



FINANCIAL MARKET ANALYSIS

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July 9, 2012

Disappointing US jobs data caps equity market rally

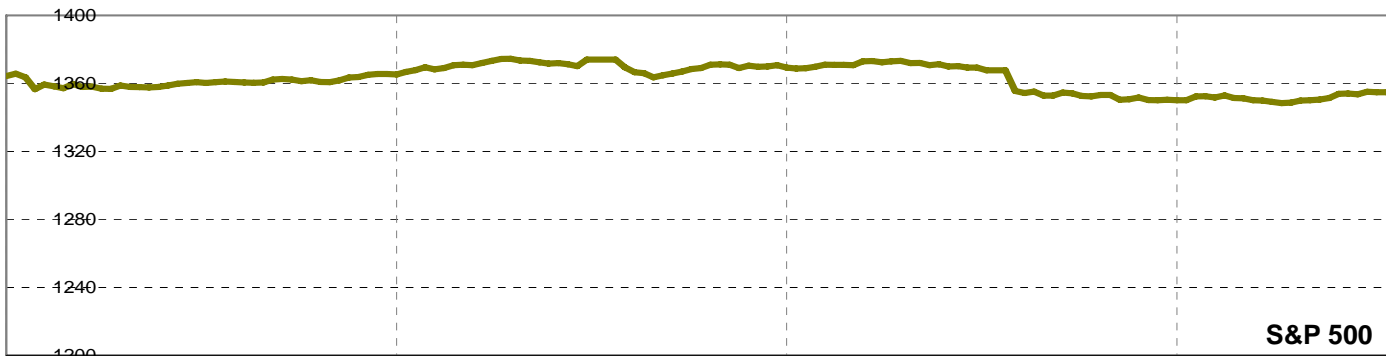
Equity markets rose last week after the European Central Bank cut interest rates, the Bank of England expanded its quantitative easing programme and the People's Bank of China surprised markets with a second interest rate cut in a month. US jobs data out on Friday however put a dampener on sentiment as June non-farm payrolls missed market expectations, coming in at +80K versus consensus of +100K. The S&P 500 ended the week marginally lower (-0.55%) to close at 1,354.68, while the Stoxx Europe index fell -0.95% to 224.28. Focus this week will be on Monday's EU Finance Ministers meeting where discussions on banking supervision, Spanish bank recapitalization and Greece are on the agenda. Markets will also be closely watching the release of China's June data (CPI, PPI, Trade Data, Industrial Production, Retail Sales, FAI, Money Supply and New Yuan Loans) which are due out throughout the week, as well as 2Q12 GDP on Friday. Singapore 2Q12 GDP is also due to be released on Friday, while the Bank of Japan, Bank Indonesia and Bank of Korea will announce policy rate decisions on Thursday. In the US, we get Consumer Credit (Monday); International Trade Balance and Wholesale Inventories (Wednesday); Initial Jobless Claims, Import Price Index and Federal Budget Balance (Thursday); Producer Price Index and Reuters/Michigan Sentiment (Friday). Data out of Europe include UK Industrial Production and Trade Balance on Tuesday, and Euro Area Industrial Production on Thursday.

| | Jul 6 Close | Last week's return | YTD Return | YTD return (USD) |
|----------------------------|----------------|-----------------------|---------------|---------------------|
| S&P 500: | 1354.68 | -0.55% | +7.72% | +7.72% |
| Stoxx Europe: | 224.28 | -0.95% | -0.66% | -5.86% |
| Nikkei 225: | 9020.75 | +0.16% | +6.69% | +3.16% |
| MSCI Asia ex Japan: | 413.25 | +1.56% | +5.21% | +5.21% |

In this issue:

- *US equities: Market indicators signal a likely inflection in stock price trends*
- *Europe economy: France: Hard choices lie ahead*
- *Japan economy: BoJ likely to leave policy unchanged this week*

