Citigold Select

Q1 2012

standpoint

GLOBAL MARKET ANALYSIS

The Fear Factor

Looking at the overall performances and volatility of risky assets, or at the evolution of bonds spreads over the year, many investors will probably be happy to leave 2011 behind. Unfortunately, when we look at the various comments from analysts and economists, the sky ahead does not look any brighter in 2012 than it did last year.

"Low potential growth and cyclically weak economic activity due to the necessary fiscal tightening and the enduring credit crunch will delay the completion of the deleveraging process and increase its cost." (Willem Buiter, Citi Chief Economist)

citibank

In most cases, observers expect a continued deterioration of the economic environment and the forecasts that are most highlighted in the media are those predicting extreme events such as global recession, break-up of the Euro Area or default of a major European country, for example. Citi analysts also forecast a sluggish global economic environment characterized by a recession in the Euro Area and increasing divergences between economic regions. In a Developed World that is increasingly focused on deleveraging necessity, both in the private and the public sectors, Citi analysts think that economic growth is likely to remain subdued for an extended period of time.

"There is more debt in more sectors in more countries than ever." (Matt King, Citi Credit Strategist)

Citi analysts also point out that risks to their base case scenario are rather biased to the downside (deeper deterioration) than to the upside (improvement). Indeed, a significant portion of the record global debt pile will have to be refinanced this year. Citi analysts estimate that Eurozone banks have some €250 billion of senior unsecured debt maturing while the International Monetary Fund (IMF) estimates that the G7 and BRIC countries (Brazil, Russia, India and China) combined will face US$7.6 trillion of maturing bonds.

"Heavy political elections agenda and sovereign debt refinancing uncertainties are likely to feed market volatility." (Vincent Deschamps, Citi Head of Investment Research, EMEA)

Furthermore, in a number of countries, political leaders are likely to be increasingly stretched between guarding national interests and fulfilling international obligations in an election year. Citi analysts think that these are sources of uncertainties that are likely to have a major influence on market performance in the coming months.

Now, when we compare the overall market forecasts for 2012 to those in early 2011, we observe that a major key difference lies in the fact that the consensus mood and prospects are particularly pessimistic today, while it was particularly optimistic back in early 2011. To be sure, the economic context turned out particularly challenging in 2011, but was it a surprise? As pointed out by Citi analysts, concerns such as a Greek default, liquidity squeeze in Italy and Spain, rating downgrade of Triple-A sovereign issuers, un-sustainability of fiscal deficits in Developed Markets, weaknesses of the Euro construction, impact of private sector deleveraging on global economic activity and the slowdown of the Chinese economy in a context of inflation pressures, credit bubble and global demand slowdown are all events that were well known by the economic, financial and political community.

"2011 has been another year that many people would rather forget, but it's been especially tough if you started it very bullish on risky assets." (Richard Cookson, Citi Private Bank CIO)

The mood was particularly optimistic at the start of 2011 as all these risks were overshadowed by the so-called success of quantitative easing programs in the US and its impact on market performances. Citi analysts point out that if the year was indeed tough; it has been pretty bad for investors who actually underestimated these risks in the first place and did not adapt their portfolios accordingly. Indeed, they remind us that a large part of the potential underperformance of an investment strategy tends not to come from the economic environment itself, but rather, from underestimating, or overestimating, the risks lying ahead. This often happens when one mixes up risk awareness with fear, or opportunity awareness with greed.

As a new year begins, there is no reason to be fearful. But there are many risks and challenges, as well as opportunities and solutions, that investors should address properly in their investment strategy, and, hopefully, enjoy the year! ◻

NORTH AMERICA

Modest gains expected in 2012

Poor investor sentiment, supportive US credit conditions, attractive valuations and depressed corporate earnings expectations all argue for modest gains in US equities in 2012. Citi analysts have set end-2012 targets of 1,425 for the S&P 500 index and 13,550 for the Dow Jones Industrial Average. While they expect low corporate earnings growth, fiscal uncertainty and corporate margin pressures to challenge the equity market throughout 1H12, they see potential for a rally in 2H12 as progress is made in Europe and as we gain more insight into the US electoral process.

Employment growth and commodity price weakness are likely to impact corporate margins negatively, but considering that the equity market already appears to be pricing in a much weaker corporate earnings outlook, the downside may be limited. Meanwhile, government policy issues have been one of the biggest concerns for US equity investors and thus the Presidential election is likely to be watched carefully. Housing trends also look like they could find a bottom in 2012 as excess homes get absorbed around mid-year (another possible catalyst for 2H12 strength). Moreover, time could also alleviate fears of a much broader global banking "contagion" from Europe's sovereign debt issues. Thus, 2012 overall could prove rewarding even if 1H12 is a bit more challenging.

In terms of sectors, Citi favours Food Beverage & Tobacco, Diversified Financials, Insurance, Semiconductors & Semi Equipment, Technology Hardware & Equipment and Telecoms, and is neutral on Consumer Services, Media, Food & Staples Retailing, Household & Personal Products, Energy, Regional Banks, Healthcare Equipment & Services, Commercial Services & Supplies, Transportation, Materials and Utilities.

EUROPE

Uncertainties dominate

Turbulences and fears have dominated financial markets over the past year and Citi analysts think they will not leave quickly nor without a fight. Deepening of the sovereign crisis, economic recession, fiscal austerity, earnings slowdown, Euro break-up fears and lack of political leadership combined with a heavy electoral agenda do not bode well for equities in 2012. However, Citi analysts observe that valuations are very compelling as cyclically adjusted price-to-earnings ratios are approaching the record lows observed during the hyper inflation period in the 70's and the credit bubble burst in 2008. In other words, Citi analysts think that a lot of bad news seems already priced in and that pessimists would need more fuel such as a full credit crunch, Euro break-up or global recession to drive share prices materially lower.

