4 September 2014 │ 80 pages

Strategy
Western Europe

European Equity Strategy

Bull Market — ABS, TLTRO, QE = Liquidity Trumps Earnings

- **Liquidity put** — The post-financial crisis landscape has been dominated by central bank actions, ie ZIRP & QE. Divergence = key macro theme in coming quarters. US/UK growth robust and rate hikes getting closer. ECB/BoJ nearing QE, due to CPI under-shoot and mandate risk in the Euro Area. ECB actions (ABS, TLTROs, QE) to further fuel "convergence trades", eg Financials, periphery. Overall, global growth remains on modest but fragile recovery path.

- **Equity bull market continues** — European equity return = 8% YTD (150% since 2009 lows). Re-rating since mid-2012 has been sharp, from 10x to 17x P/E = not cheap. But equity still super-cheap vs other asset classes (eg credit). Bull case needs liquidity support followed by earnings delivery = base case. We target 370 for end-14 Stoxx (400 for end-15).

- **Key themes** — 1) Where in the cycle: our analysis suggests very few end cycle flags, 2) ECB QE: a) extends search for yield, eg DY*G, b) Euro banks, c) debt/equity arb, eg surplus FCF, d) REV, 3) Rising US bond yields: financials/cyclicals over defensives, 4) Sectors/Countries: prefer financials, cyclicals and periphery = Insurance, Banks, Resources, Autos, Construction (Up to O/weight), Norway, Italy, Ireland, Sweden score best on our models. Intesa Sanpaolo replaces Danske Bank on our Citi Europe Focus List, joins AXA, Allianz, Caixabank, DNB as preferred Financials on list.

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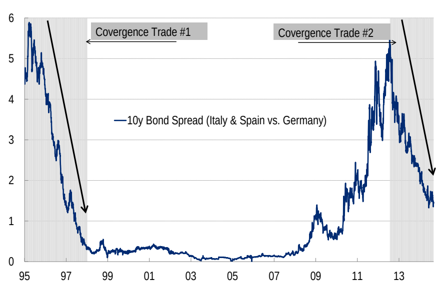
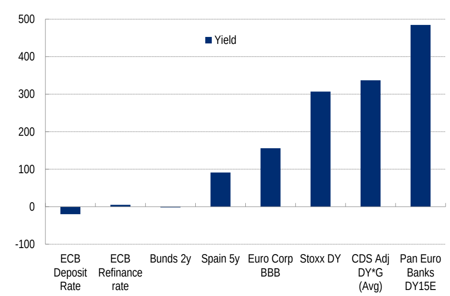
Figure 1. Euro Convergence Trade #2, ECB Action = More Fuel...



Source: DataStream & Citi Research

Figure 2. ...for Search for Yield Across Europe (BPs)



Source: ECB, DataStream & Citi Research

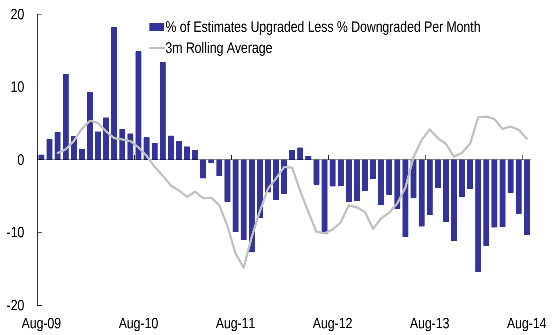
See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

Contents

Bull Market — Divergence, ECB QE to Bridge to Earnings Growth, Search for Yield

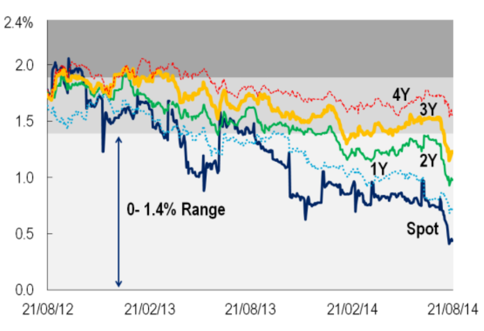
- **Divergence and liquidity put** — We still back our "Goldilocks in a Strait-Jacket" analogy of the global economy, ie low/modest growth floored by policy put and ceilinged by high debt/de-leveraging. Risk of sharp fall or rise in global growth unlikely, according to our economists, who continue to back progressive/modest global recovery. This should be a supportive backdrop for corporate sector. Divergence to become a clear trend over coming quarters, eg divergent growth and policy action between US/UK and Euro Area/Japan. This means different influences for financial markets and investors to deal with. Growth path in US has been re-established at 3%+ following weak 1Q14. Tapering to be followed in 2H15 by rising interest rates. US bond yields to rise before then, ie this year. Recent weakness in Euro Area macro data, especially Germany, weak survey data and, most importantly, persistent CPI under-shoot is likely to lead to additional ECB liquidity support including Citi base case of QE around end-2014. UK economy continues to boom with strongest G7 GDP growth expected in 2014 and 2015. Early-2014 EM fears have subsided but investors need to keep an eye on China's credit expansion and those EM economies with big current account deficits into higher US rate hikes. Don't ignore (geo) politics, eg Scotland, Ukraine, Middle East.
- **Equity bull market to continue** — European equities have returned 8% YTD, recovering strongly from the recent summer sell-off as bad news (weaker macro data) has quickly become good news (more ECB liquidity). There has been a strong re-rating since mid-2012. European equities now 17x P/E, from 10x then. No longer cheap in absolute terms, but still super cheap relative to other asset classes, eg credit. Europe has lagged the US in this cycle, but has still returned 150% since 2009 lows. We stay bullish and target 370 for end-2014 Stoxx (400 for end-2015). Bull case relies more heavily on ECB liquidity than previously, given recent slowdown in Euro Area macro data. But, also requires earnings growth to come through in coming 12-18 months. Here, we are encouraged by: 1) improving growth dynamics in periphery (ex-Italy), and 2) better than expected underlying earnings from European banks in 2Q14 reporting season. We think liquidity trumps earnings concerns over coming months.
- **How to position with ECB/Fed divergence** — Investors need to consider 2 main questions, in our view: 1) where are we in this cycle, and 2) what to do in environment of diverging European/US growth/policy? First question is hard to answer; this is an abnormal/extreme cycle in many ways. Macro, eg output gaps, interest rates, investment, suggests that we are closer to early cycle than late cycle in both the US/UK and Euro Area, although Euro Area is a long way behind US/UK. Market factors, eg RoE, valuation, M&A activity, also suggest that we are far from late cycle. Only IPO activity is flagging "late cycle". We think this cycle has some time to run and that EPS delivery will sustain decent equity gains over coming 12-18 months. Divergence leads us to back exposure to both ECB QE and rising US bond yields over coming months. ECB action, we think, extends the search for yield, eg DY*G, surplus FCF, and also should directly support Financials, especially Banks. Our REV strategy should do well in this environment (page 54). Rising US bond yields should support Financials/Cyclicals over Defensives. At a sector/country level, we prefer financials, cyclicals and periphery = Insurance, Banks, Resources, Autos, Construction (Up to O/weight), Norway, Italy, Ireland, Sweden score best on our models. Intesa Sanpaolo replaces Danske Bank on our Europe Focus List, joins Akzo Nobel, Allianz, AZN, AXA, BG, Caixabank, Continental, DNB, Experian, Kering, Novo Nordisk, Philips, Renault, Rio Tinto, Siemens, Vodafone.

Figure 3. Earnings Remain Under Pressure — Downgrades



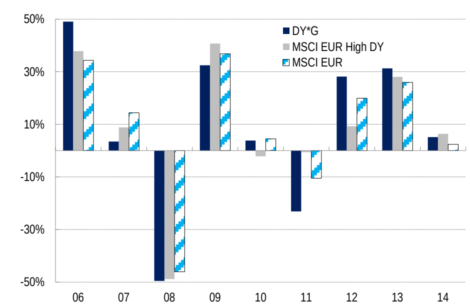
Source: DataStream & Citi Research

Figure 4. But, ECB Likely to Face CPI Under-Shoot With QE



Source: ECB, BNB, Haver & Citi Research

Figure 5. QE to Extend Search for Yield, eg DY*G



Source: MSCI, Factset, DataStream & Citi Research

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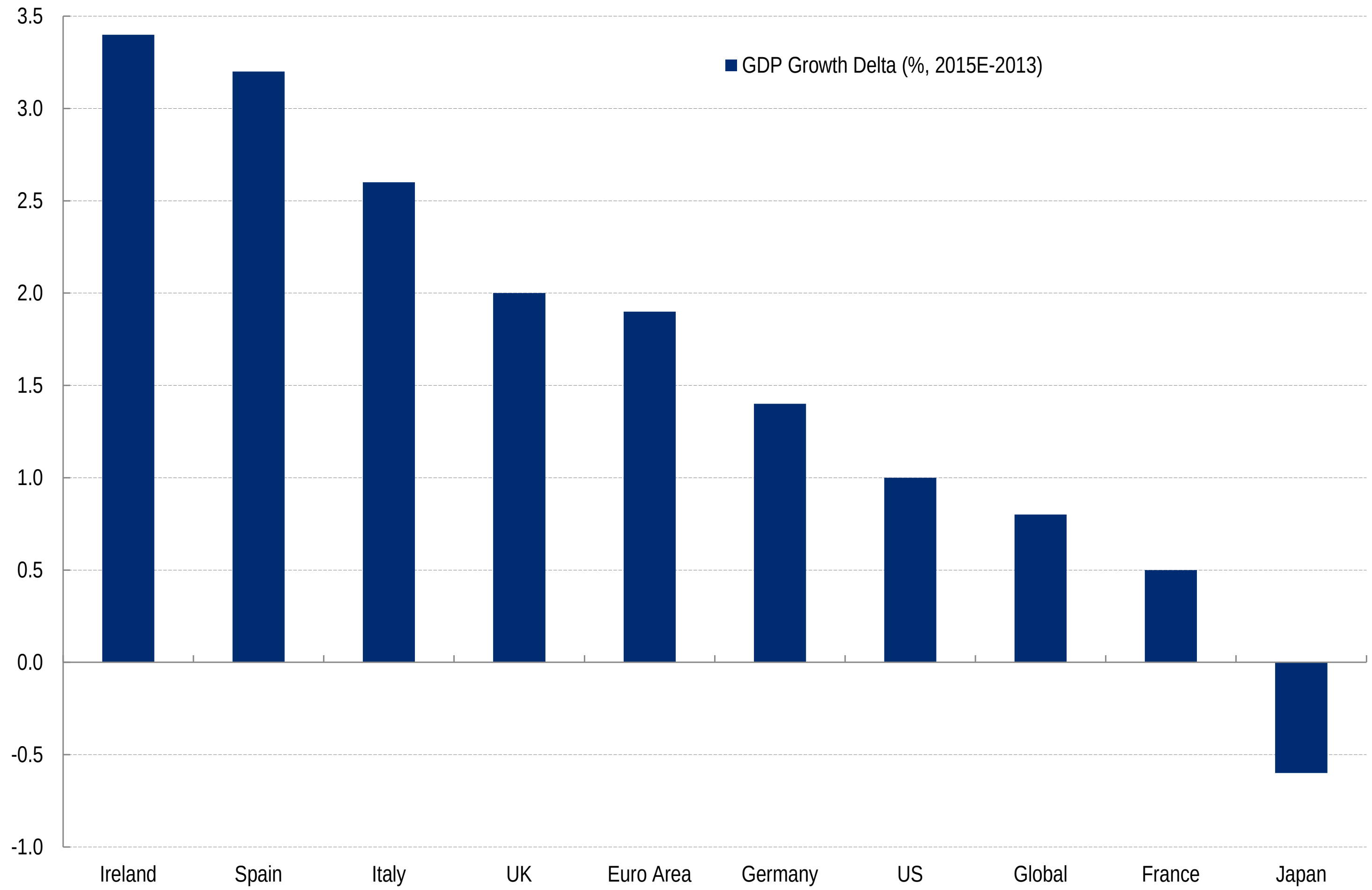
Macro — Global Recovery, ECB QE

Macro — Europe (Still) Has the Biggest GDP Growth Delta

- Overall, Willem Buiter and our economics team expect progressive global recovery in 2014-15E. Citi forecasts 2.8% global GDP growth in 2014E, rising to 3.4% in 2015E.
- Despite recent weakness, Europe is expected to enjoy the biggest improvement in GDP growth from 2013 to 2014-15E. Periphery (ex-Italy) = stronger momentum than core.
- Our economists forecast 1.5% GDP growth in the Euro Area in 2015 vs -0.4% in 2013 (3.6% vs 1.7% respectively in the UK).
- Systemic risks have fallen sharply over the past two years in Europe, eg current accounts. Key risk now is CPI.
- Weak CPI and further disinflationary pressure is likely to lead to QE in the Euro Area later around year end.
- US GDP growth has returned to a 3%+ path. This should help to reverse falling bond yields over coming quarters as we near higher policy rates (2H15).
- In EM, investors should keep an eye on: 1) China credit expansion, 2) geopolitical events, and 3) current account weak economies.

Figure 6. Citi GDP Growth Delta (2015E Less 2013 GDP Growth)



Source: Citi Research

Macro — Global Recovery On Track, Just Not That Exciting

- Citi global GDP growth forecasts for 2014E have remained pretty stable around 3% since late 2012.
- Systemic risk has fallen sharply in last 2 years, especially in Europe eg improved current accounts, strong bank balance sheets. Recent geopolitical events small impact, to date.
- Lower risk environment is encouraging capital allocators "up the risk curve", eg business investment, M&A, flows to equity.

Figure 7. Citi 2014 GDP Growth Forecasts (%)

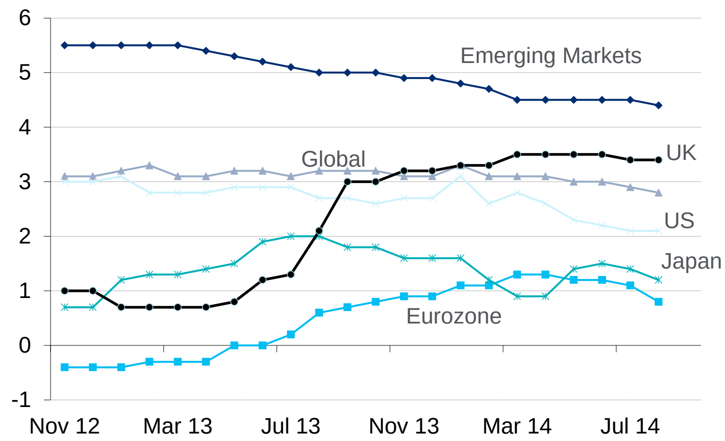
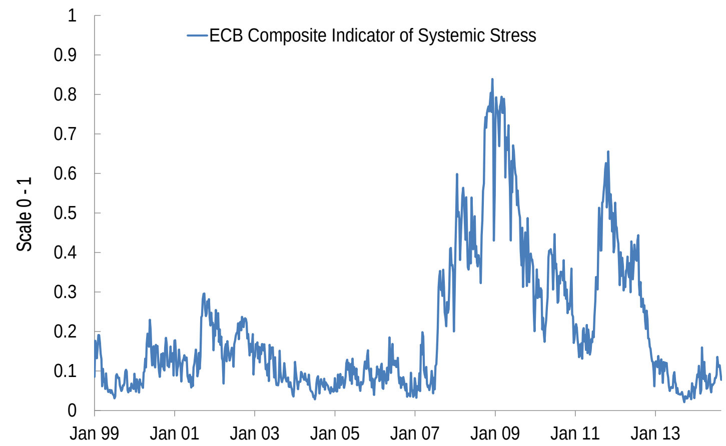


Figure 8. ECB Composite Indicator of Systemic Stress



- Tobias Levkovich, our US strategy colleague highlights relationship between US bank lending standards and investment.
- Investment now starting to catch-up with bank lending. This should support decent US GDP growth and contribute, in turn, to rising US bond yields.
- Investors need to keep eye on EM macro risk, eg big current account economies, rise in Chinese debt levels (private sector).

Figure 9. Banks Tightening C&I Loans to Large Firms (%) vs. Private Nonresidential Fixed Investment (Y/Y) - Lagged Three Quarters

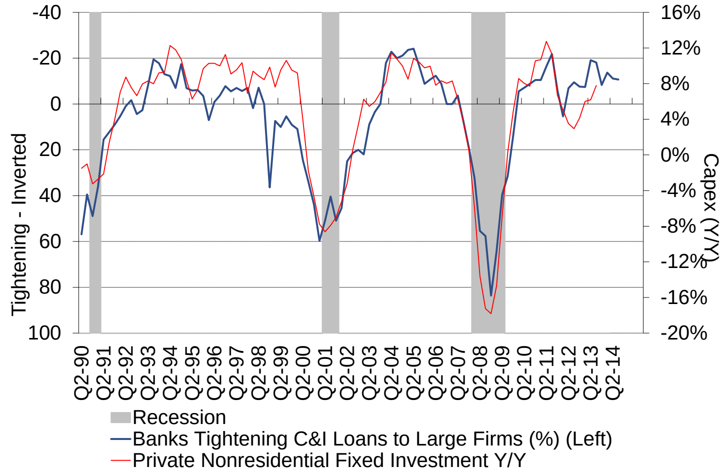
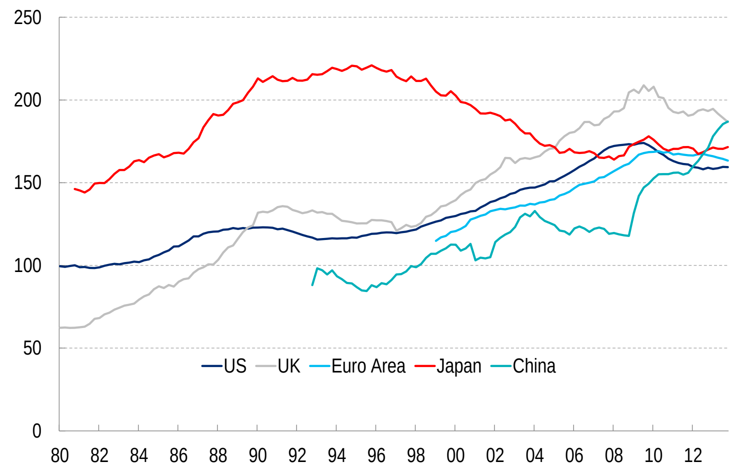


Figure 10. Private Debt/GDP (%)



Source for all charts: ECB, DataStream, Citi Research

Macro — Europe = Mixed Bag

- Good news = Euro Area exited recession in 2Q13. Modest recovery.
- Less good news = weak recent macro data and growth has lagged rest of world since 2008, even Japan.

Figure 11. Citi GDP Growth Forecasts - Eurozone

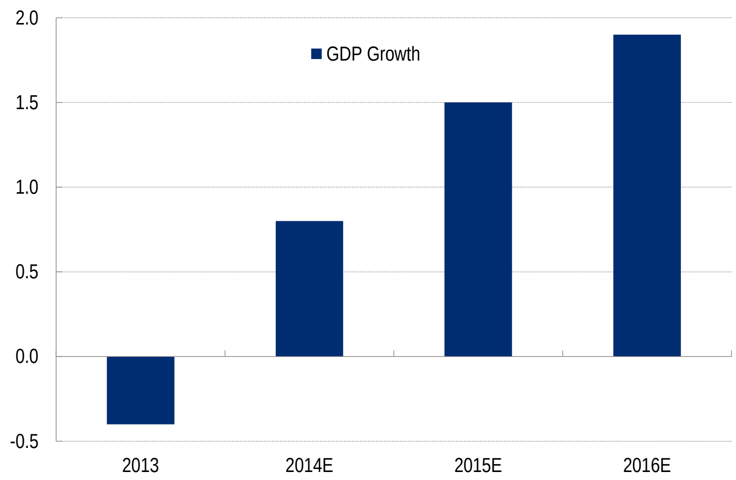
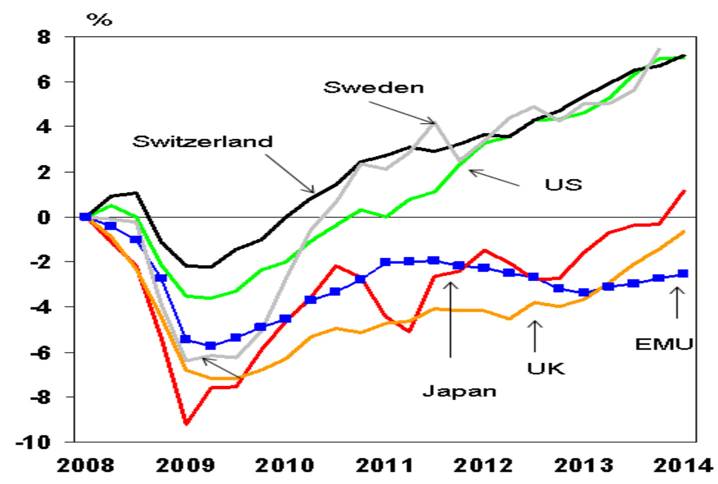


Figure 12. Change in Real GDP Since Q1-2008



- Output gap still wide suggest plenty of slack across region and little risk of CPI pressure.
- Good news = Euro Area unemployment has started to fall, even in the periphery.

Figure 13. Output Gap Estimates (%)

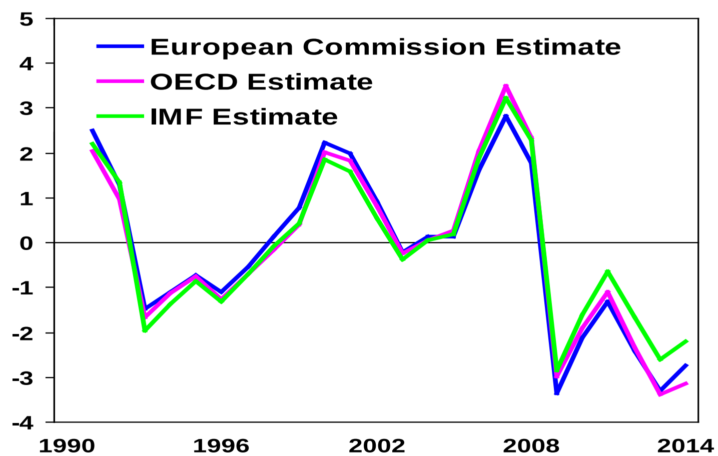
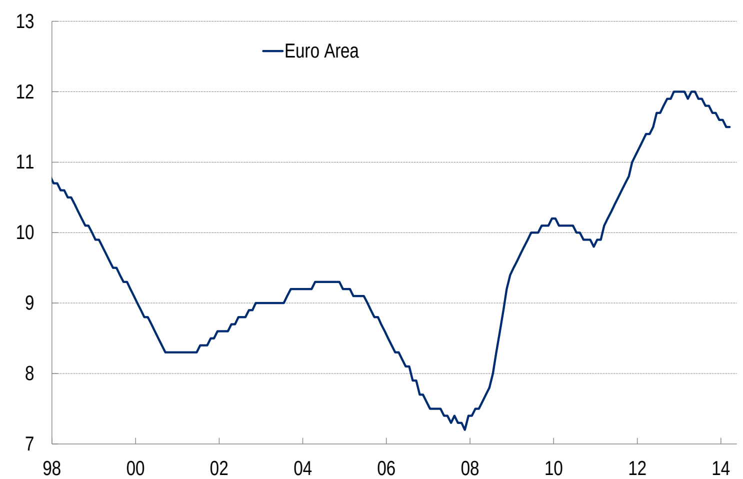


Figure 14. Unemployment Rate (%)



Source for all charts: Eurostat, IMF, Citi Research

Macro — Europe = Mixed Bag

- Bank lending standards, as measured by ECB, show easing = a little more encouraging.
- Historically, this is when private sector loan growth has been positive.
- Investment should follow bank lending standards with a lag.

Figure 15. Latest ECB bank lending survey a little more encouraging

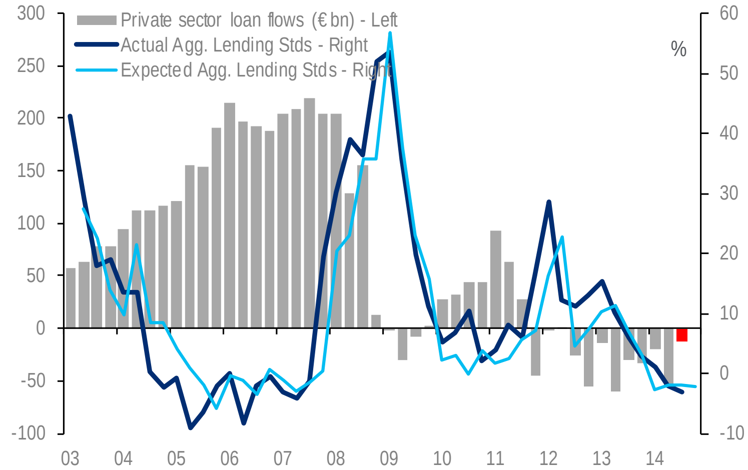
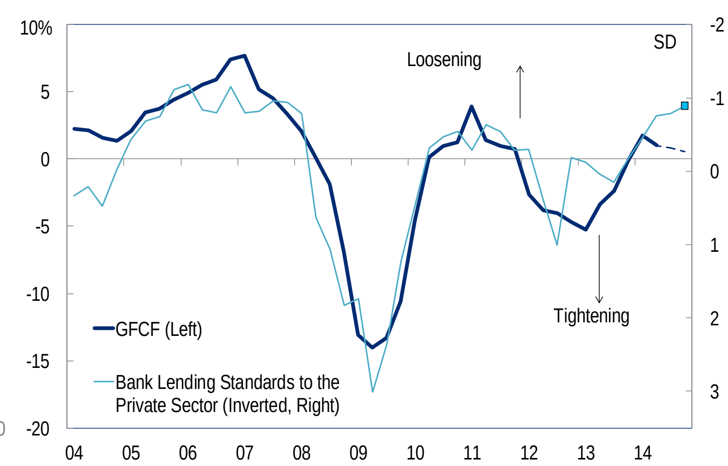


Figure 16. Recovering investment should follow with a lag



- Periphery enjoying more momentum than core eg economic sentiment indicators higher in periphery now for first time in several years.
- Rebalancing in periphery, ex-Italy, has come a long way eg recovery in profit share of GDP, lower wages/unit labour costs.

Figure 17. Euro Area — Economic Sentiment Indicator, 2008-Jul 14

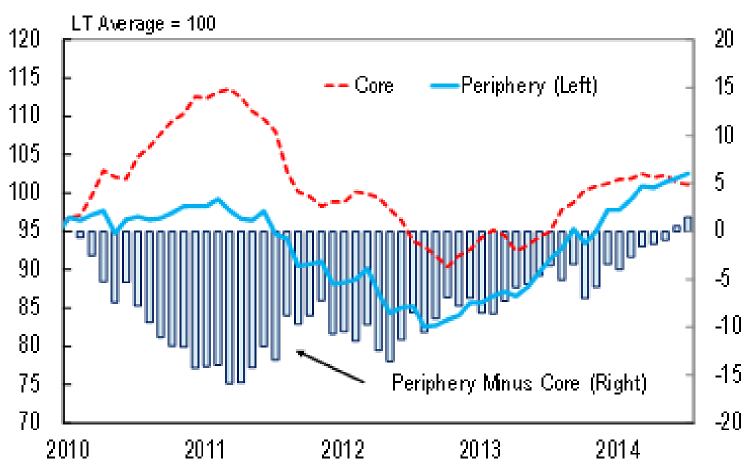
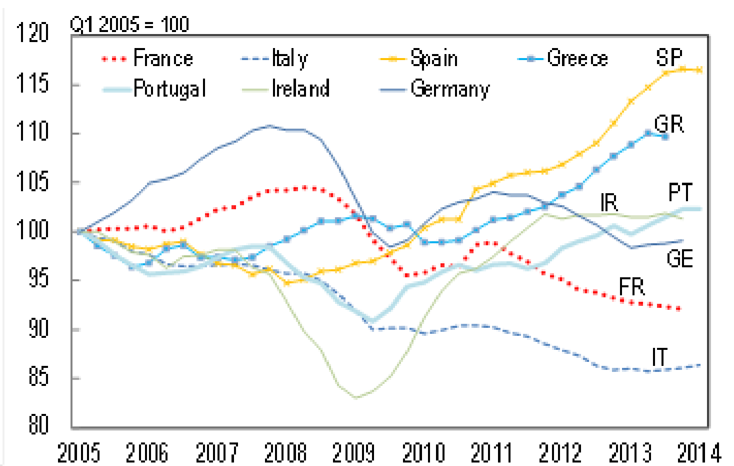


Figure 18. Selected Euro Area Countries — Profit Share of Non-Financial Corporations (Pct. of NFC Gross Value Added), 2005-Q1 14



Source for all charts: EU Commission, Eurostat, BNB, ECB, Bloomberg, Haver, Citi Research

Macro — Europe = Mixed Bag

- 2Q14 GDP growth was disappointing, especially in Germany. Italy returned to recession. Survey data for 3Q14 also not that encouraging.
- German Citi Economic Surprise Index (CESI) has fallen beyond -70 level for only fourth time since 2008-09 crisis.
- Our economists have cut forecasts for cumulative German growth in 2014-15 by 1.6% since June.

Figure 19. Euro Area — Real GDP Growth (QQ SA), Q2 2014

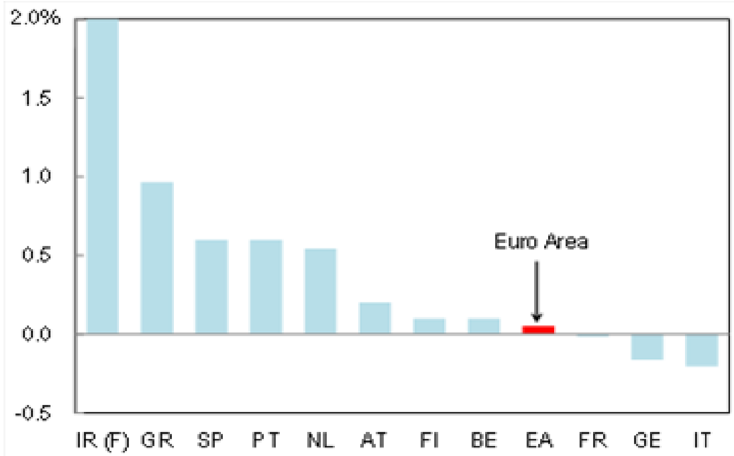
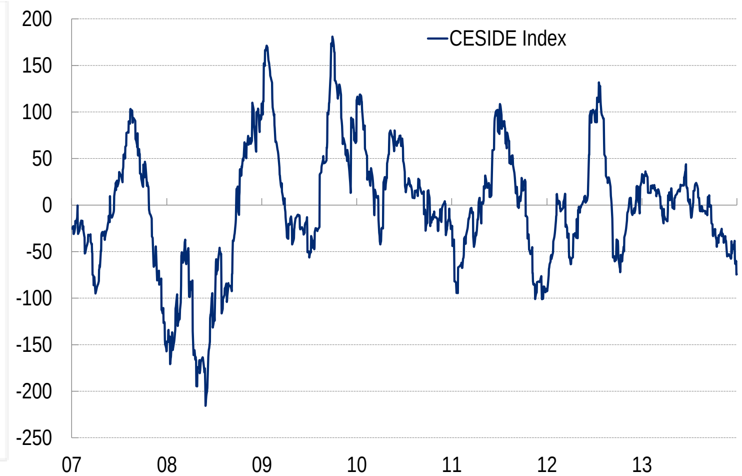


Figure 20. German CESI Index



- Germany is more vulnerable than most European countries to external risks in part due to high export exposure, eg Russia.
- Enhanced sanctions, weaker Russian GDP and (gas) supply disruptions could present additional headwinds for European growth.

Figure 21. 2013 AE Exports to Ukraine, Russia & CIS Mongolia (% of AE GDP)

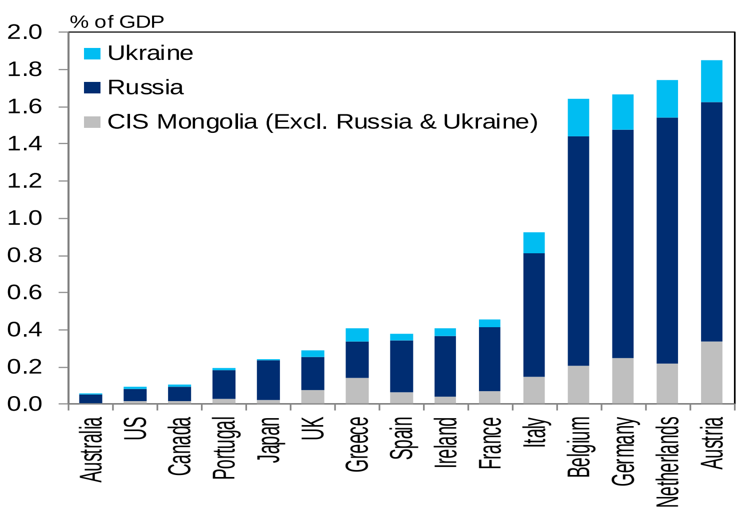
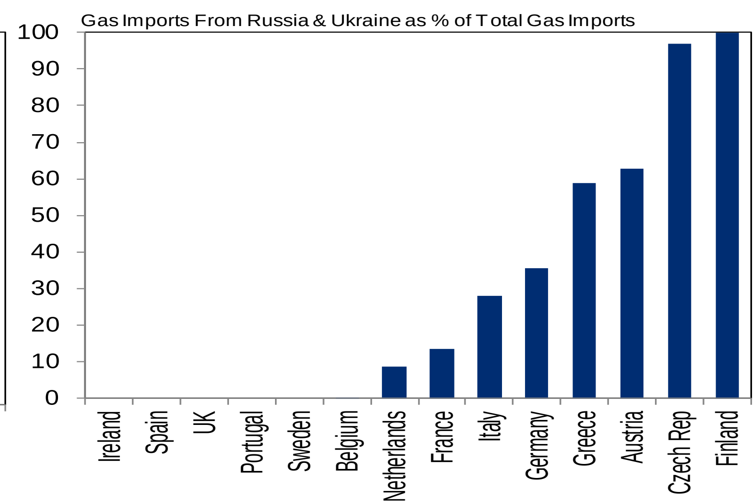


Figure 22. 2011 Bilateral Gas Imports from Russia & Ukraine (% of Total Gas Imports)



Source for all charts: Eurostat, Haver, IMF, Citi Research

Macro — European Economic Repair Scorecard = Some Progress, More to be Done

- Private sector de-leveraging has not begun in aggregate in the Euro Area.
- This is in contrast to sharp de-leveraging in the US and UK, which has contributed to the cyclical (modest) pick-up in these economies.
- But, one size does not fit all in the Euro Area (Figure 16). Sharp de-leveraging has taken place in countries such as Spain and Ireland.

Figure 23. Change in Private Debt/GDP Ratios In This Crisis Compared to Historical Experience

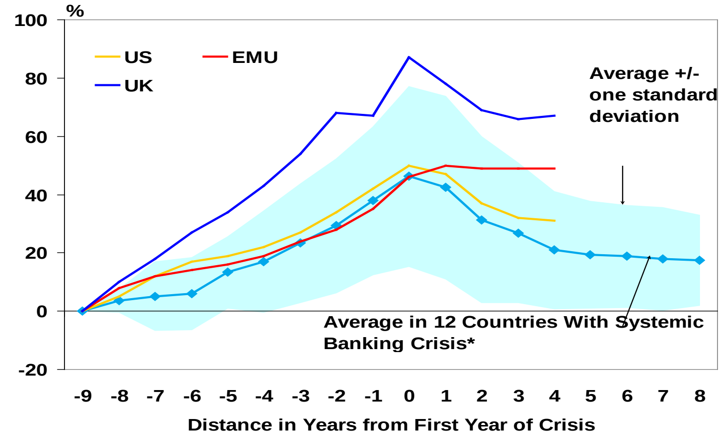
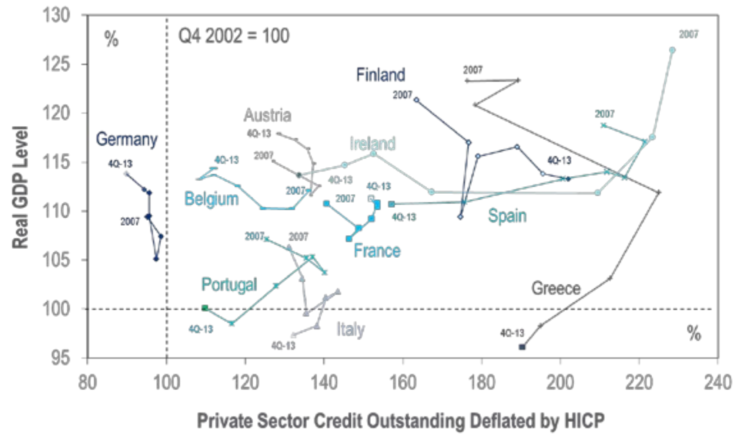


Figure 24. Can a country Deleverage and Grow at the same time?