TAKING STOCK

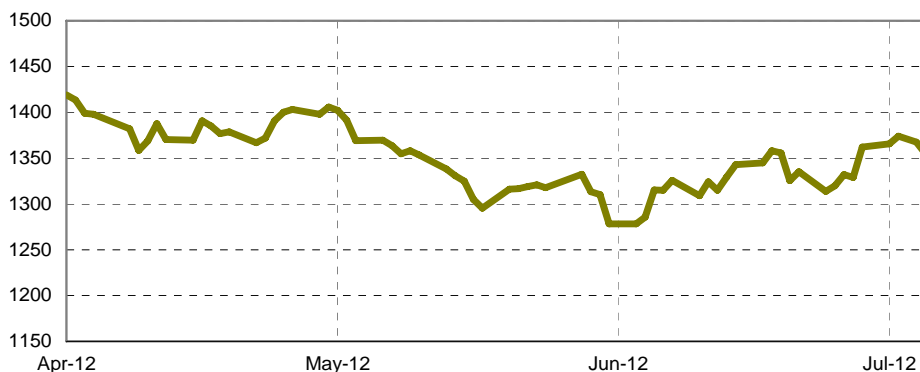


| Monday Jul 2 | Tuesday Jul 3 | Wednesday Jul 4 | Thursday Jul 5 | Friday Jul 6 |
|---|--|---|---|---|
| <p>S&P: +0.25%</p> <p>STOXX: +1.16%</p> <p>Nikkei: -0.04%</p> <p>MSCI Asia ex Japan: +0.42%</p> <p>US: The ISM manufacturing activity index fell to 49.7 in Jun (first sub-50 reading since Jul '09), vs. 53.5 in May, below market expectations of 52.0.</p> <p>US: The May Commerce Department construction spending report revealed a 0.9% MoM increase (largest increase since Dec '11, pushing index to highest level since Dec '09), vs. 0.6% MoM in Apr, above market expectations of 0.2% MoM.</p> <p>EU: Eurozone Jun final manufacturing PMI was revised to 45.1 from 44.8.</p> <p>EU: Eurozone unemployment rate rose to a new post-EMU record high of 11.1% in May.</p> <p>EU: UK's manufacturing PMI for Jun rose to 48.6 from 45.9, more than 3 points above consensus.</p> <p>JP: Bank of Japan Jun Tankan – The business confidence diffusion index (DI) for large manufacturing firms rose to -1 in Jun from -4 in Mar, better than market expectations of -4. Notably, the material sector became more optimistic, suggesting that falling commodity prices in the survey period likely had a positive impact. Meanwhile, automakers drove better sentiment in the processing sector.</p> <p>AP: China manufacturing PMI (HSBC) edged down by 0.2ppt to 48.2 in Jun.</p> <p>AP: Korea headline CPI eased to 2.2% YoY in Jun, after staying at 2.5% YoY for two straight months. On a MoM basis, CPI fell to -0.1% from 0.2% in May.</p> | <p>S&P: +0.62%</p> <p>STOXX: +1.15%</p> <p>Nikkei: +0.70%</p> <p>MSCI Asia ex Japan: +1.17%</p> <p>US: Factory orders increased +0.7% MoM in May vs. -0.7% MoM in Apr, above market expectations of +0.1% MoM. Ex-transportation orders rose +0.4% MoM (Apr -0.9%), while ex-defense orders rose +0.5% MoM (Apr -0.2%).</p> <p>EU: Eurozone PPI was -0.5% MoM (2.3% YoY) in May vs. 0.0% MoM (2.6% YoY) in Apr, below market expectations of -0.3% MoM (2.5% YoY).</p> <p>EU: UK Construction PMI for Jun fell to a contractionary 48.2 from 54.4 in May, below consensus of 53.0.</p> <p>EU: UK mortgage approvals in May were 51.1K, better than consensus of 50K but down slightly from 51.8K in Apr. Consumer credit of £0.7bn far exceeded both consensus of £0.1bn and Apr's figure of £0.3bn.</p> <p>AP: Australia building approvals for May printed the largest upward surprise in over 10 years, rising 27% vs. market expectations of 5%. The level of monthly approvals is now back to where it was in early 2011, before the European debt crisis reached its zenith.</p> <p>AP: The Reserve Bank of Australia left the cash rate unchanged at 3.50%.</p> <p>AP: China non-manufacturing PMI rose by 1.5ppts to 56.7 in Jun.</p> <p>AP: In value terms, Hong Kong May retail sales grew at a slower single digit pace of 8.8% YoY (Apr 11.4%); while volume only recorded 5.8% YoY growth (Apr 7.6%).</p> | <p>S&P: Closed</p> <p>STOXX: -0.18%</p> <p>Nikkei: +0.41%</p> <p>MSCI Asia ex Japan: +0.48%</p> <p>EU: Eurozone Jun services PMI was revised up to 47.1, from a flash print of 46.8 (May 46.7). This comes despite a downward revision to the German measure to 49.9 (Flash 50.3), but follows the direction of the upward revision to the French measure to a final 47.9 (Flash 47.3). Spain records an increase to 43.4 from 41.8 in May, as does Italy, to 43.1 from 42.8 in May. The final Jun Eurozone composite PMI was thus revised up to 46.4 from the flash print of 46.0 (May 46.0).</p> <p>EU: Eurozone retail sales unexpectedly increased in May as gains from France to Ireland and Portugal helped offset decreasing demand in Germany. Sales advanced 0.6% MoM from Apr, when they slipped -1.4% MoM. Market expectations was for sales to remain unchanged MoM. From a year earlier, sales fell -1.7% YoY in May vs. -3.4% YoY in April and market expectations of -1.0% YoY. In France, retail sales rose 1.2% MoM in May (Apr -2.1%). In Spain and Ireland, sales advanced 1.2% MoM and 1.7% MoM, respectively. Portugal reported a gain of 2.9% MoM, while German retail sales fell -0.3% MoM.</p> <p>EU: UK Jun services sector PMI dipped to 51.1 from 53.3 in May, worse than market expectations of 52.8.</p> <p>AP: Australia retail sales rose by 0.5% in May, exceeding the consensus estimate of 0.2%. Apr was revised up to 0.1% from -0.2%.</p> <p>AP: China Services PMI (HSBC) fell to 52.3 in Jun from a 19-month high of 54.7 in May, the largest decline since Aug.</p> | <p>S&P: -0.47%</p> <p>STOXX: -1.10%</p> <p>Nikkei: -0.27%</p> <p>MSCI Asia ex Japan: +0.01%</p> <p>US: The ADP employment estimate rose 176K in Jun (May +136K, Consensus +100K).</p> <p>US: Initial jobless claims for the week ending 30 Jun fell -14K to 374K, below market expectations of 385K. The 4-week average fell to 385.8K from 387.3K last week.</p> <p>US: Jun ISM non-manufacturing index fell to 52.1 vs. 53.7 in May.</p> <p>EU: The European Central Bank cut both the refi and deposit rates by 25bps, taking them to record lows of 0.75% and 0, respectively. <i>Citi expects the ECB to cut the refi rate to 0.5%; regards a negative deposit rate of -0.25% as possible.</i></p> <p>EU: May German industrial orders grew 0.6% MoM (Apr -1.4%, Consensus 0.0%).</p> <p>EU: The Bank of England left its official Bank Rate unchanged at 0.5%, and announced additional £50bn of QE, taking the total to £375bn. <i>Citi expects QE to be expanded further to a total of about £500bn.</i></p> <p>AP: Australian exports rose 2.2% in May while imports increased 3.2%. This resulted in a small trade deficit of -A\$0.3bn in May.</p> <p>AP: The People's Bank of China announced a second rate cut in a month. The policy rate cuts are doubly asymmetric: the 1 yr lending and deposit rates were cut by 31 bps and 25 bps, respectively; the lending rate floor is relaxed further to 30% below the base. <i>Citi continues to expect one more policy rate cut and two more RRR cuts for the rest of the year, and more of them could occur in 3Q.</i></p> | <p>S&P: -0.94%</p> <p>STOXX: -1.94%</p> <p>Nikkei: -0.65%</p> <p>MSCI Asia ex Japan: -0.53%</p> <p>US: Non-farm payrolls rose +80K in Jun vs. a revised +77K in May (Prev. +69K), below market expectations of +100K. The unemployment rate stayed unchanged at 8.2%, weighed down by a +156K increase in the civilian labour force (partially offset by a +128K rise in household employment), in line with expectations for no change.</p> <p>EU: May German industrial production rose 1.6% MoM, vs. -2.1% MoM in Apr and Consensus of 0.1% MoM.</p> <p>EU: The latest figures for the French central government budget showed deterioration to -€69.6bn in the Jan-May period from -€68.4bn in the corresponding period of 2011. This comes as a result of a 4.4% rise in spending that exceeded a 2.2% increase in revenues.</p> <p>EU: European Central Bank funding to Italian banks was €281.4bn in Jun, up from €272.7bn in May.</p> <p>EU: Jun UK producer prices data showed an ebbing of pipeline cost pressures, with input prices falling -2.2% MoM (-2.3% YoY), following -2.6% MoM (0.0% YoY) in May. Three consecutive months of declining input prices have triggered a further decline in output prices, with the Jun figure dropping by -0.4% MoM (2.3% YoY), even softer than the market prediction of -0.2% MoM (2.4% YoY), the second consecutive month of declines, vs. -0.2% MoM (2.9% YoY) in May. Core output PPI dipped -0.2% MoM for a 2.0% YoY rate, down from 0.2% MoM (2.3% YoY) in May.</p> |
| Over the Weekend Jul 7 and Jul 8 | | | | |
| Others: -- | | | | |

