International Personal Bank

Market Outlook

February 2014

A secular bull run with bumps along the way

After Developed Market stocks returned 30% in 2013 amid historically low volatility, and after the rather positive outlooks announced across the financial industry, January's pullback in global shares is rather upsetting. With no meaningful intra-year stock market corrections since 2012's 9% summer drop, there is more historical precedent for a correction of magnitude than continued stability. Yet akin to the periods following drops in 2010-2012, Citi analysts still expect eventual new cycle highs in many developed country share markets, and an enduring economic recovery.

A secular bull run with bumps along the way

Stocks outpaced underlying earnings in 2013 driven by re-ratings. However, such gains are unlikely to be repeated in 2014. With earnings becoming the main driver for equities now, it is a valid concern that interest rates may become a headwind and volatility is likely to increase.

Citi analysts continue to think that a 1Q14 correction (in the 5%-10% range) is developing given weakening EPS forward guidance trends and some softening in the some real activity data, not to mention euphoric sentiment levels. From the longer term perspective, however, Citi analysts believe that the basis for the Raging Bull thesis set out more than two years ago remain intact albeit it may be a rougher ride in 2014 with many bumps. Indeed, the secular bull market of the 1980s and 1990s had bouts of volatility too and investors took advantage of those pullbacks. During the 18-year period of equity bull market from 1982 to 2000, there were some awful moments including the stock market crash of 1987 and the sharp pullback in 1990 as well as in 1998.

In this context, Citi analysts believe that, when lead indicators of volatility emerge, it is wise to pay attention and see them as opportunities. Accordingly, chasing the tape simply on the basis of momentum may not be a good strategy since expecting another 25%-30% appreciation in 2014 seems rather excessive.

More positives than negatives

While disappointment in emerging economies and a lackluster though improving Europe could hold back the earnings story, credit conditions remain favourable in the US. Admittedly, the improving labour market is encouraging and stock buyback activity has stepped up.

Another good news can be found in the fund flows. Money has begun to flow into equity funds lending support to investors' anticipation that the Great rotation, which is a shift to equities from other pain trades, could be the key support. While equity funds continue to receive inflows since 2013, most of inflows have come from money markets rather than bond outflows. Indeed the Great Rotation has been damaging for a number of markets such as gold, commodities, and Emerging Markets. However, still large amount of money is sitting with bond funds which are likely to be pain trades this year when discounting high growth, higher rates and Fed tapering.

How further might stock prices go?

In Citi's view, stock prices may move higher as earnings improve but not in the way that was experienced in 2013. Street consensus bottom-up expectations of roughly 11% EPS growth in 2014 and Citi's forecast of around 7% (Citi's year-end S&P 500 2013 EPS forecast is $110.10 and their 2014 EPS estimate to $117.50) suggest that there is room for price appreciation.

To gauge potential returns, a very basic and simple measure is Citi's P/E Bulls Eye approach which looks all the way back to 1940 and it implies that there is somewhere between 5% and 9% upside potential now. In addition, Citi's normalized earnings yield gap suggests that there is still a 91% chance of gains in the next 12 months for share prices.

Patience and prudence may be rewarded

With a 1,975 S&P 500 target by 2014 year-end, Citi analysts remain generally constructive in the longer term while continuing to take a near-term tactical caution approach. However, market sentiment may remain uneasy for a while and there is no immediate visibility as to when the US equity markets may resume their upward trend.

Longer term though, investors are likely to be rewarded for patience and prudence. To avoid the risk of missing the timing, it appears more prudent to use market volatility as an opportunity to scale in US equities. In volatile markets, time diversification (such as dollar cost averaging) has been proven to be a good investment strategy as was diversifying markets and asset classes.

Markets

Equities Markets

United States: Expansion may be on a modestly stronger track

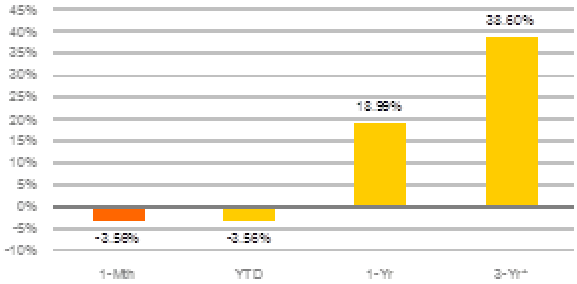
- Citi's updated forecast continues to show a quarterly pattern of growth averaging 3% through 2015 with unemployment dropping below 6% and inflation staying low but edging above 1.5%. Absent shocks, the economy has key supports from ample resource slack and a strong financial tailwind.

