2013 Outlook and Strategies

2013 AT A GLANCE

- The investment landscape in 2013 is likely to look very similar to 2012. Investors remain concerned about the economic challenges facing the US economy, the unresolved financial crisis in the Eurozone and the slowing rate of growth in China. We see few catalysts to change the picture.
- Yields are expected to remain low in 2013, in light of weak global growth prospects. While we expect core government bonds to underperform higher-grade credit, heightened uncertainties ensure that safe-haven markets will continue to enjoy flight-to-quality demand.
- The Eurozone crisis is far from being resolved, but we expect Germany to try to keep the bloc wobbling along, until elections are out of the way in October 2013. The wild card will be whether electorates in depression-hit Southern Europe will continue to take the pain. Still, European equity markets factor in a significant amount of systemic risk, and in our view appear undervalued. They look particularly attractive relative to the US, where valuations look high and risks are still largely skewed to the downside.
- The US economy faces significant challenges. Although monetary policy will remain loose, fiscal policy will be tightened come what may.
- Chinese growth will be faster than its developed-world counterparts, but it too faces the prospect of slower growth as it deals with lower demand for its exports and the aftermath of a credit boom. We remain cautious on emerging markets overall, given their worrying dependence on China.

STRATEGY HIGHLIGHTS

- **EQUITIES.** We recommend striking a balance between income and growth, focusing on companies that offer a reasonable dividend yield but more importantly the growth required to sustain it.
- We also highlight the euro area, which we believe will outperform the US in 2013.
- **FIXED INCOME.** We continue to prefer high-grade, intermediate-term corporate bonds, though we would recommend lower-quality investment-grade issuers.
- **HEDGE FUNDS.** We highlight strategies that can help hedge tail risks and dampen the volatility of portfolios.
- **PRIVATE EQUITY.** Market dislocations from continuing banking stress and regulatory change are expected to generate investment opportunities as banks offload assets. We favor managers with a flexible and opportunistic investment approach.
- **REAL ESTATE.** Big cities are expected to drive demand for urban real estate and are likely to present opportunities to seek attractive risk-adjusted returns.
- **COMMODITIES.** Buy-and-hold strategies generally won't work, but there are still ways to take advantage of swings in commodities prices.
- **FOREIGN EXCHANGE.** In the current environment where currency volatility is very low, we encourage investors to consider such opportunities to hedge their portfolios.

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Transforming Uncertainty into Opportunity: Our Core Themes for 2013

Eduardo A. Martinez Campos, Global Head of Investments

With the conclusion of two critical political events in 2012, the US election and Chinese political transition, much of what occupied investors' attention in 2012 will remain in focus throughout 2013. After repeated rounds of monetary and market stabilization efforts in the US and Europe, the key macro drivers of the global economy remain weak and, as with 2012, there are few catalysts for growth to change the picture in 2013. Investors are well aware of the economic and fiscal challenges facing the US economy, the unresolved financial crisis that shrouds the European Union and its banking system and the slowing rate of growth of the Chinese economy. These realities will directly influence investor sentiment and behavior in 2013. Given the additional uncertainties caused by structural shifts taking place in financial markets, including more regulation and deleveraging, one can understand why investors' portfolios and risk appetite remain focused on capital preservation and income generation, as opposed to growth.

Given this context, Citi Private Bank's investment thesis for 2013 centers on three simple themes:

(1) INVESTORS SHOULD CONTINUE TO SEEK YIELD, BUT FOCUS ON THE SUSTAINABILITY AND RISK-ADJUSTED NATURE OF THEIR SOURCES OF INCOME.

In a slow-growth, low-rate environment, the quest for yield often drives investors to add significant, unintended risk to their income portfolios. By extending fixed income duration, accepting poorer credit quality in bond portfolios or simply by adding too much leverage to enhance returns, the possibility of losses if and when rates rise grows silently, but steadily. While these income enhancement strategies, including investments that harvest returns from volatility, may be valid ways to increase yield in the current market environment, investors must actively assess the inherent risks in each strategy and evaluate their overall portfolio risk. Risk-adjusted, relative value analysis should become the norm in assessing how yield enhancement opportunities fit within a portfolio context to achieve sustainable income growth. Our Labs and Investment Counselors can help investors through this process by a number of means, from undertaking complete portfolio reviews to carrying out assessments on how individual income strategies are affected by changes in market conditions. By updating Lab analyses regularly, investors can take actions to either recognize profits or reduce risk.

(2) TO ENSURE CAPITAL PRESERVATION AMID UNCERTAINTY, INVESTORS SHOULD FOCUS ON DYNAMIC PORTFOLIO ALLOCATION, THE RELATIVE VALUATION OF THEIR INVESTMENT OPTIONS AND STRATEGIES, AND THE IDENTIFICATION OF TACTICAL OPPORTUNITIES THAT GENERATE SINGULAR, UNCORRELATED RETURNS.

Since the beginning of the 2008 financial crisis, we have seen investors respond to extreme market volatility by rebalancing their portfolios impulsively, typically reducing duration, risk and illiquidity, often by seeking the security of cash to preserve capital. Capital preservation requires a dynamic investment strategy reflected in multi-asset portfolios that are devised through an intensive asset allocation process, focusing on specific opportunities that offer true value and diversification. Citi Private Bank believes that the analysis of current valuations compared both through time and across asset classes is central to building strong portfolios, as understanding when an asset is relatively expensive or undervalued allows for the development of more resilient portfolios. Our expectation and experience is that assets behave cyclically and tend to revert to historical valuation averages over time. By making buy and sell decisions in the context of current relative asset valuations, portfolio risk is reduced and returns are enhanced.

Citi Private Bank's unique Adaptive Valuation Strategies (AVS) specifically looks at valuations to drive long-term performance. Our Global Investment Committee (GIC) complements this by focusing on shorter-term tactical opportunities to profit from current market valuations globally. In *2013 Outlook and Strategies*, our experts address some of the key uncertainties and opportunities that we expect to confront investors over the year. This includes the value we find in European equities, why we do not think there is a bond bubble and what that means for your fixed income portfolio, how to think about portfolio risk versus "unknown risks" and where to find sources of uncorrelated returns.

(3) WE EXPECT GLOBAL, STRUCTURAL SHIFTS IN FINANCIAL MARKETS AND WORLD DEMOGRAPHICS TO GIVE RISE TO UNIQUE, ONCE-IN-A-LIFECYCLE OPPORTUNITIES IN 2013 AND BEYOND. INVESTORS SHOULD HARNESS GLOBAL CHANGE AND SEEK WAYS TO TRANSFORM ADVERSITY AND UNCERTAINTY INTO OPPORTUNITY.

Preserving capital also means paying attention to and taking advantage of the opportunities embedded in markets suffering from uncertainty. Portfolios should rise in value to maintain their spending power. The tumultuous global events of the past five years have had profound effects on global financial institutions and the behavior of individual investors. In turn, there are now significant, structural market dislocations, from heavy financial regulation to how banks are funded, that are permanent and crucial in assessing opportunities. These tectonic shifts are presenting us with unique, once-in-a-lifecycle opportunities that investors ought to evaluate when balancing capital preservation and growth strategies. At the top of the list is global deleveraging both in the private and public sectors, which has left important real economy and consumer segments unable to secure bank financing. Alternative financing options create higher return profiles for investors. In the context of a slow growth world, Citi Private Bank is also seeing a structural shift in some emerging countries (though not yet China) to an economic model that favors internal demand rather than exports. For such markets, the development of internal consumerism has corresponding implications on equities that are primarily driven by consumer growth. Global demographics are also changing the way we view opportunities in real estate, where urbanization is driving new office, residential, retail and warehouse development. Our experts write about how investors can take advantage of these global structural shifts through alternative investments including real estate, private equity and other asset classes.

As your trusted advisor, our mission is to help you navigate through the 2013 financial and geopolitical landscape with a goal to preserve capital, generate sustainable income and take advantage of timely, unique investment opportunities. We welcome a discussion with you.

Review of 2012: Déjà Vu?

Alexander Godwin, Global Head of Asset Allocation

When looking back over 2012, you may feel an eerie sense of familiarity. The usual pattern, established in 2010 and 2011, was again repeated: Weakening economic data in the US was met with yet another round of monetary stimulus in the late summer. Meanwhile, Europe continued to see deteriorating economic performance while grappling with its debt crisis.

There were, though, some new developments. Both the European Central Bank (ECB) and the Federal Reserve announced monetary policy plans that were potentially far more aggressive than those of recent years.

IN EUROPE, GROWTH CONTINUED TO FALL ACROSS THE BOARD

In Europe, the ECB set out a plan, called Outright Monetary Transactions (OMT), to buy bonds of peripheral countries if they applied for aid to Europe's bailout fund (the European Stability Mechanism, or ESM). The announcement had the desired impact, sending yields on peripheral bonds sharply lower. The promise of a bailout of Spain's beleaguered banking sector and the eventual ratification of the ESM by Germany added to the impression that Europe was slowly taking positive steps to resolving its crisis.

Alas, while some of the systemic concerns were allayed (temporarily, at least), the European economy continued to slow. Some parts of Europe are now in a depression. Worryingly, the slowdown even extended to Germany, which had previously seemed immune to the problems of its neighbors.

Germany has been the main driver of matching aid with strict conditionality in the form of austerity and structural reform. Over the course of the year, the negative economic consequences have become clear, not least in Greece. What economists dub "the paradox of thrift" (the calamitous effects of all sectors trying to save at once) has hit parts of Europe very hard. At one point it looked certain that Germany would effectively force Greece out of the Eurozone by refusing to grant more aid.

However, in the run-up to elections in October 2013, politicians in Germany seem increasingly concerned about the outlook for their economy and of any blowups on the edges of Europe that might dramatically worsen a deteriorating domestic economy. For fear that other countries would be caught up in a resulting pile-up, the result has been a shift in policy toward trying to prevent any country, Greece included, from crashing for now. The deal over Greece in November should essentially be seen in that light: papering over as many cracks as possible while doing very little to help in the long term.

MIXED BAG OF DATA IN THE US

Across the Atlantic, the Federal Reserve (Fed) announced a plan to buy mortgage-backed securities from the market. What was new was that the Fed said that it would not put a cap on the amount that it buys but that it would increase it were the economy not to improve quickly.

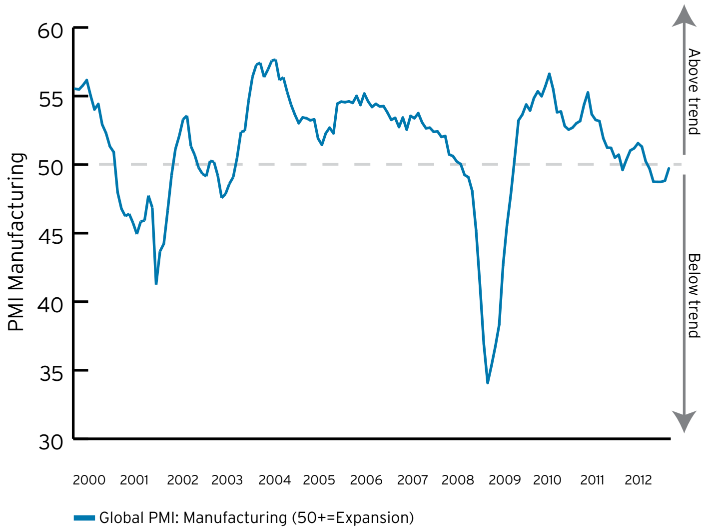
Understandably so, perhaps. Economic data in the United States showed no clear sign of anything approaching sustainable economic growth. Obama's reelection, with a Republican-controlled House, left the status quo unchanged and another four years of political gridlock seems the most likely outcome.

We were skeptical that either central bank plan would bring lasting benefits. We expected the global economy would continue to suffer from the same malaise that has blighted it since the onset of the crisis: low or negative growth driven by a large debt overhang (both private and public) and the accompanying need for deleveraging. This would likely diminish the effectiveness of monetary policy.

That debt overhang is certainly clear in the case of Europe and the United States. But we have also worried about China, as anyone who has read our work is aware. With private-sector debt ballooning by over 60 percentage points of GDP over the previous four years according to Fitch Reports, Chinese growth had become much more dependent on ballooning credit and was therefore unsustainable. Any signs that this credit binge was slowing would be bad for growth. Although credit growth still seems fairly high, that growth rate has been falling and it required a lot of government spending to prevent a worse outcome.

Not that the outcome was good. China's slowdown over the course of 2012 caught most commentators off guard and forced many to revise down their expectations for growth. Most expected the Chinese authorities to respond with an aggressive stimulus package to smooth the transition that occurred at the end of the year. This did not happen. The result has been weak performance for most asset classes, not least industrial commodities and many stock markets in the emerging world that have relied heavily on Chinese demand.

Figure 1: Global PMI — Global Growth Continues to Be Weak



Source: Citi Private Bank using Bloomberg, as of December 7, 2012.

2012 AT A GLANCE

Market Events

JANUARY
- S&P downgrade France from AAA; eight other Eurozone countries downgraded
- Fed to keep rates near zero until at least late 2014
- "Fiscal Pact" agreed by the EU is signed; UK and Czech Republic abstain

FEBRUARY
- ECB allots €529.5bn in LTRO
- Moody's downgrades Italy, Portugal and Spain
- BoJ increases bond-buying program by $130bn
- BoE announces third round of QE

MARCH
- China cuts growth target to 7.5% from 8% target
- Eurozone jobless rate hits a new high
- Putin elected for third term as Russia's President
- Eurozone backs second Greek bailout of €130bn

APRIL
- Spanish yields rise toward 6%
- Oil price spike caused by Iranian confrontation threatens global economy

MAY
- Greek protest vote against austerity leaves elections undecided
- Socialist Hollande beats Sarkozy to become the new French President

JUNE
- Cyprus is the fifth Eurozone country to seek emergency funding from Europe
- Spanish yields at euro-era highs
- US Treasury and bund yields at all-time lows

In an environment where global growth continued to slow, despite the best efforts of central banks, we believed that government bond yields would continue to fall, though we much preferred credit since falling government bond yields would continue to compress spreads. Globally, intermediate corporate bonds returned 14% over the year, which compares well with global equities, which returned 17%, especially taking into account the much greater volatility of the latter.

We had a significant underweight in equities at the beginning of 2012, driven by high valuations, the difficult economic picture and the significant downside skew to risks at the beginning of the year. Most equity markets shrugged off these concerns, fueled by the promise of aggressive monetary stimulus. But because we are unconvinced that monetary easing will help in the longer term, we remained underweight throughout the year. Indeed, we have been broadly underweight equities since February 2011.