Please note: Citi analysts' comments are in italics. Source: Bloomberg, Reuters, Associated Press, CR

US/NORTH AMERICA

S&P 500 (2/4/2012 to 6/7/2012)



Source: Bloomberg

Economic Outlook

Still expecting relatively modest growth of 2%

Halfway through 2012, the outlook continues to show relatively modest growth near 2%, slow improvement in unemployment and low inflation. But minor changes to the forecast belie a significantly altered backdrop of lower than expected interest rates and ongoing challenges for policymakers to lend support to financial conditions.

Recent signs of slowing likely have been somewhat overplayed as earlier pent-up vehicle demand is levelling off and the effects of a mild winter have exaggerated swings in hiring. Housing markets are beginning to stir and consumers are reaping a minor windfall from falling fuel prices that may add about US\$75 billion to discretionary income.

As the "fiscal cliff" threat becomes more widely appreciated, Citi analysts expect most of its effects to be avoided, leaving about a percentage point of drag on 2013. But Citi's base case that the Euro Area crisis will intensify leaves a major downside risk intact. The Federal Reserve (Fed) is expected to attempt greater accommodation through guidance or greater transparency about the conditions for exit. While the hurdles are higher now, unsterilized quantitative easing (QE) remains an option in the event that recovery appears threatened or inflation forecasts fall further below desired ranges.

The Week Ahead

11/7

- The **trade deficit** probably narrowed to -US\$47.5 bn in May from -US\$50.1 bn in April, largely reflecting a drop in the petroleum bill.

12/7

- Initial jobless claims** for the week ending 7 July probably fell by about 20K to 355K, amid special factors surrounding this year's auto sector retooling period.
- The steep drop in petroleum prices in May dominated the **import price index**, and Citi analysts expect an even bigger decline in June (-1.9%).

13/7

- The **producer price index** likely declined again in June (-0.3%), on sharply lower energy prices.
- Consumer sentiment likely continued to droop in early July. Citi analysts expect the **Reuters/Michigan Sentiment index** to edge down to 72.0 from 73.2 in June.

Equities

Market indicators signal a likely inflection in stock price trends

| | Last week's close | Last week's return | YTD return |
|--------------------|-------------------|--------------------|------------|
| S&P 500 | 1354.68 | -0.55% | +7.72% |
| DJIA | 12772.47 | -0.84% | +4.54% |
| Nasdaq | 2937.33 | +0.08% | +12.75% |

A variety of both short and intermediate term gauges suggest that markets may be poised to rally this summer into the fall, despite all the anxiety surrounding European sovereign credit issues, slowing global economic growth, and the US elections, as well as the US fiscal cliff. While all the major concerns are valid reasons for worry, Citi analysts believe that a good chunk of the risk appears already priced into index levels.

Indeed, Citi's Panic/Euphoria Model, normalized earnings yield gap analysis and implied long-term earnings-per-share (EPS) growth approaches all suggest a better than 94% chance of market gains in the next year, while credit conditions and hiring intentions imply that a US recession is unlikely. Furthermore, the data highlights a 90% or better probability of gains within the next six months. As such, Citi analysts are sticking to their end-2012 target of 1,425 for the S&P 500 index.

Source: CR

Bonds

Preference for high-grade corporates and emerging market debt

| | Jul 6 2012 | Jun 29 2012 | Jun 22 2012 |
|-------------------|------------|-------------|-------------|
| 2-yr Try: | 0.270% | 0.301% | 0.303% |
| 5-yr Try: | 0.643% | 0.718% | 0.754% |
| 10-yr Try: | 1.549% | 1.645% | 1.674% |

Treasuries: Citi analysts expect yield curves to flatten, and for gains to be potentially generated in the intermediate- to longer-dated maturity range.

High-grade corporates: A strengthening technical backdrop, large cash balances, low default rates, decreasing net issuance, and a smaller universe of safe haven assets continue to remain supportive.

High-yield corporates: Although valuations have become more attractive, Citi analysts remain cautious due to festering concerns in Europe and expectation that global growth will continue to slow. As such, they selectively favour high quality, double-B rated issuers and select single-B rated issuers with strong fundamentals.

EMD: Increased corporate bond issuance in emerging markets may present opportunities to pick up yield while benefiting from stronger domestic growth.

