1 OCTOBER 2018

Cyclical Stocks: Further to Run?

Citi analysts think it is too early to give up on cyclicals – Energy, Materials, Industrials, Consumer Discretionary, Financials and Technology sectors – as continued growth in the global economy may indicate that cyclicals are due to bounce back.

Global cyclical stocks – except Technology – started the year strongly, but struggled during the market correction in February. Despite a recent rebound, cyclicals in every major market are still below their peak earlier this year – having fallen most in Australia as well as emerging markets (EM) while most resilient in the US.

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Market Performance

In the US – the Dow Jones Industrial Average, S&P 500 and Nasdaq Composite were up by 1.51%, 0.57% and 0.20% respectively in September.

The European Stoxx 600 fell 0.59% while the Nikkei 225 and Topix were up by 5.73% and 4.94%, respectively.

The MSCI Emerging Markets fell 2.12% while the MSCI Emerging Europe gained 5.88%.

Meanwhile, MSCI AsiaXJapan fell 2.47% while Hong Kong's Hang Seng was down by 1.99%.

In China, the Shanghai Composite Index was up 1.56%.

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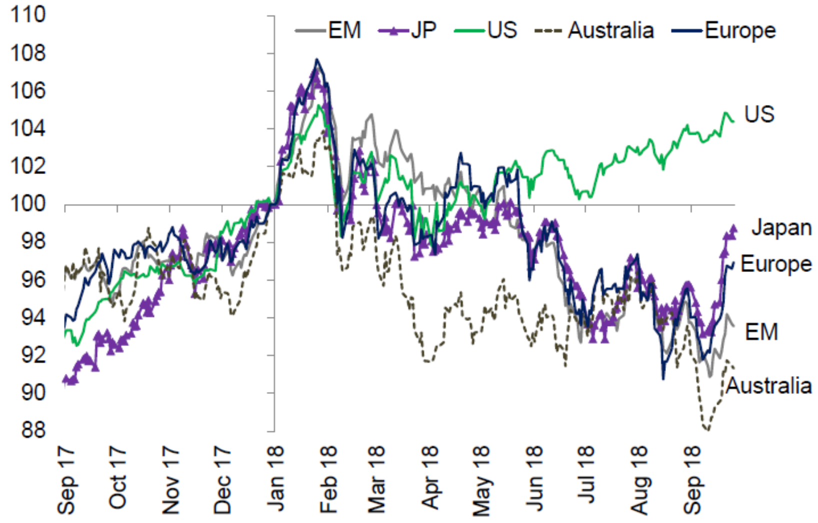
Cyclical Stocks: Further to Run? (continued)

- Cyclicals (except Technology) have underperformed defensives in all major markets except EM, where defensives have been even worse. Severe cyclical underperformance in Japan was partly a function of strong performance from Japanese defensives. In Europe, the Financials sector was the biggest drag on the cyclical trade.

"Cyclicals are also now at a 20% discount relative to defensives."

Cyclicals Performance in USD



Source: Citi Research, MSCI, Datastream. As of 26 September 2018.
Note: IT is excluded from this analysis. Rebased on 31 December 2017.

- Global cyclicals are now trading at a price-to-earnings (PE) ratio of 13x, compared to 15.5x back in January. Cyclicals are also now at a 20% discount relative to defensives, compared to a 10% discount in January.

- Citi analysts believe this economic and market cycle has further to run and that it is too early to turn defensive across equity portfolios as robust global economic fundamentals mean that cyclicals should continue to fare well. Citi analysts also believe that the recent underperformance of cyclicals is an attractive opportunity for investors.

- Citi analysts see scope for a rebound in cyclicals outperformance in the eurozone and in EM, especially if trade tensions abate and macro indicators stabilize – as they are showing signs of doing.

- However, the period of strong synchronized global growth between 2016 and early 2018 is unlikely to re-emerge, meaning that the upside gains from cyclicals may be limited. As a result, Citi analysts remain neutral on cyclicals versus defensives.

EM Asia Equities: Recovery Ahead?

Can EM Asia equities bounce back from market fears due to USD strength and trade risks?

