

Economics

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Portfolio Economics

Labor's Turn to Awaken: Peak Margins but Not EPS

- While the U.S. expansion shows some signs of greater strength and durability, 4Q 2011 earnings were weaker than we expected, even excluding financials. Non-cyclical areas accounted for much of the shortfall versus our own expectations. This combination leaves our outlook for S&P 500 Operating EPS at \$101 in 2012 intact, though now requiring a higher 3%-3½% growth rate. We continue to expect \$105.50 in 2013.
- Our slightly revised estimates should be viewed as tentative. Assessments after 1Q results tend to be more useful than 4Q readings. But aside from waxing and waning EPS surprises in the past two quarters, the fundamental question remains: Will a regional downturn cause shocks and recessions elsewhere?
- The slight drop in financial sector profits in 4Q already showed the signs of forward-looking stress that might lead a future downturn in the real economy. However, that market deterioration has since measurably reversed. Meanwhile the severe employment retrenchment of 2008-2009 has left us relatively more optimistic on the labor market than corporate profits, though the two can't part ways indefinitely. We continue to see future profits compared unfavorably with those boosted by fiscal easing, which is now waning in recovery. Labor markets have still to catch up.
- Even with peak margins, revenue expansion should boost profits at a slower pace as increases in employee compensation get "recycled" in the economy. In contrast to slow overall growth, areas of concentrated exposure to peripheral Europe and counterparties should see revenue and profit declines. Non-energy commodity profits are poised for measurable decline in 2012 near current price levels.
- Beyond Europe, significant U.S. policy questions remain in late 2012 that are relevant for the macro-level outlook. They should include investor questions such as, "will dividend income be taxed at 15%, 20% or 43.4%?"

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

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Labor's Turn to Awaken

Despite a relatively firm increase in U.S. output in 4Q 2011 - the 2.8% increase in real GDP was the strongest sequential gain since 2Q 2010 - EPS results for S&P 500 firms came in below our estimate for the quarter. While we thought financial sector earnings could drag down results (and they did) other earnings grew less than we estimated, and the breadth of earnings gains was more modest than in recent quarters. This has caused us to revise 2011 EPS estimates down some, but offsetting positive developments argue in favor of leaving full year 2012 EPS forecasts unchanged for the time being (see figure 1; Note: the quarterly path of EPS gains has been revised, see appendix 1).

We would view the 2012 estimate as tentative. Finalized 4Q 2011 earnings readings remain to be seen. More importantly, how closely 1Q 2012 EPS results track our estimates is usually more indicative of any likely revisions to our full year forecasts.

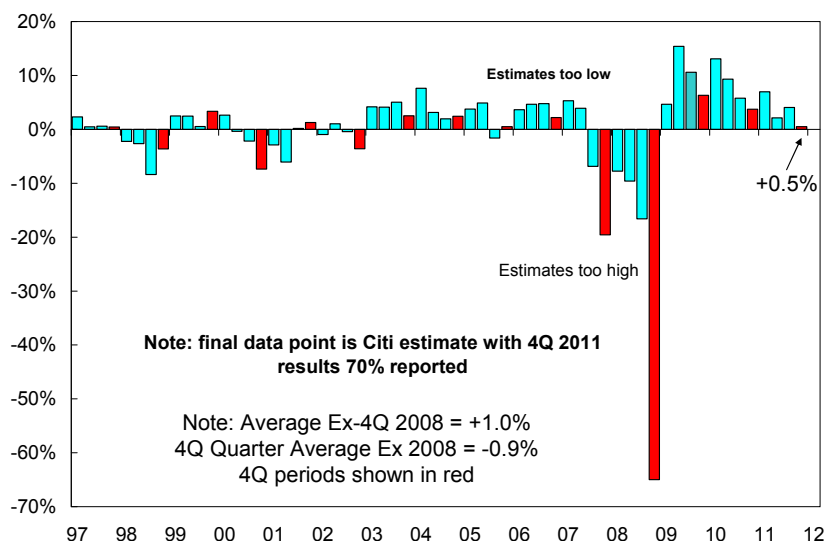
Figure 1. Citi Estimates and Consensus: S&P 500 EPS

	Citi Ests		Citi Ests		Consensus Operating	
	Operating EPS	y/y%	GAAP EPS	y/y%		y/y%
2010	85.49	37.8	77.35	51.8	85.49	37.8
2011	97.80	14.4	87.50	13.1	97.63	14.2
2012	101.00	3.3	91.00	4.0	105.9	8.5
2013	105.50	4.5	94.00	3.3	NA	NA

Sources: S&P, Thomson Financial, Citi Investment Research and Analysis Note: the 2011 operating EPS estimate was \$99.25 previously. The Citi GAAP EPS estimate was \$90.00.

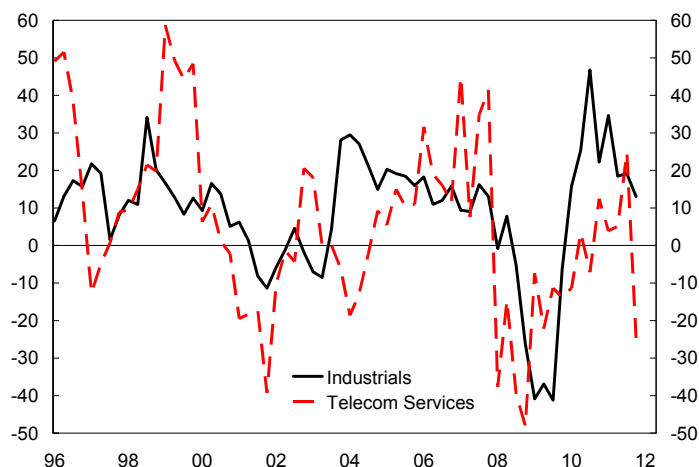
While improving from a soft start, the 63.9% of EPS results that have beat consensus estimates reported in 4Q thus far is historically moderate. The absolute level of total EPS failed to significantly beat the end-of-quarter consensus for the first time in the recovery to date (see figure 2). While compared to our own estimates, this was driven to some extent by non-cyclical sectors like Telecom Services, Staples and Utilities (see figure 3), the solid 3.1% gain in industrial production in the fourth quarter and nearly as large a gain over the past year implied somewhat stronger overall non-financial EPS results (see figure 4).

Figure 2. Quarterly S&P 500 EPS Relative to End-of-Quarter Analysts Estimates (% Difference)



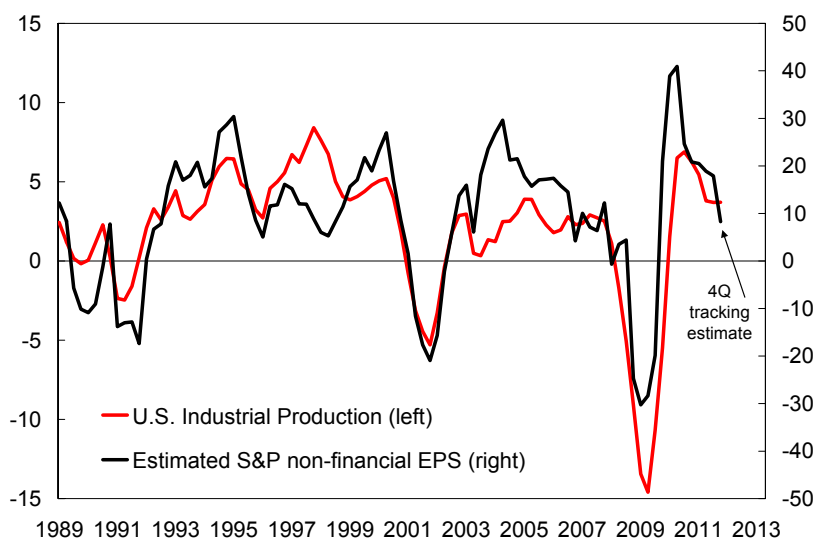
Sources: S&P, Thomson Financial, Citi Investment Research and Analysis

Figure 3. S&P 500 Telecom Services Sector EPS and Industrial Sector EPS Y/Y%



Sources: S&P, Factset, Citi Investment Research and Analysis

Figure 4. U.S. Industrial Production vs S&P 500 EPS Ex-Financials, Y/Y%



Sources: FRB, S&P, Thomson Financial, Bloomberg

As figure 2 also shows, 4Q periods have been somewhat different from other quarters even when excluding the unprecedented collapse of 2008. Since 1997, 4Q periods (ex-2008) have seen EPS results fall 0.9% below the end-of-quarter consensus on average. This compares to a 1% rise for other quarters. The difference would be more extreme if 2008 was included.

We probably should have taken this seasonal anomaly into greater consideration in recent forecasts, particularly amid some modest evidence that changing seasonal patterns or seasonal adjustment itself has tended to *slightly* bias up economic reports in the winter months.¹

¹ Please see "Broken Seasonal Factors or Changing Seasonal Patterns," February 2, 2012 for discussion.

Recovering labor markets have a record of supporting revenue growth and profits too, if at a slower pace than early on in economic cycles.

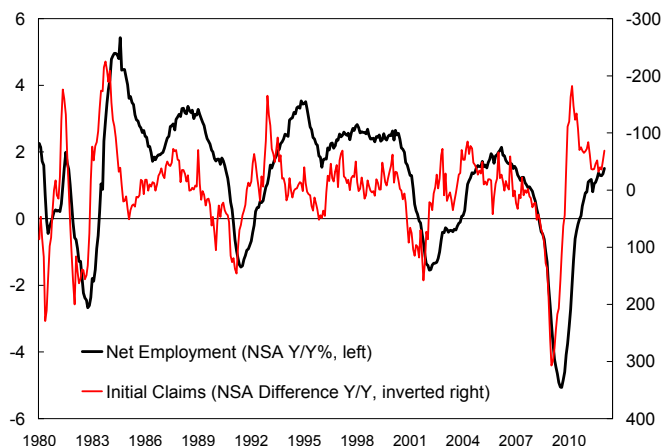
Just weeks ago, questions remained if labor income gains would prove adequate to sustain expansion.

In adjusting forward-looking EPS forecasts, we've taken into account firmer signs for the domestic expansion against the latest disappointing tracking data for profits - which reversed surprisingly strong 3Q results.

The decline in the path of jobless claims and firming in every net U.S. employment measure suggests a durable, self-reinforcing U.S. expansion (see figures 5-8). Furthermore, recovering labor markets have a record of supporting revenue growth and profits too, if at a slower pace than early on in economic cycles (see figures 9-10). This is because business labor costs for compensation get recycled into the consumer spending that is the revenues of other firms. This is unless the personal savings rate is rising significantly.

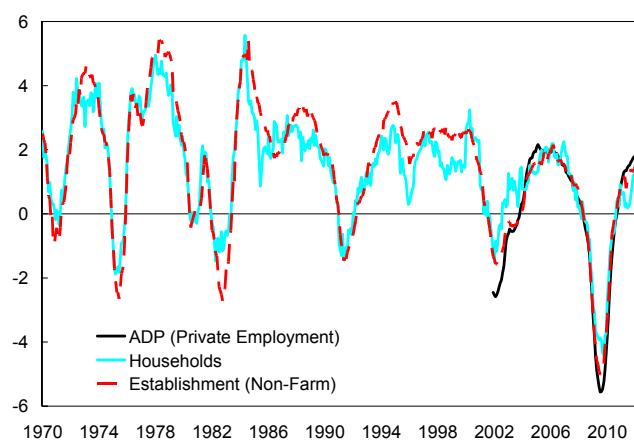
It should be understood as well though that the more than three-million net increase in employment during the past two years has merely kept pace with adult population growth (see figure 11).² As such, labor compensation gains are not about to rage broadly at the expense of profits. Not more than a few weeks ago, there was widespread questioning as to whether labor income gains would prove adequate to *sustain* expansion.

Figure 5. Non-Farm Employment Y/Y% and Initial Unemployment Claims Y/Y Difference (Not Seasonally Adjusted)



Sources: BLS

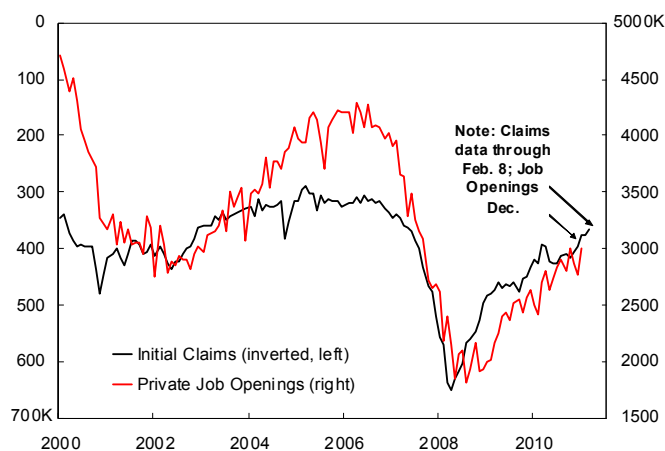
Figure 6. U.S. Employment: Establishment vs Household Survey Y/Y% Changes, Not Seasonally Adjusted, ADP Private Employment Est Y/Y%



Sources: BLS, ADP

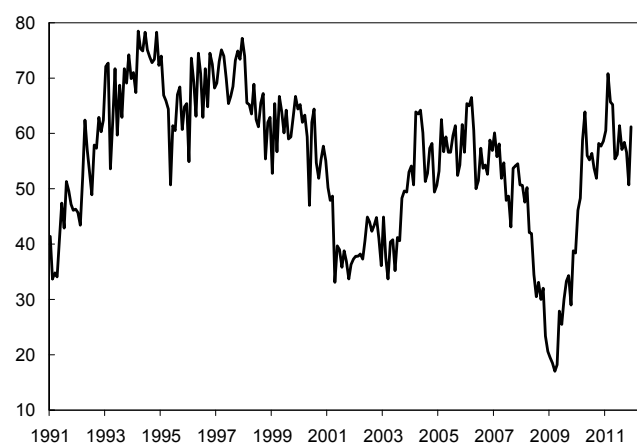
² Please see "Employment's Unpredictable Path," *Comments on Credit* by Robert Diclemente, February 10, 2012 for discussion.

Figure 7. Initial Jobless Claims vs Job Openings (Thousands)



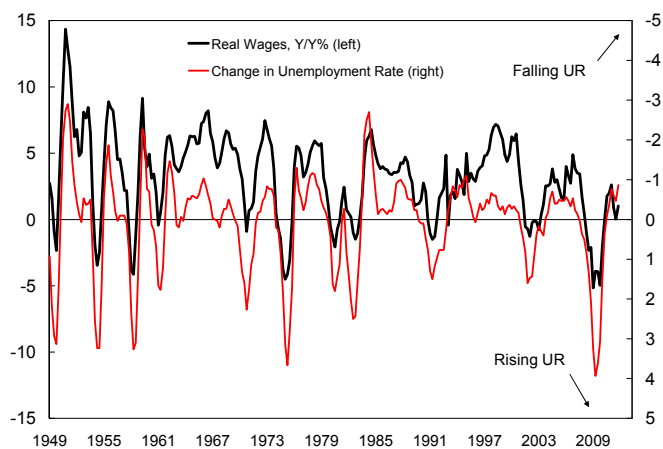
Sources: BLS

Figure 8. Diffusion Index: Share of Private Industries with Expanding Employment (%)



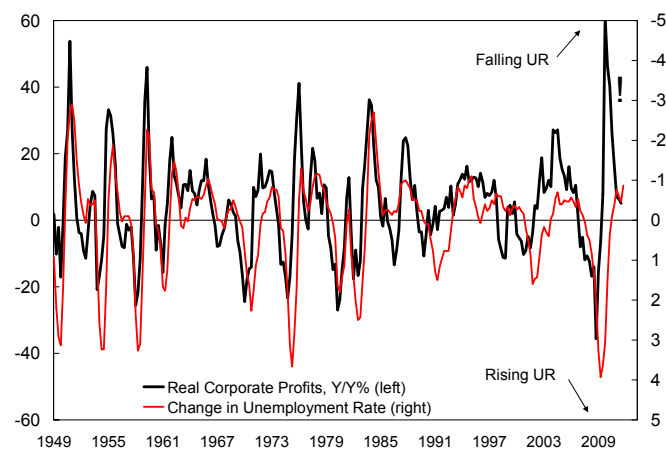
Sources: BLS

Figure 9. Real Wage Payments Y/Y% vs Difference (Y/Y) in Unemployment Rate (Inverted)



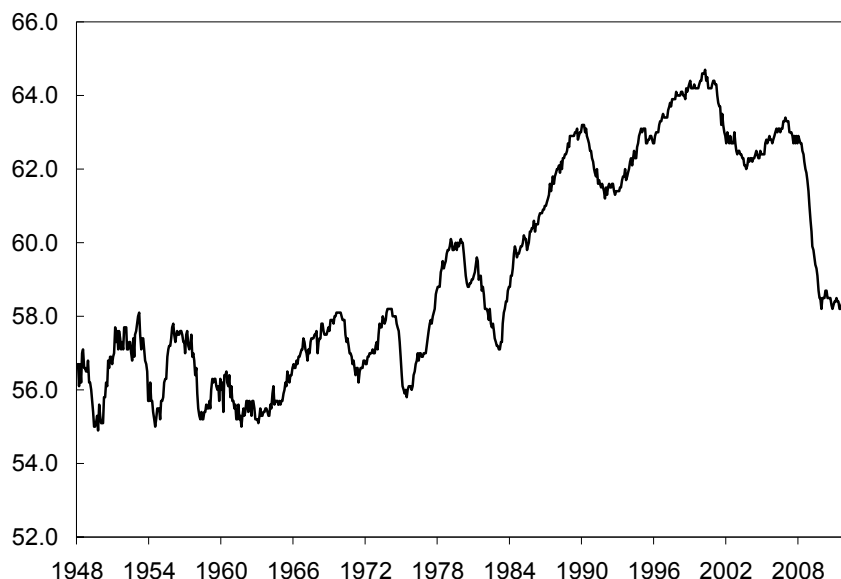
Sources: BLS, BEA

Figure 10. Real Corporate Operating Profits Y/Y% vs Difference (Y/Y) in Unemployment Rate (inverted)



Sources: BLS, BEA

Figure 11. Employed Share of the Population Age-16+ %

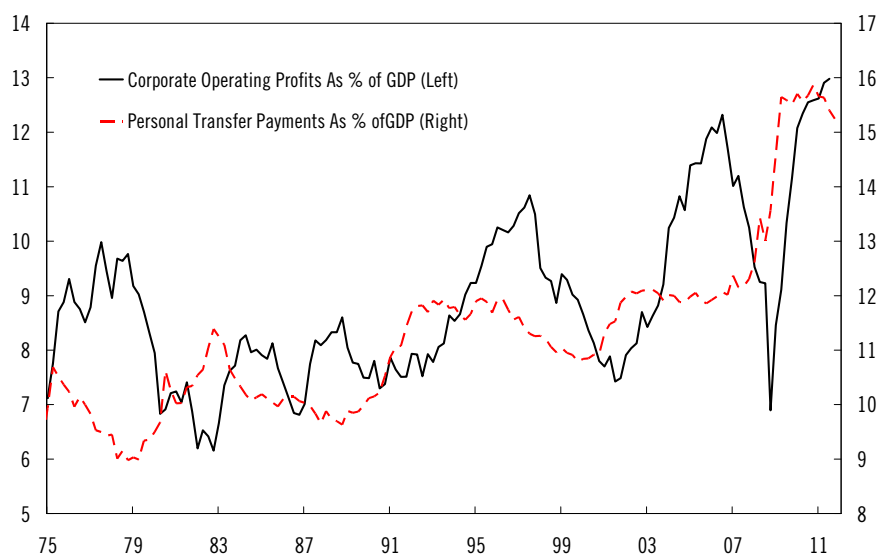


Source: BLS

Deficit financed transfers of personal income have fallen for a second consecutive quarter. This means private compensation or savings needed to offset any demand loss.

But another factor away from stronger output and compensation data has been at work, as we've long warned. Sharp increases in transfer payments of income, largely deficit financed, have boosted aggregate demand in recent years, incrementally providing "labor cost free" profits. But transfer payments/receipts fell for a second consecutive quarter in 4Q 2011 (see figure 12).

Figure 12. Corporate Operating Profits and Government Transfer Payments to Persons As % of GDP



Source: BEA Note: Transfer payments data through 4Q 2011, profits data 3Q 2011.

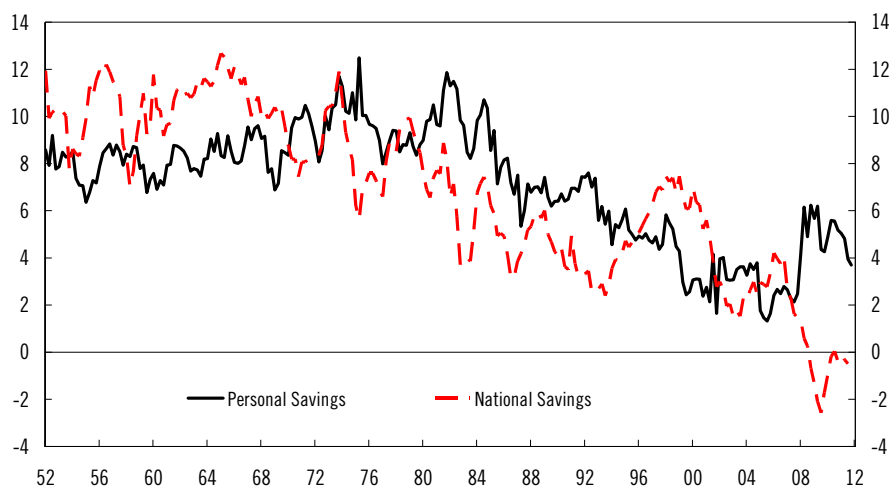
Even without the expiry of extended unemployment benefits, payments have fallen by \$32 billion over the past year already.

