

Equities

31 October 2011 | 25 pages

Tactical Environment. VIX to Exceed '11 High

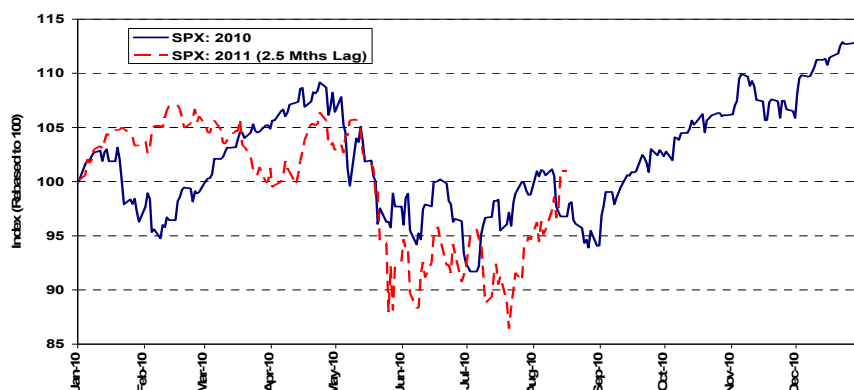
Derivatives/Multi-Strategy Road Ahead 2012

■ Derivatives
■ Equities

- **2012: More Vicious than 2010 & 2011** — The EFSF package has “kicked the can down the road”. Risk of a small loss has been reduced at the expense of potentially increasing the chance of a larger one later. Thus, trading pattern in 2012 may resemble 2010's and 2011's – with even greater volatility and more tactical.
- **Room for Normalisation Near-Term** — Markets may end higher over the next 4 months if trading pattern in 2010 were to be repeated. There is still room for normalisation: 1) Equity Index Skew remains elevated, 2) Quasi-Sovereign still cheap vs. Sovereign, 3) Credit continues to be highly correlated with Equities. The only concern is USD, which weakened too rapidly against EUR.
- **Conservatively Constructive for Now** — 1) Long China Oversold Basket (BBG: CGCHSOLD <INDEX>), Short HSCEI, reiterating our trade from [How to Put on Risk in China](#). Basket constituents from beaten-down sectors such as financials, insurance and cement; 2) Long Sovereign CDS, Short Quasi-Sovereign CDS; 3) Buy TWSE calls. TWSE heavily lagged NDX. Value in calls with falling implied and steep skew. 21-Dec-11 110% calls cost 38bps premium; 4) Accumulate 2013 HSCEI dividends. Currently dividend futures at 6% discount to CIRA estimates, even after we put in Zero-Dividend-Growth for all sectors in 2012, and for Financials and Energy in 2013 and 2014
- **When Metrics Turn Complacent Again...** — ... we would be exiting our trades and consider the following: 1) Hedge out Currency Exposure during “Risk-Off”, 2) Long Basket of “Strong-USD Winners” in Utilities, Healthcare and Technology, Short Basket of “Strong-USD Losers” in Real Estate, Materials and Oil & Gas, 3) Other trades: long volatility, short industrial metals and receiving rates in Asia

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SPX's trading pattern in 2010 and 2011. 2012's maybe similar, with potentially more volatility



Source: Citi Investment Research and Analysis

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

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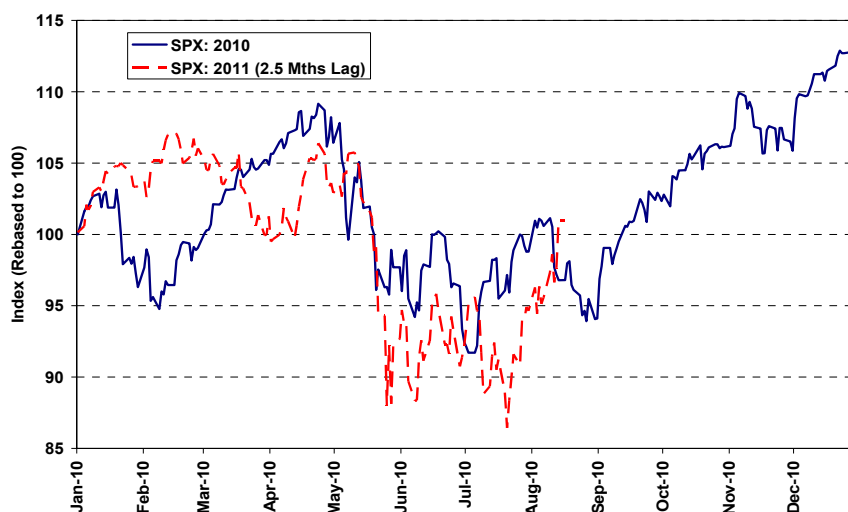
Constructive for now. Turns when Risk Metrics shows Complacency

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2012: More Vicious than 2010 & 2011

The title of our last “Road Ahead” publication, [Cross the River by Feeling the Stones](#) (20-Jun-11), turned out to be most appropriate in predicting market environment in 2H11. This title is also relevant in describing 2012’s market conditions. We have already seen the first two stages in this crisis: private debt in 2008, public debt in 2010 and 2011. While it appears the EFSF package is adequate to avoid any Eurozone-driven financial market catastrophe for now, CIRA Global Credit Strategist, Matt King, sees the risk of a small loss reduced at the expense of increasing the chance of a big one later ([European Credit Weekly](#), 28-Oct-11). Moreover, many of the details are yet to be decided ([Euro Area: Sovereign Debt Crisis Update](#), 27-Oct-11). Lastly, it is difficult to see how Eurozone-growth prospects can be improved. Already, CIRA’s economics team is forecasting recession in the Eurozone – predicting 0.3% contraction in GDP in 2012 ([Global Economic Outlook and Strategy](#), 26-Oct-11).

Figure 1. SPX’s trading pattern in 2010 and 2011. 2012’s maybe similar, with potentially more volatility*

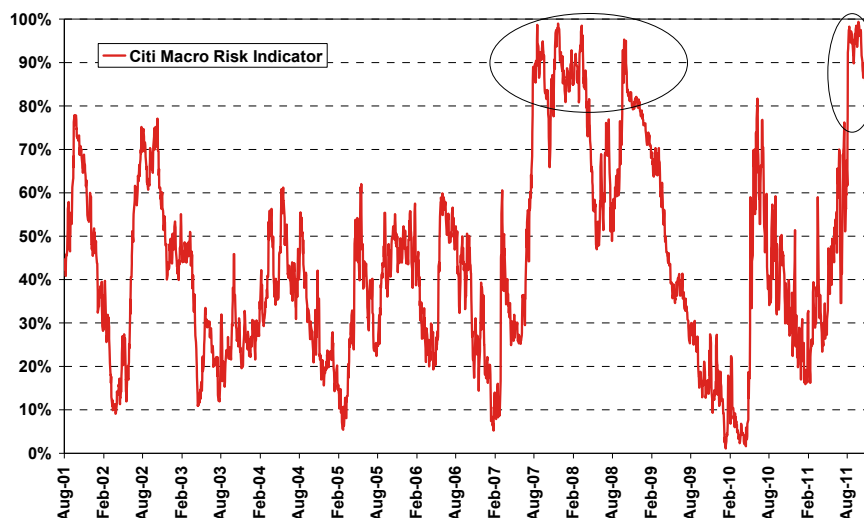


Source: Citi Investment Research and Analysis

* SPX 2011 with 2.5 months lag, because sell-off in 2010 started end of April, and 2011 in July

In our opinion, problems from 2008 have not really been solved as the authorities keep “kicking the can down the road”. To predict what 2012’s markets would look like, we superimpose SPX’s trading pattern in 2011 to 2010’s (Figure 1). They are similar -- except 2011 was more volatile. In our opinion, trading pattern next year may resemble what we saw over the last two years – with even greater volatility and more thus more tactical. The Citi Macro Risk Indicator (Figure 2) had exceeded levels in 2010 and hit the extreme level of 1 in Aug-11. Just as it did from Aug-07 to Feb-09, it could potentially stay at this elevated level for an extended period, i.e. into 2012.

