



2012 Outlook

2012 AT A GLANCE

- The global economy is very likely to slow sharply this year. Quite how sharply it slows and why will define how risky assets will perform.
- The eurozone crisis is front and center of market worries. Investors have become increasingly concerned about the solvency of some of the world's largest economies.
- The possibility of a catastrophic outcome keeps us cautious on European equities.
- We continue to recommend US non-financial, long-dated investment grade corporate debt and, to a lesser extent, longer-dated US Treasuries.
- Although the US has performed better than expected recently, we anticipate events in the US to continue to be overshadowed by the unfolding crisis in Europe and the potential for a significant slowdown in growth in China.
- Asian economies still remain highly leveraged to the global industrial cycle. A sharp recession in Europe would hit Asia where it hurts the most – in its trade and capital flows.
- Currency volatility and lower growth are the main risks for Latin America in 2012 and we recommend local investors to hedge currency risk.
- We advise taking an underweight position in emerging markets, especially countries with high export exposure to China, including South Africa, Russia and Brazil.

ASSET CLASS HIGHLIGHTS

- **EQUITIES.** We would stick to companies with sustainable and high dividends and stable market shares.
- **FIXED INCOME.** The outlook for 2012 is attractive for corporate investment grade bonds. Corporate balance sheets are strong while firms continue to seek to pay off debts and raise their credit ratings.
- **HEDGE FUNDS.** We believe the current period of deleveraging will create interesting opportunities, and we prefer managers who can wait for these to take hold, rather than look to apply hefty leverage to ordinary spread convergence opportunities.
- **FOREIGN EXCHANGE.** We expect the dollar to appreciate against most currencies – in particular the euro and the currencies of emerging nations and commodity exporters.
- **COMMODITIES.** Many commodities remain highly exposed to demand from China. It is likely that commodity prices will fall as this demand slows.
- **PRIVATE EQUITY.** In the US and Europe, looming corporate debt maturities combined with market uncertainty may result in attractive investment opportunities in the coming years.
- **REAL ESTATE.** Investors continue to seek safety and stability and will likely focus on prime properties in core markets. Investors must remain cautious as adverse global economic growth re-forecasting will continue to influence all property markets.

INVESTMENT PRODUCTS: NOT FDIC INSURED • NOT CDIC INSURED • NOT GOVERNMENT INSURED • NO BANK GUARANTEE • MAY LOSE VALUE

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Review of 2011

Richard Cookson, Global Chief Investment Officer

POWERFUL THOUGH IT MIGHT BE, THE CONSENSUS IS OFTEN WRONG. THE ONLY QUESTION IS IN WHICH DIRECTION IT IS WRONG

At the beginning of 2011, the consensus agreed that yields on those government bonds still deemed creditworthy by the ratings agencies would climb vertiginously, meaning that prices would fall. On this argument, only the irrational would put their money into government bonds and the long end of the Treasury or core European bond market. The wise, so the consensus had it, would instead buy equities and all things emerging: emerging currencies, emerging debt, industrial commodities and (especially) emerging equities. The emerging world, after all, was where the growth was.

WE HAVE CONSISTENTLY FAVORED THE MARKETS THAT MOST OTHERS HAVE SHUNNED AND SHUNNED THE MARKETS THAT THEY FAVORED

Over the months we took many sledgehammers to this consensus. We have been table-thumpingly more bullish about US investment grade fixed income and far more cautious about equities. The underlying reason is that most of the developed world was in a Japan-like situation, in which the private sector would continue to save, thus slowing growth and keeping bond yields low. Europe's situation was much worse, because European countries were locked into the straightjacket of monetary union and, with spreads of peripheral countries' bonds rising, the pain would be much greater than in Japan because doubts about solvency would be greater. This was why we held no peripheral debt in our recommended portfolios.

THE PARADOX OF QE

Although the consensus believed that the end of a second round of quantitative easing (QE) would cause a sharp rise in Treasury yields, the evidence, we said, suggested exactly the opposite: that a Japan-like situation in which the private sector

continued to save, would lead to the paradox of QE – when the Federal Reserve stopped lapping up bonds, activity would slow and bond yields would *fall*, not rise. In last February's edition of *Quadrant* called "Maturing reflections," we wrote: "Whilst there may be a bit more upside in yields, we continue to believe investors should take the opportunity to extend their maturity in the US and parts of Europe."

Indeed, at the end of March we upped our fixed income exposure in earnest as US activity started to roll over, taking a scythe to consensus forecasts in all their guises. By June, it had become clear that growth in the US had slowed sharply. Many people were talking about a "soft patch." We thought it looked more as if the US economy had fallen into quicksand.

Not only have we been heavily overweight US high-grade fixed income, we have consistently favored the long end of the curve (that is, maturities of ten years and more). Until August, we concentrated our heavy overweights mainly on Treasuries and long-dated core government bonds, and we switched to long-dated US dollar corporates in the summer. Although we started the year heavily overweight high yield, we slashed this exposure in the spring. This strategy couldn't have turned out better. High yield bonds struggled in 2011. The long end of the Treasury market has been one of the best-performing assets on the planet. The second best? Not gold, but long-dated US corporate debt.

LITTLE ENTHUSIASM FOR EUROPEAN FIXED INCOME

We have repeatedly warned that European sovereign stresses were anything but a little local difficulty. These stresses were of global systemic importance; another reason, we thought, why the bid for government bonds that were still deemed creditworthy would be so strong. With the short, though painful, exception of a foray into Italian equities, we kept out of all peripheral European equities.

Though our overall call on core European equities was too bullish, at least we recommended cutting positions to all US and European financials in early March. In “Oil be damned,” we wrote that “the slow train wreck that is the peripheral crisis shows no sign of abating ... it is getting worse.” This is a theme that repeated again and again over the following months.

Midyear we again emphasized the euro area stresses which would lead to further selling of the euro and even lower core bond yields putting equity prices under pressure – hence our underweight position most of the year. Slowing growth in much of the developed world and huge systemic risks in Europe would not be good for an asset class that relies on growth and dislikes the sorts of threats that Europe presented. Where we were wrong was in assuming that core Europe would outperform the US, given that if Europe exploded in a miasma of despair and litigation, US equities would suffer, if anything, more, because cyclically adjusted valuations were twice those

of European stocks. In fact, in relative terms, US stocks have done better than their European counterparts.

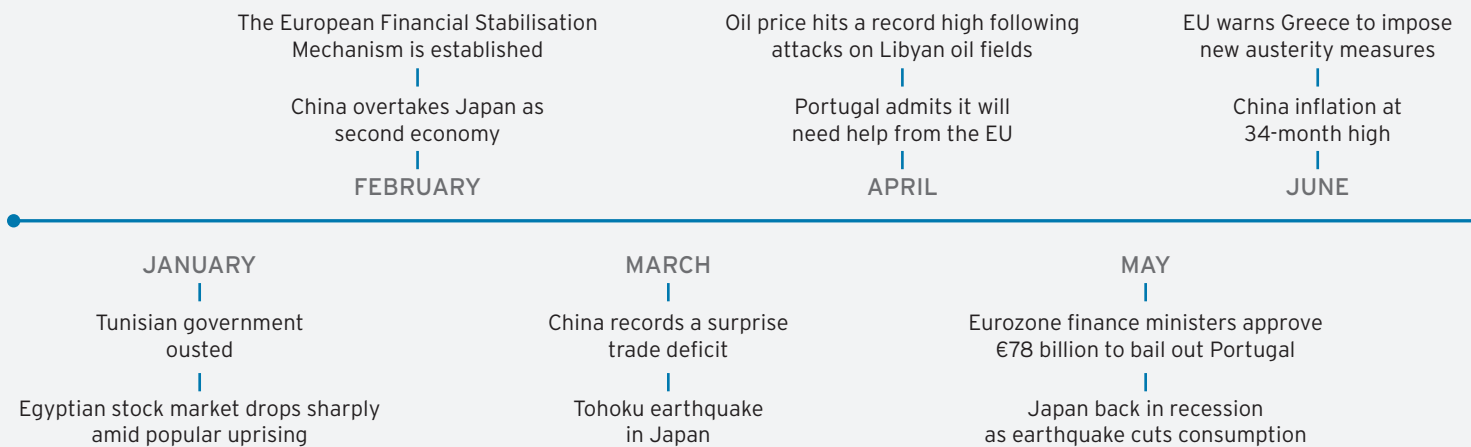
We avoided the worst of the carnage in financial stocks and recommended a zero weighting in Europe and the US in early March. We closed this out in mid August, with financials on both sides of the pond having fallen by -28.1% and -22.4%, respectively (as at December 20, 2011).

JAPAN IN RELATIVE TERMS

We also liked Japan at the beginning of the year. The call did splendidly for a while, but then the tragic Japanese earthquake struck in March and Japanese stocks plummeted. We stuck to our guns and while the large cap market has not done well in absolute terms, it has done very well in relative terms. Moreover, Japanese small caps have been one of the best performing of all equity markets since the middle of March.

2011 AT A GLANCE

Market Events



IN OUR VIEW, GROWTH, INFLATION AND POLITICAL RISKS WERE RISING UNCOMFORTABLY FAST IN THE EMERGING MARKETS

We articulated our concerns early and forcefully. Last January we wrote: "Investors are, we think, paying too much for growth prospects in the emerging world at a time when inflation, and ultimately growth concerns are mounting. Underweight EM." China was especially worrying, because growth seemed to be driven by what looked like uncomfortably fast growth in house prices and credit. These things do not generally end well and the problem, we thought, was that much of the rest of the emerging world and many commodity exporting countries, such as Brazil, Australia, South Africa and Russia, would suffer a lot were China to slow sharply.

ENTHUSIASM FOR THE UNLOVED US DOLLAR

In May, we wrote: "Heightened risk aversion and falling commodity prices and break even rates are likely, we think, to have another effect: a continued bounce in the dollar ... All things equal, that bounce is likely to continue until the US economy slows sufficiently that the Fed starts muttering about QE3. So expect a continued rise in the DXY (the broadest tradable US dollar index) and a fall in the LDXY and the ADXY (Latin American and Asian currencies indices against the dollar)." Since our call, the DXY has risen by over 5%, while both the LDXY and ADXY have fallen. The LDXY in particular has fallen by over 10% since making the call (as at December 20, 2011). We expect this trend to continue.

The consensus, it is fair to say, has been forced to move a long way since the start of the year.



Never Confuse the Possible with the Probable: The Outlook for Markets in 2012

Richard Cookson, Global Chief Investment Officer

THE GLOBAL ECONOMY IS VERY LIKELY TO SLOW SHARPLY THIS YEAR. QUITE HOW SHARPLY IT SLOWS AND WHY WILL DEFINE HOW RISKY ASSETS WILL PERFORM

It is, as Sherlock Holmes might have said, a cardinal error to confuse the probable with the possible. Below we articulate five possible outcomes both for the global economy and for markets in 2012, ranging from reasonable to downright awful. None of these will be exactly right: there is, after all, an almost infinite range of outcomes. Doubtless things will happen that are, quite simply, unforeseeable.

The following are our best to worst potential scenarios.

