FINANCIAL MARKET ANALYSIS

Volume 14, Issue 6 **February 10, 2014**

A temporary slowdown?

Highlights

The ECB disappointed market hopes of action last week, keeping its interest rates, non-standard measures unchanged and not ending SMP sterilisation. But ECB President Draghi opened the door to action in March. He slightly strengthened the forward guidance language by adding that it was ‘firmly’ determined to maintain the high degree of monetary policy accommodation. Meanwhile, the US payroll growth was sluggish for the second straight month with the nonfarm payroll employment rising a disappointing 113k in January below the consensus forecast of +180k. While it is premature to suggest the slowdown signals a significant deterioration in the economy’s growth trend, economic data suggest that growth in Q1 may be slowing temporarily to a 1.5% to 2% pace. While the extreme winter weather may be part of the story, some consolidation after an especially strong demand and production in the 2H last year could also be a factor. In Citi analysts' view, there is considerably less fiscal drag in the offing and financial conditions and ample slack remain highly supportive of above-trend growth this year.

Performance

Stock markets ended the week higher with the MSCI World gaining 0.76%. The S&P 500 and Stoxx Europe 600 rebounded 0.81% and 0.8% respectively while Japanese stock market continued to post a sharp loss with the Topix losing 2.58% over the week. Asian stocks continued to underperform with the MSCI Asia ex Japan dropping 0.81% last week. While Hong Kong (HSI) and Offshore Chinese stocks (HSECEI) lost 1.81% and 1.76% respectively, onshore Chinese stocks (Shanghai Composite) gained 0.56%.

The Week Ahead

The most important releases in the US will be retail sales consumer sentiment while the focus will be on the newly-named Federal Reserve Chair Janet Yellen who will present the FOMC’s Semi annual Monetary Policy Report to the Congress. In Europe, focus will be on Q4 GDP and industrial production while Japan will see the current account balance and core machinery orders to be released this week. China’s trade data, new credit data and inflation numbers are due out this week. Elsewhere in Asia, Australia’s employment data, India’s inflation and Malaysia’s 4QGDP will be released. Also central banks in Korea and Indonesia will decide key rates this week.

	Feb 7 Close	Last week’s return	YTD Return	YTD return (USD)
S&P 500:	1797.02	+0.81%	-2.78%	-2.78%
Stoxx Europe:	325.09	+0.80%	-0.97%	-2.17%
Topix:	1189.14	-2.58%	-8.69%	-6.16%
MSCI Asia ex Japan:	519.04	-0.81%	-5.88%	-5.88%

Citigold

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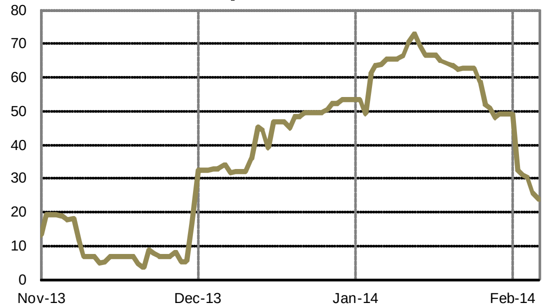
Citi Economic Surprise Index - US



Source: Bloomberg

Economic Outlook

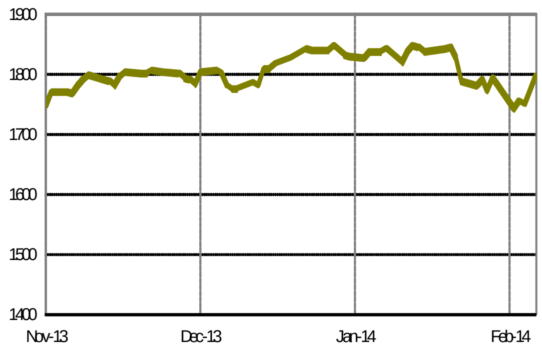
Let Down Amid Impressive Trends

Economic data at the start of 2014 suggest that growth in Q1 may be slowing temporarily to a 1.5% to 2% pace. While the extreme winter weather may be part of the story, some consolidation after an especially strong spurt in demand and production in the second half could also be a factor. There is considerably less fiscal drag in the offing and financial conditions and ample slack remain highly supportive of above-trend growth this year.