Figure 2. Citi Macro Risk Indicator* remains at elevated levels



Source: Citi Investment Research and Analysis

* Equally-weighted index of EM sovereign spreads, US credit spreads, US swap spreads and implied Fx, equity and swap rate volatility

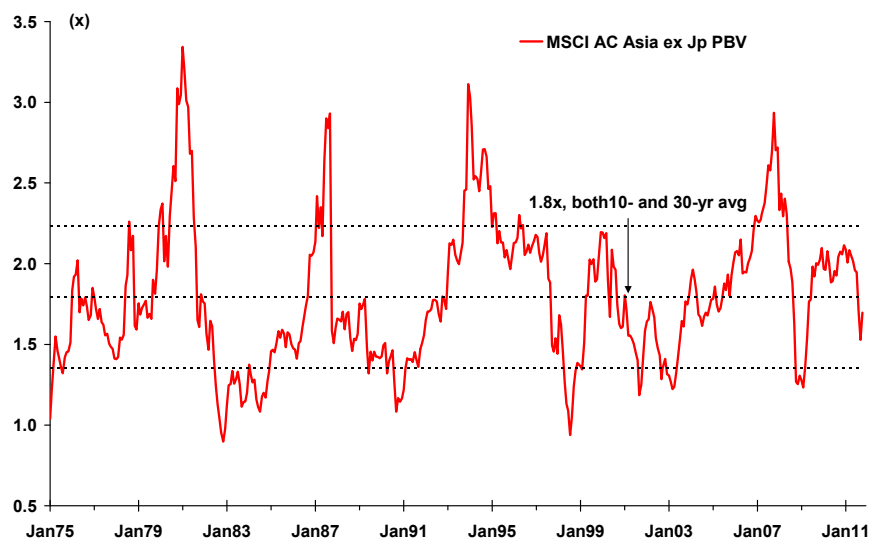
In our opinion, European peripherals' adoption of the EUR is the main issue, because they cannot devalue their currencies vis-à-vis other countries in the Eurozone, which would have been the most effective way of economic adjustment. This is likely to lead to a prolonged period of growth underperformance and deflation in the European Peripherals. Although it is far from a like-for-like comparison, we may draw some parallel between the current situation and the Asian crisis. Please see the Appendix for details.

The breakup of EUR is not CIRA's houseview. However, it is a topic that will be talked about again in 2012 – and that will bring volatility to the market.

Key Metrics Indicate Room for Normalisation in Near-Term

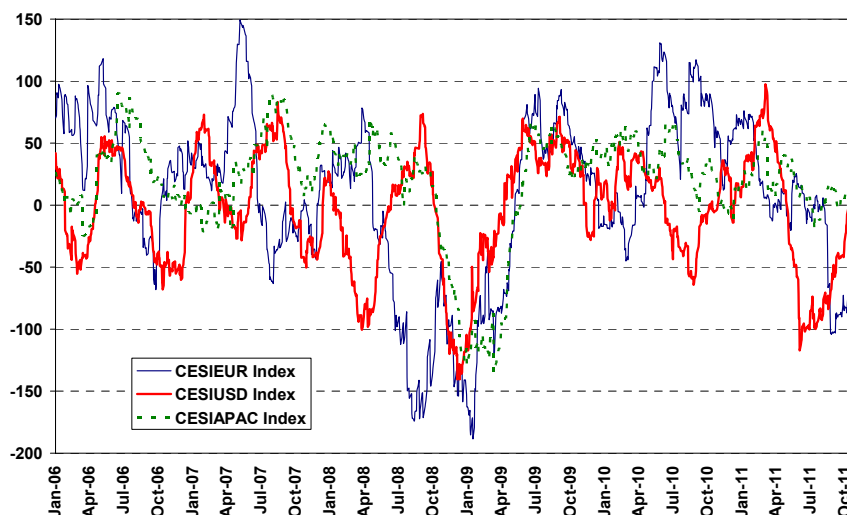
Referring to Figure 1 – if you believe in a repetition of 2010's trading pattern, the market may be higher over the next 4 months or so. CIRA Pan-Asian Equity Strategist, Markus Rosgen, points out equities are currently cheaper than the long-term average (Figure 3). Moreover, expectations corrected severely in Aug-11 and Sep-11 – it did not take much to surprise on the upside in Oct-11. Figure 4 shows Citi's US Economic Surprise Indicator rebounded very fast from "extreme weakness" to "average territory".

Figure 3. Equities are currently cheaper than long-term average



Source: Citi Investment Research and Analysis

Figure 4. Citigroup US Economic Surprise Indicator back to “average territory”, as it only took moderate numbers to exceed beaten-down expectations*



Source: Citi Investment Research and Analysis

* Economic Surprise Indicator measures actual vs. expected. If actual beats expected, the indicator would rise

Figure 5 shows a number of cross-asset indicators investors may follow if they want to gauge market sentiment. In our opinion, the strong rebound we saw in Oct-11 was due to over-panic in the markets, which we discussed in the article [How to Put on Risk in China](#) (11-Oct-11). Because of the potential tactical nature of the markets in 2012, investors must monitor these indicators and be prepared to adjust their positions. At this moment, while these indicators are no longer at extreme-panic levels, there is still room for normalisation. Thus, we are conservatively constructive about the markets at this stage.

Figure 5. Rough indicators to look at and actions for investors to consider

Indicators	Put Risk-On When...	Take Risk-Off When...
USD	Dollar Strong	Dollar Weak
Equity Index Skew	Skew Steep	Skew Flat
Quasi-Sovereign vs. Sovereign CDS	Spread Wide	Spread Narrow
Credit vs. Equities	High Correlation between them	Low Correlation between them

Source: Citi Investment Research and Analysis

1. USD

Figure 6 shows CIRA's Global Macro Strategy team's Fx forecasts. They expect elevated risk aversion and weaker global growth expectations to drive USD gains over the short to medium term across the board. Please refer to sections later in this article for thoughts on Asian currencies and trading implications

Figure 6. CIRA expects USD to strengthen over next 12M*

Currency	Ticker	Spot	0-3M	6-12M	3M Rtn	12M Rtn
DXY	DXY	74.95	79.91	82.08	6.6%	9.5%
Euro	EURUSD	1.42	1.31	1.25	-7.6%	-11.9%
Pound	GBPUSD	1.61	1.54	1.51	-4.3%	-6.2%
Australian	AUDUSD	1.07	0.96	1.02	-10.3%	-4.7%
New Zealand	NZDUSD	0.82	0.73	0.79	-10.9%	-3.6%

Source: Citi Investment Research and Analysis

* As of 28-Oct-11

Strong USD is bad news for Asian risk assets. As we discussed in [The Search for Tail-Hedge Continues...](#) (22-Sep-11), in the last 5 periods of DXY strength since 1980:

- Asia underperformed the US. On average, US +16% vs. -28%, -20% and -4% for AxJ, Australian and Japanese equities respectively
- No Asian Countries have registered positive returns (Figure 7)
- All Asian Sectors have fallen in price (Figure 8)

Figure 7. Pan-Asian country performance during periods of USD Strength since 1980*

From	To	Trade-Wgt USD appre	MSCI Ch	MSCI HK	BSE 30	JCI	KOSPI	KCI	PCI	STI	TWSE	SET	AxJ	MSCI AU	MSCI JP	SPX
7/1980	3/1985	55%	-	-21%	73%	-	-14%	-12%	-93%	-1%	31%	-15%	-20%	-25%	106%	48%
4/1995	8/1998	28%	-16%	-31%	-31%	-84%	-80%	-81%	-71%	-64%	-18%	-90%	-45%	-9%	-47%	86%
10/1999	2/2002	18%	-7%	-24%	-29%	-49%	-11%	-5%	-46%	-32%	-33%	-17%	-25%	-2%	-47%	-19%
3/2008	11/2008	18%	-43%	-44%	-53%	-61%	-57%	-39%	-44%	-49%	-53%	-56%	-49%	-49%	-30%	-32%
11/2009	6/2010	19%	-7%	-3%	5%	26%	4%	9%	13%	2%	-3%	19%	1%	-16%	-3%	-6%
Average			-18%	-25%	-7%	-42%	-32%	-25%	-48%	-28%	-15%	-32%	-28%	-20%	-4%	+16%

