5 December 2013 | 89 pages

Strategy
GEMS

GEMS Road Ahead 2014

Much of What Drove EM Underperformance Has Passed. MXEF to 1185 (+17%) by end-2014E

- **EM now at a discount, rel EPS revisions improving as is relative liquidity** — EM is now at a 29% discount vs DM and yet EM generates both a higher ROE and ROA than does DM. Back in 2007, EM at over 3x P/BV was 3.4 stdev above mean valuations and expensive. Now at 1.5 times, it is 0.6 stdev below and cheap. EM has delivered more earnings than DM, but EM has under-delivered vs expectations since 2010. Relative EPS revisions vs DM reached a low in November, the same low as during the various 1997/98 EM crises. Relative sentiment has also shifted away from EM, now favoring DM. Taper and a European growth recovery should start to shift the liquidity advantage back toward the exporters within EM.

- **Asia over EMEA over Lat Am** — Within EM, the most attractive region is Asia with a combination of attractive valuations, expanding central bank liquidity, and negative positioning. There are more CA surpluses in Asia and the region is more export driven than the other two regions. We are overweight China, Korea, and Taiwan, underweight the rest of Asia. EMEA is our neutral position. Valuations appear attractive, liquidity is still tight, and the consensus is overweight. Underweight South Africa, underweight Turkey, and overweight Russia. Our underweight region is Lat Am. Valuations are generally uninspiring, liquidity is generally tight with prospects of getting tighter, and Lat Am has the weakest EPS revisions of the three EM regions. We are underweight Brazil and Chile but overweight Mexico.

- **Cyclical and financial twist avoiding domestic defensives** — With an improving global top-line growth environment, the best way to access this is through high asset-turn sectors. Asia has more of these than the other regions of EM owing to the higher weight in manufacturing. Consumer discretionary, energy, and semiconductors are our favorite sectors to own. The other areas that remain substantially undervalued are financials and real estate; we are also overweight both of these sectors. We are underweight materials, utilities, telecoms, consumer staples, and healthcare.

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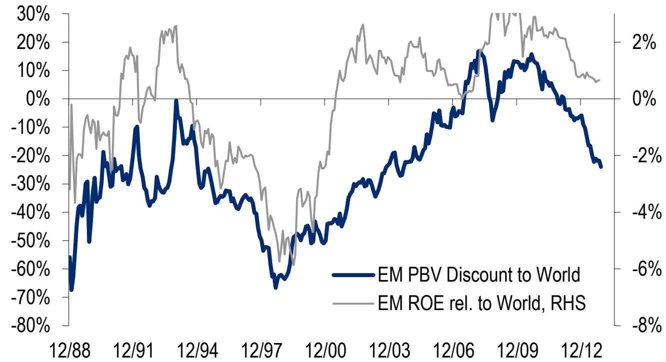
Much of what drove the underperformance has passed

Since 2010, EM has underperformed DM. As time has passed, the critics of EM have become more vocal, which in a way is strange, as this logic would imply one is never a buyer of cheap/unwanted assets but always a buyer of more sought-after momentum. The issue with the latter is that when momo stops, the trade is crowded and expensive and there is no fall back. This is especially true in EM, where listed equity can very quickly become private equity.

The EM underperformance was driven by higher valuations, failure to meet investor expectations, and worse liquidity growth.

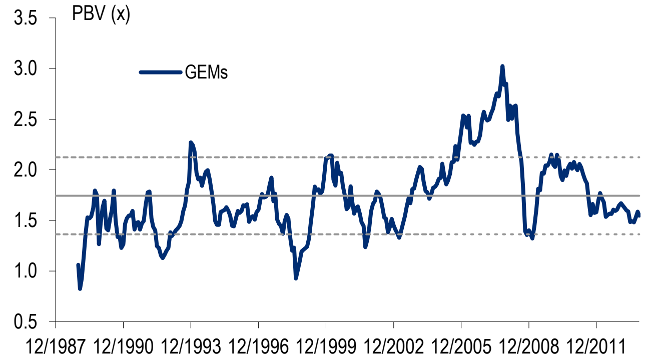
So what do we believe to the reasons as to why EM has underperformed? First, by the time of the GFC (global financial crisis), EM was expensive vs DM (see Figure 1). EM now trades at a discount to DM, yet ROE continues to be above that of DM. Sure EM has traded at bigger discounts, 1987 or 1997/8. To trade at the same discount as back then, EM would have to go down to 1 times book vs 1.5x at present (assuming no change in DM P/BV). To make that one's central case scenario we believe is too aggressive. In absolute terms (see Figure 2), the PBV for EM has gone from a historically unsustainable 3 times book to the current 1.5x, or 0.6 stdev below the mean. Sure EM has some problem children, but that does not assume the whole family is a write-off. Nor is the DM family comprised only of saints.

Figure 1. PBV and ROE of EM vs DM



Source: MSCI, Citi Research

Figure 2. Price to book of GEMS



Source: MSCI, Citi Research

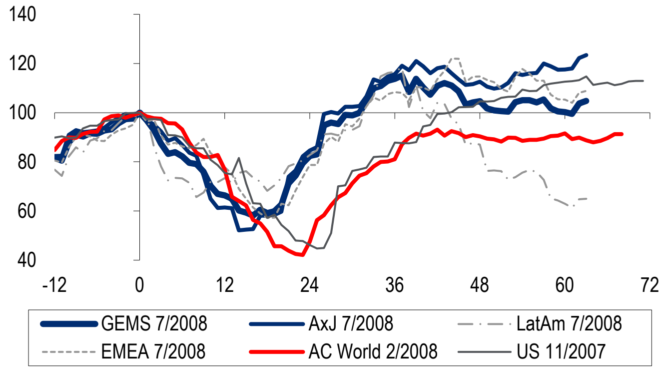
As such, over-valuation as an impediment for performance appears largely gone.

On to the second reason, EPS delivery vs expectations. EM has out-earned DM when compared to the pre-GFC peak. DM earnings are down 10%, whilst EM earnings are up 5%. In DM, the USA has been the out-performer with earnings up 14%; in EM, Asia is doing best of all with earnings up 23% and thus beating even the USA (all the data is in USD).

EM earnings have outperformed DM but in a game of expectations, EM under-delivered vs DM.

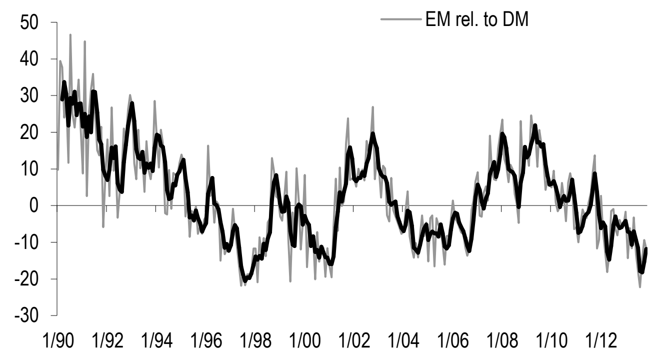
EM has delivered earnings but as per Figure 3, EM has failed to meet expectations. Recall, the GFC - for once - did not originate in the EM world but in DM. Expectations in DM were thus rock bottom, whilst they proved to be too high in EM. So as per Figure 4, analysts have spent the last three years revising down their earnings forecasts more so in EM than DM. Effectively, EM disappointed relative to expectations whilst DM, from a very low base, surprised to the upside. That's all well and good, but right now, where are expectations greater, EM or DM? You guessed it right: given a chance, EM is getting a bad rap and we think at some stage investors focus will turn on the absolute earnings and say "wow, I thought that the numbers were much worse than that."

Figure 3. Regional EPS since their 2007/08 peaks



Source: MSCI, Citi Research

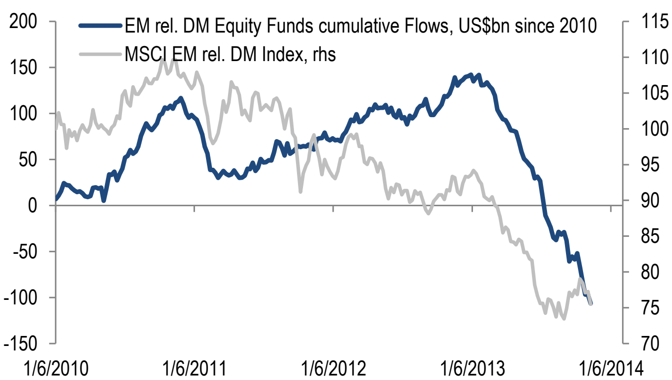
Figure 4. Earnings Revision Index of EM vs DM



Source: IBES Aggregatem Citi Research

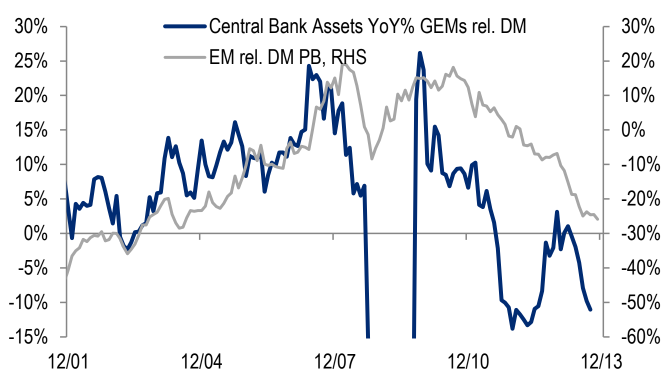
The relative EPS revisions between DM and EM have already peaked, incidentally at roughly the same levels as they did back in 1997/8. As of late, EPS revisions in EM have actually been better than those in DM. At present, the numbers in EM are just getting less bad than in DM but as is often quoted, investing is about the second derivation and that is now in EM's favor. So now we have greater absolute earnings, an improving EPS revisions profile in EM, and sentiment that is worse in EM than DM. For confirmation thereof, just look at the relative flows into EM vs DM funds.

Figure 5. EM vs DM fund flows



Source: EPFR, Citi Research

Figure 6. EM v DM central banks expansion



Source: Haver, CEIC, Citi Research

This brings us on to the third point: relative central bank balance sheets (Figure 6). Between 2002 and 2007, the asset side of the central banks' balance sheets in EM were expanding more rapidly than those of DM. Why? Buoyant capital flows and strong export performance. Post the GFC, DM did QE in all of its various guises; EM did not do QE. The relative liquidity advantage switched from EM to DM and with it, DM outperformed EM. If the house view proves correct that the Fed will taper during 2014, then we should get a relative swing in the asset side of DM vs EM balance sheets for two reasons.

The arrival of QE led to the DM central banks' balance sheet growing more so than that of EM.

First, the asset side of DM balance sheets should begin to shrink. Second, the Fed would be doing taper because growth is improving (note that our Euro GDP forecast calls for an end to the recession in 2014), all of which should improve export demand for EM countries. As exports contribute to the asset side of the central banks' balance sheets, these should show expansions. The ratio of EM vs DM central banks' balance sheets should thus improve even more quickly.

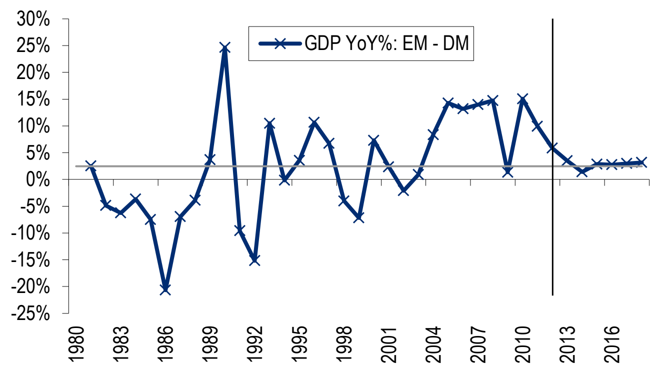
Valuations have compressed, relative EPS revisions have peaked, and taper plus stronger export growth should redress the liquidity shortfall.

In sum, the relative value gap has closed, as too has the relative EPS expectation gap, with the relative liquidity gap the final component to close as we look in to 2014. What drives markets, especially in EM, is a combination of value, EPS revisions (i.e. expectations), and liquidity. For EM, all three are beginning to look more favorable.

No, the relative GDP gap isn't widening, nor should one care

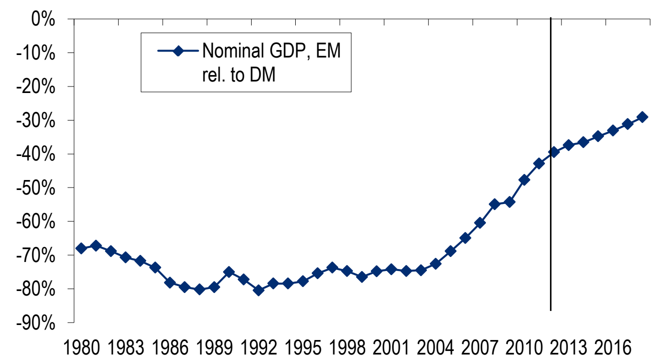
The view by investors is that EM GDP growth is losing steam, especially compared to DM. In Figure 7, we highlight the EM to DM GDP growth gap since the 1980s. The data is from the IMF, as is the forecast for the next few years. We would be careful about the forecast as it assumes near-constant growth differentials, which as we can see, with the exception of the mid-2000 period, has never happened. Still compared to the long-run mean, the growth gap is in line with its historic average and over time it is supposed to widen a bit in favor of EM, in our economists' view.

Figure 7. EM vs DM GDP Growth



Source: IMF, Haver, Citi Research

Figure 8. EM GDP relative to DM



Source: IMF, Haver, Citi Research

Between 1980 and 2005, the relative GDP between EM vs DM was flat, yet Asia had four bull markets with average annualized returns of 48% p.a.

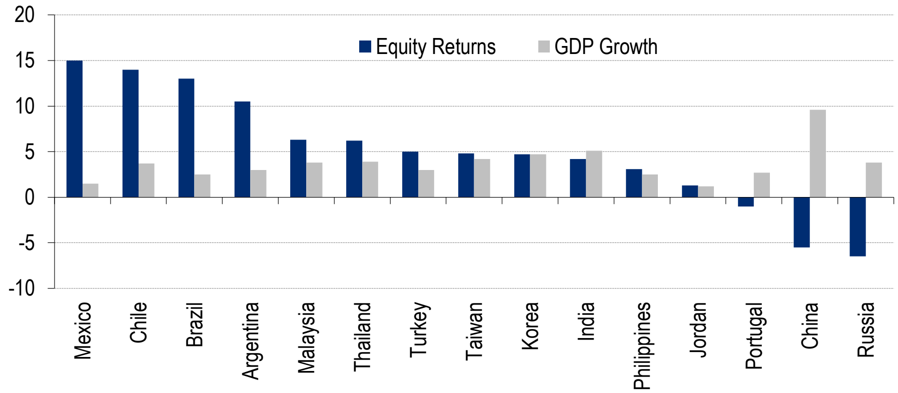
More interesting than the simple growth differential is if we look at the EM GDP as a %age of DM nominal GDP chart (see Figure 8). First, for a period in the 1980s, DM was gaining on EM, and in terms of relative GDP, EM was at exactly the same level in relative GDP terms from 1980 to 2005. Now, we don't have data on the whole of EM during this period, but we do for Asia. Between 1980 and 2005, Asia ex had four bull markets. The average annualized stock price return during those periods stood at 48% p.a, whilst the average annualized EPS growth stood at 9%. On average, the bull runs lasted for 36 months.

The first lesson here is that one's growth can be the same as that of DM – one can even do worse and yet one can still have bull markets. At least, that is what history suggests. Second, bull markets are about multiple expansion, i.e. investors believe tomorrow will be better than today and hence they are willing to pay up for earnings; and third, EM is catching up to DM GDP, as the base of total EM GDP is rising. EM grows less, but from a larger base--every 1% of GDP growth today generates more additional demand that it did just a year ago: a 1% increase in EM GDP today generates as much additional GDP as 4% would have generated 10 years ago and 7% 20 years ago.

The GDP growth differential is in line with the long-run mean. Nor does high GDP growth guarantee higher stock market returns.

Finally, if our arguments alone are not convincing enough, we point to Figure 9 and Messrs Dimson, Marsh, and Staunton, all esteemed academics as opposed to lowly brokers. Since 1980, there has been a negative relationship between GDP growth and stock market returns. Who would have thought it?!

Figure 9. GDP growth does not guarantee return in equity market



Source: Citi Research, Dimson, Marsh and Staunton

Be long global creditors, not local debtors

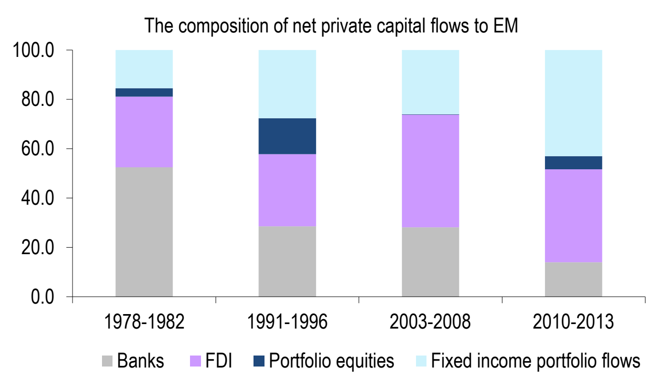
We continue to have a two-tier strategy within EM. We generally favor the more globally exposed markets in EM, those with CA surpluses, low financial vulnerability, attractive valuations, and generally +ve price and EPS momentum. Quite a mouthful, so let's simplify things.

Avoid CA deficits/high financial vulnerability and markets where there are plenty of bond tourists.

The popular theme over the last few years to focus purely on the domestic economy and domestic consumption we believe has run its course. The consensus is long this theme, it is expensive, and it no longer appears supported by the underlying fundamentals. In the same way as EM went from expensive to cheap, so the domestic consumption story appears set to go from expensive to cheap. With expected stronger global growth in 2014, the need to pay extortionate multiples for domestic consumption no longer seems prevalent.

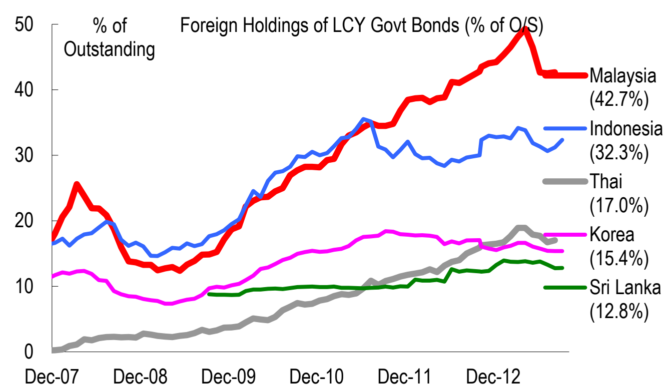
Additionally, CA deficits long sought after by investors - they were the ultimate signs of excessive consumption - now seem to be viewed with distrust as to the funding of these deficits. Over the course of the last few years, bond investors have been rather generous with their capital (see Figure 10). Equity investors, on the other hand, have been rather more reticent when it comes to parting with their hard-earned cash.

Figure 10. Foreign flows were bond, not equity driven



Source: Citi Research

Figure 11. Avoid the tourist bond holders



Source: Citi Research

So, if we want to look at risks in EM, the bond market is good place to start (see Figure 11). We notice that often CA deficit and high weighting by foreigners have a tendency to go hand in hand. To avoid these issues, markets that have CA surpluses have tended to come with less risk, stronger liquidity positions, and often also lower valuations. In terms of broad measures of financial vulnerability, see Figure 12.

Figure 12. Market Rankings in various aspects

	Curr Acct % GDP	Import Coverage	FX Reserves Growth	FX Vulnerability	PBV dev from 5Y avg	GEM Funds Ownership	Net Debt	Debt	1=Best
CN	2	1	1	3	1	1	2	1	1
HK	2	2	2	3	2	3	1	1	2
IN	3	3	3	1	1	3	2	3	3
ID	3	3	3	1	2	2	1	1	2
KR	1	2	2	3	1	1	3	1	1
MY	1	2	3	1	3	1	2	3	2
PH	1	1	1	2	3	2	3	2	1
SG	1	2	1	2	2	2	2	3	1
TW	1	1	2	3	2	1	1	-	1
TH	2	2	3	2	3	3	3	2	3
BR	3	1	3	1	1	2	3	3	3
MX	2	3	1	2	3	2	3	2	3
TR	3	3	1	1	2	3	1	1	1
ZA	3	3	2	2	3	1	2	2	3
RU	2	1	2	3	1	3	1	2	1
AxJ	1	1	1	3	2	1	2	2	1
LatAm	3	3	3	1	3	2	3	3	3
EMEA	2	2	2	2	1	3	1	1	2

Source: Citi Research

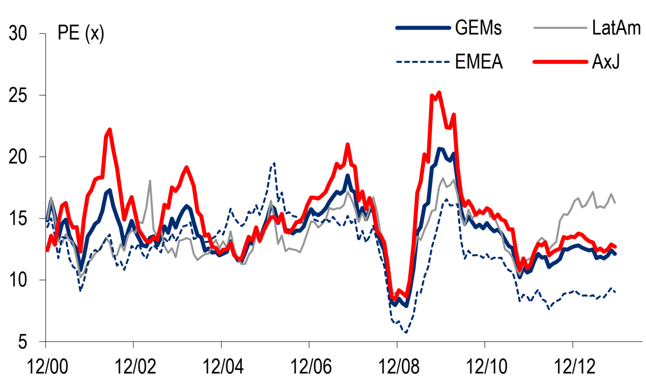
OW Asia, neutral EMEA, and underweight Lat Am

Asia has the better fundamentals, strongest earnings growth, cheap valuations, CA surpluses, and is a consensus underweight.

In our asset allocation as we go into 2014 vs 2013, it is unchanged. Why aren't we changing it? Simply put, it is working, and given where the fundamentals appear to be heading, we see nothing to suggest that we are about to witness a reversal.

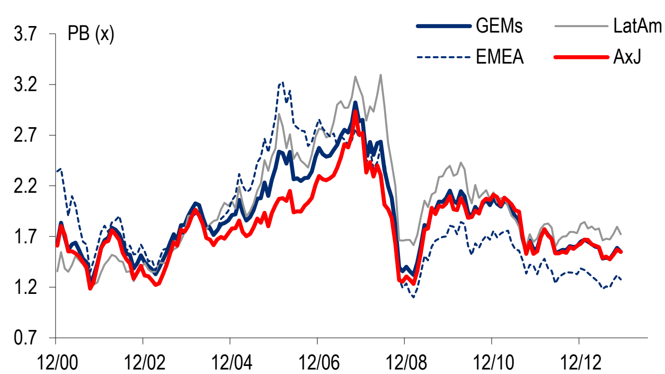
Valuations: in Figure 13 we show the trailing P/Es for the three regions. Cheapest of the three is EMEA, followed by Asia and then Lat Am. The last has performed poorly but earnings have done even worse, hence the PE re-rating. Even based on PBV (see Figure 14), Lat Am is still at historical average PBV whilst the other two regions are trading at below-average valuations.

Figure 13. Trailing PE in EM regions



Source: MSCI, Citi Research

Figure 14. Price to book in EM regions



Source: MSCI, Citi Research

The same is true when we look at implied EPS growth rates to perpetuity: they are lowest in Asia, followed by EMEA, and then Lat Am. So, on the first consideration, value in EMEA in absolute terms is cheaper but, as per Fig 13 and 14, over time EMEA has always been cheaper. Relative to its own history, Asia stacks up very well and in terms of de-rating, the Asian de-rating has been bigger than that of EMEA. In both P/E and P/BV terms, Lat Am remains the most expensive region. Compared to the other two regions, Lat Am has also seen the smallest de-rating.

Figure 15. Implied EPS Growth in EM regions

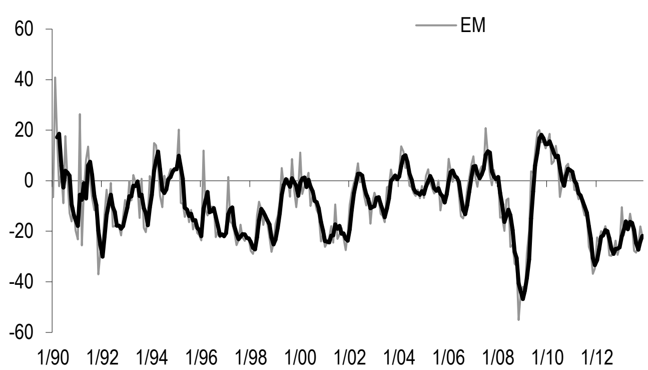
	PE		EPS Growth		Cosf of	Implied
12/2/2013	Next 12mth	2nd 12mth	Next 12mth	2nd 12mth	Equity	Growth
EM	10.5	9.6	12.2%	9.8%	12.6%	2.5%
AC Asia ex JP	11.2	10.1	13.3%	11.0%	11.5%	1.8%
EM Asia	10.7	9.6	14.0%	11.2%	11.8%	1.6%
LATAM	12.4	11.0	17.8%	12.1%	13.5%	5.0%
EMEA	8.7	8.4	3.7%	3.9%	14.4%	2.8%

Source: IBES, FactSet, MSCI, Citi Research

Best EPS revisions in EMEA, followed by Asia, and then Lat Am

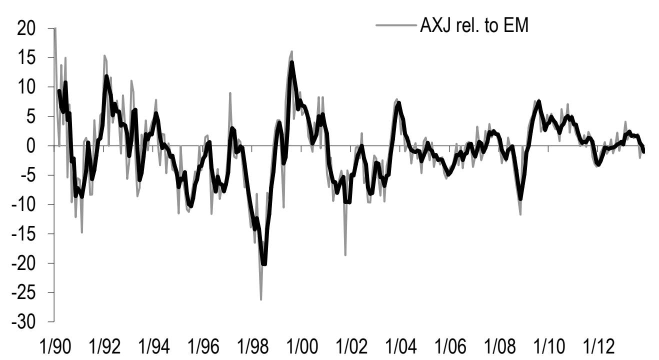
EPS revisions: In terms of earnings revisions, we've already highlighted the DM vs EM EPS revisions dynamic in Figure 4, so let us turn to the regional variance. Figure 17-19 highlight the relative earnings revisions by EM region. At present, the strongest EPS revisions come from the EMEA region: as we measure (up-down)/total revisions, it is the smaller markets that are seeing better revisions. Sadly, it is not the likes of South Africa or Russia at the moment. The next strongest revisions are found in Asia. There has been a bit of a dip as of late in the Asian revisions, here too driven by the smaller markets in ASEAN, which have suffered most from the currency weakness. The weakest revisions have come out of Lat Am, which continues to lag the other two regions. In terms of sectors, the industrials, materials, and consumer staples are still showing the weakest earnings revisions, whilst the health care sector, utilities financials, and cons discretionary are currently showing the best revisions.

Figure 16. GEMS Earnings Revision Index



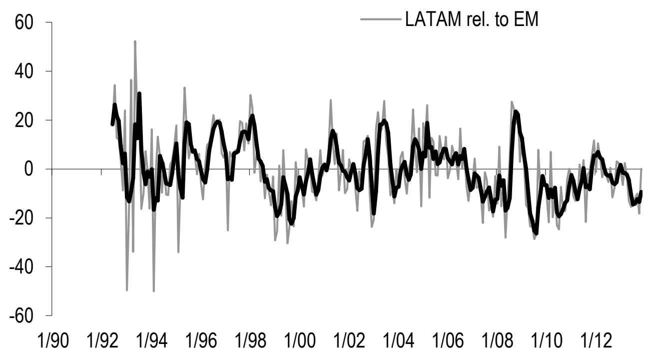
Source: IBES Aggregate, Citi Research

Figure 17. Asia earnings revision index relative to EM



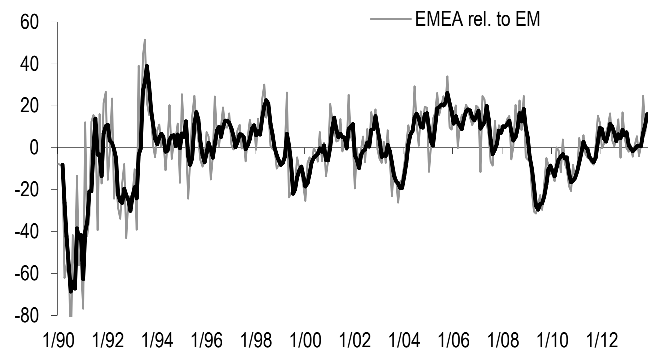
Source: IBES Aggregate, Citi Research

Figure 18. LatAm earnings revision index relative to EM



Source: IBES Aggregate, Citi Research

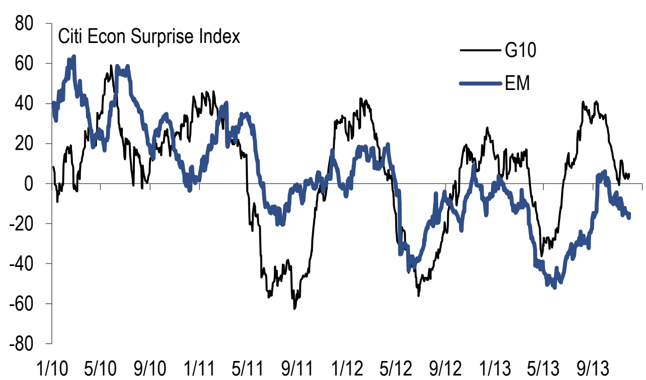
Figure 19. EMEA earnings revision index relative to EM



Source: IBES Aggregate, Citi Research

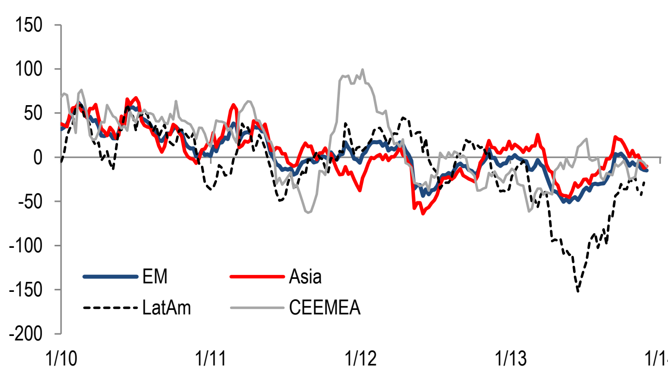
Economic surprise indices: Very much coincident with the EPS revisions data is the CECI (Citi economic surprise indices). Figure 20 highlights both the G10 and the EM economic surprise index. As you can see, both are at present rolling over. The G10 is still above zero, so the economic data is generally coming out as expected, whilst in the case of EM, the data generally appears weaker than economists are forecasting. What happens next? Economists usually tend to get more bearish as it is embarrassing to be wrong, and by the time forecasts have been cut, we usually find that the actual data comes out better than expected.

Figure 20. Economic Surprise in GEMS vs G10



Source: Citi Research

Figure 21. Economic Surprise in GEMS by regions



Source: Citi Research

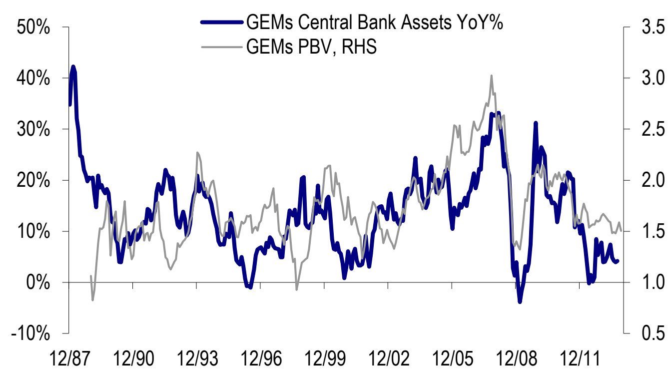
CESI is rolling over in DM, and in EM it is weakest in Lat Am.

When we look at it by EM region, the biggest recovery has occurred in Lat Am, where the data was missing forecasts by the widest margin (too many optimists vs data releases). Whilst the degree of misses narrowed, it has begun to widen again recently, showing that vs forecasts, the released data is weaker again. In the case of both EMEA and Asia, data has also been weaker than expected but the gap between the released data and the forecast is closer than it has been in Lat Am. Looking ahead, the risk for Lat Am and parts of EMEA – this is where the majority of CA deficits reside - is that should taper happen more quickly, the risk of data disappointments is larger than in Asia as there are more CA surpluses in Asia.

Liquidity: When we compared EM vs DM, one of the points of difference was the relative growth rate of the asset side of the central banks' balance sheets. In the EM context, where the asset side of the central bank's balance sheet goes, there goes the market multiple. In that regard, when we look at the three regions of the

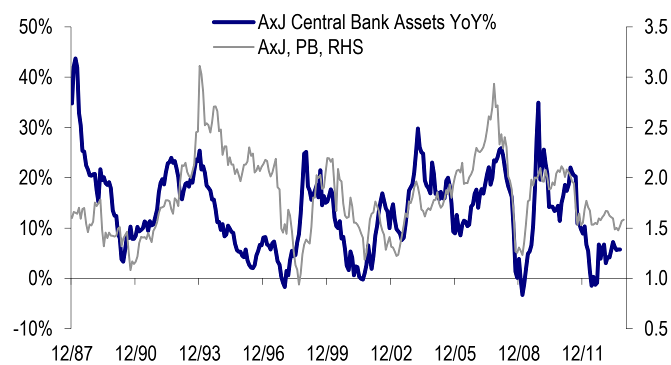
EM world, the strongest growth rate in central bank liquidity is found in Asia. Why? This is also where there are more CA surpluses than in the rest of the EM regions. Rising CA surpluses driven by stronger trade surpluses and capital flows buoy domestic liquidity. In the case of both EMEA and Lat Am, we are seeing significantly weaker growth in the asset side of the central bank balance sheet. Another way to look at this is to divide the EM asset class into two: CA surplus vs those running a CA deficit. The former have stronger liquidity growth than the latter, hence also our preference for those markets with stronger current accounts.

Figure 22. Central Banks Expansion in GEMS



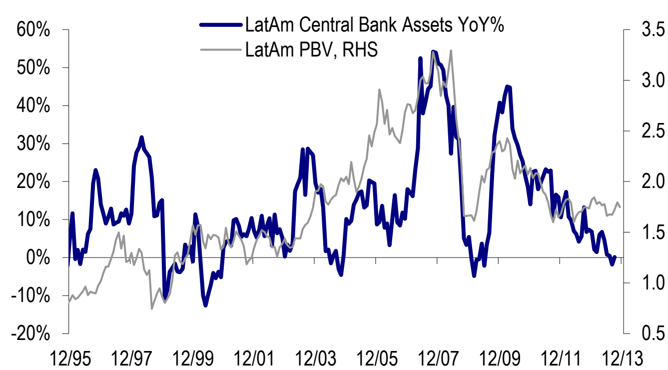
Source: Haver, MSCI, CEIC, Citi Research

Figure 23. Central Banks Expansion in Asia



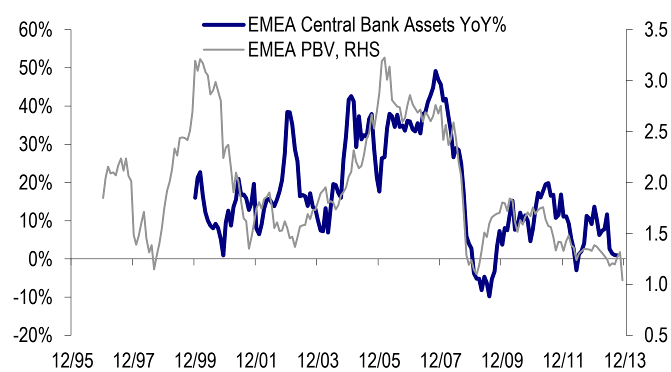
Source: Haver, MSCI, CEIC, Citi Research

Figure 24. Central Banks Expansion in LatAm



Source: Haver, MSCI, CEIC, Citi Research

Figure 25. Central Banks Expansion in EMEA



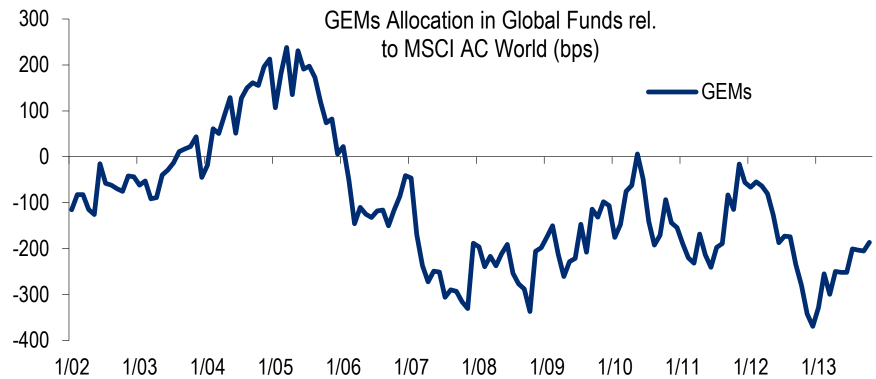
Source: Haver, MSCI, CEIC, Citi Research

The strongest central banks' balance sheet expansion is in Asia, the weakest in EMEA and Lat Am.

