

# MARKET OUTLOOK

March 2010

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## Big fiscal deficits

Sovereign debt concerns over the last few weeks have again focused investors' minds on fiscal sustainability. In the past, countries in the most pressing fiscal situations have often been emerging economies or those ravaged by war. So it is unusual now to have the weakest government balance sheets in developed economies during peacetime. By contrast, emerging economies, in general, are sitting on the strongest fiscal positions.

Citigold

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# Feature

## Big fiscal deficits

The most worrisome fiscal positions are in southern Europe and they are especially acute in Greece. Greece is not a particularly large economy or equity market. But recent events have had a meaningful impact upon global asset markets. Uncertainties are considerable and it is understandable that many investors are inclined to see wider contagion as a significant risk for global markets, whether this is justified by the fundamentals or not. Indeed, Citi's bond strategists see significant scope for contagion to drive up yields in vulnerable markets. This would be unhelpful, but not unmanageable, for global equities, Citi analysts believe.

**Chart 1: Global Price-to-Book And Previous Defaults/Crises**



Source: MSCI, Citi Investment Research and Analysis. As of February 17, 2010.

In the opinion of Citi analysts, how far this contagion spreads into global equity markets is really a function of the impact of current events upon the outlook for the global economy. Citi's economists have been forecasting a "sustained but uneven" recovery for 2010 – a backdrop that is anticipated to support a strong rebound in earnings per share (EPS) and allow global equities to grind higher.

Current equity valuations also appear reasonable and should provide some protection against further disappointments, say Citi analysts. They highlight that global equities are currently trading on a trailing price-to-book of 1.8x, well below the 3x reached before the Asian crisis and the 2.7x reached before the recent financial crisis. Indeed, current levels are even well below the 2.1x reached before the Mexican crisis in 1995. Citi analysts as such believe that further contagion in global equities is likely to be limited from here. However, big fiscal deficits (and the ways that they are eventually resolved) will still have important implications for regional equity markets.

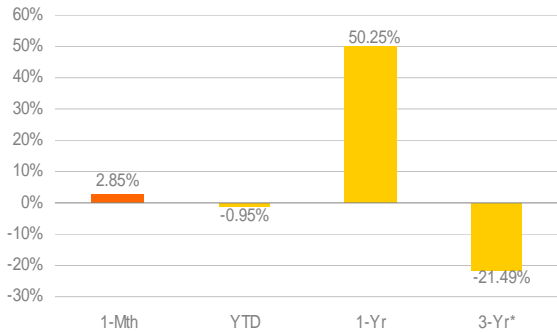
A possible outcome from these sovereign credit issues, Citi analysts believe, could be a weaker recovery but with monetary policy remaining easier for longer. A weaker recovery means that profits growth may become scarcer. Right now, the growth trade has two components for equity investors, "cyclical" and "structural". Perhaps one casualty of the current sovereign debt concerns and a weaker global economic recovery could be the cyclical growth trade — focusing equity investor attention on just the structural growth trade.

Easier monetary policy could provide the liquidity to drive the structural growth trade to unprecedented levels. This has happened before. Previously, very easy money conditions (like the late 1980s and late 1990s) have had a tendency to pump up the growth trade of the time, as long as the easy money finds its way into the equity market. In the late 1980s the growth trade was Japan. In the late 1990s it was Technology. Today Citi analysts think the most obvious growth trade is Emerging Markets.

So, the current episode of global sovereign stress could actually end up being positive for Emerging Markets equities. Emerging governments have amongst the strongest balance sheets in the world and some are net creditors. Also, easy money for longer is likely to continue to support Emerging Market equities, at least relative to developed markets. This is in stark contrast to previous sovereign debt crises, which took their greatest toll on Emerging Markets.