- Some countries have been more successful than others at reducing unit labour costs relative to the rest of the Euro Area.
- The periphery ex-Italy have all seen a sharp fall in ULCs in the last few years, which has been positive for competitiveness.
- Euro Area private sector credit cycle has double dipped. Region needs positive credit growth to boost growth/sustain recovery.

Figure 25. Unit Labour Costs Dynamics Relative to Euro Area Avg

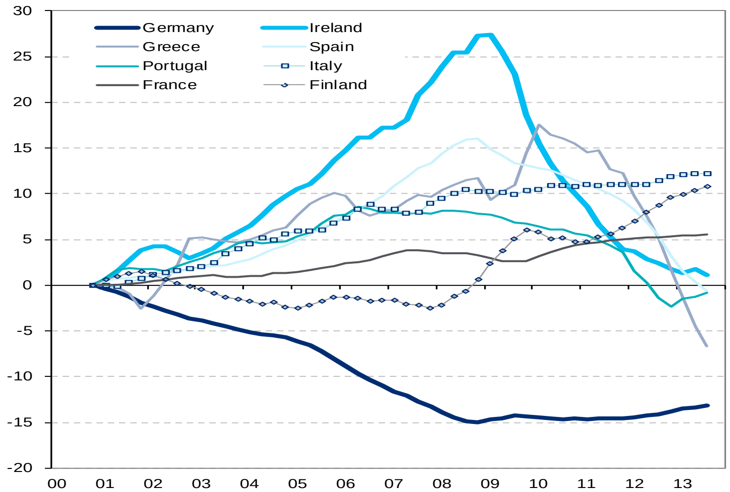
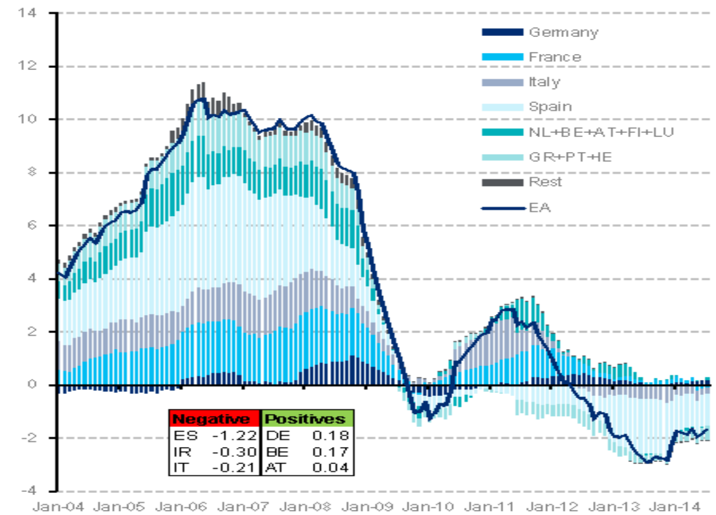


Figure 26. Widespread retrenchment in private sector credit growth



Source for all charts: Haver, European Commission, European Central Bank, Citi Research

Macro — CPI Under-Shoot Suggests ECB QE Nearing

- Delivering price stability over the medium-term is the ECB's sole mandate. Market-implied CPI has collapsed in recent weeks.
- Current pricing of inflation in various markets suggests that the ECB is putting credibility at risk.
- Consensus inflation expectations continue to fall.
- With disinflationary pressures/deflation risks rising, our economists see ECB QE as more likely than not in 4Q14.

Figure 27. Euro 1-year Inflation Swaps, spot and forwards

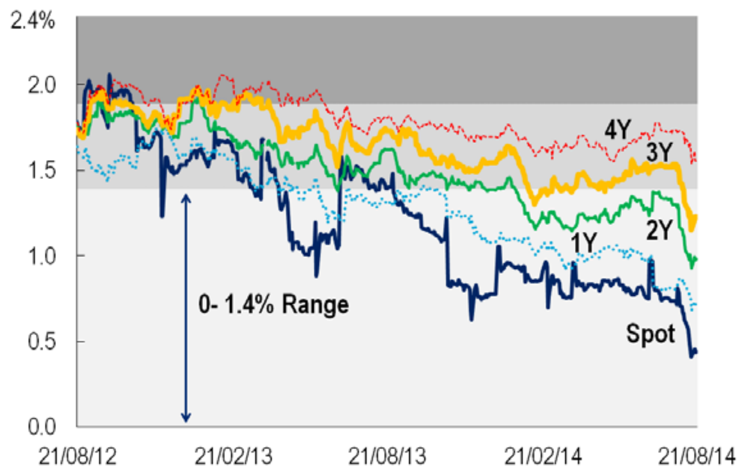
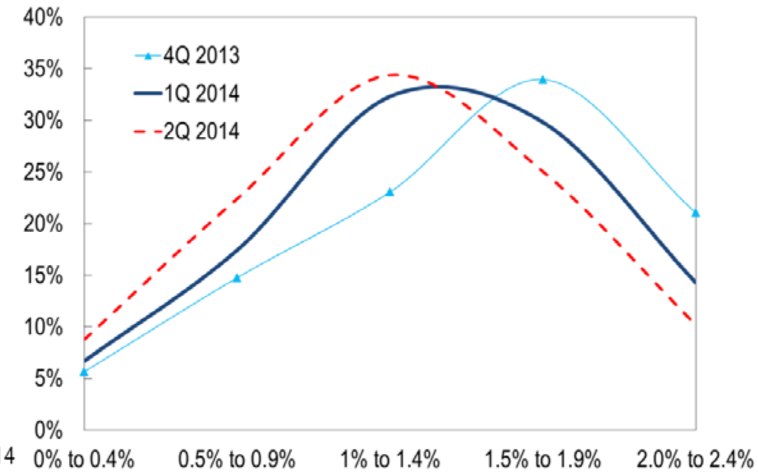


Figure 28. SPF: Aggregate probability distribution of average 2015 HICP



- High levels of real bank loans in periphery key example of ongoing risk within region.
- These real rates need to come down sharply to support a turn in the credit cycle. ECB QE may help here.
- ECB has shrunk its balance sheet over past 2 years. This has contributed to stronger euro and to lower CPI. ECB QE would reverse this shrink.

Figure 29. Real Bank Lending Rates to Non-Financial Companies (Loans Up to €1m), Versus CPI Ex-Tax

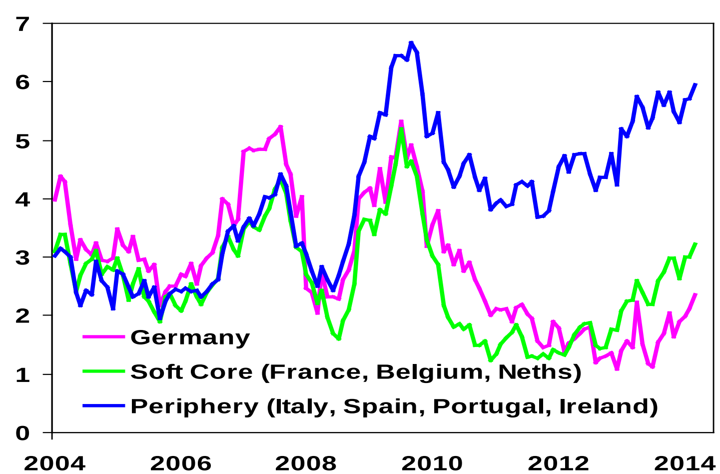
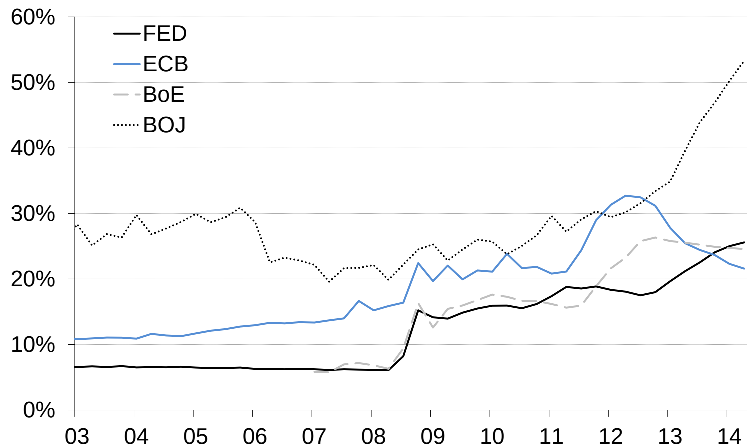


Figure 30. Central Banks Size of Balance Sheet as % of GDP



Source for all charts: European Commission, ECB, BNB, Bloomberg, Haver, Citi Research

Macro — Citi Economists Expect ECB QE Around End-14

- ECB QE of €1tn is the base case of our economics team around end-14 = 1) improve financial conditions, 2) boost real and nominal GDP, 3) fill the M3 money supply gap which has emerged in the past few years.
- Figure 16 shows the eligible market assets in the Eurosystem. Our economists expect a 60/40 split between public/private sector assets, with private assets mainly banks bonds/loans.

Figure 31. Needing to fill the M3 money supply gap

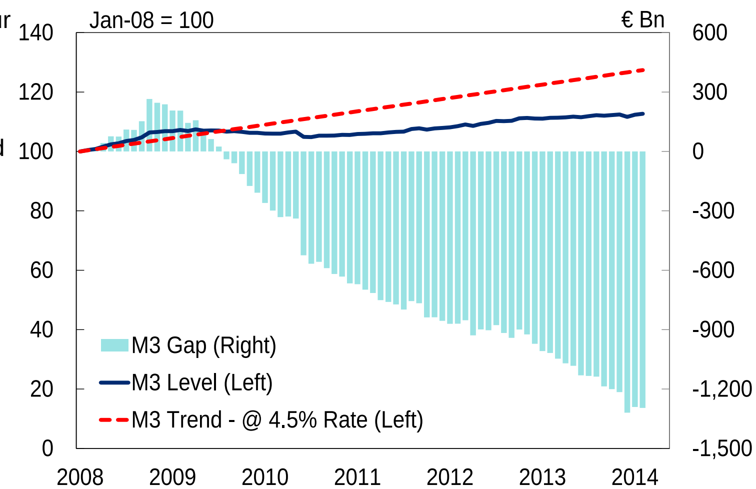
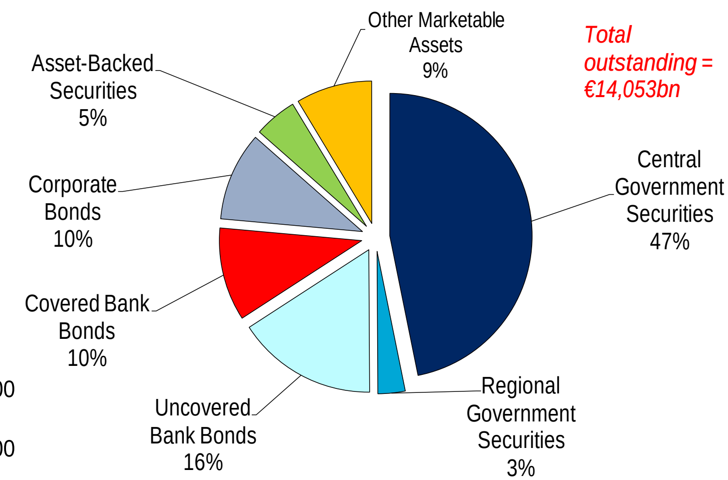


Figure 32. Eurosystem – Eligible Market Assets, €bn, 2Q-14



- ABS is a small part of the Eurosystem asset base and so would be hard for QE to target efficiently, at the moment.
- But, some countries have more exposure to ABS than others; QE could help credit easing in such countries.

Figure 33. Structured Finance, Balances Outstanding, % of GDP, 1Q-14

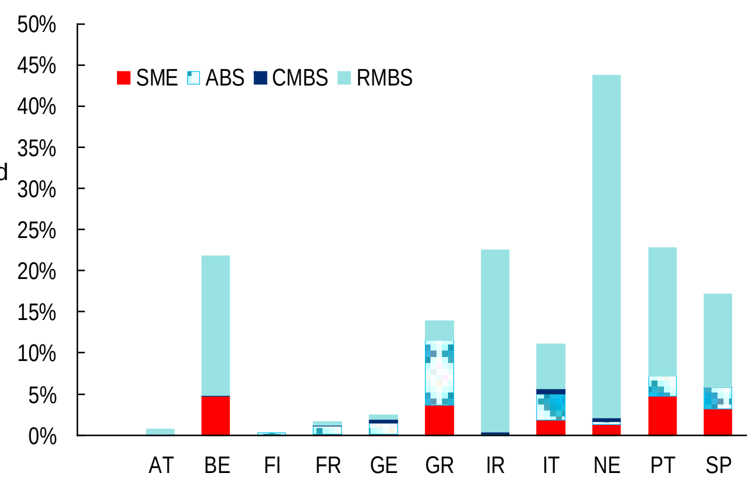
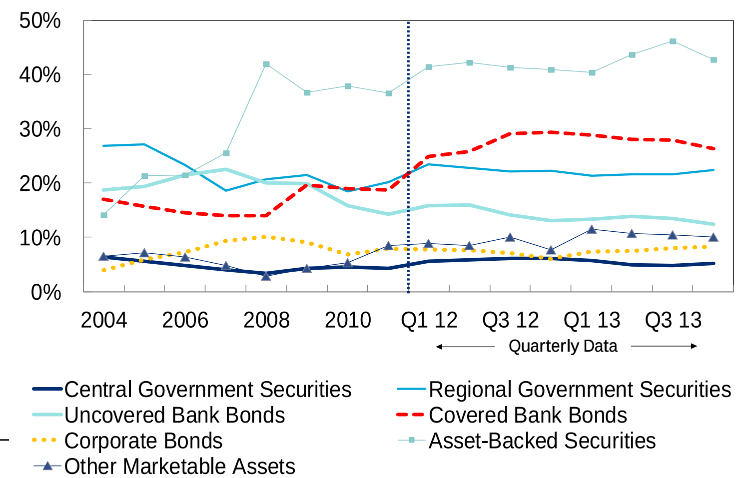


Figure 34. Use of collateral, % Eligible Market Assets



Source for all charts: European Central Bank, AFME and Citi Research

Macro — Boom Time in UK

- UK economy expected to enjoy fastest growth across G7 in 2014 and 2015.
- Expansion led by consumer spending and investment. Little impact from net trade.
- Business surveys at 25-year highs suggest that growth could, if anything, surprise on the upside.

Figure 35. Citi GDP Growth Forecasts - UK

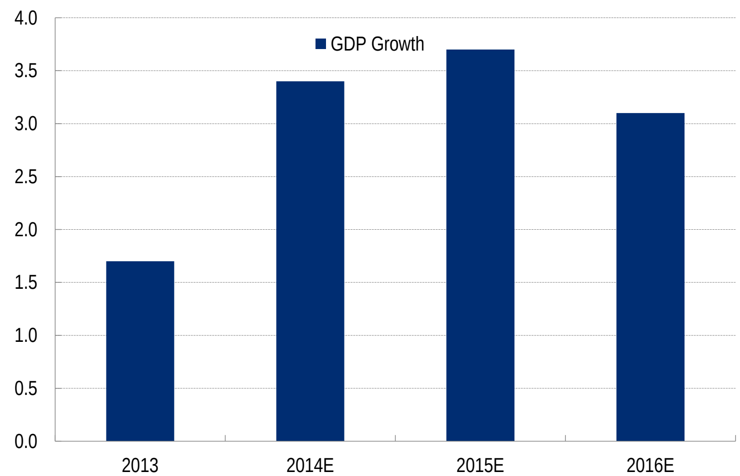
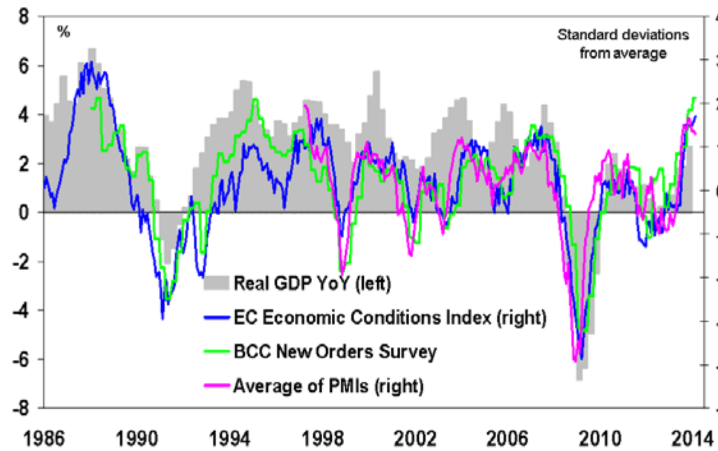
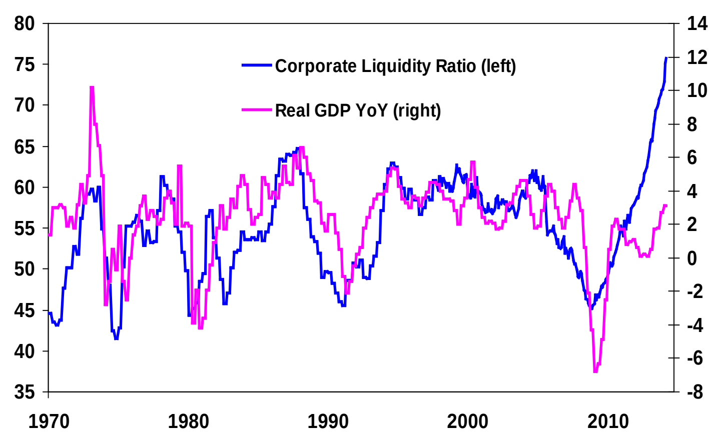


Figure 36. UK Business Surveys and GDP Growth



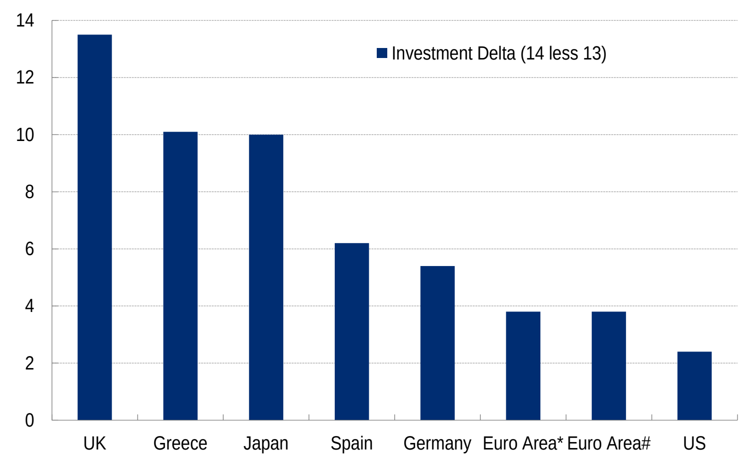
- UK corporate liquidity ratio measures sterling bank deposits to bank debt, at 45-year highs and suggests strong support for GDP growth.
- UK likely to see biggest investment growth delta. Michael Saunders, our UK economist, expects investment growth of c13% in 2014 and c17% in 2015.

Figure 37. UK Corporate Liquidity Ratio and GDP Growth



Source for all charts: European Central Bank, BCC, ONS, EC, AFME and Citi Research

Figure 38. Investment Delta



Note: Same delta for EA Fixed Investment and Business Equipment 2014E/2013A y/y growth.

(Bull) Market — Re-rating, QE Before Earnings

Market — Bull Market

- European equities are at all-time highs in total return terms. Bull market.
- In price terms, European equities still short of 2000 and 2007 peak levels.
- Still lagging bull market returns from 1990s and 2003-07.

Figure 39. Stoxx Total Returns

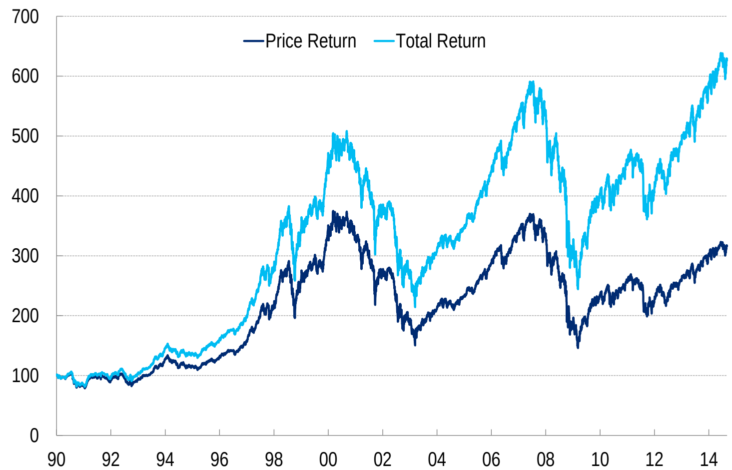
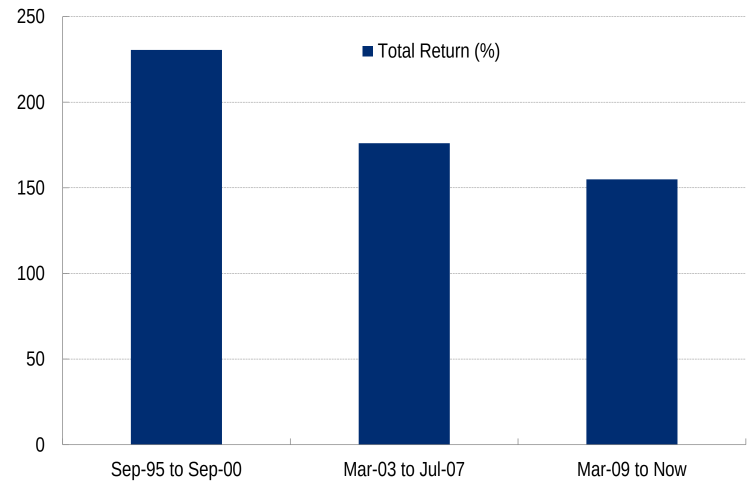


Figure 40. Stoxx Performance By Bull Runs



- Risk assets have easily out-gunned risk-free assets since 2009.
- Equity has returned 2.5x credit, but with more volatility; government bonds have easily beaten cash returns.
- Over 100 shares from the Stoxx 600 index has returned more than 400% since the 2009 lows. Almost half of the companies in the index have seen their share price return at least 200%.

Figure 41. ABC = Anything But Cash

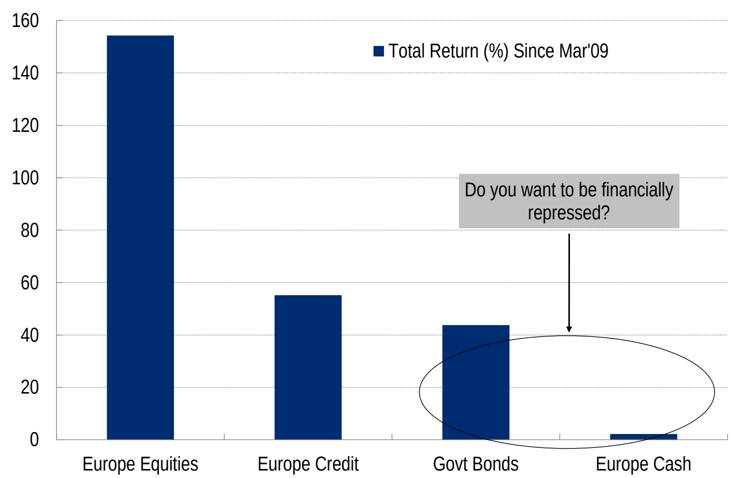
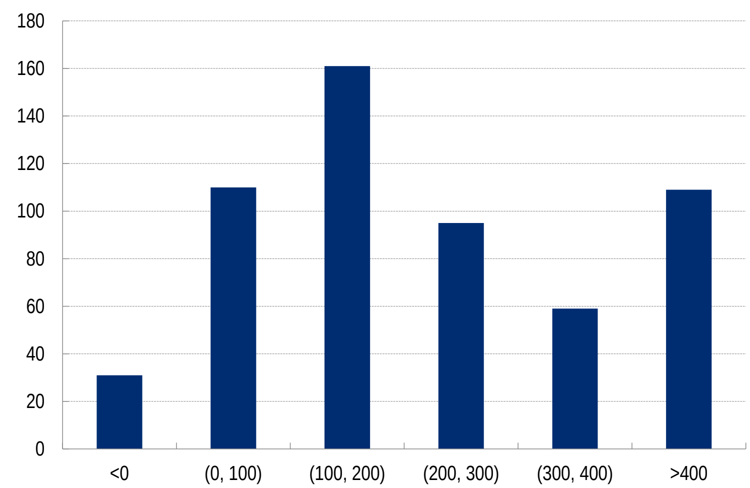


Figure 42. Distribution of Stoxx Returns Since March 2009 (# Stocks)



Source for all charts: DataStream & Citi Research

Market — Bull Market

- Government bonds have been the surprise package YTD. Ahead of equity and credit returns. Equity has edged credit.
- Investors in Spanish, Italian and French 10-year bonds would have enjoyed 15%+ returns YTD. Returns from bunds also over 10%.

Figure 43. YTD Total Returns by Asset Classes

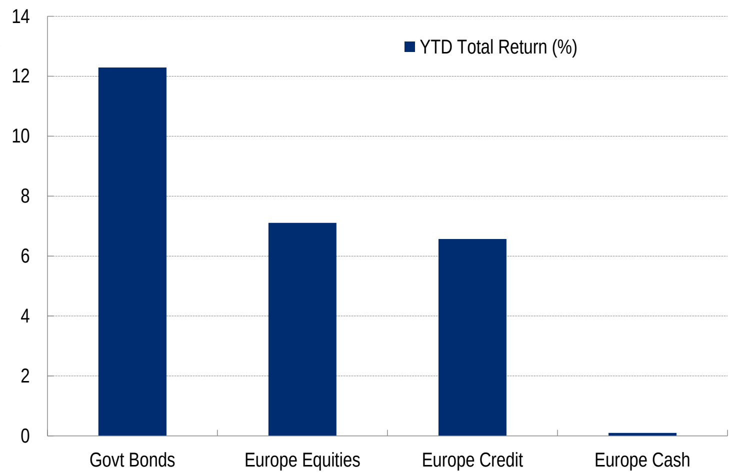
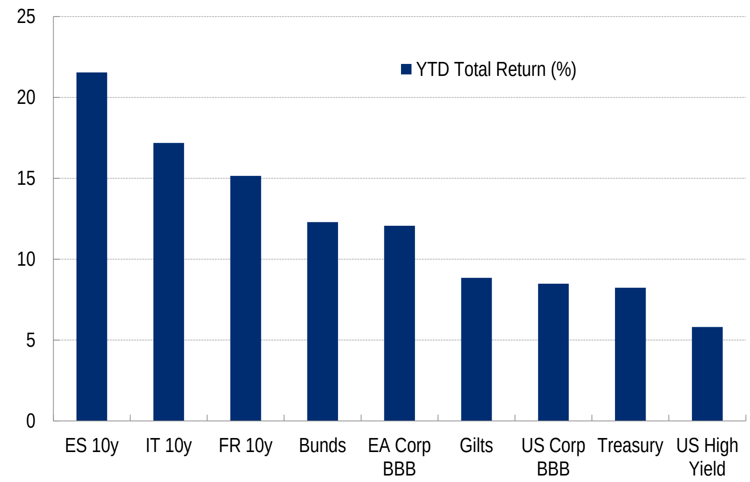


Figure 44. YTD Total Returns by Fixed Income Assets



- Spain is the best performing 'big' equity market in Europe. DAX has been a laggard, partly due to proximity to Russia/Ukraine crisis.
- Health Care has been best performing sector YTD. Real Estate and Utilities have also returned 15%+ YTD. Commodity sectors have done well, after 3 years of poor performance.

Figure 45. Top/ Bottom 5 Countries by YTD Total Returns

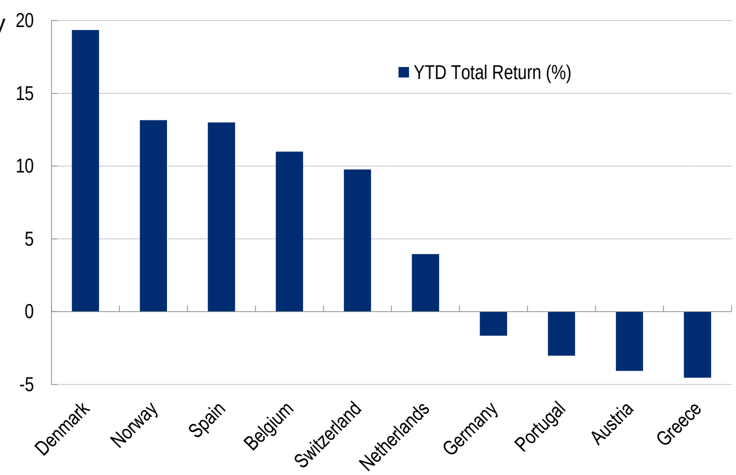
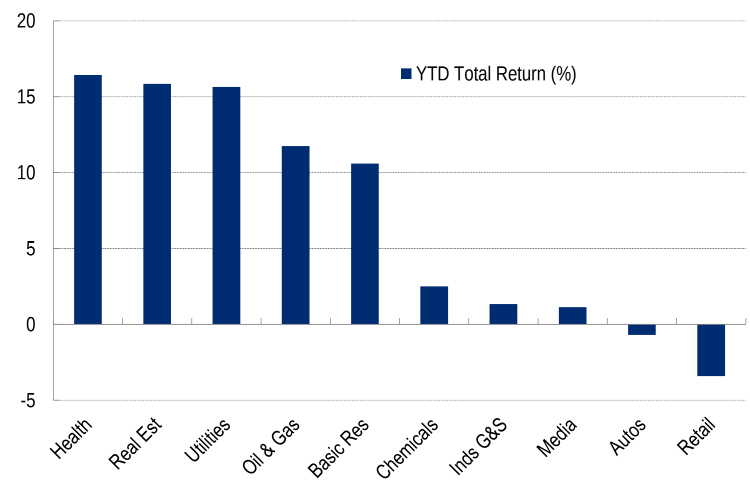


Figure 46. Top/ Bottom 5 Sectors by YTD Total Returns



Source for all charts: DataStream & Citi Research

Market — Valuation: Re-rated (Absolute) = No Longer Absolutely Cheap

- European equities have re-rated over the past couple of years, from c10x to over 17x on a trailing P/E basis.
- This is the biggest re-rating of any region in the world in the past 2 years.
- Now above post-1970 average = need earnings growth to sustain higher share prices. We think that happens over coming quarters but QE/liquidity to support before earnings.
- European equities still look cheap on a cyclically-adjusted P/E (CAPE) basis.

Figure 47. MSCI Europe Trailing PE

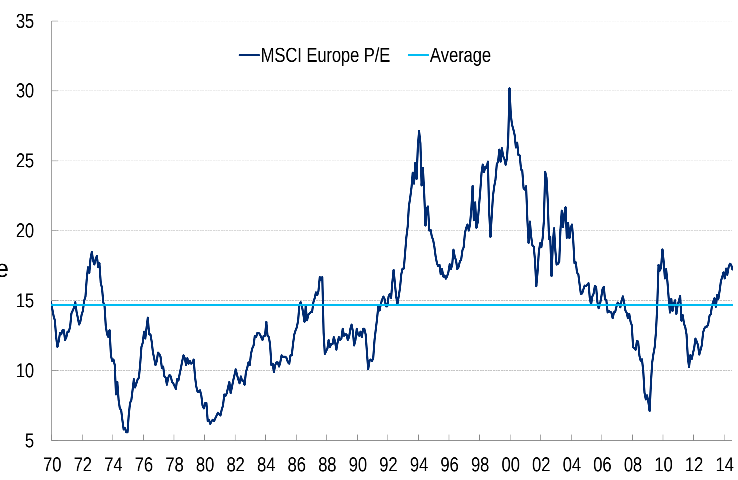
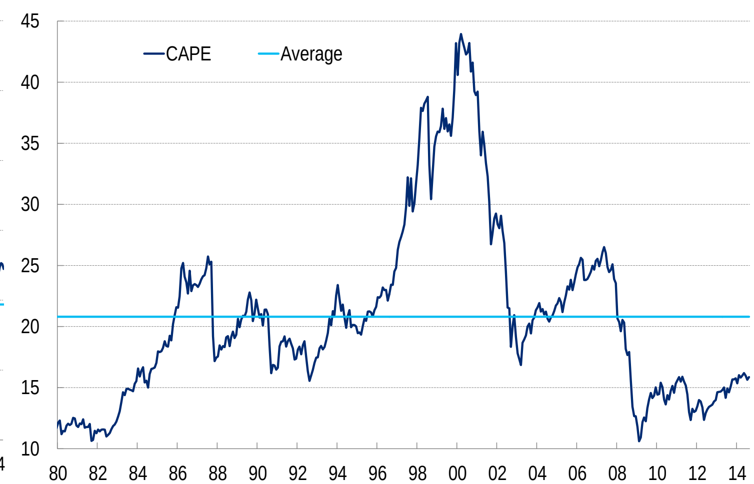


Figure 48. Europe CAPE



- High r-squared between trailing P/Es and 10-year total return CAGRs over the last 40 years. This suggests that it is better to "buy low not high"! Sound advice for all long-term investors.
- Current CAPE suggests that 10-year total return CAGRs higher than with P/Es; neither in "red flag" territory, but less attractive prospective returns than in 2009.

Figure 49. Future Returns from P/E

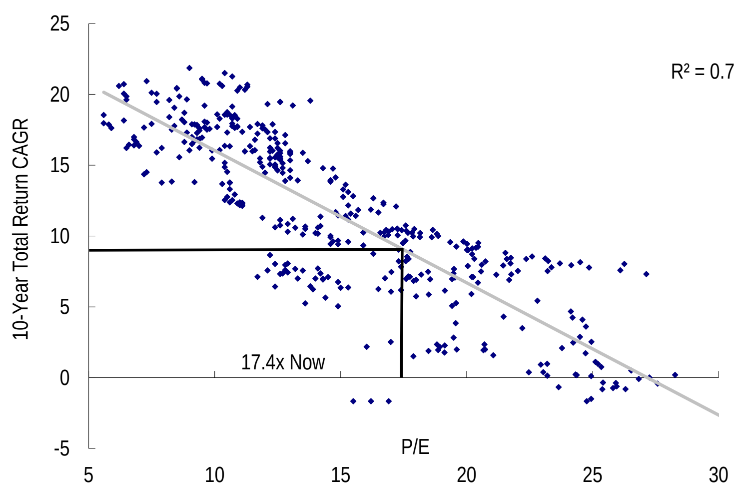
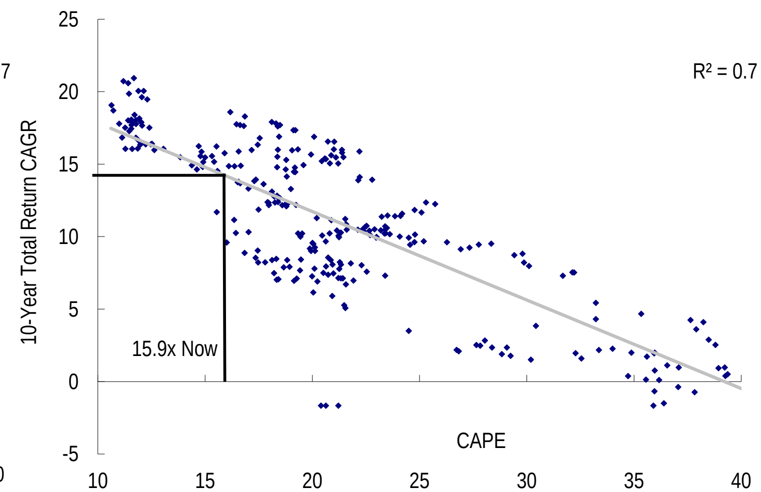


Figure 50. Future Returns from CAPE



Source for all charts: DataStream & Citi Research

Market — Valuation: Re-rated (Absolute) = No Longer Absolutely Cheap

- Re-rating of European equities also clear on an EV/EBITDA and price/book basis, back to long-term price-book average following recent re-rating.

