



# FINANCIAL MARKET ANALYSIS

Volume 12, Issue 29

July 30, 2012

## EU policymakers' pledge to protect the euro spurs risk rally

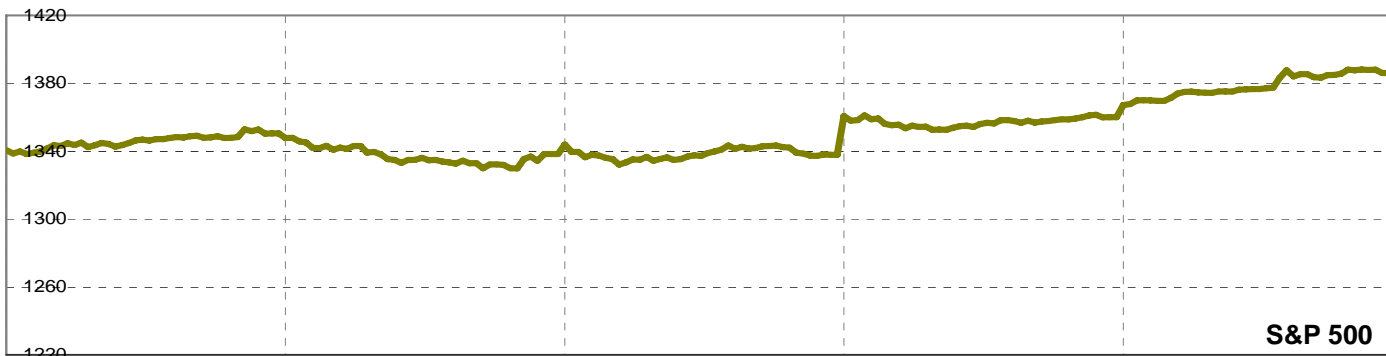
The risk trade came back on last week after European Central Bank (ECB) President Mario Draghi, German Chancellor Angela Merkel and French President Francois Hollande pledged to do everything they can to protect the euro. A slew of better-than-expected corporate earnings results out of the US and Europe also added to the positive sentiment. The S&P 500 index advanced 1.71% to end the week at 1,385.97, while the Stoxx Europe index gained 2.18% to close at 230.47. Focus this week will be on the Federal Open Market Committee Meeting taking place on Tuesday-Wednesday, and the ECB and Bank of England meetings on Thursday. Key data in the US includes the Chicago Purchasing Managers Index and Consumer Confidence reports on Tuesday, ISM Manufacturing on Wednesday and Payrolls on Friday. Eurozone data include Consumer Confidence (Monday), CPI and Unemployment (Tuesday), Manufacturing PMI (Wednesday), PPI (Thursday) and Services PMI and Retail Sales (Friday). In the UK, Manufacturing/Construction PMI are published on Wednesday/Thursday and Services PMI is on Friday. In Asia, we have Japan Industrial Production (Monday); Reserve Bank of India policy meeting, Korea Industrial Production, Singapore Unemployment and Taiwan 2Q12 GDP (Tuesday); China Manufacturing PMI, Indonesia and Korea CPI (Wednesday); Hong Kong Retail Sales (Thursday); China Non-Manufacturing PMI (Friday).

	Jul 27 Close	Last week's return	YTD Return	YTD return (USD)
<b>S&amp;P 500:</b>	1385.97	+1.71%	+10.21%	+10.21%
<b>Stoxx Europe:</b>	230.47	+2.18%	+2.08%	-2.68%
<b>Nikkei 225:</b>	8566.64	-1.19%	+1.32%	-0.72%
<b>MSCI Asia ex Japan:</b>	410.67	-0.33%	+4.55%	+4.55%

### In this issue:

- *US economy: FOMC likely to use communications this week*
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# TAKING STOCK

