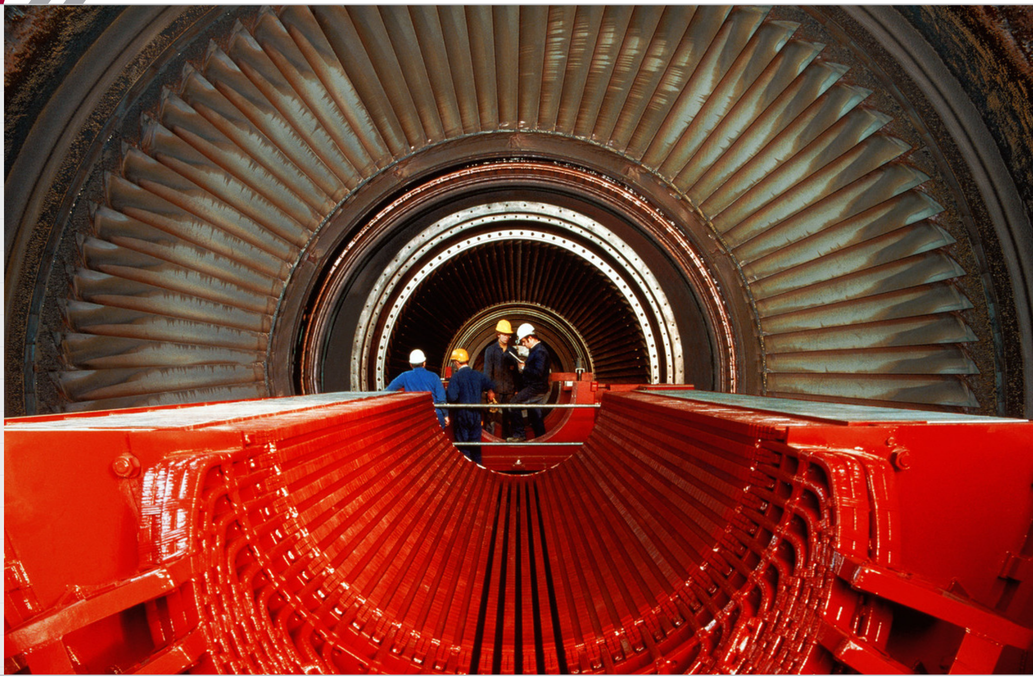
Citi Private Bank

theview INVESTMENT OUTLOOK MARCH 2009

CITIGROUP GLOBAL MARKETS INC.



The $2.5 Trillion Repair Job

Geithner's plan to fix the financial system is a good one. Now he needs to execute.

BY JEFF APPLEGATE AND CHARLES REINHARD

Moments after US Treasury Secretary Timothy Geithner unveiled the Obama administration's much-anticipated Financial Stability Plan (FSP) on Feb. 10, the stock market began sinking. Curiously enough, the credit markets barely budged—a sign, perhaps, that the fixed income players were willing to give the $2.5 trillion plan a chance. In our view, the FSP has the features needed to get bank lending and securitized markets functioning in a more normal fashion. Now Geithner needs to put it to work, which is what we—and the markets, somewhat more tentatively—expect to see in the weeks ahead.

STRESS TEST. The first element of the FSP is a comprehensive regulatory stress test for major banks. The aims of this test are to make sure the banks could still lend even if they suffer further losses and to recapitalize banks that fall short. The exam looks at a bank under worsening economic conditions—a 3.3% contraction in GDP in 2009, an average 10.3% unemployment rate in 2010 and another 25% decline in home prices.

After the review, banks needing more capital will be encouraged to seek private sources. Still, the US Treasury, Federal Reserve and other agencies are committed to making sure banks have the capital and liquidity necessary to make credit available. A vital aspect of the first piece of the FSP is that the government will provide a temporary capital buffer to recapitalize banks that need it and take convertible preferred shares in exchange. The budget released Feb. 26 includes $750 billion for the financial rescue plan as needed to be carried on the books as a $250 billion loss. What if the banks need more? That will depend on the extent of further losses, which the next part of the FSP, the Public-Private Investment Fund, is designed to address.

(continued on inside cover)

The $2.5 Trillion Repair Job

(continued from cover)

BY JEFF APPLEGATE
Chief Investment Officer
Citi Global Wealth Management

BY CHARLES REINHARD
Senior Investment Strategist
Citi Global Wealth Management

This investment fund, which is to acquire bad assets from banks, is crucial. The government will lend money to private investors such as hedge funds to buy these assets, thereby letting the market set the price. The difference between that price and whatever values banks are carrying on their books would have to be absorbed as additional bank losses. Since the private-sector cost of borrowing will be low and the loan is nonrecourse, demand for these assets could be quite robust; by extension, potential bank write-downs and additional recapitalization needs will be commensurately lower.

LEVERAGING UP. The third part of the FSP is the expansion, up to $1 trillion, of the Federal Reserve's previously announced Term Asset-Backed Securities Loan Facility (TALF). The plan calls for using $100 billion of Troubled Asset Relief Program funds, and then leveraging them by a factor of 10. In essence, this is a further extension of the Fed's credit easing, as the central bank will now become a market maker in securitized credit card, auto, student, commercial and residential loans. The Fed's initial foray into credit easing in the commercial paper market last autumn succeeded in getting that market working again with lower absolute yields and spreads. The subsequent venture into the mortgage market achieved positive results as well. We think the TALF will work, too. This should also mean the Federal Reserve's balance sheet, which had recently dropped back below $2 trillion as some of its commercial paper holdings matured, will rise again—potentially to $3 trillion—as the TALF ramps up (see chart).

Temporary Dip The Federal Reserve's balance sheet is expected to climb to $3 trillion as the Term Asset-Backed Securities Loan Facility starts acquiring loans.

Data Source: Federal Reserve as of 18 February 2009

While the FSP may fall short of what ultimately will be required, in our view it is an innovative initiative. Combined with the $787 billion stimulus package signed by President Obama on Feb. 17 and the $275 billion Homeowner Affordability and Stability Plan introduced by the president on Feb. 18, the FSP is another element that should lead to a recovery in economic growth in the second half of 2009. This recovery should be anticipated first in US and global equity markets. Moreover, this steady flow of initiatives from the Obama White House confirms our view that this administration will be much more activist than its predecessor.

BEYOND THE US. Developed-country central banks, such as those in the UK, Japan and Canada, are moving toward a Fed-type ZIRP (Zero Interest Rate Policy) or deploying credit easing to keep local credit markets functioning. Unfortunately, the European Central Bank hasn't been aggressive enough on rates, though we expect that it will move closer to ZIRP this summer. Developing-country central banks, such as those of China and Brazil, continue to reduce interest rates—albeit from much higher levels—to stimulate their local economies. Finally, global fiscal policy stimulus is at work, too. Including the US, our economists estimate fiscal stimulus will be more than 5% of global GDP across 2009 and 2010 (see table).