Source: Citi Investment Research and Analysis

* Periods when DXY +18% or more

Figure 8. AxJ sector performances during periods of USD Strength since 1980*

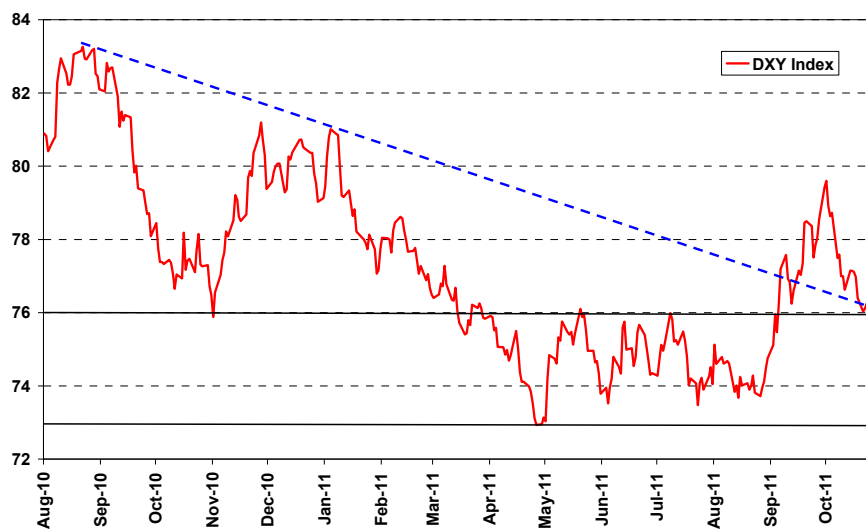
From	To	Trade-Wgt USD appre	Oil & Gas	Basic Mats	Indust.	Cons Disc	HealthCare	Cons Stap	Telco	Util	Banks	Insur	Real Est	Tech
7/1980	3/1985	55%	-	-16%	-12%	-37%	24%	24%	-	46%	-14%	-	-48%	-
4/1995	8/1998	28%	-57%	-54%	-28%	-58%	-44%	-49%	-45%	-41%	-46%	-26%	-58%	27%
10/1999	2/2002	18%	-32%	-29%	-21%	-25%	-17%	-18%	-32%	-12%	-14%	-14%	-17%	-19%
3/2008	11/2008	18%	-49%	-64%	-57%	-51%	-39%	-45%	-41%	-35%	-40%	-42%	-55%	-53%
11/2009	6/2010	19%	7%	-7%	5%	13%	21%	10%	5%	4%	-5%	-7%	-9%	-1%
		Average	-33%	-34%	-23%	-32%	-11%	-16%	-28%	-7%	-24%	-22%	-38%	-12%

Source: Citi Investment Research and Analysis
* Periods when DXY +18% or more

However, because of “competitive devaluation”, USD strengthening is unlikely to be a one-way street. It is best to look at USD technicals to determine when it is overbought, i.e. one should put “risk-on” positions, and vice versa:

- The crudest way is to look at the chart for DXY (Figure 9). From the chart, the best time to buy risk assets appears to be when DXY is trading just over 76. Investors may decide to take some risk off the table when DXY enters the 73 to 76 range. Currently DXY is hovering around the 76 level – so neither strong-buy nor strong-sell on risk assets at this stage.

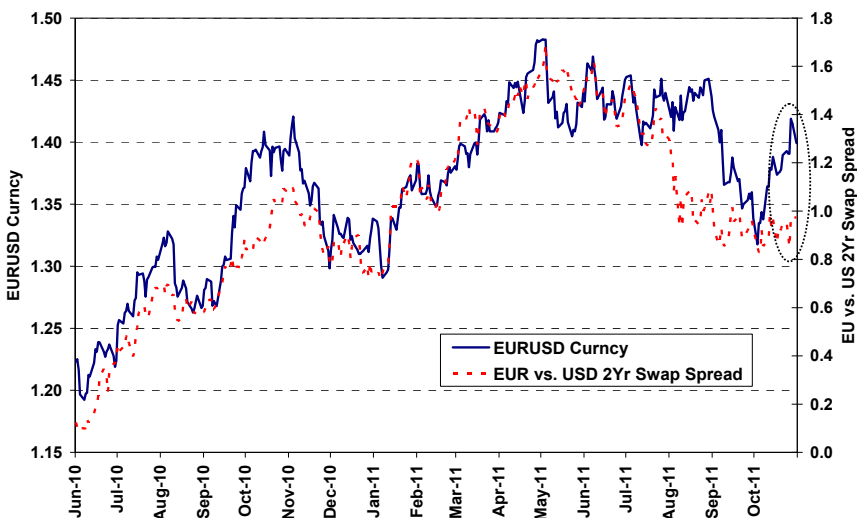
Figure 9. Putting on, or taking off risks, according to DXY technicals



Source: Citi Investment Research and Analysis

- We can also compare how interest rate differential stacks up against exchange rate. Currently, EURUSD appears to be overvalued --- with fair value more towards the low 1.30 area (Figure 10). This is negative for “risk-on”

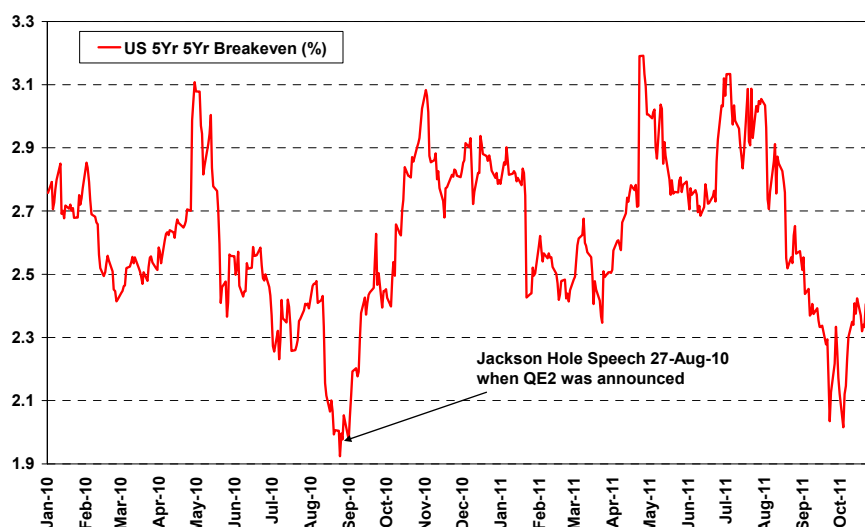
Figure 10. Interest rate differential suggests EURUSD to be currently overvalued



Source: Citi Investment Research and Analysis

- QE3 is the wild card. USD weakened on the back of QE2. Please refer to [What If There Were To Be QE3?](#) (01-Jun-11) for the effect on other asset classes. At this stage, we do not think QE3 is likely, because 5Yr5Yr Breakeven Inflation in the US, which is one of the key metrics the FED looks at, is still higher than the Aug-10 level when QE2 was announced (Figure 11). Should that change, however, we may need to refine our core thesis about USD strengthening.

