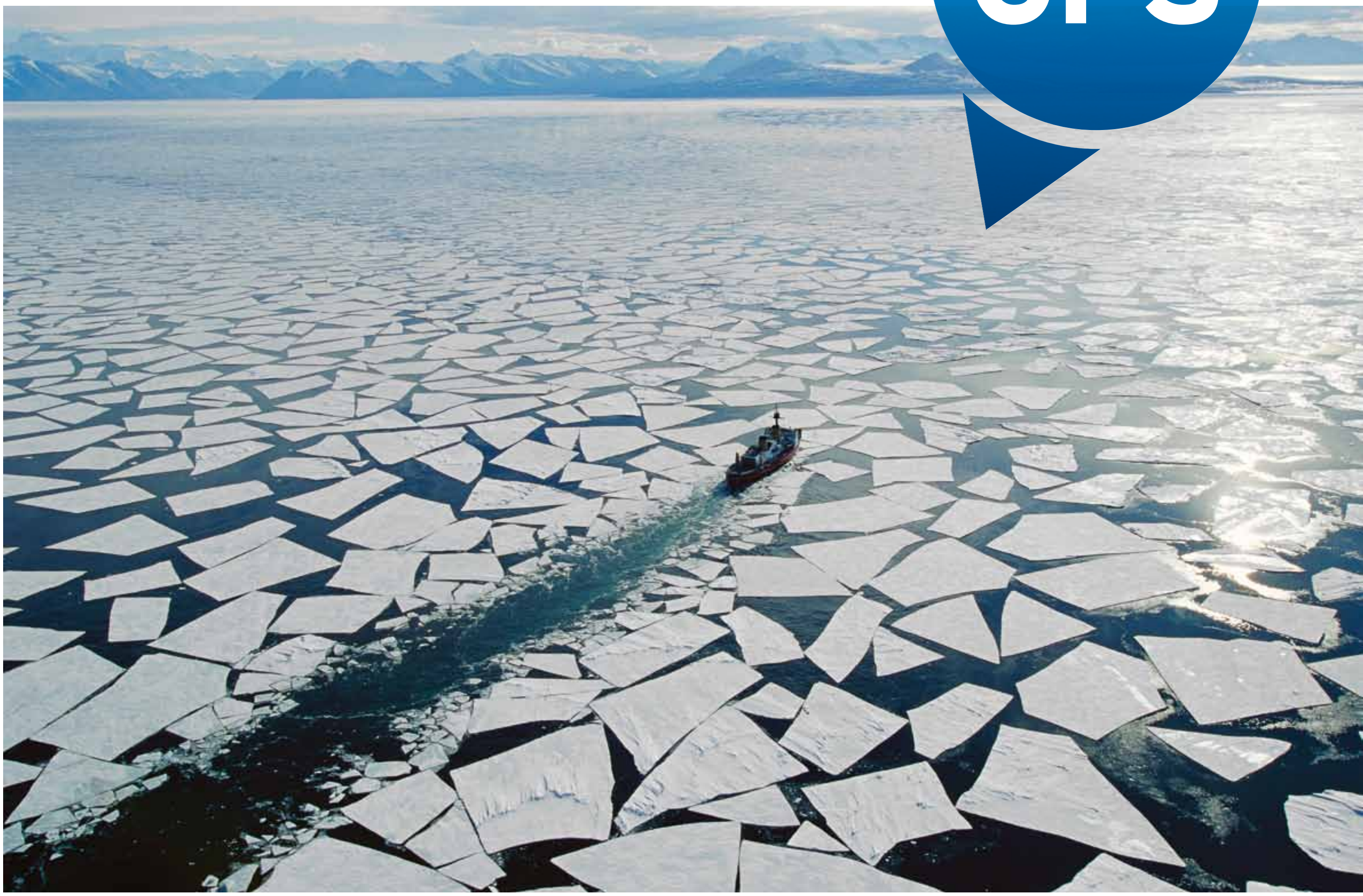

2012 INVESTMENT THEMES

Navigating Towards a Growth Course

Citi GPS: Global Perspectives & Solutions

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2012 INVESTMENT THEMES

Navigating Towards a Growth Course

Most investors were only too happy to see the back of 2011 and now look forward to 2012 with a sense of cautious optimism that things will be brighter. What do we think brighter means? For our purposes, it means growth — growth in confidence, growth in employment, growth in income, growth in spending and growth in the economy. 2012 looks to be a year where we seek to get ourselves out of the doldrums and get our confidence back. Inevitably, though, we will encounter challenges on the path to growth — some that are forecast, some that will surprise — in addition to a certain amount of "baggage" that we carried forward from last year despite us wishing it would disappear with the turn of the calendar page.

Globally we expect the economy to grow 2.5% in 2012, down from about 3% in 2011 and from over 4% in 2010. Compared to a typical recession, today's GDP growth is somewhat weaker than expected and unemployment is still much higher than one would expect to see at this point in the recovery. Because of this, many investors are beginning to believe that the major developed economies are on the threshold of a "lost decade". Governments, households and financial institutions are working to pay down debt levels that have been building up over the past 30 years — built to levels that haven't been seen since the 1930s. History shows previous periods of de-leveraging have often been times of below-average real GDP growth and "lost decades". The question that needs to be answered is whether the world can delever without this having a knock-on effect on asset prices and economic growth. We think confidence could be the determining factor here.

The crisis in Europe continues to be a drag on the global economy, with the sovereign and banking crisis likely to lead to a protracted recession in the eurozone. Incremental fiscal tightening, structural reforms, tight financial conditions and a continued "uncertainty overhang", which is weighing strongly on domestic demand, all contribute to the curtailing of economic growth. The European crisis is not just a European problem as multi-nationals that trade directly in Europe and firms that compete with European exporters in other markets are all affected. Although the euro area will be under intense strain, we believe it will likely remain intact and, given the high costs of exit for any member country, a break-up of the eurozone has less than a 5% probability.

Despite the obvious macro headwinds, global corporate earnings and cash flow continue to grow at a solid rate. While these are typically a positive sign for investment and job growth, high levels of volatility and ongoing uncertainty of late have resulted in a meaningful slowing of capex investment by corporates over the past two years. With the cost of equity high and the cost of debt unusually low, corporates have instead been de-equitising — using cash to buy cheap equity or pay big dividends. Although this should continue to support stock prices going forward, it remains to be seen if economic growth can recover without an increase in capex to fuel job growth.

Discussion around tail risks will continue to make headlines in 2012 as investors and corporates worry about the potential of the "next shoe to drop". The fate of the Chinese economy and whether its growth engine can continue to drive global demand is a concern but we believe rebalancing to promote structural and marginal demand would lay a solid footing for continued growth. Countries moving towards financial repression to solve their debt problems could also slow emerging market growth but we argue that EMs might react quite favourably to such measures. Commodities are being torn between lower demand impact from the US, Europe and China and supply disruptions due to political unrest. For 2012, we believe most commodity prices will be range-bound but subject to both downside demand and upside supply tail risks.

Contents

1. Europe – Crisis Outlook

Willem Buiter
Chief Global Economist

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Global Economics

We expect the euro area (EA) sovereign debt and banking crisis to intensify further in 2012, with sovereign yield spreads vs. Bunds and bank funding stress remaining high in many EA countries, and the EA in recession. We do not, however, expect the euro area to break up in 2012 or the following years, nor do we expect the disorderly default of an EA sovereign. The risk that either or both of these disaster scenarios materialise is, however, non-negligible.

In our central projection, two or more insolvent sovereigns (Greece, Portugal, and possibly Ireland) undergo orderly debt restructuring in 2012-13. We also expect a ring-fencing of the illiquid but most likely solvent sovereigns (Italy, Spain, Belgium, France and Austria) through greater ECB involvement, directly or indirectly, as lender of last resort for sovereigns and for banks, through enhanced EA-wide fiscal facilities and through extra-EU assistance, most likely organized through the IMF. This suggests that, after increasing market stress and further widening of sovereign bond spreads in 1H 2012, spreads are likely to narrow in the course of the year but remain at high levels. Finally, we expect fiscal support, through national governments or through EA or EU institutions or facilities (such as the EFSF/ESM or the EIB), for bank recapitalization and for term bank funding. In addition to the limited further fiscal integration in the EA implied by our central projection for 2012, we also expect the euro area countries to commit to and take the first steps towards deeper fiscal integration to prevent and mitigate future fiscal debacles. Joint and several guaranteed E-bonds can be part of this medium-term scenario, but are unlikely to figure prominently in the solution of the present crisis.

Incremental fiscal tightening, structural reforms, tight financial conditions and a continued ‘uncertainty overhang’ will strongly weigh on domestic demand and push the EA into recession in 2012. We also expect a further GDP contraction in 2013. Then and thereafter, very loose monetary policy and external demand will prop up growth, while domestic demand is likely to remain weak.

