

MARKET OUTLOOK



February 2012

Oil in 2012

Oil demand is largely a function of GDP growth and the impact of oil prices is visible in the changing ratio between the two. One of the persistent themes in the oil market has been that we are living through 2008 all over again and that seemingly robust oil market fundamentals are going to give way in the face of a rapidly deteriorating macro environment. Citi analysts however look at the world rather differently and instead believe that oil could pose a significant threat to the macro environment.

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Citigold

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Feature

Oil in 2012

Oil supplies may be constraining global GDP growth

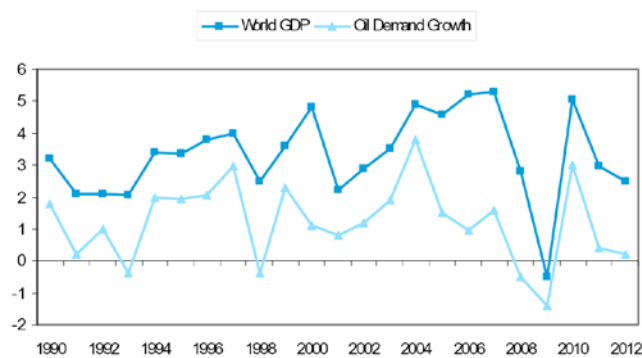
The redundancy in the system is slim and the threats to supply are many, Citi analysts say. In addition, they caution that the long list of world geopolitical issues involve significant threats to major portions of the world's oil supply, such that the risk of an oil price spike may be significant in 2012.

Despite the risks, they expect Brent prices to be range bound between US\$100/bbl and US\$120/bbl and averaging US\$110/bbl in 2012 and US\$120/bbl in 2013. Simply put, oil supplies could be constrained for the next 2-3 years, as there do not appear to be enough liquids supplies coming to market to allow for unconstrained demand growth. Citi analysts estimate that the world is operating with about 2.5 million barrels per day (mb/d) of spare production capacity, virtually all of which is in Saudi Arabia, with the rest scattered around other core Gulf Organization of Petroleum Exporting Countries (OPEC) members.

Absent supply disruptions, they expect to see a marginal increase in spare capacity, but the margin remains slim and the potential disruptions numerous, including but not limited to: oil-disrupting violence in Iraq; tensions between Israel and Iran; US sanctions and an European Union embargo on Iranian oil; sanctions on Syria; succession and the possibility of strife in Saudi Arabia; elections in Venezuela and Angola; and ongoing violence in Nigeria, Sudan and Yemen.

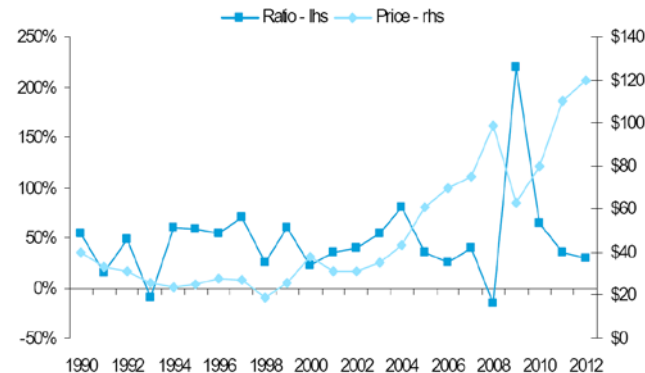
Citi analysts think that oil supplies may be constraining global GDP growth, and that this could remain the case until there is a paradigm shift – either oil demand shifts lower through a transition to more of a natural gas based transportation system in some key markets, or, more likely, shale, tight oil and deepwater production reach a scale that moves the needle on a global basis for liquids supplies. But none of these are likely to happen over the next two years, in their view.

Oil Demand Growth and World GDP Growth



Source: Citi Investment Research and Analysis. As of January 9, 2012.

