MARKET OUTLOOK

Possible Grexit looming

Citi analysts have put the probability of Greece exiting the Euro Area (Grexit) in the next 12-18 months at about 90% and, within that timeframe, think that it is increasingly likely that Grexit could occur in the next six months or so, conceivably even as early as September/October depending on the outcome of the September Troika (European Union, European Central Bank and International Monetary Fund) report on Greece. There is also a crucial series of meetings and events in the coming weeks that may clarify how this plays out.

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Possible Grexit looming

Likelihood of Grexit becoming even clearer…

The likelihood of Grexit itself is coming into even sharper focus, in Citi analysts' view. There appears to be a sizeable – and probably unbridgeable – gap between the Greek government's ability to quickly cut the fiscal deficit and implement major supply-side reforms and privatisations, and the measures that creditor nations require to extend further funding. The Greek government has sought a two-year extension of the latest austerity programme, with a slower pace of fiscal tightening. At the same time, attitudes appear to be hardening among official bodies and especially creditor nations, with a growing reluctance to do "whatever it takes" to keep Greece in the European Monetary Union (EMU) and a growing willingness to contemplate the likelihood that one or more countries will exit EMU.

There is a busy timetable of key meetings and events in the coming weeks that may clarify how this dilemma could play out.

- **6 September:** ECB meeting and press conference, when the ECB is likely to present details of the Conditional Government Bond Purchase Programme (CGBPP).
- **Around September 11:** EU Commissioner Michel Barnier will present the proposal for a single bank supervisor (the ECB) in the Euro Area.
- **12 September:** German constitutional court will rule on the legality of the European Stability Mechanism (ESM). If the court decides in favour, the German President can sign the ESM treaty immediately. Germany is the final signatory needed for the treaty to enter into effect. Once all ESM member states pay their obligations to the first capital tranche, the fund will become operational. However, the court may also require additional information, particularly on the ECB's bond purchase plans under existing ESM programmes, before making a final ruling. Anything other than a positive ruling from the court will prevent Germany ratifying the treaty in the short term.
- **12 September:** Dutch election, with polls pointing to an inconclusive result, which could inhibit approval of further EMU rescue measures.
- **13-14 September:** Meeting of G20 Finance Ministers and Central Bank Governors in Mexico.
- **14-15 September:** Informal meeting of European Finance Ministers (ECOFIN) with Central Bank Governors.
- **During September:** Troika assessment on Greece.

The precise timing of Grexit, if it happens, remains uncertain. But Citi analysts believe it could even occur as soon as September/October, if the upcoming Troika report confirms that Greece's programme is off-track and creditor nations are unwilling to provide Greece any funding extension or extra time. However, creditor nations may provide enough funding to delay Grexit to after the December review, for example to allow plans for common bank supervision to be finalised. This might ensure that if Grexit prompts wider bank recapitalisation needs (in the other Euro Area countries), these can be mutualised via the ESM (either immediately or at a later stage). A deferral beyond September also could be more likely if the German Constitutional Court causes a delay in ESM ratification. Or, the Greek establishment may accept at some stage that it will be unable (or unwilling) to implement the measures required to stay inside EMU and decide itself that Grexit is inevitable.

…But the exact mechanics remain uncertain

In the event Grexit happens, Citi analysts envisage an extended bank holiday and some form of capital controls and limits on deposit withdrawals in Greece (and perhaps some temporary restrictions in some other EMU countries as well). Prior examples highlight that currency redenomination need not be uniform: for example, when Argentina abandoned its currency peg to the US Dollar in 2002, the government decided to apply a 1-to-1 exchange rate for Bank loans and a 1.4-to-1 exchange rate to deposits. Moreover, when East Germany adopted the Deutsche Mark as legal tender on July 1, 1990, just ahead of German unification in October of the same year, the East German mark was converted at par for wages, prices, pensions and savings up to a limit of 4000 East Mark/person. Financial claims, including corporate and housing loans, and savings in excess of 4000 East Mark were converted at a ratio of 2:1 into the Deutsche Mark. Citi analysts believe that a new Greek currency could fall by about 60%, pushing inflation markedly higher in 2013-16, but the scale of currency decline is highly uncertain.

Possible Grexit looming

With policymakers aware that Grexit could be a “Lehman” moment – that causes massive unanticipated disruption – Grexit (if it happens) is likely to prompt a huge policy response, with policymakers using conventional and unconventional tools. The approach may be to err on the side of being overly generous rather than emphasise long-run moral hazard or inflation concerns. Greece itself could probably receive financial assistance from the IMF and EU, while the ECB (and other central banks) may provide extensive extra liquidity and, in some cases, monetary policy easing as well. In addition, assistance for Italy and Spain is likely to be promptly activated (if it is not already in place) with little or no extra conditionality on top of what has already been agreed. Fiscal targets for other periphery EMU countries may also be eased, at least for 2012 and 2013.