Gross financing requirements for Austria, Belgium, France, Italy, the Netherlands, and Spain exceed €2trn until 2Q 2014. Italy and Spain alone need to jointly raise around €10bn every week in 2012 and 2013. Against that, deducting the current commitments to the Irish, Portuguese and second Greek programs, the European Financial Stability Facility (EFSF) has around €300bn of loss absorption capacity available and even that amount currently exists only in the form of guarantees rather than cash. As plans to leverage the firepower to the EFSF to €1trn seem unlikely to work, the EFSF would run out of money in a matter of months if it had to fund both Italy and Spain — two countries at high risk of losing market access completely. This would leave the EFSF without any funds to expend on secondary market purchases or bank support. Increasing the size of the EFSF is, regrettably, politically infeasible at the moment.

Enter the euro area’s lender of last resort: the ECB

In the absence of sufficiently large sources of funding from outside the EU, more substantial ECB support will be needed to avoid disorderly default of global systematically significant EA sovereigns such as Italy and Spain. We expect such ECB support to be forthcoming. The ECB could substantially expand its secondary market purchases of EA sovereign debt in the Securities Markets Programme (SMP) or directly or indirectly fund other vehicles (such as the IMF, the EFSF or the EIB) to purchase EA sovereign debt in primary or secondary markets or to bypass the sovereign debt markets altogether by providing loans. The ECB has already loosened collateral requirements for funding EA banks, reduced minimum reserve requirements for these banks and started providing 3-year funding through its new long-term refinancing operation that is likely to be partially used to buy EA sovereign debt. Faced with the choice between financial stability — avoiding disorderly EA sovereign defaults that would bring down much of the European and American banking system — and strict adherence to its purported principle of not providing either quasi-fiscal or liquidity support to EA sovereigns, the ECB is likely to choose financial stability, as it did in May 2010. But, as in the past, the ECB is likely to insist on and succeed in obtaining reciprocal actions by the beneficiary countries (through greater fiscal austerity and structural reform) and by the EA member states collectively, through enhanced joint fiscal support facilities and through commitments to greater fiscal integration in the future.

Continued and expanded ECB support for EA sovereigns requires four conditions to be met. First, market conditions need to be very tight and disorderly. It is possible that it would take one or two actual auction failures by Italy or Spain as a potential catalyst to spur the ECB into action. Second, policymakers of countries in need of ECB support, such as Italy or Spain, would need to make credible commitments to undertake further fiscal and structural reform to reduce future non-market funding requirements, probably under a Troika program. Third, policymakers of creditor/ donor nations, notably Germany, would need to commit to increasing their own fiscal support activities, by finalizing and implementing EFSF reform that is already agreed in principle, and by charting ways to reduce the need for ECB involvement in the future, including further increases in the EFSF/ESM guarantees or credible steps towards fiscal integration in the medium term. Fourth, euro area governance rules have to be tightened immediately, including the commitment to introduce automatic penalties for countries that do not comply with the fiscal rules of the enhanced Stability and Growth Pact.

Can the euro area survive?

Our base case remains that the euro area will not break up. However, risks of break-up are no non-negligible. The ECB's refusal to stand behind expanded rescue efforts could, if it turns out to be more than another tough move in the three-sided game of chicken between the ECB, the beneficiary countries and the donor countries, result in a string of disorderly EA sovereign defaults and EA break-up. Even if the ECB acts, the German parliament and population may decide that such an increase in ECB support is a price not worth paying for EA membership and walk out, probably together with other core countries. In light of the very high costs that these decisions would entail, we would give both scenarios a very low (sub 5%) probability of happening.

Debtor countries are likely to have to accept greater oversight and a partial surrender of fiscal sovereignty in return for expanded support, as is currently being proposed by the EU Commission. Such politically intrusive oversight, coupled with growing consolidation fatigue after years of austerity and recession, may lead to one of more countries storming out of the euro area. Such a break-up scenario would be somewhat less damaging, in our view, because it would result in less risk of 'exit fear contagion' than a forced exit. We also still consider an exit by a fiscally weak country very unlikely, except in the case of Greece, but the risk s of such irrational actions may clearly rise over time. In view of the continuing high degree of political uncertainty in Greece, it cannot be ruled out that the country will leave the euro (around 25% probability, in our view), either by storming out, or by being pushed out because of a refusal by the Troika to continue funding the sovereign and the banks following non-compliance with the Greek program, possibly around the time of the next round of private sector/official sector involvement.

2. Global Politics - Vox Populi

Tina Fordham
Senior Global Political Analyst

2011 was, from a political perspective, a 'year of living dangerously', dominated by the collision between sovereign debt dynamics and weak leadership in the developed world, political change and conflict in MENA, and rising social unrest globally. 2012 is shaping up to feature the continuation of these themes plus two more: a concentration of elections and leadership transitions in some of the world's largest economies, and rising geopolitical tensions. The risks from this more unstable political outlook against a worsening global economic backdrop as well as growing scepticism that politicians possess the will or the capacity to act will bear great significance for markets, in our view, and signal that the post-financial crisis re-calibration between government, society, and markets is still evolving.

Across developed markets and emerging markets, rising anti-establishment sentiment is a theme that is increasingly prevalent, and risky. The emergence of more globalized public expectations — whether anxiety over stagnating living standards in the developed world or demands for enhanced civil and political rights in the emerging markets— that was much in evidence in 2011 will only accelerate, in our view.

Revolutions are complex and relatively rare, requiring the masses to overcome differences in pursuit of a common goal, but increased access to information and communications technology has dramatically narrowed the distance between people and helped them overcome fear of the authorities. The result is profound: a reduced willingness to tolerate the perceived excesses of elites and the old social order, and heightened potential for protests to cause disruption, violence, and pressure to alter the legislative agenda. The most recent example of this new global protest movement came as a surprise to many: Russia, where disputed parliamentary elections have prompted the largest protests of the post-Soviet period, dealing a significant blow to Putin's once enviable popularity. The broader implication is clear: assumptions of long-term political stability, even where living standards are improved, should be revisited.

For 2012, the political risk factor that both government officials and market participants must track closely is shifting and more volatile public opinion — the Vox Populi. This marks a change in trend from previous decades, which saw widespread progress toward the globalization, democracy and free trade agenda and limited instances of protest.

New protest movements and political parties

With six eurozone governments collapsing in 2011 and the majority of leaders in the advanced economies experiencing approval ratings well below 50%, pronounced public dissatisfaction with political elites is evident. Two trends are emerging as a result: growing public protests and a proliferation of new political parties and movements. Both pose challenges to the prevailing political order.

Although "people power" has not yet consolidated into electoral power in many cases, we judge that loosely organized movements such as Occupy Wall St and Spain's 'Los Indignados' have already influenced the political process by drawing attention to income inequality and youth unemployment, issues that subsequently enjoy higher public awareness. While they have yet to move beyond slumber parties to fielding candidates or articulating concrete policies, the potential over time for these movements to consolidate into more organized political forces will increase in the event of a deeper recession or extended period of slow growth, in our view.

The second trend is the emergence of new political parties and movements, from the Republican-aligned Tea Party movement in the US, to a host of new parties in Europe and the rise of political Islamist parties in the Arab world. In the mature democracies, these groups and parties are distinguished by their focus on budgetary and fiscal considerations. Parties such as the Dutch Freedom Party and Finland's True Finns have historically been defined by opposition to immigration, limiting their public support. By expanding their agenda to fiscal considerations, especially unpopular eurozone bailouts, they have attracted sufficient support to enter parliament. While the role of these new parties remains small, as dealmakers or spoilers, a protracted economic crisis would likely see their public support grow and could increase the weight of non-mainstream ideas in the political process. A key test of the appeal of right-wing populism will come with French elections in April and May, where the National Front could draw support from dissatisfied voters on both the left and the right, potentially taking the contest into a second round and influencing the tenor of the debate.

Yet despite fears that the global financial crisis would prompt a resurgence of radical 20th-century political ideologies such as communism or fascism, none of the post-crisis political shifts evident to date presents a meaningful challenge to liberal democracy and capitalism, in our view. Indeed, the highly indebted countries along the eurozone periphery that held elections last year not only voted in parties from the mainstream opposition campaigning on a platform of adherence to bailout conditions, but awarded them a mandate with parliamentary majorities. This suggests that in the developed world, the new political divide is between the politics of credit and debt, governance and globalization rather than the traditional left and right sides of the spectrum.

While social tensions and political change are at perhaps their highest level in decades, we do not foresee a return to the political ideologies of the 1930s. The key factors underpinning our view include the fact that current unemployment, while high, is nowhere near the 25% level of the Great Depression; the presence of a social safety net that helps minimize social deprivation; and the end of communist regimes in most of the world since the 1990s. These factors limit the appeal of radical ideologies, though the risk of populism and anti-globalization policies remains.

