MARKET OUTLOOK

March 2012

Asia: Growth headwinds could emerge near-term

After a strong year-end bounce in 2011, Citi analysts expect the pace of economic recovery in Asia to lose momentum in the near term as a sharper contraction in Europe, a slowdown in China, and some waning US core retail sales momentum work their way through the production cycle. Nonetheless, they view the near-term slowing momentum as a soft patch and continue to forecast robust GDP growth of 6.9% for 2012. They do however caution that a sharp oil price spike poses a key risk to their outlook.

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Feature

Asia: Growth headwinds could emerge near-term

Waning momentum

In the near term, the pace of economic recovery in Asia may lose some momentum from the strong bounce we saw in late 2011, as a sharper contraction in Europe (exacerbated by a harsh winter), a slowdown in China, and some waning US core retail sales momentum work their way through the manufacturing production cycle. But barring any new shocks, Citi analysts remain confident that the overall manufacturing cycle in the region has probably bottomed and could see further expansion going into 2H12. Moreover, an improving US employment situation and surprisingly resilient labour markets across Asia (unemployment rates have barely budged) alongside accommodative G4 central bank policies should continue to provide support to global final demand. They as such view the near-term slowing momentum as a soft patch and continue to forecast robust GDP growth of 6.9% for the region in 2012.

Chinese growth likely to slow significantly in 1Q12 but policy easing may gain momentum in coming months

Citi analysts estimate that China's GDP growth may decelerate on a seasonally adjusted annualized basis to 6.8% in 1Q12 (8.0% YoY) from 8.7% in 4Q11 (9.1% YoY), but believe that Chinese policymakers are likely to provide sufficient policy easing to keep growth close to the 8% range this year. They however caution that if the slower than expected M2 growth, new loans and total social financing are a harbinger of a much sharper than expected investment-led slowdown in 1Q12, we could see downside risk for the rest of the region. This could make the more China-trade linked economies like Singapore, Hong Kong, Taiwan, Malaysia and Korea relatively more vulnerable. But as China's slowdown is likely to be more investment-driven, fuelled by property/construction, we can take comfort in the fact that Asia's exports to China that are targeted for domestic investment is, on average, well below 30% of its total exports to China.

Meanwhile, China's policy easing could gain momentum in March as inflation comes off sharply and sufficient consensus may be built at the National People's Congress. With the reverse impact of the Lunar New Year food-price inflation, Citi analysts expect China's Feb inflation reading to fall significantly to a sub-4% reading (potentially as low as 3.5%) when released in March. That should remove the political hurdle to more overtly ease liquidity conditions via a few more reserve requirement ratio (RRR) cuts and other macro-prudential measures on the loan-to-deposit ratio (LDR) without being overly worried about unsettling inflation expectations. Citi analysts forecast three more RRR cuts but do not expect the government to cut its 1-Year deposit rate.

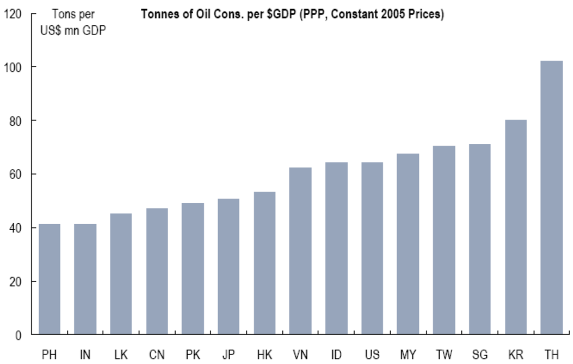
China appears to have more room on the fiscal than monetary front to support demand (given very low real deposit rates, and financial stability risks associated with the legacy credit expansion of the last few years). The National People's Congress convenes on 5th March and could set the stage for passage of a more proactive fiscal policy. Citi analysts forecast a deficit of 2.5% of GDP in 2012 (vs. last year's deficit undershoot of ~1% of GDP), though policy lags may mean that a more pronounced bounce in economic activity may not be seen until 2H12.

