

US Equity Strategy | 10 January 2014

The PULSE Monitor – Market Outlook

	Positive	Neutral or Mixed	Negative
Price	✓ →		
Unanticipated		✓	
Liquidity		✓	
Sentiment			✓
Earnings	✓		

Source: Citi Research - U.S. Equity Strategy

Key Takeaway

- **P:** Market still appears modestly undervalued based on a variety of metrics.
- **U:** Sovereign debt risks, Fed policy shifts, geopolitics, and inflation.
- **L:** Domestic equity inflows while M2 declined.
- **S:** Panic/Euphoria moved further into Euphoria territory; while our Cyclical Expectations Model (CEM) ticked up.
- **E:** Seven out of ten S&P 500 sectors showed EPS revisions to the upside thus far in January, while the percent of upward revisions inched up to 44.8%.

Euphoria at 2001 Levels, Surpassing 2008 Highs

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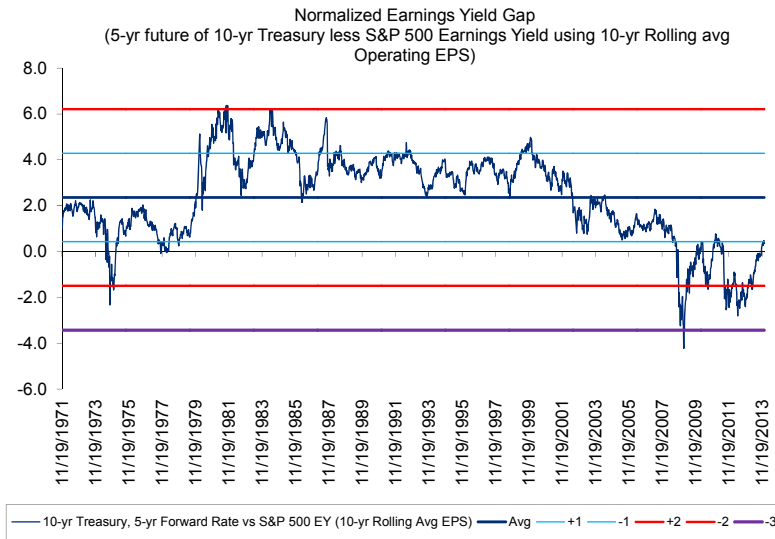
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Price (Valuation)

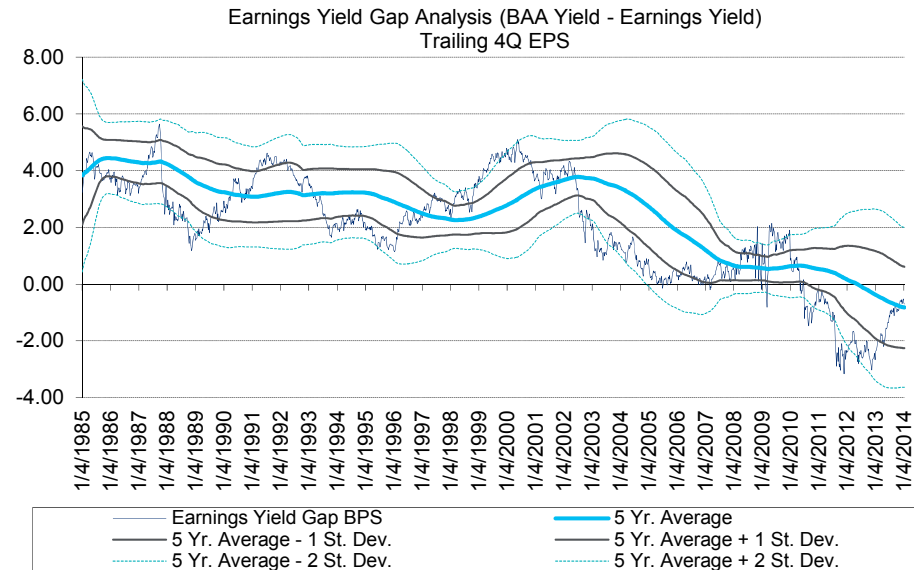


Source: Haver Analytics and Citi Research – U.S. Equity Strategy

Key Takeaway

- The normalized earnings yield gap analysis ticked down to 1.04 standard deviation below its 40-year average.
- Our earnings yield gap is now 0.64 standard deviations above the rolling mean, suggesting that equity valuations are modestly overvalued based on this metric.