On the surface, the latest jobs report suggests that employment gains fell off a cliff from a 256K pace in October-November to just 94K in December-January. Citi analysts do not think that either of these is indicative of hiring trends or broader momentum. Benchmark revisions show that updated job growth averaged 194K or 33K more than unrevised, first-reported estimates for all of 2013. Apart from weather distortions, swings in retail employment appear exaggerated leading up to and following yearend holidays.

Citi analysts do not expect a pause in Fed tapering but cannot rule it out given officials' previous willingness to err in an easing direction even on dubious data. With forward rate expectations well anchored and effectively decoupled from the end of QE, the Fed should feel comfortable on its current course.

S&P 500 (7/11/2013 to 7/2/2014)



Source: Bloomberg

	Last week's close	Last week's return	YTD return
S&P 500	1797.02	+0.81%	-2.78%
DJIA	15794.08	+0.61%	-4.72%
Nasdaq	4125.86	+0.54%	-1.21%

- **End-2014 S&P500 Index Target: 1975**

Equities

Near term volatility but long term growth remains intact

While stock prices have dipped recently, lofty investor sentiment, excessive earnings estimates and even a peaking in the Citi Economic Surprise Index (CESI) were suggesting that the S&P 500 was vulnerable to this kind of a backup. Yet, many appear to have been caught over exposed as reactive momentum chasing in late 2013 overwhelmed these factors.

Nevertheless, the Fed's latest senior loan officers' survey showed incremental easing in lending standards for large corporations which is a clear positive for subsequent economic activity, if history is any guide. Generally, the survey leads GDP, industrial production, employment and profit margin patterns by nine months and also is predictive of S&P 500 revenue direction by 12 months. The margin relationship is particularly intriguing for the IT, Industrials and Financials sectors as well as Consumer Discretionary. Thus, the 1Q14 poll represents another positive for the domestic economy in 2014.

Indeed, the latest bout of equity market choppiness was anticipated as several notable signs were flashing amber, but the overall environment is more upbeat. While valuation, for instance, does not screen well for three-month gains, it continues to support 12-month appreciation with better than 90% probability. Thus, acting in proactive fashion makes more sense than reacting to every new piece of information especially when some of it was likely to occur based on past behaviour.

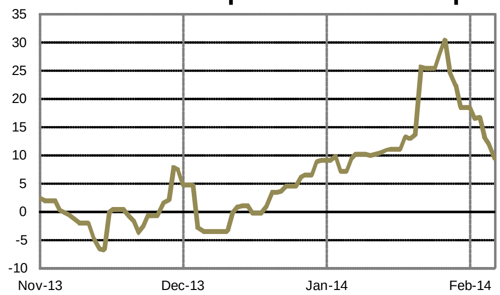
Economic Outlook

ERS: An Alternative Solution to OMT?

As euro area (EA) countries get closer to primary surpluses, applying some mechanism to lower the cost of sovereign debt financing would be a solution to avoid having to contemplate tackling excessive debt burdens at a future date. With the ECB's Outright Monetary Transactions (OMT) under threat, finding a mechanism to support spread compression could prove very valuable if the risk free rate begins to increase.

Citi analysts think that this latest proposal, European Reward System (ERS) has a reasonably good chance of being accepted by member states as it does not require treaty changes, it limits the size of conditional budgetary transfers and it supports restoring debt sustainability. Citi analysts also note that it has strong political backing from Paris. A mechanism to accelerate spread consolidation across the EA could soon become necessary at a time when financial market volatility could hamper investors' risk appetite. A reasonable (and politically acceptable) initial premium limit would be around 200bp, in Citi's view, potentially narrowing to 150bp in the second year and 100bp in the third.

Citi Economic Surprise Index - Europe



Source: Bloomberg

Equities

Pullback = Another Buying Opportunity?

