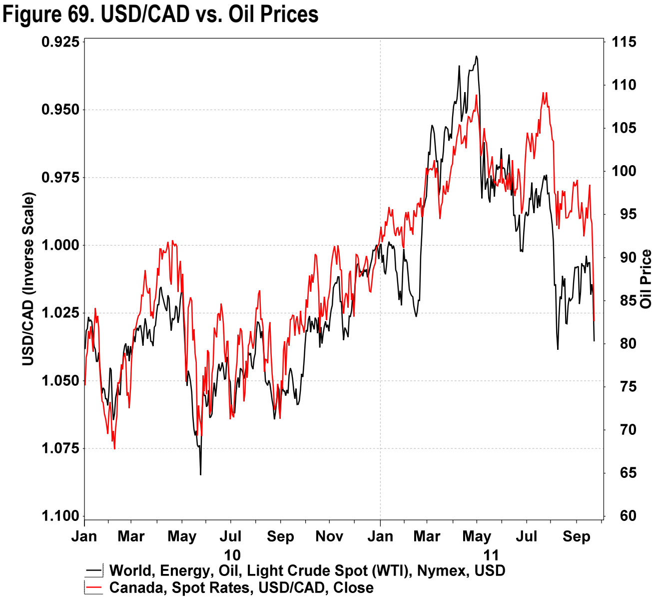
Taking all these factors into account, we feel that AUD has probably peaked, at least for the medium term and may trade a rather lower range over the short term. We predict 0.95 over 0-3 months and look for around 1.02 over 6-12 months.

Figure 68. AUD/USD Regressed on 2y Swap Differentials



Source: Reuters EcoWin

Figure 69. USD/CAD vs. Oil Prices



Source: Reuters EcoWin

NZD corrected hard in early August from over 0.88 to a low below 0.80 before retracing over 60% of this move lower over the rest of the month. Since then, NZD is again depreciating in line with the general move higher in the USD. We expect more downside in NZD as with AUD. Lower commodity prices, more risk aversion and softer global growth will all be key factors. Right now, New Zealand is really in a minority of one amongst G10 countries that price in higher policy rates over the next 6-12 months. We recognize that this is partly because rates are relatively low (compared with Australia) and partly because rates were cut in March as an emergency response to the earthquake. Nonetheless, we have seen recently in the EM world that rates have reversed course as the global economy has slowed and it is possible that any rebound in RBNZ rates will also be delayed. As this occurs, the NZD may weaken somewhat further against a relatively strong USD. We forecast 0.76 over 0-3 months and then 0.83 over 6-12 months. This implies that the NZD outperformance of AUD since March will continue.

It still appears that USD/CAD has formed a double bottom at around 0.945 in early May and late July and has since been moving higher. The recent move above parity seems to be warranted given the general USD rally, a prior misalignment with rate differentials and with oil prices (see Figure 69). We expect a further move higher to around 1.06 over 0-3 months.

Longer term, some modest upside in USD/CAD would please policymakers, especially the Bank of Canada who see currency strength as a downside risk to growth. Recent economic news has been weak (as elsewhere) and the labour market has been especially disappointing. While rates may not fall as implied in market forwards, the Bank of Canada may yet offer a (second) conditional unchanged rate commitment. This may also limit upside for CAD. Overall, we forecast a return to parity at 12 months.

European Crosses

GBP – Cheap but slow progress higher likely

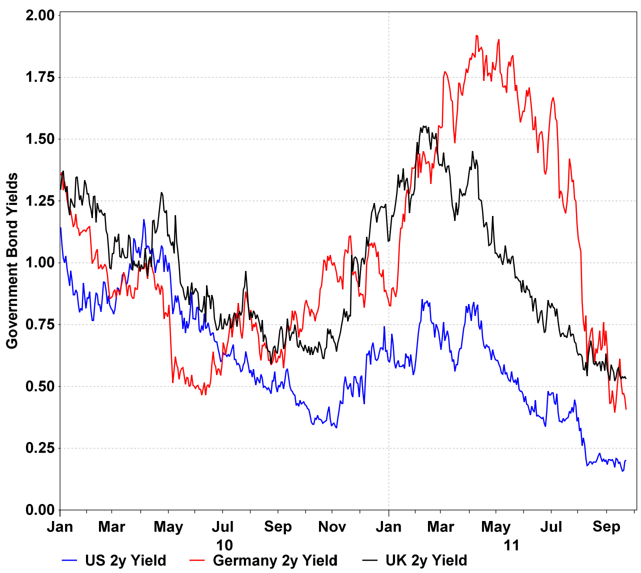
Sterling continues to move broadly sideways, relative to the average of the USD and EUR, and has done so since mid 2010 (see Figure 70), most recently moving sharply lower against the USD but gaining vs. EUR. This broad stability in GBP has come against a sharp move towards expectations of easier monetary policy (via additional asset purchases – QE2) and away from expectations of higher policy rates which was the prevalent view early in 2011. As such, the relative resilience of GBP is surprising but, of course, we need to remember that exchange rates are relative prices not absolute ones. Since front end yields in the US have fallen more or less in parallel with the UK, while yields on front end AAA EUR have fallen much more sharply and converged on the UK (see Figure 71), there is an offsetting support to GBP from rate differentials. GBP is also helped by being fundamentally cheap, where our WERM estimates of long term “fair value” are EUR/GBP 0.79 and GBP/USD 1.73.