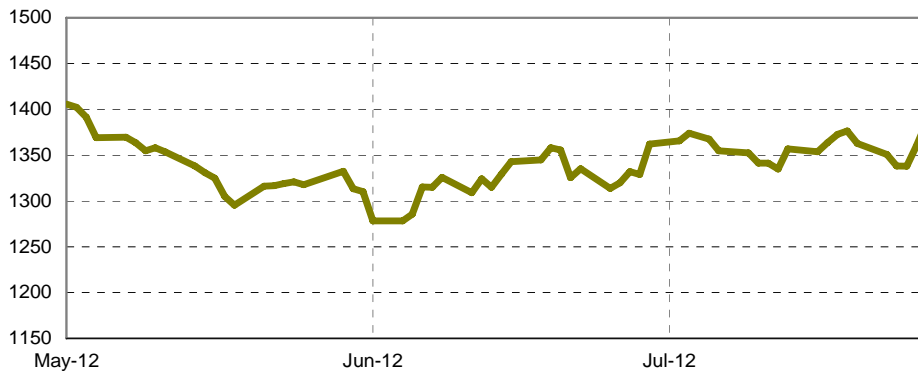


Monday Jul 23	Tuesday Jul 24	Wednesday Jul 25	Thursday Jul 26	Friday Jul 27
<p>S&amp;P: <b>-0.89%</b> STOXX: <b>-2.77%</b> Nikkei: <b>-1.86%</b> MSCI Asia ex Japan: <b>-2.41%</b></p> <p><b>US:</b> The Chicago Fed national activity index rose to -0.15 in Jun vs. -0.48 in May. Consumption and housing -0.23 vs. -0.26 in May. Production and income +0.13 vs. -0.27 in May.</p> <p><b>EU:</b> Preliminary Jul Eurozone consumer confidence index dipped to -21.6, from -19.8 in Jun (Consensus -20.0).</p> <p><b>EU:</b> The Bank of Spain estimates that the Spanish economy contracted by -0.4% QoQ and -1.0% YoY in 2Q12, vs. -0.3% QoQ and -0.4% YoY respectively in 1Q12. The central bank also said that Spain's latest budget measures should allow it to meet its new deficit goals.</p> <p><b>AP:</b> Australia PPI increased by 0.5% QoQ (1.1% YoY) in 2Q12, above the 0.3% QoQ (1.0% YoY) consensus estimate, the first time in over a year that the PPI had surprised on the upside.</p> <p><b>AP:</b> Hong Kong CPI fell to 3.7% YoY in Jun (May 4.3%, Consensus 4.0%). CPI ex-govt's one-off relief measures also eased to 4.5% YoY vs. 5.1% YoY in May.</p> <p><b>AP:</b> Singapore headline CPI rebounded to 5.3% YoY in Jun from 5.0% YoY in May, above consensus of 5.4% YoY. Core CPI stayed stable at 2.7% YoY.</p> <p><b>AP:</b> Taiwan's unemployment rate fell to 4.24% sa in Jun from 4.25% sa in May, better than consensus of 4.30% sa. Industrial production declined -2.44% YoY in Jun from -0.21% YoY in May, below expectations of +0.5% YoY.</p>	<p>S&amp;P: <b>-0.90%</b> STOXX: <b>-1.01%</b> Nikkei: <b>-0.24%</b> MSCI Asia ex Japan: <b>-0.07%</b></p> <p><b>US:</b> Markit manufacturing PMI fell to 51.8 in Jul, vs. 52.5 in Jun and market expectations of 52, the lowest since Dec '10.</p> <p><b>US:</b> Home prices rose +0.8% MoM in May; +3.7% in 12 months through May.</p> <p><b>EU:</b> Eurozone manufacturing PMI fell to 44.1 in Jul (Jun 45.1); services PMI edged up to 47.6 (Jun 47.1); composite PMI held steady at 46.4.</p> <p><b>EU:</b> Jul French INSEE industrial survey revealed a dip in the headline manufacturing composite business climate gauge to 90 from 91 in Jun, lower than the consensus of 91.</p> <p><b>EU:</b> Moody's changed the outlook to negative for Germany, Netherlands, Luxembourg and affirms Finland at AAA, citing rising uncertainty in Euro Area debt crisis. Sees increased risk of Greek exit. Says chances are growing that more support will be needed for sovereigns including and Spain and Italy.</p> <p><b>EU:</b> UK BBA data revealed a sharp decline in the volume of banks' mortgage approvals, to 26,269 in Jun from 29,567 in May (-11.2% MoM, -20.5% YoY) and vs. 33,056 a year ago.</p> <p><b>AP:</b> China manufacturing PMI (HSBC) flash reading hit a 5-month high of 49.5 in Jul from 48.2 in Jun.</p> <p><b>AP:</b> Hong Kong Jun exports fell sharply by -4.8% YoY (May+5.2%), imports declined -2.9% YoY (May +4.6%). The Jun trade deficit widened to -HK\$44.7bn vs. -HK\$35.6bn in May.</p>	<p>S&amp;P: <b>-0.03%</b> STOXX: <b>+0.37%</b> Nikkei: <b>-1.44%</b> MSCI Asia ex Japan: <b>-0.59%</b></p> <p><b>US:</b> Jun new home sales fell to 350K (-8.4% MoM), vs. 382K in May, below market expectations of 372K.</p> <p><b>EU:</b> Jul German Ifo business climate indicator fell to 103.3 from 105.2 in Jun, below consensus of 104.7.</p> <p><b>EU:</b> ECB quarterly lending survey – Net tightening of lending 3Q at -10% and -13% vs. -9% and -17% 2Q for companies and households respectively. But the survey reported a significant fall in company loan demand in 3Q.</p> <p><b>EU:</b> Egan-Jones downgraded Italy's sovereign rating to CCC-Plus from B-Plus.</p> <p><b>EU:</b> UK prelim 2Q12 GDP contracted -0.7% QoQ vs. market expectations of -0.2% QoQ, taking the annual rate down to -0.8% YoY vs. -0.2% YoY in 1Q12.</p> <p><b>JP:</b> The customs clearance trade balance turned around to a ¥61.7bn surplus before seasonal adjustment in Jun from a -¥910.4bn deficit in May, the first surplus since Feb '12. On a seasonally adjusted basis, the balance improved to -¥300.8bn from -¥618.3bn in May.</p> <p><b>AP:</b> Australia 2Q12 CPI rose 0.5% QoQ (1.2% YoY) vs. 0.1% QoQ (1.6% YoY) in 1Q12 and consensus of 0.6% QoQ (1.3% YoY).</p> <p><b>AP:</b> Bank of Thailand kept the O/N repo rate at 3.00%.</p>	<p>S&amp;P: <b>+1.65%</b> STOXX: <b>+3.74%</b> Nikkei: <b>+0.92%</b> MSCI Asia ex Japan: <b>+0.61%</b></p> <p><b>US:</b> Initial jobless claims for the week ending 21 Jul declined -35K to 353K, well below market expectations of 380K. The 4-week average fell to 367.3k from 376.0K in the week prior.</p> <p><b>US:</b> Durable goods orders rose 1.6% in Jun, vs. 1.6% in May and consensus of 0.3%. Ex transportation, orders fell -1.1% (May 0.8%). Capital goods orders nondefense ex air fell -1.4% (May 2.7%).</p> <p><b>EU:</b> Eurozone M3 money supply rose 3.2% YoY in Jun, up from 3.1% in May and faster than market expectations of 2.9%, but camouflaged evidence of another month of a YoY decline in loans to the private sector (Jun -0.2% vs. May -0.1%).</p> <p><b>EU:</b> German import prices declined -1.5% MoM (+1.3% YoY) in Jun, vs. -0.7% MoM (+2.2% YoY) in May.</p> <p><b>EU:</b> German Gfk consumer sentiment indicator rose to 5.9 in Jul from 5.8 in Jun.</p> <p><b>AP:</b> The Reserve Bank of New Zealand kept the OCR at 2.50%. <i>Citi now expects the first rate hike in 2Q13 vs. 1Q13 previously.</i></p> <p><b>AP:</b> Philippines' monetary board cut the O/N policy rate by 25 bps to 3.75%. <i>Citi projects the O/N rate at 3.5% by end-2012; believes a 25 bps cut is likely in Oct.</i></p> <p><b>AP:</b> Korea 2Q12 GDP grew 2.4% YoY vs. 2.8% YoY in 1Q12 and consensus of 2.5% YoY.</p> <p><b>AP:</b> Singapore Jun industrial production rose 7.6% YoY, vs. 6.8% in May and market expectations of 2.8%.</p>	<p>S&amp;P: <b>+1.91%</b> STOXX: <b>+1.96%</b> Nikkei: <b>+1.46%</b> MSCI Asia ex Japan: <b>+2.19%</b></p> <p><b>US:</b> 2Q12 GDP rose 1.5% QoQ vs. consensus of 1.4%. 1Q was revised higher +2.0% from 1.9%. 2Q core PCE rose 1.8% QoQ (1Q 2.2%).</p> <p><b>US:</b> The final Jul Reuters/Michigan Sentiment estimate was 72.3 vs. prelim reading of 72.0 and 73.2 in Jun.</p> <p><b>US:</b> White House estimates of economy: real GDP growing +2.3% YoY in 2012, +2.7% in 2013, and +3.5% in 2014; CPI at +2.1% in 2012, +1.9% in 2013, and +2% in 2014, sees unemployment rate at 8% in 2012, 7.7% in 2013, and 7.3% in 2014; and sees 10-Year yield at 2% in 2012, 2.7% in 2013, and 3.5% in 2014.</p> <p><b>EU:</b> The pan-German prelim Jul HICP inflation rate held steady at 2.0% YoY vs. market expectations of a dip to 1.9%.</p> <p><b>EU:</b> French Jul consumer confidence fell to 87 from 89 in Jun.</p> <p><b>EU:</b> Spain's unemployment rate increased to 24.63% in 2Q12 from 24.4% in 1Q12.</p> <p><b>JP:</b> Nationwide core CPI fell -0.2% YoY in June, weakening slightly from -0.1% YoY in May. The main cause was a renewed negative contribution (-0.10ppt) from petroleum products, including gasoline, after a 0.03ppt boost in May.</p> <p><b>JP:</b> Retail sales moderated in June to a 0.2% YoY gain (-1.2% MoM) after strong growth of 3.6% YoY (0.7% MoM) in May.</p> <p><b>AP:</b> Taiwan's leading index rose 0.4% MoM in Jun, the 10<sup>th</sup> consecutive month of improvement. The coincident index rose 0.5% MoM.</p>
<b>Over the Weekend Jul 28 and Jul 29</b>				
<b>Others: --</b>				