Citi analysts recognize that in a context of slowing growth and profit margin erosion, valuations alone do not suffice to justify a rebound in equity markets. Citi analysts have indeed decreased substantially their corporate earnings growth estimate to between -10% and -15% for European companies in 2012. They therefore prefer companies that are able to take advantage of the increasing economic decoupling between Europe and the rest of the world, and of the broad based corporate deleveraging process to deliver balance sheet quality and growth exposure to investors. They define "growers" as companies whose profit growth is largely exposed to the strong economic dynamic of emerging markets, companies which are able to grow sales volumes in a challenging economic environment, such as Global Leaders, and companies with the ability to grow dividends and return cash to investors.

JAPAN

Compelling valuations

Citi analysts see potential for TOPIX to stage a sharp rebound in 2012 on two key factors, valuations and corporate earnings. Valuations have reached a level that is as attractive as, or even more attractive than, their level at the time of the index's post-Lehman failure low. Moreover, under Citi analysts' main scenario, which assumes that a global recession can be avoided, they expect TOPIX earnings-per-share (EPS) for FY3/13 to come in more than 30% higher than in FY3/10. This could spell the end to "Everyday Low Prices" before the end of 2012, in their view.

The main reason behind the current stock market slump would be pressure from the market on Eurozone policymakers (or, more specifically, the European Central Bank) to purchase large amounts of government bonds and to implement mandatory capital injections for financial institutions. Japanese equities are not expected to bounce back until the probability has increased that such policies will be formulated in response to market pressure.

As a result of weak macroeconomic momentum and downward pressure on valuations from the strong yen, Citi analysts expect the next rebound in Japanese equities to be smaller than the rebound from the post-Lehman failure low. They think the recovery of TOPIX may mirror the weakness of global economic momentum and proceed slowly. Their end-2012 TOPIX forecast is 870.

Citi analysts see non-nuclear energy as a long-term theme and therefore favour sectors that are related to energy. On the other hand they disfavour the utilities sector due to uncertainty regarding the nuclear accident and compensation.

CITI Outlook

A snapshot of Citi's global market views across a select group of asset classes, regions and currencies over the next six to twelve months.

Our Market Outlook reflects our assessment of each asset class independently of other asset classes. The Global Investment Committee (GIC) has cut its risk exposure further and has increased their underweight position in global equities. Correspondingly, they have added to their position in fixed income and initiated a position in gold. They believe gold is likely to do well in an environment of further monetary easing globally – something already firmly underway by central banks in the US and the UK, and is likely to be followed by a swath of emerging market countries. Risks stemming from the European debt crisis have heightened and decisive intervention by the European Central Bank (ECB), or through a bailout plan with enough firepower, may only arrive once the crisis is severe enough that no other option appears available. This could require more pain and steeper falls in markets, and all this makes holding equities a less attractive proposition.

GLOBAL EQUITIES

MARKET	MARKET OUTLOOK
	NEGATIVE
US	Negative
Europe	Negative
Japan	Positive
Latin America	Negative
Asia Pacific	Negative
Eastern Europe	Negative

GLOBAL FIXED INCOME

MARKET	MARKET OUTLOOK
	POSITIVE
Global Government	Negative
Global High Grade Corporates	Positive
High Yield	Positive
Emerging Markets	Positive
Asia	Positive

ALTERNATIVE INVESTMENTS

MARKET	MARKET OUTLOOK
	N/A
Hedge Funds	Neutral
Gold	Positive

GLOBAL CURRENCIES

CURRENCY	OUTLOOK VS USD
Euro	Negative
Yen	Neutral
British Pound	Negative

ASIA PACIFIC

Potential for more upside than downside

Citi analysts believe there may be more upside than downside in Asian equities and see potential for 25-30% upside over the next 12 months, assuming that a more settled macro picture or earnings resilience at the corporate level leads to investors regaining their appetite for risk. They forecast the MSCI Asia ex Japan index at 575-600 by end-2012.

With Europe expected to slip back to recession and global growth likely to be subdued, investors are understandably concerned about corporate earnings. Consensus corporate earnings growth forecasts have been on the decline and currently stand at 11% for 2012. Historically, a global recession would mean an over 20% earnings drop in Asia, but this is not Citi's base case. That said, until earnings forecasts revisions stabilize, uncertainty is likely to prevail. Valuations however suggest that a lot of bad news may already be priced into the Asian equity market. The MSCI Asia ex Japan index was trading at 1.5x price-to-book and 10.5x price-to-earnings as of December 21, 2011. Citi analysts note that from those valuation levels, Asian equities have typically been higher 92% of the time in the next 12 months based on the last 36 years.

Meanwhile, with real interest rates remaining negative and the loan to deposit ratio way below the historical high, liquidity is also not much of an issue in Asia. As such, Citi analysts believe that certain cyclicals, Tech, Industrials and Energy may offer value along with Banks and Real Estate; the Consumer space however looks over-owned and pricey. In terms of markets, they prefer North Asia – Hong Kong, Korea and Taiwan.

LATIN AMERICA

Poor sentiment drove record outflows

Citi analysts observe that the deterioration in the global economic outlook and the European sovereign crisis have particularly dampened sentiment in Latin America. Furthermore, fears about Brazilian inflation, credit bubble, and understandable concerns about increasing government intervention in Brazil and Peru have also contributed to increase the wave of risk aversion towards Latin American assets. This resulted in strong fund outflows in 2011 which, reaching 12.6% of total assets under management (AUM), outpaced other emerging markets outflows (only 6% in Asia by comparison) as well as the relative-to-AUM outflows observed in Latin America during the 2008 market collapse.

