

# MARKET OUTLOOK



December 2010

## **Sovereign debt turmoil in the Euro Area periphery**

The unprecedented peacetime deterioration in the public finances of advanced economies has claimed its second Euro Area sovereign victim. After Greece, which was forced by lack of market access into a €110 billion European Union/ International Monetary Fund financial support facility in May, Ireland has requested external financial support. Sovereign debt sustainability in advanced economies has held centre stage for most of 2010 and contagion fears remain rife.

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# Feature

## Sovereign debt turmoil in the Euro Area periphery

### Bailout #1: Greece

Amid widespread concerns over the solvency and liquidity of the Greek sovereign and growing spreads on Greek sovereign debt, the European Union (EU) and the International Monetary Fund (IMF) cobbled together a €110 billion rescue package for Greece in May 2010. The Greek sovereign agreed to implement large spending cuts, tax rises and structural measures to improve its competitiveness and measures to improve the collection and provision of public, in particular fiscal, data. In return, Greece receives loans in various tranches, implying that it would not need to access markets until 2013, as long as it complied with the agreed adjustment program.

### Bailout #2: Ireland

On 21 November 2010, the Irish government and the EU/IMF announced that they had agreed in principle to a rescue program. Details were subsequently announced on 28 November. European Finance Ministers, the IMF and the Irish government agreed in principle on a €85 billion support package for Ireland, of which €67.5 billion will come from the European facilities (€22.5 billion from the European Financial Stabilisation Mechanism (EFSM) — the EU Commission's €60 billion facility — €22.5 billion from the European Financial Stability Facility (EFSF) — including €17.7 billion from the Eurogroup's €440 billion guarantee pool, €3.8 billion from the UK, €0.6 billion from Sweden and €0.4 billion from Denmark) and the IMF (€22.5bn). The loans will have a maturity between four and 10 years. The approval of the measures will have to be done by official Eurogroup and Ecofin meetings, the IMF board of directors and the Irish Parliament. Additionally, the Irish Government notes that the State's contribution to the facility will be €17.5 billion, coming from the National Pension Reserve Fund and other domestic cash resources.

### Contagion fears: Who's next? Portugal? Spain?

**Portugal:** The EU/IMF agreement with Ireland is likely to shift the focus of the markets to Portugal, say Citi analysts. They note that Portugal's debt level — around 80% of GDP in 2010 — is close to the Euro Area average and that it has avoided the housing bubbles and bank excesses of Ireland (or Spain). However, its government deficit remains stubbornly high and its growth prospects poor. Indeed, despite the fiscal austerity package implemented in May, the Portuguese central government budget deficit has yet to show signs of improvement as at the end of October. Citi analysts highlight that growth in Portugal has been slow for many years, and in their opinion, the high level of private debt (non-financial private sector debt is close to 250% of GDP), the funding difficulties of Portuguese banks and the additional fiscal austerity announced for the next years imply that growth is unlikely to pick up soon. They as such hold the view that it remains likely that Portugal may access the EFSF soon.

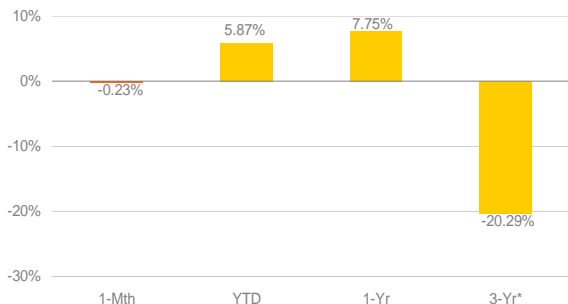
**Spain:** Citi analysts note that until recently, Spain has benefited from some benign developments. Market concerns about its banking system receded following the publication of stress test results in July and fiscal revenues have picked up after the imposition of austerity measures in May. But, in their view, Spain falls close to Ireland's or Portugal's risk class, considering that the stress tests have been discredited, and the size of unrealised losses in the banking sector is highly uncertain, but probably large. Moreover, given the exposure of banks to the construction and real estate sectors and to overleveraged consumers, the size of capital injections into banks which the government has agreed to so far — around €10 billion (1% of GDP) — seems woefully inadequate according to Citi analysts. By comparison, the Irish government is committing 30% of GDP and rising. Official growth forecasts also appear unduly optimistic to Citi analysts as austerity and private deleveraging is likely to take a toll on growth in Spain. Additional fiscal tightening may as such be needed to meet next year's deficit target. With such measures and without large negative surprises in the banking sector, they believe that Spain may yet muddle through without external help. But should it need assistance, it could bring the current facilities to or beyond its limits.