Oil price risks cast a darker cloud on the region

Citi analysts caution that potentially higher oil prices, which may have a knock-on impact on other commodity prices, pose a key risk to their growth outlook for Asia. Flaring Mideast tensions, especially in Iran, have pushed up Brent crude prices to around US$125/bbl. According to Citi analysts, the initial direct impact on growth can be measured by the level of oil intensity of a country's production base. In other words, those who use more oil to produce per unit of output could be more vulnerable. When comparing oil consumption per unit of output on a purchasing power parity (PPP) adjusted basis (Citi analysts think this is a better way to compare units of output across countries as it adjusts for varying price levels), they note that Thailand, Singapore, Korea and Indonesia are relatively more oil intensive than the Philippines or South Asia. However, they believe one would also need to qualify that vulnerability to the extent that net energy/oil exporters (Malaysia is a standout, Indonesia to a much lesser extent) would be cushioned from the positive income effect, which it could also pass on to its domestic population via subsidies. Korea and Thailand stand out as being the most oil-intensive in Asia as well as being the largest net oil importers in the region.

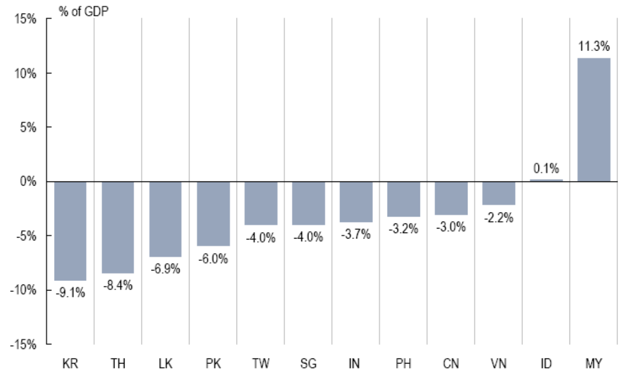
Asia: Growth headwinds could emerge near-term

Oil Intensity in 2010 – Oil Consumption in Tons per GDP in US$mn 2005 prices, purchasing power parity (PPP) adjusted



*Note:Adjusted downward to exclude oil used for refinery for re-exports.
Source: BP, EIA, World Bank and Citi Investment Research and Analysis.
As of February 24, 2012.

Oil and Gas Trade Balance in 2011 (As a percentage of GDP)



Source: CEIC Data Company Ltd. As of February 24, 2012.

However, the second round impact will be how oil price spikes impact global final demand in aggregate (with a global redistribution of income between net exporters and importers). Citi analysts note that an oil price spike by 50% (US$175/bbl on Brent) could potentially lead to a global recession from their current 2% base case growth scenario, and would clearly impact the more open/trade dependent economies in the region (Singapore, Taiwan, Hong Kong, Malaysia, Thailand and Korea).

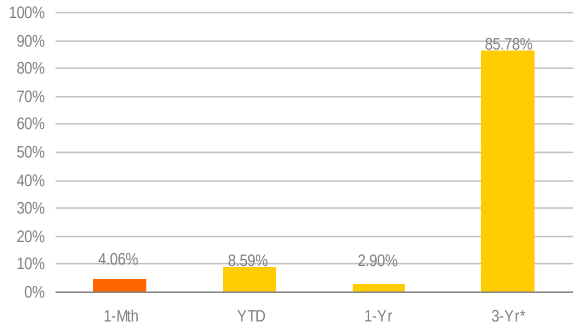
Another risk factor to growth is to what extent policy (especially monetary) responds to the rise in oil prices. Even before the rise in oil prices, Citi analysts had held the view that room for many Asian Central Banks (ex- India) to cut rates was limited. This is because real rates are already low to begin with, liquidity is ample, core inflation sticky in some cases and financial stability risks from household debt and asset bubble risks warrant prudence. They were only expecting India, the Philippines, Thailand and Vietnam to cut rates (and believe Indonesia could opportunistically do so) while all others were expected to stand pat on main monetary policy tools (but China to cut RRR). The rise in oil prices and stalling FX appreciation has only strengthened this argument. They do not expect further monetary policy tightening in Asia (the net bias is to be neutral or ease), but a shift in their policy rate outlook will depend on how much oil prices rise from here, sensitivity of inflation to oil prices and where inflation is headed versus their estimated central bank comfort threshold. In their view, the monetary policy outlook for India and Indonesia may be worth watching if oil prices continue their sharp ascent.