It has been a testing start to the year for investors. Initial gains from the first couple of weeks have been returned with interest as emerging markets (EM) concerns have dragged equity markets lower. European equities have pulled back by 5%, the third 5%+ pull-back since start-2012. As in previous pull-backs — mid-2012 and mid-2013 — Citi analysts believe that the recent weakness could be viewed as an opportunity to reload and to rebalance portfolios.

Indeed, Citi analysts stay bullish and target roughly 20% returns from UK and European equities in 2014 driven by: 1) higher global GDP growth, 2) recovering profit growth, and 3) capital flows to equity.

Within equities, Citi analysts prefer to focus on companies that have: 1) earnings momentum & REV, 2) re-leveraging optionality & growth at a reasonable price (GARP), and 3) surplus free cashflow (FCF). At a sector level, this suggests a preference for Financials & Cyclicals, eg Banks, Mining, Travel & Leisure, over Defensives, eg Food & Beverage, Telecoms, Oil & Gas, Utilities.

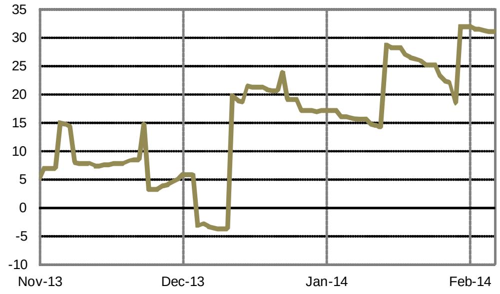
STOXX (7/11/2013 to 7/2/2014)

Source: Bloomberg

	Last week's close	Last week's return	YTD return
STOXX	325.09	+0.80%	-0.97%
FTSE 100	6571.68	+0.94%	-2.63%
DAX	9301.92	-0.05%	-2.62%

- **End-2014 Stoxx Index Target: 370**

Citi Economic Surprise Index - Japan



Source: Bloomberg

Economic Outlook

Additional easing action likely in this summer (June-August)

Citi economists are skeptical that the recent turbulence in emerging markets and the ensuing yen appreciation could have any impact on the BoJ's monetary policy. That said, a combination of weaker-than-expected export growth, sharp declines in household demand after the consumption tax hike in April, only modest growth in base salaries in the ongoing spring wage negotiations and stalling inflation and/or inflation expectations would likely eventually prompt the BoJ to take additional easing action in this summer (June-August), in Citi's view.

Citi economists maintain their long-standing view that the BoJ is likely to implement fresh easing in this summer after having confirmed the negative impact from the consumption tax hike. Most importantly, they believe growth and inflation (plus inflation expectations) in the coming quarters are likely to be weaker than the BoJ's outlook.

In Citi's view, the BoJ appears to be overly optimistic about the overseas economy given that an increasing number of central banks in the emerging countries are poised to tighten monetary policy going forward. As such, a meaningful downside surprise to the overseas economy and Japan's exports—vis-à-vis the BoJ's relatively optimistic outlook—might provide the reason to act for policymakers.

Topix (7/11/2013 to 7/2/2014)

Source: Bloomberg

	Last week's close	Last week's return	YTD return
Nikkei	14462.41	-3.03%	-11.23%
Topix	1189.14	-2.58%	-8.69%

Equities

Tokyo gubernatorial election likely to pose as tailwind

As polls had suggested, Yoichi Masuzoe won the Tokyo gubernatorial election. Citi analysts think this result may be reassuring to investors and could ultimately prove a tailwind for Japanese equities. Also, former PM Morihiro Hosokawa, who ran on an anti-nuclear stance, did not garner a particularly large share of the vote, so there may be little impact on Japan's nuclear policy in Citi's view.

Citi analysts think Japanese equities could rise due to strength of US equities and yen weakness last week. It looks as if the Tokyo gubernatorial election may not cause problems for the Abe administration, as some had worried, and it may reassure investors and ultimately prove a tailwind for Japanese equities. However, the market had been expecting Mr. Masuzoe to win, so his election itself is unlikely to have a significant impact on the market.

