

Monday Morning Musings

Setting the Scene for Twenty Thirteen

■ Equities

- **Initiating a preliminary 2013 year-end S&P 500 forecast of 1,615 may seem overly optimistic amidst the substantive challenges out there.** Calibrating year-end targets in an environment where US economic difficulties are evident, European GDP is expected to continue contracting and developing countries' growth is waning would present enough hurdles to overcome. But, things get even more complicated by the upcoming elections which will affect fiscal policy direction in the face of a looming fiscal cliff and a required debt ceiling lift in 1Q13. Fortunately, various factors still argue for equity market gains.
- **Attractive valuation, credit dynamics and implied earnings growth all support market appreciation even as sentiment is not as constructive.** The proprietary Panic/Euphoria Model is no longer generating a highly probabilistic sentiment-based "buy" signal, but various valuation metrics and earnings-based methodologies provide a positive backdrop for further index gains. In addition, the Fed's lending standards survey does not intimate that the domestic outlook is facing problems given the typical nine-month lead on business activity or 12-month lead on S&P 500 revenues.
- **Economic and earnings expansion is likely even as margin concerns persist.** With a helpful credit basis, one should expect improvement in capital investment, industrial production and employment to sustain US GDP development which then underscores a modest EPS growth rate to \$108 in 2013 (up from \$103 in 2012), which puts Citi within the broad consensus top-down estimate range of \$105-\$110, albeit lower than bottom-up expectations of 10%+ growth. Double-digit market appreciation will then require a lowering of risk premiums which is likely to be a result of policy initiative to address fiscal imbalances, almost irrespective of who wins the White House later this year.
- **A plausible shift towards The Raging Bull thesis outlined last December remains intact.** The Raging Bull argument highlighted growth drivers such as the energy sector's expansion, US manufacturing competitiveness, the explosive penetration of IT mobility and a housing rebound, combined with some positive demographic shifts for baby boom echo savers and more fiscally responsible behavior out of politicians. This amalgamation would then allow for a secular bull market to replace the Trading Places regime identified back in 2001 and a year-end market objective that takes out the previous highs would blend in nicely.
- **Risks abound but risk premiums reflect many uncertainties, barring new shocks.** A chaotic unraveling of European sovereign debt woes, a Chinese hard landing, new Middle Eastern tension that disrupts oil supplies and American fiscal deadlock could all be seen as new shocks that would undermine this 2013 view. Yet, one does not build a framework on low probability based outcomes but rather a base case with clearly identifiable risk parameters. There is no shortage of worries, but equity risk premiums near 30-year highs seem to reflect a good deal of them.

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Making Some Green in 2013

With more favorable news out of the European Central Bank alongside what has been perceived as respectable US consumer activity (via August retailing activity and auto sales), equity prices have caught a relatively good bid since June, with the S&P 500 appreciating by roughly 12% already surpassing our year-end 2012 target of 1,425 (established in December 2011) a few months early. Indeed, we rarely alter the targets mid-year since the process taken to arrive at the objective is fairly disciplined and can involve 10 or so factors that generate outcomes, with the ultimate forecast built on where most of the numbers cluster. The various metrics used in this year's calculations can be found in Figure 1, though there is one particular and glaringly missing element in the approaches utilized this go round and it relates to investor sentiment. The initial target of 1,615 for 2013 (which will be reviewed around year-end as is typical in our process) is derived from a fairly disciplined method garnering data that is congregating around the 1,600 area with two clear outliers around 1,250 on the low end and more than 2,000 on the high end. When we remove those two more extreme figures, the numbers come in around 1,610 on both the mean and the median.