Even without an outright expiration of emergency duration unemployment benefits programs, the labor market recovery and individual benefits expirations have resulted in a \$32 billion drop in unemployment insurance payments over the past year. Roughly three fourths of such payments are covered by government outlays, which can be deficit financed, thus not requiring an immediate claim on other income. From the perspective of profit growth, private sector labor compensation and other sources of demand must make up for this drop in transfer income.

Overall, the replacement of fiscal easing with private demand is a very encouraging sign that could include some restoration of national savings (see figure 13). But it will continuously limit profit gains over the remainder of the expansion. As figure 14 shows, the business cycle expansion does not explain the latest 20% increase in EPS for S&P 500 firms. Easy, demand-augmenting fiscal policy does (see figures 15-16).

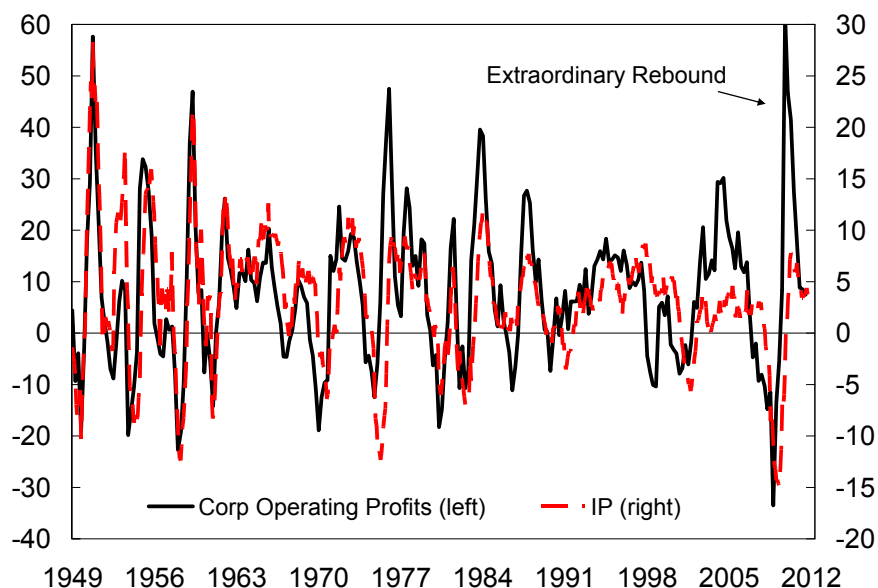
The strengthening of the expansion from a period of record high profits per worker is likely to improve labor markets more incrementally than profits, though it will also help sustain high profits and likely allow them to grow somewhat further as labor income gains push up revenues (see figures 17-18). This assumes shocks won't generate an entirely new economic contraction during the forecast horizon.

Figure 13. Personal Savings as % of Disposable Income vs Net National Savings as % of GDP



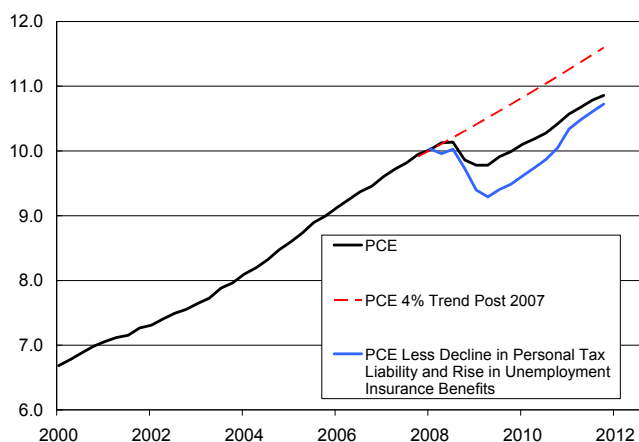
Sources: BEA, FRB Note: Personal savings data through 4Q 2011, national savings data 3Q 2011.

Figure 14. Corporate Operating Profits (National Accounts) vs Industrial Production Y/Y%



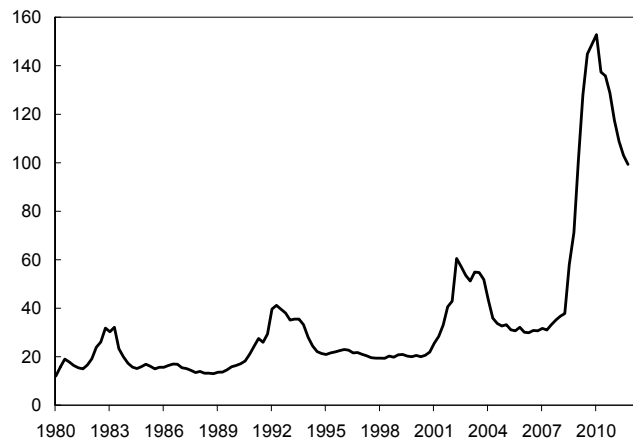
Sources: BEA, FRB Note: IP data through 4Q 2011, Profits 3Q 2011

Figure 15. Nominal Consumer Spending, Scale of Post 2007 Stabilizers and Level Assuming Trends Growth Rate through 2012 (\$ Trillions)



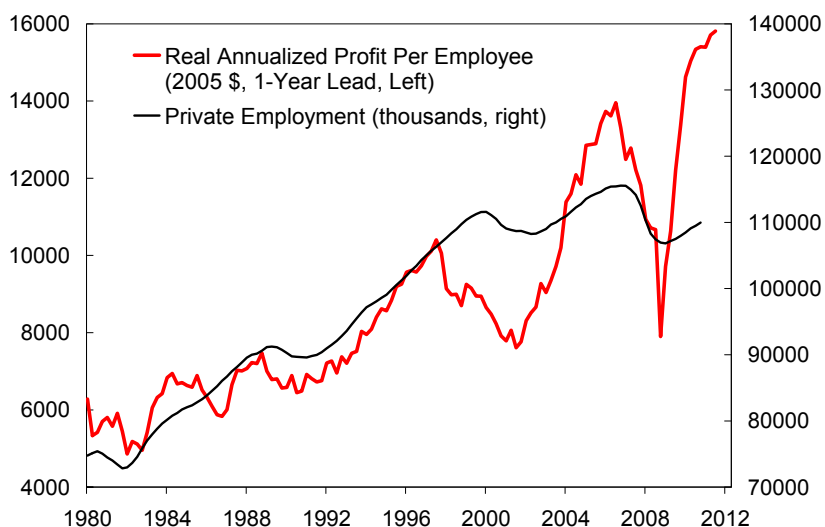
Sources: BEA, Citi Investment Research and Analysis Note: Post 2007 trend held to 4%, below 4 3/4% 20-year trend.

Figure 16. Government Transfer Payments of Unemployment Insurance, Billions of \$ SAAR



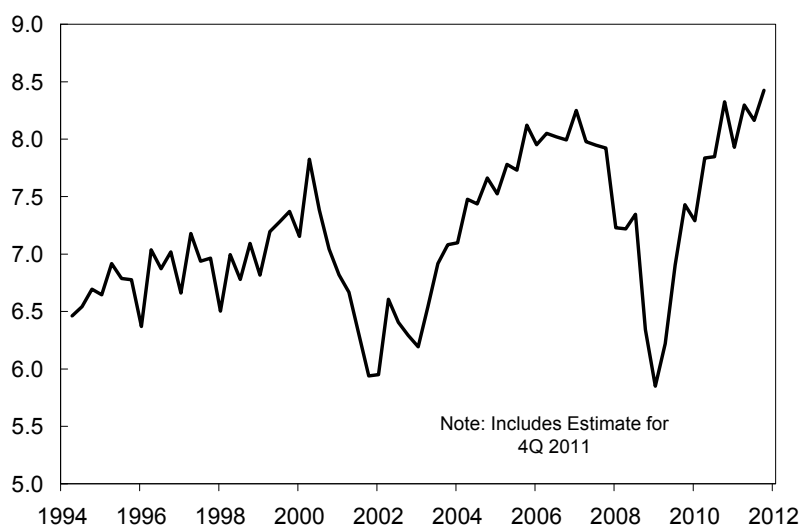
Source: BEA

Figure 17. Real Annualized Profit Per Employee (1-Year Lead) vs Private Employment



Sources: BEA, BLS Note: Employment data through 4Q 2011, profits 3Q 2011

Figure 18. S&P 500 Ex-Financials: Operating Profits as % of Sales



Sources: S&P, Factset, Bloomberg, Citi Investment Research and Analysis

Binary Events Drive Economic Outlook

The more immediate concern for profits is the persistence of economic expansion rather than the distribution of labor and capital income. While domestic activity has strengthened and broadened for the time being, the European sovereign debt crisis seems destined to produce more change in the outlook than it has to date (please see "The Outlook as a Minefield," January 23, 2012.)

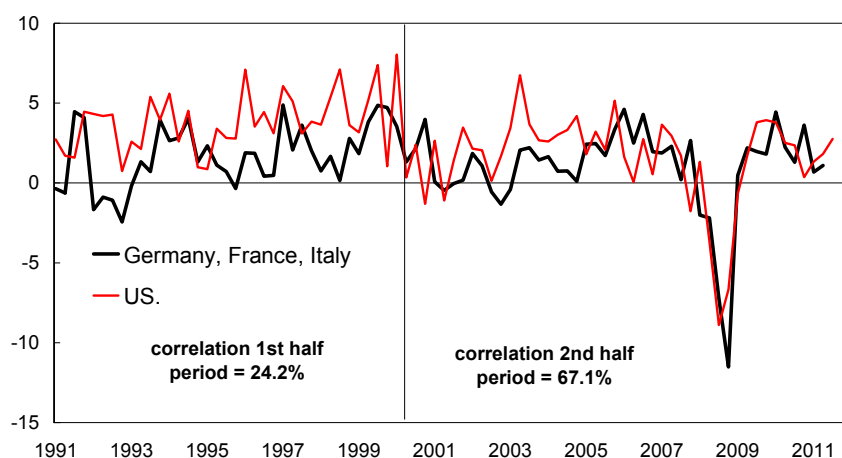
Financial markets have braced some for the possibility of a disorderly breakup of the Euro system. At worst, this is a very small probability, but with ramifications of catastrophic proportions. The least disruptive alternative scenario seems an

Regional slowdowns differ from cross-border shocks. Which of the two the Euro sovereign debt presents remains to be seen.

austerity-led contraction in the Euro periphery that is limited to weakening consumption in those countries, and with it, related trade flows.

As figure 19 shows, the correlation between quarterly U.S. GDP growth and the larger European economies has been 67% in the past 10 years. But if the 2008/2009 period is excluded, the correlation drops to 19%, essentially the same low level of the prior decade. We believe this illustrates that the path for the global expansion isn't explained by its slowest regional growth rate. Cross border impact depends on whether the weak regions triggers substantial shocks within others, as was the case in 2008/2009, led by the U.S.

Figure 19. Real U.S. GDP vs Large Europe Aggregate Q/Q% Change SAAR



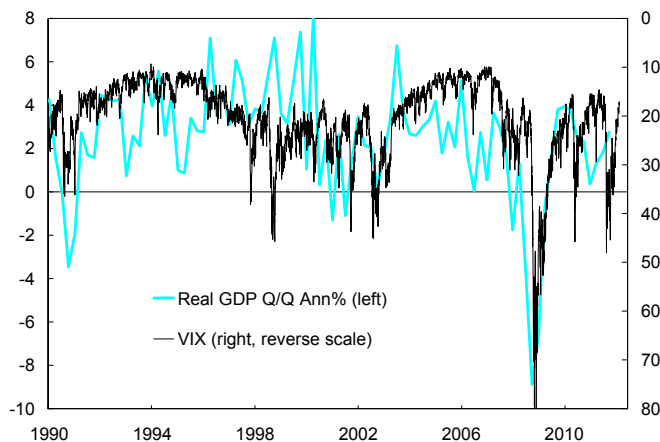
Sources: BEA, Haver Analytics, Citi Investment Research and Analysis

As figures 20-21 show, some of the signs in financial markets have already suggested such a collective shock could take place. This drove down profits in the sentiment-sensitive financial sector in 4Q 2011. As figure 22 shows, this is a precursor to declines in non-financial profits with a lag. However, the latest observations on these same stress indicators have moved in the direction of stability.

New signs of near-term stability, but unclear in duration.

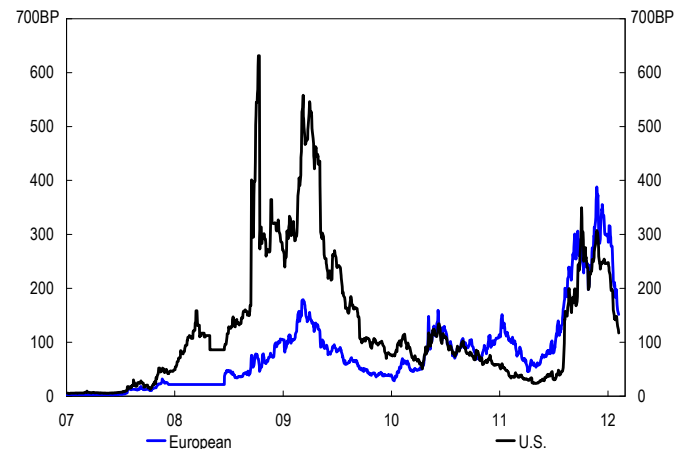
At the present stage, the impact of financial events will be just at the *very beginning stages* of pass through to the real economy. However, we should also acknowledge some signs that near-term economic performance, even in likely areas of future weakness, are showing somewhat more vigor than we had feared (see figure 23).

Figure 20. Real GDP Q/Q % Change SAAR vs Daily S&P 500 VIX



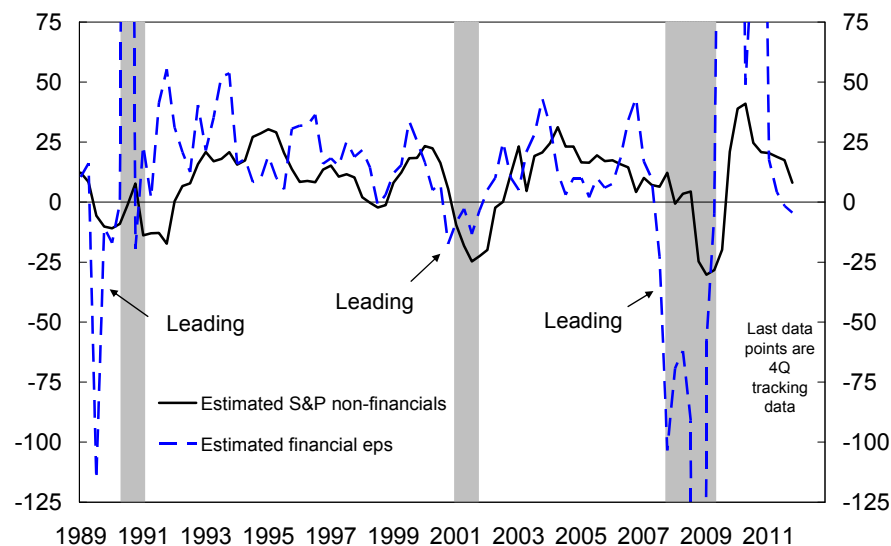
Sources: BEA, CBOE, Haver Analytics

Figure 21. Index of Large Financial 1yr CDS, Euro area vs U.S. Firms



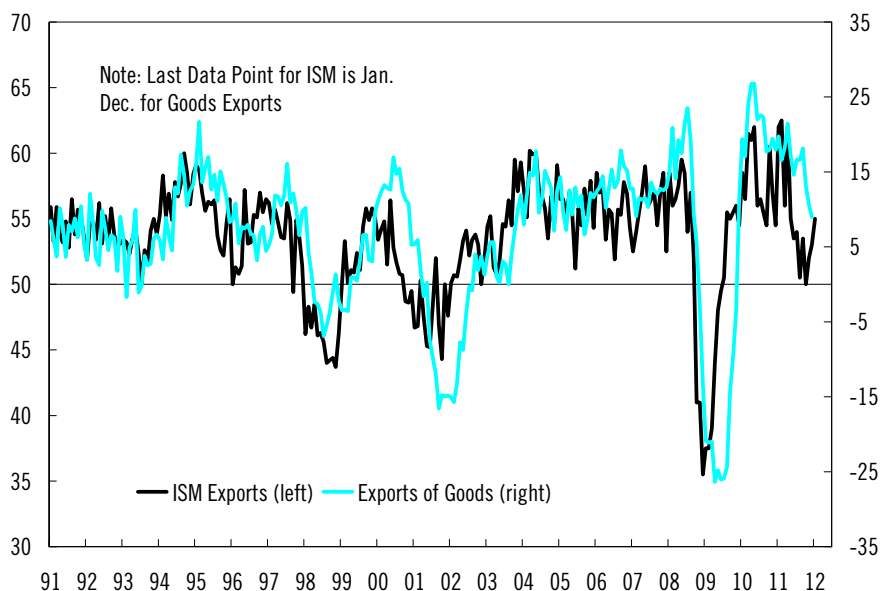
Sources: Bloomberg, Citi Investment Research and Analysis

Figure 22. S&P Financial vs Non-Financial Operating Profits, Y/Y%



Sources: S&P, Thomson Financial, Bloomberg, Citi Investment Research and Analysis Note: figure shows absolute value % changes constrained to +75%, -125%.

Figure 23. ISM Export Orders Index vs Nominal U.S. Goods Exports Y/Y%



Sources: Census, ISM

Towards the end of 2012, the U.S. will confront automatic and severe fiscal tightening and likely consider mitigating steps.

Of course, the extent and duration of the latest improvement in risk tolerance amid challenges in Europe remains to be seen (please see “Rising Risks of Greek Euro Area Exit,” Willem Buiter, Ebrahim Rahbari February 6, 2012). Towards the end of 2012, likely following U.S. Presidential and Congressional election results, markets will need to confront the sharp tightening in fiscal policy that would occur in the absence of an alternative agreement between both congressional chambers and the President (see figures 24-25).

Figure 24. Expiring Fiscal Stimulus Measures, Jan 2013

	Billions of Dollars	Percent of GDP
Bush Tax Cuts — Top Two Tax Brackets	\$55	0.4%
Bush Tax Cuts — Other Measures	195	1.3
99-Week Unemployment Insurance Benefits	50	0.3
2% Payroll Tax Cut	110	0.7
3.8% Medicare Tax on Investment Income	20	0.1
BCA Sequester	95	0.6
Total Fiscal Contraction	\$525	3.4%

Sources: Congressional Budget Office and Citi Investment Research and Analysis.

Figure 25. Simulated Economic Impact of Expiring Fiscal Measures (Percentage Point Differences from Base Case), 2013

All Scheduled Tightening	1Q	2Q	3Q	4Q	4Q/4Q 2013
Real GDP	-7.4	-4.6	-2.3	-1.7	-4.0
Domestic Demand	-8.6	-4.9	-3.2	-2.6	-4.7
Consumer Spending	-7.3	-3.7	-2.9	-2.3	-4.1
Most Bush Tax Cuts Remain	1Q	2Q	3Q	4Q	4Q/4Q 2013
Real GDP	-5.2	-3.5	-1.6	-1.1	-2.9
Domestic Demand	-6.0	-3.6	-2.1	-1.7	-3.3
Consumer Spending	-4.0	-2.6	-2.0	-1.6	-2.6

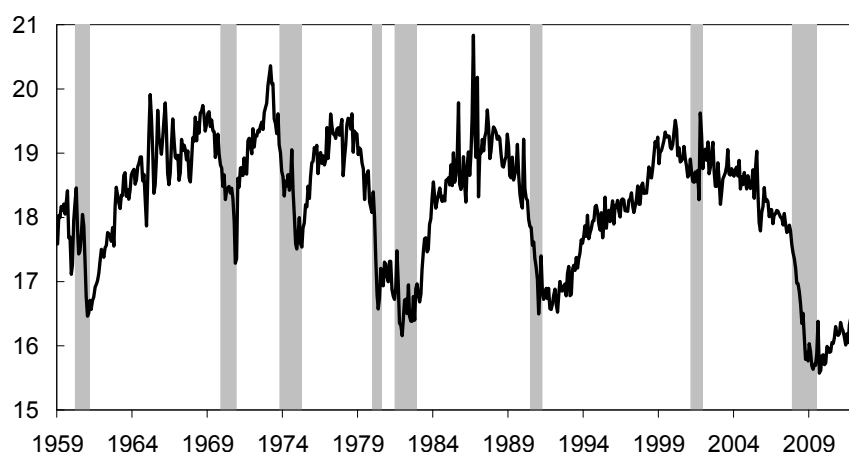
Notes: These results are based on simulations using a standard macro model incorporating the fiscal policy changes in Figure 5. The second set of results includes only the rise in the top two tax brackets from the Bush tax cuts and all the other new taxes and spending cuts. Please see “The Outlook for 2012,” Robert Diclemente et al, Dec. 14, 2011 Source: Citi Investment Research and Analysis.

