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Monday Morning Musings

Mixed Emotions Meets Uncertainty

- Equities

Tobias M Levkovich
+1-212-816-1623
tobias.levkovich@citi.com

Lorraine M Schmitt
lorraine.m.schmitt@citi.com

Andrew T Ward
andrew.t.ward@citi.com

- **Investors seem confused and frustrated rather than fearful.** Anecdotal evidence argues that the investment community has recovered rather dramatically from its state of fear last fall when European pressures dominated the headlines and (ultimately erroneous) US recession calls were being made. Indeed, macro-oriented intra-stock directional price movement correlation represents an "easy" way to quantitatively measure such views and it is currently signaling mixed feelings.

- **Sentiment measures reflect anxiety not distress.** The proprietary Panic/Euphoria Model is stuck in neutral (having slipped back from early March complacency) providing very little predictive stock price guidance currently, but it is also no longer in "panic territory" which historically has provided clear buying moments given its statistical probability scores. Other metrics such as the State Street Investor Confidence Index is admittedly low, but it does not yield much predictive power.

- **Money flows are not necessarily as poor as many might think.** While US-oriented equity mutual fund flows have been relatively poor with investors continuing to prefer bond funds as well as emerging markets equities, exchange traded funds have experienced inflows to US-oriented product more than offsetting the mutual fund weakness. Thus, there are signs of modest interest versus previous indications of no involvement. And, indeed, hedge fund exposures have increased.

- **The "VIX Fix" is highly questionable.** Too many investors and financial media types track the alleged VIX fear gauge but the volatility index is easily accessible and thus provides no "edge," in our opinion. Even approaches that look at the index's skew are equally available to most professional investors which again implies that there is no additional market insight being provided. Accordingly, a relatively low VIX reading does not suggest that investors are unaware of the risks.

- **The Citi Economic Surprise Index still argues for caution.** The CESI continues to drop, and some inflection off of a bottom may be needed to feel more confident about a market turn. Earnings upside surprises and beating expectations alone may not be enough to generate greater investor appetite for stocks. In addition, some clarity with respect to very substantial political/fiscal challenges most likely is needed to pull down equity risk premiums and allow for P/E multiple expansion.

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

It Is Not That Simple

The tendency to use shortcuts given constant time pressures makes investors like easy answers to complex problems. In this context, there is a powerful pull to utilize easily available broad measures for almost any issue. For instance, polls can tell us which candidate is more likely to win presidential elections, but a more detailed state by state study is often far more conclusive since electoral college votes determine who wins the White House. Thus, there are clear shortcomings to popular approaches such as the VIX or surveys to gauge investor sentiment.

For example, the VIX has not been a great predictive indicator for future stock price direction unless it is stressed considerably. Indeed, a study we conducted looking at the VIX climbing 25% from lows generates only random stock price outcomes (see Figure 1). When reviewing +25% moves off of the low point in the VIX within any month and seeing what happens to equities over the next three, six and 12 months only confirms that it is a rather inadequate predictor of future trend even as so many pundits use it to get a "fix" on investment community leanings. Moreover, easily available data provides little if any unique insight for fund managers seeking an "edge."

Figure 1.

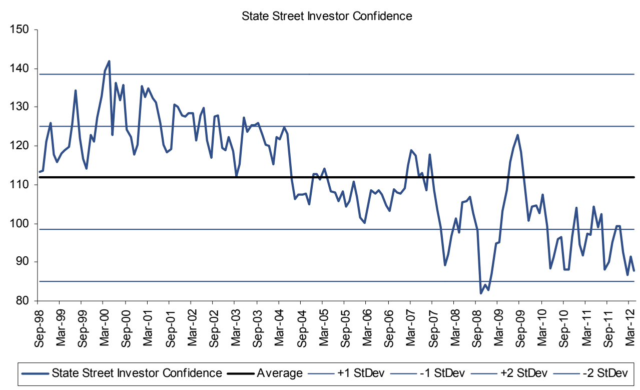
Performance when VIX is up +25% from Low in a Month