Within equities, we have preferred companies with sustainably higher dividends. Income, we have long averred, would trump growth. This continued to work well this year, as Figure 2 shows. We also preferred Europe (and to a lesser extent Japan) to the US. We believed Europe was significantly under-valued, while earnings growth in the US had started to sharply decelerate. After a rocky start to the year, European equities bounced back sharply. Over 2012, returns for euro area stocks have been around 22%, compared with total returns for US stocks of a couple of points less. Japanese stocks returned about 19% over the year. Because of worries about China, in particular, and big valuation differences, we also preferred European stocks to emerging stocks, particularly those in China and trade-sensitive North Asia. Again, we have been underweight emerging stocks since January 2011.

JULY

Spain receives a €100bn bailout of its banks

Moody's changes outlook on Germany, Luxembourg and the Netherlands to negative

AUGUST

Premier Wen of China announces CNY8trn worth of stimulus projects in a bid to boost growth

Bernanke indicates further QE at Jackson Hole, shortly after which it is delivered

SEPTEMBER

ECB announces plan to support the European bond markets (OMT)

Dutch elections end favorably for pro-euro parties

Ratification of the ESM by Germany

OCTOBER

Moody's downgrades the ratings of five Spanish regions

Sandy arrives on the US Atlantic Coast

IMF downgrades its 2012 global economic growth forecast from 3.5% to 3.3%

NOVEMBER

Obama wins the US Presidential Election

Leadership transition in China

Greek austerity budget approved by parliament

Moody's downgrades France from AAA

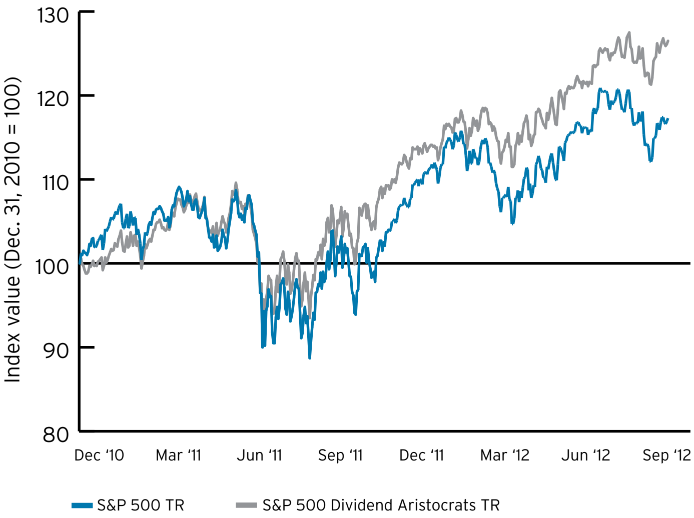
DECEMBER

Shinzo Abe of Liberal Democratic Party wins Japanese election

US fiscal cliff negotiations

European negotiations on EU budget

Figure 2: Income-Generating Stocks Have Outperformed Growth Stocks Since December 2011



Source: Citi Private Bank using Bloomberg, as of December 7, 2012. Past performance is no guarantee of future results.

While Chinese stocks listed offshore have done reasonably (Chinese companies listed in Hong Kong returned 15% over 2012), domestic Chinese stocks have been crushed. Including dividends, the Shanghai Composite has returned 1% since December 2012; since August 2009, it has fallen more than 40%. South Korean and Taiwan's shares have both returned 13%. Again, the volatility has not been for the faint-hearted. Commodity-dependent Latin America has done a bit worse than that; Brazilian stocks have risen 11% over the year. Emerging stocks overall are roughly flat since the beginning of 2011.

Within commodities, our only position has been in gold, though with returns denominated in euros. We believe that gold benefits from increased levels of monetary stimulus globally. This played out fairly well: Gold rose by 5% over the course of 2012.

2013 Global Political Outlook: Leaders Under Pressure as *Vox Populi* Risks Persist

Tina Fordham, Senior Global Political Analyst, Citi Research

Regardless of their political system, global political elites currently face a combination of challenges almost unprecedented in modern peacetime. They also face a greater level of public scrutiny, thanks to wider access to information, than at any time in history.

From the Arab Street to Main Street, concerns about income inequality and elite corruption have risen to the top of the political agenda, threatening to topple leaders when they least expect it. Whether they choose to consolidate their hold on power in the face of heightened people power or take the risks inherent in reform will determine the shape of things to come for many years.

In our view, heightened *Vox Populi* risk — the concept that shifting and more volatile public opinion poses a newly powerful risk to the investment environment — is here to stay. It can take the form either of orderly political transitions (through elections or other formal mechanisms), or protests and demonstrations. The potential for *Vox Populi* risk to bring about change in policy or leadership has been accelerated by media and technology and the weak economic outlook, which have together compressed the time frame for galvanizing political protest.

POPULISM, SEPARATISM, POLITICAL FRAGMENTATION

Given these constraints, we expect limited appetite for reforms beyond those mandated by market pressure, and a continued preference for short-term, just-in-time piecemeal solutions. Even where incumbent leaders are reelected, as in the US and as current polls suggest is likely for Angela Merkel in Germany in 2013, we believe that political elites will struggle to govern in the months and years ahead, constrained by weaker mandates, shrinking political capital and rising public ire in the face of lower growth prospects and unpopular austerity. Rising social tensions and the risks of populism are also likely to continue the trend of the past several years toward political fragmentation: more multi-party coalitions and the rise of NEAPs — new, extreme and/or alternative parties.

NEAPs have yet to take power in any country; only in crisis-wracked Greece, where living standards are back to the level of a decade ago, has Syriza, the biggest alternative party, made significant headway. Constrained by lack of experience, inferior organizational strength and generally limited policies, the likes of the US Tea Party or Italy's Five Star movement have had only brief successes so far. But continued frustration with current political elites could see their support increase over time, particularly if economic conditions continue to deteriorate and the middle classes continue to be squeezed.

POLL POSITION: 2013 ELECTIONS BEAR WIDER GEOPOLITICAL IMPLICATIONS

Several countries important for markets will go to the polls in 2013. For geopolitics, perhaps most important are contests in Israel and Iran. In Israel, which holds elections on January 22, Benjamin Netanyahu, the incumbent prime minister, will probably return to power, helped by a temporary cease-fire with Hamas in November. Iran's presidential elections on June 14 are likely to be tightly controlled, but since President Mahmoud Ahmadinejad is unable to run again, Iran will need to choose another president. For good or ill, this will enable Iran's leadership to send a signal to other countries about what path it is likely to take at a time when tough sanctions appear to be having a bigger effect than in the past.

Although concerns about the potential for conflict remain high, in our view prospects for diplomacy in response to global challenges — such as the tensions between Israel and Iran — are on the rise. War, at least in the traditional sense of conflict between states, looks increasingly unattractive, given global economic fragility and its growing unpopularity with conflict-fatigued citizens and greater fiscal constraints. In his second term, President Obama may well deploy US "soft power" more assertively; whether this is enough to resolve long-standing global disputes is an open question.

Italy's elections, probably in March, mark an important political milestone following the departure in 2011 of Silvio Berlusconi and his replacement with an unelected technocrat, Mario Monti. In the meantime, reforms are likely to be on hold as parties position themselves for the race. One question is whether Italians turn up at the ballot box, given a deepening recession, unpopular austerity measures and widespread public apathy. Another question is whether they will vote for existing parties, given increasing antipathy to them. At least two parties have been formed in the past year. Polls suggest Italy's election will be the next of a series of European anti-incumbent elections, but Italy's political system is in such flux that confident predictions are difficult.

Chancellor Angela Merkel and her Christian Democratic Union/ Christian Social Union (CDU/CSU) coalition have maintained a lead in the polls for two years, helped by a relatively robust economy. But as this slows, Merkel, who faces elections no later than October 2013, will want to avoid any Eurozone chaos that could send the German economy into recession. Since her coalition partner, the Free Democrats (FDP), have seen their vote drop by at least half recently, expect a CDU/CSU and Social Democratic Party (SPD) coalition after next year's election. This is unlikely, though, to lead to a different policy when it comes to the European periphery.

In a rare recent instance, globally, of an incumbent candidate winning a second term, Barack Obama was reelected US president and will go on to a second four-year term. From the challenge of reforming the tax code, to a likely resumption of Middle East tensions, ongoing conflict in Syria and the need to work with a new Chinese leadership, Obama in his second term faces significant challenges at home and abroad. Nevertheless, domestic pressures will be center-stage, with the fiscal cliff having commanded attention for the remaining weeks of the "lame duck" session of Congress and testing the limits of bipartisan deal-making in a highly polarized environment.

UNITED STATES: FISCAL CLIFF AND TAX REFORM IN FOCUS IN 2013 AS OBAMA STARTS HIS SECOND TERM

In the US system, the next election is never more than two years away; with this in mind, both parties will already think of positioning themselves for 2014, and may be more willing to compromise than in the run-up to elections. Will they go far enough?

Politics is the art of the possible; what is possible in the current US political configuration seems likely to disappoint markets hoping for a "grand bargain."

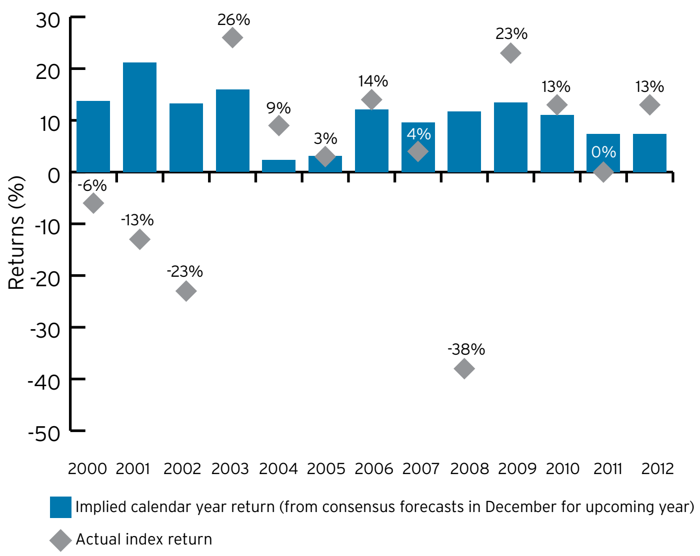
Outlook for 2013: Rinse and Repeat

Richard Cookson, Global Chief Investment Officer

Last year looked easy but made a lot of smart investors look foolish. This year is likely to be equally challenging. The consensus is that equities will rise a fair amount (emerging equities more than their developed counterparts); that, helped by resurging profits, cyclical stocks will do better than their more defensive counterparts; and that bonds will do badly — very badly, many think.

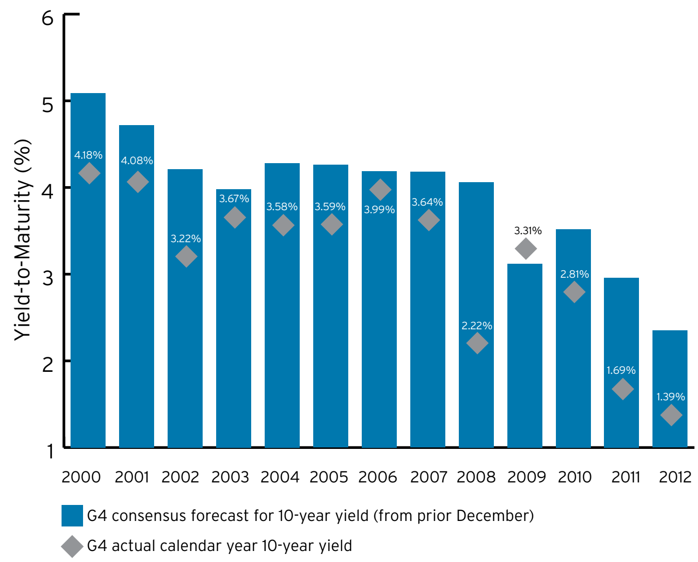
But then the consensus always says that equity markets will rise; almost always predicts that profits will go up; generally says that emerging equities will outperform; and has a very pronounced bias that bond yields are going only one way: up. For a dose of realism, the first two sets of charts overlay those expectations with the actual outcomes. As you can see, the results aren't terribly reassuring to those who would put much stock by consensus forecasts (Figures 1 and 2).

Figure 1: Equity Consensus Forecasts Versus the Actual Index Returns



Source: Citi Private Bank using Consensus Economics and Bloomberg as of December 7, 2012. For illustrative purposes only. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events.

Figure 2: 10-Year Bond Yields Consensus Forecasts Versus Actual Yield-to-Maturity



Source: Citi Private Bank using Bloomberg as of December 7, 2012. For illustrative purposes only. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events.

We suspect, in contrast, that this year is likely to be a more volatile version of last year but that in the end the consensus will be wrong in just about all respects. Much as we would like to be, it is not easy to feel optimistic about global growth when the private sector across the developed world is still saving and public purses are being tightened.

Globally, growth and profits are likely to be still more meager this year than last. Income is thus again likely to triumph over growth. In other words, cyclical risk will again go unrewarded. Yields on those bonds still counted as relatively riskless are thus unlikely to rise; they may fall further. We would increase the quality of sub-investment-grade portfolios and reduce the quality of our investment-grade ones.

The arguments against bonds and more bond-like investments should sound wearyingly familiar. The *bien pensant* now talk of a bubble but have sneered at the lowly yields fetched by bonds for as long as I can remember. The argument that equities are a better investment than bonds will absolutely be right at some stage — and indeed is now right in some regions, we think, though not generally those about which strategists in general have been most optimistic. We hold no European or Japanese government debt and are overweight equities in both regions. But in general terms anyone who has thought equities far the better investment over the past few years has been wrong.

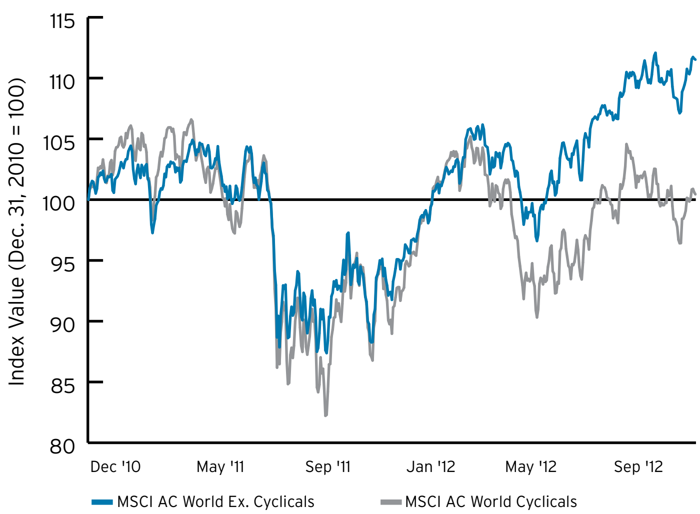
From the beginning of 2009, close to the nadir of risk appetite in the financial crisis, global equities have returned 60%,[1] according to MSCI. These numbers are flattering though, for two reasons. First, most of those returns were in 2009 and 2010. Over the past couple of years they have done very little indeed. Second, the US stock market accounts for over 40% of global market capitalization and has done pretty well. Absent the contribution from the US, stocks have done much worse. But with or without the US contribution, long- and intermediate-dated corporate bonds have done a lot better. Long-dated corporate bonds have returned 70%,[2] according to Yield Book since the start of 2009 and have done far better than equities over the past two years, especially adjusted for volatility.