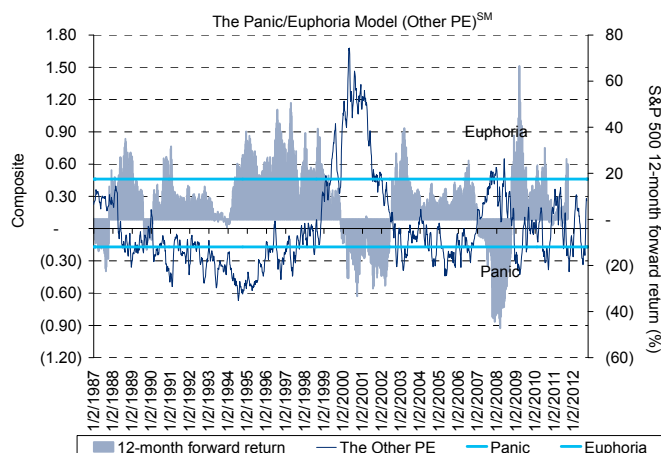
Figure 1. S&P 500 2013 Target Results

Models	2013 Targets (applying August close price)	
	12-mth Fwd Return	12-mth Fwd Return
Trailing S&P 500 P/E Bull's-Eye (12x-14x trailing earnings)	10.6% Avg Gain 1,556	11.5% Median Gain 1,568
Swiss Franc/US Dollar Analysis	11.7% Avg Gain 1,571	12.0% Median Gain 1,575
Consumer Confidence Based on latest reading 60.6 (60-70 interval)	8.9% Avg Gain 1,532	6.2% Median Gain 1,494
S&P 500 Percent of Market Value Attributable to PV of Flat Earnings above 91%	17.5% Avg Gain 1,653	14.8% Median Gain 1,615
Average forward PE of 14.89x Using 2013 forecast of \$108	1,608	
	27.5% Avg Gain	28.6% Median Gain
Earnings Yield Gap (Cyclically Adjusted Earnings Yield vs 10-yr Treasury, 5-yr Future) b/w -2&-3 SD's	1,793	1,809
Rolling 4-quarter Operating EPS and Y/Y Return Study	10.2% Avg Gain 1,550	13.9% Median Gain 1,602
GDP Forecaster	-9.9% Avg Gain 1,267	-9.80% Median Gain 1,269
Price to Book Analysis		
Current Book Value	639	
+ next 5 quarters earnings (based on Citigroup estimates)	134	
- next 5 quarters dividends	38	
2013 Book Value	735	
Book Value adjusted for estimated one-time charges	698	
2013 target based on 2.88x book value	2,011	
	Average 2013 Target 1,616	Median 2013 Target 1,617

Source: Citi Research

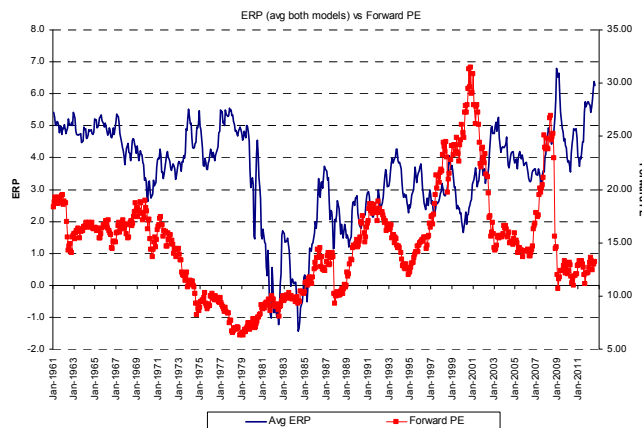
Investor sentiment is no longer sending out the kind of buy signals seen in the latter part of 2011 or even generated back in June of this year by virtue of panic readings during those periods on the Panic/Euphoria Model (see Figure 2). The current levels suggest complacency which makes the market somewhat accident prone and subject to increased volatility. While this may have some negative effect in the near term, longer term risks are still being picked up by the equity risk premium remaining elevated (see Figure 3) as investors fret about a variety of disquieting factors including the fiscal cliff, elections (in the Netherlands and the US soon plus next year's in Germany) not to mention weaker economies around the world, to name a few issues. Our sense is that no matter who wins the domestic presidential elections, some actions on fiscal policy to shrink deficits most likely will be enacted although the specifics are far from certain. However, the notion of pushing down risk premiums usually means multiple expansion and one can see that to some degree with the very recent ECB announcement of "unlimited bond buying" taking down the risk of a more severe credit development in periphery government funding costs allowed for stock prices to bounce sharply.

