

US Equity Strategy | 28 September 2012

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 appears undervalued based on earnings yield gap analysis and other metrics.
- **U:** Economic momentum, sovereign debt risks, geopolitics, and inflation.
- **L:** Domestic equity fund outflows and M2 increased last week.
- **S:** Panic/Euphoria moved further into neutral territory; while our Cyclical Expectations Model (CEM) inched up.
- **E:** Five out of ten S&P 500 sectors showed EPS revisions to the upside thus far in September, while the percent of upward revisions slid to 43.7%.

Estimate Revisions Slipping Again but Money Supply Ticks Up

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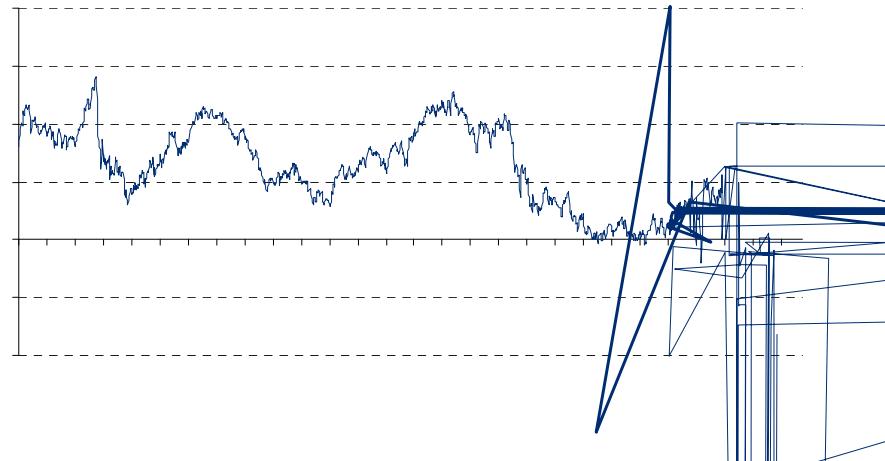
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Price (Valuation)

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



Price (Valuation)



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

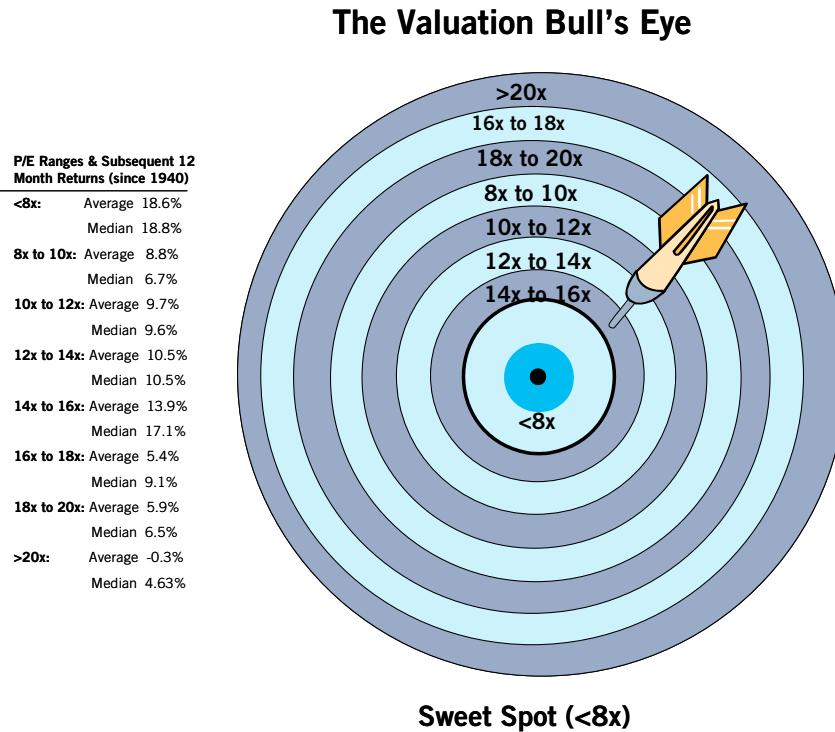
Key Takeaway

- At two-to-three standard deviations below its 40-year weekly average, the market outcome statistics remain bullish.
- Normalized earnings yield gap analysis indicates a 97% probability of S&P 500 gains over the next six months.
- Our earnings yield gap is now 1.20 standard deviations below the rolling mean, suggesting that equity valuations are attractive based on this metric, though investors anticipate higher bond yields in the future.

