2012 Mid-Year Outlook

2012 AT A GLANCE

- In the Eurozone, the second half of the year will be no different than the first, with the exception of worries about a Greek exit and what this may mean to investor confidence.
- In the US, fears are likely to mount about the tightening of fiscal policy come January 1, as this would almost certainly tip it into a recession.
- China, too, looks to be slowing fast. As we've been saying for many months, China has had a credit bubble, a housing bubble, a sharply falling current-account surplus, sharply rising foreign-exchange reserves and, until recently, very swift rises in real money supply.
- Excluding the US, the global purchasing managers' index (PMI), a pretty good real-time guide to overall growth, is falling fast and is now much lower than it was at the same time last year. This does not auger especially well for risky assets.
- Given that much of the source for the slowdown has been China, the prices of industrial commodities are likely to fall further. If that is true, that means that emerging stocks and emerging currencies will remain under downward pressure.
- We continue to prefer, as we have for many a month, long-dated fixed income assets, especially in US dollars. We prefer investing in corporate, hard-currency EM debt and (for US taxpayers) municipals.

STRATEGY HIGHLIGHTS

- **EQUITIES.** We believe there are opportunities to reshape equity positions, looking beyond mere valuations toward stocks with above-average, reliable earnings growth, stable and growing dividends.
- For investors considering equity allocations on a strategic basis, customized volatility-weighted indices may offer a more balanced and diversified risk exposure.
- **FIXED INCOME.** A well-diversified fixed income portfolio that consists of global investment-grade bonds may provide attractive risk-adjusted returns in a low-growth/low-inflation environment.
- **HEDGE FUNDS.** We highlight strategies with a low net exposure to equity markets either as standalone opportunities or ways of diversifying existing portfolios that have significant directional exposure.
- **FOREIGN EXCHANGE.** In a risk-off environment, we believe investors should favor currencies like the US dollar. However, FX should not be thought of as a buy-and-hold strategy.
- **PRIVATE EQUITY.** Private equity investors and hedge funds are gearing up with new credit-oriented opportunity funds and distressed debt strategies aimed at benefiting from the anticipated market dislocations.
- **REAL ESTATE.** Investment in UK commercial real estate continues to resonate with investors and may offer the potential for bond-style income and the opportunity for growth.

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Review of the First Half of 2012

Alexander Godwin, Global Head of Asset Allocation

"THIS TIME IS DIFFERENT"

If there was ever a statement that has so frequently been proved false, it must be the proclamation that "this time is different." Yet the consensus at the beginning of 2012 was exactly that. A new period of sustainable global economic growth, stability, climbing equity markets and rising rates was, the consensus expected, due to replace the tumultuous environment of the past three years.

We, however, were much more skeptical. We expected economic data in the US to weaken in the summer, much as it did in 2010 and 2011. Elsewhere, we were considerably more cautious on the outlook for China and the prospects of stabilization in Europe.

We entered this year underweight both developed and emerging market equities. We had, instead, positioned portfolios toward a significant weighting in corporate investment-grade fixed income, focused on long-dated securities in the US.

Corporations, especially in the US, have strong balance sheets and have been focused on paying down debt and improving credit ratings. We reasoned that this and our expectations that Treasury yields would continue to fall would drive good returns from this fixed income asset class.

Yet, over the first three months of the year, equity markets climbed and even Treasury yields looked like they were rising. Economic data out of the US continued to improve, while the finalization of the Greek bailout coupled with the Long-Term Refinancing Operation (LTRO) liquidity support by the European Central Bank (ECB) seemed to stabilize the European situation.

Had the consensus finally gotten something right? As it turns out, the same question could have been asked in March of 2010 and 2011 after similar rallies in the first quarters of those years. Yet, the answer in both cases was a resounding no, as markets and economic growth began to reverse course.

THE US — IT WOULDN'T LAST LONG

We long doubted that 2012 would be any different. Our analysis suggested that US economic data was artificially exaggerated by incorrect seasonal adjustments, while abnormally warm winter weather had also had a temporary beneficial impact.

We believed payback was due as these effects went into reverse going into the summer months, and this was exactly what happened. The following three months showed a rapid deceleration of economic performance, with markets following suit. Equity markets have fallen while Treasury yields have touched fresh lows.

EUROPE — CRISIS STILL LOOMS

In Europe, it seemed to us that the multiple attempts to cure the crisis had done nothing to heal the underlying causes. Even more concerning, there seemed to be political constraints that would prevent the necessary remedies from being administered.

Since the adoption of the euro, the rest of Europe had become progressively less competitive compared to Germany. While Germany embarked on labor market, tax and welfare reform, the rest of Europe saw spiraling wages. Since 2000, German labor costs have risen by a mere 7% compared to 30%, 35% and 42% for Italy, Spain and Greece, respectively.[1]

In a common currency regime, where devaluation does not appear to be an option, it seems the only way for these countries to regain competitiveness and stimulate economic growth is to replicate German-style reforms.

As you can imagine, this does not make for feel-good politics. Enormously unpopular with voters, we expected these policies would be almost impossible to implement and cost many political careers throughout the region.

In the absence of structural improvements and with the private sector deleveraging, it has been largely government spending that has supported economic activity throughout much of Europe. The result has been soaring public borrowing.

With structural reforms and austerity plans disappointing, and government borrowing continuing to grow, we did not think it would be long before creditors started to become concerned over the ability of governments to repay what they owe.

It seemed likely that peripheral government bond yields would rise (as creditors demand more return to compensate them for the heightened risk), and perhaps that governments might even get shut out of bond markets completely.

While the EU could easily support smaller economies, such as Greece or Portugal, what concerned us were the behemoths of Spain and Italy which even Germany would struggle to support if they could not borrow at low rates.

With this in mind, we had no positions in Eurozone government bonds, save for a small position in short-dated German bunds. This was the right decision. Bond yields across Europe have soared and prices have fallen.

CHINA NEEDS TO REBALANCE ITS GROWTH FOR THE SAKE OF THE MAJORITY

The one source of light over the past three years has been China. Growth rates have been resilient in the face of the general worldwide malaise.

At the tail end of 2011, however, it looked like growth was slowing. The sanguine consensus was not concerned. It would be a major year of political transition, which the central government would want to go smoothly without any hint of economic crisis. The result, the consensus expected, would be proactive monetary and fiscal policy that would underwrite a continued high growth rate.

We had been concerned that the driver of economic growth had been an unsustainable rise in both private sector borrowing and house prices. In the past few years, China has seen a more aggressive expansion in credit compared to any previous world credit bubble (including the US and UK to 2007 and Japan to 1990).

2012 AT A GLANCE

Market Events

JANUARY

- France stripped of AAA credit; eight other Eurozone countries downgraded
- The Fed to keep rates near zero until at least late 2014
- "Fiscal Pact" agreed by the EU is signed; The UK and Czech Republic abstain

FEBRUARY

- ECB allots €529.5bn in LTRO
- Italy, Portugal and Spain downgraded; Austria, Britain and France in negative outlook
- BoJ increases bond-buying program by $130bn
- Bank of England announces third round of QE

MARCH

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

If the slowing of growth in China marked the popping of such a bubble, then we suspected that the ability of the central government to control it would be much less than the consensus opinion suggested. We have been underweight China and those commodity exporting countries that are highly reliant on it for much of this year.

The past six months suggest that our fears appear to be realized. Economic growth has decelerated much quicker than the consensus expected. Housing prices are falling and demand for credit is low.

What has surprised even us, though, is that China has not reacted anywhere near as aggressively as was assumed by the consensus. The opacity of Chinese politics makes the reasons difficult to fathom, although we suspect it has much to do with who is benefiting from both economic growth and the accompanying stimulus.

The danger we suspect facing politicians is many Chinese becoming disillusioned that they are not seeing the benefits from growth and stimulus. It would be easy to see why. The 70 richest Chinese politicians have wealth estimated at $89.8bn. This compares with the top 660 politicians in the US with total wealth estimated at $7.5bn.[2]

China needs to make house prices more affordable and keep inflation low. It is probably more important for them to rebalance growth toward helping the majority than simply maintaining growth per se — and this could mean stimulus will not be as aggressive as first thought.

A new period of sustainable economic growth looks as far away as ever, as the United States and China continue to slow and the crisis in Europe remains unresolved. It seems that this time is not so different.

[1,2]**Source:** Bloomberg, as of June 2012

APRIL

Oil price spike caused by Iranian confrontation threatens global economy

Spanish yields rise toward 6%

MAY

Greek protest vote against austerity leaves elections undecided

Hollande beats Sarkosy to become the new French president

JUNE

US Treasury and bund yields at all-time low

Spain asks Europe for a €100mm bailout of its banks

Spanish yields at euro-era highs

Cyprus is the fifth Eurozone country to seek emergency funding from Europe

An Awful Lot of Noise: Second Half Outlook

Richard Cookson, Global Chief Investment Officer

NOISE

Fischer Black, joint author of the famous option-pricing model, was a man of few words. Famously, he once presented a paper to the American Finance Association called, simply, *Noise*. It lasted all of 15 minutes. In finance, noise is pretty much all information that isn't of fundamental importance to valuing securities. There is, then, an awful lot of it. The snag is that it's very hard to disentangle, especially when it comes to Europe. European politicians, knowing that markets want fundamental changes to the way in which the Eurozone economy is run, dress up their pontifications as the very opposite of noise. Some 20 meetings of the European great and the good since the crisis began, investors are starting to wise up to these tricks. But of course they're always worried that something might just have changed, so there's always some sort of joyous reaction. Thus it has been with the latest European package. Not much has really changed but the hope is that Germany will be less obstructive in doling out its balance sheet to all and sundry.

