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Economics

27 June 2012 | 80 pages

Global Economic Outlook and Strategy

June 2012

- Global growth prospects are worsening, reflecting the EA crisis and EM slowdown. This month, we are cutting our global growth forecasts for both 2012 and 2013, and remain well below consensus and IMF forecasts for both years. We now expect global growth of 2.6% this year and 2.7% in 2013, down by 0.1% for 2012 and down by 0.2% for 2013 from last month. This is the second consecutive downgrade to our 2013 global growth forecast and the first for 2012. A broad-based emerging market slowdown is now underway, and we are making substantial downgrades this month to our 2012-13 growth forecasts for Brazil, China, India, Indonesia, Hungary, Korea and South Africa.
- The EMU crisis is likely to worsen, with widespread recessions, banking sector strains and deficit overshoots. We expect the upcoming EU Summit will produce a political commitment to move towards a "banking union" for EA countries over time, but do not expect this will resolve the crisis. Bailouts for Cyprus and the Spanish banks are likely to be agreed soon, and both Italy and Spain are likely to enter some form of Troika bailout for the sovereign before end-2012. Near term (next 2-3 quarters), we continue to expect at least one sovereign rating downgrade by one major agency for Italy, Spain, Greece, Ireland and Portugal. Over the next 2-3 years, we expect a wider range of sovereign downgrades, including the US, Japan, France and the Netherlands. Over the next 2-3 years, we expect that a combination of fiscal and economic weakness, high market yields, and the need for some form of sovereign bailout will see Italy and Spain reduced below investment grade by at least one major agency.
- We expect further widespread monetary policy loosening in coming months. The ECB is likely to cut rates by 0.25% at the July meeting, and will probably resume its multi-year LTRO programme soon after. The UK is likely to restart QE at the July meeting. For China, additional policy measures this year could include two more rate cuts to boost demand and two more RRR cuts to bring money growth to 14%. The other BRIC countries are also likely to loosen monetary policy in H2-2012. For the US, the Fed's decision to extend Operation Twist may not be the last easing step, and extra QE will be likely if recovery appears threatened or the outlook deteriorates significantly further.

Figure 1. Currency and Interest Rate Forecasts (End of Period, Unless Specified), as of 27 June 2012

	27 June 2012	3Q 12 Forecast	4Q 12 Forecast	1Q 13 Forecast	2Q 13 Forecast	3Q 13 Forecast	4Q 13 Forecast
United States: Federal Funds	0.25	0.25	0.25	0.25	0.25	0.25	0.25
10-Yr. Treasuries (Period Ave.)	1.63	1.60	1.80	2.00	2.10	2.35	2.60
Euro Area: US$/€	1.25	1.24	1.21	1.18	1.15	1.19	1.23
Euro Repo Rate	1.00	0.50	0.50	0.50	0.50	0.50	0.50
10-Yr. Bunds (Period Ave.)	1.53	1.40	1.25	1.25	1.35	1.50	2.00
Japan: Yen/US$	80	80	81	81	82	83	83
Call Money	0.10	0.10	0.10	0.10	0.10	0.10	0.10
10-Yr. JGB (Period Ave.)	0.82	0.95	1.10	1.20	1.10	1.30	1.30

Source: Citi Investment Research and Analysis

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With thanks to Jan Maguire

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

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Figure 2. Forecast Highlights and Changes from Last Month

Global	Global growth prospects are worsening, reflecting the EA crisis and EM slowdown. This month, we are cutting our global growth forecasts for both 2012 and 2013, and remain well below consensus and IMF forecasts for both years. We now expect global growth of 2.6% this year and 2.7% in 2013, down by 0.1% for 2012 and by 0.2% for 2013.
United States	Economic growth is continuing at a disappointing pace, although some areas of slowing have been exaggerated. The dual threats of persistent financial turmoil and large-scale fiscal drag will likely keep the Fed focused on ways to enhance accommodation.
Euro Area	We continue to believe the likelihood that Greece will leave the euro area over the next 12-18 months is 50-75%. We also expect Spain and Italy to come under programmes by end-2012. Governments are likely to agree in principle to form a banking union, but this is unlikely to actually be finalised soon. We expect the ECB to cut rates in July and to restart multi-year LTROs soon.
China	We are cutting our 2012 growth forecast to 7.8% from 8.1% to reflect weak 2Q activity and further softening of EU demand. We also cut 2013 growth forecast from 8.5% to 7.9%, assuming incoming leaders will accept slower growth for better quality amid continued recession in the euro area. We cut our 2012 inflation forecast from 3.5% to 2.9%.
Japan	The consumption tax hike bill (calling for a tax rate hike to 8% in April 2014 and to 10% in October 2015) is likely to be approved by August. However, the tax rate hike in April 2014 will probably hit growth significantly and as a result, we believe that the second tax hike slated just 18 months after the first hike will be politically difficult to implement.
United Kingdom	After recently acknowledging the weakness in the economy, the MPC are likely to resume QE at the July meeting, with either £50bn or £75bn. Further QE beyond that is likely, alongside credit easing, to try and lift the stagnant economy,
Canada	Despite significant externally-focused downside risks and uncertainties, the BoC retains its slightly hawkish policy bias. Hence, we continue to expect stable rates this year and modest withdrawal of stimulus from early 2013.
Australia	The sizeable further rate cuts priced in markets would require a significant deterioration in the global economic outlook.
Emerging Asia (ex China)	Asia's expansion is losing momentum — including in India — alongside softening global growth. Inflation is receding but inflation expectations have proved sticky. We now expect India will cut rates by 50-75bps this year; but most other countries will likely stay on hold for now given already low rates and, in some, use of fiscal easing.
CEEMEA	CEEMEA risks remain to the downside, and we have revised our growth outlook for Hungary and South Africa in particular. Central Europe remains hostage to growth and deleveraging risks from the Eurozone; while any further pressure on energy prices will pose some problems for Russia.
Lat Am	With slowing growth, the central banks of Colombia, Chile and Peru have turned more dovish as a result of activity data pointing toward slower growth ahead. We also see further room for monetary easing to continue in Brazil, although in Mexico rates are likely to remain stable.

Source: Citi Investment Research and Analysis

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

	Equities	G10 Rates	Credit	Securitized Products	FX †	Commodities	Global Macro Strategy †
Overall View	Cheap valuations, reasonable EPS, easy monetary policy should limit downside	EMU crisis now dominates. Uncertainty remains high and risk-aversion is likely to continue to drive yields lower	Technical support risks being overwhelmed by escalating sovereign crisis	Short, high-quality sectors optimise defensive positioning. Off-the-run sectors offer upside	USD higher	Bearish industrial commodities although bullish met coal	Risk aversion rising until policy response
Most-Favoured Region/Sector	Japan, Asia Pac ex Japan/ IT, Industrials, Utilities	5yr EUR	Low-beta core non-fins	US CMBS senior tranches	USD	Precious Metals, Grains and Oilseeds (due to weather risks)	USD
Least-Favoured Region/Sector	US, Australia/ Healthcare, Telecoms, Cons. Disc	>10yr USD	Periphery sub-debt	Spanish and Irish RMBS	EUR, AUD	Bulk Commodities	Equities
Key Risks	Escalation of EMU crisis, hard landing in China	Rapid EMU contagion or a sudden EMU resolution	Sovereign crisis; bank runs; global slowdown	Regulation	QE3, improvement in risk appetite	EMU contagion, oil shock double-dip, risk-off financial outflows China hard landing	EMU breakup, China growth, US fiscal, Central Bank stimulus

Source: Citi Investment Research and Analysis
† Summary view from our Global Macro Strategy Market Commentary team (see page 54 for definition of market commentary). The authors are not independent research analysts and may have knowledge of the Firm's positions and/or the Firm's interest in one or more of the securities referenced herein.

Overview — EA Crisis and EM Slowdown

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We are cutting our global growth forecasts, with sizeable downgrades to our EM growth forecasts

Global growth prospects are worsening, reflecting the EA crisis and EM slowdown. This month, we are cutting our global growth forecasts for both 2012 and 2013, and remain well below consensus and IMF forecasts for both years. We now expect global growth of 2.6% this year and 2.7% in 2013, down by 0.1% for 2012 and by 0.2% for 2013. PPP-weighted, we expect global growth of 3.0% this year and 3.2% in 2013, down by 0.2% for both years from last month. This is the second consecutive downgrade to our 2013 global growth forecast and the first for 2012. Indeed, in recent months we had been edging up our 2012 growth forecast.

We are cutting our emerging market growth forecasts quite sharply this month and a broad-based EM slowdown is now underway

In particular, we are cutting our forecasts for emerging market growth by 0.3% for both 2012 and 2013 (to 4.9% and 5.5% respectively). This is the eighth biggest one-month downgrade of the last 10 years to our EM forecasts (for the current and next year). At the same time, we remain gloomy on the euro area, and expect recession in both 2012 and 2013 amidst high financial market strains and the likelihood that both Italy and Spain will need bailouts for their sovereign debt. Our US growth forecasts are little changed, at 2.1% for 2012 and 2.0% for 2013. We are making only a few forecast upgrades, including Australia, New Zealand and Switzerland.

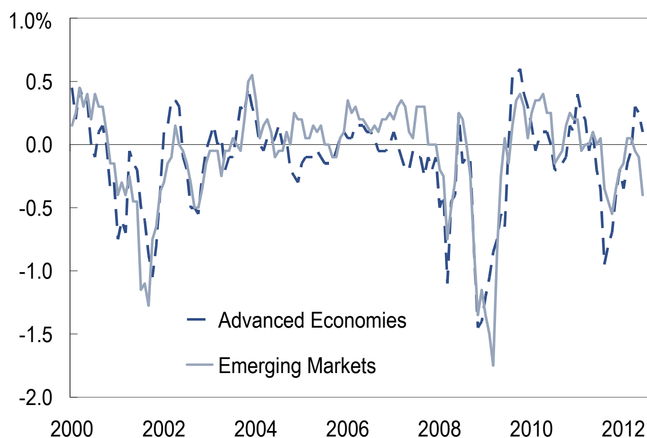
Figure 4. Selected Countries — Industrial Production Forecasts (Pct.), 2011-13F

	2011	2012F	2013F
World	**3.8%**	**2.6%**	**3.0%**
United States	4.1	4.1	3.0
Japan	-2.4	3.5	3.3
Euro Area	3.6	-2.7	-1.3
United Kingdom	-1.2	-1.0	1.3
Canada	3.5	0.2	0.3
China	13.9	11.1	11.7
India	3.4	4.1	4.5
Korea	6.9	3.7	5.1
Brazil	0.3	-1.0	2.8

Source: Citi Investment Research and Analysis

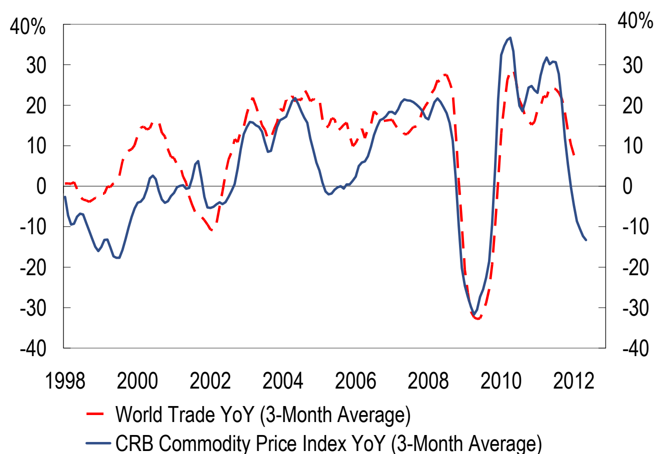
The emerging market slowdown is quite broad-based, and we are making substantial downgrades this month to our 2012-13 growth forecasts for China, India, Indonesia, Korea, Hungary, South Africa and Brazil. The causes of these downgrades vary, but the common pattern is a mix of past tightening, softer economic data, adverse spillovers from the EMU crisis, and the gradual pace of policy stimulus. For China, 2Q growth may fall below 7.5% YoY and we are cutting our forecasts to 7.8% for 2012 and 7.9% for 2013, from 8.1% and 8.5% respectively last month. The authorities are reluctant to repeat the massive investment-led stimulus of 2008-09, and easing is likely to remain cautious, tolerating an extended period of growth slightly below 8% YoY. A marked slowdown also is underway in India, with the pace of loosening constrained by worries over sticky inflation and risks that the sovereign rating might be cut to below investment grade[1]. We expect further rate cuts in many EM countries, including all four BRIC countries, but that this will be too late to prevent this year's slowdown. Nevertheless, aggregate EM growth should continue to outpace the advanced economies for many years.

Figure 5. Global — 3-Month Sum of Revisions to Citi Growth Forecasts for Current and Next Year, 2000-12



Source: Citi Investment Research and Analysis

Figure 6. Global — World Trade and Commodity Prices YoY, 1998-2012



Sources: IMF, Datastream and Citi Investment Research and Analysis

We do not regard commodity price weakness as a springboard for economic recovery

[1] See India Macro Flash - Moody's Retains Sovereign Rating/Outlook at Baa3, Stable; Relatively More Sanguine on Growth vs S&P and Fitch, Rohini Malkani, 25 June 2012.

Against this backdrop, many commodity prices recently have fallen and Citi maintains a neutral to slightly bearish short-term outlook across all major commodity sectors. We regard the weakness of commodities partly as a side effect of economic weakness – especially the EM slowdown — and caution against the idea that the boost to real incomes among commodity-users by itself will reverse this slowdown. Recovery across EM is likely to need widespread policy stimulus.

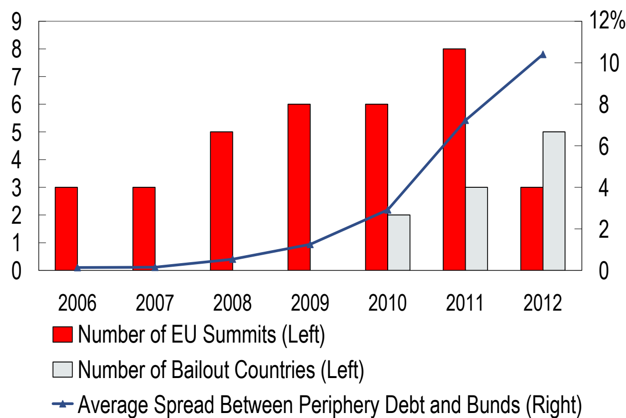
We continue to believe periphery countries face persistent economic weakness and fiscal strains

We remain gloomy on euro area prospects[2]. We continue to believe that the current policy framework of liquidity assistance (via Troika bailouts and ECB liquidity measures) coupled with fiscal austerity and supply side reforms will fail to return the periphery economies to fiscal sustainability, economic recovery or tolerable yields on market financing. Recent data show widespread recession among periphery economies, and surveys suggest that further pain lies ahead. Economic weakness is likely to hit revenues and cause government debt/GDP ratios to overshoot official forecasts in most periphery countries this year, and also create continued widespread doubts about medium-term fiscal prospects. Moreover, all this worsens the vicious circle between weak economies, capital-weak banks (leading to worsening credit availability) and fiscally-weak governments (implementing fiscal austerity and reluctant to recapitalize banks on an adequate scale).

The upcoming EU Summit will probably agree a political commitment to move towards banking union

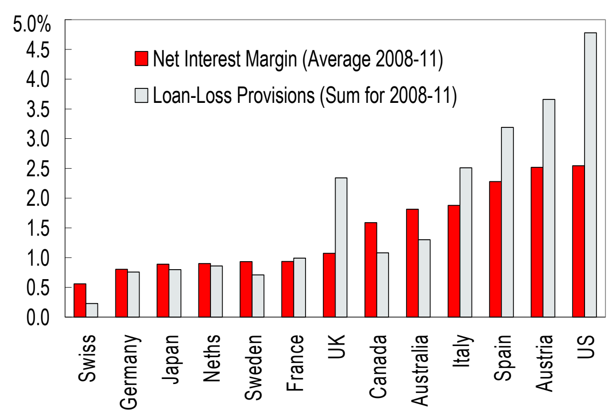
We doubt the upcoming EU Summit – the 3rd this year and the 28th since the start of 2008[3] — will create a significant breakthrough. EU leaders will probably make a political commitment to the long term aim of a "banking union" for the euro area, with common bank regulation and mutualisation of EA deposit guarantee schemes. Such a move could have long term advantages as a backdoor form of fiscal burden sharing, helping to allow the ESM (or a new ESM-backed facility) to recapitalize banks directly rather than via the sovereign. It would probably also encourage the ECB to extend further liquidity assistance to strained banks in the interim.

Figure 7. EU — Number of EU Council Meetings and Bailout Countries, and Sovereign Debt Spreads, 2006-12



Note: We only show full EU Council meetings, including the upcoming one. Periphery debt spreads is the unweighted average for Greece, Portugal, Ireland, Italy and Spain. We show the number of bailout countries at yearend, and include Spain and Cyprus for 2012.
Sources: EU Commission, Datastream and Citi Investment Research and Analysis

Figure 8. Selected Countries — Banks' Loan-Loss Provisions and Interest Margins, 2008-11



Note: Loan-loss provisions are shown as a share of total assets.
Sources: BIS and Citi Investment Research and Analysis

[2] See "*Global Economics View - What's Next for Spain and Italy?*, Willem Buiter and Ebrahim Rahbari, 25 Jun 2012, and "*Race to Save the Euro Would Follow 'Grexit'*", Willem Buiter, 25 Jun 2012, Citi.

[3] We only include full EU Council meetings. The pre-crisis schedule used to be 3 EU Summits per year. At that pace, one would expect this would be the 14th Summit since the start of 2008.

Banking sector strains are a severe impediment to EA growth, with worries that many banks have not yet made provisions on an adequate scale…

Measures to resolve banking sector weaknesses are certainly badly needed. Widespread worries over bank capital health are creating funding strains that are reflected in worsening credit availability, especially in periphery economies. BIS data show that banks in many EMU countries have made a markedly lower share of loan loss provisions over 2008-11 (as a share of total assets) than US and UK banks, despite also suffering severe economic weakness at home and externally. The disparities in loan-loss provisions across countries remain closely linked to the banking sector's net interest margins, which suggests that in some cases the scale of provisions is set more by what banks can afford to put aside rather than how much would be genuinely needed to cover expected losses. Of course, this leaves worries that additional future bank provisions may further erode bank capital.

…with some EA governments reluctant or unable to bear bank recapitalization costs

Moreover, as the IMF recently pointed out[4], European policymakers have – to a far greater extent than the US and UK – reacted with liquidity provision to banks rather than government-financed bank recapitalization. As a result, we suspect that further bank recapitalizations lie ahead in the euro area. Under the current framework, such capital needs would probably fall on euro area governments, further straining sovereign balance sheets. In addition, the IMF expects that European banks will reduce their balance sheets by 6-10% ($2.2tn-$3.8tn) and, while some of this may fall outside the euro area, a sizeable part also is likely to be felt within the EA[5].

Figure 9. US, UK, Euro Area — Banking Sector Crises Outcomes and Resolution in the Euro Area and the United States

Country	Output Loss (Pct of GDP)	Increase in Debt (Pct of GDP)	Monetary Expansion (Pct of GDP)	Fiscal Costs (Pct of GDP)	Fiscal Costs (Pct of Financial System Assets)	Liquidity Support (Pct of Financial System Balance Sheet)
All Banking Crises 1970-2011	23.0%	12.1%	1.7%	6.8%	12.7%	9.6%
Crises in Advanced Economies	32.9	21.4	8.3	3.8	2.1	5.7
Euro Area (Current Crisis)	23.0	19.9	8.3	3.9	1.7	13.3
US (Current Crisis)	31.0	23.6	7.9	4.5	2.1	4.7
UK (Current Crisis)	25.0	24.4	9.4	8.8	2.5	5.6

Sources: IMF and Citi Investment Research and Analysis

We doubt current proposals for a banking union will resolve these problems.

Initial moves to banking union will probably be quite narrowly drawn…

- First, any banking union will probably be confined initially to a relatively small number of systematically important financial institutions (SIFIs) – which already face capital surcharges under BIS standards. The German government is likely to continue to insist that funding (from the ESM) only comes in exchange for a loss of control. But this scheme would not cover the many small and medium-sized Spanish banks whose recapitalisation needs are currently being assessed. Costs of recapitalizing SIFIs have not been responsible for any of the bailouts agreed so far (Greece, Portugal, Ireland), under discussion (Spanish banks and Cyprus) or likely in coming quarters (Spanish sovereign and Italy). Many EA governments remain reluctant to lose control over regional or local banks in this category. For this reason, it may not be possible to subsequently re-engineer the Spanish bank bailout to come directly from the ESM rather than via the sovereign.

…and experience so far does not make us confident that banks' recapitalization needs will be assessed adequately

- Second, attempts at pan-EU assessments of banks' capital needs through the EBA have been unsuccessful, with reluctance to force banks to recapitalize on a big enough scale. It is unclear whether a new euro area regulator would be any more successful or would be similarly hobbled.

[4] See "*Systemic Banking Crises Database: An Update*", IMF Working paper WP/12/163, Laeven and Valencia

[5] See "*IMF Global Financial Stability Report*", April 2012.

It is unclear if moves to a banking union will be consistent with continued financial repression of periphery banks by periphery governments

- Third, it is unclear if moves to a banking union and rigorous common bank regulation would be consistent with the desire of many periphery governments to (through financial repression) lean on domestic banks to support the domestic government bond market. At present, periphery banks' liquid assets in aggregate are concentrated in the relatively illiquid debt of their own governments. This close link has been exacerbated by the surge in purchases following the ECB's two 3-year LTROs. Between Nov-11 and Mar-12, holdings of domestic government debt rose by 31% for Portuguese banks, 32% among Italian banks and 51% for Spanish banks[6]. These bond purchases gave temporary liquidity assistance to periphery governments, but have left a hangover of weakened bank balance sheets and increased the concentration of periphery risks in weak hands. As the BIS recently argued "*Sovereign debt holdings are an important drag on banks' efforts to regain the trust of their peers and the markets at large. Of these holdings, exposures to sovereigns on the euro area's periphery are perceived as carrying particularly high credit risk. And for many banks headquartered in the periphery countries, such exposures are much higher than common equity*."[7] Creditor nations may be unwilling to share recapitalization costs if periphery banks continue to be used as a "piggy bank" for fiscally-weak governments, and will instead insist that periphery banks over time shift their liquid assets to genuinely high quality government (or ESM/EFSF) debt. However, with few other buyers for their debt, we doubt that fiscally-weak sovereigns will be willing to lose the ability to repress their own banks.

A euro-wide DGS would need heavy backing from creditor nations to provide effective defence against deposit flight

- Fourth, a euro-wide deposit guarantee scheme (DGS) would probably not prevent capital flight out of periphery countries. A traditional DGS probably would fail to stem deposit exodus, because such schemes protect against insolvency of an individual bank, and lack the larger funding needed to protect depositors against general redenomination risk. A DGS that protects against redenomination risk would imply a huge contingent fiscal liability that weak countries could not afford and which creditor nations would be unlikely to be willing to give. Moreover, even an extended DGS would probably not fully stem deposit flight, because it would probably only cover personal deposits up to a certain size (€100,000 per person per bank is typical for existing EU DGS) and hence exclude large personal deposits or corporate deposits[8].

We continue to believe the probability of 'Grexit' is 50-75%...

In the probable absence of a breakthrough at the EU summit, we expect the EMU crisis to intensify further: We continue to believe the probability of Grexit (Greek EMU exit) over the next 12-18 months is 50-75%. In the near term, some relaxation on the timing of austerity, some limited early disbursement of funds to pay for essential public goods and services, and some token pro-growth gestures courtesy of the European Investment Bank and EU Structural and Cohesion funds will most likely keep Greece in the EA in Q3. However, we consider it highly unlikely that Greece will comply sufficiently with even the 'lite' fiscal austerity conditionality, let alone with structural reform conditionality (including privatisation targets), which is unlikely to be relaxed. Political opposition to austerity and reform are now stronger in Greece than ever before. So is resistance to bailouts in the core EA member states. The troika may forgive a Greek failure in the September progress assessment, but is unlikely to tolerate another failure to comply by the December assessment.

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[6] Including loans, the total exposure of Spanish banks to the Spanish general government sector is now close to 10% of banks' assets.

[7] Source: BIS Annual Report June 2012.

[8] The European Commission estimated in 2010 that a general EU-wide DGS up to €100,000 would cover about 40% of aggregate bank deposits. See "*Impact Assessment on Deposit Guarantee Schemes*", Commission Staff Working Document, 2010.

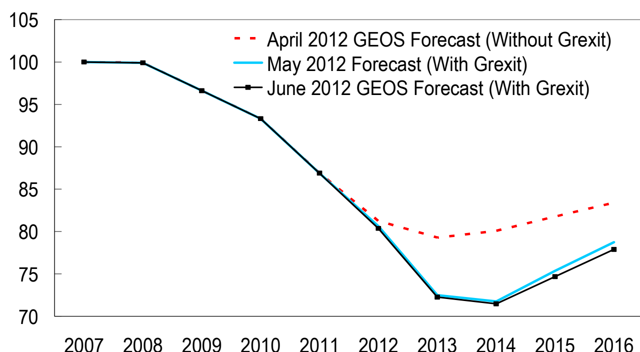
…likely to be triggered by the Troika's reluctance to modify the programme substantially, and Greece's inability to meet even slightly modified targets

Grexit may well be triggered by a troika review declaring Greece wilfully non-compliant with the conditionality of its programme, stopping the disbursements to the Greek sovereign. In this scenario, Greece would default and the Eurosystem and the Greek ELA (Emergency Liquidity Assistance provided by the Greek Central Bank) would stop funding the Greek banks. At that point Greece would have to exit EMU, following the imposition of capital controls, foreign exchange controls, restrictions on deposit outflows and a temporary suspension of the Schengen Agreement. We believe this scenario will become more likely as risks rise that the Spanish and Italian sovereigns will also need bailouts. It is highly probable that the core EA countries will refuse to take on significant extra exposures to Spain (over and above the €100bn already committed for the Spanish banking sector bailout) and/or any significant exposure to Italy unless it can be established unambiguously that a persistently non-compliant country will be denied further funding.

Grexit is not definite, but is the most likely outcome in our view

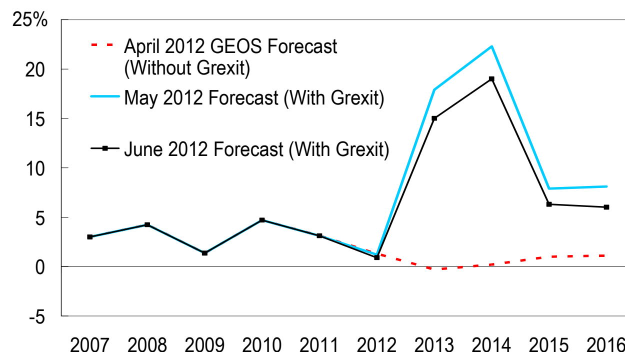
It is possible that Greece will remain a member of EMU, but this would, in our view, require three highly unlikely developments. Greece would have to transform its institutional and political delivery capacity and implement far-reaching structural reforms, including privatisation, as well as 'lite' austerity which would be required even with material concessions by the troika. Moreover, even if Greece stays in the euro area a substantial debt restructuring would be required to get Greece back on a sustainable path. Hence, other EA member states would have to accept sizeable writedowns (in NPV terms) on about €200bn worth of official exposure on the Greek sovereign through the ECB, the Greek Loan Facility and the EFSF (perhaps, for example, by converting those debts to zero coupon perpetuals)[9]. In addition, official creditors would have to agree to keep funding most of the continued Greek fiscal deficit, while the ECB would have to keep funding Greek banks, both through the Eurosystem's facilities and through the Greek ELA. It is possible that these three developments will indeed occur, but unlikely in our view.

Figure 10. Greece — Level of Real GDP (Indexed to 2007=100), 2007-16F



F Citi forecast. Sources: Eurostat and Citi Investment Research and Analysis

Figure 11. Greece — YoY CPI Inflation, 2007-16F



F Citi forecast. Sources: Eurostat and Citi Investment Research and Analysis

We assume Grexit would be followed by sharp currency weakness, rising inflation and delayed recovery

For the sake of argument, we model in our forecasts (as last month) a Grexit occurring on 1 January 2013. But, we stress that this is a fairly arbitrary date rather than a forecast. Our base case assumes that the new currency would quickly weaken by about 60%, leading to a surge in inflation, with the economy initially contracting sharply and then recovering somewhat, followed by a sizeable further debt restructuring at some stage. The damage could be limited (but not avoided) by ensuring that Greece remains an EU member even after EA exit. As an EU member,

[9] The IMF would be protected in any such deal through its preferred creditor status.

Greece would be able to benefit from external financial assistance (through the balance-of-payments facility of the EU and the IMF Standby Program) — as used since 2008 by Latvia, Romania and Hungary. It could also continue to access EU Structural and Cohesion Funds and benefit from EIB investment programmes on its territory. We believe that ongoing EU membership of Greece after Grexit would be the most likely outcome. Should Greece also exit the EU, the remaining 26-member EU is at risk of having a failing state on its South-Eastern border.

Portugal and Ireland will probably both need a second bailout – and eventual debt restructuring looks likely

Portugal and Ireland will probably both need a second bailout, and – given strong records of complying with the current programmes — both are likely to get one. We suspect these second bailouts would not include PSI initially. Nevertheless, with both countries likely to face persistent economic weakness, and with their government debt/GDP ratios likely to rise above 130% in 2013 or 2014, eventual debt restructuring looks likely, perhaps during 2014-15[10].

We expect that both Spain and Italy to enter some form of bailout before year end…

In addition, we expect that both Spain and Italy will enter some form of sovereign bailout by the end of this year. For Spain, we expect that the bank bailout currently under discussion will have to be supplemented by a broader bailout of the sovereign. With the weak economy, sizeable bank recapitalization needs (which may well eventually exceed the €100bn ceiling under the current proposal), it is unlikely, in our view, that the Spanish government will have access to affordable market funding anytime soon, even if aided by a combination of financial repression and subsidized ECB funding. In our view, Italy also is an early candidate for recourse to external financial support, because of the fiscal vulnerabilities from high debt rollover, disappointing progress on growth-enhancing structural reform and privatization and doubts about the government's ability and willingness to hit its fiscal targets amidst economic weakness[11].

…and such programmes will probably consist of partial funding, with the remaining funding needs covered – via repression and ECB liquidity – by domestic banks

The likely shapes of programmes for Italy and Spain are unclear but will probably include some degree of fiscal and structural reform conditionality on the sovereign, funding for the sovereign via the EFSF (or ESM once it is born), and involvement of the IMF in the design and monitoring of the programme. IMF co-funding is possible but not essential. These programmes would be only partly funded, given that the EMU rescue facilities are too small to allow full funding. Continued market access would also be useful to possibly prevent Spain and Italy from becoming step-out guarantors for the EFSF, as a PR effort to distinguish Spain and Italy in the eyes of the public, investors and the Spanish and Italian voters from Greece, Ireland and Portugal, and also to limit the increase of the debt or the remaining guarantors. It is also possible that normal market access could be regained more easily if a semblance of market access is maintained all the way through. However, many investors would be likely to shun issuance by programme countries, because they would be effectively subordinated to official lenders (with virtual certainty in the case of IMF funding). As a result, it may take severe repression of domestic banks, and the lure of further ECB multi-year liquidity, to fill the funding gaps.

The end-game is likely to include a significant amount of sovereign and bank debt restructuring

Over the next few years, the end-game for the euro area is likely to be a mix of EMU exit (Greece), a significant amount of sovereign debt and bank debt restructuring (Portugal, Ireland and, eventually, perhaps Italy, Spain and Cyprus) with only limited fiscal burden-sharing. Although the risk of a full EMU breakup is not negligible any more, we do not expect such a breakup to happen, but nor do we expect a sufficient move to fiscal burden-sharing to resolve the fiscal problems of periphery countries.

[10] See "Euro Economics Weekly - Ireland — Recession Casts Doubt On Fiscal Sustainability, Michael Saunders et al, 18 May 2012, Citi.

