MARKET OUTLOOK

A Parade of Structural Reform

Amid an economic slowdown and thus deteriorations in corporate earnings, investors are keen to know which other country will join the reform parade to fuel the growth. Citi analysts observe that the recent announcement of reform in India helped the local equity market outperform by more than 10% in just a few weeks. Elections in Mexico have provided the prospect of serious reform and hiked the local equity market as well. Both markets having been significant outperformers so far this year.

Citigold

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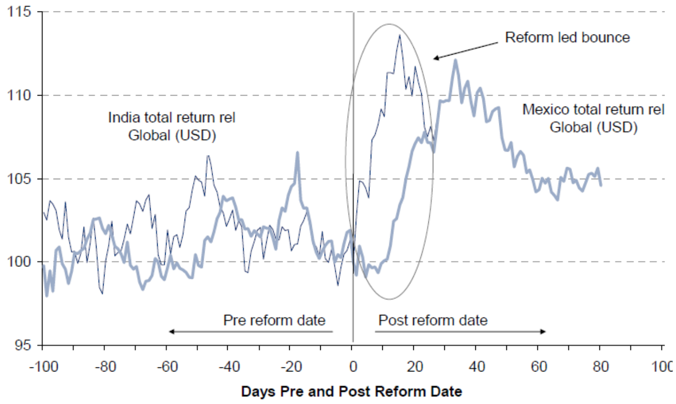
A Parade of Structural Reform

The Need for Reform

Slow growth has been a key feature of the current global economic cycle. Citi analysts attribute this sluggish growth to a combination of deleveraging in developed markets and sharply weaker growth in major Emerging Markets. Markets used to be quite optimistic about global economy when the global economy growth rebounded by 4.2% in 2009 from the negative growth of -1.9% in 2008 which was the worst year for the global economy since the 1930s. But optimism gradually eroded as growth slowed again.

Global GDP grew by 3% in 2011 and Citi analysts forecast a moderate growth to around 2.5% for this year. Next year's growth may not see a dramatic rebound. The weakness in global economic growth is clearly weighing on global corporate profits. Many governments have turned to structural reform to support growth. In some countries, reform seems to be underway (India and Brazil, for example), in others, the promise of reform is high (such as Mexico) while in several countries, the prospect of reform may represent 'a triumph of hope over experience' (the US, Russia and Korea). Meanwhile, the Euro Area is confronted with the need to introduce structural reforms (mainly concerning labour market flexibility) at a time of savage fiscal adjustment which may likely be a daunting task.

Reform Has Helped India and Mexico Outperform



Source: MSCI, Citi Research, as of Oct 24, 2012

Type of Reforms

Structural reform can take place in different areas under different economic and political backdrops. However, the aim of such reforms is broadly similar, they tend to be focused on similar areas of an economy and follow a typical pattern:

- **Labour Reform –** to increase the flexibility of labour markets, to make it easier to 'hire and fire', to reduce the size of the informal sector and to reduce payroll taxes on employees;
- **Fiscal Reform –** to reduce direct taxes and increase indirect taxes with a view to increasing the incentives to work; simplifying the tax system; also, tax reform can take the form of seeking to reduce the informal economy (again) by widening the tax net, and also to reduce tax evasion;
- **Reform of Subsidies –** to cut subsidies (often on food and energy) to reduce price distortions and to increase government revenues;
- **Public Sector Company Reform –** to open up government-owned entities to private competition by privatizing part or all of the company and to allow it to enter into contracts (for production or distribution, for example) with private companies;
- **Administrative Reforms –** to reduce bureaucracy and 'red tape' in the operation of companies and government and so improve the ease of doing business;
- **Financial Market Reforms –** to improve the functioning of markets such as through less onerous regulation, an easing of listing and/or reporting requirements or the easing of controls on inflows from overseas or from domestic institutions (such as pension funds) to increase market liquidity. However, in the Euro Area currently, the aims under this heading are much grander – improved regulatory control, a bank deposit guarantee system and a banking union.