EUROZONE CRISIS CONTINUES WITH NEW CONCERNS OF A GREEK EXIT

Although such a change is desperately needed – on its present course the Eurozone will sooner or later cease to exist – I suspect that it is fanciful to assume that anything other than a lot more pain than it is suffering at the moment will cause Germany actually to change course. Until it does the Eurozone crisis will rumble on. In this respect, the second half of the year will be no different than the first.

The exception is that worries about a Greek exit from the Eurozone are likely to mount. The problem here is what the prospect of a Greek exit is doing to investors' confidence elsewhere. We don't really see much change afoot. Investors are likely to continue to sell bonds in peripheral European countries and depositors to take their money out of peripheral banks. Political tensions between creditor countries are likely to continue to mount, not least because the European economy will probably continue to shrink – and continue to shrink fastest where austerity is greatest: in the periphery.

US ECONOMY FAILS TO GAIN TRACTION

Much as the rest of the world likes to blame all of its woes on Europe, this is simply not true. Many other countries have problems that are entirely home-grown, too. The private sector in the US is still busy trying to pay off all those debts that they accumulated in the go-go years. That's why, four-and-three quarter years after Lehman Brothers went bust, interest rates in the US are still at historical lows and the reason why the economy fails to gain any meaningful traction. Indeed, were it not for hugely loose fiscal and monetary policy growth over the past few years, growth would have been a lot more meager than it has been. Actually, the US would now be in a second depression. Unfortunately, in the second half of the year, fears are likely to mount about the tightening of fiscal policy come January 1. One can but hope that, all evidence to the contrary, Congress will prove more statesmen-like than it has in the previous couple of years and put this tightening off: The US may have a recession anyway, but a tightening of fiscal policy on the scale that is planned would almost certainly tip it into one.

RAPID SLOWDOWN IN CHINA AMID VARIOUS DOMESTIC PROBLEMS

China, too, is slowing fast. Again, some of this is due to weakness elsewhere, but China has domestic problems aplenty. As we've been saying for many, many months, China has had a credit bubble, a housing bubble, a sharply falling current-account surplus, sharply rising foreign-exchange reserves and, until recently, very swift rises in real money supply. Put these all together and, as far as we can see, they always spell trouble. Nor do policymakers seem in the frame of mind to plunk their foot on the accelerator. Doing so would not only risk (from their point of view, anyway) renewed inflation and house-price rises but also (more importantly) exacerbate the anyway stark differences between the rich and politically well-connected and the vast mass of the population. That, so far as I can assess, has almost nothing to do with Europe.

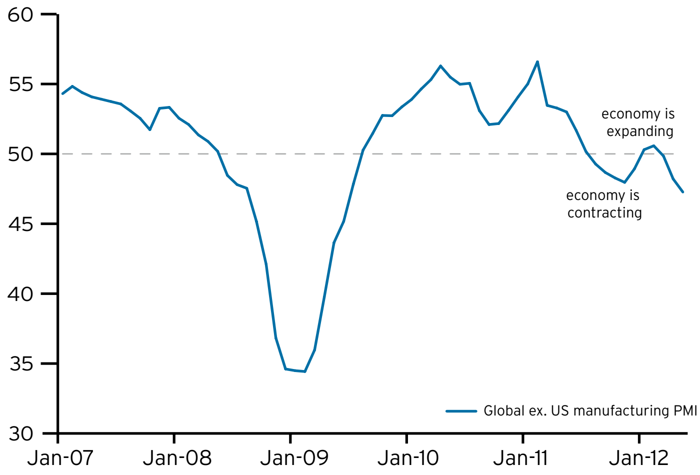
Small wonder, then, that the global economy is decelerating fast. Excluding the US, the global purchasing managers' index (PMI), a pretty good real-time guide to overall growth, is falling fast and is now much lower than it was at the same time last year. Little wonder, too, that profits are now falling globally, compared with a year ago.

The US PMI has held up better than its counterparts elsewhere, but is likely to fall further. Were it not for credit write-backs for the banks, US profits would also be falling. We expect them to do so in the second half of this year.

RISKY ASSETS REMAIN UNDER PRESSURE

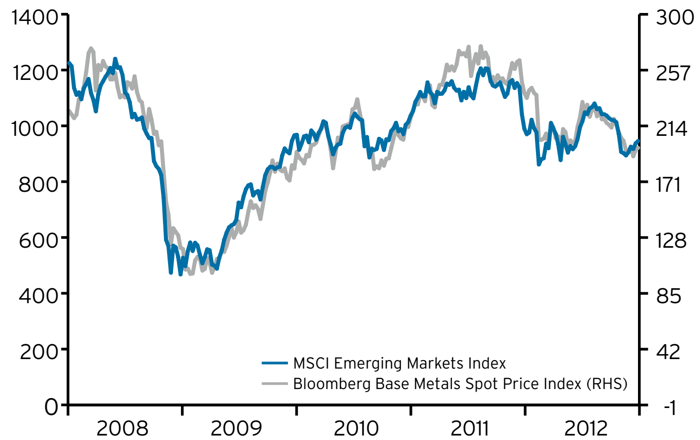
None of this augers especially well for risky assets. In general, they are likely to remain under pressure, punctuated by spasms of hope that the Europeans are about to get their act together or that central banks are likely to step up loosening. Given that much of the source for the slowdown has been China, the prices of industrial commodities are likely, I suspect to fall further. As Figure 2 shows, if that is true, that means that emerging stocks and emerging currencies will remain under downward pressure.

Figure 1: Slowdown in the Global Economy



Source: Citi Private Bank, Bloomberg, as of June 2012

Figure 2: As Commodities Fall, Emerging Market Stocks Remain Under Pressure

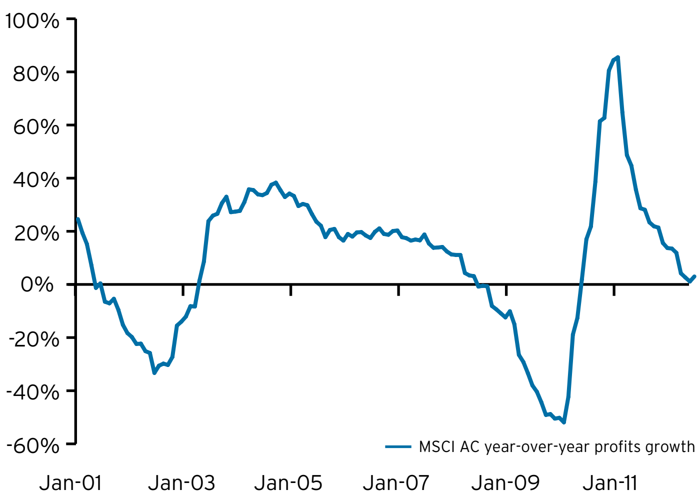


Source: Citi Private Bank, Bloomberg, as of June 2012

MUCH OF THE SAME FOR DEVELOPED STOCKS, WITH DEFENSIVES LIKELY TO DO BETTER THAN CYCLICALS

The same is true, I suspect, for developed stocks, with the proviso that, at half the valuation of their American counterparts, at least investors are paid for a lot of European risk. Clearly, US stocks have outperformed over the past six months. But we are, I suspect, getting to the point where weaker-than-expected growth and profits that are turning over in the US start to eat into this outperformance. Defensives are likely to do better than cyclicals.

Figure 3: Year-over-Year Profit Growth Falling Dramatically



Source: Citi Private Bank, Bloomberg, as of June 2012

LONG-DATED FIXED INCOME CONTINUES TO BE OUR PREFERENCE

We continue to prefer, as we have for many a month, long-dated fixed income assets, especially in US dollars. Interest rates will stay on the floor and inflation expectations are likely to fall. In that environment, US Treasuries are likely to do reasonably in the second half of the year, but given where yields have fallen to, it is impossible for them to do very well. Far better, we think, to invest in corporates, hard-currency emerging market debt and (for US taxpayers) municipals. US Treasury yields are likely to rise a touch when the Fed conducts another round of quantitative easing (QE), as growth expectations rise but, from a credit point of view, spreads would also come down.

Adaptive Valuation Strategies: Citi Private Bank's Strategic Asset Allocation Approach

Alexander Godwin, Global Head of Asset Allocation

In May, we introduced our new approach to strategic asset allocation, called Adaptive Valuation Strategies (AVS). Our new approach has been developed because of the extremely challenging markets of the past ten years or so.

Conventional wisdom assumes that equities always outperform bonds over the long term. Over the very long term this must be true, otherwise capitalism wouldn't work. And indeed, since 1910, US equities have on average returned 3.95% per year more than government bonds and 2.66% per year more than corporate investment grade bonds.[1] At the end of the last century many investors positioned their portfolios on the expectation that equities would continue to outperform.

It didn't quite turn out that way. Since the turn of the century, equities have barely broken even while many bond markets have had one of the greatest bull markets in history. Positioning a portfolio on the basis of equities outperforming bonds was, it transpires, simply wrong. And the reason it was wrong was because of a paradox: that if everyone believes in the equity-risk premium (the extra return that equities deliver over bonds) then share valuations are driven up to the sorts of levels where they won't deliver that extra return.

AVS does not assume that past trends will continue. Instead, the approach uses current valuation levels to understand what returns are likely to look like in the future. For example, equity markets tend to see valuation levels revert back to their historical averages over ten-year periods. We use cyclically adjusted price-to-earnings (CAPE) to measure this mean reversion. CAPE measures the valuation of markets compared to a ten-year average of earnings. This measure has the advantage of not being distorted by the peaks and troughs of the earnings cycle. Nor is it dependent on the accuracy of earnings estimates. Rather, CAPE seeks to identify the cross-cycle trend in earnings in an objective manner.

When valuation levels are high, as we have seen since 2000, this tendency for valuations to mean-revert can have a brutal effect on equity returns. Indeed, at their all-time-high valuation levels in December 2000, the mean reversion would have led to a predicted -1.5% equity returns over the following ten years — even were you to have assumed average earnings growth and included dividend payments. Comparatively high yields in bond markets would, in contrast, have made those markets far more attractive.

