2012 Annual Outlook:

Like a Bird on a Wire

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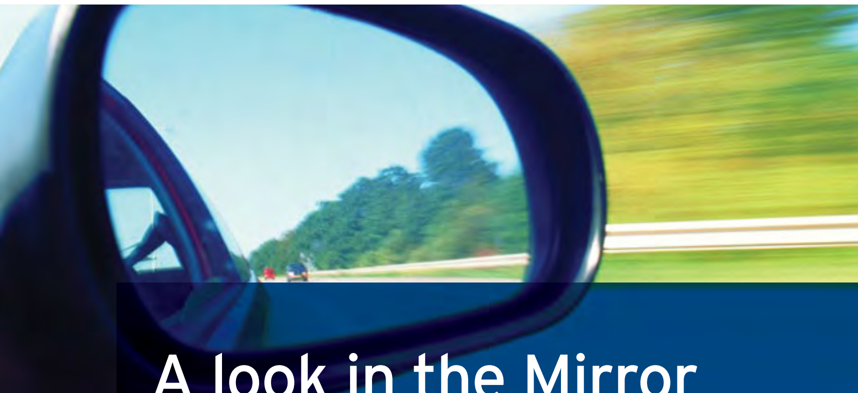


A look in the Mirror

When historians look back on the year 2011, this could well be qualified as one of the most "uncertain" years in economic history. Furthermore, with investors' attention focused primarily on the deterioration of the Sovereign crisis in Developed Countries, rarely in post-World War II history have we observed such an important influence of the political world, or rather the lack of political action, on financial markets.

At the start of the year, Citi economists already expressed their skepticism about the sustainability of the economic rebound, particularly in developed countries, by highlighting the crude reality of the debt burden and the failure of the US Quantitative Easing programs to reach their fundamental objectives.

The good old formula which consisted in driving the economy back into recovery by encouraging credit and expanding public debt has hit the wall of the deleveraging imperatives.

In Europe, governments were hoping that a positive global economic context, a few austerity measures and patience would be sufficient to bring back the balance in their finances. Whilst in the US, an economic rebound driven by fiscal stimulus, positive corporate earnings and strong equity market performances were masking the harsh reality of the failures of the QE programs: by the end of the year, private credit did not improve, real estate prices did not rebound and unemployment didn't show the slightest sign of improvement.

The traditional economic recovery approach which consists of expanding public debt, building up deficits and easing credit conditions to initiate a rebound in the economic activity and a recovery of the internal demand through corporate investments and households' consumption just hasn't worked. In 2009, the private sector came out of the credit bubble crisis with one imperative: deleveraging. In 2011, the public sector has, in turn, reached its limit in terms of debt and deficits. Political leaders must face the challenge of bringing back the balance in public finances in a gloomy economic context. As pointed out by Citi's Political analyst Tina Fordham, stretched between electoral goals, fundamental democratic, sovereignty principles and economic imperatives, 2011 has brought political leaders on the verge of a nervous breakdown.

Uncertainties have generated investors' nervousness and market volatility, but the underperformance of risky assets has remained very small.

In such a strenuous economic and political environment, it is not surprising to see how nervous investors have been and how volatility has increased. Indeed, risk aversion has continued to drive investors towards safe assets throughout the year, primarily US Treasuries and German Bunds, to the extent that on November 30th, the yields on the 1-year German Bund became negative. This nervousness also reflected in equity markets. Indeed, looking at the volatility index (VIX), we have seen in 2011 a pattern in terms of peak and average volatility for the year that has been very similar to what we observed in 2001 and 2002. In that context, the overall performance of global equities in 2011 appears to be astonishing. Whilst, in 2001 and 2002, global equities (MSCI World Index) retreated by 17.8% and 21% respectively, Year-to-Date (Dec. 11), global equities are down by a mere 6.5%. In a context of lowest ever US and German Bund yields, the loss of the US triple-A rating, the risks of Euro Area break-up, the replacement of 2 European democratic governments by teams of technocrats and a major natural and nuclear disaster amongst other, 2011 has indeed been extremely tough, however rather resilient with the portfolios.