Key Takeaway

- Our model using Baa yields instead of the 10-year Treasury shows the market is undervalued at 1.46 standard deviations below the mean.
- Valuations using 10-year average earnings show stocks being relatively inexpensive versus A-rated bonds.
- One of our highly correlated valuation metrics now shows the S&P 500 to be more than 35% undervalued.

P/E “Bull’s Eye”



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

- The dart reflects the 14.26x 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): 14.26x
- P/E (2012E EPS): 14.05x
- P/E (2013E EPS): 13.40x
- Price to Sales: 1.34x vs. avg Price to Sales of 1.29x since 1985
- Price to Book: 2.26x vs. avg Price to Book of 2.83x since 1985
- Price to EBITDA: 6.75x vs. avg Price to EBITDA of 7.41x since 1985
- Market Value: \$13.70 trillion
- Dividend Yield: 2.21%

The dart is here.

Citi Economic and Market Analysis

S&P 500 Operating EPS forecast:

- 2008A = \$61.79
- 2009A = \$62.05
- 2010A = \$85.49
- 2011A = \$97.82
- 2012E = \$103.00
- 2013E = \$108.00

Unanticipated

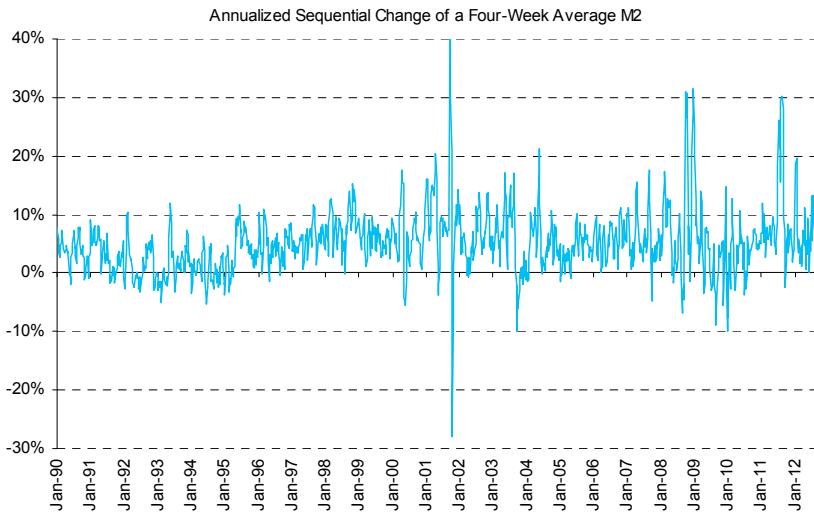
Negative Market Impact

- European Sovereign Credit
- Economic/Earnings Disappointments
- Middle East Upheaval
- Government Policy Missteps
- Protectionism
- Foreign Exchange Volatility