Citi analysts think that the outflow trend and the decline in regional equity markets have been excessive relative to Latin America's relatively benign macro outlook for 2012. They believe that as long as the situation does not turn into a full fledged financial crisis, which could also bring the US economy into recession, policy can help weather the slowdown ahead. Furthermore, Citi analysts' forecasts for commodity prices and the US dollar for 2012 do not point to any major moves in either asset class. This suggests that the role these factors will play in Latin American returns may be more muted in 2012 than usual.

Citi analysts view Brazil and Chile as the most attractively valued markets in Latin America, while Mexico is the most expensive. The preference for Brazillian equities stems from the fact that local factors are increasingly becoming drivers of performance. Even though European politics has been a key driver of Brazilian performance, the domestic macro outlook has been gaining relevance and is bound to continue doing so, according to Citi analysts.

CEEMEA (Central & Eastern Europe, Middle East and Africa)

Central Europe most sensitive to the Euro Area debt crisis

In the context of moderate global economic growth and heightened recession risks in the Euro Area, Citi analysts anticipate a slowdown in economic activity in the CEEMEA region as well. Similar to what happened during the 2009 recession, CEEMEA countries appear more vulnerable to the developing debt risks in Europe than other emerging markets. Within CEEMEA, the brunt of this economic slowdown is expected to be borne by Central Europe, where both Hungary and the Czech Republic are likely to come very close to a new recession in 2012, according to Citi analysts. Central European countries are also the most exposed to a potential increase in deleveraging by western European banks. Elsewhere, growth should be positive but modest, well below levels experienced both last year and prior to the crisis. Citi analysts think that the Russian economy may have upside potential as it could see a boost if oil prices remain resilient.

Citi analysts believe that CEEMEA equities have the potential to perform well over the year provided that the Euro debt crisis offers signs of stabilization or resolution, the pace of China's economic growth remains reasonable and the US economy continues to grow, even at a modest pace. However, they also warn that disappointment in one of these factors could turn out into a bad year for CEEMEA equities given their high sensitivity to investors' risk appetite. Citi analysts also observe that CEEMEA equities, while apparently cheap, do not appear to be pricing in a Euro break-up or a sharp fall in commodity prices, and investor positioning does not look particularly bearish. This still leaves scope for plenty of market volatility which justifies a defensive bias as the year starts.

NORTH AMERICA

Credits appear attractively valued relative to fundamentals

The economy is expected to continue on a path of slow and uneven expansion, with GDP growth forecasted to rise from 1.7% in 2011 to 1.9% in 2012. While financial conditions are improving slowly, they still represent a modest headwind to economic growth. Monetary policy is as such expected to remain focused on supporting financial conditions, but with inflation within desired ranges and unemployment stubbornly high, the Federal Reserve (Fed) is unlikely to raise policy rates until sometime beyond 2013. Instead, the Fed may opt to use communication strategies to extend accommodation, expand their balance sheet or renew purchase of mortgage backed securities (MBS).

Citi analysts expect 10-Year Treasury yields to remain in a fairly tight range of around 2% through 1H12. The recent range of 1.7% -2.4% seems reasonable, in their view, given still resilient US GDP growth and European risks. European concerns will continue to dampen Treasury yields. Despite the US credit rating downgrade by S&P in 2011, Treasuries remain a safe haven asset. Further, concerns of outright financial contagion raise the possibility of a return to 2008-2009. Finally, weaker economic growth in Europe may constrain US economic growth; though this is addressed in our expectations for sub-2% GDP growth.

Meanwhile, US credits appear attractively valued relative to the fundamental backdrop. Corporate earnings are expected to remain robust and new issue supply is likely to continue on a declining trend. Citi analysts see potential for investment grade and high-yield bond spreads to tighten by 75 bps and 100 bps, respectively, by end-2012, though they expect the trading environment to remain choppy.

EUROPE

Deleveraging and decoupling

Citi analysts think that the deepening sovereign crisis likely drove the Euro Area into recession during the fourth quarter of 2011 and that the recession is likely to pursue in 2012, increasing the decoupling between the Euro Area economy and the rest of the world. They expect real GDP to fall by -1.2% in 2012, with a further small fall of -0.2% in 2013. However, they continue to think that the Euro Area will not break up, and that no country will exit the European Monetary Union (EMU) in 2012. They also recognized downside risks for 2012, both from EMU breakup/exit scenarios, and also from the vicious circle between weakening economies, financial market strains and accelerated bank deleveraging. On the monetary policy side, Citi analysts expect the European Central Bank (ECB) to cut the main refinancing rate to 0.5% in mid-2012 and also to extend its non-standard measures given the increasing tensions in the banking sector.

In a context of economic recession and political jitters, Citi analysts think the sovereign crisis is likely to deepen further in 2012. They think that credit ratings will continue to be under pressure across the region which will increase the wave of government yields decoupling between all European countries and German Bunds. In the corporate sector, Citi analysts continue to believe that the broad based deleveraging process and the benign global growth outlook in a context of wide credit spreads over sovereign yields offer an attractive fundamental backdrop for corporate bonds. However, they strongly underweight Financials, which are most exposed to the risk of sovereign default.