- Monetary policy prospects remain unchanged in the wake of recovery's momentum and a belated start to tapering of QE. Citi analysts expect the final tapering decision in September, followed by an end to reinvestment in early 2015 and limited rate hikes beginning later that summer. Citi analysts see two-way risks here: Forward rate guidance has shifted the focus to the lack of inflation pressures, which could delay action beyond 2015. But a plausible case for faster recovery and encouraging wage gains could telescope initial tightening to the start of 2015.

- Shifting to equities, while investors have focused on strong quarterly results with EPS trends exceeding estimates by a fair margin thus far, one has to realize the lowering of expectations during 4Q13 that was ignored when liquidity and momentum defined trading activity. More critically, forward estimates have been cut and the renewed concern about emerging markets is likely adding to a growing lack of conviction in earnings trends, with some investors also worrying about currency shifts, deflationary risks and potentially higher labour costs.

- Having said that, the good news remains – hiring intentions show the strong possibility of more jobs in the US thereby supporting consumer activity, while increased capital spending plans also provide credence in expecting domestic economic growth. And S&P 500 EBIT margins have upside capacity as eight of 10 sectors are still generating profitability below their 2007 highs. As a result, earnings growth is a key element of the 2014 investment story for stocks, but expectations had been too high and are now resetting to a more reasonable level.

Chart 1: S&P 500 Index



*Denotes cumulative performance
Performance data as of 31 January 2014
Source: Bloomberg

Euro-Area: ECB may cut the refi rate to 0% in June

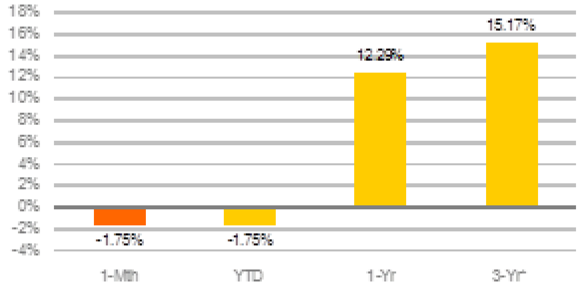
- Sentiment surveys have recovered further in December and January, with headline readings now roughly back to long-term averages. Business cycle dynamics are improving a little, helped by better external demand, reduced fiscal drag and improving financial conditions. But private credit growth remains negative and employment is only just about stabilising.

- Citi analysts are lifting their euro area GDP growth forecasts by 0.2pp for 2014 and by 0.3pp for 2015, to 1.1% and 1.3% respectively. Nevertheless, recovery is likely to stay subdued by historical norms hence – amidst very low inflation — prompting the ECB to loosen further. Citi's base case is that the ECB may lower the refi rate to 0% in June, and take the deposit rate into negative territory at -0.1%, although they would not rule out an earlier (but smaller) move in March (15bp refi cut, but stable deposit rate).

- Last year saw the beginning of a new investment regime. This is likely to be characterized by lower macro risk, rising growth opportunity and rising risk appetite. Indeed, given an improving macro backdrop in both the US and across Europe, Citi analysts favour companies which can benefit from stronger economic growth and which are operationally geared. Additionally, we expect companies to raise financial leverage.

- This makes sense with a combination of: 1) macro risks significantly lower, 2) growth opportunities still capped, 3) wide funding gap between cost of debt and equity. This also suggests a pick-up in corporate actions in 2014. So overall, Citi analysts prefer companies which can benefit from: 1) economic leverage, 2) operational leverage, and 3) financial re-leveraging. These companies are likely to be part of the earnings leadership group in the coming 12-18 months. This suggests a clear preference for Financials and Cyclicals over Defensives.

