

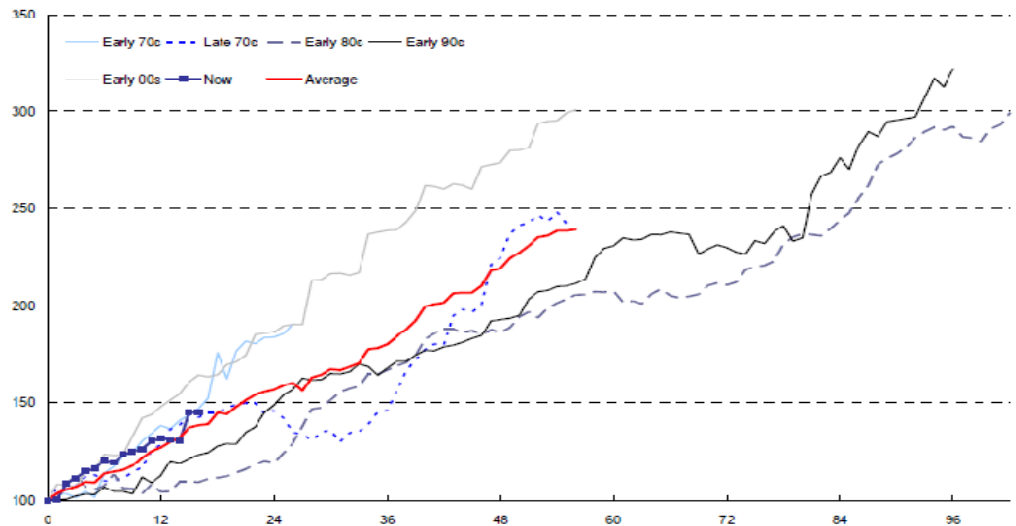


Equity markets outlook

Jane Coffey, Head of Equities

Despite the continued recovery in corporate profits, global equity markets made little progress over the first half of 2011 as investors were hit by a barrage of difficult macroeconomic issues, ranging from the Fukushima nuclear disaster in Japan to the sovereign debt crisis in peripheral Europe. GDP expectations have been pared back in most developed markets, whilst many emerging markets are facing uncomfortably high inflation and are tightening monetary policy, putting pressure on valuations across the globe. However, we believe that both these issues will improve over the second half of the year and in so doing remove a big barrier to equity market valuations.

Figure 1. Earnings Cycles



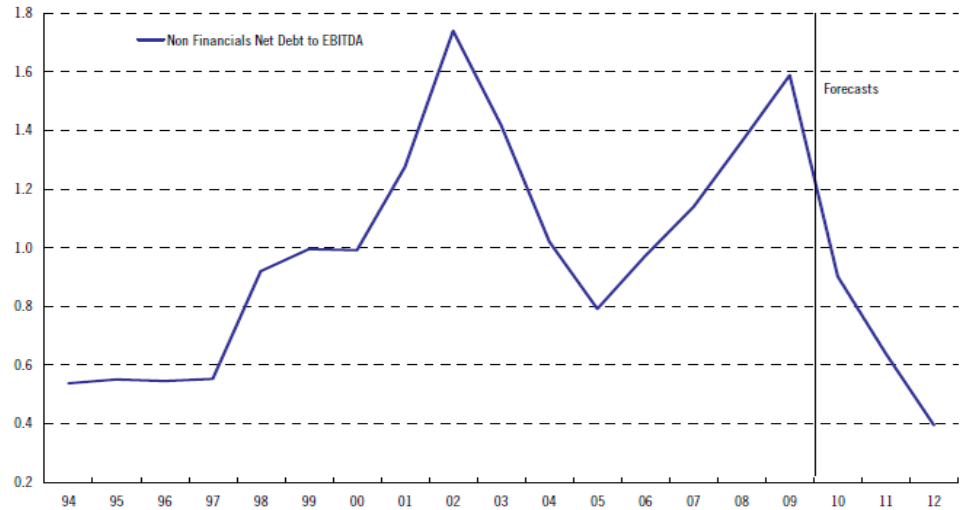
Note: Average for first 4 years. Source: Citi Investment Research and Analysis and DataStream

Two other issues are also coming to a head and should improve through the summer. Late July saw the Eurozone governments reaffirm their commitment to the single currency and implement measures to assist those peripheral countries facing financing problems. Greece, Ireland and Portugal had seen sharp rises in financing costs as the market questioned their solvency in the face of unsustainably large deficits. Meanwhile, even Italy and Spain began to have liquidity problems and their rates edged up. Although these bailout funds cannot offer the complete solution, they can buy time for the countries to address their underlying imbalances and allow the economies and the banking systems to continue to function. Additionally, at the time of writing, we continue to await an agreement in the US to increase the permissible size of their total debt pile and a compromise as to how they are looking to address the ongoing deficit; we would not expect them to choose to default over such an issue.

Despite all these dilemmas, we feel quite optimistic about equity markets. Investors have reduced their risk appetite and are generally cautiously invested, valuations are back to levels significantly below long term averages, corporate earnings, balance sheets and cashflows are healthy and company directors are buying three

times more stock than they are selling. The H1 earnings season has started well with more companies beating forecasts than missing, and in many cases, good dividend increases reflect managements' confidence about the sustainability of that growth. Strong corporate cashflow is also encouraging growth, capex, share buybacks and M&A activity, all of which should support valuations.

Figure 42. Net Debt/EBITDA 1994-2012



Source: Citi Investment Research and Analysis and DataStream

Many of the themes we have seen driving markets so far in this recovery will continue to bias investors to certain segments of the market. We remain cautious on the developed market consumer and expect no let up in the tough times on the high street. Government spending will be under increasing pressure as deficits are addressed, so companies exposed to both government infrastructure or services will also remain depressed. However the recent temporary headwinds facing commodity producers should ease in H2 and we believe basic materials, oil and certain industrials will maintain the pricing power necessary to generate further earnings growth and, importantly, dividend growth. Financial sectors remain mixed, with legislation and deleveraging weighing on many developed market bank prospects, although Asian banks and the better capitalised niche players in high margin businesses will benefit from lessening completion in intrinsically growing markets.

Source: rlam as at 27th July 2011 unless otherwise stated.

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