1 GLOBAL POLICY EASES, THE US RECOVERS

The first scenario is that the US continues to recover, helped by extraordinarily loose fiscal and monetary policy. Building on its attempt to lend to sovereigns by the back door through very cheap long-term lending to the banks, the European Central Bank (ECB) stops its opposition to becoming the lender of last resort and, in effect, eases policy sharply, perhaps in conjunction with a number of other big central banks, not least the Federal Reserve. Dramatic fiscal tightening in the US is postponed. China eases monetary and fiscal policy early and sharply, thus preventing more than a mild slowdown. Global growth still slows and the eurozone has a recession, but it is less sharp. Risk appetite bounces drastically, for a while.

2 A GLOBAL MUDDLE THROUGH, BUT MARKETS BECOME INCREASINGLY CONFIDENT ABOUT POLICY

The second is a sort of continued muddle through, only with markets becoming increasingly impressed with the resolve of European Union institutions and countries to get a grip. Rather than wheeling out one big bazooka, the policy works by a successful combination of small-arms fire. Encouraged by

better-than-expected numbers, the Federal Reserve holds off from further bouts of quantitative easing (QE). However, there is some monetary and fiscal easing in the emerging world, which supports risk appetite. Fiscal tightening in the US is put off for another day. The eurozone has a recession and global growth slows, but again, it is less sharp. Risk appetite climbs somewhat, but not as sharply as in the first scenario. It's a sort of slow burn rather than a big bang.

3 A EUROPEAN MUDDLE THROUGH, BUT MARKETS REMAIN UNIMPRESSED BY POLICY

The third is a European muddle through that fails to impress but that stops short of default. That's pretty much where we are at the moment. Markets continue to fret about the fragmented and misguided efforts by European politicians. Current proposals for dealing with the debt crisis by a sharp tightening of fiscal policy are, after all, deeply recessionary, politically nasty and therefore probably won't work. Fiscal policy is tightened pretty much across the board in the developed world. More QE is forthcoming, but barely offsets this. China and other emerging countries continue to keep policy tighter than expected. Global growth slows sharply. Markets fret about European default.

4 SELECTED EUROPEAN DEFAULTS, GLOBAL CONTAGION

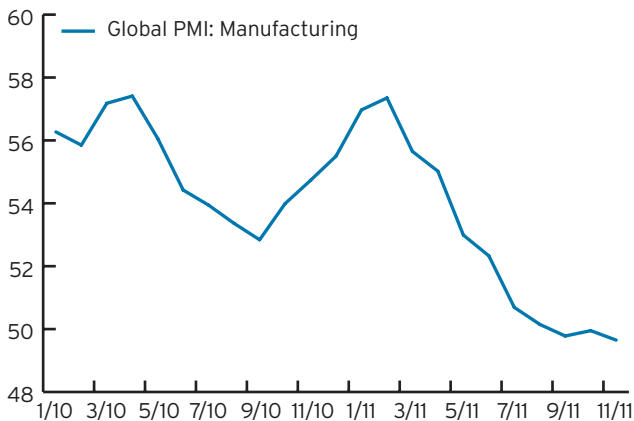
Fourth, there is an actual default, or even more than one, but within the euro. Here, contagion spreads fast and confidence is shattered globally. Sharp easing by central banks elsewhere fails to turn confidence around. Chinese policymakers perform a quick volte face thanks to rapidly diminishing exports, but to no avail. The world has a recession.

5 WIDESPREAD EUROPEAN DEFAULTS, A EURO BREAK-UP AND GLOBAL DEPRESSION

Fifth is a break-up of the euro and widespread default. Central banks elsewhere ease sharply but, having run out of fiscal bullets, the world has a recession bad enough to call it a depression.

Put in these terms, you can see it is clearly possible that risky assets (though probably not the global economy) will suddenly and spontaneously recover momentum, sparked by an ECB that wades in and buys vast quantities of peripheral debt, and supported by coordinated easing by the Federal Reserve, the UK Monetary Policy Committee, the People's Bank of China and various others. Whether that outcome is probable, or more probable than the other outcomes, is another matter. There is a decided downside skew to our scenarios. Think of it this way: the two worst outcomes are a lot worse than the two best and also, in some sense, a lot more probable – if only because they are really only a continuation of the tensions that we have seen escalating over the past year.

The global economy is slowing

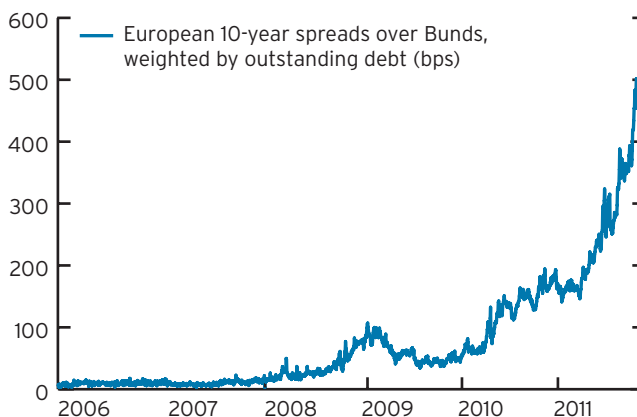


Source: Citi Private Bank using Bloomberg, as at December 19, 2011. PMI = Purchasing Managers Index.

EUROPE IN A STRAJTJACKET

The eurozone crisis is, justifiably, front and center of market worries at the moment. Investors have become increasingly concerned about the solvency of some of the world's largest economies.

Soaring spreads: investors remain concerned about the eurozone crisis



Source: Citi Private Bank using Bloomberg, as at December 19, 2011. Bps = basis points.

Liquidity in most European government bond markets has all but evaporated and is also pretty dreadful in its most creditworthy. By the end of 2012, Italy, France and Spain must borrow a total of €17 billion each and every week. That provides a lot of potential flash points. The optimistic gloss is that the ECB will do what it takes to keep things on the road. Indeed, it is already willing to lend long-term money for banks to invest in government bonds. Unfortunately, even if they take the bait, they are unlikely to take much. It would be surprising if there wasn't a European default of some sort in 2012. And surprising, too, if this didn't lead to more contagion.

And then what? European banks are finding it increasingly hard to fund. Regardless of whether or not European banks take up some of the slack for their own government bonds, banks from other eurozone countries and from elsewhere around the world are still selling their European debt exposures.

From being the province of the apparently extremist wing of the financial market commentariat, talk of a break-up of the euro has become entirely mainstream. From an investment viewpoint, the worse the crisis becomes and the greater the carnage in markets, the more volatile will be the reaction to any perceived "solution."

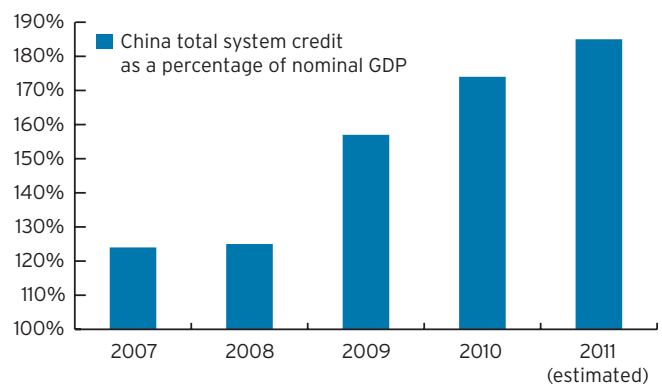
THE CASE FOR FISCAL TIGHTENING IN THE US

Globally, the weakness of the eurozone was partly offset at the end of last year by relatively decent growth in the US. Of course, this was helped by a Federal Reserve that had been more active than any other central bank on the planet. But the US has also been running a very loose fiscal policy: its fiscal deficit in 2011 was still an alarming 9.3% of GDP, down only a touch from the previous year. So another way of thinking about the relative strength of the US economy (certainly when compared with European economies) has been that it has yet to tighten fiscal policy in any meaningful sense. Although the country needs to tighten fiscal policy, it is unlikely that it will be forced to tighten much by markets. There are advantages to being the world's reserve currency. Although the failure of the Super Committee won't in theory have an effect on the tightening of fiscal policy until 2013, it would be surprising, to say the least, if the debate about how to tighten fiscal policy were not to become more acrimonious in the election year, with all the associated effects on confidence. And all the while the private sector continues to pay down its debts, thereby crimping growth.

CHINA'S SLOWING GROWTH

Chinese growth has been very unstable, driven by what looks very much like a credit and property bubble. Over the past four years, total outstanding credit in China has grown by about 60 percentage points of GDP and property prices have doubled since January 2009. It would be more than a little surprising were these two facts unconnected. What is also unsurprising is that growth is starting to slow sharply as credit taps have been turned off and property prices fall. Although policy can be loosened further, the Chinese have nothing like as much room to loosen as they did in 2008. And where China goes, so goes much of the emerging world and associated plays: emerging equities, emerging currencies and industrial commodity prices.

Rapid rise in credit in China



Source: Citi Private Bank using *Chinese Banks: Growth of Leverage Still Outpacing GDP Growth*. Fitch Ratings Report, July 2011.

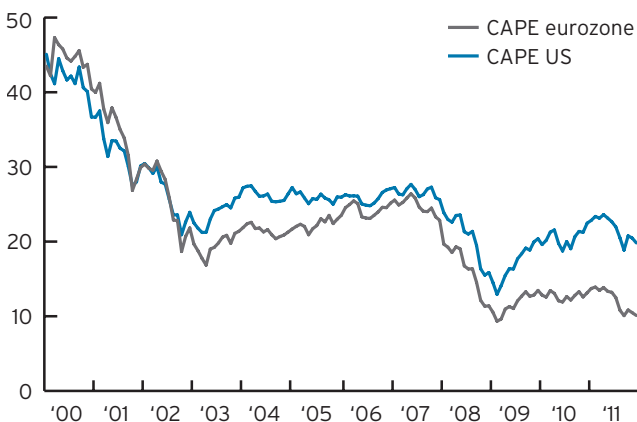
SO WHERE DOES THIS LEAVE YOU, THE INVESTOR?

In such a world, we think the risks of very nasty outcomes are a lot worse than the upside from any short-term fix for the eurozone or from coordinated central bank easing. The skew, as we said earlier, is heavily weighted to the downside. This is not only because we expect the global economy to continue to weaken; it is also because the results of a very nasty outcome are worse than the results of a nice outcome are good.

Those risks might not yet be probable – though they are getting that way – but they are a lot greater than merely possible.

We would counsel caution for now. If these risks do materialize, we think it will lead to investment opportunities that would be an awful lot more attractive than they are now.