Figure 11. QE3 unlikely: US 5Yr5Yr breakeven inflation higher than Aug-10 levels



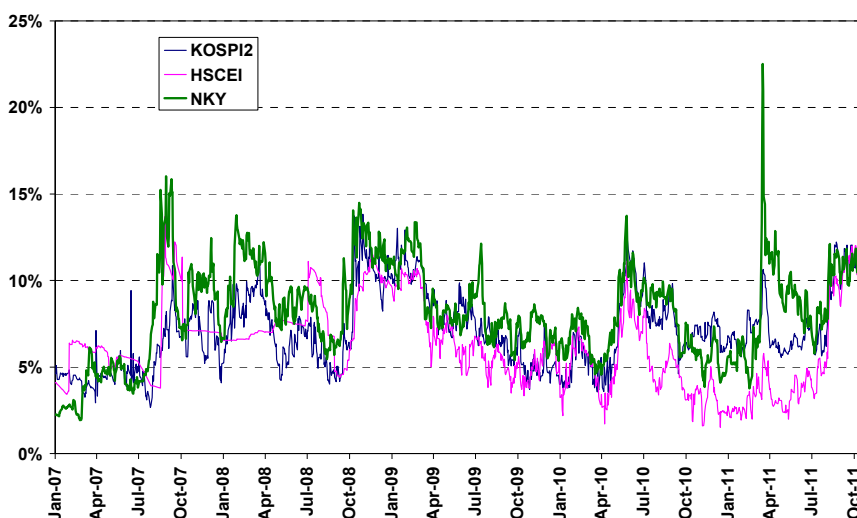
Source: Citi Investment Research and Analysis

2. Equity Index Skew

Another key indicator is equity skew, which measures the expensiveness of puts vs. calls. Figure 12 shows how skew in key regional indices had exceeded Lehman levels in this round of sell-off, but over the past couple of weeks skew has been falling. It is difficult to derive any trading rules on the back of skew – Figure 2 shows

an uncertain environment can persist for a prolonged period. However, we can use skew as a gauge of short-term sentiment, i.e. if it exceeded Lehman levels it is a sign of panic, and investors should look to trim their shorts, taking advantage of elevated volatility levels by selling puts to cover shorts, or even selling outright puts for bombed-out names for investors with long staying power.

Figure 12. Skew exceeded Lehman levels but has been coming in over the last couple of weeks

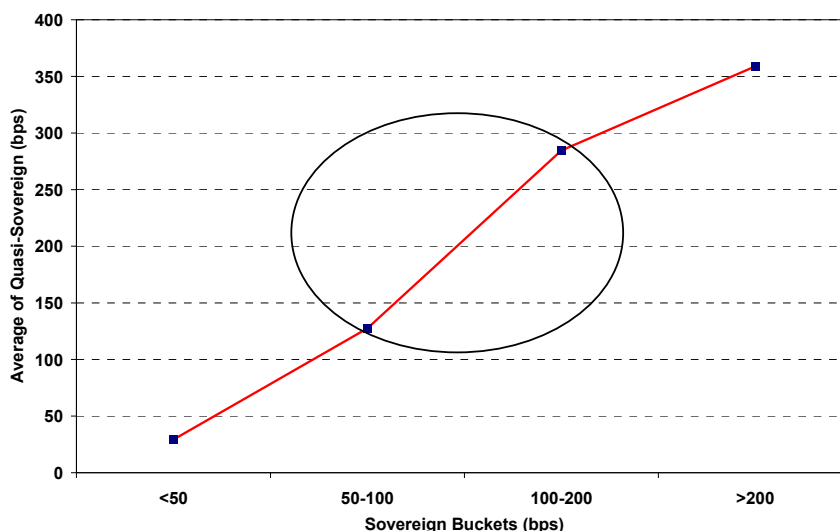


Source: Citi Investment Research and Analysis

3. Quasi-Sovereign CDS vs. Sovereign CDS

We touched upon this in [How to Put on Risk in China](#) (11-Oct-11). This may appear China-Centric, but to us it is a useful global risk indicator. The importance of SOEs means they are seen as “too big to fail”. In times of distress, credit of SOEs will be pushed to “unreasonable” levels. How “unreasonable” this is will be important for us to estimate if markets have entered panic territory. In that article we showed the spread of Quasi-Sovereign vs. Sovereign has exceeded Lehman levels. To us that was overdone. It was not fundamentally-driven, because Corporate CDS becomes much more sensitive to Sovereign as the latter goes above 100bps – this is true for Europe and also for China (Figure 13).

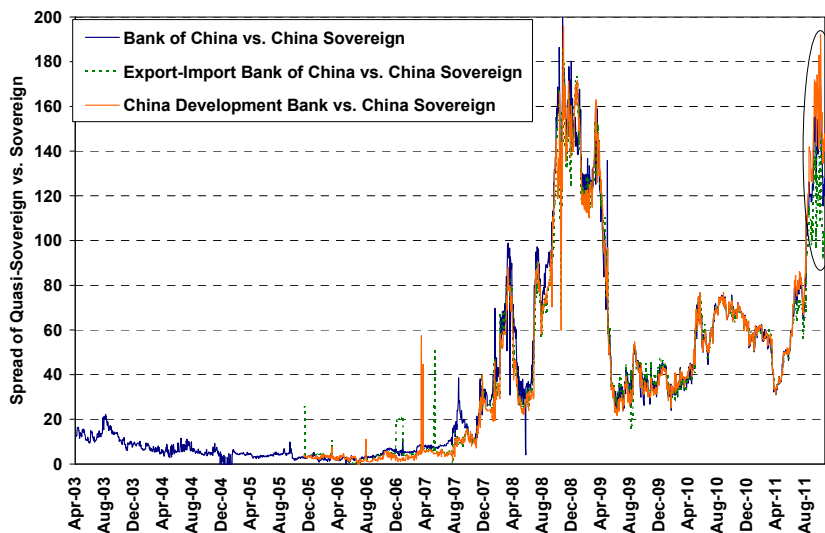
Figure 13. China Quasi-Sovereign more sensitive to Sovereign when the latter goes to 100-200bps zone



Source: Citi Investment Research and Analysis

Currently, in-line with our recommendation, the spread has started to contract and probability of default over the next 5 years has become somewhat more reasonable (Figure 14 and Figure 15). In our opinion, there is still some room for normalisation.

Figure 14. Chinese Quasi-Sovereign no longer trading at total distress against Sovereign



Source: Citi Investment Research and Analysis

Figure 15. Probability of Default in Chinese Quasi-Sovereign came down slightly in Oct-11

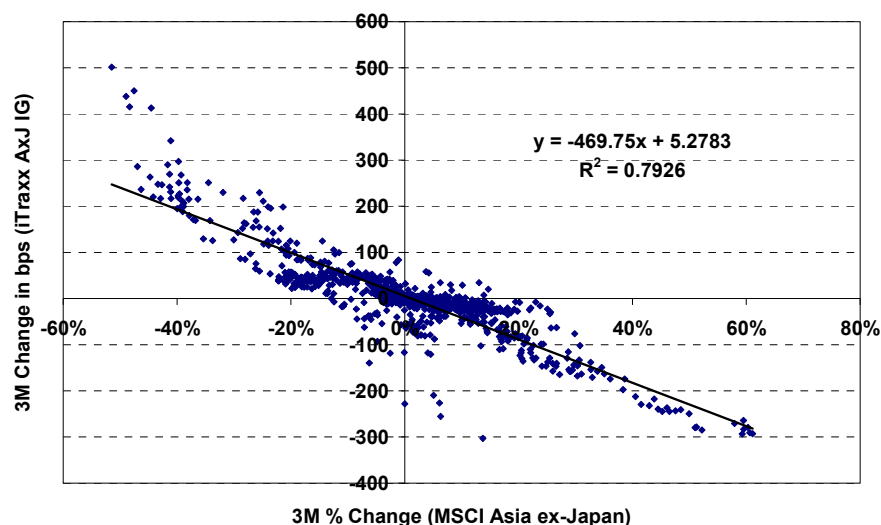
CDS	5Yr Lvl	Current Def Prob in 5Yrs	Def Prob in early Oct-11
China	130	10%	11%
Export Import	235	18%	20%
Bank of China	258	20%	22%
China Dev Bank	278	21%	24%

Source: Citi Investment Research and Analysis

4. Credit vs. Equities

Finally, we look at the relationship between equities and credit. For example, in [Cross the River by Feeling the Stones](#) (20-Jun-11), we spotted credit to be overbought vs. equities, and recommended investors to hedge their Asian equities exposure via iTraxx Asia ex-Japan CDS. This proved to be a viable strategy in times of risk-off, when asset classes become highly correlated and “lagging” asset classes catch up. Currently, the two asset classes are trading fair vs. each other – since 25-Jul-11, MSCI Asia ex-Japan fell by 14%. This model predicted 71bps widening in iTraxx Asia ex-Japan – very close to the actual 69bps widening (Figure 16). High correlation between these two asset classes means market is still pricing in panic.