In the near term, Citi believes that the size of the EFSF and the EFSM could potentially be extended by the Euro Area and EU member states. The European Central Bank could also potentially increase its support (e.g. by purchasing Spanish sovereign debt through its Securities Markets Program (SMP) and funding Spanish banks using Spanish sovereign debt as collateral). But, in the longer term, there may be a need for large-scale restructuring of Spanish bank debt and possibly the sovereign debt.

It as such appears that despite the recent drama, the plot is still evolving and sovereign credit risk is likely to remain an enduring concern going onto 2011. Hence, unless the fiscally strained Euro Area countries can convince markets that they will be on a sustainable fiscal path by 2013, Citi analysts believe that the peripheral bond markets are likely to remain under strain.

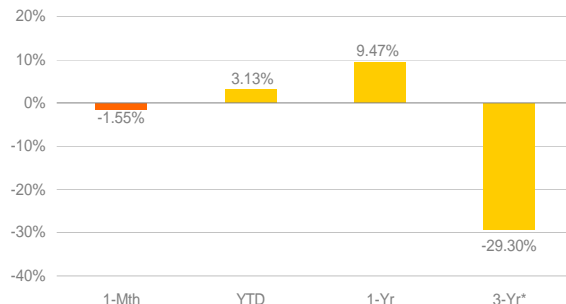
# Equity markets

Chart 1:  
S&P 500 Index



\*Denotes cumulative performance  
Performance data as of 30 November 2010  
Source: Bloomberg

Chart 2:  
Dow Jones Stoxx 600 Index



\*Denotes cumulative performance  
Performance data as of 30 November 2010  
Source: Bloomberg

## United States

### Moderate economic expansion expected in 2011

- Growth has slowed recently as fiscal policy's thrust has ended and the mid-year flare-up of sovereign debt concerns triggered a widespread reduction in risk appetite that undermined financial support to activity. However, concerns that recovery might falter altogether have been assuaged somewhat by more recent evidence of moderate spending and job growth, and the Federal Reserve's (Fed) reenergized effort to buoy financial conditions through purchases of longer-dated Treasuries. In Citi's view, moderate recovery is likely to continue but with subpar contributions from the consumer sector and especially housing, where downside risks linger.
- Until officials can be more confident of positive feedback loops between economic and financial activity, monetary policy is expected to remain highly accommodative through all of 2011. Citi's base case is for exit strategies, including initial policy rate hikes, to remain on hold until later in 2012.
- From an equity perspective, in spite of all the angst surrounding the consumer sector, a near 14% gain in the S&P 500 in the past six months is noteworthy given the traditional relationship between changes in stock market wealth and core retail sales activity. Such a development alongside modestly higher employment does not appear to imply a challenged holiday sales season but rather a decent outcome which might surprise investors to the upside.
- However, having said that, Citi analysts note that their primary sentiment indicator, the proprietary Panic/Euphoria Model has reclaimed "complacency" territory. This was last seen in April 2010 before markets backed off, and suggests that hopes for a late 2010 rally may very well be in jeopardy.

