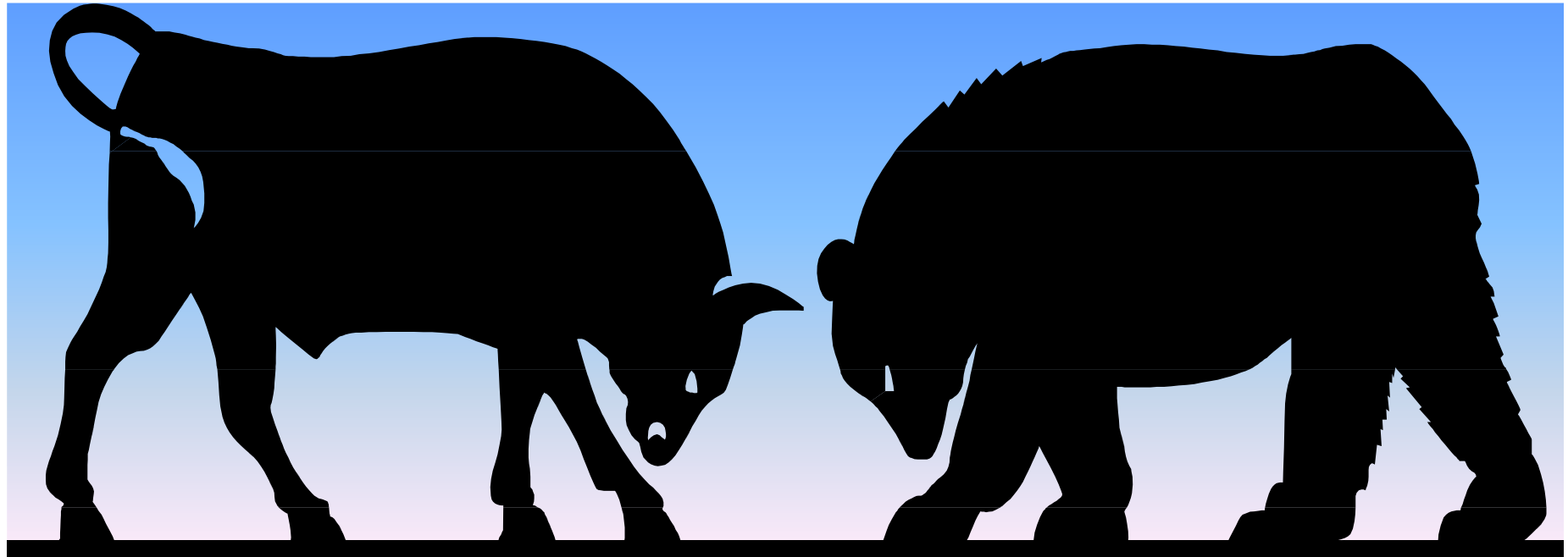


US Equity Strategy | August 2012



## Exploiting the Gap Between Fundamental Reality and Market Perception The Delve Into Twelve (and Beyond)

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

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# US Equity Strategy Publications

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To be added to our distribution list for any of the following publications, please contact Yolanda Sanchez at [yolanda.sanchez@citi.com](mailto:yolanda.sanchez@citi.com)

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- Weekly
  - *Monday Morning Musings*: call note on various topics; varies and can include discussion of broader market concerns, potential equity market catalysts, or review of recent sector and industry group weighting changes.
  - *PULSE Monitor*: chart pack which monitors the current conditions in five areas that we consider to be key stock market drivers: Price (or stock market valuation), Unanticipated events, Liquidity, Sentiment, and Earnings.
- Monthly
  - *Funds Flows Footprints*: this monthly note updates and comments on trends in mutual funds flows.
  - *Citi Strategic Baskets (CSB) Update*.
- Bi-monthly
  - *SIGN - Sector & Industry Group Navigator*: evaluate earnings, sentiment, valuation, fundamentals and trading places (beta and seasonality) to establish S&P 500 recommended sector and industry group weightings.
- As Needed
  - *Washington Watch*: discusses political issues that are salient to the equity market.

## Four Key Concepts

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- I. The 2H12 Outlook
- II. Challenges Cap the Upside
- III. “Insulated” Opportunities
- IV. The Raging Bull Thesis

# The 2H12 Outlook

- A constructive equity market view for 2H12 is appropriate given skeptical investor sentiment, supportive US credit conditions, attractive valuation and depressed earnings expectations.
- Investor anxiety about sovereign credit woes in Europe, US fiscal challenges, a Chinese economic slowdown and global employment difficulties have left the S&P 500 trading at a very attractive earnings yield gap, which generated a 97% chance of gains over the next 12 months. In addition, panic readings again offer up a near 90% probability of market gains, following the recent slide in markets since early April.
- Benign credit environment argues for US GDP progress into next year and the present value of flat earning held into perpetuity also is signaling a strong rally opportunity.
- Some margin pressures are to be expected. Employment growth and commodity price weakness are likely to impact corporate margins negatively, while fixed overhead cost underabsorption in Europe and a stronger US dollar will also eat into profitability.
- Election outcome and fiscal uncertainty may hamper stock price trends, but Citi's Economic Surprise Index and higher intra-stock correlation are signaling another upside move for stocks in 2H12.

## Price Targets

	2008A	2009A	2010A	2011A	2012E <sup>1</sup>
S&P 500	903	1,115	1,258	1,258	1,425
DJIA	8,776	10,428	11,578	12,218	13,550

Source: Citi Research – U.S. Equity Strategy

<sup>1</sup>2012 S&P 500 and DJIA targets initially established on 9/16/11; lifted on 12/30/11

## S&P 500 EPS Estimates

	2008A	2009A	2010A	2011A	2012E
S&P 500 Operating EPS Estimate	\$61.79	\$62.05	\$85.49	\$97.84	\$103.25
Y/Y Change	-26.80%	0.40%	37.80%	14.4%	5.5%

Source: Citi Research – U.S. Economics

**Financial Sector Asset Write Downs (\$ Impact on S&P 500 EPS)**

2007 = \$9.00 2008 = \$23.00 2009E = \$7.00 2010E = \$0.00

# Trading Places Thesis Still In Place for 2012

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## Factors:

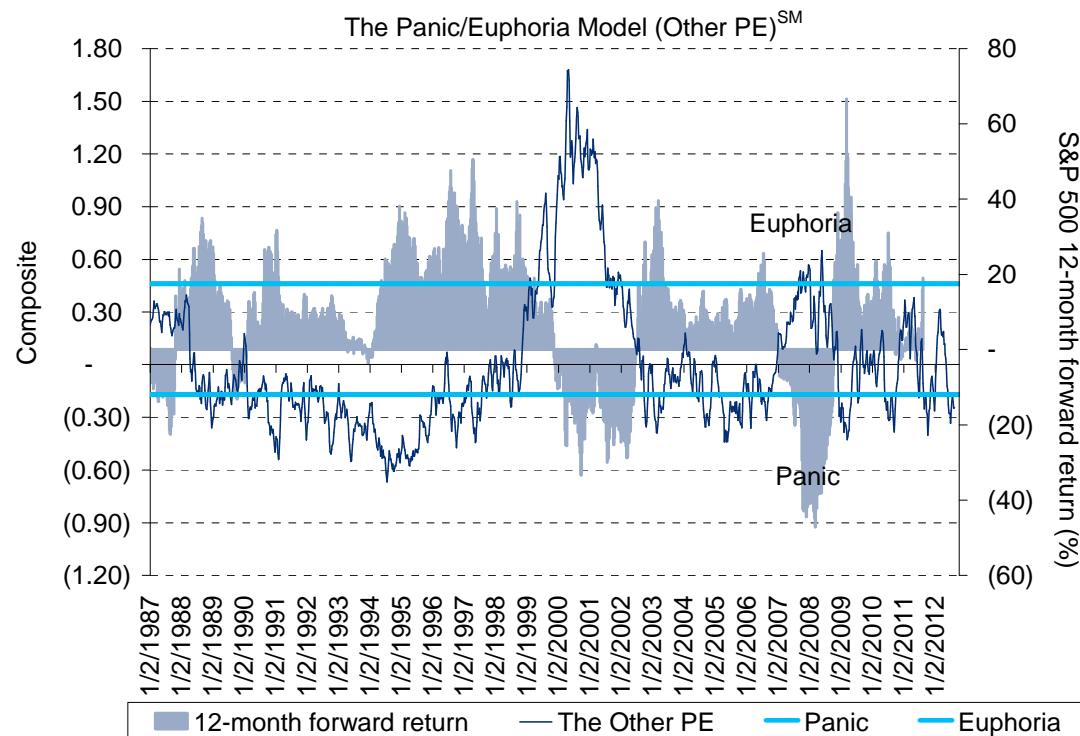
- Sentiment
- Valuation
- Credit Conditions
- Earnings Expectations

## Triggers:

- Citi Economic Surprise Index
- Intra-stock Price Correlation

# Sentiment

## The Panic/Euphoria Model<sup>SM</sup>

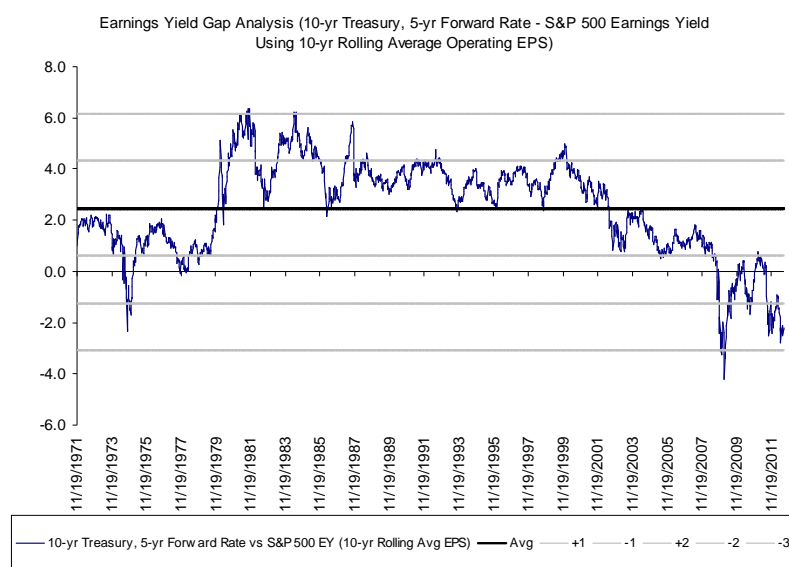


Source: Haver Analytics and Citi Research – U.S. Equity Strategy

- Fell into “panic” territory on June 1<sup>st</sup> after being in “neutral” territory since early January (spent much of 2H11 in panic). When in panic, there is a 96% probability of gains 12 months later averaging 17%.
- Panic/Euphoria 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.