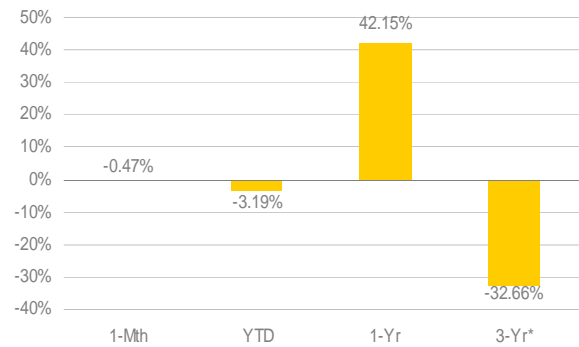
# Equity markets

Chart 2:  
S&P 500 Index



\*Denotes cumulative performance  
Performance data as of 26 February 2010  
Source: Bloomberg

Chart 3:  
Dow Jones Stoxx 600 Index



\*Denotes cumulative performance  
Performance data as of 26 February 2010  
Source: Bloomberg

## United States

### Resumption of growth may be sustained but moderate

- Gradual firming in final demand on the back of diminishing financial headwinds suggests the resumption of growth may be sustained but moderate. However, financial recovery remains far from complete, and Citi analysts expect policy efforts to remain focused for now on supporting the economy's advance.
- Indeed, while the Federal Reserve's (Fed) extended efforts to loosen credit and aid market functioning have substantially slowed financial headwinds impeding recovery, Citi analysts believe that actively exiting from maximum accommodation will require compelling proof that recovery is self-sustaining and that key financial roadblocks are cleared. As such, initial rate hikes are not expected until the fourth quarter.
- Meanwhile, inflation is likely to remain near 1.5%, reflecting the lagged effects of financial restraint and economic slack. Citi analysts believe that limited private credit demand is likely to mute upward cyclical pressures on interest rates. However, the lack of a fiscal exit strategy, amid an eroding long-run deficit outlook, poses a threat of crowding-out pressures as recovery matures.
- The S&P 500 could be setting up for further gains, driven by earnings strength and positive news flow of continued domestic economic strength. While Citi analysts' yearend target of 1,175 assumes approx 7% gain from current levels, stocks could potentially trade even higher before backing off when the Fed starts to withdraw liquidity.
- In terms of sectors, several industry groups (such as Energy, Capital Goods and Consumer Services) still have rising revision trends that do not appear to be approaching historical peaks, and may offer positive trading potential.

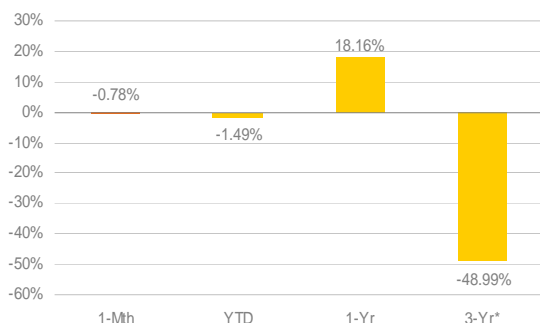
## Euro-Area

### GDP growth could be capped in 2011

- With disappointing GDP in 4Q09 and a likely weak start into 2010 – partly due to bad weather – Citi analysts have revised down their 2010 GDP forecast again by 0.2 points to 1.1%, a third consecutive downward revision.
- At the same time, fiscal problems in Greece and other euro area countries (Ireland, Portugal and Spain) look far from being solved. Although the Greek-led government bond crisis is not likely to have a big impact on GDP in 2010, Citi analysts think that the larger broad-based fiscal tightening is likely to cap GDP growth in 2011.
- Nevertheless, the European Central Bank (ECB) is unlikely to react immediately to the crisis in Greece and may go ahead with the gradual exit from its non-standard measures in 2010. Citi analysts now expect the ECB to continue the unlimited funding facility in its Main Refinancing Operations until autumn. Nevertheless, ECB liquidity is likely to shrink in 2H10, probably leading to a gradual increase in overnight rates by around 70 bps until year-end. Citi analysts expect the first ECB rate hike in 1Q11.
- Citi analysts continue to be optimistic on the returns for European equities over bonds. Indeed, the economic and corporate earnings recovery as well as attractive valuations could stand European equities in good stead in 2010.
- As such, investors may wish to focus on companies which can deliver in 2010; shift up quality, growth and cap curves over the coming 12-18 months. In terms of sectors, they favour Basic Resources, Banks and Food & Beverage.

