

# Global Economic Outlook and Strategy

## Prospects for Economies and Financial Markets in 2010 and Beyond

- After the most severe global recession for decades, we now expect a sustained but uneven global recovery. Almost all major economies exited recession in Q2 and Q3, and on balance our GDP forecasts continue to rise. The initial bounce in output is likely to be quite solid and even across major economies. Thereafter, we expect recovery to be uneven across regions: strongest in non-Japan Asia, slowest in Europe and Japan. For the US, a fairly solid recovery is likely in 2010-11 — despite lagging credit availability — but the medium-term fiscal outlook poses major policy challenges.
- As recovery strengthens, many emerging markets — especially in Asia and Latin America — are likely to hike rates in H1-2010, with the PBOC's first hike forecast in Q3-2010. Australia and Norway also are likely to tighten further in early 2010. But with subdued inflation and some residual worries among policymakers over recovery's sustainability, we are postponing our forecast for the first Fed hike to Q4-2010 (Q2-2010 previously), and for the first ECB hike to Q1-2011 (from Q4-2010). Rising inflation may still lead the UK MPC to hike in Q2 or Q3 2010, while we still expect the BoJ to keep rates on hold in 2010.
- This month's Overview highlights key themes for 2010 and beyond: a solid, but uneven recovery; why Asia's quick rebound is sustainable; central bank exit strategies; bank retrenchment and credit availability; unsustainable fiscal trends; and longterm trends in the size of major economies. This month's GEOS also gives detailed forecasts for a wider range of emerging market countries.
- Returns from risk assets are unlikely to be as stellar in 2010 as in recent quarters. Nevertheless, Citi strategists believe that with improving growth prospects, strong corporate earnings, and gradual central bank tightening, risk assets will continue to do reasonably well — outperforming government bonds and cash — in the next couple of quarters. We expect interest rate term structures to normalise, with higher yields and flatter curves.

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Jan Maguire for preparing the document

**Figure 1. Currency and Interest Rate Forecasts (End of Period, Unless Specified), as of 23 Nov, 2009**

	23 Nov 09	4Q 09	1Q 10	2Q 10	3Q 10	4Q 10	1Q 11
		Forecast	Forecast	Forecast	Forecast	Forecast	Forecast
United States: Federal Funds	0.13	0.13	0.13	0.13	0.13	1.00	1.50
10-Yr. Treasuries (Period Ave.)	3.40	3.45	3.45	3.75	4.15	4.45	4.65
Euro Area: US\$/€	1.49	1.50	1.62	1.61	1.60	1.57	1.54
Euro Repo Rate	1.00	1.00	1.00	1.00	1.00	1.00	1.25
10-Yr. Bunds (Period Average)	3.29	3.35	3.35	3.60	3.90	4.00	4.10
Japan: Yen/US\$	89	87	84	84	85	86	87
Call Money	0.10	0.10	0.10	0.10	0.10	0.10	0.10
10-Yr. JGB (Period Average)	1.32	1.30	1.25	1.40	1.40	1.50	1.60

Source: Citi Investment Research and Analysis

See Appendix A-1 for Analyst Certification and important disclosures.

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**Figure 2. Forecast Highlights and Changes from Last Month**

■ Global	Almost all major economies exited recession in Q2 and Q3, and we expect a sustained but uneven global recovery. We again make more GDP forecast upgrades than downgrades. With low inflation, most major central banks will likely not be quick to hike rates and we have postponed the forecast start of Fed and ECB tightening to Q4-10 and Q1-11 respectively.
■ United States	Diminishing drag from financial markets and housing suggest the resumption of growth will be sustained. But continued tightening in consumer and mortgage credit and a lagging labor market point to a later start to normalizing Fed policy. An intractable budget deficit will mean greater pressures on interest rates when recovery generates larger private credit needs.
■ Euro Area	Following strong GDP growth in 2H 2009, we expect a modest recovery with low inflation in 2010 and 2011. We now expect the ECB to keep the repo rate at 1% until early 2011, although overnight rates are likely to rise during 2010. Fiscal policy tightening is likely to start in 2011 and the consolidation process is likely to take years.
■ China	The economy continues to strengthen with trade providing the immediate rebound. Investment will support growth in the coming years, without major progress in consumption or rebalancing. Macro policy exit will likely be gradual given still-uncertain inflation dynamics.
■ Japan	The economy likely will return to above-trend growth during 2010 after a temporary pause early next year, led by exports. But deflation will probably persist well into 2011. Japan's fiscal condition is unlikely to improve over the next couple of years, but high private savings should keep long-term interest rates relatively low in the near future.
■ United Kingdom	The U.K. economy is recovering, but faces major obstacles from relatively high inflation and the colossal fiscal deficit. The main uncertainties for 2010 are the interplay between political uncertainties, the fiscal deficit and troublesome inflation data. The MPC are likely to hike rates relatively early compared to the ECB.
■ Canada	Financial conditions continue to normalize and signs of revitalization are evident. Nonetheless, Canada is likely to experience a muted and protracted recovery. Significant economic slack and downside risks probably will warrant a highly accommodative BoC policy stance for an extended period.
■ Australia	The RBA is likely to increase the cash rate target by 25 bps in December, and to a peak of 5.50% by end-2010. Monetary policy remains highly accommodative and below where it needs to be, given the likelihood of trend-like GDP growth in 2010 and a further acceleration in 2011.
■ Emerging Asia (ex China)	Asia's growth should continue to outperform globally with recovering exports and ongoing support for domestic demand. With inflation normalizing ahead of the developed markets, many Asian central banks are likely to hike earlier than the US and should find liquidity management and asset reflation a growing problem. Pressure for Asia FX appreciation probably also will rise, and should find further support if PBOC gradually moves on CNY as we expect.
■ Latin America	Ample global liquidity will provide continued support to economic recovery, but test Latin American policy makers with new challenges. Central banks are likely to be forced to hike sooner, while fiscal policymakers should soon begin to withdraw some of the stimulus enacted this year. Even if timing is perfect, local currencies will remain under strengthening pressures, tempting policymakers to resist such dynamics through reserve accumulation and, possibly, distortionary FX regulations.
■ CEEMEA	In general, we expect a weak recovery in CEEMEA, thanks to poor credit availability and limited chances of a strong export recovery. Partly for that reason, public finance vulnerability will remain a theme during 2010, putting pressure on yield curves to stay relatively steep. Energy exporters, on the other hand, are enjoying the benefits of stronger balances of payments.

## Overview: Prospects for 2010 and Beyond

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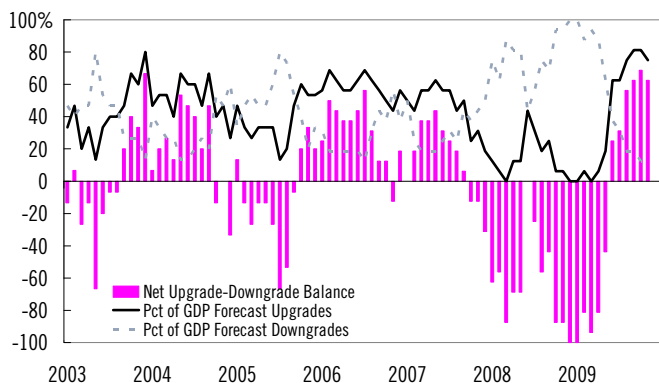
After the most severe global recession for decades, we now expect a sustained but uneven global recovery. Almost all major economies exited recession in Q2 and Q3, and on balance our GDP forecasts continue to rise. This month, we are slightly upgrading our 2010 GDP forecasts for the US and Canada, with larger upgrades for Japan, UK, Australia, New Zealand, Hong Kong, Korea, Argentina, Hungary, Poland, Czech Republic and Turkey, and only minor downgrades in the Euro Area, South Africa and Sweden. Our GDP forecasts are above consensus in most major countries. By contrast, our 2010 inflation forecasts generally remain low (apart from a few exceptions, e.g. UK), with more downgrades than upgrades over the last three months as a whole. We highlight six main themes:

### 1. Widespread Initial Recovery, Then Greater Disparities

The initial bounce in output is likely to be quite solid and even across all major economies. Helped by the turn in inventories, improved financial conditions, plus huge monetary and fiscal stimulus, the main economies all probably have had a quarter or two of fairly strong output growth in H2-2009. This momentum is likely to carry into continued strong global growth in many regions in early 2010.

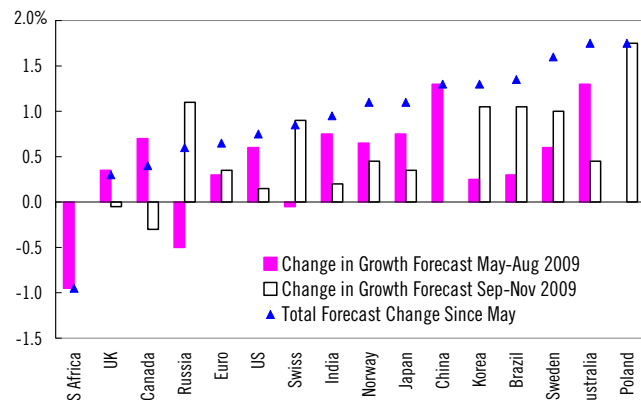
After this initial burst, we expect recovery to be uneven across regions. For non-Japan Asia, huge monetary and fiscal stimulus, plus relatively healthy banks, competitive exchange rates and inter-regional economic integration already have spurred a strong V-shaped rebound, and we expect that rebound to be sustained in 2010-11. Non-Japan Asia has accounted for about 25% of global growth in the last 10 years, but probably will account for about 40% in 2010-11 — far more than the G7 (25%-30%). We expect a more gradual medium-term recovery in Europe and Japan. The euro area recovery will be capped by poor credit availability and corporate retrenchment, the strong euro and, in some EMU countries, major fiscal restraint. For the US, previous imbalances in housing, household savings and corporate over-expansion have largely corrected. Despite only slowly improving credit availability, a fairly solid recovery is likely in 2010-11. The medium-term fiscal outlook is the biggest policy challenge.

Figure 3. Global — Pct of Citi Growth Forecast Upgrades and Downgrades, 3-Month Total, 2003-09



Note: Based on the 16 countries shown in Figure 4  
Source: Citi Investment Research and Analysis

Figure 4. Global — Changes in Citi Growth Forecasts for 2009-10 from May to Nov 2009



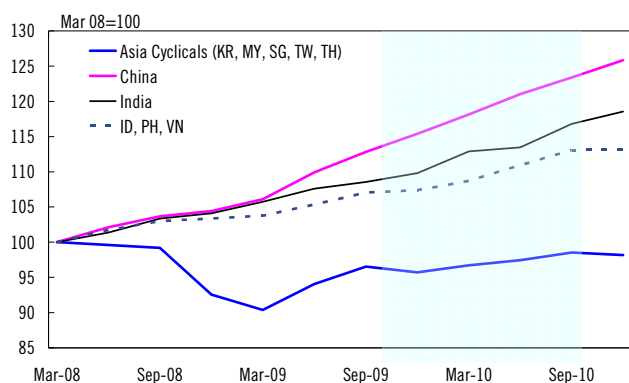
Source: Citi Investment Research and Analysis

## 2. Why Asia's Recovery Is Sustainable

Asia's growth should continue to outperform globally, led by China, despite a weak consumer outlook in US and Europe. After having an earlier and sharper rebound than the rest of the world, aided by inventory-restocking, aggressive policy stimulus, and strong final demand from China, we expect the region's recovery will continue to gain momentum in 2010. We forecast Emerging Asia's growth to improve from 5.1% in 2009 to 7.8% in 2010. China leads the pack, but many other countries are expected to post 5+% GDP growth, such as the more domestic-demand driven economies of India, Indonesia, and Vietnam, alongside sharp cyclical rebounds in the more export-oriented countries led by Singapore and Korea.

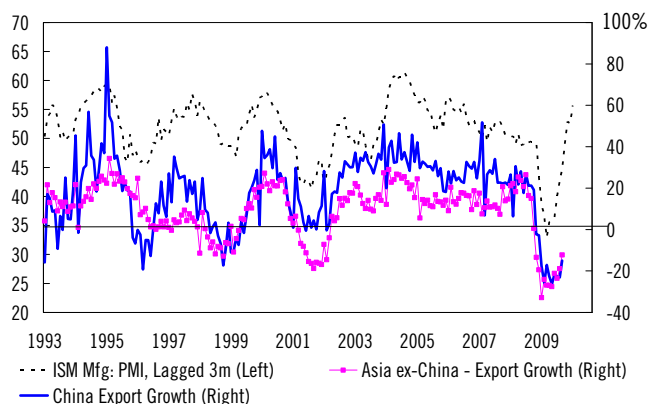
Inventory correction in the developed markets and resilient EM demand should be able to sustain manufacturing production and exports across Asia until at least 1H 2010. The US ISM manufacturing surveys show inventory liquidation is abating, and diffusion measures for new orders and production have rapidly returned to the early-2006 levels. There is still room for re-stocking in US and Europe to support Asia's export and manufacturing sector (as inventory-shipment ratios in some Asian countries still look close to historical average) at least through the earlier part of 2010.

Figure 5. Asia's Real GDP Trajectory, 2008-2010F



Source: Citi Investment Research and Analysis

Figure 6. US ISM Indices & Asia's Exports (Pct. YoY), 1993-2009



Sources: CEIC and Citi Investment Research and Analysis

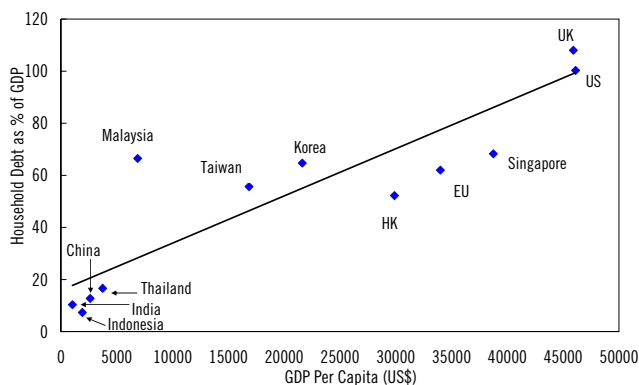
For China, we expect rapid growth (8.7% in 2009, 9.8% in 2010 and 9% in 2011), which will provide some support to the region via trade. China's investment growth is expected to slow from this year's policy driven surge, but after posing a *significant* drag to growth this year, an expected 13% export rebound in 2010 should bring net exports' contribution to overall growth to almost flat. This export pick-up, with consumption growing in line with income, should produce stronger headline GDP growth next year. China's robust growth should provide some incremental support to the region via trade, with East and Southeast Asia's share of final goods exports to China rising (from 43.6% in 1996 to 54.7% in 2008), and China running a notable trade deficit on final demand goods with Korea and Taiwan.<sup>1</sup> While China has not been a significant capital exporter to the region yet, with most recent overseas investments concentrated in natural resources (benefiting Australia, for example) and portfolio investments still concentrated in G10, some gradual shift is possible in the coming years.

<sup>1</sup> See ADB Economics Working Paper – *Can Trade with the PRC be an Engine for Growth for Developing Asia* (October 2009)

Policy stimulus will only be gradually unwound in the region, and interest rates are likely to stay below neutral for most of 2010. In contrast to the sharp fiscal deterioration in many advanced economies, Asia's fiscal trajectory will likely remain manageable, with the debt trajectory rising the most in Korea and Malaysia, by around 10ppts from 2007 levels.<sup>2</sup> In Korea's case, it is still well within the normal range for countries with single-A ratings. While some withdrawal of budget stimulus will likely be pursued in more fiscally-vulnerable countries like Malaysia, we think China and Korea are unlikely to meaningfully withdraw stimulus. Fiscal balance improvements in 2010 for the region will be mostly driven by automatic stabilizers as the economy improves, rather than through significant fiscal tightening. On the monetary front, assuming headline inflation rises on average by 2-3 percentage points in 2010, we expect rate hikes will range between 50bps (Malaysia) and 125bps (India, Indonesia, Korea) in Asia. Nevertheless, overall policy rates for Asia (ex China) at the end of 2010 will still be about 175bps below the average of the last 7 years.

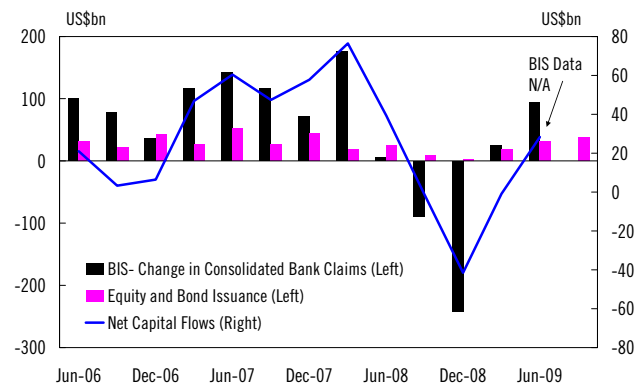
Structural features (e.g. demographics and low household leverage) provide a decent outlook for medium-term consumption growth for many Asian countries, with the largest potential for China given its size and the lowest share of private consumption to GDP in the region. The stable political environment, an improving investment climate plus healthy capital inflows could also support investment in India and Indonesia. There is also room for investment shares to GDP in Malaysia, Thailand and Philippines to recover after having remained the lowest vis-à-vis pre-Asian crisis levels. Indeed, governments in Malaysia and Thailand have made announcements to boost service sector activity and public infrastructure investments, respectively, although it is unclear how well Malaysia will execute its services sector liberalization reforms and how Thailand's political issues will affect project implementation. Nonetheless, Asia benefits from relatively benign liquidity conditions. Capital inflows have recovered relatively quickly, and alongside a still-accommodative monetary stance anticipated for most of 2010, this will provide financing support for domestic demand growth.

Figure 7. Asia, US, EU and UK — Household Debt (% of GDP) vs. Per Capita GDP, 2008



Note: EU and India data are 2007  
Sources: IMF and Citi Investment Research and Analysis

Figure 8. Net Capital Flows and Some Components of Capital Inflows into Asia, 2006-Q3 09



Sources: IMF, BIS and Citi Investment Research and Analysis

<sup>2</sup> For advanced G20 debt projections, see IMF – *State of Public Finances – Cross Country Monitor* (3 Nov 2009)

### 3. Central Bank Exit Strategies in 2010-12

The global economic recovery already has prompted interest rate hikes in a few countries, but our forecasts do not anticipate an early or aggressive turn by the main central banks. Despite significant progress toward stabilizing financial conditions, inflation prospects remain unusually benign and a durable recovery is not yet established. We expect China's first rate hike will come in Q3-2010. The Fed is not expected to hike until later in the year, with the ECB perhaps on hold until early 2011. With Japan's deflation expected to persist, initial tightening there may not occur until late 2011.

So far, the major central banks are still in varying stages of providing liquidity support, purchasing long-duration assets and intervening directly in private credit markets. The Federal Reserve, the Bank of Canada and the Bank of Japan recently have provided so-called commitment language which points to extremely low rates continuing for some time, while the UK MPC further expanded quantitative easing.

Even so, the untested nature of unconventional measures and their sheer scope require that central banks begin to develop a framework for policy exit that minimizes risks on both sides, overstaying accommodation or prematurely disrupting financial conditions and economic recovery. The November G-20 Communiqué highlighted that, while recovery remains dependent on policy support for now, countries would establish a new consultative "mutual assessment process" to help develop policy options for smooth adjustment across regions.

The Federal Reserve has been the most expansive in its use of a wide set of unconventional tools and correspondingly has been out front educating the public on the credibility of its own exit strategy. Key elements of this plan are already underway, as loosening in interbank and money market funding has allowed the Fed's short-term liquidity provisioning to shrink substantially. Similarly, the Fed's credit easing is being capped off as confidence in market functioning and access has risen. Nevertheless, Fed officials will likely be reluctant to back away from the commitment to near-zero rates until labor markets stabilize and there is greater confidence that financial conditions will underpin the recovery process, and these conditions may only come together around midyear.

For the Fed and other central banks, exit strategies will have to contend with still very large balance sheets and expanded bank reserves as decisions to raise overnight rates approach perhaps late next year. While the sequence of actions may yet be undecided, we would expect that the Fed's new ability to pay interest on reserves (IOR) will place a controlled floor under rates despite enlarged reserve levels. The ECB's interest-paying deposit facility already has demonstrated success on this score as its balance sheet has grown.

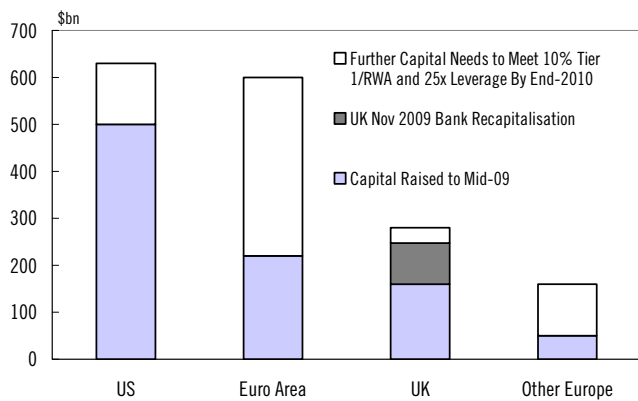
Fed officials have suggested that the IOR option would likely be undertaken with other actions to drain reserves and excess liquidity. These include much larger reverse repos than the Fed has historically arranged. Dry runs with dealers suggest there is significant capacity for this, but the Fed also may opt to corral excess reserves in term deposits. The more aggressive, and perhaps least likely, initial strategy would entail the outright sale of longer-duration assets. The Fed has become the dominant player in mortgage-backed securities and would need to have great confidence in the effects of outright sales on borrowing rates and credit conditions in order to maneuver this kind of tightening exercise. In any event, officials anticipate that prepayments and redemptions would allow an estimated \$100-200 billion of assets to runoff each year over the next few years.

#### 4. Bank Retrenchment, Credit Availability and Bank Regulation

The acute phase of the global banking crisis is past. Libor-OIS spreads have plunged, major banks' share prices have rallied and CDS spreads have fallen sharply. However, after-effects of the financial crisis should continue to have a major influence on economies and markets in years to come.

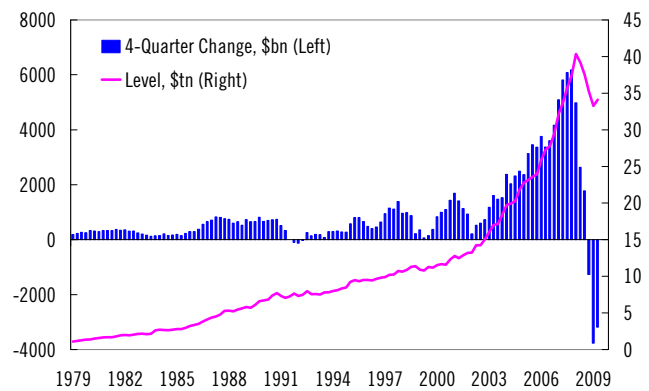
First, credit availability is likely to stay poor for a long period, probably a year or two rather than a quarter or two, as banks retrench and seek to raise extra capital, especially in Europe. The IMF recently estimated that bank writedowns and losses from the financial crisis and recession will total \$1020bn among US banks, \$1620bn among European banks and \$170bn among Asian banks<sup>3</sup>. The IMF estimate that banks in aggregate have raised about \$930bn of capital since the crisis began but, allowing for retained earnings to end-2010, would need to raise a further \$740bn capital (roughly \$87bn of which has been since raised in the UK) to hit the expected regulatory norms: ratios of 10% Tier 1/Risk weighted assets and 25x leverage, by end-2010. According to the IMF, US banks would need to raise a further \$130bn in new capital (having already raised \$500bn). By contrast, euro area banks have raised \$220bn so far and would need a further \$380bn (and would take until mid-2012 to generate the necessary capital through retained earnings).

Figure 9. Global — Bank Capital Raised So Far And Possible Future Needs, \$bn, 2007-10



Note: UK figure for capital raised includes £8bn contingent capital from the UK Government. In practice, further capital needs for UK banks may need to be revised up because of lower use of the APS than assumed by the IMF. Sources: HM Treasury, IMF and Citi Investment Research and Analysis

Figure 10. Global — Level and Change in Banks' External Assets, \$bn, 1979-Q2 2009



Sources: BIS and Citi Investment Research and Analysis

Second, even once bank retrenchment ends, the financial landscape in 2010 and beyond will not quickly return to pre-recession norms. There is a wide debate over key aspects of bank regulation: bank capital and liquidity levels – and whether liquidity must be segmented by region; the appropriate mix of deposit-taking and investment banking in large banks; the scale of banks' international assets relative to home country assets and GDP. Policymakers also are debating whether and how to use monetary policy or macro-prudential regulations to rein in future asset and credit booms.<sup>4</sup>

<sup>3</sup> See "Global Financial Stability Report", IMF, October 2009

<sup>4</sup> See "Countercyclical Macro Prudential Policies in a Supporting Role to Monetary Policy", IMF, November 2009.



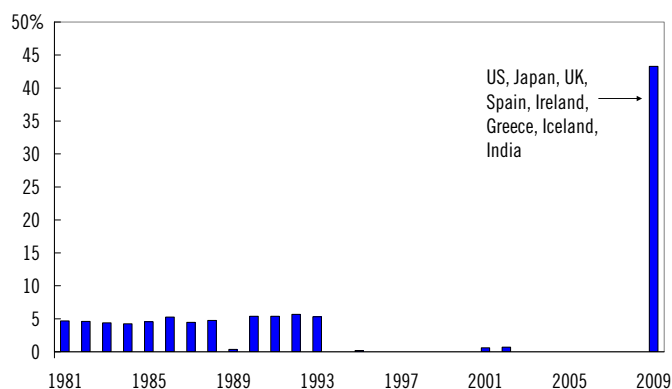
Full effects of these changes are not yet clear. We doubt this will translate into slower growth for financial services as a whole: rather, on average overall credit availability will probably be more constrained and less pro-cyclical in upswings.

- Private savings rates are likely to stay relatively high across industrial countries, as some households and companies face curtailed credit availability and some opt to self-insure — running higher savings levels and holding more liquidity — in the wake of large-scale wealth losses plus greater income uncertainty, and as protection against any future disruption in credit availability.
- Potential growth may be reduced in the wake of a declining capital stock, structural damage to the labor market and higher financing hurdles, as it becomes harder to turn ideas into innovation, hitting small business formation.
- Further drop in banks' external assets, with no quick return to the turbo-charged credit boom of recent years. Governments have discovered that global banks create huge contingent fiscal liabilities, and some governments will aim to stop their banks “going global” on anything like the prior scale.

## 5. How Will Unsustainable Fiscal Trends Be Resolved?

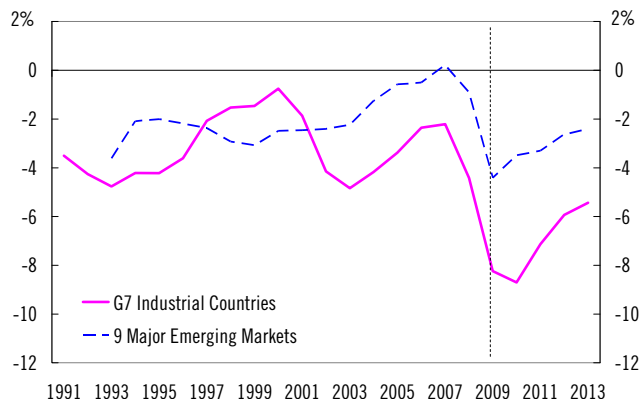
As recession recedes, the major policy challenge for the next few years will be to get fiscal policies back to a sustainable path. Fiscal costs of recession, over-reliance on windfall revenues in the boom, fiscal stimulus and financial rescue measures, have lifted the aggregate G7 fiscal deficit to about 10% of GDP in 2009, twice the 80-08 peak (5.1% of GDP). Seven industrial countries (US, Japan, UK, Spain, Ireland, Greece, Iceland), plus India, have fiscal deficits at or above 10% of GDP this year — a level that implies major consolidation is needed to get back to fiscal sustainability. Jointly, these countries account for about 43% of global GDP. Outside wartime, it is unprecedented for so many big industrial countries to run such huge deficits. At prior peaks, countries with deficits of 10% of GDP-plus accounted for no more than 5%-6% of global GDP.