As long as an adequate global policy response is forthcoming, the US and global financial markets and economy should complete its bottoming process. Almost across the board, that policy mix seems appropriate, in our view. However, there remain concerns over the risk of protectionism. The "Buy American" provision in the US fiscal stimulus package is one example; fortunately, it was mostly gutted after the White House opposed it.

PROTECTIONIST RISKS. In some circles, it's considered "financial protectionism" when global banks reduce lending or sell assets outside their markets. In our view, such actions are more a corporate response to the downturn. Similarly, we disagree that backing US automakers is "industrial protectionism." Canada and Germany, for example, have been supportive of American auto companies in those nations just as the US has been. So, while protectionism remains a risk to markets, it is a fairly low-level threat, given the globalization of labor and capital extant today.

ROUND TRIP. US and global equities have round-tripped back to their November lows, as consensus earnings estimates and valuation reflect the deeper recession. US and global expected earnings for 2009 are now $64 and $17, respectively, versus $87 and $24 in November, while forward price/earnings ratios are 12 and 11, respectively, versus nine and eight previously.

Historically, prospective equity returns have depended quite a bit on the characteristics defining the starting point. Currently, P/E ratios are below their long-term historical averages. Earnings are also below trend. As a result, equities would stand to benefit if markets move toward more-normalized valuations in the months and quarters ahead. In addition, market recoveries usually take place in a favorable liquidity environment—and that liquidity is in place. Moreover, while the credit markets have not returned to normal, they are moving in that direction—and borrowing costs are low.

REAL YIELD. The US equity market also looks promising in terms of real yield, or the yield on risk-free Treasury bonds less the inflation rate. In the 1950 through 2008 period, any time real yields were below 3%, as they are now, stocks were up an average of 13.5% in the next 12 months. That is significantly greater than the 5.1% afforded to Treasury bonds or 3.1% to cash in the same environment. That history is yet another reason for investors to stay resolute through these difficult times. ■

Global Fiscal Stimulus The US and China have the biggest programs underway to stimulate their economies. All together, the various plans add up to some 5% of world GDP.

Country	Comment
US	$787 billion plan, 65% spending and 35% tax relief. Lower withholding taxes should start in mid March. Infrastructure spending should be felt later on.
China	Rmb 4 trillion with 75%+ for infrastructure development, earthquake reconstruction and other projects. Provincial governments have added another Rmb 25 trillion in proposals. Early signs stimulus is already being felt.
Euro Zone	Targeting households and businesses via tax and subsidy changes, plus some investment.
Japan	Direct subsidies to households, tax incentives for business investment and security investment, and subsidies for industries hit by higher input costs in 2008.
UK	Cut in the Value Added Tax (VAT).
Australia	Fiscal stimulus to families, pensioners, first-home buyers, increased payments to the states and a focus on infrastructure.
Canada	Infrastructure spending, tax cuts, increased unemployment benefits and backstopping of key industries, including the autos, telecommunications, forestry and aerospace.
Korea	35.6 trillion won total fiscal package was approved last year. Households and firms will receive tax cuts, while construction firms will gain from higher direct subsidies and infrastructure spending.
Mexico	If development bank lending is included, total stimulus is closer to 1% of GDP.

Data Source: Citi Economic & Market Analysis as of 18 February 2009

Lessons From a Bear Market

BY MARSHALL KAPLAN
Senior Equity Strategist
Smith Barney Private Client Investment Strategy

BY WILLIAM MANN
European Equity Strategist
Smith Barney Private Client Investment Strategy

With global equity markets off 50% from the late-2007 high and a likelihood of further bad news on the economy and earnings over the next few quarters, we thought it appropriate to step back and assess what we have learned from this difficult period. Bear markets are very effective in exposing problems, exploiting weaknesses and punishing hubris. We believe it is important to use the experience to learn from mistakes and find ways to improve investments, so as to prosper in an eventual upturn.

1. A SELL DISCIPLINE TRUMPS CONVICTION. Selling stocks is a "negative art." Most investors find it easier to identify the positive traits of a company than to recognize and act upon an investment decision gone wrong. Said differently, most of us are quicker to buy new clothing than to discard an old favorite, no matter how worn or out of style it may be.

Investors often justify a plummeting share price by deriving ever-new reasons to hold on to a stock that similarly may be out of style. We call this "thesis drift," and it can have a meaningful negative impact on performance. If an investor's original investment thesis is damaged, quite possibly the market's view is, too. This can lead to rapid downward share-price movements when the market comes around to recognizing the flaw. Swift, thorough and realistic reassessment—in combination with emotional detachment—are all key to avoiding thesis drift and the damage it can inflict on your portfolio.

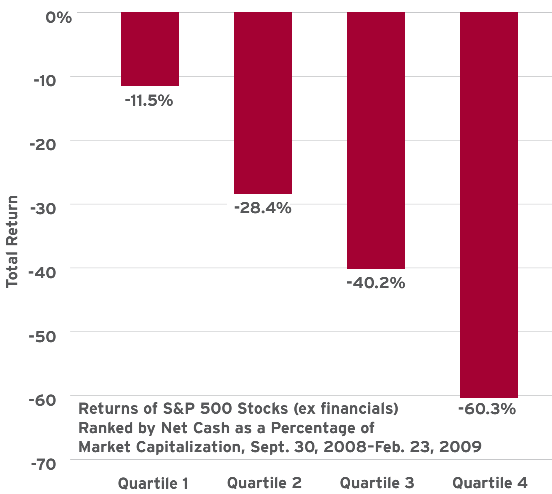
2. CASH IS KING, BALANCE SHEET STRENGTH IS PARAMOUNT. We have long focused on the importance of a company's financial flexibility—characterized by a strong balance sheet and the ability to generate significant free cash flow—in our stock selection process. During the last year, companies that rely on outside financing, friendly capital markets or rising asset values to support their business models have found that they are no longer in control of their destiny.

Over the past several weeks, there has been a resurgence of capital-raising, especially in Europe, which has led to higher stock prices. Such results tend to be short-lived as the underlying weaknesses in the firms remain.

The market recognizes these differences. For instance, we took the Standard & Poor's 500 stocks, excluded the financial stocks and sorted the remainder based on the ratio of net cash as a percentage of market capitalization on Sept. 30, 2008. Then we tracked the returns through Feb. 23, 2009. The top quartile of companies experienced an average loss of -11.5%, while the bottom quartile posted -60.3%.