2012 in 3-D
Deleveraging, Divergence and Distrust

It is a human characteristic that at the end of the year we all hope that the coming year will be better than the preceding one. Needless to say that after such difficult year, this is perhaps even more true today. However, when talking with investors during the traditional seminars and conferences organized during the end of year period, the most recurrent questions that we hear are "Do you think the Euro Area will break-up?", "Will Italy default?", "Can the banking sector avoid a collapse", "Will the US come with a plan for their deficit before the elections?" or "What will happen to world if the bubble bursts in China?". This is not an exhaustive list, for sure, but significantly enough, there have been relatively few queries on the risks associated with to see oil prices reaching 200$/bbl, for example. This simple observation is representative of an advisory (maybe a better word) context that remains extremely challenging as we step into 2012. Economic and political uncertainties are likely to dominate and that are skewed to the downside which translates into a general broad-based lack of confidence. The positive side is that investors and observers appear much more risk-aware than they were at the start of 2011, when, at the time, the markets' consensus was particularly enthusiastic.

The political agenda promises to be increasingly difficult in 2012 as pressure to find sustainable fiscal solutions in the Euro Area and in the US will build in the context of presidential elections both in France and in the US, and also of legislative elections in Germany in 2013.

After the last EU Summit in December 2011, Citi analysts observe that, similar to previous summits, small steps in the right direction have been made. They also consider the speed at which the crisis is addressed remains much too slow and that the dissensions between the EU leaders'national interests remain immense. It seems certain that Fiscal Union is on the table, however, Citi analysts wonder to what extent France's President Sarkozy can give ground on the question of fiscal sovereignty a few months from elections or Chancellor Merkel will open the door to the fiscal solidarity debate in a pre-election year. Obviously, the recent fate of the Papandreou, Berlusconi and Zapatero governments isn't encouraging. Similarly, in the US, our analysts think that the probability to see Republicans and Democrats agree on a Grand fiscal program in a presidential year is pretty close to nil. Tina Fordham, Citi's Political Analyst, highlights that while national leaders may yet find the courage to address the looming challenges, the risk is increasing that it will be too little, too late, greatly increasing the costs of an eventual solution and the risk of a policy errors.

The global economic activity is expected to slowdown, driven by continued deleveraging in the private sector and deficit reduction program in the public sectors.

At the global level, Citi analysts expect a slower and modest economic growth characterized by an important divergence between the different major economic regions and an increasing dependence on China. Citi analysts expect 2.5% GDP growth for the world economy in the coming year, i.e. a modest mid-cycle slowdown rather than global recession. They recognize that risks are skewed to the downside, particularly if the EU crisis would lead to an uncontrolled default contagion, but they think that the risk of global recession remains relatively low.

After the burst of the credit bubble in 2008, both households and companies in the developed markets started to clean their balance sheets of the excessive debt load. However, after a period of 30 years of continual debt increase, the efforts performed during the last 4 years

have barely scratched the surface of the debt pile. For example, in terms of private sectors debt-to-GDP levels, the UK and some individual euro area countries are still similar to or higher than the early 90s peak in Japan, which was then followed by 10-15 years of marked deleveraging and economic weakness. Citi analysts expect the ongoing bias to increased private savings and private sector deleveraging will continue to cap spending, resulting in an extended period with subpar recoveries in consumer spending and private investment compared to previous cycles. On the Public side, governments in developed markets find themselves caught between the need to support economic growth to boost employment, to reduce the debt load, and the imperative to structurally improve their Fiscal Balances. With deficits close to 9% in the US and in the UK, 11% in Japan, and 4,5% for the Euro Area, Citi analysts think that governments will have to act on both expenses and income. In a context of general austerity in both public and private sectors, Citi analysts expect no miracle for Developed Countries in 2012. They forecast a GDP growth of 1.9% in the US, 0,5% in the UK and a contraction of -1,2% in the Euro Area.

Slower demand from Developed Countries and credit risks in China threaten economic growth in the Emerging Markets, but lower inflation gives room for Monetary support.

Citi analysts highlight this as a key risk for Emerging Markets, that, although stronger fiscal balances and lower debt-to-GDP ratios protect them against the development of a sovereign crisis, Emerging Markets are not entirely immune. Not only do Emerging Markets' exports suffer from global demand slowdown, but also, in periods of severe stress and increase of risk aversion, Emerging Markets, that had access to financing opportunities during the 'good times', can suddenly face a situation where financial inflows are getting scarcer, independent of long-term domestic fundamentals, as foreigners are rushing for the door in search of safe havens. Citi analysts also recognize that risks are biased to the downside in China where local governments' indebtedness appears excessive and where a hard landing in the property sector continues to feed concerns. However, they still think that China has a reasonable set of tools to deal with these risks. Citi analysts also think that with the slowdown of the global demand, inflation pressures will cool down in Emerging Markets, which will give more room for further monetary accommodation where needed. All in all, Citi analysts forecast that Emerging Markets' GDP will grow at 5,1% in 2012, a pace 5 times higher than the Developed Countries.

