

MARKET OUTLOOK



Central Bank Exit Strategies in 2010-12

With downside risks to growth receding, the key policy challenge for 2010 and beyond is whether central banks and governments can successfully manage the exit strategies from extreme monetary accommodation and huge fiscal deficits without creating further instabilities and denting future growth prospects.

Feature

Central Bank Exit Strategies In 2010-12

The global economic recovery already has prompted interest rate hikes in a few countries, but Citi analysts' forecasts do not anticipate an early or aggressive turn by the main central banks. Despite significant progress toward stabilizing financial conditions, inflation prospects remain unusually benign and a durable recovery is not yet established. Citi analysts expect China's first rate hike to probably come in the third quarter of 2010. The US Federal Reserve (Fed) is not expected to hike until later in the year, with the European Central Bank (ECB) perhaps on hold until early 2011. With Japan's deflation expected to persist, initial tightening there may not occur until late 2011.

So far, the major central banks are still in varying stages of providing liquidity support, purchasing long-duration assets and intervening directly in private credit markets. The Fed, the Bank of Canada and the Bank of Japan recently have provided so-called commitment language which points to extremely low rates continuing for some time, while the UK MPC further expanded quantitative easing.

Even so, the untested nature of unconventional measures and their sheer scope require that central banks begin to develop a framework for policy exit that minimizes risks on both sides, overstaying accommodation or prematurely disrupting financial conditions and economic recovery. The November G-20 Communiqué highlighted that, while recovery remains dependent on policy support for now, countries would establish a new consultative "mutual assessment process" to help develop policy options for smooth adjustment across regions.

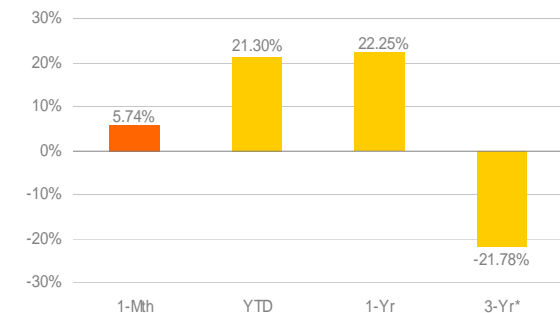
The Fed has been the most expansive in its use of a wide set of unconventional tools and correspondingly has been out front educating the public on the credibility of its own exit strategy. Key elements of this plan are already underway, as loosening in interbank and money market funding has allowed the Fed's short-term liquidity provisioning to shrink substantially. Similarly, the Fed's credit easing is being capped off as confidence in market functioning and access has risen. Nevertheless, Fed officials may be reluctant to back away from the commitment to near-zero rates until labour markets stabilize and there is greater confidence that financial conditions will underpin the recovery process – conditions that may only come together around mid 2010 in Citi analysts' opinion.

For the Fed and other central banks, exit strategies will have to contend with still very large balance sheets and expanded bank reserves as decisions to raise overnight rates approach perhaps late next year. While the sequence of actions may yet be undecided, Citi analysts expect that the Fed's new ability to pay interest on reserves (IOR) is likely to place a controlled floor under rates despite enlarged reserve levels. The ECB's interest-paying deposit facility already has demonstrated success on this score as its balance sheet has grown.

Fed officials have suggested that the IOR option is likely to be undertaken with other actions to drain reserves and excess liquidity. These include much larger reverse repos (transactions whereby the Fed borrows money to primary dealers than the Fed has historically arranged). Preparative tests with dealers suggest there is significant capacity for this, but the Fed also may opt to take control of excess reserves in term deposits. The more aggressive and perhaps least likely, initial strategy would entail the outright sale of longer-duration assets. The Fed has become the dominant player in mortgage-backed securities and would need to have great confidence in the effects of outright sales on borrowing rates and credit conditions in order to manoeuvre this kind of tightening exercise. In any event, officials anticipate that prepayments and redemptions would allow an estimated US\$100-200 billion of assets to runoff each year over the next few years.

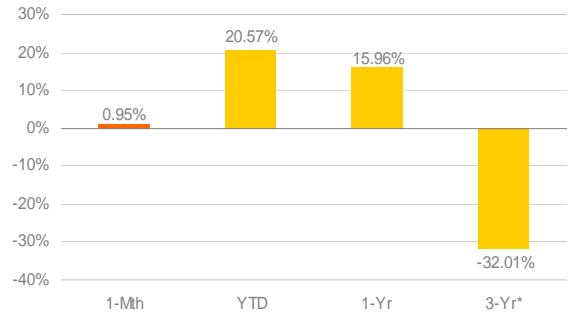
Equity markets

Chart 1:
S&P 500 Index



*Denotes cumulative performance
Performance data as of 30 November 2009
Source: Bloomberg

Chart 2:
Dow Jones Stoxx 600 Index



*Denotes cumulative performance
Performance data as of 30 November 2009
Source: Bloomberg