Currencies

USD: USD strength likely to continue

| September 2012 forecasts | | |
|--------------------------|--------|--------|
| EURUSD | USDJPY | USDCAD |
| 1.24 | 80 | 1.03 |

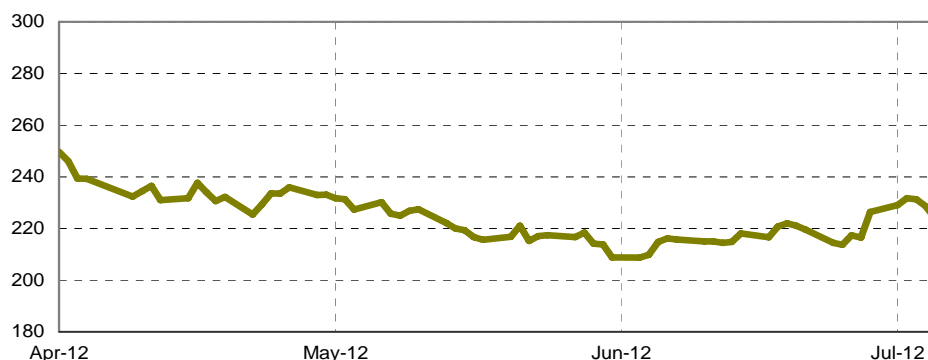
USD strength continues to be Citi analysts' central forecast, reflecting potential US cyclical outperformance as well as periodic bouts of risk aversion. Higher bond yields relative to other G10 countries may also support USD.

Medium term, risk stem from the so called "fiscal cliff" and US policy paralysis after the Presidential Elections in November. Citi analysts however expect this to be contained.

All in all, Citi forecasts anticipate further USD gains medium-term, especially relative to G10 majors with EUR/USD potentially falling through 1.20 and AUD towards 0.95.

EUROPE

STOXX (2/4/2012 to 6/7/2012)



Source: Bloomberg

Economic Outlook

France: Hard choices lie ahead

The new French government has presented its supplementary 2012 budget, incorporating most of the key policy items contained in President Hollande's election manifesto. The objective of the government was twofold, in Citi's view: First, to show its electors that key promises would be met; and second, to demonstrate to investors and its Euro Area neighbours that France would deliver on its budget deficit commitments with the country still under an Excessive Deficit Procedure (EDP).

The government is facing a challenging task of delivering a 1.5ppt reduction in 2013 to bring the budget deficit to 3% of GDP at a time when the economic scenario is deteriorating. The strategy to increase the fiscal pressure from already elevated levels could easily backfire given the fragility of the growth outlook and depressed levels of economic confidence. But slashing public spending without enough time to review where the axe needs to fall could also have serious political consequences in a country where the preservation of the social model is taken very seriously. Citi analysts think structural reforms need to be implemented in the near term to boost the economy's potential growth rate, without which the debt trajectory could become problematic.

The Week Ahead

9/7

- **Germany:** The May trade surplus (€17.0bn) is likely to increase to the highest reading since June 2008.

10/7

- **UK:** Manufacturing output probably rebounded in May (0.5% MoM, -1.3% YoY) while utilities output fell sharply, leaving industrial production roughly flat MoM (0.1% MoM, -1.7% YoY).

11/7

- **Germany:** Citi analysts expect a confirmation of the flash estimates, showing a decline in the National CPI and HICP by -0.2 points to 1.7% YoY and 2.0% YoY, respectively in June.

12/7

- **Euro Area:** The fall in the output component of the manufacturing PMI and also the drop in industrial confidence readings in the EU Commission survey point to a third consecutive fall in industrial output in May (-0.5% MoM, -3.8% YoY).

13/7

- **Italy:** The final reading for June HICP is likely to come in line with the flash estimate of 3.6% YoY.

Equities

Still favouring North over South Europe

| | Last week's close | Last week's return | YTD Return |
|----------|-------------------|--------------------|------------|
| STOXX | 224.28 | -0.95% | -0.66% |
| FTSE 100 | 5662.63 | +1.64% | +1.62% |
| DAX | 6410.11 | -0.10% | +8.68% |

While liquidity, valuation and positioning have contributed to the recent snap back rally, Citi's medium term view about the Eurozone crisis has not changed. They still think that Greece is more likely than not to leave the euro in the next 12-18 months and that both Spain and Italy are likely to require some form of support from the troika also over the next 18 months.

Whether we are looking at regions or countries within Europe, the recent rally has eroded much of the extreme value case for the periphery and Citi analysts expect fundamentals to begin re-asserting themselves.

Therefore, structurally, Citi analysts view strong balance sheets as a pre-requisite for sustained outperformance and continue to back their preference for North over South Europe. In addition, they believe companies with exposure to emerging markets are likely to do well in this current environment.

Bonds

Favour UK Gilts vs German Bunds

| | Jul 6 2012 | Jun 29 2012 | Jun 22 2012 |
|------------|------------|-------------|-------------|
| 2-yr Try: | -0.010% | 0.124% | 0.135% |
| 5-yr Try: | 0.340% | 0.611% | 0.642% |
| 10-yr Try: | 1.327% | 1.583% | 1.581% |

Citi analysts remain positive on the long end of the German yield curve, which has bull-flattened around 25 basis points. Indeed, the yield difference between 10 year and 30 year German Bunds now stands at around 50 basis points, a six-month low.

Conversely, the UK Gilt curve has bull-steepened, due to the reduction in QE and higher-than-expected inflation data. Market indicators show that inflation expectations have since retreated. Citi analysts find the long end of the UK curve attractive.

Currencies

EUR: Downward pressures remain GBP: Renewed BoE easing a GBP negative

| September 2012 forecasts | | |
|--------------------------|--------|--------|
| GBPUSD | USDCHF | EURGBP |
| 1.55 | 0.97 | 0.80 |

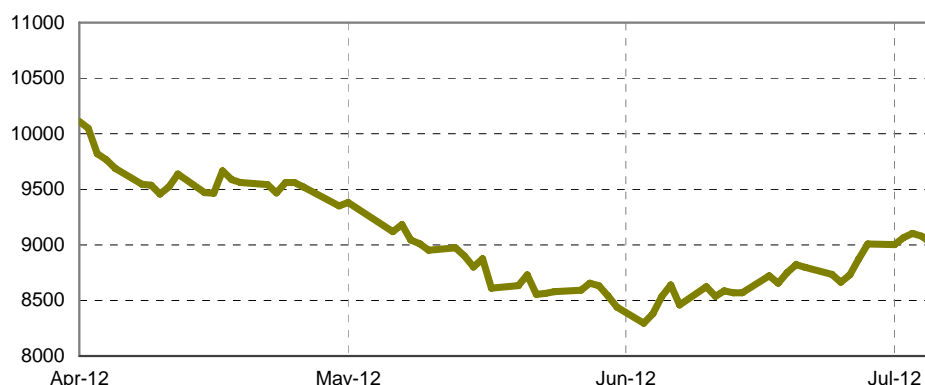
Within G10, EUR is expected to be notably weak, potentially falling on all major crosses as further European Central Bank rate cuts, long-term refinancing operations (LTROs) and the ongoing rise in risk premia undermine the single currency. Citi forecasts EUR/USD consolidating in a 1.20-1.30 band for the next few months before trending through the lower level of this band over 6-12 months with a 1.10-1.20 trading range then possible.