Chart 1: GDP and Inflation Forecasts

	GDP		Inflation	
All data in %	2012	2013	2012	2013
Global	2.5	3.1	3	2.9
United States	1.9	1.9	1.8	1.7
Japan	1.8	1.3	-0.3	-0.1
Euro Area	-1.2	-0.2	2	1.1
Germany	0.3	1.2	1.8	2
France	-0.7	0.5	1.8	1.5
Italy	-1.9	-1.1	2.4	0.9
Spain	-1.9	-0.8	1.2	0.1
Greece	-4.9	-3.1	1.4	-0.4
United Kingdom	0.5	1.2	2.7	2.4
Emerging Markets	5.1	6	5.3	5.3
China	8.4	8.6	4.1	4.3
India	7	7.7	7.5	7
Korea	3.7	4.4	3.3	3.3
Czech	0	2.1	2.7	2
Hungary	0.1	1.7	5.2	3.4
Poland	1.9	2.8	2.9	2.6
Romania	1.7	3.2	3	2.5
Russia	2.5	4.2	6.2	6.1
Brazil	3.5	4.5	5.6	5.2
Turkey	2.5	4.3	8.1	6.6

Source: Citi Investment Research and Analysis

Global High Income Equities

In a world of deleveraging and lower growth, Citi analysts think that dividends are likely to play an increasingly important part of total return opportunities from equities.

Tactical hedge against deleveraging and low growth context

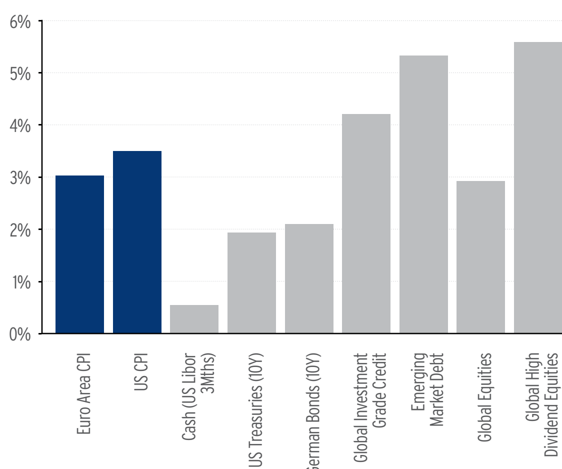
Citi analysts observe that throughout history, high dividend companies or companies able to increase their dividend yields in periods of subpar economic growth tend to achieve better performances relative to other equities style as the capacity of a company to distribute dividend is highly correlated to its capacity to generate cash flows and earnings growth. Citi analysts think that Dividends will also be a sign of corporate health in the years ahead. For example, some banks are cutting their dividends to zero while other industries are paying bigger and bigger dividends.

As we have highlighted earlier, a key concern for the economic activity in the Developed Markets is the broad based and deep deleveraging process that started at the peak of the credit bubble in the corporate sector. Companies strengthen the quality of their balance sheet by reducing their debt and increasing their capital. Doing so, they have markedly increased their stock pile of cash. Citi analysts estimate, for example, that US companies are sitting on a record 2000 $billions of cash. In a period of risk aversion and economic strain, Citi analysts think that companies able to return cash through higher dividends are likely to be favored by investors seeking evidence of corporate strength.

The combination of ultra low yields and increasing pension funding needs offers a structural support to high dividend investment strategies

Demography has always had an important structural influence on the performance of investment strategies. Two of the key features of long term demographic trends are the ageing population and the "baby-boomers" generation progressively arriving at retirement age. According to the United Nations, the world counts today 700 Millions retired people out of a 7 Billion world population, a ratio of 1 to 10, and estimates are that in 2050, the ratio will reach 1 to 5 as people live longer and an increasing number of people come to retirement. With increasing concerns about the sustainability of the capacity of governments to fund future pension needs, one of the key concerns for this generation will be the financing of their pension. Indeed, in a world characterized by ultra low Triple-A government yields and deteriorating sovereign debt quality, Citi analysts think that investors will increasingly look for alternative sources of yields. In this regards, they think that high and stable dividends yielding equities are likely to play a key role in the long term pension portfolio construction strategy of investors.