Figure 16. Credit and Equities have been moving very much in tandem. They become highly correlated when environment is under stress



Source: Citi Investment Research and Analysis

Trades for Now: Conservatively Constructive

The previous section shows that while equity index skew and spread between quasi-sovereign and sovereign are not at extreme-panic levels any more, there is still room for normalisation. Credit and Equities are still moving in tandem, which may decouple as the market calms down. USD is a risk – it weakened too fast vs. EUR, in our opinion. At this stage, we would concentrate upon conservatively constructive trading strategies. We would turn more aggressive buyers should there be sufficient pullbacks, e.g. caused by fall in EURUSD.

Figure 17. Constituents of CIRA China Oversold Basket (BBG: CGCHSOLD <INDEX>)

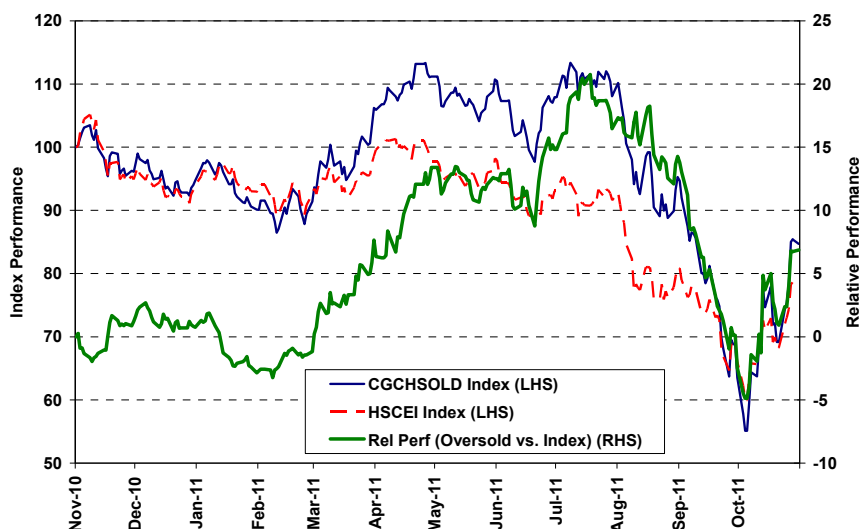
BBG	Name
914 HK	Anhui Conch Cement
3323 HK	CNBM
2328 HK	PICC Property & Casualty
2318 HK	Ping An Insurance Group
1288 HK	Agricultural Bank of China
3328 HK	Bank of Communications
3968 HK	China Merchants Bank

Prices (as of Oct. 28): ACC (HK\$28.85), CNBM (HK\$9.88), PICC (HK\$11.12), Ping An (HK\$59.05), ABC (HK\$3.60), BoCom (HK\$5.48), CMB (HK\$16.92)
Source: Citi Investment Research and Analysis

1. Long China Oversold Basket (BBG: CGCHSOLD <INDEX>), Short HSCEI

The constituents (Figure 17) are mostly in beaten-down sectors such as financials, insurance and cement. We recommended this trade in [How to Put on Risk in China](#) (11-Oct-11). For illustration, Figure 18 shows how this basket would have performed this past year. CIRA China Strategist, Minggao Shen, wrote in [China Equity Strategy](#) (28-Oct-11) about selective easing from the Chinese Government. Investors should look to add to this trade on pullbacks.

Figure 18. Add to long CIRA China Oversold Basket, short HSCEI on pullbacks



Source: Citi Investment Research and Analysis

2. Long Sovereign CDS, Short Quasi-Sovereign CDS

We recommended this trade in [How to Put on Risk in China](#) (11-Oct-11). The gap has been closing, but Figure 14 shows the spread is still relatively elevated and there could still be some upside at this stage. Figure 19 shows indicative levels where investors may put on this trade.

Figure 19. Continue to recommend credit normalisation: Long China Sovereign CDS, Short Quasi-Sovereign CDS

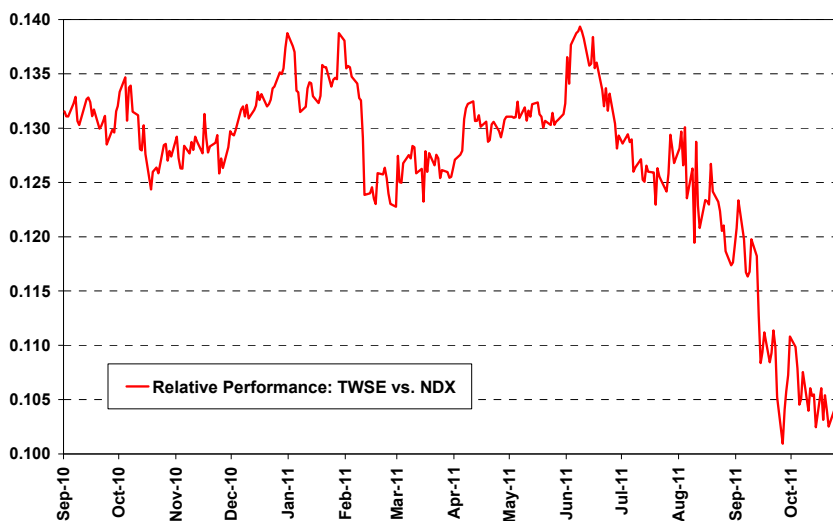
Quasi-Sovereign 5Yr CDS	Bid Level	Entry Level (China Sovereign 5Yr CDS offered at 137)
Export-Import Bank	228	-91
Bank of China	252	-115
China Development Bank	271	-134

Source: Citi Investment Research and Analysis

3. Buy TWSE calls

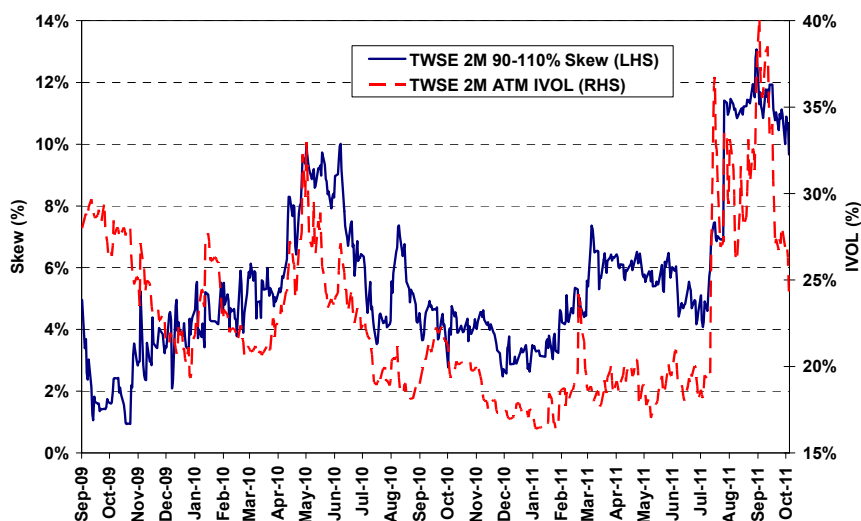
Taiwan remains a laggard in the Asian market – both in terms of recovery in local index as well as currency (Figure 28). Moreover, it is interesting to note how much it has been lagging NDX (Figure 20). There is value to buy calls, because 1) index implied has been falling but, 2) skew is still relatively steep (Figure 21). Investors may consider buying TWSE 21-Dec-11 110% calls at 38bps premium (Strike = 8,400. Ref. Spot = 7,616.06. IVOL = 19.6%, 3M/1M HVOL = 28.5%/20.8%)

Figure 20. TWSE has underperformed NDX in 2H11



Source: Citi Investment Research and Analysis

Figure 21. Value in TWSE Calls with : 1) IVOL pulling back, 2) Skew still steep



Source: Citi Investment Research and Analysis

4. Accumulate 2013 HSCEI Dividend Swaps

Figure 22 compares HSCEI dividend futures markets (BBG: DHCA <INDEX>) against: 1) CIRA projected dividends, 2) Zero-Dividend-Growth for all sectors in 2012, 3) Zero-Dividend-Growth for all sectors in 2012, plus No Growth for Financials and Energy in 2013 and 2014.