European equities are cheap relative to the US and will become cheaper if the crisis worsens



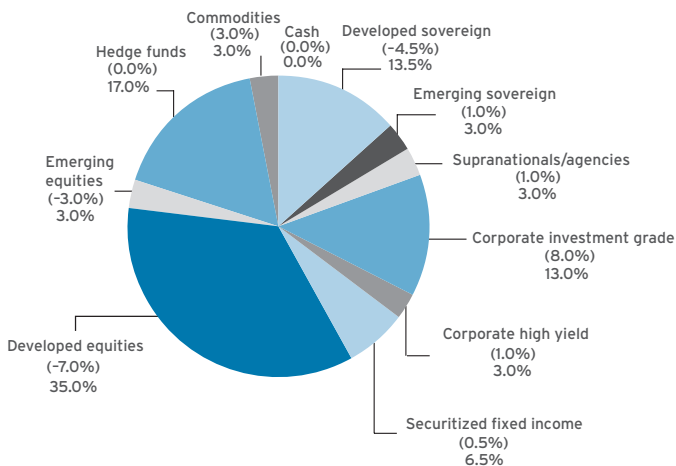
Source: Citi Private Bank using Bloomberg, as at December 19, 2011. CAPE = cyclically adjusted price-to-earnings ratio.

From an equity perspective, parts of Europe are, even on our very conservative cyclically adjusted valuation metrics, already very cheap. They will become cheaper still were the crisis to worsen further. But in that case, given the size of the eurozone and its debts, it would be very surprising indeed if valuations elsewhere did not also fall. Cheap valuations are splendid so long as you didn't hold them before they got cheaper.

We would therefore stick to companies with sustainable and high dividends and stable market shares. We would also continue to recommend US non-financial, long-dated investment grade corporate debt and, to a lesser extent, longer-dated US Treasuries. The number of genuinely risk-free securities is falling by the week. Yes, the US fiscal position is lamentably bad, but it is still the go-to asset when times are hard, not the least of reasons being that the US dollar is still the global reserve currency. The days when Eurocrats could dream otherwise are long gone.

Asset Allocation and Asset Class Overview

Alexander Godwin, Global Head of Asset Allocation



GLOBAL INVESTMENT COMMITTEE'S CURRENT ASSET ALLOCATION

The portfolio allocation shown has been designed for investors who have a preference for investments that offer some combination of income and capital appreciation. It should be suitable for investors who are willing to subject their portfolio to some risk for potential growth and a level of income commensurate with their overall risk tolerance.

Source: Citi Private Bank, as at December 19, 2011.

DEVELOPED MARKET EQUITIES

The outlook for developed market equities in 2012 is negatively impacted by the continued crisis and the likely deep recession in Europe. Decelerating growth in China adds to the severe headwinds facing this asset class. While remaining underweight overall, some regions offer more attractive valuations because they are already factoring in some of these concerns. In particular, valuation levels in Europe and Japan are compelling, especially in comparison to the more expensive US market.

EMERGING MARKET EQUITIES

Emerging markets remain heavily dependent on the future growth prospects for China, which continues to consume vast amounts of exports (notably commodities) from other emerging nations. The evident deceleration in Chinese growth – a result of both falling exports to Europe and also

slowing activity in the property market – is likely to have a negative impact across the asset class. We advise taking an underweight position in emerging markets, especially countries with high export exposure to China, including South Africa, Russia and Brazil.

DEVELOPED SOVEREIGN BONDS

Without a firm resolution to the European crisis, the outlook remains negative for much of the eurozone sovereign bond market. We expect to see much volatility with the continued progression of rescue attempts. The one exception, so far, remains the German Bund market. Short-dated German Bunds remain our only position in the eurozone. US Treasuries and UK gilts are likely to remain more resilient with proactive central banks keeping monetary policy extremely loose. Treasuries benefit from the dollar's status as the world's reserve currency.

CORPORATE INVESTMENT GRADE BONDS

The outlook for 2012 is attractive for corporate investment grade bonds. Corporate balance sheets are strong while firms continue to seek to pay off debts and raise their credit ratings. Yields are attractive, especially relative to sovereign bonds. Overall we remain overweight corporate investment grade, with a strong emphasis on long-dated bonds in North America, where corporate balance sheets are particularly strong.

CORPORATE HIGH YIELD BONDS

The outlook for high yield bonds is inextricably linked with that of equities given the high historic correlation between the two asset classes. As with equities, high yield bonds remain sensitive to the ongoing crisis in Europe and the slowdown in China – especially the impact this will have on corporate health and profitability. However, yields do remain high while defaults continue to be low. This makes the asset class attractive relative to equity markets, in particular in the US where equity valuations are high.

EMERGING MARKET SOVEREIGN BONDS

Emerging market bonds remain sensitive to the prospects for growth globally. However, the financial health of emerging market sovereigns has clearly improved significantly over the past five years, with many nations enjoying fiscal and reserve positions that should make them more resilient than in the past. Yield levels are attractive and we recommend a small overweight position concentrated in the foreign currency bonds of high-quality nations.

COMMODITIES

Many commodities remain highly exposed to demand from China. It is likely that commodity prices will fall as this demand slows. This is particularly true of industrial metals. While this is also true of energy-related commodities, political instability in many exporting nations make this commodity especially volatile. We advise a small position in gold (likely to do well in euros), and commodity and emerging market currencies.

CURRENCIES

With economic data for the US appearing to be slightly better, expectations of further quantitative easing have receded, at least in the short-term. This is likely to support the dollar and we expect the dollar to appreciate against most currencies – in particular the euro and the currencies of emerging nations and commodity exporters. The British pound should also fare relatively well, as will the Japanese yen.

Equities in an Environment of Slow Growth

Archie Foster, Head of Equity Advisory, EMEA

With such a large range of macro outcomes and market-influencing factors in front of us – from the European sovereign debt crisis, to US elections, to Chinese credit bubbles, to unrest in the Middle East and North Africa – putting specific year-end targets on global equity markets seems to us even more guesswork than usual. Instead, we will offer some observations on what we believe will be the driving forces in the equity markets over the next 12 months.

DELEVERAGING COMPROMISES GROWTH

We continue to view the structural backdrop for equities as difficult in general. Developed market economies (specifically the US, the UK and the Economic and Monetary Union, which make up 43% of global GDP) are only now beginning to deleverage after 30 years of increased borrowing. Though one could argue that corporations and individuals began the deleveraging process in 2008, when looked at systemically, portions of private sector debt were simply transferred to the public sector during the financial crisis via massive stimulus programs. In other words, the leverage did not leave the system. It's now beginning to, and we believe it will for some time as consumers, corporations and governments cut debt at the same time, either by choice or force of markets.

We believe that this period of deleveraging is likely to lead to weaker economic growth, and, as a result, slower growth or a contraction in revenues and earnings.

Politicians have the ability (but perhaps not yet the will) to enact policies that can soften the immediate economic blow and we expect that when the pain gets to a certain level they will act. Unfortunately, the situation may have to deteriorate further before we get to that point. However, in our view, even

if the European Central Bank (ECB) decides to ride in with bagfuls of fresh euros to support the financial system, the quid pro quo is likely to be even more fiscal austerity and an acceleration of the deleveraging trend which is a process that will take time to complete. Therefore, we believe that the risk of an extended period of weak GDP growth is real in almost any scenario.

SO WHAT DOES THIS BACKDROP MEAN FOR EQUITY MARKETS IN 2012?

The world has a growth problem. Profit margins are already at elevated levels. This suggests to us that corporate earnings are likely to be more dependent on final demand than driving efficiencies even further, which given the backdrop in which we find ourselves is not a good thing. Citi Investment Research & Analysis is looking for about flat global earnings growth in 2012, and in our opinion even this subdued estimate may prove optimistic. The issue is that this number looks conservative compared with the consensus of analysts' expectations, which is currently forecasting double-digit growth. To us it seems highly likely that more headline-grabbing downward earnings revisions are forthcoming, even if one assumes that economic growth stabilizes at current levels.

On the positive side, there are a few regional markets where an extended slow growth scenario seems to be at least somewhat priced in – especially when looked at on a longer term, cyclically adjusted basis. Therefore, even though the economic backdrop continues to look daunting, this does not necessarily preclude certain markets from outperforming if they are priced attractively.

On a cyclically adjusted price-to-earnings basis, we find:

- valuations in core Europe and Japan to be far more compelling (and potentially somewhat supportive of their markets) than in the US, where we see increasing risk that markets, not politicians, eventually force policy change and where we believe this risk may not be priced in at current valuation levels
- emerging markets look like more of a mixed bag, with the likes of emerging Europe, Middle East and Africa looking less expensive, Latin America (excluding Brazil) looking more expensive, and Asia somewhere in between.

VALUATIONS

Unfortunately, however, valuation by itself is rarely a good tool for making timing decisions. In other words, if the European situation deteriorates, those cheap markets may very well get cheaper still. We believe that investors need to be given a reason to “look over the valley” in order for valuations to begin adjusting higher on a sustained basis, and until they are shown the blueprint for comprehensive, attainable and serious reforms versus endless quick-fixes and rhetoric, it’s hard to imagine that they will truly be willing to discount the potential for better growth ahead.

TACTICAL VERSUS STRUCTURAL OPPORTUNITIES

With this all said, when assessing equity markets we like to look at both structural and tactical factors, because while markets tend to move in a general direction for extended periods, they do not tend to move in either direction in a straight line. In other words, there are usually tactical opportunities to be long in structural bear markets, just as there may be opportunities to be short in bull markets.

While sluggish economic growth is not good for profits growth and stock prices generally, history is littered with rallies which occur during difficult times. Indeed, as shown in the table, these rallies can be quite strong and can last for weeks, if not months.

With this in mind, we believe that there is, at least on a short-term basis:

- the potential for upside headline risk in the form of a potential third round of quantitative easing and continued decent near-term economic numbers in the US
- more constructive rhetoric from Europe (especially if the pain spreads further to the likes of Germany)
- policy loosening steps possibly by China and other emerging market countries.

The caveat on this front is that the data might have to get worse before these various policy actions are taken. Nonetheless, given that investor expectations currently range from the subdued (US) to borderline apoplectic (Europe), should the headlines break the right way, we would not rule out a decent “risk on” rally at some point in the first half of 2012, albeit potentially from lower levels than today. We would caution against being sucked into a headline-based rally at this point, however. While we do see pockets of relatively attractive valuation, other important signposts still seem to be in the distance.

As a result, we believe that equity markets in general are likely to be stuck in a broad trading range with the bottom supported by valuation (at least in certain regions) and the top capped by a lack of growth. Unfortunately, the risk in our view is that the bottom end of the range may not have been established yet due to still-simmering macro issues and our resultant growth concerns.

Weekly rallies in US equities within structural bear markets

	BEAR 1		BEAR 2		BEAR 3		BEAR 4	
	From	To	From	To	From	To	From	To
	Nov 1929	Jul 1932	Mar 1937	Apr 1942	Feb 1966	Jul 1982	Apr 2000	Present
Minimum %	0.27		0.13		0.22		0.04	
25th %	2.63		1.13		1.44		1.75	
Median %	6.21		3.16		2.98		3.32	
75th %	8.37		6.62		4.68		5.99	
Maximum %	19.05		25.52		16.43		27.25	
Average rally	1.5 weeks		2 weeks		1.9 weeks			

Source: Global Financial Data, as at December 6, 2011. For illustrative purposes only. Past performance is no guarantee of future results.

We realize that bull markets are borne from difficult periods and more often than not equity markets move in advance of situations actually improving. With that in mind, we would lean towards becoming more structurally bullish if we saw a combination of:

- cheap valuations
- signs that constructive policies will be put in place which balance austerity and the need to spur near-term growth
- signs of financial sector estimate revisions stabilizing.