We still think that the longer term effects of tighter fiscal policy in the UK may be a recovery in the currency as the current account improves and the UK’s credit also improves. The question then becomes: where are we on the dynamic path? We think we may already have passed the point of maximum weakness and note that sterling lows have been rising since late 2008. Furthermore, market concerns about fiscal issues in both the EUR and USD mean that GBP can win by default over the longer term. We therefore still expect broad stability in GBP with a continued drift lower in EUR/GBP but weakness in GBP/USD.

Figure 70. GBP vs. Average of USD and EUR (Lower In Chart=Stronger GBP)

Source: Bloomberg, Citi

Figure 71. 2y Yield Moves Help GBP



Source: Reuters EcoWin

Scandis – NOK/SEK higher near term

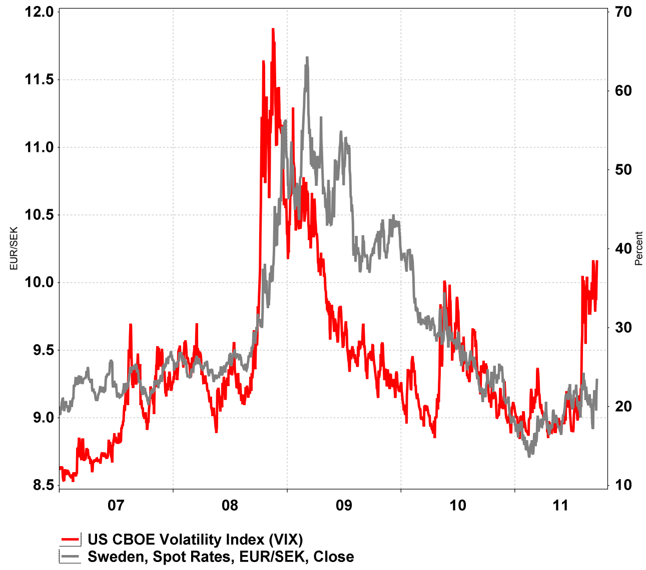
EUR/SEK bottomed out in February/ March and has been trending erratically higher since then. SEK has tended to be a "risk on" currency in the past. This is in part down to the high beta nature of Swedish equities and the Swedish economy to events in Europe. As growth expectations globally have fallen, so too have forecasts for Sweden started to edge lower and expectations of higher Riksbank policy rates have been scaled back to zero.

This highlights a problem for SEK bulls. While static fundamentals such as Sweden's strong external surplus and relatively good fiscal position are attractive at a time of balance sheet/ fiscal concerns elsewhere, Sweden's exposure to the growth cycle is a problem if you are bearish on the economic outlook. Notably, higher risk aversion and spikes in EUR/SEK are sometimes correlated although this link does seem to be diminishing somewhat more recently (see Figure 72).

We forecast upside to 9.35 over 0-3 months and then a move lower over 12 months to 9.00. WERM "fair value" for EUR/SEK is below 8.80 so an abatement in risk aversion could see SEK perform strongly.

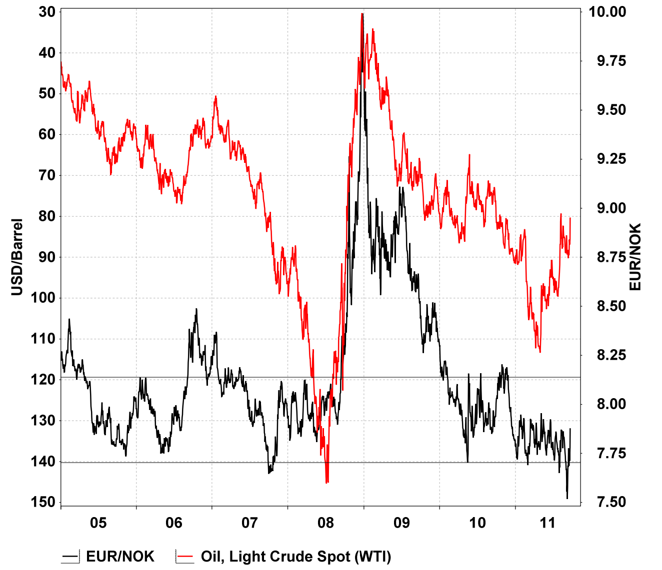
In Norway, EUR/NOK remains in a mainly sideways trading range. After a sharp spike lower in early September, the cross is again back in a 7.70-7.90 band (Figure 73) after Norges Bank Governor Olsen suggested that a stronger NOK was unhelpful. We find it hard to have a strong directional view on the NOK. As in Sweden, the fiscal/ external balance numbers appear great. But while the beta of Norway inc to Europe is lower than for Sweden, NOK is still exposed to oil prices which we forecast lower. This push me-pull me, plus the Norges Bank's aversion to NOK appreciation, seems likely to keep EUR/NOK somewhat range bound. Our "fair value" WERM estimate is 7.68 so our longer term bias is small NOK appreciation in the forecasts.

Figure 72. EUR/SEK vs. VIX



Source: Reuters EcoWin

Figure 73. EUR/NOK vs. Crude Oil Price



Source: Reuters EcoWin

CHF – Peg holds for a while at least

EUR/CHF had effectively bottomed even before the SNB shocked markets with the announcement of an asymmetric peg on EUR/CHF at 1.20 (or higher) on 6 September. Since the peg announcement, spot has been drifting modestly higher as the SNB tries to avoid a sense of one way risk (i.e. that the peg could be tested with no risk to speculators of upside in the cross).