Price (Valuation)



Source: Haver Analytics and Citi Research – U.S. Equity Strategy

Key Takeaway

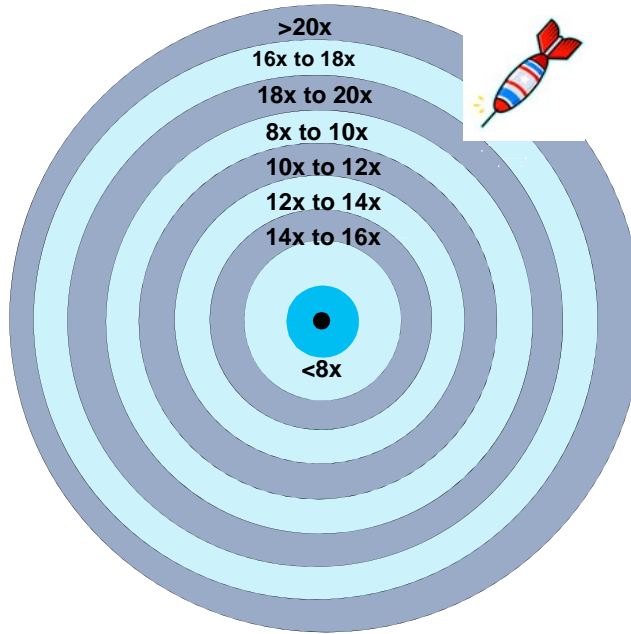
- Our model using Baa yields instead of the 10-year Treasury shows the market is fairly valued at 0.08 standard deviations above the mean.

P/E “Bull’s Eye”

The Valuation Bull’s Eye

P/E Ranges & Subsequent 12 Month Returns (since 1940)

<8x:	Average	18.6%
	Median	18.8%
8x to 10x:	Average	8.8%
	Median	6.7%
10x to 12x:	Average	9.7%
	Median	9.6%
12x to 14x:	Average	10.8%
	Median	12.4%
14x to 16x:	Average	12.6%
	Median	15.3%
16x to 18x:	Average	5.4%
	Median	9.1%
18x to 20x:	Average	5.9%
	Median	6.5%
>20x:	Average	-0.43%
	Median	4.43%



Sweet Spot (<8x)

Source: Haver Analytics and Citi Research – U.S. Equity Strategy

- The dart reflects the 16.70x P/E multiple of the S&P 500 based on trailing four-quarter S&P 500 Operating EPS.

Current Valuation Metrics

S&P 500 Characteristics

- P/E (Trailing 4Q EPS): 16.70x
- P/E (2014E EPS): 15.64x
- P/E (2015E EPS): 14.59x
- Price to Sales: 1.66x vs. avg Price to Sales of 1.29x since 1985
- Price to Book: 2.68x vs. avg Price to Book of 2.80x since 1985
- Price to EBITDA: 8.28x vs. avg Price to EBITDA of 7.41x since 1985
- Market Value: \$17.40 trillion
- Dividend Yield: 1.99%

The dart is here.

Citi Economic and Market Analysis

S&P 500 Operating EPS forecast:

- 2010A = \$85.28
- 2011A = \$97.84
- 2012A = \$103.76
- 2013E = \$110.10
- 2014E = \$117.50
- 2015E = \$126.00

Unanticipated

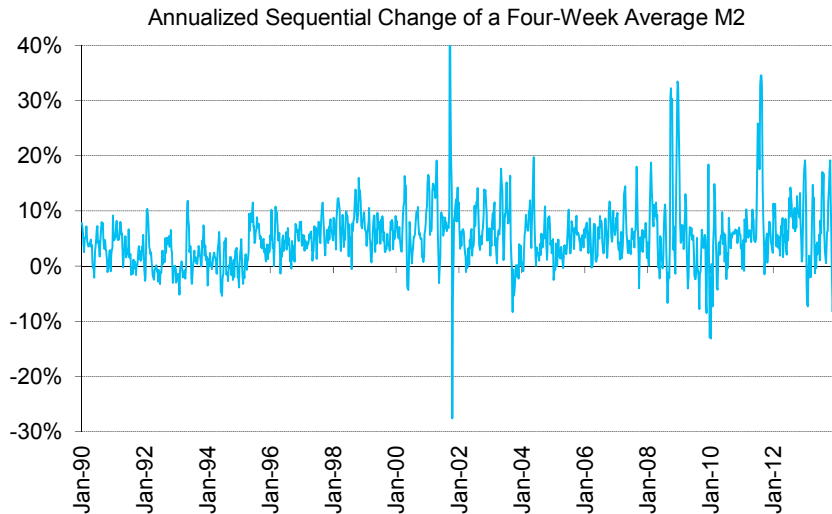
Negative Market Impact

- Economic/Earnings Disappointments
- A Tightening Fed
- Government Policy Missteps
- Geopolitical Upheavals
- Foreign Exchange Volatility
- Protectionism

