Citigold

Market Outlook.

May 2013.
‘Sell in May and Go Away’ – A myth or Self-fulfilling prophecy?

This is even more so in emerging countries than developed counterparties. The US slowdown looks cyclical because it is owed to modest fiscal tightening. However, China is possibly seeing a more structural slowdown with continued growth deceleration going into 2014 as the drag from reforms (including regulation on local government debt and off-balance sheet credits), policy tightening brought by FX reforms (leading to appreciation), as well as narrowing the regulated interest rate corridor – may likely pose growth challenges.

It appears that history might not repeat itself this spring. In effect, wobbles in equities may have started, in part, because of discussion about “tapering” or gradual withdrawal of Fed QE. But this seems to be self limiting for now. With significant fiscal drag, any tightening of financial conditions via lower stock prices may likely draw forth increasingly dovish Fed commentary leading markets to extend the QE end game further into the future and hence limiting the damage.

While Citi analysts recently have shaved 0.1% off their global growth forecast for 2013 to 2.6%, their base case is that there could be a reacceleration of global growth in 2014, led by a faster expansion of the US consumer boosted by better housing and employment numbers as fiscal drag fades in 2H13. Despite short-term headwinds, they expect global GDP to grow at close to its 30yr average of 2.8%. If this proves to be the case, the medium-term outlook for risk assets remains constructive.

Valuations: Re-rated, but still below average

Furthermore, equity valuations are not stretched. Indeed, the MSCI AC World trailing PE is currently trading around 15.5x. While this is almost 4 points higher than the lows of 3Q 2011, it is still below the long-term average of 17x (chart 1). Even on a cyclically adjusted global PE (CAPE) that compares current share prices to 10-year average EPS, the current CAPE is 19x. This compares to a long-term average of 24x and a low in 2008 of 12.5x (chart 2).
Finally, monetary policies remain supportive, with ongoing Fed QE now supplemented by a similar sized balance sheet expansion in Japan. The UK could yet join in the party and even in EM economies, policymakers are likely to be leaning more towards ease/less tightening as growth has slowed and there has been little impetus to inflation.

Chart 3: Central Bank balance sheets in G3

Sources: Haver, BoJ, Citi Research. As of 19 April 2013

The ultimate question: should we remain invested?

Citi analysts continue to expect significant positive returns from global equities in 2013 outperforming credit returns. With valuations arguably more stretched in credit than equity markets, there seems to be little room for spread tightening in credit with core bond yields likely resuming upward trends this year.

In the near term however, Citi analysts are becoming a little more cautious about risky assets as “risk-off” signals have been witnessed across the markets. With the rising risk aversion likely for the time being, it could take longer to reverse anomalies in equity valuations with slow growth and other headline event risks in place. In such an environment, the great debate here is whether it is value or momentum that is most likely to drive relative returns. And the answer is probably a combination of both. Value-driven performance may remain elusive and momentum trades are likely to prevail as distorted valuations could persist for longer than expected in the midst of headline event risks. However, long-term value could likely play out as a core driver of expected returns from a cross-asset perspective. Thus, the message for the short term is probably to follow the flow of money. The Fed and the BoJ are the major suppliers of liquidity with the BoJ likely gaining precedence over the remainder of the year. Consequently, Citi analysts are overweight Japanese equities and local EM rates.

Medium term, Citi analysts continue to favour Japanese equities on the back of weaker Yen and European equities given better valuations and strong earnings potential. In conclusion, Citi analysts believe while there is certain seasonality to equity market returns in recent years, any pullback could likely present an opportunity to allocate more assets to equities.
Equity Markets

**Australia**

**Lower interest rates on the horizon**

- Monetary policy remains the focus of attention in Australia. Evidence suggests that the higher AUDUSD exchange rate is adversely affecting the Treasury's ability to raise taxes from USD-denominated commodity sales and the continuing budget deficit is hurting Labour’s chance of re-election in September.

- Citi expects Australian GDP growth to achieve 2.7% in 2013 and 3.1% in 2014. Up until now, the RBA has shown little willingness to aggressively cut rates since growth was expected to fall in the middle of the 2.5% to 3.5% target range. Similarly, 1Q inflation data was recently released and showed some softness, but the headline rate of 2.5% year-on-year falls right in the middle of the 2%-3% target range. Nevertheless, the April monetary policy statement retained its dovish bias and Citi expects the Board to follow through with a 0.25% rate cut by the end of 2Q. Since the statement was released at the beginning of the month, not only inflation but also employment data and business and consumer confidence surveys have underperformed expectations. Throughout 1Q, household and consumer data had been fairly upbeat, whilst business confidence remained subdued. The unexpected change in consumer confidence would tend to indicate further downward pressure on credit growth and economic performance moving forward.