Figure 2.



Source: FactSet, Haver Analytics and Citi Research – US Equity Strategy

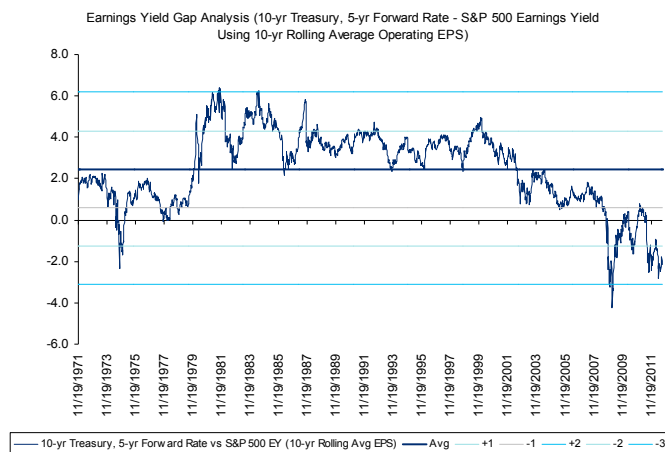
Figure 3.



Source: Haver Analytics and Citi Research – US Equity Strategy

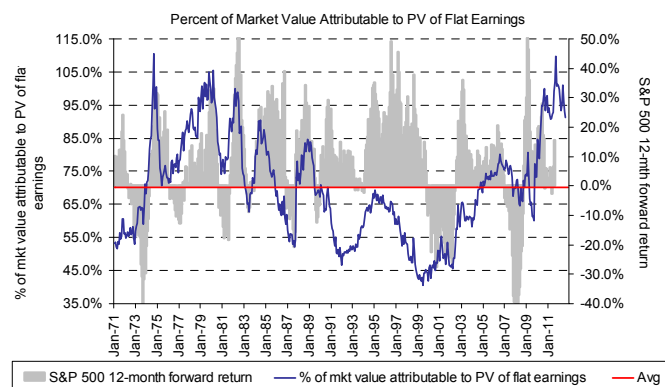
When reviewing some of the factors listed in Figure 1, one can see impressive probabilities for future gains next year. Figure 4 highlights the normalized earnings yield gap approach that generates powerful probabilities when the gap is between two and three standard deviations below average (see Figure 5). In addition, the present value of flat EPS growth into perpetuity is at a level that supports index gains in more than 90% of prior observed instances (see Figure 6). Interestingly, the average P/E of the past 50 years (see Figure 7) would argue that a 15x P/E multiple is appropriate particularly when there is limited inflation and that would calculate to a 1,620 market outcome by year-end 2013. However, we suspect many investors will counter with the elevated corporate margins concern and what that might mean for future trends.

Figure 4.



Source: Haver Analytics and Citi Research – US Equity Strategy

Figure 6.



Source: Haver Analytics and Citi Research – US Equity Strategy

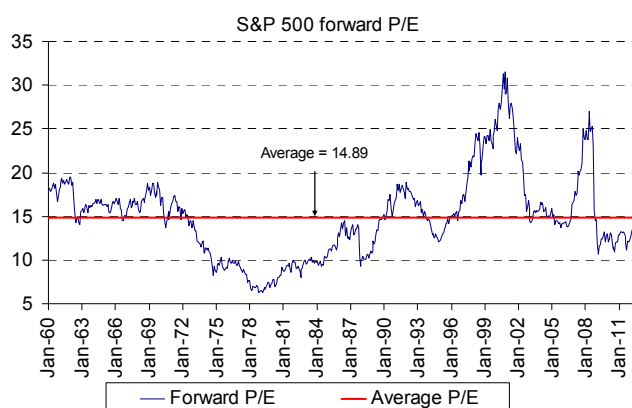
Figure 5.