- Two key sources of recent emerging market (EM) turbulence have been a faster-growing US and slower growth in China. Market sentiment has also been somewhat negative, largely due to USD strength and trade risks.

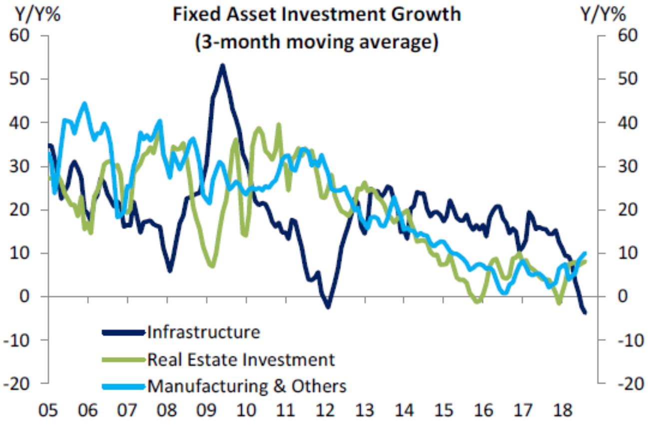
- A faster-growing US is usually positive for markets, but accelerating growth occurred only in the US this year due to tax cuts – growth elsewhere merely held steady. Citi analysts believe this growth gap may narrow in 2019 as the tax cut impact is unlikely to be repeated. However, the US economy may still be healthy – but the degree to which it can beat expectations is already subdued as expectations have risen.

- China's growth slowdown was mostly driven by domestic tightening – but the government has taken significant policy easing steps, which may likely show more impact from Q4 2018 into the first half of 2019.

- Infrastructure investment growth – the biggest drag on growth so far this year – could be revived from negative to over 10% in 4Q18. Monetary and regulatory easing is restoring credit growth, particularly in bond issuance.

"Citi analysts believe EM Asia equities could see strong returns over the coming decade."

Infrastructure investment dragged growth, but may now be revived with funding from more local bond issuance



Source: National Bureau of Statistics, Haver Analytics. As of 31 August 2018.

- Citi analysts believe EM Asia equities could see strong returns over the coming decade. Even if short-term tactical allocation shifts may be made in the asset class as a result of trade and monetary policy developments, they are unlikely to change Citi analysts' longer-term strategic view.

Further Upside for European Equities

Citi analysts are positive on Europe ex-UK equities as trade tensions between Europe and the US subside.

- In September, Europe ex-UK equities traded nearly 5% lower than the beginning of August – driven primarily by escalating global trade risks and higher investor risk aversion. Citi analysts are now less concerned about the possibility of a US-Europe trade war, following constructive discussions in August between US President Donald Trump and European Commission President Jean-Claude Juncker. Citi analysts also believe the US is unlikely to impose auto tariffs upon the EU.

- Citi analysts are overweight Europe ex-UK equities – favoring French and Swiss equities as well as the banking sector. Citi analysts also continue to favor mid-caps – which outperformed over the last six months, benefiting from their domestic orientation as global trade tensions rose.

- On a cyclically adjusted price-to-earnings basis, Europe ex-UK equities (21x) are trading at a 25% discount relative to US equities (28x). This is also significantly cheaper than the 12% discount upon which Europe has historically traded. On a price-to-book basis, Europe is 47% cheaper than the US – which is a historically low level.

- Earnings also continue to be strong in Europe, with consensus estimates currently pointing to 11% growth in 2018 and 10% in 2019.

"On a price-to-book basis, Europe is 47% cheaper than the US – a historically low level."

Europe versus US equity price-to-book discount

Source: Bloomberg. As of 13 September 2018.

US Midterm Elections May Weigh on USD

Could this be the turning point towards long-term USD weakness?