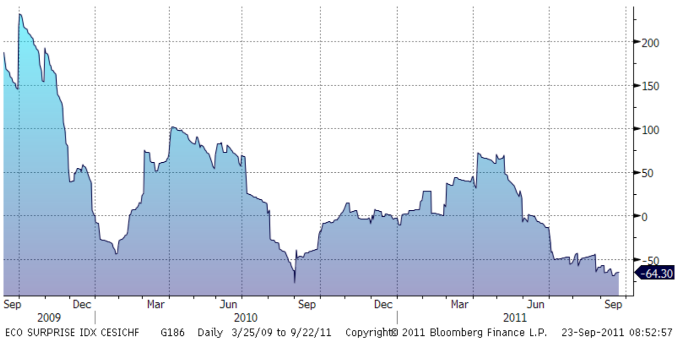
For now, we expect the peg to hold. One of the key issues is that this is effectively an easing of monetary policy by the SNB but it is one that is justified and therefore credible. For example, easier money is warranted by the current zero core inflation in Switzerland (6m annualised rates are running at -1%) and by the sharp weakening in Swiss economic activity (see Figure 74 on our Citi ESI). As the SNB also commented on 23 September, the currency cap is warranted by deflationary risks with growth likely to have stopped altogether in the second half of the year.

For so long as this weak growth/ low or negative inflation background persists, the market is unlikely to really test the SNB resolve. Setting a currency peg effectively makes the domestic money supply endogenous. In 2009, base money growth in Switzerland rose to over 150% pa as the SNB intervened at various levels to stem EUR/CHF losses (see Figure 75). But with an unlimited commitment to sell CHF at 1.20, domestic money growth rates will explode to even higher levels. Already, base money growth is reaccelerating. We have calculated that if all bondholders in the periphery 3 (Greece, Ireland, Portugal) sold out to the SMP or EFSF and then gave their EUR to the SNB, Swiss base money growth would be circa 800%. If we throw in Spain and Italy, this might rise to 2000-4000%. This may seem an extreme scenario but, on the other hand, it does not allow for other liabilities such as bank deposits making their way into CHF.

So a key medium term question becomes this. Will the SNB tolerate such massive domestic money growth? For sure, there is no reason not to now. But what if we see some signs of economic recovery and a sharp rise in local real estate prices and other asset markets? Alternatively, or additionally, assuming that over 6-12 months the EMU crisis comes to a head with sovereign defaults and a weak EUR generally, the longer term sustainability of this peg remains in doubt.

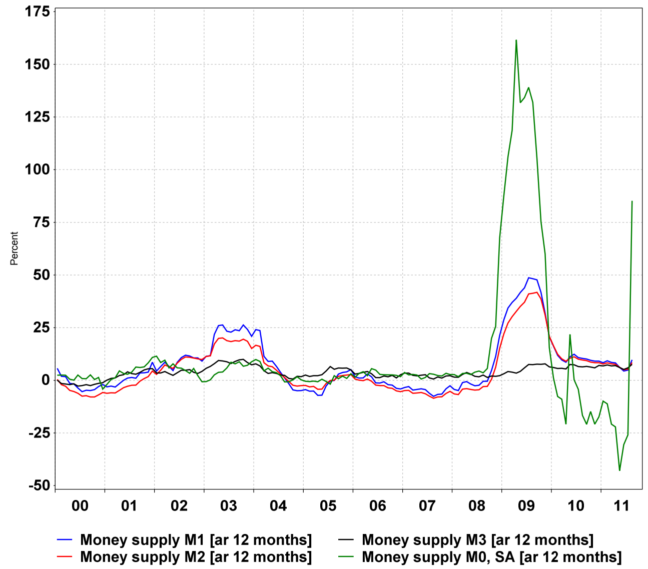
Our forecast is for 1.20-1.25 to hold over 0-3 months. Over 12 months, we are not so sure. We show 1.19 as a point forecast. This clearly implies the peg is stressed at this horizon though we recognise that if it does break it will probably break by more than 0.01. Our forecast reflects our uncertainty on the time horizon over which this may occur.

Figure 74. Swiss Economic Surprise Index (ESI)



Source: Bloomberg

Figure 75. Swiss Money Growth



Source: Reuters EcoWin

EM Exchange Rates

"Synchronised sinking" is perhaps the best description of moves in EM exchange rates since our last FX *Forecast*. Major EM crosses plummeted in September. Since September 1, an equal weighted basket of Latam FX is down 9%, CEEMEA by 10% and Asia 5%.

Adverse global conditions, not local fundamentals, are the chief driving force here, and are expected to persist and even intensify for some countries, in the near-term. The potent combination of significant downside risks to global growth and sharply reduced risk appetite are dollar positive – and therefore tend to be EM FX negative. Hefty reversals in foreign portfolio flows have worsened corrections for many EMs, prompting several central banks, including Korea, Brazil, Turkey and Indonesia to intervene to contain sell-offs and dampen volatility. In EM FX, the parallels with 2009 are striking, as indeed is the contrast with the last round of interventions, which were designed to prevent currency strength. The parameters of the currency war have changed radically.

Of the three regions, CEEMEA FX is in the eye of the storm. With EUR/USD expected to grind down to 1.25, Eurozone banks (and some economies) under severe pressure, and large local distortions in some CEEMEA economies, the risks for regional FX are running high. The HUF is forecast to be the hardest-hit, and 15% lower in six months time relative to current spot. The beleaguered ZAR is the only currency in the region that could appreciate over the next twelve months, although tight links with vulnerable metals remain the main downside risk.