Growth Rarely Remains So Close to Trend

Our current outlook, for growth near 2% in both 2012 and 2013, represents a continuation of a current “unhappy stalemate” that in fact, is unlikely to remain indefinitely. Growth is constrained unusually near trend as potential, binary events either pull activity lower, or allow significant pent up demand and deep private sector restructuring to show through to a more substantial recovery (see figure 26).

To be clear, our baseline forecast does anticipate significant incremental fiscal spending restraint in 2013, which might possibly be mitigated. But it also delays significant tax increases, as has been routine in the past few years, but such might not be the case either.

Figure 26. “Discretionary” Consumer Spending as % of Total Consumer Spending



Sources: BEA and Citi Investment Research and Analysis.

Aside from the severe impact suggested by a possible if unlikely sharp fiscal tightening in 2013, investors in equities and other asset classes might want to consider again the unique issue of dividend tax policy.

Many questions on tax policy will come to a head late this year.

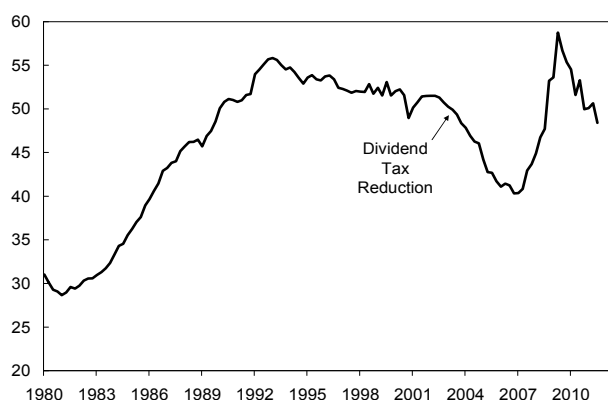
Corporations can only pay dividends from their after tax profits. Only profitable firms that are taxed at the higher end of effective tax rates pay them. While few firms pay the statutory maximum 35% corporate tax rate, the effective corporate tax rate including unprofitable firms was 24.6% on average in the 10 years through 2010, even with two recessions during the period. Debt, on the other hand, is fully tax deductible and can be used to repurchase shares, even theoretically by unprofitable firms.

Since the top individual income tax rate on dividends was cut to 15% in May 2003 from 35%, S&P 500 dividend payments have increased at a 5.6% compounded rate. But this includes the 20.4% drop of 2009, the largest annual drop since 1942. In the initial years after the tax rate reduction, gains were stronger, averaging a 9.0% rate, far above the prior 40 year growth rate of 5.2%, which included periods of much more rapid inflation.

Impressively, total national corporate dividend payments rose at an 18.1% rate from 2003-2007. Ordinary corporate dividends that qualified for the lower tax treatment rose sharply within the larger national figure.

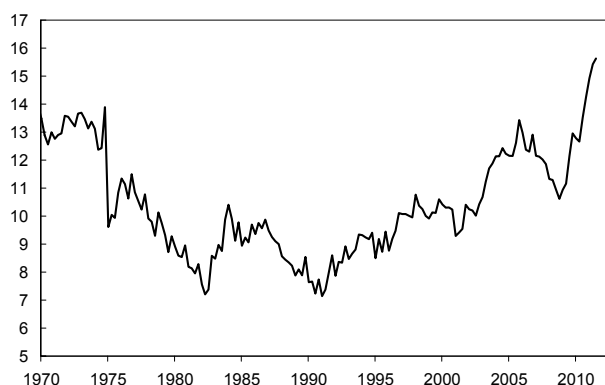
While influenced more significantly by other factors - particularly the LBO boom of the mid 2000s followed by deep recession and subsequent risk aversion - since the change in dividend tax policy, non-financial corporate balance sheets have become healthier, and thus more shock resistant (see figures 27-28).

Figure 27. Credit Market Debt/Net Worth: Non-Farm Non-Financial Corporations



Source: FRB

Figure 28. Total Liquid Assets as % of Liabilities: Non-Farm Non-Financial Corporations

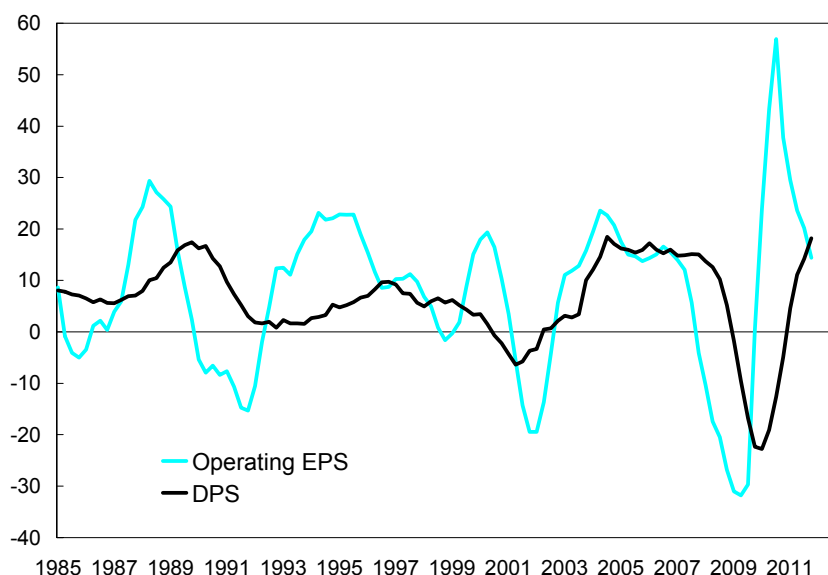


Source: FRB

S&P 500 dividend payments soared 16.7% in 2011. From a currently still low payout ratio, dividend payments would likely continue rising near a double-digit pace in the next two years if top dividend tax rates were constrained to a range near 20% (see figure 29). From the perspective of economic growth, dividend payments might be a less than an ideal way of recycling profits. However, the income and investments dividend payments generate and fund still seem superior to merely hoarding retained earnings.

If tax rates were stable, we believe DPS growth could remain near double-digits for the next two years or longer.

Figure 29. S&P 500 Operating EPS vs Dividends Per Share (4-Quarter Averages) Y/Y%



Sources: S&P and Thomson Financial.

However unlikely, moving from a 15% maximum personal dividend tax to 43.4% significantly reduces after-tax returns on equities, and would imply a measurable drop in their value.

Concrete discussions of how to mitigate personal income tax increases are likely to come first, and only with the clarity of election results. But we would view a restoration of the maximum personal income tax rate on dividend income - 39.6% in 2013 with an additional 3.8 percentage point to 43.4% to fund expanded federal healthcare benefits - as likely to kill off the trend of rising dividend payments. These taxes, collected on corporate income after taxes of up to 35% are paid, could mean that as little as 36.8 cents of a pre-tax profit could be distributed to a share holder if both the corporation and share holder pay maximum statutory rates. This includes only the Federal income taxes, not any state or local levies.

In valuing any effect in markets, we have always taken the view that investors value retained earnings, not just dividend payments. But the difference in the value of a higher tax stream collected by the Treasury from investors compared to a lower tax stream should be capitalized, as this strictly and quantifiably reduces after-tax returns.

In 2011, we estimate the taxes collected on qualified dividends totaled \$18.2 billion. At the higher 2013 tax rates embedded in current law, and assuming dividend payments slow sharply to a mere 3% future growth rate, we estimate the capitalized value of the lost income stream to investors near \$1.0 trillion, or 8% of the S&P 500's value.³ If dividend payments stopped growing all together but didn't fall, the loss in value would be roughly half that amount.

³ The current maximum statutory individual dividend tax rate is 15%. But the effective rate paid on qualified dividends was most recently reported at 11.7%. So we estimate an increase in the effective rate to 33.9% for this exercise. Our estimates of total taxes paid at current rates in 2013 would be \$20.5 billion, at the higher rate \$59.3 billion, for a difference of \$38.8 billion. At a 3% future growth rate and a 6.2% discount rate (our current estimate of required equity return), the capitalized value of this dividend stream is \$1.2 trillion. However, a small portion of qualified dividend taxes are paid by corporate and other entities, and as such we use a \$1 trillion value, or \$500 billion under a zero dividend growth scenario.

Sector Earnings Estimates Updated

Our revised industry sector earnings estimates and related valuation measures are in figures 30-31. Once again, the revisions largely reflect the 4Q 2011 results that deviated meaningfully from our expectations, which were above consensus. Actual results were very mildly above consensus.

Figure 30. S&P 500 Sector EPS Growth (%) Forecasts: Consensus vs. Citigroup (GICS Classifications)

							Consensus: Feb 2012		Citi Forecast	
	2005	2006	2007	2008	2009	2010	2011F	2012F	2011F	2012F
S&P 500 Total	13.8	15.2	(4.1)	(26.8)	0.4	38	16	7	14	3
Consumer Discretionary	(2)	7	(12)	(52)	53	48	12	8	17	7
Consumer Staples	7	6	10	11	3	6	8	3	6	3
Energy	51	23	4	19	(59)	51	36	(0)	38	2
Financials	7	24	(33)	(-132)*	243.3*	115	6	8	(1)	2
Health Care	10	8	12	8	1	12	6	3	6	4
Industrials	19	14	12	(1)	(34)	28	21	9	21	8
IT	17	11	17	3	(8)	43	19	20	16	7
Materials	22	30	6	(7)	(51)	85	31	5	33	(13)
Telecom Services	14	19	24	(9)	(24)	(4)	(2)	4	(2)	2
Utilities	16	11	13	1	(2)	5	4	(4)	2	3

Sources: Bloomberg, Factset, and Citi Investment Research and Analysis.

Figure 31. S&P 500 Sector Earnings and Market Cap as Percent of Total

Sector	Citigroup Estimated Sector Earnings Share of Total S&P (%)					Change in Earnings Share (Pct Pts)				Market Cap %	PE Multiples			
	2008	2009	2010	2011	2012	2009	2010	2011	2012		2009	2010	2011	2012
S&P 500											14.6	12.8	13.3	
Consumer Discretionary	5.4	8.4	9.0	9.3	9.6	3.0	0.6	0.3	0.3	10.8	19.9	17.2	14.7	15.0
Consumer Staples	13.3	13.3	10.2	9.6	9.5	0.1	(3.1)	(0.6)	(0.1)	10.8	14.9	15.1	15.4	15.0
Energy	25.9	10.9	11.9	14.5	14.3	(15.0)	1.0	2.6	(0.3)	12.0	18.4	14.7	10.8	11.2
Financials	(8.3)	11.9	18.5	16.2	15.9	20.2	6.6	(2.3)	(0.3)	14.3	21.1	12.6	10.6	11.9
Health Care	17.7	17.9	14.5	13.6	13.6	0.2	(3.4)	(0.9)	0.0	11.4	12.3	10.9	11.2	11.1
Industrials	15.2	10.5	9.7	10.4	10.8	(4.7)	(0.8)	0.7	0.4	10.9	17.0	16.4	13.2	13.4
IT	17.4	16.5	17.0	17.5	18.0	(0.9)	0.6	0.4	0.5	19.9	21.1	15.9	14.0	14.7
Materials	4.3	2.0	2.7	3.2	2.7	(2.2)	0.7	0.5	(0.5)	3.7	30.7	19.9	13.9	18.1
Telecom Services	4.6	3.8	2.7	2.3	2.3	(0.8)	(1.2)	(0.4)	(0.0)	2.7	14.4	17.0	17.6	15.8
Utilities	4.6	4.7	3.6	3.2	3.2	0.1	(1.1)	(0.4)	(0.0)	3.5	13.7	13.3	15.3	14.3

Sources: Bloomberg, Factset, and Citi Investment Research and Analysis.

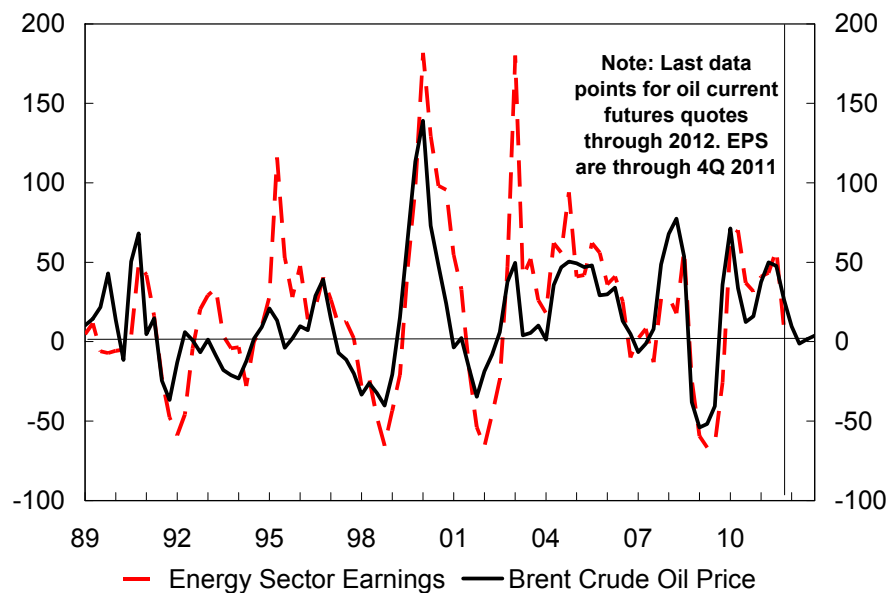
Some aspects of the domestic outlook have improved, and therefore argue against sharp revisions to 2012 estimates at this time. However, some drivers of sector revisions stand out. Unusually, the global crude oil price has firmed since our estimates were last revised in the fall 2011. While 4Q Energy sector results fell short of the robust global price as other aspects of the industry besides marketing petroleum lagged, the more solid trajectory for energy futures is a large part of our forecast maintaining overall EPS results for the S&P 500 in 2012. Even with EPS estimates somewhat less robust than the projected change in the crude oil price, our Energy sector estimate was revised from a 5% projected decline in 2012 to a 2% gain (see figure 32).

Unusual firming in petroleum and softening in other industrial commodity prices. Our estimates reflect a very heavy energy sector EPS weighting.

In complete contrast, non-energy industrial materials prices have fallen below the trajectory of our last update, suggesting a deeper 13% EPS decline compared with 5% previously (see figure 33). In general, we believe industrial commodities prices reflect changes in the trajectory of real economic growth more rapidly than anything aside from financial assets.

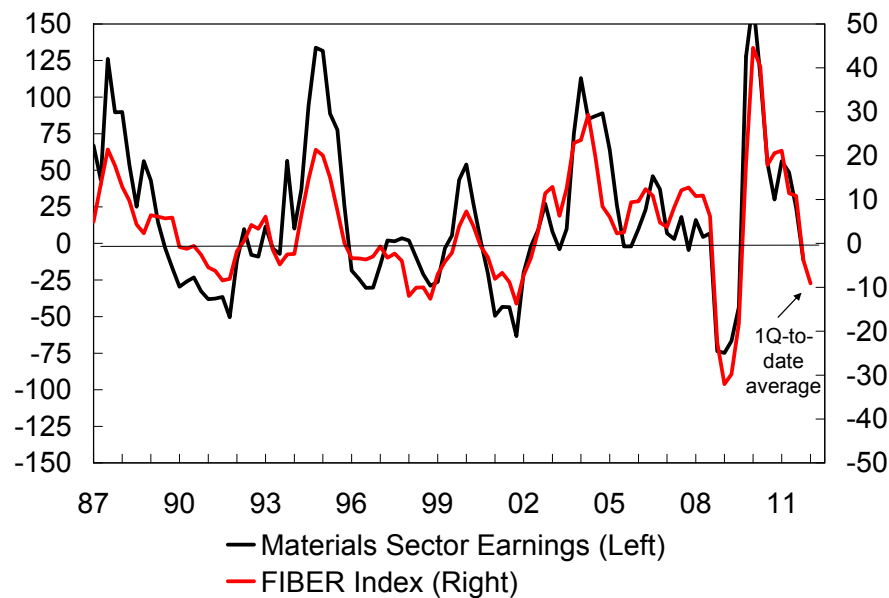
In the initial period of global slowdowns following commodity booms, early cycle declines in commodity prices provide some benefit to late cycle industrial commodity consumers. Meanwhile, strong capital investment continues in commodity industries until prices decline very sharply. This suggests continued EPS outperformance for the Industrial sector in 2012 (see figure 34).

Figure 32. S&P 500 Energy Sector vs Brent Crude Oil Price Y/Y%



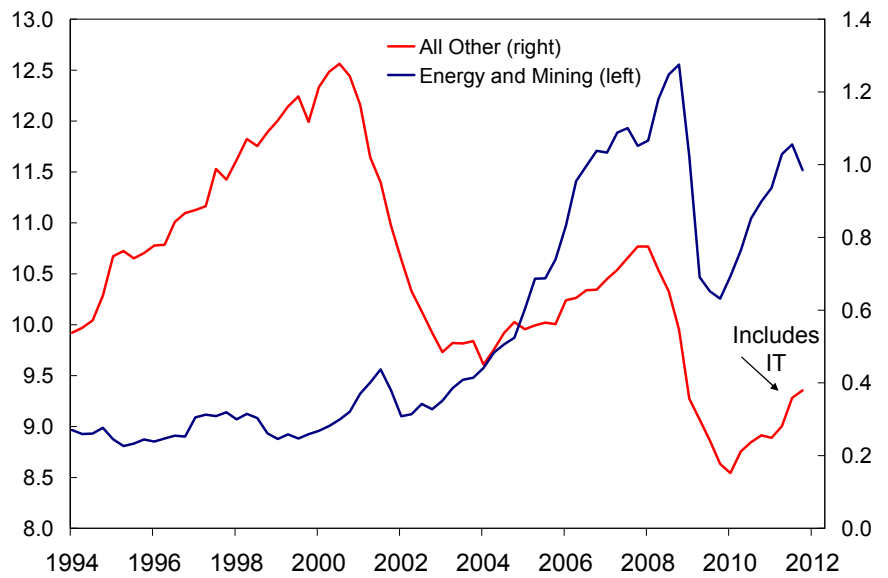
Sources: S&P, Thomson Financial, Factset, Haver Analytics

Figure 33. S&P Materials Sector EPS and FIBER Index of Industrial Materials Prices Y/Y%



Sources: FIBER and Citi Investment Research and Analysis.

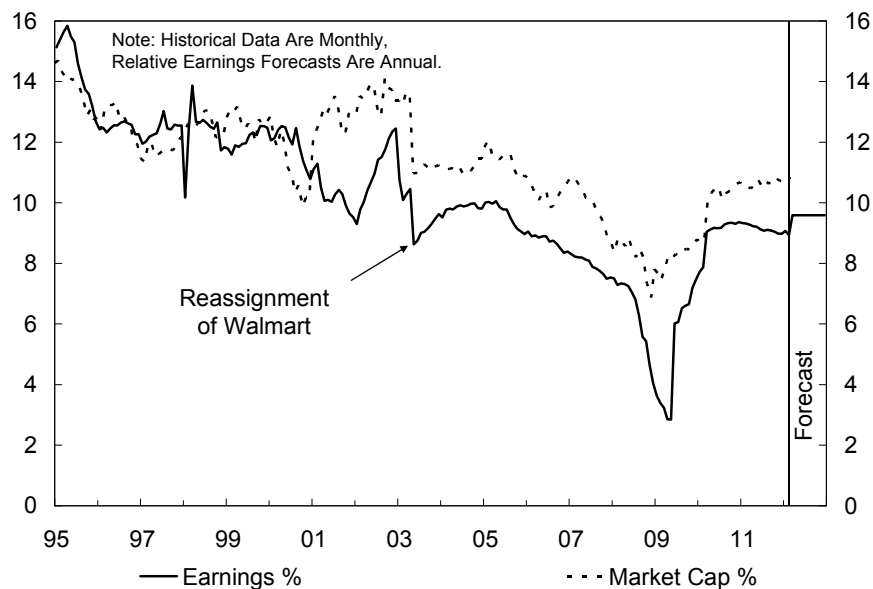
Figure 34. Non-Residential Fixed Investment: Energy and Mining vs All Other as % of U.S. GDP



Sources: BEA and Citi Investment Research and Analysis.

