When Expectations turn into Illusions

Volatility increased and risky assets underperformed in the second quarter of this year – with the MSCI World loosing up to 8.3% between May and June. This volatility is a sign that investors are currently struggling on one hand with a high level of optimism that has fueled a period of strong market performances, and on the other hand, economic data that have been less and less supportive during the last quarter.

One of the most important indicators that Citi analysts track is the evolution of “Economic Surprises”. An economic surprise is measured by the difference between the actual level of economic indicators and the expected level of those indicators. History indeed shows a strong correlation between the short-term performances of financial markets and the trend of economic surprises as bonds yields and stocks prices tend to increase when economic surprises are positive, and vice versa.

Despite the relative underperformance of equities during the second quarter, Citi analysts have observed a decoupling between equities, bonds yields and economic surprises. Economic surprises have indeed collapsed, Triple-A bonds yields have melted but equity prices have been remarkably resilient relative to the extent of deterioration in the economic indicators. Citi’s Global Investment Committee sees in that decoupling a sign of excessive optimism among equity investors. The large divergence between investors’ sentiments and economic data leads one to wonder to which extent market resilience is being driven by fundamental expectations or by investors’ illusions.

Illusion #1: “US Quantitative Easing is an economic success”
An investor looking at the performance of his portfolio over the last two years may perceive the Quantitative Easing (QE) programs of the US Federal Reserve (Fed) as a major success as equities posted strong performances during the two periods of QE. However, supporting the performance of financial markets was not among the objectives of the QE programs. The objectives were to revive Households Credit flows, to support Real Estate prices and to bring down unemployment. Over the period, outstanding Households Credit continuously contracted, Real Estate prices remained at the same level as at the trough of the Subprime crisis in April 2009, and the unemployment rate remained stubbornly higher than 9%. Citi analysts recognize the important role of the QE program in helping banks, companies and households to repair their balance sheets, in restoring liquidity flows and in supporting the competitiveness of the US economy (through a weaker US dollar), but they think that the expectations of a strong economic recovery boosted by successful QE programs is an illusion.

**Illusion #2: “Developed Markets’ Debt crisis is contained”**

What the development of the Greek crisis in May-June has shown is that 18 months after the outbreak of the crisis, continuous political debates, billions of euros of financial support and several austerity programs, no sustainable political or fiscal solution has been found. At the same time, thinking that the debt crisis is concentrated on Greece or even the Euro Periphery countries is a mistake. Citi analysts evaluate that the necessary fiscal adjustment to bring the level of US debt to 60% of the GDP by 2030 is similar to the fiscal adjustment required in Greece, but the fiscal programs implemented in the US are not even half the size of the fiscal programs implemented in Greece (as a percentage of GDP). Obviously the status of the US dollar as a world currency and the size of the US Treasury market make this burden more bearable for the US. But Citi analysts think that the belief that the US debt burden can be addressed, moreover in an election year, without consequences on economic activity is an illusion.

**Illusion #3: “Strong Performance of US equities”**

Over the last few months, US stocks and indices have been praised for their strong performance, in absolute terms and relative to other regions. In local currency terms, the S&P 500 index is indeed up 2.3% year-to-date June 23, while the MSCI Europe index is down 3% over the same period. However, Citi analysts argue that this outperformance is more the result of US dollar weakness than the consequence of fundamental performance. Indeed, corrected for Trade Weighted US dollar weakness, US stocks are actually down 2.6% year-to-date. More interestingly, in euro terms, the performance of the S&P 500 index is -5.1%, which means that by neutralizing the currency effect, European stocks actually outperformed US stocks. As such, thinking that stock markets can perform in the absence of sound fundamental support is also an illusion. Citi analysts have not revised their expectations in terms of global economic activity and do not envisage recession scenarios in 2011 and 2012. At the same time, thinking that the debt crisis is concentrated on Greece or even the Euro Periphery countries is a mistake. Citi analysts evaluate that the necessary fiscal adjustment to bring the level of US debt to 60% of the GDP by 2030 is similar to the fiscal adjustment required in Greece, but the fiscal programs implemented in the US are not even half the size of the fiscal programs implemented in Greece (as a percentage of GDP). Obviously the status of the US dollar as a world currency and the size of the US Treasury market make this burden more bearable for the US. But Citi analysts think that the belief that the US debt burden can be addressed, moreover in an election year, without consequences on economic activity is an illusion.