Figure 1. Key Election Dates in 2012

14-Jan	Taiwan Presidential	1-Jul	Mexico Presidential & Legislative
4-Mar	Russia Presidential	July	India Presidential
29-Mar	Iran Parliamentary	September	Angola Parliamentary
March	Greece Parliamentary	October	China Leadership Transition
22-Apr	France Presidential	7-Oct	Venezuela Presidential
April	South Korea Parliamentary	6-Nov	USA Presidential & Legislative
June	Egypt Presidential	December	South Korea Presidential Elections

Source: IFES Election Guide - Election Calendar, World Events Calendar - Council on Foreign Relations, CIRA

3. Payback Time - Delever Decade

Matt King
Global Head of Credit Products Strategy

Over the past 30 years, the global economy has produced strong and steady GDP growth accompanied by a rally in asset prices (equities, real estate and bonds). This growth, however, has been accompanied by an increase in borrowing. In the US there's a pretty good relationship between the amount of borrowing and the amount of GDP growth and this also holds across other countries — the more you borrowed, the more you grew. Given the current economic climate and the recent focus on sovereign debt and on debt in general, it is increasingly clear that the next 10 years are unlikely to see debt levels increase. The question that needs to be answered is whether we can run the process in reverse — deleverage — and not have a knock-on effect on asset prices and economic growth.

Where are we in the recovery?

Investors are struggling to make sense of the current economic recovery. The consensus view has been that, although we lost some output in the recession, we should bounce back to the same growth trajectory going forward. This can be seen in consensus expectations for long-term growth in the US which remain in the 2.7% or so range. But if you look at prior financial crises, what you find is that after the recessionary drop in output, you tend to also get a lower trajectory of growth because people are forced to deal with their debt.

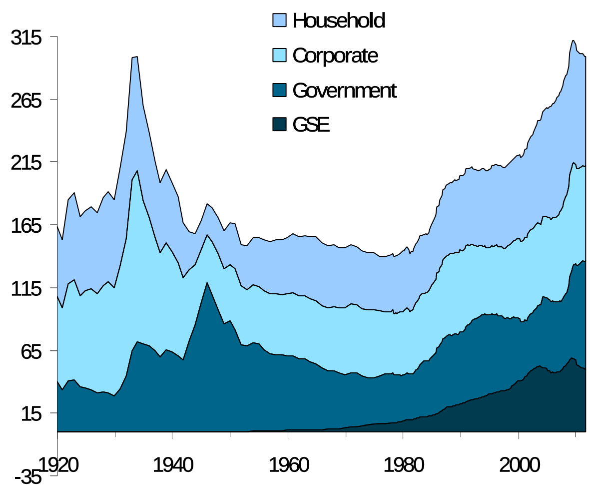
Looking at the current state of the global economy, the recovery in GDP growth has been a little weak compared to a typical recession while equity markets have rebounded even more strongly than usual. But something seems broken, as unemployment is still much higher than we would expect to see at this point in the recovery. In the past, central banks' interest rate cuts have always managed to spark rises in consumer borrowing and associated spending. But this time we have interest rates lower than ever, and yet, instead of borrowing, consumers are choosing to pay down their debt. On the corporate side, borrowing is picking up, but mostly to fund share buybacks or M&A, not to fund investments that would lead to new hiring and lower unemployment. Fixing this has more to do with increasing confidence in the future than with lowering interest rates.

How much debt have we built up?

The amount that we've borrowed over the past 30 years is somewhat alarming. In the US, debt-to-GDP across nonfinancial parts of the economy is at a level last seen in the 1930s. To date, almost all of the deleveraging by corporates and consumers has been offset by an increase in government debt. Here lies the problem. There have been no instances of an advanced economy that paid down debt across both the public and private sector over the last 30 years or even in any individual decade over the last 30 years. It's all been about leveraging up.

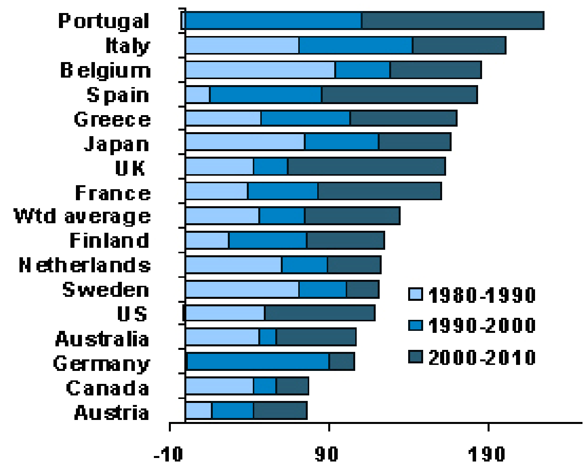
How did we get this levered? Blame it on the Wealth Effect — the feeling that we were worth it. What allowed consumers to save less and less and spend more and more in the 1980s and 1990s was that their net worth was going up as the markets were saving for them. As their net worth has fallen with the fall-off in markets, consumers have had to save more. If consumers are saving more that means they are borrowing less and spending less. If they don't spend then they're not driving someone's profit line, which in turn risks having a negative effect upon asset prices. But if consumers start to fear for their net worth — either as a result of this, or perhaps in response to governments embarking upon fiscal tightening — they will save all the more, creating a vicious circle.

Figure 2. That 1930s Feeling – US Debt/GDP across nonfinancial sectors



Source: Citi Investment Research and Analysis

Figure 3. Household, Corporate & Gov't Debt Chg by Decade, % GDP



Source: Citi Investment Research and Analysis

Can you have government deleveraging and economic growth?

Yes, there have been cases where governments have successfully tightened their fiscal policies, but under further examination the reason they were so successful was that government deleveraging was offset by a leveraging up by the private sector. Part of the reason why governments have leveraged up today is because corporates and individuals are saving and government investment is the only way to drive the economy. There have been historical episodes where both public and private sectors have deleveraged but in these cases, depreciation of the currency has been the key to success. This is something that's much easier for a smaller economy to do when the rest of the world is growing. It's much more difficult for, say, the US, as emerging markets are pegged to the dollar, or for eurozone periphery countries, which are locked into a common currency.

Against such a backdrop, deleveraging is liable to prove painful. Just how painful, depends critically upon confidence. Dealing with debt isn't just about how much there is, but also about your expectations for asset prices. A big mortgage isn't a worry if you think real estate prices are going to rise but if you think prices are going to fall, it's logical to pay your mortgage down. Decisive intervention from the central banks is one way to try to prop up asset prices, but as confidence in their ability to do so waxes and wanes, so there is likely to be more volatile GDP growth over the coming decade.

Conclusions for fixed income & credit

Over the next 10 years, debt in developed countries needs to fall. It seems highly unlikely that we continue to lever up like we have over the past 30 years. But deleveraging on this scale has not been attempted since at least the 1930s and demographics are likely to make things harder now too. The challenge will be to test the linkages between debt growth, economic growth and asset growth to see if we can grow without borrowing. The good news is it's all about confidence. The bad news is that this makes for a very uncertain environment. This is positive for fixed income investments, which over an extended time horizon seem likely to offer better risk-adjusted returns than riskier vehicles such as real estate or equities.

4. Lost Decades - How to Survive

Robert Buckland
Global Equity Strategist

Many investors are of the view that major developed economies are on the threshold of a "lost decade" — a long period of low growth — as governments, households, and financial institutions work to pay down debt.

Surprisingly, equity market performance in "lost decades" has not always been poor. Of course, low growth itself is a negative for corporate earnings and equity markets but equity markets have risen in a few historical "lost decade" instances. We find that these examples have three things in common: 1) low starting valuations; 2) rising EPS; and 3) higher inflation. Companies that have done best during these "lost decades" share common characteristics. They look for new sources of demand, they have pricing power, they are effecting in managing costs, and they de-equitise.

Mention of a "lost decade" immediately conjures up thoughts of Japan's dismal economic performance over the past 20 years. Japanese real GDP grew by just 1.4% per annum during the 1990s and a paltry 0.7% over the past 10 years. However, if we define "lost decades" as those with little, if any, real GDP growth over a rolling 10-year period, we can find 10 examples, not just Japan, over the last 20 years including the US in the 1930s and the UK in the 1970s.

Figure 4. Lost Decades

Region/ Sector	Start Year	Real GDP/ Volume	Equity Mkt Return* (Capital)	Equity Mkt Return* (Total)	Bond Returns	Inflation^	EPS CAGR	Starting Cyclically Adjusted PE
Sweden	1988	1.4%	20%	22%	14%	5%	15%	20
UK	1974	1.5%	13%	19%	15%	14%	10%	16
Italy	1990	1.4%	10%	13%	15%	4%	2%	23
Germany	1993	1.4%	5%	7%	8%	2%	2%	16
US Tobacco	1980	-1.8%	3%	3%	n.a	9%	5%	16
UK Retail	1990	1.7%	-2%	-2%	n.a	2%	4%	24
Eurozone	2001	1.1%	-3%	0%	-5%	2%	2%	46
Japan	1990	1.4%	-3%	-3%	7%	1%	-6%	93
US	1929	0.8%	-6%	-1%	-1%	-2%	-7%	26
Japan	2000	0.7%	-6%	-5%	2%	0%	2%	63

* US Tobacco and UK Retail returns are relative to local equity market ^ Annualized rate of change except for US Tobacco and UK retail implicit price deflator, start years and starting cyclically adjusted PERs
Source: Datastream, GFD, MSCI, Citi Investment Research & Analysis

Are we at the beginning of another lost decade in developed markets? We highlighted earlier that the last 30 years have been characterized by a building up of debt in most developed economies. And the linkages between economic and credit growth mean that the process of de-leveraging should result in weaker growth. Indeed, history shows previous periods of de-leveraging have often been times of below-average real GDP growth. While central bank policy is helping to offset these obvious headwinds to growth, we think the risks of an extended period of subdued real GDP growth in developed markets are material.