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

# US/NORTH AMERICA

## S&P 500 (2/4/2012 to 27/7/2012)



Source: Bloomberg

## Economic Outlook

### FOMC likely to use communications this week

Citi analysts expect the Federal Open Market Committee (FOMC) to use communications this week, extending the horizon for low rates to at least mid-2015 and announcing that additional balance sheet measures are likely to be introduced soon in the event improvement in the job market does not resume this summer. Although Citi analysts do not rule out asset purchases, most likely focused on MBS, or a new bank lending operation, the thresholds for aggressive easing may not have been met, especially in light of perceived costs. The FOMC may have a better sense of its options and the need for action in September. Lingering restraint on credit stands out as the key headwind frustrating monetary accommodation efforts.

With financial conditions holding up reasonably well and inflation prospects steady, the question of recovery's momentum is likely key to near-term policy. June readings on payrolls, retail sales, and business spending raised doubts about the second half and ongoing fiscal belt tightening has been a persistent drag. Nonetheless, annual revisions to GDP show that growth recently has been somewhat stronger and real income gains in the first half were a solid 3.3%. Jobless claims have bucked other signs of weakening and along with other factors suggest employment gains picked up to an estimated 140,000 in July.

## The Week Ahead

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- Although payroll employment expanded at a subdued pace again in June, Citi analysts still expect that **personal income** increased at a healthy pace of 0.4%.
- Consumer confidence** likely edged down in July to 61.5 after falling for the past four months.

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- The **ISM manufacturing** gauge likely fell sharply in June to 51.0, with weakness centered in new orders and production.
- Citi analysts expect another gain in June total **construction spending** (0.4%), led by residential structures, especially single family dwellings.

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- Initial jobless claims** for the week ending July 28 likely rose by 17K to 370K after a surprisingly large drop in the prior week.

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- Citi analysts expect a bounce in **payroll employment** in July to 140K after three exceptionally soft readings averaging 75,000.
- Citi analysts look for a roughly unchanged reading on the July **ISM non-manufacturing activity index** (52.0).