# Equity markets

Chart 4:  
Topix Index



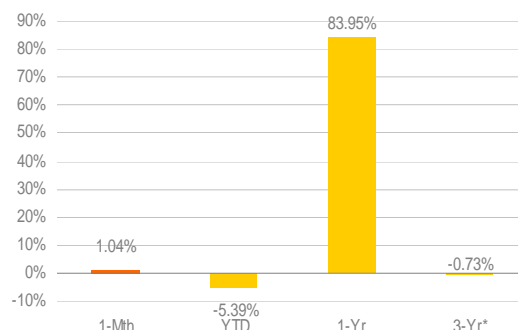
\*Denotes cumulative performance  
Performance data as of 26 February 2010  
Source: Bloomberg

## Japan

### Deflation expected to persist well into 2011

- The economy could continue to grow at a 1.5%-2% per annum pace this year, after a temporary slowdown in the current quarter, under a combination of a continued upward trend in exports, the new support measures for households (e.g. child allowance) and a modest pickup in business and housing investment.
- Meanwhile, the narrowing but still-large economic slack, coupled with an outright fall in unit labour costs, could exert strong downward pressure on inflation in years to come. Core inflation (excluding just fresh food) may stay negative well into 2011.
- In this context, Citi analysts expect the Bank of Japan (BOJ) to maintain the current policy rates until late-2011. Meanwhile, policymakers appear unlikely to deliver such measures as the zero interest rate policy, quantitative easing and an increase in outright JGB purchases under our economic scenario, unless there is a sharp movement in the currency or JGB markets.
- Relative to the rest of the world, Japanese share prices bottomed on November 27, 2009 and outperformed global share prices by 10.4% in the subsequent period through end-January this year. This amounts to top-class performance among the major nations, and Citi analysts believe this could potentially be sustained.
- In terms of sectors, environmental technologies look favourable as Citi analysts foresee market growth in next-generation autos, photovoltaic power generation, nuclear power, zero-emission housing, and energy efficient machinery. Meanwhile, firms with low-priced consumer goods and services that can grow in emerging economies also look promising not just in the near term but also over the long term.

Chart 5:  
MSCI Asia ex Japan Index



\*Denotes cumulative performance  
Performance data as of 26 February 2010  
Source: Bloomberg

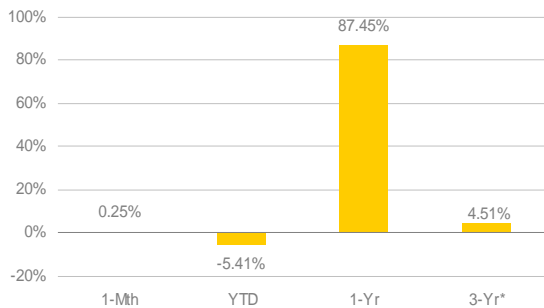
## Asia Pacific

### 2010 outlook remains robust

- Economic momentum in the region remains robust this year given strong balance sheets of governments, households and corporates, high capital ratios of banks and prospects for a technological catchup.
- In Citi's view, this is likely to trigger the need for policy normalisation. While they expect to see more unwinding of emergency liquidity measures, outright policy rate hikes (small) seem not far off for a few countries — India, Malaysia and Thailand, though some are being delayed (Korea).
- Citi analysts continue to expect currency appreciation in Asia, particularly from Korean Won (KRW), Indian Rupee (INR) and Indonesian Rupiah (IDR), supported by robust growth, strong capital inflows and the potential for early tightening by central banks.
- Investor sentiment has gone from complacency to concern exceedingly quickly over recent weeks. Emerging markets may still be the place to be, but flows have slowed, with valuations and earnings increasingly in focus. Another indicator for caution is that more stocks are trading above their 200-day moving average than any time since 1999. This may indicate that equities are overbought, a condition which historically precedes a correction.
- Nevertheless, in terms of investment strategy, Citi analysts see potential for growth-focused strategies to again help investors outperform as Asian corporations move towards the mature earnings recovery phase of their cycle. In particular, Citi analysts favour Hong Kong, Korea and Taiwan and the telecoms, banks, information technology and energy sectors.