What transpires in Asia is to a large extent hinged on the heavily managed yuan, where the outcome is as yet unclear. At the current juncture, with inflation running uncomfortably high and growing costs of FX intervention, we expect China to continue with its “normal” trend appreciation. However, we acknowledge that given our EUR/USD forecasts, this would mark an important departure from the past. Likewise in Latam, commodity prices are a key risk to our forecasts, as three of the four crosses in the region are tightly linked with metals and/or oil.

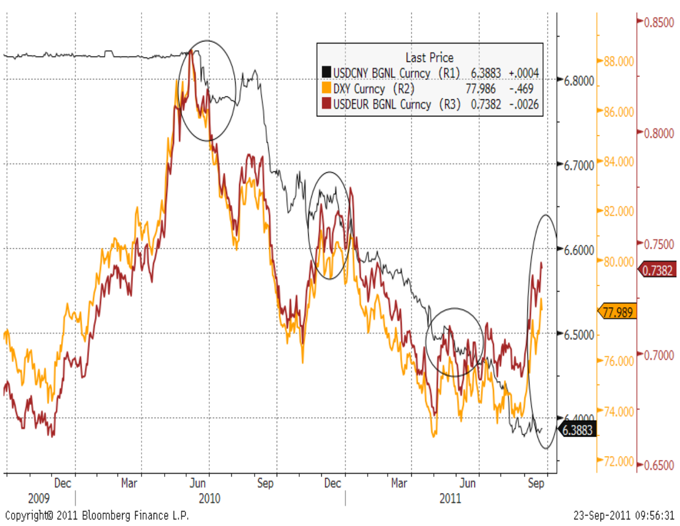
EM Asia – CNY trend vs. global growth fears

Intensifying downside risks to global growth, and sharply reduced appetite, are the major forces that lead us to crunch our EM Asia FX forecasts downwards this month. A key question surrounds China’s policy approach. Will China continue with "normal" trend appreciation, especially if our DXY forecasts are borne out? Furthermore, CNY still plays a central role in the region, though perhaps less than before, especially if global growth fears accelerate and have a bigger impact on the smaller open economies.

USD/CNY has flat-lined during all four meaningful DXY rallies since June 2010, suggesting the sideways move since mid-August could persist (see Figure 76). Arguing for continued CNY strength, however, is the growing pressure on China to bring domestic inflation under control. The need for a policy tightening anchor, and to curb the (increasingly evident) costs of rapid FX reserve accumulation, adds further weight to a CNY-constructive policy.

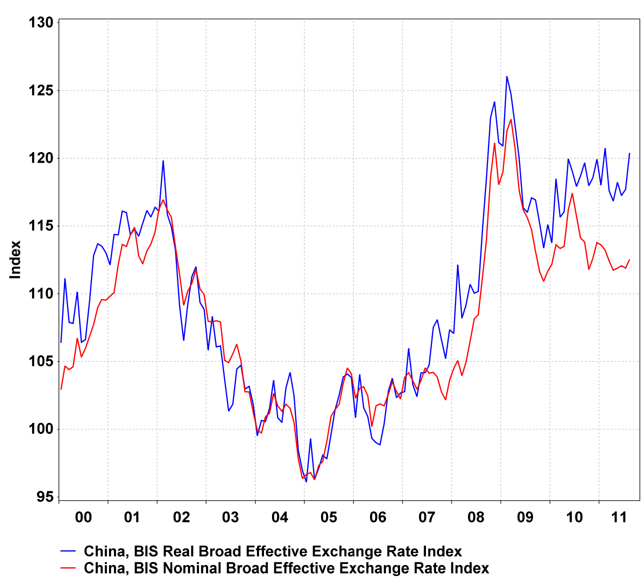
For now, we stick with our CNY forecast of moderate appreciation, with USD/CNY at 6.3 in 0-3 months, and 6.12 at 6-12 months. This would make CNY the most resilient cross in its region. To be sure, taking August as a whole the RMB did in fact gain versus USD, in contrast with other EM currencies; it also fell by the least in the first three weeks of September. With sticky inflation, still hovering above 6% on the latest print, and a sizeable trade surplus, a firmer currency will be important to manage domestic conditions (see Figure 77). Longer term, it remains a key ingredient for needed global rebalancing.

Figure 76. DXY and USD/CNY Since 2009



Source: Bloomberg

Figure 77. China Nominal and Real Effective Exchange Rates



Source: Reuters EcoWin

KRW and INR sit at the opposite end of the spectrum. Sharp spikes in each in September leave them as amongst the worst performing Asian EMs in the last one, three and six months. In our forecast global setting, both are forecast to keep their depreciating trend, if improving somewhat 6-12 months out.

For INR, the weakening influences of a stronger dollar and greater risk aversion are heightened by domestic factors – including growing signs of inflation getting “baked in” to the wider economy and sizeable twin deficits on the current and fiscal accounts, which is unusual in Asia. Any further central bank tightening is unlikely to provide much support: this comes at the worst point in the cycle, with slowing growth and high and sticky prices; and the allure of carry has eroded in any case. That said, although we have raised our 3 and 6-12 month forecasts since last month, to 49.5 and 47.5 respectively, our current forecasts relative to spot show some near term weakening followed by medium term bounce. 6-12 months out, INR is helped by the relatively attractive domestic growth story, favourable composition of external debt and domestically financed fiscal deficit.