Oil Prices and Demand/GDP Ratio



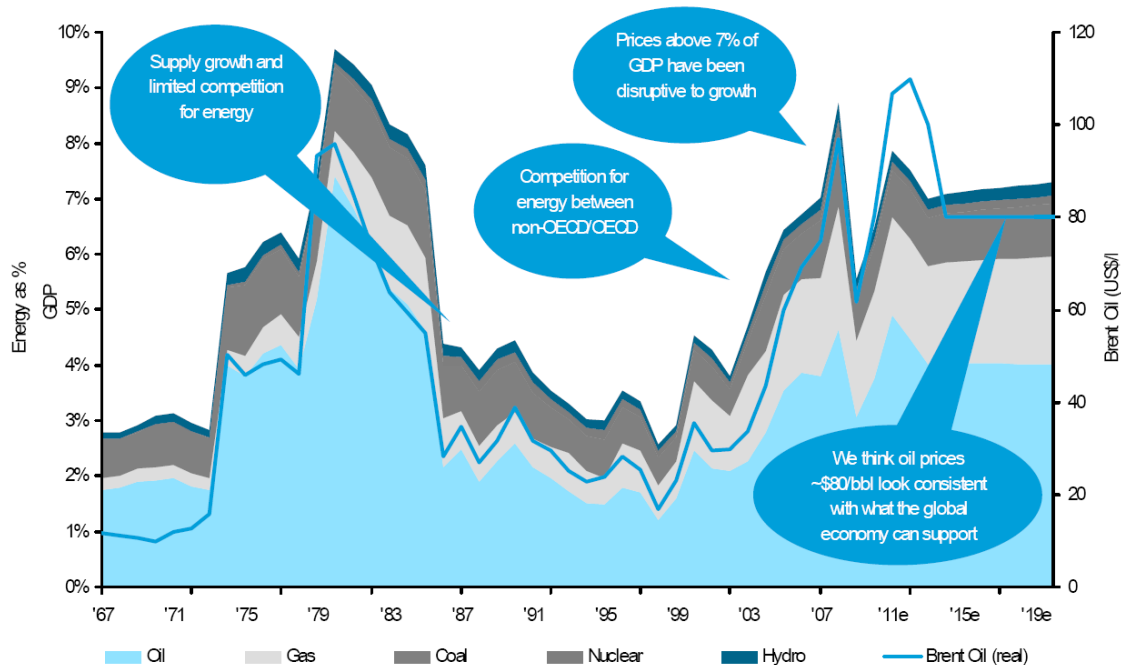
Source: Citi Investment Research and Analysis. As of January 9, 2012.

They believe we are now living in a crude oil-constrained world and oil prices may have to stay close to the pain point for the global economy in order to constrain demand growth. The pain point for the global economy is estimated to be around US\$120/bbl; at that price total expenditure on energy would consume about 9% of global GDP, a level that has historically been enough to cause the global economy to slow. Citi analysts do recognize, however, that the pain point is a moving target and is a function of the prices of other energy sources and of the general robustness of the global economy.

Feature

Oil in 2012

Energy Expenditures as a Percentage of Global GDP and Oil Prices



Source: Citi Investment Research and Analysis. As of January 9, 2012

Possible spikes but likely unsustainable

The low level of spare capacity and the numerous risks to oil supplies make the odds of an oil price spike high, in Citi analysts' view. If it is a major disruption that drives prices higher, for example Iran attempting to block the Straits of Hormuz, then prices could potentially move north of US\$150/bbl in very quick fashion. Citi analysts do not, however, expect them to stay there for very long, as they believe that level is simply too much of a burden for the global economy and could lead to a global recession which would in turn take oil demand and prices much lower.

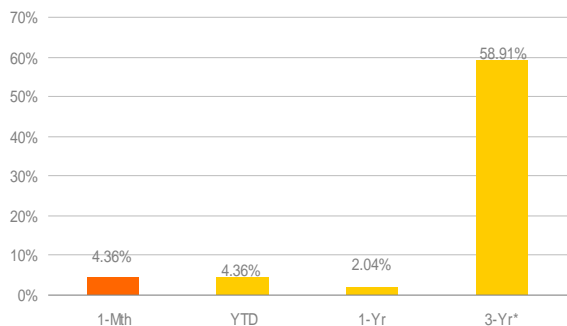
Citi analysts note that historically, oil price spikes resulting from supply disruptions have typically been followed by recessions – the 1973 OPEC embargo on the US and resulted in a 300% price spike, which saw global GDP growth drop from 6.4% in 1973 to 1.5% in 1974 and 0.9% in 1975. Similarly, the Iranian revolution and Iran-Iraq war from 1978 to 1981 saw oil prices double and global GDP growth drop to an average of 1.3% from 1980 to 1982, versus a 4.2% average for the previous three years.