Grexit unlikely to be the end-game to the EMU crisis

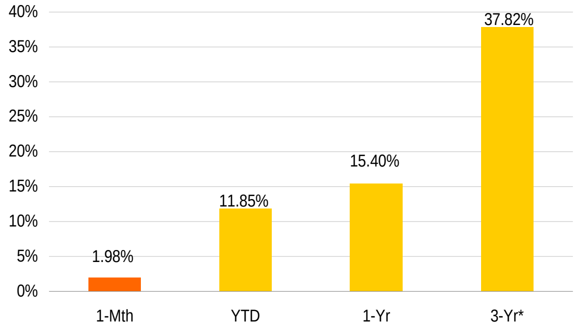
Even so, Citi analysts doubt that potential Grexit and the resultant policy responses would be a cathartic event that ends EMU strains. Indeed, they suspect that Grexit, if it happens, could intensify the withdrawal of private sector funds from periphery EMU countries. Grexit would fundamentally change the nature of EMU, establishing that exit can occur. Greece’s non-compliance with its programme is unique at present. But, there are echoes of Greece’s economic problems – persistent economic weakness, poor external competitiveness, fragile banking system and unsustainable fiscal trends – in a range of other periphery countries.

In Citi analysts’ opinion, the EMU end-game is likely to be a mix of EMU exit (Greece), a significant amount of sovereign debt and bank debt restructuring (Portugal and, eventually, perhaps Ireland, Italy and Spain), with only limited official fiscal burden sharing (via the ESM, European Financial Stability Facility (EFSF) and ECB losses) and ongoing liquidity support from the ESM and the ECB. Portugal is still expected to get a second bailout (or a prolonged extension of the current programme), with no private sector involvement (PSI) initially but a high chance of PSI and official sector involvement (OSI) over the next three years or so. Ireland may well also need some external assistance beyond the end of the current programme, although – with the deficit likely to undershoot official forecasts and evidence that the country has some access to markets – this may take the form of partial funding via the EFSF/ESM and the backstop of ECB market purchases if needed.

Nevertheless, for Portugal, Ireland, Italy and Spain, the crisis looks set to leave a legacy of high unemployment and very high government debt-to-GDP ratios (90%+, and, in most cases, well above that level). Citi analysts doubt that any of these countries will be able to sustain normal market access at a tolerable yield without the backstop of official support in coming years. There are arguments in favour of implementing widespread debt restructuring early, to limit the extent to which restructuring risks hang over the system and paralyse decision-making. However, in practice the process is likely to be lengthy and drawn-out over several years, because of hopes that periphery countries can grow their way back to fiscal sustainability and widespread reluctance to inflict early losses on the already-weak banking system.

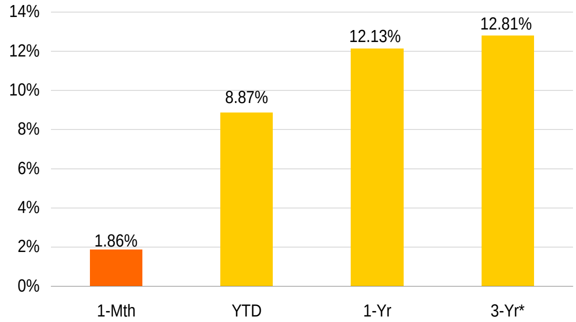
Equity markets

Chart 1:
S&P 500 Index



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

Chart 2:
Dow Jones Stoxx 600 Index



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

United States
Near-term caution appears appropriate

- Rebounds in employment and consumer spending in July have eased fears that the expansion might be at risk. Although major downside threats remain due to scheduled fiscal tightening next year and the ongoing financial crisis in Europe, the US recovery is proceeding on a modest 2% track, according to Citi analysts.

- Citi's base case expects further eventual accommodation but this vigil is likely to extend well beyond the next few months and into 2013. For now, the improvement in key early 3Q12 data is likely to forestall action at their next meeting. In the meantime, Operation Twist has been extended and officials are likely to use public statements to underscore their readiness to buoy financial conditions, most likely through MBS purchases or a new lending program. Action remains contingent on either a serious financial shock or more credible evidence that economic momentum, particularly in labour markets, is stalling.

- A near 11% rally by the S&P 500 index off its June lows seem to have caught many within the investment community by surprise, as once again investors turned defensive after May's severe market correction. Going forward, Citi analysts believe that while sentiment and valuation still support further gains, estimate revision momentum and intra-stock correlation no longer generate as much enthusiasm as before.