When we look at the growth rate of the central banks' balance sheet vs market multiple, the biggest disconnect at present is to be found in Lat Am. Liquidity remains weak but the Ibovespa in particular has rallied from the July lows and until there is an improvement in either exports or capital inflows, that rally remains suspect to us. In terms of outlook, the Asia economies have a higher export-to-GDP ratio and their equity markets have a higher weight in exporters. So those wanting/willing to participate in the improvement in the global growth outlook should find more opportunities to do so in Asia than in either of the other two regions.

Sentiment/Positioning: At present, EM is not top of investors list of "preferred investment destination." If we were talking holiday destinations, we'd all be laughing all the way to the bank; unfortunately, we are not. Just look at our relative performance vs DM, multiple de-rating or relative fund flows. See Figure 26 as proof that top of the investment list we are not.

Figure 26. EM allocation in global fund

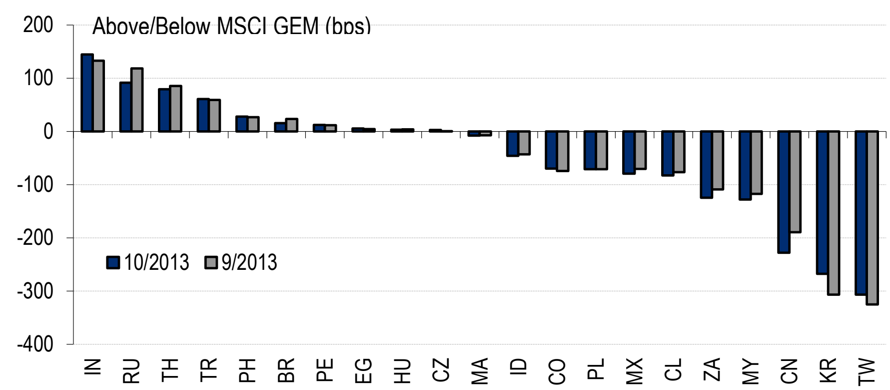


Source: EPFR Global, MSCI, Citi Research

Sentiment toward EM remains poor; just look at the relative valuations or performance, or even flows.

For the average global fund, EM is an underweight (Figure 27)--less of an underweight than it was at the depth during the summer, but an underweight nonetheless. When it comes to the various regions, Asia is the region least liked by investors owing to the underweights in China, Korea, and Taiwan. EMEA is generally an overweight, with investors overweight Turkey but more circumspect when it comes to South Africa but generally overweight Russia. Lat Am is an underweight, with investors underweight Mexico and Chile but overweight Brazil.

Figure 27. Country allocation in GEM funds rel. to MSCI EM



Source: EPFR Global, MSCI, Citi Research

One may well ask how come there is a big underweight in Asia but no big overweights in the other two regions? Asia represents more than 60% of the whole index after all. Well, that is because there is an infinite overweight by EM investors in EM in DM stocks. We can download about US$300 bn of AUM at EM funds and get it right down to the stock level. And when this is done, bingo, 13-15% of their AUM is in these well-known EM in DM stocks, i.e. outside of the MSCI EM benchmark. Now, in a bear market, the EM in DM trade has absolutely been the right way to be positioned historically. When capital returns to EM, however, this has been the wrong way to be, as EM in EM has tended to have a higher beta than EM in DM.

Consensus is UW Asia, UW Lat Am but overweight EMEA.

So overall sentiment remains weak, with most investors skeptical about the ability of EM to generate absolute returns let alone perform in line or, even potentially, do better than DM. In that respect, we have come full circle compared to 2010. In 2010, EM was seen as the part of the globe that had saved the world from a complete GDP collapse. Europe was seen as inches away from splintering, the US was potentially going to double dip, and Japan, well, was going to be Japan, so little in terms of expectations there. Fast forward to today--EM is viewed as hopeless: there are issues everywhere, be they elections, CA deficits, poor corporate governance, etc. Compare that to the USA. It has shale gas, a manufacturing renaissance, and improving fiscal balance, amongst other attributes. Europe (who would have thought?) is coming out of recession, importantly did not break up, and has better corporate governance and first-class companies. It was hard for EM to do better than expected post-2010 and it was equally hard for DM to disappoint; it feels eerily similar at present, but the roles have reversed.

Investment themes:

Avoid CA deficits, go long CA surplus and markets with low foreign bond ownership.

The first theme is to **avoid CA deficit** (i.e. global debtor) and be long global creditors. Taper should refocus investors on the perils of US$ shortages. We expect weaker local currencies and thus a higher risk of central banks responding with tighter money. Not a good outcome for equities. Country longs: China, Korea, Taiwan, and Russia; avoids: Indonesia, India, South Africa, Turkey, and Brazil.

Asset turn is the way to go, avoid margin maximizers

The second investment theme, **focus on asset turn**. Based on our house view that the global growth environment is improving, we think it pays to focus on those stocks, sectors, and countries that stand most to gain from an improvement in top-line growth. These tend to be consumer cyclicals, technology, and selected industrials. Simultaneously, we seek to **avoid the margin maximizers**--the sectors that have been most defensive. This includes the broad consumer staples space, health care but also the materials space, preferring to be long the energy space.

Focus on value and +ve EPS revisions in to tighter US liquidity this always outperforms.

Third, the **investment style** that has tended to do best during periods of tighter money has been low trailing P/E, low P/CE, i.e. **value and +ve EPS revisions**. We don’t think investors should go chasing high ROE, rising real ROE or margins; no value plus EPS revisions appears to be the way to go. This means that along the asset-turn sectors mentioned above, we need to add the financials in EM.

GEMS Market Drivers Summary

Figure 28. Asia Country View

Country	Recommended weighting	Why?	BULL	BEAR	Country Strategists' Top Buys
China	Overweight	Second-lowest implied EPS growth to perpetuity, consensus underweight, low FX vulnerability, asset side of PBOC expanding.	Very low valuations, poor sentiment means it does not take much to change expectations, subdued earnings expectations.	Policy paralysis leads to hard landing, credit sector seizes up. NPL issues understated and will cause a hard landing.	0939.HK, 6837.HK, 2319.HK, 2318.HK
India	Underweight	Twin deficits, valuations not expensive but not low either. EPS revisions remain weak. Consensus overweight.	Room for interest rate cuts in 2014, currency has fallen so much, has to bounce back, CA deficit showing signs of improving.	Policy paralysis, inflation sticky. One of the biggest overweights in EM equities. Elections in 2014.	REDY.BO, ICBK.BO, IDEA.BO, LART.BO, MRTI.BO, TISC.BO, WIPR.BO
Indonesia	Underweight	Foreign investors very overweight the local bond market, equity investors looking to exit. CA deficit looks sticky. Not inexpensive	Large populations, good demographics, domestic growth driven not exports. CA will adjust and growth resume.	Interest rate cycle on the up. Further foreign selling of bonds weakens the currency more, well held. Elections in 2014.	BMRI.JK, BBNI.JK, SMGR.JK, SCMA.JK
Korea	Overweight	Pick up in global growth set to benefit Korea, valuations vs self remain attractive. Foreign investors remain skeptical. Runs large CA surplus.	Few own it, many dislike it. No one can see a catalysis, the fact that it is low priced even by Korean standard and few own it is enough to get to move higher	Cyclical, always inexpensive, don't pay dividends.	000720.KS, 005380.KS, 051910.KS, 005930.KS, 000660.KS
Malaysia	Underweight	Defensive market, not particularly inexpensive.	Defensive market, consensus underweight, large domestic pool of money.	Unsustainable fiscal position, too small to be a domestic story, high foreign ownership of local bonds.	DSOM.KL, MBBM.KL, SKPE.KL, SIME.KL
Taiwan	Overweight	Good earnings revisions, esp in the technology space, increase in cross straights ties a +ve. Loan growth improving, valuations still supportive.	Large underweight by investors, valuations neutral, very little fx vulnerability. Few foreign bond tourists. Exports improving.	Cyclical market, not expensive but neither inexpensive; who needs another tech gizmo?	2311.TW, 2324.TW, 4904.TW, 2903.TW, 2886.TW, 1303.TW, 1789.TW
Thailand	Neutral	Reasonable earnings revisions and valuations. Domestic side expensive but cyclical part of the market low priced.	Populist government, large foreign reserves, consumer spending stable, valuations still okay.	Consensus overweights, fiscal position unsustainable. Election looming in 2014?	AMAT.BK, DTAC.BK, KBANf.BK, LH.BK, SCC.BK

Source: Citi Research

Figure 29. EMEA Country View

Country	Recommended weighting	Why?	BULL	BEAR	Country Strategists' Top Buys
Russia	Overweight	Cheapest market in EM with negative EPS growth of 3.3% to perpetuity. Low expectations. Runs a CA surplus.	Better global growth, narrowing of the Russian corporate governance discount, like China, hard to find anyone who has anything +ve to say.	Policy remains suboptimal, no change to corporate governance, commodity prices fall further.	GAZP.MM, MGNTq.L, MAILRq.L, SBER.MM
South Africa	Underweight	Expensive equity market with deteriorating price and EPS revisions, weak external accounts.	Quality management, global companies, eventually the J curve will kick in, currency oversold.	In a rising interest rate environment, twin deficits hurt, further valuation compression.	NPNJn.J, TBSJ.J, IMPJ.J, FSRJ.J
Turkey	Underweight	Valuations, revision remain favorable. FX risks on the rise with tighter money. Consensus overweight.	Large domestic market, valuations remains supportive, regional expansion plans.	FX vulnerability, twin deficits and a consensus overweight. Foreign investors big overweights in the bond market.	ARCLK.IS, BIZIM.IS, HALKB.IS, SISE.IS, THYAO.IS
Poland	Underweight	European recovery story, GDP growth acceleration, EPS growth recovery in 2014 but on the expensive side.	Europe is recovering; this will help Poland, earnings acceleration in 2014. Fund flows supportive.	Euro recovery has the potential to be a blip; the equity market has had a narrow outperformance, nor is it inexpensive.	PKO.WA, GPW.WA
Greece	Underweight	Better opportunities in other EMEA markets, many challenges remain, economy still contracting, just less so. Market had a strong rebound in 2013.	Any corporate that has survived the last few years deserves a break.	Small market, economy still sensitive to shocks	OTEr.AT

Source: Citi Research

Figure 30. LatAm Country View

Country	Recommended weighting	Why?	BULL	BEAR	Country Strategists' Top Buys
Brazil	Underweight	Rising interest rates, slowing economy, poor earnings revisions, central bank liquidity creating weakness.	Sentiment quite negative, multiples have come off. Global growth pick up will help the external side esp with a weaker currency.	Earnings still have a long way to come off, rates set to continue to rise, election causes paralysis, rates hurt consumption. Consensus overweight.	VALE.N, BRFS.N, RENT3.SA, MILS3.SA
Mexico	Overweight	US growth outlook improving. Only reform story in EM, yoy growth comps getting easier. Investors underweight.	Reform minded administration, key beneficiary from stronger US growth.	Not the cheapest market in EM, taper may scare the large number of foreign bond investors.	Walmexv.mx, Comparc.mx Alsea.mx
Chile	Underweight	One of the more expensive markets in EM, vs the rest of EM the earnings revisions remain poor as does price momentum. We do not see major changes post the election.	Poor performing market vs EM for a few years, at average valuations, election uncertainty out of the way.	No significant de-rating, hence average valuations whilst other have been de-rated. Higher corporate tax rates.	RIP.SN, EOC.N, FAL.SN

Source: Citi Research

Market Intelligence

Figure 31. GEMS Market Intelligence

	Mkt Cap	P/E (X)			EPS Growth (%)			Yield (%)	PBV (x)	ROE (%)			US$ Performance		
03 Dec 13	USD bil	2013	2014	2015	2013	2014	2015	2014	2014	2013	2014	2015	1W	1M	YTD
GEMs	**3,797**	**11.7**	**10.4**	**9.5**	**11.5**	**12.1**	**9.8**	**3.0**	**1.4**	**12.8**	**13.1**	**13.1**	**-0.3**	**-2.4**	**-5.0**
Asia ex JP	**2,991**	**12.7**	**11.2**	**10.1**	**10.4**	**13.2**	**11.0**	**2.7**	**1.4**	**12.1**	**12.5**	**12.6**	**0.9**	**0.0**	**1.6**
EM Asia	**2,414**	**12.1**	**10.6**	**9.5**	**11.5**	**14.0**	**11.2**	**2.6**	**1.4**	**13.0**	**13.4**	**13.5**	**1.0**	**-0.1**	**0.7**
China	777	10.2	9.3	8.4	11.2	9.3	11.6	3.4	1.4	14.7	14.5	14.5	1.5	4.6	3.9
Hong Kong	379	16.4	15.1	13.7	10.5	9.0	9.6	3.0	1.3	8.1	8.4	8.3	1.0	1.0	8.7
India	234	16.5	14.3	12.3	8.9	15.6	15.5	1.7	2.3	15.5	15.9	16.3	2.1	-2.4	-7.8
Indonesia	85	14.3	12.7	11.2	1.9	12.2	14.1	3.1	2.6	21.1	20.7	20.7	0.8	-8.2	-23.0
Korea	610	10.4	8.5	7.7	8.9	22.3	10.0	1.2	1.0	11.1	12.1	12.0	-0.6	-1.4	2.8
Malaysia	146	17.0	15.6	14.2	-0.5	8.8	9.5	3.1	2.0	13.2	13.1	13.4	1.8	-0.8	4.1
Philippines	35	19.5	18.2	15.4	7.4	7.4	16.0	2.3	2.6	14.7	14.4	14.8	2.3	-6.0	2.3
Singapore	198	15.0	13.8	12.5	-3.7	8.7	10.5	3.6	1.4	9.5	9.8	10.3	-0.2	-1.1	-0.4
Taiwan	435	15.9	14.3	13.0	28.2	11.4	9.9	3.3	1.7	11.2	11.7	12.1	1.5	-1.0	4.8
Thailand	92	13.1	11.6	10.4	12.5	13.0	11.5	3.8	1.8	15.6	16.0	16.2	1.0	-6.6	-9.0
EMEA	**665**	**8.8**	**8.6**	**8.2**	**14.6**	**3.1**	**4.0**	**4.0**	**1.1**	**13.0**	**12.3**	**11.9**	**-2.4**	**-5.6**	**-10.0**
Czech Republic	9	10.1	11.4	12.2	-6.8	-11.3	-6.4	6.5	1.3	13.6	11.7	10.7	0.6	-7.4	-13.6
Hungary	10	10.8	9.1	7.9	-14.3	18.2	14.7	3.3	0.8	8.1	9.0	9.7	0.2	-6.2	-9.7
Poland	65	13.8	13.4	12.2	-23.2	3.4	10.1	4.1	1.3	9.7	9.6	10.1	-2.4	-1.1	-0.3
Russia	223	5.1	5.2	5.5	-1.7	-2.6	-3.9	4.5	0.6	13.4	11.9	10.4	-3.0	-7.2	-6.3
Turkey	64	10.1	9.3	7.9	7.5	8.0	18.4	3.8	1.3	14.7	14.4	15.2	-4.5	-5.4	-19.1
Egypt	7	10.2	7.0	8.0	-0.3	46.3	-12.7	3.6	0.8	8.1	11.1	8.4	0.6	1.4	-0.9
Greece	19	98.0	44.1	14.9	n/a	122.5	194.8	1.4	0.9	0.5	2.0	10.5	4.7	0.8	51.5
South Africa	268	15.0	13.3	12.0	4.0	12.4	10.9	3.6	2.1	15.7	16.0	16.3	-2.2	-5.9	-13.4
LatAm	**718**	**14.5**	**12.3**	**10.9**	**6.5**	**18.0**	**12.1**	**3.2**	**1.6**	**11.7**	**12.7**	**13.1**	**-2.4**	**-7.0**	**-16.6**
Brazil	406	12.3	10.4	9.3	12.7	18.4	11.6	4.1	1.3	11.4	12.5	12.8	-4.3	-9.6	-18.7
Chile	59	18.1	14.6	12.5	14.4	24.3	16.8	2.7	1.7	9.6	11.5	12.5	-1.0	-9.0	-23.9
Colombia	40	16.4	14.6	12.4	-6.6	12.4	9.9	3.5	1.7	14.2	14.5	14.5	-0.7	-9.8	-22.4
Mexico	198	20.3	17.5	15.6	-4.4	15.7	12.3	1.6	2.4	12.8	13.6	13.9	0.9	0.3	-5.1
Peru	15	13.7	11.3	9.6	-31.1	21.2	17.1	2.5	1.7	14.0	15.0	15.6	-1.1	-11.3	-36.1

Source: IBES, MSCI, FactSet, Citi Research

GEMS Model Portfolio

Figure 32. GEMS Model Portfolio

RIC	Name	Price 12/3/2013	Mkt Cap US$mn	Ratings	Wgts (%) in MSCI EM	Model Wgts	O/U-Wgts bps	2014E PE	2014E EPS Growth (%)	2014E DivYld (%)
	GEMs				**100.0**	**100.0**	**0.0**	**8.0**		**3.3**
	EM Asia				**63.6**	**69.5**	**591**			
	China				**20.5**	**25.0**	**453**			
0939.HK	China Construction Bank	6.26	201,881	1		5.0		5.4	9.7	6.5
2380.HK	China Power International	2.84	2,346	1		2.5		7.0	-10.1	5.7
0883.HK	CNOOC	15.96	91,916	1		4.0		8.2	4.5	4.1
3988.HK	Bank of China	3.72	133,949	1		5.5		5.2	4.9	6.7
0762.HK	China Unicom	12.14	37,215	1		4.5		16.0	33.9	2.4
2777.HK	Guangzhou R&F Properties	12.1	5,029	1		2.0		6.1	10.6	7.4
1133.HK	Harbin Electric	5.63	1,000	1		1.5		7.5	1.9	2.3
	India				**6.2**	**4.5**	**-166**			
CAIL.BO	Cairn India	319.65	9,792	1		1.5		5.3	-4.6	3.8
TAMO.BO	Tata Motors	399.3	19,098	1		2.0		8.3	8.0	0.1
ICBK.BO	ICICI Bank	1086.1	20,104	1		1.0		10.9	19.4	2.0
	Indonesia				**2.2**	**1.0**	**-125**			
INTP.JK	Indocement	19100	5,916	1		1.0		12.2	7.1	2.7
	Korea				**16.1**	**18.0**	**193**			
000720.KS	Hyundai E&C	62500	6,558	1		0.5		10.2	22.2	1.0
005930.KS	Samsung Electronics	1461000	202,789	1		6.0		6.2	11.0	0.7
005380.KS	Hyundai Motor	239000	49,609	1		3.5		5.2	13.9	1.0
017670.KS	SK Telecom	228500	17,386	1		3.5		8.1	31.8	4.1
066570.KS	LG Electronics	66900	10,316	2		3.0		11.8	125.6	0.3
161390.KS	Hankook Tire	61600	7,190	1		1.5		8.8	8.7	1.3
	Malaysia				**3.9**	**2.0**	**-185**			
UMWS.KL	UMW Holdings	12.5	4,538	1		2.0		13.0	13.2	4.4
	Philippines				**0.9**	**0.5**	**-42**			
FLI.PS	Filinvest Land	1.28	710	-		0.5		-	-	-
	Taiwan				**11.5**	**15.5**	**405**			
2317.TW	Hon Hai Precision	78.1	34,687	-		3.0		-	-	-
2474.TW	Catcher	180.5	4,584	1H		2.0		10.8	-5.3	3.8
2324.TW	Compal	22.2	3,314	1		1.5		8.6	422.9	7.6
2330.TW	TSMC	104	91,225	1		5.0		12.8	13.7	2.9
2891.TW	Chinatrust FHC	19.35	9,631	-		2.0		-	-	-
2882.TW	Cathay FHC	46	18,619	1		2.0		18.7	4.5	1.1
	Thailand				**2.4**	**3.0**	**59**			
PTT.BK	PTT	307	27,249	2		1.5		7.2	21.1	4.8
KTB.BK	Krung Thai Bank	18.6	8,078	1		1.5		7.4	13.7	5.4
	EMEA				**17.5**	**17.5**	**-2**			
	Other EMEA				**1.2**	**0.0**	**-117**			
	Poland				**1.7**	**1.0**	**-72**			
GPW.WA	GPW	40.85	554	1		1.0		13.0	29.8	6.6
	Russia				**5.9**	**11.5**	**562**			
SBER.MM	Sberbank RF	100.24	67,587	1		4.0		5.5	12.5	3.7
SNGS.MM	Surgutneftegaz	26.81	34,179	1		3.5		4.1	-14.5	2.6
MGNTq.L	Magnit	64.25	30,355	1		3.0		24.4	19.5	1.0
NVTKq.L	Novatek OAO	131.1	39,693	1		1.0		12.7	8.7	2.4
	South Africa				**7.0**	**3.5**	**-355**			
FSRJ.J	FirstRand Limited	32.8	17,900	1		2.0		10.4	16.3	4.8
MPTJ.J	Mpact Limited	26.95	427	1		1.5		10.8	14.8	3.6
	Turkey				**1.7**	**1.5**	**-20**			
ARCLK.IS	Arcelik	13.2	4,365	1		0.5		11.9	21.3	3.5
SISE.IS	Sisecam	2.61	2,102	1		1.0		7.2	27.6	3.3

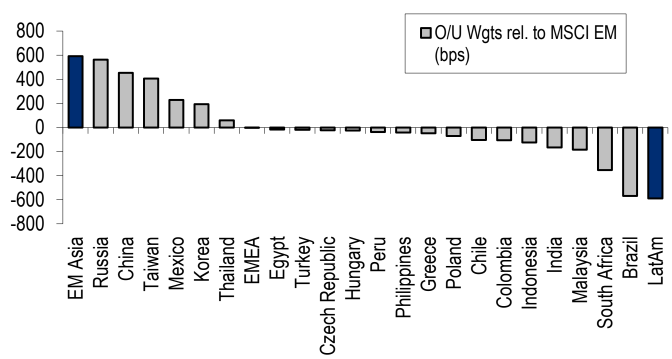
*MSCI market weightings as of 12/3/2013.
Source: Citi Research

Figure 32. GEMS Model Portfolio (Continued)

RIC	Name	Price 12/3/2013	Mkt Cap US$mn	Ratings	Wgts (%) in MSCI EM	Model Wgts	O/U-Wgts bps	2014E PE	2014E EPS Growth (%)	2014E DivYld (%)
	LatAm				**18.9**	**13.0**	**-590**			
	Brazil				**10.7**	**5.0**	**-569**			
VALE.N	Vale	14.85	73,970	1		1.5		7.5	-2.3	3.9
ITUB4.SA	Itaú Unibanco	31.5	66,664	1		1.5		9.1	15.0	3.3
BRKM5.SA	Braskem	20.71	5,673	1		2.0		11.4	86.2	1.9
	Chile				**1.5**	**0.5**	**-104**			
RIP.SN	Ripley	407.9	1,479	1		0.5		17.1	30.7	1.8
	Mexico				**5.2**	**7.5**	**228**			
COMPARC.MX	Gentera	24.41	3,008	1		3.0		15.0	20.1	2.2
WALMEXV.MX	Walmex	34.3	46,134	1		2.0		22.9	12.3	2.2
OHLMEX.MX	OHL Mexico	34.29	4,531	1H		2.5		8.3	17.6	0.0
	Other LatAm				**1.4**	**0.0**	**-144**			

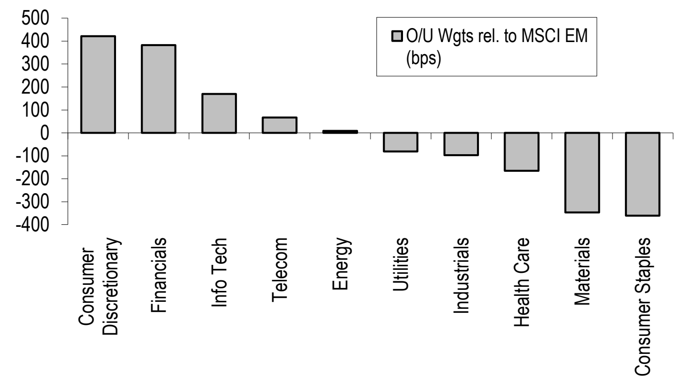
*MSCI market weightings as of 12/3/2013.
Source: MSCI, Citi Research

Figure 33. Model Country O/U-wgts relative to MSCI EM



Source: MSCI, Citi Research

Figure 34. Model Sector O/U-wgts relative to MSCI EM



Source: MSCI, Citi Research

Fund Flow Insights

Investors return to DM equities, but exit EM

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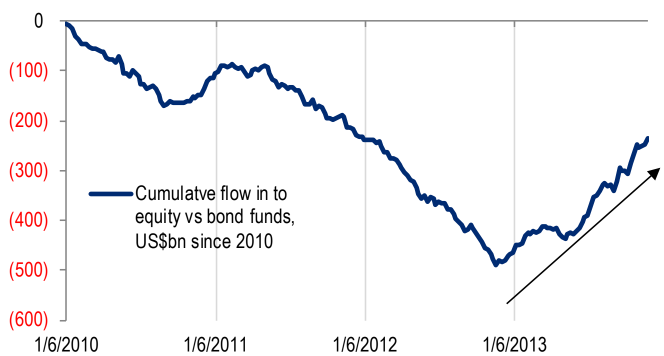
The year 2013 has been a generous one for equities. Since late 2012, the inflow into equity funds continued to exceed those into bond funds (Figure 1), reversing the flight to bonds trend since the global financial crisis. Year to date (from the week 1/2/2013 to 11/27/2013), we have seen US$253.1bn of inflows into equity funds vs. only US$20.6bn into bond funds.

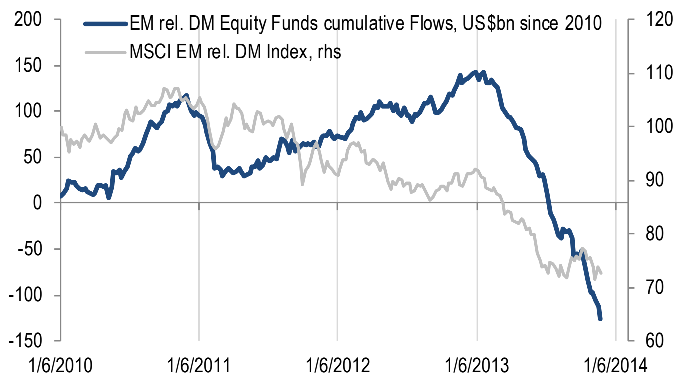
The equity flow, however, appears largely tilted toward developed market funds (see Figure 2). Since the start of 2013, equity flows into EM funds underperformed those into DM funds. YTD, inflow into DM funds has been US$260bn; outflow from EM equity funds has been US$7.04bn.

Figure 1. Cumulative Equity vs Bond fund flows



Source: EPFR Global, Citi Research

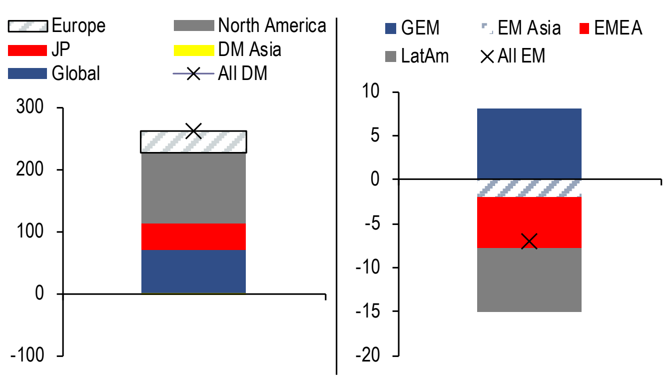
Figure 2. Cumulative EM vs DM equity fund flows



Source: EPFR Global, Citi Research

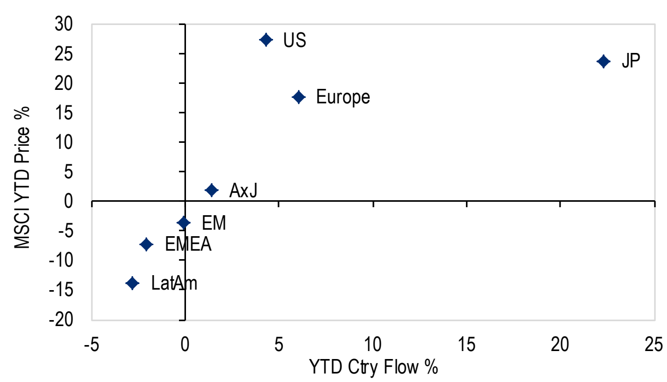
Looking at this in further detail, Asia, EMEA, and LatAm funds all had outflows in 2013. Broad GEM fund was the only class that has positive inflow YTD. The divergence between DM vs EM flow was justly reflected in market performance (Figure 4). Japan (with its Abenomics story) and Europe (with recovery hopes) rank high in both flows and performance. EMs all reside at the lower left hand corner of the chart.

Figure 3. 2013YTD Equity fund flows by geographic focus, US$bn



Source: EPFR Global, Citi Research

Figure 4. YTD country equity Flow vs market performance



Source: EPFR Global, MSCI, Citi Research

Asia by Country

China

Breaking Out from a Trading Range

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- **Reform-led re-rating** – The reform plan laid out in the 3rd plenum should help China avert a near-term hard landing and unleash the country's growth potential. Investor sentiment will normalize in anticipation of the benefits, and MSCI China will break out from its two-year range and gain 20%-plus in 2014, on our analysis. Our base case is for a smooth reform process and 8.6% earnings growth in 2014. This scenario assumes banking and capital goods will re-rate from distressed levels. But before pressing ahead, the economy may slow and cause volatility in company profits.

- **Reform expectations could initially inflict pain** – Businesses may put investment decisions on hold, fearing negative consequences from the reforms. GDP growth could therefore come under pressure. SOEs could delay capex before SOE reform, local governments' infrastructure spending might stall ahead of land reforms, and property-sector investments could slow due to property-tax fears. Unless export growth picks up unexpectedly, the pace of reforms will be dictated by economic growth. A below-target rate would slow reforms, and measures to boost demand and enhance productivity would be front-loaded.

- **Key themes: Deregulation, consolidation and innovation** – SOE, land, financial and fiscal policy deregulation are central to the reform process – positive for structural sectors, mixed for banks and cyclicals. Deregulation would trigger consolidation in the manufacturing and services sectors, but SOEs could break up. Our analysts believe that liquid milk, diaper, tissue, home appliance, aerospace & defense, gas distribution, and paper are in the late stages of consolidation. To escape the middle-income trap and for firms to retain competitiveness, innovation is a must for China. In manufacturing, productivity has improved in textile, paper and printing, and computer and communication equipment.

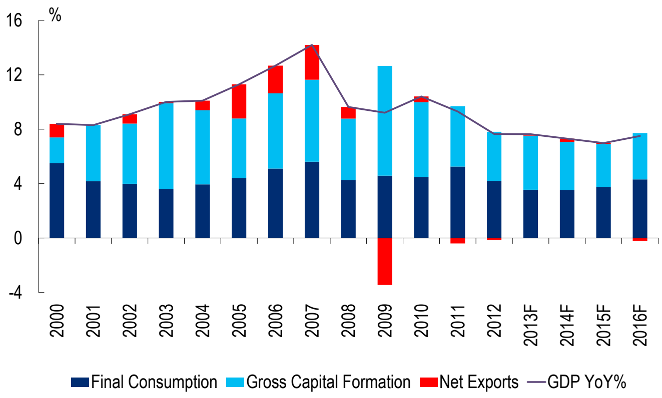
- **Monetizing the transition** – China's equity-market performance in 2014 will, in our view, depend on the balance between reform and growth. We are *positive* on auto, apparel, shoes, home appliances, consumer staples, healthcare, insurance, brokerages, gas and water utilities, and alternative energy; *moderately positive* on banks, machinery; airlines; paper, IT and cement; *neutral* on property, chemicals, department stores and supermarkets, IPPs, and power equipment.

