

MARKET OUTLOOK

June 2013



Equities Rally Drive Global Re-rating

Since the lows of 2011, global equities have rallied 30% while Earnings per Share remained flat. This has been the biggest mid-cycle re-rating of global equities in over 40 years, according to Citi analysts. This re-rating obviously raises the question of equities attractiveness, particularly in a context where investors increasingly fear the end of monetary stimulus.

Citigold

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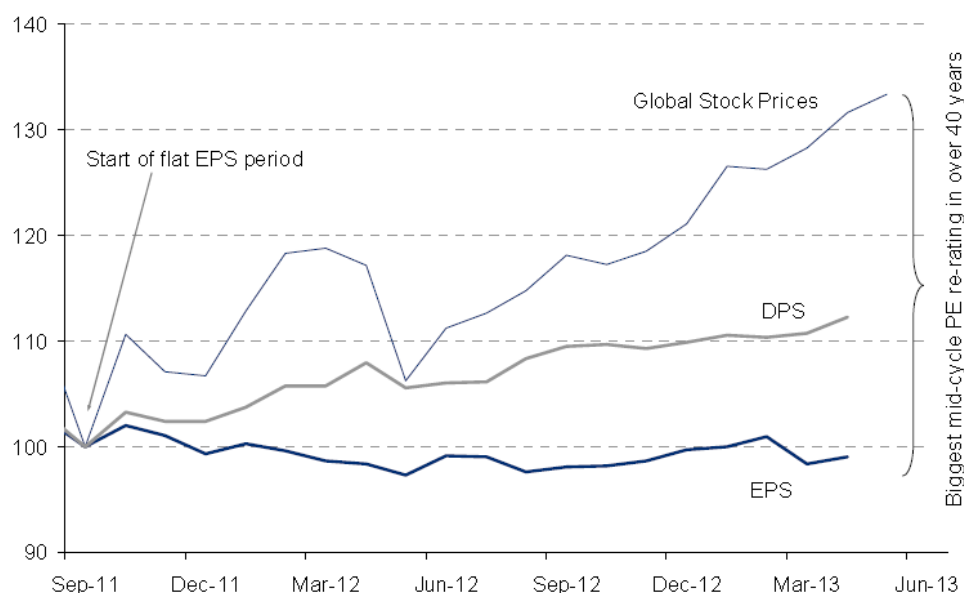
Feature

Equities Rally Drive Global Re-rating

Global equities have rallied more than 30% since the 2011 lows but EPS have been flat. Re-ratings like this are normal during the start of market recoveries like 2009, but are unusual during mid-cycles. In fact we have just had the biggest mid-cycle re-rating in over 40 years, according to Citi analysts. Stock market valuations still look cheap relative to bonds and cash, but they no longer look exceptionally attractive relative to their own history. Citi analysts believe that the re-rating over the last 18 months means that investors should expect weaker through-the-cycle returns from here. Current dividend yields suggest the biggest 10-year forward returns will be in Asia and Australia and the weakest in Japan and the US.

The current risk-on phase in global equities has pushed many equity indices to new highs. Most celebrated have been the new highs in US stock indices. But we also find the major indices in Germany, India, Indonesia, Malaysia, the Philippines, South Africa, Thailand, Turkey and the UK are at or above previous peaks. However, the 30% increase in stock prices has been against a backdrop of flat EPS (Figure 1). Global equities traded on 12x trailing EPS in Sep 2011 versus 16x now.

Figure1: Price up, EPS Flat = Biggest Mid-Cycle Re-rating in Over 40 Years



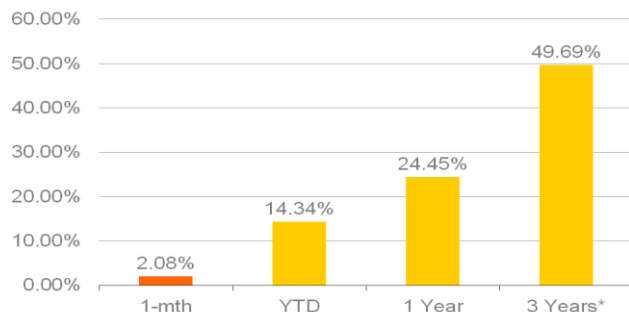
Sources: Citi Investment Research & Analysis, Bloomberg, MSCI

So why have stock prices increased even though EPS have not? Citi analysts argue that much of the gain could be down to simple reversion-to-the-mean re-rating. Indeed, at 12x PE global equities traded on a 30% discount to the long-run average; now they trade pretty close to averages. Also, they say that the global “search for yield” has been another obvious driver. Investors have drifted out of low yielding assets into equities where yields are higher. Companies have attempted to fulfil the requirements of these new equity investors by raising dividends, even though EPS have been flat. As shown in Figure 1, global DPS have increased by an average of 12% over this period and have helped to fill the gap between prices and EPS. The global re-rating on PEs has been large, the re-rating on dividend yields has been less so.

