MARKET OUTLOOK

December 2012

Is Quantitative Easing working?

Policy-makers have adopted aggressive methods to push interest rates and bond yields down to unprecedented levels. It is hoped that these low rates will trigger a stronger recovery in corporate capex and jobs. Citi analysts think that QE may be having the opposite impact to that intended. Instead of encouraging capex and job creation, ultra low interest rates are bringing yield-starved capital into the global equity market. These investors are more interested in dividends and share buybacks than corporate expansion.

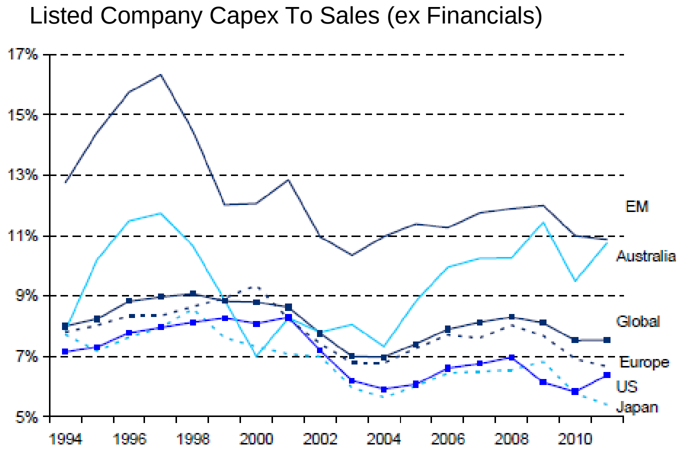
Citigold

citibank

Is Quantitative Easing working?

Capex subdued

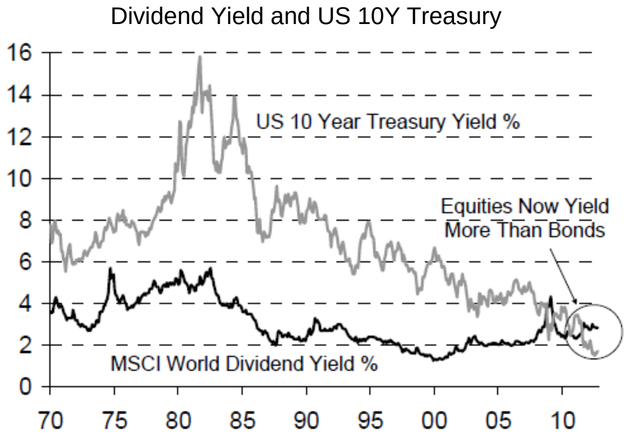
Balance sheets are strong, profitability is high and the cash is piling up. Add ultra-low rates to the mix and surely CEOs will kick off a capex and hiring binge. But this has not really been happening, in the listed corporate sector at least. In fact, capex/sales ratios for publicly listed companies across the world have been heading downwards for much of the past decade (see chart below). Why? As central banks pour fresh cash into their domestic government bond markets via QE, so it is hoped that private sector capital will be flushed out into riskier assets, in search of higher returns. These markets should then, in theory, provide risk-taking capital to risk-taking corporates who will use it to build factories and, most importantly, employ staff to work in those factories. QE has clearly helped to push corporate bond borrowing costs down to all-time lows; and this has triggered a wave of new issuance. So far, so good; this part of the transmission mechanism seems to be working well enough. But this burst of issuance does not seem to reflect a confident corporate sector borrowing heavily to fund expansionary capex. Rather, CEOs seem to have used this money to refinance old debts.



Source: Citi Research, Factset, Worldscope, as of Nov 21, 2012

Equity now the yield asset

With aggressive monetary policy having pushed interest rates to all-time lows, the global equity market now consistently trades on a dividend yield above treasuries for the first time in over 50 years (see chart below). The eight largest global equity markets now all trade on dividend yields higher than their government bond markets. Accordingly, dividend funds have taken over from more growth-oriented EM funds as the best-selling equity products. These new equity investors are more interested in dividends and share buy-backs than sponsoring CEO growth aspirations. They'll take a bigger dividend over a new factory, anytime. Policymakers may succeed in forcing capital into equities but, from their perspective, it is the wrong kind of capital: income-seeking rather than growth-seeking.



Source: Citi Research, Factset, Worldscope, as of Nov 21, 2012

Is Quantitative Easing working?

What does this mean for policymakers?

If policy-makers really do want to encourage stronger economic growth (and especially higher employment), then Citi analysts believe they may need to take a closer look at the equity market's part in driving corporate behaviour.

