

Mid-Year Road Ahead 2014

Don't Fight the ECB

- **Stay Bullish** — European equities have returned 160%+ since 2009 lows and 7-8% YTD. There has been a sharp re-rating since mid-2012, from 10x to 17x on a trailing P/E basis. Shares are no longer cheap in absolute terms, but we stay bullish due to: 1) progressive global economic recovery in 2014-15, 2) return to double-digit earnings growth in 2014-16E, 3) super-cheap relative valuations, eg vs credit, 4) rising risk appetite, eg M&A, demand for equity. ECB QE later this year should also be supportive. Overall, we stick with our end-2014 Stoxx target of 370 and forecast c20% total returns from European equities to the end of 2015. Within the market, we think that investors should position for both rising US bond yields and ECB QE. The former could reverse recent rotation and suggests cyclicals/financials over defensives. The latter could further fuel convergence trades, with financials and the periphery as key beneficiaries.

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

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Dear Investor Clients



Markets are up. But, despite 7-8% YTD returns from European equities it has been a challenging 1H14 for most investors. Healthy headline gains mask a turbulent few months in terms of [rotation within equity markets](#). This rotation appears to have been driven by a combination of aggressive investor re-positioning and a sharp fall in US bond yields, which was contrary to start-year consensus thinking. A key part of our Strategy team's view is the reversal of some of this rotation in 2H14, aligned with Citi's view that US 10-year bond yields head back to/above 3% in coming quarters. In particular, Jonathan Stubbs suggests that investors use the rotation as an opportunity to raise exposure to growth and cyclical.

Elsewhere, we continue to have a [non-consensus view on ECB QE](#), which Guillaume Menuet and our European economics team think is likely by end-year. Following on from further liquidity announcements last week from ECB President Draghi, we expect this additional liquidity to fuel further convergence trades across the Euro Area. This should, in turn, provide support for both Financials and the periphery. For example, we have recently [added CaixaBank](#) in Spain to the Citi Focus List to reflect this.

Expectations of liquidity support, signs of macro improvements across Europe and a belief of double-digit earnings growth in 2014-15E continue to keep our strategists bullish on European equities, and our [bullish call](#) has been extended in this mid-year Road Ahead update. But, we should also not get complacent. EM macro risks, eg China credit, appear more worrisome now than DM ones and the work of our political analyst, Tina Fordham, suggests [more sober markets would price tail risks](#) rather differently.

We see mixed recent messages in terms of risk appetite and liquidity within equity markets. Low volatility and low volumes have been a feature of 2014 equity markets. But, so have rising corporate actions, both [in terms of M&A](#) and equity issuance, as well as positive net inflows into European equities. Overall, we are encouraged by signs of normalisation in European economies and financial markets, eg job creation, business investment, periphery issuance, M&A, equity primary. This would suggest that the crisis years are starting to recede into the history books, although it is some time yet before we can be confident of writing an epitaph.

Last, it is not enough to write “substantive” research in this environment. We aim always to provide thought-leading, actionable insight. Please use this report, and our services, to help you outperform in 2H14.

Kind regards

Terence Sinclair

Head of Research, Europe, Middle East and Africa

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Focus List Europe

Citi Focus List Europe

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- **The Citi Focus List Europe** — European analysts' 15-20 strongest Buy ideas for the next 12 months. It also reflects some of our UK & European Strategy team's preferred investment themes such as Earnings Leadership, Operating Leverage, Restructuring/Self Help, Capital Return and Corporate Actions.
- **Liquidity, Actionability & Citi Edge** — The Focus List highlights liquid names in which investors can build positions. We believe that Citi analysts offer investors strong views with differentiated analysis on Focus List stocks. Liquidity means some names with higher return expectations are excluded.
- **Bloomberg Code** — The up-to-date list and its components can be consulted at all times on Bloomberg: CGRBBUYE Index GO.

Figure 1. Citi Focus List Europe

Company Name	Ticker	Target Price	Current Price	Latest Key Research	Strategy Themes*
AstraZeneca PLC	AZN.L	£ 49.0	£ 43.1	Looking For A Deal, Waiting For The Pipeline	RS, CA
Akzo Nobel NV	AKZO.AS	€ 65.0	€ 54.5	Akzo Nobel NV (AKZO.AS) - Restructuring to drive value and share price; upgrade to Buy	OL, RS, CA
Aviva PLC	AV.L	£ 5.9	£ 5.1	Aviva PLC (AV.L): The 3 Phases of the Aviva Investment Case	EL, OL, RS
AXA SA	AXAF.PA	€ 24.0	€ 17.3	AXA SA (AXAF.PA): Overly Bearish Sentiment on Earnings Prospects - Buy	EL, OL, RS
Brit Am Tobacco	BATS.L	£ 36.5	£ 35.0	We believe acquiring RAI would help BAT...	EL, CR, RS, CA
BG Group	BG.L	£ 14.0	£ 12.7	Global Oil Vision: Stand and Deliver: Global Energy Enters a New Cycle	RS
BHP Billiton PLC	BLT.L	£ 21.0	£ 19.2	SOTP	RS, CA
CaixaBank SA	CABK.MC	€ 5.1	€ 4.3	Spanish Banks: After the Crisis	RS, CR, CA
Continental AG	CONG.DE	€ 210.0	€ 164.1	ADAS: Building the Car of the Future & the Opportunity for Conti	EL, CR, CA
Danske Bank A/S	DANSKE.CO	Dkr 175.0	Dkr 149.5	Danske Bank A/S (DANSKE.CO): The Bridge	RS, CR
Kering	PRTP.PA	€ 185.0	€ 161.8	A Good End to the Year in Luxury, Offset by a Bleak Outlook for Puma	OL, RS, CA
Novo Nordisk A/S	NOVOB.CO	Dkr 280.0	Dkr 231.6	Outlook still not priced in, >30% upside still available	EL, OL, CR
Philips	PHG.AS	€ 30.0	€ 23.2	Reiterate Buy – Feedback From West Coast Symposium	RS, OL
Renault SA	RENA.PA	€ 88.0	€ 66.6	Renault: Still significant cost savings ahead. Raising TP to €88	OL, RS, CA
Rio Tinto PLC	RIO.L	£ 38.5	£ 32.0	Tweaking Commodity Forecasts – Maintain Bullish Stance	RS, CA
Roche Holding AG	ROG.VX	SFr 300.0	SFr 266.1	Immunotherapy Ninja	EL

Source: Citi Research

Key to Strategy Themes:

- Earnings Leadership – EL
- Operating Leverage – OL
- Restructuring/Self Help – RS
- Capital Return – CR
- Corporate Actions – CA

Equity Strategy

European Equity Strategy

Position for Rising US Bond Yields & ECB QE

Jonathan Stubbs

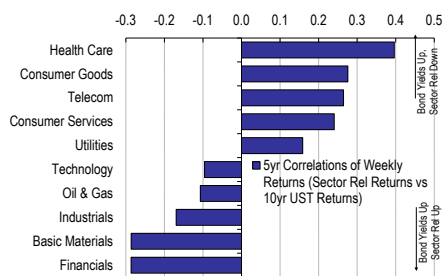
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US growth on track, QE from the ECB, Eyes open on China/EM — Willem Buiter & team continue to back a progressive recovery of the global economy, expecting 3% GDP growth this year and 3.5% in 2015E. Europe is expected to enjoy the biggest GDP growth delta between 2014-15E vs 2013. But, it was US GDP (weather) and CPI disappointments which stole the show in 1Q14. This helped to drive a fall in US bond yields to support sharp rotation in equity markets. In Europe, Euro Area deflation risks mean that our economists expect ECB QE in 4Q14, while a booming UK economy suggests policy rates could rise by year end. We think that rising US bond yields and ECB QE will be two key influences on European share prices in 2H14. Elsewhere, keep a close eye on risks in EM. For us, these are tail risks to monitor.

Bull market — European equities have returned 160%+ since the 2009 lows. Shares no longer look cheap but also don't look expensive. Indeed, on a CAPE basis or relative to other asset classes (eg cash, credit), European equities do still appear cheap. Further upside needs earnings growth. We have not seen much in recent times, but expect 10%+ earnings growth in 2014-15. We maintain our end-14 Stoxx target of 370. We initiate an end-15 Stoxx target of 400. This is based on a 2015-16E earnings growth CAGR of c10% and an end-15 12-month forward P/E of c14.5x, slightly higher than the current level. Higher investor and corporate risk appetite can support equity valuations above "fair value" territory, especially with interest rates remaining low.

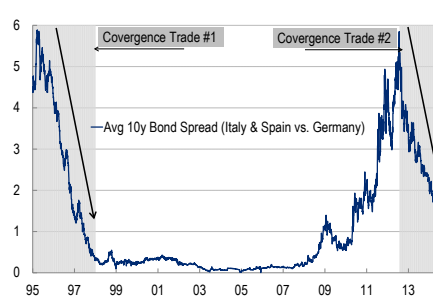
Rotation, QE, New Regime, Show Me..., Size, Search for Yield — 1) Rotation — Investor re-positioning & sharp anti-consensual fall in US bond yields has driven rotation in equity markets = opportunity to add exposure to growth (eg DY*G over DY) and to financials/cyclicals funded by defensives, 2) ECB QE likely in 4Q14 — to provide further fuel to convergence trades (eg financials, periphery), 3) New Regime — signs of normalisation with broadening economic growth (jobs, investment) & rising risk appetite (M&A, equity inflows), 4) Show Me the Money — given value re-rating and narrow valuation spread between cheap and expensive shares, we think that investors should own "delivery", eg exposure to earnings/dividend/FCF momentum, 5) Size — valuation, flows & corporate actions suggest more support for bigger-caps; we prioritise themes over size, 6) Search for yield/income — low interest rates/QE have encouraged search for yield, which is likely to continue; given outperformance, recent rotation and re-rating from high DY stocks, we think that this is a good time for investors to add back exposure to growth (eg DY*G over DY only).

Figure 2. UST Yields vs Eur Sectors (Corr.)



Source: Datastream, Citi Research

Figure 3. Convergence Trade #2 in Euro Area



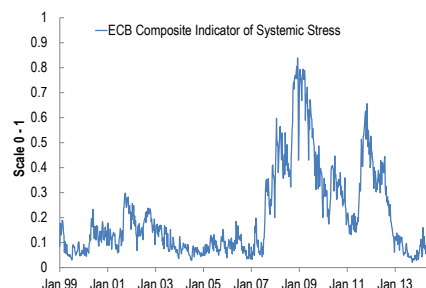
Source: Datastream, Citi Research

Macro — Global Recovery, ECB QE

Macro improving = less risk, ie sharply lower systemic risk, and more opportunity, ie rising GDP growth 2014-15E...

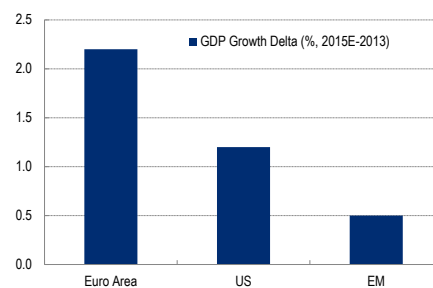
...and liquidity support remains in place globally, with ECB on QE path also later in 2014

Figure 4. ECB Indicator of Systemic Stress



Source: ECB, Citi Research

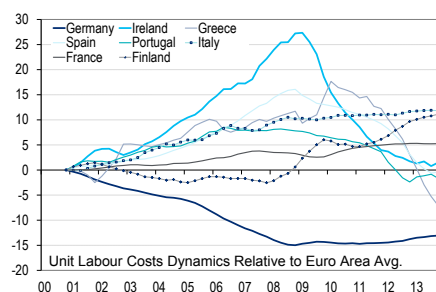
Figure 5. Europe Biggest GDP Growth Delta



Source: Citi Research

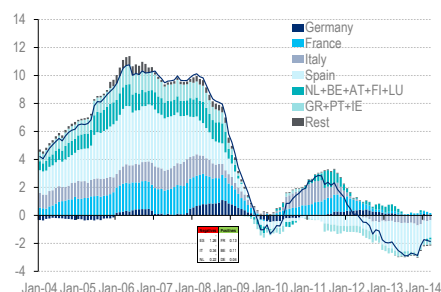
Signs of rebalancing and restructuring across Euro Area, but credit recovery needed to sustain economic recovery.

Figure 6. Unit Labour Costs Dynamics



Source: European Central Bank, Citi Research

Figure 7. Retrenchment in private sector credit

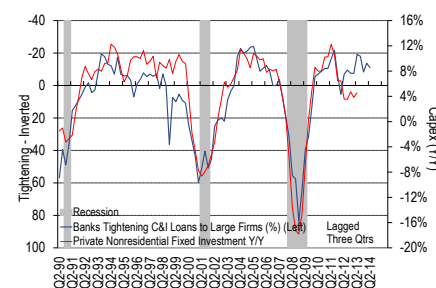


Source: European Central Bank, Citi Research

Business investment picking up in US and Euro Area shows signs of broadening recovery...

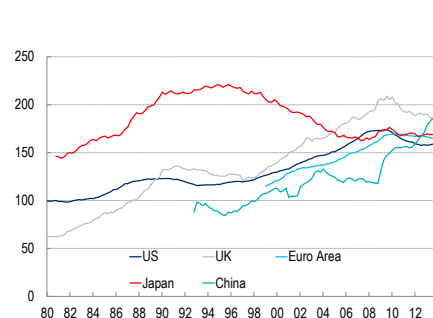
...but keep your eyes open on EM, eg China credit expansion.

Figure 8. Banks Tightening vs. Private Nonresidential Fixed Investment



Source: DataStream, Citi Research

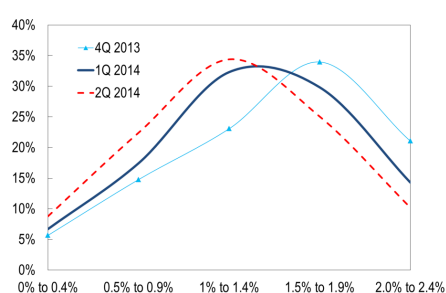
Figure 9. Private Debt/GDP (%)



Source: Citi Research

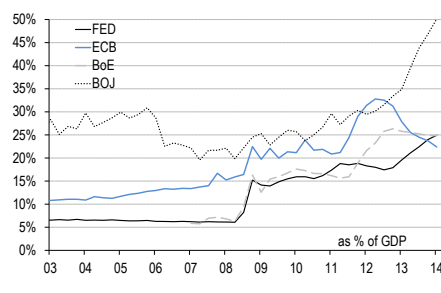
CPI expectations have fallen in Euro Area (and the US). Citi thinks QE now likely from ECB in late 2014; €1tn would reverse ECB net tightening.

Figure 10. SPF: Agg probability of avg 15HICP



Source: Euro Commission, BNB, ECB, Citi Research

Figure 11. Central Banks Balance Sheet



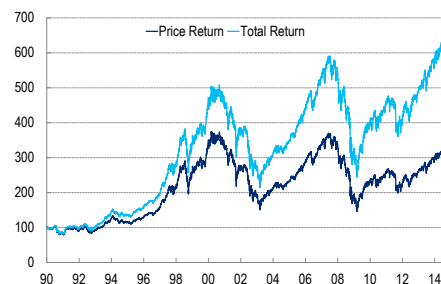
Source: Citi Research

Market — Bull Market, Re-rating, Risk Appetite Up

Bull market = 160% returns since 2009 lows; most investors have been too cautious...

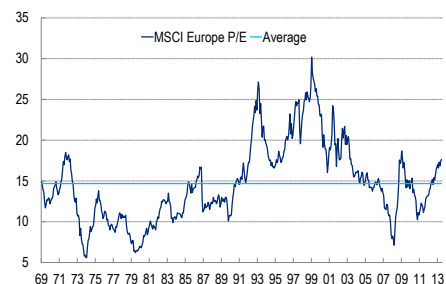
...but there has also been sharp re-rating since mid-2012 = equities no longer cheap.

Figure 12. Stoxx Total Returns



Source: DataStream, Citi Research

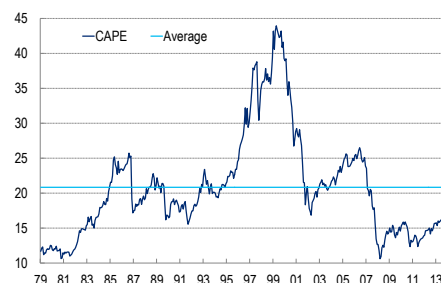
Figure 13. MSCI Europe Trailing PE



Source: DataStream, Citi Research

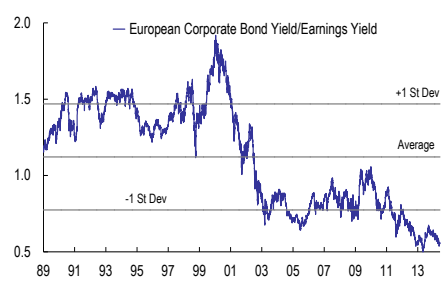
Shares still look attractive relative to other asset classes such as credit....the equity bull is unlikely to die without a helping hand from credit.

Figure 14. Europe CAPE



Source: DataStream, Citi Research

Figure 15. Corporate Bond EYR



Source: DataStream, Citi Research

Higher P/E market needs earnings growth and signs that it is starting to come through...

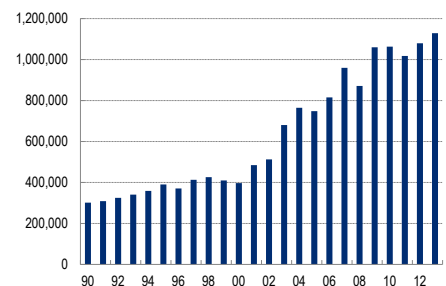
...corporates also have a lot of cash on balance sheets...

Figure 16. Europe ex-UK Earnings Growth Expectations, 2011-2015



Source: Factset, Citi Research

Figure 17. Cash on Balance Sheets (\$mn)

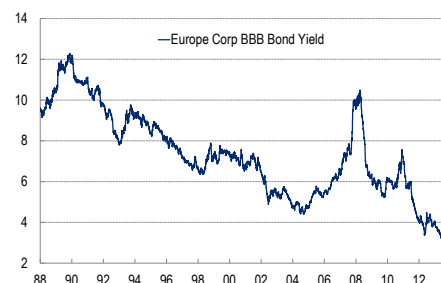


Source: Datastream, Citi Research

...and cost of debt funding is at record lows.

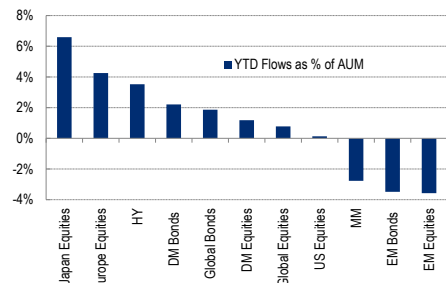
Corporates (M&A) and investors (flows) are going up the risk curve.

Figure 18. Europe Corporate BBB Yield



Source: EPFR, Citi Research

Figure 19. Equity Flows YTD



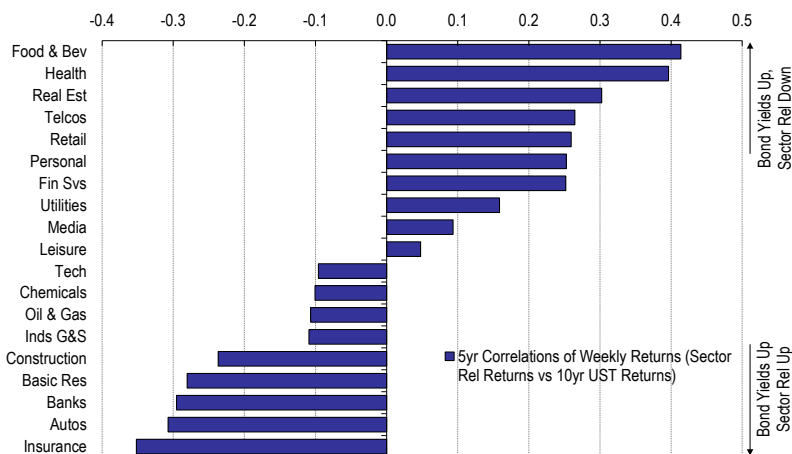
Source: EPFR, Citi Research

Theme #1 — Position for Rotation Reversal on High US BY

Fall in US bond yields surprised many in 1H14. Combined with investor re-positioning, this drove sharp rotation within equity markets. 2H13 winners tended to lag in 1H14.

A return to 3%+ US GDP growth in 2H14-2015E should help drive 10-year US Treasury yields back towards/above 3%. We think recent rotation is an opportunity for investors to raise exposure to growth and cyclical.

Figure 20. US Treasury Yields vs European Sectors (Correlation)



Source: Datastream, Citi Research

We look for stocks with negative correlation with US 10-year bonds and with positive earnings momentum = plenty of Financials, Autos, Construction and other Cyclical stocks.

Figure 21. +ve EMO Rel Stocks With Historic Correlations to rising UST yields

RIC	Stock	>€5bn Market Cap	<0 5yr Correl of Weekly Ret (Stock Rel vs 10yr UST)	>8 -6m Rel Earn Mo	P/E Rel	10y Median P/E Rel	% from 10y Median P/E Rel
AEGN.AS	Aegon	11666	-0.5	13	62	66	-7
FIA.MI	Fiat	6666	-0.3	53	69	98	-29
ISP.MI	Intesa Sanpaolo	34338	-0.3	13	116	92	27
CRDI.MI	Unicredit	34562	-0.3	26	110	99	11
VIE.PA	Veolia Env.	6125	-0.3	15	165	152	9
SEBa.ST	SEB A	15693	-0.3	12	83	94	-12
DAIGn.DE	Daimler	68507	-0.2	15	76	89	-15
VLOF.PA	Valeo	7106	-0.2	23	92	94	-2
CBKG.DE	Commerzbank	11001	-0.2	15	95	87	9
ADEN.VX	Adecco R	10390	-0.2	19	102	123	-17
KBC.BR	KBC Groupe	10738	-0.2	11	70	78	-11
CONG.DE	Continental	18708	-0.2	12	89	89	0
SGEF.PA	Vinci	28622	-0.2	9	98	106	-8
SGOB.PA	Saint Gobain	19155	-0.2	12	105	93	12
NHY.OL	Norsk Hydro	5423	-0.2	32	163	125	31
AV.L	Aviva	18977	-0.2	10	75	66	12
UBI.MI	UBI Banca	6091	-0.2	25	142	100	41
IFXGn.DE	Infineon Tech	10258	-0.2	24	125	146	-14
BMWG.DE	BMW	29604	-0.2	11	74	86	-14
UBSN.VX	UBS R	52822	-0.2	9	96	96	0
ALUA.PA	Alcatel-Lucent	8284	-0.2	293	192	133	44
LLOY.L	Lloyds Banking	45823	-0.2	12	74	84	-13
SAN.MC	Banco Santander	86985	-0.1	10	100	79	26
AHT.L	Ashtead Group	5448	-0.1	23	113	131	-14
ACCP.PA	Accor	6956	-0.1	11	158	146	8
CAPP.PA	Cap Gemini	8541	-0.1	9	105	120	-13
TPK.L	Travis Perkins	5106	-0.1	12	94	98	-4
MAERSKb.CO	A P Moller – Maersk B	14311	-0.1	9	87	93	-6
CRH.L	CRH	14845	-0.1	15	142	112	27
VWS.CO	Vestas WindSystems	8791	-0.1	79	212	179	19

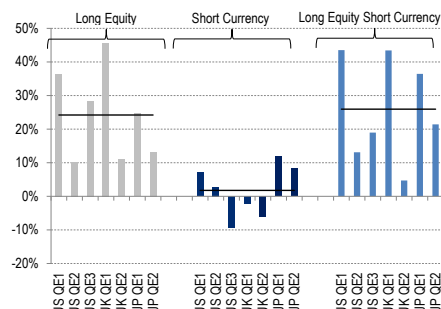
Source: Datastream, Citi Research

Theme #2 — Position for ECB QE in 2H14

During the 7 QE periods of the last few years equities have performed well.

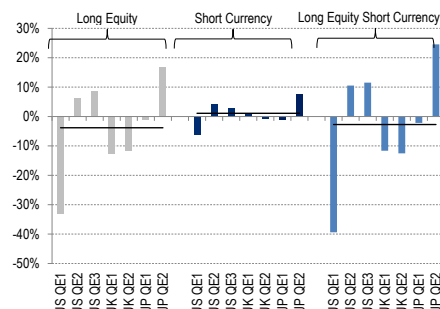
Running a long equity strategy in the 3 months ahead of a QE programme has been less effective.

Figure 22. Asset Returns During QE



Source: DataStream, Citi Research

Figure 23. Asset Returns 3M Before QE

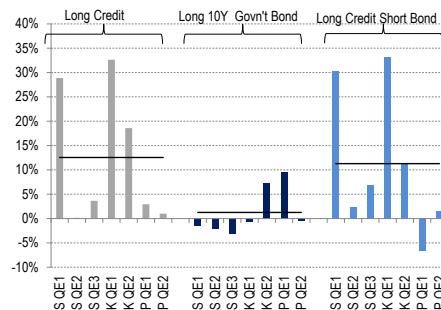


Source: DataStream, Citi Research

Credit has also performed well during these 7 QE programmes, while government bond performance has been mixed.

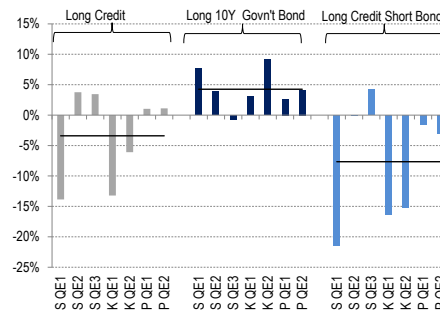
Government bonds, however, have performed well in the months ahead of QE programmes.

Figure 24. Asset Returns During QE



Source: DataStream, Citi Research

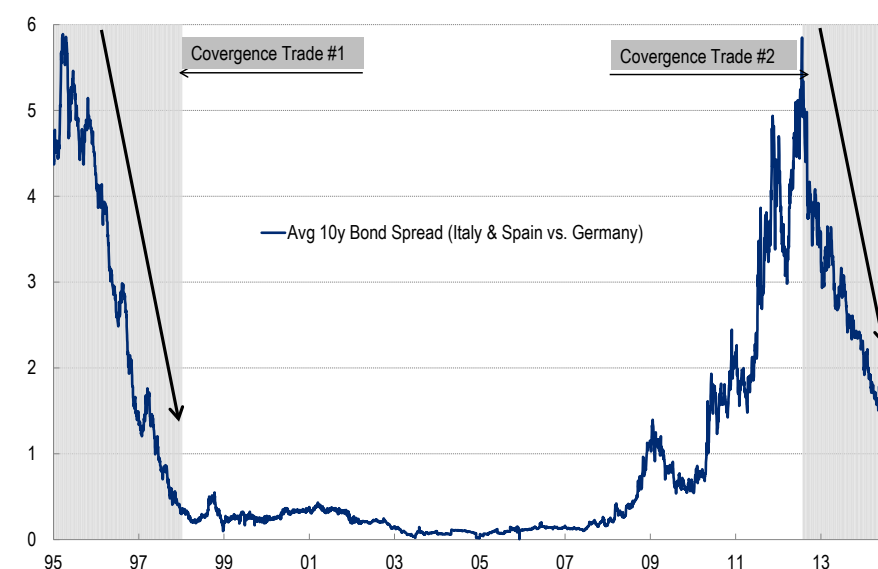
Figure 25. Asset Returns During 3M Before QE



Source: DataStream, Citi Research

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...

Figure 26. Convergence Trades, Part I & II — ECB QE: More Fuel for Current Conv. Trade



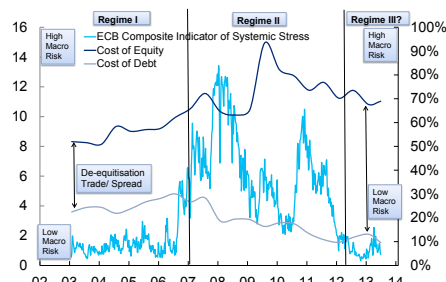
Source: DataStream, Citi Research

Theme #3 — Rising Risk Appetite

We previously argued that fall in macro risk & wide de-equitisation spread would mean that a lot of “stuff would happen”.

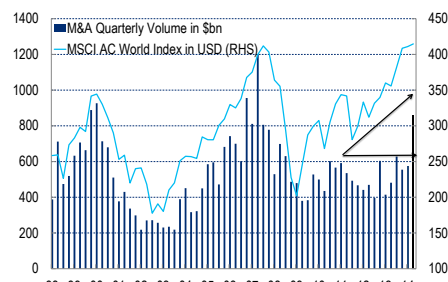
In a world of narrow spreads, the gap between the cost of debt and cost of equity is impressively wide. This is the fuel for a sustained wave of corporate activity.

Figure 27. Low Macro Risk + De-equitisation Arbitrage = Stuff Will Happen



Source: ECB, Citi Research

Figure 28. Global Equity Prices vs M&A Value by Quarter in \$bn



Source: Dealogic, Citi Research

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 29. Surplus Cash and Strong Balance Sheets

RIC	Stock	>10€Bn Market Cap	Avg DY (13E-15E)	Avg FCFY (13E-15E)	>200bps Avg FCF- Avg DY	<1 Net Debt/EBITDA14
ROG.VX	Roche	153085	3.5	5.9	2.3	0.1
AZN.L	AstraZeneca	65564	4.0	6.2	2.3	0.2
NOVOB.CO	Novo Nordisk 'B'	64609	2.3	4.6	2.3	-0.4
SAPG.DE	SAP	52896	1.8	5.9	4.1	0.0
BLT.L	BHP Billiton	51342	4.2	7.7	3.5	0.7
RIO.L	Rio Tinto	50096	4.4	7.7	3.3	0.7
UNc.AS	Unilever Certs.	49780	3.9	6.7	2.8	0.9
ULVR.L	Unilever (UK)	42148	3.7	6.5	2.7	0.9
RB.L	Reckitt Benckiser	40922	2.8	5.6	2.8	0.4
CFR.VX	Richemont N	40298	1.8	5.1	3.2	-1.7
BT.L	BT Group	39444	4.1	8.4	4.3	1.0
LVMH.PA	LVMH	38654	2.7	5.5	2.8	0.6
OREP.PA	L'Oreal	30655	2.4	4.5	2.1	-0.8
ERICb.ST	Ericsson B	27747	3.6	6.0	2.3	-2.1
ASML.AS	ASML Hldg	24075	1.3	4.8	3.5	-1.2
RR.L	Rolls-Royce Holdings	23083	2.4	4.7	2.3	0.2
PHG.AS	Philips Electronics	22161	3.4	7.1	3.7	0.3
CONG.DE	Continental	18745	2.5	6.3	3.9	0.8
MICP.PA	Michelin	16764	3.7	6.2	2.5	0.2
BAES.L	BAE Systems	16487	5.0	7.8	2.8	0.3
SAF.PA	Safran	15980	2.7	5.4	2.7	0.4
HNKG_p.DE	Henkel Pref.	15126	1.7	13.5	11.8	0.1
MAERSKb.CO	A P Moller - Maersk B	14251	2.4	4.7	2.3	0.9
ATCOa.ST	Atlas Copco A	14034	3.3	5.5	2.2	0.7
UHR.VX	Swatch B	13589	1.7	4.3	2.5	-0.9
NXT.L	Next	12714	2.3	6.3	4.0	0.5
ASSAb.ST	Assa Abloy B	12485	2.2	5.0	2.9	0.5
LEGD.PA	Legrand	12383	2.5	5.3	2.7	0.8
KGF.L	Kingfisher	12164	2.8	5.0	2.2	-0.4
KNEBV.HE	Kone B	11779	3.2	5.3	2.1	-1.0
PUBP.PA	Publicis Groupe	11336	2.3	7.0	4.8	-0.8
WOS.L	Wolseley	10925	3.0	5.4	2.4	0.6
BSY.L	BSkyB	10447	4.1	7.4	3.3	0.7
ADEN.VX	Adecco R	10232	2.9	7.0	4.1	0.9
IFXGn.DE	Infineon Technologies	10213	1.9	4.9	2.9	-1.9

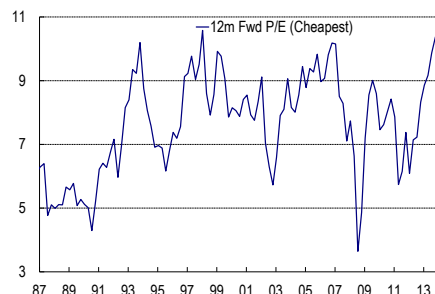
Source: Citi Research

Theme #4 — Show Me the Money

Cheapest quintile of European stocks now trading at highest P/E levels in last 25 years in absolute terms.

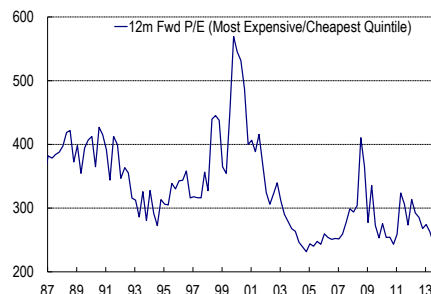
Conclusion = cheap was cheap in early 2009 and indeed in mid-2011/12, but now cheap is no longer cheap.

Figure 30. Cheapest Quintile — 12m Fwd Absolute P/E



Source: DataStream, Citi Research

Figure 31. Most Expensive vs Cheapest Quintile — 12m Fwd P/E

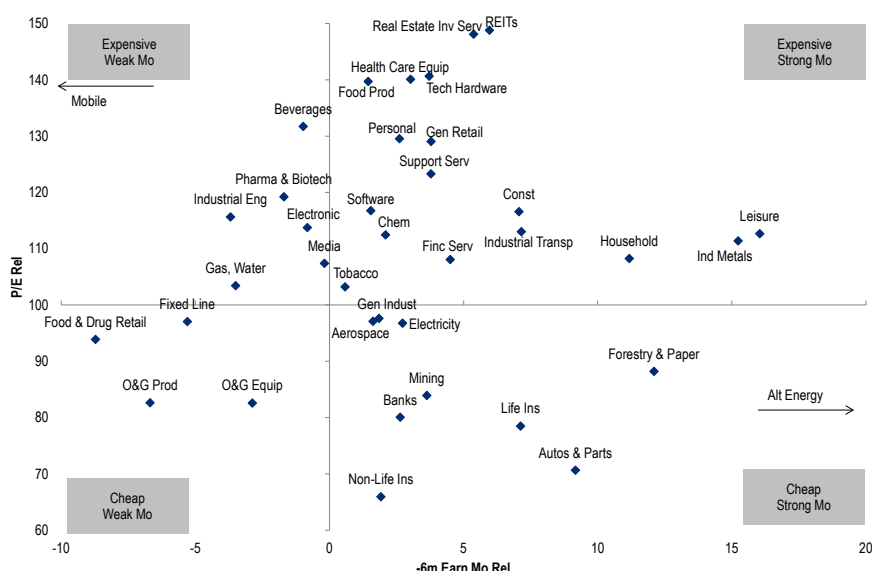


Source: DataStream, Citi Research

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 Banks, Autos & Mining; also sectors such as Electricity and Aerospace & Defense.

Figure 32. Six Months Earnings Mo and P/E Rel – Sectors



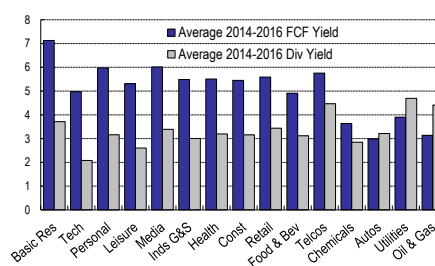
Source: DataStream, Citi Research

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.

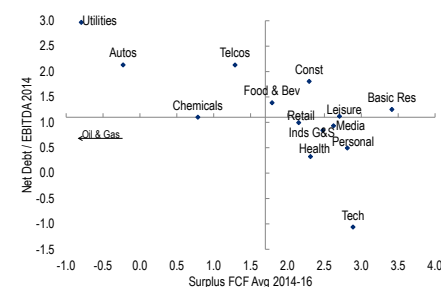
Strong balance sheets further enhance optionality; sectors with strong balance sheets and high surplus FCF should be well positioned.

Figure 33. Surplus Free Cash Flow



Source: Citi Research

Figure 34. Surplus FCF & Strong BS



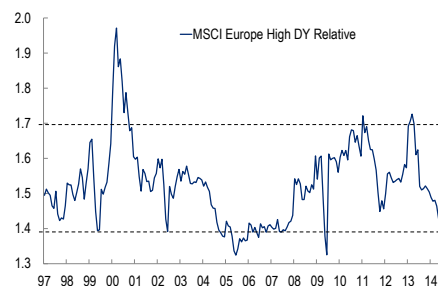
Source: Citi Research

Theme #5 — Income & The Search for Yield

One theme that was a key beneficiary of falling US bond yields YTD and of recent equity rotation was high DY stocks.

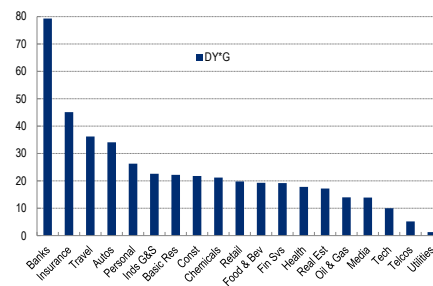
The global MSCI High DY index has never been so expensive in the past 20-years in P/E or DY terms relative to the market. MSCI High DY Europe index is close to lows of DY relative c20y trading range.

Figure 35. MSCI Europe High DY Relative



Source: DataStream, Citi Research

Figure 36. DY*G European Sectors



Source: DataStream, Citi Research

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.

There are 4 banks in the top 5 slots in this screen. Nordic banks are well represented as are big-cap Consumer Staple and Health Care stocks.

Figure 37. CDS Adjusted DY*G Screen

Stock	RIC	Mkt Cap	<Median (74) CDS	>2.5% Trailing DY	CDS Adj Dividend Score	>4% 2yr Ann. Div Growth	>0 or Fin Avg 14E-16E FCF Less Avg 14E-16E DY	DY*G	>0.3 DY*G/CDS
Nordea Bank	NDA.ST	33123	47	4.11	8.74	20.04	Fin	92	1.96
Barclays	BARC.L	46318	73	2.69	3.71	45.72	Fin	131	1.80
Natixis	CNAT.PA	4335	66	3.33	5.08	28.58	Fin	98	1.50
BT Group	BT.L	37275	62	2.70	4.35	27.39	4.5	81	1.30
BNP Paribas	BNPP.PA	55955	70	2.86	4.08	24.83	Fin	83	1.19
Unilever Certs.	UNc.AS	49607	27	3.35	12.65	7.28	2.8	25	0.96
Unilever (UK)	ULVR.L	41730	27	3.38	12.77	7.28	2.7	25	0.93
Roche	ROG.VX	151263	30	2.90	9.75	8.54	2.4	27	0.90
SEB A	SEBa.ST	15415	65	4.52	6.95	11.65	Fin	57	0.88
Sanofi	SASY.PA	93142	36	3.63	10.14	8.37	2.0	31	0.86
Legal & General	LGEN.L	16312	66	4.10	6.22	13.25	Fin	56	0.84
Imperial Tobacco Gp.	IMT.L	31413	68	4.37	6.43	10.88	1.0	50	0.73
Michelin	MICP.PA	16863	59	2.85	4.83	14.58	2.5	43	0.73
Anheuser-Busch Inbev	ABI.BR	60978	47	2.55	5.48	11.83	3.1	33	0.72
Nestle R	NESN.VX	185403	23	3.01	13.36	4.69	0.8	15	0.65
Deutsche Post	DPWGn.DE	26222	34	3.01	8.94	7.11	1.5	21	0.63
SES Fdr	SESFd.PA	8663	68	4.00	5.89	10.00	1.1	41	0.60
AXA	AXAF.PA	36284	73	4.77	6.58	9.16	Fin	44	0.60
Reed Elsevier	REL.L	12655	50	2.77	5.52	10.20	4.9	29	0.58
SKF B	SKFb.ST	7149	63	3.21	5.09	10.79	3.4	36	0.58
Daimler	DAIGn.DE	65597	42	3.45	8.18	7.15	1.9	24	0.57
British American Tobacco	BATS.L	80224	46	4.05	8.83	6.27	3.2	25	0.55
Atlas Copco A	ATCOa.ST	13994	55	2.79	5.07	10.03	2.2	29	0.53
WPP	WPP.L	20324	61	2.82	4.64	10.92	4.7	30	0.49
Diageo	DGE.L	57482	49	2.52	5.20	8.82	0.9	24	0.49
Swedbank A	SWEDa.ST	17645	72	5.87	8.15	5.52	Fin	35	0.49
Syngenta	SYNN.VX	26484	41	2.88	7.10	7.06	1.5	19	0.46
Centrica	CNA.L	20840	65	5.17	7.95	5.19	1.8	27	0.41
Pearson	PSON.L	11587	70	4.10	5.90	6.67	0.8	27	0.39
Koninklijke DSM	DSMN.AS	9467	48	3.21	6.74	5.58	3.3	18	0.38
Schneider Electric	SCHN.PA	39389	55	2.81	5.08	6.93	2.8	20	0.35
Solvay	SOLB.BR	7200	67	2.73	4.07	8.00	2.1	24	0.35
Unibail-Rodamco	UNBP.AS	19329	72	4.24	5.90	5.14	Fin	23	0.32

Source: Bloomberg, Factset, Citi Research, Datastream

Sector Strategy — Cyclical 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 (FCFDY) and earnings momentum, 15% and 15% of the model respectively. We have further 10% weights on sales exposure to the US and Europe, ie where there is healthy GDP growth delta, and also to beta, balance sheet strength, price/book rankings and correlation to rising US bond yields.

Figure 38. Sector Attribution Model

Factor Weight	EM Exp	US Exp	EU Exp	Earnings Mo	P/B	Abs P/E Rel to 5yr History	B/S	DY*G	FCF-DY	US Bond Yields	Beta	Overall Rank
	0%	10%	10%	15%	10%	5%	10%	5%	15%	10%	10%	100%
Insurance	3	13	3	7	1	12	-	2	-	1	5	6.1
Basic Resources	19	14	17	6	4	4	7	7	1	3	2	6.3
Automobiles & Parts	14	6	15	2	10	1	9	4	15	2	1	7.1
Banks	10	15	7	12	2	5	-	1	-	4	3	7.3
Technology	17	9	14	7	5	6	1	17	2	8	11	7.3
Travel & Leisure	6	5	8	1	17	2	9	3	4	11	13	7.3
Construction & Materials	7	12	9	3	8	14	12	8	7	5	6	7.8
Financial Services	8	2	13	5	14	13	-	12	-	6	4	8.0
Industrial Goods & Services	13	8	10	10	18	7	6	6	6	7	8	8.8
Real Estate	1	19	1	4	13	9	-	14	-	13	7	9.1
Personal & Household Goods	16	11	16	9	16	3	4	5	3	16	15	10.0
Media	2	4	6	16	11	17	13	16	5	12	10	10.4
Retail	9	16	4	18	7	8	5	10	9	17	9	10.8
Chemicals	15	7	11	11	19	10	7	9	14	9	12	11.2
Oil & Gas	11	3	12	16	6	15	3	15	17	10	16	11.5
Health Care	5	1	19	15	12	18	2	13	8	18	17	11.9
Utilities	4	18	2	13	3	16	15	19	16	15	18	13.2
Telecommunications	12	17	5	19	9	19	14	18	13	14	13	13.9
Food & Beverage	18	10	18	14	15	11	11	11	11	19	19	14.1

Source: Citi Research

We Overweight Insurance, Basic Resources, Autos, Banks, Tech, Travel & Leisure. We Underweight Food & Beverage, Telecoms, Oil & Gas and Chemicals. Our model would also be Underweight Health Care and Utilities. We are Neutral both sectors in our overall allocation.

Citi Focus List Europe

The Citi Focus List Europe is the meeting point for our strategy views and the conviction Buy ideas from Citi analysts. We restrict the universe to liquid stocks.

The current list is: Akzo Nobel, AstraZeneca, Aviva, AXA, BHP Billiton, British American Tobacco, BG Group, CaixaBank, Continental, Danske Bank, Kering, Novo-Nordisk, Philips, Renault, Rio Tinto, Roche. Please see the Focus List section for more details on individual stock names.

Strategy Outlook

We stay bullish on European equities and forecast c20% total returns to end-2015, based on c10% earnings growth CAGR & modest further re-rating. Rising investor/corporate risk appetite can keep multiples at or above current levels. Investors should position for rising US bond yields and ECB QE in 2H14. The former could reverse recent rotation and suggests cyclicals/financials over defensives. The latter could further fuel convergence trades with financials and the periphery as key beneficiaries.

Macro Research

European Quantitative Research

Maintain Long Term Preference For Estimates Momentum

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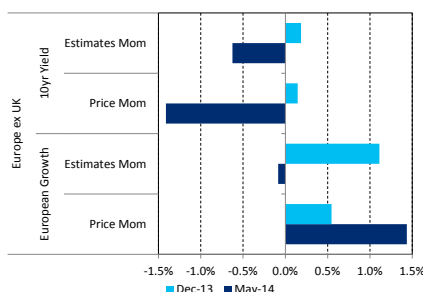
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■ **Style Performance** — This has been a good year for Value in Europe, with Growth and Price Momentum lagging. Our preferred style of Estimates Momentum has also performed well, emphasizing the importance of Earnings Leadership.

■ **Estimates Momentum has it all** – Exposure to Estimates Momentum can be beneficial given the style's inherent bias to stock level fundamentals, whilst also having exposure to macro-orientated recovery plays found within Price Momentum. The empirical relationship between earnings and prices is strong. Over the past few years equity prices have risen, while earnings have lagged. Further equity market gains should be driven more by EPS gains rather than PE expansion. Identifying Earnings Leadership (or where the earnings delivery will come from) is key.