# Bond markets

Chart 6:  
MSCI Emerging Markets Index



\*Denotes cumulative performance  
Performance data as of 26 February 2010  
Source: Bloomberg

## Emerging Markets

### Positive on CEEMEA and Latin American equities

- The balance of data in the months ahead should continue to show signs of recovery and moderate inflationary pressures in Latin America. Moreover, concerns about fiscal fundamentals in Europe should have a limited impact on most market-friendly credits in Latin America, as fiscal deterioration is likely to reverse in the next two years, with marginal impact on government balance sheet.
- Meanwhile, CEEMEA<sup>1</sup> remains the weakest link in Emerging Markets with respect to growth and inflation. This is the one part of the world where there is still some downward pressure on policy interest rates, given the fact that monetary policy in a number of countries had to be tightened during the crisis to limit the risk of capital flight.
- Most Latin American currencies are likely to continue benefiting from a weak USD and the global recovery in the short term, but the picture could become more mixed over the medium term as a variety of policy and political concerns kick in. Over in CEEMEA, Citi analysts expect the South African Rand (ZAR) and Russian Ruble (RUB) to continue to benefit from strong commodity prices and improved external accounts.
- Improving growth, rising corporate earnings and a weaker dollar have provided support for Latin American equities and Citi analysts believe that any new eruption of the fiscal crisis in Greece is unlikely to break the long-term rising trend. They are overweight Brazil and Mexico.
- Despite a number of global concerns, Citi analysts remain positive on CEEMEA over the medium term given that economic data has been beating expectations, earnings forecasts have been rising and valuations remain undemanding. They are overweight Russia.

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

## High-grade corporate debt expected to outperform

### US Treasuries

Citi analysts anticipate volatility to remain low and rates to remain range bound in the near term.

### US Corporates

As fundamentals improve, Citi analysts expect spreads to tighten an additional 25% in 2010. With a nod to the significant shift in government yield curves, corporate debt is expected to outperform other high-grade asset classes. As for High yield bonds, de-leveraging, the pickup in demand and much improved financing conditions imply a sharp drop in default rates during 2010 and suggest opportunities, but on a highly selective basis.

### Euro Bonds

Citi's outlook is less optimistic in the UK given the nation's fiscal burden and percolating inflation pressures. However, they have a more positive view on the government markets in the Euro area, where interest rates are likely to move only incrementally higher. Citi analysts do not expect European Central Bank (ECB) rate hikes to occur before early 2011 and anticipate the government curve to steepen modestly.

### Emerging Market Debt

Citi analysts are constructive on Asia and Latin America credits as improved liquidity and risk appetite persist.

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# Investment Insights

## A Look Back At History

Developments in Greece have raised concerns on contagion risks that Greece poses to European equities. This month, we take a look back at how European equities performed during emerging market crises over the past 15-20 years.

**Dow Jones Stoxx 600 Index and Emerging Market Crises**



Source: DataStream. As of February 25, 2010.

- ❖ The DJ Stoxx 600 index moved sideways during the 1994 Mexican crisis. Little contagion for developed market equities. But, global emerging markets (GEMs) did not escape, posting a near-30% decline.
- ❖ In the 1997-98 Asian crisis, European equities rose 40%. No contagion there. GEMs fell 40%. Plenty of contagion.
- ❖ The Russian crisis was the one crisis in which European and GEMs performance were aligned, with both regions suffering 20-25% falls. European equities actually fell further in early-October 1998 to register a 30%+ total correction.
- ❖ During the Argentinean crisis, the government announced “corralito” in late-November 2001, placing restrictions on bank withdrawals and the transfer of money abroad. During the following 6-7 months, GEMs actually rose 15-20%. No contagion. European equities, taking a post-9/11 recovery pause for breath during the ongoing technology, media and telecoms (TMT) bear market, fell a little over 5%. No contagion.

Source: Citibank N.A., Singapore Branch, Regional Wealth Management.

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