Earnings Yield Gap Analysis (10-yr Treasury, 5-yr Forward Rate - S&P 500 Earnings Yield Using 10-yr Rolling Average Operating EPS)

	S&P 500 Forward Return								
	3-mth	6-mth	12-mth	3-mth	6-mth	12-mth	3-mth	6-mth	12-mth
	-3 StDevs and Below			-3 StDev to -2 StDev			-2 StDev to -1 StDev		
Average	19.9%	34.2%	49.8%	6.4%	16.1%	27.5%	0.8%	3.6%	9.8%
Median	21.5%	39.0%	50.9%	6.8%	16.4%	28.6%	2.4%	4.7%	9.9%
Total	5	5	5	74	64	39	207	204	203
% Up	80%	100%	100%	78%	97%	100%	59%	65%	88%
%Down	20%	0%	0%	22%	3%	0%	41%	35%	12%
	-1 StDev to Average			Avg to +1 StDev			+1 StDev to +2 StDev		
Average	0.5%	0.2%	1.2%	3.4%	6.8%	12.0%	0.0%	0.9%	6.4%
Median	1.0%	1.2%	4.7%	3.3%	6.7%	13.4%	0.3%	2.5%	8.2%
Total	665	665	665	883	883	883	277	277	277
% Up	57%	57%	62%	71%	76%	78%	55%	57%	62%
%Down	43%	43%	38%	29%	24%	22%	44%	43%	38%
	+2 StDevs and Above			Random Outcomes					
Average	5.9%	1.7%	15.5%	1.9%	3.9%	8.0%			
Median	8.0%	0.4%	17.0%	2.3%	4.3%	9.4%			
Total	5	5	5	2116	2103	2077			
% Up	80%	60%	100%	64%	67%	72%			
%Down	20%	40%	0%	36%	33%	28%			

Source: Haver Analytics and Citi Research – US Equity Strategy

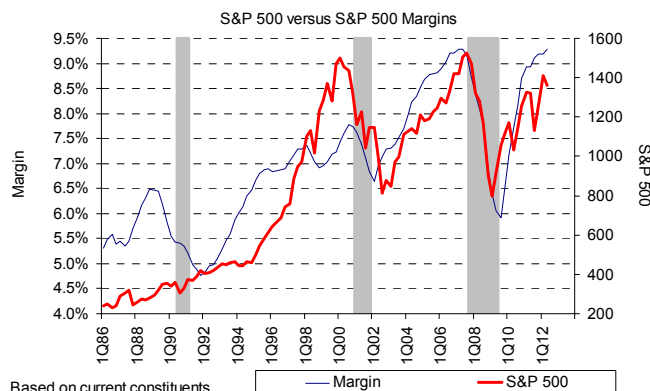
Figure 7.



Source: Haver Analytics and Citi Research – US Equity Strategy

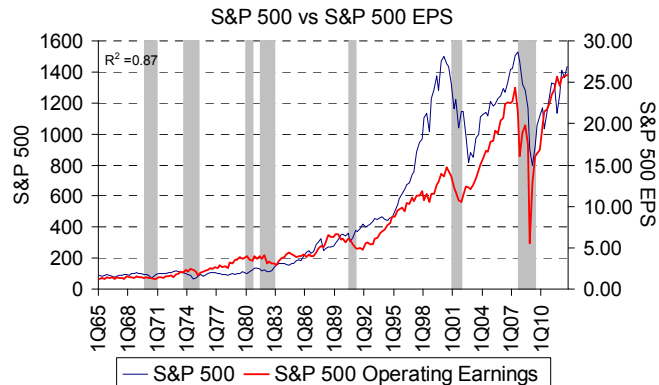
Margins might come under some pressure as we noted in a detailed report on July 10th, 2012, [Equity Strategy - Structural Shifts Expand Margins, Short-term Pressures Remain](#), but we would stress that a collapse in margins and earnings would be needed to crush equity prices if history is any guide (see Figures 8 and 9) and credit conditions just do not support that perspective given its lead indicator relationship to industrial activity (see Figure 10). Earnings tend to be highly linked to changes in industrial production (see Figure 11) and there is good reason to expect improvement in 1H13 even if recent data has been more muted (reflecting the nine-month lag from more challenged lending standards in 4Q11).

Figure 8.