Positive Market Impact

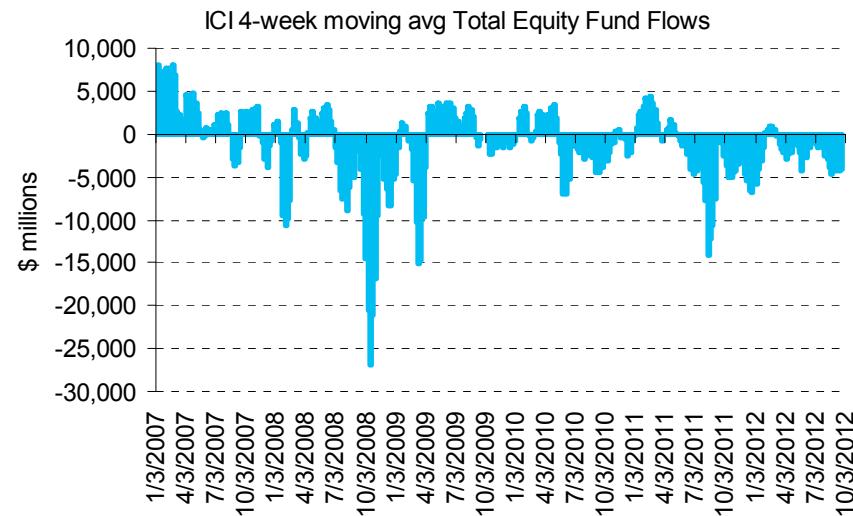
- Efficacy of Fed/ECB/Government Policy
- Earnings Resilience
- Improving Housing Data
- Strengthening Industrial Data
- US Fiscal Progress
- M&A
- Mutual Fund Inflows

Liquidity



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

Liquidity (Money Flows)



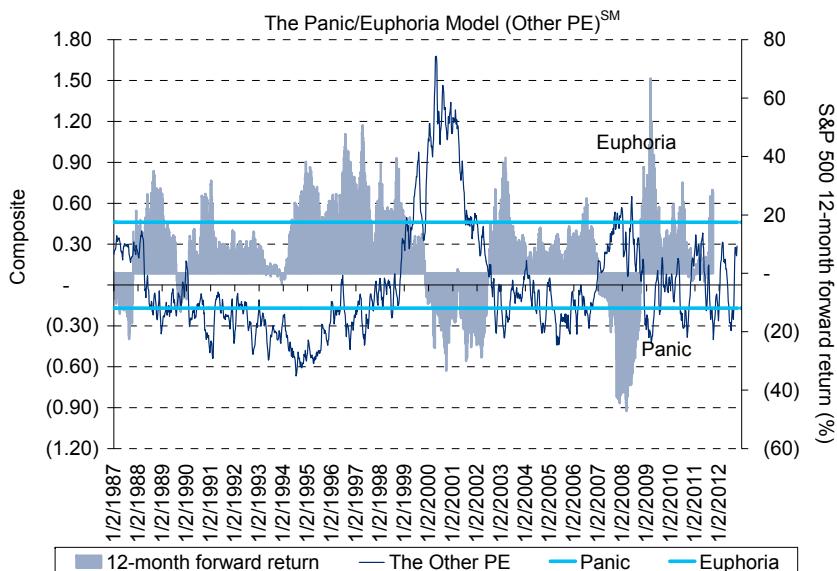
Source: Haver Analytics and Citi Research – U.S. Equity Strategy

Key Takeaway

- Sequentially, M2 increased last week.
- The annualized sequential change of the four-week average jumped to 12.07% from 7.00% in the prior week.

- According to ICI, investors pulled \$5.16 billion from total equity funds for the week-ending September 19th.
- Domestic funds suffered outflows of \$4.80 billion while foreign funds posted outflows of \$355 million.
- Bond funds attracted inflows of \$8.00 billion.
- For overall equity funds, the four-week moving average dipped to an outflow of \$4.05 billion from the prior week's four-week average outflow of \$4.22 billion.