Figure 39. Changing Face of Macro Factors



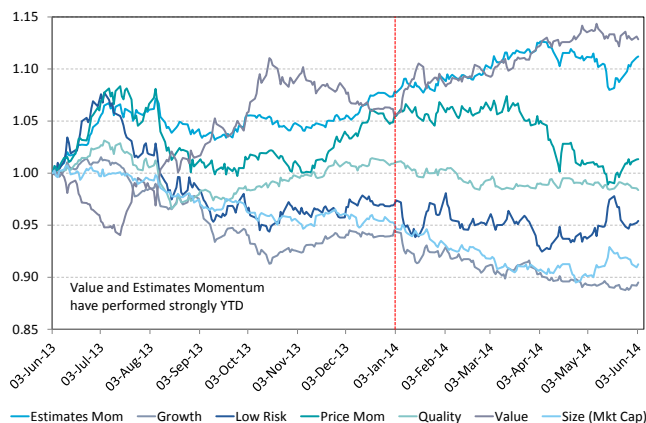
Source: MSCI, IBES, Worldscope, Citi Research

■ **Estimates Momentum is no Longer a Beneficiary of GDP Growth** – With our rates strategists calling for rising yields through 2014/15 and equity strategists looking for trades that fit this thesis¹, it is interesting to note that our proprietary risk models imply that rising yields are a general headwind for Estimates and Price Momentum. It is worth noting that at the turn of the year Estimates Momentum was a beneficiary of European GDP Growth, our European RAM model implies this is now a marginal headwind. This suggests the market concurs with our thesis – investors need not pay a premium for Growth during periods of GDP expansion – and could explain some of the recent re-rating of Growth and Momentum stocks.

■ **Changing Face of Momentum** – Both High Risk and Value/Price Momentum correlations remain elevated in Europe (Figure 41). Momentum is no longer the high Quality, defensive Growth trade from 2012/13. Riskier/cheaper sectors have outperformed year-to-date which has resulted in Value and High Risk taking on more Earnings Leadership. This is reinforced by the fact that EPS Certainty has decreased across Earnings Leadership stocks, which have become more volatile and less defensive.

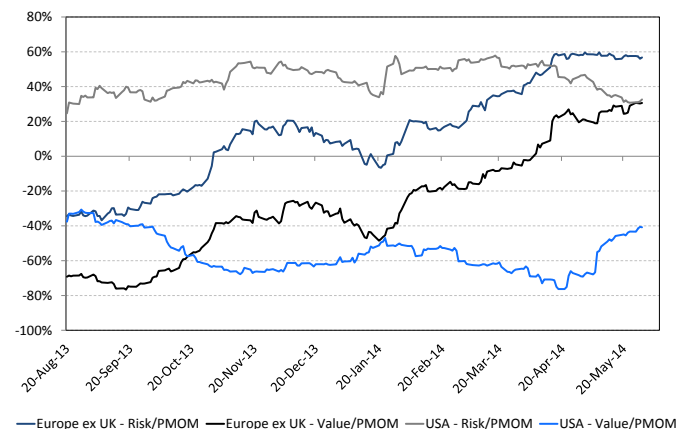
■ **Add Value/Risk exposure as Earnings Leadership Defines** – Given a strongly performing equity market and further upside called for by our strategists, we anticipate investors will continue to be rewarded by taking on selective Value/Risk exposure as Earnings Leadership defines.

Figure 40. Long/Short MSCI Europe Daily Style Returns



Source: IBES, Worldscope, Factset, Citi Research

Figure 41. Style Correlations (60day Rolling Long/Short Returns)



Source: Bloomberg, Citi Research

¹ [Global Equity Strategist: Treacherous Treasuries, Citi Research, 29th May 2014](#)

2014 YTD Style Leaders and Laggards

- Value and Estimates Momentum lead the way year-to-date. Our long-held preference for Estimates Momentum continued to make positive returns in most sectors, reflecting our view of an improving environment for stock picking.
- Size has been a significant determinant of stock returns this year, despite large caps showing strong performance in the recent rotation in early May. Smaller caps have generally outperformed their larger peers. This has been particularly apparent in Financials and Telcos. Indeed, Size has only delivered positive returns to the Energy, Healthcare and Staples sectors year-to-date.
- Low risk has lagged, although it should be noted that focusing on low risk within 'riskier' sectors (e.g. Financials and Materials) delivered positive returns. Interestingly, both Financials and Materials sectors have also delivered positive returns for Value.

Figure 42. Performance Spread Between High (Top 20%) and Low (Bottom 20%) Factor Portfolios in 2014 YTD – MSCI Europe

	Quantile Perf.	Pure Perf.	Cons Disc	Cons Staples	Energy	Financials	Health Care	Industrial	Info Tech	Materials	Telcos	Utils
Valuation	6.0%	4.3%	10.9%	-6.3%	10.1%	10.5%	8.5%	12.4%	13.9%	1.2%	1.5%	1.5%
Earnings Yield - 12m forward	3.0%		9.9%	-3.9%	13.5%	-6.1%	3.7%	7.1%	10.8%	-8.2%	8.8%	4.6%
Earnings Yield- 12m historical	1.1%		7.8%	-4.8%	9.9%	-7.4%	1.2%	5.2%	10.8%	-7.0%	7.5%	3.1%
Cash Flow To Price	8.2%		11.5%	-1.6%	-7.0%		4.7%	9.9%	14.9%	-2.0%	5.3%	7.2%
Dividend Yield	6.6%		4.9%	-6.6%	8.8%	1.2%	12.2%	13.2%	15.7%	5.8%	-12.4%	1.5%
Book to Price Ratio	6.5%		8.0%	-3.9%	-0.9%	8.7%	-0.5%	5.3%	10.0%	-1.1%	-1.0%	4.7%
Sales to Price Ratio	3.1%		12.0%	-5.7%	8.4%		-18.6%	1.9%	-0.1%	-4.5%	5.3%	8.4%
EBITDA / EV	6.7%		12.6%	-4.6%	14.3%		0.5%	1.5%	18.8%	-5.3%	11.1%	-6.9%
Sales / EV	-0.9%		9.6%	-8.9%	7.9%		-9.9%	1.5%	-0.2%	-4.3%	2.4%	-1.2%
Growth	-5.7%	-0.9%	-6.2%	-1.0%	-1.7%	-5.3%	-0.8%	-7.3%	-5.8%	2.4%	-6.0%	-5.7%
Earnings Growth (12m fwd)	-0.2%		0.1%	-4.2%	-8.3%	8.9%	0.7%	-5.8%	-3.6%	-0.1%	12.7%	-2.2%
SB Growth-Value Score	-5.4%		-5.6%	7.5%	-1.5%	-4.5%	-19.5%	-1.3%	-5.7%	1.3%	-4.3%	-2.3%
One Year Sales Growth	-4.7%		-9.5%	-4.1%	0.5%		0.6%	-6.7%	6.3%	0.3%	0.8%	-4.9%
Long Term Earnings Growth	-4.7%		-0.8%	6.3%	-8.2%	-5.0%	-9.3%	-7.7%	-2.8%	8.9%	12.6%	-8.0%
One Year EPS Growth	-6.9%		-12.2%	2.6%	-1.6%	-8.1%	6.4%	-9.1%	-0.9%	6.5%	-15.5%	-1.5%
Low Risk	-1.1%	1.1%	-6.8%	10.2%	-1.1%	2.5%	-3.1%	-1.6%	-8.0%	6.8%	10.0%	-2.4%
Debt to Equity (Inverted)	-4.6%		-9.1%	0.5%	6.0%		16.6%	-8.3%	-8.7%	-0.7%	-3.6%	-4.3%
Earnings Stability	-2.0%		-3.9%	7.4%	-1.6%	-1.6%	-5.1%	-4.8%	-2.4%	-3.8%	13.7%	7.3%
MSCI AC World Beta	0.2%		-1.8%	-1.0%	-2.2%	1.6%	-3.3%	0.7%	-6.2%	6.5%	1.0%	-3.7%
MSCI Country Index Beta	2.0%		-0.7%	-3.3%	4.1%	1.6%	-2.2%	-5.6%	0.3%	8.4%	14.4%	-8.6%
Size (Market Cap)	-3.9%	-2.3%	-7.4%	1.8%	9.1%	-9.1%	4.0%	-3.4%	-8.6%	-5.8%	-12.2%	-3.2%
Quality	0.2%	-1.2%	1.2%	2.1%	6.9%	-9.3%	15.2%	-5.5%	1.4%	-1.4%	-16.8%	-2.5%
Earnings Certainty	-5.0%		-7.1%	4.2%	3.9%	-7.3%	2.4%	-9.3%	6.7%	-2.7%	7.2%	-3.4%
Return on Equity	-4.9%		-4.3%	-3.1%	-5.8%	-4.9%	5.3%	-3.7%	6.6%	0.2%	-4.6%	-8.6%
Net Profit Margin on Sales	-2.4%		-3.5%	1.9%	-14.4%		11.4%	1.4%	-0.2%	0.4%	-4.3%	-10.3%
Margin Growth	-3.2%		-3.2%	-4.8%	-13.6%	-5.2%	-4.7%	-9.0%	21.6%	-7.9%	-10.5%	-5.1%
Earnings Qual. (Accruals) (Inv)	1.8%		6.3%	0.4%	-11.7%		6.3%	0.5%	1.9%	5.8%	-17.0%	11.7%
B/S Quality (NOA) (Inv)	0.2%		-0.3%	-7.2%	21.7%		21.1%	-0.8%	3.4%	-2.6%	-9.6%	-0.8%
Price Momentum	-5.6%	-4.6%	-1.8%	-4.9%	10.3%	-13.5%	8.5%	-5.6%	3.1%	-14.0%	-9.1%	-2.1%
3 months	-5.8%		-9.2%	5.0%	-1.3%	-8.4%	7.0%	-2.4%	-11.5%	-15.0%	-5.8%	-1.8%
12 months	-4.9%		-2.6%	-6.0%	9.2%	-9.4%	13.6%	-3.6%	8.3%	-7.0%	-9.9%	-3.5%
First 11 months	-3.9%		-3.3%	-4.5%	15.1%	-11.3%	4.7%	-3.9%	6.7%	-8.8%	-12.0%	-3.5%
Estimates Momentum	3.0%	4.3%	9.3%	0.3%	-2.0%	1.2%	3.9%	4.7%	15.8%	-11.4%	-0.8%	0.5%
1m Change in Earnings F'cast	-1.2%		-2.9%	1.3%	4.8%	1.2%	-9.4%	-6.2%	-6.2%	-13.8%	10.3%	10.1%
Earnings Revision	1.5%		7.8%	0.7%	-0.9%	2.3%	2.3%	3.8%	1.5%	-12.1%	-1.7%	8.2%
Sales Revisions	1.7%		6.9%	3.3%	4.5%		6.0%	-3.1%	9.1%	-1.8%	-3.0%	4.4%
Cash Revisions	2.6%		7.8%	5.6%	-4.9%		-6.5%	6.3%	13.1%	-7.5%	11.6%	7.5%

Source: IBES, MSCI, Worldscope, Citi Research

Note: Quantile performance refers to the spread of returns between the top and bottom quintile of styles, while the Pure performance refers to style performance where others sources of risk exposure such as Country, Sector and other style exposure have been removed. Baskets with less than 5 stocks have been removed.

Global Economic Outlook

Will AE Inflation Weakness Last?

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We are cutting our 2014 global growth forecast marginally, chiefly reflecting softness in Q1 US growth and a less robust US housing outlook

Softer activity data and low inflation open the door to renewed easing in China...

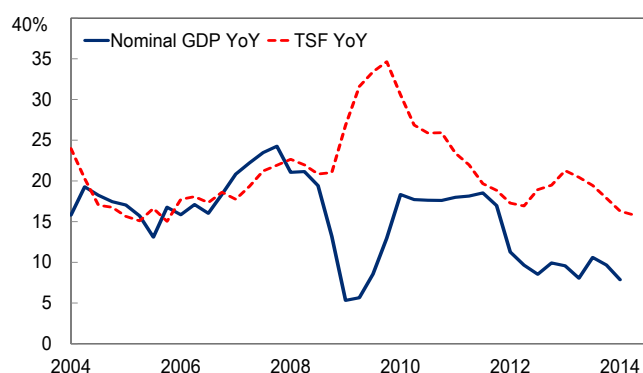
...but we continue to have major worries over the sustainability of China's credit-fuelled growth path

We are marginally trimming our 2014 global growth forecast to 3.0% YoY (at current exchange rates), and continue to expect global growth to pick up to 3.5% in 2015. Among the individual countries, we are marking down our 2014 US growth forecast to 2.3% from 2.6% last month and 2.8% two months ago, with this latest downgrade reflecting mainly the weakness in Q1 activity as well as a slower housing outlook in subsequent quarters². In addition, we are lifting our 2014 Japan growth forecast to 1.4% from 0.9% last month, and trimming that for 2015 to 0.9% from 1.0%, reflecting our assumption that the surge in Q1 growth (5.9% QoQ SAAR, a higher figure than we expected a month ago) will unwind, with weakness in coming quarters.

For China, early signs for Q2 growth are generally soft, with downbeat readings for industrial production, retail sales and fixed asset investment. The YoY growth of TSF (total social financing, a broad credit measure) slowed below 16% YoY in April, the lowest since 2005. With inflation falling, we continue to expect the authorities to introduce further modest targeted easing measures to prevent GDP growth slowing below 7% YoY in coming months. Overall, our forecasts for economic growth in China are unchanged this month, at 7.3% for 2014 and 7.0% for 2015.

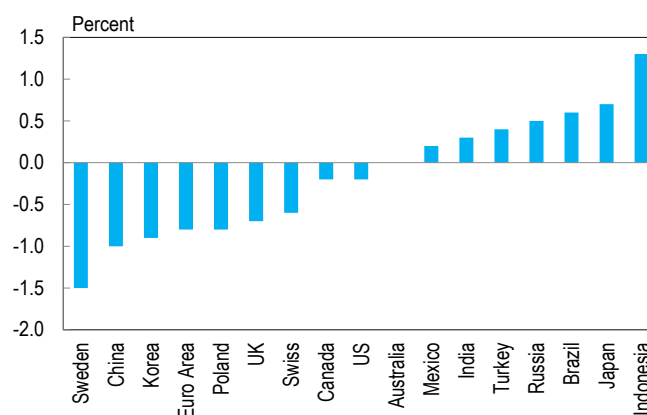
But we continue to have major worries over China's short-term and medium-term growth prospects. The credit-fuelled investment surge of recent years has already lifted the ratio of private debt/GDP (taking the gross unconsolidated debts of the household and non-financial corporate sectors) to 186% of GDP in Q3-13 (latest data) from 117% at end-2008. With TSF growth still roughly twice nominal GDP growth (7.9% YoY in Q4-13), the private debt/GDP ratio probably is still rising rapidly. That credit impulse has helped support growth, but its effectiveness seems to be diminishing, with signs that Q1 growth may have been much weaker than the officially reported number and a rising stock of unsold homes³.

Figure 43. China — YoY Growth of Total Social Financing and Nominal GDP, 2004-14



Sources: DataStream and Citi Research

Figure 44. Global — Revisions to Consensus CPI Inflation Forecasts for 2014 Over the Last 12 Months



Sources: Consensus Economics and Citi Research

² See "[Housing Worries May be Policy Induced](#)" *US Economics Weekly*, William Lee, 16 May 2014, Citi.

³ See "A Reality Check on GDP Deflator and Job Creation", 9 May 2014, and "Risk of a Property Market Slump: The Tail Is Getting Fatter", 19 May 2014, Shuang Ding and Minggao Shen, Citi.

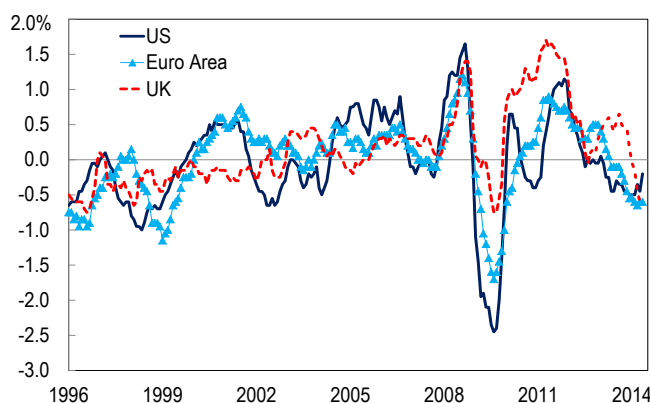
We doubt that China can maintain high growth without a continued — and ultimately unsustainable — credit boom

AE inflation is low and consensus forecasts for AE inflation have fallen sharply in recent months

We doubt that China will transition back to strong export-led growth anytime soon. The recent dip in the exchange rate has helped reduce China's real trade-weighted exchange rate (CPI based, BIS data) by 5% since January, reversing the rise in H2-13. But the real exchange rate is still 28% above the 1999-2007 average, squeezing export profitability. With the FX rate levelling off at RMB6.20-6.25/USD recently, recent FX moves seem to have been aimed more at discouraging speculative inflows than seeking a meaningful improvement in external cost competitiveness. But the lack of a major impulse from net trade adds to risks of a sharper economic slowdown in China if and when the authorities really seek to rein in the credit boom.

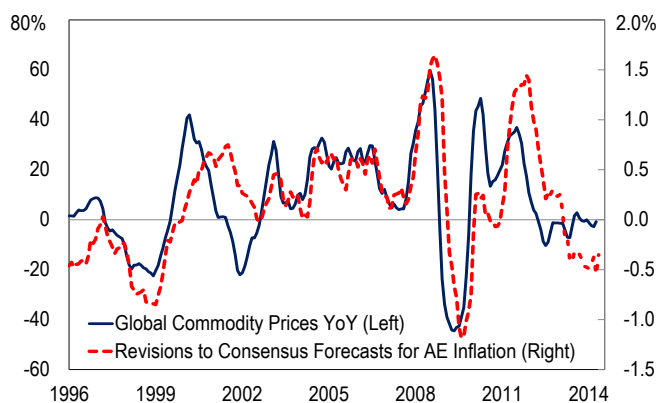
Overall inflation in advanced economies (AEs) remains very low, and consensus forecasts for AE inflation have fallen markedly over recent months. On the IMF data, overall AE inflation was just 1.3% YoY in March, down from 1.6% YoY at end-2012 and 2.5% YoY at end-2011. In turn, AE consumer price inflation in general has undershot central bank forecasts in recent quarters, and consensus inflation forecasts have fallen unusually sharply across a wide range of AEs. Over the last 12 months, the consensus for 2014 CPI inflation has fallen by 0.2 percentage points in the US, 0.8pp in the euro area, 0.7pp in the UK, 0.6pp for Switzerland and by 1.5pp for Sweden. At first glance, Japan might seem like an outlier, with the consensus for 2014 CPI inflation up by 0.7pp over the last year: but this includes the recent sales tax hike (which would add 1.6% to prices if fully passed on⁴). Allowing for the possibility that this tax hike was not fully anticipated a year ago, consensus expectations for underlying inflation in Japan may also have fallen slightly. Overall, consensus forecasts for AE inflation ex Japan in the current and next year have fallen by 0.4 percent over the last 12 months⁵. In the last 20 years, the only episodes with greater drops in consensus inflation forecasts were 1998-99 (after the Asian EM crisis) and 2009 (Great Financial Crisis). Moreover, we suspect that the consensus for EMU has still not fallen enough.

Figure 45. US, Euro Area, UK— 12-Month Sum of Revisions to Consensus Inflation Forecasts, 1996-2014



Sources: Consensus Economics and Citi Research

Figure 46. Global — Commodity Prices and 12-Month Sum of Revisions to Advanced Economy Inflation Forecasts, 1996-2014



Note: We show the rolling 12-month sum of revisions to consensus forecasts for inflation in the US, Euro Area, UK, Canada and Sweden in the current and next year, GDP-weighted. Sources: IMF, Consensus Economics and Citi Research

The trends in consensus expectations for EM inflation are more varied

The picture across EMs is far more varied, with the consensus forecast for 2014 inflation down by roughly 1 percent over the last year in China and Korea, but still up from a year ago in India and Indonesia (although inflation forecasts for these

⁴ See "Tokyo core CPI rose 2.7%, slightly undershooting market forecast", Kiichi Murashima and Naoki Iizuka, 25 April 2014, Citi.

⁵ We use the rolling 12-month sum of revisions to consensus forecasts for inflation in the US, Euro Area, Japan, UK, Canada and Sweden in the current and next year, GDP-weighted.

The persistent and large output gaps across most AEs continue to cap inflation...

countries have edged down recently). By contrast, consensus inflation forecasts have continued to rise in recent months for Russia and Brazil. These differences partly reflect specific tax and subsidy measures, but also the CPI impact of sizeable FX depreciation in some EMs over the last year.

In our view, the widespread weakness in AE inflation reflects a mix of common factors and country-specific factors, some temporary and some persistent. The first and most obvious factor is the disinflationary effects of persistent large output gaps across most AEs: the IMF estimates the average output gap among AEs at 2-2½% of potential GDP this year, and that the level of GDP remains below potential in all AEs apart from New Zealand and Malta. However, in general, AE output gaps have not expanded in the last year. Hence, while output gaps help explain why inflation is low, this factor probably does not explain why inflation has slowed so much recently.

...while recent downward pressures also reflect the 2012-13 EM slowdown

The other key factor has been the EM slowdown and sluggish AE growth in 2012-13 — and the resultant slide in commodity prices and various EM exchange rates. The IMF broad commodity price index fell by 11% from early-2012 to mid-2013, with the CRB index in USD terms down by 20% from early-2011 to late-2013. As Figure 7 shows, revisions to consensus AE inflation forecasts tend to broadly follow swings in commodity prices. Note that this link probably partly reflects commodities' direct role in costs, but perhaps also an indirect link, in that commodity prices also often are a timely guide to global growth and capacity pressures that affect AE inflation more widely through various channels, including traded goods prices and FX swings. CPB data suggest that unit values (ie prices) for traded manufactured goods fell 2.0% YoY in February, having been flat YoY a year earlier. In turn, prices of consumer durables (which have a relatively high import content), have weakened markedly in both the US and euro area. In addition, there has been a range of idiosyncratic factors that have helped cap inflation in individual countries.

Disinflationary effects from the output gap and FX swings are particularly large in the euro area...

- In the euro area, disinflationary pressures from the large output gap and sluggish economy are particularly powerful, with the EC, IMF and OECD all putting the output gap at 2-3½% of GDP this year. Unit labour costs rose by just 0.6% YoY in Q4-13 and have risen by an average of only 0.7% YoY over the last 5 years. In addition, with the appreciation of the euro (up 12% trade-weighted since Draghi's "*whatever it takes*" speech in July-2012), prices for imported goods (measured by unit values) are down by 5.1% since Aug-2012. In the CPI, the drop in import prices has helped to pull the inflation rate of non-energy consumer goods (which have a relatively high import content) down to just 0.1% YoY in April from 0.8% a year earlier, with consumer durables prices down 0.8% YoY — the sharpest drop since 2009. Services inflation remains low (1.3% YoY in Feb-April), but its trend has slowed only slightly over the last year.

...while US inflation additionally has been depressed by weakness in medical costs

- In the US, the inflation rate of health care services (which have a weight of 17.0% in PCE) has tumbled from 1.9% YoY in Mar-13 to 0.8% YoY in Mar-14 (the lowest since detailed monthly data began in 2000). The inflation rate of pharmaceuticals and other medical products also weakened abruptly in early 2013 and, while it has recently edged up again, it remains below the 2012 pace. These trends may reflect the sequester, which appears to have dampened spending and pricing of health care. This factor should become less of an issue going forward as the abrupt retrenchment of the sequester becomes more distant.

The tax- and regulatory-driven boost to UK inflation has declined...

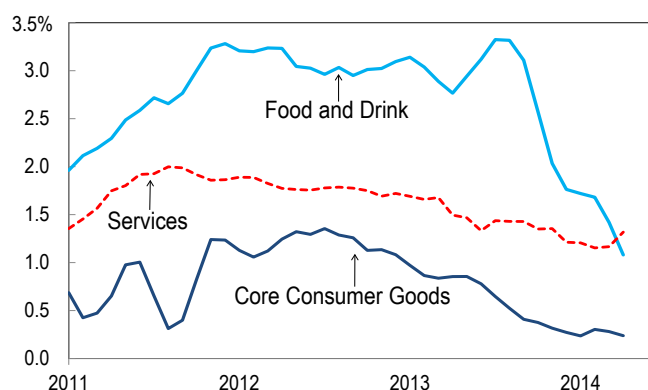
- In the UK, the prior boost to inflation from taxes, utilities and energy surcharges has faded, partly because the government acted to limit the extent to which its own policies were eroding real incomes and impeding recovery. Moreover, prior weakness in commodity prices has helped cap food and petrol prices. The joint contribution to YoY CPI inflation from utilities, education, petrol, tobacco, food

and drink is down from 1.5 percent in April-13 to 0.6 percent in April-14. This has more than accounted for the last year's inflation slowdown (from 2.4% YoY in April 2013 to 1.8% in April 2014). Excluding the direct impact of these items, inflation actually edged up from 1.2% YoY in April-2013 to 1.7% in April-2014 (of course, this may be indirectly affected by the idiosyncratic factors noted above).

...while weakness in Sweden's headline CPI inflation rate has been exaggerated by lower mortgage payments

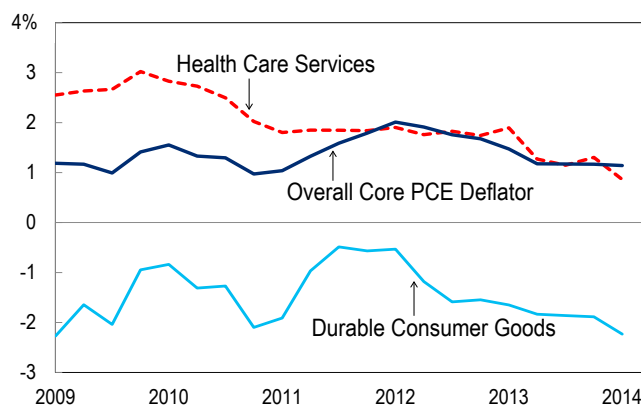
■ In Sweden, the slide in the headline inflation rate (which briefly turned negative in Jan-Mar this year) was exaggerated by falling mortgage rates — a result of low fixed rates. The underlying CPIF inflation rate, which measures inflation with a fixed interest rate, remains low, at 0.5% YoY in April (similar to a year ago) and is subdued (as in many other AEs) by weak import prices and a large output gap — but does not actually show deflation⁶.

Figure 47. Euro Area — YoY CPI Inflation, 3-Month Averages, 2011-14



Sources: Eurostat and Citi Research

Figure 48. US — Split of YoY PCE Inflation, 2009-14



Sources: Bureau of Economic Analysis and Citi Research

Overall AE Inflation probably is near its low, but trends will probably be more diverse in coming months

With commodity prices rebounding recently (the CRB is up 10% since the start of the year), we suspect that overall AE inflation will stay low in coming months — but overall probably will not slow significantly further. Moreover, AE inflation trends in H2 this year are likely to show a much more varied picture than the uniform weakness evident in H1. For the US, we expect YoY PCE core inflation to pick up by a half point by yearend, as the disinflationary impact from health care and external costs declines. In the UK, with the strong economic upturn lifting capacity use, and signs of a pickup in pay, we believe that the drop in inflation has largely run its course, with CPI inflation likely to stabilise at about 1¾% YoY in the rest of this year and, barring a new disinflationary shock, rise to roughly match the 2% target in 2015. By contrast, in the euro area, we expect the large output gap and further effects of the strong euro will keep euro area inflation well below consensus, at below 1% YoY on average in 2014 and 2015 — and below 1½% even in 2016-17.

We continue to expect ECB and BoJ easing this year, with BoE hiking this year and Fed tightening in 2015

Against this backdrop, the ECB cut rates at the June meeting, and we expect them to implement some credit easing measures plus a major QE programme in H2 this year. We continue to expect further BoJ QE but, as discussed last month, believe this is likely to come in the autumn or later given the BoJ's relatively bullish assessment of growth prospects and nearterm difficulties in judging the economy's underlying path after the surge in Q1. We expect the BoE to start to hike rates late this year, with Fed tightening in H2-15.

⁶ See "Not True Deflation, but Sustained 'Low-flation in Sweden'", Tina Mortensen, 1 May 2014, Citi.

**Renewed growth disappointment in EMs
could trigger new disinflationary
pressures in AEs**

Nevertheless, there are considerable downside risks for AE inflation in the next couple of years. In particular, if there is renewed disappointment in EM growth — especially China — then this could unleash new disinflation pressures across AEs, perhaps by some mix of softer commodity prices, currency swings and lower domestic cost pressures in some EMs. If so, pressure for QE in the euro area and Japan would expand further, while the tightening that we project for the UK (from late this year) and US (next year) might be scaled down or delayed.

Rates Forecast Commentary

US Rates Strategy:

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US: Treasury yields moved lower in May across a range of maturities with 10y yields falling to 2.51%, just above their lowest level since July 2013. Despite instances of very strong data, including 288,000 jobs added in April, and a small increase in the rate of inflation, rates investors remain skeptical that the economic recovery, and Fed mid-2015 rate hike timeline, is on track. In addition, geopolitical concerns continued to weigh on yields. Citi's positioning market metrics indicate that there are still shorts in the market. This is consistent with recent price action, where rallies have been more violent than sell-offs. Fundamental data is still strong, though, and so we have not significantly changed our forecasts from last month.

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Core Europe: The broad policy scenario remains unchanged and Citi still expects depo/refi rate cuts at the June ECB meeting, followed by some sort of asset purchase plan towards the end of the year. Recent volatility in non-core markets as well as the breakout of USTs from this year's range have driven Bund yields far below what we consider to be a medium-term equilibrium. In order to challenge our 1.60% year-end forecast, we would need a significant change in the macro environment, both in terms of real activity as well as inflation. In the meantime, the yield curve continues to trade in a very directional fashion (bull flattening / bear steepening) and the contagion effect from periphery to semi-core is expected to be very moderate once we've cleared the European Election. As such we have left our forecast for OAT/Bund spreads unchanged at 40bp in Q4 2014.

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EMU Periphery: Political event risk is driving a correction in non-core EGBs with significant performance differences between Italy and Spain, because Spain not only lacks a Eurosceptic movement but is also perceived as being more flexible and responsive in tackling structural imbalances. Looking forward we still expect spreads to converge going into year-end, as the current return volatility is short-lived and might not be enough to derail the established trends of increasing non-resident participation in EMU peripheral assets. We have slightly adjusted our Bono/BTP spread forecast and we're now going for a flat differential at 120bp over Bunds at the end of this year. In the very near-term, we still see some room for Spain outperforming Italy, as scenario not too dissimilar from Q1 2013 when BTPs were rocked by political elections.

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UK: Our UK yield forecasts are little changed this month. Global bond markets have rallied, but the medium-term outlook for the UK is broadly unchanged, in our view. BoE Governor Carney may have sounded a little more dovish at the *May Inflation Report*, but the data continues to point to strong growth and shrinking spare capacity. Citi continues to expect the MPC to hike rates in November 2014. Front-end yields are likely to move higher, flattening the 2s10s curve. We also continue to expect 10yr gilts to underperform Bunds as the 'great de-coupling' becomes further entrenched.

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Japan: We have modified our forecasts on JGB yields on the back of change in our forecast on the expected timing for additional easing from this summer to autumn or even later. We expect a tighter range than before as a prolonged range-bound market is likely. It may well take longer than expected to judge whether or not the BoJ need to ease further. We expect volatility will remain low and that demand for carry will gradually push yields lower. On the other hand, sub-50bp of 10yr yield is less likely than before given that US rates are expected to increase over time. Although we revised up our lower bound of rates, we also revised down our upper bound of rates, so that 10yr yields will probably remain below 1% due to additional easing by the BoJ — including an increase in JGB purchases.

Figure 49. Interest Rate and Bond Market Forecasts as of 21 May 2014

	Current	Quarterly Average (Unless Specified)					
		3Q 14F	4Q 14F	1Q 15F	2Q 15F	3Q 15F	4Q 15F
US							
Policy Rate (Fed Funds) End Quarter	0.25	0.25	0.25	0.25	0.25	0.75	1.00
3-Month Libor	0.22	0.22	0.22	0.35	0.65	0.85	1.05
2 Year Treasury Yield	0.34	0.60	0.80	1.05	1.25	1.50	1.70
5 Year Treasury Yield	1.52	2.00	2.30	2.50	2.65	2.75	2.85
10 Year Treasury Yield	2.51	2.95	3.20	3.40	3.45	3.50	3.55
30 Year Treasury Yield	3.35	3.60	3.80	3.85	3.90	3.90	3.90
2-10 Year Treasury Curve	216	235	240	235	220	200	185
2 Year Swap Spread (Swap Less Govt), bp	15	12	12	12	12	12	12
10 Year Swap Spread (Swap Less Govt), bp	10	15	15	15	15	15	15
30 Year Swap Spread (Swap Less Govt), bp	-2	-5	-5	-5	-5	-5	-5
30 Year Mortgage Yield	4.20	4.70	5.00	5.25	5.40	5.60	5.70
10 Year Breakeven Inflation	220	225	230	235	235	235	235
Euro Area							
Policy Rate End Quarter	0.25	0.10	0.10	0.10	0.10	0.10	0.10
Overnight Rate (EONIA)	0.18	0.00	0.00	0.00	0.00	0.00	0.00
3-Month (EURIBOR)	0.32	0.15	0.15	0.15	0.15	0.15	0.15
2 Year Schatz Yield	0.08	0.10	0.05	0.05	0.05	0.05	0.05
5 Year Bobl Yield	0.46	0.60	0.50	0.50	0.50	0.60	0.60
10 Year Bund Yield	1.39	1.60	1.60	1.70	1.70	1.80	1.80
30 Year Bund Yield	2.27	2.35	2.35	2.45	2.45	2.55	2.55
2-10 Year Bund Curve	131	150	155	165	165	175	175
10 Year BTP-Bund Spread	187	140	120	120	120	120	120
10 Year Bono-Bund Spread	168	140	120	120	120	120	120
2 Year BTP-Schatz Spread	81	50	40	40	40	40	40
2 Year Bono Schatz Spread	74	50	45	45	45	45	45
10 Year OAT-Bund Spread	48	50	40	40	40	40	40
10 Year Swap Spread (Swap Less Govt.), bp	25	20	20	20	20	20	20
10 Year Breakeven Inflation	136	140	140	145	145	150	150
Japan							
Policy Rate End Quarter	0.10	0.10	0.10	0.10	0.10	0.10	0.10
3-Month Libor	0.14	0.15	0.15	0.15	0.15	0.15	0.15
2 Year Treasury Yield	0.08	0.10	0.10	0.10	0.15	0.15	0.10
5 Year Treasury Yield	0.19	0.20	0.25	0.30	0.35	0.35	0.30
10 Year Treasury Yield	0.59	0.65	0.70	0.85	0.95	0.95	0.85
30 Year Treasury Yield	1.70	1.70	1.75	1.85	1.90	1.90	1.85
2-10 Year Treasury Curve	51	55	60	75	80	80	75
2 Year Swap Spread (Swap Less Govt.), bp	11	12	12	14	14	14	14
10 Year Swap Spread (Swap Less Govt.), bp	16	15	17	22	22	20	17
10 Year Breakeven Inflation	135	120	100	110	110	105	105
UK							
Policy Rate End Quarter	0.50	0.50	0.75	1.25	1.50	2.00	2.50
3-Month Libor	0.53	0.55	1.00	1.55	1.70	2.10	2.55
2 Year Treasury Yield	0.70	1.30	1.60	1.85	2.10	2.40	2.60
5 Year Treasury Yield	1.89	2.40	2.70	2.85	2.90	3.05	3.10
10 Year Treasury Yield	2.61	3.00	3.30	3.50	3.55	3.65	3.70
30 Year Treasury Yield	3.39	3.70	3.75	3.85	3.90	3.95	4.00
2-10 Year Treasury Curve	191	170	170	165	145	125	110
10 Year Swap Spread (Swap Less Govt.), bp	10	15	15	20	20	25	25
10 Year Breakeven Inflation	308	320	325	340	345	350	350
Australia							
Policy Rate End Quarter	2.50	2.50	2.50	2.50	2.75	3.00	3.25
3-Month Libor	2.71	2.60	2.75	2.80	3.10	3.25	3.50
2 Year Treasury Yield	2.69	2.80	2.95	3.30	3.60	3.80	3.93
5 Year Treasury Yield	3.18	3.55	3.90	4.15	4.30	4.45	4.60
10 Year Treasury Yield	3.66	4.15	4.40	4.65	4.75	4.85	4.95
2-10 Year Treasury Curve	97	135	145	135	115	105	102
10 Year Swap Spread (Swap Less Govt.), bp	28	35	40	40	45	45	50

Source: Citi Research

Credit Outlook

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Credit has been remarkably resilient relative to most other asset classes so far this year. Both the iTraxx Main and € iBoxx Corp are 13% tighter than where they were at the start of January. Yet we think the rally has [further to go](#). Even before the recent ECB meeting, we suspected that the mid-May wobble represented little more than profit taking, and with some of the more vulnerable longs trimmed, scope for the tightening to resume had grown.

We're admittedly [skeptical](#) about the impact that the raft of new ECB measures will have on economic fundamentals. But, as we've been [stressing](#), liquidity is simply far [more important](#) in the current environment in determining how spreads perform than fundamentals. And now it looks like the credit market will receive another wave of liquidity. Though other asset classes have been slower to react, the rally in synthetics following Draghi's announcement feels more than justified to us, and likely portends further tightening over the next few months.

Furthermore, we struggle to envision a negative catalyst over the summer: yes, US yields are likely to rise if the data there improves as our economists expect it to, but [we reckon](#) there's unlikely to be sufficient momentum to generate any real concerns on that front until September at least.

We're inclined to favour cash relative to CDS: our recent discussions with investors would suggest that most remain relatively conservatively positioned. On aggregate, we reckon investors on the whole are far less long in cash than many accounts suspect everyone else is.

Instead real money investors have temporarily been adding exposure through the indices in anticipation of more supply. As it stands, net supply in [€ IG](#) has been very negative year-to-date, at -€49bn. Especially now that the ECB moves look set to increase bank lending at the expense of new bond issuance, we doubt that supply volumes will be anywhere near enough to consume the pile of cash waiting to be invested.

So we reckon cash spreads will catch up after underperforming synthetics quite considerably over the last few weeks. The aggregate basis on the € iBoxx Corp, which is now at its most negative since early January, at -8bp, is likely to move back towards neutral in the coming sessions, and remain there over the summer.

The recent ECB moves also accentuate our [preference](#) for credit in euros over dollars. The ECB is moving towards easing while the Fed is withdrawing policy support, and, as the US economy improves, beginning to face the prospect of raising rates. Furthermore, the US credit cycle is much more developed than in Europe: corporate payout ratios are considerably higher and banks in the US have far less deleveraging left to do.

Yet we retain our concerns about the vulnerabilities building on the sidelines. Growth in the Eurozone remains subdued and it's only due to the remarkably lenient "stressed" criteria in the upcoming EBA stress tests that the problems afflicting Eurozone banks are likely to remain largely unexposed for now.

So while our orientation is fundamentally long, we'd still advise being selective in taking exposure to the extent you can be:

- Stay away from the low beta stuff that doesn't offer as much value even if the rally continues and that looks most vulnerable to forced-selling in the (for-now) unlikely event that a selloff really gets underway.
- Favour financials over non-financials. European banks are likely to be the chief beneficiaries of the ECB measures, with the TLTROs giving them access to cheap funding that makes them even less reliant on the bond markets for funding than they were previously.
- Take duration, but in CDS rather than in cash, where you're not as well compensated for it. CDS curves in senior financials in particular still look [far too steep to us](#), and we expect investors to be pushed further out as the tightening continues.

And finally, go down in quality, or even better, subordination: it's the highest quality corps that are [re-leveraging the fastest](#) and are most likely to engage in M&A and share buybacks. Conversely their lower-quality counterparts stand to benefit more if the reach for yield continues, and they're far more likely to be snapped up if the [urge to merge](#) holds up.

Global Foreign Exchange Outlook

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- Lower FX volatility and stable rates in low yield funding currencies creates a fertile ground for carry traders. We expect broad carry friendly trends to persist over the next couple of months and reflect this in our 0-3m forecasts in both G10 and EM.
- A critical issue in G10 space remains the euro given Citi's, still non-consensus, forecast for a QE programme from the ECB later this year. Whilst we see scope for a dip in the single currency in the 6-12m horizon on this "news", supportive BBOP fundamentals reassert themselves longer term.
- Our USD/JPY forecasts have been trimmed this month across the forecast horizon. This reflects Citi's expectations that further BoJ ease will come later than previously expected. JPY weakness is extremely reliant on further BoJ easing, in our view.
- In EM, the carry dynamic means we have raised our short term forecasts for a range of high yielding currencies. Our forecasts now show a roughly flat overall EM performance in 0-3 months, against modest depreciation expected previously.
- Further out, EM fundamentals still concern us and we continue to show an equally weighted basket of EM currencies around 4% weaker vs. the USD.
- CNY remains the only EM currency to have weakened vs. the USD year-to-date. We forecast further near term weakness but ultimately a push back towards the 6.00 level.

Figure 50. DM & EM – Forecasts Paths

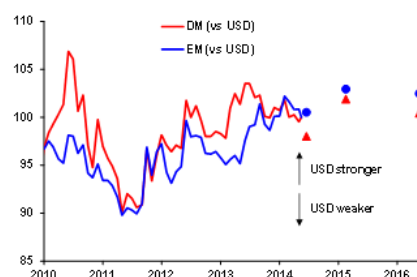


Chart shows GDP weighted baskets. Today = 100

Source: Citi Research and Bloomberg

Figure 51. EM Regions – Forecasts Paths

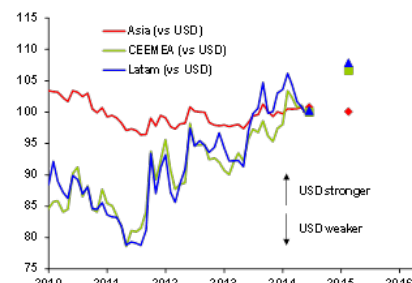


Chart shows GDP weighted baskets. Today = 100

Source: Citi Research and Bloomberg

Foreign Exchange Forecasts

Figure 52. Citi Foreign Exchange Forecasts

		Market data			Forecasts			Returns***	
		spot*	3m Fwd	12m Fwd	0-3 mos	6-12 mos	long-term	3 mos rtn	12 mos rtn
G10									
Euro	EURUSD	1.37	1.37	1.37	1.40	1.35	1.41	2.4%	-1.9%
Japanese yen	USDJPY	102	101	101	100	105	111	-1.4%	3.7%
British Pound	GBPUSD	1.68	1.68	1.67	1.73	1.70	1.74	3.3%	1.8%
Swiss Franc	USDCHF	0.89	0.89	0.89	0.88	0.93	0.91	-1.6%	4.8%
Australian Dollar	AUDUSD	0.93	0.93	0.91	0.94	0.95	0.94	1.2%	4.3%
New Zealand Dollar	NZDUSD	0.86	0.86	0.83	0.87	0.86	0.85	1.6%	3.2%
Canadian Dollar	USDCAD	1.09	1.09	1.10	1.09	1.12	1.15	-0.1%	2.0%
Dollar Index**	DXY	80.01	80.04	80.06	78.37	81.61	79.75	-2.1%	1.9%
G10 Crosses									
Japanese yen	EURJPY	139	139	139	140	141	157	0.9%	1.7%
Swiss Franc	EURCHF	1.22	1.22	1.22	1.23	1.25	1.29	0.8%	2.7%
British Pound	EURGBP	0.82	0.82	0.82	0.81	0.79	0.81	-0.9%	-3.7%
Swedish Krona	EURSEK	9.01	9.03	9.06	9.05	9.20	9.00	0.2%	1.5%
Norwegian Krone	EURNOK	8.16	8.19	8.28	8.10	8.00	7.70	-1.1%	-3.4%
Norwegian Krone	NOKSEK	1.10	1.10	1.09	1.12	1.15	1.17	1.3%	5.1%
Australian Dollar	AUDNZD	1.08	1.08	1.09	1.08	1.10	1.11	-0.4%	1.0%
Australian Dollar	AUDJPY	95	94	92	94	100	104	-0.2%	8.2%
Asia									
Chinese Renminbi	USDCNY	6.23	6.20	6.24	6.30	6.08	6.00	1.7%	-2.5%
Hong Kong Dollar	USDHKD	7.75	7.75	7.75	7.76	7.76	7.75	0.1%	0.1%
Indonesian Rupiah	USDIDR	11423	11545	12110	11400	12100	11800	-1.3%	-0.1%
Indian Rupee	USDINR	58.9	59.9	63.1	59.0	62.0	63.0	-1.6%	-1.7%
Korean Won	USDKRW	1024	1031	1044	1030	1040	980	-0.1%	-0.3%
Malaysian Ringgit	USDMYR	3.23	3.26	3.32	3.30	3.40	3.37	1.3%	2.3%
Philippine Peso	USDPHP	43.8	43.9	44.1	44.0	45.0	43.0	0.3%	2.1%
Singapore Dollar	USDSGD	1.25	1.25	1.25	1.26	1.26	1.26	0.5%	0.5%
Thai Baht	USDTHB	32.5	32.7	33.2	32.5	33.0	33.0	-0.7%	-0.7%
Taiwan Dollar	USDTWD	30.2	30.1	29.9	30.5	30.2	29.8	1.4%	1.1%
EMEA									
Czech Koruna	EURCZK	27.4	27.4	27.4	27.4	27.7	26.5	-0.2%	1.1%
Hungarian Forint	EURHUF	306	308	312	310	315	325	0.6%	0.9%
Polish Zloty	EURPLN	4.19	4.22	4.29	4.20	4.30	4.00	-0.5%	0.1%
Israeli Shekel	USDILS	3.46	3.47	3.47	3.40	3.60	3.85	-1.9%	3.7%
Russian Ruble	USDRUB	34.8	35.6	37.9	35.5	38.1	37.1	-0.1%	0.5%
Russian Ruble Basket		40.6	41.5	44.2	42.0	44.0	44.0	1.1%	-0.5%
Turkish Lira	USDTRY	2.10	2.15	2.30	2.08	2.20	2.40	-3.5%	-4.2%
South African Rand	USDZAR	10.39	10.57	11.10	10.30	11.10	10.80	-2.5%	0.0%
LATAM									
Brazilian Real	USDBRL	2.22	2.28	2.45	2.25	2.50	2.65	-1.3%	2.0%
Chilean Peso	USDCLP	554	560	574	550	580	590	-1.7%	1.0%
Mexican Peso	USDMXN	13.0	13.1	13.4	12.8	13.1	12.7	-2.0%	-2.2%
Colombian Peso	USDCOP	1926	1942	2009	1900	1990	2050	-2.2%	-0.9%

* market data including spot as of 8:55 AM London time on 16-May-2014

** The DXY forecasts are implied from the forecasts of the constituent crosses. *** Returns are relative to forwards

Source: Bloomberg and Citi Research

Overview: Carry Still in Vogue

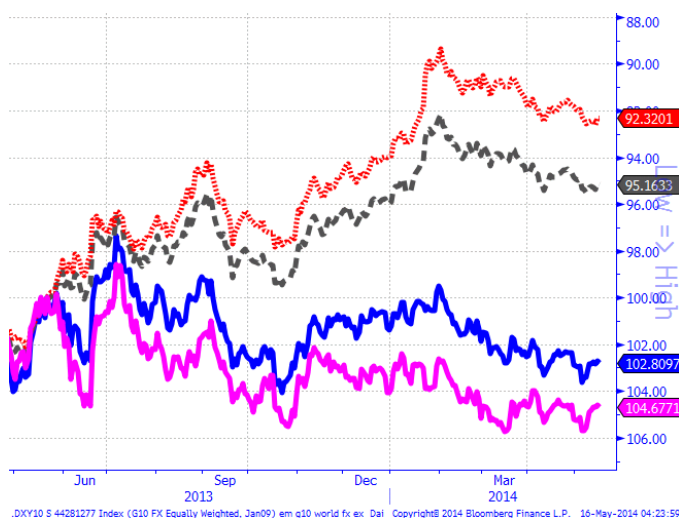
It still looks like G10 Central Banks will remain easier for longer, with US yields dropping through the lower end of the 2.6-2.8% range in recent days and ongoing speculation about further ease from the ECB at the 5 June meeting. Meanwhile, implied volatilities remain extremely low (Figure 5).