JAPAN

JGB yield could struggle around 1.00%

Citi analysts now expect GDP growth of -0.9% in 2011 and +1.1% in 2012. These figures represent a downward revision from their previous forecasts of -0.4% in 2011 and +1.8% in 2012 respectively. The revision was due to the latest exports and business investment data which were notably weaker than expected on the back of a harsh overseas environment. From next spring onward, reconstruction demand is expected to bolster the economy as the third supplementary budget is executed. Citi analysts estimate that reconstruction demand including public work projects and residential investment will add 0.7-0.8 percentage points to GDP growth in FY12. That said, they believe this temporary and exogenous demand should not be overrated in an overall economic forecast.

As fiscal discipline does not appear to be a top priority among politicians, there is an increased risk of a downgrade to Japan's sovereign rating. On the other hand, with the European debt crisis likely to persist, flight-to-quality demand for JGBs is likely to be strong. On balance, JGB yield could struggle around 1.00% for months.

ASIA PACIFIC

Staying defensive

GDP growth in the region is expected to slow from 7.3% in 2011 to 6.9% in 2012. There is likely to be trend divergence within the region, with growth probably slowing more noticeably in the more trade dependent economies. Asia's monetary policy flexibility is constrained by sticky core inflation, fear of a third round of quantitative easing in the US (QE3) and, in most cases, very low real/nominal rates. Monetary easing, if any, is likely to be very limited (except for Indonesia).

In the wake of European debt and global growth concerns, the good news is that Asia's sovereign fundamentals and fiscal flexibility remain strong. Moreover, external vulnerability is lower than in 2008 and banking sector leverage is more manageable with credit penetration still low in many countries.

Investment grade bonds look to be in good shape fundamentally, and despite an estimated sizeable supply pipeline of US$23.0bn in 2012, Citi analysts see potential for investment grade to outperform high-yield in the early part of the year as the more defensive play. Citi analysts prefer quasi-sovereign issuers in fundamentally sound sectors such as Power and Oil & Gas, and disfavour Real Estate, Autos, Steel, as well as Banks in India and China. In high-yield, opportunities could come further out given the near term deterioration in Chinese property sector fundamentals. Confidence should return once the market is convinced that a hard landing can be avoided in China. Citi analysts favour Thermal Coal and Power, and within China high-yield, they prefer Cement and selective Property names, and disfavour Forestry, Pipes and Steel. ◘

CURRENCIES

EURO

Further downside likely

Citi analysts observe that the EUR/USD has been choppy, but trending lower as the European Central Bank (ECB) has softened its monetary policy, driving rate differentials lower. Citi analysts also point out that during the last quarter of 2011, Euro-Periphery issues have spread to core Europe as shown by the widening of Austrian, Belgium and even French spreads. They think that this trend is likely to continue weighing on the currency pair. On the other hand, the non-standard measures adopted by the ECB to improve banks' liquidity situations are likely to stem further deleveraging by European banks and may go a long way towards reducing the illiquidity currently plaguing sovereign debt markets, according to Citi analysts. They also see downside risks on the USD with fiscal pressures and a possible third round of quantitative easing in the US. Citi analysts forecast EUR/USD to drop into a 1.20-1.25 range.

YEN

USD/JPY broadly stable medium-term

Citi analysts observe that USD/JPY has continued to trade in a range bound fashion over the last quarter of 2011. Investors made a bit of an effort to break to the upside but there has not yet been any real follow through. Overall, the inclination is to be short JPY given poor fundamentals, according to Citi analysts. Japanese economic growth remains fragile and is supported by a large and very probably unsustainable fiscal deficit. Reconstruction spending should support growth in 2012 but tax hikes in 2013 will likely be needed to finance this. However, Citi analysts also observe that investors have become more cautious following losses on short JPY positions. While US rates remain at low level, Citi analysts would not expect much upside on USD/JPY and forecast USD/JPY at ¥76 over a 6-12 months period.

BRITISH POUND

Cheap but unlikely to strengthen

GBP/USD has largely been moving sideways given the uncertainty surrounding the direction of UK interest rates. Citi analysts think that the relative resilience of the British pound is partly due to the fact that the Bank of England (BoE) has not been as aggressive as the US Federal Reserve. Citi analysts also observe that the British pound has become somewhat of a safe haven from Eurozone risk, despite the UK's large trade and financial exposure to the continent, and its own growth issues. The fact that the UK is now perceived as a safe haven while the BoE in is the middle of a new quantitative easing (QE) initiative is a sign of how extreme market worry about EUR is. Citi analysts think the BoE is likely to expand its QE program further, which is likely to drag GBP/USD to around 1.50.

DOLLAR BLOC

USD likely higher across the board

AUD has been in an erratic and volatile bear trend against a challenged environment for global economic growth and reduced risk appetite. Risks from slower China growth and the likelihood of further interest rate cuts from the Reserve Bank of Australia are additional factors that need to be watched. AUD has therefore likely peaked and may trade in a lower range over the short to medium term. NZD is expected to track AUD lower given that the Reserve Bank of New Zealand is unlikely to raise interest rates anytime soon. Bank of Canada is also likely to keep interest rates on hold (possibly through to early 2013), so there is no obvious driver for CAD from this source. Oil prices may however be the wild card as high oil prices has traditionally suggested a somewhat stronger CAD.

Citi analysts' end-June 2012 forecasts currently stand at USD 0.99/AUD, USD 0.76/NZD and CAD 1.04/USD.

ASIA PACIFIC

Reserves still matter, but China matters more

Exchange rates in emerging Asia are expected to stay mostly flat in the near term before appreciating further out. Reflecting the need for less near-term pressure for RMB appreciation to curb China's inflation as growth slows, a gentler pace of RMB strengthening against USD implies less support for Asian emerging market currencies.

