MARKET OUTLOOK

May 2013

“Sell in May and Go Away” – A myth or Self-fulfilling prophecy?

Many investors dread May as historically some of the worst equity returns have been recorded in this month. Especially over the past three years, May has been cruel to the global markets. The fact that economic data from the US and China in recent weeks along with the ongoing financial crisis in Europe have disappointed pretty much around the globe has given more weight to fears that “Sell in May and Go Away”, an old market adage, could come true.

This is even more so in emerging countries than developed counterparties. The US slowdown looks cyclical because it is owed to modest fiscal tightening. However, China is possibly seeing a more structural slowdown with continued growth deceleration going into 2014 as the drag from reforms (including regulation on local government debt and off-balance sheet credits), policy tightening brought by FX reforms (leading to appreciation), as well as narrowing the regulated interest rate corridor – may likely pose growth challenges.

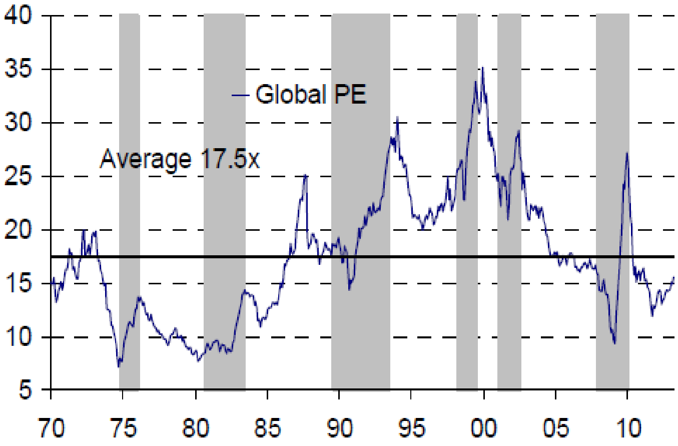
It appears that history might not repeat itself this spring. In effect, wobbles in equities may have started, in part, because of discussion about "tapering" or gradual withdrawal of Fed QE. But this seems to be self limiting for now. With significant fiscal drag, any tightening of financial conditions via lower stock prices may likely draw forth increasingly dovish Fed commentary leading markets to extend the QE end game further into the future and hence limiting the damage.

While Citi analysts recently have shaved 0.1% off their global growth forecast for 2013 to 2.6%, their base case is that there could be a reacceleration of global growth in 2014, led by a faster expansion of the US consumer boosted by better housing and employment numbers as fiscal drag fades in 2H13. Despite short-term headwinds, they expect global GDP to grow 3.1% in 2014, and believe that over the next 18 months, the global economy could grow at close to its 30yr average of 2.8%. If this proves to be the case, the medium-term outlook for risk assets remains constructive.

Valuations: Re-rated, but still below average

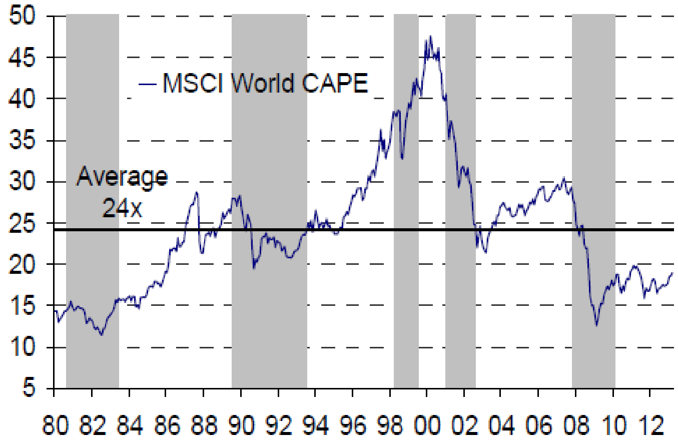
Furthermore, equity valuations are not stretched. Indeed, the MSCI AC World trailing PE is currently trading around 15.5x. While this is almost 4 points higher than the lows of 3Q 2011, it is still below the long-term average of 17x (chart 1). Even on a cyclically adjusted global PE (CAPE) that compares current share prices to 10-year average EPS, the current CAPE is 19x. This compares to a long-term average of 24x and a low in 2008 of 12.5x (chart 2).