Lower volatility, and expected stable rates in low yield funding currencies creates a fertile ground for carry traders (Figure 4). We expect these broad carry friendly trends to persist over the next couple of months and reflect this in our 0-3m forecasts in both G10 and EM.

The end game for carry is always a shock to monetary policy or rates in funding currencies however, and this is still most likely to emanate from the US, in our view, given relatively bullish Citi growth and relatively high PCE forecasts later this year. EM fundamentals also still concern us and we think tail risks from China remain significant. As such, our 6-12m forecasts reflect this with generalised USD appreciation over that time horizon.

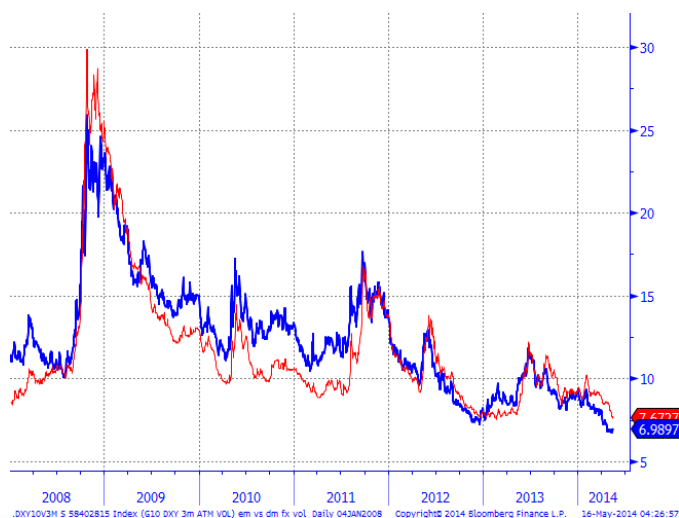
A critical issue in G10 space remains the EUR given Citi's forecast expecting a QE programme from the ECB later this year. We discuss this further in the EUR section below. Bottom line: we see scope for a dip by the EUR on the 6-12m horizon on this "news" which is far from consensus at this point. But fundamentals including valuation and broader trends in the current account and capital inflows remain positive EUR over the long haul.

Figure 53. Global USD Index (Grey-Dash) vs. EM (Red), G10 (Blue) and G10 ex AUD, CAD, NZD (Pink). Higher = USD Up; 22 May 13 = 100



Source: Bloomberg and Citi Research

Figure 54. 3m Implied Volatilities: EM (Red) vs. DM (Blue)



Source: Bloomberg and Citi Research

Commodities

Market Outlook

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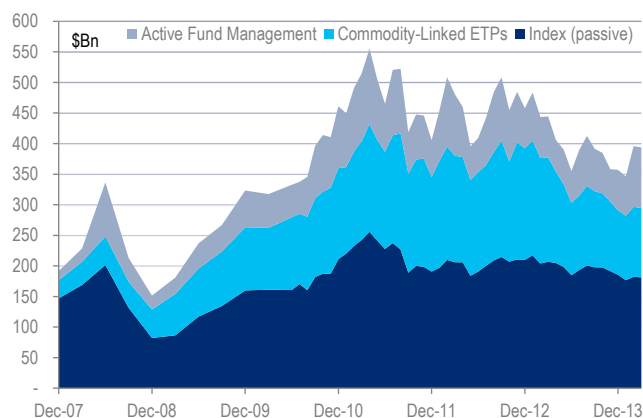
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Commodities have rallied c8% this year against fundamental expectations—on the back of adverse weather in the US and Latin America, local policy decisions (i.e. Indonesia ore export ban/nickel) and geopolitical heat in the Black Sea region and Middle East. Investors have taken note and poured new money into commodity-linked funds and index swaps, further boosting asset market valuations this year after massive retrenchment in 2013 totaling a record c\$50Bn. Indeed, year-to-date (through mid-May) aggregate passive net inflows have totalled more than c\$5.75Bn, with the strength broad-based across all major sectors including precious metals, energy and agriculture. This has fed through to higher consumer costs although we expect some of this to start measurably easing by the end of 2014. **Another factor behind the flows into commodities has been the move of the WTI forward curve into a structural backwardation, which provides a positive roll yield for index investors, coupled with the breakdown of asset market correlations amongst commodities versus stocks, bonds and the US dollar, which provides macro investors a real diversification benefit for holding commodities exposure.**

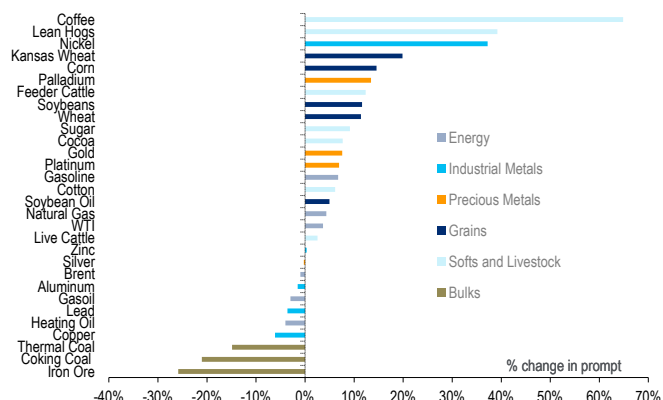
Final estimates of retail and institutional commodities assets under management (AUM) for 1Q 14 suggest a sharp 10.25% quarterly gain to c\$394Bn at the end of March — down 11% year/year but some c\$30Bn north of the 4Q'13 AUM average. While this figure (which excludes OTC/structured note products) remains a far cry from the recent AUM peak of c\$555Bn in April 2011 during the height of the Libyan civil war and MENA spring, the across the board 1Q increase in market valuation for index, exchange traded product and actively managed funds totalling c\$37Bn does confirm the sharp turnaround for the asset class this year after shedding a record c22% in AUM during 2013.

Figure 55. Retail and Institutional Commodities AUM



Sources: Citi Research estimates

Figure 56. Year-to-Date Commodity Price Changes*



Sources: Bloomberg, Citi Research, *through Friday 16 May

Brent prices have been stuck in range of \$105 and \$111 this year. Citi now expects this range to persist through the end of 2014 and to only slide slightly lower in 2015. Coming into 2014, the risks to the oil market looked clearly biased to the downside: Libya, Iran and Iraq all looked set to add significantly to OPEC supplies amid a continuation of the US shale revolution. The outlook for demand growth appeared weak given EM currency and general macro weakness, coupled with the structural headwinds to oil demand growth. However, bullish geopolitics countered bearish fundamentals. Libyan exports have barely returned amidst

ongoing protests. The Iranian nuclear negotiations continue but are now entering a critical stage concerning the details of the nuclear fuel production capabilities that Iran will be allowed to retain. Iraq has seen export volatility amidst elevated levels of violence and a standoff with the KRG over payment, while the escalating violence in Nigeria adds to the heightened sense of supply fragility. Iran, Iraq and Libya could each account for an additional 1 m-b/d of crude over the coming year. The lumpy and uncertain nature of these potential supply additions makes for a great deal of uncertainty over the outlook for supply even though this is not evidenced in oil market implied vols as indicated by the very narrow trading range for flat price.

The Russia/Ukraine crisis in particular has introduced a large and completely unexpected source of geopolitical risk for the natural gas and oil markets. The situation remains fluid, but a near term resolution with an end to tensions between Moscow and the West seems less likely. The West and Russia seem to be now locked into a relationship of “Mutually Assured Destitution”, given Russia’s unmatched energy superpower status. Russia exports as much oil as Saudi Arabia and ~1.5 times as much gas as Qatar. Including coal, Russia’s energy exports are equivalent to Saudi Arabia and Qatar combined (the world’s second and third largest energy exporters). The ongoing crisis introduces upside risk to a market that was otherwise stuck in neutral to bearish territory. The supply disappointments from Kashagan and Libya, and the risk of returning Iranian volumes, coupled with the increasing instability in Nigeria, all point to a more balanced set of risks than was expected at the start of 2014. As such, **Citi’s base forecast is now for the current trading band to hold through 2014, with a range bound market continuing next year but for prices to grind slightly lower.**

Global natural gas prices are likely to trade range-bound or a bit lower, despite differences in geography. While unique sets of factors affect regional gas markets differently, the core price driver remains inventory levels in different regions. In the US, a cold winter left stocks depleted, causing a sharp price run-up to over \$6 at one point. Although the rise has subsequently deflated to some extent, prices are staying in the ~\$4.5/MMBtu range, still a steep change from last year’s mid to high-\$3 range. Current prices are more moderate than before because some in the trade believe that shale production growth would be so strong that gas inventories should be replenished to normal levels by the 2015-16 winter (even though inventories heading into the 2014-15 winter could be at an 8 to 10-year low despite vast growth in demand). An expectation of a mild summer, which reduces demand, also contributes to prices being more subdued. However, prices could be at the low-end of the range in an already tight fundamental market.

In contrast, the European market has a vast gas inventory overhang after a mild winter that the price decline is showing no sign of reversing despite the tension in Ukraine, which arguably should have a greater impact on gas flow than on oil. As of mid-May, gas inventories in the EU28 are at ~56% of capacity and nearly 70% full in the UK. The UK is also where the price benchmark NBP is set. In comparison, UK gas storage was ~26% full at the same time last year, with total European inventory also sizably lower then. The European market is exhibiting a very similar pattern to the US market back in 2012 but in a slow-motion drift lower, rather than the rapid capitulation seen in the US. The reason is that coal-to-gas switching in power generation (a mechanism used in the US), is not as effective in Europe because gas is still much more expensive than coal. Although prices have now fallen to the ~\$7.5 range (~45-p/th), the marginal cost of gas-fired generation at ~\$60/MWh could still be ~\$20/MWh higher than coal. Elevated LNG flows into the UK, mainly from Qatar, also add to supply even with high gas inventories.

In global LNG, supply seems to be ample, where future supply can be viewed as current storage. Assessed prices have edged to the mid-\$13 level through summer, down from the mid-\$15 range last year and nearly \$20 this past winter. However, some in the market expect a modest reversal when summer really begins. Nonetheless, certain utility buyers who have over-contracted could be looking to sell their LNG cargoes back in the spot market, while Japanese buyers did not seem to be as active, particularly as coal-fired generation has risen by more than 10% y/y so far. Longer term, the possible completion of the much anticipated pipeline gas deal between China and Russia could add further gas supply to the market later this decade.

For the copper market, Chinese macroeconomic concerns appear to have taken a back seat for now. Preliminary April trade data for China's unwrought copper and copper product imports category surprised the market on the upside, showing 52% y/y growth, while Chinese copper product fabrication rates picked up by around 24% y/y, which we believe has been driven by the impact of the placing of the year's first major tender from The China Grid Corporation in March. We understand that Chinese copper fabricators ran down copper inventory through the first quarter, in part due to the high cost of credit and the high costs in tying up capital in inventory, and thus rising fabrication rates had a quick follow through to physical copper demand. **It is worth emphasizing that the largest tender of the year from the China Grid Corp is due to be placed in July, and we therefore expect this to lead to a further boost to fabrication demand for copper in the following months.** As pointed out in our April 13 Quarterly Commodities Outlook, the dramatic pull back in both LME and SHFE copper prices in March appeared to be overdone, and somewhat divorced from the physical realities of the market. LME inventory draws remain increasingly supportive, with levels now at their lowest (at 186,253 MT) since October 2008, while SHFE stocks have generally been on a downward trend since mid-March. We expect LME draw trends in particular to be a continued feature of the copper market over the next month, while Chinese import volumes are also likely to remain supportive. **We continue to expect copper to trade in the higher reaches of a \$6,500-\$7,000/MT range, and see little prospect of significant downside moves.**

Nickel remains the key bullish story of the metals space, with prices hitting YTD highs of \$21,625/MT in mid-May; trading levels are playing out in line with our expectation that a restrictive Indonesian ore export ban would be introduced and adhered to, which in turn would significantly boost prices. However, the higher reaches of the rally do appear to have been a case of too much too soon, and as we outlined in our 9 May publication, *Nickel - where next for prices?* a pull back towards \$18,500/MT was highly likely. Indeed, this would represent in our view a good buy in point on our expectation of further upside moves as the Indonesian ore export ban, introduced on January 12, increasingly tightens the nickel market. We forecast further H2 upside potential, as the market moves from a modest first half surplus into a growing second-half 2014 deficit.

Iron ore prices have fallen to new lows on the year, breaching \$105 per Citi forecasts. We have previously highlighted Q2 as the time of greatest downside pressure to iron ore prices due to a combination of seasonal demand weakness in China before any fundamental improvement (anticipated in August or September), and rising supply. Supply growth is coming from three main sources: 1) strong underlying production growth from RIO and FMG (unlike last year when Australian supply growth was concentrated in the last four months of the year, this year is focused on Q2); 2) increase in Chinese domestic production as northern mines that had delayed seasonal restarts due to low prices in March have now resumed production thanks to better April prices; and 3) seasonal increase in Brazilian

exports. Near term price risk remains to the downside, but declines below \$100 are not expected to be prolonged, with Q3 prices forecast to be in the low \$100s.

Thermal coal prices have remained subdued over the past month. We expect prices to move somewhat lower over the summer (NEWC averaging \$72) as production curtailments remain modest, Indonesian production continues to expand despite government efforts, Chinese demand hits a seasonal low period, and US exports increase.

The combination of adverse weather conditions in Latin America and California, geopolitical heat in the Black Sea grain producing bloc, piglet disease, low calf/cattle inventories and robust US export sale developments boosted agriculture prices across the board through April of this year and against the fundamental backdrop for most crops considering the bumper 2013 Northern Hemisphere harvest. **But 1H 14 price strength could lead to new-crop price weakness for many staple crops save for perhaps a few 'equatorial/emerging market' softs such as cocoa and coffee where balances appear tight and could be further buttressed by an El Nino event in 2H 14.** Grain prices already seem to be easing in May for the benchmark row crops including corn and soybeans as sowing progress and weather conditions have improved. Yet another record US corn crop and stabilising (flat) annual demand growth for ethanol output (representing c40% of US consumption) should see Dec. 1 2014 peak inventories scale 11-bn bushels to an all-time high and weigh on prices by year-end where we see about 15-20% downside from current levels of USd480/bu. Soybean prices could stay elevated for the next three months and keep supporting bull-spreading of the forward curve as US balances appear even tighter than 2012/13. However, record US planted acres, ongoing market competition from Latin America on the supply-side, and easing of the rate of Chinese demand growth could send prices towards USd1000/bu in 4Q'14. Soft commodities such as cocoa and coffee are likely to remain in historically higher trading ranges however — during 2H 14 and into 2015 — as balances are already tight and the increasing probability of an El Nino event can enhance price and supply volatility for these non-US centric crops.

Figure 57. Commodity Price Forecast Table

		Point Prices																	
		0-3M	6-12M		Q3 2013	Q4 2013	Q1 2014	Q2 2014E	Q3 2014E	Q4 2014E	Q1 2015E	Q2 2015E	Q3 2015E	Q4 2015E		2012	2013	2014E	2015E
Energy				5Y Cyclical															
NYMEX WTI	USD/bbl	103.0	103.0	81.0	108.0	97.6	99.0	103.0	107.0	99.0	101.0	96.0	104.0	97.0		94.1	98.0	102.0	100.0
ICE Brent	USD/bbl	109.0	110.0	85.0	112.0	109.3	107.8	109.0	111.0	108.0	106.0	103.0	108.0	103.0		111.7	108.7	109.0	105.0
Henry Hub Natural Gas	USD/MMBtu	4.70	4.85	5.50	3.55	3.85	5.20	4.70	4.80	4.90	4.50	4.40	4.50	4.60		2.75	3.73	4.90	4.50
Base Metals				LT Price															
LME Aluminum	USD/MT	1,770	1,820	2,200	1,827	1,815	1,752	1,740	1,780	1,800	1,830	1,860	1,890	1,900		2,049	1,888	1,770	1,870
LME Copper	USD/MT	6,650	6,800	6,200	7,096	7,161	7,005	6,650	6,700	6,800	6,800	7,000	7,200	7,500		7,945	7,352	6,785	7,125
LME Lead	USD/MT	2,100	2,300	2,200	2,116	2,134	2,127	2,050	2,150	2,250	2,350	2,100	2,200	2,370		2,072	2,158	2,145	2,255
LME Nickel	USD/MT	19,000	22,000	21,000	13,996	13,980	14,693	18,400	18,500	19,000	22,000	23,000	24,000	26,500		17,592	15,105	17,650	23,875
LME Tin	USD/MT	23,000	24,500	20,000	21,284	22,951	22,622	22,900	23,000	24,000	25,000	24,000	23,000	25,000		21,108	22,340	23,130	24,250
LME Zinc	USD/MT	2,040	2,130	2,100	1,896	1,932	2,027	2,010	2,050	2,100	2,150	2,200	2,250	2,300		1,963	1,940	2,045	2,225
Precious Metals				LT Price															
COMEX Gold	USD/T. oz	1,320	1,360	1,050	1,330	1,274	1,297	1,310	1,330	1,340	1,340	1,350	1,360	1,400		1,669	1,416	1,320	1,365
Silver	USD/T. oz	20.6	21.4	16.5	21.5	20.8	20.5	20.4	20.8	21.0	21.5	21.9	22.4	23.2		31.2	24.0	20.7	22.3
Platinum	USD/T. oz	1,470	1,525	1,763	1,456	1,397	1,428	1,445	1,500	1,525	1,525	1,565	1,640	1,675		1,552	1,490	1,475	1,600
Palladium	USD/T. oz	820	860	780	729	725	745	800	830	850	875	900	900	925		645	728	805	900
Bulk Commodities				5Y Cyclical															
Hard Coking Coal (Spot)	USD/MT	120	130	200	143	142	122	117	130	135	145	150	155	160		191	148	130	153
Thermal Coal Asia (NEWC)	USD/MT	75	80	90	77	82	79	72	72	80	82	78	75	80		94	84	76	79
Iron Ore Spot (TSI)	USD/MT	105	100	81	133	135	120	110	102	100	98	92	85	85		128	135	108	90
Agriculture																			
CBOT Corn	USD/bu	470	390	N/A	512	430	450	470	440	380	420	450	505	505		695	578	435	470
CBOT Wheat	USD/bu	650	655	N/A	650	655	616	650	655	655	650	640	635	635		750	684	645	640
CBOT Soybeans	USD/bu	1,425	1,000	N/A	1,405	1,304	1,355	1,440	1,325	1,075	1,050	1,050	1,000	1,100		1,465	1,406	1,300	1,050
CBOT Rice	USD/cwt	15.4	15.3	N/A	15.6	15.5	15.5	15.3	15.0	15.0	14.4	14.2	14.1	14.1		14.9	15.5	15.2	14.2
NYB-ICE Cotton	USD/lb	90.0	78.0	N/A	85.6	80.3	88.0	90.0	85.0	75.0	75.0	75.0	75.0	75.0		80.0	83.3	85.0	75.0
Sugar#11	USD/lb	17.0	18.0	N/A	16.7	17.7	16.5	18.0	18.0	18.0	18.5	18.5	18.5	18.5		21.6	17.5	17.6	18.5
ICE Coffee	USD/lb	180	200	N/A	118	110	152	185	200	200	225	225	225	225		175	126	180	225
ICE Cocoa	USD/MT	3,000	3,200	N/A	2,420	2,706	2,880	2,950	3,100	3,075	3,400	3,400	3,500	3,300		2,348	2,405	3,000	3,400

Source: Citi Research, *subject to revision

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Politics – Global Political Outlook

Beware the *Vox Populi*: The Trend Towards Contentious Politics Against a Market Backdrop of Low Volatility

Figure 58. Political Signposts – 2014 2H

July 9	Indonesian presidential election
July 13	Slovenian parliamentary election
August 10	Turkish presidential election
September 14	Swedish general elections
September 18	Scottish independence referendum
September 20	New Zealand general elections
October 5	Brazilian general elections (runoff on October 26)
November	Lebanese parliamentary election (tentative)
November 4	United States midterm election
November 9	Catalonia independence referendum (Spain)
December	Last date for Romanian presidential election

Source: Citi Research

Figure 59. Major Political Developments of the First Half of 2014

Russia-Ukraine crisis	South China Sea tensions
Thailand coup d'etat	Syrian civil war
Libya coup d'etat	Iran nuclear negotiations
South African election gives ANC a reduced majority	Turkey local elections and AKP hegemony
India election gives BJP landslide	European elections & the rise of non-mainstream parties

Source: Citi Research

This year, the political risk temperature has been high. But markets have barely batted an eyelash, localizing these risks. Could this uncoupling be misplaced as QE recedes?

It seems like political risk is on the front page every day: crowds of protestors gathering, a rally calling for independence, a military coup, or scenes of civil conflict. Is there more unrest globally, or is 24/7 media coverage creating this perception? Is social media to blame? We think the answer to this question lies in better understanding what we call ***Vox Populi risk***, a new variation of political risk which we have been tracking for the past two years. We define *Vox Populi* risk as shifting and more volatile public opinion that poses ongoing, fast-moving risks to the business and investment environment.

Figure 60. For More Information on *Vox Populi* Risk, See Our New GPS Report:

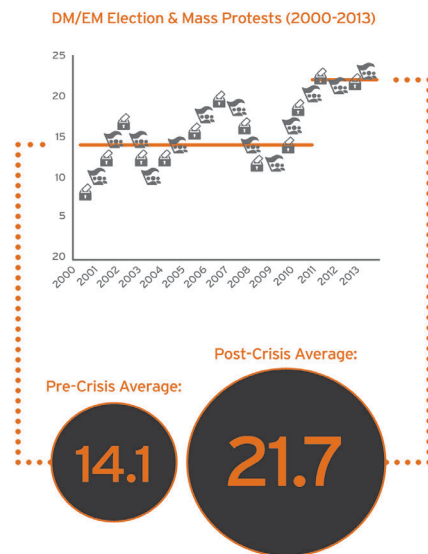
[Citi GPS: TAKING IT TO THE STREETS - What the New Vox Populi Risk Means for Politics, the Economy and Markets](#)

Source: Citi Research

There has been a dramatic and measurable increase in the number of elections, mass protests and government collapses over the past three years — a 54% increase versus the previous decade — as well as a proliferation of new and fringe political parties, many of which are anti-establishment. The new *Vox Populi* is being fuelled by growing perceptions of incoming inequality and anxiety about globalization, particularly amongst middle classes. In developed markets, this has resulted in new and alternative political parties which are having an impact on policy debate and increasing the formation of fragile coalitions and referendum risk.

In emerging markets, there is a greater chance of street demonstrations, rebellions and sustained tensions that elections may fail to resolve. In some cases, local protests can become geopolitical risks almost overnight, as in the Syrian civil war and Ukraine's Euromaidan. For petrostates, a fall in petroleum prices is leading to an outcry for improved governance and a more equitable distribution of income.

Figure 61. The Yearly Average of Elections and Mass Protests in Major Markets Has Jumped 54% in the Post-Crisis Environment



Source: Citi Research

In **Europe**, anti-establishment and euroskeptic parties had their strongest-ever showing in May's European Parliament elections. These groups, and not the left, are now the European political alternative, signalling challenges ahead in further political contests. These parties are a mixed group of Brussels critics, anti-system populists, and traditional nationalists, even extremists, with little in common that would unite them in Strasbourg. More notably, many are attempting to re-brand their appeal to attract a broader segment of discontented voters. Heading into the 2015 election cycle, this vote represents a significant "midterm" signpost for the embattled national governments.

The second half of the year will feature several significant political signposts, both in DM and EM. We're tracking key EM elections in Indonesia, Turkey and Brazil, as well as United States midterm elections, and high-profile independence votes in Scotland and Catalonia. In the background, **geopolitical risks in the Middle East and in the Asia-Pacific** continue to simmer, with tensions spiking periodically. Nevertheless, we see little appetite either to resolve these tensions or conversely to exacerbate them, suggesting they will continue to disrupt local markets on occasion.

In **Indonesia**, as in India earlier this year, the opposition is expected to take power. The opposition PDI-P has nominated popular Jakarta governor Joko Widodo. The presidential election is July 9. In **Turkey and Brazil**, the storyline is shaping up to be incumbent re-election. Prime Minister Recep Tayyip Erdogan's AKP party maintained control in March's local elections, putting Erdogan on track to become Turkey's first executive president despite public discontent and corruption scandals. The Turkish election is August 10. The Brazilian election will heat up after the World Cup in Rio de Janeiro. President Dilma Rousseff's approval rating has improved, but she faces both challenges from Aécio Neves and Eduardo Campos, as well as the criticism of the business community for her economic policies. Rousseff leads her closest rival Neves, 41%-22% in the latest Datafolha poll, suggesting a runoff may be the base case. The election is October 5, with a runoff on October 26.

In the **United States**, Republicans' chances to regain the US Senate have risen, with a minimum of three pickups likely. Still, control of the Senate will come down to races in individual states like Louisiana, Arkansas, Alaska and North Carolina. The outcome may be uncertain right through election night. The election is November 4.

In the textbook cases of what we call **referendum risk**, independences votes will take place in **Scotland and Catalonia** in the second half of the year. As these DM governments struggle with regionalism, secessionism and a drive for the return of sovereignty, even a failed vote may set the stage for a market-moving surprise. Based on today's polling, we expect the vote in Scotland to fail. The latest Survation poll shows the 'No' side up by 10%. In Catalonia, the two-part ballot question may keep the region inside Spain but force Madrid's hand on greater devolution of power. Scotland votes on September 18, and Catalonia on November 9.

Figure 62. Major-Market Elections for 2015-2016

2015	Date	Citi GDP 2014F		Governing Party	Government Orientation
Nigeria	February 14	6.4%	↔	People's Democratic Party	Center-right
Finland	April (TBD)	1.1%	↑	Coalition Party (coalition)	Center-right
United Kingdom	May 7 (TBD)	3.6%	↔	Conservative Party (coalition)	Center-right
Turkey (legislative)	June 13	3.5%	↑	AKP	Center-right
Mexico (legislative)	July 5	4.0%	↑	PRI	Center-left
Denmark	September (TBD)	1.5%	↑	Social Democrats (coalition)	Center-left
Argentina	October (TBD)	0.0%	↑	Front for Victory	Center-left
Canada	October (TBD)	2.7%	↔	Conservative Party	Center-right
Poland	October (TBD)	3.6%	↔	Civic Platform (coalition)	Center-right
Portugal	October (TBD)	2.0%	↑	Social Democratic Party	Center-right
Spain	December (TBD)	1.6%	↑	Partido Popular	Center-right
2016	Date	Citi GDP 2015F		Governing Party	Government Orientation
Croatia	February (TBD)	1.2%	↑	Social Democratic Party (coalition)	Center-left
Taiwan	March	3.8%	↑	Kuomintang	Center-right
South Korea	April	4.0%	↔	Saenuri Party	Center-right
Ireland	April (TBD)	3.3%	↑	Fine Gael (coalition)	Cross-party
Japan (Upper House)	July (TBD)	0.9%	↓	Liberal Democratic Party	Center-right
United States	November 8	3.1%	↑	Democratic Party	Center-left
Russia (legislative)	December	2.3%	↑	United Russia	Centrist
Australia	January 2017 (TBD)	2.9%	↔	Liberal Party (coalition)	Center-right

Source: Citi Research. GDP forecasts are given for the year prior to the election.

Will 2015 will be another political year? The focus may return to a slow-growth Europe, with elections in Portugal, Spain, the United Kingdom and Poland. In May's European Parliament elections, many parties in government fared notably poorly. The broader Union-wide move against austerity will likely be anchored further, as socio-economic conditions have not materially improved in most EU states, even if growth is nominally improved or positive. In the face of such voter discontent, *the likely policy impact will come from national governments who feel compelled toward a more populist tone.* For that reason, political risk from government policy is likely to rise in these member states. For example, we expect the British Conservatives to continue to press immigration, European devolution, and even a Brexit referendum as issues as they attempt to fend off UKIP in next year's UK election.

Accounting & Valuation

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The International Accounting Standards Board (IASB), following years of delay, has finally completed its joint revenue recognition standard with the US Financial Accounting Standards Board (FASB), and its new standard on financial instruments is expected this year. However a converged standard on leases is looking less likely, following a divergence in proposed treatment by the Boards.

New revenue standard issued in May 2014 – The long awaited new revenue recognition standard, IFRS 15: Revenue from Contracts with Customers, was issued in May 2014. The joint project between the IASB and US FASB has resulted in substantially similar new revenue recognition rules being issued under both IFRS and US GAAP. The new standard, which is effective from 1 January 2017, is likely to have a significant impact on telecom companies which will now be required to allocate revenue, in the case of a bundled transaction, to both the handset and the network service. This is likely to result in significantly greater initial revenue recognition when compared to existing practice by most European telecom companies of limiting revenue recognition to the cash receipt. We also think that the new disclosure requirements could improve transparency in a number of sectors, such as oil services, which use percentage of completion methods of revenue accounting.

Lease accounting plans clarified, but diverged – Following the revised exposure draft issued in May 2013 on the long-delayed and controversial joint Lease accounting project, the IASB and FASB have reached different decisions on how lessee accounting should be treated under IFRS and US GAAP. Whilst both boards have agreed that leases should be recognised on balance sheet, different conclusions have been reached on the appropriate P&L treatment (discussed further in our recent note [The Standards: April Update](#), dated 3 April 2014). If convergence is not reached on this issue, accounting differences may significantly distort comparison of IFRS and US GAAP reporters.

Financial Instruments standard expected this year - The remaining elements of IFRS 9: Financial Instruments covering the final rules on classification and measurement, and impairment of financial assets, are expected to be issued this year. The new standard is expected to be effective from 1 January 2018 and will introduce an expected credit loss model for loans and other debt instruments, a new hedge accounting model designed to better reflect companies risk management activities and new classification rules. IFRS 9 will also require the change in fair value of liabilities arising from changes in own credit risk to be recognised in Other Comprehensive Income, rather than in the P&L.

Uncertain corporate tax environment – Companies are facing a more uncertain tax environment. The rhetoric from governments is increasingly critical of international corporate tax planning structures, and an OECD action plan was endorsed in September 2013 by the G20 to address tax avoidance by multinational companies (see [Taxing Times - Are corporate tax planning structures at risk?](#)). Potential tax benefits can be a significant factor in M&A decisions, particularly for US companies looking at sizeable European targets, highlighted in Pfizer's offers for AstraZeneca. In our note [Taxing Times - Thoughts on US inversions and UK tax attractions](#) dated 9 May 2014, we discussed how US companies may relocate via M&A activity without triggering inversion tax penalties, and the UK corporate tax changes which have made the UK a more attractive location for companies

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Equity Research by Sector

Automobiles and Parts

Structural growth with value

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- **Investment Thesis** – We see no reason to alter our bullish stance on Autos, though ex-China EM is likely to see weakness for the remainder of 14E global car sales should still grow driven by Chinese expansion and modest recovery in Europe. As such, we still do not see a credible scenario in which global car sales could decline by 5-10% in 14/15E that would justify current trading multiples that still reflect high levels of cyclical downturn risk, in our view. Furthermore, suppliers are increasingly relevant (see [The Car of the Future](#)) which we believe suggests they should trade on multiples closer to capital goods companies.
- **Sector Themes** – In our view, suppliers continue to offer the best business model in Autos as content per vehicle increases. Premium OEMs have the biggest regulatory challenges while mass market OEMs can at least restructure to higher profitability. We have long believed that Financial Services and Auto manufacturing are deeply interlinked as most cars are sold on credit. We continue to think the market undervalues Fincos, as in general car financing is still more profitable than manufacturing.
- **Strategy Themes** – Of Citi's key strategy themes for the next year, we see Autos as most exposed to Earnings Leadership, and Restructuring. 1) Autos also have some of the strongest Earnings momentum, as car penetration rates grow in China (currently 8% vs 92% US). 2) Restructuring offers an opportunity for mass market players which operate at c. 70% capacity.
- **Valuation** – European Autos trade on a PE of c.10x on FY14e vs the European market average of c.14x. Autos remain one of the cheapest sectors with a FY14e PE relative of 74 and FY15e PE even lower relative of 68.
- **Risks** – Although Europe is recovering, there is clear weakness in ex-China EM (influenced by higher interest rates), especially LatAm, Mediterranean basin and Russia. OEMs more exposed to these regions, such as Fiat and RNO, are more at risk from the deteriorating markets, although order books remain strong and OEMs have upgraded European growth prospects recently.
- **Stocks for the next 12 months** – Overall we continue to prefer suppliers to OEMs, with Conti our top pick (both Conti & RNO are on the Focus List), driven by our bull case on Automotive Electronics & its highly cash-generative business model. RNO is still the cheapest OEM with the potential for higher savings from operational restructuring and rising margins as Nissan utilises Renault's excess capacity & its entry level brand gains market share. We also think its highly performing Finco (RoE > 25%) could give up some returns & boost market share.

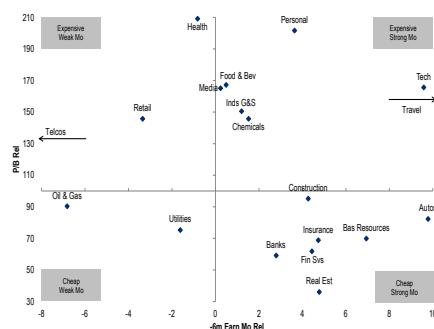
Automobiles & Parts: Most Favoured and Least Favoured

Ticker	Rating	Price	Target	Yield	ETR	2015E			
		(Jun. 7)	Price	(%)	(%)	P/E	P/BV	ROE	
Most Favoured									
Renault SA	RENA.PA	Buy/1	€71.84	€88.00	2.9%	25.4%	6.2x	0.7x	11.9%
Cheapest Auto Stock with Nissan (using excess Europe capacity) and Financial services (RoE>25%) benefits. On-going cost reductions through model platforms and its market leading entry-level Dacia range gives it a competitive edge.									
Continental AG	CONG.DE	Buy/1	€176.55	€210.00	2.0%	21.0%	11.7x	2.6x	24.2%
The industry's best model, with technological leadership that has reduced its cyclicity and a market leader in both auto components and tyres. As organic growth continues to outstrip car production, we believe it deserves the higher multiples of its capital goods peers.									
Least Favoured									
Fiat SpA	FIA.MI	Sell/3	€7.72	€6.60	0.0%	-14.5%	19.4x	1.1x	5.0%
We see Fiat offering poor relative value. Its recent mid-term plan also requires high levels of investment which we think exposes it to changes in credit market sentiment. Next catalysts seem negative including a potential mandatory convertible bond and US GAAP disclosure									
Nokian Tyres plc	NRE1V.HE	Sell/3	€30.44	€26.00	4.6%	-10.0%	15.0x	2.8x	19.9%
In the short term, uncertainty over the Russian market and the rouble could see more consensus downgrades. In the long term, it is likely to see margin contraction as Russian tyre market becomes more competitive.									

Source: Citi Research, Powered by dataCentral

Autos continue to be some of the most undervalued names in Europe. The market also seems to misprice Auto banks without regard to how commercial banks are valued.

Figure 63. Autos are Cheap...



Source: Citi Research

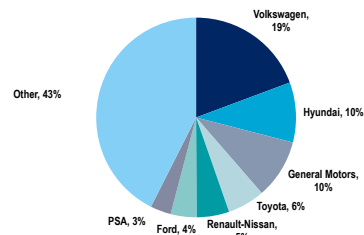
Figure 64. ...and their Fincos are undervalued

	14E RoE	Trading value P/B on 14E
Banco Santander	7.7%	1.13x
France Banks	7.2%	0.74x
Germany Banks	4.8%	0.55x
Iberia Banks	6.1%	1.12x
UK Banks	6.3%	0.97x
BMW FS	21.1%	
DAI FS	19.2%	
VW FS	10.1%	
PSA FS	9.9%	
RNO FS	25.9%	

Source: Citi Research

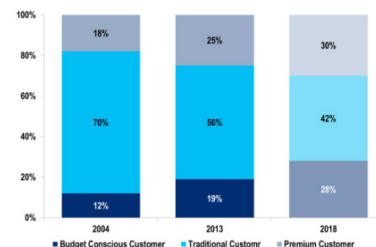
China is now the world's largest market and car penetration is continuing to rise. At the same time, globally, consumer trends are changing with entry level and premium cars growing more popular.

Figure 65. China LV Market Share, 2013



Source: LMC

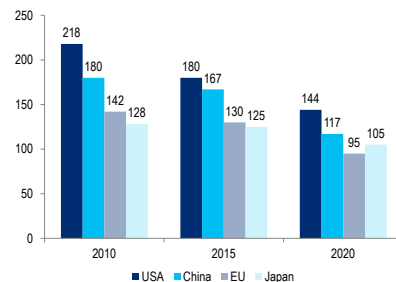
Figure 66. Bipolarity of Customer Base



Source: Fiat

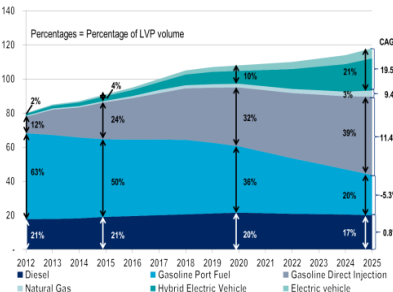
CO2 rules are pushing OEMs to rely more on Supplier technology and, we believe, this should mean more investment in alternative fuels

Figure 67. CO2 regulation is getting stricter...



Source: Continental

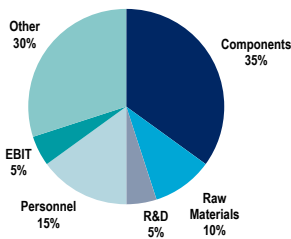
Figure 68. ...meaning more alternate fuels



Source: Continental

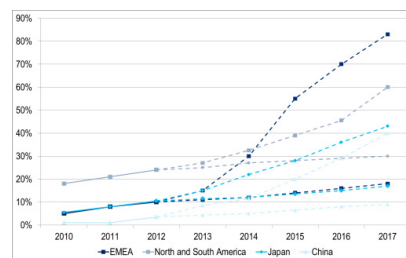
We prefer suppliers to OEMs as fuel efficiency, increased safety, and infotainment will likely see their revenue outpace OEMs'.

Figure 69. OEM cost structure favours suppliers



Source: Company Data, Citi Research

Figure 70. Rates of embedded telematics



Source: Continental

⁷ Stocks mentioned: (BMW.G.DE; €88.90; 2); (CONG.DE; €166.55; 1); (DAI.G.DE; €67.41; 2); (FIA.MI; €7.35; 3); (VLOF.PA; €94.89; 1); (VOW.G.DE; €190.30; 1); (RENA.PA; €68.70; 1); (012330.KS; ₩297,000; 2); (7201.T; ¥908; 1); (7203.T; ¥5,526; 1); (GM.N; US\$33.46; 1); (PEUP.PA; €9.79; 3); (SAN.MC; €7.36; 2)

Banks

The 3Rs of European Banking

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- **Investment Thesis** – We remain Overweight with the sector at an inflection point on capital, restructuring and real economy, while the transition to ECB supervision should serve to reduce the sector risk premium (as the Fed has done for US banks).
- **Return of Capital Back on the Table** — The capital return story is growing with 4 out of 6 Nordic banks beating on 2013 dividends, including a higher-than-consensus first dividend at Danske Bank (Buy, Focus list, DKr150) since 2007. Both CS and UBS have guided to payout over 50% as well as a supplementary capital return in UBS' case. French banks' payout targets have been raised to 40-50% even if potentially higher litigation-related settlements could delay by a year (eg BNP Paribas). Likewise, Intesa plans to distribute c€10bn dividends over 2014-17E, including a c90% payout ratio in 2017.
- **Regulation No Longer One-Directional** — On the back of LCR (liquidity) forbearance, we have also seen Leverage and NSFR (stable funding) 'softening' while ring-fencing requirements have been 'kicked into the long grass'. Overall, the broad contours of regulation have largely been defined, although banks need to do more around resolution mechanisms; GLAC (gone concern loss absorbing capital) or senior bail-inable debt should come into focus later in the year.
- **Banking Union Should Reduce Sector Risk Premium** — We expect the AQR & stress-test to introduce greater transparency on 'problem' assets and speed-up the 'healing' process – including via 'front-loading' of impairments and related capital raising as we have seen across a number of European banks in recent quarters, including BP, BPM, Deutsche Bank as well as Greek banks. On our illustrative 'stress-test' – based on AQR, macro shock, RWA harmonisation & sovereign stress – we estimate c€12bn additional capital needs at a minimum 5.5% level, rising to €27bn at a more conservative 6.5% fully-loaded ratio.
- **Restructuring & Provisioning Normalisation To Drive Upgrades** — In 1Q14, European banks beat underlying consensus expectations by 9% driven by lower costs and provisioning ([European Banks 1Q14 Earnings Heat Map](#)). Banks have targeted cost programmes of c10% of expense base, of which two-thirds has yet to be delivered. We expect market focus to increasingly shift from balance sheet metrics towards provision 'normalisation' – we see a 'normalised' sector RoTE of c13% in the current low-rate environment. The major Swiss banks and UK international banks remain most geared to the rising US rates cycle
- **"Whatever It Takes", Redux** – We continue to believe that potential QE – including targeted ABS purchases – could provide for positive revaluation of sovereign portfolios, lower term deposit funding costs (linked to sovereign spreads) and lower cost of equity (notably for periphery banks), albeit not expected by our economists until later in the year per [The ECB And QE: "Whatever it Takes", Redux](#). We are Buyers of 'self-help' peripheral banks including Bankia, Caixa (Focus list stock) and UniCredit; Danske is also on our Focus list while we also like UBI among the small banks.

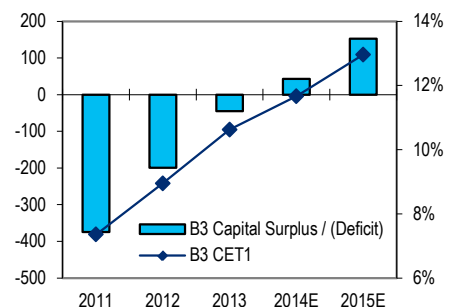
Banks: Most Favoured

Ticker	Rating	Price	Target	Yield	ETR	2015E			
		(Jun. 7)	Price	(%)	(%)	P/E	P/BV	ROE	
Most Favoured									
CaixaBank SA	CABK.MC	Buy/1	€4.67	€5.10	4.3%	13.5%	14.4x	1.0x	7.3%
Caixabank is the classic self-help story in the European periphery with attractive valuations and under-appreciated earnings potential. Caixa is a play on four themes: 1) improving net interest margins; 2) cost optimisation; 3) normalising provisions; and 4) capital rebuild									
Danske Bank A/S	DANSKE.CO	Buy/1	Dkr155.50	Dkr175.00	2.6%	15.1%	10.4x	0.9x	9.2%
Danske is the lowest rated Nordic bank trading at 1.1x P/TB 2014E. The re-rating catalysts are: (1) Recovery – emerging Danish economic recovery post-08. (2) Restructuring – new CEO's income & cost initiatives aim to improve the RoE from 5.0% (2013) to 9% by 2015 and to 12% in the long term. (3) Return of capital – Fully loaded B3 CT1 ratio at 13.0% at 1Q14									

Source: Citi Research, Powered by dataCentral

European banks are going through an inflection point on capital, in 2013. The Nordic and Swiss banks remain amongst the best-placed banks for capital return.

Figure 71. Sector Capital Deficit Turning to Surplus, 2011-15E (€ bn)

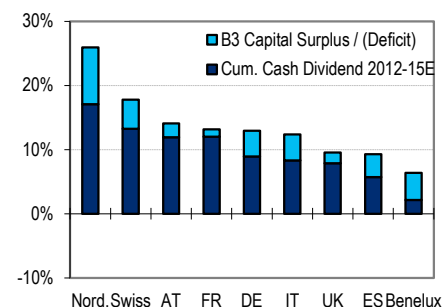


Source: Company Reports, Citi Research Estimates

Notes: 1) Europe ex Greece and Portugal

2) We assume minimum mortgage risk-weights of 15% and apply a +50% surcharge on internal model-based market risk RWAs

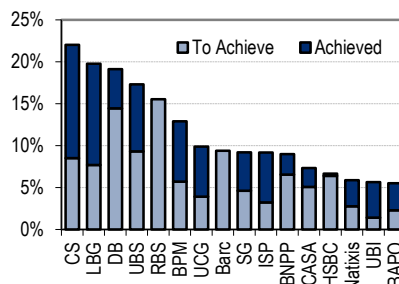
Figure 72. Capital Surplus Position: By Country, 2015E, % of Market Cap



Source: Citi Research Estimates

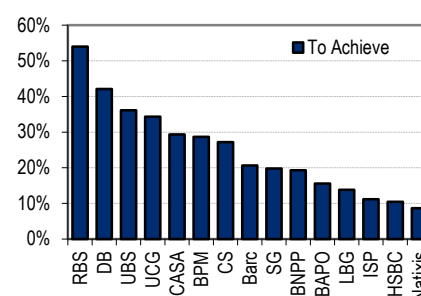
Banks have targeted cost programmes of c10% of expense base, of which one-third has been achieved.