In the Sovereign bonds sector, Citi analysts avoid periphery bonds as confidence continues to wane as speculation about a potential peripheral restructuring sends short-term periphery bond yields and credit default swaps to record highs. On the other hand, they have an overweight stance on core Europe, particularly Triple-A Bunds which, barring the need to fully recapitalize the banking sector, are likely to receive a safe haven bid. Citi analyst also see potential for corporate bonds to continue to benefit from improving corporate balance sheets on the back of lower expenses and growing earnings as real interest rates remain attractive despite a hawkish monetary policy by the ECB.
North America

Fixed income

Weakening recovery means delay in rate hikes and no reduction in the Fed’s balance sheet

The Federal Reserve (Fed) may face some difficult choices in 3Q11. As planned, its extraordinary intervention in the securities markets (quantitative easing or “QE2”) was brought to an end. This enhances the Fed’s credibility as it had repeatedly promised to do so. But the numerous economic data releases coming in below expectations have undercuts its message that the US economy is now fully able to grow without this exceptional support. This softness has led Citi analysts to push back their forecast for the first policy rate hike to 3Q12. The US economy is expected to grow 2.5% in 2011 and just 2.8% in 2012, fast enough to reduce unemployment only to 8.5% in 3Q12.

This economic softness has also led Citi analysts to lower their forecast for the level of the 10-year Treasury rate to just 3.35% in 4Q11, though this still represents a rise from current levels. The anticipated rise should occur from a mild acceleration in economic activity in 2H11. This somewhat more sombre economic backdrop has not lessened Citi analysts’ preference for investment grade corporate credit. Although yield spreads to sovereign bonds have narrowed considerably over the last year, as corporate default rates have continued to fall and corporate balance sheets have strengthened from earnings growth, Citi analysts believe these trends may have further to go.

Japan and Asia Pacific

Equities

US stocks could benefit from a positive fiscal surprise

In line with softening economic numbers and the end to the Federal Reserve’s quantitative easing program (QE2), US equity markets have been under some pressure over 2Q11. Citi analysts continue to forecast the S&P 500 index finishing the year at 1,400 and view current investor positioning as potentially overly bearish, providing an attractive entry point for US equities.

Earnings momentum to recover rapidly after the slowdown

Japanese corporate earnings momentum slowed down following the earthquake but Citi analysts expect a turnaround in momentum in the second half of this year, as supply chain disruptions are resolved and reconstruction demand materializes. Going by price-to-earnings, price-to-book and return on equity measures, Japanese equities are an attractive lot. However, Citi analysts remain cautious in the near term, but grow more optimistic in the medium term. While the undervaluation of Japanese equities is expected to be rectified in time, there remain potential short-term risks, such as taking longer than expected to overcome the nuclear crisis, growing uncertainty over the burden that financial institutions may have to bear due to the nuclear accident compensation, and concerns of a global economic slowdown.

Citi’s end-2011 fair-value estimates for TOPIX and Nikkei 225 currently stand at 920 and 10,300 respectively. Non-nuclear energy is seen as a long-term theme and therefore sectors related to energy, in addition to Consumer Staples, are preferred. Citi analysts are also overweight Utilities and Financials given poor visibility regarding the nuclear crisis and compensation.

Asia Pacific equities

Growth moderation does not equate to earnings moderation

Citi analysts think that inflation remains a concern in the region, but some Asian emerging market central banks are likely to moderate their hawkish stance on interest rates given the ongoing Eurozone debt crisis and expectations for the US Federal Reserve to only commence rate hikes in 2012. The likely exceptions to this are the People’s Bank of China, the Reserve Bank of India and Bank of Thailand, which are grappling with high inflation, and are expected to continue their aggressive stance by raising rates going forward.

