19 September 2012 │ 56 pages

Global

Global Economic Outlook and Strategy

September 2012

- The outlook is balanced between economic fragilities — with slowing growth in Asia, subpar recovery in the US and widespread recessions plus periphery strains in Europe — coupled with a new wave of central bank stimulus (monetary policy, credit easing and extra liquidity) across all major economic regions. Both sides of this balance (economic fragilities and policy response) appear likely to be greater than the consensus has been expecting.
- We expect that by year-end, the ECB, Sweden, Denmark and a range of major emerging markets will cut rates again, the PBOC will implement two more RRR cuts and the BoE will expand QE again. The Fed's new easing campaign appears likely to persist well into 2013, accompanied by further widespread easing across both developed and emerging markets. But, even with policy action, economic growth in major countries is likely to remain disappointing in 2013. We are leaving our 2012 global growth forecast (at current exchange rates) at 2.5%, while cutting our 2013 forecast to 2.6% from 2.8% last month. Within that, we are making notable cuts to our growth forecasts for China and Japan, plus more modest forecast downgrades to a range of emerging markets, especially in Asia plus Central and Eastern Europe.
- In the euro area, some key tail risks have receded for now. Nevertheless, we still expect that the euro crisis will rumble on, with persistent economic weakness — especially in periphery countries — and recurring episodes of financial strains. We continue to put the probability of Grexit in the next 12-18 months at about 90%. Moreover, the 'ECB-put' — the yield level for Italy and Spain at which ECB buying will be activated — probably is above current levels, given that both countries seem reluctant to move into an EFSF/ESM programme unless forced by markets. In addition, over the longer term, adverse fiscal trends point to risks of a wider series of debt restructuring in EMU, including Portugal and, eventually, perhaps Ireland, Italy and Spain. Citi's economists and strategists continue to expect further sovereign credit ratings downgrades over the next 2-3 quarters in the euro area.

Figure 1. Currency and Interest Rate Forecasts (End of Period, Unless Specified), as of 19 Sep 2012

	19 Sep 2012	4Q 12 Forecast	1Q 13 Forecast	2Q 13 Forecast	3Q 13 Forecast	4Q 13 Forecast	1Q 14 Forecast
United States: Federal Funds	0.25	0.25	0.25	0.25	0.25	0.25	0.25
10-Yr. Treasuries (Period Ave.)	1.83	1.65	1.75	2.00	2.25	2.55	2.75
Euro Area: US$/€	1.31	1.27	1.20	1.15	1.17	1.19	1.21
Euro Repo Rate	0.75	0.50	0.25	0.25	0.25	0.25	0.25
10-Yr. Bunds (Period Ave.)	1.67	1.50	1.55	1.60	1.75	2.00	2.00
Japan: Yen/US$	78	77	77	76	77	78	79
Call Money	0.10	0.10	0.10	0.10	0.10	0.10	0.10
10-Yr. JGB (Period Ave.)	0.80	0.95	1.10	1.20	1.10	1.30	1.30

Source: Citi Research

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With thanks to Jan Maguire

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Figure 2. Forecast Highlights and Changes from Last Month

■ Global	Overall, we are leaving our 2012 global growth forecast (at current exchange rates) at 2.5%, while cutting our 2013 forecast to 2.6% from 2.8% last month, with notable downgrades to our forecasts for China and Japan.
■ United States	The Fed's impatience with subpar job growth has prompted a new easing campaign that appears likely to persist well into next year. But barring a fiscal policy calamity, recovery's micro-foundations suggest a gradual improvement in the growth outlook.
■ Euro Area	With its OMT Programme, the ECB reduced the risk of a near-term break-up of the euro area. However, it is now up to euro area governments to set up support packages in order to benefit from ECB support. We expect the ECB to cut the refi rate further to 0.25% in early 2013 and set a negative deposit rate.
■ China	We keep our growth forecast of 7.9% for 2012, but cut our 2013 growth forecast to 7.6% from 8% previously. We assume the new government will tolerate growth below potential to facilitate rebalancing and contain inflation of goods and asset prices. We no longer expect a rate cut this year.
■ Japan	We expect a technical recession in H2 this year. Significant downside surprises to the July economic data prompted us to expect negative growth in Q3. Moreover, as an economic slowdown in the major trading partners continues longer than generally anticipated, negative growth appears likely to persist into Q4, driven by continued declines in exports.
■ United Kingdom	The economy is likely to show a technical rebound in Q3 but the underlying path remains flat. The MPC remains likely to expand QE further, most likely soon after the current programme expires at end-October.
■ Canada	Downside risks and uncertainties will keep the BoC on hold through early 2013. But strong domestic fundamentals and rising household debt offer a compelling case for higher rates thereafter.
■ Australia	We have trimmed our 2013 GDP forecast given slower growth in Asia and the fall-out for key commodity prices. We do not expect a near-term rate cut, but if the outperformance of the AUD against commodity prices widens further this may force the RBA to cut.
■ Emerging Asia (ex China)	Economic momentum continues to slow, while inflation concerns are largely benign (except India). Central banks have been in 'wait and see' mode since Jackson Hole, but we expect a few more can cut — Korea, at some point India (if it makes more fiscal reform progress), and (to reduce mounting sterilization costs) possibly also the Philippines.
■ CEEMEA	The most visible change to our CEEMEA forecasts this month reflects a weakening of the outlook in central and eastern Europe: Hungary, Poland and Ukraine GDP have all been marked down, partly reflecting weaker external demand and partly due to worse domestic spending indicators.
■ Lat Am	In Latam, there were few major revisions to our growth forecasts, but we did raise our 2012 inflation estimates for Brazil, Mexico and Peru on the back of pressure on food prices. This has not substantially altered our monetary policy calls in the region. We still expect an additional 25bp cut in Brazil, although we have delayed the start of monetary tightening to October 2013. In Mexico, we still see the central bank on hold for the foreseeable future.

Source: Citi Research

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

	Equities	G10 Rates	Credit	Securitized Products	FX	Commodities	Global Macro Strategy
Overall View	To have markets rise materially from here, we need to see re-acceleration in EPS growth / new money flowing into equities	ECB to activate OMT, thus stabilising the front-end of peripheral curves	Diminished tail risk and impressive technicals pushing valuations higher	Short, high-quality sectors optimise defensive positioning. Off-the-run sectors offer upside	USD weaker short term	Bearish most industrial commodities although see some short-term seasonal strength in crude and agriculture	Continued easy money balances negative macro
Most-Favoured Region/Sector	Japan, Asia Pac ex Japan, Australia / IT, Energy, Health Care	Front end of the EUR curve	Select Financials; Periphery; Triple-Cs	US CMBS senior tranches	EUR, CAD	Precious Metals, Grains and Oilseeds (due to weather risks)	Gold, Risk Assets
Least-Favoured Region/Sector	Europe ex UK/ Cons. Disc, Industrials, Utilities	EUR 5y	Singles names that have run too far, too fast	Spanish and Irish RMBS	USD, AUD	Copper, Zinc, Coffee	Core FI, China-sensitive risk assets
Key Risks	Deeper downturn in Continental Europe earnings, profits begin to collapse in the US	Negative surprise on peripheral growth and failure to comply with fiscal targets	Sovereign crisis; bank runs; global slowdown	Regulation	Central banks stop easing. Risk rally loses steam	EMU contagion, oil shock double-dip, risk-off financial outflows, China hard landing, QE3	EMU breakup, China slowdown, US fiscal cliff

Source: Citi Research

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Overview — Central Banks to the Rescue, Again

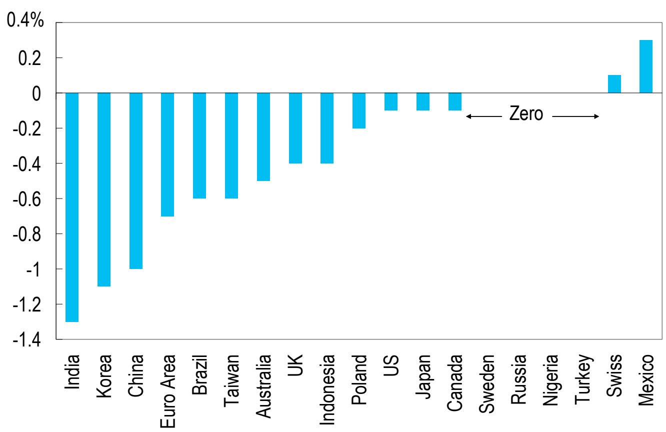
The outlook is a mix of disappointing growth with widespread — and generally quite aggressive — policy support

The outlook is balanced between economic fragilities — with slowing growth in Asia, subpar recovery in the US and widespread recessions plus periphery strains in Europe — coupled with a new wave of central bank stimulus (monetary policy, credit easing and extra liquidity) across all major economic regions. Both sides of this balance (economic fragilities and policy response) appear likely to be greater than the consensus has been expecting. China's stimulus includes some fiscal measures but in general the emphasis is more on monetary and credit stimulus. Indeed, fiscal policy will generally be restrictive in advanced economies. Moreover, both the US Fed and ECB have deliberately chosen to set no public limit on their actions: they will do "whatever it takes". Easing is likely to be only moderately successful: the more extreme downside risks are likely to fade, but economic growth in major countries is likely to remain disappointing in 2013 — hence producing an extended bias to ultra-low rates and unconventional stimulus.

We are cutting our forecasts for 2013, especially in China, Japan and various Asian emerging markets

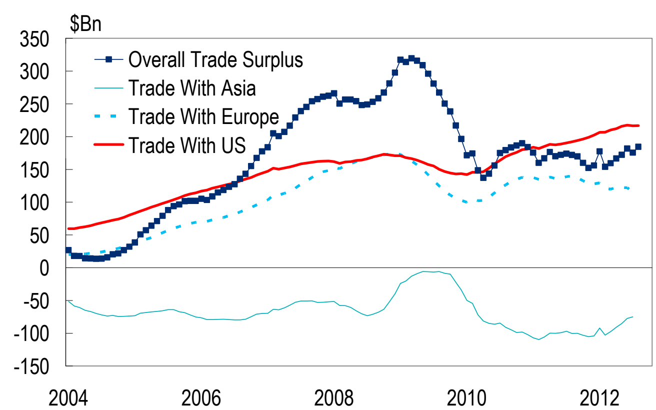
Overall, we are leaving our 2012 global growth forecast (at current exchange rates) at 2.5%, while cutting the 2013 forecast to 2.6% from 2.8% last month. Within that, we have cut our 2013 China growth forecast to 7.6% from 8.0%[1], with our 2012 forecast staying at 7.9%. In all, over the last six months, we have cut our 2012 China growth forecast by 0.5% and cut our 2013 forecast by 1.0%. This is among the sharpest pace of downgrades seen in recent years. We also are making modest downgrades to our 2013 forecasts this month for Korea, Indonesia and the Czech Republic. In addition, we are sharply cutting our Japan growth forecasts, to 2.1% in 2012 and 1.3% in 2013 (down by 0.6% and 0.5%, respectively, from last month). Against that, we are edging up our 2013 euro area growth forecast to minus 0.9% from minus 1.0% last month, but remain well below consensus. In total we have cut our 2013 EMU forecast by 0.7% since April.

Figure 4. Global — Change Over last Six Months In Citi Forecasts for 2013 Real GDP Growth



Source: Citi Research

Figure 5. China — 12-Month Sum of Trade Surplus, US$ Bn, 2004-12



Sources: Datastream and Citi Research

Asian growth continues to slow, with weakness in both domestic demand and exports…

There is widespread evidence of a marked slowdown in growth across Asia, driven by lagged effects of previous domestic tightening plus weaker import growth in advanced economies, especially Europe. For example, China's export growth (goods only) slowed to 4.9% YoY in June-August, with exports to Europe down

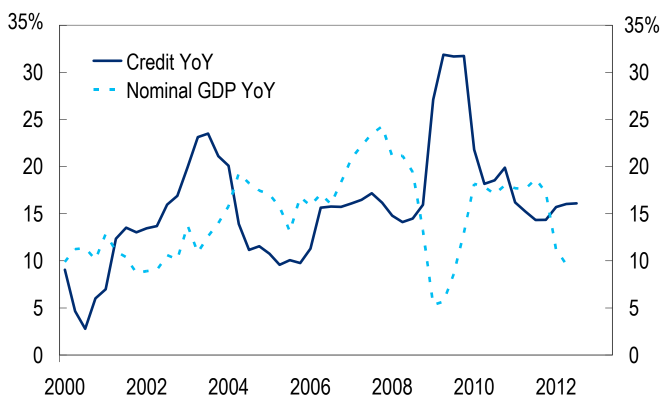
[1] See "*Weathering QE3*", Minggao Shen and Shuang Ding, China Economics Weekly, 14 September 2012, Citi.

10.4% YoY. But the fact that China's trade surplus rose 30% YoY in USD terms in January-August, with imports weakening more than exports, indicates that the slowdown reflects domestic demand as well as exports. As in 2009, China's slowdown is being transmitted to other Asian economies through marked weakness in imports, exacerbated by destocking. Total exports from Singapore, Taiwan and Korea fell 3% YoY on average in June-August, the sharpest drop since late-09.

…but significant loosening is now under way in China, albeit far less aggressively than in 2009

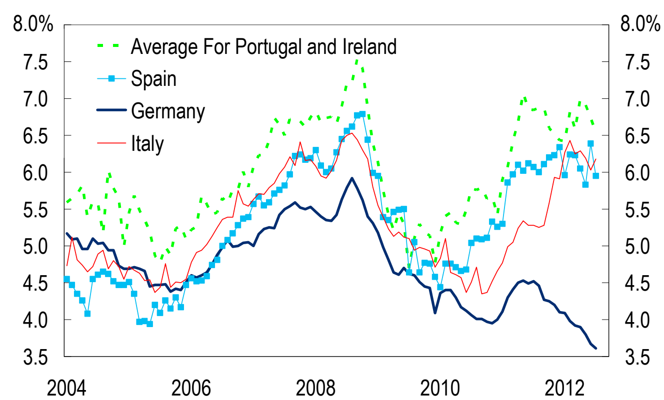
China's slowdown has persisted longer than we expected a few months ago, but is now being countered by wide-ranging policy stimulus, with front-loaded fiscal spending, policy rate cuts in June/July and major investment projects[2]. We continue to expect two more RRR cuts this year although a policy rate cut now seems more unlikely than previously. The wide range of policy channels means that it can be difficult to gauge the scale of effective policy stimulus. The credit data gave a clear early sign of the huge impact of the 2009 easing, and the uptick in credit growth to 16.1% YoY in August from 14.0% YoY in Nov-11 suggests that easing is under way — but nothing like as strongly as in 2009. We expect that easing will continue to be much less powerful than in 2009, with the government tolerating a mild slowdown and setting a 7.0% growth target for 2013 (after the 7.5% target in 2012). This balance between stimulus and slowdown reflects the government's long-run aim of rebalancing the economy away from excess dependence on investment and easy credit, plus worries that aggressive stimulus might again push inflation higher.

Figure 6. China — Credit Growth and Nominal GDP YoY, 2000-12



Sources: Datastream and Citi Research

Figure 7. Euro Area — Average Interest Rates on New Bank Business Loans Up to €1m, Over 1 Year Maturity, 2004-12



Sources: ECB and Citi Research

The US recovery remains disappointing, with unemployment persistently high…

In the US, the economy is not slowing significantly further, but recovery remains disappointing compared to official expectations and previous cycles, with the jobless rate (8.1% in August) staying persistently high. In turn, policymakers' growing frustration with halting progress in labor markets has now led the Fed to trump widespread expectations of new easing efforts with a deluge of words and deeds designed to bolster financial conditions and the broader economic outlook.

…and we expect Fed to keep buying securities well into 2013

The Fed's statement did not pre-judge the path for Operation Twist and the balance sheet beyond year-end, but we expect that at that time they will continue to buy Treasuries as part of a larger unsterilized program unless job growth strengthens much more than we expect in the next few months[3]. Looking out through H1-2013,

[2] See "*China Economics Weekly: Last Policy Window Looming*", Minggao Shen and Shuang Ding, 10 September 2012, Citi.

[3] See "*U.S. Economics Weekly: Market and Policy Comments: High Expectations, High Hurdles*", Bob DiClemente, 14 September 2010, Citi.

this would imply roughly $650 billion of overall bond purchases, or broadly in line with what markets were expecting in the event of a lump-sum approach. The Committee signaled an even stronger ongoing easing bias as well as an intention to keep policy highly accommodative longer than might be warranted solely on the basis of historical relationships between interest rates and economic performance. We expect the Fed will keep rates at the current ultra-low level until 2015, with rates rising only slowly thereafter.

Recent events have greatly reduced some dangerous EMU tail risks

In the euro area, some key tail risks have receded for now. The ECB's new OMT programme greatly reduces the risk of near-term EMU breakup or disorderly financing conditions for Italy and Spain, while risks that the German constitutional court and Dutch election would significantly limit the euro area's rescue facilities have faded. Nevertheless, we still expect that the euro crisis will rumble on, with persistent economic weakness — especially in periphery countries — and recurring episodes of financial strains. Three particular problems loom.

We continue to put the probability of Grexit over the next 12-18 months at about 90%...

First, we continue to put the probability of 'Grexit' (Greece exits EMU) in the next 12-18 months at about 90%, and within that period believe it is most likely to happen in the next 2-3 quarters[4]. Fiscal trends remain weak, with revenues and privatization proceeds markedly undershooting official forecasts, while the election earlier this year has not significantly improved Greece's ability to get the programme back on track. Moreover, the Troika members probably are now much less fearful than early this year about the systemic consequences of Grexit. Private sector exposure to Greece has been cut sharply, while a potentially adequate firewall for Italy and Spain is now in place through the combination of an EFSF/ESM programme plus the ECB's OMT framework. Prior attempts to construct a firewall — by leveraging up the EFSF, expanding IMF resources or introducing the ECB multi-year LTROs — either failed to get off the ground or lacked staying power. Until recently, the absence of a solid firewall for Italy and Spain raised risks that Grexit would destabilise the overall euro area, hence more or less obliging the Troika to continue to support Greece. Now, with a firewall in place, Grexit is more manageable and hence more likely. Grexit probably would still intensify capital flight out of other periphery countries, but it also would probably be accompanied by OMT-related support for Italy and Spain plus massive liquidity support from the ECB and other major central banks.

…although timing is uncertain and could be delayed into 2013

Nevertheless, Grexit is not certain and its potential timing is highly uncertain. The risk of Grexit in the next couple of months probably has receded, with deadlines being pushed off. Policymakers may be unwilling to trigger Grexit in the run-up to the US elections, and while Middle East tensions are so high. We continue to assume, for modelling purposes, that Grexit occurs on 1 January 2013, but stress that gauging the precise timing of such an event is next to impossible. Indeed, there is a chance that the current paralysis of deferred deadlines plus reliance in Greece on short-term bill issuance and ELA expansion could extend for a while into 2013.

We expect that both Spain and Italy will move into EFSF/ESM programmes in the next 6-9 months…

Second, it is unclear how the near-term vulnerabilities of Italy and Spain will be resolved. We expect that both countries will roll into an EFSF/ESM programme (activating the ECB's OMT programme) in the next 2-3 quarters (ie by mid-2013) and most likely in the next few months. We also assume that the ECB will cap two-year yields in both countries at about 200-300bp over German yields, but without announcing a specific yield target. Nevertheless, both the timing of any external support programme, and the details, remain uncertain.

[4] See "*Global Economic outlook and Strategy*", Willem Buiter et al, August 2012, Citi.

…but the rescue facilities may only be activated if the crisis worsens first

At present, the Spanish government seems to be trying to put in place the key elements that would be needed under an EFSF/ESM programme, but without the close monitoring that would be required with such a programme. One possibility is that the government will request a programme (with only limited extra conditionality) once the Budget (expected in September) and regional elections (due October 21) are past, even if yields are around current levels (or lower). But it is more likely, in our view, that the Italian and Spanish governments will both only seek a programme if the EMU crisis escalates further, via either a sharp rise in their yields or Grexit or both. With the knowledge that such a sell-off could be quickly reversed if it triggers large ECB purchases, the timing of such a yield spike is uncertain. The current fragile stalemate may persist for a while, although the unresolved uncertainties probably have an economic cost, by extending the mood of business caution.

We doubt that the current approach of austerity and supply side reform will return any of the periphery countries to fiscal sustainability…

Third, even though EFSF/ESM (and ECB) support probably can ensure that Italy and Spain are funded for a couple of years or so, we doubt that reform measures taken in this period will ensure these countries return to a sustainable fiscal path thereafter. We similarly have doubts over the long-run fiscal prospects for Ireland and Portugal[5]. In all of these countries, economic underperformance is likely to lead to revenue shortfalls and further overshoots in fiscal deficits and public debt/GDP ratios. The sources of weakness vary slightly, with a greater role for high household debts in Ireland and Spain, more emphasis on longstanding supply-side weaknesses in Portugal and Italy, and a general problem of poor credit availability[6].

… nor do we expect that the OMT programme will iron out differences in credit availability and bank lending rates

Moreover, although the ECB's OMT programme ostensibly aims to even out differences in bank lending rates between countries, in practice we suspect that cross-country variation in credit availability will stay high. As of July (latest data) the average bank lending rates on new business loans over 1 year maturity up to €1m were 3.61% in Germany (down 0.9 percentage points from a year ago) compared with 5.95% in Spain (little changed from a year ago) and 6.18% in Italy (up 0.9 ppts from a year ago). The examples of Ireland and Portugal — where bank lending rates are above 6% — make it clear that lending rates in Italy and Spain may well stay high even once countries are in programmes. Even if local banks are recapitalized, persistent economic weakness is likely to imply high credit risks in periphery economies, while foreign banks — which played a big role in fuelling the pre-crisis booms in periphery economies — are likely to continue to retreat.

Longer term, risks remain of more widespread sovereign debt restructuring in EMU

The EMU end-game is likely to be a mix of EMU exit (Greece), sovereign debt and bank debt restructuring (Portugal and, eventually, perhaps Ireland, Italy and Spain), with only limited official fiscal burden-sharing (via the ESM, EFSF and ECB losses) and ongoing liquidity support from the ESM and the ECB. Both Portugal and Ireland are likely to get some form of external support beyond their current programmes, perhaps via the ESM's Enhanced Conditionality Credit Line (ECCL) facility plus ECB OMT purchases. Nevertheless, for Portugal, Ireland, Italy and Spain, the crisis will leave a legacy of high unemployment and very high government debt/GDP ratios (90%+, and in most cases, well above that level)[7]. We doubt that any of these countries will be able to achieve sustained market access at a tolerable yield without the backstop of official support in coming years. But we expect that the path to widespread restructuring (if it occurs) will be drawn out over several years.

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[5] See "*Focus on Portugal*", Euro Economics Weekly, Juergen Michels, 17 August 2012, and "*Ireland – Crucial Period Ahead*", Euro Economics Weekly, Michael Saunders, 14 September 2012, Citi.

[6] See "*Lending Surveys Reveal Persistent Fragility* " Euro Economics Weekly, Guillaume Menuet, 10 August 2012, Citi.

[7] No country has ever exited an IMF programme with a debt/GDP ratio as high as Greece's likely level in coming years. Only two countries have ever exited an IMF programme with debt/GDP ratios above prospective levels in Ireland and Portugal. See "*2011 Review of Conditionality*", IMF, September 2012.