India – The base-effect sharp disinflation we have seen in the last few months (from 9.5% in November to 6.55% in January), alongside moderating core inflation, has cleared the “optics” for the Reserve Bank of India (RBI) to ease the policy rate (Citi analysts expect another cash reserve ratio (CRR) cut in March and a policy rate cut to start in April, after the FY13 Budget). However, the sensitivity of WPI inflation on fuel is high, not to mention the budgetary impact on subsidies, and could be a risk factor to Citi’s accommodative policy outlook of at least a 100 bps cut from the RBI.

Indonesia – Bank Indonesia (BI) has been the most aggressive in easing monetary policy in Asia. While Citi analysts do not see worrisome signs of overheating yet given long lags of policy and the additional capacity built by its recent years of investment activity, they believe BI’s stance has not built a cushion to inflation risks amid strong growth, elevated price expectations, and potential energy subsidy reforms.

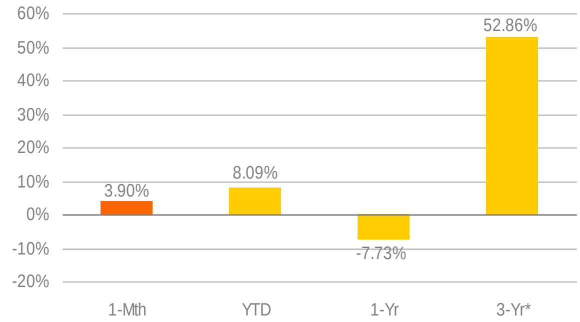
Equity markets

Chart 1:
S&P 500 Index



*Denotes cumulative performance
Performance data as of 29 February 2012
Source: Bloomberg

Chart 2:
Dow Jones Stoxx 600 Index



*Denotes cumulative performance
Performance data as of 29 February 2012
Source: Bloomberg

United States
Near-term consolidation likely

- Economic growth is continuing at a modest pace sustained by increasing employment, supportive policies and a mild winter. Rising demand for autos and business equipment indicates that key cyclical forces are pushing activity forward, and these are gradually overtaking diminishing drag from housing and state and local spending. Nonetheless, the threat of ill-timed major fiscal restraint looms over the two-year horizon.

- The Federal Reserve's (Fed) latest easing move successfully lowered interest rates and helped lift credit and equity markets. Payroll tax relief and other temporary supports have been extended as expected, but absent legislation, sweeping tax hikes and spending cuts that could undermine recovery are scheduled for 2013.

- Equity markets have surprised many with an impressive start to 2012, raising concerns on its sustainability. Although Citi analysts are maintaining their constructive full-year view on US equities, they caution that several metrics signal potential for a consolidation near-term.

- They had previously highlighted that 1) their Panic/Euphoria sentiment indicator is currently near complacency levels; 2) stock price momentum correlation has collapsed; 3) the Citi Economic Surprise Index is at peak like levels, suggesting potential for economic data to start disappointing; and 4) margin pressures are growing. Additionally, they note that two other metrics are now implying the same. First, corporate earnings revision momentum has been disappointing. Typically, there is a tighter relationship between earnings and the S&P 500 and the divergence is worrying in the short term. Second, Citi's Market Liquidity Index, which typically leads equity prices by nine months is close to average levels, implying fairly low probability of major market appreciation.

Euro-Area
ECB may cut rates to 0.5% in 2H12

- While Greece and the Eurogroup seem to have prevented an imminent disorderly Greek default, the Greek situation remains a huge source of uncertainty. If Greece is unable or unwilling to fulfil the austerity measures and structural reforms required by the Troika, the resultant lack of financing could leave Greece forced to leave the Euro Area. In this case, governments and the European Central Bank (ECB) are likely to take action in order to prevent the Euro Area from splintering further.