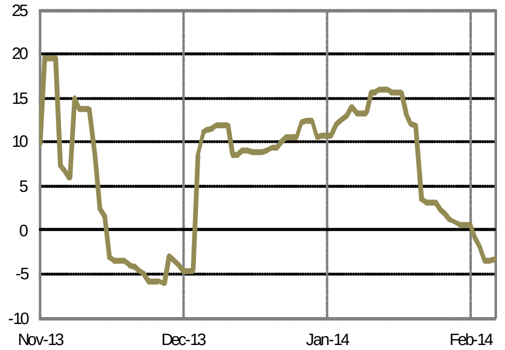
Mr. Masuzoe's first pledge was to ensure the Tokyo Olympics and Paralympics are "the best ever", and as such market attention could once again focus on Olympics-related names, He has also pledged to expand childcare and nursing care services, so the market could focus on names related to those areas as well.

- **End-2014 Topix Index Target: 1520**

Citi Economic Surprise Index – Asia Pac Ex Japan

Source: Bloomberg

Citi Economic Surprise Index – China



Source: Bloomberg

MSCI AC Asia ex Japan (7/11/2013 to 7/2/2014)

Source: Bloomberg

	Last week's close	Last week's return	YTD return
MSCI AC Asia ex Japan	519.04	-0.81%	-5.88%

- **End-2014 MSCI AC Asia ex Japan Index Target: 660**

Economic Outlook

EM Selloff Redux – Why Asia Outperformed the Rest of EM

Asia outperformed other EM in the recent sell off strikingly different from its underperformance in the taper-led EM selloff in 2013. The latest round of worries revolve around growth concerns with US and China impacting perceived prospects for export recovery, and thus, could put greater pressure on import compression to facilitate current account (CA) adjustment, in a backdrop of less favourable external funding environment.

Asia's four "taper-sensitive" countries – India, Indonesia, Malaysia and Thailand – are all already seeing CA adjustment, though India is the most dramatic. Asia's rebounding export momentum since 3Q13 could falter short-term, but Citi's outlook on US economic recovery in 2014F has not materially changed. China's slowdown risk is a real concern, though recent PMI manufacturing softness is indistinguishable from seasonal weakness.

Asia's capital flow structure is in much better position than other EM regions to deal with taper. Portfolio debt flows to EM is likely the most vulnerable type of capital flow to Fed's QE Exit. EM Asia not only benefits from having more sizeable CA surplus which reduces its relative exposure to swings in capital flows, but the proportion of net capital flows that are net "portfolio debt" flows is also much smaller in Asia than both Latam and CEEMEA.

Equities

Fund Flow Insights

In the week ended 2/5/2014, foreign net selling in Asia widened as Taiwan and Korea saw over US$1bn of net selling. Thailand was also sold down by US$516mn. This was the 15th week of outflows from EM equity funds and was the largest outflow since August-2010. The major outflow was from GEM funds, at US$4.8bn, while Asia funds had US$966mn of outflow. EMEA funds and LatAm funds had respective outflows of US$361mn and US$199mn. China funds ended a 6-week run of inflows with US$132mn of outflow this week

Amid heavy portfolio outflows from EM, Citi analysts have shown the result from their recent study on whether any market is in the distress zone with the Altman Z-score formula which is a model for predicting bankruptcy within two years.

The model tells that the best positioned is the US, followed by EMEA and then Asia. The weakest Z-scores are in Latam, followed by Europe and then Japan. The aggregates do not suggest any part of the universe is in the distress zone. It is also noteworthy that the EM aggregate remains above the levels seen between 1995 and 2003 when valuation multiples for EM were generally higher than at present. Looking at valuations versus sovereign risks, Citi analysts find Korea, Hong Kong, and Thailand are all trading cheap while the Philippines, India and Malaysia are trading rich versus risks given their Z-scores.