[11] See "Euro Economics Weekly -- Focus on Italy", Jürgen Michels et al, 8 June 2012, Citi.

Figure 12. Selected Countries — Economic Forecast Overview (Percent), 2011-2016F

	GDP Growth						CPI Inflation						Short-Term Interest Rates					
	2011	2012F	2013F	2014F	2015F	2016F	2011	2012F	2013F	2014F	2015F	2016F	2011	2012F	2013F	2014F	2015F	2016F
Global	**3.0**	**2.6**	**2.7**	**3.6**	**3.7**	**3.8**	**3.7**	**2.8**	**2.7**	**2.8**	**2.8**	**2.8**	**2.53**	**2.35**	**2.34**	**2.60**	**2.89**	**3.26**
Based on PPP weights	*3.6*	*3.0*	*3.2*	*3.9*	*4.0*	*4.1*	*4.2*	*3.2*	*3.1*	*3.1*	*3.1*	*3.0*						
Industrial Countries	**1.3**	**1.2**	**1.0**	**2.1**	**2.3**	**2.5**	**2.3**	**1.7**	**1.3**	**1.5**	**1.5**	**1.5**	**0.76**	**0.58**	**0.53**	**0.67**	**0.99**	**1.54**
United States	**1.7**	**2.1**	**2.0**	**3.5**	**3.5**	**4.0**	**2.5**	**1.7**	**1.5**	**2.1**	**2.2**	**2.2**	**0.25**	**0.25**	**0.25**	**0.40**	**1.15**	**2.10**
Japan	**-0.7**	**2.7**	**1.4**	**1.5**	**1.5**	**1.2**	**-0.3**	**0.2**	**-0.1**	**0.3**	**0.4**	**0.5**	**0.10**	**0.10**	**0.10**	**0.10**	**0.13**	**0.48**
Euro Area	**1.5**	**-0.7**	**-0.8**	**0.8**	**1.1**	**1.2**	**2.7**	**2.3**	**1.6**	**1.1**	**1.0**	**1.0**	**1.19**	**0.75**	**0.50**	**0.50**	**0.50**	**0.75**
Canada	2.4	2.0	2.2	2.7	3.2	3.5	2.9	1.6	1.6	2.0	2.0	2.0	1.00	1.00	1.63	2.19	2.50	3.00
Australia	2.0	3.7	3.4	3.8	3.8	3.6	3.4	1.8	3.2	2.9	2.7	2.5	4.75	3.56	3.44	4.50	5.00	5.25
New Zealand	1.3	2.3	2.8	3.0	3.2	3.4	4.0	1.6	2.4	2.6	2.9	2.8	2.50	2.50	3.25	4.25	5.00	5.50
Germany	3.1	1.2	0.9	1.0	1.3	1.1	2.3	1.9	2.1	2.2	2.2	2.2						
France	1.7	-0.1	-0.2	0.9	1.2	1.8	2.3	2.1	0.8	1.4	1.9	1.6						
Italy	0.5	-2.6	-2.0	0.1	0.9	0.7	2.9	3.1	1.0	-0.4	-0.7	0.2						
Spain	0.7	-2.1	-3.1	0.4	1.9	1.4	3.1	1.5	0.3	0.2	0.7	1.1						
Greece	-6.9	-7.5	-10.1	-1.1	4.5	4.3	3.1	0.9	15.0	19.0	6.3	6.0						
Ireland	0.7	-1.0	0.4	2.0	2.1	2.1	-0.4	0.1	0.2	0.5	0.6	0.6						
Portugal	-1.6	-4.6	-5.5	-0.6	1.5	1.5	3.6	2.6	1.5	0.4	0.1	0.2						
Netherlands	1.3	-1.5	-0.6	1.0	1.2	1.4	2.3	2.8	2.5	1.6	1.9	1.8						
Belgium	2.0	0.0	-0.3	0.8	1.5	1.9	3.5	2.9	1.7	1.9	2.3	2.3						
Denmark	1.0	0.7	1.3	1.6	1.7	1.8	2.8	2.5	1.7	1.5	1.6	1.8	1.30	0.16	-0.20	0.55	0.60	1.00
Norway	2.5	3.0	2.9	2.7	2.7	2.9	1.3	1.3	1.8	2.0	2.4	2.5	2.10	1.50	1.90	2.30	2.90	3.30
Sweden	4.0	0.4	1.9	2.4	2.5	2.7	3.0	1.2	1.6	2.2	2.1	2.0	1.80	1.20	1.10	1.60	2.10	2.50
Switzerland	2.1	1.4	0.8	1.1	1.1	1.1	0.2	-0.9	-1.4	-0.9	0.4	0.7	0.22	0.00	0.00	0.00	0.00	0.00
United Kingdom	0.6	-0.4	0.6	1.1	1.7	2.5	4.5	2.6	1.8	1.8	1.6	1.5	0.50	0.50	0.50	0.50	0.50	1.04
Emerging Markets	**6.0**	**4.9**	**5.5**	**5.7**	**5.7**	**5.7**	**6.1**	**4.7**	**4.8**	**4.7**	**4.6**	**4.5**	**5.70**	**5.30**	**5.20**	**5.50**	**5.60**	**5.60**
China	**9.2**	**7.8**	**7.9**	**7.6**	**7.3**	**7.0**	**5.4**	**2.9**	**3.1**	**3.8**	**4.0**	**4.0**	**3.20**	**3.20**	**3.00**	**3.60**	**4.00**	**4.00**
Taiwan	4.0	2.8	4.2	4.5	4.5	4.5	1.4	1.9	2.1	1.8	1.8	1.8	0.80	0.90	0.90	1.10	1.30	1.40
India	6.5	6.4	6.9	7.1	7.3	7.4	8.8	7.4	6.5	6.0	6.0	6.0	8.20	7.80	7.50	7.50	7.50	7.50
Indonesia	6.5	6.1	6.3	6.7	6.5	6.7	5.4	4.4	4.7	5.3	5.8	5.4	5.40	3.80	4.20	4.50	4.60	5.10
Korea	3.6	2.8	3.6	3.8	4.0	4.2	4.0	2.8	3.0	3.1	3.0	3.2	3.20	3.10	2.90	3.50	4.30	4.50
Czech Republic	1.7	-1.0	1.0	2.6	3.3	3.5	1.9	3.2	2.4	1.8	2.3	1.6	0.80	0.60	0.30	1.00	1.60	2.30
Hungary	1.7	-0.9	0.8	2.0	2.0	1.8	3.9	5.2	3.5	3.5	3.1	3.3	6.00	6.80	6.00	6.00	5.90	5.50
Poland	4.3	2.7	2.4	3.1	3.4	3.4	4.3	3.9	2.6	2.5	2.5	2.5	4.20	4.70	4.30	4.40	4.80	4.80
Romania	2.5	1.3	3.0	4.2	4.3	4.3	5.8	2.8	2.7	2.5	2.5	2.5	6.20	5.30	5.00	5.00	5.00	5.00
Russia	4.3	3.5	4.0	4.1	4.0	4.2	8.4	5.1	6.9	5.8	5.5	5.0	8.10	8.00	7.10	6.00	6.00	5.40
Turkey	8.5	2.5	4.3	4.6	4.6	4.6	6.5	9.4	7.0	6.0	5.9	5.4	6.00	5.80	6.30	8.00	7.60	7.50
Nigeria	7.8	7.4	6.8	7.2	6.9	7.2	10.8	12.4	9.8	10.3	9.5	9.0	8.90	15.00	12.50	10.50	10.00	9.50
South Africa	3.1	2.7	3.6	4.4	4.4	4.5	5.0	6.1	5.4	5.2	5.4	5.5	5.50	5.50	6.10	6.50	6.50	6.50
Argentina	8.9	3.0	3.0	2.0	2.0	3.5	9.8	9.6	11.4	14.4	15.0	16.5	18.40	13.50	17.70	16.00	14.00	13.00
Brazil	2.7	2.3	4.5	4.5	4.5	4.5	6.6	5.1	5.3	4.5	4.0	4.0	11.70	8.50	7.90	9.40	9.00	8.30
Mexico	3.9	3.9	3.8	3.5	3.6	3.7	3.4	4.0	3.9	3.9	3.8	3.7	4.50	4.50	4.50	4.60	5.50	6.40
Venezuela	4.2	5.0	3.5	4.0	3.0	2.5	27.1	23.6	27.5	31.6	29.6	29.6	13.30	14.40	14.40	13.00	12.90	12.70

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

Figure 13. Selected Countries — Economic Forecast Overview (Percent), 2011-2016F

	Current Balance (Pct of GDP)						Fiscal Balance (Pct of GDP)						Government Debt (Pct of GDP)					
	2011	2012F	2013F	2014F	2015F	2016F	2011	2012F	2013F	2014F	2015F	2016F	2011	2012F	2013F	2014F	2015F	2016F
Global	**0.5**	**0.3**	**0.3**	**0.1**	**0.2**	**0.2**	**-4.9**	**-4.3**	**-3.4**	**-2.9**	**-2.6**	**-2.4**	**80**	**82**	**82**	**82**	**81**	**79**
Based on PPP weights	*0.7*	*0.5*	*0.3*	*0.1*	*0.1*	*0.1*	*-4.3*	*-3.9*	*-3.2*	*-2.8*	*-2.6*	*-2.4*						
Industrial Countries	**-0.5**	**-0.6**	**-0.4**	**-0.3**	**-0.2**	**-0.1**	**-6.8**	**-5.7**	**-4.5**	**-3.8**	**-3.2**	**-3.0**	**105**	**111**	**113**	**115**	**115**	**115**
United States	**-3.1**	**-3.2**	**-3.0**	**-3.1**	**-3.2**	**-3.2**	**-9.4**	**-7.8**	**-5.9**	**-4.6**	**-4.0**	**-4.0**	**98**	**104**	**106**	**108**	**108**	**108**
Japan	**2.0**	**1.5**	**1.7**	**2.0**	**2.0**	**2.0**	**-10.7**	**-10.5**	**-8.1**	**-7.9**	**-7.5**	**-7.1**	**228**	**235**	**242**	**246**	**251**	**255**
Euro Area	**0.0**	**0.0**	**0.1**	**0.2**	**0.4**	**0.5**	**-4.1**	**-3.3**	**-2.7**	**-2.5**	**-1.8**	**-1.4**	**87**	**95**	**97**	**97**	**96**	**95**
Canada	-2.8	-2.6	-2.4	-2.0	-1.5	-0.9	-1.4	-1.2	-0.5	-0.1	0.2	0.4	85	85	84	83	81	79
Australia	-2.3	-4.1	-5.3	-4.9	-3.5	-3.2	-3.4	-3.0	0.1	0.1	0.3	0.4	6	10	9	9	8	7
New Zealand	-4.2	-5.0	-7.0	-6.4	-5.8	-5.5	-9.2	-4.1	-3.6	-0.9	0.1	0.9	22	27	31	34	35	36
Germany	5.8	5.2	3.8	3.5	3.4	3.2	-1.0	-0.6	-0.4	-0.4	-0.1	0.2	81	83	83	81	79	77
France	-2.2	-1.9	-1.1	-0.3	0.3	0.4	-5.2	-4.5	-4.0	-3.5	-2.6	-1.8	86	93	99	101	101	99
Italy	-3.2	-2.3	-1.8	-1.5	-1.3	-1.2	-3.9	-2.9	-2.9	-3.0	-2.1	-2.2	120	130	135	138	137	139
Spain	-3.5	-2.5	-1.7	-0.3	0.7	1.7	-8.9	-6.2	-6.0	-5.1	-4.0	-2.9	69	84	101	106	106	106
Greece	-9.6	-7.6	-3.5	0.7	2.5	3.1	-9.1	-10.8	-5.8	-4.9	-3.2	-6.3	165	157	437	382	103	92
Ireland	0.1	3.8	4.0	6.4	8.0	9.4	-13.0	-9.4	-9.8	-7.6	-6.3	-5.4	108	122	130	133	134	137
Portugal	-8.1	-4.5	-2.5	-1.5	-1.4	-1.0	-4.2	-5.5	-4.2	-4.3	-2.6	-2.4	108	120	133	100	103	103
Netherlands	8.4	9.6	9.5	8.5	7.5	7.1	-4.7	-4.5	-3.5	-2.3	-1.5	-1.0	65	70	73	74	73	72
Belgium	-0.8	-0.2	0.3	1.0	2.0	2.4	-3.7	-2.8	-2.6	-2.3	-1.5	-1.1	98	112	119	118	115	112
Denmark	6.6	5.5	5.4	4.0	3.5	3.7	-1.9	-3.5	-2.0	-1.9	-1.7	0.5	47	49	49	50	50	48
Norway	14.0	14.3	14.9	15.2	15.8	16.5	13.8	13.6	14.0	15.0	17.0	18.5	NA	NA	NA	NA	NA	NA
Sweden	7.0	7.0	7.2	7.3	7.2	7.3	0.1	-0.1	-0.2	0.6	1.2	1.5	37	37	36	33	31	28
Switzerland	14.8	12.4	11.1	10.4	10.4	10.5	0.7	0.5	0.1	0.2	-0.1	-0.4	52	51	50	50	50	50
United Kingdom	-1.9	-1.7	-0.7	0.2	1.0	1.4	-8.3	-6.7	-7.9	-7.4	-6.8	-5.8	83	89	96	102	106	109
Emerging Markets	**2.2**	**1.9**	**1.4**	**0.8**	**0.7**	**0.7**	**-1.5**	**-1.8**	**-1.7**	**-1.6**	**-1.7**	**-1.7**	**34**	**34**	**33**	**32**	**31**	**30**
China	**2.8**	**2.0**	**1.5**	**1.0**	**1.0**	**1.0**	**-1.3**	**-2.4**	**-1.5**	**-1.0**	**-1.0**	**-1.0**	**15**	**16**	**16**	**15**	**15**	**14**
Taiwan	8.8	8.7	8.4	8.0	8.0	8.0	-1.9	-1.6	-1.6	-1.3	-1.0	-0.7	39	39	40	42	43	44
India	-4.0	-3.5	-2.6	-2.2	-1.7	-1.1	-8.4	-8.0	-7.7	-7.0	-6.5	-5.0	69	69	68	66	64	63
Indonesia	0.2	-1.9	-1.2	-0.9	-1.0	-0.9	-1.2	-1.8	-0.7	-1.0	-0.5	-0.5	26	25	24	23	23	22
Korea	2.4	1.8	1.9	1.2	0.2	-0.7	1.5	1.2	1.5	1.6	1.5	2.2	33	3	32	31	29	27
Czech Republic	-3.0	-2.2	-2.2	-3.7	-2.3	-2.0	-3.1	-3.2	-2.9	-2.3	-1.5	-0.5	4	45	46	45	44	41
Hungary	1.7	1.2	1.9	1.5	1.0	1.0	4.3	-2.8	-2.5	-3.0	-3.0	-3.0	8	7	78	77	77	77
Poland	-4.3	-3.8	-4.5	-5.2	-5.3	-4.9	-5.1	-3.1	-2.5	-1.8	-1.5	-1.5	54	52	50	48	47	45
Romania	-4.4	-4.5	-4.7	-5.0	-5.0	-5.0	-4.1	-2.4	-2.2	-2.5	-2.3	-2.0	39	39	39	39	38	37
Russia	5.3	5.8	2.4	-1.0	-1.0	-1.0	2.0	0.3	0.1	-0.1	-1.1	-1.1	8	9	9	8	8	8
Turkey	-10.0	-7.5	-6.9	-6.4	-5.9	-5.5	-1.3	-2.2	-2.5	-2.5	-2.7	-3.0	41	41.0	39.4	39	38	36
Nigeria	6.1	5.7	6.4	5.0	4.0	3.5	-3.1	-2.2	-2.1	-2.6	-3.0	-2.6	NA	NA	NA	NA	NA	NA
South Africa	-3.4	-4.7	-5.6	-6.6	-6.3	-5.8	-5.0	-4.8	-4.2	-3.6	-3.5	-3.5	38	41	42	43	43	43
Argentina	0.0	0.1	-0.3	-0.5	-0.6	-0.7	-1.6	-3.0	-2.0	-1.3	-0.6	0.1	41	43	47	52	53	53
Brazil	-2.1	-2.1	-2.5	-2.7	-3.0	-3.3	-2.6	-1.9	-2.7	-2.5	-2.3	-2.6	63	63	63	64	64	65
Mexico	-0.8	-1.4	-2.0	-2.5	-2.4	-2.6	-2.5	-2.2	-2.0	-1.9	-1.9	-1.8	40	40	38	38	38	37
Venezuela	9.1	4.9	3.7	5.6	5.8	5.0	-5.0	-5.0	-4.0	-5.2	-5.0	-4.8	43	35	35	35	36	37

Note: Fiscal deficit and debt figures for all countries are general government debt and deficits. We assume sovereign debt restructuring in Portugal in 2014 and Greece in 2015. Source: Citi 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	2012F	2013F	2011	2012F	2013F	2011	2012F	2013F	2011	2012F	2013F
Global		**-0.1**	**-0.2**		**-0.2**	**-0.2**	**0.2**	**0.1**	**0.1**		**-0.2**	**-0.1**
Based on PPP weights		*-0.2*	*-0.2*		*-0.2*	*-0.2*	*0.1*	*0.1*			*-0.1*	*-0.1*
Industrial Countries			**-0.1**		**-0.2**	**-0.2**	**0.2**	**0.2**	**0.2**		**-0.1**	
United States			**-0.1**		**-0.2**	**-0.2**		**0.1**	**0.1**			
Japan		**0.1**	**-0.1**		**-0.2**	**-0.1**			**-0.3**			
Euro Area		**-0.1**	**-0.1**		**-0.2**	**-0.2**		**0.1**			**-0.2**	**0.2**
Canada	-0.1		-0.1		-0.2	-0.1		-1.0	-0.8			
Australia		0.9	-0.1		-0.1	-0.2		-0.1	0.5			
New Zealand		0.5	0.5				-0.2	0.2	0.6	-1.2	1.8	-0.5
Germany		-0.2	-0.1		-0.2	-0.2		-0.2	-0.7		-0.1	-0.1
France			-0.1		-0.2	-0.2					-0.1	0.1
Italy		-0.1			-0.5	-1.0						-0.2
Spain		0.1	-0.5		-0.7	-2.0		-0.4	-0.7		0.2	0.3
Greece		-0.1			-0.3	-0.3		0.8	0.9		-0.1	
Ireland		-0.2						0.6	0.4		-0.1	-0.1
Portugal			-0.3		-0.5	-0.7		0.1				-0.1
Netherlands						-0.1	-0.6	-0.2				
Belgium			-0.4								0.4	0.3
Denmark		0.1	0.1	0.1	0.3		0.1	-0.3	-0.1		0.5	0.4
Norway												
Sweden			-0.1				-0.2		-0.1	-0.1	0.3	
Switzerland	0.2	0.7	-0.1		0.2	0.1	-0.2	-1.4	-2.9	0.1	0.3	0.3
United Kingdom		-0.2	0.1		-0.3			-0.4	-0.2		-0.4	-0.2
Emerging Markets		**-0.3**	**-0.3**		**-0.2**	**-0.2**		**-0.1**	**-0.2**		**-0.2**	**-0.2**
China		**-0.3**	**-0.6**		**-0.6**	**-0.4**						
Taiwan		-0.5										
India	-0.4	-0.6	-0.6	-0.2	0.4			0.6	0.8			
Indonesia		-0.1	-0.2					-0.9	-0.3			
Korea		-0.6	-0.6		-0.2	-0.2		0.7	1.2		-0.2	0.3
Czech Republic		-0.4	-0.3		-0.1	-0.3	-0.1	0.4	0.4		-0.1	-0.1
Hungary		-0.4	-0.1		-0.4	-0.4		0.2	0.9			
Poland					0.1			0.1	-0.5			
Romania							-0.2					
Russia							0.1	0.5	0.3			
Turkey					-0.3			0.9	1.1			
Nigeria			-0.2					0.2				
South Africa		-0.2	-0.2									
Argentina						-0.8	-0.4	-0.2	-0.5			1.0
Brazil		-1.0			-0.3	-0.3			-0.1			-0.1
Mexico					0.1							
Venezuela				2.6	-3.4	0.1		-2.0	-4.6			

Source: Citi Investment Research and Analysis

Figure 15. Selected Countries — Economic Forecast Overview and Exchange Rate Forecasts (Percent), 2011-2016F

	10-Year Yields						Exchange Rates Versus U.S. Dollar*						Exchange Rate Versus Euro					
	2011	2012F	2013F	2014F	2015F	2016F	2011	2012F	2013F	2014F	2015F	2016F	2011	2012F	2013F	2014F	2015F	2016F
Industrial Countries																		
United States	**2.80**	**1.80**	**2.25**	**3.00**	**3.40**	**3.75**	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**	**1.39**	**1.26**	**1.19**	**1.30**	**1.33**	**1.35**
Japan	**1.12**	**0.98**	**1.22**	**1.50**	**1.75**	**1.75**	**79**	**81**	**82**	**84**	**84**	**84**	**110**	**102**	**98**	**109**	**112**	**114**
Euro Area	**2.71**	**1.52**	**1.53**	**2.30**	**2.50**	**3.00**	**1.39**	**1.26**	**1.19**	**1.30**	**1.33**	**1.35**	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**
Canada	2.78	1.87	2.64	3.40	3.50	3.75	1.01	1.02	1.00	0.97	0.96	0.96	1.39	1.28	1.18	1.26	1.28	1.30
Australia	4.63	3.35	3.85	4.90	5.25	5.50	1.01	1.01	0.95	0.90	0.90	0.90	1.37	1.25	1.25	1.43	1.48	1.51
New Zealand	4.74	3.75	4.50	5.00	5.40	6.00	0.77	0.79	0.72	0.64	0.64	0.64	1.79	1.59	1.66	2.04	2.09	2.11
Germany	2.71	1.52	1.53	2.30	2.50	3.00												
France	3.31	2.71	2.66	3.30	3.30	3.60												
Italy	5.19	6.45	8.03	7.30	6.50	6.00												
Spain	5.43	6.44	8.03	7.10	6.30	5.80												
Netherlands	3.04	2.13	2.10	2.70	2.85	3.30												
Belgium	4.21	3.36	3.28	3.50	3.50	3.80												
Denmark	2.80	1.22	1.25	2.35	2.65	3.25	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Norway	3.07	2.08	2.11	2.90	3.20	3.75	5.66	5.98	6.26	5.67	5.52	5.41	7.84	7.52	7.43	7.35	7.34	7.32
Sweden	2.66	1.53	1.57	2.35	2.60	3.25	6.60	7.06	7.29	6.56	6.40	6.28	9.14	8.88	8.65	8.51	8.50	8.49
Switzerland	1.53	0.64	0.60	1.15	1.50	2.10	0.90	0.96	1.01	0.93	0.93	0.94	1.25	1.20	1.20	1.21	1.24	1.27
United Kingdom	3.00	1.87	2.00	2.50	3.00	3.50	1.59	1.56	1.50	1.64	1.68	1.71	0.87	0.81	0.79	0.79	0.79	0.79
Emerging Markets																		
China	**3.52**	**2.70**	**2.56**	**3.25**	**3.62**	**3.62**	**6.46**	**6.33**	**6.31**	**6.16**	**6.12**	**6.09**	**9.00**	**7.96**	**7.49**	**7.98**	**8.12**	**8.23**
Taiwan	1.38	1.35	1.50	1.60	1.70	1.80	29.40	29.88	28.86	28.50	28.39	28.29	40.93	37.58	34.25	36.94	37.70	38.27
India	8.40	8.25	8.25	8.25	8.25	8.25	46.63	53.99	54.74	52.34	51.43	50.66	64.92	67.90	64.98	67.83	68.31	68.55
Indonesia	7.20	6.84	7.00	7.25	7.00	7.00	8763	9387	9630	9640	9593	9543	12201	11804	11431	12494	12742	12912
Korea	3.90	3.45	3.50	4.13	4.88	5.13	1108	1146	1146	1079	1047	1018	1542	1441	1360	1399	1391	1377
Czech Republic	3.68	3.39	3.39	3.46	3.82	4.00	17.7	20.4	21.8	19.0	17.9	16.9	24.6	25.6	25.9	24.6	23.7	22.8
Hungary	7.63	8.35	8.00	7.91	7.69	7.40	201	226	243	223	215	209	279	284	289	289	286	283
Poland	5.99	5.63	5.38	5.55	5.57	5.40	2.96	3.37	3.70	3.04	2.94	2.88	4.12	4.24	4.39	3.94	3.90	3.90
Romania	NA	NA	NA	NA	NA	NA	3.04	3.52	3.64	3.23	3.07	2.93	4.23	4.42	4.31	4.19	4.07	3.97
Russia	NA	NA	NA	NA	NA	NA	29.4	32.5	34.9	33.0	31.9	31.0	41.0	40.9	41.4	42.8	42.4	41.9
Turkey	NA	NA	NA	NA	NA	NA	1.68	1.80	1.87	1.86	1.88	1.91	2.34	2.26	2.22	2.41	2.50	2.59
Nigeria	NA	NA	NA	NA	NA	NA	156	161	165	163	165	164	217	202	196	211	219	222
South Africa	8.24	8.21	8.90	9.15	9.20	9.20	7.26	8.27	8.81	8.92	9.27	9.64	10.11	10.40	10.46	11.57	12.31	13.04
Argentina	NA	NA	NA	NA	NA	NA	4.13	4.55	5.45	6.75	8.34	9.99	5.74	5.73	6.47	8.75	11.08	13.52
Brazil	11.45	10.07	9.48	9.24	8.75	8.25	1.67	1.97	1.93	1.85	1.83	1.81	2.33	2.48	2.30	2.40	2.43	2.45
Mexico	6.83	6.26	6.74	7.10	7.38	7.72	12.4	13.4	13.4	12.3	12.5	12.8	17.3	16.9	15.9	16.0	16.6	17.3
Venezuela	13.65	12.44	12.64	13.90	13.80	13.70	4.29	4.30	6.50	6.50	9.75	9.75	5.98	5.41	7.72	8.42	12.95	13.19

*Per USD except Euro Area, Australia, New Zealand, United Kingdom. Note: All foreign exchange forecasts are consistent with the rolling forecasts presented in Figure 85. Source: Citi Investment Research and Analysis

Figure 16. Short Rates (End of Period), as of 27 Jun 2012 (Percent)

	Current	3Q 12	4Q 12	1Q 13	2Q 13	3Q 13	4Q 13
United States	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**
Japan	**0.10**	**0.10**	**0.10**	**0.10**	**0.10**	**0.10**	**0.10**
Euro Area	**1.00**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**
Canada	1.00	1.00	1.00	1.25	1.50	1.75	2.00
Australia	3.50	3.25	3.25	3.25	3.25	3.50	3.75
New Zealand	2.50	2.50	2.50	2.75	3.00	3.50	3.75
Denmark	0.45	-0.20	-0.50	-0.50	-0.30	0.00	0.00
Norway	1.50	1.50	1.50	1.75	1.75	2.00	2.00
Sweden	1.50	1.25	1.00	1.00	1.00	1.00	1.00
Switzerland	0.00	0.00	0.00	0.00	0.00	0.00	0.00
United Kingdom	0.50	0.50	0.50	0.50	0.50	0.50	0.50
China	3.25	2.75	2.75	2.75	2.75	3.00	3.25

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

Figure 17. 10-Year Yield Forecasts (Period Average), as of 27 Jun 2012 (Percent)

	Current	3Q 12	4Q 12	1Q 13	2Q 13	3Q 13	4Q 13
United States	**1.63**	**1.60**	**1.80**	**2.00**	**2.10**	**2.35**	**2.60**
Japan	**0.82**	**0.95**	**1.10**	**1.20**	**1.10**	**1.30**	**1.30**
Euro area (Germany)	**1.53**	**1.40**	**1.25**	**1.25**	**1.35**	**1.50**	**2.00**
Canada	1.75	1.65	1.85	2.30	2.50	2.75	3.00
Australia	2.97	3.15	3.25	3.40	3.70	4.00	4.30
New Zealand	3.40	3.60	3.80	4.00	4.40	4.75	4.90
Denmark	1.38	1.10	0.65	0.65	1.05	1.40	1.90
Norway	2.14	2.00	1.85	1.85	1.95	2.05	2.55
Sweden	1.24	1.40	1.25	1.25	1.40	1.55	2.05
Switzerland	0.62	0.60	0.52	0.52	0.57	0.65	0.90
United Kingdom	1.69	1.60	1.65	1.70	1.80	2.00	2.50

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 27 Jun 2012

	Spread vs. US$						Spread vs. Germany					
	Current	3Q 12	4Q 12	1Q 13	2Q 13	3Q 13	Current	3Q 12	4Q 12	1Q 13	2Q 13	3Q 13
United States	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**	**11**	**21**	**56**	**76**	**76**	**86**
Japan	**-82**	**-66**	**-71**	**-81**	**-101**	**-106**	**-71**	**-45**	**-15**	**-5**	**-25**	**-20**
Euro Area	**-11**	**-21**	**-56**	**-76**	**-76**	**-86**	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**
Canada	12	5	5	30	40	41	23	26	61	106	117	127
Australia	136	157	147	142	162	168	146	177	203	218	238	254
New Zealand	179	203	203	203	234	244	190	223	259	279	310	331
France	100	94	64	44	39	24	110	115	120	120	115	110
Italy	448	504	594	624	574	564	458	525	650	700	650	650
Spain	517	504	594	624	574	564	527	525	650	700	650	650
Netherlands	44	49	24	-6	-16	-36	54	70	80	70	60	50
Belgium	158	149	134	124	104	74	168	170	190	200	180	160
Denmark	-25	-51	-116	-136	-106	-96	-15	-30	-60	-60	-30	-10
Norway	51	39	4	-16	-16	-31	61	60	60	60	60	55
Sweden	-39	-21	-56	-76	-71	-81	-29	0	0	0	5	5
Switzerland	-101	-101	-129	-149	-154	-171	-91	-80	-73	-73	-78	-85
United Kingdom	6	-1	-16	-31	-31	-36	16	20	40	45	45	50

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 27 Jun 2012

Country	Current Rate (%)	Sep 12	Dec 12	Mar 13	Jun 13	Sep 13	Total Cumulative Rate Moves Expected
South Africa	5.50	0	0	0	50	50	100
Turkey	5.75	0	0	0	0	75	75
Indonesia	3.75	0	0	25	25	0	50
Thailand	3.00	0	0	25	25	0	50
Philippines	4.00	0	0	0	0	25	25
Mexico	4.50	0	0	0	0	0	0
Israel	2.25	0	0	0	0	0	0
Brazil	8.50	-100	-25	0	0	100	-25
Korea	3.25	-25	0	-25	0	25	-25
Colombia	5.25	0	-50	0	0	25	-25
Chile	5.00	0	-50	0	0	0	-50
Czech	0.75	-25	-25	0	0	0	-50
China	3.25	-50	0	0	0	0	-50
Poland	4.75	0	0	-25	-25	0	-50
India	8.00	-25	-50	0	0	0	-75
Hungary	7.00	-25	-75	0	0	0	-100
Russia	8.00	0	0	-50	-50	-50	-150

Source: Citi Investment Research and Analysis

Figure 20. Foreign Exchange Forecasts (End of Period), as of 27 Jun 2012

	vs. USD						vs. EUR					
	Current	Sep 12	Dec 12	Mar 13	Jun 13	Sep 13	Current	Sep 12	Dec 12	Mar 13	Jun 13	Sep 13
United States	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**	**1.25**	**1.24**	**1.21**	**1.18**	**1.15**	**1.19**
Japan	**80**	**80**	**81**	**81**	**82**	**83**	**100**	**99**	**98**	**96**	**95**	**98**
Euro Area	**1.25**	**1.24**	**1.21**	**1.18**	**1.15**	**1.19**	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**
Canada	1.03	1.03	1.02	1.01	1.00	0.99	1.28	1.27	1.23	1.19	1.15	1.18
Australia	1.00	1.00	0.99	0.97	0.96	0.94	1.25	1.24	1.23	1.21	1.20	1.26
New Zealand	0.79	0.79	0.77	0.75	0.73	0.70	1.59	1.56	1.56	1.57	1.58	1.69
Norway	5.99	6.06	6.19	6.34	6.47	6.24	7.49	7.50	7.48	7.47	7.45	7.42
Sweden	7.05	7.26	7.35	7.43	7.51	7.24	8.81	8.99	8.88	8.76	8.65	8.61
Switzerland	0.96	0.97	0.99	1.02	1.04	1.01	1.20	1.20	1.20	1.20	1.20	1.20
United Kingdom	1.56	1.55	1.52	1.49	1.46	1.51	0.80	0.80	0.80	0.79	0.79	0.79
China	**6.36**	**6.33**	**6.34**	**6.34**	**6.35**	**6.30**	**8.0**	**7.8**	**7.7**	**7.5**	**7.3**	**7.5**
India	56.7	54.0	54.5	55.0	55.5	54.6	70.8	66.9	65.9	64.8	63.9	65.0
Korea	1162	1140	1149	1157	1164	1142	1452	1412	1388	1363	1341	1359
Poland	3.41	3.40	3.59	3.77	3.94	3.68	4.26	4.22	4.33	4.44	4.54	4.38
Russia	33.2	33.4	34.2	34.9	35.6	34.9	41.5	41.4	41.3	41.1	41.0	41.5
South Africa	8.45	8.41	8.56	8.71	8.85	8.85	10.56	10.41	10.34	10.26	10.20	10.53
Turkey	1.82	1.78	1.82	1.85	1.88	1.87	2.28	2.21	2.19	2.18	2.17	2.23
Brazil	2.07	2.01	1.99	1.97	1.95	1.92	2.58	2.49	2.40	2.32	2.24	2.29
Mexico	13.9	13.4	13.5	13.6	13.7	13.3	17.3	16.6	16.3	16.0	15.8	15.8

Note: All foreign exchange forecasts are consistent with the rolling forecasts presented in Figure 84. Source: Citi Investment Research and Analysis

Figure 21. Foreign Exchange Forecasts (End of Period), as of 27 Jun 2012

	vs. JPY					
	Current	Sep 12	Dec 12	Mar 13	Jun 13	Sep 13
United States	**80**	**80**	**81**	**81**	**82**	**83**
Japan	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**
Euro Area	**100**	**99**	**98**	**96**	**95**	**98**
Canada	78	78	79	81	82	83
Australia	80	80	80	79	79	78
New Zealand	63.0	63.5	62.3	61.1	59.8	58.1
Norway	13.4	13.2	13.0	12.8	12.7	13.2
Sweden	11.4	11.0	11.0	10.9	10.9	11.4
Switzerland	83	83	81	80	79	82
United Kingdom	125	124	122	121	120	124
China	**13**	**13**	**13**	**13**	**13**	**13**
India	1.41	1.48	1.48	1.48	1.48	1.51
Korea	14.50	14.25	14.23	14.22	14.19	13.84
Poland	23.5	23.5	22.5	21.6	20.8	22.4
Russia	2.4	2.4	2.4	2.3	2.3	2.4
South Africa	9.5	9.5	9.4	9.3	9.3	9.3
Turkey	44.0	44.9	44.5	44.0	43.6	44.1
Brazil	38.8	39.8	40.6	41.3	42.1	42.9
Mexico	5.8	6.0	6.0	6.0	6.0	6.2

Note: All foreign exchange forecasts are consistent with the rolling forecasts presented in Figure 84. Source: Citi Investment Research and Analysis

Country Commentary

United States

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The cyclical upturn remains on a sluggish 2% track. Although softening in some data has been exaggerated by payback from a mild winter, the pullback in hiring and consumer spending has raised doubts about the second half. The Fed continues to battle financial headwinds and has indicated a readiness to seek greater accommodation if unemployment stalls. Consumers are enjoying a windfall from declining gasoline prices and housing indicators are transitioning from deeply depressed levels toward modest growth. Still, the upside to growth could remain checked by European financial turmoil, domestic political uncertainty and ongoing fiscal drag. Our base case assumes the U.S. will avoid a fiscal calamity in 2013 but meaningful restraint from the public sector is still likely.