Equity markets in lost decades

Why did stock prices rise during some of these lost decades and not others? We find those where stock prices were strong share common characteristics. In general there was more inflation, the period started with low equity valuations and corporate earnings per share grew.

Lost decade checklist

So given our checklist of inflation, cheap starting valuations and EPS growth, which equity regions are best placed to survive a potential lost decade from here? In Figure 5, we compare the major developed equity regions on these metrics. Citi economists forecast Japan, the eurozone and the UK will experience particularly sluggish real GDP growth over the next 4-5 years. At the moment, inflation is rising fastest in the UK and US. If current inflation is an indicator of future inflation then these regions are better placed for a lost decade, in our view. Also monetary policy looks to be positive for future inflation as both the UK and US have negative real interest rates. This contrasts with Japan where real interest rates are higher, despite zero policy rates.

Figure 5. Checklist For a Lost Decade

	Avg GDP 2011-15	Avg CPI 2011-15	Real Interest Rate (Policy Rate less 2011 CPI)	Current CAPE	Current Interest Rate
US	2.4	2.2	-2.9	20	0.25
Japan	1.1	-0.1	0.4	17	0.10
Eurozone	0.5	1.5	-1.7	13	1.00
UK	1.3	2.8	-4	14	0.50
Ideal For A Lost Decade		> 2	as low as possible	< 23x	

Source: MSCI, Citi Investment Research and Analysis

It is encouraging that all developed equity regions are trading at reasonable valuations. However, the eurozone and the UK stand out as being the cheapest. Our sample of lost decades in the past shows that markets have risen if the starting cyclically-adjusted PE (CAPE) was less than 23x.

How to survive a lost decade

So if we are at the beginning of a lost decade, we estimate regional allocation should be Overweight those markets where there are clear signs of inflation, attractive valuations and rising EPS. Within this context, we view the UK as well placed to survive a lost decade The central bank has embarked on aggressive monetary policy which has driven up inflation (the highest in the developed world) and will potentially be positive for future inflation too. Meanwhile, UK equities are currently amongst the cheapest in the world.

Our simple framework highlights why equities in the EMU periphery could be exposed if economic growth remains sluggish. Unlike the US or UK, the European periphery does not have its own central bank or currency. Therefore, these countries cannot rely on easier monetary policy and weaker exchange rates to help deliver nominal growth supporting company profits and stock prices. Compounding issues is the ECB’s focus on price stability. While valuations remain attractive, we fear this may not be enough for markets to outperform.

We believe the process of de-leveraging has further to play out in developed economies. This raises the possibility of below trend GDP growth for some time to come. Real growth in the coming years may be in line with levels we have previously associated with “lost decades”. History shows that equity market returns during lost decades are not always as poor as we saw in Japan in the 1990s and again in the 2000s. For equity markets to rally, even against a backdrop of weak GDP growth, we need to see inflation, cheap starting valuations and EPS growth. If the developed world is in the early stages of a coming lost decade, we think the UK equity market could be best placed.

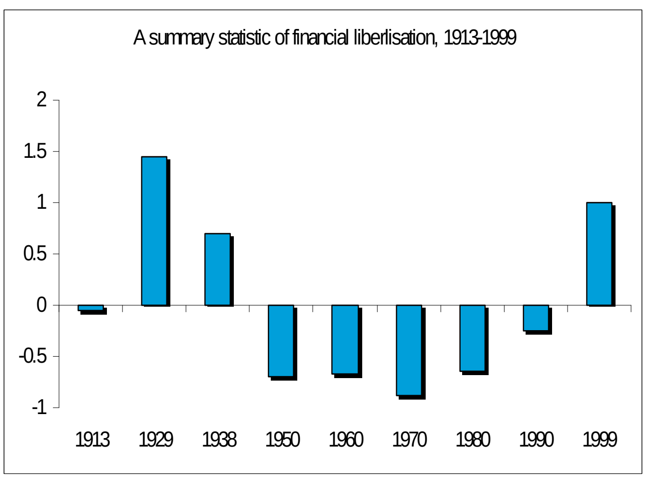
5. Financial Repression - Good in EM

David Lubin
Head of Emerging Markets Economics

One idea gaining visibility these days is that the best solution to the developed world's debt problems may be 'financial repression'. This refers to a family of policies — interest rate ceilings, reserve requirements, capital controls, transaction taxes, liquidity requirements, regulatory bullying and outright state ownership — designed to create a financial system that is more inclined to assist a government in refinancing its debt. For a generation that has grown accustomed to liberalized financial markets, the policies that promote financial repression seem archaic. But it's worth noting that financial repression was the norm, not the exception, for most of the period between World War II and the early 1980s.

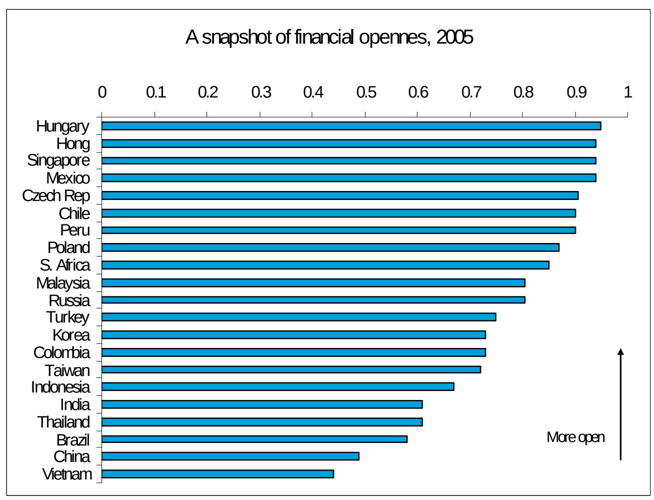
Assuming that this is really the zeitgeist, and that advanced economic policymakers move steadily back to the future to create a financial system that acts more like a captive market to absorb government paper, we ask the question: how would policymakers in emerging market economies (EMs) view all this? Roughly speaking, we think the answer is: quite favourably. There are two main reasons for thinking this way. First, there are plenty of EM economies that are already financially repressed, and whose policymakers would likely be reasonably happy staying that way. A second reason has to do with global capital mobility. A move towards financial repression by developed market policymakers could set the stage for more limited global capital mobility, and since this could reduce the risk of 'destabilising speculation' in EM currencies, it is likely to win support among many emerging economy policymakers.

Figure 6. Financial Liberalisation - Out of Fashion Most of 20th Century



Source: Rajan & Zingales; Citi Investment Research and Analysis

Figure 7. Financial Openness in 2005 Based on Data from IMF Staff



Source: IMF, Citi Investment Research and Analysis

How financial repressed are EMs already?

If is often suggested that one of the reasons why, say, China and India survived the post-Lehman global recession is that they avoided many of the financial excesses that characterised those countries that were most affected by the crisis. Their ability to do so was, in part, the result of financial repression. The banking sector in India was liberalised in the 1990s, but by 2007,, the public sector still owned 70% of banking sector assets. At the same time, banks didn't respond to liberalisation measures by taking on substantially more risk. In China, the banking system is almost entirely state-owned and has recently been the instrument of a quasi-fiscal stimulus that helped support Chinese GDP in the aftermath of the Lehman crisis.

Other countries, too, seem to have done well with largely repressed financial systems: Brazil and Russia are obvious examples. These countries have banking sectors that are dominated by publicly owned institutions.

Limiting global capital mobility

High levels of state ownership in finance are not the only source of financial repression in EM, however. Recent policymaking in EM is — on the whole — becoming more rather than less repressive. One increasingly visible tool of repression is the use of reserve requirements. The main reason why these 'repressive' reserve requirements have become more visible is that they have allowed EM central banks to cope with the central policy dilemma they have faced since late 2009: how to tighten monetary policy without sucking in unwelcome speculative capital inflows? In other words, it is the headache created by global capital mobility that seems to be helping to push EM authorities towards policies that can be described as more repressive.

EM clearly don't need capital controls to make public debts more easily refinanceable; but they might want them to ease worries about what used to be called 'destabilising speculation', and that is what gives EM the incentive to acquiesce in policies that promote financial repression. This is already evident: the increasing use of capital controls in the past two years in EM is one way in which EM policymakers have already expressed a desire to roll back the extent of financial liberalization. Although it is true that capital controls can be easily thought of as a temporary measure to deal with a short-term episode of excessive inflows, the likely persistence of negative real interest rates in developed markets and associated 'push factors' mean that EMs are more likely to be stuck with the need to address the problem of excessive flows.

There are, however caveats that would make EM want to limit any squeeze on speculative capital flows. First, a global squeeze on speculative capital flows runs the risk of throwing the baby of legitimate hedging activities out with the bathwater of speculation. Second, EM central banks with large reserves positions are themselves portfolio investors. So, their willingness to squeeze global capital mobility might be constrained, as they themselves would suffer from reduced levels of market liquidity. A third constraint on EM willingness to restrict global capital mobility may come from China, which has taken a number of steps to internationalize the RMB.