The Bank of England (BoE) has acknowledged that the UK economy is likely to stay weak and signalled that further quantitative easing (QE) may be forthcoming. Citi analysts expect further QE in July, with £75bn likely to be announced in the run up to November. Considering that previous QE expectations had weighed on GBP, Citi analysts have lowered their GBP/USD forecasts to 1.55 in 0-3 months and 1.46 in 6-12 months. EUR/GBP is forecasted to be broadly stable at 0.79 in 6-12 months.

Source: CR

JAPAN

Nikkei 225 (2/4/2012 to 6/7/2012)



Source: Bloomberg

Economic Outlook

BoJ likely to leave policy unchanged this week

The June Tankan published last week indicated (1) a moderate pick up in the large manufacturers' business confidence diffusion index (DI) and a positive surprise against market expectations, (2) healthy sentiment among large non-manufacturers, (3) solid business investment plans for fiscal 2012, and (4) an improvement in financial conditions. Overall, the June Tankan was stronger than markets had expected and it is consistent with steady economic growth, in Citi's view. The Bank of Japan (BoJ) is as such likely to hold the line at this week's policy meeting. First, Japan's economy is proceeding in line with the BoJ's base-case scenario. Second, the yen exchange rate has stayed in the ¥79 range against the USD. This is generally consistent with the assumed level by large manufacturers (¥78.95 on average in fiscal 2012) in the Tankan. Finally, political pressure on the BoJ has been scarce, probably because lawmakers are too busy dealing with the current uncertain political situation due to the consumption tax hike bill.

The Week Ahead

9/7

- Citi expects the **current account** to generate a ¥365.1bn surplus before seasonal adjustment (-36.4% YoY) and a ¥507.5bn surplus after the adjustment (+75.8% MoM) in May.
- **Private machinery orders ex ships and power plants** (private core orders) likely decreased -4.2% MoM in May (+7.3% YoY) after a +5.7% MoM advance in April (+6.6% YoY).

11/7

- The **domestic corporate goods price index** probably declined -0.4% MoM in June (-1.0% YoY) after falling -0.4% MoM in May (-0.6% YoY).
- The **tertiary industry activity index** likely climbed 0.9% MoM (+3.1% YoY) in May after a -0.3% MoM fall in April (+2.5% YoY). A strong gain in wholesale and retail trades likely helped the index to turn around for the first time since last December.

Equities

Rallies in range bound markets

| | Last week's Close | Last week's return | YTD return |
|--------|-------------------|--------------------|------------|
| Nikkei | 9020.75 | +0.16% | +6.69% |
| Topix | 771.83 | +0.23% | +5.93% |

Since the post-Lehman low in March 2009, TOPIX has been rallying and pulling back between 700 and 1,000. Broadly speaking, there have been four rallies and four pullbacks. Rallies have had an average duration of 4.3 months and added an average 16.8%. Citi analysts studied metrics that may lead TOPIX, including foreigner net buying of Japanese equities, the revision index, the evaluated margin gain/loss ratio, margin long position, margin short position, and the short ratio. They found that foreigner net buying of Japanese equities and the evaluated margin gain/loss rate tend to work as leading metrics.

In the four rallies, Securities, Other Financials, and Transport Equipment were in the top five in both average and median values. Outperforming in all four rallies were Machinery, Wholesale, Non-ferrous Metals, and Other Financials. In the rally from March to August 2009, companies with low price-to-book ratios and degraded balance sheets outperformed substantially. The effectiveness of price-to-earnings ratios as a metric has intensified as the reliability of profit forecasts has increased as the economy normalized. The impact of balance sheet health on share price performance has diminished as awareness of bankruptcy risk has receded.

Source: CR

Bonds

Some JGB underperformance around the fiscal year-end expected

| | Jul 6 2012 | Jun 29 2012 | Jun 22 2012 |
|------------|------------|-------------|-------------|
| 2-yr Try: | 0.105% | 0.114% | 0.103% |
| 5-yr Try: | 0.200% | 0.220% | 0.223% |
| 10-yr Try: | 0.800% | 0.837% | 0.830% |

Ongoing downgrades to Japan's growth outlook and continued expectations of Bank of Japan (BoJ) bond purchases are supporting JGBs. The divergence between Japanese yields and the other major markets looks overstretched, however, and Citi analysts think that there may be potential for some JGB underperformance around the fiscal year-end. But with policy rates likely to remain near zero for a long time and the BoJ maintaining its duration commitment, Citi analysts believe that calls for a fiscally driven bear-market are premature.

Currencies

JPY: USD/JPY likely to trade sideways

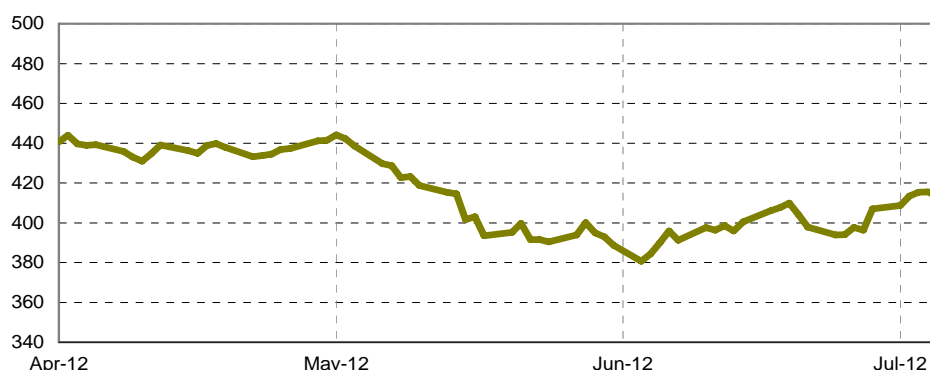
| | September 2012 forecast | | |
|--|-------------------------|--------|--------|
| | USDJPY | EURJPY | AUDJPY |
| | 80 | 99 | 80.0 |

In risk-off periods, both USD and JPY tend to be beneficiaries, though the exchange rate tends to move moderately lower. But for now at least, 75-76 seems to be the line in the sand for Ministry of Finance/Bank of Japan (BoJ) intervention. As such, the bottom part of the range could hold for the short- to medium-term, absent a serious deterioration in global growth and risk appetite.

