Global Market Analysis by Citi EMEA Regional Consumer Bank

Standpoint

Annual Outlook

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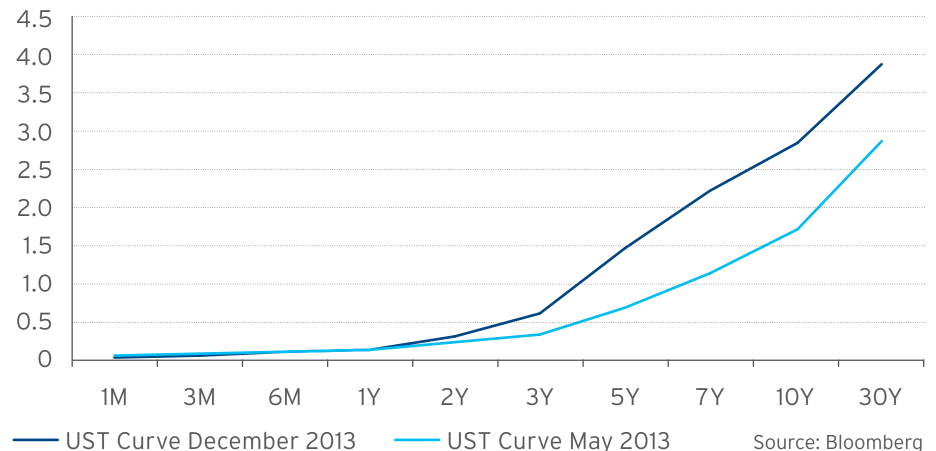
Global Context in 2014

New Year, New Cycle, New Era

As we reach the turn of the year, it is a classic exercise to revisit what happened during the past year and try to determine what could be the economic and markets drivers of the year to come and whether any major trend is going to change or emerge. Obviously, markets and economic trends are not influenced by the turn of a calendar, though the turn to 2013 which coincided with the US Fiscal cliff deadline could have turned out dramatic indeed. However, as the US economy started to show signs of sustainable growth recovery and the US Fed dared envisaging the end of its unlimited Quantitative Easing (QE) program, it seems obvious that we have reached crossroads, and not just the turn of a new year. From a cyclical perspective, the US Fed mentioned for the first time the possibility of tapering its Treasury purchase program, not because as in the case of QE1 and QE2 the program has reached its deadline, but because the US economy was improving and progressively achieving performances which would no longer justify such a large amount of monetary support. After 5 years of unprecedented monetary easing, the US economy is starting to show signs of sustainability and taper can be envisaged. Definitely the turn of a cycle, but not only that. Indeed, as taper has been envisaged for the first time by the Fed, Treasury yields have soared during the summer highlighting two implications: monetary transition will be complicated, and the great bond bull market era was coming to an end. After 32 years of continuous yields decrease which allowed strong returns, generous incomes and safety for bond investors, the trend of Treasury yields has changed its course which in the near term drove a significant steepening of the US yield curve.

US Yield Curve Steepening



"While the change in the yields trend doesn't necessarily imply a long and painful bear market for bonds, it will certainly require a change in investment behaviour for traditional bonds investors in the coming years"

New year, new cycle, new era, 2014 will be marked by a number of brand new challenges with higher yields, quantitative easing taper, increasing US energy autonomy, crucial phases in the European crisis and in Japan's desperate reflation plans or deep reforms in the Chinese economy which will probably accelerate the end of the commodity super cycle and further weigh on Emerging Markets as a whole. In many aspects the world in 2014 will be much different from what it was one or two years ago, and in many aspects it will be for the better.

New Monetary Policy Context

Monetary policy has been the key driver of markets for the last 5 years. QE in the US and UK, LTRO in Europe, Abenomics in Japan, aggressive easing drove yields lower and equity prices higher in absence of sustainable economic improvement in developed markets. In 2013 Markets have been very sensitive to the monetary policy topic, but in the US the story was no longer about expansion, but about taper. In 2014, engaging the withdrawing of the QE monetary policy in the US will probably be one of the key to markets returns.

How do we know markets are ready to accept QE taper? In order to see a smoother market acceptance of taper, we will probably have to see a further normalization of the US yield curve, i.e. a progressive steepening of the curve happening along with further improving economic data.