A more restrictive approach to regulating global capital flows could, in time, be part of an entirely new approach to international financial order, in our view. Exchange rates would remain flexible but determined more by current account flows than by capital flows; with real interest rates staying negative for prolonged periods; and where the direction of policy remains biased towards increasing the use of financial repressive measures. And, this is a world in which EM policymakers might be comfortable. So, as financial repression remains the zeitgeist for developed market policymakers, we think that aspects of this repression will find a welcome audience among their EM counterparts.

Figure 8. A Snapshot of Where We Might Be Headed?

	Bretton Woods	Age of liberalisation	And in the future?
	1945-early 1970s	Early 1970s-late 2000s	Late 2000s-?
Financial liberalisation	Paralysis	Growth	Reversal
Exchange rate regimes	Fixed	Floating	Floating
Capital controls	Yes	No	Yes
Real interest rates	Negative	Positive	Negative

Source: Citi Investment Research and Analysis

6. De-Equitisation - Truly Global

Robert Buckland
Global Equity Strategist

De-equitisation is now a truly global theme that is being reported by all of Citi Investment Research & Analysis' (CIRA's) regional strategists. It is about companies returning capital to shareholders through buybacks, dividend increases and cash/debt financed M&A. The rationale to de-equitise has hardly ever been stronger, especially in lowly rated developed markets. Even in some Emerging Markets, which have traditionally been areas of significant equitisation, CIRA's strategists report that companies are looking to accelerate capital returns.

The capacity for companies to support their share price through capital returns has helped limit the downside in stock markets through the early autumn, in our view. As the benefits from de-equitisation remain compelling, we believe that they will continue to be ready buyers, even if investors are not. This corporate demand for equities should continue to support stock prices going forward.

An unusual situation

A number of years ago, Citi's European strategy team highlighted its equity market was de-equitising and the theme was becoming a more important driver of returns. They forecast the unusual combination of strong profits growth, cheap equity valuations and a low cost of debt would lead to buybacks, M&A and/ or dividend increases. We are now presented with a similarly unusual situation, but this time it's global.

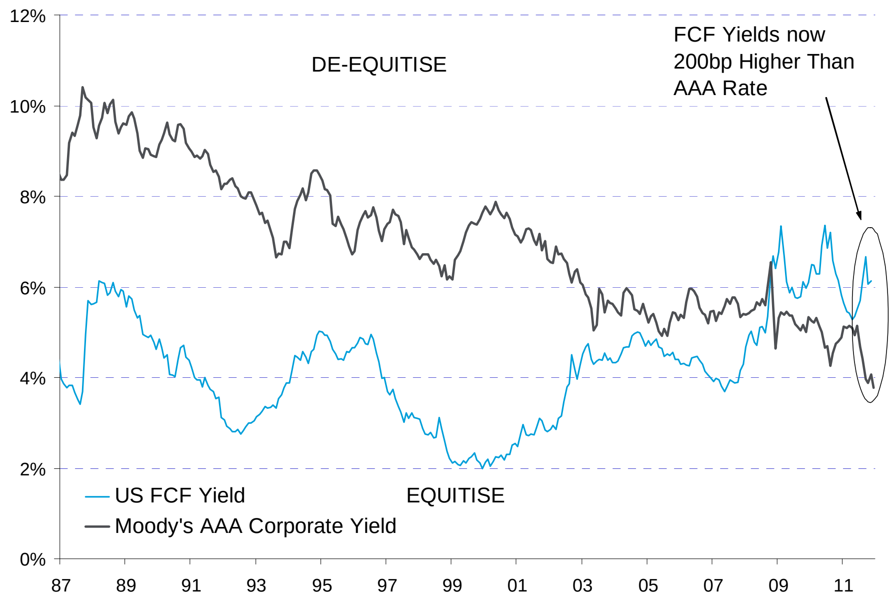
Despite the obvious macro headwinds, global corporate earnings continue to grow at a solid rate. The third quarter reporting season in the US showed that aggregate net income had grown by 19% YoY, 6% better than expected. In the US in 2Q11, companies were sitting in $2 trillion of cash — double the level held in 2000 and 40% more than in 2009. While global profit growth is still running at a double-digit rate, investors do not believe this is sustainable. Weakness in stock prices in 2011 suggests investors are anticipating a contraction in profits, even given the recent rally. This makes for low valuation — down to levels that are low even on a 30-year horizon.

In a world where profit growth is running at double-digit rates and cashflows are solid, we might expect corporate confidence to be strong enough to drive a pick-up in investment. However, companies remain cautious. Tobias Levkovich, our US strategist, notes that new investment has slowed meaningfully in the last 2 years. Our European strategists suggest job growth is suffering as companies choose not to invest. Even in Japan and the rest of Asia, where companies have been historically bigger spenders on new investment, our regional strategists find corporates holding back on capex.

Corporate opportunity

The unusual situation provides a unique opportunity or companies to de-equitise, using cash to buy cheap equity or pay big dividends. Indeed, while US investors have been selling equities in 2011, US companies have been buying. The financial logic for companies to retire equity and de-equitise is clear — the cost of equity is unusually high, while the cost of debt or cash is unusually low. By selling debt and buying equity, companies are picking up an almost 250-basis point carry. The attractiveness of this carry trade has helped drive a significant pick-up in buyback activity.

Figure 9. US Free Cash Flow (FCF) Yield vs. Cost of Debt



Source: Factset, Datastream, MSCI

Meanwhile, low equity valuations and a lack of investor demand have pressured companies to scale back or pull IPOs and secondary issues. All this means that net equitisation has been meagre for most parts of the global equity universe.

De-equitisation around the world

The economic logic for further de-equitisation remains compelling. With strong balance sheets and low valuations being present across most equity markets, de-equitisation is becoming an increasingly global theme. Indeed, CIRA strategists and analysts have identified corporate returns of cash as a key trend across the world.

In the US, Latin and America and Europe, corporates are seen to be increasing capital returns at the expense of new investment as economic and political uncertainty makes corporates more cautious on capital investment. Normally at this point in the cycle, job growth is strongly supported by rising capex and opex, Instead, companies are choosing to return capital to shareholders.

We can even see more de-equitisation in previously reluctant Japan. Holdings of cash and cash equivalents are also their highest since 2000. At the same time, debt/equity ratios are the lowest they have been since 2000, so there is little need to pay down debt. The expectation is for further growth in the number of companies boosting shareholder returns and those taking advantage of the yen's strength and low overseas equity prices to pursue M&A.

Corporates in Asia ex-Japan (as explored in more detail in the next section) are in a position with very low gearing and very high free cash flow and cash flow levels. Cash for de-leveraging has come partly from profits by mainly from a reduction of capex and most of this cash has been returned in the form of dividends, not buybacks.

Even companies in Emerging Markets, usually associated with growth investment, are focused on returning cash to shareholders and weak equity markets have led to an increase in companies wishing to support share prices through buybacks. Historically in global emerging markets, the value of buybacks has been highest in CEEMEA (mainly Russia), followed by Asia and Latin America.

7. Asia - Dividends or Buybacks?

Markus Rosgen
Head of Asia Regional Equity Strategy

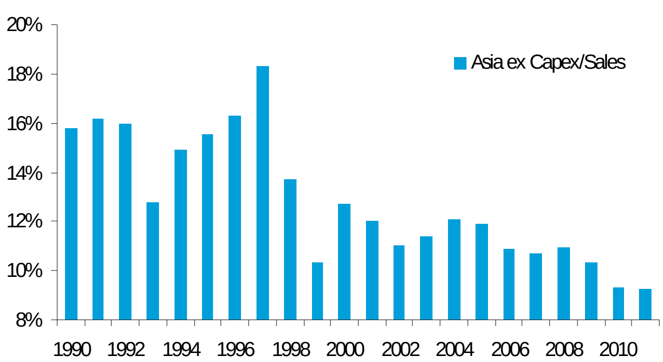
In the developed markets, corporates engage in M&A, buybacks and pay dividends. In Asia, two out of these three options are a rarity, but dividends are available aplenty. The family ownership structure that is prevalent through Asia makes hostile takeovers nearly impossible, and in the same vein it makes share buybacks difficult. The easiest way to keep harmonious relationships among the family is through the payment of dividends. That explains why 93% of companies in Asia ex-Japan pay them.

Over the past 10 years, dividend investing in Asia has lead to outperformance. Not only that, Asian yield investing has also beaten GEMS yield investing. More ironic, dividend investing has outperformed growth. With dividend coverage and free cash flow high, dividends are not under threat in Asia and this dividend investing should be ignored at your peril.