The Fed's decision to extend Operation Twist may not be the last easing step. Officials want to remain supportive while they resolve key forecast uncertainties. There are higher perceived costs now to growing the balance sheet, but it's doubtful the policy status quo would survive another downgrade to the outlook. With progress toward full employment expected to be slower than thought earlier and the threat of major fiscal tightening for 2013, the debate is likely to persist into 2013.

Sharp slowing in food and energy prices has eased earlier worries about inflation somewhat. Underlying trends are expected to remain muted and close to target over the forecast horizon. Wage growth is slow but steady and inflation expectations also have been relatively stable, providing some additional policy flexibility.

Figure 22. United States — Economic Forecasts, 2011-2013F

					2012				2013			
		2011	2012F	2013F	1QE	2QF	3QF	4QF	1QF	2QF	3QF	4QF
GDP	SAAR				1.7%	1.6%	2.1%	2.4%	1.2%	1.8%	2.7%	3.1%
	YoY	1.7%	2.1%	2.0%	2.0	2.1	2.1	2.0	1.8	1.9	2.0	2.2
Domestic Demand	SAAR				1.7	1.8	2.0	2.1	1.1	1.9	2.6	3.0
	YoY	1.9	1.8	1.9	1.8	1.9	1.7	1.9	1.7	1.8	1.9	2.1
Consumption	SAAR				2.6	2.0	2.3	2.3	1.2	2.0	2.8	3.3
	YoY	2.2	2.1	2.1	1.8	2.1	2.3	2.3	2.0	1.9	2.1	2.3
Business Investment	SAAR				3.2	2.3	3.5	4.1	4.3	4.6	5.3	5.2
	YoY	8.8	5.1	4.3	8.5	6.4	3.5	3.3	3.6	4.1	4.6	4.9
Housing Investment	SAAR				20.1	7.2	11.2	20.0	15.4	16.2	12.3	15.7
	YoY	-1.3	11.3	15.0	9.1	9.9	12.4	14.5	13.3	15.6	15.9	14.9
Government	SAAR				-4.0	-0.1	-0.7	-1.8	-2.8	-1.6	-1.1	-1.0
	YoY	-2.1	-2.1	-1.6	-2.3	-2.1	-2.2	-1.6	-1.4	-1.7	-1.8	-1.6
Exports	SAAR				7.4	4.0	6.0	7.5	6.2	5.5	5.6	6.2
	YoY	6.7	5.1	6.1	4.5	4.6	5.0	6.2	5.9	6.3	6.2	5.9
Imports	SAAR				6.7	3.8	3.8	4.3	4.3	4.4	4.6	5.2
	YoY	4.9	3.9	4.3	3.1	3.7	4.3	4.5	4.1	4.2	4.4	4.6
PCE Deflator	YoY	2.5	1.7	1.5	2.3	1.7	1.4	1.3	1.2	1.4	1.7	1.9
Core PCE Deflator	YoY	1.4	1.8	1.6	1.9	1.8	1.8	1.8	1.7	1.6	1.6	1.7
Unemployment Rate	%	9.0	8.1	7.8	8.3	8.2	8.0	7.9	7.8	7.8	7.8	7.7
Federal Gov't Balance (Fiscal Year)	$Bn	-1297	-1175	-875								
	% of GDP	-8.7	-7.6	-5.5								
General Gov't Balance (Cal Year)	% of GDP	-9.4	-7.8	-5.9								
Federal Debt	% of GDP	68	74	78								
General Gov't Debt	% of GDP	98	104	106								
Current Account	US$bn	-473	-501	-479	-558	-502	-477	-469	-458	-481	-473	-503
	% of GDP	-3.1	-3.2	-3.0	-3.6	-3.2	-3.1	-3.0	-2.9	-3.0	3.0	-3.1
S&P 500 Profits (US$ Per Share)	YoY	14.4	5.5	4.6	8.9	6.5	1.4	5.7	2.7	5.3	4.2	6.2

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

Japan

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We are revising down Japan's growth forecasts for the second half of this year, mainly reflecting our more cautious view about China's economy. Peaking-out in reconstruction demand from the earthquake and disappearing policy effects (i.e. the government's subsidies for eco-car purchases), along with tepid export growth, will likely slow GDP growth to nearly 1% in H2. In particular, we expect exports and industrial production to remain lackluster amid the tepid global economy.

The consumption tax hike bill (calling for a tax rate hike to 8% in April 2014 from 5% currently and to 10% in October 2015) is now very likely to be approved by the Parliaments by August. However, the tax rate hike in April 2014 will probably have a significant negative impact on the economy by way of payback to frontloaded spending in 2013 ahead of the tax hike and erosion in real disposable income caused by higher prices. As a result, we figure that the second tax hike slated just 18 months after the first hike will be politically difficult to implement. In that case, concerns over Japan's fiscal sustainability will likely intensify.

We expect the Bank of Japan to take additional action sooner than later. Most importantly, the BoJ's core inflation (excluding just fresh food) forecasts are unlikely to be met and this will probably provide room for further easing. We believe that several factors will stand in the way of policymakers' forecasts. First, inflation has become less sensitive to the output gap, probably thanks to continued declines in unit labor costs. Second, the positive contributions to core inflation from TV and air-conditioner prices will drop off early next year. Lastly, crude oil prices have plunged recently. As these developments become visible, the BoJ is likely to implement additional easing, in our view.

Figure 23. Japan — Economic Forecasts, 2011-13F

					2012				2013			
		2011	2012F	2013F	1Q	2QF	3QF	4QF	1QF	2QF	3QF	4QF
Real GDP	YoY	-0.7%	2.7%	1.4%	2.7%	3.7%	2.1%	2.3%	1.6%	1.4%	1.3%	1.2%
	SAAR				4.7	2.3	1.2	1.1	1.8	1.7	0.7	0.8
Domestic Demand	YoY	0.1	3.0	1.4	3.5	3.6	2.8	2.3	1.7	1.4	1.2	1.1
	SAAR				4.1	2.7	1.5	0.9	1.8	1.5	0.6	0.7
Private Consumption	YoY	0.1	2.9	1.1	3.6	3.5	2.6	1.8	0.9	0.9	1.0	1.4
	SAAR				4.9	1.8	0.8	-0.5	1.4	1.8	1.2	1.1
Business Investment	YoY	1.0	2.5	2.7	2.8	3.7	4.2	-0.4	2.5	2.5	2.7	2.9
	SAAR				-8.2	2.5	2.4	2.2	2.9	2.6	3.0	3.1
Housing Investment	YoY	5.4	3.1	6.1	0.0	5.2	1.8	5.5	10.0	8.1	5.8	0.7
Public Investment	YoY	-3.0	8.1	-2.9	9.4	5.7	8.0	9.5	4.8	-1.0	-6.0	-9.0
Exports	YoY	-0.2	4.2	3.7	1.0	9.1	1.0	6.0	3.8	3.5	3.8	3.8
	SAAR				12.4	5.2	2.5	4.2	3.1	4.2	3.5	4.2
Imports	YoY	5.9	6.9	3.9	6.6	8.6	6.3	6.2	5.0	3.8	3.4	3.5
	SAAR				7.9	8.4	5.1	3.3	3.3	3.6	3.5	3.6
CPI	YoY	-0.3	0.2	-0.1	0.3	0.4	0.1	0.1	-0.3	-0.2	0.0	0.1
Core CPI	YoY	-0.3	0.0	-0.1	0.1	0.0	-0.2	-0.2	-0.3	-0.2	0.0	0.1
Nominal GDP	YoY	-2.8	2.0	1.2	1.4	3.0	1.6	2.1	1.4	1.2	1.1	1.1
Current Account	¥ tn	9.6	7.0	8.3	7.1	6.6	6.7	7.3	7.8	8.1	8.3	8.9
	% of GDP	2.0	1.5	1.7	1.5	1.4	1.4	1.5	1.6	1.7	1.7	1.8
Unemployment Rate	%	4.6	4.5	4.3	4.5	4.5	4.4	4.4	4.3	4.3	4.3	4.3
Industrial Production	YoY	-2.4	3.5	3.3	4.8	6.9	2.0	2.6	2.4	3.8	4.0	3.2
Corporate Profits (Fiscal Year)	YoY	-12.5	22.5	15.0								
General Govt. Balance (Fiscal Year)	% of GDP	-10.7	-10.5	-8.1								
General Govt Debt	% of GDP	228	235	242								

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

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Euro Area

We continue to estimate a 50-75% probability of Grexit in the next 12 to 18 months, using this as a baseline scenario in our economic forecasts. From 2013 onwards, our macro forecasts model a scenario whereby Greece is not a member of the euro area, but stays in the EU. With some small amendments of the Memorandum of Understanding likely, immediate Grexit (Q3-12) is unlikely, but heightened uncertainty will undermine economic activity. We also expect that Spain and Italy will request support for their governments from the EFSF/ESM this year (it might be deferred to 2013) which would then leave six states (It, Sp, Gr, Por, Irl and Cyprus), representing 34% of euro area GDP, under some kind of programmes.

The broadening of the euro area debt and banking crisis and the risk of contagion from Grexit spurred talks in respect to creating a banking union in the near to medium term and also further integration of euro area fiscal policy, including a transfer of budgetary power, in the longer term. While we expect that the EU Summit at the end of June will in principle agree to form a banking union, we do not expect any details. We also do not expect that the “compact for growth”, mainly including a more efficient use of EU structural funds and extra EIB loan capacity (€60 to €70bn), will have a big impact on GDP. While the euro member countries will probably get some more time to reduce their deficits, we do not expect a turn-around in austerity measures, and therefore fiscal tightening should remain a headwind for the economy.

With the further deterioration of the economic situation in June, suggesting that downside risks to the ECB base case scenario are materializing, we expect the ECB to cut rates by 25bp in July and to 0.5% by the end of Q3 or in early 4Q. We expect the deposit rate to decline from currently 0.25% to 0.1%. After expanding the eligible collateral pool in June, we expect that the ECB will ease collateral rules further and soon restart its multi-year LTRO programme. The ECB might announce a new LTRO as early as the July meeting, which then might be implemented in the course of the summer.

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

Figure 24. Euro Area — Economic Forecasts, 2011-13F

					2012F				2013F			
		2011	2012F	2013F	1QF	2QF	3QF	4QF	1QF	2QF	3QF	4QF
Real GDP	YoY	1.5%	-0.7%	-0.8%	-0.1%	-0.6%	-1.1%	-1.2%	-1.3%	-1.0%	-0.6%	-0.1%
	SAAR				0.0	-1.5	-1.7	-1.4	-0.5	-0.2	-0.2	0.5
Final Domestic Demand	YoY	0.3	-1.4	-1.2	-0.8	-1.1	-1.8	-1.8	-1.8	-1.4	-0.9	-0.4
Private Consumption	YoY	0.2	-0.9	-0.9	-0.6	-0.6	-1.3	-1.2	-1.4	-1.1	-0.7	-0.2
Government Consumption	YoY	-0.3	-0.7	-1.2	-0.3	-0.6	-0.9	-1.2	-1.5	-1.4	-1.1	-0.8
Fixed Investment	YoY	1.6	-3.4	-2.0	-2.2	-3.2	-4.0	-4.2	-3.4	-2.5	-1.5	-0.8
— Business Equipment	YoY	3.7	-3.7	-2.6	-1.4	-3.4	-5.0	-5.1	-4.4	-2.9	-1.9	-1.2
— Construction	YoY	-0.8	-2.8	-0.5	-3.0	-2.8	-2.4	-2.8	-1.7	-1.2	0.0	1.1
Stocks (Contrib. to Y/Y GDP Growth)		0.2	-0.4	-0.1	-0.5	-0.7	-0.4	-0.1	0.0	0.0	-0.1	-0.1
Exports	YoY	6.3	1.6	1.3	2.9	1.6	0.4	1.3	0.6	1.1	1.4	1.8
Imports	YoY	4.1	-1.0	0.3	-0.3	-1.3	-2.0	-0.2	-0.4	0.2	0.5	0.9
CPI	YoY	2.7	2.3	1.6	2.7	2.4	2.2	2.0	1.7	1.6	1.7	1.7
Core CPI	YoY	1.4	1.6	1.2	1.5	1.5	1.5	1.6	1.5	1.5	1.3	0.7
CPI Ex Energy and Food	YoY	1.7	1.7	1.3	1.9	1.8	1.5	1.7	1.5	1.6	1.4	0.8
Unemployment Rate	YoY	10.2	11.1	11.4	10.9	11.1	11.2	11.3	11.4	11.4	11.4	11.4
Current Account Balance	EUR bn	-4.2	-4.5	7.5								
	% of GDP	0.0	0.0	0.1								
General Government Balance	EUR bn	-387.6	-313.4	-259.4								
	% of GDP	-4.1	-3.3	-2.7								
General Government Debt	EUR bn	8215.3	8957.9	9193.0								
	% of GDP	87.2	94.7	96.7								
Gross Operating Surplus	YoY	2.6	-0.6	0.3								

Sources: Eurostat and Citi Investment Research and Analysis

Germany

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With deteriorating business sentiment readings and weak Q2 activity data, we are cutting our 2012 GDP forecast from 1.4% to 1.2% and the 2013 forecast from 1.0% to 0.9%. However, we still believe that Germany will not fall back into recession as solid domestic demand (supported by historically low interest rates and wage gains) is likely to offset the adverse effect on exports of weakness in the rest of the euro area. With lower energy prices, we are also cutting our 2012 inflation forecast from 2.1% to 1.9% and the 2013 forecast from 2.3% to 2.1%. German inflation will probably be modest in coming years but will slightly exceed the EMU average. The government and opposition finally agreed to ratify the Fiscal Compact and ESM. With likely requests for extra EMU support measures, including banking union and expansion of ESM lending capacity, plus the heated debate about child-care benefits, Angela Merkel's government coalition should remain fragile.

France

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The Socialist Party gained an absolute majority in the lower house, and this gives French President François Hollande and Prime Minister Jean-Marc Ayrault complete control of the domestic policy agenda. The government's strategy to meet the 2012 deficit target (4.5% of GDP) chiefly relies on higher taxes. Other key aspects — public spending plans and proposals for structural reforms — are to be announced during July. We remain pessimistic about the government's chances of hitting the 3% budget deficit target in 2013. We continue to expect France to slip back into recession for the rest of 2012. Further ahead, we cut our growth forecast for 2014-16 by about 0.3% per year (GDP growth to average 1.3%) to reflect the likelihood of a delay to structural adjustments and rise in the overall tax burden.

Italy

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With thanks to Carla Clifton

We are keeping our 2013 GDP growth forecast at -2.0% and cutting our 2012 forecast slightly to -2.6% from -2.5% of GDP last month. Household consumption and investment will probably fall sharply in 2012-13, driven by rising unemployment, weak consumer confidence and heightened uncertainty from the EMU crisis. Despite the planned drop in public spending, we expect that Italy will fail to meet the 2012 deficit target. With the weak economy and overshooting deficit, we expect Italy to request external support before the end of this year or in early 2013.

Figure 25. Germany, France and Italy — Economic Forecasts, 2011-13F

		Germany			France			Italy		
		2011	2012F	2013F	2011	2012F	2013F	2011	2012F	2013F
Real GDP	YoY	3.1%	1.2%	0.9%	1.7%	-0.1%	-0.2%	0.5%	-2.6%	-2.0%
Final Domestic Demand	YoY	2.3	1.3	1.8	0.9	0.1	0.1	-0.3	-4.2	-3.2
Private Consumption	YoY	1.4	1.3	1.5	0.3	0.2	0.2	0.2	-3.3	-2.4
Fixed Investment	YoY	6.6	1.6	4.1	3.6	-0.9	-0.8	-1.2	-10.6	-8.7
Exports	YoY	8.4	2.8	2.0	5.5	2.6	1.9	6.4	0.2	-0.5
Imports	YoY	7.9	2.3	3.8	5.2	0.3	1.5	1.3	-8.5	-4.8
CPI	YoY	2.3	1.9	2.1	2.3	2.1	0.8	2.9	3.1	1.0
Unemployment Rate	%	6.0	5.5	5.4	9.2	9.6	9.4	8.5	10.6	11.9
Current Account	€bn	147.7	135.8	102.2	-43.4	-38.3	-21.7	-50.5	-36.5	-27.3
	% of GDP	5.8	5.2	3.8	-2.2	-1.9	-1.1	-3.2	-2.3	-1.8
General Govt. Balance	€bn	-26.7	-14.8	-11.1	-103.1	-92.1	-81.8	-62.4	-44.8	-44.2
	% of GDP	-1.0	-0.6	-0.4	-5.2	-4.5	-4.0	-3.9	-2.9	-2.9
General Govt. Debt	% of GDP	81.2	83.2	82.6	86.0	93.5	99.2	120.1	129.5	135.1
Gross Trading Profits	YoY	2.7	4.6	0.3	3.0	0.0	1.0	NA	NA	NA

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

Spain

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With thanks to Deimante Kupciuniene

We revise our forecast for 2012 up by 0.1pp to a 2.1% contraction, but revise our outlook for 2013 down by 0.5pp to -3.1%, substantially below the forecasts of the Spanish government or IMF, or consensus. Spain formally applied for a EFSF/ESM bank bail-out on June 25 and we expect it to add €100bn to Spain's general government debt in 2013, but we also expect a troika bail-out with sovereign conditionality to follow the bank bail-out in due course.

Greece

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With thanks to Carla Clifton

We continue to assign a 50-75% probability to Greece leaving the euro and model a scenario where this happens in January 2013. Greek GDP is likely to fall sharply in 2012 and 2013. We believe that the Troika might allow the new Government more time to cut the deficit to 3.0% of GDP, but the Troika is unlikely to agree the new Government's request for substantial changes to the MoU. The resultant standoff is likely to cause further delays to the €30bn of disbursements originally planned for end-June. Even if the June disbursement is eventually made towards the end of the summer, the government's probable failure to meet even a slightly amended MoU is likely to rule out further disbursements thereafter.

Ireland

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We are cutting our 2012 GDP forecast to minus 1.0% from minus 0.8% last month, in anticipation of a negative Q1 GDP figure and further weakness in Q2. A negative Q1 figure probably would signal that the government and IMF 2012 growth forecasts (0.3% and 0.5% respectively) are out of reach, and hence that the medium-term fiscal outlook remains poor. We expect discussions on a second bailout to start soon, and eventual debt restructuring remains likely.

Portugal

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With thanks to Carla Clifton

We continue to expect 2102 GDP will fall by about 4.6% but are cutting our 2013 forecast to minus 5.5% from minus 5.2% last month. This chiefly reflects a gloomier view on prospects for net trade. With the probable deficit overshoot in 2012 and little hope to return to market funding in 2013, we expect a second bailout package for Portugal in 3Q or 4Q this year. We do not expect debt restructuring at this stage, but restructuring is likely eventually, probably in 2014-15.

Figure 26. Spain, Greece, Ireland and Portugal — Economic Forecasts, 2011-13F

		Spain			Greece			Ireland			Portugal		
		2011	2012F	2013F	2011	2012F	2013F	2011	2012F	2013F	2011	2012F	2013F
Real GDP	YoY	0.7%	-2.1%	-3.1%	-6.9%	-7.5%	-10.1%	0.7%	-1.0%	0.4%	-1.6%	-4.6%	-5.5%
Final Domestic Demand	YoY	-1.7	-5.0	-5.8	-9.6	-11.4	-12.6	-3.0	-5.8	-2.2	-5.3	-7.1	-5.9
Private Consumption	YoY	-0.1	-2.2	-4.3	-7.1	-10.2	-12.1	-2.7	-2.0	-2.9	-4.0	-7.1	-4.6
Fixed Investment	YoY	-5.2	-10.5	-10.5	-20.6	-21.6	-19.1	-10.6	-21.4	-17.9	-11.4	-11.5	-11.9
Exports	YoY	9.1	-1.1	-2.3	-0.8	-3.1	-1.2	4.1	3.2	3.9	7.6	2.1	-0.1
Imports	YoY	-0.1	-10.4	-12.4	-8.0	-17.9	-10.4	-0.6	0.1	2.5	-5.2	-4.7	-1.6
CPI	YoY	3.1	1.5	0.3	3.1	0.9	15.0	-0.4	0.1	0.2	3.6	2.6	1.5
Unemployment Rate	%	21.6	24.7	25.9	17.3	23.6	29.0	14.4	15.7	17.6	12.7	16.2	18.7
Current Account	€bn	-37.8	-26.7	-18.1	-21.1	-15.6	-6.1	0.1	5.8	6.3	-13.9	-7.5	-3.9
	% of GDP	-3.5	-2.5	-1.7	-9.6	-7.6	-3.5	0.1	3.8	4.0	-8.1	-4.5	-2.5
General Govt. Balance	€bn	-95.3	-65.8	-63.6	-19.6	-21.7	-4.7	-20.4	-14.6	-15.4	-7.3	-3.9	-6.0
	% of GDP	-8.9	-6.2	-6.0	-9.1	-10.8	-5.8	-13.0	-9.4	-9.8	-4.2	-5.5	-4.2
General Govt. Debt	% of GDP	68.6	83.9	101.4	165.3	156.5	437.3	108.2	121.7	130.3	107.8	119.9	133.0

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

Netherlands

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We continue to forecast that the Netherlands will not meet the 3% of GDP deficit target in 2013. The economy is sluggish and incumbent PM Mark Rutte (one of the main advocates of the April austerity deal) now suggests that he will try to amend several parts of the measures if re-elected. However, we expect that the planned VAT rate hike in October will occur. The economy grew in Q1, but recent weakness in surveys and housing hints at renewed weakness this year and in 2013.

Belgium

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Belgium still requires around €3bn to hit its 2013 budget deficit target, in our view. Although the government will likely want to wait for the communal elections in October before announcing any adjustments, it seems that freezing some of the benefits and tax thresholds will be one of the preferred options. We are revising down our 2013 GDP forecast by 0.4ppt to -0.3% to reflect the fourth successive decline in business confidence in July, the likelihood of additional fiscal tightening, and a fresh warning from the Belgium central bank that the housing market is overvalued by 15%, which is likely to weigh somewhat on residential investment.

Slovakia

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We keep our growth forecast of 2.2% in 2012 and 1.8% in 2013. The trend of foreign trade driven recovery and weakness in domestic demand is likely to continue. Our forecast is below the official forecasts. The National Council approved the ESM without amendments. Slovakia has to pay the initial contribution to the ESM capital of €264mn this year. The Fiscal Compact is planned to be approved in 2H12. Total issuance for the year-to-date likely covers the total gross borrowing requirements for 2012. However, there is an upside risk at €0.5bn that points to the coverage of borrowing requirements at 94% now.

Slovenia

The overall confidence index improved slightly in May, but still suggests that the economy is slipping back into recession after modest GDP growth (0.2%QoQ) in 1Q12. Both private and public consumption rose in Q1, but we expect that both will be hit by austerity measures aimed at cutting the fiscal deficit to 3.5%-4% of GDP from 6.4% last year.

Figure 27. Netherlands, Belgium, Slovakia and Slovenia — Economic Forecasts, 2011-2013F

		Netherlands			Belgium			Slovakia			Slovenia		
		2011	2012F	2013F	2011	2012F	2013F	2011	2012F	2013F	2011	2012F	2013F
Real GDP	YoY	1.3%	-1.5%	-0.6%	2.0%	0.0%	-0.3%	3.3%	2.2%	1.8%	0.2%	-0.9%	0.6%
Final Domestic Demand	YoY	0.7	-1.7	-1.0	2.5	-0.3	0.3	0.6	0.5	1.0	-2.6	-1.4	0.1
Public Consumption	YoY	0.2	-0.5	-0.6	0.6	0.1	0.0	-3.5	1.5	-1.3	-0.9	0.8	-0.4
Private Consumption	YoY	-1.1	-1.6	-1.2	0.9	-0.1	0.2	-0.4	-0.4	0.6	-0.1	0.1	0.8
Investment (Ex Stocks)	YoY	5.8	-3.6	-1.0	5.2	-0.3	0.7	5.7	1.5	3.2	-10.2	-8.5	-1.5
Exports	YoY	3.8	3.4	1.7	4.4	0.7	2.0	10.8	3.7	3.5	7.8	-1.7	1.8
Imports	YoY	3.5	3.1	1.5	5.1	0.4	2.0	4.5	2.9	3.7	4.7	-2.4	1.6
CPI (Average)	YoY	2.3	2.8	2.5	3.5	2.9	1.7	3.9	3.6	2.8	1.8	3.0	3.0
Unemployment Rate	%	5.3	6.3	6.4	7.2	7.6	8.0	13.2	13.6	13.5	8.2	9.1	10.2
Current Account	% of GDP	8.4	9.6	9.5	-0.8	-0.2	0.3	0.1	0.5	-0.5	-1.5	-0.8	0.3
General Govt Balance	% of GDP	-4.7	-4.5	-3.5	-3.7	-2.8	-2.6	-4.8	-4.8	-3.2	-6.4	-4.0	-3.2
General Govt Debt	% of GDP	65.2	69.9	73.0	98.1	111.9	118.6	43.4	46.6	48.4	47.6	51.4	53.3

Note: Our forecasts for the Netherlands do not take account of the revised GDP data published on 26 June 2012.
F Citi forecast. YoY Year-on-year growth rate. Sources: National sources and Citi Investment Research and Analysis

UK

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We are cutting our 2012 UK growth forecast again, and now expect GDP to fall by 0.4% this year versus a drop of 0.2% last month, leaving next year's growth forecast at the meager pace of about ½%. Recent data suggest that the economy has remained soft in Q2, with weakness in retail sales, industrial production, exports construction and business surveys — and the extra bank holiday for the Queen's Diamond Jubilee in June will also hit Q2 growth. The economy faces major and persistent headwinds from high household debt, poor credit availability, fiscal drag and the EMU crisis. Real GDP is still about 4% below the pre-recession peak after 16 quarters: markedly underperforming versus the major recession/recovery cycles of the 1930s, 1970s, 1980s and 1990s. We expect that GDP will not regain the pre-recession peak (Q1-08) until 2016.

We believe the long period of inflation stickiness is ending, with CPI inflation likely to return to the 2% target late this year. The stickiness of inflation has mainly reflected lagged effects from sterling's plunge in 2007-09, plus some secondary effects from VAT hikes, global oil prices and low productivity growth. The inflation boost from the low pound is now fading, while other inflation pressures are being crushed by weak pay growth and the stagnant economy. Unless external costs rise, inflation is likely to drop below target next year and subsequently. The fiscal deficit should fall to 6-7% of GDP in 2012/13, because of the absorption of the pension fund of the state-owned postal service. But the medium-term trend is of a gently falling deficit, with the general government gross debt/GDP ratio likely to reach about 100% in 2014 or 2015. The MPC is likely to resume QE at the July meeting and expand it markedly further in coming quarters, alongside credit easing and, perhaps, a lower Bank Rate and emergency fiscal loosening in the Autumn Statement late this year.