Given the already fragile state of the global economy (and the equally fragile state of investor sentiment), signs point to the possibility of strong negative feedback loops coming into play – and a similar outcome (i.e. a global recession) cannot be written off even if the percentage increase in oil prices is lower. Given that oil prices are already close to the pain threshold for the global economy, Citi analysts think a reasonable estimate of a sustainable ceiling may be around US\$120/bbl. Currency movements obviously make this a moving target, however, and a strong USD accompanied by high oil prices can make the ceiling lower, and more solid.

All in all, Citi analysts' base case is constructive for oil prices. Their bull case, to which they assign a 25% probability, is that one of the many possible geopolitical risks to supply comes to fruition – oil prices would spike higher and take a toll on the global economy. Their bear case comes from a disintegration of the Euro (an event assigned a 5% probability), or a hard landing in China. Either of these could cause oil to test long-term replacement cost support levels which they estimate at US\$70-US\$90/bbl.

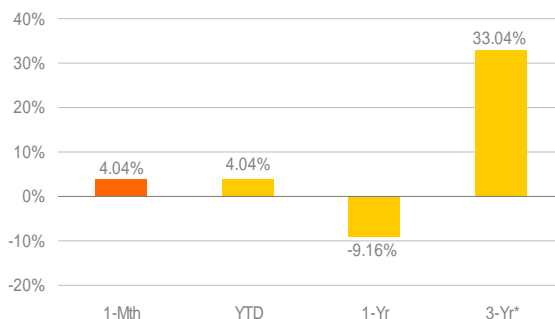
Equity markets

Chart 1:
S&P 500 Index



*Denotes cumulative performance
Performance data as of 31 January 2012
Source: Bloomberg

Chart 2:
Dow Jones Stoxx 600 Index



*Denotes cumulative performance
Performance data as of 31 January 2012
Source: Bloomberg

United States

Fed taking a more accommodative stance

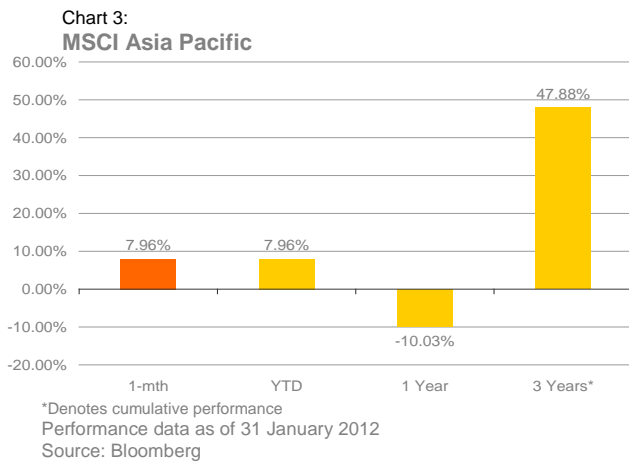
- Citi's updated forecast continues to show relatively subdued but sustained economic growth near 2%. Unsettled financial conditions remain a drag on the recovery's ability to gain traction but gradual improvement in the labour market and the resilience of activity in the face of negative shocks have introduced upside possibilities.
- Indeed, Citi analysts have slightly raised their forecast for payroll employment growth to just shy of 2 million jobs in 2012, with unemployment now expected to dip to 8.25% by year-end. Recent data also show increasing evidence that activity in the small business sector is picking up, a good sign that the recovery may be gaining self-sustainability.
- Nevertheless, the Federal Reserve (Fed) recently expanded its communications strategy at its FOMC meeting, enhancing transparency and accountability. Specifically, the Fed extended the likely period of near zero policy rates out to late 2014. While Chairman Bernanke was careful not to rule out asset purchases should conditions warrant, there was no indication of a new round of Quantitative Easing (QE).
- While equity valuations have slid since the tech bubble of the late 1990s and early 2000s, P/E trends seem surprisingly depressed given the incredibly low interest rate environment. In this context, Citi analysts believe there is ample reason to believe in multiple expansion in the next 12 months.
- There is typically an inverse relationship between equity risk premiums and P/E valuation and there have been many reasons to be concerned over the past decade, ranging from wars, sovereign credit woes, a financial crisis to peak margin worries and home price anxiety and high unemployment rates. However, there does seem to be an easing in some of these issues, which suggest higher stock prices.

