

MARKET OUTLOOK

December 2011



European Monetary Union Crisis: Lender of last resort on the way

Citi analysts expect the Euro Area sovereign debt and banking crisis to intensify further in 2012, with sovereign yield spreads versus Bunds and bank funding stress remaining high in many Euro Area countries, and the Euro Area in recession. They do not, however, expect the Euro Area to break up in 2012 or the following years, nor do they expect the disorderly default of a Euro Area sovereign. The risk that either or both of these disaster scenarios materialise is, however, non-negligible.

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European Monetary Union Crisis: Lender of last resort on the way

In Citi analysts' central projection, two or more insolvent sovereigns (Greece, Portugal and possibly Ireland) are likely to undergo orderly debt restructuring in 2012-13. They also expect a ring-fencing of the illiquid but (most likely) solvent sovereigns (Italy, Spain, Belgium, France and Austria) through greater European Central Bank (ECB) involvement. This suggests that after a potential increase in market stress and further widening of sovereign bond spreads in the first half of 2012, spreads are likely to narrow over the course of the year, though it is still likely to remain at high levels. Finally, they expect fiscal support, through national governments or through common Euro Area or EU institutions or facilities (such as the European Financial Stability Facility (EFSF) or the European Investment Bank (EIB)), for bank recapitalisation and for term bank funding. Euro Area countries may also commit to and take the first steps towards deeper fiscal integration to prevent and mitigate the risk of future fiscal debacles.

Citi analysts expect incremental fiscal tightening, structural reforms, tight financial conditions and a continued 'uncertainty overhang' to strongly weigh on domestic demand and push the Euro Area into recession in 2012 (GDP forecast -1.2%). They also expect a further contraction in GDP in 2013 (GDP forecast -0.2%). Then and thereafter, very loose monetary policy and external demand are likely to prop up growth, while domestic demand could remain weak.

Gross financing requirements for Austria, Belgium, France, Italy, the Netherlands, and Spain may exceed €2 trillion until 2Q14. Italy and Spain alone need to jointly raise around €10 billion every week in 2012 and 2013. Against that, deducting the current commitments to the Irish, Portuguese and second Greek (still-to-be-finalised) programmes, the EFSF has around €300 billion of loss absorption capacity available and even that amount currently exists only in the form of guarantees rather than cash. As plans to leverage the firepower of the EFSF to €1 trillion seem unlikely to work, the EFSF would run out of money in a matter of months if it had to fund both Italy and Spain — two countries at high risk of losing market access completely. This leaves the EFSF without any funds to expend on secondary market purchases or bank support. Increasing the size of the EFSF (to, say, €3 trillion) is, regrettably, politically infeasible at the moment, in Citi analysts' opinion.

Enter the Euro Area's lender of last resort: The ECB

In the absence of sufficiently large sources of funding from outside the EU, more substantial ECB support will be needed to avoid disorderly default of globally systemically significant Euro Area sovereigns like Italy and Spain. Citi analysts expect such ECB support to be forthcoming. They believe the ECB could substantially expand its secondary market purchases of Euro Area sovereign debt in the Securities Markets Programme (SMP), directly or indirectly fund other vehicles (such as the IMF, the EFSF or the EIB) to purchase Euro Area sovereign debt in primary or secondary markets or to bypass the sovereign debt markets altogether by providing loans. Faced with the choice between financial stability – avoiding disorderly Euro Area sovereign defaults that would bring down much of the European and American banking system – and strict adherence to its purported principle of not providing either quasi-fiscal or liquidity support to Euro Area sovereigns, the ECB is likely to choose financial stability, as it did in May 2010. But, as in the past, the ECB is likely to insist on and to succeed in obtaining reciprocal actions by the beneficiary countries (through greater fiscal austerity and structural reform) and by the Euro Area member states collectively, through enhanced joint fiscal support facilities and through commitments to greater fiscal integration in the future.