A Parade of Structural Reform

The most common objective of such structural reforms is to boost real growth in an economy by improving incentives, reducing inefficiencies and improving the functioning of factor markets, both capital and labour (India, Mexico and even, at present, the US and the Euro Area). In Indonesia, the implementation of a recent land reform proposal is also positive for long-term growth, in Citi's view. In China, however, the aim of the next stage of reform is to achieve lower, but better quality, sustainable growth. Other aims of structural reforms in place at present include reducing budget deficits (the US and the Euro Area), improving the competitiveness of certain sectors of the economy hurt by other developments (Brazil) and the financing of higher government spending (Russia).

However, even under the common objectives of reforms, sector and stock beneficiaries will vary depending on each government's focus. Citi analysts believe that to materialize the benefits from structural reform in the long term, investors may need to keep an eye out for the areas where reforms take place.

The Reform Agenda

Market	Reform	Comment
Already Announced/Soon to Be Announced		
Brazil	Infrastructure	Privatization of additional roadway, concession for new railroads, auction of airports.
Brazil	Taxation	Cut in tax has lowered electricity and gasoline prices. Payroll taxes replaced/lowered.
China	Hukou System	Provides affordable but differentiated social security between urban and rural residents. Has been relaxed in select regions and should be abolished in next few years.
China	Land Reform	Farmers not appropriately compensated when they give up plots. Pilot reforms being tested in two provinces.
Europe	Banking Union	Increase confidence in the Euro project
Europe	Pension Reform	Decrease fiscal burden
India	Corporate governance	Ensure more transparent corporate governance.
India	Energy	Reduced subsidies on Energy products
India	FDI Reform	FDI limit raised for Retail, Broadcasting, Insurance, Power Exchanges, Civil Aviation. Positive for the currency.
India	Financial Liberalization	Withholding tax on O/S loans lowered, introduction of commodity derivatives trading positive for corporates.
Korea	Chaebols	Limit cross holdings of Financial companies. Positive for non-chaebols.
Mexico	Labour reform	More flexible labour force required. Reform process complicated by large and powerful unions.
Potential		
China	Financial Liberalization	Includes FX flexibility, opening up the capital account, interest rate liberalization.
Europe	Labour	Easing of hiring and firing process. Increase confidence in the Euro project
India	Tax	Simplified tax platform positive for entire economy
Mexico	Energy	Current constitution limits oil and gas exploration to state owned oil company. Co-investments to be allowed.
Mexico	Fiscal	Wider tax base, chances to VAT, reduce spending.
US	Dividend Taxation	Provide further incentive for buybacks, capex
US	Fiscal	Smaller government debt levels has been consistent with higher PEs
Hopeful		
China	Decentralization	The centralized system has been effective in promoting investment-led growth, but it can be an obstacle to urbanization and consumption led growth
Mexico	Micro-economic	Many sectors remain uncompetitive including cement, financial services, telecoms, media, beverages and retail.
Mexico	Social Safety Net	Incoming administration promised reforms to social security, unemployment insurance and retirement savings.
Russia	FDI	Will increase investment by foreign companies given already high growth rates in Russia
Russia	Micro-economic	Across entire economy to improve the ease of doing business in Russia.
Russia	Taxation	Oil sector investment in greenfield projects likely to benefit from improved corporate tax regime
Sth Africa	Labour	Recent strikes highlights need for reform. One party state suggests little political will.
Sth Africa	Microeconomic	Recent strikes highlights need for reform. One party state suggests little political will.