Corporate health check, top decile

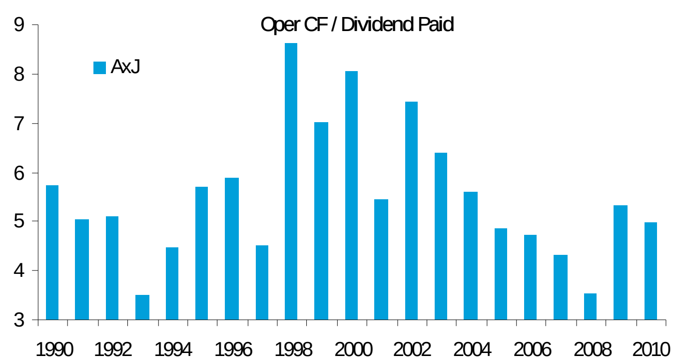
The Asian corporate sector has not looked this healthy for more than a decade. Gearing is low with the cash from deleveraging coming from profits but more importantly from a reduction in the level of capex in corporate Asia. As the capex to sales ratio has declined, the free cash flow to sales ratio has shot up. With plenty of free cash flow at hand, corporate Asia set about reducing its debt levels and returning cash to shareholders. Rather than being hoarders of capital, Asian corporates have been willing to share the fruits of their labour with the owners of capital. Looking at the ratio of operating cash to dividends paid the prospect for further dividend growth looks good.

Figure 10. Capex Spending in Asia Has Been Decreasing....



Source: Worldscope, MSCI, Citi Investment Research and Analysis

Figure 11. Cash Flow is Healthy Enough to Cover Dividends



Source: Worldscope, S&P Global Indices,Citi Investment Research and Analysis

Dividends are not as volatile as you might think

Figure 12. DPS is relatively stable

Volatility (Quarterly, Annualized)

MSCI AxJ	10Y	20Y
EPS	22%	129%
BPS	6%	10%
CEPS	17%	24%
DPS	12%	13%

Source: Citi Investment Research and Analysis

One concern is that dividends are very volatile given that Asia-ex has a volatile earnings stream. With most companies more focused on the pay-out ratio than the payment of a dollar amount, dividends too must be volatile. The good news here is that both the pay-out and dollar amount are among the least volatile of corporate metrics and this has been the case over both the past 10 and 20 years. Earnings per share have been the most volatile, followed by cash flows. Whilst most Asian companies like to talk about the pay-out ratio rather than fixed dollar amounts, there is clearly greater flexibility in the pay-out ratio than most investors realize.

Performance speaks for itself in both absolute and relative terms

Growth continues to be the prime reason why investors come to Asia. Looking at performance data, it seems they should buy value and income instead. Interestingly, the best performing EPS growth quintile is actually not the highest earnings growth quintile — higher growth is actually correlated with lower returns. Yes, the highest dividend yield quintile is also the best performing quintile.

Figure 13. Yield Beats Growth in Stock Picking

Since Dec 2000 - May 2011	Compound annual growth per annum				
	Q1	Q2	Q3	Q4	Q5
Dividend Yield	24.2%	21.8%	17.8%	10.4%	9.2%
Dividend Growth	19.2%	20.1%	20.6%	19.1%	17.9%
Dividend Payout	18.7%	20.3%	18.8%	16.4%	10.9%
EPS Growth	15.8%	20.1%	18.9%	16.8%	15.2%

Source: CIRA Quant team, Citi Investment Research and Analysis

Dividends work because interests are aligned

So, why does dividend investing work in Asia-ex Japan? First, investors' interests and those of the main shareholders — more often than not the founding family — are aligned. As the owning families get larger, cash, i.e. dividends, is used as a means of keeping the peace. Added to which, in some jurisdictions, dividends are taxed lightly or not at all, e.g. in Hong Kong, which is attractive to family owners. Second, for a company to pay a dividend there have to be profits. So by following the dividend theme, investors will end up buying profitable companies, which over time is a good strategy to follow. Third, as companies pay out capital there is a high probability that management appreciate shareholders and know something about capital management, both of which have over time proven to being a good thing for shareholders.

Buy-backs: few and far between and erratic

In the US and Europe, CEO compensation is linked to EPS growth or an ROE formula with options attached. As such a CEOs' incentive is to reach the goals that increase rewards. Buying back stock helps in getting you there. In Asia-ex, CEOs are often the owners of the business and are not tied to an ROE or EPS formula. They already own the business. Furthermore, the ownership structure — minority owners of shares, but still the largest single shareholder — makes buybacks more difficult. Buybacks may trigger take-over rules that mean they cannot be undertaken as the owning family lacks the capital to complete a full takeover.

For these reasons, buybacks tend to happen most often with previously nationalized companies, i.e. telecoms, rather than with private companies. That's not to say that buybacks are not rewarded by the stock market, it is just that they are few and far between. In terms of buyback performance, stocks perform well post buybacks, but in the run-up to the buyback, stocks have on average underperformed. Among all the stocks listed in Asia-ex, on average only about 17% do buybacks and then the average percentage of shares outstanding that is bought back is a mere 2%. Compare that to dividends: in Hong Kong, 93% of companies pay dividends and in Singapore, that number is 100%.

8. China - Rebalancing Required

Minggao Shen
Head of China Research

China enters the second year of the 12th five-year plan (FYP) facing tremendous external headwinds; the euro area is expected to fall back into recession, reducing demand from China's biggest external market; growth in the US will likely remain subpar, increasing the chances of trade and currency related frictions; domestically, a hard landing can be avoided, but major structural hurdles need to be removed to ensure a smooth migration to a slower but more balanced growth environment; and leadership changes during the period pose both uncertainties and opportunities.

Against this backdrop, the economy could hit a soft patch in early 2012, coinciding with a property market adjustment and external weakness. In preparation, the focus of macro policies has already shifted from anti-inflation to growth stability. We expect prudent monetary policy to normalize liquidity and proactive fiscal policy to forestall downside risks. Property tightening will likely be eased after a sizable price correction. We forecast growth to slow to 8.4% in 2012, and see a deeper-than-expected euro area recession, QE2 in the US and, undershooting of property prices as the main risks to our growth forecast.

Rebalanced growth: Where does marginal demand lie?

Rebalancing is the key to promoting structural and marginal demand. The current external demand deficit could be partially offset by cyclical easing, but a more important factor is demand creation. In other words, cyclical easing needs to be accompanied by structural reforms to lay a solid footing for growth.

In our view, a more rebalanced growth in China implies slower growth but demand creation and a more efficient use of resources. This requires a balance between the speed and quality of growth. Inevitably, China's growth will have to be adjusted from its faster base of 9-11% to a slower base of 6-8% in the coming decade. This adjustment is also necessary as there is no immediate substitute for slowing export growth and the property sector correction. If the quality of growth improves, slower growth could provide the same benefits to Chinese citizens.

Marginal demand is likely in the services sectors, though rising incomes will promote consumption in general. As China's GDP per capita is now more than $4,000, we believe a structural change in demand is now emerging. Looking at the consumption expenditure structure for urban China, the structure of the low income group of urban households is reminiscent of Korea's in 1976, and the high-income group structure is similar to that of Korea in 1985. It's thus possible to use the structure of 1985 and 1995 in Korea to predict the expenditure structure of low-income and high-income groups of urban Chinese households. The marginal demand clearly shifts from staples to healthcare, transportation and communications, and recreation and cultural activities. Meanwhile, it also indicates that consumer staples can remain an important component of consumption in the following decade. A similar comparison between Taiwan and rural Chinese households can be done.

Resource efficiency is likely the key to sustaining growth after the high-investment period is over. If resource efficiency can be improved, China could require less investment to produce the same rate of growth. This would reduce the bottleneck of bank financing. More competition and normalized cost of capital are two keys to improve resource allocation efficiency.

High growth can be sustained longer if China embarks on a new set of reforms to improve resource allocation, including removing barriers for private capital to access monopolized services industries (including telecommunications, healthcare, and financial services) and liberalising the interest rate. However, fundamental changes are more likely after the new leadership takes full control in 2013-14. The incumbent government is expected to follow through on the commitment to achieve universal basic pension coverage within the tenure of the administration, and continue with reforms in a measured way, such as further cuts in the tax burden on small enterprises and services sectors and pressing for dividend payouts by large SOEs and listed companies.

Policy relaxation: Where to invest?

Policy relaxation is needed to stimulate domestic demand and compensate for the lost external demand. The key question is what to stimulate. Due to the nature of reactive policy, it is likely the policy easing will focus on traditional demand, (e.g. infrastructure) and on sectors that will promote industrial upgrades (e.g. the 7 strategic new sectors: new-generation information technology, energy-saving and environment protection, new energy, biology, high-end equipment manufacturing, new materials and new-energy cars). Two traditional sources of demand — property and autos — are unlikely to be the leading beneficiaries of policy support.

Administrative tightening may lead to a sharper-than-expected correction in the property sector. If purchase restrictions continue, as Chinese leaders have recently indicated, developers looking to generate volumes would either have to cut prices sharply to reach qualified buyers who cannot afford higher prices, or aggressively cut the pace of investment in order to preserve desirable levels of liquidity. Land sales and new floor area started in October had all recorded negative YoY growth. Should this trend continue, property investment growth would very likely fall below 2008 levels.

Auto sales are highly correlated to transaction volumes in the property sector so sales in autos should slow alongside lower property sector volumes. However, you could see a gain from rising household incomes and replacement demand as auto consumption is still in its early stages in China. Despite this, we believe auto demand will likely still be under pressure in 2012 due to a high base under stimulus and traffic control in cities.