Figure 73. Announced Cost Savings Targets (As a % of 2013 Cost Base)



Source: Company Reports & Citi Research estimates

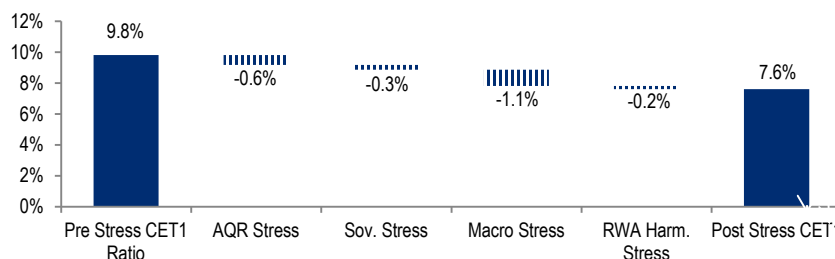
Figure 74. Potential Cost Savings Targets to be Achieved (As % of 2013 Post-Provision Profit)



Source: Citi Research

Sector-level capital shortfall of €12bn at 5.5% min, €27bn at 6.5% and €58bn at 7.5%

Figure 75. Stress Test – Citi European Banks Universe



Source: Citi Research Estimates, EBA 2011 Stress Test, Company Reports

⁸ **Stocks mentioned:** (BAPO.MI; €14.08; 2); (BARC.L; £2.42; 1); (BKIA.MC; €1.49; 1); (BNPP.PA; €51.67; 1); (CABK.MC; €4.56; 1); (CAGR.PA; €11.73; 1); (CNAT.PA; €5.10; 2); (CRDI.MI; €6.60; 1); (CSGN.VX; SFr27.20; 1); (DANSKE.CO; Dkr154.40; 1); (DBGn.DE; €29.76; 1); (HSBA.L; £6.23; 2); (ISP.MI; €2.49; 2); (LLOY.L; £0.78; 2); (PMII.MI; €0.68; 3); (RBS.L; £3.40; 3H); (SOGN.PA; €42.77; 1); (UBI.MI; €7.01; 2H); (UBSN.VX; SFr17.97; 1)

Basic Resources – Metals & Mining

Mining Fight-Back

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- **Investment Thesis** – We maintain our short-term (12 months) bullish stance on the equities. In our latest [Diversified Debate](#) series we conclude that the mining companies are marginally reducing their earnings volatility but significantly reducing the overall value at risk. Our analysis further suggests that the large mining companies could defend their dividend yields and de-gear even under a repeat of the 2008/2009 pricing scenarios.
- **Sector Themes** – Mining Fight-back is our theme for the sector which, we believe, will play out over the next few years. The mining companies are addressing the wrongs of the past and we expect the sector will transition to being priced as value / yield stocks. The cut-back in capex for the mining sector is improving the supply/demand balance of commodities, together with generating higher capital returns and cash flow.
- **Strategy Themes** – We believe that alpha will be the biggest driver of stock performance in the mining sector in 2014. It is likely we are moving from a top-line commodity driven environment into a bottom-up company-driven one.
- **Valuation** – We forecast the sector to deliver a CAGR in earnings of around 7% and importantly free cash flow yield is expected to grow at a CAGR of 23.9% until the end of the decade, and broadly dividend yields are now supportive for the sector against the market.
- **Risks** – The transition of China's economy away from investment and towards consumption represents substantial downside risk to the sustainability of commodity consumption, in our view. However, there is little visibility over the timing of this transition.
- **Stocks for the next 12 months** – We believe the large diversified miners will outperform the sector in 2014; we favour Rio Tinto, BHP Billiton and Glencore (Rio Tinto & BHP are part of Citi Focus List). We remain underweight the gold and base metals stocks, & our least favoured large-cap miner is Anglo American.

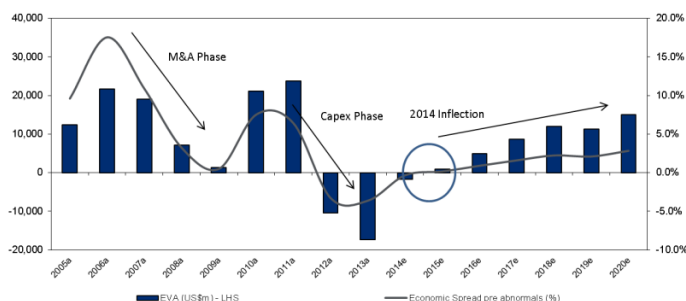
Metals & Mining: Most Favoured and Least Favoured

	Ticker	Rating	Price (Jun. 7)	Target Price	Yield (%)	ETR (%)	2015E		
							P/E	P/BV	ROE
Most Favoured									
Rio Tinto PLC	RIO.L	Buy/1	£31.69	£38.50	3.9%	25.5%	9.5x	1.7x	18.6%
<i>We view Rio Tinto as the cash flow king of the European metals & Mining sector. We expect a free cash flow yield of 10% for FY2015.</i>									
BHP Billiton PLC	BLT.L	Buy/1	£18.92	£21.00	4.2%	15.2%	12.2x	1.9x	16.7%
<i>We believe that BHB Billiton fits the Slim, Spin and Growth theme and is the most diverse of the large global mining companies.</i>									
Glencore PLC	GLEN.L	Buy/1	£3.25	£3.90	3.2%	23.2%	10.4x	1.2x	12.4%
<i>Glencore has outlined a strategy of high hurdle rates and returning excess cash to shareholders.</i>									
ArcelorMittal	ISPA.AS	Buy/1	€11.25	€13.20	1.4%	18.8%	11.8x	0.5x	4.6%
<i>As mining capex rolls off, the group's FCF profile is looking increasingly supportive with an estimated FCF yield of 10% in 2015.</i>									
Salzgitter AG	SZGG.DE	Buy/1	€31.00	€37.60	1.1%	22.4%	8.8x	0.5x	6.5%
<i>SZGG has the strongest balance sheet of all European listed steel peers; we see it as the best equipped to weather the weak earnings outlook.</i>									
Least Favoured									
Anglo American PLC	AAL.L	Neutral/2	£14.65	£15.00	3.4%	5.8%	12.7x	0.9x	7.4%
<i>We expect Anglo to deliver long term value under the current strategy while think that Anglo is likely to be a story for 2015/16 rather than 2014.</i>									
Antofagasta	ANTO.L	Sell/3	£7.73	£7.10	3.2%	-4.9%	13.1x	1.8x	14.4%
<i>We continue to maintain our Sell rating on the stock with a TP of £7.60 due to capex timing.</i>									
First Quantum Minerals Ltd	FQM.L	Sell/3	£11.84	£9.50	1.7%	-18.1%	9.1x	1.2x	13.8%
<i>FQM is adding new capacity at the top of the incentive price curve relative to its legacy asset.</i>									
African Barrick Gold Plc	ABGL.L	Sell/3	£2.16	£1.78	0.0%	-17.5%	9.5x	0.7x	7.4%
<i>ABG looks cheap on short-term valuation metrics but, in our opinion, expensive on longer-term valuation metrics.</i>									
Polymetal	POLYP.L	Sell/3	£5.49	£4.50	3.6%	-14.3%	11.8x	1.6x	15.4%
<i>The weak silver price is a key issue for the group with 48% of its revenue derived from silver.</i>									

Source: Citi Research, Powered by dataCentral

We believe that the appetite for both capex and M&A has diminished in the sector. This is resulting in the sector moving into EVA creation (ROIC – WACC) territory. We believe this is yet to be priced into the mining equities.

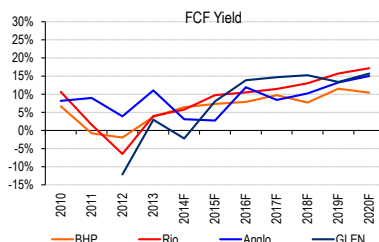
Figure 76. EVA creation European mining sector



Source: Company data, Citi Research estimates

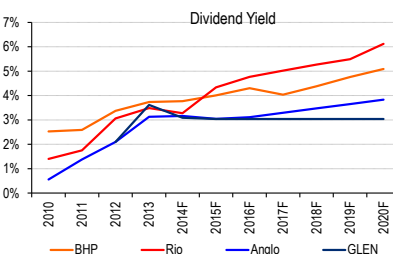
Even under a bearish iron ore price forecast, we expect the large mining companies to continue to generate very strong (c10%) cash flow yields, which is likely to lead to significant degearing coupled with increased dividend payments.

Figure 77. FCF Yield



Source: Company Reports and Citi Research Estimates

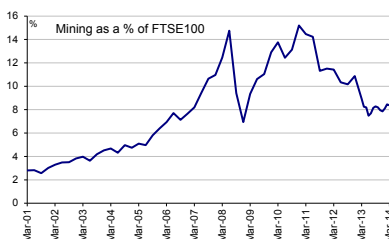
Figure 78. Dividend Yield



Source: Company Reports and Citi Research Estimates

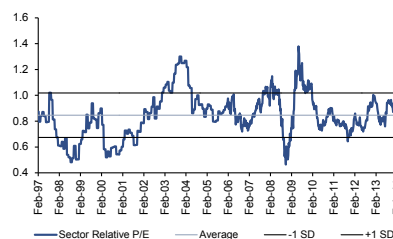
In past 12 months the index weighting for Mining sector has settled around 8% while on relative PE terms the sector is trading close to historical averages.

Figure 79. Index Weight Stabilising?



Source: Bloomberg

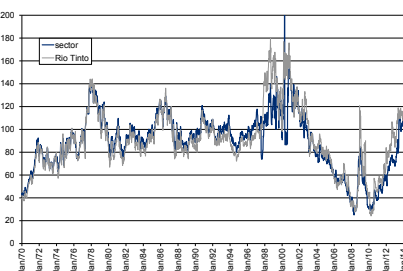
Figure 80. Sector PE Relative to UK Market



Source: DataStream

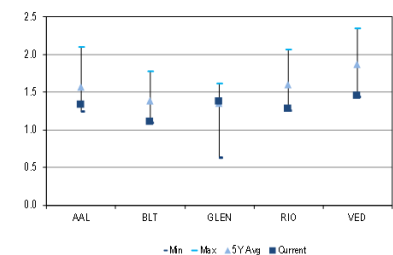
The mining companies are trading at or near a five-year historical low. Moreover, on a dividend yield basis, the mining companies are trading at a 14-year high and near a historical peak versus the market.

Figure 81. Dividend yield mining sector relative to the market



Source: Datastream, Citi Research

Figure 82. Diversified equities 12M rolling beta



Source: Bloomberg, Citi Research

⁹ Stocks mentioned: (AAL.L; £14.99; 2); (BLT.L; £19.06; 1); (GLEN.L; £3.26; 1); (RIO.L; £31.27; 1); (ANTO.L; £7.75; 3); (ISPA.AS; €11.25; 1); (POLYP.L; £5.43; 3); (SZGG.DE; €31.06; 1); (ABGL.L; £2.20; 3); (FQM.L; £11.96; 3)

Chemicals

Self-help in a competitive environment

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- **Investment Thesis** – We are selective due to multiplicity of factors. Economic recovery, improved volumes, the potential of cyclical recovery in 2015 and supportive agricultural demand environment play against strong European currencies, the loss of structural competitiveness of European assets versus China (coal to chemicals) and the US (shale gas effect) and oversupply in most markets (from caprolactam to urea). We have passed the worst forex effects, construction is recovering and pricing now looks stable at low levels. In such an environment, we recommend self-help and names leveraged to volume recovery notably Akzo Nobel. We also expect structural growth stories of Clariant and DSM to outperform. The outlook for Industrial stocks is mixed; we expect recovery but some stocks already discount this. We have a Sell rating on Lanxess (C4 chain) and prefer AKE (C3 chain).
- **Sector Themes** – Limited pricing power (probable cyclical recovery in 2015), solid volume recovery (operational leverage) and FX headwinds. Cost control critical in such a scenario to defend up margins.
- **Strategy Themes** – We favor self-help, operational leverage, cyclical upturn and structural growth. Given limited pricing power, we like names that have good operational leverage to maximize value in a volume driven growth environment.
- **Valuation** – The sector now trades on a PE14E of 17.1x. We prefer stocks with good earnings visibility, which are trading at discount compared with its peers. We like AKE (PE14E 11.4x. vs. peers at 15.7x), CLN (13.8x vs. 19.7x for peers) and DSM (14.7x vs 19.7x for peers).
- **Risks** – Pace of economic recovery, supply growth delays, long term threat from coal to chemicals and shale gas related investments from 2017. FX headwinds will still be significant in 2Q and there are risks due to QE tapering. In the ag space, oversupply and adverse weather are key risks this year.
- **Stocks for the next 12 months** – Akzo Nobel - operational leverage, cyclical upturn and self-help; DSM - beneficiary of growth in nutrition demand and restructuring; CLN and AKE - earnings recovery, improving FCF and ROCE, attractive valuation. Linde - solid structural growth story with good earnings visibility driven by the global energy megatrends. The valuation discount to peers undervalues the shares, we believe. Solvay - sluggish growth and structurally challenged business portfolio likely to lead to consensus downward revisions.

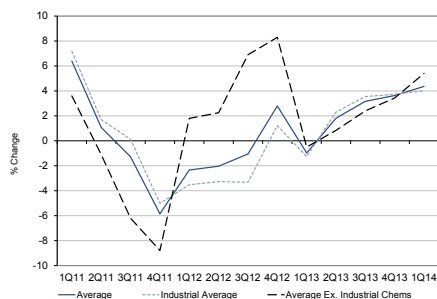
Chemicals: Most Favoured and Least Favoured (

	Ticker	Rating	Price (Jun. 7)	Target Price	Yield (%)	ETR (%)	2015E		
							P/E	P/BV	ROE
Most Favoured									
Akzo Nobel NV	AKZO.AS	Buy/1	€55.80	€65.00	2.8%	19.3%	14.7x	2.7x	16.6%
A combination of recovery in its core end markets (paint for construction, shipbuilding), self-help and stable raw material costs should drive strong EPS improvement, which should support outperformance									
DSM NV	DSMN.AS	Buy/1	€52.39	€65.00	3.2%	27.3%	13.0x	1.4x	10.2%
High grain prices in 2012 badly impacted demand and some prices for its nutritional additives. With grain prices well off their peaks, we are seeing recovery, which should lead to EPS improvement supported by self-help.									
Least Favoured									
Lanxess	LXSG.DE	Sell/3	€51.55	€37.00	1.7%	-26.5%	17.2x	2.1x	8.9%
Oversupply of butadiene is likely to keep rubber margins under pressure. Self-help will mitigate some of this pressure but we believe shares are priced for a far stronger cyclical recovery than we see as possible.									
Solvay SA	SOLB.BR	Sell/3	€119.35	€80.00	2.7%	-30.3%	15.2x	1.6x	10.0%
Structural challenges in about 40% of the group's sales base, loss of competitiveness of European energy intensive assets and high valuation versus projected ROCE									

Source: Citi Research, Powered by dataCentral

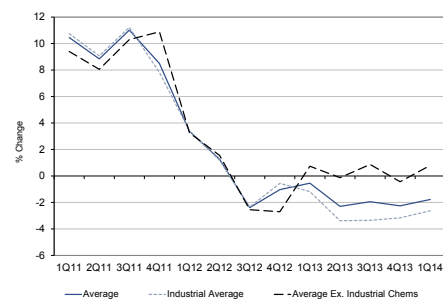
Volumes are clearly on uptrend but price recovery is still selective

¹⁰Figure 83. Trends in Volume Growth



Source: Citi Research, Company Reports

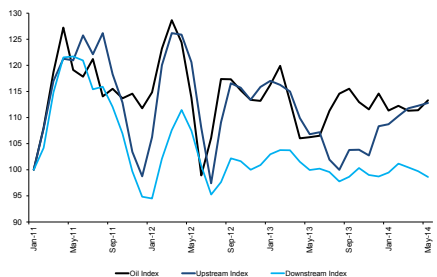
Figure 84. Trends in Price Growth



Source: Citi Research, Company Reports

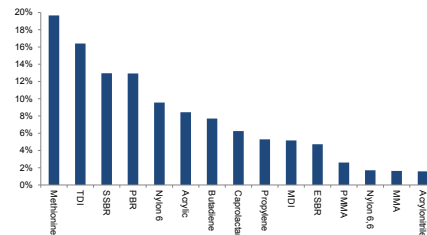
Margins for downstream players remain under pressure due to supply growth

Figure 85. Upstream vs. Downstream price



Source: Citi Research, ICIS, CMAI

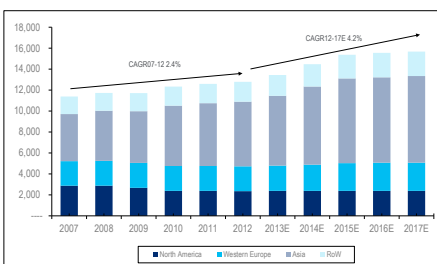
Figure 86. Co-products supply 2014e



Source: Citi Research, CMAI, ICIS

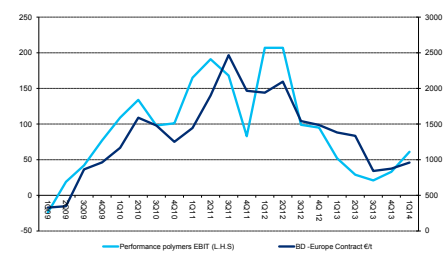
Above trend supply growth of BD to limit pricing upside for C4 chain

Figure 87. Butadiene Supply growth



Source: Citi Research, CMAI

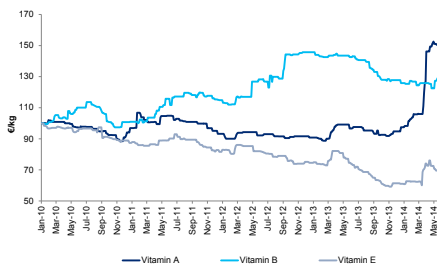
Figure 88. LXS – Performance Polymers EBITDA vs. Butadiene Price



Source: Citi Research, IHS, Company Reports

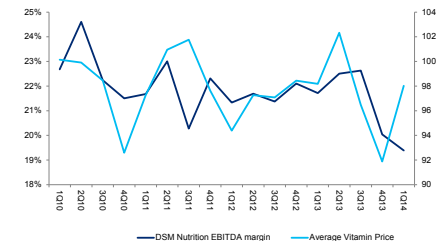
Vitamin prices have started to recover driven by improvement in animal feed demand

Figure 89. Spot Prices for Vitamin A, B2 & E



Source: Feedinfo News Service

Figure 90. Prices and DSM EBITDA Margin



Source: Feedinfo News Service, company reports

¹⁰ Stocks mentioned: (AKZO.AS; €55.42; 1); (AKE.PA; €74.39; 1); (CLN.VX; SF18.45; 1); (DSMN.AS; €52.60; 1); (LXSG.DE; €52.22; 3); (PHORQ.L; US\$11.20; 1); (SOLB.BR; €119.15; 3); (YAR.OL; Nkr273.70; 1); (LING.DE; €155.20; 1)

Construction – Building Materials

Pricing in Growth

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- **Investment Thesis** – A gentle recovery in Europe and continued recovery in the US with EM continuing to hold up at decent levels of growth supports further EBITDA growth this year. Cost savings, deleveraging and an improving pricing outlook further support profit growth from here. Balance sheets continue to improve with Distribution and Light-side companies in generally good shape and the Heavy-side moving towards investment grade. M&A starting to pick up.
- **Sector Themes** – Corporate activity and M&A seems to be gaining momentum as the visibility over the recovery improves and corporates entertain solutions to boost growth and returns. Private construction continues to be stronger than Public and infrastructure work with renovation performing relatively better than new build. Pricing power is improving in the US as utilization rates start to improve but Europe remains more muted. Uncertainties and risks in EM continue to be an issue for the Heavy-side stocks.
- **Strategy Themes** – the sector is well placed to benefit from operating leverage in DM, with the US recovery more fully established and Europe showing signs of improvement. Heavy-side companies continue to take out costs and pursue other corporate activity to improve growth and returns. The Merchants have initiatives to improve their asset turn (essentially sell more from existing branch network) to drive returns higher.
- **Valuation** – Since the middle of 2012 the sector has nearly doubled and consequently offers less compelling value on current estimates. Valuation wise, the sector resides on an EV:EBITDA multiple of 9.3 and c.8 times for 2014E and 2015E respectively with the 2015 multiples broadly in line with long run average ratings. Valuation is therefore pricing in continued EPS recovery into 2015.
- **Risks** – The most significant risk is that Europe takes a step back and recovery is not sustained or that EM suffers a significant GDP cut leading to generally slower growth. Input costs are generally subdued but a continued lack of pricing power in Europe could be a concern for the Heavy-side companies.
- **Stocks for the next 12 months** – We continue to favour exposure to the US and Western Europe, with the best visibility of growth in the US and UK. The UK merchants (Travis and Wolseley) look attractive value. We remain more selective on the European building products names and have Buys on Saint Gobain and Wienerberger. We have a buy on Heidelberg given its relatively better end market exposure and scope for de-leveraging this year helped by disposals.

Building Materials: Most Favoured and Least Favoured

	Ticker	Rating	Price (Jun. 7)	Target Price	Yield (%)	ETR (%)	2015E		
							P/E	P/BV	ROE
Most Favoured									
Saint Gobain	SGOB.PA	Buy/1	€44.67	€47.00	2.9%	8.1%	15.6x	1.2x	7.8%
<i>Good medium term value from a sustained volume recovery in Europe and the US & profit recovery in Flat Glass, supported by a healthy balance sheet</i>									
Wolseley PLC	WOS.L	Buy/1	£34.12	£36.60	5.6%	12.8%	14.9x	2.5x	16.0%
<i>Strong recovery, market share gains in the US & positive trends in the UK; improving margins and robust balance sheet incl. potential for sp. dividend</i>									
Least Favoured									
Geberit AG	GEBN.VX	Sell/3	SFr302.30	SFr270.00	2.7%	-8.0%	22.2x	5.5x	26.1%
<i>Big exposures to sluggish European markets but trades on a premium rating relative to the sector, on our estimates</i>									

Source: Citi Research, Powered by dataCentral

The sector is up 10% YTD, on the back of higher corporate activity and prospect of a modest recovery in Europe.

The 2015E EV/EBITDA multiple is in line with historical average of c8x

Consensus EPS has remained broadly stable at a relatively low level

Balance sheets remain in decent shape and should see a steady improvement supported by better free cash generation

Construction sentiment in Europe has edged back a bit after a good start to the year. Q2 trends are likely to give a clear picture of underlying trends, but generally speaking, Germany and the UK look relatively strong.

The US continues to see steady positive momentum driven by solid demand in the residential and private non-residential markets

Heavyside pricing should continue to improve to broadly cover input cost inflation, which has been rising at a slower pace

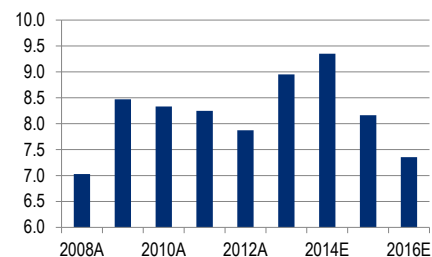
Pricing is expected to show steady recovery in the US

¹¹Figure 91. Absolute Price Performance



Source: DataStream, Citi Research

Figure 92. Sector EV/EBITDA



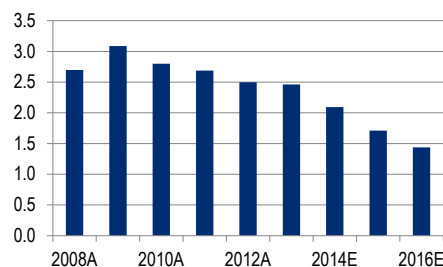
Source: Company data, Citi Research estimates

Figure 93. Sector EPS (€)



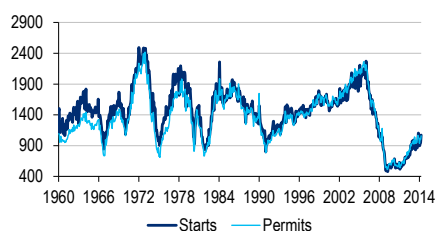
Source: DataStream, Citi Research

Figure 94. Sector Net Debt to EBITDA



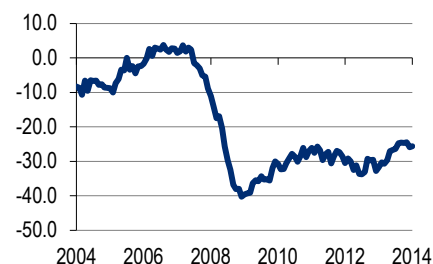
Source: Company data, Citi Research estimates

Figure 95. US Housing Starts & Permits



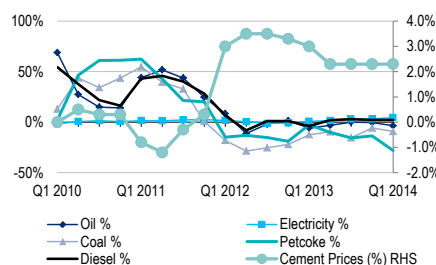
Source: DataStream, U.S. Census Bureau

Figure 96. EU Construction Confidence



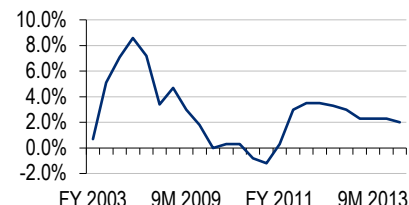
Source: DataStream

Figure 97. Energy Costs, Annual Change, %



Source: DataStream, Citi Research

Figure 98. Global Cement Price Trends



Source: Company data, Citi Research

¹¹ Stocks mentioned: (BZU.MI; €12.93; 2); (CRH.L; €20.22; 2); (GEBN.VX; \$297.50; 3); (GRF_u.L; £5.72; 1); (HEIG.DE; €63.56; 1); (HWDN.L; £3.10; 2); (ITAI.MI; €8.36; 2); (KSP.L; €13.13; 2); (MSLH.L; £1.69; 1); (ROCKB.CO; Dkr1,090.00; 2); (SGOB.PA; €41.89; 1); (SHIL.L; £1.98; 1); (TPK.L; £16.97; 1); (TTNr.AT; €24.10; 3); (VCTP.PA; €61.97; 2); (WBSV.VI; €13.03; 1); (WOS.L; £33.91; 1)

Construction – UK Housebuilding

Strong Earnings Growth & Cash Returns

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- **Investment Thesis** – Clearly, the sector has had a very strong run, and the rate of change in share prices is unlikely to be as strong as it has been over the last few years. But looking out on a 12-18 month view, and assuming that the macro backdrop remains favourable, we expect the sector to continue to deliver good growth in net assets, returns and capital returns. Balance sheets are generally strong, with minimal leverage and good cash-flow supporting capital returns.
- **Sector Themes** – At what point in the cycle we are at and how this cycle is managed by the companies is a key issue. Some Housebuilders have initiated multi-year cash return programmes to demonstrate their focus on capital discipline (to avoid investing in land at the top of the cycle) and better management of the cycle. Cash returns will continue to be a theme in the sector. Smaller names have chosen to drive volume to take markets share while the land market remains conducive. Government support (Help to Buy) is supporting volumes with fears that this may be taken away as recovery is fully established.
- **Strategy Themes** – the sector is well placed to deliver significant EPS growth as house price inflation returns, volumes get back to more normal levels and costs remain manageable. We expect more cash returns with the outlook for dividend distributions across the sector looking positive as cash-flow improves and balance sheets remain strong.
- **Valuation** – Sector resides on a 2014E and 2015E P/NAV multiple of 1.6x and 1.4 times (c.1.2 times excluding Persimmon and Berkeley) respectively. Sector average dividend yield is c.4% and 6% for this year and 2015E respectively.
- **Risks** – Key risks to our scenario are primarily that land prices start to rise to unsustainable levels (driven by more entrants or more leverage funding land purchases or unsustainably high house price inflation) and that interest rates increase to a level that de-rails rather than slows the housing market.
- **Stocks for the next 12 months** – We have 6 Buys and 1 Neutral in the sector. Persimmon and Taylor Wimpey offer attractive dividends yields, with Bellway and Bovis residing on unstretched book multiples for 2015e and attractive growth.

UK Housebuilders: Most Favoured and Least Favoured

	Ticker	Rating	Price (Jun. 7)	Target Price	Yield (%)	ETR (%)	2015E		
							P/E	P/BV	ROE
Most Favoured									
Bellway PLC	BWY.L	Buy/1	£15.00	£17.50	3.3%	19.9%	8.5x	1.2x	15.4%
<i>Relatively attractive valuation, good volume growth and margin progress supported by sound balance sheet</i>									
Taylor Wimpey PLC	TW.L	Buy/1	£1.12	£1.35	2.7%	23.3%	9.0x	1.4x	15.9%
<i>Well positioned to deliver good earnings improvement, net asset growth and capital returns</i>									
Least Favoured									
Berkeley Group Holdings PLC	BKGH.L	Neutral/2	£23.76	£25.60	7.6%	15.3%	11.6x	2.3x	22.9%
<i>Valuation looks to us relatively full</i>									

Source: Citi Research, Powered by dataCentral

The sector has had a strong run in 2013 and is now down 2% YTD. Berkeley, Redrow and Bellway have seen the most decline YTD

Sector resides on a P/NAV of 1.4x for 2015E (c1.2x ex Persimmon and Berkeley).

UK transactions show a steady increase but they still remain c.40% below peak levels.

Existing house prices increased by c.5% last year, driven by a strong recovery in London, South East, Wales & North West

Housing supply remains well below underlying demand.

Mortgage approvals are now c.45% below peak levels.

Asset turn remains below historical levels and improving return on capital remains a key focus for the sector.

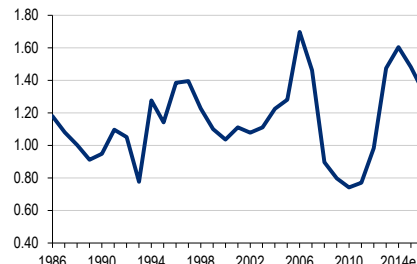
Berkeley and Persimmon generate the highest returns in the sector

¹²Figure 99. Sector Share Price Performance



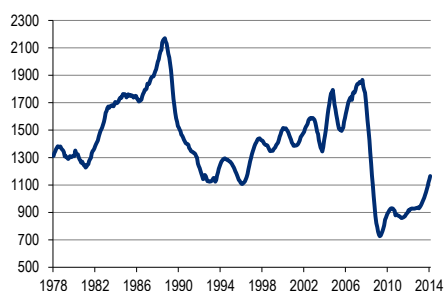
Source: DataStream

Figure 100. Sector P/NAV



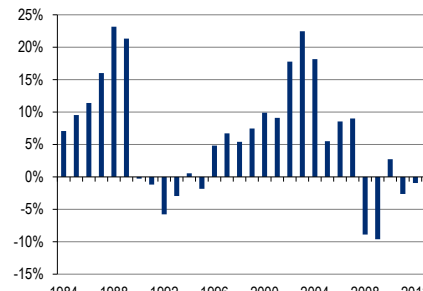
Source: Company data, Citi Research

Figure 101. UK Housing Transactions



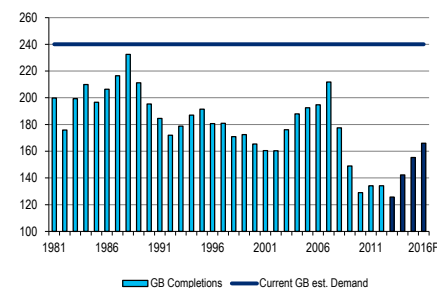
Source: DataStream

Figure 102. UK Annual House Price Inflation



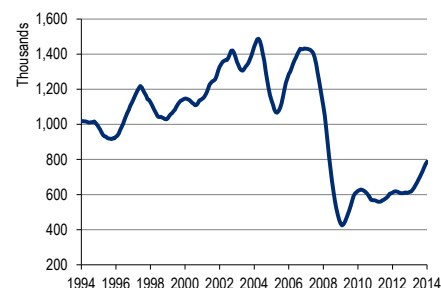
Source: Halifax

Figure 103. Housing Demand vs. Supply



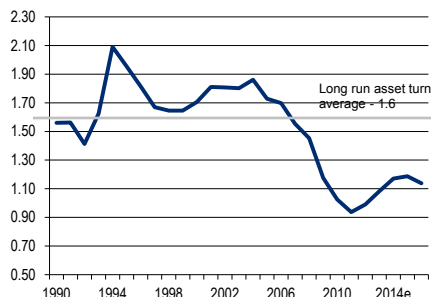
Source: NHBC, Government statistics, Citi Research

Figure 104. UK Mortgage Approvals



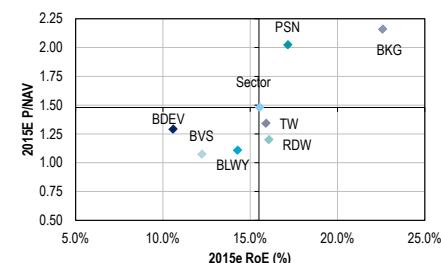
Source: Bank of England, DataStream

Figure 105. Sector Asset Turn



Source: Company data, Citi Research estimates

Figure 106. 2015E RoE vs. P/NAV



Source: Citi Research

¹² Stocks mentioned: (BDEV.L; £3.56; 1); (BKGH.L; £22.95; 2); (BVS.L; £7.54; 1); (BWY.L; £13.78; 1); (PSN.L; £13.33; 1); (RDW.L; £2.70; 1); (TW.L; £1.09; 1)

Financial Services

Flows and Returns

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- **Investment Thesis** – We continue to prefer asset managers to exchanges and inter-dealer brokers. Net inflows to European and UK equity funds support the AMs, increased equity market activity is helping parts of Exchange businesses, but revenue outlook remains subdued for IDBs.
- **Sector Themes** – 1) Regulation. 2014 is the year of implementation: Retail Distribution Review, Dodd Frank, MIFID II, EMIR, FTT. 2) Structural Change. We see an opportunity for the UK retail funds market from the proposed lifting of annuity purchase requirements in April 2015. 3) Profitability. Revenue margins continue to fall, driven by regulation, competition and business mix. Increased scale – of fund flows and transaction activity – offers the best solution.
- **Strategy Themes** – 1) Operating leverage. Rising market levels and activity should drive revenue growth. Relatively fixed cost bases make this sector well positioned to benefit from positive operating leverage. 2) Restructuring. Early responses to a difficult backdrop in recent years mean restructuring and cost savings plans are coming to an end. The sector must see fundamental top line growth now. 3) Capital return. Excess cash generation has been used first to reduce financing, second for M&A. We expect M&A to continue but also expect capital return to shareholders through higher dividends and buybacks.
- **Valuation** – At 12.5x 2015 PE, UK AMs look inexpensive relative to market. Mainstream Exchanges are pricier at 14.8x, but 11.1x for IDBs reflect their poor revenue and earnings outlook.
- **Risks** – 1) Weaker-than-expected equity market returns; this would have a negative impact on AUM through both performance and flows. 2) Risk aversion; subdued investor appetite for equity flows and trading activity could negatively impact earnings growth and sector re-rating prospects.
- **Stocks for the next 12 months** – Our favoured stocks are Jupiter and Schroders. Our least favoured stocks are Man Group and Hargreaves Lansdown.

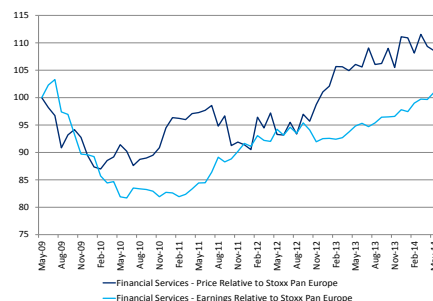
Financial Services: Most Favoured and Least Favoured

	Ticker	Rating	Price (Jun. 7)	Target Price	Yield (%)	ETR (%)	2015E		
							P/E	P/BV	ROE
Most Favoured									
Jupiter Fund Management	JUP.L	Buy/1	£4.16	£4.40	7.2%	13.0%	13.7x	3.6x	26.9%
Positively exposed to UK and European fund flows and markets, plus beneficiary of structural growth in UK retail funds due to lifting of the annuity purchase requirement for pensioners.									
Schroders PLC	SDR.L	Buy/1	£26.74	£28.80	2.5%	10.2%	14.2x	2.8x	19.2%
We expect rising markets and recovering European and UK Retail Equity fund flows to benefit SDR AUM progression. This, combined with only a small decline in management fee margins (mix bias towards retail) and positive operational leverage should drive earnings growth.									
Least Favoured									
Hargreaves Lansdown PLC	HRGV.L	Sell/3	£12.99	£10.00	2.5%	-20.5%	35.7x	25.0x	75.2%
Competitive pricing pressure threatens to dilute volume benefits of RDR: HL's historical 20%+ earnings growth is under threat, yet its PE multiple remains stubbornly high. Negative earnings momentum.									
Man Group PLC	EMG.L	Sell/3H	£1.02	£0.88	3.6%	-10.4%	14.8x	1.3x	8.5%
Dependence on GLG Alternatives and Long Only for fund flows means not only concentration risk but also falling revenue and profit margins. A 2016 recovery story priced as a 2014 one.									

Source: Citi Research, Powered by dataCentral

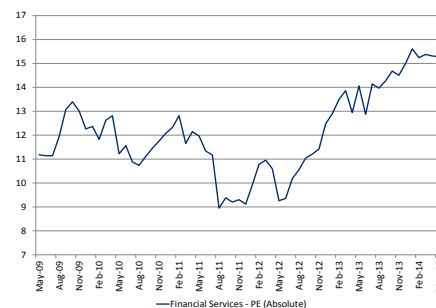
Sector PE re-rating moderate this year compared to last year

¹³Figure 107. Financial Svs — P & E Rel



Source: Citi Research, Datastream

Figure 108. Financial Svs — P/E Absolute



Source: Citi Research, Datastream

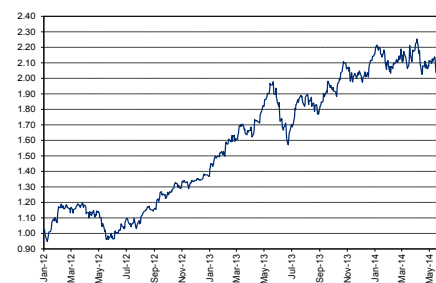
Sector YTD performance volatile and flattish overall

Figure 109. Exchanges / IDBs Performance



Source: Citi Research, Bloomberg

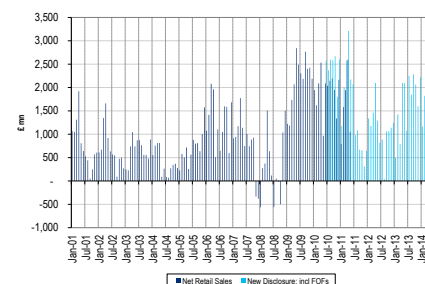
Figure 110. Asset Managers Performance



Source: Citi Research, Bloomberg

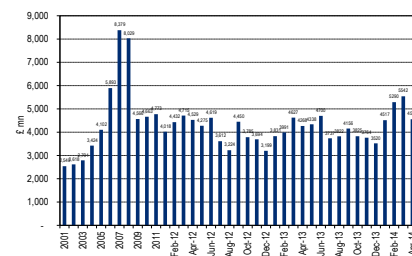
UK retail flow recovery on track

Figure 111. UK Mutual Fund Net Flows (£bn)



Source: Investment Management Association

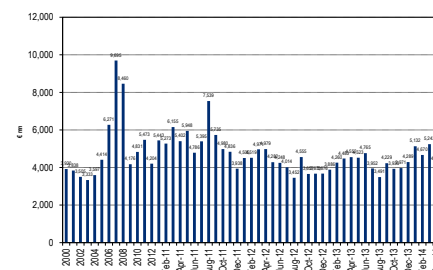
Figure 112. LSE Cash Equities ADV (£bn)



Source: Company data

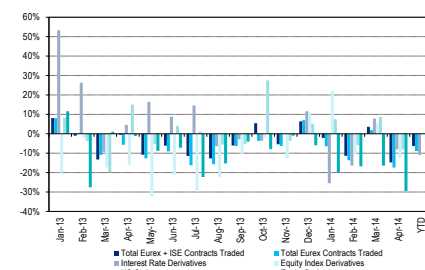
Strong cash equity volumes but derivative volumes remain weak

Figure 113. Xetra Cash Equities ADV (£bn)



Source: Company data

Figure 114. Eurex Derivatives YoY Growth (%)



Source: Company data

¹³ Stocks mentioned: (DB1Gn.DE; €55.46; 2); (EMGL; £0.94; 3H); (HRGV.L; £11.95; 3); (JUP.L; £3.96; 1); (LSE.L; £19.27; 2); (SDRL.L; £26.11; 1)

Food & HPC – Food (Manufacturing)

Expect Gradual Improvement

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- **Investment Thesis** —We expect food companies to deliver consistent mid-single-digit organic revenue growth and high-single-digit earnings growth over the long-term and we view the recent slowdown in Emerging Markets demand as a temporary phenomenon. Combined with progressive dividend policies, this should support a double-digit return, assuming current valuations hold.
- **Sector Themes** — Growth for the Food manufacturers has slowed recently, partly on the broad slowdown in Emerging Markets demand, but also as pricing has diminished as a contributor to organic sales growth, given the recently more benign raw material environment. The key debate for 2014 is the extent to which growth can recover in the second half as guided broadly by food companies and the extent to which Food companies' Developed Markets businesses can pick up to mitigate the growth gap left by slower EM businesses in the short term.
- **Strategy Themes** —We think the Food group doesn't lend itself particularly well to Strategy's Themes, although self help and corporate actions are probably the most relevant of the current themes in play. We see Nestlé's greater commitment to addressing its underperforming business as long overdue and its inorganic shift towards the "wellness" end of its Nutrition, Health and Wellness strategy is interesting, whilst Unilever continues, rightly, to transition its business towards HPC and EM and away from Food and DM.
- **Valuation** — The sector trades close to all-time high absolute valuations. However, relative to the broader market, most stocks are trading broadly in-line with their five-year historical average.
- **Risks** — A material further slowdown in EM growth rates is the key risk for the sector, in our view. Commodity volatility is likely to remain a theme; however, at present, raw material inflation doesn't look like being a significant risk in 2014.
- **Stocks for 2014** — Nestlé is our top large-cap pick. We expect top-line growth to accelerate accompanied by improving cashflow. We expect growth to accelerate in 2014 and further progress to be made in addressing underperforming business units. Despite the setback on Sucralose, Tate and Lyle is our top pick amongst the Foods mid-caps.

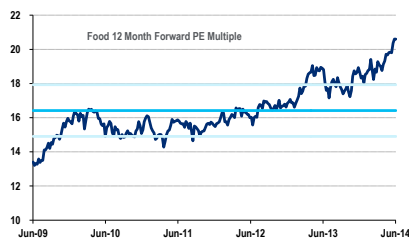
Food Manufacturing: Most Favoured and Least Favoured

	Ticker	Rating	Price (Jun. 7)	Target Price	Yield (%)	ETR (%)	2015E		
							P/E	P/BV	ROE
Most Favoured									
Nestle	NESN.VX	Buy/1	SFr68.95	SFr73.00	3.3%	9.1%	18.5x	3.3x	17.6%
<i>Accelerating growth, dominance in key EMs and restructuring.</i>									
Tate and Lyle	TATE.L	Buy/1	£6.82	£8.00	4.0%	21.4%	12.9x	2.5x	20.4%
<i>Exposure to mega-trend of calorie reduction across Food/Beverage industry</i>									
Least Favoured									
Associated British Foods PLC	ABF.L	Neutral/2	£30.27	£31.00	1.1%	3.6%	26.7x	3.4x	11.7%
<i>Primark's strong growth prospects look fairly valued</i>									

Source: Citi Research, Powered by dataCentral

Sector trading at a very high multiple vs historical average in absolute terms but relative valuation less demanding.

Figure 115. Food — 12m Fwd P/E Absolute



Source: Citi Research, DataStream

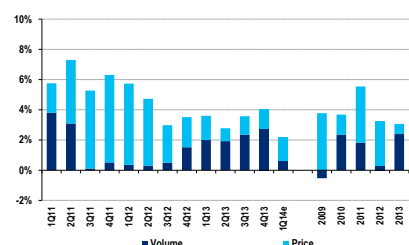
Figure 116. Food — 12m Fwd P/E Relative



Source: Citi Research, DataStream

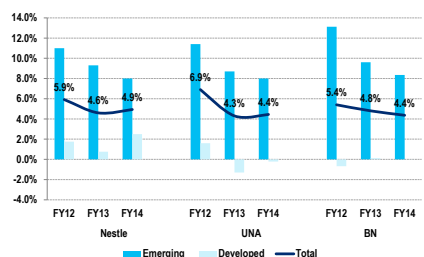
Defensive growth trades at a high P/E in absolute terms but not relative to the market.

Figure 117. Volume filling up for pricing



Source: Citi Research

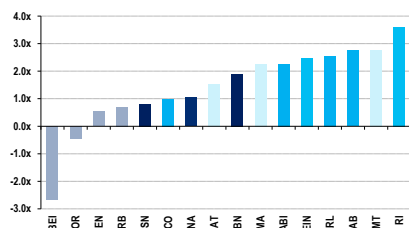
Figure 118. EM vs DM Organic growth



Source: Citi Research

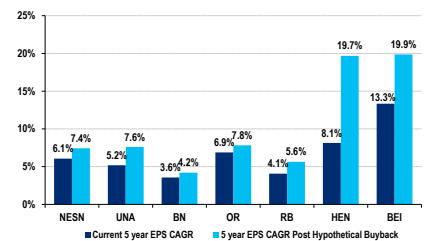
'Beverage Leverage' could lead to EPS growth in the low-teens, we estimate.