China: Top Buys and Top Sell

	Ticker	Rating	Price (Nov. 29)	Target Price	Yield (%)	ETR (%)	2014E P/E (x)	2014E P/BV (x)	2014E ROE (%)
Top Buys									
CCB	0939.HK	Buy	6.28	7.80	6.5	29.0	5.4	1.0	19.7%
Solid fundamentals, outperforming NPL formations and high provisions. Best capitalized big bank and slight discount to ICBC									
Haitong Sec	6837.HK	Buy	13.42	14.00	1.5	5.8	20.1	1.5	7.9%
Leading broker, key beneficiary of development of China's capital market. Earnings less vulnerable on more prudent trading strategy and less aggressive debts issuance									
Mengniu Dairy	2319.HK	Buy	35.45	38.00	0.9	8.1	25.3	3.2	14.5%
Downstream business has long term growth potential, with liquid milk driven by product mix upgrade and baby formula by industry consolidation									
Ping An	2318.HK	Buy	72.30	75.00	1.3	4.8	14.2	2.1	15.8%
Good value; arguably the best execution in the sector									
Top Sell									
PetroChina	0857.HK	Sell	9.17	7.40	4.1	-15.2	10.9	1.1	10.5%
We forecast decline in reported earnings in 2014 and think the street's expectation for its natural gas earnings growth is too high. Stock is at a premium to peers									

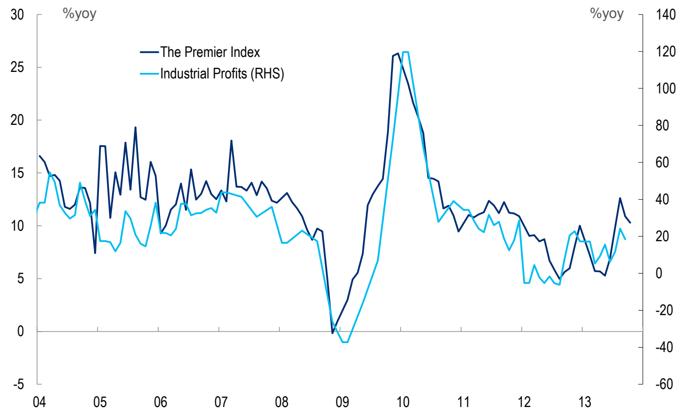
Source: Citi Research estimates

Figure 1. Contribution to GDP



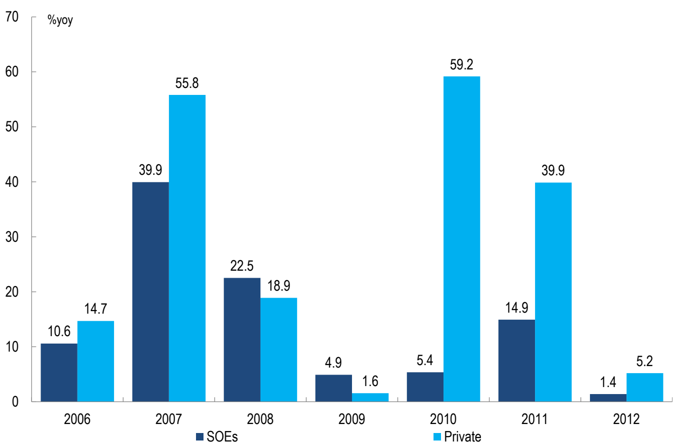
Source: CEIC and Citi Research

Figure 2. Li Keqiang Index vs. Industrial Profit Growth



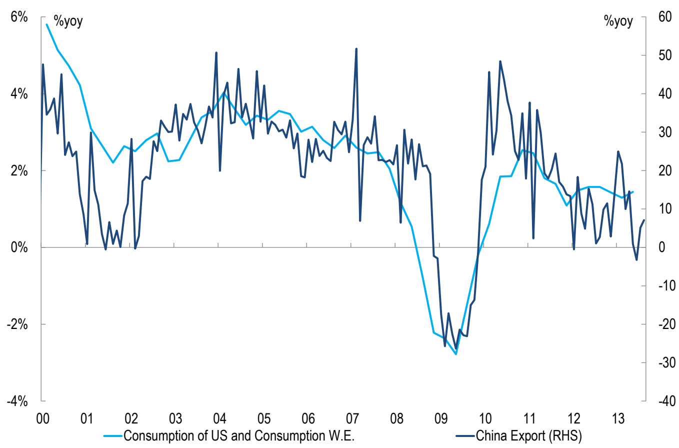
Source: CEIC, Bloomberg and Citi Research

Figure 3. Capex Growth Among A-share Listed Companies



Source: Bloomberg and Citi Research

Figure 4. China Export Growth vs. Consumption Growth in US and EU



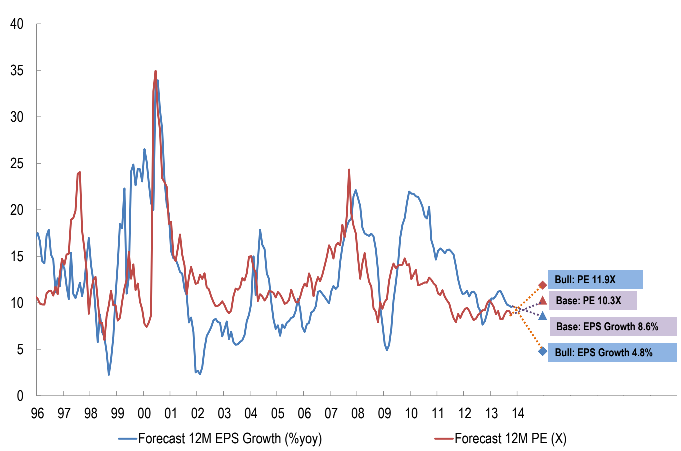
Source: CEIC, Haver and Citi Research

Figure 5. Index Scenario Analysis

	MSCI China	SHCOMP	HSCEI
Base case: Range High in 2012-2013			
PE back to high in 2013 (X)	10.3	10.2	8.0
10% below Consensus EPS Growth in 2014 (%)	8.6	7.2	7.9
Index Target	**77**	**2,805**	**14,335**
Potential gain of the index (%)	**19.2**	**27.7**	**25.2**
Bull case: Better Implementation of reform but earnings halved			
PE Back High in 2011 (X)	11.9	12.6	10.2
Projected EPS Growth in 2014 (%)	4.8	4.0	4.4
Index Target	**86**	**3,350**	**17,434**
Potential gain of the index (%)	**33.1**	**52.5**	**52.3**

Source: Citi Research

Figure 6. MSCI China Valuation and EPS Growth Forecasts



Source: Factset and Citi Research

India

2014: Exciting, Distracting, Attracting… and Only Steady

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- **An exciting year** – Encompassing the Economy, Earnings, Elections and Expectations. These should make 2014 an eventful year; but at the end of it, we see the market largely holding its 'Old Normal' pace and valuation frame-work. We set a 2014 Dec Sensex target of +5% or 21,800 at 12.5X PE (Dec15); consistent with our Dec13 18,900 target (12.5x Dec 14), and suggesting it is 'only steady'.

- **With distractions and attractions** – It will be an eventful year, and there's a lot ahead; a) Elections; (State–Dec13, National May14): exciting, impactful but always difficult to call (big surprises previous two times) b) Reforms; Kick-started, but awaiting impact, c) Macro turns: rates & currency and d) Flows – offshore taper risks, domestic risks likely tapering. There will be distractions, and attractions.

- **But a steadier real world reality** – Beyond the attractions and distractions, we see a steadier and relatively slower real environment. We expect a slight GDP growth pick-up (5.6% FY15E), average but up-ticking earnings trajectory (8/15%, FY14/15E), and investment/ risk appetite that remains tepid (No Room for Complacency). The real world will remain sober (so should valuations); whether the headlines are drinking in joy, or drowning in sorrows.

- **A sober and stock-picking strategy** – A modest return year; a) Overall Defensive bias b) Play business momentum – IT, Pharma and Telecom – rather than big recovery/revival c) Stock-picking – High return opportunities out there d) Mid-caps; Build some appetite. This portfolio might not work every time of the year (with 6 months of election imponderables ahead); but should be good through the year.

- **The surprises** – 2014 could be the year India sets itself up for a turn, but we don't believe it's the year of the big (up) turn. That said, the primary surprises could lie in the elections (up or downside), Oil (more upside) and tapering turns (up or down).

India: Top Buys

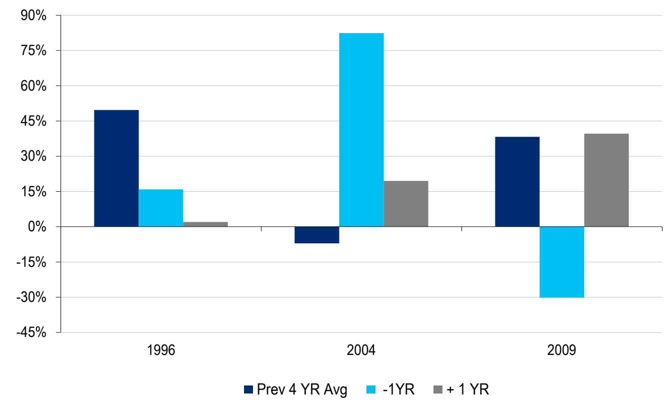
	Ticker	Rating	Price (Nov. 29)	Target Price	Yield (%)	ETR (%)	FY15E P/E (x)	FY15E P/B (x)	FY15E ROE (%)
Top Buys									
Dr Reddy	REDY.BO	Buy	2,485	3,145	0.5	26.3	17.5	3.7	23.5%
Strong US pipeline to drive healthy medium-term growth; ticks most boxes on longer term growth engines (biosimilars, technology products)									
ICICI	ICBK.BO	Buy	1,067	1,250	1.9	16.7	10.9	1.5	14.8%
Strong P&L momentum (margins, fees, costs), no new issues on the balance sheet and setting itself up well for when the asset quality cycle turns									
IDEA	IDEA.BO	Buy	175	205	0.3	17.1	21.3	3.2	15.8%
Pure-play wireless operator, most leveraged to improving sector dynamics and regulatory/ policy regime; valuations are decent - only 10% premium to Bharti India wireless biz									
Larsen & Toubro	LART.BO	Buy	1,043	1,087	1.3	3.2	19.4	2.8	14.9%
Rebound likely in 2HFY14, trading at adjusted core P/E of 15.2x FY14E and 14.0x FY15E									
Maruti Suzuki	MRTI.BO	Buy	1,677	1,910	0.6	15.6	15.4	2.2	15.2%
Dominant player in PV segment; strong market share, capacity and the widest dealership network make it best positioned to benefit from overall industry growth									
Tata Steel	TISC.BO	Buy	401	525	2.0	30.5	9.6	1.0	10.5%
Resilient Indian operations; Europe benefiting from operational efficiencies, volumes, value addition									
Wipro	WIPR.BO	Buy	471	595	2.1	25.6	13.0	2.9	24.9%
Growth is picking up and expected to converge with peers shortly; valuations at ~13x FY15E are reasonable									

Source: Citi Research estimates

Figure 1. India's Earnings Multiple: Now vs. Then ('Old Normal')

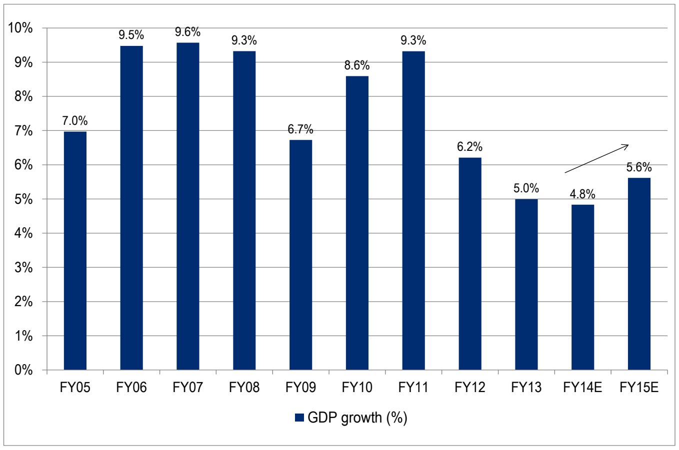
Source: MSCI, Datastream and Citi Research

Figure 2. Sensex Returns: Into and Out of General Elections



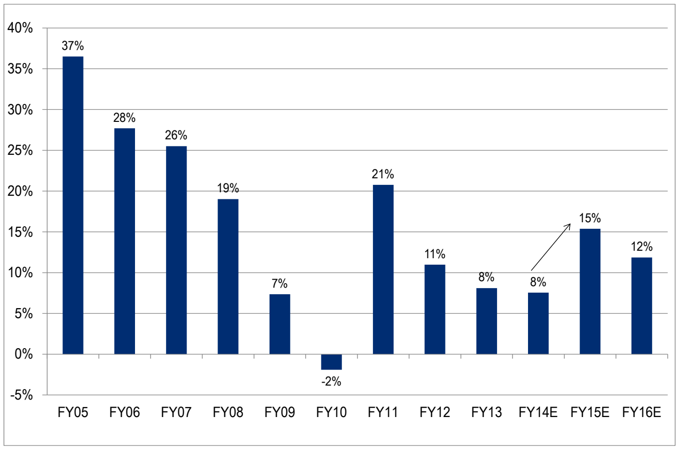
Source: Bloomberg, Citi Research

Figure 3. Trends in GDP growth



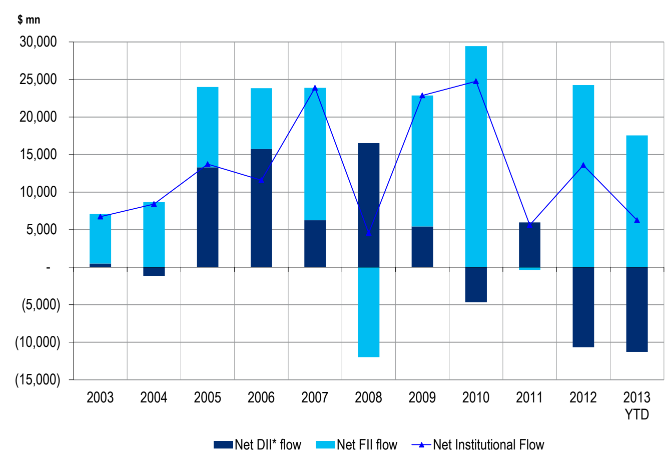
Source: CSO, Citi Research

Figure 4. Trends in Sensex Earnings Growth



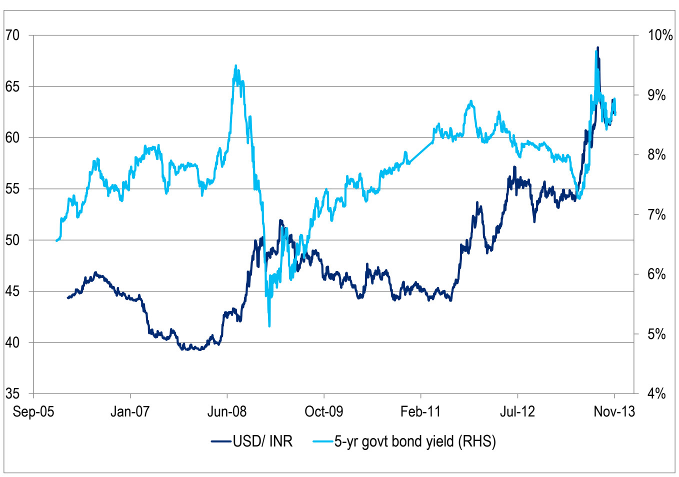
Source: Company reports, Citi Research

Figure 5. Trends in Institutional Flows into Indian Equities



Source: Bloomberg

Figure 6. Trends in the Rupee and Interest Rates



Source: Bloomberg

Indonesia

Challenging Macro Outlook; Focus on Stock Selection

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- **Cautious but maintain our index target of 5,300** – With the outlook for the Indonesian market pretty challenging, we advocate a bottom-up approach for better performance. In the near term, export-oriented sectors such as coal and CPO could attract greater investor interest due to the weak rupiah. Electioneering will be intense, and election-related spending will ramp up from the end of 2013. From a 12-month perspective, our relatively defensive top picks are listed below. The market is trading on a 14E P/E of 13.0x, around its seven-year mean.

- **Parliamentary election in April and Presidential in July** – Indonesia will be in for another coalition government as none of the political parties is likely to gain more than 25% of parliamentary votes. Three candidates are expected to run for presidency, but a coalition would mean that political parties would wield more power than the president and that a second round of voting may be needed to elect a president, after the first proves inconclusive. We believe the reform process and outward looking economic policies will remain intact under any president, which would help vault Indonesia to a top-10 economy by 2025.

- **Tackling the CAD and external imbalances should be the focus in 2014** – Regardless of which party wins Indonesia's parliamentary election or who emerges victorious in the presidential polls, policies to tackle Indonesia's economic problems – such as the widening current-account deficit and a depreciating rupiah – will be executed only at end-2014.

- **Weak rupiah and higher labor cost could put pressure on earnings in 2014** – The weak rupiah, as well as higher labor and fuel prices, will continue to influence corporate earnings, especially of companies with large US$ exposure and high labor costs that have not been passed on to consumers. Interest rates are rising, and our economist expects another 25-50bp rate hike before a drop in 2H14E when inflation eases. Our global strategist expects the US to begin tapering in March 2014, making it more difficult for the central bank to cut rates.

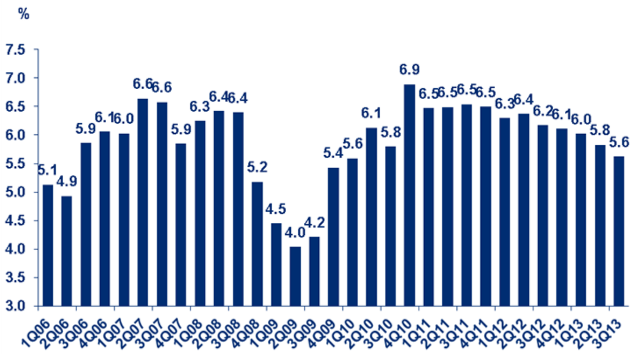
- **What are the risks?** — The risks to our call are: 1) High oil prices; 2) Volatility in the exchange rate; 3) Negative political developments; and 4) Significant US tapering.

Indonesia: Top Buys and Sell

	Ticker	Rating	Price (Nov. 29)	Target Price	Yield (%)	ETR (%)	2014E P/E (x)	2014E P/BV (x)	2014E ROE (%)
Top Buys									
Bank Mandiri	BMRI.JK	Buy	7,650	9,000	3.1	20.5	9.8	1.8	19.6%
Has diversified presence and invested in subsidiaries, so no CAR burden in the future; also has the highest provisions against current and special mention loans									
Bank Negara Indonesia	BBNI.JK	Buy	4,100	4,950	3.3	23.8	9.1	1.4	16.8%
Cheapest multiples among the large-cap banks with potential joint-venture of its subsidiary, Life Insurance, a short-term catalyst									
Semen Indonesia	SMGR.JK	Buy	12,800	19,000	3.1	51.8	12.3	3.1	27.1%
Better cost control from its aggressive coal securing method, higher ROE, stronger long-term growth with plans to increase capacity by 41% in 2017, and stable EBITDA									
Surya Citra Media	SCMA.JK	Buy	2,850	3,450	2.5	23.5	23.3	11.5	54.9%
Most profitable media player with strong FCF and decent c.3% yield									
Top Sell									
Garuda	GIAA.JK	Sell	495	440	0.0	-11.1	72.8	0.8	1.1%
With ~40% of total costs represented by US dollar-based fuel expense, a weaker IDR is likely to create a significant headwind in the near-to-intermediate term									

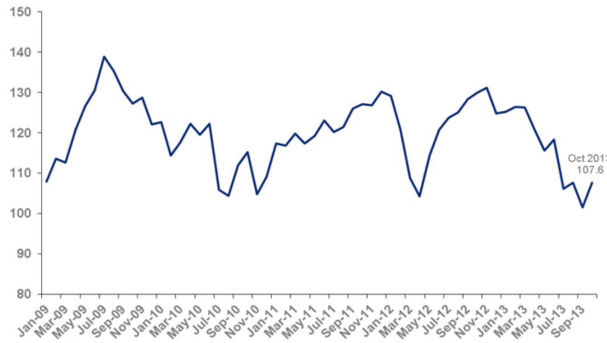
Source: Citi Research estimates

Figure 1. Quarterly GDP growth (%)



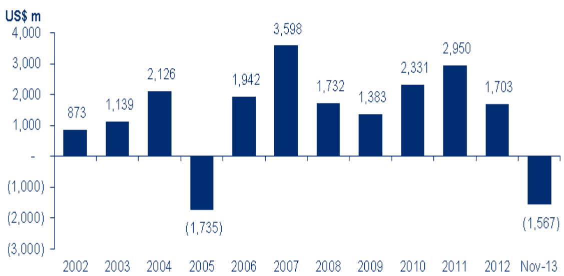
Source: Citi Research, Bloomberg

Figure 2. Business Confidence Index



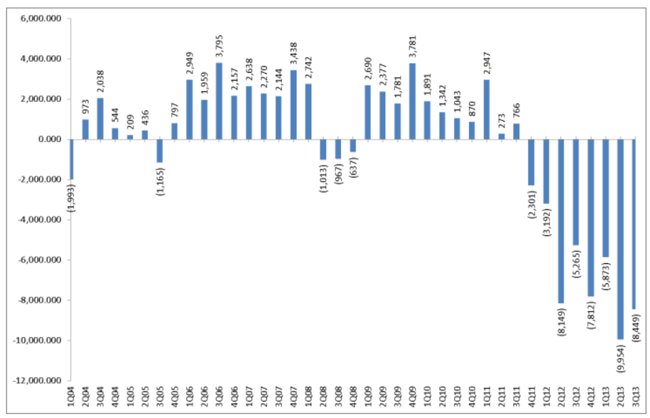
Source: Citi Research, CEIC

Figure 3. Equity Net Foreign Inflow/Outlook



Source: Citi Research, CEIC

Figure 4. Quarterly CAD



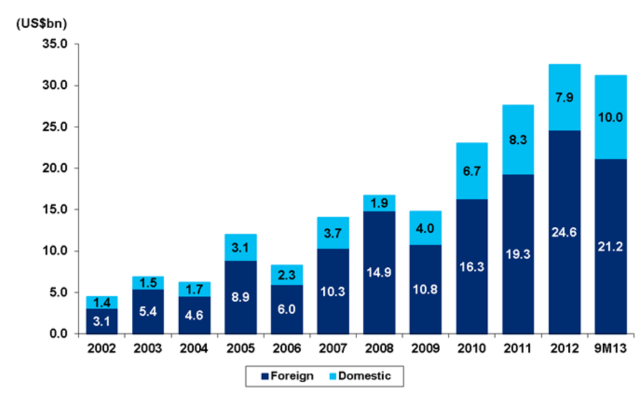
Source: Citi Research, BPS

Figure 5. Election Timetable

Date	Event
30-Aug-13	Partai Demokrat announced 11 nominees for its presidential candidates convention
15-Sep-13	11 nominees in Partai Demokrat convention present mission statements to public
4-Nov-13	Election Commission (KPU) published final voters list: 186.6m eligible to vote
11 Jan - 5 April 14	Official campaign period
9-Apr-14	Legislative election
9-Jul-14	1st round of Presidential election
Sep-14	2nd round of Presidential election, if needed
21-Oct-14	New president takes office

Source: Citi Research, Directorate of Debt Management

Figure 6. FDI and Domestic Investment Realization



Source: Citi Research, BKPM

Korea

Valuation Merit to Emerge Amid Economic Rebound

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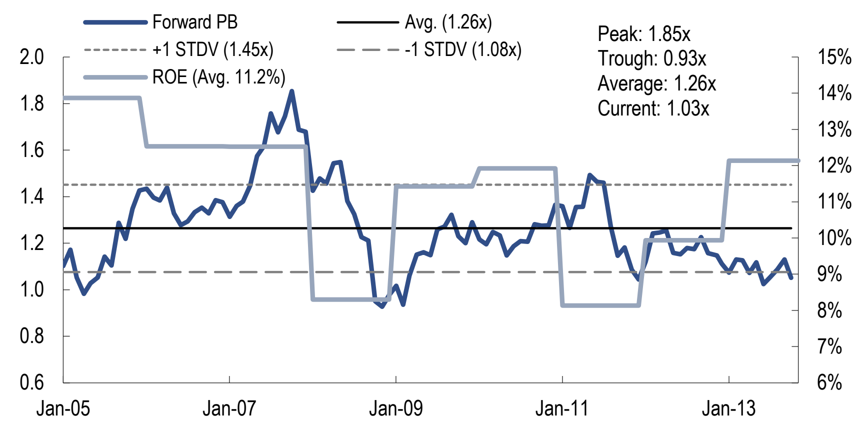
- **KOSPI target 2400 –** Based on our economists' 3.2% global GDP growth forecast for 2014, we expect Korea's GDP to recover to 3.7% during the same period (vs. 2.9% in 2013E). We set our KOSPI target for 2014E at 2400, based on a 2014E P/B of 1.23x (ROE of 10.9%), a slight discount to the historical average of 1.26x (ROE of 11.2%).
- **Korea is a regional overweight –** Our regional/GEMS strategist remains overweight on Korea. Basically, our country/sector allocation model continues to have a cyclical, pro-global growth tilt, with more value to be found in markets such as Russia, Korea, and Taiwan.
- **Positive macro outlook for 2014 –** Our Korea economist expects GDP growth of 3.7% in 2014, from 2.9% in 2013 as the recovery pace remains intact. Consumption is likely to expand further on continued job growth and better prospects for housing and equity markets. Improvements in the global economy, especially advanced economies, and an upswing in ITC products will support a rebound of exports. Meanwhile, local facilities investment should grow fast, along with a recovery in consumption and exports. Downside risks, though, are further weakening of JPY and a delayed recovery in the Korean housing market.
- **Low valuations –** Korea currently trades at 1.03x 14E P/B vs the historical average of 1.26x, with 14E P/B more than 1SD below mean. We forecast 12.1% ROE for 2014E vs the historical average of 11.2%.
- **Sector picks –** We would overweight the tech and auto sectors for higher earnings visibility and cheap valuations. We also are positive on the construction sector in expectation of an earnings recovery in 2014.
- **Strategist's top stock picks –** Our top picks are Hyundai E&C, SK Hynix, SEC, Hyundai Motor and LG Chem.

Korea: Top Buys

	Ticker	Rating	Price (Nov. 29)	Target Price	Yield (%)	ETR (%)	2014E P/E (x)	2014E P/BV (x)	2014E ROE (%)
Top Buys									
Hyundai E&C	000720.KS	Buy	62,900	85,000	1.0	35.9	10.2	1.2	12.7%
Accumulating overseas order backlog (book to bill ratio of 4.0x) and gradual OPM improvement should underpin 2-yr EPS CAGR of 27%									
Hyundai Motor	005380.KS	Buy	252,000	320,000	1.0	27.9	5.5	0.9	17.6%
Improving global autos demand, refreshing model cycle and likely capacity roadmap announcement									
LG Chem	051910.KS	Buy	290,500	350,000	1.4	21.9	10.6	1.4	14.5%
Chemical (ethylene) cyclical upturn; differentiated chemical product mix; capacity growth of 17% over 2012-14E									
SEC	005930.KS	Buy	1,494,000	1,900,000	0.7	27.8	642	1.2	21.0%
High rerating opportunities still ahead on 1) resilient smartphone, 2) multi-year memory growth and 3) improving mid-term shareholder return policy									
SK Hynix	000660.KS	Buy	35,400	45,000	0.0	27.1	5.5	1.4	29.8%
Most leveraged pure memory play on persistent strong memory fundamentals on the back of structural change to the competitive landscape									

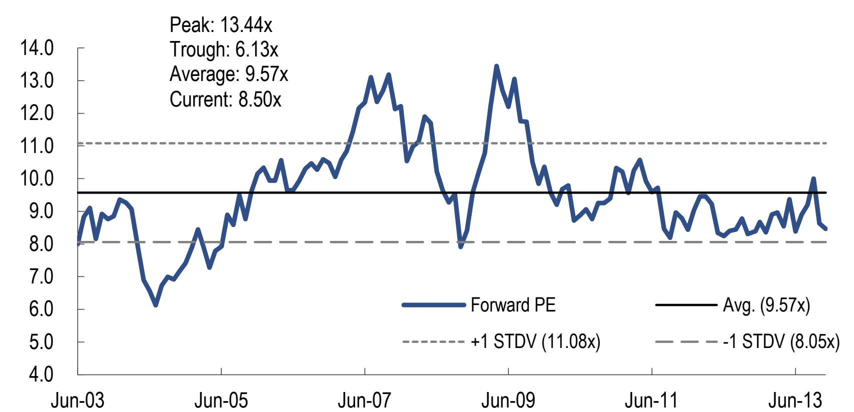
Source: Citi Research estimates

Figure 1. Forward PB Trends



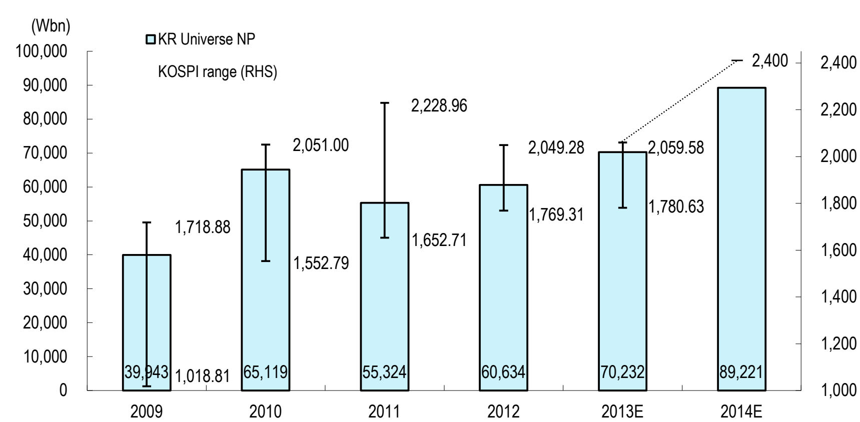
Source: Citi Research

Figure 2. Forward PE Trends



Source: Citi Research

Figure 3. KR Universe NP Trends vs. KOSPI Range



Source: Citi Research

Malaysia

Execution Phase Post Elections

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- **Working through a tough Budget** – Malaysia has set ambitious economic targets, including reducing the 2014 deficit to 3.5% of GDP (RM37.1bn) vs 4% in 2013 (or RM39.2bn). The government forecasts growth of 5-5.5% for 2014 vs. Citi's 5% (2013E: 4.5-5.0%; Citi: 4.5%). While this has reduced the risk of a rating downgrade, there could be downside risk to growth projections on pullbacks in fiscal spending and consumption. A commencement of a 6% GST from April 2015 also adds uncertainty in the latter half of 2014, though this may be mitigated by lower taxes for middle- and lower-income workers and a 1%-point reduction in corporate tax (from the 25% level previously).

- **Taper talk and uncertainty in ASEAN** – Malaysia has historically outperformed during periods of market volatility. For 2013, the KLCI has outperformed ASEAN peers (in USD terms) as expectations of US tapering of bond purchases started to build in May. Aggregate earnings revision trends have also held up better in the tail end of 2013, especially in contrast to the higher earnings growth rates that investors baked in earlier in the year for Thailand, Indonesia and the Philippines. Assuming Malaysia's budget/fiscal discipline holds, the KLCI is likely to be less impacted as tapering expectations build up further in 2014. Our bottom-up KLCI target is pegged at 1880, which implies 16.0x P/E and 2.1x PB (historical averages: 18.0x PE and 2.0x PB).

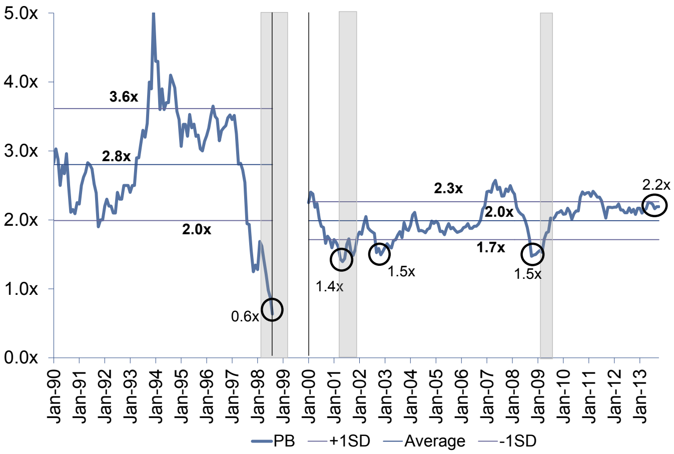
- **Key stock picks** – Our top picks are *Maybank* (most diversified business model to play the rising investment cycle, monitoring recent top mgmt. changes), *SapuraKencana* (continued growth potential), *Sime Darby* (diversified business with earnings growth potential from property and plantations) and *Digi* (strong earnings growth potential; also our only Buy-rated telco in Malaysia). Stocks that we do not like include *Maxis* (expensive valuation with little notable upward operating momentum), *IHH Healthcare* (large valuation premium to regional peers overprices the positives) and *MMHE* (limited clarity on potential contracts).

Malaysia: Top Buys and Top Sells

			Price	Target	Yield	ETR	2014E		
	Ticker	Rating	(Nov. 29)	Price	(%)	(%)	P/E (x)	P/BV (x)	ROE (%)
Top Buys									
DiGi.com	DSOM.KL	Buy	4.87	5.50	4.7	17.7	21.4	nm	nm
Strong earnings growth potential; potential material increase in dividends on capital restructuring									
Maybank	MBBM.KL	Buy	9.78	11.11	5.1	18.7	12.7	1.8	14.3%
Most diversified business model to play the rising investment cycle, monitoring recent top mgmt. changes									
SapuraKencana Petroleum	SKPE.KL	Buy	4.29	5.00	0.0	16.6	21.0	3.4	16.1%
Continued growth potential which includes both expansion into upstream segment and its core existing O&G services business									
Sime Darby	SIME.KL	Buy	9.65	11.38	3.6	21.6	16.2	2.0	12.7%
Diversified business; earnings growth potential from property and plantation (on better CPO price in FY14) segments									
Top Sells									
IHH Healthcare	IHHH.KL	Sell	4.05	2.85	0.0	-29.6	46.0	1.8	3.9%
Stock's large premium to regional peer group overprices the positives; Citi's estimates remain below consensus									
Malaysia Marine & Hvy Eng	MHEB.KL	Sell	3.76	2.92	2.7	-19.7	24.5	2.8	11.8%
Failed to deliver on sustainable contracts wins; limited clarity on potential upcoming contracts									
Maxis	MXSC.KL	Sell	7.03	5.80	5.7	-11.8	22.7	9.6	39.7%
Expensive valuation; little notable upward momentum in terms of operating trends or service revenue									

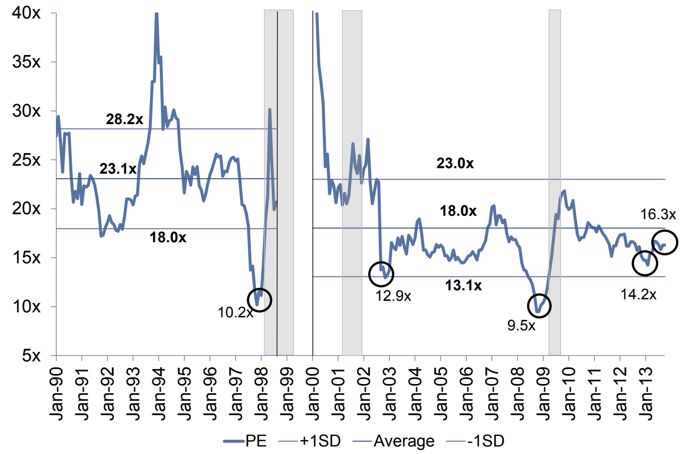
Source: Citi Research estimates

Figure 1. Malaysia: Historical P/B Valuation, Since 1990



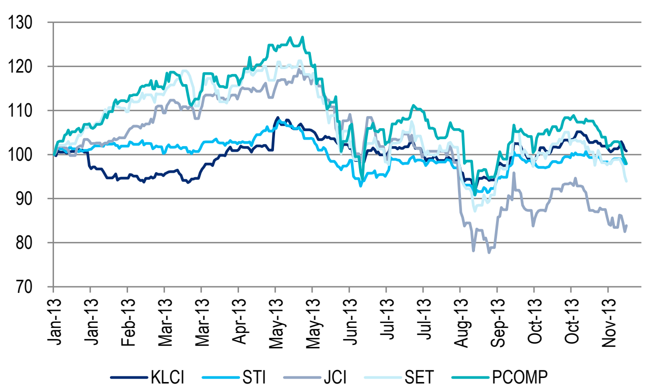
Source: MSCI, Factset and Citi Research

Figure 2. Malaysia: Historical P/E Valuation, Since 1990



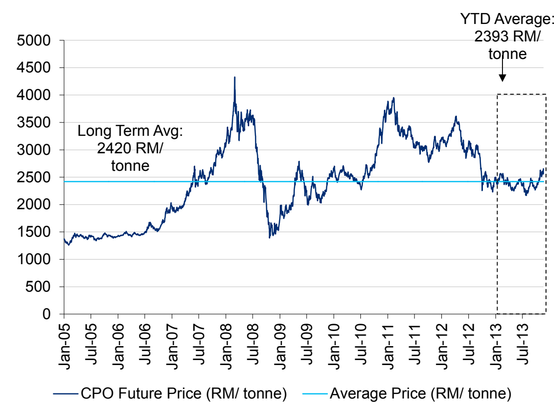
Source: MSCI, Factset and Citi Research

Figure 3. Price Perf. of KLCI vs. Other ASEAN Markets (USD Terms)



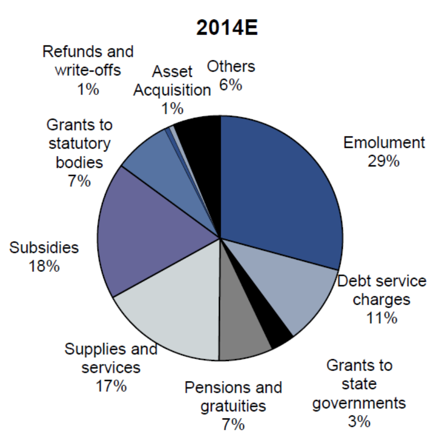
Source: Bloomberg, Citi Research; Indexed as of 1 Jan 2013

Figure 4. Malaysia CPO Price Trend



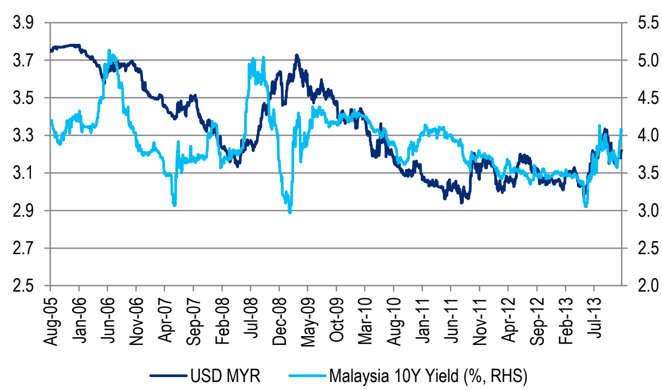
Source: Bloomberg, Citi Research

Figure 5. Breakdown of Federal Government Operating Expenditure



Source: Economic Report 2013/2014, Citi Research

Figure 6. USD MYR vs Malaysia 10Y Bond Yield



Source: Bloomberg, Citi Research

Philippines

Beyond the Near Term, Trends Should Remain Positive

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- **Some near-term bumps –** The devastation wrought by Typhoon Yolanda may slow 4Q13 GDP growth, but the rebuilding efforts could prompt a sharp recovery in 1Q14. Hence, our 2014 GDP growth forecast of 7.3%. The current account remains in surplus. Inflation should stay within an acceptable range of 4-5%; hence, we expect a gradual 50bps policy rate hike in 2H14. Aside from the reconstruction theme, we see deployment of excess liquidity and gradually rising rates as key drivers of the market.

