23 September 2013 | 40 pages

Western Europe

European Credit Sector Recommendations

As the risks go by…

- The decision by the FOMC to continue with its current level of asset purchases caught many – including us – by surprise, and it is an added tailwind to an already supportive scenario for credit. We expect a moderate spread tightening into year end.

- Our credit survey points to a mild appetite for credit. Cash outflows remain a risk, but for now we are rather seeing a moderate pickup in inflows, supporting demand. In spite of the recent surge in issuance, we still expect a scenario of flat or slightly negative net issuance in the next quarter.

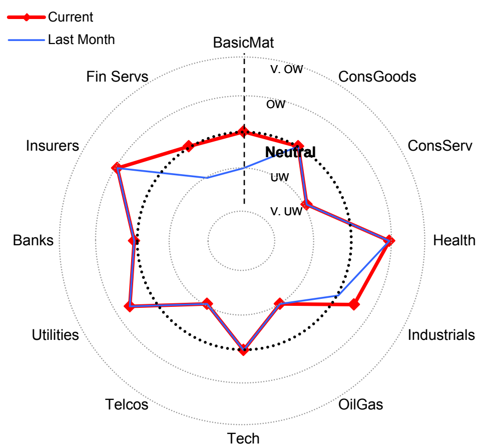
- **Key sector recommendations:** Maintain overweight in Insurers, which we still prefer to Banks from a fundamental perspective. Within Banks, we like non-European and "soft core" European banks to peripheral European ones. We move to neutral on Basic Materials and Financial Services on valuation grounds and selectively overweight on Industrials as the outlook for capital goods is improving. We remain neutral on Consumer Goods and maintain a slight overweight on Utilities via the Italian names. We remain underweight Oil & Gas.

Teresa Cascino
+44-20-7986-9580
teresa.cascino@citi.com

Hans Lorenzen
+44-20-7986-3568
hans.lorenzen@citi.com

Matt King
+44-20-7986-3228
matt.king@citi.com

Figure 1. Citi Recommended Positioning



Source: Citi Research
All recommendations are made using the iBoxx € index as a benchmark.

Figure 2. iBoxx Weightings by Sector

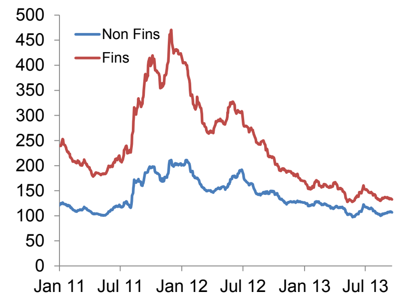
	Mkt Value (Percent)	Duration	Beta	Wgt. Dur. (Years)	Wgt. Beta (Years)
€ iBoxx	100.0%	4.4	0.9	4.4	4.1
Non-Fin	55.7%	4.7	0.8	2.6	2.1
Fin	44.3%	4.1	1.1	1.8	2.0
Basic Mat.	3.9%	4.6	0.8	0.2	0.2
Cons. Goods	9.4%	4.2	0.5	0.4	0.2
Cons. Servic	3.4%	4.7	0.6	0.2	0.1
Healthcare	2.7%	3.6	0.4	0.1	0.0
Industrials	8.0%	4.6	0.7	0.4	0.3
Oil & Gas	4.7%	4.4	1.1	0.2	0.2
Technology	0.5%	6.0	0.5	0.0	0.0
Telecoms	8.8%	5.1	1.0	0.4	0.5
Utilities	14.4%	5.1	0.9	0.7	0.7
Banks	35.3%	4.0	1.1	1.4	1.6
Fin Servs	4.8%	4.3	0.5	0.2	0.1
Insurance	4.2%	4.7	1.7	0.2	0.3

Source: MarkIt, Citi Research

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

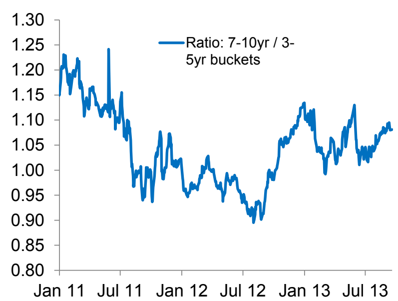
Contents

Figure 2. iBoxx € Corps and Fins



Source: MarkIt, Citi Research

.Figure 3. iBoxx € Non Fins Curve Steepness



Source: MarkIt, Citi Research

Sector and bond recommendations

A market, comfortably neutral and in a wait-and-see mode, was caught out by the FOMC decision not to taper. One by one the risk factors seem to be fading, leaving the prospect that credit is now liable to squeeze tighter again.

Definitely, as we have been arguing in one of our recent weeklies, the resilience of the credit markets to all the uncertainties in the September agenda was a strong indication of a solid technical backdrop. Our credit survey results pointed to a mild appetite for credit, which investors have been expressing mainly via the primary markets so far. Recent concerns about cash outflows now appear to be fading with reports of inflows even in EM. And in spite of the recent surge in issuance, we still expect a scenario of flat or slightly negative net issuance into near end. The recent decision from the FOMC is an added tailwind to this scenario, in our view. It is definitely likely to raise questions about the longer-term trajectory. Yet the obvious discomfort the Fed feels with rising yields, suggests they'd rather err on the side of higher inflation down the road than another stunted recovery. And for the time being that is positive for credit.

This scenario leaves us expecting moderate spread tightening into year end, once the remaining uncertainties in September are behind us. Therefore:

- We have been tactically neutral going into September, but as these risks dissipate we would revert to our modest strategic overweight.
- In Banks, we recommend investors remain long old style T1: LMEs will see this asset class shrink further over time as it is progressively replaced with the riskier AT1. We also recommend selectively reducing underweights in LT2: we expect LME activity also at this level and valuations versus old style T1 seem wide. In general, we prefer a conservative portfolio coupled with select exposures in HY and in non-financial hybrids.
- Keep shortening duration. Cash curves are still flat on an historical basis – we would remain underweight spread duration and compensate by moving down in credit quality (Figure 3) as the breakeven to volatility ratio of non-financials BBB rated is very high compared to AAA (Figure 5 – 3mth Breakeven (Basis Points) vs 3mth Breakeven/Vol Ratio by Maturity).
- In the periphery, we would keep our exposure in non-financial companies with relatively solid stand-alone fundamentals (Italian utilities) over the banks.
- Within financials, we remain overweight insurers. Within banks, we like non-European and “soft core”-European banks to peripheral European ones. Within non-financials, we remain neutral on Consumer Goods and maintain a slight overweight on Utilities via the Italian names. We also move to neutral on Basic Materials and Financial Services on valuation grounds and selectively overweight on Industrials as the outlook for capital goods is improving. Generically, we prefer higher beta sectors with comparatively good earnings visibility, and remain underweight on Basic Materials and Oil & Gas.

Suggested Picks and Pans

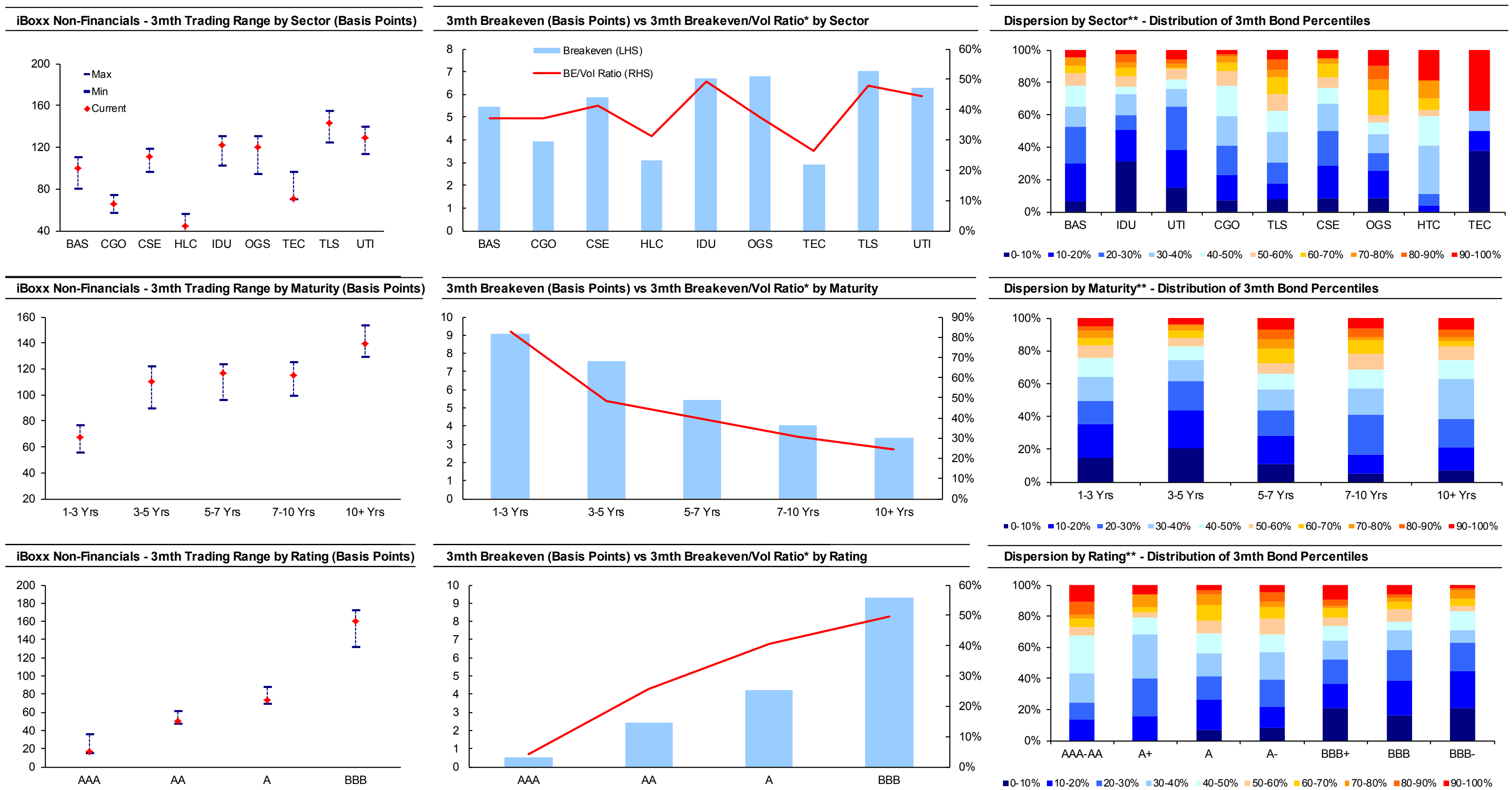
Figure 4. Suggested Picks and Pans[1]

Sector	Position	Picks	Pans
Basic Materials	Neutral	Linde Rio Tinto Glencore	Lanxess BASF Solvay
Consumer Goods	Neutral	Kering Pernod-Ricard	BMW Daimler Volkswagen RCI Banque
Consumer Services	Underweight		Metro Tesco Casino Carrefour
Health Care	Overweight	Bayer Amgen Roche	
Industrials	Overweight	Siemens Alstom Hutchison Whampoa	Schneider Electric Bouygues Atlas Copco
Oil & Gas	Underweight		OMV BP
Technology	Neutral		
Telecoms	Underweight	BT	Orange (France Telecom) Belgacom
Utilities	Overweight	Italian Utilities	E.ON
Banks	Neutral	Morgan Stanley Lloyds Banking Group BNP Paribas Credit Agricole Barclays	Spanish Banks Smaller Italian Banks
Insurance	Overweight	Swiss Life CNP Assurances Talanx	HanRe Munich Re
Financial Services	Neutral		

Source: Citi Research

[1] To produce individual and sector recommendations we use various scoring systems relative to history and to peers to determine richness and cheapness. We factor in overall spread movements as well as the potential effects of individual credits on a sector. We use this information along with fundamental data and credit-specific news to determine our positioning.

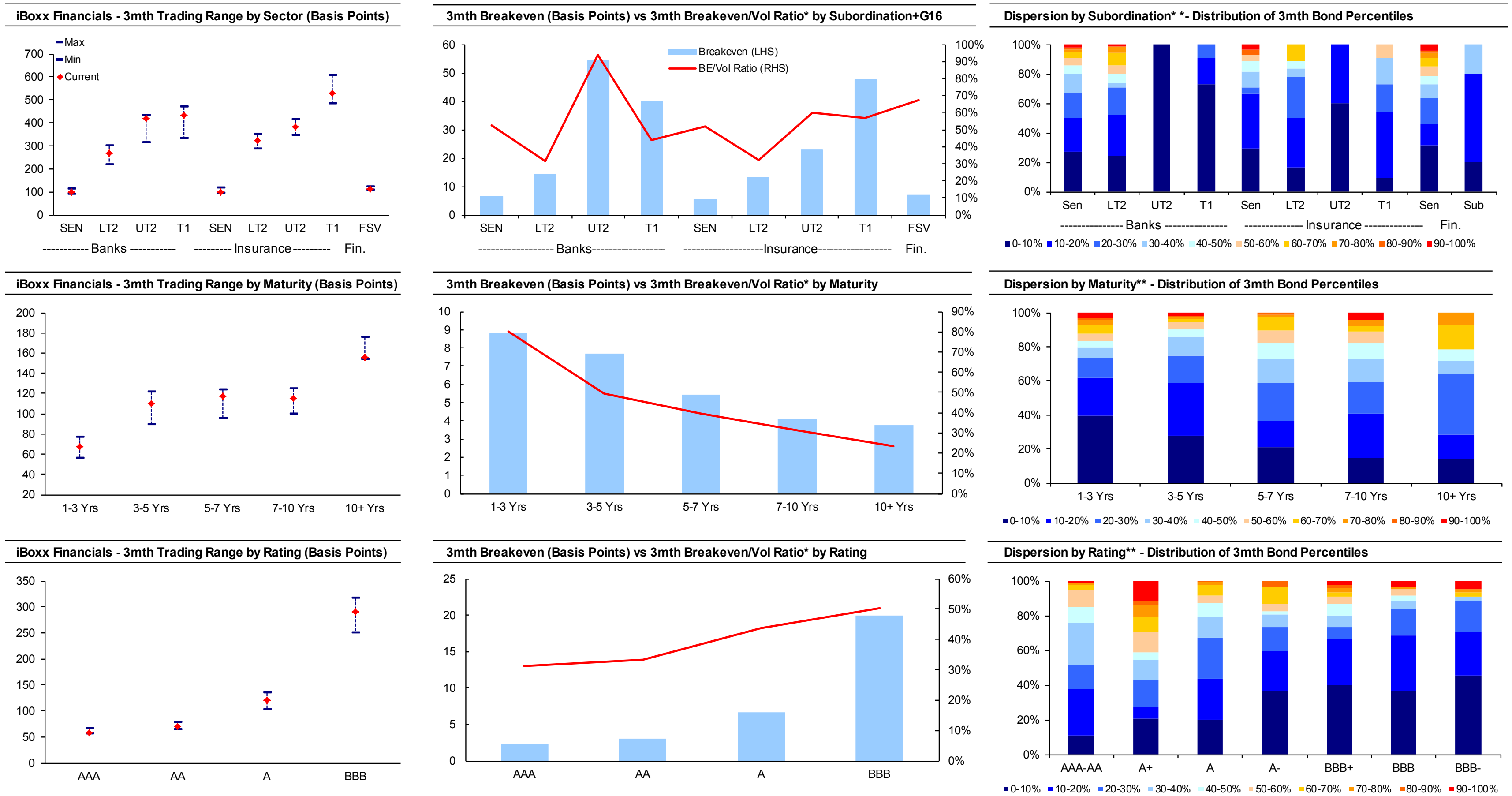
Figure 5. iBoxx EUR Sector Relative Performance – Spread Change and Dispersion Charts – Non Financials



Source: iBoxx, Citi. * Break-even (Spread/Duration) measures how much widening the carry can compensate for. Dividing by volatility gives a simple measure of likelihood that spread movements will exceed that point.
** Dispersion charts aggregate individual bond performance for various buckets (sectors, ratings etc). For each bond the current percentile in the 3mth trading range is calculated. For each bucket the distribution of bond percentiles is then aggregated. Dark red shows the percentage of bonds that are trading at or very near their 3mth wides. Dark blue shows the percentage bonds at or very near 3mth tights. Light colours show bonds trading mid-range.

Source: MarkIt, Citi Research

Figure 6. iBoxx EUR Sector Relative Performance – Spread Change and Dispersion Charts – Financials



Source: iBoxx, Citi. * Break-even (Spread/Duration) measures how much w idening the carry can compensate for. Dividing by volatility gives a simple measure of likelihood that spread movements w ill exceed that point.
** Dispersion charts aggregate individual bond performance for various buckets (sectors, ratings etc). For each bond the current percentile in the 3mth trading range is calculated. For each bucket the distribution of bond percentiles is then aggregated. Dark red show s the percentage of bonds that are trading at or very near their 3mth w ides. Dark blue show s the percentage bonds at or very near 3mth tights. Light colours show bonds trading mid-range.

Source: MarkIt, Citi Research

Sector Recommendations

Basic Materials: neutral

Move to neutral in Basic Materials

Despite some improvements in base metal demand from China last month, we think the outlook for commodity demand is still challenged. Yet valuations close to 2-year wides versus the iBoxx seem to have priced in most of the bad news. Moreover, compared to the Oil & Gas industry, where capex commitments are still high and companies are being much slower in adjusting to a scenario of sluggish demand, this sector is coming to terms with its structural issues, by preserving cash flow, reducing capex and selling off assets. The last company to announce an ambitious restructuring plan was Glencore, against which the 2018 maturities look cheap. The support provided to EM credit by the FOMC decision not to taper suggests it is a good time to reduce any underweights in EM basic material producers like Vale. These considerations lead us to move to neutral on the sector.

Prospects for Basic Materials remain weak in spite of better data from China

Yet fundamental challenges remain significant. We would not be carried away too much by the recent strong data on copper demand from China: quite likely, the strength is due to the fact that copper is used as a way to raise cash by Chinese investors (the so called "cash for copper" trade). Therefore, it might have more to do with the dire credit conditions of the Chinese market, than with real demand. Our economists have upgraded their forecasts on China's growth, and expect 2013 and 2014 GDP growth to reach to 7.6% and 7.2%, respectively, but see the recent rebound in the economy as transitory. China's consumption accounts for the bulk of global demand for metals.

Chemicals will likely experience weak margins

The outlook in chemicals does not look much better. Increased competition and weak pricing power are likely to keep pressure on chemicals in the near term. Many companies have reduced guidance. Two notable exceptions are Linde and Air Liquide, which maintained their guidance for 2013.

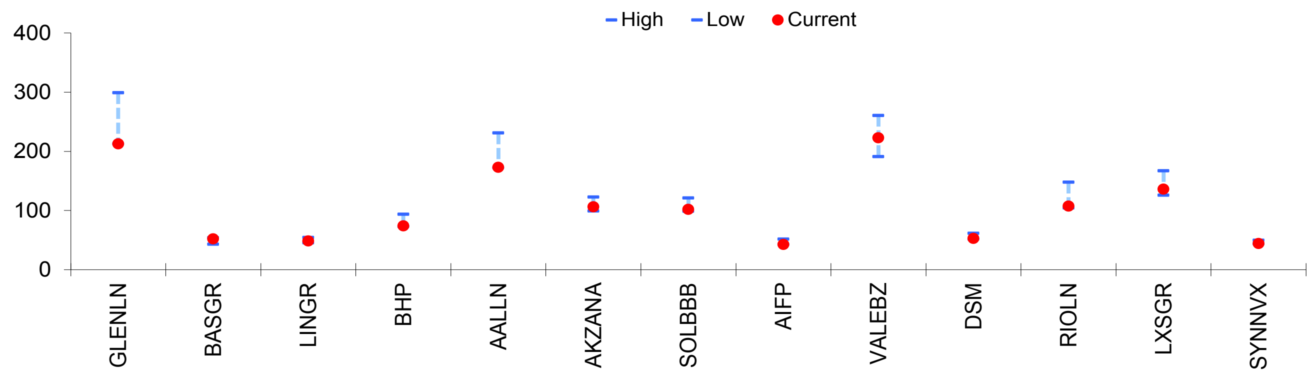
We close our underweight on Akzo Nobel and BHP after the slight underperformance of last month. These companies are restructuring their business, which will likely improve their profitability.