	S&P 500		
	3 mths later	**6 mths later**	**12 mths later**
Average	1.17%	3.66%	8.81%
Median	2.32%	3.99%	12.44%
# times up	277	303	323
# times down	181	155	109
	458	458	432
% up	60.48%	66.16%	74.77%
% down	39.52%	33.84%	25.23%

Source: Haver Analytics and CIRA – US Equity Strategy

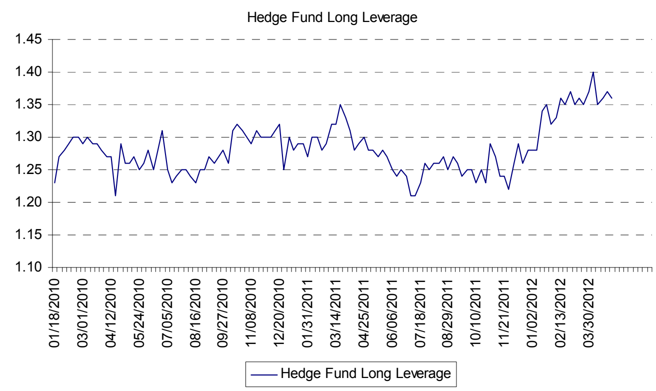
The easily accessible State Street Investor Confidence Index, which measures money flows within managed funds to ascertain investor risk appetite or aversion has also proven to be a less than reliable forecaster of market return (see Figure 2) though we would argue that getting a read on aggregate hedge fund exposure to equities is far more useful (see Figure 3) – but such data is much harder to come by. Keep in mind that if it is much more challenging to get any information, it probably is also more valuable.

Figure 2.



Source: Bloomberg and CIRA – US Equity Strategy

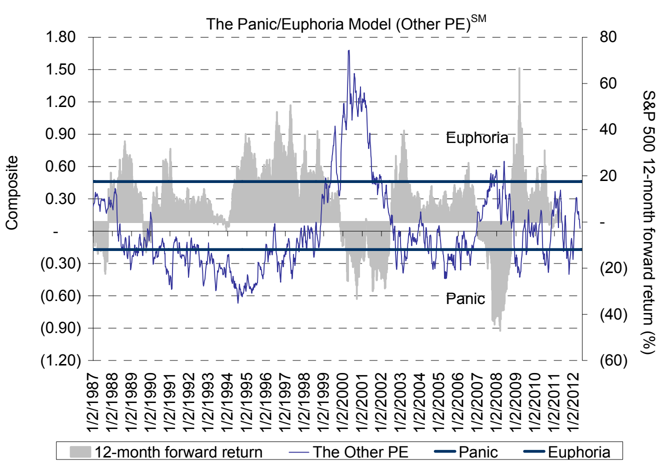
Figure 3.