Although likely a focus of policy easing, infrastructure investment, which was the key driver of growth under the stimulus program, has limited upside potential but may continue to be the growth stabilizer. Looking across the provinces, only central and western provinces have the potential for further investments as many already have high investment to GDP ratios. Only a few (i.e. Henan, Hunan, Heilongjiang, Jiangxi and Jilin) have both lower infrastructure investment to GDP ratios and loan to GDP ratios. This suggests that, unless more fiscal transfer or bank loans are available for those non-coastal provinces, infrastructure investment will be capped going forward.

9. Oil in 2012 - Risky to Growth

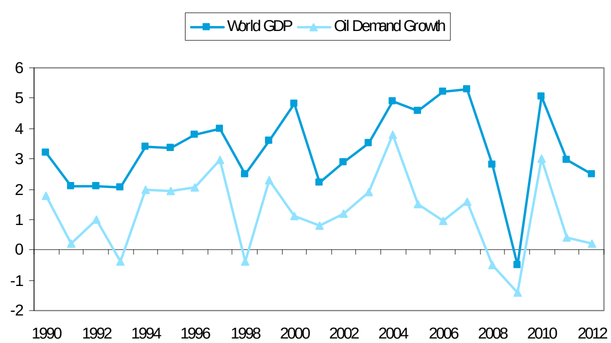
Edward L. Morse
Head of Global Commodities Research

Oil demand is largely a function of GDP growth and the impact of oil prices is visible in the changing ratio between the two. One of the persistent themes in the oil market has been that we are living through 2008 all over again and that seemingly robust oil market fundamentals are going to give way in the face of a rapidly deteriorating macro environment. We look at the world rather differently and instead believe that oil could pose a significant threat to the macro environment. The redundancy in the system is slim and the threats to supply are many. In addition, the long list of world geopolitical issues involve significant threats to major portions of the world's oil supply, such that the risk of an oil price spike is significant in 2012.

Despite the risks, we expect prices to be range bound between $100 and $120 and averaging $110 in 2012 and $120 in 2013. Simply put, we think that oil supplies are constrained for the next 2-3 years, as we just do not see enough liquids supplies coming to market to allow for unconstrained demand growth. We think the world is operating with about 2.5m b/d of spare production capacity, virtually all of which is in Saudi Arabia, with the rest scattered around other core Gulf OPEC members. Absent supply disruptions, we expect to see a marginal increase in spare capacity, but the margin remains slim and the potential disruptions numerous, including but not limited to: oil-disrupting violence in Iraq; tensions between Israel and Iran; US sanctions and an EU embargo on Iranian oil; sanctions on Syria; succession and the possibility of strife in Saudi Arabia; elections in Venezuela and Angola; and ongoing violence in Nigeria, Sudan and Yemen.

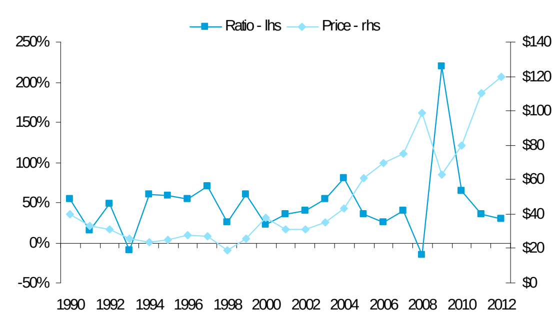
We think that oil supplies are constraining global GDP growth, and that this will remain the case until there is a paradigm shift — either oil demand shifts lower through a transition to more of a natural gas based transportation system in some key markets, or, more likely, shale, tight oil and deepwater production reach a scale that moves the needle on a global basis for liquids supplies, and none of these is going to happen over the next two years.

Figure 14. Oil Demand and GDP Growth



Source: Citi Investment Research and Analysis

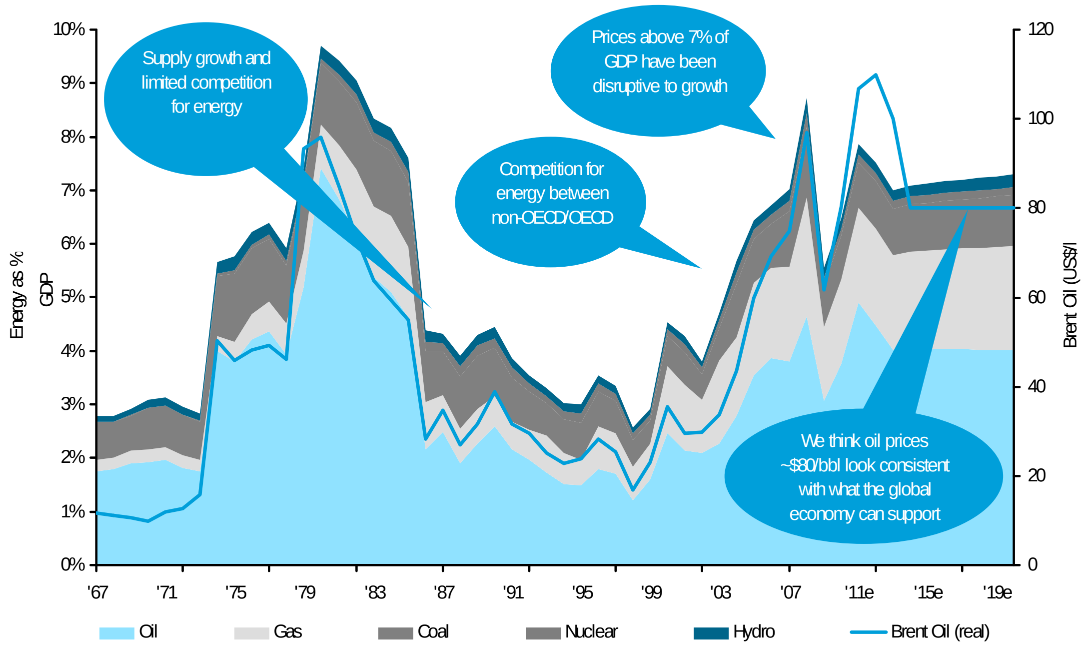
Figure 15. Oil Prices and Demand/ GDP Ratio



Source: Citi Investment Research and Analysis

We think we are now living in a crude oil-constrained world and oil prices have to stay close to the pain point for the global economy in order to constrain demand growth. We estimate the pain point for the global economy to be around $120/bbl; at that price total expenditure on energy would consume about 9% of global GDP, a level that historically has been enough to cause the global economy to slow. We do recognize, however, that the pain point is a moving target and is a function of the prices of other energy sources and of the general robustness of the global economy.

Figure 16. Energy Expenditures as a % of Global GDP and Oil Prices



Source: Citi Investment Research and Analysis

Possible spikes but unsustainable

The low level of spare capacity and the numerous risks to oil supplies make the odds of an oil price spike high. If it is a major disruption that drives prices higher, for example Iran attempting to block the Straits of Hormuz, then we would expect prices to move north of $150/bbl in very quick fashion. We do not, however, expect them to stay there for very long, as that level is simply too much of a burden for the global economy and we would expect a global recession to be the result, taking oil demand and prices much lower. Historically, oil price spikes resulting from supply disruptions have typically been followed by recessions — the 1973 OPEC embargo on the US and resulting 300% price spike saw global GDP growth drop from 6.4% in 1973 to 1.5% in 1974 and 0.9% in 1975. Similarly, the Iranian revolution and Iran-Iraq war from 1978 to 1981 saw oil prices double and global GDP growth drop to an average of 1.3% from 1980 to 1982, versus a 4.2% average for the previous three years.

Given the already fragile state of the global economy (and the equally fragile state of investor sentiment), signs point to the possibility of strong negative feedback loops coming into play — and we would expect a similar outcome (i.e. a global recession) even if the percentage increase in oil prices is lower. Given that oil prices are already close to the pain threshold for the global economy, we think that around $120/bbl is a reasonable estimate of a sustainable ceiling. Currency movements obviously make this a moving target, however, and a strong USD accompanied by high oil prices can make the ceiling lower, and more solid.

Our base case is constructive for oil prices. Our bull case, to which we assign a 25% probability, is that one of the many possible geopolitical risks to supply comes to fruition — oil prices would spike higher and take a toll on the global economy. Our bear case comes from a disintegration of the Euro (a 5% probability event0, or a hard landing in China. Either of these would cause oil to test long-term replacement cost support levels which we estimate at $70-$90/bbl

10. Gold – Where to Now?

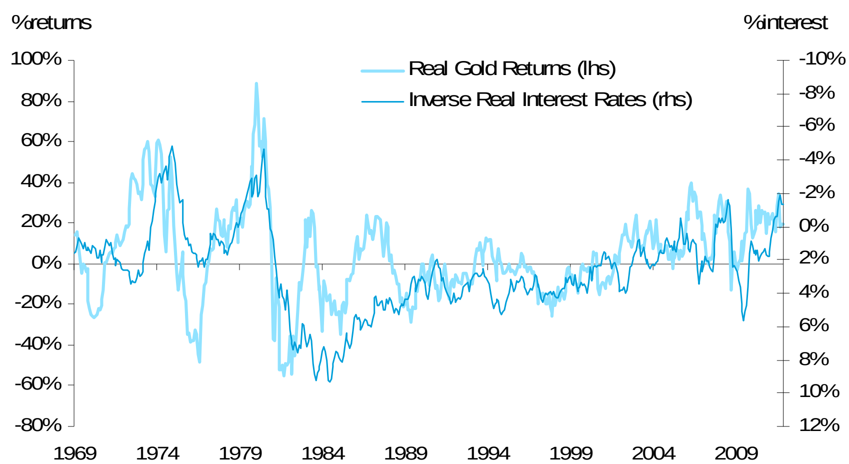
Edward L. Morse
Global Head of Commodity Research

Gold has performed outstandingly from 2009 to 2011, with a CAGR of over 25%. This has been a function of its special status as a universally accepted medium-of-exchange and financial store of value. In our view, during periods of macro-financial uncertainty (which we expect will continue for the foreseeable future), there are three major macro-financial factors that should drive nominal and real gold returns: 1) denomination effects from inflation and currency adjustments; 2) real interest rates; and 3) financial demand for gold as a safe haven and source of liquidity.