**Figure 11. Global — Major Economies With Fiscal Deficits At or Above 10% of GDP, as Share of Global GDP, 1981-2009**



Sources: IMF and Citi Investment Research and Analysis

**Figure 12. Global — Fiscal Deficits in Industrial Countries and Emerging Markets, Pct of GDP, 1991-2013**



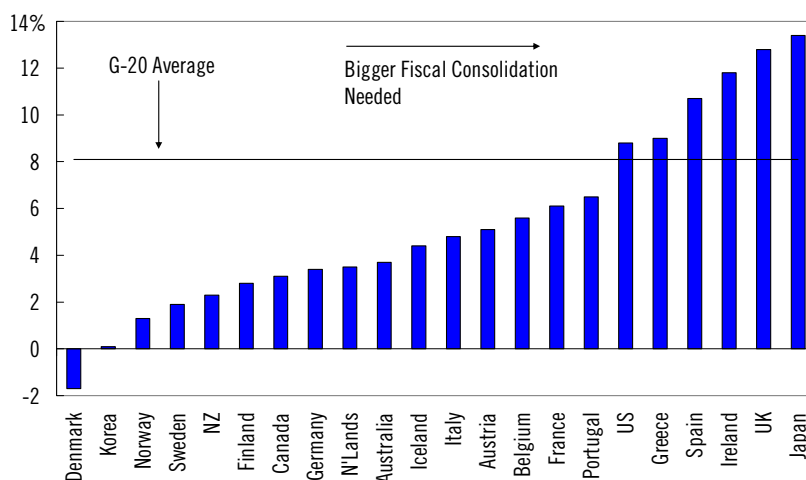
Note: The nine emerging economies are Brazil, China, India, Korea, Mexico, Poland, Russia, S. Africa, Turkey. Sources: IMF and Citi Investment Research and Analysis

The IMF recently estimated that advanced economies on average will need to tighten fiscal policy (i.e. improve their structural primary balance) by 8% of GDP over the next 10 years to stabilise debt/GDP ratios at “moderate” and “safer”

levels of 60% of GDP by 2030.<sup>5</sup> The required adjustment exceeds 9% of GDP for Japan, the UK, Ireland, Spain, the US and Greece. Fiscal challenges may be even bigger in some countries, as nearterm deficits exceed even the IMF's forecasts.

So far, market reaction has been modest. CDS spreads and intra-EMU spreads are higher, with ratings downgrades in several countries. But, rising private savings, collapsing private sector borrowing needs, ultra-low policy rates, bond buying by banks (and some central banks) have kept government bond yields relatively low. Nevertheless, unsustainable fiscal trends — if not corrected — will probably pose bigger challenges for markets as private spending and interest rates rise from cyclical lows. Most likely, without major fiscal consolidation, rising public debt ratios over time will push up real rates, crimp medium-term growth and eventually undermine sovereign credit quality.<sup>6</sup>

**Figure 13. Advanced Economies — Fiscal Tightening (Pct. of Annual GDP) Needed Between 2010 and 2020 to Achieve 60% of GDP Public Debt Ratio By 2030**



Note: Japan's target public debt ratio is 80% of GDP. Sources: IMF and Citi Investment Research and Analysis

The IMF argues that prior major fiscal consolidations usually have taken 5-10 years, and are more likely to succeed if backed up by fiscal rules and focused on curbing spending. In theory, such measures could be offset by a long period of relatively low interest rates to sustain growth: a classic tight fiscal/loose monetary policy mix. However, there are major hurdles in many countries to such consolidation. Major and extended fiscal restraint may not be politically feasible in many countries. Moreover, policymakers — justifiably — do not want to tighten fiscal policy too fast, lest they crush the nascent recovery (and fiscal restraint without recovery would also leave the deficit very high). Moreover, the scope for fiscal restraint to pull interest rates down may be limited in Japan (which is likely to have near-zero interest rates anyway) and among individual EMU member states. Even for the US and UK, the handover between fiscal and monetary policy may not be smooth. And an over-reliance on tax hikes might hurt potential growth. As a result, routes back to fiscal sustainability appear unclear for many countries.

<sup>5</sup> See "The State of Public Finances Cross-Country Fiscal Monitor", November 2009, IMF. For Japan, the target is public debt equal to 80% of GDP. See also "OECD Economic Outlook", November 2009

<sup>6</sup> See "Fiscal Stimulus to the Rescue? Short-Run benefits and Potential Long-Run Costs of Fiscal Deficits", IMF Working Paper, November 2009

- For the US, longer-term fiscal concerns have been overshadowed by the focus on macro stabilization and the push for a much bigger public role in health care. At present, it is unclear as of this writing whether health care changes will be finalized this year, and there are doubts whether it is possible to expand entitlement provisions and also cut overall costs. Proposed legislation would cut barely 1% off ten-year deficits, still leaving the debt ratio rising from 55% in FY09 to 75%-100% (or more) ten years out. Near term, the deficit is expected to stay around 10% of GDP in fiscal year 2010 and drop to 7%-8% in 2011. The Administration's February plan will be watched closely for credible spending restraint to complement higher taxes and whether that blueprint foresees deficits falling to 3% or less beyond the five-year window. As recovery matures and private borrowing resumes, pressures on real interest rates are likely, especially if deficit forecasts remain unanchored.
- Within EMU, political willingness to cut the deficit seems higher in Spain and Ireland than Greece. However, growth is likely to lag the euro area norm in all three countries, reflecting high real exchange rates, Spain's housing collapse, Ireland's bank woes, and Greece's weak supply-side.<sup>7</sup> Moreover, fiscal drag in these countries would probably not yield a windfall of markedly lower ECB rates. Unless fiscal restraint causes a spontaneous drop in private savings, growth will suffer — and weak growth in turn will keep fiscal deficits high. Most likely, coming years will see major fiscal drag — especially in Spain and Ireland — persistently weak growth, but stubbornly high deficits in all three countries and a search for alternative sources of finance: e.g. selling assets, securitising specific revenues or seeking extra EU funding.<sup>8</sup> We do not, however, see default risks: if needed, other euro area countries would support them.
- For the UK, the main issue is the political sustainability of fiscal consolidation. We do expect major fiscal consolidation if the Conservatives win a big majority (50+ seats). That would avoid a sovereign credit crisis and allow a long period of relatively low interest rates. However, there is a sizeable risk that the election yields a hung parliament or tiny Conservative majority. If so, it may not be politically possible to implement enough fiscal consolidation to avert severe worries over the UK's sovereign credit quality.
- Japan faces both political and economic obstacles to fiscal consolidation. The new administration plans new spending (mostly subsidies to the household sector) of 7.1 trillion yen in fiscal 2010, 12.6 trillion yen in 2011, and 13.2 trillion yen in 2012 and beyond (on a cumulative basis). However, the DPJ's plans to cut other expenditures and to lift revenues are not yet solid: indeed, the DPJ has committed to not hike the consumption tax for the next four years. With modest growth, the general government deficit is unlikely to fall below 9%-10% of GDP in the next five years and the debt-to-GDP ratio is likely to approach or even hit 250%. Major fiscal consolidation is unlikely unless bond yields rise sharply, and that is far from certain given the very high level of private savings, especially the corporate sector.

And yet, previous experience suggests that unsustainable trends eventually are forced to correct. The process by which unsustainable fiscal trends are resolved will be a major influence on economic prospects in 2010 and beyond. Countries that fail to achieve fiscal sustainability may over time face a painful mix of worsening sovereign credit quality and rising debt service costs, undermining growth and making the eventual fiscal crunch even tougher.

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<sup>7</sup> Greece ranks 109 in 183 countries in the World Bank's Doing Business study, by far the lowest of the euro area

<sup>8</sup> Spain and Greece both have public sector assets (financial and non-financial) equal to about 80% of GDP

## 6. The Longterm Outlook — to 2015 and Beyond

In 1980, the world's biggest economies (USD terms) were the G7 plus China. The list was the same in 2000 and 2005, albeit with China moving up the rankings. And in 2005 — as in 1980 — four of the seven biggest economies were in Europe. But, the ranking of global economies will change markedly in the next 5-15 years. Many industrial countries have experienced severe recessions and face headwinds from bank retrenchment, major medium-term fiscal restraint and, some cases, adverse demographics. By contrast, we envisage a virtuous circle of rapid industrialisation and buoyant domestic demand in Asia, supporting growth in resource-rich regions (Africa, LatAm, Middle East, Russia).

Figure 14. Global — Approximate Size of 10 Biggest Economies in USD Terms, Indexed to US = 100, 1980-2020F

Rank	1980		2000		2005		2010F		2015F		2020F	
		US =100		US =100		US =100		US =100		US =100		US =100
1	US	100	US	100	US	100	US	100	US	100	US	100
2	Japan	38	Japan	47	Japan	36	China	38	China	59	China	85
3	Germany	30	Germany	19	Germany	22	Japan	36	Japan	29	Japan	26
4	France	25	UK	15	UK	18	Germany	25	Germany	20	India	24
5	UK	19	France	13	China	18	France	20	UK	17	Russia	19
6	Italy	17	China	12	France	17	Italy	16	France	16	Germany	19
7	China	11	Italy	11	Italy	14	UK	16	India	16	UK	17
8	Canada	10	Canada	7	Canada	9	Brazil	13	Russia	15	France	15
9	Spain	8	Brazil	6	Spain	9	Spain	11	Brazil	14	Brazil	15
10	Argentina	7	Mexico	6	Brazil	7	Russia	11	Italy	13	Italy	12

Note: We use IMF data for 2000 and 2005, with Citi forecasts for nominal GDP and exchange rates over 2010-20

Sources: IMF and Citi Investment Research and Analysis

Figure 14 presents data for the size of economies in USD terms, forecasts for the next few years and approximate projections out to 2020. Clearly, these estimates are increasingly uncertain at longer horizons, and become more an arithmetic exercise in extrapolating nominal growth trends and exchange rate forecasts, rather than genuine economic forecasts. Russia's economic growth, in particular, is highly dependent on commodity price trends and may be constrained by adverse demographics plus the relatively poor legal and institutional infrastructure.

But the general trend is more important than the exact numbers, and reflects the seemingly inexorable trends of population size plus industrialisation of many emerging markets. The global economy will likely become dominated by a different group of countries: more high-growth emerging markets with big populations but lower income per head; more Asia countries among the top five and fewer European countries.

- Even with revaluation via the stronger yen, China will probably overtake Japan as the world's second biggest economy in 2010. During 10-11, the economies of Russia and India will probably pass Canada and Spain in size.
- By 2015, Russia, India and Brazil will probably also have overtaken Italy, with India's economy similar in size to France.
- By 2020, India (and perhaps Russia) will probably also overtake Germany, France and the UK. In the next 10-20 years, if not before, emerging markets will probably be two of the world's biggest four economies, and three of the biggest six, although still well below G7 countries in GDP per head. There may be no EU country in the top five economies. China's economy will probably exceed the euro area around 2018 (EMU enlargement may delay the crossover

by a year or two).<sup>9</sup> Between 2020 and 2030, China's economy will probably overtake both the US and EU, with India exceeding Japan.<sup>10</sup> By about 2025, the economies of Korea and Indonesia will probably exceed those of Italy and Canada. These crossovers are not decades away: just 10-20 years.

- In addition, with population ageing, dependency ratios will likely rise more rapidly in Europe and Japan (but not the US) than in emerging markets as a whole.

Over time, these shifts will have far-reaching implications:

First, as emerging markets industrialise, high underlying growth in Asian infrastructure, investment and consumer spending should become a major influence on global growth. At the 04-07 peak, US consumption rose by about \$500bn per year in nominal terms: the rise slowed to about \$300bn in 2008 and around zero in 2009. The YoY rise in nominal investment in non-Japan Asian economies already is up from \$100bn per year on average in 00-03, to \$270bn per year in 04-07 and \$370bn per year in 08-09, and is likely to average \$700-800bn per year in 2010-14. In real terms, using 2009 prices, US consumer spending rose by about \$300bn per year in 04-07, but shrank in 2008 and 2009. On the same basis (real terms, 2009 prices), the annual growth in investment in non-Japan Asia was about \$235bn per year in 2004-07, but is likely to average about \$460bn per year in 2010-11 and \$550-600bn per year in 2012-14.

Second, whether sustainable or not, there may be a shift in thinking about the appropriate model for economic growth and financial markets. China and India have more closed capital accounts and financial systems than many emerging economies and far more closed than the developed world. Arguably, this is one of the factors that allowed these countries to escape crisis in the 1990s and to survive the recent crisis relatively well: i.e. by restricting capital inflows they have limited currency appreciation pressure and become less vulnerable to "sudden stops" in capital flows. If "excessive financial liberalisation" helps explain the 1990s emerging markets crises and the developed-country crisis of 2008-9, then we might enter a period where capital controls and constraints on global credit cycles become a more visible facet of the global financial architecture.<sup>11</sup>

To simplify, in the first stage of the post-war era ("Bretton Woods"), major economies had fixed exchange rates and closed capital accounts (1945 to early 1970s). In the second stage ("post-Bretton Woods"), most major economies had floating exchange rates and open capital accounts (early 1970s to late 2000s). In the third stage, ("post-post-Bretton Woods"), some major economies will have floating or semi-floating exchange rates, but closed or partly closed capital accounts, while many industrial countries will have subtle constraints on credit expansion from bank regulation and capital standards.

Third, as EM economies expand, their capital surpluses/deficits, and allocation of investable funds, will likely exert growing effects on global real interest rates, currencies, asset prices and capital flows.

And fourth, with the G7 increasingly replaced by the G20, may there eventually be a consolidation to a new G6 (US, Euro, China, India, Russia, Brazil)?

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<sup>9</sup> The IMF estimate that in PPP terms, China's GDP overtook Japan's in 2001 and will exceed EMU in 2012

<sup>10</sup> Our projection is considerably earlier than some estimates. A report by the Carnegie Institute (Policy Brief 61, July 2008) estimated that the US-China crossover will occur between 2030 and 2035

<sup>11</sup> See "The Debate on the International Monetary System", IMF, November 2009 for a discussion of such issues

## Conclusions and Market Outlook

With downside risks to growth receding, the key policy challenge for 2010 and beyond is whether central banks and governments can successfully manage the exit strategies from extreme monetary accommodation and huge fiscal deficits without creating further instabilities and denting future growth prospects.

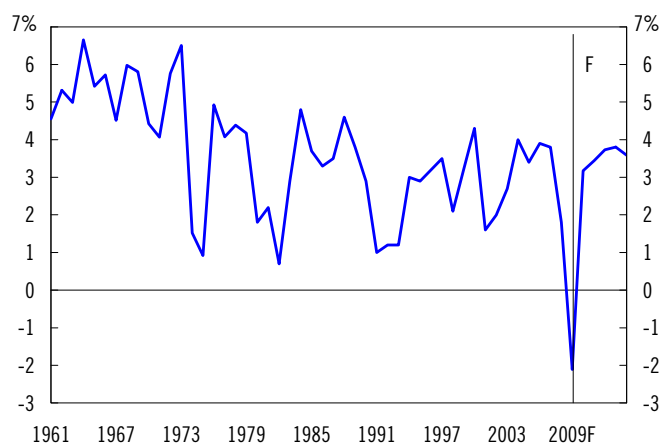
We are fairly optimistic that central banks can manage the gradual return to neutrality without destabilising the recovery. We do not expect major central banks to tighten in response to asset price gains alone. Rather, with ample spare capacity, inflation should be low enough in most countries to allow monetary tightening to be delayed until a strong and sustained recovery is secure. Consistent with growth and inflation prospects, we expect China to hike in Q3-10, with the Fed on hold until Q4-2010, the ECB a bit longer, while for the SNB and Japan, the complete lack of upside inflation risks is likely to produce an even longer period of ultra-low policy rates. Among industrial countries, only the UK faces a probable inflation problem in 2010 that may require early tightening. By contrast, we have far more doubt as to whether fiscal policies in high-deficit countries will return to a sustainable path quickly enough to avoid extra upward pressure on real yields as recovery builds.

Figure 15. Selected Countries – Industrial Production Data and Forecasts, 2009-11F

	2009F	2010F	2011F
World	-8.7%	6.8%	5.0%
United States	-9.8	4.7	3.7
Japan	-22.3	11.5	4.2
Euro Area	-14.6	4.3	3.0
United Kingdom	-10.2	0.2	0.8
Canada	-11.4	-0.1	1.7
China	11.0	14.0	13.0
India	7.5	8.0	9.0
Korea	8.0	6.2	8.2
Brazil	8.0	9.0	5.0

Source: Citi Investment Research and Analysis

Figure 16. Global GDP Growth, Outturns and Forecast, 1961-2013F



Note: Based on actual GDP at market exchange rates.

Sources: World Bank, IMF and Citi Investment Research and Analysis

Returns from risk assets are unlikely to be as stellar in 2010 as in recent quarters. Nevertheless, with improving growth prospects, strong corporate earnings, and no rush among most central banks to remove policy stimulus, we expect that risk assets will continue to do reasonably well — outperforming government bonds and cash — in the next couple of quarters. Our valuation metrics point to a further 25%-30% tightening in average credit spreads, with global equities continuing to grind higher and continued gains in metals and energy commodities (ex natural gas). As central bank tightening approaches, potential gains from risk assets inevitably will shrink, but many risk assets may well offer greater protection against central bank tightening and fiscal worries than government bonds.

Figure 17. Citi Global Economics Team

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Source: Citi Investment Research and Analysis

Figure 18. Selected Countries — Economic Forecast Overview (Percent) 2009F-2011F

	GDP Growth			CPI Inflation			Current Balance (% of GDP)			Fiscal Balance (% of GDP)		
	2009F	2010F	2011F	2009F	2010F	2011F	2009F	2010F	2011F	2009F	2010F	2011F
<b>Global</b>	-2.1	3.2	3.4	1.4	2.5	2.6	0.2	0.1	0.0	-6.9	-6.8	-5.5
Based on PPP weights	-1.5	3.7	3.9	2.1	3.1	3.3	0.6	0.4	0.2	-6.5	-6.2	-5.0
<b>Industrial Countries</b>	-3.4	2.1	2.3	0.1	1.3	1.3	-0.9	-0.8	-0.8	-8.0	-8.1	-6.6
United States	-2.6	2.7	3.1	-0.3	2.0	1.2	-3.1	-3.8	-4.4	-10.0	-10.0	-7.5
Japan	-5.3	1.5	1.5	-1.3	-1.5	-0.3	2.7	3.2	3.4	-9.3	-7.2	-9.2
Euro Area	-3.8	1.5	1.5	0.3	1.2	1.5	-0.2	0.4	0.5	-6.6	-7.1	-5.2
Canada	-2.7	2.5	3.4	0.3	1.4	2.0	-2.7	-2.2	-1.6	-3.7	-2.8	-1.6
Australia	1.1	3.3	3.4	1.9	2.3	2.7	-4.2	-5.2	-5.1	-2.3	-4.7	-3.6
New Zealand	-1.5	2.5	3.4	2.3	2.4	2.3	-2.4	-6.3	-7.0	-2.2	-4.4	-5.1
Germany	-4.8	2.0	1.9	0.3	0.9	1.5	4.6	5.5	5.5	-3.9	-5.9	-5.2
France	-2.3	1.8	1.6	0.1	0.9	1.4	-2.1	-1.3	-0.4	-7.8	-8.0	-7.0
Italy	-4.7	1.4	0.8	0.8	1.5	1.4	-3.2	-2.4	-1.4	-5.8	-5.8	-5.5
Spain	-3.5	0.1	0.5	-0.3	0.8	1.1	-6.4	-5.0	-7.4	-11.0	-10.7	-9.5
Netherlands	-4.0	1.4	1.4	1.1	0.9	1.2	6.0	5.1	7.6	-4.0	-5.6	-4.5
Denmark	-5.4	1.2	1.7	1.5	1.9	1.9	2.1	2.2	2.5	-1.8	-4.6	-3.8
Norway	-1.1	2.8	2.7	2.3	1.9	2.0	15.6	16.6	17.5	7.4	7.0	7.6
Sweden	-4.5	2.5	2.4	-0.4	0.9	1.9	6.8	7.4	8.3	-2.1	-3.3	-2.3
Switzerland	-1.4	1.1	1.7	-0.5	-0.1	-0.1	8.0	8.7	9.4	-0.7	-0.7	-1.3
United Kingdom	-4.7	1.5	2.3	2.1	3.5	2.8	-2.7	-2.0	0.1	-12.3	-13.4	-11.6
<b>Emerging Markets</b>	0.8	5.7	5.9	4.5	5.1	5.6	2.7	2.2	1.8	-4.5	-3.8	-3.1
China	8.7	9.8	9.0	-0.6	3.0	3.8	6.6	6.1	5.4	-3.0	-2.8	-2.7
Hong Kong	-3.2	4.0	5.0	0.5	1.8	2.0	8.5	9.0	10.0	-1.5	-1.0	0.0
India*	6.2	7.8	8.5	2.7	5.0	4.5	-0.8	0.1	0.2	-10.3	-9.0	-8.5
Korea	-0.1	4.7	5.0	2.7	3.0	3.2	4.8	2.4	1.1	-2.5	-1.9	-0.1
Singapore	-1.3	6.5	5.1	0.3	2.8	2.1	12.0	11.7	10.4	-4.0	-3.0	5.0
Czech Republic	-4.3	1.5	2.5	1.0	1.0	2.4	-1.2	-1.1	-1.8	-6.5	-5.8	-5.1
Hungary	-6.4	0.5	3.2	4.0	3.9	3.3	-2.9	-3.2	-3.4	-4.0	-3.9	-2.7
Poland	1.4	2.6	3.6	3.5	2.0	2.3	-1.7	-2.5	-3.4	-6.0	-6.7	-4.4
Romania	-7.1	1.3	2.7	5.5	3.7	3.5	-4.8	-6.1	-6.5	-8.0	-6.0	-5.0
Russia	-7.5	3.0	4.1	11.7	6.8	8.3	3.9	3.2	3.0	-6.5	-4.2	-3.9
Turkey	-5.7	4.2	5.5	6.2	7.1	6.6	-2.1	-3.8	-4.0	-6.5	-5.0	-4.2
Nigeria	4.8	4.6	6.2	12.3	8.8	10.2	6.2	11.9	9.8	-5.6	-3.8	-2.5
South Africa	-1.9	2.6	3.1	7.4	6.0	6.8	-4.2	-5.2	-5.7	-7.6	-6.3	-5.4
Argentina	-3.3	2.0	2.0	15.4	19.3	17.4	3.1	3.2	0.5	-2.3	-1.8	-1.0
Brazil	0.2	5.0	4.0	4.9	4.0	4.1	-1.1	-2.2	-2.7	-3.2	-1.8	-2.5
Mexico	-7.1	3.6	3.8	5.4	4.9	4.4	-0.9	-1.2	-2.2	-2.1	-2.5	-1.8
Venezuela	-2.6	-1.7	0.5	28.7	30.4	39.0	-0.4	6.3	4.0	-5.8	-3.5	-1.0

Note: \*For India, inflation measure is the wholesale price index on fiscal year basis. Source: Citi Investment Research and Analysis



Figure 19. Change in Economic Forecast from the Previous Month (Percentage), 2009-2011F

	GDP Growth			CPI Inflation			Current Balance (% of GDP)			Fiscal Balance (% of GDP)		
	2009F	2010F	2011F	2009F	2010F	2011F	2009F	2010F	2011F	2009F	2010F	2011F
<b>Global</b>		<b>0.1</b>			<b>0.1</b>	<b>0.1</b>	<b>0.1</b>	<b>0.1</b>	<b>NA</b>	<b>0.5</b>	<b>-0.5</b>	<b>NA</b>
Based on PPP weights		0.1	NA	0.2	0.1	NA	0.1		NA	0.4	-0.5	NA
<b>Industrial Countries</b>		<b>0.2</b>	<b>-0.1</b>	<b>0.1</b>	<b>0.1</b>	<b>0.1</b>	<b>0.2</b>	<b>0.1</b>	<b>NA</b>	<b>0.7</b>	<b>-0.6</b>	<b>NA</b>
United States	-0.1	0.1	-0.4	0.1	0.2		0.1	0.2	NA	2.0	-1.0	NA
Japan	0.4	0.5	0.3	-0.1		0.2	-0.2	-0.2	NA	2.0	1.4	NA
Euro Area	-0.1	-0.1		0.1	0.1	0.1	0.5		NA	-0.6	-0.6	NA
Canada		0.1	-0.3			0.1	0.3	0.2	NA		0.1	NA
Australia		0.5	0.2		-0.3	-0.5	-0.3	-1.2	NA	0.4	0.2	NA
New Zealand	0.2	1.2	0.6	0.2	0.4	-0.4	3.3	-2.3	NA	-0.6		NA
Germany		0.1	-0.1		-0.1	0.1		0.3	NA		0.2	NA
France	-0.2	0.2	-0.2		0.1	-0.1	-0.2	0.5	NA			NA
Italy	-0.1	0.4	0.3		0.1	-0.3	-0.4	-0.3	NA			NA
Spain	0.2	0.5	-0.2	0.1	0.1		-0.1	-0.2	NA	-1.0	-1.2	NA
Netherlands	0.2		-0.3						NA			NA
Denmark	-0.4	0.7	NA			NA	0.6	0.9	NA	0.2	-0.6	NA
Norway	0.2	0.2	0.1		-0.2	-0.5			NA		0.3	NA
Sweden	0.3	-0.1	-0.7		-1.3	-0.3	0.1	0.5	NA			NA
Switzerland			0.1	0.1	0.2	0.1	-0.3	-2.4	NA		0.6	NA
United Kingdom	-0.3	0.2			0.1	0.1		0.1	NA	0.3	0.6	NA
<b>Emerging Markets</b>	<b>0.1</b>	<b>0.1</b>	<b>0.3</b>	<b>0.1</b>		<b>0.3</b>		<b>0.1</b>	<b>NA</b>		<b>-0.3</b>	<b>NA</b>
China							-0.1	-0.1	NA		-0.4	NA
Hong Kong	-0.1	0.8	NA	0.2	0.2	NA		1.0	NA			NA
India*	0.4		0.2	0.7			0.1		NA	0.2	-0.5	NA
Korea	0.7	0.7	1.0	-0.3	0.3	0.7	-0.2	0.3	NA		0.1	NA
Singapore	-0.3		NA	0.1	1.4	NA	-1.0	0.7	NA			NA
Czech Republic	0.4	0.2	NA		-0.3	NA	0.3	0.5	NA	0.1	0.8	NA
Hungary		0.4	NA			NA		0.1	NA	-0.2	-0.2	NA
Poland	0.5	0.8					0.3	0.1	NA	-0.2		NA
Romania			NA	-0.1	-0.9	NA			NA	-0.5		NA
Russia				-0.3	-1.8	-1.3	-0.1	-0.2	NA			NA
Turkey	0.3	0.7		-0.1		0.6	-0.2	-0.7	NA			NA
Nigeria	0.6		NA	0.5		NA	13.5	12.8	NA	-0.7	-0.5	NA
South Africa	0.2	-0.1	0.1			0.8	0.6	0.1	NA	-1.2	-0.3	NA
Argentina	0.2	1.5	NA	1.2	0.6	NA	0.3	1.0	NA	-0.1	-0.3	NA
Brazil									NA	-0.2		NA
Mexico	0.3		-0.1		0.7	0.5	-0.1		NA			NA
Venezuela	-0.4		NA			NA		2.5	NA			NA

Note: For India, inflation measure is the wholesale price index on fiscal year basis. Source: Citi Investment Research and Analysis

Figure 20. Short Rates (End of Period), as of 23 November, 2009

	Current	4Q 09	1Q 10	2Q 10	3Q 10	4Q 10	1Q 11
<b>United States</b>	0.13	0.13	0.13	0.13	0.13	1.00	1.50
<b>Japan</b>	0.10	0.10	0.10	0.10	0.10	0.10	0.10
<b>Euro Area</b>	1.00	1.00	1.00	1.00	1.00	1.00	1.25
Canada	0.25	0.25	0.25	0.25	0.75	1.25	1.75
Australia	3.50	3.75	4.25	4.50	5.00	5.50	5.75
New Zealand	2.50	2.50	3.00	4.00	4.50	5.00	5.50
Denmark	1.25	1.25	1.25	1.25	1.25	1.25	1.50
Norway	1.50	1.50	2.00	2.25	2.50	3.00	3.25
Sweden	0.25	0.25	0.25	0.50	0.75	1.00	1.50
Switzerland	0.25	0.25	0.25	0.25	0.25	0.25	0.25
United Kingdom	0.50	0.50	0.50	0.50	1.00	1.50	1.50
<b>China</b>	5.31	5.31	5.31	5.31	5.58	5.85	6.39

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

Figure 21. 10-Year Yield Forecasts (Period Average), as of 23 November, 2009

	Current	4Q 09	1Q 10	2Q 10	3Q 10	4Q 10	1Q 11
<b>United States</b>	3.40	3.45	3.45	3.75	4.15	4.45	4.65
<b>Japan</b>	1.32	1.30	1.25	1.40	1.40	1.50	1.60
<b>Euro Area (Germany)</b>	3.29	3.35	3.35	3.60	3.90	4.00	4.10
Canada	3.38	3.45	3.35	3.65	4.25	4.90	5.10
Australia	5.42	5.50	5.60	5.75	5.90	6.10	6.30
New Zealand	6.03	6.00	6.50	7.00	7.30	7.50	7.50
Denmark	3.65	3.74	3.70	3.90	4.15	4.25	4.35
Norway	4.06	4.22	4.15	4.45	4.75	4.85	4.95
Sweden	3.29	3.40	3.45	3.75	4.05	4.15	4.30
Switzerland	2.00	2.09	2.37	2.46	2.62	2.62	2.43
United Kingdom	3.66	3.91	4.01	4.35	4.74	4.94	5.13