Figure 8. Selected Countries — Economic Forecast Overview (Percent), 2011-2016F

	GDP Growth						CPI Inflation						Short-Term Interest Rates					
	2011	2012F	2013F	2014F	2015F	2016F	2011	2012F	2013F	2014F	2015F	2016F	2011	2012F	2013F	2014F	2015F	2016F
Global	**3.0**	**2.5**	**2.6**	**3.2**	**3.5**	**3.9**	**3.6**	**2.8**	**2.9**	**3.0**	**2.8**	**2.8**	**2.45**	**2.33**	**2.25**	**2.49**	**2.84**	**3.28**
Based on PPP weights	*3.7*	*2.9*	*3.1*	*3.6*	*3.8*	*4.1*	*4.1*	*3.2*	*3.2*	*3.2*	*3.1*	*3.0*						
Industrial Countries	**1.3**	**1.2**	**0.9**	**1.6**	**2.2**	**2.6**	**2.3**	**1.8**	**1.7**	**1.9**	**1.5**	**1.6**	**0.76**	**0.61**	**0.46**	**0.53**	**0.91**	**1.51**
United States	**1.8**	**2.2**	**1.9**	**3.0**	**3.5**	**4.0**	**2.4**	**1.9**	**1.9**	**2.1**	**2.2**	**2.2**	**0.25**	**0.25**	**0.25**	**0.25**	**1.10**	**2.10**
Japan	**-0.8**	**2.1**	**1.3**	**0.2**	**1.5**	**1.2**	**-0.3**	**0.2**	**-0.1**	**2.2**	**0.3**	**0.5**	**0.10**	**0.10**	**0.10**	**0.10**	**0.10**	**0.27**
Euro Area	**1.5**	**-0.6**	**-0.9**	**0.3**	**0.7**	**1.3**	**2.7**	**2.5**	**2.2**	**1.4**	**1.0**	**1.0**	**1.19**	**0.81**	**0.25**	**0.25**	**0.31**	**0.69**
Canada	2.4	2.0	2.2	2.8	3.2	3.5	2.9	1.7	1.9	2.0	2.0	2.0	1.00	1.00	1.63	2.19	2.50	3.00
Australia	2.1	3.7	3.2	3.4	3.8	3.6	3.4	1.8	3.0	2.9	2.7	2.5	4.75	3.69	3.50	4.10	4.60	4.75
New Zealand	1.3	2.3	2.8	3.0	3.2	3.4	4.0	1.5	2.2	2.6	2.9	2.8	2.50	2.50	2.94	3.60	4.20	4.80
Germany	3.1	1.0	0.6	0.5	0.7	1.5	2.3	2.0	2.2	2.5	2.2	2.2						
France	1.7	-0.1	-0.2	0.9	1.2	1.8	2.1	2.1	1.4	1.4	1.6	1.5						
Italy	0.5	-2.5	-2.1	-0.2	0.4	0.3	2.9	3.2	2.3	0.3	-0.1	0.9						
Spain	0.4	-1.8	-3.2	-0.8	0.9	2.4	3.1	2.4	3.2	1.4	1.5	1.6						
Greece	-6.9	-7.6	-10.7	-3.4	1.4	1.8	3.1	0.8	14.9	18.9	6.2	5.9						
Ireland	1.4	-0.6	0.6	2.4	2.4	2.5	0.2	1.7	1.2	1.4	1.6	1.6						
Portugal	-1.7	-3.8	-5.7	-1.3	1.1	1.8	3.6	2.9	2.6	0.9	0.1	0.1						
Netherlands	1.1	-0.7	-0.8	0.8	1.0	1.1	2.3	2.6	2.8	1.6	1.9	1.8						
Belgium	1.8	-0.2	-0.2	0.7	1.4	1.8	3.5	2.6	1.5	1.9	2.2	2.2						
Denmark	0.8	0.1	1.1	1.6	1.7	1.8	2.8	2.5	1.9	2.1	2.2	2.0	1.30	0.91	0.30	0.32	0.41	0.94
Norway	2.5	3.5	3.2	2.7	2.7	2.9	1.3	0.8	1.7	2.0	2.4	2.5	2.10	1.50	1.90	2.50	3.00	3.30
Sweden	4.0	1.0	1.9	2.3	2.5	2.7	3.0	1.1	1.5	2.3	2.1	2.0	1.80	1.40	1.00	1.40	2.00	2.40
Switzerland	1.9	1.2	1.0	0.9	0.9	0.9	0.2	-0.8	-1.3	-0.9	0.4	0.6	0.22	0.00	0.00	0.00	0.00	0.00
United Kingdom	0.7	-0.5	0.3	1.0	1.3	2.3	4.5	2.6	2.1	2.2	1.7	1.5	0.50	0.50	0.50	0.50	0.50	1.04
Emerging Markets	**6.0**	**4.7**	**5.3**	**5.5**	**5.5**	**5.6**	**6.0**	**4.5**	**4.7**	**4.6**	**4.6**	**4.5**	**5.51**	**5.20**	**5.07**	**5.43**	**5.63**	**5.73**
China	**9.3**	**7.9**	**7.6**	**7.3**	**7.0**	**6.8**	**5.4**	**2.9**	**3.3**	**3.8**	**4.0**	**4.0**	**3.22**	**3.25**	**3.13**	**3.50**	**3.88**	**4.00**
Taiwan	4.0	1.7	3.6	4.5	4.5	4.5	1.4	2.0	2.0	1.8	1.8	1.8	0.82	0.87	0.87	0.98	1.17	1.40
India	6.5	5.4	6.2	6.9	7.3	7.4	8.9	8.0	7.0	6.0	6.0	6.0	8.20	7.80	7.50	7.50	7.50	7.50
Indonesia	6.5	6.2	6.1	6.3	6.5	6.5	5.4	4.4	4.7	4.7	5.7	5.4	5.43	4.03	4.50	4.50	4.63	5.13
Korea	3.6	2.6	3.3	3.7	4.1	4.2	4.0	2.4	2.8	3.1	3.0	3.2	3.20	3.06	2.56	3.25	4.00	4.38
Czech Republic	1.7	-1.0	0.4	1.5	2.2	2.8	1.9	3.4	2.4	1.5	2.2	1.8	0.75	0.49	0.05	0.55	1.50	2.25
Hungary	1.7	-1.1	0.8	1.8	2.0	1.8	3.9	5.7	4.2	3.5	3.1	3.3	6.04	6.73	5.52	5.50	5.44	5.00
Poland	4.3	2.4	2.2	2.8	3.3	3.3	4.3	3.8	2.6	2.5	2.5	2.5	4.22	4.58	3.88	4.13	4.71	4.75
Romania	2.5	1.3	3.0	4.2	4.3	4.3	5.8	3.1	3.1	2.5	2.5	2.5	6.19	5.25	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	8.12	8.08	8.44	8.10	7.85	7.75
Turkey	8.5	2.5	4.3	4.6	4.7	4.7	6.5	9.1	7.0	6.0	5.9	5.4	6.00	5.75	6.31	8.00	7.56	7.50
Nigeria	7.8	7.4	6.5	7.2	6.9	7.2	10.8	11.9	10.2	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	4.2	4.4	4.2	5.0	5.5	4.8	5.3	5.2	5.2	5.50	5.17	4.63	5.29	5.50	5.50
Argentina	8.9	1.5	3.0	2.0	2.0	3.5	9.8	9.9	11.9	15.0	15.0	18.0	13.47	13.48	17.70	20.00	20.00	20.00
Brazil	2.7	1.4	3.9	4.5	4.5	4.5	6.6	5.3	5.4	4.5	4.0	4.0	11.71	8.46	7.46	8.88	9.00	8.25
Mexico	3.9	3.9	3.8	3.5	3.6	3.7	3.4	4.2	4.0	3.9	3.8	3.7	4.50	4.50	4.50	4.65	5.46	6.42
Venezuela	4.2	5.0	3.5	4.0	3.0	2.5	27.1	21.2	22.3	27.6	25.8	25.8	13.30	14.40	14.40	13.00	12.90	12.70

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

Figure 9. 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	**0.3**	**0.1**	**-0.1**	**-0.3**	**-0.2**	**-0.1**	**-4.9**	**-4.2**	**-3.4**	**-2.9**	**-2.5**	**-2.4**	**82**	**83**	**83**	**82**	**81**	**80**
Based on PPP weights	*0.5*	*0.3*	*0.0*	*-0.2*	*-0.2*	*-0.1*	*-4.2*	*-3.9*	*-3.2*	*-2.8*	*-2.5*	*-2.4*						
Industrial Countries	**-0.7**	**-0.8**	**-0.8**	**-0.8**	**-0.6**	**-0.5**	**-6.8**	**-5.6**	**-4.4**	**-3.7**	**-3.1**	**-2.7**	**108**	**113**	**115**	**116**	**116**	**116**
United States	**-3.1**	**-3.1**	**-3.0**	**-3.1**	**-3.2**	**-3.2**	**-9.4**	**-7.5**	**-5.9**	**-4.9**	**-4.0**	**-4.0**	**103**	**107**	**110**	**112**	**112**	**112**
Japan	**2.1**	**1.0**	**1.1**	**1.5**	**1.7**	**1.7**	**-10.7**	**-10.7**	**-8.1**	**-6.6**	**-6.2**	**-5.8**	**228**	**237**	**242**	**243**	**247**	**251**
Euro Area	**0.0**	**0.5**	**0.4**	**0.5**	**0.7**	**0.8**	**-4.1**	**-3.3**	**-2.7**	**-2.3**	**-1.9**	**-1.4**	**87**	**94**	**94**	**94**	**94**	**92**
Canada	-2.8	-3.3	-3.7	-3.5	-2.6	-2.1	-1.4	-1.2	-0.5	-0.1	0.2	0.4	85	85	84	83	81	79
Australia	-2.3	-3.8	-4.6	-5.6	-3.5	-3.2	-3.4	-3.0	0.1	0.1	0.3	0.4	26	29	28	27	25	23
New Zealand	-4.2	-5.0	-7.0	-6.4	-5.8	-5.5	-9.2	-4.1	-3.6	-0.9	0.1	0.9	36	39	39	43	42	44
Germany	5.7	5.7	4.0	3.5	3.2	3.7	-1.0	-0.3	-0.3	-0.6	-0.6	-0.6	81	83	83	82	81	79
France	-2.0	-1.7	-0.9	-0.1	0.5	0.5	-5.2	-4.4	-3.7	-2.9	-2.4	-1.7	86	94	99	100	99	98
Italy	-3.3	-1.7	-1.3	-1.1	-1.0	-0.9	-3.9	-3.0	-2.9	-2.6	-2.3	-2.0	120	129	135	138	139	140
Spain	-3.5	-1.4	1.8	3.6	3.0	2.5	-9.1	-6.6	-5.5	-4.1	-3.3	-1.8	69	91	96	99	100	98
Greece	-9.8	-6.6	-2.1	1.8	3.7	4.3	-9.1	-11.2	-5.8	-6.1	-5.7	-10.7	165	156	431	429	129	114
Ireland	1.1	-0.1	1.7	3.9	5.2	6.4	-12.8	-8.4	-8.0	-5.4	-3.5	-2.7	107	118	121	121	118	116
Portugal	-8.1	-4.9	-2.8	-1.9	-1.7	-1.2	-4.2	-5.1	-4.9	-5.4	-2.9	-2.0	108	122	134	89	92	92
Netherlands	8.5	9.6	9.6	8.6	7.6	7.2	-4.7	-4.3	-3.9	-3.6	-3.0	-2.5	65	72	75	78	79	79
Belgium	-1.0	-0.1	0.4	1.2	2.1	2.5	-3.7	-2.7	-2.1	-1.6	-1.4	-1.2	98	112	118	116	114	111
Denmark	6.5	5.5	5.4	4.4	3.5	3.7	-2.0	-3.5	-2.0	-1.9	-1.7	0.5	47	49	49	49	49	47
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	6.5	6.7	6.9	7.3	7.2	7.3	0.1	-0.3	-0.4	-0.3	0.7	1.5	37	37	36	34	32	29
Switzerland	14.3	12.2	11.6	11.1	11.8	12.9	0.7	0.4	0.0	0.0	-0.4	-0.7	53	52	51	51	51	51
United Kingdom	-1.9	-2.4	-1.4	-1.0	-0.2	0.3	-8.2	-6.4	-7.3	-6.6	-5.8	-4.6	83	87	94	98	102	104
Emerging Markets	**2.1**	**1.6**	**1.1**	**0.5**	**0.4**	**0.4**	**-1.4**	**-1.9**	**-1.8**	**-1.7**	**-1.8**	**-1.9**	**34**	**33**	**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**	**16**	**15**	**15**
Taiwan	8.8	8.7	8.4	8.0	8.0	8.0	-1.9	-1.6	-1.6	-1.3	-1.0	-0.7	39	39	40	42	43	44
India	-4.2	-3.0	-2.1	-1.5	-1.0	-0.3	-8.4	-8.5	-8.0	-7.5	-7.0	-6.5	69	69	69	67	65	64
Indonesia	0.2	-2.3	-1.7	-1.1	-1.2	-0.9	-1.2	-2.1	-1.5	-1.4	-1.0	-0.5	26	25	24	23	23	22
Korea	2.4	2.1	1.5	0.8	-0.2	-1.0	1.5	0.8	1.3	1.6	1.5	2.2	33	34	33	31	29	27
Czech Republic	-3.0	-1.4	-1.7	-3.0	-4.2	-2.7	-3.1	-3.2	-3.2	-2.3	-1.5	-0.5	41	45	47	48	48	46
Hungary	1.7	2.1	3.0	2.5	2.2	2.0	4.3	-3.1	-3.9	-3.6	-3.3	-3.0	81	79	79	79	79	79
Poland	-4.3	-3.6	-4.2	-5.1	-5.3	-5.1	-5.1	-3.4	-3.0	-2.5	-2.2	-2.2	54	51	51	50	49	48
Romania	-4.4	-4.0	-4.7	-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	5.7	2.4	-1.0	-1.0	-1.0	2.0	0.3	0.1	-0.1	-1.1	-1.1	8	9	8	8	8	8
Turkey	-10.0	-7.5	-7.0	-6.3	-5.8	-5.3	-1.3	-2.2	-2.5	-2.5	-2.7	-3.0	41	41	39	39	38	36
Nigeria	3.4	2.3	3.4	3.0	1.9	1.3	-3.1	-2.2	-2.1	-2.6	-3.0	-2.6	NA	NA	NA	NA	NA	NA
South Africa	-3.4	-5.7	-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	42
Argentina	0.0	0.9	0.3	-1.0	-1.0	-1.0	-1.7	-2.8	-3.0	-3.0	-3.0	-3.0	40	38	40	41	42	43
Brazil	-2.3	-2.3	-2.7	-3.0	-3.2	-3.6	-2.6	-2.6	-2.4	-2.1	-1.8	-2.0	54	54	55	55	56	56
Mexico	-0.8	-1.0	-1.4	-2.5	-2.4	-2.6	-2.4	-2.2	-2.0	-1.9	-1.9	-1.8	40	40	38	38	38	37
Venezuela	9.1	4.9	4.1	5.7	6.0	5.2	-5.0	-5.0	-4.0	-5.2	-5.0	-4.8	43	36	40	41	41	42

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 Research

Figure 10. 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			**-0.2**			**0.1**					**0.1**	**0.1**
Based on PPP weights		*-0.1*	*-0.1*				*-0.1*					*0.1*
Industrial Countries		**-0.1**	**-0.1**		**0.1**	**0.1**		**0.1**	**0.1**		**0.1**	**0.1**
United States					**0.1**			**0.1**	**0.2**		**0.3**	
Japan		**-0.6**	**-0.5**					**-0.2**	**-0.2**		**-0.2**	**-0.1**
Euro Area			**0.1**		**0.1**	**0.2**		**0.2**	**0.2**			**0.1**
Canada												
Australia			-0.2			-0.2		0.3	0.7			
New Zealand												
Germany		-0.1										
France					0.1	0.2	0.2	0.2	0.2		-0.1	0.1
Italy			0.1									0.1
Spain	-0.3	-0.1	0.1		0.3	0.2		0.8	1.7	-0.2	-0.1	
Greece			-0.5									-0.3
Ireland		-0.1			0.3	0.2		0.1	0.3		-0.5	-0.2
Portugal	-0.1	0.1	0.4		0.1	0.3		-0.4	-0.3		-0.4	0.8
Netherlands			0.2		-0.1	0.1						-0.2
Belgium												0.1
Denmark		-0.6	-0.3			0.2	-0.2			-0.1		
Norway		0.5	0.3			0.1						
Sweden		-0.1			0.1		-0.5	-0.3	-0.3		-0.2	-0.2
Switzerland	-0.2	-0.7					-0.5	-0.7	-0.1		-0.4	-0.4
United Kingdom		0.1	-0.2			0.4		0.3	0.8		0.5	0.9
Emerging Markets			**-0.2**		**-0.1**			**-0.1**				
China	**0.1**		**-0.4**		**0.2**	**0.4**						
Taiwan		-0.7			0.1	-0.1						
India												
Indonesia			-0.2						-0.2			-0.8
Korea		-0.2	-0.3						-0.4			
Czech Republic		0.2	-0.2		0.1	-0.1		1.6	0.2			-0.1
Hungary		-0.2			0.1	0.3		0.2	0.3			-0.2
Poland		-0.2			-0.1	-0.1					-0.1	-0.1
Romania					0.3	0.4		0.5				
Russia												
Turkey									0.1			
Nigeria			-0.3		-0.5	0.4			-0.1			
South Africa					-0.3	-0.2		-1.0				
Argentina					0.1	0.1		0.6	1.1			
Brazil											-0.7	0.3
Mexico					0.2	0.1				0.1		
Venezuela		-0.5			-2.1	-5.5		0.1	0.4			

Source: Citi Research

Figure 11. Selected Countries — Economic Forecast Overview and Exchange Rate Forecasts (Percent), 2011-2016F

	10-Year Yields						Exchange Rates Versus U.S. Dollar*						Exchange Rate Versus Euro					
	2011	2012F	2013F	2014F	2015F	2016F	2011	2012F	2013F	2014F	2015F	2016F	2011	2012F	2013F	2014F	2015F	2016F
Industrial Countries																		
United States	**2.80**	**1.80**	**2.15**	**2.90**	**3.40**	**3.75**	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**	**1.39**	**1.30**	**1.18**	**1.24**	**1.29**	**1.34**
Japan	**1.12**	**0.90**	**1.18**	**1.25**	**1.75**	**1.75**	**79**	**80**	**77**	**80**	**81**	**81**	**110**	**103**	**91**	**99**	**104**	**109**
Euro Area	**2.71**	**1.59**	**1.73**	**2.25**	**2.50**	**3.00**	**1.39**	**1.30**	**1.18**	**1.24**	**1.29**	**1.34**	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**
Canada	2.78	1.88	2.50	3.30	3.50	3.75	1.01	0.98	0.98	0.97	0.96	0.96	1.39	1.27	1.15	1.20	1.25	1.29
Australia	4.63	3.25	3.68	4.40	4.90	5.30	1.01	1.03	0.97	0.95	0.94	0.93	1.37	1.25	1.22	1.31	1.38	1.45
New Zealand	4.74	3.58	3.94	4.60	5.25	5.75	0.77	0.82	0.78	0.70	0.68	0.67	1.79	1.59	1.52	1.77	1.90	2.01
Germany	2.71	1.59	1.73	2.25	2.50	3.00												
France	3.31	2.59	2.36	2.85	3.05	3.50												
Italy	5.19	5.75	4.85	4.75	5.00	5.50												
Spain	5.43	6.27	5.48	5.00	5.00	5.50												
Netherlands	3.04	2.01	1.99	2.50	2.70	3.20												
Belgium	4.21	3.13	2.70	3.05	3.25	3.70												
Denmark	2.80	1.49	1.58	2.30	2.65	3.25	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Norway	3.07	2.09	2.33	2.90	3.20	3.75	5.66	5.78	6.13	5.87	5.63	5.42	7.84	7.49	7.24	7.29	7.29	7.29
Sweden	2.66	1.64	1.76	2.30	2.60	3.25	6.60	6.73	7.09	6.70	6.45	6.25	9.14	8.72	8.37	8.31	8.35	8.40
Switzerland	1.53	0.64	0.90	1.05	1.50	2.10	0.90	0.93	1.02	0.97	0.95	0.95	1.25	1.20	1.20	1.20	1.23	1.27
United Kingdom	3.00	1.81	1.91	2.35	2.50	3.00	1.59	1.60	1.54	1.58	1.64	1.70	0.87	0.81	0.77	0.79	0.79	0.79
Emerging Markets																		
China	**3.52**	**2.87**	**2.80**	**3.17**	**3.55**	**3.67**	**6.46**	**6.32**	**6.32**	**6.18**	**6.12**	**6.09**	**9.00**	**8.19**	**7.46**	**7.66**	**7.93**	**8.18**
Taiwan	1.38	1.35	1.50	1.60	1.70	1.80	29.40	29.73	30.08	28.76	28.41	28.31	40.93	38.51	35.52	35.68	36.78	38.03
India	8.40	8.25	8.25	8.25	8.25	8.25	46.63	54.01	55.24	52.73	51.60	50.83	64.92	69.97	65.23	65.43	66.80	68.28
Indonesia	7.20	6.06	6.45	6.80	7.00	7.25	8763	9455	9797	9681	9611	9558	12201	12250	11569	12012	12443	12840
Korea	3.90	3.27	2.89	3.70	4.63	5.00	1108	1131	1126	1077	1045	1018	1542	1465	1330	1336	1353	1367
Czech Republic	3.68	3.04	3.16	3.46	3.82	4.00	17.7	19.3	21.6	19.8	18.4	17.1	24.6	25.0	25.6	24.6	23.8	23.0
Hungary	7.63	7.98	7.26	7.16	6.94	6.65	201	224	258	236	222	211	279	291	305	292	287	284
Poland	5.99	5.24	5.38	5.38	5.40	5.34	2.96	3.22	3.63	3.20	3.01	2.90	4.12	4.17	4.29	3.97	3.90	3.90
Romania	NA	NA	NA	NA	NA	NA	3.04	3.44	3.72	3.45	3.22	3.01	4.23	4.46	4.39	4.28	4.17	4.05
Russia	NA	NA	NA	NA	NA	NA	29.4	31.2	34.8	33.8	32.6	31.4	41.0	40.4	41.0	42.0	42.2	42.2
Turkey	NA	NA	NA	NA	NA	NA	1.68	1.81	1.90	1.86	1.87	1.89	2.34	2.34	2.24	2.31	2.42	2.54
Nigeria	NA	NA	NA	NA	NA	NA	156	158	161	163	165	164	217	205	191	202	214	220
South Africa	8.24	8.21	8.90	9.15	9.20	9.20	7.26	8.16	8.68	8.75	9.10	9.51	10.11	10.58	10.25	10.86	11.78	12.77
Argentina	NA	NA	NA	NA	NA	NA	4.13	4.58	5.46	6.90	7.94	9.36	5.74	5.93	6.44	8.56	10.27	12.58
Brazil	11.45	10.07	9.48	9.24	8.75	8.25	1.67	1.97	2.05	2.04	1.97	1.89	2.33	2.55	2.42	2.53	2.56	2.54
Mexico	6.83	5.80	6.44	6.84	6.99	7.29	12.4	12.9	13.0	12.4	12.4	12.7	17.3	16.7	15.3	15.3	16.1	17.1
Venezuela	13.65	12.36	12.56	13.90	13.80	13.70	4.29	4.30	6.50	6.50	9.75	9.75	5.98	5.57	7.68	8.07	12.62	13.10

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

Figure 12. Short Rates (End of Period), as of 19 Sep 2012 (Percent)

	Current	4Q 12	1Q 13	2Q 13	3Q 13	4Q 13	1Q 14
United States	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**
Japan	**0.10**	**0.10**	**0.10**	**0.10**	**0.10**	**0.10**	**0.10**
Euro Area	**0.75**	**0.50**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**
Canada	1.00	1.00	1.25	1.50	1.75	2.00	2.00
Australia	3.50	3.50	3.50	3.50	3.50	3.50	3.75
New Zealand	2.50	2.50	2.50	2.75	3.00	3.50	3.75
Denmark	0.20	0.05	0.05	0.05	0.05	0.05	0.05
Norway	1.50	1.50	1.75	1.75	2.00	2.00	2.25
Sweden	1.25	1.00	1.00	1.00	1.00	1.00	1.25
Switzerland	0.00	0.00	0.00	0.00	0.00	0.00	0.00
United Kingdom	0.50	0.50	0.50	0.50	0.50	0.50	0.50
China	**3.00**	**3.00**	**3.00**	**3.00**	**3.00**	**3.25**	**3.25**

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

Figure 13. 10-Year Yield Forecasts (Period Average), as of 19 Sep 2012 (Percent)

	Current	4Q 12	1Q 13	2Q 13	3Q 13	4Q 13	1Q 14
United States	**1.83**	**1.65**	**1.75**	**2.00**	**2.25**	**2.55**	**2.75**
Japan	**0.80**	**0.95**	**1.10**	**1.20**	**1.10**	**1.30**	**1.30**
Euro area (Germany)	**1.67**	**1.50**	**1.55**	**1.60**	**1.75**	**2.00**	**2.00**
Canada	1.93	1.80	2.00	2.40	2.65	2.95	3.15
Australia	3.26	3.10	3.30	3.60	3.80	4.00	4.10
New Zealand	3.64	3.50	3.70	3.85	4.00	4.20	4.30
Denmark	1.75	1.30	1.35	1.45	1.60	1.90	1.95
Norway	2.28	2.10	2.15	2.20	2.35	2.55	2.55
Sweden	1.64	1.50	1.55	1.60	1.80	2.05	2.05
Switzerland	0.62	0.61	0.62	0.64	0.69	0.77	0.86
United Kingdom	1.90	1.70	1.60	1.80	2.00	2.25	2.30