Chart 1: MSCI World Trailing PE



Sources: Citi Research, Factset. Grey bars are EPS contractions. As of April 8, 2013

Chart 2: MSCI World CAPE



Sources: Citi Research, Factset. Grey bars are EPS contractions. As of April 8, 2013

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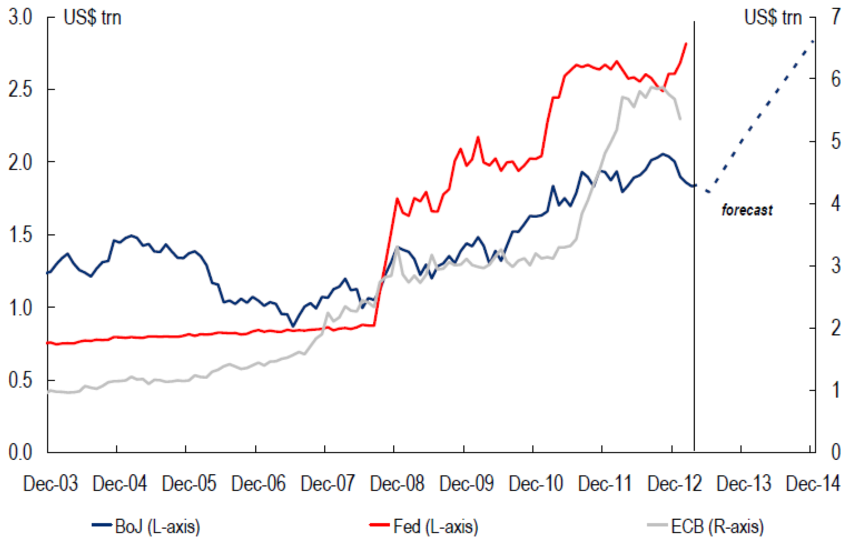
Finally, monetary policies remain supportive, with ongoing Fed QE now supplemented by a similar sized balance sheet expansion in Japan. The UK could yet join in the party and even in EM economies, policymakers are likely to be leaning more towards ease/ less tightening as growth has slowed and there has been little impetus to inflation.

Chart 3: Central Bank balance sheets in G3



Sources: Haver, BoJ, Citi Research. As of 19 April 2013

The ultimate question: should investors remain invested?

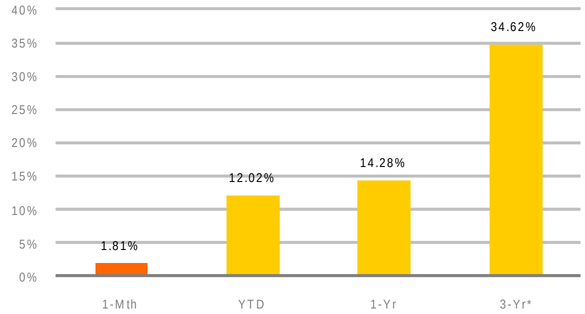
Citi analysts continue to expect significant positive returns from global equities in 2013 outperforming credit returns. With valuations arguably more stretched in credit than equity markets, there seems to be little room for spread tightening in credit with core bond yields likely resuming upward trends this year.

In the near term however, Citi analysts are becoming a little more cautious about risky assets as "risk-off" signals have been witnessed across the markets. With the rising risk aversion likely for the time being, it could take longer to reverse anomalies in equity valuations with slow growth and other headline event risks in place. In such an environment, the great debate here is whether it is value or momentum that is most likely to drive relative returns. And the answer is probably a combination of both. Value-driven performance may remain elusive and momentum trades are likely to prevail as distorted valuations could persist for longer than expected in the midst of headline event risks. However, long-term value could likely play out as a core driver of expected returns from a cross-asset perspective. Thus, the message for the short term is probably to follow the flow of money. The Fed and the BoJ are the major suppliers of liquidity with the BoJ likely gaining precedence over the remainder of the year. Consequently, Citi analysts are overweight Japanese equities and local EM rates.