Figure 7. Basic Materials Picks and Pans

Picks	**Linde:** The hybrid bond underperformed comparable non-financial hybrids in the past six months. Within an uninspiring sector, this company is maintaining healthy sales growth, especially in America and in its healthcare division. Guidance for 2013 was maintained. While we worry about investors having record longs in hybrids already, and Linde's is far from the cheapest in the sector, we would still consider it as a means of picking up beta without moving into the periphery.
	Glencore: This high-beta company has underperformed peers over the last 6 months, and now its 2018 bonds look cheap, especially when compared to Thyssenkrupp. We think the initiatives the company proposed are credible and their targets realistic.
	Rio Tinto: The market seems concerned about Rio Tinto's exposure to iron ore, which will likely suffer as demand for steel is sluggish. However, our equity analysts expect capex to decline significantly in the next two years, and debt metrics should improve faster for Rio than for BHP, even in the adverse scenario of iron ore prices much weaker than current ones. Shareholder-friendly activity is a risk, but the company seems committed to maintaining A ratings and it is selling non-core assets, against which the bonds look cheap.
Pans	**Lanxess:** Remain underweight. All the rating agencies have the company on Negative outlook and further downgrade pressure is likely. The company continues to experience volume and price erosion, and its market share is under pressure. We expect more producers to emerge in the next few months. Our equity analysts are bearish on the outlook for this company and reduced their earnings estimates. These concerns are better reflected in CDS, but the two bonds in the iBoxx EUR are likely to cheapen further.
	BASF: Longer maturity bonds in particular seem expensive. We don't see catalysts for major widening, but the outlook for the company looks challenging: chemicals production is relatively weak, and demand is likely to remain slow for most of its products. Moreover, there is some M&A risk in our view. We don't see these pressures easing any time soon. The longer maturity bonds are among the tightest in their universe.
	Solvay: We remain underweight. We expect more consensus downgrades for the company, as about 40% of sales are likely to face significant structural challenges. Our equity analysts think management's earnings guidance is too ambitious. The cost-cutting measures the company is putting in place are unlikely to offset this and we think the hybrid bond will cheapen further.

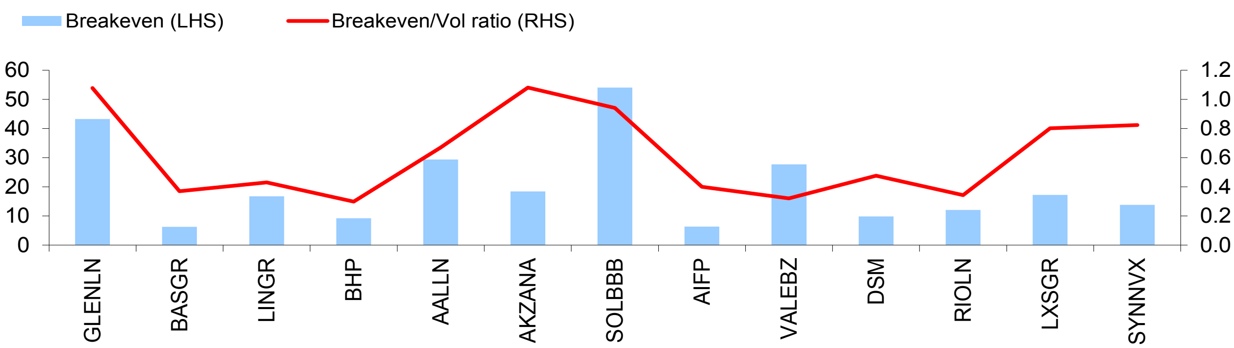
Source: Citi Research. Please refer to the footnotes on page 4 for our methodology.

Figure 8. CDS 3mth Trading Range by Sector (bp)



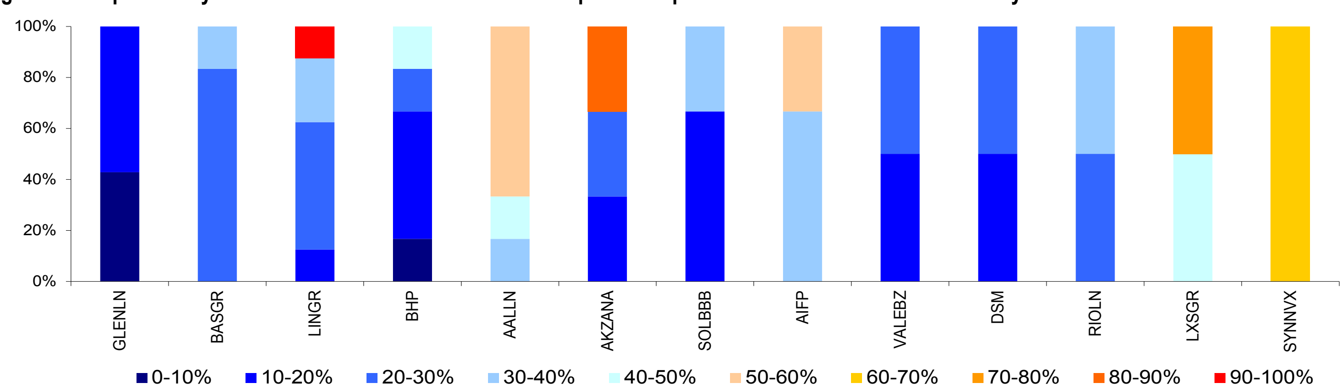
Source: MarkIt, Citi Research

Figure 9. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio* by Sector



Source: iBoxx, Citi Research

Figure 10. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth history



Source: iBoxx, Citi Research

* The breakeven (Spread/Duration) measures how much widening the carry can compensate for. The breakeven to volatility ratio measures the likelihood that spread movements will exceed that point. In the dispersion chart, we calculate the current percentile for each bond in the 3-month trading range, and then we aggregate the distribution of percentiles by issuer. Dark red shows the percentage of bonds trading close to 3-month wides, while dark blue shows the percentage of bonds very near 3-month tights.

Consumer Goods: neutral

Remain neutral on Consumer Goods

Remain neutral on Consumer Goods. While in general the sector benefits from conservative balance sheets and strong credit metrics, we see little scope for it to continue its outperformance especially at current, all-time tight levels: we see potential for releveraging and M&A activity, and the auto industry is still suffering from weak trends.

Luxury Goods are experiencing some weakness in sales. Tobacco companies are unlikely to outperform

From a credit perspective, in **Personal & Household Goods** we remain neutral on tobacco companies as we see little scope for outperformance from current levels in a sector where regulatory risks are on the rise and emerging market exposure could become an issue due to currency devaluation in their key markets. Companies in the luxury goods space are experiencing some weakness in sales. With some supply risk on the horizon and some M&A appetite for smaller players in the sector, we prefer to remain neutral in the bond space on LVMH. But we think the underperformance of the Kering 3.125% '19 bond, which has taken spreads to six-month wides, is unjustified.

M&A risk is higher in Food and Beverage companies.

We remain neutral on most **Food & Beverage** companies**,** on the basis of weakening EBITDA and M&A risks. We continue to like ABI Inbev because of its defensiveness, but close overweights after the recent outperformance. Pernod is experiencing some weakness in China, especially in its upper market products like cognac. But longer term we think emerging markets will continue generating sales growth for food and beverage companies, therefore we maintain our long.

The crisis of the automotive industry is likely to bring further deterioration in margins.

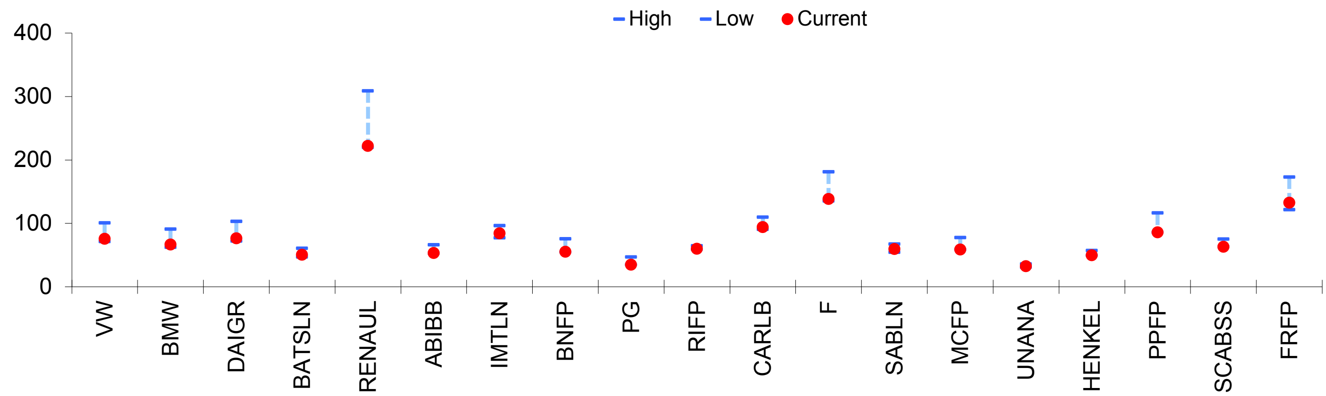
The recent news on auto sales trends in China is positive for the German automakers as they counterbalance a weak European market. We think the luxury sector in general will not be much affected by slowing growth in EM, however we believe bonds by BMW and Daimler at current levels offer little protection should the market turn more negative from here. As regards VW, instead, we would move to neutral on the 2% Jan20 and on the 2% Mar21 after their underperformance in the last 3 months.

Figure 11. Consumer Goods Picks and Pans

Picks	**Kering:** we like the 3.125% Apr19 bond in particular, which is one of the few in the space to be close to its six-month wides. The last earnings release was positive, showing good growth in most brands and across regions. Only Asia ex Japan is showing slower growth, more than offset by strength elsewhere.
	Pernod Ricard: Spreads are suffering perhaps because of its slower EM sales. Yet the company has strong credit metrics and cash generation. Spirits are more discretionary than other beverages, especially in EM, but we think emerging markets will continue playing a significant role in its growth. We like its defensiveness. Moreover, this company has lower M&A appetite than peers, and it is strongly committed to an IG rating.
Pans	**BMW and VW:** We acknowledge that these big companies have so far managed the slowdown in sales effectively, although some margin erosion is visible. They have a strong market position and flexibility in adapting to a weaker demand scenario. Our equity analysts believe most of the negative effects on earnings of the current auto recession are over. Yet we think risk/reward remains very poor for credit, as spreads remain very tight on an historical basis. However, we would move to neutral on the VW 2% Jan 20 and on the VW 2% Mar 21 after their underperformance in the last 3 months.
	RCI Banque (Renault): While there are some positives like the likelihood of government support for RCI Banque (as at PSA), the divestment of non-core assets and its somewhat encouraging Q2 results, the fundamental challenges seem too big to justify current valuations, especially considering that the company is uncomfortably close to a HY rating in our view. The company relies heavily on the payment of dividends by Nissan, an asset which we believe the company could not easily sell if needed. Moreover, we are uncomfortable about Renault's real inventory trends, which look more supported by sales to dealers than by actual sales. Spreads at their historical tights offer too little protection in our view.
	Daimler: Although its last results were encouraging, this is the weakest German auto maker in our view, and again at its tight spread levels and given the outlook for European auto demand we think there are better defensive alternatives. It is likely that profitability will improve on the back of improvements in the fleet, however among the German automakers; it has the weakest cash flow. Some bonds have marginally underperformed the market, but overall they remain tight on an historical basis and we don't see much value in them.

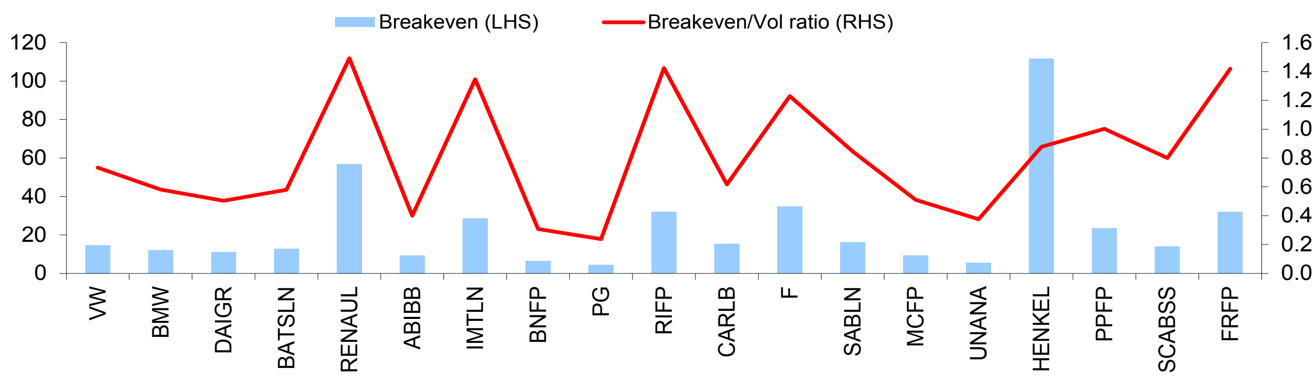
Source: Citi Research. Please refer to the footnotes on page 4 for our methodology.

Figure 12. CDS 3mth Trading Range by Sector (bp)



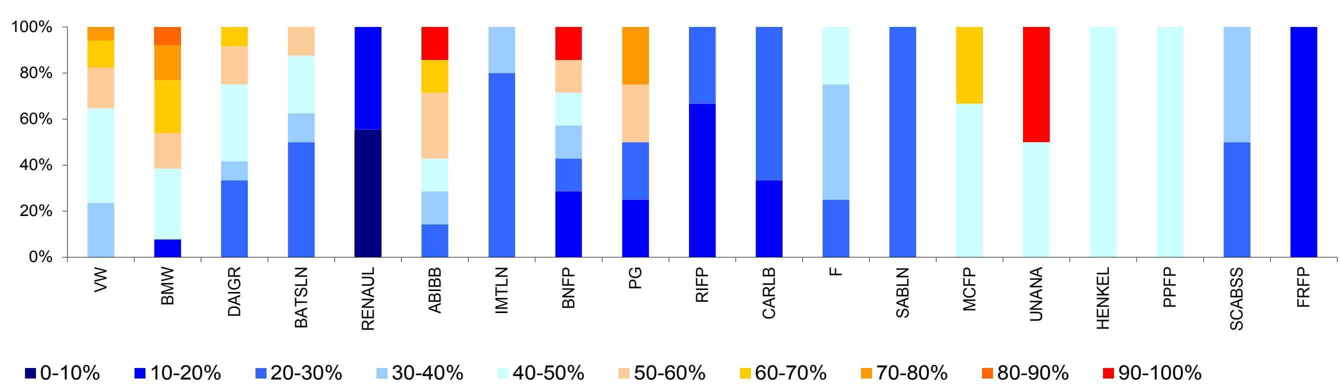
Source: MarkIt, Citi Research

Figure 13. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio[*] by Sector



Source: iBoxx, Citi Research

Figure 14. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth history



Source: iBoxx, Citi Research

[*] The breakeven (Spread/Duration) measures how much widening the carry can compensate for. The breakeven to volatility ratio measures the likelihood that spread movements will exceed that point. In the dispersion chart, we calculate the current percentile for each bond in the 3-month trading range, and then we aggregate the distribution of percentiles by issuer. Dark red shows the percentage of bonds trading close to 3-month wides, while dark blue shows the percentage of bonds very near 3-month tights.

Consumer Services: underweight

We remain underweight on Consumer Services

Many Consumer Services names benefit from a perceived safe-haven status and remain tight on a historical basis; yet high competition and stagnant profitability remain significant challenges for most of the issuers in spite of high investment. For a conservative positioning we would rather look at industrials: leverage is comparatively lower and financial flexibility higher, against slightly higher spreads. Industrials also have better quality fundamentals than most retail companies we follow: for this reason we think they will benefit relatively more than retail from improving economic trends in Europe.

Profit growth will likely remain weak for the companies we follow

In spite of improving retail sales and consumer confidence data in Europe, we expect profit growth to remain slow for the retail companies we follow. For them, most of the growth so far came from square footage expansion, and this is set to slow down in the medium term as these companies already have a large real estate portfolio. Some of these companies are exposed to EM, where they are investing heavily to grow space. But results are weaker than such huge investments would imply. On the contrary, our equity analysts note that in 1Q13 EM growth LFL sales growth fell below even that of developed markets.

In France, Carrefour is experiencing some modest improvements in its hypermarket business, but its LatAm growth is being negatively affected by FX depreciation and it is very exposed to peripheral Europe. Weaker sales and wage inflation are also likely to negatively affect margins in its Chinese business. Casino also reported a further weakening in LFL sales in France. We think its EM exposure played a significant role in its underperformance in June.

We wouldn't be more than neutral on media

In **Media**, we are concerned about earnings at most professional publishers. Apart from Reed Elsevier, our equity analysts are cautious on the growth prospects of the companies in iBoxx. We are also concerned about the EM exposure of some of them (like WPP) and M&A activity. For this reason, at current levels we prefer to remain neutral.

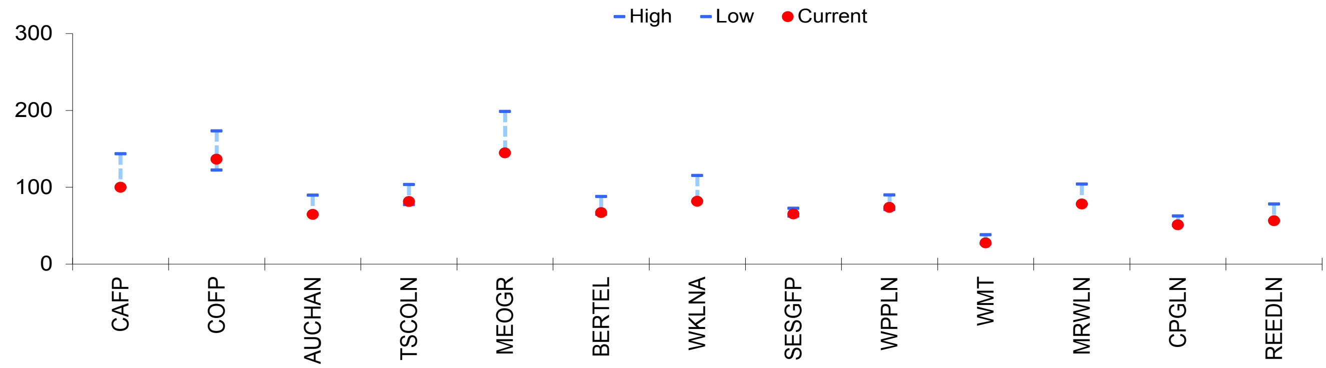
We close our overweight on GTECH as spreads on its bonds reached their all-time tights. We also reduce our underweight on Casino: the long end part of the curve underperformed peers and it is at its six month wides.

Figure 15. Consumer Services Picks and Pans

Pans	**Metro:** This company has finally entered a turnaround phase, with management reducing capex and deleveraging by divesting part of its real estate portfolio. We take advantage of last month's performance to partly close our underweight. Yet we think that any balance sheet improvement will take time, while spreads are historically very tight: while acknowledging the good intentions of management, we don't feel compensated for the risks the company faces.
	Tesco: We fear further underperformance to come for Tesco. It is engaging in significant investments as it tries to revamp its UK business. Yet, we think the turnaround will take time. Moreover, the company's credit metrics are worsening. LFL sales continue to deteriorate, although this is partly due to a slowdown in space growth. The company has recently been downgraded to the BBB area, yet bonds look still tight vs history. Recent news of a joint venture with China Resource Enterprise to combine their retail operations in China and the sale of Fresh and Easy would be a positive step towards tackling its problematic Chinese and US operations, but other challenges remain.
	French food retail: Carrefour and**,** to a lesser extent, **Casino** bonds look too tight given the challenges they are facing in France. Carrefour is slowly changing its strategy for French hypermarkets in order to reduce costs. Sales in peripheral Europe have not worsened over the last quarter, but Latin American sales are unimpressive. Casino reported a further weakening in its French LFL sales, and might suffer from its EM exposure, however the longer dated bonds are now at their six-months wides, suggesting it is time to reduce the underweight.