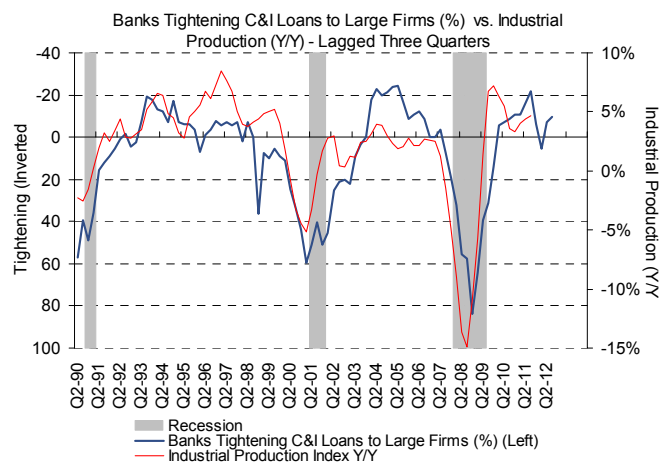
Source: FactSet, Haver Analytics and Citi Research – US Equity Strategy

Figure 9.



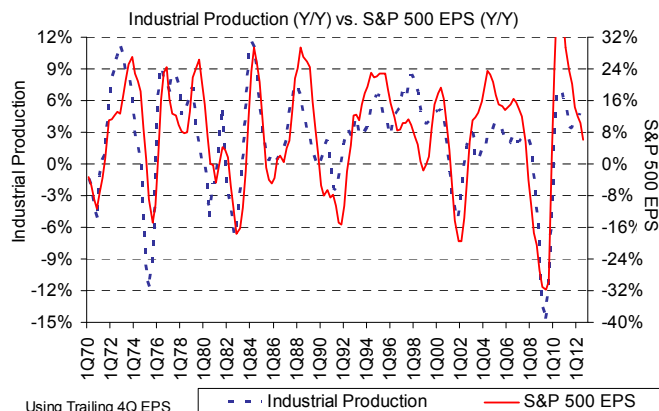
Source: Haver Analytics and Citi Research – US Equity Strategy

Figure 10.



Source: Haver Analytics and Citi Research – US Equity Strategy

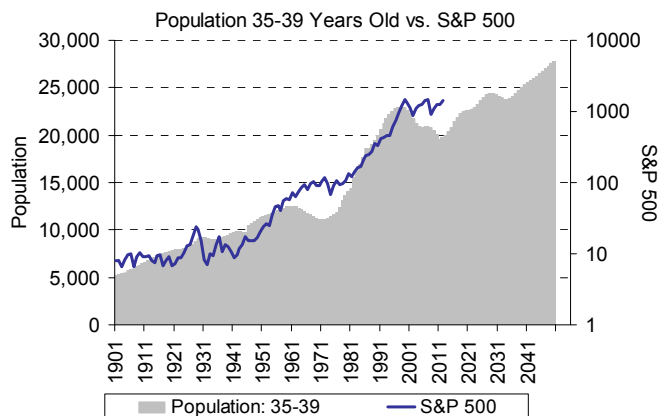
Figure 11.



Source: Haver Analytics and Citi Research – US Equity Strategy

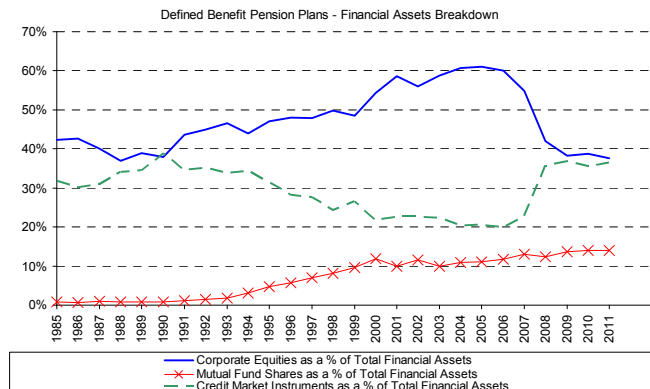
We recognize that the S&P 500 hitting 1,600 or better would translate into a new high for the index, taking out the prior peak of 1,558 achieved in October 2007 (which was slightly ahead of March 2000's peak of 1,523) and that it could trigger a definitional change in the market's advance to beginning a new secular bull run. This development would tie in nicely with the outlook established in our December 14, 2011 report, [The Raging Bull Thesis](#). At the time, many investors were skeptical about the housing sector gaining some positive traction and that there was an emerging energy boom due to new extraction technologies like hydraulic fracturing. More fund managers also have come around to the notion of much more competitive US manufacturing base causing an intriguing renaissance as was outlined nine months ago. Furthermore, the baby boom echo entering their savings years in 2013 would generate a new set of equity fund inflows (see Figure 12) and at some point pension funds would be forced back towards equities (see Figure 13) in order to achieve promised 7%-8% returns; something that seems highly doubtful owning bonds yielding only 3%-4%.