Figure 51. EV/EBITDA

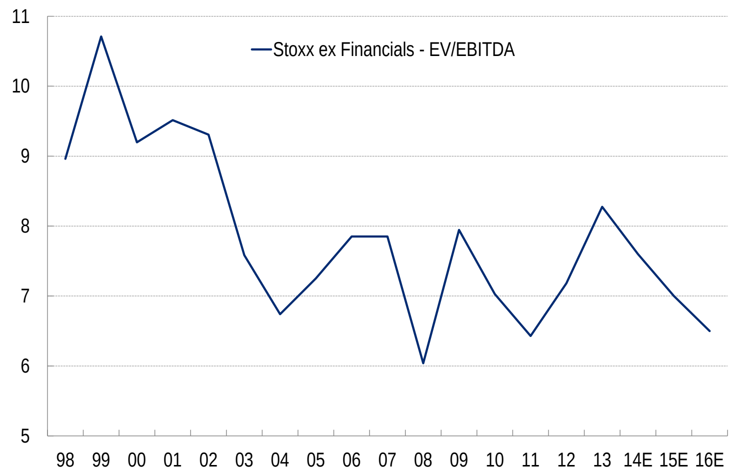
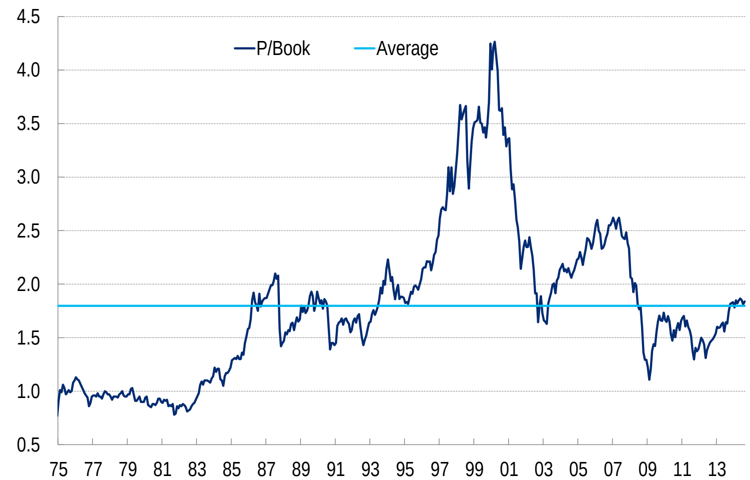


Figure 52. Price to Book



- On a median P/E basis, European equities = stretched. Now at 18x vs 12x in mid-2012. This is why some investors are increasingly nervous.
- 1987, 1994, 1998, 2000 and 2007 also saw high median P/Es ahead of sharp sell-offs or bear markets.
- High median P/Es were sustained through the 2003-07 bull market while earnings growth was delivered.
- On a median DY basis, heading back towards long-run average.

Figure 53. Median P/E

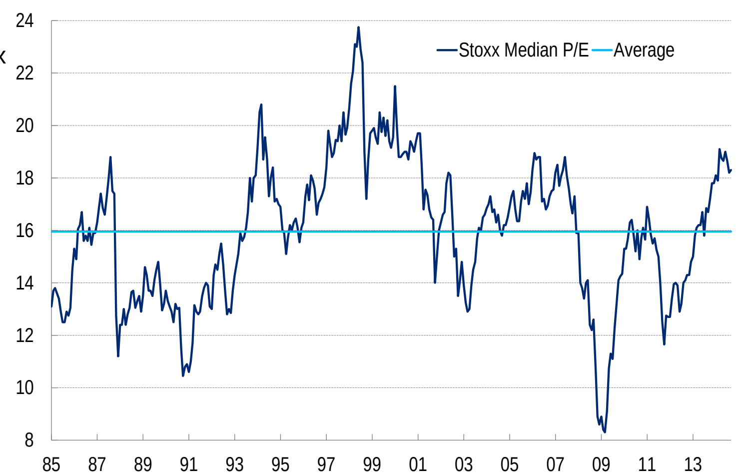
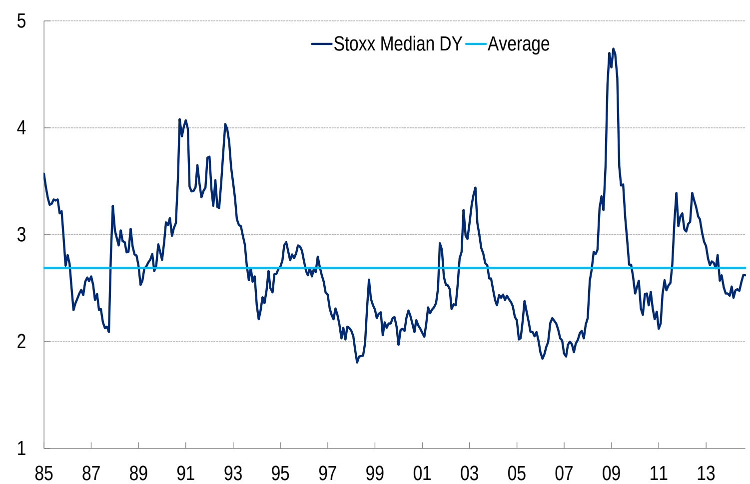


Figure 54. Median DY



Source for all charts: DataStream & Citi Research

Market — Valuation: Europe Cheap vs US on Price/Book, Expensive vs EM on P/E

- European equities look cheap relative to the US on price/book.
- On trailing P/E basis, Europe has almost closed the valuation discount to the US and has sharply re-rated vs EM over the past 2 years.
- This suggests that EM is one of the last regional value trades for global equity investors.

Figure 55. P/Book – Relative

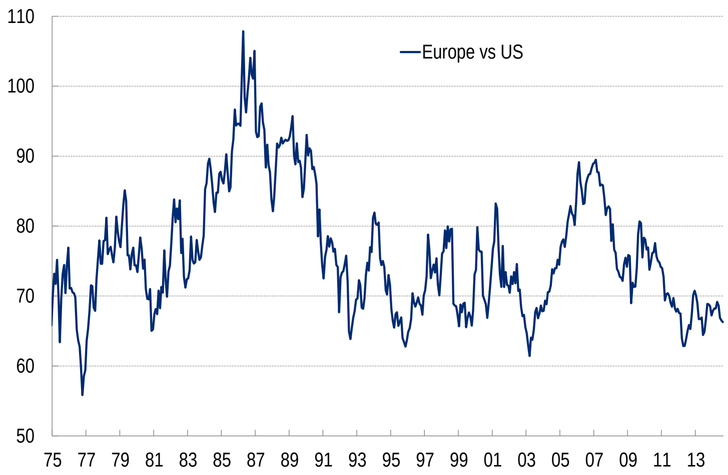
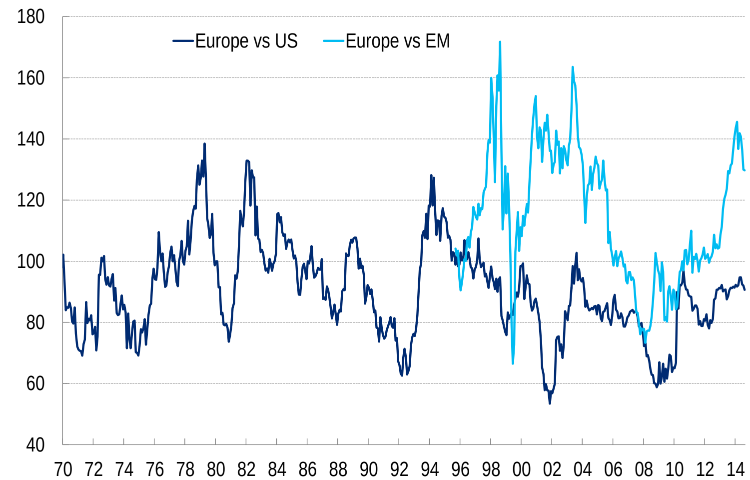


Figure 56. P/E – Relative



- US is most expensive region, but also has highest RoE. Japan has lowest RoE and cheap on price/book. Europe in middle of pack.
- Same ex-financials as whole market on this basis.

Figure 57. P/Book vs ROE

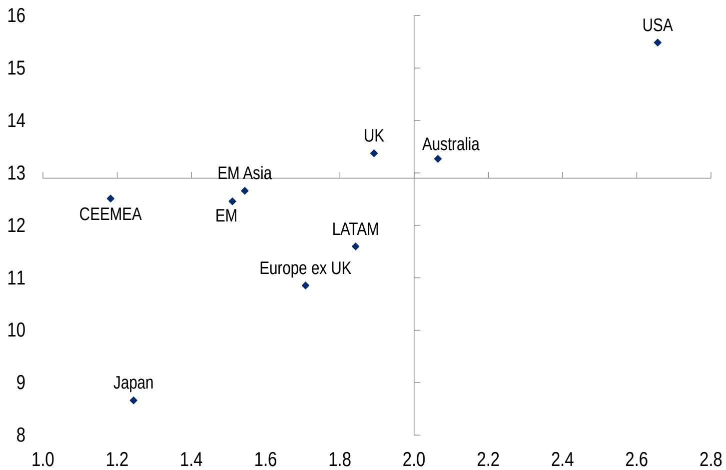
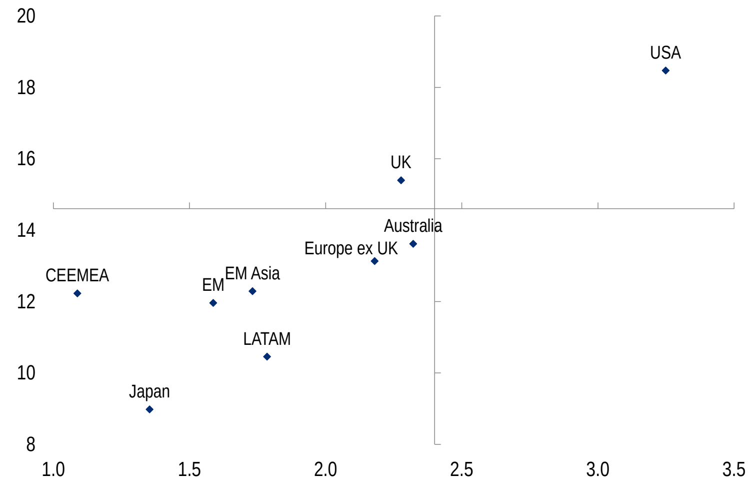


Figure 58. P/Book vs ROE – ex-Fins



Source for all charts: DataStream & Citi Research

Market — Valuation: Equities Super Cheap vs Credit

- European equities look less attractive now vs 2 years ago in absolute terms (eg P/E). But, still look very attractive relative to other asset classes, eg credit, bonds.
- Credit looks as expensive vs equity now as equity did vs credit in 1999-2000. This suggests that CFOs should be using the credit market for funding.

Figure 59. Corporate Bond EYR

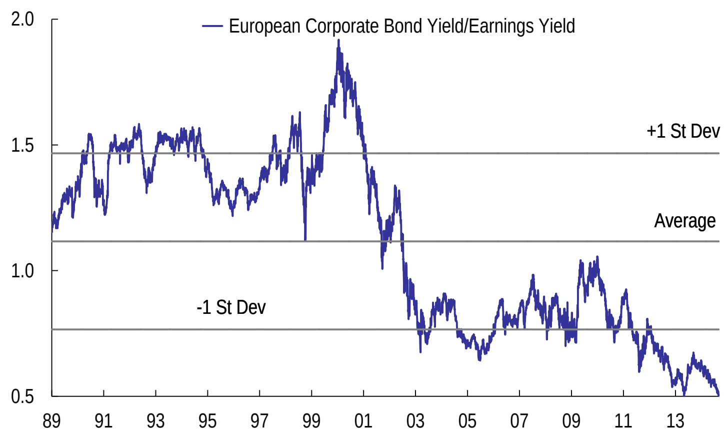
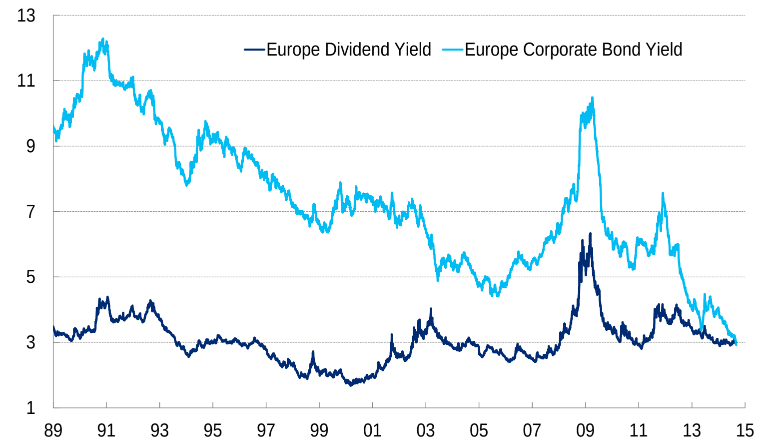


Figure 60. Corporate Bond DY



- Only three counties in Europe have a DY below country benchmark bond yields: Portugal, Ireland and Greece.
- Either equity is super cheap vs government bonds or bonds are super expensive, or somewhere in between.

Figure 61. Country DY vs BY

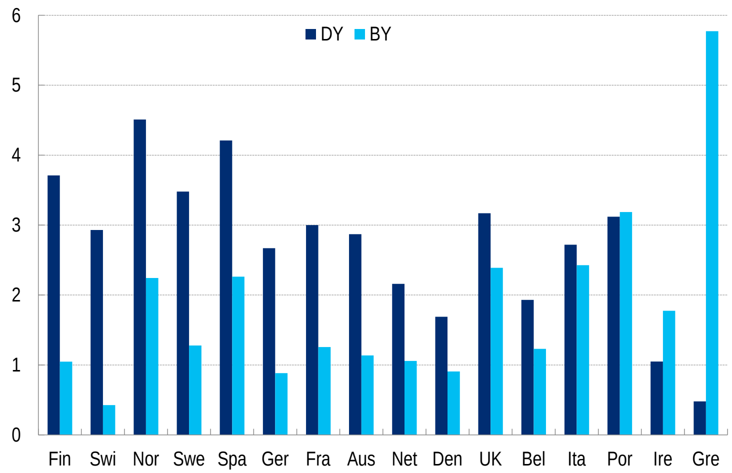
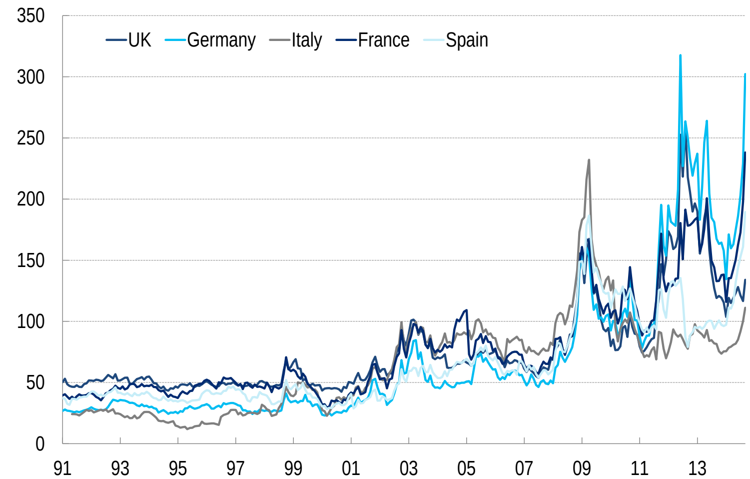


Figure 62. Country DY vs Country Bond Yield



Source for all charts: DataStream & Citi Research

Market — Earnings: Improving…Very Slowly

- Earnings downgrades have been the norm over the past few years alongside sub-par economic growth.
- Near-term macro weakness probably keeps pressure on downgrades, although weaker euro should off-set.
- But, Citi banks team highlights improving underlying earnings, which is encouraging.
- Lead economic indicators support pick up in 2014-15 earnings growth.

Figure 63. Europe Earnings Growth Expectations, 2011-2015

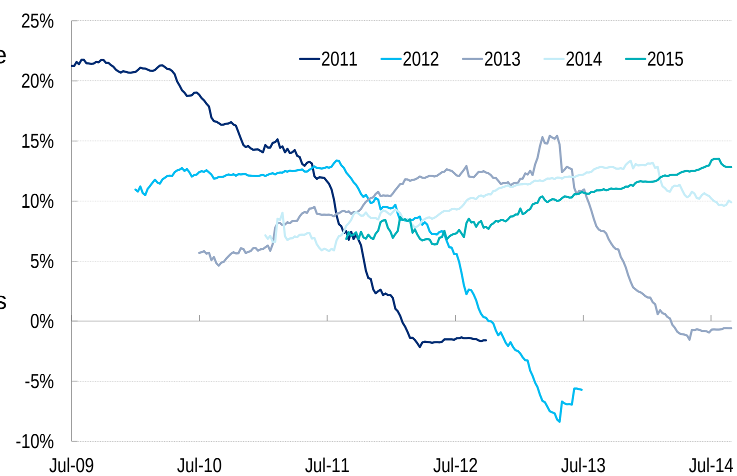
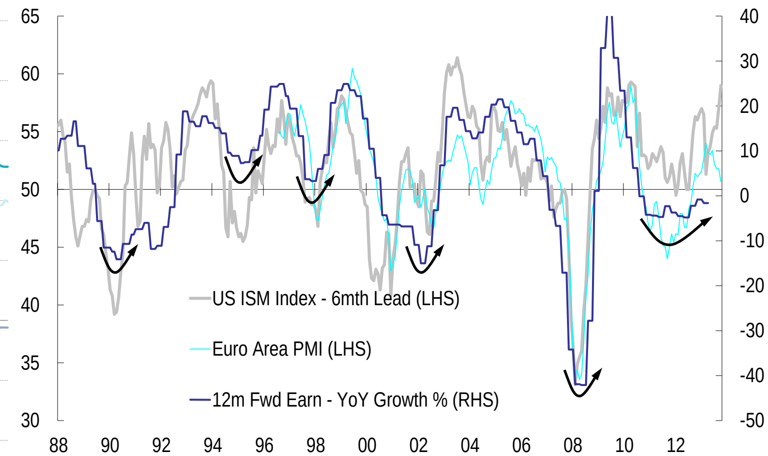


Figure 64. PMIs and Europe Earnings Growth



- Europe ex-UK earnings have been stronger than UK earnings in past 12-18 months despite much stronger macro backdrop in the UK.
- Sector composition, eg heavy commodity skew in UK, and better earnings from ex-UK than UK banks helps to explain.

Figure 65. Europe-UK Earnings Growth Expectations, 2011-2015

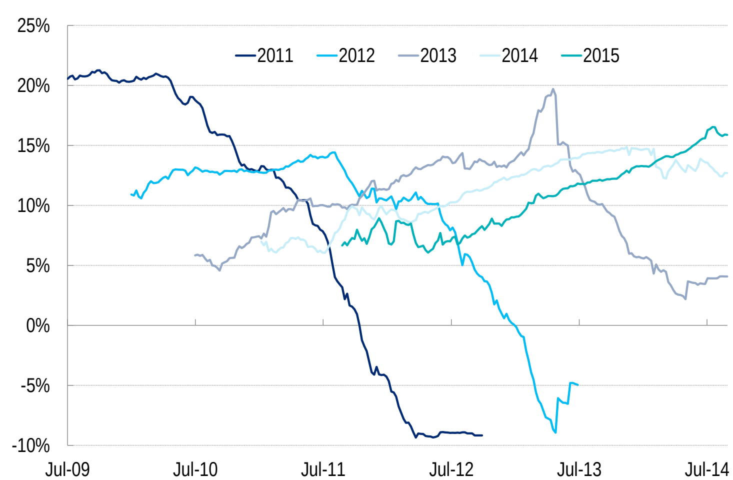
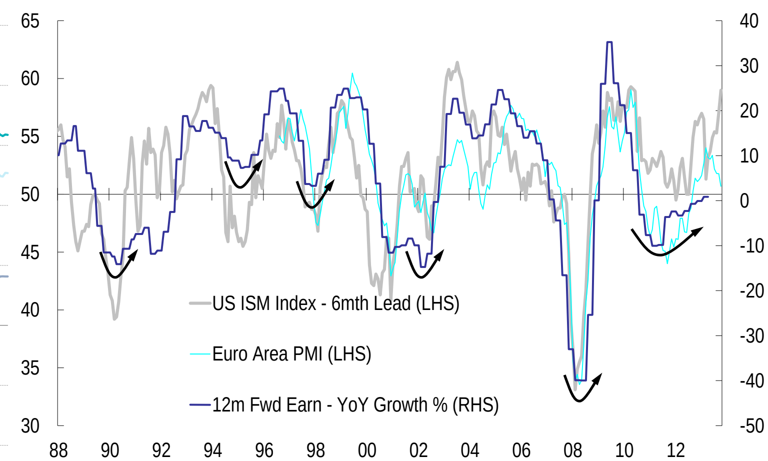


Figure 66. PMIs and Europe ex UK Earnings Growth



Source for all charts: Factset, Haver, DataStream & Citi Research

Market — Earnings: Improving…Very Slowly

- Net downgrades still dominate across Europe, with heavier downgrades in UK.
- Bear case for European equities is that pick-up in earnings growth will not happen.
- We think that sharp economic downturn needed for this scenario, which is unlikely is ECB exercises policy put.

Figure 67. Net EPS Upgrades/Downgrades – Pan Europe

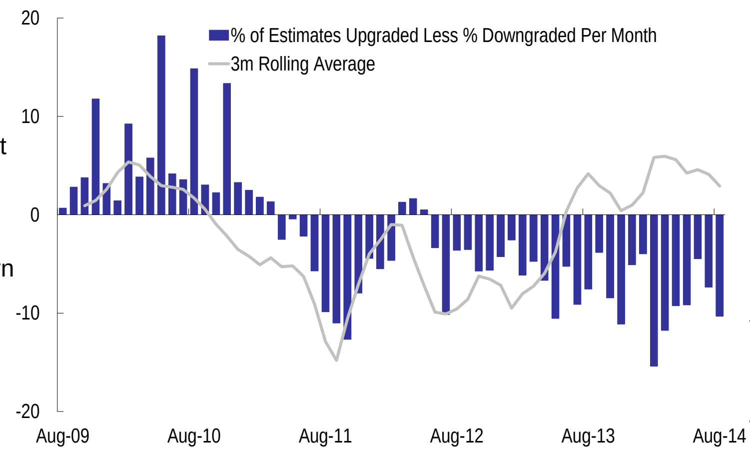
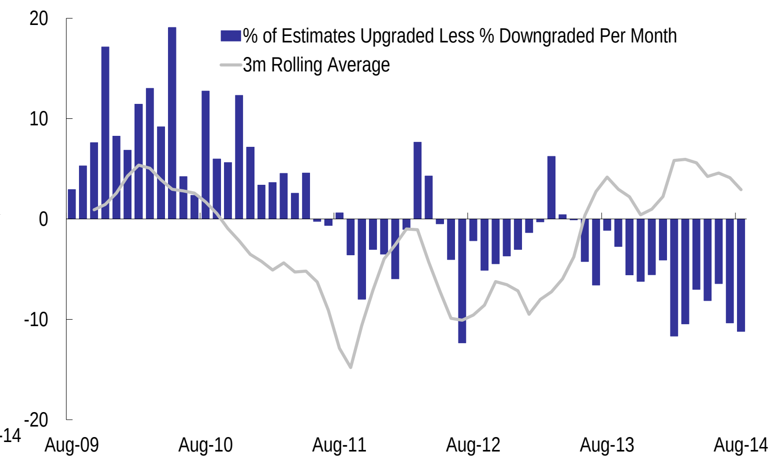


Figure 68. Net EPS Upgrades/Downgrades – UK



- 14 out of 19 European sectors have seen their 12-month forward earnings rise since start-year. Only Health Care, Oil & Gas, Media, Retail and Telcos have seen net downgrades on this basis.
- More downgrades in the UK with 11 sectors in net downgrade territory since start-year. This keeps the UK with the weakest EPS trends of any major market in the world. Big downgrades for big sectors too.

Figure 69. 12m Forward Earnings YTD Delta – Pan Europe Sectors

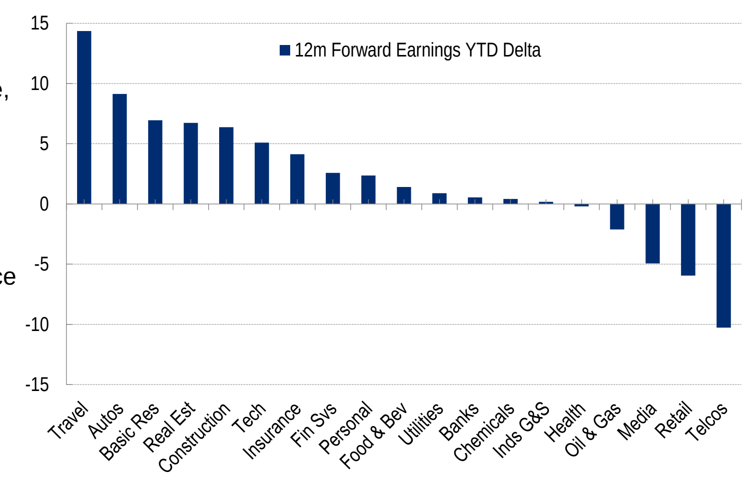
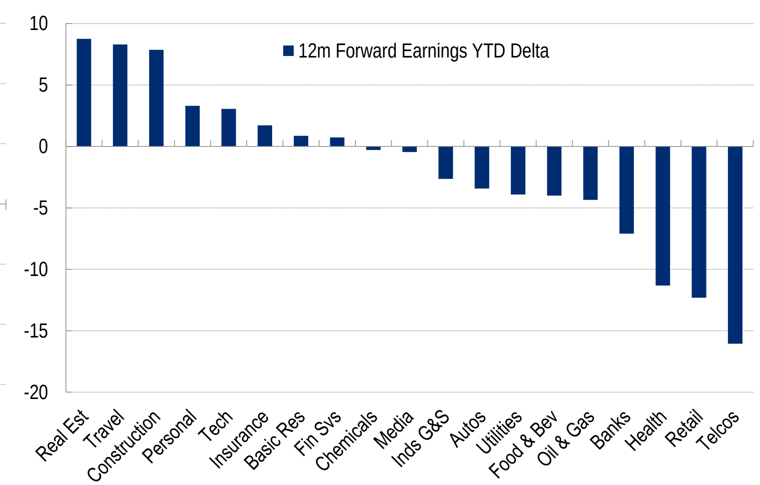


Figure 70. 12m Forward Earnings YTD Delta – UK Sectors



Source for all charts: DataStream & Citi Research

Market — Corporates in Decent Shape

- European balance sheets appear to be in decent shape.
- Record levels of cash on balance sheets as at end-2013.

Figure 71. Net Debt to EBITDA

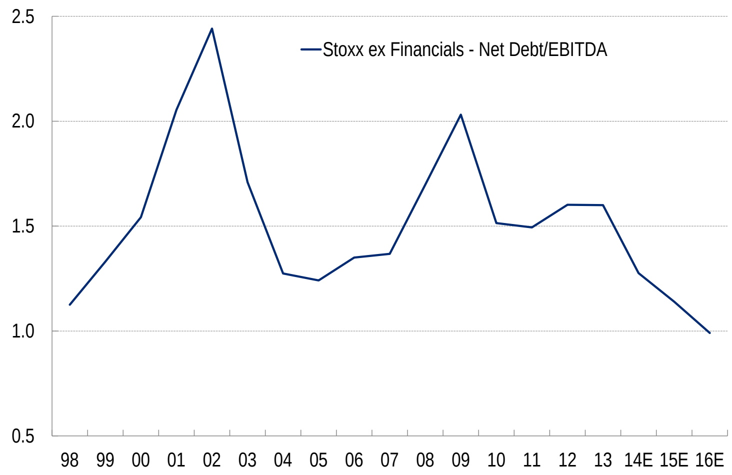
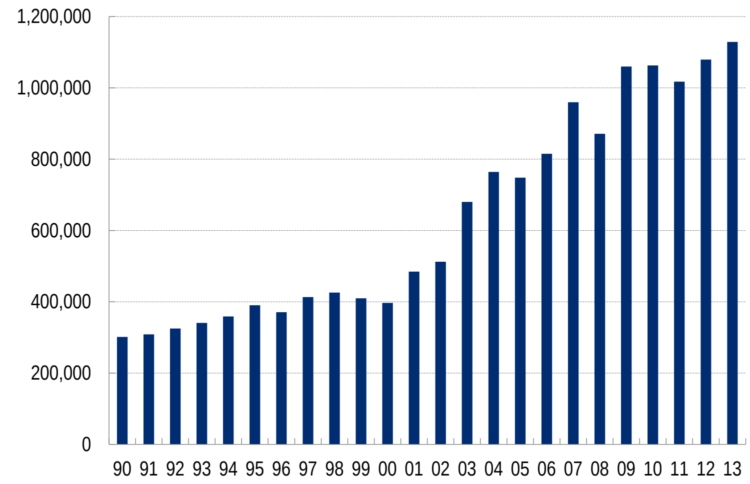


Figure 72. Cash on Balance Sheets ($mn)



- High RoE can often be a warning signal to investors that end-cycle is approaching.
- Global RoEs are some way short of last 2 cyclical peaks
- Europe ex-UK RoEs remain depressed relative to the rest of the world; lower also than EM RoEs.

Figure 73. ROE

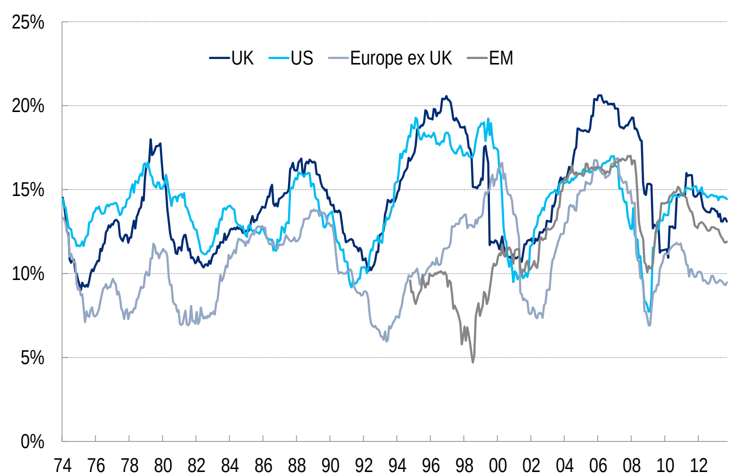
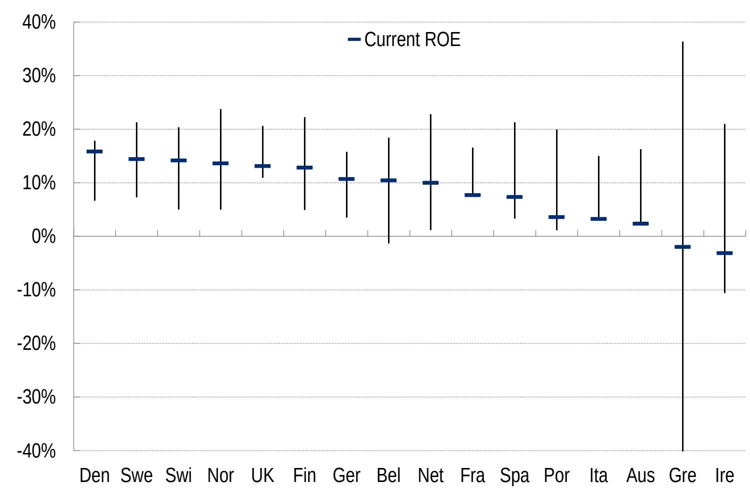


Figure 74. ROE – Current vs History



Source for all charts: MSCI, DataStream & Citi Research

Market — Equities 7, Bonds 0

- German/UK and US equities have higher annualised returns than their respective government bonds over 1, 2, 3, 5, 10, 20 and 25 years = Equities 7, Bonds 0.
- This could force/encourage some investors, eg tourists, away from the bond market.

Figure 75. Germany Annualised Returns (%)

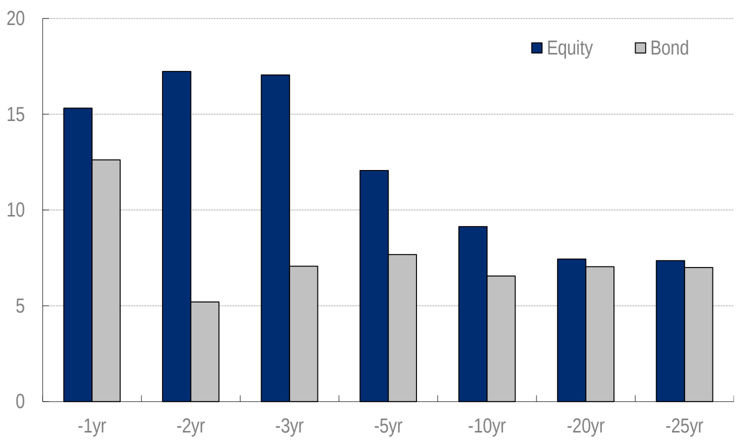
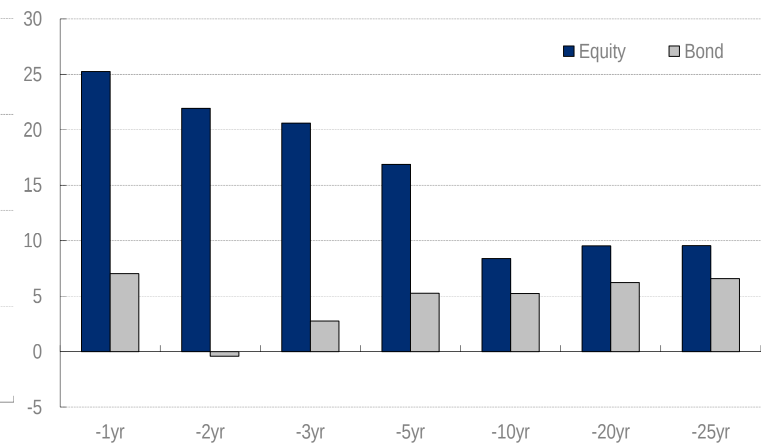


Figure 76. US Annualised Returns (%)



- But, capital flows tend to follow multi-year risk-adjusted returns. Investors tend to like decent returns with low volatility as well. This makes it easier to sleep at night.
- Risk-adjusted return profile much more attractive in US than in Europe.
- Momentum investors will stick with US equities. Liquidity/recovery potential is the story in Europe.

Figure 77. Germany Annualised Risk Adj Returns

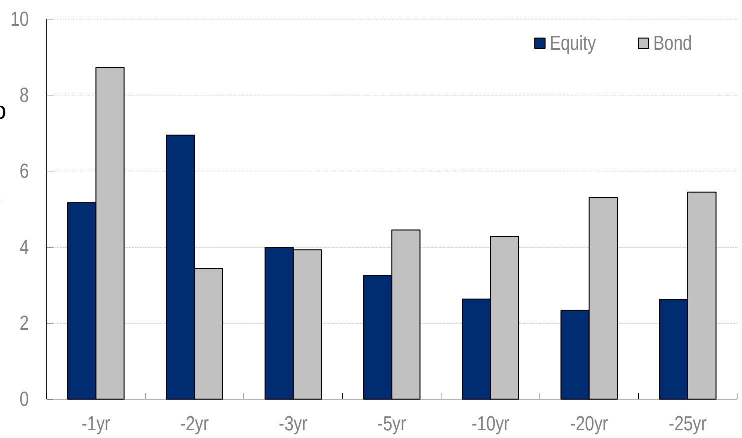
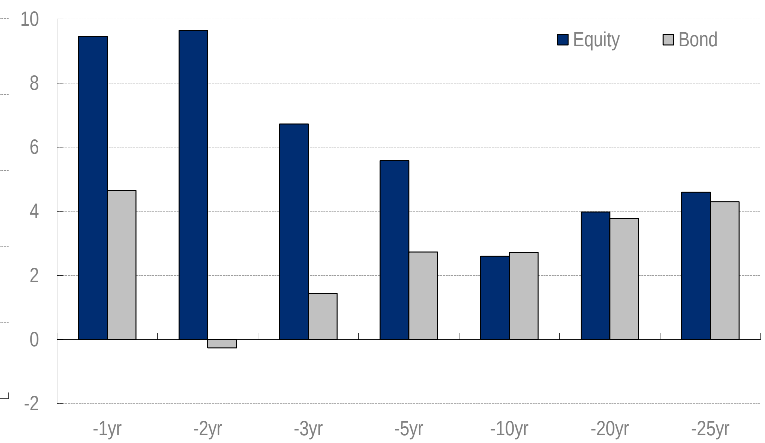


Figure 78. US Annualised Risk Adj Returns



Source for all charts: DataStream & Citi Research

Market — Rolling Risk-Adjusted Returns & Flows

- 5-year risk-adjusted equity returns have only been higher than those for bonds twice previously in the last 25 years: 1) mid/late 1990s, 2) 2007-08.
- Mid/late 1990s saw period of strong multi-year net inflows to equities and strong equity returns. 2007-08 didn't.
- What about now? Economic, profit and financial disaster followed 2007-08. Not our base case now. We back period of net inflows and further equity gains.