Medium term, Citi analysts continue to favour Japanese equities on the back of weaker Yen and European equities given better valuations and strong earnings potential. In conclusion, Citi analysts believe while there is certain seasonality to equity market returns in recent years, any pullback could likely present an opportunity to allocate more assets to equities.

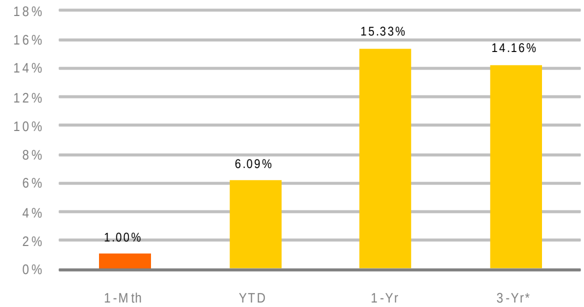
Equity markets

Chart 1:
S&P 500 Index



*Denotes cumulative performance
Performance data as of 30 April 2013
Source: Bloomberg

Chart 2:
Dow Jones Stoxx 600 Index



*Denotes cumulative performance
Performance data as of 30 April 2013
Source: Bloomberg

United States
1H13 strength could be maintained

- Citi analysts continue to expect economic growth of 1.9% this year and picking up further in 2014 to 2.8%. Support for expansion has improved with moderate but sustained job gains, more effective monetary accommodation as reflected in buoyant financial markets, and the rippling effects of reviving housing. Short-term volatility due in part to weather distortions has provided an extra lift to 1Q13 GDP but consumer discretionary spending has softened post tax hikes. Fiscal drag is nearing its peak impact in the next several months as sequestration is implemented.

- The Federal Reserve's (Fed) aggressive forward guidance and open-ended bond-buying have yielded the longest stretch of accommodative financial conditions since the late-1990s. The drag from fiscal restraint and policymakers' high bar for satisfactory job growth will likely sustain QE at an elevated pace through 1H13 but may begin to taper the pace by the start of 4Q13. High unemployment and low inflation suggest no start to exit strategies through 2014.

- While the broad investment community was of the belief that 2H13 would experience better economic trends and thus stocks would appreciate, Citi's US equity strategy view has been more first-half oriented as credit conditions argued for corporate sector growth and "panic" readings last June signalled a high probability of market strength over the course of the subsequent 12 months.

- Indeed, 1H13 strength could be maintained as sentiment, valuation, implied earning growth and credit conditions support the rally. Citi analysts would not be surprised if the rally carried the S&P 500 Index into the 1,650-75 area as things tend to overshoot. But European economic woes, a possible pullback in QE and the battles over a new budget for FY2014 could cause a mild market setback in 2H13..

Euro-Area
ECB may cut rate by another 25 bps later this year

- Citi analysts are slightly cutting their 2013 GDP forecast to -0.6% YoY from -0.5%, but leave the 2014 forecast unchanged at -0.3%. Activity data suggest that the recession continued in 1Q13. Weakness in sentiment indicators points to GDP growth around zero in the remainder of the year.

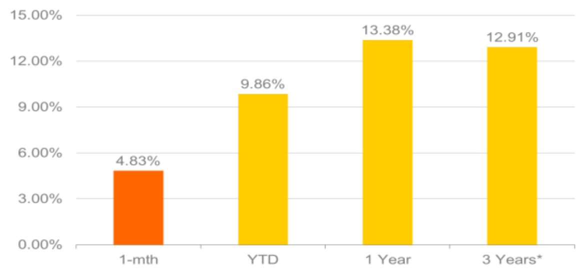
- Available data suggest that the Cyprus rescue package, including the bail-in of non-insured deposits, has not led so far to deposit flight in other countries. Without increased pressure on bank funding, additional far-reaching non standard measures are unlikely for the time being. While the ECB wants to contribute to improving lending conditions to SMEs, Citi analysts suspect the central bank may take only limited action, targeting a reduction in the valuation haircuts on such loans when used as collateral for the ECB operations. Recent comments suggest that more Council members acknowledge the ongoing economic weakness and falling inflationary pressure. Citi expects a further refi rate cut in the reminder of the year to 0.25%.