## Equities

### Beta plays – Diversified Financials and Insurance

	Last week's close	Last week's return	YTD return
<b>S&amp;P 500</b>	1385.97	+1.71%	+10.21%
<b>DJIA</b>	13075.66	+1.97%	+7.02%
<b>Nasdaq</b>	2958.09	+1.12%	+13.55%

A variety of metrics, including sentiment, valuation, implied earnings expectations, and credit conditions have been instrumental to the more bullish stance outlined in late June, and thus one can derive that a higher beta tilt to portfolios may be appropriate. Moreover, nearer-term triggers like the Citi Economic Surprise Index and high intra-stock realized price correlation argue for the recent rally to continue.

If we look at historical data, industry groups such as Diversified Financials, Autos, Insurance, and Materials have demonstrated high beta over the past five years relative to low beta areas such as Telecom Services, Utilities, Pharma & Biotech, and Food & Staples Retailing.

Having said that, while Citi analysts believe that higher beta names could outperform, they do not favour Autos and Materials given European economic woes. Instead, Insurance and Diversified Financials are their preferred plays for beta positioning.

Source: CR

## Bonds

### Preference for high-grade corporates and emerging market debt

	Jul 27 2012	Jul 20 2012	Jul 13 2012
<b>2-yr Try:</b>	0.239%	0.202%	0.238%
<b>5-yr Try:</b>	0.651%	0.575%	0.620%
<b>10-yr Try:</b>	1.546%	1.457%	1.488%

**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 remain medium-term

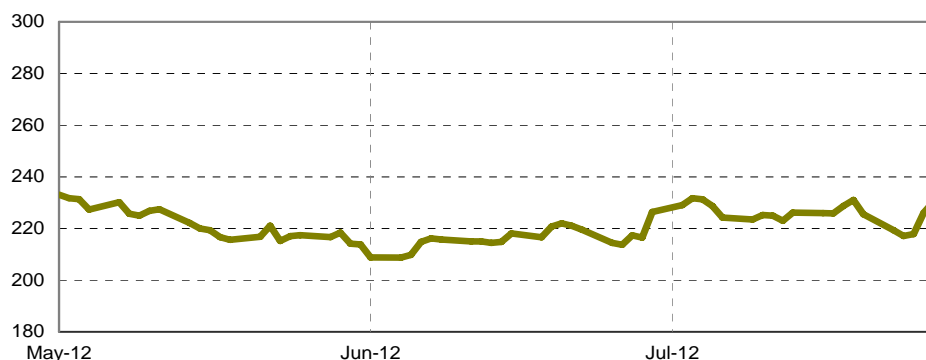
September 2012 forecasts		
EURUSD	USDJPY	USDCAD
1.22	78	1.01

USD strength in the face of better risk appetite and position unwinds suggests underlying fundamental strength. It appears that FX investors believe that while the US economy may be sub-par, it is still likely to outperform other developed regions. Equity outperformance and bond market underperformance on trend also suggest similar expectations are in other asset classes. These factors are likely to drive USD appreciation over the medium term, absent US policy mis-steps.

All in all, Citi analysts forecast further USD upside over the medium term, especially relative to G10 majors with EUR/USD potentially falling towards 1.15. Overall, gains of around 5% over 6-12 months appear likely versus G10 currencies.

# EUROPE

STOXX (2/4/2012 to 27/7/2012)



Source: Bloomberg

## Economic Outlook

### ECB likely to leave rates unchanged in August

While there is a chance that the European Central Bank (ECB) might cut interest rates in August, Citi analysts expect the Governing Council to leave rates unchanged — main refinancing rate at 0.75%, deposit rate at 0.0% and marginal rate at 1.5% — and open the door to cut rates further, including the deposit rate to negative, in September. In Citi's view, only if there was a request from Spain (which so far has not been willing to ask) and Italy for European Financial Stability Facility (EFSF) assistance for the sovereign, would the ECB be willing to use the Securities Market Programme (SMP) again. While there are signs that the ECB might change its stance on European Stability Mechanism (ESM) access to the ECB's lending operations, the ECB is not expected to do a U-turn on that issue as early as August.

Looking forward, Citi analysts expect the ECB to cut the refinancing rate to 0.25% and the deposit rate to -0.5% by the end of the year. Once the ESM has the ability to provide capital directly to banks, the ECB may accept giving the ESM access to its open market operations. In the event of the ECB seeing a risk of deflation (which is regarded as unlikely to happen any time soon), Citi believes the ECB could also go ahead with quantitative easing (QE).

## The Week Ahead

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- **Spain:** Citi analysts expect **2Q12 GDP** growth of -0.6% QoQ, slightly below the Bank of Spain's preliminary estimate of a contraction of -0.4% QoQ.

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- **Germany:** Following two months of declines, Citi analysts expect a rebound in June **retail sales** (+0.6% MoM).

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- **UK:** The **manufacturing PMI** bounced by 2.7 points in the June survey, but Citi analysts expect renewed weakness in the July index (46.0), reflecting sluggish domestic demand plus the drag on UK exports from the EMU crisis.

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- **Norway:** Citi analysts expect the May **unemployment rate** to remain stable at 3.0%.

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- **Euro Area:** Following a somewhat larger than expected gain in May, Citi analysts expect June **retail sales** to return to their downward trend (-0.3% MoM).