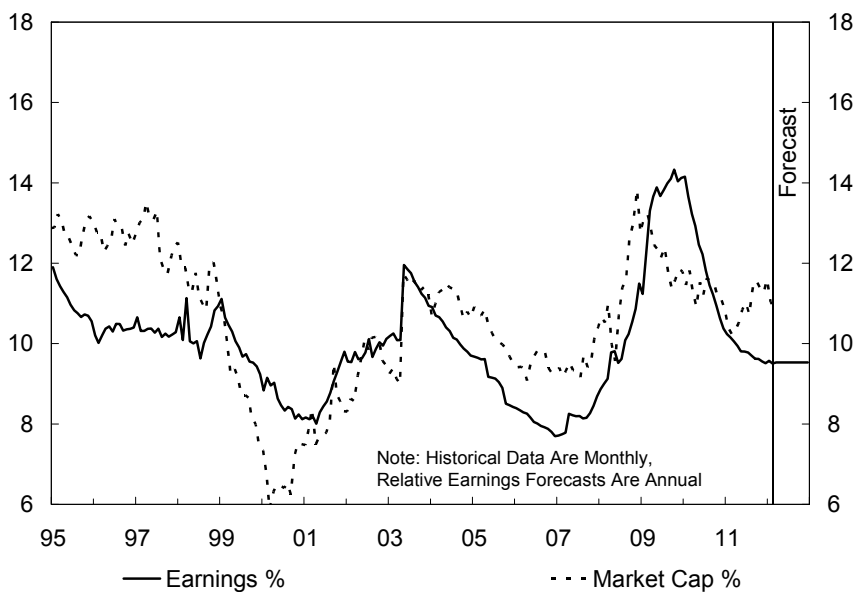
Sector Market Cap, Earnings Contributions

Figure 35. Consumer Discretionary Sector Market Cap & Earnings as % of S&P Total



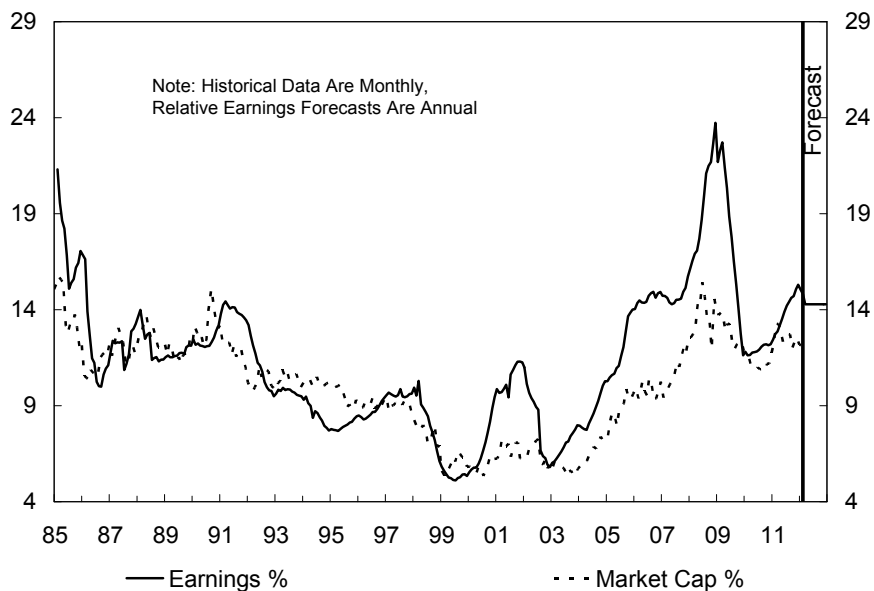
Sources: S&P, Thomson Financial, Factset, and Citi Investment Research and Analysis.

Figure 36. Consumer Staples Sector Market Cap & Earnings as % of S&P Total



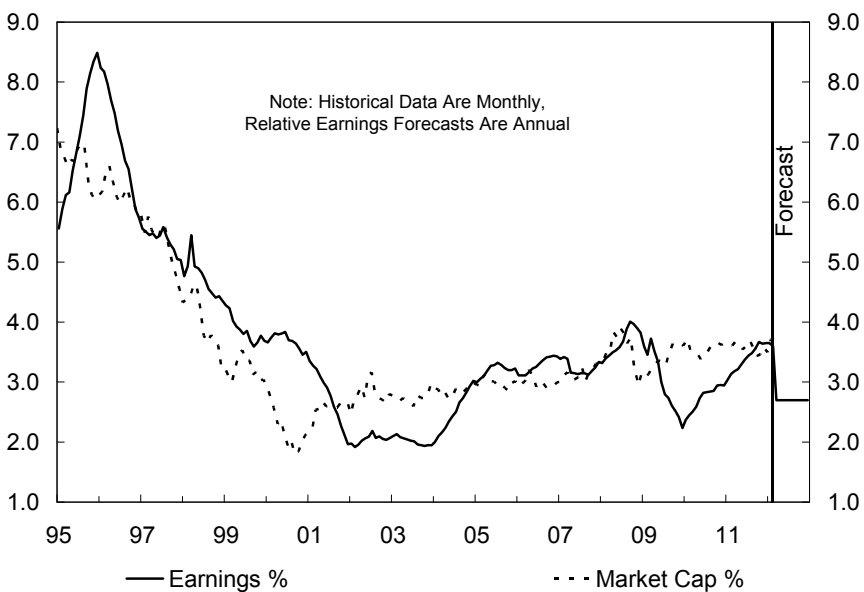
Sources: S&P, Thomson Financial, Factset, and Citi Investment Research and Analysis.

Figure 37. Energy Sector Market Cap & Earnings as % of S&P Total



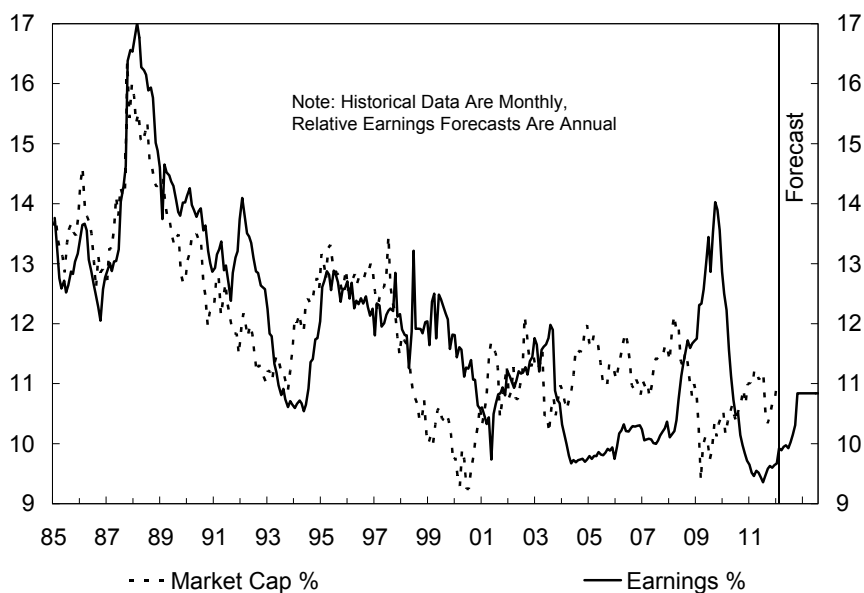
Sources: S&P, Thomson Financial, Factset, and Citi Investment Research and Analysis.

Figure 38. Materials Sector Market Cap & Earnings as % of S&P Total



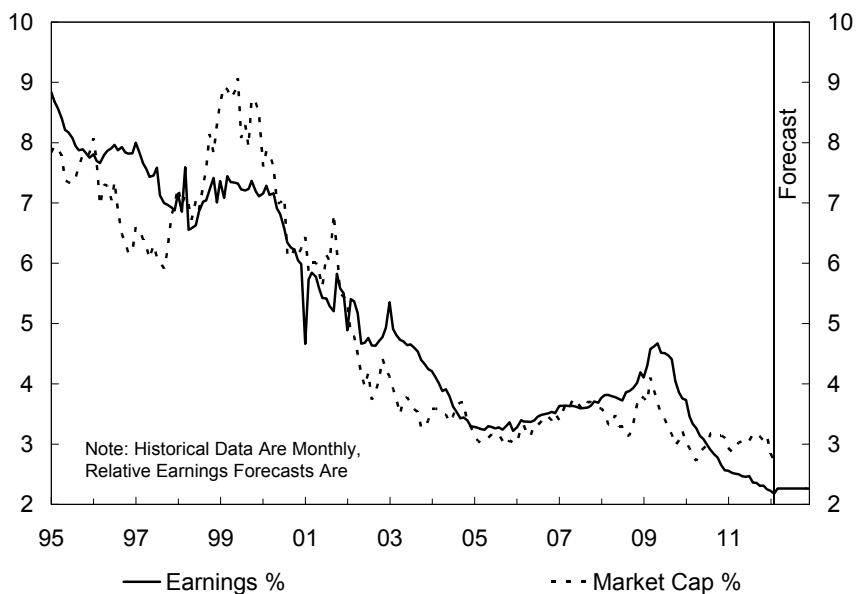
Sources: S&P, Thomson Financial, Factset, and Citi Investment Research and Analysis.

Figure 39. Industrials Sector Market Cap & Earnings as % of S&P Total



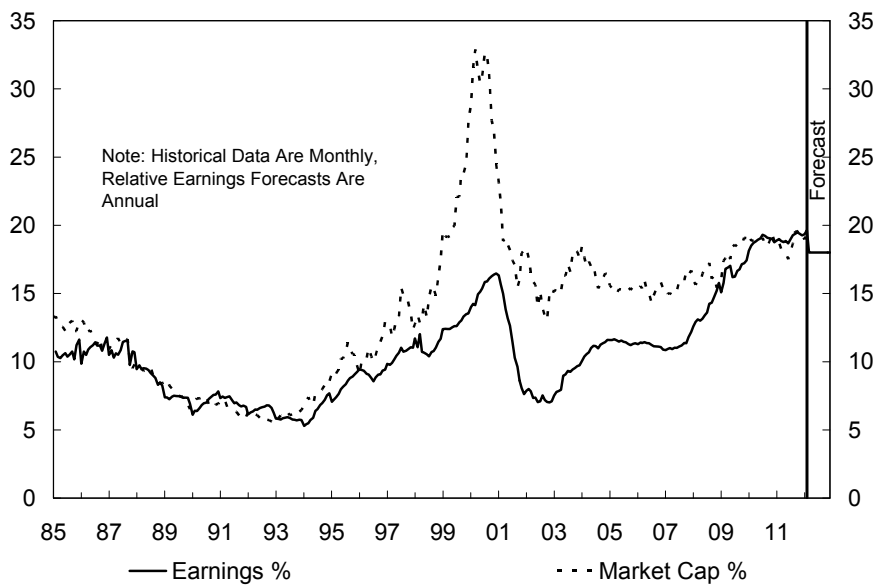
Sources: S&P, Thomson Financial, Factset, and Citi Investment Research and Analysis.

Figure 40. Telecom Services Sector Market Cap & Earnings as % of S&P Total



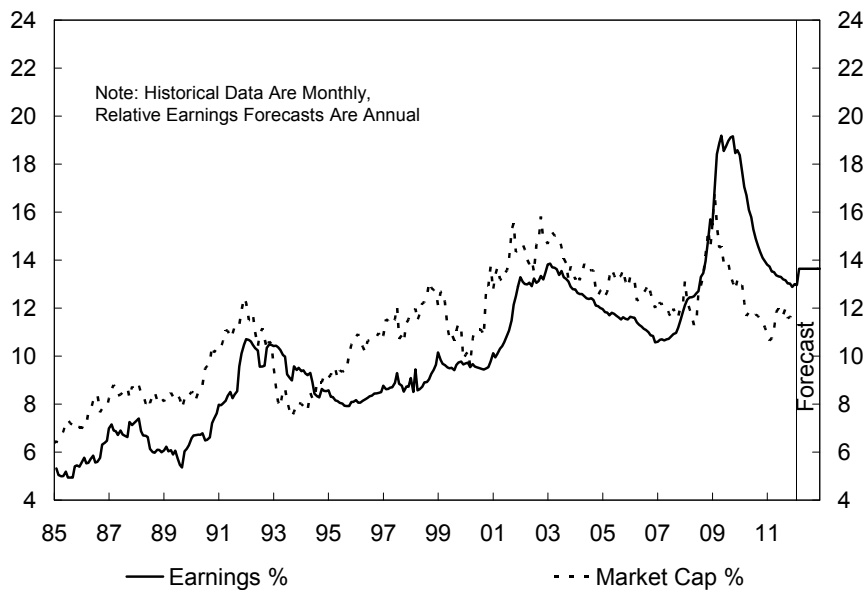
Sources: S&P, Thomson Financial, Factset, and Citi Investment Research and Analysis.

Figure 41. IT Sector Market Cap & Earnings as % of S&P Total



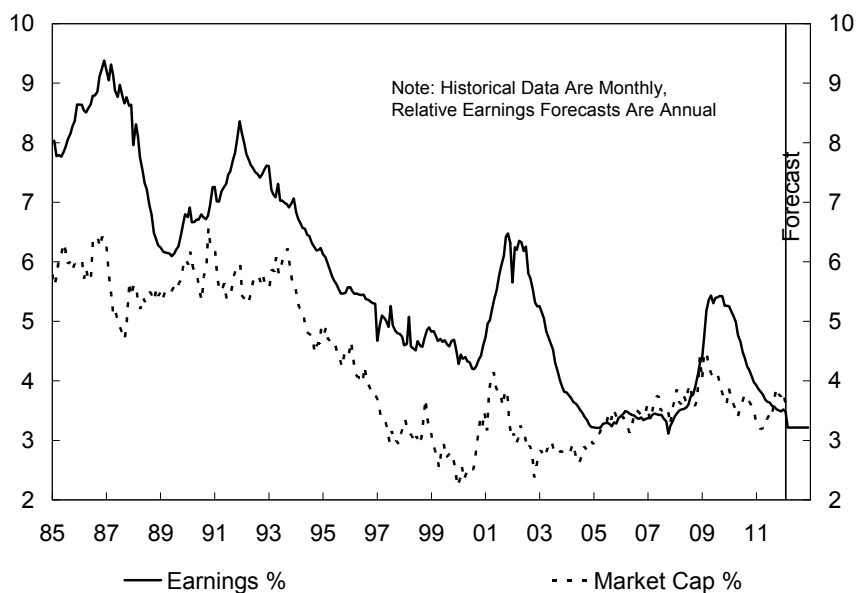
Sources: S&P, Thomson Financial, Factset, and Citi Investment Research and Analysis.

Figure 42. Healthcare Sector Market Cap & Earnings as % of S&P Total



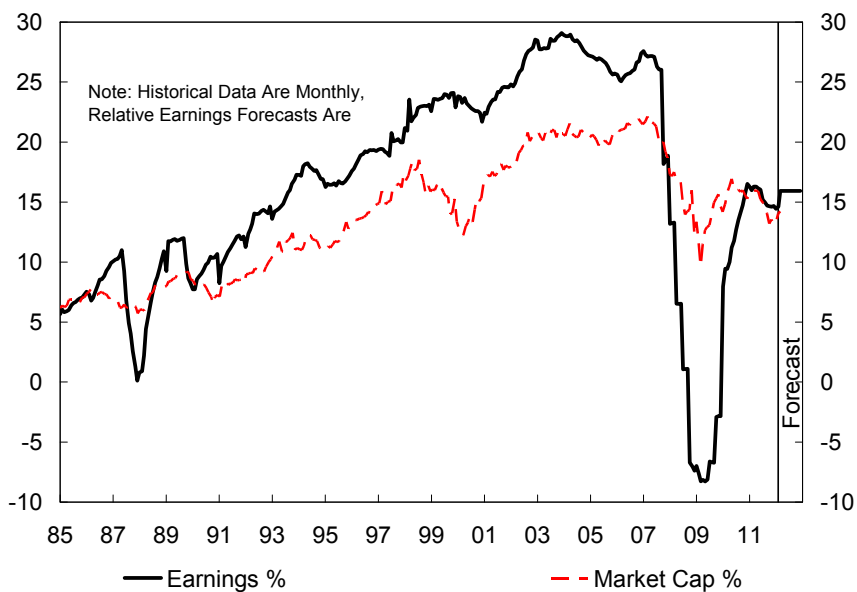
Sources: S&P, Thomson Financial, Factset, and Citi Investment Research and Analysis.

Figure 43. Utilities Sector Market Cap & Earnings as % of S&P Total



Sources: S&P, Thomson Financial, Factset, and Citi Investment Research and Analysis.

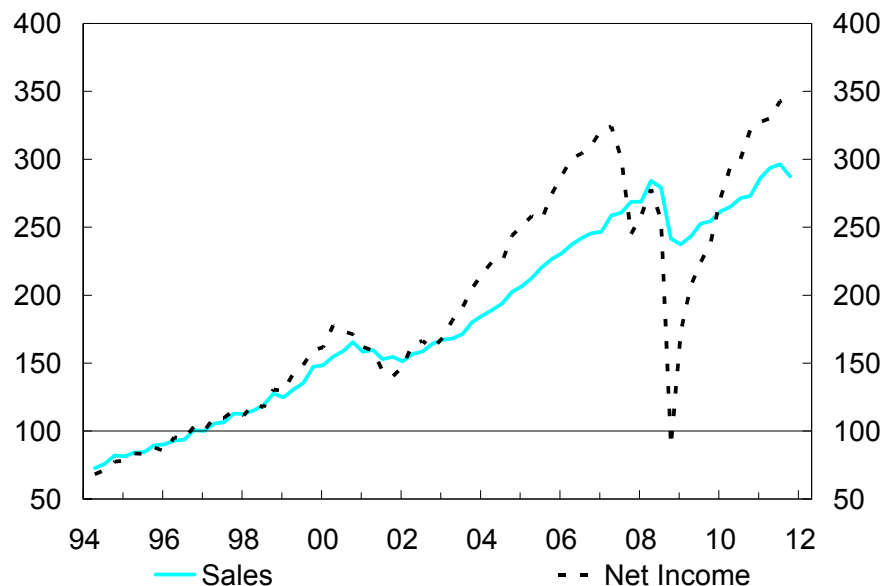
Figure 44. Financial Sector Market Cap & Earnings as % of S&P Total



Sources: S&P, Thomson Financial, Factset, and Citi Investment Research and Analysis.

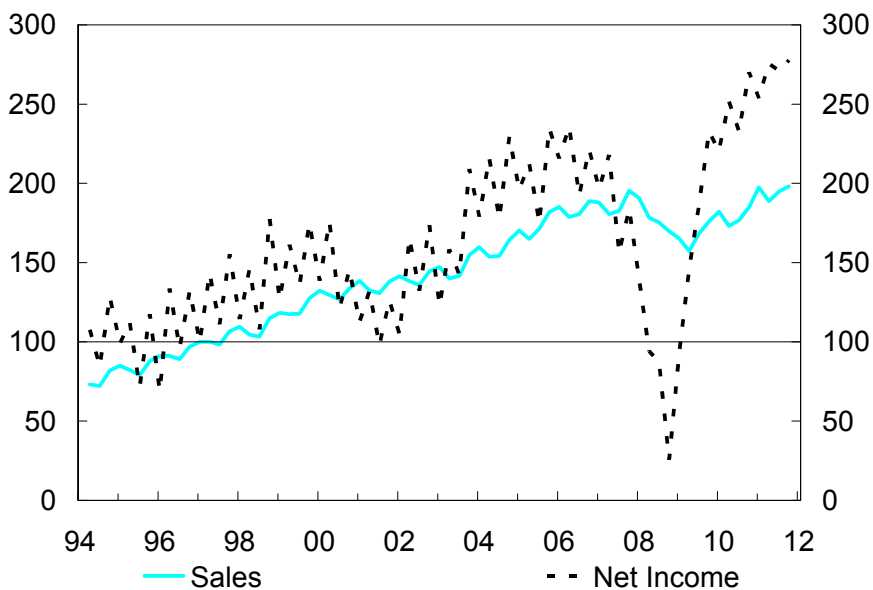
Sector Revenue and EPS Indices

Figure 45. S&P 500 Operating EPS and Revenue Indices 1Q 1997=100



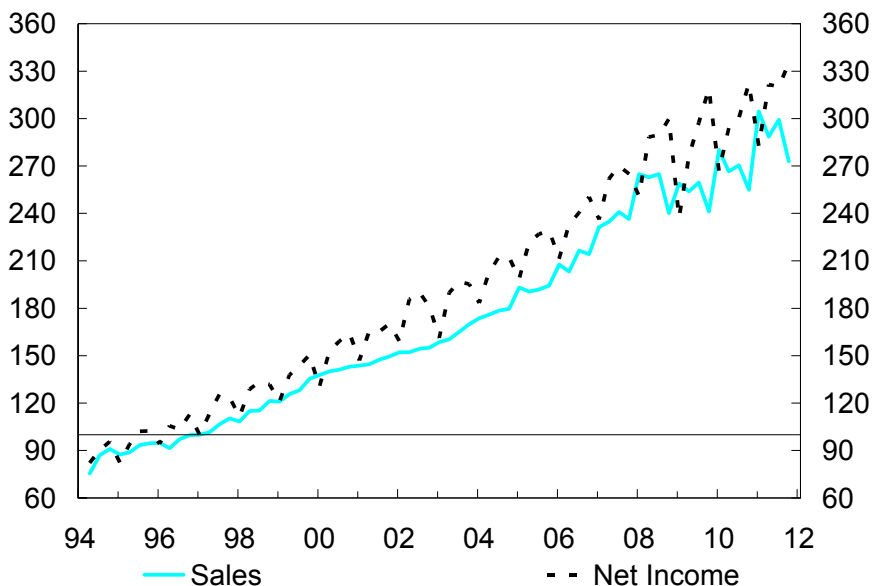
Sources: S&P, Thomson Financial, Factset, and Citi Investment Research and Analysis.