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

Figure 22. 10-Year Yield Spreads (Period Average), as of 23 November, 2009

	Spread vs. US\$						Spread vs. Germany					
	Current	4Q 09	1Q 10	2Q 10	3Q 10	4Q 10	Current	4Q 09	1Q 10	2Q 10	3Q 10	4Q 10
<b>United States</b>	NA	NA	NA	NA	NA	NA	14	13	13	19	29	50
<b>Japan</b>	-211	-218	-223	-239	-279	-300	-197	-205	-210	-220	-250	-250
<b>Euro Area</b>	-14	-13	-13	-19	-29	-50	NA	NA	NA	NA	NA	NA
Canada	-2	-5	20	15	20	51	12	8	33	34	50	101
Australia	206	210	220	205	179	169	220	223	233	223	209	219
New Zealand	269	261	313	334	324	314	283	274	326	352	353	364
France	15	17	17	14	6	-10	29	30	30	33	35	40
Italy	65	62	62	61	61	40	79	75	75	80	90	90
Spain	42	47	57	56	56	40	56	60	70	75	85	90
Netherlands	6	7	7	1	-9	-50	26	20	20	20	20	20
Belgium	21	22	25	21	14	-50	37	35	35	38	40	43
Denmark	22	26	22	11	-4	-25	36	39	35	30	25	25
Norway	63	74	67	66	56	35	77	87	80	85	85	85
Sweden	-14	-8	-3	-4	-14	-35	0	5	10	15	15	15
Switzerland	-143	-139	-111	-133	-157	-188	-129	-126	-98	-114	-128	-138
United Kingdom	26	47	57	61	61	50	40	60	70	80	90	100

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

Source: Citi Investment Research and Analysis

Figure 23. Emerging Market Countries — Short Rates Actual and Forecast (End of Period), as of 23 November, 2009

	Current Rate (%)	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10	Cumulative rise in rates by Dec 2010
Chile	0.50	0	0	100	125	75	300
Brazil	8.80	0	0	100	100	0	200
Turkey	6.50	0	75	75	0	0	150
India	4.75	0	25	25	50	25	125
Indonesia	6.50	0	0	50	50	25	125
Korea	2.00	0	50	25	25	25	125
Mexico	4.50	0	25	50	50	0	125
Thailand	1.25	0	25	50	0	50	125
Philippines	4.00	0	0	0	50	50	100
China	5.31	0	0	0	27	27	54
Czech	1.30	0	0	25	25	25	75
Israel	0.80	25	50	0	0	0	75
Taiwan	0.10	0	0	25	25	25	75
Malaysia	2.00	0	0	0	0	50	50
Poland	3.50	0	0	0	25	25	50
South Africa	7.00	0	0	0	0	50	50
Russia	9.50	0	-50	0	0	0	-50
Romania	8.00	0	-50	-50	-25	0	-125
Hungary	7.00	-50	-75	-25	0	0	-150

Source: Citi Investment Research and Analysis

Figure 24. Foreign Exchange Forecasts (End of Period), as of 23 November, 2009

	vs USD							vs EUR					
	Current	Dec-09	Mar-10	Jun-10	Sep 10	Dec 10	Current	Dec-09	Mar-10	Jun-10	Sep 10	Dec 10	
United States	NA	NA	NA	NA	NA	NA	1.49	1.50	1.62	1.61	1.60	1.57	
Japan	89	87	84	84	85	86	133	130	136	136	135	135	
Euro Area	1.49	1.50	1.62	1.61	1.60	1.57	NA	NA	NA	NA	NA	NA	
Canada	1.06	1.07	1.00	1.01	1.02	1.02	1.59	1.61	1.62	1.62	1.62	1.61	
Australia	0.92	0.92	1.00	0.99	0.98	0.97	1.62	1.63	1.62	1.62	1.62	1.62	
New Zealand	0.73	0.73	0.78	0.77	0.76	0.75	2.04	2.05	2.08	2.08	2.09	2.11	
Norway	5.64	5.51	5.00	5.00	5.00	5.03	8.41	8.08	8.03	7.98	7.91	7.83	
Sweden	6.90	6.77	6.16	6.14	6.11	6.13	10.29	9.96	9.86	9.76	9.64	9.52	
Switzerland	1.01	1.01	0.93	0.93	0.94	0.94	1.51	1.51	1.50	1.49	1.48	1.47	
United Kingdom	1.66	1.66	1.75	1.69	1.63	1.59	0.90	0.92	0.95	0.98	0.99	0.96	
China	6.83	6.80	6.75	6.70	6.65	6.62	10.2	10.2	10.9	10.8	10.6	10.4	
India	46.7	45.0	44.0	43.0	42.5	41.5	69.6	67.5	71.1	69.0	67.8	65.3	
Korea	1157	1100	1075	1075	1050	1050	1726	1650	1737	1726	1675	1653	
Poland	2.77	2.73	2.48	2.43	2.39	2.37	4.13	4.01	3.91	3.81	3.73	3.70	
Russia	28.8	28.0	27.0	26.9	26.9	26.8	43.0	42.0	43.6	43.2	42.9	42.3	
South Africa	7.52	7.29	7.03	7.10	7.16	7.35	11.22	10.93	11.36	11.39	11.43	11.56	
Turkey	1.49	1.46	1.43	1.44	1.46	1.48	2.22	2.19	2.31	2.32	2.33	2.34	
Brazil	1.73	1.65	1.70	1.70	1.70	1.80	2.59	2.48	2.75	2.73	2.71	2.83	
Mexico	13.0	12.8	12.9	12.9	13.0	13.1	19.5	19.2	20.8	20.7	20.7	20.6	

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

Figure 25. Foreign Exchange Forecasts (End of Period), as of 23 November, 2009

	vs JPY					
	Current	Dec-09	Mar-10	Jun-10	Sep 10	Dec 10
United States	89	87	84	84	85	86
Japan	NA	NA	NA	NA	NA	NA
Euro Area	133	130	136	136	135	135
Canada	84	81	84	84	83	84
Australia	82	80	84	84	83	83
New Zealand	65.0	63.3	65.4	65.1	64.8	64.0
Norway	15.8	15.7	16.8	16.9	17.0	17.0
Sweden	12.9	12.8	13.7	13.8	13.9	14.0
Switzerland	88	86	90	90	91	91
United Kingdom	148	144	148	143	138	136
China	13	13	12	13	13	13
India	1.90	1.93	1.91	1.96	2.00	2.06
Korea	13.01	12.68	12.78	12.73	12.38	12.27
Poland	32.1	31.8	33.9	34.7	35.6	36.1
Russia	3.1	3.1	3.1	3.1	3.2	3.2
South Africa	11.8	11.9	12.0	11.9	11.8	11.6
Turkey	59.7	59.4	59.0	58.5	58.1	57.6
Brazil	51.3	52.6	49.5	49.7	49.9	47.5
Mexico	6.8	6.8	6.5	6.5	6.5	6.5

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

Figure 26. Long-Term Forecasts (Calendar Year Average), as of 23 November, 2009

	GDP					CPI					Short-Term Interest Rates				
	2010	2011	2012	2013	2014	2010	2011	2012	2013	2014	2010	2011	2012	2013	2014
<b>Global</b>	<b>3.2</b>	<b>3.4</b>	<b>3.7</b>	<b>3.8</b>	<b>3.6</b>	<b>2.5</b>	<b>2.6</b>	<b>2.7</b>	<b>2.7</b>	<b>2.6</b>					
<b>Industrial Countries</b>	<b>2.1</b>	<b>2.3</b>	<b>2.6</b>	<b>2.6</b>	<b>2.4</b>	<b>1.3</b>	<b>1.3</b>	<b>1.6</b>	<b>1.8</b>	<b>1.8</b>					
United States	2.7	3.1	3.5	3.5	3.0	2.0	1.2	1.7	2.0	2.0	0.30	1.75	2.75	3.25	3.25
Japan	1.5	1.5	1.2	1.0	1.0	-1.5	-0.3	0.1	0.7	0.7	0.10	0.30	0.80	1.30	1.50
Euro Area	1.5	1.5	1.7	1.8	1.8	1.2	1.5	1.7	1.8	1.8	1.00	1.90	3.25	3.75	3.75
Canada	2.5	3.4	3.3	3.6	3.5	1.4	2.0	1.9	2.0	2.0	0.63	2.50	4.13	4.25	4.25
Australia	3.3	3.4	3.7	3.2	3.0	2.3	2.7	2.8	3.0	2.6	4.80	5.75	6.25	6.75	6.25
New Zealand	2.5	3.4	3.2	2.8	2.7	2.4	2.3	2.7	2.3	2.5	4.10	6.00	6.70	6.40	6.10
Germany	2.0	1.9	1.7	1.7	1.6	0.9	1.5	1.2	1.3	1.3	NA	NA	NA	NA	NA
France	1.8	1.6	1.8	1.8	1.7	0.9	1.4	1.3	1.2	1.7	NA	NA	NA	NA	NA
Italy	1.4	0.8	1.0	1.0	1.0	1.5	1.4	1.8	1.9	1.9	NA	NA	NA	NA	NA
Spain	0.1	0.5	1.1	1.5	1.7	0.8	1.1	1.5	1.7	1.8	NA	NA	NA	NA	NA
Netherlands	1.4	1.4	1.9	1.9	1.9	0.9	1.2	1.4	1.6	1.8	NA	NA	NA	NA	NA
Denmark	1.2	1.7	1.9	2.0	2.2	1.9	1.9	2.0	2.0	2.1	1.35	2.15	3.50	4.00	4.25
Norway*	2.8	2.7	3.3	3.5	3.4	1.9	2.0	2.5	2.6	2.6	2.40	3.75	4.50	5.00	5.00
Sweden	2.5	2.4	3.0	3.3	3.5	0.9	1.9	2.2	2.2	2.3	0.60	2.20	3.70	4.00	4.00
Switzerland	1.1	1.7	2.0	2.5	3.0	-0.1	-0.1	0.7	0.8	1.5	0.25	0.30	0.81	1.50	2.00
United Kingdom	1.5	2.3	3.3	3.3	3.0	3.5	2.8	2.2	2.2	2.2	0.79	1.75	2.55	3.55	4.00
<b>Emerging Markets</b>	<b>5.7</b>	<b>5.9</b>	<b>6.1</b>	<b>6.2</b>	<b>5.8</b>	<b>5.1</b>	<b>5.6</b>	<b>5.2</b>	<b>4.6</b>	<b>4.0</b>					
China	9.8	9.0	9.0	8.8	8.5	3.0	3.8	4.0	3.5	3.5	5.4	6.5	6.8	6.9	6.9
Hong Kong	4.0	5.0	4.5	4.5	4.2	1.8	2.0	2.5	3.0	2.5	0.4	2.1	3.6	3.5	3.3
India**	7.8	8.5	8.5	8.6	9.0	5.0	4.5	4.0	4.0	4.0	6.0	6.0	6.0	6.0	6.0
Korea	4.7	5.0	5.2	4.9	4.8	3.0	3.2	3.1	2.8	2.8	2.9	3.7	4.2	4.9	5.0
Singapore	6.5	5.1	5.8	6.0	6.0	2.8	2.1	2.0	2.0	2.0	1.1	1.0	2.5	4.0	4.0
Czech Republic	1.5	2.5	3.5	4.5	4.0	1.0	2.4	2.2	2.5	2.5	1.6	2.7	3.6	3.6	3.7
Hungary	0.5	3.2	3.8	3.9	4.0	3.9	3.3	3.1	3.0	2.8	5.5	7.0	7.0	6.0	5.5
Poland	2.6	3.6	5.0	4.5	4.5	2.0	2.3	2.5	2.8	2.5	3.7	4.4	4.8	5.0	5.0
Romania	1.3	2.7	4.0	5.0	5.0	3.7	3.5	3.0	3.0	3.0	7.4	6.3	5.6	5.5	5.5
Russia	3.0	4.1	4.0	4.6	4.5	6.8	8.3	7.5	5.9	5.5	8.5	8.0	7.5	6.0	6.0
Turkey	4.2	5.5	5.8	6.0	6.0	7.1	6.6	6.0	5.3	4.8	8.0	10.5	9.5	8.5	7.8
Nigeria	4.6	6.2	6.7	6.4	6.3	8.8	10.2	9.2	9.5	10.3	9.0	10.0	10.3	10.0	10.5
South Africa	2.6	3.1	3.3	3.7	4.2	6.0	6.8	6.5	5.8	5.5	7.1	9.0	9.5	9.5	9.3
Argentina	2.0	2.0	2.0	2.0	2.0	19.3	17.4	12.5	8.5	6.5	9.3	11.5	10.5	9.5	9.0
Brazil	5.0	4.0	4.5	4.5	4.5	4.0	4.1	4.0	4.0	4.0	9.8	10.8	10.6	10.0	9.3
Mexico	3.6	3.8	4.2	3.3	3.5	4.9	4.4	3.8	3.1	3.1	5.3	5.8	6.8	6.1	6.0
Venezuela	-1.7	0.5	1.5	2.5	3.0	30.4	39.0	37.0	35.0	31.0	15.3	19.4	17.2	15.1	12.5

Note: \*For Norway, mainland GDP. \*\*For India, inflation measure is the wholesale price index. All fx forecasts are consistent with the long-term forecasts presented in Appendix 1. Source: Citi Investment Research and Analysis

Figure 27. Long-Term Forecasts (Calendar Year Average), as of 23 November, 2009

	Ten-Year Yields					Exchange Rate Versus U.S. Dollar					Exchange Rate Versus Euro					
	2010	2011	2012	2013	2014	2010	2011	2012	2013	2014	2010	2011	2012	2013	2014	
United States	3.95	4.85	5.25	5.25	5.00	NA	NA	NA	NA	NA	1.60	1.49	1.43	1.37	1.31	
Japan	1.39	1.71	1.75	2.00	2.25	85	89	90	92	94	135	132	129	126	123	
Euro Area	3.73	4.10	4.20	4.20	4.20	1.60	1.49	1.43	1.37	1.31	NA	NA	NA	NA	NA	
Canada	4.00	5.25	5.50	5.35	5.10	1.01	1.02	1.03	1.03	1.04	1.62	1.52	1.47	1.41	1.36	
Australia	5.84	6.40	6.70	6.90	6.50	0.99	0.92	0.89	0.86	0.83	1.62	1.61	1.60	1.59	1.58	
New Zealand	7.08	7.50	7.20	6.70	6.40	0.76	0.68	0.66	0.63	0.61	2.09	2.19	2.18	2.16	2.15	
Denmark	4.01	4.35	4.45	4.45	4.45	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	
Norway	4.56	4.85	5.00	4.05	5.05	5.01	5.18	5.38	5.59	5.82	8.00	7.71	7.68	7.65	7.62	
Sweden	3.86	4.25	4.40	4.45	4.50	6.14	6.28	6.38	6.49	6.62	9.80	9.33	9.11	8.89	8.67	
Switzerland	2.52	2.43	2.52	2.54	2.58	0.94	0.97	1.01	1.05	1.09	1.50	1.45	1.44	1.44	1.43	
United Kingdom	4.52	5.10	5.10	5.10	5.10	1.66	1.61	1.66	1.72	1.79	0.96	0.93	0.86	0.80	0.73	
<b>Emerging Markets</b>																
China	3.63	3.90	4.00	3.70	3.70	6.68	6.47	6.30	6.10	5.93	10.67	9.62	9.00	8.35	7.76	
Hong Kong	2.39	2.90	3.00	3.00	3.00	7.75	7.75	7.75	7.75	7.75	12.38	11.53	11.07	10.61	10.15	
India	7.75	7.75	7.75	7.75	7.75	42.8	42.5	40.0	39.0	39.0	68.3	63.2	57.1	53.4	51.1	
Korea	5.30	5.60	5.70	6.00	6.00	1063	1038	1000	925	900	1698	1543	1428	1266	1179	
Singapore	3.06	4.20	4.30	4.50	4.50	1.35	1.35	1.30	1.30	1.30	2.16	2.00	1.86	1.78	1.70	
Czech Republic	4.50	4.50	4.31	4.28	4.30	16.19	16.65	16.81	16.80	17.56	25.86	24.77	24.00	23.00	23.00	
Hungary	7.40	6.90	6.80	6.80	6.20	162	169	172	175	183	259	251	245	240	240	
Poland	5.65	5.83	5.54	5.45	5.45	2.42	2.45	2.52	2.56	2.67	3.86	3.64	3.60	3.50	3.50	
Romania	NA	NA	NA	NA	NA	2.63	2.77	2.80	2.81	2.82	4.20	4.12	4.01	3.85	3.70	
Russia	9.00	8.50	8.00	7.50	6.50	26.90	26.68	26.83	27.44	28.08	42.98	39.67	38.32	37.57	36.79	
Turkey	NA	NA	NA	NA	NA	1.45	1.57	1.60	1.62	1.62	2.32	2.33	2.28	2.22	2.12	
Nigeria	8.50	10.00	9.00	9.25	10.50	151	147	146	144	143	241	219	208	197	187	
South Africa	9.25	9.65	9.75	9.75	9.75	7.16	8.16	8.90	9.30	9.60	11.44	12.13	12.71	12.73	12.58	
Argentina	17.33	17.25	14.00	13.00	12.25	4.10	4.73	5.12	5.43	5.70	6.56	7.03	7.32	7.43	7.47	
Brazil	11.37	11.41	10.85	9.85	9.18	1.73	1.80	1.82	1.85	1.89	2.76	2.68	2.60	2.54	2.48	
Mexico	8.77	8.60	7.85	7.50	7.38	12.96	13.35	13.55	13.50	13.40	20.71	19.85	19.35	18.48	17.55	
Venezuela	12.00	13.00	13.00	11.00	9.50	3.15	3.92	4.76	5.73	6.77	5.03	5.83	6.80	7.84	8.87	

<sup>a</sup> Ten-year bund yield. Exchange rate versus U.S. dollar shows US\$/€. <sup>b</sup> US\$/A\$. <sup>c</sup> US\$/NZ\$. <sup>d</sup> US\$/£. <sup>e</sup> 5-year government bond yield. NA Not available. All fx forecasts are consistent with the long-term forecasts presented in Appendix 1. Source: Citi Investment Research and Analysis

## Country Commentary

### United States

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After two years of financial turmoil and crisis punctuated by a near-freefall in spending and output, the U.S. economy has begun to stabilize. Although recovery appears fragile and weaker than published GDP suggests, key drags are fading and the financial underpinnings for sustained rebound are coming into view. We do not expect the kind of powerful upturn that might be anticipated after such a deep and long slide. But a moderate turn that can withstand a gradual retreat from maximum policy support seems increasingly likely.

There has been much controversy about the role that policies have played in the resumption of growth in recent months. Very bullish forecasts argue that as stimulus takes effect, the release of large-scale pent-up demand and supply will safely position the economy for above-trend growth. Pessimists turn that view on its head by asserting that once stimulus fades, underlying weaknesses still present downside risks, which will hobble recovery next year.

In our judgment, the two key interrelated drags associated with financial strains and the collapse of housing are losing their force. In the case of homebuilding, that pressure has reversed as a one-point drag on GDP is now contributing about a half-point to growth. We are skeptical that home prices have bottomed given a sizable overhang of vacant homes for sale and further foreclosures. But the downside risks at much reduced prices may be overshadowed by sky-high affordability and extended tax credits that may lure pent-up buyers. The new home market is undersupplied and even employment in this sector may be poised to rise as building activity gains.

Healthy access to credit remains a sticking point but overall financial conditions are substantially improved and at least for now are aiding recovery. This development may be key to sustaining a moderate upturn as fiscal and other supports wind down. In some cases, markets are functioning without special aid. Interbank and money markets are extremely accommodating as fears of systemic breakdowns have been overcome. In the bond market, improved credit conditions have allowed firms to bolster liquidity and build a war chest for future needs. Surplus cash flow and widening profit margins reinforce the notion that the corporate sector is prepared for recovery.

A rising equity market is an important feature of the more supportive financial landscape, especially now that earlier negative wealth effects are dissipating. The rallies in credit and equities have pulled the Citi Financial Conditions Index from historically weak readings virtually back to norms. Importantly, this lift has begun to show through to real activity measures as layoff rates are diminishing steadily and final demand is reviving.

In contrast to past recoveries, the consumer is playing only a supporting role. Fiscal prodding has boosted spending in recent months, but as this support fades, income will likely provide a modest handoff. Wealth has stabilized, but at a substantially reduced level. Persistent worries about jobs and income along with reduced access to credit may prevent a cyclical dip in savings rates.

Consumers also may be helped by continued low inflation next year. Recession has left oceans of slack economywide. A lower dollar and higher commodity

prices have drawn attention to the risk of higher relative prices, but without a strong financial tailwind beneath aggregate demand or an emerging psychology of inflation to drive behavior, we believe pricing power will remain bottled up. History has shown that with profit margins wide, competitive pressures will reinforce low inflation perhaps beyond next year.

The path for monetary policy is complicated by the uncertainties surrounding the exit from near-zero rates and the Fed's expanded balance sheet. We expect active retreat to begin later next year, contingent on confidence in a sustained recovery with supportive financial conditions and a consensus that inflation is unlikely to slow further. These are all high hurdles and we cannot rule out that even a modest retreat from accommodation could be put off beyond 2010. Our base case expects a 1% funds rate at year end but that will need to be buttressed by additional balance sheet measures to maintain a stable floor under rates (see discussion of exit strategies in Overview).

The fiscal outlook may present greater challenges because of scheduled tax hikes for 2011 and a potentially risky push for greater public support to health care. Absent a credible plan for deficit reduction with fundamental restraints on spending, fiscal pressures on bond yields could surface as early as next year and intensify as private sector credit needs emerge with a maturing recovery and a less accommodating Fed. However, model simulations that include a possible lurch higher in tax rates for upper-income earners would deflect growth noticeably in 2011. For the moment, our forecast leaves these out, but we expect to incorporate higher-tax rate effects in the base case as budgetary politics are resolved.

Figure 28. United States — Economic Forecast, 2009F-11F

		2009F	2010F	2011F	2009F		2010F			2011F	
					3QE	4QF	1QF	2QF	3QF	4QF	1QF
GDP	SAAR				2.7%	2.6%	3.4%	2.4%	3.5%	3.2%	3.1%
	YoY	-2.6%	2.7%	3.1%	-2.5	-0.5	2.0	2.8	3.0	3.1	3.0
Consumption	SAAR				3.2	1.4	1.7	2.3	2.7	2.7	3.1
	YoY	-0.6	2.0	2.9	-0.1	1.1	1.3	2.1	2.0	2.3	2.7
Business Investment	SAAR				-4.6	0.1	2.2	3.0	4.7	5.6	5.6
	YoY	-17.9	0.8	5.9	-19.4	-14.9	-3.1	0.1	2.5	3.9	4.7
Housing Investment	SAAR				21.5	9.4	10.8	23.3	26.3	15.1	6.8
	YoY	-20.0	13.7	12.1	-18.4	-10.9	3.1	16.1	17.2	18.7	17.6
Government	SAAR				2.8	1.0	1.6	0.6	1.0	0.8	0.0
	YoY	2.0	1.6	0.1	2.0	1.9	3.0	1.5	1.0	1.0	0.6
Exports	SAAR				17.2	2.6	5.0	5.8	5.5	5.6	6.6
	YoY	-10.7	5.6	6.6	-10.8	-5.2	4.9	7.5	4.7	5.5	5.9
Imports	SAAR				21.6	5.0	6.2	6.7	6.3	6.6	5.9
	YoY	-14.4	6.4	6.1	-13.9	-8.8	3.7	9.7	6.0	6.4	6.4
CPI	YoY	-0.3	2.0	1.2	-1.6	1.4	2.4	2.4	1.8	1.4	1.2
Core CPI	YoY	1.7	1.2	1.1	1.5	1.6	1.6	1.2	1.1	1.1	1.1
Unemployment Rate	%	9.3	10.4	9.8	9.6	10.2	10.4	10.6	10.4	10.2	10.0
Gov't Balance (Fiscal Year)	% of GDP	-10.0	-10.0	-7.5							
Assumed WTI Spot Price	US\$	62.2	83.8	87.1	68.2	78.3	81.7	83.4	84.5	85.5	86.2
Current Account	US\$bn	-437	-560	-678	-452	-482	-519	-543	-572	-605	-634
	% of GDP	-3.1	-3.8	-4.4	-3.2	-3.3	-3.6	-3.7	-3.9	-4.1	-4.2
S&P 500 Profits (US\$ Per Share)	YoY	1.1	16.0	9.0	-6.3	210.3	36.0	12.9	10.1	9.6	10.0

Notes: F Citi forecast. E Citi estimate. YoY Year-to-year percent change. SAAR Seasonally adjusted annual rate

Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, I/B/E/S, Treasury Department, *Wall Street Journal*, and Citi Investment Research and Analysis

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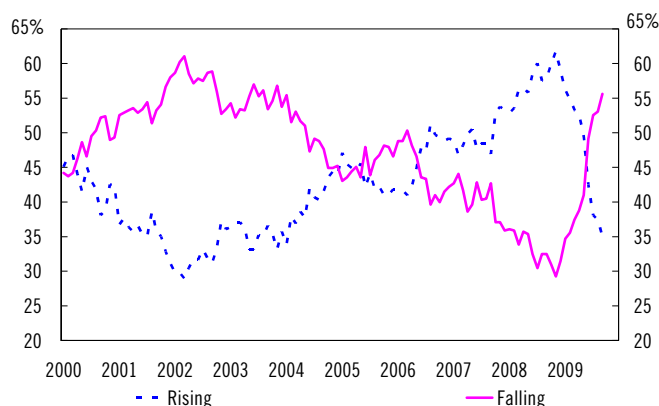
## Japan

After a temporary pause in activity early next year, the Japanese economy likely will return to a growth path somewhat above the potential growth rate of the economy (+0.5-1.0%) in 2010, mainly driven by a steady increase in exports, particularly those to Asia. Meanwhile, we expect business investment and labor income conditions to remain anemic, reflecting the exceptionally low level of economic activity. Deflation will probably persist well into 2011 amid large economic slack and declines in unit labor cost. Japan's fiscal condition is quite unlikely to improve over the next couple of years, and we are skeptical about the long-term fiscal sustainability. However, we expect long-term interest rates to remain relatively low in the near future, with private domestic saving expected to continue to more than offset the large fiscal deficit.

Real GDP grew at an annual rate of 3.7% on average over Q2 and Q3, mostly thanks to positive impacts from the government policy measures – public works spending and subsidies to the household sector — and a rebound in exports. But we expect the economy to pause temporarily early 2010 as the impacts of policy measures start to taper off. Moreover, export growth will probably moderate with an initial stage in which restocking pushes up export strongly but temporarily coming to an end.

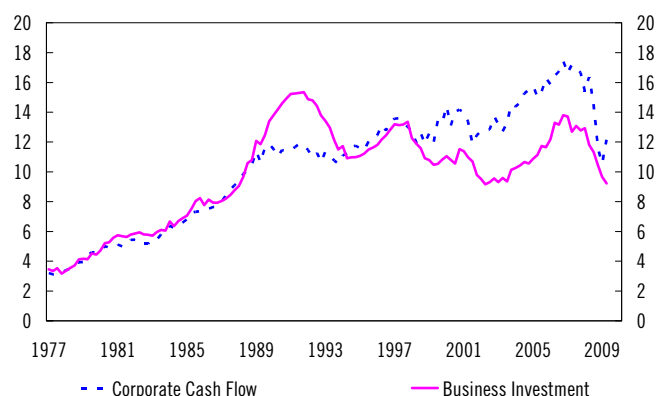
However, a near-term pause in economic activity is unlikely to signal another leg down in the economy. First, exports will probably continue to grow, at a slower but solid pace, mostly thanks to recoveries in emerging/commodity economies. In particular, we expect exports of capital goods to China will be strong in 2010. Second, the new administration plans to start policy measures to support the household sector (such as the child allowance) next spring, and this should provide some boost to consumer spending. Third, business investment will probably pick up, albeit very modestly, with the manufacturing sector (especially technology sectors) expected to start investing amid an upward trend in export and industrial production. Meanwhile, public investment likely will plunge in 2010. Fiscal stimulus introduced by the prior administration will run its course, while the current government plans to reduce public works spending partly in order to finance other spending.

