

MARKET OUTLOOK



September 2009

Positioning For Recovery

With emerging markets (as measured by MSCI Emerging Markets index) having carried the bulk of investor attention, rising 48% year-to-date as of 31 August 2009 versus a more modest rise of over 14% in US equities (as measured by MSCI US index), Citi analysts believe it may be time for investors to re-focus their attention on US equities.

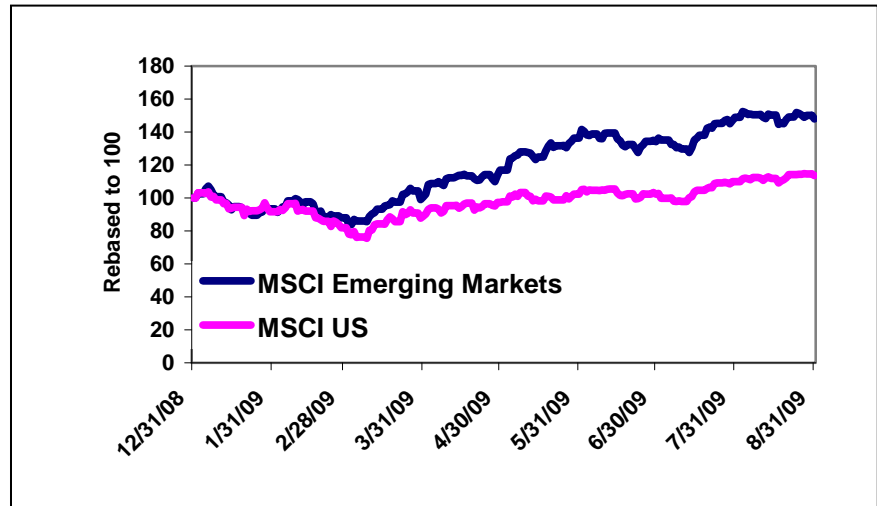
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Feature

Positioning For Recovery: US

Tactical investors may wish to consider the opportunity presented by the anticipated acceleration of US economic growth in coming months

Chart 1:
Performance of MSCI Emerging Markets index and MSCI US index



Source: Bloomberg. 31 December 2008 - 31 August 2009.

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Indeed, the rationale for the emerging markets rally to date has been underpinned by the earlier economic recovery seen in these economies, especially in China. While Citi Investment Research & Analysis' (CIRA's) expectations are for Chinese economic growth to continue to accelerate through early-2010, unlike in the first half of 2009, where Chinese equities outpaced US and Global equities easily, the continuation in Chinese economic growth is likely now to be complemented by an acceleration in US economic growth through the balance of 2009 and into 2010.

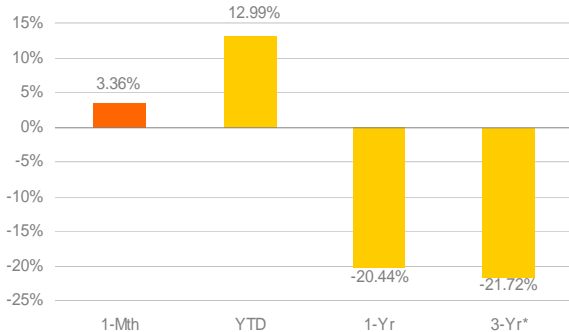
From the second quarter 2009 trough in US economic growth of -4.0% year-on-year, CIRA expects US economic growth to accelerate to 1.5% year-on-year growth, or by 550 bps by the first quarter of 2010. In contrast, from its trough in the first quarter of 2009, Chinese economic growth is expected to accelerate by 520 bps, from 6.1% year-on-year to a forecast 11.3% year-on-year in the first quarter of 2010, according to CIRA. Indeed, CIRA notes that a peaking in initial claims for unemployment insurance as well as a pick-up in auto sales and pending home sales are signs of the coming cyclical pick-up expected in the US in coming months.