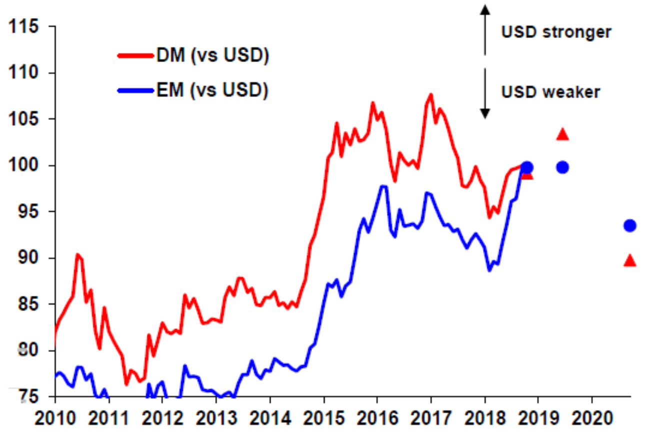
- USD: Citi analysts believe that if the Democrats regain control over the Lower House in the upcoming US midterm elections, this could accelerate the turning point where US fiscal policy becomes less USD supportive, turning USD strength into long-term weakness. Citi analysts also reiterate that fiscal stimulus, tax reform and larger deficits may all be bearish factors for the USD.

- EUR: Citi analysts are bullish EUR for the long term if Europe's data momentum improves – although renewed political uncertainty from Italy or elsewhere and continued weak data/inflation news may pose as downside risks for EUR.

- JPY: JPY is the outperformer versus USD this year, illustrating its attractiveness as a safe haven. Event risks around the Italian budget, Brexit and trade disputes could support the currency, although Citi analysts believe policy divergence could be bearish for JPY.

> "Fiscal stimulus, tax reform and larger deficits may all be bearish factors for the USD."

DM & EM – Forecasts Path



Source: Citi Research. As of September 2018.

- GBP: Valuation is supportive for GBP as it is now one of the cheapest currencies in G10. However, it could experience further weakness and volatility in the short term as the UK heads towards the traditionally Eurosceptic Conservative Party conference as well as the climax of Brexit negotiations.

- EM: Citi analysts expect further weakness from EM currencies – with IDR possibly the weakest due to a trade balance that has yet to improve. Citi analysts expect the RMB to modestly appreciate in six to 12 months, which may largely reflect Citi analysts' view of stabilized macro conditions and increased capital inflow on attractively valued equity market in China.

World Market at a Glance

	Last price	52-Week	52-Week	Historical Returns (%)			
	28-Sep-18	High	Low	1 week	1 month	1 year	Year-to-date
US / Global							
Dow Jones Industrial Average	26458.31	26769.16	22332.96	-1.07%	1.51%	18.22%	7.04%
S&P 500	2913.98	2940.91	2507.99	-0.54%	0.57%	16.09%	8.99%
NASDAQ	8046.35	8133.30	6454.86	0.74%	0.20%	24.68%	16.56%
Europe							
MSCI Europe	463.28	523.74	444.33	-1.31%	-1.06%	-2.40%	-5.02%
Stoxx Europe 600	383.18	403.72	362.04	-0.29%	-0.59%	-0.82%	-1.54%
FTSE100	7510.20	7903.50	6866.94	0.27%	-1.40%	2.56%	-2.31%
CAC40	5493.49	5657.44	5038.12	-0.01%	0.15%	3.77%	3.41%
DAX	12246.73	13596.89	11726.62	-1.48%	-2.24%	-3.60%	-5.19%
Japan							
NIKKEI225	24120.04	24306.54	20285.06	1.05%	5.73%	18.45%	5.95%
Topix	1817.25	1911.31	1645.16	0.73%	4.94%	8.42%	-0.02%
Emerging Markets							
MSCI Emerging Market	1047.91	1278.53	998.67	-0.33%	-2.12%	-2.28%	-9.54%
MSCI Latin America	2576.51	3243.07	2366.54	1.16%	2.92%	-10.67%	-8.90%
MSCI Emerging Europe	164.38	187.38	147.18	3.30%	5.88%	4.42%	-0.73%
MSCI EM Middle East & Africa	252.11	324.53	235.16	0.90%	-2.43%	-4.39%	-14.85%
Brazil Bovespa	79342.42	88317.83	69068.77	-0.13%	2.41%	7.85%	3.85%
Russia RTS	1192.04	1339.41	1039.29	3.70%	10.55%	5.91%	3.26%
Asia							
MSCI Asia ex-Japan	655.34	780.56	627.97	-0.72%	-2.47%	-0.14%	-8.14%
Australia S&P/ASX 200	6207.56	6373.50	5650.90	0.21%	-1.54%	9.47%	2.35%
China HSCEI (H-shares)	11017.87	13962.53	10196.71	-0.08%	-0.72%	1.32%	-5.90%
China Shanghai Composite	2821.35	3587.03	2644.30	0.85%	1.56%	-15.52%	-14.69%
Hong Kong Hang Seng	27788.52	33484.08	26219.56	-0.59%	-1.99%	1.34%	-7.12%
India Sensex30	36227.14	38989.65	31243.71	-1.67%	-6.86%	15.81%	6.37%
Indonesia JCI	5976.55	6693.47	5557.56	0.32%	-1.09%	2.32%	-5.96%
Malaysia KLCI	1793.15	1896.03	1657.78	-0.97%	-1.85%	2.00%	-0.20%
Korea KOSPI	2343.07	2607.10	2218.09	0.17%	1.73%	-1.27%	-5.04%
Philippines PSE	7276.82	9078.37	6923.67	-1.44%	-7.24%	-10.78%	-14.97%
Singapore STI	3257.05	3641.65	3102.73	1.22%	0.29%	0.93%	-4.29%
Taiwan TAIEX	11006.34	11270.18	10189.04	0.31%	0.15%	6.89%	3.42%
Thailand SET	1756.41	1852.51	1584.68	0.02%	2.23%	5.40%	0.15%
Commodity							
Oil	73.25	75.27	49.10	3.49%	6.89%	42.07%	21.23%
Gold spot	1192.50	1366.18	1160.27	-0.54%	-0.70%	-7.37%	-8.48%