Figure 79. Germany Risk Adj Returns (5Y Rolling)

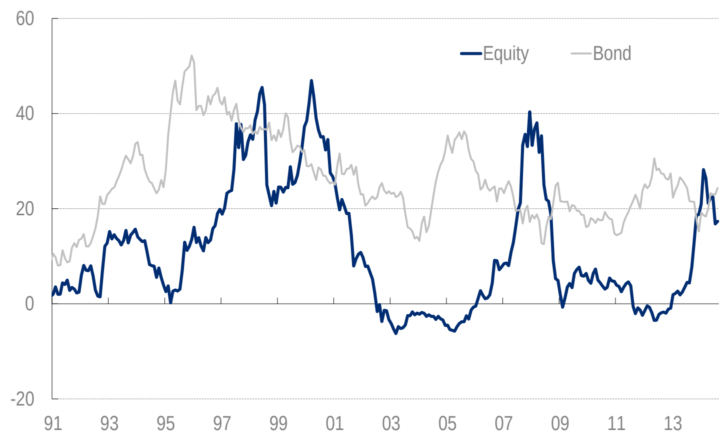
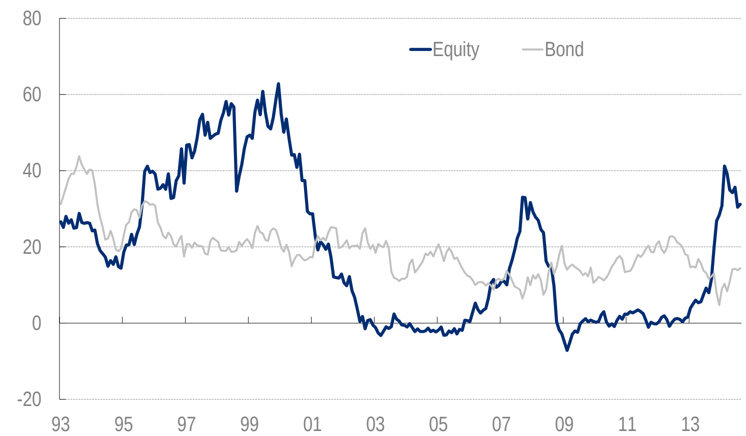


Figure 80. US Risk Adj Returns (5Y Rolling)



- The flow worm has turned. Money started to return to equity in mid-2013; also interesting to see money flowing back to bonds YTD.
- Our credit colleague, Matt King, suggests this reflects a lot of liquidity chasing fewer financial assets, eg global issuance running at c$1tn/year vs c$4tn/year pre-financial crisis.
- Japan and European equities have seen the highest YTD net equity inflows as % of AUM, according to EPFR data; HY outflows.

Figure 81. Flows — Back to Equity

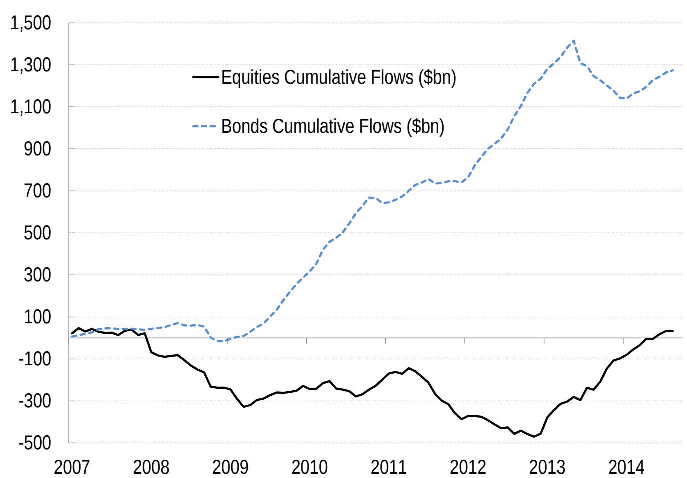
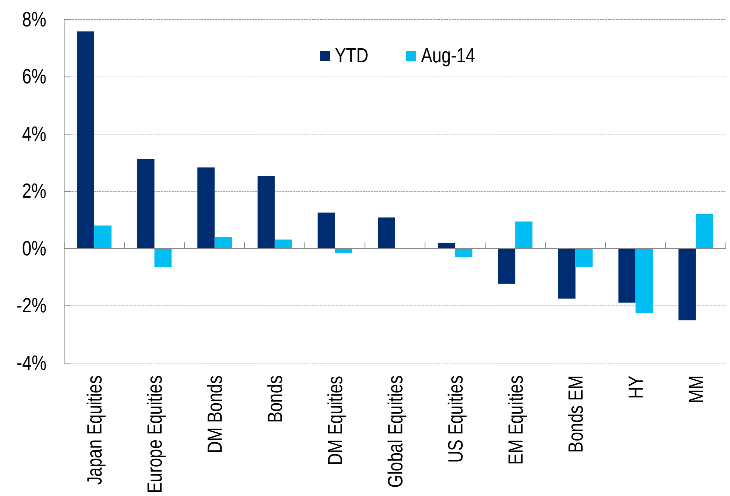


Figure 82. Equity Flows



Source for all charts: EPFR, DataStream & Citi Research

Market — Target Sensitivity

- We maintain our end-14 Stoxx target of 370. This is based on c20% cumulative earnings growth in 2014-15E and a 12-month forward P/E of c14.5x at the end of 2014, slightly higher than current P/Es.
- Liquidity support, ie QE, is likely to be an important support over coming months, in our view, and should counter any near-term fall in earnings expectations.
- End-2015 Stoxx target = 400, based on expectations of annualised earnings growth around 10% through to end-2016 and a 12-month forward P/E of c14.5x.
- This would imply close to 20% total returns from European equities to the end of 2015 from current levels.
- In the UK, target end-2015 FTSE 100 at 8100. This is based on double-digit earnings growth in 2015-16E and an end-2015 12-month forward P/E of around 14-14.5x, slightly above current valuation levels.

Figure 83. Stoxx 600 and FTSE 100 Ready Reckoners for End-2015 Market Targets

Stoxx	Fwd PE at end-2015						
EPS Growth (2015-16)	13.0	13.5	14.0	14.5	15.0	15.5	16.0
10%	320	332	344	357	369	381	394
15%	334	347	360	373	386	399	411
20%	349	362	376	389	402	416	429
25%	363	377	391	405	419	433	447
30%	378	392	407	421	436	451	465
35%	392	408	423	438	453	468	483
40%	407	423	438	454	470	485	501

FTSE 100	Fwd PE at end-2015							
EPS Growth (2015-16)	12.5	13.0	13.5	14.0	14.5	15.0	15.5	16.0
5%	6,248	6,498	6,748	6,998	7,248	7,498	7,748	7,998
10%	6,546	6,808	7,069	7,331	7,593	7,855	8,117	8,379
15%	6,843	7,117	7,391	7,665	7,938	8,212	8,486	8,759
20%	7,141	7,427	7,712	7,998	8,283	8,569	8,855	9,140
25%	7,438	7,736	8,034	8,331	8,629	8,926	9,224	9,521
30%	7,736	8,045	8,355	8,664	8,974	9,283	9,593	9,902
35%	8,034	8,355	8,676	8,998	9,319	9,640	9,962	10,283

Source: Citi Research

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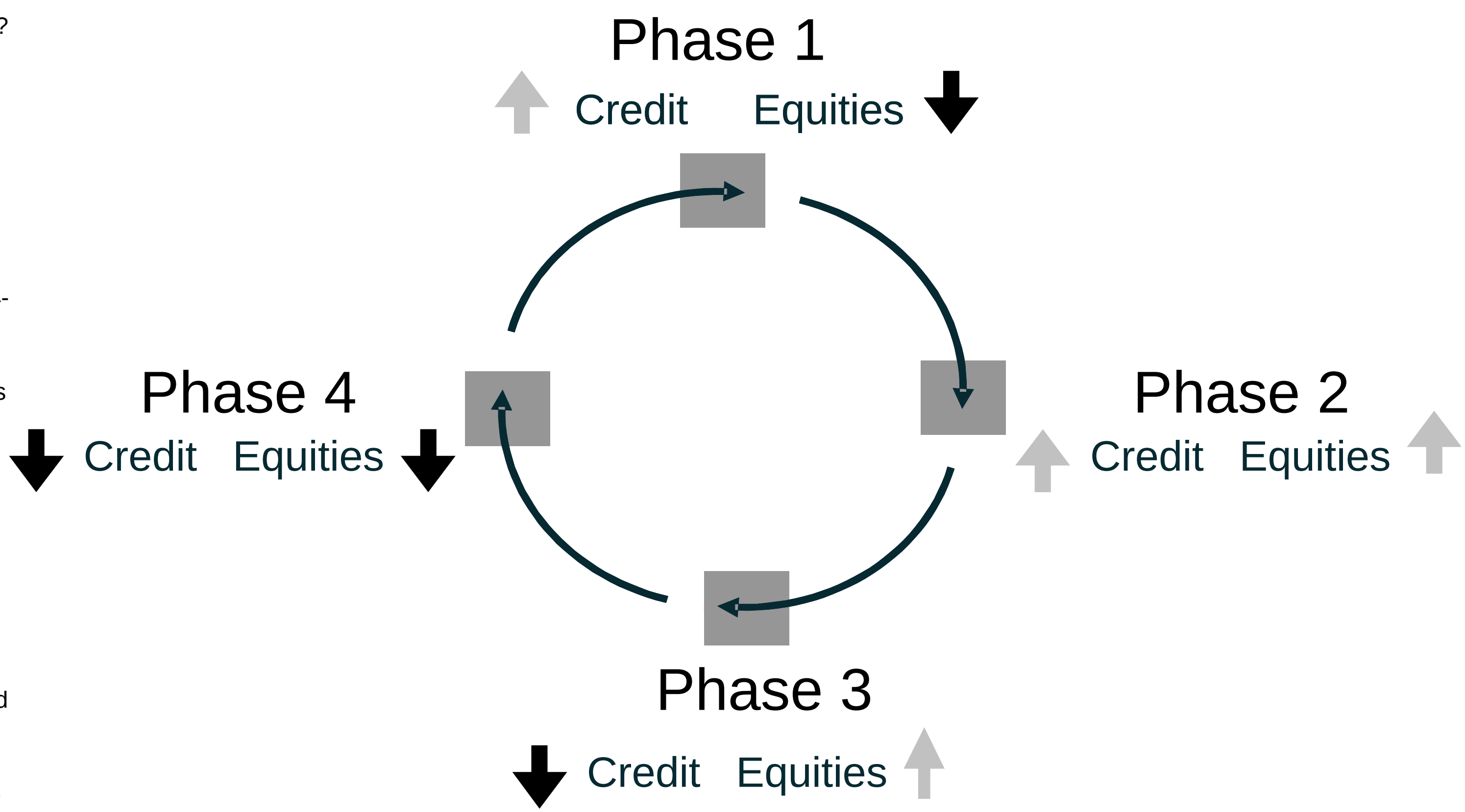
Key Themes — Policy Divergence: Position for QE

Key Investment Theme #1 — Where in the Cycle?

- The key question for investors to answer is always: "where in the cycle"? Get that right, or close to right, and investment decisions become easier.
- The relationship between credit and equity cycles offers a framework for discussing this question; we use Matt King's original credit clock concept.
- We have been in Phase 2 for the last 4-5 years. Here, equity and credit enjoy positive returns, generally as there is enough EPS/FCF for both bondholders and shareholders (although in Europe's case equity gains have recently been re-rating and little EPS).
- Our credit colleagues worry that we could be nearing a turn in the credit cycle with spreads heading higher as US heads towards a tightening cycle and as corporate leverage re-asserts its relationship with spreads. This could suggest Phase 3 of the cycle.
- But, in Europe, QE could sustain credit spreads tighter and lower for longer. In turn, we believe that this can support higher share prices while we wait for a more decisive improvement in the economic and hence EPS cycle.

Figure 84. Credit/Equity Cycle



Source: Citi Research

Key Investment Theme #1 — Where in the Cycle?

- Figure 85 shows how US HY spreads have moved through the 4 Phases of our credit/equity cycle. Figure 86 shows the same for global equities.
- Credit tends to lead equity at the end and start of each cycle, although the lead time varies from cycle to cycle.
- This tells us that credit is an important warning flag to equity investors trying to answer the "cycle" question.

Figure 85. US HY Spreads* Through Credit Cycles (bp)

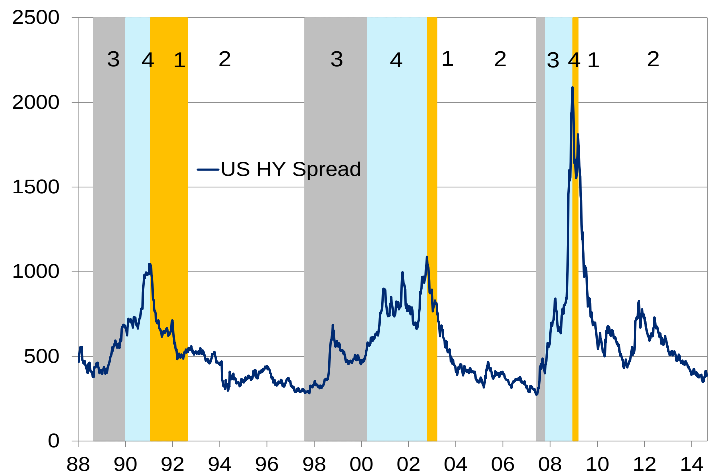
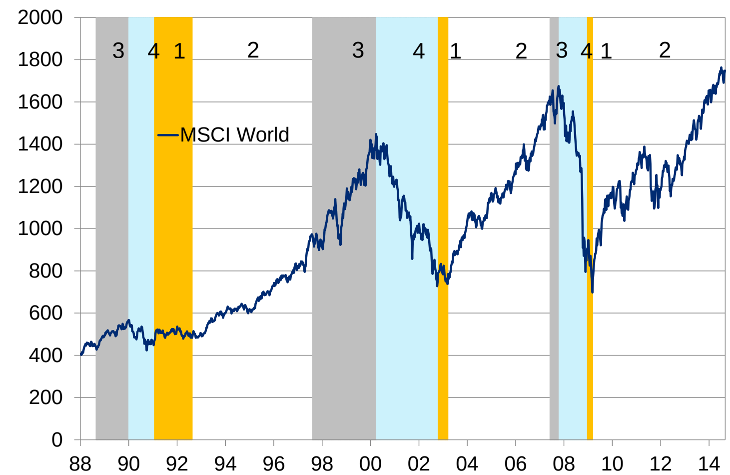


Figure 86. MSCI World Through Credit Cycles



- Figure 87 shows similar for European HY spreads. These have moved in tandem with US spreads over the past 15+ years. Divergent ECB/Fed policy over coming quarters may change this relationship a little.
- Figure 88 repeats for European equities. The last 2 Phase 4 periods have been violent with TMT unwind and GFC.

Figure 87. EUR HY Spreads** Through Credit Cycles (bp)

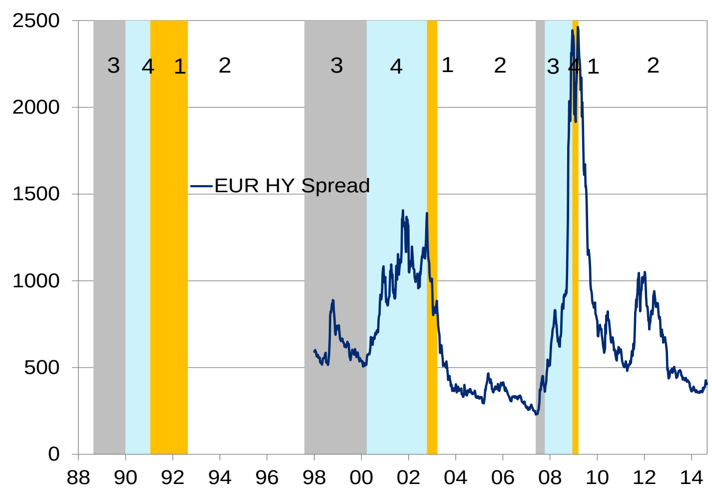
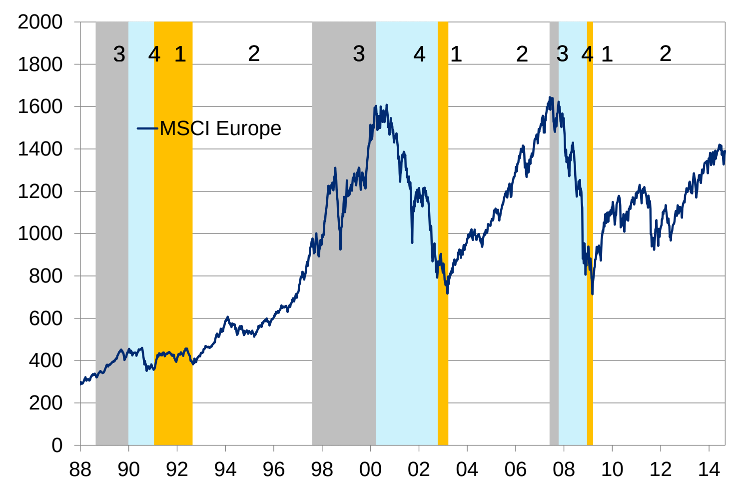


Figure 88. MSCI Europe Through Credit Cycles



Source for all charts: DataStream & Citi Research. *US High Yield minus UST 7Y Yield. **EUR High Yield minus 10Y Bunds Yield

Key Investment Theme #1 — Where in the Cycle?

- Phase 2 of the credit/equity cycle tends to be long. The current Phase 2 is the longest of the three cycles we have the data to study.
- Phase 1 tends to be the shortest in duration, ie equity turns quickly after credit at the start of the cycle.
- Phase 3 (and 4) have less consistency of duration. In 2007, this Phase lasted 3-4 months vs 30+ months in the late 1990s.
- HY spread widening was small in 2007 before Phase 4 ripped.

Figure 89. Duration Of Credit Cycle Phases (Months)

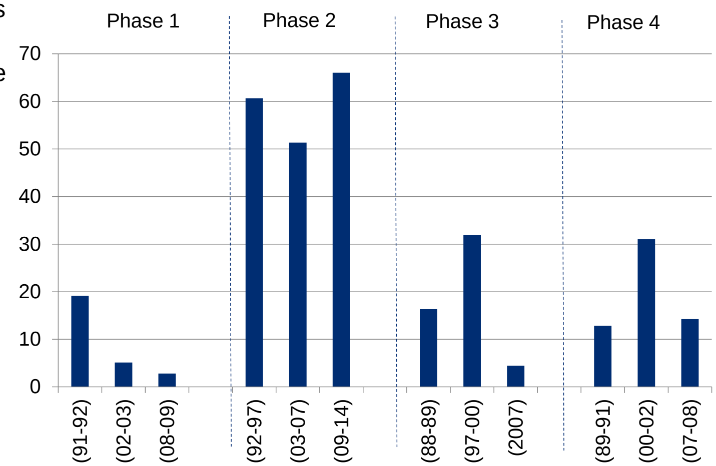
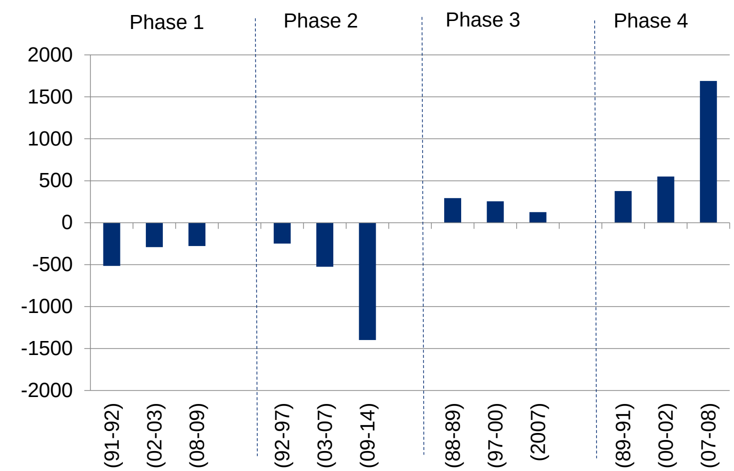


Figure 90. US HY Spread Moves During Credit Cycle Phases (bp)



- This is already the best Phase 2 for equity performance. Phase 3 performance averages over 25%, but with wide variability. Phase 4 is best avoided, if possible.

Figure 91. Global Equity Price Performance During Credit Cycle Phases

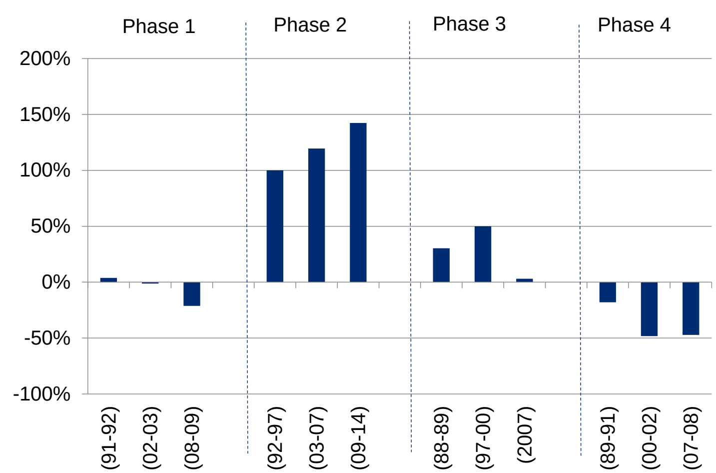
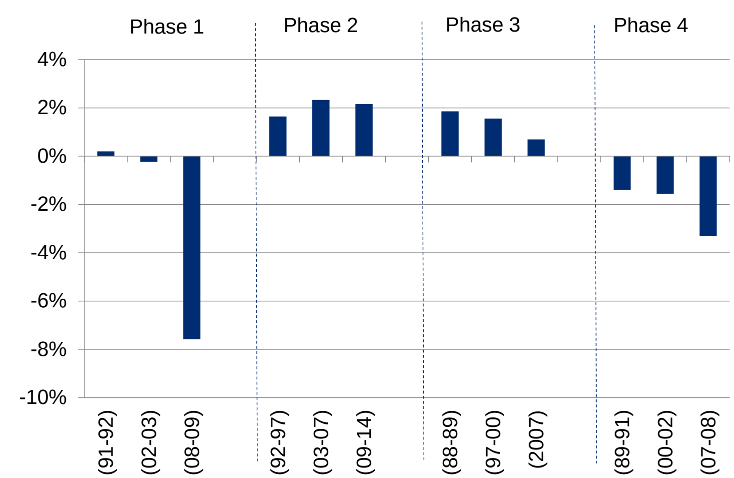


Figure 92. Global Equity Price Performance Per Month



Source for all charts: DataStream & Citi Research

Key Investment Theme #1 — Where in the Cycle?

- Given the length of the current Phase 2, the brevity of Phase 3 in 2007, signs of increasing corporate leverage and our credit colleagues' view, we think that it is prudent to consider risks that we could flash through Phase 3 to Phase 4 once again...time for a good old checklist.
- Our analysis of market variables, eg valuation, RoE etc, and macro variables, eg output gap, business investment etc, suggested that there are few flags currently warning that investors should be treading carefully.
- The pace of IPOs is the only factor that draws comparison to previous end of Phase 3. In fact, most macro variables, in the US as well as in Europe, suggest that we are closer to early cycle than late cycle, eg output gaps, policy rates.

Figure 93. Checklist For End Of Phase 3 – Should we be Worried?

	EurxUK	UK	US/Global
Equity Valuations			
CAPE	No	No	No
PB	No	Yes	No
DY	No	Yes	No
Policy Rate	No	No	No
Yield Curve (10Y minus 2Y)	No	No	No
EPS	No*	No*	No*
Capex	No	No	No
RoE	No	No	No
Net Debt/EBITDA	Perhaps**	Perhaps**	Perhaps
M&A	No	No	No
IPOs	No	Yes	Yes
HY Spread	Not yet	Not yet	Not yet
Business Investment	No	No	No
Unemployment	No	No	No
Output Gap	No	No	No

Source: Citi Research. * = EPS fell sharply in 2007-08; we expect EPS growth to be 9-10% in 2014-15E globally and c10% annualized in Europe over the next 2 years. **Corporate balance sheets do not look stretched unless Ebitda collapses from here, this is not our base case.

Key Investment Theme #1 — Where in the Cycle?

- Earnings fell sharply after Phase 4 in the early 1990s, but ahead in the last two cycle. The 2008-09 earnings cycle was particularly brutal. We expect global EPS to rise by 9-10% annualised in 2014-15E not collapse.
- Global RoEs have been above 13% prior to previous Phase 3 to 4 transitions, currently 12%.

Figure 94. MSCI World EPS (log scale) Through Credit Cycles

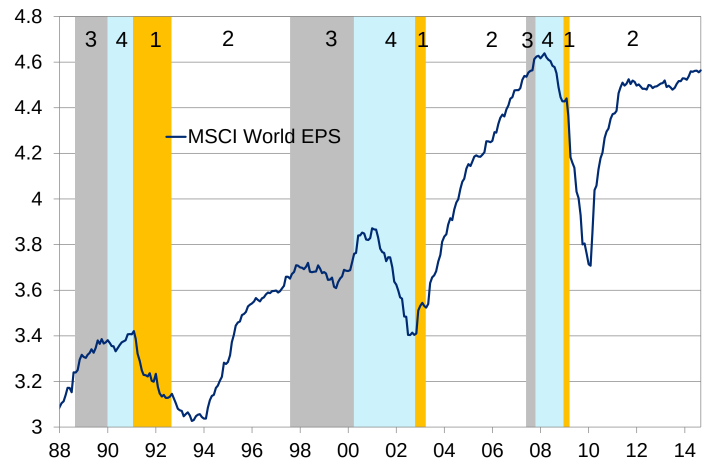
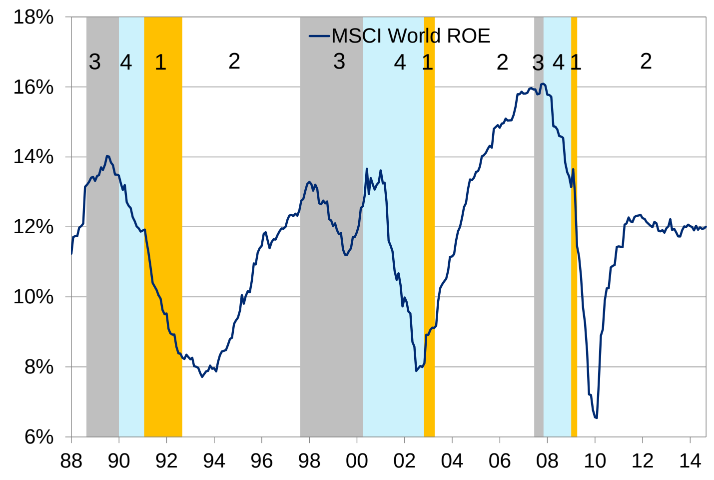


Figure 95. MSCI World RoE Through Credit Cycles



- In Europe, RoE and EPS are more depressed. There are signs that EPS trends are stabilising although recent macro weakness may challenge this. RoE, remarkably, is not far off the end cycle lows of 1993, 2003 and 2009.
- This suggests: 1) potential for RoE recovery over the next couple of years, and 2) hard to see end-cycle RoE levels unless economic growth is about to collapse, ie no effective policy put; we think this is very unlikely.

Figure 96. MSCI Europe EPS (log scale) Through Credit Cycles

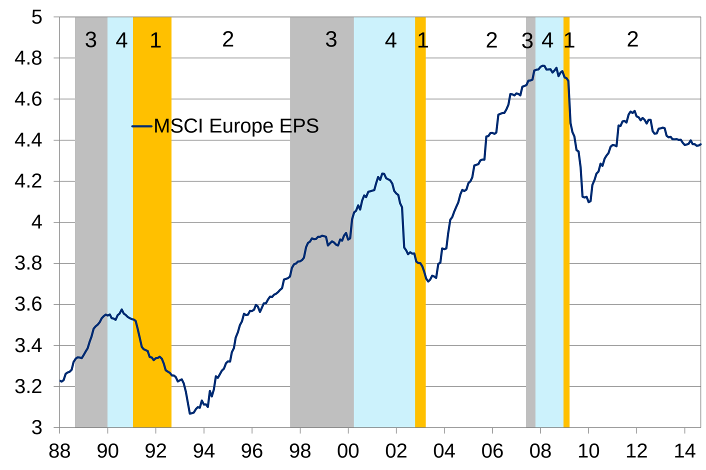
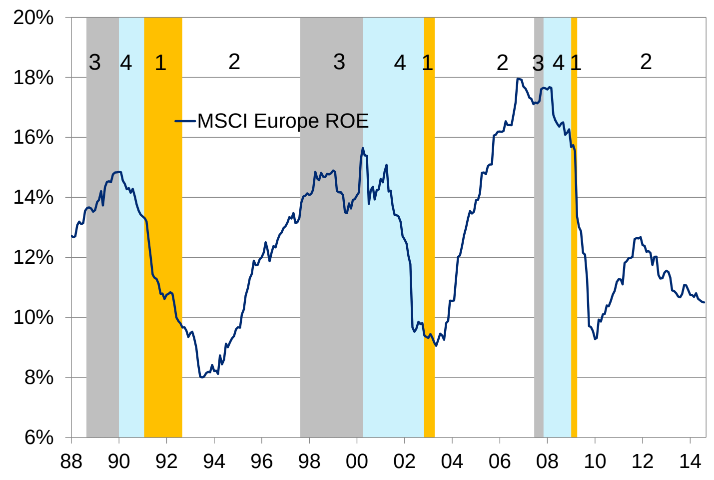


Figure 97. MSCI Europe RoE Through Credit Cycles



Source for all charts: DataStream & Citi Research

Key Investment Theme #1 — Where in the Cycle?

- Policy rates suggest early not late cycle. Rates still at rock bottom. Output gaps also negative in US and Europe suggesting far from late cycle.

Figure 98. Policy Rates Through Credit Cycles

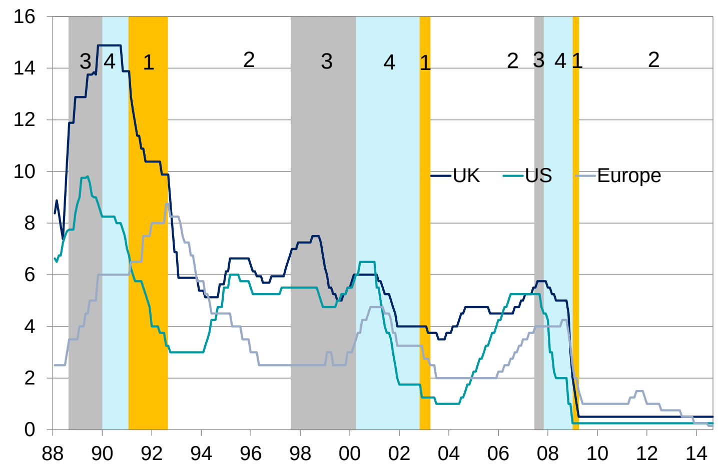
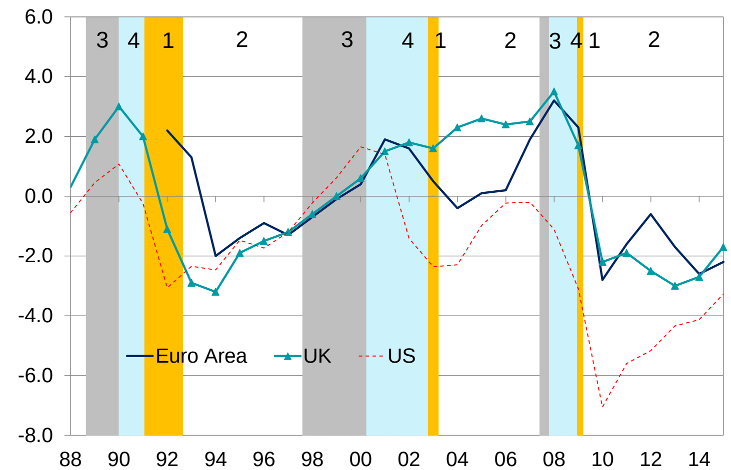


Figure 99. Output Gaps as % of Potential GDP Through Credit Cycles



- Matt King cites liquidity risk in less liquid credit markets as key risk for investors to monitor.
- Phase 3 periods have historically brought bubbles to equity markets, eg Japan, TMT, EM.
- Perhaps another round of equity bubble fun in yet to come...we would not be surprised, as we speculated as early as January 2009...

Figure 100. US Credit Mutual Fund Assets Vs. Dealer Inventory ($bn, IG+HY)

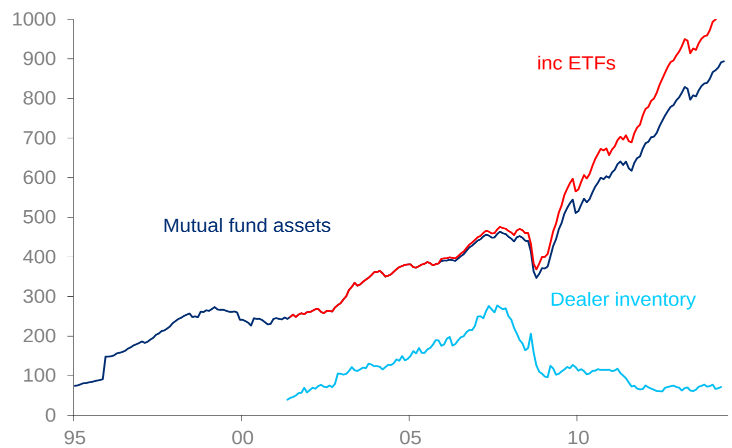
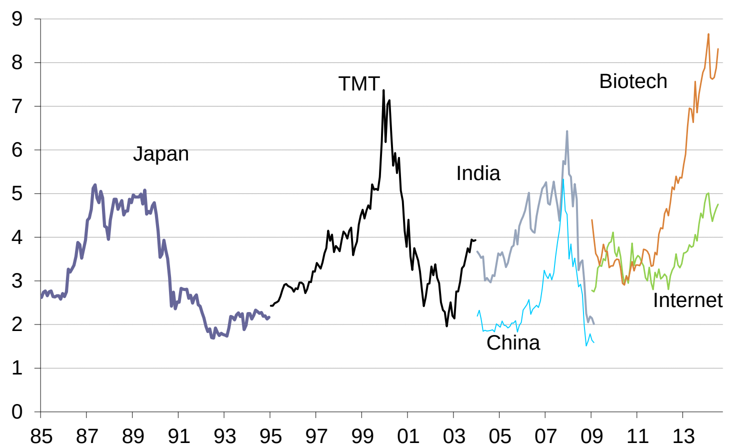


Figure 101. P/B Through Equity Bubbles

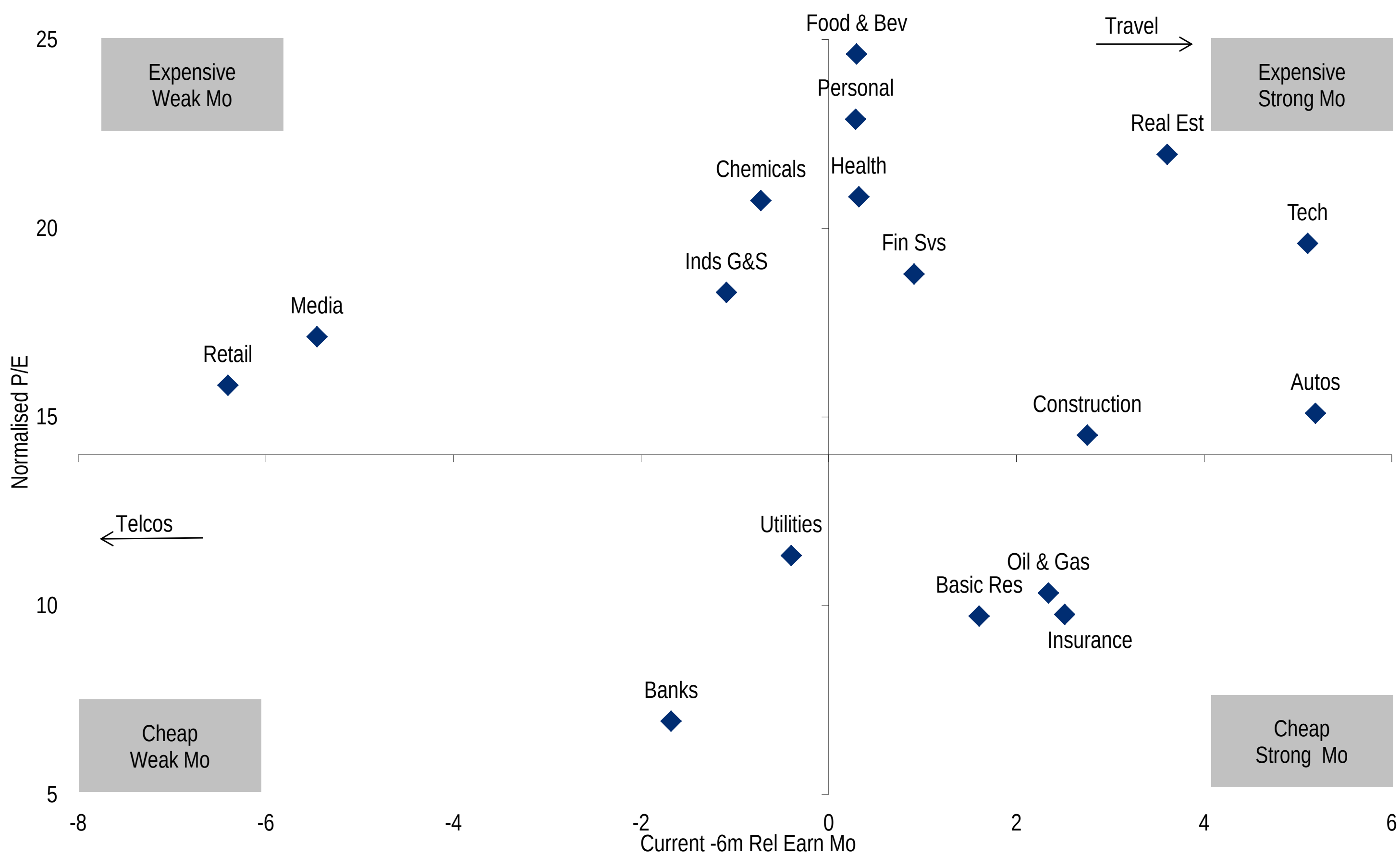


Source for all charts: ICI, NY Fed, Bloomberg, Haver, DataStream & Citi Research

Key Investment Theme #1 — Where in the Cycle?