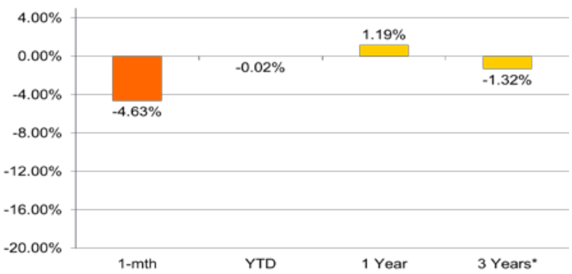
Chart 2: DJ Euro Stoxx 600 Index



*Denotes cumulative performance
Performance data as of 31 January 2014
Source::: Bloomberg

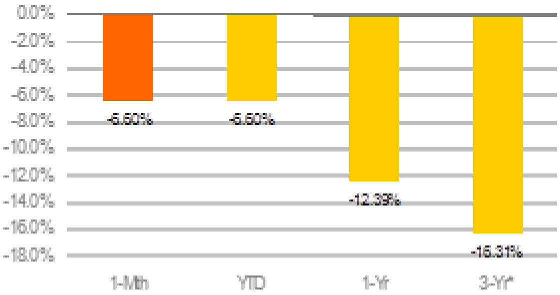
Equities Markets

Chart 3: MSCI Asia Pacific Index



*Denotes cumulative performance
Performance data as of 31 January 2014
Source::: Bloomberg

Chart 4: MSCI Emerging Markets Index



*Denotes cumulative performance
Performance data as of 31 January 2014
Source::: Bloomberg

Japan

BoJ could implement additional easing

- The consumption tax hike to 8% in April may create significant distortions in the economy. The 3ppt hike in the tax rate in the context of modest growth in wages is expected to erode real purchasing power of household income, and this, along with a dropout of ongoing rush demand ahead of the tax hike, could weigh on household spending materially in early fiscal 2014 (starting April). Meanwhile, "policy offsets" designed to mitigate the negative impact of the tax hike may probably not be sufficient, in Citi's view.
- Citi analysts think Japan's policymakers continue to have a strong incentive to seek further yen depreciation to stimulate profits, lift inflation, and entrench higher inflationary expectations.
- In Citi's view, Japanese equities have entered a longer-term upward phase as it appears a medium-term trend toward yen weakness is underway..

Asia Pacific

Exports grow at moderate and uneven pace

- EM Asia exports continue to get a moderate and uneven lift from improving demand in advanced economies. Current accounts are improving noticeably in Indonesia, Malaysia, while India's is stabilizing at lower levels. External stability has given space for central banks in India and Indonesia to pause, while damage from escalating political risks is pushing Thailand to cut.
- Meanwhile in China, the key factors shaping the economic outlook in 2014 are reform initiatives, the rising cost of capital and export growth. In order to achieve around 7.5% growth, Chinese authorities may put growth ahead of reform, acting to curb money market rates after the Chinese New Year, and facilitate two-way volatility in the RMB market.
- From an equity point of view, Citi analysts look at the long term relationship between current accounts and stock market performance. They find that equity markets in big surplus countries have strongly outperformed those with big deficits.