Figure 28. United Kingdom — Economic Forecasts, 2011-2013F

					2012				2013			
		2011	2012F	2013F	1QF	2QF	3QF	4QF	1QF	2QF	3QF	4QF
Real GDP	YoY	0.6%	-0.4%	0.6%	-0.1%	-0.3%	-0.7%	-0.4%	0.2%	0.8%	0.7%	0.6%
	SAAR				-1.2	-1.4	1.1	0.0	0.9	1.1	0.5	-0.1
Domestic Demand	YoY	-0.9	-0.2	-0.7	0.3	0.0	-0.1	-1.0	-1.4	-0.8	-0.5	-0.2
(Incl. Inventories)	SAAR				1.6	-1.7	-1.3	-2.6	0.1	0.7	-0.1	-1.4
Consumption	YoY	-1.2	0.5	1.0	-0.1	0.5	0.9	0.7	0.8	1.0	1.0	1.0
	SAAR				0.6	0.8	0.5	0.8	1.0	1.6	0.6	0.6
Investment	YoY	-1.2	-6.4	-9.4	-0.4	-4.6	-7.9	-12.5	-13.0	-9.7	-8.1	-6.2
	SAAR				-1.3	-16.3	-10.9	-20.5	-3.4	-2.7	-4.5	-13.7
Exports	YoY	4.6	2.4	5.6	-0.6	2.3	3.9	4.2	5.5	6.0	5.8	5.3
	SAAR				0.3	2.8	6.1	7.8	5.4	4.8	5.1	6.0
Imports	YoY	1.2	1.2	2.6	0.9	1.1	1.6	1.2	1.6	2.9	3.0	3.0
	SAAR				1.7	-1.6	2.9	1.8	3.5	3.6	3.0	1.9
Unemployment Rate	%	8.1	8.6	9.3	8.2	8.3	8.8	9.0	9.2	9.3	9.3	9.3
CPI Inflation	YoY	4.5	2.6	1.8								
Merch. Trade	£bn	-99.7	-89.0	-74.1								
	% of GDP	-6.6	-5.8	-4.7								
Current Account	£bn	-29.0	-26.4	-11.0								
	% of GDP	-1.9	-1.7	-0.7								
PSNB	£bn FY	-126.0	-105.1	-126.3								
	% of GDP	-8.3	-6.8	-8.0								
General Govt. Balance	% of GDP	-8.3	-6.7	-7.9								
Public Debt	% of GDP	82.9	88.5	95.6								
Gross Nonoil Trading Profits	YoY	3.5	-0.3	4.9								

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

Switzerland

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We are raising our 2012 growth forecast for Switzerland to 1.4% from 0.7% last month, while leaving our 2013 forecast little changed (0.8% this month, 0.9% last month). This revision reflects the surprise strength of Q1 GDP (up 0.7% QoQ, whereas we expected 0.1% QoQ) and the recent uptick in the Kof survey. Exports are being hit by the super-strong CHF, but consumer spending is solid, fuelled by low interest rates, gains in housing activity and solid job growth (1.4% YoY in Q1-2012). The SNB is likely to continue to defend the CHF1.20/€ level.

Sweden

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Sweden's economy is slowing, but remains likely to outperform within Europe. Exports are weakening, while consumer spending will also probably slow, reflecting the softer housing market and only limited support from economic policies. The government continues to prioritise the need for fiscal safety margins rather than stimulating demand. Nevertheless, recent comments from FM Borg suggest that the Autumn Budget Bill will be more expansionary than previously indicated. The Riksbank is expected to continue to cut rates to 1% this year due to rising unemployment and low inflation.

Denmark

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Although escaping recession in 1Q 2012 (GDP was up 0.3% Q/Q), economic activity indicators continue to point to a long period of limited economic expansion in Denmark, with GDP growth well below the long-term average of 1.6% Y/Y in coming years. Given the ongoing EMU crisis, we expect that inflows to Danish assets will remain strong near-term. With the CD rate at just 5bp, Denmark is on the verge of zero interest rate policy (ZIRP). Given continued appreciation pressure on the DKK, there is a real possibility of rates going negative.

Norway

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Norway's economic growth remains solid; mainland GDP (excl. oil/gas and shipping) grew by a well-above trend 4.1% Y/Y in 1Q and the latest regional network report suggests that growth will only slow marginally near-term. The oil sector is booming, while consumer spending is benefiting from the strong jobs market and income gains. Fiscal policy is also supportive (with a net stimulus of 0.75% of mainland GDP this year). The Norges Bank left its key rate at 1.5% in June, but signalled an earlier rate hike than previously, with a 25bp hike likely in Q2 13 with a 50/50 probability of an earlier hike.

Figure 29. Switzerland, Sweden, Denmark and Norway — Economic Forecasts, 2011-2013F

		Switzerland			Sweden			Denmark			Norway		
		2011	2012F	2013F	2011	2012F	2013F	2011	2012F	2013F	2011	2012F	2013F
Real GDP	YoY	2.1%	1.4%	0.8%	4.0%	0.4%	1.9%	1.0%	0.7%	1.3%	2.5%	3.0%	2.9%
Final Domestic Demand	YoY	1.8	2.1	1.6	2.8	1.2	1.7	-0.5	1.4	1.3	3.2	2.7	3.3
Public Consumption	YoY	2.6	3.3	1.8	1.9	0.5	0.8	-1.0	0.6	0.6	1.6	1.9	2.2
Private Consumption	YoY	0.9	1.8	0.8	2.1	1.2	1.9	-0.5	1.1	1.1	2.4	2.9	2.9
Investment (Ex Stocks)	YoY	3.9	2.1	3.3	7.1	2.3	3.0	0.4	3.6	2.9	8.1	3.5	6.4
Exports	YoY	3.6	0.4	2.1	7.4	0.2	3.3	6.8	1.1	2.8	1.0	2.5	4.9
Imports	YoY	2.1	3.9	3.8	6.5	-0.7	3.3	5.3	2.4	2.8	2.9	2.5	4.3
CPI (Average)	YoY	0.2	-0.9	-1.4	3.0	1.2	1.6	2.8	2.5	1.7	1.3	1.3	1.8
Unemployment Rate	%	3.1	3.2	3.6	7.5	7.8	8.0	7.6	7.7	7.6	3.3	3.3	3.2
Current Account	% of GDP	14.8	12.4	11.1	7.0	7.0	7.2	6.6	5.5	5.4	14.0	14.3	14.9
General Govt Balance	% of GDP	0.7	0.5	0.1	0.1	-0.1	-0.2	-1.9	-3.5	-2.0	13.8	13.6	14.0
General Govt Debt	% of GDP	52	51	50	37.0	36.5	35.5	46.5	48.6	49.1	NA	NA	NA

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

Canada

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The Canadian expansion persists, with the economy currently growing just below its production potential. Excess supply created by the global recession continues to be reduced, employment and income growth are healthy, and numerous measures of slack are improving. We anticipate real GDP growth of between 2% and 2¾% over the next few years. Total inflation will remain below the 2% target on falling energy prices, but should revert to target within the BoC's projection horizon. Core inflation will remain close to 2% with only brief deviations over the medium term. Monetary policy is extraordinarily stimulative as real rates remain solidly in negative territory. Meanwhile, fiscal policy is becoming more restrictive, as governments are reducing spending in order to restore deficits and debt levels to pre-crisis norms. Business and consumer confidence remain largely upbeat and domestic financial conditions are quite stimulative. However, the composition of growth is unbalanced as housing activity is robust but consumer spending is adding to debt burdens in an environment of modest income growth. Despite declining commodity prices of late, Canadian firms continue to experience strong profit growth and high margins. Firms also enjoy adequate access to financing and are well capitalized. These factors should continue to drive the ongoing capex revival. Meanwhile, fiscal consolidation continues to dampen growth and will continue to do so ahead. Net exports are expected to remain lackluster amid modest external demand and ongoing competitiveness challenges, including the persistent strength of the Canadian dollar.

Risks to the inflation outlook are two-sided, but roughly in balance. Upside risks include (1) stronger US domestic demand and/or smoothing of scheduled 2013 fiscal restraint; and (2) stronger Canadian consumer spending. Downside risks include (1) worsening of the Euro Area sovereign debt and banking crisis including Grexit; (2) the US fiscal cliff; (3) a sharp downturn in Chinese growth that saps commodities demand, and (4) Canadian consumer retrenchment and/or disorderly housing market decline. Interest rates will likely remain fixed this year given downside risks and lingering uncertainties. Policy normalization will probably resume in early 2013 given Canada's strong economic fundamentals and the BoC's concern that low interest rates are facilitating wanton consumer debt accumulation.

Figure 30. Canada — Economic Forecast, 2011-2013F

					2012F				2013F			
		2011	**2012F**	**2013F**	**1Q**	**2QF**	**3QF**	**4QF**	**1QF**	**2QF**	**3QF**	**4QF**
Real GDP	YoY	2.5%	2.0%	2.2%	1.8%	2.4%	1.7%	1.9%	1.9%	2.1%	2.3%	2.5%
	SAAR				1.9	1.5	1.7	2.3	2.0	2.3	2.6	3.0
Final Domestic Demand	YoY	3.0	1.7	2.5	1.7	1.6	1.7	1.9	2.2	2.4	2.6	2.8
	SAAR				1.3	1.9	1.8	2.5	2.7	2.5	2.8	2.9
Private Consumption	YoY	2.4	1.7	2.3	1.9	1.6	1.7	1.6	2.0	2.4	2.4	2.4
	SAAR				0.9	0.6	2.4	2.5	2.4	2.4	2.4	2.4
Government Spending	YoY	0.1	-1.9	0.6	-2.3	-2.4	-1.9	-0.9	-0.1	0.7	0.9	0.8
	SAAR				-2.3	-2.5	0.1	1.0	0.8	0.8	0.8	0.9
Private Fixed Investment	YoY	8.9	5.7	5.1	6.5	6.0	5.1	5.1	4.7	4.2	5.4	6.1
	SAAR				7.6	7.1	1.8	4.1	6.1	5.0	6.5	6.8
Exports	YoY	4.6	5.1	3.7	4.8	7.3	4.5	3.7	3.6	3.3	3.7	4.2
	SAAR				2.5	4.5	3.8	4.0	2.1	3.5	5.3	6.0
Imports	YoY	7.0	2.9	4.4	4.1	1.0	3.0	3.6	3.6	4.4	4.7	5.0
	SAAR				4.4	1.3	4.0	4.5	4.5	4.5	5.5	5.5
CPI	YoY	2.9	1.6	1.6	2.3	1.7	1.3	1.2	1.2	1.1	1.8	2.2
Core CPI	YoY	1.7	2.0	2.2	2.1	2.0	1.9	1.9	2.2	2.2	2.4	2.2
Unemployment Rate	%	7.5	7.2	6.9	7.4	7.3	6.9	7.3	7.2	7.0	6.6	6.9
Current Account Balance	% of GDP	-2.8	-2.6	-2.4	-2.3	-2.5	-2.4	-3.1	-2.6	-2.5	-2.3	-2.3
Net Exports (Pct. Contrib.)		-1.5	0.4	-0.7	-0.6	0.9	-0.5	-0.6	-1.3	-0.8	-0.6	-0.4
Inventories (Pct. Contrib.)		0.3	-0.2	0.2	1.0	0.1	0.2	0.2	0.3	0.3	0.2	0.2
Budget Balance (Fiscal Year)	% of GDP	-1.4	-1.2	-0.5								
Federal Budget Debt	% of GDP	33.5	33.4	32.4								
General Govt. Debt	% of GDP	85.0	84.9	83.9								

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

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Australia

The 2012 full-year forecast has been boosted by the outsized increase in Q1 GDP (of 1.3%). Even allowing for some probable payback in coming quarters, this still leaves our 2012 GDP growth forecast at 3.7%, versus 2.8% last month. We expect slightly slower growth next year given the forecast slowdown in Australia's major trading partners. While the headline growth outlook is positive, the composition of growth remains uneven, with surging mining investment, moderate consumer spending and recessionary levels of housing activity. As a result, we expect consumer price inflation to stay within the bottom half of the RBA's 2%-3% inflation target until well into next year, assuming the new carbon tax does not unhinge inflationary expectations. Market pricing is for further deep cuts in the RBA cash rate, but in our view this is likely only if the global backdrop deteriorates significantly.

New Zealand

The surprisingly strong Q1 GDP rise of 1.1% has lifted our full year forecast of economic growth in 2012 to 2.3%. However, the surge in growth in Q1 was not as broad based as in Australia, with a soft result for consumer spending and a large contribution from inventories. A key risk to the outlook is whether the strength in business investment, particularly equipment investment, can be maintained given the uncertain global backdrop, lower commodity prices and the lack of domestic pricing for companies. We also do not expect agriculture to provide as large a boost to growth as it has over the past 12 months on the back of favourable seasonal conditions. Consequently, we continue to believe that the RBNZ will not rush to raise the OCR. We see the OCR remaining at its current 2.5% until late in Q1 next year.

Figure 31. Australia and New Zealand — Economic Forecast, 2011-2013F

	Australia			New Zealand		
	2011	2012F	2013F	2011F	2012F	2013F
Real GDP[a]	2.1%	3.7%	3.4%	1.3%	2.3%	2.8%
Real GDP (4Q versus 4Q)	2.5	3.5	3.6	1.9	2.6	3.0
Real Final Domestic Demand	4.0	3.8	3.6	2.3	1.7	2.8
Consumption	3.3	3.7	3.2	2.5	2.3	2.1
Govt. Current & Capital Spending[b]	-0.8	-0.1	0.6	1.8	1.3	1.3
Housing Investment	1.1	-5.0	3.0	-12.0	7.4	12.6
Business Investment[c]	16.9	12.8	8.5	6.9	2.0	5.0
Exports of Goods & Services	-1.3	6.0	8.2	2.4	4.0	3.0
Imports of Goods & Services	11.4	7.3	7.9	6.0	2.7	3.7
CPI	3.4	1.8	3.2	4.0	1.6	2.4
CPI (4Q versus 4Q)	3.1	2.5	2.9	1.8	2.2	2.4
Unemployment	5.1	5.3	5.1	6.5	6.4	5.6
Merch. Trade, BOP (Local Currency, bn)	17.9	-14.2	-31.3	3.3	2.4	-0.4
Current Account, (Local Currency, bn)	-33.2	-61.4	-84.1	-8.3	-10.8	-16.3
Percent of GDP	-2.3	-4.1	-5.3	-4.2	-5.0	-7.0
Budget Balance[d] (Local Currency, bn)	-47.7	-44.4	1.5	-15.9	-12.1	-6.5
Percent of GDP	-3.4	-3.0	0.1	-9.2	-4.1	-3.6
General Govt. Debt (% of GDP)[e]	5.9	9.6	9.2	21.8	27.1	30.9
Gross Trading Profits[f]	6.2	-1.4	6.1	na	na	na

BOP Balance of payments basis. CPI Consumer Price Index. F Citigroup forecast. NA Not available. [a]Averaged-based GDP in Australia and New Zealand. [b] In New Zealand excludes capital spending. [c] In New Zealand includes government capital spending. [d] Fiscal year ending June. Australia's underlying cash balance. [e]Australia and New Zealand Budget definition and forecasts. [f]Company gross operating surplus. Sources: NZIER and Citi Investment Research and Analysis.

China

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Growth appears to have stabilized, but 2Q growth may fall below 7.5% YoY. Industrial production (in real terms) accelerated slightly from 9.3% YoY in Apr to 9.6% in May. FAI and retail sales sped up in real terms, benefiting from falling inflation. Money and credit growth beat expectation in May, while the rebound of fiscal revenue and trade growth may reflect one-off factors. In general, economic activity in April and May was weak by historical standards. Assuming a moderate pick-up in activity in June, we estimate that GDP growth in 2Q was about 7.3% YoY (below our previous forecast of 7.5%), down from 8.1% in Q1. Falling international commodity prices and the negative output gap will likely keep CPI inflation below 3% for most of the remaining months this year. We therefore revise down our forecast for 2012 average annual inflation from 3.5% YoY to 2.9%.

We expect a 2H growth rebound, but downgrade the annual forecast for 2012. Unless the sovereign debt problem in Europe escalates to a full-blown economic and financial crisis, we expect the government to make full use of the room under the current policy mix, instead of resorting to 2008-09 type of stimulus. Additional policy measures this year could include two more rate cuts to boost demand and two more RRR cuts to bring money growth to 14%. These measures, on top of the policy easing since the beginning of the year, are expected to support a rebound of YoY growth in 3Q. However, due to anemic domestic activity in 2Q and expected further weakening of EU demand, we trim 2012 growth forecast from 8.1% to 7.8%.

We also revise down 2013 growth, assuming the incoming leaders would accept slower growth for better quality amid continued recession in the euro area. For 2013 and beyond, we assume the new government will introduce reforms to correct cost distortions, and deregulate investment to encourage private sector involvement. Growth may stay below potential in the next few years, but the structure may improve. We expect growth to rebound only slightly in 2013 to 7.9% (relative to our previous forecast of 8.5%), and medium-term growth may approach 7%. The correction of over-investment and government policies to support consumption will likely cause the investment-to-GDP ratio to decline as early as 2013-14.

Figure 32. China — Economic Forecasts, 2011-2013F

					2012F				2013F			
		2011	2012F	2013F	1QF	2QF	3QF	4QF	1QF	2QF	3QF	4QF
Real GDP	YoY	9.2%	7.8%	7.9%	8.1%	7.3%	7.8%	8.0%	8.2%	8.0%	7.8%	7.7%
Real Final Domestic Demand	YoY	10.2	9.2	9.0								
Consumption	YoY	9.7	9.4	9.2								
Fixed Capital Formation	YoY	10.7	9.0	8.8								
Industrial Production	YoY	13.9	11.1	11.7	11.6	10.0	11.2	11.5	12.0	12.2	11.4	11.2
Exports	YoY	20.3	6.3	10.7	7.6	8.8	5.4	3.8	6.0	9.0	12.0	15.0
Imports	YoY	24.9	8.3	13.0	6.9	6.2	8.0	11.7	9.0	11.0	14.0	17.0
Merchandise Trade Balance	$bn	155	130	102	1	62	54	14	-12	58	51	6
FX Reserves	$bn	3,181	3,423	3,544	3,305	3,392	3,436	3,423	3,411	3,469	3,535	3,544
Current Account	% of GDP	2.8	2.0	1.5								
Fiscal Balance	% of GDP	-1.3	-2.4	-1.5								
General Govt. Debt	% of GDP	15.3	16.1	15.9								
Urban Unemployment Rate	%	4.1	4.2	4.1	4.1	4.2	4.2	4.2	4.1	4.1	4.1	4.1
CPI	YoY	5.4	2.9	3.1	3.8	3.0	2.2	2.7	2.8	2.9	3.1	3.4
Exchange Rate (end period)	CNY/$	6.29	6.34	6.25	6.30	6.36	6.33	6.34	6.34	6.35	6.30	6.25
1-Yr Deposit Rate (end period)	%	3.50	2.75	3.25	3.50	3.25	2.75	2.75	2.75	2.75	3.00	3.25

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

India

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India's recently-released data for Q1-2012 GDP came in at 5.3% YoY, significantly below expectations. A key point to note is that this is the lowest quarterly reading in the current GDP series – even during the 2008-09 global crisis, quarterly GDP growth had troughed at 5.6% YoY. The slowdown in Q1-2012, plus revisions to prior data, prompted the government to revise down its advance GDP estimate for FY12 to 6.5% from 6.9%. Following this, we now expect FY13/FY14 GDP estimates to come in at 6.4% and 6.9%, thereby expecting a 'U' shaped recovery. We reiterate our view that the interplay of the four deficits (current account, fiscal, liquidity and governance) has led to a de-rating of the India story. As mentioned earlier, aggressive thrust on policy and execution reform is key to reverse the slowdown.

While growth has decelerated, headline WPI and CPI stand elevated at 7.6% and 10.3% YoY respectively. This was the key reason behind the RBI keeping rates on hold in its recent monetary policy meeting. While acknowledging a significant slowdown in growth, the RBI highlighted inflation worries, stating *"persistence of overall inflation both at the wholesale and retail level points to serious supply bottlenecks and sticky inflation expectations.*" Going forward, with headline inflation likely to remain sticky, we believe our rate cut call of 50-75bps for the year is contingent on government taking steps on fuel price adjustments and/or policy-related issues in the investment space.

On the rating front, following S&P's revision to India's sovereign outlook from stable to negative, Fitch also revised the sovereign outlook to negative. We maintain our view that odds of a sovereign ratings downgrade to sub-investment are high and would be negative for all asset classes. Similar to the RBI's decision, the rating agencies also put the onus on the government to create a positive investment environment and implement tax and subsidy reforms. While most of the macro variables are still dismal, one key change is the trend reversal in India's current a/c deficit. We expect India's CAD to improve to 3.5% of GDP v/s earlier expectations of it coming in the 4% range. This is due to lower oil prices and moderating gold demand which more than offsets the deceleration in exports. However, a key point to note is that the overall BoP is still likely to be in the red due to lower FDI and external borrowings. This, coupled with trends in the REER, supports our global FX team's view of the INR remaining weak in the near-term at 54-56 levels, although we expect a return to a steady appreciation path in the medium term.

Figure 33. India — Economic Forecasts, FY2012/13-2014/5F

		FY 12/13F	FY 13/14F	FY 14/15F
Real GDP	YoY	6.4%	6.9%	7.1%
Final Domestic Demand	YoY	5.7	7.1	7.5
Private Consumption	YoY	6.0	6.7	7.0
Fixed Investment	YoY	5.5	8.0	9.0
Exports	YoY	13.5	15.0	11.0
Imports	YoY	8.3	10.8	9.3
Wholesale Price Index*	YoY	7.4	6.5	6.0
Consumer Price Index	YoY	7.0	6.5	6.0
Current Account	US$ bn	-65	-57	-58
	% of GDP	-3.5	-2.6	-2.2
Consolidated Fiscal Balance	% of GDP	-8.0	-7.7	-7.0
Centre Fiscal Balance	% of GDP	-5.5	-5.0	-4.5
US Dollar Exchange Rate	Average	54.5	53.8	51.9

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

Korea

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Facing the further slowdown of China and sluggish eurozone, we are cutting our real GDP growth forecast for 2012 and 2013 to 2.8% and 3.6%, each down by 0.6% from our prior forecasts. We expect a meaningful recovery of the economy to come in 2H13 as exports and investment rebound along with improvements of financial markets as well as the global economy. In particular, based on our baseline scenario of Grexit, we expect Korea's economy to record negative growth of 0.1%QoQ in 1Q13 due to weakness in exports and domestic demand. As well as the deterioration in economic sentiment from external headwinds, a further slowdown of economic growth would increase the household debt service burden and delay the recovery of private consumption as well. Household debt reached 164% of disposable income at the end of 2011. The BoK is expected to cut the policy rate once in this year, most likely in 3Q12, and once more in 1Q13, with a total of 50bps of easing by mid-2013. However, the government is not likely to implement a supplementary budget but is expected to squeeze extra spending from the budget by around KRW6trn in 2H12 to support growth by increasing funds and minimizing carry-over.

Indonesia

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Bank Indonesia has apparently started to pause its money market rate increases in June, suggesting they are comfortable with the current slope of the yield curve. Its official statements have been emphasizing commitment to maintaining FX market liquidity, following the policy glitch and IDR spike last month. Recently we have seen more active intervention, and this is confirmed by the decline in foreign reserves by almost $5bn to $111.5bn as of May. BI also introduced the new USD time deposit facility for banks which in the first auction drew in a total of $0.7bn, a modest addition to FX reserves, although we don't expect any further rapid increase in the amount placed in this facility due to the unappetizing rates given. Inflation remained tame in May and the decline in oil prices has derailed previous plans to raise domestic fuel prices. However amid declining non-oil commodity prices, especially coal, Indonesia has seen the trade balance worsen and tilt to a deficit of $0.6bn in April. This month we have raised our 2012 forecast for the current account deficit to 1.9% GDP, from previously 1.0%, and accordingly revised our YE12 IDR forecast to 9,489/US$. Amid these headwinds, we also toned down our FY12 and FY13 GDP growth forecasts to 6.1% and 6.3%, from previously 6.2% and 6.5%.

Figure 34. Korea and Indonesia — Economic Forecasts, 2011-2013F

		Korea			Indonesia		
		2011	2012F	2013F	2011	2012F	2013F
Real GDP	YoY	3.6%	2.8%	3.6%	6.5%	6.1%	6.3%
Final Domestic Demand	YoY	1.3	2.4	3.2	5.7	6.5	7.0
Private Consumption	YoY	2.3	1.5	2.0	4.7	4.4	4.5
Fixed Investment	YoY	-1.1	3.4	4.9	8.8	11.4	12.1
Exports	YoY	9.5	2.0	3.3	13.6	4.3	11.7
Imports	YoY	6.5	1.6	2.0	13.3	6.4	15.1
Consumer Price Index	YoY	4.0	2.8	3.0	5.4	4.4	4.7
Unemployment Rate	%	3.4	3.3	3.3	6.6	6.1	5.9
Current Account	US$ bn	26.5	20.0	22.4	1.7	-17.2	-11.4
	% of GDP	2.4	1.8	1.9	0.2	-1.9	-1.2
Fiscal Balance	% of GDP	1.5	1.2	1.5	-1.2	-1.8	-0.7
US Dollar Exchange Rate	Average	1108	1146	1146	8763	9387	9630

Sources: Haver Analytics and Citi Investment Research and Analysis

Hong Kong

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HK likely to see a fragile recovery starting in 2Q, but we are cutting our growth forecasts to 2.5% for 2012 (down 0.1% from last month) and 3.8% for 2013 (down 0.4%), reflecting China and Eurozone worries. On a YoY basis, GDP could improve from 0.4% in 1Q to 1.9% in 2Q on base effects, but the recovery is likely be capped by potential contagion risks via trade, asset market volatility, banks' deleveraging and lower consumer and business confidence. Officials announced several measures to promote the CNH market, and further measures could be announced during President Hu's visit to HK on 1 July. Despite the recent ex-HKMA Chief Yam's comments on the need to review the HKD peg, our view remains that the HKD peg will remain intact in the near/medium term. Domestic interest rates are likely to stay low near term.

Singapore

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GDP momentum is poised to slow sharply in Q2. The recovery in NODX and manufacturing has lost momentum, and external demand headwinds have also been mirrored in other trade and transport related segments. Despite some moderation, supply constraints could keep inflation elevated at 4% in H2-12. With tighter foreign worker quotas from July, the marginal easing of labor market tightness in 1Q12 may prove temporary. With supply constraints reducing potential growth, the hurdle for macro policies to switch to supporting demand is high; it would take a more severe growth slowdown for MAS to ease policy, and even so any easing will be calibrated. Despite a fall in May new home sales from April's record, the risk of further property cooling measures has not subsided completely.

Taiwan

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Real GDP growth was dismal in 1Q12 (0.4% YoY) and will likely stay low in 2Q12. We are cutting our 2012 GDP forecast, for the third time this year, to 2.8% from 3.3% to reflect weak exports in April-May and the deteriorating H2 outlook. Still, the CBC will likely keep rates unchanged as monetary policy currently remains accommodative. Eyes are on the upcoming 8th cross-strait meeting where we expect the Taipei and Beijing governments to conclude a long-awaited investment protection agreement. After that, the CBC and the PBoC will likely sign a currency settlement agreement in the summer so that Taiwan banks can start building RMB businesses in Taiwan. We expect both interest rates and NT$ to stay low near term, but both will likely rise when the economy shows stronger recovery signs.

Figure 35. Hong Kong, Singapore and Taiwan — Economic Forecasts, 2011-2013F

		Hong Kong			Singapore			Taiwan		
		2011	2012F	2013F	2011	2012F	2013F	2011	2012F	2013F
Real GDP	YoY	5.0%	2.5%	3.8%	4.9%	3.6%	5.0%	4.0%	2.8%	4.2%
Final Domestic Demand	YoY	7.5	4.2	1.9	3.4	4.6	3.8	1.3	0.8	2.9
Private Consumption	YoY	8.4	3.8	2.0	4.1	3.8	4.8	3.0	1.9	3.0
Fixed Investment	YoY	7.3	6.0	2.0	3.3	9.0	2.7	-3.8	-2.0	5.1
Exports	YoY	4.2	0.5	6.0	2.6	3.8	5.9	4.5	2.2	6.2
Imports	YoY	4.6	1.0	5.1	2.4	5.2	6.6	-0.6	-0.6	5.1
CPI	YoY	5.3	4.0	3.0	5.2	4.4	3.3	1.4	1.9	2.1
Unemployment Rate	%	3.4	3.5	3.7	2.0	2.2	2.1	4.4	4.3	4.2
Current Account	US$ bn	12.4	24.3	28.2	57.1	41.7	41.2	41.3	42.0	44.8
	% of GDP	5.1	9.4	10.2	21.9	14.9	13.1	8.8	8.7	8.4
Fiscal Balance	% of GDP	3.9	0.8	0.7	1.5	1.0	1.0	-1.9	-1.6	-1.6
US Dollar Exchange Rate	Average	7.78	7.76	7.76	1.26	1.26	1.26	29.40	29.88	28.86

Sources: Haver Analytics and Citi Investment Research and Analysis

Russia

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The economy is slowing with weaker industrial production and investment. The consumer sector is closer to overheating (6.8%YoY in May), but is likely to lose steam in 2H once the effect of pre-election spending fades. We keep our 2012 GDP growth forecast of 3-3.5% (assuming oil prices between US$100-110/bbl in 2H12), although risks are probably skewed to the downside. Despite historically low price growth (3.7%YoY in May), the CBR remains concerned about medium-term inflation risks and will likely try to keep interest rates in the 5-6% range this year. Meanwhile the CBR cut the rate on currency swap operations and has been systematically expanding the list of securities eligible as collateral to ease access to refinancing. The MoF is also working on anti-crisis measures such as freezing about 18% of spending budgeted for 2013. The 2012 current account surplus will likely exceed US$100bn, but we think quarterly surpluses will fall to US$20bn in 2H12 – almost half the level of 1Q12 (US$43bn). The current account balance could shrink to US$80bn should oil fall to US$80-90 range. Capital outflows should remain sizeable, but will likely moderate in line with the lower current account surpluses. We expect the ruble basket to stay within 36-37 for the rest of 2012, supported by tight liquidity and weaker domestic demand. We expect the basket will trade through 39 if oil prices fall to US$80/bbl and risk aversion rises sharply, as happened in late-08.

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Declines in oil prices and non-energy imports have led us to revise our 2012 current account deficit forecast from around 8.5% of GDP to 7.5%. Nonetheless, the ongoing gap between the current account deficit and capital inflows show the country is not facing the strong inflow scenario envisaged by the CBT. Recent evidence suggests most of the external financing has been secured through banks, via either short-term loans or non-resident deposit inflows. With this caveat, we think attractive yields, Moody's recent upgrade and lower oil prices will continue to support the lira near-term. In this respect, the key issue is whether the CBT will continue to keep TRY liquidity tight, particularly if the lira strengthens further. This is not a trivial risk as defending the currency is not a free lunch, because high interest rates would hurt growth dynamics. We believe the CBT has limited scope to relax policy without hurting market sentiment, until external financing pressures subside. However, a marked slowdown of growth from the official 4% forecast may force the CBT to loosen, which would weaken the lira.

Figure 36. Russia and Turkey — Economic Forecast, 2011-13F

		Russia			Turkey		
		2011	2012F	2013F	2011	2012F	2013F
Real GDP	YoY	4.3%	3.5%	4.0%	8.5%	2.5%	4.3%
Final Domestic Demand	YoY	1.7	1.5	2.0	9.8	1.6	4.5
Private Consumption	YoY	6.3	5.9	5.3	7.7	1.0	4.5
Fixed Investment	YoY	8.0	6.7	9.0	18.3	2.3	4.9
Exports	YoY	0.4	1.0	2.7	6.5	1.8	5.5
Imports	YoY	20.3	4.3	5.8	10.6	-1.4	6.2
CPI	YoY	8.4	5.1	6.9	6.5	9.4	7.0
Unemployment Rate	%	6.6	7.5	7.5	9.8	9.8	10.0
Current Account	US$ bn	98.8	107.1	46.6	-77.2	-60.3	-60.1
	% of GDP	5.3	5.8	2.4	-10.0	-7.5	-6.9
Fiscal Balance	% of GDP	2.0	0.3	0.1	-1.3	-2.2	-2.5
US Dollar Exchange Rate	Average	29.4	32.5	34.9	1.68	1.80	1.87

Source: Citi Investment Research and Analysis

Hungary

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The government's compromise on the Central Bank Bill will likely facilitate the start of official IMF/EU loan aid talks soon. Rapid progress is unlikely, given our expectations of tough fiscal conditions. Political compromise looks especially challenging given the plunge in the governing party's popularity, which has closed the gap between support for the ruling Fidesz and left-wing opposition parties. In the absence of an IMF deal, the government's commitment to fiscal discipline is unlikely to generate sufficient external market funding to cover rising FX debt redemptions, given economic weakness and prior damage to the government's credibility. Therefore we stick to our expectation that the deal will be concluded in 4Q12. Low growth remains the key vulnerability for debt dynamics. The fiscal tightening for 2013 largely reflects the planned introduction of the financial transaction tax, which may contribute to further deleveraging and hit domestic demand. At the same time, weak external growth will probably hit industrial exports. The easing inflation outlook and deteriorating growth prospects will probably support MPC doves. We expect 100bp cumulative cuts, in gradual steps, by year-end/early 2013, but the pace and timing will likely be highly conditional upon the external risk environment.