KRW has been supported by currency swaps with Japan and China, but slowing inflation and a more dovish tone from the central bank suggest that focus may shift towards maintaining a more export-supportive exchange rate. INR was the worst performer in 2011 as India continues to grapple with twin deficits on the current and fiscal accounts in an increasingly "stagflationary" domestic setting. While a lot of this appears priced into USDINR, INR may remain under pressure. A shortage of USD funding could also place SGD under pressure in the near term.

Further weakness appears likely for IDR and PHP in the near term. Bank Indonesia is clearly more concerned about growth and appears to be more at ease with a weaker exchange rate. Export weakness is also likely to weigh on PHP. Similarly, lacklustre economic growth along with a weaker current account position may dampen the outlook for THB.

Citi's end-June 2012 forecasts (against the USD) for the different currencies currently stand at: 6.27 (Chinese Renminbi), 7.77 (Hong Kong Dollar), 52.00 (Indian Rupee), 9300 (Indonesian Rupiah), 3.12 (Malaysian Ringgit), 43.80 (Philippines Peso), 1.28 (Singapore Dollar), 1145 (Korean Won), 30.50 (Taiwan Dollar) and 30.60 (Thai Baht).

EMERGING MARKETS

CEEMEA currencies likely to continue underperformance within EM

The situation in Europe continues to take its toll on CEEMEA currencies but many also carry their own deep economic and policy imbalances. Overt reliance on exports (to Western Europe) for growth and/or largely externally owned banking systems pose considerable challenges. The Czech koruna, Israeli shekel and Hungarian forint may be amongst the weakest performers in the region. In Hungary, a weaker exchange rate could be detrimental to private sector balance sheets that are highly levered in foreign exchange. The Polish zloty is similarly high beta to developments in Europe and shares Hungary's vulnerabilities of private sector balance sheets that are bloated by forex loans and relatively low reserve cover. Being free of the forex loan burden plaguing many in the region, and with good debt ratios, CZK looks in much better shape than either HUF or PLN. But further weakness is likely given its export-intensive economy and recent outperformance. Meanwhile, the Russian ruble could hold its ground if oil stays above US$100-110/bbl. The South African rand faces pressure from a sizable current account deficit, weak economic growth outlook and slowing portfolio inflows. Confidence in ILS may be undermined as the current account surplus swings into a deficit. The Turkish lira is supported by its relatively safer banks following its own banking crisis in the early 2000s and the central bank's focus on propping up the currency through a high overnight rate, but is weighed down by its balance of payments position.

Latin American currencies are expected to stay flat in the near term before appreciating modestly further out. In a world where large domestic, external and banking sector imbalances are the focus of market attention, Latam fares better than many. The main risk though, is that three of the four Latam currencies (Brazilian real, Chilean and Mexican pesos) are backed by commodities and may be confronted with a "double-whammy": a weaker global growth environment and stronger USD, plus sliding metals and oil prices. BRL must contend with three forces in the near term: what transpires in China, prices of metals and oil, and the impact of aggressive central bank monetary easing. Apart from its relatively poor reserve position, Chilean fundamentals look fair. But Chile is highly exposed to copper, which dominates both exports and the forex rate. Meanwhile, MXN prospects may be dependent on the US growth outlook given that exports to the US account for roughly a fifth of total output and have driven about a third of average real GDP growth since 2003. Finally, the Colombian peso could potentially appreciate over the near and medium term. Supportive factors include: strong foreign direct investment inflows, better fiscal figures and a firmer domestic growth outlook. ◻

COMMODITIES

Challenging environment for commodities going into 2012

Policy response – particularly out of Europe – will be a key catalyst for commodity direction. Citi's outlook for global growth remains positive for 2012 and commodities could benefit from any uptick in growth. Further monetary stimulus is anticipated from the European Central Bank and the Bank of England, though it remains an open question in the US. But it is net positive for commodities if the Federal Reserve were to proceed with QE3. Going into 2012, global growth prospects and investor sentiment are expected to influence the risk-on/risk-off cycle for commodities. Geopolitical tensions within the Organization of the Petroleum Exporting Countries (OPEC) and the Middle East and North Africa (MENA) region will also be of particular relevance to petroleum markets.

Citi analysts estimate that total demand for oil may rise from 89.4m b/d in 2011 to 90.3m b/d in 2012, while total supply could increase from 88.5m b/d in 2011 to 90.3m b/d in 2012. Beyond demand and supply, they see potential for oil prices to be supported at over US$100/bbl by several other factors: geopolitical risks, expectations of more liquidity tranches to come via monetary policy, and Citi's house views that the Euro currency union does not break up, and China manages a soft landing. They forecast WTI prices to average US$100/bbl in 2012 and Brent prices to average US$110/bbl in 2012.

Gold prices have been supported by investment demand on the back of market uncertainty and financial tensions, and Central Bank buying. Citi analysts continue to hold a positive outlook for gold prices, as investors remain risk averse and look for risk protection, and see potential for gold prices to average US$1,710/oz in 2012. They however caution that current tensions and concerns are likely to dissipate over time and jewellery demand (which can be quite price sensitive) is unlikely to be able to make up for the loss of investment demand when sovereign financial tension eases.

REAL ESTATE INVESTMENT TRUSTS

Seeking earnings and NAV growth in a slower growth environment

Citi analysts believe the US REIT sector may be positioned to continue to benefit from a number of key tailwinds in 2012, albeit not as strong as they were in 2011. These include: 1) Reasonable and growing dividends – Dividends remain reasonable (approximately 4%) and are backed by the lowest payout ratios on record. With cash flow growth likely to remain positive, dividends look positioned to continue to grow; 2) Better balance sheets and cost of capital advantage – US REITs have strong access to attractively priced debt and equity capital especially relative to when we headed into the 2008 recession, limiting dilutive equity raises. Low interest rates also act as a strong support for US REITs and direct property pricing which should keep cap rates flat to down and also makes dividend yields and implied cap rates more attractive; 3) Solid earnings drivers – The sector's cash flow growth is expected to remain positive (+10% in 2012) with positive re-financings, continued internal growth and increased external growth activities; and 4) Limited new supply – New construction levels, while off the lows, remain depressed.