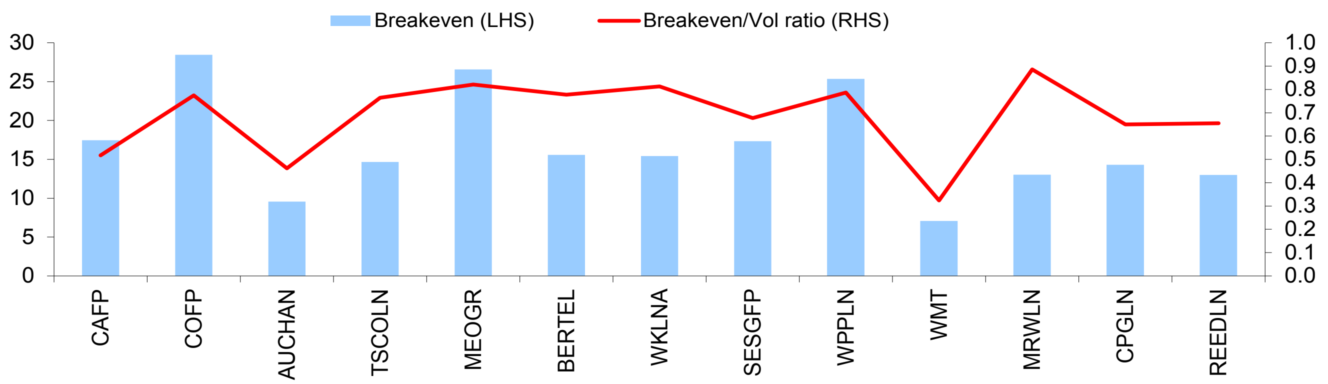
Source: Citi Research. Please refer to the footnotes on page 4 for our methodology.

Figure 16. CDS 3mth Trading Range by Sector (bp)



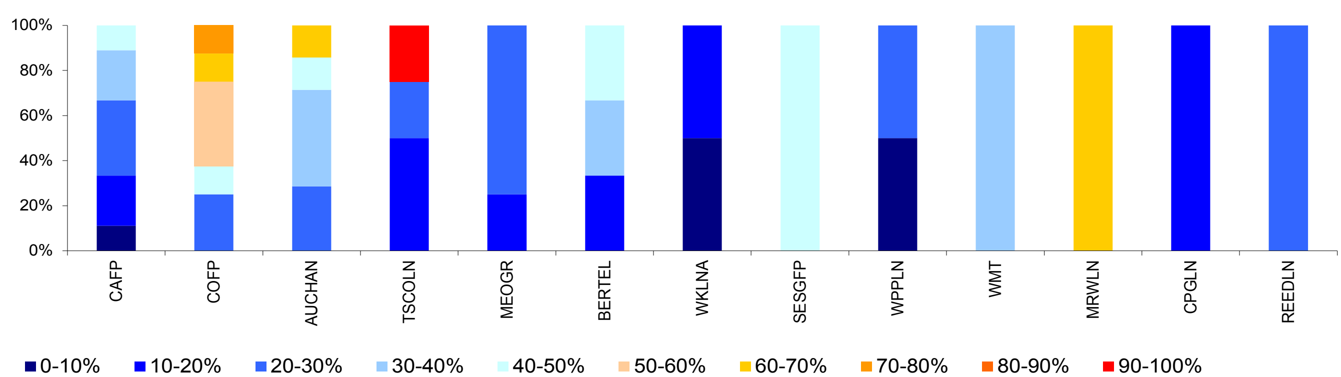
Source: MarkIt, Citi Research

Figure 17. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio* by Sector



Source: iBoxx, Citi Research

Figure 18. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth history



Source: iBoxx, Citi Research

*The breakeven (Spread/Duration) measures how much widening the carry can compensate for. The breakeven to volatility ratio measures the likelihood that spread movements will exceed that point. In the dispersion chart, we calculate the current percentile for each bond in the 3-month trading range, and then we aggregate the distribution of percentiles by issuer. Dark red shows the percentage of bonds trading close to 3-month wides, while dark blue shows the percentage of bonds very near 3-month tights.

Healthcare: overweight

Maintain an overweight on Healthcare

The low beta names in Healthcare have underperformed the iBoxx last month, but we maintain a small overweight as we continue to like their defensiveness.

Patent expiration risk has been effectively managed

Pharmaceutical companies have been quite active in mitigating the risk of a patent cliff, by increasing their investments in R&D and acquiring patents. This was the main credit risk on the horizon and it is largely behind us. We expect R&D productivity to improve. Some companies are also likely to benefit from innovations in cancer immunotherapy (Roche, Novartis and Sanofi, for example). Balance sheets look strong currently, but we expect them to weaken over time as favourable funding costs are likely to encourage debt-financed M&A and/or share repurchases. However, most of the firms have the financial flexibility to manage medium-sized M&A in our view; therefore we don't see these as a major problem.

European pharmaceuticals are focusing on generics

European companies are likely to diversify away from branded pharmaceuticals, in favour of generic, over-the-counter and animal health products. We think this strategy is less risky than the one followed by most US companies, which instead tend to focus on branded pharmaceuticals.

Revenue growth is constrained by austerity measures and competition with generics

Fiscal austerity in Europe and healthcare reforms in the US are likely to weigh on revenue growth, however we expect healthy growth from EM in spite of the current turmoil. Within the sector we believe the winners are likely to be those companies with a strong Phase III testing pipeline, or which are more geographically and product diversified, like Roche.

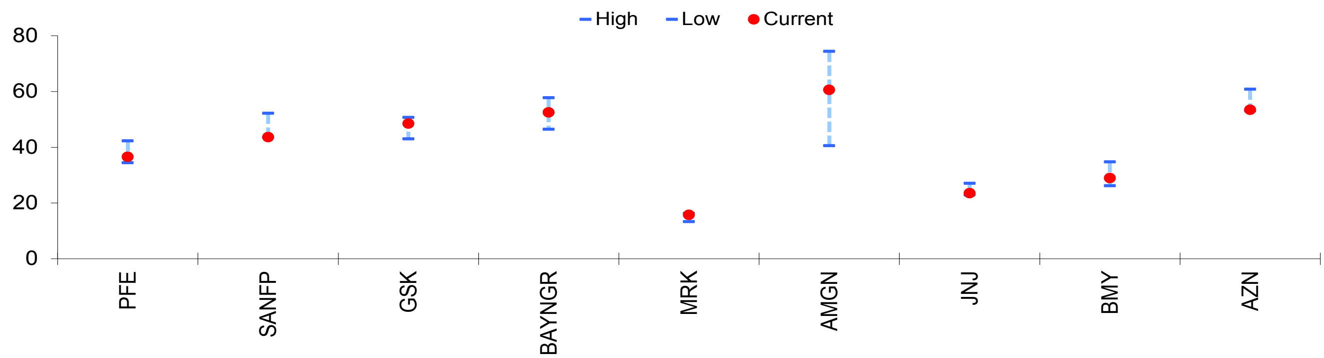
We close our overweight on GSK after last month's strong performance.

Figure 19. Healthcare Picks and Pans

Picks	**Roche:** overweight. It has quite a strong pipeline for blood cancer drugs, Alzheimer's, etc. It is only performing in line with peers, which we believe is unjustified given its strong fundamentals, focus on improving its pipeline and strong cash flow generation.
	Bayer: The subordinated bond underperformed the sector over the last six months, and we think it offers good value, being a good way to increase beta exposure via a company with strong credit fundamentals. We think the underlying earnings momentum of new drugs will offset the weakness of part of its drug portfolio. We expect a recovery by the end of the year in its MatScience and Healthcare divisions, which drove the recent earnings underperformance.
	Amgen: Bonds widened on leverage concerns regarding the Onyx acquisition. However, spreads are now at their six-month wides. The deal will be funded with cash and bank loans, so the risk of new issuance is minimal. There are some downgrade risks related to the acquisition, however we think Amgen has the flexibility to maintain its rating in the BBB area. With the uncertainty related to the acquisition now cleared, we think bonds offer an interesting entry point to get exposure to a conservative sector.

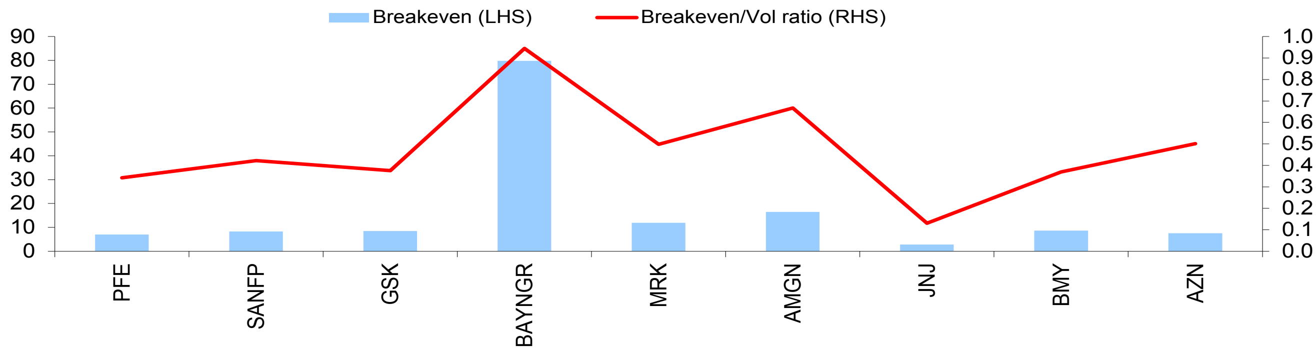
Source: Citi Research. Please refer to the footnotes on page 4 for our methodology.

Figure 20. CDS 3mth Trading Range by Sector (bp)



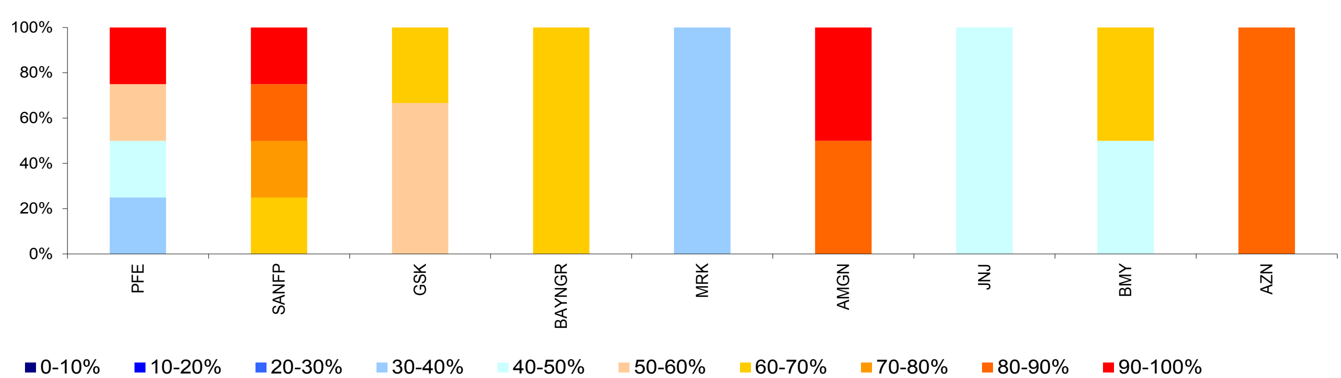
Source: MarkIt, Citi Research

Figure 21. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio* by Sector



Source: iBoxx, Citi Research

Figure 22. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth history



Source: iBoxx, Citi Research

* The breakeven (Spread/Duration) measures how much widening the carry can compensate for. The breakeven to volatility ratio measures the likelihood that spread movements will exceed that point. In the dispersion chart, we calculate the current percentile for each bond in the 3-month trading range, and then we aggregate the distribution of percentiles by issuer. Dark red shows the percentage of bonds trading close to 3-month wides, while dark blue shows the percentage of bonds very near 3-month tights.

Industrials: overweight

Move to a small overweight on Industrials

Supported by their geographic diversification and strong fundamentals, Industrials have been one of the best performing sectors in non-financials over the last six months. Earnings and margins are still weak and there is some M&A risk. However, the global economic outlook is moderately improving, leverage is comparatively lower and financial flexibility higher, and valuations look attractive in some cases.

Challenges at a company level are still evident in Industrials, but prospects for capex demand are improving

Challenges at a company level are still evident, especially for those exposed to EM. The last earnings season has been uninspiring: most companies disappointed expectations. Yet, better-than-expected economic data induced many analysts to upgrade their expectations for the next earnings season. Our European Earnings Revisions Index for Industrials (CGERPEIN Index <GO>) is now at 0.10, the highest level in this year. The PMI manufacturing index for Europe now looks firmly above 50. Moreover, our equity strategists note that improvements in lending standards, (with the percentage of banks loosening their lending conditions to large enterprises now close to historical highs), anticipate capex expansion by about nine months. These data, coupled with mildly positive company commentaries, make us think that the prospects for capital goods companies might have improved somehow. Yet we expect mining capex demand to remain dire. A survey by our equity analysts on capex intentions in the mining sector highlights further weakening, with negative implications on pricing.

We remain cautious on construction exposed to EM

We remain cautious on construction. While we are seeing signs of recovery in some markets like the UK, construction confidence indices in Europe are still depressed. The weakness in some EM countries like Morocco, India and Mexico does not help either. The key question for the next six months is whether construction companies will manage to cut costs and contain the effects of their EM exposure.

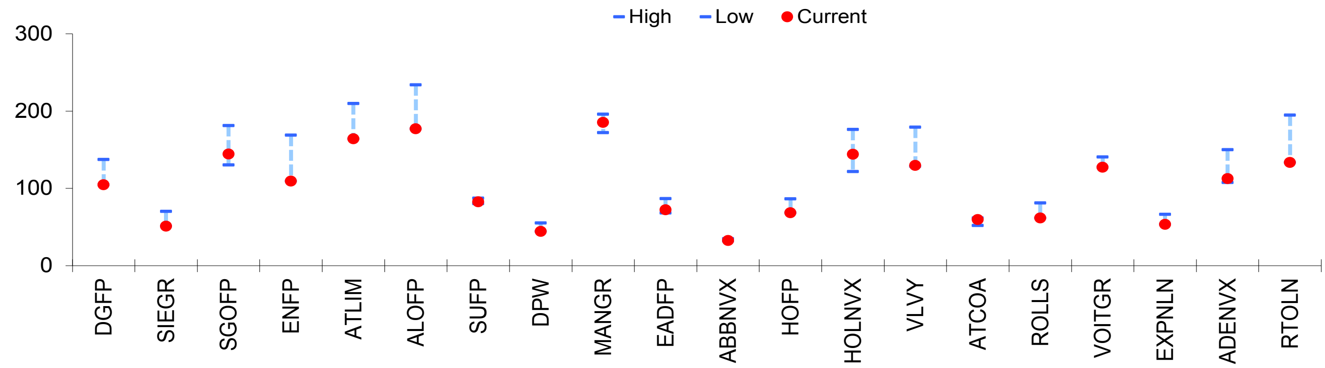
We close our Overweight on PostNL as the spread seems to have stabilized at levels last seen in January 2013, before UPS scrapped its acquisition plans for TNT Express. We also close our overweight on Abertis as spreads have reached historical tights.

Figure 23. Industrials Picks and Pans

Picks	**Alstom:** Although the outlook on capital goods in Europe is still uninspiring, we think Alstom is handling its challenges successfully. The company reported orders were ahead of expectations and it maintained guidance for low single-digit organic sales growth and stable operating margins in 2013/14. We think that the company has the ability to generate positive FCF by the end of 2013. We would buy on any underperformance in CDS and bonds.
	Hutchison Whampoa: Bonds are underperforming CDS, probably because cash investors are more wary than CDS market participants of its acquisitive strategy and EM exposure. However, rating agencies guided that the company is able to manage bolt-on acquisitions within its rating. This company gets 50% of its revenues from Europe. Spreads are now at their 6-months wides, but should tighten on the back of the FOMC decision and outperform the sector.
	Siemens: We like the hybrid bond, which is wide to history, and might be called, in our view, as the company does not really need such an expensive form of funding. The company reduced its profit margin guidance recently and the fact that Mr. Ackerman is stepping down as vice chairman suggests that there are still issues at a managerial level, but the new CEO might accelerate the restructuring of the business. Moreover, Siemens should benefit from recovery in Europe.
Pans	**Atlas Copco:** We don't like mining capex companies, as the mining sector is aggressively cutting capex, weakening the company's orders. The acquisition of Edwards, a company exposed to oil capex equipment, increases Atlas Copco's cyclicality, in our view. Edwards' stretched balance sheet is also of concern.
	Schneider Electric: We expect further underperformance given sluggish growth in the infrastructure and real estate markets in Europe and risks in China. Its recent bid for Invensys looks expensive, and although it will not be financed with debt, we are concerned that the deal will worsen the cash position of the company. Its end markets remain lacklustre. Although it underperformed peers last month, we believe it remains too tight to history given the challenges it faces.
	Bouygues: Weakness in its phone business led the company to reduce its sales guidance, although the company maintained its EBITDA guidance. Bonds have tightened less than peers over the last six months, but we think they will continue underperforming.

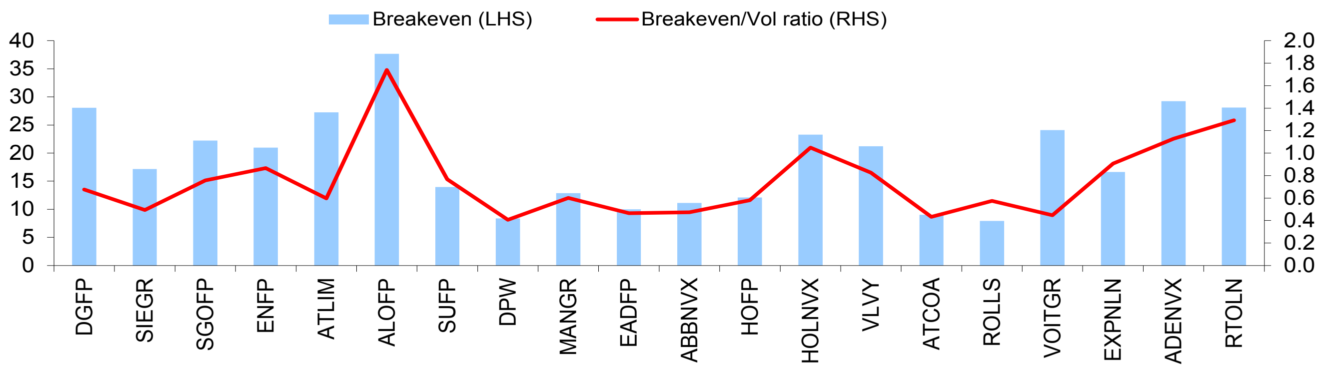
Source: Citi Research. Please refer to the footnotes on page 4 for our methodology.

Figure 24. CDS 3mth Trading Range by Sector (bp)



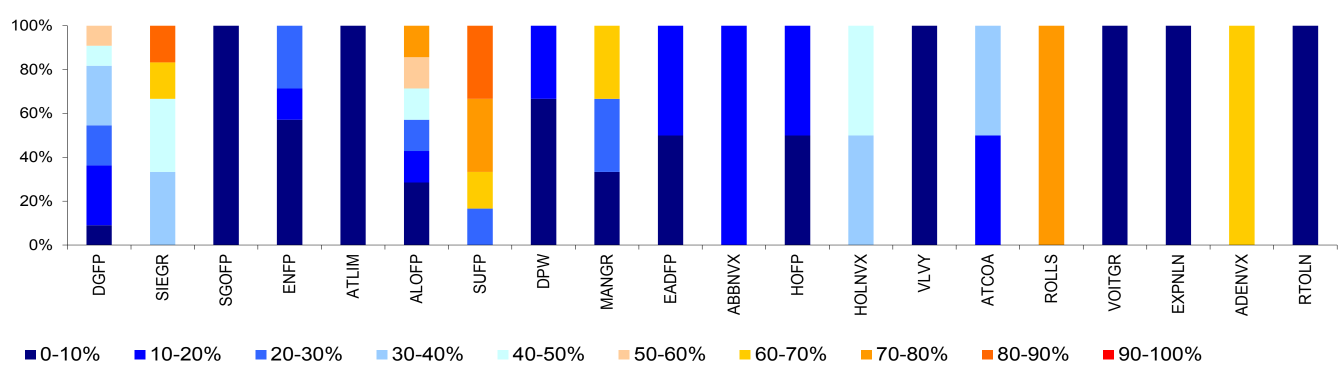
Source: MarkIt, Citi Research

Figure 25. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio* by Sector



Source: iBoxx, Citi Research

Figure 26. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth history



Source: iBoxx, Citi Research

* The breakeven (Spread/Duration) measures how much widening the carry can compensate for. The breakeven to volatility ratio measures the likelihood that spread movements will exceed that point. In the dispersion chart, we calculate the current percentile for each bond in the 3-month trading range, and then we aggregate the distribution of percentiles by issuer. Dark red shows the percentage of bonds trading close to 3-month wides, while dark blue shows the percentage of bonds very near 3-month tights.