You might, of course, argue that such returns are exactly what you would expect in a bubble. The snag with this argument is that such returns, as we have argued for two-and-a-half years, are also exactly what you would have expected in a Japan-style malaise. So large are the economic headwinds that, more than four years after Lehman went bust, central banks are still printing money by the truckload. Yields on long-dated bonds, we think, reflect a dismal growth outlook (hence the near-zero interest rates across the developed world) and very quiescent core inflation.

Although equity markets were fairly robust last year, I suspect that this was partly because of the drop in government bond yields that reached levels unseen in human history. If you push down the discount rate in your valuation assumptions but not the growth rate, equities will indeed look cheap. But this is a valuation illusion, we think, because profits growth assumptions are too high. Globally, rate of growth in current year-over-year corporate profits have dropped by about 17 percentage points, on MSCI numbers, over the past 12 months. They are now shrinking compared with a year ago. In fact, since MSCI data exclude "one-offs," they are falling more than the 2% suggested by the MSCI numbers. It has been striking how strong equity markets have been in the teeth of those downgrades. Either profits expectations will start to pick up or markets will crack.

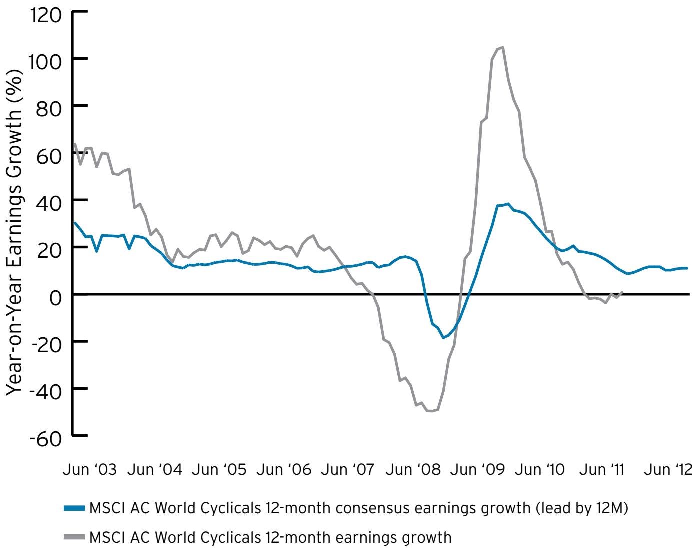
For all that those of a more bullish persuasion are latching on to decent stock performance as a reason to be more bullish about economic and profits growth, the extraordinary thing about stock markets last year is how the rally was led not by cyclical stocks but by their more defensive counterparts. Cyclicals, as Figure 3 shows, have done almost nothing for two years.

Figure 3: Cyclical Stocks Versus Non-Cyclical Stocks over the Past Two Years



Source: Citi Private Bank using Bloomberg as of December 7, 2012. For illustrative purposes only.

Figure 4: Cyclical Profits Expectations Versus the Actual Outcome



Source: Citi Private Bank using Bloomberg as of December 7, 2012.
For illustrative purposes only.

Many argue that extreme underperformance means that cyclical stocks are now cheap. What makes cyclicals look cheap are apparently generous forward-earnings multiples. But anyone that has used such valuations over the past couple of years has been wrong-footed because profits expectations for cyclical stocks have been crushed by weak growth. Given our views on global growth, it follows that there is further downside risk. We are sticking with our view that decent-quality yields and defensive growth are still the best place to be.

Geographically, we're most optimistic about stocks in countries where economic growth has been weakest because valuations are lowest. As we've been saying for some time, cyclically adjusted equity valuations for the likes of the euro area and Japan are cheap, especially against bonds; emerging stocks are getting cheaper, but aren't yet cheap enough, we think. The US is still very expensive. Combined with very low bond yields, those valuations mean that our strategic model has increased overall equity allocations to slightly more than double what they would have been in 2007 or 2000 – just over 50% versus 25% in those two earlier periods. But tactical optimism for equities over bonds is limited mainly to the euro area and Japan. We would be more optimistic about stocks overall were US stocks cheaper. They're not, so we aren't.

COMMODITIES: THE MIDDLE KINGDOM LOOKS MIDDLE-AGED

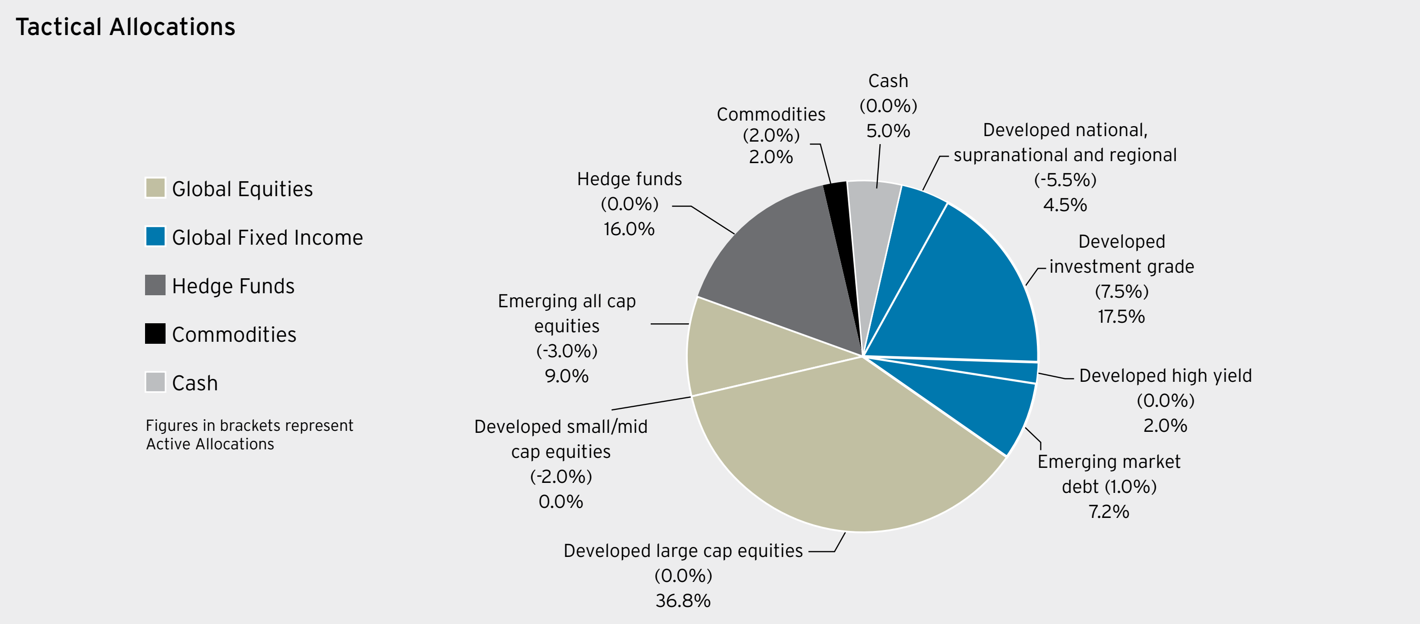
We have been warning of the perils of a China slowdown for two years, for this, we said, would lead to sharp falls in the price of industrial commodities and the underperformance of commodity-related assets, not least those stock markets (and currencies) that rely on their staying high. China has slowed, leading to falls in industrial commodities and the under-performance of most China-related assets (though not all: step forward the Australian dollar). Many are now talking of a pickup in Chinese growth. We think it will slow further as the country's leaders struggle with dreadful demographics and the need to mop up the aftereffects of a credit bubble. Along with increases in supply, this means commodities prices are expected to fall further. The good news is that this will help reduce inflationary pressures, not least in the emerging world; the bad, that falling commodities prices mean that emerging stocks are again likely to underperform.

[1]MSCI as of December 19, 2012.

[2]Yield Book as of December 19, 2012.

Asset Allocation: How Diversification Can Help Add Value in Difficult Times

Alexander Godwin, Global Head of Asset Allocation



Source: Citi Private Bank as of December 2012. Strategic = benchmark; Tactical = the Citi Private Bank Global Investment Committee's current view; Active = the difference between strategic and tactical. All allocations are subject to change at discretion of the Office of the Chief Investment Officer of the Citi Private Bank. This asset allocation represents risk level 3, which is designed for investors with a blended objective who require a mix of assets and seek a balance between investments that offer income and those positioned for a potentially higher return on investment. Risk level 3 may be appropriate for investors willing to subject their portfolio to additional risk for potential growth in addition to a level of income reflective of his/her stated risk tolerance.

Anyone investing over the past 20 years has learned from hard-won experience that the returns produced by markets vary dramatically over time. Equity markets have seen an enormous swing from the huge double-digit returns of the 1990s to barely breaking even since 2000. In contrast, global long-dated corporate bonds have generated 9% returns a year over the entire period and a touch over that since 2000. Clearly, the right allocation in the 1990s has not been the correct allocation so far this century.

This is not a recent phenomenon. Stretching all the way back to 1910, we see the same wide variability of long- and short-term returns. All equity markets have experienced ten-year periods of losses, as have high yield and emerging market bonds. On the other hand, all have also seen greater than 15% annual returns over the same horizon. History tells us we cannot afford to not reposition portfolios as the environment evolves. We believe portfolios need to be actively adapted, positioning for where both good short- and long-term returns are expected to come from in the future.

ADAPTIVE VALUATION STRATEGIES (AVS): INVESTING OVER THE LONG TERM

Our approach to strategic asset allocation, called Adaptive Valuation Strategies (AVS), which we adopted last year after much stringent historical testing, assumes that these changing relative returns are not bolts from the blue. Rather, that over long periods of time, the valuation at which investors buy assets is, ultimately, the main determinant of which asset classes do well and which do not. It assumes this because that is, in fact, what has happened over the past century. We believe that, over the long term, today's equity valuation and yield levels give the best indicators of what future long-term returns will look like. As these levels evolve over time, so do our return expectations, and we align our portfolios to take advantage of those changes. Our asset allocation methodology will then reposition clients' portfolios to harness that historical regularity of valuation-driven out- and underperformance.

For equities, our estimated returns over the long term exploit the tendency for valuation levels to revert to their historical averages over a long enough period of time. We use cyclically adjusted price-to-earnings (CAPE), a valuation measure that, unlike most traditional yardsticks, seeks objectively to adjust for the peaks and troughs of a profits cycle. For most fixed income, our expectations are linked to current yield levels.

Our long-term calculations, which don't discriminate between different markets, indicated that equities looked very expensive compared with other asset classes in 2000. Our model would have suggested a weighting of only 25% in equities in a balanced portfolio because cyclically adjusted valuations were so high. The same would have been true in 2007. Now, globally at least, they look much more attractive, hence we have a weighting of more than double that. Developed markets trade at a CAPE of 17, which is reasonable compared to the historical average of a touch under 15, though US equities on our analysis are expensive. Total returns will also be boosted by dividends and earnings growth. Given that earnings growth for emerging market and small caps is higher (though so are valuations) we would assume similar returns from all those markets over the next ten years.

In contrast, we believe that fixed income may not offer attractive returns in the long term. High yield corporate bonds and emerging market debt may return more over the next ten years, but not as much as equities. While they have greater risk and are highly illiquid, we see potentially attractive returns for private equity and real estate. However, please keep in mind that investing in alternative investments is speculative and not suitable for all investors.

Within a typical portfolio, then, we propose a relatively high weight in equities for the long term. However, this is not the end of the story. Looking at long-term returns is just the first part of how we position our portfolios. What happens in the short term is just as important.

TACTICAL STRATEGY: ADAPTING IN RESPONSE TO SHORT-TERM CHANGES

It is equally important to adapt your portfolio to the changing shorter-term environment. Markets have suffered gargantuan fluctuations in returns over the short term. Since 1990, equity markets, high yield and emerging market debt have all experienced losses of 30% or greater over one year, while also enjoying returns over 40% in other years. Our tactical asset allocation seeks to adjust the long-term advice provided by AVS for the shorter-term market environment.

We are less optimistic on equities in the short term compared to our longer-term forecasts. One of the main reasons for this is the high valuation of US equity markets (which comprise over 40% of the developed-world index) combined with rapidly slowing corporate-profit growth.

On the other hand, European equities seem far more attractive. Valuations are half those in the United States, reflecting the severe pessimism of investors. As we explain later on in the publication, such a disparity in valuations has nearly always resulted in Europe outperforming over shorter periods.

A potentially slightly more stable period in the crisis in the run up to the German elections in October 2013 is also supportive of our view, though of course European growth and corporate profits continue to fall.

Emerging markets are another area in which we have been and remain cautious, given their worrying dependence, in general, on China. We are concerned about the ballooning expansion in private-sector credit (something that in other countries has only ever ended in a crisis), what has looked like a housing bubble and the huge misallocation of capital. Anecdotal signs that China is losing some export competitiveness is also concerning, with increasing news of manufacturing being "onshored" back to the US and Europe.

We are thus underweight equities relative to the high weight advised by AVS. This is driven predominately by our significant underweight to the US and emerging markets, with Europe and Japan slight overweights.

With global growth likely to continue to be dented by private-sector and, increasingly, public-sector deleveraging, we believe that yields on safe government bonds will remain low. They may even fall further. Higher-quality corporate debt will be supported by that trend, but also from strong corporate balance sheets and still attractive yields relative to government bonds. While we have almost no conventional developed-world government debt in our portfolios, our strong weighting in fixed income is concentrated on emerging debt and on longer-dated corporate bonds, especially in the US.

Figure 1: Emerging Market Equities Versus Long-Dated Corporate Bond Returns Since Start of 2011

Source: Citi Private Bank using Bloomberg, as of December 7, 2012.

Finally, within commodities our only overweight is in gold, which we believe is closely linked to monetary stimulus. With our outlook for low growth, we believe central banks will continue to increase stimulus. From a tactical perspective, though, we favor holding gold in currencies other than the dollar, especially in euros, as holding gold in that way may provide a much better hedge for the portfolio.

Adaptive Valuation Strategies, developed by the Office of the Chief Investment Officer, is Citi Private Bank's strategic asset allocation methodology. It is one component that impacts the asset allocations within the client portfolios.

Multi-Asset Portfolios: Regional Perspectives

NORTH AMERICA

Lex Zaharoff, Head of Investment Lab, North America

When times are tough, investors tend to do too little or too much. Below are three typical conversations highlighting clients' concerns and our response in helping them to take the appropriate risks to potentially earn the most attractive returns.