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

Figure 14. 10-Year Yield Spreads (Period Average), as of 19 Sep 2012

	Spread vs. US$						Spread vs. Germany					
	Current	4Q 12	1Q 13	2Q 13	3Q 13	4Q 13	Current	4Q 12	1Q 13	2Q 13	3Q 13	4Q 13
United States	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**	**17**	**16**	**21**	**41**	**51**	**57**
Japan	**-104**	**-71**	**-66**	**-81**	**-116**	**-127**	**-87**	**-55**	**-45**	**-40**	**-65**	**-70**
Euro Area	**-17**	**-16**	**-21**	**-41**	**-51**	**-57**	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**
Canada	10	15	25	40	40	41	27	31	46	81	92	97
Australia	145	147	157	162	157	147	162	162	178	203	209	204
New Zealand	183	187	198	188	178	168	200	203	218	229	229	224
France	46	59	49	24	9	3	62	75	70	65	60	60
Italy	324	384	279	284	274	243	340	400	300	325	325	300
Spain	375	509	354	359	324	293	391	525	375	400	375	350
Netherlands	10	19	9	-16	-26	-32	26	35	30	25	25	25
Belgium	83	94	84	59	44	33	99	110	105	100	95	90
Denmark	-8	-36	-41	-56	-66	-67	0	-20	-20	-15	-15	-10
Norway	45	44	39	19	9	-2	55	60	60	60	60	55
Sweden	-19	-16	-21	-41	-46	-52	-11	0	0	0	5	5
Switzerland	-121	-105	-114	-137	-157	-180	-105	-89	-93	-96	-106	-123
United Kingdom	7	4	-16	-21	-26	-32	23	20	5	20	25	25

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

Figure 15. Emerging Market Countries — Short Rates Actual and Forecast of Additional Rate Moves (End of Period), as of 19 Sep 2012

Country	Current Rate (%)	Dec 12	Mar 13	Jun 13	Sep 13	Dec 13	Total Cumulative Rate Moves Expected
Brazil	7.50	-25	0	0	100	100	175
Turkey	5.75	0	0	0	75	75	150
Indonesia	4.00	25	25	0	0	0	50
China	3.00	0	0	0	25	0	25
Mexico	4.50	0	0	0	0	0	0
Russia	8.25	0	25	0	0	-25	0
South Africa	5.00	-50	0	0	0	50	0
Israel	2.25	-25	0	0	0	0	-25
Korea	3.00	-25	-25	0	0	25	-25
Philippines	3.75	-25	0	0	0	0	-25
Romania	5.25	0	-25	0	0	0	-25
Czech	0.50	-45	0	0	0	0	-45
Chile	5.00	0	-50	0	0	0	-50
India	8.00	-25	-25	0	0	0	-50
Thailand	3.00	-50	0	0	0	0	-50
Poland	4.75	-50	-25	-25	0	0	-100
Hungary	6.75	-75	-50	0	0	0	-125

Source: Citi Research

Figure 16. Foreign Exchange Forecasts (End of Period), as of 19 Sep 2012

	vs. USD						vs. EUR					
	Current	Dec 12	Mar 13	Jun 13	Sep 13	Dec 13	Current	Dec 12	Mar 13	Jun 13	Sep 13	Dec 13
United States	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**	**1.31**	**1.27**	**1.20**	**1.15**	**1.17**	**1.19**
Japan	**78**	**77**	**77**	**76**	**77**	**78**	**103**	**98**	**92**	**88**	**90**	**93**
Euro Area	**1.31**	**1.27**	**1.20**	**1.15**	**1.17**	**1.19**	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**
Canada	0.97	0.96	0.97	0.98	0.98	0.98	1.27	1.21	1.17	1.13	1.15	1.16
Australia	1.06	1.02	0.99	0.96	0.96	0.96	1.24	1.24	1.22	1.20	1.23	1.25
New Zealand	0.83	0.82	0.80	0.79	0.77	0.75	1.58	1.55	1.50	1.47	1.53	1.60
Norway	5.69	5.82	6.05	6.24	6.15	6.07	7.46	7.37	7.28	7.20	7.22	7.24
Sweden	6.56	6.81	7.05	7.24	7.10	6.98	8.61	8.62	8.47	8.35	8.34	8.33
Switzerland	0.93	0.95	1.00	1.04	1.02	1.01	1.22	1.20	1.20	1.20	1.20	1.20
United Kingdom	1.62	1.59	1.55	1.52	1.53	1.54	0.81	0.79	0.78	0.76	0.77	0.77
China	**6.32**	**6.33**	**6.34**	**6.35**	**6.31**	**6.27**	**8.3**	**8.0**	**7.6**	**7.3**	**7.4**	**7.5**
India	54.3	55.0	55.6	55.9	55.1	54.4	71.2	69.7	66.8	64.4	64.7	64.9
Korea	1117	1126	1134	1138	1123	1109	1465	1425	1363	1312	1319	1324
Poland	3.10	3.32	3.58	3.80	3.65	3.50	4.07	4.20	4.31	4.38	4.28	4.18
Russia	30.5	32.3	34.0	35.4	35.0	34.7	39.9	40.8	40.9	40.8	41.1	41.4
South Africa	8.23	8.50	8.61	8.70	8.70	8.71	10.79	10.75	10.35	10.04	10.22	10.40
Turkey	1.80	1.84	1.88	1.92	1.90	1.89	2.35	2.33	2.26	2.21	2.23	2.26
Brazil	2.02	2.02	2.03	2.05	2.05	2.05	2.65	2.55	2.45	2.36	2.41	2.45
Mexico	12.7	12.7	13.0	13.2	13.0	12.8	16.7	16.1	15.6	15.2	15.2	15.2

Source: Citi Research

Figure 17. Foreign Exchange Forecasts (End of Period), as of 19 Sep 2012

	vs. JPY					
	Current	Dec 12	Mar 13	Jun 13	Sep 13	Dec 13
United States	**78**	**77**	**77**	**76**	**77**	**78**
Japan	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**
Euro Area	**103**	**98**	**92**	**88**	**90**	**93**
Canada	81	81	79	78	79	80
Australia	83	79	76	73	74	74
New Zealand	64.9	63.2	61.5	59.9	59.0	58.0
Norway	13.8	13.3	12.7	12.2	12.5	12.8
Sweden	11.9	11.4	10.9	10.5	10.8	11.1
Switzerland	84	81	76	73	75	77
United Kingdom	127	123	119	115	118	120
China	**12**	**12**	**12**	**12**	**12**	**12**
India	1.44	1.41	1.38	1.36	1.40	1.43
Korea	14.27	14.56	14.80	14.94	14.60	14.27
Poland	25.2	23.3	21.4	20.0	21.1	22.2
Russia	2.6	2.4	2.3	2.2	2.2	2.2
South Africa	9.5	9.1	8.9	8.8	8.8	8.9
Turkey	43.6	42.1	40.7	39.7	40.4	41.2
Brazil	38.8	38.4	37.7	37.1	37.5	37.9
Mexico	6.1	6.1	5.9	5.8	5.9	6.1

Source: Citi Research

Country Commentary

United States

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Growth appears to be on a 1½% track in the second half, a shade below an already subpar trend that has characterized recovery so far. A severe drought has undercut farm output and the combination of increased business uncertainty and slowing abroad has held back investment. Most of this should correct post-election and with an expected return of normal growing conditions next year. Meanwhile, consumer finances are improving and housing markets are bottoming. Fiscal drag is likely to remain a headwind, with serious downside risks in the event scheduled tax increases and spending restraint cannot be recast over year-end. Our projections assume that the US will avoid the 'fiscal cliff' in 2013 but drag in the range of 1% from the public sector is still likely.

The Federal Reserve has upstaged debate about prospective monetary policy with the launch of a new, open-ended bond-buying program focused on MBS. Policymakers' patience with gradual labor market improvement has run out and the outlook that inflation is likely to remain low has elevated a bias to continue supporting financial conditions through QE or other means until there is substantial strengthening in labor markets. We expect that unsterilized Treasury purchases will follow the end of Operation Twist, especially if there is no resolution to the fiscal policy stand-off by January.

Despite near-term bumps in food and gasoline prices, more persistent inflation trends are expected to remain relatively muted. Wage and compensation measures have been range bound near 2% and surveys of longer-term inflation expectations have been stable, providing an element of monetary policy flexibility.

Figure 18. United States — Economic Forecasts, 2011-2013F

					2012				2013			
		2011	2012F	2013F	1QE	2QF	3QF	4QF	1QF	2QF	3QF	4QF
GDP	SAAR				2.0%	1.7%	1.9%	1.3%	1.6%	1.9%	2.9%	3.2%
	YoY	1.8%	2.2%	1.9%	2.4	2.3	2.4	1.7	1.6	1.7	1.9	2.4
Domestic Demand	SAAR				2.2	1.6	1.7	1.7	1.1	2.2	3.0	3.2
	YoY	1.8	2.0	1.9	2.1	2.0	1.9	1.8	1.5	1.7	2.0	2.4
Consumption	SAAR				2.4	1.7	1.7	1.9	1.2	2.1	3.0	3.2
	YoY	2.5	1.9	1.9	1.8	2.0	2.0	1.9	1.6	1.7	2.0	2.4
Business Investment	SAAR				7.5	4.2	3.5	3.1	4.2	5.5	6.5	7.3
	YoY	8.6	8.2	4.7	12.5	9.9	6.2	4.6	3.8	4.1	4.8	5.9
Housing Investment	SAAR				20.5	8.9	10.3	11.9	18.8	19.8	20.0	19.0
	YoY	-1.4	11.4	16.2	9.3	10.5	12.9	12.8	12.4	15.1	17.6	19.4
Government	SAAR				-3.0	-0.9	-0.4	-1.0	-2.8	-1.8	-1.2	-1.2
	YoY	-3.1	-1.9	-1.6	-2.2	-2.3	-1.6	-1.3	-1.3	-1.5	-1.7	-1.8
Exports	SAAR				4.4	6.0	2.0	3.2	4.2	5.3	6.0	7.0
	YoY	6.7	3.9	4.5	4.0	4.5	3.4	3.9	3.9	3.7	4.7	5.6
Imports	SAAR				3.1	2.9	2.6	2.2	3.5	5.8	6.0	5.9
	YoY	4.8	3.3	4.0	3.2	3.9	3.4	2.7	2.8	3.5	4.4	5.3
PCE Deflator	YoY	2.4	1.9	1.9	2.4	1.7	1.6	1.9	1.8	2.0	2.1	1.9
Core PCE Deflator	YoY	1.4	1.8	1.6	1.9	1.8	1.7	1.7	1.6	1.6	1.7	1.7
Unemployment Rate	%	9.0	8.2	7.8	8.3	8.2	8.2	8.1	7.9	7.9	7.8	7.6
Federal Gov't Balance (Fiscal Year)	$Bn	-1297	-1175	-875								
	% of GDP	-8.7	-7.3	-5.5								
General Gov't Balance (Cal Year)	% of GDP	-9.4	-7.5	-5.9								
Federal Debt	% of GDP	68	74	78								
General Gov't Debt	% of GDP	103	107	110								
Current Account	US$bn	-466	-488	-486	-549	-470	-465	-466	-454	-485	-486	-518
	% of GDP	-3.1	-3.1	-3.0	-3.5	-3.0	-3.0	-2.9	-2.8	-3.0	-3.0	-3.1
S&P 500 Profits (US$ Per Share)	YoY	14.7	5.3	4.9	8.9	6.5	1.0	5.1	2.7	5.3	4.6	6.8

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

Japan

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We currently expect a technical recession in the second half of this year. Significant downside surprises to the July economic data — especially exports and industrial production — prompted us to expect negative growth in the third quarter. Moreover, as the economic slowdown in Japan's major trading partners is continuing longer than generally anticipated, negative growth appears likely to persist into the fourth quarter, driven by continued declines in exports. Indeed, recent trade statistics indicate that exports to the US and oil-producing nations, which had been supporting overall exports until this spring, eventually lost steam this summer.

We expect prospective declines in export to have a knock-on effect on domestic demand. While business surveys such as the Bank of Japan's Tankan underscore healthy capex *budgets*, there are signs (e.g. machinery orders) that companies are postponing actual spending in the face of a challenging external environment. However, we expect consumer spending to remain relatively firm, apart from distortions caused by temporary factors. While car sales look set to fall substantially after subsidies for eco-friendly car purchases run out this autumn, steadily improving labour market conditions are likely to support spending for other items. We also expect reconstruction demand from the earthquake to continue to support activity moderately in quarters to come.

We expect Japan's exports to resume modest growth in 2013, as the US manufacturing cycle turns up alongside a pick-up in the Chinese economy and stabilization in Europe. At the same time, front-loaded demand ahead of the consumption tax hike in April 2014 likely will emerge first in residential investment and then in consumer spending, which will probably support relatively strong growth. However, activity likely will slow very sharply in 2014 when pre-tax hike demand drops out and real household income is eroded by the 3%-point tax hike and the resultant price hikes. A sharp slowdown in activity may make the second tax rate hike slated in October 2015 politically difficult to implement.

Figure 19. Japan — Economic Forecasts, 2011-13F

					2012				2013			
		2011	2012F	2013F	1Q	2QF	3QF	4QF	1QF	2QF	3QF	4QF
Real GDP	YoY	-0.8%	2.1%	1.3%	2.8%	3.3%	1.3%	1.1%	0.2%	0.7%	1.6%	2.4%
	SAAR				5.3	0.7	-1.1	-0.3	1.7	2.7	2.5	2.7
Domestic Demand	YoY	0.2	2.7	1.5	3.6	3.3	2.3	1.6	0.8	1.2	1.7	2.4
	SAAR				4.6	1.0	0.2	0.4	1.5	2.5	2.5	3.0
Private Consumption	YoY	0.1	2.3	0.8	3.7	3.2	1.6	0.9	-0.1	0.3	1.2	2.0
	SAAR				5.0	0.5	-1.8	0.0	0.9	2.1	1.6	3.6
Business Investment	YoY	1.2	3.0	2.2	3.1	5.5	4.7	-1.3	0.9	0.5	2.7	4.9
	SAAR				-6.3	5.6	-1.9	-2.2	2.0	4.0	7.4	6.2
Housing Investment	YoY	5.7	1.6	9.7	0.2	4.3	0.5	1.6	6.7	9.1	11.5	11.4
Public Investment	YoY	-2.8	7.9	-0.7	8.9	3.3	8.6	10.8	5.5	1.0	-3.0	-5.8
Exports	YoY	-0.1	3.0	1.9	1.2	8.7	-0.5	2.8	0.6	0.5	2.8	3.9
	SAAR				14.3	5.0	-5.2	-1.8	4.8	4.5	3.6	2.5
Imports	YoY	6.3	6.7	3.8	6.8	8.5	6.0	5.8	4.4	3.6	3.5	3.8
	SAAR				9.1	6.7	4.2	3.2	3.8	3.5	3.7	4.3
CPI	YoY	-0.3	0.2	-0.1	0.3	0.2	0.0	0.2	-0.3	-0.1	0.1	0.0
Core CPI	YoY	-0.3	0.0	0.0	0.1	0.0	-0.1	0.1	-0.2	-0.1	0.1	0.0
Nominal GDP	YoY	-2.8	1.2	0.9	1.5	2.2	0.4	0.5	-0.3	0.3	1.4	2.1
Current Account	¥ tn	9.6	4.8	5.2	5.9	5.4	4.1	3.7	4.7	5.3	5.5	5.3
	% of GDP	2.1	1.0	1.1	1.2	1.1	0.9	0.8	1.0	1.1	1.1	1.1
Unemployment Rate	%	4.6	4.4	4.2	4.5	4.4	4.3	4.3	4.3	4.3	4.1	4.2
Industrial Production	YoY	-2.4	0.2	0.5	4.8	5.3	-3.6	-2.9	-3.1	-0.8	3.0	3.1
Corporate Profits (Fiscal Year)	YoY	-16.3	7.5	20.0								
General Govt. Balance (Fiscal Year)	% of GDP	-10.7	-10.7	-8.1								
General Govt Debt	% of GDP	228	237	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 Research

Euro Area

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We leave our 2012 GDP forecast unchanged at -0.6%, but revise our 2013 forecast slightly up from -1.0% to -0.9%, reflecting less adverse financing conditions in the periphery countries amid the ECB actions, plus some likely delay in austerity measures, eg in the Netherlands. However, as the ECB support measures only come under the conditions that countries are under ESM programmes, which probably include austerity measures, we continue to expect ongoing recessions in periphery countries. Furthermore, although Greece is likely to get the next disbursement of the Troika programme, we expect that the funding will stop at one of the next few assessments, keeping the probability of Grexit of around 90% over the next 12-18 months. Purely for modelling purposes, we continue to assume that the timing of Grexit will be on January 1, 2013.

With its Outright Monetary Transaction (OMT) Programme, the ECB has greatly reduced risks of a near-term break-up of the euro area. With its uncapped bond purchases, the ECB can overcome the financial limitations of the ESM/EFSF and cap short-end government bond yields relative to Germany. However, ECB action will only be triggered once a country agrees on an EFSF/ESM programme, and the timing of this remains uncertain. In our view, Spain probably will be the first country to use the OMT programme, but it remains uncertain if and when the government will request an ESM programme (most likely an Enhanced Conditions Credit Line, or ECCL). In order to limit the recognition of external interference, the Spanish government currently is working on additional reform and austerity measures, which are aimed to meet requirements under a programme. But, even so, we suspect that Spain will only request support in the event of renewed market pressure. Likely backed by a weaker growth outlook and in order to limit upside pressure on the currency, we expect the ECB to cut the refi rate to 0.5% in 4Q 2012 and to 0.25% in early 2013. While the deposit rate is likely to remain unchanged in 4Q we expect the deposit rate to fall to -0.25% in early 2013.

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

Figure 20. Euro Area — Economic Forecasts, 2011-13F

					2012F				2013F			
		2011	**2012F**	**2013F**	**1QF**	**2QF**	**3QF**	**4QF**	**1QF**	**2QF**	**3QF**	**4QF**
Real GDP	YoY	1.5%	-0.6%	-0.9%	0.0%	-0.5%	-0.9%	-1.1%	-1.3%	-1.1%	-0.8%	-0.3%
	SAAR				-0.1	-0.7	-1.6	-2.0	-0.8	0.1	-0.5	0.2
Final Domestic Demand	YoY	0.3	-1.3	-1.3	-1.0	-1.0	-1.5	-1.7	-1.7	-1.5	-1.2	-0.7
Private Consumption	YoY	0.1	-1.1	-1.0	-1.0	-0.7	-1.3	-1.2	-1.3	-1.1	-1.0	-0.7
Government Consumption	YoY	-0.1	-0.3	-1.1	0.0	0.1	-0.2	-1.1	-1.3	-1.5	-1.1	-0.4
Fixed Investment	YoY	1.6	-3.2	-2.2	-2.4	-3.0	-3.6	-3.9	-3.2	-2.6	-1.9	-1.1
— Business Equipment	YoY	3.7	-3.3	-2.5	-1.8	-2.9	-4.1	-4.4	-3.6	-3.0	-2.3	-1.1
— Construction	YoY	-0.8	-4.0	-2.1	-3.2	-4.3	-3.9	-4.4	-3.6	-2.1	-1.7	-1.1
Stocks (Contrib. to Y/Y GDP Growth)		0.1	-0.6	-0.2	-0.4	-0.8	-0.6	-0.4	-0.3	-0.2	-0.1	-0.1
Exports	YoY	6.3	2.7	1.7	2.6	3.4	2.1	2.6	2.2	1.3	1.5	1.7
Imports	YoY	4.1	-0.3	0.6	-0.9	-0.3	-0.7	0.8	0.9	0.3	0.4	0.7
CPI	YoY	2.7	2.5	2.2	2.7	2.5	2.5	2.5	2.2	2.2	2.4	2.0
Core CPI	YoY	1.4	1.6	1.5	1.5	1.6	1.5	1.7	1.6	1.5	1.7	1.4
CPI Ex Energy and Food	YoY	1.7	1.8	1.7	1.9	1.8	1.7	1.9	1.7	1.8	1.9	1.5
Unemployment Rate	YoY	10.2	11.2	11.5	10.9	11.2	11.3	11.4	11.5	11.5	11.5	11.5
Current Account Balance	EUR bn	-3.2	44.8	35.3								
	% of GDP	0.0	0.5	0.4								
General Government Balance	EUR bn	-387.6	-314.9	-255.7								
	% of GDP	-4.1	-3.3	-2.7								
Primary Balance	% of GDP	-1.1	0.0	0.6								
General Government Debt	EUR bn	8,215.6	8,920.5	8,936.3								
	% of GDP	87.2	94.1	93.8								
Gross Operating Surplus	YoY	2.3	-0.4	0.4								

Sources: Eurostat and Citi Research

Germany

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We leave our GDP forecasts roughly unchanged for 2012-2013. Exports are likely to be capped by the slowdown in external demand (mainly in EMU but also non-EMU countries), plus the euro's recent appreciation, but solid domestic demand will provide some support. With the general election (set for autumn 2013) approaching, the political debate is getting more heated. The euro area rescue mechanisms are likely to be a main area of the debate. In addition to support measures to euro area partners (particularly Greece), we expect that there will be extended debate on bank supervision and conditions for direct ESM lending to banks. On domestic policies, social security systems are getting more attention, as some parts of CDU/CSU and the opposition SPD propose more generous pension benefits.

France

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We leave our 2012 and 2013 forecasts unchanged. All eyes will be on the 2013 budget on September 28, targeting a deficit of 3% of GDP. We are not convinced that investors will judge the government's GDP baseline of 0.8% for 2013 as being realistic when the consensus is looking for the economy to grow by only 0.3%. Early indications are that the budget savings worth around €30bn will come mostly from tax increases (2/3, with an equal split between corporates and households, in both instances relying on the larger and wealthier groups). The remaining €10bn should come from curbing government expenditure, essentially maintaining the policy of the previous government to freeze outlays in nominal terms, excluding pensions and debt servicing costs. We forecast a budget deficit overshoot to 3.7% of GDP.

Italy

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With thanks to Carla Clifton

We are keeping our forecast for Italy's GDP growth in 2012 unchanged at -2.5%, but edge up our 2013 forecast to -2.1% from -2.2% last month. The Finance Minister recently indicated that the government's new macroeconomic forecasts (due sometime in September) could show GDP down by between 2% and 2.4% this year, versus the previous forecast of a 1.2% drop. We expect the fiscal deficit to be 3.0% of GDP for 2012 and 2.9% for 2013, such that the government will miss the deficit targets of 1.7% and 0.5% of GDP, respectively. The weak economy in 2012 and 2013 will undermine revenues, while savings from the Spending Review are likely to take time to materialise and to be somewhat offset by higher social spending and lower national insurance contributions as unemployment rises.

Figure 21. 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%	1.0%	0.6%	1.7%	-0.1%	-0.2%	0.5%	-2.5%	-2.1%
Final Domestic Demand	YoY	2.4	0.7	1.1	0.9	0.2	0.2	-0.3	-4.0	-3.2
Private Consumption	YoY	1.7	0.8	0.8	0.3	-0.2	0.2	0.2	-3.3	-2.3
Fixed Investment	YoY	6.4	0.0	2.8	3.6	0.3	-0.3	-1.2	-9.4	-8.1
Exports	YoY	7.9	4.4	2.1	5.5	2.4	1.8	6.4	0.2	-1.5
Imports	YoY	7.5	2.8	2.8	5.2	1.2	1.9	1.3	-7.8	-5.1
CPI	YoY	2.3	2.0	2.2	2.1	2.1	1.4	2.9	3.2	2.3
Unemployment Rate	%	6.0	5.5	5.6	9.2	9.8	10.0	8.5	10.6	11.9
Current Account	€bn	146.6	150.0	108.3	-39.2	-34.3	-17.7	-51.5	-26.8	-20.1
	% of GDP	5.7	5.7	4.0	-2.0	-1.7	-0.9	-3.3	-1.7	-1.3
General Govt. Balance	€bn	-26.6	-7.8	-8.8	-103.1	-89.8	-77.6	-62.4	-46.0	-44.8
	% of GDP	-1.0	-0.3	-0.3	-5.2	-4.4	-3.7	-3.9	-3.0	-2.9
Primary Balance	% of GDP	1.6	2.0	1.7	-2.6	-2.2	-1.5	1.0	2.5	3.1
General Govt. Debt	% of GDP	81.2	83.4	82.7	86.0	93.9	98.6	120.1	129.1	135.3
Gross Trading Profits	YoY	1.3	2.7	-0.1	-2.2	1.0	2.0	NA	NA	NA

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

Spain

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With thanks to Deimante Kupciuniene

Following the ECB's announcement of the OMT facility, we continue to expect Spain will request a sovereign bail-out soon, most likely by end-2012. This move could occur after regional elections on October 21, or even earlier if bond yields rise sharply. This month we are slightly cutting our 2012 GDP growth forecast to -1.8% from -1.7% last month, and edging up our 2012 deficit forecast to 6.6% of GDP from 6.5% previously, after weakness in Q2 domestic demand.