# Valuation

## Earnings Yield Gap (Cyclically Adjusted Earnings Yield vs 10-yr Treasury, 5-yr Future)



## EYG (Cyclically Adjusted Earnings Yield vs 10-yr Treasury, 5-yr Future) – S&P 500 Fwd Performance

Earnings Yield Gap Analysis (10-yr Treasury, 5-yr Forward Rate - S&P 500 Earnings Yield Using 10-yr Rolling Average Operating EPS)

	S&P 500 Forward Return								
	3-mth	6-mth	12-mth	3-mth	6-mth	12-mth	3-mth	6-mth	12-mth
	<b>-3 StDevs and Below</b>			<b>-3 StDev to -2 StDev</b>			<b>-2 StDev to -1 StDev</b>		
Average	19.9%	34.2%	49.8%	6.4%	17.0%	27.7%	0.5%	3.1%	9.2%
Median	21.5%	39.0%	50.9%	6.9%	18.1%	29.3%	2.2%	4.4%	9.9%
Total	5	5	5	71	61	36	211	208	207
% Up	80%	100%	100%	77%	97%	100%	59%	64%	87%
%Down	20%	0%	0%	23%	3%	0%	41%	36%	13%
	<b>-1 StDev to Average</b>			<b>Avg to +1 StDev</b>			<b>+1 StDev to +2 StDev</b>		
Average	0.6%	0.3%	1.4%	3.4%	6.8%	11.9%	0.0%	0.9%	6.4%
Median	1.1%	1.3%	4.8%	3.3%	6.8%	13.4%	0.3%	2.4%	8.1%
Total	661	661	661	882	882	882	276	276	276
% Up	58%	57%	62%	71%	76%	78%	55%	57%	62%
%Down	42%	43%	38%	29%	24%	22%	45%	43%	38%
	<b>+2 StDevs and Above</b>			<b>Random Outcomes</b>					
Average	6.4%	2.6%	16.9%	1.9%	3.9%	7.9%			
Median	8.2%	3.6%	20.4%	2.3%	4.3%	9.4%			
Total	6	6	6	2112	2099	2073			
% Up	83%	67%	100%	64%	67%	72%			
%Down	17%	33%	0%	36%	33%	28%			

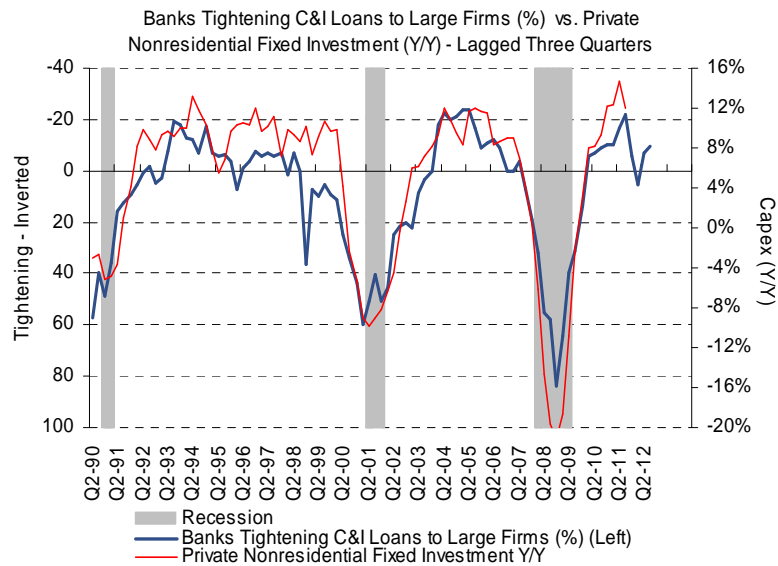
Source: Haver Analytics and Citi Research – U.S. Equity Strategy

- Valuation looks compelling on this normalized metric and still attractive on other approaches.

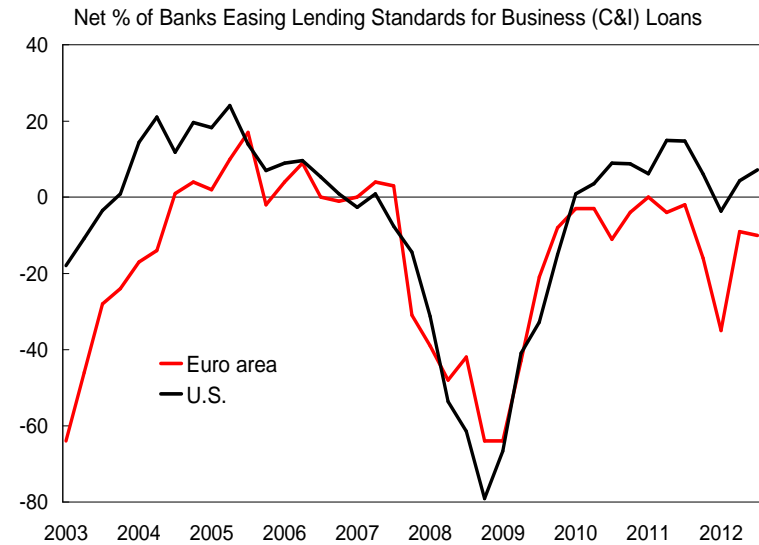


# Credit Conditions

## Bank Tightening Standards vs. Capex



## Bank Tightening Standards – US vs Europe



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

- Credit leads business and economic activity by nine months and still argues for growth in 2012.
- Europe is clearly geared for recession.

# Earnings

## S&P 500 and S&P 500 GICS Sectors – EPS Growth Forecasts (Consensus vs. Citi)

					Bloomberg Consensus:			Citi Forecast		
	2007	2008	2009	2010	August 2012 *			2011	2012E	2013E
S&P 500 Total	(4.1)	(26.8)	0.4	38.0	14.7	6.2	11.7	14.4	5.5	4.6
Consumer Discretionary	(12.0)	(52.0)	53.0	48.0	12.7	7.1	15.2	17.0	6.0	N/A
Consumer Staples	10.0	11.0	3.0	6.0	7.4	1.9	8.4	6.0	2.0	N/A
Energy	4.0	19.0	(59.0)	51.0	35.6	(11.5)	9.0	38.0	(5.0)	N/A
Financials	(33.0)	-132*	243*	115.0	3.9	16.1	12.8	1.0	10.0	N/A
Health Care	12.0	8.0	1.0	12.0	5.3	1.0	7.5	6.0	2.0	N/A
Industrials	12.0	(1.0)	(34.0)	28.0	20.7	9.2	12.7	21.0	10.0	N/A
IT	17.0	3.0	(8.0)	43.0	18.5	19.4	13.3	16.0	10.0	N/A
Materials	6.0	(7.0)	(51.0)	85.0	30.7	(2.9)	20.7	33.0	(13.0)	N/A
Telecom Services	24.0	(9.0)	(24.0)	(4.0)	34.7	0.1	17.2	(2.0)	2.0	N/A
Utilities	13.0	1.0	(2.0)	5.0	2.4	(4.4)	3.2	2.0	(3.0)	N/A

\*Absolute value change, Citi estimates embed \$47 bln loss in 2008, \$60 bln, \$75 bln profit in 2009/10 through August 3, 2012

Source: Bloomberg and Citi Global Markets

## Estimated Earnings Per Share Growth for S&P 500 Sectors

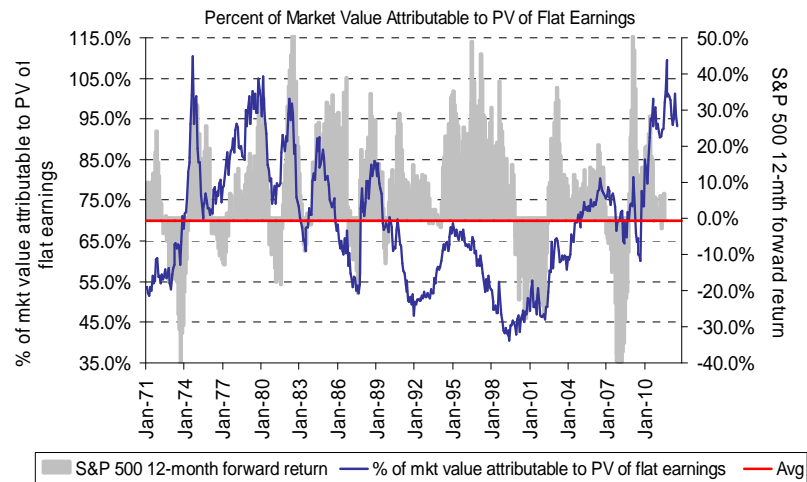
S&P 500 EPS Growth Estimates									
Sector	1Q11	2Q11	3Q11	4Q11	1Q12E	2Q12E	3Q12E	4Q12E	1Q13E
Consumer Discretionary	14.7%	9.4%	16.4%	6.3%	6.6%	-0.9%	4.3%	16.9%	12.8%
Consumer Staples	5.6%	8.5%	6.0%	2.3%	2.8%	1.2%	1.5%	6.2%	5.8%
Energy	41.3%	43.3%	57.7%	8.9%	-3.4%	-16.8%	-27.0%	-3.7%	-3.7%
Financials	22.5%	5.1%	-1.6%	-7.0%	14.7%	4.0%	20.3%	30.8%	-2.4%
Health Care	6.6%	5.2%	6.8%	4.6%	0.7%	1.3%	-4.7%	1.5%	1.7%
Industrials	34.0%	18.6%	19.0%	15.4%	14.1%	8.6%	1.2%	3.9%	5.7%
IT	24.2%	23.2%	9.9%	13.3%	14.0%	5.1%	3.8%	12.1%	10.0%
Materials	56.7%	48.5%	30.0%	-11.5%	-8.5%	-16.8%	-19.3%	21.2%	17.9%
Telecom Services	9.4%	5.1%	19.6%	-25.7%	-2.3%	2.3%	-1.8%	12.8%	3.1%
Utilities	0.8%	2.2%	4.8%	-0.8%	-7.0%	0.3%	-4.1%	8.0%	8.5%
S&P 500	20.8%	16.3%	14.5%	5.0%	6.3%	-0.5%	-1.5%	10.5%	4.5%
Ex-Financials	20.5%	18.7%	17.5%	7.2%	4.6%	-1.3%	-4.9%	7.3%	6.1%

Source: Bloomberg and Citi Global Markets

- 4Q12 EPS growth expectations seem excessive; Citi is below consensus for 2012 and 2013.