"BUY BONDS NOW? YOU MUST BE KIDDING?"

As we explain elsewhere in the publication, we have not believed for years that investment-grade corporate bonds are overvalued and we still don't. In presenting this view to our clients, some have expressed skepticism ("At these levels, rates have only one direction to go and that is up") or regret ("I should have listened to you last year or the year before; now I have missed the run"). We think the first view is mistaken and the second misses the point. Investing is about the future, not the past. What matters is the valuation level an investor is buying into today compared to the levels in the other asset classes on a risk-adjusted basis. As Alex Godwin outlined, we still think that investment-grade bonds today can provide better forward-looking risk-adjusted returns than US stocks. What matters, we think, is the extra spread that clients are offered; yields are low mainly because Treasury yields are low.

Some clients have chosen to sit in cash since the opportunity cost in a low-inflation environment seems small. It is important to note, though, that inflation is personal. While economists and markets focus on the rate of inflation for the typical consumer – the Consumer Price Index (CPI), our clients are not the typical consumer. The annual increases in the cost of maintaining their lifestyle or achieving their other financial goals is different from the cost of goods and services for the average consumer. In fact, most research indicates that the inflation rate a wealthy family faces is higher than the CPI. The implication is clearly that cash is not a risk-free asset for wealthy individuals. We still think that investors should therefore reach out along the credit curve, whether that be in municipals or in corporate debt.

"WITH ALL THESE CONCERNS: US DEFICITS, EURO AREA RECESSION, INSTABILITY IN THE MIDDLE EAST AND A SLOWING CHINA IN TRANSITION, WHY SHOULD I NOT SELL EVERYTHING TODAY?"

We entirely understand these concerns. After all, Citi Private Bank's Chief Investment Officer (CIO) has been talking about them at length for more than two years. But as he says, when it comes to investing, the question is not whether there are lots of risks – clearly there are – but how much clients are paid to take them. So the way we believe clients should react to all of these concerns is to assess how much they are now paid to take those risks; whether, in other words, they are already paid more than enough. If they are paid a lot, then downside risk becomes much less of a worry. Indeed, there may well be many good investment opportunities when everyone else is panicking.

Clients should also distinguish between different types of uncertainty: to paraphrase Donald Rumsfeld, the "known unknowns" – the expected risks and volatility in markets for which investors should be compensated in the form of future returns; and the "unknown unknowns" – those extreme events, the equivalent of the Hurricane Sandys of the financial markets – that are impossible to predict but clearly occur with greater frequency than one expects. Both types of risk are important, but assuming valuations reflect risks of the more normal sort (and that is a big if), our clients should focus more on managing the right level of extreme downside risk (estimating the impact of the unknown unknowns) rather than normal market volatility. A good investment strategy is one where the investor will manage to stay the course when an extreme event occurs. While we can't predict when one will occur, there are strategies available to manage the impact of it. The challenge is to overcome the natural bias of not buying insurance until the risk is obvious. Investors should buy insurance when the sun is shining, not when the heavens open.

"WHAT IS THE SINGLE HIGHEST-YIELDING INVESTMENT I CAN MAKE TODAY?"

It is understandable, given the very low level of yields available through intermediate maturity sovereign and high-quality bonds, that there is a desire by many clients to reach for higher-yielding instruments. There are many ways of doing this. Investors can extend maturities, buy higher-risk/higher-yielding bonds, take currency risk or liquidity risk — but each has risks which, while not generally as high as those in equities, could erase any and all returns earned through the higher yields. For example, some of the most popular higher-yielding asset categories of the last couple of years — Master Limited Partnerships (MLPs), Real Estate Investment Trusts (REITs), sub-investment-grade bonds — had some of the greatest drops in value in the 2008/09 crisis. Also, simply extending duration may not be the panacea it seems, since a sharp rise in rates might lead to a fall in the price of the bond (though how much of one, for the geeks out there, depends on the maturity and yield on the bond concerned).

Identifying sustainable yield continues to be one of our highest conviction themes into 2013. Our recommended approach is to implement a multi-strategy portfolio, drawing on diverse sources of risk that are contained in different asset classes. These multi-strategy yield portfolios may include exposures to dividend-paying stocks, longer maturities, credit risks, prudent credit and selling volatility or undesired sector exposures. The exact composition will vary over time as relative valuations change.

Overall, our best advice in managing the financial markets roller coaster is to allocate to both a strategic portfolio, designed using our innovative Adaptive Valuation Strategies methodology, and an opportunistic portfolio to take advantage of mispriced investments.

ASIA

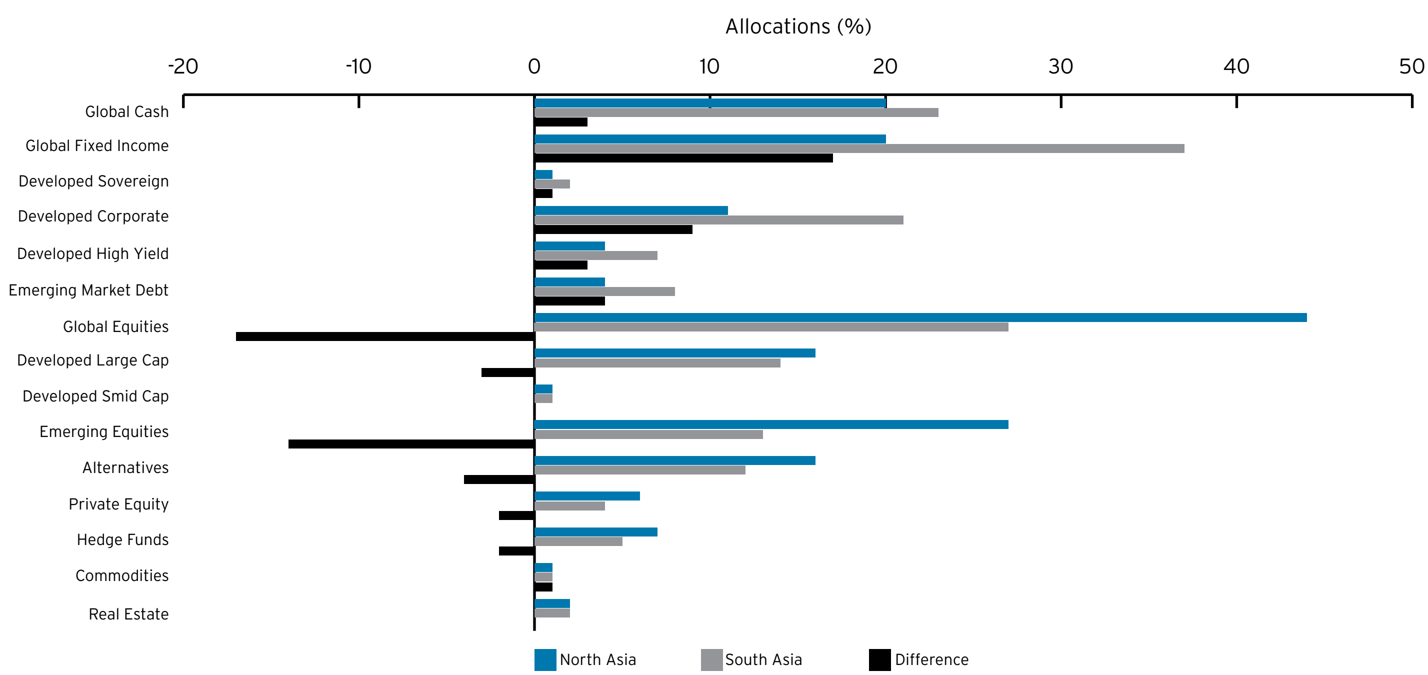
John Woods, Chief Investment Officer, Asia

The enduring aftershock of the global financial crisis continues to reverberate among Asian clients. Where once there was demand for risky assets, now we see risk aversion. And where once an expectation of capital gains drove investment decisions, income or yield now dominates.

We looked at this by studying the portfolios of clients with moderate risk tolerance across Asia. They are, it is fair to say, even more conservative than we are — and we have been much more conservative than most. Relative to the positions recommended by Citi Private Bank's Global Investment Committee (GIC), the average client portfolio is 10% underweight equities, 15% overweight fixed income and 4% underweight alternatives (comprising private equity, hedge funds, commodities and real estate). Given that most Asian investors had a much greater appetite for risk than those elsewhere in the world, this probably underestimates how conservative they have become.

There are stark differences between clients in North and South Asia when it comes to risk appetite, though. North Asian clients far prefer equities, which comprise a substantial 44% of their portfolios. South Asian clients, by contrast, prefer bonds (Figure 1). We wouldn't, however, expect overall preferences to change much in 2013. Equities look likely to be range-bound. The global economy continues to slow (boosting bonds) and corporate profits continue to fall (at some stage, if this continues, helping to undermine the rally we have seen this year). Europe is expected to continue shrinking, but Asian eyes are likely to be still more focused on what happens in China, given last year's slowdown and with the new regime taking over in the spring.

Figure 1: Comparing North Asia and South Asia Asset Allocations



Source: Citi Private Bank, Asia Investment Lab, as of November 2012.

The raft of problems that China faces is too big to get unduly excited about an apparent slight pickup in growth at the tail end of last year. And investors have found out that, for all of Asia's long-term growth potential, profits and stock market performance are quite another matter. Rarely has demand for fixed income been so high and demand for everything else so low.

Rather than attempting to understand these markets, let alone trade them, most Asian clients are likely to continue to prefer safer, yield-generating assets, though this will probably include higher-dividend equities too. We suggest equity-heavy North Asian clients switch more of their money into high-grade bonds, since these tend to do well in periods of heightened market volatility. We prefer intermediate-maturity US dollar-denominated corporates, given our expectations that government yields will remain low and spreads are likely to compress further. We also suggest they explore REITs,* particularly those issued in Singapore. Although these did well last year, we still think that yields and potential total returns look attractive.

But there are deeper lessons for Asian investors to draw from what has happened in recent years. The first is that Asian investors, perhaps even more than investors elsewhere, need to expand their horizons beyond Asia. Who would have thought that stocks in crisis-hit Europe would have outperformed Asian stocks for the second year in a row? Which leads to a second thought: that some of the best investments are made at the worst of times and the worst investments at what are, apparently, the best of times.

That is not to say that we recommend wading in wholeheartedly. Indeed, where insurance is cheap we would continue to suggest you consider buying it. Global risks are, we think, probably higher than the performance of many markets this year would indicate. This is important because what happens in the US, in Europe or in the Middle East in 2013 is likely to be as important as what happens in Asia itself. Historically high correlations across higher-beta assets have meant Asia's risk appetite has tended to follow risk appetite elsewhere. And as investors have found to their cost, risk appetite and risk aversion tend to be binary.

Although equities have done little in aggregate in the past couple of years and will probably struggle in 2013 too, in our view Asia's consumer market is likely to grow more in the years ahead and equities are a good way of investing in that story. Asian companies are not the only way of doing so. Indeed, improving productivity and lower unit labor costs are disproportionately benefiting not Asian companies but companies in the developed world, particularly as wage growth accelerates across Asia. So we would also suggest that investors in Asia — and elsewhere — explore developed market consumer-oriented companies that source from — or sell into — Asia.

For these reasons, we would summarize our principal recommendations as follows. First, stay conservative, in the face of continued expected headwinds in 2013. Second, investors with a high proportion of equities should still think about investing more in fixed income, even though yields have fallen. Third, those that have had an overly heavy weighting in fixed income should think about starting to lighten up. This isn't as contradictory as it sounds. Even though we are probably gloomier than most, we wouldn't throw the baby out with the bathwater. For all the risks, clients need to make sure that they position their portfolios for the best long-term returns.

And some of the best long-term returns are starting to be found, we think, in some equity markets and in alternative investments.** Investors need to put emotion aside and not become too defensive.

*REITs are subject to special risk considerations similar to those associated with the direct ownership of real estate. Real estate valuations may be subject to factors such as changing general and local economic, financial, competitive, and environmental conditions. REITs may not be suitable for every investor.

**Alternative investments are speculative and entail significant risks that can include losses due to leveraging or other speculative investment practices.

LATIN AMERICA

Daniel de Ontanon, Head of Investments, Latin America

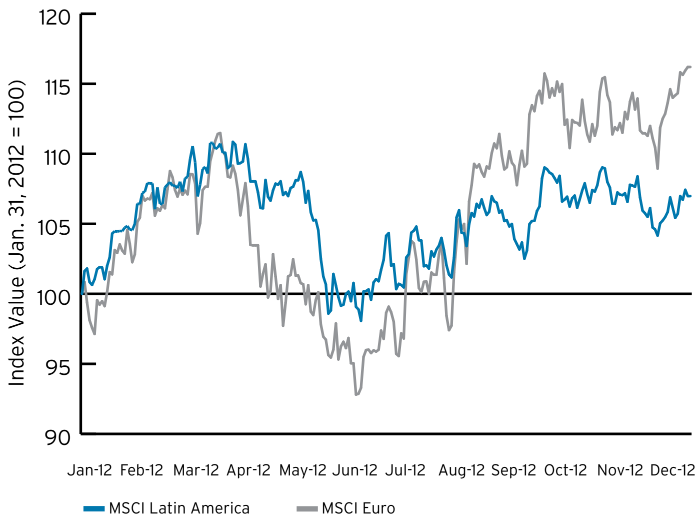
Latin American investors look too much to the regional assets they think they know. They need to expand their horizons.

As consumers, we tend to prefer what we know. At some point in our life we tried something new (a product, a service, a husband) and liked it. Chances are that we will buy it again — or at least something very much like it. Marketing folk have known this for years and have tried to exploit it by making new products similar to popular existing ones. Many in Latin America do the same in investing. Portfolios tend to be choc-a-bloc with well-known regional names, particularly well-known Brazilian names, given how large the Brazilian stock market is. Although this strategy rewarded investors for many years before the financial crisis and for a couple of years afterward, it most certainly has not done so for the past two years. Excessive concentration can bring many rewards, but it also brings many risks. Little by little, the world has changed and those changes have meant that investors would have done far better to have had greater exposure to more attractively valued markets elsewhere in the world — and to ones that benefited from those changes.

Consider, for example, a Brazilian investor who has invested largely in Brazilian bonds and equities because he has done well from them before and he knows them. In 2009 and 2010, just about everything did well not least because the Brazilian economy seemed to be booming. Brazilian growth was boosted by a China that was growing fast and boosting commodity prices. Brazilian equities flew and corporate spreads fell sharply. Local government debt also did splendidly because interest rates elsewhere were so low. Domestic assets appeared even more attractive given that the real seemed to do nothing but rise. This benign backdrop started to change in 2011. Commodity prices started to drop. The Bovespa fell 18%. Anyone with high weightings in commodity-related companies would have done worse still. The real dropped sharply, though local bonds did well, helped by falling rates.