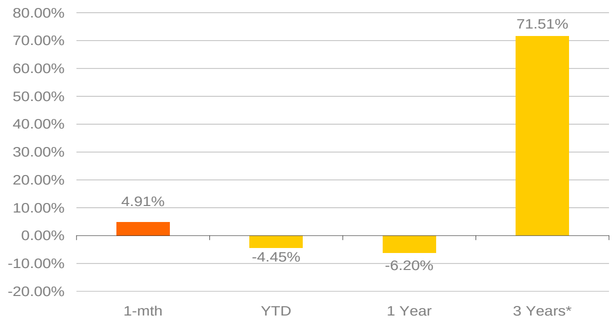
- As such, Citi analysts expect that unless the situation in Greece worsens rapidly in coming weeks, the ECB is likely to leave interest rates unchanged in March and April. However, with more signs of worsening credit availability and potential for inflation to undershoot the ECB's target of "below, but close to 2%" in the medium term, the ECB could cut the refinancing rate to 0.75% in late 2Q12 and lower it further to 0.5% in 2H12.

- Citi analysts continue to back decent gains for European equities till year-end, but think that it would not be surprising if equity markets took a pause for breath after the recent rally. Synchronized global liquidity has driven a pull-back free rally of 20%+ since November-2011 for European equities, and there have only been three rallies of more than 25% without a 5% pull-back since 2000. The near-term risk-reward thus looks less attractive compared to three months ago, though Citi analysts continue to believe that any potential dips in the market may present opportunities.

- Indeed, this may be a good time for investors to be more selective and discerning on their beta exposure. In terms of investment strategy, Citi analysts continue to back beta and companies with strong balance sheet. Defensive growth stocks are likely to do well as they could benefit from the macro mega-trends of de-leveraging and divergence.

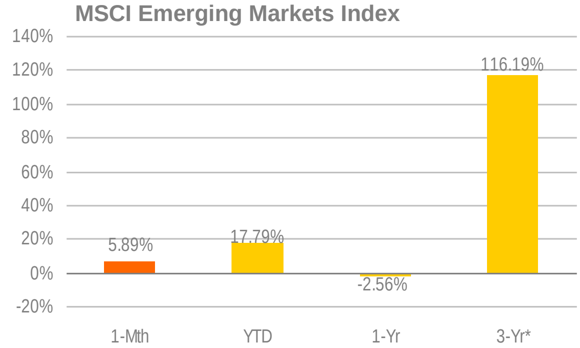
Equity markets

Chart 3:
MSCI Asia Pacific



*Denotes cumulative performance
Performance data as of 29 February 2012
Source: Bloomberg

Chart 4:
MSCI Emerging Markets Index



*Denotes cumulative performance
Performance data as of 29 February 2012
Source: Bloomberg

Japan
Growth likely to pick up in 2H12

- Recent survey data showed tentative signs of stabilization in activity in some of Japan's major trading partners, while JPY depreciated against USD moderately in the wake of the Bank of Japan's (BoJ's) new easing action. While Citi analysts expect only slight growth in 1H12 amid export weakness, activity may accelerate to an annual rate of 2% or higher in 2H12 thanks to moderately faster global growth and reconstruction demand from the earthquake.
- The recent rapid rise in equity markets has raised questions on its sustainability. While Citi analysts see potential for a temporary correction due to profit taking, they also see three factors supporting the uptrend through to before the Golden Week at the end of April: central banks globally are bolstering monetary easing measures; foreigners turned net buyers of Japanese equities in January; and leading indicators have been showing continued improvement.

Asia Pacific
Slowing momentum but no hard landing expected

- The pace of economic recovery is expected to lose momentum in the near term after a strong year-end bounce in 2011. With global manufacturing indices bottoming, the US employment situation improving, labour markets in Asia surprisingly resilient, G4 central bank policies accommodative and China's bias towards easing policy emerging, Citi analysts see the near-term slowing momentum as a soft patch.
- Since the mid-1970s, the average equity market cycle for Asia ex Japan has on average been eight years – five up-years followed by three down-years. According to Citi analysts, we are in year 3 of the up-cycle. At this stage of the cycle, we usually have price-to-earnings (PE) expansion. On average, markets have historically risen 3.5 times more than earnings growth. In terms of investment strategies, value has done better than growth in all but one cycle.