## Equities

### Raising Media sector to Overweight

	Last week's close	Last week's return	YTD Return
STOXX	230.47	+2.18%	+2.08%
FTSE 100	5627.21	-0.43%	+0.99%
DAX	6689.40	+0.90%	+13.41%

Citi analysts have raised Media to Overweight (from Underweight) and lowered Health Care to Neutral (from Overweight). In their view, the Media group offers exposure to defensive growth at a reasonable price. For instance, while the Media sector earnings have performed in line with Health Care over the past 12-15 months, price performance has lagged. As such, Citi analysts believe that there is an opportunity for that relative performance to reverse somewhat in the coming months.

The Utilities sector has also been raised to Neutral from Underweight. Outside Spain, Citi analysts see reduced earnings risk across this group over the next 12 months and relative earnings trends for the sector have recently turned positive.

Finally, Citi analysts have lowered the Oil & Gas sector to Underweight (from Neutral) as they continue to see an uninspiring combination of low growth and low returns.

## Bonds

### Favour UK Gilts vs German Bunds

	Jul 27 2012	Jul 20 2012	Jul 13 2012
2-yr Try:	-0.029%	-0.074%	-0.042%
5-yr Try:	0.418%	0.240%	0.309%
10-yr Try:	1.398%	1.167%	1.260%

Citi analysts remain positive on the long end of the German yield curve, which has 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: Likely to give back some of its gains in the short term

September 2012 forecasts		
GBPUSD	USDCHF	EURGBP
1.56	0.98	0.78

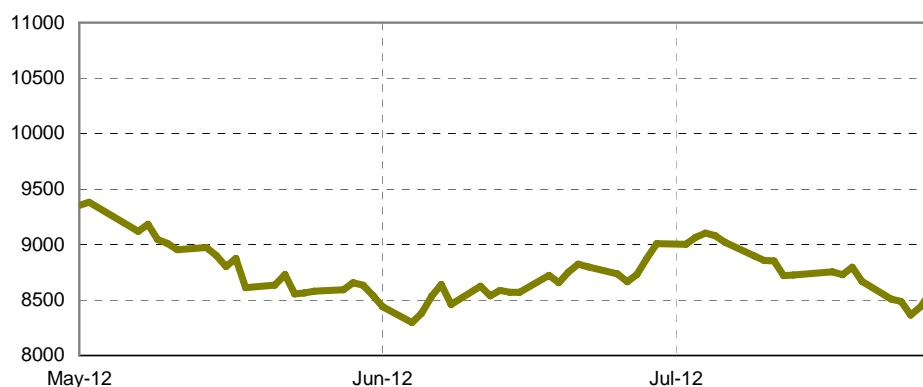
EUR is likely to be weak medium-term assuming Greece exits the EMU, volatile and wide bond yield spreads between core and periphery, weak EMU growth, further European Central Bank rate cuts and additional long-term refinancing operations (LTROs). Citi forecast EUR/USD heading to 1.15 over 6-12 months, though there may be some stability near-term given the recent sharp move lower.

Citi analysts expect the quantitative easing (QE) program to be expanded to a total of £500bn, alongside liquidity and credit easing. This is GBP negative vs. USD, but may already be priced in to some extent. Moreover, there is still the risk of QE3 for the USD itself. As a result, GBP/USD is expected to maintain its recent 1.54-1.58 range short-term. Given expectations for EUR/USD to stabilise for awhile, GBP may consolidate vs. EUR. More medium term, with EUR losing ground again, EUR/GBP may push modestly lower and GBP/USD could fall to around 1.50.

Source: CR

# JAPAN

Nikkei 225 (2/4/2012 to 27/7/2012)



Source: Bloomberg

## Economic Outlook

### New BoJ members: Dovish but reticent about concrete measures

At the press conference last week, two new Bank of Japan (BoJ) members – Mr. Sato and Mr. Kiuchi – showed a dovish stance about policy. Mr. Kiuchi stated that “additional easing should be considered if it has become unlikely that inflation reaches the price stability goal of 1% despite the current accommodation”. Mr. Sato also referred to additional easing measures such as a shift of the BoJ’s asset purchases towards riskier assets. The new members were somewhat reticent about concrete policy measures. Moreover, their remarks were similar to the BoJ’s mainstream views in various aspects. In Citi’s view, the near-term impact on policy of the addition of the two new members may be limited, though they are likely to stimulate policy debates on the board. If upward pressures on the yen intensify, Citi analysts believe the new members may propose additional measures, but even in that case, the most likely option may be to purchase more short-term and long-term JGBs for now.

## The Week Ahead

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- **Industrial production** probably increased +1.9% MoM (-0.1% YoY) in June after -3.4% MoM (+6.0% YoY) in May, the first gain in three months.

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- **Nominal household spending** likely rose 3.5% YoY and decreased -0.5% MoM in June (May 4.3% YoY, 0.9% MoM) while real spending probably advanced 3.5% YoY and fell -0.4% MoM (May 3.9% YoY, 1.5% MoM).
- Citi expects a 4.4% **unemployment rate** for June, no change from May. The effective **job offers-to-seekers ratio** probably rose to 0.84 in June from 0.81 in May, the highest level since August 2008 (0.86).
- June **housing starts** likely stood at 893K (+6.8% YoY) on a seasonally adjusted annualized basis (May 903K, +9.3% YoY). On a MoM basis, housing starts probably fell -1.1% (May +0.8%).