Performance was better in 2012, but not exactly mouth-watering. The Bovespa was one of the world's worst-performing stock markets. Brazilian corporate bonds didn't do so well either, thanks to some high-profile defaults in the financial sector and a few other, highly indebted companies running into trouble. Although Mexican and Colombian stocks did fine, other large Latin American stock markets struggled, not least those in Chile, which did even worse than Brazilian stocks. Equity markets in the US and the euro area (yes, that's right, the euro area) did much better. Indeed, euro area stocks outperformed their US counterparts. Non-Brazilian corporate debt did better, sometimes much better, than both. Given the fall in the real, the returns that Brazilian investors would have received would have been a lot higher.

Figure 1: Euro Area Stocks Have Outperformed Latam Stocks in 2012



Source: Citi Private Bank using Bloomberg, as of December 7, 2012.

WHY DID THE LATIN INVESTMENT ENVIRONMENT SOUR AND HOW SHOULD INVESTORS GUARD AGAINST FUTURE SLOWDOWNS AND SHARP FALLS IN ASSET PRICES?

The first thing to bear in mind is that there is no such thing as a one-way bet in financial markets. Markets move up and down and that is a fact of life. Second, companies within a particular geography tend to be exposed to a very similar economic environment, which means that their returns are driven by similar factors. Not only has the Brazilian economy been very linked to commodities, so have many of its companies. As China slowed, so commodities prices fell and the capacity for commodity-producing companies to pump out bumper profits also fell. Financial firms suffered because they have all been affected by the same slowdown and the increasingly cautious (not to mention debt-strapped) consumer. The third reason is that markets are driven by expectations. Few people really expected China (or Brazil, for that matter) to slow and that slowing to drive down commodities prices. So the effects were much bigger when they did because valuations were high.

What investors — in Latin America or elsewhere — can do to load things in their favor is to guard against too much concentration in one company, country, region or asset class. Although Brazilian equities haves struggled, bond markets have been pretty buoyant. And they should think more globally. True, markets around the world have become far more correlated over the past few years, but this only means that they increasingly move in the same direction, not to the same degree. This is where valuations matter, at least in the long or even medium term. A big reason that European stocks have done comparatively well this year is because everyone was scared stiff and valuations were very low.

In today's difficult environment, Latin American investors need, of course, to take advantage of good domestic opportunities whenever they arise, but should remember that equity markets or other assets elsewhere in the world often provide returns to help offset sickly domestic markets. This means not that they should buy things they do not understand, but that, when it comes to investing, it's often the case that people don't understand what drives asset prices, even domestic ones, as well as they think. That's where we aim to help.

An Expert Guide to Stock Selection

Archie Foster, Senior Portfolio Manager, Tailored Portfolio Group

With growth and yields likely to be low next year, we run through what investors should be thinking about when looking at individual stocks.

While equity markets in both the US and Europe have posted decent returns in 2012, individual stock selection has again been hard because of a plethora of economic, political and regulatory headwinds. These are likely to remain in place in 2013, which probably means a volatile year for equities. Selectivity will therefore be key to performance. Below we highlight our approach to stock-picking in the current environment.

Citi Private Bank's CIO believes that continued austerity in Europe and a pickup in fiscal tightening in the US will cause growth in developed markets to be slow at best. Although Chinese growth will be faster than its developed-world counterparts, it too faces the prospect of slower growth as it deals with lower demand for its exports and the aftermath of a credit boom. Potentially positive offsets to these headwinds come in the form of prolonged loose monetary policy worldwide, low cyclical valuation in Europe and, in the US, a slow improvement in housing coupled by increased activity in the energy sector. So while our return expectations are subdued, we don't believe that shunning equities altogether is the right course of action.

STOCK-PICKING IN AN ENVIRONMENT OF LOW GROWTH AND LOW YIELDS

Given that the broad macro backdrop seems both short of yield and growth, we look for stocks that provide both a better-than-average yield as well as access to the limited growth opportunities available worldwide. The search for yield continues given the prospect for an extended period of low growth, low interest rates and low returns; and investors are increasingly looking to higher-yielding equities as a potential source of total return. However, while screening for dividend yield is indeed part of our investment process, we don't recommend focusing on high yields as the sole criterion for stock selection, since the highest-yielding stocks also tend to carry higher risk. Hence we suggest targeting names with a reasonable dividend payout compared with their respective balance sheets and cash-flow generation, as well as the ability to increase those cash flows in the future, to provide some comfort surrounding dividend sustainability and potential for capital appreciation.

DIFFERENT STOCKS, COMMON ATTRIBUTES

When selecting stocks in the current environment, we consider everything from mid-cap to mega-cap. While we may be drawn to certain sectors given the macroeconomic outlook, we consider ideas that span both defensives and cyclicals. But though our ideas may come from very different corners of the market, they tend to share common attributes, outlined below with the help of a theoretical stock.

Strong or Free Cash-Flow Generation: We believe that free cash flow (FCF), while not infallible, is one of the better measures of a company's financial flexibility. It measures cash left over after accounting for all operating expenses, capital expenditures and for our purposes (as we view dividend payments as a commitment to shareholders), dividends. Managements of companies with excess cash have the flexibility to increase investment in their business, pay off debt, and/or pay or increase dividends. We look for companies that either have strong FCF generation today or that we believe are close to an inflection in FCF growth. Our theoretical stock carries a free cash-flow yield (FCF divided by market capitalization) of 5.2%, a level that we consider healthy.

Strong/Strengthening Balance Sheet: With interest rates low, carrying higher levels of debt may be generally more manageable than it has been in the past. Nonetheless, while low rates may lessen the burden of servicing debt, a company must still service it, which takes cash away from other potential uses. We lean toward companies that carry a reasonable amount of debt, balancing the ability to invest for growth and the flexibility to return excess cash to shareholders.

The measure we use when looking at debt levels is net debt divided by Earnings Before Interest, Tax, Depreciation and Amortization (EBITDA) and view a number below 2.5X as acceptable. At the same time, we also consider companies that carry a slightly higher net debt ratio if free cash-flow generation is strong and management has stated its intention to pay off debt in the near future. Our theoretical stock carries a net debt/EBITDA ratio of 0.7X, which we believe offers sufficient financial flexibility.

Positive Internal Change: We believe that companies initiating material strategic change may present interesting opportunities. Strategic change requires solid management and execution, the lack of which may present risks. However, when properly handled, strategic change may lead to higher growth, margins and market share. As an example, our theoretical stock has, over the past two years, shed its more cyclical, underperforming businesses and has used the proceeds from these sales to invest in research and development and bolster its structural growth businesses via a series of bolt-on acquisitions. This has, in turn, boosted its structural growth profile.

Identifiable Growth Opportunities: In a slow-growth environment overall, there may nonetheless be specific growth opportunities for companies on the sector, subsector and/or product levels. These opportunities tend to be less abundant when the overall environment is tough, and therefore a deeper level of research is needed to identify them. Our theoretical stock, with its recent shift in focus, has positioned itself as the leader in areas (now representing 70% of revenue) that we expect to grow at a rate of 2X global GDP over the course of the next five years due to demographics, emerging market growth and visible changes in consumer behavior.

Capital Return: We look for companies with the ability to provide a reasonable level of capital return to shareholders in the form of dividends and share buybacks for a couple of specific reasons. First, in an uncertain environment for equities, we like being paid part of our return "up front," as it offers some level of certainty and cushion. Second, we believe that managements of companies that consistently pay a dividend and/or buy back shares tend to be better stewards of capital than those that do not. In other words, if a management knows that it is expected to distribute a portion of its cash flow to investors, it may be less likely to overpay for an acquisition or invest in unproductive capex or R&D. We look for dividend coverage ratios of 1X or higher, in an attempt to avoid companies that pay out more in dividends than they produce in cash flow. Our theoretical stock carries a dividend yield of 3.4% and a cash dividend coverage ratio of over 2X.

Attractive Valuation: Even names that possess all of the attributes that we are drawn to can be overvalued, so attention should always be paid to how much one is paying. We look at a stock's valuation (on various metrics depending upon sector) compared with its own history over the course of a cycle, keeping in mind what our expected rate of growth is. In the case of our theoretical stock, it trades at slightly under 14X current earnings and slightly over 11X 2013 estimates. Earnings growth is expected to be 11% this year and close to 18% next year. Its P/E range has been 10X–30X over the past 10 years. So valuation looks attractive.

High yields are nice, but sustainability is key. Show us a stagnant company with a high yield and we'll show you an eventual dividend sustainability issue. Low interest rates are driving investors towards higher-yielding equities. However, in the current environment we believe that dividend yield is only part of the stock-picking story. In our view, balance is key, as without it companies can run into dividend sustainability issues. With growth opportunities scarce, companies need to balance debt management, investment for growth, and the return of capital to shareholders — and not overreach on these uses of cash flow. We would advise caution to top-quintile dividend yields and focus instead on companies that can provide a reasonable dividend yield and the growth required to sustain it.

Following in Rothschild's Footsteps...

Alexander Godwin, Global Head of Asset Allocation
Don Marchesiello, Global Head of Traditional Investments Research and Management

Unlikely though it may seem, we favor euro area over US stocks in 2013.

Deepening recession? Falling profits? Uncertain future? Looks like time to buy Europe, then. Indeed, we believe that European equity markets are poised to outperform their counterparts in the United States in 2013. Behind our conviction lie the dramatically more attractive valuation levels in Europe, which have historically been associated with periods of much better relative performance.

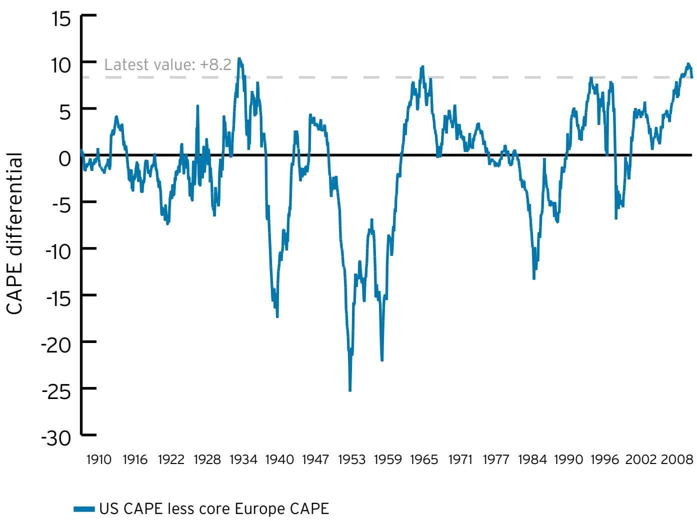
It is commonly thought to have been Baron Rothschild who was credited with saying that the time to buy is when there is blood on the streets. Tasteless and probably wrongly attributed though the quote might be, there has been much truth to the thought behind it down the years. Anyone brave enough to have bought Russian bonds in 1998, or Brazilian debt at the tail end of 2002, or junk bonds in late 2008 would have done famously. And, of course, its opposite has been equally true: that you should sell when everyone else is overly optimistic. As you should have done all things Chinese in 2007; or anything to do with technology in the late 1990s.

The idea is that investors become overly pessimistic in a very difficult situation and drive valuations far below where they should be. By the opposite token, people can often be too enthused by apparently unstoppable forces and overpay for assets that have done relatively well. The unstoppable then stops and valuations fall to earth with a bump. The current disparity in valuations between the US and Europe reflects just such a confluence of misplaced pessimism and optimism. Historically, a valuation disparity of this magnitude has frequently been a good buying opportunity for European stocks compared with US stocks over the following 12 months.

When looking at valuations we use cyclically adjusted price-to-earnings multiples, which adjust for the peaks and troughs of the profits cycle. On this measure, whenever in the past Europe has traded significantly below the US (we look at a multiple more than 5X cheaper) it has generally outperformed. Looking back to 1910, Europe's relative valuation was that much lower on 155 months. Over the following year, Europe outperformed 60% of the time. But over the following two and five years, it outperformed 75% and 99% of the time, respectively.

At 12.7X, the cyclically adjusted multiple of core Europe is eight times less than the US, which fetches a CAPE of 20.8X — a number that has been consistently exceeded only in bubbles in the past 100 years. Our European data uses only the number from France and Germany, for which we have a lot of historical data. On these numbers, the valuation gap has been this wide only three times in the past 100 years. Without exception, over long periods of time, European stocks were always the better investment at current differences in multiples, even using just those French and German numbers. Given how much cheaper peripheral equities are compared with core stocks, it seems safe to assume that, overall, Eurozone stocks have never been this cheap compared with their US counterparts (Figure 1).

Figure 1: Overall, Eurozone Stocks Have Never Been This Cheap Compared with Their US Counterparts



Source: Citi Private Bank using Bloomberg, as of December 7, 2012.

These are compelling statistics, especially because we capture both world wars, the Depression and the other huge social, economic and political changes of the past 100 years. The current bleak picture is not without precedent, then.

In both the US and in Europe, we continue to recommend decent-quality stocks with high dividends. Many European companies have payouts with valuations that are increasingly attractive relative to corporate-bond yields, which have fallen sharply.

For non-US investors seeking sustainable yield strategies within European equities, the CitiFocus List features dedicated high-dividend European strategies that specifically focus on companies that seek above market average dividend yields.

For clients seeking a more diversified approach, we also have strategies that invest in a diversified portfolio of high-quality, larger-capitalization European companies. We also have a "special situations" strategy, looking at stocks that may be beneficiaries of mergers or acquisitions, or those undertaking restructuring that is likely to unlock value for investors.

The deepening recession has certainly put more pressure on European companies to restructure themselves, creating opportunities for active managers to add value for their investors.

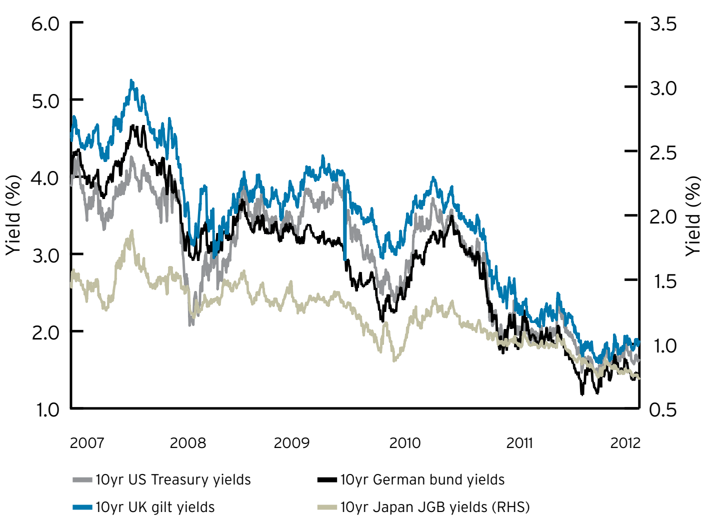
No, It’s Not a Bubble

Michael Brandes, Global Head of Fixed Income Strategy
Don Marchesiello, Global Head of Traditional Investments Research and Management

You’ve probably read elsewhere that there’s a bond bubble. No, there isn’t. While we are very underweight nominal government bonds, that’s because we prefer other sectors, such as corporate and emerging market debt. Returns in 2013 are bound to be less, though, than last year.