Figure 12.



Source: Haver Analytics and Citi Research – US Equity Strategy

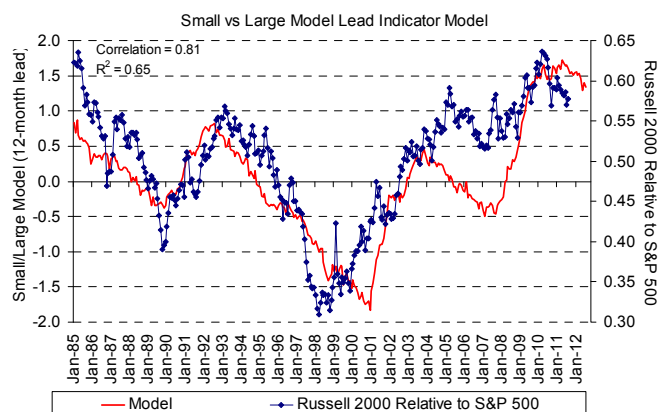
Figure 13.



Source: Haver Analytics and Citi Research – US Equity Strategy

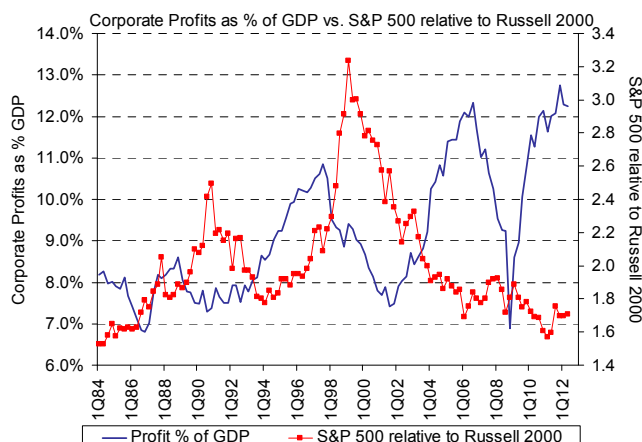
There is legitimate reason for concern given a slew of geopolitical and geo-economic issues that require resolution and therefore disruptions to global energy supplies or a new financial crisis might render our aforementioned base case view unreliable. However, there is never certainty in any projection and one can choose to hedge portfolios for low probability outcomes. In this context, it is hard to argue against large caps and higher quality dividend themes. Our large cap lead indicator still augurs well for these names (see Figure 14) and margin pressures also support a large cap bias (see Figure 15). Growth styles also seem preferable to a pure value orientation based on margin worries (see Figure 16), but seeking out share shrinkers over just dividend growers makes eminent sense too (as highlighted in Figure 17). Accordingly, investors can take positions that provide some inherent hedges as well so as not to be too far out ahead of markets with excessive risk.

Figure 14.



