citigroup

See page 61 for Analyst Certification and Important Disclosures

EQUITY

RESEARCH:

GLOBAL

Equity Strategy

September 29, 2006

Ajay Kapur, CFA
Global Strategist
212-816-4813
ajay.kapur@citigroup.com
United States

Niall MacLeod
44-207-986-4449
niall.j.macleod@citigroup.com
United Kingdom

Tobias M. Levkovich
U.S. Strategist

Robert Buckland
Jonathan Stubbs
Europe Strategists

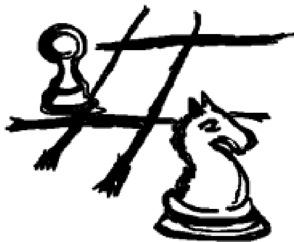
Tsutomu Fujita
Patrick Mohr
Japan Strategists

Markus Rösgen
Asia-Pacific (ex-Japan) Strategist

Geoffrey Dennis
Latin America/CEEMEA Strategist

Adrian Blundell-Wignall
Alison Tarditi
Australia Strategists

Manolis Liodakis
Keith L. Miller
Global Quantitative Research



Global

The Global Investigator

The Plutonomy Symposium — Rising Tides Lifting Yachts

- **Time to re-commit to plutonomy stocks – Binge on Bling.**
  Equity multiples appear too low, the profit share of GDP is high and likely going higher, stocks look likely to beat housing, and we are bullish on equities. The Uber-rich, the plutonomists, are likely to see net worth-income ratios surge, driving luxury consumption. Buy plutonomy stocks (list inside).
- **Plutonomy stocks at a premium, but relative pricing power is key.**
- **Our Plutonomy Symposium take-aways.**
  The key challenge for corporates in this space is to maintain the mystique of prestige while trying to grow revenue and hit the mass-affluent market. Finding pure-plays on the plutonomy theme, however, is tricky.
- **Plutonomy and the Great Conundrums of our age.**
  We think the balance sheets of the rich are in great shape, and are likely to continue to improve. Don't be shocked if the savings rate worsens as equities do well.
- **What could go wrong?**
  Beyond war, inflation, the end of the technology/productivity wave, and financial collapse, we think the most potent and short-term threat would be societies demanding a more 'equitable' share of wealth.

Global — The Plutonomy Symposium — Rising Tides Lifting Yachts........................ 7
U.S. — Calibrating 2007 Targets 21
Europe — Avoiding the Mega-traps.. 27
Japan — Birth of the Abe Administration 31
Asia-Pacific — If It's Due to Speculation=Bullish; If Due to Weaker Growth=Bearish... 37
Latin America — Think Small.. 43

Citigroup Research is a division of Citigroup Global Markets Inc. (the "Firm"), which does and seeks to do business with companies covered in its research reports. As a result, investors should be aware that the Firm may have a conflict of interest that could affect the objectivity of this report. Investors should consider this report as only a single factor in making their investment decision. Non-US research analysts who have prepared this report, and who may be associated persons of the member or member organization, are not registered/qualified as research analysts with the NYSE and/or NASD, but instead have satisfied the registration/qualification requirements or other research-related standards of a non-US jurisdiction.

Customers of the Firm in the United States can receive independent, third-party research on the company or companies covered in this report, at no cost to them, where such research is available. Customers can access this independent research at http://www.smithbarney.com (for retail clients) or http://www.citigroupgeo.com (for institutional clients) or can call (866) 836-9542 to request a copy of this research.