Chart 2: Asset Classes Yields versus Inflation



Sources, Citi, Bloomberg, MSCI, Blackrock, Moody's

Growth in European Stocks

The collapse of Growth stocks during the 2001 TMT crisis has left a sour taste in the mouth of many investors, leaving a strong impression that Growth stocks meant risky and expensive stocks while Value stocks meant cheap and secure stocks. The historical and fundamental analysis shows us that the reality is a bit different.

The "defensive" profile of a stock depends more on the overall economic context than on simple absolute valuations.

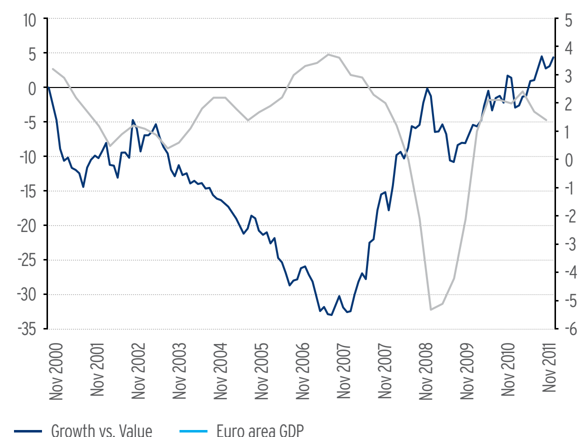
Citi analysts continue to consider that valuation of stocks is a major determinant factor of the potential long term performances. However, they also observe that in the near term, absolute valuations are not the key performance driver. Indeed, over the last 10 years, equity valuations have constantly decreased and traded in low bands, but it hasn't prevented the occurrence of 2 historical bull and bear markets.

From a pure valuation perspective, Citi analysts observe that particularly low and attractive valuations have probably provided a certain safety net for European equities in 2011, but they also observe that this pattern has characterized all types of stocks, irrespective of the earnings performances of companies. With estimated Price-to-Earnings (PE) ratios at 12.6, the valuations of European growth stocks appear historically cheap. Surely, value stocks appear even cheaper, with estimated PE's at 8.5, but Citi analysts think that "when expensive is cheap and cheap is cheaper", the robustness of the "Earning" feature becomes an increasingly important factor.

In a context of low growth, deleveraging, global economic divergences and risk aversion, cheapness is common, but growth is a rare and precious corporate feature.

Citi analysts forecast an economic context that will be challenging for European companies. Indeed, political uncertainties combined with fiscal austerity measures and deleveraging in the private sectors will make it difficult for companies to increase earnings, even more so when profit margins have reached record levels after 3 years of strong expenses reductions efforts. In this context, Citi analysts think that investors should prefer companies that will be able to generate earnings growth. As illustrated in chart 3, Citi analysts observe that European growth stocks tend to outperform value stocks when the domestic economic context deteriorates and vice versa. In particular, they prefer Defensive Growth stocks, i.e. companies able to deliver strong and consistent earnings growth through economic cycles; Emerging Growth stocks, companies where 25% or more of the earnings stream is directly exposed to the faster economic growth dynamics of Emerging Markets; and finally Top Liners Growth, companies that will be able to expand their sales volume base through market share gains and higher competitiveness.

Chart 3: Relative Performance of Europe Growth and Value Stocks



Sources: Bloomberg, MSCI, Eurostat

Quality in Corporate Credit

Corporate Investment Grade Bonds have been hurt by the increase in risk aversion in 2011, but to a much lower extent than during the subprime crisis thanks to much sounder and very attractive corporate balance sheet quality.

Is it possible today to find an asset class that offers decent yields?, that is cheap?, that is benefiting of the broad based deleveraging trend?, that is relatively protected against to the low growth global economic growth context? Citi analysts think that the asset class that best fits the description is the Investment Grade Corporate Bonds sector.

Corporate deleveraging weighed on the economic activity but supported credit quality

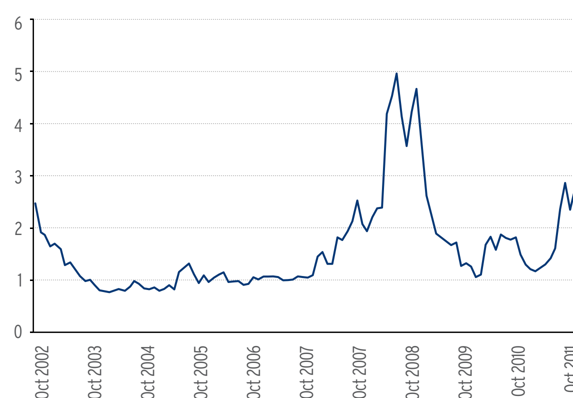
The events of 2008–09 resulted in much focus being placed on repairing corporate balance sheets and in the broad based deleveraging process that is weighing so much on the economic activity in the Developed Markets. During the last 2 to 3 years, companies have focused on reducing debt exposure and increasing cash positions. Citi analysts observe now that companies are sitting on record piles of cash and have substantially improved their debt to earnings levels. With Net Debt to Earnings (EBITDA) levels at 1.3 in Europe and the US, Investment Grade companies have reached their the lowest relative debt levels of the last decade.