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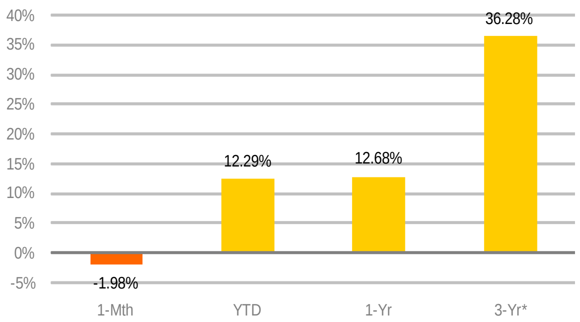
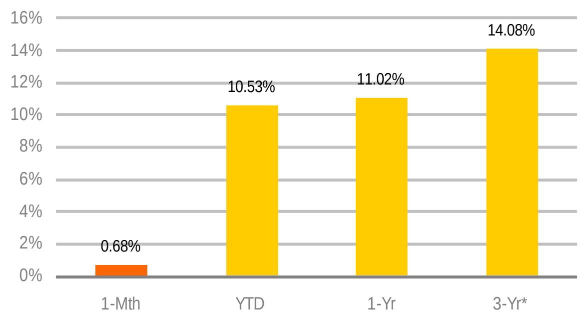
Equity markets

Chart 1:
S&P 500 Index



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

Chart 2:
Dow Jones Stoxx 600 Index



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Performance data as of 31 October 2012
Source: Bloomberg

United States
Likely to stay mixed near term

- Reassuring strength in retail sales and housing data have buoyed growth prospects somewhat but the uncertainties surrounding the election and fiscal policy have stalled business spending. Fiscal drag is likely to remain a headwind, with downside risks if scheduled tax increases and spending restraint cannot be recast over yearend.

- The Federal Reserve's aggressive new easing bias and open-ended bond-buying program have helped bolster financial conditions for the moment. Policymakers' patience with gradual labour market improvement has run out and the outlook that inflation is likely to remain low has elevated a bias to continue supporting financial conditions through QE or other means until there is substantial strengthening in labour markets. Citi analysts expect that unsterilised Treasury purchases will follow the end of Operation Twist, with a focus on medium- and longer-term securities.

- Investors appear to be waiting for some sign of safety before stepping in after an impressive rally since early June. In short, Citi analysts examine four issues which could provide a clearer picture — economic trends, valuation, earnings expectations, and investor sentiment. When it comes to the economy, the Fed's lending standards survey appears to be signalling a rebound in industrial activity by early 2013 given its normal nine-month lead. Secondly, valuation also remains compelling.

- Finally, neither the Panic/Euphoria Model nor intra-stock correlation suggests that markets are likely to run up in the short term, even if historically, there is a typical rally in 4Q. Indeed, the election's outcome on the fiscal cliff and next year's debt ceiling lift could detract from that kind of typical thinking. Thus, Citi analysts do not see a need to rush into the stock market currently, but would remain buyers on weakness for 2013 gains.

Euro-Area
Continue to back Defensive growth strategy

- Citi analysts continue to forecast negative GDP growth (-0.4% in 2012 and -0.7% in 2013), reflecting ongoing private sector deleveraging, tight financing conditions and fiscal drag. Citi has lowered their view on the probability of Grexit in the next 12-18 months to 60% from 90% previously, and put the most likely date as early 2014 instead of early 2013. Nevertheless, the prospects of eventual Grexit are likely to prolong uncertainty about the stability of the euro and undermine growth in the periphery countries.

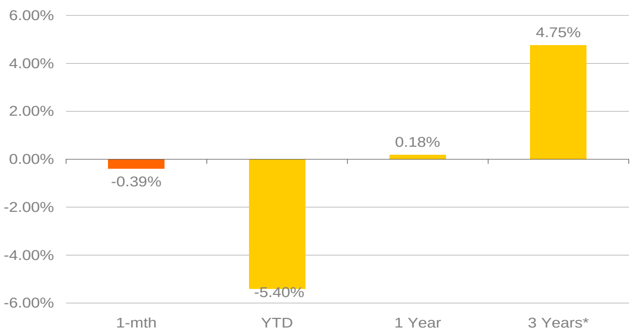
- The European Central Bank (ECB) is expected to cut the refi rate by 25 bps to 0.5% in December, but postpone the expected timing of the next cut from 1Q 2013 to 2Q. At that stage the ECB may probably also cut the deposit rate from zero now to -0.25%.