By linking expectations of return to current valuation and yield levels, AVS seeks to position portfolios for the current market environment — even if the return prospects of each asset class deviate substantially from long-term trends.

RISK

The environment over the past ten years has also called into question many approaches to measuring and quantifying risk. The most common measure is volatility. But volatility is not what investors really care about; it is losses. Moreover, conventional methods attempt to understand the risk of a portfolio using historical data that is readily available. Unfortunately, this data frequently only goes back to 1990, leaving only a small data set with only a few occasions of genuinely severe periods of market stress.

AVS uses a gauge known as Extreme Downside Risk (EDR). This measure seeks to quantify the potential loss of a portfolio during a period of extreme market stress. We believe this is how most investors think about their portfolios. And we use data that goes back a lot further. This means that it captures many more periods of stress.

By examining how markets behave during such market environments as the great depression, oil shocks and 1987 crash, a much richer picture can be built of the likely performance of each asset class during future periods of market stress.

Conventional approaches to quantifying risk typically use probability distributions to interpret the historical data in order to forecast how asset classes will behave in the future. Unfortunately, these distributions tend to come attached with some assumptions that can lead to underestimating the risk of a portfolio. One example is the frequent assumption that correlations are static — regardless of whether the markets are stable in a period of severe stress. As anyone who lived through 2008 can testify, this is not an assumption that fits with a reality of rocketing correlations during times of crisis.

AVS does not use a probability distribution to examine risk. Instead, the raw data is used to examine how a portfolio would have actually behaved in such severe market environments in the past. The risk measure, EDR, is calculated by considering the average of the worst 5% of periods through longer data periods.

ADAPTIVE

This approach combines these expectations for risk and return to build portfolios that offer the potential of achieving attractive long-term expected return for a given tolerance to risk.

One important characteristic of this approach is that, as valuations and yields change, so too will our asset allocation advice. We seek to balance the important need to adapt portfolios to the market environment with the importance of limiting the costs of any rebalancing.

We do this by limiting rebalancing to, at most, once per quarter. But we only do this if the potential benefits — in terms of a greater expected return — outweigh the transaction costs of making the change.

LINKING WITH TACTICAL

AVS provides the strategic foundation for our asset allocation. This seeks to position portfolios for the long term: in our case over a ten-year period. However, we make tactical adjustments to this advice to incorporate our shorter-term views and thinking.

These adjustments are determined by our Global Investment Committee (GIC) led by the Global Chief Investment Officer, factoring in a wide range of variables — including politics, economics, investor positioning and sentiment as well as valuation levels.

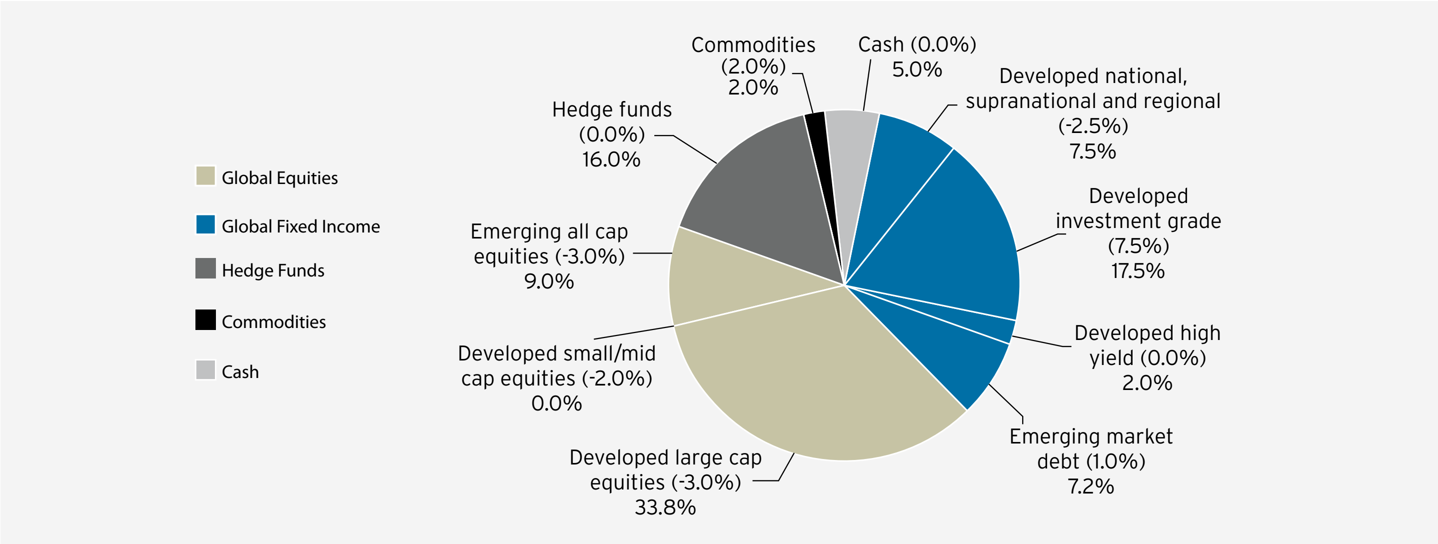
[1]Source: Global Financial Data and Bloomberg, as of July 2012

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.

Extreme Downside Risk (EDR) is a measure used to estimate the risk of an asset allocation. EDR seeks to estimate the typical type of loss, over a 12-month time horizon, an asset allocation may experience in a period of extreme market stress. The EDR for an asset allocation is calculated using a proprietary methodology and database. For a given asset allocation, this approach estimates the loss, over a 12-month time horizon, the asset allocation may have experienced during historical periods of extreme market stress. EDR is calculated by taking the average loss in the worst 5% of these historical periods of extreme market stress. EDR does not estimate the maximum possible loss. Potential losses for a given asset allocation may exceed the value of the EDR. Please refer to our Adaptive Valuation Strategies white paper where we discuss EDR in greater detail.

Asset Allocation and Asset Class Overview

Alexander Godwin, Global Head of Asset Allocation



Source: Citi Private Bank, as of July 2012

Figures in brackets are the difference versus the strategic benchmark.

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 OCIO of the Citi Private Bank.

DEVELOPED MARKET EQUITIES

It seems increasingly clear that 2012 is following a similar pattern to 2011, where US economic data decelerated markedly in the summer months. What is new is that now corporate profit growth appears to be falling also. This, combined with the economic problems in China and the seemingly perpetual crisis in Europe, creates a difficult environment for equities. One glimmer of hope is the expectation of further monetary stimulus; however, this is unlikely until markets fall further. We remain underweight equities.

EMERGING MARKET EQUITIES

Economic data out of China appears to be getting progressively worse. What has taken many by surprise, however, is the slow pace to respond with monetary and fiscal stimulus. Emerging markets remain highly dependent on Chinese growth and without a stimulus-led recovery, the region is likely to continue to suffer from a decelerating growth path. We remain underweight.

DEVELOPED SOVEREIGN BONDS

We continue to believe that yields will remain low for countries that are considered "risk-free" (including US Treasuries, German bunds and UK gilts) as we remain in a low-growth, deflationary and deleveraging environment. With no resolution of the crisis in Europe, we expect yields to continue their upward trajectory for much of Europe. We have no positions in Eurozone bonds save for a small position in short-dated German bunds.

CORPORATE INVESTMENT-GRADE BONDS

We focus on bonds issued by investment-grade-rated corporates in the US. These bonds are supported by strong and improving balance sheets, with corporations focused on paying down debt and improving credit ratings. We have a heavy overweight in this asset class as a result of such positive fundamentals.

CORPORATE HIGH YIELD BONDS

High yield bonds are highly correlated with equities, and are likely to follow the same path in the future. While default rates have remained below average, low yields offer no room to maneuver if economic problems were to persist.

EMERGING MARKET SOVEREIGN BONDS

Emerging market sovereign bonds have benefited from the improving fundamentals of developing countries over the past decade. Credit rating upgrades have coincided with improved fiscal and reserve positions. While we, by-and-large, expect this to continue, yield levels now factor much of this in. We have a small overweight to this asset class.

COMMODITIES

Base metals and energy remain sensitive to global economic growth, with base metals in particular exposed to growth in China. As China, along with the rest of the world, has decelerated, there has been pressure on the prices of these commodities. We expect gold to be driven by expectations of money supply growth and we have a position in gold driven by our belief that central banks will have to respond to slowing growth globally.

CURRENCIES

We continue to favor the dollar, sterling and yen as safe-haven currencies in the belief we are likely to see further deterioration in the global economic environment, and especially China. On the other side, we continue to be negative on the euro, emerging market and commodity currencies.

▶ EQUITIES

Looking Beyond Valuations

Archie Foster, Head of Equity Advisory, EMEA

In December of last year, we laid out the reasons why we felt that the equity markets would remain difficult in 2012, despite the chances for periodic bouts of "risk on." These reasons centered on what we felt were challenging economic growth prospects due to the continued deleveraging of developed market economies and the potential knock-on effects to emerging markets. Unfortunately, nothing that has occurred over the past six months has compelled us to shift this structural thesis. So while we still have an optimistic view that there are likely to be periodic, tactical opportunities to trade shifts in sentiment — most likely based on policy announcements or the speculation thereof — these moves: a) are generally quite difficult to time; and b) at least for the time being, are not likely to be particularly long-lasting. In this environment, a deeper, more granular approach to equity investing is required, in our view.