Greece

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With thanks to Carla Clifton

We are keeping our 2012 GDP forecast at -7.6% YoY but cut our 2013 forecast to -10.7% from -10.2% before, partly reflecting the implementation of extra austerity measures around year-end. In our view, political tensions fuelled by rising social unrest, plus Greece's failure to sufficiently implement agreed measures, means that there is a high chance that Greece will leave EMU in the next 12-18 months. While the current Troika review probably will not trigger Grexit, we believe that Greece will stop getting funding after one of the subsequent few assessments, thereby triggering Grexit. As before, we assume for modelling purposes that Grexit occurs on 1st January 2013, but stress uncertainty over this timing.

Ireland

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We continue to look for GDP to undershoot official and consensus forecasts, falling slightly this year (down 0.6%), with only modest growth in 2013 (0.6%). Nevertheless, with recent upward revisions to real and nominal GDP growth in 2011, revenue gains probably will keep the 2012 deficit near official forecasts. Even so, with the high and rising debt ratio, we still expect that Ireland will need the backstop of external financial support in coming years. Ireland probably also will need some form of debt restructuring — either through the transformation of bank bailout costs into ESM liabilities or PSI haircuts on government debt or both — to return to a sustainable fiscal path.

Portugal

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With thanks to Carla Clifton

We are edging up our 2012 GDP forecast to -3.8% from -3.9% last month. However, recent data suggest that domestic demand is still falling, and that the boost from net exports is too small to offset this. We also revised up our 2013 forecast to -5.7% from -6.1%, reflecting the relaxation of fiscal targets for 2012 and 2013. However, with such a recession expected, Portugal remains on an unsustainable fiscal path and we therefore continue to have a debt restructuring (including PSI and OSI) in our base case, which we expect to occur in 2014.

Figure 22. Spain, Greece, Ireland and Portugal — Economic Forecasts, 2011-13F

		Spain			Greece			Ireland			Portugal		
		2011	2012F	2013F	2011	2012F	2013F	2011	2012F	2013F	2011	2012F	2013F
Real GDP	YoY	0.4%	-1.8%	-3.2%	-6.9%	-7.6%	-10.7%	1.4%	-0.6%	0.6%	-1.7%	-3.8%	-5.7%
Final Domestic Demand	YoY	-1.8	-4.5	-5.9	-9.6	-9.7	-12.3	-4.3	-1.7	-3.8	-5.3	-7.5	-6.6
Private Consumption	YoY	-0.9	-2.3	-4.1	-7.1	-8.8	-11.2	-2.4	-2.6	-2.8	-4.0	-6.7	-5.4
Fixed Investment	YoY	-5.3	-10.0	-9.8	-20.6	-19.4	-18.5	-12.8	1.9	-8.6	-11.4	-15.7	-13.2
Exports	YoY	7.7	2.4	3.9	-0.8	-3.5	-0.7	5.0	5.4	4.5	7.5	4.4	0.0
Imports	YoY	-0.8	-6.3	-5.2	-8.0	-11.5	-7.8	-0.3	4.6	1.9	-5.2	-6.3	-2.4
CPI	YoY	3.1	2.4	3.2	3.1	0.8	14.9	0.2	1.7	1.2	3.6	2.9	2.6
Unemployment Rate	%	21.7	24.8	26.2	17.4	23.8	29.5	14.4	15.5	17.2	12.7	15.7	18.6
Current Account	€bn	-37.5	-14.6	18.9	-21.1	-13.2	-3.7	1.8	-0.2	2.8	-13.9	-8.1	-4.4
	% of GDP	-3.5	-1.4	1.8	-9.8	-6.6	-2.1	1.1	-0.1	1.7	-8.1	-4.9	-2.8
General Govt. Balance	€bn	-96.8	-69.4	-57.2	-19.6	-22.5	-4.6	-20.4	-13.4	-13.2	-7.3	-8.4	-7.8
	% of GDP	-9.1	-6.6	-5.5	-9.1	-11.2	-5.8	-12.8	-8.4	-8.0	-4.2	-5.1	-4.9
Primary Balance	% of GDP	-6.2	-3.6	-1.2	-2.2	-3.4	-5.6	-4.9	-4.3	-2.5	-0.4	-1.0	-0.1
General Govt. Debt	% of GDP	69.3	91.5	95.5	165.3	156.4	431.5	106.5	118.5	121.4	107.8	121.7	133.9

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 Citi Research

Netherlands

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The pro-European parties were the winner of the September 12 election. A coalition looks likely of the centre-right liberal party of caretaker PM Mark Rutte and the centre-left PvdA, maybe including another centrist party. As PdvA opposes the implementation of near-term austerity measures, the Netherlands probably will try to cite "exceptional circumstances" to stretch the fiscal adjustment, As a consequence, we revise our deficit forecast for 2013 from 3.7% of GDP to 3.9% and our GDP forecast from -1.0% to -0.8%.

Belgium

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We maintain our GDP forecasts of a small drop of 0.2% in 2012 and 2013, but see some improvement in the quarterly profile from the spring of 2013. Weighing on the outlook is the large financial burden related to a cross-border lender and cuts to GDP growth made by the Federal Planning Bureau, which lowered its 2012 and 2013 forecasts by 0.2ppt and 0.6ppt to -0.1% and 0.7%, respectively. These changes will require the government to find an extra €4.6bn in the 2013 budget. On the positive side, the Belgian debt agency announced that it had raised its 2012 issuance target by 21% to €38.3bn to pre-fund for 2013 and lock in attractive yields.

Slovakia

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Having cut our 2013 growth forecast a month ago, we are not altering our forecasts this month. The August confidence indicator worsened for the fourth month in row, but the MinFin has announced measures of €500mn (plus a reserve of €100mn that is likely to be used) for the rest of 2012. We keep our fiscal deficit forecast at slightly more than 3% of GDP in 2013 reflecting the government's political commitment to cap the deficit, even though our growth forecast is well below the MinFin's (2.1%).

Slovenia

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After GDP fell by 1%QoQ in 2Q12, with weakness in exports and probable greater fiscal consolidation, we are cutting our growth forecasts. We now forecast GDP will fall by 1.7%YoY in 2012 (drop of 0.9ppt forecast last month), followed by a 0.8% drop in 2013 (rise of 0.1ppt forecast last month). There is a proposal for state guarantees of up to €4bn for banks' bad claims. The reason for the transfer is to clean up the banks' balance sheets before the privatization process. The proposal for guarantees of up to €4bn covers more than 60% of all current bad claims and almost 120% of non-performing claims and represents 11% of GDP.

Figure 23. Netherlands, Belgium, Slovakia and Slovenia — Economic Forecasts, 2011-2013F

		Netherlands			Belgium			Slovakia			Slovenia		
		2011	2012F	2013F	2011	2012F	2013F	2011	2012F	2013F	2011	2012F	2013F
Real GDP	YoY	1.1%	-0.7%	-0.8%	1.8%	-0.2%	-0.2%	3.3%	2.4%	1.3%	0.2%	-1.7%	-0.8%
Final Domestic Demand	YoY	0.6	-1.0	-1.0	1.9	-0.3	0.2	0.6	0.2	0.5	-2.6	-2.6	-0.9
Public Consumption	YoY	0.1	0.6	-0.1	0.8	0.1	-0.1	-3.5	0.2	-2.1	-0.9	-1.8	-1.3
Private Consumption	YoY	-1.0	-1.1	-1.3	0.2	-0.6	0.1	-0.4	-0.2	0.2	-0.1	-0.5	-0.3
Investment (Ex Stocks)	YoY	5.7	-3.4	-1.5	4.1	0.0	0.7	5.7	0.8	2.7	-10.2	-8.9	-2.1
Exports	YoY	3.9	3.2	1.2	5.5	-0.4	1.7	10.8	5.7	2.2	7.8	-2.3	-2.9
Imports	YoY	3.6	2.7	0.7	5.7	-0.6	1.7	4.5	4.1	3.7	4.7	-2.6	-3.2
CPI (Average)	YoY	2.3	2.6	2.8	3.5	2.6	1.5	3.9	3.6	2.7	1.8	2.5	2.7
Unemployment Rate	%	5.3	6.1	6.9	7.2	7.2	7.7	13.2	13.5	13.9	8.2	8.4	9.6
Current Account	% of GDP	8.5	9.6	9.6	-1.0	-0.1	0.4	0.1	1.2	-1.1	-1.5	-1.4	-1.1
General Govt Balance	% of GDP	-4.7	-4.3	-3.9	-3.7	-2.7	-2.1	-4.8	-4.9	-3.3	-6.4	-4.2	-3.3
Primary Balance	% of GDP	-2.6	-2.5	-2.3	-0.4	0.3	1.0	-3.5	-3.5	-1.9	-4.5	-2.1	-1.1
General Govt Debt	% of GDP	65.2	71.6	75.4	97.8	111.6	117.6	43.4	46.7	49.4	47.6	52	54.4

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

UK

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Our growth forecasts are little changed from last month, at -0.5% for 2012 and +0.3% in 2013, versus -0.6% and +0.5% respectively last month. Recent data suggest that Q3 GDP growth is likely to be positive, but we regard this chiefly as a technical rebound from the erratic weakness in Q2 caused by the Queen's Jubilee and the sharp drop in construction activity. The Olympic Games probably did not have a big effect on Q3 GDP growth either way. The underlying path of the economy has been roughly flat over the last year and, we expect, will be roughly flat in the next few quarters. With headwinds from high private debts, poor credit availability, the EMU crisis and fiscal drag, we expect that GDP will not regain the pre-recession peak (Q1-08) until 2016.

Inflation is likely to fall further in coming months and, even with recent rises in energy and food prices, probably will drop below the 2% target around year-end. We believe that weakness in productivity will not stop inflation falling: the supply of labour has increased, leading to declines in real wages as people price themselves into work — which shows up as weakness in productivity but (since the whole process is driven by weakness in pay) this does not constitute an inflation threat. Unless external costs rise, inflation is likely to stay below target on average next year and subsequently. The fiscal deficit will 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 underlying deficit will rise slightly this year because of economic weakness, with little change likely in 2013. The general government gross debt/GDP ratio is likely to continue to rise, putting the government in breach of its target to achieve a falling debt/GDP ratio in 2015/16. The MPC is likely to expand QE markedly further in coming quarters, most likely in November when the current QE programme ends.

Figure 24. United Kingdom — Economic Forecasts, 2011-2013F

					2012				2013			
		2011	2012F	2013F	1QF	2QF	3QF	4QF	1QF	2QF	3QF	4QF
Real GDP	YoY	0.7%	-0.5%	0.3%	-0.2%	-0.5%	-0.6%	-0.6%	-0.1%	0.5%	0.3%	0.6%
%	SAAR				-1.6	-1.6	1.8	-0.9	0.3	0.7	1.1	0.3
Domestic Demand	YoY	-0.5	-0.2	-0.6	0.3	0.2	-0.8	-0.4	-0.6	-1.3	-0.4	0.0
(Incl. Inventories)	SAAR				0.3	2.0	-2.5	-1.6	-0.2	-0.9	1.1	0.2
Consumption	YoY	-1.1	-0.2	1.6	-0.9	-0.8	0.5	0.5	1.1	1.9	1.7	1.6
	SAAR				-0.4	-1.7	2.4	1.6	2.0	1.8	1.4	1.3
Investment	YoY	-1.4	-1.7	-6.2	1.9	-1.2	-3.1	-4.4	-5.2	-7.4	-6.3	-6.1
	SAAR				7.9	-12.0	-5.0	-7.5	4.2	-19.6	-0.5	-6.8
Exports	YoY	4.4	1.8	5.9	-1.0	0.4	5.1	2.7	5.4	9.1	4.6	4.6
	SAAR				-6.6	-6.5	23.7	2.9	3.5	7.6	4.4	3.2
Imports	YoY	0.5	2.9	3.1	0.7	2.9	4.6	3.2	4.0	3.1	2.3	2.8
	SAAR				-1.3	5.8	7.6	0.8	1.9	2.3	4.3	2.8
Unemployment Rate	%	8.1	8.1	8.0	8.2	8.0	8.2	8.1	8.1	8.0	8.0	7.8
CPI Inflation	YoY	4.5	2.6	2.1	3.5	2.7	2.4	2.0	1.9	2.1	2.2	2.1
Merch. Trade	£bn	-100.3	-100.3	-87.1								
	% of GDP	-6.6	-6.5	-5.5								
Current Account	£bn	-29.0	-37.5	-22.9								
	% of GDP	-1.9	-2.4	-1.4								
PSNB	£bn FY	-126.0	-102.4	-118.8								
	% of GDP	-8.3	-6.6	-7.5								
General Govt. Balance	% of GDP	-8.2	-6.4	-7.3								
Government Primary Balance		-5.1	-3.6	-4.5								
Public Debt	% of GDP	82.5	87.2	93.7								
Gross Nonoil Trading Profits	YoY	6.3	-2.0	2.3								

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

Switzerland

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Our Swiss economic forecasts are little changed from last month, with slight upgrades (0.2% each year) to our 2012 and 2013 GDP forecasts (to 1.2% and 1.0% respectively) but continued negative inflation. The SNB recently reaffirmed its determination to continue to resist any appreciation pressure on the CHF and — with inflation negative — has plenty of reason to avoid allowing monetary conditions to tighten. We expect a long period of ultra-low rates.

Sweden

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Most activity indicators confirm our view of a growth slowdown in Sweden in the second half of the year. Supportive economic policies, however, suggest that a recession should be avoided; the government plans to present a stimulus package in the autumn budget and the Riksbank lowered its key policy rate by 25bp to 1.25% at the September meeting. A weaker international growth outlook, more expansionary policies from other central banks, a strong SEK (which is likely to stay strong ahead), very subdued domestic core inflation, a gradual weakening of the labour market and decreasing capacity use support our view of a 1% trough in the repo rate by year-end.

Denmark

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Denmark has experienced negative GDP growth in three out of the last four quarters, and economic activity contracted 0.9% Y/Y (0.5% Q/Q) in 2Q, forcing a downgrade of our GDP forecast by 0.6pp to 0.1% Y/Y this year. With a weaker DKK vs. the EUR, much suggests that DNB's strategy with a negative CD-rate, so far, has had the desired effect, and the need for independent Danish interest rate cuts is no longer imminent. With the lending rate at only 0.2% at present, we do not expect DNB to fully shadow additional near-term ECB action; the lending rate is seen at 0.05% in 4Q and we see no changes to the CD-rate.

Norway

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We raise our 2012 mainland GDP growth forecast to 3.5% Y/Y (from previously 3.0%) following the strong 2Q GDP estimate. The Norwegian economy has so far been largely unaffected by the global slowdown. Momentum in the Norwegian economy is strong and lead indicators only point to a marginal slowdown near term. Main growth drivers are high activity in the oil sector and a recovery in private consumption — fuelled by strong labour market and income growth. Given strong domestic fundamentals, Norges Bank now signals a 25bp rate hike in 2Q '13 with 50/50 probability of even earlier tightening.

Figure 25. Switzerland, Sweden, Denmark and Norway — Economic Forecasts, 2011-2013F

		Switzerland			Sweden			Denmark			Norway		
		2011	2012F	2013F	2011	2012F	2013F	2011	2012F	2013F	2011	2012F	2013F
Real GDP	YoY	1.9%	1.2%	1.0%	4.0%	1.0%	1.9%	0.8%	0.1%	1.1%	2.5%	3.5%	3.2%
Final Domestic Demand	YoY	2.0	2.3	1.4	2.9	1.8	1.6	-0.7	0.7	1.2	3.2	3.1	3.3
Public Consumption	YoY	2.0	2.1	1.5	1.9	0.9	1.1	-1.3	0.2	0.8	1.5	2.0	2.5
Private Consumption	YoY	1.2	2.3	0.5	2.2	1.5	1.7	-0.8	0.5	1.1	2.4	3.6	3.5
Investment (Ex Stocks)	YoY	4.0	2.4	4.0	7.0	4.1	1.9	0.2	2.2	2.3	8.1	3.5	4.1
Exports	YoY	3.8	0.5	2.5	7.5	0.7	2.4	7.0	2.0	2.8	0.9	2.3	5.0
Imports	YoY	4.2	2.8	3.5	6.4	0.1	2.8	5.3	2.3	3.0	2.8	2.5	3.3
CPI (Average)	YoY	0.2	-0.8	-1.3	3.0	1.1	1.5	2.8	2.5	1.9	1.3	0.8	1.7
Unemployment Rate	%	3.1	3.2	3.5	7.5	7.6	7.8	7.6	7.8	7.8	3.3	3.0	3.0
Current Account	% of GDP	14.3	12.2	11.6	6.5	6.7	6.9	6.5	5.5	5.4	14.0	14.3	14.9
General Govt Balance	% of GDP	0.7	0.4	0.0	0.1	-0.3	-0.4	-2.0	-3.5	-2.0	13.8	13.6	14.0
General Govt Debt	% of GDP	52.5	51.5	50.8	37.0	36.5	35.7	46.5	48.7	49.2	NA	NA	NA

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

Canada

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The Canadian expansion is progressing largely as expected, with material support from consumers, and business investment in capital, labor and inventories. Financial conditions continue to brighten. The slow start to third quarter GDP expansion, amid moderating global growth and planned maintenance shutdowns in the energy sector, may ultimately be offset by the more recent upswing in commodity prices. However, fiscal consolidation is still under way and net exports are weighing on growth. Moreover, increasing business caution and cooling housing activity probably will continue to cap output and employment near term.

Risks to the inflation outlook are two-sided, but remain roughly in balance. Upside risks include (1) increased global inflationary pressures linked to higher commodity prices or lower than anticipated potential growth; (2) greater Canadian housing momentum; and (3) stronger Canadian exports with reduced competitiveness impediments. Downside risks include (1) failure to contain the Euro Area crisis resulting in contagion to Canada via financial, confidence and trade channels; (2) realization of the US Fiscal Cliff or hard landings among key Emerging Market trading partners; and (3) Canadian consumer retrenchment related to outsized household debt levels and/or disorderly correction of the domestic housing market.

The economy is still poised to expand by about 2% this year and next, and pick up slightly in 2014. Key consumer inflation gauges should return to the BoC's 2% target by 2H 2013. Externally focused downside risks and lingering uncertainties will keep the central bank on the sidelines through year-end. However, underlying domestic strength, a fully functioning financial system, balanced risks, and ongoing concern about household debt accumulation amid low interest rates should prompt the bank to retain its slightly hawkish policy tack. Barring the realization of a confluence of downside risks, we maintain our call for a first rate hike in 1H 2013.

Figure 26. Canada — Economic Forecast, 2011-2013F

					2012F				2013F			
		2011	2012F	2013F	1Q	2QF	3QF	4QF	1QF	2QF	3QF	4QF
Real GDP	YoY	2.4%	2.0%	2.2%	1.8%	2.5%	1.7%	1.8%	1.9%	2.0%	2.3%	2.5%
	SAAR				1.8	1.8	1.5	2.2	2.0	2.4	2.7	2.8
Final Domestic Demand	YoY	3.0	1.6	2.4	1.7	1.6	1.5	1.8	2.1	2.3	2.7	2.7
	SAAR				1.3	1.7	1.3	2.7	2.6	2.5	2.8	2.9
Private Consumption	YoY	2.4	1.7	2.3	1.9	1.7	1.7	1.6	2.0	2.3	2.4	2.4
	SAAR				0.7	1.1	2.0	2.5	2.3	2.4	2.4	2.5
Government Spending	YoY	0.1	-1.5	0.7	-2.3	-1.9	-1.4	-0.4	0.4	0.7	0.9	0.8
	SAAR				-2.3	-0.5	0.2	1.0	0.8	0.8	0.8	0.8
Private Fixed Investment	YoY	8.9	6.0	5.4	6.6	5.9	5.6	5.8	5.3	4.9	5.6	5.9
	SAAR				7.9	6.5	3.9	5.2	5.6	5.0	6.6	6.3
Exports	YoY	4.6	4.6	3.7	5.2	6.7	4.0	2.8	2.6	3.4	3.9	4.9
	SAAR				4.0	0.8	4.0	2.4	3.2	4.2	5.9	6.3
Imports	YoY	7.0	4.1	4.7	4.3	2.4	4.5	5.0	4.9	4.4	4.7	5.0
	SAAR				5.1	9.0	4.0	4.5	4.5	4.5	5.5	5.5
CPI	YoY	2.9	1.7	1.9	2.3	1.6	1.3	1.5	1.5	1.5	2.1	2.4
Core CPI	YoY	1.7	1.8	2.2	2.1	2.0	1.5	1.7	1.9	2.0	2.5	2.2
Unemployment Rate	%	7.5	7.3	7.0	7.4	7.3	7.3	7.3	7.2	7.0	7.0	6.9
Current Account Balance	C$bn	-48.4	-57.6	-68.5	-40.6	-64.1	-53.6	-71.8	-66.3	-68.7	-69.5	-69.7
	% of GDP	-2.8	-3.3	-3.7	-2.3	-3.6	-3.0	-4.0	-3.7	-3.8	-3.8	-3.7
Net Exports (Pct. Contrib.)		-1.5	-0.2	-0.9	-0.4	-1.8	-0.4	-1.2	-1.0	-0.6	-0.5	-0.3
Inventories (Pct. Contrib.)		0.3	0.1	0.3	0.7	1.7	0.4	0.5	0.1	0.2	0.0	0.0
Budget Balance (Fiscal Year)	% of GDP	-1.4	-1.2	-0.5								
Federal Budget Debt	% of GDP	33.5	33.9	33.0								
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 global backdrop remains challenging despite the resilience of the domestic economy so far. The fall in commodity prices means lower income growth and the AUD so far has not provided much of a cushion. As a result, mining companies are reviewing capex and hiring plans. That said, the short term outlook for the economy is largely unchanged and we continue to forecast real GDP growth for 2012 of 3.7%. But we have lowered our 2013 forecasts. We now expect growth of 3.2% in 2013 (previously 3.4%). In particular, the outlook for employment looks weaker than we had previously expected and this could weigh on consumer spending. State governments are adding to the fiscal tightening by the federal government. With some mining capex being deferred, we have trimmed our business capex forecast. Our base case for the RBA cash rate is for no change over the remainder of this year given earlier cuts in May and June, but if China continues to slow and unemployment in Australia creeps higher then we would expect the RBA to cut further before year-end. Moreover, the Fed's QE3 announcement raises the risk that the AUD remains higher for longer, placing more pressure on the RBA to cut.

New Zealand

Q2 GDP will be released this morning. In our view, the recovery remains patchy, but has a number of drivers including housing, the Christchurch reconstruction and business investment. The main negatives include deleveraging (though a positive longer term), the global backdrop, fiscal caution and the strong NZD. Hiring in the labour market remains subdued and, consistent with this, consumer spending is growing slowly. Given sub trend economic growth, inflation is subdued and likely to remain so. This provides the opportunity for the RBNZ to cut further if needed. RBNZ estimates for the 90-day bill rate imply the current OCR could remain unchanged until Q3 2013, compared to the previous guidance that implied one quarter earlier. The next OCR announcement late next month will be the first for the new Governor, Mr. Graeme Wheeler, who previously worked at the World Bank. We do not expect any major change in policy approach in the short term.