- **Slowing EPS growth, not broad-based –** Consensus expectations for 2014 EPS growth have slowed to 7.9%, from 11.1% in 2013. Earnings revision indicator (ERI) likewise dipped into negative territory in 2H13. The slowdown is not broad-based and is largely driven by weaker bank earnings on falling trading income, which also would drag on profit growth of the parent conglomerates.

- **Easing valuations but vulnerable to de-rating on QE taper –** 12M P/E has eased to 17.7x from a peak of 20.9x in May. Bottom-up price targets of PSEi stock constituents point to a target of 6,750, or 19.6x P/E, 1.6 SD above mean. Having benefited from QE flows, YTD net foreign buying still amounts to US$842m. About 60% of net foreign flows since QE3 have flowed out since the taper talk started in August. A retreat back to pre-QE3 valuation of 16x P/E would put support at 5,500, 0.5 SD above mean. Meanwhile, excess domestic liquidity could mitigate the impact of the foreign outflows.

- **Risks** − Aside from the risk of a reversal of flows, downside risks on the macro front include sharp inflation pressures that trigger an earlier-than-expected policy rate hike and further delays in PPP.

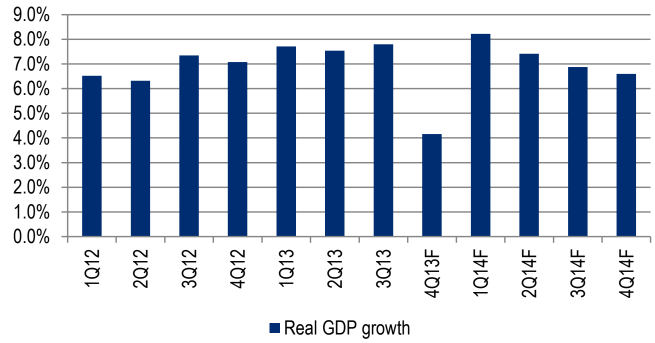
- **Stock picks** − Our expectation of a V-shaped GDP recovery implies that any share price weakness would be an enhanced opportunity to accumulate big-cap stocks that benefit from investment spending and stable domestic consumption. We continue to favor SM Investments, Banco de Oro and Metrobank, while we see the opening of MCP's casino in 2014 as a positive catalyst for the stock. BPI and JFC look vulnerable to profit-taking given premium valuations.

Philippines: Top Buys and Sells

	Ticker	Rating	Price (Nov 29)	Target Price	Yield (%)	ETR (%)	2014E P/E (x)	2014E P/BV (x)	2014E ROE (%)
Top Buys									
Banco de Oro	BDO.PS	Buy	77.95	96.00	2.1	24.3	14.6	1.6	11.1%
Poised to benefit from investment spending dividend and low consumer lending penetration									
Melco Crown	MCP.PS	Buy	14.10	16.50	0.0	17.0	nm	7.2	-18.9%
Our top pick in Philippines gaming; opening of City of Dreams Manila in 4Q14 is the key catalyst									
Metrobank	MBT.PS	Buy	78.55	97.69	1.0	25.3	12.7	1.4	12.0%
Reasonable valuations and efforts to sell non-financial assets are a step in the right direction									
SM Investments	SM.PS	Buy	755.00	920.00	1.4	23.0	19.2	2.4	13.6%
Still a play on the Phil macro theme, being a proxy for the overall economy									
Top Sells									
BPI	BPI.PS	Sell	92.00	92.0	2.4	2.0	16.9	2.8	17.3%
Capital-raising could trim ROE premium; expensive valuations									
Jollibee	JFC.PS	Sell	177.10	89.00	0.9	-49.1	39.1	6.6	18.0%
Brand premium factored in expensive valuations									

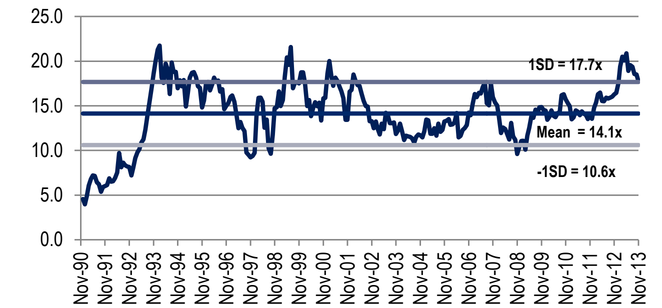
Source: Citi Research estimates

Figure 1. Public Investments Key to V-shaped GDP Recovery in 1Q14



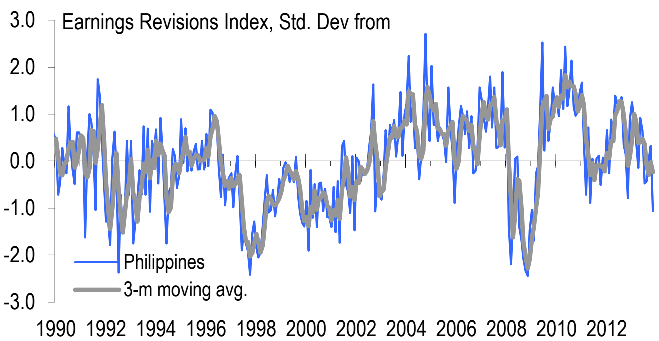
Source: Citi Research estimates

Figure 2. PSEi Trading at 17.7x, 1.02 SD Above the Mean



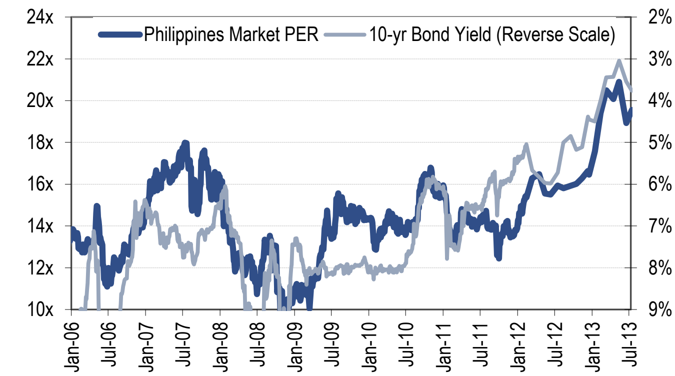
Source: Citi Research, as of 22 November 2013

Figure 3. Earnings Revision Indicator in Negative Territory



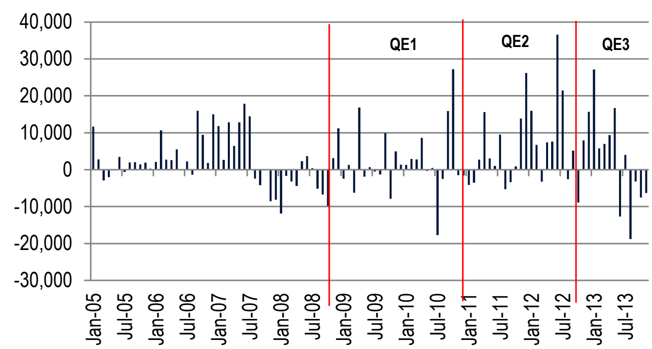
Source: ERI, CEIC, Citi Research

Figure 4. P/E vs. 10-yr Bond Yield



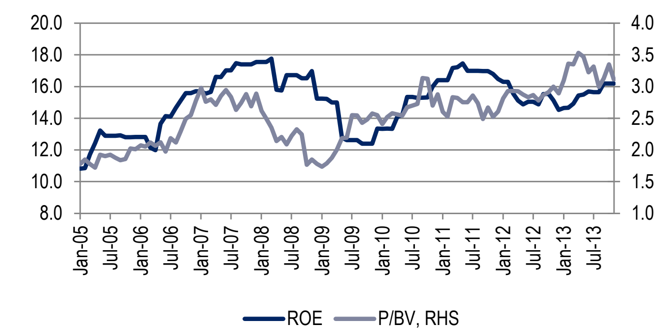
Source: PSE, Citi Research

Figure 5. Risk of Foreign Outflows Through Period of QE Tapering



Source: CEIC, PSE, as of 22 November 2013

Figure 6. Improving ROE of 16.2% Reflected in 3.1x P/BV



Source: Citi Research, as of 22 November 2013

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Taiwan

A Stock-Picker's Market

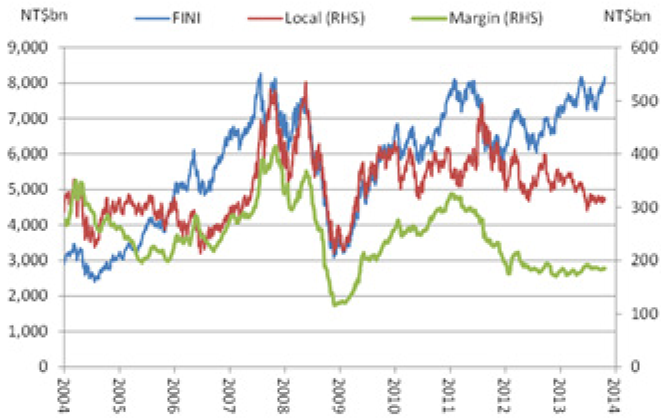
- **FINIs are only buyers** – Local investors have been spooked by domestic politics while liquidity is flowing into China to fund credit shortfalls there. Market valuations are near historic highs with slowing forecast aggregate earnings growth. Our index forecast of 8,700 for 2014 offers only 5% upside from current levels and 2% from our YE2013 index forecast of 8,500. Thus, the index and big cap names offer limited upside from here. Taiwan will likely continue to be a stock-picker's market next year.
- **Small caps looking toppy** – This asset class reached a top by the end of 3Q13. These stocks are particularly sensitive to liquidity conditions, which have been impacted by the outflow to China. Largely for this reason, we still favor the Banks.
- **Healthcare emerging** – While healthcare stocks have been correcting of late, along with non-tech small caps, we view this as an opportune entry point for the bulk of FINI investors who have sat out two years of share price appreciation.
- **Apple diversifying suppliers will benefit ODMs** – While margins will remain thin and there will likely be ramp-up costs and initial yields concerns, the outlook for the ODMs is nonetheless improved compared to an ex-Apple outlook.
- **Safe-haven Telcos not so safe anymore** – The results of the 4G license bidding suggest a higher cost base and possibly more aggressive pricing for 4G operations now that Hon Hai and Tingyi Groups have entered the fray.
- **Banks continuing to benefit from expanding lending ties with China** – Tight credit conditions in China combined with the establishment of China branches have allowed Taiwanese banks to lend to SMEs in China via the offshore loan market.

Taiwan: Top Buys and Top Sells

	Ticker	Rating	Price (Nov. 29)	Target Price	Yield (%)	ETR (%)	2014E P/E (x)	2014E P/BV (x)	2014E ROE (%)
Top Buys									
ASE	2311.TW	Buy	29.40	36.00	4.0	25.3	11.4	1.7	16.1%
Following copper wire bonding, SiP is the next growth-driving catalyst as ASE will benefit from Apple's proliferation of finger print sensors to devices outside of iPhone 5s									
Compal Electronics	2324.TW	Buy	22.35	29.00	7.5	32.0	8.7	0.9	10.5%
Growth will be driven by: 1.) sale of loss-making telecom sub Vibo to Taiwan Star; 2.) Acquisition of CCI, which unites resources for Apple business; 3.) 2H13 iPad allocation									
Far Eastone	4904.TW	Buy	63.40	72.00	6.7	19.7	15.7	2.8	18.0%
Only telco that has delivered earnings growth year to date. Mgmt vows to maintain 100% dividend payout ratio									
Far Eastern Department	2903.TW	Buy	30.20	35.00	3.5	19.2	20.2	1.4	7.3%
Anniversary sales have been strong so far, especially at newer stores Top City (Taichung) and Mega City (Banchiao)									
Mega FHC	2886.TW	Buy	24.85	27.13	4.9	13.5	11.3	1.2	11.1%
Still a top defensive play and a key beneficiary of recovering macro environment given its corporate franchise and leadership position in FX									
Nan Ya Plastics	1303.TW	Buy	64.80	74.00	4.3	17.3	16.4	1.8	11.2%
Will enjoy the strongest earnings growth amongst the Formosa sisters, given strong leverage to DRAM price recovery through 38% equity stake in Nanya Tech									
ScinoPharm	1789.TW	Buy	92.80	115.00	1.8	25.5	37.5	6.0	16.5%
Utilization ramp at Changshu plant is just beginning; the site could potentially free up around 30% of Taiwan's (fully utilized) finished API capacity by value									
Top Sells									
Chunghwa Telecom	2412.TW	Sell	92.80	85.00	5.4	-2.9	18.4	2.0	10.6%
Persistent fixed line tariff pressure from the NCC and increased competition on mobile service due to new entrants, who may resort to aggressive pricing strategies									
Novatek	3034.TW	Sell	119.50	99.00	5.0	-12.4	15.1	2.8	19.1%
Lacking substantial long-term growth driver. De-rating is possible given on-going large panel inventory correction									

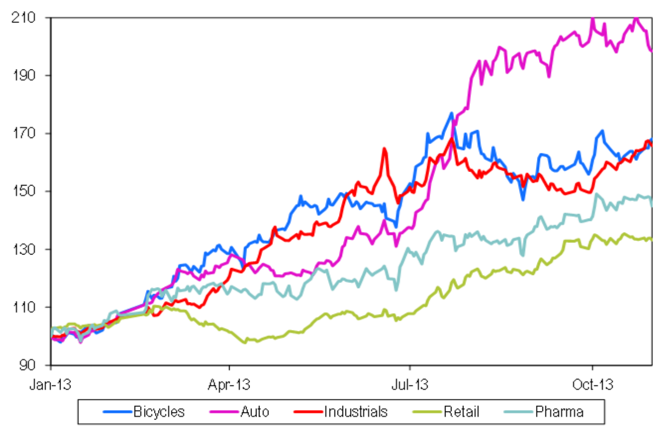
Source: Citi Research estimates

Figure 1. FINI Buying Leading



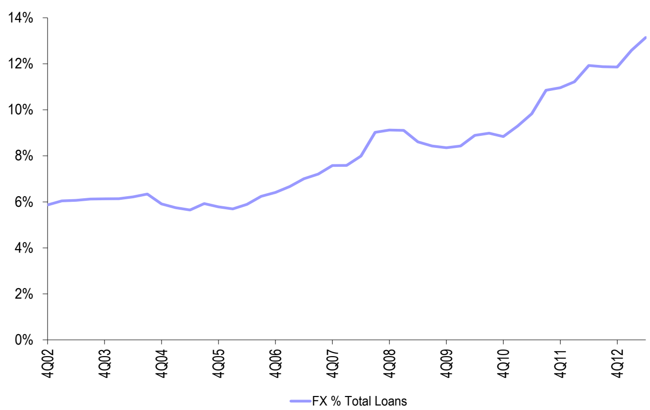
Source: Citi Research, TEJ

Figure 2. Small Cap Performance by Sector



Source: Citi Research, Bloomberg

Figure 3. FX Loans as % of Total

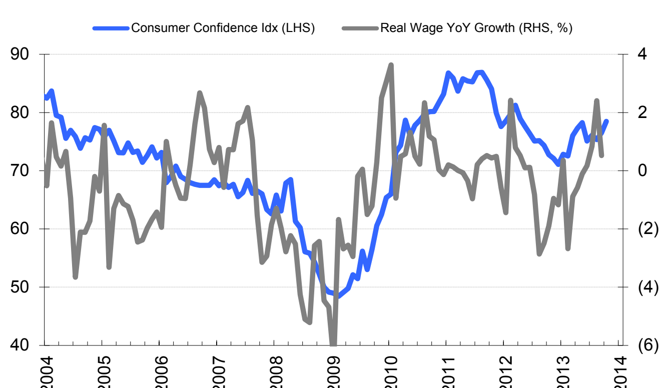


Source: CBC

Figure 4. Semi v IT Hardware v Display Performance

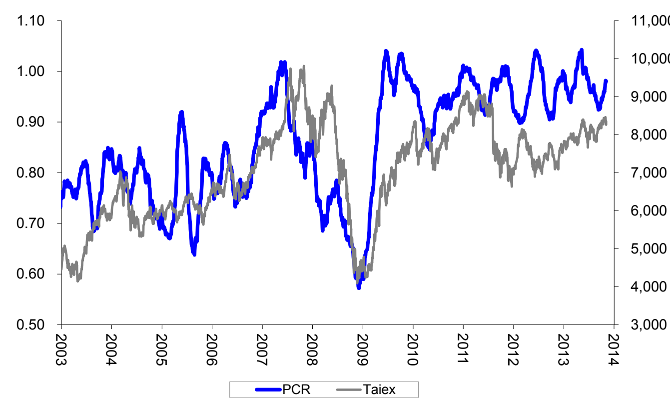
Source: Citi Research, Bloomberg

Figure 5. Consumer Confidence v Real Wage Growth



Source: Citi Research, TEJ

Figure 6. Put-to-Call Ratio



Source: Citi Research, Bloomberg

Thailand

Lack of Policy Juice; Strategy Execution Is Key

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- **Less supportive macro in absence of stimulus kickers** – Macro indicators (industrial production, business and consumer confidence) suggest sluggish momentum in the absence of stimulus initiatives (such as minimum wage and first car since 2011). Legislation and execution of Bt2trn infra plan seem more challenging than anticipated. Gov. credibility was further dented by an unpopular blanket amnesty bill. Without aggressive populist policies in the pipeline and actual infra spending likely coming through only by 2H14, companies' strategies to generate earnings will be key differentiators as top-line growth normalizes.

- **Investment and spending coming off peak** – FDI has been strong for the past few years with a soft patch lately. However, we expect renewed industry after the government introduced more industry promotions in addition to its infra spending plan. Property sales normalized after a strong run in FY12-1H13. Loan growth also began to moderate to cycle average pace.

- **Tourism growth remains strong** – Tourism grew by 22% for 10M13 with half of the growth driven by Chinese arrivals. This should support domestic spending momentum as government stimulus winds down.

- **Valuation: mid cycle vs avg. growth** – SET P/E has retraced to avg valuation. Consensus anticipates 12% EPS growth for 14E (vs 10% in 13E; a revision from 15% in early 2013). Banks, Property, Energy remain under avg P/E valuation.

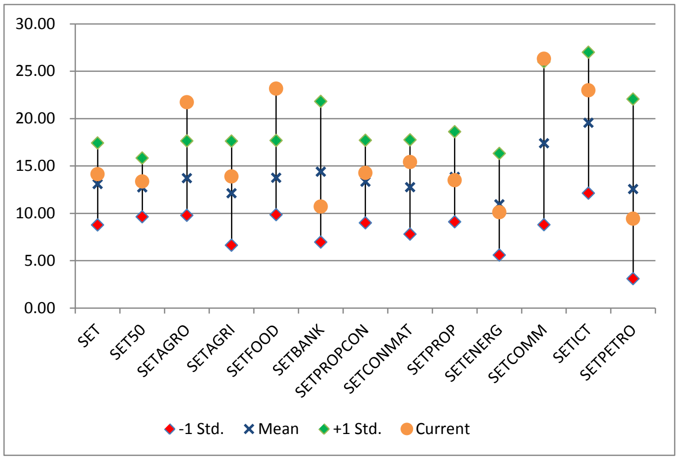
- **Focus on quality and structural stories** – With modest earnings growth and a less exciting macro, we believe SET will be a stock-picker's market. We focus on quality names that can deliver in a tough environment (banks - KBANK; property – LH). Plus, we look for exposure to structural themes of continued FDI into ASEAN (AMATA), ASEAN growth strategy and chemical margin recovery in 2014E (SCC), and positive structural changes in the telco industry (DTAC).

Thailand: Top Buys and Top Sell

	Ticker	Rating	Price (Nov. 29)	Target Price	Yield (%)	ETR (%)	2014E P/E (x)	2014E P/BV (x)	2014E ROE (%)
Top Buys									
AMATA	AMAT.BK	Buy	15.8	35.0	8.1	126.6	4.6	1.3	32.2%
High beta play on continued FDI into Thailand; c70% of revenue comes from industrial land sales									
DTAC	DTAC.BK	Buy	106.0	130.0	6.5	27.3	15.4	7.2	46.6%
Cost savings from 3G migration / lower concession fee; good revenue momentum from strong urban users shifting to data; valuation not too demanding adj for growth									
KBANK	KBANf.BK	Buy	169.0	242.0	3.5	46.7	8.5	1.7	20.5%
Strong non-II and funding franchise to support resilient earnings growth despite loan momentum slowdown									
LH	LH.BK	Buy	10.2	13.8	6.0	41.3	13.4	3.0	22.8%
Focused on landed property; hence lower execution risk; condo presales more stable than for peers; attractive 6% yield									
SCC	SCC.BK	Buy	394.0	565.0	4.3	47.0	11.8	2.6	23.5%
Recovery of PE/PP margin to boost earnings growth in 2014; despite downgrade on cement growth outlook, acquisition in building materials supports earnings outlook									
Top Sell									
TISCO	TISCO.BK	Sell	39.7	37.5	5.5	-0.2	7.3	1.3	19.1%
Triple hurdles in 2014; first used car NPLs in early 2014, potential NPL from steel exposure in mid-year, and NIM squeeze from rate tightening towards year end									

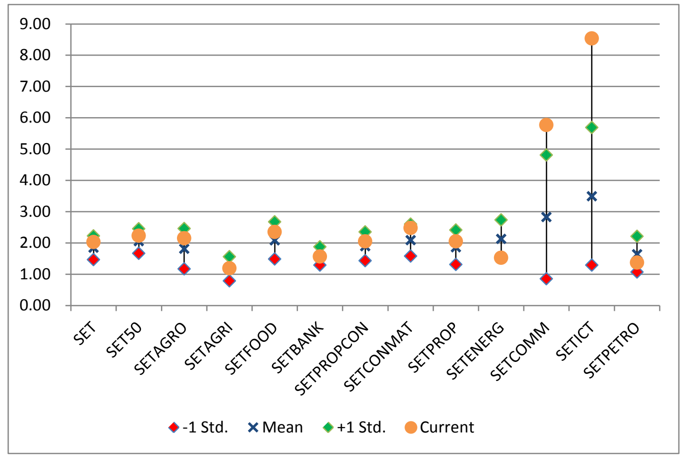
Source: Citi Research estimates

Figure 1. SET P/E – Overall Market At Average Valuation



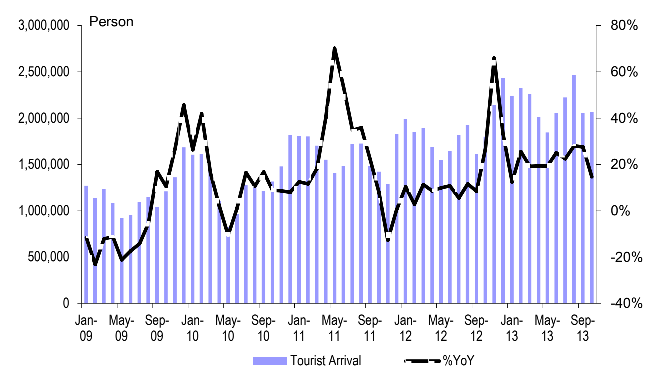
Source: SETSMART; Citi Research estimates

Figure 2. SET P/B



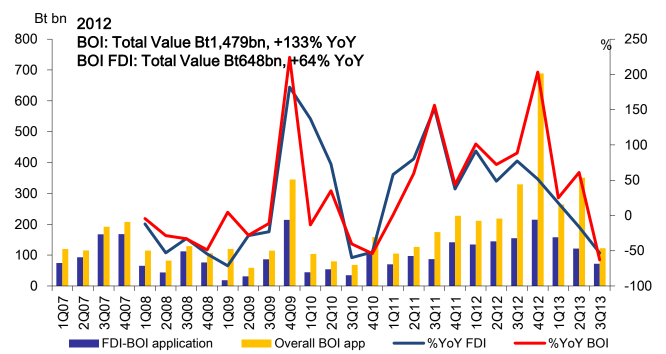
Source: SETSMART; Citi Research estimates

Figure 3. Tourism: Chinese = Half the Growth in 13E; 10M13 +22%



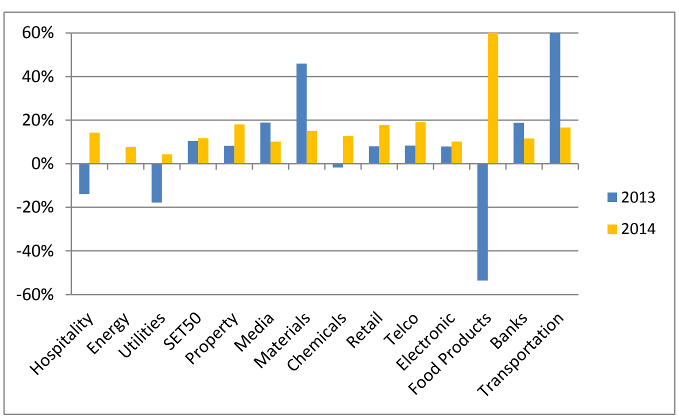
Source: Tourism Authority of Thailand

Figure 4. FDI: Slowdown After Strong Surge in 2012



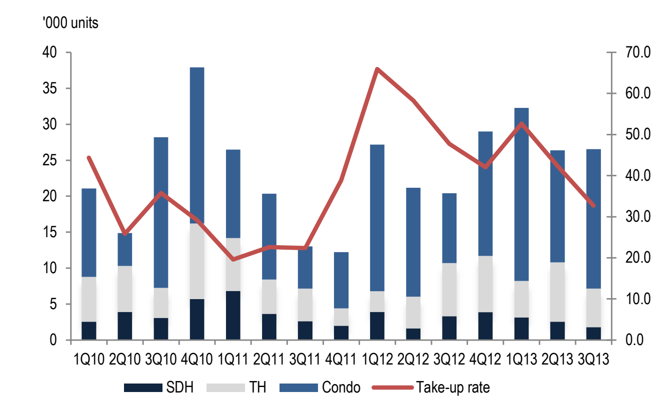
Source: BOT, BOI

Figure 5. SET Earnings Growth Trend



Source: Citi Research

Figure 6. New Launches and Take-up Rate (All Segments)



Source: Citi Research and AREA

EMEA by Country

Greece

2014 Is a "Show Me" Year

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- **Through the worst (for Now)** – After stepping back from the brink and the possibility of euro exit in 2012 (with the formation of a coalition led by center-right New Democracy) in 2013 the economy started to take important baby steps forward. Austerity has continued and the government will need a third bailout package in 2014 but there is some ground for cautious optimism on the economy. Unemployment has stabilized at 27%. GDP growth improved to -3.0% in 3Q from -3.7% with the IMF forecasting small growth in 2014 after a ~25% decline in peak to trough GDP over the last six years.

- **Corporate earnings as barometer** – Retailer Jumbo reported +3% y/y sales growth in Greece in the quarter ending 30th Sept. OPAP 3Q beat estimates with 9M13 EBIT of €142m vs. Citi at €126m marking the first quarter of y/y revenue growth (+0.7%) after 12 declining quarters helped by "improving consumer sentiment". Results at other Greek corporates such as Titan Cement where sales grew +6% y/y and EBITDA was +22% are being driven by strong overseas earnings.

- **Liquidity to support market** – We expect the market to be supported in the short term at least by inflows from emerging market funds following the move from MSCI DM to EM at the end of November. Greece will be about 0.45% in the EM index vs. 1.4bps in MSCI World and about 4.2% in MSCI EM Europe vs. 7bps in MSCI Europe DM. We think that Greece will prove to be an attractive investment destination for EM funds given the market depth, survivors' party where companies that have survived the crisis are emerging stronger, and the economic recovery story.

- **Still many challenges** – for both politicians and the economy. Following November's vote of no confidence, the ruling coalition's parliamentary majority in the 300 member parliament is now only three. There is still a financing gap in 2014 that will require additional bailout money (€240bn so far) and differences with the Troika on the likely fiscal gaps for 2014 and fiscal measures required to achieve 2014 budget projections.

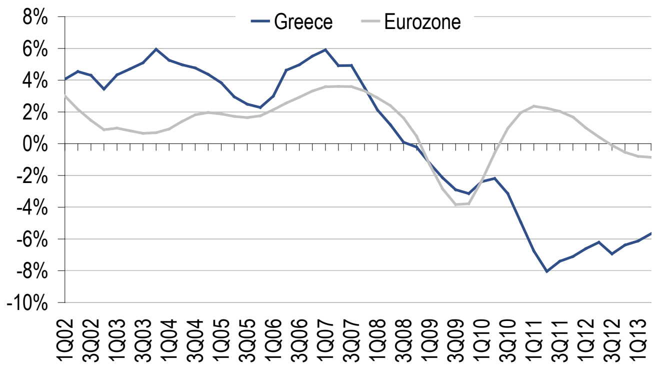
- **Stay defensive** – After a 38% rise the ASE General Index over the last 12 months valuations for many companies and sectors in our coverage universe already look rich, especially given the potential for further economic and political upheaval.

Greece: Top Buy

	Ticker	Rating	Price (Nov. 29)	Target Price	Yield (%)	ETR (%)	2014E P/E (x)	2014E P/BV (x)	2014E ROE (%)
Top Buy									
OTE	OTEr.AT	Buy	9.17	10.5	0.0	14.5	13.6	2.1	15
Revenue losses to slow as company benefits from extensive cost-cutting and deleveraging. Also, good value vs. European telcos at ~4x 2014E EV/EBITDA.									

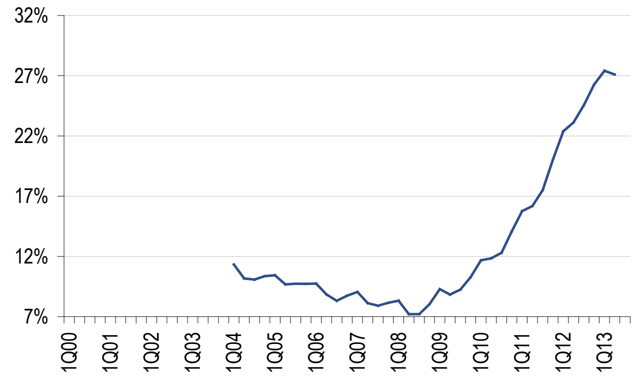
Source: Citi Research estimates

Figure 1. Real GDP Growth, 1Q02-2Q13



Source: Haver, Datastream

Figure 2. Unemployment, 1Q04-2Q13



Source: Datastream

Poland

A "Pricey" Market With Funds Flow Driven Upside Risk

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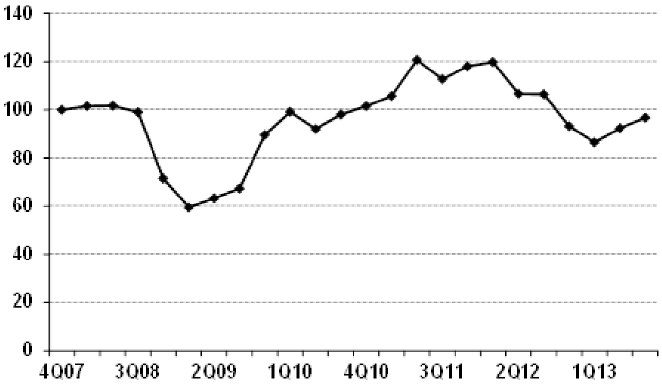
- **Impressive returns** – The Polish broad market is up ytd by 15% and 19% over the last 6m but the real action is taking place in the small/mid-cap space with ytd returns of 43% and 36% respectively. It appears that the market is ignoring PF reform with the rally being driven by strong FF and expectation that macro recovery accelerates. Significant multiple rerating has been the main factor pushing stock prices higher.
- **Macro past the inflection point and more is expected** – There are more signs that the macro has past the inflection point and that the recovery driven by strong net exports improving consumption and IP is sustainable. However, investments have still been lagging and employment growth is yet to come. Citi Economists look for GDP growth of 3.1% in 2014 and 3.6% in 2015.
- **Earnings are recovering (although not everywhere) –** With very low expectations, earnings have been surprising on the upside this year (especially in banks) but in number of cases being down yoy. However, GUS data on corporate earnings has been showing positive reversal over the last two quarters. The consensus based WIG30 earnings are estimated to increase by 12% in 2015 and 15% in 2015 following a double-digit decline in 2012. On street estimates WIG30 trades at a median PE of 17x for 2013E declining to 14x in 2014 (which is not a bargain level).
- **Supportive funds flow creates upside risk** – YTD funds flows were very supportive of the market with local PF net buying of Zl 20bn, mutual funds of Zl 4.4 and foreign flows Zl 6.8bn. As PF next year are likely to be marginal buyer the key players can be local mutual funds that just started to enjoy sizable inflows. We see this as the biggest potential upside risk for polish equities especially in the small/mid-cap space.
- **How to play this market** – As the market is more flow than earnings driven (likely to stay this way in 2014) we struggle with "rich" valuation to find high conviction Buy ideas. We would recommend play this market more on a sector relative basis. From this perspective we would expect the small/mid-cap segment outperforming large caps. We would underweight utilities – Tauron (TPE.WA; ZL4.96; 1) is our favoured name in the sector – and commodity sector, both not leveraged to local macro. As relative winners we would see media and consumer sectors together with non-commodity exporters. In the financial sector, which looks toppy to us, our favoured name is PKO BP.

Poland: Top Buys and Top Sells

	Ticker	Rating	Price (Nov.29)	Target Price	Yield (%)	ETR (%)	2014E P/E (x)	2014E P/BV (x)	2014E ROE (%)
Top Buys									
PKO BP	PKO.WA	Buy	41.15	47	1.2	15.5	15.1	1.8	13
Best play on improving Polish macro. PKO BP looks reasonably valued vs. its forecast earnings and it also looks relatively cheap vs. its history and local peers.									
GPW	GPW.WA	Buy	42.99	49	4.4	18.4	13.7	2.7	20
Leverage to improving turnover on the polish market driven by potentially accelerating fund flows.									
Top Sells									
PKN Orlen	PKN.WA	Sell	47.9	34	1.4	-27.6	12.9	0.7	6
Lackluster financial performance driven by exposure to weak refining environment at unattractive valuation.									
Rovese	RSE.WA	Sell	2.29	1.3	0.0	-43.2	15.3	0.8	5
Demanding valuation for highly leveraged business that is still struggling to improve its profitability.									