Positive Market Impact

- Mutual Fund Inflows
- Improving Housing Data
- Employment Growth
- Upbeat Earnings Guidance
- Efficacy of Fed/ECB/Government Policy
- Strengthening Industrial Data
- M&A

Liquidity

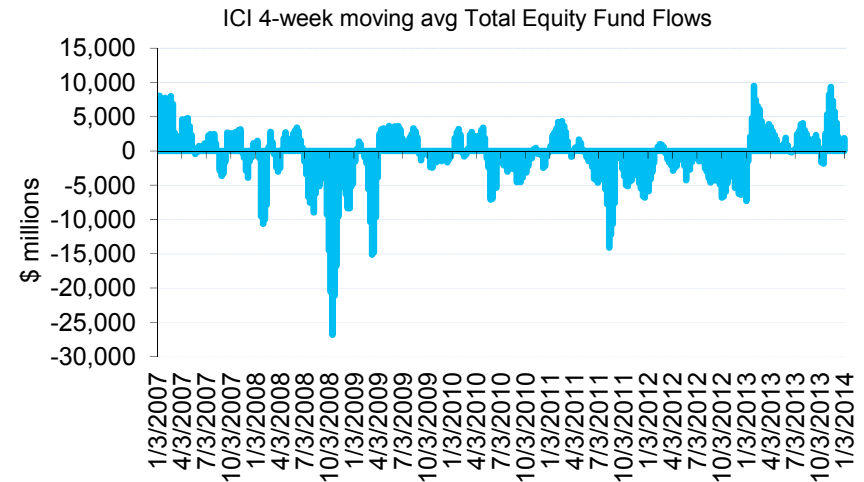


Source: Haver Analytics and Citi Research – U.S. Equity Strategy

Key Takeaway

- Sequentially, M2 declined last week.
- The annualized sequential change of the four-week average dropped to 4.25% from 7.83% in the prior week.

Liquidity (Money Flows)

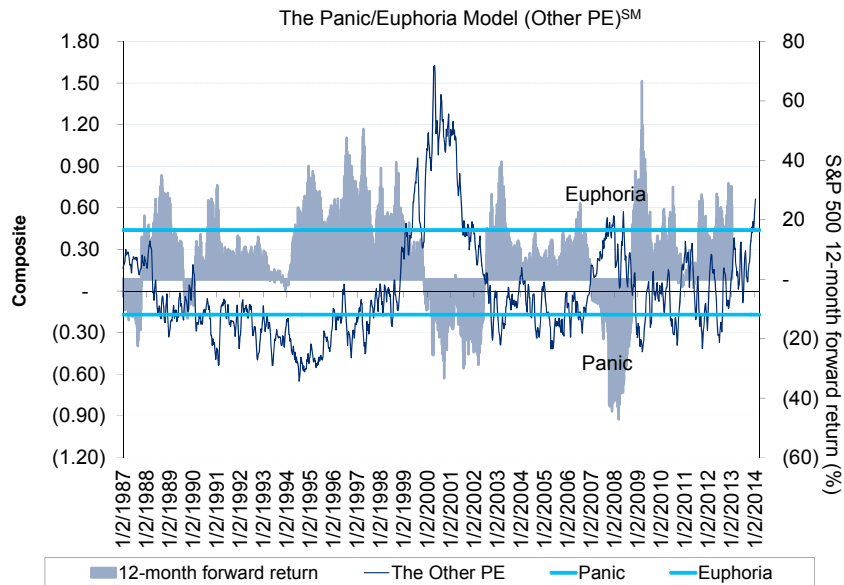


Source: Haver Analytics and Citi Research – U.S. Equity Strategy

Key Takeaway

- According to ICI, investors added \$6.00 billion to total equity funds for the week-ending January 1st.
- Domestic funds attracted inflows of \$3.32 billion, while foreign funds posted inflows of \$2.69 billion.
- Bond funds experienced outflows of \$2.85 billion.
- For overall equity funds, the four-week moving average jumped up to an inflow of \$1.86 billion from the prior week's four-week average inflow of \$872 million.