Conversely, the sector would undoubtedly be negatively impacted by a market sell-off, retrenching funds flow and widening credit and capital costs which have all raised the sector's downside risks. Given the upside and downside risks, Citi analysts hold a more subdued flat to +10% total return outlook for 2012, translating to MSCI US REIT index levels of 740-820 versus +5 to +15% for 2011. In terms of investment strategy, they prefer companies that can increase earnings and net asset value (NAV) even in a slow growth environment. They also favour mid- to larger-cap companies that can benefit from having better access to capital, high quality portfolios, stable fundamentals and growth opportunities. Within the sector, they prefer Multifamily, Malls and Lodging and disfavour Office, Shopping Centres and Healthcare.

Tobias M Levkovich

Chief US Equity Strategist, Citi Investment Research and Analysis

Six major developments argue for a new secular US bull market beginning within the next 12-18 months. The investment community is distracted by having lost 50%+ in stocks twice since 2000, the plunge in home prices, peak-like profit margins, employment challenges and a European sovereign debt/banking crisis, but there are changes that may provide catalysts for a major shift in equity price direction.

The six factors that could potentially come together over the next few years include energy independence, a local manufacturing renaissance, technology-based transformational change, demography, a housing sector bottom and fiscal reform. While each individually is important, the coalescence of these developments could prove to be very powerful for investors. It is relatively rare for just one concept to drive investors in a particular direction but it is often the combination of several catalysts that can act as the fuel for stock price trends. Thus, there is a good reason to be bullish about the coming several years in equities despite fears around high (and thereby perceived unsustainable) corporate profitability as well as justified European economic concerns.

#1: The Fiscal Problem and Its Likely Resolution

We continue to think that investors are unwilling to pay up for equities while the continuation of budget deficits and growth of national debt erodes the foundation of economic progress. Fiscal responsibility could as such address rising risk premiums and allow for multiple expansion. By 2013-14, the US will begin to experience a sharp increase in mandatory fiscal spending, based on current budget assumptions, and we suspect that a response will be hammered out by the country's political leadership to address this problem. Indeed, proposals have come forward such as the Bowles-Simpson commission's report that many see as a promising start. Interestingly, Americans seem more willing to accept these options as they show their concern via "wrong track" polls.

#2: The Impressive Coming US Energy Story

For almost four decades, since the 1973-74 oil embargo, America has been struggling with energy supplies and the need to keep its economy powered by hydrocarbons. Various plans have failed to solve the problem, from corporate average fuel economy (CAFE) standards to bio-fuels to electric cars and more. Yet, America stands on the verge of a major change that puts it on a course to near self-sufficiency, according to a past President of the Organization of Petroleum Exporting Countries (OPEC) as well as Citi's head of commodities research, Ed Morse.

The Gulf of Mexico is expected to see oil production climb from 1.55 million barrels per day (mbd) to 4.0 mbd by the end of the decade, while shale oil could add another 2.0 mbd, and a shift to natural gas for heavy trucks could save the country from using another 0.5 mbd. Overall, US imports of oil should drop from 9.0 mbd to 2.0 mbd, which easily can be purchased from Canada and Mexico. Keep in mind that 7.0 mbd would equal US$700 million daily and more than US$250 billion annually. The implications are simply stunning on America's current account figures, trade balances and even potentially the positioning (and cost) of US military forces around the world. The increase in production of shale gas could also add millions of new jobs.

#3: A Possible Turn in the Housing Sector

A nascent US housing recovery could emerge after excess homes get absorbed in mid-2012. There are indications that excess home supply is dwindling, and that could provide a floor in home prices, bank/mortgage losses, construction industry job pressures, consumer confidence and even GDP drags. After six years, the housing bubble deflation may end as it often takes that long to absorb such excesses. Keep in mind, that a bottom in housing has many impacts. The GDP drag could be reversed and employment could get a boost given nearly 2 million unemployed construction workers.

There are other benefits such as the banking industry no longer having to worry about an endless decline in the value of outstanding mortgages, which could bring about credit losses. Unemployment rates have also been stubbornly high partially due to the lack of mobility from areas that do not have jobs to areas that do. While home equity accounts for less than 15% of household net worth and may not massively shift consumer spending, any improvement has widespread benefits that could include related industries such as construction materials, home improvement retailers, etc.

#4: A Manufacturing Renaissance

An American manufacturing renaissance appears to be taking place. Reports of companies bringing manufacturing back to the US have emerged due to higher land costs and wages in China, and there appears to be a much more competitive dynamic in America currently. While many have perceived the US manufacturing base as being in permanent decline, there are indications of a turn taking place.

Both the Boston Consulting Group (BCG) and AllixPartners have recently released reports discussing the new competitiveness of American manufacturing bases given 15%-20% wage increases in China and volatile transportation costs. Tragic natural disasters in Japan and Thailand also have made companies want to have more domestic sourcing options. BCG's report also suggested that building a new plant in Tennessee may be cheaper than doing so in China given property price increases in Asia.