## Equities

### Changes in how Japanese companies spend their money

	Last week's Close	Last week's return	YTD return
<b>Nikkei</b>	8566.64	-1.19%	+1.32%
<b>Topix</b>	726.44	-1.01%	-0.30%

There are four primary ways companies can use their cash holdings: 1) to pay down debt; 2) for capex; 3) on merger and acquisition (M&A); and 4) for shareholders' return. Citi analysts believe capex and in particular, in-out M&A are likely to increase in FY12.

In the Bank of Japan's Tankan survey, manufacturers say they plan to increase capex by 7.2% in FY12. Management sentiment deteriorated in the wake of the March 11 disaster, resulting in capex being held below depreciation costs. However, management sentiment has since improved, and capex is likely to rise, in part as a rebound after previous curtailment.

Indeed, the number of in-out M&A by Japanese firms appears to be recovering. If the pace seen since the start of the year continues, in-out M&A numbers would hit a record level in 2012. Citi analysts see three main reasons for the increase in in-out M&A: 1) management sees the need to make forays overseas from the standpoint of long-term growth as the domestic population is declining; 2) the yen is strong at around ¥80/\$; and 3) the emergency facility to combat yen strength set up by the government in August 2011 is being used.

Source: CR

## Bonds

### Some JGB underperformance around the fiscal year-end expected

	Jul 27 2012	Jul 20 2012	Jul 13 2012
<b>2-yr Try:</b>	0.102%	0.100%	0.105%
<b>5-yr Try:</b>	0.188%	0.185%	0.186%
<b>10-yr Try:</b>	0.747%	0.744%	0.778%

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

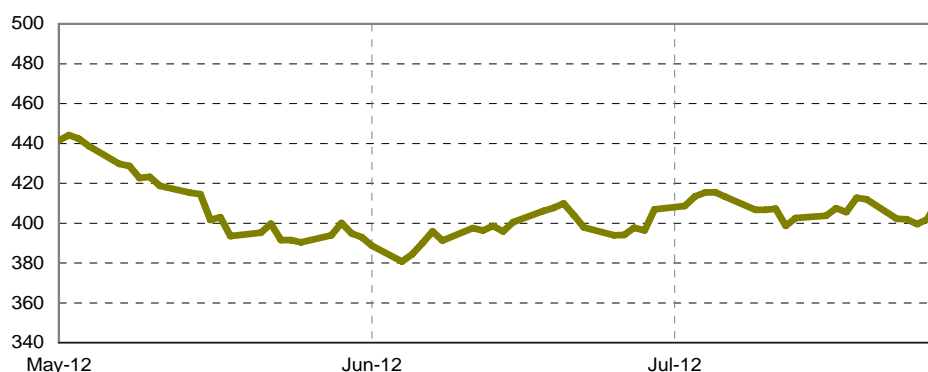
September 2012 forecast		
USDJPY	EURJPY	AUDJPY
78	95	81.2

USD/JPY continues to trade mainly sideways, broadly within a 75-85 range. Citi's forecasts essentially see this continuing. Should the Federal Reserve (Fed) move towards QE3, this may temporarily push USD/JPY lower along with other USD crosses. In the current environment of disappointing economic data everywhere (including the US), core bond yields are unlikely to move up much and USD/JPY may drift a bit lower over 0-3 months in line with rate differentials. However, intervention from the Bank of Japan/Ministry of Finance is likely to slow the downside from 76 onwards.

One factor that has supported JPY is the BoJ's stance. Typically, the BoJ is much less aggressive with monetary easing than the Fed. This may be changing slightly with the BoJ finally adopting an inflation target, though significant additional quantitative easing still seems lacking. As such, upside in USD/JPY may be limited by this conservative stance despite a gradual deterioration in other fundamentals such as the trade balance. Citi forecasts USD/JPY at 82 in 6-12 months, which is well within the range since mid-2010.

# ASIA PACIFIC EX JAPAN

MSCI Asia ex Japan (2/4/2012 to 27/7/2012)



Source: Bloomberg

## The Week Ahead

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- **India:** The Reserve Bank of India is likely to keep the O/N Repo and Reverse Repo rates unchanged at 8% and 7%, respectively.
- **Korea:** June industrial production probably slowed to 1.4% YoY (0.3% MoM s.a.) on drags from domestic demand and exports.
- **Singapore:** The unemployment rate likely edged up to 2.2% s.a. in 2Q12.
- **Taiwan:** Citi forecasts an above-consensus 1.0% YoY for 2Q12 preliminary GDP growth.

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- **China:** The official Manufacturing PMI (CFLP) likely improved slightly to 50.4 in July from 50.2 in June.
- **Korea:** July CPI inflation probably moderated further to 2.1% YoY, but rose 0.4% MoM s.a.

2/8

- **Hong Kong:** June Retail sales growth may continue to stay in single digit, with both volume (5.7% YoY) and value (7.9% YoY) growth affected by more conservative spending and steeper than usual summer sales.

## Economic Outlook

### Growth worries continue with focus shifting West-ward

The dominant theme of slower growth persists, but Citi analysts think the source of growth concern has shifted West-ward amidst signs that China's growth has stabilized in 2Q12, while growing concern may now be centred on persistent data disappointments in the US. However, there are five reasons why Citi analysts do not to expect a prolonged downturn in Asia.

First, a double-dip recession is not expected in the US as upside in housing and some better labour gauges counterbalanced by uncertainty ahead of elections could continue to keep growth in an expansionary mode, albeit at a slower pace. Second, Asia's financial system continues to function well with Asia's exposure to Europe ex UK banks relatively small and declining. Third, unemployment rates are still close to historic lows in many Asia countries and remain supportive of domestic demand. Fourth, room for counter-cyclical policy easing remains alive and well despite concerns about food inflation. And lastly, unlike last year, electronics leading indicators, while softening, look in stronger shape now. Inventory overhang also looks much milder.