International investing may not be for everyone. There may be additional risk associated with international investing, including foreign, economic, political, monetary and/or legal factors, changing currency exchange rates, foreign taxes, and differences in financial and accounting standards. The possibility that adverse political events, financial problems, or natural disasters in a country or region will cause investments in that country or region to lose value. The risks of investing in emerging or developing markets can be substantially greater than the risks of investing in developed markets.

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WHERE ARE THE OPPORTUNITIES NOW?

Given our assessments, we would suggest equity investors' focus should remain on high quality, large capitalization companies with global scope, solid balance sheets, and strong free cash flow generation. We would suggest attention be paid to companies with visible sources of demand, pricing power, effective cost management, and solid, sustainable dividend yields. Correlation is high, so stocks of high-quality global companies which in general possess recognizable brands, pricing power, and exposure to faster-growing emerging markets can be bought as cheaply as lesser quality ones. In our view, this represents an opportunity for longer-term investors willing to build positions during particularly bearish moments.

Importantly, however, in this environment investors also need to be very aware of timing. We would suggest extending investment time horizons and purchasing positions over time on weakness either in the cash market or via various derivative strategies. We would not chase rallies. Finally, we would advise that more cyclical exposure and lesser quality names be reduced or eliminated on bouts of strength. We believe that equities will continue to be volatile so discipline and a focus on quality will be increasingly important.

Safety First

Michael Brandes, Global Head of Fixed Income Strategy

The festering European debt crisis and slowing global growth are poised to be the principal drivers of return in the fixed income market in 2012. Uncertainties fueled by peripheral Europe are likely to keep safe-haven sentiment elevated as contagion concerns persist. This bodes well for the performance of high-quality fixed income assets, long-dated debt and on-the-run securities that feature superior market liquidity.

FADING INFLATION PRESSURES

Falling inflation in the developed world promotes a climate of low interest rates, which is good for (current) bondholders, but not so good for investors reaching for yield. Unfortunately, we expect bond yields to be largely capped around recent ranges and to trend lower in some regions like the US and Japan, but especially Europe. High-quality conventional government debt is poised to outperform inflation-linked securities.

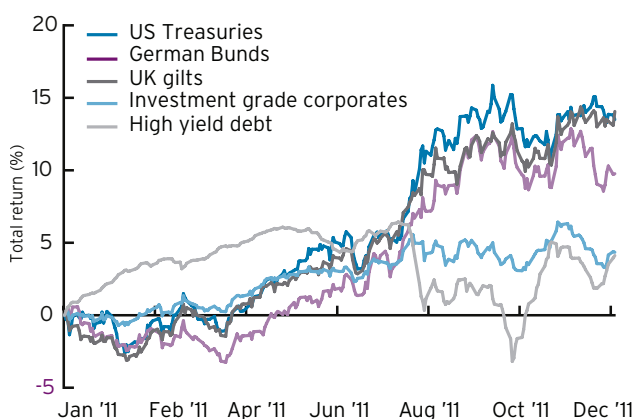
Nominal debt is not only likely to generate better returns as inflation expectations decline, but also because linkers typically fail to benefit from flight-to-quality demand. During periods fueled by heightened volatility and broad uncertainties, bond investors tend to place a greater premium on liquidity, not inflation protection.

While inflation is still relatively high in many emerging economies, slowing growth and falling food prices should contain interest rates and bolster the case for monetary policy. In Latin America, we favor Mexico and Brazil government debt. In Asia, we recommend local currency bonds in Indonesia and South Korea, but would avoid India, where inflation pressures persist. Investors should limit exposure to eastern European issuers due to strong ties to the Western European banks.

The recent rise in German Bund yields (and other "core" European AAA-rated countries) reminds investors that the meaning of "risk free" government debt is currently being recalibrated.

Elevated credit default swaps (CDS) for highly rated European sovereigns are a reflection of deep burden-sharing concerns as the periphery crisis escalates. Italy, Belgium and France trade at historically high CDS levels, which has fueled record borrowing costs in the cash bond market. The gap between Germany and United States CDS is historically wide, and 10-year Bund yields are higher than US 10-year Treasuries for the first time since the middle of the financial crisis in 2009.

Flight to quality



Source: Citi Private Bank using The Yield Book, as at December 7, 2011.

RUNNING FOR COVER

In our view, bond investors will be recalibrating sovereign risks for years to come. While we do not expect another downgrade to Treasury debt this year, the risk of further rating actions will persist until a clearer fiscal path is established in Washington.

Standard & Poor's cut the US from AAA to AA+ on August 5, while Moody's and Fitch assigned negative outlooks to the debt on August 2 and November 28, respectively.

That said, a ratings agency downgrade and a few negative outlooks are not going to put a dent in the US Treasury market. Despite recent concerns about credit quality, the breadth and depth of the Treasury market remains unparalleled (the market has doubled in size since 2008 to around \$9.8 trillion). The US dollar's status as the world's reserve currency also underpins extraordinary financing flexibility. Thus, we don't put much emphasis on ratings actions, and consider them lagging indicators.

Of course, US government bond yields are not dictated by ratings actions. Instead, the Federal Reserve governs levels at the front end of the curve while inflation expectations and demand determine the long end. In our view, interest rates aren't going anywhere with the Fed committed to rock-bottom policy rates through mid-2013 and inflation pressures muted.

A LITTLE KNOWN FACT

By the end of Operation Twist (the Fed's program to swap \$400 billion of its short-dated Treasury debt for longer-term securities announced on September 21) the central bank will own approximately 30% of long-dated (6-year to 30-year) Treasuries outstanding. This should further inhibit any rise in long-term US bond yields.

If economic conditions don't improve materially, we expect a third round of quantitative easing (QE) to commence in the US this year. The decision to reinvest maturing debt from the Fed's \$2.8 trillion balance sheet into agency mortgage-backed securities (MBS), which was announced with Operation Twist, opened the door for outright purchases of mortgage debt in QE3. Even if QE3 does not come to pass, agency MBS spreads are attractive and prepayment risks are low despite the recent launch of the Home Affordable Refinance Program (HARP 2.0), the enhanced US government program to assist troubled homeowners.

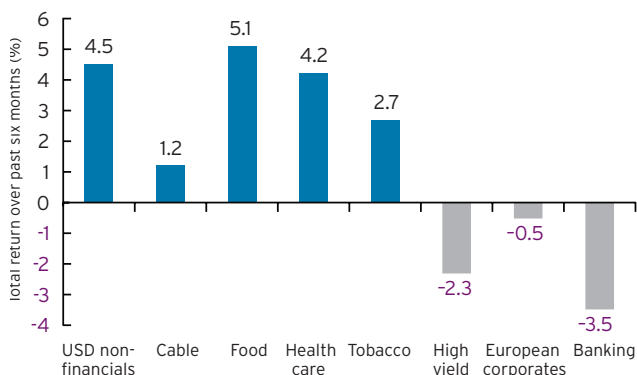
FIXED INCOME STRATEGIES FOR 2012

Corporate bonds

Our strongest conviction in fixed income continues to be long-dated high-grade corporate bonds. We favor non-financial issuers in the US, where fundamentals are solid, balance sheets are strong and liquidity is robust. While slowing growth will compress profits, these companies feature much-improved balance sheets, record cash balances and low financing needs. Financial metrics are broadly healthier than pre-crisis levels. For example, net debt to EBITDA (earnings before interest, taxes, depreciation and amortization) among non-financial issuers has continued to reach new lows as companies reduce debt burdens and refinance existing borrowings into longer-dated (and lower coupon) obligations.

Given our expectation for low rates to continue, we estimate that USD high-grade corporates should again generate good returns (with the majority of those gains due to carry or coupon). Our favorite defensive sectors include cable/media, chemicals, health care, tobacco and food. Each features issuers that have strong cash flows, stable operating results and are likely to be more resilient than even higher-quality financial issuers as economic uncertainties persist.

Defensive sectors to outperform



Source: Citi Private Bank using The Yield Book, as at December 7, 2011.

Financial institutions also retain stronger balance sheets and historically attractive valuations. However, we are reluctant to add any bank exposure given the heightened risks in Europe and persistent strains in the wholesale funding markets. Potential bank recapitalizations and sovereign restructurings in Europe will boost risk premiums and volatility across the sector.

Indeed, we expect the entire bank and finance sector to underperform non-financial corporate bonds globally – even among the highest quality issuers that retain manageable exposures to European peripheral debt. EU financial institutions will continue to underperform comparably rated (ex-EU) issuers and senior debt is poised to outperform subordinated securities as recapitalization plans intensify.

High yield

Lower-rated asset classes, such as high yield, are bound to remain volatile despite relatively decent valuations. We are in no doubt that fundamentals have improved, near-term refinancing risks have greatly diminished, and that current spreads overcompensate for potential default risks. However, as long as risk appetite remains depressed, lower-rated debt is likely to underperform. This is especially true in Europe,

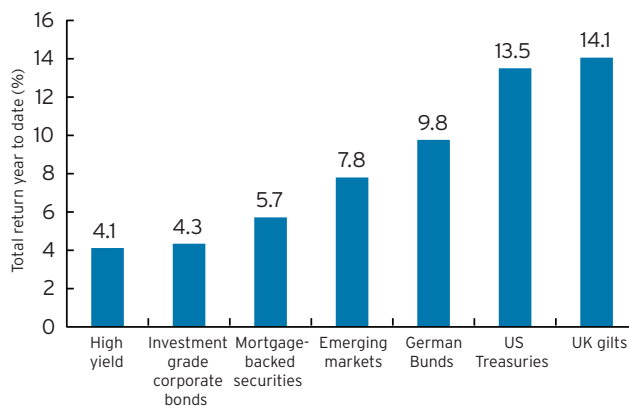
where capital markets are closed to high yield issuers. To make matters worse, EU banks have reduced lending capacity as they shore up balance sheets to meet tougher regulatory standards (ie Basel III).

Bond market participants have clearly been more receptive to US-based high yield issuers. Indeed, US high yield has outperformed European high yield by nearly 800 basis points during 2011. We expect this trend to continue given (modestly) better growth prospects and stronger balance sheets in the US.

Government debt

The UK is not immune to the peripheral problems in continental Europe. However, gilts are benefiting from the Bank of England's decision on October 6 to boost its bond purchase program from £200 billion to £275 billion. Gilts also benefit from the government's renewed commitment to its austerity plan on November 30, which solidifies the UK's AAA rating. Long-dated UK gilts, which generated the most impressive bond returns of 2011, remain our favorite recommendation in government debt.

Preserving principal



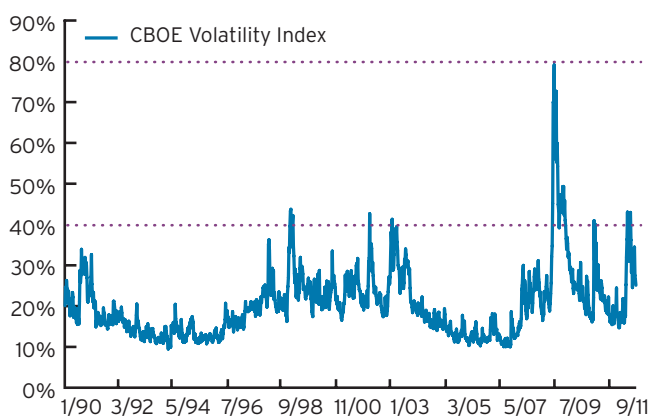
Source: Citi Private Bank using The Yield Book, as at December 7, 2011.