Furthermore, financial flexibility is a major driver of dividends, something that is at the top of the list when evaluating investments. In the current high-dividend-yield environment, it is important to separate companies

Cash Counts In a recession, companies with more cash on their balance sheets do better than those that have less.



Data Source: FactSet as of 23 February 2009 with sustainable dividends from those with dividend yields that only appear high because the stock price has fallen and the earnings are suspect, creating a temporary high ratio of dividend to stock price. In this latter case, the market must anticipate that the dividend will be cut soon to conserve precious cash. Stock-price performances have shown meaningful divergence between companies maintaining (or even increasing) dividends and those that can't. We expect this theme to deepen over coming quarters. Consequently, we caution investors to maintain a watchful eye over dividend payout ratios and forecast earnings growth as a health check on dividend sustainability and growth.

3. AVOID "MENTAL ACCOUNTING." Investors have a tendency to perform "mental accounting." This is a theory, developed in the 1980s, positing that individuals tend to divide their assets into separate categories or "mindsets" and account for them differently. Essentially, it says that people value some dollars more than others. For instance, $1,000 won with a lottery ticket may be treated as "fun money" and spent on something frivolous, while the same amount that is earmarked for a retirement-account contribution is treated as indispensable. However, in fact, a dollar is a dollar.

Likewise, with investment portfolios, we have been guilty of congratulating ourselves when dodging one potential pitfall while another company already in our portfolio is subjected to the same forces as the company we avoided.

4. FEAR IS OFTEN INVERSELY CORRELATED WITH BUYING OPPORTUNITIES. Opportunities exist in the current market, but it takes a willingness to go against the current negative sentiment to invest in them. It also takes a lot of patience to hold them while waiting for the market to recognize their true value. The current market volatility requires a willingness to act quickly on investor misperceptions—as emotionally charged markets are often driven by fear and greed, rather than by the careful analysis of fundamentals. Often, the right portfolio action to take is also the most difficult one to take.

5. AVOID NARROW FOCUS AND SCAN THE HORIZON. Investors tend to focus on the ongoing themes—say, the collapse of financial stocks or the expected increase in infrastructure spending. It is equally important to keep an eye out for emerging themes, which may exert as much influence on share prices as existing forces. For instance, while the market's attention was focused on the unfolding financial crisis in Western Europe, it was slow to recognize the rapid deterioration of Eastern Europe. This opened up a second front, potentially just as damaging as existing pressures that first surfaced in the west. Identification of new themes can have a meaningful, positive impact on portfolio performance, if acted upon quickly.

6. BEAR MARKETS DON'T LAST FOREVER. While hindsight affords us the luxury of seeing things through a rearview mirror, it is the road ahead that provides promise. Indeed, cash levels at nonfinancial firms are at historically high levels, and the S&P 500 trades at approximately 15 times our current forecast of $51 for 2009 operating earnings. Our proprietary sentiment indicators are at levels that have historically proven to be attractive entry points for equity investors, and traditional valuation metrics such as price/sales ratio and price/book value are at 20-year lows. However, until we have greater clarity on the economic outlook, focusing on companies with strong financials, organic growth opportunities and reasonable valuations should prove to be a prudent strategy. ■

Bond Market: Better, but With Choosy Investors

BY MICHAEL BRANDES
Senior Fixed Income Strategist
Smith Barney Private Client
Investment Strategy

BY STEVE REICH
Economic Research
Citi Global Wealth Management

The economic data continues to be dismal and uncertainty remains high, but conditions in the bond market are improving. Although price performance has been mixed, fixed income spreads have largely contracted across the board since December when the Federal Reserve cut the overnight rate to zero. Yields peaked during the fourth quarter and are likely to remain range-bound or decline further as the year progresses, in our view.

Much of the positive momentum can be attributed to government efforts. The Fed's agency mortgage purchase program, which started last month, has led to a 50-basis-point decline in long-term rates. Policymakers are expected to spend $500 billion by June 30.

MORE GOVERNMENT FINANCING. Government officials recently made important changes to the auction calendar. Of note, the seven-year Treasury security will return to monthly auctions. What's more, the Treasury said it is considering adding a four-year or 20-year issue. Additionally, the 30-year bond will now be sold eight times a year. As the size and frequency of bond auctions have increased, we now expect a 20% jump in borrowing in the current fiscal year to about $2 trillion.

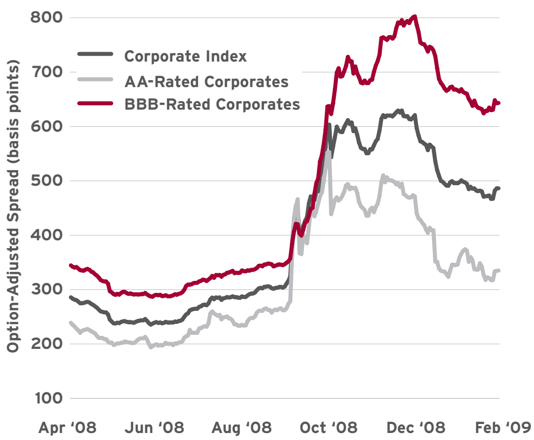
Not surprisingly, government yields have backed up from record lows in December. The recent rise correlates with the increase in inflation expectations. For instance, since the beginning of the year, TIPS (Treasury Inflation-Protected Securities) break-even rates have risen sharply. The five-year forward TIPS break-even threshold is up to nearly 200 basis points, from less than 50 basis points in early January.

We expect deflation to ultimately trump concerns about higher inflation. Thus, the backup in Treasury yields appears to be self-limiting, unless it was largely driven by lower risk aversion. Also, investors should keep in mind that Fed officials have stated that they would purchase Treasurys outright if higher yields were to push up consumer borrowing costs.

IMPRESSIVE ISSUANCE. Another big plus has been the corporate primary-issue market. With the exception of FDIC-backed securities, the new-issue market was essentially shut down during the final months of 2008. In contrast, some $150 billion has been launched year to date. That is about 25% higher compared with the same period in 2008. About 35% of investment-grade supply has been issued under a government-sponsored program. Even some high yield issuers have tapped the market, mainly higher-rated issuers in defensive sectors, such as health care and cable.

Long-term investors are benefiting from spreads that more than compensate for default risks, in our view. Notably, average yields in the corporate market have declined substantially since December—falling this month below 7%, from more than 9%—in Citi's BIG Credit Index.

Spreading Out Credit markets are easing, but the gap between yields on higher- and lower-rated bonds is greater.