- If the world is some way from late cycle and if Europe is earlier cycle, as would be suggested by both market and macro variables, then it is sensible for investors to have exposure to sectors/countries with potential for earnings recovery from depressed levels.
- Sectors that look cheap on a normalised P/E, ie cheap relative to trend 10-year earnings, and which also have positive 6m relative earnings trends are Insurance, Oil & Gas and Basic Resources. We are Neutral Oil and Overweight the others.
- Banks looks cheap on this basis, although the sector is unlikely to return to previous earnings levels, but has negative earnings trends vs the market. Our analysts suggest that on an underlying earnings basis, ie excluding exceptionals such as litigation penalties, the sector would score better on earnings metrics.

Figure 102. Relative Earnings Mo vs. Normalised P/E – Sectors

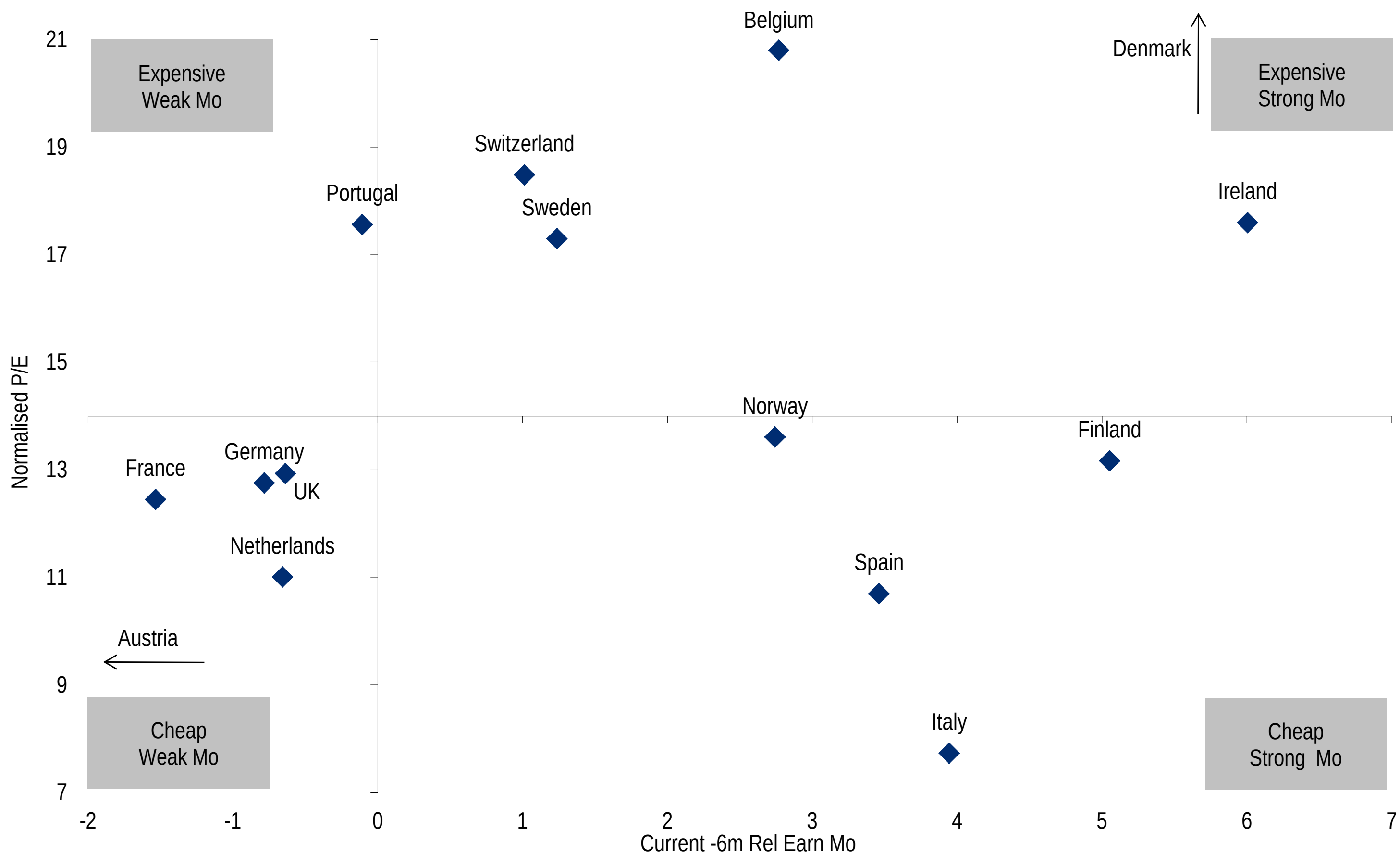


Source: DataStream & Citi Research

Key Investment Theme #1 — Where in the Cycle?

- Italy and Spain are the stand-out markets which look cheap on a normalised P/E and which also have positive 6m relative earnings trends.

Figure 103. Relative Earnings Mo vs. Normalised P/E – Countries



Source: DataStream & Citi Research

Key Investment Theme #1 — Where in the Cycle?

- At a stock level, Financials dominate the low normalised P/E and positive earnings screen.

Figure 104. Cheap on Normalised P/E & Positive 6 month Relative Earnings Momentum Screen

		>€5bn	<10	>0
RIC	Stock	Market Cap	Normalized P/E	-6m Rel Earn Mo
RBS.L	Royal Bank Of Sctl.Gp.	10256	1.3	28
CBKG.DE	Commerzbank	10882	1.8	5
POP.MC	Banco Popular Espanol	8896	3.1	7
CRDI.MI	Unicredit	32316	3.7	23
LLOY.L	Lloyds Banking Group	51359	5.4	13
CAGR.PA	Credit Agricole	12443	6.2	3
ING.AS	ING Groep	40414	6.3	2
UBI.MI	UBI Banca	5361	6.7	19
AEGN.AS	Aegon	11028	6.8	2
AAL.L	Anglo American	27112	6.8	0
RENA.PA	Renault	12332	7.5	2
AV.L	Aviva	19352	7.7	8
UBSN.VX	UBS R	48898	7.8	2
BP.L	BP	111825	7.9	2
KBC.BR	KBC Groupe	10665	7.9	1
ISP.MI	Intesa Sanpaolo	31628	8.4	16
AXAF.PA	AXA	38950	8.8	0
BBVA.MC	BBV Argentaria	54221	9.0	5
NOK1V.HE	Nokia	23949	9.0	22
SABE.MC	Banco De Sabadell	9098	9.3	43
ENEI.MI	Enel	25657	9.3	4
VIE.PA	Veolia Environnement	6105	9.4	21
TKAG.DE	ThyssenKrupp	9202	9.5	41
REP.MC	Repsol Ypf	18187	9.9	0

Source: DataStream & Citi Research

Key Investment Theme #2 — Policy Divergence: ECB Easing vs Fed Tightening

- Central banks have had to dig deep into their tool-kits following the 2008-09 global financial crisis. Interest rates have headed towards 0% and QE has been used in the UK, US and Japan.
- During the 7 QE periods of the last few years equity has performed well.
- Running a long equity strategy in the 3 months ahead of a QE programme has been less effective.
- Our economists expect ECB QE in coming months.

Figure 105. Asset Returns During QE

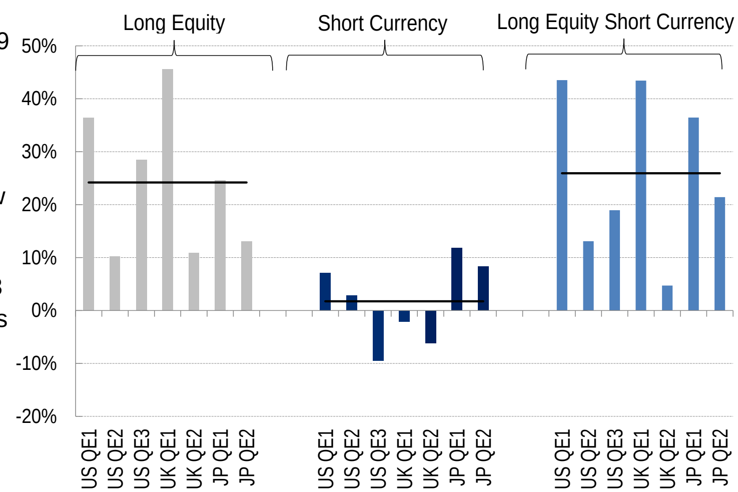
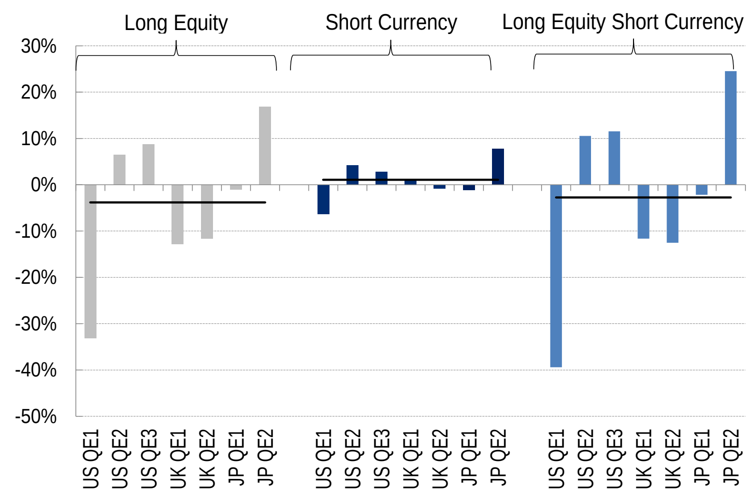


Figure 106. Asset Returns During 3 Months Before QE



- Credit has also performed well during these 7 QE programmes, while government bond performance has been mixed.
- Government bonds, however, have performed well in the months ahead of QE programmes.

Figure 107. Asset Returns During QE

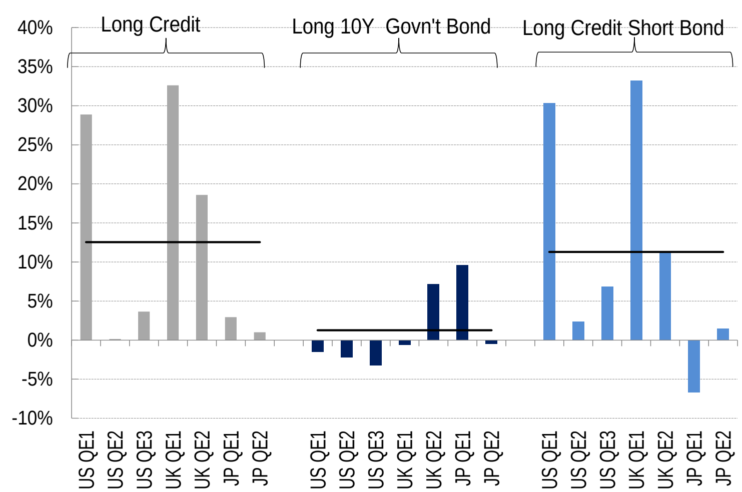
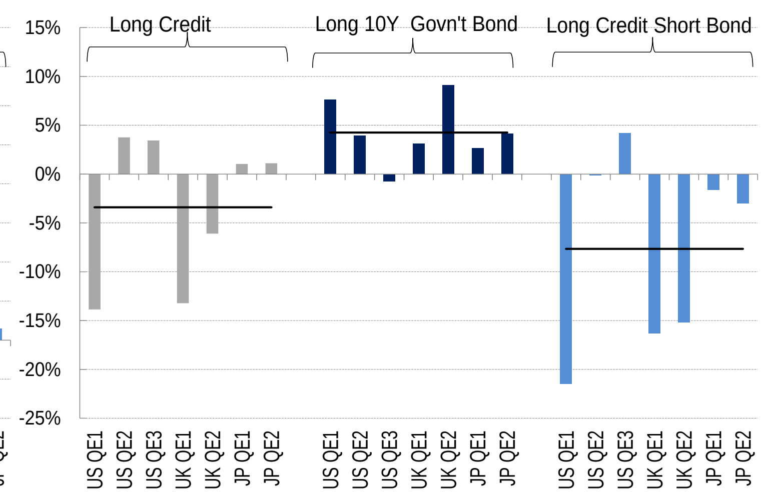


Figure 108. Asset Returns During 3 Months Before QE

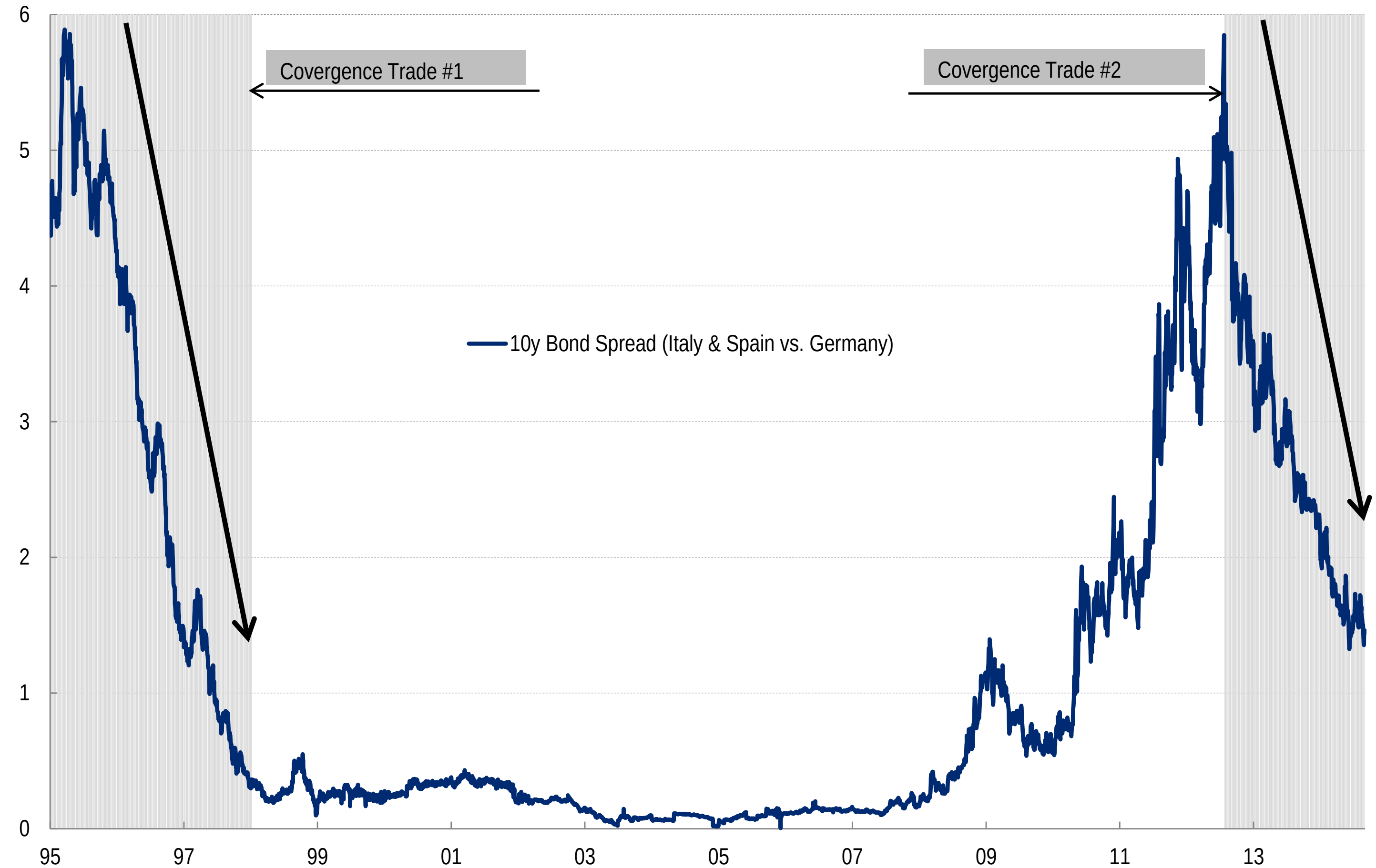


Source for all charts: DataStream & Citi Research

Key Investment Theme #2 — Policy Divergence: ECB Easing vs Fed Tightening

- 1995-98 was the original convergence trade in Europe. Bond spreads between the periphery and core collapsed from 600 bps to close to parity as countries moved to comply with Maastricht criteria ahead of the launch of the euro in 1999.
- There were some spectacular moves in European bond yields in the mid-late 1990s. For example, 10-year BTP yields fell from c14% in early 1995 to sub-4% in early 1999. Equity markets and financials were carried along for the ride.
- Since Draghi's "bumble bee" speech in July 2012, there has been a second European convergence trade, no less spectacular than the first. Italian/Spanish bond spreads have fallen from a 600 bp average to below 150 bps in less than two years.
- Our key message is: "Don't fight the ECB". QE would likely provide further fuel for the current convergence trade to support equities, financials/domestic cyclicals & periphery. Stay long Euro banks into end-year.

Figure 109. Convergence Trades, Part I & II — ECB QE: More Fuel for Current Convergence Trade



Source: DataStream & Citi Research

Key Investment Theme #2 — Policy Divergence: ECB Easing vs Fed Tightening

- Italian equities have re-rated sharply, in price/book terms. But, have only recovered their pre-crisis levels.
- Italian equities remain cheaper than pre Convergence Trade #1 in 1995. Then, 10-year BTP yields were 14% vs 3% now.
- Further liquidity support for peripheral fixed income securities should also provide further support to peripheral equities, including bank shares, especially if ECB QE is partly aimed at bank assets.

Figure 110. Price/Book and Bond Yield Absolute

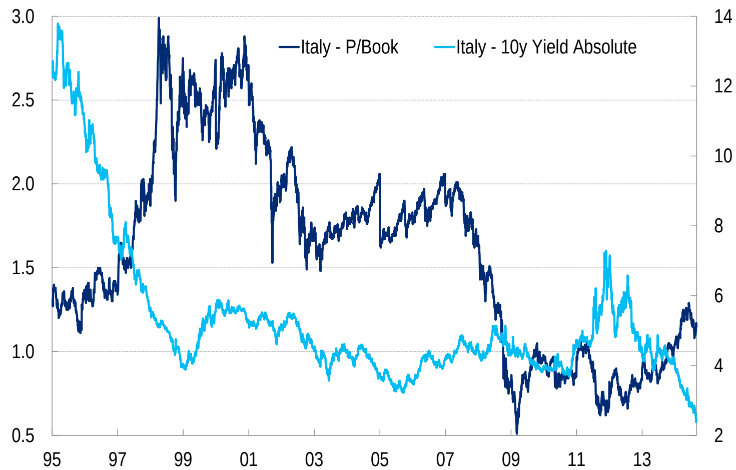
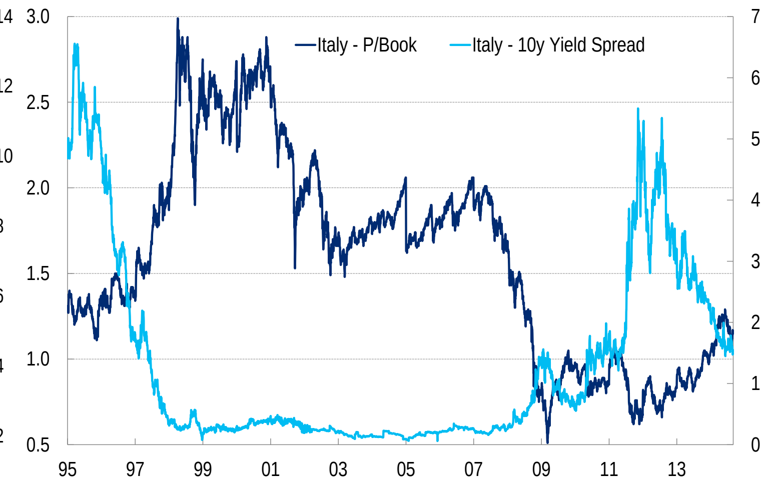


Figure 111. Price/Book and Bond Yield Spread



- In relative terms, Italian equities followed Italian bonds on the way down, between 2009/10 and 2011/12.
- Italian equities left behind on the way back up. This suggests that Italian bonds have been bigger beneficiaries of liquidity support than Italian equities.
- Figure 79 shows that Italian equities have performed in line with their relative earnings performance in the last few years. Better earnings needed for sustain outperformance.

Figure 112. Relative Equity Performance and Bond Yield Spread

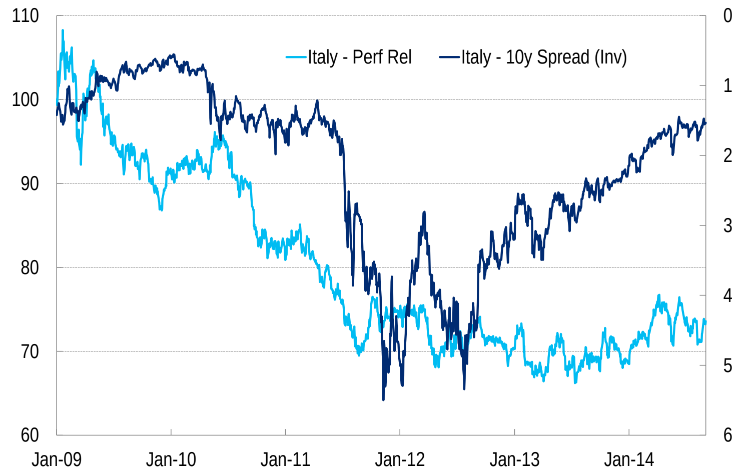
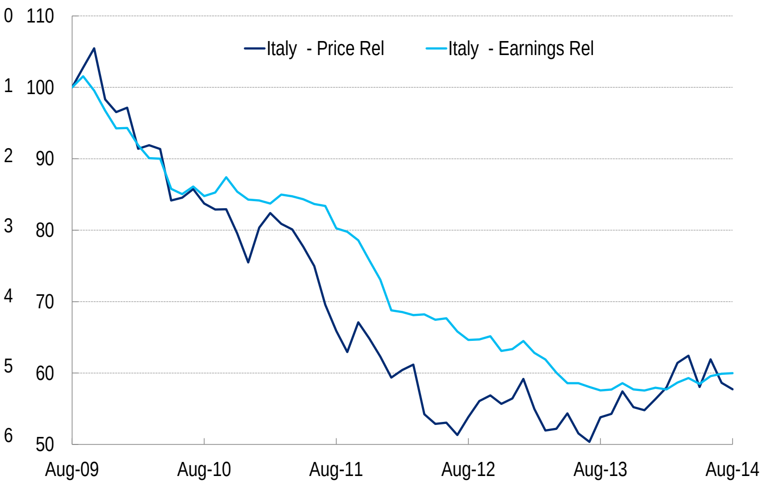


Figure 113. Price and Earnings Relative



Source for all charts: DataStream & Citi Research

Key Investment Theme #2 — Policy Divergence: ECB Easing vs Fed Tightening

- Spain is similar to Italy. Spanish equities have enjoyed a strong re-rating since Draghi's mid-2012 "whatever it takes" speech.

Figure 114. Price/Book an Bond Yield Absolute

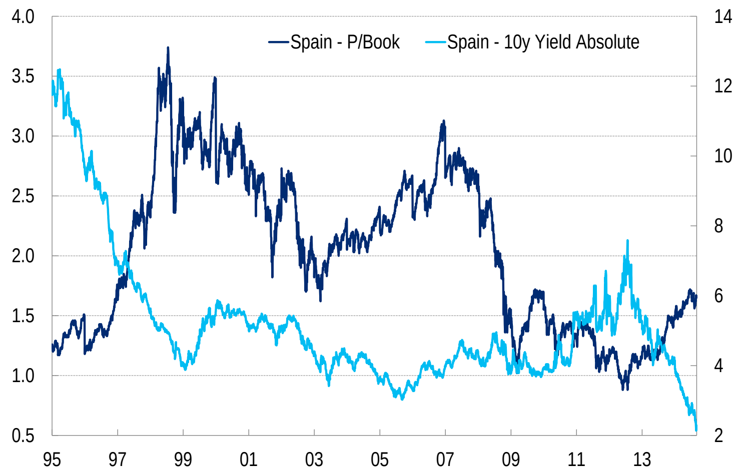
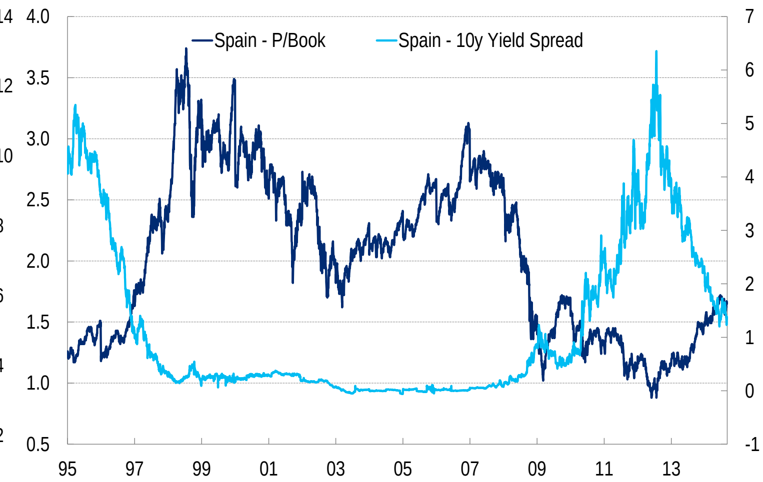


Figure 115. Price/Book an Bond Yield Spread



- Spanish bonds have done better than Spanish equities.
- But, Spanish equities have re-rated sharply in P/E relative terms. The market's price relative has moved higher in last 2 years while earnings relative has troughed but not risen.
- Earnings leadership needed for sustained outperformance, although further liquidity support (eg ECB) can help sustain performance in the near-term.

Figure 116. Relative Equity Performance and Bond Yield Spread

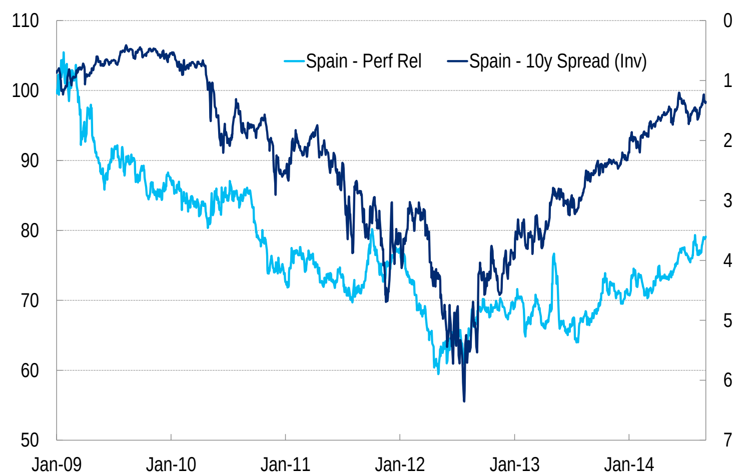
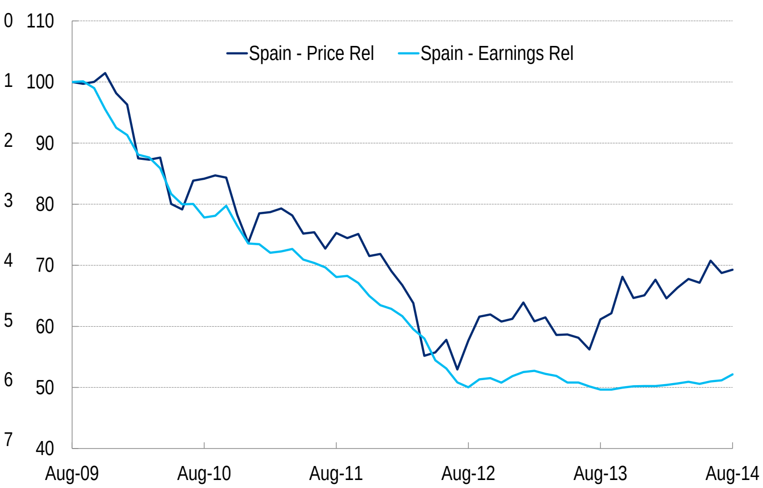


Figure 117. Price and Earnings Relative



Source for all charts: DataStream & Citi Research

Key Investment Theme #2 — Policy Divergence: ECB Easing vs Fed Tightening

- Ahead of BoJ QE in early 2013, Financials and Cyclicals enjoyed strong re-rating and outperformance.
- Since Draghi "whatever it takes" speech in July 2012, we have seen similar leadership in European equity markets, with periphery also amongst best performing countries.

Figure 118. Japan QE Performance

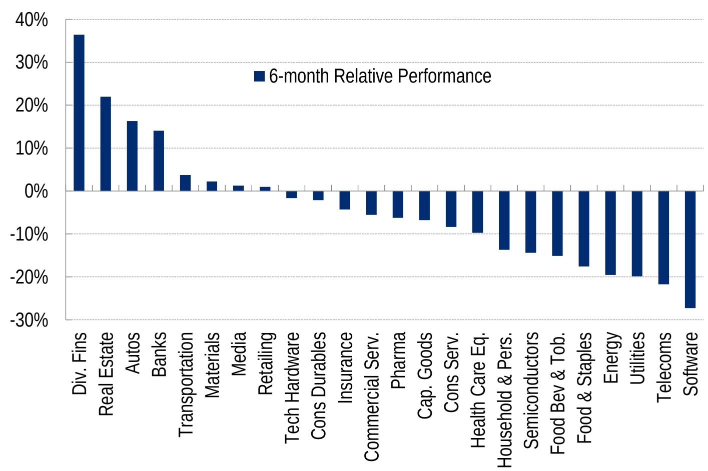
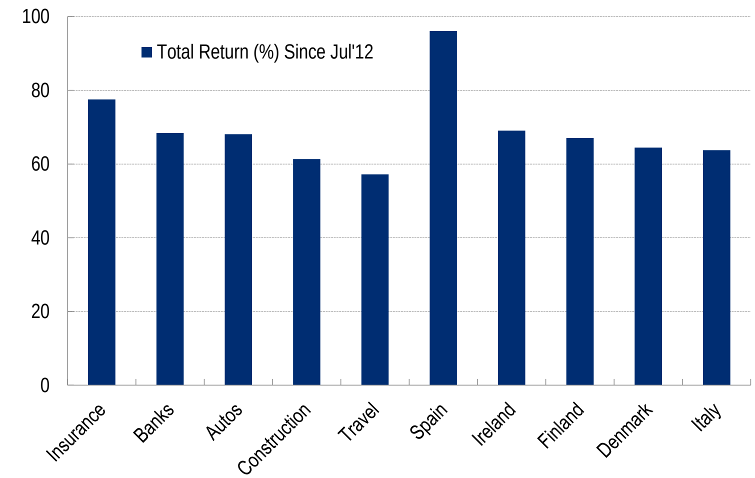


Figure 119. Top 5 Sectors/Countries post "Whatever it Takes"



- Despite outperformance from European banks over last couple of years, still cheap versus 10-year price/book range compared to rest of the market.
- Figure x shows those large-cap stocks with the highest correlation to peripheral bond spreads. AXA and Intesa Sanpaolo are most highly correlated. Both are on the Citi Europe Focus List.