Policy rates of almost nothing have produced an increased appetite for almost anything that yields more. Historically low government-bond yields in the developed world are not, we think, about to reverse course anytime soon. They are, we think, merely a reflection of global growth prospects that are, to be frank, quite poor (Figure 1).

Figure 1: Core Risk-Free Rates Are Bound to Stay Low



Source: Citi Private Bank using Yield Book, as of December 7, 2012.

In the emerging world, slowing economic activity and easing inflation pressures should allow central banks more latitude to lower rates. Sovereign fundamentals that have in general been improving (with some exceptions) provide abundant opportunities for relative value in fixed income.

We favor external (hard currency) emerging market debt over locally denominated bonds, largely because we’re not that optimistic about many emerging market currencies.

While we expect core government bonds to underperform, heightened uncertainties ensure that safe-haven markets (inter alia, German bunds, US Treasuries, UK gilts) will continue to enjoy flight-to-quality demand across the maturity spectrum. That said, risk-free yields are unlikely to fall much farther. We favor spread markets (such as corporate and securitized debt), where spreads are, we think, still fairly generous and are thus well-positioned to outperform government bonds in the coming year.

Demand is expected to remain steady for US residential mortgage-backed securities (thanks to the Federal Reserve buying approximately one-half times of expected net supply) and for other collateralized instruments. During periods of uncertainty, highly rated assets that reside at the top of the capital structure, such as covered bonds, remain well-bid.

Corporate bonds are our favorite asset class, though, led by investment-grade issuers.

Although yields are trading near historic lows, that is mostly because government yields are so low. Spreads are attractive. Moreover, absolute yields as a percentage of risk-free rates are high. Solid fundamentals are reflected in strong balance sheets and minuscule default rates. Refinancing needs (even among high yield issuers) are probably modest in the coming year.

That said, corporate bonds are expected to post coupon-like returns in 2013 rather than the huge gains of the past few years. Government rates and absolute yields are already near record lows, corporate profits are falling, and balance sheet leverage is creeping higher at some issuers, mainly higher-grade, non-financial issuers. Elevated global uncertainties — from European periphery troubles, to US fiscal issues, to China’s slowdown, and Middle East turmoil — could prompt a reversal in risk appetite.

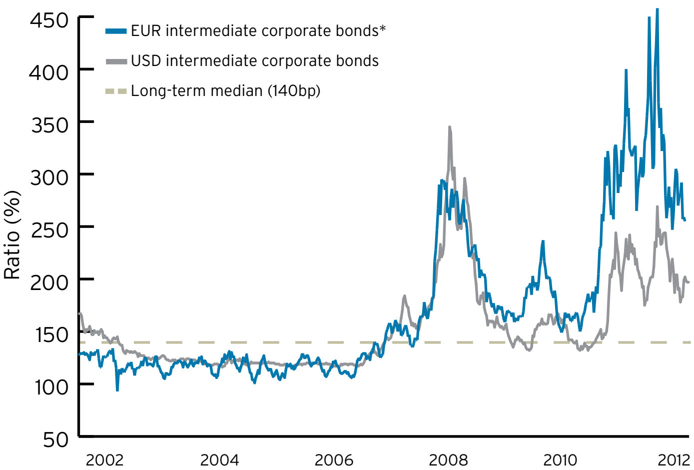
We prefer investment-grade to sub-investment-grade borrowers. True, spreads are still reasonable for sub-investment-grade bonds, but absolute yield levels have fallen substantially.

We would recommend limiting speculative-grade exposures to double-B and high-quality single-B issuers domiciled in core developed countries.

We prefer bank and finance debt (including subordinated structures), particularly in the US, where balance sheets continue to improve and excess yield over industrials persists. In non-financials, we prefer companies with strong high cash flows and stable earnings, such as in the tobacco and cable/media sectors.

While investors wary of a bond bubble principally fear duration, we expect duration to bolster returns in the coming year, just as it has done in the past few years. High-grade corporate yield curves are relatively steep and feature one of the best ways for investors to add duration exposure. Given heightened volatility at the long-end of the curve, we continue to favor intermediate maturities. This better insulates portfolios from a potential bear steepening, were all the uncertainties about which we have fretted long and loud to subside (Figure 2).

Figure 2: Intermediate Corporate Bonds Are Still Attractive



Source: Citi Private Bank using Barclays Capital, as of December 6, 2012.
*Ratio = corporate-bond yield as a percentage of the risk-free rate.

As well as having experts in-house to manage fixed income portfolios, Citi Private Bank's Global Managed Investments' fixed income team can recommend third-party fixed income fund strategies for investors wishing to implement some of our key investment themes for 2013.

We have managers for both US and non-US investors that are able to implement many different views on investment-grade corporate credit. Some have a defensive bias; some may go further down the quality spectrum; and some concentrate on more-aggressive duration plays. Even in high yield, where we are becoming more cautious, there are managers that concentrate on higher-credit-quality issuers, perhaps by overweighting BB- and B-rated bonds and underweighting CCC-rated bonds; and others that reflect defensiveness by shortening the maturity of the bonds they hold. In addition, we have strategies that venture further down the capital structure, such as preferred securities, to allow investors to implement a view on corporate bonds in search of the quest for sustainable yield. For emerging market debt, we have managers who specialize in sovereign bonds, some who specialize in corporate debt and others who specialize in both. Within our list of third-party fund managers, then, investors have the opportunity to implement many views on the broad array of fixed income markets.

The Search for Independent Returns

Eric Siegel, Global Head of Hedge Fund Investments
Alexander Godwin, Global Head of Asset Allocation

Given their decidedly lackluster performance overall in recent years, the case for investing in hedge funds would seem difficult. Nothing could be further from the truth.

We believe there is a deep pool of hedge funds that have offered good returns, low correlations and protection during market drawdowns. In a world in which it is increasingly difficult to find independent sources of return, it is even more vital for ultra high net worth clients to have exposure to these funds within their portfolio. Institutional investors have already made this move, and we believe others should follow their lead.

Over the past five years, hedge funds as measured by the HFRI Hedge Fund Composite Index have returned just 1% a year. The HFRI returns have also been highly correlated with other asset classes (correlations with developed equities are 88%) and, for all the talk of how well hedge funds were able to manage risk, they still fell 20% on average in 2008. Looking at the overall index would suggest that investing in hedge funds is not a good idea at all. End of story? Not a bit of it — which is why institutional investors are increasingly gravitating toward hedge funds.

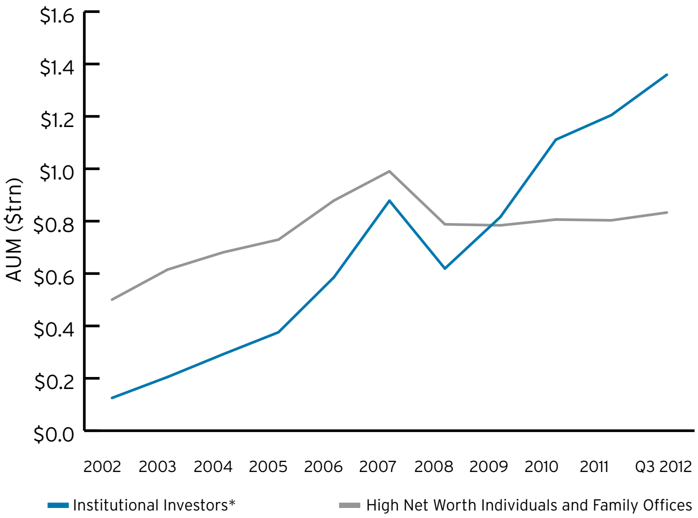
One of the uncomfortable truths of modern-day investing is that markets of all stripes have become much more correlated. With markets and asset classes increasingly correlated, it has become progressively more difficult to find investments that offer attractive returns independent from swings in risk appetite. As global growth continues to slow, moreover, and available returns for other asset classes have been bid down so much, it becomes even more vital to identify such uncorrelated investment opportunities.

Hidden beneath those lackluster broad indices, certain hedge fund strategies have been demonstrating just such characteristics. Their returns are uncorrelated with traditional asset classes; they can help hedge tail risks; and they can, as a result, help dampen the volatility of a traditional investment portfolio. That is why those strategies are increasingly playing an important, perhaps even unique role in some of the larger multi-asset-class portfolios. Even those with less cash should, we think, heed the lesson.

Two strategies in particular stand out: Global Macro and Commodity Trading Advisors (CTA). Both types of strategies look to invest in global macro trends, with Global Macro funds taking a qualitative approach, filtered by human judgment, and CTAs using quantitative models. What makes both strategies attractive is that they offer very low correlations to equity markets (18% and -11%, respectively) and have a proven ability to be resilient in large drops in equity markets. Global Macro funds as a group rose 5% in 2008 and CTAs by 14%.[1]

From Equity Long/Short funds, to Relative-Value funds, to Event-Driven funds: More than 500 funds posted positive returns in 2008; and over 150 achieved double-digit returns in that period. These types of returns can provide meaningful tail-risk protection to a portfolio in difficult years for risk-assets, such as in 2008. While the broad index has a high correlation, almost a third of funds have correlations below 20% and nearly a fifth of them exhibit negative correlations. These funds can be found in every type of strategy.

Figure 1: Sources of Hedge Fund Industry AUM by Investor Type



Source: Citi Prime Finance analysis based on HFR Data.

*Institutional Investors include Endowments and Foundations, Pension Funds, Insurance Funds and Sovereign Wealth Funds.

Institutional investors have been the first movers in this new model of diversification. Thus has the nature of the underlying investors in hedge funds changed dramatically in the past decade. A study by Citi Prime Finance in June 2012 found that institutional investors accounted for 60% of all hedge fund investments at the end of 2011; in 2003, they had made up only a quarter (Figure 1). With more institutional money has come pressure for better risk-management and less swinging from the rafters. Furthermore, as bank proprietary desks continue to shed their trading operations under legislation designed to limit risk taking (including the so-called "Volcker rule"), so hedge funds have been able to hire better talent. Ultra high net worth clients have been much slower to adopt the strategy. We would strongly advise them to think hard about doing so.

[1]Sources: HFRI Macro Index and BarclayHedge – Barclay CTA Index, respectively.

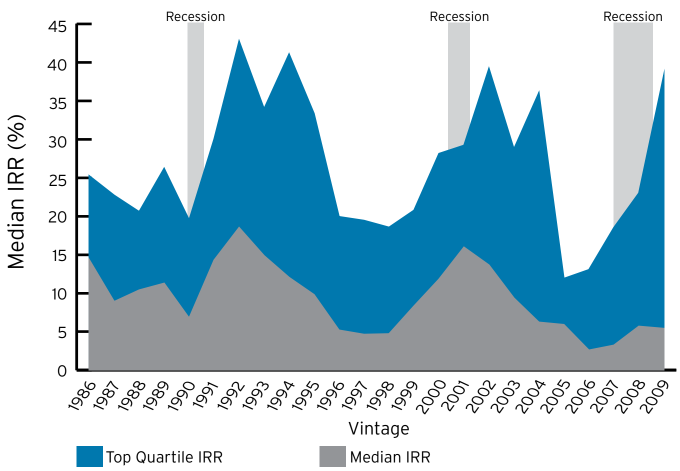
Taking Advantage of Bank Deleveraging

Daniel O'Donnell, Global Head of Private Equity and Real Estate Research and Management
Alex Gregory, Private Equity Research

Weak growth and troubled banks can be investors' friends. Over the last two decades, the highest private equity returns were generated in the vintage years immediately following recessions (Figure 1).

Attractive opportunities in private equity may come from assets that banks – especially European banks – will be forced to sell in coming years (Figure 2).

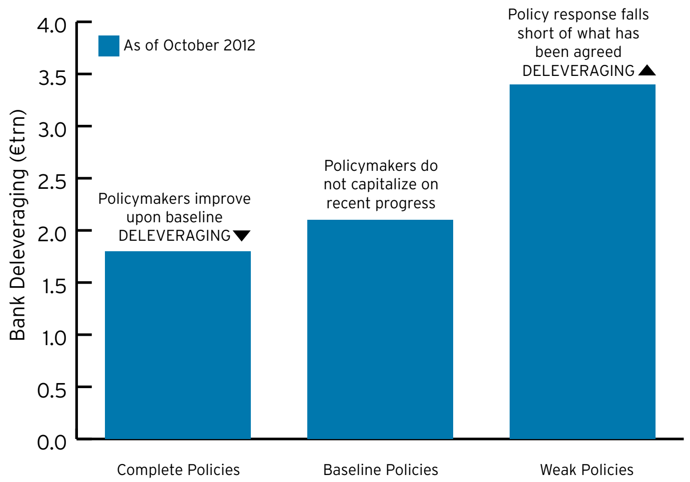
Figure 1: Attractive Returns in Private Equity Have Historically Been Achieved During Times of Market Dislocation



Source: Thomson One Global Buyout returns as of December 2012. Past performance is no guarantee of future results. Actual results may vary.

We believe forced selling by institutions are likely to create opportunities. Nowhere is this more true, we think, than the current need for US and especially European banks to shed assets. Banks in Europe and the United States are likely to have to sell at least $5trn of assets over the next three to five years. US banks are much farther down this path than their European counterparts.

Figure 2: European Bank Deleveraging Forecasts Under Different Policy Responses Over 18 Months



Source: IMF as of October 2012. Complete Policies: generate moderate funding costs, affordable debt levels, reduced stress in banking system; Baseline Policies: systemic risks averted but strains remain; Weak Policies: national policies falter, political solidarity underpinning Eurozone reforms fragments, or shocks overwhelm firewalls.

Although likely sellers are European banks, it is important to note that the attractive assets that they are selling may not be European; many, for example, are in the US. Given that demand is constrained, we think that the resultant supply/demand imbalance presents an opportunity for investors to buy discounted assets, via managers with a proven track record of buying distressed assets and a broad investment mandate to do so across industries and geographies.

Bank deleveraging is normal after a credit spree and subsequent financial crisis. Of the 20 past episodes studied by the Bank for International Settlements, 17 subsequently involved bank deleveraging. This time is different only in its severity. Since the onset of the global financial crisis, banks in both Europe and the US have been shrinking their balance sheets with a will. Slowing economic growth generally, but a

European recession in particular; changing government and economic policies; new regulations and capital standards (Basel III and Solvency II): All necessitate banks to deleverage. The regulatory aim is to repair balance sheets and set the ground for a more stable global banking system.