**Figure 29. Japan — Proportion of Items Whose Prices Rose and Fell from a Year Ago in Nationwide CPI (Percent), 2000–Sep 09**



Sources: Ministry of Internal Affairs and Communications and Citi Investment Research and Analysis

**Figure 30. Japan — Cash Flow and Business Investment at Non-Financial Corporate Sector (Seasonally Adjusted, Trillion Yen), 1977–Q2 09**



Sources: Ministry of Finance and Citi Investment Research and Analysis



Deflation likely will persist well into 2011 amid large economic slack and declines in unit labor costs. The Bank of Japan (BoJ) also expects negative core inflation (excluding fresh food but including energy) in fiscal 2011 (starting April 2011). In September, core CPI (excluding food and energy) fell 1.0% year-over-year and prices of more than half of the items included in the CPI fell, indicating the breadth of price declines (see Figure 29). We expect the next rate hike will be delayed until H2-2011. Notably, as a result of persistent deflation, nominal GDP growth will probably be virtually zero in 2010. In this environment, companies will have to depend upon reductions in labor costs in order to make profits, which would bode ill for consumers.

Japan's fiscal condition is by far the worst among the industrialized countries. We expect that fiscal deficit of the general government will stay near 10% of GDP through 2014 and the gross debt-to-GDP ratio will approach or even reach 250% in 2014. New JGB issuance in 2011 will probably increase meaningfully compared with 2010, reflecting the planned new spending under the new government and sharp declines in non-tax revenues such as a transfer from the special budget accounts. In environment, Japan's interest rate markets will continue to be quite vulnerable to fiscal concern in years to come.

However, a sharp and sustainable rise in long-term interest rates appears unlikely for the next few years. The fiscal deficit is still being financed by private domestic savings. While the household saving rate will probably continue to fall (in part reflecting population ageing), the corporate sector is likely to maintain large excess saving (see Figure 30). We expect cost-cutting, along with sales growth, will drive corporate cash flow going forward while business investment is unlikely to recover strongly amid excessive production capacity. Thus, private domestic saving will probably continue to offset the fiscal deficit and a rise in long-term interest rates will probably be moderate.

Figure 31. Japan — Economic Forecast, 2009-11F

		2009F	2010F	2011F	2009F		2010F				2011F
					3Q	4QF	1QF	2QF	3QF	4QF	1QF
Real GDP	YoY	-5.3%	1.5%	1.5%	-4.4%	-1.2%	2.1%	1.8%	1.1%	1.1%	1.4%
	SAAR				4.8	1.0	-0.2	1.6	1.8	1.1	1.1
Domestic Demand	YoY	-3.5	0.6	1.3	-2.5	-2.2	0.0	1.0	0.6	0.7	1.1
	SAAR				3.3	0.1	-0.5	1.2	1.3	0.7	1.0
Private Consumption	YoY	-0.9	0.8	1.2	-0.2	0.3	1.2	0.8	0.5	0.9	1.3
	SAAR				2.8	-1.2	-0.8	2.4	1.5	0.6	0.7
Business Investment	YoY	-17.8	2.2	3.4	-16.9	-10.0	-1.3	4.1	3.1	3.0	2.9
	SAAR				6.6	2.8	2.6	4.2	2.7	2.4	2.3
Housing Investment	YoY	-13.8	-7.7	3.1	-20.2	-24.5	-19.1	-9.8	-1.2	2.2	3.3
Public Investment	YoY	10.7	-7.0	-4.8	12.4	14.5	6.0	-8.5	-10.0	-14.5	-11.0
Exports	YoY	-25.0	10.5	4.7	-23.3	-8.4	18.0	12.5	7.3	5.5	5.3
	SAAR				28.0	13.6	4.2	5.7	5.7	6.4	3.2
Imports	YoY	-14.7	4.1	4.4	-13.5	-13.0	1.9	7.1	4.2	3.2	3.2
	SAAR				14.1	8.8	2.9	3.2	2.2	4.3	3.2
Core CPI	YoY	-1.3	-1.5	-0.3	-2.3	-1.8	-1.4	-1.8	-1.6	-1.2	-0.8
Nominal GDP	YoY	-5.4	0.0	0.7	-4.4	-3.1	-0.6	0.0	0.2	0.3	0.8
Current Account	¥ tn	13.1	15.2	16.3	14.9	14.3	14.7	14.9	15.5	15.8	16.0
	% of GDP	2.7	3.2	3.4	3.1	3.0	3.1	3.1	3.2	3.3	3.3
Unemployment Rate	%	5.2	5.8	5.4	5.5	5.6	5.9	6.0	5.8	5.6	5.5
Industrial Production	YoY	-22.3	11.5	4.2	-20.1	-5.3	22.7	14.2	7.4	3.8	3.9
Corporate Profits (Fiscal Year)	YoY	-3.0	75.0	15.0							
General Govt. Balance (Fiscal Year)	% of GDP	-9.3	-7.2	-9.2							

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

## Euro Area

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We expect economic recovery with low inflation in the euro area. While temporary factors are likely to contribute to decent economic growth at the beginning of the recovery in 2H 2009, we expect lower growth momentum in 2010 and 2011. In 2010, loose fiscal and monetary policies are likely to propel private sector demand. The ECB will probably not start to hike rates until late 2010 or early 2011, and fiscal tightening also in aggregate will be deferred to 2011. With deleveraging in the euro area banking sector — and also in the household and corporate sectors — likely to be a drag for private sector demand for a while, the exit from monetary and fiscal stimulus measures will probably be gradual.

With average GDP growth of 2¼% SAAR (0.6% QQ) in 2H 2009, we expect decent nearterm GDP by euro area standards. However, temporary factors, like the scrapping bonus for cars and the rebuilding of inventories, are probably major contributors for growth in that period. Once these factors run out, we expect more modest growth rates around 1.3% SAAR (0.3% QQ) in 2010. Also, after a very strong boost to growth from net exports in 2H 2009, we expect that net exports will be less supportive, partly due to the expected further strengthening of the EUR. Although government capital expenditure and tax reductions are likely to contribute to growth in 2010, we expect a smaller impact on GDP than 2009's scrapping bonus. With ongoing balance sheet problems in the banking sector, we expect that lending conditions for households and companies will remain tight in 2010. Furthermore, companies probably will make more efforts to reduce their funding gap, suggesting that business investment will stay low. As households already increased their saving rate substantially, we do not expect an additional burden from that side in 2010. But with a weak income situation, private consumption is likely to stagnate next year.

For 2011 we expect that strains in private sector balance sheets will ease somewhat, helping to propel domestic demand. But, the expected gradual exit from monetary and fiscal stimulus measures is likely to cap growth at around 1.6% SAAR (0.4% QQ) in 2011. In this scenario, the output gap is likely to remain negative even in 2011 (around 1.5%) and the level of GDP at the end of 2011 will still be about 1% below the pre-crisis reading of 1Q 2008.

Figure 32. Euro Area — ECB Main Refinancing Rate and Overnight Rate, 2007–Mar 2011F

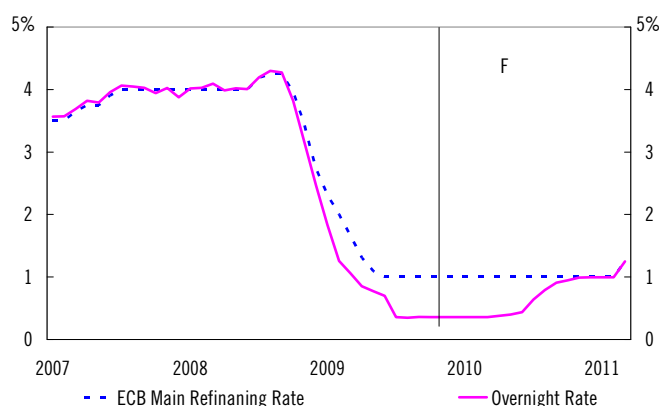
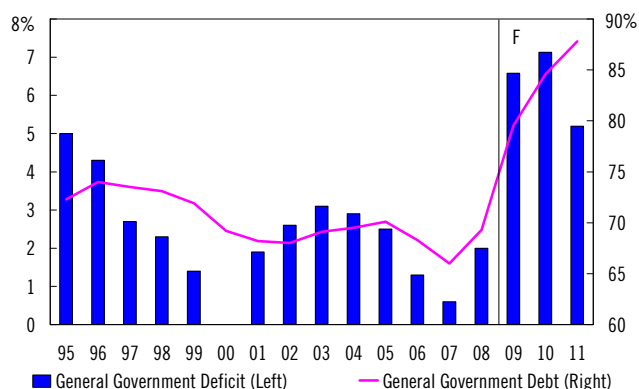


Figure 33. Euro Area — General Government Deficit and Debt (as Pct of GDP), 1995–2011F



Sources: Ecowin and Citi Investment Research and Analysis Forecasts

Sources: Ecowin and Citi Investment Research and Analysis Forecasts

With this economic outlook, we expect that core inflation will moderate further. We expect that wage growth will slow and that companies will struggle to implement price increases as long as domestic demand stays weak. The expected further strengthening of the EUR will also limit upside pressure which might emerge from rising commodity prices. Hence, we expect that inflation is likely to stay below the ECB's aim of "below, but close to 2%" for several years.

With little upside risk for inflation, the ECB probably will leave its main refinancing rate at 1.0% until 4Q 2010 or 1Q 2011, with gradual tightening thereafter. The ECB will not want to be trapped in a situation of low interest levels for too long — as in 2003/2005. But, before hiking rates, we expect the ECB to withdraw most of its liquidity support. As the situation in the European banking sector probably will remain fragile, we expect that the ECB will withdraw the liquidity supply gradually. In our view, banks will get generous liquidity in 1H 2010, but once the first 12-month tender expires in July 2010, the ECB is likely to withdraw liquidity more quickly, unless there is a renewed emergency. The reduction in liquidity is likely to close the gap between the overnight rate and the ECB's target rate (see Figure 32).

Fiscal policy will start the exit from the stimulus measures later. European decision makers decided that member countries shall go ahead with approved stimulus packages in 2010. They also in principle agreed to start fiscal consolidation in 2011, unless the economic situation deteriorates again. As temporary stimulus measures will expire in 2011, the first step of consolidation probably will be relatively easy. But, in order to bring down the deficit ratios below 3% of GDP by 2013 — as required by the European Commission for most countries — additional substantial fiscal tightening will be necessary. In our view, it is very unlikely that the currently high-deficit (and high debt) countries, i.e. France, Italy, Ireland, Spain or Greece will hit this deadline. According to our forecasts, the euro area general government debt-to-GDP ratio will rise from pre-crisis 66.0% in 2007 to 88% in 2011 (see Figure 33).

Figure 34. Euro Area — Economic Forecast, 2009F-11F

		2009F	2010F	2011F	2009		2010F				2011F
					3Q	4QF	1QF	2QF	3QF	4QF	1QF
Real GDP	YoY	-3.8%	1.5%	1.5%	-4.1%	-1.6%	1.2%	1.7%	1.7%	1.3%	1.3%
	SAAR				1.5	3.0	1.2	1.2	1.4	1.5	1.0
Final Domestic Demand	YoY	-2.5	0.1	1.0	-2.7	-1.8	-0.5	-0.2	0.4	0.8	0.9
Private Consumption	YoY	-1.1	-0.1	0.8	-1.2	-0.9	-0.4	-0.3	0.1	0.4	0.5
Government Consumption	YoY	2.4	1.7	1.1	2.3	2.1	1.8	1.6	1.7	1.7	1.5
Fixed Investment	YoY	-10.5	-0.9	1.5	-11.2	-8.2	-3.2	-1.5	0.1	1.0	1.3
— Business Equipment	YoY	-15.2	0.1	3.2	-16.6	-12.7	-3.2	-0.3	1.2	2.8	3.1
— Construction	YoY	-5.5	-0.7	0.3	-5.2	-2.8	-1.9	-1.0	0.1	0.2	0.1
Stocks (Contrib. to Y/Y GDP Growth)		-0.5	0.6	0	-0.7	-0.4	0.3	1.0	0.7	0.2	0.1
Exports	YoY	-14.0	4.7	3.7	-14.8	-6.3	4.3	6.6	4.8	3.2	3.0
Imports	YoY	-12.0	3.2	3.1	-13.3	-7.7	1.1	5.0	4.0	3.0	2.7
CPI	YoY	0.3	1.2	1.5	-0.4	0.4	0.9	1.2	1.4	1.4	1.5
Core CPI	YoY	1.4	1.1	0.8	1.3	1.2	1.0	1.2	1.2	0.9	0.8
CPI Ex Energy and Food	YoY	1.4	1.2	1.0	1.2	1.2	1.0	1.4	1.3	1.1	1.0
Unemployment Rate	YoY	9.4	10.6	10.3	9.6	10.1	10.4	10.6	10.7	10.7	10.6
Current Account Balance	EUR bn	-22	32	44							
	% of GDP	-0.2	0.4	0.5							
General Government Balance	EUR bn	585.1	651.2	485.5							
	% of GDP	-6.6	-7.1	-5.2							
General Government Debt	EUR bn	7066	7727	8208							
	% of GDP	79.5	84.6	87.7							
Gross Operating Surplus	YoY	-10.0	5.0	5.0							

Source: Citi Investment Research and Analysis

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## Germany

Germany is likely to outperform the euro area economy in terms of GDP growth in 2010 and 2011. After the freefall in exports during the crisis, Germany is benefiting from the recovery in global demand. With its high competitiveness relative to its euro area peers, Germany is likely to cope better with EUR strengthening than its neighbors. Although the German banking sector has a larger need to deleverage than the euro area average, German households and companies benefit from better balance sheet positions. And in order to prevent a credit crunch, we expect additional measures from the government to support loans to companies. This comes on top of other substantial fiscal stimulus measures for 2010, focusing on public investment and income support for households and companies. For 2011, when most public investment programs run out, we expect that the government will start with modest fiscal consolidation. Hence, unless the economic situation deteriorates again, we see only a small chance for further fiscal easing in 2011. However, there is still a chance that the centre-right government will proceed with the planned income tax rate cuts, but probably only in combination with a broader tax base.

## France

So far the recovery of French GDP has been due to improving net exports, reflecting increasing exports and falling imports in 2Q and 3Q 2009. In contrast to Germany, this is an unusual pattern for France. For 2010, we expect domestic demand will make major positive contributions to GDP, propelled by substantial fiscal measures — including public investment and government supported loans to companies. However, capital expenditure faces prolonged headwinds from the ongoing correction in housing investment and retrenchment by non-financial companies. Weakness in house prices probably will be a drag for households' net wealth in 2010, but incomes are likely to improve gradually as employment stabilizes during 2010 after the substantial fall in 1H 2009. Hence, private consumption is likely to continue to grow modestly in 2010. In 2011, the running-out of some fiscal measures is likely to contribute to a reduction in the general government deficit-to-GDP ratio, but we do not expect substantial fiscal consolidation in France. This is likely to be postponed, remaining a potential drag for GDP growth in the future.

Figure 35. Germany and France — Economic Forecast, 2009F-11F

		Germany			France		
		2009F	2010F	2011F	2009F	2010F	2011F
Real GDP	YoY	-4.8%	2.0%	1.9%	-2.3%	1.8%	1.6%
Final Domestic Demand	YoY	-1.3	0.8	1.1	-0.8	0.4	1.5
Private Consumption	YoY	0.6	-0.2	0.7	0.6	0.5	1.3
Fixed Investment	YoY	-9.4	2.7	3.1	-7.0	-1.4	2.4
Exports	YoY	-14.1	7.9	5.6	-10.7	5.2	3.0
Imports	YoY	-8.6	5.9	4.4	-10.0	5.2	3.0
CPI	YoY	0.3	0.9	1.5	0.1	0.9	1.4
Unemployment Rate	%	7.6	8.4	8.4	9.1	9.6	9.5
Current Account	€bn	111	135	138	-39.3	-26.1	-7.9
	% of GDP	4.6	5.5	5.5	-2.1	-1.3	-0.4
General Govt. Balance	€bn	93.9	-144.4	-130.9	-149.6	-157.5	-141.7
	% of GDP	-3.9	-5.9	-5.2	-7.8	-8.0	-7.0
General Govt. Debt	% of GDP	73.2	77.0	80.3	78.3	84.0	88.5
Gross Trading Profits	YoY	-15.4	7.1	8.6	-4.1	4.5	3.0

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

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## Italy

Italy exited the recession in 3Q, with a healthy rebound of 2.4% QQ SAAR, but this is unlikely to be repeated in coming quarters. The medium-term trend growth rate is likely to be in the 1% area. Still, two factors may allow GDP to run briefly above potential in coming quarters. First, re-stocking will likely sustain activity further in 4Q 09 and possibly in 1Q 10. Second, business investment should rebound in 1H 10, lifted by the fiscal rebates on re-invested profits and by the extremely low level reached by the investment ratio over GDP (15-year low). Prospects on private consumption, on the other hand, remain bleak, as unemployment is still likely to increase in 2010 and fiscal policy may become less supportive. Consumption should under-perform overall GDP growth in 2010 and in 2011. The government committed to reduce the fiscal deficit below the 3% limit by 2012, which implies a fiscal tightening of around 3pp of GDP over three years. A less supportive fiscal policy and the run-out of spending incentives should cause growth to decelerate again in 2011.

## Spain

The Spanish recovery will likely be slower than in the rest of the euro area. We expect GDP growth to return positive in 4Q 09, but to remain very weak throughout 2010 and 2011. The drag from de-leveraging should ease relative to 2009, but will continue to limit household spending. High unemployment will also be a drag on spending ability: we expect it to plateau at 20% but to hover around that level for a while. Housing will still be a negative contributor to growth both in terms of construction activity and of house purchases. More importantly, policy will become less growth-supportive from 2010 onwards. A fiscal tightening of 1% of GDP has already been approved for 2010, but we estimate the overall correction required to meet the 3% deficit-to-GDP target by 2013 to be around 9% of GDP. Disinflation should continue, as the necessary adjustment to regain some competitiveness and support exports. As a result, real rates will likely be much higher than they used to be in the past decade; so monetary policy will not help to offset the required fiscal tightening. Overall, we believe that a new trend growth rate for Spain is around 1.5% per year, much lower than the average growth rate of 3.8% in the 99-07 period.

Figure 36. Italy and Spain — Economic Forecast, 2009F-11F

		Italy			Spain		
		2009F	2010F	2011F	2009F	2010F	2011F
Real GDP	YoY	-4.7%	1.4%	0.8%	-3.5%	0.1%	0.5%
Final Domestic Demand	YoY	-3.3	1.1	0.6	-5.8	-0.7	0.0
Private Consumption	YoY	-1.5	0.9	0.5	-4.7	-0.5	0.0
Fixed Investment	YoY	-13.0	0.8	4.0	-15.0	-4.0	0.2
Exports	YoY	-20.2	0.6	0.4	-14.0	0.9	1.3
Imports	YoY	-16.0	-1.1	-0.3	-19.7	-1.3	1.9
CPI	YoY	0.8	1.5	1.4	-0.3	0.8	1.1
Unemployment Rate	%	7.6	8.7	8.9	17.9	19.4	20.1
Current Account	€bn	-49.1	-37.2	-23.1	-67.1	-52.1	-79.1
	% of GDP	-3.2	-2.4	-1.4	-6.4	-5.0	-7.4
General Govt. Balance	€bn	-89.0	-91.2	-88.6	-117.3	-115.1	-104.5
	% of GDP	-5.8	-5.8	-5.5	-11.0	-10.7	-9.5
General Govt. Debt	% of GDP	114.5	117.2	119.5	57.3	68.0	76.7

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

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## UK

The recession now appears to be ending, with marked gains in exports, housing, retail sales and business surveys in recent months. We believe the economy is growing again in 4Q and will expand steadily in coming quarters, at a roughly similar pace to the euro area.

The UK, like other countries, still faces a drag from poor credit availability. In addition, the UK faces two extra challenges in 2010. First, inflation is likely to stay sticky, overshooting consensus and MPC expectations. We expect CPI inflation to rise above 3% in 2010 if the planned VAT hike occurs, possibly staying above 3% for a while if there is a second VAT hike. The UK has pursued the most aggressive monetary easing of any major country (ultra low policy rates and huge QE), and an extended inflation overshoot could seriously strain the MPC's anti-inflation credibility. As growth improves, we expect the MPC to hike in Q2 or Q3, rather earlier than the ECB.

Second, the UK has a complex interplay between fiscal and political risks, with the fiscal deficit at 13% of GDP and the election likely to be held in May 2010. Our base case is that the Conservatives will win a big majority (50+ seats), and quickly announce a major extended fiscal consolidation programme. This would probably avert a sovereign credit crisis, and usher in a benign period of fairly low interest rates and (with a weak pound) export-led growth. However, there is a sizeable risk of a hung parliament or a tiny Conservative majority. Such outcomes could lead to major doubts whether fiscal consolidation can be implemented fast enough to avert a financial crisis. Such pressures could be exacerbated by the unwinding of the MPC's QE gilt purchases.

Figure 37. United Kingdom — Economic Forecast, 2009F-11F

		2009F	2010F	2011F	2009F		2010F			2011F	
					3Q	4QF	1QF	2QF	3QF	4QF	1QF
Real GDP	YoY	-4.7%	1.5%	2.3%	-5.2%	-2.8%	0.3%	1.5%	2.1%	1.9%	1.8%
	SAAR				-1.6	2.6	2.5	2.7	0.8	1.8	1.8
Domestic Demand (Incl. Inventories)	YoY	-5.3	0.7	1.6	-5.6	-3.4	-0.5	1.0	0.9	1.1	1.0
	SAAR				-0.3	-0.1	1.8	2.7	-0.6	0.7	1.2
Consumption	YoY	-2.7	1.0	1.9	-2.8	-1.3	0.2	1.8	1.1	1.0	1.4
	SAAR				1.7	1.3	0.4	3.7	-0.8	0.9	1.7
Investment	YoY	-17.5	-10.9	2.9	-19.9	-20.8	-16.9	-13.8	-7.5	-4.0	-1.0
	SAAR				-24.6	-12.4	-10.6	-6.3	-0.3	1.5	1.2
Exports	YoY	-10.0	8.0	8.7	-10.7	-4.9	4.9	8.4	9.2	9.4	8.6
	SAAR				6.5	8.9	10.3	7.8	9.9	9.8	6.9
Imports	YoY	-12.0	4.5	5.8	-11.7	-6.9	1.9	6.0	4.3	6.0	5.4
	SAAR				11.3	-1.4	7.2	7.4	4.1	5.5	4.7
Unemployment Rate	%	8.3	10.17	10.10	8.7	9.7	10.1	10.3	10.2	10.1	10.1
CPI Inflation	YoY	2.1	3.5	2.8	1.5	1.9	3.2	3.6	3.6	3.7	3.2
Merch. Trade	£bn	-81.9	-79.1	-58.9	-20.2	-21.0	-21.0	-21.1	-19.0	-17.9	-16.2
	% of GDP	-5.9	-5.5	-3.9	-5.8	-6.0	-5.9	-5.8	-5.2	-4.9	-4.4
Current Account	£bn	-38.2	-28.7	1.0	-10.8	-11.5	-9.7	-8.9	-6.0	-4.1	-1.7
	% of GDP	-2.7	-2.0	0.1	-3.1	-3.3	-2.7	-2.5	-1.6	-1.1	-0.5
PSNB	£bn FY	-180.1	-179.9	-156.0							
	% of GDP	-12.9	-12.3	-10.2							
General Govt. Balance	% of GDP	-12.3	-13.4	-11.6							
Public Debt	% of GDP	60.3	71.3	79.7							
Gross Nonoil Trading Profits	YoY	-4.4	16.7	9.3							

Note: FY Fiscal Year. Source: Citi Investment Research and Analysis

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## Switzerland

The Swiss recession probably ended in 3Q, given the recent improvement in business surveys. We expect a modest recovery (1.1% GDP growth) in 2010, versus 2.8% average annual growth in 2004-08). Inflation markedly undershot consensus expectations this year and, with the sizeable output gap and strong currency, is likely to markedly undershoot the consensus and SNB forecasts in 2010 as well. As a result, the SNB is likely to stay on hold for an extended period, to end-2010 at least and perhaps even to end-2011.

## Sweden

The Swedish economy is set for above-trend growth in 2010-11, outpacing consensus and MPC forecasts. Growth will benefit from the external pick up, while high household savings and sustained fiscal expansion provide a good starting point for stronger domestic demand. Investment is unlikely to pick up until 2011, while unemployment will go on rising until 2Q or 3Q 2010, and inflation will stay low in 2010. Nevertheless, the economic upturn and house price gains will probably lead the Riksbank to start hiking rates in 2Q 2010.

## Denmark

The Danish economy is likely to recover gradually during 2010 and to a larger extent in 2011. Exports will benefit from faster external demand and additional curbs on wage growth, plus improving productivity. Unemployment is not set to peak until mid-10, and given the slack in the economy, inflation is set to ease further. Risks include a prolonged housing market slump and the high level of mortgage debt accumulated by some households in recent years, both of which would add additional strains on private consumption.

## Norway

A clear recovery is underway in the Norwegian economy, fuelled by consumer spending and supported by high wage growth, lower inflation and a gradual pick up in jobs. Capacity use is not likely to rise enough to boost investment growth until 2011. Unemployment is set to peak during 2010, and could even start falling in 2011. Inflation should not be an immediate threat but, with demand recovering strongly, the Norges Bank is set to normalize rates in 2010-11. Given Norway's huge oil revenues, there appears to be no threat of major fiscal tightening.

**Figure 38. Switzerland, Sweden, Denmark and Norway — Economic Forecast, 2009F-2011F**

		Switzerland			Sweden			Denmark			Norway		
		2009F	2010F	2011F	2009F	2010F	2011F	2009F	2010F	2011F	2009F	2010F	2011F
Real GDP <sup>a</sup>	YoY	-1.4%	1.1%	1.7%	-4.5%	2.5%	2.4%	-5.4%	1.2%	1.7%	-1.1%	2.8%	2.7%
Public Consumption	YoY	2.5	1.5	1.3	1.6	1.1	0.6	2.3	1.7	1.4	5.8	3.5	3.3
Private Consumption	YoY	1.3	2.5	1.4	-0.9	1.9	2.0	-4.9	1.9	2.2	-0.3	3.4	2.1
Investment (Ex Stocks)	YoY	-3.2	-2.0	-1.7	-19.1	-2.8	4.5	-12.0	-2.0	2.1	-7.8	-1.5	2.8
Exports	YoY	-12.1	2.0	5.8	-13.2	4.8	4.2	-10.4	2.0	4.6	-9.3	3.1	2.6
Imports	YoY	-7.1	2.8	5.0	-15.2	4.0	4.1	-13.0	1.7	5.1	-10.6	2.8	2.7
CPI (Average)	YoY	-0.5	-0.1	-0.1	-0.4	0.9	1.9	1.5	1.9	1.9	2.3	1.9	2.0
Unemployment Rate	%	3.7	4.7	5.1	8.6	10.2	9.7	3.6	5.5	6.0	3.3	3.8	3.6
Current Account	% of GDP	8.0	8.7	9.4	6.8	7.4	8.3	2.1	2.2	2.5	15.6	16.6	17.5
General Govt Balance	% of GDP	-0.7	-0.7	-1.3	-2.1	-3.3	-2.3	-1.8	-4.6	-3.8	7.4	7.0	7.6
General Govt Debt	% of GDP	41.3	40.7	39.4	40.0	44.0	45.0	35.0	37.0	40.0	58.0	59.0	57.0

<sup>a</sup> For Norway, mainland GDP. F Citi forecast. YoY Year-on-year growth rate. Source: Citi Investment Research and Analysis

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## Canada

Canadian financial conditions continue to normalize and signs of revitalization are evident. Nonetheless, close trade and production ties to the United States, and particular vulnerability to commodity and currency price volatility, suggest a muted and protracted recovery ahead. The estimated 11% decline in industrial production and the significant amount of excess capacity generated over the last year should weigh on domestic demand and lead to only gradual improvements in labor market measures over the medium-term. Healthy balance sheets, financial market gains and a reviving domestic housing market are currently providing support to firms and households. But monetary and fiscal policies will remain critical to underpinning the economy until sustainable private demand is realized.

Important challenges to the outlook include the evolution of external demand growth and emerging fiscal woes among key trading partners. However, the primary downside risk to growth and inflation projections remains persistent, non-fundamental Canadian dollar appreciation. The Bank of Canada (BoC) confirmed that currency strength is dampening output and subduing prices, and that it will offset favorable economic developments this year. As such, consumer inflation measures probably will not return to the central bank's 2% target until mid 2011 and economic activity will remain somewhat restrained.

Slack and lingering downside risks likely will keep the BoC on the sidelines through the middle of next year. However, intensification of ill currency effects could prompt additional stimulus measures before then. Offsetting policy tactics include moral suasion, an extension of the conditional commitment duration and/or the deployment of QE. Holding all else equal, we continue to anticipate a first rate hike in the second half of 2010. Even a year-end level of 1¼% would still prove highly accommodative.

