

## Despite U.S. Congress, a Gradual Return of Confidence

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In recent weeks, as U.S. fiscal policymakers were waging their “war on certainty”, most investors remained surprisingly calm. U.S. equities fell no more than 2% from the time it became clear that there would be a government shutdown and the public threats of a looming U.S. Treasury default were stepped up. In contrast to the relatively calm response by private investors to the latest political tempest, we find that the scars of the 2008-2009 down turn still seem to have left an imprint on the portfolio preferences of the same investors.

In a recent poll of more than 50 large family office representatives from 20 countries conducted by Citi Private Bank, investors overwhelmingly said they expect U.S. interest rates to rise moderately in the coming year, with 60% expecting long-term market rates to rise 50 basis points and 17% expecting an increase of 100 basis points or more. Just 2% of those polled expected U.S. rates to fall, with the balance looking for rates to remain “flat.” Combining this view with current low market yields, it implies an expectation for a near zero total return in long-term, high quality bonds over the coming year. Meanwhile, the same group indicated the weighted expectation for their overall, long-term portfolio return was 8%.

When asked about the asset allocation of their portfolios, the weighted allocation to public stocks averaged about 25%, with the largest share of the respondents allocating less than 30%. Reflecting views that very low rates would gradually climb, the allocation to bonds was also a low 17%. For various classes of less liquid and/or alternative investments, the weighted average was 19%.

However, using these weightings, our own return expectation for such a portfolio - with the remainder a very large implied overweight to cash (a shade below 40%) comes to just 4.4%. This matches what we at Citi Private Bank observe generally among end investors: very high cash holdings, with a current asset allocation unlikely to achieve return targets.

Asked if U.S. stocks were more likely to rise or fall 10% over the coming year, 65% expected a gain. What does this all suggest? In our view, under-invested bulls.

As Figures 1 and 2 show, in the past six years the U.S. stock market fell 50%, then more than tripled on very little investor participation or “flow volume”, which is typical of collapse periods and snapbacks. This is not the pattern in maturing bull markets, when returns moderate, but participation increases. Given a wide range of options, stocks were the single largest choice for the next incremental investment among surveyed family office investors.

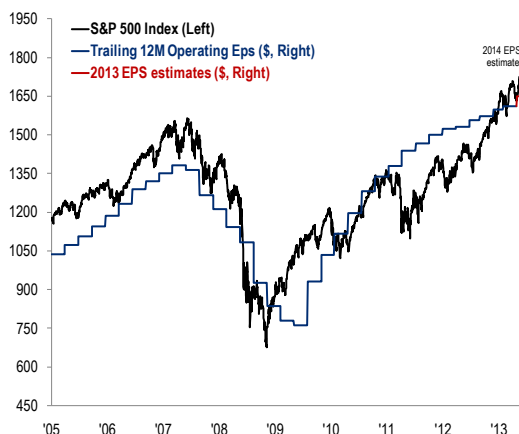
Meanwhile, as Figure 3 shows, long-term U.S. real return bonds now offer yields a full 100 basis points below the average of the past 10 years — an unusually bad decade for U.S. labor markets, capital flows and generalized economic performance.

Interestingly, without any calculations in common, we estimate that the embedded inflation-adjusted earnings per share (EPS) growth rate priced into current U.S. share prices is at a similar level to real U.S. rates: just 0.7%. This is well below long-term norms, and quite the mirror opposite of the bubble-period's enormous expectations, which peaked in 2000 at roughly double the current market price/earnings multiple.<sup>1</sup>

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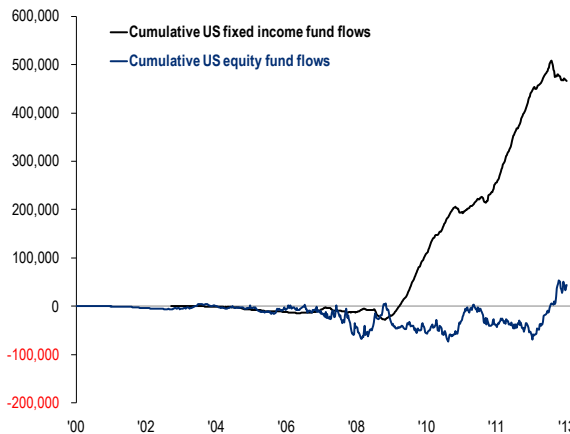
<sup>1</sup> The real expected EPS growth rate for the S&P 500 is estimated with a normalized EPS level (to avoid cyclical peaks and troughs and average in future recessions) and an equity return requirement set at the historical average 100-basis points premium to the BBB-rated corporate bond yield. Using the current market price level, it estimates the EPS growth rate consistent with these assumptions, deflated with a survey of long-term inflation expectations.