Poland

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The Polish economy is showing signs of a further deterioration in growth prospects. GDP slowed to 3.5%YoY in 1Q from 4.3% in 4Q with disappointing private consumption and fixed investment performance, although net exports proved somewhat stronger than expected. Given that private spending is already slowing, with cuts in public infrastructure spending likely later this year, we look for economic growth to decelerate further in 2H, bringing overall 2012 growth down to around 2.7% YoY. Recent falls in the manufacturing PMI suggest the EMU crisis has already begun to hit export orders. Currency weakness could bring temporary relief to Polish exporters, but there is little chance for a substantial labour market recovery. The uncertainties over the EMU crisis do not help in this respect. Due to slowing growth, the central bank is likely to keep interest rates on hold in July, especially given the downward surprise in the May CPI. Budget revenues are already feeling the impact of weaker domestic demand and we expect this will continue in coming months. However, thanks to a one-off payment of central bank profits, we expect the Finance Ministry should be able to keep the budget deficit below the planned level of PLN 35 bn.

Figure 37. Hungary and Poland — Economic Forecasts, 2011-2013F

		Hungary			Poland		
		2011	2012F	2013F	2011	2012F	2013F
Real GDP	YoY	1.7%	-0.9%	0.8%	4.3%	2.7%	2.4%
Final Domestic Demand	YoY	-1.2	-1.9	-1.1	3.5	2.8	2.0
Private Consumption	YoY	0.0	-1.1	-0.8	3.1	2.3	2.5
Fixed Investment	YoY	-5.4	-5.6	-2.0	8.3	5.6	1.0
Exports	YoY	8.4	2.1	5.3	7.5	4.5	4.5
Imports	YoY	6.3	1.0	4.0	5.8	2.9	2.3
CPI	YoY	3.9	5.2	3.5	4.3	3.9	2.6
Unemployment Rate	%	11.6	11.8	11.0	12.5	12.9	11.7
Current Account	US$ bn	2.0	1.5	2.4	-22.2	-18.3	-20.8
	% of GDP	1.7	1.2	1.9	-4.3	-3.8	-4.5
Fiscal Balance	% of GDP	4.3	-2.8	-2.5	-5.1	-3.1	-2.5
Euro Exchange Rate	Average	279	284	289	4.12	4.24	4.39

Sources: Haver Analytics and Citi Investment Research and Analysis

Czech Republic

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With a disappointing confidence survey and significant fall of GDP in 1Q12, we now expect Czech GDP to fall by 1%YoY, followed by a milder recovery of 1% in 2013. Domestic demand remains weak, hit by fiscal consolidation and higher inflation in early 2012. While the latter is likely to ease from mid-2012, fiscal consolidation is likely to remain in place and is one of the key disinflationary factors for the Czech economy. After the May CPI decelerated to 3.2%YoY, we expect it to reach 3% in June, 0.6% pts below the CNB's May forecast. Moreover, recent data appear disinflationary. For example, GDP fell by 0.7%YoY in 1Q12 (with a bigger fall in household consumption), while monthly data from industry suggest a deceleration of nominal wage growth. The annual current account deficit narrowed to 1.8% of GDP in May. We forecast that the trade surplus will worsen and leave the overall 2012 current account at around 2.2% of GDP in 2012 – but this is still down from 3.0% in 2011 and hence likely to be supportive for the currency. We do expect the currency to weaken slightly, but doubt this will stop the CNB from cutting its policy rate to 0.25% later this year.

Romania

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Recent economic data do not paint an encouraging picture. Although sentiment indicators suggest consumers may be turning somewhat more optimistic, we are concerned about growth prospects given the absence of strong signals from supply-side indicators and worries about the sustainability of Romania's strong export performance. This backdrop, coupled with the benign near-term inflation outlook, is likely to raise the pressure on the NBR to loosen. Nonetheless, given the recent depreciation of the leu, the NBR is not likely to relax its stance. If anything, the Bank has tightened RON liquidity to stem currency weakness, pushing money markets closer to the policy rate. Where do we go from here? Our analysis suggests the leu's disappointing performance with respect to its peers in the region is more to do with the low interest rate differential and less to do with the EMU sovereign debt crisis. Consequently, we believe the NBR is likely to keep RON liquidity tight enough to keep money market rates closer to the policy rate. Against this backdrop, we expect EUR/RON to be around 4.40 by year-end, with risks tilted towards a weaker currency.

Figure 38. Czech Republic and Romania — Economic Forecasts, 2011-2013F

		Czech Republic			Romania		
		2011	2012F	2013F	2011	2012F	2013F
Real GDP	YoY	1.7%	-1.0%	1.0%	2.5%	1.3%	3.0%
Final Domestic Demand	YoY	-0.9	-0.5	1.7	1.9	0.9	2.7
Private Consumption	YoY	-0.6	-1.5	1.2	1.3	0.9	2.7
Fixed Investment	YoY	-0.9	0.1	3.8	6.2	1.2	3.5
Exports	YoY	11.0	5.0	4.1	10.5	5.5	4.2
Imports	YoY	7.5	0.5	4.1	11.5	3.9	3.2
CPI	YoY	1.9	3.2	2.4	5.8	2.8	2.7
Unemployment Rate	%	8.5	8.7	8.8	5.4	5.2	5.2
Current Account	US$ bn	-6.3	-4.1	-4.0	-8.3	-7.7	-8.2
	% of GDP	-3.0	-2.2	-2.2	-4.4	-4.5	-4.7
Fiscal Balance	% of GDP	-3.1	-3.2	-2.9	-4.1	-2.4	-2.2
EURCZK, USDRON	Average	24.6	25.6	25.9	3.0	3.5	3.6

Sources: Haver Analytics and Citi Investment Research and Analysis

Brazil

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After the meagre 1Q12 GDP growth print, we are cutting our 2012 annual growth estimate to 2.3% (from 3.3% previously). Despite the significant downward revision, we continue to expect economic growth to accelerate steadily in coming quarters, implying a narrowing of the negative output gap starting 2H12. The slower GDP expansion, decline in commodity prices and several tax reductions have improved the inflation outlook for this year, leading us to cut our end 2012 CPI inflation forecast to 4.9% (from 5.3%). Lower growth and inflation estimates point to further room for monetary policy easing. Therefore, we also cut our Selic rate call, expecting it to reach 7.25% by 2012 year end. For 2013, considering that we keep our GDP growth estimate at 4.5% as well as our CPI inflation forecast at 5.6%, we estimate that central bank will likely hike interest rates by 200bp, implying a Selic rate at 9.25% by 2013 year end. Regarding FX, global turmoil should keep USD/BRL temporarily at a higher level in the near term, pointing to a bullish view for BRL in the medium/long term. Finally, the government will likely accomplish the primary fiscal target of 3.1% of GDP, unless the expected GDP recovery fails, motivating the government to ease fiscal policy further.

Mexico

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Activity figures early in 2Q12 suggest that external demand is slowing, albeit at a gradual pace: industrial output in April rose 3.6% y/y, below our estimate at 5.2%. Nevertheless, domestic demand is still showing good momentum, with private consumption and investment in 1Q12 posting solid growth rates of 4.3% and 8.6% y/y, respectively, and formal job creation for May rose 4.5% y/y. Thus, we keep our annual GDP growth estimates for 2Q12 and the whole year unchanged at 4.5% and 3.9% respectively. Headline inflation meanwhile has surprised on the upside, as the print for the first half of June at 4.3% y/y is already above Banxico's variability range of 3% +/- 1%. We however see limited inflation risks as the rise is essentially driven by volatile farm prices, while core inflation remains well behaved at 3.5% y/y. Accordingly, Banxico's neutral policy stance should remain essentially unchanged: we see the policy rate closing this year at its current 4.5% level. The presidential race is coming to an end with PRI's Enrique Pena Nieto as the most likely winner of the July 1 election. We believe investors also should watch for the results of congressional elections, as they will be also relevant for assessing structural reform prospects in the coming administration.

Figure 39. Brazil and Mexico — Economic Forecasts, 2011-2013F

		Brazil			Mexico		
		2011	2012F	2013F	2011	2012F	2013F
Real GDP	YoY	2.7%	2.3%	4.5%	3.9%	3.9%	3.8%
Final Domestic Demand	YoY	3.8	3.2	5.1	5.0	4.7	4.5
Private Consumption	YoY	4.1	4.0	5.0	4.5	4.2	4.0
Fixed Investment	YoY	4.7	0.9	7.7	8.9	7.9	7.5
Exports	YoY	4.5	4.4	21.4	6.7	8.6	7.5
Imports	YoY	9.7	7.4	20.7	6.7	8.9	6.1
CPI	YoY	6.6	5.1	5.3	3.4	4.0	3.9
Unemployment Rate	%	6.1	6.3	6.5	5.3	5.2	5.3
Current Account	US$ bn	-48.6	-51.4	-65.4	-8.7	-15.6	-26.2
	% of GDP	-2.1	-2.1	-2.5	-0.8	-1.4	-2.0
Fiscal Balance	% of GDP	-2.6	-1.9	-2.7	-2.5	-2.2	-2.0
US Dollar Exchange Rate	Average	1.67	1.97	1.93	12.44	13.40	13.38

Sources: Haver Analytics and Citi Investment Research and Analysis

Argentina

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Several indicators are confirming our view that Argentina is inexorably marching towards a long period of "stagflation", i.e. a combination of low growth and high inflation. For instance, OJF, a local consultancy firm, reported that economic activity fell 1.2% YoY in May, posting its first annual decline since October 2009. Meanwhile, opposition congressmen reported that annual CPI inflation stood at 23.9% in May, while monthly consumer inflation came in at 1.7%. Additionally, expectations have deteriorated sharply, which probbaly will cap investment and private consumption. For example, 5-year CDS are priced around 1250bp, and the spread between the official exchange rate and the blue-chip-swap stands above 45%. The Universidad Torcuato Di Tella reported that their consumer confidence index shrank 20.3% YoY in June. We continue to expect (non-official) real GDP growth to be only about 1% in 2012 and 2013, with a significant downside risk for both forecasts. We expect the official data to show growth of about 3% YoY in both years. Despite the slowdown in growth, we expect (non-official) CPI annual inflation to stand at 25% by the end of 2012, and at 35% by December 2013. Finally, we expect the USDARS to be 4.8 and 6 at the ends of 2012 and 2013, respectively.

Venezuela

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The presidential campaign has heated up with the official registration by president Chávez and opposition candidate Henrique Capriles. There are now clear disputes between the candidates, although President Chávez still does not want to have a formal debate with Mr. Capriles. Latest polls show Mr. Chávez maintaining an advantage over Mr. Capriles, while at the same time the percentage of undecided voters lingers around 29%. Strategies from both sides are not proving effective to convince these voters, in a framework that benefits the incumbent candidate. Although everything seems to be about politics these days in Venezuela, some dark clouds are forming in the economic outlook as oil prices have been stuck below US$100/barrel, reducing oil revenues. We expect this situation to have an impact next year, as a Venezuelan version of a “fiscal cliff” unfolds due to what we forecast to be a sharp fall in government spending.

Figure 40. Argentina and Venezuela — Economic Forecasts, 2011-2013F

		Argentina			Venezuela		
		2011	2012F	2013F	2011	2012F	2013F
Real GDP	YoY	8.9%	3.0%	3.0%	4.2%	5.0%	3.5%
Final Domestic Demand	YoY	12.0	3.3	3.8	7.6	6.0	1.8
Private Consumption	YoY	10.7	2.8	2.8	4.0	6.4	0.7
Fixed Investment	YoY	-	-	-	4.4	2.6	2.2
Exports	YoY	4.3	1.9	2.1	4.7	6.8	5.2
Imports	YoY	17.8	5.2	6.5	15.4	8.5	-0.9
CPI	YoY	9.8	9.6	11.4	27.1	23.6	27.5
Unemployment Rate	%	8.1	8.1	8.0	6.5	6.4	6.7
Current Account	US$ bn	0.0	0.3	-1.5	27.2	17.7	13.4
	% of GDP	0.0	0.1	-0.3	9.1	4.9	3.7
Fiscal Balance	% of GDP	-1.6	-3.0	-2.0	-5.0	-5.0	-4.0
US Dollar Exchange Rate	Average	4.13	4.55	5.45	NA	NA	NA

Sources: Haver Analytics and Citi Investment Research and Analysis

Saudi Arabia

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We have lowered our price forecasts for Brent for 2012 and 2013, to US$115 and US$99 per barrel respectively. Although May figures show sustained oil production at just below the 10mbpd mark, meaning an average oil production of 9.75mbpd so far this year, we are lowering our production assumption to 9.5mbpd, from 9.7mbpd previously, because over-supply risks in the remainder of the year will likely lead to production cuts. The result is that our economic forecasts have been cut somewhat, to 6.8% in 2012 and 6.0% for 2013 (down by 0.3% and 0.5% respectively from last month). With no change to our government spending forecast, we expect the fiscal surplus will be around 16.9% of GDP in 2012, compared to our prior forecast of 20.5% of GDP. We have not revised our forecast for growth in the non-oil economy, which will remain strong, around 8.5% YoY, on the back of continued high government expenditure and increased domestic demand. We continue to expect progress on passing the mortgage law in 2012, which we believe will create a significant boost to the local housing sector and domestic demand. Meantime, inflation remains sticky, and was stable at 5.2% in May, but we continue to expect demand side pressure to pose a significant threat to price stability in the coming months.

United Arab Emirates

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Dubai International Financial Centre Investments (DIFCI) has repaid the US$1.25bn sukuk due June 13. The repayment is the second major repayment by a Dubai-based government-related entity this year, and is likely to reinforce investor confidence in Dubai's ability to manage its public sector debt overhang, in our view. We believe the macro story also remains positive. Lead indicators point to a continued recovery in Dubai's economy, with DP World announcing a 9% increase in volumes at Jebel Ali Port and DHCOG, which owns the Jumeirah Hotel group, announcing strong revenue growth. In a recent Knight Frank report, Dubai premium property prices showed a strong recovery as well, up 4% in Q1-2012, higher than any of the 22 other global cities surveyed in the report. That said, supply continues to come on line, meaning prices are likely to remain soft outside the mature premium areas of Dubai. We still see down-side risks to economic growth in the coming 18 months, including uncertainty over global economic growth and regional geo-political risks.

Figure 41. Saudi Arabia and United Arab Emirates — Economic Forecasts, 2011-2013F

		Saudi Arabia			United Arab Emirates		
		2011	2012F	2013F	2011	2012F	2013F
Real GDP	YoY	6.8%	6.8%	6.0%	5.3%	0.5%	3.4%
Final Domestic Demand	YoY	7.7	7.8	7.9	3.0	3.4	3.4
Private Consumption	YoY	3.9	5.0	5.0	1.0	2.0	2.0
Fixed Investment	YoY	13.5	10.0	10.0	5.0	5.0	5.0
Exports	YoY	10.7	7.9	-7.3	13.0	13.0	13.0
Imports	YoY	1.4	15.0	15.0	15.0	15.0	15.0
CPI	YoY	5.0	7.0	8.0	0.9	1.1	1.3
Current Account	US$ bn	154.3	157.7	101.6	48.7	11.9	20.7
	% of GDP	26.8	26.8	17.4	15.0	3.5	5.7
Fiscal Balance	% of GDP	13.7	16.9	4.3	-	-	-
US Dollar Exchange Rate	Average	3.75	3.75	3.75	3.67	3.67	3.67

Sources: Haver Analytics and Citi Investment Research and Analysis

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With falling global oil prices in May, the naira has come under pressure once again. We believe the key economic indicator to watch in the coming months is the level of foreign exchange reserves: falling reserves would increase the pressure on the Central Bank of Nigeria (CBN) to re-think its soft peg; while stable or rising reserves would confirm its view that the current pressure is temporary and will ease as the oil price recovers back over US$100/barrel. We expect inflation to increase in coming months on the back of rising food prices, while growth will slow marginally due to stagnant oil production and the activities of Boko Haram in the north of the country. As a result, we think the CBN will be reluctant to raise rates, even with the currency under pressure. With Ngozi Okonjo-Iweala as finance minister, alongside incumbent central bank governor, Lamido Sanusi, Nigeria has a respected economic team committed to improving fiscal discipline and driving a return to more orthodox monetary policies and improved fiscal discipline. But the key will be the progress they make in 2H 2012 with structural reform, notably the formal implementation of the proposed Sovereign Wealth Fund (SWF) and the electricity sector.

South Africa

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The Q1-12 growth data continue to highlight the unfavourable external environment facing the country. We expect that growth will be only about 2.7% in 2012, remaining subpar, and will only start to modestly recover into 2013. Although the Treasury remains committed to budget deficit reduction and debt stabilisation -- focusing more on micro policy steps to foster stronger growth -- weak revenue growth and pressure from the public wage bill mean that a significant reduction in the deficit is only likely in 2014/15. In the meantime, even with weak housing sector growth and rising inflation eroding household purchasing power, the ongoing monetary stimulus is supporting resilient consumer spending. Corporate finances are relatively healthy and there are signs of an upturn in private investment. We expect no immediate change in the monetary policy stance, with a rate hike unlikely before early 2013 and only gradual normalisation afterwards, although inflation will probably hover around the top end of the 3%-6% target range in the next 15 months. However, we think it is unlikely that inflation will make a sustained breach of the upper limit, although rand fragility and wage stickiness pose upside risks. Poor export performance and the high import content of capital spending suggest that the current account deficit will gradually widen, after recently being kept low by favourable trends in the terms of trade.

Figure 42. Egypt, Nigeria and South Africa — Economic Forecast, 2011-2013F

		Egypt			Nigeria			South Africa		
		2011	2012F	2013F	2011	2012F	2013F	2011	2012F	2013F
Real GDP	YoY	1.8%	2.0%	2.7%	7.8%	7.4%	6.8%	3.1%	2.7%	3.6%
Final Domestic Demand	YoY	2.9	2.7	2.6	NA	NA	NA	4.6	3.1	3.7
Private Consumption	YoY	5.0	0.9	0.8	NA	NA	NA	4.9	2.5	2.9
Fixed Investment	YoY	-5.6	3.7	6.5	NA	NA	NA	4.3	4.4	5.7
Exports	YoY	3.7	-3.8	6.3	NA	NA	NA	5.9	5.3	6.2
Imports	YoY	8.1	-2.3	5.5	NA	NA	NA	9.1	6.7	7.0
CPI	YoY	10.2	8.4	12.5	10.8	12.4	9.8	5.0	6.1	5.4
Unemployment Rate	%	12.1	13.0	14.5	NA	NA	NA	26.0	25.7	25.2
Current Account	US$ bn	-5.4	-7.2	-9.0	15.9	17.0	21.9	-13.6	-17.8	-21.9
	% of GDP	-2.3	-2.9	-3.4	6.1	5.7	6.4	-3.4	-4.7	-5.6
Fiscal Balance	% of GDP	-10.1	-9.3	-7.5	-3.1	-2.2	-2.1	-5.0	-4.8	-4.2
US Dollar Exchange Rate	Average	5.94	6.07	6.63	155.9	161.01	165.17	7.26	8.27	8.81

Source: Citi Investment Research and Analysis

Figure 43. Selected Emerging Market Countries — Economic Forecast Overview, 2011-2013F

	GDP Growth			CPI Inflation			Current Balance (% of GDP)			Fiscal Balance (% of GDP)		
	2011	2012F	2013F	2011	2012F	2013F	2011	2012F	2013F	2011	2012F	2013F
Asia	**7.2%**	**6.4%**	**6.8%**	**5.7%**	**3.7%**	**3.8%**	**2.3%**	**1.6%**	**1.3%**	**-2.2%**	**-2.8%**	**-2.1%**
China	9.2	7.8	7.9	5.4	2.9	3.1	2.8	2.0	1.5	-1.3	-2.4	-1.5
Hong Kong	5.0	2.5	3.8	5.3	4.0	3.0	5.1	9.4	10.2	3.9	0.8	0.7
India*	6.5	6.4	6.9	8.8	7.4	6.5	-4.0	-3.5	-2.6	-8.4	-8.0	-7.7
Indonesia	6.5	6.1	6.3	5.4	4.4	4.7	0.2	-1.9	-1.2	-1.2	-1.8	-0.7
Korea	3.6	2.8	3.6	4.0	2.8	3.0	2.4	1.8	1.9	1.5	1.2	1.5
Malaysia	5.1	5.0	5.3	3.2	2.3	3.1	11.0	8.2	6.7	-5.0	-5.0	-4.7
Pakistan	2.8	3.1	4.2	10.5	11.0	11.0	-2.8	-3.6	-3.8	-6.5	-6.2	-5.5
Philippines	3.9	4.9	5.3	4.8	3.3	3.8	3.1	3.1	2.5	-2.0	-2.4	-2.1
Singapore	4.9	3.6	5.0	5.2	4.4	3.3	21.9	14.9	13.1	1.5	1.0	1.0
Sri Lanka	8.3	7.1	7.4	6.8	7.5	7.7	-7.4	-6.8	-6.1	-6.9	-6.5	-6.0
Taiwan	4.0	2.8	4.2	1.4	1.9	2.1	8.8	8.7	8.4	-1.9	-1.6	-1.6
Thailand	0.1	4.7	4.6	3.8	2.9	3.2	3.4	1.1	0.2	-1.5	-4.7	-3.9
Vietnam	5.9	5.0	5.6	18.6	9.1	7.3	-1.1	-1.2	-3.7	-3.5	-4.5	-4.3
Latin America	**3.9**	**3.1**	**4.1**	**6.8**	**5.8**	**6.1**	**-1.0**	**-1.4**	**-1.9**	**-2.3**	**-2.0**	**-2.2**
Argentina	8.9	3.0	3.0	9.8	9.6	11.4	0.0	0.1	-0.3	-1.6	-3.0	-2.0
Brazil	2.7	2.3	4.5	6.6	5.1	5.3	-2.1	-2.1	-2.5	-2.6	-1.9	-2.7
Chile	6.0	4.5	5.0	3.3	3.4	3.0	-1.3	-1.8	-1.9	1.6	0.7	0.6
Colombia	5.9	4.0	4.5	3.4	3.2	3.2	-3.0	-3.1	-2.9	-2.9	-1.8	-1.6
Mexico	3.9	3.9	3.8	3.4	4.0	3.9	-0.8	-1.4	-2.0	-2.5	-2.2	-2.0
Panama	10.6	9.2	7.0	5.9	5.6	3.2	-12.7	-11.6	-10.0	-2.3	-3.0	-3.0
Peru	6.9	5.7	6.5	3.4	3.6	2.9	-1.3	-2.4	-2.8	1.7	1.2	-0.3
Venezuela	4.2	5.0	3.5	27.1	23.6	27.5	9.1	4.9	3.7	-5.0	-5.0	-4.0
Europe	**5.0**	**2.8**	**3.6**	**6.7**	**5.4**	**5.7**	**-0.2**	**0.3**	**-1.1**	**-0.3**	**-1.2**	**-1.1**
Czech Republic	1.7	-1.0	1.0	1.9	3.2	2.4	-3.0	-2.2	-2.2	-3.1	-3.2	-2.9
Hungary	1.7	-0.9	0.8	3.9	5.2	3.5	1.7	1.2	1.9	4.3	-2.8	-2.5
Kazakhstan	7.5	5.8	5.7	8.3	5.2	5.8	7.6	1.9	2.4	5.9	1.7	3.0
Poland	4.3	2.7	2.4	4.3	3.9	2.6	-4.3	-3.8	-4.5	-5.1	-3.1	-2.5
Romania	2.5	1.3	3.0	5.8	2.8	2.7	-4.4	-4.5	-4.7	-4.1	-2.4	-2.2
Russia	4.3	3.5	4.0	8.4	5.1	6.9	5.3	5.8	2.4	2.0	0.3	0.1
Slovakia	3.3	2.2	1.8	3.9	3.6	2.8	0.1	0.5	-0.5	-4.8	-4.8	-3.2
Turkey	8.5	2.5	4.3	6.5	9.4	7.0	-10.0	-7.5	-6.9	-1.3	-2.2	-2.5
Ukraine	5.1	3.0	4.5	8.0	2.4	6.5	-5.2	-6.7	-4.5	-3.8	-3.5	-3.2
Africa/Mideast	**6.0**	**4.1**	**5.0**	**5.5**	**5.9**	**6.1**	**11.4**	**11.5**	**11.0**	**2.3**	**3.6**	**0.6**
Bahrain	3.2	3.0	3.9	-0.4	3.0	3.5	11.6	29.2	21.4	-1.2	4.8	5.1
Egypt	1.8	2.0	2.7	10.2	8.4	12.5	-2.3	-2.9	-3.4	-10.1	-9.3	-7.5
Ghana	14.4	7.5	6.5	8.7	10.2	11.6	-8.2	-7.3	-4.8	-5.4	-5.6	-6.0
Iraq	9.4	9.3	11.5	5.6	5.0	6.0	-5.1	32.7	66.7	15.8	16.5	25.2
Israel	4.9	2.7	3.0	3.4	2.0	2.2	0.1	-1.5	-1.0	-2.7	-3.7	-3.2
Jordan	2.6	2.5	3.0	4.4	5.0	5.0	-10.6	-12.4	-11.7	-3.9	-8.0	-9.5
Kenya	4.5	5.0	5.8	14.0	11.9	8.2	-11.8	-10.5	-9.5	-5.5	-5.0	-4.9
Kuwait	4.3	0.2	2.5	4.7	5.0	5.0	47.5	43.3	40.6	17.1	13.4	4.4
Lebanon	6.0	3.5	4.3	5.1	6.0	5.0	-21.3	-22.6	-23.5	-6.8	-8.0	-9.1
Nigeria	7.8	7.4	6.8	10.8	12.4	9.8	6.1	5.7	6.4	-3.1	-2.2	-2.1
Oman	4.9	3.0	4.5	4.0	3.0	3.0	3.4	2.7	15.3	5.4	3.0	0.2
Qatar	18.1	6.0	8.3	3.0	3.0	3.0	38.7	38.2	30.3	8.1	7.1	3.3
Saudi Arabia	6.8	6.8	6.0	5.0	7.0	8.0	26.8	26.8	17.4	13.7	16.9	4.3
South Africa	3.1	2.7	3.6	5.0	6.1	5.4	-3.4	-4.7	-5.6	-5.0	-4.8	-4.2
Tanzania	6.3	6.2	6.8	12.7	15.8	7.4	-10.5	-11.9	-11.2	-7.8	-6.2	-5.8
UAE	5.3	0.5	3.4	0.9	1.1	1.3	15.0	3.5	5.7	NA	NA	NA
Uganda	5.7	4.5	5.5	18.6	16.5	5.9	-11.1	-12.5	-10.7	-7.2	-5.5	-5.2
Zambia	6.6	6.5	6.9	8.7	7.5	8.0	2.5	1.2	-2.5	-3.2	-4.2	-5.2
Total	**6.0**	**4.9**	**5.5**	**6.1**	**4.7**	**4.8**	**2.2**	**1.9**	**1.4**	**-1.5**	**-1.8**	**-1.7**

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

Figure 44. Citi Global Economics Team *For Informational Purposes Only*

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Figure 45. Citi Global Strategy and Macro Team *For Informational Purposes Only*

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

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Sovereign Ratings Outlook

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

Given economic updates in this publication and based on rating agency criteria, we highlight our economists' and strategists' main expectations for sovereign ratings over the near-term. We are keeping the majority of our views unchanged since we last published (May 2012), but we do expect additional downgrades of Spain and Italy over the longer term.

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 (Up to 9 Months) Forecast Rating	Citi Longterm (Next 2-3 Years) Forecast Rating & Outlook	Current Rating	Current Outlook	Citi Nearterm (Up to 9 Months) Forecast Rating	Citi Longterm (Next 2-3 Years) Forecast Rating & Outlook
US	AA+	Neg	AA+ (Neg)	AA ↓	Aaa	Neg	Aaa (Neg)	Aa1 ↓
Canada	AAA	Stable	AAA	AAA	Aaa	Stable	Aaa	Aaa
Japan	AA-	Neg	AA- (Neg)	A+ ↓	Aa3	Stable	Aa3	A1 ↓
Germany	AAA	Stable	AAA (Neg W)	AAA (Neg)	Aaa	Stable	Aaa (Neg W)	Aaa (Neg)
France	AA+	Neg	AA+ (Neg W)	AA ↓	Aaa	Neg	Aaa (Neg W)	Aa1 ↓
Italy	BBB+	Neg	BBB ↓	BBB- ↓↓	A3	Neg	Baa1 ↓	Ba1 ↓↓↓↓
Spain	BBB+	Neg	BBB ↓	BBB - ↓↓	Baa3	Neg W	Baa3 (Neg)	Ba1 ↓
Austria	AA+	Neg	AA+ (Neg W)	AA ↓	Aaa	Neg	Aaa (Neg W)	Aa1 ↓
Belgium	AA	Neg	AA (Neg W)	AA- ↓	Aa3	Neg	Aa3 (Neg W)	Aa3
Finland	AAA	Neg	AAA (Neg W)	AA+ ↓	Aaa	Stable	Aaa (Neg W)	Aaa (Neg)
Greece	CCC	Stable	D ↓↓↓↓	CCC ↑↑↑↑	C		C	Caa2 ↑↑↑↑
Ireland	BBB+	Neg	BBB- ↓↓	BB ↓↓↓↓	Ba1	Neg	Ba2 ↓	Ba3 ↓↓
Netherlands	AAA	Neg	AAA (Neg W)	AA+ ↓	Aaa	Stable	Aaa (Neg W)	Aaa (Neg)
Portugal	BB	Neg	B+ ↓↓	CCC ↓↓↓↓↓	Ba3	Neg	B1 ↓	Caa2 ↓↓↓↓↓
UK	AAA	Stable	AAA	AAA (Neg)	Aaa	Neg	Aaa (Neg)	Aaa (Neg)
Switzerland	AAA	Stable	AAA	AAA	Aaa	Stable	Aaa	Aaa
Sweden	AAA	Stable	AAA	AAA	Aaa	Stable	Aaa	Aaa
Denmark	AAA	Stable	AAA	AAA	Aaa	Stable	Aaa	Aaa
Norway	AAA	Stable	AAA	AAA	Aaa	Stable	Aaa	Aaa

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

Key Expected Ratings Issues

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Citi continues to expect further downgrades over the near and long-term (Figure 46). As before, we continue to expect downgrades in the near-term (next 2-3 quarters) for Italy, Spain, Greece, Ireland and Portugal. Over the longer term (next 2-3 years), we believe that the combination of rising debt/GDP ratios, economic weakness, high market yields and the need for some form of sovereign bailout programme mean that both Italy and Spain are likely to be reduced to below investment grade by at least one major agency.

Moody's on the need for some form of official support for sovereigns

Since we last published, Moody's has given further clarification on its criteria regarding topics of external support for a sovereign:[12] "*Given the experience with PSI in Greece and the intentions expressed by euro area officials around the developments of the ESM, Moody's believes the debts of euro area sovereigns that are fully dependent upon funding from official sources to fund their borrowing requirements represent speculative grade risks…*"

Moody's on a "Grexit" scenario

Furthermore, in terms of a "Grexit" scenario (Citi's base case assumes 50-75% likelihood), Moody's has highlighted the following[13]: "*In Spain and Italy, Greece's exit would likely cause pressures to mount to the point where those sovereigns would need to turn to the EFSF / ESM for financial support at some point over the next year. The solvency tests that would likely be required and the burden-sharing that might be imposed if direct financial support were to be needed for an extended period are incompatible with investment grade ratings…we would therefore move the ratings of those sovereigns down towards or into speculative grade in anticipation of support being sought (consistent with our approach when Ireland and Portugal entered support programmes)*".