One factor that has supported JPY is the BoJ's stance. Typically, the BoJ is much less aggressive with monetary easing than the Federal Reserve. This may be changing slightly with the BoJ finally adopting an inflation target, though significant additional quantitative easing still seems lacking. The recent political breakthrough on the sales tax may be slightly positive for JPY as it implies fiscal sustainability medium-term and suggests that pro-cyclical fiscal tightening may be avoided short-term and thus there may be less need for significant additional BoJ easing. Nonetheless, two new doves recently joined the BoJ Board, so some easing is possible and may be combined with intervention if USD/JPY slips to the lower end of the trading range.

ASIA PACIFIC EX JAPAN

MSCI Asia ex Japan (2/4/2012 to 6/7/2012)



Source: Bloomberg

The Week Ahead

- 9/7
- **China:** June CPI inflation likely fell to 2.1% YoY, PPI to -3.1% YoY.
- 10/7
- **China:** June exports likely grew by 8.1% YoY, imports by 7.6% YoY; resulting in a trade surplus of US\$24.8bn (May US\$18.7bn).
- 11/7
- **Malaysia:** May industrial production likely slowed to 2.0% YoY (Apr 3.1%).
- 12/7
- **Indonesia:** Bank Indonesia is likely to keep the policy rate and FasBI rate at 5.75% and 3.75%, respectively.
 - **Korea:** Bank of Korea is likely to retain the policy rate at 3.25%.
- 13/7
- **China:** 2Q12 GDP growth probably slowed to 7.3% YoY (1Q12 8.1%). Industrial production likely grew by 10.0% YoY in June; retail sales by 13.0% YoY; and FAI by 19.6% YoY.
- 11-15/7
- **China:** June M2 and M1 growth may have risen to 13.3% YoY and 3.9% YoY, respectively. New Yuan loans may have reached Rmb820bn.

Economic Outlook

China: Policy actions support expectations for growth to bottom out in 2Q12

The People's Bank of China's second interest rate cut in a month is inline with Citi's expectations that further policy easing was needed in the beginning of July to contain the growth downturn. The timing of the cuts has hinted that the growth in 2Q12 is worse than the government expectation. The fall of CPI also allows for more aggressive policy easing. More importantly, the government has again confirmed that it will take every measure needed to stabilize the economy. Citi analysts continue to expect one more policy rate cut and two more reserve requirement ratio (RRR) cuts for the rest of the year, with more of them likely occurring in 3Q12.

Policy rate cuts should promote credit demands and help fund projects approved by the National Development and Reform Commission (NDRC) recently, while aggressive lending rate cuts should boost investment in the near term. Together with possible fiscal policy supports, Citi analysts expect China's growth to bottom out in 2Q12 at 7.3% YoY. A mild growth rebound in 2H12 is likely, though a structural downturn in the medium term is still expected.

Equities

China: Positive on 2H12 earnings outlook

| | Last week's close | Last week's return | YTD Return |
|--------------------|-------------------|--------------------|------------|
| MSCI Asia ex Japan | 413.25 | +1.56% | +5.21% |

Corporate earnings have been squeezed due to slower economic growth. But the policy moves, if they continue, should boost credit demand, facilitate economic activities and improve the economic outlook, and therefore reduce the downside risks of earnings in 2H12. However, banks' ability and willingness to lend remains a challenge. Citi analysts believe the Chinese market appears oversold as it has priced in more bad news than good news. Downside may be limited as more investors feel the market is too cheap to sell. The lack of visibility and conviction on the upside has also prevented market participants from entering the market. The policy catalysts may as such tilt the balance towards the positive side. The lending rate liberalization implies lower cost of capital, and capital intensive sectors (e.g., Property, Infrastructure, Capital Goods, Utility and Transportation) could gain from the policy move. But, these gains are likely losses in the Banking sector as net interest margins are squeezed by asymmetric rate cuts. While the bank-heavy market index may remain under pressure, Financial sector divergence (with Insurance and Securities potentially outperforming the Banking sector) could materialize in the near term.

Source: CR

Bonds

Opportunities in Indonesia dollar bonds

While there are legitimate concerns about the deterioration in its external accounts and quality of policymaking (especially in relation to FX management adding liquidity risk to holding Indonesian assets), Citi analysts do not anticipate the deterioration in external accounts to be very dramatic – BI could tolerate currency weakness and rising bond yields to offset global de-risking to keep FX reserve coverage at decent levels, still stronger than some EM countries like Turkey. Albeit the negative sentiment on the currency and risk to IDR-denominated government bonds, Citi analysts still believe Indonesia's credit fundamentals remain on sound footing – debt ratios remain very low, and prospects for growth and attracting FDI flows remain strong.

Currencies

AUD: Under pressure EM Asia: A flat CNY

| September 2012 forecasts | | |
|--------------------------|--------|--------|
| AUDUSD | NZDUSD | USDSGD |
| 1.00 | 0.79 | 1.25 |

Citi's cautious view on risk assets going forward suggests that AUD could give back some of the recent gains. A downshift in Chinese growth is likely to generate AUD weakness. Domestic monetary policy is also unlikely to provide a boost to the currency given that the Reserve Bank of Australia is forecast to cut rates again this year.