Sentiment

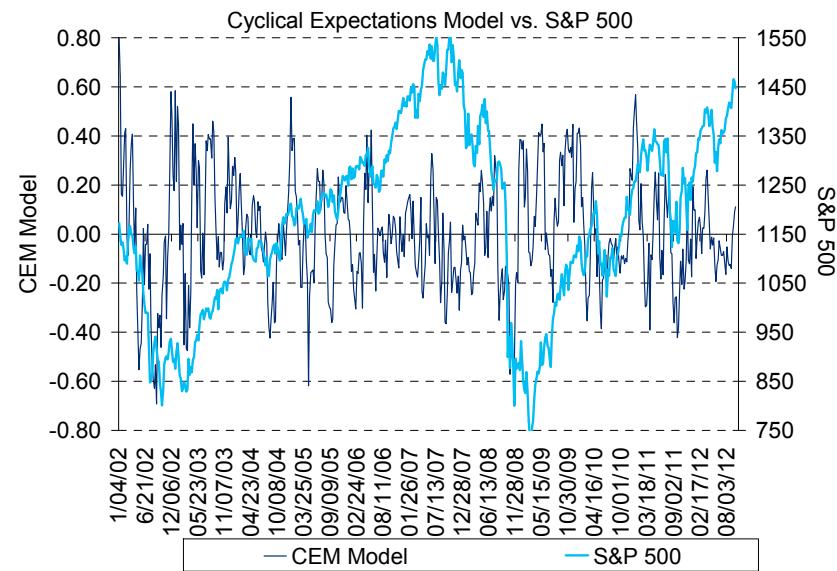


Source: Haver Analytics, FactSet, and Citi Research – U.S. Equity Strategy

Key Takeaway

- Our Panic/Euphoria moved further into neutral territory this week.
- This week's Panic/Euphoria reading was 0.29; versus last week's revised number of 0.21. Panic readings begin at -0.17 while Euphoria begins at 0.46.
- Panic readings argue for significant market gains in the next 6-12 months with better than 90% historical probability.
- 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

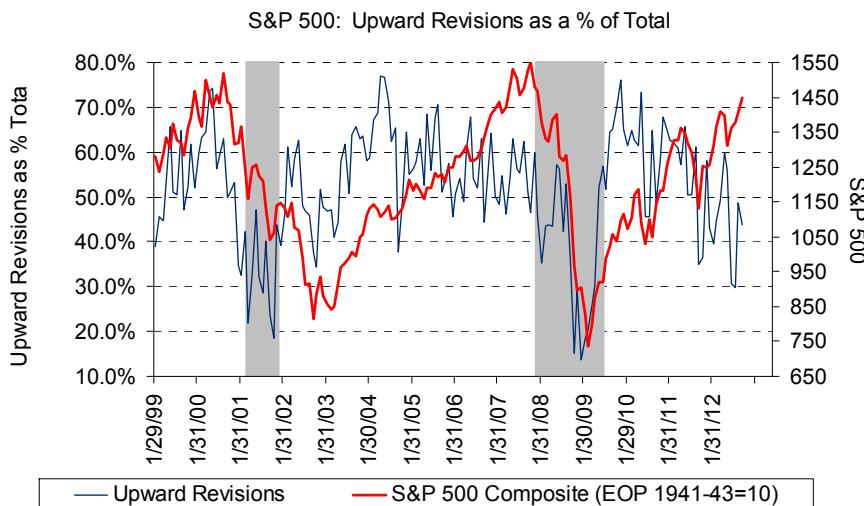


Source: Haver Analytics, FactSet, and Citi Research – U.S. Equity Strategy

Key Takeaway

- Our Cyclical Expectations Model (CEM) inched higher this week.
- 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.

Earnings



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

Earnings

	Monthly Upward Revisions as a % of Total Monthly Revisions						Avg Since 1990
	Sep-12	Aug-12	Jun-12	Mar-12	Dec-11	Sep-11	
S&P 500	43.67%	48.75%	30.54%	49.24%	43.06%	34.83%	49.06%
Consumer Discretionary	52.26%	50.75%	35.93%	55.23%	50.00%	40.85%	52.04%
Consumer Staples	70.00%	47.49%	41.35%	51.46%	48.63%	46.15%	47.51%
Energy	45.55%	49.89%	24.23%	38.59%	51.10%	41.11%	46.69%
Financials	58.99%	50.42%	22.79%	62.72%	32.50%	35.43%	47.41%
Health Care	54.41%	50.69%	36.88%	51.14%	41.54%	47.48%	52.03%
Industrials	18.67%	52.29%	33.12%	37.92%	57.23%	24.88%	47.32%
Information Technology	29.81%	43.83%	27.17%	52.42%	34.47%	19.41%	55.82%
Materials	35.45%	24.87%	29.46%	43.48%	20.00%	35.00%	41.48%
Telecom Services	21.43%	70.39%	75.00%	38.89%	12.00%	26.09%	45.96%
Utilities	47.46%	58.47%	28.85%	40.15%	49.23%	41.46%	45.67%

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

Key Takeaway

- Thus far in September, S&P 500 upward earnings estimate revisions dipped to 43.7% versus 48.8% in August.