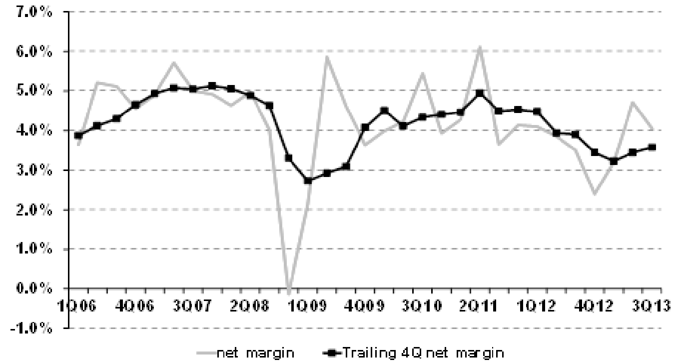
Source: Citi Research estimates

Figure 1. Polish Corporate Profits (4Q Trailing), 1Q05-3Q13



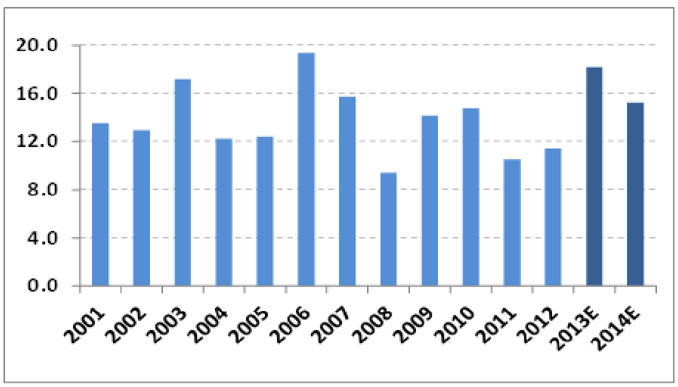
Source: Citi Research/DMBH, Central Statistical Office

Figure 2. Polish Corporate Net Margin, 1Q06-3Q13 (Percentage)



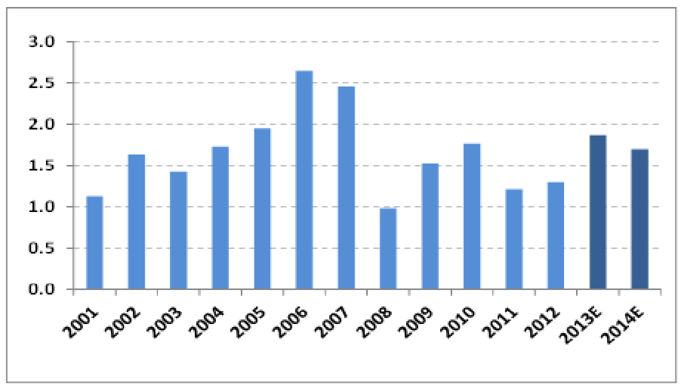
Source: Source: Citi Research/DMBH, Central Statistical Office

Figure 3. Polish Market Median P/E (Year-end)



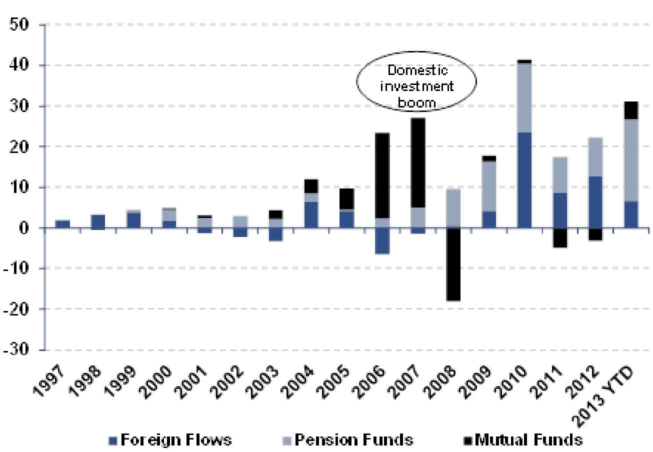
Source: Citi Research/DMBH estimates, DataCentral

Figure 4. Polish Market Median P/BV (Year-end)



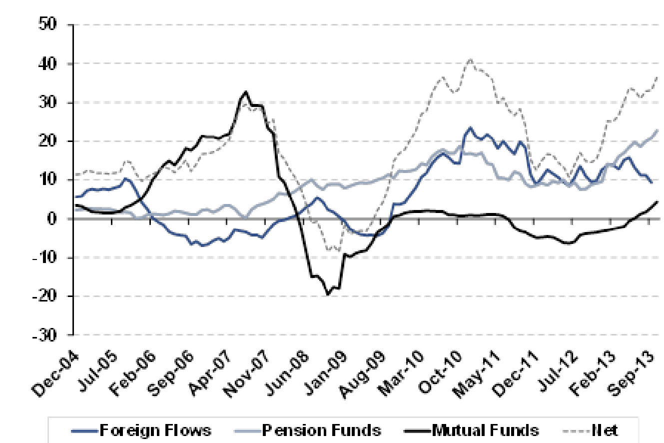
Source: Citi Research/DMBH estimates, DataCentral

Figure 5. Net Equity Purchases 1997-YTD 2013 (Zl bn)



Source: KNF, Citi Research/DMBH estimates

Figure 6. Net Equity Purchases 12m Trailing (Zl bn)



Source: KNF, Citi Research/DMBH estimates

Russia

Lack of Economic and Earnings Growth Is in the Price

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- **Attractive valuation, but lack of EPS growth is a problem** – Down slightly YTD in USD terms, Russia is still a relative outperformer in the GEMS universe. Valuations appear attractive – 5.5x 2014 PE on consensus earnings – but the earnings growth outlook is by far the weakest of all the major GEMS markets. However, dividend yield is now among the highest in GEMS (4.5% 2014E).

- **Weak economy** – Q2 GDP growth was just 1.2%, compared to 4.3% a year ago; and high-frequency indicators since then (retail sales, car sales, industrial production, credit demand…) have remained very weak. Our economist believes that GDP growth in 2013 is likely to come in below the Economy Ministry's forecast of 1.8% (Citi: 1.5%). There are risks of stagflation as inflation continues to hover in the 6.5-7.5% range, well above the Central Bank's target of 5-6%.

- **A widening fiscal deficit** – There has been no major impact yet from the slowdown in public finances, but this could change. The budget has already fallen into a deficit, forecast to reach 2% of GDP in 2013 and widen further in 2014. Far-reaching economic reforms are needed to ensure that the fiscal account does not come under significant stress going forward.

- **Value in Russian Energy** – Despite some tax uncertainty in the Russian energy sector; the large-caps in particular offer compelling value. Gazprom is our analyst's top pick: European exports have remained robust, leading the company to raise its 2013 guidance; while dividend yield looks increasingly attractive.

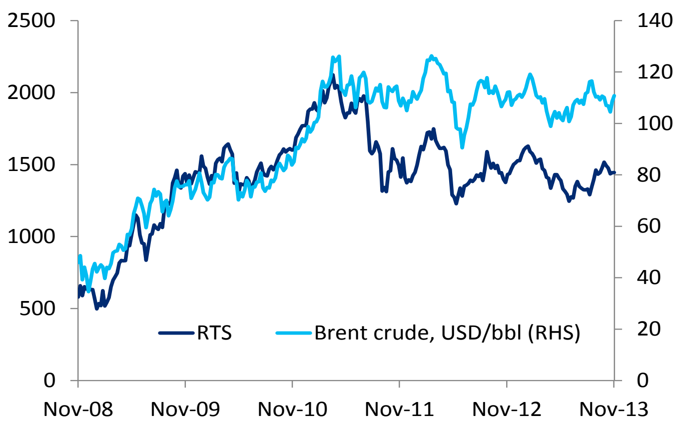
- **Internet over Retail and Banks** – Slowing consumption trends mean that Russian retail sector growth rates should decelerate. Against this background, we prefer quality (top pick: Magnit). A more interesting sector today is Russian internet, where increased penetration and growing ad spend are among the key drivers. In Russian banks, index heavyweight Sberbank is our analyst's preferred pick.

Russia: Top Buys and Top Sells

	Ticker	Rating	Price (Nov 29)	Target Price	Yield (%)	ETR (%)	2014E P/E (x)	2014E P/BV (x)	2014E ROE (%)
Top Buys									
Gazprom	GAZP.MM	Buy	143.1	7.8	6.0	86.7	3.4	0.3	9
Company recently raised guidance; 2014 extraction tax levels may be better than expected; chunky dividend increase expected									
Magnit	MGNTq.L	Buy	65.9	80	0.8	22.2	25.0	6.2	27
Best in class and differentiated food retailer; sustained earnings growth to justify valuation premium to peers									
Mail Ru Group	MAILRq.L	Buy	41.35	42.5	6.8	9.9	27.8	4.3	19
Russian social media leader; high growth, diversified revenue streams, focus on the core business; compelling relative valuation									
Sberbank RF	SBER.MM	Buy	103.07	145.0	0.0	40.7	5.6	1.0	19
Market leader, well positioned to deliver 19% ROE; discount to GEMS peers despite higher profitability, stronger capital position									
Top Sell									
Rusal	0486.HK	Sell	2.31	2.0	0.0	-13.4	NM	0.5	-3
Poor aluminium pricing and deteriorating premiums weigh on earnings; market in surplus									

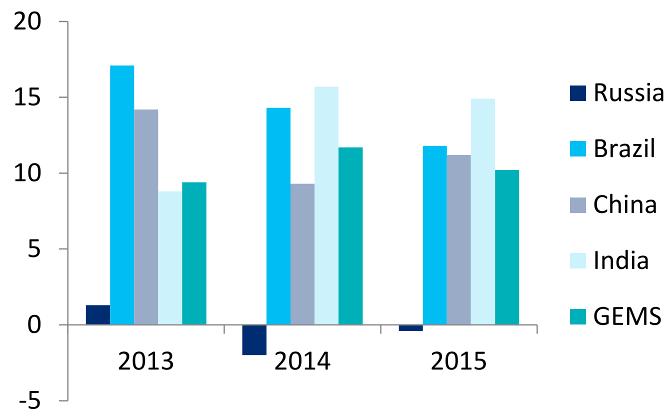
Source: Citi Research estimates

Figure 1. Oil price and RTS index



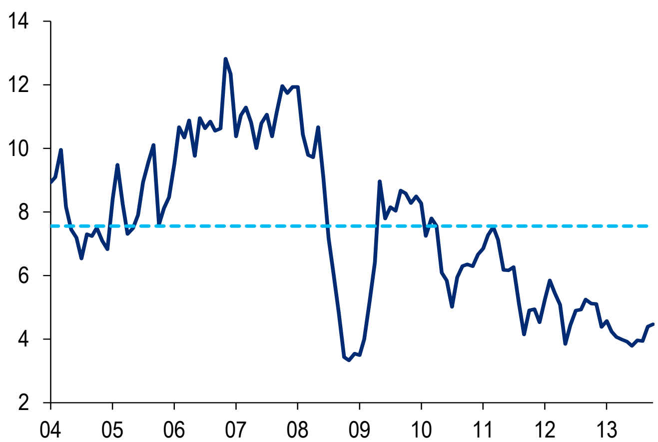
Source: Citi Research, Datastream

Figure 2. EPS growth, consensus



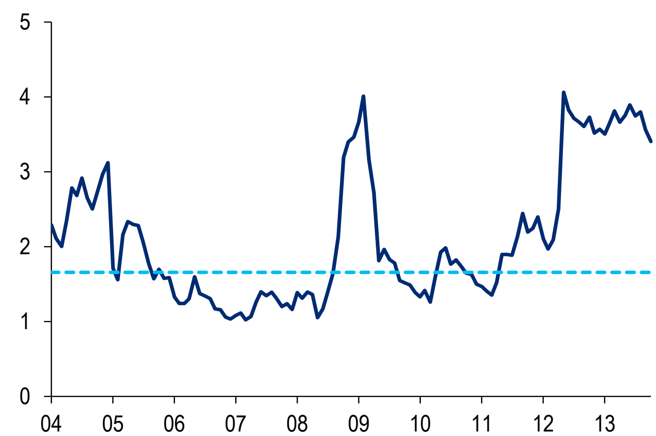
Source: Source: Citi Research, Datastream

Figure 3. MSCI Russia – PE Ratio (12 mth fwd)



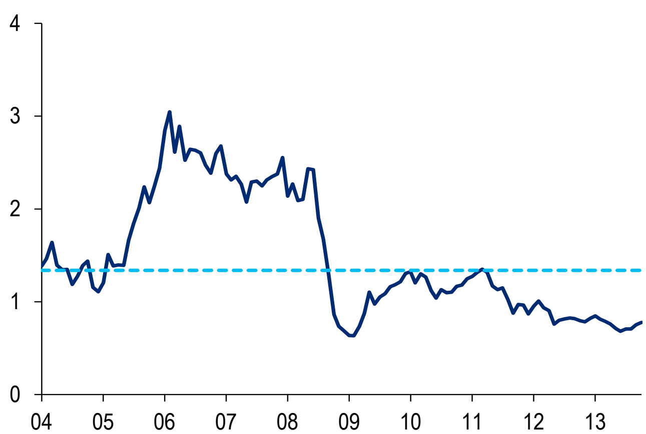
Source: Citi Research, Datastream

Figure 4. MSCI Russia – Dividend Yield (%)



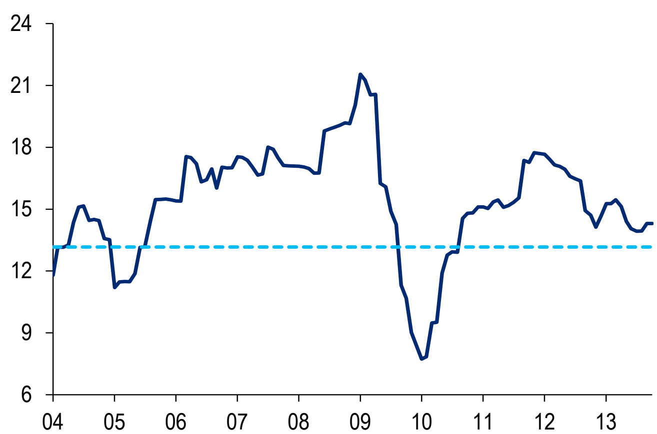
Source: Citi Research, Datastream

Figure 5. MSCI Russia – PB Ratio



Source: Citi Research, Datastream

Figure 6. MSCI Russia – ROE



Source: Citi Research, Datastream

South Africa

SA Equities No Longer Deserve to be Priced like a DM

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- **Never been more expensive –** The SA market currently trades at its most expensive multiple since 1996. Given the SA market was largely closed before that time however, the current multiple effectively stands as the most expensive on record.

- **Relative valuations stretched –** SA equities have traditionally traded at a 30% discount to global equities, but now trade smack on PE parity. Versus emerging markets, SA equities have historically traded at a 10% discount, but now trade at a hair-raising 35% premium.

- **Unsustainable detachment –** Such stretched valuations, and detachment from their EM foundations, can only last for so long. We believe we are now entering a period where the SA equity market's EM characteristics will start to increasingly hold sway!

- **Hints of structural stagflation** – We have written on the clouds forming which could keep growth lower and inflation higher for longer than expected. For those companies exposed to domestically generated earnings, margins will likely have to be squeezed; the local discretionary retailers are most at risk.

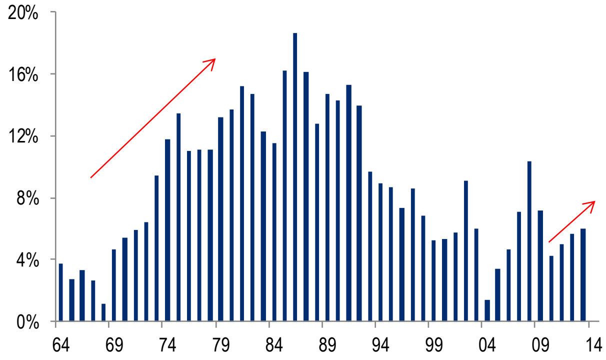
- **Catalyst for reversion to EM** – In addition to stagflation, we identify another four factors, which we see as likely catalysts to drag the SA market towards valuations more in line with emerging markets; 1) Earnings Downgrades to Industrials ,2) Current Account Pressures ,3) Another Credit Rating Downgrade, and, 4) GEM Equity Outflows.

South Africa: Top Buys and Top Sells

	Ticker	Rating	Price (Nov. 29)	Target Price	Yield (%)	ETR (%)	FY14E P/E (x)	FY14E P/B (x)	FY14E ROE (%)
Top Buys									
Naspers	NPNJn.J	Buy	972.88	1220	0.5	25.9	34.5	6.3	16
We still expect strong underlying growth for Tencent (and Mail.Ru), spurred by a weaker ZAR.									
Tiger Brands	TBSJ.J	Buy	284.29	330	3.1	19.2	14.0	3.7	24
The company's mix of staples / foods is positioned well to weather a stagflationary period in the SA economy.									
Impala Platinum	IMPJ.J	Buy	118.25	170	2.0	45.8	14.2	1.4	10
The company has invested in infrastructure that should allow it to access a superior amount of Merensky ounces relative to peers.									
FirstRand	FSRJ.J	Buy	33.81	37.9	4.7	16.8	10.7	2.3	23
Recent underperformance means the stock is now showing value to our target price. Without doubt our top quality SA bank.									
Top Sells									
AngloGold Ashanti	ANGJ.J	Sell	135.52	145	0.3	5.7	35.1	1.3	5
The company is still FCF negative, and relies heavily on an increasing gold price (something we remain skeptical of).									
Sappi	SAPJ.J	Sell	30.81	26.5	0.0	-15.3	12.8	1.2	10
Ongoing demand and pricing weakness in paper markets will keep Sappi's core operations under pressure.									
Vodacom	VODJ.J	Sell	121.82	105	6.8	-7.0	13.3	8.1	63
Downside risks to valuation is not adequately accounting for in current share price.									

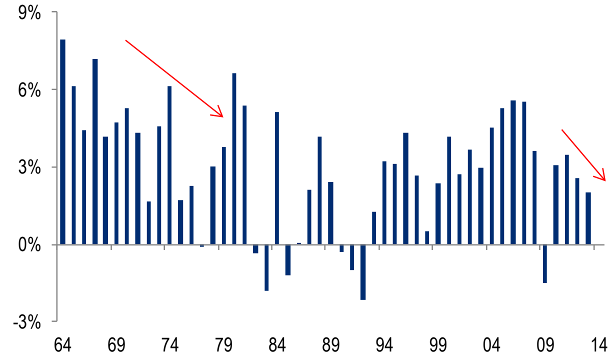
Source: Citi Research estimates

Figure 1. Annual Inflation – South Africa



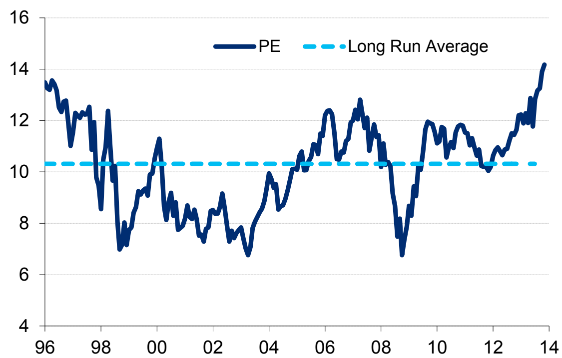
Source: Citi Research, Datastream

Figure 2. Annual Economic Growth (real) **– South Africa**



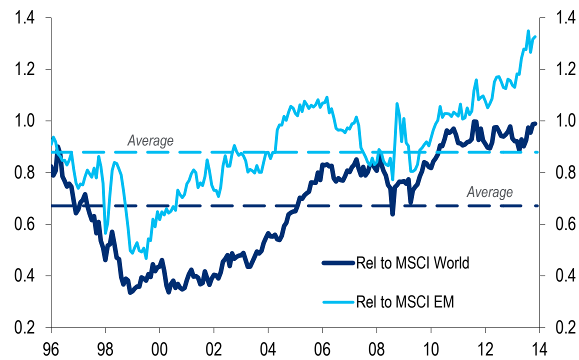
Source: Source: Citi Research, Datastream

Figure 3. FTSE / JSE All Share Index – PE Ratio (12 mth fwd)



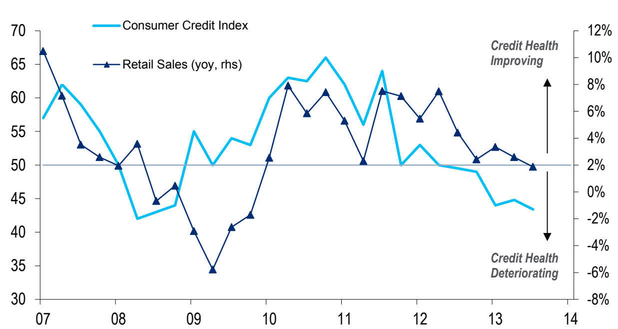
Source: Citi Research, Datastream

Figure 4. FTSE / JSE All Share Index PE* Relative



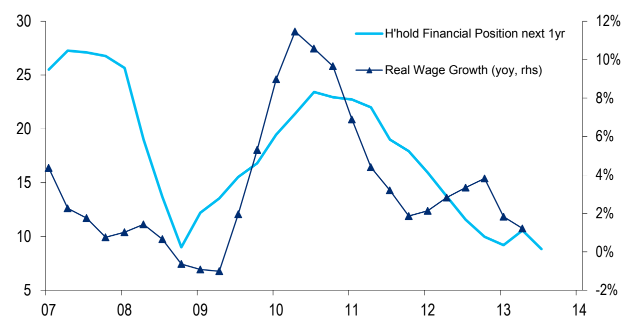
Source: Source: Citi Research, Datastream (PE on 12m fwd consensus earnings)

Figure 5. SA Consumer Credit Index vs Retail Sales



Source: Citi Research, Datastream, Transunion

Figure 6. Household Financial Position (next 12 m) **vs Real Wage Growth**



Source: Source: Citi Research, Datastream

Turkey

Domestic Macro Concerns, But Value Emerging

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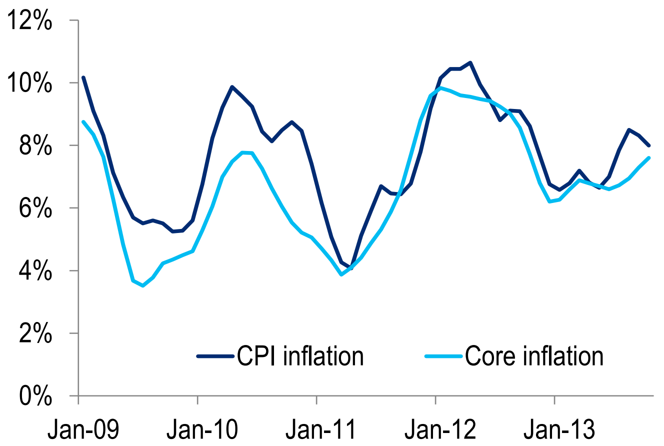
- **Valuation not a threat** – At a PE of <10x 2014 consensus earnings, Turkish equities now trade at a discount to GEMS. The medium term value of the market looks rather compelling if we take account of the 18% earnings growth which consensus analysts expect for 2015 (compared to 5% in CEEMEA and 10% in GEMS).
- **Inflation continues to deteriorate** – Many of Turkey's macro indicators do not currently look particularly healthy. Exchange rate volatility, sticky services inflation, and elevated inflation expectations lead our economist to forecast year end inflation to be c.7.5%, well above the CBT's 5% target.
- **Current account concerns** – Low domestic savings, high inflation and sliding competitiveness render all Turkish assets highly at risk due to Turkey's current account vulnerabilities. Our economist forecasts a widening of the current account deficit from 5.8% of GDP in 2012 to 6.9% in 2013.
- **Buy the banks** – The slowing macro picture, combined with interest and exchange rate volatility, has impacted the outlook for asset quality of Turkish banks. That said, NPLs remain stable and P/B valuations look attractive – hence our Turkish banks analyst currently rates all Turkish banks Buy.
- **Recovery from Consumer?** – BIM was the only Turkish consumer stock that beat our Q3 estimates, amid a tough consumer spending environment (social unrest, currency weakness, higher interest rates etc). But consumer sector companies are now more broadly reporting signs of stabilization – according to our analyst, BIZIM and Arcelik should benefit the most from the gradual recovery in consumer spending in 2014.

Turkey: Top Buys

	Ticker	Rating	Price (Nov 29)	Target Price	Yield (%)	ETR (%)	2014E P/E (x)	2014E P/BV (x)	2014E ROE (%)
Top Buys									
Arcelik AS	ARCLK.IS	Buy	13.6	13.7	3.4	4.1	12.2	2.0	17
Should benefit from a consumer recovery; market share gains in intl markets; TRY weakness and improved European demand									
Bizim	BIZIM.IS	Buy	23.05	26.0	2.5	15.3	20.0	5.6	30
Weak 3Q13 already in the price, consensus too pessimistic; fastest EBITDA growth in Turkish consumer in 2013-15									
Halkbank	HALKB.IS	Buy	15.5	18.25	2.6	20.3	9.0	1.2	14
Highest ROAs among peers, driven by higher NIMs; ROE gap vs peer justifies valuation premium; better ability to grow									
Sisecam	SISE.IS	Buy	2.74	3.35	3.3	25.5	7.5	0.7	10
Should benefit from weak TRY, price increases, muted cost pressures; potential to unlock further value through land sales and IPOs									
Turkish Airlines	THYAO.IS	Buy	7.48	8.87	2.5	21.1	7.6	1.4	19
Improved operating conditions; good margin outlook; Istanbul's location and low-cost labour availability are an advantage									

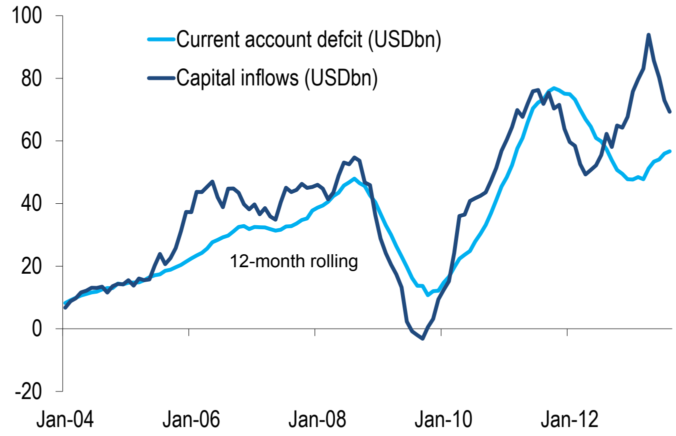
Source: Citi Research estimates

Figure 1. CPI inflation and core inflation, yoy



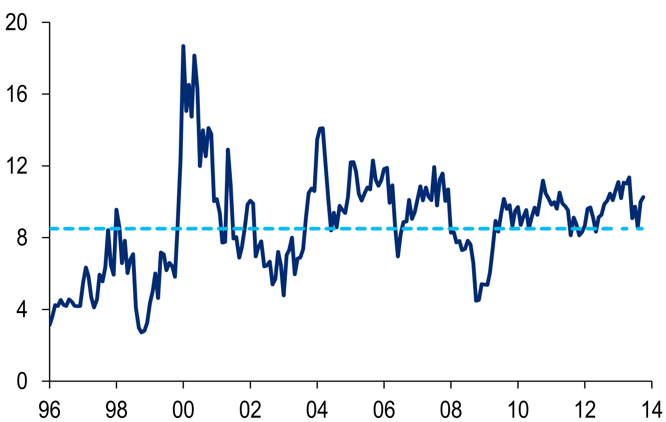
Source: Citi Research, Haver

Figure 2. Current account deficit (USDbn) and capital inflows (USDbn)



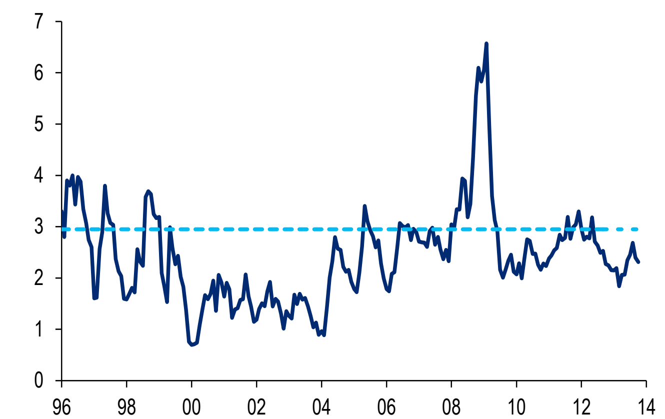
Source: Source: Citi Research, Haver

Figure 3. MSCI Turkey – PE Ratio (12 mth fwd)



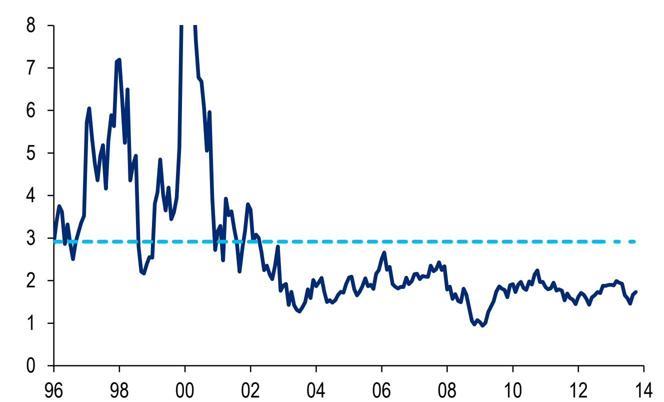
Source: Citi Research, Datastream

Figure 4. MSCI Turkey – Dividend Yield (%)



Source: Citi Research, Datastream

Figure 5. MSCI Turkey – PB Ratio



Source: Citi Research, Datastream

Figure 6. MSCI Turkey – ROE

Source: Citi Research, Datastream

Latin America by Country

Brazil

Commodities for Protection (really)

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- **Prepare for stress** – The combination of 1) US monetary "tapering"; 2) a possible Brazil sovereign-debt downgrade, and 3) election-year fiscal pressure means pressure on Brazil's currency, rising domestic rates, and slow growth.
- **40% BRL-protected** – The Brazilian stocks that tend to do best in weak-currency/high-interest-rate/low-growth contexts are about 40% of the market: 1) commodity exporters; 2) other commodity firms selling domestically at dollar-linked prices; 3) multinationals with non-BRL revenue. Note that in 3Q13, with the BRL down 10% y-on-y, the aggregate earnings of Brazilian listed (Ibovespa) companies surged 16%, pulled along by metals & mining up 136% and pulp & paper up 70%. The BRL is already down another 3.8% since then.
- **60% not protected** – On the other hand, domestically oriented firms — from retailers to airlines — suffer from a weak BRL on rising opex and interest expense and erosion of consumer purchasing power. Worse, they're directly exposed to rising domestic interest rates (we expect 10.75% by February 2014, the highest real rate of any major economy), and from the associated likely slowdown of GDP growth from 2.6% (Citi estimate) in 2013 to 2.0% in 2014.
- **Financials the exception** – The one large domestic sector we like for 2014 is commercial banks. They are structured to benefit from rising interest rates. To deal with falling rates in 2011/2012/2013, they cut costs and diversified into fee-generating businesses. In 2014, they should benefit from all sides: lower costs, more fees, higher rates. Plus public-sector banks have been told to slow their loan growth, opening space for private-sector banks to revive growth.
- **Target 64,000** – Historically the earnings yield in Brazil correlates best with real interest rates, sovereign risk, GDP acceleration or deceleration, and commodity prices in BRL terms. Our forecasts for these variables and earnings produces a 64,000 year-end 2014 target, largely driven by the commodity group.

Brazil: Top Buys and Top Sell

	Ticker	Rating	Price (Nov. 29)	Target Price	Yield (%)	ETR (%)	2014E P/E (x)	2014E P/BV (x)	2014E ROE (%)
Top Buys									
Vale	VALE.N	Buy	15.32	18	7.8	25.3	7.8	0.9	13
Attractive valuation. Export-oriented mining business. Settlement of tax disputes better than expected. Management on right track. Volumes rising.									
Brasil Foods	BRFS.N	Buy	22.2	30	1.1	38.6	19.4	2.6	14
Large portion of sales in foreign markets. Better pricing in domestic market will improve results in 2014. Solid new management with eye on numerous improvements.									
Localiza	RENT3.SA	Buy	33.79	41	1.5	22.8	15.2	4.2	31
Sound track record of good results. Reasonable valuation and good earnings prospects in 2014 on car rentals for World Cup, election activity, infrastructure projects.									
Mills	MILS3.SA	Buy	31.4	41	1.0	31.6	21.4	3.4	17
Equipment supplier positioned to gain from infrastructure investments in Brazil. Rising EBITDA and decreasing capex can lead to high dividends by late 2014.									
Top Sell									
PDG	PDGR3.SA	Sell/3H	1.68	1.5	0.0	-10.7	NM	0.5	0
Poor results and low earnings visibility from this stretched homebuilder. High valuations even after sell-off.									

Source: Citi Research estimates

Protection from stress

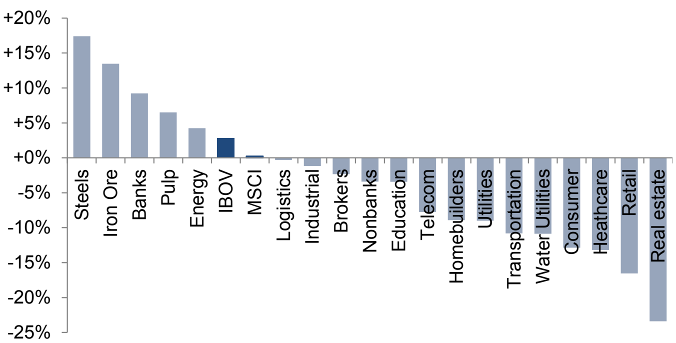
A number of factors suggest stress in Brazilian markets next year, especially for domestically oriented firms lacking non-BRL revenue. Figure 2 shows that Brazilian fiscal management has deteriorated, as measured by the total public-sector primary (i.e. before interest expense) surplus.

As the reference interest rate dropped to 7.25% in 2012, after years in the teens, the government argued that it could afford a lower primary surplus. But because of high inflation, the Central Bank has now raised rates to 10.0%. We expect another 75 bp by Feb. 2014. Figure 3 shows two-year debt already priced near 12%.

Figure 4 shows that CDS protection on Brazilian sovereign five-year bonds costs 180 bp, above the regression line of other BBB-rated markets. S&P put Brazil on negative credit watch in June 2013. It typically downgrades within six to 24 months.

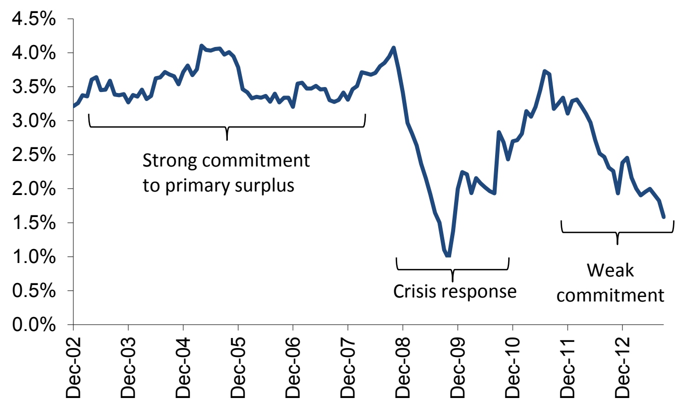
Figure 1 shows that a few sectors tend to do well (in local currency) when interest rates rise in Brazil. One is banks, as already described. The others are commodity players. They do well not because interest rates rise, but because rising rates are typically associated with deteriorating confidence, which is separately correlated with a falling currency.

Figure 1. Equity market correlation with interest rate



Source: Bloomberg, Citi Research

Figure 2. Primary surplus (% GDP)

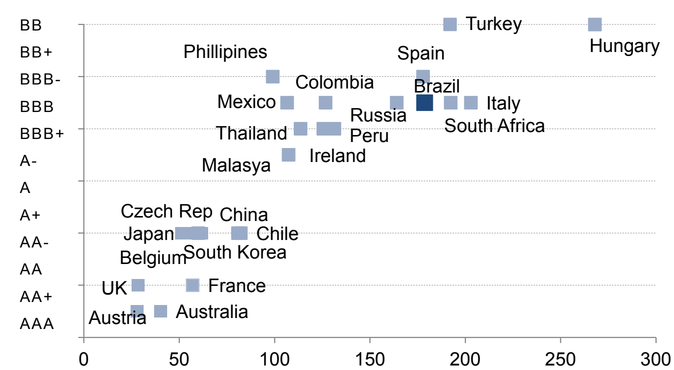


Source: Brazilian Central Bank

Figure 3. Two-year nominal interest rate

Source: Bloomberg, Citi Research

Figure 4. Rating and CDS spread, five-year sovereign bonds



Source: Bloomberg, Citi Research

Chile

Earnings Bottoming, Headwinds Priced In

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- **Many headwinds, but priced in** — We believe most headwinds are already priced in at current levels as earnings are finally at an inflection point after eight consecutive quarters of declines, local institutional investors' exposure to the local market is at an all-time low and election-related fears should dissipate over the coming months. We introduce a 2014 year-end target of 4,500 which suggests 16% upside. We expect earnings to expand 20% next year.