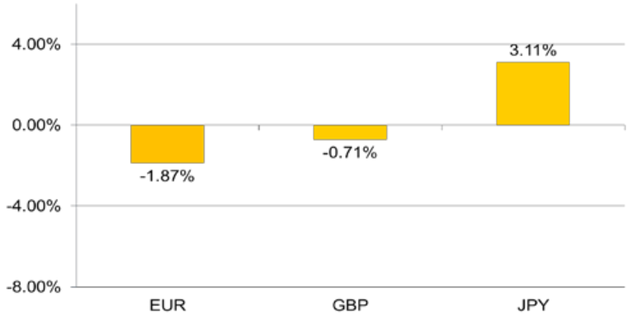
Emerging Markets

Further currency weakness expected

- The outlook for a strong export-led recovery remains uncertain in CEEMEA1, and a number of countries (Russia, South Africa and Turkey) have uncomfortably high inflation. Furthermore, of the major EM economies, the ones running the widest current account deficits are in CEEMEA: Turkey (6.9% of GDP) and South Africa (5.9% of GDP). As a result, Citi analysts are forecasting GDP growth to remain tepid at 2.8% in 2014.
- Following a contraction of 5.6% yoy in 2012, CEEMEA EPS is expected to contract further by 0.7% in 2013, and only rebound very modestly in 2014 (3.3%). As such, the EPS growth outlook is the weakest amongst the three EM regions. In terms of valuations, the region's PE multiple of 8.7x (2014E) is at a discount to the rest of EM. However, this is largely due to Russia's extremely low PE of 5.5x 2014E. Citi's MSCI EM EMEA target for end-2014 is 358and preferred market remains Russia.
- From an FX point of view, a number of CEEMEA currencies are looking increasingly weak: Turkey and South Africa top the list but Russia looks vulnerable too. In fact, the zloty and shekel are the only currencies in the region expected to strengthen over the next three months. On the other hand, Citi analysts see LatAm currency weakness extending in the near term, with BRL forecast to be a significant underperformer.
- Within LatAm, Citi analysts continue to expect sluggish growth in Brazil, and look for real GDP growth of only 2.0% in 2014. Conversely, GDP growth may rise to 3.8% in Mexico. Despite slow growth, the Selic rate should reach 10.75% in Brazil, while in Mexico, Banxico may remain on hold in 2014. In Argentina and Venezuela, macroeconomic imbalances continue to grow, leading to low growth and high inflation, and eroding international reserves.
- As for LatAm equities, Citi analysts are expecting reasonable EPS growth both for Mexico and Brazil in 2014E at 9% and 17% respectively. They prefer Mexico to Brazil as the region has the best exposure to an improving US. In particular, selected consumer stocks and REITs are favoured based on acceleration of growth into 2014.

Equities Markets

Chart 5: Currencies (1Mth vs US Dollar)



Performance data as of 31 January 2014
Source::: Bloomberg

Currencies

- In early 2014 trading, FX markets have replicated the broad patterns of the latter half of last year when Fed tapering/less expansive monetary policy began to be priced in. Thus far, we see less a generalised strong USD trend and more one of strength vs. EM currencies and commodity backed proxies like CAD and AUD. JPY, of course, remains on a completely divorced trend against most currencies. Meanwhile, some G10 currencies with strong fundamentals continue to trade relatively robustly vs. the USD, e.g. EUR and GBP.

- In the case of EUR, Citi analysts still see flows as potentially positive this year. The broad balance of payments surplus may run at 3% of GDP or more this year with a current account surplus dominating this but being augmented by equity inflows. A key risk would be if the ECB became more overtly unfriendly to the EUR by openly talking down the currency or engaging in QE-like monetary policy. Overall, Citi's medium-term forecasts are unchanged with 1.40 still the 6-12 month target.

- In the case of GBP, it is more a story of super-strong economic growth with associated risks that markets increasingly price in early tightening. Markets are likely to anticipate higher base rates in this environment, especially with the Bank of England's 7% unemployment rate threshold expected to be hit in the not too distant future. Accounting for the admittedly already strong GBP rally, Citi analysts project moderate further upside for GBP over both 0-3m and 6-12m horizons. They expect EUR/GBP at 0.81 and 0.80, respectively, which implies GBP/USD at 1.69 and 1.75, given their EUR/USD views.

- JPY is likely to be the weakest G10. With the BoJ committed to continue QE through end-2014. Citi economists think an additional package of around JPY15 trn may follow the raising of the sales tax in April and a further JPY60-70trn could be committed trough 2015. If so, and with the Fed expected to be long stopped by then, USD/JPY may have a lot more upside with 115 pencilled in for their 2-year forecast but much higher levels possible. In the near term, Citi analysts expect 105 in 0-3 months and 107 in 6-12 months.

Bond Markets

Positive on High Yield

US Treasuries

Citi analysts think that fundamental improvements in the economy in 2014 maybe more significant than 2013, but that Treasury yields may rise much more modestly. Citi's rationale is that much of the rise in Treasury yields in 2013 was a 'normalization' of yields from levels which were well below fundamental fair value. They continue to forecast 3.25% for the 10yr Treasury at year-end.

Euro Bonds

Citi analysts do not expect much change in Bund yields from current levels in coming quarters. Inflation remains very low (0.8% YoY) and the euro area recovery is modest. Citi analysts expect the front end of the EUR curve to decouple further from the US given Citi's forecast of further ECB easing. Meanwhile in UK, Citi analysts have brought forward the first rate hike to 4Q14 (previously 2Q15) and expect policy rates to move up to 2% by late-2015. This suggests that the 10yr gilt-Treasury spread could widen to around +30bp in a year from now and make us even more bearish on 10yr gilts vs Bunds.