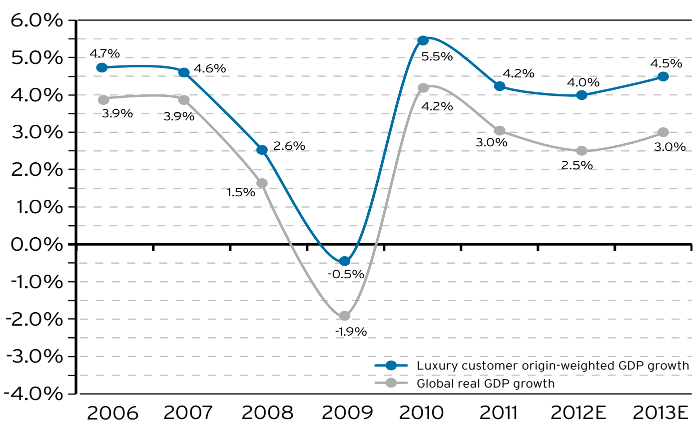
Specifically, we would focus on a combination of the following:

- **Go to where the growth is:** One of the reasons that investors flock toward defensives in times of stress is that demand for their goods and services tend to hold up well and can offer some visibility of growth. However, given the effects of globalization, the impact of the growth in the competition from private label and generic drugs, and the varying robustness of product cycles, we would caution that all names in, for instance, consumer staples or health care are not created equal. Investors must be increasingly discerning and focus on defensive growth vs. defensives as a whole by focusing on companies with visible growth drivers such as a new product cycle, new geographic focus or more streamlined product set. We'd also note that defensives' valuations in general have held up relatively well, so one must be aware of what type of expectations might be priced into stock prices at any given time.

  At the same time, we would not focus our attention solely on the defensive areas of the market. Again while we're not expecting strong growth (due to deleveraging), we're not expecting a global recession either (due to policy). Therefore, while growth is likely to be scarce, we believe that there will be pockets of growth in which to invest.

Investors will need to dig a little deeper than usual to find these opportunities, but we believe that select companies focusing on providing productivity enhancement (mobility, testing, automation) on the corporate side — as companies attempt to hold on to current record high margins — and small luxuries (brand names, affordable "status" purchases) on the consumer side — as consumers seek out select quality purchases without breaking the bank — may be examples of attributes to consider.

Figure 1: Luxury Goods vs. Real GDP

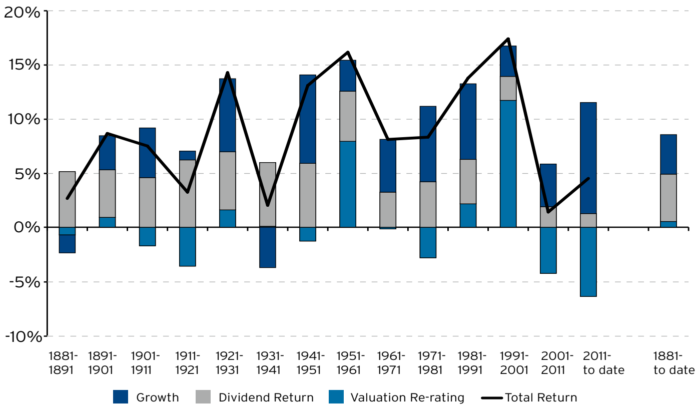


Source: Citi Research

In a slower growth environment, companies that can grow consistently are likely to be rewarded with higher relative multiples.

- **Get paid up front:** We continue to believe, as we have for some time, that stable and growing dividends will become more and more important to total return in this environment. This is due to a combination of lower return expectations, higher payouts due to investor demand and a bit of simple mean reversion.

Figure 2: S&P 500 — Annualized Returns by Decade



Source: Citi Private Bank, Investment Lab, as of June 2012; Global Equity Strategist ("The End of a Cult," September 2012 and "Buy, Not Build," November 2010) by Robert Buckland, Citi Research and Bloomberg. Past performance is no guarantee of future results.

This being said, we would strongly caution against "reaching for yield." Investors should be quite selective and willing to give up a little yield for increased visibility/sustainability of dividend growth, by focusing on companies with reasonable payout ratios, high expected growth of free cash flow and a history of steady, consistent dividend growth.

- **Find the beneficiaries of sluggish growth:** Given varying circumstances, some companies will usually benefit from others' headwinds. Specifically, we see a period of time ahead where some of the users of commodities may benefit from softness in the commodities complex as a whole. For instance, rising commodity prices have been acting as a headwind for earnings in basic apparel, home and personal care, and food and beverage companies (to name a few examples), and we believe that these headwinds may well shift to tailwinds as we head through the year and into 2013. We believe that this may provide investors an additional layer of earnings visibility to certain companies, provided demand for their products remains resilient.

While we believe that equity market volatility will continue for the time being, making tactical investing difficult, this is not to say that we would shun the asset class altogether. Valuations, at least in certain geographies, suggest that at least a good measure of the effects of a sluggish economic environment is being factored into current prices. However, as we've mentioned before, while valuation is important, it isn't everything. In this environment, therefore, we believe deeper analysis centered around a combination of growth and yield is necessary when investing in equities.

All Indices Are Not Created Equal

Philip Watson, Head of Investment Lab, EMEA
Michelle Reese, Senior Investment Lab Analyst, EMEA

How to invest in equities has been a hotly debated topic for many years — inviting diverse considerations ranging from which securities to invest in, to the timing of entry and exit. One question capturing the minds of academics and practitioners today concerns allocation: How should I allocate to the stocks within my portfolio? What weighting should I assign to stock A versus stock B?

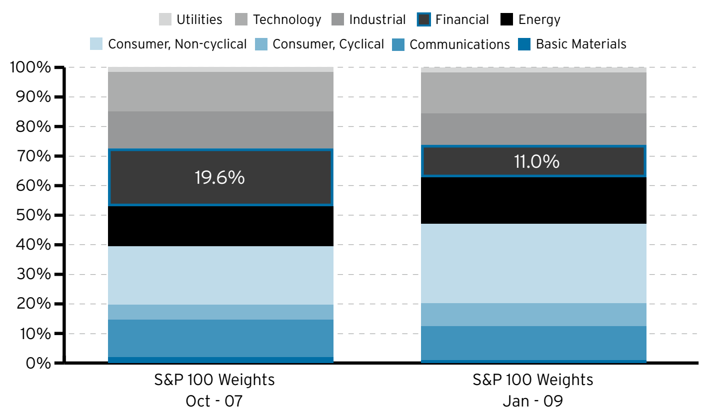
The intriguing part of this is that in practice — consciously or not — equity investors today commonly invest with reference to an index (S&P 500, FTSE, Hang Seng and so on). Each of these equity indices is composed of a list of companies commonly termed "the constituents." When weighted, these constituents collectively form the index. Many equity indices are weighted to these companies according to their market capitalization, where market capitalization is calculated as the share price multiplied by the number of shares outstanding (or those shares readily available in the market, in the case of a free-float calculation).

It is therefore not an exaggerated statement to say that the market capitalization approach heavily influences the equity asset management industry. This is in a number of different ways — through benchmarking of performance to these indices as well as through index tracking investment products. The rise of the passive ETF industry — an estimated $1.5tn by the end of 2011[1] — typifies this where an ETF will strive to deliver performance that is commensurate with the tracking index.

Despite this heavy uptake among investors of the market capitalization approach, many experts acknowledge that investing this way is not without its faults and that it can lead to unintended concentration exposures:

- **Single stock concentration:** The bias toward the largest companies' market cap weighting can lead to concentrations in a single stock. For example, Apple today accounts for around 12% of the NASDAQ, while HSBC accounts for 7% of the FTSE 100 and AIA for 12% of the MSCI Hong Kong Index.[2]
- **Sector concentration:** In the same way that market cap approaches can lead to stock concentrations, the approach can also lead to sector concentration. For example, in October 2007, the financial sector accounted for almost 20% of the S&P 100, after rounding up. By January 2009, this had fallen to 11%, as illustrated in Figure 1 below — a steep loss in this case for owners of supposedly diversified equities.[3]

Figure 1: Sector Concentration — 2007 vs. 2009



Source: Citigroup Global Markets Limited, Bloomberg. Historic price performance may be presented in a currency other than the currency of the country in which you reside. Your actual return on a product linked to the Index may increase or decrease with fluctuations between currencies. All information shown net of dividend tax withholding & gross of fees. Past performance is no guarantee to future results. Allocations as at start of referenced month.

- **Unintended style bias:** As higher market capitalization rewards companies with larger weights, the approach can have an unintended bias toward growth stocks. Historically, investors have typically paid more for growth companies while at the same time value has tended to outperform growth over time. As well, investors are often paying for past positive performance: The better a constituent's historical performance, the greater the representation in the index — which in turn means more bought by investors tracking the index.

How might investors look to mitigate these biases? In a market environment dominated by a risk-on/risk-off dynamic, long-term investors may consider placing more emphasis on extracting value within a risk management framework. A balanced risk approach may offer investors unique investment opportunities, including preserving many benefits of traditional index investing such as access, transparency and liquidity, while potentially offering a more balanced and diversified risk exposure across its components.

In order to overcome the potential issues associated with market cap-weighted indices, a number of innovative index approaches have been devised over the past few years including fundamental, equally weighted and risk-based indices. In context of the latter, the notion of using an equal-risk contribution methodology is gaining traction. Instead of weighting stocks by market capitalization, this approach looks to weight stocks by the risk they individually contribute. Compared to traditional market cap approaches, an equal-risk approach can potentially help investors achieve diversified exposure to a similar universe of equities while reducing some of these unintended biases and maintaining transparency and liquidity associated with that universe of stocks.

COMPONENT COMPARISON ON AN EQUAL RISK VS. MARKET CAPITALIZATION FRAMEWORK

We use Citi VIBE US as an example of an index that uses an equal-risk contribution framework and the S&P 100 as an example of an index that uses market capitalization. See Figures 2a and 2b.

An equal-risk approach would aim to provide:

- A lower-risk access for investors into diversified equities — providing lower volatility compared with equivalent market capitalization approaches;
- Significant returns on both an absolute and risk-adjusted basis;
- A lower beta than traditional market cap approaches.