- Since mid-March, European equities have receded on soggy global economic data, ongoing Euro Area concerns and unexciting earnings data. In Citi's view, valuation still looks reasonable (absolute) to super attractive (relative). Earnings risk remains modest, without a GDP cliff which our economists think is unlikely. As such, Citi analysts believe the current pullback appears healthy and could present opportunities for investors.

- In particular, Citi analysts favour 3 key strategies: 1) companies with earnings momentum, balance sheet strength, US exposure, 2) high surplus cashflow stocks with strong balance sheets, and 3) European Financials with strong capital positions and attractive income characteristics.

Equity markets

Chart 3:
MSCI Asia Pacific Index



*Denotes cumulative performance
Performance data as of 30 April 2013
Source: Bloomberg

Japan
2% inflation target remains uncertain

- Recent BoJ's policy decisions overwhelmed even the most bullish forecasts among market participants. In Citi's view, Governor Kuroda's strategy is to affect expectations among consumers, companies and market participants by bold easing measures in order to achieve 2% inflation in a relatively short timeframe. However, it is uncertain when and how far expectations among the general public will shift, given the unprecedented experiment of monetary policy. Citi analysts remain sceptical that the measures taken so far are powerful enough to change stubborn deflationary expectations into inflationary expectations.

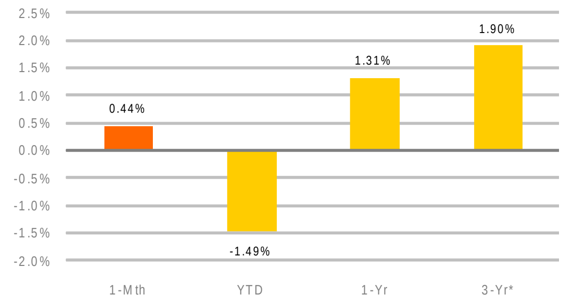
- From here, we expect financial markets to gradually shift their focus to 3 developments: 1) Economic fundamentals, 2) the growth strategy that the Abe administration plans to publish in June and 3) the administration's possible clarification of its stance on the consumption tax hike.

Asia Pacific
May play catch up in medium term

- There have been two significant macro developments, one of them being the downshift in global growth expectations. In Citi's view, more industrialized economies of Korea, Singapore and Taiwan could be more vulnerable than the "Emerging" parts of Asia given less leeway to lean on domestic demand. Inflation concerns have receded in the region with the help of benign commodity prices, giving support for some extension of monetary accommodation.

- Asia-ex and EM do not have the attributes of the markets that are going up. They have weaker price and revisions momentum and they are less liquid. But they have value and higher growth. However none of those attributes currently interest investors. Citi analysts believe that the current growth scare may eventually pass.

Chart 4:
MSCI Emerging Markets Index



*Denotes cumulative performance
Performance data as of 30 April 2013
Source: Bloomberg

Emerging Markets
Neutral on Latam equities

- Since monetary injection by the Bank of Japan is likely to fuel the demand for risky assets, high-yielding CEEMEA economies — eg Poland, Hungary, Turkey, South Africa, Russia — could find themselves on the receiving end of additional capital flows.

- Although valuations are attractive (at 8.1x 2013E earnings, compared to 10.8x for GEMs), sentiment on CEEMEA remains poor and earnings momentum appears weak. Preferred markets include Turkey where the EPS outlook is strong. Economic growth is likely to accelerate further, helping investor sentiment.

- In 6-12 months, as the US dollar gains ground more generally, CEEMEA currencies, particularly ZAR and HUF, are anticipated to weaken further. Meanwhile, Citi analysts expect some Latam strength to sustained in the near term (lifted by MXN and BRL), with some give-back over the medium term as the US dollar strengthens more broadly.

- Within Latin America, Citi analysts now expect the monetary policy tightening cycle to begin in April with a 25 bps hike in Brazil. In Mexico, economic activity has softened a bit in the past couple of months, partially thanks to calendar effects, but Citi is maintaining their call for 3.6% GDP growth this year.