On average, EM Asia currencies are forecast to be modestly higher versus USD in the near term but flat further out. Heavy management in EM Asian FX (ex INR) has tended to mean that currencies are lower beta to global forces than either CEEMEA or Latam. Current account surpluses, and for the most part, good reserve ratios, have reinforced this relative resilience. Yet Asian economies and exchange rates are sensitive to developments in China, and are also the most open/export-reliant economies in EM. The combination of fresh (if modest) monetary easing in China and significant prospective falls in local inflation rates from lower oil prices creates room for easier monetary conditions. Citi forecasts USD/CNY at 6.33 over the next three months, and 6.35 in the medium term.

WORLD MARKETS AT A GLANCE

| | Previous Week's Close | 52-Week High | 52-Week Low | Weekly Return | YTD Return | YTD Return (USD) |
|--|--------------------------|-----------------|----------------|------------------|---------------|---------------------|
| UNITED STATES | | | | | | |
| Dow Jones Industrial Average | 12772.47 | 13338.66 | 10404.49 | -0.84% | +4.54% | +4.54% |
| S&P 500 | 1354.68 | 1422.38 | 1074.77 | -0.55% | +7.72% | +7.72% |
| Nasdaq | 2937.33 | 3134.17 | 2298.89 | +0.08% | +12.75% | +12.75% |
| EUROPE | | | | | | |
| DJ Euro STOXX | 224.28 | 281.13 | 194.63 | -0.95% | -0.66% | -5.86% |
| FTSE 100 | 5662.63 | 6084.08 | 4791.01 | +1.64% | +1.62% | +1.42% |
| DAX | 6410.11 | 7523.53 | 4965.80 | -0.10% | +8.68% | +2.99% |
| JAPAN | | | | | | |
| Nikkei 225 | 9020.75 | 10255.15 | 8135.79 | +0.16% | +6.69% | +3.16% |
| TOPIX | 771.83 | 879.48 | 692.18 | +0.23% | +5.93% | +2.43% |
| ASIA | | | | | | |
| MSCI Asia ex Japan | 413.25 | 493.16 | 353.80 | +1.56% | +5.21% | +5.21% |
| Hong Kong Hang Seng | 19800.64 | 22835.03 | 16170.35 | +1.85% | +7.41% | +7.60% |
| Shanghai Composite Index | 2223.58 | 2826.96 | 2132.63 | -0.08% | +1.10% | +0.05% |
| Taiwan Weighted Index | 7368.59 | 8839.14 | 6609.11 | +0.99% | +4.19% | +5.46% |
| Korea KOSPI | 1858.20 | 2192.83 | 1644.11 | +0.23% | +1.78% | +3.12% |
| Mumbai Sensex | 17521.12 | 19131.70 | 15135.86 | +0.52% | +13.37% | +7.85% |
| Singapore Straits Times Index | 2978.55 | 3227.28 | 2521.95 | +3.48% | +12.55% | +14.64% |
| Kuala Lumpur Composite | 1620.55 | 1620.55 | 1310.53 | +1.34% | +5.87% | +4.95% |
| Thai Stock Exchange | 1200.08 | 1247.72 | 843.69 | +2.39% | +17.04% | +16.34% |
| Jakarta Composite Index | 4055.20 | 4234.73 | 3217.95 | +2.52% | +6.10% | +3.05% |
| Philippines Stock Exchange Index | 5362.68 | 5403.16 | 3715.01 | +2.22% | +22.66% | +28.62% |
| Australia All Ordinaries | 4198.98 | 4717.50 | 3829.40 | +1.54% | +2.14% | +1.51% |
| EMEA | | | | | | |
| Russia MICEX Index | 1414.28 | 1748.30 | 1241.62 | +1.93% | +0.86% | -1.51% |
| South Africa JSE All Shares Index | 34226.21 | 34808.92 | 28305.41 | +1.54% | +7.00% | +4.64% |
| Turkey ISE National 100 Index | 62780.58 | 64463.13 | 48600.16 | +0.38% | +22.46% | +26.90% |
| LATIN AMERICA | | | | | | |
| Mexico Bolsa Index | 39831.65 | 40550.23 | 31561.51 | -0.92% | +7.43% | +11.01% |
| Brazil Bovespa Index | 55394.05 | 68969.99 | 47793.49 | +1.91% | -2.40% | -10.57% |
| COMMODITIES | | | | | | |
| Gold | 1583.75 | 1921.15 | 1522.65 | -0.85% | +1.28% | +1.28% |
| Oil | 84.45 | 110.55 | 74.95 | -0.60% | -14.55% | -14.55% |
| FIXED INCOME | | | | | | |
| Citigroup World Government Bond Index | 625.57 | 627.29 | 583.51 | +0.50% | +2.68% | +2.68% |

Source: Bloomberg (As at July 6, 2012)