Hedge Funds for Volatile Markets

Francis X. Frecentese, Global Head of Hedge Fund Investments

Heightened volatility across global markets has dominated 2011 and we believe this environment is likely to persist – the continuing uncertainty surrounding developed market sovereign debt, global political risks and muted global growth prospects. The CBOE Market Volatility Index (VIX), a measure of implied volatility and a gauge of market uncertainty, has spiked above 40 during three distinct periods since the middle of 2008.¹ In contrast, the VIX crossed 40 only three times in the first 18 years of the index (1990-2008).

Volatility reaches all-time high



Source: Citi Private Bank using Bloomberg, as at December 16, 2011.

The disparity between winners and losers in the hedge fund space has never been greater than in 2011. Over 50% of hedge fund failures occur due to operational rather than investment reasons, and in volatile markets it is all the more important to track, monitor and analyze risk from as many perspectives as

possible. We believe that hedge funds continue to offer investors active management of exposures and risks, and expertise in navigating and profiting from market volatility. We focus on hedge funds that can produce returns with limited exposure to the direction of broader markets, in particular, relative-value funds with a long-volatility bias; global macro and commodity trading advisor (CTA) funds that can quickly adjust their positioning; funds with a proven track record of producing returns on the short side of the market; and specialist long-short equity funds. We expand on these views below.

RELATIVE VALUE

We foresee directional trading to remain challenging in 2012. We believe the current market environment favors hedge funds that can exploit spreads rather than take broad directional views.

While relative value can mean different things to different people, we define the strategy as being able to take advantage of market volatility by entering risk-adjusted spread trades after market dislocations create attractive entry points across asset classes.

We prefer managers who look to buy tails² when possible and practical. We believe the current period of deleveraging will create interesting opportunities, and we prefer managers who can wait for these to take hold, rather than look to apply hefty leverage to ordinary spread convergence opportunities.

¹There is no official significance to the VIX going over 40. However, the long-term average is around 20, so we believe that a figure double the average represents a significant period of market stress.

²“Buy tails” is a term used by many traders to express hedging tail events. This is the buying out of the money options in various asset classes to protect themselves from extreme market movements. The overall theme is that we want managers who are willing to pay out a bit extra in order to hedge themselves given the current market environment.

MACRO AND CTAS

While the chopiness of markets in 2011 has not been easy for CTA managers, we believe these trend-following strategies still play an important role in clients' portfolios given that they should be able to capture returns from a sustained downtrend (as many did in 2008). We look to select macro managers who are not only able to identify trends, but are also able to find the best expression of risk-reward across asset classes and instruments in order to outperform other strategies in difficult markets.

EVENT DRIVEN AND CREDIT

Traditional long-biased, event-driven and high-yield focused credit hedge funds face headwinds given the deleveraging that is expected to continue in the developed markets, where the majority of these managers traffic given their size, liquidity and transparency vis-à-vis less developed markets. Nonetheless, we believe there will be pockets of opportunity created by these forces from which hedge funds will look to profit. For example, continued stress in the European banking system may create opportunities for distressed credit managers to buy attractively priced assets from forced sellers, though with heightened volatility. Furthermore, given our expectation that market volatility will persist, those managers who are able to both buy and short credit will be well positioned to rotate their portfolios between net long and net short through the credit cycle.

Finally, the recent market dislocations have created opportunities in merger-arbitrage strategies, where spreads have widened to historically attractive levels and deal volume remains healthy globally.

LONG-SHORT EQUITY

Volatile markets have produced historically high correlations between single-name equities, making individual stock selection difficult.

There have been 11 days in which 490 or more stocks in the S&P 500 Index all moved in the same direction on a given day since the inception of the index. Of those 11 instances, six have occurred in the second half of 2011.

Given this environment, we continue to favor specialists in the long-short strategy. Those managers who specialize in a narrow skill set – for example, in a particular sector, region or style – are more equipped to stay the course, avoid style-drift and realize profits through deep fundamental analysis. Furthermore, we believe corporations will meet varying levels of success in adapting to the current, low-growth environment, and equity long-short managers will be in a position to select winners and losers when correlations do eventually revert to their long-term mean.

An investment in alternative investments (eg hedge funds, private equity) can be highly illiquid, are speculative and not suitable for all investors. Investing in alternative investments is for experienced and sophisticated investors who are willing to bear the high economic risks associated with such an investment. Investors should carefully review and consider potential risks before investing. Certain of these risks may include, loss of all or a substantial portion of the investment due to leveraging, short selling or other speculative practices; lack of liquidity in that there may be no secondary market for the fund and none is expected to develop; volatility of returns; restrictions on transferring interests in the fund; potential lack of diversification and resulting higher risk due to concentration of trading authority when a single advisor is utilized; absence of information regarding valuations and pricing; complex tax structures and delays in tax reporting; less regulation and higher fees than mutual funds; and manager risk.

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A Forecast for Foreign Exchange

Jeremy Hale, Head of Global Macro Strategy, Citi Investment Research & Analysis

With global growth risks skewed towards weakness, we remain wary on some commodity-backed currencies, especially the Australian and New Zealand dollars. Not only are these significantly overvalued against traditional medium-term metrics, the support these currencies receive from terms-of-trade gains (higher commodity prices) and carry (high interest rates) are waning. The Canadian dollar may hold up better but will probably also depreciate somewhat against the US dollar.

The winners in G10 are probably the US dollar, the Japanese yen and, just about, the British pound. The latter creeps into our plus list because it has “cheapness” on its side, but we are aware that UK policymakers want that competitive edge to continue, so upside for the currency is limited. The yen is a winner because the Bank of Japan is so conservative. The scale of money base creation in the US, UK, Switzerland and others simply swamps what the Japanese will tolerate. Longer term, this probably means deflation in Japan and yen appreciation.

US DOLLAR'S A WINNER, BUT ONLY JUST ...

As for the US dollar, we would prefer to buy the greenback if we were confident either of a strong US recovery or a slip back into recession. Both of these tails tend to create strong dollar environments, while the middle bit of sub-trend “stall speed” growth is usually not favorable.

In an environment of reduced risk appetite, as in 2008, the dollar tends to appreciate as US investors return capital to home, while dollar funding to foreign holders of US assets becomes harder to source outside the spot market, at least without official help.

... EVEN AGAINST EMERGING MARKET CURRENCIES

What applies to the dollar versus developed currencies also generally applies to the emerging markets (EM). Carry and commodity EM currencies, such as the Mexican peso, the Brazilian real, the Russian ruble and the South African rand, have been investor favorites but remain vulnerable, as we have seen both in 2008 and, more recently, in a risk-off, slow-growth world. EM rates are likely to fall, eroding carry advantages, and commodity prices may well fall further.

CHINA WILL SET THE ASIAN CURRENCY TONE

The Asian currencies are a little different, which is to say worse. For sure, some are already weak, as interest rates are expected to fall (eg the Indian rupee). But others will be buoyed in part by the performance of the renminbi. The dollar/renminbi rate is the great pivot in Asian foreign exchange. When the USD is strong, the Chinese usually stabilize the USD/CNY spot and this seems to have been evident recently. The case for significant USD/CNY downside seems limited now to say the least. A hard landing in China could even produce the shock of renminbi depreciation. If so, this could produce leveraged downside for other Asian currencies which remain consensus favorites to appreciate.

EURO FRUSTRATIONS

Finally, there's the euro/dollar rate. Investors and hedgers in this pair have had a frustrating time in 2011 as the spot has gone up, sideways and then down since September, but ended up roughly flat on the year as we write. There is no doubt that if the EUR/USD was trading only on relative credit risk (as reflected by credit default swaps or government bond yield spreads) or bank stress, the spot rate would be a lot lower now. We know that investors and short-term speculators don't like the euro.

SO WHAT IS HOLDING IT UP?

Part of the story is that reserve managers are selling the dollar and buying the euro, particularly oil-producing countries, given the relative strength of some oil prices recently. But another part of the story is that the euro continues to trade on old-fashioned relative monetary variables, despite the crisis.

A significant move lower thus requires much easier monetary policy compared with the Federal Reserve. With a third round of quantitative easing mooted by the Federal Open Market Committee, and Operation Twist/unchanged zero policy rates to 2013 already in place, the European Central Bank actually has to play catch up. If it does, the wider euro area might just be saved and the EUR/USD rate is likely to fall quite a bit this year. If it does not, however, the Economic and Monetary Union stresses could continue and the EUR/USD could continue to frustrate euro bears.

Interest rate differentials still drive EUR/USD



Source: Citi Private Bank using Reuters EcoWin, as at December 8, 2011.

Commodities in a Challenging Market

Jeremy Hale, Head of Global Macro Strategy, Citi Investment Research & Analysis

Slow growth, high risk aversion and long positioning suggest that the medium- to long-term upside for commodity prices in general remains limited.

That said, there are differences within the complexes. In the case of the outperformer of 2011, precious metals/gold, one might almost make the case for currency rather than commodity status. Once upon a time, many major currencies were backed by gold.

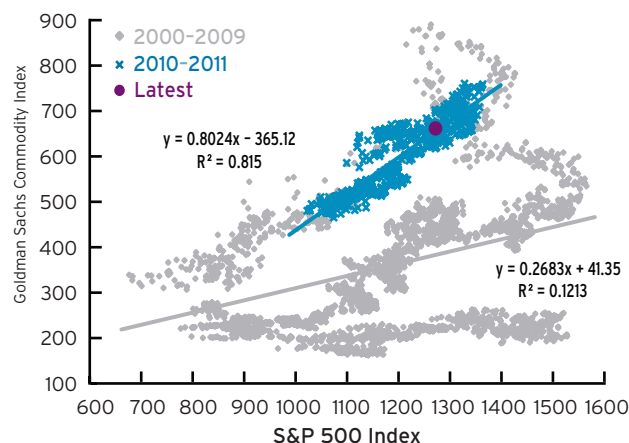
Now, only gold is backed by gold. With major central banks engaged in unprecedented and experimental quantitative easing/money base expansion, the fixed supply of gold is a relative advantage. With zero policy rates set to remain the norm in major economies for some time, the zero coupon on gold is no longer a drag. Reserve managers are back buying for the first time in a while.

All in all, we like the long-term outlook. Our only note of caution is that we are not alone in this view. Positioning remains stretched and, during recent market volatility, gold was positively related to risk appetite for the first time in a while, suggesting that positioning was driving the market.