Oil & Gas: underweight

Maintain underweight on Oil & Gas

Although the longer-term challenges of the industry are unlikely to get resolved in the short term, with negative news from Syria, production disruptions in Libya and the economy recovering in Europe and US, we think it is time to selectively reduce our underweight on Oil and Gas. The sector is very wide to the iBoxx, having underperformed the market in the last three months. However, for companies like Royal Dutch Shell, the underperformance over the last three months suggest it is time to close our underweight. We also recommend closing any underweight on Petrobras at current spreads: the FOMC decision not to taper is favourable for EM credit and its bonds are now at their June highs.

Short-term positives

Crude oil markets remain firmly in backwardation, and outages will likely provide ongoing support to the markets. The situation in Syria is likely to cause oil prices to increase further, given the production outages in Libya. Moreover, the economic recovery in Europe and the US will provide some support to global demand. Yet we would not read too much in the recent uptick in Chinese oil imports: quite likely it was due to oil restocking, rather than a sustained increase in demand.

Long-term negatives

In the longer term, however, big oil firms face significant challenges, and it seems to us that they have been much slower than miners to reposition their business for a scenario of subdued prices. Exploration and production activities are increasingly costly. The capex commitments of the oil industry as a whole remain high and sticky, weakening cash flow. At least some industry players seem to have finally acknowledged the problem, and announced write-downs (Shell) and capex reductions (Total). It seems like the industry is adapting very slowly to an environment of subdued oil prices: investment is at an all-time high, absorbing on average about 100% of operating cash flow.

The winners should be the low-cost producers

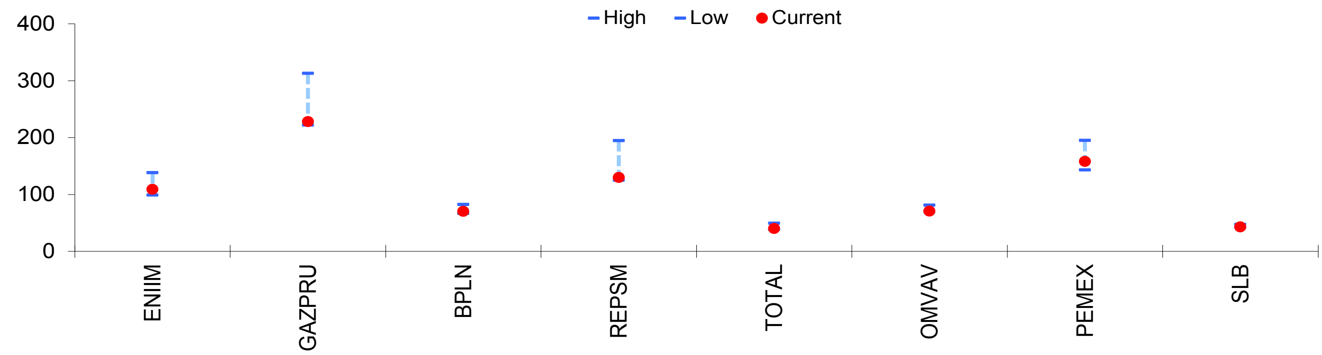
In a scenario of subdued oil price growth, we think the winners will be the low-cost producers like Repsol and BG, but these are fairly valued, in our view.

Figure 27. Oil and Gas Picks and Pans

Pans	**OMV:** Seems tight given operational challenges. We are concerned about its Romanian and Turkish exposure. While the acquisition of assets in the North Sea is a longer-term positive, we are worried that it will imply more capex (and leverage) in hard-to-develop projects.
	BP: We maintain our underweight on BP. We acknowledge that BP has been restructuring its business after the Macondo spill, focusing on exploration and developing key assets. However, legal challenges from the Macondo spill are still significant. Moreover, reserve replacement ratios versus peers are low, in the region of 75-85% versus a sector average of above 100%, indicating that the company might need further investments to develop its reserves in a time of subdued oil price growth.

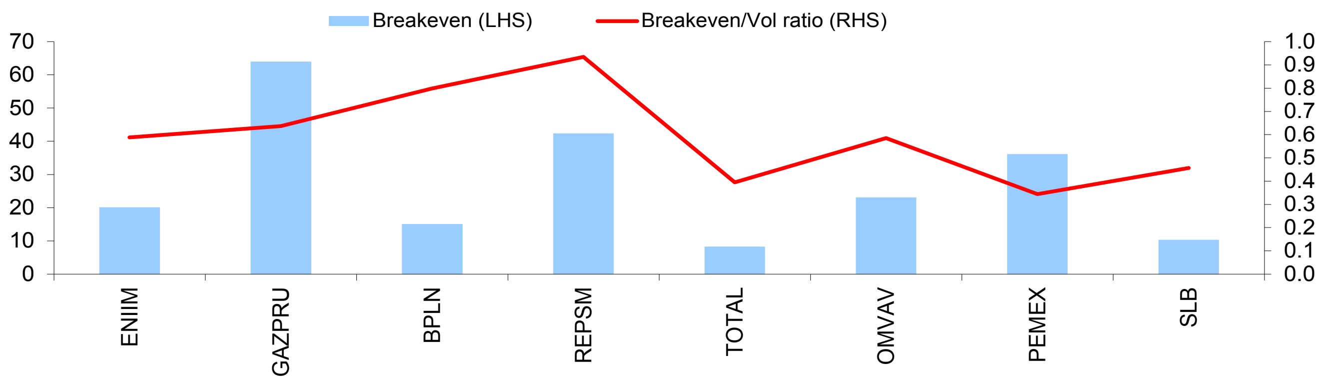
Source: Citi Research. Please refer to the footnotes on page 4 for our methodology.

Figure 28. CDS 3mth Trading Range by Sector (bp)



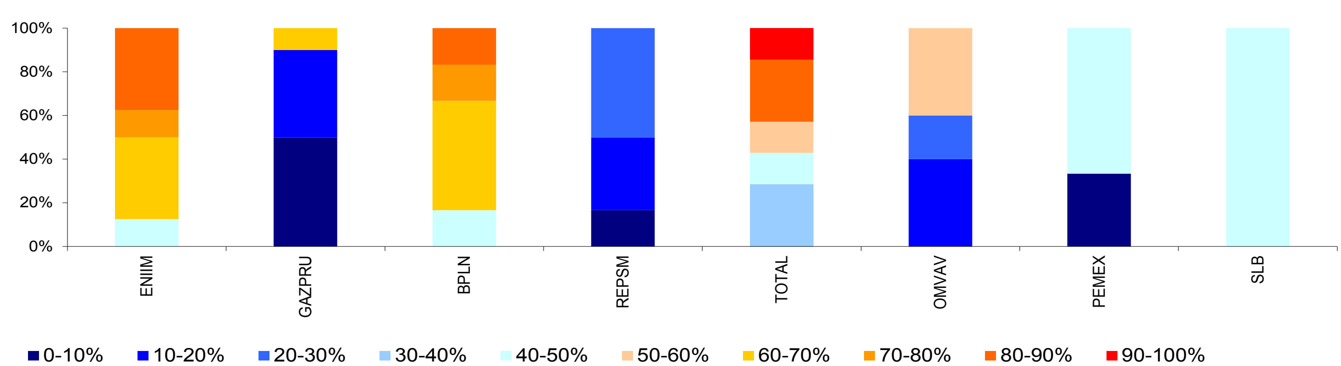
Source: MarkIt, Citi Research

Figure 29. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio* by Sector



Source: iBoxx, Citi Research

Figure 30. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth history



Source: iBoxx, Citi Research

* The breakeven (Spread/Duration) measures how much widening the carry can compensate for. The breakeven to volatility ratio measures the likelihood that spread movements will exceed that point. In the dispersion chart, we calculate the current percentile for each bond in the 3-month trading range, and then we aggregate the distribution of percentiles by issuer. Dark red shows the percentage of bonds trading close to 3-month wides, while dark blue shows the percentage of bonds very near 3-month tights.

Technology: neutral

Two new additions to the iBoxx, but we don't see an opportunity there

Since August, the index includes two high-quality names: Microsoft and Oracle. The widening in these, together with IBM, caused this sector to underperform last month. We don't really see an opportunity in Microsoft and Oracle's bonds at current levels: the widening is mainly due to their status as recent new issues, which had initially rallied hard, and to the acquisition of Nokia by Microsoft. Overall, we stay neutral on Technology on valuation grounds: the remaining bonds in the sector have been among the best performers in iBoxx over the last six months, supported by strong credit fundamentals and positive business trends, in spite of their cyclicality.

For example, ASML sales guidance is a positive, in our view; however spreads at their historical tights do not look very inspiring.

Microsoft bonds look cheap on an historical basis for a AAA-rated company. Yet we think the risks around the acquisition of Nokia's phone business are significant and hard to quantify, while the upside would be small at current levels.

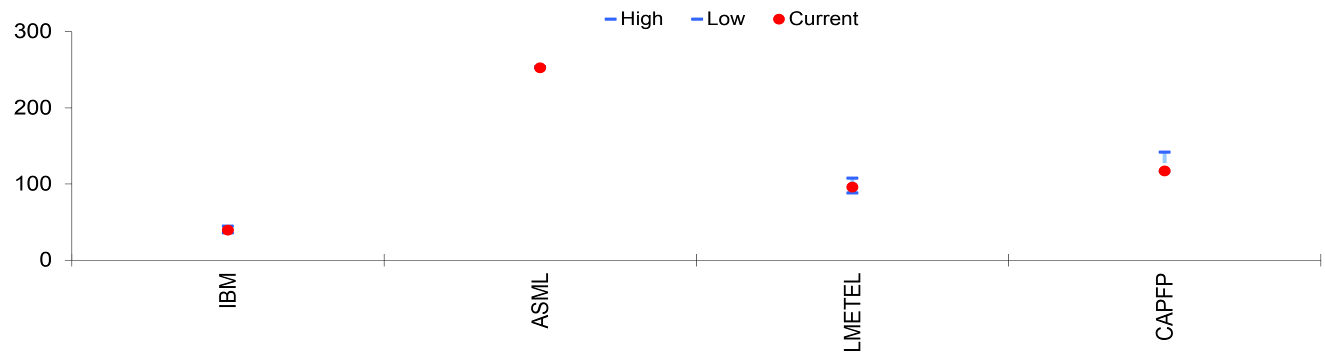
The long-term outlook for technology is positive, investment demand is picking up

For Ericsson, in spite of the worse-than-expected Q2 results (which were affected by FX headwinds, divestitures and some weakness in Chinese and US sales), the long-term growth outlook for mobile broadband is positive, as global penetration rates are still low and there are still substantial needs for transmission infrastructure. After a cyclical slowdown in investments in Europe, the company is experiencing increasing demand as telco companies invest in the modernization of the European network, and margins are likely to improve. Moreover, it continues to expand its higher-margin wireless capacity and packet core business. But we think these positive trends are already priced in. The rally in equity has more to do with the M&A spree in the technology and telco sectors over the summer, which caught investors short and induced them to reposition.

The consulting business is growing

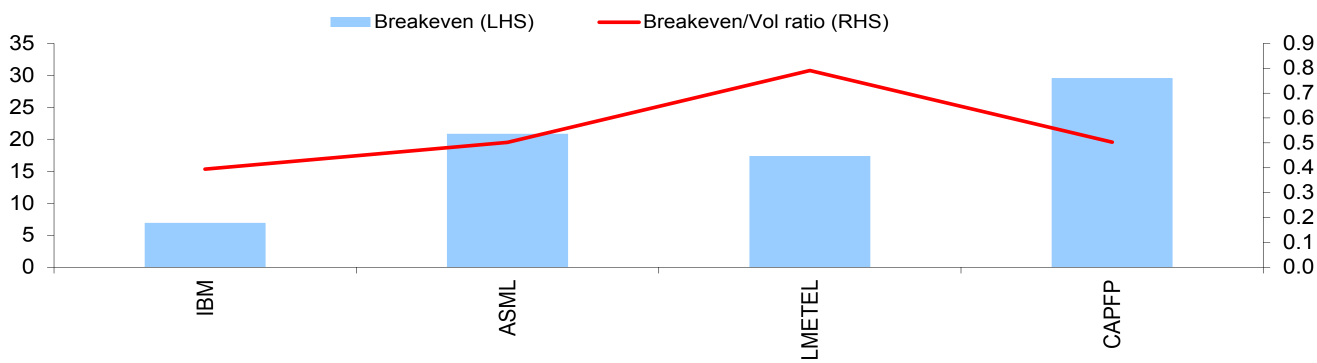
In spite of lower-than-expected H1 revenues, Cap Gemini is showing good margin growth, and confirmed its FY guidance. However, we think this is mostly priced in.

Figure 31. CDS 3mth Trading Range by Sector (bp)



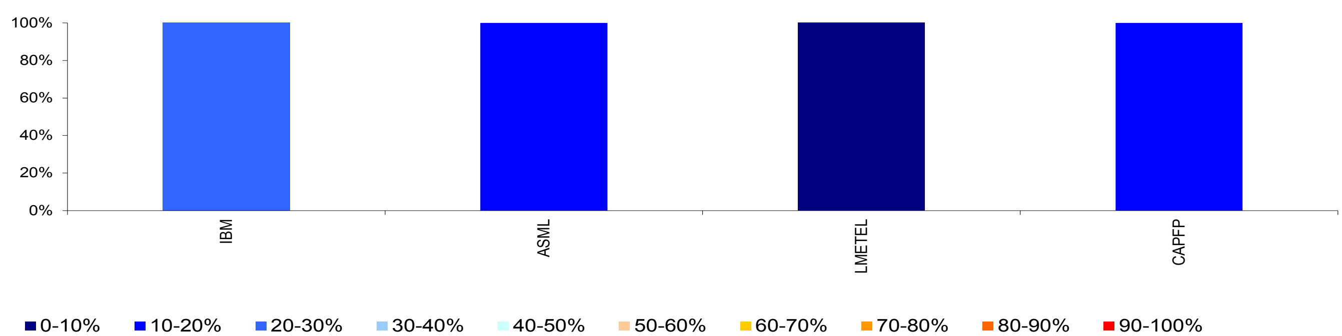
Source: MarkIt, Citi Research

Figure 32. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio* by Sector



Source: iBoxx, Citi Research

Figure 33. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth History



Source: iBoxx, Citi Research

* The breakeven (Spread/Duration) measures how much widening the carry can compensate for. The breakeven to volatility ratio measures the likelihood that spread movements will exceed that point. In the dispersion chart, we calculate the current percentile for each bond in the 3-month trading range, and then we aggregate the distribution of percentiles by issuer. Dark red shows the percentage of bonds trading close to 3-month wides, while dark blue shows the percentage of bonds very near 3-month tights.

Telecoms: underweight

Challenges in telcos are not over yet

Telcos has been one of the worst performing sectors in the iBoxx in the last six months, after Basic Materials and Oil and Gas. In spread terms, it is the widest of the non-financial space. We think valuations would justify selectively reducing our underweight.

The sector is still challenged

However, we don't yet feel comfortable with this sector: telecoms have seen their revenues and earnings declining in recent years: weakening demand, and increased competition have taken their toll on profits, especially in peripheral Europe. The last earnings season was no exception. While we see some improvements, a significant recovery in earnings seems unlikely near-term: the last reading of our Earnings Revisions Index at -0.30 (CGERPETE Index <go>) confirms this impression.

Telcos are going through a transformational phase

The wave of acquisitions, divestitures and increased capex which is sweeping Telcos at the moment is a sign that the industry is coming to terms with these structural weaknesses and is going through a transformational phase. We see this process ending up with more consolidated markets across Europe, with the strongest incumbents migrating to a more data- and content-intensive business model. Longer term, we think these developments are positive at least in terms of improving business diversification and costs, and mitigating competition. Yet event risk is high, and we are concerned that in a context of easy access to debt, the incentive to reward shareholders rather than bondholders or to leverage in order to pursue M&A (as in the case of Verizon) remains significant, even if credit metrics are still feeling the pressure of weak EBITDA growth.

Close underweight on Telecom Italia

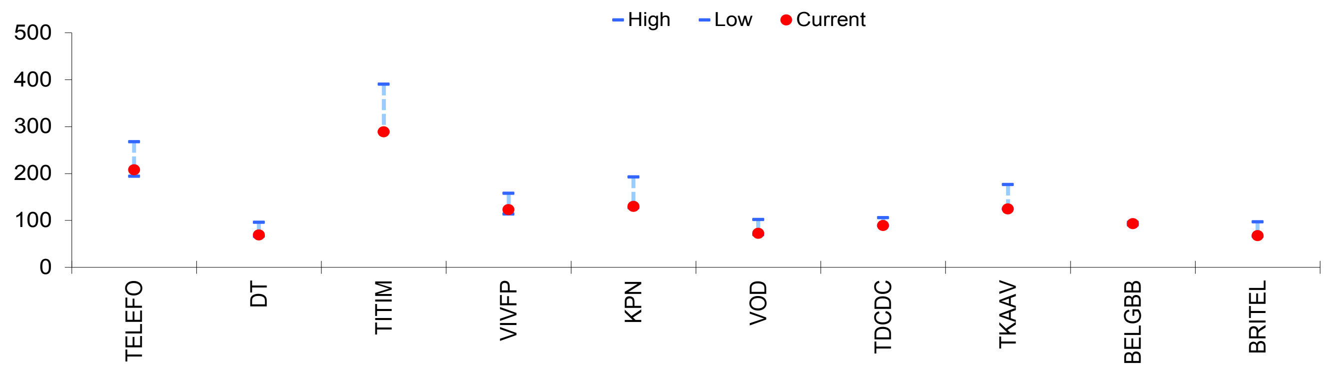
We recommend closing the underweight in Telecom Italia, in spite of its weak results last month, as the bonds are close to their six-month wides and some positive catalysts might be on the horizon: we might have news of market consolidation in autumn, and the company might decide to do a rights issue, although the timing is uncertain.

Figure 34. Telecommunications Picks and Pans

Picks	**BT:** Within an uninspiring sector, we think BT is likely to perform better than peers from an operating perspective. The next phase of group-wide restructuring and the development of BT Sport should drive EBITDA up. Its last results were solid. The pension deficit will continue to be a lingering risk, but even accounting for it, our equity analysts forecast a net debt/EBITDA ratio of 1.6x, below Deutsche Telekom or Vodafone, and higher yields should be a help.
Pans	**Orange (France Telecom):** Remain underweight. Our equity analysts expect net debt/EBITDA to increase to 2.36x by end 2013, much above what the company is targeting. It is also unlikely, in our view, that EBITDA will stabilize in 2014 as suggested by management. Revenue trends are getting worse and cost cutting measures are not enough to offset this.
	Belgacom: Our equity analysts expect the company to increase leverage to pay dividends. The market is also extremely competitive in Belgium and in spite of the better-than-expected results last month, margins might be weakened by aggressive new offers. We are worried that this is not adequately reflected in spreads still close to their all-time tights.

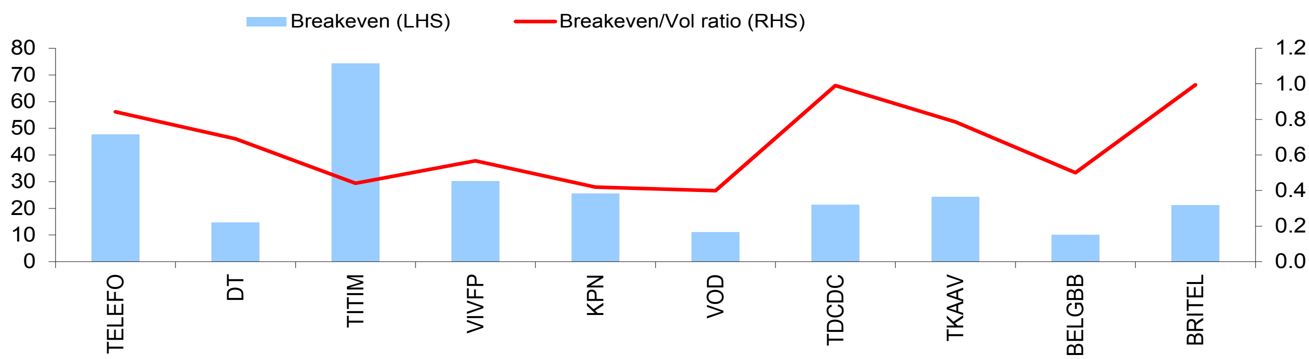
Source: Citi Research. Please refer to the footnotes on page 4 for our methodology.