Admittedly, though, Tobias Levkovich, CIRA's US equity strategist notes that valuations in US equities now sit near fair value levels. He admits, however, "stock prices can move above trend line valuations". Indeed, with corporate earnings estimate revision trends still shy of worrisome levels and sentiment not yet enthusiastic, he notes that there may be room for further stock price gains. However, on a more strategic perspective, "investors may need to be more circumspect as share prices climb".

On balance, while emerging market equities are expected to continue to participate in the global recovery through year-end, Citi analysts believe tactical investors may wish to consider the opportunity presented by the anticipated re-acceleration of US economic growth in coming months and the prospect for further multiple expansions that have historically accompanied it.

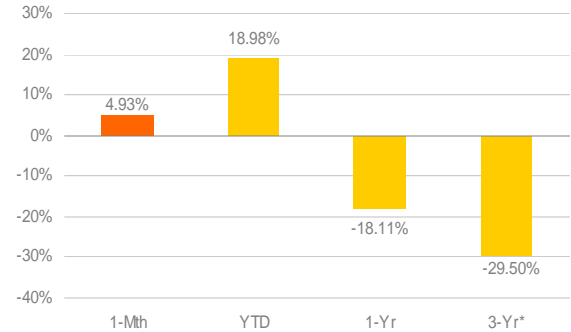
Equity markets

Chart 2:
S&P 500 Index



*Denotes cumulative performance
Performance data as of 31 August 2009
Source: Bloomberg

Chart 3:
Dow Jones Stoxx 600 Index



*Denotes cumulative performance
Performance data as of 31 August 2009
Source: Bloomberg

United States

Resumption of growth likely to be sustained

- Improving financial conditions have raised the probability that the near-term resumption of economic growth will be sustained. Nonetheless, lingering restraints on consumers suggest recovery's momentum may be slow to build.
- Indeed, massive production cuts have pared inventories more in line with spending, while layoffs are subsiding. At the same time, construction and sales of homes have risen. Nevertheless, the large negative wealth effects on consumers may be peaking now but worries about future income persist. While confidence is slowly returning, spending is likely to lag income gains in recovery's early stages, according to Citi analysts.
- The Federal Reserve's ongoing attempts at accommodation through credit-support operations have helped to buoy financial conditions. The financial headwinds have eased enough to allow for renewed growth but the revival in risk appetites still appears fragile. Citi's baseline foresees a gradual timetable for unwinding accommodation, beginning mid-2010.
- With revisions of corporate earnings estimate still shy of worrisome levels and sentiment not yet enthusiastic, Citi analysts believe that there may be room for further stock price gains, though the upside potential is becoming much more limited.
- Within sectors, Citi analysts are now on overweight Materials given the likelihood of rising production trends and further improvement in corporate earnings estimate revisions. At the same time, they also favour Financials, Industrials and Energy.