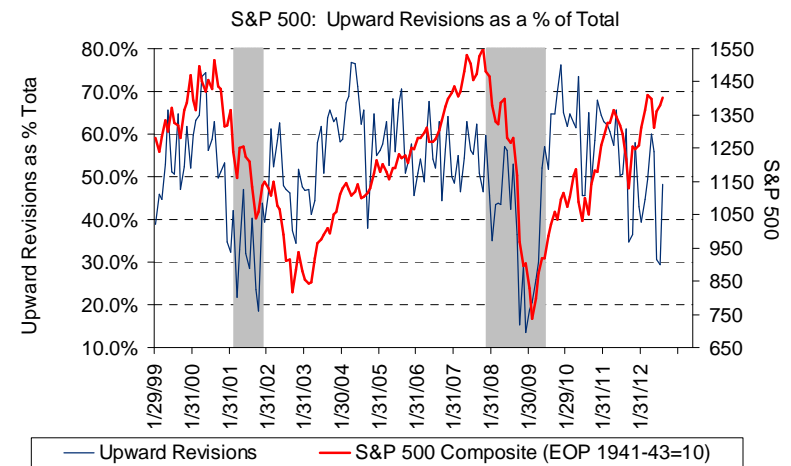
# Earnings

## % of Market Value Attributable to PV of Flat Earnings



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

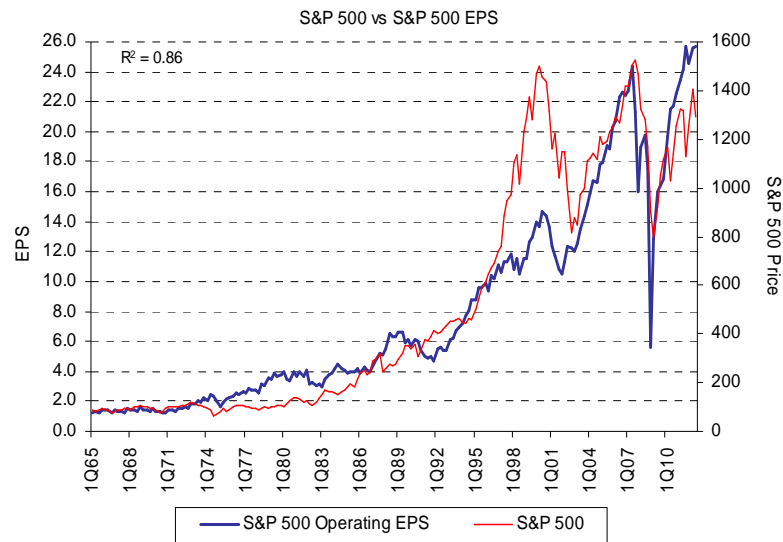
## S&P 500 Upward Revisions



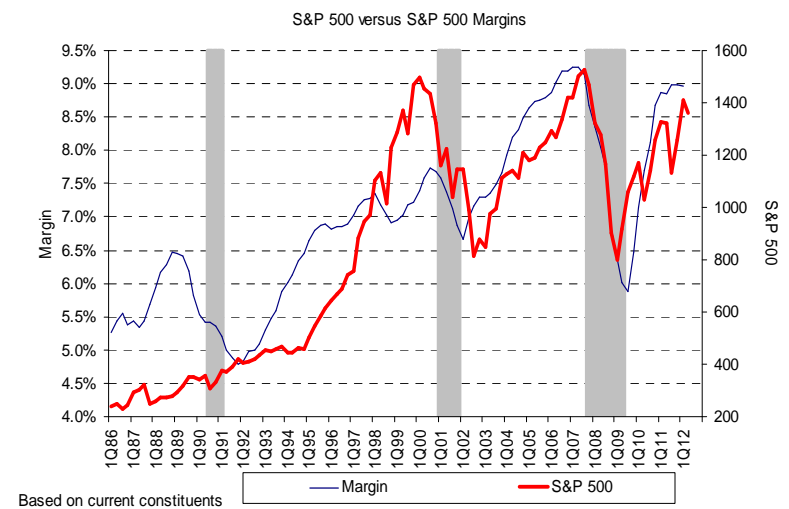
- Current expectations for long-term EPS growth are very depressed; akin to last round of equity dislocation.

# Earnings & Margins

## S&P 500 Performance vs. Earnings



## S&P 500 Performance vs. Margins

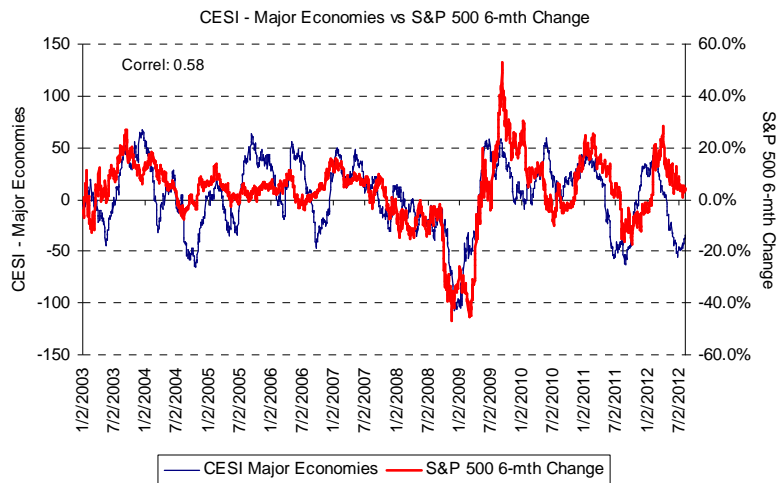


Source: FactSet, Haver Analytics and Citi Research – U.S. Equity Strategy

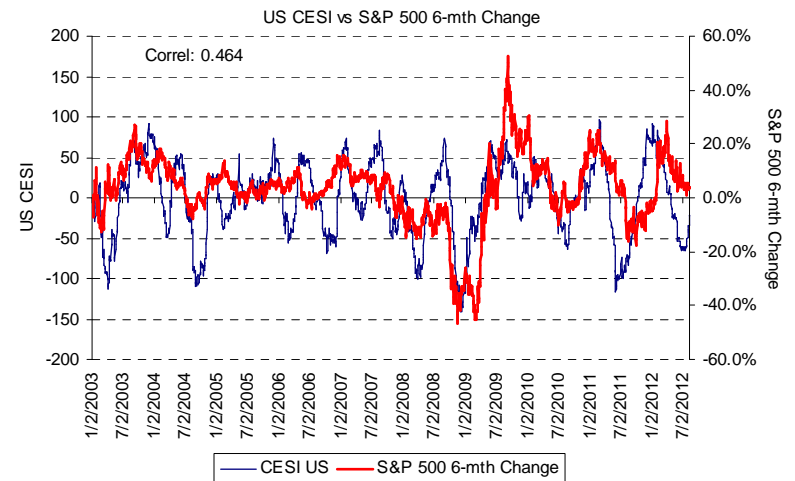
- Recessions are required to crush EPS (and thereby markets).

# Near-Term Opportunity

## G10 CESI vs S&P 500



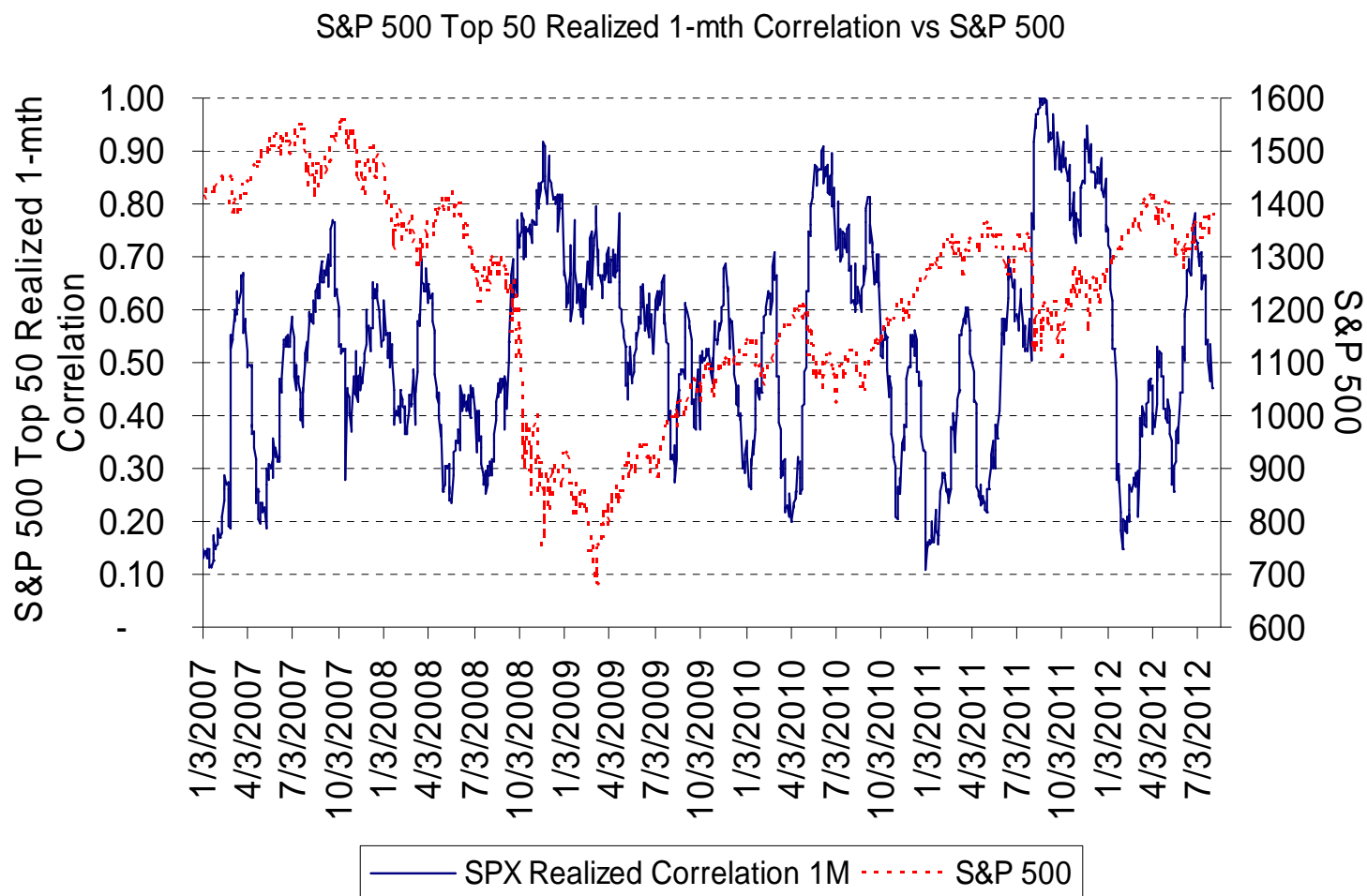
## US CESI vs S&P 500



Source: Bloomberg and Citi Research – U.S. Equity Strategy

# Near-Term Opportunity

## S&P 500 Top 50 Realized Correlation vs S&P 500



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

# Challenges That Cap Upside

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- Rationale:

- Presidential Election/Fiscal Policy Uncertainty
- Margin Pressures from Lower Commodity Prices and Employment Growth
- European Economic Woes

# Near-Term Challenges

## 2012 Electoral College Scorecard

2012 Electoral Vote Scorecard July 2, 2012

COOK POLITICAL REPORT ELECTORAL COLLEGE VOTING RATINGS						
Solid Dem (14 States)	Likely Dem (3 States)	Lean Dem (3 States)	Toss Up (7 States)	Lean Rep (1 States)	Likely Rep (4 States)	Solid Rep (19 States)
California (55)	Maine (4)	Michigan (16)	Colorado (9)	North Carolina (15)	Arizona (11)	Alabama (9)
Connecticut (7)	Minnesota (10)	Pennsylvania (20)	Florida (29)		Georgia (16)	Alaska (3)
Delaware (3)	New Mexico (5)	Wisconsin (10)	Iowa (6)		Indiana (11)	Arkansas (6)
Hawaii (4)			Nevada (6)		Missouri (10)	Idaho (4)
Illinois (20)			New Hampshire (4)			Kansas (6)
Maryland (10)			Ohio (18)			Kentucky (8)
Massachusetts (11)			Virginia (13)			Louisiana (8)
New Jersey (14)						Mississippi (6)
New York (29)						Montana (3)
Oregon (7)						Nebraska (5)
Rhode Island (4)						North Dakota (3)
Vermont (3)						Oklahoma (7)
Washington (12)						South Carolina (9)
Washington DC (3)						South Dakota (3)
						Tennessee (11)
						Texas (38)
						Utah (6)
						West Virginia (5)
						Wyoming (3)
<b>182 E.V.</b>	<b>19 E.V.</b>	<b>46 E.V.</b>	<b>85 E.V.</b>	<b>15 E.V.</b>	<b>48 E.V.</b>	<b>143 E.V.</b>
192 ELECTORAL VOTES		270 ELECTORAL VOTES NEEDED TO WIN			191 ELECTORAL VOTES	
227 ELECTORAL VOTES					191 ELECTORAL VOTES	

Note: These are current electoral vote ratings and will change continuously from now until Nov. 4th