"Investors should remember that employment gains are no threat to the economic expansion"

Steven Wieting
Chief Investment Strategy, Citi Private Bank

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Secondly, when good news will be seen as good news. Indeed, during the second half of 2013, most of data illustrating better economic performances where accompanied by fears of monetary taper which had a negative impact on markets. Citi analysts think that this somehow paradoxical negative correlation between markets and economic data will reverse when investors see that better economic data are actually generating direct returns for them, in other words when they start being echoed in corporate earnings growth.

Also, despite talks of taper, US monetary policy is likely to continue being highly accommodative. Even after the Fed begins to taper its securities purchases, most likely early in 2014, Federal Reserve policy will remain expansionary. And even if tapering commences as anticipated, the size of the Fed's balance sheet will likely expand through most of next year. It has also become clear from the confirmation hearings of the likely next Fed Chair, Janet Yellen, that policymakers don't see rate hikes as a serious possibility until well into 2015.

Japan is nowhere near any monetary support withdrawal. In the contrary, Japan continues to pursue the cyclical targets of ending deflation, moving to 2% inflation, and closing the output gap. To date, the major instruments used have been a temporary fiscal stimulus and, more notably, an unprecedented expansion of the Bank of Japan's balance sheet and the monetary base (which is slated to double from its end-2012 level by the end of 2014). While this aggressive policy mix can make headway in defeating the deflationary demons that have long plagued Japan, even more stimulus may be required. In particular, the sales tax increases scheduled for April 2014 and October 2015 could kill the budding recovery. Therefore, Citi analysts think that the Bank of Japan is prepared do more, likely next summer.

In the euro area, besides structural and fiscal headwinds, the recovery has received less support from monetary policy than has been the case in many other advanced economies. The recent drop in inflation to around 3/4%, well below the ECB's 2% objective, prompted a modest rate cut at the central bank's November meeting. But the ECB has failed to use all its policy tools to aggressively counter the disinflationary – even deflationary – risks that appear to be taking hold.

> "Even if outright deflation is avoided, the ECB's stance seems too restrictive: Unemployment is running high, at 12.2%, and there is excess capacity in most individual member states"
>
> **Willem Buiter**
> Citi Chief Economist

Yet the ECB has allowed its balance sheet to shrink significantly since the end of 2012, and was unwilling until recently to cut the refi rate. Perhaps more worrying, policymakers seem constrained regarding the use of additional policy tools, with little

Economic Forecasts Table

	GDP Growth	CPI Inflation
United States	2.7	1.8
Japan	1.6	2.3
United Kingdom	3.2	2
Euro Area	0.9	0.9
Germany	1.9	1.5
France	0.8	1.2
Italy	0.2	0.2
Spain	0.2	-0.4
Greece	-1.9	-2.9
Czech Rep.	1.9	1.2
Hungary	1.9	1.5
Poland	3.1	1.9
Russia	2.6	5.3
Brazil	2	6
China	7.3	3.3
India	5.6	5

Source: Citi Research

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consensus regarding another LTRO, a cut in the deposit rate into negative territory (which might help weaken the external value of the euro) or credit easing measures aimed directly at lowering the cost and increasing the availability of credit for Small and Medium Enterprises, especially in the periphery.

Monetary policy in EMs was disproportionately affected by external conditions during 2013. Citi analysts expect a similar situation for 2014. Despite the mild hysteria in financial markets, the Fed's "taper talk" through the late spring and summer does not appear to have done significant damage even to the worst-affected EMs. Citi analysts think that despite some fragilities, EMs were in a better position to respond to the yield shock and live with it than in the past. No doubt when tapering is actually implemented there will again be some financial arrhythmia and another rush out of EM securities and currencies. But Citi analysts believe that the effects of this on the real economies will likely be minor, partly muffled by the use of monetary policy. The countries to watch remain those with: (1) a prior domestic credit boom/bubble; (2) an open capital account; and (3) external vulnerability through a large current account deficit and a large stock of foreign currency liabilities.

Europe and Austerity

Citi analysts already argued earlier in 2013 that the slowdown in the pace of fiscal consolidation had been a major driver behind the improvement in domestic demand recorded in the euro area since last spring. A look at the 2014 country budget drafts submitted to the EU Commission in October indicates that this slowdown is likely to continue in 2014, when fiscal policy at the aggregate euro area level is likely to be broadly neutral. However, they think that an improvement in the cyclical fiscal position should generate another small drop in the euro area budget deficit from around 3% in 2013 to 2.6% in 2014. Yet, the more relaxed stance from policymakers and markets on fiscal developments implies that the fiscal position is unlikely to improve much in their view, especially in those countries like Spain where economic rebalancing makes cutting government deficits more difficult. Some pressure may increase again on Spain and Italy to deliver more consolidation, but they think fiscal deficits in these countries will generally remain somewhat higher than currently envisaged, adding further upside pressure on public debts.