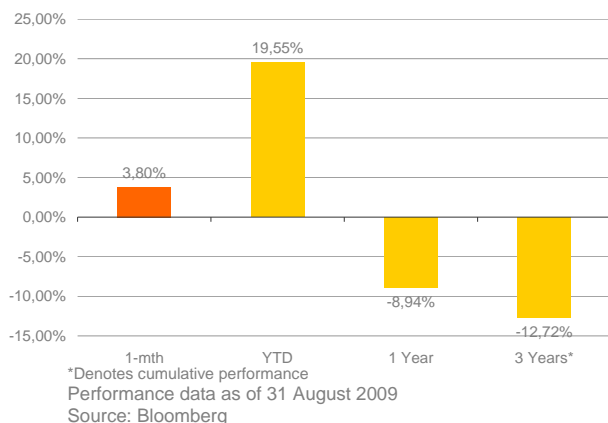
Euro-Area

ECB may leave interest rates unchanged until 4Q10

- Citi analysts have revised up their 2009 and 2010 GDP forecast to -4.0% and 1.0% respectively. These forecast changes are due to a smaller-than-expected contraction in 2Q09 and a more upbeat outlook. Citi analysts now expect a modest recovery to start in 3Q09. In addition to the support from fiscal and monetary policy for domestic demand, improving global demand is likely to propel euro area exports as well.
- However, Citi analysts continue to forecast a weaker recovery in the euro area relative to many other regions. This partly reflects the less aggressive stimulus from fiscal and monetary policy in the euro area than elsewhere. In addition, ongoing balance sheet problems of euro area banks are likely to remain a drag for financing conditions.
- In this weak economic environment, inflation is likely to remain low for a long period of time and downside risks for inflation remain. Citi analysts believe the European Central Bank (ECB) is likely to react to this outlook by not raising interest rates before late 2010.
- History shows September as the worst month for European and UK equity returns, suggesting the risk of a short-term pull back is increasing. Nevertheless, Citi analysts continue view any pull-back as an opportunity to seek exposure to a market that has not fully priced in recovery.
- Citi analysts are sticking to their core view: 1) Positive on equities, 2) Quality risk assets are relatively cheap, 3) The recovery trade do not appear to be priced in, and 4) Clear winners and losers may emerge within industry groups. Within sectors, Citi analysts are overweight defensive sectors such as Health Care and Telecoms while underweight Industrials and Utilities.

Equity markets

Chart 4:
MSCI Asia Pacific Index



Japan

Double Dip likely in Japan

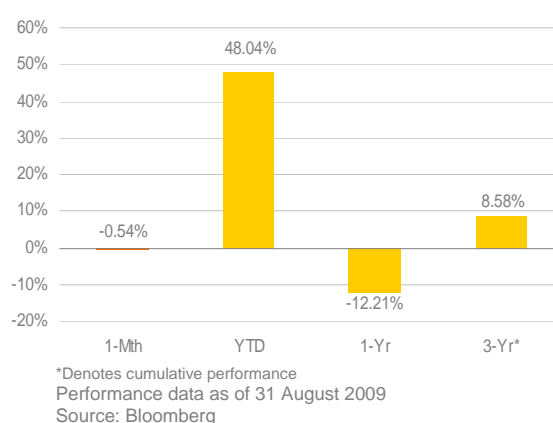
- Citi analysts expect growth in the second half of 2009 to exceed the potential growth rate of the economy (around 1%) thanks to sharp inventory liquidation in both domestic and overseas markets and the effect of the fiscal stimulus packages.
- Prospects for private domestic demand remain bleak. Sluggish sales growth, along with unusually low capacity utilization, is very likely to weigh on business investment in coming quarters.
- Citi analysts expect the economy to show renewed weakness next year, as the effect of the stimulus package wanes and the recovery in major trading partners remain modest.
- Citi analysts see a risk that Japanese equities may continue to lag other markets, even as the world economy enters a recovery phase, with policy likely to remain loose till year-end. Relative share price performance of Japanese stocks appears to hinge on the equity supply-demand balance, as well as the execution of new economic policies of the Democratic Party of Japan (DPJ).

Asia Pacific

Central banks likely to stand pat this year

- Citi analysts expect Asian central banks to hike interest rates gradually given lingering concerns about the sustainability of growth momentum, but believe many may now hike interest rates earlier given that the Federal Reserve (Fed) is expected to start in mid 2010.
- However, in the near term, with inflation remaining subdued and the growth path unclear, Citi analysts expect central stand pat in the coming months, focusing on liquidity management amid strong external flows.
- Nevertheless, Citi analysts continue to favour sectors that display strong cashflow and dividend yield. Hence, Citi analysts remain positive on Banks, Telecoms and Tech sectors, prefer large-caps to small and mid-caps, and North Asia to China, India and Southeast Asia.