Source: www.cookpolitical.com

## Expiring/Starting Fiscal Measures, January 2013

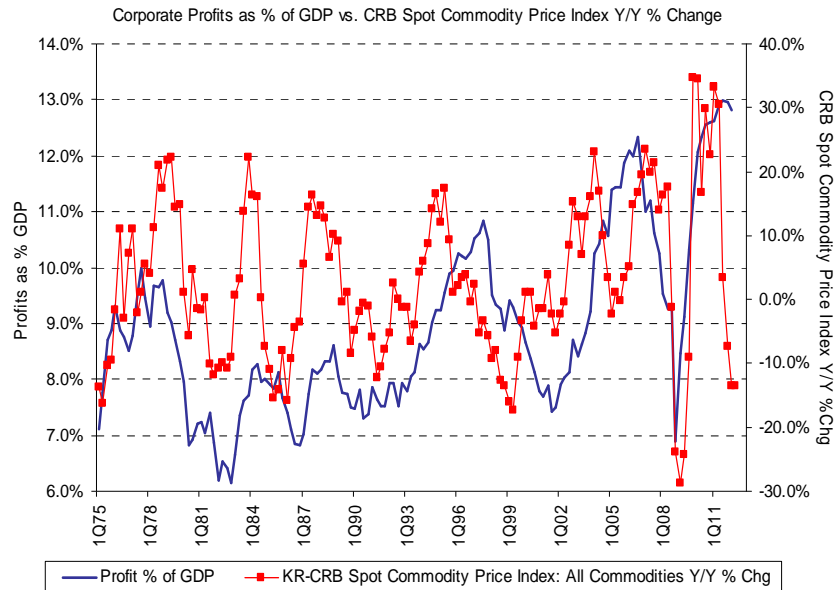
	<u>Billions of Dollars</u>	<u>Percent of GDP</u>
Bush Tax Cuts — Top Two Tax Brackets	\$55	0.4%
Bush Tax Cuts — Other Measures	195	1.3
99-Week Unemployment Insurance Benefits	50	0.3
2% Payroll Tax Cut	110	0.7
3.8% Medicare Tax on Investment Income	20	0.1
<u>BCA Sequester</u>	<u>95</u>	<u>0.6</u>
<b>Total Fiscal Contraction</b>	<b>\$525</b>	<b>3.4%</b>

Source: CBO and Citi Research – US Economics



# Near-Term Challenges

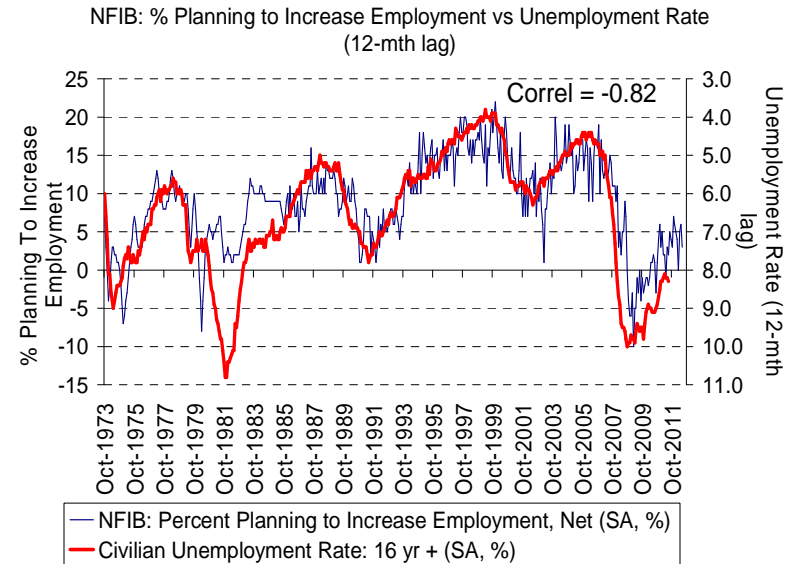
## Commodity Prices vs Margins



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

- Stock prices are reflecting margin concerns.

## NFIB: % Planning to Increase Employment vs Unemployment



# European Exposure

## S&P 500 Geographic Sales Exposure

	Geographic Revenue Breakouts For Latest Fiscal Year (2011 or 2012)					
	% of Total Revenues					
	North America	EMEA	Latam	Asia/Pacific	ROW/Other	Total Foreign
<b>S&amp;P 500</b>	<b>67.57%</b>	<b>10.58%</b>	<b>2.42%</b>	<b>5.61%</b>	<b>14.25%</b>	<b>32.43%</b>
<b>Consumer Discretionary</b>	<b>73.21%</b>	<b>9.79%</b>	<b>4.96%</b>	<b>2.07%</b>	<b>9.69%</b>	<b>26.79%</b>
Automobiles & Components	51.38%	27.23%	1.56%	0.59%	19.23%	48.62%
Consumer Durables & Apparel	57.88%	15.50%	6.83%	6.68%	10.22%	42.12%
Consumer Services	39.10%	10.51%	30.25%	6.49%	13.03%	60.90%
Media	79.14%	9.85%	2.26%	1.53%	7.22%	20.86%
Retailing	90.19%	2.43%	0.04%	0.88%	6.44%	9.81%
<b>Consumer Staples</b>	<b>70.69%</b>	<b>9.36%</b>	<b>2.43%</b>	<b>2.99%</b>	<b>14.43%</b>	<b>29.31%</b>
Food & Staples Retailing	85.33%	0.00%	0.00%	0.00%	14.67%	14.67%
Food Beverage & Tobacco	53.08%	21.25%	4.00%	6.06%	15.07%	46.92%
Household & Personal Products	41.08%	26.02%	12.24%	10.94%	10.55%	58.92%
<b>Energy</b>	<b>61.30%</b>	<b>13.37%</b>	<b>1.07%</b>	<b>3.84%</b>	<b>23.80%</b>	<b>38.70%</b>
<b>Financials</b>	<b>75.33%</b>	<b>9.87%</b>	<b>2.00%</b>	<b>5.12%</b>	<b>7.68%</b>	<b>24.67%</b>
Banks	100.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Diversified Financials	64.61%	7.34%	4.07%	9.28%	14.69%	35.39%
Insurance	76.13%	18.04%	0.44%	2.66%	2.74%	23.87%
Real Estate	88.01%	3.14%	1.25%	1.90%	5.70%	11.99%
<b>Health Care</b>	<b>77.74%</b>	<b>9.49%</b>	<b>0.35%</b>	<b>3.47%</b>	<b>8.94%</b>	<b>22.26%</b>
Health Care Equipment & Services	92.09%	3.16%	0.35%	1.26%	3.15%	7.91%
Pharmaceuticals, Biotechnology	49.26%	22.08%	0.34%	7.84%	20.45%	50.74%
<b>Industrials</b>	<b>61.66%</b>	<b>15.49%</b>	<b>3.74%</b>	<b>10.32%</b>	<b>8.76%</b>	<b>38.34%</b>
Capital Goods	56.36%	19.06%	4.66%	12.43%	7.44%	43.64%
Commercial & Professional Serv	80.02%	6.32%	0.88%	4.17%	8.61%	19.98%
Transportation	81.94%	0.73%	0.15%	1.85%	15.47%	18.06%
<b>Information Technology</b>	<b>40.91%</b>	<b>8.76%</b>	<b>1.12%</b>	<b>16.16%</b>	<b>32.48%</b>	<b>59.09%</b>
Semiconductors & Semiconductor	15.51%	12.52%	2.65%	65.54%	3.68%	84.49%
Software & Services	49.35%	9.40%	0.10%	5.21%	34.54%	50.65%
Technology Hardware & Equipment	40.42%	7.30%	1.57%	12.68%	38.02%	59.58%
<b>Materials</b>	<b>51.04%</b>	<b>19.84%</b>	<b>5.78%</b>	<b>10.57%</b>	<b>12.77%</b>	<b>48.96%</b>
Telecommunication Services	99.96%	0.00%	0.00%	0.04%	0.00%	0.04%
<b>Utilities</b>	<b>94.32%</b>	<b>0.64%</b>	<b>4.72%</b>	<b>0.27%</b>	<b>0.04%</b>	<b>5.68%</b>

- Areas of concern center on Autos, Capital Goods and Materials.
- Exposure in “defensives” are less worrisome.

Source: Bloomberg, Company Reports and Citi Research – U.S. Equity Strategy

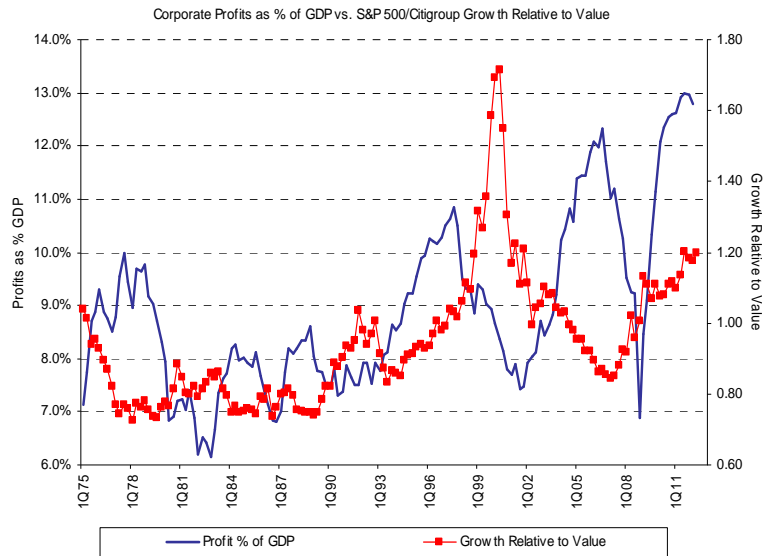
## 2012 “Insulated” Long/Short Opportunities

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- Margin Pressure
- Corporate Cash Uses
  - Capex/Capacity
  - Dividends
  - M&A

# Margin Pressure

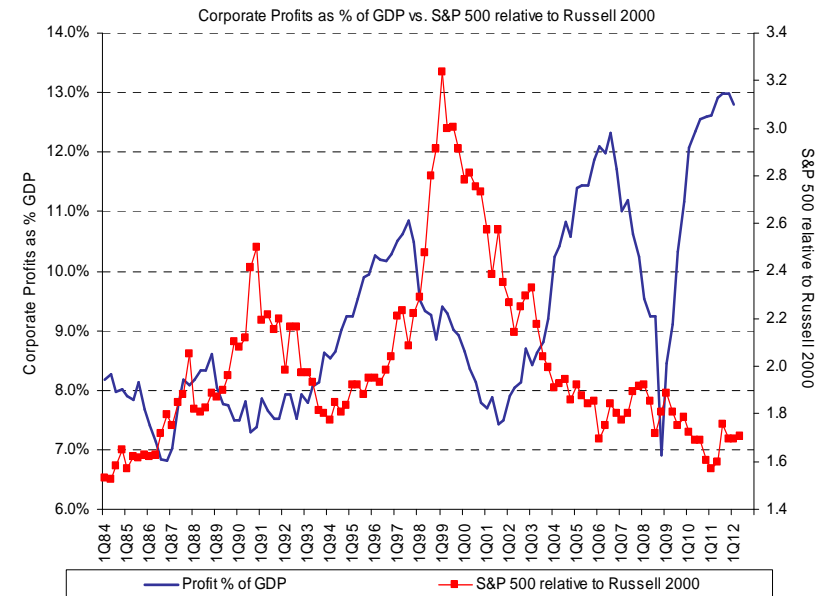
## Corporate Margins vs Growth Relative to Value



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

- Profitability shifts have style investing impact.