Source: Citi Research as of 1 October 2018.

Currency Forecasts

	Currency	Last price 28-Sep-18	Forecasts Dec-18	Mar-19	Jun-19	Sep-19
G10-US Dollar						
Euro	EURUSD	1.16	1.16	1.14	1.12	1.16
Japanese yen	USDJPY	114	113	113	114	111
British Pound	GBPUSD	1.30	1.31	1.28	1.26	1.31
Swiss Franc	USDCHF	0.98	0.98	1.01	1.02	1
Australian Dollar	AUDUSD	0.72	0.72	0.7	0.69	0.71
New Zealand	NZDUSD	0.66	0.65	0.64	0.63	0.64
Canadian Dollar	USDCAD	1.29	1.31	1.31	1.32	1.29
EM Asia						
Chinese Renminbi	USDCNY	6.87	6.84	6.82	6.79	6.65
Hong Kong	USDHKD	7.83	7.85	7.84	7.84	7.84
Indonesian Rupiah	USDIDR	14,903	15229	15266	15292	15212
Indian Rupee	USDINR	72.5	72.4	71.7	71	71.2
Korean Won	USDKRW	1,109	1136	1143	1148	1132
Malaysian Ringgit	USDMYR	4.14	4.16	4.17	4.17	4.1
Philippine Peso	USDPHP	54.0	54.3	54.5	54.7	54.2
Singapore Dollar	USDSGD	1.37	1.37	1.37	1.37	1.35
Thai Baht	USDTHB	32.3	33.4	33.6	33.7	33.3
Taiwan Dollar	USDTWD	30.5	30.7	30.6	30.5	30.3
EM Europe						
Czech Koruna	USDCZK	22.21	22	22.39	22.68	21.8
Hungarian Forint	USDHUF	279	281	288	293	284
Polish Zloty	USDPLN	3.69	3.72	3.81	3.87	3.71
Israeli Shekel	USDILS	3.64	3.61	3.63	3.64	3.6
Russian Ruble	USDRUB	65.6	68.7	67	65.4	65.3
Turkish Lira	USDTRY	6.06	6.16	6.5	6.79	6.73
South African Rand	USDZAR	14.14	15.43	15.6	15.72	15.36
EM Latam						
Brazilian Real	USDBRL	4.05	3.77	3.73	3.7	3.66
Chilean Peso	USDCLP	657	710	717	722	701
Mexican Peso	USDMXN	18.7	19.6	19.8	20	20
Colombian Peso	USDCOP	2972	3015	3033	3048	3028

Source: Citi Research as of 1 October 2018.

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