Figure 27. Australia and New Zealand — Economic Forecast, 2011-2013F

	Australia			New Zealand		
	2011	2012F	2013F	2011	2012F	2013F
Real GDP[a]	2.1%	3.7%	3.2%	1.3%	2.3%	2.8%
Real GDP (4Q versus 4Q)	2.6	3.6	3.2	1.9	2.6	3.0
Real Final Domestic Demand	4.2	5.0	3.4	2.3	1.7	2.8
Consumption	3.3	3.9	2.8	2.5	2.3	2.1
Govt. Current & Capital Spending[b]	0.1	2.3	1.8	1.8	1.3	1.3
Housing Investment	1.3	-4.9	2.8	-12.0	7.4	12.6
Business Investment[c]	17.0	15.8	7.5	6.9	2.0	5.0
Exports of Goods & Services	-1.3	6.4	8.0	2.4	4.0	3.0
Imports of Goods & Services	11.5	7.8	6.6	6.0	2.7	3.7
CPI	3.4	1.8	3.0	4.0	1.5	2.2
CPI (4Q versus 4Q)	3.1	2.6	2.5	1.8	1.8	2.3
Unemployment	5.1	5.2	5.5	6.5	6.4	5.6
Merch. Trade, BOP (Local Currency, bn)	18.0	-14.1	-28.5	3.3	2.4	-0.4
Current Account, (Local Currency, bn)	-33.2	-55.9	-72.6	-8.3	-10.8	-16.3
Percent of GDP	-2.3	-3.8	-4.6	-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	36.2	38.9	38.9
Gross Trading Profits[f]	6.1	-3.9	3.9	NA	NA	NA

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

China

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3Q growth is likely to be flattish. Due to lack of policy action, industrial production (IP) growth slowed further to 8.9% YoY in August amid accelerating inventory reduction. The August PMI dropped below 50 for the first time since last November. Industrial production growth may improve slightly in September on better loan growth and property investment. While the manufacturing sector looks weaker in 3Q than in 2Q, agriculture, construction and service sector growth appears quite resilient, and will likely compensate the IP disappointment. On balance, we expect 3Q growth at 7.6% YoY.

We expect a 4Q rebound and keep our 2012 growth forecast at 7.9%. The speed-up of project implementation, supported by frontloaded fiscal spending and accommodative monetary and credit policy, appears to have already stabilized final demand. We expect to see the full impact of advanced fiscal spending in the months ahead, together with roughly Rmb5tn (nearly 10% of GDP) of fiscal spending by year-end under the current budget. The stronger credit expansion in August suggests the annual implicit loan quota may have been increased from Rmb8tn to Rmb8.5tn. Full utilization of the room of the current policy mix is expected to promote restocking very soon. In addition, previously the PMI was often boosted during periods of US QE. We forecast a rebound of growth in 4Q to 8.2% YoY, delivering annual growth of 7.9%.

We downgrade our 2013 growth forecast to 7.6% from 8% previously. While China can weather the QE3 quite well in the near term, the global liquidity easing can complicate China's efforts to contain goods and asset price inflation, especially against China's medium-term agenda to rebalance the economy. The incoming government may tolerate growth below the potential level to bring down investment growth and contain the inflationary pressure from domestic pricing reforms and the spillover from QE3. The growth target may be downgraded from 7.5% in 2012 to 7.0% in 2013, while the inflation target may be set at 3-4%. The policy stance may return to neutral, and weak external demand will likely make a negative contribution to growth. Growth may stay close to 8% YoY in 1Q, benefiting from policy easing in 2012, but slow down over the year, with annual growth falling to 7.6%. We forecast CPI inflation to rise to 3.5% by the end of the next year.

Figure 28. China — Economic Forecasts, 2011-2013F

					2012F				2013F			
		2011	2012F	2013F	1Q	2Q	3QF	4QF	1QF	2QF	3QF	4QF
Real GDP	YoY	9.3%	7.9%	7.6%	8.1%	7.6%	7.6%	8.2%	8.0%	7.8%	7.6%	7.2%
Real Final Domestic Demand	YoY	10.3	9.1	8.4								
Consumption	YoY	9.8	9.4	8.9								
Fixed Capital Formation	YoY	10.8	8.7	8.0								
Industrial Production	YoY	13.9	10.0	9.5	11.6	9.5	9.1	10.0	9.7	9.6	9.6	9.1
Exports	YoY	20.3	8.1	9.2	7.6	10.6	8.7	5.5	6.0	8.0	10.0	12.0
Imports	YoY	24.9	8.1	11.4	6.9	6.5	7.8	11.0	9.0	10.0	12.0	14.0
Merchandise Trade Balance	$bn	155	167	141	1	69	72	26	-12	65	70	19
FX Reserves	$bn	3,181	3,301	3,461	3,305	3,240	3,302	3,301	3,289	3,355	3,439	3,461
Current Account	% of GDP	2.8	2.0	1.5								
Fiscal Balance	% of GDP	-1.3	-2.4	-1.5								
General Govt. Debt	% of GDP	15.2	16.1	16.1								
Urban Unemployment Rate	%	4.1	4.2	4.1	4.1	4.1	4.2	4.2	4.1	4.1	4.1	4.1
CPI	YoY	5.4	2.9	3.3	3.8	2.9	2.1	2.7	2.8	3.3	3.5	3.5
Exchange Rate (end period)	CNY/$	6.29	6.33	6.27	6.30	6.35	6.31	6.33	6.34	6.35	6.31	6.27
1-Yr Deposit Rate (end period)	%	3.50	3.00	3.25	3.50	3.25	3.00	3.00	3.00	3.00	3.25	3.25

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

India

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Following almost two years of a near-paralysis on policy, the government over two working days announced several long-awaited reforms which include (1) Fuel price related measures (2) FDI in many sectors including retail (3) Divestments in four public sector undertakings. This is undoubtedly positive and bodes well for all asset classes, especially the INR. Key factors triggering the sudden awakening include (1) Averting a potential sovereign rating downgrade (2) Focus on growth which has fallen to a ten-year low (3) Need to attract capital flows to finance the current account deficit and (4) Upcoming general elections and, more importantly, stronger political will with the PM saying “We have to bite the bullet, if we have to go down, let us go down fighting”.

These measures are a big sentiment positive, and bode well for both consumer and business confidence, which have been on a downtrend. Moreover, this sets a good platform for addressing ‘execution’-related issues that have resulted in a collapse in investment. However, we are maintaining our 5.4% GDP estimate for FY13 as the impact on the numbers will probably be felt towards the latter part of FY13 or FY14. On the fiscal front, given the unrealistic subsidy estimates, despite the fuel price hike, we expect the deficit to touch 5.9% of GDP versus Budget estimates of 5.1%. Moreover the divestments announced are expected to bring in Rs150bn while the budgeted numbers are at Rs300bn. Nonetheless, the reform measures send a strong signal and are likely to reduce concerns of a ratings downgrade.

The fuel price hike will result in inflation increasing by about 125bps. While we expect inflation to remain above the RBI's medium target, we maintain our view of a 50bps rate cut in 2HFY13 due to the growth slowdown, the FM’s emphasis on the possibility of further fiscal measures and the RBI saying "monetary policy also has an important role in supporting the growth revival". On the capital account, while the long-awaited measures relating to FDI in retail will aid flows in FY14, the ability and willingness of the government to act despite coalition pressures bodes well for FDI in other sectors. However, reforms coupled with global liquidity easing are a big positive for portfolio flows. Thus, despite the recent uptrend in oil prices, we maintain our view of the capital flows being more than sufficient to finance the current account deficit. All of this points to a further appreciation in the INR.

Figure 29. India — Economic Forecasts, FY2012/13-2014/5F

		FY 12/13F	FY 13/14F	FY 14/15F
Real GDP	YoY	5.4%	6.2%	6.9%
Final Domestic Demand	YoY	4.8	5.8	7.3
Private Consumption	YoY	5.0	5.5	6.7
Fixed Investment	YoY	5.5	8.0	9.0
Exports	YoY	8.0	15.0	11.0
Imports	YoY	6.0	10.8	9.5
Wholesale Price Index*	YoY	8.0	7.0	6.0
Consumer Price Index	YoY	7.0	6.5	6.0
Current Account	US$ bn	-55	-46	-40
	% of GDP	-3.0	-2.1	-1.5
Consolidated Fiscal Balance	% of GDP	-8.5	-8.0	-7.5
Centre Fiscal Balance	% of GDP	-5.5	-5.0	-4.5
US Dollar Exchange Rate	Average	55.0	54.4	52.1

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

Korea

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The investment slump in 2Q12 was deeper than previous estimated. The BoK revised down facilities and construction investment in 2Q by 0.6%p and 0.7%p in YoY terms, respectively, leading to a 0.1%p downward revision of real GDP growth. Reflecting recent weak domestic demand as well as the expected further China slowdown in 2013, we are cutting our growth forecasts for 2012 and 2013 by 0.2%p and 0.3%p to 2.6% and 3.3%% respectively. In August, exports continued to contract, falling by 6.2%YoY after dropping 8.8%YoY in July. The weaker-than-expected global backdrop is likely to weigh on exports in coming months while the lacklustre housing market and high household debt are likely to limit recoveries of consumption and construction investment. Headline inflation probably will bottom out from September, after hitting a decade low of 1.2%YoY in August on the back of typhoon damage and rising oil prices. However, we think headline inflation will stay below 3% for a while due to the negative output gap and high base effects from a year ago. Nevertheless, the BoK left the policy rate unchanged at 3% at the September MPC meeting. With weak domestic demand, low headline inflation, and increased downside risks to global economy, we believe the BoK will cut the rate by 25bps in October .

Indonesia

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Coincident indicators in 3Q still point to relatively strong domestic demand, with retail sales and consumer confidence holding up, despite some weakness on motorcycle sales, following lower rubber exports and implementation of minimum down-payment regulations in June. The trade deficit narrowed in July, and the Fed's QE3 may help prop up portfolio inflows, yet on the other hand prospects of a strong export rebound in 2013 remain dim. While we maintain our FY12 GDP growth forecast at 6.2%, we revise our FY13 forecast to 6.1% (from previously 6.3%). The pace of improvement in the CA deficit could also be slower (FY13 CA deficit forecast revised to 1.7% GDP from 1.5%). Therefore, despite inflows post-QE3 announcement, the policy bias will remain mindful of trade fundamentals. BI has signaled preference for IDR depreciation and, with the deeper slowdown in China, we see the IDR heading towards 9,850/US$ in 6-12M and also expect the FasBI rate to reach 4.50% by YE13. On inflation, we revise up our 2013 CPI forecast to 5.0% to include a possible rise in electricity tariffs.

Figure 30. Korea and Indonesia — Economic Forecasts, 2011-2013F

		Korea			Indonesia		
		2011	2012F	2013F	2011	2012F	2013F
Real GDP	YoY	3.6%	2.6%	3.3%	6.5%	6.2%	6.1%
Final Domestic Demand	YoY	1.3	1.6	2.4	5.7	6.5	7.0
Private Consumption	YoY	2.3	1.5	1.6	4.7	5.1	4.5
Fixed Investment	YoY	-1.1	0.7	3.8	8.8	11.4	10.6
Exports	YoY	9.5	2.6	3.4	13.6	4.3	6.0
Imports	YoY	6.5	1.0	1.8	13.3	7.1	7.9
Consumer Price Index	YoY	4.0	2.4	2.8	5.4	4.4	4.7
Unemployment Rate	%	3.4	3.3	3.3	6.6	6.1	5.9
Current Account	US$ bn	26.5	24.1	17.8	1.7	-20.4	-15.9
	% of GDP	2.4	2.1	1.5	0.2	-2.3	-1.7
Fiscal Balance	% of GDP	1.5	0.8	1.3	-1.2	-2.1	-1.5
US Dollar Exchange Rate	Average	1108	1131	1126	8763	9455	9797

Sources: Haver Analytics and Citi Research

Hong Kong

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The economic recovery remains tepid in 3Q, with trade suffering on global slowdown while local consumption is also trending down (as reflected in disappointing July retail sales). The Legislative Council Elections resulted in an even more fragmented legislature and could pose hurdles to future policy passing. However, we believe the Government will likely prioritize the provision of public housing, helping the elderly and medical reforms — these measures likely will face fewer political roadblocks. The Government announced additional measures to increase public housing supply and tightened mortgage standards to help cool the property market. The HKD is likely to stay near the strong end of its band in the near term, given risk-on sentiment and QE will likely induce capital inflows into HK.

Singapore

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Incoming data continue to point towards a mild technical recession in 3Q12, and we shave our 2012 and 2013 forecasts a notch to 2.3% and 3.2%, respectively. This forecast assumes a short-lived rebound in 4Q12 from the lagged effects of boosts to sentiment and recovery in China. Meanwhile, headline inflation is likely to stay close to the upper end of MAS's 3.5-4.5% forecast but weaker growth has translated into lower MAS forecasts for core inflation. Overall, the shift in the cyclical balance of risks towards growth likely justifies a 'slight' slope reduction from 2.5%p.a to 1.5-2%. Risk factors that could potentially cause MAS to stand pat include the need to anchor inflation expectations, to look past shorter and shallower cyclical fluctuations to avoid flip-flopping, and to offset effects of QE3 (capital inflow, inflation).

Taiwan

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Growth momentum remained weak in 3Q12, as exports contracted again by 4.2% YoY in August. By contrast, CPI inflation surged to a four-year high of 3.4% YoY in August on typhoon effects. We believe rising inflation pressure and high housing prices will likely dominate downside growth risks to lead to no change in policy rates in September. The legislature will revise laws on government debt limit and revenues distribution in the current session to give local government more room to spend. However, the government still faces a tight fiscal situation and will try to access private money to fund infrastructure projects in order to boost the economy. There has been good news with the investment protection agreement and the currency settlement MOU with mainland China, and we expect more breakthroughs in cross-strait negotiations later this year to provide more growth catalysts.

Figure 31. 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%	2.2%	3.8%	4.9%	2.3%	3.2%	4.0%	1.7%	3.6%
Final Domestic Demand	YoY	7.5	4.8	1.9	3.4	3.3	2.9	1.3	0.7	2.8
Private Consumption	YoY	8.4	4.4	2.0	4.1	2.8	3.3	3.0	1.9	2.7
Fixed Investment	YoY	7.3	6.6	2.0	3.3	6.6	2.6	-3.8	-2.6	5.2
Exports	YoY	4.2	-0.4	6.0	2.6	2.6	3.8	4.5	1.7	5.3
Imports	YoY	4.6	0.4	5.1	2.4	4.2	4.6	-0.6	-0.7	4.8
CPI	YoY	5.3	3.8	3.2	5.2	4.5	3.2	1.4	2.0	2.0
Unemployment Rate	%	3.4	3.4	3.7	2.0	2.2	2.1	4.4	4.3	4.2
Current Account	US$ bn	12.4	12.8	15.2	57.1	41.7	41.2	41.3	41.9	42.6
	% of GDP	5.1	5.0	5.5	21.9	15.1	14.1	8.8	8.7	8.4
Fiscal Balance	% of GDP	3.9	0.8	1.1	1.5	1.0	1.0	-1.9	-1.6	-1.6
US Dollar Exchange Rate	Average	7.78	7.76	7.76	1.26	1.25	1.26	29.40	29.73	30.08

Sources: Haver Analytics and Citi Research

Russia

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The beginning of the third quarter was marked by decelerating growth. Retail sales growth slowed to 5.1%YoY in July from 7% in 1H. Furthermore, the Ministry of Economy's GDP flash estimate stood at 2.6% in July after 4.5%YoY growth in 1H. We expect the slowdown will continue due to fading real wage growth — despite the temporary boost from the budget in September. Inflation is currently running at about 6.2%YoY after tariff indexation. The 5-6% inflation target of the CBR has thus been breached, but the monetary stance has recently been tightened. We also note that, despite the RUB2tn claims of the CBR to the banking system, the fluctuations in market rates are not very closely linked to refinancing operations with the CBR. Still, the repo auction rate seems to determine the mean of the interbank rates. We expect some support to the banking liquidity in September from MoF deposits, and October is likely to be liquidity-neutral. We are slightly more positive on the ruble in the short term due to the risk-on mood. However we forecast the basket will approach 37 by 2013 due to weaker oil prices, capital outflows, unstable investor sentiment and the budget deficit of around RUB2tn in November-December.

Turkey

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The release of the 2Q GDP reading showed that the rebalancing in demand has advanced further in year-on-year terms, with domestic demand making a negative 2 pp contribution and foreign demand adding a hefty 5.7 pp to overall growth. In line with expectations, there was a considerable pick-up in 2Q, with GDP growing by 1.8% QoQ (seasonally and working day adjusted) following a contraction of 0.1%QoQ in 1Q. In our view, the weak state of domestic demand and the rising probability that this year's growth will remain below the 4% official forecast point to a more relaxed policy stance ahead of the fairly heavy election calendar. This suggests the CBT is likely to continue to keep its funding rate low (in the 6.0%-6.5% range) as long as the global environment permits. In our view, the sharp drop in interest rates complicates the outlook for the lira for the rest of the year. In this regard, there is some evidence to suggest that foreign investors in aggregate have reduced long TRY positions considerably in August. Against this backdrop and Turkey's large external financing needs, we expect the lira to weaken in Q4 this year, which may lead the CBT to tighten next year, or even earlier, depending on the degree of pressure on the currency.

Figure 32. 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	9.9	-0.8	4.5
Private Consumption	YoY	6.3	5.9	5.3	7.8	-0.3	4.5
Fixed Investment	YoY	8.0	6.7	9.0	18.5	-3.6	5.0
Exports	YoY	0.4	1.0	2.7	6.4	14.9	5.5
Imports	YoY	20.3	4.3	5.8	10.9	-2.4	6.2
CPI	YoY	8.4	5.1	6.9	6.5	9.1	7.0
Unemployment Rate	%	6.6	7.5	7.5	9.8	9.2	9.5
Current Account	US$ bn	98.8	107.1	46.6	-77.1	-60.1	-60.0
	% of GDP	5.3	5.7	2.4	-10.0	-7.5	-7.0
Fiscal Balance	% of GDP	2.0	0.3	0.1	-1.3	-2.2	-2.5
US Dollar Exchange Rate	Average	29.4	31.2	34.8	1.68	1.81	1.90

Sources: Haver Analytics and Citi Research

Hungary

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The MPC surprised with a 25bp rate cut in August, as external members outvoted internals based on the argument of broad-based economic weakness. The move came against the rising inflation outlook amidst contracting domestic demand, which supports our view that the evolution of risk premiums is likely to be the main constraint on the scope for the MPC (with its dovish bias) to deliver gradual rate cuts. While global risk appetite may support further gradual reduction in rates, fiscal risks and disagreements with the Troika about fiscal measures may increase specific domestic risk factors. In our view, the government is likely to be reluctant to change the core of its economic policies to compromise with loan conditions in the absence of market pressure, but the timing of the turning point is likely to depend on external factors. Rate cuts may continue in 25bp steps in the meantime, but we believe the chance of a halt in rate cuts during 2012 is high given domestic risk factors. From a funding prospective the government has sufficient reserves to roll over its debt until 2Q13. Rising local currency debt issuance or any FX debt issuance may be warning signals that the government's strategy is to avoid a deal at least until the next elections, which are due in spring 2014.

Poland

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In response to signs of economic slowdown the Monetary Policy Council (MPC) has softened its rhetoric substantially, shifting from "tightening" to "easing bias". Central bank governor Belka also signaled that the September communiqué de-facto opens doors for an interest rate cut either in October or November. This marks a significant change in the MPC's stance as the NBP was the only EU central bank to hike rates in May this year and only in July the Council insisted further hikes were more likely than cuts. In our view, the tone of the statement suggests interest rates might be cut by 25bp to 4.50% as early as October and will decline towards 3.75% in 2013. On the fiscal policy side, the 2013 budget draft presented by the government appears to be based on optimistic revenue assumptions and we believe the potential budget shortfall could reach 0.6% of GDP unless the Finance Ministry curbs spending or increases taxes (or receives larger than expected profit from the central bank). Taking this into account, we expect the topic of potential fiscal slippage will come to the fore in the coming months and is likely to add to the risk premium at the long end of the yield curve, contributing to its steepening.

Figure 33. Hungary and Poland — Economic Forecasts, 2011-2013F

		Hungary			Poland		
		2011	2012F	2013F	2011	2012F	2013F
Real GDP	YoY	1.7%	-1.1%	0.8%	4.3%	2.4%	2.2%
Final Domestic Demand	YoY	-1.2	-1.9	-1.2	3.5	1.3	1.8
Private Consumption	YoY	0.0	-1.1	-0.3	3.1	1.7	2.2
Fixed Investment	YoY	-5.4	-5.6	-4.0	8.3	1.2	1.2
Exports	YoY	8.4	1.9	4.5	7.5	2.0	2.3
Imports	YoY	6.3	0.5	3.1	5.8	-1.3	0.1
CPI	YoY	3.9	5.7	4.2	4.3	3.8	2.6
Unemployment Rate	%	11.6	11.0	10.8	12.5	13.1	13.5
Current Account	US$ bn	2.0	2.7	3.8	-22.2	-17.9	-19.6
	% of GDP	1.7	2.1	3.0	-4.3	-3.6	-3.6
Fiscal Balance	% of GDP	4.3	-3.1	-3.9	-5.1	-3.4	-3.0
Euro Exchange Rate	Average	279	291	305	4.12	4.17	4.29

Sources: Haver Analytics and Citi Research

Czech Republic

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The upward revision of GDP in 1H12 and the modest fall in value added has led us to slightly lift our 2012 GDP forecast to -1%YoY from -1.2% previously, but we are cutting our forecast of a modest 2013 recovery to 0.4% (0.6% previously). While the confidence indicator and base effects represent a negative risk to our forecasts, we expect the inventory cycle will be supportive for the economy next year. CPI inflation is likely to ease to 2.5% in 2013 after 3.4% this year, but this is accompanied by two risks – food prices and a significant political risk that the proposed hike in VAT rates to 15% and 21% is not approved (current alternative of VAT rates at 17.5% suggests inflation of around 1.5% in 2013E). Regarding political tensions, we expect the consolidation package (0.7% of GDP) will be approved in some form; if not there will be an early election in 1H13. We expect a 25bp cut in the policy rate to 0.25% on 27 September and probably to 0.05% by year-end. Furthermore, we also expect the Bank Board will introduce some form of 'conditional' commitment for its interest rate forecast. Our forecast for a weaker koruna over the next 2-3 quarters could ease monetary conditions after the policy rate reaches the effective zero bound. However, if the koruna maintains its appreciation momentum into 2013, this could result in FX intervention and even the possibility of negative policy rates.

Romania

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The August inflation reading, which came in above expectations (3.9% YoY vs. 3.7%), confirms our view that a sharp reversal in food prices is under way. This, coupled with the deterioration in forward-looking inflation expectations, and the lue depreciation, points to more difficult short-term inflation dynamics. The evolution of core inflation, which excludes administered prices and highly volatile prices, also confirms the deterioration in underlying inflation dynamics. With this backdrop, we expect YoY inflation to jump further in September and then fluctuate between 4.2% YoY-4.5% YoY thereafter, ending the year at around 4.5%. Given the increased probability that year-end inflation will exceed the upper uncertainty band for the inflation target (3% ±1pp), we believe the rationale for a tighter monetary policy stance is now much stronger than before. Against this backdrop, we expect the NBR to keep liquidity conditions tight. In our view, heightened political uncertainty and the ongoing euro area crisis are likely to keep depreciation pressures at elevated levels. This, coupled with a more challenging inflation outlook, suggests upward pressures on interest rates are likely to continue in the near term, which may even lead the NBR to consider tightening.

Figure 34. Czech Republic and Romania — Economic Forecasts, 2011-2013F

		Czech Republic			Romania		
		2011	2012F	2013F	2011	2012F	2013F
Real GDP	YoY	1.7%	-1.0%	0.4%	2.5%	1.3%	3.0%
Final Domestic Demand	YoY	-0.9	-1.9	-0.2	1.9	1.8	2.8
Private Consumption	YoY	-0.6	-2.6	0.2	1.3	0.8	2.7
Fixed Investment	YoY	-0.9	-1.4	0.8	6.2	6.5	3.5
Exports	YoY	11.0	4.3	1.7	10.5	-1.4	4.2
Imports	YoY	7.5	-0.8	0.7	11.5	-0.2	3.2
CPI	YoY	1.9	3.4	2.4	5.8	3.1	3.1
Unemployment Rate	%	8.5	8.5	8.8	5.4	5.0	5.0
Current Account	US$ bn	-6.3	-2.7	-3.0	-8.3	-7.0	-8.1
	% of GDP	-3.0	-1.4	-1.7	-4.4	-4.0	-4.7
Fiscal Balance	% of GDP	-3.1	-3.2	-3.2	-4.1	-2.4	-2.2
EURCZK, USDRON	Average	24.6	25.0	25.6	3.0	3.4	3.7

Sources: Haver Analytics and Citi Research

Brazil

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2Q12 GDP grew 0.4% QoQ, reinforcing the view that the current recovery is very soft compared with prior episodes of monetary easing. We believe global and domestic factors are behind this disappointing response, which supports our rather pessimistic view on 2012 and 2013 GDP growth, currently forecast at 1.4% and 3.9%, respectively. On the inflation front, food prices continue to exert upward pressure on CPI inflation, although these effects remain limited. Therefore, we maintain our 2012 and 2013 CPI inflation forecasts at 5.2% and at 5.6%. Regarding monetary policy, after the Copom's message that the easing cycle is approaching an end, we keep our view that the Selic rate will be cut by a final 25bp to 7.25% in October. Nonetheless, we postpone the beginning of the tightening cycle to October 2013. On the FX front, government/CB interventions will likely keep USD/BRL hovering around the range between 2.0 to 2.10. Finally, given the frustrating performance of tax revenues, explained by the weak recovery and tax exemptions, we now expect the primary fiscal surplus to reach 2.5% of GDP this year, below the 3.1% target.