Data Source: The Yield Book as of 19 February 2009

PICKY PURCHASERS. Still, even as buyers come back to the corporate market, they are getting choosier. Look at the chart, which shows spreads for the Citi High Grade Corporate Index, and two components of it, the AA-rated and BBB-rated companies. Until last fall, the difference between the AA and BBB was about 100 basis points. Spreads converged in the aftermath of the Lehman Brothers bankruptcy, and have since widened. Now, because investors prefer higher-rated bonds, BBBs yield about 300 basis points more than AAs.

We continue to be defensive and are wary about reaching for yield by sacrificing credit quality or liquidity. After all, neither the stimulus package nor the policy initiatives are going to prevent consumer delinquency or corporate default rates from accelerating in the near term as economic conditions worsen.

QUALITY COUNTS. Long-term investors should focus on opportunities in the high-grade corporate market, which we expect will be the best-performing fixed income sector this year. Investors need to seek out government-guaranteed financial company bonds and longer-maturity bonds of high-quality issuers selling at low dollar prices. US investors should also consider the municipal market, where lower liquidity and limited institutional demand has generated a historically steep yield curve and returns that are high relative to taxable Treasurys.

Although the high yield market may continue to be supported by strong mutual fund inflows and a dearth of new supply, we advise investors to limit exposure to fairly short-duration securities rated at least BB. Tight lending conditions and poor earnings prospects are apt to generate increased defaults this year. What's more, we believe that recovery rates on those defaults will be much lower than in past cycles.

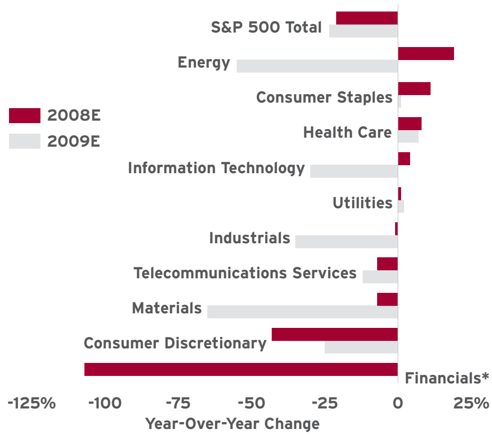
LOWER YIELDS IN EUROPE. While events in the US have been a key determinant of Euro Zone bond yields, the markets decoupled in mid February as investors became increasingly concerned about the health of European banks. Because of investor demand, German bond prices rose and the yields headed back toward their 3% cyclical lows. Concern about sovereign credit quality kept many national bond yields above their recent lows, as investors have also become concerned about the ability of the market to absorb new government bond issuance. Nonetheless, poor economic fundamentals and falling risk appetite should continue to support European government bonds. Although the European Central Bank kept rates steady at 2% at their Feb. 5 meeting, we think the policy rate will be cut to 0.5% by mid year. With inflation contained, Euro Zone government bond yields could fall further, in our view.

BRITAIN'S LINGERING INFLATION. UK government bonds have taken a slightly different path, as investors worry that lingering inflation may keep the Bank of England (BOE) from stimulating the economy as much it should. Recent inflation reports show that prices have not stabilized, as expected. Still, we believe that there is little risk of inflation because the labor market has turned decidedly weaker. In fact, much of the current inflationary pressure is external, as the weak pound keeps import prices high. The BOE lowered its policy rate to 1% at its Feb. 5 meeting, and we expect rates to fall to 0.5% by mid year.

LOW PROSPECTS FOR JAPAN. With the Japanese policy rate at 0.1%, and 10-year bond yields at just 1.3%, there is little more that monetary policy can do to stimulate the economy. With Japanese equities at 20-year lows, we think that Japanese bond yields will remain low, too, as investors remain risk averse. ■

» Earnings Erosion

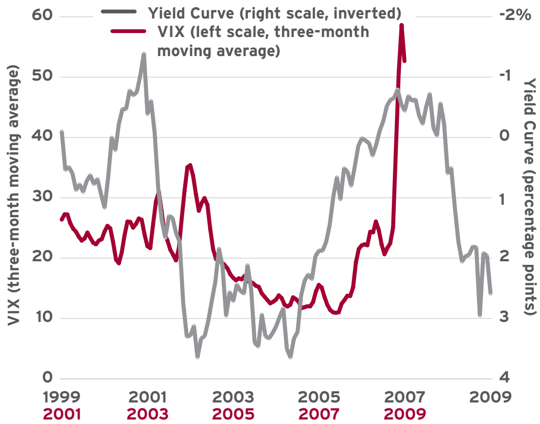
Citi's S&P 500 Earnings Growth Forecast



*Financial earnings for 2009 going from negative to zero
Data Source: Citi Economic & Market Analysis as of 20 February 2009

» Forecasting Volatility

Yield Curve Shown as a Leading Indicator of the VIX



Note: Yield Curve shown from 1999, VIX since 2001
Data Source: Bloomberg as of 30 January 2009

The sharpest global downturn of the post-World War II era will wreak havoc on corporate profits, writes Steven Wieting of Citi Economic & Market Analysis in a Feb. 20 report. Wieting slashed his forecast for 2009 S&P 500 operating earnings to $51 from his previous forecast of $62, a 17.7% decline. He also cut his 2010 forecast to $54 from $65. Operating profits, or profits before write-offs, were $84.46 in 2007, just 4% off their $88.08 peak in 2006.

While much of the attention for the last year has been on the financial sector, Wieting says profits for nonfinancial companies only started their decline in the fourth quarter, and thus still have far to fall. The materials sector, for instance, which is highly sensitive to the economic cycle, declined an estimated 7% in earnings in 2008; Wieting forecasts a 65% decline in 2009. Sectors that still managed to make gains in 2008, such as energy, up 19%, and information technology, up 4%, are projected to go negative this year, down 55% and 30%, respectively.

The only sectors that Wieting thinks will be positive in both 2008 and 2009 are consumer staples, health care and utilities. Those sectors usually do best in recessions and, for that reason, are considered defensive investments.

Today's high stock-market volatility, as measured by the VIX, is unnerving to many investors. But those who study the yield curve, as measured by the difference in yield between the 10-year Treasury note and the fed-funds rate, could have anticipated it.

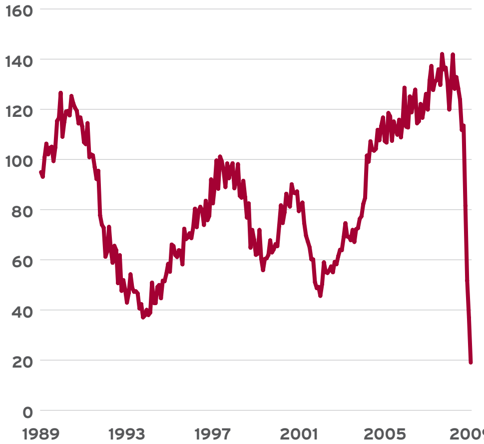
There is a lead-lag relationship between the yield curve and market volatility, with the yield curve leading the VIX by about two years. For instance, when the Fed is draining liquidity from the financial system by raising the fed-funds rate, as it did in the 2003 to 2006 period, short-term rates typically rise relative to longer-term rates, leading to a flatter yield curve. As the chart shows, market volatility shot up in 2007 and 2008 and remains relatively high.