For KRW, large withdrawals by foreigners from capital markets have been the major source of sharp sell-offs. Korea’s banking system is also the only one its region that has a direct risk of contagion from global developments, being heavily reliant on wholesale funding and with large FX mismatches. With likely fading support from the current account surplus, and innate sensitivity to global financial markets, we expect KRW to weaken to 1200, before strengthening to around the 1140 level by early next year.

IDR has been dragged down by similar forces plaguing KRW, i.e., abrupt unwinding of overcrowded foreign positions in money and bond markets. Although outflows so far have mostly been concentrated at the short end, this could spread quite easily if tensions in global markets escalate as we expect. The central bank’s foreign reserve cover (7 months of imports and short term external debt) has improved significantly from pre-Lehman levels (4.7 months), and has been deployed in recent central bank interventions. But this matters less in the global environment that we are anticipating. We are cutting back our IDR forecast to 9300 for 3 months ahead, and 8,900 in 6-12 months.

Our MYR forecast follows close at the heels of KRW. Commodity-backed MYR has sold off more sharply than most in its region in the last six months, a pattern that should be sustained over 0-3 months given heavy foreign positioning in the bond market. An estimated 70+% and 34% of BNM bills and MGS securities respectively are foreign-owned. USD/MYR is expected to drop to 3.06, in 6-12 months time.

We also scale back our optimism on the Baht. Here too, likely continued unwinding of foreign portfolio investments remains the chief near term risk. However, a healthy current account surplus and lower political risk premia should together facilitate modest Baht appreciation further out. While the PHP cannot entirely shrug off global forces, it is less vulnerable to hefty portfolio outflows than Thailand, with resilient OFW remittances and steady BPO proceeds. This is reflected in our fairly steady forecasts both 3 and 6 months ahead. The possibility of a credit rating upgrade would also boost onshore sentiment.

In keeping with the regional sell-off, TWD depreciated quite sharply against the USD in recent weeks. This is expected to continue, if at a more moderate clip than others in the region, because of strong domestic fundamentals. Finally, we revise our 3 and 6-12 month SGD forecasts to 1.30 and 1.24 respectively, while acknowledging a number of downside risks. Chief amongst these is an historically tight correlation between SGD and EUR.

CEEMEA looks most exposed

Until the Latam "capitulation" that kicked-in in earnest after the FOMC's twist, CEEMEA currencies had been much weaker versus the USD than either Latam or Asia in beta adjusted terms. The regional fx price return so far this month is about -10%, on average, which strikingly, is also worse than May 2010. There are, of course, significant variations *within* the CEEMEA group: in spot terms, TRY is one of the better performers in EM; by contrast, the HUF, PLN, and ZAR fall at the very bottom of their EM cohort. Our CEEMEA forecasts capture some of the idiosyncratic forces that have driven divergent performances, but with one overriding theme going forward: what transpires in Europe. With EUR/USD expected to grind down to 1.25 in the next 6-12 months, Eurozone banks under intensifying pressure, weakening growth and a prospective Greek default, risks for CEEMEA FX as a whole are running high.

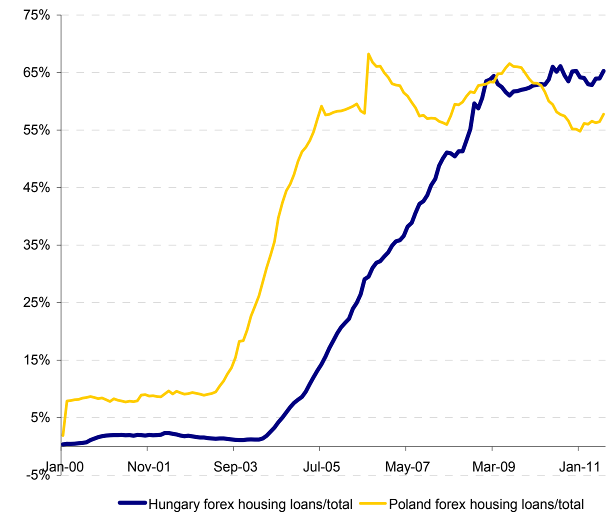
Of the three CEE currencies, the CZK outperformed both PLN and HUF in the third quarter as a whole, although it too shed value against the EUR, in line with our August forecast. Increasing downside risks for global growth, a stronger USD dollar and disinflationary domestic factors are likely to weigh against CZK in the near-term. Importantly in our expected global (and particularly European) setting, the central bank should also be comfortable with a weaker CZK, which marks a departure from early 2009; the Czech economy is heavily export-reliant, so any boost to competitiveness would be welcome. Longer term, the foreign trade surplus, good fiscal position, and no exposure to the high forex leverage risks for HUF and PLN should keep the currency relatively stable.

The HUF meanwhile sold off heavily in recent weeks, with sporadic official announcements on an FX mortgage debt repayment "program" and prospective reversal of earlier fiscal plans worsening the correction. Fundamentals are not supportive. The economy is weak and weakening further; the central bank is debating a rate hike, which would damage growth prospects even more, and Hungary shows overt reliance exports to the euro zone. Furthermore, basic vulnerabilities include a highly fx-levered private sector and unstable public finances (see Figure 78). The FX mortgage debt program in particular is projected to shave 1% of GDP from banking sector profits. Capturing these risks, our EUR/HUF forecast implies a near 15% depreciation in the HUF over the 6-12 month timeframe, and is our most bearish FX call this month.