- Market expectations of interest rate cuts have buoyed share prices recently. The S&P/ASX200 index is relatively concentrated with only 10 stocks accounting for approximately 55% of market capitalisation. 9 of these stocks are considered to be high dividend payers, and prices therefore tend to rise as interest rate expectations fall. The other positive effect is that the costs of interest on debt capital tend to fall, which can improve margins across the market. Other cost control programs are also pointing to margin expansion leading into 2014 and Citi believes that the increased profitability will continue to support the market, despite a challenging environment for top-line revenues.

**United States**

**1H13 strength could be maintained**

- Citi analysts continue to expect economic growth of 19% this year and picking up further in 2014 to 2.8%. Support for expansion has improved with moderate but sustained job gains, more effective monetary accommodation as reflected in buoyant financial markets, and the rippling effects of reviving housing. Short-term volatility due in part to weather distortions has provided an extra lift to 1Q13 GDP but consumer discretionary spending has softened post tax hikes. Fiscal drag is nearing its peak impact in the next several months as sequestration is implemented.

- The Federal Reserve’s (Fed) aggressive forward guidance and openended bond-buying have yielded the longest stretch of accommodative financial conditions since the late-1990s. The drag from fiscal restraint and policymakers’ high bar for satisfactory job growth will likely sustain QE at an elevated pace through 1H13 but may begin to taper the pace by the start of 4Q13. High unemployment and low inflation suggest no start to exit strategies through 2014.

- While the broad investment community was of the belief that 2H13 would experience better economic trends and thus stocks would appreciate, Citi’s US equity strategy view has been more first-half oriented as credit conditions argued for corporate sector growth and “panic” readings last June signalled a high probability of market strength over the course of the subsequent 12 months.

- Indeed, 1H13 strength could be maintained as sentiment, valuation, implied earning growth and credit conditions support the rally. Citi analysts would not be surprised if the rally carried the S&P 500 Index into the 1,650-75 area as things tend to overshoot. But European economic woes, a possible pullback in QE and the battles over a new budget for FY2014 could cause a mild market setback in 2H13, thus hitting their 1,615 target by year-end.
**Equity Markets**

**Euro-Area**

ECB may cut rate by 25 bps in May

- Citi analysts are slightly cutting their 2013 GDP forecast to -0.6% YoY from -0.5%, but leave the 2014 forecast unchanged at -0.3%. Activity data suggest that the recession continued in 1Q13. Weakness in sentiment indicators points to GDP growth around zero in the remainder of the year.

- Available data suggest that the Cyprus rescue package, including the bail-in of non-insured deposits, has not led so far to deposit flight in other countries. Without increased pressure on bank funding, additional far-reaching non standard measures are unlikely for the time being. While the ECB wants to contribute to improving lending conditions to SMEs, Citi analysts suspect the central bank may take only limited action, targeting a reduction in the valuation haircuts on such loans when used as collateral for the ECB operations. Recent comments suggest that more Council members acknowledge the ongoing economic weakness and falling inflationary pressure, suggesting that the ECB could cut the refi rate by 25 bp to 0.5% in May. Citi expects a further refi rate cut in the reminder of the year to 0.25%.

- Since mid-March, European equities have fallen 5%, on soggy global economic data, ongoing Euro Area concerns and unexciting earnings data. In Citi’s view, valuation still looks reasonable (absolute) to super attractive (relative). Earnings risk remains modest, without a GDP cliff which our economists think is unlikely. As such, Citi analysts believe the current pullback appears healthy and could present opportunities for investors.

- In particular, Citi analysts favour 3 key strategies: 1) companies with earnings momentum, balance sheet strength, US exposure, 2) high surplus cashflow stocks with strong balance sheets, and 3) European Financials with strong capital positions and attractive income characteristics.

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**Japan**

End-2013 TOPIX target raised to 1300

- Recent BoJ’s policy decisions overwhelmed even the most bullish forecasts among market participants. In Citi’s view, Governor Kuroda’s strategy is to affect expectations among consumers, companies and market participants by bold easing measures in order to achieve 2% inflation in a relatively short timeframe. However, it is uncertain when and how far expectations among the general public will shift, given the unprecedented experiment of monetary policy. Citi analysts remain sceptical that the measures taken so far are powerful enough to change stubborn deflationary expectations into inflationary expectations.

- From here, we expect financial markets to gradually shift their focus to 3 developments: 1) Economic fundamentals, 2) the growth strategy that the Abe administration plans to publish in June and 3) the administration’s possible clarification of its stance on the consumption tax hike. While positive news from economic data is expected, there remain significant uncertainties surrounding whether the administration can craft a compelling growth strategy that could improve the growth potential of the economy.