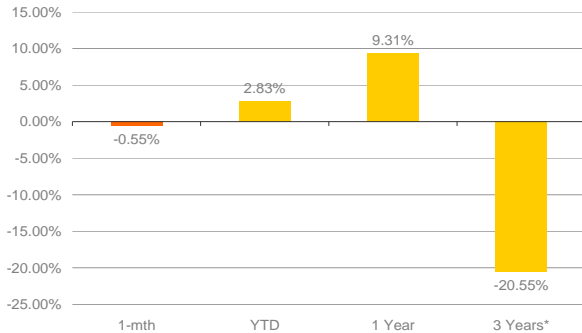
## Euro-Area

### Sovereign debt crisis may continue in 2011 and beyond

- The sovereign debt crisis looks likely to remain at the top of the agenda and could affect economic and market developments in the Euro Area over the next few years. In order to bring government budgets back on a sustainable path, all Euro Area countries — but particularly the periphery ones — will need to tighten fiscal policy in 2011. Citi analysts expect the austerity measures to have a negative impact on economic growth for the Euro Area on average, and believe that it is likely to contribute to a large divergence in growth in 2011 and 2012 between the fiscally-strained periphery countries and the healthier core countries.
- In an environment of weak domestic demand, Citi analysts expect inflation to stay low over the forecast horizon. While the European Central Bank (ECB) is likely to reduce its non-standard measures further in the near term, policy rates are likely to remain on hold until 2012. But, the ECB could potentially act earlier should there be signs of higher money or credit growth, or increasing inflation expectations.
- This macro economic back drop coupled with corporate earnings trends leads Citi analysts to maintain their preference for Northern over Southern European equity markets. They also reiterate their long-held preference for companies with strong balance sheets and international exposure.
- They note that equity markets in the North (Germany, France and the UK) have posted stronger performance versus the South (Italy, Spain, Portugal, Ireland and Greece). In the North, Germany proved slightly more resilient during this latest Irish led selloff; up over 13% since end-June, reversing its underperformance from 1H10. In the South, Ireland has been the worst performer since end-June, down 13%.

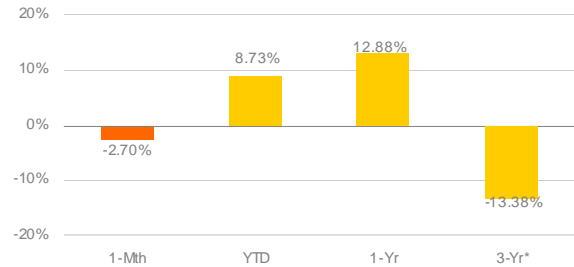
# Equity markets

Chart 3:  
MSCI Asia Pacific



\*Denotes cumulative performance  
Performance data as of 30 November 2010  
Source: Bloomberg

Chart 4:  
MSCI Emerging Markets Index



\*Denotes cumulative performance  
Performance data as of 30 November 2010  
Source: Bloomberg

## Japan Economy may return to above trend growth

- Citi analysts expect the economy to return to a growth track that is somewhat above the potential growth rate of the economy (+0.5-1.0%) in 2011 amid sustained expansion of the global economy. Deflation is likely to persist at least into 2012, reflecting shrinking but still large economic slack, and continued declines in unit labour costs.
- Japanese equities are likely to remain sluggish through the end of the year due to the strong yen and risk of further capital rising. Low valuations may however limit downside risks, Citi analysts believe. They continue to see the preconditions for a real rebound in Japanese equities as being a rise in the US long-term rate and bold monetary easing by the BoJ, and think these conditions could come into place in January–March 2011.

## Asia Pacific No signs of a bubble yet

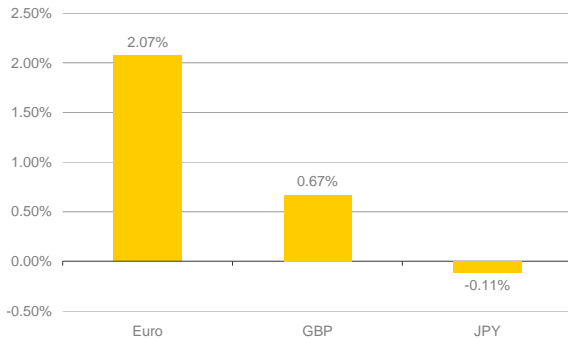
- Asia's growth could moderate on a year-on-year basis due to base effects, especially in 1H11. But momentum is expected to stay relatively strong as investment remains buoyant in many countries.
- Asian central banks could potentially hike policy rates by an average of 75 bps in 2011, and/or pursue liquidity tightening measures in an attempt to combat inflation concerns. Targeted regulatory measures to curb property are also expected to be prevalent in 2011, especially in China, Hong Kong, Singapore, and possibly, in Malaysia.
- On the equity end, there has been much talk about a bubble but there has been little, if any, evidence. Looking at eight factors, from valuations, balance sheets, and trading activity flows to prior bubbles, leads Citi analysts to conclude that talk of a bubble is premature at this stage.