Hence, downward ratings pressure is clearly linked to a sovereign receiving some form of official support. Should Spain and Italy become "*fully dependent upon funding from official sources to fund their borrowing requirements*" then it is likely that Moody's would rate them as sub-Investment Grade.

We believe Spain and Italy will aim to retain partial market access

Citi's view is for Italy and Spain to receive partial support from official funding sources, not complete support, largely because current bailout mechanisms are inadequate in size (*What's Next for Spain and Italy?*): "*The sovereign bailouts [for Italy and Spain] are highly likely to involve fiscal and structural reform conditionality for the sovereign. They are also likely to aim to retain partial market access for Italy and Spain, relying on a mix of ECB-subsidised funding and financial repression to ensure take-up of the residual government funding needs by domestic banks and other financial institutions*"

Moody's downgraded Spain from A3 to Baa3 (Credit Watch Negative) on 13 June. The review period should run for 3 months

Moody's is currently reviewing Spain in light of recent developments: "*we will need to review the implications of the increasing pressures on the Spanish government, and will take any further rating actions we think are needed to reflect the increased risk to creditors of the government needing to seek external support*".

Given that Spain and Italy are to preserve some form of market access, we believe the sovereigns will remain Investment Grade in the near-term (albeit with downward rating pressure). Furthermore, even if they are rated sub-IG by Moody's in the longer-term, provided S&P maintain an IG rating (as we expect), both Spain and Italy would remain eligible for IG indices.

[12] "*Ratings Action: Moody's downgrades Spain's government bond rating to Baa3 from A3, on review for further downgrade*". Moody's Investor Service, 13 June 2012

[13] "*Rating Euro Area Governments Through Extraordinary Times – Implications of Spain's bank recapitalisation needs and the rising risk of a Greek exit* ". Moody's Special Comment, 8 June 2012.

Rates Strategy

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Since the last GEOS publication, there has been something of a turnaround in market sentiment. 10yr Bund yields have risen by 40bp from their low of 1.17% at the start of June, whereas Spanish 10yr yields are unchanged over the same period, thereby tightening the spread considerably. The devil, however, is in the detail. The spread has tightened by virtue of higher Bund yields and not lower Spanish yields, indeed at the time of writing 10yr Bonos yields are at 6.55% which is 45bp higher than they were at the time of our last publication and the two week moving average is at an all-time high of 6.75%. Italian BTP yields, while not as distressed as they were in November of last year, have also been rising steadily since mid-March.

Equity markets have performed well over the past few weeks, reinforcing the appearance of a developing “risk-on” sentiment. We think, however, that this may have more to do with expectations of the extension of Operation Twist and potential further QE from the Bank of England than with a significant change in sentiment towards Europe.

Speculation about potential reactivation of the SMP, and comments suggesting that EFSF/ESM facilities might be used to buy bonds have also been cited as reasons for the rally but we remain sceptical. At best EFSF bond purchases give existing longs a bid to sell into, but they are unlikely to trigger a surge of new demand.

The fundamental backdrop in Europe has not changed. Recent Spanish auctions have been reasonably well supported but largely, we believe, by domestic institutions, further magnifying the sovereign/bank mutual dependency. Furthermore, the recent series of small, short end auctions means that Spain is now beginning to lose ground on its required issuance run-rate, while the average maturity of the debt portfolio is falling (it has declined to just over 7 years from over 8 years in mid 2010 and 7.7 years as recently as the end of last year); both of these factors are pushing re-investment risk higher.

The announcement of an extension to Operation Twist has stabilised US Treasury yields, and UK Gilt yields are little changed over the past two weeks. The story, then, is higher German yields and some observers have attributed this to a rising risk of fiscal transfer. We do not agree with this assessment at all. We do not believe that Germany will end up footing the bill for the resolution of the EMU crisis, but rather that Germany will need to soften its stance on the role and mandate of the ECB and its ability to monetise its balance sheet. While this may eventually be somewhat inflationary for certain areas, the process of getting to that point will probably entail further significant declines in growth. As such, we believe that the recent sell-off in German bonds has more to do with congested positioning than it has to do with any fundamental shift in the global situation. We respect the price action, but we would look for any sign of stabilisation to re-initiate long duration positions in the core markets.

We therefore retain our forecasts for lower and even negative German yields, lower UK Gilt yields, and stable but low US Treasury yields.

Figure 47. Interest Rate and Bond Market Forecasts as of 27 Jun 2012

		Forecast End Period					
	Current	3Q 12	4Q 12	1Q 13	2Q 13	3Q 13	4Q 13
US							
Policy Rate (Fed Funds) End Quarter	0.25	0.25	0.25	0.25	0.25	0.25	0.25
3-Month Libor	0.46	0.45	0.42	0.45	0.55	0.65	0.75
2 Year Treasury Yield	0.30	0.28	0.35	0.45	0.55	0.70	0.85
5 Year Treasury Yield	0.71	0.70	0.85	1.00	1.10	1.25	1.40
10 Year Treasury Yield	1.63	1.60	1.80	2.00	2.10	2.35	2.60
30 Year Treasury Yield	2.68	2.60	2.85	3.10	3.20	3.50	3.80
2-10 Year Treasury Curve	133	132	145	155	155	165	175
2 Year Swap Spread (Swap Less Govt.), bp	23	25	30	30	30	35	35
10 Year Swap Spread (Swap Less Govt.), bp	14	16	18	22	25	25	25
30 Year Swap Spread (Swap Less Govt.), bp	-26	-30	-40	-50	-50	-50	-50
30 Year Mortgage Yield	3.63	3.65	3.8	3.95	4.05	4.25	4.45
10 Year Breakeven Inflation	206	215	220	225	230	235	240
Euro Area							
Policy Rate	1.00	0.50	0.50	0.50	0.50	0.50	0.50
Overnight Rate (EONIA)	0.33	0.20	0.15	0.15	0.15	0.15	0.15
3-Month Libor	0.56	0.50	0.30	0.30	0.30	0.30	0.30
2 Year Treasury Yield	0.08	0.00	-0.15	-0.15	-0.15	0.00	0.05
5 Year Treasury Yield	0.56	0.45	0.20	0.20	0.30	0.60	0.90
10 Year Treasury Yield	1.53	1.40	1.25	1.25	1.35	1.50	2.00
30 Year Treasury Yield	2.20	2.20	2.00	2.00	2.10	2.25	2.50
2-10 Year Treasury Curve	145	140	140	140	150	150	195
10 Year BTP-Bund Spread	453	525	650	700	650	650	600
10 Year Swap Spread (Swap Less Govt.), bp	42	50	45	40	35	30	30
10 Year Breakeven Inflation	158	170	160	160	170	190	200
Japan							
Policy Rate	0.10	0.10	0.10	0.10	0.10	0.10	0.10
3-Month Libor	0.20	0.20	0.20	0.20	0.20	0.20	0.20
2 Year Treasury Yield	0.10	0.10	0.10	0.15	0.10	0.15	0.15
5 Year Treasury Yield	0.22	0.30	0.40	0.45	0.40	0.55	0.55
10 Year Treasury Yield	0.82	0.95	1.10	1.20	1.10	1.30	1.30
30 Year Treasury Yield	1.84	1.90	2.00	2.05	2.00	2.15	2.15
2-10 Year Treasury Curve	72	85	100	105	100	115	115
2 Year Swap Spread (Swap Less Govt.), bp	24	25	26	27	26	28	28
10 Year Swap Spread (Swap Less Govt.), bp	1	5	7	10	7	12	12
10 Year Breakeven Inflation	NA	NA	NA	NA	NA	NA	NA
UK							
Policy Rate	0.50	0.50	0.50	0.50	0.50	0.50	0.50
3-Month Libor	0.90	0.90	0.85	0.85	0.90	1.00	1.00
2 Year Treasury Yield	0.37	0.35	0.40	0.40	0.50	0.60	0.60
5 Year Treasury Yield	0.88	0.90	0.85	0.85	0.95	1.25	1.60
10 Year Treasury Yield	1.69	1.60	1.65	1.70	1.80	2.00	2.50
30 Year Treasury Yield	3.18	2.80	2.65	2.65	2.75	2.80	3.25
2-10 Year Treasury Curve	132	125	125	130	130	140	190
10 Year Swap Spread (Swap Less Govt.), bp	37	35	35	40	40	40	40
10 Year Breakeven Inflation	267	250	240	250	260	275	300
Australia							
Policy Rate	3.50	3.25	3.25	3.25	3.25	3.50	3.75
3-Month Libor	3.50	3.40	3.40	3.40	3.60	3.80	4.10
2 Year Treasury Yield	2.49	2.40	2.50	2.60	2.70	2.90	3.25
5 Year Treasury Yield	2.50	2.50	2.60	2.70	2.85	3.10	3.50
10 Year Treasury Yield	2.97	3.15	3.25	3.40	3.70	4.00	4.30
2-10 Year Treasury Curve	48	75	75	80	100	110	105
10 Year Swap Spread (Swap Less Govt.), bp	90	85	80	70	65	60	55

Source: Citi Investment Research and Analysis

Credit Outlook

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Corporate valuations across the board improved meaningfully this month, on what we believe were fairly modest positive developments. In the U.S. the CDX.IG and CDX.HY indexes tightened 9 bp and 73 bp, respectively, cash spreads more or less kept pace (HG 16 bp tighter, HY 56 bp tighter), and the S&P 500 rallied 3.7%. It was a similar story in Europe, with cash corporates 11 tighter, the iTraxx index 15 bp better, and the Euro Stoxx up 6.3%. And in the EM space cash corporates improved 30 bp on average so far this month.

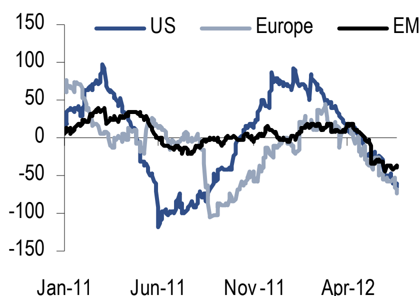
The news flow in Europe was encouraging with talk of banking unions, purchases of sovereign debt by the EFSF, and the relaxation of austerity targets for Greece, and the oversubscribed Spanish 2-yr note auction last week also helped investor sentiment. In addition, some are hopeful that more positive catalysts may come from the upcoming EU summit. That said, we would be very hard pressed to attribute the bulk of spread tightening to more investors being confident that the sovereign crisis is diminishing.

It would be equally difficult to attribute richer valuations to positive changes in the fundamental backdrop. In fact, the Citi Economic Surprise Indexes for the U.S., Europe, and the EM show exactly the opposite. Each of the surprise indexes remains in negative territory, and two of the three continue to trend sharply lower. Only the EM index is showing some signs of stabilizing (see Figure 48).

We would argue that the rally has far more to do with investor positioning than it does with encouraging developments. Basically, everyone seems to have the same trade on…neutrality. The Street obviously has very little appetite for any risk at this stage, our sales team notes that as a rule of thumb their accounts are doing very little, and our own investor survey results show that current investor positioning is hovering as close to neutral as it has ever been (see Figure 49).

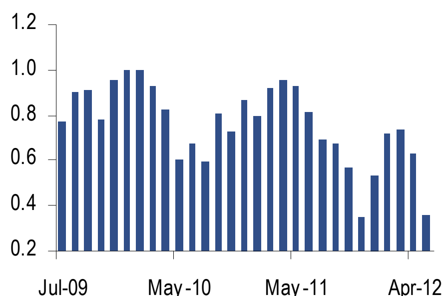
Cautious positioning is not just a credit market phenomenon either. For example, Figure 50 shows that mutual funds in the equity space have aggressively de-risked in recent months as well. The beta (vs. the S&P500) of the typical fund is now at its lowest level since the sell-off last fall. The key point is that with so many market participants unwilling to express a view it really does not take much volume at all in order to cheapen ***or*** richen valuations meaningfully.

Figure 48. Citi Economic Surprise Indexes remain negative territory



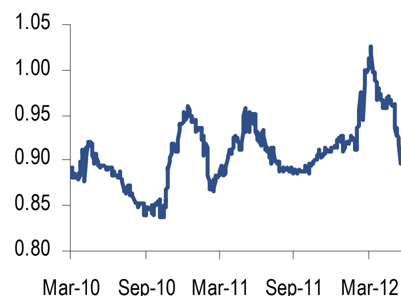
Note: As of June 21, 2012
Sources: CIRA and, Bloomberg

Figure 49. Investor positioning hovering as close to neutral as it has ever been (-2 very short, +2 very long)



Sources: CIRA

Figure 50. Equity mutual funds aggressively de-risked in recent months

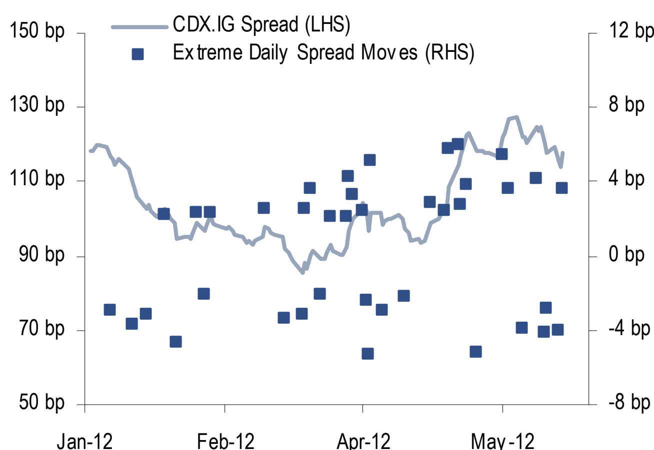


Note: As of June 20, 2012; Beta calculated vs Citi proprietary mutual fund index (an asset weighted index of the top 100 mutual fund NAVs normalized on Jan 1 200
Sources: CIRA and Bloomberg

This factor — investor positioning — plays a key role in our investment outlook. In general, we believe that credit spreads offer value in the context of our base case fundamental outlook. The problem, though, is threefold: (1) base case default expectations are not driving the price action, other risk factors are; (2) everyone is holding the same position, which also translates into high volatility; and (3) we see little chance that this backdrop changes anytime soon, which means that the negative carry associated with staying on the sideline can be quite painful.

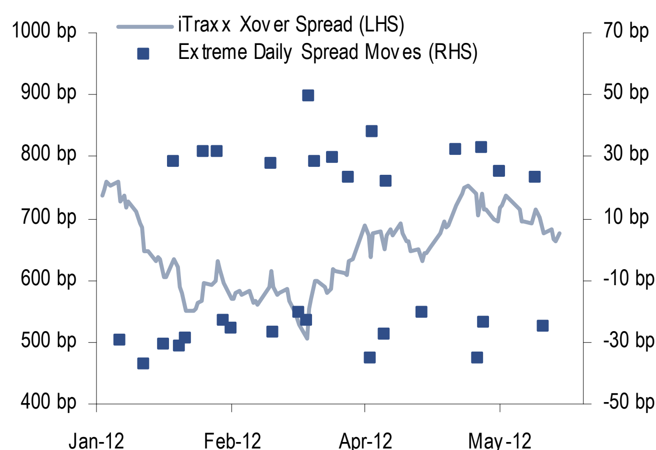
Looking forward, our base case expectation is that spreads will be range-bound (albeit in a big range) in the near-term, but the price action very, very choppy. Said differently, status quo, as this is to a large extent how the market has been trading. In Figure 51 we juxtapose extreme daily spread changes for CDX.IG against its absolute spread level. We see that the index has been trading in a 40 bp range this year, but 34% of all daily spread moves are extreme and extreme moves have been occurring in both directions. In Figure 52 we go through the same exercise for the iTraxx Xover index, and see that 26% of all moves are extreme. Again, big moves occur in both directions.

Figure 51. YTD CDX.IG spread level and extreme daily spread moves



Note: As of June 21, 2012; extreme daily spread moves defined as more than +/-2bp
Source: CIRA, Markit

Figure 52. YTD iTraxx Xover spread level and extreme daily spread moves



Note: As of June 21, 2012; extreme daily spread moves defined as more than +/-20bp
Source: CIRA, Markit

Global Equity Strategy

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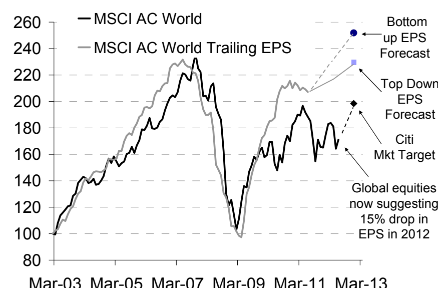
Global equities are up 2% YTD and 5% from the lows reached in early June. Reduced fears of a sudden Greek exit from the Eurozone after the election results and expectations of further policy easing from major central banks seem to have helped the global stock market. Attractive valuations, healthy corporate performance and the belief that world economy is not heading into a double dip mean that we remain constructive. For end-2012, we target 360 on the MSCI ACWI benchmark, implying 18% upside from current levels. The main risk to our outlook is further escalation in the EMU crisis with potential secondary consequences for global growth.

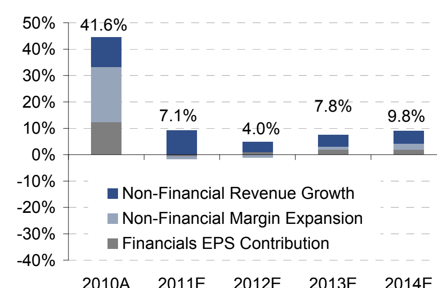
The close lead/lag relationship between global share prices and trailing EPS suggests that the market is pricing in global EPS to contract by 15% in 2012 (see Figure 53). We think this is unlikely to happen and forecast 4% EPS growth this year and 8% in 2013 (see Figure 54). Bottom-up consensus suggests global EPS to grow by 10% in 2012 and 13% in 2013. So we are more cautious than the analyst consensus but not as bearish as the market is suggesting now.

Figure 53. MSCI AC World Price vs EPS (9m Lagged)



Sources: MSCI, Citi Research

Figure 54. Top-down Global EPS Growth Forecasts



Sources: Citi Research, Factset

While we think there is more upside from here until year-end, investors shouldn't be anticipating the gains we had during the 2009 rally. Back then, there was both a re-rating of stock markets and a recovery in global EPS, both from depressed levels. Currently, valuations are low, but global profits are not depressed like they were in 2009. So, our expected gain for the stock market is more likely to be similar to the one we had in 2010-11.

The Eurozone crisis remains the biggest concern and investors are closely watching the policy response. Our economists think the ECB and other central banks have the firepower to act when they see it necessary. Another positive is that there appears to be a lot of bad news already priced in. Global equities look cheap, especially against artificially low core government bond yields. Cheap valuations should limit the downside when pullbacks occur. Global equities are trading at 17x Cyclically Adjusted PE (CAPE) while the long-term average is 24x.

Peaking global margins have been a concern for investors. While Western margins are close to their all time peaks, capex has been lagging and is not competing away these super-normal profits. Companies are returning cash through dividends and buybacks instead of investing in new capacity. While this may be worrying for longer-term profitability and is certainly unhelpful for job creation, it serves to sustain profits and cash flow in the shorter run. As a result, while we admit profit margins remain susceptible to cyclical downturns, we think margins are more sustainable at

these levels than many think. This is another reason why we remain positive on markets.

Our key regional and global sector recommendations are summarised in Figure 56. We are Neutral on Emerging Markets as we no longer expect significant outperformance from EM equities. EM companies have struggled to turn premium GDP growth into premium EPS growth and we don't see this changing soon. We are Neutral on the UK. While it stands out as one of the cheapest markets in the world, the UK is suffering weakening EPS and GDP trends in the short-term. We are Overweight Japan. In the medium term, we believe earnings growth in Japan will remain robust. We are Neutral on Europe ex UK equities. While sovereign concerns will continue to weigh on the region, liquidity provisions by the central bank should help support equity markets. We are Underweight the US. While solid earnings should support US equities, we believe regions offering cheaper valuations will outperform. Joining the US amongst our Underweights is Australia.

Our sector strategy has a slight tilt towards cyclicals. We are Neutral on Financials. Deleveraging and weak demand in Europe is likely to keep a lid on performance. We are Overweight Industrials as we prefer operational leverage to financial leverage. Industrial companies have successfully de-leveraged and aggregate cash balances are at record levels. They also benefit from solid earnings trends. We are Overweight Utilities. The sector has been a serial underperformer, but now seems to be enjoying stabilising earnings momentum along with cheap valuations. Our analysts note that political risks remain in Europe, while the US sector, which is a much larger component of the global benchmark, looks to be an attractive contrarian allocation for investors. The sector has a dividend yield of more than 4.5%. We are Neutral on Consumer Staples. The earnings outlook for Consumer Staples remains sound and is supported by considerable barriers to entry and growing EM exposure. But it stands out as being amongst the most expensive across the world. Still, amongst the consumer sectors we prefer Staples to Discretionary (which includes Autos, Media and Retailers). Consumer Discretionary remains our least favoured cyclical, in part because valuations are high and earnings revisions could be weakening.

Figure 55. Strategists' Forecasts

Region	Index	Current Level (21 Jun 12)	End 2012 Target	Exp Gain (%)
US	S&P 500	1326	1425	8%
Pan Euro	DJ Stoxx600	248	285	15%
UK	FTSE 100	5566	6200	11%
Japan	Topix	754	960	27%
Asia xJpn	MSCI Asia x JP	477	585	23%
Australia	S&P/ASX 200	4088	4750	16%
GEMs	MSCI EM	932	1100	18%
LATAM	MSCI Latam	3473	4300	24%
CEEMEA	MSCI EM EMEA	312	350	12%
Global	**MSCI ACWI**	**306**	**360**	**18%**

Sources: MSCI, Citi Research

Figure 56. Regional And Global Sector Recommendations

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

Source: CIRA

Securitized Products Strategy

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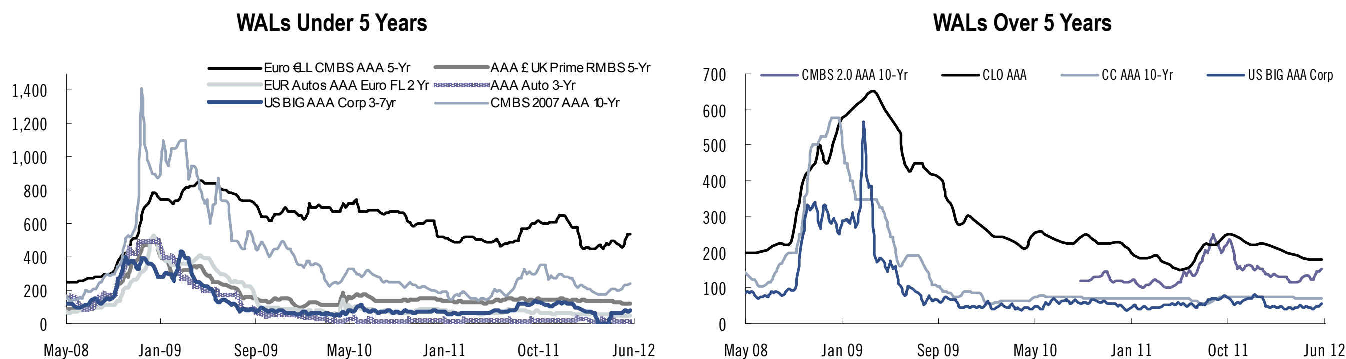
The risky assets' bucket of the credit barbell recommendation we have been advocating these past few months should remain attractive despite elevated macro pressures. Spreads remain attractive and entry point prices offer upside potential to long-term averages. In our view, several factors could thwart a 2011 Redux: 1) still strong corporate profit margins, 2) better-than-expected consumer spending, and 3) falling energy prices. These factors should also bolster economic conditions, which would benefit credit trades. Indeed, the increasingly visible threat of contagion from Europe's financial crisis and cautionary signs from recent economic data are stirring up fears that the first quarter's gains will erode. Yet the market needs patience to wait out what might prove to be temporarily softer data which represent paybacks from the unusually mild winter.

Figure 57. Selected Securitized Products Sectors — Spread Performance, May 08-Jun 12



Source: Citi Investment Research and Analysis

Volatile Environment Reinforces Focus on Short High Quality Product

Still, the market's renewed macro concerns reinforce the focus on short, high-quality securitized products. For example, the US CABS sector has a history of holding up reasonably well in this kind of challenging environment. In Europe, we recommend investors shift to a slightly more defensive strategy in the near-term. Our non-agency strategists are also more cautious.

The market flight-to-quality is rampant, evidenced by the recent strong bid for high quality sovereign bonds — US 10YR yields fell below 1.5% for the first time ever and German 2YR notes are near 0%. But our US economists opine that "core demand among consumers appears to be on a slightly better track than thought, and incoming data do not support the view that a new slowdown has begun in the past month".[14]

The economists reason that corporate profits from current production continue to rise and profit margins are near their 40YR highs. These factors should support moderate job growth, as long as demand does not lose steam. Another factor that could lend support is the decline in oil and gasoline prices — a timely event as the US approaches a more active summer driving season.

[14] See Comments on Credit - Cautionary Tales, Robert DiClemente et al, June 1 2012

Selected Securitized Products Recommendations

- **Auto subs remain top pick.** At swaps + 100–175bp, 3YR single-A and triple-B auto ABS represent a better value to the long-term adjusted means than most other generic sectors. In senior sectors, we like auto lease, dealer floorplan, equipment, and private label credit cards. Off-the-run triple-A sector spreads range from roughly swaps + 20–60bp. Student loans also have some momentum.

- **Euro CMBS market weight.** We recommend cutting the senior European CMBS overweight to market weight. Although we like certain European CMBS stories, we expect funding concerns to pressure the sector in the near term.

- **Non-agency current recommendation.** Since macro uncertainties persist, we remain cautious in the near term. For longer term investors, we believe that non-agencies offer attractive yields relative to other sectors. Recent re-default performance on modified loans in lower credit sectors has been better than anticipated. This improvement does not appear to be reflected in current pricing assumptions.

- **CMBS 2007-vintage duper pickup.** We prefer the 2007-vintage dupers to the earlier-vintage dupers, as the 2007 dupers now pick up 150bp to the 2005-vintage. Macro weakness typically leads to wider 2007-vintage dupers than the earlier-vintage dupers, and this time is no different. But investors must be comfortable with the higher mark-to-market risk that accompanies it.

Sector Relative Value and Allocation Recommendations

Our securitized products strategists have mixed views on the market, ranging from bullish to neutral, and Figure 58 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 58. Sector Relative Value and Asset Allocation Recommendations — Selected Sectors, June 2012

Sector	Strategist Recommendation	Spreads Relative to Long-Term Averages	Comments
CABS	0	Fair	Remain market weighted. Subordinate auto ABS is our top pick. We also like senior auto lease ABS.
CMBS	0	Fair	2007 dupers now pick up 150bp to those from 2005. While we continue to recommend this spread pickup, investors must be comfortable with the higher mark-to-market risk that accompanies it.
Agency MBS	0	Fair	Demand should slow in upcoming months. Weak economic data and sovereign concerns in Europe elevate the probability of QE.
European Securitized Products	0	Cheap to Fair	We prefer a defensive bias in our barbell strategy with stable, short sectors, combined with select off-the-run opportunities. We prefer core country yield opportunities in UK BTL and UN NCRMBS. We downgrade to a market weight in European CMBS on funding concerns.

Source: Citi Investment Research and Analysis

Commodity Outlook and Forecast

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Citi maintains a neutral to slightly bearish short-term outlook across all major commodity sectors heading into the summer season. To be sure, after a precipitous 10% decline this past May, in an even harsher repeat of their negative performance during May 2011 and May 2010, commodity prices had somewhat stabilized this month. Markets, particularly for precious metals, have been somewhat disappointed by the Fed's decision to extend Operation Twist instead of a more activist quantitative easing, but scope remains for further easing particularly as economic conditions worsen. The agriculture complex also made gains on weather-related supply concerns that boosted grains and oilseed prices. Further deterioration of crop ratings could remain a bright spot for the sector this summer but it is unlikely cereal and wheat prices will reach 2011 highs as planted acres and ending inventory levels still remain relatively healthy.

Figure 59. Citi Commodities Point Prices and Quarterly Forecast*

			Forecasts												
		Recent Spot	0-3M	6-12M	5Y Cyclical	Q1_2012	Q2_2012E	Q3_2012E	Q4_2012E	2012E	Q1_2013E	Q2_2013E	Q3_2013E	Q4_2013E	2013E
Energy															
NYMEX WTI	USD/bbl	79.8	90.0	80.0	81.0	103.0	95.0	100.0	80.0	95.0	85.0	85.0	85.0	85.0	85.0
ICE Brent	USD/bbl	91.0	105.0	100.0	85.0	118.4	110.0	120.0	105.0	115.0	105.0	95.0	100.0	95.0	99.0
Henry Hub Natural Gas	USD/MMBtu	2.6	2.5	2.7	N/A	2.5	2.4	2.5	2.3	2.4	3.1	3.5	3.8	3.7	3.6
Base Metals															
LME Aluminum	USD/MT	1,862	2,300	2,350	2,500	2,216	2,250	2,300	2,350	2,279	2,350	2,380	2,420	2,400	2,388
LME Copper	USD/MT	7,314	8,550	8,550	7,500	8,314	8,500	8,550	8,600	8,491	8,500	8,360	8,340	8,300	8,375
LME Lead	USD/MT	1,816	2,175	2,275	2,300	2,118	2,100	2,175	2,250	2,161	2,300	2,250	2,250	2,300	2,275
LME Nickel	USD/MT	16,577	19,000	21,525	22,000	19,721	18,500	19,000	20,500	19,430	22,550	22,475	23,000	23,250	22,819
LME Tin	USD/MT	18,680	23,000	24,250	24,500	22,986	22,500	23,000	23,500	22,997	25,000	26,000	26,500	25,000	25,625
LME Zinc	USD/MT	1,801	2,150	2,258	2,300	2,042	2,050	2,150	2,240	2,121	2,275	2,300	2,280	2,350	2,301
Precious Metals															
Gold	USD/T. oz	1,566	1,740	1,790	1,050	1,691	1,680	1,740	1,760	1720.0	1820	1890	1840	1790	1835
Silver	USD/T. oz	26.7	30	29	15	32.7	31.0	29.5	29.0	30.6	28.3	27.5	26.8	26.0	27.1
Platinum	USD/T. oz	1,431	1,725	1,725	1,500	1,604	1,675	1,725	1,725	1682.0	1725.0	1725.0	1725.0	1725.0	1725.0
Palladium	USD/T. oz	606	870	913	600	683	750	870	900	801.0	925.0	925.0	925.0	925.0	925.0
Bulk Commodities															
Hard Coking Coal (benchmark Asia)	USD/MT		225	230	220	235	215	235	245	233	235	235	230	225	231
Thermal Coal Asia (NEWC)	USD/MT	88	90	115	105	116	114	120	125	119	130	135	140	140	136
Iron Ore Spot (TSI)	USD/MT	137	130	135	100	142	160	150	145	149	140	140	135	135	138
Agriculture															
Corn	USd/bu	591	610	600	N/A	641	610	610	600	615	600	610	590	600	600
Wheat	USd/bu	673	640	635	N/A	643	650	640	630	641	640	660	700	700	675
Soybeans	USd/bu	1,443	1,475	1,353	N/A	1,272	1,425	1,400	1,380	1,369	1325	1305	1305	1275	1,303
Rice	USD/cwt	14.47	15	15	N/A	14.31	15.15	15.05	15.10	14.90	15.15	15.20	15.25	15.00	15.15
Cotton	USd/lb	74	80	80	N/A	93	90	90	90	91	N/A	N/A	N/A	N/A	90
Sugar	USd/lb	20.2	20	25	N/A	24.5	24.0	24.0	25.0	24.4	N/A	N/A	N/A	N/A	24.0
Coffee	USd/lb	155	175	183	N/A	205	185	185	180	189	N/A	N/A	N/A	N/A	200
Cocoa	USD/MT	2,094	2,275	2,308	N/A	2,308	2,275	2,315	2,300	2,300	N/A	N/A	N/A	N/A	2,400

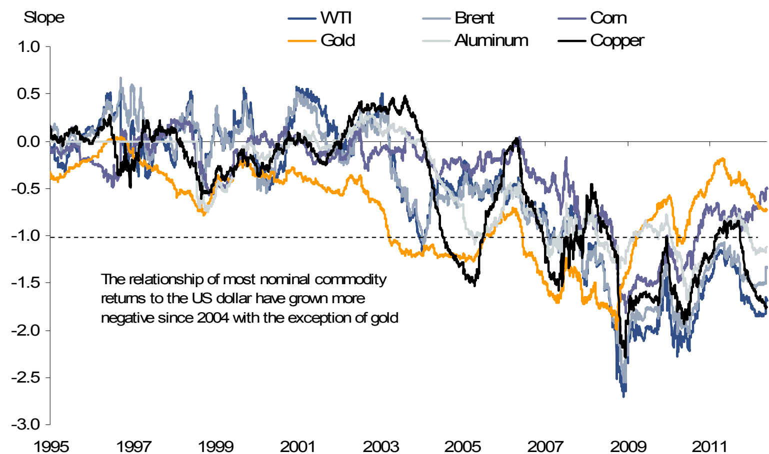
Source: Citi estimates, *subject to revision

Much hinges on overall risk sentiment as macroeconomic conditions continue to darken. Clearly the Eurozone woes take center stage, especially as related to depreciation in the Euro cross and parallel US dollar strength, but also through ripple effects on the global financial system. Citi estimates that the impressive US dollar rally in May explained a large share of the weakness in nominal commodity returns during that month; the negative 'correlationship' prices share with FX moves structurally strengthening since 2004 across a broad basket of underliers diverse as corn, oil and copper[15]. Adverse currency gyrations are perhaps the biggest risk for commodity prices for the balance of 2012. Despite the June rebound in EURUSD,

[15] Ahn, Daniel. "FX Effects" Citigroup: 25 May 2012.