Where does that leave valuations now compared with history? While global equities look cheap compared with bonds and cash, they no longer look as attractive when compared with their own history. Global equity valuations have moved back closer to 40-year averages although the big PE re-rating for Australia, Latin America and Europe ex UK means that these markets now look slightly expensive on PEs. Going further, Citi analysts expect further gains supported by moderate EPS growth and dividend increases. But valuations imply less impressive gains from here. The current dividend yield suggests 10-year forward global equity returns should be nearer to 6-7% p.a. down from 9-10% 18 months ago. Dividend yields imply the best future returns should be in Asia ex Japan and Australian equities and the weakest in Japan and the US.

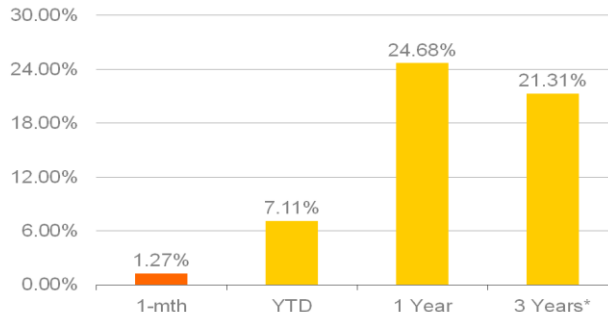
Equity markets

Chart 1:
S&P 500 Index



*Denotes cumulative performance
Performance data as of 31 May 2013
Source: Bloomberg

Chart 2:
MSCI Europe Index



*Denotes cumulative performance
Performance data as of 31 May 2013
Source: Bloomberg

United States QE tapering expected as of September

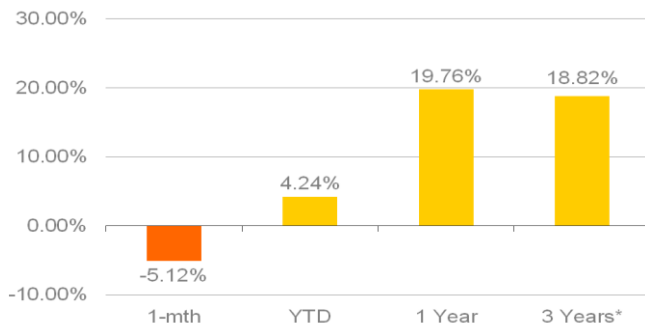
- Despite some very near-term softening in activity, Citi analysts continue to expect economic growth this year near 2½% (4Q/4Q). Support for expansion has improved with sustained job growth, more effective monetary accommodation, and the spillover effects of reviving housing.
- The Federal Reserve's aggressive forward guidance and open-ended bond-buying have contributed to extremely accommodative financial conditions. But a dip in Q2 growth and officials' high bar for a satisfactory jobs outlook will likely sustain QE at the current pace into the second half, according to Citi analysts. They expect an initial tapering of QE by September but purchases could extend at a slower rate until next spring when unemployment is expected to drop below 7%. Low inflation suggests policymakers will be slow to signal a start to exit strategies through most or all of 2014.
- Despite stretched valuations (cyclically-adjusted price-to-earnings ratio of 23x), margins at near-record highs and a scant dividend yield, we believe that the US is likely to sustain cyclical leadership in both economic and earnings growth. Signs of economic recovery have been reflected in an improving housing market, stabilizing PMIs, resilient earnings and a pick-up in capital spending which will provide positive momentum for US markets.
- Indeed, 1H13 strength could be maintained as sentiment, valuation, implied earning growth and credit conditions support the rally. But European economic woes, a possible pullback in QE and the battles over a new budget for FY2014 could cause a mild market setback in 2H13.