## Equities

### EPS revisions pattern resembles that of prior cycles

	Last week's close	Last week's return	YTD Return
MSCI Asia ex Japan	410.67	-0.33%	+4.55%

August and September have historically been the heaviest months of corporate earnings revisions post the mid-year results. The latest revisions have taken on the same pattern as in prior years. With Institutional Brokers' Estimate System (IBES) expectations still running at 13.8% for this year, Citi analysts see room for disappointment. They expect earnings-per-share (EPS) growth to come in between 4-8% for this year. But markets already appear to be pricing in much weaker earnings revisions than we have seen thus far.

The worst revisions are in Taiwan, China and Thailand. By sector, the worst near term revisions have been with the Material and Energy space. Compared to historical revisions vs. price-to-book, Hong Kong, Singapore, Taiwan and Thailand are all pricing in a significant worsening of revisions. Banks, Real Estate and Technology are pricing in worse revisions than what we have currently, while Consumers are priced for significantly better revisions. Overall investor positioning remains very cautious with the relative performance or risk vs. quality only having been worse in 1997/98, 9/11 and SARS.

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: FX as part of overall easing

September 2012 forecasts		
AUDUSD	NZDUSD	USDSGD
1.04	0.80	1.25

Citi analysts' short- and long-term valuation models continue to suggest that AUD/USD should be trading around 90-94, and their forecasts is for spot to move towards that over the medium to long term. With AUD likely to come down again, albeit probably not until 4Q12, and with key commodity prices also likely to be weaker, Citi analysts expect a move back below parity in AUD/USD over 6-12 months in the context of generalised USD strength and a stable USD/CNY rate.

Growth weakness within EM Asia relative to expectations has been marked on the back of the Chinese slowdown and export intensive Asian currencies may now underperform. Asian exporters have kept their currencies broadly stable against both USD and CNY but this is unlikely to be sustained if domestic data continues to weaken and USD strengthens as expected over the medium term. There is also a growing recognition that a weaker currency could be desirable as part of broader monetary easing. Considering that China needs to maintain export competitiveness, Citi forecasts USD/CNY at 6.38 over the next three months.

# WORLD MARKETS AT A GLANCE

	Previous Week's Close	52-Week High	52-Week Low	Weekly Return	YTD Return	YTD Return (USD)
<b>UNITED STATES</b>						
Dow Jones Industrial Average	13075.66	13338.66	10404.49	+1.97%	+7.02%	+7.02%
S&P 500	1385.97	1422.38	1074.77	+1.71%	+10.21%	+10.21%
Nasdaq	2958.09	3134.17	2298.89	+1.12%	+13.55%	+13.55%
<b>EUROPE</b>						
DJ Euro STOXX	230.47	266.70	194.63	+2.18%	+2.08%	-2.68%
FTSE 100	5627.21	5989.07	4791.01	-0.43%	+0.99%	+2.39%
DAX	6689.40	7282.01	4965.80	+0.90%	+13.41%	+8.13%
<b>JAPAN</b>						
Nikkei 225	8566.64	10255.15	8135.79	-1.19%	+1.32%	-0.72%
TOPIX	726.44	872.42	692.18	-1.01%	-0.30%	-2.30%
<b>ASIA</b>						
MSCI Asia ex Japan	410.67	490.51	353.80	-0.33%	+4.55%	+4.55%
Hong Kong Hang Seng	19274.96	22808.33	16170.35	-1.86%	+4.56%	+4.68%
Shanghai Composite Index	2128.77	2721.53	2120.63	-1.84%	-3.21%	-4.47%
Taiwan Weighted Index	7124.49	8771.64	6609.11	-0.56%	+0.74%	+1.52%
Korea KOSPI	1829.16	2173.28	1644.11	+0.34%	+0.19%	+1.77%
Mumbai Sensex	16839.19	18523.78	15135.86	-1.86%	+8.96%	+4.56%
Singapore Straits Times Index	2998.49	3227.28	2521.95	-0.57%	+13.31%	+17.67%
Kuala Lumpur Composite	1624.94	1647.94	1310.53	-1.10%	+6.15%	+6.68%
Thai Stock Exchange	1178.01	1247.72	843.69	-2.53%	+14.89%	+15.07%
Jakarta Composite Index	4084.21	4234.73	3217.95	+0.07%	+6.86%	+3.33%
Philippines Stock Exchange Index	5219.55	5403.16	3715.01	+0.17%	+19.39%	+24.91%
Australia All Ordinaries	4234.39	4589.60	3829.40	+0.09%	+3.00%	+4.73%
<b>EMEA</b>						
Russia MICEX Index	1406.30	1741.72	1241.62	-0.64%	+0.29%	+0.44%
South Africa JSE All Shares Index	34671.00	34808.92	28305.41	+1.30%	+8.40%	+6.83%
Turkey ISE National 100 Index	64372.81	64498.27	48600.16	+4.18%	+25.56%	+30.56%
<b>LATIN AMERICA</b>						
Mexico Bolsa Index	41476.48	41600.59	31561.51	+1.64%	+11.86%	+17.28%
Brazil Bovespa Index	56553.12	68969.99	47793.49	+4.35%	-0.35%	-7.74%
<b>COMMODITIES</b>						
Gold	1622.90	1921.15	1522.65	+2.42%	+3.79%	+3.79%
Oil	90.13	110.55	74.95	-1.43%	-8.80%	-8.80%
<b>FIXED INCOME</b>						
Citigroup World Government Bond Index	627.67	629.42	587.92	-0.28%	+3.03%	+3.03%