## Corporate Margins vs Large Relative to Small Cap



# Capex/Capacity

## Capex by Sector

	Aggregate Capex					
	2007	2008	2009	2010	2011E	2012E
Consumer Discretionary	86,704	88,061	67,817	61,213	68,592	79,618
Consumer Staples	44,620	47,681	42,102	41,264	43,374	46,456
Energy	135,401	174,383	136,140	150,339	195,072	226,856
Financials	NA	NA	NA	NA	NA	NA
Health Care	25,018	25,122	22,206	22,332	25,503	28,378
Industrials	41,204	40,751	30,539	33,051	43,987	47,150
IT	46,454	44,388	34,403	43,273	56,470	62,586
Materials	23,684	26,912	19,549	19,297	26,551	32,928
Telecom Services	48,798	49,676	44,109	48,496	50,261	54,526
Utilities	55,962	67,517	64,836	62,795	72,718	81,949
<b>Total</b>	<b>507,845</b>	<b>564,490</b>	<b>461,701</b>	<b>482,060</b>	<b>582,529</b>	<b>660,445</b>

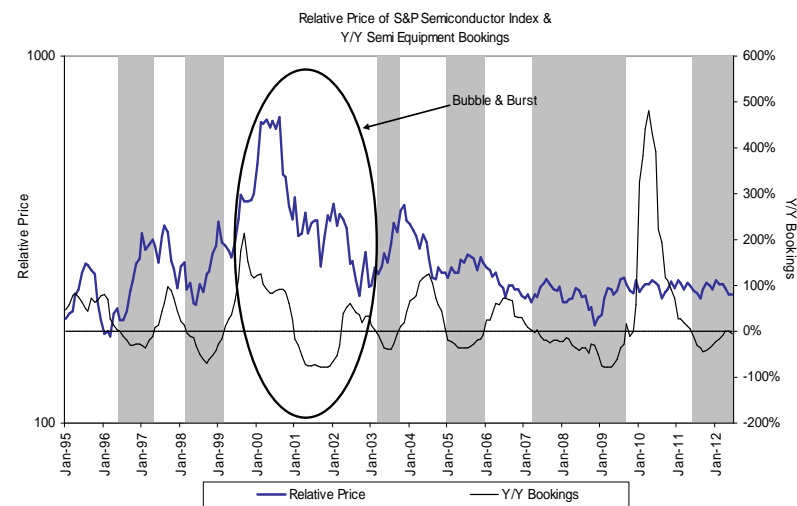
  

	Aggregate Capex Y/Y Change				
	2008	2009	2010	2011E	2012E
Consumer Discretionary	1.6%	-23.0%	-9.7%	12.1%	16.1%
Consumer Staples	6.9%	-11.7%	-2.0%	5.1%	7.1%
Energy	28.8%	-21.9%	10.4%	29.8%	16.3%
Financials					
Health Care	0.4%	-11.6%	0.6%	14.2%	11.3%
Industrials	-1.1%	-25.1%	8.2%	33.1%	7.2%
IT	-4.4%	-22.5%	25.8%	30.5%	10.8%
Materials	13.6%	-27.4%	-1.3%	37.6%	24.0%
Telecom Services	1.8%	-11.2%	9.9%	3.6%	8.5%
Utilities	20.6%	-4.0%	-3.1%	15.8%	12.7%
<b>Total</b>	<b>11.2%</b>	<b>-18.2%</b>	<b>4.4%</b>	<b>20.8%</b>	<b>13.4%</b>

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

- Credit conditions and cash support more investment even without tax incentives.

## Semi Indicator

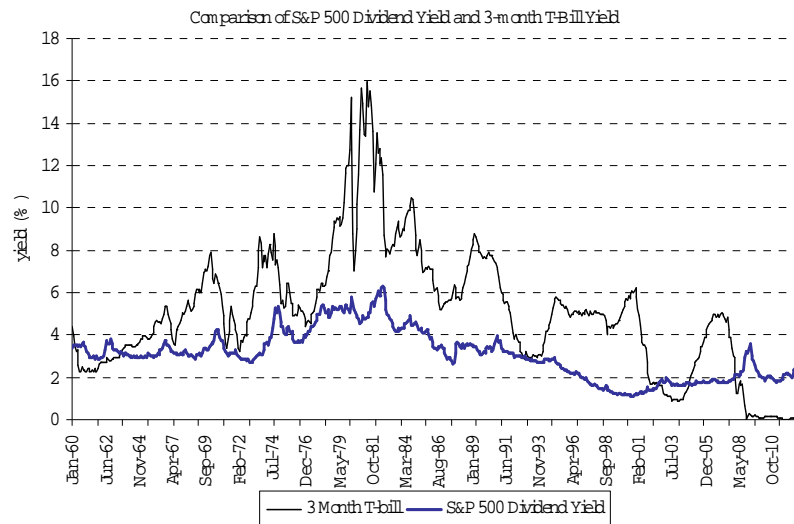


Note: Shaded areas reflect capacity growth slowing (ex bubble period)  
When bookings go negative, relative performance increases and when bookings climb, performance suffers

- Weakness in semi capex helps chip stocks.
- Capacity growth helps determine pricing power.

# Dividends

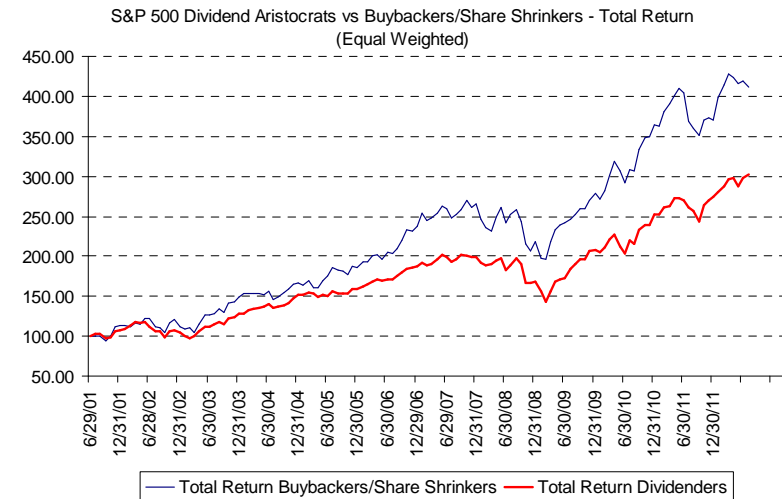
## Dividend Yield vs T-bill Yield



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

- Dividends are critical to winning back stockholders after a “lost” decade in equities as well as retaining “Boomer’s” money.

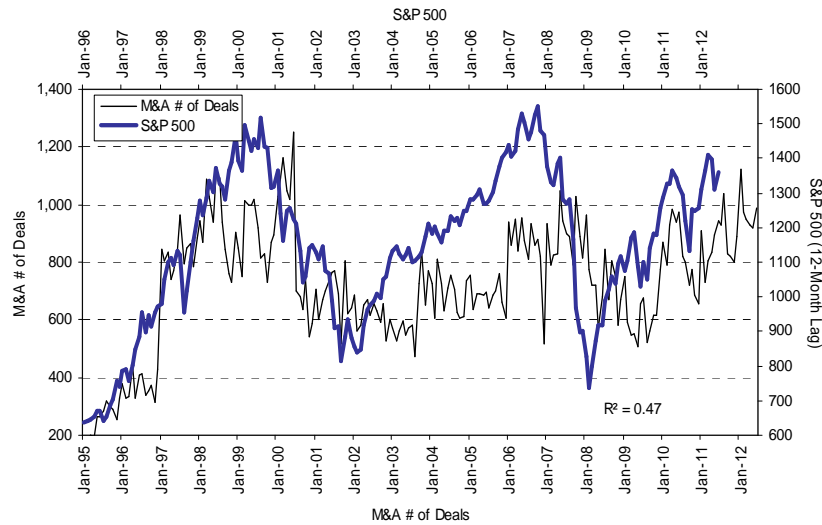
## Dividends vs. Share Shrinkers \*



\* Shrinkers: Equally weighted index of: AZO, BMC, INTU, KR, PGR, COL, SHW, WAT.

- Share shrinkage outperforms dividend payouts.

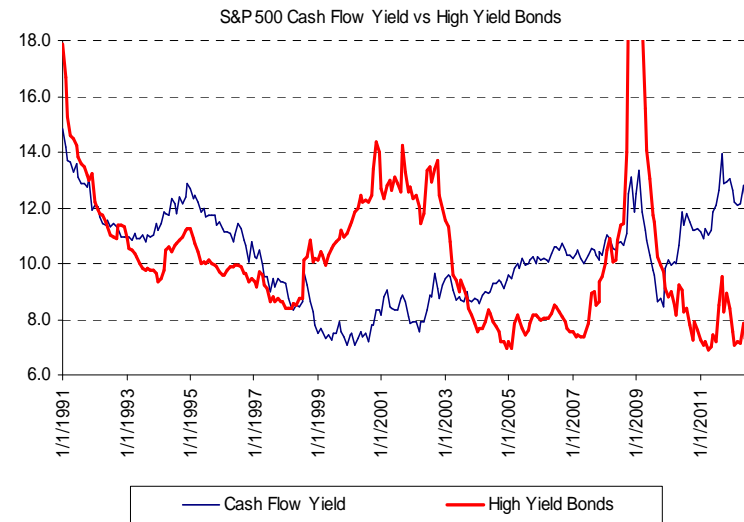
## Number of M&A Deals vs. S&P 500 (12-Mo. Lag)



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

- A pick up in “de-equitization” seems likely.

## S&P 500 Cash Flow Yield vs Junk Bond Yield



- Energy, Telecom, Materials, Information Technology, and Health Care have the widest spreads.

# The Raging Bull Thesis

---

- Developments Behind New Secular Bull Market Beginning in 12-18 Months:

- Nascent US Housing Recovery

- American Manufacturing Renaissance

- US Energy Independence

- The Technology/Mobility Explosion

- Demographic Shift

- Pension Fund Re-allocation

- US Fiscal Reform

Growth Drivers

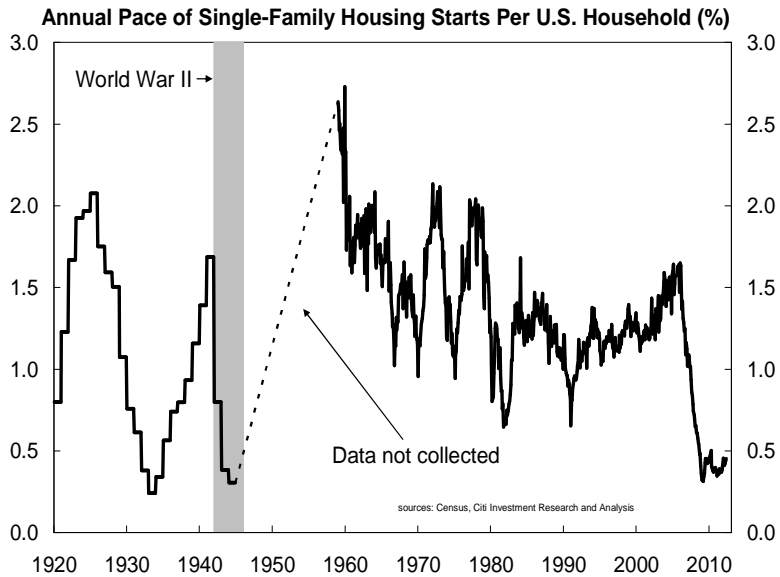
New Flows

Multiple Enhancer



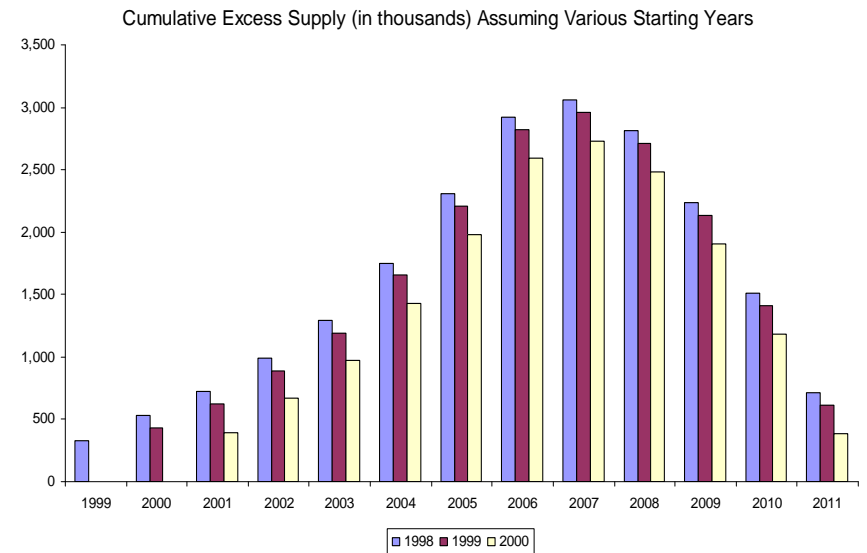
# The Housing Sector

## Home Building Activity



Source: Citi Research – US Economics

## Excess US Homes Depletion

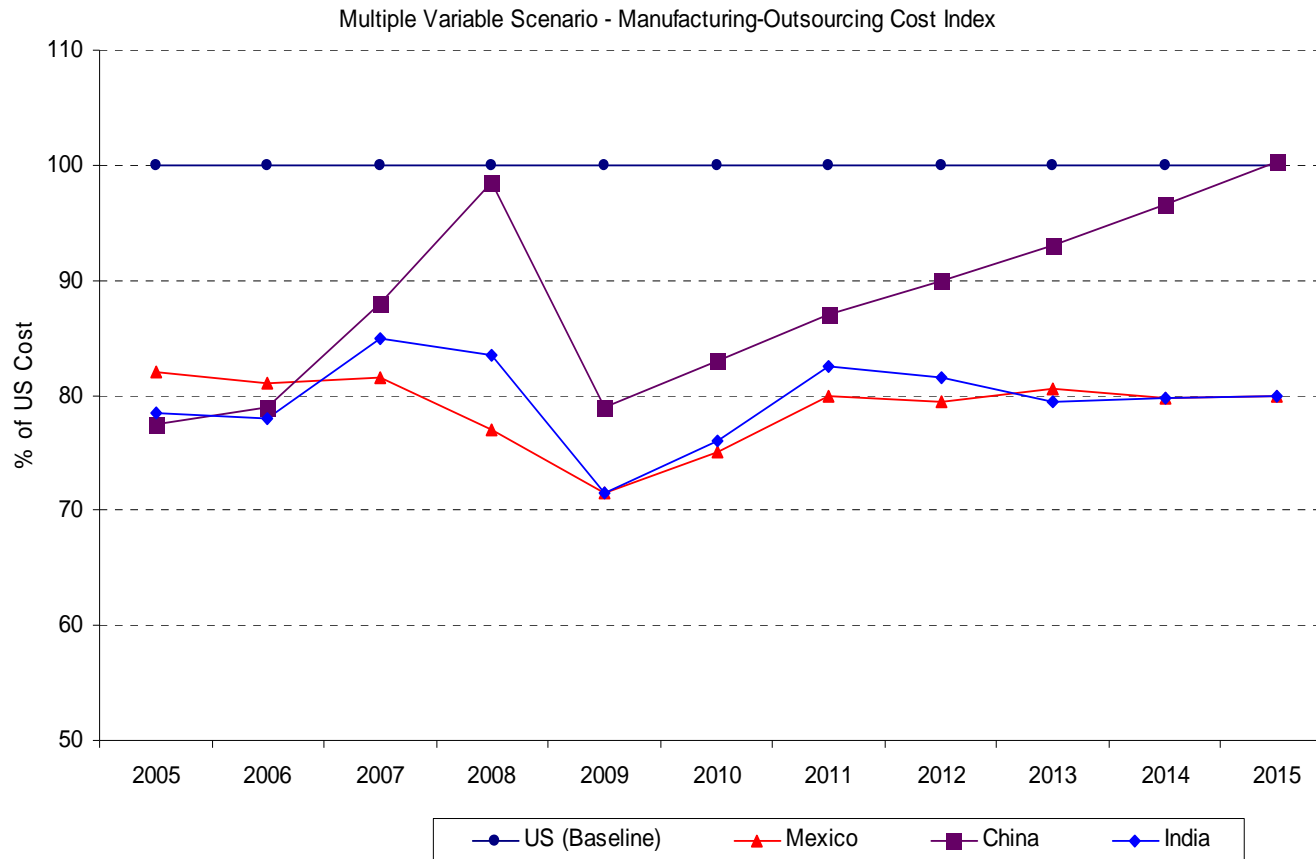


Source: Citi Research - Homebuilding

- A bottom seems very likely and probably sooner rather than later.

# US Manufacturing Competitiveness

## Manufacturing Outsourcing Cost Index



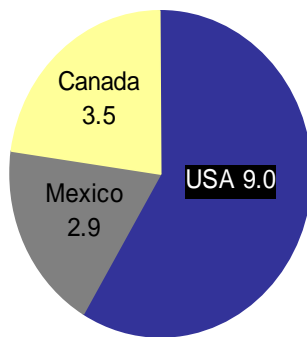
Source: AlixPartners

- Exchange rates, rising wages, and higher transportation costs are making the US very competitive.

# US Energy Story

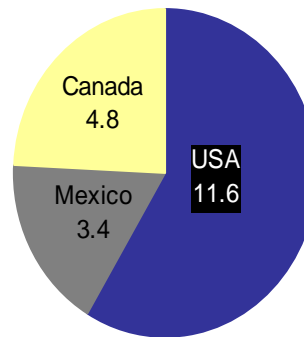
## North American Liquids Supply Production (M B/D)

North American Liquids Supply Production (M B/D) - 2011



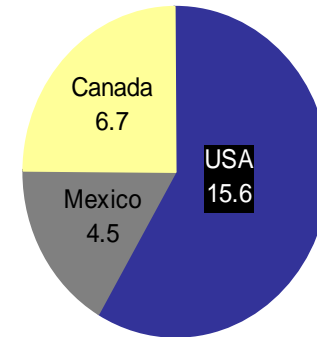
Total: 15.4 (MB/D)

North American Liquids Supply Production (M B/D) - 2015



Total: 19.8 (MB/D)

North American Liquids Supply Production (M B/D) - 2020



Total: 26.8 (MB/D)

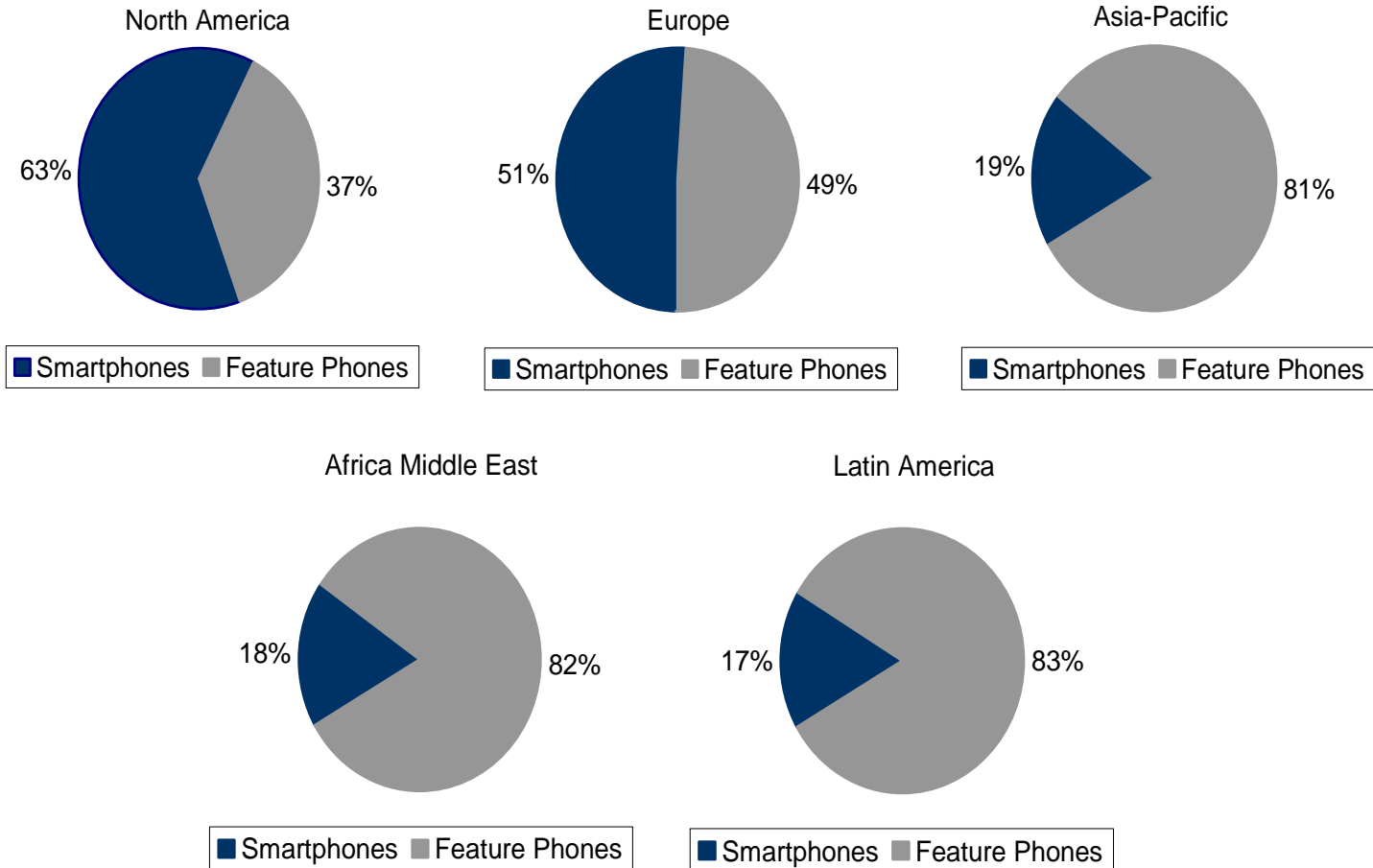
Source: Citi Research – Commodities Strategy

- North American liquids supply production growing by about 75% between 2011 and 2020.
- US oil imports to drop to 2 million barrels per day in 2020 from slightly less than 9 mbd in 2011.