Figure 2a: Illustrative Index Component Weights

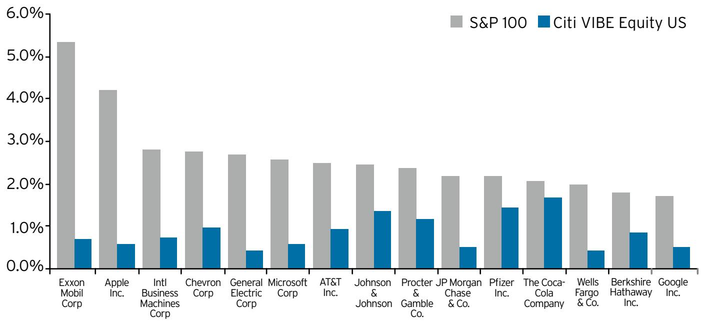
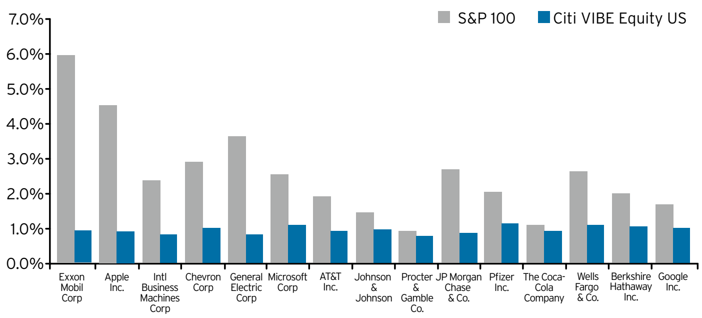


Figure 2b: Illustrative Index Component Volatility Contributions



Source: Citi Global Markets Limited, Bloomberg, as of June 2012. Weights and volatility contribution using 120-day volatility, as of last quarterly rebalancing date of the S&P 100. Citi Volatility Balanced Beta (Citi VIBE) methodology relies on market price volatility (both historic and implied) as a measure of risk. The index does not attempt to identify or quantify any specific risks which may be relevant to a stock, sector, industry or geographic region.

Of course, no investment approach is without its risks. Just as the equal-risk approach might protect against quick downturns within the markets, so too might it underperform the market capitalization approach during the markets' relief rallies, reflecting the lower market sensitivity of an equal risk approach. And as would be expected, despite the similarity in company universe, tracking error to market capitalization benchmarks might be considerably higher among equal-risk approaches than their market capitalization exchange-traded product counterparts — so, not a tool for hedging or for matching a market capitalization-weighted index.

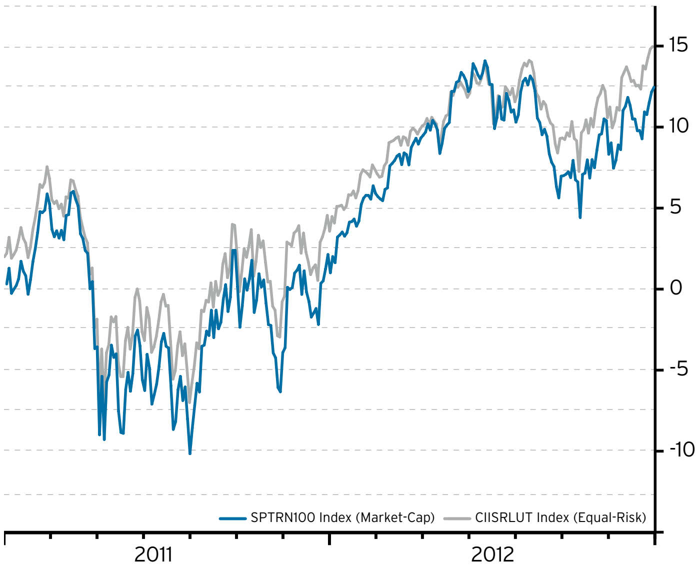
With these considerations in mind, it is left to determine which investors would find an equal-risk approach appropriate for their equity market exposure. The approach seems more appropriate for strategic equity investors — those with slightly longer-term time horizons. And given the built-in risk management framework, the approach is likely to be suitable for those who seek systematic diversified equity exposure in a more "risk-conscious" manner.

None of the above removes the challenge of knowing where and when to invest, though. This approach can be used in conjunction with a market-informed view driven potentially from a range of factors including technical, momentum, fundamental and valuation factors. For example, investors might apply an equal-risk approach to an index universe that is cheap when looking at cyclically adjusted price earnings.

And so the quest for "smarter" beta continues. Are we heading for a revolution in the way that indexing works? Probably not. But it may be that in years to come the power of money flow lays the path for a disentangling of a hugely embedded approach. But for now, it's an interesting debate at the very least.

Compared to a market capitalization-weighted approach, a risk-weighted approach may offer a more balanced and diversified risk exposure. This approach should be considered by investors looking to allocate to equity markets on a strategic basis.

Figure 3: Equal Risk vs. Market-Cap Total Returns



Statistics: June 10, 2011 – June 19, 2012	Ann. Return	Ann. Std. Dev.
Citi VIBE US Net Total Return Index	13.3%	20.2%
S&P 100 Net Total Return Index	12.2%	22.3%

The data presented for the Citi VIBE US Index is shown as of inception (June 10, 2011). For the S&P 100 Index, net total return for the last five years is as follows:

2007: 5.4%, 2008: -35.8%, 2009: 21.3%, 2010: 11.8%, 2011: 2.5%, YTD: 11.7% (YTD is as of July 19, 2012).

Source: Bloomberg, as of July 2012. CIISRLUT is the Citi VIBE US Net Total Return Index. SPTRN100 is the S&P 100 Net Total Return Index. Past performance is no guarantee of future results.

Please refer to specific Citi VIBE disclosure at the end of this publication.

[1]Source: BlackRock ETP Landscape, Q4 2011

[2]Source: Bloomberg, as of May 2012

[3]Source: Bloomberg

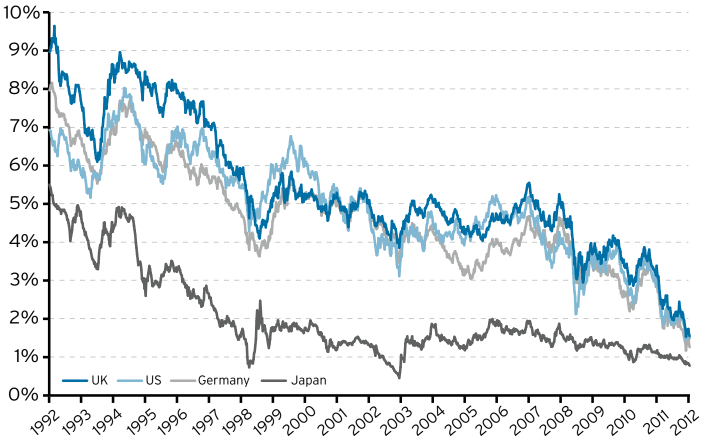
FIXED INCOME

Yield vs. Safety in a Volatile World

James Leighton, Senior Portfolio Manager, Tailored Portfolio Group

Investors typically want the best of both worlds — high returns with minimal risks — and this is especially true in today's bond markets where historically low government yields are encouraging greater risk taking. This is of course the desired effect of ultra accommodative monetary policy in an environment of feeble growth and subdued inflation. We expect this macroeconomic backdrop to persist for a prolonged period of time and that it will probably result in continued low bond yields as investors look for income and safety. However markets will likely remain volatile, in our view, as investors grapple with such major enduring headwinds as the Eurozone debt crisis, tighter fiscal policy and an Asian slowdown.

Figure 1: Historically Low Government Yields

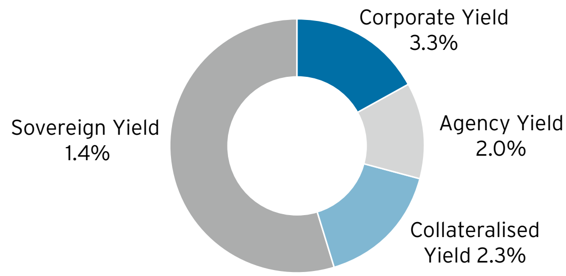


Source: 10 year yields, Bloomberg, as of June 2012

How should we be positioned to make sure we capture yield and yet have some protection from downside risks? Government bond yields look unenticing (Figure 1) with the developed world now converging with Japan. Consequently investors should look to other sectors that could potentially offer higher yields (Figure 2).

A well diversified fixed income portfolio that consists of global investment grade bonds issued by governments, agencies and companies may provide attractive risk adjusted returns in a low growth/low inflation environment for investors looking to capture additional yield.

Figure 2: Corporate Yields Attractive in the Global Investment Grade Universe



Source: Merrill Lynch, as of June 2012

Corporate bonds may look attractive in this low yield world but how do investors cope with the additional volatility associated with this asset class?

Historically one of the best ways to help reduce risk without giving up return has been to hold a diversified portfolio of global broad bonds (i.e corporate, agencies and governments) — this can be evidenced by the Sharpe ratio of 1.01 (Figure 3).

Figure 3: Historically Global Broad Has Produced Attractive Risk/Return Characteristics

	Global Government	Global Corporate	Global Broad
Return	5.8%	6.2%	6.0%
Standard Deviation*	3.0%	4.0%	2.8%
Sharpe Ratio*	0.89	0.77	1.01
Average Difference Over Cash	2.7%	3.1%	2.8%
Probability Return < Cash	19.0%	22.0%	15.7%
Probability Return < Zero	2.5%	5.8%	1.5%

Source: Merrill Lynch, December 1996 – June 2012. Past performance is no guarantee of future results.