Conversely, when the Fed is adding liquidity to the financial system by lowering the fed-funds rate, as it did in 2001 and 2002, short-term rates typically fall relative to longer-term rates. The Fed action made the yield curve steeper, and the stock market response was a lower VIX in the middle part of the decade.

Now, we note that the Fed has been pumping up liquidity for nearly two years; it follows that volatility could start subsiding soon.

No Tools Required

Japan Machine Tool Order Index



Data Source: Japan Machine Tool Builders' Assn. as of 31 January 2009

For most of last year, Japan seemed fairly insulated from the direct impact of the global financial crisis, as its banks were not weighed down by the same level of bad assets as were those of the US and Europe. But with the financial crisis having spawned a broader economic crisis, Japan is now feeling the full brunt of the slowdown.

There's no better example of this trend that the plight of the Japanese Machine Tool Order index, which fell 83% during the past four months. Orders dropped at nearly the same pace for both domestic and foreign buyers, as capital investment in manufacturing evaporated in both Japan and throughout developing markets of Asia. The index fell 71% in the early 1990s, but that decline played out over several years, not months.

Business investment is falling because the financial crisis is making it more difficult and more expensive to obtain credit for expansion. Also, with weakening consumer demand and rising economic uncertainty, manufacturers are canceling projects or delaying major capital investments.

NINE SIGNPOSTS FOR 2009

In January, we introduced "Nine Signposts for 2009," indicators to watch for improvements in the markets and the economy. The table below shows there has been recent improvement.

Data Source: Bloomberg as of 27 February 2009

One of the big gainers is the Baltic Dry Index, a measure of shipping rates for commodities, which is 1950 (see chart), up from 774 in December. Recent reports suggest China's stimulus plan is already creating demand for the raw materials these vessels carry.

To obtain the most recent copy of "Nine Signposts for 2009," contact your Private Banker.

Signpost	Starting Level	Current Level	Reading
S&P 500 Advance-Decline Line	-7271	-9000	D
Korean Composite Stock Price Index	1118	1063	SD
LIBOR-OIS Spread	126 bps	101 bps	I
Spreads on Citigroup High-Grade and High Yield Indexes	563/ 1846 bps	511/ 1675 bps	I
Supply of US Existing Homes for Sale	11.2 mos.	9.6 mos.	I
Univ. of Mich. Consumer Sentiment	55.3	56.3	SI
Baltic Dry Index	774	1950	I
Citi Financial Conditions Index	-3.9 std. dev.	-1.7 std. dev.	I
US Leading Economic Indicators (six-month change)	-5.4%	-3.7%	I

I = Improvement, SI = Slight Improvement, D=Deterioration, SD=Slight Deterioration

Data Source: Bloomberg, The Yield Book, Citi Economic & Market Analysis, The Conference Board as of 27 February 2009 or latest possible date

Slicing Sectors to Sharpen Our Advice

BY DOUGLAS SCHINDEWOLF
Director of Tactical Asset Allocation
Citi Global Wealth Management

Each month, the Investment Outlook section on the At a Glance page summarizes the Global Investment Committee's (GIC) tactical, or short-term, asset allocation recommendations. Although we have not changed these recommendations in recent months, we have made changes to the table to sharpen the GIC's investment guidance.

BREAKING BONDS. First, under the heading "Global Investment-Grade" in the bonds section, we now break out "Agencies & Government-Related" securities as a separate subasset class. This category includes bonds from such issuers as Fannie Mae, Freddie Mac and Government National Mortgage Association—the securities known as "Ginnie Maes." Though we approach investing on a global basis, this sector is made up almost entirely of US agencies. Few securities issued outside the US fit under this category.

Previously, these securities were part of the broader "Government" category. The additional granularity enables us to highlight the extent of the flight to quality and liquidity over the past several months. These "plain vanilla" government securities, such as US Treasury notes and bonds, have become very expensive and not particularly attractive as a long-term investment, in our judgment.

As we see it, more-attractive opportunities exist in other sectors of the investment-grade bond market—such as agencies and corporate bonds, which investors have shunned amid a sharp increase in risk aversion. We reflect this view in our "underweight" recommendation for the government bond sector and "overweight" recommendation for the agency and corporate sectors. This differentiation is difficult to reflect in our model portfolios because Treasurys, agencies and investment-grade corporate bonds are aggregated into a core subasset class. Nevertheless, we are slicing the bond universe into smaller, more homogeneous sectors for those investors wishing to capitalize on what we view as an opportunity arising from the market turmoil of the past several months.

INTRODUCING COMMODITIES. Second, starting this month, we have added commodities to the Investment Outlook table. However, we note that unlike the other asset classes that we follow, we do not view commodities as a strategic asset class that should be a core holding for most portfolios. That's because our studies show that over longer horizons, we expect commodities to deliver modest returns, on average. Investment returns in actual commodities tend to track broad inflation; investments in a collateralized, futures-based commodity index, such as the Dow Jones-AIG Commodity Index, tend to earn a little more than the inflation rate. Those returns, in our view, are not attractive enough to offset the considerable volatility commodities bring to portfolios, even though commodities' correlation with other asset classes is generally low.

Nevertheless, we believe that commodities can add significant value over relatively short horizons. As such, we will endeavor to identify those times when an allocation to a broad-based commodity vehicle seems appropriate. We will then reflect that opportunity with an overweight recommendation in the table. Our sense is that this is not one of those times, given the likelihood of sluggish global economic activity for the next several months—hence, we keep our underweight recommendation for now. ■

AT A GLANCE

Base Case

Below is a summary of the Global Investment Committee's base case for world economies. Unless noted, estimates are for 2009.

GDP Growth

US: -2.7%, from 1.2% in 2008

Euro Zone: -2.5%, from 0.8% in 2008

Japan: -6.7%, from -0.7% in 2008

UK: -3.4%, from 0.7% in 2008

Developing economies: 1.6%, from 5.3% in 2008

Inflation

US: -1.0%, from 3.8% in 2008

Euro Zone: 0.3%, from 3.3% in 2008

Japan: -1.4%, from 1.4% in 2008

UK: 1.0%, from 3.6% in 2008

Monetary Policy

US Federal Reserve: likely to remain steady at 0.0% to 0.25% through 2009

European Central Bank: likely to lower rate 150 basis points to 0.5% by mid 2009

Bank of Japan: likely to remain steady at 0.1% through 2009

Bank of England: likely to lower rate 100 basis points to 0.25% by mid 2009

Investment Outlook

The following table summarizes our tactical (short-term) adjustments to our strategic portfolios, which represent the blend of asset classes we believe are best suited, over the long run, for achieving maximum return for various levels of risk tolerance. In our tactical recommendations, we identify which subasset classes to overweight or underweight within each global asset class.