Sentiment

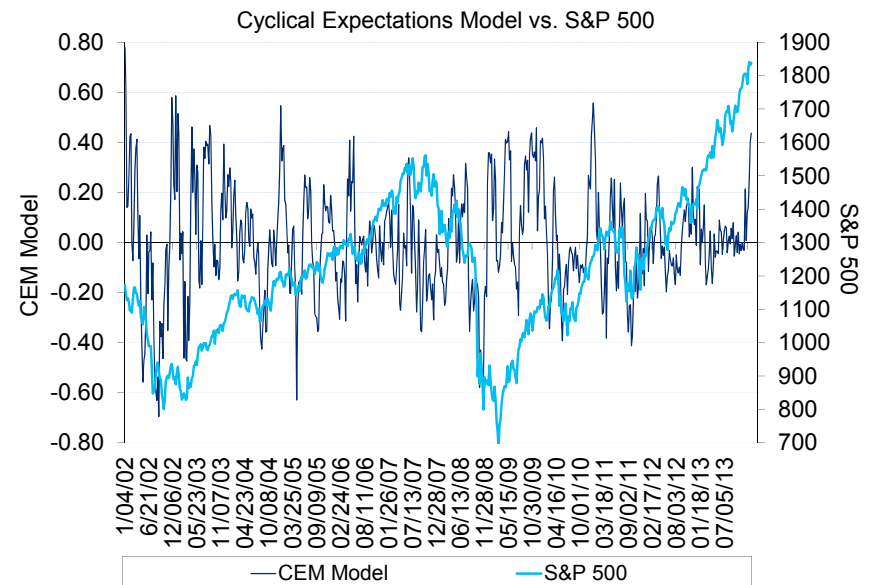


Source: Haver Analytics, FactSet, and Citi Research – U.S. Equity Strategy

Key Takeaway

- Our Panic/Euphoria model moved further into euphoria territory.
- This week's Panic/Euphoria reading was 0.66, versus last week's revised number of 0.61.
- Euphoria readings indicate the market may retreat with an 83% historical probability of losses in the next 12 months.
- Components: NYSE short interest ratio, margin debt, Nasdaq daily volume as % of NYSE volume, a composite average of Investors Intelligence and the American Association of Individual Investors bullishness data, retail money funds, the put/call ratio, CRB futures index, gasoline prices and the ratio of price premiums in puts versus calls.

Sentiment

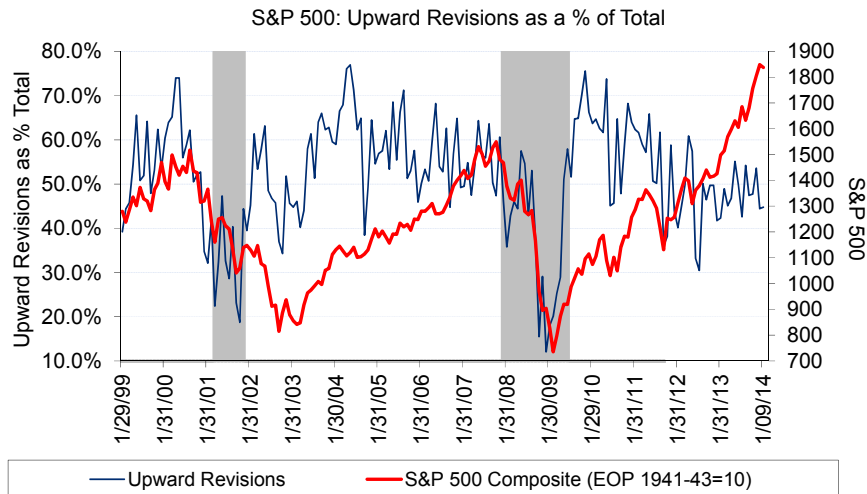


Source: Haver Analytics, FactSet, and Citi Research – U.S. Equity Strategy

Key Takeaway

- Our Cyclical Expectations Model (CEM) inched higher this week and is beginning to look peak-like, thus vulnerable to a near-term reversal, which signals short-term caution for the market.
- The CEM is a one-to-three week market lead indicator.
- This model is comprised of six factors including credit spreads, steepness of yield curve, Redbook retail sales, copper and oil prices, and railroad freight - total carloads.
- Intra-stock correlation has fallen to just above 30%, showing that macro has receded from the collective mindset as a source of market discontent.

Earnings



Source: FactSet, and Citi Research – U.S. Equity Strategy

Key Takeaway

- Thus far in January, upward earnings revisions ticked up to 44.8% from 44.4% in December.