- **IPSA Outlook for 2014** — The Chilean stock market has had 3 years of poor performance influenced by weak corporate results, significant capital raising from companies, weak commodity prices, investor preference for developed over emerging markets, Fed tapering fears, and more recently political noise from the upcoming presidential and parliamentary elections.

- **Don't forget the earnings cycle** — So far around 70% of the IPSA index has reported their 3Q results showing a 90% yoy increase in aggregated earnings, which is ahead of our expectations and reaffirms our call that the earnings cycle has bottomed and a recovery has started.

- **Implications** — The presidential election results were more or less expected by the market as most polls had predicted this outcome and thus were already priced in. This outcome doesn't change our expectations and we maintain our 4,500 target for the IPSA, which offers 21% upside from current levels. Chile is currently trading at a 15.8x 12-month forward P/E, a tad below its long term average.

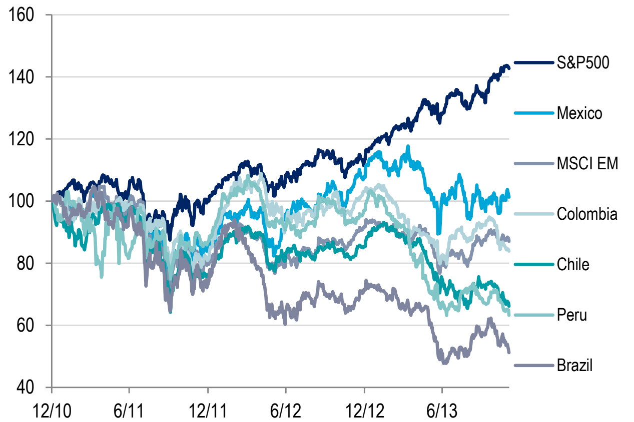
- **Underweight Chile in EM** — From a EM perspective, Markus Rosgen remains underweight the Chilean market. Relative to the other markets in the EM universe, the market looks expensive, the earnings revisions have underperformed those of the rest of the EM space. Overall, Lat Am EPS revisions have been the weakest of all the EM regions. Finally as our model also looks at price momentum as a determinant of its relative attractiveness, Chile as an underperforming market fails to inspire. As such, the market is neither cheap, nor does it have stronger EPS revisions or price momentum, hence the underweight.

Chile: Top Buys

			Price	Target	Yield	ETR	2014E		
	Ticker	Rating	(Nov. 29)	Price	(%)	(%)	P/E (x)	P/BV (x)	ROE (%)
Top Buys									
Ripley	RIP.SN	Buy	395	530	1.8	36.0	16.6	1.0	6
Cheap valuation, professional management. The brand is well known and many consumers carry Ripley cards.									
Endesa Chile	EOC.N	Buy	43.78	52.1	2.4	21.7	15.6	2.1	14
Attractive valuation, margin stability, healthy balance sheet, leverage on electricity prices.									
Falabella	FAL.SN	Buy	4950	6000	1.3	22.5	22.0	2.2	11
Attractive margin and sales area expansion. Able to generate strong margins through extensive use of private label merchandise.									

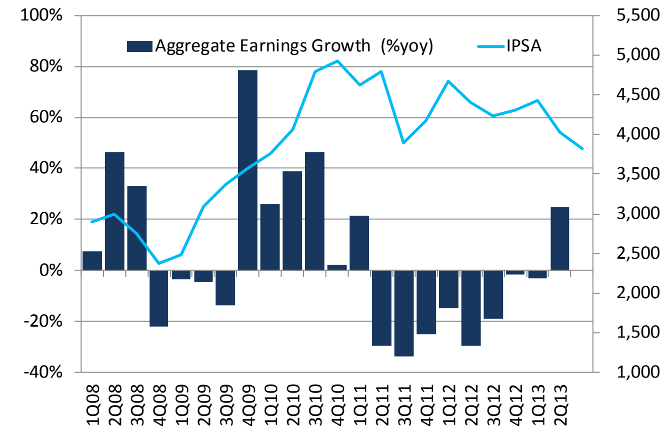
Source: Citi Research estimates

Figure 1. Market Performance (12/2010=100)



Source: FactSet, Citi Research

Figure 2. Quarterly Earnings Growth



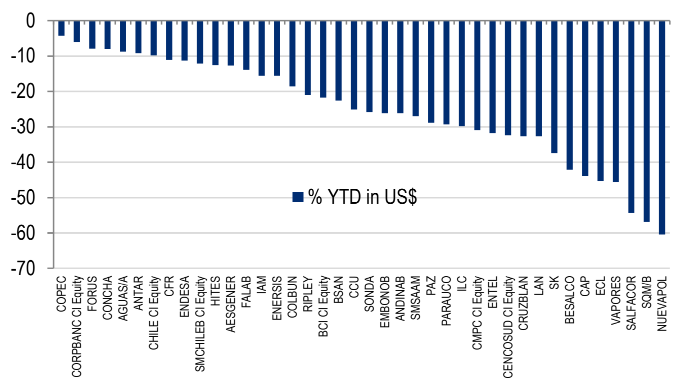
Source: SVS Bloomberg

Figure 3. Equity raising in the pipeline

Pending	US$ million
LATAM	1,000
CFR	700
Quiñenco	690
Gener	450
BCI	400
Fasa	380
Parauco	230
AquaChile	120
Security	100
Masisa	100
Australis	60
Salfacorp	41
Total	4,271

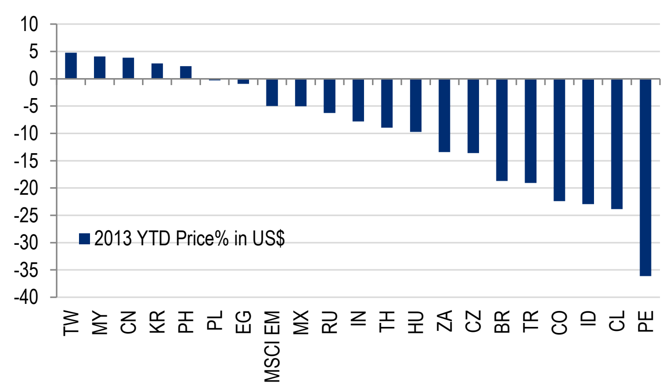
Source: SVS, Citi Research

Figure 4. All IPSA stocks had negative returns this year (in USD)



Source: Bloomberg, Citi Research

Figure 5. Returns YTD in USD (%)



Source: MSCI, Citi Research

Figure 6. Chile PE and relative PE

Source: MSCI, Citi Research

Mexico

Paradoxically, We See Earnings Cuts as a Buy Signal

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- **We are bullish on Mexican equities, after 1Q** – In the coming months, we are looking for 2014 earnings estimates to come down and signal grounded expectations for Mexican equities. It is unusual to argue for stocks to go up on earnings cuts. However, it is our sense that investors have lower GDP and net income growth expectations than sell side numbers. We continue to believe energy reform will pass in 2013 and that Mexico will benefit in 2014 from FDI flows to the energy sector, from lower electricity tariffs and lower gas prices.

- **Growth debate continues** – Our reading is that investors outside Mexico are more bullish than locals, but less bullish than the sell side consensus. We believe many corporates are looking for 2014 GDP growth of around 2.5%, which is too pessimistic. This week, the sell side consensus (Banco de Mexico Survey) for 2014 GDP growth was revised down to 3.3% from 3.4% a month ago. Since late 2012, the consensus estimates for 2014 GDP had hovered in the 3.6%-4.0% range. Growth of investment is the key, in our view. With conservative investment (one-half of current estimates) and consumption growth assumptions it is easy to get to 2.9% in 2014.

- **Earnings revisions still coming** – Growth matters to earnings expectations. The 3Q results showed that expectations for 2013 growth have been dampened: we had less negative surprises than in any quarter since 4Q12, when the slowdown began. Earnings growth estimates for 2014, however, keep going up, as 2013 estimates come down: Factset consensus now stands at 19% earnings growth for 2014, compared to 8% in January. Consequently, as the market has declined, the forward P/E multiple has kept pace and even risen. Our own estimates are more conservative, calling for 9% earnings growth in 2014. We see earnings revisions as the last piece to fall into place as 2014 expectations become grounded.

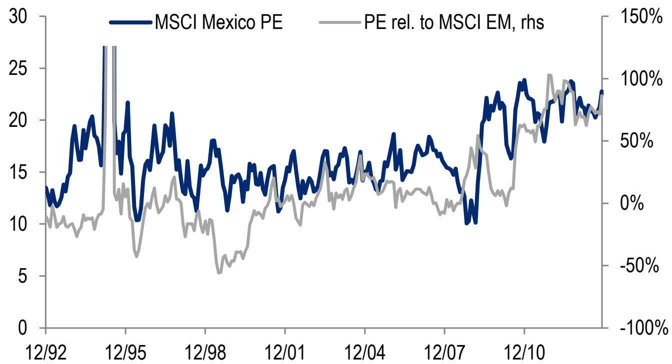
- **Best house in a bad neighborhood continues** – We continue to see Mexico as an emerging market that stands out from the rest due to progress in domestic structural reforms, market oriented policymaking, macro stability and close linkage to US manufacturing renaissance. We have also heard from local asset managers that the interest from investors, especially Asian based, in investing in Mexican equities and fixed income continues to spark interest.

Mexico: Top Buys

	Ticker	Rating	Price (Nov. 29)	Target Price	Yield (%)	ETR (%)	2014E P/E (x)	2014E P/BV (x)	2014E ROE (%)
Top Buys									
Walmex	Walmexv.mx	Buy	34.76	41.3	1.7	20.5	23.2	3.4	17
Stands to gain from increased government spending directed to lower income consumers. Will face easier comps starting 4Q13.									
Gentera	Comparc.mx	Buy	24.78	29.0	2.2	19.2	15.2	3.5	25
Reasonable valuation for a countercyclical business like micro-lending, with a core product that has a proven track record of resilience.									
Alsea	Alsea.mx	Buy	39.48	41.4	0.0	4.9	31.1	5.4	20
Vips acquisition adds more to EBITDA than potential dilution to pay down debt. Acquisition potentially offers positive synergies in domestic restaurant business.									

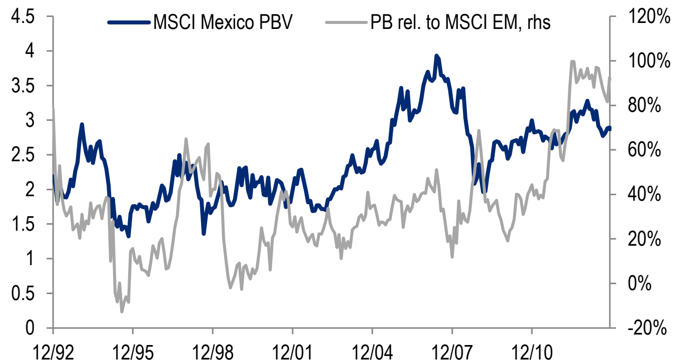
Source: Citi Research estimates

Figure 1. Mexico's PE ratio



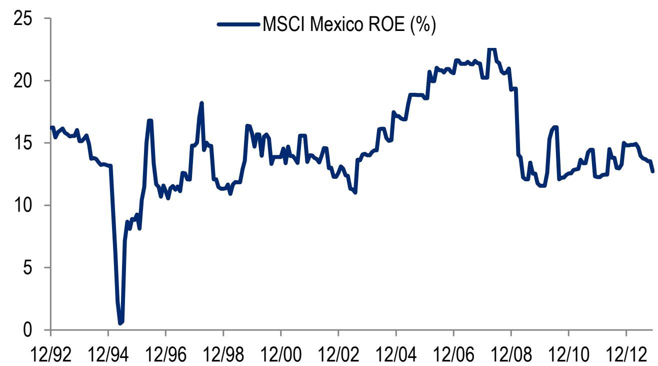
Source: MSCI, Citi Research

Figure 2. Mexico's Price to Book



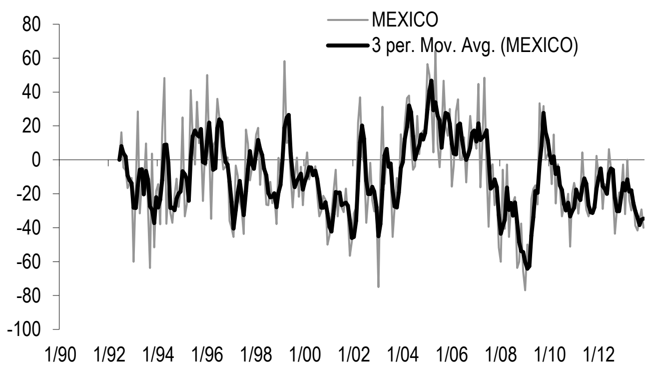
Source: MSCI, Citi Research

Figure 3. Mexico's ROE



Source: MSCI, Citi Research

Figure 4. Mexico's Earnings Revision Index



Source: IBES, Citi Research

Macro Outlook

Emerging Markets Macro and Strategy Outlook

Prospects for 2014 and beyond

EM Economics and Strategy

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- Three questions are likely to dominate investors' thinking about EM in 2014. The *first* is about the future of capital flows to EM: will Fed 'tapering' and the prospect of US monetary tightening cause sustained outflows from EM? The *second* is about EM's export recovery: will EM's recent export slump ever reverse? And the *third* is about China: will 'China risk' re-emerge as a threat to EM growth?

- We think it is worth being cautious about the outlook for capital flows to EM. Net portfolio flows have been stronger in recent years than we've seen them since 1993 – the year that preceded the 'Tequila' crisis. To be sure, there are good reasons to think that the rise in flows to EM has some 'sticky' characteristics: investor 'home bias' has fallen in recent years, and the global fixed income asset class has grown.

- But equally there are reasons to think that there have been 'excessive' inflows into EM. Capital outflows from EM will pick up, we think, at whatever stage the *front-end* of the US Treasury curve starts to shift upwards. For some large EMs, cross-border borrowing from international banks has risen sharply, and these flows could be threatened when short-term US rates rise. We create a 'Vulnerability Index' that tries to identify where the risks lie.

- Could EM gain on the current account – through export growth – what it loses on the capital account? Structural reform might be one way to achieve this, but the evidence is mixed. Another is that EM might be 'bailed out' by a strong DM recovery, but we continue to worry that DM's recovery may be less EM-friendly than in the past. A third path towards export recovery is real exchange rate depreciation. Indeed, we expect EMFX to weaken by 4% on average next year.

- The third question is about China, and in recent months, investors have had good reasons to become less panicked about the downside risks to China's growth: August through October 2013 saw three consecutive months of double-digit industrial production growth, and the market has responded warmly to the reforms outlined in the Third Plenary. The result is that indicators of fear about China – the 5 year CDS spread, for example – are currently very low by historical standards.

- But we think the distribution of outcomes for China next year seems skewed. China's growth model shows vulnerability in a number of areas: poor demographics, falling productivity, over-investment and high leverage. We investigate the parallels between China today and two earlier episodes: Japan in the early 70s and Korea in the 1990s, both examples of credit-fuelled, investment-heavy growth that ended in an abrupt slowdown. If 'crisis = vulnerability + trigger', we think the market will continue to wrestle with the factors that might trigger 'China risk' in 2014.

Prospects for 2014 and beyond

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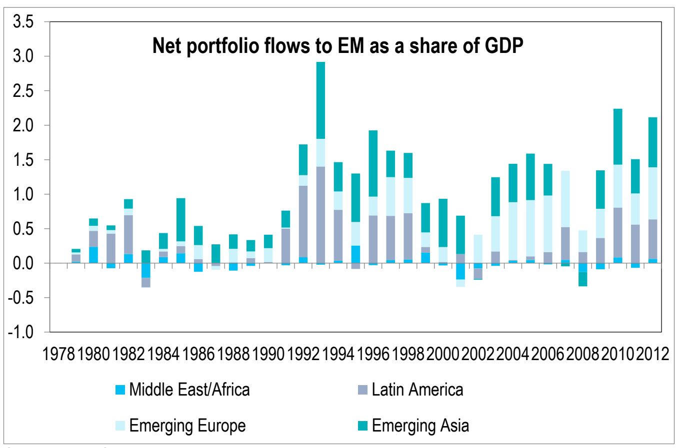
With thanks to Ilker Domac

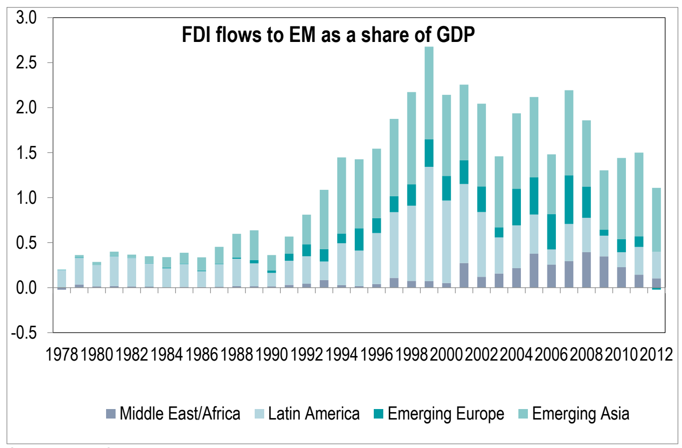
Three questions are likely to dominate investors' thinking about EM in 2014. The *first* is about the future of capital flows to EM: will Fed 'tapering' and the prospect of US monetary tightening cause sustained outflows from EM? The *second* is about EM's export recovery: will EM's recent export slump ever reverse? And the *third* is about China: will 'China risk' re-emerge as a threat to EM growth? These three questions were very broadly discussed among investors during the course of 2013, and so in a sense 'nothing's new' as we go into the New Year. Overall we find it difficult to come up with optimistic answers to any of these questions, and so we think it makes sense to be quite cautious about the environment facing emerging markets. That said, there are few market participants these days that are truly optimistic about EM: the risks facing this group of economies are increasingly well-understood. Since the perception of those risks is, to some degree, reflected in asset prices now, there probably isn't a strong case to argue that EM faces a 'crisis'. Indeed, a better way to think about EM is that it faces a '*chronis*' – no abrupt chaos necessarily, but rather a series of small, albeit painful, adjustments in asset prices as investors get used to a world where EM is no longer characterised by rapid, export-led growth and large accumulations of fx reserves; but is driven instead by slower growth, slightly weaker sovereign balance sheets, and more reliance on domestic spending.

Figure 1. Portfolio flows to EM in 2010 and 2012 reached levels, as a share of GDP, almost as high as in 1993, just before the Tequila crisis…



Source: IIF, Citi Research

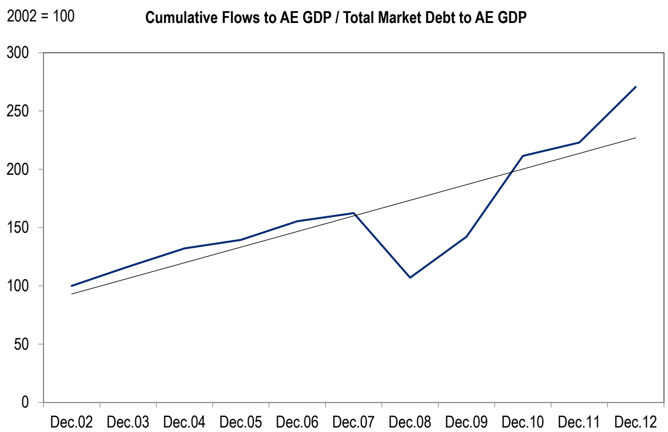
Figure 2. …while FDI flows have diminished since their late 1990s peak



Source: IIF, Citi Research

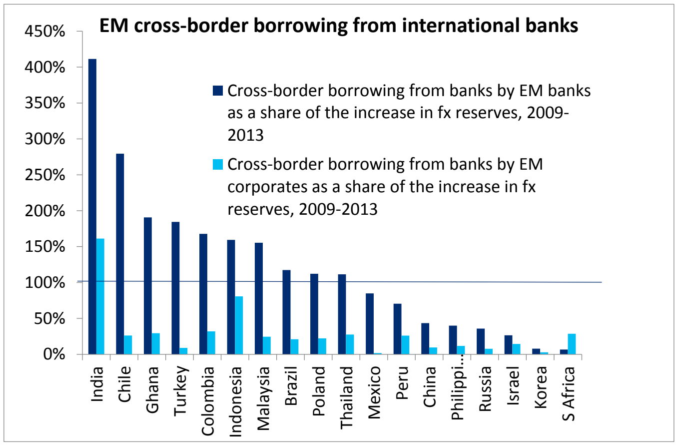
We think it is worth being cautious about the outlook for capital flows to EM. Net portfolio flows have been exceptionally strong in recent years (Figure 1), stronger than we've seen them since 1993 – the year that preceded the 'Tequila' crisis. And in some respects at least, the rationale behind the recent surge in capital inflows is similar to what it was then: a period of extremely loose US monetary policy. Of course, there are substantial differences between EM now and EM 20 years ago: the accumulation of fx reserves in recent years has created big pools of 'self-insurance'; pegged exchange rate regimes have, for the most part, given way to floating exchange rates; and the *composition* of capital flows has improved in the sense that currency risk is better-shared these days between debtors and creditors, whereas in the past it resided mostly with debtors in EM. And there are other reasons why 'this time might be different' for capital flows, and why capital flows to EM in particular should have increased over time. One is simply that the global fixed income asset class has grown over time. Fixed income share of advanced economies GDP grew 47% between 2002 and 2013. It is only natural that allocations to EM would grow in tandem with that growth. Nevertheless, cumulative inflows into EM captured a growing share of global fixed income portfolios representing today an allocation 170% larger than in 2002. Another reason for increasing capital flows to EM is the fall in 'home bias' among investors.

Figure 3. When standardised by the growth of global fixed income, EM inflows do appear 'excessive' in recent quarters…



Source: IMF, BIS and Citi Research.

Figure 4. …and a substantial increase in cross-border exposure of international banks creates risks around a rise in short-term US rates

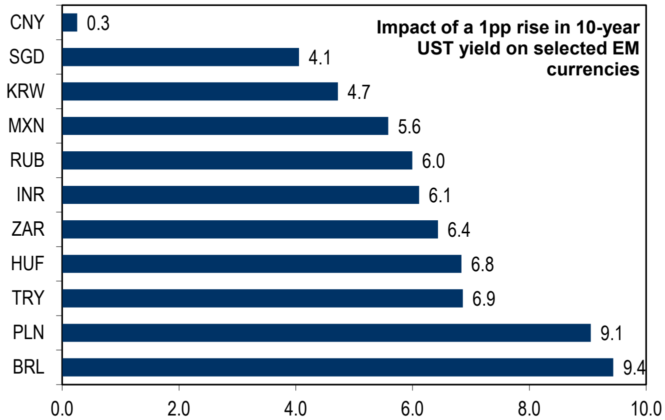


Source: BIS, Citi Research.

Much of the capital that has flowed into EM will be unwilling to leave, but there are also reasons to suspect that there have been 'excessive' inflows. The IMF's analysis of this suggests that that the 'excess' bond flow to EM has been between US$370-470 bn in the past four years. Our own results, which consider the rise in flows to EM relative to the growth of the global fixed income market, are broadly similar (Figure 3). On this analysis, we find inflows were 'too high' by approximately US$165bn. If we assume that there has been excess, the corollary of this is that there should be some pull-back in the coming quarters. Why? Simply that expected changes in US monetary policy create uncertainty about the outlook for capital flows to EM. Indeed, EM's sensitivity to rising US Treasury yields was a dominant theme of 2013, and it would probably be prudent to assume that further increases in US Treasury yields will remain a source of stress for EM currencies and bond markets. Figures 5 and 6 provide a statistical approach to understanding the sensitivity of fx and CDS spreads to rises in US 10 year yields, relying on 28 weeks' worth of data between May 2013 and November 2013.

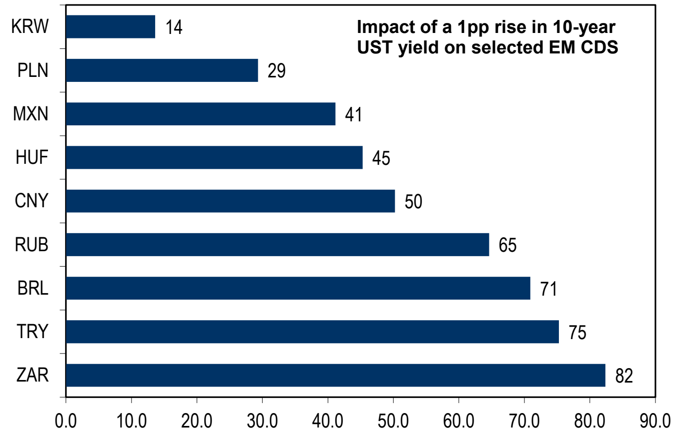
Capital outflows from EM will pick up further, we think, at whatever stage the *front-end* of the US Treasury curve starts to shift upwards. For some countries – India, Chile, Turkey, Colombia, Indonesia, Malaysia, Brazil – cross-border borrowing from *international banks* has also been an important feature of their capital inflows, and these flows could be threatened when short-term US rates rise. To be sure, banks are less important overall as a supplier of cross-border capital to EM than they used to be. In the 1970s, banks were the overwhelmingly dominant source of external financing from EM, and that's changed: between 2009 and 2012, banks were responsible for only 15% of net flows to EM (it was 65% between 1978 and 1982). But for some countries, especially those mentioned above, the rise in inflows from banks in recent years has been strong, and has in many cases helped to finance domestic credit booms. Between 2009 and June 2013, net cross-border inflows from banks amounted to US$170 billion for Brazil; US$580 bn for China; US$116 bn for Turkey; US$147 bn for India. Figure 4 suggests that flows from international banks to a range of countries have more than financed these countries' reserves accumulations since 2009. And why might banks lose risk appetite when the front end of the US curve rises? The reason for this is that banks tend to fund themselves at the shorter end of the US curve, and so their willingness to continue extending cross-border credit to EM might be constrained as we get closer to rising short term US rates. Certainly, the history of capital flows to EM points to a high degree of sensitivity to increases in Fed Funds.

Figure 5. EM currencies exhibited a high degree of sensitivity to changes in US 10 year yields between May and October…



Source: Citi Research. The equation used is Δ EXRt = constant + β ΔUSTt + ut, where ΔEXR is the weekly percentage change in the currency, and ΔUST is the change in the US 10 year yield.

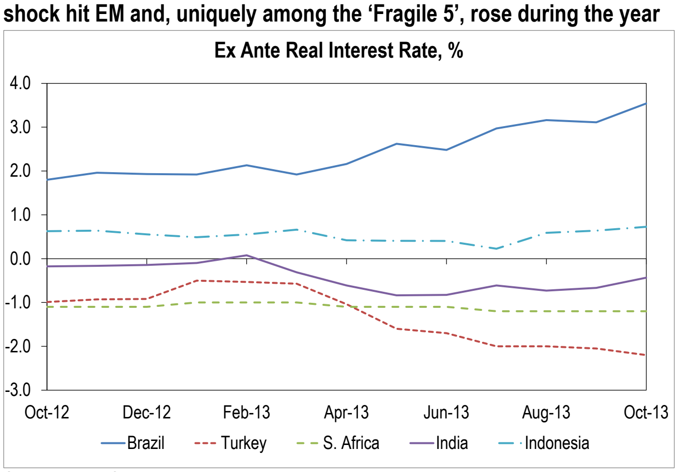
Figure 6. …and so did EM CDS spreads



Source: Citi Research. The equation here is ΔCDSt = constant + β Δ(UST)t + ut

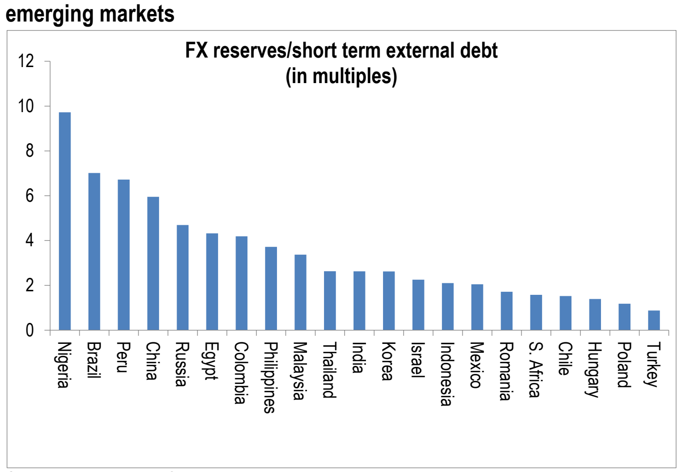
The shocks that EM received during 2013 from rising US yields raise the question: exactly what constitutes vulnerability? The casual answer to this question tends to focus on large current account deficits overwhelmingly financed by volatile capital flows; real interest rates that are too low to attract funding for external deficits; and levels of fx reserves that provide inadequate levels of self-insurance. Yet this is a partial approach to capturing the factors that constitute vulnerability in EM. Take Brazil for example: Brazil's real policy rate is very high by global standards and, uniquely in EM, actually went up during 2013. Moreover, Brazil's current account deficit, just over 3% of GDP, is largely financed by FDI, and its level of reserves adequacy is among the strongest in EM (Figures 7 and 8). So the inclusion of Brazil in the group of countries so badly affected by rising US Treasury yields suggests that the analysis of vulnerability must go deeper than a simple understanding of external financing constraints.

Figure 7. Brazilian ex-ante real interest rates were high before the May shock hit EM and, uniquely among the 'Fragile 5', rose during the year



Source: IMF, Citi Research.

Figure 8. Brazilian reserves adequacy is also among the highest in emerging markets

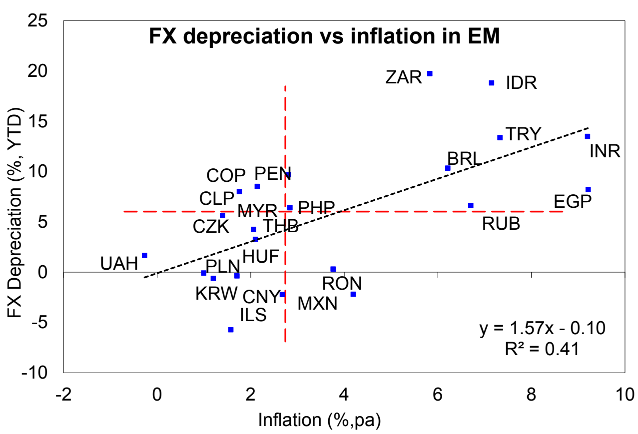


Source: Bloomberg, Citi Research

A broad approach to understanding vulnerability in EM will include measures of stress in the public sector, external accounts, financial system and in the corporate sector. Against this backdrop, the obvious starting point in our case is to investigate the link between the currency depreciation (our measure of crisis incident) and standard vulnerability indicators. To this end, we focus on the 2013 EM sell-off.

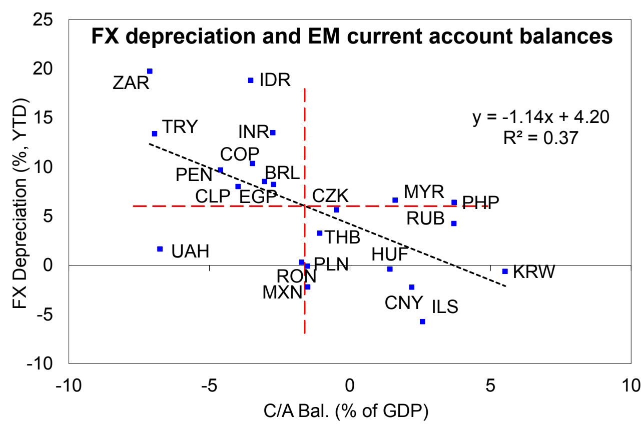
Specifically, we look at the link between year-to-date exchange rate depreciation and our (latest) 2013 forecasts for vulnerability indicators. Our findings suggest that credit growth, inflation, reserves (% of GDP) and current account balance (% of GDP) are the most relevant variables in explaining the currency depreciation during the most recent EM sell-off episode (Figures 9 and 10). Surprisingly, a number of standard vulnerability indicators (Reserves % of C/A balance + short-term external debt, short-term external debt/reserves, REER misalignment, and fiscal variables, etc.) contain little explanatory power for the exchange rate movements during the recent sell-off. It is worth noting that our findings don't suggest these variables aren't important in terms of capturing vulnerability. Instead, the results imply that headline vulnerability indicators such as credit growth, inflation and current account deficit itself have played a more important role in shaping investors' decisions during the recent sell-off.

Figure 9. Our analysis suggests that inflation dynamics are an important determinant of vulnerability to an fx sell-off…



Source: IMF, Citi Research.

Figure 10. …in addition to the more intuitive vulnerability created by large current account deficits



Source: Bloomberg, Citi Research

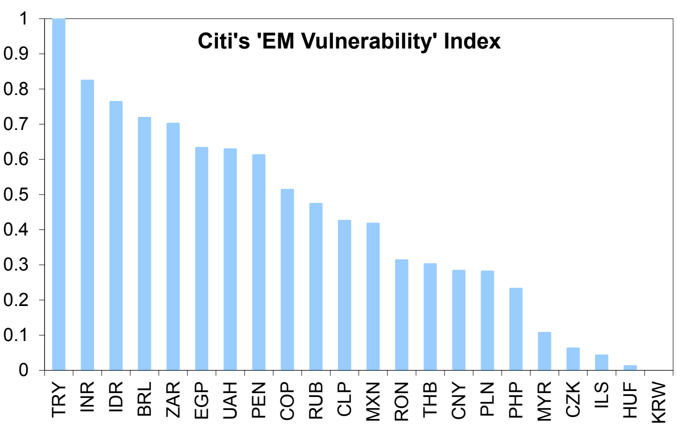
Based on our empirical results, we construct a Vulnerability Index consisting of variables that seem to have a closer link with the exchange rate movements during the recent sell-off: C/A balance as a % of GDP, inflation, credit growth and reserves as a % of GDP. In order to ensure robustness, we consider two versions: (i) using equal weights and (ii) using weights based on regression analysis (weighted).[1] Using our latest 2014 forecasts, Figure 11 presents a forward-looking version of our (weighted) Vulnerability Index. Given that the Index reasonably explains some of the exchange rate vulnerability that we saw in 2013 (Figure 12), the conclusion is that the countries most obviously affected by risk aversion this year – Brazil, India, Indonesia, Turkey, South Africa - continue to look vulnerable going into next year.

EM is unlikely to face a 'sudden stop', but if capital inflows prove to be scarcer, we doubt that EM will be able to offset the impact of this with a sharp increase in export growth. In the past, episodes of capital outflow from EM have often been described as 'sudden stops', as though flows are governed by a kind of 'on-off' switch. Bond issuance data for 2013 suggests that EM is far from suffering a 'sudden stop' in this way: monthly issuance in September 2013, following four months of fear about US 'tapering', was US$58 bn, only US$2 bn short of the US$60 bn issued in January this year. One reason for this is that, after all, EM

[1] We regress the exchange rate depreciation (year-to-date) on variables under consideration. The estimated regression coefficients are as follows. C/A balance (% of GDP)= -0.8; credit growth=0.3; inflation=0.89; reserves (% of GDP)=-0.02.