Figure 35. CDS 3mth Trading Range by Sector (bp)



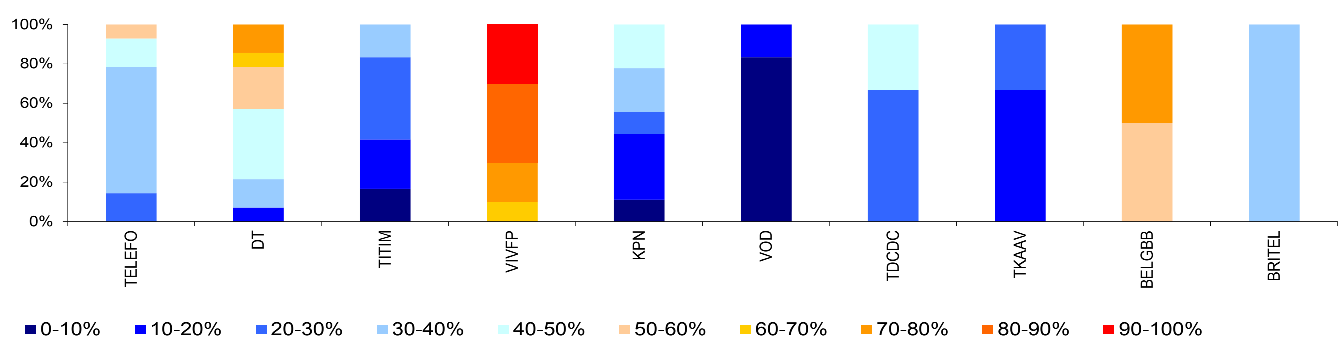
Source: MarkIt, Citi Research

Figure 36. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio* by Sector



Source: iBoxx, Citi Research

Figure 37. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth History



Source: iBoxx, Citi Research

* The breakeven (Spread/Duration) measures how much widening the carry can compensate for. The breakeven to volatility ratio measures the likelihood that spread movements will exceed that point. In the dispersion chart, we calculate the current percentile for each bond in the 3-month trading range, and then we aggregate the distribution of percentiles by issuer. Dark red shows the percentage of bonds trading close to 3-month wides, while dark blue shows the percentage of bonds very near 3-month tights.

Utilities: overweight

Maintain a small overweight in Utilities

We maintain a small overweight in Utilities, via the high-beta Italian names, but remain neutral on the remainder. Admittedly, oversupply implies that many core utilities face a weak outlook for prices, against a backdrop of weak demand. However, spreads remain wide versus iBoxx and historically, implying that this is largely priced in.

EBITDA is unlikely to grow much

The main risk we see for utilities is that EBITDA growth is being hampered by slow revenues, as demand is sluggish and governments try to contain the increase in energy bills and increase tax revenues at the same time. High capex requirements in a context of weak energy prices are also of concern. These factors put some dividends at risk across the sector, but we don't see them hampering debt sustainability.

Italian utilities' spread versus their sovereign is quite wide

Such considerations are particularly relevant for Italian utilities. Yet the spread to their sovereign remains wide. In the case of Enel, which is the name we like the most, spreads to the sovereign are close to their beginning of April wides. We find this unjustified: the company is cutting costs and deleveraging, and our equity analysts expect it to achieve its net debt target of €42bn by year end.

Remain neutral on Spanish utilities

We remain neutral on the Spanish utilities, as sovereign-related downgrade risks might weigh on valuations, and growth prospects in Latin America (where these companies have investments) appear to be weakening. In spite of such concerns, we find them less attractively valued than Italian utilities.

Regulatory uncertainty and geopolitical risks are a concern for the sector

Regarding the core utilities, earnings expectations have been cut again last month by 2.9%, and a cumulative 13% ytd. Analysts seem concerned about regulatory uncertainty in Germany and geopolitical risks.

It is unlikely that the sector will be shareholder-friendly for now

We find it unlikely that peripheral utilities will issue debt to pay dividends, given their sensitivity to ratings, in particular in the periphery and at the senior level. Dividend cuts and issuance of hybrids look more likely.

Close the underweight on RWE

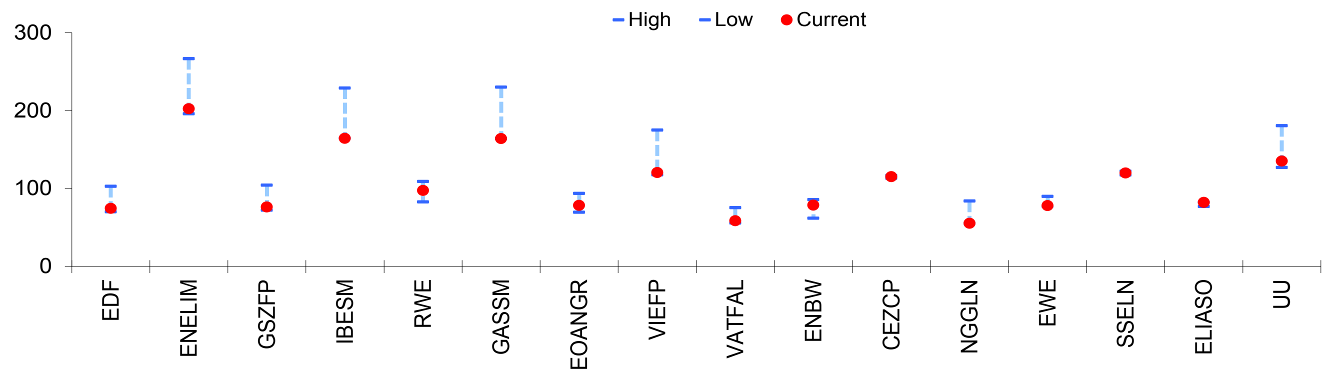
We close our underweight on RWE. We think the company will announce a rights issue and it just announced a cut to the dividend, which will support credit.

Figure 38. Utilities Picks and Pans

Picks	**Italian Utilities:** The spread versus their sovereign of most Italian utilities is quite wide historically. We think this will reverse in the next few months, so we are comfortable maintaining an overweight on them while hedging our sovereign exposure by shorting Italian sovereign bonds. Moreover, while their earnings outlook looks challenged by a sluggish energy market and by regulatory risk, and these companies are going through substantial cost cutting and divestitures to manage their leverage, which is key to their business model. We expect them to manage their balance sheet conservatively, as they have done so far, to keep their cost of debt down. **Enel** and **Terna** look the best positioned in terms of earnings quality.
Pans	**E.ON:** In spite of its ongoing challenges, E.ON has been one of the best performing utilities over the last three months. The last results were better than expected, but our equity analysts are unconvinced about company's guidance (which was reiterated), due to lower profitability and costs on gas and nuclear storage. The expansion in Brazil and Turkey is also likely to have a negative impact on EPS. Leverage is increasing: from our analysts' estimates, net debt/EBITDA is set to increase to 2x from 1.8x last year. The company is changing its business mix, moving from thermal generation to renewables and exploration and production activities. Yet execution risk on its cost-cutting programme is high and generation will likely remain weak. We are also concerned about its Brazilian exposure, which is set to increase given the new structure of the MPX capital raising, and the surprise departure of the CFO.

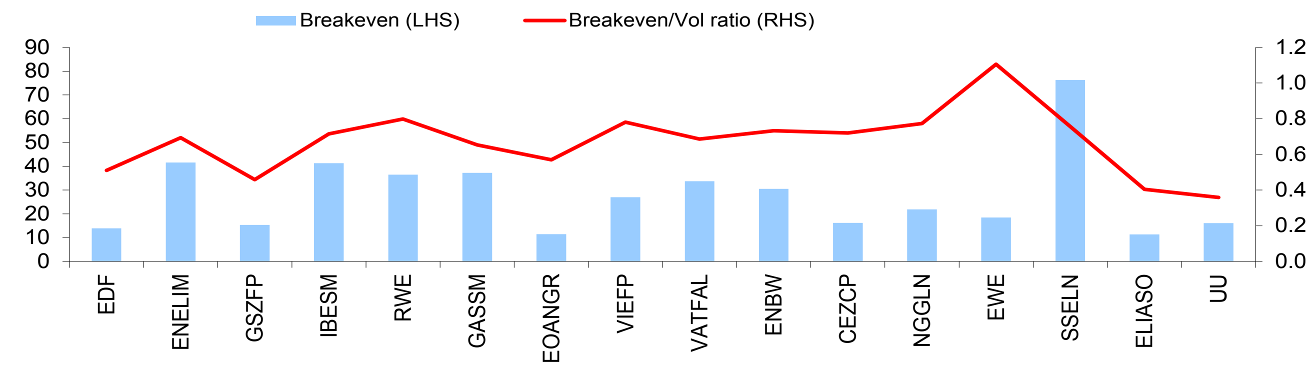
Source: Citi Research. Please refer to the footnotes on page 4 for our methodology.

Figure 39. CDS 3mth Trading Range by Sector (bp)



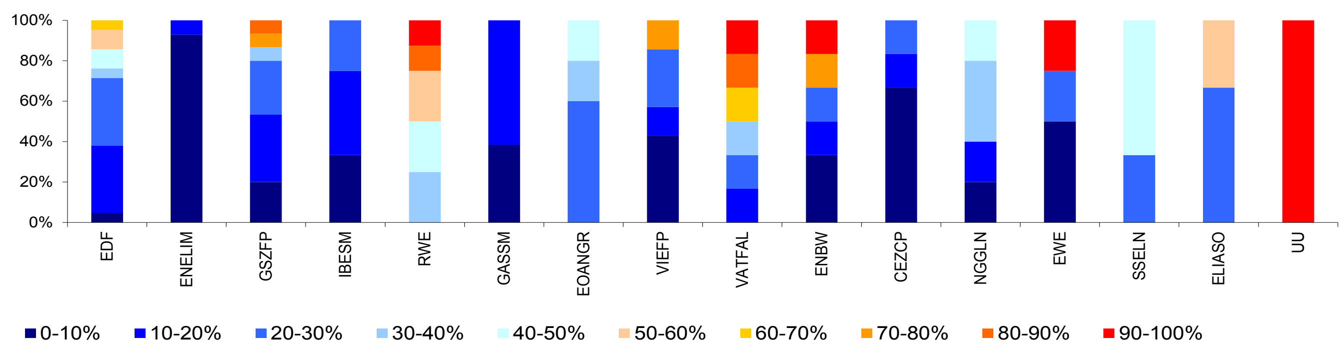
Source: MarkIt, Citi Research

Figure 40. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio* by Sector



Source: iBoxx, Citi Research

Figure 41. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth History



Source: iBoxx, Citi Research

* The breakeven (Spread/Duration) measures how much widening the carry can compensate for. The breakeven to volatility ratio measures the likelihood that spread movements will exceed that point. In the dispersion chart, we calculate the current percentile for each bond in the 3-month trading range, and then we aggregate the distribution of percentiles by issuer. Dark red shows the percentage of bonds trading close to 3-month wides, while dark blue shows the percentage of bonds very near 3-month tights.

Banks: neutral

Remain neutral on Banks

Banks marginally widened over the last month, slightly outperforming the iBoxx. Yet spreads are as tight as they were in 2008, as if the market believes the worst is over for the European banking system. Perhaps it is: banks have been deleveraging, strengthening their capital levels, working through their problematic assets. Now that the European economy is showing signs of recovery, we expect to see gradual improvements on asset quality and cost of credit. Yet we remain neutral: there are other high-beta sectors, which offer the same levered upside to the state of the economy without quite the same potential downside in the event of tail risks.

It's still a tale of two Europes

From a fundamental perspective, the last earnings season confirmed the general trends we have seen previously: most peripheral banks continue to suffer from high levels of NPLs, high credit costs and weak net interest income, while core banks are benefiting from good asset quality, although loan growth is still sluggish.

We expect more issuance and LME activity

New issuance risk is on the rise: new capital securities (AT1) are likely to be issued over coming months, and in general we find the valuations aggressive relative to old-style T1. Banks will look at how to optimize their capital position in light of CRD IV, which has been finalized at a European level recently, and will likely engage in a combination of LMEs and new issuance. On aggregate, we think the market will be able to absorb the new issuance with no particular problems, but we think risks are lower for those banks which have already a relatively strong capital position.

Close underweights on HSBC and StanChar

We recommend closing any underweight on HSBC and Standard Chartered. The FOMC decision will support credit exposed to EM, and for this reason these bonds are rallying. Yet at current spreads we prefer US peers, which offer more protection, in our view.

We remain concerned about Spanish banks and smaller banks in Italy

The mildly positive data on the Italian economy are not enough to offset the risks from political instability, in our view. While the risk of snap elections seems lower now, the Government coalition is still fragile. Moreover the recent decision by LCH Clearnet to reduce its exposure to Italy will make it harder for banks to fund themselves in private markets. We remain underweight the smaller Italian players like the cooperative banks, and neutral on the national champions, like Intesa and Unicredit. That said, we think the recent plan to raise equity by MPS should support CDS at the margin. The same applies to Banca Popolare di Milano, which is also planning a capital increase. As regards Spanish banks, we remain underweight, in particular for the domestic banks, as house price declines and further restructuring costs are likely. Weakness in their LatAm business suggests they will not benefit much from their geographic diversification in the short term.

The entry point for peripheral covered bonds is not attractive

The challenges still present in peripheral Europe make us prefer covered bonds to senior here, also because the recent draft directive establishing a European-wide framework for bail-ins explicitly excludes covered bonds from bail-ins. However, valuations close to their June lows versus core and Spanish senior bonds make us think that the entry point is not attractive at the moment. The trade is still attractive in Italy.

We prefer old style T1.

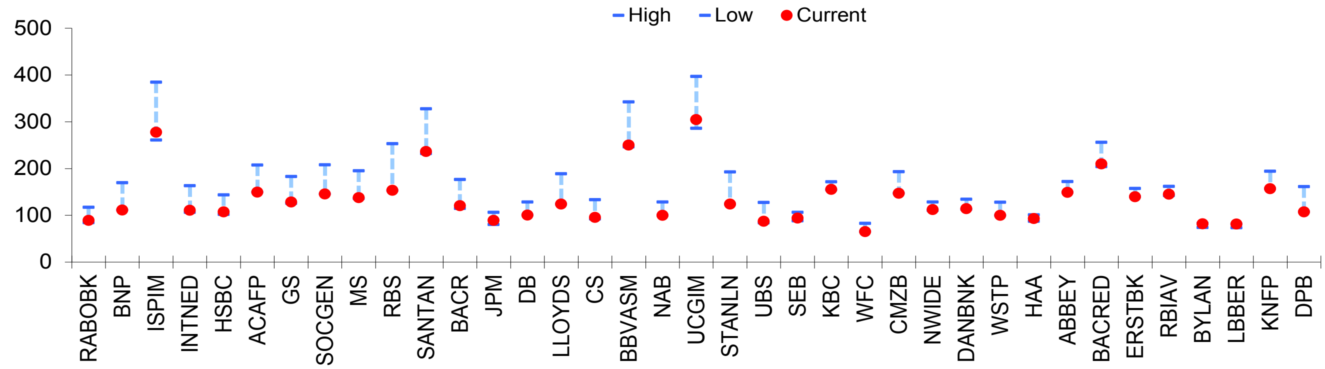
When it comes to junior debt, we prefer old style T1 to LT2. T1 valuations look in line to LT2 on the basis of their historical relationship. Moreover, there is quite likely to be LME activity at this level now that AT1 is being issued. Yet also LT2 will be subject to LMEs and valuations versus T1 look wide. We recommend selectively reducing the underweight. We close our underweight on Australian banks: spreads are at six-month wides, especially on their junior debt. We are also closing our overweights on JPM and Goldman Sachs given their outperformance over the last six months.

Figure 42. Banks Picks and Pans

Picks	**Morgan Stanley:** Bonds have underperformed peers in the last three months (especially Goldman). The company is migrating to a more conservative business model, more focused on flow trading and wealth management. We expect MS bonds to progressively tighten as its de-risking strategy progresses: we wouldn't be surprised to see it trading inside GS once its repositioning is completed. In its Q2 results, FICC revenues were partly affected by its de-risking strategy, but equities and investment banking performed well. The asset and wealth management businesses show strong margins. The tougher regulations regarding the leverage ratio proposed in the US might provide further support to MS credit, even at the T1 level, as the company might issue preferred stock to comply with the regulation.
	French Banks: French banks are reducing their business risk in general, their capital position is strong and they are committed to cost control**. BNP Paribas** had strong Q2 results. Its Italian business BNL showed better revenue in spite of ongoing deleveraging. Retail banking is performing well, and its capital position and leverage are improving. We find this reflected more in the T1, which performed strongly over the last 6 months, than at the senior and LT2 level. Similar arguments can be applied to **Credit Agricole**: the bank is shrinking its investment bank arm and reducing RWA. We expect its capital position to improve further. Credit Agricole has been one of the biggest underperformers among the core banks in the last six months, creating a good entry point especially at the senior and LT2 level. We take comfort that the international exposure of **SocGen** is benefiting from signs of recovery in Romania and Russia, while risks from Slovenia should be manageable, however here we would wait for a better entry point.
	Barclays: It has underperformed on a six-month horizon, presumably on concerns regarding how it would satisfy the requirement of the PRA of a leverage ratio of 3%. Barclays currently has a leverage ratio of 2.3%. However, the initiatives Barclays announced to achieve the 3% target are positive for credit: we are therefore surprised of the underperformance of the 6% Jan21 and the 6.625% Mar22 bonds, which are now close to their mid-February levels, while there is some new issuance risk at the T1 level as Barclays will issue some Additional Tier 1 securities with a 7% fully loaded CET1 trigger.
	Lloyds Banking Group: We see the underperformance of last month as an opportunity to increase exposure to Lloyds. Lloyds is continuing in its deleveraging process, net interest margins are improving and we think we will continue to see consensus upgrades on this. Its Q2 results show lower impairments and stronger net interest margin. Uncertainties regarding its capital position and leverage targets are largely solved.
Pans	**Spanish banks:** Valuations on the smaller Spanish banks look expensive versus the risks they run, in our view, especially at the senior level. The Spanish banking system remains challenged by asset quality deterioration, weak net interest income, accelerating house price declines and slow revenue growth. Our equity analysts think problem assets are not yet at their peak. These challenges are unlikely to be resolved any time soon: although there are mild signs of improvement in the Spanish economy, it is expected to remain weak in 2013 and 2014. We expect provisions and write-downs to keep increasing, driven by regulatory pressure. We are also concerned about regulatory forbearance, as shown by the recent proposals to use deferred tax assets to increase CET1. This confirms our suspicion that further losses are likely and that the capital position of these banks is not solid enough. Weakness in their LatAm businesses is an additional headwind. At the margin we prefer larger Italian banks to Spanish ones. However, we reduce our underweight in light of the equity raising announced by Banco de Sabadell. This is a route that other Spanish banks might take. Regarding the bigger players, **Santander** is continuing its deleveraging process and its last results were in line. We remain neutral on the company. **BBVA**, on the other hand, benefits from a higher coverage ratio on its NPLs than Santander, and might benefit more than domestic banks from a pickup in economic activity in Spain. We think the recent underperformance offers a good opportunity to reduce shorts.
	Smaller Italian Banks: We are wary of smaller Italian banks at these levels. The government coalition looks fragile, hampering its ability to push for structural economic reforms, and recent opinion polls show that there is a high probability of a hung parliament should elections occur in the next months. Italian banks continue to be over-exposed to Italian sovereign debt and to the economy. The recent decision by LCH Clearnet to move to 'cash settlement' in Italy will make it harder for them to fund themselves. The profitability of Italian banks remains weak. We remain underweight the smaller players and neutral on the national champions (Intesa, Unicredit).