Mexico

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Activity is slowing, but still performing reasonably well. GDP grew by 4.1% y/y in 2Q12 and 3.6% saar. Meanwhile, industrial production grew by 4.9% YoY in July, helped by yet another strong showing by transportation equipment (up 15% y/y). We reiterate our 3.9% GDP growth forecast for 2012. Inflation has recently risen due to supply-side shocks affecting farm prices — a bird flu outbreak led to disruptions in the local egg market. Thus, headline inflation was 4.6% y/y in August and is likely to surpass the upper limit of Banxico's variability range (4%) for several months; we now expect year-end annual headline inflation at 4.0%, up from 3.8% a month ago. Since there is no evidence that these shocks are leading to generalized price pressures, and recent peso strength should help to bring inflation down, we still think Banxico will stay on hold for the rest of 2012. President-elect Enrique Peña Nieto is already preparing to take office on December 1. Meanwhile, President Calderón used a new preferential-initiative faculty to submit two important Bills to the new Congress: a Labor Reform and a Reform to the General Law on Government Accounting, which extends federal transparency and accountability standards to the three orders of government. Incremental progress on the structural reform front is still our central scenario.

Figure 35. Brazil and Mexico — Economic Forecasts, 2011-2013F

		Brazil			Mexico		
		2011	2012F	2013F	2011	2012F	2013F
Real GDP	YoY	2.7%	1.4%	3.9%	3.9%	3.9%	3.8%
Final Domestic Demand	YoY	3.8	2.3	4.7	5.0	4.2	4.4
Private Consumption	YoY	4.1	3.0	4.6	4.5	3.7	4.0
Fixed Investment	YoY	4.7	-0.7	8.5	8.9	7.3	7.4
Exports	YoY	4.5	2.8	21.4	6.7	7.1	7.8
Imports	YoY	9.7	6.3	20.8	6.7	6.4	7.4
CPI	YoY	6.6	5.3	5.4	3.4	4.2	4.0
Unemployment Rate	%	6.1	6.3	6.5	5.2	4.8	4.8
Current Account	US$ bn	-52.5	-54.0	-71.6	-9.0	-11.5	-17.8
	% of GDP	-2.3	-2.3	-2.7	-0.8	-1.0	-1.4
Fiscal Balance	% of GDP	-2.6	-2.6	-2.4	-2.4	-2.2	-2.0
US Dollar Exchange Rate	Average	1.67	1.97	2.05	12.44	12.88	12.97

Sources: Haver Analytics and Citi Research

Argentina

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Activity indicators have improved recently, on the back of higher industrial production (particularly automobile production). However, there are some facts that should not go overlooked. First, Argentine automobile sales (i.e., exports plus domestic sales of national cars) remained under pressure during July-August, shrinking 19.6% YoY, compared to a 13.8% YoY drop during 1H12. Second, leading indicators do not suggest that a rebound is imminent. Consequently, in our view it may be premature to increase our non-official real GDP growth forecasts, and we continue to expect non-official (i.e. 'true') real GDP growth to be -1.7% and 2% in 2012 and 2013, respectively. However, we acknowledge that there might be an upside bias to our activity forecasts. (The table below shows our forecasts for official real GDP growth.) On the FX front, the BCRA has been raising the rate of depreciation of the ARS, following the marked appreciation of the ARS, in real multilateral terms over the last year. As per our estimates, the real effective exchange rate appreciated by 21% between July 2012 and the same month of 2011. Overall, we continue to expect the official USDARS to stand at 4.9 and 6 by the end of 2012 and 2013.

Venezuela

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With only weeks before the presidential election takes place on October 7, presidential campaigns by President Chávez and opposition candidate Henrique Capriles have reached their climax. In an environment in which both candidates have stepped up the mutual attacks, most polls still favor Mr. Chávez over Mr. Capriles. These results come despite the Amuay refinery accident, proof that President Chávez is showing what we define as the "non-stick surface effect", considering that no developments seem to be affecting his favorability and popularity. The opposition campaign argue that polls suggest Capriles is closing the gap, but to be clear this is only happening with one pollster, which creates uncertainty but does not affect our base case of a Chávez victory. As usual throughout past months, the economy has taken a secondary role as economic activity continues to flourish and inflation keeps trending down. We expect GDP growth of 5% and inflation of 18% for 2012. Nevertheless, the behavior of the economy going forward will depend on the results of the presidential elections as voters are choosing between two very different ways of handling the economy.

Figure 36. Argentina and Venezuela — Economic Forecasts, 2011-2013F

		Argentina			Venezuela		
		2011	2012F	2013F	2011	2012F	2013F
Real GDP	YoY	8.9%	1.5%	3.0%	4.2%	5.0%	3.5%
Final Domestic Demand	YoY	12.0	1.7	3.2	7.6	8.4	1.8
Private Consumption	YoY	10.7	3.1	3.4	4.0	6.2	0.7
Fixed Investment	YoY	-	-	-	4.4	7.5	2.2
Exports	YoY	4.3	-2.8	3.6	4.7	1.8	4.9
Imports	YoY	17.8	-3.3	5.0	15.4	14.3	-0.9
CPI	YoY	9.8	9.9	11.9	27.1	21.2	22.3
Unemployment Rate	%	7.2	7.5	8.3	6.5	6.0	6.3
Current Account	US$ bn	0.0	4.2	1.6	27.2	18.1	13.3
	% of GDP	0.0	0.9	0.3	9.1	4.9	4.1
Fiscal Balance	% of GDP	-1.7	-2.8	-3.0	-5.0	-5.0	-4.0
US Dollar Exchange Rate	Average	4.13	4.58	5.46	4.29	4.30	6.50

Sources: Haver Analytics and Citi Research

Saudi Arabia

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Saudi oil production continues at record-high levels, as global supply constraints and elevated geopolitical risks have maintained upward pressure on oil prices despite a worsening global economic outlook. August figures show production at just under 10mbpd, bringing the year to date average to 9.8mbpd. As a result, we have edged up our production assumption for 2012 to 9.75mbpd (from 9.6mbpd previously), while at the same time reducing our price forecasts for Brent for 2012 to US$108 per barrel (from 113 previously). With no change to our expenditure forecast, we expect the government's budget surplus will come in at around 14.5% of GDP in 2012, slightly below our previous forecast of 15.4% of GDP. We have not revised our forecast for growth in the non-oil economy, which will remain strong, at around 8.5%, this year on the back of continued high government expenditure and increased domestic demand. At the beginning of July, the Saudi Council of Ministers finally approved the long-awaited mortgage law and we believe it transforms the stagnant mortgage market, though some caution is merited given the likely challenges a surge in housing demand could introduce. August inflation eased significantly to just 3.8% YoY, the lowest level in over two years, though over the medium term we think the drive to hire Saudis in place of cheap foreign labour and rising demand for housing, given chronic supply shortages, are likely to add to medium-term inflationary pressure.

United Arab Emirates

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Investor demand for Dubai assets continues to improve following the positive message communicated by the successful refinancing of the three major public sector sukuk falling due this year. Yields on the 2017 Department of Finance sukuk have fallen from 4.8% at issuance earlier this year, to 3.1%, while the five-year CDS premium has fallen from 475bp at the start of the year to just 280bp. This is the lowest level since before the Lehman Brothers crisis. We remain positive on Dubai's macro-economic outline, despite significant global headwinds, but remain at the same time wary of the elevated regional political risks, particularly with respect to Iran, and the impact this may have on Dubai's asset prices. The Abu Dhabi Crude Oil Pipeline (ADCOP) has been inaugurated with a shipment of crude oil to a Pakistani refinery in July. The pipeline has a maximum capacity of 1.8mbpd, the majority of Abu Dhabi's 2.5mbpd production, and runs directly from Abu Dhabi to Fujairah on the UAE's east coast.

Figure 37. Saudi Arabia and United Arab Emirates — Economic Forecasts, 2011-2013F

		Saudi Arabia			United Arab Emirates		
		2011	2012F	2013F	2011	2012F	2013F
Real GDP	YoY	7.1%	7.8%	5.9%	4.2%	0.6%	3.4%
Final Domestic Demand	YoY	6.8	7.8	7.9	0.0	3.4	3.4
Private Consumption	YoY	4.7	5.0	5.0	4.0	2.0	2.0
Fixed Investment	YoY	10.1	10.0	10.0	-0.5	5.0	5.0
Exports	YoY	18.7	1.3	-2.0	14.3	13.0	13.0
Imports	YoY	13.7	15.0	15.0	6.5	15.0	15.0
CPI	YoY	5.0	7.0	8.0	0.9	1.1	1.3
Current Account	US$ bn	142.7	122.8	87.7	48.7	12.0	20.7
	% of GDP	23.9	19.1	13.6	15.9	3.7	6.0
Fiscal Balance	% of GDP	13.6	14.5	4.9	-	-	-
US Dollar Exchange Rate	Average	3.75	3.75	3.75	3.67	3.67	3.67

Sources: Haver Analytics and Citi Research

Egypt

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The changes to the leadership of the Supreme Council of the Armed Forces (SCAF) in mid-August, and the removal of much of its powers, have once again changed the political landscape in Egypt. In effect, the swings in power and popularity seen in 2012 have once again shifted back to the new president, Mohamed Mursi, and the Muslim Brotherhood (MB), from the military. With some clarity in the political outlook the government has the opportunity to push ahead with economic reform, while also seeking to re-write the constitution. The key signal of the government's reformist intentions will be the ability to sign a deal with the IMF. This may be possible by the end of 2012, although negotiations could well drag on into 2013. Any delay is likely to reflect the difficulties of moving forward from a general agreement on what policy changes need to be made, with discussions over exchange rate likely to be difficult. But the central bank has allowed the EGP to weaken marginally since June, although it is unclear how long it will let the current depreciation run for, or whether a more substantive adjustment is politically possible.

South Africa

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Despite the rebound in real GDP growth in Q2, driven by a recovery in the mining sector, we expect growth to remain weak in 2H following events at Marikana which will negatively impact on mining production. In addition, the prices of South African commodity exports have declined of late although the weaker rand is cushioning local producer margins, giving some boost to competitiveness. Nonetheless, real export performance remains poor and is further undermined by the Euro Zone debt crisis. Finally, there are some signs that the more solid consumer demand growth seen in 2011 also seems to be losing steam. The combination of these trends means that, while the current account deficit was moderate in 2011, we expect it to widen sharply in 2012-13. With concerns about weak growth dominant, monetary policy has remained accommodative for a sustained period. In fact, given the lack of fiscal space, the SARB seems convinced that the only support to the economy in the short term will come from monetary policy, hence the surprise 50 basis point cut in the Repo rate to 5% in July. The challenge for the SARB will be whether it will make another cut in late 2012 or early 2013. But the reality remains that, despite efforts at more micro-focused policy interventions, structural obstacles to stronger growth will not dissipate soon and continue to limit the economy's ability to generate sufficient employment. All this continues to point to a weaker rand going forward.

Figure 38. Egypt, Nigeria and South Africa — Economic Forecast, 2011-2013F

		Egypt			Nigeria			South Africa		
		2011	2012F	2013F	2011	2012F	2013F	2011	2012F	2013F
Real GDP	YoY	1.8%	2.0%	2.7%	7.8%	7.4%	6.5%	3.1%	2.7%	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	7.5	10.8	10.8	11.9	10.2	5.0	5.5	4.8
Unemployment Rate	%	12.1	13.0	14.5	NA	NA	NA	26.0	25.7	25.2
Current Account	US$ bn	-5.4	-7.1	-7.2	8.8	6.9	11.9	-13.6	-21.7	-22.2
	% of GDP	-2.3	-2.9	-2.8	3.4	2.3	3.4	-3.4	-5.7	-5.6
Fiscal Balance	% of GDP	-10.1	-9.3	-7.7	-3.1	-2.2	-2.1	-5.0	-4.8	-4.2
US Dollar Exchange Rate	Average	5.94	6.09	6.63	155.9	158.28	161.42	7.26	8.16	8.68

Sources: Haver Analytics and Citi Research

Figure 39. Selected Emerging Market Countries — Economic Forecast Overview, 2011-2013F

	GDP Growth			CPI Inflation			Current Balance (% of GDP)			Fiscal Balance (% of GDP)		
	2011	2012F	2013F	2011	2012F	2013F	2011	2012F	2013F	2011	2012F	2013F
Asia	**7.3%**	**6.3%**	**6.5%**	**5.7%**	**3.5%**	**3.7%**	**2.3%**	**1.6%**	**1.2%**	**-2.1%**	**-2.9%**	**-2.2%**
China	9.3	7.9	7.6	5.4	2.9	3.3	2.8	2.0	1.5	-1.3	-2.4	-1.5
Hong Kong	5.0	2.2	3.8	5.3	3.8	3.2	5.1	5.0	5.5	3.9	0.8	1.1
India*	6.5	5.4	6.2	8.9	8.0	7.0	-4.2	-3.0	-2.1	-8.4	-8.5	-8.0
Indonesia	6.5	6.2	6.1	5.4	4.4	4.7	0.2	-2.3	-1.7	-1.2	-2.1	-1.5
Korea	3.6	2.6	3.3	4.0	2.4	2.8	2.4	2.1	1.5	1.5	0.8	1.3
Malaysia	5.1	5.0	5.3	3.2	1.8	2.4	11.0	5.0	4.0	-4.8	-4.7	-4.3
Mongolia	17.3	16.0	17.5	9.2	13.0	14.0	-32.4	-25.5	-10.4	-3.6	-3.7	-1.5
Philippines	3.9	5.0	5.3	4.8	3.3	3.5	3.1	2.6	2.4	-2.0	-2.4	-2.1
Singapore	4.9	2.3	3.2	5.2	4.5	3.2	21.9	15.1	14.1	1.5	1.0	1.0
Sri Lanka	8.3	6.7	7.3	6.8	7.4	7.6	-7.8	-4.5	-3.8	-6.9	-6.7	-6.0
Taiwan	4.0	1.7	3.6	1.4	2.0	2.0	8.8	8.7	8.4	-1.9	-1.6	-1.6
Thailand	0.1	4.8	4.6	3.8	2.9	3.1	3.4	-2.9	-2.2	-1.5	-4.7	-3.9
Vietnam	5.9	5.2	5.6	18.6	8.9	7.1	-0.6	0.3	-0.6	-2.9	-4.5	-4.3
Latin America	**3.9**	**2.4**	**3.8**	**6.8**	**5.8**	**5.8**	**-1.1**	**-1.4**	**-1.8**	**-2.3**	**-2.4**	**-2.2**
Argentina	8.9	1.5	3.0	9.8	9.9	11.9	0.0	0.9	0.3	-1.7	-2.8	-3.0
Brazil	2.7	1.4	3.9	6.6	5.3	5.4	-2.3	-2.3	-2.7	-2.6	-2.6	-2.4
Chile	6.0	4.9	4.5	3.3	3.0	3.1	-1.3	-2.8	-2.5	1.4	0.7	0.6
Colombia	5.9	4.0	4.5	3.4	3.2	3.2	-3.0	-3.0	-2.9	-2.9	-1.8	-1.6
Mexico	3.9	3.9	3.8	3.4	4.2	4.0	-0.8	-1.0	-1.4	-2.4	-2.2	-2.0
Panama	10.6	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	6.1	5.8	3.4	3.7	3.0	-1.9	-3.3	-2.6	1.8	0.5	-0.6
Venezuela	4.2	5.0	3.5	27.1	21.2	22.3	9.1	4.9	4.1	-5.0	-5.0	-4.0
Europe	**5.0**	**2.7**	**3.5**	**6.7**	**5.3**	**5.8**	**-0.2**	**0.3**	**-1.2**	**-0.3**	**-1.3**	**-1.2**
Czech Republic	1.7	-1.0	0.4	1.9	3.4	2.4	-3.0	-3.3	-5.3	-3.1	-3.2	-3.2
Hungary	1.7	-1.1	0.8	3.9	5.7	4.2	1.7	2.1	3.0	4.3	-3.1	-3.9
Kazakhstan	7.5	5.5	6.0	8.3	5.1	5.7	7.6	1.9	2.4	5.9	1.7	3.0
Poland	4.3	2.4	2.2	4.3	3.8	2.6	-4.3	-3.6	-3.6	-5.1	-3.4	-3.0
Romania	2.5	1.3	3.0	5.8	3.1	3.1	-4.4	-4.0	-4.7	-4.1	-2.4	-2.2
Russia	4.3	3.5	4.0	8.4	5.1	6.9	5.3	5.7	2.4	2.0	0.3	0.1
Slovakia	3.3	2.4	1.3	3.9	3.6	2.7	0.1	1.1	-1.1	-4.8	-4.9	-3.3
Turkey	8.5	2.5	4.3	6.5	9.1	7.0	-10.0	-7.5	-6.9	-1.3	-2.2	-2.5
Ukraine	5.1	2.1	3.5	8.0	1.2	8.1	-5.2	-7.3	-5.4	-3.8	-3.6	-2.6
Africa/Mideast	**5.8**	**4.3**	**5.0**	**5.5**	**5.6**	**5.8**	**10.2**	**8.8**	**8.3**	**2.2**	**2.8**	**0.1**
Bahrain	1.9	2.8	3.6	-0.4	3.0	3.5	10.3	11.4	3.3	-1.1	0.4	-0.3
Egypt	1.8	2.0	2.7	10.2	7.5	10.8	-2.3	-2.9	-2.8	-10.1	-9.3	-7.7
Ghana	14.4	7.5	6.5	8.7	10.2	8.4	-8.2	-7.3	-4.9	-5.4	-6.8	-6.2
Iraq	9.4	9.3	11.5	5.6	5.0	6.0	-5.1	28.1	50.7	15.8	11.8	14.3
Israel	4.9	2.7	3.0	3.4	2.0	2.2	0.1	-1.5	-1.1	-2.7	-3.7	-3.2
Jordan	2.6	2.5	3.0	4.4	5.0	5.0	-12.4	-14.2	-13.5	-7.0	-11.0	-12.5
Kenya	4.5	5.0	5.8	14.0	9.7	5.8	-11.8	-10.5	-9.5	-5.5	-5.0	-4.9
Kuwait	4.0	0.9	2.8	4.7	5.0	5.0	44.1	43.9	41.1	17.1	13.4	4.4
Lebanon	6.0	3.5	4.3	5.1	6.0	5.0	-22.9	-24.2	-25.1	-5.7	-6.9	-8.1
Nigeria	7.8	7.4	6.5	10.8	11.9	10.2	3.4	2.3	3.4	-3.1	-2.2	-2.1
Oman	3.5	3.0	4.4	4.0	3.0	3.0	16.4	2.7	8.3	5.6	6.0	3.0
Qatar	18.1	6.0	8.3	3.0	3.0	3.0	31.6	31.0	24.2	8.1	7.1	3.3
Saudi Arabia	7.1	7.8	5.9	5.0	7.0	8.0	23.9	19.1	13.6	13.6	14.5	4.9
South Africa	3.1	2.7	3.6	5.0	5.5	4.8	-3.4	-5.7	-5.6	-5.0	-4.8	-4.2
Tanzania	6.3	6.2	6.8	12.7	15.4	7.7	-20.1	-11.9	0.0	-7.8	-6.2	-5.8
UAE	4.2	0.6	3.4	0.9	1.1	1.3	15.9	3.7	6.0	NA	NA	NA
Uganda	5.7	4.5	5.5	18.7	14.7	5.7	-13.2	-12.5	-10.7	-7.2	-5.5	-5.2
Zambia	6.6	6.5	6.9	6.4	6.7	6.9	0.4	2.6	2.4	-3.2	-3.5	-3.7
Total	**6.0**	**4.7**	**5.3**	**6.0**	**4.5**	**4.7**	**2.1**	**1.6**	**1.0**	**-1.4**	**-1.9**	**-1.8**

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

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Source: Citi Research.

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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 (2-3 quarters) and longer (2-3 years) term. Citi economists and strategists continue to expect further downgrades over the near term in the euro area, and a broader range of downgrades over the longer term.

Figure 42. Advanced Economies — Sovereign Long-Term Debt Ratings and Citi Ratings Forecasts

	S&P Ratings				Moody's Ratings			
Country	Current Rating	Current Outlook	Citi Near-term (Up to 9 Months) Forecast Rating	Citi Longterm (Next 2-3 Years) Forecast Rating & Outlook	Current Rating	Current Outlook	Citi Near-term (Up to 9 Months) Forecast Rating	Citi Longterm (Next 2-3 Years) Forecast Rating & Outlook
US	AA+	Neg	AA+ (Neg)	AA ↓	Aaa	Neg	Aaa (Neg)	Aa1 ↓
Canada	AAA	Stable	AAA	AAA	Aaa	Stable	Aaa	Aaa
Japan	AA-	Neg	AA- (Neg)	A+ ↓	Aa3	Stable	Aa3	A1 ↓
Germany	AAA	Stable	AAA (Neg W)	AA+ ↓	Aaa	Neg	Aa1 ↓	Aa1 ↓
France	AA+	Neg	AA+ (Neg W)	AA (Neg) ↓	Aaa	Neg	Aa1 ↓	Aa1 (Neg) ↓
Italy	BBB+	Neg	BBB ↓	BBB- ↓↓	Baa2	Neg	Ba1 (Neg) ↓↓	Ba2 ↓↓↓
Spain	BBB+	Neg	BBB ↓	BBB - ↓↓	Baa3	Neg W	Ba1 (Neg) ↓	Ba2 ↓↓
Austria	AA+	Neg	AA+ (Neg W)	AA (Neg) ↓	Aaa	Neg	Aa1 ↓	Aa1 (Neg) ↓
Belgium	AA	Neg	AA (Neg W)	AA- ↓	Aa3	Neg	A1 ↓	A1 ↓
Finland	AAA	Neg	AAA (Neg W)	AA+ (Neg) ↓	Aaa	Stable	Aaa (Neg)	Aaa (Neg)
Greece	CCC	Neg	D ↓↓↓↓	CCC ↑↑↑↑	C		C	Caa2 ↑↑↑↑
Ireland	BBB+	Neg	BBB ↓	BBB- ↓↓	Ba1	Neg	Ba2 ↓	Ba2 ↓
Netherlands	AAA	Neg	AAA (Neg W)	AA+ (Neg) ↓	Aaa	Neg	Aa1 ↓	Aa1 (Neg) ↓
Portugal	BB	Neg	B+ ↓↓	CCC ↓↓↓↓↓	Ba3	Neg	B1 ↓	Caa2 ↓↓↓↓↓
UK	AAA	Stable	AAA (Neg)	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 Research

Key Expected Ratings Issues

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Given Citi's view of the probability of a Greek exit in the near term (next 2-3 quarters) and comments by the rating agencies, we continue to expect the ratings of many core EMU sovereigns to be downgraded some time in the next 2-3 quarters, including Germany. These moves reflect the weak economic backdrop and broad-based fiscal slippage compounded by Greek exit. Our views also reflect the fact that Moody's and S&P already have many EMU countries on Negative Outlook. Full details can be found in our latest *Sovereign Ratings Outlook.*

Improved sentiment but fundamental rating drivers largely unchanged

Views largely unchanged and mostly predicated on a 'Grexit' scenario

Going forward, our views on how sovereign ratings might evolve are largely unchanged since we last published. Recent developments have affirmed our views and have not alleviated our general expectations for downward ratings pressures:

ECB announcement has not altered our expectations on sovereign ratings going forward

- **ECB announcement largely neutral on ratings:** Although the market impact from the ECB's OMT announcement has been mostly positive, both Moody's and S&P indicate the impact on ratings is not as significant. Both rating agencies point to the potential benefits of the program but that ultimately, it is largely a buying time exercise. S&P noted (7th Sept) that "*The announcements that the ECB made largely conform with Standard & Poor's Rating Services' expectations and therefore do not affect our current euro area sovereign ratings and outlook*" They conclude, "*the ECB's position has been constructive….it's up to the governments to use this respite effectively*". Moody's has a similar view in their piece entitled "*ECB Debt Purchases Can Buy Time for Struggling Sovereigns, but Crisis Resolution Requires Government Action*" (10th Sept).