- The outperformance of Defensive Growth strategy has been supported by superior earnings trends over the past few years. For now, Citi analysts see selective risks from the stabilisation of Chinese growth, from a better US growth environment in 2H13-2014 and from increasing evidence of corporate leverage. Unlike 2003-07, when Defensive Growth underperformed, this is not broad global economic recovery or widespread adoption of corporate leverage. This is why Citi analysts continue to back Defensive Growth and see the recent derating as an opportunity for investors.

- Separately, Citi analysts have downgraded both Utilities and Telecoms to Underweight, from Neutral. They see growth, capex and political challenges for both sectors. In addition, in the case of meaningful downside macro risks in Europe, Citi analysts doubt these sectors are defensive enough.

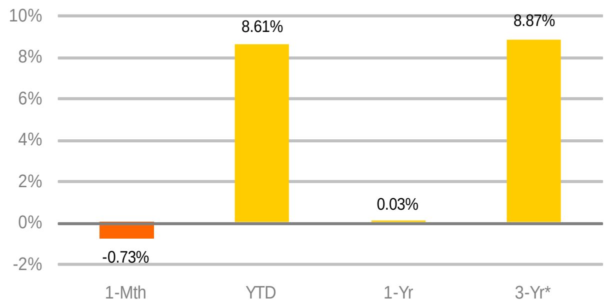
Equity markets

Chart 3:
MSCI Asia Pacific Index



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

Chart 4:
MSCI Emerging Markets Index



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Performance data as of 31 October 2012
Source: Bloomberg

Japan
Rebound in earnings not as robust as expected

- Citi analysts had expected a technical recession in 2H2 even before the escalation of the Japan-China dispute, but have now cut 4Q GDP projections even deeper into negative territory (-1.6%). Moreover, the China factor likely will strengthen the corporate tendency to postpone business investment amid a worsening outlook for Chinese demand. The Bank of Japan (BoJ) recently expanded the asset purchase program by ¥11 trillion. This decision represents a continuation of the BoJ's "incremental" approach and its impact on overall financial conditions and FX markets may likely be moderate.
- Following the earthquake last year, Japanese corporate profits declined by 55% according to the MSCI 12 month trailing EPS measure. They have since begun to recover as the economy rebuilds. However, Citi strategists note that the rebound in earnings will not be as robust as previously forecast.

Asia Pacific
Earnings continue to do fine

- Signs are growing of stabilisation to mildly rebound in manufacturing and exports, led by some bottoming signs in China and the favourable impact of central bank policy action in advanced economies to loosen financial conditions. Nonetheless, Citi analysts expect Asian central banks may continue to focus on downside growth risks versus inflation, with a policy bias to ease marginally or keep rates on prolonged hold, and limit the extent of FX outperformance via intervention.
- In the currency space, despite recent INR correction, Citi analysts maintain the view that INR could remain supported by high carry and some reform progress relief (despite execution disappointment risks), plus RBI is among a handful of EM central banks that may welcome some disinflation via currency strength. At the same time, they still continue to favour PHP and MYR – both have resilient growth dynamics and central banks have been relatively absent in intervention.

Emerging Markets
Cautious on Latam equities

- Within Emerging Europe, growth forecasts in Czech, Hungary, Poland, Romania, Turkey and South Africa have all been marked down, partly reflecting weaker external demand and partly due to worse domestic spending indicators. While in Latam, with external conditions improving, albeit slightly, and activity performing relatively well in most countries, central banks are likely to remain on hold in the months to come.