Figure 120. European Sectors Price/Book Relative, Last 10 Years

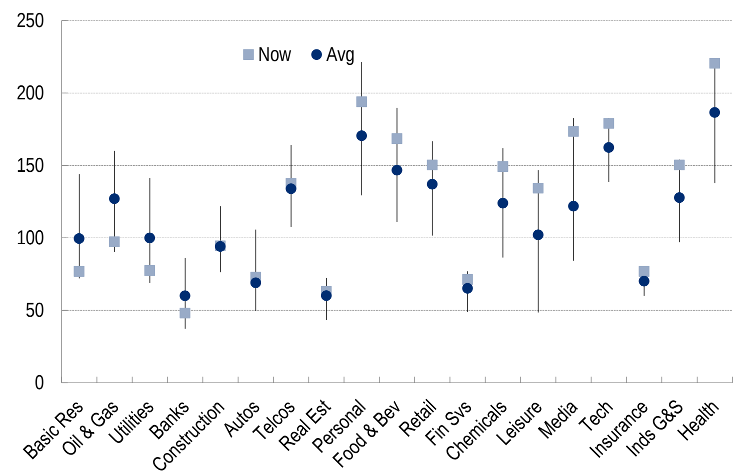


Figure 121. Large Cap Stocks Most Sensitive to 10y IT/ES Spread

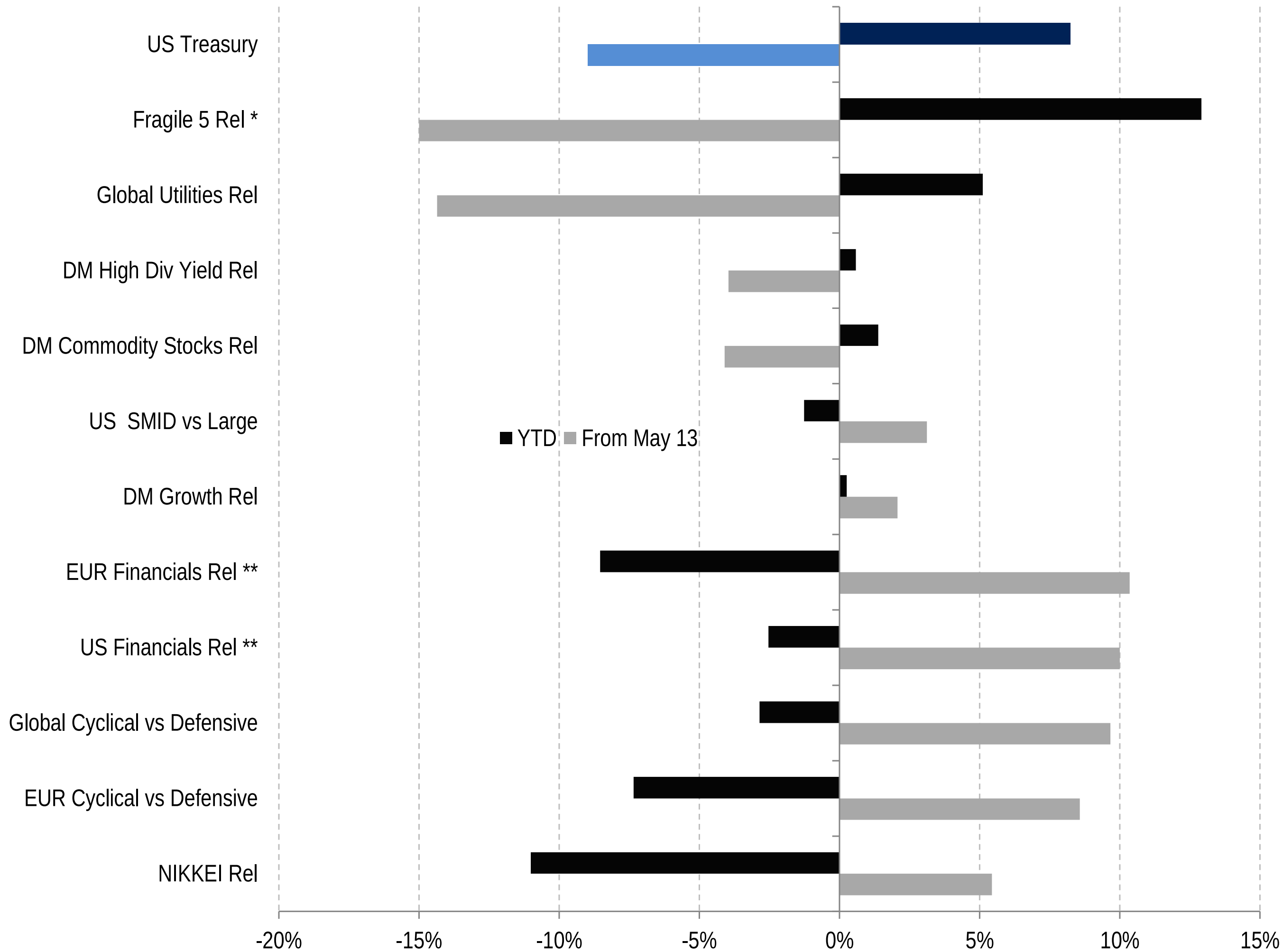
RIC	Stock	>€10bn Mkt Cap	5yr Correlations of Weekly Returns
AXAF.PA	AXA	38950	-0.63
ISP.MI	Intesa Sanpaolo	31628	-0.62
CRDI.MI	Unicredit	32316	-0.60
SOGN.PA	Societe Generale	30792	-0.58
CAGR.PA	Credit Agricole	12443	-0.58
BNPP.PA	BNP Paribas	57795	-0.57
BBVA.MC	BBV Argentaria	54221	-0.55
ING.AS	ING Groep	40414	-0.54
SAN.MC	Banco Santander	89396	-0.54
GASI.MI	Assicurazioni Generali	20789	-0.49

Source for all charts: DataStream & Citi Research

Key Investment Theme #2 — Policy Divergence: ECB Easing vs Fed Tightening

- ECB liquidity actions are likely to have the biggest home-grown impact of regional asset prices and leadership trends.
- But, moves in US bond yields are likely to provide the biggest external influence on European prices and leadership trends.
- Most market participants have been wrong-footed by falling US bond yields in 2014.
- Within the equity market this move has supported various rotations with 2H13 leaders turning laggards YTD, eg cyclicals vs defensives, Nikkei, Utilities.
- Better US data is likely to drive US bond yields higher over coming quarters. We note that 2-year yields are already on a rising trend. This could drive some rotation reversal including support for cyclicals over defensives as well as a shift from DY only to DY*G.

Figure 122. Performance Of UST Sensitive Trades 2014 YTD and May-Dec 2013

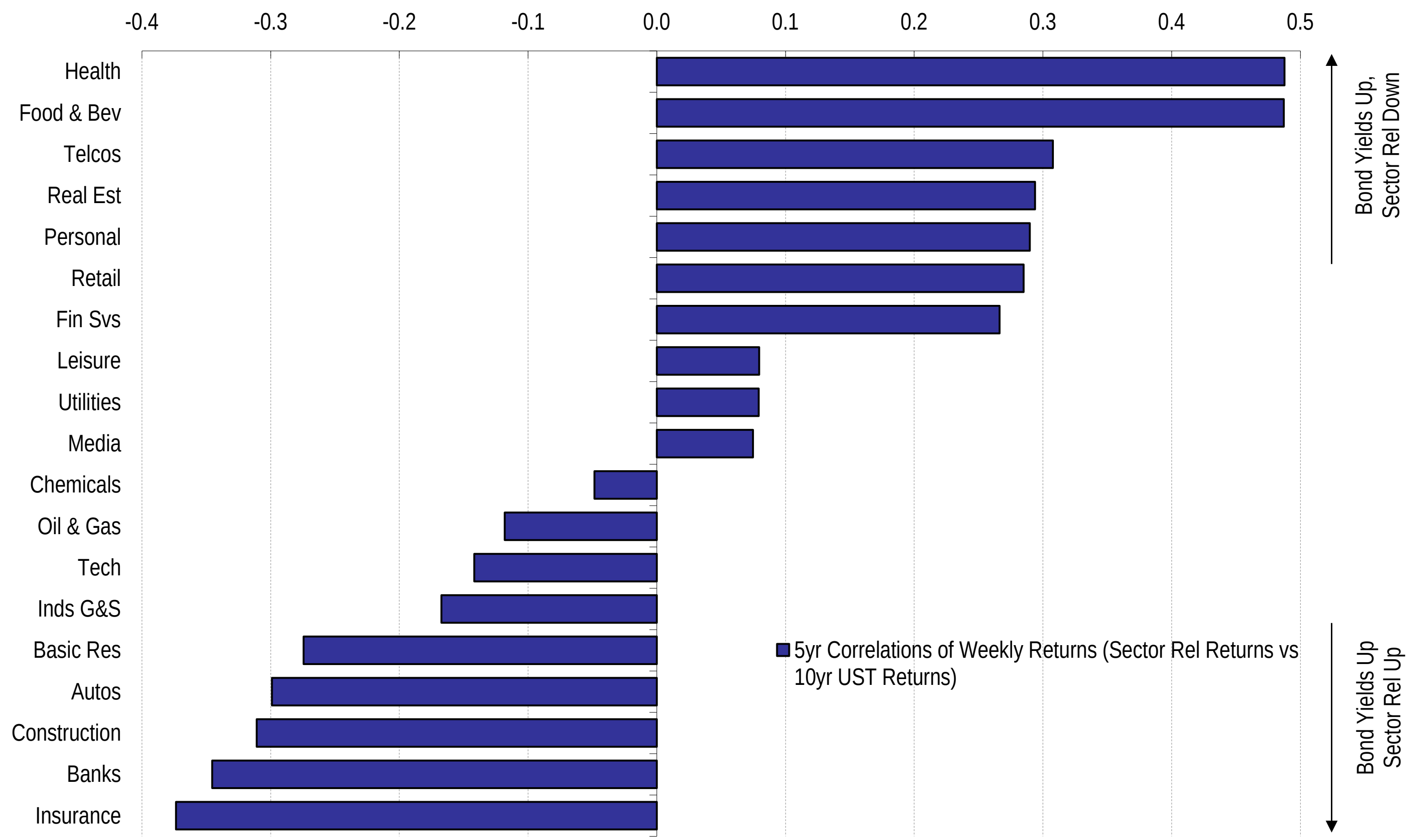


Source: DataStream & Citi Research

Key Investment Theme #2 — Policy Divergence: ECB Easing vs Fed Tightening

- European Defensive sectors tend to have positive correlation to US bond returns, ie when bond yields fall they perform well in relative terms and when bond yields rise they don't.
- European Cyclical and Financial sectors are the other way round and should outperform when US bond yields rise, as they did in 2H13.
- To be most exposed to rising US bond yields, investors should be Overweight Insurance, Banks, Construction and Autos and Underweight Food & Bev and Health Care.

Figure 123. US Treasury Yields vs European Sectors (Correlation)



Source: DataStream & Citi Research

Key Investment Theme #2 — Policy Divergence: ECB Easing vs Fed Tightening

- This screen looks for European companies which have negative correlation with US 10-year bonds, ie they tend to outperform when bond yields rise.
- We also add an earnings momentum filter to capture stocks which would also feature in the long-side of our earnings momentum basket.
- Plenty of Financials, Autos, Construction and other Cyclical stocks.

Figure 124. +ve Earnings Mo Rel Stocks With Historic Correlations Which Suggest Outperformance When US Bond Yields Rise

RIC	Stock	>€5bn Market Cap	5yr Correl of Weekly Returns (Stock Rel vs 10yr UST)	>8 -6m Rel Earn Mo	P/E Rel	10y Median P/E Rel	% from 10y Median P/E Rel
LLOY.L	Lloyds	51359	-0.3	13	68	84	-18
TKAG.DE	ThyssenKrupp	9202	-0.3	41	132	91	44
VLOF.PA	Valeo	6914	-0.3	17	81	89	-9
CRDI.MI	Unicredit	32316	-0.3	23	92	97	-5
ISP.MI	Intesa Sanpaolo	31628	-0.3	16	99	92	8
ADEN.VX	Adecco R	9769	-0.3	9	97	121	-20
CRH.L	CRH	12996	-0.3	13	123	119	4
NHY.OL	Norsk Hydro	6085	-0.2	55	150	124	21
HEIG.DE	HeidelbergCement	8028	-0.2	8	88	100	-12
DAIGn.DE	Daimler	61174	-0.2	10	66	87	-24
VIE.PA	Veolia Environnement	6105	-0.2	21	155	152	2
AHT.L	Ashtead Group	6216	-0.2	19	119	130	-8
RBS.L	Royal Bank Of Sctl.Gp.	10256	-0.2	28	85	75	13
UBI.MI	UBI Banca	5361	-0.2	19	113	100	13
ALUA.PA	Alcatel-Lucent	7385	-0.2	30	159	133	20
NOK1V.HE	Nokia	23949	-0.2	22	160	126	27
BMWG.DE	BMW	28482	-0.2	12	67	86	-21
VOLVb.ST	Volvo B	14601	-0.2	10	96	101	-5
TPK.L	Travis Perkins	5423	-0.2	9	95	97	-2
CCL.L	Carnival	5172	-0.2	26	123	130	-5
ITV.L	ITV	9915	-0.2	12	111	124	-10
SAN.MC	Banco Santander	89396	-0.1	9	97	80	21
DANSKE.CO	Danske Bank	14660	-0.1	18	79	90	-13
VWS.CO	Vestas Windsystems	7176	-0.1	49	140	179	-22
YAR.OL	Yara International	6791	-0.1	13	84	82	3

Source: DataStream & Citi Research

Key Investment Theme #3 — ECB QE to Extend European Search for Yield (DY*G)

- ECB liquidity actions including QE around end-14 is likely to extend the search for yield/income, in our view.
- Yield compression has been key global theme in financial markets in last few years, in Europe since mid-2012.

Figure 125. Global/US Yield Convergence

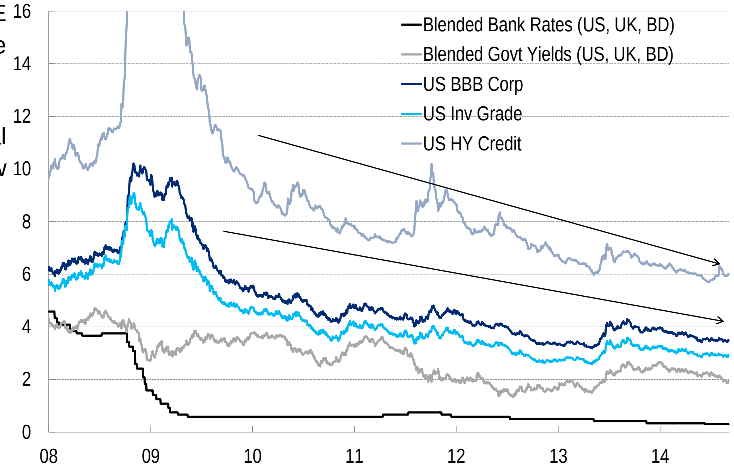
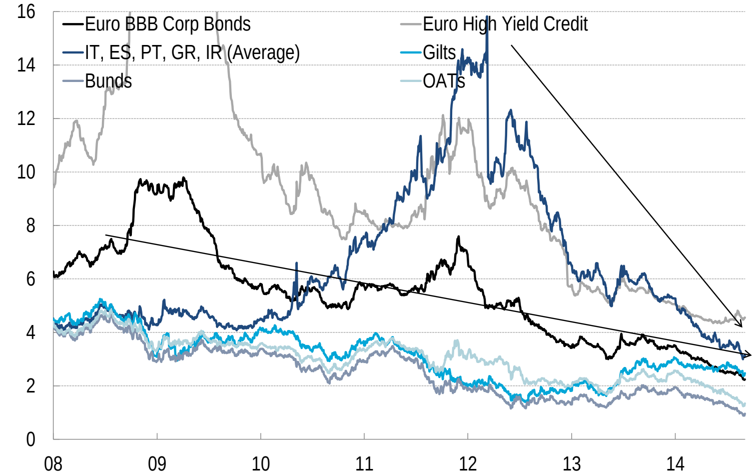


Figure 126. European Yield Convergence



- Equity yields, eg DYs, have also compressed in last few years. Harder to find value is one consequence of this.

Figure 127. Trailing DY

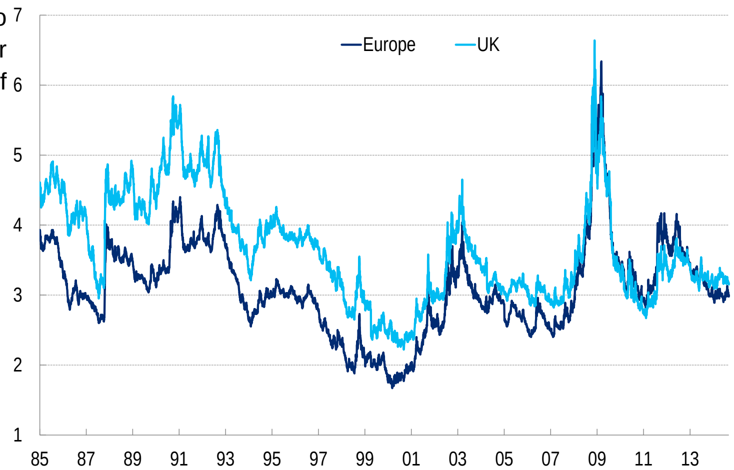
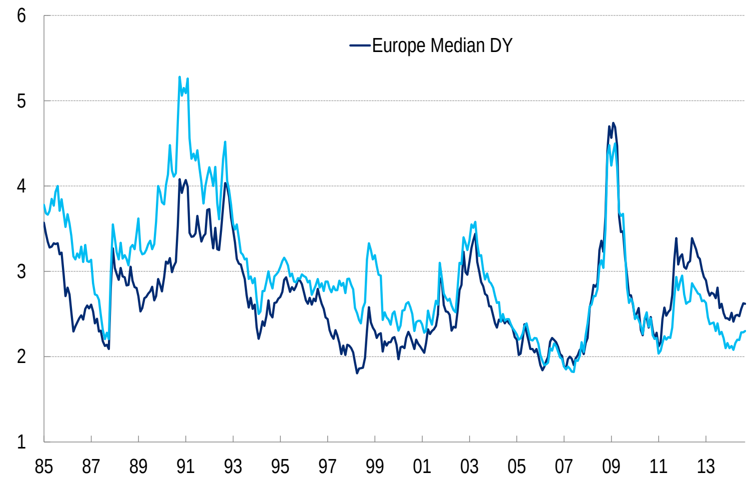


Figure 128. Median DY



Source for all charts: DataStream & Citi Research

Key Investment Theme #3 — ECB QE to Extend European Search for Yield (DY*G)

- Globally, high DY looks even less attractive relative to the market on 20-year valuation lows (ie expensive).
- A global DY*G strategy, which probably gains support if/when US bond yields rise, would also tilt towards financials and cyclicals over Utilities and Telecoms.

Figure 129. DY & PE Relative of MSCI High DY Index

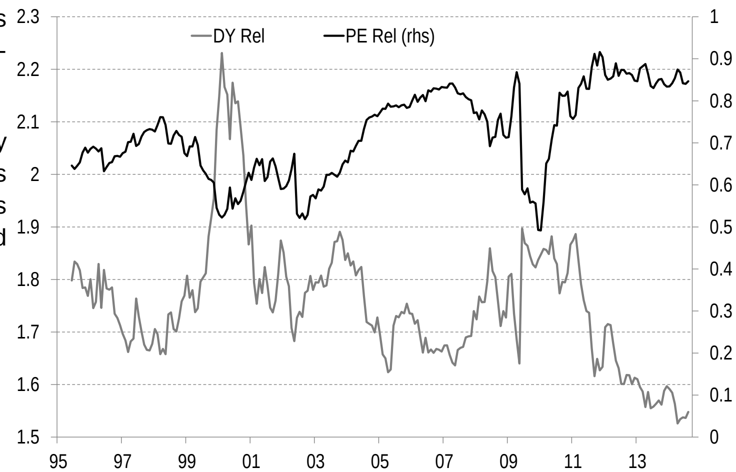
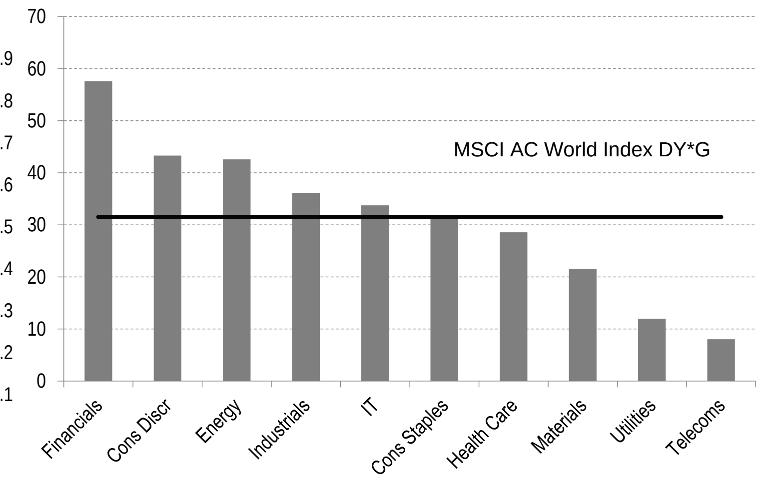


Figure 130. DY*G Global Sectors



- MSCI Europe high DY index relative to rest of market looks expensive, ie low DYR.
- This suggests Financials and cyclicals in Europe ahead of TMT, Utilities and Oil.

Figure 131. MSCI Europe High DY Relative

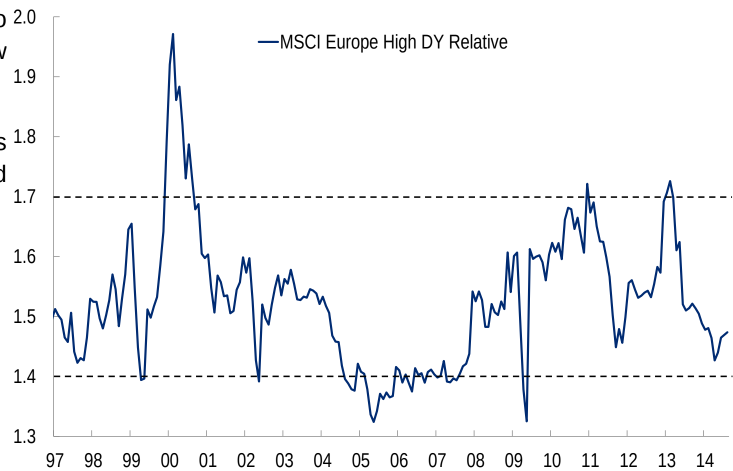
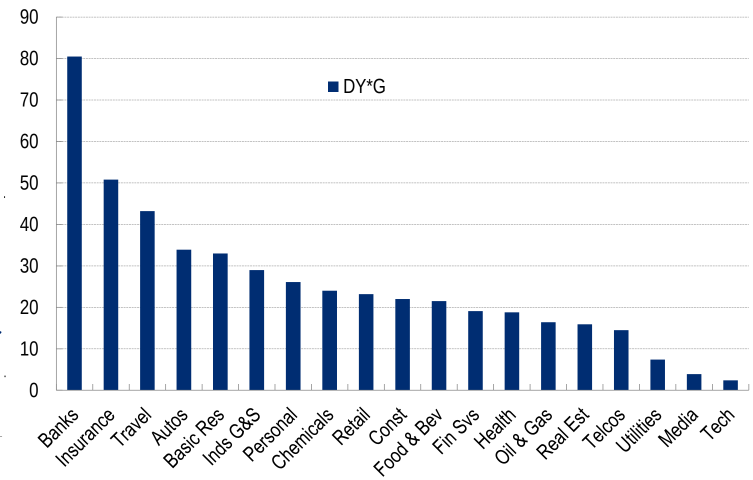


Figure 132. DY*G European Sectors

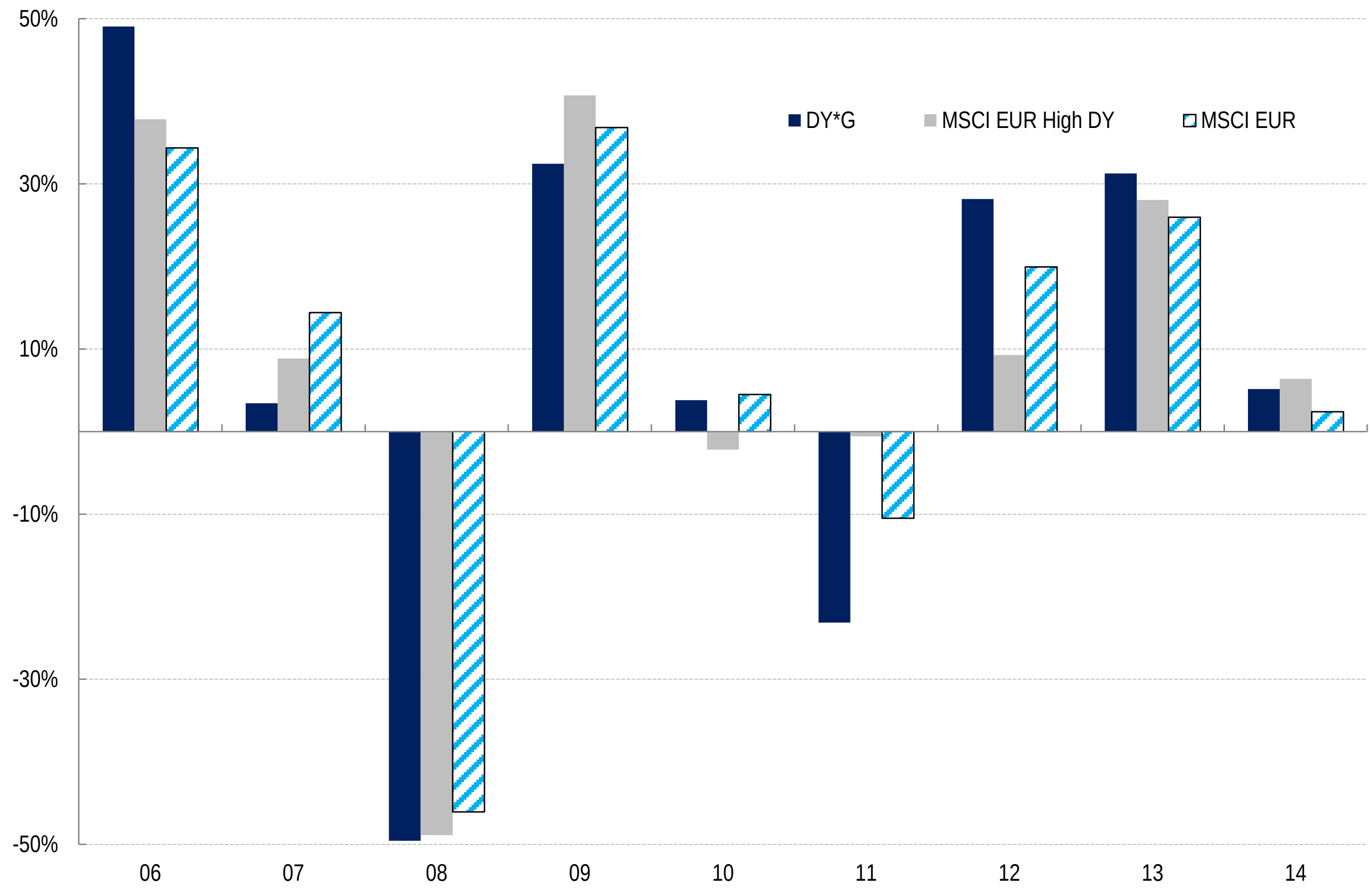


Source for all charts: MSCI, Factset, DataStream, Citi Research

Key Investment Theme #3 — ECB QE to Extend European Search for Yield (DY*G)

- European DY*G strategy has performed well vs market and high DY only strategy since 2012.
- This strategy has some exposure to the search for yield and some to improving growth opportunities and higher bond yields at some point in time.

Figure 133. Europe Yield Strategies (US$ Rtn.) — DY*G Strategy Outperforming Since 2012

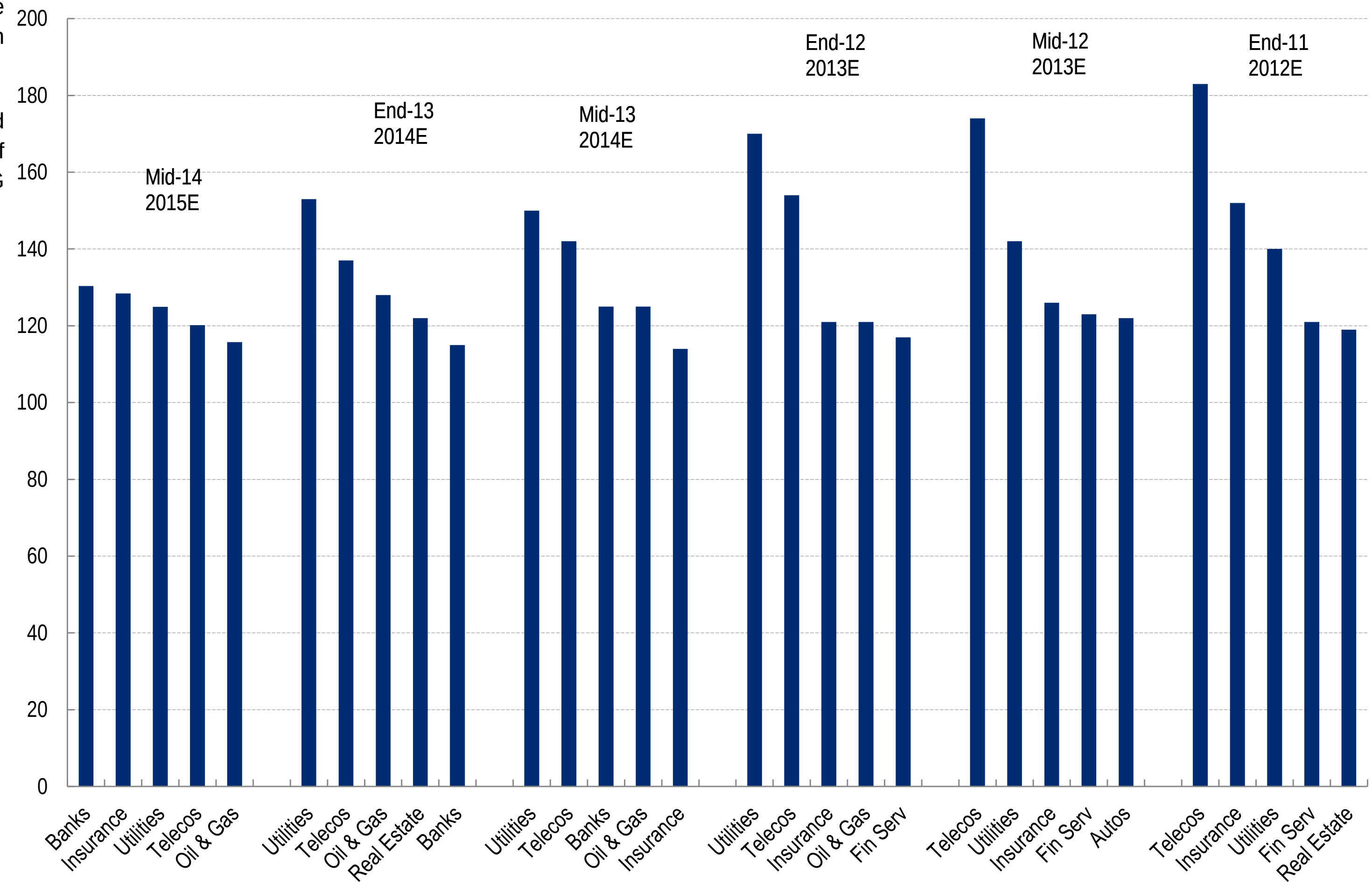


Source: DataStream, Citi Research

Key Investment Theme #3 — ECB QE to Extend European Search for Yield (DY*G)

- More choice now for European income investors with 5 big sectors trading on similar 2015E dividend yields.
- DY convergence across market should make delivery, growth and quality of dividends more important, hence DY*G or CDS-adjusted DY*G.

Figure 134. Top 5 European Sector DYR



Source: Citi Research

Key Investment Theme #3 — ECB QE to Extend European Search for Yield (DY*G)

- We look for stocks with decent DY, decent dividend growth, decent dividend cover and a high DY*G score.
- We think this strategy is more appropriate than a high DY only strategy in 2H14.
- Barbell strategy with mix of Financials (eg DNB, Allianz, Aviva, UBS, AXA, Intesa, Nordea) and non-Financials (ABInbev, Rio Tinto, BT, Renault, Persimmon, Michelin).

Figure 135. Looking for DY*G — Income and Income Growth Screen

		>€10b	>3%		>1.5	>35
RIC	Stock	Mkt Cap €m	Curr. DY	2y Ann. Divi. Growth	Dividend Cover 14	DY*G
SIEGn.DE	Siemens	79308	3.6	20.6	1.9	73.4
ABI.BR	Anheuser-Busch Inbev	64551	2.7	12.7	1.7	34.0
ALVG.DE	Allianz	58715	4.4	11.6	2.5	51.5
DGE.L	Diageo	55992	2.9	11.6	1.7	33.3
RIO.L	Rio Tinto	50824	3.9	13.6	2.4	52.7
UBSN.VX	UBS R	48898	2.5	75.0	2.5	188.0
GLEN.L	Glencore	45446	2.8	10.7	1.9	30.2
BARC.L	Barclays	43458	3.4	40.7	2.8	137.9
BT.L	BT Group	39783	2.9	17.7	2.4	51.5
AXAF.PA	AXA	38950	4.7	11.7	2.4	55.3
CSGN.VX	Credit Suisse R	32116	2.7	70.8	3.3	189.2
ISP.MI	Intesa Sanpaolo	31628	2.7	50.8	2.1	134.7
NDA.ST	Nordea Bank	31456	5.1	22.9	1.6	118.0
SOGN.PA	Societe Generale	30792	3.9	50.0	1.9	194.5
BMWG.DE	BMW	28482	3.2	14.4	3.1	46.4
VOWG.DE	Volkswagen Pref.	24577	2.8	27.1	4.4	76.1
WPP.L	WPP	21277	2.8	12.2	2.2	33.6
SRENH.VX	Swiss Re	21272	5.4	12.2	1.8	66.0
CPG.L	Compass Group	20901	2.6	13.8	1.8	36.0
GASI.MI	Assicurazioni Generali	20789	3.2	17.0	2.9	54.5
AV.L	Aviva	19352	3.0	13.9	3.2	41.5
LGEN.L	Legal & General	17864	4.0	16.0	1.6	64.5
MICP.PA	Michelin	15752	3.2	15.4	2.9	49.9
SEBa.ST	SEB A	15646	4.9	9.6	1.6	46.8
REL.L	Reed Elsevier	14165	2.6	12.8	2.0	33.5
DNB.OL	DNB	12993	2.8	26.4	3.5	74.0
CAGR.PA	Credit Agricole	12443	3.3	37.3	3.0	124.9
RENA.PA	Renault	12332	3.3	18.2	3.8	59.4
OML.L	Old Mutual	12205	4.3	10.9	2.0	47.0
AEGN.AS	Aegon	11028	3.9	12.5	2.8	48.7
PSHG_p.DE	Porsche Pref.	10604	3.6	18.3	4.6	65.3
BSY.L	BSKyB	10497	3.5	13.5	2.0	47.3
KGF.L	Kingfisher	9040	3.4	11.5	2.1	39.3
TECF.PA	Technip	7560	2.7	14.3	2.1	38.9
YAR.OL	Yara International	6791	3.2	13.7	2.5	44.5
ADN.L	Aberdeen Asset Man.	6604	3.8	15.3	1.8	58.9
PSN.L	Persimmon	5051	5.2	16.6	1.7	86.7

Source: DataStream & Citi Research

Key Investment Theme #3 — ECB QE to Extend European Search for Yield (DY*G)

- To compare the whole market, including financials, we screen using a CDS-adjusted DY*G score.
- This shows companies which offer investors a combination of: 1) low risk, 2) income, and 3) growth.
- We think this is an attractive through-cycle approach to investing.
- Plenty of financials on this screen vs very few if any in 2012.

Figure 136. CDS Adjusted DY*G Screen

			<Median (65)	>2.5%		>4%	>0 or Fin		>0.3
RIC	Stock	Mkt Cap	CDS	Trailing DY	CDS Adj Dividend Score	2yr Ann. Div Growth	Average 2014E-2016E FCF Less Average 2014E-2016E DY	DY*G	DY*G/CDS
CSGN.VX	Credit Suisse R	32116	49	2.70	5.51	76.95	Fin	206	4.20
BARC.L	Barclays	43458	54	2.92	5.41	39.11	Fin	132	2.45
CNAT.PA	Natixis	4574	51	3.02	5.98	32.09	Fin	113	2.23
CAGR.PA	Credit Agricole	12443	60	3.10	5.21	36.98	Fin	124	2.08
BNPP.PA	BNP Paribas	57795	57	2.90	5.09	38.16	Fin	111	1.95
SIEGn.DE	Siemens	79308	41	3.12	7.62	19.89	2.7	71	1.73
NDA.ST	Nordea Bank	31456	60	4.39	7.32	18.54	Fin	95	1.59
UNc.AS	Unilever Certs.	49765	24	3.48	14.81	8.88	2.9	31	1.34
ALVG.DE	Allianz	58715	37	4.05	10.95	10.70	Fin	48	1.28
ULVR.L	Unilever (UK)	43922	24	3.39	14.44	8.88	2.7	30	1.26
SEBa.ST	SEB A	15646	49	4.40	9.06	11.49	Fin	56	1.16
LGEN.L	Legal & General	17864	56	4.06	7.24	13.96	Fin	56	1.00
CPG.L	Compass Group	20901	32	2.53	8.02	11.91	1.3	31	0.99
RIO.L	Rio Tinto	50824	48	3.79	7.90	11.53	2.2	45	0.93
TEL.OL	Telenor	12192	36	4.93	13.69	6.31	0.6	33	0.91
SASY.PA	Sanofi	100626	37	3.34	9.09	9.53	1.8	32	0.88
DPWGn.DE	Deutsche Post	23600	30	3.22	10.71	7.70	1.4	26	0.86
NESN.VX	Nestle R	190465	20	3.01	15.31	5.19	0.8	16	0.81
MICP.PA	Michelin	15752	56	2.99	5.31	14.02	3.3	46	0.81
DGE.L	Diageo	55992	39	2.90	7.43	10.77	0.1	31	0.79
AXAF.PA	AXA	38950	56	4.29	7.67	9.18	Fin	43	0.77
BT.L	BT Group	39783	59	2.83	4.84	15.54	4.0	45	0.77
SKFb.ST	SKF B	6635	54	3.43	6.34	11.02	2.7	40	0.74
SYNN.VX	Syngenta	25436	38	3.04	8.12	9.62	1.4	27	0.72
ATCOa.ST	Atlas Copco A	14289	54	2.72	5.03	12.51	2.2	36	0.66
SESFd.PA	SES Fdr	8975	62	3.79	6.12	10.00	1.0	41	0.65
DAIGn.DE	Daimler	61174	34	3.64	10.57	5.86	2.2	22	0.64
INVEb.ST	Investor B	12847	54	3.10	5.69	9.46	Fin	33	0.60
KGF.L	Kingfisher	9040	61	3.23	5.34	10.27	2.6	35	0.58
REL.L	Reed Elsevier	14165	45	2.51	5.63	8.92	3.3	23	0.52
DBKGn.DE	Deutsche Bank	33922	61	2.88	4.76	10.55	Fin	30	0.50
WPP.L	WPP	21277	53	2.76	5.27	9.40	4.4	26	0.50
UNBP.AS	Unibail-Rodamco	19874	58	4.38	7.57	6.20	Fin	28	0.48
SCHN.PA	Schneider Electric	37252	39	2.91	7.47	6.04	2.8	18	0.47
PSON.L	Pearson	11444	64	4.42	6.86	7.02	0.1	30	0.46
SCMN.VX	Swisscom R	9855	38	4.13	10.87	4.32	1.4	18	0.46
WLSNc.AS	Wolters Kluwer	6359	54	3.32	6.14	6.57	4.8	22	0.40
DSMN.AS	Koninklijke DSM	9220	53	3.35	6.28	6.24	3.1	21	0.39

Source: Bloomberg, DataStream & Citi Research

Key Investment Theme #3 — ECB QE to Extend European Search for Yield (Banks)

- ECB liquidity measures should be supportive for the region's banks, eg lowering funding costs and direct purchases of bank loans/assets (QE).
- Listed bank balance sheets have improved over past few years. Net surplus from big deficit.
- NPL cycle likely to improve as unemployment falls, according to our Banks team.