- Citi analysts expect corporate earnings forecasts for FY3/14 along with FY3/13 results announcements to be relatively conservative leaving more upside risks. The main reason for this has been yen weakness during this time. The yen has weakened quickly, so many analysts appear to have been still using old forex assumptions that are more conservative than current rates (¥99/$, ¥130/€).

- Given that aggregate April-December sales for publicly traded companies were up 3.0% and retained profit was up 5.9%, there seems to be more upsides for earnings revisions for FY3/14. With the revised FX forecast, Citi analysts’ TOPIX target now stands at 1,300 and 1,320 for end-2013 and end-March 2014 respectively.

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** Equity Markets 4**
Equity Markets

Chart 5: MSCI Asia ex Japan Index

<table>
<thead>
<tr>
<th>Period</th>
<th>Performance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1-Mth</td>
<td>2.43%</td>
</tr>
<tr>
<td>YTD</td>
<td>3.90%</td>
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<tr>
<td>1-Yr</td>
<td>9.76%</td>
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<tr>
<td>3-Yr*</td>
<td>13.19%</td>
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</tbody>
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*Denotes cumulative performance
Performance data as of 30 April 2013
Source: Bloomberg

Asia Pacific
May play catch up in medium term

• There have been two significant macro developments, one of them being the downshift in global growth expectations. In Citi’s view, more industrialized (NIEs) economies of Korea, Singapore and Taiwan could be more vulnerable than the “Emerging” parts of Asia given less leeway to lean on domestic demand. However, historically, Malaysia and Thailand are quite sensitive to the global demand cycle.

• Global growth concerns, especially on China, have dealt a heavy blow on commodity prices. With the exception of Indonesia and Singapore, inflation concerns have receded in the region with the help of benign commodity prices, giving support for some extension of monetary accommodation.

• From an equity perspective, why is Asia-ex underperforming, compared to Japan and US? What sets Japan apart is better price momentum (stock market has gone up) and better earnings revisions (best in Asia and globally) but companies have slightly worse quality attributes (less good balance sheets and cash flows). In terms of the US, relative to the world it is a more expensive market but it offers more liquid and better quality companies. From that, it seems that investors like good price momentum and good EPS revisions, and that they also like liquidity and, in the case of the US, quality.

• Asia-ex and EM, on the other hand, do not have the attributes of the markets that are going up. They have weaker price and revisions momentum and they are less liquid. But they have value and higher growth. However none of those attributes currently interest investors. Citi analysts believe that the current growth scare may eventually pass. When it does, value could likely be a very rewarding attribute and equities may benefit from growth. In other words, Asia and EM could outperform medium term with investors gravitating back to value and growth of Asia-ex Japan.

Emerging Markets
Neutral on Latam equities

• Since monetary injection by the Bank of Japan is likely to fuel the demand for risky assets, high-yielding CEEMEA* economies – eg Poland, Hungary, Turkey, South Africa, Russia – could find themselves on the receiving end of additional capital flows.

• Although valuations are attractive (at 8.1x 2013E earnings, compared to 10.8x for GEMs), sentiment on CEEMEA remains poor and earnings momentum appears weak. Preferred markets include Turkey where the EPS outlook is strong. Economic growth is likely to accelerate further, helping investor sentiment.

• In 6-12 months, as the US dollar gains ground more generally, CEEMEA currencies, particularly ZAR and HUF, are anticipated to weaken further. Meanwhile, Citi analysts expect some Latam strength to sustained in the near term (lifted by MXN and BRL), with some giveback over the medium term as the US dollar strengthens more broadly.

• Within Latin America, Citi analysts now expect the monetary policy tightening cycle to begin in April with a 25 bps hike in Brazil. In Mexico, economic activity has softened a bit in the past couple of months, partially thanks to calendar effects, but Citi is maintaining their call for 3.6% GDP growth this year.

• As for Latin American equities, Citi analysts are neutral. Despite expected double-digit EPS growth for 2013, LatAm’s relative earnings momentum has been weak. Meanwhile, valuations are the highest among the main EM regions. Preferred markets include Mexico (expectations of another strong earnings forecast in 2013, structural reform and a cheap peso).

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

Positive on High-grade corporates and Emerging market debt

US Treasuries
US Treasuries may remain range-bound as sluggish growth prospects, political uncertainties, and the US fiscal debate weigh heavily on the yield curve. As uncertainties dissipate, rates may seek higher ground later this year to reflect lower tail risks and improving growth prospects.

US Corporates
While Citi still believes that the fundamental backdrop is relatively strong, balance sheet improvements have reversed. With higher government rates and only modest spread compression, Citi analysts expect modest returns this year and favour maturities in the 5-10 year range.

US High-Yield
High yield corporate bonds continue to benefit from low government yields, low default rates and simulated monetary policies conducive for risk assets. Although Citi analysts expect Treasury rates to rise during 2H13, high yield bond spreads may compress and the attractive carry could boost performance.