In the same time, Citi analysts observe that Investment Grade Corporate spreads over Sovereign yields have increased during the year, a sign that in a wave of risk aversion, correlation between credit and equity risks increases as investors ask higher yields to hold corporate debt.

Spreads are particularly attractive, but risk aversion is likely to generate near term volatility.

Citi analysts also observe that although spreads have increased in 2011, the default rate in the sector has remained extremely low as companies achieved to grow earnings in a modest but positive global economic context. Going forward, Citi analysts think that the fundamental backdrop will remain supportive enough to keep the default rate between 2-3%, a level that would justify narrower spreads in the future. Over the medium to longer term, Citi analysts think that the combination of high spreads, improved credit quality and low default rates makes Investment Grade Corporate bonds very attractive for investors. However, they also recognize that in the near term, this is risk aversion rather than fundamentals that is likely to drive spreads trend. In which case, they expect continued high volatility in the asset class. Finally, within Investment Grade Corporate bonds, our analysts underweight substantially financials as they are more sensitive to the development of the sovereign debt crisis in the Euro Area.

Chart 4: Corporate Investment Grade Spreads



Sources: Bloomberg, Moody's

Forecast tables

Chart 5: Interest Rates

	10-Years Yield		Short Term Rates	
All data in %	2012	2013	2012	2013
United States	2.2	2.7	0.25	0.25
Japan	1.16	1.5	0.1	0.1
Euro	1.5	1.5	0.75	0.5
Germany	1.5	1.5		
France	3.56	3		
Italy	6.56	5.2		
Spain	6.11	4.7		
Belgium	4.75	4		
Switzerland	0.76	0.78	0	0
United Kingdom	1.76	1.5	0.5	0.5
Czech Republic	3.85	3.39	0.75	1.19
Hungary	7.79	7.61	6.73	6.13
Poland	5.24	5.43	4.06	3.75
Romania	7.57	7.59	5.13	5
Russia	7.57	7.59	7.5	6
Turkey			5.75	7.25

Source: Citi Investment Research and Analysis

Chart 6: Exchange Rates

	Versus US Dollar		Versus Euro	
All data in %	2012	2013	2012	2013
United States			1.27	1.29
Japan	76	78	96	100
Euro	1.27	1.29		
Switzerland	0.97	1.02	1.24	1.32
United Kingdom	1.55	1.61	0.82	0.8
China	6.15	5.9	7.84	7.52
Czech Republic	19.8	18.9	25.3	24.1
Hungary	252	230	322	294
Poland	3.44	3.15	4.38	4.02
Romania	3.33	3.36	4.25	4.29
Russia	33.5	33	42.6	42.1
Turkey	1.86	1.82	2.37	2.32

Source: Citi Investment Research and Analysis

Chart 7: Commodities

		2012E	2013E
Energy			
WTI	USD/bbl	72	92.5
Brent	USD/bbl	86	102
Base Metals	Metals		
Aluminum	USD/MT	2,300	2,566
Copper	USD/MT	8,113	8,534
Lead	USD/MT	2,244	2,356
Nickel	USD/MT	21,063	23,419
Tin	USD/MT	21,750	23,938
Zinc	USD/MT	2,075	2,256
Precious Metals			
Gold	USD/T.	1,950	1,744
Silver	USD/T.	33	27

		2012E	2013E
Bulk			
Hard coking Coal	USD/MT	275	248
Thermal Coal	USD/MT	139	148
Iron Ore	USD/MT	160	135
Agriculture			
Corn	USD/bu	676	
Soybeans	USD/bu	1,363	
Wheat	USD/bu	710	
Rice	USD/cwt	15.5	
Cotton	USD/lb	100	
Sugar	USD/lb	25	
Coffee	USD/lb	250	
Cocoa	USD/MT	3,095	

Source: Citi Investment Research and Analysis

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