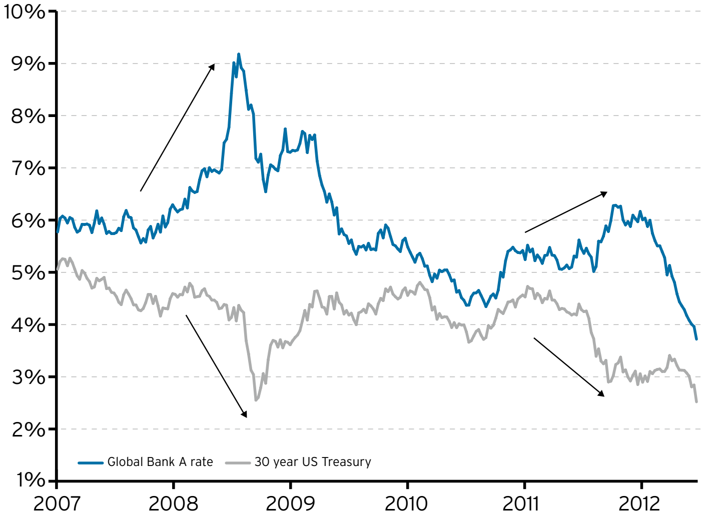
With the paltry level of government yields and relative attractiveness of corporate as opposed to sovereign credit fundamentals, the largest source of relative risk in most global broad portfolios is understandably corporate credit. There are essentially three routes to help reduce the volatility coming from credit risk:

1. **Take less credit risk:** This can be difficult and expensive for long-only investors as liquidity is often thin and can dry up in stressed markets. Due to the asymmetric nature of credit risk the key is to have diversified exposure with strict limits as to exposure per individual issuer. In addition, investors should pay careful attention to the domicile of corporate debt and avoid exposure to heavily indebted and structurally impaired countries (e.g., the Eurozone periphery). Therefore, we view more favorably a sizeable allocation to emerging market investment-grade bonds where sovereign debt fundamentals look healthy.

2. **Hedge with interest rate risk:** In past episodes of volatility in corporate bonds, core government yield curves flattened dramatically as the markets price in a heightened probability of recession and deflation (Figure 4). Accordingly, global broad investors should consider including some exposure in long maturity governments despite historically low yields.

3. **Hedge with FX positioning:** Periods of risk reduction have often been associated with a flight to the USD as investors unwind trades and seek liquidity. Consequently, this has led to possibilities to partially hedge the volatility associated with credit risk by tactically overweighting the USD.

Figure 4: Long Treasury Yields Collapse with Volatile Credit Markets



Source: Bloomberg, as of June 2012

*Standard Deviation: A measure of the dispersion of a set of data from its mean. The more spread apart the data, the higher the deviation. Standard deviation is also known as historical volatility and is used by investors as a gauge for the amount of expected volatility. Sharpe Ratio: A ratio used to measure risk-adjusted performance. The Sharpe ratio is calculated by subtracting the risk-free rate – such as that of the 10-year US Treasury bond – from the rate of return for a portfolio and dividing the result by the standard deviation of the portfolio returns.

Diversifying Directional Exposure

Francis X. Frecentese, Global Head of Hedge Fund Investments
Eric Siegel, Head of Alternative Solutions

Even though 2008 and 2011 were the two worst years in the history of hedge funds, the inclusion of hedge funds in a diversified portfolio of equity and fixed income assets through this period would have helped increase returns and reduce volatility.

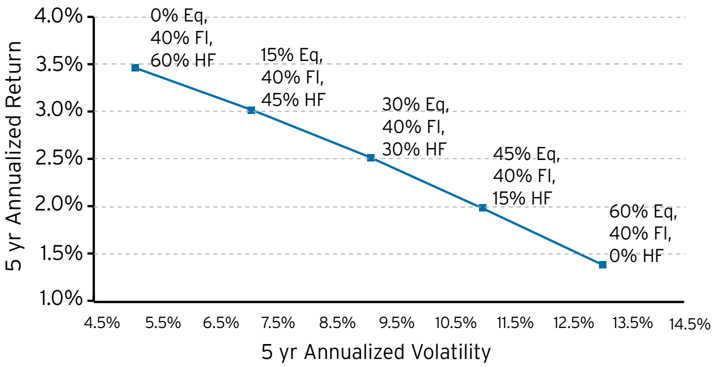
Furthermore, on a standalone basis, despite difficult markets, hedge funds delivered on their broad objective of producing attractive risk-adjusted returns through 1H12. Evaluated over a longer market cycle, hedge fund relative performance is even stronger. Hedge funds outperformed the global equity markets over the past five years on both an absolute and risk-adjusted (Sharpe ratio) basis.

Figure 1: Historically Hedge Funds Have Outperformed Global Equity Markets (Over Past Five Years)

	HFRI Fund Weighted Composite Index	MSCI World TR Net Index (USD)
Annualized Returns (5 yr)	1.14%	-2.96%
Annualized Volatility (5 yr)	7.96%	21.06%
Sharpe Ratio (5 yr)	0.03	(0.18)

Source: Citi Private Bank, Hedge Fund Research, as of June 2012. Past performance is no guarantee of future results.

Figure 2: Adding Hedge Funds to a Portfolio May Enhance the Risk Adjusted Return



Source: Citi Private Bank, Hedge Fund Research, as of June 2012. Past performance is no guarantee of future results.

Looking forward, we believe the case for hedge funds is as strong as it has ever been. Interest rates are at or near all time lows, with the 10-year Treasury well under 2%. Risk-based asset classes such as equities offer the potential for higher returns, but with high levels of volatility and drawdown risk. We believe that a diversified portfolio of hedge funds can provide investors with "equity-like" returns over an investment cycle with low levels of correlation to traditional asset classes and substantially lower volatility than equity markets.

PREFERRED STRATEGIES FOR UNCERTAIN MARKETS

Investors concerned about macroeconomic uncertainty and the impact of that uncertainty on financial markets should be focused on those hedge funds that have little correlation to traditional markets. We highlight four core hedge fund strategies in particular that derive their returns primarily through security selection and relative value as opposed to market long-biased market trades.

- **Relative Value Managers:** These managers seek to generate returns by identifying and structuring trades between related securities. Technical trading factors can often cause dislocations which these managers can arbitrage. Because trades are typically structured with effectively offsetting long and short positions, overall exposure to the market is limited. Many relative value managers utilize significant leverage in order to magnify small spreads between securities into attractive returns. This can result in high risk adjusted returns for a period of time, but can subject the fund to significant left tail risk. We prefer funds that utilize only modest amounts of leverage. We also prefer funds that can generate returns from long volatility/divergence trades as opposed to a pure short volatility profile.
- **Discretionary Macro Managers:** These managers utilize fundamental macroeconomic analysis and technical market analysis in order to structure trades on the direction of certain markets. While these funds may take a directional

view on a particular market at any particular point in time, their flexibility has historically resulted in low levels of correlation to traditional markets over any reasonable market cycle. Notably, macro funds have typically performed particularly well on a relative basis during "risk-off" market cycles. We generally prefer macro funds that employ a "prop desk" approach allocating capital to a wide range of traders and that utilize strict risk controls.

- **CTAs:** Commodity Trading Advisors ("CTAs") take directional positions in futures contracts on a wide range of underlying commodities including stocks, bonds, currencies, metals and agricultural commodities. Trading decisions are most often determined by quantitative trend following algorithms. CTAs have typically displayed substantial convexity in their return profile — i.e., generating high returns during strongly trending markets while performing poorly during choppy or stagnant markets. Historically, they've displayed negative correlation to risk-based assets like stocks, resulting in strong portfolio diversification benefits.
- **Market Neutral and Low Net Equity Long/Short Managers:** Equity long/short managers look to generate attractive risk-adjusted returns by identifying long and short opportunities in stocks that they perceive to be under-and-overvalued, respectively. We prefer managers, particularly in this economic environment, who maintain a low overall net exposure to the broad equity markets, thereby generating the bulk of their returns from security selection as opposed to market movements.

We note that these strategies individually outperformed the global equity markets in 2011 and 2012 (through May), periods marked by volatile equity markets and broad macroeconomic uncertainty. In particular, we highlight the outperformance during the difficult months of September 2011, August 2011 and May 2012, which saw sharp drawdowns in the global equity markets; each strategy was able to outperform the market during those months.

A diversified portfolio of hedge funds can potentially provide returns with lower volatility and low correlation to traditional asset classes over an investment cycle. Four key strategies to consider are Relative Value, Discretionary Macro, CTAs and strategies with a low net exposure to equity markets.

Figure 3: Hedge Fund Strategy Returns and Volatility

	2012 YTD	2011	2010	2009	2008	2007	May 2012	Sept 2011	Aug 2011	Vol Since 2011
Barclay CTA Index (USD)	0.3%	-3.1%	7.1%	-0.1%	14.1%	7.6%	2.7%	-0.1%	-0.4%	5.4%
HFRI Macro (Total) Index	-0.1%	-4.2%	8.1%	4.3%	4.8%	11.1%	1.4%	-1.2%	-0.5%	4.7%
HFRI Relative Value (Total) Index	3.9%	0.2%	11.4%	25.8%	-18.0%	8.9%	-1.3%	-1.7%	-2.2%	3.9%
HFRI EH: Equity Market Neutral Index	1.2%	-2.1%	2.9%	1.4%	-5.9%	5.3%	-0.7%	-2.8%	-2.5%	3.9%
MSCI World TR Net Index (USD)	5.9%	-5.5%	11.8%	30.0%	-40.7%	9.0%	-8.6%	-8.6%	-7.0%	17.5%

Source: Citi Private Bank, Hedge Fund Research, as of June 2012. Past performance is no guarantee of future results.

It should also be noted that investments in hedge funds are speculative and entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns, restrictions on transferring interests in the fund, potential lack of diversification, absence of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than mutual funds and advisor risk.

Diversification does not ensure against loss of principal.