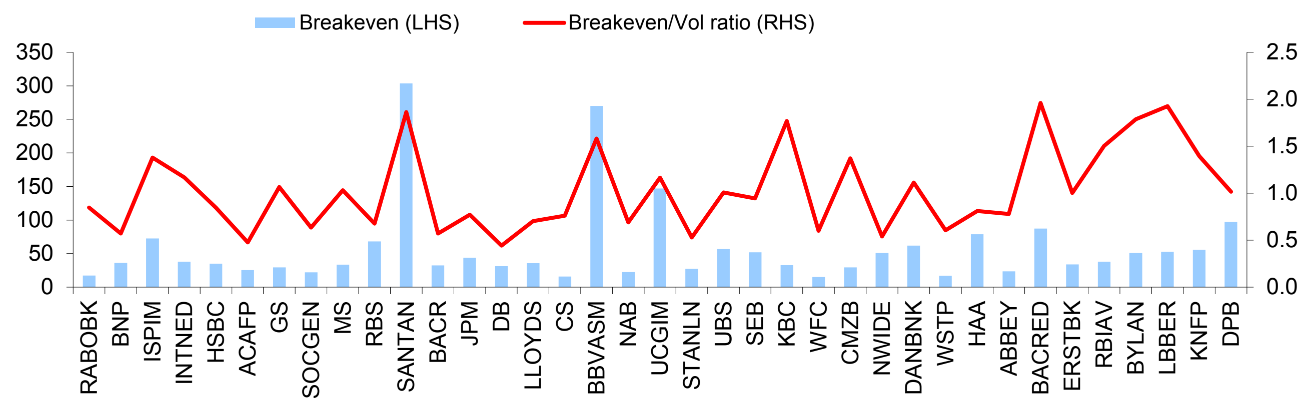
Source: Citi Research. Please refer to the footnotes on page 4 for our methodology.

Figure 43. CDS 3mth Trading Range by Sector (bp)



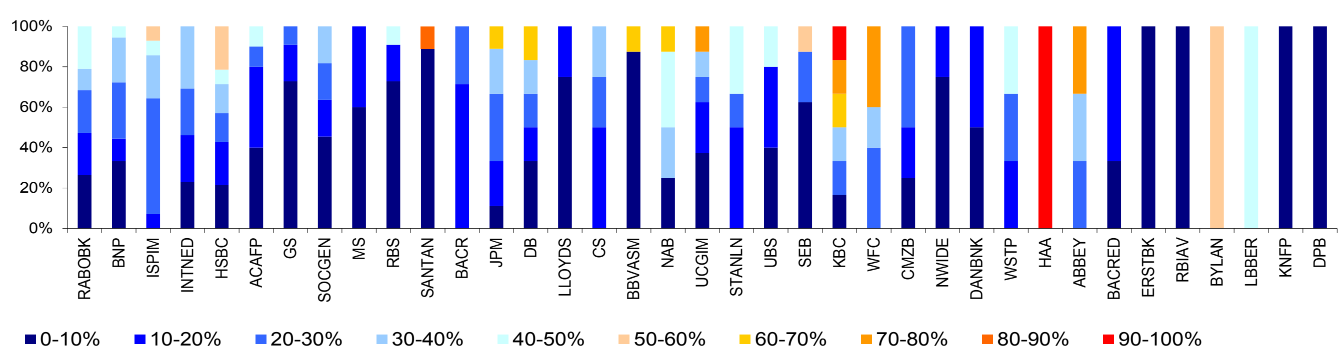
Source: MarkIt, Citi Research

Figure 44. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio* by Sector



Source: iBoxx, Citi Research

Figure 45. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth History



Source: iBoxx, Citi Research

* The breakeven (Spread/Duration) measures how much widening the carry can compensate for. The breakeven to volatility ratio measures the likelihood that spread movements will exceed that point. In the dispersion chart, we calculate the current percentile for each bond in the 3-month trading range, and then we aggregate the distribution of percentiles by issuer. Dark red shows the percentage of bonds trading close to 3-month wides, while dark blue shows the percentage of bonds very near 3-month tights.

This page is intentionally left blank

Insurance: overweight

We wouldn't go any longer…

Rather than offering an opportunity to get longer, we see last month's selloff in some insurers as a healthy correction to bonds which are either very tight (Munich Re) or which are likely to suffer from political risks (Generali). Investors remain heavily long; and there is some lingering regulatory uncertainty, as the voting on the Omnibus II directive is likely to be delayed again to March 2014.

… but we still prefer insurers to banks and we remain overweight

And yet we still recommend being moderately long, both overall and relative to banks. From a fundamental perspective we continue to believe that insurers are less risky than banks. The long-term nature of insurers' liabilities gives them more flexibility to adapt to times of distress, and anyway they have de-risked substantially since the onset of the 2008 crisis. Moreover, we think the prospect of rising yields in the US and elsewhere will benefit the bottom line of European insurers in general.

We see less new issuance risk in insurers than in banks

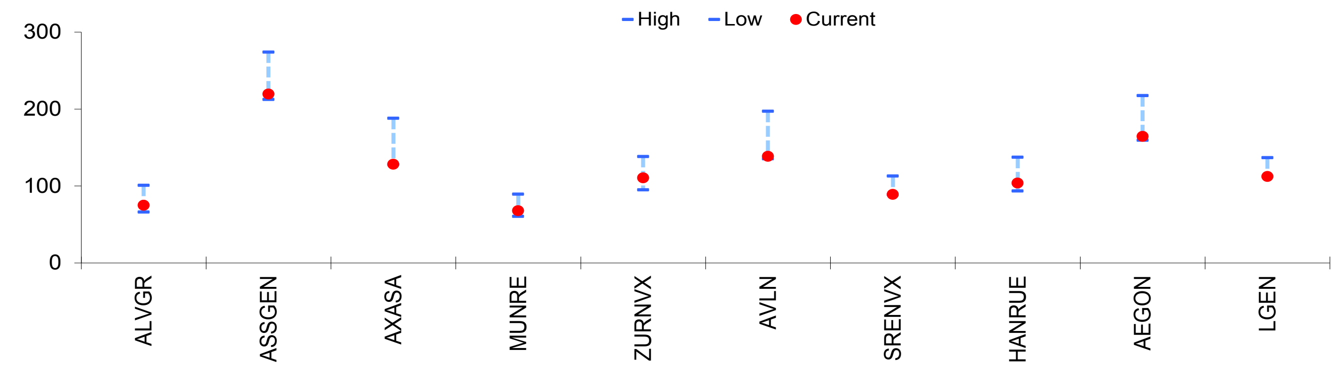
The recent listing of systemically important insurers, which include, among others, Allianz and Prudential, implies higher capitalisation requirements for these players and therefore is credit positive, although we might see some new issuance from the less well-capitalised insurers once the regulation is finalised. In any case, we expect less issuance over the next month than in the banking sector. For these reasons, although bank debt valuations are in line to insurance debt on an historical basis, and at the T1 level banks look even cheaper, we still prefer insurers to banks.

Figure 46. Insurance Picks and Pans

Picks	**Swiss Life:** Given the strength of its balance sheet, its leading market position in the Swiss life insurance market, its growth prospects in Germany and France and its strong capital adequacy, we think Swiss Life T1 bonds should outperform peers. We take profit on the T1 bond as it is now very tight.
	CNP Assurances: In spite of their tightening over the last six months, the LT2, UT2 and T1 bonds continue to offer value when compared to peers. The company has a leading position in the French market. While its capital position could be better, its Q2 results were good and it benefits from the equity participations of La Banque Postale and CDC, which have supported CNP by accepting share dividends to help it improve its capital ratios.
	Talanx: We continue to like the LT2 bond. The company is quite conservative and is benefiting from a solid operating performance, strong profitability and good capitalisation.
Pans	**HanRe:** We like Hannover Re's strong credit metrics. But the name trades very tight to history and peers even after recent underperformance, and we don't think the widening we have seen recently really provides a buying opportunity.
	Munich Re: Its capitalisation looks good and its business profile solid, and earnings expectations are rising. But bonds remain tight to their peers and to history even after recent underperformance. There are no negative catalysts in sight, but at current spreads we think there are better opportunities elsewhere in the sector.

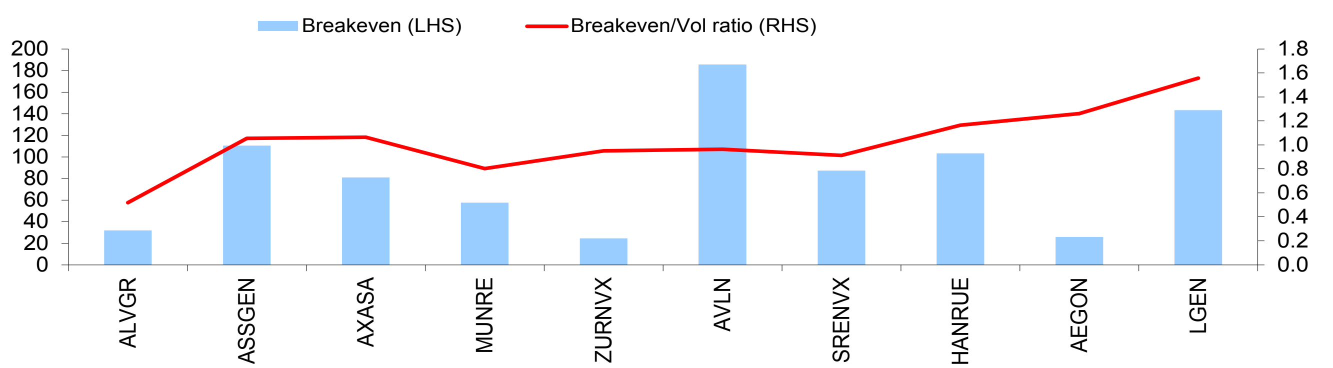
Source: Citi Research. Please refer to the footnotes on page 4 for our methodology.

Figure 47. CDS 3mth Trading Range by Sector (bp)



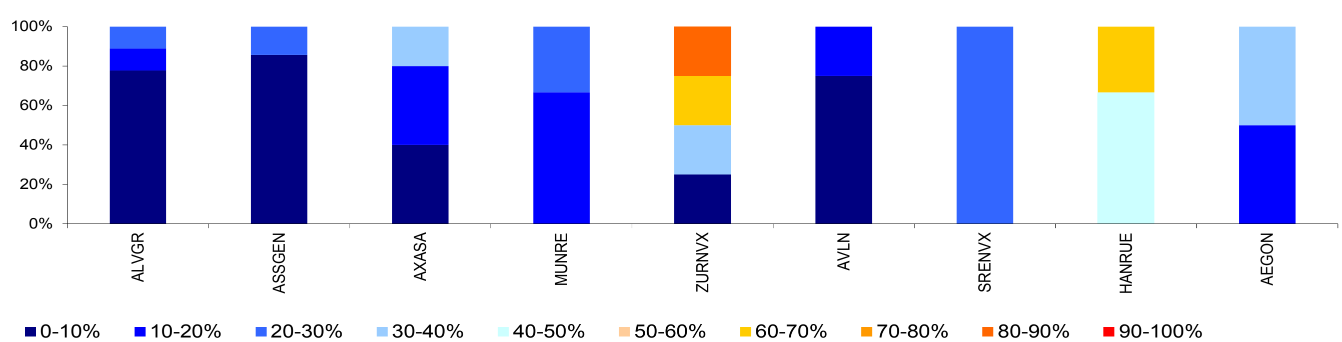
Source: MarkIt, Citi Research

Figure 48. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio[*] by Sector



Source: iBoxx, Citi Research

Figure 49. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth History



Source: iBoxx, Citi Research

[*] The breakeven (Spread/Duration) measures how much widening the carry can compensate for. The breakeven to volatility ratio measures the likelihood that spread movements will exceed that point. In the dispersion chart, we calculate the current percentile for each bond in the 3-month trading range, and then we aggregate the distribution of percentiles by issuer. Dark red shows the percentage of bonds trading close to 3-month wides, while dark blue shows the percentage of bonds very near 3-month tights.

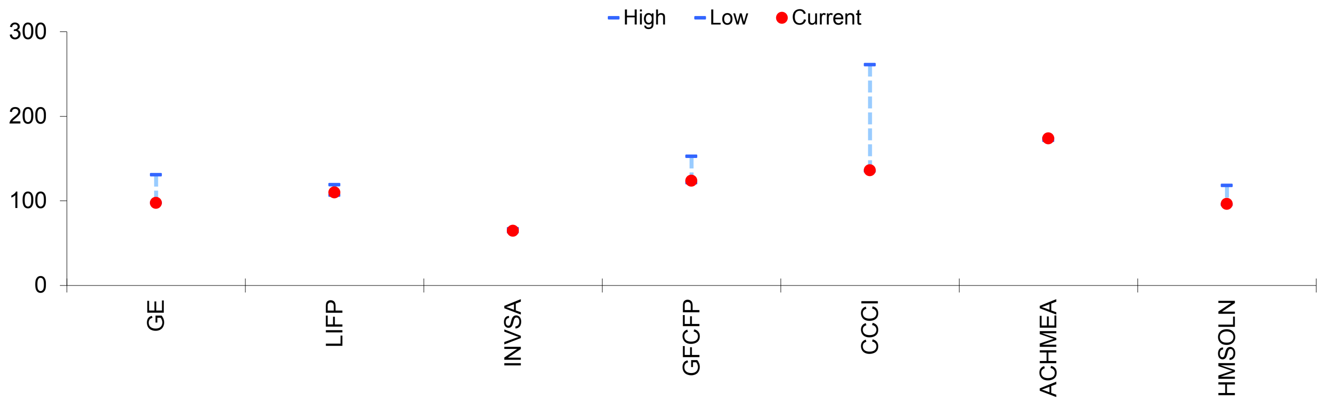
Financial Services: neutral

Move to neutral on Financial Services

Move to neutral on the Financial Services industry. The mild recovery we are seeing in Europe implies better prospects for the real estate industry, which provides better support to the current tight valuations. However, we think bond investors wanting to go anywhere near this space would do much better to buy equally or higher-rated CMBS, RMBS or ABS instead: spreads trade wider, for structures, which to our minds are more robust. The rest of the sector is mainly dominated by General Electric, which we expect to perform in line with the market.

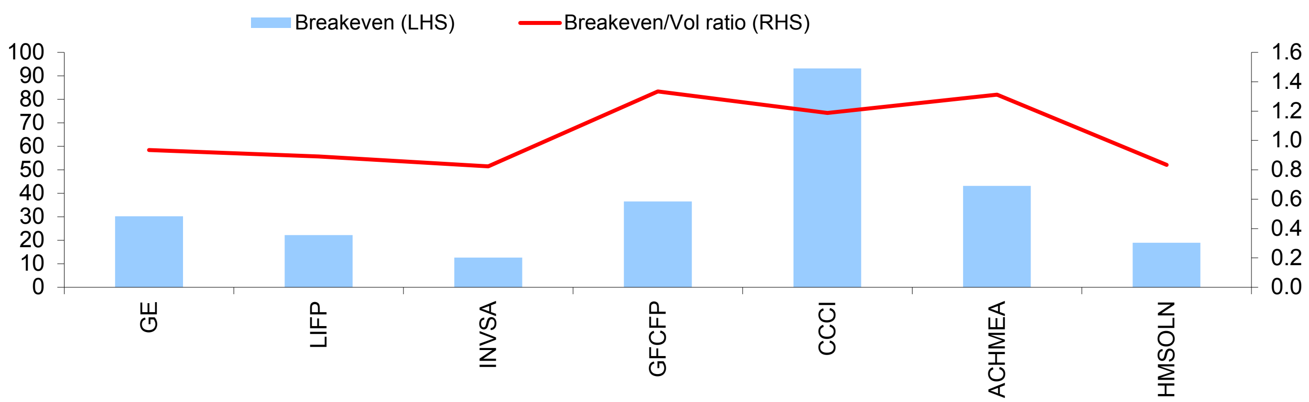
We close our underweight on Klepierre and Gecina after the underperformance of last month.

Figure 50. CDS 3mth Trading Range by Sector (bp)



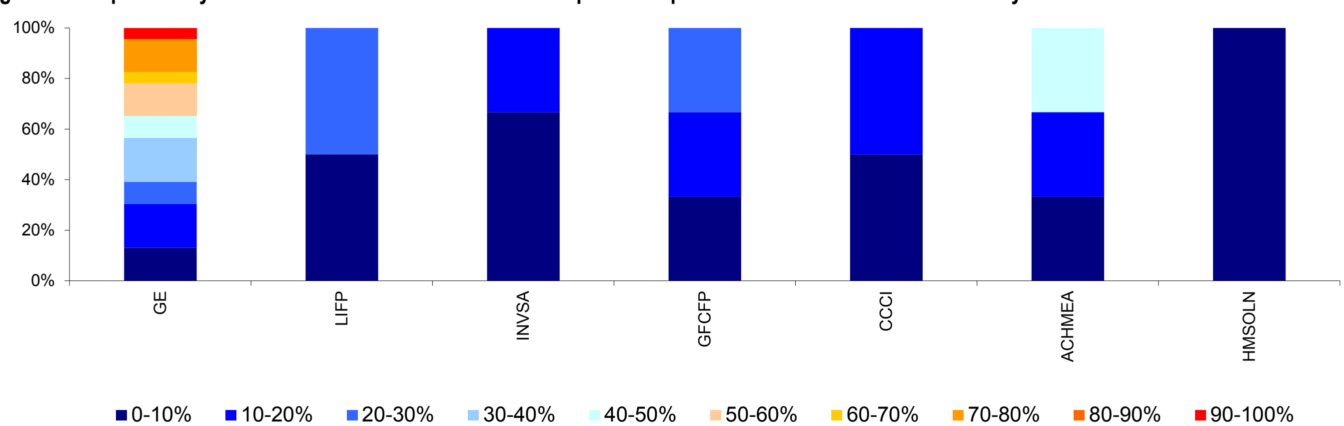
Source: MarkIt, Citi Research

Figure 51. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio* by Sector



Source: iBoxx, Citi Research

Figure 52. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth History



Source: iBoxx, Citi Research

* The breakeven (Spread/Duration) measures how much widening the carry can compensate for. The breakeven to volatility ratio measures the likelihood that spread movements will exceed that point. In the dispersion chart, we calculate the current percentile for each bond in the 3-month trading range, and then we aggregate the distribution of percentiles by issuer. Dark red shows the percentage of bonds trading close to 3-month wides, while dark blue shows the percentage of bonds very near 3-month tights.

Notes

Appendix A-1

Analyst Certification

The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

IMPORTANT DISCLOSURES

Citigroup Global Markets Limited is currently acting as advisor to Assicurazioni Generali Spa (the company) in the announced sale of the company’s US Life Reinsurance Business (Generali U.S.) to Scor SE

Citigroup Global Markets Inc. owns a position of 1 million USD or more in the debt securities of Pernod Ricard SA

Citigroup Global Markets Inc. owns a position of 1 million USD or more in the debt securities of Standard Chartered PLC

Citigroup Global Markets Inc. owns a position of 1 million USD or more in the debt securities of Oracle Corp

Citigroup Global Markets Inc. owns a position of 1 million USD or more in the debt securities of BNP Paribas SA Citigroup Global Markets Limited is currently mandated as sole global co-ordinator in relation to the recently announced re-IPO of BNP Paribas SA's polish subsidiary, BNP Paribas Bank Polska.

Citigroup Global Markets Inc. owns a position of 1 million USD or more in the debt securities of RCI Banque SA

Citigroup Global Markets Inc. owns a position of 1 million USD or more in the debt securities of Vale SA

Citigroup Global Markets Inc. owns a position of 1 million USD or more in the debt securities of JPMorgan Chase & Co

Citigroup Global Markets Inc. owns a position of 1 million USD or more in the debt securities of General Electric Co

Citigroup Global Markets Inc. owns a position of 1 million USD or more in the debt securities of Intesa Sanpaolo SpA

Citigroup Global Markets Inc. owns a position of 1 million USD or more in the debt securities of Goldman Sachs Group Inc

Citigroup Global Markets Inc. owns a position of 1 million USD or more in the debt securities of Societe Generale

Citigroup Global Markets Inc. owns a position of 1 million USD or more in the debt securities of Morgan Stanley

Citigroup Global Markets Inc. owns a position of 1 million USD or more in the debt securities of HSBC Holdings PLC

Citigroup Global Markets Inc. owns a position of 1 million USD or more in the debt securities of Microsoft Corp

Citigroup Global Markets Inc. owns a position of 1 million USD or more in the debt securities of Amgen Inc

Citigroup Global Markets Limited ('Citi') provided a fairness opinion to Thyssenkrupp AG ('TK')in respect of the sale of Thyssenkrupp's Tailored Banks business to Wuhan Iron & Steel Corporation ('WISCO'). Consequently Citi had been restricted from offering any view, recommendation, rating or opinion on Thyssenkrupp AG from 28th September 2012.