If anything, low interest rates are increasingly part of the problem rather than the solution. Perversely, they may be turning the world's largest companies into capital distributors rather than investors. Perhaps rates should be allowed to rise back to more natural levels. This might be painful at first, but it could stop equity investors being so income-obsessed. Or maybe the real problem here is depressed equity valuations. Low PEs and high dividend yields reflect the long slow death of the equity cult. At the margin, current valuations encourage CEOs to distribute through buybacks or dividends. They discourage capex and job creation.

What does this mean for investors?

Equity markets supported despite weak growth: While subdued corporate activity might be discouraging for the performance of the world economy, it is not necessarily bad news for equity returns. Income-seeking capital should help to support global equities. De-equitisation through share buybacks and cash bids should help to shrink global equity supply back down towards demand. With borrowing rates so low, buybacks and bids should be accretive. This means that even if earnings growth is held back by weak economic growth, EPS can still expand.

Equity income and de-equitisation strategies are still key: Premium yields relative to bonds should continue to attract income-seeking investors to the equity asset class. This will keep the appetite for equity income strategies strong. In the absence of top-line growth, companies will need to find other ways to boost returns to shareholders. This might be through cash or debt-funded buybacks, which should be highly accretive, with share valuations low and financing cheap.

Could this change?

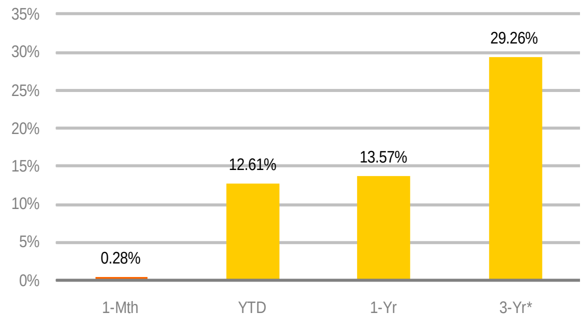
Many investors think that bonds are in a bubble and ready to burst. Citi analysts suspect that a sharp upturn in yields would initially be painful for the global equity market, but may help to reverse capital flows over the longer run. A bear market in bonds may be the equity market's best hope of attracting back some of the capital lost over recent years. Higher bond yields might eventually reduce the income obsession and make equity investors more sympathetic to corporate growth strategies. Bond yields would need to move quite a lot higher to cross back above equity yields.

For now though, Citi analysts think that this outcome is unlikely. Policymakers remain committed to keeping bond yields artificially low. If private sector selling were to put upward pressure on yields, then the public sector could use further QE to absorb that selling. Yields seem likely to remain low for now.

Perhaps it is just a matter of time before ultra-low interest rates do have the intended impact and growth accelerates. This seems more likely in the less indebted EM economies. In these circumstances, Citi analysts might expect policymakers to allow rates to drift up. A better global economy might even encourage a more growth-oriented outlook from CEOs and investors.

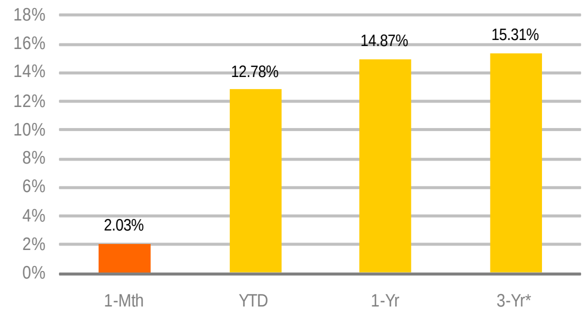
Equity markets

Chart 1:
S&P 500 Index



*Denotes cumulative performance
Performance data as of 30 November 2012
Source: Bloomberg

Chart 2:
Dow Jones Stoxx 600 Index



*Denotes cumulative performance
Performance data as of 30 November 2012
Source: Bloomberg

United States
Modest growth is expected to continue

- The pace of economic growth is expected to remain modest in 2013 as a new round of fiscal belt tightening blunts the effects of a maturing cyclical expansion. Slow and erratic growth has been a hallmark of the recovery thus far as businesses have been wary of a variety of downside threats, while lingering imbalances in key sectors have limited recovery's breadth. Among the latter, however, housing is transitioning for the better and consumer finances are somewhat improved alongside a healthy corporate sector.

- The looming fiscal cliff remains the central uncertainty. While Citi analysts expect a short-term agreement to avoid most of the fiscal cliff, it is unclear whether a compromise will include raising the debt ceiling. Nevertheless, based on the expectation of slow declines in unemployment, Citi analysts think the Federal Reserve (Fed) is likely to extend QE through at least the better part of 2013 and possibly beyond.