Figure 46. S&P Consumer Discretionary Sector Operating EPS and Revenue Indices 1Q 1997=100



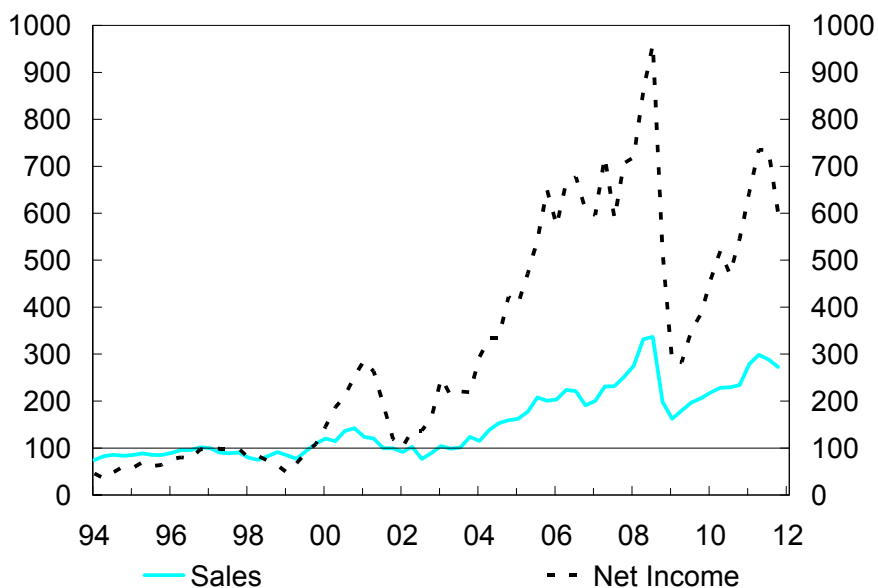
Sources: S&P, Thomson Financial, Factset, and Citi Investment Research and Analysis.

Figure 47. S&P Consumer Staples Sector Operating EPS and Revenue Indices 1Q 1997=100



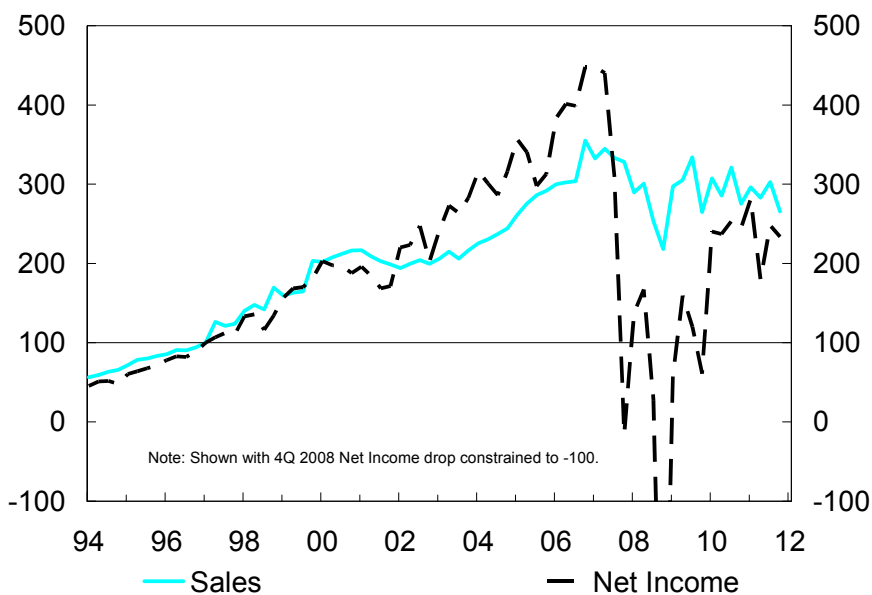
Sources: S&P, Thomson Financial, Factset, and Citi Investment Research and Analysis.

Figure 48. S&P Energy Sector Operating EPS and Revenue Indices 1Q 1997=100



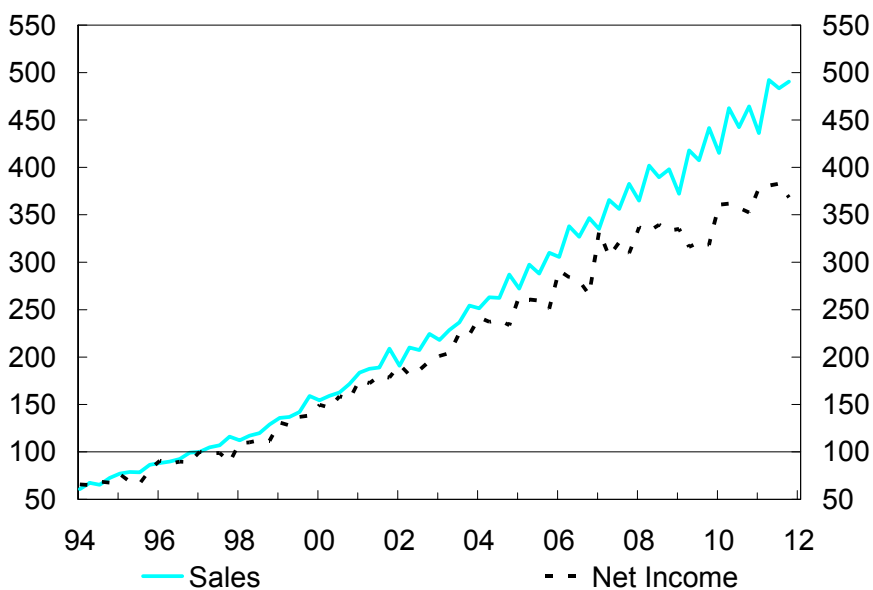
Sources: S&P, Thomson Financial, Factset, and Citi Investment Research and Analysis.

Figure 49. S&P Financials Sector Operating EPS and Revenue Indices 1Q 1997=100



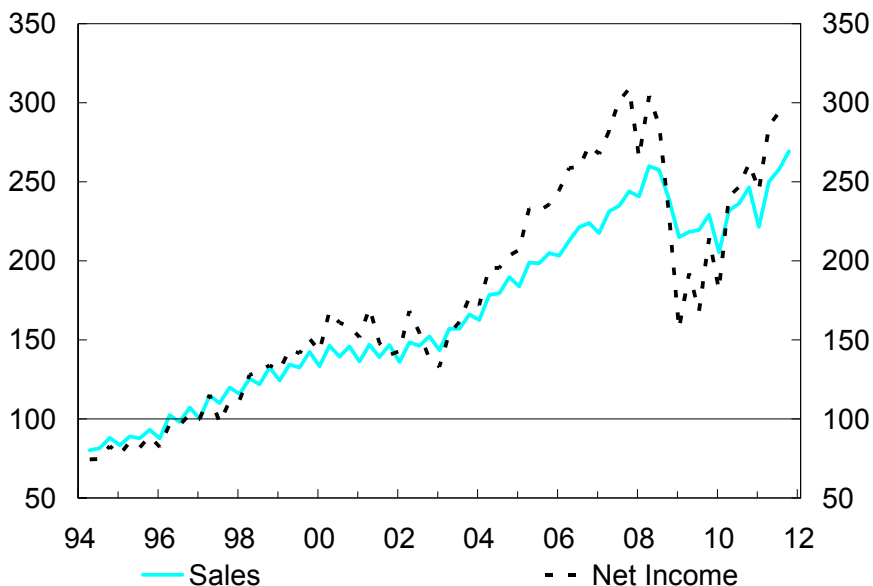
Sources: S&P, Thomson Financial, Factset, and Citi Investment Research and Analysis.

Figure 50. S&P Healthcare Sector Operating EPS and Revenue Indices 1Q 1997=100



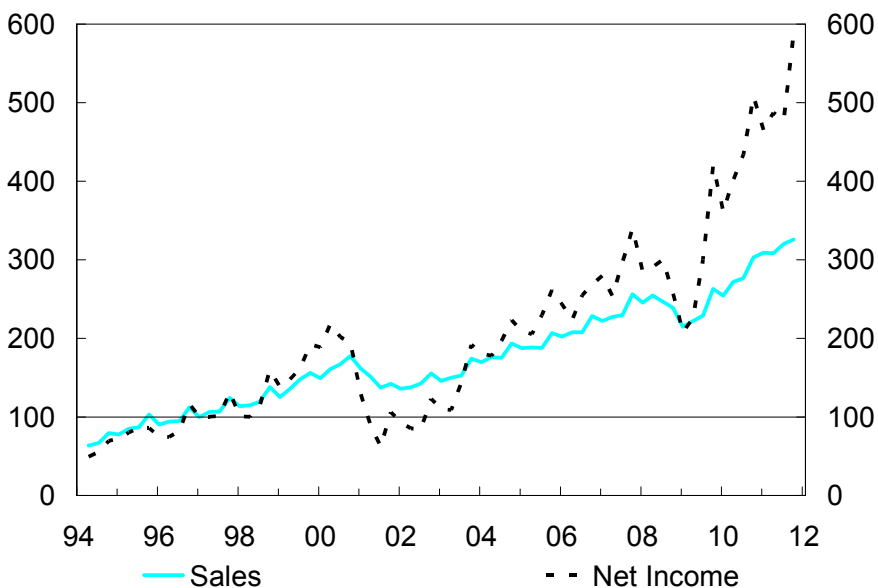
Sources: S&P, Thomson Financial, Factset, and Citi Investment Research and Analysis.

Figure 51. S&P Industrial Sector Operating EPS and Revenue Indices 1Q 1997=100



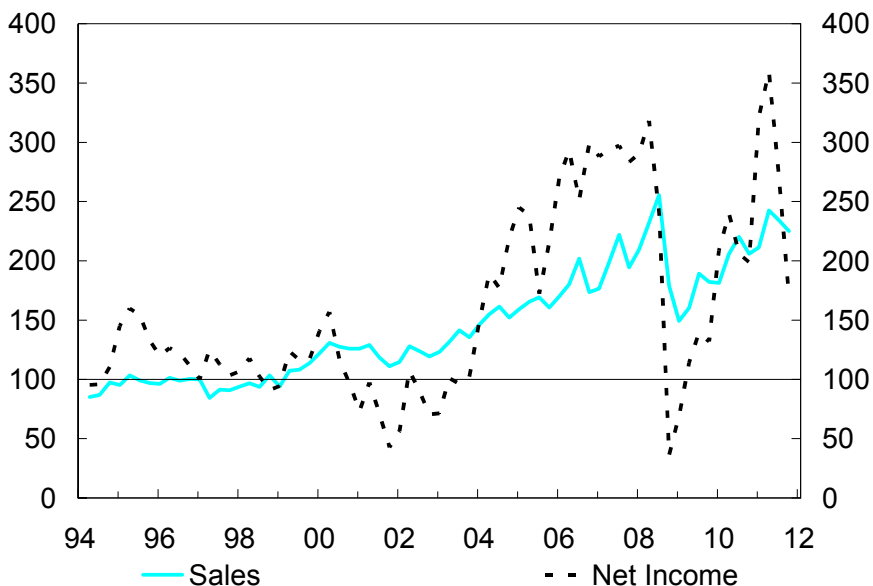
Sources: S&P, Thomson Financial, Factset, and Citi Investment Research and Analysis.

Figure 52. S&P IT Sector Operating EPS and Revenue Indices 1Q 1997=100



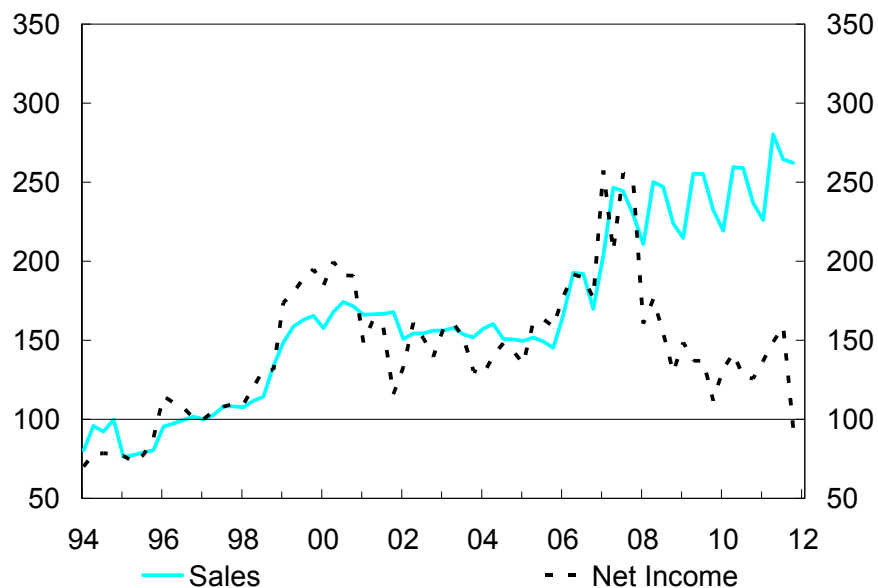
Sources: S&P, Thomson Financial, Factset, and Citi Investment Research and Analysis.

Figure 53. S&P Materials Sector Operating EPS and Revenue Indices 1Q 1997=100



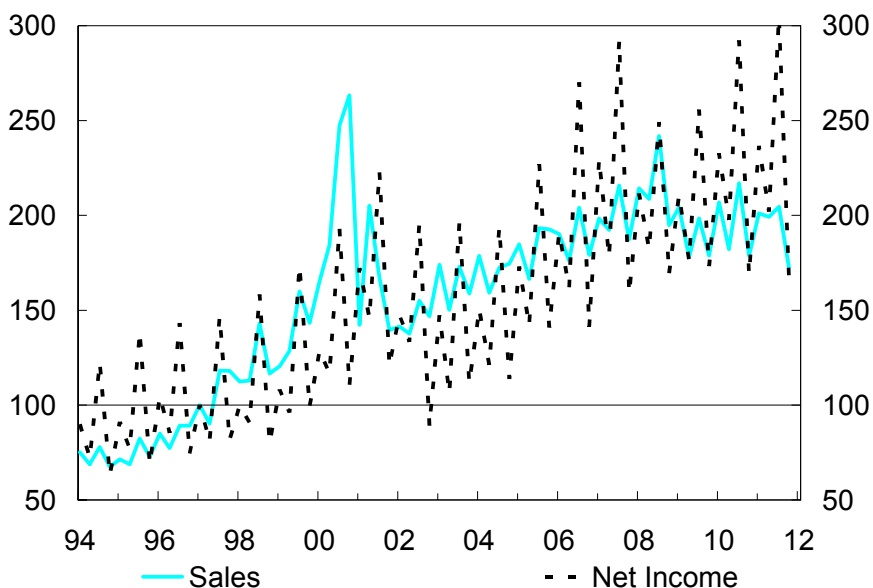
Sources: S&P, Thomson Financial, Factset, and Citi Investment Research and Analysis.

Figure 54. S&P Telecom Services Sector Operating EPS and Revenue Indices 1Q 1997=100



Sources: S&P, Thomson Financial, Factset, and Citi Investment Research and Analysis.

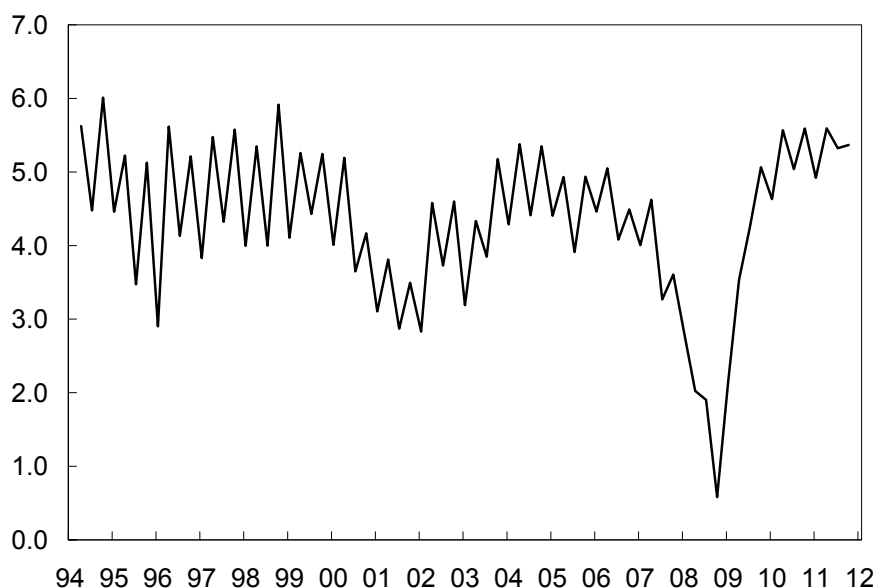
Figure 55. S&P Utility Sector Operating EPS and Revenue Indices 1Q 1997=100



Sources: S&P, Thomson Financial, Factset, and Citi Investment Research and Analysis.

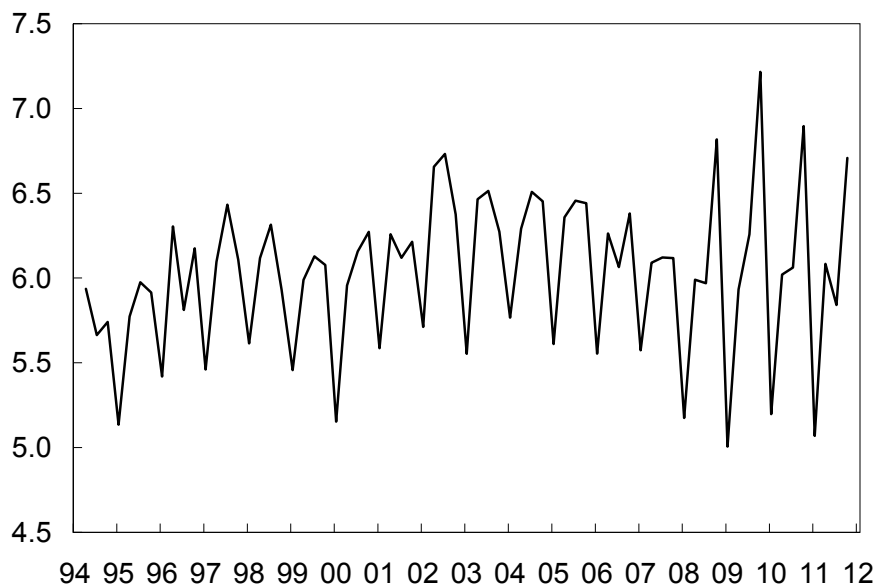
Sector Margins

Figure 56. S&P Consumer Discretionary Sector Margin (Operating Profit as % of Sales)



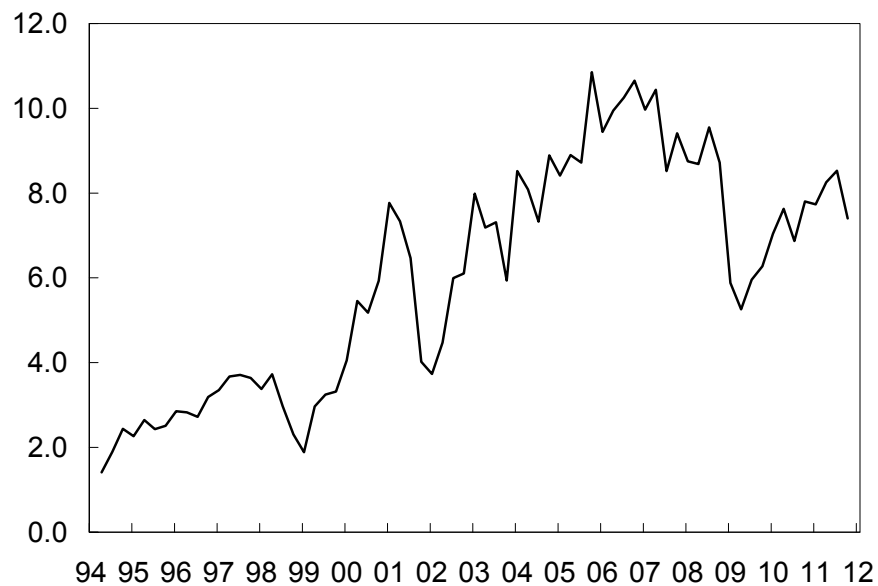
Sources: Factset and Citi Investment Research and Analysis.

Figure 57. S&P Consumer Staples Sector Margin (Operating Profit as % of Sales)



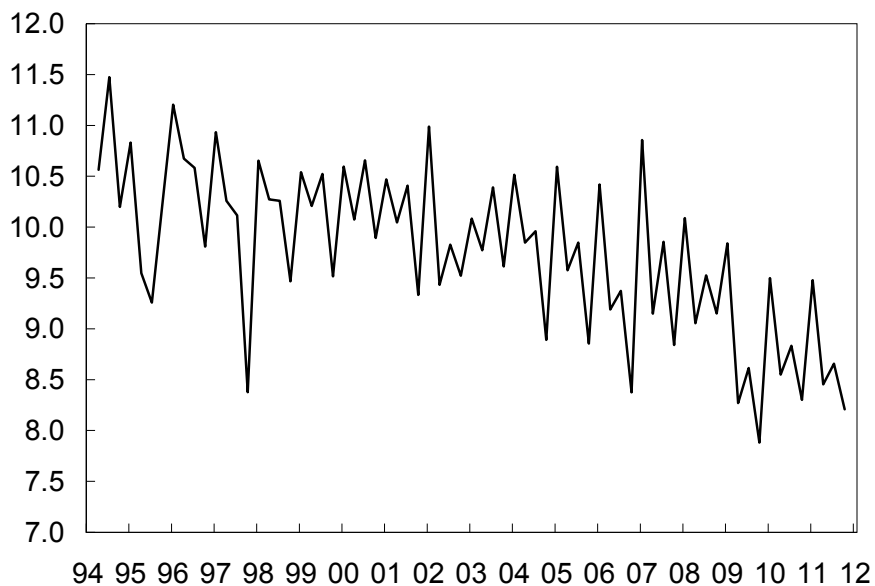
Sources: Factset and Citi Investment Research and Analysis.