Euro-Area Grexit no longer in base case scenario

- Citi analysts think that economic activity is likely to contract further into the second half of 2013, likely prompting the ECB to cut its main refinancing rate again by 25bp to 0.25% as the scenario of a recovery continues to be pushed back. Positive financial market sentiment, if it were to persist, should help the economy stabilize during 2014.
- Citi analysts indeed cut their euro area 2013 GDP forecasts slightly to -0.7% YY from -0.6%, but raised their 2014 estimate to +0.0% from -0.3%. There are two main drivers behind these revisions. First, the 1Q GDP estimate disappointed slightly, particularly from Germany, together with evidence of continued underlying weakness in the soft core. Second, they no longer expect Greece to leave the euro area in 2014, removing the downward bias in their baseline forecast around year-end.
- The economic situation in Europe remains challenging. Unemployment rates in most countries continue to rise. Recent manufacturing PMI have remained in contraction territory even in Germany and France. However, with the ECB's continued back stop to governments and banks, and German politicians' concerns for stability in the run-up for German elections, the possibility of a major crisis seems less likely – at least in the short term. With valuations still extremely cheap (a cyclically-adjusted price-to-earnings ratio of 13x), Citi analysts maintain their small overweight to European large cap equities, with emphasis in the core.
- In particular, Citi analysts favour 3 key strategies: 1) companies with earnings momentum, balance sheet strength, US exposure, 2) high surplus cash flow stocks with strong balance sheets, and 3) European Financials with strong capital positions and attractive income characteristics.

Equity markets

Chart 3:
MSCI Asia Pacific Index



*Denotes cumulative performance
Performance data as of 31 May 2013
Source: Bloomberg

Japan

Focus expected to shift to fundamentals

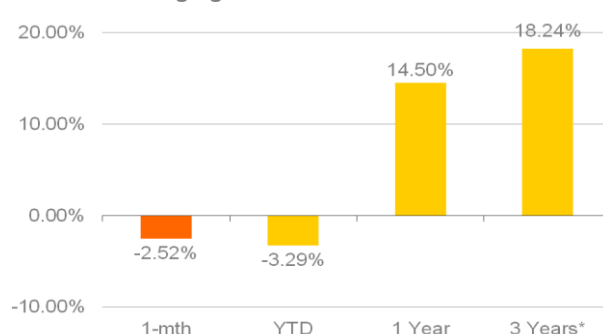
- The Bank of Japan (BoJ) has demonstrated its commitment to aggressive monetary easing at their last meeting, with the intent to overcome deflation. Haruhiko Kuroda, the newly-nominated BoJ governor, has pledged to double the monetary base over two years through the aggressive purchase of long term bonds in order to achieve its 2% inflation target. We may, therefore, start to see inflation expectations leak higher, as well as Japanese government bond yields.
- From here, Citi analysts expect financial markets to gradually shift their focus to developments of: 1) Economic fundamentals, 2) the growth strategy that the Abe administration plans to publish in June.

Asia Pacific

May play catch up in medium term

- The recent data coming out of China have been mixed. PMI data, after a period of strength, is now pointing to decelerating manufacturing growth. China seems to be facing a policy dilemma between deflating property prices and boosting the economy. With weak global demand, China has come to rely on investment spending in infrastructure and property to support growth – precisely those sectors that it is trying to curb excesses in.
- They Asia's growth prospects seem to be improving with the help of external demand, especially with positive surprises from the US. Export-oriented economies, such as Taiwan and South Korea, will be the first to benefit should global consumption improve. Therefore Citi analysts remain neutral on Asia ex Japan.

Chart 4:
MSCI Emerging Markets Index



*Denotes cumulative performance
Performance data as of 31 May 2013
Source: Bloomberg