Citi analysts believe four potential conditions may need to be satisfied for the ECB to act: First, market conditions need to be very tight and disorderly. It is possible that it may take one or two actual auction failures by Italy or Spain as a potential catalyst. Second, policymakers of countries in need of ECB support, such as Italy or Spain, may need to make credible commitments to undertake further fiscal and structural reform to reduce future non-market funding requirements, probably under a Troika (European Commission, ECB and IMF) programme. Third, policymakers of creditor/donor nations, notably Germany, may need to commit to increasing their own fiscal support activities, by finalising and implementing EFSF reform that is already agreed in principle, and by charting ways to reduce the need for ECB involvement in the future, including further increases in EFSF (and from 2013 the European Stability Mechanism (ESM)) guarantees or credible steps towards fiscal integration in the medium term. Fourth, Euro Area governance rules may have to be tightened immediately, including the commitment to introduce automatic penalties for countries that do not comply with the fiscal rules of the enhanced Stability and Growth Pact.

Once market confidence is lost, as has been the case with Italy and Spain, it is unlikely to return for some time, often years. Citi analysts therefore expect that continued ECB support for Italy and Spain may be needed over the coming years. However, continued commitment by both debtor and creditor nations to respect and maintain the necessary conditions for ECB involvement cannot be taken for granted. This means that the ECB is unlikely to commit itself to the necessary rescue operations for a substantial period of time. Neither is the ECB expected to commit itself publicly to use its entire non-inflationary loss absorption capacity to the support of illiquid but (most likely) solvent sovereigns. Indeed, Citi analysts do not anticipate any kind of firm ECB commitment to a particular funding target. Instead, they believe the ECB could base its further actions contingent on progress on policy commitments and to refrain from providing rhetorical support to its actual interventions.

Full resolution of the Euro Area sovereign debt and banking crisis requires bringing down excessive debt levels for a number of Euro Area sovereigns as well as the Euro Area/EU banking sector, a process that can take many years in the absence of decisive action to restructure excessive debt. Low potential growth and cyclically weak economic activity due in part to the necessary fiscal tightening and the enduring credit crunch is likely to delay the completion of the deleveraging process and increase its cost. 'Big bazooka' action by the ECB could bring down Italian and Spanish yields substantially and, if appropriate fiscal austerity and structural reform measures are implemented by Spain and Italy, enduringly. The absence of such ECB commitment alone implies that pressures in private funding and sovereign debt markets are unlikely to abate substantially and persistently even after the ECB comes in on a scale sufficient to prevent disaster.

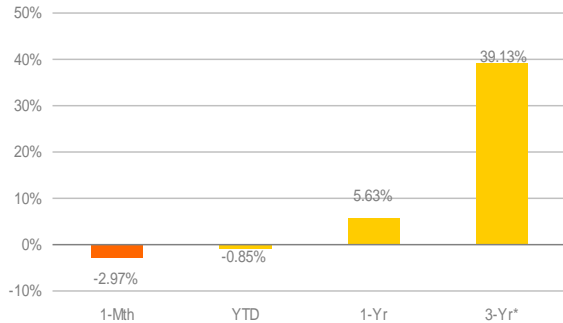
Can the Euro Area survive?

Citi's base case remains that the Euro Area will not break up. However, risks of break-up are now non-negligible. Potential refusal by the ECB to stand behind expanded rescue efforts could result in a string of disorderly Euro Area sovereign defaults and Euro Area break-up. Even if the ECB acts, the German parliament and population may decide that such an increase in ECB support is a price not worth paying for Euro Area membership and walk out, probably together with other core countries. In light of the very high costs that these decisions would entail, Citi analysts gives both scenarios a very low (sub 5%) probability of happening.