Figure 22. HSCEI dividend futures against various dividend estimates

	2012	2013	2014
Dividend Futures Market			
Div Futures Bid	300	303	306
Div Futures Offer	325	312	336
Various Dividend Estimate Assumptions			
CIRA Estimates	359	392	434
Zero-Growth in 2012	322	352	389
Zero-Growth in 2012 & for Financials/Energy 2013 & 2014	322	332	340
Market vs. Estimates			
Discount vs. CIRA Estimates	10.6%	25.7%	29.1%
Discount vs. Zero-Growth 2012	-0.8%	12.8%	15.8%
Discount vs. Zero-Growth 2012 & for Financials/Energy 2013 & 2014	-0.8%	6.3%	1.1%

Source: Citi Investment Research and Analysis

Figure 23. Sector Contribution to HSCEI Dividends

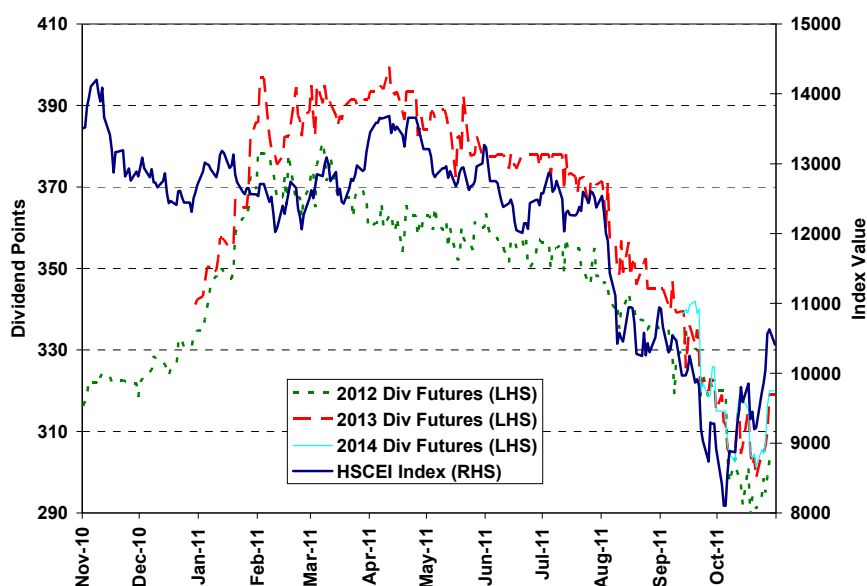
Sector	Div Contribution
Financials	60.5%
Energy	24.4%
Materials	6.8%
Industrials	3.9%
Telecom	1.8%
Consumer Discretionary	1.3%
Utilities	0.6%
Information Technology	0.3%
Health Care	0.2%
Consumer Staples	0.2%

Source: Citi Investment Research and Analysis

The market currently appears to be pricing in zero-dividend growth in 2012. However, even if we price in such estimates, as well as no dividend growth for the two largest dividend contributing sectors (i.e. financials and energy, see Figure 23) for 2013 and 2014 as well, 2013 dividend futures appears to be trading cheap. It is also the best liquidity compromise amongst the three most active futures. To trade size however, investors may prefer OTC dividend swaps instead.

These dividend futures have been under pressure because of the fall in spot (Figure 24). These are interesting instruments to accumulate if investors believe we have seen market bottom this year.

Figure 24. HSCEI dividends have been under pressure as spot drops



Source: Citi Investment Research and Analysis

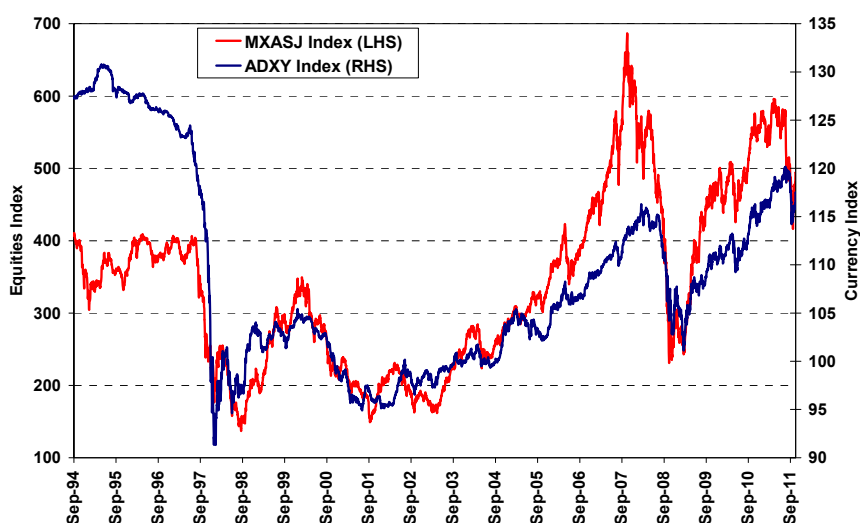
When Metrics Turn Complacent...

Because of this tactical trading environment, we would be ready to exit the trades we highlighted in the previous section if our metrics turn complacent. At that stage, we would most likely consider trades we show in this section. We will provide investors with updates when we change our positioning:

1. Hedge out Currency Exposure during "Risk-Off"

In general, despite talks about Asian currencies' fundamentals, e.g. inflation leading to currency appreciation, stronger government balance sheets, etc, they are still highly correlated to risk assets (Figure 25).

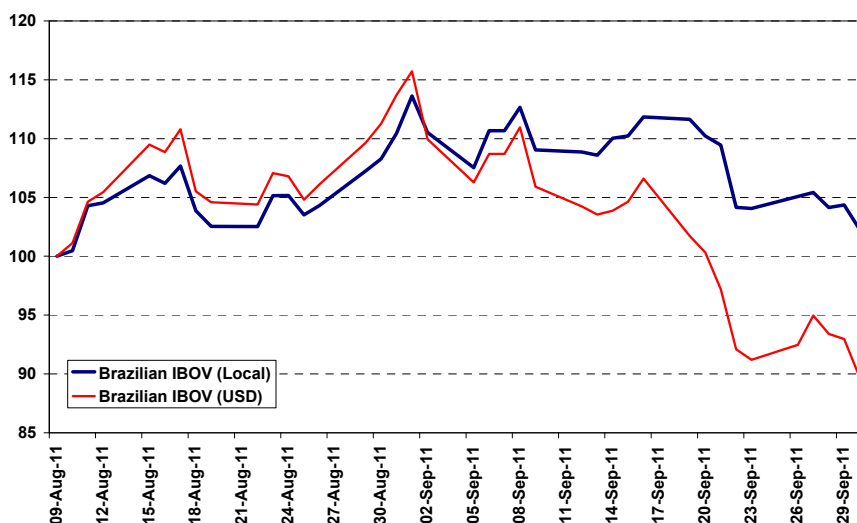
Figure 25. Asian currencies still highly correlated to equities



Source: Citi Investment Research and Analysis

In [Ignore Currencies at Your Own Peril](#) (26-Sep-11), we pointed out how one can get market direction right, but end up losing money through the example on IBOV (Figure 26). At times of distress, we are more likely to see such dislocations.