- As such, with political and geopolitical uncertainty rising, possibly to a crescendo in the next couple of months, Citi analysts believe that some caution may be appropriate. It also appears more prudent to stick with high quality dividend yielders at this juncture that also have moderate growth characteristics than chasing high beta or economically leveraged names.

Euro-Area
ECB likely to cut rates by 50 bps by year-end

- Greece might manage to get some more months of funding from the Troika, however, the increasing unwillingness of some creditor countries to expand support for Greece suggests that "Grexit" — to which Citi analysts attach a probability of about 90% — could happen as early as September/October. In particular, if the German constitutional court approves Germany's ESM participation, this could increase the probability of Grexit soon.

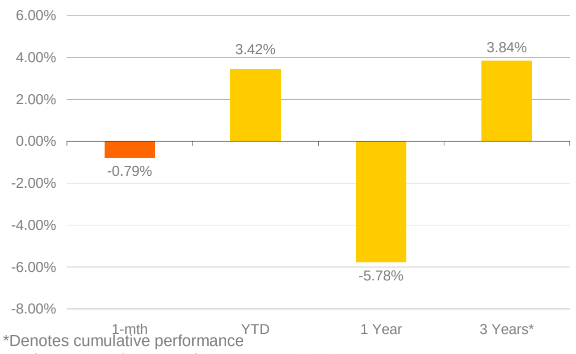
- If and when Spain or Italy has sought support from the ESFS/ESM, the European Central Bank (ECB) is also expected to resume its multi-year LTRO programme. Likely backed by a weaker growth outlook, the ECB could cut the refi rate to 0.5% and the deposit rate to -0.25%. During 4Q12, Citi analysts expect a reduction of the main refi and the deposit rate to 0.25% and -0.5%, respectively.

- Over the last decade, mega cap has been the weakest performing group eight out of the ten years. It has been the best performing twice, both years that the market fell, highlighting defensive characteristics. Indeed, mega caps in Europe have performed much like the Japanese market, while mid caps have delivered EM-type returns.

- There are two similarities. One, lack of appetite for equity as an asset class, and two, no market for corporate control. Since the end of the Japanese bubble there has been a consistent switch out of equities, driving the derating of valuations. This pattern of outflows has also been seen in Europe. However, all other things being equal, the flows out of equity should have impacted mid caps as much as mega caps. But mid cap has had another buyer, the corporate sector through buy backs and M&A. While mega caps have also been buying back stock, there is very little chance of a cash bid for mega caps, according to Citi analysts.

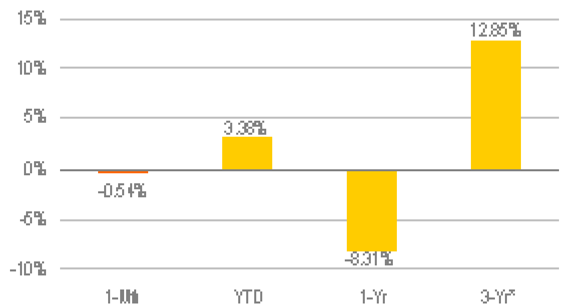
Equity markets

Chart 3:
MSCI Asia Pacific Index



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

Chart 4:
MSCI Emerging Markets Index



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

Japan
Growth may slow in 2014 due to tax hike

- Economic growth this year and next could be pushed up to 2.7% and 1.8% respectively, by reconstruction demand from the earthquake and frontloaded spending ahead of the consumption tax hike. But Citi expects a sharp contraction in GDP right after the tax hike in April 2014, which could in turn make the second tax hike slated for October 2015 less likely. Citi analysts expect the Bank of Japan (BoJ) to take additional easing action in late October when policymakers publish a semi-annual economic outlook report.

- Citi analysts see two potential impacts from the strengthening of the Fed policy duration effect on Japanese equities: 1) a negative impact from JPY appreciation versus USD stemming from lower US interest rates; and 2) a positive impact from higher stock prices in the US and increased investor risk appetite. Overall, the negative impact on Japanese equities from JPY strength is expected to be offset by the potential rise in US equities.

Asia Pacific
Valuations suggest upside probability

- Growth worries continue to dominate, with forecast downgrades in India, Hong Kong and Taiwan. Malaysia's and Indonesia's growth remained strong — in Indonesia's case this prompted a marked current account deterioration and earlier-than-expected rate hike. For others, benign inflation still leaves a window for some cuts, notably Korea, Thailand and Philippines, but sticky inflation likely mean delayed easing room for India.

- A slower Chinese economy and flat CNY has important implications for export/China-led Asian currencies. In particular, the Korean Won (KRW), Taiwan Dollar (TWD) and Malaysian Ringgit (MYR) are expected to face the largest downside risks in the medium term.