United States

Key drags on economy look to be fading

- After two years of financial turmoil and crisis punctuated by a near-freefall in spending and output, diminishing drag from financial markets and housing suggest that the resumption of growth is likely to be sustained.
- Healthy access to credit remains a sticking point but overall financial conditions are substantially improved and at least for now are aiding recovery. This development may be key to sustaining a moderate upturn as fiscal and other supports wind down.
- The path for monetary policy is complicated by the uncertainties surrounding the exit from near-zero rates and the Federal Reserve's (Fed) expanded balance sheet. Citi analysts expect active retreat to begin later next year, contingent on confidence in a sustained recovery with supportive financial conditions and a consensus that inflation is unlikely to slow further.
- Citi analysts have upgraded their 2009 year-end targets for the S&P 500 and DJIA to 1,100 and 10,400 respectively, from 1,000 and 9,500. They believe that the combination of a better credit environment and a surge in leading indicators argues for substantially stronger industrial trends over the next six to nine months.
- In particular, industrially sensitive groups such as Capital Goods and Energy are most exposed to recovering business investment and thus any betterment in business activity could potentially benefit stock prices in these specific areas. However, Citi analysts are not so positive on the Materials sector given less than attractive valuation and earnings revision trend.

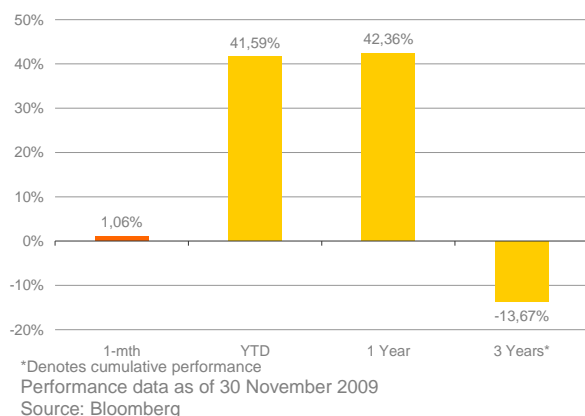
Euro-Area

Lower growth momentum expected in 2010 and 2011

- While temporary factors (scrapping bonus for cars and the rebuilding of inventories) are likely to contribute to decent economic growth at the beginning of the recovery in 2H09, Citi analysts expect lower growth momentum in 2010 and 2011.
- Core inflation is likely to moderate further as wage growth is anticipated to slow and companies may struggle to implement price increases as long as domestic demand stays weak. The expected further strengthening of the EUR may also limit upside pressure which might emerge from rising commodity prices.
- The European Central Bank (ECB) is anticipated to keep interest rates on hold until early 2011. With deleveraging in the euro area banking sector — and also in the household and corporate sectors — likely to be a drag for private sector demand for a while, the exit from monetary and fiscal stimulus measures are likely to be gradual.
- Citi analysts continue to back the case for European equities over bonds in the coming 12 to 18 months. They think there is a case founded on economic and corporate profit recovery into 2010, as well as attractive equity valuations (especially in mega-caps and high-yielding big-caps). Improving demand from investors could also provide further support to rising share prices.
- Key themes that they see developing over the coming 12-18 months include: 1) from blind recovery to delivery, 2) search for growth, 3) moving up the size scale, 4) absolute value in defensives, 5) the rise of dividends and 6) the return of debt equity arbitrage opportunity.

Equity markets

Chart 3:
MSCI Asia Pacific (Inc. Japan) Index



Japan

Deflation may persist well into 2011

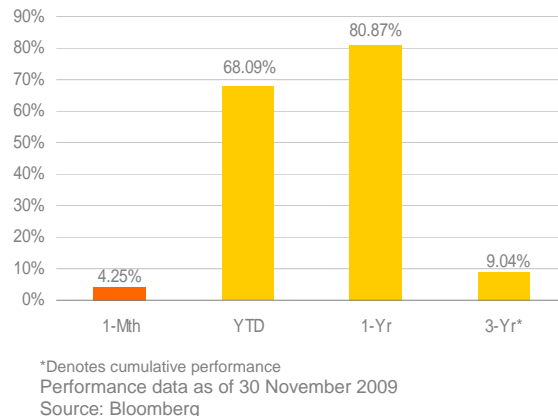
- After a temporary pause in activity early next year, Citi analysts believe the Japanese economy is likely to return to a growth path somewhat above the potential growth rate of the economy (+0.5 to +1.0%) in 2010, mainly driven by a steady increase in exports, particularly those to Asia. They forecast Real GDP growth of +1.5% in 2010.
- Japanese equities' fundamentals are recovering steadily but share prices remain weak. From the end of June to November 26, Japanese equities fell 9.8%, compared with gains in other regional markets. Citi analysts believe that this could be due to the rapid increase in large equity financing deals.