The risk-off environment also continues to pummel the high-beta PLN, which shares HUF's vulnerability to forex loans, with a worse fiscal position *and* in an election year (although other economic fundamentals are much stronger). PLN is forecast to weaken further in the short term as Euro Area risks escalate, but bounce back to 4.3 in 6 to 12 month's time. Two scenarios seem possible in the near term. If EUR/PLN rose to 4.60-4.80 in the next 3 months, in line with our forecast, our calculations suggest that the debt to GDP threshold level of 55% could be exceeded, increasing PLN's vulnerability. If, however, heavy FX intervention to strengthen PLN is pursued in place of fiscal tightening, the PLN could find temporary support.

Cut backs in risk appetite once again drove capital outflows from the Russian economy, hitting the oil-backed RUB despite relatively firm oil prices and tight domestic liquidity conditions. Risks are mainly to the downside: a forecast fall in oil prices and accelerating supply of liquidity via budget spending should trigger further weakening of the ruble in the short term, above the recent CBR target band of 32.15-37.15 for the basket. The CBR will continue to intervene, but the band is likely to be moved up or widened. We think the basket could depreciate to 38 rubles in 2012 as oil prices fall and the current account surplus narrows to US$18bn. Figure 79 shows how sensitive USD/RUB is to global risk appetite.

Figure 78. Share of Forex Loans in Stock of Total Housing Loans



Source: Citi and Reuters EcoWin

Figure 79. Ruble Basket and Citi GMS GRAMI

Source: Citi and Bloomberg

For the ZAR, it might seem as though the bulk of bad news is already priced in: since the July S&P peak, the ZAR has lost nearly a fifth of its value against the dollar, and has been the worst EM performer against both the USD and EUR for several weeks. But in our forecast global setting, the ZAR continues to look weak, with a fragile domestic recovery, poor competitiveness, and growing downside risks for commodities, particularly metals. Near term, ZAR looks oversold, but longer term, our outlook for the currency is still negative.

Our TRY forecast, which has TRY basically flat vs. the EUR, balances two separate forces. Acting against FX recovery are large external financing needs (the current account deficit is nearly in double-digits), made worse by the central bank's radical policies. In its favour are the CBT's apparent willingness to support the lira via FX sale auctions, and the decline in the probability of a rate cut this year. The government's new Medium-Term Plan (to be announced in late September or early October) may have important implications for the trajectory of the lira.

Finally, the shekel has weakened beyond our previous forecast, and the prospect of a strong dollar and sustained risk aversion suggest the risks stay skewed to the downside. In recent sessions the ILS has proved surprisingly resilient, however, mostly thanks to the very low level of foreign involvement in the domestic fixed income market. Only some 3% of Shahars are foreign-owned. Nonetheless, with rising risk premia from regional tensions, and the scope for a "catch up", we expect USD/ILS to rise to 3.80 near-term.

Latam – A new kind of war

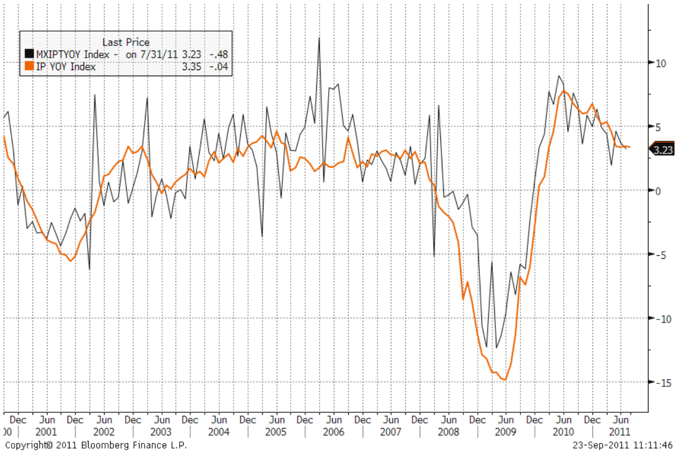
Capitulation in BRL, which at its trough had plummeted by nearly 20% against the USD, has been the most striking development in Latam FX markets in recent weeks. Ironically in the context of recent history, large-scale official intervention to *strengthen* the currency was needed to curb the sell-off. Our current forecasts show a reversal in the medium term, as some "overshooting" is corrected.

The main threat to such a recovery is that three of the four Latam currencies (BRL, CLP, MXN) are backed by increasingly vulnerable commodities, and so may be confronted with a "double-whammy": a weaker global growth environment and risk appetite, plus sliding metals and oil. It is notable that, in the latest wave of "risk off", some currencies seem to have led commodity price movements.

Our 6-12 month forecast for the BRL at 1.80 still leaves it weaker than its 1.70 average for the past two years. Notwithstanding aggressive intervention to shore up the BRL, there are several reasons to believe that recent BRL depreciation should be more persistent than we envisaged previously. Metals and oil comprise half of all exports, and, as observed in 2008, the feed back from commodity prices to the exchange rate can powerful. China is Brazil's chief trading partner, magnifying the risks. Finally, with carry support forecast to drop away as the central bank cuts interest rates, downward pressure on BRL could remain. The local interest rate futures curve is pricing in 140bps of easing by next April.