Figure 119. EU Staples' 2013 Net Debt/EBITDA



Source: Company reports and Citi Research

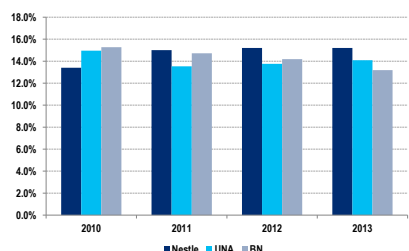
Figure 120. Increasing Leverage to 2x 2017E



Source: Citi Research

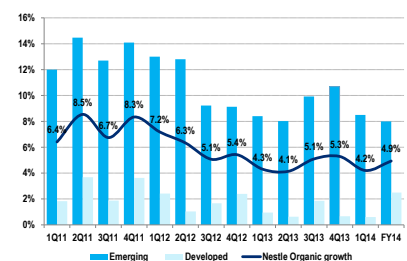
Nestlé's margin expansion has been more consistent and should remain so, in our view.

Figure 121. EU Food Historical Margin



Source: Company reports and Citi Research

Figure 122. Nestle: Moderation in EM growth requires DMs to pick up the slack



Source: Company reports and Citi Research

EM organic growth run rate still robust.

¹⁴ Stocks mentioned: (ABI.BR; €81.22; 1); (BAT.S.L; £35.59; 1); (BEIG.DE; €73.70; 1); (CARLb.CO; Dkr570.00; 2); (HEIN.AS; €51.27; 2); (HNKG.p.DE; €85.48; 2); (IMT.L; £26.70; 2); (NESN.VX; SF70.25; 1); (OREP.PA; €128.50; 2); (PERP.PA; €89.73; 2); (RB.L; £51.30; 1); (RCOP.PA; €68.75; 2); (SAB.L; £32.70; 2); (SWMA.ST; SKr229.30; 3); (UNc.AS; €32.04; 2); (DANO.PA; €54.94; 2)

Food & HPC – HPC

Expect Performance to Accelerate in 2H14

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- **Investment Thesis** — Although our investment recommendations are stock specific, rather than industry-thematic, we have a positive view on the European HPC group. We think that the combination of business reinvention, stronger execution and application of strong balance sheet optionality is likely to drive further good stock performance in 2014.
- **Key Debates/Sector Themes** — At a sector level, the key debates have been around whether the slowdown in Emerging Markets demand has troughed, how long the slowdown might last and whether Developed Markets can recover or accelerate to fill the EM growth gap. Beyond the macro backdrop, an ongoing debate has been whether the HPC companies will use their collective balance sheet strength (most are either net cash or close to it) to pursue M&A.
- **Strategy Themes** — We think Reckitt (with its active pursuit of transformational M&A in Consumer Health and the ongoing Strategic Review of RB Pharma) and, Beiersdorf (on its path of successful execution of the “Blue Agenda”), are likely to fit into our strategists’ restructuring theme. Balance sheet strength across the HPC group and acknowledgement from all managements that they are on the look-out for deals suggests (as well as action in the cases of Reckitt, L’Oréal and Henkel so far this year) that all of our companies fit the re-leveraging theme.
- **Valuation** — The sector trades at close to all-time high valuations, which reflects sustained strong execution in a secular growth market.
- **Risks** — Along with further risk of currency headwinds from some of the EM, the key risk to our forecasts is that demand slows further (particularly in EM) and HPC proves less resilient to that slowdown than has been the case so far. Beyond this operational risk, the primary risk to our coverage is either further rotation out of Staples / defensive growth as a whole or intra-sector rotation out of HPC, given its outperformance over the past couple of years.
- **Stocks for the next 12 months** — Reckitt Benckiser and Beiersdorf remain our top picks in 2014, with both investment cases being driven by their respective turnaround stories. Our Buy case on Reckitt is based on i) its transformation into a Consumer Health led HPC company and ii) fuller realization of the value of RB Pharma. Our Buy case on Beiersdorf is based on further execution on the turnaround plan. We are Neutral on L’Oréal and Henkel.

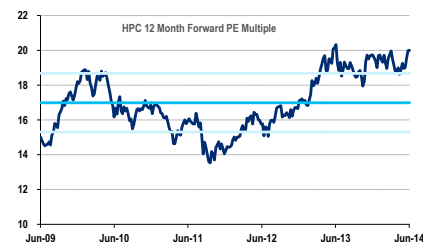
HPC: Most Favoured and Least Favoured

	Ticker	Rating	Price	Target	Yield	ETR	2015E		
			(Jun. 5)	Price	(%)	(%)	P/E	P/BV	ROE
Most Favoured									
Reckitt Benckiser	RB.L	Buy/1	£51.09	£57.00	2.6%	14.1%	18.5x	4.9x	28.9%
Transformation into a Consumer Health led HPC company and fuller realization of the value in RBP									
Beiersdorf	BEIG.DE	Buy/1	€73.85	€83.00	1.1%	13.5%	24.9x	3.8x	16.2%
Further execution on the turnaround plan									
Least Favoured									
L'Oréal	OREP.PA	Neutral/2	€127.55	€125.00	2.2%	0.2%	21.4x	2.7x	12.7%
We think its attractions are well recognised in current consensus expectations and view the stock as fully valued									

Source: Citi Research, Powered by dataCentral

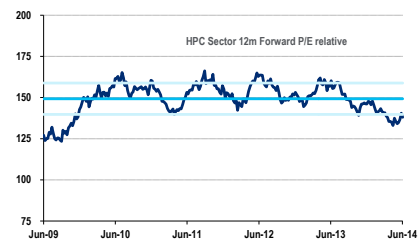
P/E looks rich in absolute terms, but valuation relative to the market is much more reasonable.

Figure 123. HPC — 12m Fwd P/E Absolute



Source: DataStream

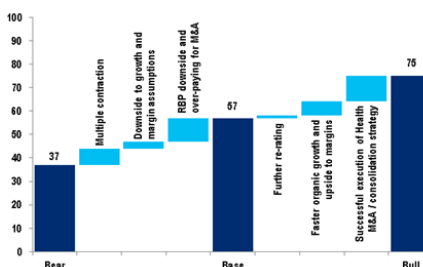
Figure 124. HPC — 12m Fwd P/E Relative



Source: DataStream

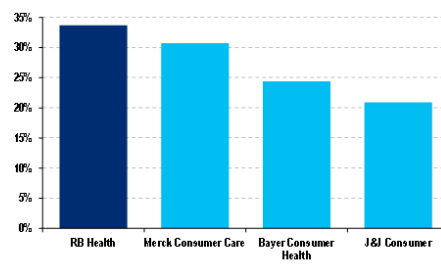
There are lot of moving parts at Reckitt, including the ongoing Strategic Review of RB Pharma (RBP) and the active pursuit of transformational acquisitions in Consumer Health. We see the ongoing transformation delivering margin-accretive revenue upside relative to consensus expectations.

Figure 125. Bear-to-Bull Valuation Bridge



Source: Company Reports and Citi Research

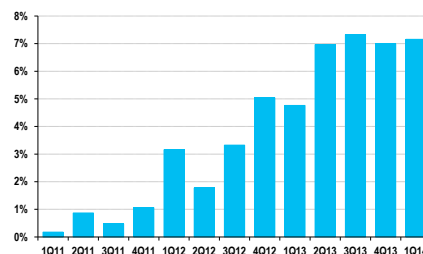
Figure 126. 2010-13 Organic Sales Growth CAGR vs Top 5 Global Consumer Health Peers



Source: Company Reports and Citi Research

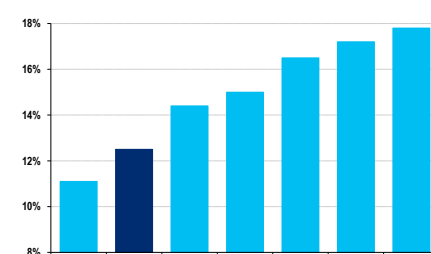
Beiersdorf is still early in its turnaround under a very dynamic and (relatively) new CEO. The initial focus is clearly on growth, but over time there is also a significant margin opportunity to drive substantial and sustained earnings growth.

Figure 127. Beiersdorf's Organic Sales Growth is Clearly Accelerating...



Source: Company Reports and Citi Research

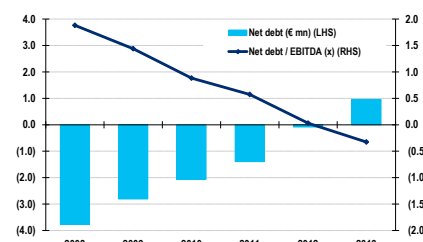
Figure 128. ... and the Company has a Low Operating Margin vs. Its Primary Peers



Source: Company Reports and Citi Research

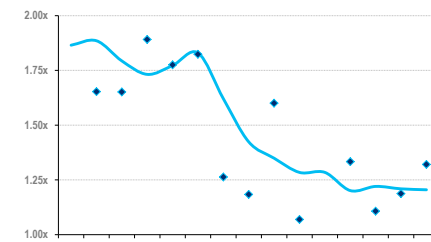
We see limited further upside in Henkel or L'Oréal, although both have the balance sheet capacity (even after Henkel's recent deals) to pursue more accretive acquisitions.

Figure 129. Henkel's Balance Sheet Looks Ready to Accommodate Further Deals



Source: Company Reports and Citi Research

Figure 130. L'Oréal's Outperformance of the Global Cosmetics Market Is Diminishing



Source: Company Reports and Citi Research

¹⁵ Stocks mentioned: (BEIG.DE; €73.86; 1); (EL.N; US\$76.75; 1); (HNGK_p.DE; €85.22; 2); (LVMH.PA; €145.00; 1); (OREP.PA; €127.20; 2); (PG.N; US\$80.36; 1); (RB.L; £51.15; 1); (UNc.AS; €31.92; 2)

Food & Beverages — Beverages

Short-Term Challenges Mitigated by Self-Help

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- **Investment Thesis** - Sector earnings downgrades could be close to bottoming out and sentiment is improving. However with limited EPS growth this year, uncertainty on the pace of EM recovery and demanding valuations, we struggle to see much upside on a 6-12 month view, unless EM growth accelerates more than we expect, as comps get easier. We continue to prefer beer to spirits in the current environment.
- **Sector Themes** - EM slowdown is the dominating theme in the sector, though there is evidence of a slight improvement in some markets. In addition, investors are waiting for evidence of a recovery in W Europe (but we don't think it will be material). The brewers face a benign input cost outlook for 2H14, which should mitigate some of the pressures. M&A is a relevant theme, particularly in beer.
- **Strategy Themes** — In our view, ABI screens well for “self-help”, as it offers double-digit EPS growth in 2014-15 on our estimates, with upside risk, we believe, from leveraging its premium portfolio internationally and using the balance sheet.
- **Valuation** — While absolute PEs remain high, the sector's valuation relative to the market has pulled back to 137, broadly in line with its 5-year average, which in our view seems justified in the context of slower EM growth.
- **Risks** — The main risks are related to EM macro and FX. The demand for Beverages in EMs is more discretionary than other staples, so more GDP-sensitive. As regards FX, beverages companies all have significant transactional exposure in EMs, in addition to translational risk.
- **Stocks for the next 12 months** - Our top pick in Beverages is ABI, as it is one of the very few staples offering (visible) double-digit EPS growth in FY14-15, on our estimates. Medium term, we see scope for earnings upside from ABI leveraging its premium portfolio internationally, particularly Corona (see our note [here](#)), and using its balance sheet either to do acquisitions (more likely) or to buy back shares. We are also positive on Britvic -- we forecast 14% EPS CAGR over FY13-16E, underpinned by cost savings. We see scope for material EPS upgrades from international expansion, primarily, but also from improving UK macro and further cost savings, as discussed in our note [here](#). On 15.7x CY15E, we believe Britvic's valuation is still attractive.

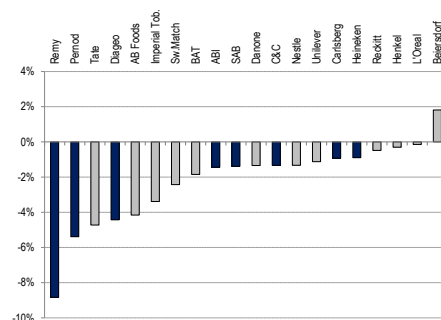
Beverages: Most Favoured and Least Favoured

			Price	Target	Yield	ETR	2015E		
	Ticker	Rating	(Jun. 7)	Price	(%)	(%)	P/E	P/BV	ROE
Most Favoured									
AB-InBev	ABI.BR	Buy/1	€81.06	€89.00	3.0%	12.8%	18.9x	3.1x	17.3%
Plenty of self-help in the current environment; use of cash optionality medium term.									
Britvic	BVIC.L	Buy/1	£7.66	£8.50	2.7%	13.7%	16.4x	15.2x	95.7%
14% EPS growth over '13-16E underpinned by cost savings, international expansion and improving macro to provide further boost									

Source: Citi Research, Powered by DataCentral

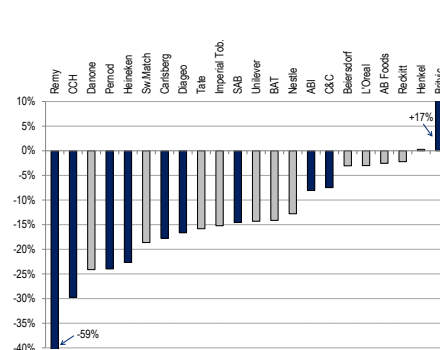
Figure 131 and Figure 132 show the downgrades we have put through in the past 18 months on org sales growth and EPS forecasts for beverages and other staples. The sales slowdown has been particularly sharp for spirits, because EM demand is more discretionary.

¹⁶Figure 131. Chg to CY14 Org Sales Growth Ests



Source: Citi Research Estimates

Figure 132. Chg to CY14 EPS Ests



Source: Citi Research Estimates

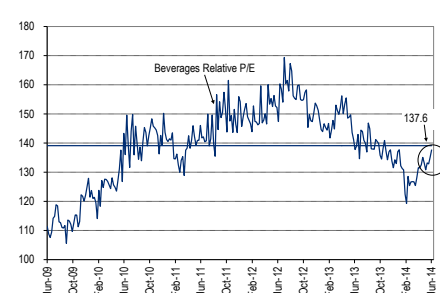
EM currencies and weak demand could drive further EPS downgrades, but the downside is limited, in our view, as some of the companies have plenty of scope for self-help and there are other mitigating factors, like lower barley costs for the brewers. All else equal, we expect barley to represent a margin benefit of 20-70bps for the brewers. Beverages valuations reflect some of the ST challenges. The sector's PER has moved closer to its 5-yr average, as Figure 134 shows.

Figure 133. Barley Tailwind for the Brewers

	Estimated 2014 Barley Cost vs 2013	Benefit to 2014 Group EBIT Margin
ABI	-2%	+20bps
SAB	-4%	+40bps
Heineken	-10%	+60bps
Carlsberg	-10%	+70bps

Source: Citi Research Estimates

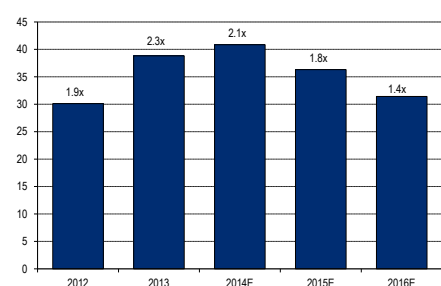
Figure 134. Beverages P/E Rel to Euro Stoxx



Source: DataStream, Citi Research

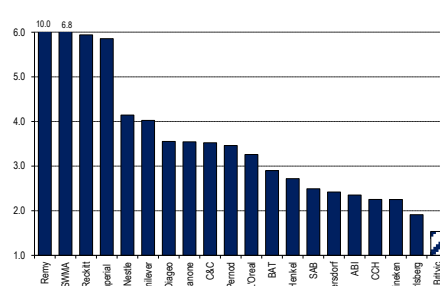
The most attractive aspect of the ABI investment case in the medium term is the cash optionality, in our view. Over FY14-15E, ABI is likely to generate around \$22bn of excess cash, which it could return to shareholders or use for M&A. Either way, we think it will be good for earnings and for the share price. Figure 136 shows Britvic is the cheapest European staples stock on PEG.

Figure 135. ABI – Net Debt / EBITDA, FY12-16E



Source: Company Reports, Citi Research Estimates

Figure 136. Consumer Staples – PEG Ratios*



Source: Citi Research. * '13PE/EPs CAGR 13-16

¹⁶ Stocks mentioned: (ABF.L; £30.17; 2); (ABI.BR; €80.59; 1); (BATS.L; £35.70; 1); (BEIG.DE; €73.73; 1); (BVIC.L; £7.48; 1); (CARLB.CO; Dkr570.00; 2); (CCH.L; £13.80; 2); (DANO.PA; €54.49; 2); (DGE.L; £19.17; 1); (GCC.I; €4.59; 2); (HEIN.AS; €51.60; 2); (HNKG_p.DE; €85.27; 2); (IMT.L; £26.61; 2); (NESN.VX; SF70.35; 1); (OREP.PA; €127.85; 2); (PERP.PA; €89.46; 2); (RB.L; £51.15; 1); (RCOP.PA; €67.66; 2); (SAB.L; £32.94; 2); (SWMA.ST; SKr230.80; 3); (TATE.L; £6.90; 1); (UNc.AS; €31.95; 2)

Health Care - Pharmaceuticals

Positive Thesis Underpinned By Improving R&D Returns And M&A

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- **Investment Thesis** – Remains positive. Strong re-rating over the past 3yrs has been driven by improving R&D returns for the overall industry (*Shrink, Smarten, Spin*) and a more benign regulatory / payor environment, esp in US (*I Pay, You Pay*). Corporate restructuring and portfolio management is again in focus given the recent move towards rationalization of non-core assets. Ongoing sector consolidation will continue, although mega-mergers seen in the last decade appear unlikely (with the notable exception of AZN and PFE).
- **Sector Themes** – (i) improving regulatory environment, esp FDA's willingness to expedite time to market of truly innovative drugs; (ii) reimbursement environment in US, especially in light of the Affordable Care Act; (iii) industry opportunity from immunotherapy and ability to transform management of majority of cancers in the developed world in the near future. (iv) green shoots in the European pricing environment (v) Restructuring, particularly divestment of non-core/sub-critical divisions; (vi) Biotech valuations in the US.
- **Strategy Themes** – (i) Earnings Leadership: the sector should return to strong underlying growth starting 2015e post significant patent expiries (Citi est 4% rev growth in 2014/15, 9%/8% EPS growth); (ii) Operating Leverage: Positive driven by new products and cost rationalization (BAYG, NOVOB, ROG); (iii) Restructuring: positively exposed given recent moves within the sector towards portfolio rationalization and narrowing of focus. Options remain with portfolio management of non-core divisions and established tail products; (iv) Capital Return: historically has received high priority. Potential remains for increased buybacks given recent non-core divestitures; (v) Corporate Actions: AZN & SHP given ongoing M&A reports.
- **Valuation** – EU pharma trades at 14.2x 2014e multiple for a 2014-19 sales and EPS CAGR of 4.6% and 9.5%. Comparable multiple is 16.2x for US pharma for a comparable 9.7% 5-year EPS CAGR.
- **Risks** – Regulatory environment, market access and reimbursement pressures for novel drugs are the key challenges for the industry over the near to medium term. Given high emerging market exposure, relative weakness in EMs could materially impact growth prospects for the sector.
- **Stocks for the next 12 months** – Our top picks for 2014 are Roche, AZN, Novo and Bayer amongst the large caps and Shire and Hikma among the mid-caps. Roche, AZN and NovoB are on the Citi EU Focus List, HIK on the Citi CEEMEA Focus List. Roche and AZN are our preferred names in EU pharma, along with BMJ, to play the developing immunotherapy theme.

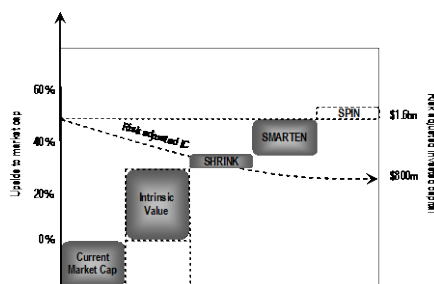
EU Pharmaceuticals: Most Favoured and Least Favoured

	Ticker	Rating	Price	Target	Yield	ETR	2015E		
			(Jun. 7)	Price	(%)	(%)	P/E	P/BV	ROE
Most Favoured									
Roche Holding AG	ROG.VX	Buy/1	SFr267.20	SFr300.00	3.2%	15.5%	15.8x	7.6x	50.0%
Significant op leverage from new products; communication improving around immunotherapy pipeline, potential remains underappreciated.									
AstraZeneca PLC	AZN.L	Buy/1	£43.28	£49.00	4.2%	17.4%	16.8x	3.7x	17.2%
Deeply under-appreciated pipeline, especially in immunotherapy. Substantial upside even in the absence of resumption of bid speculation (PFE)									
Novo Nordisk	NOVOb.CO	Buy/1	Dkr244.30	Dkr280.00	2.0%	16.6%	21.5	15.2	70.8
Sustainable revenue growth/margin expansion story under-appreciated. Significant pipeline catalysts next 12ms. Blue sky scenario (15% EBIT growth)									
Bayer AG	BAYGn.DE	Buy/1	€105.20	€110.00	2.0%	6.6%	14.3x	3.5x	18.9%
Op leverage from new products, continuing strength in crop science, return to profitability in MatScience. Portfolio restructuring upside.									
Least Favoured									
Merck KGaA	MRCG.DE	Neutral/2	€126.05	€122.00	1.5%	-1.7%	13.8x	2.2x	10.8%
Significant headwinds to base business esp key MS product Rebif and lack of near term catalysts. Senior management churn also headwind.									

Source: Citi Research, Powered by dataCentral

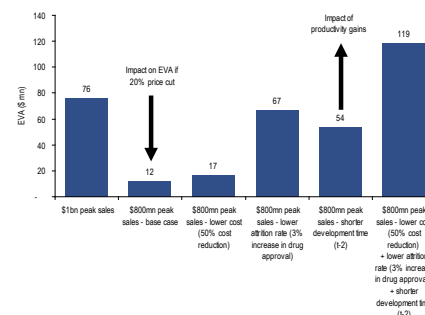
R&D expenditure is not scalable. We estimate the industry still has substantial excess capacity. We advocate a “Shrink, Smarten, Spin” strategy which will reduce the risk-adjusted invested capital of the industry and drive upside to current valuation levels. Our risk-adjusted EVA model shows that reducing the “cost of R&D failure” can more than offset reimbursement pressures and transform R&D returns

Figure 137. “Shrink, Smarten, Spin”



Source: Citi Research

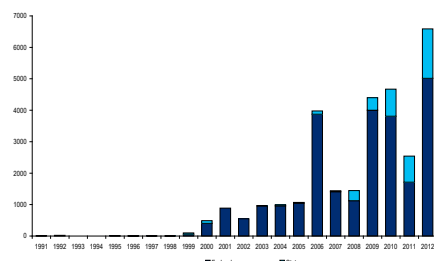
Figure 138. Material increases in R&D productivity are required to offset reimbursement pressure.



Source: Citi Research

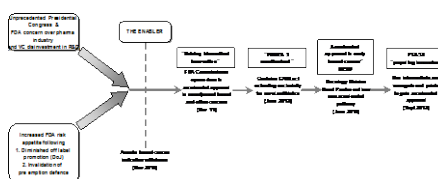
Greater enforcement activity by the DoJ, legislative enforcement of new expedited approval pathways and the ability of the FDA to remove indications from drugs approved under the Accelerated Approval pathway which then fail to deliver the expected clinical benefits e.g. Roche’s Avastin in breast have all been key enablers of an improved risk appetite at the FDA. The recent White House PCAST report calls on the FDA to take more risk and outlines a set of practical initiatives over the next 1-5 years with the stated goal of doubling the output of innovative new drugs by the FDA.

Figure 139. The fines and settlements levied by the Department of Justice have increased from \$500m in 2000 to \$6bn in 1H12



Source: Citi Research

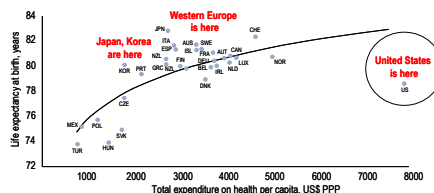
Figure 140. The PCAST recommendations will help to transform industry R&D productivity



Source: Citi Research

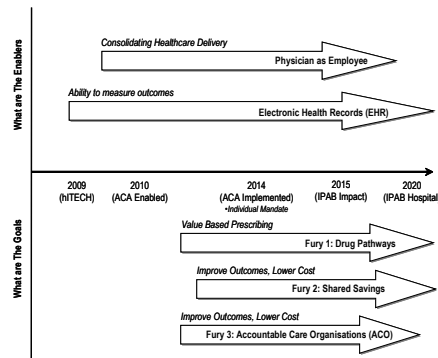
The “Three Furies” of shared savings models, drug pathways and ACOs are the long-term structural risks to the US pharmaceutical market. However, we believe any negative impact on pricing and utilization of high-cost physician administered specialist drugs will be slow given (i) the modest contribution of pharmaceuticals to total healthcare/Medicare spend (10% of total, 18% of Medicare), (ii) only gradual adoption of meaningful electronic health records (EHRs), and (iii) the fragmentation and complexity of the US payer/provider market.

Figure 141. US healthcare spend is clearly unsustainable given macro-economic pressures



Source: Citi Research

Figure 142. Radical changes to US Healthcare Delivery only Likely to Impact Pharma EPS Post ‘17



Source: Citi Research

17 Stocks mentioned: (AZN.L; £43.65; 1); (BAYGn.DE; €105.75; 1); (NOVOB.CO; Dkr233.50; 1); (ROG.VX; Sfr269.00; 1); (SHP.L; £34.84; 1); (HIK.L; £16.90; 1) (PFE.N; US\$29.59; 1) (MRCG.DE; €126.60; 2)

Industrial G&S —Aerospace & Defence

Remain Positive on Civil Aero

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- **Investment Thesis** – Civil stocks have underperformed the broader market YTD on worries over order cancellations, timing of cash flow recovery & weakness in USD. Civil cycle fundamentals remain attractive with robust air traffic growth & disciplined airline capacity expansion. Our outlook for c5% CAGR in large aircraft deliveries remains underpinned by improving GDP growth outlook, penetration of air travel in EM & significant aircraft replacement demand in developed markets.
- **Sector Themes** – A key theme in A&D has been M&A, with a number of companies (e.g. RR, QinetiQ) announcing significant acquisitions & disposals this year. With a number of A&D companies listing inorganic growth as a strategic priority, M&A activity is likely to remain elevated this year. Another theme has been product refresh with Airbus poised to decide whether to re-engine its A330 platform (and perhaps also the A380). Continued need for product refresh could cause civil R&D to continue increasing.
- **Strategy Themes** – Airbus & Safran fit into our strategists' themes of operating leverage & self-help. Both offer significant EBIT growth prospects driven by increasing production & margin improvement through better execution. BAE & Airbus fit into the capital returns theme given their large ongoing buybacks.
- **Valuation** – The European Civil Aero sector is c15-20% above mid cycle levels, which could come under pressure if earnings growth proves to be slower/weaker than expected. Defence sector is trading close to mid cycle levels, consistent with a flattish earnings outlook.
- **Risks** – Delays and/or cost overruns on aircraft & engine development programmes, continued softness in civil aero aftermarket, sharp increase in order cancellations/deferrals, significant weakening of USD, continued high levels of R&D outlays & slower/weaker than expected recovery in cash flows.
- **Stocks for the next 12 months** – We like Airbus & Safran due to their civil OE cycle exposure, large backlogs & potential for margin improvement. We like Thales due to restructuring led margin upside & attractive valuation.

Aerospace & Defence: Most Favoured and Least Favoured

	Ticker	Rating	Price (Jun. 7)	Target Price	Yield (%)	ETR (%)	2015E		
							P/E	P/BV	ROE
Most Favoured									
Airbus Group NV	AIR.PA	Buy/1	€53.69	€60.00	2.3%	14.0%	15.3x	2.9x	20.0%
<i>Earnings growth led by margin upside at Airbus Commercial, strong visibility underpinned by large backlog, attractive looking valuation</i>									
Safran	SAF.PA	Buy/1	€51.26	€54.00	2.3%	7.7%	15.3x	2.6x	17.9%
<i>CFM56 franchise, margin upside in Propulsion (rising volumes, aftermarket recovery) and Equipment (restructuring)</i>									
Thales	TCFP.PA	Buy/1	€46.99	€52.00	2.6%	13.3%	12.7x	2.0x	15.2%
<i>Cost savings to bring margin at par with peers, potential to stimulate organic growth (through EM focus), attractive valuation</i>									
Least Favoured									
BAE Systems	BAES.L	Neutral/2	£4.27	£4.25	4.7%	4.2%	10.2x	3.8x	34.2%
<i>Challenging sales growth outlook due to defence budget constraints in US and Europe</i>									
Rolls Royce	RR.L	Neutral/2	£10.76	£10.50	2.0%	-0.4%	15.0x	2.7x	19.7%
<i>Difficulty in assessing margin upside potential, complex accounting, M&A risks</i>									
Meggitt Plc	MGIT.L	Neutral/2	£5.22	£5.00	2.7%	-1.5%	13.1x	1.8x	11.2%
<i>Aftermarket recovery and strong growth prospects in Energy offset by limited margin upside and considerable defence exposure</i>									
MTU Aero Engines	MTXGn.DE	Neutral/2	€69.54	€65.00	1.9%	-4.6%	14.9x	2.4x	14.6%
<i>Strong programme exposure offset by a relatively anemic aftermarket recovery; depressed cash conversion; premium valuation, on our numbers</i>									

Source: Citi Research, Powered by dataCentral

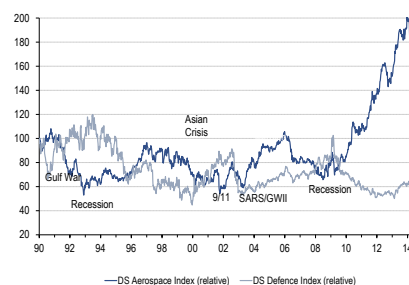
Civil sector has underperformed Defence YTD led mainly by weakness in RR share price following their weaker than expected 2013 results/2014 outlook. However, air traffic and airline capacity continue to show robust growth, underpinning our positive outlook on civil cycle fundamentals.

Historically, traffic growth has been 1.5-2x of GDP growth. Based on Citi economists' GDP growth expectations, 5-7% pa traffic growth over the medium term looks achievable. EM growth and replacement demand in developed markets should drive further orders and underpin deliverability of the current backlog. Book to bill may fall in 2014 due to tough comps although it seems unlikely to fall materially below 1x.

We expect large aircraft deliveries to increase by +5% CAGR 2013-16E driven by ramp up in new aircraft and higher production of existing aircraft. Our positive outlook on aircraft deliveries remains underpinned by a record aircraft backlog.

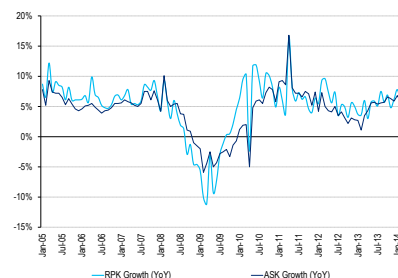
We forecast US defence base budget to be flat this year and next followed by modest 1-2% pa growth expected thereafter. Our forecasts are consistent with the scale of spending declines seen in previous US defence budget cycles. Defence sector trades on mid cycle P/E, which is consistent with flattish outlook for defence budgets, in our view.

Figure 143. Aerospace vs. Defence Sector Perf



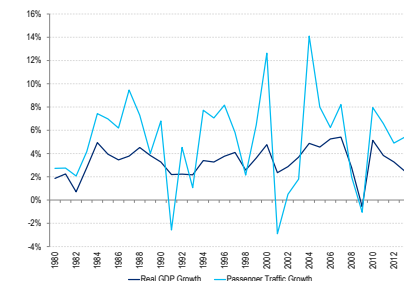
Source: Datastream

Figure 144. Air Traffic And Capacity Growth



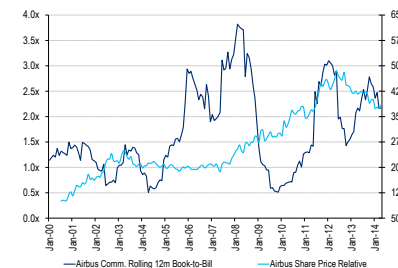
Source: IATA

Figure 145. LT Passenger Traffic Growth



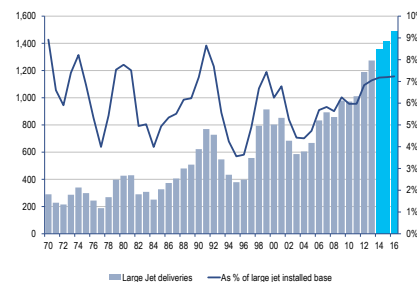
Source: ICAO, IMF

Figure 146. EADS Orders vs. Price Relative



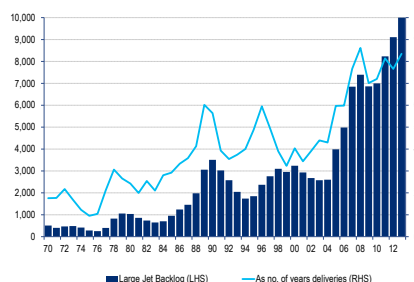
Source: Airbus & Datastream

Figure 147. Large Jet Deliveries: 1970-2016E



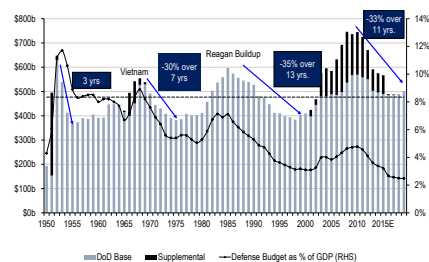
Source: Airbus, Boeing, Citi Research

Figure 148. Large Jet Backlog: 1970-2013



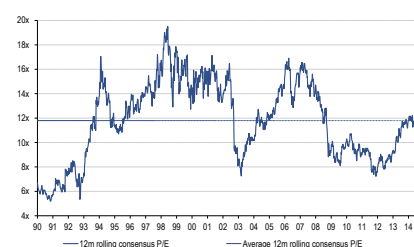
Source: Ascend, Citi Research

Figure 149. US DoD Budgets: FY1950-2019E



Source: US DoD, Citi Research

Figure 150. Defence Sub-Sector P/E rating



Source: Datastream

¹⁸ **Stocks mentioned:** Airbus Group NV (AIR.PA; €52.59; 1); BAE Systems (BAES.L; £4.25; 2); Meggitt Plc (MGIT.L; £4.94; 2); MTU Aero Engines (MTXGn.DE; €67.41; 2); Rolls Royce (RR.L; £10.56; 2); Safran (SAF.PA; €49.61; 1); Thales (TCFP.PA; €45.27; 1); Boeing Co. (BA.N; US\$136.39; 1); QinetiQ (QQ.L; £2.10; Not Rated)

Industrial G&S - Capital Goods

Attractions Remain

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- **Investment Thesis** – The sector appears fully valued, both in absolute terms and relative, against a slowing Chinese economy (FAI,IP). However, there do remain some opportunities from :1) Trading in Europe appears to have found a bottom (capex is 15% below the 2008 peak); 2) consensus EPS growth expectations now look more sensible and 3) we are seeing increased use of balance sheets supporting earnings and share prices.
- **Sector Themes** – Sector remains highly macro driven. Key themes: 1) European recovery; 2) China rebalancing (new structural growth: automation, food & beverage and Health Care); 3) China competition risk 4) US investment driven by lower energy costs benefiting the likes of IMI; 5) use of strong balance sheet (recent step-up in M&A, buy-backs); and 6) restructuring, as companies look to drive their own EPS organically.
- **Strategy Themes** – Capital Goods is a global sector and nearly all the companies have a degree of “global champion”. The likes of Atlas Copco and Schneider Electric sit near the top of this pile. The sector also on average has c.40% exposure to Europe and as such remains leveraged to any potential recovery. In addition, we also see scope for upside from self-help stories with the likes of Philips, Volvo, Sandvik and GEA.
- **Valuation** – The sector remains at the upper end of historical ranges in absolute terms on both a P/E (16.5x14E) and EV/EBIT (12.6x4E) basis. However, this in part reflects the market’s re-rating as the P/E relative is more mid-range, and has been on a downward trend since around the start of 2011.
- **Risks** – The main risk is slower growth and its impact on EPS momentum. Linked to this, concerns remain around the current peak nature of sector margins. On a company basis, concerns remain on the delivery of restructuring actions at the likes of Philips, Volvo, Electrolux and Sandvik.
- **Stocks for the next 12 months** – Our top picks are for self-help, secular growth, European recovery or improving quality. Top Picks: Philips, Volvo, Atlas Copco, GEA and IMI.

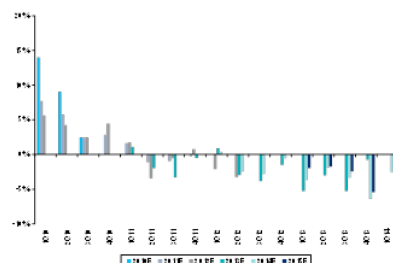
Capital Goods: Most Favoured and Least Favoured

	Ticker	Rating	Price	Target	Yield	ETR	2015E		
			(Jun. 7)	Price	(%)	(%)	P/E	P/BV	ROE
Most Favoured									
Philips	PHG.AS	Buy/1	€23.66	€30.00	3.4%	30.2%	12.2x	1.7x	11.4%
Benefits from restructuring, healthcare and construction recovery									
Atlas Copco	ATCOa.ST	Buy/1	SKr192.80	SKr233.00	3.0%	23.8%	15.8x	4.4x	30.1%
Best positioned in mining, attractive DM exposure, balance optionality									
Volvo AB	VOLVb.ST	Buy/1	SKr93.70	SKr120.00	3.2%	31.3%	10.1x	2.1x	22.0%
Attractive end-markets, credible self-help, structurally changing									
GEA Group	G1AG.DE	Buy/1	€32.93	€37.00	2.0%	14.3%	13.4x	2.1x	15.9%
food capex, EPS accretion through bolt-ons									
IMI	IMI.L	Buy/1	£16.00	£17.35	2.3%	10.8%	17.4x	5.5x	30.8%
self-help, DM short-cycle and construction recovery									
Least Favoured									
Kone	KNEBV.HE	Sell/3	€30.26	€25.00	3.1%	-14.3%	18.4x	5.9x	35.3%
China property slowdown, stretched valuations									

Source: Citi Research, Powered by dataCentral

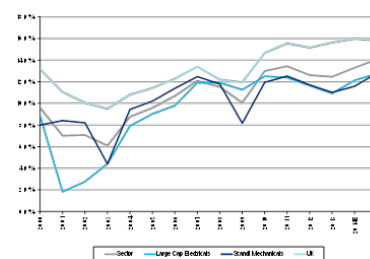
Sector EPS momentum turned negative in 2Q11 and the trend has continued since. With margins back near peak levels the debate has been that there could be continued downside.

Figure 151. Consensus Net Upgrades/Downgrades



Source: DataStream, Citi Research

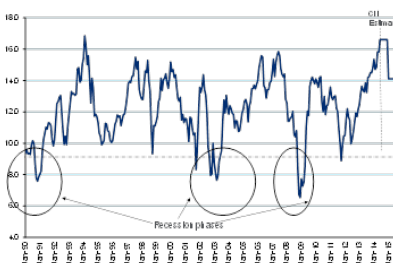
Figure 152. Sector Operating Margins



Source: DataStream, Citi Research

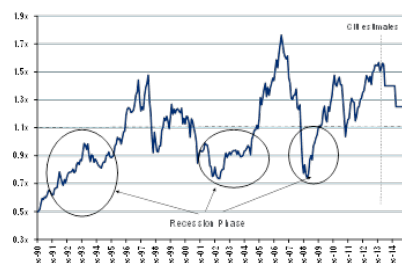
Sector P/E and EV/Sales are now towards the high end of their historical ranges. However, this in part reflects the market's re-rating as the P/E relative is more mid-range, and has been on a downward trend since around the start of 2011.

Figure 153. Sector P/E Absolute, 1990-2014E



Source: DataStream, Citi Research

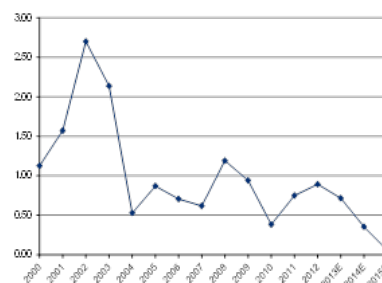
Figure 154. Sector EV/Sales, 1990-2015E



Source: DataStream, Citi Research

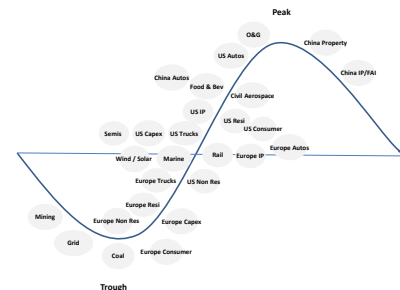
Net Debt has fallen significantly in the last 2 years. Balance sheets in the sector remain robust and we've seen increasing acquisition and buy-back activity throughout 2014 so far. From an end market perspective, we like DM construction, DM trucks and grid investments.

Figure 155. Sector Net Debt/EBITDA



Source: DataStream, Citi Research

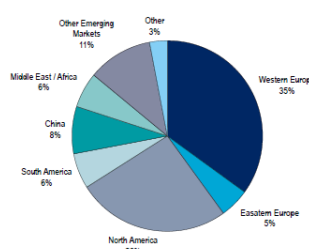
Figure 156. Where Are We in the Cycle?



Source: DataStream, Citi Research

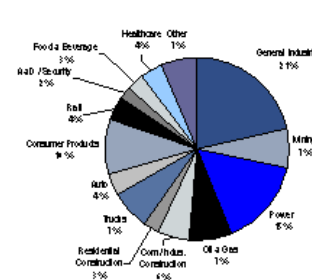
Capital Goods is a diverse sector with wide geographic and end market exposures.

Figure 157. Geographical Sales Split, 2014E



Source: Citi Research

Figure 158. End Market Split, 2014E



Source: Citi Research

¹⁹ Stocks mentioned: (ATCoA.ST; SKr196.30; 1); (ELUXb.ST; SKr170.40; 1); (G1AG.DE; €31.29; 1); (IMIL.L; £15.39; 1); (PHG.AS; €23.34; 1); (VOLVb.ST; SKr97.65; 1) (SCHN.PA; €66.50; 2); (KNEBV.HE; €30.99; 3)

Industrial G&S – Business Services

Buying into de-rated quality franchises

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- **Investment thesis** – We recommend investors buy the sector's strong franchise stocks that have suffered YTD underperformance with the market's pursuit of Beta-plays.
- **Sector Themes** – We are Overweight high growth and ROCE TIC sub-sector and Buyers of all three players - Intertek, SGS and Bureau Veritas. We continue to back Temporary power despite the soft patch as it offers rare powerful structural growth. We are also Buyers of Amadeus and Experian. Valuations for the sector's lower growth cyclicals, including generalist staffers, leave them potentially vulnerable to any lead indicator deceleration. We are also generally underweight lower growth, mature companies where margin pressure is endemic (eg Securitas, Rentokil).
- **Strategy Themes** – We expect our overweight higher quality franchises to see operational leverage with sales growth. They should also be able to drive earnings upgrades from deploying cashflow at above WACC ROCE, either through bolt-on acquisitions or share buybacks.
- **Valuation** – The sector 12m forward PE has moved up from 16x in November to current 18x. This is towards the top of its decade average range.
- **Risks** – Faster than expected Eurozone macro recovery could lead cyclicals to outperform.
- **Stocks for 2014** – Buys: Aggreko, Amadeus, SGS, Intertek and Experian. Sells: Securitas, Electrocomponents, Randstad, Regus and Rentokil.

Business Services: Most Favoured and Least Favoured

	Ticker	Rating	Price (Jun. 7)	Target Price	Yield (%)	ETR (%)	2015E		
							P/E	P/BV	ROE
Most Favoured									
Aggreko PLC	AGGK.L	Buy/1	£16.87	£20.00	1.7%	20.3%	18.6x	3.5x	20.3%
We continue to recommend buying Aggreko shares for exposure to emerging markets power supply / demand imbalances.									
Amadeus	AMA.MC	Buy/1	€31.73	€35.00	2.5%	12.8%	18.8x	5.4x	28.0%
Amadeus is one of the most profitable companies in Biz Services with a post-tax ROCE of 30% and one of our Cash Flow Kings.									
SGS	SGSN.VX	Buy/1	SFr2,223.00	SFr2,500.00	2.9%	15.4%	21.7x	6.5x	31.2%
SGS offers best in sector economics, its de-rating has removed valuation froth. We also expect organic and M&A momentum in 2014.									
Intertek	ITRK.L	Buy/1	£29.00	£39.40	1.3%	37.2%	18.5x	4.5x	24.8%
Intertek offers exposure to strong growth/ high ROCE TIC sector. The stock is trading at a 5-year high 12m fwd PE discount to SGS.									
Experian	EXP.N.L	Buy/1	£10.50	£14.10	2.4%	36.6%	18.0x	4.7x	24.9%
Experian is sector's top quality franchises with high returns, barriers to entry, strong cash generation and above average structural growth.									
Least Favoured									
Securitas	SECUB.ST	Sell/3	SKr77.50	SKr60.00	3.9%	-18.7%	11.8x	2.5x	20.0%
Securitas has 85% sales exposure to developed market statis guarding which grows around GDP but with endemic pricing pressure.									
Electrocomponents	ECM.L	Sell/3	£2.80	£2.15	3.9%	-19.4%	17.1x	2.8x	18.1%
Electros is a structurally challenged distributor, with a weak 3-4% over-the-cycle growth due to its bias towards developed market.									
Randstad	RAND.AS	Sell/3	€43.97	€35.00	2.5%	-17.9%	13.4x	2.1x	17.2%
Randstad is trading much ahead of our buying zone of 130% EV/Gross Profit level, discounting better than cycle average margins.									
Regus	RGU.L	Sell/3	£2.00	£1.25	1.3%	-36.0%	17.4x	2.8x	17.5%
Regus operates in low barriers to entry developed market, which is exposed to price discounting.									
Rentokil	RT0.L	Sell/3	£1.17	£0.93	0.2%	-20.1%	13.6x	-66.9x	na
Rentokil's high exposure to well outsourced and low growth market makes it unable to generate meaningful organic growth.									