Figure 39. Canada — Economic Forecast, 2009-11F

		2009F	2010F	2011F	2009		2010				2011
					3QF	4QF	1QF	2QF	3QF	4QF	1QF
Real GDP	YoY	-2.7%	2.5%	3.4%	-3.3%	-1.8%	0.6%	2.3%	3.4%	3.7%	3.7%
	SAAR				0.0	2.5	3.3	3.6	4.0	3.7	3.5
Final Domestic Demand	YoY	-1.0	4.3	3.1	-0.7	1.7	4.2	5.2	4.0	3.7	3.5
	SAAR				8.6	4.3	3.7	4.3	3.7	3.2	2.9
Private Consumption	YoY	0.0	2.4	3.4	0.0	1.2	2.0	2.4	2.5	2.7	3.0
	SAAR				2.6	1.5	2.0	3.5	3.0	2.5	3.0
Government Spending	YoY	3.7	7.8	1.7	5.6	7.3	8.7	9.0	7.4	5.8	4.1
	SAAR				11.4	10.0	8.5	6.1	5.0	3.5	1.9
Private Fixed Investment	YoY	-10.6	5.6	4.0	-10.1	-3.9	5.0	8.9	4.4	4.2	4.4
	SAAR				23.6	6.0	2.8	4.3	4.4	5.2	3.9
Exports	YoY	-14.0	6.0	6.3	-13.9	-8.3	2.1	9.1	6.4	6.6	6.4
	SAAR				18.8	5.8	7.2	5.2	7.4	6.8	6.3
Imports	YoY	-13.3	10.5	6.4	-11.8	-3.5	11.3	15.8	8.1	7.2	6.7
	SAAR				40.9	10.0	8.0	7.5	7.0	6.5	6.0
CPI	YoY	0.3	1.4	2.0	-0.9	0.8	1.5	1.3	1.2	1.6	1.8
Core CPI	YoY	1.7	1.3	1.9	1.6	1.5	1.5	1.2	1.2	1.3	1.6
Unemployment Rate	%	8.3	8.6	8.1	8.6	8.8	9.0	8.8	8.4	8.4	8.4
Current Account Balance	C\$bn	-41.5	-34.8	-26.8	-53.2	-36.9	-34.9	-37.7	-35.6	-31.0	-28.9
	% of GDP	-2.7	-2.2	-1.6	-3.5	-2.4	-2.2	-2.4	-2.2	-1.9	-1.8
Net Exports (Pct. Contrib.)		0.7	-2.1	-0.6	-7.7	-2.0	-0.9	-1.3	-0.4	-0.4	-0.4
Inventories (Pct. Contrib.)		-1.7	0.1	0.6	-0.2	0.0	0.2	0.3	0.4	0.6	0.7
Budget Balance (Fiscal Year)	% of GDP	-3.7	-2.8	-1.6							

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

After rebounding quickly from the global financial crisis, the Australian economy is expected to grow at a trend rate, i.e. between 3% and 3.5%, in 2010. Despite the global economic downturn, the terms of trade have stayed near historical highs and we expect new gains in coming years. Fiscal and monetary policies remain stimulatory. Growth in 2010 will benefit from a cyclical upswing in housebuilding, restocking, strong public investment, solid exports and a pick-up in mining investment. The economy's medium term prospects are closely tied to the surge in living standards throughout Asia, especially China and India. This is driving plans for a new round of investments in mining and infrastructure, and related to that, likely heavy capital inflows. Because the upswing starts with lower levels of spare capacity than usual, inflation risks are skewed to the upside. The RBA expects inflation in the next few years to average the mid point of the 2%-3% target, but this could prove too optimistic unless interest rates quickly move out of the emergency zone. We expect the RBA to normalise official rates to around 5.5% by end 2010.

## New Zealand

The New Zealand economy will gradually recover in 2010, below a trend growth rate in 2010 of 2.5% and above trend in 2011 of 3.4%. Growth in 2010 is being led by the consumer, residential investment and the government sector. The strong NZD may hit exports, and inflation is likely to be in the target range through 2010 as wage gains remain low. Additional key issues for markets in 2010 include regulatory changes with respect to banks' funding composition as well as tax changes for housing and business which are aimed at smoothing business cycles and assisting monetary policy. We expect the OCR to remain accommodative in 2010, with the OCR around 4.50% by year end 2010.

Figure 40. Australia and New Zealand — Economic Forecast, 2009F-2011F

	Australia			New Zealand		
	2009F	2010F	2011F	2009F	2010F	2011F
Real GDP <sup>a</sup>	1.1%	3.3%	3.4%	-1.5%	2.5%	3.4%
Real GDP (4Q versus 4Q)	2.5	3.5	3.4	0.2	3.8	2.5
Real Final Domestic Demand	0.5	3.6	3.4	-3.4	2.1	3.4
Consumption	1.5	2.3	2.9	-0.9	1.3	2.6
Govt. Current & Capital Spending	3.3	7.8	-1.8	3.6	6.0	1.1
Housing Investment	-6.6	9.2	10.8	-17.6	7.5	9.9
Business Investment	-4.8	-0.7	9.3	-13.5	2.9	8.4
Exports of Goods & Services	4.6	7.7	6.3	-1.4	0.4	3.2
Imports of Goods & Services	-8.5	12.3	7.6	-16.9	5.5	4.5
CPI	1.9	2.3	2.7	2.3	2.4	2.3
CPI (4Q versus 4Q)	2.4	1.9	3.1	1.9	2.1	2.3
Unemployment	5.7	5.8	5.2	7.0	6.0	5.8
Merch. Trade, BOP (Local Currency, bn)	-5.9	-18.0	-15.8	-0.4	-0.8	-1.1
Current Account, (Local Currency, bn)	-50.8	-65.9	-67.7	-4.4	-11.8	-13.9
Percent of GDP	-4.2	-5.2	-5.1	-2.4	-6.3	-7.0
Budget Balance <sup>b</sup> (Local Currency, bn)	-27.1	-57.7	-46.6	-3.9	-7.7	-9.3
Percent of GDP	-2.3	-4.7	-3.6	-2.2	-4.4	-5.1
General Govt. Debt (% of GDP) <sup>c</sup>	-1.3	3.7	7.0	-9.6	-15.6	-22.0
Gross Trading Profits <sup>d</sup>	-5.2	3.9	7.2	NA	NA	NA

Source: Citi Investment Research and Analysis

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

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## China

As we conclude the first year of recovery, the outlook for the economy remains moderately positive. Investment will likely continue to be the key contribution to growth in 2010 and beyond, but momentum might wear out gradually. Infrastructure, one third of total investment, should remain a major component. Property (another 20% of investment) will likely stay elevated due to improved market sentiment and abundant liquidity. The change in senior leadership in 2012 also favors investment, given the tradition to boost the economy ahead of the handover and that investment remains the preferred instrument.

Trade is expected to significantly buoy growth in 2010, but less so afterwards. The nearly \$100bn shrinkage in the surplus subtracted an estimated 3.8 pct pts from growth in 2009, practically erasing the contribution from consumption. This trade drag will disappear in 2010 due to base effects and improving demand in the US. We expect the surplus to remain in modest decline, but the return of positive export growth should ease overcapacity and boost private investment.

Consumption growth is likely to be relatively stable. The improvement in trade had brought jobs back to the coastal manufacturing regions that are actually seeing shortages for both skilled and unskilled labor. This is a boon to wage incomes, making up for the cuts during the crisis. The private service sector, also benefiting from the export recovery, could produce labor demand and income growth. Strong sales in car and housing industries will also create some lasting effects in consumption.

Uncertainties over growth sustainability and inflation will probably limit macro policy changes. In the near-term, rebounding external demand may suffice, but credit-sensitive domestic demand will become crucial to sustaining above-8% growth beyond 2010. Meanwhile, past experience suggests stock and property price surges are often followed by rising CPI inflation, and this could force policy to unwind relatively soon. This pressure could mount in an environment with excess liquidity, imported commodity price inflation, and capital inflows. Local government-driven price reform in utility and fuel could lift inflation expectations. Therefore, policymakers would be loathe to make significant changes and further stretch the current growth model.

We expect bank lending growth to fall to 20%-25% next year, down from this year's 33%, but still above the 15%-18% in normal years. Policy interest rates are at historically low levels, but will probably begin to return to normal. We expect the first hike in 3Q 10 on rising inflation, and to stabilize deposit growth. China may hike before the U.S. if domestic pressures override worries over interest rate differentials.

The renminbi probably will face appreciation pressures from non-dollar economies early in 2010 as the dollar weakens, with appreciation pressure from the U.S. once the dollar starts to stabilize. As the effective value has recently returned to pre-crisis levels, the combined effects of dollar weakness, FX reserve accumulation, protectionism, and rising interest rate expectations could all promote currency appreciation as early as 1Q 10.

Although our base case rules out a double dip, the risk remains. A renewed collapse in financial conditions could again sharply reduce trade and exacerbate overcapacity. China may not be able to exit and instead would have to increase stimulus and tolerate further distorted growth. Conversely, upside

surprises to inflation and/or asset bubbles may trigger sudden and premature policy exit that could drag China's GDP growth to below 8%.

This crisis effectively concluded China's export-led growth. In our view, export growth in the post-crisis era probably will be halved from the 25%-30% pace during 2002-07. China's export market share will probably stabilize in the near future. The surplus will likely be flat or in moderate decline in the coming years, as the Chinese economy enters an era of growth without external support.

Still, China's recovery has come without sizable restructuring. In real terms and also based on current statistics, we expect investment growth to have peaked this year, but its share of GDP would rise from 42% in 2008 to 49% in 2012. Household consumption's share may stay around 35%, with a slight pickup only by 2014. Net exports share may fall from 9% in 2008 to below 2% by 2014. Afterwards, China's growth would likely depend more on consumption, but could also settle in a lower trend of 6%-8%.

Other than possible statistical revisions, there is unlikely to be major progress in resolving structural imbalances in our forecast horizon. Rebalancing could get a one-time boost from data revisions to the service sector, which is underreported in official data, as new services and small businesses were often overlooked. But data revisions cannot fix the problem. China does not need double-digit growth going forward to become the world's largest economy in 2025. The quality of growth is much more important than the quantity. When exports/investment can no longer boost growth, China will eventually rely more on consumption.

Figure 41. China — Economic Forecast, 2009F-2011F

		2009F	2010F	2011F	2009		2010				2011
					3Q	4QF	1QF	2QF	3QF	4QF	1QF
Real GDP	YoY	8.7%	9.8%	9.0%	8.9%	10.4%	11.3%	10.2%	9.4%	9.2%	8.6%
Real Final Domestic Demand	YoY	13.5	10.9	9.8							
Consumption	YoY	8.6	9.0	8.9							
Fixed Capital Formation	YoY	19.4	13.0	10.8							
Industrial Production	YoY	11.0	14.0	12.5	12.4	17.3	18.0	16.0	14.0	12.0	11.0
Exports	YoY	-17.6	13.4	12.5	-20.3	-7.0	12.7	15.8	15.5	12.4	12.5
Imports	YoY	-14.1	16.2	15.0	-11.9	9.7	26.5	17.8	14.5	12.3	15.0
Merchandise Trade Balance	\$bn	203.1	203.9	201.1	39.1	66.3	45.2	35.4	48.1	74.8	45.0
FX Reserves	\$bn	2,400	2,750	3,050	2,273	2,400	2,500	2,580	2,660	2,750	2,830
Current Account	% of GDP	6.6	6.1	5.4							
Fiscal Balance (trailing 4-qtr sum)	% of GDP	-3.0	-2.8	-2.7	-2.4	-3.0	-2.4	-1.7	-1.8	-2.8	-2.5
General Govt. Debt	% of GDP	22.1	22.7	23.0							
Urban Unemployment Rate	%	4.3	4.1	4.0	4.3	4.3	4.2	4.2	4.1	4.1	4.0
CPI	YoY	-0.6	3.0	3.8	-1.2	0.3	1.5	2.3	2.6	3.6	4.1
Exchange Rate (end period)	CNY/\$	6.80	6.62	6.40	6.83	6.80	6.75	6.70	6.65	6.62	6.55
One-Year Base Lending Rate	%	5.31	5.85	6.66	5.31	5.31	5.31	5.31	5.58	5.85	6.39

(End of Period)

Source: Citi Investment Research and Analysis

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## Brazil

We estimate 2010 GDP growth at 5%, and have an upward bias to this forecast. The main reasons are the consistent signs of improvement in the labor market as well as in credit concessions, and they feed through each other as income grows stronger, leading to lower delinquency rates. Under these conditions, the output gap should continue to narrow in coming quarters, requiring interest rate hikes by around April 2010, when capacity use will likely reach levels that would pressure consumer inflation. Overall, we expect the central bank to increase the Selic rate by 200bp in 2010, through 50bp increments. The robust economic growth along with the strongest real exchange rate level since 1999 should lead to a significant deterioration in 2010 current account. We forecast a deficit of US\$44 billion (2.2% of the GDP from 1.1% expected in 2009). On fiscal policy, the deterioration seen in 2009 should be partially offset by a recovery in tax revenues as activity rebounds, which is likely to reduce the risks on this front.

## Mexico

We have made a slight upward revision in our 2009 GDP estimates for the first time this year to -7.1% from -7.4% before. For 2010 we expect a 3.6% growth rate, driven by the reactivation of global trade, particularly of US demand. We see the gradual recovery to be assisted by a sound local financial system, a relatively resilient labor market, and renewed export competitiveness. Thus, although imports will grow, we see a modest 2010 current account deficit (1.2% of GDP), which should prove constructive for the MXN. On the fiscal front, the revenue law passed by Congress should reduce risks of a downgrade by allowing the broad debt-to-GDP ratio to stabilize at about 40% in 2010-11. However, the inflationary impacts of tax measures will likely interrupt the declining path of inflation, posing a dilemma for Banxico. We think policymakers will react by staging a 25bp preventive hike in January, followed by a formal hiking cycle later in 2010: we see the funding rate closing at 5.75% in 2010 from 4.5% currently.

Figure 42. Brazil and Mexico — Economic Forecast, 2009F-11F

		Brazil			Mexico		
		2009F	2010F	2011F	2009F	2010F	2011F
Real GDP	YoY	0.2%	5.0%	4.0%	-7.1%	3.6%	3.8%
Final Domestic Demand	YoY	0.1	5.7	5.0	-7.2	4.0	4.7
Private Consumption	YoY	3.6	5.5	4.0	-7.2	3.9	4.2
Fixed Investment	YoY	-14.1	9.8	9.7	-11.0	6.3	8.4
Exports	YoY	-8.3	9.5	4.4	-18.2	7.2	7.5
Imports	YoY	-12.9	14.9	13.0	-20.1	8.7	9.8
CPI	YoY	4.9	4.0	4.1	5.4	4.9	4.4
Unemployment Rate	%	8.2	8.0	7.9	5.7	6.0	5.5
Current Account	US\$ bn	-17.5	-43.9	-57.1	-7.8	-11.6	-23.1
	% of GDP	-1.1	-2.2	-2.7	-0.9	-1.2	-2.2
Fiscal Balance	% of GDP	-3.2	-1.8	-2.5	-2.1	-2.5	-1.8
US Dollar Exchange Rate	Average	2.0	1.7	1.8	13.6	13.0	13.3

Source: Citi Investment Research and Analysis

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## Argentina

We believe that activity is on its way to recovery but at a slower pace. Partial activity indicators signal that the economy is gaining traction and we expect to see sustained growth during 1H 10, helped by a strong harvest. The government's overtures to the markets and high global liquidity have led to a reversal of the capital account in recent months. The central bank is likely to allow only some nominal appreciation, and hence most of the expected real appreciation of the peso will come through higher inflation. Indeed, we expect the increase in money supply to reaccelerate inflation closer to 20%. This increase in inflation could fuel the current bout of social protests into 2010, hurting investment and consumption. The fiscal outlook continues to deteriorate, adding pressures on the central bank to finance the nominal budget deficit in 2010. We keep our 2010 USD/ARS forecast at 4.5, but believe most of the weakening of the peso will occur in the second half.

## Venezuela

The transition from privately-owned domestic production to nationalized ownership probably will continue, as higher commodity prices provide the government with the resources to resume this strategy. Scarcity plus the switch from the official to the parallel exchange rate market as the main provider of US dollars for imports purposes should provide enough strength for prices to increase again in 2010 by about 30%. On the exchange rate front, we consider two alternative scenarios which we think are equally likely. In the first scenario, a devaluation of the official currency takes place in 1Q 10 as the government sees that, despite its efforts to close the gap between the official and parallel rates, the difference between the two is high and the associated costs of trying to close it are even higher. In the second one, no devaluation takes place during 2010 since December's National Assembly elections leads the government to abstain from any unpopular measures that could reduce its popularity and therefore its voting majority. Activity will probably continue to fall in 2010, despite the increase in oil revenues as domestic production and investment are not expected to rebound amid the uncertainty and lack of incentives.

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Figure 43. Argentina and Venezuela — Economic Forecast, 2009F-11F

		Argentina			Venezuela		
		2009F	2010F	2011F	2009F	2010F	2011F
Real GDP	YoY	-3.3%	2.0%	2.0%	-2.6%	1.7%	0.5%
Final Domestic Demand	YoY	-2.2	2.8	4.2	-2.6	-2.2	0.0
Private Consumption	YoY	1.5	3.4	4.7	-1.9	-2.3	0.0
Fixed Investment	YoY	-16.0	2.0	10.0	-6.9	-6.6	-4.3
Exports	YoY	-6.5	13.0	9.5	-11.0	-0.3	0.0
Imports	YoY	-25.2	17.0	16.6	-5.5	-2.1	0.3
CPI	YoY	15.4	19.3	17.4	28.7	30.4	39.0
Unemployment Rate	%	10.1	12.1	9.9	7.8	10.0	11.5
Current Account	US\$ bn	9.4	10.5	7.5	-0.6	14.0	12.7
	% of GDP	3.1	3.2	0.5	-0.4	6.3	4.0
Fiscal Balance	% of GDP	-2.3	-1.8	-1.0	-5.8	-3.5	-1.0
US Dollar Exchange Rate	Average	3.8	4.1	4.7	2.2	3.2	3.9

Source: Citi Investment Research and Analysis

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## Russia

We believe the Ministry of Economy is thinking of imposing capital controls to limit excessive pressure on the ruble, including limits on public enterprise borrowing, Brazilian-style capital controls, and differentiated reserve requirements. We still expect the Ruble to appreciate in 4Q09 and 2010 to about 34 against the basket, owing to the higher-than-expected current account and large capital inflows. Risks to our baseline forecast are still tilted towards a stronger ruble appreciation; up to 32-30 rubles against the basket. The current account surplus is likely to reach 3.9% of GDP in 2009 and 3.2% in 2010. Thus, Russia would accumulate reserves in 2010 and experience only a moderate loss in 2009. This should allow the CBR to continue with rate cuts. However, we believe that owing to still-elevated inflation, a pick up in domestic demand in line with our forecast of 3% growth in 2010 would put a brake on the CBR's ability to cut rates. Therefore the CBR will likely be forced to allow moderate Ruble appreciation. Key risks are oil prices and investor sentiment. An increase in risk aversion towards EM will again put pressure on Russia's capital account. We therefore believe that ruble volatility is likely to continue.

## Turkey

Whether or not the Government will opt for an IMF deal remains an important uncertainty, which creates grounds for upside and downside surprises. With this in mind, our assessment of Turkey's economic outlook for 2010 is built on two main themes. *First*, we believe that fiscal pressures are likely to rise owing to the possibility of a less favorable revenue performance than currently budgeted and a challenging domestic debt redemption profile. *Second*, we expect the combination of base effects, commodity prices and administrative price adjustments to push the annual inflation rates upwards through 1H 2010. Specifically, we forecast inflation to rise to over 7.0% at end-2010 and exceed 7.5% in 2Q 2010, which will lead the CBT to tighten its policy stance. This backdrop paints a difficult picture for the economic recovery, with GDP set to grow around 4.0% in 2010 after a contraction of around 6.0% in 2009. We recognize the combination of a strong pick-up in global risk appetite and larger-than-planned privatization proceeds could make it possible for Turkey to carry on without an IMF program next year. However, in our view, this will require not only good fortune, but also good policies.

Figure 44. Russia and Turkey — Economic Forecast, 2009F-11F

		Russia			Turkey		
		2009F	2010F	2011F	2009F	2010F	2011F
Real GDP	YoY	-7.5%	3.0%	4.1%	-5.7%	4.2%	5.5%
Final Domestic Demand	YoY	-6.1	2.9	6.2	-6.8	5.5	6.4
Private Consumption	YoY	-10.0	2.5	6.0	-2.8	4.8	5.5
Fixed Investment	YoY	-15.5	0.0	10.0	-22.9	7.5	9.8
Exports	YoY	-10.0	10.0	10.0	-15.0	7.5	8.0
Imports	YoY	-19.4	9.0	15.0	-24.2	18.0	15.5
CPI	YoY	11.7	6.8	8.3	6.2	7.1	6.6
Unemployment Rate	%	8.3	8.0	8.0	14.3	12.5	11.0
Current Account	US\$ bn	50.7	53.0	58.0	-13.1	-27.8	-36.6
	% of GDP	3.9	3.2	3.0	-2.1	-3.8	-4.0
Fiscal Balance	% of GDP	-6.5	-4.2	-3.9	-6.5	-5.0	-4.2
US Dollar Exchange Rate	Average	31.8	27.0	26.7	1.43	1.45	1.57

Source: Citi Investment Research and Analysis

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## Hungary

After a deep and painful recession in 2009, the Hungarian economy has chances for marginal growth in 2010, mainly thanks to a positive contribution from net exports. In our view, policy stimulus for the economy will be delivered in the form of gradual interest rate reductions which should bring the base rate to 5.50% in 1H 10. Declining inflation should not be an obstacle to monetary easing, but we expect the central bank to be rather cautious as it will probably want to maintain the spread between Hungarian and euro area rates at a level that would guarantee a relatively stable or appreciating exchange rate. An important source of uncertainty in the coming months will be parliamentary elections in spring 2010, which may cause a change in the government. We see a risk that the new government may allow some increase in the fiscal gap in 2010. However, we think this would be a rather modest stimulus that would leave the cyclically adjusted budget balance at a relatively safe level, with the actual budget deficit at around 4% of GDP.

## Poland

We expect economic growth to accelerate to 2.5%-3% YoY in 2010 but this will likely be insufficient to lead to a substantial labour market improvement. Rising unemployment should help keep wage demand in check and should eventually translate into a drop of the inflation rate. According to our forecasts, below-potential GDP growth and base effect will lower the CPI towards 1.5% in 2H 2010. The monetary policy outlook seems particularly uncertain as nine out of ten members of the Monetary Policy Council will be replaced in early 2010. However, given the low inflation prospects and deteriorating labour market, we expect the monetary authorities to wait until 2H 10 with any policy tightening when rates will likely be lifted by 50bps to 4.00%. Taking into account relatively strong GDP and low current account deficit, we see room for further strengthening of the zloty towards 3.80 EUR/PLN in late 2010. The biggest challenge for the Polish authorities in the coming years will be to keep the public debt below 55% of GDP, as according to Polish law breaching this would trigger fiscal tightening that might push Poland into economic weakness or recession.

Figure 45. Hungary and Poland — Economic Forecast, 2009F-11F

		Hungary			Poland		
		2009F	2010F	2011F	2009F	2010F	2011F
Real GDP	YoY	-6.4%	0.5%	3.2%	1.4%	2.6%	3.6%
Final Domestic Demand	YoY	-4.1	-1.2	1.9	1.1	1.0	3.9
Private Consumption	YoY	-4.8	-0.7	1.9	2.4	1.8	3.5
Fixed Investment	YoY	-5.6	-3.2	3.2	-2.7	-0.7	5.5
Exports	YoY	-11.7	7.0	8.2	-9.8	4.3	9.0
Imports	YoY	-18.8	6.8	7.8	-15.1	3.9	10.0
CPI	YoY	4.0	3.9	3.3	3.5	2.0	2.3
Unemployment Rate	%	11.1	10.8	9.1	12.5	13.0	14.0
Current Account	US\$ bn	-4.3	-5.2	-5.5	-8.5	-14.0	-20.2
	% of GDP	-2.9	-3.2	-3.4	-1.7	-2.5	-3.4
Fiscal Balance	% of GDP	-4.0	-3.9	-2.7	-6.0	-6.7	-4.4
US Dollar Exchange Rate	Average	176	162	169	2.7	2.4	2.5

Source: Citi Investment Research and Analysis

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## Czech Republic

Improving industrial activity and restocking of inventories underpinned GDP growth in 3Q. The recent improvements in industrial output and export performance partly reflect the positive impact from car scrappage subsidy schemes in some EU countries, particularly Germany. As this stimulus is withdrawn, we expect economic performance to be somewhat weaker in 4Q, but any deterioration is likely to be limited by stronger euro area growth, which will likely support GDP growth in 2010 reflecting the openness of the Czech economy. However, next year is unlikely to be as bright given the probable labour market deterioration. Subdued consumer demand, resulting in a mild recession in 4Q 09-1Q 10, will likely be accompanied by tighter fiscal policy (after the austerity fiscal package was approved) and with only a mild recovery in investment activity due to low capacity utilisation. We expect the weaker koruna and recovery to push inflation somewhat higher; we expect the central bank to deliver gradual policy rate hikes to 2% in 2010 and 3% in 2011.

## Romania

The performance of Romanian assets has so far not been commensurate with the impressive external adjustment and the generous EU-IMF package. The government's collapse in October ahead of the highly charged presidential elections has further complicated near term economic prospects. Our base case scenario for 2010 and thereafter is built on the assumption of a more stable political environment by early 2010. This is a prerequisite for the credible implementation of the EU-IMF supported economic program, which will, in turn, promote fiscal discipline and facilitate the adoption of the required structural reforms. Concurrently, we expect GDP to remain below potential in 2010 which, coupled with our expectations of a moderate leu recovery, should support the disinflation process, with inflation declining to around 3.8% by the end of next year. The noted developments will likely enable the NBR to resume its easing campaign through cutting rates by as much as 125bp in 2010. There will likely be a closer scrutiny of the implementation of the IMF program going forward, which will shape investor sentiment and the pace of the economic recovery. As a result, developments over program implementation will be an important source of upside and downside surprises for Romanian assets.

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Figure 46. Czech Republic and Romania — Economic Forecast, 2009F-11F

		Czech Republic			Romania		
		2009F	2010F	2011F	2009F	2010F	2011F
Real GDP	YoY	-4.3%	1.5%	2.5%	-7.1%	1.3%	2.7%
Final Domestic Demand	YoY	-1.4	-0.2	2.2	-11.9	1.1	4.2
Private Consumption	YoY	1.2	0.7	2.3	-14.0	1.0	3.0
Fixed Investment	YoY	-8.3	-2.5	4.0	-8.4	1.1	7.0
Exports	YoY	-14.0	5.9	10.2	-23.4	9.7	5.0
Imports	YoY	-14.0	7.7	10.6	-31.5	5.8	7.0
CPI	YoY	1.0	1.0	2.4	5.5	3.7	3.5
Unemployment Rate	%	8.2	9.7	10.6	6.3	7.2	6.8
Current Account	US\$ bn	-2.6	-2.4	-1.5	-8.1	-12.1	-13.3
	% of GDP	-1.2	-1.1	-1.8	-4.8	-6.1	-6.5
Fiscal Balance	% of GDP	-6.5	-5.8	-5.1	-8.0	-6.0	-5.0
US Dollar Exchange Rate	Average	17.4	16.2	16.6	2.9	2.6	2.8

Source: Citi Investment Research and Analysis



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## Nigeria

We expect growth will remain in the 4%-5% range in 2010 as oil production recovers in 1H and agricultural and government sector growth remains robust. However, other sectors of the non-oil economy may struggle, as the banking sector continues to consolidate and investment is curtailed as the May 2011 elections approach. Meanwhile, the recovery in oil production against the background of strong prices should drive a reduction in the fiscal deficit, although inflation is likely to remain a concern and may mean that interest rates rise in 2010. The naira has been extremely volatile since late July, with the market unable to find a direction. We expect the currency to stabilise at levels of around N151-152:USD1 in 1H 10 as foreign exchange earnings pick up and the USD remains weak on global markets, but the risks are to the downside with elections approaching and the amnesty in the Delta remaining fragile. Although the new minister of finance and CBN governor have yet to outline a coherent approach to economic policy, both are committed reformers and we expect some progress with reform and policy coordination in 2010.

## South Africa

We expect the nascent upturn currently visible in the economy will be confirmed in current quarters, as exporters respond with a moderate lag to recovering global demand, inventory cutbacks gradually come to an end and past monetary/fiscal easing feed through to final demand. Nonetheless, export competitiveness problems amid a strong rand, still-elevated household debt levels and the likelihood of strong electricity price hikes in 2010-12 suggest the recovery will be relatively sluggish. Hence, we only project growth of about 3% in 2010 and 2011, well below the circa -4.5% potential pace that prevailed before the global crisis. The output gap should thus remain ample, helping a further moderation in inflation in 2010, but rand vulnerability and power tariff hikes make a renewed breach of the 3%-6% target likely in 2011. The current account deficit is likely to widen again in 2010 as domestic demand recovers, to about 5% of GDP, while the budget deficit will remain substantial despite efforts at curbing spending growth. In such an environment, we expect that the SARB will be in no rush to raise rates, but will eventually need to start hiking (by late 2010) and normalize rates to around 9.50% in the following year.