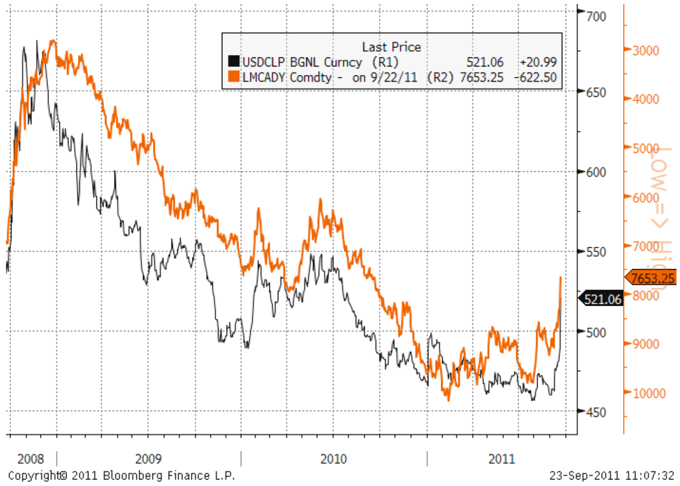
For MXN, it is what transpires in the US, and indeed oil prices, that is of paramount importance (see Figure 80). With the bulk of all exports, and a large chunk of real growth driven by exports to the US alone, MXN is extremely sensitive to developments in the US – and has shed value quickly as a result. Going forward, the question is whether the peso can reverse this underperformance, even if global growth concerns linger and oil prices fail to stage a meaningful rally. The chief support to this outcome would be that local fundamentals, and indeed overall competitiveness, are much better now than they have been during past crisis periods.

Figure 80. Ultra-Tight Links Between US and Mexico (Industrial Production)



Source: Bloomberg

Figure 81. CLP and Copper Prices



Source: Bloomberg

CLP meanwhile is copper-backed, so in this aspect is perhaps most exposed of the four regional crosses. Based on historical relationships, if copper falls to the 6500-7000 range, CLP should weaken to 550 (Figure 81). A front-loading of rate cuts – we are anticipating the central bank to stand pat this year, but cut by 100bps next year – is an added risk. Over the longer term, however, we expect fundamentals to reassert themselves, supporting CLP once again.

Depreciation observed in the USD/COP was a fraction of what was observed in other Latam currencies. We expect this strength to be maintained, with USD/COP at 1850 in both 3 and 6 months time. The Colombian financial system's poor USD cash position, however, could be an important risk factor. As of September 9, the USD cash position held by the financial sector stood at US$498.1 million, almost a half of what is considered to be the "normal" level.

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

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Figure 83. Citi Quarterly Interpolated Forecasts

Quarterly Interpolated Forecasts

	Currency	Spot	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13
G10-US Dollar											
Euro	EURUSD	1.35	1.35	1.29	1.28	1.26	1.25	1.26	1.28	1.29	1.30
Japanese yen	USDJPY	76	76	75	75	76	76	77	77	78	78
British Pound	GBPUSD	1.55	1.54	1.52	1.51	1.51	1.51	1.54	1.58	1.61	1.65
Swiss Franc	USDCHF	0.90	0.91	0.95	0.95	0.95	0.95	0.98	1.00	1.02	1.04
Australian Dollar	AUDUSD	0.98	0.98	0.95	0.98	1.00	1.02	1.00	0.98	0.97	0.95
New Zealand Dollar	NZDUSD	0.78	0.78	0.76	0.79	0.81	0.83	0.78	0.73	0.68	0.63
Canadian Dollar	USDCAD	1.03	1.03	1.06	1.04	1.02	1.00	0.99	0.97	0.96	0.95
Dollar Index*	DXY	78.11	78.36	80.88	81.29	81.70	82.03	81.33	80.65	79.98	79.35
G10 Crosses											
Japanese yen	EURJPY	103	103	97	96	96	95	97	98	100	102
Swiss Franc	EURCHF	1.22	1.22	1.23	1.22	1.20	1.19	1.23	1.27	1.31	1.35
British Pound	EURGBP	0.87	0.87	0.85	0.84	0.84	0.83	0.82	0.81	0.80	0.79
Swedish Krona	EURSEK	9.30	9.30	9.34	9.22	9.11	9.00	8.95	8.90	8.85	8.80
Norwegian Krone	EURNOK	7.88	7.88	7.90	7.85	7.80	7.75	7.74	7.72	7.71	7.70
Norwegian Krone	NOKSEK	1.18	1.18	1.18	1.18	1.17	1.16	1.16	1.15	1.15	1.14
Australian Dollar	AUDNZD	1.26	1.26	1.25	1.24	1.24	1.23	1.30	1.37	1.44	1.51
Australian Dollar	AUDJPY	74.6	74.3	71.4	73.5	75.6	77.5	76.6	75.7	74.9	74.1
EM Asia											
Chinese Renminbi	USDCNY	6.39	6.35	6.30	6.24	6.18	6.12	6.05	6.00	5.93	5.87
Hong Kong Dollar	USDHKD	7.80	7.79	7.78	7.77	7.77	7.76	7.76	7.75	7.75	7.75
Indonesian Rupiah	USDIDR	8941	9100	9300	9200	9000	8900	8800	8750	8700	8650
Indian Rupee	USDINR	49.4	49.2	49.5	48.0	47.5	47.5	47.0	46.5	46.3	46.0
Korean Won	USDKRW	1167	1170	1200	1180	1160	1140	1110	1080	1060	1050
Malaysian Ringgit	USDMYR	3.17	3.21	3.20	3.11	3.09	3.06	3.00	2.96	2.94	2.89
Philippine Peso	USDPHP	43.6	43.8	43.7	43.5	43.0	42.8	42.0	41.7	41.6	41.5
Singapore Dollar	USDSGD	1.29	1.30	1.29	1.26	1.25	1.24	1.22	1.21	1.19	1.17
Thai Baht	USDTHB	30.9	30.8	30.7	30.6	30.5	30.0	30.0	29.9	29.8	29.5
Taiwan Dollar	USDTWD	30.4	30.5	30.8	30.2	29.8	29.5	29.2	28.8	28.5	28.2
EM Europe											
Czech Koruna	EURCZK	24.74	24.78	25.29	25.12	24.95	24.78	24.53	24.28	24.03	23.79
Hungarian Forint	EURHUF	290	294	335	333	332	329	322	314	307	300
Polish Zloty	EURPLN	4.41	4.42	4.64	4.52	4.41	4.29	4.19	4.09	3.99	3.90
Israeli Shekel	USDILS	3.69	3.70	3.79	3.73	3.66	3.60	3.55	3.50	3.45	3.40
Russian Ruble	USDRUB	32.0	32.1	32.9	33.4	33.8	34.1	33.4	32.7	31.9	31.3
Russian Ruble Basket	RUB	37.1	37.1	37.2	37.5	37.8	38.0	37.3	36.7	36.1	35.5
Turkish Lira	USDTRY	1.84	1.84	1.86	1.87	1.87	1.88	1.86	1.83	1.81	1.79
South African Rand	USDZAR	8.27	8.25	8.01	8.18	8.35	8.50	8.57	8.63	8.69	8.76
EM Latam											
Brazilian Real	USDBRL	1.86	1.86	1.82	1.81	1.81	1.80	1.77	1.75	1.72	1.70
Chilean Peso	USDCLP	517	517	520	524	527	529	519	509	499	490
Mexican Peso	USDMXN	13.8	13.7	13.2	13.1	13.1	13.0	12.8	12.6	12.4	12.2
Colombian Peso	USDCOP	1902	1898	1850	1850	1850	1850	1850	1850	1850	1851