# Technological Innovation and Penetration - Mobility

## Geographic Smartphone Penetration

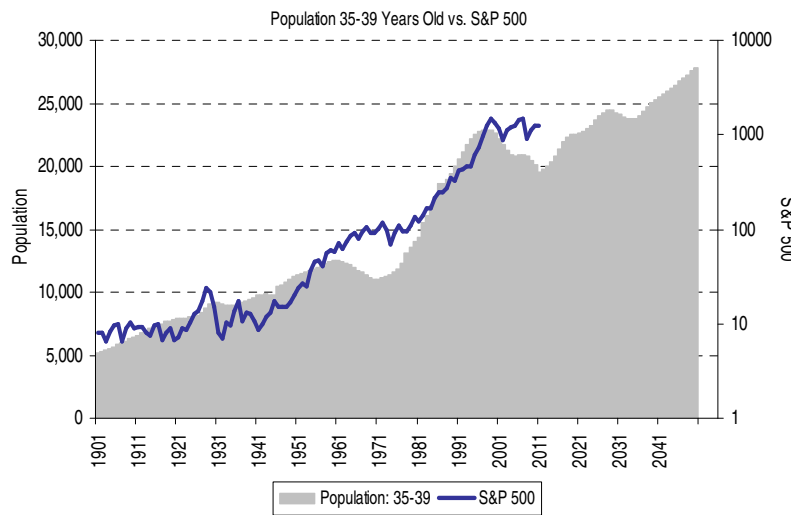
Smartphone Penetration by Region



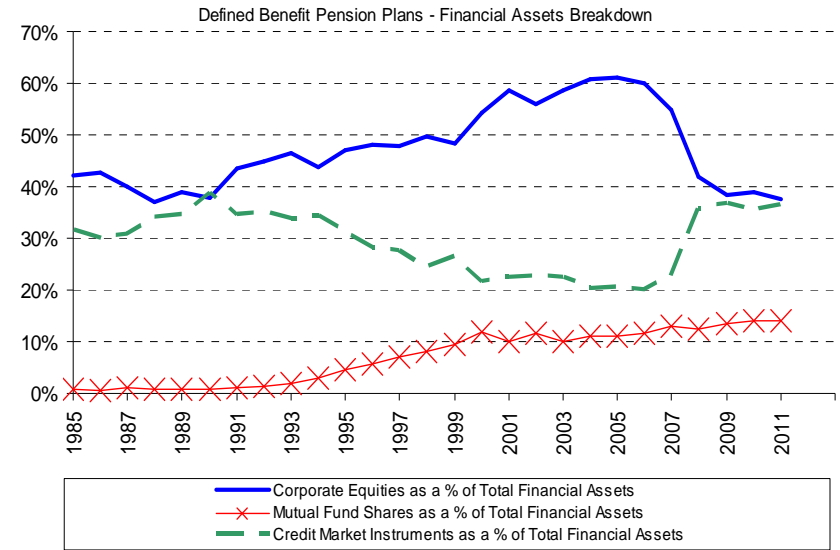
Source: VisionMobile

# Demographic Shift

## New Baby Boom Echo Savers



## DB Pension Plans – Financial Assets Breakdown

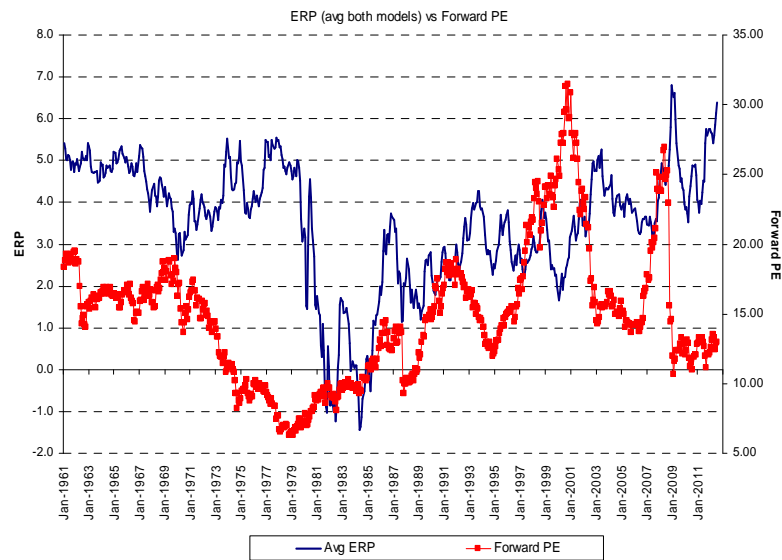


Source: Haver Analytics and Citi Research – US Equity Strategy

- The baby boom echo should begin saving for retirement in 2013.

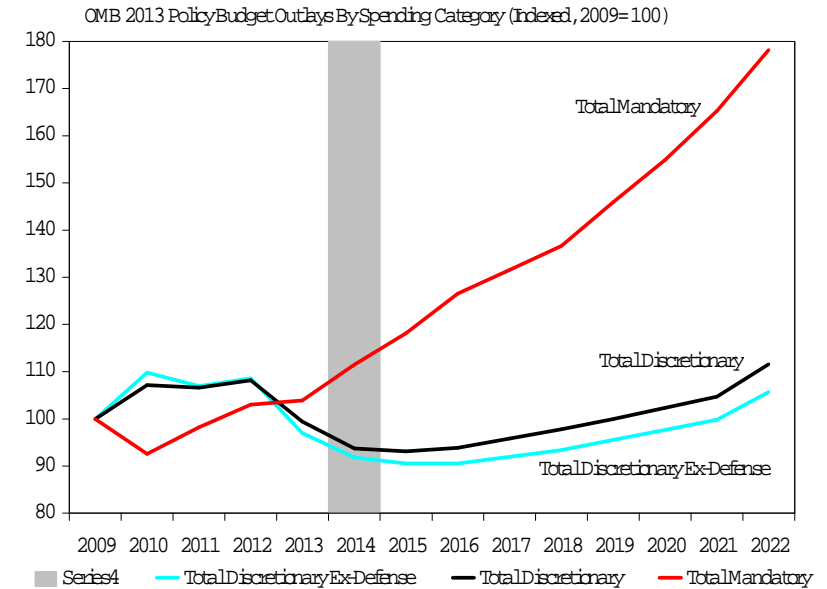
# US Fiscal Reform

## Equity Risk Premium vs P/E



Source: OMB and Citi Research – US Economics

## Mandatory Government Spending



Source: Haver Analytics, FactSet and Citi Research – US Equity Strategy

- \$525 billion fiscal cliff beginning in 2013 will compel political action.
- Surge in 2014 mandatory spending should force reform, especially given the “prequel” in Europe.

# “Trading Places” Thesis Remains Intact

## Industry Group Recommendations

<i>Overweight</i>	<i>Market Weight</i>	<i>Underweight</i>
Food, Beverage & Tobacco	Banks	Autos & Components
Household & Personal Products	Commercial Services & Supplies	Consumer Durables & Apparel
Insurance	Energy	Capital Goods
Semis & Semi Equipment	Health Care Equipment & Services	Retailing
Tech Hardware & Equipment	Pharma & Biotechnology	Materials
Telecom Services	Real Estate	Software & Services
Utilities	Transportation	Consumer Services
Diversified Financials	Food & Staples Retailing	Media

## Sector Recommendations (Based on Industry Group Recommendations)

<i>Overweight</i>	<i>Market Weight</i>	<i>Underweight</i>
Consumer Staples	Energy	Consumer Discretionary
Financials	Health Care	Industrials
Information Technology		Materials
Telecom Services		
Utilities		

## Recent Changes

- On July 13<sup>th</sup>, we lifted Diversified Financials to Overweight from Market Weight, reduced Food & Staples Retailing to Market Weight from Overweight, and downgraded Media to Underweight from Market Weight.
- On May 11<sup>th</sup>, we raised Household & Personal Products to Overweight from Market Weight, lifted Pharma & Biotech to Market Weight from Underweight, reduced Diversified Financials to Market Weight from Overweight, and lowered Consumer Services to Underweight from Market Weight.
- On March 9<sup>th</sup>, we lifted Food & Staples Retailing to Overweight from Market Weight, raised Utilities to Overweight from Market Weight, upgraded Real Estate to Market Weight from Underweight, and reduced Materials to Underweight from Market Weight.
- On November 11<sup>th</sup>, we raised Health Care Equipment & Services to Market Weight from Underweight, upgraded Media to Market Weight from Underweight, lifted Materials to Market Weight from Underweight, and lowered Software & Services to Underweight from Market Weight.
- On September 9<sup>th</sup>, we raised Household & Personal Products to Market Weight from Underweight, lifted Transportation to Market Weight from Underweight, upgraded Telecom Services to Overweight from Market Weight, and lowered Energy to Market Weight from Overweight.

Source: Citi Research - US Equity Strategy

# Citi Research Recommended List

	YTD								Recent Changes:
	Through August 7, 2012	2011	2010	2009	2008	2007	2006	2005	
S&P 500 Performance	11.43%	0.00%	12.78%	23.45%	-38.49%	3.53%	13.62%	3.00%	*WCRX was removed after the close on 7/17/2012, see call note for details
S&P 500 Total Return	12.83%	2.11%	15.06%	26.46%	-37.00%	5.49%	15.79%	4.90%	*AET was added after the close on 7/16/2012, see call note for details
Recommended List Index Equal Weighted Performan	9.47%	-8.47%	14.82%	42.57%	-35.93%	8.59%	14.99%	14.01%	Rec List changes are announced via a call note posted on Velocity and other vendor platforms; we do not maintain an email list announcing changes; FA's with questions, please contact MSSB Equity Sales at 914-225-7000
Recommended List Index Equal Weighted Total Retu	10.46%	-6.77%	17.00%	45.55%	-34.53%	10.13%	16.50%	15.29%	
Recommended List Portfolio Beta	1.24								

	Statistical Overview				Analyst Ratings, Targets & Estimates							Attributes			
	Date Added	Price Added	Price Since (8/7/12)	Perf. Since Added	Mkt Cap (mil)	2012 Perf. YTD	Fiscal Year End	Rating	Price Target	EPS Estimates Next	Cur.	P/E Next	Cur.	5-Year Beta	Div. Yield Drivers, Fundamentals & Valuation
<b>CONSUMER DISCRETIONARY</b>															
Starwood Hotels & Resorts (HOT)	7/27/2010	\$48.38	\$56.10	15.96 %	\$11,067	16.95%	Dec	1	\$65.00	\$2.64	\$2.52	21.3	22.3	1.90	0.9% Leverage to cyclical recovery in hotel demand, global growth opportunities
Harley-Davidson (HOG)	4/10/2012	\$46.86	\$42.37	-9.58 %	\$9,618	9.00%	Dec	1	\$53.00	\$3.45	\$2.75	12.3	15.4	1.89	1.5% Improving retail trends, investment in consumer recovery
Newell Rubbermaid Inc (NWL)	11/20/2009	\$14.45	\$17.42	20.55 %	\$5,050	7.86%	Dec	1	\$21.00	\$1.80	\$1.65	9.7	10.5	1.37	2.3% Attractive FCF yield, aggressive cost cutting will help offset tough environment
<b>CONSUMER STAPLES</b>															
Reynolds American Inc (RAI)	4/8/2011	\$35.71	\$45.69	27.95 %	\$25,835	10.31%	Dec	1	\$50.00	\$3.28	\$2.98	13.9	15.3	0.43	5.2% Unique int'l exposure, improving cigarette mkt share trends
Procter & Gamble (PG)	5/11/2012	\$63.68	\$66.22	3.99 %	\$181,450	-0.73%	Jun	1	\$75.00	\$4.07	\$3.87	16.3	17.1	0.48	3.4% Healthy FCF, business model w/relatively dominant mkt share and balanced brand portfolio
<b>ENERGY</b>															
Apache Corp (APA)	12/21/2009	\$101.79	\$88.03	-13.52 %	\$34,420	-2.82%	Dec	1	\$120.00	\$9.77	\$9.50	9.0	9.3	1.35	0.8% Growth opportunities, strong balance sheet
<b>FINANCIALS</b>															
Goldman Sachs Group, Inc. (GS)	4/13/2009	\$124.33	\$103.24	-16.96 %	\$51,126	14.17%	Dec	1	\$120.00	\$12.15	\$10.95	8.5	9.4	1.58	1.8% Attractively priced, well positioned, relatively clean balance sheet
Blackstone Group L.P. (BX)	7/13/2012	\$12.86	\$13.70	6.53 %	\$6,916	-2.21%	Dec	1	\$18.00	\$1.77	\$1.39	7.8	9.8	2.06	2.9% Strong strategic positioning, market share gains, rising alternative allocations
CME Group Inc (CME)	7/27/2010	\$56.77	\$53.06	-6.54 %	\$17,562	8.88%	Dec	1	\$58.00	\$3.78	\$3.33	14.0	15.9	0.98	3.4% Improving volumes in interest rate futures, potential in-roads into OTC mkts
Macerich Co (MAC)	3/9/2012	\$54.43	\$58.20	6.93 %	\$7,757	15.02%	Dec	1	\$61.50	\$3.12	\$3.05	18.6	19.1	1.87	3.8% Trading at a discount to peers, solid balance sheet, good internal & external growth drivers
<b>HEALTH CARE</b>															
Aetna (AET)	7/16/2012	\$38.03	\$37.20	-2.18 %	\$12,432	-11.83%	Dec	1	\$56.00	\$5.60	\$5.15	6.6	7.2	1.12	1.9% Earnings upside potential
Covidien Ltd (COV)	10/17/2008	\$45.76	\$57.18	24.96 %	\$27,404	27.04%	Sept	1	\$64.00	\$4.42	\$4.27	12.9	13.4	0.87	1.6% Favorable business mix, higher EPS outlook
<b>INDUSTRIALS</b>															
FedEx Corp. (FDX)	9/9/2011	\$73.40	\$89.82	22.37 %	\$28,387	7.56%	May	1	\$105.00	\$9.00	\$7.35	10.0	12.2	1.06	0.6% Poised for significant EPS growth in FY12 & FY13
CSX Corp. (CSX)	1/13/2011	\$23.09	\$22.84	-1.08 %	\$23,753	8.45%	Dec	1	\$27.00	\$2.05	\$1.85	11.1	12.4	1.24	2.5% Likely to exceed operating ratio internal targets, upside potential to EPS estimates
<b>INFORMATION TECHNOLOGY</b>															
Lam Research (LRCX)	3/30/2012	\$44.62	\$35.71	-19.97 %	\$4,785	-3.54%	Jun	1	\$39.00	\$4.55	\$1.55	7.8	23.0	1.17	0.0% Solid execution and growth in operating margins despite difficult cost environment
Qualcomm (QCOM)	8/23/2011	\$48.06	\$61.34	27.63 %	\$105,014	12.14%	Sept	1	\$74.00	\$3.95	\$3.63	15.5	16.9	0.85	1.6% Smart phones remain strong, chip unit build plans accelerating
Texas Instruments Inc (TXN)	6/10/2011	\$32.15	\$29.23	-9.08 %	\$33,257	0.41%	Dec	1	\$31.00	\$2.10	\$1.64	13.9	17.9	0.91	2.3% Likely continuation of share gain, better-than-expected mgmt of expenses
Amphenol Corp. (APH)	2/4/2011	\$57.52	\$61.36	6.68 %	\$9,879	35.18%	Dec	1	\$71.00	\$3.90	\$3.42	15.8	17.9	1.23	0.7% Strong end-market growth, org & inorg expansion, product mix improvement
<b>UTILITIES</b>															
The AES Corp. (AES)	6/10/2011	\$12.31	\$11.53	-6.34 %	\$8,642	-2.62%	Dec	1	\$16.00	\$1.29	\$1.24	9.0	9.3	1.27	1.4% More focused direction from mgmt and attractive valuation