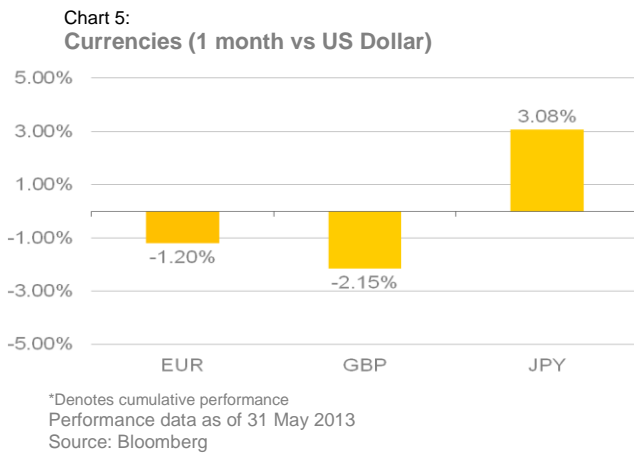
Emerging Markets

Further EPS disappointment likely in Emerging Europe

- The fundamentals for many emerging market (EM) countries remain attractive relative to both history and most developed countries. In addition, by starting from higher interest rates, EM central banks have greater scope to loosen monetary policy. Moreover, potential inflows from Japanese investors (prompted by the Bank of Japan's asset purchase program) are likely to support further spread tightening, according to Citi analysts.
- The 2013 EPS growth expectation for emerging markets (EM) have risen significantly. There appears however to be room for further disappointment in Central Eastern Europe, Middle East and Africa (CEEMEA), given the uncertainty regarding the ongoing Eurozone crisis.
- Central banks in Turkey, Israel, Poland and Serbia have all, in the past few weeks, cut rates by more than expected, earlier than expected, or completely out of the blue. This is a good reflection of the fall in inflationary pressures that have been induced by weak economic activity and subdued commodity prices.
- Citi analysts have recently cut their Brazil growth forecasts for 2013 and 2014, but still expect that COPOM will only make three 25bps hikes. They also downgraded their Mexico growth forecast, but do not expect additional monetary easing. The drop in central bank reserves in Argentina has led the authorities to raise interest rates and strengthen import controls.
- After a prolonged period of underperformance, EM equities are now beginning to look like good value. Using cyclically-adjusted PE ratios, emerging markets now trade at 15x versus developed markets 20x. This is much cheaper than in the 2007 when emerging stocks traded at a seven point premium to developed stocks.

Currencies

Bond markets



Currencies

- The market focus on QE scale back discussion has resumed more recently following strong revisions to payrolls, more encouraging data and Fed's acknowledgement tapering could come in the months ahead. Citi analysts keep an eye on inflation expectations but they think that consistent growth in the labor market is likely the most important gauge for policy direction at this stage. To the extent which further relative outperformance of US data continues to support capital inflows, the presently more risk-correlated USD could persist.
- Citi analysts remain bearish on the EUR over the medium term. At the most recent ECB meeting, the main refinancing rate was cut 25bp and President Draghi indicated the ECB was operationally ready for negative rates. Mr. Draghi highlighted downside risks to the current economic outlook and that the ECB continues to stand ready to act. Citi analysts see EUR risks as continuing to be on the downside given the rather limited growth impact that the rate cut could have and that further rate cuts should make EUR an even more attractive funding currency.
- Sterling lost ground more recently following another weak retail sales release and evidence that 'rebalancing' ambitions have yet to produce results. Weak data could highlight the downside risks to the BoE's latest somewhat optimistic growth projections.
- Citi analysts believe Japanese policymakers may need to introduce further easing measures before achieving 2% inflation. In the near term markets are likely to pay attention to the heightened JGB volatility and Abe's growth reforms. Citi analysts doubt that the recent spike in yields will attract foreign demand given the accompanied volatility and continue to see risks for JPY on the downside.

Positive on High-grade corporates and Emerging market debt

US Treasuries

Citi analysts remain cautious on the outlook for rate-sensitive fixed income markets. As medium term growth prospects improve and the market begins to reflect expectations that the Fed will incrementally normalize monetary policy, they expect to see gradually rising yields especially for US treasuries over the next few years.

IG Corporates

As the economic recovery gains traction, Citi analysts expect interest rate to increase, thus returns on investment grade bonds are likely to moderate from the spectacular levels of the past. While they expect rising rates to have a negative impact on corporate credit, Citi analysts believe this will be somewhat offset by tightening credit spreads.

High-Yield

Further stimulus in the US and Europe has helped to bolster risky assets, and Citi analysts believe that high yield presents a lower-beta alternative to equity exposure. Despite historically low yields and less attractive valuations, risk-on momentum is likely to generate further positive returns as appetite for yield and easy monetary policies persist.

Emerging Market Debt

Debt markets in emerging nations have benefitted from improved fiscal balances and more credible monetary regimes. Easing inflation pressures allow central banks more room to ease (or at least, not hike), boosting fixed income asset markets.

Euro Bonds

Citi analysts believe that core rates are likely to be range-bound near term as recession, political instability in Italy and two more ECB rate cuts this year are likely to weigh heavily on Core European yield curves.

Japan Bonds

Citi analysts think that we might start to see inflation expectations leak higher, as well as Japanese government bond yields. Though reaction is likely to be minimal due to the current investor base, they maintain no position in Japanese government bonds.

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