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

Source: Citi Investment Research and Analysis

Figure 84. Citi Annual Forecasts

Annual Forecasts

	Currency	Spot	2011*	2012*	2013*	2014*	2015*
G10-US Dollar							
Euro	EURUSD	1.35	1.38	1.26	1.29	1.32	1.34
Japanese yen	USDJPY	76	79	76	78	81	83
British Pound	GBPUSD	1.55	1.57	1.52	1.62	1.67	1.70
Swiss Franc	USDCHF	0.90	0.90	0.96	1.02	1.03	1.03
Australian Dollar	AUDUSD	0.98	1.01	1.00	0.96	0.92	0.89
New Zealand Dollar	NZDUSD	0.78	0.78	0.80	0.67	0.63	0.62
Canadian Dollar	USDCAD	1.03	1.01	1.01	0.96	0.96	0.97
Dollar Index**	DXY	78.16	77.34	81.59	79.80	78.94	78.48
G10 Crosses							
Japanese yen	EURJPY	103	108	96	101	106	112
Swiss Franc	EURCHF	1.22	1.24	1.21	1.32	1.36	1.37
British Pound	EURGBP	0.87	0.88	0.83	0.80	0.79	0.79
Swedish Krona	EURSEK	9.30	9.19	9.07	8.84	8.80	8.80
Norwegian Krone	EURNOK	7.88	7.86	7.78	7.71	7.70	7.69
Norwegian Krone	NOKSEK	1.18	1.17	1.17	1.15	1.14	1.14
Australian Dollar	AUDNZD	1.26	1.29	1.25	1.46	1.47	1.43
Australian Dollar	AUDJPY	74.6	79.5	75.8	74.7	74.2	74.2
EM Asia							
Chinese Renminbi	USDCNY	6.39	6.42	6.15	5.90	5.80	5.60
Hong Kong Dollar	USDHKD	7.80	7.78	7.77	7.75	7.75	7.75
Indonesian Rupiah	USDIDR	8941	8922	8975	8675	8650	8625
Indian Rupee	USDINR	49.4	47.0	47.5	46.1	45.1	44.1
Korean Won	USDKRW	1167	1134	1148	1053	1010	980
Malaysian Ringgit	USDMYR	3.17	3.11	3.07	2.93	2.88	2.85
Philippine Peso	USDPHP	43.6	43.6	42.8	41.5	41.0	41.0
Singapore Dollar	USDSGD	1.29	1.27	1.24	1.19	1.17	1.16
Thai Baht	USDTHB	30.9	30.6	30.3	29.6	28.9	28.9
Taiwan Dollar	USDTWD	30.4	29.9	29.7	28.3	27.8	27.8
EM Europe							
Czech Koruna	EURCZK	24.74	24.74	24.85	23.94	23.29	22.73
Hungarian Forint	EURHUF	290	290	329	305	294	287
Polish Zloty	EURPLN	4.41	4.27	4.35	3.96	3.78	3.65
Israeli Shekel	USDILS	3.69	3.59	3.63	3.44	3.40	3.40
Russian Ruble	USDRUB	32.0	30.3	33.7	31.8	30.9	30.5
Russian Ruble Baske	RUB	37.1	35.4	37.6	35.9	35.4	35.2
Turkish Lira	USDTRY	1.84	1.72	1.87	1.80	1.74	1.68
South African Rand	USDZAR	8.27	7.45	8.40	8.73	9.11	9.51
EM Latam							
Brazilian Real	USDBRL	1.86	1.72	1.80	1.72	1.73	1.76
Chilean Peso	USDCLP	517	496	525	499	508	528
Mexican Peso	USDMXN	13.8	12.6	13.0	12.4	12.4	12.7
Colombian Peso	USDCOP	1902	1847	1850	1852	1880	1913

*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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