Source: Citi US Equity Trading Strategy

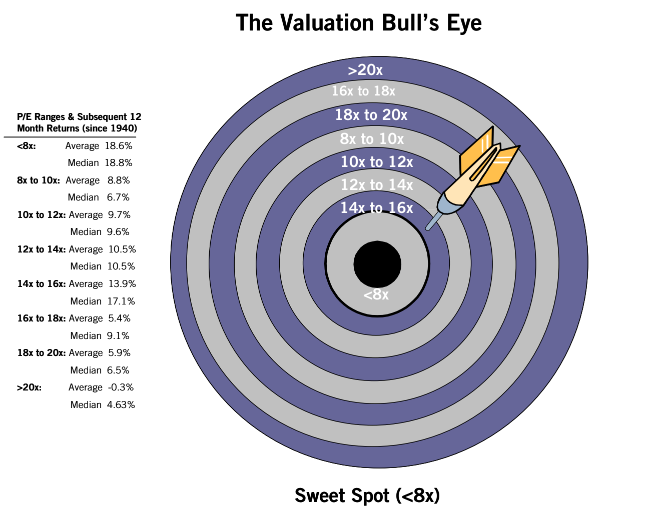
The Panic/Euphoria Model is our key sentiment measure and it shows fairly neutral readings at the moment, having backed off from complacency readings in March (see Figure 4), but still well above the panic levels seen late last year when investors were deeply worried about Europe, China and the US. As a reminder, when in panic territory, there is a near 90% probability that stock prices are up in the subsequent six months and there is a better than 95% chance of gains in the next year. At its current stage, this unique model is not arguing for chasing the tape higher, especially as it remains only 2%-3% away from our 2012 S&P 500 year-end target. However, longer-term investors should be buying shares on weakness given our Raging Bull Thesis looking out the next several years. Note that some investors do not think share prices are cheap enough to buy, but our P/E Bulls-Eye analysis would suggest a respectable likelihood of gains over the next 12 months (see Figure 5).

Figure 4.



Source: Haver Analytics and CIRA – US Equity Strategy

Figure 5.

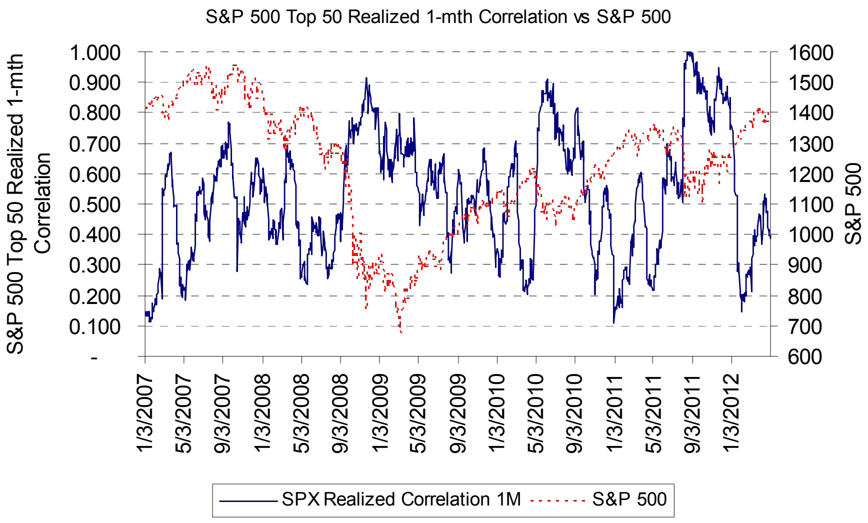


Source: Haver Analytics and CIRA – US Equity Strategy

One other way to quantify if investors are overly focused on macro conditions and possibly forgetting individual company fundamentals is to review intra-stock price correlation – do share prices move in tandem or is there unique company stock price diffusion? Figure 6 illustrates that in the summer and fall of 2011, it was "all

macro, all the time" with 0.9 or higher correlation. By March this year, it had plunged to 0.2 almost implying that all of the world's problems had been solved, raising the risk profile, in our opinion. Now, with about 0.4 correlation, it is a much tougher call.

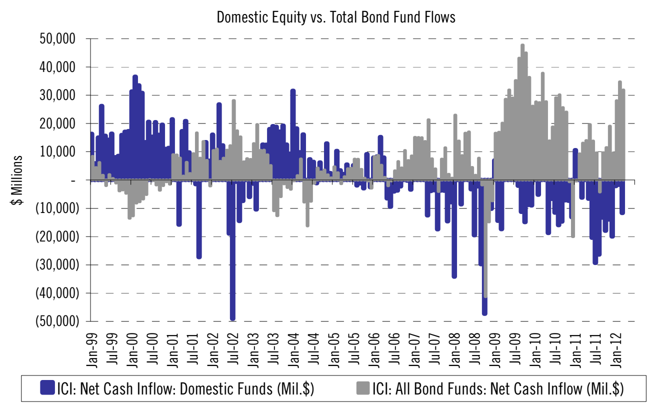
Figure 6.