Figure 58. S&P Energy Sector Margin (Operating Profit as % of Sales)



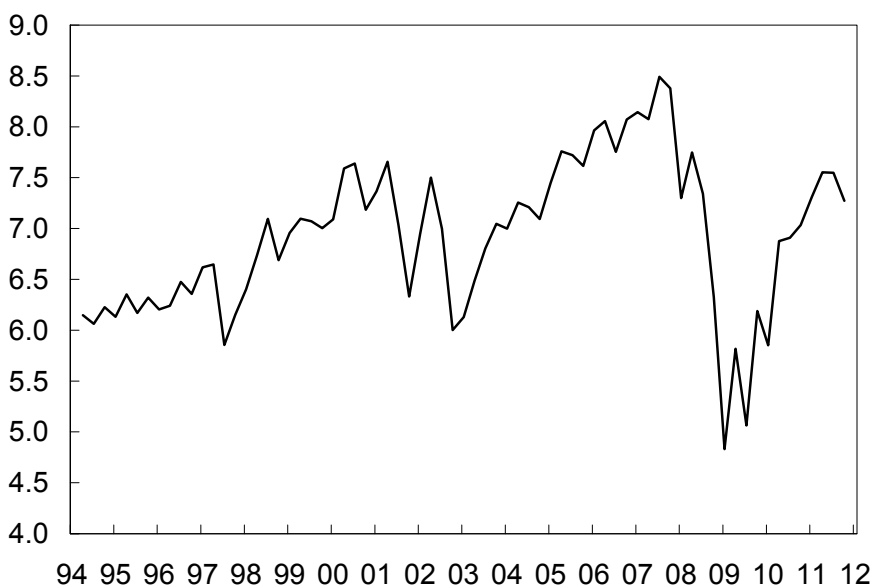
Sources: Factset and Citi Investment Research and Analysis.

Figure 59. S&P Healthcare Sector Margin (Operating Profit as % of Sales)



Sources: Factset and Citi Investment Research and Analysis.

Figure 60. S&P Industrials Sector Margin (Operating Profit as % of Sales)



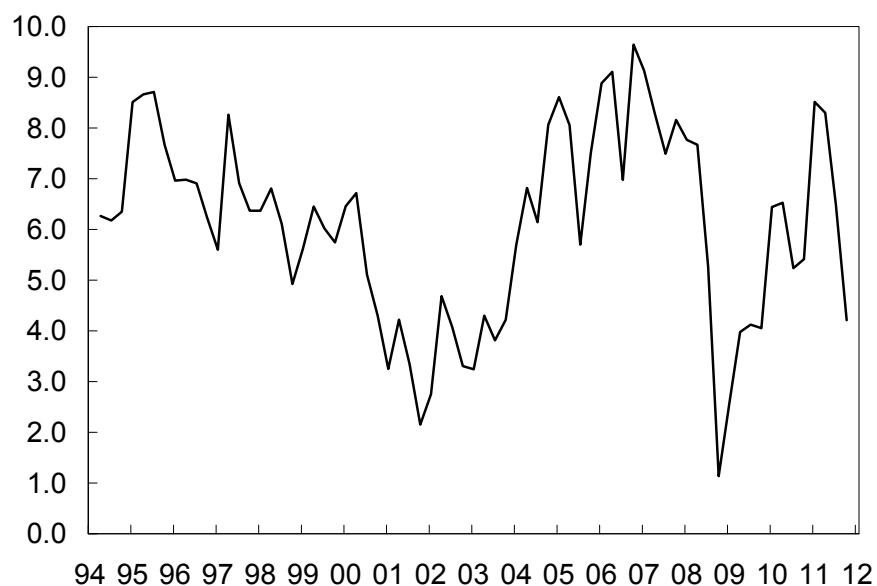
Sources: Factset and Citi Investment Research and Analysis.

Figure 61. S&P Information Technology Sector Margin (Operating Profit as % of Sales)



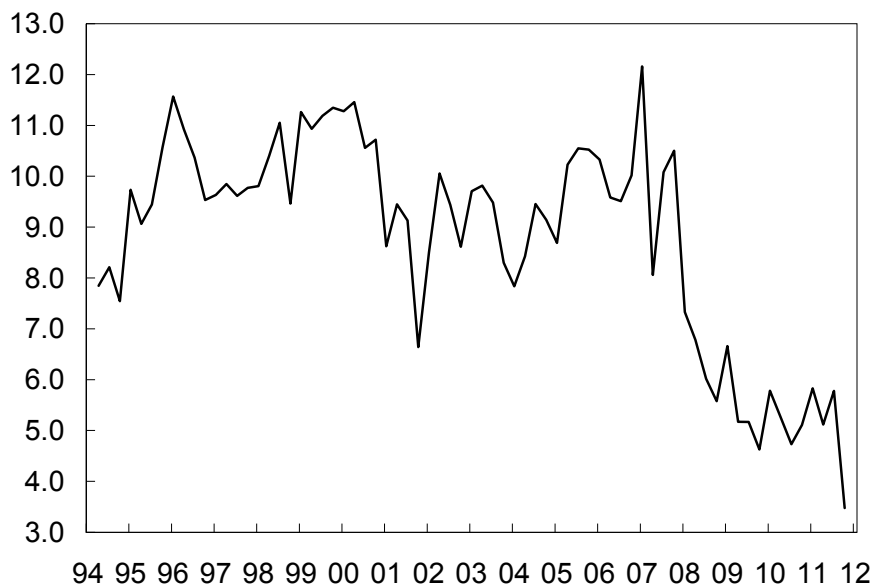
Sources: Factset and Citi Investment Research and Analysis.

Figure 62. S&P Materials Sector Margin (Operating Profit as % of Sales)



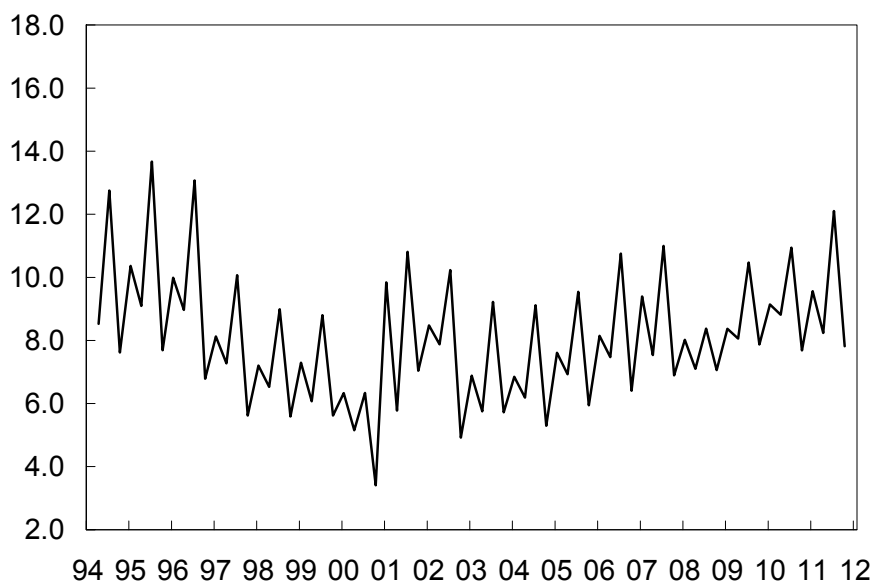
Sources: Factset and Citi Investment Research and Analysis.

Figure 63. S&P Telecom Services Sector Margin (Operating Profit as % of Sales)



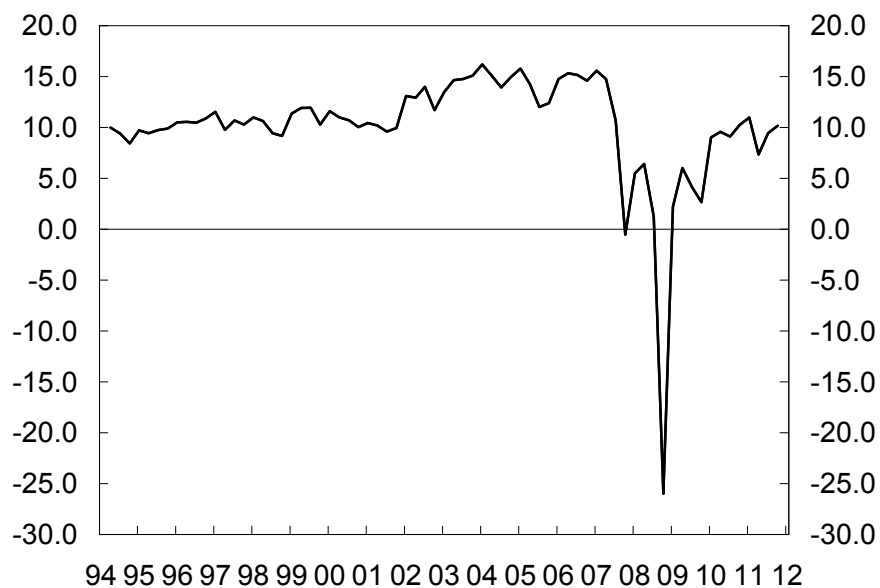
Sources: Factset and Citi Investment Research and Analysis.

Figure 64. S&P Utilities Sector Margin (Operating Profit as % of Sales)



Sources: Factset and Citi Investment Research and Analysis.

Figure 65. S&P Financials Sector Margin (Operating Profit as % of Sales)



Sources: Factset and Citi Investment Research and Analysis.

Appendix 1 Quarterly and Annual Overall S&P 500 EPS Level Estimates

S&P 500 Earnings and Estimates

Annual Data:

	Pre-Write-off (Operating) Earnings (\$/Shr)	Year/Year Change (%)	Reported (GAAP) EPS (\$/Shr)	Year/Year Change (%)
Citi Estimates:				
2010	85.49	37.8	77.35	51.8
2011	97.80	14.4	87.50	13.1
2012	101.00	3.3	91.00	4.0
2013	105.50	4.5	94.00	3.3
2014	110.00	4.3	99.00	5.3
2015	115.00	4.5	102.00	3.0
2016	121.00	5.2	107.00	4.9

Quarterly Data:

Actual:

1Q07	22.71	9.6	21.33	8.3
2Q07	24.40	9.4	21.88	8.8
3Q07	21.31	-5.7	15.15	-29.4
4Q07	16.04	-28.5	7.82	-61.4
1Q08	18.96	-16.5	15.54	-27.1
2Q08	19.78	-18.9	12.86	-41.2
3Q08	17.49	-17.9	9.73	-35.8
4Q08	5.56	-65.3	-23.25	-397.3*
1Q09	12.83	-32.3	7.52	-51.6
2Q09	16.03	-19.0	13.51	5.1
3Q09	16.39	-6.3	14.76	51.7
4Q09	16.80	202.2	15.18	165.3*
1Q10	19.71	53.6	17.48	132.4
2Q10	21.48	34.0	19.68	45.7
3Q10	21.75	32.7	19.52	32.2
4Q10	22.55	34.2	20.67	36.2
1Q11	23.50	19.2	21.44	22.7
2Q11	24.14	12.4	22.24	13.0
3Q11	25.65	17.93	22.63	15.9

Forecasts

4Q11	24.51	8.7	*absolute value change
1Q12	24.80	5.5	
2Q12	25.25	4.6	
3Q12	25.50	-0.6	
4Q12	25.45	3.8	
1Q13	25.55	3.0	
2Q13	26.25	4.0	
3Q13	26.40	3.5	
4Q13	27.30	7.3	

Sources: S&P, Thomson Financial, Factset, and Citi Investment Research and Analysis.

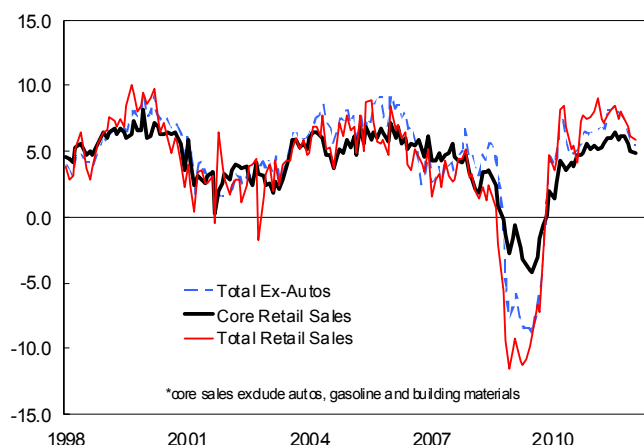
Appendix 2

Citigroup Forecast		Last Update: February 13, 2012												
	Percent Change from Preceding Quarter at Annual Rate or Percent Change from Year-Ago Quarter													
	History			Forecast							Hist	Forecast		
	2011.1	2011.2	2011.3	2011.4	2012.1	2012.2	2012.3	2012.4	2013.1	2013.2	2010	2011	2012	2013
Real GDP (Q/Q)	0.4	1.3	1.8	2.8	1.7	1.7	2.0	2.1	1.0	1.7				
—Y/Y % Change	2.2	1.6	1.5	1.6	1.9	2.0	2.0	1.9	1.7	1.7	3.0	1.7	1.9	1.9
—4Q/4Q % Change											3.1	1.6	1.9	2.1
Personal Consumption Expenditures (Q/Q)	2.1	0.7	1.7	2.4	1.9	1.6	2.2	2.4	1.1	1.8				
—Y/Y % Change	2.8	2.2	2.0	1.7	1.7	1.9	2.0	2.0	1.8	1.9	2.0	2.2	1.9	1.9
Durable Goods	11.8	(5.3)	5.7	12.9	5.2	3.9	5.7	5.9	2.7	3.0	7.2	8.0	5.8	4.1
Nondurable Goods	1.6	0.2	(0.6)	1.3	1.7	1.8	1.3	1.9	0.9	1.6	2.9	1.7	1.2	1.5
Services	0.8	1.9	1.9	1.1	1.4	1.1	2.0	2.0	1.0	1.7	0.9	1.5	1.5	1.7
Gross Private Domestic Investment (Q/Q)	3.8	6.4	1.3	13.9	5.6	8.1	6.6	5.7	9.4	7.3	17.9	4.3	7.2	7.7
Nonresidential Fixed Investment (Q/Q)	2.1	10.3	15.7	2.7	6.0	4.0	4.1	4.1	4.7	3.9				
—Y/Y % Change	10.0	8.0	9.1	7.6	8.6	7.0	4.2	4.6	4.2	4.2	4.4	8.6	6.0	4.3
Structures (Q/Q)	(14.4)	22.6	14.4	1.3	1.0	1.5	2.1	3.6	3.2	2.9	(15.8)	4.7	4.2	3.2
—Y/Y % Change	1.5	4.9	7.4	5.0	9.4	4.4	1.5	2.0	2.6	2.9				
Equipment & Software (Q/Q)	8.7	6.3	16.2	3.2	7.9	4.9	4.9	4.3	5.3	4.3				
—Y/Y % Change	13.4	9.2	9.7	8.5	8.3	8.0	5.2	5.5	4.9	4.7	14.6	10.1	6.7	4.7
Residential Fixed Investment (Q/Q)	(2.5)	4.2	1.3	9.4	9.3	10.9	13.8	15.9	17.4	18.3				
—Y/Y % Change	(2.9)	(6.8)	1.4	3.0	6.0	7.7	10.8	12.5	14.5	16.3	(4.3)	(1.5)	9.3	16.9
Change in Private Inventories (\$bln)	49.1	39.1	(2.0)	33.2	29.8	41.0	44.6	43.0	53.0	56.3	58.8	29.9	39.6	59.7
—contribution to GDP	0.3	(0.3)	(1.4)	1.1	(0.1)	0.3	0.1	(0.0)	0.3	0.1	1.6	(0.1)	0.1	0.2
Net Exports (\$bln)											(422)	(408)	(391)	(391)
—contribution to GDP	(0.3)	0.2	0.4	0.4	0.0	(0.1)	(0.1)	0.0	0.1	0.0	(0.5)	0.2	(0.0)	0.0
Exports (Q/Q)	7.9	3.6	4.7	6.0	3.8	3.8	4.6	4.9	5.1	5.0	11.3	6.9	4.5	4.9
Imports (Q/Q)	8.3	1.4	1.2	2.4	3.0	3.4	4.2	4.0	3.8	4.1	12.5	4.8	2.9	4.1
Gov't Consumption & Investment (Q/Q)	(5.9)	(0.9)	(0.1)	(4.8)	(1.9)	(2.1)	(1.5)	(1.4)	(5.6)	(2.9)	0.7	(2.2)	(2.1)	(2.6)
Federal	(9.4)	1.9	2.1	(7.9)	(2.9)	(4.8)	(4.4)	(4.1)	(12.8)	(7.3)	4.5	(2.0)	(3.6)	(6.7)
State & Local	(3.3)	(2.8)	(1.6)	(2.7)	(1.1)	(0.2)	0.4	0.4	(0.8)	0.1	(1.8)	(2.3)	(1.1)	0.1
Addenda:														
Final Sales (Q/Q)	0.0	1.6	3.2	1.6	1.8	1.3	1.9	2.2	0.7	1.6				
—Y/Y % Change	2.2	1.9	2.3	1.6	2.0	2.0	1.6	1.8	1.5	1.6	1.4	2.0	1.9	1.7
Nominal GDP (Q/Q)	3.1	4.0	4.4	3.0	3.4	3.1	3.3	3.4	2.8	3.2				
—Y/Y % Change	4.1	3.8	3.9	3.6	3.7	3.5	3.2	3.3	3.2	3.2	4.2	3.9	3.4	3.4
Inflation Measures														
GDP Chain-type Price Index (Q/Q)	2.5	2.5	2.6	0.2	1.7	1.5	1.3	1.3	1.8	1.4	1.2	2.1	1.4	1.5
Consumer Price Index (Y/Y %)	2.2	3.3	3.8	3.3	2.4	1.6	1.3	1.4	1.5	1.7	1.6	3.2	1.7	1.7
Core Consumer Price Index (Y/Y %)	1.1	1.5	1.9	2.2	2.2	2.1	1.9	1.8	1.7	1.6	1.0	1.7	2.0	1.7
Producer Price Index (Y/Y %)	5.0	6.7	6.9	5.5	2.4	0.9	0.6	0.6	0.9	0.9	4.2	6.0	1.1	1.0
Interest Rates														
Federal Funds (% End of Period)	0.10	0.07	0.06	0.04	0.25	0.25	0.25	0.25	0.25	0.25				
Federal Funds (% Annual Avg)											0.17	0.10	0.25	0.25
10-year Treasury Bond (% Period Avg)	3.46	3.21	2.43	2.05	1.95	2.05	2.20	2.40	2.50	2.65	3.21	2.79	2.15	2.70
Others														
Industrial Production (Y/Y % Change)	5.4	3.8	3.7	3.7	3.5	3.9	3.0	2.6	2.5	2.6	5.3	4.2	3.2	2.9
Unemployment Rate (%)	8.9	9.1	9.1	8.7	8.6	8.5	8.4	8.3	8.4	8.3	9.6	9.0	8.5	8.4
Federal Budget Balance (\$bln, FY, Unified)											(1,294)	(1,296)	(1,125)	(975)
% of GDP											(8.9)	(8.7)	(7.3)	(6.0)
Corporate Earnings														
S&P 500 Oper EPS Pre-writeoffs (\$/share)	23.50	24.14	25.65	24.51	24.80	25.25	25.50	25.45	25.55	26.25	85.49	97.80	101.00	105.50
S&P 500 Oper EPS Pre-writeoffs (Y/Y %)	19.2	12.4	17.9	8.7	5.5	4.6	(0.6)	3.8	3.0	4.0	37.8	14.4	3.3	4.5
S&P 500 GAAP EPS (\$/share)	21.44	22.24	22.63								77.35	87.50	91.00	94.00
S&P 500 GAAP EPS (Y/Y %)	22.7	13.0	15.93								51.8	13.1	4.0	3.3

Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, Office of Management and Budget, Federal Reserve Board, First Call, and Citi Investment Research and Analysis.

U.S. Economic Charts of the Week

Retail Sales Total, Ex-Autos and Core Y/Y%



Retail sales continued to surprise and confound forecasters using industry-data inputs. Overall retail sales rose a less-than-expected 0.4%, but the surprise was in auto dealer sales, which fell 1.1% despite a 4.7% rise in unit vehicle sales reported in the month. The unit vehicle sales figures and separate estimates for pricing and content are used in GDP calculations, not the Census data.

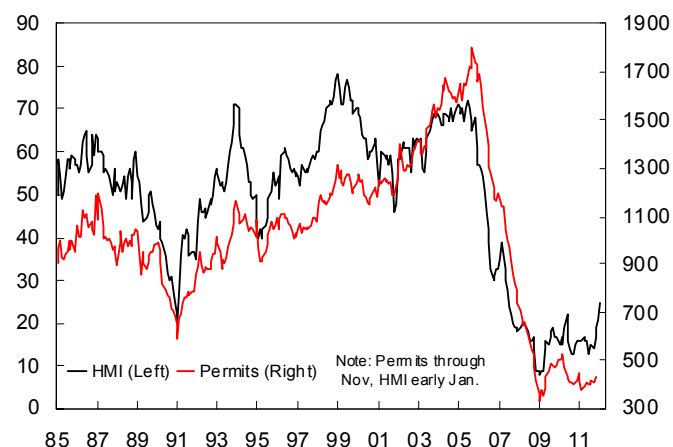
Away from autos, sales rose a stronger-than-expected 0.7%, but non-auto sales were revised down in December to show a 0.5% drop. In light of such revisions and source data mismatches, the “saw-toothed” pattern of monthly sales declines and sold gains in various categories might be better taken with a grain of salt, and averaged over the two periods, at minimum.