Asian credit spreads have widened as Europe’s sovereign debt crisis progresses, with growing uncertainty about how its policymakers will respond. But good quality oversold names may be worth taking a look at, given the high carry available.

From an industry perspective, austerity measures are expected to remain a near-term overhang for China’s property sector. This may deter real money from buying aggressively, though Citi analysts remain selectively positive on the sector as the financial profiles of property developers remain relatively healthy. Away from the Chinese property names, there have been a slew of Chinese industrial sector names, including some State-Owned Enterprises (SOEs) that have issued USD bonds in Asia, both in terms of dated bonds as well as corporate perpetuals, offering an opportunity to diversify out of the property sector in China.

Citi analysts also like Asian banks, given their balance sheet strength when compared to some of their European rivals, and the supportive regulatory environment they operate in. It makes a compelling argument for some of the regional banks to call their capital securities as has been the case with some of them.
Global REITs and commodities

Real Estate Investment Trusts (REITs)

US REITs appear on track to deliver positive total returns in 2011

US REITs look to be working towards their third consecutive year of positive returns and outperformance versus the broad market. Implied cap rates for the sector have consistently declined since hitting over 10% back in March 2009 and now sit around 6%. The move has been driven and supported by improving fundamentals; significant capital moving back into real estate, both direct and through the public stocks; and low interest rates/capital costs. Earnings for 1Q11 were also solid, coming in ahead of Citi’s expectations with guidance ranges being held steady or raised in most cases and general optimism from REIT landlords. The optimism is being driven by improving fundamentals, a strengthening financing market and an accelerating investment landscape. Overall core Funds From Operations (FFO) growth came in at 6.7% versus the 4.7% Citi analysts expected. Of the companies under Citi’s coverage, 33 companies beat expectations, only 20 have missed, and 13 were in-line. Fundamentals have generally been modestly ahead of expectations despite a negative impact from bad weather which had impacted leasing and led to increased costs. Year-over-year same-store net operating income growth came in at 2.8% versus 19% in the fourth quarter. Occupancy levels were up 60 bps over last year to 92.4%, and down 30 bps sequentially, better than the normal seasonal declines.

Citi analysts also note that a number of ingredients seem to be signalling a potential return of the US REIT leveraged buyout; there is increased capital looking to get placed into real estate, the financing environment is strong with higher levels of leverage being attained and interest rates remain exceptionally low – making a leveraged carry trade attractive. The biggest limiting factor may be US REIT valuations as a whole which appear modestly ahead of private market values given the sector’s access and cost of capital advantage.

Commodities

Support seen for commodity prices over the medium to longer term

Risk aversion in general is likely to remain elevated in the near term given lingering concerns pertaining to the health of the global economy (with signs of slowing in the US and China). This is further compounded by prospects of a reduction of liquidity given the end of the US Federal Reserve’s second round of quantitative easing (QE2) and potential monetary policy tightening in both the emerging and developed world. Such an environment puts commodity prices in a vulnerable position. Citi analysts say globally considering that investment demand for commodities has grown substantially in recent years and net long speculative positioning is still at historically high levels. But over the medium to longer term horizon, they expect commodity prices to be supported by: i) an ongoing global economic recovery with strong emerging market growth; ii) a weak USD, and iii) the prospect of higher demand for commodities for inflation protection. Although downside risks stemming from concerns about US and Chinese economic growth and higher US oil inventories persist, the potential for significant falls from early May levels is likely to be limited. Ongoing tensions in the Middle East and North Africa (MENA) could lend support to oil prices over the medium term. Citi forecasts the West Texas Intermediate (WTI) crude oil price to average US$92.30/bbl in 2011 and US$108.90/bbl in 2012. Gold prices are likely to remain buoyed by safe-haven demand given ongoing risks stemming from the Eurozone sovereign debt crisis, US fiscal concerns, as well as global inflation fears. However, the end of QE2 and the gradual removal of ultra-easy monetary policies by major central banks may weigh on gold prices over the medium term. Moreover, the growth in investment demand for gold from 4% to 40% of total demand for gold in the past 10 years leaves the metal vulnerable to any sudden change in investor sentiment. Citi forecasts gold prices to average US$1,493.40/oz in 2011 and US$1,424.90/oz in 2012.
Having reached almost 1.50 in early May, EUR/USD has subsequently corrected back to a low so far just above 1.40 before bouncing. Citi analysts think lower commodity prices, reduced risk appetite, some easing in EUR-US interest rate differentials and ongoing periphery concerns may yet see EUR/USD pull back to the medium-term trend around 1.35 over the next couple of months. But, longer term, they expect USD trend weakness to persist. In their view, the main drivers of the 26% trough to peak appreciation over the next 6-12 months.