Asia Pacific

Region should continue to outperform globally

- After embarking on an earlier and sharper economic rebound than the rest of the world, aided by inventory-restocking, aggressive policy stimulus, and strong final demand from China, Citi analysts expect the region's recovery to continue gaining momentum in 2010.
- Rising inflation may prompt central banks to hike ahead of the Fed, but policy tightening is likely to be gradual for fear of threatening growth and catalyzing unwelcome capital inflows. Citi analysts expect rate hikes to range in the 50 bps (Malaysia and Taiwan) and 125 bps range (Korea, India, Indonesia, Thailand) for 2010, still leaving policy rates below neutral for 2010.
- In terms of investment strategy, Citi analysts favour companies which are able to increase either their dominance or market share in 2010, and those which make intelligent use of their capital; this should allow them to either acquire, organically grow, or return cash to shareholders. In particular, Citi analysts favour Hong Kong, Korea and Taiwan and the telecoms, banks, information technology and energy sectors.

Chart 4:
MSCI Emerging Markets Index



Emerging Markets

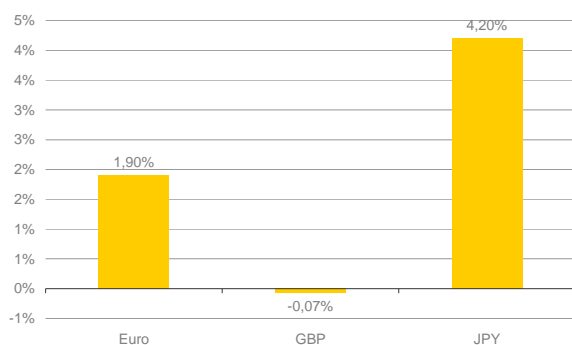
Base case for Latam equities remains positive

- Ample global liquidity may provide continued support to the economic recovery in Latin America, but could present policymakers with new challenges. Citi analysts believe that central banks in the region are likely to be pushed to hike rates sooner, while fiscal policymakers may soon begin to withdraw some of the stimulus enacted this year.
- Over in CEEMEA¹, poor credit availability and limited chances of a strong export rebound point to a weak economic recovery. Citi analysts believe that public finance vulnerability could remain a theme in 2010, putting pressure on yield curves to stay relatively steep.
- Most Latin American currencies are likely to continue benefiting from a weak USD and a global recovery in the short term. In the medium term, Citi analysts expect fiscal and inflation concerns to limit appreciation pressures. In CEEMEA, Citi analysts expect currencies to strengthen over the short and medium term, supported by buoyant risk appetite. They also see potential for the South African Rand (ZAR) and Russian Ruble (RUB) to continue benefiting from commodity prices and improved external accounts.
- After the huge gains of 2009 — the strongest year for Latin American equities since 1991, Citi's base case for 2010 remains positive although gains are anticipated to be much slower than 2009. Citi analysts favour Brazil and Chile.
- A rebound in economic activity alongside low global interest rates makes for a supportive backdrop for CEEMEA markets to year-end. In particular, Citi analysts are overweight Turkey, South Africa and Egypt. However, they do caution that some volatility in CEEMEA is likely.

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

Currencies

Chart 5:
Currencies (vs USD on 1 month)



*Denotes cumulative performance
Performance data as of 30 November 2009
Source: Bloomberg

Currencies

Euro

- Euro area economic data continue to improve relative to expectations as evidenced both by the Citi Economic Surprise Index and rising consensus forecasts.
- Citi analysts observe that improving risk appetite continues to correlate with generalized US dollar weakness versus the Euro and they estimate that strong sentiments are likely to continue to weigh on the US dollar in the near term.

Sterling

- Citi analysts consider that from a sterling perspective, low inflation expectations imply lower rates for longer which is likely to be negative at the margin.
- Citi analysts think that the drop in EUR/GBP observed in the last 3 months is likely to be short lived. Although Euro area less UK swap rate differentials did move slightly lower, the shift in EUR/GBP has been much greater and calls for a reversal.

Yen

- Citi analysts expect the JPY to continue to gently appreciate vs. the USD over the medium term although the currency will not likely lead the process of USD depreciation.
- Citi analysts estimate that the JPY is no longer in the currency funding camp and that a real exchange rate (inflation adjusted) actually much higher than the nominal rate given the extended period of deflation in Japan justifies JPY strengthening.

Bond markets

High-grade corporate bond favoured for attractive risk-reward trade-off

US Treasuries

Citi analysts anticipate volatility to remain low and rates to remain range bound in the near term.

US Corporates

Although year-end profit-taking could result in choppy near-term returns, Citi analysts expect cash bond spread tightening to continue into 2010. As for High yield bonds, Citi analysts expect tightening momentum to continue as the environment continues to be favourable to credit and investors begin to exaggerate their reach for higher yields.

Euro Bonds

Euro-denominated government bonds were recently sold off as investors became less gloomy about the economy and moved capital toward riskier assets. In Citi's view, government bonds are still considered a safe haven and may rally if equity markets falter or the economic outlook darkens.

Emerging Market Debt

Citi analysts remain neutral on emerging-market bonds. In their view, political uncertainties do not appear adequately priced into current spreads.

General Disclosure

"Citi analysts" refers to investment professionals within Citi Investment Research and Analysis, Citi Global Markets (CGM) and voting members of the Global Investment Committee.

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