Emerging Market Debt
Debt markets in emerging nations have benefitted from improved fiscal balances and more credible monetary regimes. Easing inflation pressures allow central banks more room to ease (or at least, not hike), boosting fixed income asset markets.

Euro Bonds
Citi analysts believe that core rates are likely to be range-bound near term as recession, political instability in Italy and two more ECB rate cuts this year are likely to weigh heavily on Core European yield curves.

Japan Bonds
The Bank of Japan’s (BoJ) easing measures far exceeded market expectations. It introduced monetary base in order to aggressively expand Japan’s aggregate money base. Also it expanded the JGB purchase amount and the maturity of JGBs eligible for purchase to 40 years to keep JGB long-term yields low. With these measures in place, long-term interest rates are setting record lows for the time being.

Asia Bonds
Combination of global growth worries, commodity price slump and BoJ’s recent easing measure could benefit most Asia bond markets, particularly in India and Sri Lanka. Meanwhile, Citi analysts turn more neutral on PHP bonds now that we have seen sizeable bull flattening.
Currencies

USD: Generalised strength
Citi analysts continue to forecast more generalised US dollar strength, as underlying US growth accelerates and markets start anticipating some QE withdrawal maybe from the September FOMC onwards. In their view, the recent soft patch in US data is unlikely to last. With this background in mind, Citi analysts forecast about 4-5% upside in the USD vs. other industrialised economy currencies in 6 to 12 months.

EUR: Near term rally could run out of steam
Citi analysts think generalised USD strength will be consistent with some downwards pressure on EUR/USD again. Citi still expects additional ECB rate cuts over the next couple of months and, more medium-term, looks for the Fed to scale back monetary accommodation. This suggests that relative monetary policy support could switch back in favour of the USD over the 6-12m horizon. Overall, Citi analysts forecast 1.25 over 6-12 months and 1.20 long-term.

GBP: Further weakness likely
Sterling regained ground across the board after a strong weakening in the first 2 months of the year as investors pared back bets on imminent aggressive Quantitative Easing from the Bank of England. In the meantime, however, UK macro prints may continue to disappoint and growth prospects also still look bleak. With a weak economic outlook and ultimately a possible increase in BoE accommodation, Citi economists expect further sterling weakness against the USD. Citi’s forecasts stand at 1.42 and 1.4 over 6-12 months and in the long term respectively.

JPY: Kuroda’s big bazooka
Citi analysts see the recent Bank of Japan’s (BoJ) easing measures as a “game changer” and expect the trend of JPY depreciation to be “stronger and longer” than originally thought. As the first BoJ’s aggressive expansionary measures under Kuroda are set to keep longer term JGB yields low, investors may likely be more interested in Yen carry trades and outward portfolio investment in search for yield. This would eventually contribute to further JPY weakness. Overall, Citi’s forecast shows USD/JPY at 107 in 0-3 months but they would not rule out higher levels, maybe 115 or a bit higher. More medium term, we may see some pull back to around 105 at 6-12 months. This is on the basis that risk aversion increases as the Fed starts to scale back QE, traditionally bullish for both USD and JPY but more so the latter.

AUD: USD higher
With the USD likely to continue strengthening, as underlying US growth accelerates and markets anticipate some quantitative easing (QE) withdrawal, Citi analysts forecast a lower AUD in the medium term. However, some positives factors for the AUD may likely limit the drop: (1) Risk appetite remains buoyant which tends to encourage carry trading and supports the AUD; (2) Asian currencies generally have been relatively stable in the face of growing USD strength. Overall, Citi analysts forecast 1.06 at 0-3 months. At 6-12 months, they expect parity with a gradual drift lower longer term.

EM Asia: CNY Stronger Vs. Asia
Macro support for stronger Asian currencies seems to be less than before, with Asian data/economic surprise indices turning markedly lower recently and several current account balances expected to turn less favourable too. Both KRW and MYR are expected to sell off sharply vs. the USD in the next three months, with politics playing a heightened role in the very near term. The other China-linked currencies – TWD and THB – are also expected to “decouple” somewhat from a weaker USD/CNY and move more in line with global trends, at least in the near term.

The CNY is a policy variable: onshore spot is allowed to move within a 1% band of a daily fixing, which has broken to fresh historical lows. Citi economists’ expectations remain that China is likely to shade monetary conditions tighter this year, particularly with local money and credit data perhaps exploding higher again. Given the strong policy desire to lift the “quality” of growth with a greater role for domestic demand and less emphasis on export and investment led growth, a stronger exchange rate would be a key aspect of overall tightening. Citi analysts forecast USD/CNY at 6.19 in 0-3 months and 6.10 in the medium term.
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