IG Corporates

The threat of higher interest rates (not credit quality) remains the principal concern for high grade returns, particularly in the US and UK. Thus, Citi analysts continue to favour defensive duration exposure (3-7 years) and financials over non-financial debt (with a focus on US and core EU bank / insurance issuers).

High-Yield

Citi analysts maintain a constructive view on the High Yield sector. Mutual fund inflows have strengthened the technical backdrop and credit fundamentals remain relatively strong. However, the gradual rise in long-term rates may prove to be challenging. Thus, Citi analysts prefer to minimize long duration exposures.

Emerging Market Debt

Prevailing fiscal pressures and current account deficits may exacerbate deteriorating fundamentals, accompanied by weaker currencies and wider spreads. As such, Citi analysts remain underweight EM debt and prefer to focus on short duration opportunities and limit exposure to high-quality credits.

GENERAL DISCLOSURE

"Citi analysts" refers to investment professionals within Citi Research ("CR"), Citi Global Markets Inc. ("CGMI") and voting members of the Citi Global Investment Committee.

This document is based on information provided by Citigroup Investment Research, Citigroup Global Markets, Citigroup Global Wealth Management and Citigroup Alternative Investments. It is provided for your information only. It is not intended as an offer or solicitation for the purchase or sale of any security. Information in this document has been prepared without taking account of the objectives, financial situation or needs of any particular investor. Accordingly, investors should, before acting on the information, consider its appropriateness, having regard to their objectives, financial situation and needs. Any decision to purchase securities mentioned herein should be made based on a review of your particular circumstances with your financial adviser.

Investments referred to in this document are not recommendations of Citibank or its affiliates. Although information has been obtained from and is based upon sources that Citibank believes to be reliable, we do not guarantee its accuracy and it may be incomplete and condensed. All opinions, projections and estimates constitute the judgment of the author as of the date of publication and are subject to change without notice. Prices and availability of financial instruments also are subject to change without notice. Past performance is no guarantee of future results. Investment products are (i) not insured by any government agency; (ii) not a deposit or other obligation of, or guaranteed by, the depository institution; and (iii) subject to investment risks, including possible loss of the principal amount invested.

The document is not to be construed as a solicitation or recommendation of investment advice. Subject to the nature and contents of the document, the investments described herein are subject to fluctuations in price and/or value and investors may get back less than originally invested. Certain high-volatility investments can be subject to sudden and large falls in value that could equal the amount invested. Certain investments contained in the document may have tax implications for private customers whereby levels and basis of taxation may be subject to change. Citibank does not provide tax advice and investors should seek advice from a tax adviser. Citibank N.A., London Branch is authorised and regulated by the Office of the Comptroller of the Currency (USA) and authorised by the Prudential Regulation Authority. Subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details about the extent of our regulation by the Prudential Regulation Authority are available from us on request. Our firm reference number with our UK regulators is 124704. Citibank International plc is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority. Our firm reference number with our UK regulators is 122342. Citibank N.A., London Branch and Citibank International plc are licensed by the Office of Fair Trading with licence numbers 0001486 and 0482552 respectively to extend credit under the Consumer Credit Act 2006. Citibank N.A., London Branch is registered as a branch in the UK at Citigroup Centre, Canada Square, Canary Wharf, London E14 5LB. Registered number BR001018. Citibank International plc has its registered office at Citigroup Centre, Canada Square, Canary Wharf, London E14 5LB. Registered number 01088249. Citibank N.A., Jersey Branch is regulated by the Jersey Financial Services Commission under the Financial Services (Jersey) Law 1998 for the conduct of investment business and under the Banking Business (Jersey) Law 1991 for the conduct of deposit taking business. Citi International Personal Bank is registered in Jersey as a business name of Citibank N.A. The address of Citibank N.A., Jersey Branch is P.O. Box 104, 38 Esplanade, St Helier, Jersey JE4 8QB. Citibank N.A. is incorporated with limited liability in the USA. Head office: 399 Park Avenue, New York, NY 10043, USA. Calls may be monitored or recorded for training and service quality purposes.