Source: Citi US Equity Trading Strategy and CIRA – US Equity Strategy

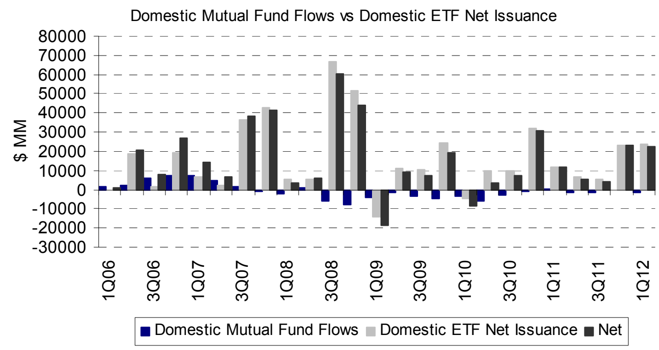
One of the more intriguing and somewhat confusing set of data to understand is money flows. Because tracking all money movement is extraordinarily difficult (given the lack of transparency in certain areas such as pension fund allocation), market watchers have to settle with mutual fund flows to gain insight. Figure 7 illustrates that individual investors have favored bonds over equities for a decade now, but more recently, there has been a bit more favorable trend towards American stocks even as US-oriented mutual funds have suffered outflows through 1Q12 (Figure 8). The offset has been inflows to US equity exchange traded funds that left the market with a net inflow. Admittedly, US investors have favored Emerging Markets for the most part (see Figure 9) and have been putting money in at an above average rate for much of the past couple of years (see Figure 10) despite having suffered losses in markets such as China, Brazil and Russia over the past 24 months.

Figure 7.



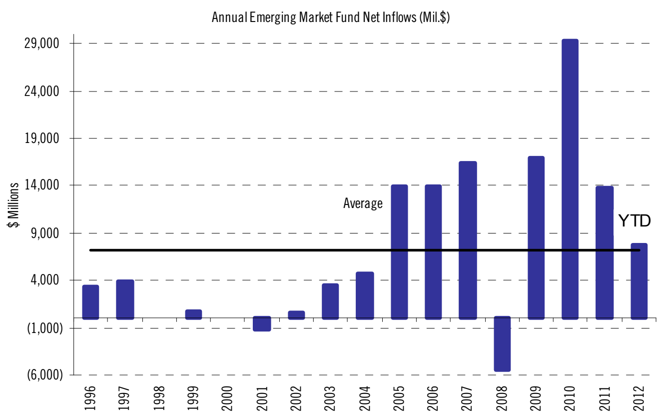
Source: Haver Analytics and CIRA – US Equity Strategy

Figure 8.



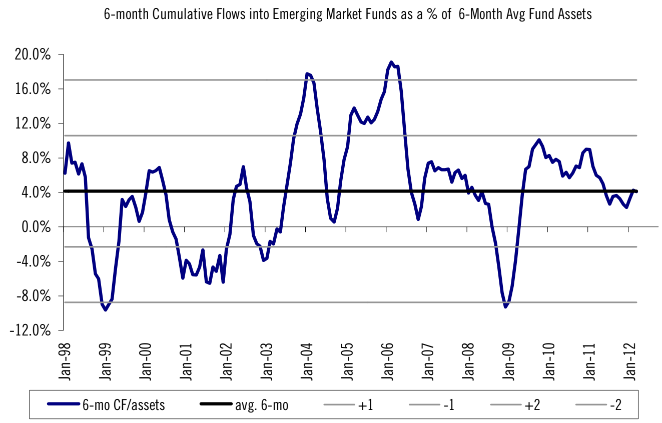
Source: Haver Analytics and CIRA – US Equity Strategy

Figure 9.