Emerging Markets
Outlook for CEEMA equities appears challenging

- A Turkish rate cut and dovish rhetoric by the Hungarian National Bank suggest that there is still concern within CEEMEA about the risks associated with weak global demand.

- With looser monetary policy in advanced economies, Latam central banks are increasingly concerned about another possible edition of "currency wars", but their responses are likely to vary. In Brazil, Citi analysts expect another 125 bps cut in the Selic this year while in Colombia, two additional 25 bps cuts are anticipated. Meanwhile, the central banks of Chile, Peru, and Mexico are likely temporarily on hold.

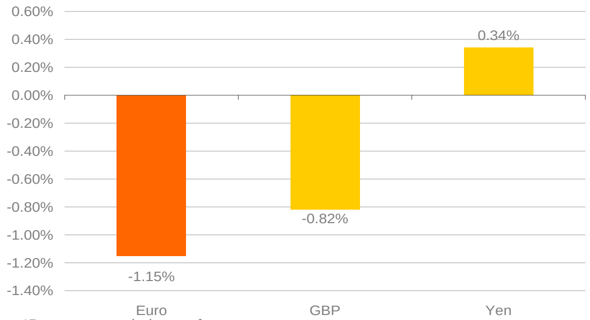
- Within CEEMEA currencies, two fresh measures from the Hungarian central bank – 2-year long-term refinancing operations (LTRO) for banks starting in March and mortgage bond purchase program – are expected to have a significant positive impact on the currency. Within Latam, the Brazilian Real (BRL) continues to look fundamentally well-supported: by a shrinking current account deficit, sound fiscal fundamentals and fair expected growth.

- While corporate earnings forecast downgrades are expected in Latam, Citi analysts do not anticipate an earnings recession and believe the region is poised for gains this year. Furthermore, valuations are attractive – trading at the same level as in late 2008 to early 2009. Citi's preferred markets are Brazil 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.

Currencies

Chart 5:
Currencies (1 Months vs US Dollar)



*Denotes cumulative performance
Performance data as of 29 February 2012
Source: Bloomberg

Currencies

- EUR/USD continues to be torn between lower risk in EMU asset markets vs. the continued downward pressure on front end rates in EMU resulting from the ECB's more dovish stance and related narrower rate differentials. Citi analysts observe that what is good for EMU — a very easy ECB — may be less helpful for the EUR depending on other Central Banks' actions. Short term, Citi analysts think this EUR/USD rally could extend a little further in the context of higher risk appetite, generalised USD weakness and assuming no disappointments near term over the Greek second bail out discussions and other related periphery risks.

- Citi analysts are sceptical still that the USD/JPY rally will proceed far over the medium term. For one thing, US short term rates remain one of the key JPY drivers and the exchange rate has already overshot fair value on this basis. Furthermore, it is pretty clear from the Fed that materially higher short rates are years away. Finally, the size of the Bank of Japan announcement, while a surprise to expectations, was still very small.

- In Asia, currencies of countries with growth dynamics that are less vulnerable to external risks and where macro policies are sound (MYR, PHP, THB) could outperform those with "unconventional" monetary policies (IDR) or where the incentive to intervene in the FX market is likely to be higher (KRW, TWD), according to Citi analysts.

- Idiosyncratic factors also count both between countries and regions. Citi analysts see Asia outperforming other EM regions medium term but BRL is forecast to give best returns relative to forwards and HUF in CEEMEA should perform well, albeit against a weak EUR

Bond markets

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.

US 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

In the UK, the recent ratings statement has had very little impact and as long as the coalition is able to maintain its strong fiscal stance, Citi analysts see no reason for Gilt investors to be overly concerned. The greater risk to Gilts would be a weakening of the government's position and a reversal of fiscal tightening; something that Citi analysts think could very likely trigger a rapid response from ratings agencies and the markets. Assuming that does not happen, they see the combination of fiscal restraint, weak growth and quantitative easing as supportive for Gilts.

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

Sources: Reuters, Bloomberg, Thomson Reuters/Jeffrie,s, CIRA.