Source: Bloomberg (As at July 27, 2012)

# CURRENCY FORECASTS

Currency		30-Jul-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14
<b>G10-US Dollar</b>											
Euro	EURUSD	1.23	1.22	1.20	1.18	1.16	1.18	1.22	1.25	1.29	1.3
Japanese yen	USDJPY	78	78	79	80	82	82	83	83	84	84
British Pound	GBPUSD	1.57	1.56	1.55	1.53	1.51	1.53	1.57	1.60	1.64	1.65
Swiss Franc	USDCHF	0.98	0.98	1.00	1.02	1.04	1.02	0.99	0.96	0.93	0.92
Australian Dollar	AUDUSD	1.05	1.04	1.02	1.00	0.98	0.96	0.94	0.92	0.90	0.90
New Zealand	NZDUSD	0.81	0.80	0.79	0.76	0.74	0.71	0.69	0.67	0.65	0.65
Canadian Dollar	USDCAD	1.00	1.01	1.01	1.00	1.00	0.99	0.99	0.98	0.97	0.97
Dollar Index	DXY	82.80	83.22	84.28	85.64	87.06	85.77	83.80	81.97	80.20	79.61
<b>G10 Crosses</b>											
Japanese yen	EURJPY	96	95	95	95	94	97	101	105	108	110
Swiss Franc	EURCHF	1.20	1.20	1.20	1.20	1.20	1.20	1.20	1.20	1.20	1.21
British Pound	EURGBP	0.78	0.78	0.78	0.77	0.77	0.77	0.78	0.78	0.79	0.79
Swedish Krona	EURSEK	8.47	8.49	8.47	8.44	8.41	8.40	8.40	8.40	8.40	8.41
Norwegian Krone	EURNOK	7.45	7.48	7.47	7.44	7.41	7.38	7.36	7.33	7.31	7.30
Norwegian Krone	NOKSEK	1.14	1.13	1.13	1.13	1.14	1.14	1.14	1.15	1.15	1.15
Australian Dollar	AUDNZD	1.29	1.29	1.31	1.32	1.34	1.35	1.36	1.37	1.38	1.39
Australian Dollar	AUDJPY	82.0	81.2	80.9	80.7	80.4	79.4	78.2	77.0	75.9	75.6
<b>EM Asia</b>											
Chinese Renminbi	USDCNY	6.38	6.38	6.37	6.36	6.34	6.30	6.25	6.21	6.16	6.14
Hong Kong Dollar	USDHKD	7.76	7.75	7.75	7.76	7.76	7.76	7.76	7.75	7.75	7.75
Indonesian Rupiah	USDIDR	9486	9452	9502	9568	9634	9649	9649	9649	9649	9639
Indian Rupee	USDINR	55.3	54.3	54.3	54.8	55.2	54.7	54.0	53.2	52.5	52.1
Korean Won	USDKRW	1136	1140	1152	1167	1182	1164	1138	1112	1086	1074
Malaysian Ringgit	USDMYR	3.15	3.15	3.17	3.20	3.22	3.21	3.18	3.15	3.12	3.10
Philippine Peso	USDPHP	41.9	42.4	42.6	42.8	43.0	42.6	42.0	41.5	40.9	40.7
Singapore Dollar	USDSGD	1.25	1.25	1.26	1.27	1.28	1.27	1.26	1.25	1.23	1.23
Thai Baht	USDTHB	31.6	31.5	31.6	31.8	32.0	31.6	31.1	30.5	30.0	29.8
Taiwan Dollar	USDTWD	30.1	30.2	30.4	30.4	30.5	30.1	29.6	29.1	28.6	28.5
<b>EM Europe</b>											
Czech Koruna	EURCZK	25.33	25.36	25.48	25.72	25.95	25.72	25.37	25.03	24.68	24.44
Hungarian Forint	EURHUF	281	293	292	289	286	286	287	288	290	289
Polish Zloty	EURPLN	4.12	4.20	4.26	4.32	4.39	4.30	4.18	4.05	3.93	3.90
Israeli Shekel	USDILS	4.05	4.16	4.20	4.20	4.20	4.16	4.11	4.06	4.01	3.96
Russian Ruble	USDRUB	32.1	33.0	33.9	34.6	35.3	34.9	34.3	33.8	33.2	32.8
Russian Ruble	Basket	35.4	36.3	36.9	37.3	37.7	37.7	37.7	37.6	37.5	37.5
Turkish Lira	USDTRY	1.82	1.79	1.81	1.84	1.87	1.87	1.87	1.86	1.85	1.86
South African Rand	USDZAR	8.19	8.25	8.37	8.52	8.67	8.70	8.71	8.71	8.72	8.80
<b>EM Latam</b>											
Brazilian Real	USDBRL	2.02	1.99	2.00	2.03	2.05	2.04	2.01	1.98	1.96	1.94
Chilean Peso	USDCLP	484	487	493	500	507	504	500	495	491	490
Mexican Peso	USDMXN	13.3	13.2	13.3	13.5	13.7	13.4	13.0	12.7	12.3	12.3
Colombian Peso	USDCOP	1792	1766	1788	1820	1853	1848	1833	1818	1803	1810

Source: CR, Bloomberg (As July 30, 2012; Forecasts as of July 20, 2012)



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