Developed Markets

10 February (Monday)

- **Europe** — Citi analysts believe that the Bank of France sentiment reading may rebound to 101 in January, and see some slight upside risks after President Hollande's formal embracing of supply side reforms and promises of lower corporate taxation.
- **Japan —** The seasonally-adjusted current account balance may generate a ¥14.4bn surplus in December for the first surplus in four months on the back of some improvement in the trade gap.

11 February (Tuesday)

- **Europe** — Weekly data indicate that Sweden's registered unemployment was stable in January at 4.6%.

12 February (Wednesday)

- **Europe** — Euro Area Industrial activity likely contracted in December (-0.4% MoM), after a large gain in November.
- **Japan —** Private machinery orders excluding ships and power plants (private core orders) likely decreased 4.1% MoM in December.
- **Japan —** The tertiary industry activity index likely climbed 0.1% MoM in December (+1.2% YoY) after a 0.6% MoM rise in November and a 0.7% MoM fall in October.
- **Japan —** M2 likely increased 4.3% YoY in January (+4.2% YoY in December) along with a 3.4% YoY gain in M3 (+3.4% YoY).

13 February (Thursday)

- **US** — Initial jobless claims for the week ending February 8 probably edged up to 335K following a sizable decline.
- **US** — Citi analysts look for a fairly downbeat retail sales report in January (-0.1%), but much of the weakness reflects erratic weather and pricing.
- **US** — Business inventories likely rose by 0.7% in December, with autos probably driving much of the increase.
- **Europe** — Citi analysts expect the final readings for German inflation in December to confirm the flash reading for the harmonised measure (-0.7% MoM, 1.2% YoY).
- **Japan —** Domestic corporate goods price index likely climbed 0.1% MoM in January.

14 February (Friday)

- **US** — Industrial production likely posted a solid increase in January (0.4%), but the rise was isolated to utilities and autos, hinting at a pullback ahead.
- **US** — Consumer sentiment likely fell in early February to 79.0.
- **Europe** — Italian GDP is expected to expand for the first time in 4Q13 by 0.3% QoQ, after lagging behind the recovery seen in the rest of the euro area since 2Q14.
- **Europe** — Netherlands' 4Q GDP is likely to show a modest 0.1% QoQ uptick, but the balance of risks appears skewed to the upside given the better performances in neighbours France and Belgium (0.4% QoQ).

Asia ex-Japan

During the week

- **China —** M2 growth likely slowed to 13.2% YoY in January with new lending rising to RMB1,181bn.

10 February (Monday)

- **Malaysia —** Citi analysts see December IP growth rising further to 7.9% YoY partly on base effects.
- **Taiwan —** Rebound in export orders and improving PMI new orders point to a mild recovery in January exports (+1.3% YoY).

11 February (Tuesday)

- **Philippines —** December exports likely rose by 10% YoY lifted by electronics exports.

12 February (Wednesday)

- **China —** The negative growth rates in trade data in January (Export: -6.1% YoY and Import: -8.9% YoY) are mainly due to distortion from base effects, but the underlying trade momentum may not be as gloomy as the headline implies in Citi's view.
- **India —** December IP growth likely remained in red (-1.4%YoY) as contraction deepened in some sectors.
- **Korea —** January jobless rate likely to inch higher to 3.2% s.a. on increased number of job seekers.
- **Malaysia —** Recent IP data is likely to support 4Q GDP growth of 4.7% YoY.

13 February (Thursday)

- **Indonesia —** BI may keep policy rates unchanged at 5.75% (FasBI) and 7.50% (BI rate).
- **Korea —** Citi analysts anticipate policy rate pause to continue in February amidst revisited financial market uncertainties and KRW weakness. January jobless rate likely to inch higher to 3.2% s.a. on increased number of job seekers.

14 February (Friday)

- **China —** Headline inflation likely slid to 2.3% YoY (previous: 2.5% YoY). Overall price level may have increased by 0.7% MoM in January with food prices staging a seasonal rally.
- **India —** Citi analysts expect lower inflation readings in January (CPI: 9% YoY; WPI: 5.4% YoY) on normalizing vegetable prices.