Source: Citi Research, Powered by dataCentral

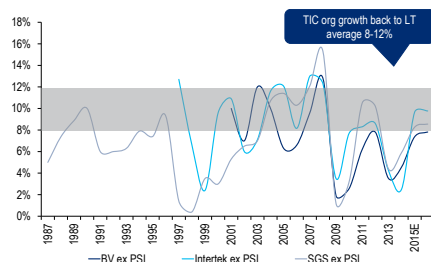
We are overweight TIC subsector and Buyers of Intertek, SGS and BV. We expect organic growth reacceleration, margin leverage and bolt-on acquisitions. In addition, we view Chinese domestic testing as an important potential opportunity.

We remain confident about temp power's mid-term opportunities, but appreciate that non-OECD GDP growth needs to inflect to fuel order intake re-acceleration. We are Buyers of both Aggreko and APR Energy.

We are Underweight the Staffing sub-sector. We think stocks are already discounting above average margins and a decent degree of sales bounce-back. We worry that earnings leverage could prove weaker than expected due to limited spare capacity.

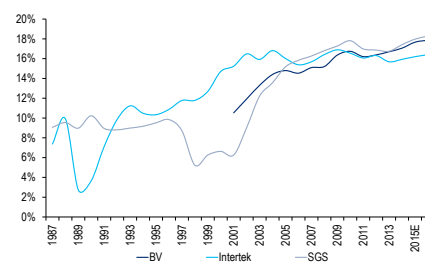
Experian remains one of the sector's top quality franchise stocks with high barriers to entry, high ROCE and cash conversion. We expect organic growth to return to typical +6% level in 2H 15 as US mortgage applications hit easier comps.

²⁰Figure 159. TIC Organic growth at LT average



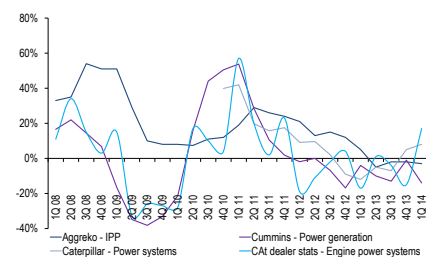
Source: Company reports, Citi Research

Figure 160. TIC margins to rise further



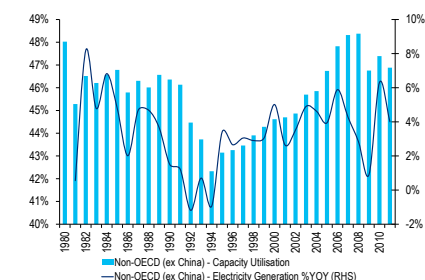
Source: Company reports, Citi Research

Figure 161. IPP growth correlation



Source: Company reports

Figure 162. Power generation vs grid utilisation



Source: DataStream

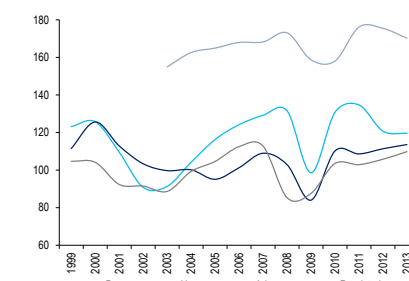
Figure 163. Staffing – Margin recovery priced in

	EV/Sales - 2014E	Margins: Cycle average	Margins: previous peak	Margins: Target
Adecco	57%	4%	5%	5.5%
Randstad	47%	4%	5%	5-6%
Michael Page	127%	12%	18%	-
Hays*	273%	27%	35%	26%

*We use net fees and conversion margin for Hays.

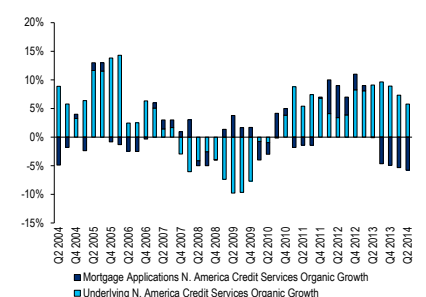
Source: Citi Research.

Figure 164. Staffing productivity comparison (€k)



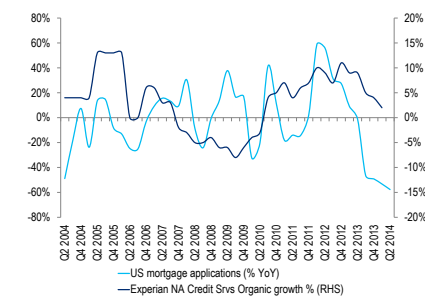
Source: Company reports, Citi Research

Figure 165. NA credit services mortgage drag



Source: Datastream, Citi Research; we assume 10% divisional sales exposure to mortgage applications.

Figure 166. NA consumer svcs mortgage drag



Source: DataStream, Company reports

²⁰ Stocks mentioned: (ADEN.VX; SF73.80; 3); (AGGL.L; £16.57; 1); (AMA.MC; €31.65; 1); (BVL.PA; €21.33; 1); (ECML.L; £2.83; 3); (EXPN.L; £10.31; 1); (HAYS.L; £1.55; 2); (ITRK.L; £28.89; 1); (MPL.L; £4.59; 2); (RAND.AS; €42.93; 3); (RGU.L; £1.93; 3); (RTO.L; £1.17; 3); (SECUB.ST; SK76.75; 3); (SGSN.VX; SF2,232.00; 1)

Insurance

Continued structural improvement

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- **Investment Thesis** – We continue to see a number of structural improvements in the insurance sector ([Four Forces report](#)), which we believe will over time lead to a reduction in COE and improvement in earnings. More recently the debate has shifted towards the impact of Euro QE, though we don't believe this derails our positive view ([QE report](#)).
- **Sector Themes** – We believe the sector is being driven Four Forces which are: i) improving capital positions that are going to benefit from greater clarity around Solvency 2, ii) improving monetization of life insurance products and improving remittances of cash to hold co's, iii) ongoing restructuring that is improving the focus of the sector, and iv) potential for a return to growth in developed and emerging markets.
- **Strategy Themes** – We see the sector benefitting from the following strategic themes i) we expect many insurers to deliver attractive earnings growth, ii) having addressed cost bases, we think the sector will benefit from operational leverage, iii) we see continued potential for restructuring although the focus is shifting towards growth, and iv) dividend yields are attractive and capital return potential is high (esp for reinsurers).
- **Valuation** – The sector trades on 10.8x 2015E PE overall, although many of our favoured stocks trade on a discount to this, and offers a 4.8% 2015E yield.
- **Risks** – Downside risks come from a prolonged delay in the global macro-economic recovery, especially if the expected rise in US and UK bond yields takes longer than expected to emerge.
- **Stocks for the next 12 months** – Aviva, Axa, Delta Lloyd and Esure.

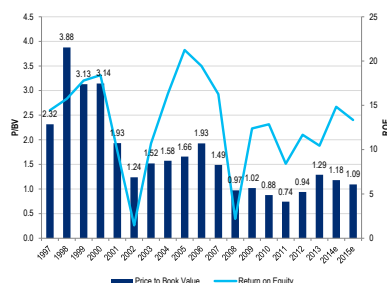
Insurance: Most Favoured and Least Favoured

	Ticker	Rating	Price (Jun. 7)	Target Price	Yield (%)	ETR (%)	2015E		
							P/E	P/BV	ROE
Most Favoured									
AXA SA	AXAF.PA	Buy/1	€18.75	€24.00	4.2%	32.2%	8.3x	0.8x	10.1%
<i>Offers high earnings growth in both L&H and P&C and trades at a significant valuation discount compared with composite peers</i>									
Aviva PLC	AV.L	Buy/1	£5.34	£5.90	2.8%	13.3%	9.5x	1.6x	16.8%
<i>Management has delivered strong progress on restructuring and the next phase is improving earnings and dividend growth</i>									
Delta Lloyd	DLL.AS	Buy/1	€18.49	€22.50	5.7%	27.4%	6.7x	1.1x	17.1%
<i>A compelling valuation supported by an improving capital position and the possibility for growth in pension buyouts</i>									
esure Group PLC	ESUR.L	Buy/1	£2.59	£2.94	6.7%	20.4%	10.3x	3.3x	34.1%
<i>A high margin and well reserved business that could grow significantly when the UK motor market improves and offers a compelling 6.5% yield</i>									
Least Favoured									
Admiral Group	ADML.L	Neutral/2	£14.93	£12.56	6.3%	-9.6%	14.2x	7.9x	58.3%
<i>We feel the current valuation premium compared with peers already factors in upside from an improving motor market</i>									
Amlin Plc	AML.L	Neutral/2	£4.80	£4.52	5.4%	-0.5%	11.2x	1.3x	11.9%
<i>A high quality business but we think earnings are too dependent on areas where pricing competition is intensifying</i>									
Assicurazioni Generali SpA	GASI.MI	Sell/3	€16.77	€15.50	3.2%	-4.4%	10.4x	1.0x	10.3%
<i>Expecting balance sheet, cash flow and margin improvements from restructuring, but feel this is more than priced into the stock</i>									
Standard Life PLC	SL.L	Neutral/2	£4.00	£3.90	3.9%	1.4%	14.9x	2.0x	13.2%
<i>Relatively weak operating cash generation and high valuation reflects strong franchise but leaves little room for upside</i>									

Source: Citi Research, Powered by dataCentral

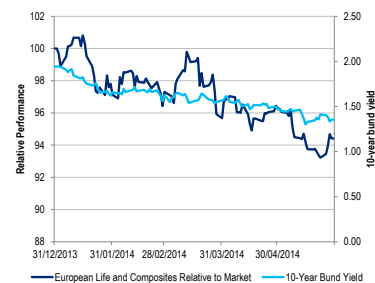
We continue to see valuation upside in the sector, and see recent yield concerns as manageable

Figure 167. Insurance — P/BV vs. ROE



Source: Factset, Citi Research estimates

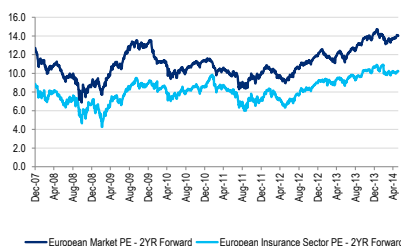
Figure 168. Insurance relative performance



Source: Factset, Citi Research

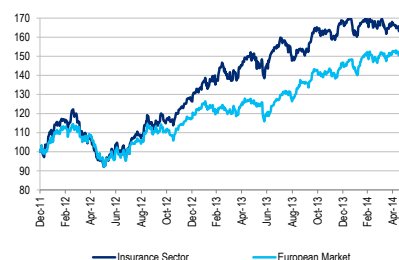
Share performance has been strong in recent years but PEs haven't re-rated vs market

Figure 169. Insurance — P/E vs Market



Source: Factset, Citi Research

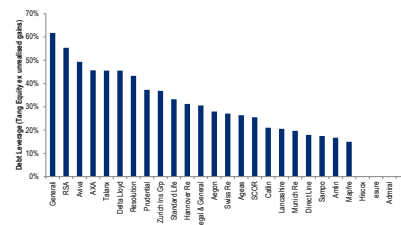
Figure 170. Insurance — Price vs Market



Source: Factset, Citi Research

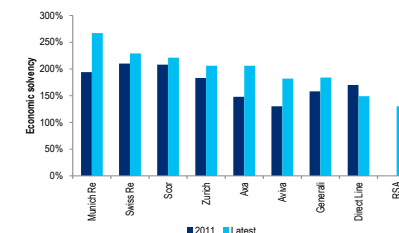
Debt leverage has reduced and capital positions are robust

Figure 171. Debt Leverage



Source: Citi Research

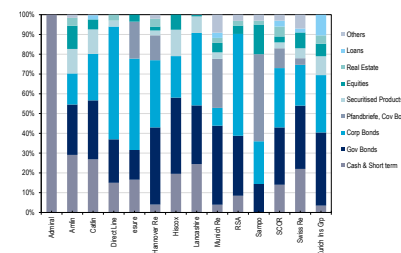
Figure 172. Economic Solvency Positions



Source: Company data; Citi Research

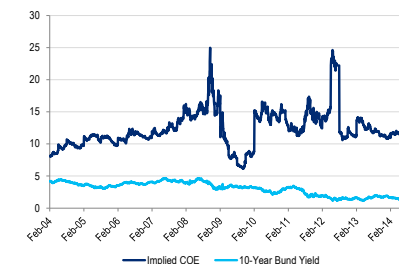
Asset allocation remains conservative

Figure 173. Insurance Asset Mix



Source: Company Data

Figure 174. Insurance — COE vs. risk-free yields



Source: Datastream

21 Stocks mentioned: (ADML.L; £14.72; 2); (AEGN.AS; €6.48; 2); (AGES.BR; €30.47; 2); (AML.L; £4.68; 2); (AV.L; £5.26; 1); (AXAF.PA; €18.06; 1); (CGL.L; £5.19; 1); (DLGD.L; £2.56; 2); (DLL.AS; €18.30; 1); (ESUR.L; £2.63; 1); (FLG.L; £3.14; 2); (GASI.MI; €16.59; 3); (HNRGN.DE; €64.92; 2); (HSX.L; £6.86; 2); (LGEN.L; £2.31; 2); (LREL.L; £6.49; 1); (MAP.MC; €2.98; 3); (MUVGn.DE; €160.75; 2); (PRUL.L; £13.70; 1); (PZU.WA; Z1449.80; 2); (RSAL.L; £4.82; 2); (SAMAS.HE; €37.10; 2); (SCOR.PA; €25.17; 1); (SL.L; £3.94; 2); (SRENH.VX; SF78.35; 2); (TLXGn.DE; €26.03; 1); (ZURN.VX; SF265.50; 2)

Media

Reversion to Mean Reversion

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- **Investment Thesis** – European Media has de-rated YTD as earnings momentum has disappointed on a combination of weaker-than-expected macro recovery, adverse FX moves and higher investment (both in growth and restructuring). What is more the extreme level of polarization observed at the beginning of the year whereby media cyclicals traded at a sharp premium to media defensives has reverted towards the mean. While both are encouraging, they don't necessarily change our view on the sector. We still think nuance is required and call on investors to be selective in their media exposure
- **Sector Themes** – We focus on (1) companies with strong 2015E growth (SKYD, RMV, JCD); (2) cyclical names that have been left behind (TF1, M6); (3) late cycle media names (REL); (4) contrarian names (BSY, PSON, DMGT). Our key sells/least preferred names focus primarily on companies where we think the market is in danger of putting a peak multiple on peak margins (our fundamental concern on names like WPP, ITV and P7S1) or where the market maybe too optimistic on either growth/recovery or relief from corporate action (MS, VIV).
- **Strategy Themes** – Our strategists focus on five themes: earnings leadership, operating leverage, restructuring/self-help, capital returns, and corporate actions. A number of names screen under each category but there are even a handful that cover all of these themes. In particular we highlight BSkyB, TF1 and Pearson, all of whom have a combination of solid growth prospects, gearing, cash return potential and potential catalysts via corporate action.
- **Valuation** – The sector has underperformed the market by -5% despite having seen earnings outperform by around 2%. The resultant -7% de-rating appears harsh, but should be seen in the context of the c. 9% re-rating seen in 2013. All in all we see valuation for the sector as (more) reasonable but not compelling.
- **Risks** – The risks for the sector relate largely to systemic factors. Should recovery in global GDP prove to be less robust than forecast, this could have a knock-on effect for growth. We also note there is a high exposure to FX volatility.
- **Stocks for the next 12 months** – Our top picks focus on either lagged cyclicals, late cycle names or contrarian plays. By sub-sector we are positive on the Professional Publishers and Internet names; selectively positive on PayTV/platforms, Outdoor and Agencies; and negative on FTA TV and Consumer Publishers. Our top picks are TF1, DMGT, Reed Elsevier, Pearson and BSkyB.

European Media: Most Favoured and Least Favoured

	Ticker	Rating	Price (Jun. 7)	Target Price	Yield (%)	ETR (%)	2015E		
							P/E	P/BV	ROE
Most Favoured									
British Sky Broadcasting Group PLC	BSY.L	Buy/1	£8.69	£10.00	3.5%	18.6%	12.5x	9.3x	92.1%
<i>We see BSkyB as well placed to navigate greater competition and with the group approaching a market multiple, we think valuation is attractive</i>									
Television Francaise 1 SA	TFFP.PA	Buy/1	€13.03	€18.00	4.2%	42.4%	15.0x	1.7x	11.3%
<i>With the group trading at little over 1x EV/Sales, we think the market materially underestimates scope for margins to recover medium-term</i>									
Pearson PLC	PSON.L	Buy/1	£11.43	£13.50	4.2%	22.3%	14.8x	1.4x	9.4%
<i>ST trends are tough but we think the market is mistaking cyclical pressures and structural pressures. We see scope for a rerating over time</i>									
Least Favoured									
ITV PLC	ITV.L	Sell/3	£1.80	£1.75	1.9%	-0.6%	12.9x	5.4x	43.6%
<i>ITV is doing the right things but we fear the market is over optimistic on the sustainability of above-peak margins. A de-rating could be painful</i>									
Mediaset SpA	MS.MI	Sell/3	€3.63	€2.70	0.0%	-25.7%	25.0x	1.8x	7.5%
<i>We think the market is too optimistic on both the timing and magnitude of ad recovery in Italy/Spain. Valuation, too, looks rich</i>									
Vivendi	VIV.PA	Neutral/2	€19.24	€19.80	5.2%	8.1%	25.4x	1.4x	3.2%
<i>We worry the market is still too optimistic on the potential scope of the strategic review; we also think that u/l EPS growth may underwhelm</i>									

Source: Citi Research, Powered by dataCentral

2014 has seen EPS momentum stall within media driven by a weaker growth outlook for emerging markets, a perhaps less robust than expected recovery in developed markets, currency pressures and ongoing restructuring efforts within selected names.

Even though earnings trends have held up well relative to the market, the lack of momentum has reversed the re-rating seen across 2013.

This doesn't necessarily make the sector cheap, but valuation certainly looks less stretched than it did at the beginning of the year.

As well as a relative de-rating at the sector level, we have seen the degree of polarization within the sector narrow.

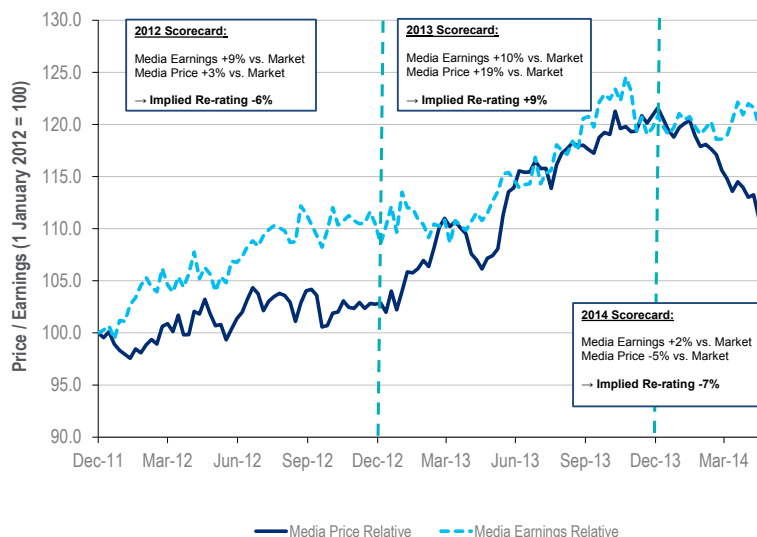
2013 saw a significant re-rating of media cyclicals – largely comprising ad-funded media owners – relative to media defensives – typically subscription-driven or global names.

In 2014 YTD we have seen this mean revert. Even where this hasn't been a function of weaker relative share price performance, we note that the market has tended to use positive EPS surprises to de-rate the media cyclicals.

Again, while this doesn't necessarily make the media cyclicals look outstanding value, it is fair to say that valuation looks a lot less extreme than it did in January 2014.

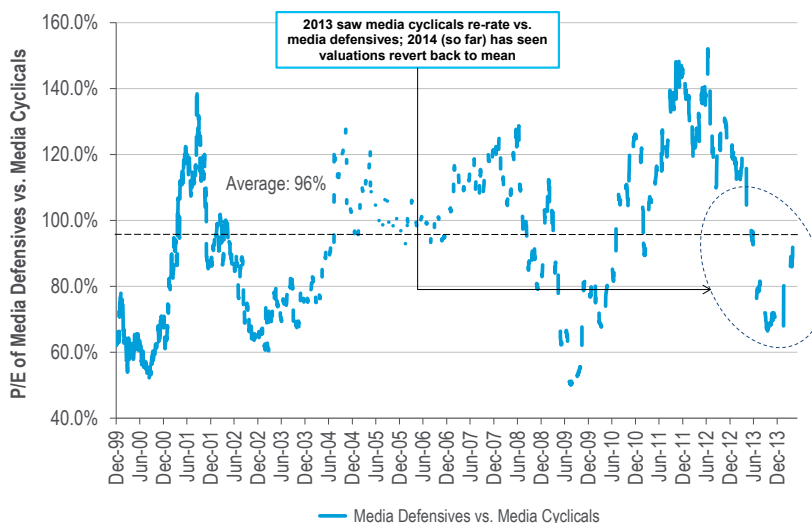
We focus on (1) companies with strong 2015E growth (SKYD, RMV, JCD); (2) cyclical names that have been left behind (TF1, M6); (3) late cycle media names (REL); (4) contrarian names (BSY, PSN, DMGT)

²²Figure 175. European Media – Share Price Performance & Earnings Relative to the Market



Source: DataStream, Citi Research

Figure 176. European Media – Valuation of Media Defensives vs. Media Cyclicals



Source: DataStream, Citi Research

Figure 177. Top Picks

TF1
DMGT
Reed Elsevier NV
Pearson
BSkyB

Source: Citi Research

Figure 178. Key Sells/Least Preferred

Buy	ITV	Sell
Buy	Mediaset	Sell
Buy	WPP	Neutral
Buy	Vivendi	Neutral
Buy	Pro7Sat1	Neutral

Source: Citi Research

²² Stocks mentioned: (BSY.L; £8.72; 1); (DMGOa.L; £8.82; 1); (ELSN.AS; €16.25; 1); (JCDX.PA; €28.56; 1); (MMTP.PA; €14.57; 1); (PSN.L; £11.48; 1); (REL.L; £9.37; 1); (RMV.L; £22.12; 1); (SKYDn.DE; €6.77; 1); (TFPP.PA; €13.10; 1); (ITV.L; £1.79; 3); (MS.MI; €3.62; 3); (PSMGn.DE; €33.56; 2); (VIV.PA; €19.32; 2); (WPP.L; £12.66; 2).

Oil & Gas

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- **Investment Thesis** – After several years of sharp deterioration we believe that earnings and returns for Big Oil are now starting to stabilise. We see that change as brought about by improving controllability on costs and scheduling of major project investment, a function of investment in the supply chain (oil services capacity) and changing relationships with suppliers (e.g. frame agreements). We see group ROE improving from 10% to 12% over the next four years, and book value growing at 7% CAGR through the period.
- **Sector Themes** – This is a period where efficient growth should be rewarded. We look to the ability of companies to bring on low-cost growth and demonstrate an ability to make productivity gains on capital being deployed. E&P companies with low-cost assets are potential M&A candidates in this environment. Service companies that can offer solutions to better productivity become market leaders.
- **Strategy Themes** – Within the Big Oil group the stabilization in profitability offers the prospect of better Capital Returns; following years of uncertainty we now see capacity for real growth in dividends across the group. Within Oil Services we also see capacity for Earnings Leadership with record book-to-bill in 1H14 underpinning a tremendous top-line visibility in the group.
- **Valuation** – Big Oil trades at 1.2x end-17 book. Offering a ROE of 12% the group is hardly deep value, but with stable returns and growing book value it is a lot more investible than it has been in recent years. For E&Ps, we see the sector discounting US\$78/bbl on our base NAVs.
- **Risks** – We view the sector through a lense of flat real oil prices, believing that there is not demand-capacity for real price inflation, nor a supply-response to allow for price deflation. In an inflationary environment leverage would likely outperform. In a deflationary environment the market may pay less attention to growth.
- **Stocks for the next 12 months** – Our key longs are BG (a Focus List name), Genel, Afren and Subsea 7. Key avoids we highlight ENI, Neste and CGG.

Oil & Gas: Most Favoured and Least Favoured

	Ticker	Rating	Price (Jun. 7)	Target Price	Yield (%)	ETR (%)	2014E		
							P/E	P/BV	ROE
Most Favoured									
BG Group	BG.L	Buy/1	£12.51	£14.00	1.5%	13.4%	18.6x	2.0x	11.4%
<i>Core growth projects (Australia and Brazil) should underpin double-digit earnings growth and returns expansion. Valuation remains attractive</i>									
Genel Energy	GENL.L	Buy/1H	£10.39	£13.60	0.0%	30.9%	20.3x	1.1x	5.7%
<i>Momentum is building towards sustainable exports from Kurdistan. Genel could also unlock value through potential asset sales</i>									
Subsea 7	SUBC.OL	Buy/1	Nkr121.50	Nkr140.00	4.3%	19.5%	11.8x	1.0x	9.6%
<i>Valuation reflects a c. 20% discount to the sector, as execution concerns appear overstated. Margins /pace of awards to pick up into 2H14.</i>									
Afren	AFRE.L	Buy/1H	£1.52	£2.12	0.0%	39.2%	12.3x	1.4x	10.6%
<i>Delivery of key developments and further success from E&A drilling could see the shares trade up towards our base NAV of 265p/share</i>									
Least Favoured									
Eni	ENI.MI	Neutral/2	€19.02	€17.75	5.3%	-1.4%	13.9x	1.2x	8.5%
<i>Earnings headwinds continue from underperforming Gas and Refining businesses</i>									
Neste Oil	NESIV.HE	Sell/3	€15.00	€12.00	4.3%	-15.7%	12.6x	1.3x	10.3%
<i>Weak fundamentals will continue pressuring returns in Refining and Renewables, as European product markets remain oversupplied.</i>									
CGG	GEPH.PA	Sell/3	€10.10	€10.50	0.0%	4.0%	22.5x	0.6x	2.8%
<i>Growth headwinds into 2015 (limited scope for increased pricing and rising competition in multi-client) are not fully reflected in valuation</i>									

Source: Citi Research, Powered by dataCentral

Compression in return on equity reflects poor capital allocation, disappointing project execution and inflation pressures. However, after several years of sharp deterioration we believe that earnings and returns for Big Oil are now starting to stabilise.

We see that change as brought about by improving controllability on costs and scheduling of major project investment, a function of investment in the supply chain (oil services capacity) and changing relationships with suppliers (e.g. frame agreements).

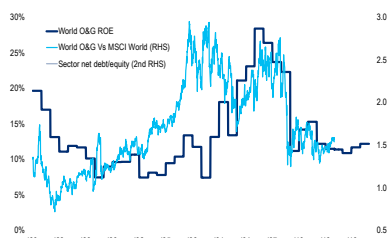
Big Oil may become increasingly willing to arbitrage political, geological or financial risks to lower the economic threshold of their investment portfolios.

Low-cost E&P positions in Kurdistan and East Africa offer potentially strong cost-curve position at attractive valuations.

Despite supposed industry austerity, European Oil Services are set for a record order intake in 1H14. Secular growth in the deepwater subsea market remains a strong investment theme with growth underpinned by robust economics and services margins protected by tangible barriers to entry.

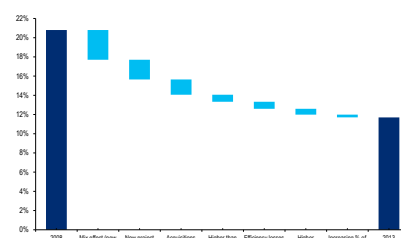
Refining is expected to struggle even further in 2014; sector valuations are still above cyclical lows.

²³Figure 179. Return on Equity under Pressure



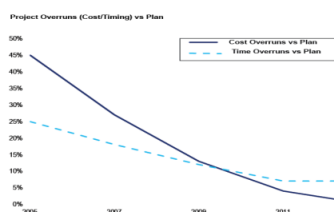
Source: Company data, Citi Research estimates

Figure 180. Big Oil: where has the money gone?



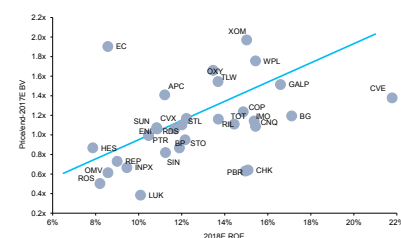
Source: Citi Research estimates

Figure 181. Improving Project Execution Trend



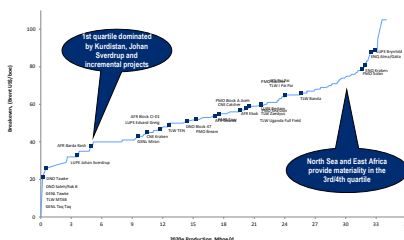
Source: Company data, Citi Research

Figure 182. Big Oil – Valuation / Profitability



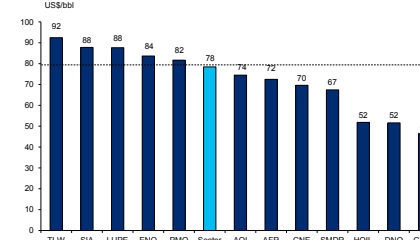
Source: Company Reports, Citi Research estimates

Figure 183. E&P – Assets on the Cost-Curve



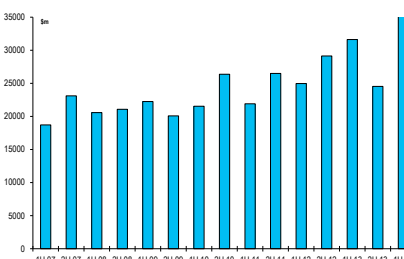
Source: Citi Research

Figure 184. E&P – Valuations look attractive



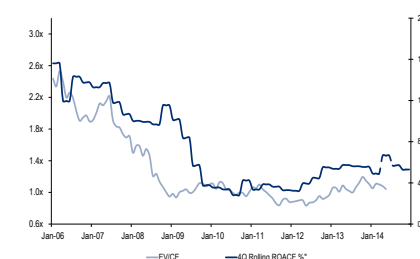
Source: Citi Research

Figure 185. Oil Services: Record Order Intake



Source: Citi Research

Figure 186. Euro Refiners: EV/CE vs ROCE



Source: Citi Research

²³ Stocks mentioned: (0386.HK; HK\$7.08; 1); (0857.HK; HK\$9.31; 3); (1605.T; ¥1,489; 1); (AFRE.L; £1.51; 1H); (AOIC.ST; SKr48.00; 1H); (APC.N; US\$101.50; 1); (BGL; £12.23; 1); (BP.L; £4.98; 2); (CHK.N; US\$29.19; 1H); (CNE.L; £2.05; 2H); (CNQ.N; US\$41.25; 1); (COP.N; US\$79.81; 1); (CVE.TO; C\$32.43; 1); (CVX.N; US\$122.37; 1); (DNO.OL; Nkr21.73; 2H); (EC.N; US\$36.87; 3); (ENI.MI; €18.62; 2); (ENQ.L; £1.42; 2H); (GALP.LS; €12.92; 1); (GENLL; £10.10; 1H); (GEPH.PA; €9.90; 3); (HES.N; US\$92.19; 2); (HOILL; £3.18; 2H); (IMO.TO; C\$53.73; 1); (LKOH.MM; US\$58.31; 1); (LUPE.ST; SKr131.40; 1); (OMVV.VI; €30.00; 2); (OXY.N; US\$99.73; 1); (PBR.N; US\$13.90; 2); (PMO.L; £3.46; 1); (RDSA.L; £23.44; 2); (REL.BO; Rs1,079.00; 2); (REP.MC; €20.11; 1); (ROSN.MM; US\$6.56; 1); (SIAL.L; £4.16; 2); (SMDR.L; £1.43; 2H); (STL.OL; Nkr181.30; 2); (STO.AX; A\$14.32; 1); (SU.TO; C\$42.16; 2); (SUBC.OL; Nkr120.40; 1); (TLW.L; £8.43; 2); (TOTF.PA; €50.58; 1); (WPL.AX; A\$41.89; 2); (XOM.N; US\$100.39; 2).

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- **Investment Thesis** – Macro risks reduction and industry consolidation have supported the luxury sector's performance in 2013 (+14%), however it has for the first time in over 5 years markedly underperformed both the European market and Global consumer discretionary. The sector continues to underperform in 2014 to date by ~3-4pp vs. DJ Eurostoxx (and by ~5-6pp when excluding LVMH). This reflects in our view: i) a normalisation in sector revenue and earnings growth profile (largely due to a slowdown in Chinese demand); ii) greater relative earnings competition on improving US and European macro; and iii) a surprising sequential deceleration in 2H13 revenue trends despite significantly easier comparatives, and a weak start to 2014 (excluding Japan). We continue to appreciate the sector's long-term drivers of double-digit earnings growth, high exposure to EM/global tourism, emergence of EM growth relays, absolute pricing power and signs of industry consolidation. High barriers to entry, capital strength, high level of vertical integration, tight family ownership and limited regulation provide additional long-term visibility.
- **Sector Themes** – We expect another year of normalised growth in 2014E with 8% sales growth (constant FX) and 9% EPS growth on continued China softness (GDP normalisation, limited space growth, gifting crackdown and outbound tourism). Going forward, we expect more balanced, homogeneous growth than in the past across the 4 main regions (Europe, US, Asia ex-Japan, Japan). Key themes: 1) rebalancing Chinese economy towards consumption; 2) distribution strategies (greater own retail penetration but slower space growth, continued wholesale rationalization, e-commerce push); 3) EM growth relays (SE Asia, Middle East, Brazil); 4) further vertical integration in manufacturing; 5) global tourism dynamics into Europe/US, intra-Asia; 6) greater fixed cost base from investments; 7) pricing strategies; 8) surplus FCF/balance sheet strength driving re-leveraging opportunities towards M&A and/or capital returns.
- **Strategy Themes** – Richemont, Swatch, Prada, Burberry = structural growth. Kering = restructuring. LVMH, Swatch, Hugo Boss, Burberry = re-leveraging. Richemont, Prada = price/share winners.
- **Valuation & Risks** – At ~19-20x 12-month forward P/E ex-Hermes and ~13.5x EV/EBIT the sector is trading broadly in line with its historical average (with a clear mid/large caps divergence). While we appreciate a return to sustainable double-digit EPS growth is possible we believe sector appetite has faded on normalising sector growth profile, weak EPS momentum, limited visibility on timing/magnitude of Chinese demand recovery, and risks of value-destroying acquisitions. Selectivity will be key, given diverging growth patterns within sector.

Luxury: Most Favoured

	Ticker	Rating	Price	Target	Yield	ETR	2015E		
			(Jun. 10)	Price	(%)	(%)	P/E	P/BV	ROE
Most Favoured									
Kering	PRT.PA	Buy/1	€162.30	€185.00	2.4%	16.4%	14.2x	1.7x	12.5%
Continued sales/earnings momentum at the smaller luxury brands, margin expansion and brand repositioning at Gucci, turnaround or exit strategy at Puma, Retail assets disposals out of the way, cost/capital discipline, reduced leverage, external growth to drive multiple expansion									
Richemont	CFR.VX	Buy/1	SFr92.05	SFr108.00	1.7%	19.0%	19.2x	3.1x	17.4%
Superior earnings growth, high-end brand portfolio/pricing power, margin/returns dominance of Cartier, untapped potential of branded jewellery, cost/capital discipline, strong balance sheet, value realisation potential from disposal of non-core assets.									

Source: Citi Research, Powered by dataCentral

EM consumers contribute ~50% of global luxury demand. We expect this mix to remain broadly stable in 2014-15E given normalisation in EM demand

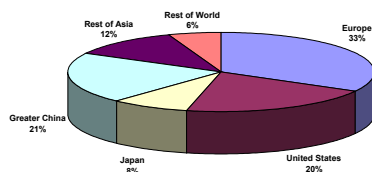
EPS growth a high multiplier of global real GDP (6-7x) reflecting: i) high multiplier of sales growth (3x historically) and ii) operational leverage (~2x).

Less operating leverage than in the past in 2014-16E from continued investments in manufacturing/retail expansion, FX headwinds, adverse geographic mix (Asia) and more limited pricing

From an absolute and relative standpoint, the sector looks reasonably valued.

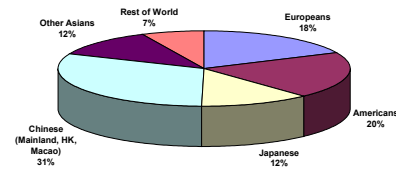
Surplus FCF/strong balance sheets drive industry consolidation

²⁴Figure 187. Luxury sales by destination, 2013E



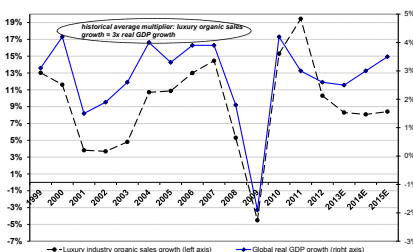
Source: Company reports, Citi Research estimates

Figure 188. Luxury sales by nationality, 2013E



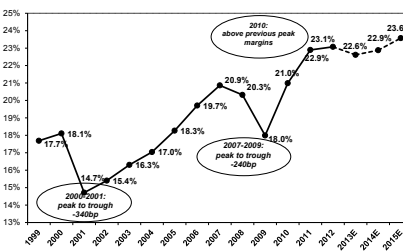
Source: Company reports, Citi Research estimates

Figure 189. Luxury sales growth (constant FX) vs. real GDP growth, 1999-2015E



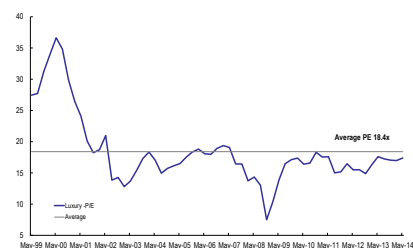
Source: Company reports, Reuters, Citi Research estimates

Figure 190. Luxury EBIT margin evolution, 1999-2015E



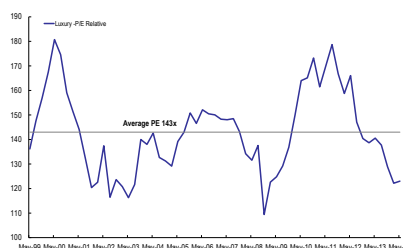
Source: Company reports, Citi Research estimates

Figure 191. Luxury Goods – 12m Forward P/E absolute, 1999-2014



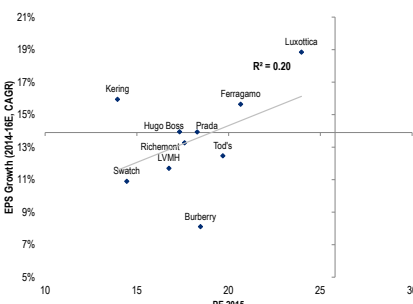
Source: Datastream, Citi Research

Figure 192. Luxury Goods – 12m Forward P/E relative, 1999-2014



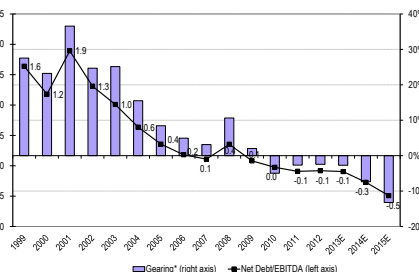
Source: Datastream, Citi Research

Figure 193. Luxury Goods – 2014-16E EPS growth vs. P/E 2015E



Source: Citi Research estimates (except Ferragamo is IBES consensus)

Figure 194. Luxury sector – Gearing and Net debt to EBITDA, 1999-2015E



Source: Company reports, Citi Research

*Gearing defined as net debt to shareholder's equity

²⁴ Stocks mentioned: (1913.HK; HK\$58.00; 1); (BOSSN.DE; €105.30; 1); (BRBY.L; £15.36; 2); (CFR.VX; SF93.20; 1); (LVMH.PA; €145.55; 1); (PRTP.PA; €160.90; 1); (UHR.VX; SF534.50; 2)

Personal & Household Goods — Tobacco

Divergent Trends

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■ **Investment Thesis** - During the last decade tobacco has outperformed thanks to its predictable (and strong) EPS growth. While we expect growth will continue to be decent - especially in EMs - we think there are greater risks to the sector now. That said, the sector has outperformed other consumer staples in the last 12 months.

■ **Sector Themes** - Current themes are 1) possible M&A in the US; 2) the very poor volumes in the EU, though there is evidence of trends are now slightly less bad than before; 3) the impact of the large tax rises in Brazil, Russia and Australia; 4) the risks and opportunities stemming from NextGen products like e-cigarettes. We think M&A is the most important issue now. [There has been a lot of speculation that Reynolds \(RAI\) could buy Lorillard \(LO\)](#). (BAT owns 42% of RAI). We believe that if RAI does buy LO, BAT will want to maintain its 42% stake in the enlarged entity. We also think that RAI would need to sell several brands for anti-trust reasons. Imperial could be a potential buyer, and if it does buy the disposed brands, we would expect the acquisition to be EPS accretive for IMT. Another possibility is that BAT simply buys the 58% of RAI it doesn't already own.

■ **Strategy Themes** - BAT fits the "self-help" and "corporate actions" themes – it is buying back about 2% of its shares annually, and clearly has pricing power. In addition, BAT has the option to acquire the 58% of RAI it doesn't already own in a deal that is likely to be 10-13% accretive to earnings. All three tobacco stocks - BAT, Imperial and Swedish Match - are buying back, although Match is doing so at a slower rate than before.

■ **Valuation** - We look at P/Es as the simplest tool for a simple sector. On this basis, IMT already factors in the marginal improvement in European volumes. Swedish Match looks especially expensive, given the outlook on volume and pricing growth in Swedish snus and cigars.

■ **Risks** - The main risk for the stocks is rotation. For EPS, the risks are different for each stock: for BAT the main risk is FX and a slowdown in EMs. For Imperial it is continued poor volumes in the EU, perhaps driven by tougher competition / tax rises and for Swedish Match it would be further competition in Swedish snus. The UK Govt has said it is likely to impose plain packaging (see our note [here](#)), with effect from 2015. We believe IMT is most at risk as a result of this, as over 20% of its profit comes from the UK.

■ **Stocks for the next 12 months** - We prefer BAT due to 1) its commitment to deliver high single-digit EPS growth through pricing (especially in second-tier EMs) and cutting costs, 2) an attractive 2015E dividend yield of 4.4%, 3) progress on innovation in conventional cigarettes and NextGen products, and 4) the exclusive option to buy the 58% it doesn't already own of RAI (see our note [here](#)).

Tobacco: Most Favoured and Least Favoured

	Ticker	Rating	Price	Target	Yield	ETR	2015E		
			(Jun. 7)	Price	(%)	(%)	P/E	P/BV	ROE
Most Favoured									
British American Tobacco PLC	BATS.L	Buy/1	£35.41	£36.50	4.1%	7.2%	15.1x	17.4x	92.8%
We expect solid EPS growth as company uses its pricing power in EMs to offset weakness in Europe and FX declines									
Least Favoured									
Swedish Match AB	SWMA.ST	Sell/3	SKr227.30	SKr211.00	3.3%	-3.9%	17.2x	190.0x	1633.5%
We remain concerned about price-based competition both in snus and cigars, and believe future growth will be slower									

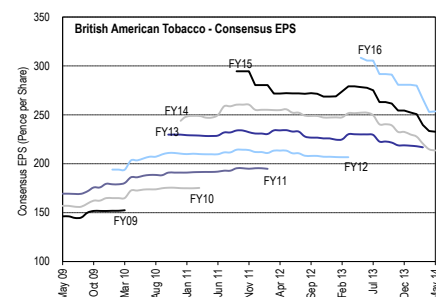
Source: Citi Research, Powered by dataCentral

EPS growth has been highly predictable in the last decade. Recently however, a combination of FX weakness (BAT) and weak volumes (IMT) has meant the companies have started to see downgrades.

European tobacco volumes have declined in an unprecedented way. We assume this is mostly due to declining affordability. Even in the UK, where unemployed trends have been mildly positive, volumes remain very weak.

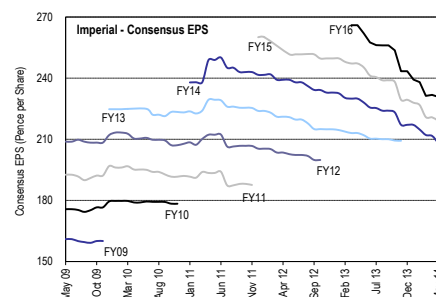
There has been a notable divergence between BAT and Imperial, reflecting the worsening growth outlook in Europe, and Imperial's problems in other markets. Swedish Match's organic growth has slowed significantly in both snus and cigars.