Spain likely to remain Baa3 in the very near-term

- **Moody's extends its review of Spain's Baa3 rating:** Spain remains under review for a possible further downgrade by Moody's. A review period typically lasts three months, but this review was extended on 30th August. Given that Spain has not requested aid and might not for several weeks, Spain is likely to remain Baa3 in the very near term in our view, probably due to the review period extending beyond September. However, the precise impact of any forthcoming assistance on Spain's Baa3 rating will likely remain uncertain, largely because we believe Spain will maintain a degree of market access in the event of receiving some form of official support (*International Interest Rate Strategist*).

Moody's comments and our economic forecasts continue to point to a US downgrade over the longer term

- **Moody's provides an update on the US Outlook:** Moody's affirmed in a special comment (11th September) that the "*the direction of the US rating and its outlook will most likely be determined by the outcome of budget negotiations during the course of 2013*". Citi continues to expect a one-notch downgrade of the US by Moody's and S&P over the next 2-3 years.

- **Dutch elections and ESM judgement largely credit neutral:** S&P stated in separate notes that the German Constitutional Court ruling on the ESM and the election results in the Netherlands have no immediate rating implications.

Global outlook: dwindling pool of AAA/Aaa sovereigns

Over the longer-term, given Citi's global economic projections and fundamentally weak backdrop, we continue to expect downwards rating pressure. Together with the US, we also envisage downwards ratings pressure for Japan over the next 2-3 years, predicated on longer-term debt sustainability trends. Canada and the Scandinavian countries are the only countries covered in our Sovereign Ratings Outlook where we believe rating agencies will maintain a "AAA Stable" status in both the near and the longer term.

European Interest Rate Strategy

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Later this year or early next year, the OMT will be transformed from being a rather credible threat to sellers of periphery into yet another version of credit easing. The impact of OMT's activation shall be felt not only in peripheral bond markets, but also in core Europe. Furthermore, rate cuts are not yet fully priced in by the market, while still being firmly on ECB's agenda. The combination of lower refinancing rates and bond purchases will most likely result in an unanticipated medium-term steepening of both core and non-core yield curves.

Between Sovereign Risk and the ECB

Expect OMT activation by Q1 2013…

The near-term outlook for Bunds will be again dictated by sovereign credit dynamics and more specifically by the uncertainty that surrounds both levels and timing of activation of the OMT framework for Spain. In our forecast we assume that Madrid will request ECB's assistance in Q1 2013 at the latest and that the period preceding the official announcement will be characterized by renewed stress in peripheral EGB markets. We expect this stress will manifest itself not just in the absolute level of German, Italian and Spanish yields, but also in a typical bear flattening of peripheral yield curves.

…to result in a strong performance of short-dated peripheral bonds

OMT's impact will be felt significantly in Q1 and Q2 2013. Especially, the 1-3y sector of the Italian and Spanish government bond curves are likely to enter a medium-term normalization process. An increased level of segmentation of the funding curve into very specific preferred habitats will likely be accompanied by the incentive to further reduce the average duration of peripheral debt. While we are convinced of the performance at the front-end of Italy and Spain in the event of OMT, we're also less certain about the outlook for 10y spreads.

Bunds to trade closer to equilibrium in the absence of a large risk premium

In the longer term, we expect Bunds to revisit the 1.80/2.20% range seen between Q3 2011 and Q1 2012. This trajectory roughly validates the 1y to 2y German forward curve. In the absence of a strong sovereign risk premium, the fundamental level for 10y Germany is more likely to hover around levels that reflect not only ECB's inflation target, but also a structurally low level of potential growth in the Euro area. In the process, we will also witness further compression in swap spreads coming from a more benign sovereign credit environment, a persistently low level of short-term rates as well as an increasingly blurred grid of implied credit ratings for EMU members. The main risk to our scenario is the event of Greece exiting the Eurozone, which we believe is not correctly discounted by the market and could lead to a short-term spike in risk aversion and Bund valuations.

Rate cuts and a steeper yield curve are not priced in by forwards

Short-term rates are likely to stay close to 0% over our forecast horizon, but we do not exclude periods of negative interest rates and yields in the likely event of a deposit rate cut into negative territory by the ECB. At current levels, the Eonia curve implies a non-insignificant probability of a deposit rate cut by February 2013. As a result, the tendency towards a steeper German yield curve is the result of our core scenarios for the Bund and the ECB. Note that this pronounced steepening is an active view against the forward curve, which is actually implying a 20 basis point flatter yield curve over the coming 24 months.

Figure 43. Interest Rate and Bond Market Forecasts as of 19 Sep 2012

		Quarterly Average					
	Current	4Q 12	1Q 13	2Q 13	3Q 13	4Q 13	1Q 14
US							
Policy Rate (Fed Funds) End Quarter	0.25	0.25	0.25	0.25	0.25	0.25	0.25
3-Month Libor	0.38	0.35	0.40	0.50	0.60	0.70	0.80
2 Year Treasury Yield	0.25	0.21	0.30	0.50	0.60	0.75	0.90
5 Year Treasury Yield	0.69	0.65	0.75	0.95	1.10	1.35	1.60
10 Year Treasury Yield	1.83	1.65	1.75	2.00	2.25	2.55	2.75
30 Year Treasury Yield	2.99	2.85	2.95	3.20	3.45	3.80	3.95
2-10 Year Treasury Curve	158	144	145	150	165	180	185
2 Year Swap Spread (Swap Less Govt.), bp	13	20	25	30	35	35	35
10 Year Swap Spread (Swap Less Govt.), bp	4	10	15	25	25	25	25
30 Year Swap Spread (Swap Less Govt.), bp	-25	-30	-35	-40	-45	-50	-50
30 Year Mortgage Yield	3.52	3.45	3.55	3.80	4.00	4.20	4.40
10 Year Breakeven Inflation	256	260	260	250	245	240	240
Euro Area							
Policy Rate	0.75	0.50	0.25	0.25	0.25	0.25	0.25
Overnight Rate (EONIA)	0.08	0.08	-0.15	-0.15	-0.15	-0.15	-0.15
3-Month Libor	0.24	0.15	0.05	0.00	0.00	0.00	0.00
2 Year Treasury Yield	0.06	0.00	-0.05	0.00	0.05	0.10	0.10
5 Year Treasury Yield	0.62	0.50	0.55	0.60	0.75	1.00	1.00
10 Year Treasury Yield	1.67	1.50	1.55	1.60	1.75	2.00	2.00
30 Year Treasury Yield	2.43	2.30	2.35	2.40	2.50	2.60	2.60
2-10 Year Treasury Curve	161	150	160	160	170	190	190
10 Year BTP-Bund Spread	340	400	300	325	325	300	275
10 Year Bono-Bund Spread	427	525	375	400	375	350	325
2 Year BTP-Schatz Spread	239	325	345	300	280	260	235
2 Year Bono Schatz Spread	341	450	325	300	280	260	235
10 Year Swap Spread (Swap Less Govt.), bp	23	40	25	20	15	10	10
10 Year Breakeven Inflation	201	170	180	185	195	200	200
Japan							
Policy Rate	0.10	0.10	0.10	0.10	0.10	0.10	0.10
3-Month Libor	0.19	0.20	0.20	0.20	0.20	0.20	0.20
2 Year Treasury Yield	0.10	0.10	0.10	0.15	0.10	0.15	0.15
5 Year Treasury Yield	0.21	0.25	0.35	0.40	0.35	0.50	0.50
10 Year Treasury Yield	0.80	0.95	1.10	1.20	1.10	1.30	1.30
30 Year Treasury Yield	1.90	2.00	2.10	2.20	2.10	2.25	2.25
2-10 Year Treasury Curve	70	85	100	105	100	115	115
2 Year Swap Spread (Swap Less Govt.), bp	20	21	23	25	23	27	27
10 Year Swap Spread (Swap Less Govt.), bp	0	3	4	6	4	8	8
UK							
Policy Rate	0.50	0.50	0.50	0.50	0.50	0.50	0.50
3-Month Libor	0.65	0.75	0.75	0.75	0.75	0.75	0.75
2 Year Treasury Yield	0.22	0.30	0.25	0.40	0.65	0.80	0.85
5 Year Treasury Yield	0.82	0.75	0.70	0.80	0.85	1.15	1.25
10 Year Treasury Yield	1.90	1.70	1.60	1.80	2.00	2.25	2.35
30 Year Treasury Yield	3.15	2.60	2.65	2.70	2.80	2.90	3.00
2-10 Year Treasury Curve	168	140	135	140	135	145	150
10 Year Swap Spread (Swap Less Govt.), bp	11	45	45	40	35	30	30
Australia							
Policy Rate	3.50	3.50	3.50	3.50	3.50	3.50	3.75
3-Month Libor	3.58	3.60	3.60	3.60	3.60	3.70	3.90
2 Year Treasury Yield	2.83	2.80	2.70	2.70	2.90	3.00	3.30
5 Year Treasury Yield	2.77	2.80	2.75	2.75	2.90	3.10	3.40
10 Year Treasury Yield	3.26	3.10	3.30	3.60	3.80	4.00	4.10
2-10 Year Treasury Curve	43	30	60	90	90	100	80
10 Year Swap Spread (Swap Less Govt.), bp	69	75	70	65	60	60	60

Source: Citi Research

Credit Strategy Outlook

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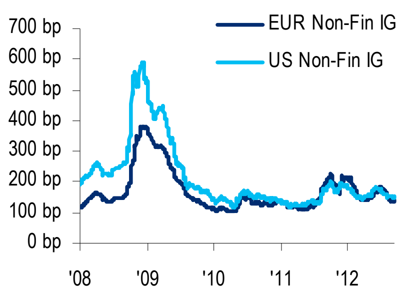
It's been risk-on since early summer, with the ECB's announcement of a new bond purchase program being the latest major catalyst. We were certainly impressed with how well the central bank managed expectations and many of the details of its new programs. And the Fed's latest QE program, detailed last week, helped sentiment as well. Clearly the prospect for a tail event any time soon has diminished sharply, but that said, while we believe that the most likely case is for further spread tightening in the near term, we would like to point out two limitations to spread tightening that the broad credit market may face in the period ahead.

First, to the extent that we are in a risk-on environment, we are not at all sure that the typical corporate bond is an effective way for most market participants to take advantage. There are exceptions (e.g., European financials, triple-Cs, etc.), but by and large many valuation metrics for the typical issuer are already very full. For example, the spread for the average high-grade non-financial issue in the European market is now only about 40 bp from the post Lehman tights, and in the US the typical high-grade name is 29 bp from the recent lows (see Figure 44).

Figure 44. High-grade non-fin spreads are near Apr '10 tights



Source: Citi Research
Note: As of September 12, 2012

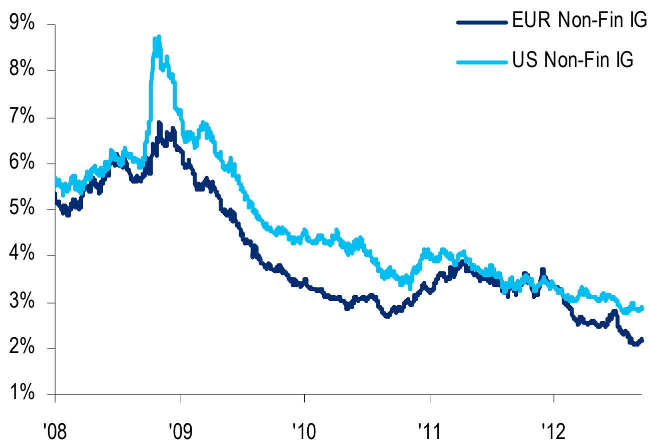
But what really highlights the "richness" of credit is the yield and price metrics. For example, the yield available for the typical corporate bond back in April '10 (previous spread tights) was 4.0% for the average single-A in the US, versus 2.6% currently. Does a 2.5%-ish yield really enable the typical investor to meet investment objectives? This single-A example is indicative of the low corporate yield problem throughout the credit space (see Figure 45). We believe that at least some market participants will increasingly look to higher-yielding alternatives, particularly in a risk-on environment.

And with regard to price, note that the typical double-B name in the US is now trading at a dollar price of approximately $108, relative to $102 back in April '10. Given that high-yield is a callable market, that's quite a large premium already, in our view. And it is also worth noting that part of the spread advantage now vs. the April '10 tights is attributable to the higher dollar prices and more dollars at risk

So we would argue that by historical standards credit may not have much room to run, and we come to the same conclusion if we compare corporate valuations to valuations in other markets as well.

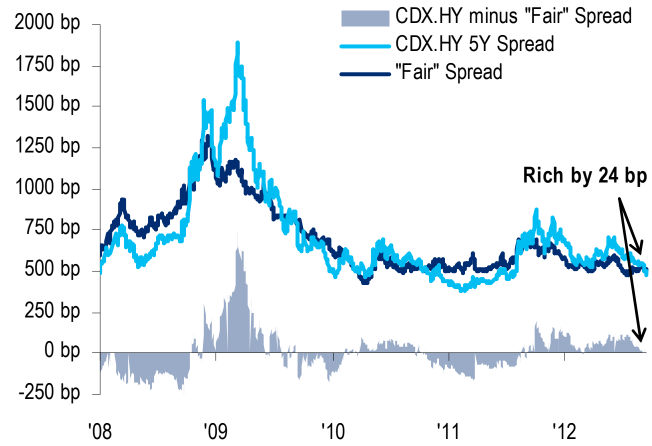
For example, our 'fair' value model takes into account default risk and a measure of systemic risk that is based on traded assets in other markets, such as the VIX, swaptions, etc. The output of this model is essentially the spread at which credit should trade in order to be consistent with valuations in other markets. We find that the typical high-yield issuer, for example, now appears to be 24 bp rich (see Figure 46).

Figure 45. Yields for non-fin corporates in both US and Europe are at multi-year lows…valuations appear full



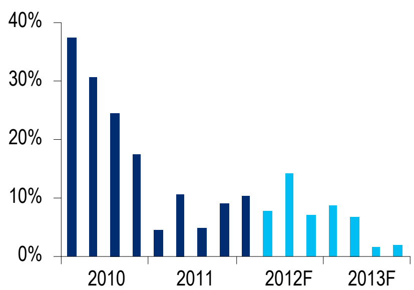
Source: Citi Research
Note: As of September 12, 2012

Figure 46. Credit appears to be rich relative to "fair" value



Source: Citi Research, Moody's
Note: As of September 12, 2012

Figure 47. Our economists expect growth in corporate profits to continue trending lower



Note: Forecasts as of August 2012
Source: Citi Research

Our second worry is that, while risk has lessened some still remains, both long-term and short-term. Yet the market appears to be very complacent about this fact. For example, we struggle to understand how the longer-term outlook in Europe has improved all that much. A Greek exit still seems likely, perhaps even following the December / January troika review, given the combination of EU governments' reluctance to cough up more money and the Greek government's continued need of it. The ECB may be able to lower borrowing costs for Spanish and Italian banks, but they seem unlikely to engage in new lending until their capital hole is plugged. And the US is starting to become more aware of its dependence on unsustainable fiscal policy (*"Moody's Says US Facing Loss of Aaa Rating Without Budget Deal Next Year,"* states Bloomberg).

With regard to corporate fundamentals, we see potential problems there as well. Declining corporate revenues and stubbornly high unemployment suggest that profits could wane meaningfully relative to analyst expectations. To that end, we're very concerned that FedEx and Intel's profit warnings could be just a taste of what's to come. And our economists seem to agree. In Figure 47 we present their growth forecasts for corporate profits, and the trend is lower, not higher.

But perhaps above all else, we have seen before that, while the unlimited firepower of central banks can temporarily produce impressive effects in the markets, their ability to produce a sustained revival in the economic backdrop remains remarkably limited. The bottom line is that, while the most likely scenario is further tightening in the near term, in our view the market is understating risk and spread widening potential.

Global Equity Strategy

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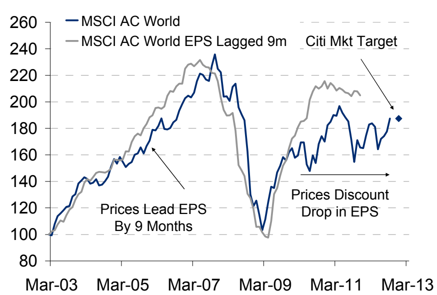
Global equities are up 14% YTD. Major central banks have not disappointed in terms of policy action, which seems to have helped markets rally. This means we have just reached our end-2012 target for MSCI AC World. To have markets rise materially from here, we need to see a re-acceleration in EPS growth and/or new money flowing back into equities.

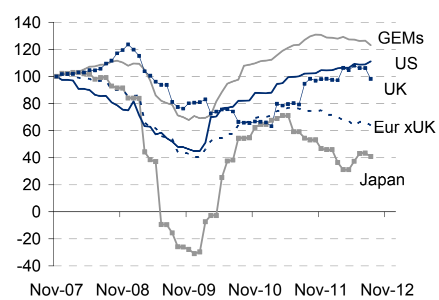
Figure 48 shows the relationship between global share prices and the trailing EPS index lagged by 9 months. Between 2003 and 2010, prices led EPS. Since then, this relationship suggests that prices have started to discount a contraction. Bottom-up consensus forecasts for 2012 have been cut during last few months and now stand at 5% for 2012 and 13% for 2013. An aggregation of Citi strategists' top-down forecasts suggests 6% EPS growth in 2012 followed by 6% in 2013. This suggests that Citi strategists are not forecasting a contraction in global profits, but they are less optimistic than bottom-up consensus.

Figure 48. MSCI AC World Price vs EPS (9m Lagged)



Source: MSCI, Citi Research

Figure 49. Trailing EPS Since November 2007



Source: Citi Research, Factset

A slowing global economy is reflected in slowing global EPS. Figure 49 shows trailing EPS since the global peak in November 2007. Only the US and EM have regained their previous highs. The scope for further EPS growth in the US is limited by already-high margins and a slowing economy, in our view. UK EPS, which has been surprisingly strong, has started to deteriorate given the weak domestic economy, exposure to the Eurozone crisis and the lower commodity prices. The Eurozone crisis has dragged Europe ex UK EPS back down to 35% below highs of 2007 and EMU recession is likely to prove a continued drag here. Overall, we suspect that the downside risks to global EPS have been rising. However, there appears to be a lot of bad news already priced in. Cheap valuations help limit the downside when pullbacks occur. Global equities are trading at 18x Cyclically Adjusted PE (CAPE) while the long-term average is 25x.

Our key regional and sector recommendations are summarised in Figure 50. Lower global GDP forecasts mean that those areas generating some growth should be valued more highly. In line with this view, we have increased our exposure to those regions with solid EPS and GDP trends, while at the same time lowered the importance of valuation in our allocation. We are Neutral on the US. GDP growth in the US, while not stellar, has remained stable over the last 18 months while other regions have fallen back into recession. Although US equity valuations are amongst the most expensive in the world, they are not extreme enough to offset the positives of superior EPS and GDP, in our view. Within the US, our strategists like IT as earnings remain solid and Telecoms as valuations are appealing.

By comparison, the Eurozone economy is only part way through a contraction, which continues to be a considerable drag on corporate profits. Although Continental European equities trade on relatively low valuations, we are Underweight the region given the uninspiring EPS outlook. Within Europe, our strategists are most cautious on some of the domestic-focused sectors such as Construction.

We are Neutral on the UK. The UK economy is also contracting but 70-80% of FTSE 100 sales come from outside of the UK, much of this directly from Emerging Markets. Large international exposure means that UK profits are very sensitive to moves in a currency which is now being depressed by unconventional monetary policy. We are also Neutral on Emerging Markets. EM companies have struggled to turn premium GDP growth into premium EPS growth and we don't see this changing soon.

Our preferred equity markets right now are all in Asia. This includes Japan, Asia Pac ex Japan and Australia where we are Overweight. Unlike Europe, Asia is not suffering a recession. By contrast, Japan has experienced a rebound in GDP and EPS following the earthquake last year. Within Japan, our strategists prefer Autos and Financials. Japanese Financials trade close to European Bank valuations but without the intertwined sovereign risks. Within Asia Pac ex Japan, our strategists like Energy, which trades on depressed valuations and IT, which benefits from solid EPS momentum. We like Australia, which benefits from easy monetary policy and attractive valuations. The dividend yield is amongst the highest in the world at more than 5%. Within Australia, our strategists are buyers of the Energy sector.

Figure 50. Regional And Global Sector Recommendations (Arrows show latest changes)

Global Regions		
Overweight	**Neutral**	**Underweight**
Asia Pac ex Japan	Global Emerging Markets	Europe ex UK
Australia	UK	
Japan	US	
Global Sectors		
Overweight	**Neutral**	**Underweight**
Energy	Consumer Staples	Consumer Discretionary
Health Care	Financials	Industrials
IT	Materials	Utilities
	Telecoms	
Sectors		
Overweight		**Underweight**
Japan - Autos		US - Capital Goods
Australia - Energy		Europe - Construction
CEEMEA - Energy		GEMs - Consumer Staples
Asia ex Japan - Energy		US - Materials
GEMs - Financials		Europe - Media
Japan - Financials		US - Retailing
US - Telecoms		Europe - Telecoms
Asia ex Japan - IT		GEMs - Telecoms
US - IT		Europe - Utilities
Europe - Pharmaceuticals		Japan - Utilities

Source: Citi Research

Securitized Products Strategy

'Lower for Longer' Strategies

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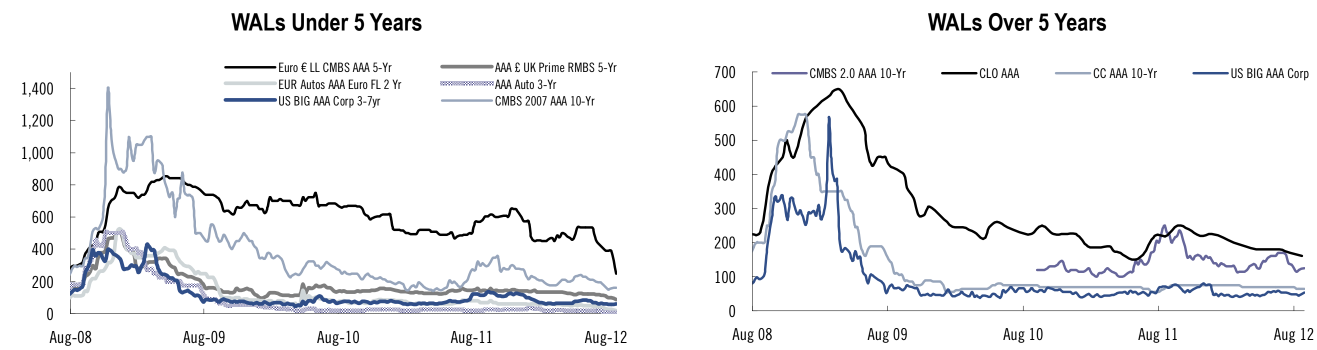
Investments in virtually all the securitized products sectors fit well with the Central Banks' 'lower for longer' policies, in our view. Our recommendations balance short and stable investments with more aggressive positions that take a view on improving collateral performance. A relatively stable market environment and ongoing moderate fundamental improvement should provide support for securitized products. Yet ironically, the global slowdown, the European debt crisis and the looming US 'fiscal cliff' are reinforcing the market's resolve to remain short and high quality, and reinforcing ABS performance. The core consumer ABS sectors like credit card, auto and FFELP student loan ABS are low-volatility sectors offering good spread pickup to Treasuries and Agencies.

Figure 51. Selected Securitized Products Sectors — Spread Performance, Aug 08-Sept 12



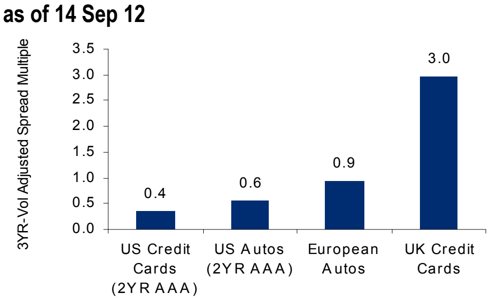
Source: Citi Research

Higher Volatility Sectors Pay Well Per Unit of Volatility

The higher volatility sectors also pay more per unit of volatility, measured over a three year period.