FOREIGN EXCHANGE

Never Buy and Hold in FX

Jeremy Hale, Head of Global Macro Strategy, Citi Research

Foreign Exchange (FX) investors should remember two basic truths about the currency markets. One, exchange rates are always and everywhere relative prices — the price of US dollars in terms of euros, the price of Japanese yen in terms of Aussie dollars and so on. So what matters for FX are relative strengths and weaknesses, not absolute ones.

The second truth about foreign exchange is that in the long run, returns are near zero and volatility high. Left alone or simply held passively, FX exposure is not a winning game. Get a currency manager, a good system or hedge everything.

Meanwhile, all asset markets, including foreign exchange, face the overhang from a series of economic crises with a common cause: too much debt. As debtors attempt to delever, business and asset market cycles will likely be volatile and shorter for at least the next five to ten years, more than they have been at any time since the late 1950s/early 1960s.

In an attempt to stem these negative pressures, Central Banks have intermittently turned on the printing presses, dressing this up as quantitative easing, long-term refinancing operations and so on. But the result is mainly the same: a huge expansion in the money base in virtually all of the major developed economies in an attempt to improve spirits and risk appetite.

In a risk-off environment, investors should favor currencies like the US dollar. We believe that the US dollar will continue to be relatively strong over the next year. However, FX should not be thought of as a buy-and-hold strategy. If risk appetite returns, investors need to be ready to respond to new signals.

No wonder then, that the only major currency with strictly limited supply, gold, has been doing well and will likely continue to outperform, potentially reaching $2,000/ounce within a year. Because of this, investors should consider accumulating gold on price declines.

More generally, FX investors are going to have to abandon notions of investing for the long term and will need tools to assess where in the risk-on, risk-off cycle we are. In a risk-on cycle, the Aussie dollar and Brazilian real, the Mexican peso, the high yield Turkish lira and Hungarian forint in Central & Eastern Europe, Middle East & Africa (CEEMEA) are currencies that historically have risen. But during risk aversion, or in a risk-off cycle, more and more frequently there has been a rush for safe havens, notably the US dollar, Japanese yen and Swiss franc, as these are currencies that typically rally when broad market sentiment is weak.

For now, all of our signals suggest that we are in this less happy stage of the cycle. Economic data are surprising to the downside everywhere and leading indicators suggest this may well continue. Rising credit spreads and implied volatilities, meanwhile, suggest investor risk appetite is falling and sentiment is depressed. More policy intervention may help to stabilize this. That being said, for now at least, we have reasons to believe that the US dollar will continue to be relatively strong.

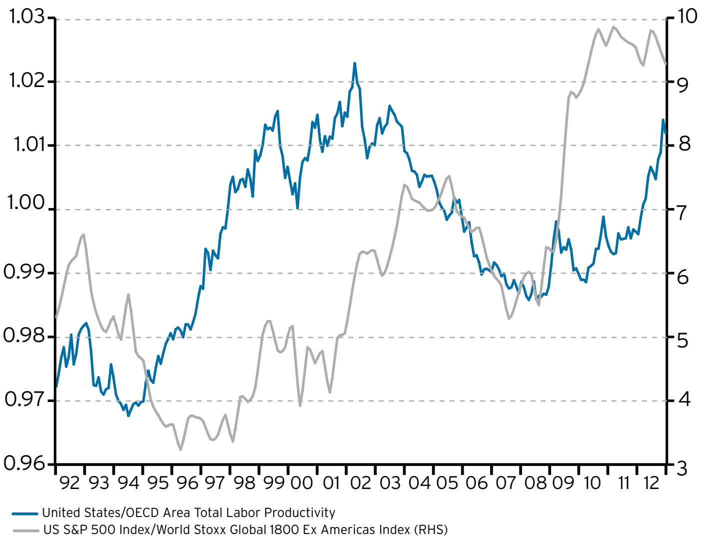
This comes back to the notion that exchange rates are relative prices. The US GDP and employment recovery since June 2009 have been fairly anemic by past standards. But the likely severe downshift in growth in China (so called "Chindown") from its boom years and the ongoing recession in the European Monetary Union (EMU) countries make the US look relatively buoyant in comparison. In fact, the Organization for Economic Cooperation and Development (OECD) Secretariat data show that US productivity relative to other developed countries is undergoing a second wave of massive outperformance (the first being in the 1995–2000 period — see Figure 1). Economic outperformance like this begets asset market outperformance. We believe that equities will likely be rated more highly, the dollar will likely be stronger and, on the other side of the coin, US bond yields will rise more, or fall less, than elsewhere.

In the case of Europe, we remain convinced that one side effect of the crisis will be much easier policy from the European Central Bank (ECB). Already, two-year swap rates have been falling faster for some time in EMU than in the US. And the expansion of the ECB balance sheet is coming through faster than the same for the Fed. In effect, the ECB is lowering the return and increasing the supply of euros at the same time and doing this much faster than it's happening in the US. This is euro negative (Figure 2).

As a result, euro rallies will likely be short-lived. We expect EUR/USD to reach 1.15 over six to 12 months. Some other European currencies with better fiscal or current account fundamentals (e.g., Sweden or Norway) will probably appreciate vs. the single currency but will likely still lose ground vs. the US dollar.

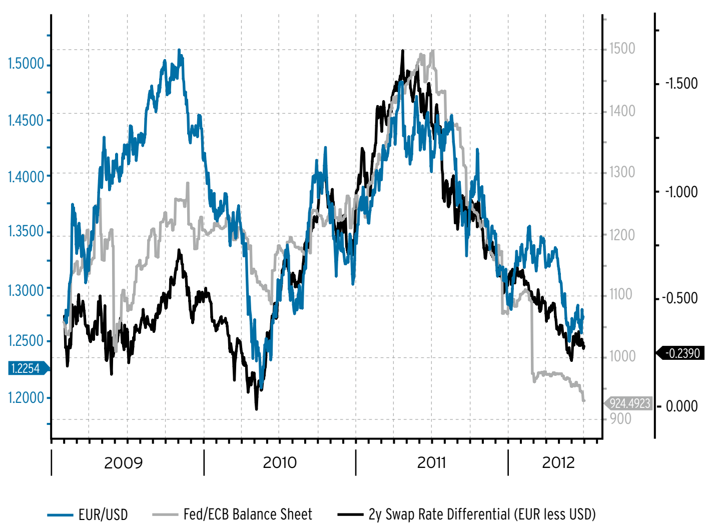
Notably, when the US dollar rallies, it typically goes up against almost everything in every region. With Chinese growth now downshifting, Asian currencies are certainly vulnerable. However, we expect USD/CNY (Chinese Yuan Renminbi) itself to flatline. Chinese problems imply downside for commodity-backed China-dependent currencies too. For example, the Aussie dollar stands out as overvalued. Overall, we look for gains of about 4–6% globally in the US dollar over the next year, with EUR/USD likely to fall more while USD/JPY will likely still be relatively stable. However, the situation is fluid. If policymakers get ahead of the game, against our expectations, and risk appetite returns, investors need to be ready to respond to new and changed signals. Never buy and hold in FX.

Figure 1: US Relative Productivity and Asset Market Performance



Source: Citi Research, Bloomberg, as of June 2012

Figure 2: Easy Money Is Bad for Local Currencies, All Else Being Equal



Source: Citi Research, Bloomberg, as of June 2012

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Distressed Opportunities in a Deleveraging Market

Daniel O'Donnell, Global Head of Private Equity and Real Estate Research and Management
Ryan Foscaldo, Private Equity Research and Management

New regulations and capital standards are requiring US and European financial institutions to recapitalize. However, European financial institutions have been particularly reluctant to sell distressed assets at steep discounts as such sales would require banks to absorb large, immediate capital losses. The International Monetary Fund forecasts that European banks are expected to delever balance sheets by approximately €2 trillion over the next 18 months.[1] According to estimates by PricewaterhouseCoopers, there are approximately €2.5 trillion of "non-core" loans that may be up for sale – at the right price.[2]

Barring further economic and financial upheaval, this slow, steady deleveraging by European banks is expected to continue, despite the European Central Bank's emergency bank loan program. A slow deleveraging process will delay the inevitable need to recognize losses, and consequently may reduce the opportunity to deploy private capital in the near term. Alternatively, if financial institutions in the US and Europe quicken the pace of deleveraging, more capital would be required to absorb these assets. Despite their reluctance, US and European financial institutions will need to continue shrinking their balance sheets.

The massive corporate debt overhang in the US and Europe may result in investment opportunities as the developed world unwinds its unprecedented buildup of leverage. Near-term vintage years of seasoned and experienced private equity managers may find themselves in a unique position to acquire assets at low valuations.

As a result, US and European-based private equity investors and hedge funds have ramped up existing platforms, rebuilt distressed trading desks that closed down in 2008 and 2009, and have begun to launch a variety of new credit-oriented opportunity funds and distressed debt strategies positioned to take advantage of anticipated market dislocations. According to Preqin, as of June 2012, distressed debt managers in the US and Europe have approximately $59.9 billion in available capital – with 64 funds currently in the market seeking to raise an additional $46.1 billion in aggregate capital commitments. This compares to a Standard & Poor's estimate that the total amount of refinancing and new money needed over the next five years is expected to be approximately $21.6 trillion and $22.6 trillion (see Figure 1).[3]

This substantial supply/demand imbalance signifies an unprecedented market opportunity, which has the potential to generate compelling investment opportunities for quality managers with broad investment mandates.