²⁵Figure 195. BAT — Consensus EPS



Source: DataStream, Citi Research

Figure 196. IMPS — Consensus EPS



Source: DataStream, Citi Research

Figure 197. EU Cigarette Volume Trends

	Cigarettes	Beer	Spirits	Yogurt
2008	-2.9%	-1.9%	0.1%	1.0%
2009	-3.6	-3.7	-2.2	+1.4
2010	-4.6	-2.2	-0.9	+1.6
2011	-4.3	+0.0	-1.1	+0.9
2012	-6.3	-0.2%	-1.8%	0.8%
2013	-7.5%			
2014E	-6% to -7%			

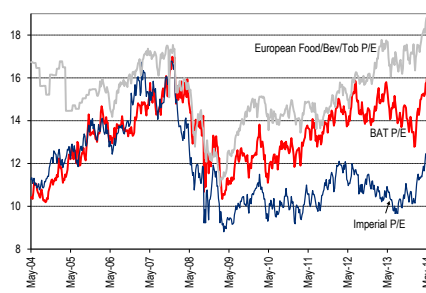
Source: Euromonitor / PM Company Reports

Figure 198. UK Price for Marlboro

UK	Retail Price (£)	Net Price (£)	Retail Price	Net Price	UK mkt vol
Nov 13	8.20	2.00	5.8%	9.1%	-10%
Nov 12	7.75	1.83	8.8%	10.3%	-6.4%
Nov 11	7.12	1.66	10.9%	7.6%	-4.7%
Nov 10	6.42	1.54	9.7%	10.4%	-1.8%
Nov 09	5.85	1.40	3.4%	5.0%	-0.5%
Nov 08	5.66	1.33	4.0%	5.6%	-5.0%
Nov 07	5.44	1.26	4.0%	5.0%	-2.4%
Nov 06	5.23	1.20	3.6%	5.3%	-3.5%

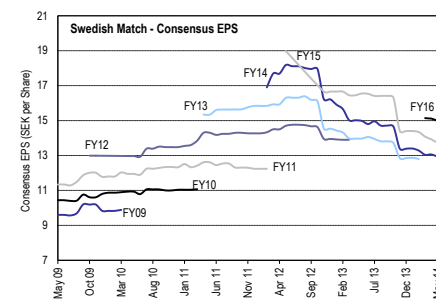
Source: Company reports and Citi Research

Figure 199. BAT vs IMT P/E Multiple



Source: DataStream, Citi Research

Figure 200. Swedish Match – Consensus EPS



Source: DataStream, Citi Research

²⁵ Stocks mentioned: (BATS.L; £35.47; 1); (IMT.L; £26.50; 2); (LO.N; US\$60.53; Not Rated); (RAI.N; US\$58.91; Not Rated); (SWMA.ST; SKR232.00; 3)

Retail – Food

Another year of modest earnings growth

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- **Investment Thesis** – We think a combination low levels of food inflation, intensifying price competition and strength of discounters will at best drive very modest earnings growth for 2014. Companies (especially in the UK) have shifted focus from space growth and expansion to FCF generation and that should support dividends.
- **Sector Themes** – Across Europe food inflation is tracking down, the impact of this on LFL sales and the competitive environment will continue to be a theme through the year. We see no signs of discounter growth in UK slowing in the near term, and this likely will result in further contraction in earnings at the listed big operators.
- **Strategy Themes** – Companies with solid LFL sales expansion are much less likely to see substantial earnings and cash flow contraction. Companies with strong balance sheets and organic FCF generation may be in a position to increase dividends and/or buy back stock.
- **Valuation** – The UK sector has de-rated over the last year as sales growth and earnings forecasts continued to be trimmed (trades on c11x 2014/15e EPS). Continental European names are better placed with modest earnings growth expectations and stabilizing top-line growth (trades on 14-16x 2014e EPS).
- **Risks** – Continued low levels of food inflation in Europe is a risk as this pressures topline sales growth forcing retailers to act on price to improve LFLs. The strength of discounters and increasing price activity in various markets may further increase competitive activity.
- **Stocks for the next 12 months** – In the UK we favour Sainsbury over its two listed peers for its continued LFL outperformance (by 3ppts), consistent strategy, geographic exposure and better earnings visibility. In Europe, we prefer Delhaize for the strength of its recovery and superior sales momentum (in the US), strong cash generation and Ahold for its strong balance sheet and potential for further cash return shareholders beyond the current buy-back. Morrisons has the worst LFL performance and is our least preferred name.

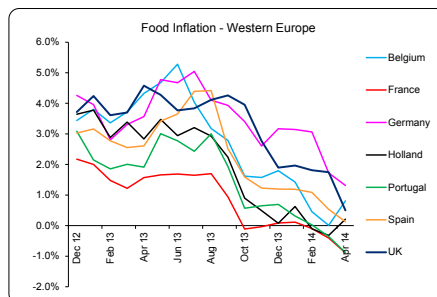
Retail - Food: Most Favoured and Least Favoured

	Ticker	Rating	Price	Target	Yield	ETR	2015E		
			(Jun. 7)	Price	(%)	(%)	P/E	P/BV	ROE
Most Favoured									
Ahold	AHLN.AS	Buy/1	€13.33	€14.90	3.6%	15.4%	13.1x	2.1x	17.7%
Strong free cash flow, potential cash return in 2015 and self-help.									
Delhaize	DELB.BR	Buy/1	€51.80	€58.00	3.1%	15.1%	11.7x	0.9x	8.2%
Improved US performance, upside from Fresh, Easy & Affordable program, strong cash generation									
Sainsbury	SBRY.L	Buy/1	£3.26	£3.50	5.3%	12.6%	10.7x	1.0x	9.8%
Strong LFL outperformance vs. listed peers but valuation does not reflect this. Better earnings visibility									
Least Favoured									
Morrison (Wm)	MRW.L	Neutral/2	£1.93	£2.20	6.7%	20.7%	14.0x	1.1x	6.9%
Will take longer to address structural issues and turn around sales momentum									

Source: Citi Research, Powered by dataCentral

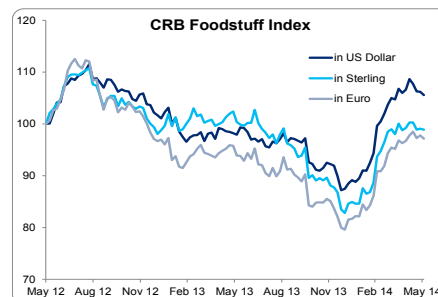
Food inflation has been edging down across Europe since last summer and has reached deflationary levels in some countries. Commodity prices have recovered somewhat this year, but we still expect food CPI to remain low at least through the two quarters

Figure 201. Low inflation across Europe



Source: DataStream

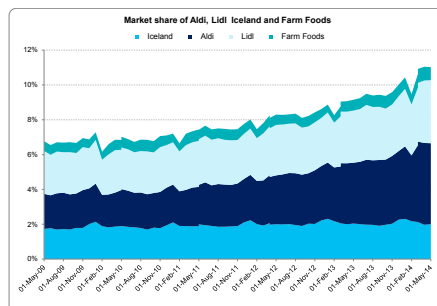
Figure 202. Some pickup in commodity prices



Source: DataStream

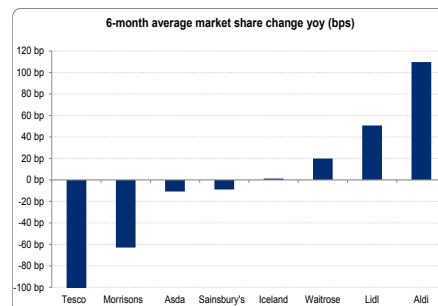
The UK market is going through big structural shifts. Discounter growth so far looks unstoppable, the sector added over 350bps market share in just 3 years.

Figure 203. Discounters share in UK at a high



Source: Kantar Worldpanel

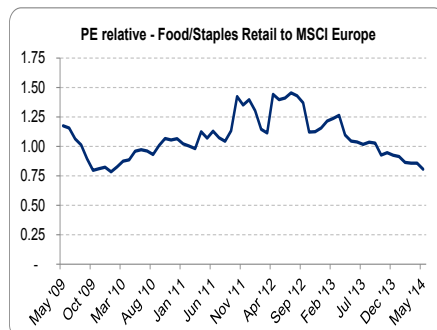
Figure 204. Tesco, Morrisons the weakest



Source: Kantar Worldpanel

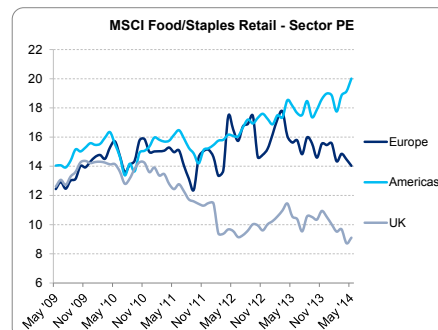
Mixed picture with Pan-Euro food retailers: while Continental names have maintained 14-16x PE multiples the UK names have de-rated

Figure 205. Sector underperformed this year



Source: Datastream

Figure 206. UK Food Retail cheapest



Source: Datastream

²⁶ Stocks mentioned: (AHLN.AS; €13.23; 1); (DELB.BR; €51.35; 1); (MRW.L; £1.92; 2); (SBRY.L; £3.28; 1); (TSCO.L; £2.93; 2)

Retail — General

The Winner Takes It All

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- **Investment Thesis** – Despite the improving 2014-15 UK consumer demand forecast with stable/low growth on the continent, we believe that the valuation re-rating of the sector over the last 2 years offers some valuation multiple downside risk ahead of UK interest rate cycle increases. Hence our Top Buy codes focus on retailers with strong market share gain dynamics, a stable or credible EBIT margin expansion agenda, and/or elevated cash returns to shareholders. These retailers should generate a c.+15-20% ETR over the next 12 months (see below).
- **Sector Themes** – The migration of sales to online channels requires retailers to cover online logistics costs while store-based costs remain. Where online sales are 100% incremental, EBIT margins can be enhanced; where online sales cannibalize store-sales, EBIT margins can fade (potentially sharply into loss) without material opex efficiency gains.
- **Strategy Themes** – Focus remains on buying online winners, given the potentially sharply polarizing trading performances across the sector driven by the above channel shift customer dynamics.
- **Valuation** – In light of the variation in balance sheet structures across the sector, we focus on EV/EBIT as our primary valuation metric. Given our view that the sector's current 11x 2015E EV/EBIT multiple has some modest downside risk (towards the c.10x long-run sector average), we argue that significant share price performance will be primarily driven by premium EBIT growth and cash generation dynamics (including elevated cash returns) across the sector.
- **Risks** – The primary risk to our sector investment thesis relates to the potential for a material change in the consumer demand outlook. In general terms, a -100bp decline in gross consumer earnings equates to -200bp LFL sales fade and c.-10% earnings reduction for the average general retailer under our coverage (albeit this relationship is becoming less clear due to the disruptive influence of online).
- **Stocks for the next 12 months** – Most favoured: H&M, Next, Sports Direct. Least favoured: adidas, Debenhams, M&S.

General Retail: Most Favoured and Least Favoured

	Ticker	Rating	Price (Jun. 7)	Target Price	Yield (%)	ETR (%)	2015E		
							P/E	P/BV	ROE
Most Favoured									
Sports Direct International Plc	SPD.L	Buy/1	£8.13	£10.00	0.0%	23.0%	19.7x	4.5x	25.7%
<i>Combination of strong online revenue growth, EBIT margin progress and European store roll out is forecast to drive >+20% EBIT growth p.a.</i>									
Next Group PLC	NXT.L	Buy/1	£66.30	£76.00	5.2%	19.8%	16.5x	25.5x	182.4%
<i>>5% dividend yield plus low teens earnings growth (driven by international online and UK space growth) is forecast to drive a c.20% ETR this year</i>									
Hennes & Mauritz AB	HMb.ST	Buy/1	SKr284.00	SKr315.00	3.4%	14.3%	21.5x	9.0x	43.5%
<i>Stable LFL gross profit trends and +10% space growth forecast to drive low-teen EPS progress, in conjunction with c.+4% DY</i>									
Least Favoured									
adidas Group	ADSGn.DE	Neutral/2	€76.45	€81.00	2.1%	8.0%	16.9x	2.4x	15.0%
<i>We argue that the 2014 consensus EPS forecast agenda remains too optimistic, raising the prospect of near-term share price downside</i>									
Marks and Spencer Group PLC	MKS.L	Neutral/2	£4.51	£4.65	4.0%	7.1%	13.4x	2.5x	19.4%
<i>We fear that the online channel shift will largely offset any improvements in the group Gen Merch LFL gross profit trends.</i>									
Debenhams Plc	DEB.L	Neutral/2	£0.73	£0.80	4.7%	14.2%	10.0x	1.1x	11.2%
<i>We remain concerned that the race to achieve a fit-for-purpose online revenue channel remains a very significant headwind to 2014/15 earnings</i>									

Source: Citi Research, Powered by dataCentral

Our Pan-European Household Available Cashflow framework argues for a c.+1% decline in 2014 LFL retail sales. In this environment we continue to prefer revenue growth and self-help retailers over more cyclical stocks.

Within the UK we argue for a c.+2.5% LFL growth trend in 2014, rising to +3% in 2015. However we expect the store based sales to remain broadly flat due to online migration.

We argue that retailers suffering high levels of store based sales cannibalisation will struggle to deliver material EBIT progress in 2014-15 in absence of material opex efficiency gains.

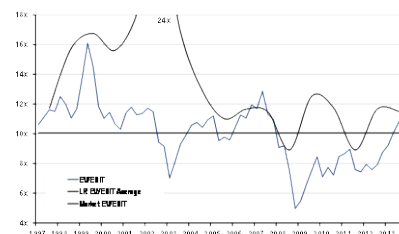
The Government's mortgage guarantee scheme should lead to incremental housing transactions through 2014 and 2015

27 Figure 207. Segmentation & Recommendations

	Buy	Neutral
Growth	ASOS H&M DNLM SPD	ADS ITX
Self-Help	KGF NXT SHFJ SMWH AMER	
Cyclical	DRTY HFD	BWNG DEB INCH HOME MKS

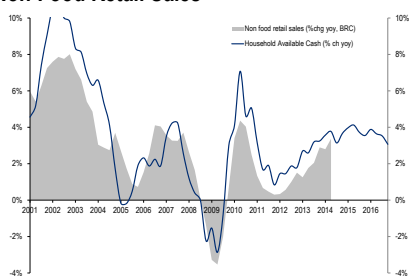
Source: Citi Research

Figure 208. UK General Retail – EV/EBIT



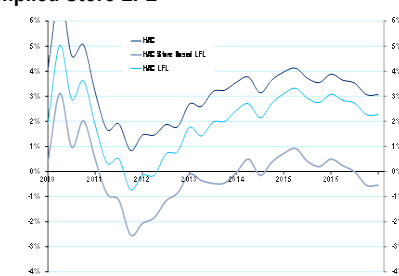
Source: DataStream & Citi Research

Figure 209. Household Available Cash vs. Non-Food Retail Sales



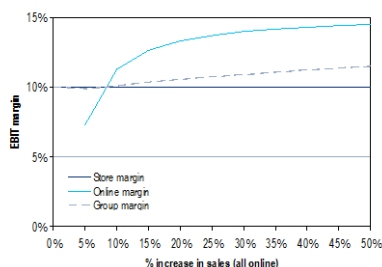
Source: ONS, DataStream, BoE, BRC and Citi Research

Figure 210. Household Available Cash with Implied Store LFL



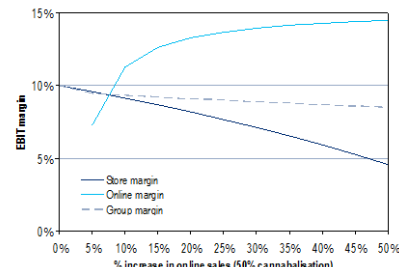
Source: ONS, DataStream, BoE, BRC and Citi Research

Figure 211. Extra Sales Are Generated Online



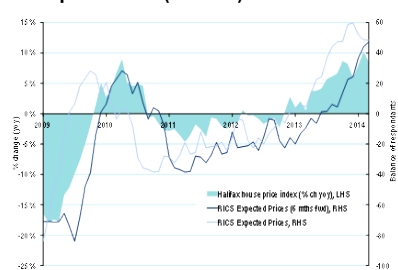
Source: Citi Research

Figure 212. Online Generates Extra Sales, 50% of Which Migrate From In Store



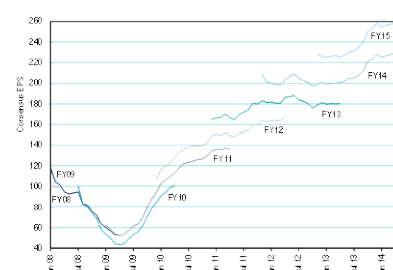
Source: Citi Research

Figure 213. Halifax House Prices vs. RICS Price Expectations (6m fwd)



Source: DataStream and RICS

Figure 214. UK Retail – Consensus EPS



Source: DataStream

27 Stocks mentioned: (AMEAS.HE; €15.40; 1); (ASOS.L; £28.50; 1); (BWNG.L; £4.59; 2); (DEB.L; £0.74; 2); (DNLM.L; £8.69; 1); (DRTY.L; £0.88; 1); (HFD.L; £4.85; 1); (HMB.ST; SKr284.40; 1); (HOME.L; £1.87; 2); (INCH.L; £6.17; 2); (ITX.MC; €104.55; 2); (KGF.L; £3.81; 1); (MKS.L; £4.46; 2); (NXT.L; £65.45; 1); (SHFJ.J; R55.10; 1); (SMWH.L; £10.08; 1); (SPD.L; £7.84; 1); (ADSGn.DE; €77.03; 2)

Technology

Emphasize resilience, return and restructuring

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- **Investment Thesis** – We believe a mix of attractive fundamentals and balance sheet strength as well as opportunities to suit diverse investment ideas makes Tech an appealing sector within EU. As ever favourable Tech thematic orientation is the primary criterion, while from a strategic angle, we like stories with resilient business models backed by earnings leadership, capital return and restructuring.
- **Sector Themes** – In our view, the ongoing growth and convergence of devices remains the most influential theme for the sector – from continued proliferation of devices in EM (Device Explosion) to their saturation in DM (Device Exhaustion), and transitioning on to the Internet of Things (Device Expansion).
 - **Semiconductors** – Within semis, we see multiple favorable structural trends (e.g. rising content in autos, energy efficiency) but we believe that the cyclical recovery is increasingly priced in. We stay selective and prefer ASML.
 - **Telecom Equipment** – Spending environment remains choppy overall, but TD-LTE rollout in China and LTE build out in EMEA represent pockets of strength over the next few quarters.
 - **Software** – Overall IT spend growth is still scarce – we see EU and Asia reversion to mean as likely catalyst for improvement. Software as a Service (SaaS) is now mainstream, in conjunction with rising adoption of cloud.
 - **IT Services** – We see business models adapting to keep up with the changing nature of demand. Europe and BPO offer most potential. While cloud maybe a long term risk, it could emerge as an opportunity first.
- **Strategy Themes** – With valuations catching up with fundamentals for structural growth names like IFX and ARM, we place greater emphasis on names with earnings leadership backed by resilient business models (SAP, SGE), self-help / restructuring (CAPP, ALU), capital return (NOK, ASML) and M&A (ATO, DSY).
- **Valuation** – The forward earnings multiple for the sector as a whole (SX8P) has been broadly unchanged over the past 6 months, and it continues to trade at a premium to the broader EU market – justifiably so in our view, owing to attractive structural drivers, stronger balance sheets and M&A prospects. However, at a stock-specific level, we see strong variance in valuations and remain selective.
- **Risks** – 1) Broad-based macro-driven softening of demand impacting semis, 2) constrained IT budgets (particularly discretionary) impacting growth of Software & IT Services firms, 3) FX rate fluctuations, 4) sub-par M&A implementation, 5) management transition, 6) increased competition from Asian vendors
- **Stocks for the next 12 months** – ASML, CAPP, NOK

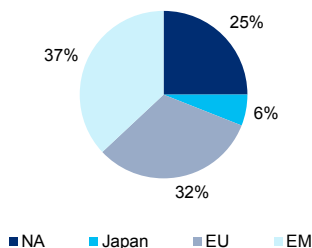
Technology: Most Favoured and Least Favoured

	Ticker	Rating	Price	Target	Yield	ETR	2015E		
			(Jun. 7)	Price	(%)	(%)	P/E	P/BV	ROE
Most Favoured									
ASML Holding NV	ASML.AS	Buy/1	€65.19	€74.00	1.1%	14.6%	18.2x	3.5x	20.2%
a) Limited downside to capex, b) diminishing concerns around EUV, and c) increased contribution from service & holistic litho sales									
Nokia Oyj	NOK1V.HE	Buy/1	€5.84	€7.00	0.0%	19.9%	20.2x	2.3x	8.6%
a) Stable fundamentals post devices sale allows firm to engage in phase of capital returns, b) shift to TDD-LTE should benefit NOK vs. others									
Capgemini SA	CAPP.PA	Buy/1	€54.44	€60.00	2.0%	12.2%	14.8x	1.7x	11.8%
a) Transformation of business through industrialisation, b) disciplined execution on leveraging forces, c) supportive demand trends, d) M&A									
Least Favoured									
STMicroelectronics	STM.PA	Sell/3	€7.09	€6.00	4.2%	-11.1%	19.6x	1.6x	7.5%
a) Potential returns (RoCE and RoE) do not justify current trading levels, b) FD-SOI encouraging but not a panacea for all digital issues									

Source: Citi Research, Powered by dataCentral

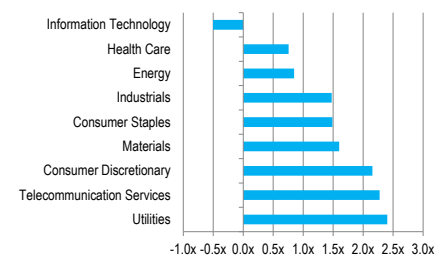
The European Technology sector boasts of attractive long term fundamentals such as high exposure to emerging markets (EM) and balance sheet strength

Figure 215. Estimated revenue by geography



Source: Company data, Citi Research

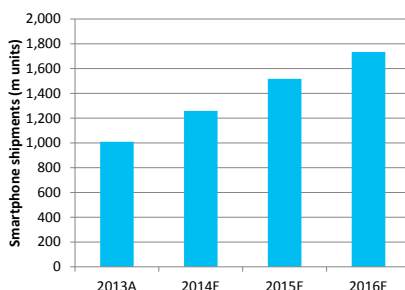
Figure 216. CY2013 EV/EBITDA for Sectors



Source: Company data, Bloomberg, Citi Research

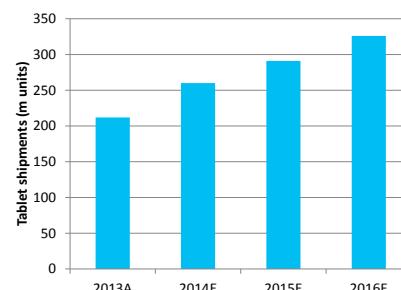
Growth and convergence of devices remains the most influential theme for the sector

Figure 217. Citi Global Smartphones Forecast



Source: Citi Research

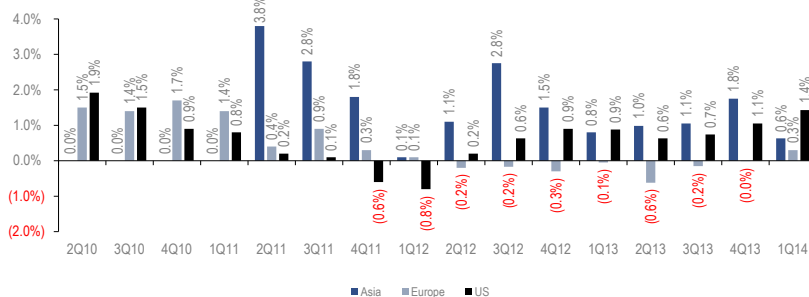
Figure 218. Citi Global Tablets Forecast



Source: Citi Research

Global IT spend growth is still scarce, but improving in 2014

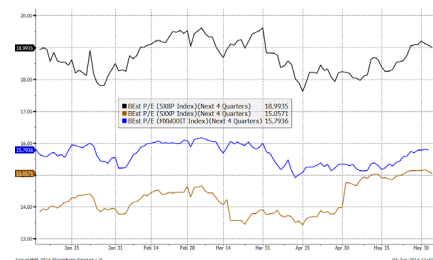
Figure 219. CIO IT Spending Expectations for Following Year



Source: Citi Research

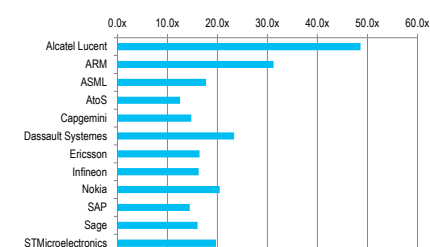
The forward multiple for the sector as a whole has been broadly unchanged YTD. At stock-specific level, we see strong variance.

Figure 220. SX8P vs. SXXP vs. MSCI World IT



Source: Bloomberg, Citi Research

Figure 221. 2015E P/E multiples



Source: Citi Research

28 Stocks mentioned: (ALUA.PA; €2.87; 1); (ARM.L; £9.12; 2); (ASML.AS; €63.60; 1); (ATOS.PA; €64.60; 1); (CAPP.PA; €53.91; 1); (DAST.PA; €93.02; 1); (ERICB.ST; SKr82.30; 2); (IFXGn.DE; €9.03; 2); (NOK1V.HE; €5.86; 1); (SAPG.DE; €55.38; 1); (SGE.L; £4.13; 1); (STM.PA; €7.10; 3)

Telecommunications

Diminishing Returns

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- **Investment Thesis** – Following 13% outperformance in 2013, 2014 has seen European Telcos underperform by 3.5% year to date. Sharp falls in consensus earnings have pushed the sector up to a 16% premium to the market on PE at 17.2x vs 14.8x for the market. Some of this is due to lower gearing and costly carrying of cash balances but some is higher investment levels and depreciation plus weaker FX. At this level we see enthusiasm for benefits from regulation and consolidation as vulnerable to disappointment that could cause a sell-off as investors seek better value elsewhere. We are therefore cautious, preferring quality such as Swisscom as well as Inmarsat with its capex peak now passing.
- **Sector Themes** – We expect levels of M&A to remain elevated for some time but caution that the level of investor enthusiasm for in-market consolidation in Europe may be overdone. Also migration of voice to IP is potentially disruptive, whether it originates from OTT providers like WhatsApp or the network operators.
- **Strategy Themes** – The key themes are the potential for recovery in Europe helped by friendlier regulation and an improving macro outlook along with increased M&A as well as technology driven price inflation through 4G and fast broadband.
- **Valuation** – The current sector EV/EBITDA has increased to 6.9x after trading around 5x from late 2009 until mid-2013. The sector 2014 P/E has risen to 17.2x vs its 10-year average of 11.5x, partly due to the dilutive impact of the VZW sale. The sector **DY has declined to a no longer exceptional 4.3%**.
- **Risks** – Despite increased optimism around the industry, financial trends have so far improved only very slightly. There is a risk the trends continue to be poor and translate into further consensus downgrades before the end of 2014. The EU telecoms regulatory proposals could be killed off by the Council of Ministers and onerous concessions may be imposed on the German consolidators.
- **Stocks for the next 12 months** – Our most favoured stocks for 2014 are Swisscom and Inmarsat. Swisscom has invested ahead of its peers giving it a material competitive advantage and is trading on a below sector PE of 15.4x 2014E. For Inmarsat, the long investment phase in Global Xpress ending with regional service entry imminent, and the company has committed to a network to support airline passenger connectivity which is another strongly growing area. Additionally, option value around its US L-Band spectrum remains, following reactivation of the Co-operation Agreement at the end of March.

Telecoms Services

	Ticker	Rating	Price	Target	Yield	ETR	2015E		
			(Jun. 7)	Price	(%)	(%)	P/E	P/BV	ROE
Most Favoured									
Swisscom AG	SCMN.VX	Buy/1	SFr530.00	SFr600.00	4.2%	17.4%	14.5x	3.7x	26.9%
Swisscom trades below 15x earnings in 2014, while a sale of Fastweb could reduce that further to below 12x. Swisscom is one of few European telcos that could deliver real revenue growth in the medium term and benefits from low regulatory and competitive risk									
Inmarsat plc	ISA.L	Buy/1	£7.53	£8.25	4.1%	13.7%	38.3x	4.9x	12.4%
The Global Xpress investment phase is coming to an end, regional commercial service is imminent and the stock yields 4% with good growth prospects.									
Least Favoured									
Telecom Italia SpA	TLIT.MI	Sell/3	€0.99	€0.50	0.0%	-49.3%	23.1x	1.0x	4.6%
TI faces significant pricing pressure in Italian mobile and fixed which has been driving earnings expectations down, and what look to be ambitious expectations on the part of investors for the outcome of a complex exit from Brazil.									
Zon Optimus SGPS SA	ZONOP.LS	Sell/3	€4.99	€3.20	2.4%	-33.5%	27.7x	2.4x	8.0%
At 11x EBITDA and nearly 30x earnings Zon is expensive and exposed to further revenue declines as it continues to struggle against two aggressive competitors in Portugal.									

Source: Citi Research, Powered by dataCentral

Sharp falls in consensus earnings have pushed the sector up to a 16% premium to the market on 2014 PE at 17.2x vs 14.8x for the market.

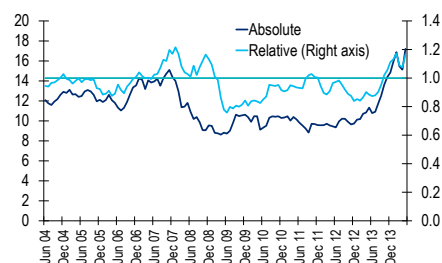
Following 13% outperformance in 2013, 2014 has seen European Telcos underperform by 3.5% year to date.

Sector average EV/EBITDA is close to a single standard deviation high on both 12 month trailing and forward bases, vs 9-10 year averages.

European mobile service revenue growth finally started to improve in 1Q14, both inc and exc the impact of MTR reductions, which are set to moderate further as 2014 progresses.

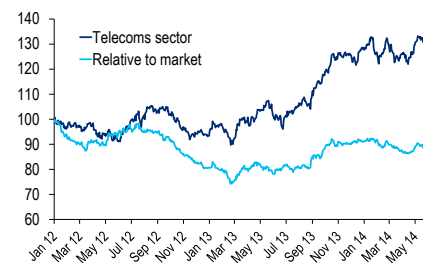
Fixed line revenue growth is gradually improving and of the larger operators BT Group is performing strongly compared to its peers.

²⁹Figure 222. Sector PE and PE relative



Source: Datastream

Figure 223. Sector performance, abs & rel (TSR)



Source: Datastream

Figure 224. EV/EBITDA – trailing 12 months



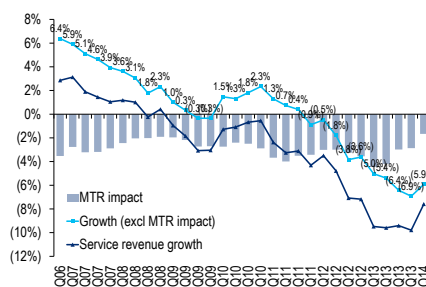
Source: Bloomberg

Figure 225. EV/EBITDA – trailing 12 months



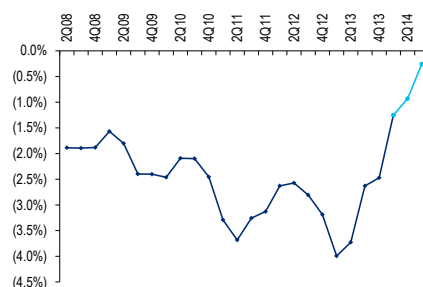
Source: Bloomberg

Figure 226. Mobile service revenue growth



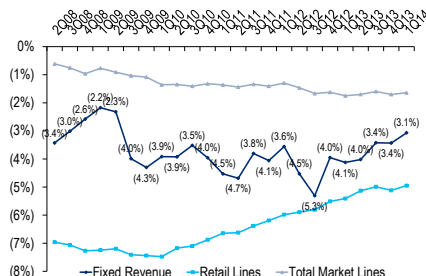
Source: Company Reports & Citi Research estimates

Figure 227. Drag on growth from MTR cuts



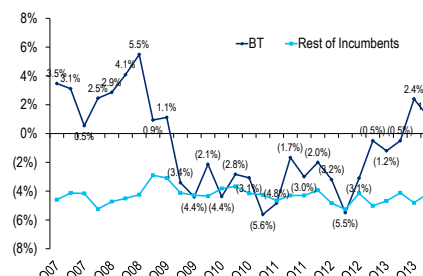
Source: Company Reports & Citi Research estimates

Figure 228. Europe fixed line revenue growth



Source: Company Reports & Citi Research estimates

Figure 229. BT ahead on fixed revenue growth



Source: Company Reports & Citi Research estimates

²⁹ Stocks mentioned: (BT.L; £4.05;) (SCMN.VX; \$Fr530.00; 1) (ISAL; £7.55; 1) (TLIT.MI; €1.00; 3) (ZONOP.LS; €4.99; 3)

Travel & Leisure - Hotels & Leisure

Re-rating largely complete, Earnings to follow

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- **Investment Thesis** – We have seen a substantial re-rating of most sector stocks in the last 4 years and most subsectors are now approaching prior peak valuations. We therefore focus on stocks that have will see above average earnings growth or which have coherent self-help stories.
- **Sector Themes** – 1) **Hotels** – Improving European economies should drive a positive supply/demand balance and reverse recent RevPAR underperformance. 2) **Caterers** – The global outsourcing trend and economic recovery support an attractive growing market but valuations are starting to look full. 3) **Gambling** – We expect a UK Online market shake-up around the new PoC tax in Dec 14. Market leaders are expected to reinforce their positions. Growth in newly regulated markets should continue 4) **Tour Operators** – Capacity concerns remain as LCC continue to increase their fleets. But improving consumer confidence, a more exclusive offering, and cost cutting should continue to drive growth. 5) **Pubs/Restaurants** – Growth in eating out continues to be the key long-term driver but improved sentiment on the UK consumer should be a short-term driver for the sector in 2014.
- **Strategy Themes** – Earnings Leadership - *Accor, Merlin, Thomas Cook*. Operating Leverage – *Accor, Merlin*. Restructuring/self-help – *Accor, Mitchells & Butlers, Thomas Cook*. Capital return – *Compass, Betfair, Intercontinental*. Corporate actions – *Accor, Betfair, Mitchells & Butlers*.
- **Valuation** – After a strong 2013 earnings multiples for the quality names are mostly above historic averages and we expect an increased focus on value, especially for companies that can deliver meaningful earnings growth as the cycle recovers or restructuring delivers.
- **Risks** – Our bias is moving towards value companies and as a result we see increased risk of operational mishaps. In particular our preference for UK/European exposure relies on an improving economy. Regulatory risks remain, in particular for Gaming and to a lesser extent Pubs whereas geo-political risks could impact Tour Operators and Hotels.
- **Stocks for the next 12 months** – Most favoured - *Accor, Greene King, Thomas Cook*. Least favoured – *bwin.party, Ladbrokes, Marstons*

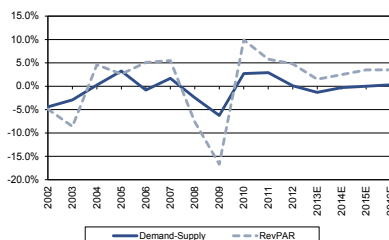
Hotels & Leisure: Most Favoured and Least Favoured

	Ticker	Rating	Price (Jun. 7)	Target Price	Yield (%)	ETR (%)	2015E		
							P/E	P/BV	ROE
Most Favoured									
Accor SA	ACCP.PA	Buy/1	€38.98	€42.00	2.1%	9.8%	22.8x	3.1x	14.0%
<i>Well placed to benefit from a cyclical recovery in Europe (70% of EBIT). The new CEO is bringing fresh impetus to restructuring</i>									
Greene King	GNK.L	Buy/1	£8.74	£10.00	3.4%	17.9%	13.6x	1.7x	12.8%
<i>Greene King is the quality name in the UK pubs space which should benefit from an improving UK consumer environment</i>									
Thomas Cook Group	TCG.L	Buy/1	£1.57	£2.50	0.0%	58.9%	9.6x	3.1x	30.8%
<i>Management's confidence in Wave 1 cost savings (£460m) has driven the announcement of £150m of new Wave 2 savings. We expect further progress over the summer</i>									
Least Favoured									
bwin.party digital entertainment plc	BPTY.L	Sell/3	£1.17	£0.95	3.2%	-15.6%	24.6x	1.6x	3.4%
<i>Ongoing declines in the group's European business and a slower than expected start in New Jersey are incompatible with c24x PE in our opinion</i>									
Ladbrokes	LAD.L	Sell/3	£1.52	£0.90	2.6%	-38.1%	18.7x	2.6x	15.0%
<i>Further delays in the online turnaround have caused us to lose faith in Ladbrokes. Given the upcoming POC tax we see further risks ahead</i>									
Marston's	MARS.L	Sell/3	£1.51	£1.25	4.4%	-12.8%	11.7x	1.0x	8.9%
<i>With around 50% of EBIT still coming from ex growth leased and tenanted pubs and high leverage we still see downside risks</i>									

Source: Citi Research, Powered by dataCentral

Hotels: Improved sentiment around the European economies suggests that we could be at the start of a renewed upgrade cycle for European focused hotel names. US RevPAR remains robust but we prefer those with leverage towards a European recovery (eg Accor

³⁰Figure 230. EU Supply/demand vs RevPAR



Source: STR, Citi Research

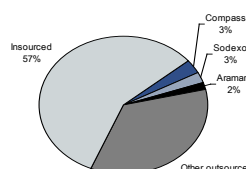
Figure 231. Hotels EV/EBITDA



Source: Datastream

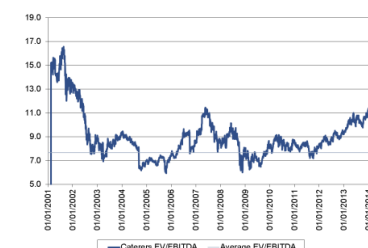
Caterers: Defensive sector with significant market share and growth opportunity for the larger players. Performed well in 2013 and somewhat geared to a European recovery. Compass remains our preferred play given its strong management, ongoing margin improvement and share buybacks.

Figure 232. On-Site Services market share



Source: Company data, Citi Research

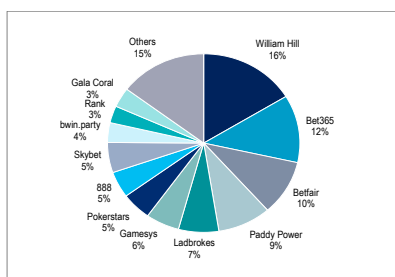
Figure 233. Caterers EV/EBITDA



Source: Datastream

Gaming: Ahead of the PoC tax in Dec 2014, we expect a market shake up in the highly competitive UK online market. We expect market leaders WHill and PAP to be winners. We remain concerned for those overly exposed to Retail (LAD). Pricing changes should provide a boost for Betfair.

Figure 234. Estimated UK online gambling market share -2012



Source: Gambling data, Citi Research

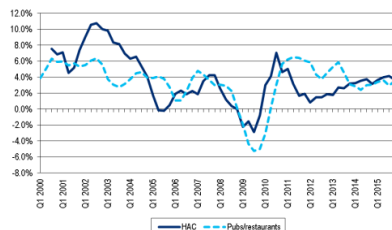
Figure 235. Gaming EV/EBITDA



Source: Datastream

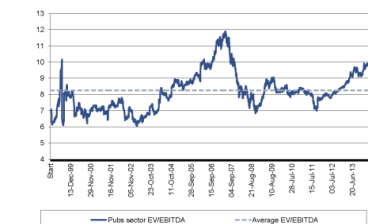
Pubs/Restaurants: We expect the eating out market to continue to grow at the expense of the drinking out market. Broader market growth should be supported by improving UK Household available cash. We prefer businesses that can generate higher/improving returns such as DOM, GNK, MAB

Figure 236. Household available cash improving



Source: ONS, Citi Research

Figure 237. Pubs EV/EBITDA



Source: Datastream

³⁰ Stocks mentioned: (ACCP.PA; €38.53; 1)/(IHG.L; £23.50; 1)/(WTB.L; £42.06; 2)/(CPG.L; £9.98; 2)/(TCG.L; £1.64; 1)/(WMH.L; £3.57; 1)/(PAP.L; €52.38; 2)/(BET.F.L; £9.87; 1)/(LAD.L; £1.54; 3)/(MAB.L; £4.20; 1)/(GNK.L; £8.56; 1)/(DOM.L; £5.71; 1)/(MERL.L; £3.64; 1)/(MARS.L; £1.51; 3)/(BPTY.L; £1.17; 3)/(888.L; £1.27; Not Rated)/(RNK.L; £1.61; Not Rated)/(EXHO.PA; €79.04; 2)/(ARMK.N; US\$26.42; Not Rated)

Travel & Leisure – Air Transport

Buy Flags on Restructuring; Ryanair for Growth and Cash

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- **Investment Thesis** – We expect flag carrier operating margin to double to c.4.8% in 2014 from c.2.4% in 2013, driven by cost restructuring, with most programs expected to deliver a 10% reduction in ex-fuel CASK by 2015. Ryanair and easyJet should register profitable growth (+7-10% EPS) and sustainable cash generation (6-7% FCF yield) over the medium term by winning market share. Airports are defensive but should deliver steadily increasing income.
- **Sector Themes** – In 2H14, we see industry capacity discipline starting to relax partly driven by AF-KLM and Lufthansa growing their LCC subsidiaries. We estimate +6% ASK in 2014, highest in 3 years. Main losers are likely to be 2nd-tier flag's where LCCs plan new bases. However, we expect limited consolidation by flag carriers given management focus on restructuring programs.
- **Strategy Themes** – Restructuring is a key catalyst for AF-KLM, IAG and Lufthansa. The three flag-carriers are in the midst of aggressive restructuring, mainly in loss-making short & medium-haul networks, with a 10% reduction in ex-fuel CASK expected by 2015. As weaker carriers retrench capacity, we expect Ryanair and easyJet to emerge as market share winners. Strong FCF generation at Ryanair (c.4% FCF yield) should support dividends and buybacks in line with our strategist's income/ de-equitisation theme.
- **Valuation** – Flag carrier P/B and EV/EBITDAR have rebounded from historic low levels driven by on-track restructuring progress. Among LCCs, Ryanair is currently trading at FY14E P/E of 16.3x.
- **Risks** – Main risks to flag carriers are: (i) a sharp increase in capacity (ii) deepening European recession (iii) labour strikes in opposition to restructuring (iv) resumption of oil price increases
- **Stocks for the next 12 months** – Top pick of the flag carriers are (i) IAG, on confidence in achieving 2015 restructuring objectives - €1.8bn op. profit and (ii) Lufthansa for value (CMP @ 44% discount to SOTP value of €35). Top pick among the LCCs is Ryanair for market share gain driven growth and cash returns. Vienna Airport and Fraport are our top pick airports for their FCF profile.

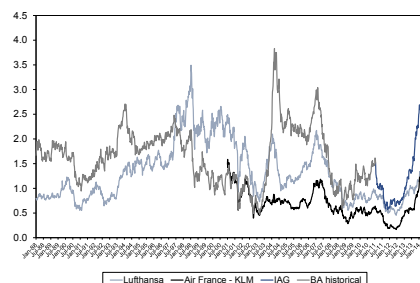
Air Transportation: Most Favoured and Least Favoured

	Ticker	Rating	Price (Jun. 10)	Target Price	Yield (%)	ETR (%)	2015E		
							P/E	P/BV	ROE
Most Favoured									
International Consolidated Airlines Group, S.A.	ICAG.MC	Buy/1	€5.12	€7.00	0.0%	36.7%	8.2x	1.9x	26.5%
<i>Iberia restructuring on track; High growth Vueling becoming increasingly valuable; BA's exposure to recovering premium traffic</i>									
Lufthansa	LHAG.DE	Buy/1	€19.93	€26.50	2.3%	35.3%	5.4x	0.8x	13.1%
<i>Least risky of flags, less exposed than IAG and AF-KLM to southern Europe, Best value- c.44% below SOTP value of €35</i>									
Ryanair	RYA.I	Buy/1	€7.51	€7.75	4.8%	7.9%	16.4x	3.1x	19.0%
<i>Profitable growth over medium term secured after aircraft order. Sustainable FCF generation should enable more buybacks and special dividends</i>									
Least Favoured									
Norwegian Air Shuttle ASA	NWC.OL	Sell/3	Nkr245.3	Nkr180.0	0.0%	26.6%	17.1x	2.5x	16.2%
<i>Norwegian's 260 short haul aircraft order unlikely to be absorbed by European market. Dilutive equity issuance likely, to fund aircraft order</i>									

Source: Citi Research, Powered by dataCentral

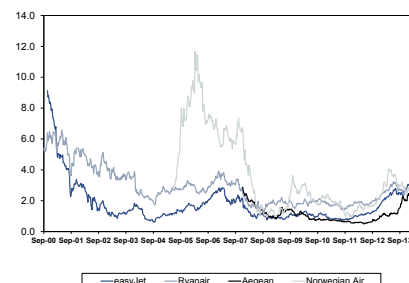
P/BV multiples off historical lows driven by capacity discipline, restructuring progress and stable oil prices

Figure 238. Flag Carrier P/BV, 1988-2014



Source: Citi Research Estimates, Datastream

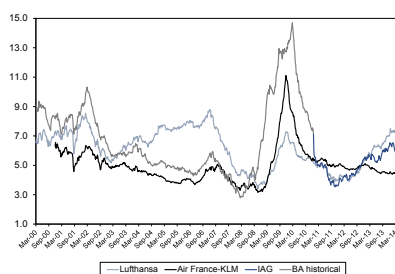
Figure 239. LCCs P/BV, 2000-14



Source: Citi Research Estimates, Datastream

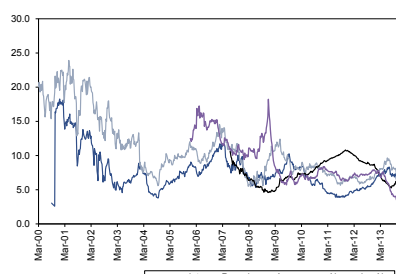
At historical averages post run-up in airline share prices

Figure 240. Flag Carrier EV/EBITDAR, 2000-14



Source: Citi Research Estimates, Datastream

Figure 241. LCCs EV/EBITDAR, 2000-14

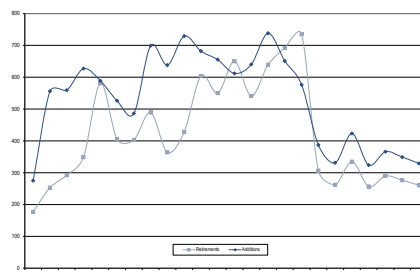


Source: Citi Research Estimates, Datastream

6% ASK growth expected in Europe for 2014; Aircraft additions at 370 a/c to outpace retirements of 262 a/c in 2014

Restructuring delivery to drive improvement in profitability

Figure 242. Summary of Aircraft Additions and Retirements, 1997-2020E (Europe)



Source: Company Reports, Ascend and Citi Research

Figure 243. European Airlines – Operating Income, 2014E-15E (€ millions)

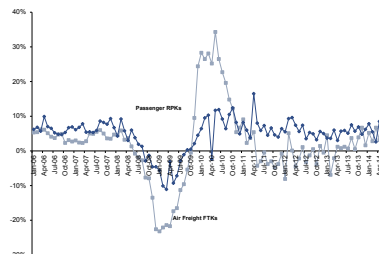
	Currency	FY14E	Margin	FY15E	Margin	% change
Operating Income						
Aegean Airlines	€	68	7.6%	82	8.3%	20.0%
Air Arabia	€	436	12.0%	558	13.2%	27.9%
Air France-KLM	€	790	3.1%	1,053	4.0%	33.3%
easyJet	£	579	12.6%	653	13.4%	12.8%
IAG	€	1,400	7.0%	2,009	9.5%	43.5%
Lufthansa	€	1,589	5.2%	2,314	7.2%	45.6%
Norwegian Air	NOK	836	4.1%	1,375	6.0%	64.3%
Royal Jordanian	JD	79	9.2%	90	10.0%	13.3%
Ryanair*	€	797	15.0%	926	16.2%	16.1%
SAS	SKr	1,062	2.7%	1,860	4.6%	75.2%
Turk Hava Yolları	TL	1,158	4.7%	1,483	5.3%	28.0%
Total	€	6,151*	5.8%	8,284	7.4%	34.7%

Source: Company Reports and Citi Research Estimates

Freight – some signs of stability on a low base

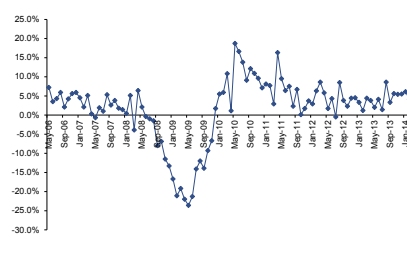
Corporate travel – growth stabilizing at 4-5% range

Figure 244. International Passenger & Freight Tonne Kms, 2006-13 (% Chg. YOY)



Source: IATA

Figure 245. Global Monthly Premium Traffic, 2006-13 (% Chg. YOY)



Source: IATA

³¹ Stocks mentioned: (AGN:AT; €8.29; 1); (AIRA.DU; Dh1.45; 1); (AIRF.PA; €11.47; 1); (EZJ.L; £16.00; 2); (FRAG.DE; €55.06; 1); (ICAG.MC; €4.98; 1); (LHAG.DE; €19.67; 1); (NWC.OL; Nkr238.60; 3); (RJAL.AM; JD0.470; 2); (RYA.I; €7.42; 1); (SAS.ST; SKr13.75; 2); (THYAO.IS; TL7.07; 1); (VIEV.VI; €69.22; 1)

Travel & Leisure – Surface Transport

Living with Low Volume Growth

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- **Investment Thesis** — The WTO sees global trade growth in 2014 of 4.5% vs. 2.5% in 2013 (weak intra EU trade) and 5.4% 20-year average with a continued bias to emerging markets with 6.3% growth. We expect this to translate to c.5% sea freight and c.2% global air freight market growth. We believe the stocks best equipped to deal with still challenging industry conditions are (1) DP World with >85% of EBITDA from emerging markets where 1Q14 volume growth was strong particularly in the UAE and pricing power remains strong; and (2) K + N with industry leading margins and returns and leading positions in many emerging markets backed by rising cash returns.
- **Sector Themes** — Ports and forwarders combine financial strength, sustainable organic growth from structural changes in global trade, varying degrees of operating leverage and further M&A in response to supply chain trends in the forwarding and logistics space and in the most financially and strategically challenged sub sectors (such as shipping).
- **Strategy Themes** — We view K + N as a key beneficiary of structural growth as supply chains in emerging markets become more sophisticated with potential to boost cash returns given nearly SFr1bn of excess cash. We also see scope for DP World to boost capital returns as the portfolio matures; to benefit from significant operating leverage inherent in a fixed cost business; and to continue to explore.
- **Valuation** — Relative valuation to global peers for these companies has improved due to the favourable positioning. Turnaround candidates such as Panalpina and TNT Express were re-rated in 2013 on economic optimism. K + N trades in line with US peers vs. a discount of 10-27% to US peers in recent years. DP World trades in line with other emerging market ports stocks on 12x 14E adjusted EV/EBITDA.
- **Risks** — We believe the key risks are slower than expected GDP growth and weaker confidence that impacts the flow of physical goods and also mix effects that impact revenue. Asset heavy businesses like shipping lines and ports with high fixed costs are exposed to persistent imbalances in supply and demand.
- **Stocks for next 12 months** — We highlight DP World and K + N as stocks for a still uncertain world where growth and future prospects are unevenly distributed. We believe onerous self-help expectations for some companies, particularly Panalpina, risk disappointment in 2014 as we do not expect tough market conditions (mix and lower average weight etc) seen since 2007 to assist turnaround situations.