Euro-Area

ECB may cut rates to 0.5% in 2Q12

- Largely due to additional fiscal tightening measures (mainly in Italy and Spain), Citi analysts are cutting their GDP forecast for the euro area to -1.5% for 2012 and -0.4% for 2013. After the downgrade of several euro area countries' sovereign ratings, the European Financial Stability Facility's (EFSF) functioning is likely to suffer and the planned introduction of the European Stability Mechanism (ESM) looks ambitious.
- The European Central Bank (ECB) has announced that it will widen the collateral pool further to pave the way for substantial use of the second 3Y LTRO in February. In addition, Citi analysts expect that the ECB will take further action to widen the collateral pool to ease banks' funding problems. On rates, Citi analysts anticipate the ECB to cut the main refinancing rate from 1.0% to 0.5% in 2Q, to reduce the deposit rate to 0.1% and to reduce the rate for marginal lending facility to 1.25%.
- Given the widening macro dispersion between Europe vs. US and Emerging Markets (EM), Citi analysts believe that stocks with international exposure should help deliver better earnings growth and a lower risk profile than European-focussed stocks.
- Indeed, gradual improvements in the labour and housing market, combined with reviving auto production and signs of increased competitiveness signal that the US is doing better. By itself, a US GDP growth forecast of 2% is fairly subdued. But the US and Eurozone GDP growth differential is reaching levels (of around 3.5%-4%) not seen in recent decades. The gap is even wider when comparing Eurozone with EM GDP growth expectations. An EM and Eurozone GDP growth differential of 6.5%-7% for 2012 is the widest level seen since the onset of the financial crisis. In a world that has not enough growth and too much debt, EM appears well placed with more growth than DM and less debt too.

Equity markets

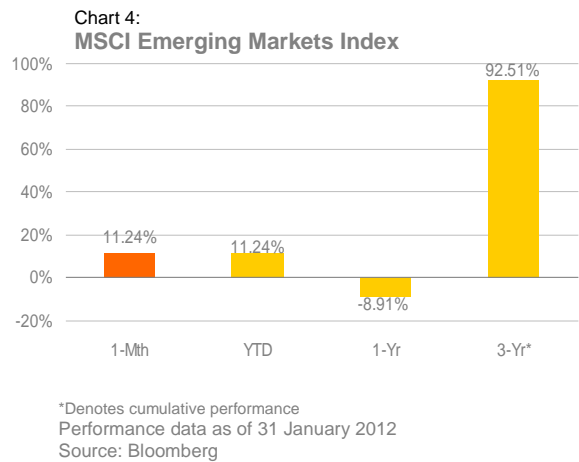


Japan Japanese stocks remain undervalued

- Japan's corporate and household sectors do not face as much balance sheet adjustment pressure as their US and European peers, but the economy remains quite vulnerable to external slowdowns and yen appreciation. Citi analysts expect economic activity to stay sluggish in 1H12 before picking up in 2H12 thanks to moderately faster global growth and reconstruction demand from the earthquake.
- At end-December 2011, the TOPIX cyclically adjusted price-to-earnings ratio (CAPE) stood at 7.4x, a slight increase from 7.3x at end-September. But the TOPIX CAPE remains lower than in past TOPIX bottoms and suggest that Japanese stocks remain undervalued on the measure, according to Citi analysts

Asia Pacific Risk appetite may hold out

- Despite unresolved issues from the Eurozone, Citi analysts believe that risk appetite towards Asia may hold out based on the following: 1) Asia's manufacturing cycle, led by technologies, could bottom this quarter; 2) liquidity strains from international banking spillovers remain limited so far; and 3) sharp food-led deflation anticipated in the near-term could raise policy easing 'expectations, notably in China and Korea.
- North Asian markets, which were sold off last year due to growth and financial fears, should be bought back, according to Citi analysts. Asia appears to be back on the easing cycle, which should benefit financials and growth sensitivities. Citi analysts are overweight Hong Kong, Korea and Taiwan, and neutral China. Sectors preferred include banks, energy, industrials technology and real estate.