With economic growth slowing in the emerging world and Chinese growth a major risk to the complacent consensus, food prices and industrial metals may well continue to underperform. Oil and energy are likely to fare somewhere in the middle. Absent supply shocks, we see recent West Texas Intermediate (WTI) oil price gains as a technical closing of the

Brent-WTI spread, which was at historic wides. The global demand-supply ratio is reasonably balanced now so, as things stand, we expect range trading or downwards pressure on oil in the more extreme scenarios for global growth. However, the upside tail risks for oil prices are greater (in USD per barrel, even if not the probability) than the downside, given ongoing political stress in the Middle East, especially the Iranian/Israeli stand-off over Iran's nuclear programs.

Commodity prices still highly correlated with equities



Source: Citi Private Bank using CIRA and Bloomberg, as at December 8, 2011. R² is a statistical measure that represents the percentage of a security's movements that can be explained by movements in a benchmark index. For equities the benchmark is the S&P 500 Index.

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

Opportunities in Distressed Debt

Daniel O'Donnell, Global Head of Private Equity and Global Co-Head of Real Estate Research and Management

Ryan Foscaldo, Private Equity Research and Management

The current economic malaise continues to drive global uncertainty, resulting in investment decisions that may be sub-optimal and/or based on non-economic rationale.

As fear and uncertainty increases and the pricing of particular investments declines below their perceived long-term intrinsic value, investors must determine whether the prices of these opportunities make sense or if they are catching the proverbial falling knife.

Investors in distressed debt generally focus on two investment strategies, non-control (trading strategies) and control investing. In terms of geography, distressed investors typically seek opportunities in the US and Northern Europe as these regions have less opaque bankruptcy laws than other jurisdictions. In the US and Europe, looming corporate debt¹ maturities combined with market uncertainty may result in attractive investment opportunities in the coming years. Unless the US and European economies drastically improve, coupled with sustainable growth in the high yield market and the re-emergence in the availability of bank debt, handling the volume of refinancing necessary may present a structural challenge in 2013. Many distressed investors expect this wave of debt maturities to drive defaults and restructurings, potentially creating an opportunity to acquire the debt of fundamentally good companies at attractive implied valuations.

In the US, where approximately \$2.2 trillion of corporate debt is expected to mature between 2011 and 2015, low interest rates and quantitative easing have aided the lending environment. However, lending by US banks continues to be affected by new international and domestic regulation. In Europe, where approximately \$1.3 trillion of corporate debt is expected to mature between 2011 and 2015, lending conditions remain tight as banks repair balance sheets and face additional regulatory constraints imposed by Basel III and national regulators. Against this backdrop, political and economic turmoil across Europe underscores serious concern over sovereign creditworthiness and the fragility of the banking system.²

The next four years may prove to be troubling for companies seeking ways to refinance substantial upcoming debt maturities.

Distressed debt funds again may see themselves in a strong position to selectively choose companies to support while demanding ample compensation for doing so. In light of the expected market opportunity, distressed debt for control investors may be appropriately positioned to generate attractive risk-adjusted returns. Notwithstanding the current decline in the credit markets, investors should take a measured approach to investing in distressed opportunities given market uncertainty.

¹References to corporate debt, throughout this document, refer to public and private debt owed by corporates, which are classified as being outside the financial sector. The data for US and Europe corporate debt (in USD) are from S&P and Moody's, respectively, as at Q2 2011.

²This is particularly evident in the European credit markets where, as at December 1, 2011, the S&P European Leveraged Loan Index was trading at 85.1% of par. This compares to the US credit markets (as represented by the S&P/LSTA US Leveraged Loan 100 Index), which was trading at 90.5% of par as at December 1, 2011. Please note that the US index traded at a low of 59.2% of par in December 2008 and the Europe index traded at a low of 59.1% of par in January 2009.

Distressed investing includes bonds with unfavorable credit characteristics that are typically non-rated or rated below investment grade. High yield bonds trade at yields substantially higher than bonds with more favorable credit characteristics and often suffer from lack of liquidity and marketability. Defaults can occur when a bond issuer fails to make principal or interest payments when due. Defaults can also occur for failure to meet non-payment obligations such as reporting requirements, or when a material problem occurs for the issuer such as a bankruptcy.

Prime Locations in Global Real Estate

Daniel O'Donnell, Global Head of Private Equity and Global Co-Head of Real Estate Research and Management

Kwang-Meng Quek, Global Co-Head of Real Estate Research and Management

Jeffrey Locke, Tim Bowring and Caroline Sia, Real Estate Research and Management

Nearly four years after the global financial crisis began, many real estate markets remain unsettled as a result of increased financial market volatility and heightened economic uncertainty. Despite the headwinds, the impact varies as some locations and property types are showing continued improvement, while others are weakening.

Throughout the recovery, investor preference has gravitated toward high-quality properties in central business districts (CBDs) in cities such as Beijing, London, Munich, New York, Paris and Sydney.

THE UNITED STATES

In 2012, investors in the US are likely to continue to focus on stabilized prime properties in the top six markets – Boston, Chicago, Los Angeles, New York, San Francisco and Washington, DC. Demand for investment opportunities is expected to be considerably less for properties that are not stabilized or outside major markets where debt financing will be difficult to obtain and more expensive. However, even in primary markets, expectations have been tempered. In the two largest office markets in the US (New York and Washington, DC), New York has experienced a quarterly decline in leasing activity of more than 40% from Q2 2011, while Washington, DC, has seen year-on-year activity declines of nearly 25% due to changes in the finance and government sectors.¹ Accordingly, investors must use caution when investing in these prime markets.

¹Global Market Perspective: Fourth Quarter 2011. Jones Lang LaSalle, Q4 2011.

²The JLL European Index is calculated from the change in headline face rents for the highest quality space in the premier office submarket in 24 European cities, weighted on the basis of the total office stock (all grades) in each city's overall market.

EUROPE

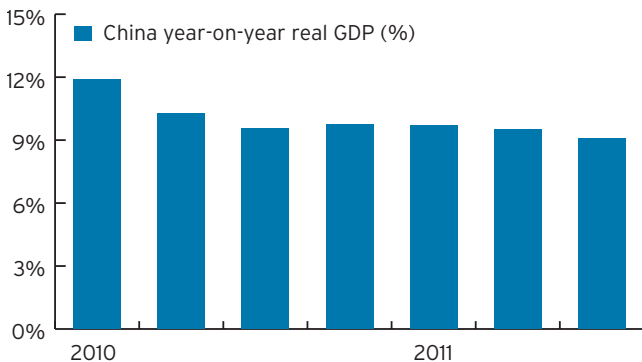
Similarly in Europe, prime cities such as Berlin, London, Munich and Paris have seen steady growth against a backdrop of economic uncertainty. Rental rates across most major CBDs increased during the first half of 2011. Although rental rate increases are slowing, prime rents hardly changed in Q3 2011 and the Jones Lang LaSalle European Index² remained unchanged over the same period. Limited new supply is likely to keep rents relatively stable in the near term. In these European prime markets the lack of quality product and the strength of investor demand for tangible assets (especially in the UK) should support capital values. In certain markets, such as Milan, Rome, Brussels, Stockholm and areas outside major cities, property values are being hampered by a lack of demand and an increase in supply as banks reduce their real estate holdings to comply with legislation such as Solvency II and Basel III.

ASIA

The Asia Pacific region led the global economy in 2011, but that trend is likely to weaken. Concerns over the European debt crisis and increasing doubts about the future pace of global economic expansion have caused softening in the commercial sector as firms remain cautious in the near term. In the residential sector, property prices are moderating due to regulatory measures by governments. Hong Kong and Singapore are the most affected by this current climate. Investors in these markets might experience lower rental growth and capital value growth in 2012 due to expansions in supply and lower growth forecasts.

China's recent decline in its growth rate illustrates this point (see chart). However, office rentals rates in China are expected to continue to increase in the near term albeit at a slower pace than 2011. Demand in the Beijing and Shanghai office markets continues to be strong as multinational corporations and domestic companies are experiencing continued growth and therefore further demand for more office space to absorb expansions or start-ups. Beijing has shown one the fastest declines in office vacancy in the region falling from 23% in 2010 to barely 8% by Q3 2011.³ Investors should focus on corporate hiring sentiment throughout Asia as the outlook varies across the region.

China's recent decline in growth



Source: Citi Private Bank using China National Bureau of Statistics. Data as at Q3 2011.

³Global Market Perspective: Third Quarter 2011. Jones Lang LaSalle, Q3 2011.

⁴Latin American Quarterly Outlook, Real Capital Analytics. Prudential Real Estate Investors, October 27, 2011.

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 and properties.

All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events.

LATIN AMERICA

In Latin America, commercial sales volume in the first half of 2011 was \$5.6 billion; significantly higher than the \$1.9 billion in the first half of 2010, with Brazil experiencing the strongest investment activity in the region.⁴ After experiencing double-digit rental rate increases over the past few years, capital appreciation and rental rates could be slowing for office markets in Sao Paulo and Rio de Janeiro, as the heavy volume of new completions will increase supply. Brazil's industrial market remains strong as both domestic and national firms demand higher quality space. In 2012, investment activity is likely to benefit from commodity exports and domestic demand, but it is also likely to ease as rental rates and capital values increase at a more measured rate.

IMPLICATIONS FOR REAL ESTATE

Overall, the combination of the prevailing global economic uncertainty and stringent lending standards has driven investors toward more conservative strategies in nearly every investor market. Investors seeking safety and stability are likely to continue to focus on prime properties in core markets. However, investors should reduce yield and return expectations as asset prices have reached pre-financial crisis levels in many markets. Conversely, high growth markets, such as Asia and Latin America, may be able to generate more attractive returns relative to the US and Europe. Investors must remain cautious as adverse global economic growth reforecasting will continue to influence all property markets.

At a Crossroads

Alexander Godwin, Global Head of Asset Allocation

The future course of events in Europe is increasingly dependent on whether and how policy makers respond to the sovereign debt crisis. The signs are not good. It is likely that 2012 will see further turmoil as rescue packages fail to tackle the underlying causes of the crisis.

Certainly, it looks like Europe is in for a deep and prolonged recession as austerity measures begin to bite. Indeed, this looks to be already well under way. More concerning is the prospect of spiraling debt costs leading to a disorderly break-up of the eurozone, possibly with one or more countries defaulting.

This possibility cannot be discounted. Any resolution of the crisis will need to convince markets that debt levels are sustainable. The current prescription, austerity and structural reform, is unlikely to accomplish this.

One key indicator of the sustainability of debt levels is the debt-to-GDP ratio. This measure looks to compare what you have to pay back (your debt) with what you have to pay it back with

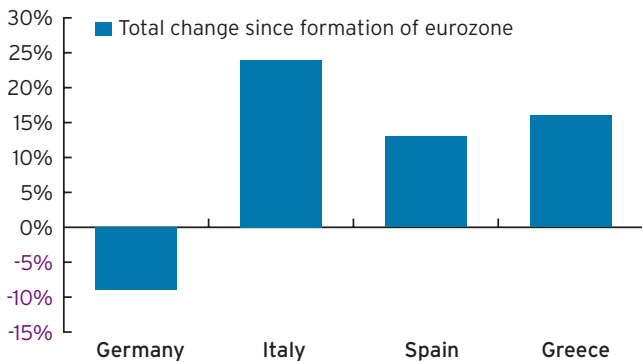
(your GDP). While the desired outcome is for this ratio to fall to a lower level, austerity may actually do the opposite. Austerity measures, certainly of the scale required, may well cause a contraction in GDP that will more than offset any movements in the debt position.