³²Surface Transport: Most Favoured and Least Favoured

	Ticker	Rating	Price (Jun. 10)	Target Price	Yield (%)	ETR (%)	2015E		
							P/E	P/BV	ROE
Most Favoured									
Kuehne & Nagel International	KNIN.VX	Buy/1	SFr123.00	SFr130.00	3.2%	8.9%	20.2x	5.0x	25.8%
<i>Improving near term outlook allied to long term structural growth potential. Immediate and significant scope for capital returns given SFr1 bn of surplus cash</i>									
Least Favoured									
Panalpina	PWTN.S	Sell/3	SFr145.20	SFr118.00	1.4%	-17.4%	26.0x	4.3x	16.7%
<i>Unrealistic valuation given realistic assumptions on the pace and outcome of current restructuring</i>									

Source: Citi Research, Powered by dataCentral

³² Stocks mentioned: (KNIN.VX; SFr122.40; 1); (PWTN.S; SFr145.40; 3) (TNTN.AS; €6.52; 2) (DPW.DI; US\$20.00; 1)

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Utilities

Sell Gearing, Buy Growth

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- **Investment Thesis** – A lower for longer rates environment and a series of capex cuts and disposals has helped the sector drive FCF improvement and we expect that by 2016 dividends will finally be cash-flow covered. However, profitability remains under pressure and scope for further self-help measures is limited. With the sector on 16x 2016E PE we believe it is time to switch from the leveraged plays to those who can generate earnings growth.
- **Sector Themes** – Electricity and gas demand remains lackluster, despite improving economic growth. Renewables continue to both steal market share from traditional generation and to accentuate the oversupply situation. Regulation remains a headwind with concerns over rising customer bills and lost competitiveness vs the shale-gas fired US making headlines. Self-help is #1 in most utilities business plans, but further benefits are limited from here.
- **Strategy Themes** – During 2014-16 we expect utilities to continue to focus on self-help measures, reducing capex, cutting operating costs, reorganizing subsidiaries and tinkering with their portfolios in an effort to improve FCF. The sector overall has substantial operational leverage but with topline pressurized despite economic growth, this is acting as a headwind.
- **Valuation** – Sector is on 16x 2016 PE a premium to the broader market and at its highest level for more than a decade despite offering no earnings growth
- **Risks** – Regulation, further decline in commodity prices poor reinvestment of disposal proceeds are the main risks to the sector's outlook.
- **Stocks for the next 12 months** – Iberdrola, Suez Environnement, Pannon

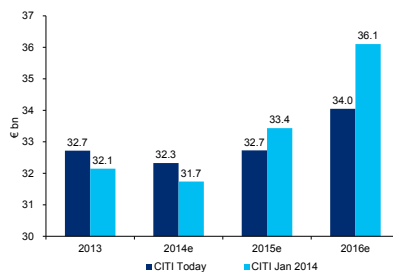
Utilities: Most Favoured and Least Favoured

	Ticker	Rating	Price (Jun. 7)	Target Price	Yield (%)	ETR (%)	2015E		
							P/E	P/BV	ROE
Most Favoured									
Iberdrola	IBE.MC	Buy/1	€5.38	€5.40	5.0%	5.4%	15.2x	0.9x	6.1%
<i>Able to generate earnings and dividend growth through free cash flow deployment</i>									
Suez Environnement	SEVI.PA	Buy/1	€15.21	€15.00	4.3%	2.9%	19.1x	1.8x	11.2%
<i>Balance sheet headroom, improving in ROCE and FCF generation create scope for modest organic and top-up inorganic growth</i>									
Pannon Group PLC	PNN.L	Buy/1	£7.84	£7.80	4.1%	3.6%	17.1x	2.5x	14.8%
<i>Enhanced status in regulatory review provides long-term visibility and improving UK economy and project commissioning help EPS growth</i>									
Red Electrica de Espana SA	REE.MC	Buy/1	€64.77	€58.00	4.5%	-6.0%	16.2x	3.6x	22.8%
<i>Pending regulatory visibility should allow stock to rerate to in-line with peers and creates scope for material regearing</i>									
Drax Group Plc	DRX.L	Buy/1	£6.37	£7.50	3.3%	21.1%	17.8x	1.7x	9.7%
<i>Stock is pricing in near to a worse-case scenario whereas we see scope for biomass conversion and UK market tightening to create value</i>									
Least Favoured									
RWE AG	RWEG.DE	Sell/3	€29.66	€24.80	3.4%	-13.0%	15.5x	2.1x	13.7%
<i>Stretched balance sheet and declining profitability increase the risk of a substantial capital increase</i>									
ENEL SpA	ENEI.MI	Sell/3	€4.27	€3.50	3.0%	-14.9%	14.6x	1.0x	7.1%
<i>Business plan targets look too ambitious and dividend increase expectations likely too optimistic</i>									
SSE PLC	SSE.L	Sell/3	£15.56	£12.70	5.6%	-12.8%	12.7x	2.4x	19.6%
<i>UK supply market review and rising competition pose risks to medium-term earnings profile.</i>									
E.ON AG	EONGn.DE	Sell/3	€14.42	€11.50	4.2%	-16.1%	17.8x	0.8x	4.6%
<i>International expansion unlikely to deliver earnings growth, whereas domestic core business remains under pressure</i>									
Energias de Portugal	EDP.LS	Sell/3	€3.62	€3.00	5.1%	-12.0%	16.1x	1.5x	9.0%
<i>Business plan and consensus expectations too high, In our opinion dividend only sustainable at the expense of growth</i>									

Source: Citi Research, Powered by dataCentral

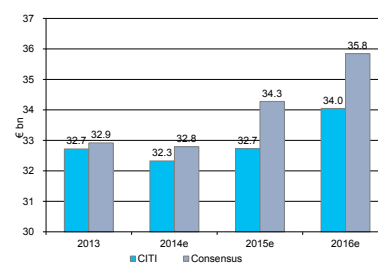
Earnings momentum yet to turn positive

³³Figure 246. Another 2% earnings cut ytd



Source: Citi Research

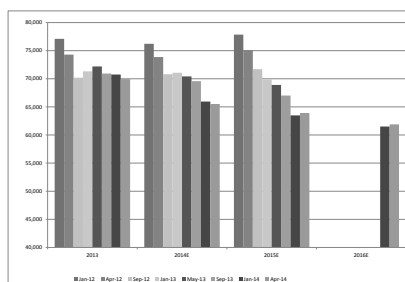
Figure 247. Citi estimates below consensus



Source: IBES and Citi Research Estimates

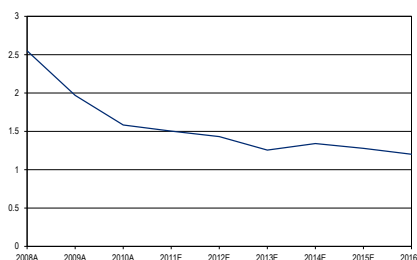
Scope for self-help reduces post 2016

Figure 248. Capex revisions coming to an end?



Source: Company data, Citi Research Estimates.

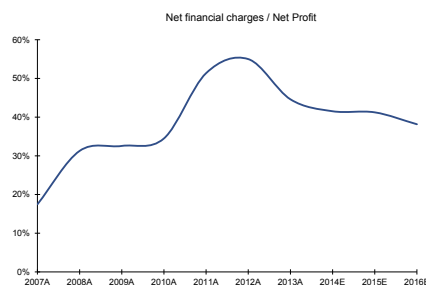
Figure 249. Capex/D&A declining



Source: Company data, Citi Research estimates

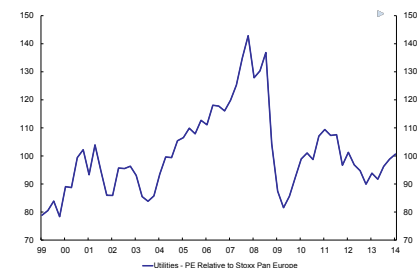
Lower for longer interest rate environment has cushioned earnings and boosted PE multiple

Figure 250. Declining rates have benefited EPS



Source: Company data and Citi Research estimates.

Figure 251. Sector moved to premium to market



Source: Datastream, IBES and Citi Research.

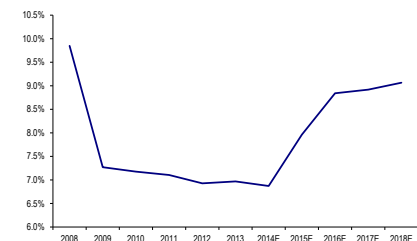
Iberdrola and Suez Environnement, can deliver earnings growth and feature in our top picks

Figure 252. 1/3 of Iberdrola (IBE.MC; €5.28; 1) cash flow is for growth

2014-2016e	
Operating Cash Flow	13,849
Capex & Capitalised costs	(10,377)
Operating Free Cash Flow	3,471
Dividends & Share buybacks	(5,031)
Ordinary Net Cash Generation	(1,560)
Tariff deficit securitisation	1,430
Disposals	776
deconsolidation of NEO	800
FX/others	311
Net Debt Reduction	1,772

Source: Citi Research.

Figure 253. Suez Environnement's (SEVI.PA; €14.79; 1) ROCE on a rising trend



Source: Company data and Citi Research Estimates.

³³ Stocks mentioned: (IBE.MC; €5.26; 1); (PNN.L; £7.61; 1); (SEVI.PA; €14.80; 1)

Euro SMID

Still attractive despite continued re-rating

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- **Investment Thesis** – European mid- and small caps are now both trading at a c.20% premium to average. Having been considerably re-rated in recent years, we don't expect ratings to expand meaningfully from here. Despite this, we continue to be positive on the space but believe earnings growth will be most important from here, hence our focus on earnings momentum strategies. Also, subdued levels of M&A in 2013 particularly amongst SMID vs. large-caps could mean more corporate activity in 2014, another measure of rising risk appetite.
- **Sector Themes** – Our key themes for 2014 are 1) Earnings momentum 2) Low leverage/strong FCF and 3) Disinflation strategies
- **Valuation** – On a P/E basis, SMID cap equities have continued to re-rate in 2014. Mid-caps have re-rated by about 3% to trade currently on c.16x 12m forward earnings. Small-caps have seen more of a rerating (+4%) YTD and trade on a 21% premium to the 7-year average at 16.2x trailing earnings.
- **Risks** – We believe slowing European economic growth in 2014 and particularly disinflation would present a significant headwind to equities, particularly those who are highly levered. Additionally, the likely tapering of quantitative monetary easing in the UK may reduce risk appetites and subsequently demand for equities. On the upside continued UK and US economic growth could see equities perform significantly better than expectations. Increased M&A activity, especially among the SMID universe would also be a significant driver to equities.
- **Stocks for the next 12 months** – Our key Buys are exposed to two broad themes; earnings momentum, low leverage and corporate restructuring/self-help. For more details, see the [European SMID Monthly](#).

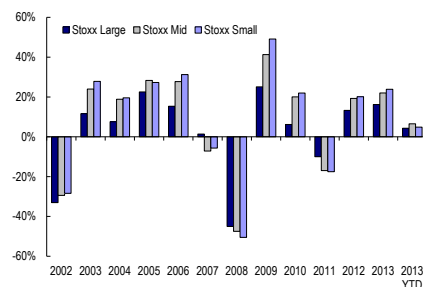
³⁴Figure 254. European SMID – Key Buys (Priced at close 10 June 2014)

Key Buys							
RIC	Company	Sector	Country	MV €bn	Curr	Curr price LC	T.Price LC
AGL.MI	Autogrill	Consumer Services	Italy	1.8	EUR	7.02	7.9
AKE.PA	Arkema	Materials	France	4.8	EUR	74.80	90.0
AMEAS.HE	Amer Sports	Consumer Durables & Apparel	Finland	1.8	EUR	15.42	18.0
ANDR.VI	Andritz	Capital Goods	Austria	4.5	EUR	43.50	51.5
DLL.AS	Delta Lloyd	Insurance	Netherlands	3.5	EUR	18.38	22.5
ELUXb.ST	Electrolux	Consumer Durables & Apparel	Sweden	5.6	SEK	164.60	190.0
FRAG.DE	Fraport	Transportation	Germany	5.0	EUR	53.99	69.0
G1AG.DE	GEA	Capital Goods	Germany	6.4	EUR	33.38	37.0
GFJG.DE	Gagfah	Real Estate	Luxembourg	2.7	EUR	12.64	14.1
IGG.L	IG Grp	Diversified Financials	United Kingdc	2.6	GBP	5.81	7.0
KUNN.S	Kuoni	Consumer Services	Switzerland	1.3	CHF	384.75	510.0
MED.MI	Mediolanum	Insurance	Italy	4.7	EUR	6.43	7.6
PNDORA.CO	Pandora	Consumer Durables & Apparel	Denmark	7.1	DKK	410.80	450.0
SMDS.L	DS Smith	Materials	United Kingdc	3.7	GBP	3.19	3.5
TUIGn.DE	TUI	Consumer Services	Germany	3.5	EUR	12.69	15.5

³⁴ Stocks mentioned: (AGL.MI; €7.06; 1); (AKE.PA; €76.10; 1); (AMEAS.HE; €15.49; 1); (ANDR.VI; €43.23; 1); (DLL.AS; €18.44; 1); (ELUXb.ST; SKr167.20; 1); (FRAG.DE; €55.06; 1); (G1AG.DE; €33.38; 1); (GFJG.DE; €12.69; 1); (IGG.L; £5.84; 1); (KUNN.S; SFr379.00; 1); (MED.MI; €6.51; 1); (PNDORA.CO; Dkr413.50; 1); (SMDS.L; £3.24; 1); (TUIGn.DE; €12.83; 1)

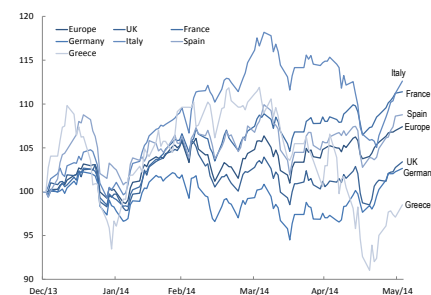
If current trends persist, 2014 will be another year of SMID caps outperformance

Figure 255. Annual Performance by Size



Source: Datastream

Figure 256. YTD Performance by Market



Source: Datastream

Both small and mid-caps have continued to re-rate through 2014

Figure 257. Stoxx Small-Cap PE



Source: Datastream

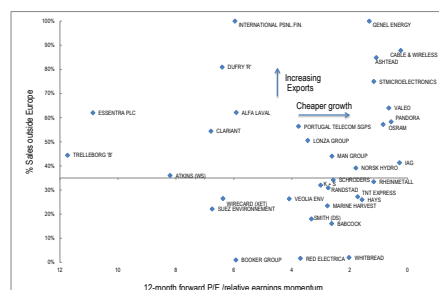
Figure 258. Stoxx Mid-Cap PE



Source: Datastream

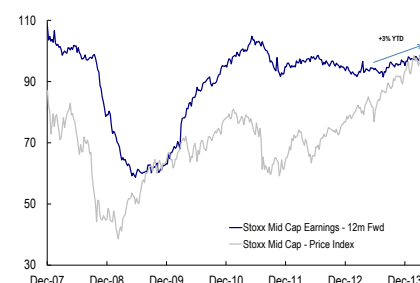
Market earnings are weak, companies with earnings momentum stand to benefit

Figure 259. Exporters and PEG



Source: company reports, Datacentral and Datastream.

Figure 260. Mid-cap earnings and growth indices



Source: Datastream.

During periods of disinflation we want exposure to companies with revenues outside Europe and low leverage

Figure 261. Exporters with low leverage

RIC	Company	Price	Rating	Net Debt/EBITD	Ex Europe Sales
FRES.L	Fresnillo Plc	9.7	3	0.2	100%
GENL.L	Genel Energy	12.8	1	-1.2	100%
FLS.CO	FLSmith	42.6	1	1.5	90%
MTXGN.DE	MTU Aero Engines	67.4	2	1.2	82%
VLLP.PA	Vallourec	40.8	2	1.6	81%
LUX.MI	Luxottica Group SpA	41.6	1	0.7	79%
PGS.OL	PGS	7.9	2	0.9	78%
STM.PA	STMicroelectronics	7.1	3	-0.8	75%
GEPL.PA	CGG	9.9	3	1.8	74%
PECL.MI	Pirelli	12.5	2	1.0	72%

Source: Company reports and Datastream.

Figure 262. Euro dominated high leverage

RIC	Company	Price	Rating	Net Debt/EBITD	Europe Sales
ENAG.MC	Enagas SA	21.5	1	3.5	100%
GETP.PA	Groupe Eurotunnel	9.7	1	7.6	100%
LUPE.ST	Lundin Petroleum	14.4	1	3.9	100%
TDC.CO	TDC	7.2	2	2.3	100%
PTNL.AS	PostNL NV	3.5	2	2.2	100%
REE.MC	Red Elctrica de Espana SA	62.4	1	3.6	98%
EDF.PA	Electricite de France	25.5	2	2.8	93%
GALP.LS	Galp Energia	13.0	1	2.3	91%
FER.MC	Ferrovial, S.A.	15.8	1	6.6	90%
EDP.LS	Energias de Portugal	3.5	3	4.8	89%

Source: Company reports and Datastream.

35 Stocks mentioned: (FRES.L; £7.87; 3); (GENL.L; £10.31; 1H); (FLS.CO; Dkr313.20; 1); (MTXGN.DE; €68.65; 2); (VLLP.PA; €39.82; 2); (LUX.MI; €42.02; 1); (PGS.OL; Nkr66.10; 2); (STM.PA; €7.18; 3); (GEPL.PA; €10.29; 3); (PECL.MI; €12.52; 2); (ENAG.MC; €21.52; 1); (GETP.PA; €9.90; 1); (LUPE.ST; SKr130.30; 1); (TDC.CO; Dkr53.60; 2); (PTNL.AS; €3.61; 2); (REE.MC; €65.25; 1); (EDF.PA; €26.45; 2); (GALP.LS; €13.01; 1); (FER.MC; €16.35; 1); (EDP.LS; €3.70; 3)

UK SMID

The Grind Higher

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- **Investment Thesis** – The FTSE 250 has had a slow start to the year (+0.2% YTD vs. +1.3% for FTSE 100 and +1.4% for FTSE Small Cap). Despite a c.5% de-rating YTD, the FTSE 250 remains on a c.9% premium vs. its historical average on a forward 12m PE basis. Looking to the second half, we continue to believe that 2014 will be a year of gradual progress for the FTSE 250. We see potential for support from M&A, but this has been slow to get going despite improved business investment confidence.
- **Strategy Themes** – We continue to back stocks with; 1) Positive/stable earnings mo, in particular those which have underperformed YTD (e.g. Senior and DS Smith), 2) Attractive (i.e. >3.5%) and growing dividend yields (e.g. IG Group), and 3) Self-help stories which are capable of driving revenues and earnings upwards, regardless of the wider macro outlook.
- **Valuation** – The FTSE 250 trades at c.9% premium to its 12m forward PE historical average. Further, it is also trading at a 9% premium to the FTSE 100 on a forward 12m PE basis (vs. a 6% average discount historically).
- **Risks** – 2014 median EPS growth for the FTSE 250 is looking more reasonable at c.6% YoY growth. However, the 10% growth for 2015 clearly assumes the economic recovery is sustained. That said, an easing FX headwind could prove supportive to accelerating EPS growth rates.
- **Stocks for the next 12 months** – The top picks from our coverage are DS Smith, IG Group and Senior. Our least favoured names are Balfour Beatty and Fidessa.

UK SMID: Most Favoured and Least Favoured

	Ticker	Rating	Price (Jun. 10)	Target Price	Yield (%)	ETR (%)	2015E		
							P/E	P/BV	ROE
Most Favoured									
DS Smith PLC	SMDS.L	Buy/1	£3.23	£3.50	2.6%	10.8%	13.1x	2.4x	15.9%
We continue to see upside from an improving macro outlook, revenue growth initiatives, and industry consolidation.									
IG Group	IGG.L	Buy/1	£5.85	£7.00	4.1%	23.9%	14.1x	3.4x	25.3%
We see upside potential to our numbers driven by increased traction with strategic initiatives such as share dealing from calendar H2 2014.									
Senior	SNR.L	Buy/1	£2.88	£3.30	1.9%	16.4%	13.1x	2.6x	20.5%
We continue to see upside driven by continued growth in the Aerospace division, the continuing cyclical recovery in Flexonics, and further incremental acquisitions.									
Least Favoured									
Balfour Beatty	BALF.L	Neutral/2	£2.39	£2.33	5.4%	3.0%	11.6x	1.6x	11.1%
Uncertainty remains over the operational performance and outlook for the UK construction business, as well as the group's strategy going forward with a disposal of Professional Services planned.									
Fidessa	FDSA.L	Neutral/2	£23.76	£24.85	1.6%	6.2%	25.4x	4.8x	19.9%
Fidessa is well positioned for robust growth on a medium term basis, but we believe this outlook is largely factored in to the premium valuation.									

Source: Citi Research, Powered by dataCentral

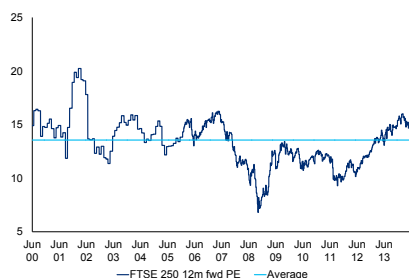
Despite de-rating 5% YTD, the FTSE 250 remains at c.9% premium vs. its long-run average fwd 12m PE. Earnings growth is the key to drive the index higher.

With the exception of the Russell 2000, Chinese mid-caps and Emerging EMEA, the FTSE 250 has underperformed YTD, while value has outperformed growth by c. 2% in the past 12 months.

Earnings downgrades have continued (net downgrades for 35 consecutive months). Median EPS growth for 2014 is now 6%.

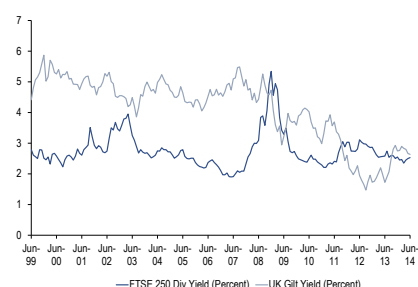
YTD the 4th and 5th deciles have been the best performers. We are beginning to see a recovery in business confidence, particularly the US and UK.

Figure 263. FTSE 250 —12m Fwd P/E



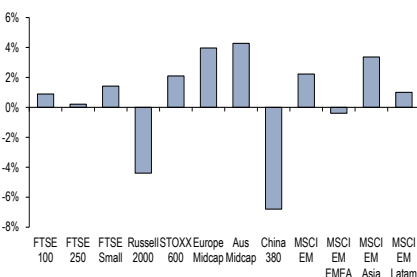
Source: DataStream & Citi Research, as of 04/06/2014

Figure 264. FTSE 250 Divi Yield vs Gilts



Source: DataStream, as of 04/06/2014

Figure 265. YTD Market Performance (£ equivalents)



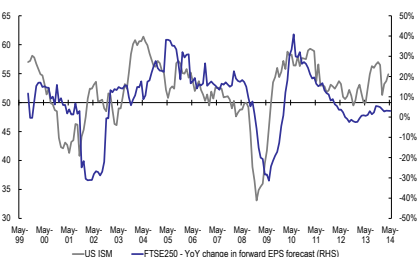
Source: DataStream, Citi Research, as of 04/06/2014

Figure 266. Value vs. Growth



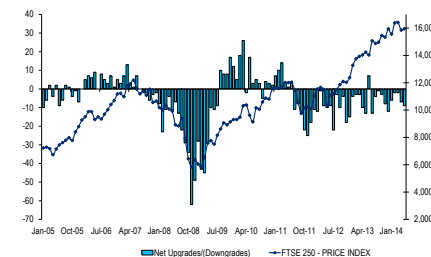
Source: DataStream, as of 04/06/2014

Figure 267. ISM vs FTSE 250 12m Fwd Earnings



Source: DataStream & Citi Research

Figure 268. FTSE 250 Net up/downgrades >5%



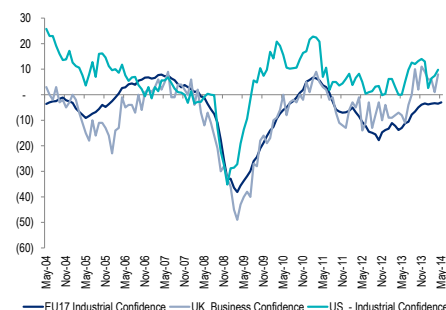
Source: DataStream & Citi Research

Figure 269. FTSE 250 PE Deciles Performance

	Av. PER	1m	3m	6m	12m	Y2D
1st Decile	50.2	3.3%	-6.1%	0.9%	14.1%	2.0%
2nd Decile	22.1	2.1%	-4.1%	6.3%	18.8%	1.6%
3rd Decile	19.5	-1.2%	-6.0%	6.7%	9.7%	-0.9%
4th Decile	17.6	0.1%	-1.7%	10.7%	22.0%	4.4%
5th Decile	16.3	0.1%	-3.8%	7.9%	21.1%	4.1%
6th Decile	14.8	0.6%	-6.9%	8.3%	25.1%	2.1%
7th Decile	13.8	-2.2%	-7.3%	2.6%	17.8%	-3.4%
8th Decile	12.6	-2.1%	-5.3%	-4.3%	8.6%	-6.2%
9th Decile	11.6	-2.4%	-8.7%	5.3%	17.8%	0.4%
10th Decile	6.9	-0.4%	1.2%	10.6%	12.4%	2.9%

Source: DataStream & Citi Research

Figure 270. Business Confidence Index



Source: DataStream & Citi Research

³⁶ Stocks mentioned: (BALF.L; £2.40; 2); (FDSA.L; £23.98; 2); (IGG.L; £5.84; 1); (SMDS.L; £3.21; 1); (SNRL; £2.91; 1)

Italy

Same Old Risks, New Potential Opportunities

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- **Investment Thesis** – We see a glimmer of hope that the worst may be over for Italy and we give Matteo Renzi the benefit of the doubt – although it may take a little bit longer than market hopes to change Italy. At the very least, we do not expect Italy to revert to being the epicentre of the financial crisis in the short term.
- **Sector Themes** – We maintain our positive view on Italy (see [Same Old Risks, New \(Potential\) Opportunities](#)), as years of underperformance leave room for further outperformance of Italian equities in a broader positive equity market environment. However, investors should bear in mind that gains would result in multiple expansion given both the macro picture (see [Italy - Q1 GDP Downward Surprise and Political Uncertainty](#)) and the limited scope of the Italian Stock Exchange.
- **Strategy Themes** – While for our strategists Italy scores 4th on earnings momentum and 3rd on price/book relative to history vs. other Western European countries, we would advise investors to implement a barbell strategy, favoring banks/financials and quality stocks, while avoiding fully domestic stocks.
- **Valuation** – The combination of a limited number of investable stocks and the renewed interest of overseas investors (who have been underweight Italy for nearly a decade) in Italian stocks is fuelling multiple expansion in the Italian equity market. However, investors should bear in mind that there is a widening gap between fundamentals and stock prices, and that – given the state of the Italian economy – fundamentals are unlikely to improve in the short term.
- **Risks** – macro environment remains weak and Matteo Renzi's honeymoon period with Italians might end abruptly if the PM fails to deliver on promises
- **Stocks for the next 12 months** – Our Buys include **Autogrill**, **Luxottica**, **Prysmian**, **Yoox** and **WDF**, as well as **Unicredit**, **Mediobanca** and the asset gatherers **Banca Generali** and **Mediolanum**.

Italy: Most Favoured and Least Favoured

	Ticker	Rating	Price (Jun. 10)	Target Price	Yield (%)	ETR (%)	2014E		
							P/E	P/BV	ROE
Most Favoured									
Autogrill SpA	AGL.MI	Buy/1	€7.02	€7.90	0.0%	12.6%	59.4x	4.0x	7.0%
Restructuring potential. Three drivers of margin enhancements: 1) recovery in US; 2) re-shaping of EU operations; 3) re-engineering of Italian operations.									
Luxottica Group SpA	LUX.MI	Buy/1	€41.93	€47.00	1.9%	14.0%	27.8x	4.3x	16.2%
The world leader in eyewear, a sector experiencing secular trends: 1) ageing population in AE; 2) unpenetrated EM; 3) sunglasses premiumization.									
Banca Generali SpA	BGN.MI	Buy/1	€22.66	€27.00	4.2%	23.3%	17.0x	5.5x	33.7%
Well positioned to prosper in the structurally growing financial advisory industry, thanks to solid business model and management team as well as best in class network. The stock also offers best in class dividend yield (c.4.5%)									
Least Favoured									
Mediaset SpA	MS.MI	Sell/3	€3.82	€2.70	0.0%	-29.4%	43.6x	2.0x	4.8%
Core FTA experiencing steep decline in advertising with recovery still missing. DTT channels increase programming costs. PPV is loss making business.									
Arnoldo Mondadori Editore	MOED.MI	Sell/3	€1.21	€0.77	0.0%	-36.6%	16.6x	0.8x	4.9%
Highly exposed to declining magazine business, suffering from negative trends in circulation and advertising. High gearing.									
Landi Renzo	LR.MI	Sell/3	€1.28	€0.87	0.0%	-32.0%	-47.7x	1.1x	-2.3%
We fear Landi might struggle to capitalize on CNG (and LNG) global opportunity. Gearing is back to uncomfortable levels.									

Source: Citi Research, Powered by dataCentral

[†] **Stocks mentioned:** (AGL.MI; €6.78,1), (LUX.MI; €41.62,1), (PRY.MI; €17.00,1), (YOOX.MI; €22.98,1), (WDF.MI; €9.93,1), (CRDI.MI; €6.23,1), (MDBI.MI; €7.12; 1H), (BGN.MI; €20.87,1), (MED.MI; €6.11,1)

Figure 271. Stocks Mentioned in Equity Strategy Note

Stock	RIC	Price	Rating	Currency	Stock	RIC	Price	Rating	Currency
A P Moller - Maersk B	MAERSKb.CO	14,520.00	2	DKK	Legrand	LEGD.PA	45.58	2	EUR
Accor	ACCP.PA	38.97	1	EUR	Lloyds Banking	LLOY.L	0.79	2	GBP
Adecco R	ADEN.VX	75.55	3	CHF	L'Oreal	OREP.PA	129.05	2	EUR
Aegon	AEGN.AS	6.52	2	EUR	LVMH	LVMH.PA	144.35	1	EUR
Akzo Nobel	AKZO.AS	54.20	1	EUR	Michelin	MICP.PA	91.37	1	EUR
Alcatel-Lucent	ALUA.PA	2.89	1	EUR	Natixis	CNAT.PA	5.14	2	EUR
Anheuser-Busch Inbev	ABI.BR	83.31	1	EUR	Nestle R	NESN.VX	69.65	1	CHF
Ashtead Group	AHT.L	9.06	1	GBP	Next	NXT.L	64.24	1	GBP
ASML Hldg	ASML.AS	66.15	1	EUR	Nordea Bank	NDA.ST	99.40	1	SEK
Assa Abloy B	ASSAb.ST	340.30	3	SEK	Norsk Hydro	NHY.OL	33.35	2	NOK
AstraZeneca	AZN.L	43.62	1	GBP	Novo-Nordisk	NOVOB.CO	244.30	1	DKK
Atlas Copco A	ATCOa.ST	194.50	1	SEK	Pearson	PSON.L	11.31	1	GBP
Aviva	AV.L	5.29	1	GBP	Philips Electronics	PHG.AS	23.80	1	EUR
AXA	AXAF.PA	18.53	1	EUR	Publicis Groupe	PUBP.PA	63.22	2	EUR
BAE Systems	BAES.L	4.25	2	GBP	Reckitt Benckiser	RB.L	51.24	1	GBP
Banco Santander	SAN.MC	7.82	2	EUR	Reed Elsevier	REL.L	9.49	1	GBP
Barclays	BARC.L	2.41	1	GBP	Renault	RENA.PA	69.53	1	EUR
BG	BG.L	12.28	1	GBP	Richemont N	CFR.VX	92.45	1	CHF
BHP Billiton	BLT.L	18.85	1	GBP	Rio Tinto	RIO.L	31.48	1	GBP
BMW	BMWG.DE	91.68	2	EUR	Roche	ROG.VX	271.30	1	CHF
BNP Paribas	BNPP.PA	51.34	1	EUR	Rolls-Royce Holdings	RR.L	10.51	2	GBP
British American Tobacco	BATS.L	35.35	1	GBP	Safran	SAF.PA	49.82	1	EUR
BSKyB	BSY.L	8.67	1	GBP	Saint Gobain	SGOB.PA	42.75	1	EUR
BT Group	BT.L	3.96	1	GBP	Sanofi	SASY.PA	79.45	2	EUR
CaixaBank	CABK.MC	4.65	1	EUR	SAP	SAPG.DE	55.32	1	EUR
Cap Gemini	CAPP.PA	53.29	1	EUR	Schneider Electric	SCHN.PA	69.84	2	EUR
Centrica	CNA.L	3.30	2	GBP	SEB A	SEBa.ST	92.35	1	SEK
Commerzbank	CBKG.DE	12.50	2H	EUR	SES Fdr	SESFd.PA	27.11	1	EUR
Continental	CONG.DE	173.20	1	EUR	SKF B	SKFb.ST	172.30	2	SEK
CRH	CRH.L	17.04	2	GBP	Solvay	SOLB.BR	120.30	3	EUR
Daimler	DAIGn.DE	69.44	2	EUR	Swatch B	UHR.VX	528.00	2	CHF
Danske Bank	DANSKE.CO	156.80	1	DKK	Swedbank A	SWEDa.ST	180.30	2	SEK
Deutsche Post	DPWGn.DE	26.69	1	EUR	Syngenta	SYNN.VX	337.30	2	CHF
Diageo	DGE.L	19.01	1	GBP	Travis Perkins	TPK.L	16.76	1	GBP
Ericsson B	ERICb.ST	83.45	2	SEK	UBI Banca	UBI.MI	7.16	2H	EUR
Fiat	FIA.MI	7.88	3	EUR	UBS R	UBSN.VX	17.99	1	CHF
Henkel Pref.	HNKG_p.DE	85.46	2	EUR	Unibail-Rodamco	UNBP.AS	210.45	NR	EUR
Imperial Tobacco Gp.	IMT.L	26.13	2	GBP	Unicredit	CRDI.MI	6.78	1	EUR
Infineon Technologies	IFXGn.DE	9.02	2	EUR	Unilever (UK)	ULVR.L	26.88	2	GBP
Intesa Sanpaolo	ISP.MI	2.58	2	EUR	Unilever Certs.	UNc.AS	32.22	2	EUR
KBC Groupe	KBC.BR	42.24	1	EUR	Valeo	VLOF.PA	102.90	1	EUR
Kering	PRTP.PA	164.90	1	EUR	Veolia Env.	VIE.PA	14.34	2	EUR
Kingfisher	KGF.L	3.83	1	GBP	Vestas Windsystems	VWS.CO	294.20	2	DKK
Kone B	KNEBV.HE	30.12	3	EUR	Vinci	SGEF.PA	56.55	NR	EUR
Koninklijke DSM	DSMN.AS	51.78	1	EUR	Wolseley	WOS.L	33.37	1	GBP
Legal & General	LGEn.L	2.32	2	GBP	WPP	WPP.L	13.09	2	GBP

Source: Citi Research (June 10th)

Appendix A-1

Analyst Certification

The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

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Pradeep Pratti, Analyst, holds a long position in the securities of Pfizer, Tate and Lyle.

Robert S Morris, Analyst, holds a long position in the securities of Chesapeake Energy Corp, Canadian Natural Resources Ltd, Occidental Petroleum Corp.

Alexander J Glasner, Associate, holds a long position in the securities of Tesco, International Consolidated Airlines Group, S.A., Burberry Group PLC, Lloyds Banking Group PLC.

A member of the household of Ronald Paul Smith, Analyst, holds a long position in the securities of Henkel, Bayer AG.

A member of the household of Ehud Gelblum, Ph.D., Analyst, holds a long position in the securities of Alcatel-Lucent.

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Banche Italiane, Toyota Motor, Nordea, Glencore PLC, Continental AG, Aegon NV, Alcatel-Lucent, HeidelbergCement AG, Rolls Royce, Fresnillo Plc, BNP Paribas SA, Africa Oil Corp, Aviva PLC, Gagfah SA, BMW AG, Reckitt Benckiser, HSBC Holdings PLC, Zurich Insurance Group, Volkswagen AG, ProSiebenSat.1 Media, Ageas SA/NV, Societe Generale, Danone, PZU, Pfizer, International Consolidated Airlines Group, S.A., Energias de Portugal, Procter & Gamble Co, Electricite de France, Steinhoff International Holdings Ltd, Nissan Motor, Lloyds Banking Group PLC, Antofagasta, Pernod-Ricard, Skandinaviska Enskilda Banken AB, Tesco, General Motors Company, Sinopec, Repsol, Swedbank AB, Bayer AG, Nestle, Sanofi SA, Intesa Sanpaolo, Enagas SA, AB SKF, Valeo SA, Banco Popolare, Danske Bank A/S, Capgemini SA, Total, Barclays PLC, African Barrick Gold Plc, Credit Suisse, Imperial Oil Limited, ENEL SpA, Diageo, Balfour Beatty, Banca Popolare di Milano, Daimler AG, Safran, Afren, Natixis, Renault SA, Telecom Italia SpA, Ecopetrol, Merlin Entertainments PLC, Chesapeake Energy Corp, Anglo American PLC, SABMiller, Banco Santander, Canadian Natural Resources Ltd, Petrobras, Unilever PLC, Delta Lloyd, CaixaBank SA, Iberdrola, Chevron, Exxon Mobil Corp, AXA SA, Suez Environnement, BP, BHP Billiton PLC, Centrica PLC, Peugeot SA, France.

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Sanofi SA, Intesa Sanpaolo, Enagas SA, Vallourec, London Stock Exchange PLC, Lukoil, Drax Group Plc, IG Group, Woodside Petroleum Ltd, AB SKF, Publicis Groupe SA, Ferrovial, S.A., Valeo SA, MTU Aero Engines, Hikma Pharmaceuticals, PhosAgro, Pandora, Red Electrica de Espana SA, Michael Page Group, Compass Group, L'Oréal, Banco Popolare, Rio Tinto PLC, Danske Bank A/S, Panalpina, Capgemini SA, Securitas, Total, STMicroelectronics, Barclays PLC, African Barrick Gold Plc, Legrand, Tullow Oil, Experian, OMV AG, Michelin, Swedish Match AB, Munich Re, Beiersdorf, Credit Suisse, SIG PLC, Dassault Systemes SA, Sky Deutschland, Imperial Oil Limited, Tate and Lyle, Vivendi, Schneider Electric, Admiral Group, Royal Jordanian Airlines, ITV PLC, British American Tobacco PLC, AstraZeneca PLC, ENEL SpA, Diageo, Cenovus Energy, Balfour Beatty, Galp Energia, LVMH, Linde AG, Friends Life, Pirelli, Assa Abloy, Banca Popolare di Milano, Daimler AG, Buzzi Unicem, Occidental Petroleum Corp, Infineon Technologies, Safran, Sampo Oyj, Carlsberg, Afren, Soco International, Natixis, Renault SA, ASOS Plc, Telecom Italia SpA, Shire Pharmaceuticals, Ecopetrol, JCDecaux, Coca Cola HBC AG, Reed Elsevier PLC, Nokian Tyres plc, Thomas Cook Group, Hannover Re, Chesapeake Energy Corp, Anglo American PLC, SABMiller, Ericsson LM, Cairn Energy, World Duty Free, Banco Santander, Hiscox Ltd, Canadian Natural Resources Ltd, Petrobras, Nokia Oyj, Unilever PLC, Landi Renzo, Premier Oil, Delta Lloyd, DSM NV, DNO, Lufthansa, Swiss Re, Santos Ltd, Luxottica Group SpA, CaixaBank SA, Iberdrola, Chevron, Subsea 7, Thales, Sainsbury, Reliance Industries, Kuehne & Nagel International, Exxon Mobil Corp, AXA SA, William Hill, Suez Environnement, Swisscom AG, Kingspan, Talanx, Merck KGaA, BP, BHP Billiton PLC, BAE Systems, ARM Holdings PLC, Deutsche Boerse AG, Atlas Copco, Syngenta AG, Regus, Next Group PLC, Centrica PLC, Royal Dutch Shell, Peugeot SA, France, Greece in the past 12 months.

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PLC, African Barrick Gold Plc, Legrand, Tullow Oil, Experian, OMV AG, Michelin, Munich Re, Beiersdorf, Credit Suisse, SIG PLC, Imperial Oil Limited, Tate and Lyle, Vivendi, Schneider Electric, Royal Jordanian Airlines, British American Tobacco PLC, AstraZeneca PLC, ENEL SpA, Diageo, Cenovus Energy, Balfour Beatty, Galp Energia, LVMH, Linde AG, Friends Life, Pirelli, Assa Abloy, Banca Popolare di Milano, Daimler AG, Buzzi Unicem, Occidental Petroleum Corp, Infineon Technologies, Safran, Sampo Oyj, Carlsberg, Afren, Soco International, Natixis, Renault SA, ASOS Plc, Telecom Italia SpA, Shire Pharmaceuticals, Ecopetrol, JCDecaux, Coca Cola HBC AG, Reed Elsevier PLC, Thomas Cook Group, Hannover Re, Chesapeake Energy Corp, Anglo American PLC, SABMiller, Ericsson LM, Cairn Energy, World Duty Free, Banco Santander, Hiscox Ltd, Canadian Natural Resources Ltd, Petrobras, Nokia Oyj, Unilever PLC, Landi Renzo, Premier Oil, Delta Lloyd, DSM NV, DNO, Lufthansa, Swiss Re, Santos Ltd, Luxottica Group SpA, Darty Plc, CaixaBank SA, Iberdrola, Chevron, Subsea 7, Thales, Sainsbury, Reliance Industries, Kuehne & Nagel International, Exxon Mobil Corp, AXA SA, William Hill, Suez Environnement, Swisscom AG, Kingspan, Talanx, Merck KGaA, BP, BHP Billiton PLC, BAE Systems, ARM Holdings PLC, Deutsche Boerse AG, Atlas Copco, Syngenta AG, Regus, Next Group PLC, Centrica PLC, Royal Dutch Shell, Peugeot SA, France, Greece.

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<i>Data current as of 31 Mar 2014</i>	12 Month Rating			Relative Rating		
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<i>% of companies in each rating category that are investment banking clients</i>	33%	26%	28%			
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<i>% of companies in each rating category that are investment banking clients</i>	0%	0%	100%			
Citi Research Asia Quantitative Radar Screen Model Coverage	20%	60%	20%			
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Citi Research Asia Quantitative Radar Screen model recommendations are based on a regionally consistent framework to measure relative value and

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