> "An additional layer of uncertainty on the deficit projections may stem from the expected fall in inflation"
>
> **Giada Giani**
> European Economist Citi.

While lower inflation is a positive development for real disposable income and spending, especially in periphery countries, it is also likely to have more negative effects on tax revenues than implicitly embedded in the budget plans. Citi analysts find that nominal GDP growth forecasts contained in the budget plans are generally overly optimistic. Therefore, even if real GDP growth develops broadly according to plans, 2014 nominal GDPs are still likely to underperform by some margin the assumptions made in the budgetary plans, generating upside risks on the headline deficits

Implementing Reforms in China

Citi analysts believe that the reforms laid out in the 3rd plenum should help China avoid a near-term hard landing and kick off the country's long-awaited structural rebalancing in 2014-2020. If properly implemented, they will reshape China's economy and the equity market, with government intervention giving way to market forces. Their base case calls for a smooth reform process and 8.6% earnings growth in 2014. But before pressing ahead, the economy may slow and cause volatility in company profits. Businesses may put investment decisions on hold, fearing negative consequences from the reforms. Also, Deregulation would trigger consolidation in the manufacturing and services sectors, but Sovereign Owned Enterprises (SOEs) could break up. To escape the middle-income trap and for firms to retain competitiveness, innovation is a must for China.

Commodity super cycle eases further

The downward shift in China's economic growth rate combined with the decline in the commodity intensity of growth will have a permanent and profound impact on global markets, according to Citi analysts. China has reached a new phase, less focused on infrastructure and urbanization, both of which are highly commodity intensive. Lower single-digit economic growth shifting to a greater emphasis on consumption rather than investment hits industrial metals, bulk commodities and to a lesser degree energy demand.

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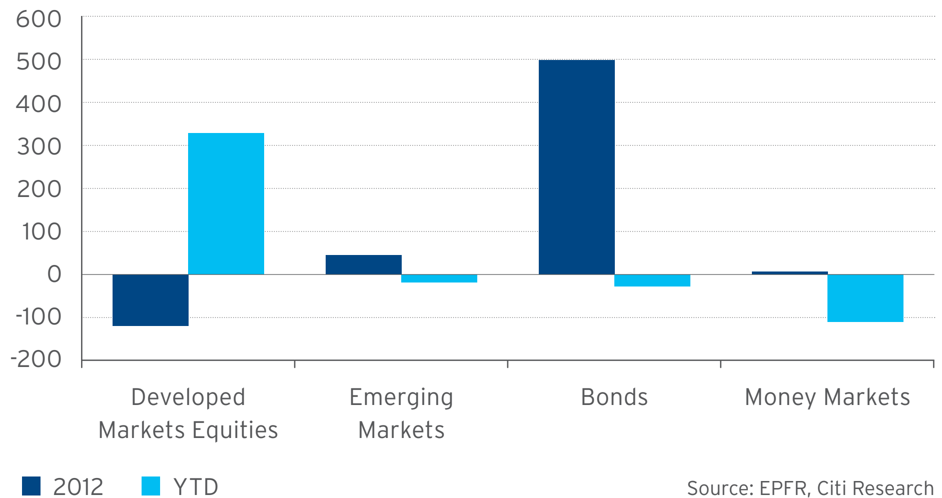
"It will be a period of focus on unique individual commodity cycles and new relations emerging between and among commodities and other asset classes from fixed income to foreign exchange to global equities"

Edward Morse,
Global Head Commodities Citi.

The denomination effects of changes in the relative value of the US dollar is likewise going to continue to impact commodities, and Citi's long-term bullish view of the US dollar is likely to place an even further drag across the asset class this year. But to the degree that commodity-producing countries depend on specific commodity exports, differentiated conditions should impact the FX values of different commodity currencies in varied ways as well, providing further opportunities for investors.

Citi analysts anticipate that for the next few years, each commodity looks more likely to be sitting on its individual supply/demand fundamentals than on more general factors affecting all of them. This means that as either their separate long-term and short-term cyclical logistics take over, for some prices will rise while for others they will decline, and it will be more complicated for investors to find appropriate exposure across commodities as long/short rather than long only strategies will be required to deliver alpha.