Vis-à-vis the strategic allocation: Overweight means up to 10% greater; Neutral: no change to the strategic allocation; Underweight: up to 10% below.

	RELATIVE WEIGHT	BENCHMARK INDEX
Global Equities	OVERWEIGHT	MSCI All Country World
Global Bonds	UNDERWEIGHT	Barclays Capital Multiverse (hedged)
Hedge Funds & Managed Futures	NEUTRAL	HFRX Global Hedge Fund
Cash	NEUTRAL	Three-Month LIBOR

» Equities	RELATIVE WEIGHT WITHIN EQUITIES	BENCHMARK INDEX
Developed Market Large & Mid Cap	UNDERWEIGHT	MSCI World Large Cap
United States	*OVERWEIGHT*	S&P 500
Europe ex UK	*UNDERWEIGHT*	MSCI Europe ex UK Large Cap
United Kingdom	*UNDERWEIGHT*	MSCI UK Large Cap
Japan	*UNDERWEIGHT*	MSCI Japan Large Cap
Asia Pacific ex Japan	*NEUTRAL*	MSCI Pacific ex Japan Large Cap
Developed Market Small Cap	OVERWEIGHT	MSCI World Small Cap
Emerging Markets	OVERWEIGHT	MSCI Emerging Markets

» Bonds	RELATIVE WEIGHT WITHIN BONDS	BENCHMARK INDEX
Global Investment-Grade	OVERWEIGHT	Barclays Capital Global Aggregate
Government	*UNDERWEIGHT*	Barclays Capital Global Government
Agencies & Government-Related	*OVERWEIGHT*	Barclays Capital Multiverse-Govt.-Related
Corporate	*OVERWEIGHT*	Barclays Capital Global Corporate
Securitized	*NEUTRAL*	Barclays Capital Global Securitized
High Yield	UNDERWEIGHT	Barclays Capital Global High Yield
Emerging Markets	UNDERWEIGHT	Barclays Capital Global Emg. Mkts.
Inflation Protected	NEUTRAL	Barclays Capital Global Inflation-Linked

» Hedge Funds & Managed Futures	RELATIVE WEIGHT WITHIN HEDGE FUNDS	BENCHMARK INDEX
Relative Value/Event Driven	NEUTRAL	HFRX Blend*
Equity Long/Short	NEUTRAL	HFRX Equity Hedge
Managed Futures/Macro	NEUTRAL	HFRX Macro and CISDM CTA

» Commodities	RELATIVE WEIGHT	BENCHMARK INDEX
Commodities	UNDERWEIGHT	Dow Jones-AIG Commodity Index

* Consists of: Convertible Arbitrage, Distressed Securities, Merger Arbitrage, Fixed Income-Corporate and Equity Market Neutral indexes. ▲▼ Arrows indicate change from previous month.

» Currencies

	vs. US	vs. Japan	vs. Euro	vs. Canada	vs. Australia	vs. UK	vs. China	vs. Brazil	vs. Mexico
US $		o	▼ –	o	–	▼ –	o	–	▼ –
Japan ¥	o		▼ –	o	–	▼ o	o	▼ –	▼ –
Euro €	▲ +	▲ +		▲ +	▲ o	▲ o	▲ o	▲ o	▲ o
Canada	o	o	▼ –		–	o	o	–	▼ –
Australia	+	+	▼ o	+		▼ o	▲ +	o	o
UK £	▲ +	▲ o	▼ o	o	▲ o		▲ o	▲ o	▲ o
China	o	o	▼ o	o	▼ –	▼ o		▼ –	▼ –
Brazil	+	▲ +	▼ o	+	o	▼ o	▲ +		o
Mexico	▲ +	▲ +	▼ o	▲ +	o	▼ o	▲ +	o	

Based on 6-to-12-month horizon. o = +/- 5% change from current level; + = greater than 5% expected appreciation; - = greater than 5% expected depreciation.
▲▼ Arrows indicate change from previous month.

A Fresh Start—or 2008 All Over Again?

BY RAY NOLTE
Chief Executive Officer
Hedge Fund Management Group
Citi Alternative Investments

Will hedge funds repeat last year's awful performance or will this asset class stage a turnaround? The HFRX Global Hedge Fund Index, a broad-based measure of industry returns, posted its first monthly increase in some time, with a gain of 1.1%, versus an 8.56% loss for the Standard & Poor's 500 Index. Almost all the substrategies finished in positive territory; the two that were negative were only modestly so (see chart).

THIN TRADING. In our view, it is still too soon to declare that last year's big losers have made a bottom and are now in their recovery phase. In fact, the trading volume is sparse in many of the securities owned by these groups; as such, much of the gains may have come from marking up the securities in the portfolio based on few transactions. Still, these gains may indicate that selling pressure has abated.

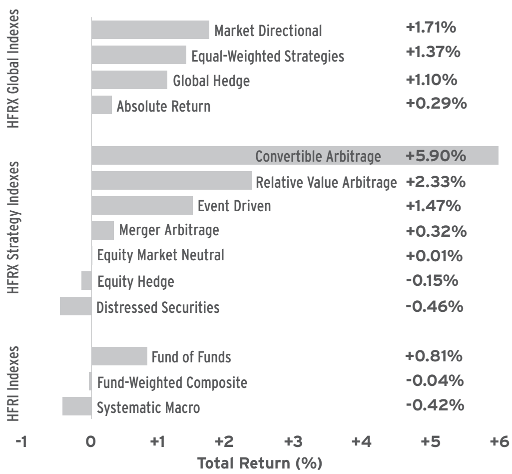
Even so, many hedge funds hold significant amounts of securities that need to be liquidated. These positions are now in the liquidating share classes and/or special-purpose-vehicle shares established late last year to deal with demand for redemptions. As the markets recover, and as the prices for these securities improve, managers will start selling these locked-up assets so they can return the capital to investors.

LOWER RISK LEVELS. Risk levels at most funds remain low. Net and gross exposures are especially low for the long-short equity funds; leverage levels remain low in the relative value and event-driven fund groups. The lower risk levels were most noticeable in the long-short equity sector, which tends to have a long bias and a higher correlation to the equity markets than most other strategies. On the other hand, systematic macro funds stood out because of a slight increase in leverage. This strategy has been running counter to the industry; last year, it was up 18.3%.