Key Takeaway

Upward revisions as a % of total revisions for the S&P 500 were down thus far in September from August with five sectors showing revisions to the upside.

- Consumer Staples** – Beverages, Food & Drug Retailing, Food Products, Household Products, and Tobacco boosted revision levels.
- Industrials** – Aerospace & Defense, Air Freight & Logistics, Airlines, Machinery, and Road & Rail contributed to the plunging revision levels.
- Information Technology** – Internet Software & Services, Semiconductor Equipment & Products, and Software were responsible for the weakness.
- Materials** – Chemicals and Paper & Forest Products sent revisions higher.
- Telecom Services** – Diversified and Wireless Telecommunication Services led to the decline in upward revisions.

The PULSE Prognosis

Where We Stand on the Equity Market

- The PULSE framework is neutral on three fronts (unanticipated, sentiment and liquidity), and positive on two (earnings, and valuation).
- Our Panic/Euphoria model remained in neutral territory, while our proprietary Cyclical Expectations Model moved higher. One of our highly-correlated valuation metrics argues that the S&P 500 is more than 35% undervalued, and other metrics also are attractive.
- Equity markets retreated this week. In September, consumer confidence jumped to a better-than-expected 70.3 on gains in both the present situation (+3.7 to 50.2) and expectations (+12.6 to 83.7). New home sales were flat in August at 373k. Durable goods orders plunged by 13.2% in August as defense orders sank by 27.8%. Core capital goods orders (ex-defense and aircraft) rose by 1.1%. 2Q GDP was revised down to 1.3% from 1.7%. Initial weekly jobless claims for the week-ending September 22 fell by 26,000 to 359,000.
- Given uncertainties around the upcoming 3Q12 reporting period (with downward guidance potential), the November elections, the fiscal cliff and plausible corporate restraint around policy direction, we expect some near-term volatility in the markets. Moreover, the Panic/Euphoria Model is signaling complacency readings while intra-stock price correlation has reversed its trend since becoming extended in June, which also indicates market strength could begin to wane. However, this does not alter our outlook for 2013 which remains attractive given signals from valuation, implied earnings growth and credit conditions to name a few factors, but with a fair amount of good news now behind markets (such as the Fed's latest QE, the German court decision on ECM and the pro-Europe Dutch elections), near-term upside catalysts may be wanting.
- On August 13th, Citi Economist, Steven Wieting fine tuned his 2012 S&P 500 estimate to \$103.00 from \$103.25 (+5.3 y/y growth) and left his 2013 estimate of \$108.00 unchanged (+4.9% y/y growth).
- On September 21, 2012, we raised Consumer Services to Market Weight from Underweight, reduced Food, Beverage & Tobacco to Market Weight from Overweight, lowered Household & Personal Products to Market Weight from Overweight, lifted Transportation to Overweight from Market Weight, and upgraded Software & Services to Market Weight from Underweight. We are maintaining Overweights on Diversified Financials, Semis & Semi Equipment, Tech Hardware & Equipment, Insurance, Telecom Services, and Utilities. Underweights on Autos & Components, Consumer Durables & Apparel, Retailing, Media, Capital Goods, and Materials are sustained.

S&P 500 Operating Earnings	2010A	2011A	1Q12A	2Q12E	3Q12E	4Q12E	2012E	1Q13E	2Q12E	3Q12E	4Q12E	2013E
Citi	\$85.49	\$97.82	\$25.60	\$25.70	\$25.90	\$25.80	\$103.00	\$26.30	\$27.05	\$27.10	\$27.55	\$108.00
Thomson Consensus	\$85.32	\$97.82					\$103.42					\$115.30

Index	2008A	2009A	2010A	2011A	2012E	2013E
S&P 500	903	1,115	1,258	1,258	1,425	1,615
DJIA	8,776	10,428	11,578	12,218	13,550	15,300

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



Appendix A-1

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