They believe debtor countries are likely to have to accept greater oversight and a partial surrender of fiscal sovereignty in return for expanded support, as is currently being proposed by the EU Commission. Such politically intrusive oversight, coupled with growing consolidation fatigue after years of austerity and recession, may lead to one or more countries storming out of the Euro Area. Such a break-up scenario would be somewhat less damaging, in Citi analysts' view, because it would result in less risk of 'exit fear contagion' than a forced exit. They also still consider an exit by a fiscally weak country very unlikely, except in the case of Greece, but the risks of such irrational actions may clearly rise over time. In view of the continuing high degree of political uncertainty in Greece, it cannot be ruled out that the country will leave the euro (around 25% probability, in Citi's view), either by storming out, or by being pushed out because of a refusal by the Troika to continue funding the sovereign and the banks following non-compliance with the Greek programme, possibly around the time of the next round of private sector involvement/official sector involvement (PSI/OSI) programme.

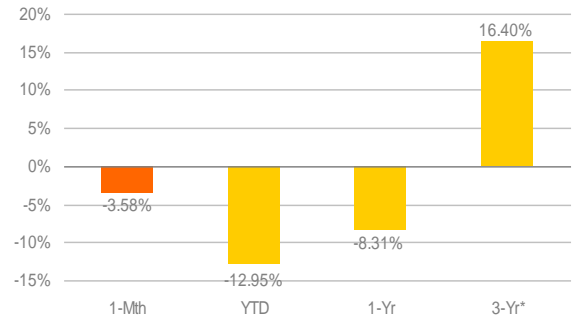
Equity markets

Chart 1:
S&P 500 Index



*Denotes cumulative performance
Performance data as of 30 November 2011
Source: Bloomberg

Chart 2:
Dow Jones Stoxx 600 Index



*Denotes cumulative performance
Performance data as of 30 November 2011
Source: Bloomberg

United States Slow and uneven expansion anticipated

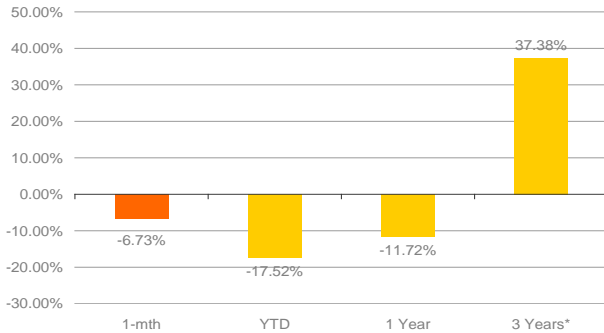
- The financial supports for growth are improving slowly but overall conditions still represent a modest headwind for the economy. Indeed, auto output and sales have rebounded as Japanese supply lines have reopened and production increased. Consumer spending is rising at the fastest rate in a year and business spending on equipment is growing at double-digits.
- However, the lack of any revival in housing remains the key shortfall in the broader recovery and prospects favour very modest gains in homebuilding. Furthermore, the relative weakness in construction and finance along with ongoing retrenchment has contributed to slow employment gains and the jobless rate could decline very little in 2012.
- As such, monetary policy is expected to remain focused on supporting financial conditions throughout the two-year horizon. With inflation within desired ranges and unemployment stubbornly high in the forecast, Citi analysts do not expect overnight rates to rise until sometime beyond 2013.
- While easing conditions have slipped somewhat in October, the Federal Reserve's (Fed) crucial lending standards survey still does not show substantial stress. The latest National Federation of Independent Business survey demonstrates that the volatility seen this summer (and also in the summer of 2010) did not have staying power, as there has been improvement in the credit expectations data, reversing the trend seen several months ago.
- Indeed, credit historically leads all forms of investment in human, physical and working capital by nine months and the recent data does not sustain 1H12 recession views. Accordingly, Citi analysts remain constructive on US equities as sentiment, valuation, broad earnings expectations and credit conditions are still supportive.