- CEE currencies rallied in the early phases of risk on this summer but have since stabilized in line with the EUR. While the greater risk is towards strength, on balance Citi analysts do not expect much appreciation. Relative to the Euro, they anticipate modest weakness over 0-3m, picking up a bit over 6-12m. Meanwhile, Citi analysts expect Chilean Peso (CLP) to be the worst performer in Latin America as the central bank cuts rates and commodity price gains are capped by weak Chinese demand.

- Citi analysts are cautious on Latin American equities, where the region, as a whole, has suffered from weak earnings momentum (everywhere except Mexico), carries a higher than average valuation premium to history and has limited scope now for monetary easing. Under such conditions, Citi's preferred market is Peru.

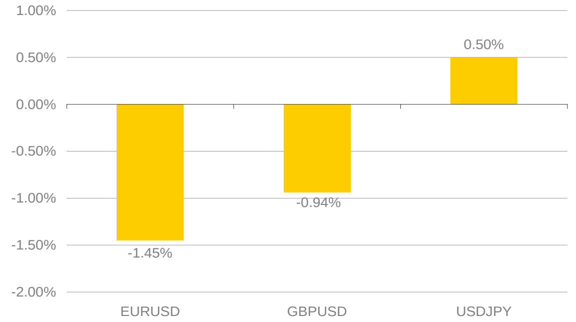
- Emerging Europe, overall, looks better now on interest rates, with monetary easing expected in all CE3 countries in Q4. The main support remains valuations with Emerging Europe still trading at just 7.9x 2013 earnings (versus a forward average of 9.9x). Under such conditions, Citi's preferred market is Czech Republic.

Currencies

Bond markets

Chart 5:

Currencies (1 Month)



*Denotes cumulative performance

Performance data as of 31 October 2012

Source: Bloomberg

Currencies

- Loose monetary policy and receding pessimism over growth in Asia and the future of the Eurozone have added to USD headwinds. For now, Citi analysts expect the USD to continue to trade with broader swings in asset markets.

- Over the longer term, Citi analysts remain unconvinced that the firewall envisaged by President Draghi could play the role of a game changer for EUR. They expect Eurozone growth will remain weak and force the ECB to accommodate further in coming months. Citi analysts suspect a Spanish bailout request could still be some time away and that before which EUR will continue to face stronger headwinds.

- Of the G10 majors, GBP appears comparatively attractive and some trimming of shorts could continue to support the currency in the coming month, according to Citi analysts.

- The SNB continues to defend the peg to EUR with the utmost determination. Citi analysts do not expect any change in policy in the near term and would not rule out a move back lower towards 1.20.

- It is unclear how much of the JPY weakness is driven by the pickup in sentiment and rise in global yields and how much is due to Japan specific factors. Citi analysts suspect headwinds from the deterioration in trade data and the increasingly aggressive monetary policy will continue to weigh on JPY.

- Citi economists expect the RBA to ease further in coming months, but with almost 75bp of cuts priced into the market this need not surprise investors. Continued signs that Asian economic data has stabilized and may rebound should keep AUD supported close to current levels.

Positive on High-grade corporates and Emerging market debt

US Treasuries

Citi analysts expect slowing growth and heightened event risks in Europe to anchor bond yields and foster safe haven demand for developed market government securities, which should keep interest rates low.

US Corporates

Corporate issuers continue to benefit from the low interest rate environment, allowing them to refinance maturing debt at attractive rates while enhancing liquidity and strengthening balance sheets. Meanwhile, although spreads remain attractive relative to low default rates, yield levels are near historic lows. Record low absolute yields suggest caution is warranted should a risk-off move occur.

Euro Bonds

Citi analysts expect slowing global growth, falling earnings expectations, and heightened geopolitical uncertainties to keep interest rates low in Core European bonds. In the near term, they also think that Sovereign bond spreads in the region will be driven by uncertainties regarding the timing and levels of OMT activation for Spain as well as Grexit talks.

Emerging Market Debt

With central bank easing likely to keep investors focused on risky assets, Citi analysts expect demand for emerging market debt to remain high. Moreover, valuations remain attractive, as current spread levels remain