Chart 5:
MSCI Emerging Markets Index

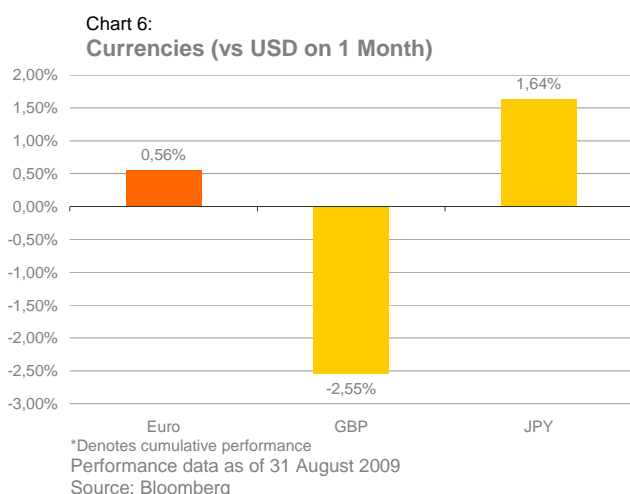


Emerging Markets

Slow recovery expected for most CEEMEA countries

- Citi analysts now believe risks to growth in Latin America are more balanced, but still see very benign inflationary pressures. They as such do not anticipate any interest rate hikes by central banks until 2Q10, with Brazil likely waiting until 2011.
- While some CEEMEA economies are showing signs of stabilizing in 2H09, only a very slow recovery in 2010 is expected for most as external demand remains weak and credit constrained. The outlook for African countries seems brighter with most showing positive growth as domestic demand holds up. While growth in the Middle East has been held back by lower oil production, higher oil prices are likely to help the outlook for 2010.
- In Latin American, Citi analysts see potential for the Mexican Peso (MXN) and Brazilian Real (BRL) to relatively outperform regional currencies. In their opinion, the Mexican Peso (MXN) could benefit from the expected pick up in US activity, while the Brazilian Real (BRL) remains supported by strong external accounts and a more robust fiscal outlook. Over in CEEMEA, the Turkish Lira (TRY) remains vulnerable on IMF program uncertainty and fiscal concerns.
- In Latin America, while another correction may be likely over the seasonally-weak months of September and October, Citi analysts remain positive in the long term and continue to favour Brazil.
- In CEEMEA, rising corporate earnings expectations are likely to underpin sentiment towards risk assets. However, Citi analysts see that the upside is constrained by uncertainties over the pace of recovery. Citi analysts are overweight on South Africa, Poland and Egypt.

Currencies



Currencies

Euro

- Euro area economic data continue to improve relative to expectations as evidenced both by the Citi Economic Surprise Index and rising consensus forecasts.
- Citi analysts observe that Improving risk appetite continues to correlate with generalized US dollar weakness versus the Euro and they estimate that strong sentiments are likely to continue to weigh on the US dollar in the near term.

Sterling

- The Bank of England sent a strong signal in the Inflation Report on 12 August that a large output gap would dampen inflation pressure for some time even as activity recovers.
- Citi analysts consider that from a sterling perspective, less inflation implies lower rates for longer and is negative at the margin.

Yen

- Citi analysts expect the JPY to continue to gently appreciate vs. the USD over the medium term although the currency will not likely lead the process of USD depreciation.
- Citi analysts estimate that the JPY is no longer in the currency funding camp and that a real exchange rate (inflation adjusted) actually much higher than the nominal rate given the extended period of deflation in Japan justifies JPY strengthening.

Bond markets

Favour high-grade corporate bonds

US Treasuries

As credit markets appear to move towards normality, Citi analysts are underweight US Treasuries as improving risk appetites are likely to continue this sector's underperformance.

US Corporates

Despite the rally in the corporate bond market, spreads are still attractive on a historical basis. This segment continues to be Citi's preferred investment within the fixed income space for 2009. On the other hand, they are cautious on high yield bonds as spreads have fallen fast, but may not be sustainable. Also, fundamentals remain weak as bank credit lines are scarce and defaults are likely to reach double digits later this year.

Euro Bonds

Euro-denominated government bonds were recently sold off as investors became less gloomy about the economy and moved capital toward riskier assets. In Citi's view, government bonds are still considered a safe haven and may rally if equity markets falter or the economic outlook darkens.

Emerging Market Debt

Citi analysts remain cautious on emerging-market bonds as they may face further volatility in coming months. For investors seeking exposure, Citi analysts prefer countries with sound economic fundamentals and minimal political risk.

General Disclosure

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

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