A turnaround for hedge funds also requires restoration of investor confidence and a stabilization of assets under management. To that end, we still expect to see redemptions through the first quarter. Barring another shock to the system, we expect redemptions to slow down for the mid-year-notice period.

A NEW PLAY. As a result of the dislocations—industry consolidation, trading desk shutdowns and skittish investors—we expect attractive opportunities to emerge. Perhaps the biggest opportunity lies in the Public-Private Investment Fund, part of the Obama administration's Financial Stability Plan. In this program, the government will lend money to private investors to buy bad assets from banks, thereby letting the market set the price. Since the private-sector cost of borrowing will be low and the loans will be nonrecourse, it is expected to attract hedge fund managers. Still, returns are likely to be volatile, at least in the near term. To take advantage of these new opportunities, investors need a long time horizon and a lot of patience. ■

Coming Back The Standard & Poor's 500 sank 8.56% in January, but hedge funds eked out a slightly positive return.



Data Source: Hedge Fund Research as of 31 January 2009

Reasons to Be Optimistic

MILTON EZRATI
Senior Economist, Market Strategist and Partner Lord, Abbett & Co.

Milton Ezrati is the senior economist, market strategist and a partner at Lord, Abbett & Co., an investment firm with some $70 billion in assets under management (as of Dec. 31, 2008). He is responsible for providing economic research and strategy to clients that enable them to gain context and a framework for understanding the economy and the markets, both locally and at the global level. Jeff Applegate, chief investment officer of Citi Global Wealth Management, spoke with Ezrati on a Feb. 18 client call. What follows are excerpts from that conversation.

APPLEGATE: Do you see anything positive in the financial indicators?

EZRATI: We're seeing signs of a financial thaw. Look at the TED (Treasury bill to Eurodollar lending rate) spread. In November, at the worst of this crisis, the spread was 460 basis points; now it's only 100 basis points.

The banks are lending, too. At first, the Federal Reserve created all these reserves. While the monetary base was larger, the money supply wasn't, because the banks weren't lending. But now, the money supply is growing. The M1 number has increased in excess of 20%, at an annual rate.

APPLEGATE: And are there some bright spots in the economy?

EZRATI: The area that's most significant is housing. The supply of unsold houses dropped from more than a 12-month supply to under 10 months' worth—in large part because the builders have cut back. We also see that people are taking advantage of low mortgage rates. By our calculations, the supply of unsold houses could come down to about four or five months' worth by June or July. That would probably end the steepest slide, or maybe even end the slide altogether, in housing.

While consumer spending has been extremely disappointing, there is a silver lining here, and I don't think we should underrate it. US consumers' savings rate is at over 3% now, up from zero last June. That's an almost $300 billion annual rate, which is a significant number because it is also about 2% of outstanding liabilities.

It does suggest that deleveraging is proceeding; and of course, the further it goes the more consumers are going to feel comfortable about spending—not spending the way they once did during the boom, but at least spending in tandem with income growth.

APPLEGATE: How do you assess the employment picture?

EZRATI: Although we have seen tremendous layoffs in the last few months, two things suggest that unemployment may not get as bad as the market fears. The first of these is that, outside of autos and the financial sector, balance sheets are not in bad shape. Yes, earnings have come down. But the pressure to lay people off is not nearly as great as it might have been. In fact, corporate America went into this recession in better financial shape than it has gone into previous recessions.

The other significant thing is the jump in productivity that we saw in the fourth quarter. It indicates that business was laying off at a much faster rate than it was cutting production. This doesn't suggest that we will avoid further layoffs, but rather that layoffs will not proceed at the breakneck pace of the last few months. ■

The Cult of Equity Under Attack

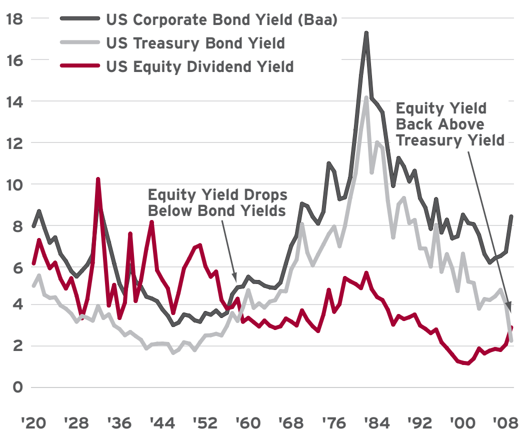
BY ROBERT BUCKLAND
Chief Global Equity Strategist
Citi Investment Research & Analysis

Global equities have returned -29% this decade, compared with 80% from government bonds. There have been two 50% equity bear markets in just five years. This mix of miserable returns and extreme volatility has led some to pronounce that, after 50 years, the "cult of equity" is dead. The phrase refers to the belief—a widely accepted view—that stocks are the most desirable asset class. Indeed, there is evidence that investors may be reappraising the role of the asset class and the long-term implications for valuations.

A HISTORY LESSON. The cult of equity began in the late 1950s. Before that, US equities traded with a higher yield than that of Treasurys and corporate bonds. Presumably, investors demanded a high prospective return to compensate for the risk inherent in holding stocks. This aspect overwhelmed the more positive attributes of equities, such as their potential for capital gains and inflation hedging.

That all changed in the late 1950s. A long bull market pushed dividend yields below bond yields, a situation that must have driven US equity strategists to distraction (see chart). All their valuation models would have screamed "sell." As the chart shows, they would have had to wait until November 2008 for dividend yields to once again rise above Treasury yields. There's still a long way to go before US dividend yields cross over corporate bond yields. This structural valuation shift occurred in the UK and Japan, too.

Crossing Yields The dividend yield on US equities exceeds that on Treasurys, leading some analysts to wonder if it signals the end of investors' 60-year love affair with stocks.



Data Source: Global Financial Data, Datastream, Citi Investment Research & Analysis as of 31 December 2008

WHY DID THIS HAPPEN? Most obviously, the 1950s marked the start of a period of relative peace and prosperity. It came on the heels of a tumultuous 50 years that included two world wars and an economic depression. In hindsight, the case for equities over bonds was especially compelling in the early 1950s. In 1951, US equities yielded 7%, versus 2% on Treasurys and 3% on Baa corporate bonds. Equities appeared to be a better asset match for any defined benefit pension plan trying to earn the 8% return generally required to keep up with growth in liabilities. The yield crossover coincided with economist Harry Markowitz's first considerations of Modern Portfolio Theory. This premise promoted the idea that a well-diversified equity portfolio could achieve superior returns while helping to reduce risk.