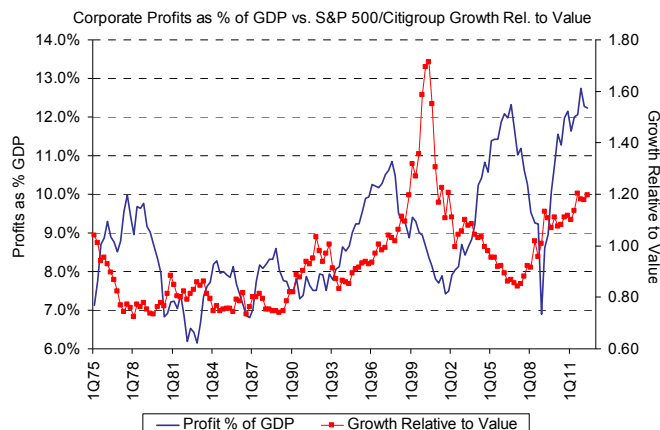
Source: Haver Analytics and Citi Research – US Equity Strategy

Figure 15.



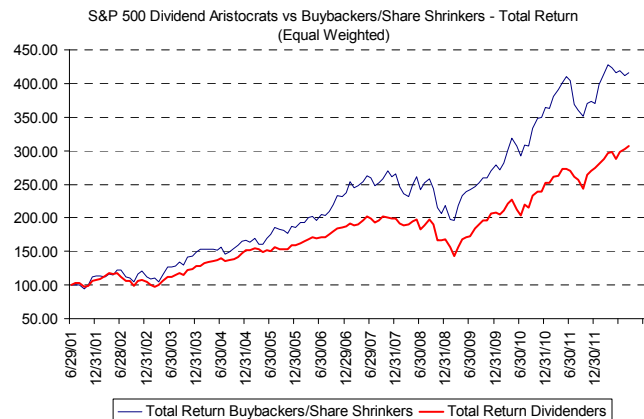
Source: Haver Analytics and Citi Research – US Equity Strategy

Figure 16.



Source: Haver Analytics and Citi Research – US Equity Strategy

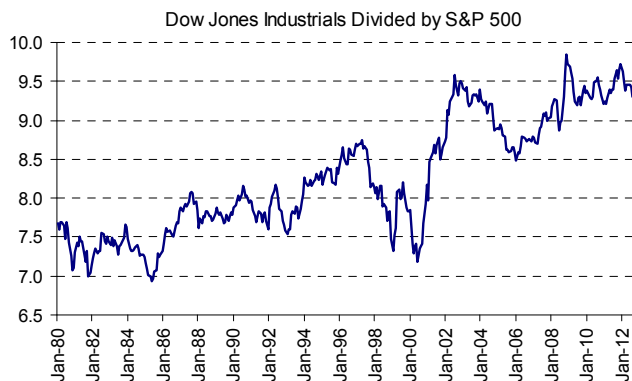
Figure 17.



Source: FactSet and Citi Research – US Equity Strategy

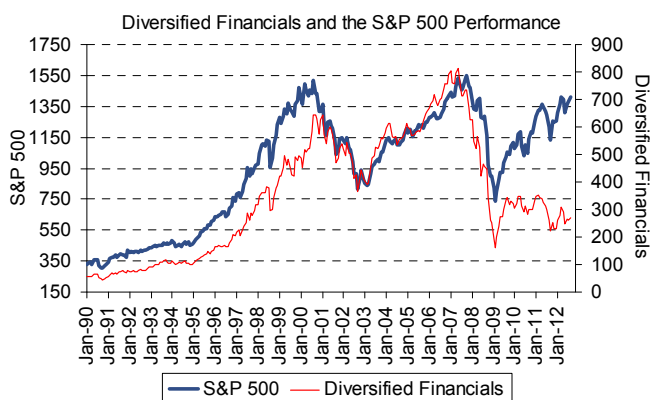
As a final note, we should stress that our preliminary Dow Jones Industrial Average year-end 2013 objective of 15,300 (up from 2012's 13,550) is derived from the S&P 500 targeting mechanism and the relationship between the two indices (see Figure 18). To be fair, a stronger overall equity market may benefit Diversified Financials stocks as the two are linked (see Figure 19) and we remain overweight this industry group even as it shows up more prominently in value indices.

Figure 18.



Source: Haver Analytics and Citi Research – US Equity Strategy

Figure 19.



Source: Haver Analytics and Citi Research – US Equity Strategy

Appendix A-1

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