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Figure 47. Egypt, Nigeria and South Africa — Economic Forecast, 2009F-11F

		Egypt			Nigeria			South Africa		
		2009F	2010F	2011F	2009F	2010F	2011F	2009F	2010F	2011F
Real GDP	YoY	4.4%	4.8%	5.2%	4.8%	4.6%	6.2%	-1.9%	2.6%	3.1%
Final Domestic Demand	YoY	5.7	5.9	3.7	NA	NA	NA	-0.2	2.1	3.0
Private Consumption	YoY	4.4	5.9	3.2	NA	NA	NA	-3.0	0.9	2.6
Fixed Investment	YoY	10.4	6.1	4.8	NA	NA	NA	5.1	4.8	5.0
Exports	YoY	-1.8	2.8	5.8	NA	NA	NA	-17.8	10.7	6.5
Imports	YoY	2.3	6.0	2.0	NA	NA	NA	-15.2	15.7	6.6
CPI	YoY	11.4	9.8	12.1	12.3	8.8	10.2	7.4	6.0	6.8
Unemployment Rate	%	9.0	10.3	10.8	NA	NA	NA	25.5	25.8	0.0
Current Account	US\$ bn	-5.4	-4.2	-2.5	11.9	26.1	25.5	-14.3	-19.7	-17.3
	% of GDP	-2.8	-1.9	-9.8	6.2	11.9	9.8	-4.2	-5.2	-5.7
Fiscal Balance	% of GDP	-8.0	-8.8	-7.8	-5.6	-3.8	-2.5	-7.6	-6.3	-5.4
US Dollar Exchange Rate	Average	5.54	5.35	5.44	150	151	147	7.18	7.16	8.16

Source: Citi Investment Research and Analysis

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## India

Affected by monsoons, 2009 is declared an all-India drought year, and agriculture growth probably fell by about 4%. However, unlike past droughts, the impact will be muted due to (1) on-going stimulus measures via the national rural employment guarantee act, the farm waiver and the pay revision and (2) the impact of new hydro-carbon discoveries. We expect FY10 GDP growth of about 6.2% vs. 6.7% in the previous year. With macro improvements, we expect the investment cycle to regain momentum thereby resulting in FY11 GDP growth coming in at 7.8%. Higher food prices are putting upward pressure on inflation and we expect inflation as measured by the WPI to cross 6% levels by March 10 from 1.5% currently. While loan growth remains anemic, better-than-expected industrial data and rising WPI will likely prompt tightening by early 2010. We maintain our call of 125bps tightening in 2010 as inflation is primarily supply-side driven and excess tightening would have implications for the INR. Given the core theme in FX of a structural dollar weakness, coupled with an improvement in domestic growth and the balance of payments, we expect the rupee to strengthen to Rs44/US\$ by March 10 and Rs41/US\$ by March 11. However, in the near-term, the rupee like other EM assets will likely continue to oscillate between “risk aversion” and “return to risk”.

## Korea

Based on the resilient economic growth shown in 2Q (2.6% QoQ) and 3Q (2.9% QoQ), our annual GDP growth rate for 2009 is now raised to -0.1% from -0.8% previously. As the world economy bottoms out of the crisis, we expect the current growth momentum from exports will continue in 4Q and following years, though the pace might slow. Construction investment will probably increase due to expectations of economic recovery and spillover effects from export sectors. We anticipate this business recovery to raise the number of new jobs to 200,000 or more after 2H-2010 and ultimately lead to a pick up in private consumption. Booming output of semiconductors, LCD, and industrial plants exports etc., will probably contribute to a USD25.9bn current account surplus in 2010. Even with the appreciation of KRW against USD, headline inflation will probably rise to 3.0% in 2010, as the demand gap and raw material costs increase. The Government will maintain its accommodative stance to bolster sluggish private sectors such as SMEs or construction industry, even if BOK begins tightening by a policy rate hike in early 2010.

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Figure 48. India and Korea — Economic Forecast, 2009F-11F

		India			Korea		
		2009F	2010F	2011F	2009F	2010F	2011F
Real GDP	YoY	6.2%	7.8%	8.5%	-0.1%	4.7%	5.0%
Final Domestic Demand	YoY	6.8	9.0	10.2	0.0	3.7	4.9
Private Consumption	YoY	4.9	6.5	7.5	-0.1	3.2	4.6
Fixed Investment	YoY	9.0	14.0	15.5	-1.9	4.4	6.0
Exports	YoY	1.0	11.0	10.8	-1.7	7.1	11.8
Imports	YoY	4.0	13.0	7.7	-9.4	9.8	12.6
Wholesale Price Index*	YoY	2.7	5.0	4.5	NA	NA	NA
Consumer Price Index	YoY	10.0	6.0	5.0	2.7	3.0	3.2
Unemployment Rate	%	NA	NA	NA	3.4	3.2	3.1
Current Account	US\$ bn	-10.6	0.9	3.5	40.0	25.9	12.9
	% of GDP	-0.8	0.1	0.2	4.8	2.4	1.1
Fiscal Balance	% of GDP	-10.3	-9.0	-8.5	-2.5	-1.9	-0.1
US Dollar Exchange Rate	Average	46	43	42	1273	1063	1038

Note: \*In India, policymakers look at the wholesale price index

Source: Citi Investment Research and Analysis

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## Hong Kong

The economy has suffered a double whammy from the global financial tsunami in early 2009, sharp contraction in trade and capital outflow. However, as strong growth in China and other Asian economies led to a recovery of exports and return of capital, the economy improved fast in 2H09. In particular, pilot projects of RMB loans and government bonds have attracted a significant capital inflow that induced rapid buildup of FX reserves and rising asset prices. Going forward, the Hong Kong economy is likely to boom on the recovery of global trade and bullish financial markets in 2010 and 2011. Inflation pressure will likely rise in the coming two years but should stay under control. Even with the Fed's expected starting rate hike during 2010, monetary conditions will likely remain loose to underpin financial and housing markets. The HKD-Linked Exchange Rate System (Peg to USD) will likely continue to hold, even though markets probably will once again speculate on band widening or even de-pegging, especially when RMB accelerates the process of internationalization.

## Singapore

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While moderation in growth momentum is inevitable after the recent V-shaped bounce, growth support will come from the opening of the two Integrated Resorts in 1Q 10, trade related services, and infrastructure spending. Base effects could lift YoY growth rates to above 10% in 1Q10, before moderating as accommodative policies are gradually withdrawn. As the output gap turns positive in 2H 10, upside inflation risks from wages and rents could add to pressures from commodity and car prices. Likely upward revisions in imputed rents in January could push headline inflation above the MAS's forecast of 1%-2%. The SGD NEER has traded above the strong side of the policy band, as a possible prelude to formal tightening in April 2010.

Recommendations of the Economic Strategies Committee (ESC), which has been tasked to chart medium term strategy, will be announced in January. Officials have mentioned that labour constraints and the lower productivity growth will imply lower medium term trend growth, with the former likely signaling some tightening of immigration rules. The budget in February, which will remain in deficit owing to infrastructure spending, will also be used as a platform to put the ESC's recommendations into policy.

Figure 49. Hong Kong and Singapore — Economic Forecast, 2009F-11F

		Hong Kong			Singapore		
		2009F	2010F	2011F	2009F	2010F	2011F
Real GDP	YoY	-3.2%	4.0%	5.0%	-1.3%	6.5%	5.1%
Final Domestic Demand	YoY	-1.4	4.8	3.4	-1.7	5.9	5.9
Private Consumption	YoY	-1.5	4.0	3.7	-1.2	3.6	5.0
Fixed Investment	YoY	-2.9	8.7	3.3	-3.6	10.5	8.0
Exports	YoY	-9.9	5.4	7.1	-11.6	10.2	6.0
Imports	YoY	-9.3	5.7	6.3	-12.8	9.4	6.6
CPI	YoY	0.5	1.8	2.0	0.3	2.8	2.1
Unemployment Rate	%	5.4	5.2	4.9	3.4	3.0	2.8
Current Account	US\$ bn	17.9	20.1	23.8	21.0	24.1	23.0
	% of GDP	8.5	9.0	10.0	12.0	11.7	10.4
Fiscal Balance	% of GDP	-1.5	-1.0	0.0	-4.0	-3.0	5.0
US Dollar Exchange Rate	Average	7.75	7.75	7.75	1.5	1.3	1.3

Source: Citi Investment Research and Analysis

Figure 50. Selected Emerging Market Countries — Economic Forecast Overview, 2009F-11F

	GDP Growth			CPI Inflation			Current Balance (% of GDP)			Fiscal Balance (% of GDP)		
	2009F	2010F	2011F	2009F	2010F	2011F	2009F	2010F	2011F	2009F	2010F	2011F
<b>Asia</b>	<b>5.1%</b>	<b>7.8%</b>	<b>7.7%</b>	<b>1.0%</b>	<b>3.6%</b>	<b>4.1%</b>	<b>5.3%</b>	<b>4.5%</b>	<b>3.9%</b>	<b>-4.2%</b>	<b>-3.7%</b>	<b>-3.1%</b>
Bangladesh	5.7	6.1	6.7	6.5	6.2	6.0	2.5	1.7	1.0	-5.0	-4.8	-4.5
China	8.7	9.8	9.0	-0.6	3.0	3.8	6.6	6.1	5.4	-3.0	-2.8	-2.7
Hong Kong	-3.2	4.0	5.0	0.5	1.8	2.0	8.5	9.0	10.0	-1.5	-1.0	0.0
India*	6.2	7.8	8.5	2.7	5.0	4.5	-0.8	0.1	0.2	-10.3	-9.0	-8.5
Indonesia	4.3	5.5	6.0	5.0	6.2	6.7	1.9	0.8	0.2	-2.0	-1.6	-1.5
Korea	-0.1	4.7	5.0	2.7	3.0	3.2	4.8	2.4	1.1	-2.5	-1.9	-0.1
Malaysia	-2.0	5.2	5.0	0.6	2.3	3.0	14.9	11.6	13.0	-7.4	-6.2	-4.0
Pakistan	2.6	3.8	4.3	10.5	12.0	12.0	-4.5	-4.6	-4.6	-5.2	-5.8	-5.5
Philippines	1.4	3.7	4.8	3.1	3.7	4.4	5.5	4.7	2.9	-4.5	-3.8	-2.9
Singapore	-1.3	6.5	5.1	0.3	2.8	2.1	12.0	11.7	10.4	-4.0	-3.0	5.0
Sri Lanka	3.2	5.8	6.3	3.3	6.5	8.0	-3.1	-4.4	-3.7	-6.5	-6.6	-5.4
Taiwan	-3.5	4.3	5.0	-0.7	0.9	1.5	11.9	7.8	7.5	-3.9	-2.5	-2.0
Thailand	-3.3	4.2	5.0	-1.0	2.5	3.5	8.0	7.1	3.8	-4.9	-5.8	-4.8
Vietnam	4.7	6.0	6.1	7.0	8.5	9.0	-8.6	-8.2	-5.6	-8.2	-5.6	-4.7
<b>Latin America</b>	<b>-2.4%</b>	<b>3.5%</b>	<b>3.5%</b>	<b>7.6%</b>	<b>7.9%</b>	<b>8.3%</b>	<b>-0.6%</b>	<b>-1.0%</b>	<b>-1.6%</b>	<b>-3.0%</b>	<b>-2.2%</b>	<b>-1.8%</b>
Argentina	-3.3	2.0	2.0	15.4	19.3	17.4	3.1	3.2	0.5	-2.3	-1.8	-1.0
Brazil	0.2	5.0	4.0	4.9	4.0	4.1	-1.1	-2.2	-2.7	-3.2	-1.8	-2.5
Chile	-1.7	4.4	4.0	1.6	1.7	2.8	1.2	0.3	0.1	-4.0	-1.3	2.0
Colombia	0.1	2.5	3.5	4.2	3.7	3.4	-1.8	-2.3	-2.2	-2.8	-3.7	-2.5
Ecuador	-0.5	2.0	3.5	5.0	2.1	3.0	-3.1	-2.4	-1.0	-5.0	-4.0	-3.2
Mexico	-7.1	3.6	3.8	5.4	4.9	4.4	-0.9	-1.2	-2.2	-2.1	-2.5	-1.8
Panama	1.5	4.0	4.5	2.6	4.4	3.6	-6.5	-8.6	-7.0	-2.5	-2.0	-1.5
Peru	1.3	5.0	5.0	3.0	1.5	2.6	0.5	-1.2	-1.2	-2.7	-0.9	-0.3
Uruguay	1.3	5.1	5.0	7.1	5.7	5.5	0.0	-1.8	-2.0	-2.5	-1.5	-0.5
Venezuela	-2.6	-1.7	0.5	28.7	30.4	39.0	-0.4	6.3	4.0	-5.8	-3.5	-1.0
<b>Europe</b>	<b>-5.7%</b>	<b>2.9%</b>	<b>4.1%</b>	<b>8.1%</b>	<b>5.6%</b>	<b>6.2%</b>	<b>0.2%</b>	<b>-0.3%</b>	<b>-0.3%</b>	<b>-6.3%</b>	<b>-4.9%</b>	<b>-4.1%</b>
Czech Republic	-4.3	1.5	2.5	1.0	1.0	2.4	-1.2	-1.1	-1.8	-6.5	-5.8	-5.1
Hungary	-6.4	0.5	3.2	4.0	3.9	3.3	-2.9	-3.2	-3.4	-4.0	-3.9	-2.7
Kazakhstan	-0.5	2.6	6.8	7.3	7.0	6.5	-3.0	1.8	7.5	-3.5	-2.8	1.0
Poland	1.4	2.6	3.6	3.5	2.0	2.3	-1.7	-2.5	-3.4	-6.0	-6.7	-4.4
Romania	-7.1	1.3	2.7	5.5	3.7	3.5	-4.8	-6.1	-6.5	-8.0	-6.0	-5.0
Russia	-7.5	3.0	4.1	11.7	6.8	8.3	3.9	3.2	3.0	-6.5	-4.2	-3.9
Slovakia	-5.5	3.1	3.5	1.6	2.0	3.6	-4.9	-5.6	-3.4	-6.0	-5.8	-4.3
Turkey	-5.7	4.2	5.5	6.2	7.1	6.6	-2.1	-3.8	-4.0	-6.5	-5.0	-4.2
Ukraine	-14.5	2.9	3.5	16.1	11.0	9.8	0.0	1.5	13.4	-5.8	-6.3	-7.1
<b>Africa/Mideast</b>	<b>1.8%</b>	<b>3.4%</b>	<b>4.5%</b>	<b>9.2%</b>	<b>6.8%</b>	<b>7.9%</b>	<b>-0.8%</b>	<b>-0.1%</b>	<b>0.0%</b>	<b>-6.4%</b>	<b>-5.8%</b>	<b>-5.0%</b>
Egypt	4.4	4.8	5.2	11.4	9.8	12.1	-2.8	-1.9	-9.8	-8.0	-8.8	-7.8
Ghana	5.2	5.9	16.8	19.1	8.6	9.5	-11.3	-13.1	-9.5	-10.9	-7.2	-5.8
Israel	0.4	1.3	3.0	3.2	2.8	2.9	3.0	1.8	0.7	-5.2	-4.6	-4.1
Kenya	3.4	4.6	5.2	20.3	6.8	8.5	-3.6	-4.6	-5.0	-4.9	-5.2	-5.5
Nigeria	4.8	4.6	6.2	12.3	8.8	10.2	6.2	11.9	9.8	-5.6	-3.8	-2.5
South Africa	-1.9	2.6	3.1	7.4	6.0	6.8	-4.2	-5.2	-5.7	-7.6	-6.3	-5.4
Tanzania	5.0	5.7	7.2	12.0	9.6	6.5	-8.7	-8.8	-8.3	-4.3	-4.6	-3.1
Uganda	6.5	7.6	6.1	13.3	9.7	9.6	-6.2	-6.5	-4.6	-2.6	-3.9	-3.2
Zambia	4.8	5.5	5.7	13.4	10.6	12.5	-3.8	-0.6	-1.2	-2.6	-2.8	-3.2
<b>Total</b>	<b>0.8%</b>	<b>5.7%</b>	<b>5.9%</b>	<b>4.5%</b>	<b>5.1%</b>	<b>5.6%</b>	<b>2.7%</b>	<b>2.2%</b>	<b>1.8%</b>	<b>-4.5%</b>	<b>-3.8%</b>	<b>-3.1%</b>

Note: \*For India we use the wholesale price index as the inflation measure. Source: Citi Investment Research and Analysis

## Notes

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## Rates Strategy — 2010 The Year of Normalisation

We expect 2010 to be the year of normalisation for the term structure of rates. This makes the longer-term risk-reward asymmetric, favouring higher yields and flatter curves. However, the lack of any imminent change in policy stance and the cost of carrying "normalisation" trades will likely keep the markets close to current levels over the next couple of months. A significant front-end led sell-off looks like being a theme for the second half of 2010 rather than a trade for the final months of 2009 or even Q1 2010.

That said, we do think front-end yields can rise significantly, well before the Fed actually hikes rates. The market currently prices a very benign path of policy rate normalisation and although the front two or three Eurodollar contracts look to be relatively well supported at current levels, yields on the late 2012 and early 2013 contracts at around 3.5% have plenty of upside as the first hike approaches. The long-end, however, is showing signs of a similar dynamic to the one we saw at the start of the last tightening cycle. Steep curves and tight credit spreads have shifted the balance in favour of duration extension over credit risk as a yield enhancement trade. Fiscal risks and long-term inflation risks as a driver of higher long-term yields are, in our opinion, overstated. This means that the re-emergence of a trading pattern similar to the 2004-2005 "bond conundrum" is distinctly possible.

The end of Quantitative Easing measures is likely to put some upward pressure on yields but we estimate this as being in the region of 40-50 basis points. Thus we expect 10yr note yields to be capped at about 4% for the first part of 2010 and to move up towards 4.5% after the Fed has actually begun to tighten. For this reason, bear flattening remains our core view for the US curve.

We expect Europe to outperform the US in the medium term, but unfriendly cash-flow dynamics may delay this into the end of 2009. Based on our forecasts for the relative paths of policy rates, our model predicts that 10yr Bunds should outperform Treasuries by about 50bp next year. Given the relatively benign outlook for 10yr US Treasury yields, this implies that 10yr Euro yields are unlikely to change significantly from current levels between now and mid-2010.

The Euro curve is likely to remain in a very tight range. We favour a modest further steepening of 2s10s as the cash flow dynamic turns less supportive through December but we think the curve will eventually flatten as the cycle matures. There is probably plenty of time to consider Euro steepeners, though past experience suggests that the trigger for the first significant flattening of the Euro curve comes from the first rate hike in the US cycle.

We remain bearish on gilts beyond the end of QE, particularly after mid-year if the Conservative Party fails to gain a significant majority at the general election. If they do get an absolute majority we can probably expect a period of severe fiscal restraint that should be relatively bond-supportive, but the current low level of yields, the risk of a hung parliament, the ensuing lack of credible fiscal austerity and the implications for the UK's debt rating all add-up to a very poor risk-reward profile for gilts. Similarly, JGBs will face a struggle between a supportive monetary backdrop, with policy rates set to remain accommodative for the foreseeable future, and a deteriorating fiscal outlook. This is likely to keep the yield curve steep, particularly if global yields are in an upward trend.

Figure 51. Interest Rate and Bond Market Forecasts (End of Period), as of 23 November, 2009

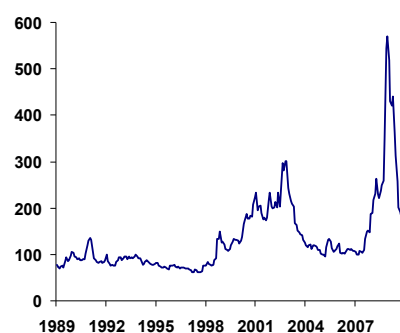
	Current	Forecast End Period					
		4Q 09	1Q 10	2Q 10	3Q 10	4Q 10	1Q 11
<b>US</b>							
Policy Rate (Fed Funds) End Quarter	0.13	0.13	0.13	0.13	0.13	1.00	1.50
3-Month Libor	0.27	0.30	0.50	1.00	1.25	2.00	2.50
2 Year Treasury Yield	0.69	1.25	1.75	2.50	2.75	3.25	3.60
10 Year Treasury Yield	3.40	3.45	3.45	3.75	4.15	4.45	4.65
30 Year Treasury Yield	4.30	4.50	4.50	4.65	4.65	4.75	4.75
2-10 Year Treasury Curve	266	220	170	125	140	120	105
2 Year Swap Spread (Govt Less Swap), bp	32	40	40	40	40	40	35
10 Year Swap Spread (Govt Less Swap), bp	12	24	25	26	28	30	40
30 Year Swap Spread (Govt Less Swap), bp	-10	-10	0	5	10	10	15
30 Year Mortgage Yield	4.11	4.30	4.45	4.75	5.15	5.55	5.75
10 Year Breakeven Inflation	2.20	2.00	2.25	2.35	2.40	2.50	2.50
<b>Euro Area</b>							
Policy Rate	1.00	1.00	1.00	1.00	1.00	1.00	1.25
3-Month Libor	0.67	0.75	0.90	1.00	1.00	1.25	1.75
2 Year Treasury Yield	1.31	1.25	1.25	1.25	1.50	1.75	2.50
10 Year Treasury Yield	3.29	3.35	3.35	3.60	3.90	4.00	4.10
30 Year Treasury Yield	4.14	4.15	4.25	4.25	4.30	4.35	4.40
2-10 Year Treasury Curve	198	210	210	235	240	225	160
10 Year BTP-Bund Spread	80	80	90	80	70	70	60
2 Year Swap Spread (Govt Less Swap), bp	41	30	25	25	20	20	25
10 Year Swap Spread (Govt Less Swap), bp	24	15	20	25	30	35	30
30 Year Swap Spread (Govt Less Swap), bp	-5	0	5	10	15	15	20
10 Year Breakeven Inflation	2.43	2.00	2.00	2.25	2.25	2.50	2.50
<b>Japan</b>							
Policy Rate	0.10	0.10	0.10	0.10	0.10	0.10	0.10
3-Month Libor	0.32	0.35	0.35	0.35	0.40	0.45	0.45
2 Year Treasury Yield	0.26	0.25	0.25	0.25	0.25	0.30	0.35
10 Year Treasury Yield	1.32	1.30	1.25	1.40	1.40	1.50	1.60
30 Year Treasury Yield	2.18	2.15	2.10	2.25	2.25	2.30	2.40
2-10 Year Treasury Curve	106	105	100	115	115	120	125
2 Year Swap Spread (Govt Less Swap), bp	32	30	30	30	30	25	25
10 Year Swap Spread (Govt Less Swap), bp	14	10	15	15	15	10	10
30 Year Swap Spread (Govt Less Swap), bp	-4	5	5	5	5	5	5
10 Year Breakeven Inflation	-0.94	-0.95	-0.90	-0.90	-0.90	-0.85	-0.85
<b>UK</b>							
Policy Rate	0.50	0.50	0.50	0.50	1.00	1.50	1.50
3-Month Libor	0.61	0.75	1.00	1.25	1.50	2.00	2.25
2 Year Treasury Yield	1.27	1.25	1.50	1.75	2.00	2.50	2.75
10 Year Treasury Yield	3.66	3.91	4.01	4.35	4.74	4.94	5.13
30 Year Treasury Yield	4.14	4.50	4.55	4.75	5.00	5.13	5.25
2-10 Year Treasury Curve	239	266	251	260	274	244	238
2 Year Swap Spread (Govt Less Swap), bp	50	90	85	65	45	40	35
10 Year Swap Spread (Govt Less Swap), bp	16	35	30	25	20	15	10
30 Year Swap Spread (Govt Less Swap), bp	-12	-15	-10	-5	0	0	0
10 Year Breakeven Inflation	3.15	3.25	3.25	3.25	3.50	3.50	3.50
<b>Australia</b>							
Policy Rate	3.50	3.75	4.25	4.50	5.00	5.50	5.75
3-Month Libor	3.96	4.10	4.40	4.75	5.30	5.60	5.85
2 Year Treasury Yield	4.42	4.90	5.10	5.40	5.70	5.95	6.15
10 Year Treasury Yield	5.42	5.50	5.60	5.75	5.90	6.10	6.30
2-10 Year Treasury Curve	100	60	50	35	20	15	15
10 Year Swap Spread (Govt Less Swap), bp	69	60	50	45	40	40	30

Source: Citi Investment Research and Analysis

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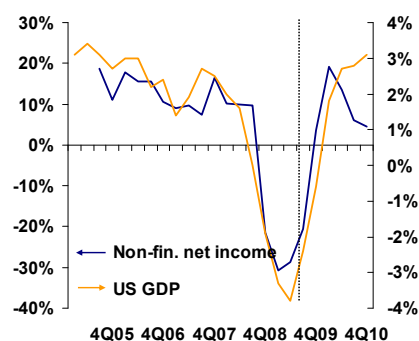
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Figure 52. US non-fin. BIG spread to benchm. (bp)



Source: Citi Investment Research and Analysis

Figure 53. S&P earnings expectations vs. US GDP w. Citi forecast



Source: CIRA, ThomsonOne Analytics

## Credit Strategy — Euro Credit Outlook 2010

### Back To Normal?

It's been two extraordinarily tumultuous years. Having priced in a scenario bordering on the collapse of the modern financial system, risk premia across most parts of the credit market have fallen by 60-70% since March (see Figure 52).

It seems as if credit markets are now, finally, returning to some kind of normality. But where does that leave the outlook for 2010? For two years the world looked for direction in credit, now the credit outlook increasingly rests on the world, unless technicals drive us into an overshoot. Both scenarios should allow risk premia to fall further next year.

### Fundamental Foundations

The trajectory for global recovery our economists envisage for 2010 goes hand in hand with substantial improvements in the corporate outlook. Bottom-up analyst expectations for earnings and revenue growth in 2010 may be ambitious, but they are not inconsistent with growth projections (see Figure 53).

Coupled with cost controls on employment, capex and payouts to shareholders, improving earnings are allowing companies to retain more cash. In the US, the 2Q 09 non-financial funding surplus was as high as we've seen it in more than 20 years. That cash, in turn, is being applied to debt reduction (see Figure 54). In Europe, where cost cutting has been less aggressive, net debt levels are stabilizing, but not falling yet. From a credit perspective, the combination of rising profits and falling debt marks something of a sweet spot in the cycle, where leverage is brought down almost as rapidly as it went up during 2007-08.

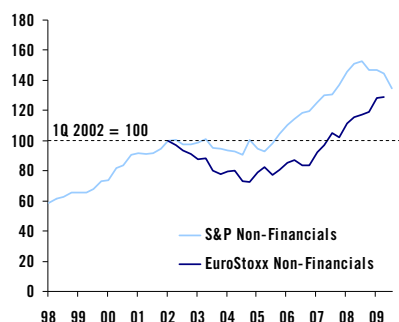
Evidently, assuming confidence continues to build through 2010, more corporates will switch their attention from creditors to shareholders. However, at this stage we believe only companies with very strong balance sheets will dare to lever up. Against very low capacity utilisation, they are more likely to acquire their smaller (and often more highly levered) competitors than embark on big expansionary capex programmes.

At the lower end of the credit spectrum, companies with near-death experiences still fresh in memory will likely stay firmly focused on bringing down debt. Deleveraging, the pickup in demand and much improved financing conditions imply a sharp drop in default rates during 2010. We forecast the US speculative-grade default rate will fall to 5.5% by the end 1H10 from the current level of around 12.5%. If the recovery remain on track, the default rate is likely to fall further in the second half of the year. European (12-month trailing) default rates are likely to peak early in 2010, but then they too should fall fairly sharply thereafter.

The financial sector should enter 2010 still carrying a heavy load. Impairment rates are likely to remain extremely elevated through much of the year, reducing the scope for banks to strengthen their balance sheets organically, despite very high net interest margins. As the new regulatory framework begins to take shape, it is clear that many banks have further work to do on their capital ratios. While some banks have recently chosen to address perceived capital deficits with new equity, we expect banks, in Europe in particular, will

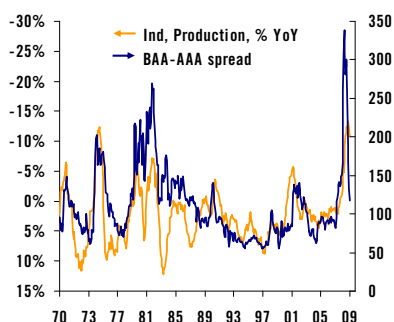


**Figure 54. Net debt of select EU and US corporates**



Source: CIRA, Bloomberg

**Figure 55. US credit spread vs. ind. production**



Source: CIRA, Moody's, Ecowin

continue to use balance sheet contraction as an alternative means of reducing shortfalls.