Source: Census Bureau.

While we would prefer to smooth these monthly readings, the January core retail sales level was a solid 1.7% annualized above the 4Q pace, to the benefit of 1Q 2012 growth estimates. By comparison, the core retail sales revisions to 4Q should result in some downward revision to 4Q real consumer spending data, offsetting some other sources of potential upward revision to 4Q real GDP, including an even larger rise in inventories last quarter.

While the January core sales gain was large, it is unlikely to be the pace for the whole quarter. Averaging recent months, core retail sales are rising moderately while highly cyclical auto sales are continuing a solid recovery. The very latest chain store sales readings through mid February have softened to a 2.9% year/year clip from a 3.8% average pace on average in the fourth quarter, a moderation, but far from a new-year plunge.

Weekly General Merchandise Same Store Sales Indices, Y/Y%



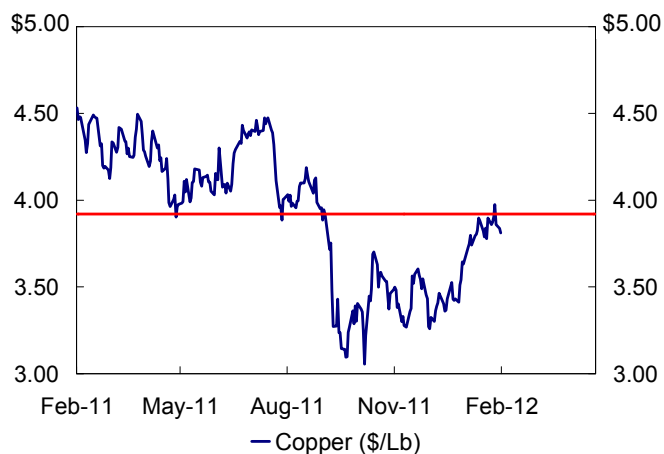
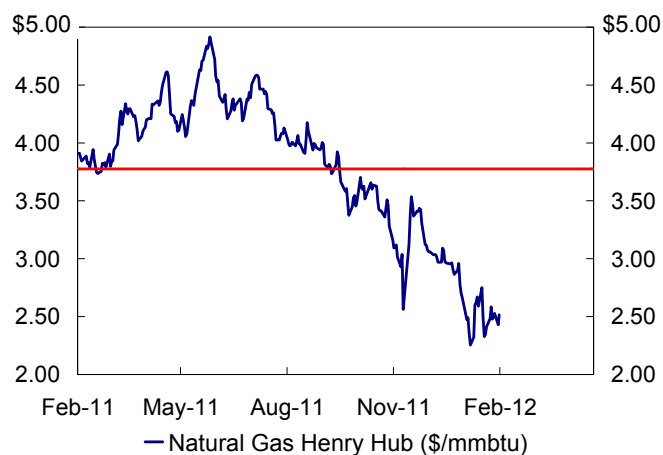
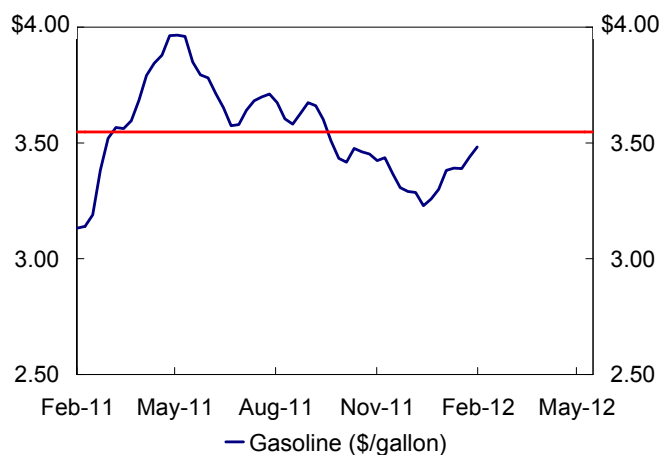
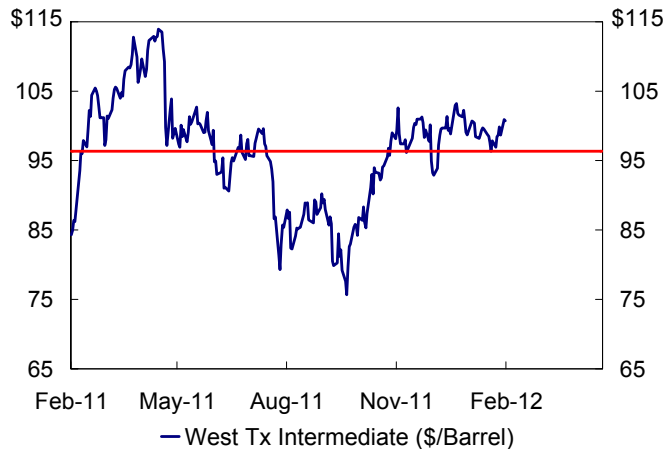
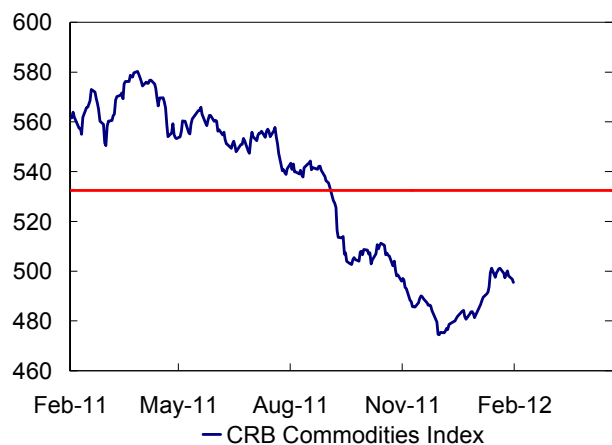
Source: Johnson Redbook and International Council of Shopping Centers

Select Market Statistics Relative to Latest 12-month Average and Year-Ago Values

	5-Year Avg	14-Feb-12	Y/Y% *	QTD/ QPY **		5-Year Avg	14-Feb-12	Y/Y% *	QTD/ QPY **
Stock Indices					Commodities				
DJIA	11,186.82	12,878.28	5.3%	5.2%	JOC Industrial Price Index	434.01	495.44	-11.8%	-11.4%
S&P 500	1,210.58	1,350.50	1.7%	0.9%	Energy				
NASDAQ	2,322.57	2,931.83	4.5%	2.1%	WTI	81.70	100.74	19.5%	5.5%
Wilshire 5000	12,470.31	14,273.87	1.3%	0.3%	Natural Gas (\$/mmbtu)	5.63	2.52	-35.7%	-37.8%
Russell 2000	507.07	562.44	2.2%	0.0%	Metals				
Interest Rates (%)					Aluminum (cents/lb)	2,045.32	2,075.50	-10.9%	-11.1%
Fed Funds	1.48	0.12	-0.04	-40.7%	Copper (\$/lb)	3.23	3.81	-15.9%	-14.8%
3-Month	1.24	0.12	-0.01	-58.7%	Precious Metals				
1 Year	1.47	0.18	-0.12	-53.8%	Gold (\$/troy oz)	1,067.21	1,722.00	25.4%	21.3%
2 Year	1.70	0.29	-0.55	-64.5%	Platinum (\$/troy oz)	1,483.38	1,628.00	-11.6%	-13.7%
5 Year	2.58	0.81	-1.54	-61.2%	Silver (\$/troy oz)	19.73	30.66	-0.1%	-0.8%
10 Year	3.51	1.92	-1.69	-43.2%	Grains and Feeds				
30 Year	4.27	3.06	-1.60	-33.1%	Corn (\$/bu)	4.54	6.37	-4.3%	-2.2%
Foreign Exchange					Soybeans (\$/bu)	10.71	12.38	-7.5%	-11.1%
Trade-Weighted Dollar	101.61	97.89	-0.1%	1.6%	Wheat (\$/bu)	8.81	9.40	-21.1%	-18.8%
USD/EUR	1.39	1.31	-2.6%	-5.1%	Foods				
JPY/USD	96.46	78.39	-6.4%	-6.4%	Live Cattle (\$/cwt)	118.20	175.50	23.2%	18.4%
USD/GBP	1.71	1.57	-2.7%	-2.6%	Coffee (\$/bu)	1.91	2.49	-16.9%	-12.9%
CHF/USD	1.06	0.92	-5.1%	-1.1%	Cocoa (\$/ton)	3,010.15	2,456.00	-37.9%	-34.9%
CAD/USD	1.06	1.00	1.0%	2.2%	Lumber				
RMB/USD	6.92	6.30	-4.4%	-4.1%	Lumber (\$/1000 board ft)	262.67	286.00	-2.4%	-5.8%
** Quarter to date over last year same quarter average					Fibers and Textiles				
* Most recent date over the same date a year ago					Cotton (\$/lb)	0.78	0.86	-53.4%	-48.4%
					Burlap (\$/Yd)	0.48	0.46	-13.5%	-14.7%
					Fiber Industrial Materials				
					Index (All)	149.59	168.47	-8.4%	-8.9%
					Textiles	77.73	79.92	-12.7%	-11.5%
					Metals	231.79	264.78	-14.7%	-14.4%
					Crude Benzene	182.00	208.51	6.7%	1.8%
					Miscellaneous	162.63	191.36	-5.0%	-5.9%

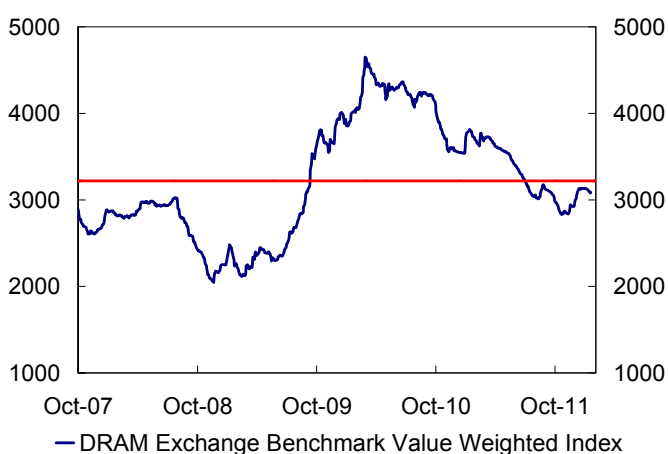
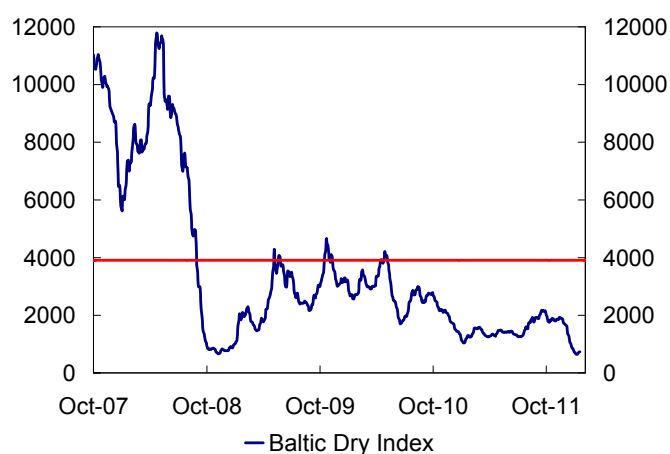
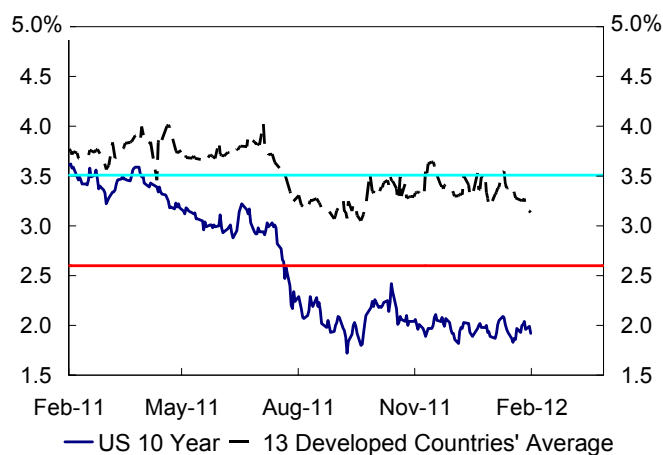
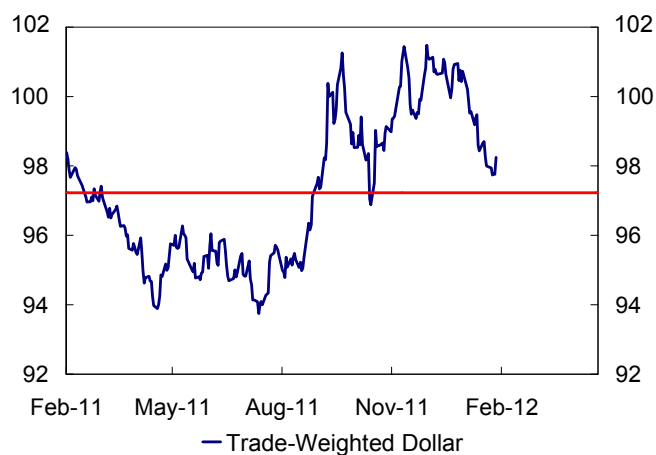
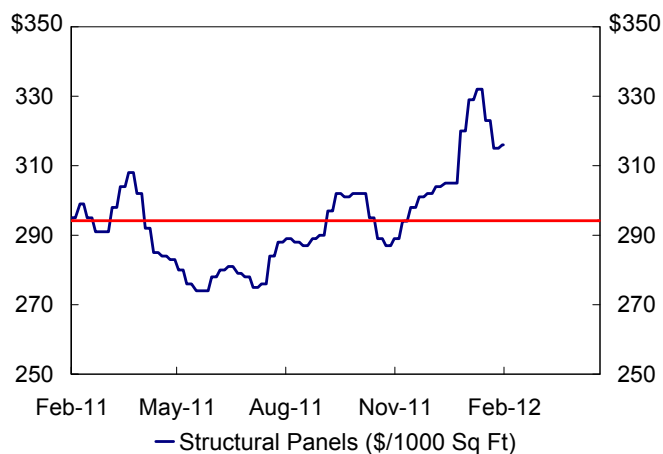
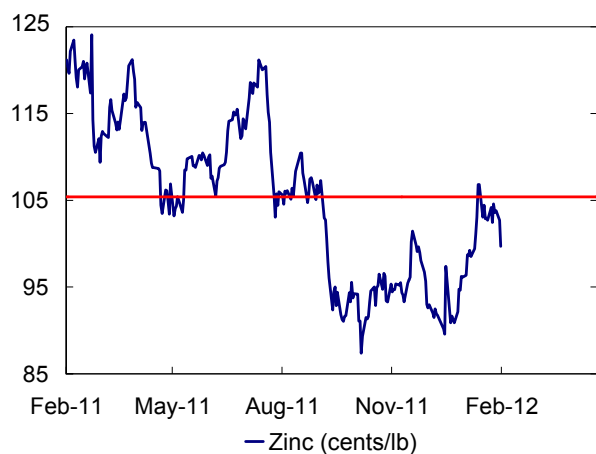
Source: Haver Analytics.

Select Market Statistics and Latest 12 Month Average (Commodities)



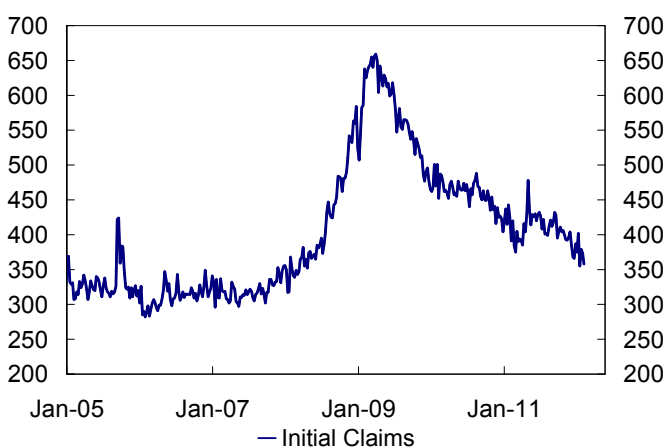
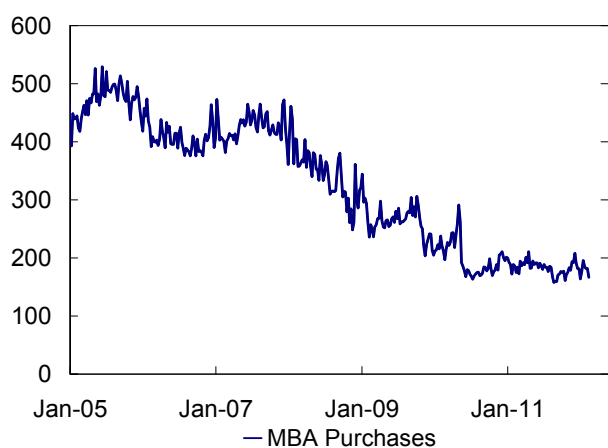
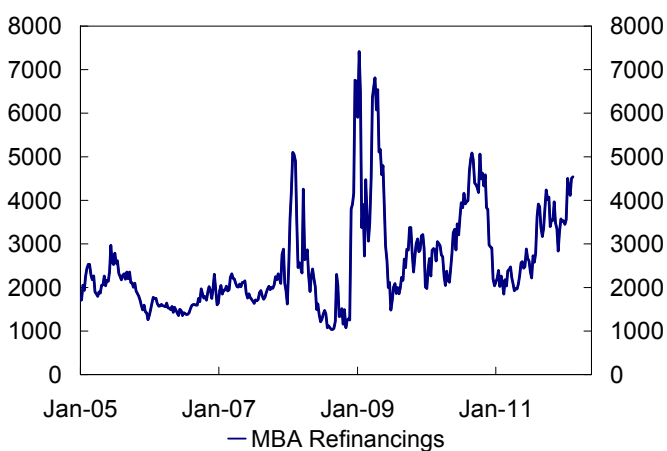
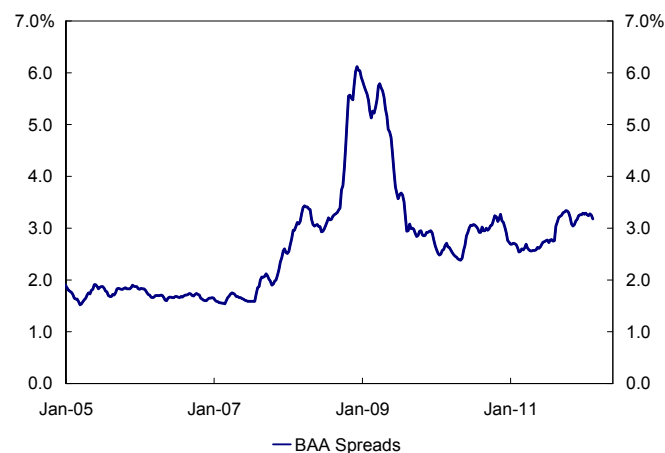
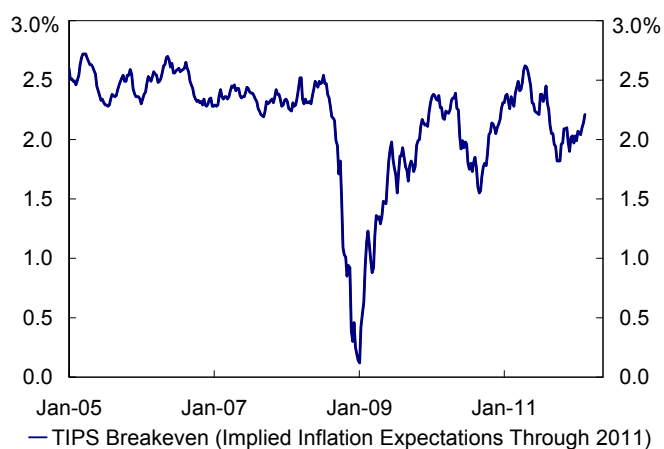
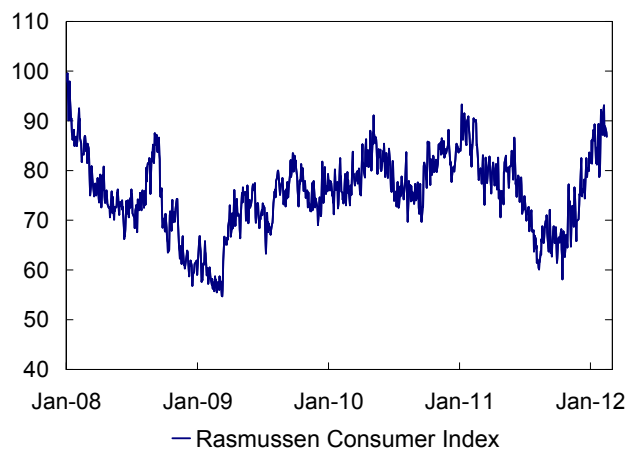
Sources: Commodity Research Bureau, Wall Street Journal, and Energy Information Administration.