WORLD MARKETS AT A GLANCE

	Previous Week's Close	52-Week High	52-Week Low	Weekly Return	YTD Return	YTD Return (USD)
UNITED STATES						
Dow Jones Industrial Average	15794.08	16588.25	13784.01	+0.61%	-4.72%	-4.72%
S&P 500	1797.02	1850.84	1485.01	+0.81%	-2.78%	-2.78%
Nasdaq	4125.86	4246.55	3105.37	+0.54%	-1.21%	-1.21%
EUROPE						
DJ Euro STOXX	325.09	337.65	274.97	+0.80%	-0.97%	-2.17%
FTSE 100	6571.68	6875.62	6023.44	+0.94%	-2.63%	-3.65%
DAX	9301.92	9794.05	7418.36	-0.05%	-2.62%	-3.88%
JAPAN						
Nikkei 225	14462.41	16320.22	11065.06	-3.03%	-11.23%	-8.77%
TOPIX	1189.14	1308.08	930.04	-2.58%	-8.69%	-6.16%
ASIA						
MSCI Asia ex Japan	519.04	566.88	475.70	-0.81%	-5.88%	-5.88%
Hong Kong Hang Seng	21636.85	24111.55	19426.36	-1.81%	-7.16%	-7.22%
Shanghai Composite Index	2044.50	2444.80	1849.65	+0.56%	-3.38%	-3.55%
Taiwan Weighted Index	8387.35	8668.95	7663.23	-0.89%	-2.60%	-4.15%
Korea KOSPI	1922.50	2063.28	1770.53	-0.96%	-4.42%	-6.15%
Mumbai Sensex	20376.56	21483.74	17448.71	-0.67%	-3.75%	-4.08%
Singapore Straits Times Index	3013.14	3464.79	2953.01	-0.47%	-4.87%	-5.28%
Kuala Lumpur Composite	1808.59	1882.20	1599.94	+0.25%	-3.13%	-4.64%
Thai Stock Exchange	1296.49	1649.77	1205.44	+1.74%	-0.17%	+0.01%
Jakarta Composite Index	4466.67	5251.30	3837.74	+1.08%	+4.50%	+5.03%
Philippines Stock Exchange Index	6011.14	7403.65	5562.13	-0.50%	+2.06%	+0.68%
Australia All Ordinaries	5184.51	5453.10	4610.60	-0.40%	-3.15%	-2.79%
EMEA						
Russia MICEX Index	1478.48	1550.01	1271.48	+1.65%	-1.70%	-6.81%
South Africa JSE All Shares Index	45340.76	47348.48	37717.78	+0.46%	-1.98%	-6.70%
Turkey ISE National 100 Index	64614.34	93398.33	60753.53	+4.46%	-4.70%	-7.61%
LATIN AMERICA						
Mexico Bolsa Index	40525.74	45249.91	37034.30	-0.87%	-5.15%	-6.73%
Brazil Bovespa Index	48073.60	59472.49	44107.06	+0.91%	-6.67%	-7.50%
COMMODITIES						
Gold	1267.27	1669.73	1180.50	+1.83%	+5.11%	+5.11%
Oil	99.88	112.24	85.61	+2.45%	+1.48%	+1.48%
FIXED INCOME						
Citi Treasury Index	1361.78	1392.61	1331.45	+0.04%	+1.35%	+1.35%
Citi World Big Index	197.69	198.49	190.96	+0.10%	+1.60%	+1.60%
Citi World Govt Index	647.71	650.43	627.83	+0.07%	+1.59%	+1.59%
Citi High Yield	826.58	828.46	767.09	+0.21%	+0.93%	+0.93%
Citi Global Emerging Mkt Sovereigns	640.66	688.93	612.40	+1.14%	+0.20%	+0.20%
Citi GEM Sovereign Asia	555.04	607.61	509.39	+0.59%	+0.74%	+0.74%

Source: Bloomberg (As at February 7, 2014)