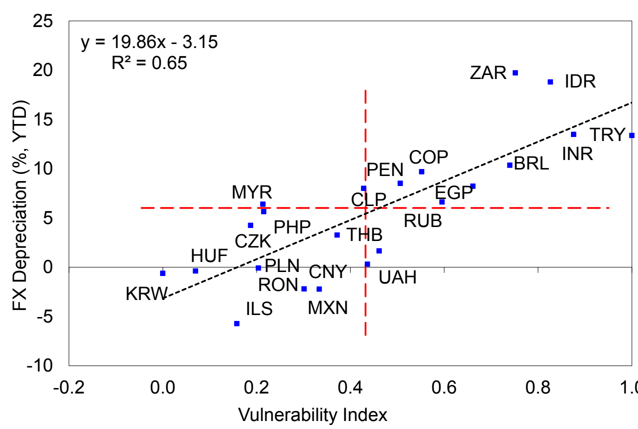
fundamentals are considerably better than they were during previous episodes of capital outflow. Another is based on the idea that what EM loses on the capital account (through capital outflows) it might recover on the current account (through export growth). In principle, there are three main paths towards optimism about EM export growth. One is that 'structural reform' in EM can impressively increase the supply capacity of EM exporters. Another is that a recovery in DM demand conditions will help to fuel a recovery in EM export growth. And if neither of these work, a third path towards export recovery is real exchange rate depreciation: EM re-prices its goods and services to levels that allow exports to grow.

Figure 11. Our EM vulnerability index - based on credit growth, C/A , reserves and inflation - provides a snapshot of risks going into 2014…



Source: Citi Research

Figure 12. …given that the Index is reasonably helpful in explaining currency risk in 2013

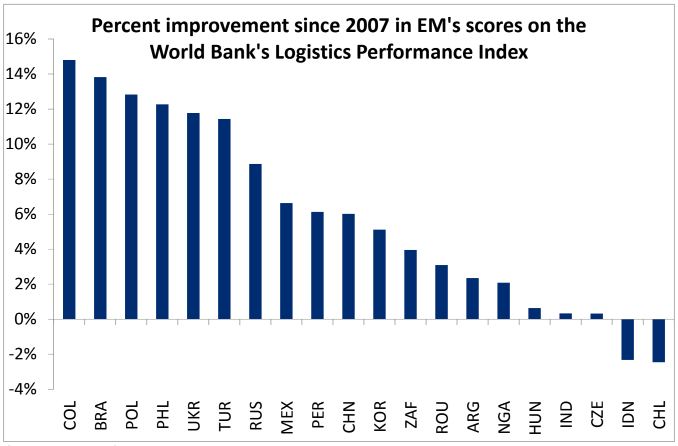


Source: Citi Research

A weaker environment for capital flows has led to a more visible debate about structural reform in EM. One question worth considering: why has it taken so long for 'structural reform' to occupy centre-stage in the debate about economic policy in EM? In some countries, of course – China, Mexico, India – the debate isn't new, but across EM it seems that structural reform is being discussed now with an urgency that was lacking in previous years. One reason for this, we think, can be traced back to the EM crises of the 1990s and early 2000s. During that period, the principal diagnosis of EM vulnerability was that it largely resulted from *weak sovereign balance sheets*: excessively high public debt/GDP ratios and inadequate levels of fx reserves. During the past 10 years, EM policymakers made a strenuous effort to address those balance sheet weaknesses, and in doing so – in the context of big gains in EM's terms of trade – helped to push into the background any other concerns about structural weaknesses. Now they are coming to the foreground.

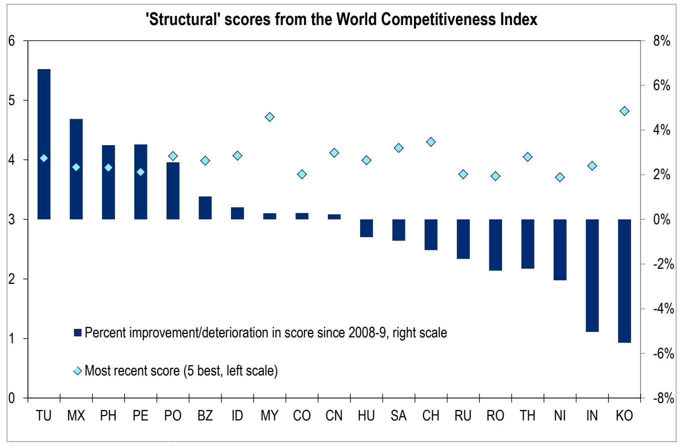
Recent progress in structural reform has been mixed, and is difficult to measure reliably. Although the debate about structural reform in EM has been reinvigorated recently, actual evidence of progress across EM is relatively mixed. Unfortunately, it is also difficult to find consistency across the most commonly known measures of microeconomic efficiency. Take, for example, the World Bank's Logistics Performance Index, whose overall score reflects perceptions of a country's logistics based on efficiency of customs clearance process, quality of trade- and transport-related infrastructure, ease of arranging competitively priced shipments, quality of logistics services, ability to track and trace consignments, and frequency with which shipments reach the consignee within the scheduled time. If we look at the performance of these indicators for various EMs over the past 5 years, the picture is relatively encouraging: with the exception of Chile and Indonesia, EMs have seen improving logistics scores between 2007 and 2012 (Figure 13).

Figure 13. The World Bank's Logistics Performance Index suggests that the microeconomic climate has improved in most EMs in recent years...



Source: IMF, Citi Research.

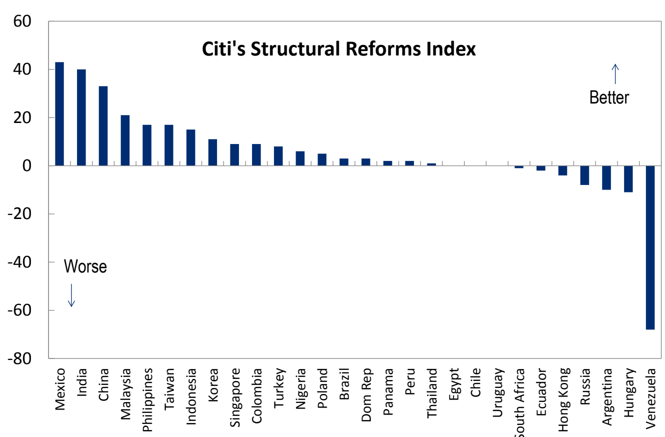
Figure 14. ...but the picture coming from the World Competitiveness Index is more mixed across countries



Source: Bloomberg, Citi Research

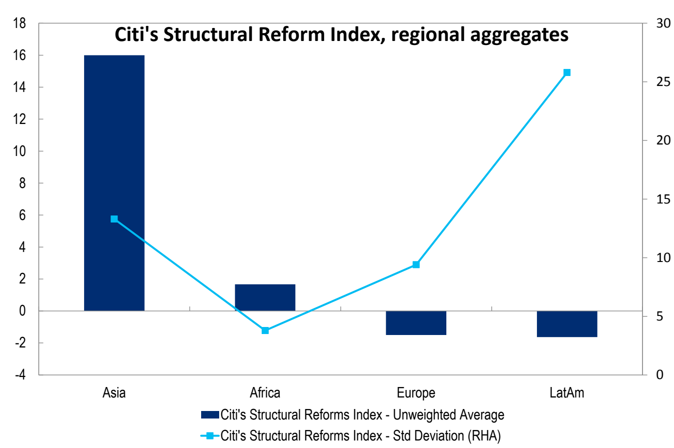
Progress according to the WEF's World Competitiveness Reports has been mixed. An alternative way of assessing what's been done in the area of structural reform is to consider the World Competitiveness Index (WCI) produced by the World Economic Forum. The WCI is divided into 12 'pillars', some of which are conjunctural – assessing the 'macroeconomic environment', for example – and some of which are purely structural. What we've done is to take some of the obviously structural pillars in the WEF's analysis and to see how countries' scores have changed in the past five years. The 'pillars' we think relevant are 'institutions' (which covers areas like intellectual property protection, judicial independence); 'infrastructure'; 'goods market efficiency'; 'labour market efficiency'; 'technological readiness'; 'business sophistication' and 'innovation'. The picture painted here (Figure 14) is much more mixed than the evidence from the Logistics Performance Index. While some countries – Turkey, Mexico, Philippines, Poland – have seen their World Competitiveness Scores improve on these structural measures there are plenty of others – Korea, India, Nigeria, Thailand, Russia, Romania – which have not.

Figure 15. Citi's structural reform index is based on our assessment of progress during 2014 in various policy areas relevant for growth



Source: Citi Research.

Figure 16. Led by India, China, Malaysia and the Philippines we expect Asia to deliver the strongest gains in structural reform next year

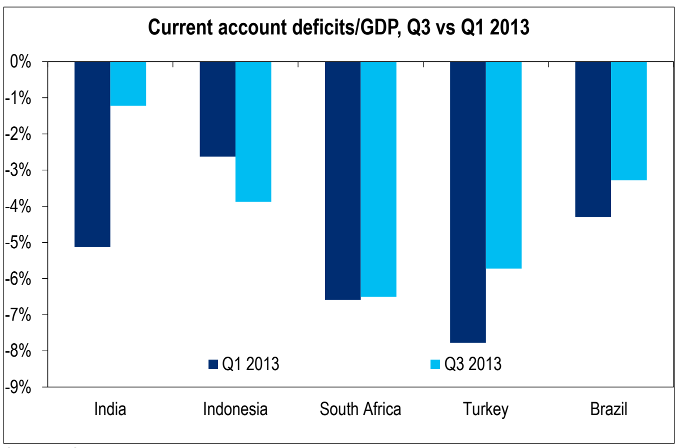


Source: Citi Research

We think structural reform, however measured, will remain an important theme next year, and we present a sketch of what we think the main issues are by country. We've surveyed Citi's EM economists to get their subjective assessment of the likelihood of structural reform progress in a number of areas: trade and capital account liberalisation; domestic financial liberalisation; tax reform; ownership; labour market reform; and land use. As Figure 16 makes clear, we expect the most from Asia, led by expected reforms in India, China, Malaysia, and the Philippines. But the picture is rather mixed across EM, and as with all reform: expectation is one thing, delivery another.

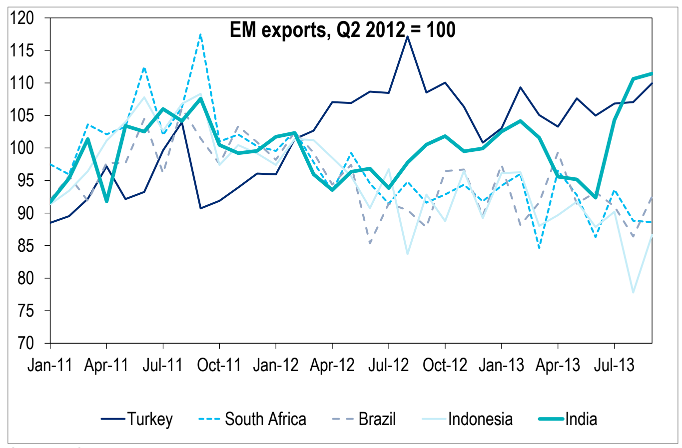
Our expectations about structural reform across EM confirm what has become evident during 2013: Asia's resilience stands in contrast to the vulnerabilities that exist in other parts of EM. Take India for example: we expect Indian reform process to accelerate next year; and it is, by a long way, the country that has done the most to shrink its current account deficit in the aftermath of the 2013 sell-off. This adjustment effort (Figure 17) is partly built on a recovery of exports – India's export growth rate is one of EM's highest currently – and is also a function of administrative efforts to restrict gold imports, which in 2012 accounted for 10% of India's import bill.

Figure 17. Current account adjustment has been much more impressive in India than in any of the other deficit economies…



Source: Citi Research.

Figure 18. …partly generated by a much more rapid Indian export recovery than others have seen



Source: Citi Research

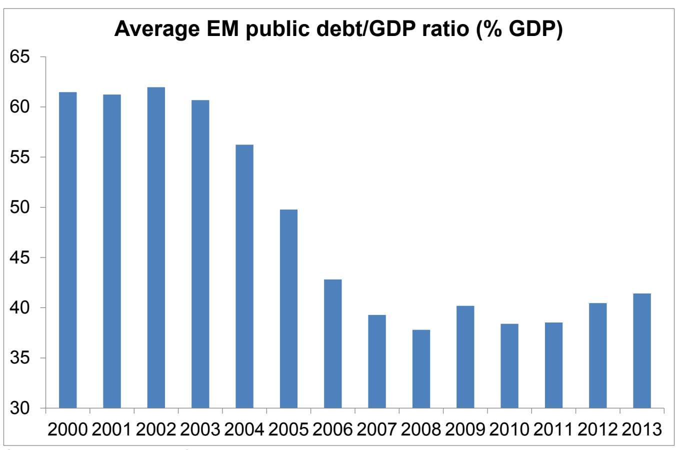
Vulnerability is partly enhanced by officials' reluctance to tighten policy. The weak growth environment in 2013 constrained the policy response to the capital outflows that started to become visible in May. A country can produce a nasty current account deficit in one of two ways: either i) the economy is overheating, causing import growth to accelerate; or ii) exports are weak because global demand conditions are poor. If it's the former, then it is easy for policymakers to put together a decisive response: the central bank will be happy to raise interest rates aggressively to address overheating concerns, and the government might also be willing to tighten fiscal policy for the same reasons. But when the deficit is generated by weak export growth, policymakers will be much less willing to do what's needed to shrink the external financing gap. The cost of tightening is just too great, in terms of lost GDP growth.

The unwillingness of EM officials to tighten policy is equally evident in central banks and finance ministries. EM central banks these days are faced with two problems. One is that - for many countries - inflation is uncomfortably high. In Brazil, Russia, South Africa, Indonesia, India, amongst others, inflation is above target, and that problem has been magnified by the exchange rate depreciation of recent months.

But at the same time, the persistence of weak activity (partly explained by weak export growth) makes central bankers reluctant to depress domestic spending. And central bankers feel entitled to think this way, because the intellectual climate in the past few years has moved away from 'pure' inflation targeting towards a greater emphasis on 'flexible' inflation targeting. There is barely an EM central banker on the planet these days who believes that their mandate is to pursue the inflation target no matter what the cost to the real economy.

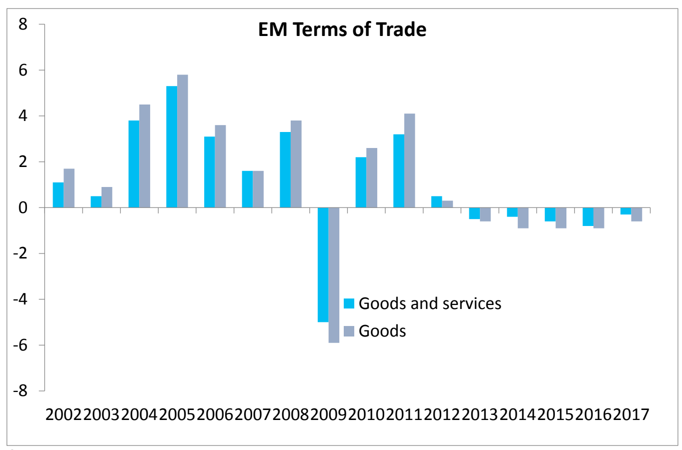
And it's not only monetary conditions that stay loose, but also the fiscal stance. As we've highlighted in past research, all of the large EMs with current account deficits and capital outflows – Brazil, India, Indonesia, South Africa and Turkey – have important elections coming up in 2014. That argues against a tighter fiscal stance, particularly since governments seem keen on pushing a slightly looser fiscal policy in order to compensate for weak external demand and to plug their admittedly substantial infrastructure deficits. And in general, we think it makes sense to expect some marginal deterioration in public debt ratios in EM. Average debt/GDP ratios have, we think, seen their best days, as Figure 19 suggests. Since EM can no longer rely on the very positive terms of trade improvement that characterised the period between 2002 and 2008 (Figure 20), public sector balance sheets should automatically take up some of the burden of supporting growth. One implication of this is that EM will probably find it difficult to sustain the steady improvement in sovereign creditworthiness that has helped to define the asset class since 2004.

Figure 19. Fiscal policy is likely to stay relatively loose…



Source: Fitch Ratings, Citi Research.

Figure 20. …as long as the EM terms of trade stay substantially less benign than they were in the 2000s, which appears to be the IMF's view

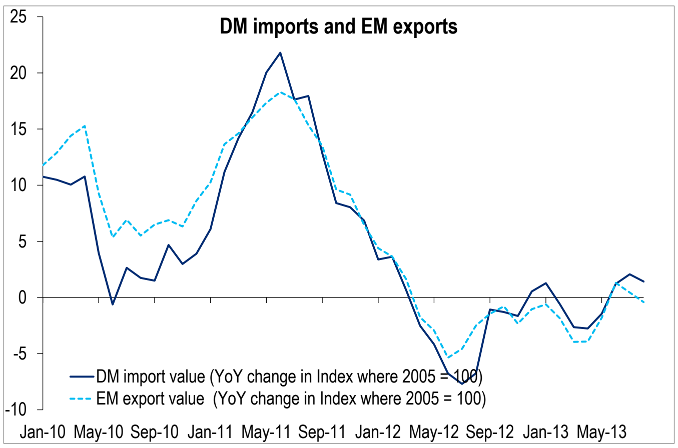


Source: IMF

EM could conceivably be 'bailed out' by a positive external demand shock, but the evidence so far is mixed. As we showed earlier, export growth from EM has had its bright spots in recent months: India, for example, or to a lesser extent Turkey (Figure 18). Yet overall, the EM's export performance has been disappointing in the past few quarters, and this is perhaps the central component in the whole story of EM's slowdown of 2012 and 2013. The biggest cause by far of this export disappointment has been the fact that world trade growth remains unusually weak. Data from the CPB in the Netherlands show world trade volumes (goods only) up by just 2.1% YoY in January-August, less than the IMF's 2.9% forecast for 2013 world GDP growth. By contrast, in the pre-Lehman period, world trade growth on average usually grew 1.5-2 times as fast as global GDP. For example, over 1980-2007 as a whole, global GDP growth (real terms) averaged 3.5% YoY, while world trade growth in goods and services averaged 6.1% YoY – an average elasticity of 1.8 times.

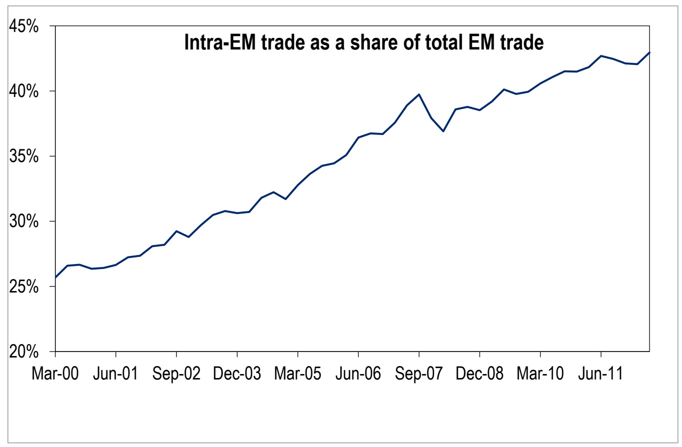
We continue to think that DM growth may not be as import intensive as it has been in recent years. (See Emerging Markets Macro and Strategy Outlook - Will DM's Recovery Be EM-friendly?). Real exchange rates (deflated by unit labour costs) of the US, Japan and UK are 14%, 21% and 5% respectively below their 1994-2007 averages, making room for import-substitution. And since we expect a Eurozone current account surplus of some 2.6% GDP over the next 2 years, the external demand environment facing EM is likely to remain somewhat constrained. Although intra-EM trade may continue to grow, it remains less than half of EM's total trade; and the rate of its growth seems to have decelerated in recent years (Figure 22). All in all: if capital flows, structural reform and export growth are all subject to some doubt going into 2014, the burden would be on currencies to take the strain. On average, we expect EMFX to weaken by 4% in 2014. And that burden would grow if China is, once again, a source of shock for EM, as it seemed to be in the middle of 2013.

Figure 21. EM export growth seems constrained by weak DM demand, and a slight recovery in DM import values this year didn't help much



Source: CPB Netherlands; Citi Research

Figure 22. Intra-EM trade has grown, but the pace at which it has grown has been weakening recently



Source: IMF; Citi Research

China's growth model is looking increasingly strained. The ability of the economy to deliver sustained (high) growth, without continued policy impulse seems to be dwindling. As the authorities (including the PBOC and CBRC) move towards containing some financial excesses, economic activity could well show another leg of disappointing growth. Overall, we think the debate about China's susceptibility to a sharp slowdown will stay alive during 2014.

One way of assessing China's vulnerability to an abrupt slowdown is to look at Asia's economic history over the past 40 years. Chinese officials themselves sometimes talk about Japan's slowdown in the mid-1970s and Korea's slowdown in the late 1990s as a way of explaining the inevitability of China's transition to a weaker level of GDP growth. But Japan's experience in the 70s, and Korea's in the 90s, are not obviously auspicious precedents for China: both these countries suffered a very abrupt slowdown after a period of strong, credit-fuelled, investment-led growth which boosted their investment/GDP ratios to historically high levels[2].

[2] See, for example, *'China's Rebalancing: Lessons from East Asian Economic History'*, John L. Thornton China Center Working Paper Series, October 2013, by David Dollar; and '*Rebalancing China's Economic Growth: Some Insights from Japan's Experience*', by Tomoyuki Fukumoto and Ichiro Muto, Bank of Japan Working Paper Series No. 11-E-5, July 2011; *'An Economy in search of stable growth: Japan since the oil crisis'*, by Nakamura Takafusa, The Journal of Japanese Studies, Winter 1980.

Japan and Korea's experience during these years were also associated with rapid appreciation of the real exchange rate, which has also been a feature of China's economic development in the past few years. Of course, the abrupt slowdown that 70s Japan and 90s Korea faced didn't put a stop to their development: per capita income levels continued to rise in PPP terms after a one-year shock (1974 for Japan, 1998 for Korea). But the decline in average GDP growth was notable in both cases. In Japan, GDP growth averaged 8.6% in the five years up to 1973, but only 3.1% in the five years from 1974; while in Korea, GDP growth averaged 7.4% in the five years up to 1997, but only 5% in the five years from 1998. Each country suffered a year of recession: 1974 in Japan, 1998 in Korea.

To be sure, there are plenty of differences between China now and other Asian economies in the past few decades. Japan and Korea were both somewhat richer economies than China is today; both were more urbanised; and Korea's economy in particular had a different path of development in the sense that it ran a current account deficit, rather than the surpluses that existed in 1970s Japan or 2000s China. These differences are summarised in Figure 23.

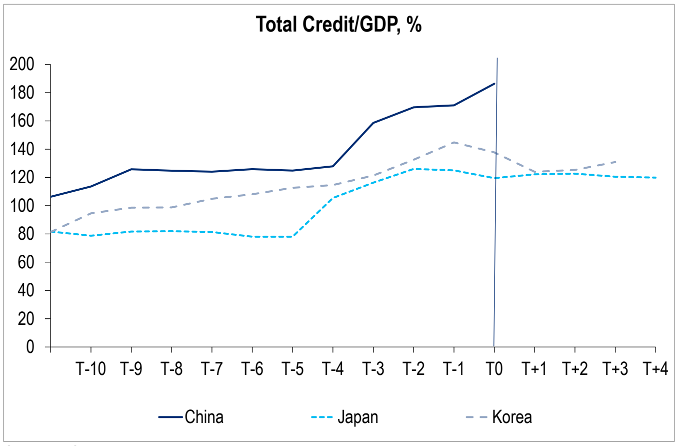
Figure 23. China now, Japan and Korea then: similarities and differences.

	GDP/capita	Urbanisation	CA/GDP	(X+M)/GDP	Peak I/GDP	Credit/GDP
Japan, early 1970s	13,771	72%	1.8	22%	39%	140%
Korea, mid 1990s	17,893	78%	-2.3	49%	39%	132%
China today	8,069	50%	2.2	44%	51%	186%

Source: Citi Research

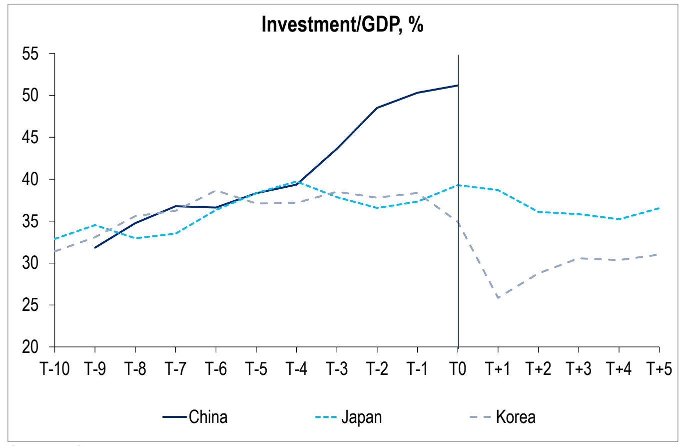
But the vulnerabilities created in Japan and Korea in past decades show some 'family resemblances' to what's going on in China these days. Japan saw a very large increase in private sector credit extension during the early 1970s, which led the total stock of bank credit to the private sector grow from 82% GDP in 1969 to 143% GDP in 1973. But one remarkable feature of the rise in Japanese leverage in the early 1970s is that bank loans to the private sector tell only a small part of the story. In order properly to understand Japan's credit boom in the early 1970s – very like China's today - a broader definition of credit is needed. Including credit from non-banks to local governments and to SOEs, the build-up in Japanese leverage at that time was remarkable, rising quickly to 199% of GDP in 1973. Pre-1973 Japan was characterised by very loose monetary policy which, among other things, led to speculative acquisition of land. Unlike today's China, though, Japan did also experience a sharp rise in inflation in 1971-1972, to which policymakers responded by tightening monetary policy in spring of 1973, several months before the economy's slowdown was triggered by the external shock of the oil crisis. In Korea, too, the years preceding 1997 saw a build-up of bank credit but, in a similar way to Japan, the economy's leverage wasn't purely a bank-led phenomenon: including credit from specialised institutions and other lenders, the total credit stock in Korea rose from around 108% GDP in 1993 to 145% in 1997.

Figure 24. Substantial accumulation of credit stocks was evident in Japan in the early 1970s and Korea in the 1990s…



Source: Citi Research

Figure 25. …and those credit stocks helped to keep investment ratios high until an external shock triggered slowdown and rebalancing.

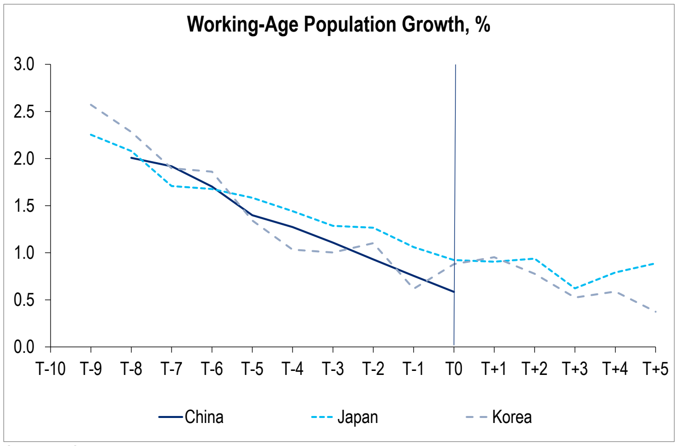


Source: Citi Research

The pre-crisis periods in Japan and Korea were also characterised by a big rise in investment spending. In Japan and Korea, the extension of credit was heavily oriented towards investment spending, as is the case in China today: the ratio of investment to GDP rose from 32% in 1967 to 36% in 1973 in Japan. And in Korea too, the investment/GDP ratio also rose from 32% to 37% between 1990 and 1997 (although it did briefly rise to 39% in 1991). In Japan's case, this credit-fuelled investment boom was also marked by a couple of other similarities to China: a network of cooperative relationships between banks, firms and suppliers (the *keiretsu* system); and a strong element of financial repression, in which the household sector was effectively providing a subsidy to manufacturing as a consequence of excessively low real interest rates.

In Japan, the credit-fuelled investment boom was associated with a rise in the real exchange rate. Korea's pre-crisis experience didn't have much impact on the real exchange rate, which remained broadly stable in the years running up to the 1997 crisis. However, Japan's experience with its real effective exchange rate was arguably more similar to what we're seeing in China. The Yen appreciated by around 25% between 1969 and 1973. This was partly the result of the Smithsonian agreement of 1971, which revised exchange rates under the Bretton Woods regime that had been in place since 1944: the yen appreciated under from 360/$ to 308/$. China's real exchange rate has appreciated by 15% since late 2008, largely thanks to a hefty nominal exchange rate appreciation since the Yuan was 'de-pegged' in 2010. Nominal exchange rate appreciation seems to be consistent with China's objectives to 'internationalise' the Yuan. Since China lacks deep and liquid capital markets and an internationally accessible legal system – factors which help to underpin, say, the Euro or the Dollar as international currencies – it seems to be offering nominal exchange rate stability as a substitute.

Figure 26. Japan and Korea saw sharp declines in the growth rate of their working age populations in the run-up to their slowdowns



Source: Citi Research

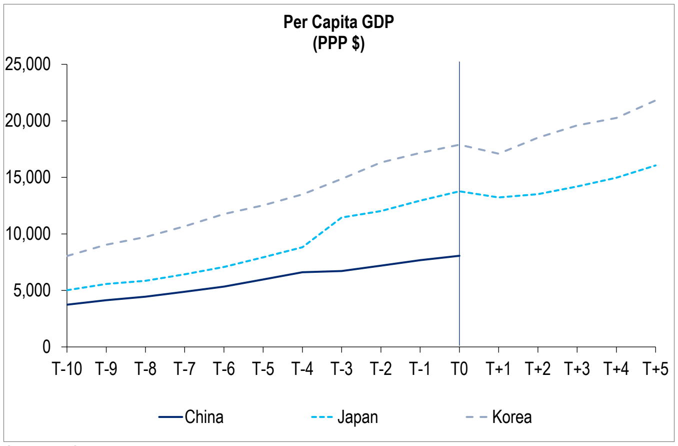
Figure 27. Less efficient credit-dependent growth has put downward pressure on the return on capital in China

Source: Citi Research. The real return on capital is defined as the capital share of income divided by the capital output ratio, less depreciation and the difference between the investment goods deflator and the GDP deflator. Methodology follows (insert)

Demographic change helped to interrupt Japan and Korea's booms. Both Japan and Korea experienced sharp declines in the growth rate of their working age populations in the years running up to their sharp slowdowns. In the five years before 1973, the growth rate of Japan's working age population averaged 1.3%, and fell to 0.8% in the five years after. In Korea, working age population growth had been as high as 2.5% in the late 1980s, and had fall to just 1% in 1997, before falling further thereafter to just 0.3% in 2003. In China, very rapid growth in the working age population ended in the 1990s, but the change is accelerating: while WAP growth averaged 1.5% in the 10 years prior to 2008, the UN expects growth this year to be just 0.3%, before contracting from 2016. A declining working age population implies that without a simultaneous reallocation of workers to higher productivity jobs, potential GDP growth decelerates. And, if growth slows down for this structural reason, resolving other imbalances becomes increasingly taxing.

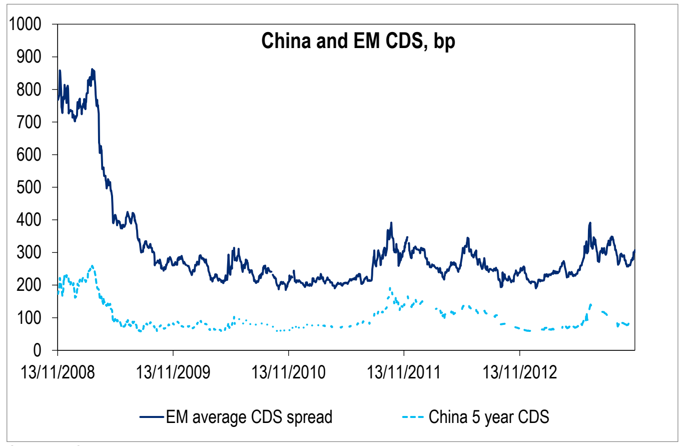
Vulnerability is not, by itself, enough to bring on a sharp slowdown. The overwhelming lesson of Japan's and Korea's experiences in the 1970s and 1990s is that their sharp slowdowns were, in each case, triggered by an external shock: the oil crisis in Japan's case, and the Asian Financial Crisis in Korea's case. And this probably provides the single most important lesson for China. Whatever vulnerabilities are created by China's credit-fuelled, investment-led growth, or by the associated decline in the return on capital in China, it seems right to suppose that it will take some nasty trigger to turn that into a sharp slowdown. It seems that some informal equation – [*crisis* = *vulnerability* + *trigger*] – holds true. By definition, of course, no one is able to predict or identify a trigger. But it is reasonable to assume that market participants will remain highly alert to whatever might trigger a possible abrupt Chinese slowdown, given the sharp slowdowns that have occurred in countries with similar development paths in the past. In recent months, investors have had good reasons to become less panicked about the downside risks to China's growth: August through October 2013 saw three consecutive months of double-digit industrial production growth, and the market has responded warmly to the reforms outlined in the Third Plenary. The result of these developments is that indicators of fear about China – the 5 year CDS spread, for example – are currently very low by historical standards.

Figure 28. An abrupt slowdown in China won't derail the country's development if Japan and Korea's experiences are anything to go by…



Source: Citi Research.

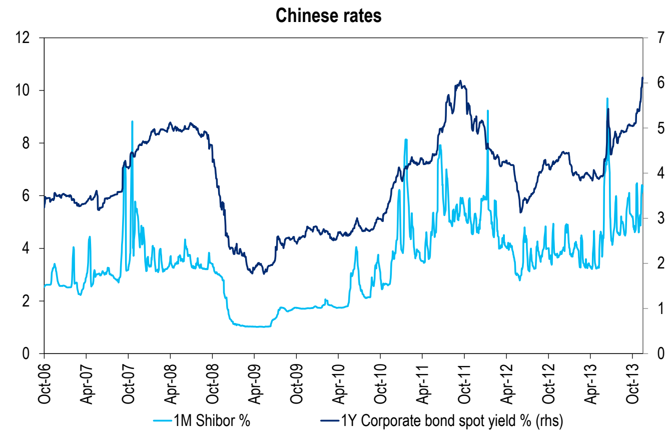
Figure 29. …but China 5 year CDS has rarely traded at such a steep discount to the rest of EM as now



Source: Citi Research

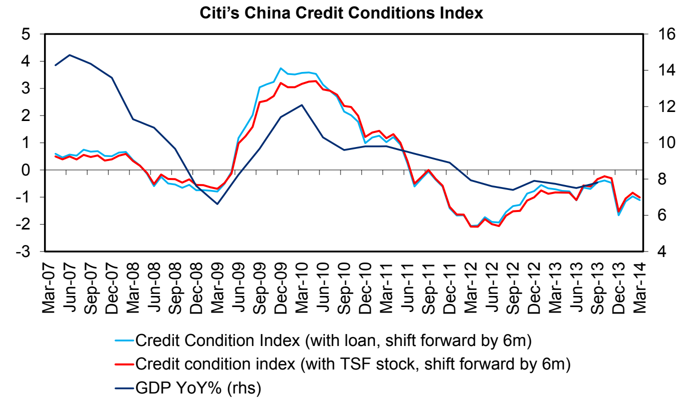
The distribution of outcomes for next year seems skewed. China's growth model exhibits problems in a number of areas: demographics, productivity, over-investment and high leverage. The reforms outlined in the Third Plenary of the 18th CCCPC last month contained elements that exceeded our expectation – land reform, for example, or investment deregulation – but implementation of the reforms may cause some deceleration in growth. Increases in land and utilities prices will probably erode profitability for the corporate sector as interest rate reform erodes the profitability of the financial sector; rural land reform, which involves redistribution of land sale proceeds in favour of farmers, will reduce the share of revenues accruing to local governments, with an impact on their capacity to invest in infrastructure; and stricter environmental standards could constrain the investment model on which China has depended in recent years. On the other hand, the reforms fell short in other key areas. There seems to be little progress on the household registration system (hukou) and rural land reform, limiting the medium term reallocation of workers to more productive activities. There is progress in opening certain sectors to investment but less progress on State Owned Enterprises, overcapacity or leverage. There is progress on financial reforms, but the risk is that deregulation proceeds faster in finance than in the rest of the economy potentially generating a credit problem. The lack of progress in these reforms could further affect that ability of the economy to sustain growth in the short term. Compounding the challenge, monetary policy has exhibited a tightening bias since June, with the result that credit conditions have tightened. And there is relatively little fiscal space in China. For all these reasons, we think it would be wise to expect further waves of nervousness about the risk of sharp slowdown in China next year, as investors grope to identify the trigger that could launch China into a major slowdown (China Macro View - Economic Prospects for 2014: Making a Down Payment for Long-Term Growth).