Flows By Asset Class (USD Billions, December 2013)



Source: EPFR, Citi Research

Great Rotation: Myth or Reality?

2013 has brought us signs of a rotation of capital flows. The reduction in macro risk, improvement in data releases and continuation of cheap money have contributed to the reversal of the flow trends we've seen in the past few years: bond inflows and equity outflows (at least in Developed Markets). Between 2007 and 2012 equity funds globally suffered from outflows of almost $180bn, which represent the equivalent of 5% of assets under management (AUM), according to EPFR data, while bond funds enjoyed record inflows of $1.2tr (45% of AUM).

The first half of 2013 saw inflows into both assets but since June bond inflows have reversed, with outflows of $178bn, or 3.5% of assets under management. This is a modest reversal in the context of the flows of the past 5-6 years, but perhaps early signs that rotation is on its way. In particular, Citi analysts observe that Western European funds appear to be the main beneficiary of the funds flow rotation. Indeed, since June they've attracted $36bn (or 4.4% of AUM). This has been a sharp reversal of the previous 5-6 years, when European funds have been hit most by outflows. Since June, only Japanese funds have benefitted from similarly strong inflows, while US funds have attracted more modest inflows of 1.3% of AUM. EM funds, equity and bonds combined, have suffered from redemptions of -2.9% of AUM. Going forward, Institutional Investors and Pension Funds in particular will play a key role in determining the pace of the flow rotation. Indeed, they are the main buyer of fixed income instruments and are currently increasing their allocation to bonds to match future liabilities obligations on the back of low yields.

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Equities

Earnings and Dividends Growth

The Great Rerating

While Global equities have risen 40% in the past two years, global earnings per share (EPS) have stayed flat driving the MSCI World index to rerate from 12x to 17x price-to-earnings (P/E). With the valuation close to the long-run median, many investors now question the sustainability of this rerating driven bull market. In order to assess the risk related to the rerating, understanding the context is key. Two years ago investors were pricing doom scenarios for the world economy, including the collapse of the Euro Area, sovereign debt default contagion among developed countries, ineffectiveness of monetary policy in the US and in the UK and overall incapability of political leaders across the world to drive the necessary reforms. At that time, some markets were even trading below their book value. One can certainly question the appropriateness or the speed at which reforms are being implemented, or sometimes forced, but two years later these doom scenarios have not occurred and uncertainties have receded. In other words, the world today is a much better place to be invested. In that respect, it is not really a surprise to see that the equity regions which collected the most inflows were those where concerns were the deepest, like Europe.

Also, while global equities are no longer as cheap as they were in 2011, they do not yet look particularly expensive either. Citi's view may not be as bullish on global equities as it was two years ago, but our analysts still expect a double digit gain in the MSCI World benchmark by the end of 2014, with half of this increase to be driven by a resumption of EPS growth. Going forward, the EPS growth contribution to equities return will be crucial. As the world is a better place to be invested, and as it is fairly reflected in equity valuations, earnings have to rebound and reflect this broad economic context improvement. Fortunately, the core scenario of Citi analysts anticipate a return of EPS growth of 7% next year driven by improving GDP growth in particular in the US, UK and Japan in an still extremely accommodative monetary policy context.

Dividends Matter Too

Reducing the performance of equities to a simple sentiment improvement factor would be underestimating the importance of dividends. Indeed, Citi analysts observe that as dividend yields surpassed bonds yields for the first time in half a century, a non-negligible number of income seeking investors have increased their equity allocation in their search for new sources of yield. Although global equities no longer yield more than the benchmark 10-year US Treasury bonds, dividend yield is high in relation to the long term average, given that US Treasury have historically traded at twice the yield of global equities. It is too early to say that the global dividend obsession is over as equities still yield more than government bonds in most major equity markets. The key message here is, as good dividend yields and dividend growth continue to attract income-hungry capital to the equity asset class, global equities may slowly rise over the medium term with investors focusing on dividends rather than earnings.

Investment Strategy: Dividend Growth Strategies

The global payout ratio (Dividend per share/EPS) has risen to 42% since 2011, but it is still well below the long-run median. Indeed, an increase to this level would imply another 10% increase in the global dividend base. A rise to a 50% payout ratio (which would not be unreasonable given the general lack of good capital expenditure opportunities) would imply dividends of 20% higher. Understanding that investors want higher dividends, Citi analysts recognize that many companies have the scope for higher payout.