Figure 26. Getting direction right, but ending up losing money if you ignored currency effect...*



Source: Citi Investment Research and Analysis

* Brazilian IBOV +2% in BRL terms, but -10% in USD terms from 09-Aug-11 to 29-Sep-11

During sharp squeezes, the opposite may happen, i.e. investors may be able to “bottom-fish” in EM and catch both market rebound as well as benefitting from EM currency appreciation vs. USD. If USD-denominated investors do want to take on EM currency risks, they would be well-advised to compare where currencies are vs. the highs and lows since Lehman crisis (Figure 27). We draw the same conclusion as we did in the aforementioned article – INR has the least room for further depreciation vs. USD, if we assume GFC levels would hold.

Figure 27. Range where Asian currencies had been trading since Sep-08

Currency	Current	Max*	Min*	Downside**	Upside**
INR	48.82	51.97	44.03	39.7%	60.3%
TWD	29.86	35.17	28.51	79.7%	20.3%
MYR	3.07	3.73	2.94	83.4%	16.6%
THB	30.54	36.28	29.52	84.9%	15.1%
SGD	1.24	1.55	1.20	88.1%	11.9%
KRW	1104.88	1570.65	1049.97	89.5%	10.5%
IDR	8808.00	12650.00	8464.00	91.8%	8.2%

Source: Citi Investment Research and Analysis

* Max = Weakest Level of Asian Currency vs. USD; Min = Strongest Level

** We work out the Range = (Max-Min). Then Downside = (Max – Current)/Range; Upside = (Current – Min)/Range

Figure 28 measures how much Asian currencies and local indices have recovered since 01-Aug-11. At this stage, currencies have lagged in their recovery vs. local equity indices --- 48% vs. 58% respectively. The fact that equity indices have recovered more than half of their losses justifies our stance in building constructive positions constructively at this stage. Korea and Singapore have been recovering the fastest on average across both currencies and equities, while Taiwan has lagged.

Investors may consider putting on currency hedges should Asian currencies recover to 70% from the bottom:

- Hedge currency exposure via Fx Forwards. These are standardised, liquid, OTC products. Prices are on BBG: for example, “CNY <Curcny> FRD”
- If investors would like to protect equity portfolios, they may consider quanto options instead of vanilla ones. Quantos cost marginally more, effectively fixes Fx rate at inception and is constant through life of the trade

Figure 28. Currency recovery lagging equity index recovery since 01-Aug-11

Currency	Index	Currency Recovered	Index Recovered	Average
TWD	TWSE	44.0%	40.5%	42.3%
THB	SET50	45.3%	47.6%	46.5%
INR	NIFTY	20.7%	78.8%	49.8%
IDR	JCI	46.9%	60.7%	53.8%
HKD	HSCEI		56.8%	56.8%
MYR	FBMKLCI	51.5%	66.3%	58.9%
KRW	KOSPI2	62.9%	56.2%	59.6%
SGD	FSSTI	65.0%	54.9%	60.0%
Average		48.1%	57.7%	53.4%

Source: Citi Investment Research and Analysis

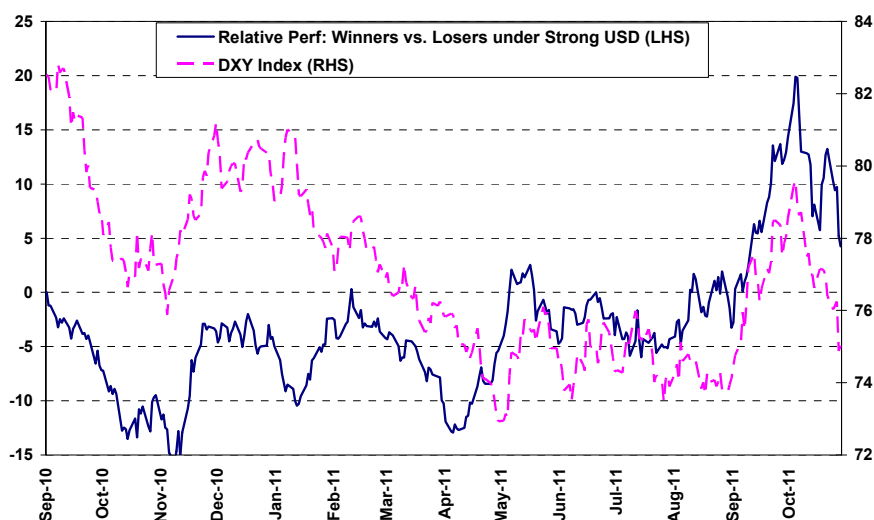
2. Relative Basket Trade for Strong USD

Referring to Figure 8 and to our earlier article [The Search for Tail-Hedge Continues...](#) (22-Sep-11), no sectors in Asia have historically registered positive returns in past periods of USD strength. Relatively speaking:

- Winners under Strong USD: Utilities, Healthcare and Technology outperformed
- Losers under Strong USD: Real Estate, Materials and Oil & Gas underperformed

In the aforementioned article, we recommended buying a basket of stocks from the three sectors that historically outperformed under strong USD, and hedge with a basket of sectors that underperformed in the past. Figure 29 shows how close the relative performance of these baskets vs. the DXY index. Given sharp snapbacks in DXY, investors would be well-advised to trade around this spread. We would recommend investors to add to this trade if DXY goes to 74.

Figure 29. Buy winners basket, Short losers basket for strong USD if DXY goes to 74



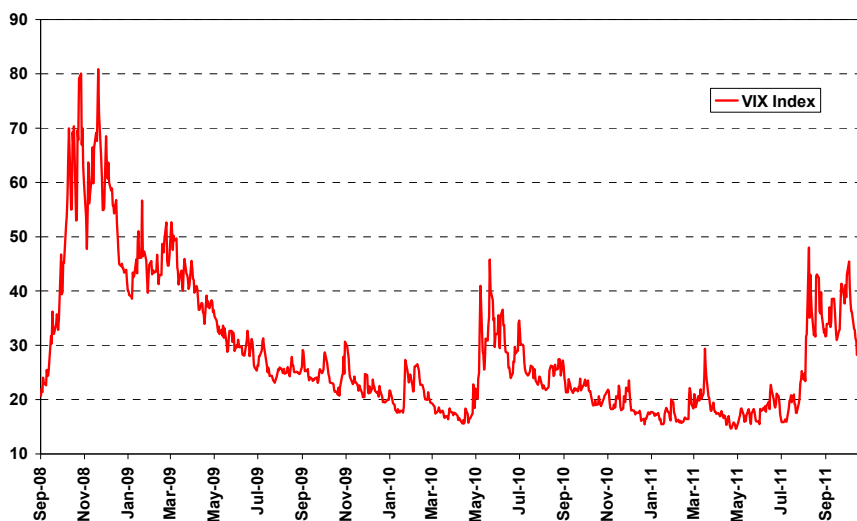
Source: Citi Investment Research and Analysis

3. Other Trades

It is harder to pinpoint the appropriate entry level at this moment for ideas in this bullet. We will provide update with more details when the time arrives.

- Long volatility. We have seen VIX testing 50 during the height of the sell-off in 2010 and 2011. Compared to 2010, VIX traded higher in 2011 and with a longer period of heightened volatility (Figure 30). We believe there will be a correction sometime in 2012, and it will be more severe than what we have seen in 2010 and 2011. VIX is likely to trade higher than its peak in 2011. We will provide an update as to when and how investors should buy volatility.