## Emerging Markets CEEMEA and Latam currencies continue to remain supported

- CEEMEA appears to be the weak link of the global emerging markets, as several large markets begin to pale in attraction on weaker GDP and earnings trends. With the exception of Poland, private consumption is likely to remain a drag on growth due to weak credit supply and tight fiscal stance.
- Meanwhile, after a strong recovery and rising inflation in 2010, most central banks in Latin America appear poised to hike policy rates in 2011 to prevent overheating. In Brazil, where Citi expects the SELIC rate to rise by up to 200 bps, real growth is anticipated to fall from 7.6% in 2010 to about 4.5% in 2011. But inflation could remain above 4.5% over 2010-11, due to persistent capital inflows.
- USD liquidity and strong commodity prices are likely to continue benefitting Latam currencies – Brazilian Real (BRL) and Chilean Peso (CLP). Citi also expects further currency appreciation in CEEMEA, particularly the Czech Koruna (CZK) and Polish Zloty (PLN), on the back of renewed risk appetite.
- Citi analysts are more cautious about Latin America's near-term economic outlook due to the pressures from a slowing global economy – in particular China and the US. However, the region's GDP growth is expected to continue to outperform that of the developed countries. Within Latin America, they are overweight Brazil. Their 2011 year end target for the MSCI Latin America currently stands at 5,300.
- As for CEEMEA equities, despite attractive valuations and robust earnings growth, the biggest risks include potential commodity price declines, currency volatility and links to developed Europe. Within CEEMEA, Citi analysts are overweight Russia, Poland and Egypt.

# Bond markets

Chart 5:  
Currencies (vs US Dollar on 1 month)



\*Denotes cumulative performance  
Performance data as of 30 November 2010  
Source: Bloomberg

## Currencies

- Trend weakness in the USD is likely to continue absent a major new bout of risk aversion. Over 6-12 months, Citi analysts forecast 4% downside relative to forwards on a Trade-weighted basis and more vs. average EM FX.
- Gradual normalisation of ECB policy still supports EUR upside medium term (1.45 in 6-12 months) assuming no change of monetary policy if Spain is dragged into the periphery crisis.
- AUD should offer overall best G10 currency returns over 6-12 months. SEK should outperform other European currencies.
- In the emerging world, Citi analysts expect currency appreciation to resume following the recent bout of volatility. The main drivers should continue to be a search for yield, strong macro fundamentals and, for some, higher commodity prices.
- In EM Asia, CNY appreciation against the USD is likely to continue helped by an evident need to contain rising inflation. Higher USD liquidity and a stronger CNY should support appreciation in EM Asia, despite policy attempts to resist it.
- Risk appetite should continue driving CEEMEA FX higher. QE2 and higher commodity prices are likely to be key supports for LatAm currencies.

## Positive on High-grade and High-yield corporate debt

### US Treasuries

Flight-to-quality sentiment has had an impact on US treasuries; current valuations are unattractive in Citi's view.

### US Corporates

Potential opportunities in quality US corporate debt at the lower end of the investment grade spectrum, given the recent sell-off, particularly in the financial, metals and mining sectors. Meanwhile, high-yield spreads are anticipated to continue grinding tighter over time as positive technical factors and improving fundamentals support performance.

### Euro Bonds

Investors may find value in sovereigns that have been impacted by concerns in the periphery, but are unlikely to default, such as Italy and Belgium (despite continued political risks). Citi analysts prefer maturities in the 10 to 15 year range, which appear to have the most attractive carry opportunities.

### Emerging Market Debt

Citi analysts favour Asian and Latin American sovereign credits as improved market liquidity and healthy risk appetite persist.

### 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 Strategy Committee.

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