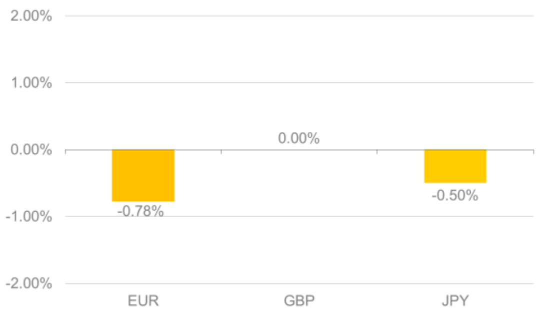
- As for Latin American equities, Citi analysts are neutral. Despite expected double-digit EPS growth for 2013, LatAm's relative earnings momentum has been weak. Meanwhile, valuations are the highest among the main EM regions. Preferred markets include Mexico (expectations of another strong earnings forecast in 2013, structural reform and a cheap peso).

Currencies

Bond markets

Chart 5:

Currencies (1 month vs US Dollar)



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Currencies

- The market focus on QE scale back discussion has diminished more recently following comments from less hawkish members that purchases could be increased if disinflationary pressures grow. While the Fed's choice to highlight the two way flexibility on purchases could be read as moderately dovish, it could also represent progress toward target based QE guidance. Upcoming jobs data will be of great focus for the market in gauging what next steps at the Fed will look like. To the extent which further relative outperformance of US data continues to support capital inflows, the presently more risk-correlated USD could persist according to Citi analyststs.

- At the most recent ECB meeting, the main refinancing rate was cut 25bp and President Draghi indicated the ECB was operationally ready for negative rates. Mr. Draghi highlighted downside risks to the current economic outlook and that the ECB continues to stand ready to act. Citi analysts see EUR risks as continuing to be on the downside given the rather limited growth impact that the rate cut could have and that further rate cuts should make EUR an even more attractive funding currency.

- Sterling regained ground as investors have pared back bets on imminent aggressive QE from the BoE and data improved. While data avoids another dip GBP could remain relatively supported, albeit close to current levels given the recent build up of longs. Citi analysts maintain however that over the medium term the pound remains a sell on rallies given the continued fiscal drag from austerity and private sector deleveraging. Concerns about future weakness of the UK economy and sterling remain firmly in place.

- Citi analysts believe Japanese policymakers may need to introduce further easing measures before achieving 2% inflation However, we doubt they will make those changes at the upcoming meeting in late April, as the full impact of the first round of easing has yet to filter through.

Positive on High-grade corporates and Emerging market debt

US Treasuries

US Treasuries may remain range-bound as sluggish growth prospects, political uncertainties, and the US fiscal debate weigh heavily on the yield curve. As uncertainties dissipate, rates may seek higher ground later this year to reflect lower tail risks and improving growth prospects.

US Corporates

While Citi still believes that the fundamental backdrop is relatively strong, balance sheet improvements have reversed. With higher government rates and only modest spread compression, Citi analysts expect modest returns this year and favour maturities in the 5-10 year range.

US High-Yield

High yield corporate bonds continue to benefit from low government yields, low default rates and simulative monetary policies conducive for risk assets. Although Citi analysts expect Treasury rates to rise during 2H13, high yield bond spreads may compress and the attractive carry could boost performance.

Emerging Market Debt

Debt markets in emerging nations have benefitted from improved fiscal balances and more credible monetary regimes. Easing inflation pressures allow central banks more room to ease (or at least, not hike), boosting fixed income asset markets.

Euro Bonds

Citi analysts believe that core rates are likely to be range-bound near term as recession, political instability in Italy and two more ECB rate cuts this year are likely to weigh heavily on Core European yield curves.

Japan Bonds

The Bank of Japan's (BoJ) easing measures far exceeded market expectations. It introduced monetary base in order to aggressively expand Japan's aggregate money base. Also it expanded the JGB purchase amount and the maturity of JGBs eligible for purchase to 40 years to keep JGB long-term yields low. With these measures in place, long-term interest rates are setting record lows for the time being.

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