As we noted, US banks are much farther down the path of shrinking their balance sheets. In the midst of the global financial crisis, the Federal Reserve and US Treasury were quick to take decisive measures to shore up the banking system by injecting fresh capital into financial institutions and forcing banks to take losses. Prodded by regulators, financial institutions took advantage of a more benign environment to start selling in the second half of 2009 and the rate started to pick up in 2010. Loan-to-deposit ratios for US financial firms thus fell from almost 100% in the fourth quarter of 2007 to 73% as of the second quarter of 2012. But the Federal Reserve and the Treasury are still pressuring financial firms to clean their balance sheets, imposing severe penalties for capital tied up as owning poor credit assets is accelerating the trend.

In contrast, European banks have been much slower to do so. The problem is that they have been reluctant, so far, to sell distressed assets at steep discounts, wherever they are. Such sales would, assuming the prices of those assets had not already been marked down sufficiently, cause banks to absorb immediate capital losses, sometimes large ones. But new regulations and capital standards and the length and depth of Europe's economic woes mean that recognition of losses will occur over time. The International Monetary Fund (IMF) forecasts that European banks will deleverage their balance sheets by about €2.2trn ($2.9trn) over the next 18 months. That may be an underestimate. PricewaterhouseCoopers reckons about €2.5trn ($3.3trn) of European banks' non-core loans may be for sale. Slowly, despite their obvious reluctance, European banks will need to shrink.

Private equity is going to be a major buyer of distressed assets. According to Preqin, a private equity firm, as of September 2012 private equity firms in the US and Europe specializing in distressed debt, special situations and turnarounds had about $66.5bn in available capital. Another 51 funds were seeking to raise another $43.1bn in commitments. This is something of a drop in the ocean compared to the expected refinancing and new money needs of European and US companies and banks over the next five years. The imbalance presents, we think, an opportunity for good private equity managers.

The question is one of price. Banks trying to sell assets in both Europe and the US are finding that buyers are demanding discounts of 50% for their most troubled assets. The better health of US financial firms, not least because of the relative health of the US economy and continued pressure from regulators (who are, indeed, helping to oversee the process), means that the problems of matching buyers and sellers is not as great in America. Europe, though, is another matter.

Given their perilous state, European banks are often unwilling or unable to accept such steep discounts, since the loss that they realize might undermine their capital ratios even further, especially given their dismal profits. Ironically, the European Central Bank's liquidity injections via so-called long-term, term refinancing operations early in 2012 and late in 2011 made funding easier and the need to shed assets less intense, or so the banks hoped, at any rate. But given how much more leveraged (and troubled) European banks are than their US counterparts, we think that has done little more than slow the process. What is in doubt, though, is the speed and valuations at which they do so.

That is why, in our efforts to find ways for investors to exploit this opportunity, we have been seeking managers that have a highly flexible investment approach, one that invests across a number of geographies, asset types and throughout the capital structure in order to potentially generate superior risk-adjusted returns. Typically, these managers have broad, deep and experienced market perspectives, along with opportunistic investment approaches that enable them to act nimbly and decisively — especially during periods of market dislocation.

Investing in Global Urbanization

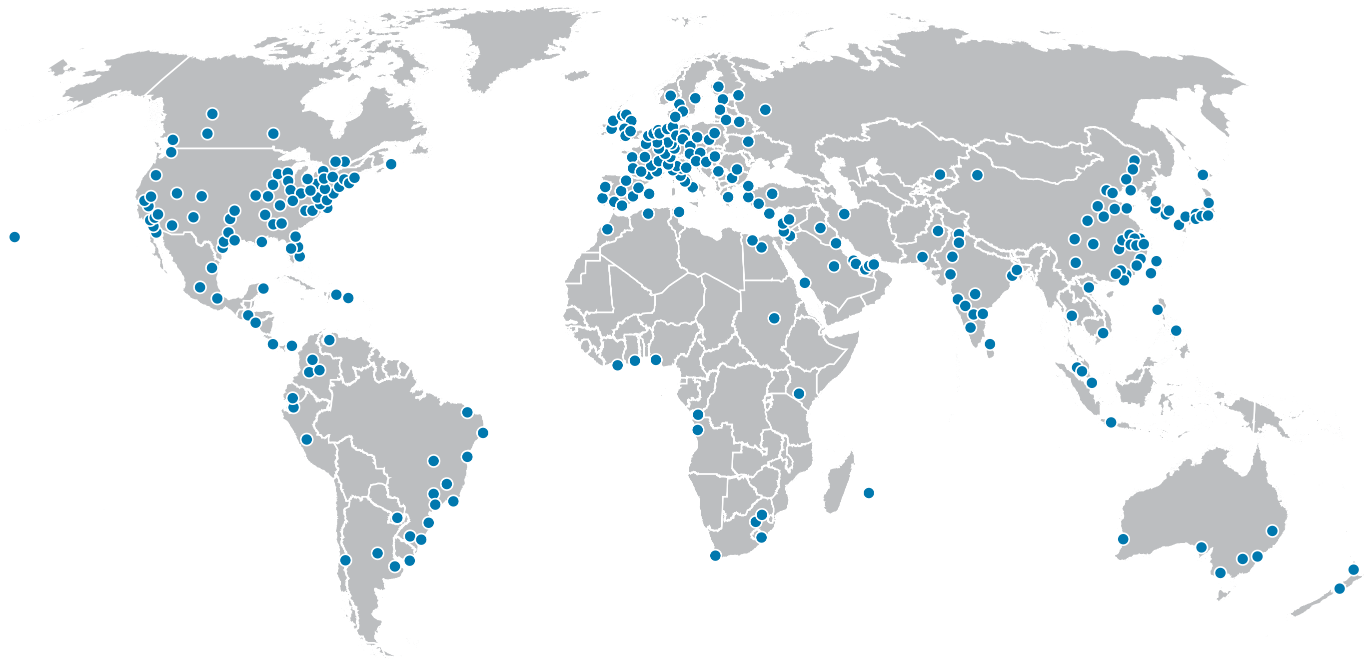
Marc Rucinski, Real Estate Research

THE SHIFT TO CITIES AND HOW TO PROFIT FROM IT

In 2008, a milestone was crossed in the way people live. For the first time, more than half of the world's population lived in urban areas. These are generally defined as cities and towns with dense populations, at least three quarters of whom are not fishing or farming. This trend will almost certainly continue, as the more widespread use of technology means fewer jobs in traditional agriculture.

The result will be bigger cities with more people crammed into them and, as a consequence, more of the world's economic activity. As economic growth becomes ever more concentrated in big cities, so the influx of a skilled, educated and highly paid workforce will continue to drive demand for urban real estate. We strongly believe that this will continue to generate attractive risk-adjusted returns in big cities.

Figure 1: 300 Cities Account for 40% of Global GDP*



Source: Jones Lang LaSalle, World Winning Cities 2012. *Based on population GDP, corporate presence, air connectivity, commercial real estate stock and real estate investment volumes.

The numbers are already striking. Although the world's largest 300 cities already account for 40% of global GDP, according to Jones Lang LaSalle, this disguises the extent to which activity is gravitating to the biggest cities. Only 30 of those cities account for 17% of global output. But they account for almost 40% of Class A commercial real estate stock in those 300 cities, and almost two thirds of their real estate investment activity.[1] Since this trend is so strong, so is the underpinning in the biggest cities for real estate investing, rental rates and valuations.

Figure 2: Top 10 Cities for Commercial Real Estate Investment 2004 versus 2011

2004	2011*
1. London	1. London
2. New York	2. New York
3. Tokyo	3. Tokyo
4. Paris	4. Hong Kong
5. Washington, DC	5. Paris
6. Los Angeles	6. Singapore
7. Chicago	7. Washington, DC
8. Atlanta	8. Shanghai
9. Dallas	9. Seoul
10. Hong Kong	10. Toronto

Key:

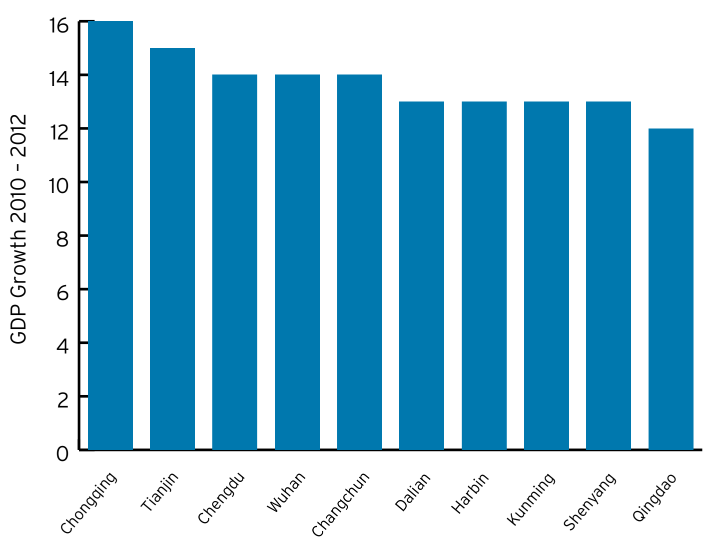
Europe
Americas
Asia Pacific

Source: Jones Lang LaSalle.

*2011 includes Q1-Q3.

Which will they be? These "top-tier cities" will comprise the most economically diverse and vital centers of global business, serving the world's leading companies, while attracting the most highly educated and highest-paid workforces. Helped in recent years by strong property rights and rule of law, the likes of London, New York, Tokyo, Paris, Singapore, Sydney and San Francisco have all done very well and will, we think, continue to do so. Joining them will be many cities in Asia, a region which by 2025 will contain at least 20 of the biggest cities ranked by GDP. In 2007, only seven of the 50 economically largest cities were in Asia.[2]

Figure 3: World's Fastest Growing Cities GDP Growth 2010 – 2012**



Source: EIU, 2011.

**Includes all cities with populations over three million.

[1]Jones Lang LaSalle: A New World of Cities, Redefining the Real Estate Investment Map: January 2012.

[2]McKinsey Global Institute: Urban World Mapping the Economic Power of Cities: March 2011.

Investors Should Consider More Opportunistic Real Estate Investments to Generate Higher Returns

Price is the big question, of course. Urban valuations are, after all, near all-time highs and there has been significant capitalization rate compression for core properties in most top-tier cities. We suggest, then, that investors should consider more opportunistic real estate investments. Investments that can transform outdated and outmoded buildings into those better able to serve current needs may offer some of the best potential returns.

These do not need only to be high-end offices and apartments. With ever greater numbers migrating to urban areas and younger people willing to forgo space for access to urban amenities, all entry points will be in high demand, especially apartments and condominiums with facilities that help offset the lack of space. Office properties with flexible floor plans needed to meet evolving tenant demands and located in cities with strong economic drivers are likely to experience higher occupancies, reduced lease-up periods and higher valuations. Retail properties that are well-located and integrated with office space in the right proportions will help draw high-end retailers and premium rents. In all cases, proximity to public transport, shops, restaurants and public amenities, such as parks and museums, will support premium valuations.

The global urbanization trend is a phenomenon that is changing the way the world's population lives and works. By investing opportunistically in well-located real estate in cities with limited supply and high barriers to entry, investors can capitalize on this trend and seek more attractive opportunities than when investing in traditional core properties.

Moreover, optimally developed or redeveloped properties that meet the demands of today's urban clients can expect premium pricing through better rental rates and premium valuations. That said, the most attractive asset class to invest in will of course vary based on local needs and supply levels for each sector. In addition, property values can fall due to environmental, economic or other reasons, and change in interest rates can negatively impact the performance of real estate companies. Identifying experienced real estate operating partners who can source, acquire and adapt existing urban real estate (whether through redevelopment, new entitlements or repositioning) into highly desirable properties will be critical in successfully benefiting from the urbanization trend.

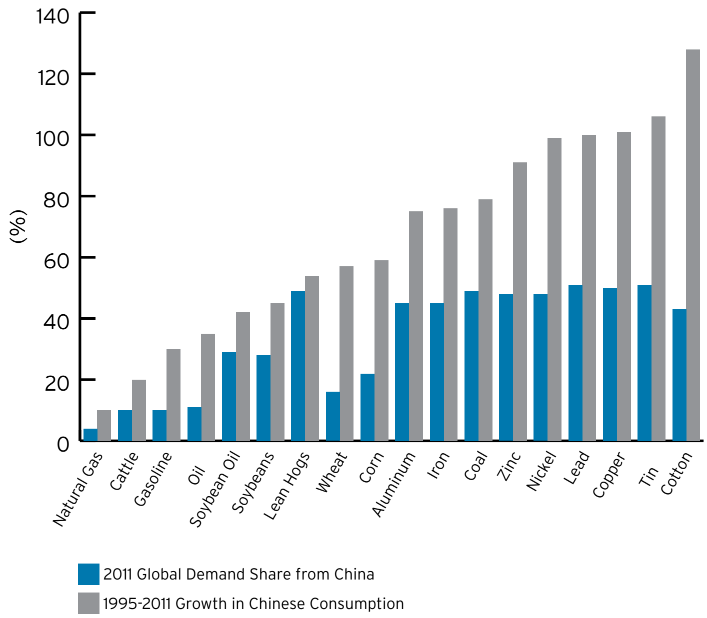
The New Abnormal

Edward Morse, Head of Global Commodities Research, Citi Research
Aakash Doshi, Commodities Strategist, Citi Research

The commodity super-cycle is over and conditions approximating those of the last decade won't return anytime soon. No longer will a pure long-only strategy bring the juicy returns investors received in 2002–2008. All is not lost though: There are still ways to take advantage of swings in commodities prices.