- From an equity perspective, given improved bank lending standards since last October and a recovery in earnings estimate revision momentum, Citi analysts are now overweight Software & Services industry group. Admittedly, the group has been one of the better performers year to date but more upside seems likely.

- Despite the outperformance of Diversified Financials this year, Citi analysts have downgraded their stance from overweight to neutral given a more mixed near-term environment. Indeed, valuation is no longer as attractive and upward earnings estimate revisions appears to be rolling over. Finally, Citi analysts are now underweight Household & Personal Products as well as Pharmaceuticals & Biotechnology groups. Seasonality does not favour these groups on a relative performance basis and earnings revision trends also suggest caution.

Euro-Area
ECB likely to cut rate to 0.25% in the course of 2013

- Citi analysts expect the euro area to remain in recession in 2013 (-0.7%) and 2014 (-0.4%). While a Grexit could happen within the next 12-18 months (maybe followed by an exit by Cyprus), a broad break-up of the Euro area is not anticipated, because governments and the ECB are expected to put in place measures to contain its contagion.

- With only Spain and Italy qualifying for the OMT in 2013, total OMT purchases are likely to be in a range of €100bn and €200bn. This suggests that with a likely use of the repayment option of the 3Y LTROs — which is expected to be around €200bn — the ECB's balance sheet of currently €3.03trn (32% of GDP) is likely to move sideways in 2013.

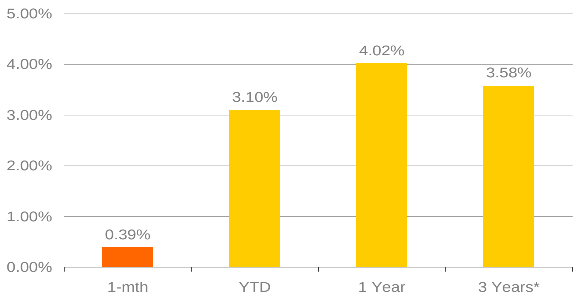
- The European Central Bank (ECB) is expected to cut interest rates further, as it is likely to become more obvious to the General Council that inflation will undershoot the inflation target of "close, but below to 2%" in the medium term. Citi expects a 25 bps cut of the refi rate in 1Q13, followed by a second refi rate cut, which may probably come in combination with a cut of the deposit rate by 25 bps in mid 2013.

- De-leveraging is here to stay. That is the conclusion of Citi's economists. Indeed, deleveraging has contributed to an environment of low growth, divergent economic fortunes and ultra-low core rates. Citi analysts believe that investors can continue to position for an extended era of deleveraging by owning companies with stronger balance sheets and better earnings delivery than their peers. This suggests that earnings, not valuation, should matter most in the next 12-months.

- In terms of sectors, Personal Goods, Software, Aerospace, Household Goods, Food Producers and General Retail are among those groups that score well on balance sheet strength and earnings momentum. On the other hand, Industrial Metals, Electricity, Fixed Line Telecoms and Construction do not.

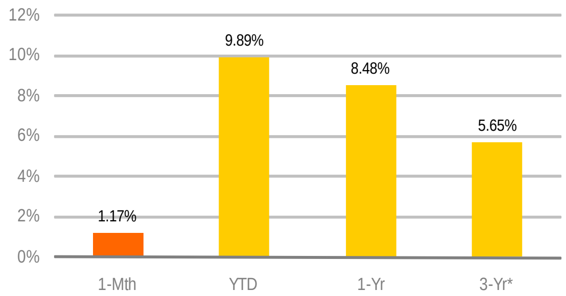
Equity markets

Chart 3:
MSCI Asia Pacific



*Denotes cumulative performance
Performance data as of 30 November 2012
Source: Bloomberg

Chart 4:
MSCI Emerging Markets



*Denotes cumulative performance
Performance data as of 30 November 2012
Source: Bloomberg

Japan
Economy could pick up in 2013

- Citi analysts expect the Japanese economy to pick up in 2013 after two consecutive negative GDP readings in 2H12, mostly thanks to a renewed increase in exports, driven by a moderate pick-up in economic activity in the key trading partners, and frontloaded demand ahead of the consumption tax hike in April 2014.
- Citi analysts expect the Bank of Japan (BoJ) to continue its incremental policy approach, mostly driven by the yen's appreciation and the political pressure under the current leadership that will end its term next spring, although near-term uncertainty over policy rose reflecting the ongoing political transition.