Select Market Statistics and Latest 12 Month Average (continued)



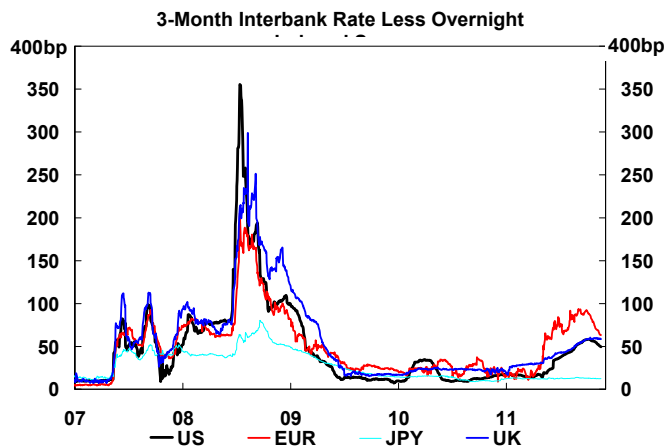
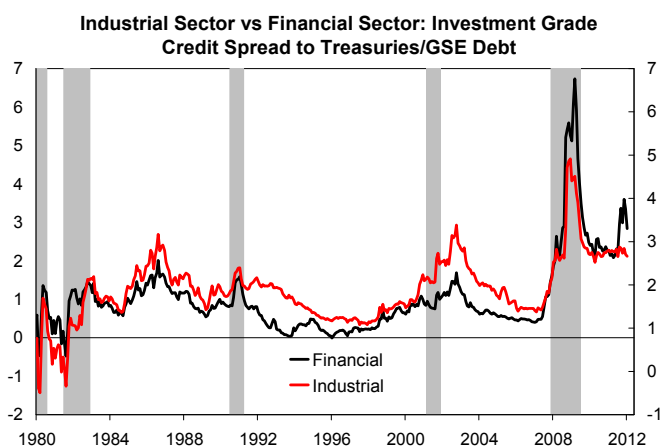
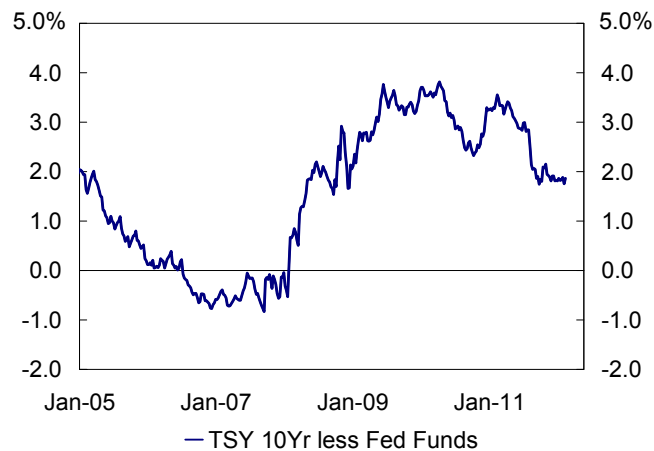
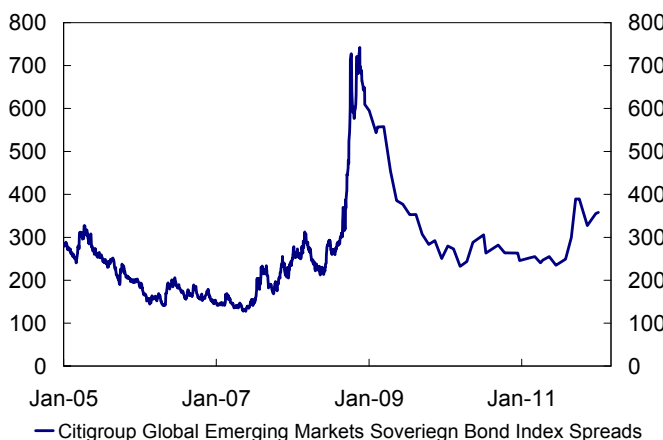
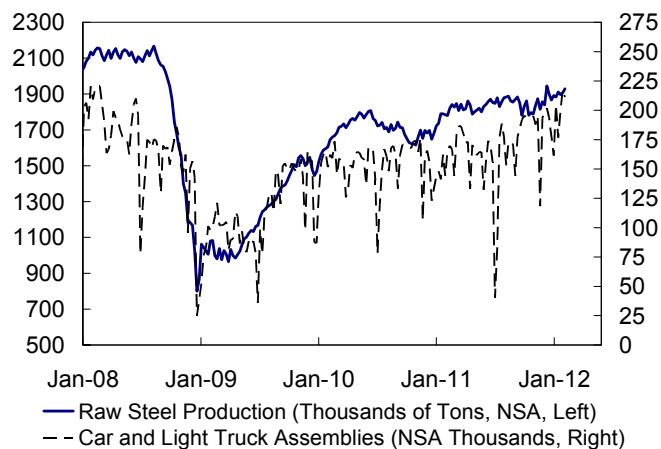
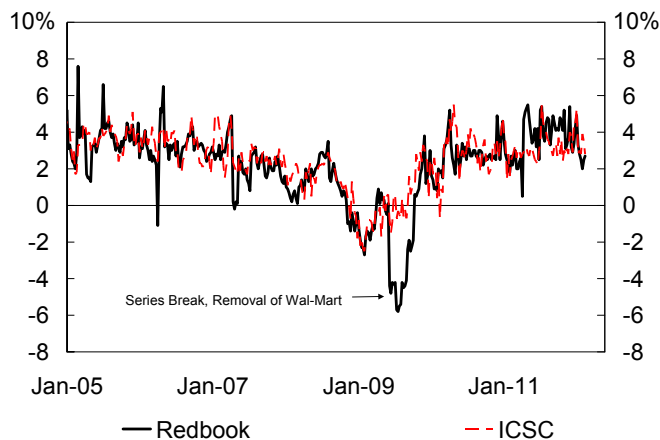
Sources: Bloomberg, Foundation for Intl Business & Economic Research, U.S. Treasury, Reuters and Wall Street Journal.

Select Economic Statistics



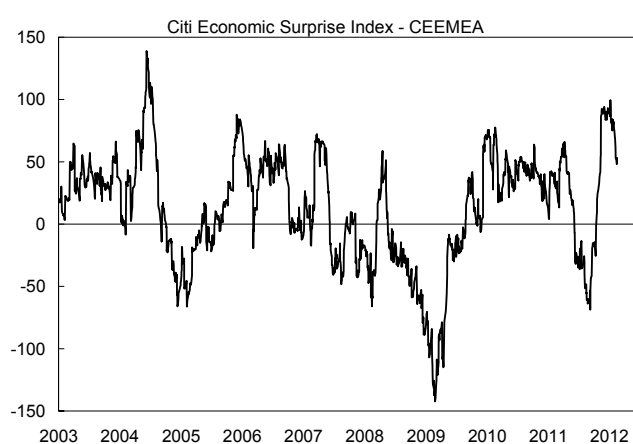
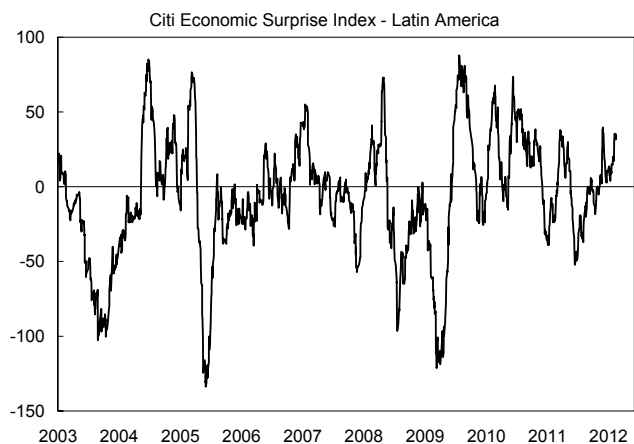
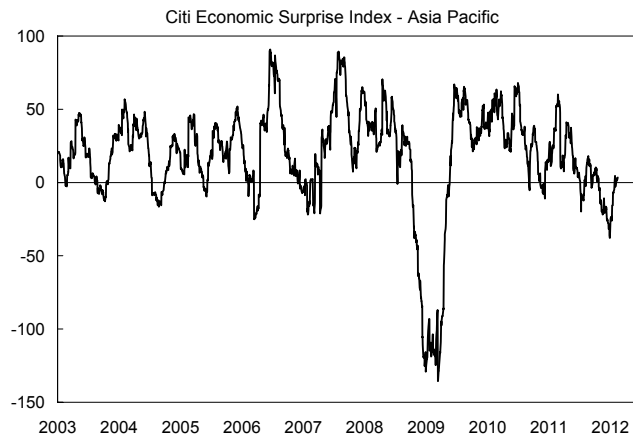
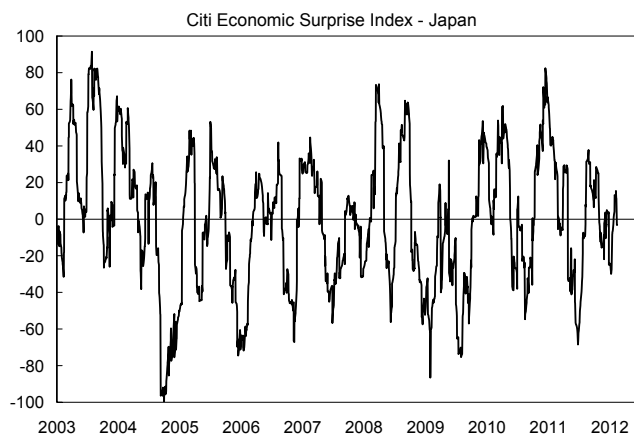
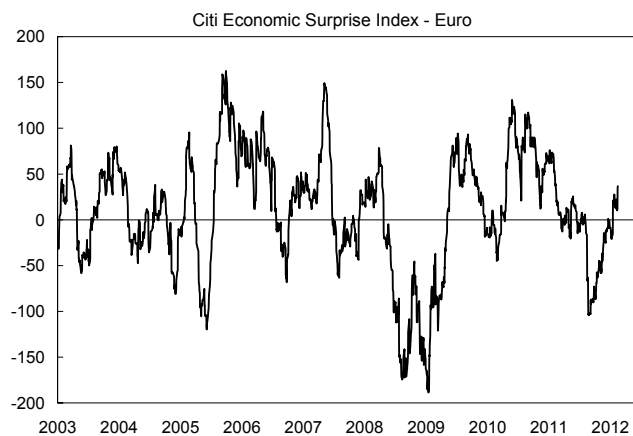
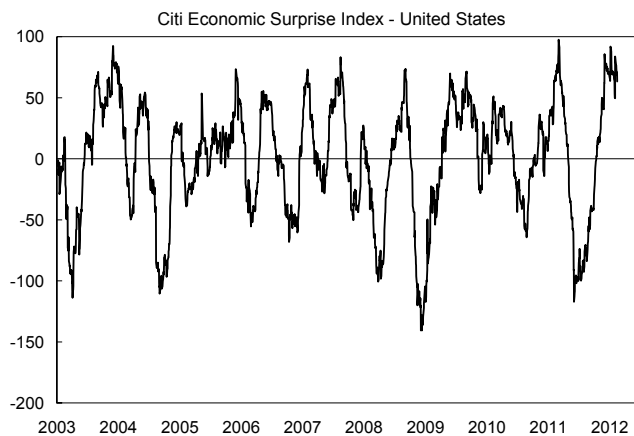
Sources: Bureau of Labor Statistics, Federal Reserve Board, Mortgage Bankers' Association and Rasmussen Reports.

Select Economic Statistics (continued)



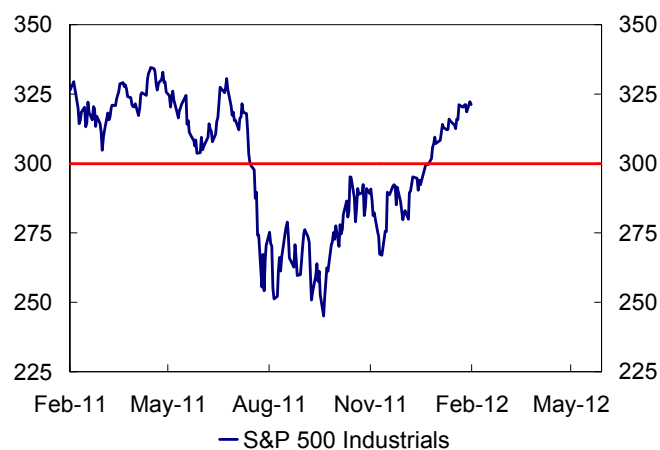
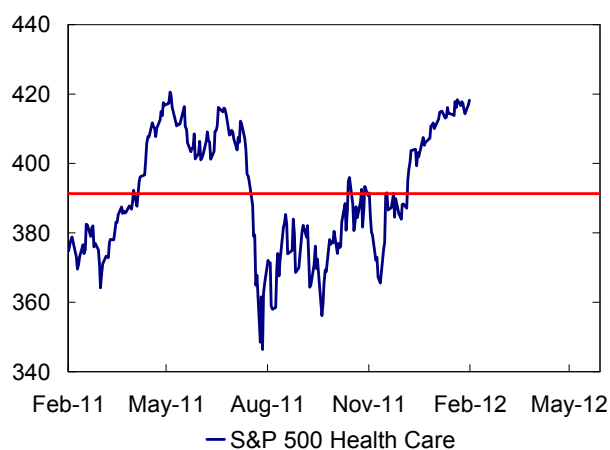
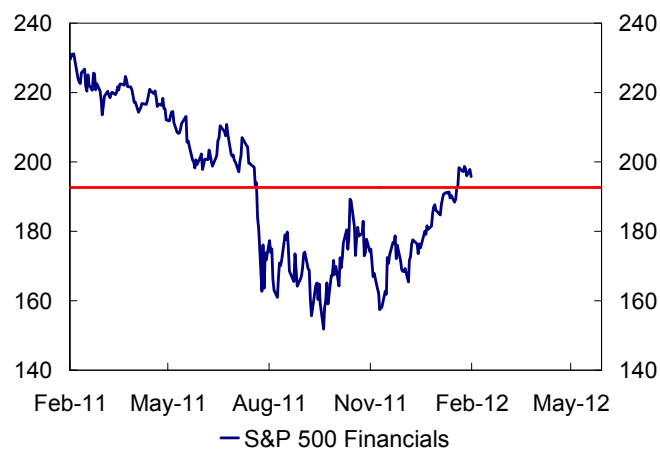
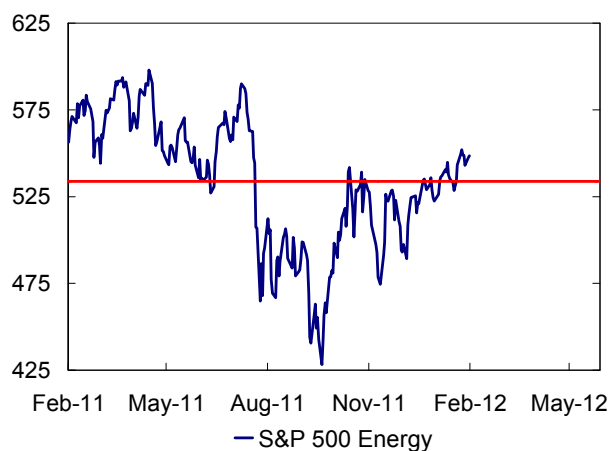
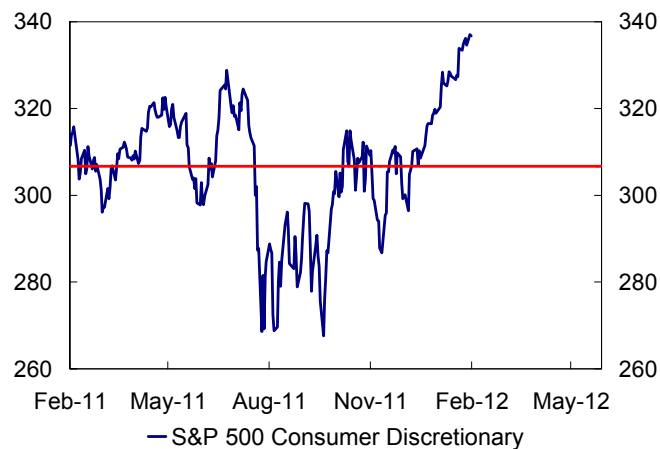
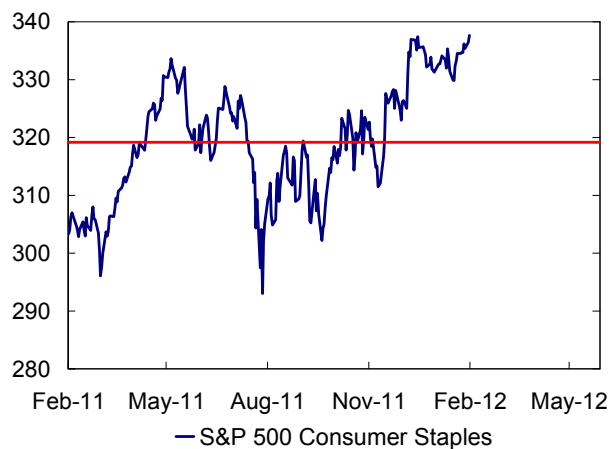
Sources: American Iron and Steel Institute, Automotive News, Bloomberg, Federal Reserve Board, Johnson Redbook, and Citigroup Global Markets.

Citi Economic Surprise Indexes



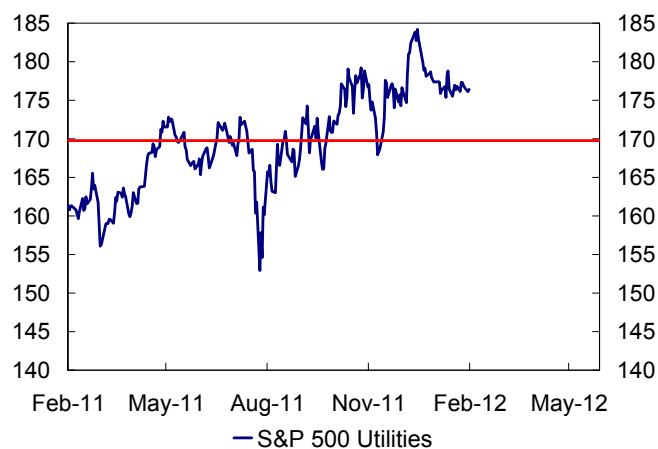
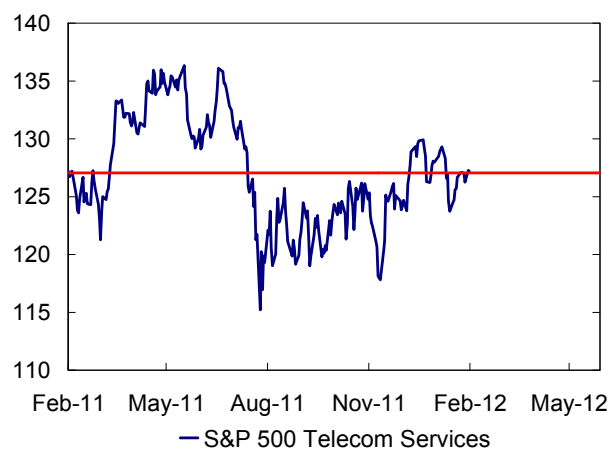
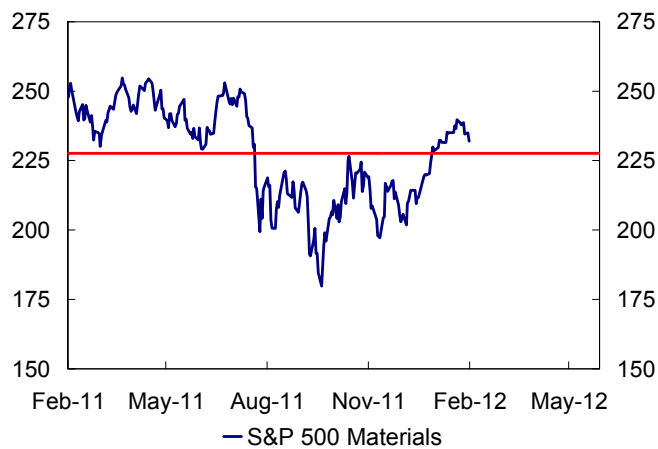
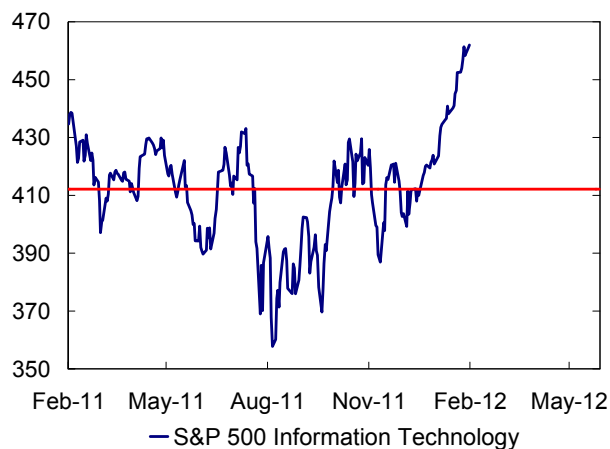
Source: Citigroup Global Markets.

S&P 10 Sectors and Latest 12 -Month Average



Source: Standard and Poor's.

S&P 10 Sectors and Latest 12 –Month Average (continued)



Source: Standard and Poor's.

Appendix A-1

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