Figure 1: Nonfinancial Corporate Debt Outstanding (USD$ billions)

	US*	Eurozone & UK**	Total
Nonfinancial Corporate Bonds	5,434	1,726	7,160
Bank Loans & Other Advances	6,082	9,682	15,764
Total Nonfinancial Corporate Debt (Excl. Securitized Loans)	11,516	11,408	22,924

Source: *Federal Reserve Flow of Funds for Nonfinancial Businesses, as of March 2012, US Bureau of Economic Analysis. **European Central Bank, Eurostat Bank of England, ONS Blue Book, as of 2011

The data in Figure 1 assumes, according to Standard & Poor's, that $17.2 trillion (75% of a total $22.9 trillion referenced) in these regions, bonds, bank loans and other advances mature on a roughly pro rata basis over an average seven-year period and would come due between 2012 and 2016. This $17.2 trillion represents only 55% of the total nonfinancial corporate debt globally, that will mature by the end of 2016.

In addition to this outstanding corporate debt, Standard & Poor's estimates that over the next five years, there will be a need for $4.4 trillion to $5.4 trillion in additional commercial debt financing (see Figure 2).

During periods of market dislocation, sourcing, executing and providing creative capital solutions take a unique combination of experience and expertise. Accordingly, seasoned and experienced private equity investors and hedge fund managers with the ability to leverage this expertise may be well-positioned to pursue investment opportunities arising from a constantly changing market environment.

More than any other theme, global credit investors have increased the resources committed to investing in European opportunities — with some managers looking to acquire distressed businesses at low valuations that are expected to trade higher, while others are focusing on the opportunity to buy assets from distressed sellers.

Anecdotally, hedge fund and private equity managers have told Citi Private Bank that many of the assets that they are seeing come to market are not necessarily "toxic" assets — rather, the assets could be of high quality (e.g., rated AA and higher). Further, many private equity investors and hedge funds are now looking to the European marketplace to acquire non-European assets at attractive prices.

Figure 2: New Nonfinancial Corporate Debt Money Demands 2012–2016

	Nominal GDP Growth Assumptions (2012-2016)*	New Money Requirements (USD$ millions)	
Region		**1x****	**1.2x*****
Eurozone	3%	1,555,771	1,889,452
UK	4%	355,398	433,349
US (Including Mortgages)	4%	2,494,802	3,042,002
Total		**4,405,971**	**5,364,803**

*Assumptions are adjusted for inflation and the Consumer Price Index, and are derived from forecasts in our sovereign reports on France, Germany, the UK and US. **Assumes debt grows at the same rate as GDP over the next five years. ***Assumes debts grows at 1.2x the rate of GDP over the next five years.

[1]International Monetary Fund, *Global Financial Stability Report*, as of April 2012

[2]PricewaterhouseCoopers, *The European NPL Barometer: Stable volume masks changing dynamics*, as of February 2012

[3]An S&P study of corporate and bank balance sheets indicated that the bank loan and debt capital markets will need to finance an estimated $21.6 trillion to $22.6 trillion wall of corporate borrowings between 2012 and 2016 in the US, the Eurozone and the UK (including both rated and unrated debt, and excluding securitized loans) – composed of outstanding debt totaling approximately $17.2 trillion that will require refinancing, plus approximately $4.4 trillion to $5.4 trillion in additional commercial debt financing over the next five years that S&P estimates companies will need to stimulate growth.
http://www.standardandpoors.com/ratings/articles/en/us/?assetID=1245333370039

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London Still a Capital Attraction

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Amid an environment of global economic uncertainty, investors continue to search for safe havens to invest. One investment opportunity that continues to resonate with investors is investment in UK commercial real estate. Citi Private Bank's recent *Wealth Report* has once again highlighted the importance of London, in particular for global investors. The survey of high net worth individuals specifically shows London as leading all other cities in terms of being "important now" and "the most important in ten years." Furthermore, research from the Economist Intelligence Unit (EIU), which ranks the competitiveness of 120 of the world's top cities, shows New York, London and Singapore leading the charge. The aforementioned provide an intriguing backdrop for both near-term and long-term investment.

Figure 1: Wealth Report: The Cities That Matter to HNWIs

Most Important Now	Most Important in Ten Years
1. London	1. London
2. New York	2. New York
3. Hong Kong	3. Beijing
4. Paris	4. Shanghai
5. Singapore	5. Singapore
6. Miami	6. Hong Kong
7. Geneva	7. Paris
8. Shanghai	8. Sao Paulo
9. Beijing	9. Geneva
10. Berlin	10. Berlin

Source: Citi Private Bank and Knight Frank, 2012

Interest in real estate in global gateway cities continues to grow as economic uncertainty persists. Specifically, investors are seeking the refuge of bricks and mortar in key locations such as London. Real estate in the UK also continues to be viewed as an attractive alternative to fixed income investments with low historical volatility and steady returns over time and, when compared to other asset classes, it has exhibited low correlation and produced strong overall returns.

The unique leasing structure in the UK is also of particular note, with tenants typically committing to ten- to 15-year leases with upward-only rent reviews every five years. This means there can be no downward revision in rent during the term of the lease, thus offering bond-style income with the opportunity for growth every fifth year. Investors are also attracted to the UK standard form of lease, which is typically full repairing and insuring. The leases allow the landlord to recover all expenses in relation to insurance and require tenants to maintain the property while at the expiration of the lease, the tenant is obliged to reinstate the property in the condition in which the property was taken.

As investors contemplate the UK real estate market, there are a variety of ways to enter from a risk return perspective. Accordingly, investors must contemplate what type of return they require and whether they are comfortable with the risk required to achieve that return. Specifically, prime properties in London (i.e., the West End and the City of London) are trading near historical highs. While we don't see valuation pressure near term, investors need to manage their return expectations in this segment of the market.

In order to generate more outsized returns, investors must be willing to take on more risk in the form of location, occupancy and/or development. Investors with the ability to reposition an underlying property have the potential to benefit from the stability of the London real estate market but with more upside potential than a fully stabilized property. However, this type of strategy is best effected with a local partner that knows the market well and has the requisite resources necessary to create value.

For example, we think the recently announced plans to transform London's "Midtown" district between the West End and the City into the capital's most vibrant cultural district could provide compelling investment opportunities going forward.

Further, as pressure on yields and rents increase in the West End and City of London, the underlying dynamics of the Midtown market will begin to favor landlords.

Currently, property investor activity remains concentrated on the acquisition of low-risk "core" assets.

The consequence of prolonged investor risk aversion is that an unsustainable pricing disparity is emerging between "core" assets and "non-core" assets. Given that risk has been oversold in most locations outside of London, we believe there may be attractive long-term investment opportunities for other key cities in the UK that have the requisite characteristics (i.e., supply, demographics, employment).

As such, we also believe that key locations outside London should also be considered that have the required dynamics. Since 3Q 2011, with the global economy continuing to exhibit significant structural risk and ongoing uncertainty, it is evident that both property investors and lending banks have become increasingly risk averse.

Additionally, the prevailing national UK property yield is appealing relative to key comparable standards. For example, an initial income yield on the UK commercial property market as of June 2012 is approximately 580 basis points above the ten-year UK gilt, with the property yield premium at close to a 23-year peak relative to this "risk-free" rate. Similarly, pricing comparisons with UK equity dividend yields, interest rate swap rates and the cost of debt financing all present a favorable property pricing dynamic.

Underlying tenant markets, akin to employment levels, take longer to recover; however, leasing activity in key sub-markets, underpinned by robust fundamentals, are showing discernable signs of improvement. It is anticipated that in key sub-markets, such as central London offices, supermarkets and prime retail warehousing, this momentum will be sustained over the medium term. These tenant markets should gain further momentum in the medium term from the virtual absence of any new-build development activity since mid-2007 and a forecast restricted level of future development activity.

Figure 2: Real Estate — West End

Prime Yields	West End
Top of Cycle (Mid 2007)	3.75%
Bottom of Cycle (Jan 2009)	6.5%
Today (Mar 2012)	4.00%

Source: Jones Lang Lasalle, March 2012. Past performance is no guarantee of future results.

Figure 3: Real Estate — The City

Prime Yields	City of London
Top of Cycle (Mid 2007)	4.25%
Bottom of Cycle (Jan 2009)	7.25%
Today (Mar 2012)	5.25%

Source: Jones Lang Lasalle, March 2012. Past performance is no guarantee of future results.

Notwithstanding the current cyclically high valuations, there doesn't appear to be any near-term pressure on valuations and demand continues to be strong. Given where overall central London values are residing, we suggest investors consider isolated opportunities in need of repositioning, active management or that reside in "non-core" locations. However, this should be done in a diversified manner and with an experienced local partner, possibly in the form of a joint venture, with the necessary level of resources and expertise to identify and deliver:

- Assets with embedded value growth potential. Capital constrained vendors who are unable to finance accretive asset management initiatives.
- Executing a long-term investment strategy that focuses upon the opportunistic acquisition of high yielding UK real estate assets, purchased at or below replacement costs.
- Significant capital upside from void reduction.
- Repositioning of assets to higher value uses.

Investment in UK commercial real estate continues to resonate with investors. Potential benefits such as unique leasing structures that offer bond style income and the opportunity for growth, as well as historical low volatility and steady returns over the longterm makes this a compelling opportunity for investors to consider. We believe this type of strategy is best effected with a local partner that knows the market well and has the requisite resources necessary to create value.

With respect to Real Estate investments, 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.

NOTES

▶ NOTES

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Note that specific criteria exist for each index including rebalancing, share eligibility and computation procedure.

VIBE Disclosure:

MARKET RISKS

The Index comprises equity constituents and is subject to all the risks associated with equities. The Index Level can go down as well as up.

The Index does not eliminate market risk. It simply reallocates the weights of the constituents, according to the defined methodology.

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The Index aims to find weights that equalize contribution to risk at each quarterly rebalancing. As a result, the weights of the constituents between rebalancing dates may deviate significantly from the weights that would be required for the constituents to have an equal risk contribution every day.

The 10% cap on the weight of each constituent overrides the optimization methodology to preserve diversification, but results in a proportionate redistribution of percentage weight and therefore a reallocation of risk contribution.

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