CHASING PERFORMANCE. Perhaps the most convincing argument for equities was their performance. Pension funds bought more and more equities because they were rewarded again and again for doing so. A $100 investment in US equities in 1950 would have been worth $58,380 at the end of 1999, versus $1,768 for the same principal amount invested in bonds. Those two numbers probably reveal more about the cult of equity than any academic study could illuminate with many pages.

THE ATTACK ON EQUITIES. Why is the equity culture coming under attack now—and, more importantly, why not sooner? Many elements had to come together. The causes go well beyond the current depressed equity values, but that steep decline is the catalyst that is prompting the reevaluation. At the same time, academics have come to question many of the underpinnings of the cult of equity. Increasingly, pension funds switch to bonds as more of their beneficiaries approach retirement. What's more, most of today's workers are in defined contribution plans in which they, not their employers, bear the investment risk. Workers could become increasingly wary of equities.

VALUATION IMPLICATIONS. What does it mean if the cult of equity is reversing? The current yield of 3.7% is still a long way from the pre-1960 level of 5.4%. Going back to that level points to an S&P 500 about 30% lower. On this basis, the UK looks less worrying, since the dividend yield is now approaching pre-1960 levels. At 3%, the Japanese dividend yield is already well past its post-1960 average of 2%; but it has a long way to go before hitting the pre-1960 average of 6.9%.

YIELDS AGAINST BONDS. We can also look at equity valuations against bonds. US equities yielded twice that of government bonds prior to 1960. At current Treasury rates, that would imply an equity market yield of nearly 6%. The S&P would need to fall by another 37% to deliver that yield on the current dividend base. Such a move would be less intimidating for Japanese equities, which, at 3%, already yield more than twice that of government bonds, at 1.3%. At the top of the bull market in 1990, Japanese equities yielded 0.5% versus 5% for government bonds. It seems that a 20-year bear market may have finally killed off the cult of equity in Japan. The UK sits somewhere between the US and Japan. It has already seen equity valuations return to their pre-1960s relationship with gilts—UK equities yielded 1.5 times gilts back then. Still, UK equities are not yet yielding twice the level of gilts—and that would imply another 25% still must come off share prices, given the current dividend base.

Perhaps this analysis suggests that the asset class with the best value right now is corporate bonds. While the current 8% yield on US Baa-rated corporate bonds might not look high relative to the 18% of the early 1980s, spreads against US Treasurys are now at early 1930s levels. US Baa-rated bonds currently yield about six percentage points more than equities, in line with their post-1960s experience. So we have yet to see any sign of reversal in the cult of equity in this valuation relationship.

This makes it clear why many investors—and our credit strategists—are now embracing the cult of the investment-grade corporate bond. Well-documented liquidity problems mean that corporate bond spreads against Treasurys are now the highest ever seen. While corporate bonds look fairly valued against equities on a post-1960 basis, they are very attractive if we return to a pre-1960 valuation.

Of course, many equity investors will be rankled to learn the asset class that did the most to get us into the current mess might eventually gain the most from it. Those of us in the equity world have had it easy for most of the past half-century. We need to accept that just as the rise of the equity culture drew capital from bonds into equities, so its reappraisal may be shifting capital back the other way.

Right now, with government bond yields already so low, higher-quality investment grade corporate bonds appear likely to be the key beneficiaries of further outflows of equities. Recent high-quality corporate bond issues have been heavily oversubscribed. Investment grade seems to be the asset class of choice among most investors we meet. ■

AUSTRALIA
Melbourne
61-3-8643-9981
Sydney
61-2-8225-4295

BAHAMAS
Nassau
242-302-8706

BRAZIL
Rio de Janeiro
55-21-4009-8161
Sao Paulo
55-11-4009-3432

CANADA
Montreal
514-393-7526
Toronto
416-947-5300
Vancouver
604-739-6222

CAYMAN ISLANDS
Grand Cayman
345-949-0355

CHANNEL ISLANDS
St. Helier, Jersey
44-1534-608-010

CHILE
Santiago
56-2-338-8850

CHINA
Shanghai
86-21-28963928

GREECE
Athens
30-210-675-6850

HONG KONG
Hong Kong
852-2868-8688

INDIA
New Delhi
91-124-418-6694
Mumbai
91-22-4001-5282

INDONESIA
Jakarta
62-21-5290-8065

ISRAEL
Tel Aviv
972-3-684-2588

ITALY
Milan
39-02-864-741
Rome
39-06-421-781

KINGDOM OF BAHRAIN
Kingdom of Bahrain
973-17-586-287

KOREA
Seoul
82-2-2124-3600

MALAYSIA
Kuala Lumpur
60-3-2383-2789

MEXICO
Mexico City
52-55-22-26-8310
Monterrey
52-81-1226-9401

PERU
Lima
511-215-2000

PHILIPPINES
Manila
63-2-985-7500

SINGAPORE
Singapore
65-6227-9188

SPAIN
Madrid
34-91-538-4400
Barcelona
34-93-316-5400
Valencia
96-353-51-47

SWITZERLAND
Geneva & Zurich
41-58-750-5000

TAIWAN
Taipei
886-2-7718-8608

THAILAND
Bangkok
66-2-232-3031

UNITED ARAB EMIRATES
Abu Dhabi
971-2-678-2727
Dubai
971-4-604-4411

UNITED KINGDOM
London
44-207-508-8000

UNITED STATES
Baltimore, MD
410-736-5531
Beverly Hills, CA
800-870-1073
Boca Raton, FL
800-870-1073
Boston, MA
800-870-1073
Chappaqua, NY
800-870-1073
Chicago, IL
800-870-1073
Denver, CO
800-870-1073
Greenwich, CT
800-870-1073
Honolulu, HI
800-870-1073
Houston, TX
800-870-1073 (US)
713-966-5102 (Int'l)
Los Angeles, CA
800-870-1073
Miami, FL
800-870-1073
305-347-1800 (Int'l)
New York, NY
800-870-1073 (HNW & LFG)
212-559-9067 (Int'l)
212-559-9155 (LatAm)
Orange County, CA
800-870-1073
Palm Beach, FL
800-870-1073
Palo Alto, CA
800-870-1073
Phoenix, AZ
800-870-1073
San Francisco, CA
800-870-1073
Seattle, WA
800-870-1073
Short Hills, NJ
800-870-1073
Uniondale, NY
800-870-1073
Washington, DC
800-870-1073 (HNW)
202-220-3636 (LFG)

URUGUAY
Montevideo
598-2-198-7000

For archives of *The View, The View Online* and *The View Up Close,* please visit the Citi Private Bank client Web site at **www.citiprivatebank.com.**

If you have questions or comments, please write to **theview@citi.com.**

(2367)