Citigroup Global Markets Limited is currently mandated as Joint Bookrunner in relation to the recently announced rights issue by Barclays Plc. Interbank Offered Rates-Related Litigation and Other Matters: Government agencies in the U.S.,including the Department of Justice,the Commodity Futures Trading Commission and the Securities and Exchange Commission,as well as agencies in other jurisdictions,including the European Commission,the U.K. Financial Services Authority,the Japanese Financial Services Agency (JFSA) and the Canadian Competition Bureau,are conducting investigations or making inquiries regarding submissions made by panel banks to bodies that publish various interbank offered rates. As members of a number of such panels,Citigroup subsidiaries have received requests for information and documents. Citigroup is cooperating with the investigations and inquiries and is responding to the requests. Consequently Citi Research is not commenting on the quantum or likelihood of any potential LIBOR related claims or settlements.

Citigroup Global Markets Inc. owns a position of 1 million USD or more in the debt securities of Bp PLC.

Citigroup Global Markets Limited is currently mandated as advisor to Lloyds Banking Group Plc in relation to the announced disposal of the Groups UK bank branches.

The Chairman of Citi serves as a director of Roche Holding AG.

A member of the household of Matt King, Strategist, holds a long position in the securities of JP Morgan Chase & Co.

A member of the household of Keith Horowitz, CFA, Analyst, holds a long position in the securities of JP Morgan Chase & Co.

Citigroup Global Markets Inc. or its affiliates beneficially owns 1% or more of any class of common equity securities of UniCredit Group, Goldman Sachs Group, Inc., Societe Generale, Glencore Xstrata PLC. This position reflects information available as of the prior business day.

Within the past 12 months, Citigroup Global Markets Inc. or its affiliates has acted as manager or co-manager of an offering of securities of ENEL SpA, Abertis, Linde AG, Daimler AG, Hutchison Whampoa, Oracle Corporation, BNP Paribas SA, Telecom Italia SpA, RCI Banque SA, Vale, BMW AG, UniCredit Group, Hannover Ruckversicherungs AG, BT Group PLC, JP Morgan Chase & Co, Credit Agricole SA, Banco Santander, CNP Assurances SA, Volkswagen AG, Petrobras, General Electric Company, Goldman Sachs Group, Inc., Societe Generale, Morgan Stanley, GlaxoSmithKline PLC, Microsoft Corp., Rio Tinto PLC, Siemens, ThyssenKrupp AG, Barclays PLC, Talanx, BP, Atlas Copco, Banco Bilbao Vizcaya Argentaria SA, Carrefour.

Citigroup Global Markets Inc. or its affiliates has received compensation for investment banking services provided within the past 12 months from WPP PLC, ENEL SpA, Abertis, LVMH, Assicurazioni Generali SpA, Akzo Nobel NV, Metro AG, Linde AG, Pernod-Ricard, Banca Popolare di Milano, Lanxess, Daimler AG, Standard Chartered PLC, Solvay SA, Hutchison Whampoa, Tesco, Belgacom SA, RWE AG, Oracle Corporation, Casino Guichard Perachon, BNP Paribas SA, Telecom Italia SpA, RCI Banque SA, Vale, BMW AG, UniCredit Group, Hannover Ruckversicherungs AG, BT Group PLC, BG Group, JP Morgan Chase & Co, AB-InBev, Alstom, Repsol, Reed Elsevier NV, Credit Agricole SA, Banco Santander, CNP Assurances SA, Bayer AG, E.ON AG, Volkswagen AG, Banca Monte dei Paschi di Siena SpA, Petrobras, General Electric Company, Intesa Sanpaolo, Goldman Sachs Group, Inc., Societe Generale, Morgan Stanley, HSBC Holdings PLC, GlaxoSmithKline PLC, Swiss Life Holding, Microsoft Corp., Amgen Inc, Klépierre, Glencore Xstrata PLC, Rio Tinto PLC, Siemens, ThyssenKrupp AG, BASF SE, Barclays PLC, Talanx, BP, BHP Billiton PLC, Lloyds Banking Group PLC, OMV AG, Munich Re, Atlas Copco, Roche Holding AG, Banco Bilbao Vizcaya Argentaria SA, Royal Dutch Shell, Carrefour, ASML Holding NV.

Citigroup Global Markets Inc. or its affiliates expects to receive or intends to seek, within the next three months, compensation for investment banking services from ENEL SpA, Abertis, Assicurazioni Generali SpA, Solvay SA, Tesco, Casino Guichard Perachon, BNP Paribas SA, Telecom Italia SpA, Vale, BMW AG, UniCredit Group, BT Group PLC, BG Group, Banco Santander, E.ON AG, Volkswagen AG, Petrobras, General Electric Company, Intesa Sanpaolo, Goldman Sachs Group, Inc., Societe Generale, HSBC Holdings PLC, GlaxoSmithKline PLC, Amgen Inc, Klépierre, Glencore Xstrata PLC, Siemens, Barclays PLC, BP, BHP Billiton PLC, Lloyds Banking Group PLC, Roche Holding AG.

Citigroup Global Markets Inc. or an affiliate received compensation for products and services other than investment banking services from WPP PLC, GTECH, ENEL SpA, Abertis, LVMH, Assicurazioni Generali SpA, Akzo Nobel NV, Metro AG, Linde AG, Pernod-Ricard, Banca Popolare di Milano, Lanxess, Daimler AG, Standard Chartered PLC, Solvay SA, Hutchison Whampoa, Tesco, Belgacom SA, RWE AG, Oracle Corporation, Casino Guichard Perachon, BNP Paribas SA, Telecom Italia SpA, RCI Banque SA, Vale, BMW AG, UniCredit Group, Hannover Ruckversicherungs AG, BT Group PLC, Bouygues SA, BG Group, JP Morgan Chase & Co, Ericsson LM, AB-InBev, Alstom, Repsol, Reed Elsevier NV, Credit Agricole SA, Banco Santander, Kering, CNP Assurances SA, Bayer AG, E.ON AG, Volkswagen AG, Banca Monte dei Paschi di Siena SpA, Petrobras, General Electric Company, Intesa Sanpaolo, Goldman Sachs Group, Inc., PostNL NV, Societe Generale, Morgan Stanley, HSBC Holdings PLC, GlaxoSmithKline PLC, Swiss Life Holding, Microsoft Corp., Amgen Inc, Klépierre, Glencore Xstrata PLC, Rio Tinto PLC, Siemens, ThyssenKrupp AG, BASF SE, Barclays PLC, Talanx, BP, BHP Billiton PLC, Lloyds Banking Group PLC, OMV AG, Munich Re, Atlas Copco, TERNA SpA, Roche Holding AG, Banco Bilbao Vizcaya Argentaria SA, Royal Dutch Shell, Schneider Electric, Carrefour in the past 12 months.

Citigroup Global Markets Inc. currently has, or had within the past 12 months, the following as investment banking client(s): BASF SE, Linde AG, Solvay SA, Amgen Inc, HSBC Holdings PLC, Barclays PLC, WPP PLC, ENEL SpA, Abertis, LVMH, Assicurazioni Generali SpA, Akzo Nobel NV, Metro AG, Pernod-Ricard, Banca Popolare di Milano, Lanxess, Daimler AG, Standard Chartered PLC, Hutchison Whampoa, Tesco, Belgacom SA, RWE AG, Oracle Corporation, Casino Guichard Perachon, BNP Paribas SA, Telecom Italia SpA, RCI Banque SA, Vale, BMW AG, UniCredit Group, Hannover Ruckversicherungs AG, BT Group PLC, BG Group, JP Morgan Chase & Co, AB-InBev, Alstom, Repsol, Reed Elsevier NV, Credit Agricole SA, Banco Santander, CNP Assurances SA, Bayer AG, E.ON AG, Volkswagen AG, Banca Monte dei Paschi di Siena SpA, Petrobras, General Electric Company, Intesa Sanpaolo, Goldman Sachs Group, Inc., Societe Generale, Morgan Stanley, GlaxoSmithKline PLC, Swiss Life Holding, Microsoft Corp., Klépierre, Glencore Xstrata PLC, Rio Tinto PLC, Siemens, ThyssenKrupp AG, Talanx, BP, BHP Billiton PLC, Lloyds Banking Group PLC, OMV AG, Munich Re, Atlas Copco, Roche Holding AG, Banco Bilbao Vizcaya Argentaria SA, Royal Dutch Shell, Carrefour, ASML Holding NV.

Citigroup Global Markets Inc. currently has, or had within the past 12 months, the following as clients, and the services provided were non-investment-banking, securities-related: WPP PLC, GTECH, ENEL SpA, Abertis, LVMH, Assicurazioni Generali SpA, Akzo Nobel NV, Metro AG, Linde AG, Pernod-Ricard, Banca Popolare di Milano, Lanxess, Daimler AG, Standard Chartered PLC, Solvay SA, Hutchison Whampoa, Tesco, Belgacom SA, RWE AG, Oracle Corporation, Casino Guichard Perachon, BNP Paribas SA, Telecom Italia SpA, RCI Banque SA, Vale, BMW AG, UniCredit Group, Hannover Ruckversicherungs AG, BT Group PLC, Bouygues SA, BG Group, JP Morgan Chase & Co, Ericsson LM, AB-InBev, Alstom, Repsol, Reed Elsevier NV, Credit Agricole SA, Banco Santander, Kering, CNP Assurances SA, Bayer AG, E.ON AG, Volkswagen AG, Banca Monte dei Paschi di Siena SpA, Petrobras, General Electric Company, Intesa Sanpaolo, Goldman Sachs Group, Inc., PostNL NV, Societe Generale, Morgan Stanley, HSBC Holdings PLC, GlaxoSmithKline PLC, Swiss Life Holding, Microsoft Corp., Amgen Inc, Gecina, Klépierre, Glencore Xstrata PLC, Rio Tinto PLC, Siemens, ThyssenKrupp AG, BASF SE, Barclays PLC, Talanx, BP, BHP Billiton PLC, Lloyds Banking Group PLC, OMV AG, Munich Re, Atlas Copco, TERNA SpA, Roche Holding AG, Banco Bilbao Vizcaya Argentaria SA, Royal Dutch Shell, Schneider Electric, Carrefour.

Citigroup Global Markets Inc. currently has, or had within the past 12 months, the following as clients, and the services provided were non-investment-banking, non-securities-related: WPP PLC, GTECH, ENEL SpA, Abertis, LVMH, Assicurazioni Generali SpA, Akzo Nobel NV, Metro AG, Linde AG, Pernod-Ricard, Banca Popolare di Milano, Lanxess, Daimler AG, Standard Chartered PLC, Solvay SA, Hutchison Whampoa, Tesco, Belgacom SA, RWE AG, Oracle Corporation, Casino Guichard Perachon, BNP Paribas SA, Telecom Italia SpA, RCI Banque SA, Vale, BMW AG, UniCredit Group, Hannover Ruckversicherungs AG, BT Group PLC, Bouygues SA, BG Group, JP Morgan Chase & Co, Ericsson LM, AB-InBev, Alstom, Repsol, Reed Elsevier NV, Credit Agricole SA, Banco Santander, Kering, CNP Assurances SA, Bayer AG, E.ON AG, Volkswagen AG, Banca Monte dei Paschi di Siena SpA, Petrobras, General Electric Company, Intesa Sanpaolo, Goldman Sachs Group, Inc., PostNL NV, Societe Generale, Morgan Stanley, HSBC Holdings PLC, GlaxoSmithKline PLC, Swiss Life Holding, Microsoft Corp., Amgen Inc, Klépierre, Glencore Xstrata PLC, Rio Tinto PLC, Siemens, ThyssenKrupp AG, BASF SE, Barclays PLC, Talanx, BP, BHP Billiton PLC, Lloyds Banking Group PLC, OMV AG, Munich Re, Atlas Copco, TERNA SpA, Roche Holding AG, Banco Bilbao Vizcaya Argentaria SA, Royal Dutch Shell, Schneider Electric, Carrefour.

Citigroup Global Markets Inc. or an affiliate received compensation in the past 12 months from Amgen Inc.

Analysts' compensation is determined based upon activities and services intended to benefit the investor clients of Citigroup Global Markets Inc. and its affiliates ("the Firm"). Like all Firm employees, analysts receive compensation that is impacted by overall firm profitability which includes investment banking revenues.

The Firm is a market maker in the publicly traded equity securities of GTECH, ENEL SpA, LVMH, Akzo Nobel NV, Pernod-Ricard, Daimler AG, Hutchison Whampoa, Tesco, RWE AG, Oracle Corporation, BNP Paribas SA, BMW AG, BG Group, Ericsson LM, Repsol, Banco Santander, Bayer AG, Volkswagen AG, Intesa Sanpaolo, PostNL NV, Societe Generale, HSBC Holdings PLC, Microsoft Corp., Amgen Inc, Barclays PLC, Munich Re, Atlas Copco, Roche Holding AG, Banco Bilbao Vizcaya Argentaria SA, Carrefour, ASML Holding NV.

For important disclosures (including copies of historical disclosures) regarding the companies that are the subject of this Citi Research product ("the Product"), please contact Citi Research, 388 Greenwich Street, 28th Floor, New York, NY, 10013, Attention: Legal/Compliance [E6WYB6412478]. In addition, the same important disclosures, with the exception of the Valuation and Risk assessments and historical disclosures, are contained on the Firm's disclosure website at https://www.citivelocity.com/cvr/eppublic/citi_research_disclosures. Valuation and Risk assessments can be found in the text of the most recent research note/report regarding the subject company. Historical disclosures (for up to the past three years) will be provided upon request.

Citi Research Equity Ratings Distribution

	12 Month Rating			***Relative Rating***		
Data current as of 30 Jun 2013	**Buy**	**Hold**	**Sell**	**Buy**	**Hold**	**Sell**
Citi Research Global Fundamental Coverage	48%	40%	12%	6%	88%	6%
% of companies in each rating category that are investment banking clients	53%	50%	45%	58%	51%	49%

Guide to Citi Research Fundamental Research Investment Ratings:

Citi Research stock recommendations include an investment rating and an optional risk rating to highlight high risk stocks.

Risk rating takes into account both price volatility and fundamental criteria. Stocks will either have no risk rating or a High risk rating assigned.

Investment Ratings: Citi Research investment ratings are Buy, Neutral and Sell. Our ratings are a function of analyst expectations of expected total return ("ETR") and risk. ETR is the sum of the forecast price appreciation (or depreciation) plus the dividend yield for a stock within the next 12 months. The Investment rating definitions are: Buy (1) ETR of 15% or more or 25% or more for High risk stocks; and Sell (3) for negative ETR. Any covered stock not assigned a Buy or a Sell is a Neutral (2). For stocks rated Neutral (2), if an analyst believes that there are insufficient valuation drivers and/or investment catalysts to derive a positive or negative investment view, they may elect with the approval of Citi Research management not to assign a target price and, thus, not derive an ETR. Analysts may place covered stocks "Under Review" in response to exceptional circumstances (e.g. lack of information critical to the analyst's thesis) affecting the company and / or trading in the company's securities (e.g. trading suspension). As soon as practically possible, the analyst will publish a note re-establishing a rating and investment thesis. To satisfy regulatory requirements, we correspond Under Review and Neutral to Hold in our ratings distribution table for our 12-month fundamental rating system. However, we reiterate that we do not consider Under Review to be a recommendation.

Relative three-month ratings: Citi Research may also assign a three-month relative call (or rating) to a stock to highlight expected out-performance (most preferred) or under-performance (least preferred) versus the geographic and industry sector over a 3 month period. The relative call may highlight a specific near-term catalyst or event impacting the company or the market that is anticipated to have a short-term price impact on the equity securities of the company. Absent any specific catalyst the analyst(s) will indicate the most and least preferred stocks in the universe of stocks under consideration, explaining the basis for this short-term view. This three-month view may be different from and does not affect a stock's fundamental equity rating, which reflects a longer-term total absolute return expectation. For purposes of NASD/NYSE ratings-distribution-disclosure rules, most preferred calls correspond to a buy recommendation and least preferred calls correspond to a sell recommendation. Any stock not assigned to a most preferred or least preferred call is considered non-relative-rated (NRR). For purposes of NASD/NYSE ratings-distribution-disclosure rules we correspond NRR to Hold in our ratings distribution table for our 3-month relative rating system. However, we reiterate that we do not consider NRR to be a recommendation.

Prior to October 8, 2011, the firm's stock recommendation system included a risk rating and an investment rating. **Risk ratings,** which took into account both price volatility and fundamental criteria, were: Low (L), Medium (M), High (H), and Speculative (S). **Investment Ratings** of Buy, Hold and Sell were a function of the Citi Research expectation of total return (forecast price appreciation and dividend yield within the next 12 months) and risk rating. Additionally, analysts could have placed covered stocks "Under Review" in response to exceptional circumstances (e.g. lack of information critical to the analyst's thesis) affecting the company and/or trading in the company's securities (e.g. trading suspension). Stocks placed "Under Review" were monitored daily by management and as practically possible, the analyst published a note re-establishing a rating and investment thesis. For securities in developed markets (US, UK, Europe, Japan, and Australia/New Zealand), investment ratings were:Buy (1) (expected total return of 10% or more for Low-Risk stocks, 15% or more for Medium-Risk stocks, 20% or more for High-Risk stocks, and 35% or more for Speculative stocks); Hold (2) (0%-10% for Low-Risk stocks, 0%-15% for Medium-Risk stocks, 0%-20% for High-Risk stocks, and 0%-35% for Speculative stocks); and Sell (3) (negative total return). For securities in emerging markets (Asia Pacific, Emerging Europe/Middle East/Africa, and Latin America), investment ratings were:Buy (1) (expected total return of 15% or more for Low-Risk stocks, 20% or more for Medium-Risk stocks, 30% or more for High-Risk stocks, and 40% or more for Speculative stocks); Hold (2) (5%-15% for Low-Risk stocks, 10%-20% for Medium-Risk stocks, 15%-30% for High-Risk stocks, and 20%-40% for Speculative stocks); and Sell (3) (5% or less for Low-Risk stocks, 10% or less for Medium-Risk stocks, 15% or less for High-Risk stocks, and 20% or less for Speculative stocks).

Investment ratings are determined by the ranges described above at the time of initiation of coverage, a change in investment and/or risk rating, or a change in target price (subject to limited management discretion). At other times, the expected total returns may fall outside of these ranges because of market price movements and/or other short-term volatility or trading patterns. Such interim deviations from specified ranges will be permitted but will become subject to review by Research Management. Your decision to buy or sell a security should be based upon your personal investment objectives and should be made only after evaluating the stock's expected performance and risk.

NON-US RESEARCH ANALYST DISCLOSURES

Non-US research analysts who have prepared this report (i.e., all research analysts listed below other than those identified as employed by Citigroup Global Markets Inc.) are not registered/qualified as research analysts with FINRA. Such research analysts may not be associated persons of the member organization and therefore may not be subject to the NYSE Rule 472 and NASD Rule 2711 restrictions on communications with a subject company, public appearances and trading securities held by a research analyst account. The legal entities employing the authors of this report are listed below:

Citigroup Global Markets Ltd	Teresa Cascino; Hans Lorenzen; Matt King; Alastair A Johnston; Dominik Frauendienst; Dimitri Y Kallianiotis, CFA; Alastair R Syme; Natalia Mamaeva; Philip Watkins; Andrew Benson; Sofia Savvantidou; Andrew S Baum; Heath R Jansen; Andrea Pistacchi; Simon Weeden; Thomas Chauvet; Thomas Dorner; Kinner Lakhani; Florent Nitu; Antonella Bianchessi; Andrew Coombs; Chris Montagu; Stefan Nedialkov; Amit B Harchandani; Farooq Hanif; Azzurra Guelfi; Mauro Baragiola; Thomas A Singlehurst, CFA; Roger Elliott; Michael J Alsford; Ronit Ghose
Citigroup Global Markets Inc	Yaron Werber, MD; Keith Horowitz, CFA; Deane M. Dray, CFA; Alexander Hacking, CFA

Citigroup Global Markets Asia	Anil Daswani
Citigroup Global Markets Brazil	Pedro Medeiros

OTHER DISCLOSURES

Citigroup Global Markets Inc. and/or its affiliates has a significant financial interest in relation to ENEL SpA, Abertis, LVMH, Akzo Nobel NV, Metro AG, Linde AG, Pernod-Ricard, Lanxess, Daimler AG, Solvay SA, Tesco, RWE AG, Oracle Corporation, Casino Guichard Perachon, BNP Paribas SA, Telecom Italia SpA, Vale, BMW AG, UniCredit Group, BG Group, JP Morgan Chase & Co, Ericsson LM, AB-InBev, Alstom, Repsol, Credit Agricole SA, Banco Santander, Bayer AG, Volkswagen AG, Petrobras, General Electric Company, Goldman Sachs Group, Inc., Societe Generale, Morgan Stanley, GlaxoSmithKline PLC, Amgen Inc, Rio Tinto PLC, Siemens, ThyssenKrupp AG, BASF SE, Barclays PLC, Talanx, BHP Billiton PLC, Lloyds Banking Group PLC, OMV AG, Roche Holding AG, Banco Bilbao Vizcaya Argentaria SA, Schneider Electric, Carrefour. (For an explanation of the determination of significant financial interest, please refer to the policy for managing conflicts of interest which can be found at www.citiVelocity.com.)