BCG notes that the "labour content ranges from only about 7% for products like video cameras to about 25 percent for a machined auto part. When transportation, duties, and other costs are included, not to mention the expected continued appreciation of China's currency, companies may find that any cost savings to be gained from sourcing in China may not be worth the time and myriad risks and headaches associated with operating a supply chain extending halfway around the world." It is however important to realize that China's manufacturing will likely still grow but more to serve its own developing needs. Thus, the studies do not argue for any collapse in China but rather suggest a resurgence of US-based manufacturing with all of its benefits.

#5: Demographics

The demographics of the baby boom "echo" should support a new cadre of investors. Many market observers have focused on the aging of America and the propensity for aging boomers to prefer the alleged safety of fixed income instruments. But the group of 35-39 year olds that is larger than its parental cohort will be entering their savings years beginning in late 2012. Note that the age group cited is the cohort of people who have married, had a child and bought a home and is now thinking about their children's education and their own retirement needs. Thus, they need to consider investing. Considering that they are unencumbered by the memory of suffering severe portfolio losses, they may be new buyers of equities, especially if bond yields move up in 2013.

#6: Technological Innovation

Technological innovation and penetration of smart mobile devices is likely to compel major new investment. Every 15 years or so, the US undergoes substantial technological change that can act as an economic propellant. The PC had a staggering impact in the mid-1980s as did the internet in the late 1990s, and the mid-2010s should be driven by mobility as smart devices penetrate the market even more. The sheer magnitude of mobility growth brings computing, the internet, purchasing and entertainment in one's palm and argues for significant investment in software, infrastructure, bandwidth and more efficient chips, batteries and production techniques. Fortunately, the US remains the global IT leader.

Conclusion

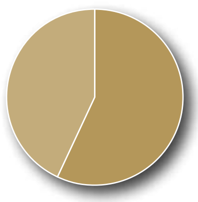
The outlook for the US is far better over the next couple of years, in our opinion, should the full confluence of the various trends highlighted above come together. We strongly doubt that investors will give the market much credit for this in the next 12 months, but the combination of a housing bottom and recovery, energy independence, a manufacturing revival, technological innovation, demography and fiscal adjustment can prove to be a very powerful series of forces. In our view, equity risk premiums are elevated due partially to the long-term US fiscal instability matched with the problems in Europe that ultimately compresses S&P 500 valuation.

ASSET ALLOCATIONS

Below are the active client asset allocations for Asian clients, which include a focus towards Asian equity. These portfolios reflect different current market views.

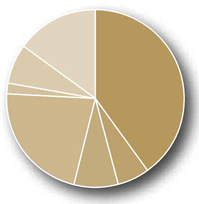
The suggested allocations are intended to be general in nature and are not to be construed as specific investment advice. Investors are encouraged to consult with their Relationship Managers to determine their allocation needs based on their risk tolerance, suitability and goals.

Active Portfolios - USD ($) Denominated



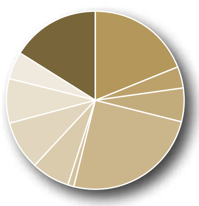
CONSERVATIVE

- US / Global Investment Grade Bonds 57%
- Asia Pacific ex Japan / Emerging Market Bonds 43%



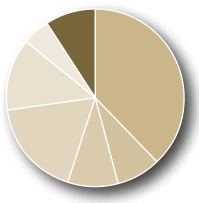
MODERATE

- US / Global Investment Grade Bonds 40%
- US / Global High-Yield Bonds 6%
- Asia Pacific ex Japan / Emerging Market Bonds 8%
- US / Global Equity 22%
- Europe Equity 2%
- Japan Equity 7%
- Asia ex Japan Equity 15%



AGGRESSIVE

- US / Global Investment Grade Bonds 19%
- US / Global High-Yield Bonds 4%
- Asia Pacific ex Japan / Emerging Market Bonds 6%
- US / Global Equity 25%
- Europe Equity 1%
- Japan Equity 7%
- Asia ex Japan Equity 9%
- Emerging Market ex-Asia / Global Emerging Market Equity 8%
- Commodity 5%
- Hedge Funds 16%



VERY AGGRESSIVE / SPECIALIZED

- US / Global Equity 38%
- Europe Equity 8%
- Japan Equity 9%
- Asia ex Japan Equity 18%
- Emerging Market ex-Asia / Global Emerging Market Equity 13%
- Commodity 5%
- Hedge Funds 9%

About the Citi Asset Allocation Process

The Citibank tactical portfolio allocations are based on the work of the Global Investment Committee (GIC) of Citi Private Bank. 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 underweight and our allocation to global bonds at overweight.**

Macro headwinds continue to weight on risk sentiment and a sustainable rally in equities appears unlikely until we see resolution of the European sovereign debt crisis. With Europe now expected to slip back into recession, global economic growth prospects are also being questioned and markets need to be reassured that a China hard landing and global recession can be avoided.

Allocation to regional equity markets

- **We have maintained our overweight allocation to Japanese equities and our underweight allocation to US equities and emerging market equities. European equities are now underweight.**

Given heightened risks in the Eurozone and lack of progress on the policy front, Citi analysts have cut their exposure to Core European equities (Germany and France) from overweight to neutral. This brings their overall position on European equities down to underweight from overweight. Although US equity valuations remain relatively rich, economic and corporate earnings data have been outpacing expectations. Citi analysts have as such slightly reduced their underweight position on US small- and mid-cap equities to acknowledge these positive signs. In their view, US large-cap equities may be more vulnerable to a sharp global slowdown.