GBP has been trading mainly sideways against the average of the USD and EUR in the second quarter of the year. A positive for the GBP is that it looks cheap. Citi analysts’ fair value estimates are GBP/USD 1.74 and EUR/GBP 0.71. This cheapness shows up in a general perception that the UK is now a lower-cost centre than historically, one of several phenomena usually follow from this. Exports rise, the currency appreciates or the inflation rate accelerates. For now, Citi analysts observe that we are getting more of the first and last mainly because the Monetary Policy Committee continues to allow above-target inflation to persist without raising interest rates. Citi analysts think that real appreciation is inevitable in the medium term as the UK economy emerges “re-balanced” in the long term with a lower fiscal deficit, current account surplus and lower consumption/higher exports. Investment. They forecast EUR/GBP at 0.85 and GBP/USD at 1.73 in the next 6-12 months.

In our view, the main drivers of the 26% trough to peak appreciation over the next 6-12 months are:
- Euro-Dollar
- Dollar-Yen
- Yen-Pound

Currencies

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Forecasts may not be attained. Past performance is no guarantee of future results.
There are additional risks associated with foreign investments.

Guest corner

Navigating Opportunities in Water Sector Investing
By Deane M. Dray, CFA Director and sector leader of the industrials group for Citi Investment Research and Analysis (CIRA)

Water is a necessity to life and the \( \$450 \) billion global water market has a powerful undercurrent of defensive growth. Regardless of where we are in the economic cycle, a relatively predictable demand for water/wastewater can be tied to population growth. This gives water its defensive growth appeal. Yet the water sector also has a significant cyclical side. Municipal budget constraints and the propensity to defer infrastructure upgrades, as well as all the industrial demands for water (including power generation, chemical/petrochemical, semiconductor, food & beverage, etc.), together add a cyclical element to the demand curve for all the equipment and services associated with the water sector. The implications are that water indeed has defensive growth properties, but it is certainly not “non-cyclical.”

The natural resource with no substitute

Water intersects multiple industrial, geopolitical, and humanitarian agendas because it is a limited resource with steadily worsening supply/demand imbalances. Bear in mind that water is always a local issue, seemingly in short supply where it is needed most, and frequently in over-abundance in locales where it is not needed (flooding being an extreme example). Water is actually denser than oil and is more expensive to pump through a pipeline. In light of the above, water’s importance as a necessity to life has significant national and transboundary implications. There are more than 20 countries today that rely for more than half of their drinking water supply on rivers flowing out of a neighboring country. We see every day the potential to expect more border disputes to arise over water, with national security implications for many countries. The United Nations estimates that by 2030 about 50% of the global population will be living in water-stressed regions. Extrapolation of current trends suggests that about one-third of the global population will not have access to adequate drinking water by 2025. The global supply of fresh water is dwindling due to pollution, the draining of underground aquifers and, arguably, the impact of climate change too.

How we define the global water sector

We like to say there is no single ‘water sector’. Instead, the water market is composed of at least 13 distinct subsectors, including the equipment and services for pumps, valves, water test, infrastructure (pipes, meters), filtration, wastewater treatment, industrial water treatment, residential water treatment, produced water treatment (from oil & gas drilling), automation/process controls, desalination, consulting, engineering services, and irrigation. The total addressed water markets of these 13 subsectors drive our bottom-up \( \$450 \) billion estimate of the global water market. On our estimates, North America represents about \( \$100 \) billion of the global market for water equipment and services.