Earnings

Monthly Upward Revisions as a % of Total Monthly Revisions							
	Jan-14	Dec-13	Sep-13	Jun-13	Mar-13	Jan-13	Avg Since 1990
S&P 500	44.78%	44.43%	47.44%	49.81%	45.12%	42.33%	49.02%
Consumer Discretionary	31.22%	46.40%	58.41%	58.33%	40.23%	41.18%	52.31%
Consumer Staples	35.14%	24.61%	25.32%	45.66%	55.76%	55.17%	47.61%
Energy	34.01%	31.89%	50.22%	44.98%	33.76%	37.17%	46.34%
Financials	45.58%	42.91%	42.21%	66.43%	57.00%	45.75%	47.89%
Health Care	52.14%	53.06%	45.86%	44.97%	56.58%	47.24%	51.87%
Industrials	52.31%	50.62%	45.91%	26.88%	30.15%	37.76%	46.92%
Information Technology	69.44%	60.72%	43.50%	55.73%	57.68%	40.74%	55.78%
Materials	36.49%	48.10%	40.00%	22.13%	36.88%	53.50%	41.15%
Telecom Services	57.14%	28.57%	35.48%	34.78%	26.09%	12.24%	46.68%
Utilities	59.65%	50.79%	50.00%	38.67%	48.81%	49.37%	45.80%

Source: FactSet, and Citi Research – U.S. Equity Strategy

Key Takeaway

Upward revisions as a % of total revisions for the S&P 500 were up thus far in January from December, with seven sectors showing revisions to the upside.

- **Consumer Discretionary** – Auto Components, Automobiles, Media, Multi-line and Specialty Retail pressured revision levels.
- **Consumer Staples** – Beverages boosted revision levels.
- **Materials** – Chemicals and Metals & Mining weighed on upward revisions.
- **Telecom Services** – Diversified Telecommunication Services led to the bounce in revision levels.

The PULSE Prognosis

Where We Stand on the Equity Market

- The PULSE framework is neutral on two (unanticipated and liquidity), mildly positive on two (earnings and valuation) and negative on sentiment.
- Our Panic/Euphoria model rose further in Euphoria territory, while our proprietary Cyclical Expectations Model climbed higher. One of our highly-correlated valuation metrics argues that the S&P 500 is roughly 20% undervalued, but several other measures are less attractive.
- Equity markets inched up 0.4% in the week ended Thursday. Initial claims for unemployment benefits fell to 330,000 last week, the lowest level since November, as holiday season volatility continued to ease. Meanwhile, the pace of growth in the U.S. services sector slowed for a second straight month in December with business activity expanding at a lower rate and new orders contracting. The US ISM Non-Mfg. dipped to 53.0 in December compared to 53.9 in the previous month and was below expectations for a reading of 54.5. The U.S. trade deficit fell to a four-year low in November, a development that likely boosted fourth-quarter economic growth by as much as a percentage point to more than 3% annualized. Finally, non-farm payrolls grew by a disappointing 74,000 in December while November was revised up to 241,000. Meanwhile, the unemployment rate dropped to 6.7%, the lowest level since October 2008, as more people left the labor force.
- We continue to think that a 1Q14 correction (in the 5%-10% range) is possible given weakening EPS forward guidance trends and some softening in the Cyclical Expectations Model, not to mention euphoric sentiment levels. While credit conditions remain favorable in the US, disappointment in emerging economies and a lackluster though improving Europe could hold back the earnings story. Admittedly, better hiring intentions are encouraging, plus stock buyback activity has stepped up and money has begun to flow into equity funds. With a 1,975 S&P 500 target by year-end 2014 as economic conditions improve this year, we remain generally constructive longer term while continuing to advise nearer-term tactical caution.
- On December 6th, we raised our year-end S&P 500 2013 EPS forecast to \$110.10 from \$109.50 and lifted our 2014 EPS estimate to \$117.50 from \$116.25.

S&P 500 Operating Earnings	2012A	1Q13	2Q13	3Q13E	4Q13E	2013E	1Q14E	2Q14E	3Q14E	4Q14E	2014E
Citi	\$103.76	\$26.74	\$27.40	\$27.68	\$28.10	\$110.10	\$28.60	\$29.30	\$29.40	\$29.70	\$117.50
Thomson Consensus	\$103.80					\$109.13					\$120.83

Index	2008A	2009A	2010A	2011A	2012A	2013A	2014E
S&P 500	903	1,115	1,258	1,258	1,426	1,848	1,975
DJIA	8,776	10,428	11,578	12,218	13,104	16,577	17,800

Source: Thomson and Citi Research - U.S. Equity Strategy

Appendix A-1

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