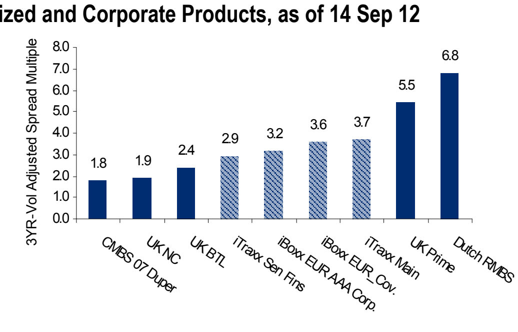
European ABS and RMBS, and US CMBS dupers in particular stand out as offering good value per unit of spread volatility when measured over a three-year period (see Figure 52 and Figure 53). In the high-quality, short WAL space, current 2YR US credit card and auto ABS offer only 40–60% as measured against 3YR spread volatility, while comparable European auto and UK credit card ABS offer 90–300% (see Figure 52). Residential and commercial mortgage sectors represent higher-risk/higher-return plays, yet offer more attractive returns per unit of volatility than the short WAL sectors. US CMBS 2007 Dupers pick up 190% of the 3YR spread volatility. UK nonconforming picks up 190% and UK buy-to-let (BTL) returns 240%. The most attractive sectors on this basis look to be UK prime RMBS, which picks up 550% and Dutch prime RMBS at 680% per unit of volatility (see Figure 53).

Figure 52. Multiples of 3YR Spread Volatility, Selected Global ABS Products as of 14 Sep 12



Source: Citi Research

Figure 53. Multiples of 3YR Spread Volatility, Selected Global Securitized and Corporate Products, as of 14 Sep 12

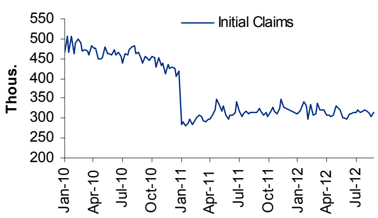


Source: Citi Research

US Economy: Balancing Act

Despite lingering concerns about the macro environment, market volatility as gauged by the VIX remains low and fundamentals in previously lagging sectors are showing some signs of improvement. Leading the increase is very strong US home price data for the last 3-4 months, and a pickup in lower-tier commercial real estate properties. Even so, it is worth keeping the perspective that these sectors are recovering from very low bases. Some sectors, like the US consumer, are setting new record performances. For example, the 60+ days delinquencies for the Citi credit card index registered 2.47% in August, dropping 21% year-over-year and by 1.3% month-over-month. Not as dramatic, but the CMBS fixed-rate 30-plus-day delinquency rate fell to 10.30% in August, 9bp lower than in July, the largest single month drop over the past year and first monthly decrease since February.

Figure 54. Initial Unemployment Claims (Thousands)



Source: US Bureau of Labor Statistics

- **Unemployment treads water**. US payroll employment rose much less than expected during August — payrolls rose by 96,000 and the July gain was revised down from 163,000 to 141,000. The unemployment rate dropped nominally, although workers leaving the workforce distort the actual trend. Unemployment fell from 8.3% to 8.1% and has remained north of 8% since early 2009. Industries adding workers include professional and technical services, food services, and healthcare. The number of long-term unemployed was little changed at 5 million, accounting for 40% of the unemployed.
- **Mixed Signals**. The Conference Board Consumer Confidence Index registered its lowest point since late 2011 in August (60.6 vs. 65.4 in July and 55.2 in Nov 2011). Consumers' short-term outlook for business conditions and employment is largely pessimistic.

Sector Relative Value and Allocation Recommendations

Our securitized products strategists have mixed views on the market, ranging from bullish to neutral, and Figure 55 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 55. Sector Relative Value and Asset Allocation Recommendations — Selected Sectors, September 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, private label credit card and dealer floorplan ABS.
CMBS	0	Fair	2007 generic duper spreads are relatively attractive to single-A corporates at a 40bp pick-up.
Agency MBS	0	Fair	OAS levels are tight, however convexity-adjusted carry is in upper end of range
European Securitized Products	+	Cheap to Fair	We prefer a core country focus in our barbell strategy with stable, short sectors, combined with select off-the-run opportunities. We prefer yield opportunities in UK BTL, UK NCRMBS and select CMBS.

Source: Citi Research

Commodity Outlook and Forecast

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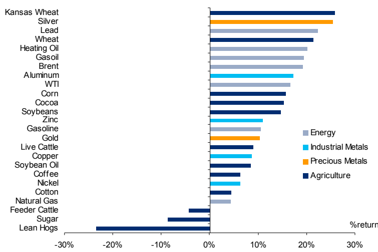
The third quarter so far has been a strong one for commodities, led by the grain and oilseed complex due to a weather-driven supply shock. The worst drought since 1988 has devastated crops across the American Midwest, in turn among the largest exporting regions for three of the four staple 'ags': corn, wheat, and soybeans. Since the beginning of June, CBOT wheat has led the complex, rallying in nominal terms +43%, but corn and soybeans have also surged in nominal terms.

But the liquids side of the energy complex also had a strong quarter. Crude and refined products have generally appreciated 10-20%, led by the distillates such as heating oil and gasoil and followed by the crudes. The strength of the petroleum complex can be partially explained by seasonality but renewed geopolitical tensions in the Middle East and an active hurricane season in the Gulf of Mexico have also dominated headlines.

Figure 56. Commodity Individual Returns, 7/1/12 to 9/14/12



Source: Bloomberg, Citi Research

Only the industrial metals complex (and livestock) has relatively underperformed, as the Chinese economy slows. Official Chinese statistics claim y-o-y real GDP growth in Q2 has fallen to +7.6%, but evidence from power production and other real data suggest growth may undershoot official targets. China is in a delicate position politically as it grapples with the transition from the fourth to the fifth generation of Communist leadership. The incoming Xi regime may decide to reverse position from current cautious policy and deploy a more aggressive fiscal stimulus but the lag time between policy approval and real economic impact suggest the industrial metals may be under continued downward pressure for some time.

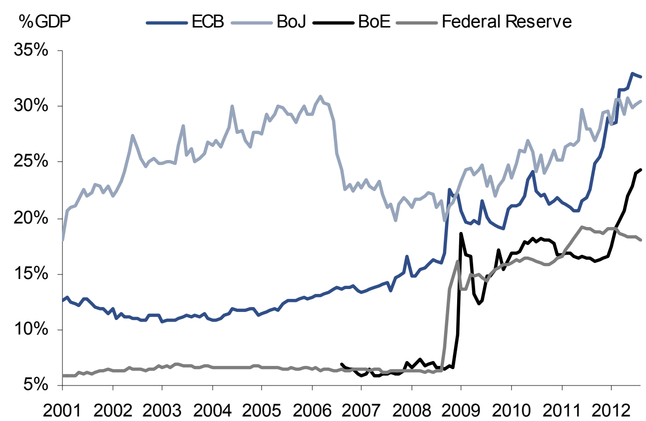
Figure 57. Citi Commodity Price Forecasts*

		Point Prices												
		0-3M	6-12M	5Y Cyclical	Q1 2012	Q2 2012	Q3 2012E	Q4 2012E	2012E	Q1 2013E	Q2 2013E	Q3 2013E	Q4 2013E	2013E
Energy														
NYMEX WTI	USD/bbl	90.0	80.0	81.0	103.0	93.3	100.0	80.0	94.0	85.0	85.0	85.0	85.0	85.0
ICE Brent	USD/bbl	105.0	100.0	85.0	118.4	108.8	120.0	105.0	113.0	105.0	95.0	100.0	95.0	99.0
Henry Hub Natural Gas	USD/MMBtu	2.8	3.4	N/A	2.5	2.3	2.8	2.7	2.6	3.2	3.3	3.4	3.5	3.4
Base Metals														
LME Aluminum	USD/MT	1,900	2,065	2,200	2,216	2,019	1,900	2,000	2,035	2,050	2,080	2,120	2,200	2,115
LME Copper	USD/MT	7,550	8,180	7,000	8,314	7,833	7,550	7,900	7,900	8,100	8,260	8,240	8,200	8,200
LME Lead	USD/MT	1,850	2,075	2,300	2,118	1,987	1,850	1,950	1,975	2,100	2,050	2,000	2,150	2,075
LME Nickel	USD/MT	16,800	22,513	22,000	19,721	17,228	16,800	20,500	18,560	22,550	22,475	23,000	23,250	22,820
LME Tin	USD/MT	18,700	22,500	19,000	22,986	20,619	18,700	21,500	20,950	22,000	23,000	23,500	22,000	22,625
LME Zinc	USD/MT	1,830	1,988	2,300	2,040	1,933	1,830	1,900	1,925	1,975	2,000	2,080	2,100	2,040
Precious Metals														
COMEX Gold	USD/T. oz	1,800	1,770	1,050	1,691	1,613	1,610	1,660	1645.0	1670	1690	1700	1720	1695
Silver	USD/T. oz	29	30	17	32.6	29.6	28.6	29.5	30.0	29.7	29.8	30.0	30.0	29.9
Platinum	USD/T. oz	1,475	1,565	1,500	1,604	1,505	1,475	1,550	1535.0	1565.0	1565.0	1565.0	1565.0	1565.0
Palladium	USD/T. oz	650	700	600	683	630	650	675	660.0	700.0	700.0	700.0	700.0	700.0
Bulk Commodities														
Hard Coking Coal (benchmark Asia)	USD/MT	225	220	200	235	215	225	195	218	205	215	210	210	210
Thermal Coal Asia (NEWC)	USD/MT	90	115	105	113	88	94	98	98	110	115	115	120	115
Iron Ore Spot (TSI)	USD/MT	130	135	81	142	139	112	105	125	115	122	122	120	120
Agriculture														
CBOT Corn	USd/bu	850	788	N/A	641	618	790	850	725	800	775	665	620	715
CBOT Wheat	USd/bu	925	953	N/A	643	641	870	925	770	975	930	850	850	900
CBOT Soybeans	USd/bu	1,875	1,645	N/A	1,272	1,426	1,690	1,810	1,550	1700	1590	1430	1400	1,530
CBOT Rice	USD/cwt	15.0	15.1	N/A	14.31	14.82	15.00	15.10	14.81	15.15	15.20	15.25	15.00	15.15
NYB-ICE Cotton	USd/lb	67	78	N/A	93	81	75	71	80	N/A	N/A	N/A	N/A	85
Sugar#11	USd/lb	23	24	N/A	24.5	21.2	23.5	23.5	23.2	N/A	N/A	N/A	N/A	23.0
ICE Coffee	USd/lb	180	185	N/A	205	171	175	180	186	N/A	N/A	N/A	N/A	190
ICE Cocoa	USD/MT	2,800	2,600	N/A	2,308	2,221	2,450	2,700	2,420	N/A	N/A	N/A	N/A	2,500

Source: Citi Research

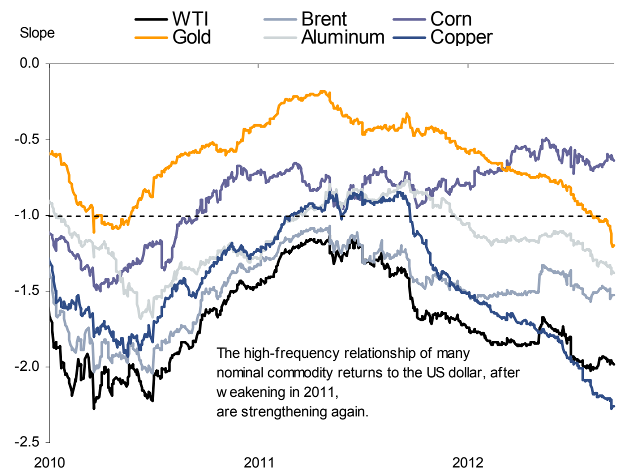
But arguably the most significant event of the third quarter for the commodities price complex may be the US Federal Reserve's decision to deploy a third round of quantitative easing, alongside the ECB's decision to purchase periphery sovereign bonds without limit. The striking feature is the open-ended and conditional nature of the recent unconventional monetary easing. The precious metals have duly responded strongly, with silver up +25% and gold up +10%. With the commodity-currency relationship historically strengthening again, easing by the world's central banks should continue to provide upside support to the commodity complex.

Figure 58. Central Bank Balance Sheets as % of GDP



Source: National central banks, Bloomberg, Citi Research

Figure 59. Commodity-Dollar Relationship

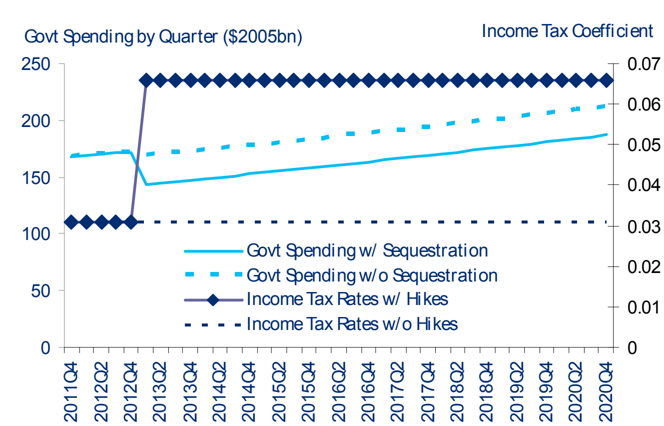


Source: Bloomberg, Citi Research

The fiscal cliff is another US policy-driven risk confronting commodity markets in the next few months. Our US economics team has estimated that the potential fiscal restraint in 2013 may shave about 3.1% off of growth. About 0.6% of this comes from BVA sequestration, with the remainder of 2.5% coming from the expiration of the Bush tax cuts, the payroll tax cut, and the Medicare tax on investment income. Effectively the US fiscal cliff could single-handedly drive a double-dip recession.

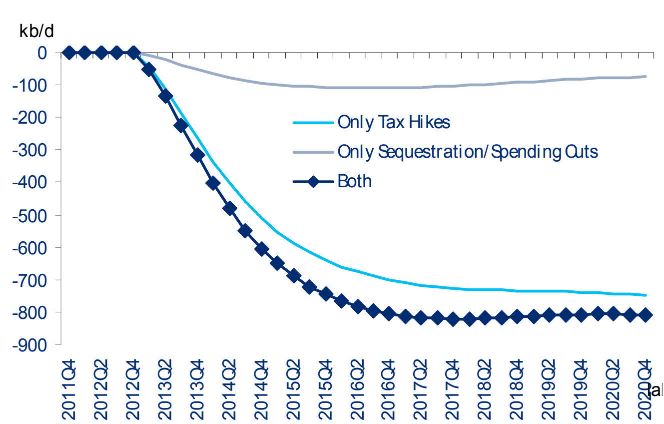
A decline in government spending and effective tax increases equivalent to the above slowdown was entered into our macroeconomic model in 2013Q1. We estimate that the subsequent economic slowdown may see US petroleum demand ultimately decline by -800kb/d but only in a slow fashion spanning two years or longer. About -700kb/d would be due to sequestration and spending cuts while the effective tax increases account for the remainder. This, in turn, would cause, all else equal, roughly a 3-4% decline in global oil prices.

Figure 60. Potential Fiscal Restraint Assumptions



Source: Citi Research

Figure 61. Estimated Impact on US Petroleum Demand



Source: Citi Research

Citi Foreign Exchange Forecasts

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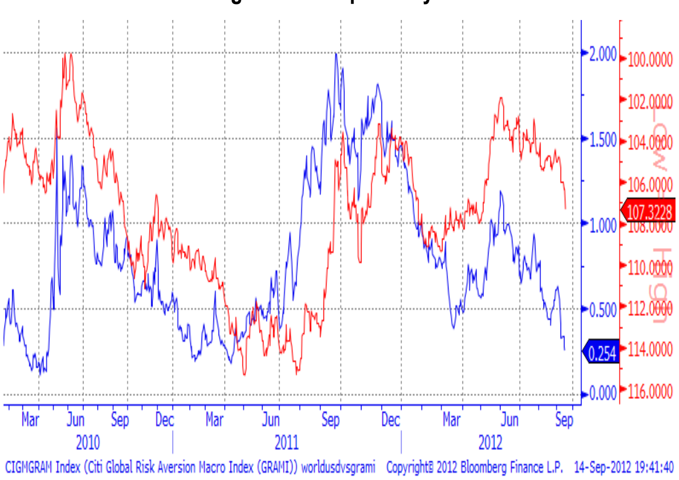
To see this piece in full please refer to *"Foreign Exchange Forecasts - September 2012"*, Citi.

Risk appetite continues to improve following a series of favourable policy interventions. The ECB meeting on 6 September outlined details of the new OMT programme and eased collateral requirements while Citi economists continue to expect this to be followed by depo/refi rate cuts and additional LTROs, albeit the latter may only come in the event of a crisis around Grexit. Meanwhile, the SNB and BoE continue to expand their balance sheets via exchange rate intervention and gilt purchases, respectively. And the Fed announced QE3, extended Twist and extended guidance at the 13 September FOMC.

We have highlighted before how better risk appetite tends to be associated with a lower USD and this is especially true when better risk appetite comes from Fed quantitative easing. While USD losses may be less than the historical beta suggests (see Figure 62) mainly because the US still seems likely to be the cyclical outperformer (Figure 63), some further downside does seem likely. Meanwhile, after a long period in which speculative and hedging positions have been short EUR, the unwind of these exposures in the face of reduced near-term EMU tail risks and lower risk premia means that the pivotal EUR/USD probably has further upside over 0-3m (see below). Overall, we expect USD to lose a further 0.5-1.0% vs. world currencies over 0-3m.

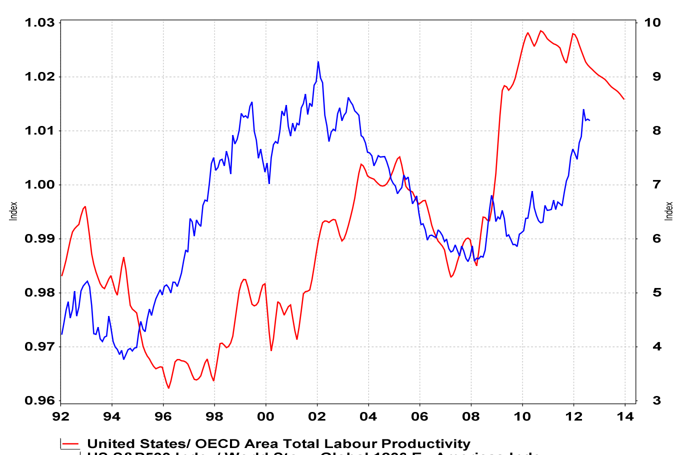
Medium term, our forecasts are USD bullish, with an appreciation of around 9% priced vs. other G10 currencies over 6-12m and 7% globally. This is turn reflects likely US cyclical outperformance plus a return to impaired risk appetite as a number of adverse developments hit markets, possibly including Grexit and a much a more prolonged/deeper slowdown than expected in China. Medium term, FX investors are likely to believe that the US economy may be sub-par but that it is still likely to better other regions. Equity market outperformance, and bond market underperformance on trend suggest similar expectations are in other asset markets. These factors are likely to drive USD appreciation over the medium term, absent US policy disasters.

Figure 62. GRAMI (Blue) vs. World USD Index (Red) — Higher = Greater Risk Aversion and Stronger USD Respectively



Sources: Citi Research and Bloomberg
World USD = Average of 4 evenly weighted regional indices (Higher = USD Weaker)

Figure 63. US / Total OECD Area Productivity (Red) and Relative Equity Market Performance (US/ World in USD – Blue)



Source: Citi Research and Reuters EcoWin

Figure 64. Citi Foreign Exchange Forecasts

		Market data			Forecasts			Returns***	
		spot*	3m Fwd	12m Fwd	0-3 mos	6-12 mos	long-term	3 mos rtn	12 mos rtn
G10									
Euro	EURUSD	1.31	1.30	1.31	1.32	1.15	1.25	1.2%	-12.1%
Japanese yen	USDJPY	78	78	77	78	76	80	0.4%	-1.8%
British Pound	GBPUSD	1.62	1.62	1.62	1.63	1.51	1.58	0.7%	-6.3%
Swiss Franc	USDCHF	0.93	0.93	0.93	0.91	1.04	0.96	-2.4%	12.6%
Australian Dollar	AUDUSD	1.06	1.05	1.03	1.05	0.96	0.95	0.0%	-6.5%
New Zealand Dollar	NZDUSD	0.83	0.83	0.81	0.83	0.79	0.69	0.0%	-3.0%
Canadian Dollar	USDCAD	0.97	0.97	0.98	0.95	0.98	0.97	-1.9%	0.4%
Dollar Index**	DXY	78.81	79.06	78.99	78.31	86.23	81.69	-0.9%	9.2%
G10 Crosses									
Japanese yen	EURJPY	103	101	101	103	87	100	1.6%	-13.7%
Swiss Franc	EURCHF	1.22	1.22	1.21	1.20	1.20	1.20	-1.2%	-1.0%
British Pound	EURGBP	0.81	0.81	0.81	0.81	0.76	0.79	0.5%	-6.1%
Swedish Krona	EURSEK	8.61	8.62	8.71	8.75	8.35	8.30	1.5%	-4.1%
Norwegian Krone	EURNOK	7.46	7.46	7.56	7.45	7.20	7.30	-0.1%	-4.7%
Norwegian Krone	NOKSEK	1.15	1.16	1.15	1.17	1.16	1.14	1.6%	0.7%
Australian Dollar	AUDNZD	1.27	1.27	1.26	1.27	1.22	1.38	0.0%	-3.6%
Australian Dollar	AUDJPY	83	82	79	82	73	76	0.4%	-8.2%
Asia									
Chinese Renminbi	USDCNY	6.32	6.35	6.40	6.31	6.36	6.15	-0.6%	-0.7%
Hong Kong Dollar	USDHKD	7.75	7.75	7.75	7.75	7.76	7.75	0.0%	0.1%
Indonesian Rupiah	USDIDR	9520	9602	9976	9600	9850	9660	0.0%	-1.3%
Indian Rupee	USDINR	54.3	55.4	57.7	54.6	56.0	52.3	-1.4%	-2.9%
Korean Won	USDKRW	1117	1124	1136	1120	1140	1070	-0.3%	0.4%
Malaysian Ringgit	USDMYR	3.04	3.06	3.11	3.05	3.13	3.11	-0.5%	0.8%
Philippine Peso	USDPHP	41.4	41.4	41.7	41.1	43.0	40.8	-0.8%	3.2%
Singapore Dollar	USDSGD	1.22	1.22	1.22	1.24	1.27	1.24	1.5%	4.0%
Thai Baht	USDTHB	30.8	30.9	31.4	30.4	32.0	29.9	-1.7%	2.0%
Taiwan Dollar	USDTWD	29.4	29.3	29.1	29.7	30.5	28.5	1.2%	5.0%
EMEA									
Czech Koruna	EURCZK	24.3	24.4	24.4	24.7	25.9	24.5	1.1%	6.0%
Hungarian Forint	EURHUF	282	285	295	290	310	290	1.6%	5.2%
Polish Zloty	EURPLN	4.07	4.10	4.22	4.11	4.40	3.90	0.1%	4.3%
Israeli Shekel	USDILS	3.89	3.93	3.96	4.00	4.20	4.00	1.9%	6.0%
Russian Ruble	USDRUB	30.5	31.3	32.7	30.8	35.4	33.7	-1.7%	8.1%
Russian Ruble Basket		34.7	35.6	37.3	35.2	37.8	37.5	-1.1%	1.4%
Turkish Lira	USDTRY	1.80	1.82	1.89	1.80	1.92	1.85	-1.0%	1.6%
South African Rand	USDZAR	8.23	8.35	8.65	8.40	8.70	8.72	0.6%	0.5%
LATAM									
Brazilian Real	USDBRL	2.02	2.05	2.13	2.00	2.05	2.05	-2.4%	-3.9%
Chilean Peso	USDCLP	471	480	495	480	510	490	0.0%	3.0%
Mexican Peso	USDMXN	12.7	12.9	13.2	12.5	13.2	12.2	-3.1%	-0.2%
Colombian Peso	USDCOP	1791	1815	1861	1820	1850	1850	0.3%	-0.6%

Source: Citi Research

Appendix A-1

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