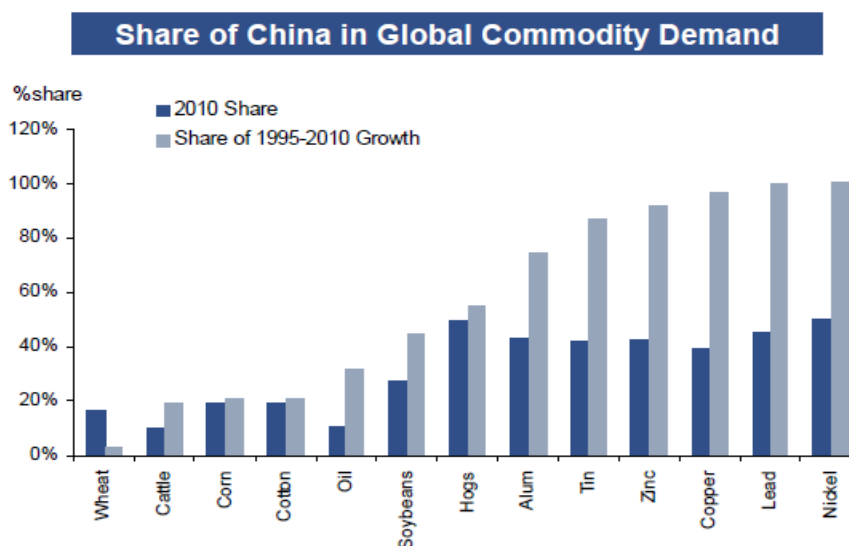
Figure 30. Potential correction in 2012 may bring VIX higher than 2011 peak



Source: Citi Investment Research and Analysis

- Shorting industrial metals, such as copper. Industrial metals tend to get sold off if there were to be a recession. China dominates industrial metals demand (Figure 31) and these were sold off aggressively during whispers of Chinese hard-landing. They have been rebounding, but should there be a change in sentiment we would be looking to enter shorts in these metals

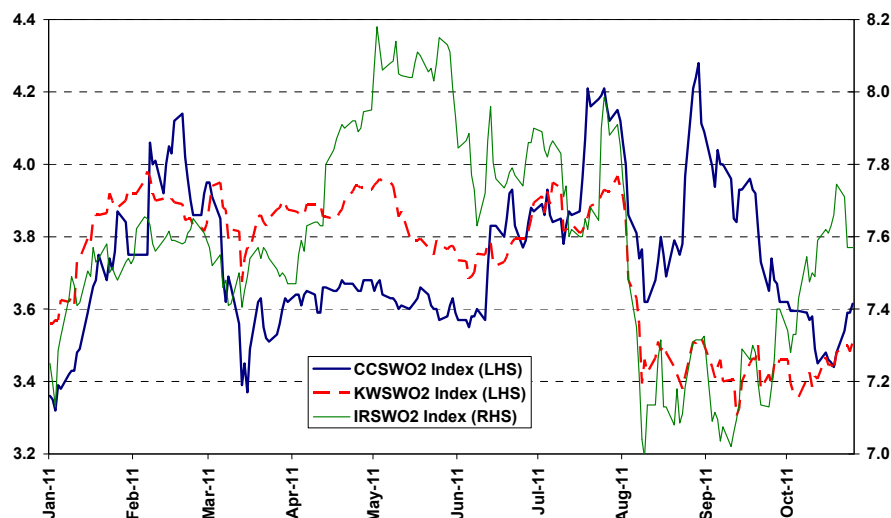
Figure 31. China dominates global commodity demand. Any worsening in sentiment there would put pressure on commodity prices



Source: Citi Investment Research and Analysis

- Receiving rates in Asia. With the FED's commitment to keep rates low for a prolonged period of time and CIRA Economics team's view on halt of monetary tightening next year in Asia, we would look to receive rates in Asia when the levels rebound to attractive levels (Figure 32)

Figure 32. Look at enter Asian receivers at better levels

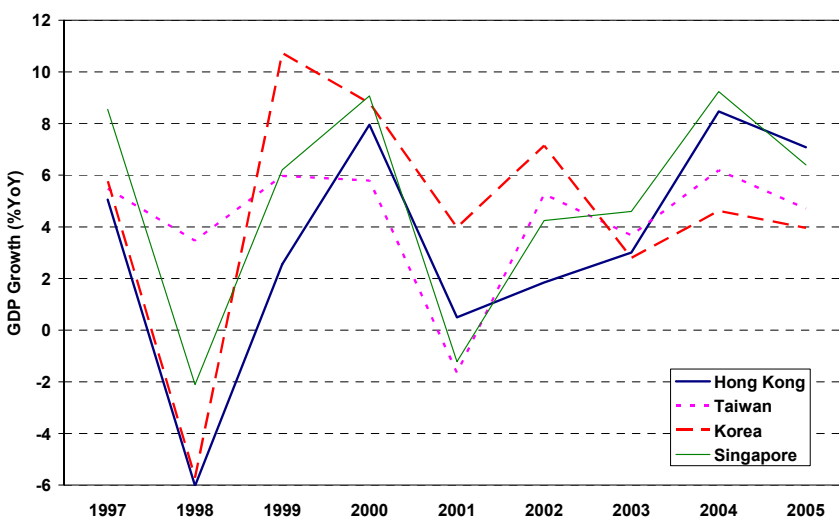


Source: Citi Investment Research and Analysis

Appendix: Single Currency Stopping Natural Economic Adjustment

Because of the USD-peg, Hong Kong is the only economy out of the “Four Asian Dragons” that did not devalue its currency. Figure 33 shows, by-and-large, Hong Kong’s recovery lagged its peers. Subsequently, there was strong rebound in Hong Kong from 2003, but that was to a large extent due to external stimulus from Mainland China in the form of CEPA.

Figure 33. European Peripherals cannot devalue their currencies because of the adoption of EUR. Their GDP Growth may lag peers’ (similar to Hong Kong after Asian crisis)*

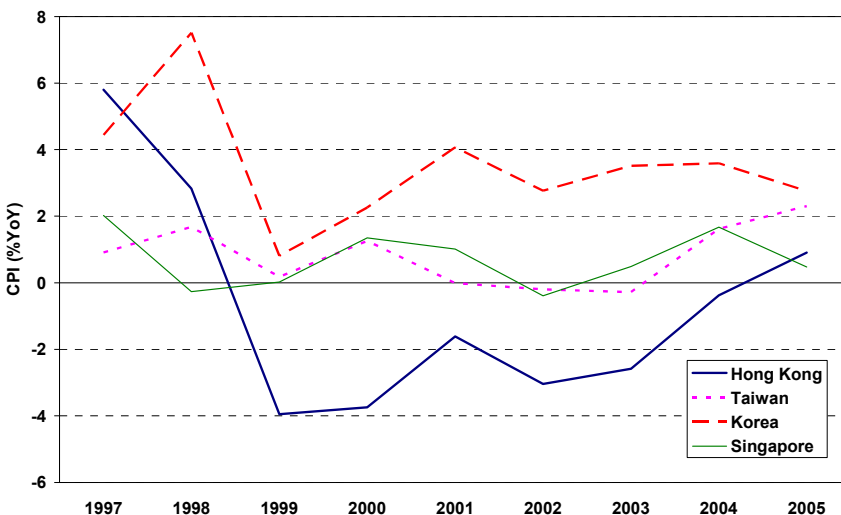


Source: Citi Investment Research and Analysis

* Hong Kong growth restored in the form of stimulus from Mainland China (CEPA) in 2003. Hard to see such measures to the Peripherals

Perhaps more alarming than poor GDP growth, is that fact that Hong Kong suffered six-years of deflation post-crisis (Figure 34) --- which continued two years into CEPA.

Figure 34. Again, because of adopting the EUR, European Peripherals may suffer from continued deflation (as did Hong Kong post Asian crisis)



Source: Citi Investment Research and Analysis

Thus, European Peripherals are likely to suffer from weak growth and deflation for years to come, and that would in turn affect the Eurozone. It is difficult to see what kind of external stimulus can come to their aid (as in the case of Mainland China's CEPA to Hong Kong back in 2003). The Eurozone and the Peripherals are currently 19% and 7% of global GDP respectively, which is significant compared to EM Asia's 10% of global GDP during the years of Asian crisis.

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Appendix A-1

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