Figure 137. Banks – Capital Surplus (€bn)

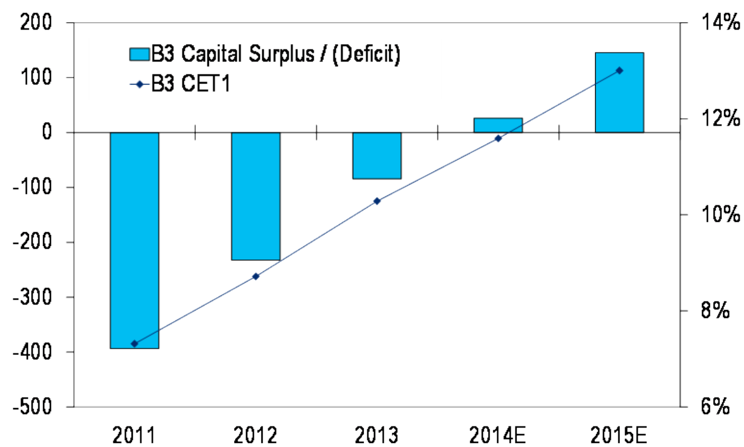
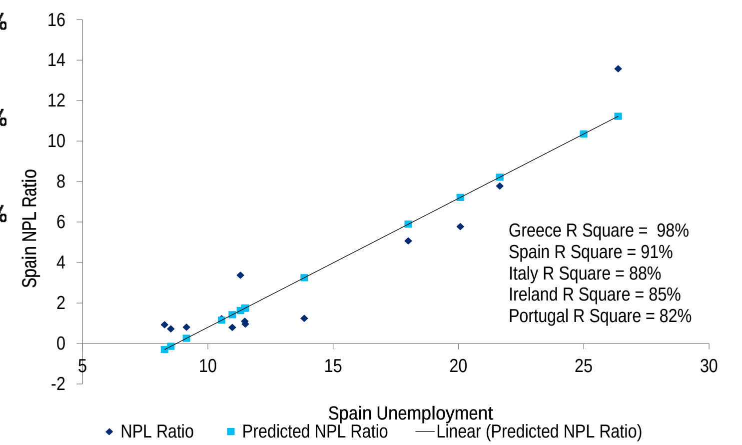


Figure 138. Spain – Unemployment & NPLs



- October's AQR and stress test provides event risk, but generally our analysts see the benefits of greater post-AQR clarity, comparability and credibility.
- European bank equity has lagged credit (CDS) and peripheral bonds YTD. This suggests QE benefits priced less keenly into equity than elsewhere.
- Other supports for Bank bull case include: capital return (high DY*G score), improving underlying earnings and ongoing support from restructuring.

Figure 139. The Road to Banking Union

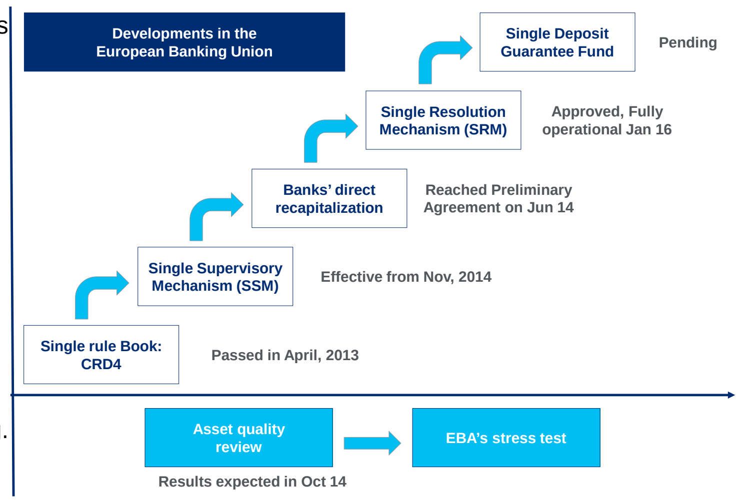
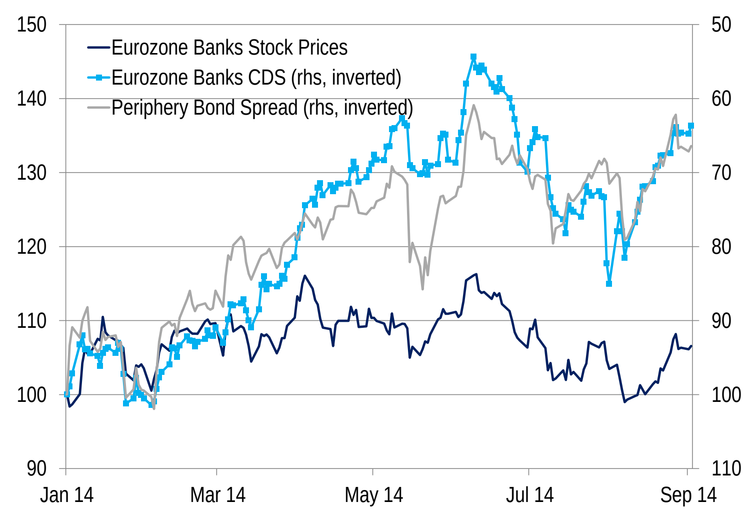


Figure 140. Banks – CDS vs Equity (vs Peripheral Bond Yields)



Source for all charts: Company Reports, Banco de España, INE, DataStream & Citi Research

Key Investment Theme #3 — ECB QE to Extend European Search for Yield (REV)

- We have favoured our REV strategy for some time. It looks for stocks with exposure to Risk, Earnings Mo & Value.
- All stocks here have sub-1x price/book ratio and trade below 10-year average price/book; in addition to beta > 1, +ve 6m earnings mo and sub 10x normalized P/E.
- Mainly financials plus Renault/Repsol.

Figure 141. REV Screen

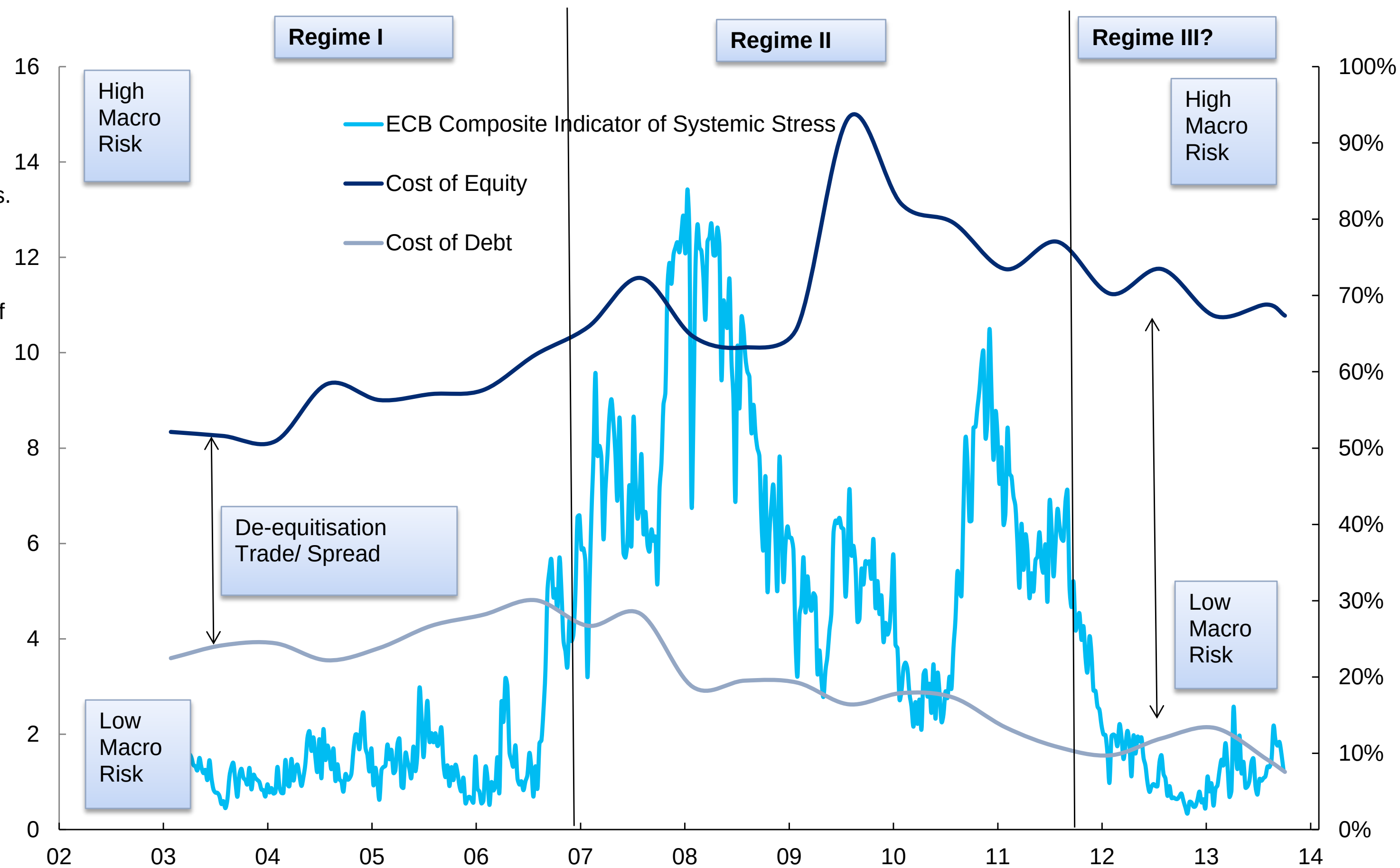
RIC	Stock	>€5bn Market Cap	>1 Beta	>1 -6m Rel Earn Mo	<10 Normalized P/E	<1 Current P/Book	10y Avg P/Book	<0 % from 10y Avg P/Book
ING.AS	ING Groep	40414	1.4	2.5	6.3	0.85	1.12	-24
AXAF.PA	AXA	38950	1.1	0.4	8.8	0.86	1.02	-16
CRDI.MI	Unicredit	32316	1.2	23.0	3.7	0.74	0.91	-18
ISP.MI	Intesa Sanpaolo	31628	1.4	15.6	8.4	0.84	0.97	-13
REP.MC	Repsol Ypf	18187	1.0	0.0	9.9	0.93	1.20	-23
RENA.PA	Renault	12332	1.7	2.3	7.5	0.76	0.77	-1
CBKG.DE	Commerzbank	10882	1.4	5.4	1.8	0.5	0.68	-27
RBS.L	Royal Bank Of Sctl.Gp.	10256	1.3	27.7	1.3	0.7	0.92	-24
SABE.MC	Banco De Sabadell	9098	1.3	43.0	9.3	0.93	1.25	-25
POP.MC	Banco Popular Espanol	8896	1.2	6.7	3.1	0.79	1.46	-46
UBI.MI	UBI Banca	5361	1.3	18.6	6.7	0.52	0.74	-30

Source: DataStream & Citi Research

Key Investment Theme #3 — ECB QE to Extend European Search for Yield (The Arb)

- Additional liquidity from the ECB is likely to sustain lower interest rates in the region.
- This should continue to underpin the arbitrage between the cost of debt and equity funding for European companies.
- This is the arbitrage which we expect capital allocators, eg CEOs, investors, to continue to exploit barring a return of system risk.
- One way of exploiting, we think, is to look to companies which offer unlevered FCF or surplus FCF.
- Our recent global strategy report showed how Apple fit this bill a year ago…

Figure 142. Low Macro Risk + De-equitisation Arbitrage = Stuff Will Happen



Source: ECB, Bloomberg & Citi Research

Key Investment Theme #3 — ECB QE to Extend European Search for Yield (The Arb)

- This is not an M&A screen, but does show those European stocks with high levels of surplus FCF and with strong balance sheets.
- These attributes should be attractive to both investors and to corporate predators.
- Both surplus FCF and strong balance sheets also give these companies plenty of optionality/firepower to invest or to return capital to shareholders.

Figure 143. Surplus Cash and Strong Balance Sheets Screen

RIC	Stock	>10€Bn Market Cap	Average DY (14E-16E)	Average FCFY (14E-16E)	>200bps Avg FCF- Avg DY	<1 Net Debt/EBITDA14
HNKG_p.DE	Henkel Pref.	14217	1.8	14.1	12.4	0.1
PUBP.PA	Publicis Groupe	10908	2.5	7.3	4.8	-0.7
CONG.DE	Continental	17527	2.6	7.1	4.5	0.7
NXT.L	Next	13868	2.3	6.1	3.8	0.6
SAPG.DE	SAP	56129	1.6	5.4	3.8	0.1
PHG.AS	Philips Electronics	21749	3.4	7.3	3.8	0.4
CFR.VX	Richemont N	37884	1.9	5.4	3.4	-1.7
BLT.L	BHP Billiton	51375	4.1	7.4	3.4	0.7
BSY.L	BSKyB	10497	4.1	7.4	3.3	0.8
MICP.PA	Michelin	15752	3.9	7.2	3.3	0.3
LEGD.PA	Legrand	11173	2.9	5.8	3.0	0.9
LVMH.PA	LVMH	35287	2.7	5.5	2.8	0.7
ASSAb.ST	Assa Abloy B	12765	2.1	4.8	2.8	0.5
SIEGn.DE	Siemens	79308	4.6	7.3	2.7	0.8
ASML.AS	ASML Hldg	27948	1.1	3.8	2.7	-1.4
RB.L	Reckitt Benckiser Group	43419	2.7	5.4	2.7	0.4
ABBN.VX	ABB	40108	3.9	6.6	2.7	0.0
ERICb.ST	Ericsson B	28884	3.5	6.1	2.6	-1.8
WOS.L	Wolseley	10839	3.1	5.5	2.4	0.7
MAERSKb.CO	A P Moller - Maersk B	14276	2.4	4.7	2.3	0.9
ATCOa.ST	Atlas Copco A	14289	3.3	5.6	2.2	0.6
OREP.PA	L'Oreal	30035	2.4	4.6	2.2	-0.8
RIO.L	Rio Tinto	50824	4.5	6.7	2.2	0.8
NOVOb.CO	Novo Nordisk 'B'	67382	2.1	4.2	2.0	-0.4

Source: DataStream & Citi Research

Key Investment Theme #4 — Show Me the Money (Focus on Delivery)

- Value re-rating within market suggests longer-term investors should fundamentally focus on relative value and delivery strategies from here.
- Cheapest quintile of European stocks now trading around highest P/E levels in last 25 years, in absolute terms.
- Conclusion = cheap was cheap in early 2009 and indeed in mid-2011/12, but now cheap is no longer cheap.

Figure 144. Cheapest Quintile — 12m Fwd Absolute P/E

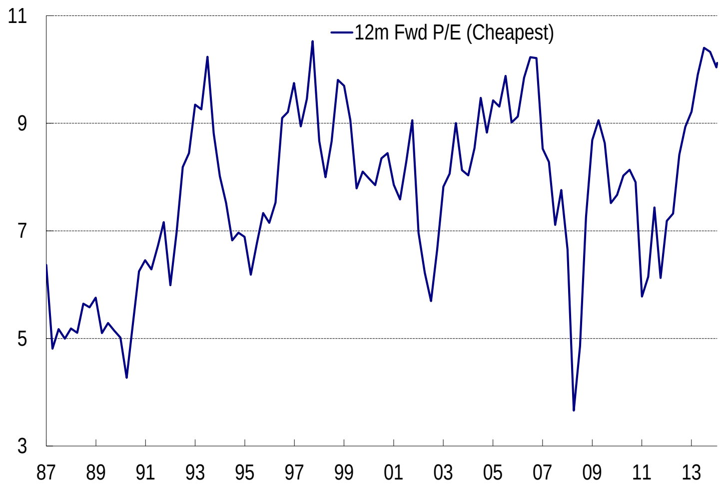
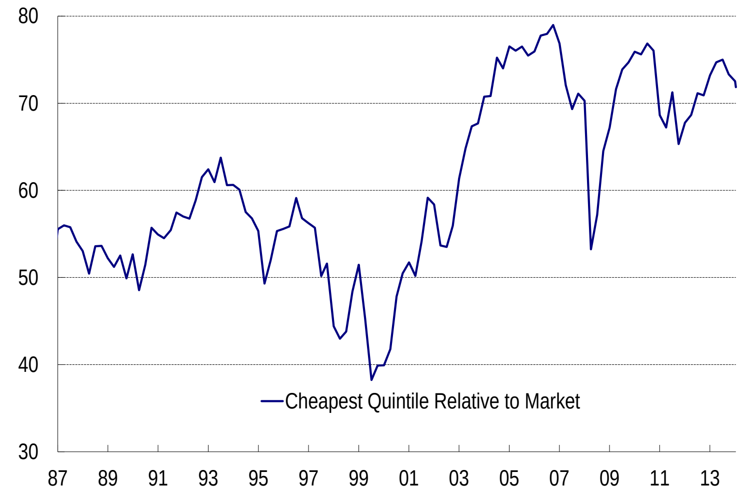


Figure 145. Cheapest Quintile — 12m Fwd Relative P/E



- Most expensive quintile of European stocks has also been re-rated in past couple of years, from 20x to 25x.
- Expensive stocks should therefore be more vulnerable to disappointments.
- Spread between expensive and cheap quintiles around 25-year lows.
- This suggests that earnings leadership, rather than valuation, should be key focus for investors in coming quarters, ie show me the money.

Figure 146. Most Expensive Quintile — 12m Fwd Absolute P/E

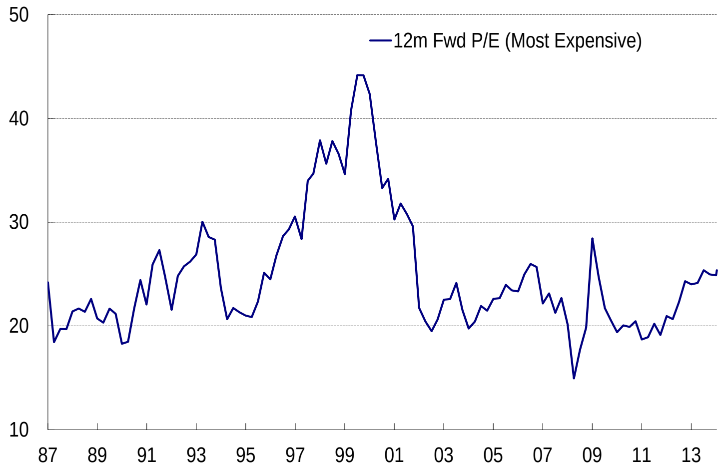
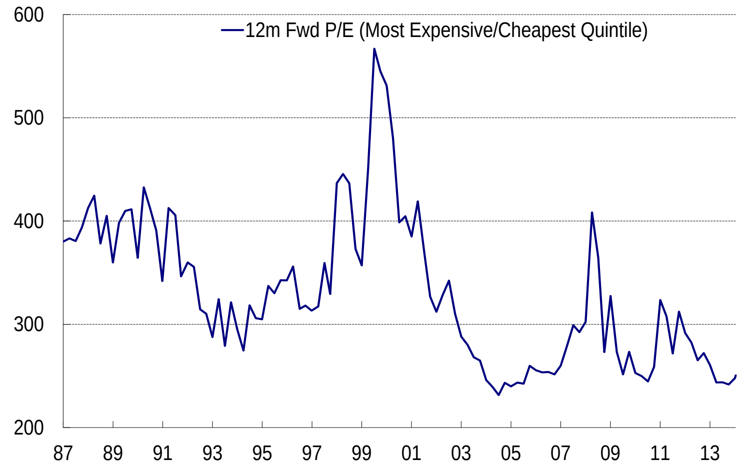


Figure 147. Most Expensive vs Cheapest Quintile — 12m Fwd P/E



Source for all charts: DataStream & Citi Research

Key Investment Theme #4 — Show Me the Money (Focus on Delivery)

- Value quintile analysis backed by Citi Quant team style analysis; we show P/E relative in context of last 10-years.
- Investors looking for cheap styles should focus on estimates/price momentum and quality.
- Lowest quality quintile actually trading at P/E premium to highest quintile. Rare and suggests value in high quality.
- Low risk and value look expensive at current levels.

Figure 148. Top Quintile – P/E Relative

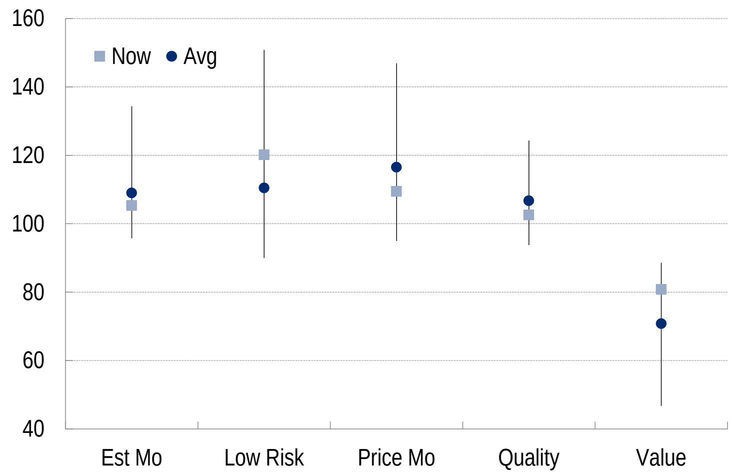
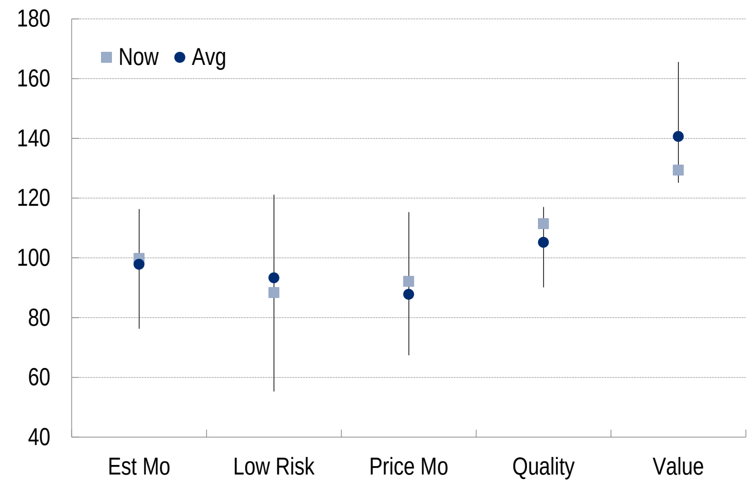


Figure 149. Bottom Quintile – P/E Relative



- Similar story on price/book multiples, with momentum styles (top quintile, ie positive momentum) again looking attractive.

Figure 150. Top Quintile – P/Book Relative

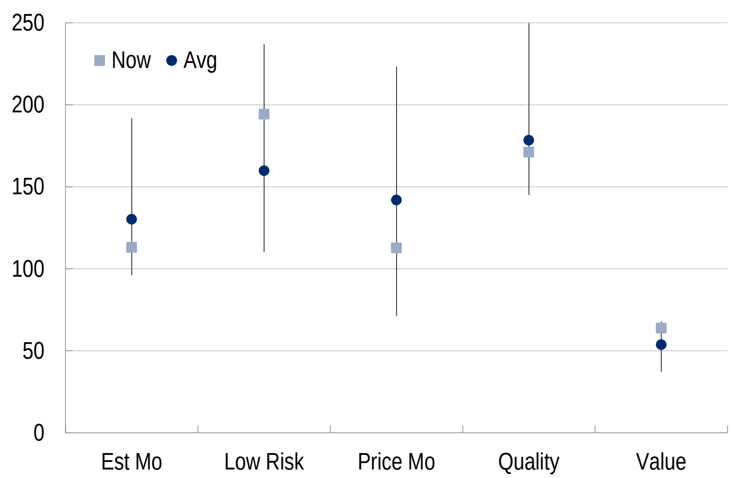
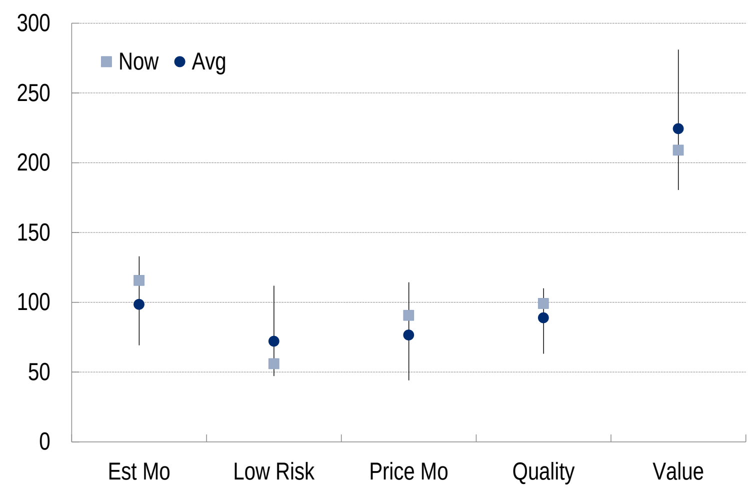


Figure 151. Bottom Quintile – P/Book Relative



Source for all charts: Citi Research

Key Investment Theme #4 — Show Me the Money (Focus on Delivery)

- Earnings momentum strategies have lost money in the last few months, on both the long and short side.
- This partly explains why it has been a tough year for investors, given the key role this strategy plays in many investment processes.
- Earnings leadership should be more important for performance leadership in next 1-2 years given valuation compression within market.

Figure 152. Long Earnings Momentum Strategy

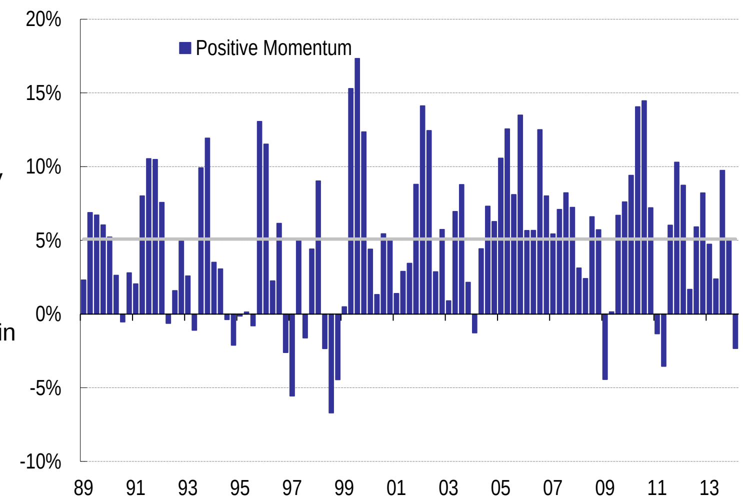
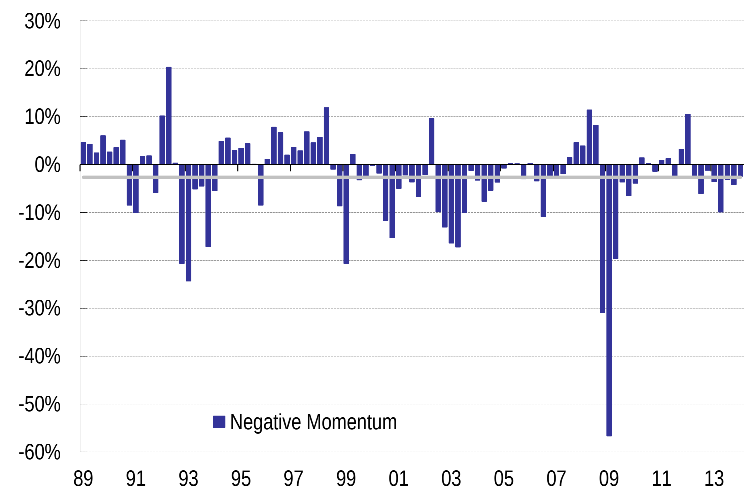


Figure 153. Short Earnings Momentum Strategy



- Financials, commodity sectors and Autos look cheap on price/book relative and also have positive relative earnings trends currently.
- Media, Retail, Telecoms, Industrials and Telecoms offer the opposite.

Figure 154. Overall Earnings Momentum Strategy

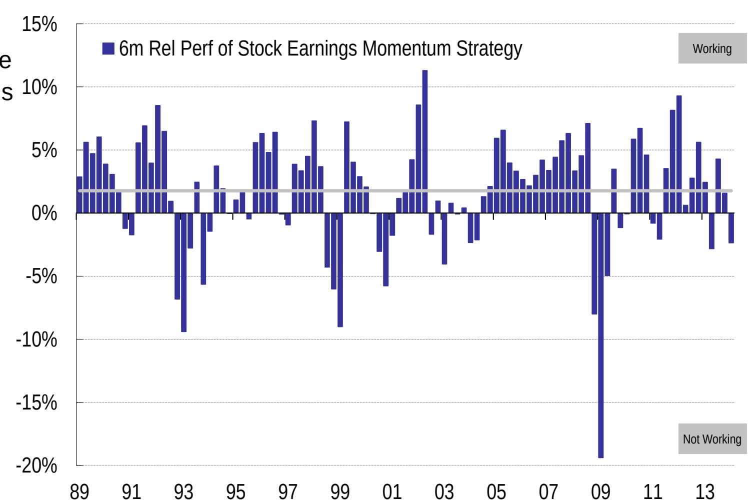
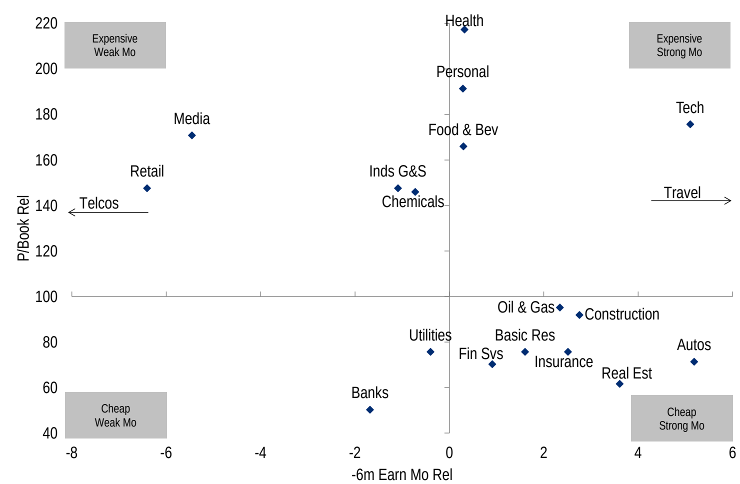


Figure 155. Six Months Earnings Mo and P/Book Rel

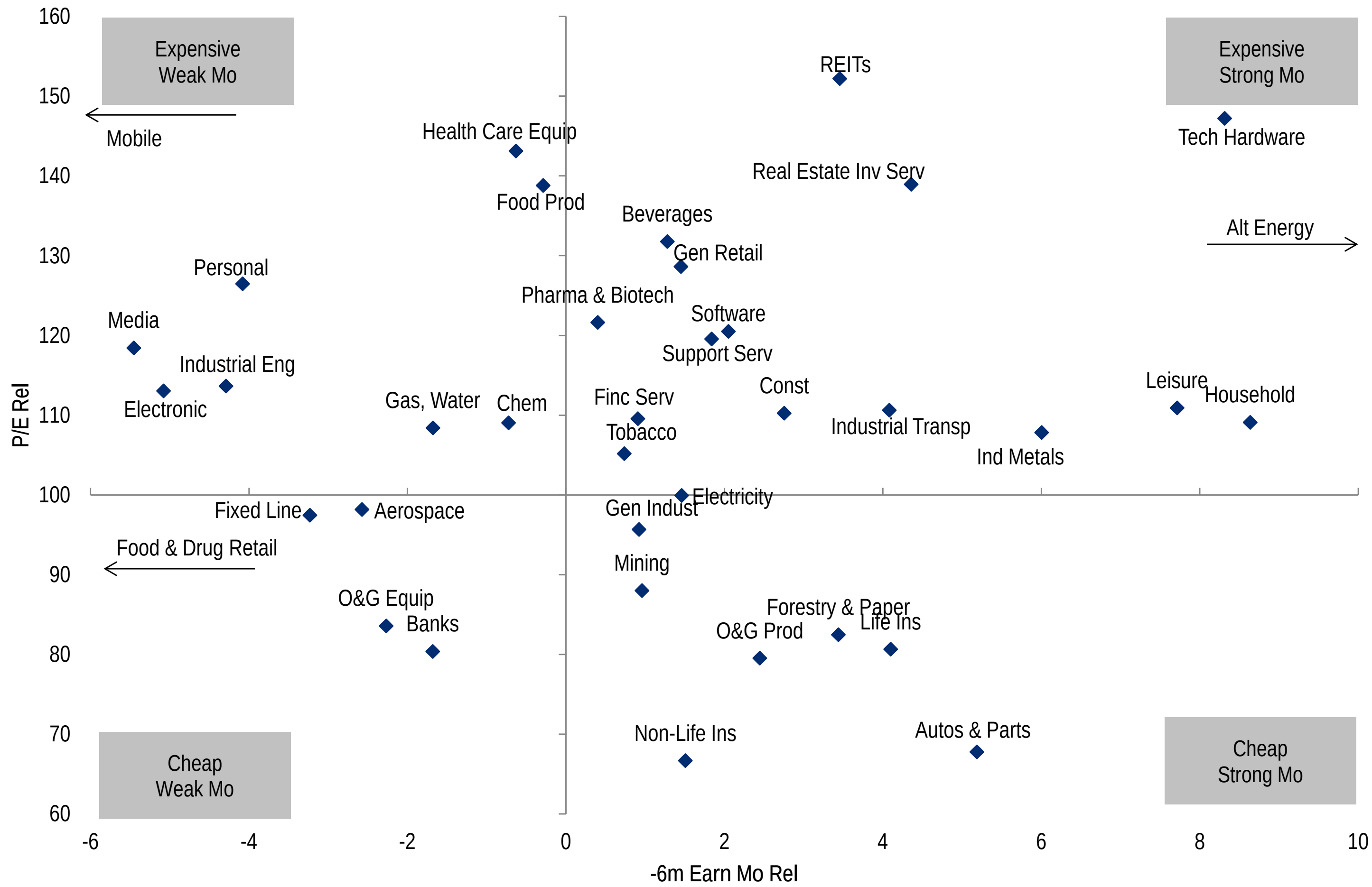


Source for all charts: DataStream & Citi Research

Key Investment Theme #4 — Show Me the Money (Focus on Delivery)

- Which sectors have the strongest relative earnings trends and also trade on a discount to the market?
- Bottom-right quadrant shows Financial and Cyclical sectors, eg Insurance, Autos & Mining; also sectors such as Electricity and Gen Industrials.
- Banks have slipped into the bottom-left quadrant but underlying earnings (eg excluding settlements) are improving, as highlighted by our analysts.

Figure 156. Six Months Earnings Mo and P/E Rel – Sectors



Source: DataStream & Citi Research

Key Investment Theme #4 — Show Me the Money (Focus on Delivery)

- We look for stocks in our long earnings momentum basket which also look cheap relative to their own 10-year P/E rel history.
- A stock must have 6-month relative earnings momentum above 8% to qualify for the earnings momentum basket.