As central banks scale back their liquidity injections during 2010, we expect banks will become increasingly active in capital markets, seeking to reduce the maturity mismatch between assets and liabilities. As such, the level of credit spreads for senior bank debt will likely be another important determinant of bank willingness to lend.

## Where Do Credit Spreads Go In 2010?

In early 2009, there was an obvious misalignment between credit spreads and all the fundamental variables that credit tends to track, be they leverage, defaults, growth or lending standards (see Figure 55). That misalignment is now gone.

On a fundamental basis, the case for further tightening in credit therefore assumes that the activity levels implied by leading indicators materialise. If they do, most of our valuation metrics are consistent with a further 25%-30% tightening in credit spread. European non-financial spreads are now only 10bp away from their 10-year average, but credit rarely hangs around the mean for long — spreads tend to be either considerably tighter or way wider. Even if spreads tighten by 30% next year, they will remain above their long-term median.

However, in credit markets, technicals can be as important as fundamentals. 2009 saw inflows to credit funds on an unprecedented scale, attracted by valuations but in turn fuelling the rapid retracement. Although, we expect inflows will diminish during 2010, we expect the market will continue to see excess demand, especially in the first half of the year. Our latest credit survey suggests that even at current spread levels, inflows remain near record levels.

That raises the possibility that credit spreads may undershoot (tighten more than warranted by fundamentals). Across financial markets, we are seeing increasing signs that leverage is leading to a build up of carry-based positions and risk appetite. Credit is no exception — as evidenced by the recent risk-adjusted outperformance of the HY CDS index in Europe versus its investment grade counterpart. Haircut levels on most credit instruments have come down significantly, facilitating a partial build up of leverage again. As easy returns become harder and harder to find in 2010, we suspect an intensifying hunt for yield may force risk premia lower.

The end of quantitative easing and other emergency programmes should curtail technical demand at the margin. But unless central banks actively seek to sell out their credit exposures, the effect will be manageable across most credit asset classes. We're not overly worried by the prospect of a few rate hikes either. In past cycles, the start of hiking cycles after recessions have not generally led to credit spread widening in the first 6-12 months. Generally, the confirmation of recovery, which gives central banks the confidence to hike, will be positive for credit as well. Typically, it is only later in the cycle when rate hikes are designed to cool the economy that credit spreads respond negatively.

In conclusion, we are positive on credit going into next year. After three years in the limelight, credit will (hopefully) become less prominent position in 2010, but there should still be opportunities for credit investors to make decent returns, if they are prepared to take risk. We'd emphasise the importance of a flexible and diversified approach in the event that spreads do end up undershooting.

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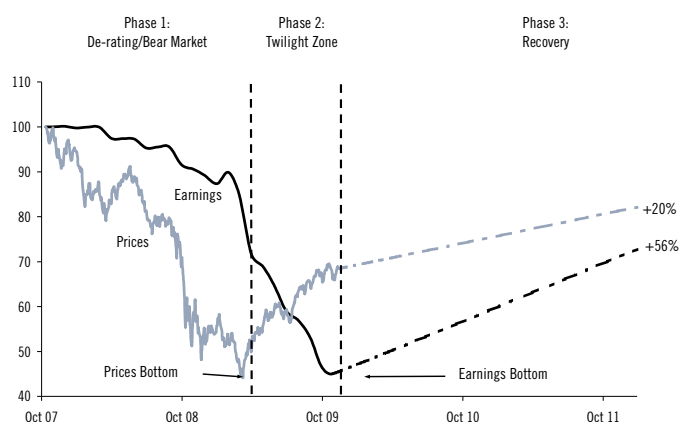
## Global Equity Strategy — 2010 Outlook

As the earnings cycle bottoms, we believe that global equities are moving out of the Twilight Zone into the Recovery Phase (see Figure 56). The Twilight Zone is the phase towards the end of most recessions when share prices rise even though corporate earnings are still falling. Global equities surged higher in the Twilight Zone and we believe they will grind higher in the Recovery Phase.

History suggests that EPS recoveries are almost always V-shaped. We do not expect it to be much different this time. Operational leverage offers the potential for a strong profit rebound even if the global economic recovery is subdued. We would see further market set-backs as a buying opportunity. A mid-cycle slowdown, perhaps created by an inevitable tightening in monetary and fiscal policy, is probably the next major challenge for global equities, but we do not expect that to happen until 2012.

Global equities have rallied more than 60% since their March lows but are still 30% below the pre-crisis highs. Our targets suggest that the MSCI AC World US\$ index (currently 295) can end 2011 around the 340 level. This forecast is based upon a 50-60% recovery in earnings (analyst consensus) and a typical 24% de-rating over the period. If anything, we think that the risk to earnings forecasts may be on the upside. This suggests decent double-digit total returns for global equities over the next two years, but nothing as spectacular as seen over the past 6 months. Of course, there will be set-backs along the way — the average correction in the first 24 months of a new bull market is around 7%-8%.<sup>12</sup> We would see these as buying opportunities. The prospect of a mid-cycle slowdown will offer new challenges for global equity markets in 2012. But for now, the combination of reasonable valuations, imminent earnings recovery, and low interest rates means that its too early to turn cautious.

Figure 56. Twilight Zone



Source: Citi Investment Research and Analysis

As trailing earnings have plunged and share prices rebounded, we have seen the fastest re-rating of global equities in the past 40 years. The overall message is that valuations are clearly not as attractive as they were six months ago. But neither are they yet prohibitively expensive, especially if we believe that companies can achieve anything like a normal EPS recovery.

<sup>12</sup> Global Equity Strategist: The Wall of Worry, 2 September 2009

**Figure 57. Regional Strategists Index Target s**

Region	Index	End 2010 Target
US	S&P 500	1150
Pan Europe	DJ Stoxx	260
UK	FTSE 100	6000
Japan	Topix	1150
Asia ex Jp	MSCI Asia ex Jp	520
LatAm	MSCI LatAm	4800
Australia	S&P/ASX 200	5500

Source: Citi Investment Research and Analysis

Top-down strategies become less appropriate as the Twilight Zone ends and the earnings recovery begins. Our regional/sector recommendations are now driven by more bottom-up factors such as earnings momentum and valuation. Our key regional and global sector recommendations are summarised in Figure 58. We look towards those regions and sectors where the potential for EPS recovery looks greatest but valuations remain attractive. We favour the higher-beta European markets. These are the cheapest markets in the world. Our European strategists, Jonathan Stubbs and Adrian Cattley, remain optimistic on the region. They think that global economic recovery, a robust corporate profit recovery, attractive valuations and improving demand for UK and European equities will drive 20%-25% returns over the coming 12-18 months.

We still favour Emerging Markets. We like CEEMEA as a cheap contrarian play, but now prefer LatAm to Emerging Asia. Asian markets are now starting to look relatively expensive. This is in line with views of our regional strategists. Our Latin American Strategist, Geoffrey Dennis, expects Latin American markets to rise further in 2010, but at a much slower pace than this year. He forecasts 21.4% USD returns over the next year. Brazil remains his top pick.<sup>13</sup> Markus Rosgen, Asia Pacific ex Japan strategist, expects his region's market returns to slow to around 9%-14%.<sup>14</sup> He prefers Hong Kong and Korea over China and India.

The US remains Underweight. Valuations do not look particularly attractive and earnings momentum is better elsewhere. Also the US tends to perform as a defensive market and is an obvious source of funds for an equity investor looking to increase risk exposure. Tobias Levkovich, our US strategist, believes that gains in 2010 are likely to be uneven and could spike above his year end S&P 500 target of 1,100 during earlier parts of the year and then back off. We are Underweight Developed Asia (mostly Australia) where strong performance now leaves relative valuations looking unattractive. Japan remains an enigma. Low RoEs provide the potential for a spectacular recovery, and earnings momentum is improving, but valuations remain a drag.

In terms of sector allocation, we think the big cyclical vs. defensive calls that worked so well in the Twilight Zone will become less appropriate as we enter the earnings Recovery Phase. Our balance between earnings momentum (which favours cyclicals) and valuation (which favours defensives) gives a pairs-trade feel to our current global sector recommendations. Within cyclicals, we favour Financials over Industrials. Within defensives, we favour Health Care over Utilities. Within commodities, we favour Energy over Materials.

**Figure 58. Regional And Global Sector Recommendations**

Overweight	Neutral	Underweight
Europe ex-UK	Japan	US
CEEMEA, LatAm	Em Asia	Developed Asia
UK		
Overweight	Neutral	Underweight
Financials	Telecoms	Materials
Energy	Consumer Staples	Industrials
Health Care	IT	Utilities
	Consumer Disc.	

Source: CIRA

<sup>13</sup> Latin America Strategy Notebook: 2010 Market Targets - Slower Gains, 9 November 2009

<sup>14</sup> Asia ex Strategy: And the Consensus Is..., 13 November 2009

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## Securitized Products Strategy

The legislative and regulatory securitization reform agenda continues to be a key focus of securitized markets and their future direction. **From that perspective, seller retention or “skin in the game” continues to occupy a central role in the proposals to reform the securitization market.** That aspect constituted most of the sections dedicated to improvements to the asset-backed securitization market, in both the Senate and the House legislative drafts that were released over the past couple of weeks. On November 10, the Senate Banking Committee circulated a discussion draft entitled "Restoring American Financial Stability Act of 2009," which included sections on securitizations and rating agencies reforms. The House Financial Services Committee proposals were released on October 27, as part of a draft of legislative language entitled, "Financial Stability Improvement Act of 2009."

Both the Senate and the House drafts basically put into legislative language some of the ABS reform ideas that were floated before in various government statements, mostly in the US regulatory reform White Paper released back in June. We discussed these issues in detail both when the White Paper was released, and more fully last month in a detailed piece on the outstanding regulatory reforms.

But the key novelty that the two drafts introduced was the fact that it now seems legislators are leaning towards 10% seller retention as the basic requirement, rather than the initially suggested 5%. According to the House draft, retention could still be reduced to a minimum of 5%, provided the seller conforms to defined and audited underwriting guidelines that regulators would determine. We commented before that while, in general, risk retention is desirable, the significant question still remains: How much is enough to align interests, and how much is too much that would render securitization uneconomical? From that perspective, it may be difficult to quantify the exact retention level that would achieve a good balance between building investor confidence and providing issuers with economic flexibility.

Moreover, providing regulators with the task of specifying due diligence guidelines that securitizers must meet to lower the required retention could prove a very challenging task that could add confusion, uncertainty, and practical obstacles to the market. **On the somewhat positive side, the legislative drafts, similar to the White Paper, seem to still leave the door open to other mechanisms in the market as an alternative to retention by securitizers.** As we commented before, this is especially relevant for CMBS where professional expert third-party buyers serve as a powerful credit review mechanism to ensure the quality of the collateral through their review and rejection process.

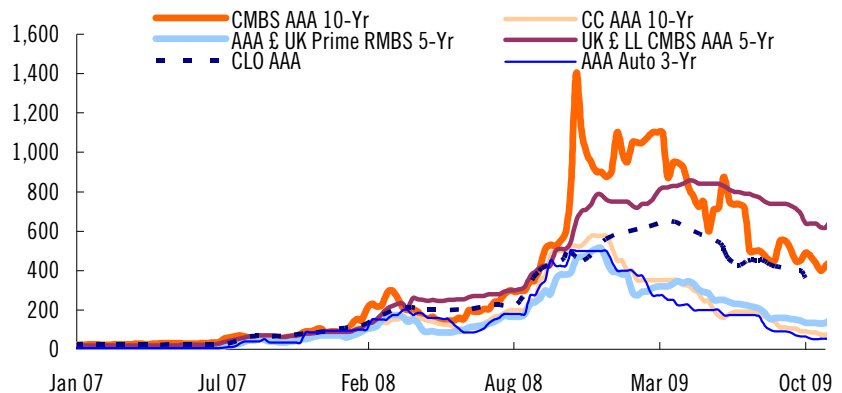
The legislative drafts did not refer directly to specific mechanisms, but did say explicitly that regulators would have the authority to provide exemptions or adjustments to the retention requirements, including exemptions or adjustments relating to the 10% risk retention threshold and the hedging prohibition the drafts also contain. **Overall then, it looks like required risk retention will clearly be part of the forthcoming reforms, which therefore makes it crucial for specific regulations to recognize existing market practices and allow flexibility to any basic rigid requirements.** We think that regulations will recognize that there are established investors for situations where a third party subordinate bond sale can be demonstrated to provide a broader benefit than simple retention, which should hopefully efficiently minimize the loan's funding

costs. But at this point it would benefit markets if there was a more explicit legislative recognition of such potential practices.

All this legislative action is taking place while the economic environment continues to present some uncertainties to the capital markets in general and securitized products in particular. In the US, the surge in unemployment in the October jobs data could reinforce public skepticism about economic recovery. But forward-looking data suggest that we are approaching a bottom to the labor market. Gradually improving consumer spending and stabilizing financial conditions should underpin moderate economic growth, which should support securitized products fundamentals.

At the same time, CMBS and consumer ABS spreads could see widening on profit taking into year-end, providing buying opportunities in both. But on-the-run and higher-quality ABS names should provide some protection. Moreover, considering technicals, PPIP has begun to be part of the market equation along with TALF, so the inclusion of the leveraged bid should add some potency to supporting technicals and limit excess widening in the sectors the PPIP and TALF managers are active in. **Beyond the government supported buying, simple relative value should also support spreads as long as global liquidity remains high.**

Figure 59. Select Securitized Products Spread performance, Jan 07-Oct 09



Source: Citi Investment Research and Analysis

## Appendix 1

*Appendix 1 is market commentary which has been prepared by Jeremy Hale and Guillermo Felices, members of the Institutional Clients Group of Citi. The information in this communication is not intended to constitute "research" as that term is defined by applicable regulations.*

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## Citi Commodity Price Forecasts

### Market Commentary

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

- This section is a summary of the November issue of our Citi Commodity Price Forecasts (published on 13 November). These monthly forecasts are a joint venture between different groups at Citi, including commodities, equities, global macro strategy and futures research. Now that a new forecasting process is in place, the equity analysts are assessing its suitability for use in their equity models
- We have revised up our short and medium term forecasts for WTI prices to USD80/bl and USD85/bl, respectively. We expect the main drivers of prices to be recovering demand, OPEC production restraint and increasing investment flows
- We maintain a bearish US natural gas price forecast relative to the forward curve. We expect short term prices to be volatile: although storage inventories are expected to remain high, winter weather remains very uncertain. Prices should rise gradually in the medium and long term as industrial demand recovers
- We remain constructive on base metals short and medium term, reflecting a recovery in global demand, some constraints in supply and higher investor flows into the complex
- We have increased our precious metals forecasts in the short and medium term. We expect gold prices to continue benefiting from reserve diversification, USD weakness and a broad attempt by authorities to keep currencies weak. We continue to expect silver to benefit from the industrial cycle upswing
- This month we maintain our forecasts for hard coking coal, thermal coal and iron ore. China's surging imports remain the most significant influence on market dynamics
- We expect corn prices to drop in the short term due to seasonal harvest pressure and a slowdown in export demand and foresee only limited gains in the medium to long term (relative to spot) as global supplies are likely to stay high. Our wheat forecasts are also bearish relative to forwards reflecting our expectation of large global supplies. Our soybean and soybean oil forecasts are broadly unchanged

- Freight rates rose sharply over the past month due to strong demand, but we continue to see freight rates softening in the medium to long term driven by a large vessel order-book leading to oversupply of shipping capacity

## Citi Commodity Price Forecasts

	Market data			Forecasts			Returns vs Fwd*		
	spot	3m Fwd	12m Fwd	0-3 mos	6-12 mos	5 years	3 mos rtn	12 mos rtn	
<b>Energy</b>									
WTI Crude	USD/bl	76.6	77.3	81.8	80.0	85.0	85.0	3.5%	4.2%
Brent Crude	USD/bl	76.8	76.58	82.8	80.2	84.8	84.4	4.7%	2.6%
NYMEX Natural Gas	USD/mmBtu	3.23	4.83	5.9	4.50	5.25	6.50	-10.2%	-19.3%
<b>Base Metals</b>									
LME Aluminium	USD/mt	1915	1941	2028	1950	2050	2500	0.5%	1.1%
LME Copper	USD/mt	6481	6496	6538	6500	7500	5500	0.1%	14.8%
LME Lead	USD/mt	2236	2256	2284	2250	2400	1750	-0.2%	5.2%
LME Nickel	USD/mt	16130	16172	16274	17500	19500	17600	8.2%	20.0%
LME Tin	USD/mt	14762	14710	14555	15000	15500	15000	2.0%	6.4%
LME Zinc	USD/mt	2124	2144	2190	2200	2300	2000	2.6%	5.2%
<b>Precious Metals</b>									
Gold	USD/oz	1107	1111	1136	1120	1200	800	0.8%	5.8%
Silver	USD/oz	17.1	17.2	17.5	18.0	19.0	12.0	4.8%	8.8%
<b>Bulk Commodities</b>									
Contract prices:									
Hard Coking Coal (benchmark Asia)	USD/t	128**	n/a	n/a	128	200	140	n/a	n/a
Thermal Coal (benchmark Asia)	USD/t	70**	n/a	n/a	70	80	80	n/a	n/a
Iron Ore Fines (Brockman)	USDc/DMTu	97**	n/a	n/a	97	112	112	n/a	n/a
<b>Agriculture</b>									
CME Corn	USDc/bu	367	416	469	360	400	425	-15.3%	-18.9%
CME Wheat	USDc/bu	437	563	676	475	500	550	-20.1%	-40.3%
CME Soybeans	USDc/bu	960	999	1014	950	900	1000	-5.1%	-11.9%
CME Soybean Oil	USDc/lb	36.5	39.0	40.5	33.0	40.0	44.0	-16.4%	-1.3%
<b>Freight</b>									
Baltic Dry Index		3954	n/a	n/a	3200	1900	1800	n/a	n/a
Capesize Rates	USD/day	72868	47500	28406	48000	23000	27000	0.7%	-7.4%
Panamax Rates	USD/day	31155	25375	16685	26000	15000	15000	2.0%	-5.4%

\*Calculated as (Forecast - Forward)/Spot

\*\*These are contract prices which in most cases have been set for one year

## Contributors

\*\* Citi Commodity Price Forecasts is a joint venture between Citi's commodities, equities, global macro strategy and futures research groups. The analysts listed below have contributed to these forecasts in one form or another.

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## Citi Foreign Exchange Forecasts

### Market Commentary

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

- Structural factors such as the US current account deficit, reserve diversification and outflows of US investor capital to more strongly growing emerging asset markets are all likely to continue to undermine the US currency over the next 6-12 months, as they have over the past 7 years. The EUR is the relative winner from reserve diversification (and maybe from cyclical “surprises”). We see AUD and CAD at USD parity supported in part by commodity price increases
- The USD is now also the prominent funding currency. As a result, an extension of the risk appetite led asset price rally next year, encouraged by major Central Banks being many months from raising rates, would also be USD bearish. Partly as a result, JPY also partakes in USD weakness
- Sterling should resume its depreciation against the EUR. In contrast, we expect further gains by both NOK and SEK against the EUR. The CHF should also appreciate vs. the Euro long term but this will be resisted by the SNB short term
- In EM Asia, we continue to expect further currency strength versus the USD short and medium term, despite noise of capital controls. We expect INR, IDR and KRW to outperform their Asian peers over these horizons, supported by robust growth and the potential for early tightening by central banks
- In CEEMEA, we expect most currencies to strengthen short and medium term, supported by buoyant risk appetite. ZAR and RUB should continue benefiting from commodity prices and improved external accounts. PLN should outperform HUF and CZK. The latter could weaken further in the short term
- Most Latam currencies are likely to continue benefiting from a weak USD and a global recovery in the short term, despite intervention risks. In the medium term, we expect political noise (BRL and COP), fiscal concerns and worsening current accounts to limit appreciation pressures

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

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



		Market data			Forecasts			Returns	
		spot	3m Fwd	12m Fwd	0-3 mos	6-12 mos	long-term	3 mos rtn	12 mos rtn
<b>G10</b>									
Euro	EURUSD	1.49	1.49	1.48	1.62	1.59	1.45	9.0%	7.3%
Japanese yen	USDJPY	89	89	89	84	85	90	-5.4%	-4.0%
British Pound	GBPUSD	1.66	1.66	1.66	1.78	1.59	1.61	7.1%	-4.1%
Swiss Franc	USDCHF	1.01	1.02	1.01	0.93	0.94	0.99	-8.4%	-7.7%
Australian Dollar	AUDUSD	0.92	0.91	0.88	1.00	0.98	0.90	10.1%	11.2%
New Zealand Dollar	NZDUSD	0.73	0.72	0.71	0.78	0.76	0.65	7.7%	7.4%
Canadian Dollar	USDCAD	1.06	1.07	1.07	1.00	1.02	1.02	-6.3%	-4.6%
<b>G10 Crosses</b>									
Japanese yen	EURJPY	133	132	131	136	135	131	3.1%	3.0%
Swiss Franc	EURCHF	1.51	1.51	1.50	1.51	1.49	1.43	-0.1%	-0.9%
British Pound	EURGBP	0.90	0.89	0.89	0.91	1.00	0.90	1.8%	11.9%
Swedish Krona	EURSEK	10.29	10.28	10.26	10.00	9.70	9.20	-2.7%	-5.5%
Norwegian Krone	EURNOK	8.41	8.43	8.54	8.10	7.95	7.62	-4.0%	-7.0%
Norwegian Krone	NOKSEK	1.22	1.22	1.20	1.23	1.22	1.21	1.3%	1.5%
Australian Dollar	AUDNZD	1.26	1.25	1.24	1.28	1.29	1.38	2.3%	3.7%
Australian Dollar	AUDJPY	82	81	78	84	83	81	4.2%	6.9%
<b>Asia</b>									
Chinese Renminbi	USDCNY	6.83	6.80	6.64	6.77	6.63	6.40	-0.5%	0.0%
Hong Kong Dollar	USDHKD	7.75	7.75	7.73	7.750	7.750	7.750	0.1%	0.3%
Indonesian Rupiah	USDIDR	9555	9745	10195	9059	9353	9000	-7.2%	-8.8%
Indian Rupee	USDINR	46.7	46.9	47.5	44.5	42.0	42.0	-5.3%	-11.9%
Korean Won	USDKRW	1157	1168	1178	1086	1050	1050	-7.1%	-11.0%
Malaysian Ringgit	USDMYR	3.39	3.41	3.43	3.29	3.27	3.20	-3.5%	-4.9%
Philippine Peso	USDPHP	47.1	47.5	48.3	46.0	45.1	45.3	-3.0%	-6.7%
Singapore Dollar	USDSGD	1.39	1.39	1.39	1.36	1.36	1.34	-2.7%	-2.8%
Thai Baht	USDTHB	33.2	33.3	33.4	32.66	32.12	32.50	-1.9%	-3.9%
Taiwan Dollar	USDTWD	32.3	32.1	31.4	31.73	32.16	32.50	-1.3%	2.3%
<b>EMEA</b>									
Czech Koruna	EURCZK	25.7	25.7	25.9	26.5	25.5	24.5	2.9%	-1.4%
Hungarian Forint	EURHUF	268	272	279	265	255	250	-2.5%	-9.0%
Polish Zloty	EURPLN	4.13	4.17	4.23	4.05	3.75	3.60	-2.9%	-11.8%
Israeli Shekel	USDILS	3.80	3.80	3.80	3.60	3.50	3.50	-5.3%	-7.9%
Russian Ruble	USD RUB	28.8	29.3	30.7	27.0	26.9	26.6	-8.1%	-13.3%
Russian Ruble Basket		35.2	35.7	37.3	34.5	34.0	32.0	-3.4%	-9.5%
Turkish Lira	USDTRY	1.49	1.52	1.60	1.42	1.47	1.60	-6.5%	-8.7%
South African Rand	USDZAR	7.52	7.69	8.10	7.00	7.20	8.50	-9.1%	-11.9%
<b>LATAM</b>									
Brazilian Real	USDBRL	1.73	1.77	1.88	1.65	1.70	1.80	-7.0%	-10.5%
Chilean Peso	USDCLP	501	499	497	500	520	520	0.2%	4.6%
Mexican Peso	USDMXN	13.0	13.2	13.8	12.8	13.0	13.1	-3.3%	-5.9%
Colombian Peso	USDCOP	1967	1985	2051	1850	2000	1900	-6.9%	-2.6%

## G10 Exchange Rates

The USD index is broadly unchanged since our last *Citi Foreign Exchange Forecasts*. Our assumption, however, is that the bear market since 2002 remains intact. Structural factors such as the US current account deficit, reserve diversification and outflows of US investor capital to more strongly growing emerging asset markets are all likely to undermine the US currency. Citi forecasts show EM countries outperforming industrialised countries on growth and that global current account imbalances improve slowly, if at all.

We know that a lower USD is a consensus view and that in any trend there are counter trend rallies. As investor risk is unwound ahead of year end, it is possible we see a correction. However, when investors return next year, they will probably foresee a further extended period of unchanged G4 Central Bank rates in the face of declining core inflation. This should encourage a related extension of risk appetite, including for carry trades in fx markets. Since the USD is now firmly a funding currency, this should, in turn, be consistent with further USD weakness. We expect this trend to be most enhanced in the period between now and the Spring. After that, markets may begin to price in Central Bank exit strategies and the USD may be able to mount something of a comeback. But we still expect the US currency to be lower than spot over 6-12 months.

### EUR/USD: Underlying US dollar bearish tone

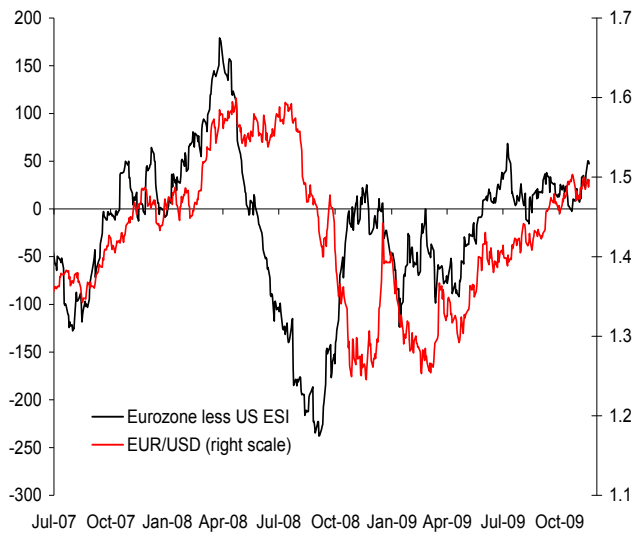
EUR/USD traded broadly sideways over the past month and was so far unable to sustain levels above 1.50. We know that the EUR has few friends in its own right since the Euro area economy remains sluggish, the currency is already above long term fair value estimates (World Exchange Rate Model (WERM) at 1.31), and there is no large Euro area current account surplus to support the currency. However, the EUR is also the only liquid market alternative to the USD and, as such, almost certainly the major beneficiary of Reserve Managers switching out of USD.

It is perhaps, also worth pointing out that absolutes rarely drive currency markets but relatives often do and certainly relatives compared to expectations. In this regard, note that Citi Economic Surprise Indices (ESIs) continue to hold up better in the Euro area than in the US in the recent past, continuing an irregular trend of Euro area out-performance since immediately after Lehman's failure (see Figure 1). Our Global Macro Leading Indicators of Consensus Forecasts also show about the same scope for upside surprises (i.e. relative to consensus forecasts) in the Euro area as in the US somewhat undermining consensus views that assume the US will outperform compared to what is priced in. None of this means that the US growth path will be lower than Europe but simply that *shocks* to market expectations are just as likely to be pro EUR as pro USD. As a result, we remain skeptical about calls for a USD rally based on US economic recovery and point to past cycles where the end of US recessions has failed systematically to support USD strength (Figure 2).

Our forecasts assume the maximum period of USD weakness comes through the spring with EUR possibly exceeding 2008 highs at 1.60. Thereafter, we assume a high plateau for the exchange rate over the 6-12 months horizon. Long term forecasts are heavily influenced by fair value estimates from our augmented PPP model (the World Exchange Rate Model – WERM). These put EUR/USD at 1.31 currently so we assume some medium term mean reversion

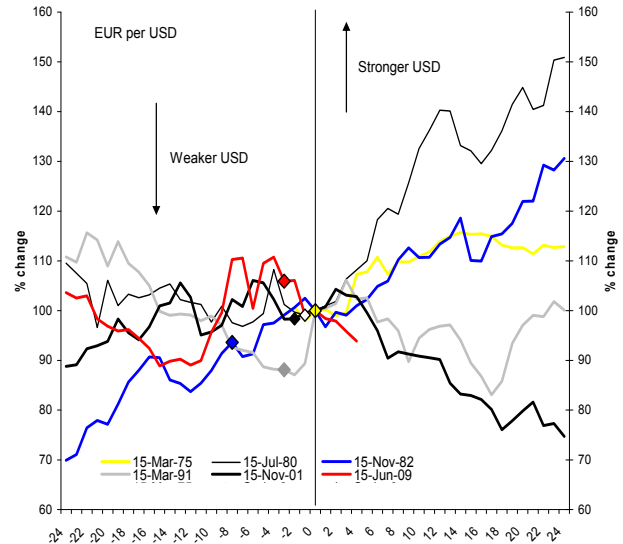
back towards that level. However, we also expect the USD to trade for some time below “fair value” in order to augment longer term current account adjustments and so set our long term forecast at 1.45.