Note: Portfolio performance based on daily index level as calculated by S&P/Citigroup Global indices; index performance incorporates historical constituent changes and is measured using daily close prices.

Price added is prior day's close when stock is added b/f market open. Price added is same day close when stock is added after market open. Methodology generally mirrors that used to calculate the S&P equal weighted index. No transaction costs are assumed.

Past performance not indicative of future performance.

Source: Citi Research, S&P Global Indices, and FactSet



# Economic Forecast

## Citi Economic Forecast

Citigroup Forecast	Last Update: July 25, 2012															
	Percent Change from Preceding Quarter at Annual Rate or Percent Change from Year-ago Quarter															
	History					Forecast					Hist			Forecast		
	2011.1	2011.2	2011.3	2011.4	2012.1	2012.2	2012.3	2012.4	2013.1	2013.2	2013.3	2013.4	2011	2012	2013	
<b>Real GDP (Q/Q)</b>	0.4	1.3	1.8	3.0	1.9	1.3	1.7	2.0	1.3	2.0	3.2	3.5				
—Y/Y % Change	2.2	1.6	1.5	1.6	2.0	2.0	1.9	1.7	1.6	1.7	2.1	2.5	1.7	1.9	2.0	
—4Q/4Q % Change													1.6	1.7	2.5	
<b>Personal Consumption Expenditures (Q/Q)</b>	2.1	0.7	1.7	2.1	2.5	1.2	1.8	2.1	1.3	2.1	3.0	3.5				
—Y/Y % Change	2.8	2.2	2.0	1.6	1.7	1.9	1.9	1.9	1.6	1.8	2.1	2.5	2.2	1.8	2.0	
Durable Goods	11.8	(5.3)	5.7	16.1	13.7	(3.3)	3.4	3.6	1.3	3.2	5.9	7.4	8.2	6.6	3.0	
Nondurable Goods	1.6	0.2	(0.6)	0.8	2.1	1.7	1.2	1.8	1.2	2.5	3.3	3.5	1.7	1.2	2.0	
Services	0.8	1.9	1.9	0.4	0.8	1.8	1.8	1.9	1.3	1.8	2.5	2.8	1.4	1.3	1.9	
<b>Nonresidential Fixed Investment (Q/Q)</b>	2.1	10.3	15.7	5.2	3.1	2.4	3.3	4.8	6.4	5.7	7.5	7.2				
—Y/Y % Change	10.0	8.0	9.1	8.2	8.5	6.5	3.5	3.4	4.2	5.0	6.1	6.7	8.8	5.4	5.5	
Structures (Q/Q)	(14.4)	22.6	14.4	(1.0)	1.9	(1.1)	1.5	2.4	2.9	3.0	3.5	3.5				
—Y/Y % Change	1.5	4.9	7.4	4.4	9.1	3.4	0.3	1.2	1.4	2.4	2.9	3.2	4.6	3.4	2.5	
Equipment & Software (Q/Q)	8.7	6.3	16.2	7.5	3.5	3.8	3.9	5.6	7.7	6.7	8.9	8.5				
—Y/Y % Change	13.4	9.2	9.7	9.6	8.3	7.6	4.7	4.2	5.2	6.0	7.2	7.9	10.4	6.1	6.6	
<b>Residential Fixed Investment (Q/Q)</b>	(2.5)	4.2	1.3	11.7	20.0	11.0	12.3	14.9	16.7	21.8	18.4	22.3				
—Y/Y % Change	(2.9)	(6.8)	1.3	3.5	9.0	10.8	13.7	14.5	13.7	16.4	17.9	19.8	(1.3)	12.0	17.0	
Change in Private Inventories (\$bln)	49.1	39.1	(2.0)	52.2	54.4	60.6	58.2	56.0	55.9	51.1	54.7	56.0	34.6	57.3	54.4	
—contribution to GDP	0.3	(0.3)	(1.4)	1.8	0.1	0.2	(0.1)	(0.1)	(0.0)	(0.1)	0.1	0.0	(0.2)	0.0	(0.0)	
<b>Net Exports (\$bln)</b>													(414)	(408)	(414)	
—contribution to GDP	(0.3)	0.2	0.4	(0.3)	0.1	(0.1)	0.0	0.1	(0.1)	(0.1)	(0.1)	(0.1)	0.1	0.0	(0.1)	
Exports (Q/Q)	7.9	3.6	4.7	2.7	4.2	3.0	4.6	5.3	5.5	5.6	6.0	6.7	6.7	3.8	5.4	
Imports (Q/Q)	8.3	1.4	1.2	3.7	2.7	2.9	3.7	3.6	5.0	5.5	5.6	5.9	4.9	2.8	4.7	
<b>Gov't Consumption &amp; Investment (Q/Q)</b>	(5.9)	(0.9)	(0.1)	(4.1)	(4.0)	(0.8)	(0.8)	(1.8)	(2.8)	(1.7)	(1.1)	(1.1)	(2.1)	(2.2)	(1.7)	
Federal	(9.4)	1.9	2.1	(7.0)	(5.9)	(0.4)	(2.3)	(3.4)	(5.7)	(3.2)	(2.2)	(2.3)	(1.9)	(3.0)	(3.4)	
State & Local	(3.3)	(2.8)	(1.6)	(2.2)	(2.7)	(1.1)	0.2	(0.8)	(0.8)	(0.6)	(0.3)	(0.3)	(2.2)	(1.7)	(0.6)	
<b>Addenda:</b>																
Final Sales (Q/Q)	0.0	1.6	3.2	1.1	1.8	1.1	1.8	2.0	1.3	2.1	3.0	3.5				
—Y/Y % Change	2.2	1.9	2.3	1.5	1.9	1.8	1.4	1.7	1.5	1.8	2.1	2.5	2.0	1.7	2.0	
<b>Inflation Measures</b>																
PCE Deflator (Y/Y %)	1.8	2.5	2.9	2.7	2.3	1.7	1.3	1.4	1.2	1.5	1.8	1.9	2.5	1.7	1.6	
Core PCE Deflator (Y/Y %)	1.1	1.3	1.6	1.8	2.0	1.9	1.8	1.8	1.7	1.6	1.6	1.7	1.4	1.9	1.6	
Consumer Price Index (Y/Y %)	2.1	3.3	3.8	3.3	0.0	1.9	1.3	1.4	1.2	1.5	1.8	1.9	3.1	1.9	1.6	
Core Consumer Price Index (Y/Y %)	1.1	1.5	1.9	2.2	0.0	2.3	2.2	2.1	2.0	1.8	1.7	1.8	1.7	2.2	1.8	
<b>Interest Rates</b>																
Federal Funds (% End of Period)	0.10	0.07	0.06	0.04	0.09	0.25	0.25	0.25	0.25	0.25	0.25	0.25				
Federal Funds (% Annual Avg)													0.10	0.25	0.25	
10-year Treasury Bond (% Period Avg)	3.46	3.21	2.43	2.05	2.04	1.82	1.45	1.65	1.80	2.10	2.35	2.60	2.80	1.75	2.20	
<b>Others</b>																
Industrial Production (Y/Y % Change)	5.5	3.6	3.3	4.0	4.4	4.7	3.8	3.1	2.2	2.3	2.9	3.6	4.1	4.0	2.8	
Unemployment Rate (%)	9.0	9.0	9.1	8.7	8.3	8.2	8.1	8.1	8.0	8.0	8.0	7.9	9.0	8.1	8.0	
Federal Budget Balance (\$bln, FY, Unified)													(1,297)	(1,175)	(875)	
% of GDP													(8.7)	(7.6)	(5.5)	
<b>Corporate Earnings</b>																
S&P 500 Oper EPS Pre-writeoffs (\$/share)	23.50	24.14	25.65	24.55	25.60	25.70	26.00	25.95	26.30	27.05	27.10	27.55	97.84	103.25	108.00	
S&P 500 Oper EPS Pre-writeoffs (Y/Y %)	19.2	12.4	17.9	8.9	8.9	6.5	1.4	5.7	2.7	5.3	4.2	6.2	14.4	5.5	4.6	
S&P 500 GAAP EPS (\$/share)	21.44	22.24	22.63	20.64									86.95	94.50	98.00	
S&P 500 GAAP EPS (Y/Y %)	22.7	13.0	15.93	-0.1									12.4	8.7	3.7	

Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, Office of Management and Budget, Federal Reserve Board, First Call, and Citi.

- 2011 real GDP growth: 1.7%.
- 2012 estimate for real GDP growth: 1.9%.
- 2013 estimate for real GDP growth: 2.0%.
- 2010 Operating EPS for the S&P 500: \$85.49.
- 2011 Operating EPS estimate for the S&P 500: \$97.84.
- 2012 Operating EPS estimate for the S&P 500: \$103.25.

# Summary

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- S&P 500 to be up in 2012 driven by sentiment, valuation, earnings and credit conditions.
- Mid-year to face some challenges including margin pressure.
- Cash use and European recession themes.
- Industry group selectivity is necessary, but not all “beta” related.
- 2013’s Raging Bull Thesis.

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# Appendix A-1

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