Citi analysts currently expect global dividends to rise by 7.7% in 2013, and by another 7.9% in 2014. With forecasts for global EPS of 8.3% in 2013 and 11.8% in 2014, the consensus view is that payout ratios are expected to stay fairly flat over the next two years. While the market is likely to be more concerned about meeting dividend than earnings expectations, Citi analysts anticipate that these forecasts may have to be revised up as companies continue to lift payout ratios from what are still conservative levels.

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Fixed Income

Normalization rather than Bear Market

The last 12 months have been particularly difficult for bonds. Outflows from Emerging Markets on the back current account deterioration fears, increase of debt leverage among corporate, but most importantly, Treasury yields, in particular in the US, have started to rise. Although yields have trended lower on a continuous basis over the last 35 years, this is not the first time yields rise. It typically happens every time an economic recovery becomes sustainable and gives birth to an expansion phase. However, starting from such a low absolute level, it seems hard to believe that after a short term period of normalization, yields will resume their long downwards trend. Since US Treasury yields reached their lowest levels in July 2012, global government bonds have gone through a maximum drawdown of 8.5% (based on the Citi World Government Bonds Index). This is not much in comparison with the equity selloff of 2008, but from a bond perspective, this is the worst period in 40 years, and on the basis of the 10 years US Treasury yields of July 2012, it represents more than 5 years of coupon. During that period, 10 years yield actually barely increased by 160 basis points to a maximum of 3% which is still largely below the average 4.5% observed during the last phase of expansion between 2003 and 2007. On the back of relatively optimistic economic expectations Citi analysts think that 2014 is likely to be a year when we see more of that 'normalization'. The question to ask is: what does normalization mean following a 30-year drop in 10yr Treasury yields from above 15% in 1981 to below 1.5% in 2012?

Our analysts anticipate that the term premium can rise further as expectations of QE taper draws closer, which means it may still be too early to expect a reversal in curve performance. However, they believe that the rise in term premium during a period of moderating Fed Funds expectations also provides some comfort that investor reaction is likely to be relatively moderate should QE tapering expectations ratchet back in. They continue to see the 2.40 – 2.75% range in 10yr Treasuries to be reasonable in the start of the year. Even in the event of a sooner than anticipated surprise taper, they think that the upper end of the range might only be extended to about 2.85%. However, as taper starts later in the year, they do expect 10yr yields to move safely above 3% in 2014 and end the year around 3.3%. Going further, they estimate that on the basis of the longer term historical relationship between yields and GDP growth, Treasury yield would hit the top of the cycle at just above 4%, which they think is still a few years away from now.

Investment Strategy – Decoupling Capital Preservation and Income Goals

Whether on the path of Normalization or, worse, of a Bear market, the change in the yields trend pattern requires also new approaches when investing in bonds. Over the last 40 years, investing in bonds meant at the same time stable returns, sustainable income and capital preservation. This was the ideal combination for investors seeking capital preservation and income but going forward, investors will have to focus on one goal. In terms of income generation strategies, investors will have to diversify their sources of income, by increasing their exposure to asset classes generating growth related sources of income such as equity dividends, or to reduce the overall credit quality of their portfolio by investing in high yields bonds which not only offer higher yields, but also better protection against the risk of rising yields. However, these strategies will also mean accepting more sources of capital volatility in portfolios. Investors who prefer to focus on capital preservation will have to be more dynamic in terms of duration management. Particularly, reducing the overall duration of their bond portfolio during the phase of yield increase reduce the negative impact of rising yields, but this will also mean more muted returns. A time where choices will have to be made.

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Emerging Markets

A New Cycle Requires a New Approach

Unusual Underperformance

Whether from an equity or bond perspective, Emerging Markets (EM) investing used to be a pretty straightforward story: commodity super-cycle and Chinese growth driving stock prices ever higher whilst healthy balance sheets in terms of current accounts or debt to GDP levels combined with stronger currencies and high yields ensured solid gains for bond investors. However, 2013 was a particularly poor year for EM asset classes. Interestingly, over the last 15 years, EM equities underperformed Global equities in a context of positive return for global equities only in 1997 and 1998. On the bond side, over the same period EM bonds delivered negative returns on a calendar year in 2 instances: 1998 and 2008.