Allocation to government and credit markets

- **We have maintained our overweight allocations to investment-grade corporate bonds and emerging market debt, and our underweight allocations to government bonds. High-yield corporate bonds are now overweight.**

Corporate earnings and balance sheets are strong around the globe and Citi analysts forecast that default rates on corporate bonds may continue to remain low. Citi analysts have added to their overweight position on US high-yield bonds, bringing their overall exposure to high-yield bonds to overweight. Although high-yield bond returns are correlated with equity returns, Citi analysts highlight that in the US, high-yield bonds look more attractively valued compared to equities and shorter duration Treasuries. They have therefore switched some money from shorter duration Treasuries to high-yield bonds.

Disclaimer

"Citi analysts" refers to investment professionals within Citi Investment Research and Analysis ("CIRA"), Citi Global Markets Inc. ("CGMI") and voting members of the Citi Global Investment Committee.

Citibank N.A. and its affiliates / subsidiaries provide no independent research or analysis in the substance or preparation of this document. The information in this document has been obtained from reports issued by CGMI. Such information is based on sources CGMI believes to be reliable. CGMI, however, does not guarantee its accuracy and it may be incomplete or condensed. All opinions and estimates constitute CGMI's judgment as of the date of the report and are subject to change without notice. This document is for general information purposes only and is not intended as a recommendation or an offer or solicitation for the purchase or sale of any security or currency. No part of this document may be reproduced in any manner without the written consent of Citibank N.A. Information in this document has been prepared without taking account of the objectives, financial situation, or needs of any particular investor. Any person considering an investment should consider the appropriateness of the investment having regard to their objectives, financial situation, or needs, and should seek independent advice on the suitability or otherwise of a particular investment. Investments are not deposits, are not obligations of, or guaranteed or insured by Citibank N.A., Citigroup Inc., or any of their affiliates or subsidiaries, or by any local government or insurance agency, and are subject to investment risk, including the possible loss of the principal amount invested. Investors investing in funds denominated in non-local currency should be aware of the risk of exchange rate fluctuations that may cause a loss of principal. Past performance is not indicative of future performance, prices can go up or down. Some investment products (including mutual funds) are not available to US persons and may not be available in all jurisdictions. Investors should be aware that it is his/her responsibility to seek legal and/or tax advice regarding the legal and tax consequences of his/her investment transactions. If an investor changes residence, citizenship, nationality, or place of work, it is his/her responsibility to understand how his/her investment transactions are affected by such change and comply with all applicable laws and regulations as and when such becomes applicable. Citibank does not provide legal and/or tax advice and is not responsible for advising an investor on the laws pertaining to his/her transaction.

Country Specific Disclosures:

Australia: This document is distributed in Australia by Citigroup Pty Limited ABN 88 004 325 080, AFSL 238098. For a full explanation of the risks of investing in any investment, please ensure that you fully read and understand the relevant Product Disclosure Statement prior to investing.

Hong Kong: This document is distributed in Hong Kong by Citibank (Hong Kong) Limited ("CHKL"). Prices and availability of financial instruments can be subject to change without notice. Certain high-volatility investments can be subject to sudden and large falls in value that could equal the amount invested.

India: This document is distributed in India by Citibank N.A. Investment are subject to market risk including that of loss of principal amounts invested. Products so distributed are not obligations of, or guaranteed by, Citibank and are not bank deposits. Past performance does not guarantee future performance. Investment products cannot be offered to US and Canada Persons. Investors are advised to read and understand the Offer Documents carefully before investing.

Indonesia: This report is made available in Indonesia through Citibank, N.A. Indonesia Branch, Citibank Tower Lt 7, Jend. Sudirman Kav 54-55, Jakarta. Citibank, N.A. Indonesia Branch is regulated by the Bank of Indonesia.

Korea: This document is distributed in South Korea by Citibank Korea Inc. Investors should be aware that investment products are not guaranteed by the Korea Deposit Insurance Corporation and are subject to investment risk including the possible loss of the principal amount invested. Investment products are not available to US persons.

Malaysia: This document is distributed in Malaysia by Citibank Berhad.

People's Republic of China: This document is distributed by Citibank (China) Co., Ltd in the People's Republic of China (excluding the Special Administrative Regions of Hong Kong and Macau, and Taiwan).

Philippines: This document is made available in Philippines by Citicorp Financial Services and Insurance Brokerage Phils. Inc, Citibank N.A. Philippines, and/or Citibank Savings Inc. Investors should be aware that Investment products are not insured by the Philippine Deposit Insurance Corporation or Federal Deposit Insurance Corporation or any other government entity.

Singapore: The information in this report has been sourced from Citigroup Global Markets Inc. ("CGMI") which is a member of FINRA and registered with the US Securities and Exchange Commission. This report is distributed in Singapore by Citibank Singapore Ltd ("CSL"). CSL provides no independent research or analysis of the substance or in preparation of this report. Investment products are not deposits and are not subject to the provisions of the Deposit Insurance and Policy Owners' Protection Schemes Act 2011 of Singapore, nor eligible for deposit insurance coverage under the Deposit Insurance Scheme. CSL accepts legal responsibility for the content of this report. Please contact your CSL Relationship Manager if you have any queries on or any matters arising from or in connection with this report.

Thailand: This document is distributed in Thailand by Citibank N.A. and made available in English language only. Investment contains certain risk, please study prospectus before investing. Not an obligation of, or guaranteed by, Citibank. Not bank deposits. Subject to investment risks, including possible loss of the principal amount invested. Subject to price fluctuation. Past performance does not guarantee future performance. Not offered to US persons.

United Kingdom: This document is distributed in U.K. by Citibank International plc., it is registered in England with number 1088249. Registered office: Citigroup Centre, Canada Square, London E14 5LB. Authorised and regulated by the Financial Services Authority.

BRINGING YOU
EXPERT VIEWS