Source: Haver Analytics and CIRA – US Equity Strategy

Figure 10.



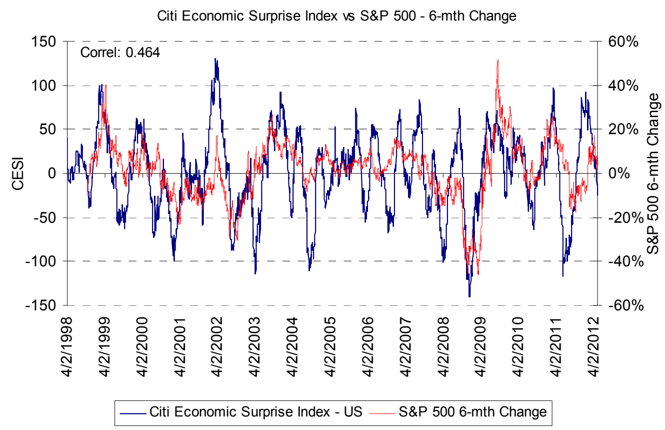
Source: Haver Analytics and CIRA – US Equity Strategy

As we noted in our May 2012 Chart of the Month report earlier this week, credit conditions have improved modestly underscoring the view that economic conditions will stay positive through year-end and thus support corporate profits as they relate strongly with industrial activity. Yet, the Citi Economic Surprise Index (see Figure 11) would argue that some inflection point off of its dropping trend is needed to feel confident to wade back into a new equity market rally effort given the lack of sentiment or correlation signals. As highlighted a couple of weeks ago, the earnings trajectory of a 17%-18% forecasted jump in 4Q12 bottom-up consensus EPS estimates seems just too optimistic given deep uncertainty on how government policy plays out.

The presidential elections, the so-called “fiscal cliff” and another required debt ceiling lift by year-end leaves much uncertainty for corporate leaders to chew on and it is doubtful that the business community will feel emboldened to accelerate capital investment in 2H12 without better clarity. Since the chances of a fiscal deal or grand bargain appears remote in the face of elections with candidates being unwilling to touch areas like taxes and entitlements that will anger their base constituencies, we may need to become fastidious poll watchers to sense equity market direction.

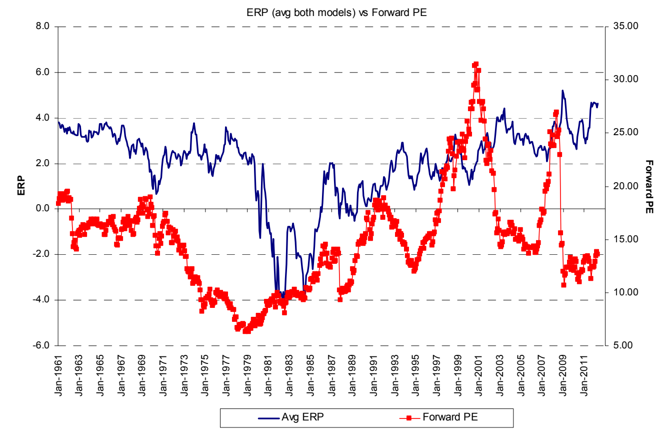
We continue to think that risk premiums are high because investors simply do not believe that the current deficit spending trend is sustainable (see Figure 12) and that either taxes go up, spending gets slashed or interest rates move higher as lenders demand higher returns for the incremental risk they are taking. If any of these (or a combination of them) occurs, US GDP growth expectations and projected long-term earnings trends could tank – accordingly, investors do not think that it is credible to assume growth can be sustained at its current pace and thus valuation gets compressed (via the risk premium increase). As a result, P/E multiple expansion is very much tied to addressing the fiscal imbalances which then can renew business and investor confidence, in our opinion.

Figure 11.



Source: Bloomberg and CIRA – US Equity Strategy

Figure 12.



Source: Haver Analytics and CIRA – US Equity Strategy

Appendix A-1

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