Figure 1. Relative Economic Surprises and EUR/USD



Source: Reuters EcoWin

Figure 2. USD/EUR Around Recoveries: Not Reliable Currency Signal?



Source: Citi, Bloomberg

### Yen — Strengthening Bias Vs. USD

We remain steadfast JPY bulls vs. the USD, expecting the JPY to participate in generalised USD depreciation but to be somewhat better protected in periods of risk aversion than carry currencies or even the EUR.

The JPY has rarely depreciated in the past during US economic recoveries. Indeed, the opposite is normally the case as Figure 3 highlights. This shows past USDJPY moves 24 months before and after recessions end (normalised at 100 at the end of the recession). For the current cycle, we assume June was the end of the recession for now.

It is also the case that past episodes of Fed tightening have not always led to USD/JPY moving higher. For example, in 1994, 7 Fed hikes (totalling 300bp) failed to stem a declining trend in the exchange rate. In 2004, the first 5 or 6 hikes also failed to stem a downtrend in USD/JPY although latter hikes in the eventual 425bp increase in the Funds Rate did rally the USD (see Figure 4).

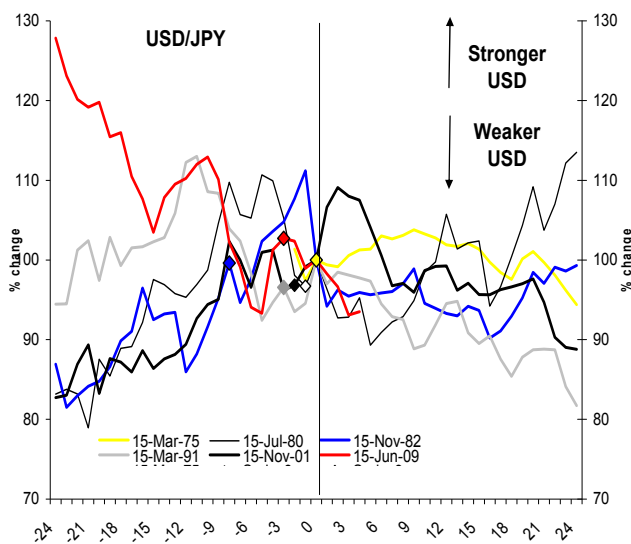
Sustained deflation in Japan, and inflation in the US, means that the real value of USDJPY is much higher than it appears from the nominal rate. For example, while the recent USDJPY nominal lows at around 88 were close to those seen on a monthly closing basis in April 1995 (85) to get the same real exchange rate today would require a nominal rate of below 60. PPP is a poor short term tool for exchange rate forecasting but should certainly be taken into account in the medium term.

Finally, JPY is no longer alone as a funding currency for fx investors buying target EM/ growth/ carry/ commodity backed currencies. With so many currencies offering near zero interest rates at the front end of the yield curve, it is now possible for Japanese fixed income investors to pick up extra yield in

key foreign markets while remaining fully currency hedged. We think this makes re-cycling Japan's current account surpluses more difficult. Increasingly, the USD is now the top funding currency, not the JPY.

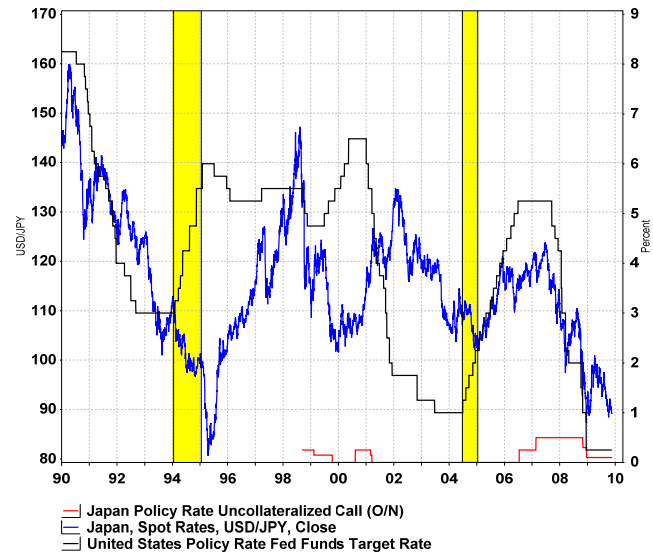
Overall, we expect a gradual trend move lower in USD/JPY, against fairly neutral positioning, forecasting 84-85 over the medium term. Our WERM "fair value" estimate is 94 and we assume some move back towards this level over the long term. But, as with EUR, the USD may trade weak to fair value against the JPY even over long term horizons.

Figure 3. USD/JPY in US Economic Recoveries



Source: Bloomberg

Figure 4. USDJPY vs. Fed Funds Rate Cycles



Source: Reuters EcoWin

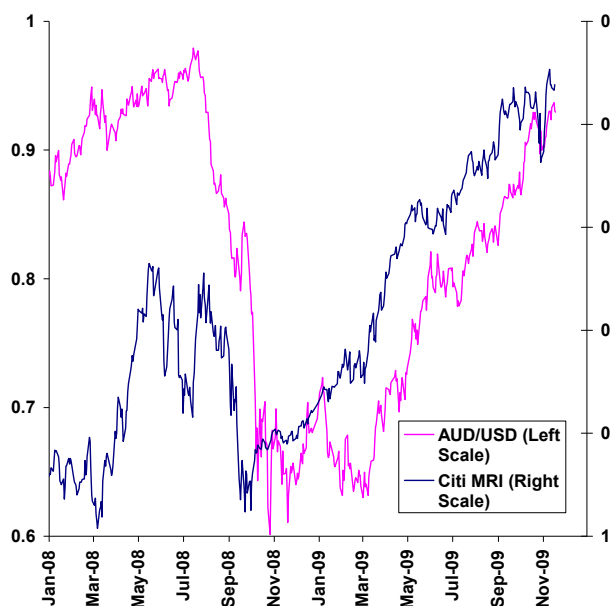
### Dollar Bloc — More Upside Medium Term

The AUD/USD rate is marginally lower than a month ago but made a new post Lehmans high at 0.941 on 16 November. Fundamental supports for AUD appreciation come from terms of trade gains and net export volumes improvements as a result of the recovery in resource prices this year. This rise in commodity prices seems partly fundamentally driven as Chinese, and other Asian EM, economic growth is commodity intensive. As such the AUD becomes something of an investor proxy for confidence in the China recovery story. Note that a part of the rise in commodity prices may also be the result of investor and speculative flows in a generally better risk appetite environment. This can also reverse, however, so AUD moves are highly correlated with the inverse of the Citi Macro Risk Index (MRI) – see Figure 5.

In addition, Australia's recession was mild by global standards (real GDP did not actually fall in 2009 unlike most other developed economies). As a result, the RBA has already begun a cycle of raising rates to normalise policy rates so rate differentials rising have also helped support the currency. Over 2010, markets price in 175-200bp points of further hikes according to A\$ bill futures while the currency itself seems to discount an additional 100bp in higher rate differentials (Figure 6). Citi economists expect this and more to be achieved but it is clear that the AUD is priced at a premium to what has happened so far.

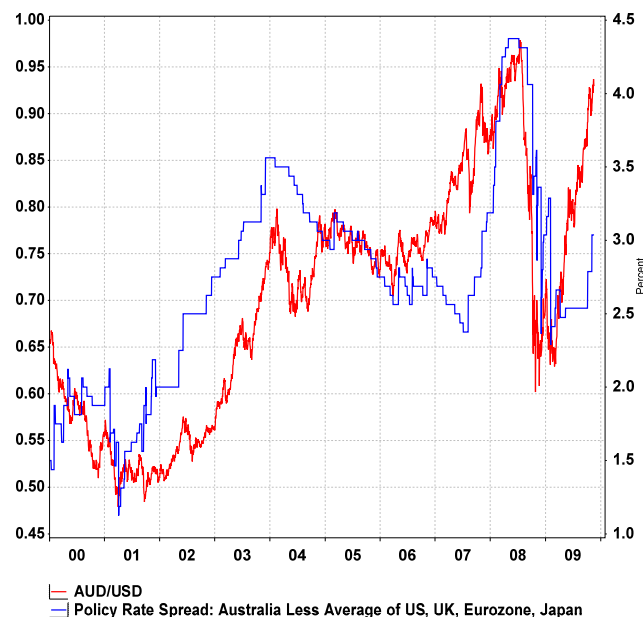
Our forecasts show AUD reaching parity in the generalised USD sell off we expect next year before easing slightly below this level again over 6-12 months.

Figure 5. AUD Correlated With Risk Appetite



Source: Bloomberg and Citi

Figure 6. AUD/USD and Policy Rate Differentials



Source: Reuters EcoWin

The New Zealand picture is still less constructive than in Australia in that the rebound in the economy is so far less well established and Citi forecasts for the NZ current account position much less constructive. As a result, we see NZD continuing to under perform AUD over the medium term. However, in the context of USD depreciation we still see reasonable upside for NZD/USD to around 0.78 over the medium term.

In Canada, higher commodity prices and US economic recovery are positive for the CAD. However, substantial spare capacity and a related projected decline in core inflation mean that the Bank of Canada is unlikely to shift from its conditional commitment to unchanged policy rates through to June 2010. Despite this, we continue to expect further gradual CAD appreciation versus the USD and forecast a possible brief flirtation with parity.

## European Crosses

### GBP — Policy Mix Likely To Be An Increasing Negative

Sterling rallied a further 2% vs. the EUR over the month since our last forecast despite deteriorating data, at least as measured, compared to expectations, by the Citi UK ESI. We suspect that this retracement from the high of 0.941 on 13 October has more to do with positioning than fundamentals. Euro area less UK swap rate differentials did move slightly lower but the shift in EUR/GBP has been much greater (see Figure 7). Already, this shift in rate differentials is starting to reverse and we think the drop in EUR/GBP will still be short lived.

One factor not yet impacting the currency is the significant fiscal tightening that an incoming Conservative government would likely undertake from next

Spring. This will likely have a negative impact on economic activity short term and thus require monetary policy to be kept easy for longer (ultra low rates and/or extension of QE). We still expect further significant downside for the GBP against other European currencies over the medium term, forecasting parity with the EUR over 6-12 months. We also expect moderate downside in GBP vs. the USD, over this time horizon, given our EUR/GBP and EUR/USD projections.

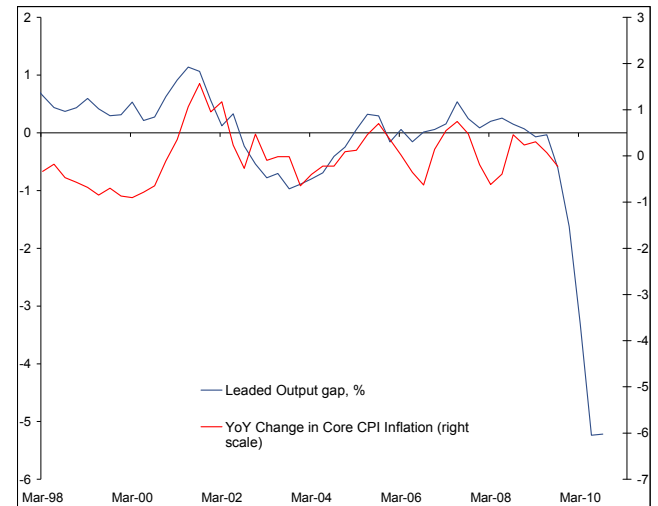
One alternative scenario is that next year's Election produces no clear winning party and fiscal policy suffers in the stalemate. While this may lead too to a knee jerk fall in the pound, we would see this mix as more likely to hurt gilts more than the currency. Conversely, a sterling rally on a clear Conservative victory should probably be faded.

Figure 7. 2y Swap Rate Differentials Driving EUR/GBP ...



Source: Reuters EcoWin

Figure 8. Large UK output Gap Suggests More Disinflation and Extended Easy Money



Source: Citi, Bloomberg

### Scandis — Long Term Value

EUR/NOK has moved somewhat higher again over the last month as Euro area less Norwegian rate differentials have stabilised. We still think that the NOK is fundamentally undervalued and therefore expect EUR/NOK to fall over the medium to long term. Short term developments, however, may be determined by positioning and market readings on Norges Bank monetary policy. Citi forecasts, market rate expectations and Norges Bank projections for rates are all now quite close over the next year with rates rising gradually to dampen inflationary pressures arising from the sharp upturn in household spending and recovery in house prices. Against an ECB rate profile that will not change for some time, this should help unlock NOK value over the medium term. We forecast a move towards long term fair value at 7.62 over the medium term.

### CHF — Range Trading To Continue Short Term, Stronger Long Term

EUR/CHF has remained range bound between 1.50 and 1.545 since mid-March and seems likely to stay in a low volatility sideways band for a while longer as the SNB maintains its opposition to appreciation of the Swiss franc

against the euro. Given this ongoing suasion, and threat of further actual intervention, the near term downside for EUR/CHF is probably limited.

On the other hand, we believe that the CHF is undervalued at current levels (WERM at 1.43) while rate differentials also suggest that a truly free float would price the cross lower, probably nearer to 1.45. We expect a gradual shift in the SNB stance to allow this longer term CHF value to be unlocked over the medium to long term. The Swiss financial system has been noticeably less impaired than in the Euro area in the crisis (the SNB argued that there is no real credit crunch in Switzerland where money and credit growth remains relatively robust). SNB activity and inflation forecasts have been revised higher and the mid 2012 CPI projection is now above the 2% target ceiling. While this is unlikely to warrant any imminent change in monetary policy, market expectations of an eventual hardening in SNB policy may help CHF appreciation over the medium to long term towards our 1.43 forecast.

## **EM Exchange Rates**

### **Emerging Asia**

We continue to expect currency appreciation in emerging Asia in the short and medium term. Our view that the large economies in the region will continue to experience robust growth and that monetary policy tightening will take place ahead of the industrialised and most of the EM world, remains broadly unchanged. We expect some of the currency strength to take place in 0-3m, in line with our continued weak USD call and buoyant risk appetite. Further out, we foresee a continuation of the appreciation trend as currencies converge to their long term equilibrium levels.

The region has experienced some noise on capital restrictions recently, but we think measures are still too mild to thwart the underlying appreciation trend. Some recent measures include Taiwan restricting non-residents' access to time deposits, Indonesia exploring foreigner restrictions on short term debt instruments (SBLs) and Korea tightening FX regulations on exporters' FX hedging and FX liquidity management of banks.

In China, recent activity data remains strong. Industrial production growth was up 16.1%yoy in October, ahead of consensus and up from 13.9%yoy in September. Growth in retail sales (16.2%yoy) and fixed asset accumulation (33.1%yoy) remained robust, and the trade surplus rose again in October, up to US\$24 billion, from US\$12.9 billion in September. Despite these CNY positives, we continue to expect the authorities to resume appreciation of the currency only gradually (around 3% per annum) from 2010 Q1. Our forecast path assumes three sources of appreciation. First, USD depreciation against major currencies. Second, a further improvement in the trade balance and/or higher capital inflows. Third, a continuation of the Chinese authorities attempts to 'internationalize' the currency.

We expect KRW, INR and IDR to lead the region's currency appreciation in the short and medium term. In addition to our weak USD view, our upward revisions to these forecasts are consistent with monetary policy tightening as early as in 2010 Q1. In the case of India, the RBI may allow for some INR appreciation to offset inflationary pressures. In Singapore, we expect the MAS to change the slope of the policy band to a "modest and gradual appreciation" stance in April 2010 (to around 1.5-2% per annum appreciation of the SGD nominal effective exchange rate - NEER) and to maintain this stance through 2010 and 2011. One of the main laggards in EM Asia is likely to be PHP due to

election risks. In addition, the reform agenda and governance issues post-elections will be important sources of uncertainty in 6-12m.

## **CEEMEA**

We are making very few changes to our currency forecasts in CEEMEA. We continue to see risk appetite as the main source of short term strength. Currencies supported by commodity prices such as ZAR and RUB (relative to the USD and EUR basket) should continue appreciating in line with our bullish medium term outlook for metals and energy prices. In the case of ZAR, the current account deficit forecast for 2009 has been revised up to -4.5% but the capital account has easily financed it so far, with no obvious reason for this to cease. The rand has recently been highly correlated with the euro, and we expect this influence to persist. In the medium term, an additional positive is likely to be the capital inflows associated with the 2010 World Cup.

RUB (relative to the USD and EUR basket) should also continue to appreciate short and medium term, given our constructive view on oil prices. In addition, improvements in the balance of payments and the fiscal outlook should foster RUB demand in the medium term. Further out, we would expect an even stronger ruble as a result of further economic improvement, reforms and de-dollarization.

In Central Europe, we continue to expect a weaker CZK versus the euro in the short term. This reflects our view that the central bank is likely to stay dovish in 2009 Q9–2010 Q1, as well as the impact of lower exports by carmakers and producers of car parts in 2009 Q4 and 2010 H1. Political risk associated with the parliamentary elections next year and a deteriorated fiscal outlook should also weigh negatively on the currency. Further out, we foresee EURCZK drifting lower towards its long term equilibrium level. Poland has better economic prospects than its regional peers for 2010 as it has avoided a recession, has limited banking system problems, and is experiencing balance of payments improvements. The zloty should benefit from this outlook and from privatization proceeds (mainly in 2010) as the government seeks alternative sources of funding to higher taxes. In Hungary, we still foresee a slightly stronger HUF, reflecting an impressive current account adjustment, as well as narrowing of the fiscal gap.

In Turkey, our bullish path for TRY in the short and medium term, reflects our weak USD view, as well as resilient risk appetite. But we still expect TRY depreciation long term as the fiscal outlook remain challenging.

## **Latin America**

We continue to expect short term upside to Latam currencies (versus the USD). Again, the main assumption behind our forecasts is that the USD reaches maximum weakness within the next three months, and that risk appetite remains buoyant. However, we are keeping our forecasts broadly unchanged compared to last month's because of increased risks of intervention to prevent currency appreciation by some Latam authorities, notably in Brazil and Colombia. We continue to see some country-specific negatives to Latam currencies in the medium term.

In Brazil, financial flows should remain strong in the near term, given optimism regarding the performance of the economy in 2010. These inflows should continue supporting BRL in 0-3m. In the medium term, wider current account deficits should begin to constrain BRL strength, in addition to the impact from



the upcoming presidential election. We expect USDBRL to stabilize at around 1.80 in the long term.

In Mexico, we expect local events to lead to a stronger MXN against the USD in the short-term. The package of fiscal reforms has been approved and entails a combination of a sustainable deficit and tax increases (that may lead to moderate inflation pressures). We are also expecting that meaningful USD inflows (associated with oil prices hedges that expire in late November) may bring additional strength to the MXN in the short-term. In addition, signs of domestic economic recovery will be clearer towards end-2009/beginning 2010. In the medium to long term, we see room for moderate MXN depreciation against the USD on the back of the structural fall in oil production and a weaker potential output growth path relative to other emerging economies.

In Chile, if the recent appreciation of the peso persists, it is likely to cause inflation to fall below the target band (2%-4%). So it is possible that the central bank may intervene if the peso strengthens to around 470. A level of 500 for CLP throughout 2010 is consistent with inflation rising back into the target band, so we have revised our short-term forecast to be consistent with this level. On November 20, the daily US\$40 million sales will end and we do not expect further sales, so we should see no further pressure on the peso from that front. Furthermore, the government extended to US\$6.0 billion the debt ceiling for 2010 in order to avoid further USD sales. We therefore expect the peso to weaken gradually in the medium term.

In Colombia, COP support from a seasonal pattern of USD inflows should persist until year-end. But this should be largely offset by central bank intervention, creating a stable environment for COP. Over the medium term, several downside risks to COP remain. In particular, uncertainty over president Uribe's re-election bid, fiscal concerns as the government deficit widens, and a continuing decline in exports to Venezuela, should keep a lid on COP appreciation against the USD.

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

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### Quarterly Interpolated Forecasts

	Currency	Spot	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11
<b>G10-US Dollar</b>											
Euro	EURUSD	1.49	1.50	1.62	1.61	1.60	1.57	1.54	1.50	1.47	1.43
Japanese yen	USDJPY	89	87	84	84	85	86	87	88	89	91
British Pound	GBPUSD	1.66	1.66	1.75	1.69	1.62	1.59	1.60	1.60	1.61	1.61
Swiss Franc	USDCHF	1.01	1.01	0.93	0.93	0.94	0.94	0.95	0.97	0.98	0.99
Australian Dollar	AUDUSD	0.92	0.92	1.00	0.99	0.98	0.97	0.95	0.93	0.91	0.89
New Zealand Dollar	NZDUSD	0.73	0.73	0.78	0.77	0.76	0.75	0.72	0.69	0.67	0.64
Canadian Dollar	USDCAD	1.06	1.07	1.00	1.01	1.02	1.02	1.02	1.02	1.02	1.02
<b>G10 Crosses</b>											
Japanese yen	EURJPY	133	130	136	136	135	135	133	132	131	130
Swiss Franc	EURCHF	1.51	1.51	1.51	1.50	1.49	1.48	1.47	1.45	1.44	1.42
British Pound	EURGBP	0.90	0.90	0.92	0.95	0.98	0.99	0.96	0.94	0.91	0.89
Swedish Krona	EURSEK	10.29	10.16	9.96	9.86	9.75	9.64	9.52	9.39	9.27	9.14
Norwegian Krone	EURNOK	8.41	8.27	8.08	8.03	7.98	7.91	7.83	7.75	7.67	7.58
Norwegian Krone	NOKSEK	1.22	1.23	1.23	1.23	1.22	1.22	1.22	1.21	1.21	1.21
Australian Dollar	AUDNZD	1.26	1.26	1.28	1.29	1.29	1.30	1.32	1.35	1.37	1.40
Australian Dollar	AUDJPY	81.7	79.7	83.9	83.7	83.4	83.0	82.5	81.9	81.3	80.7
<b>EM Asia</b>											
Chinese Renminbi	USDCNY	6.83	6.80	6.75	6.70	6.65	6.62	6.55	6.48	6.44	6.40
Hong Kong Dollar	USDHKD	7.75	7.75	7.75	7.75	7.75	7.75	7.75	7.75	7.75	7.75
Indonesian Rupiah	USDIDR	9555	9250	8900	9000	9300	9400	9300	9200	9000	9000
Indian Rupee	USDINR	46.7	45.0	44.0	43.0	42.5	41.5	41.0	42.0	43.0	44.0
Korean Won	USDKRW	1157	1100	1075	1075	1050	1050	1025	1025	1050	1050
Malaysian Ringgit	USDMYR	3.39	3.33	3.25	3.27	3.25	3.28	3.27	3.25	3.23	3.20
Philippine Peso	USDPHP	47.1	45.5	46.5	45.9	45.5	44.8	45.0	45.3	45.5	45.3
Singapore Dollar	USDSGD	1.39	1.37	1.34	1.35	1.35	1.36	1.36	1.35	1.35	1.34
Thai Baht	USDTHB	33.2	32.9	32.5	32.4	32.3	32.0	32.0	32.1	32.3	32.5
Taiwan Dollar	USDTWD	32.3	32.0	31.5	31.8	32.0	32.3	31.8	32.0	32.3	32.5
<b>EM Europe</b>											
Czech Koruna	EURCZK	25.70	26.06	26.35	26.02	25.68	25.38	25.14	24.89	24.64	24.38
Hungarian Forint	EURHUF	268	267	264	260	257	254	253	252	251	249
Polish Zloty	EURPLN	4.13	4.09	4.01	3.91	3.80	3.73	3.70	3.66	3.62	3.58
Israeli Shekel	USDILS	3.80	3.71	3.59	3.55	3.52	3.50	3.50	3.50	3.50	3.50
Russian Ruble	USDRUB	28.8	28.0	27.0	26.9	26.9	26.8	26.8	26.7	26.6	26.6
Russian Ruble Basket		35.2	34.9	34.4	34.3	34.1	33.8	33.3	32.8	32.3	31.8
Turkish Lira	USDTRY	1.49	1.46	1.43	1.44	1.46	1.48	1.52	1.55	1.58	1.61
South African Rand	USDZAR	7.52	7.28	7.03	7.10	7.16	7.35	7.67	7.99	8.32	8.65
<b>EM Latam</b>											
Brazilian Real	USDBRL	1.73	1.65	1.70	1.70	1.70	1.80	1.80	1.80	1.80	1.80
Chilean Peso	USDCLP	501	540	540	540	550	550	525	530	530	535
Mexican Peso	USDMXN	13.0	12.8	12.9	12.9	13.0	13.1	13.2	13.3	13.4	13.5
Colombian Peso	USDCOP	1967	1850	1900	1980	2000	1900	1900	1900	1900	1900

## Annual Forecasts

	Currency	Spot	2010*	2011*	2012	2013	2014
<b>G10-US Dollar</b>							
Euro	EURUSD	1.49	1.60	1.49	1.43	1.37	1.31
Japanese yen	USDJPY	89	85	89	90	92	94
British Pound	GBPUSD	1.66	1.66	1.61	1.66	1.72	1.79
Swiss Franc	USDCHF	1.01	0.94	0.97	1.04	1.09	1.09
Australian Dollar	AUDUSD	0.92	0.99	0.92	0.89	0.86	0.83
New Zealand Dollar	NZDUSD	0.73	0.76	0.68	0.66	0.63	0.61
Canadian Dollar	USDCAD	1.06	1.01	1.02	1.03	1.03	1.04
<b>G10 Crosses</b>							
Japanese yen	EURJPY	133	135	132	129	126	123
Swiss Franc	EURCHF	1.51	1.50	1.45	1.44	1.44	1.43
British Pound	EURGBP	0.90	0.96	0.93	0.86	0.80	0.73
Swedish Krona	EURSEK	10.29	9.80	9.33	9.11	8.89	8.67
Norwegian Krone	EURNOK	8.41	8.00	7.71	7.68	7.65	7.62
Norwegian Krone	NOKSEK	1.22	1.23	1.21	1.19	1.16	1.14
Australian Dollar	AUDNZD	1.26	1.29	1.36	1.36	1.36	1.36
Australian Dollar	AUDJPY	81.7	83.5	81.6	80.6	79.3	78.0
<b>EM Asia</b>							
Chinese Renminbi	USDCNY	6.83	6.68	6.47	6.30	6.10	5.93
Hong Kong Dollar	USDHKD	7.75	7.75	7.75	7.75	7.75	7.75
Indonesian Rupiah	USDIDR	9555	9150	9125	8900	8800	8800
Indian Rupee	USDINR	46.7	42.8	42.5	40.0	39.0	39.0
Korean Won	USDKRW	1157	1063	1038	1000	925	900
Malaysian Ringgit	USDMYR	3.39	3.26	3.24	3.15	3.10	3.00
Philippine Peso	USDPHP	47.1	45.7	45.3	44.3	43.9	43.9
Singapore Dollar	USDSGD	1.39	1.35	1.35	1.30	1.30	1.30
Thai Baht	USDTHB	33.2	32.3	32.2	31.8	31.3	31.3
Taiwan Dollar	USDTWD	32.3	31.9	32.2	32.3	31.8	31.8
<b>EM Europe</b>							
Czech Koruna	EURCZK	25.70	25.86	24.76	24.00	23.00	23.00
Hungarian Forint	EURHUF	268	259	251	245	240	240
Polish Zloty	EURPLN	4.13	3.86	3.64	3.60	3.50	3.50
Israeli Shekel	USDILS	3.80	3.54	3.50	3.50	3.50	3.50
Russian Ruble	USDRUB	28.8	26.9	26.68	26.83	27.44	28.08
Russian Ruble Basket		35.2	34.1	32.5	32.0	32.0	32.0
Turkish Lira	USDTRY	1.49	1.45	1.57	1.60	1.62	1.62
South African Rand	USDZAR	7.52	7.16	8.16	8.90	9.30	9.60
<b>EM Latam</b>							
Brazilian Real	USDBRL	1.73	1.73	1.80	1.82	1.85	1.89
Chilean Peso	USDCLP	501	545	530	544	560	577
Mexican Peso	USDMXN	13.0	13.0	13.4	13.6	13.5	13.4
Colombian Peso	USDCOP	1967	1945	1900	1875	1850	1850

\*Averages of end-quarter data shown in quarterly interpolation table.

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