Citigroup Global Markets Inc. or its affiliates beneficially owns 2% or more of any class of common equity securities of Goldman Sachs Group, Inc..

For securities recommended in the Product in which the Firm is not a market maker, the Firm is a liquidity provider in the issuers' financial instruments and may act as principal in connection with such transactions. The Firm is a regular issuer of traded financial instruments linked to securities that may have been recommended in the Product. The Firm regularly trades in the securities of the issuer(s) discussed in the Product. The Firm may engage in securities transactions in a manner inconsistent with the Product and, with respect to securities covered by the Product, will buy or sell from customers on a principal basis.

Citigroup Global Markets Inc. or its affiliates acts as a corporate broker to GlaxoSmithKline PLC, Glencore Xstrata PLC, BHP Billiton PLC, Lloyds Banking Group PLC.

Securities recommended, offered, or sold by the Firm: (i) are not insured by the Federal Deposit Insurance Corporation; (ii) are not deposits or other obligations of any insured depository institution (including Citibank); and (iii) are subject to investment risks, including the possible loss of the principal amount invested. Although information has been obtained from and is based upon sources that the Firm believes to be reliable, we do not guarantee its accuracy and it may be incomplete and condensed. Note, however, that the Firm has taken all reasonable steps to determine the accuracy and completeness of the disclosures made in the Important Disclosures section of the Product. The Firm's research department has received assistance from the subject company(ies) referred to in this Product including, but not limited to, discussions with management of the subject company(ies). Firm policy prohibits research analysts from sending draft research to subject companies. However, it should be presumed that the author of the Product has had discussions with the subject company to ensure factual accuracy prior to publication. All opinions, projections and estimates constitute the judgment of the author as of the date of the Product and these, plus any other information contained in the Product, are subject to change without notice. Prices and availability of financial instruments also are subject to change without notice. Notwithstanding other departments within the Firm advising the companies discussed in this Product, information obtained in such role is not used in the preparation of the Product. Although Citi Research does not set a predetermined frequency for publication, if the Product is a fundamental research report, it is the intention of Citi Research to provide research coverage of the/those issuer(s) mentioned therein, including in response to news affecting this issuer, subject to applicable quiet periods and capacity constraints. The Product is for informational purposes only and is not intended as an offer or solicitation for the purchase or sale of a security. Any decision to purchase securities mentioned in the Product must take into account existing public information on such security or any registered prospectus.

Investing in non-U.S. securities, including ADRs, may entail certain risks. The securities of non-U.S. issuers may not be registered with, nor be subject to the reporting requirements of the U.S. Securities and Exchange Commission. There may be limited information available on foreign securities. Foreign companies are generally not subject to uniform audit and reporting standards, practices and requirements comparable to those in the U.S. Securities of some foreign companies may be less liquid and their prices more volatile than securities of comparable U.S. companies. In addition, exchange rate movements may have an adverse effect on the value of an investment in a foreign stock and its corresponding dividend payment for U.S. investors. Net dividends to ADR investors are estimated, using withholding tax rates conventions, deemed accurate, but investors are urged to consult their tax advisor for exact dividend computations. Investors who have received the Product from the Firm may be prohibited in certain states or other jurisdictions from purchasing securities mentioned in the Product from the Firm. Please ask your Financial Consultant for additional details. Citigroup Global Markets Inc. takes responsibility for the Product in the United States. Any orders by US investors resulting from the information contained in the Product may be placed only through Citigroup Global Markets Inc.

The Citigroup legal entity that takes responsibility for the production of the Product is the legal entity which the first named author is employed by. The Product is made available in **Australia** through Citi Global Markets Australia Pty Ltd. (ABN 64 003 114 832 and AFSL No. 240992), participant of the ASX Group and regulated by the Australian Securities & Investments Commission. Citigroup Centre, 2 Park Street, Sydney, NSW 2000. The Product is made available in Australia to Private Banking wholesale clients through Citigroup Pty Limited (ABN 88 004 325 080 and AFSL 238098). Citigroup Pty Limited provides all financial product advice to Australian Private Banking wholesale clients through bankers and relationship managers. If there is any doubt about the suitability of investments held in Citigroup Private Bank accounts, investors should contact the Citigroup Private Bank in Australia. Citigroup companies may compensate affiliates and their representatives for providing products and services to clients. The Product is made available in **Brazil** by Citigroup Global Markets Brasil - CCTVM SA, which is regulated by CVM - Comissão de Valores Mobiliários, BACEN - Brazilian Central Bank, APIMEC - Associação dos Analistas e Profissionais de Investimento do Mercado de Capitais and ANBID - Associação Nacional dos Bancos de Investimento. Av. Paulista, 1111 - 11º andar - CEP. 01311920 - São Paulo - SP. If the Product is being made available in certain provinces of **Canada** by Citigroup Global Markets (Canada) Inc. ("CGM Canada"), CGM Canada has approved the Product. Citigroup Place, 123 Front Street West, Suite 1100, Toronto, Ontario M5J 2M3. This product is available in **Chile** through Banchile Corredores de Bolsa S.A., an indirect subsidiary of Citigroup Inc., which is regulated by the Superintendencia de Valores y Seguros. Agustinas 975, piso 2, Santiago, Chile. The Product is made available in **France** by Citigroup Global Markets Limited, which is authorised and regulated by Financial Services Authority. 1-5 Rue Paul Cézanne, 8ème, Paris, France. The Product is distributed in **Germany** by Citigroup Global Markets Deutschland AG ("CGMD"), which is regulated by Bundesanstalt fuer Finanzdienstleistungsaufsicht (BaFin). CGMD, Reuterweg 16, 60323 Frankfurt am Main. Research which relates to "securities" (as defined in the Securities and Futures Ordinance (Cap. 571 of the Laws of Hong Kong)) is issued in **Hong Kong** by, or on behalf of, Citigroup Global Markets Asia Limited which takes full responsibility for its content. Citigroup

Global Markets Asia Ltd. is regulated by Hong Kong Securities and Futures Commission. If the Research is made available through Citibank, N.A., Hong Kong Branch, for its clients in Citi Private Bank, it is made available by Citibank N.A., Citibank Tower, Citibank Plaza, 3 Garden Road, Hong Kong. Citibank N.A. is regulated by the Hong Kong Monetary Authority. Please contact your Private Banker in Citibank N.A., Hong Kong, Branch if you have any queries on or any matters arising from or in connection with this document. The Product is made available in **India** by Citigroup Global Markets India Private Limited, which is regulated by Securities and Exchange Board of India. Bakhtawar, Nariman Point, Mumbai 400-021. The Product is made available in **Indonesia** through PT Citigroup Securities Indonesia. 5/F, Citibank Tower, Bapindo Plaza, Jl. Jend. Sudirman Kav. 54-55, Jakarta 12190. Neither this Product nor any copy hereof may be distributed in Indonesia or to any Indonesian citizens wherever they are domiciled or to Indonesian residents except in compliance with applicable capital market laws and regulations. This Product is not an offer of securities in Indonesia. The securities referred to in this Product have not been registered with the Capital Market and Financial Institutions Supervisory Agency (BAPEPAM-LK) pursuant to relevant capital market laws and regulations, and may not be offered or sold within the territory of the Republic of Indonesia or to Indonesian citizens through a public offering or in circumstances which constitute an offer within the meaning of the Indonesian capital market laws and regulations. The Product is made available in **Israel** through Citibank NA, regulated by the Bank of Israel and the Israeli Securities Authority. Citibank, N.A, Platinum Building, 21 Ha'arba'ah St, Tel Aviv, Israel. The Product is made available in **Italy** by Citigroup Global Markets Limited, which is authorised and regulated by Financial Services Authority. Via dei Mercanti, 12, Milan, 20121, Italy. The Product is made available in **Japan** by Citigroup Global Markets Japan Inc. ("CGMJ"), which is regulated by Financial Services Agency, Securities and Exchange Surveillance Commission, Japan Securities Dealers Association, Tokyo Stock Exchange and Osaka Securities Exchange. Shin-Marunouchi Building, 1-5-1 Marunouchi, Chiyoda-ku, Tokyo 100-6520 Japan. If the Product was distributed by SMBC Nikko Securities Inc. it is being so distributed under license. In the event that an error is found in an CGMJ research report, a revised version will be posted on the Firm's Citi Velocity website. If you have questions regarding Citi Velocity, please call (81 3) 6270-3019 for help. The Product is made available in **Korea** by Citigroup Global Markets Korea Securities Ltd., which is regulated by the Financial Services Commission, the Financial Supervisory Service and the Korea Financial Investment Association (KOFIA). Citibank Building, 39 Da-dong, Jung-gu, Seoul 100-180, Korea. KOFIA makes available registration information of research analysts on its website. Please visit the following website if you wish to find KOFIA registration information on research analysts of Citigroup Global Markets Korea Securities Ltd. http://dis.kofia.or.kr/fs/dis2/fundMgr/DISFundMgrAnalystPop.jsp?companyCd2=A03030&pageDiv=02. The Product is made available in Korea by Citibank Korea Inc., which is regulated by the Financial Services Commission and the Financial Supervisory Service. Address is Citibank Building, 39 Da-dong, Jung-gu, Seoul 100-180, Korea. The Product is made available in **Malaysia** by Citigroup Global Markets Malaysia Sdn Bhd (Company No. 460819-D) ("CGMM") to its clients and CGMM takes responsibility for its contents. CGMM is regulated by the Securities Commission of Malaysia. Please contact CGMM at Level 43 Menara Citibank, 165 Jalan Ampang, 50450 Kuala Lumpur, Malaysia in respect of any matters arising from, or in connection with, the Product. The Product is made available in **Mexico** by Acciones y Valores Banamex, S.A. De C. V., Casa de Bolsa, Integrante del Grupo Financiero Banamex ("Accival") which is a wholly owned subsidiary of Citigroup Inc. and is regulated by Comision Nacional Bancaria y de Valores. Reforma 398, Col. Juarez, 06600 Mexico, D.F. In **New Zealand** the Product is made available to 'wholesale clients' only as defined by s5C(1) of the Financial Advisers Act 2008 ('FAA') through Citigroup Global Markets Australia Pty Ltd (ABN 64 003 114 832 and AFSL No. 240992), an overseas financial adviser as defined by the FAA, participant of the ASX Group and regulated by the Australian Securities & Investments Commission. Citigroup Centre, 2 Park Street, Sydney, NSW 2000. The Product is made available in **Pakistan** by Citibank N.A. Pakistan branch, which is regulated by the State Bank of Pakistan and Securities Exchange Commission, Pakistan. AWT Plaza, 1.1. Chundrigar Road, P.O. Box 4889, Karachi-74200. The Product is made available in the **Philippines** through Citicorp Financial Services and Insurance Brokerage Philippines, Inc., which is regulated by the Philippines Securities and Exchange Commission. 20th Floor Citibank Square Bldg. The Product is made available in the Philippines through Citibank NA Philippines branch, Citibank Tower, 8741 Paseo De Roxas, Makati City, Manila. Citibank NA Philippines NA is regulated by The Bangko Sentral ng Pilipinas. The Product is made available in **Poland** by Dom Maklerski Banku Handlowego SA an indirect subsidiary of Citigroup Inc., which is regulated by Komisja Nadzoru Finansowego. Dom Maklerski Banku Handlowego S.A. ul.Senatorska 16, 00-923 Warszawa. The Product is made available in the **Russian Federation** through ZAO Citibank, which is licensed to carry out banking activities in the Russian Federation in accordance with the general banking license issued by the Central Bank of the Russian Federation and brokerage activities in accordance with the license issued by the Federal Service for Financial Markets. Neither the Product nor any information contained in the Product shall be considered as advertising the securities mentioned in this report within the territory of the Russian Federation or outside the Russian Federation. The Product does not constitute an appraisal within the meaning of the Federal Law of the Russian Federation of 29 July 1998 No. 135-FZ (as amended) On Appraisal Activities in the Russian Federation. 8-10 Gasheka Street, 125047 Moscow. The Product is made available in **Singapore** through Citigroup Global Markets Singapore Pte. Ltd. ("CGMSPL"), a capital markets services license holder, and regulated by Monetary Authority of Singapore. Please contact CGMSPL at 8 Marina View, 21st Floor Asia Square Tower 1, Singapore 018960, in respect of any matters arising from, or in connection with, the analysis of this document. This report is intended for recipients who are accredited, expert and institutional investors as defined under the Securities and Futures Act (Cap. 289). The Product is made available by The Citigroup Private Bank in Singapore through Citibank, N.A., Singapore Branch, a licensed bank in Singapore that is regulated by Monetary Authority of Singapore. Please contact your Private Banker in Citibank N.A., Singapore Branch if you have any queries on or any matters arising from or in connection with this document. This report is intended for recipients who are accredited, expert and institutional investors as defined under the Securities and Futures Act (Cap. 289). This report is distributed in Singapore by Citibank Singapore Ltd ("CSL") to selected Citigold/Citigold Private Clients. CSL provides no independent research or analysis of the substance or in preparation of this report. Please contact your Citigold//Citigold Private Client Relationship Manager in CSL if you have any queries on or any matters arising from or in connection with this report. This report is intended for recipients who are accredited investors as defined under the Securities and Futures Act (Cap. 289). Citigroup Global Markets (Pty) Ltd. is incorporated in the **Republic of South Africa** (company registration number 2000/025866/07) and its registered office is at 145 West Street, Sandton, 2196, Saxonwold. Citigroup Global Markets (Pty) Ltd. is regulated by JSE Securities Exchange South Africa, South African Reserve Bank and the Financial Services Board. The investments and services contained herein are not available to private customers in South Africa. The Product is made available in **Spain** by Citigroup Global Markets Limited, which is authorised and regulated by Financial Services Authority. 29 Jose Ortega Y Gasset, 4th Floor, Madrid, 28006, Spain. The Product is made available in the **Republic of China** through Citigroup Global Markets Taiwan Securities Company Ltd. ("CGMTS"), 14 and 15F, No. 1, Songzhi Road, Taipei 110, Taiwan and/or through Citibank Securities (Taiwan) Company Limited ("CSTL"), 14 and 15F, No. 1, Songzhi Road, Taipei 110, Taiwan, subject to the respective license scope of each entity and the applicable laws and regulations in the Republic of China. CGMTS and CSTL are both regulated by the Securities and Futures Bureau of the Financial Supervisory Commission of Taiwan, the Republic of China. No portion of the Product may be reproduced or quoted in the Republic of China by the press or any third parties [without the written authorization of CGMTS and CSTL]. If the Product covers securities which are not allowed to be offered or traded in the Republic of China, neither the Product nor any information contained in the Product shall be considered as advertising the securities or making recommendation of

the securities in the Republic of China. The Product is for informational purposes only and is not intended as an offer or solicitation for the purchase or sale of a security or financial products. Any decision to purchase securities or financial products mentioned in the Product must take into account existing public information on such security or the financial products or any registered prospectus. The Product is made available in **Thailand** through Citicorp Securities (Thailand) Ltd., which is regulated by the Securities and Exchange Commission of Thailand. 18/F, 22/F and 29/F, 82 North Sathorn Road, Silom, Bangrak, Bangkok 10500, Thailand. The Product is made available in **Turkey** through Citibank AS which is regulated by Capital Markets Board. Tekfen Tower, Eski Buyukdere Caddesi # 209 Kat 2B, 23294 Levent, Istanbul, Turkey. In the **U.A.E**, these materials (the "Materials") are communicated by Citigroup Global Markets Limited, DIFC branch ("CGML"), an entity registered in the Dubai International Financial Center ("DIFC") and licensed and regulated by the Dubai Financial Services Authority ("DFSA") to Professional Clients and Market Counterparties only and should not be relied upon or distributed to Retail Clients. A distribution of the different Citi Research ratings distribution, in percentage terms for Investments in each sector covered is made available on request. Financial products and/or services to which the Materials relate will only be made available to Professional Clients and Market Counterparties. The Product is made available in **United Kingdom** by Citigroup Global Markets Limited, which is authorised and regulated by Financial Services Authority. This material may relate to investments or services of a person outside of the UK or to other matters which are not regulated by the FSA and further details as to where this may be the case are available upon request in respect of this material. Citigroup Centre, Canada Square, Canary Wharf, London, E14 5LB. The Product is made available in **United States** by Citigroup Global Markets Inc, which is a member of FINRA and registered with the US Securities and Exchange Commission. 388 Greenwich Street, New York, NY 10013. Unless specified to the contrary, within EU Member States, the Product is made available by Citigroup Global Markets Limited, which is regulated by Financial Services Authority.

Pursuant to Comissão de Valores Mobiliários Rule 483, Citi is required to disclose whether a Citi related company or business has a commercial relationship with the subject company. Considering that Citi operates multiple businesses in more than 100 countries around the world, it is likely that Citi has a commercial relationship with the subject company.

Many European regulators require that a firm must establish, implement and make available a policy for managing conflicts of interest arising as a result of publication or distribution of investment research. The policy applicable to Citi Research's Products can be found at https://www.citivelocity.com/cvr/eppublic/citi_research_disclosures.

Compensation of equity research analysts is determined by equity research management and Citigroup's senior management and is not linked to specific transactions or recommendations.

The Product may have been distributed simultaneously, in multiple formats, to the Firm's worldwide institutional and retail customers. The Product is not to be construed as providing investment services in any jurisdiction where the provision of such services would not be permitted.

Subject to the nature and contents of the Product, the investments described therein are subject to fluctuations in price and/or value and investors may get back less than originally invested. Certain high-volatility investments can be subject to sudden and large falls in value that could equal or exceed the amount invested. Certain investments contained in the Product may have tax implications for private customers whereby levels and basis of taxation may be subject to change. If in doubt, investors should seek advice from a tax adviser. The Product does not purport to identify the nature of the specific market or other risks associated with a particular transaction. Advice in the Product is general and should not be construed as personal advice given it has been prepared without taking account of the objectives, financial situation or needs of any particular investor. Accordingly, investors should, before acting on the advice, consider the appropriateness of the advice, having regard to their objectives, financial situation and needs. Prior to acquiring any financial product, it is the client's responsibility to obtain the relevant offer document for the product and consider it before making a decision as to whether to purchase the product.

With the exception of our product that is made available only to Qualified Institutional Buyers (QIBs) and other product that is made available through other distribution channels only to certain categories of clients to satisfy legal or regulatory requirements, Citi Research concurrently disseminates its research via proprietary and non-proprietary electronic distribution platforms. Periodically, individual Citi Research analysts may also opt to circulate research posted on such platforms to one or more clients by email. Such email distribution is discretionary and is done only after the research has been disseminated via the aforementioned distribution channels. Citi Research simultaneously distributes product that is limited to QIBs only through email distribution.

The level and types of services provided by Citi Research analysts to clients may vary depending on various factors such as the client's individual preferences as to the frequency and manner of receiving communications from analysts, the client's risk profile and investment focus and perspective (e.g. market-wide, sector specific, long term, short-term etc.), the size and scope of the overall client relationship with Citi and legal and regulatory constraints.

Citi Research product may source data from dataCentral. dataCentral is a Citi Research proprietary database, which includes Citi estimates, data from company reports and feeds from Reuters and Datastream.

ADDITIONAL INFORMATION IS AVAILABLE UPON REQUEST