CURRENCY FORECASTS

Currency		10-Feb-14	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16
G10											
Euro	EURUSD	1.36	1.37	1.39	1.40	1.40	1.40	1.41	1.41	1.41	1.41
Japanese yen	USDJPY	102	105	106	107	108	110	111	113	115	115
British Pound	GBPUSD	1.64	1.70	1.72	1.75	1.76	1.76	1.77	1.78	1.78	1.78
Swiss Franc	USDCHF	0.90	0.90	0.90	0.89	0.90	0.90	0.91	0.91	0.91	0.91
Australian Dollar	AUDUSD	0.89	0.87	0.86	0.85	0.85	0.85	0.85	0.85	0.85	0.85
New Zealand	NZDUSD	0.83	0.84	0.85	0.87	0.87	0.86	0.86	0.85	0.85	0.84
Canadian Dollar	USDCAD	1.10	1.11	1.12	1.12	1.12	1.12	1.12	1.12	1.12	1.12
Swedish Krona	USDSEK	6.49	6.28	6.28	6.29	6.27	6.26	6.24	6.23	6.21	6.18
Norwegian Krone	USDNOK	6.18	5.97	5.85	5.74	5.67	5.62	5.57	5.52	5.47	5.43
EM Asia											
Chinese Renminbi	USDCNY	6.06	6.03	6.02	6.00	6.00	6.00	6.00	6.00	6.00	6.00
Hong Kong	USDHKD	7.76	7.75	7.76	7.76	7.76	7.76	7.75	7.75	7.75	7.75
Indonesian Rupiah	USDIDR	12166	11916	11954	11992	11937	11858	11779	11698	11618	11464
Indian Rupee	USDINR	62.2	60.50	61.60	62.80	62.20	61.20	60.20	59.20	58.20	57.70
Korean Won	USDKRW	1071	1047	1039	1032	1023	1014	1005	996	987	985
Malaysian Ringgit	USDMYR	3.33	3.30	3.23	3.16	3.14	3.13	3.12	3.11	3.10	3.09
Philippine Peso	USDPHP	45.0	45.80	45.40	44.90	44.20	43.40	42.60	41.80	41.00	40.70
Singapore Dollar	USDSGD	1.27	1.27	1.27	1.27	1.27	1.26	1.25	1.25	1.24	1.24
Thai Baht	USDTHB	32.8	33.30	33.00	32.60	32.10	31.60	31.10	30.50	30.00	29.80
Taiwan Dollar	USDTWD	30.3	29.90	29.70	29.50	29.40	29.30	29.20	29.10	29.00	28.90
EM Europe											
Czech Koruna	USDCZK	20.20	19.76	19.55	19.33	19.15	18.98	18.82	18.65	18.48	18.36
Hungarian Forint	USDHUF	226	222	222	222	221	221	221	220	220	220
Polish Zloty	EURPLN	3.06	2.98	2.95	2.92	2.89	2.86	2.83	2.8	2.77	2.77
Israeli Shekel	USDILS	3.53	3.42	3.45	3.49	3.54	3.59	3.64	3.69	3.74	3.73
Russian Ruble	USDRUB	34.8	33.6	33.9	34.2	34.5	34.7	35	35.2	35.4	35.5
Turkish Lira	USDTRY	2.21	2.28	2.25	2.21	2.21	2.22	2.23	2.24	2.25	2.23
South African Rand	USDZAR	11.04	11.17	11.09	11.02	10.89	10.75	10.61	10.47	10.33	10.27
EM Latam											
Brazilian Real	USDBRL	2.38	2.46	2.48	2.50	2.52	2.54	2.56	2.58	2.60	2.58
Chilean Peso	USDCLP	554	531	522	512	512	514	516	518	520	518
Mexican Peso	USDMXN	13.3	13.20	12.90	12.70	12.60	12.50	12.40	12.40	12.30	12.30
Colombian Peso	USDCOP	2048	1954	1963	1973	1975	1975	1975	1975	1975	1964

Source: CR, Bloomberg (As of February 10, 2014; Forecasts as of January 20, 2014)

GENERAL DISCLOSURE

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