Emerging Markets
Outlook for CEEMA equities appears challenging

- CEEMEA[1] remains hostage to growth and deleveraging risks from the Eurozone. In particular, growth prospects in Poland appear to be rather gloomy plus the risk of further escalation in the conflict surrounding the Middle East is what Citi analysts would pay attention to.

- In Latam, stability appears to be still the name of the game when it comes to monetary policy (except in Brazil). Resilient growth has kept most central banks in "wait-and-see" mode but Citi analysts continue to expect easing later in the year.

- Performance of CEEMEA currencies, particularly Czech Koruna (CZK) and Hungarian Forint (HUF) are likely to remain generally weak, held back by association with EUR weakness. On the other hand, Latam currencies such as Mexican Peso (MXN), may perform relatively well short term but give back some gains medium term.

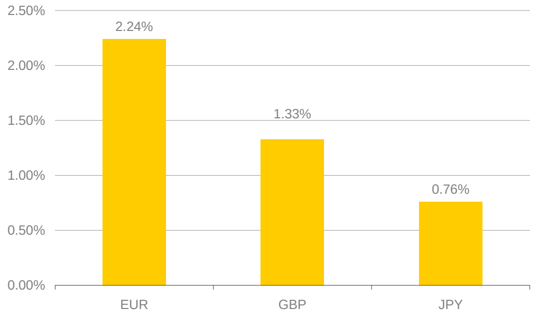
- Citi analysts have an end-2012 target of 4,000 on the MSCI Latam index. Although earnings-per-share (EPS) growth appears to be slowing, policy flexibility implies that the region can weather the European economic slowdown. They favour Brazil and Peru, and prefer the Financials, Energy and Consumer Discretionary sectors.

- While the CEEMEA region is attractively valued, there is reason for continued caution given relatively weak growth and higher exposure to the Euro Area. Under such conditions, Citi's preferred market is South Africa thanks largely to its strong and resilient earnings growth outlook. Their end-2012 target for the MSCI EM EMEA index stands at 350.

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

Currencies

Chart 5:
Currencies (1 month vs US Dollar)



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Source: Bloomberg

Currencies

- EURUSD broke out of its recent trading range, driven by hopes for a lasting resolution of the debt crisis and unexpectedly dovish August FOMC minutes. EUR could squeeze higher from here but Citi analysts doubt that we will see a reversal of its fortunes as in 2010. They expect Eurozone growth will remain weak and force the ECB to accommodate further. Grexit clouds the outlook for EUR and emergence of details from the Troika's recent Athens visit could present increased headwinds for the single currency.

- After reaching the highest level in years in early July, the USD has been receding of late as markets price in the possibility of further QE by the Fed and other major central banks. However, it appears likely that the FOMC will try a smaller measure in September before considering QE3.

- GBP has been a source of safe haven flows from Europe all year but has compared unfavorably against the commonwealth currencies and USD along most fundamentals. The recent rally runs counter to domestic fundamentals, which remain very weak on growth, competitiveness and monetary policy axes.

- AUD has underperformed other G10 small currencies during August due to Asia growth worries. Those worries have kept AUD from rallying alongside global equities and Australia's commodity terms of trade. Further policy steps in China could cause AUD to rally, though, as markets are likely to continue to trade it as a China proxy.

- JPY tempted in a fresh wave of longs in EURJPY and USDJPY during the middle part of August. A run on stops has crushed those positions and left Japanese exporters vulnerable to further downside. With improved global sentiment, Citi analysts that JPY is unlikely to rally too far, though. The local fundamental picture remains balanced with slowing growth, rising FDI outflows and increasing political uncertainty centered on the Democratic Party of Japan.

Bond markets

Positive on High-grade corporates and Emerging market debt

US Treasuries

Citi analysts expect yield curves to flatten, and for gains to be potentially generated in the intermediate- to longer-dated maturity range.

Investment Grade Corporates

A strengthening technical backdrop, large cash balances, low default rates, decreasing net issuance, and a smaller universe of safe haven assets continue to remain supportive. Meanwhile, although high yield valuations have become more attractive, Citi analysts remain cautious due to festering concerns in Europe and expectations that global growth could continue to slow. As such, they selectively favour high quality, double-B rated issuers and select single-B rated issuers with strong fundamentals.

Europe Government Bonds

As global growth slows further and heightened uncertainties persist, high quality government bonds in safe haven markets, particularly UK Gilts are likely to be well-supported.

Emerging Market Debt

Increased corporate bond issuance in emerging markets may present opportunities to pick up yield while benefiting from stronger domestic growth.