Figure 1. S&P 500 vs Trailing 12-Month Operating EPS



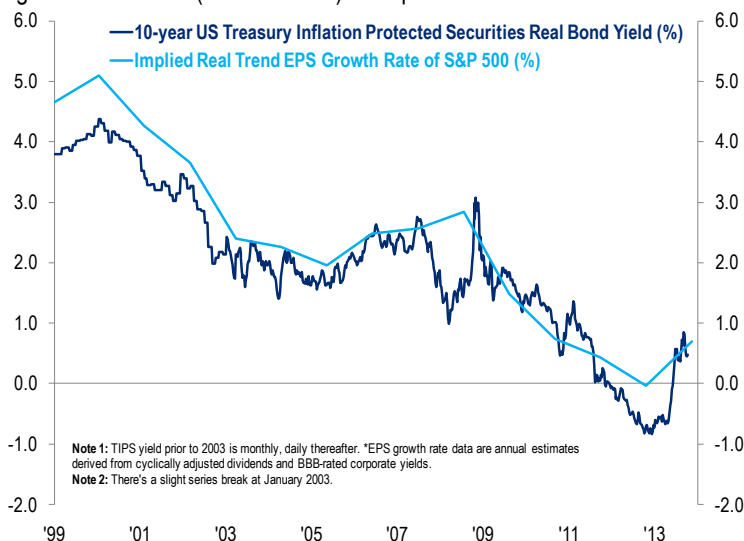
Source: Standard & Poor's, Thomson Financial, and Citi Private Bank as of October 17, 2013.

Figure 2. Cumulative U.S. Equity vs Fixed Income Fund Flows (USD, Mills.)



Source: EPFR – weekly data since inception. As of October 16, 2013.

Figure 3. Real Yield (10-Year TIPS) vs Implied Real EPS Growth Rate in S&P 500



Source: Federal Reserve Board as of September 2013, S&P, University of Michigan, Citi Private Bank

Our own future equity return expectations are positive, but well short of the pace seen over the past five years as market valuations are now far from depressed. However, in the recovery to date, investors have doubted the sustainability of huge profit gains seen at the start of the U.S. rebound. In the U.S. stock market, EPS this year may be nearly 30% above 2007's level, yet share prices are just over 10% higher than 2007's peak, as Figure 1 shows. Valuations have actually fallen during the age of quantitative easing and while profits are likely to grow slowly— unlike 2007— the U.S. economic expansion isn't over.

Our interpretation of the current market pricing is that in the years ahead, U.S. equity markets can likely absorb a gradual rise in risk-free interest rates, assuming the source of the rise is increased growth expectations, or alternatively, confidence in the sustainability of growth.

The latter explanation — concerns of sustainability — seem the more likely reasoning for the still low readings on long-term trend growth expectations that we measure in market pricing. While investors have witnessed the impact that financial deleveraging (including a dramatic rise in bank equity capital and large declines in consumer debt burdens) has had on economic growth in recent years, they haven't fully accepted the benefits in terms of safety and durability. For example, the U.S. economy grew moderately through a rather significant

fiscal tightening this year that might in other times have catalyzed an economic contraction. The economy is also likely to swiftly rebound from the modest effects of the recent government shutdown.

Markets are sure to post continued modest corrections from time to time when they become overextended, as they have in recent years. This may be the case in the near term given how smoothly markets sailed through the shutdown. The actions from the Congress – with some members playing a game of “chicken” with the full faith and credit of the U.S. government - have worked against our constructive view. Yet more and more, investors are gradually coming to believe that such negatives will be overcome.

Among the developments investors take great comfort in is the huge and likely lasting surge in U.S. energy output. Of course, this is far from a secret now, raising concerns about a “crowded consensus.” Nonetheless, there should be long-lasting impacts from the changing composition of global growth, with a stronger internal production outlook in the U.S. and some other developed economies shifting growth prospects back from certain emerging markets.

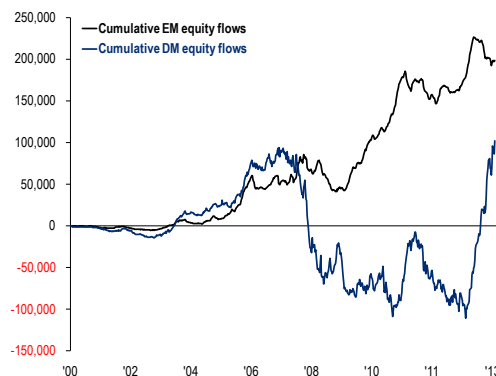
In the U.S. case, policymakers have done the U.S. dollar no favors recently with the Fed apparently treating the government shutdown as an external growth risk and extending quantitative easing. But private sector developments contrast with the decade just past, which was characterized by a falling U.S. dollar and surging external deficits (see figure 4). Over that same past decade, growth came very easy for commodity exporters in the emerging world as oil and other commodities sustained a surge in demand for a variety of reasons. Global investor portfolio flows have merely started to reflect these changes (see figure 5).

Figure 4. U.S. Mining Output Index (Crude Oil, Natural Gas and other, 4-Year Lead) vs Real Trade Weighted Dollar (Broad Index)



Source: Federal Reserve Board as of September 2013.

Figure 5. Cumulative DM vs EM Equity Fund Flows (USD, Mils.)



Source: EPFR – weekly data since inception. As of October 16, 2013.

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