AN UPHILL CLIMB TO REGAIN COMPETITIVENESS

Structural reform looks to improve competitiveness and therefore stimulate growth. This is vital. Italy and other peripheral countries have become increasingly uncompetitive, especially compared with Germany, since the formation of the eurozone.

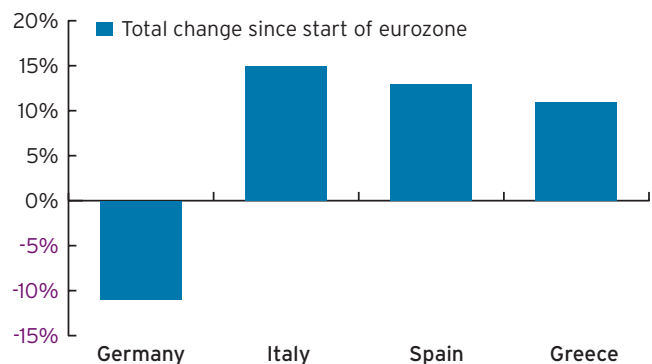
Take Italy for example. Since the formation of the eurozone, Italian labor costs and export prices have outpaced those of the industrial world by 33% and 24%, respectively.* In stark contrast, German labor costs and export prices have fallen relative to the industrial world by 2.5% and 9.2%, respectively.* Italy has a lot of ground to make up.

Export prices relative to the industrialized world



Source: Citi Private Bank, using data from *Price and Cost Competitiveness: First and Second Quarter 2011*. Directorate-General for Economic and Financial Affairs: European Commission. For illustrative purposes only. Past performance is no guarantee of future results.

Labor costs relative to the industrialized world



Source: Citi Private Bank, using data from *Price and Cost Competitiveness: First and Second Quarter 2011*. Directorate-General for Economic and Financial Affairs: European Commission. For illustrative purposes only. Past performance is no guarantee of future results.

*Data is from *Price and Cost Competitiveness: First and Second Quarter 2011*. Directorate-General for Economic and Financial Affairs: European Commission.

And Germany won't stand still. In essence, Italy will have to outpace Germany for a significant period of time to get anywhere near. Recent history does not inspire optimism. In the past, Italy was able to take a shortcut to regaining competitiveness by devaluing the lira. This is no longer an option. A depreciation of the euro would help somewhat, but not when trying to compete with more efficient eurozone countries.

A POLITICALLY ACCEPTABLE SOLUTION IS STILL FAR AWAY

Historically, the commonest way to cut debt-to-GDP ratios to a sustainable level has been to restructure and lower debts, forcing haircuts on creditors. The cost of this, especially if Italy and Spain are included, would be extremely high – perhaps even unaffordable.

Europe's entire banking system could become insolvent and require wholesale recapitalization. Few countries could afford those costs; none would emerge on the other side with a triple-A rating.

The other approach is to generate inflation. This would boost GDP in nominal terms but keep debt levels static. There are two problems here. The first is that the European Central Bank is pathologically averse to inflation. Second, even if it weren't, it is next to impossible in a deleveraging environment where growth in money supply does not feed in to growth in new credit.

VALUATIONS BEGIN TO LOOK ATTRACTIVE

The possibility of a catastrophic outcome keeps us cautious on European equities. Equity valuations throughout Europe are attractive and clearly factor in some of the difficult times ahead – much more so at least than other markets globally, especially the US. Still the possible bad outcomes, including a eurozone break-up or default, could be so catastrophic that caution is required, not least in the eurozone. Nevertheless, we prefer cheaper European markets to more expensive markets elsewhere – at least investors are paid for those risks.

Within Europe, returns on offer in core markets, such as Germany and, perhaps, France, are sufficiently high that there is no reason to take the extra risk of investing in the periphery.

Within the fixed income markets, we remain deeply cautious on peripheral bonds and even France. Germany, at least for now, may offer the only safe haven. Though even here, investors will continue to fret periodically about potential contagion. The UK, with an independent currency and monetary authority, and a government dedicated to maintaining the country's triple-A credit rating, should also be resilient, perhaps more so, in the face of the ongoing crisis.

Investment Strategies for US Investors

Lex Zaharoff, Head of Investment Lab, North America

Major elections in 2012 are unlikely to alter the political gridlock that is edging the US ever closer to fiscal crisis.

Although the US has performed better than expected recently, we anticipate events in the US to continue to be overshadowed by the unfolding crisis in Europe and the potential for a significant slowdown in growth in China.

In the near term, we may continue to see some positive news from the US economy. Unemployment is inching down and consumers seem to be willing to limit their savings and spend a little. This will certainly help in the short term, but this also lengthens the period of deleveraging. The Federal Reserve is certainly helping with its readiness to support the economy through its commitment to keep short-term rates low, liquidity high and its attempt to mitigate any increase in long-term rates using tactics such as Operation Twist. Another factor is the impact of the crisis in Europe. Global investors buying USD-denominated sovereign and high-quality corporate debt are helping to keep rates low. Even local municipalities across the US are seeing their borrowing costs lower than they otherwise would be thanks to these inflows and linkages between the debt markets. The risk-off trade into the dollar though has a negative impact on US exporters as they have unfortunately experienced a temporary reversal of dollar weakness.

We caution investors not to forget that the US economy cannot sustain the positive momentum indefinitely, given the debt burden which will only continue to grow until budget deficits are brought under control. That will not happen in 2012.

The debate on raising taxes or cutting services will be at the forefront of the election rhetoric. But talk is cheap and a credible fiscal plan remains far off. Will the automatic cuts scheduled for 2013, given the failure of the Joint Select Committee on Deficit Reduction (the Super Committee), save the day? Unlikely. Already there is talk about changing the rules or delaying the start. Normally, election years are good for the US economy with loose fiscal spending, creating a positive environment for the incumbents, but there is little to no ability to spend extra in 2012.

WHAT DOES THIS MEAN TO THE US INVESTOR?

With corporate profit margins at peak levels, it seems only a matter of time before a biting recession in Europe and decelerating demand from China translate into falling corporate earnings. And expect no help domestically – little dent has been made to high economy-wide debt levels that threaten to translate into a decade of slow growth as households gradually deleverage.

We remain overweight in fixed income and underweight US equities – valuations are simply too high for the environment of uncertainty and falling growth in which we now see ourselves. However, that does not mean there are no opportunities to profit from the current environment. There are interesting opportunities in US fixed income (see pages 15-17 of this publication for further details). The US yield curves, particularly for investment grade corporate bonds, are steep and are likely to remain so through the year. Investors should take advantage and position their fixed income portfolios on the intermediate and long maturities of strong credits.

*Borrowing against securities may not be suitable for everyone. If the value of the securities should decline below a minimum level, you may be subject to a collateral call without specific advance notice, requiring you to deposit additional cash or securities. If you cannot do so, all or a portion of your collateral could be liquidated, and a potentially taxable event could result. You are not entitled to choose which securities are sold or any extension of time to meet a collateral call. A concentrated portfolio holding a single or a few securities may be subject to greater risk of a collateral call than a diversified portfolio; a diversified portfolio will tend to be less subject to a sharp decline resulting from the negative performance of a single security. Availability, qualifications and other restrictions may vary by state. Ask your financial advisor/private banker for details.

For those with an appetite and the ability to take on more risk, as appropriate, prudent leverage might be considered. Short-term borrowing rates are at or close to recent lows. And the Federal Reserve is indicating its intention to keep interest rates low, at least until 2013. It may even try to nudge longer rates lower via another round of quantitative easing.*

Opportunities may also exist in high-dividend yielding stocks that can potentially offer attractive up-front yields. As growth slows globally, investors will begin to prize more investments that offer security of returns that are not dependent on economic growth rates.

The CBOE Volatility Index (VIX) is used as a measure of volatility as a result of investor fear or uncertainty. It is constructed using the implied volatilities of a wide range of S&P 500 Index options. Values greater than 30 are generally associated with a large amount of volatility.

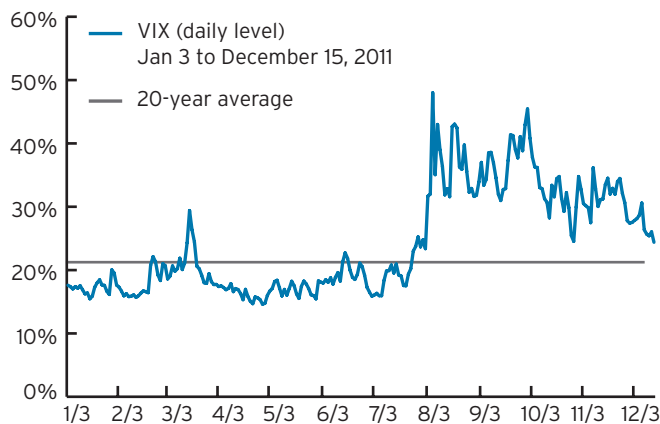
The cost of an option increases with the volatility of its underlying security, all other factors held constant. When the VIX is high, buying downside protection on the S&P 500 Index (buying a put option) or buying a right to future appreciation (buying a call option) is expensive. The seller would conversely receive a relatively greater cash payment than when volatility was low.

PROFIT FROM SELLING WHAT IS EXPENSIVE

While we expect slow growth, volatility is likely to remain high – significantly above average – and this provides some attractive investment ideas. Many investors do not focus on volatility as an asset which can be bought or sold. As with any trade, you want to sell when the market sets a price above what it is worth to you. It may be a difficult concept to embrace, but if the uncertainty of a particular asset's price is of less concern to you than the cost the market attributes to that uncertainty, you should sell the asset's volatility.

Please discuss the range of potential strategies with your Private Banker.

Taking advantage of volatility



Source: Citi Private Bank using Bloomberg, as at December 15, 2011.

It is important for you as an investor to know and understand that Options do involve risk and sometimes, significant risk, therefore may not be appropriate for all investors. Options are not suitable for all investors. The actual profit or loss from any trade will depend on the price at which the trades are executed. Please speak to your advisor to ensure you have a full understanding of the risk and reward of the strategy you are considering. Commissions, taxes, and margin costs will affect the outcome of any option transaction and can have a significant impact on the profitability of options transactions and should be considered carefully before entering into any option strategy. Because of the importance of tax considerations to all option transactions, the investor considering options should consult with his/her tax advisor as to how their tax situation is affected by the outcome of contemplated options transactions. Certain options trades/strategies must be executed in a margin account. Transactions executed in a margin account can require the investor to periodically deposit additional collateral into the account in order to maintain the positions. The preceding language is not a full description of all possible risks associated with options trading.

Before entering into any transaction using listed options, investors should read and understand the current Options Clearing Corp. Disclosure Document (Characteristics and Risks of Standardized Options), a copy of which may be obtained contacting Citigroup Global Markets Inc., Options Department, 390 Greenwich Street, New York, NY 10013 or from your advisor.