Figure 30. Market rates in China are drifting higher, which indicates some tightening of liquidity conditions…



Source: Citi Research.

Figure 31. …and our credit conditions index suggests a slowdown before too long



Source: Citi Research. Note, the credit condition index uses M2, loan outstanding/TSF stock, lending attitude of banks, expected return on Wealth Management Products, corporate bond spot yield and 1M SHIBOR, assigning coefficients based on Principal Components Analysis.

Rates Outlook

Strategic thoughts for 2014

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For full report click on: Emerging Markets Macro and Strategy Outlook - Prospects for 2014 and beyond

As we look at prospects for 2014, we believe asset prices will be driven by two fundamental undercurrents. On the one hand, the global macro outlook seems somewhat less stormy than in previous years. There is, however, an emerging change in direction for US monetary policy which should impact fixed income asset markets across the board. On the other, the EM macroeconomic outlook looks mediocre in its baseline and with a significant dose of downside risks. Faced with such macroeconomic background, we ponder how should investors approach the year?

By and large, 2014 promises to be yet another global macro year. EM will perform to the tune of the global macro environment. Absent accidents in the EM space –more on that later- it is likely that market conditions in EM will fluctuate to the tune of international markets. In particular, events such as the tapering of the Fed's large scale asset purchases, and the eventual process of convergence to the first interest rate hike, look set to play a dominant role. Yet, other global uncertainties such as the first quarter fiscal discussions in the US, the consumption tax hike in Japan and the possible increase in the BoJ's asset purchase program, or the inevitable vicissitudes of Europe's grope towards debt sustainability, will also pepper the year. These factors will likely lead to volatility and, to some extent, a trend in fixed income assets. Yet, for the future of Ems, what matters most is what actions are not currently priced in or reasonably well understood.

Tapering seems to be largely priced in. Whether tapering begins in December 2013 or March 2014 is likely to have modest effects on US Treasuries markets. Since consensus holds the view that late in Q1 is the most likely date for the beginning of the process of winding down asset purchases, a December date would probably have a larger, if still somewhat modest impact (say an extra 10-15bp movement). Conversely, if tapering were to start in Q2, long rates would probably fall by a similar amount. A somewhat different story is likely to unfold as the year progresses and the focus shifts towards the first policy rate hike. At that point, we anticipate a larger response in 2-year bonds, with a potentially amplified effect on EM assets. All in all, we expect a gradual drift up of US Treasuries and, later in 2014, a flattening of the curve.

If movements in US Treasury markets exhibit moderate volatility, even if with a well-defined trend, EM asset prices are not likely to suffer as much as they did in the May-August 2013 period. However, volatility could still be an important consideration. And, late in 2014, if front end rates begin to slide, the effects on EM may be amplified. A critical force that will keep EM "en-guard" is the potential response of capital flows and one of its components, portfolio inflows into EM institutional investors.

The EM asset class grew in the last few years faster than global fixed income assets did, in part explained by extraordinary financial conditions. The combination of low advanced economy interest rates, improved economic conditions in EM with better diversification features and greater opportunities for penetrating previously closed markets, all led to growing interest by institutional money managers into the asset class. However, inflows into the asset class exhibited a behaviour that resulted in allocations that are probably higher than those that will be observed in steady state and, thus, there is a latent risk of a correction. What may trigger a reversal of those flows is unknown. It may be a movement in US rates, a pick-up in volatility that is compounded by capital outflows, or some idiosyncratic forces. Anecdotal evidence suggests that dedicated money managers are still seeing positive inflows of AUM from institutional investors, which suggests that they are relatively stable. However, the tail event of a large capital outflow sparked by an unpredictable shock, could threaten the asset class and would likely keep investors alert.

Annual Indicators

Figure 32. Emerging Markets – Economic Forecasts, 2012-2014F

	GDP Growth			CPI Inflation			Current Balance (% of GDP)			Fiscal Balance (% of GDP)		
	2013F	2014F	2015F	2013F	2014F	2015F	2013F	2014F	2015F	2013F	2014F	2015F
Asia	**6.2**	**6.2**	**6.3**	**3.7**	**3.9**	**4.1**	**2.0**	**1.8**	**1.3**	**-2.3**	**-2.1**	**-1.7**
China	7.6	7.3	7.0	2.7	3.3	3.7	2.2	2.0	1.5	-2.0	-2.0	-1.5
Hong Kong	3.0	3.4	3.8	4.3	3.6	4.0	2.8	3.1	3.9	2.2	1.6	0.7
India*	4.8	5.6	6.7	6.0	5.0	5.0	-2.7	-2.4	-2.4	-6.7	-6.4	-6.2
Indonesia	5.7	5.3	5.5	7.1	6.6	5.7	-3.5	-2.8	-2.3	-2.1	-1.8	-1.7
Korea	2.9	3.7	3.9	1.2	2.3	3.1	5.6	4.1	3.2	0.9	2.3	2.3
Malaysia	4.5	5.0	4.9	2.1	3.4	4.3	3.7	4.4	4.0	-4.2	-3.5	-3.0
Mongolia	12.0	11.0	8.0	10.3	12.0	9.0	-27.4	-21.4	-17.6	-8.0	-6.4	-3.0
Philippines	6.7	7.3	6.8	2.8	3.5	3.9	3.5	3.1	2.9	-1.7	-1.8	-1.2
Singapore	4.0	3.5	4.0	2.4	2.1	2.2	14.0	13.5	13.0	0.7	0.5	0.5
Sri Lanka	6.8	7.0	7.0	7.0	6.5	6.5	-4.6	-3.1	-3.6	-6.0	-5.7	-5.5
Taiwan	2.0	3.2	3.8	1.1	1.7	2.3	10.9	9.8	9.5	-1.5	-1.4	-1.2
Thailand	2.8	3.1	4.3	2.1	2.2	3.1	-0.9	-0.7	-1.0	-1.8	-2.0	-2.4
Vietnam	5.2	5.5	5.8	6.7	7.1	7.2	5.0	3.8	2.5	-5.3	-4.5	-4.0
Latin America	**2.6**	**2.7**	**3.0**	**7.4**	**8.6**	**8.9**	**-2.5**	**-2.5**	**-2.1**	**-3.3**	**-3.7**	**-2.9**
Argentina	5.1	3.0	2.0	10.5	12.4	13.8	-0.5	-0.4	-0.4	-2.3	-3.1	-2.3
Brazil	2.6	2.0	2.0	6.2	6.0	5.7	-3.5	-3.4	-3.1	-3.6	-3.9	-2.7
Chile	4.0	4.0	4.5	1.7	2.6	2.9	-3.5	-3.8	-4.0	-0.3	-0.4	-0.4
Colombia	3.9	4.6	5.0	2.0	2.4	3.3	-3.1	-3.2	-3.5	-1.1	-0.7	-0.7
Mexico	1.2	3.8	4.0	3.8	4.0	3.7	-1.7	-1.9	-1.7	-2.4	-3.5	-2.5
Panama	7.2	6.5	5.5	4.0	2.7	2.8	-14.3	-13.6	-9.2	-3.5	-3.0	-3.0
Peru	4.9	4.8	4.8	2.9	3.4	2.5	-5.5	-5.6	-1.5	0.8	0.0	0.0
Venezuela	2.0	0.0	2.0	38.8	59.0	63.8	3.6	3.8	3.3	-11.7	-11.8	-11.9
Europe	**1.8**	**2.8**	**3.0**	**5.3**	**4.8**	**4.7**	**-1.0**	**-1.2**	**-1.4**	**-2.3**	**-2.5**	**-3.6**
Bulgaria	0.5	1.5	2.5	1.2	2.8	2.5	0.0	-0.8	-1.5	-2.0	-2.0	-1.2
Croatia	-1.0	1.2	2.0	2.3	2.3	2.8	-0.1	-0.5	-1.0	-5.5	-5.7	-5.0
Czech Republic	-1.3	1.9	2.4	1.4	1.2	1.9	0.0	1.3	0.7	-2.4	-2.9	-2.9
Hungary	1.0	1.9	1.5	1.7	1.5	3.3	1.5	0.9	0.8	-2.9	-3.0	-2.9
Kazakhstan	5.1	4.0	4.4	5.8	5.5	5.3	0.2	1.6	2.1	2.7	1.8	1.7
Poland	1.4	3.1	3.6	1.0	1.9	2.8	-1.5	-2.4	-3.4	-4.6	5.2	-2.6
Romania	2.5	2.8	3.3	4.1	1.9	2.7	-1.2	-3.1	-4.2	-2.5	-2.3	-2.3
Russia	1.4	2.6	2.7	6.7	5.3	4.9	1.6	1.1	0.8	-2.0	-4.3	-4.9
Serbia	2.5	2.0	2.2	8.3	6.6	5.9	-5.5	-6.0	-6.5	-5.0	-5.0	-4.7
Slovakia	0.8	1.8	2.4	1.4	1.1	1.8	4.3	4.0	3.4	-3.4	-3.2	-2.6
Turkey	3.5	3.5	3.6	7.5	7.3	6.9	-7.0	-6.3	-5.8	-1.2	-2.8	-3.2
Ukraine	-0.7	1.6	3.3	-0.3	3.9	4.8	-6.8	-5.4	-5.0	-6.7	-4.2	-4.0
Africa/Mideast	**4.4**	**5.0**	**5.3**	**4.2**	**4.5**	**5.0**	**12.5**	**10.3**	**8.1**	**2.8**	**1.1**	**-0.3**
Bahrain	4.3	4.0	4.1	3.3	2.2	2.0	5.3	2.4	-1.5	-2.2	-3.3	-5.5
Egypt	2.0	2.9	3.4	9.2	8.1	6.8	-2.7	-2.8	-3.2	-12.8	-12.1	-10.0
Ghana	7.4	6.8	6.5	11.4	11.2	8.8	-12.0	-11.2	-10.2	-9.2	-7.7	-6.5
Iraq	3.1	10.4	11.6	2.2	5.8	6.0	13.5	13.8	12.8	1.6	3.5	4.3
Israel	3.2	3.4	3.5	1.6	2.3	3.0	2.6	2.0	0.7	-3.6	-3.0	-2.5
Jordan	3.0	4.0	4.5	5.7	4.8	5.0	-15.2	-14.2	-11.9	-8.2	-9.5	-9.3
Kenya	5.5	6.1	6.5	5.6	6.6	7.3	-10.1	-9.5	-9.0	-7.0	-5.5	-4.5
Kuwait	4.2	3.8	3.9	2.6	3.3	5.0	51.0	49.5	47.8	36.8	32.1	29.5
Lebanon	1.4	-0.9	-3.1	2.1	3.7	5.0	-4.5	-5.4	-6.5	-10.0	-9.6	-8.3
Nigeria	6.5	6.5	6.3	8.5	8.8	10.6	4.3	2.0	2.2	-2.1	-2.9	-2.9
Oman	6.7	6.7	6.7	1.3	2.0	3.0	10.3	8.1	6.2	-0.2	-3.4	-5.4
Qatar	5.6	5.9	6.1	3.1	3.0	3.5	29.7	25.5	20.7	8.1	4.2	1.2
Saudi Arabia	6.1	5.8	6.2	3.5	3.4	4.1	18.1	13.5	9.0	10.3	5.1	0.4
South Africa	1.9	2.8	3.5	5.8	5.6	5.5	-7.1	-5.7	-5.3	-4.4	-4.3	-4.4
Tanzania	6.8	7.0	8.1	8.0	6.5	6.7	-10.2	-14.1	-12.4	-5.0	-5.2	-5.9
UAE	3.7	4.0	4.0	1.1	1.3	1.5	28.0	23.3	19.1	NA	NA	NA
Uganda	5.0	5.6	6.5	5.9	8.7	6.0	-12.0	-13.9	-14.9	-3.4	-3.3	-3.5
Zambia	6.0	6.4	6.3	7.1	6.8	7.4	-3.2	-2.8	-3.0	-8.5	-6.4	-5.5
Total	**4.6**	**4.9**	**5.0**	**4.7**	**5.0**	**5.2**	**1.9**	**1.6**	**1.1**	**-2.0**	**-2.2**	**-2.1**

Note: *We use the wholesale price index for inflation in India. Source: National sources, Citi Research

Economic Framework

Figure 33. Citi's Global Economic Forecasts

	GDP Growth (% YoY)			CPI Inflation (% YoY)			Current Balance (% of GDP)			Fiscal Balance (% of GDP)		
	2014F	2015F	2016F	2014F	2015F	2016F	2014F	2015F	2016F	2014F	2015F	2016F
Global	**3.1**	**3.3**	**3.5**	**3.0**	**3.0**	**3.4**	**0.7**	**0.6**	**0.3**	**-3.2**	**-2.7**	**-2.5**
Based on PPP weights	3.6	3.8	4.0	3.4	3.5	3.9	0.4	0.3	0.1	-3.2	-2.8	-2.6
Industrial Countries	**2.0**	**2.1**	**2.3**	**1.7**	**1.6**	**1.5**	**0.1**	**0.2**	**0.1**	**-3.8**	**-3.1**	**-2.9**
United States	2.7	3.1	3.2	1.8	2.0	2.2	-2.0	-1.7	-1.8	-4.6	-3.9	-3.9
Japan	1.6	0.9	1.2	2.3	1.4	1.6	1.6	1.7	1.5	-8.0	-6.2	-5.8
Euro Area	0.9	1.0	1.3	0.9	0.7	1.1	2.6	2.6	2.5	-2.6	-2.2	-2.1
Canada	2.4	2.7	2.7	1.5	1.9	2.0	-4.2	-4.2	-3.8	-0.3	0.2	0.2
Australia	2.9	3.0	3.2	3.1	2.4	2.4	-3.6	-4.3	-4.5	-2.6	-1.9	-1.0
New Zealand	3.0	2.7	2.5	2.1	2.2	2.3	-4.7	-4.9	-3.8	-1.8	-0.7	-0.9
Germany	1.9	1.7	1.7	1.5	1.6	1.8	6.8	6.2	5.3	0.0	-0.1	-0.3
France	0.8	0.9	1.4	1.2	1.3	1.5	-0.8	-0.1	0.4	-3.6	-3.2	-2.9
Italy	0.2	0.3	0.4	0.2	-0.3	0.4	1.4	1.5	1.6	-2.8	-2.7	-2.5
Spain	0.2	0.8	1.2	-0.4	-0.2	0.1	2.1	2.6	3.0	-6.2	-5.4	-4.8
Greece	-1.9	-0.5	1.1	-2.9	-2.4	-1.4	1.6	2.3	3.5	-2.3	-1.8	-1.3
Ireland	1.4	1.6	2.7	0.5	1.0	1.5	10.1	10.4	11.2	-5.6	-4.0	-3.4
Portugal	-0.5	0.4	0.7	-0.4	-1.2	-0.2	2.5	2.8	2.9	-5.0	-4.4	-3.8
Netherlands	0.4	0.9	1.2	1.3	1.3	1.4	10.0	8.6	8.1	-2.9	-2.2	-1.5
Belgium	0.6	1.0	1.4	1.3	1.1	1.1	-4.1	-3.9	-3.3	-2.3	-1.5	-1.0
Denmark	1.2	1.5	1.6	1.5	1.7	1.8	5.1	4.7	4.8	-1.8	-1.5	-1.0
Norway	2.1	2.4	2.6	2.0	2.2	2.0	13.1	13.4	13.7	11.8	11.0	10.0
Sweden	2.1	2.5	2.6	1.1	2.0	2.4	5.9	5.6	5.6	-1.6	-0.7	0.7
Switzerland	2.0	2.0	2.2	-0.1	0.9	1.1	13.0	12.8	13.8	0.6	0.8	1.2
United Kingdom	3.2	3.2	2.7	2.0	1.9	2.1	-3.0	-3.1	-3.2	-4.9	-3.7	-1.9

Source: National sources and Citi Research

Figure 34. G3 Currency and Interest Rate Forecasts (End of Period, Unless Specified), as of 28 November 2013

	28-Nov-13	1Q 14F	2Q 14F	3Q 14F	4Q 14F	1Q 15F	2Q 15F
United States: Federal Funds	0.25	0.25	0.25	0.25	0.25	0.25	0.25
10-Yr. Treasuries (Period Ave.)	2.75	2.80	2.95	3.15	3.25	3.40	3.50
Euro Area: US$/€	1.34	1.37	1.39	1.40	1.40	1.40	1.40
Euro Repo Rate	0.25	0.25	0.00	0.00	0.00	0.00	0.00
10-Yr. Bunds (Period Average)	1.70	1.70	1.70	1.70	1.80	1.90	1.90
Japan: Yen/US$	101	103	104	105	105	105	105
Call Money	0.10	0.10	0.10	0.10	0.10	0.10	0.10
10-Yr. JGB (Period Average)	0.60	0.55	0.50	0.60	0.70	0.90	1.00

Industrialised Countries 10-Year Yield Spreads (Period Average)

	Spread vs. US$					Spread vs. Germany				
	1Q 14	2Q 14	3Q 14	4Q 14	1Q 15	1Q 14	2Q 14	3Q 14	4Q 14	1Q 15
United States	**NA**	**NA**	**NA**	**NA**	**NA**	**112**	**127**	**147**	**148**	**153**
Japan	**-232**	**-237**	**-247**	**-238**	**-243**	**-120**	**-110**	**-100**	**-90**	**-90**
Euro Area	**-112**	**-127**	**-147**	**-148**	**-153**	**NA**	**NA**	**NA**	**NA**	**NA**
Canada	-20	-10	-10	-10	-10	92	117	137	137	143
Australia	153	148	138	138	138	265	275	285	285	291
New Zealand	214	219	230	240	266	326	347	377	388	419
France	-62	-82	-102	-103	-108	50	45	45	45	45
Italy	108	83	53	27	22	220	210	200	175	175
Spain	118	93	33	2	-3	230	220	180	150	150
Netherlands	-77	-92	-112	-113	-118	35	35	35	35	35
Belgium	-32	-42	-72	-78	-88	80	85	75	70	65
Austria	-72	-92	-112	-113	-118	40	35	35	35	35
Finland	-87	-102	-122	-123	-128	25	25	25	25	25
Ireland	63	38	8	-13	-18	175	165	155	135	135
Denmark	-102	-117	-137	-138	-143	10	10	10	10	10
Switzerland	-180	-195	-215	-221	-232	-68	-68	-68	-73	-79
United Kingdom	5	10	5	5	0	117	137	153	153	153

Note: Spreads calculated on annual basis (except those of the United Kingdom, Canada, Australia and New Zealand over the United States). Source: Citi Research

Appendix A-1

Analyst Certification

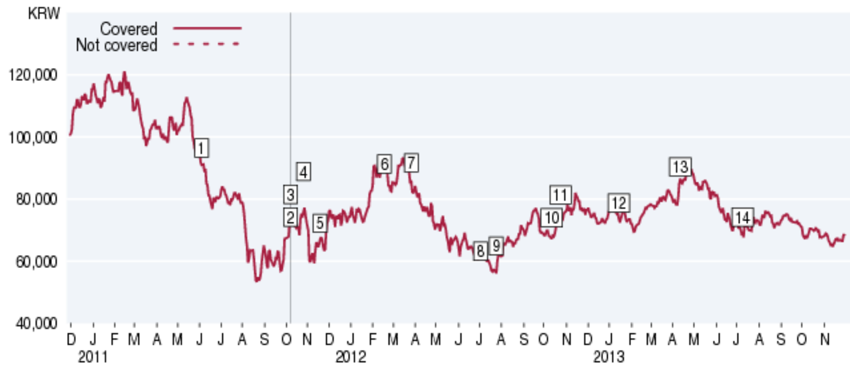
The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each 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

LG Electronics (066570.KS)

Ratings and Target Price History
Fundamental Research

Analyst: Henry H Kim, CFA



	Date	Rating	Target Price	Closing Price
1	3-Jun-11	1L	*131,931.84	90,984.12
2	7-Oct-11	Stock rating system changed		
3	7-Oct-11	*1	131,931.84	72,318.20
4	26-Oct-11	1	*112,386.39	75,738.66
5	18-Nov-11	1	*112,000.00	67,200.00
6	17-Feb-12	1	*107,000.00	91,300.00
7	27-Mar-12	1	*105,000.00	86,000.00
8	3-Jul-12	1	*93,000.00	63,200.00
9	25-Jul-12	1	*68,000.00	56,100.00
10	11-Oct-12	*2	*70,000.00	67,200.00
11	24-Oct-12	2	*75,000.00	74,000.00
12	15-Jan-13	2	*77,000.00	73,500.00
13	11-Apr-13	2	*89,000.00	86,600.00
14	9-Jul-13	2	*78,000.00	69,000.00

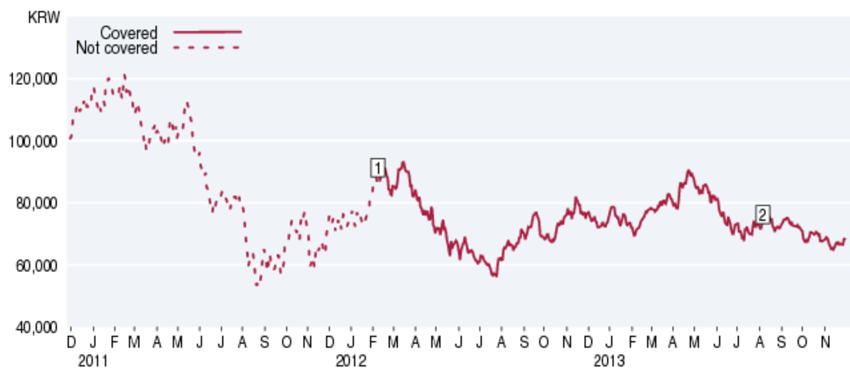
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

LG Electronics (066570.KS)

Ratings and Target Price History
Best Ideas Research
Relative Call (3 Month)

Analyst: Henry H Kim, CFA



	Date	Rating	Target Price	Closing Price
1	8-Feb-12	*ADD LP	-	89,100.00
2	6-Aug-13	*REM LP	-	74,900.00

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

SK Hynix (000660.KS)

Ratings and Target Price History
Fundamental Research

Analyst: Henry H Kim, CFA

	Date	Rating	Target Price	Closing Price
1	28-Apr-11	1M	*45,000.00	34,350.00
2	21-Jul-11	1M	*39,000.00	23,650.00
3	31-Aug-11	1M	*36,000.00	19,100.00
4	7-Oct-11	Stock rating system changed		
5	7-Oct-11	*1	36,000.00	21,500.00
6	27-Oct-11	1	*35,000.00	23,800.00
7	7-Dec-11	1	*33,000.00	22,400.00
8	21-Feb-12	1	*34,000.00	28,300.00
9	28-Mar-12	1	*41,000.00	30,550.00
10	26-Jul-12	1	*39,000.00	20,400.00
11	26-Jun-13	1	*45,000.00	30,250.00

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

SK Hynix (000660.KS)

Ratings and Target Price History
Best Ideas Research
Relative Call (3 Month)

Analyst: Henry H Kim, CFA

	Date	Rating	Target Price	Closing Price
1	11-Feb-11	*ADD MP	-	28,800.00
2	16-Mar-12	*REM MP	-	28,800.00

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Hyundai Motor (005380.KS)

Ratings and Target Price History
Fundamental Research

Analyst: Ethan Kim

	Date	Rating	Target Price	Closing Price
1	12-Jan-11	1M	*250,000.00	193,500.00
2	28-Apr-11	1M	*310,000.00	250,500.02
3	4-Oct-11	1M	*320,000.00	205,000.00
4	7-Oct-11	Stock rating system changed		
5	7-Oct-11	*1	320,000.00	200,000.00
6	23-Jul-12	1	*300,000.00	219,000.00
7	14-Nov-12	1	*280,000.00	216,500.00
8	18-Jan-13	1	*260,000.00	213,500.00
9	31-Jan-13	1	*254,000.00	205,000.00
10	26-Mar-13	1	*262,000.00	220,500.00
11	17-Apr-13	1	*256,000.00	192,500.00
12	9-Jun-13	1	*270,000.00	208,000.00
13	1-Oct-13	1	*320,000.00	254,500.00

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Hyundai Motor (005380.KS)

Ratings and Target Price History
Best Ideas Research
Relative Call (3 Month)

Analyst: Ethan Kim

	Date	Rating	Target Price	Closing Price
1	11-Feb-11	*ADD MP	-	175,500.00
2	9-Aug-11	*REM MP	-	194,000.00
3	7-Nov-11	*ADD MP	-	237,000.00

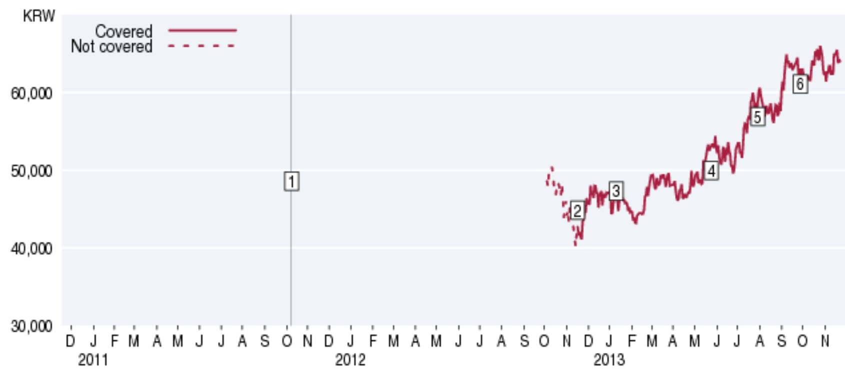
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Hankook Tire (161390.KS)

Ratings and Target Price History
Fundamental Research

Analyst: Ethan Kim
Covered since November 17 2012



	Date	Rating	Target Price	Closing Price
1	8-Oct-11	Stock rating system changed		
2	16-Nov-12	*1	*53,000.00	42,700.00
3	10-Jan-13	1	*56,000.00	46,600.00
4	24-May-13	1	*65,000.00	53,100.00
5	30-Jul-13	1	*69,000.00	58,800.00
6	27-Sep-13	1	*77,000.00	63,100.00

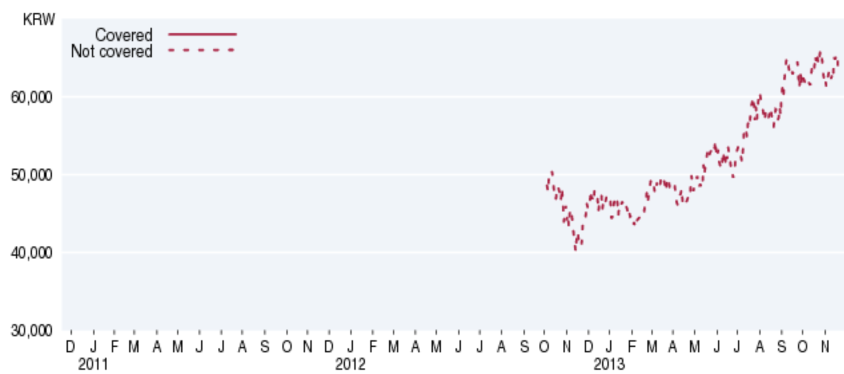
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Hankook Tire (161390.KS)

Ratings and Target Price History
Best Ideas Research
Relative Call (3 Month)

Analyst: Ethan Kim
Covered since November 17 2012



* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Samsung Electronics (005930.KS)

Ratings and Target Price History
Fundamental Research

Analyst: Henry H Kim, CFA

	Date	Rating	Target Price	Closing Price
1	28-Jan-11	1L	*1,200,000.00	1,010,000.00
2	29-Apr-11	1L	*1,250,000.00	893,000.00
3	31-Aug-11	1L	*1,200,000.00	744,000.00
4	7-Oct-11	Stock rating system changed		
5	7-Oct-11	*1	1,200,000.00	860,000.00
6	28-Oct-11	1	*1,300,000.00	945,000.00
7	7-Dec-11	1	*1,400,000.00	1,056,000.00
8	16-Mar-12	1	*1,800,000.00	1,238,000.00
9	9-Apr-12	1	*1,900,000.00	1,317,000.00
10	25-Jun-12	1	*1,970,000.00	1,132,000.00
11	1-Jul-13	1	*1,950,000.00	1,326,000.00
12	26-Jul-13	1	*1,900,000.00	1,303,000.00

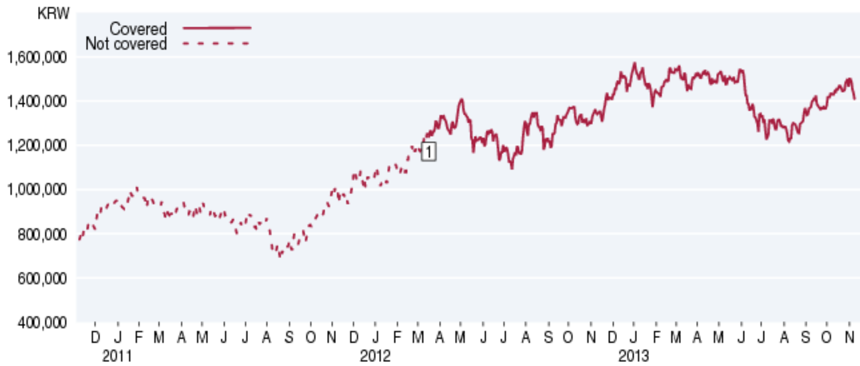
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Samsung Electronics (005930.KS)

Ratings and Target Price History
Best Ideas Research
Relative Call (3 Month)

Analyst: Henry H Kim, CFA



	Date	Rating	Target Price	Closing Price
1	16-Mar-12	*ADD MP	-	1,238,000.00

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

SK Telecom (017670.KS)

Ratings and Target Price History
Fundamental Research

Analyst: Sean Lee, CFA

	Date	Rating	Target Price	Closing Price
1	16-Jun-11	1M	*180,000.00	153,000.00
2	22-Jun-11	1M	*185,000.00	158,500.00
3	7-Oct-11	Stock rating system changed		
4	7-Oct-11	*1	185,000.00	157,500.00
5	23-Mar-12	1	*170,000.00	142,000.00
6	5-Jul-12	1	*155,000.00	128,500.00
7	27-Sep-12	1	*175,000.00	144,500.00
8	16-Jan-13	1	*190,000.00	166,000.00
9	24-Apr-13	1	*230,000.00	189,500.00
10	31-Jul-13	1	*254,000.00	220,500.00
11	10-Oct-13	1	*270,000.00	228,000.00

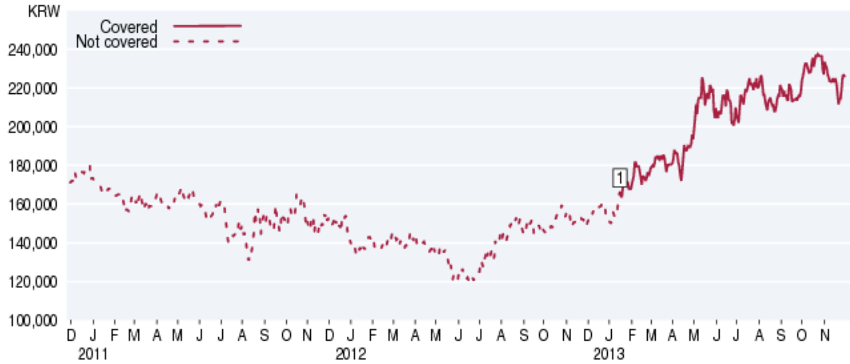
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

SK Telecom (017670.KS)

Ratings and Target Price History
Best Ideas Research
Relative Call (3 Month)

Analyst: Sean Lee, CFA



	Date	Rating	Target Price	Closing Price
1	16-Jan-13	*ADD MP	-	166,000.00

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

LG Chem (051910.KS)

Ratings and Target Price History
Fundamental Research

Analyst: Oscar Yee

	Date	Rating	Target Price	Closing Price
1	30-Jan-11	2L	*435,000.00	408,000.03
2	20-Apr-11	2L	*550,000.00	549,000.00
3	25-Sep-11	*1L	*440,000.00	316,500.00

	Date	Rating	Target Price	Closing Price
4	7-Oct-11	Stock rating system changed		
5	7-Oct-11	*1	440,000.00	322,000.00
6	23-May-12	1	*390,000.00	275,000.00

	Date	Rating	Target Price	Closing Price
7	29-Jan-13	1	*360,000.00	313,000.00
8	20-May-13	1	*350,000.00	278,000.00

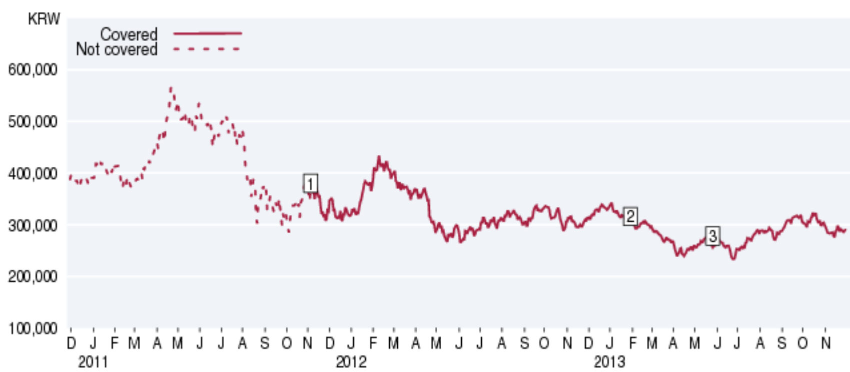
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

LG Chem (051910.KS)

Ratings and Target Price History
Best Ideas Research
Relative Call (3 Month)

Analyst: Oscar Yee



	Date	Rating	Target Price	Closing Price
1	4-Nov-11	*ADD MP	-	372,500.00

	Date	Rating	Target Price	Closing Price
2	30-Jan-13	*REM MP	-	302,000.00

	Date	Rating	Target Price	Closing Price
3	27-May-13	*ADD MP	-	256,000.00

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Hyundai E&C (000720.KS)

Ratings and Target Price History
Fundamental Research

Analyst: Sungmee Park, CFA

	Date	Rating	Target Price	Closing Price
1	4-Jan-11	1M	*89,500.00	75,000.00
2	1-Feb-11	1M	*110,000.00	86,200.00
3	7-Oct-11	Stock rating system changed		

	Date	Rating	Target Price	Closing Price
4	7-Oct-11	*1	110,000.00	57,000.00
5	20-Oct-11	1	*90,000.00	64,100.00
6	29-May-12	1	*83,000.00	69,900.00

	Date	Rating	Target Price	Closing Price
7	4-Jan-13	1	*90,000.00	73,700.00
8	2-Jul-13	1	*85,000.00	56,800.00

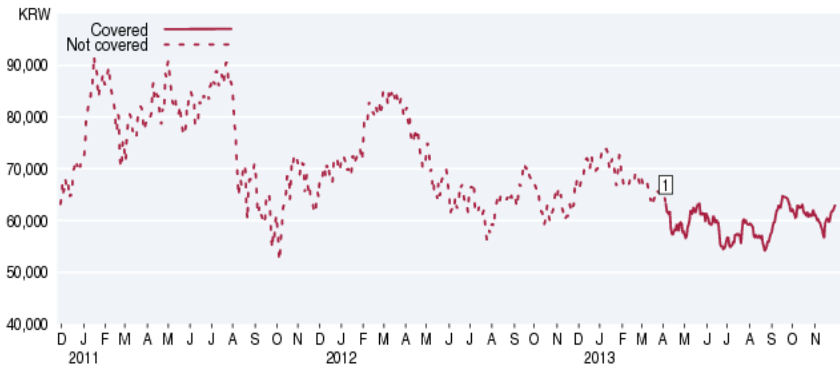
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Hyundai E&C (000720.KS)

Ratings and Target Price History
Best Ideas Research
Relative Call (3 Month)

Analyst: Sungmee Park, CFA



	Date	Rating	Target Price	Closing Price
1	4-Apr-13	*ADD MP	-	63,200.00

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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