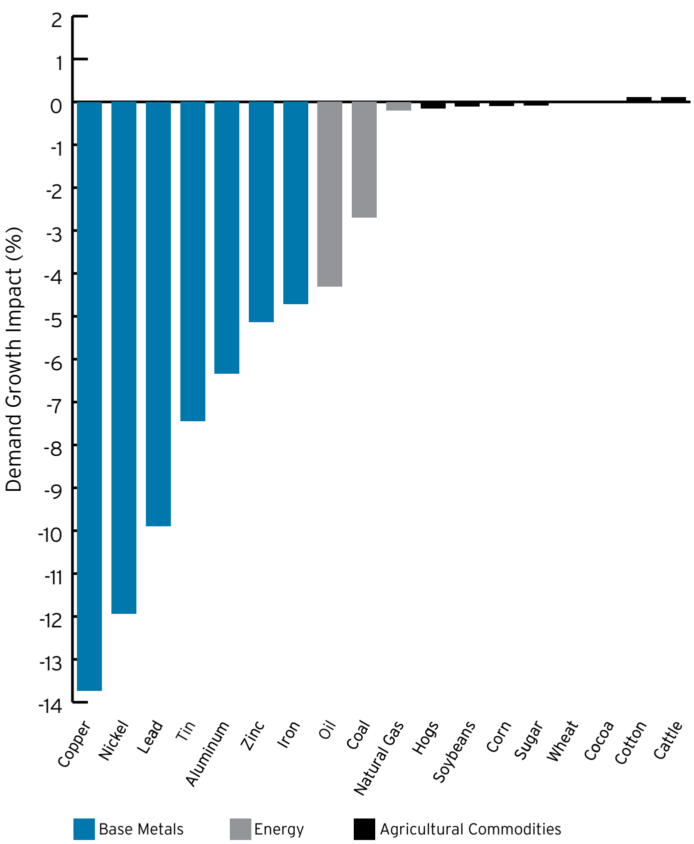
There are both supply and demand aspects to this unfolding new commodities paradigm. On the demand side are two structural shifts in China. First is the shift from robust 10% and over annual GDP growth of the past three decades to a significantly lower 6%–7% annual rate in the medium term and to under 6% by the end of this decade. At some point in the near term, though, China will likely have to confront an even more significant short-term rebalancing. The second structural shift in China is that its growth is likely to be much less energy and commodity-intensive than in the past, driven as it was by galloping increases in fixed asset investment and industrial production. The elimination of subsidies is already occurring, slowing demand for electricity and other energy sources as well as for base metals and bulk commodities. As seen in Figures 1 and 2, the combination of these two factors has repercussions across commodities, particularly those linked to industrial output.

Figure 1: Share of Chinese World Commodity Demand (2011) and Growth in Chinese Consumption (1995 – 2011)



Source: Citi Research, *The New Abnormal*, November 2012.

Figure 2: Impact of Commodity Demand Growth of Chinese "New Abnormal"



Source: Citi Research, *The New Abnormal*, November 2012.

Nonetheless, we expect a global rebound in commodities demand from today's weak levels at some point, perhaps by the end of 2013, although that assumes that all of the policy stimuli packages around the world are effective. But even assuming that demand were to rebound with global growth, commodity prices are unlikely to move sharply higher. This is because at the same time that demand has been waning — and is likely to continue to do so over time — supply in many commodities has been waxing.

What first occurred in US natural gas — a marshalling of capital and a new supply surplus — is being replicated across most commodities, including critical industrial and bulk commodities and in other longer-lead time products such as oil, despite supply disruption risks.

Indeed, disruption risks in oil markets have disguised the amount to which supply is increasing. There has been a marked increase in the normal scale of supply disruptions in oil, more than doubling from 400,000–500,000 barrels a day before the Libyan revolution. Indeed, add to that imposed boycotts on Iranian crude oil as 2013 approaches and over two million barrels a day of oil that could be available are off-line. Yet significantly higher oil and gas production is a possibility, perhaps even likely in many countries (Angola, Australia, Brazil, Canada, China, Colombia, Cyprus, Iran, Iraq, Israel, Kurdistan, Mexico, Russia, Sudan, much of East Africa), but "above-ground" issues keep preventing the oil from either being produced or evacuated efficiently to markets. As a result, the residual inventory for the world — Saudi spare production capacity — has been limited, buoying prices.

Because of these new supply and demand conditions, commodity performance is likely to become more differentiated, with winners and losers depending on the supply/demand balances for individual commodities.

We expect industrial metals to see mostly steady prices from 2012 into 2013, but with copper weakening and nickel, tin and zinc showing modest strength. Crude oil looks to be under pressure with the weight of incremental supply balanced less by demand than by those episodic supply disruptions. Precious metals look to remain firm, particularly gold, platinum and palladium, with major bulk commodities weakening. Grains markets will be adjusting to tight inventory conditions ahead but should weaken as more normalized weather patterns reemerge. Most soft commodities will likely remain subdued, with cocoa possibly seeing modest strength in the period ahead on stronger demand given the recent selloff.

INCREASED SEASONALITY CAN PROVIDE POTENTIAL OPPORTUNITIES

Seasonality will become more important to short-term price swings. In oil and grains, seasonality has been on the rise over the past few years, impacting fuel and food and through them headline inflation rates across the world. This increase reflects changing precipitation and temperature as well as changing inventory patterns. For investors, increased seasonality can provide unusual opportunities. Changing conditions in global refining make the long-short trades for summer gasoline versus heating oil and for winter heating oil versus gasoline workable, depending on timing. In grains markets, an early seasonal preview of precipitation and likely temperatures can also provide opportunities for significant investment gains in the months ahead. This is likely to be a permanent feature of the grains markets, given the extreme weather conditions being sparked by changing climatic conditions.

Enhanced seasonality, far more differentiation between price movements in various commodities and changing macro conditions will continue to create new long-short strategic opportunities and new ways to invest across different asset classes, combining commodities with foreign exchange as well as other risk markets including equities. As suitable or as appropriate, it also means that investors should start to think about using structured strategies and actively managed portfolios that seek to arbitrage the medium-term structural changes taking shape in commodities whereby prices are prone to be more range-bound or cyclical.

Last but not least is the most significant reason for investors to consider having commodity exposure despite the end of the super-cycle. When it comes to tail risk, no asset provides the exceptional rewards that can be found in commodities.

For example, over the past four years, grains have provided returns of 70% or more twice over a calendar quarter. And petroleum has been similarly if rather less volatile. Those exceptional rewards should continue to make commodities an attractive investment vehicle for a wide array of portfolio managers, as no other asset class provides such an opportunity from secular and idiosyncratic wildcards.

Generally, index components composed of futures contracts on nickel or copper, which are industrial metals, may be subject to a number of additional factors specific to industrial metals that might cause price volatility. These include changes in the level of industrial activity using industrial metals (including the availability of substitutes such as man-made or synthetic substitutes); disruptions in the supply chain, from mining to storage to smelting or refining; adjustments to inventory; variations in production costs, including storage, labor and energy costs; costs associated with regulatory compliance, including environmental regulations; and changes in industrial, government and consumer demand, both in individual consuming nations and internationally. Index components concentrated in futures contracts on agricultural products, including grains, may be subject to a number of additional factors specific to agricultural products that might cause price volatility. These include weather conditions, including floods, drought and freezing conditions; changes in government policies; planting decisions; and changes in demand for agricultural products, both with end users and as inputs into various industries.

An Asset Class for All Seasons

Malay Ghatak, Head of Global Investment Product Management

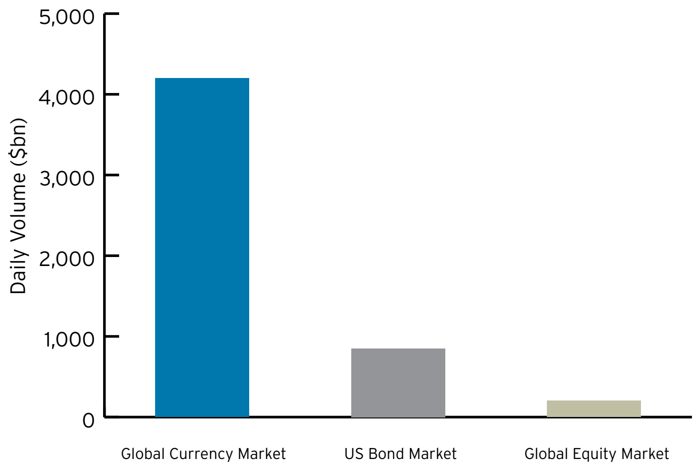
When it comes to investing, the subject that perhaps leads to the most questions is foreign exchange. Many people still tend to think of foreign exchange as an exposure rather than an asset class, one that arises, for example, from investing overseas in better-understood investments. Yet we believe they should think differently.

Foreign exchange markets are often deep and liquid, offering virtually continuous trading, which makes expressing macro views easier than in other asset classes (Figures 1 and 2). Some currency pairs are almost "perfect" markets, in that transaction costs are tiny, investors can trade large sums and they are transparent.

Historically, there have been broadly two approaches to foreign exchange markets. At one extreme are high-octane speculators, who specialize in taking leveraged directional positions on currency pairs, as well as the volatility of those currencies through options. At the other extreme are pure-play equity, private equity, fixed income and real estate investors, who make every effort to remove the impact of currency movements from their portfolios. But an interesting middle ground has developed over the last ten years or so, as more investors have started to take both strategic and tactical views on foreign exchange.

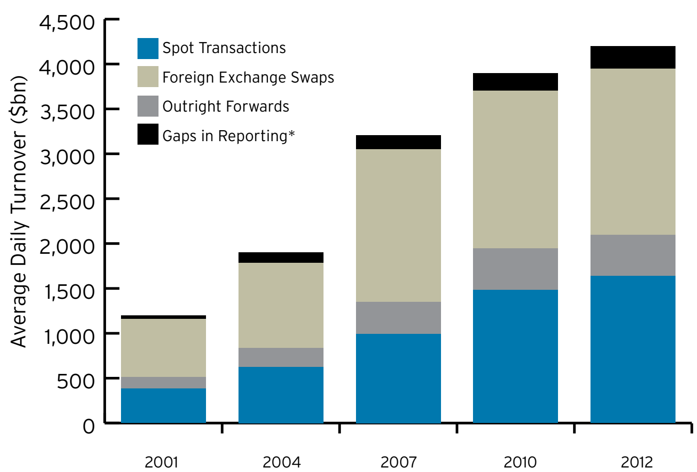
This trend has been driven by many factors, though three stand out. The first is the realization that currency risk is not something they can ignore or lock away. The second is a sharp increase in the number of currency pairs that are available to trade, not least those in emerging markets, in which investors have taken a much greater interest over the past ten years. Markets in their currencies are often now much deeper and more liquid. Third, quite simply, is that the biggest emerging economies have grown so fast compared with their rich-world counterparts, that they are now just more important. Currencies of countries with abundant natural resources, such as the Brazilian real or the South African rand, have been big favorites.

Figure 1: Daily Volume of Currency Market vs. Bond and Equity Markets



Source: Bank of International Settlements; TheCityUK estimates; Federal Reserve Bank of New York, Municipal Securities Rulemaking Board, FINRA TRACE; World Federation of Exchanges Members, as of August 2012.

Figure 2: Global Foreign Exchange Market Turnover by Instrument



Source: Bank of International Settlements; TheCityUK estimates. *Incomplete reporting of deals. 2012 data as of August 31, 2012. The FX market is the largest and most liquid financial market in the world with a daily trading volume of over $4.2trn. By comparison, the daily volume of the global equity market is approximately $200bn.

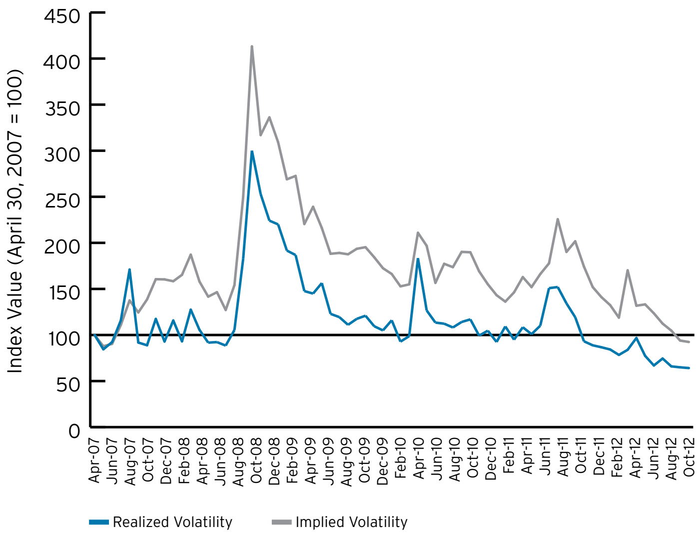
At a more tactical level, currency markets have become much more popular for playing macro trends, such as momentum (buying or selling something that appears likely to carry on in the same direction); carry (financing the buying of higher-yielding currencies by selling lower-yielding ones); and risk on/risk off (a general appetite for risk or safety). Historically, these trading strategies were the exclusive preserve of specialist Macro hedge funds or Commodity Trading Advisors (CTAs). This is now no longer the case, since private investors have cheap access to trading and the strategies themselves.

The challenge for foreign exchange is that forecasting currency pairs is even harder than forecasting other asset classes. This is partly because currency movements, perhaps even more than other asset classes, rely on a multitude of factors: growth, monetary and fiscal policy, capital and current account trends, inflation, and market positioning, to name but a few. But there is a more fundamental reason. With currencies you are always forecasting not one thing but two: There are two sides to every trade. Added to this is the fact that nominal exchange rates can deviate from theoretical value (however that may be calculated) for long periods, often years.

For all carry, trend-following, macro and volatility-driven investors, 2012 was a particularly frustrating year. Implied and realized currency volatility dropped to very low levels (Figure 3), while policy rates in the world's largest economies have all fallen to just about zero. Meanwhile, growth has failed to pick up meaningfully for the same reason that rates are likely to stay at nothing: The world's big advanced economies are still deleveraging. Downside has, however, been constrained by massive central bank quantitative easing.

Figure 3: Historical Implied and Realized Volatilities for G10 Ex-US Currencies*

Currency volatility dropped to very low levels in 2012:



*Equal-weighted basket of G10 ex-US currencies.
Source: Citi Private Bank using Bloomberg, as of October, 2012.

Perhaps none of that will change in 2013. But there are a few big, longer-term questions. The two biggest are also related: How should investors think about gold as a store of value? And how safe are fiat currencies (currencies that used to be backed by gold but now aren't)?

Gold's latest surge over the past few years has been helped by very fragile growth; political instability in many parts of the world; a much lower opportunity cost of holding it (given that rates around the world are so low); and massive money-printing by central banks. Small wonder, perhaps, that the value of something you can't print has risen in comparison. While we still like gold, we are not hugely bullish. The sheer quantity of investors now holding gold have made it, like many other assets, much more correlated to risk.

We prefer to hold the yellow metal in non-dollar terms, specifically euros, since this provides a much better hedge.

And what, more generally, of the fate of currencies where the policymakers are having to resort to quantitative easing? Many investors have been very wary about them, preferring commodity-producing countries. The problem with this argument, from our viewpoint, is that China is key to demand for commodities and China is slowing. That is largely why commodities prices have dropped and so, too, have the likes of the Brazilian real and the South African rand. Strikingly, China has suffered a net capital outflow for most of the past year.

Possibly, these questions won't be answered this year. But history teaches us that extended periods of low volatility are often followed by severe moves.

Investors would thus be prudent to avoid selling currency volatility at very low levels to generate yield, and to use such opportunities to hedge their portfolios.

Foreign exchange transactions are not suitable for all investors and are intended for experienced and sophisticated investors.

NOTES

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▶ NOTES

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