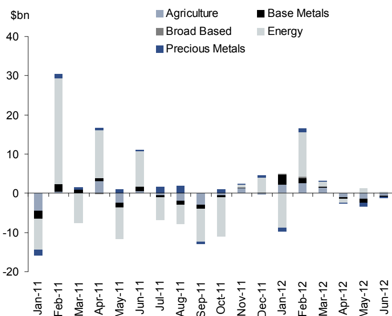
our macro strategy team finds the current bank credit and sovereign funding conundrum unsustainable and in turn expect the currency pair to fall to 1.24 in the third quarter and has set a 6-12 month target at 1.15; near decade lows. Yet an exit of the weaker sovereigns of southern Europe, may lead a euro tied to the "North Europe" core to dramatically leap in strength.

Figure 60. Regression Slopes of Dollar Returns on Nominal Commodity Returns



Source: Citi Investment Research and Analysis

Figure 61. Index and ETF Inflow by Commodity Sector



Source: Citi Investment Research and Analysis

While EMU concerns impact all asset markets, the slowdown in China is particularly daunting for commodities. This is especially true for industrials such as copper and oil given that the world's most important consumer accounts for roughly 40% of global base metals demand and represented nearly half of forecasted oil consumption growth in Citi's base case. But the deterioration in local power grid investment, declining property sales, weak construction activity or the high car and home appliance inventory, signs suggest little likelihood of a bout of industrial metals restocking in the short-term with apparent oil demand nearly flat year-on-year. Over the past month, LME copper stocks have begun to recover on the back of the surge in Chinese refined copper exports. Indeed, Chinese refined exports hit a monthly record high in May, highlighting the oversupplied nature of the local market. But absent the introduction of more consumer targeted Chinese stimulus policies or an FOMC driven LSAP, Citi remains modestly bearish towards the metals complex. Similarly, Citi is maintaining its quarterly oil price outlook but adjusting point prices to $105/bbl in 0-3mths and $100/bbl in 6-12mths for Brent, on a more bearish outlook driven by Eurozone concerns, Chinese slowdown, North American production growth and high OPEC output and ample global inventories.

Risk-off and the negative macro sentiment have already been channeled across commodity investor flows. After $5Bn in aggregate net inflows for commodity-linked ETFs during 1Q'12, April and May witnessed a sharp reversal with net redemptions totaling $2.6Bn. The month of June has seen continued although slower net outflows totaling -$670mn although outflows may again accelerate as safe haven flight sees further liquidation of commodity positions. This has mirrored the short-term trend in the much larger commodity index market which has seen assets under management scale back significantly from a peak of $280bn in March to $224bn as of June 12, 2012. Macro headwinds and US dollar strength are likely to continue keeping commodity financial flows and sentiment choppy in the short-term.

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.

- USD strength continues to be our central forecast, reflecting US cyclical outperformance as well as periodic bouts of risk aversion
- EUR should be weak across the board as further ECB rate cuts and LTROs, as well as rising risk premia, undermine the single currency
- A downshift in growth in China is the other big influence, generating weakness in the likes of AUD and EM Asia
- In Europe, renewed BoE easing is a negative for GBP relative to USD. The EUR/CHF peg should hold so long as inflation in Switzerland is contained. SEK and NOK are likely to continue to do relatively well , at least vs. EUR, given strong fiscal and external balances
- Within EM, growth weakness in Asia relative to expectations is marked, probably on the back of weakness in China. Asian FX may now underperform better LATAM currencies

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 62. Citi Foreign Exchange Forecast

		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	1.25	1.25	1.26	1.24	1.15	1.30	-0.9%	-8.4%
Japanese yen	USDJPY	80	80	80	80	82	84	0.0%	3.0%
British Pound	GBPUSD	1.56	1.55	1.55	1.55	1.46	1.65	-0.3%	-6.3%
Swiss Franc	USDCHF	0.96	0.96	0.95	0.97	1.04	0.92	0.9%	9.7%
Australian Dollar	AUDUSD	1.00	0.99	0.97	1.00	0.96	0.90	0.7%	-1.4%
New Zealand Dollar	NZDUSD	0.79	0.78	0.77	0.80	0.73	0.63	1.6%	-5.1%
Canadian Dollar	USDCAD	1.03	1.03	1.04	1.03	1.00	0.97	0.1%	-3.4%
Dollar Index*	DXY	82.53	82.49	82.30	83.06	87.82	79.86	0.7%	6.7%
G10 Crosses									
Japanese yen	EURJPY	100	100	100	99	94	109	-0.9%	-5.7%
Swiss Franc	EURCHF	1.20	1.20	1.19	1.20	1.20	1.20	0.0%	0.5%
British Pound	EURGBP	0.80	0.80	0.81	0.80	0.79	0.79	-0.6%	-2.3%
Swedish Krona	EURSEK	8.81	8.85	8.94	9.00	8.65	8.50	1.7%	-3.3%
Norwegian Krone	EURNOK	7.49	7.52	7.63	7.50	7.45	7.35	-0.3%	-2.3%
Norwegian Krone	NOKSEK	1.18	1.18	1.17	1.20	1.16	1.16	2.0%	-1.0%
Australian Dollar	AUDNZD	1.27	1.27	1.27	1.26	1.32	1.43	-0.9%	3.9%
Australian Dollar	AUDJPY	80	79	78	80	79	76	0.7%	1.6%
Asia									
Chinese Renminbi	USDCNY	6.36	6.37	6.42	6.33	6.35	6.15	-0.6%	-1.1%
Hong Kong Dollar	USDHKD	7.76	7.76	7.75	7.75	7.76	7.75	-0.1%	0.1%
Indonesian Rupiah	USDIDR	9514	9756	10216	9400	9650	9650	-3.6%	-5.5%
Indian Rupee	USDINR	56.7	57.9	60.2	54.0	55.5	52.3	-6.8%	-7.8%
Korean Won	USDKRW	1162	1170	1181	1140	1165	1080	-2.6%	-1.4%
Malaysian Ringgit	USDMYR	3.19	3.21	3.24	3.10	3.14	2.95	-3.5%	-3.1%
Philippine Peso	USDPHP	42.7	42.9	43.4	42.1	42.5	40.8	-1.9%	-2.1%
Singapore Dollar	USDSGD	1.28	1.28	1.28	1.25	1.28	1.21	-2.5%	-0.3%
Thai Baht	USDTHB	31.9	32.1	32.5	30.7	31.9	30.0	-4.2%	-1.8%
Taiwan Dollar	USDTWD	30.0	29.9	29.6	30.3	28.8	28.5	1.3%	-2.8%
EMEA									
Czech Koruna	EURCZK	25.8	25.8	25.8	25.9	26.3	24.7	0.4%	1.6%
Hungarian Forint	EURHUF	288	292	301	275	290	290	-5.7%	-3.7%
Polish Zloty	EURPLN	4.26	4.32	4.44	4.21	4.55	3.90	-2.4%	2.4%
Israeli Shekel	USDILS	3.92	3.93	3.96	3.95	4.00	4.00	0.5%	1.1%
Russian Ruble	USDRUB	33.2	33.7	35.3	33.4	35.6	33.0	-1.0%	0.9%
Russian Ruble Basket		36.9	37.6	39.3	37.0	38.0	37.5	-1.5%	-3.4%
Turkish Lira	USDTRY	1.82	1.86	1.95	1.78	1.88	1.85	-4.2%	-3.8%
South African Rand	USDZAR	8.45	8.56	8.87	8.40	8.85	8.85	-1.9%	-0.3%
LATAM									
Brazilian Real	USDBRL	2.07	2.10	2.18	2.01	1.95	1.85	-4.4%	-10.4%
Chilean Peso	USDCLP	503	510	523	493	508	490	-3.4%	-3.0%
Mexican Peso	USDMXN	13.9	14.0	14.3	13.4	13.7	12.2	-4.1%	-4.3%
Colombian Peso	USDCOP	1791	1819	1870	1763	1820	1800	-3.1%	-2.6%

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

Source: Citi Investment Research and Analysis

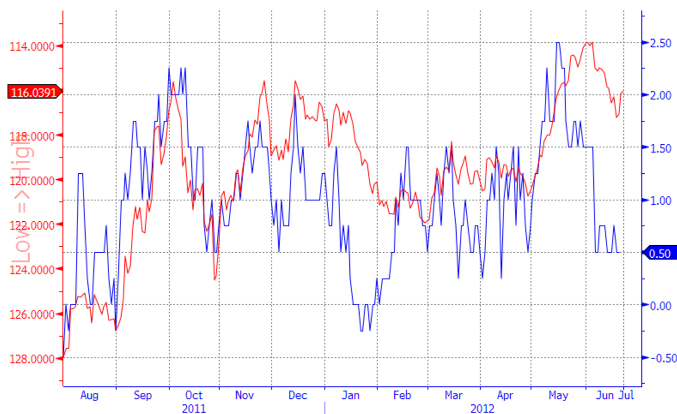
Overview

Trend USD appreciation since early February took a breather in June. A modest improvement in risk appetite has played a part with Citi's GRAMI risk aversion metric falling back from a peak of 1.2 (standard deviations of risk aversion above the LT mean) early in June to 0.8 now. The bank bailout for Spain, favourable Greek Elections, extension of Operation Twist by the Fed, rate cuts in China, promise of further ease by the BoE and expectation of the same by the ECB have all played a part. In addition, positioning in FX had become very short in risk currencies like AUD, and also EUR, and very long USD. This too set up the market for a correction, as long positioning has begun to unwind, and this could extend a bit short term (Figure 63).

More medium term, though, we remain USD bulls. We think the USD rally this year has been about more than simply risk aversion, reflecting likely US cyclical outperformance too. This reflects the likely resilience of US growth relative to elsewhere and the outperformance of both US productivity and equity markets compared with the ROW. Higher bond yields relative to other G10 countries will also likely support USD (Figure 64). The major risks to this view near term are mainly bound up in position unwinds. Medium term, the risk is the so called "fiscal cliff" and US policy paralysis after November's Presidential Elections, but Citi economists currently expect this to be contained.

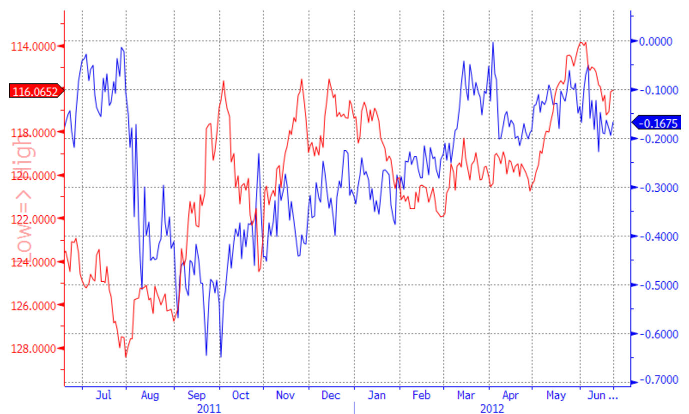
All in all, Citi forecasts anticipate further USD gains medium term, especially relative to G10 majors with EUR/USD falling through 1.20 and AUD towards 95c. Within G10, the EUR is expected to be notably weak, falling on all major crosses as further ECB rate cuts, LTROs and the ongoing rise in risk premia undermine the single currency.

Figure 63. USD vs. G10 Currencies, Even Weights (Red) vs. Citi Positioning Indicator for USD (ex EM) (Blue)



Source: Citi and Bloomberg

Figure 64. USD (Red) vs. US Bond Yields Less Other G10 Bond Yields (Blue)



Source: Citi and Bloomberg

G10 Exchange Rates

EUR/USD – Downward Pressures Remain

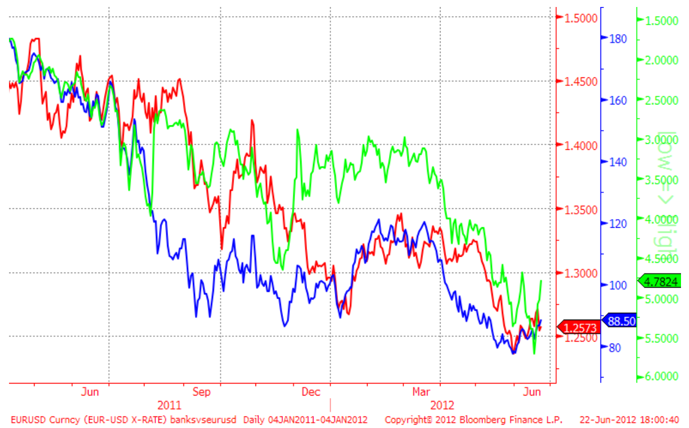
EUR/USD broke downwards through 1.25 in the latter part of May, the lowest levels seen since mid 2010, before bouncing as global risk appetite edged higher.

The general pattern seems to remain EUR lower. Weekly charts still exhibit lower highs and lows while daily price action suggests the rally may run out of steam around 1.30 (Figure 65). Meanwhile, underlying asset markets within EMU continue to struggle, notably EMU bank stocks and key periphery bond yield spreads (Figure 66), while Citi economists still put a 50-75% probability on an exit from EMU by Greece in the next 12-18 months. With huge scope for disruption and wider contagion, we find it hard to believe that the EUR will trade stronger given this background.

Figure 65. EUR/USD Technicals Suggest More Downside

Source: Bloomberg

Figure 66. EUR/USD (Red) vs. EA Bank Stocks (Blue) and Spain-Germany 10y Bond Spread (Green)

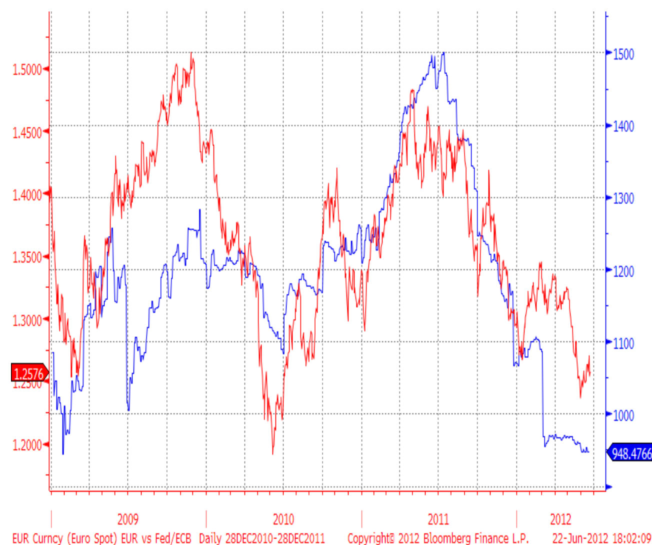


Source: Bloomberg

Furthermore, relative monetary policies remain a key driver. Fed action to extend Operation Twist is helpful for EUR but likely to be short lived support as our economists also expect ECB rate cuts and further multi-year LTROs to be forthcoming imminently. Figure 67 shows that relative Central Bank balance sheet size seem also to stack up against the EUR. Ongoing fiscal austerity within the EMU only adds to the burden for monetary policy to provide some kind of support to growth, especially as bond yields/ risk premia in the periphery widen.

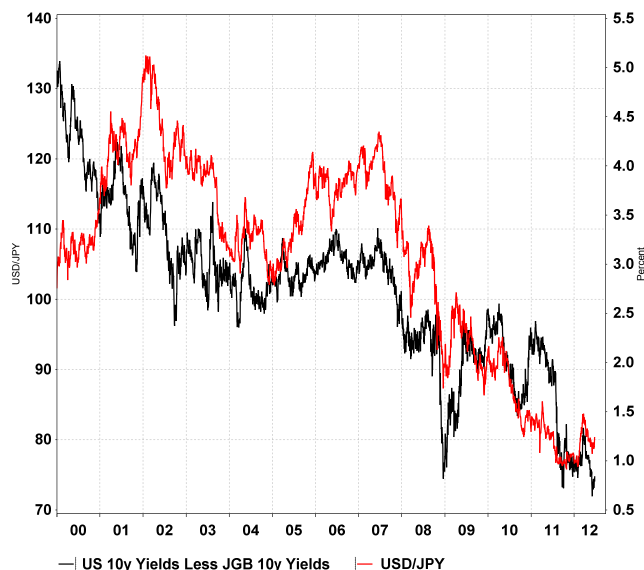
Our forecasts show EUR/USD consolidating in a 1.20-1.30 band for the next few months before trending through the lower level of this band over 6-12 months with a 1.10-1.20 trading range then possible.

Figure 67. EUR/USD (Red) vs. Relative Balance Sheet of Fed/ECB (Blue)



Source: Bloomberg

Figure 68. USD/JPY vs. 10y Bond Yield Differentials



Source: Bloomberg, Citi Investment Research and Analysis

USD/JPY – Sideways

Since late 2010, USD/JPY has mainly traded sideways in a 75-85 range and is roughly in the middle of this band at present. In periods of risk-off, both the USD and JPY tend to be beneficiaries, though the exchange rate does tend to move moderately lower. However, for now at least, 75-76 seems to be the line in the sand for MoF/BoJ intervention to buy USD, so the bottom part of the range may be expected to hold for the short to medium term absent a serious deterioration in global economies and risk appetite.

In periods of risk-on, the concurrent tendency for US bond yields to rise more than JGB yields tends to be USD supportive (Figure 68). If the recent fall in the Citi GRAMI suggests a short term period of risk-on, USD/JPY may have some limited upside and this is reflected in our forecasts of USD/JPY at 80 over 0-3m and at 82 over 6-12m but clearly the broader range is expected to remain intact.

One of the factors that, over time, has supported JPY strength is the stance of the BoJ. Typically, the BoJ is much less aggressive with monetary easing than the Fed has been. This may be changing slightly at the edges with the BoJ finally adopting an inflation target but significant additional QE, for example, still seems lacking. The recent political breakthrough on the sales tax has seen the DPJ and opposition parties agree an increase to 8% in April 2014 and 10% in October 2015 but conditional on economic growth being 3% nominal and 2% real. This is slightly JPY bullish not only because it implies fiscal sustainability medium term but because it suggests that pro-cyclical fiscal tightening will be avoided short term and thus less need for significant additional BoJ ease. Nonetheless, two new doves join the BoJ Board at the 11-12 July MPC so some easing is possible and this may yet be combined with intervention if USD/JPY were to slip to the lower end of the trading range.

Dollar Bloc – CAD Outperforms Longer Term

Our forecasts for the $-bloc currencies show them moving mostly sideways in the near term. In the longer term we see greater differentiation, with CAD the

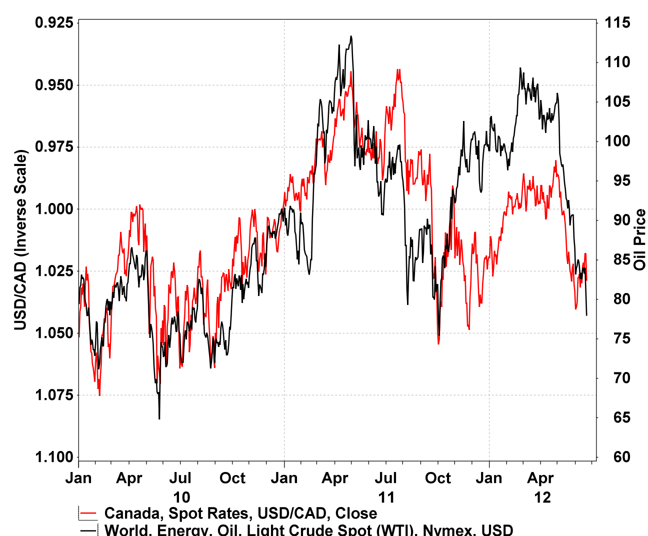
outperformer due to more compelling valuations and less exposure to a weakening growth profile in China. Plus, we think all these currencies could weaken somewhat and CAD is always low beta. One common feature in our outlook for all of the $-bloc currencies is new highs vs. the EUR within a 6-12 months timeframe.

Since our last forecast round, AUD/USD has bounced with risk appetite. Our cautious view on risk assets going forward suggests that AUD will give back some of the recent gains.

Figure 69. AUD/USD (inverted) vs. CNY spot (Red) and 12m NDFs (Black)

Source: Bloomberg, Citi Investment Research and Analysis

Figure 70. USD/CAD (Inverted) vs. Oil Prices



Source: Bloomberg, Citi Investment Research and Analysis

Domestic monetary policy is unlikely to provide a boost to the currency with the RBA forecast to cut rates again this year, although the RBA has a high hurdle to meet with about 90bp of cuts currently priced into the rates market over the next six months.

Historically, there also tends to be a close relationship between AUD and CNY NDFs (Figure 69). As discussed below, our forecasts show USD/CNY moving in a largely sideways fashion in the next year. On this basis alone, AUD/USD should also move sideways in the short run. However, we see greater (downside) risks to AUD than (upside) risks to USD/CNY NDFs, as weaker Chinese demand for commodities is more of a negative for the high-beta commodity currencies.

In the medium to longer term, we still forecast a weaker AUD. In beta-adjusted terms, AUD has continued to outperform its $-bloc peers, let alone other major currencies, going back to the start of QE2. AUD/USD remains rich to most of our short-term indicators and long-term “fair value” is closer to 0.90, according to the latest estimate from Citi’s WERM model.

The dynamics of NZD are unlikely to deviate much from AUD. First, both currencies tend to be relative beneficiaries of better global risk appetite but also underperform during risk-off episodes. Second, while the RBNZ may be at the bottom of the rates cycle, it’s doubtful that New Zealand’s central bank would tighten policy in the current global environment and the market is pricing in less than one full 25bp rate cut. Finally, NZD is also significantly overvalued relative to our long-term fair value estimates, hence the valuation pull is towards a weaker currency, just like AUD.

Our forecasts have AUD/NZD falling a bit further, to 1.26 in 0-3 months, before rebounding back to the top of the recent range (1.32) in 6-12 months. Together with our forecasts of AUD/USD, these numbers imply NZD/USD goes to 80c and 73c in the short and medium term, respectively.

CAD has been underperforming its $-bloc counterparts (beta adjusted). We doubt that this continues. The BoC remains one of the most hawkish G10 central banks, with investment spending still strong and ongoing worries about low interest rates contributing to a build-up of excessive debt in the household sector. Citi economists forecast a rate hike in early 2013, which is not currently priced by the market. On top of this, CAD remains cheap to WERM fair value at USD/CAD 0.95. There are some key risks to the Canadian growth outlook, e.g. a weaker commodity cycle and US fiscal tightening at the start of 2013. A further sharp drop in oil prices would probably be a negative for the currency as well (Figure 70). But the trend is towards tighter Canadian monetary policy relative to the US, and this should underpin appreciation in CAD vs. USD in the medium to longer term.

European Crosses

GBP – Renewed BoE Easing is a GBP Negative

After the strong Sterling rally in recent months, which caused GBP to break out of its range versus a 50:50 basket of EUR and USD, the pound lost ground against both the euro and the greenback since our last *Forecasts* (Figure 71). The market pricing renewed BoE stimulus is the main driver here.

In a recent speech, BoE Governor King abruptly shifted the Central Bank's stance on the economy and the policy outlook. He acknowledged that the economy has underperformed and is likely to stay weak, especially given the ongoing drag from the EMU crisis, and furthermore clearly set the stage for further QE. Moreover, the latest MPC minutes also signalled a shift in the policy stance, with four out of nine members voting for a QE extension.

Data continues to disappoint, with Citi's UK ESI trending into greater negative territory, currently hovering at nine month lows (Figure 72). Citi economists now expect a GDP contraction of 0.2% in 2012, and given falling inflation trends, think further quantitative easing will be forthcoming in the July MPC meeting, expecting GBP 75bn to be announced to run up until November.

Previous QE expectations had clearly been a weight on GBP, and as a result we have lowered our cable forecasts to 1.55 in 0-3 months and 1.46 in 6-12 months. However, with EUR/USD expected to also decline further in the medium term, EUR/GBP is forecast to be broadly stable at 0.79 in 6-12 months.

Figure 71. GBP vs. Average of USD and EUR (Higher = Stronger GBP)

Source: Reuters EcoWin and Citi

Figure 72. GBP ESI Continues To Trend Lower

Source: Bloomberg and Citi

Scandis – Strongly Tied To Risk-On/ Risk-Off Dynamic

After a short break to the upside, EUR/SEK is trading back within its 8.75-8.95 range established earlier this year. Since our last *Forecasts*, the cross sold-off sharply from a YTD high above 9.15. Stabilising risk appetite and, as we highlighted last month, the then prevailing EUR/SEK overshoot relative to its relationship with VIX (Figure 73), can explain the recent SEK rally.

But data continued to be weak with Citi's ESI now negative and, notably, the latest industrial production print missed expectations for the third time running. Citi economists have revised lower their Swedish GDP growth forecasts, expecting the economy to expand by only 0.4% in 2012 from 4.0% a year earlier. Weaker exports to the depressed EA countries continues to be a major drag. The Riksbank will likely continue to ease policy and Citi expects 50bp of cuts to the repo rate in the remainder of this year. With only around half of that priced into rate markets, this reduction in carry could also weigh on SEK.

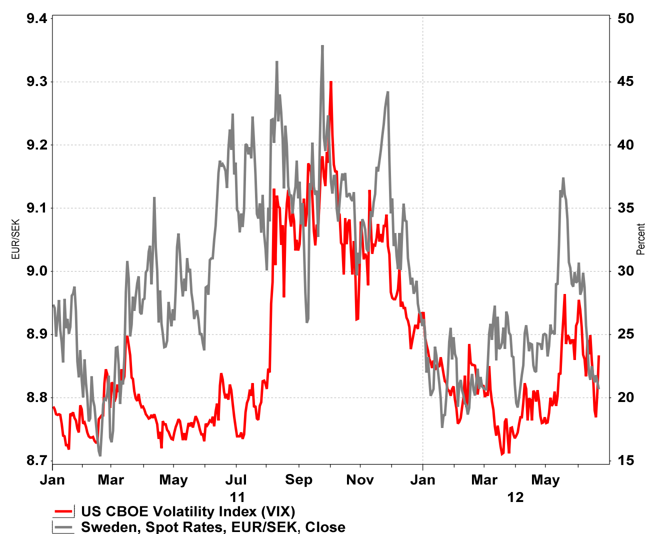
As a result, we think SEK could sell-off slightly in the short term and our forecast puts EUR/SEK at 9.0 in 0-3 months. In the medium term, strong fiscal and external balances will help EUR/SEK to start to move back towards long term fair value (e.g. our recently updated WERM model estimate is 8.49). Our forecasts show 8.65 in 6-12 months and 8.50 further out.

Turning to Norway, EUR/NOK remained above 7.50 for most of the period since the March policy rate cut. Yet given weaker risk appetite and sharply lower oil prices in recent months, it is surprising that NOK did not suffer further losses. Historically, the last time Brent futures traded close to $90/bbl, EUR/NOK was at 8.20, although we have seen divergences in the NOK-oil relationship previously (Figure 74). We forecast EUR/NOK to remain close to current spot and see it trading at 7.50 in 0-3 months.

In terms of growth, Norway is set to markedly outperform most other European economies this and next year, in part due to the stabilizing effect of the petroleum industry. Citi economists thus see the Norges Bank to be on hold until 1Q 2013, when a 25bp hike is expected. Given further ECB rate cuts, this should lend support to the Norwegian Krone. Renewed risk appetite should also help push EUR/NOK

back towards fair value (7.31 on our WERM model). We thus forecast 7.45 in 6-12 months and 7.35 further out.

Figure 73. EUR/SEK vs. VIX



Source: Reuters EcoWin

Figure 74. EUR/NOK and Oil Prices

Source: Reuters EcoWin

CHF – Peg Holds So Long As Inflation Is Contained

The Swiss Franc continues to trade in close proximity to its 1.20 peg vs. the EUR. Similar to the price action surrounding the March SNB meeting, realised EUR/CHF volatility picked up slightly in late May. But following the 14th June policy meeting, realised volatility has once again died down. In fact, the daily trading range of EUR/CHF has gradually drifter lower ever since the peg was introduced, albeit with occasional spikes, and is virtually zero at the current juncture. For now, we doubt this pattern will be disturbed.

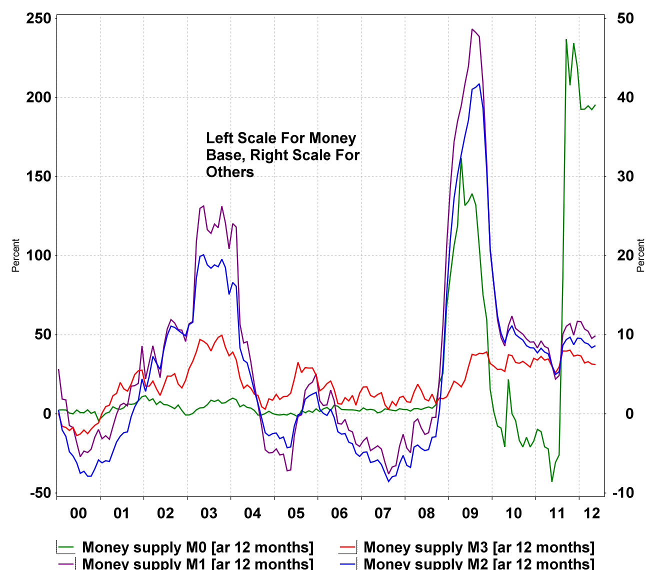
SNB policy is effectively to print as many CHF as it takes to absorb market sales of EUR. While economic activity is weak, and inflation pressures low (Citi economists' expectation) this makes sense and markets are unlikely to question the peg unless all hell lets loose in the EMU crisis. For our short to medium term forecasts, we expect the EUR/CHF peg to hold.

Longer term, though, we are beginning to have our doubts. Currency manipulation, or the subjugation of monetary policy to the exchange rate, rarely works out well, especially if it goes on for too long. The danger is, of course, that rapid local liquidity growth generates asset price, and eventually CPI, inflation. We note from Figure 75that the reserve build up in Switzerland has generated extremely rapid base money growth. Meanwhile, CPI inflation shows signs of bottoming out and house price inflation of picking up (Figure 76).

We no longer expect that an upwards realignment of the peg is likely to be credible and think that, longer term, the downside may again be tested, especially if EMU pressures build.