Three Challenges for EM

Citi analysts think that the performance of Emerging Markets asset classes going forward will be influenced by three main factors. The first is about the future of capital flows to EM: will Fed 'tapering' and the prospect of US monetary tightening cause sustained outflows from EM? The second is about EM's export recovery: will EM's recent export slump ever reverse? And the third is about China: will 'China risk' re-emerge as a threat to EM growth? Overall they find it difficult to come up with optimistic answers to any of these concerns. In particular, EM's sensitivity to rising US Treasury yields was a dominant theme of 2013, and it would probably be prudent to assume that further increases in US Treasury yields will remain a source of stress for EM currencies and bond markets. That said, Citi analysts don't believe that EM are on the verge of a new major crisis as the economic, monetary and fiscal pillars of EM economies are much more sustainable than they were 15 years ago. Indeed, there are substantial differences between EM now and then: the accumulation of FX reserves in recent years has created big pools of 'self-insurance'; pegged exchange rate regimes have, for the most part, given way to floating exchange rates; and the composition of capital flows has improved in the sense that currency risk is better-shared these days between debtors and creditors, whereas in the past it resided mostly with debtors in EM. There are also market participants these days that are truly optimistic about EM: the risks facing this group of economies are increasingly well-understood as the perception of those risks is, to some degree, reflected in asset prices now and there probably isn't a strong case to argue that EM faces a crisis. Indeed, Citi analysts expect rather a series of smaller adjustments in asset prices as investors get used to a world where EM is no longer characterized by rapid, export-led growth and large accumulations of FX reserves; but is driven instead by slower growth, slightly weaker sovereign balance sheets, and more reliance on domestic spending. They also recognize that in a challenging context greater differentiation should be made within Emerging Countries between reforming (China, Mexico), fragile (Brazil, Turkey, India, Indonesia), stable (Honk-Kong, South Korea) and a new group of fast growing economies called Frontier Markets.

Investment Strategy – The Call of the Frontier

With the underperformance of Emerging Markets and BRIC in particular, Frontier Markets offer an increasingly attractive diversifier to the classic approach to Emerging Markets investment. Indeed, from a fundamental perspective, Frontier Markets offer stronger economic attributes than BRIC in terms of demographics, younger population with higher potential productivity gains, and competitiveness with production costs largely inferior to those of BRIC countries. Frontier Markets have also offered stronger resilience to yields increase in 2013 as no major Frontier Market country belongs to the group of "weak" countries while the most at-risk countries represent a third |of Emerging Markets capitalization, among which two BRIC (India and Brazil).

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Citi Forecasts Tables

2014 Trade and Debt Forecasts

% of GDP	Current Balance	Government Debt
United States	-2	107
Japan	1.6	246
Euro Area	2.6	98
Germany	6.8	76
France	-0.8	96
Italy	1.4	137
Spain	2.1	101
Greece	1.6	190
United	-3	95
China	2	45
India	-2.4	66
Czech	1.3	49
Hungary	0.9	79
Poland	-2.4	47
Russia	1.1	10
Brazil	-3.4	60

2014 FX Forecasts

End of period	vs USD	vs EUR
United States	NA	1.39
Japan	104	145
Euro Area	1.39	NA
Canada	1.08	1.5
Australia	0.89	1.57
Norway	5.76	8
Switzerland	0.9	1.25
United Kingdom	1.73	0.8
China	6.05	8.41
India	62.98	87.54
Czech Rep.	19.4	26.9
Hungary	222	309
Poland	3	4.17
Russia	32.7	45.5
Brazil	2.42	3.37

2014 Rates Forecasts

End of period (%)	Short Rates	Long Term (10Y)
United States	0.25	3.04
Japan	0.1	0.59
Euro Area (Bunds)	0.06	1.8
United Kingdom	0.5	3.1
China	3.03	4.02
India	8	8.5
Czech Republic	0.05	2.27
Hungary	3.02	6.29
Poland	2.63	4.69
Russia	7.9	NA
Brazil	10.73	12.75

Commodity Prices Forecasts

End of period	2014	2015
Oil WTI (USD/bbl)	92.8	86.3
Oil Brent (USD/bbl)	97.5	92.5
HH Natural Gas (USD/MMBtu)	3.7	4.5
Aluminum (USD/MT)	1,835	1,950
Copper (USD/MT)	6,650	6,825
Nickel (USD/MT)	17,000	19,000
Gold (USD/T. oz)	1,255	1,350
Silver (USD/T. oz)	20.3	22.2
Platinum (USD/T. oz)	1,500	1,625
Hard Coking Coal (USD/MT)	160	170
Iron Ore (USD/MT)	120	100

Source: Citi Investment Research & Analysis

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