CURRENCY FORECASTS

| Currency | | 9-Jul-12 | Sep-12 | Dec-12 | Mar-13 | Jun-13 | Sep-13 | Dec-13 | Mar-14 | Jun-14 | Sep-14 |
|----------------------|--------|----------|--------|--------|--------|--------|--------|--------|--------|--------|--------|
| G10-US Dollar | | | | | | | | | | | |
| Euro | EURUSD | 1.23 | 1.24 | 1.21 | 1.18 | 1.15 | 1.19 | 1.23 | 1.26 | 1.3 | 1.3 |
| Japanese yen | USDJPY | 80 | 80 | 81 | 81 | 82 | 83 | 83 | 84 | 84 | 84 |
| British Pound | GBPUSD | 1.55 | 1.55 | 1.52 | 1.49 | 1.46 | 1.51 | 1.55 | 1.60 | 1.65 | 1.65 |
| Swiss Franc | USDCHF | 0.98 | 0.97 | 0.99 | 1.02 | 1.04 | 1.01 | 0.98 | 0.95 | 0.92 | 0.92 |
| Australian Dollar | AUDUSD | 1.02 | 1.00 | 0.99 | 0.97 | 0.96 | 0.94 | 0.93 | 0.91 | 0.90 | 0.90 |
| New Zealand | NZDUSD | 0.80 | 0.79 | 0.77 | 0.75 | 0.73 | 0.70 | 0.68 | 0.65 | 0.63 | 0.63 |
| Canadian Dollar | USDCAD | 1.02 | 1.03 | 1.02 | 1.01 | 1.00 | 0.99 | 0.98 | 0.98 | 0.97 | 0.97 |
| Dollar Index | DXY | 83.30 | 83.14 | 84.69 | 86.26 | 87.70 | 85.54 | 83.50 | 81.60 | 79.85 | 79.85 |
| G10 Crosses | | | | | | | | | | | |
| Japanese yen | EURJPY | 98 | 99 | 97 | 96 | 95 | 98 | 102 | 106 | 109 | 109 |
| Swiss Franc | EURCHF | 1.20 | 1.20 | 1.20 | 1.20 | 1.20 | 1.20 | 1.20 | 1.20 | 1.20 | 1.20 |
| British Pound | EURGBP | 0.79 | 0.80 | 0.80 | 0.79 | 0.79 | 0.79 | 0.79 | 0.79 | 0.79 | 0.79 |
| Swedish Krona | EURSEK | 8.64 | 8.99 | 8.88 | 8.76 | 8.65 | 8.61 | 8.57 | 8.54 | 8.50 | 8.50 |
| Norwegian Krone | EURNOK | 7.52 | 7.50 | 7.48 | 7.47 | 7.45 | 7.42 | 7.40 | 7.37 | 7.35 | 7.35 |
| Norwegian Krone | NOKSEK | 1.15 | 1.20 | 1.19 | 1.17 | 1.16 | 1.16 | 1.16 | 1.16 | 1.16 | 1.16 |
| Australian Dollar | AUDNZD | 1.28 | 1.26 | 1.28 | 1.30 | 1.32 | 1.35 | 1.37 | 1.40 | 1.43 | 1.43 |
| Australian Dollar | AUDJPY | 81.1 | 80.0 | 79.5 | 79.1 | 78.7 | 77.9 | 77.1 | 76.3 | 75.6 | 75.6 |
| EM Asia | | | | | | | | | | | |
| Chinese Renminbi | USDCNY | 6.37 | 6.33 | 6.34 | 6.34 | 6.35 | 6.30 | 6.25 | 6.20 | 6.15 | 6.15 |
| Hong Kong Dollar | USDHKD | 7.75 | 7.75 | 7.75 | 7.76 | 7.76 | 7.76 | 7.75 | 7.75 | 7.75 | 7.75 |
| Indonesian Rupiah | USDIDR | 9434 | 9405 | 9489 | 9571 | 9650 | 9650 | 9650 | 9650 | 9649 | 9649 |
| Indian Rupee | USDINR | 55.9 | 54.0 | 54.5 | 55.0 | 55.5 | 54.6 | 53.8 | 53.1 | 52.3 | 52.3 |
| Korean Won | USDKRW | 1143 | 1140 | 1149 | 1157 | 1164 | 1142 | 1121 | 1100 | 1080 | 1080 |
| Malaysian Ringgit | USDMYR | 3.19 | 3.10 | 3.11 | 3.13 | 3.14 | 3.09 | 3.04 | 2.99 | 2.95 | 2.95 |
| Philippine Peso | USDPHP | 42.0 | 42.1 | 42.2 | 42.4 | 42.5 | 42.0 | 41.6 | 41.2 | 40.8 | 40.8 |
| Singapore Dollar | USDSGD | 1.27 | 1.25 | 1.26 | 1.27 | 1.27 | 1.26 | 1.24 | 1.23 | 1.21 | 1.21 |
| Thai Baht | USDTHB | 31.8 | 30.7 | 31.1 | 31.5 | 31.9 | 31.4 | 30.9 | 30.4 | 29.9 | 29.9 |
| Taiwan Dollar | USDTWD | 29.9 | 30.3 | 29.8 | 29.3 | 28.8 | 28.7 | 28.6 | 28.6 | 28.5 | 28.5 |
| EM Europe | | | | | | | | | | | |
| Czech Koruna | EURCZK | 25.69 | 25.91 | 26.02 | 26.14 | 26.23 | 25.84 | 25.45 | 25.07 | 24.69 | 24.69 |
| Hungarian Forint | EURHUF | 290 | 275 | 280 | 285 | 290 | 290 | 290 | 290 | 290 | 290 |
| Polish Zloty | EURPLN | 4.25 | 4.22 | 4.33 | 4.44 | 4.54 | 4.38 | 4.21 | 4.05 | 3.90 | 3.90 |
| Israeli Shekel | USDILS | 3.95 | 3.95 | 3.97 | 3.98 | 4.00 | 4.00 | 4.00 | 4.00 | 4.00 | 4.00 |
| Russian Ruble | USDRUB | 32.9 | 33.4 | 34.2 | 34.9 | 35.6 | 34.9 | 34.3 | 33.6 | 33.0 | 33.0 |
| Russian Ruble | Basket | 36.3 | 37.0 | 37.4 | 37.7 | 38.0 | 37.9 | 37.7 | 37.6 | 37.5 | 37.5 |
| Turkish Lira | USDTRY | 1.82 | 1.78 | 1.82 | 1.85 | 1.88 | 1.87 | 1.86 | 1.86 | 1.85 | 1.85 |
| South African Rand | USDZAR | 8.26 | 8.41 | 8.56 | 8.71 | 8.85 | 8.85 | 8.85 | 8.85 | 8.86 | 8.86 |
| EM Latam | | | | | | | | | | | |
| Brazilian Real | USDBRL | 2.03 | 2.01 | 1.99 | 1.97 | 1.95 | 1.92 | 1.90 | 1.87 | 1.85 | 1.85 |
| Chilean Peso | USDCLP | 498 | 493 | 498 | 503 | 507 | 503 | 498 | 494 | 490 | 490 |
| Mexican Peso | USDMXN | 13.4 | 13.4 | 13.5 | 13.6 | 13.7 | 13.3 | 12.9 | 12.6 | 12.2 | 12.2 |
| Colombian Peso | USDCOP | 1785 | 1764 | 1783 | 1802 | 1820 | 1815 | 1810 | 1805 | 1801 | 1801 |

Source: CR, Bloomberg (As July 9, 2012; Forecasts as of June 27, 2012)

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