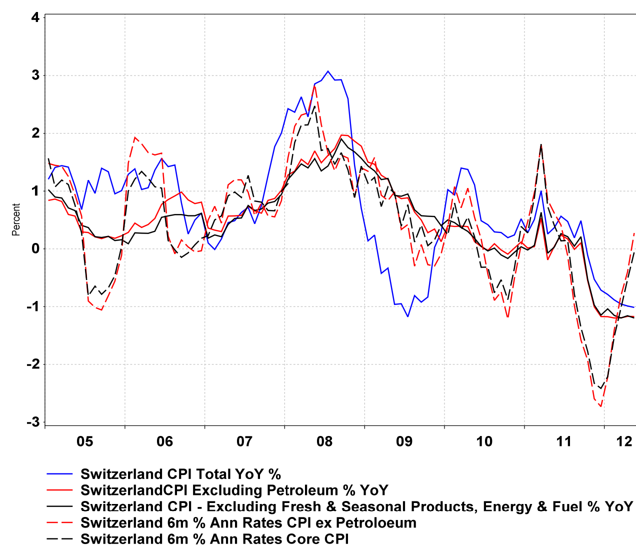
Our point forecasts remain unchanged at 1.20 but our assessment of risks has moved slightly towards believing that long EUR/CHF strategies are increasingly risky beyond the next few months.

Figure 75. Swiss Base Money Growth is Rapid



Source: Citi and Bloomberg

Figure 76. Swiss Inflation Remains Negative



Source: Reuters EcoWin

EM Exchange Rates

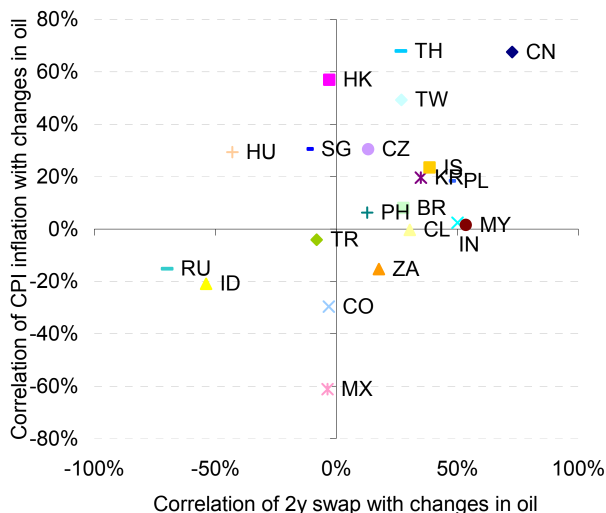
The growth slowdown underway in EM economies, and likely sharp falls in inflation pressures for many from sharply lower oil prices (Figure 77) provide a weaker backdrop for many EM currencies compared to recent years. Together, these factors may lead several EMs to “manage” their exchange rates lower as part of broader monetary easing programs. Capital flight is an added vulnerability in many, with foreign bond and equity ownership sharply higher than it was before various quantitative easing programs began.

This must be balanced, however, against very stretched US dollar longs that skew the balance of risks towards prospective EM FX strength in the very near term.

Also key is how much bad news is already priced in. So, for instance, across most of Latam and CEEMEA, 3m implied vols are generally high and above 12m realised vols (Figure 78). This is not the case in Asia, however – which in turn can be viewed either as a sign of complacency, or the relative safety of Asian FX.

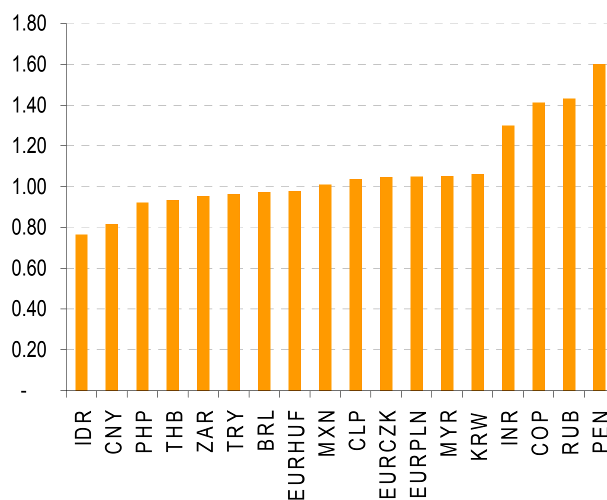
But with CEEMEA still in the eye of the EMU storm, we continue to see it as the underperformer vs. the US dollar amongst the three EM regions considered. Weakness is particularly pronounced over the medium term, with EUR/USD forecast to go down to 1.15. On average, Asian FX is forecast to be modestly higher vs. the USD in the near term, lifted by expected sharp reversals in key crosses like USD/INR, but flat further out. Latam, which already has significant downside priced, is expected to fare best.

Figure 77. EM Oil Sensitivity



Source: Citi and Bloomberg

Figure 78. Ratio of 3m Implied Volatility to 12 Month Realise



Source: Citi and Bloomberg

EM Asia – Stimulus Needed

Heavy management in EM Asian FX (ex INR) has tended to mean that currencies are lower beta to global forces than either CEEMEA or Latam. Current account surpluses, and for the most part, good reserve ratios, have reinforced this relative resilience.

Yet Asian economies and exchange rates are both ultra-sensitive to developments in China, where data has weakened perceptibly, and in general, are also the most open/export-reliant economies in EM. The combination of fresh (if modest) monetary easing in China and significant prospective falls in local inflation rates from lower oil prices (Figure 77) creates room for easier monetary conditions.

Indeed, CNY has been trading weaker against the fixing recently, with the spread between the offshore spot and fixing approaching October-November ranges (Figure 79). Part of this has been driven by strong local corporate demand for US dollars. Equally, some FX weakness may also be desirable: with lending and deposit rates already quite low, clear reluctance of the PBoC to reengineer a 2009-10 style credit "boom" and very limited fiscal stimulus so far, a flat to slightly weaker exchange rate may be the sharper way to stimulate China's export-heavy economy. With property investment likely to be a further drag on growth, we certainly see little room for RMB to appreciate against the dollar in the next year. Our forecasts have USD/CNY at 6.33 over the next three months, and 6.35 in the medium term.

At the other end of the spectrum is INR, which is forecast to retrace back to the 54-55.5 range over the 12 month forecast horizon. Our projections balance two powerful and conflicting forces. On the one hand, INR is clearly oversold, and policy makers are expected to intervene strongly as the INR weakens further. To some extent, there is also room for INR to play "catch up" with equity gains and falls in oil prices – the latter should also help India's current account position. But on the other hand, the macro setting in India is particularly poor – with combination of high interest rates, intensifying economic stagflation, sizeable twin deficits and prospective ratings downgrades providing an unhelpful backdrop for INR strength.

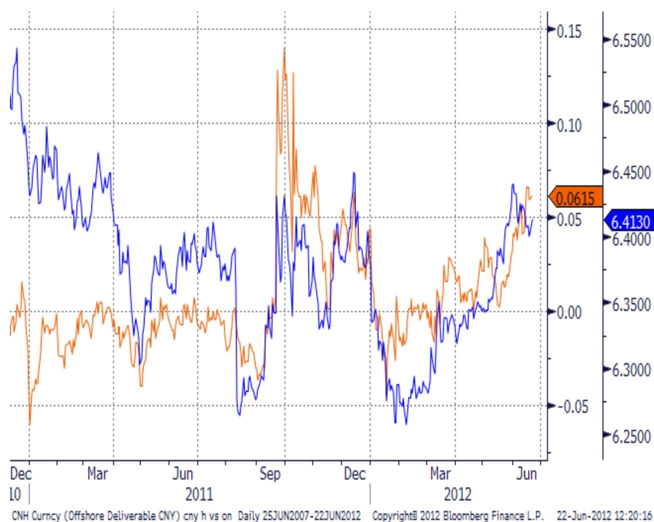
With no historical support or resistance at current levels, INR could be strained further in the very near term.

The next worst performer in Asia so far this year – IDR – continues to trade poorly, but unlike INR is expected to stay relatively weak. We forecast IDR to be around the middle of its June trading range in the next three months, at around 9400. The current account deficit is deteriorating and we expect it to grow increasingly reliant on volatile portfolio flows this year. Unlike India, IDR has the most heavily foreign owned bond market in Asia, at 30% of the total, nearly double the ratio just before the 2008 crisis. As such, we forecast IDR to stay weak over the medium term too, at 9650.

Central banks in China-led Asia, and Korea particular, turned more dovish after the surprise Chinese rate cut earlier this month. The need for stimulus in Korea is clear, with weak domestic data and much higher external vulnerability than most others in its Asian cohort. For USD/KRW, we forecast modest strengthening to 1140 in 0-3 months followed by weakness to around 1165 in the medium term. Our short term forecast is driven by the historically strong (inverse) relationship with swap rates (Figure 80), and by technical patterns, where recent KRW price action points to USD/KRW finding a base at around 1140. Further out, we expect growth/China concerns to weaken KRW.

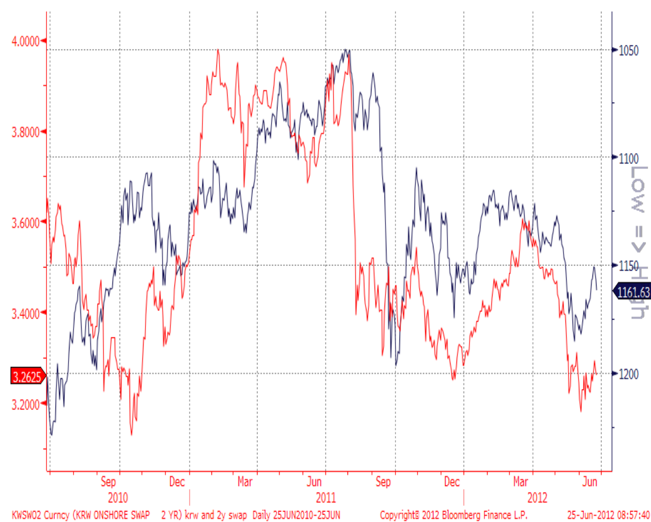
USD/THB has been trending steadily higher since March, and, after some consolidation in the first half of June, looks to be resuming its uptrend. We doubt that this persists in the very near term, as THB looks stretched to us, relative to both equities and swaps. Further out, a dovish central bank, deeply export reliant economy and current account deficit that is unusual in Asia (ex-India) should see USD/THB test recent highs of 31.9, which is also our 6-12 month forecast.

Figure 79. CNH-Fixings Spread (Orange) and USD/CNY 12M NDFs (Blue)



Source: Citi and Bloomberg

Figure 80. USD/KRW (Blue, Inverted) and 2y Korean Swap



Source: Citi and Bloomberg

MYR is also forecast to strengthen in the very near term: the sell off since May looks extreme, with MYR the second worst performing Asian currency after INR against the US dollar. This underperformance can be explained to a large extent by the performance of oil. But even on this basis the sell-off looks overdone, and we forecast USD/MYR at 3.10 in the next three months and 3.14 in the medium term.

Risks around this forecast include: fresh weakness in commodities and heavy foreign ownership of local bonds.

By contrast, PHP and TWD are forecast to stay weak. PHP has been a notable outperformer this year – the best in EM Asia vs. the US dollar. So far, the central bank has been tolerant of PHP strength, but we suspect they might step up the intervention at the current level to push USD/PHP higher. Our forecasts have USD/PHP at 42.1-42.5 over the forecast period, with risks to the upside if the central bank steps up intervention.

TWD, meanwhile, continues to lag moves in other Asian FX – despite being the most export focussed Asian economy and with the deepest sensitivity to China. Our forecasts have USD/TWD at 30.3 in the next three months making it the worst performing Asian cross by some distance.

Finally, external headwinds and stubbornly elevated inflation suggest the SGD NEER will likely creep up along the midpoint of the trading band going forward – a revision from our previous forecast path for a gradual climb to the strong side of the band. We forecast USD/SGD broadly neutral at 1.25-1.26 in 0-3 months and at 1.28 in 6-12 months out.

CEEMEA – EMU Crisis Remains Central

Our CEEMEA forecasts this month are guided by reasonably-priced Euro-area risks and better domestic news flow from some (notably Hungary) in the near term, and our 1.15 EUR/USD forecast and deepening global macro risks over the medium term. To be sure, CEEMEA FX tends to be high beta to global forces more generally, and particularly sensitive to developments in the Euro Area. But, as shown in Figure 78, CEEMEA FX has significant premia built into implied vols already.

Hungary’s forint is forecast to be the best performer in CEEMEA by a wide margin in the next three months, at 275 vs. EUR. The reason: our belief that the new central bank bill will satisfy both the IMF’s and ECB’s demands, allowing the release of badly needed funds to the government. This rather idiosyncratic development is important for HUF, a currency that has suffered in the last 12 months (-20% vs. USD), and should provide short term support even in a less risk friendly setting. Medium term, Hungary’s poor fundamentals – and sharp deterioration forecast in both growth and the fiscal balance – reassert themselves, bringing HUF back into the 290-295 range.

Some HUF strength might normally be expected to knock on to CZK – moves between the two crosses have recently tended to be highly correlated with each other, at around 60-70%. But this correlation seems to be breaking down, as the Czech central bank is poised to cut rates even closer to zero while Hungarian rates stay high. And with CZK likely to become a favoured funding currency again, and with the economy already in technical recession, we forecast relative weakness over the next twelve months. EUR/CZK is expected at 25.9 in the next three months, in line with forwards, and then back up to the November highs in the medium term.

The Israeli shekel is also expected to be weaker over the short and medium term, and our forecasts have USD/ILS at 3.95 in 0-3 months and 4.00 in 6-12 months. The BOI is gearing up for easing, with the market pricing in a full 25bps rate cut at the end-June meeting. Although budget discipline will help create the impression of a solid macro framework, we expect the market will take a rate cut as further evidence of the BOI attempting to push ILS weaker.

PLN, by contrast, is forecast to be stronger in the near term – though by less than HUF – and then sharply weaker in the 6-12 month window. Near term strength is driven by a number of factors, including the prospects for heavy FX intervention, lowered "twin deficits" with the fiscal balance being reined in, and expectation of relative outperformance of the Polish economy. Medium term, however, PLN is very high beta to both risk appetite and EUR/USD, arguably more so than the past given the near doubling of foreign bond ownership from 17% in 2008 to over 31% now. We forecast EUR/PLN at 4.21 in the next three months and 4.55 in the medium term.

The Russian Ruble is also forecast to be slightly stronger in the near term against the basket of EUR and USD, at around 37 in 0-3 months and 38 further out.. In the past we have highlighted how both oil prices and global risk appetite have been major drivers of the RUB. Thus, unless risk aversion rises sharply or Brent crude oil prices sustain the recent trend by moving to below $80/bbl, we would expect the recent weakness in the currency to abate. Furthermore, tight liquidity policy should also help the RUB stabilize. However, as with most other currencies in the region, ongoing EMU troubles further out are likely to put a floor on the RUB basket and particularly USD/RUB.

TRY will likely struggle in the medium term due to poor macro fundamentals such as Turkey's competitiveness gap and weak external balance. The higher-beta nature of the currency also means it is particularly vulnerable to bouts of risk aversion surrounding the EMU crisis. Our forecasts show the cross rallying back towards recent highs, around the 1.85-1.90 region, towards the end of this year and into 2013. In the short run, however, we think the CBT is committed to supporting the currency by keeping liquidity tight as a way to fight high inflation. On balance, this suggests that USD/TRY spot could move a bit lower in the next 0-3m. From a total return perspective, high carry means that TRY is expected to perform well compared to most CEEMEA currencies.

Our forecasts are for ZAR to stay around current spot in the near term. Our 6-12m view is adjusted sharply higher, however. Historical relationships suggest that EUR/USD at 1.15 would push very high beta USD/ZAR to 8.80-8.85 at least, roughly in the middle of its post 2009 crisis range.

Latam – Risky But Bad News Priced

Latam FX combines a fairly combustive mix of: exposure to China/commodity prices, with all four currencies commodity-backed to some degree; direct vulnerability to the European banking crisis, with a third of total credit in, e.g., both Mexico and Chile extended by European banks; and very high beta currencies like MXN and BRL. The question is how much bad news is priced in already.

On balance, we think a lot – particularly on a three month view. For example, 3m (ATM) implied vols. in Latam are elevated not only in the context of other EM, but also relative to their own realised vols over the past twelve months in three of the four crosses analysed (see Figure 78).

BRL is the outlier, with the ratio of implied to historical vol. below unity. But here, strong policy commitment – from both government and the central bank – to bring down USD/BRL is expected to be a powerful force in the near term. The recent part withdrawal of capital controls by the Brazilian authorities was an important step, and, with murmurs of a broader dismantling of IOF taxes *and* increased central bank intervention, is helping USD/BRL to break the steep upward sloping channel in place since the end of February (Figure 84). Other "intervention episodes" (e.g. last September, December) were successful and led USD/BRL to move 2 big figures

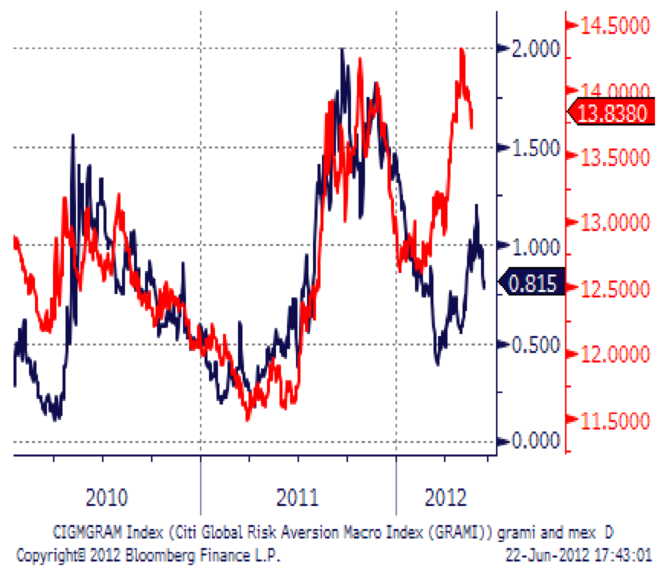
(see boxes in Figure 84). Our forecasts have USD/BRL at 2.01 in the next three months, below 3m forwards.

The Mexican peso tends to be higher beta to global developments than others in its EM cohort. This is explained by a number of factors, including deep foreign exchange markets, high foreign bond ownership (which at 51% is the highest in EM) and generally limited FX intervention. But MXN also looks oversold at current levels (Figure 85), especially given a sound macro backdrop and much better ESI readings than other EM. Our forecasts this month therefore show some recovery against the USD, to 13.4 in the next three months and 13.7 over the medium term.

Figure 81. USD/BRL

Source: Bloomberg

Figure 82. MXN Looks Oversold

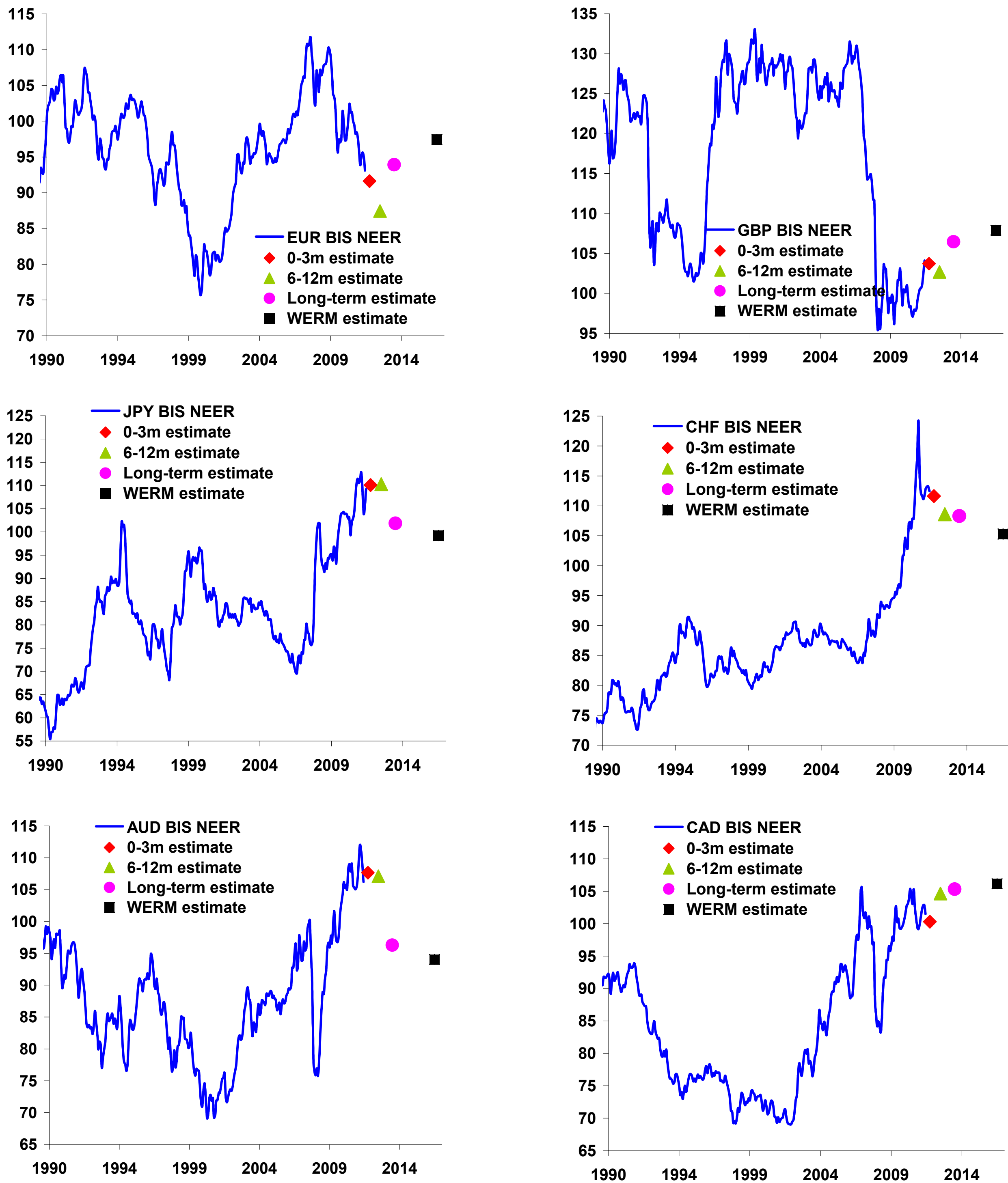


Red – USD/MXN; Blue – GRAMI With 30 day Lead
Sources: Citi and Bloomberg

Recent price action in the Colombian peso has also been choppy. But COP has still been the best performing EM currency by some distance so far this year vs. the USD, chiefly on the back of corporate flows. We now look for some pull-back: USD/COP is quickly nearing the critical 1750 support level, which will be difficult to break without more quantitative easing from the Fed. Furthermore, the Colombian central bank badly wants a weaker exchange rate, and we expect Banrep to double its minimum USD daily purchases to $40mn a day as a next step. Reflecting these forces, our forecasts have USD/COP around current spot in the near term, with COP depreciation in the medium term.

CLP, meanwhile, is expected to fare better than in May. Although we don't expect it to fully retrace back to its recent 480 base, we do expect it to recover to the upper band of its trading range between February and April, to around 493, which is our 0-3 month forecast. Medium term, however, we continue to forecast weakness: the Chilean currency and economy are intimately linked to both copper prices and the weakening Chinese economy. Copper exports alone account for around a fifth of total GDP, and China is the dominant source of global copper demand. We expect USD/CLP at around 508 in 6-12 months' time.

Figure 83. Implied Path – BIS Nominal Exchange Rates



Sources: BIS, Bloomberg and Citi

Figure 84. Citi Quarterly Interpolated Forecasts

Quarterly Interpolated Forecasts

	Currency	Spot	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14
G10-US Dollar											
Euro	EURUSD	1.25	1.25	1.24	1.21	1.18	1.15	1.19	1.23	1.26	1.30
Japanese yen	USDJPY	80	80	80	81	81	82	83	83	84	84
British Pound	GBPUSD	1.56	1.56	1.55	1.52	1.49	1.46	1.51	1.55	1.60	1.65
Swiss Franc	USDCHF	0.96	0.96	0.97	0.99	1.02	1.04	1.01	0.98	0.95	0.92
Australian Dollar	AUDUSD	1.00	1.00	1.00	0.99	0.97	0.96	0.94	0.93	0.91	0.90
New Zealand Dollar	NZDUSD	0.79	0.79	0.79	0.77	0.75	0.73	0.70	0.68	0.65	0.63
Canadian Dollar	USDCAD	1.03	1.03	1.03	1.02	1.01	1.00	0.99	0.98	0.98	0.97
Dollar Index*	DXY	82.53	82.55	83.14	84.69	86.26	87.70	85.54	83.50	81.60	79.85
G10 Crosses											
Japanese yen	EURJPY	100	100	99	97	96	95	98	102	106	109
Swiss Franc	EURCHF	1.20	1.20	1.20	1.20	1.20	1.20	1.20	1.20	1.20	1.20
British Pound	EURGBP	0.80	0.80	0.80	0.80	0.79	0.79	0.79	0.79	0.79	0.79
Swedish Krona	EURSEK	8.81	8.82	8.99	8.88	8.76	8.65	8.61	8.57	8.54	8.50
Norwegian Krone	EURNOK	7.49	7.49	7.50	7.48	7.47	7.45	7.42	7.40	7.37	7.35
Norwegian Krone	NOKSEK	1.18	1.18	1.20	1.19	1.17	1.16	1.16	1.16	1.16	1.16
Australian Dollar	AUDNZD	1.27	1.27	1.26	1.28	1.30	1.32	1.35	1.37	1.40	1.43
Australian Dollar	AUDJPY	80.2	80.2	80.0	79.5	79.1	78.7	77.9	77.1	76.3	75.6
EM Asia											
Chinese Renminbi	USDCNY	6.36	6.36	6.33	6.34	6.34	6.35	6.30	6.25	6.20	6.15
Hong Kong Dollar	USDHKD	7.76	7.76	7.75	7.75	7.76	7.76	7.76	7.75	7.75	7.75
Indonesian Rupiah	USDIDR	9514	9508	9405	9489	9571	9650	9650	9650	9650	9649
Indian Rupee	USDINR	56.7	56.5	54.0	54.5	55.0	55.5	54.6	53.8	53.1	52.3
Korean Won	USDKRW	1162	1160	1140	1149	1157	1164	1142	1121	1100	1080
Malaysian Ringgit	USDMYR	3.19	3.19	3.10	3.11	3.13	3.14	3.09	3.04	2.99	2.95
Philippine Peso	USDPHP	42.7	42.6	42.1	42.2	42.4	42.5	42.0	41.6	41.2	40.8
Singapore Dollar	USDSGD	1.28	1.28	1.25	1.26	1.27	1.27	1.26	1.24	1.23	1.21
Thai Baht	USDTHB	31.9	31.8	30.7	31.1	31.5	31.9	31.4	30.9	30.4	29.9
Taiwan Dollar	USDTWD	30.0	30.0	30.3	29.8	29.3	28.8	28.7	28.6	28.6	28.5
EM Europe											
Czech Koruna	EURCZK	25.76	25.76	25.91	26.02	26.14	26.23	25.84	25.45	25.07	24.69
Hungarian Forint	EURHUF	288	287	275	280	285	290	290	290	290	290
Polish Zloty	EURPLN	4.26	4.26	4.22	4.33	4.44	4.54	4.38	4.21	4.05	3.90
Israeli Shekel	USDILS	3.92	3.92	3.95	3.97	3.98	4.00	4.00	4.00	4.00	4.00
Russian Ruble	USDRUB	33.2	33.2	33.4	34.2	34.9	35.6	34.9	34.3	33.6	33.0
Russian Ruble Basket	RUB	36.9	36.9	37.0	37.4	37.7	38.0	37.9	37.7	37.6	37.5
Turkish Lira	USDTRY	1.82	1.82	1.78	1.82	1.85	1.88	1.87	1.86	1.86	1.85
South African Rand	USDZAR	8.45	8.44	8.41	8.56	8.71	8.85	8.85	8.85	8.85	8.86
EM Latam											
Brazilian Real	USDBRL	2.07	2.06	2.01	1.99	1.97	1.95	1.92	1.90	1.87	1.85
Chilean Peso	USDCLP	503	503	493	498	503	507	503	498	494	490
Mexican Peso	USDMXN	13.9	13.8	13.4	13.5	13.6	13.7	13.3	12.9	12.6	12.2
Colombian Peso	USDCOP	1791	1789	1764	1783	1802	1820	1815	1810	1805	1801

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

Source: Citi Investment Research and Analysis

Figure 85. Citi Annual Forecasts

Annual Forecasts

	Currency	Spot	2012*	2013*	2014*	2015*	2016*
G10-US Dollar							
Euro	EURUSD	1.25	1.26	1.19	1.30	1.33	1.35
Japanese yen	USDJPY	80	81	82	84	84	84
British Pound	GBPUSD	1.56	1.56	1.50	1.64	1.68	1.71
Swiss Franc	USDCHF	0.96	0.96	1.01	0.93	0.93	0.94
Australian Dollar	AUDUSD	1.00	1.01	0.95	0.90	0.90	0.90
New Zealand Dollar	NZDUSD	0.79	0.79	0.72	0.64	0.64	0.64
Canadian Dollar	USDCAD	1.03	1.02	1.00	0.97	0.96	0.96
Dollar Index**	DXY	82.53	82.28	85.72	80.07	78.62	77.57
G10 Crosses							
Japanese yen	EURJPY	100	102	98	109	112	114
Swiss Franc	EURCHF	1.20	1.20	1.20	1.21	1.24	1.27
British Pound	EURGBP	0.80	0.81	0.79	0.79	0.79	0.79
Swedish Krona	EURSEK	8.81	8.88	8.65	8.51	8.50	8.49
Norwegian Krone	EURNOK	7.49	7.52	7.43	7.35	7.34	7.32
Norwegian Krone	NOKSEK	1.18	1.18	1.16	1.16	1.16	1.16
Australian Dollar	AUDNZD	1.27	1.27	1.33	1.42	1.41	1.40
Australian Dollar	AUDJPY	80.2	81.4	78.2	75.8	75.6	75.7
EM Asia							
Chinese Renminbi	USDCNY	6.36	6.33	6.31	6.16	6.12	6.09
Hong Kong Dollar	USDHKD	7.76	7.76	7.76	7.75	7.75	7.75
Indonesian Rupiah	USDIDR	9514	9387	9630	9640	9593	9543
Indian Rupee	USDINR	56.7	54.0	54.7	52.3	51.4	50.7
Korean Won	USDKRW	1162	1146	1146	1079	1047	1018
Malaysian Ringgit	USDMYR	3.19	3.12	3.10	2.96	2.95	2.96
Philippine Peso	USDPHP	42.7	42.5	42.1	40.8	40.5	40.2
Singapore Dollar	USDSGD	1.28	1.26	1.26	1.21	1.20	1.20
Thai Baht	USDTHB	31.9	31.1	31.4	30.0	29.6	29.3
Taiwan Dollar	USDTWD	30.0	29.9	28.9	28.5	28.4	28.3
EM Europe							
Czech Koruna	EURCZK	25.76	25.62	25.91	24.62	23.71	22.84
Hungarian Forint	EURHUF	288	284	289	289	286	283
Polish Zloty	EURPLN	4.26	4.24	4.39	3.94	3.90	3.90
Israeli Shekel	USDILS	3.92	3.89	4.00	3.96	3.77	3.57
Russian Ruble	USDRUB	33.2	32.5	34.9	33.0	31.9	31.0
Russian Ruble Baske	RUB	36.9	36.3	37.8	37.5	37.3	37.1
Turkish Lira	USDTRY	1.82	1.80	1.87	1.86	1.88	1.91
South African Rand	USDZAR	8.45	8.27	8.81	8.92	9.27	9.64
EM Latam							
Brazilian Real	USDBRL	2.07	1.97	1.93	1.85	1.83	1.81
Chilean Peso	USDCLP	503	495	503	491	490	490
Mexican Peso	USDMXN	13.9	13.4	13.4	12.3	12.5	12.8
Colombian Peso	USDCOP	1791	1781	1811	1811	1857	1907

*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

Contributors

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

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