Euro-Area Low interest rate environment expected till 2016

- The sovereign debt crisis is probably causing renewed recession in the Euro Area, beginning in 4Q11. Real GDP could fall by -1.2% in 2012, with a further small drop of -0.2% in 2013 according to Citi analysts. While Citi analysts assume the Euro Area will not break up, and that no country will exit the EMU in 2012, further escalation of the crisis could lead to additional fiscal tightening in the non-core countries in 2012 and beyond.
- With more tensions in the banking sector, the European Central Bank (ECB) may also extend its non-standard measures and offer banks open market operations with a maturity of up to two or three years and even start buying non-covered bank bonds in 2012. They could also expand support for strained Euro Area governments, but may be more reluctant to employ more comprehensive measures, such as straight QE. Looking forward, under a low growth and moderate inflation scenario, Citi analysts expect the ECB to keep policy rates unchanged at historic lows up to 2016.
- De-equitisation was a key driver of share prices during the 2003-07 bull market, with debt-funded mergers and acquisitions (M&A) and leveraged buyouts (LBOs) in the driving seat. Citi analysts think this may continue over the next couple of years. And it is likely to get more, not less, important in an era of lower economic growth and de-leveraging. But, whereas de-equitisation mainly supported mid-caps in the mid-2000s, Citi analysts think that it could potentially be more supportive of bigger-caps, perhaps megacaps, from here.
- Indeed, whether we get a "lost decade" of growth or just an extended soft patch, Citi analysts believe that companies which offer investors a combination of strong balance sheets, robust cash flows and growth could be well-placed to outperform.

Equity markets

Chart 3:
MSCI Asia Pacific Index



*Denotes cumulative performance
Performance data as of 30 November 2011
Source: Bloomberg

Japan

BoJ may take additional easing measure

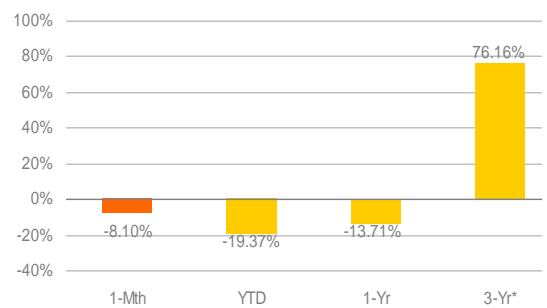
- The Japanese economy is likely to grow at a relatively stable pace in 2012 according to Citi analysts, mostly thanks to reconstruction demand from the earthquake. However, the underlying trend in the economy, which is largely driven by export and industrial production, is likely to be sluggish until 1H12, reflecting lacklustre growth in major trading partners and the yen's strength, before improving in the second half.
- Given that core inflation is also likely to remain in negative territory, the Bank of Japan (BoJ) may undertake an additional easing measure in coming months. In Citi's view, the most likely option for the BoJ is to expand the size of the asset purchase programme as well as to extend a maximum maturity of JGBs that it purchases under the asset purchase programme from 2 years currently to perhaps 5 years.

Asia Pacific

Slower growth with divergence anticipated

- The more trade dependent countries, such as Singapore, Hong Kong, Taiwan and China, where domestic factors are driving an investment slowdown, may see growth slow noticeably in 2012. On the other hand, parts of ASEAN are likely to be more resilient - Thailand owing to reconstruction, Malaysia and Philippines on fiscal support, and Indonesia on policy-driven declining real interest rates.
- Consensus corporate earnings growth in Asia ex Japan currently stands at 7% for 2011 and 11% for 2012. Historically, a recession would mean an over 20% earnings drop in Asia, so we still seem to be far from that. Meanwhile equities appear cheap, with Asia ex Japan price-to-book at 0.6 standard deviation below the historical mean, and current prices implying a mere 1% growth to perpetuity in Asia earnings; looking at mid-cycle price-to-earnings suggest the same. As real interest rates remain negative in Asia and the loan to deposit ratio is way below the historical high, liquidity is not much of an issue in Asia.