Asia Pacific
More open economies may see bigger growth upturn

- New Chinese leaders are likely to pursue a pro-stability growth stance (Citi analysts expect China's real GDP growth at 7.8% in 2013 vs. 7.7% in 2012). With the Euro Area in a prolonged shallow recession, the US growth path (sluggish in 1H but accelerating to 3% by late 2013) could be the dominant driver of the cyclical trends in Asia in 2013. Citi expects the more open economies such as Taiwan, Korea and Singapore may eventually have a bigger growth upturn in 2013 than the rest.
- After 15 months of deceleration on the asset side of Central Banks' balance sheets, these are again growing by 6.7% year on year. This has not only been positive for valuation multiples, but also for the performance of stocks with risk attributes vs those with quality attributes.
- North Asia has outperformed ASEAN stocks by 10% since the summer lows. ASEAN is a consensus overweight, which Citi analysts believe could make the rotation towards risk, as investors seek to sell large holdings in smaller, less liquid markets.

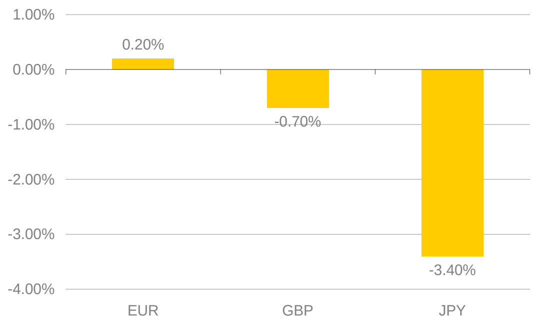
Emerging Markets
Cautious on Latam equities

- CEEMEA is likely to remain the weaker performer within Emerging Markets next year. First, further bank deleveraging will stay as a serious threat, contributing to weak domestic credit growth and capital outflows. Second, there are big external financing gaps in Turkey, Poland, Romania, Hungary and South Africa. Third, downside risks to energy prices weigh on the macro environment in Russia.
- In Latin America, GDP recovered in 2012 after a harsh slowdown in Brazil and Argentina, but the pace of recovery remains timid despite strong monetary and fiscal stimuli. Inflation may continue to test the upper limits of the target bands as central banks constrain exchange rate flexibility to avoid excessive real appreciation.
- CEEMEA currencies are forecast to underperform with the exception of the Russian Ruble, as the widely expected Euroclear access may be supportive. Over the medium term though, softer oil prices could push the currency weaker. Meanwhile, although Latam currencies have been generally weak, Citi analysts expect some catch up in the near-term, especially in the Mexican Peso but also in Chile and Colombia. Further out, the Brazilian real is expected to be the best performer.
- 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.
- The main support for CEEMEA equities remains valuations with the region 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 vs USD)



Denotes 1 months returns
Performance data as of 30 November 2012
Source: Bloomberg

Currencies

- Citi analysts believe fiscal cliff concerns are dominating investors' minds for now, but QE expansion expectations could lead to a weaker USD going into year end – especially if we get a fiscal cliff resolution in late December.

- Recent EUR strength may be attributed to investors' relief over the Greek debt deal, but Citi analysts remain sceptical that there could be further upside in EURUSD above recent highs. Firstly, the deal on Greece need not produce sustained improvement in EUR-sentiment if it cannot remove investor concerns about country's debt sustainability. And while peripheral bond yields have moved lower, the potential for more downside could be limited.

- Evidence that the coalition government will avoid easing its plan to cut the deficit could provide underlying support for GBP and its credit rating. Of the G10 majors, GBP appears comparatively attractive and some trimming of shorts could lend support to the currency in the coming months.

- The announcement of early elections where the opposition LDP is expected to take office has pushed JPY lower. This is appears to be motivated by the LDP's aggressive stance on monetary policy and JPY strength. Now trading above 82, we think the JPY selloff could lose some momentum into yearend.

- AUD has found a new base in recent weeks despite the broader fragility in other asset markets. Citi economists expect the RBA to ease further in coming months, but with over 60bp 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

Yields are likely to remain low as investors discount sub-par growth, and heightened uncertainties persist.

US Corporates

Citi analysts expect high quality corporates to continue to be well-supported (and for spreads to grind even tighter over time) given the global backdrop of easy monetary policy and strong demand for high quality fixed income assets. Meanwhile, the appetite for yield and easy monetary policy is likely to persist, thus supporting high yield bonds. Having said that, Citi analyst note that valuations are less attractive, growth is slowing and default rates are rising.

Euro Bonds

Pressures on Spain have eased due to the powerful backstop provided by the ECB's OMT, but are not likely to dissipate. Indeed, Citi analysts continue to believe that the country could be forced to accept some type of bailout arrangement. Flight-to-quality sentiment fueled by periphery worries and slower growth in Germany are likely to keep Bunds well-bid.

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 nearly 120bp above historical lows.