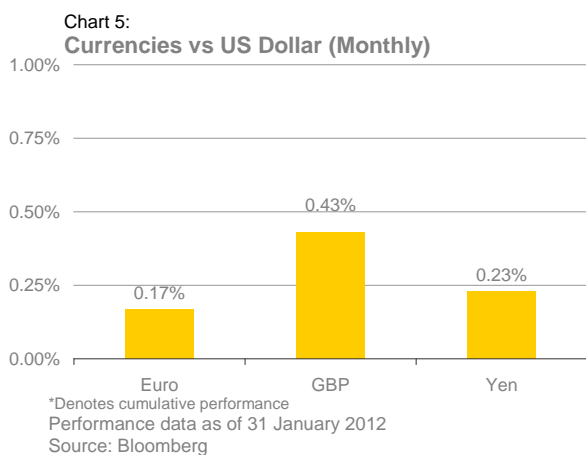
Emerging Markets Outlook for CEEMEA equities appears challenging

- Citi analysts continue to expect slower growth in 2012 with relatively contained inflation. This will provide scope for lower interest rates in some countries, with a series of 0.5% rate cuts expected to bring rates down to 9.5% in Brazil. For Mexico, recent inflation data reinforce the view for stable rates this year. The electoral scene remains uncertain in Venezuela, while Argentina's government has further strengthened exchange rate controls.
- CEEMEA¹ remains at the centre of risks associated with general risk aversion among investors as well as the specific risk of European bank deleveraging. Large external financing requirements in Turkey and Poland, could also continue to underpin the region's vulnerability.
- CEEMEA currencies, particularly Israeli Shekel (ILS) and South African Rand (ZAR) are expected to come under the most pressure near term, but then broadly recover 6-12 months out. Latam currencies are expected to remain relatively supported though the Chilean Peso (CLP) is the notable exception.
- While earnings downgrades are expected in Latam, Citi analysts do not anticipate an earnings recession and believe the region is poised for gains this year. Furthermore, it trades at 1.7x P/B, attractive compared to an historical average of 2.1x P/B and the same level as in late 2008 to early 2009. Citi's preferred markets are Brazil, Chile and Peru.
- Despite attractive valuations, the outlook for CEEMEA equities looks challenging due to the region's greater proximity to Europe. Under such conditions, Citi analysts prefer stocks with pricing power, sustainably high margins, low leverage and dividends. Citi's favoured market is South Africa, where earnings growth is expected to be relatively high, and where historically earnings have been less volatile.

1. CEEMEA is the collective term for Central and Eastern Europe, Middle East and Africa.

Currencies

Bond markets



Currencies

Decreasing risk of recession in the USD

- Citi analysts continue to view the recent USD weakness, especially against the majors, as an extended position squeeze and do not view the move as likely to be sustained. Although US economic data and European PMI data due out next week may point toward global recovery, they expect later data to continue to point to European recession and global slowdown, which should drive investors back in to the safe haven dollar.
- The recent rally in EURUSD has triggered substantial short covering. Citi analysts believe that most of the short-EUR position that was built up through the first two weeks of the year is now gone, so they see less room to the upside, although they acknowledge a further rally is possible on the back of a Greece PSI deal and supportive measures announced by the ECB at the February meeting.
- Japan's trade balance has gone negative since last year's earthquake/tsunami disaster. A broader measure of FX flows, the basic balance, is now roughly flat. Household savings is likely to continue declining, which could bring JPY weakness at some point down the road, according to Citi analysts.
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- Citi analysts think there is plentiful global liquidity to support Latam FX. Dovish central banks supportive of front end in spite of better global risk environment.

Positive on High-grade corporates and Emerging market debt

US Treasuries

Slow growth and fading inflation pressures could keep rates low. In Citi's view, curves are likely to bull-flatten further but gains appear poised to be less robust.

Corporates

Citi analysts favour non-financial issuers in the US, where fundamentals are solid, balance sheets are strong and liquidity is robust. On the other hand, despite relatively decent valuations, high yield bonds are likely to remain volatile as long as risk appetite remains depressed.

Euro Bonds

The UK is not immune to the periphery problems in continental Europe. However, gilts are benefiting from the Bank of England's decision on October 6 to boost its bond purchase program from £200 billion to £275 billion. Gilts also benefit from the government's renewed commitment to its austerity plan on November 30, which solidifies the UK's AAA rating. Long-dated UK gilts, which generated the most impressive bond returns of 2011, remain Citi's preference.

Emerging Market Debt

Spreads are still attractive as improving fundamentals and credit quality of emerging market debt provides investors with a way to diversify their sovereign holdings from developed markets.

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