Chart 4:
MSCI Emerging Markets



*Denotes cumulative performance
Performance data as of 30 November 2011
Source: Bloomberg

Emerging Markets

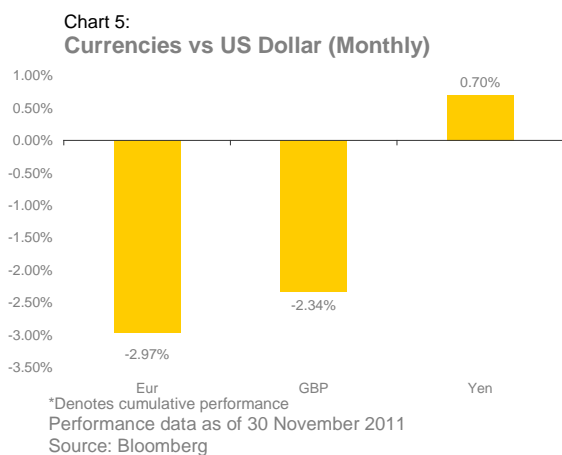
CEEMEA weakened by Euro Area crisis spill-over

- Latin America's exposure to world trade and commodity price fluctuations could cloud the outlook for 2012, with negative impact on foreign direct investment (FDI). However, Citi analysts believe that exchange rate flexibility along with monetary and fiscal policy manoeuvring could help soften the blow.
- Deleveraging risks by European banks could threaten growth and financial stability in CEEMEA¹. In addition, Middle East risks, which Citi analysts consider underpriced by the market, could create commodity price volatility, adding uncertainty to the inflation outlook.
- The decline in regional equity markets has been excessive relative to Latam's relatively benign macro outlook for next year. As long as the situation does not turn into a full fledged financial crisis, which would also bring the US economy into recession, policy can help weather the storm ahead. As such, Citi expects fairly robust returns in 2012, though not without volatility, and see Brazil and Chile as the most attractively valued markets, while Mexico appears the most expensive.
- Despite attractive valuations, CEEMEA equities could remain under pressure until a lasting solution to Europe is found. Under such conditions, Citi analysts prefer stocks with pricing power, sustainably high margins, low leverage and dividends. By sector, consumer staples and telecoms best fits this bill, while commodities and financials look less well positioned.

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

Currencies

Bond markets



Currencies

Decreasing risk of recession in the USD

- A rebound in US economic data in November makes a US recession less likely in Citi's view. This has also made Citi analysts somewhat less bullish USD in their forecasts since, somewhat counter-intuitively, the USD tends to perform well in US recessions but rather less robustly in mere mid cycle slowdowns. Furthermore, the Fed seems to be shifting slowly towards QE3, a negative for USD not least because it may encourage more reserve diversification by Asian and Middle East reserve managers.
- Widening government spreads in the Euro Area and surging Italian yields weighed on the Euro in November. Citi analysts think that the reluctance of the ECB to intervene through interest rates cuts, or via an expansion of the Securities Market Purchase program doesn't bode well for the Euro in the near term.
- The Europe debt crisis continues to take its toll on CEEMEA currencies – Hungarian Forint (HUF) and Polish Zloty (PLN) look to be the weakest links.
- Latam currencies are expected to stay flat in the near term. But in the next 6-12 month, Citi analysts continue to anticipate modest appreciation, particularly the Colombian Peso (COP).
- Asian FX are likely to maintain a weakening bias in the near term, but we if see some floor on risk sentiment, Citi analysts expect Asian FX to resume their appreciation bias – historically low real rates and balance sheet expansion of DM central banks are supportive of capital inflows into EM. In particular, high-beta Asian currencies with sound policy framework and fundamentals could outperform the region – Korean Won (KRW) and Singapore Dollar (SGD).

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.

Investment Grade Corporates

The fundamental backdrop remains solid. Balance sheets are strong, near-term liquidity is good, and default rates remain virtually zero. Citi analysts favour long-dated maturities and defensive sectors. On the other hand, while valuations have become more attractive for high-yield bonds, Citi analysts remain cautious about gains for the sector in the near term as they expect risk assets to remain volatile and potential spread compression could be limited.

Euro Bonds

Citi analysts expect any back-up in core government bond yields to be capped around recent ranges, and for long-dated interest rates to trend lower in coming months. Long-dated UK gilts remain Citi's preference, followed by German Bunds.

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.