Slowdown Alert

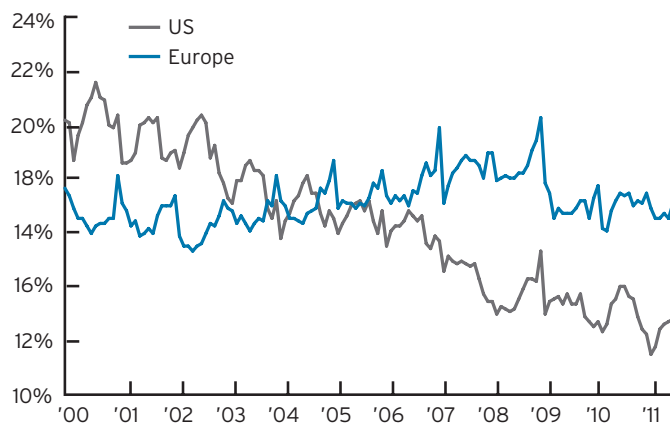
John Woods, Chief Investment Strategist, Asia Pacific

Asia is suffering from a twin pincer movement not just from a collapse in European growth but also from an economically unstable China that is also rapidly slowing. As a combination, this is likely to keep Asian risk assets under pressure for a good while yet.

The escalation of the eurozone sovereign debt crisis is being viewed among Asian policy makers with a mix of disbelief and rising dread. Asian economies still remain highly leveraged to the global industrial cycle. A sharp recession in Europe would, as it did in 2008, hit Asia where it hurts the most – in its trade and capital flows. Europe has been Asia’s most important trading partner since 2005. In 2010, for example, Asia’s European exports (excluding Japan) accounted for 18% of its total exports, compared with 13% for the US.

In the last financial crisis, Asia’s exports to Europe literally halved, pitching the region into an extended period of inflation-inducing stimulus from which it is only now starting to recover. Alas, policy flexibility remains severely impaired in many cases,

Concentration risk: Europe is by far Asia’s most important export destination



Source: Citi Private Bank using Bloomberg and International Monetary Fund, as at December 7, 2011. For illustrative purposes only. Past performance is no guarantee of future results.

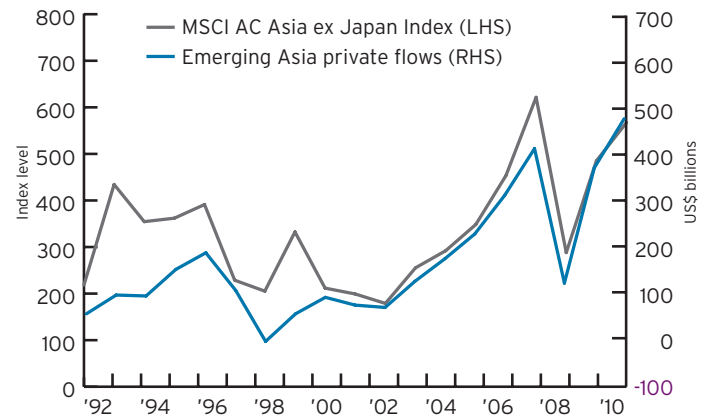
not least in China. Interest rates are lower now than they were prior to the Lehman Brothers’ crisis. While inflation has been coming down, it generally remains stubbornly high, limiting the scope for aggressive loosening should growth stumble even more. China’s scope for easing fiscal policy is likewise limited by the fact that it has already unleashed a credit bubble.

A CHALLENGE FOR CURRENCIES

A direct corollary of weaker exports is likely to be weaker currencies. If the export slowdown is accompanied by risk aversion as extreme as it was in 2008, a retreat would probably turn into a rout. The effect can be self-perpetuating, where slowing growth triggers capital outflows which impacts investor sentiment, particularly in equity markets, leading to further capital outflows.

Much of Asia would be severely challenged even if Europe were thriving. China is slowing very rapidly and doing so independently following years of poor-quality growth, largely

Price setter: net private capital flows determine Asia's equity prices



Source: Citi Private Bank using Bloomberg and Institute of International Finance, as at December 7, 2011. For illustrative purposes only. Past performance is no guarantee of future results. LHS = left-hand side; RHS = right-hand side.

brought about by substantial amounts of (mis) directed state-led investment and the credit and property bubbles of late 2008.

The symptoms of this growth strategy are evident across the economy: weak asset quality in the banking system, overly indebted local governments, an under-funded private sector and over-investment in the property sector. That an important political transition is also due this year only adds to uncertainty and a higher risk of policy error.

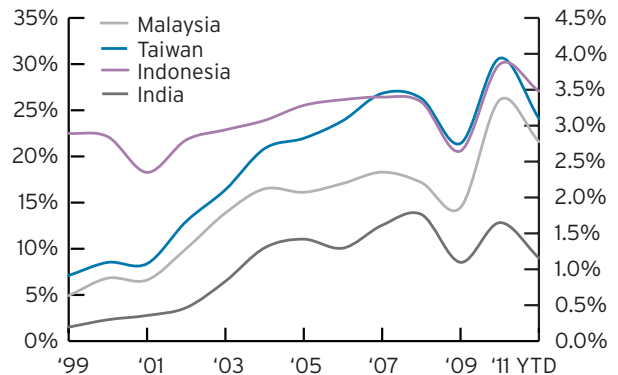
WHAT ABOUT CHINA'S CLOSE NEIGHBORS?

Those Asian countries most exposed to China's fortunes are watching its slowing growth with concern. Taiwan has slowed so much precisely because its exports to China account for over a quarter of its GDP. Malaysia has a similar problem. At the other end of the scale, the domestically oriented economies of India and Indonesia are only marginally exposed to Chinese demand and should be able to navigate its possible hard landing with a reasonable degree of resilience. Indeed, they may even benefit from falling commodity prices (a result of anemic growth) which would do much to boost real incomes.

WHAT DOES THIS MEAN FOR INVESTORS?

Slowing export growth and currency weakness, caused by slowing demand from Europe and China, lead us to assume a defensive stance in 2012. We believe risky assets, in particular Asian equities, will underperform.

Monthly exports to China as a percentage of total GDP



Source: Citi Private Bank using Customs General Administration of PRC and International Monetary Fund, as at December 2, 2011. For illustrative purposes only. Past performance is no guarantee of future results.

We suggest that investors risk seek refuge in low risk, yield generating assets.

Thus, we have a preference for:

- sovereign or corporate issuers with a strong domestic growth story
- duration as interest rates are gradually eased
- USD-denominated risk given the likely underperformance of Asian currencies
- investment grade for as long as volatility remains elevated.

Local Opportunities in a Global World

Renato Grandmont, Chief Investment Officer, Latin America

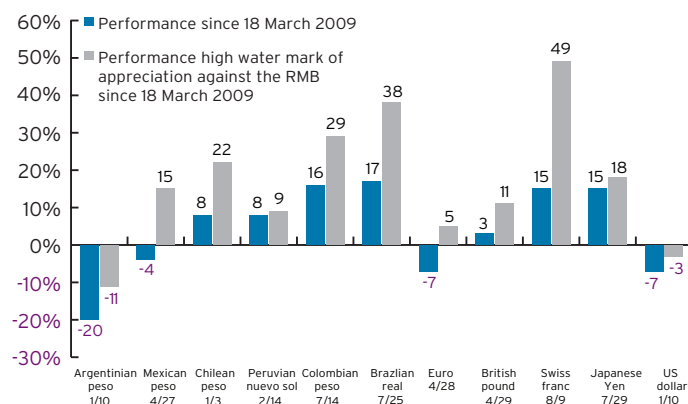
Despite the relatively strong economic conditions in Latin America – which are expected to grow 3.7% in 2012, outstripping the projected global growth of 2.5% in 2012 – the performance of Latin American assets will continue to be largely dependent on global risk appetite. The lack of visibility on factors such as the outcome of the European crisis and on the degree of China's economic slowdown will impact global growth, investment flows and commodity prices. All three mean that regional currency volatility is likely to be high in 2012 as investors adjust to internal and external policy changes. Currency volatility and lower growth are the main risks for the region in 2012 and we recommend local investors to hedge currency risk.

SOURCES OF CURRENCY RISK ABOUND

Trade flows and financial flows may deteriorate in 2012. The risk is that a sharper-than-expected slowdown in China could lead to more currency volatility for commodity exporters such as Brazil, Chile and Peru. Fortunately, many Latin American countries have room for fiscal and monetary policy stimulus and may be able to prevent growth from collapsing. In theory this would mean weaker currencies, but alas the Chinese currency is a managed float. The chart shows the degree of currency appreciation against the Chinese renminbi since the Federal Reserve initiated its first round of quantitative easing. These sharp appreciations are creating imbalances (including some Dutch disease) for some Latin American economies and have forced some governments, such as Brazil's, to intervene in order to curb the appreciation of their currencies. Global protectionist measures and local politics should keep foreign exchange volatility high.

Dutch disease happens when the appreciation of the exchange rate makes importing cheaper than producing locally and cripples the competitiveness of the industrial exporting sector.

Renminbi versus other major currencies



Source: Citi Private Bank using Bloomberg, as at December 12, 2011. The figures below the currencies show the date in 2011 at which the particular country's currency reached its performance high water mark of appreciation against the renminbi (RMB).

BRAZIL TO OUTPERFORM MEXICO

Brazil, Colombia, Chile and Peru could see their credit rating upgraded in 2012. These countries have debt-to-GDP ratios, fiscal balances and current account balances that are stronger than many European nations and do not face elections this year. While we like these countries' sovereign debt, we would avoid Argentina and Venezuela given that both countries continue an economic path of questionable sustainability and are highly dependent on commodity prices.

As at December 12, Brazil had the cheapest valuations in the region, trading at a price-to-earnings ratio* of 14.8x and a price-to-book value of 1.3x, while having the highest dividend yield at 4.2%. Monetary easing should continue in Brazil in 2012. While our economists are forecasting the overnight interest rate to drop from 11.0% to 9.5% in 2012, we believe the cuts could be even more aggressive. With inflation expected to decline from 6.5% in 2011 to 5.5% in 2012, real interest rates in Brazil are still high. However, internal fiscal dynamics will prevent real interest rates from dropping too fast.

In Mexico, we expect the central bank to remain on hold in 2012. There are two factors that may deter monetary authorities from easing, at least in the first half: presidential elections in July and Mexico's dependence on the US economy, which is surprising on the upside.

THE SHIFT TOWARD LOCAL

As the external macroeconomic environment worsens and sophistication increases, Latin American investment opportunities are likely to become more localized (less globalized). In other words, investors should look at the constituents of equity indices as performance is likely to diverge widely between sectors, for example between the large global companies (whose future is tied to global factors) and regionally focused companies (whether they are defensive or internal growth oriented). This implies that investors should look to increase allocation to managed funds rather than index funds. We also recommend that investors look for investment opportunities in regional real estate and private equity. With the European crisis worsening, European companies should continue to divest assets in the region, enriching the opportunities for these asset classes.

*The price-to-earnings ratio is calculated using the Shiller method. Cyclically adjusted price-to-earnings ratio is a valuation measure that can be applied to any equity index. The method uses ten years of trailing earnings to account for the business cycle. This measure was first created by Professor Robert Shiller of Yale University and is often referred to as the Shiller PE.

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