Figure 157. Cheapest 30 Stocks in Current Long Earnings Momentum Basket

RIC	Stock	>€5bn Market Cap	>8 -6m Rel Earn Mo	P/E Rel	10y Median P/E Rel	% from 10y Median P/E Rel
ITV.L	ITV	9915	12	95	124	-23
ADEN.VX	Adecco R	9769	9	102	121	-15
RYA.I	Ryanair Holdings	9888	8	104	122	-14
PSN.L	Persimmon	5051	21	77	90	-14
BMWG.DE	BMW	28482	12	74	86	-14
DAIGn.DE	Daimler	61174	10	76	87	-13
AHT.L	Ashtead Group	6216	19	113	130	-13
LLOY.L	Lloyds Banking Group	51359	13	74	84	-12
DANSKE.CO	Danske Bank	14660	18	81	90	-10
ATLN.VX	Actelion	10302	27	131	143	-8
REE.MC	Red Electrica Corpn.	6936	8	105	113	-6
TPK.L	Travis Perkins	5423	9	94	97	-3
RDSa.L	Royal Dutch Shell A	120972	11	78	79	-1
YAR.OL	Yara International	6791	13	81	81	0
BAB.L	Babcock International	7050	9	123	123	0
HEIG.DE	HeidelbergCement	8028	8	100	100	0
VLOF.PA	Valeo	6914	17	92	92	0
VOLVb.ST	Volvo B	14601	10	104	104	0
SN.L	Smith & Nephew	12163	9	139	136	2
GEBN.VX	Geberit R	9760	10	156	145	7
CCL.L	Carnival	5172	26	145	134	8
VIE.PA	Veolia Environnement	6105	21	165	152	9
CRDI.MI	Unicredit	32316	23	110	98	12
SIK.VX	Sika B	6188	10	148	132	12
WTB.L	Whitbread	9848	16	145	127	14
NXT.L	Next	13868	14	114	100	14
VWS.CO	Vestas Windsystems	7176	49	212	181	17
CRH.L	CRH	12996	13	142	119	20
SAN.MC	Banco Santander	89396	9	100	80	25
NOK1V.HE	Nokia	23949	22	161	126	27

Source: DataStream & Citi Research

Key Investment Theme #4 — Show Me the Money (Focus on Delivery)

- Delivery is also about surplus FCF, in our view.
- We look for sectors with surplus FCF. This presents optionality in terms of putting this FCF to work, eg bigger dividends, investing in business.
- Strong balance sheets further enhance optionality; sectors with strong balance sheets and high surplus FCF should be well positioned.

Figure 158. Surplus Free Cash Flow

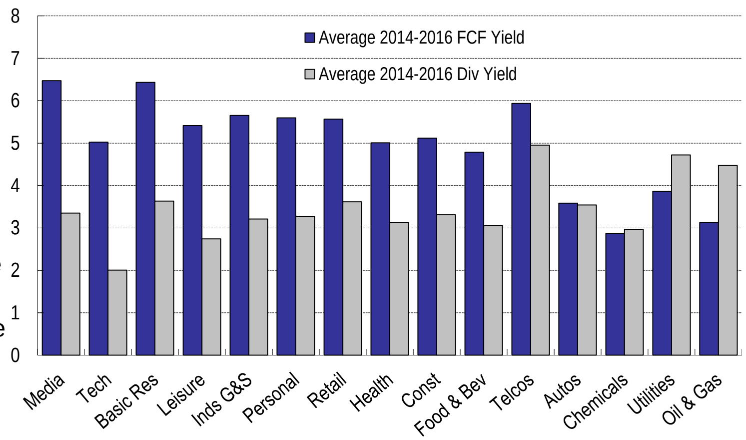
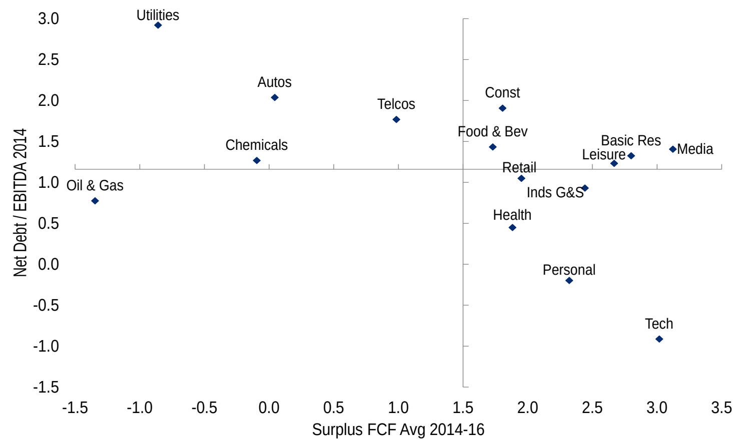


Figure 159. Surplus Free Cash Flow & Strong Balance Sheets



- Analysts expect a strong pick-up in FCF in several European sectors.
- Basic Resources expected to have the biggest FCF delta.
- Smaller deltas in already high FCF sectors such as Telecoms (-ve delta) and in Health Care & Media.
- Sectors with high delta and surplus FCF include Tech, Resources, Leisure, Industrials and Construction.

Figure 160. FCFY Delta = Avg 2014-16E FCFY less 2011-13E FCFY

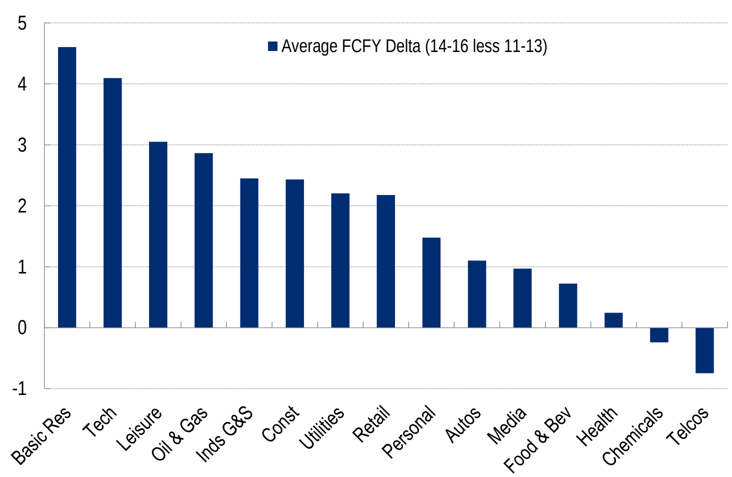
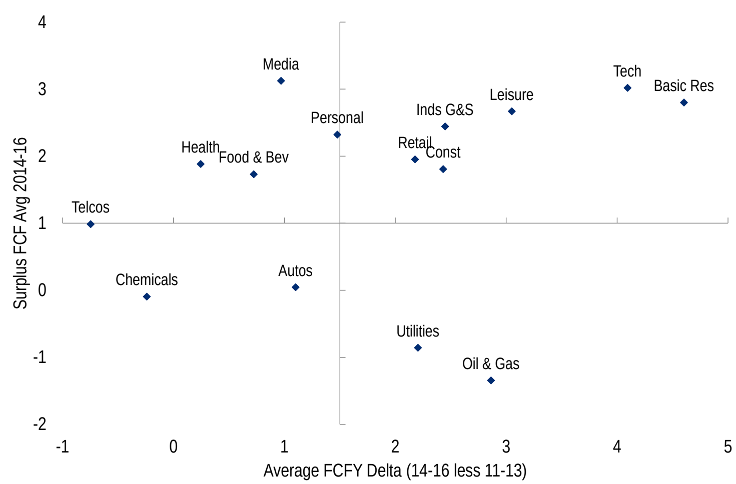


Figure 161. FCFY Delta vs Surplus FCF



Source for all charts: Citi Research

Key Investment Theme #5 — The Size Trade: More Support for Big-Caps?

- European mega-caps outperformed mid-caps in the 1990s, supported by liquidity from the convergence trade and over-exposure to TMT at the end of the decade.
- Mega-caps have lagged mid-caps since end-1999. CEOs managed to successfully dilute mega-cap returns with aggressive share issuance in the late-1990s.

Figure 162. Mega Cap Performance, 1990-99

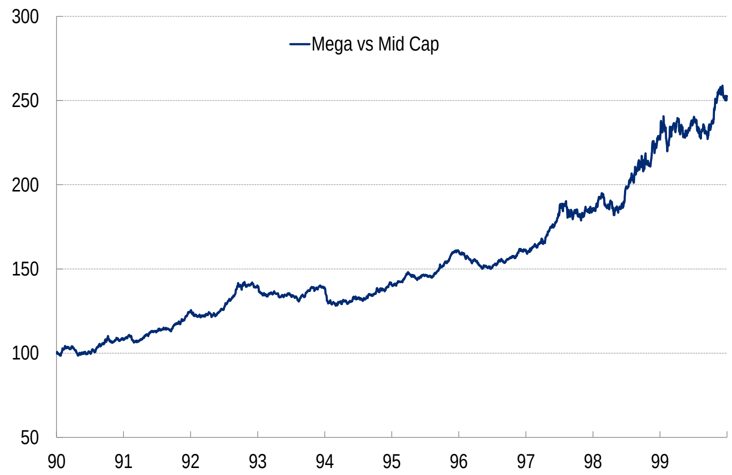
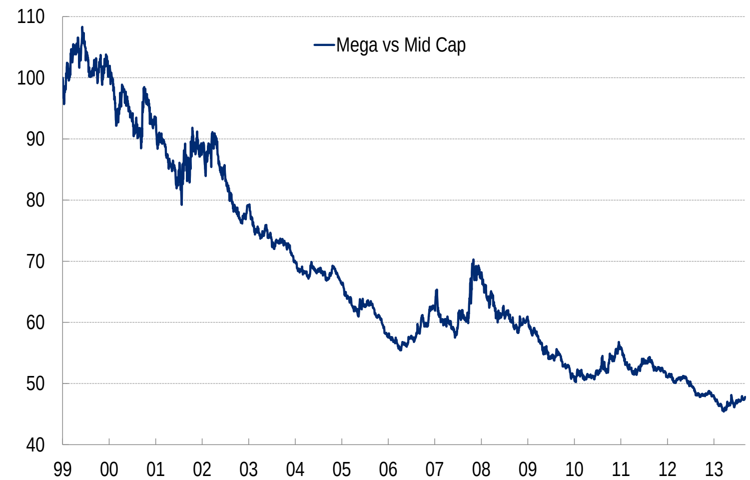


Figure 163. Mega Cap Performance, 1999 – Now



- Mega-caps leading YTD. Another reason why investors are having a tough year. First time mega-caps outperforming a rising market since late 1990s bull market.
- Improved performance from big commodity stocks on FCF delta, competitive performance from Financials and strong performance from Pharma is why.
- Large caps tend to perform better in Phase 3 of credit/equity cycle. Perhaps some signs that we are nearing that.

Figure 164. Annual Performance By Size Grouping

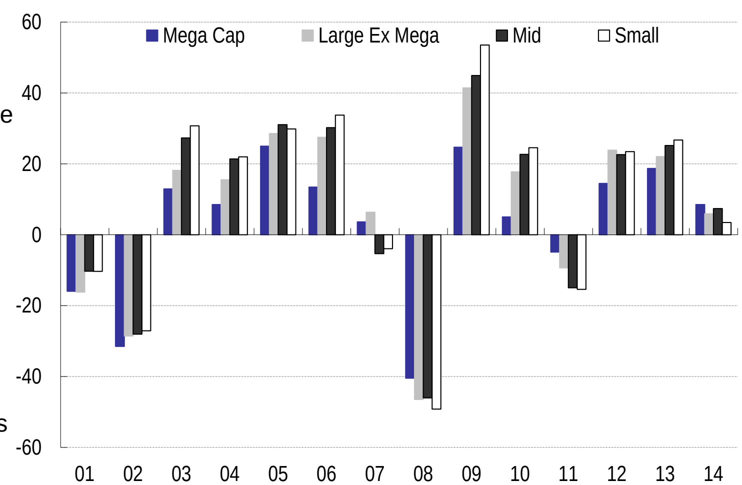
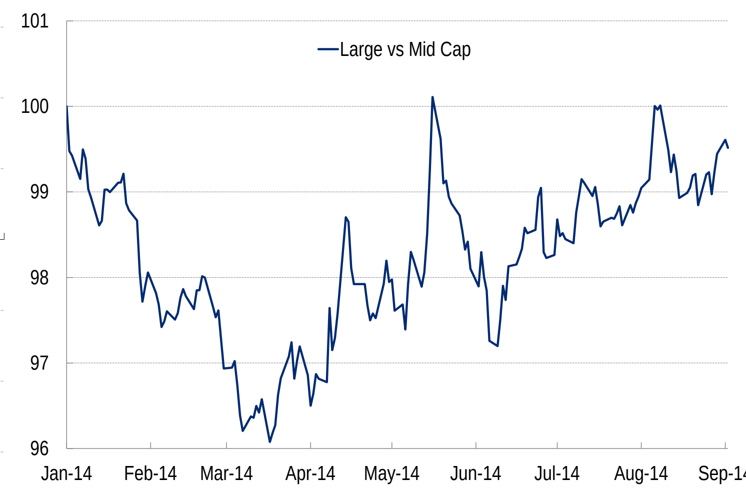


Figure 165. Large-Caps vs Mid-Caps YTD



Source for all charts: DataStream & Citi Research

Key Investment Theme #5 — The Size Trade: More Support for Big-Caps?

- All size groups have been sharply re-rated over the past 2-3 years.
- Mid-caps looked very cheap at the end of the 1990s and expensive at end-06 and end-11. Mid-caps have de-rated in last few quarters as mega-caps have re-rated, in P/E terms.
- Mega-caps and large ex-mega-caps now trading on same P/E.

Figure 166. 12m Forward P/E — Absolute

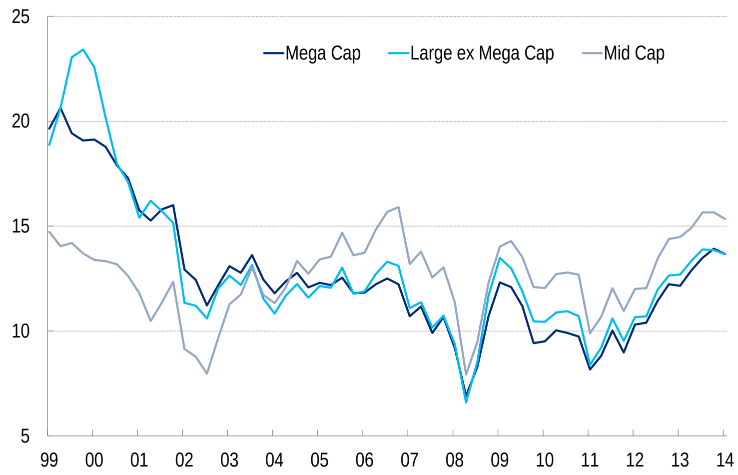
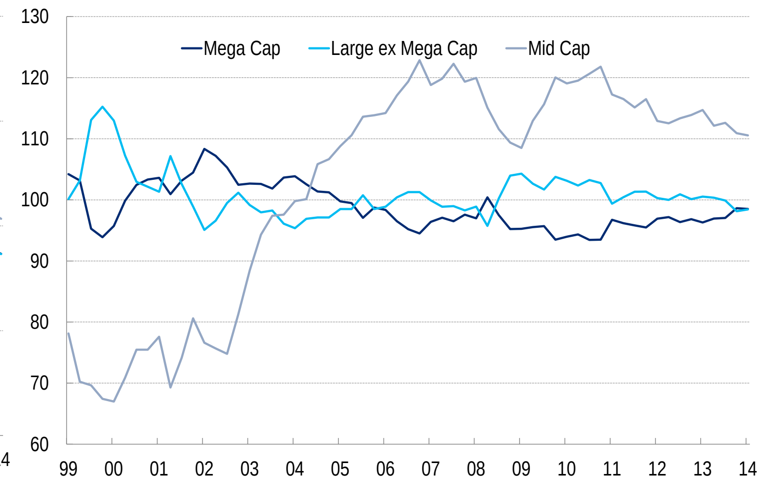


Figure 167. 12m Forward P/E — Relative



- Mega-caps are the yield trade at a size level. More evidence of the search for yield working YTD.
- Large-caps offer a higher DY than mid-caps, but look less attractive on this basis than they did in 2007 and end-2010.

Figure 168. Stoxx Trailing DY — Absolute

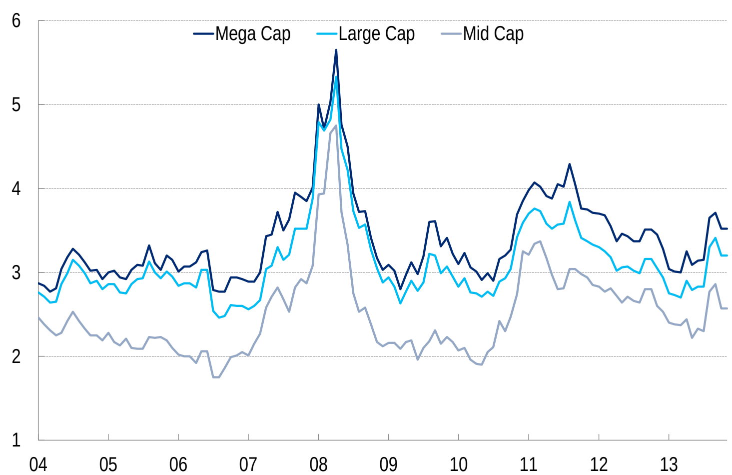
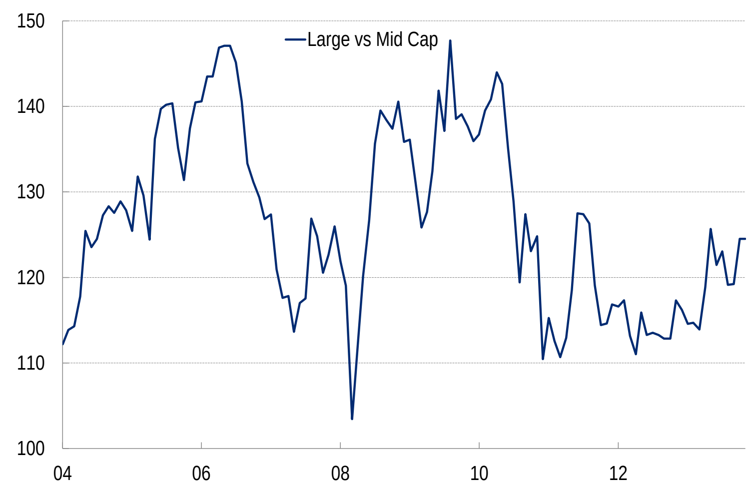


Figure 169. Trailing DY — Relative



Source for all charts: DataStream & Citi Research

Key Investment Theme #5 — The Size Trade: More Support for Big-Caps?

- All size groups have similar FCFYs 2014-16E.
- Access to cheaper debt funding should make the de-equitisation arbitrage more attractive for bigger-caps, but there is not much in it.
- Main point is that all size groups offer the same arb. This suggests that "stuff should happen", ie corporate actions, unless rates rise sharply or FCF collapses.

Figure 170. Free Cash Flow Yield

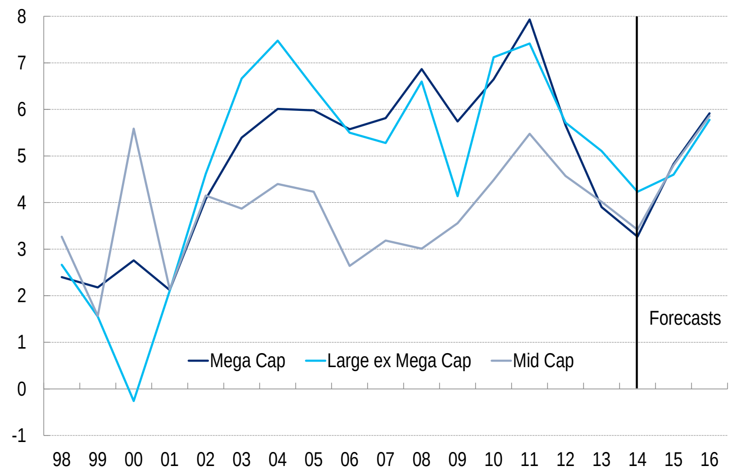
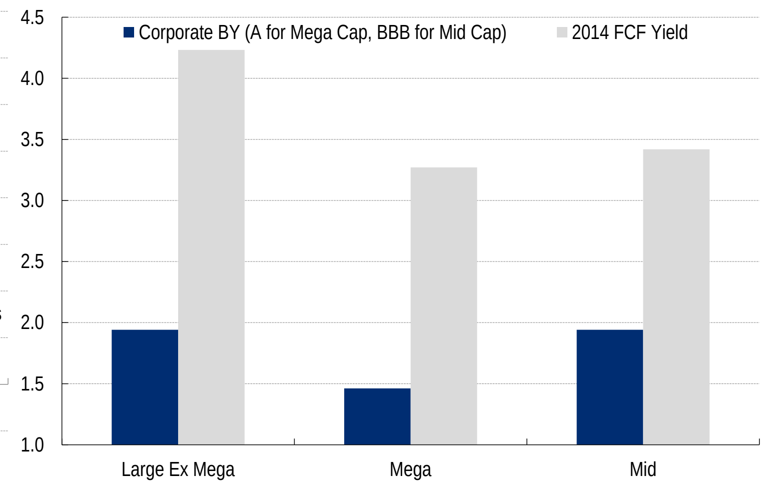


Figure 171. De Equitisation Arbitrage

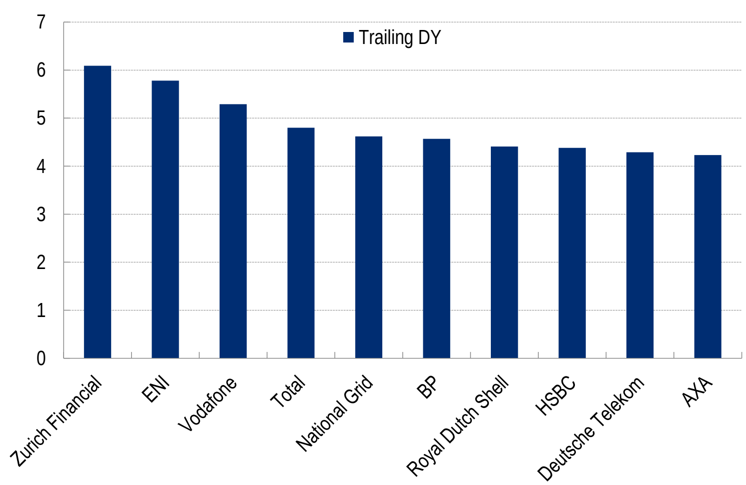


- Which mega-caps offer surplus FCF and strong balance sheets?
- Which mega-caps offer highest DYs?
- We would prefer DY*G to get exposure to improving global growth opportunities but high (and defendable) DYs should offer decent value back-stop.

Figure 172. Mega-caps — Surplus FCF and Strong Balance Sheets

RIC	Stock	Market Cap	Average FCFY (14E-16E)	Average DY (14E-16E)	>200bps Avg FCF-Avg DY	<1 Net Debt/EBITDA14
SAPG.DE	SAP	56129	5.4	1.6	3.8	0.1
CFR.VX	Richemont	37884	5.4	1.9	3.4	-1.7
BLT.L	BHP Billiton	51375	7.4	4.1	3.4	0.7
LVMH.PA	LVMH	35287	5.5	2.7	2.8	0.7
SIEGn.DE	Siemens	79308	7.3	4.6	2.7	0.8
RB.L	Reckitt Benckiser	43419	5.4	2.7	2.7	0.4
ABBN.VX	ABB	40108	6.6	3.9	2.7	0.0
ERICb.ST	Ericsson	28884	6.1	3.5	2.6	-1.8
RIO.L	Rio Tinto	50824	6.7	4.5	2.2	0.8

Figure 173. Mega-Caps — Top 10 DY



Source for all charts: DataStream & Citi Research

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Sector & Country Strategy

Sector Strategy — Cyclicals Over Defensives

- Our Sector Attribution Model weights factors that we think will be most important in driving performance over the coming 3-18 months.
- We put most weight on surplus FCF (FCF-DY) and earnings/growth, FCF/capital return and also skew to falling Euro Area bond spreads (ie QE) and rising US bond yield.
- We prefer Financials and Cyclicals to Defensives. We Overweight Insurance, Basic Resources, Autos, Banks, Tech, Travel & Leisure.
- We raise Construction to Overweight. It scores well on SAM, has exposure to a decent US outlook and also to any improvement in European growth over the next 1-2 years. Self-help and consolidation in the sector could also support.
- We Underweight Food & Beverage, Telecoms, Retail, Utilities and Chemicals.
- Our model would also be Underweight Health Care, Media and Personal & Household Goods. We are Neutral these sectors in our overall allocation, due to support from surplus FCF, strong balance sheets or both.

Figure 174. Sector Attribution Model

	US Exp	EU Exp	Earnings Mo	Earnings Current vs 10y Avg	P/B	Abs P/E Rel to 5yr History	DY*G	FCF-DY	Average FCFY Delta	B/S	US Bond Yields	Periphery Bond Spreads	Beta	Overall Rank
Factor Weight	5%	5%	15%	10%	10%	5%	10%	10%	5%	5%	5%	10%	5%	100%
Insurance	12	5	4	7	2	13	2	-	-	-	5	2	6	5.5
Banks	14	9	15	1	1	6	1	-	-	-	1	1	2	5.8
Basic Resources	15	17	9	4	4	12	5	3	1	7	3	6	4	6.5
Auto & Parts	4	13	4	19	9	1	4	12	11	7	2	4	1	7.4
Construction	13	7	7	6	8	10	10	9	5	12	4	3	3	7.4
Technology	10	14	1	9	7	9	19	2	2	2	8	8	11	7.5
Oil & Gas	5	12	2	5	6	14	14	15	4	3	10	10	12	8.3
Travel & Leisure	6	6	6	18	17	2	3	4	3	9	12	11	8	8.5
Industrial G&S	9	10	15	13	18	4	6	5	6	5	6	7	7	9.5
Real Estate	19	1	3	10	12	7	15	-	-	-	17	15	18	10.3
Utilities	17	2	12	3	3	16	17	14	7	15	13	5	17	10.4
Retail	16	3	17	11	10	5	9	7	8	6	15	14	13	11.0
Financial Services	1	19	11	14	13	15	12	-	-	-	7	16	5	11.1
Health Care	2	16	10	12	5	18	13	8	13	3	18	19	15	11.5
Media	3	8	18	8	14	17	18	1	10	13	11	12	9	11.6
Personal & HH Goods	11	15	13	17	15	3	7	6	9	1	16	17	16	11.7
Chemicals	7	11	14	16	19	8	8	13	14	9	9	9	10	12.0
Food & Beverage	8	18	7	15	16	11	11	10	12	11	19	18	19	13.0
Telecommunications	18	4	19	2	11	19	16	11	15	14	14	13	14	13.1

Source: Citi Research

Country Strategy — Ireland & Italy Near Top of Rankings

- Our Country model runs on similar factors to our Sector model. Additionally, we have a significant weight on bond spreads vs bunds to play exposure to further convergence and ECB QE. Earnings momentum carries most weight in the model currently with 20%.
- Peripheral markets have been towards the top of CAM since end-2013. Italy and Ireland are currently in the top 3 alongside Norway.

Figure 175. Country Attribution Model

	EM Exposure	US Exposure	EU Exposure	Earn Mo	ROE	P/B	Abs P/ E Rel to 5yr History	DYG	CDS Adj DY	Corporate B/S	Spread Vs Bunds	Macro	Overall Rank
Factor Weight	0%	5%	5%	20%	10%	10%	10%	5%	5%	10%	15%	5%	100%
Norway	4	12	2	7	10	7	5	5	1	6	5	5	6.2
Italy	3	1	13	2	2	4	11	4	14	14	4	12	6.3
Ireland	1	2	5	5	8	9	2	15	13	9	7	8	7.0
Sweden	8	7	10	9	11	13	1	8	2	3	9	7	7.7
Finland	13	11	6	2	9	10	6	16	4	2	13	15	7.7
UK	7	6	12	10	6	12	8	7	3	8	3	9	7.7
Spain	15	13	7	2	5	5	14	13	10	14	6	10	7.8
Denmark	14	9	11	1	15	15	4	9	11	5	15	6	8.7
Greece	2	16	1	16	8	1	16	2	16	4	1	13	8.7
Austria	16	14	9	15	1	2	15	1	7	6	11	4	8.8
Portugal	9	15	3	12	4	3	10	14	15	16	2	10	8.9
France	6	10	4	13	3	6	7	11	9	11	8	16	9.0
Switzerland	10	5	14	7	13	14	9	6	6	1	16	1	9.1
Netherland	12	4	15	11	8	11	12	3	8	9	12	2	9.6
Germany	5	8	8	13	12	8	3	10	5	12	14	3	9.9
Belgium	11	3	16	6	14	16	13	12	12	13	10	14	11.2

Source: Citi Research

Figure 176. Stocks Mentioned in this Report

RIC	Stock	Price	Rating	Currency	RIC	Stock	Price	Rating	Currency	RIC	Stock	Price	Rating	Currency
MAERSKb.CO	A P Moller - Maersk B	14,620.00	2	DKK	DPWGn.DE	Deutsche Post	25.68	1	EUR	RENA.PA	Renault	61.06	1	EUR
ABBN.VX	ABB	21.53	1	CHF	DTEGn.DE	Deutsche Telekom	11.68	2	EUR	REP.MC	Repsol Ypf	19.37	1	EUR
ADN.L	Aberdeen Asset Man.	4.46	1	GBP	DGE.L	Diageo	18.24	1	GBP	CFR.VX	Richemont	88.80	1	CHF
ATLN.VX	Actelion	112.30		CHF	DNB.OL	DNB	116.20	1	NOK	RIO.L	Rio Tinto	32.42	1	GBP
ADEN.VX	Adecco R	70.10	3	CHF	ENEI.MI	Enel	4.25	3	EUR	RBS.L	Royal Bank Of Sctl.Gp.	3.55	3H	GBP
AEGN.AS	Aegon	6.34	2	EUR	ENI.MI	ENI	19.58	2	EUR	RDSa.L	Royal Dutch Shell	24.49	2	GBP
AKZO.AS	Akzo Nobel	54.84	1	EUR	ERICb.ST	Ericsson	88.35	2	SEK	RYA.I	Ryanair Holdings	7.48	1	EUR
ALUA.PA	Alcatel-Lucent	2.66	1	EUR	GEBN.VX	Geberit R	316.30	3	CHF	SASY.PA	Sanofi	85.75	2	EUR
ALVG.DE	Allianz	133.65	1	EUR	GLEN.L	Glencore	3.71	1	GBP	SAPG.DE	SAP	59.99	1	EUR
AAL.L	Anglo American	15.94	2	GBP	HEIG.DE	HeidelbergCement	58.36	1	EUR	SCHN.PA	Schneider Electric	65.50	2	EUR
ABI.BR	Anheuser-Busch Inbev	87.80	1	EUR	HNKG_p.DE	Henkel Pref.	81.95	2	EUR	SEBa.ST	SEB A	91.40	1	SEK
AAPL.OQ	Apple	98.94	1	USD	HSBA.L	HSBC	6.60	2	GBP	SESFd.PA	SES Fdr	28.43	1	EUR
AHT.L	Ashtead Group	10.18	1	GBP	ING.AS	ING Groep	10.95	1	EUR	SIEGn.DE	Siemens	98.59	1	EUR
ASML.AS	ASML Hldg	76.25	1	EUR	ISP.MI	Intesa Sanpaolo	2.46	1	EUR	SIK.VX	Sika B	3,477.00		CHF
ASSAb.ST	Assa Abloy B	357.30	3	SEK	INVEb.ST	Investor B	258.80	1	SEK	SKFb.ST	SKF B	164.00	2	SEK
GASI.MI	Assicurazioni Generali	16.44	3	EUR	ITV.L	ITV	2.22	2	GBP	SN.L	Smith & Nephew	10.54		GBP
AZN.L	AstraZeneca	45.57	1	GBP	KBC.BR	KBC Groupe	43.84	1	EUR	SOGN.PA	Societe Generale	41.00	1	EUR
ATCOa.ST	Atlas Copco A	204.50	1	SEK	PRTP.PA	Kering	165.40	1	EUR	SRENH.VX	Swiss Re	76.25	2	CHF
AV.L	Aviva	5.34	1	GBP	KGF.L	Kingfisher	3.06	2	GBP	SCMN.VX	Swisscom R	533.00	1	CHF
AXAF.PA	AXA	19.55	1	EUR	DSMN.AS	Koninklijke DSM	51.34	1	EUR	SYNN.VX	Syngenta	326.10	2	CHF
BAB.L	Babcock International	11.15	2	GBP	LGEN.L	Legal & General	2.43	2	GBP	TECF.PA	Technip	70.04	2	EUR
SABE.MC	Banco De Sabadell	2.49	3	EUR	LEGD.PA	Legrand	44.38	2	EUR	TEL.OL	Telenor	145.00	2	NOK
POP.MC	Banco Popular Espanol	4.90	3	EUR	LLOY.L	Lloyds Banking Group	0.75	2	GBP	TKAG.DE	ThyssenKrupp	21.89	2	EUR
SAN.MC	Banco Santander	7.89	2	EUR	OREP.PA	L'Oreal	130.00	2	EUR	TOTF.PA	Total	51.77	1	EUR
BARC.L	Barclays	2.31	1	GBP	LVMH.PA	LVMH	137.60	1	EUR	TPK.L	Travis Perkins	17.17	1	GBP
BBVA.MC	BBV Argentaria	9.77	2	EUR	MICP.PA	Michelin	85.08	1	EUR	UBI.MI	UBI Banca	6.45	1H	EUR
BG.L	BG Group	12.33	1	GBP	NG.L	National Grid	9.11	2	GBP	UBSN.VX	UBS R	16.62	1	CHF
BLT.L	BHP Billiton	19.05	2	GBP	CNAT.PA	Natixis	5.48	2	EUR	UNBP.AS	Unibail-Rodamco	205.55		EUR
BMWG.DE	BMW	91.54	2	EUR	NESN.VX	Nestle R	71.70	1	CHF	CRDI.MI	Unicredit	6.40	1	EUR
BNPP.PA	BNP Paribas	54.30	1	EUR	NXT.L	Next	72.15	1	GBP	ULVR.L	Unilever (UK)	27.28	2	GBP
BP.L	BP	4.55	2	GBP	NOK1V.HE	Nokia	6.50	1	EUR	UNc.AS	Unilever Certs.	32.54	2	EUR
BSY.L	BSKyB	8.85	1	GBP	NDA.ST	Nordea Bank	91.10	1	SEK	VLOF.PA	Valeo	94.01	1	EUR
BT.L	BT Group	3.90	1	GBP	NHY.OL	Norsk Hydro	37.90	2	NOK	VIE.PA	Veolia Environnement	14.29	2	EUR
CABK.MC	Caixabank	4.83	1	EUR	NOVOb.CO	Novo Nordisk 'B'	258.00	1	DKK	VWS.CO	Vestas Windsystems	242.70	2	DKK
CCL.L	Carnival	23.58		GBP	OML.L	Old Mutual	2.06		GBP	VOD.L	Vodafone	2.09	1	GBP
CBKG.DE	Commerzbank	12.47	2H	EUR	PSON.L	Pearson	11.09	1	GBP	VOWG.DE	Volkswagen Pref.	177.30	1	EUR
CPG.L	Compass Group	9.89	2	GBP	PSN.L	Persimmon	13.47	1	GBP	VOLVb.ST	Volvo B	83.00	1	SEK
CONG.DE	Continental	166.50	1	EUR	PHG.AS	Philips Electronics	23.65	1	EUR	WTB.L	Whitbread	44.78	2	GBP
CAGR.PA	Credit Agricole	11.75	1	EUR	PSHG_p.DE	Porsche Pref.	70.16	2H	EUR	WOS.L	Wolseley	32.73	1	GBP
CSGN.VX	Credit Suisse R	26.32	1	CHF	PUBP.PA	Publicis Groupe	58.31	3	EUR	WLSNc.AS	Wolters Kluwer	21.26	2	EUR
CRH.L	CRH	14.66	2	GBP	RB.L	Reckitt Benckiser	53.65	1	GBP	WPP.L	WPP	12.98	2	GBP
DAIGn.DE	Daimler	64.14	2	EUR	REE.MC	Red Electrica Corpn.	65.55	2	EUR	YAR.OL	Yara International	311.10	2	NOK
DANSKE.CO	Danske Bank	162.00	1	DKK	REL.L	Reed Elsevier	9.94	1	GBP	ZURN.VX	Zurich Financial	279.90	2	CHF
DBKGn.DE	Deutsche Bank	27.00	1	EUR										

Source: Citi Research. Prices as of 3rd September   Additional stock: Experian (EXPN.L; £10.70; 1)

Appendix A-1

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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.

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	12 Month Rating			Relative Rating		
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