The inflation outlook generally looks stable and our economics team is forecasting global inflation to fall to 3% in 2012 and 2.9% in 2013, from 3.9% today. For the US, CPI inflation is expected to fall to only 1.8% and 1.7% in 2012 and 2013, respectively. In addition, our FX strategy team is seeing the dollar continue to rally slightly against the euro with the EUR/USD rate pressing the 1.20-1.30 range. Both of these should provide bearish pressure on the dollar-denominated gold price

Real interest rates are expected to remain low given the gloomy economic outlook and more unconventional quantitative easing (QE) may be further down the line. But for now, the world's largest banks, particularly the Fed, may play more of a wait-and-see game, testing the efficacy of the Fed's new initiative to provide greater transparency on its own forecast for target rates.

Figure 17. Gold Returns and Inverse Real interest Rates



Source: IMF, Citi Investment Research and Analysis

Meanwhile, due to the still unresolved situation in the EMU, investors, both private and public, may seek to balance financial demand for gold with sales for liquidity. Central banks had shifted to becoming net buyers of gold in 2011 for the first time in two decades, buying an estimated net 192 tons, but there is evidence that the central banks of some troubled European sovereigns are selling gold stockpiles for austerity and liquidity measures.

Taking the outlook for these three major macro-financial factors into our base forecast for gold, we are forecasting an 8% CAGR in 2012 in gold prices and 15% in 2013, followed by a rapid correction down to an average $1,250 price for 2015 due to a broader global economic recovery and macro-financial stabilization. We see bullion prices averaging $1,710/T. oz in 2012 and $1,910/T. oz in 2013.

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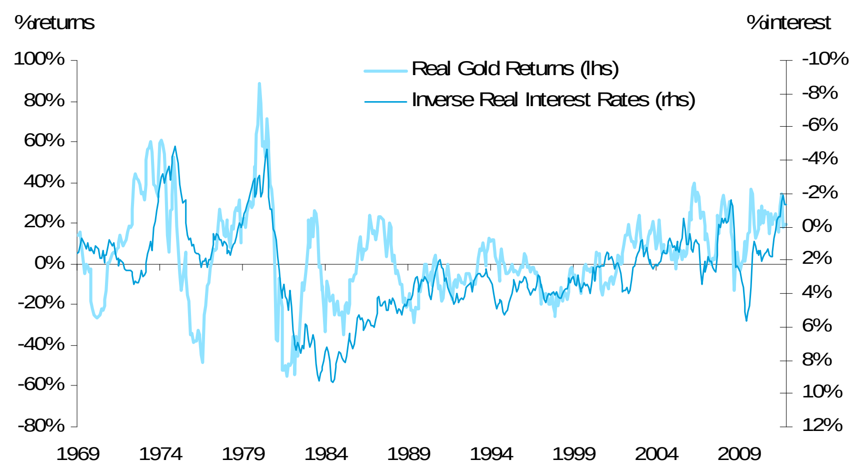
Real interest rates are expected to remain low given the gloomy economic outlook, and more unconventional quantitative easing (QE) may be further down the line. But for now, the world's largest banks, particularly the Fed, may play more of a wait-and-see game, testing the efficacy of the Fed's new initiative to provide greater transparency on its own forecast for target rates.

Figure 17. Gold Returns and Inverse Real Interest Rates



Source: IMF, Citi Investment Research and Analysis

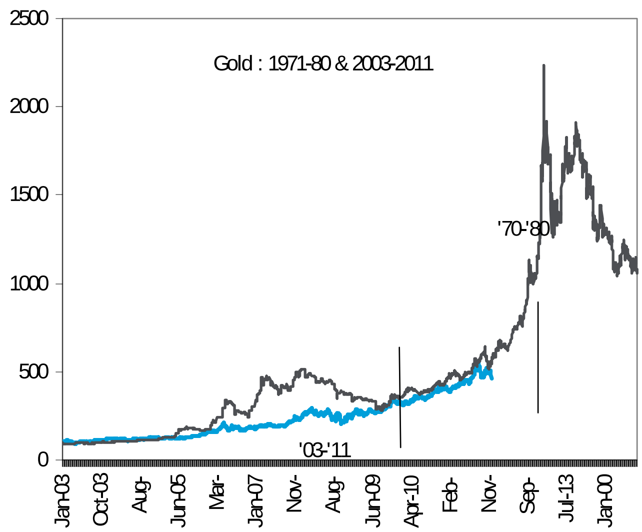
Meanwhile, due to the still unresolved situation in the EMU, investors, both private and public, may seek to balance financial demand for gold with sales for liquidity. Central banks had shifted to becoming net buyers of gold in 2011 for the first time in two decades, buying an estimated net 192 tons, but there is evidence that the central banks of some troubled European sovereigns are selling gold stockpiles for austerity and liquidity measures.

Incorporating the outlook for these three major macro-financial factors into our base forecast for gold, we are forecasting a CAGR in gold prices of 8% in 2012 and 15% in 2013, followed by a rapid correction down to an average $1,250/T. oz price in 2015 due to a broader global economic recovery and macro-financial stabilization. We see bullion prices averaging $1,710/T. oz in 2012 and $1,910/T. oz in 2013.

Where are we in the cycle?

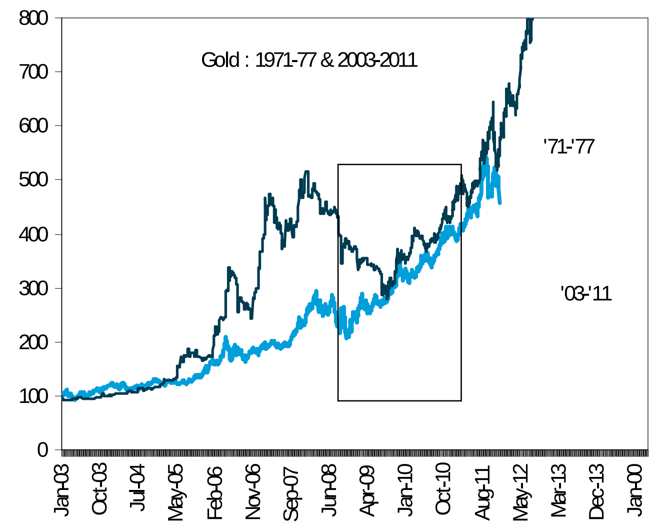
To evaluate where we are in the current cycle, we look to the past and compare gold's performance from the start of its 1971 bull market and overlay the performance of the current bull market — from 2003 to 2011. For comparison purposes, we rebase both rallies to zero and, although the patterns are very similar, what stands out as the main difference is that the 1971-77 rally was more volatile than today's rally.

Figure 18. Gold 1971-1977 and 2003-2011



Source: Datastream

Figure 19. Gold 1971-1980 and 2003-2011



Source: Datastream

The question that many are asking today is whether it's 'all over' for gold in the current bull market (i.e. have we peaked?) or whether the recent retracement is merely another 'blip' along the way. Contrasting 1975-1977 to 2009-2011, both represent instances in the gold price where a 'blip' occurred in the bull market. What we see is that the type of retracement in gold that has occurred at the end of 2011 is 'par for the course' in an ongoing bull market; the scope for a continuation of the rally can be seen if you extend the chart out to nine years and look at the entire 1971-1980 bull market.

Gold's big pullback recently has hit the headlines because of its ferocity, but it is important to put that retracement into context against where gold has come from during this bull market and also the substantial volatility that it has shown to date. This is not a 'calm' metal by any means. It reacts violently up and down, as it did in the 1971 bull market, and will likely to continue to act this way.

The contrast between the 1971-1979 bull market is fascinating because the 1970s consisted of 'Oil Crisis Mark 1' (1971-74) and 'Oil Crisis Mark 2 (1976-79) and in the current crisis we have had 'Financial Crisis Mark 1 (2008, based around sub-prime, personal balance sheets and bank balance sheets) and now we have 'Financial Crisis Mark 2' (2011, based around European banks and European sovereign debt risk).

Typically, the fundamentals link in with the technical and charting aspects, but in this bull market, because of the importance of the rise of the use of exchange traded funds (ETFs), gold is even more subject to market mood and charting levels in comparison to the fundamentals of jewellery demand and central bank purchases and sales.

Notes

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