Making the case for 4-6% global water market growth

In deriving our water market growth estimates, we consider separately the dynamics of developed and developing markets. Combined, we see these markets offering attractive and mostly defensive 4-6% growth.

Developed markets. The water/wastewater sector in developed markets, such as the US, faces an ongoing struggle to maintain its aging water infrastructure. Absent big Federal stimulus packages, we expect much of the sector to remain relegated to the ‘break and fix’ cycle of spending. We expect the water/wastewater sector, coupled with all the other water subsectors in the developed markets (such as power generation, municipal, food & beverage, industrial wastewater, etc), to exhibit growth trends in the mostly steady 1x-2x GDP annual range.

Developing markets. Developing markets are still building out their basic water treatment systems. China, for example, was treating only 52% of its wastewater as recently as 2006. We see this effort to build out basic water and wastewater infrastructure driving 8-10% underlying annual growth for at least the next five-plus years.

Investors should focus on the higher end of the water value chain

Among the water truists investors need to understand is that not all water businesses have equal intrinsic value. The water sector has a discernable value chain, with commodity products (including basic pipes, pumps and valves) at the low end, and many of the other water subsectors in the wastewater sector, coupled with all the others, exhibiting above-GDP growth.

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Asset allocations

Defensive
Seeking primarily capital preservation over time and only willing to accept very minor portfolio value fluctuations from month to month.

Income Oriented
Seeking growth of wealth over time but unwilling to accept significant fluctuations in the value of portfolio from month to month.

Growth and Income
Seeking long-term capital growth foremost but unwilling to accept significant losses on value of portfolio over the medium term.

Growth Oriented
Seeking long-term capital appreciation and willing to tolerate measured medium-term volatility in order to enhance longer-term performance.

Aggressive Growth
Seeking long-term capital appreciation and can accept potentially large losses on portfolio over the near- to medium term in order to maximise long-term performance.

Spotlight on allocations

About the Citi asset allocation process
The Citibank tactical portfolio allocations are based on the work of the Global Investment Committee (GIC) of Citibank.

The membership of the committee is comprised of experienced investment specialists from across Citi. The GIC deliberates on the macroeconomic and financial market environment in order to formulate an outlook across multiple asset classes and is responsible for maintaining tactical model portfolios based on this outlook. The tactical weights that are applied to the Citibank portfolios are aligned to the decisions of the GIC.

Allocation to bond & equity markets
- We have maintained our allocation to global equities at overweight and our allocation to global bonds at overweight.

Citi analysts believe that corporate earnings growth is likely to slow while risks have multiplied. As such, they believe that the market’s assumptions for economic growth may be disappointed. The rally in US long-term government bonds looks to be moderately overdone, providing some prospects for appreciation there and support for bond portfolios generally. Citi analysts consequently foresee better risk-adjusted return prospects for global bonds than global equities.

Allocation to regional equity markets
- We have increased our allocation to Emerging Markets equities to overweight, maintained our overweight allocation to Japanese equities and our underweight allocation to US and European equities.

Citi analysts believe that the valuations for European stocks are no longer as cheap and the risks to the downside remain. In the case of financials, they are avoiding US financials as well and see potential for margin pressures to hurt stocks there. Japan is a special case, as the earthquake has made very low valuations even more attractive. The emerging markets could profit of a bounce in risk appetite if the Greek crisis eases.

Allocation to government and credit markets
- We have maintained our allocations to government bonds, investment-grade corporate bonds at overweight but reduced high-yield bonds to underweight. We have also maintained an underweight position in emerging market debt.

Corporate earnings and balance sheets are strong around the globe and Citi analysts forecast that default rates on corporate bonds may continue to remain at historically low levels. But the fundamental outlook for this asset class has become somewhat less compelling due to tight spreads and a softening global economy. Citi analysts are mildly overweight developed market (US and Europe) and underweight Japan sovereign bonds and continue to favour emerging market bonds as valuations appear too rich.

The suggested allocations are intended to be general in nature and are not to be construed as specific investment advice. Investors are encouraged to consult with their Financial Professional to determine their allocation needs based on their risk tolerance, suitability and goals.

Data Source: Citibank NA as of March 2011.

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