Citigroup Global Markets

Global Model Portfolio by Sector

Company	RIC	Mkt	Date Added	Price Added	Price 28Sep06	U$ Perf Since Added (%)	U$ YTD Perf (%)	Rating	FY1 EPSG (%)	FY1 P/E (x)	FY1 P/B (x)	FY1 ROE (%)	FY1 Div Yld (%)	FY0 FCF Yld (%)	Wght (%)
Energy (MSCI AC World Weight: 9.5%)															**11.0**
Devon	DVN	USA	20 Sep 04	$35.545	$61.7	73.6	-1.3	1H	-0.7	9.2	1.6	19.6	0.7	5.0	3.0
Valero	VLO	USA	29 Sep 05	$57.495	$51.28	-10.8	-0.6	1H	26.8	6.0	1.8	31.3	0.5	8.1	3.0
Grant Prideco	GRP	USA	6 Apr 06	$45.49	$37.01	-18.6	-16.1	1H	85.4	11.5	4.2	35.9	0.0	4.4	3.0
TENARIS	TS	Argentina	21 Jun 06	$35.25	$35.9	1.8	56.8	1H	43.7	11.5	4.3	43.1	1.5	5.5	2.0
Materials (MSCI AC World Weight: 6.1%)															**0.0**
Capital Goods (MSCI AC World Weight: 7.4%)															**6.0**
Caterpillar Inc	CAT	USA	20 Sep 04	$37.94	$66.59	75.5	15.3	1M	36.4	12.1	4.6	42.6	1.6	2.7	2.0
MAN	MANG.DE	Germany	28 Nov 05	€42.23	€65.68	67.3	56.7	NR							2.0
Kubota	6326	Japan	29 Sep 05	¥800	¥955	14.6	-3.5	1H	1.4	15.2	1.8	12.6	1.0	4.7	2.0
Comm Serv & Supp (MSCI AC World Weight: 0.7%)															**0.0**
Transportation (MSCI AC World Weight: 1.9%)															**0.0**
Autos & Comps (MSCI AC World Weight: 2.0%)															**2.0**
Isuzu Motors Ltd	7202	Japan	18 Aug 06	¥403	¥377	-8.1	-16.1	1H	14.8	6.7	1.4	24.0	1.1	12.2	1.0
Suzuki Motor	7269	Japan	18 Aug 06	¥2920	¥2980	0.2	36.6	1M	26.5	18.8	2.0	10.8	0.4	1.7	1.0
Consumer Durables (MSCI AC World Weight: 2.1%)															**4.0**
LVMH	LVMH.PA	France	23 Feb 06	€77.2	€80.8	11.4	15.8	1M	27.7	20.7	3.6	18.2	1.7	2.7	1.5
Richemont	CFR.VX	Switzerlanc	23 Feb 06	SwF58.1	SwF60.3	8.8	11.3	1M	17.3	16.4	2.8	17.8	2.4	1.3	1.5
Meritage Homes	MTH	USA	28 Nov 05	$65.64	$42.58	-35.1	-32.3	1H	-0.9	4.5	1.0	27.8	0.0	20.8	1.0
Consumer Services (MSCI AC World Weight: 1.4%)															**1.0**
Marriott Intl	MAR	USA	28 Apr 05	$31.685	$38.48	21.4	14.9	1M	-3.0	24.6	6.0	21.7	0.6	0.1	0.5
McDonald's	MCD	USA	18 Aug 06	$36.18	$39.59	9.4	17.4	1L	15.0	16.9	3.1	18.0	2.3	2.9	0.5
Media (MSCI AC World Weight: 2.7%)															**2.0**
Mediaset	MS.MI	Italy	28 Oct 05	€9.03	€8.455	-1.8	1.6	1M	-0.2	16.0	3.4	21.7	5.3	7.8	2.0
Retailing (MSCI AC World Weight: 2.5%)															**0.0**
Food & Staples Retailing (MSCI AC World Weight: 2.1%)															**2.0**
Colruyt	COLRt.BR	Belgium	21 Jun 06	€121.5	€135.1	11.6	24.6	1L	10.5	17.8	5.2	30.8	2.0	1.4	2.0
Food Bev & Tobacco (MSCI AC World Weight: 4.4%)															**4.0**
Reynolds Amricn	RAI	USA	23 Feb 06	$53.325	$62.76	17.7	31.7	2M	5.3	15.3	3.0	17.8	4.2	1.9	2.0
Archer Daniels	ADM	USA	28 Nov 05	$24.26	$37.66	55.2	52.7	1M	26.1	14.9	2.2	18.7	0.8	3.1	2.0
Household Products (MSCI AC World Weight: 1.4%)															**2.0**
Kobayashi Pharma	4967	Japan	21 Jun 06	¥4610	¥4430	-6.3	25.7	1M	18.6	20.8	2.5	12.4	0.9	6.4	2.0
Health Care Equip & Svc (MSCI AC World Weight: 2.4%)															**0.0**
Pharma & Biotech (MSCI AC World Weight: 6.7%)															**10.0**
Tanabe Seiyaku	4508	Japan	10 Mar 05	¥1170	¥1455	9.9	27.2	2M	12.7	20.7	1.6	7.7	1.6	3.3	3.0
Biotech Basket*			29 Sep 05			-10.0	-12.4								7.0
Banks (MSCI AC World Weight: 11.3%)															**11.0**
BNP Paribas	BNPP.PA	France	29 Oct 04	€52.76044	€84.75	60.2	34.9	1M	10.5	11.0	1.8	17.6	3.4	NA	2.0
Societe Generale	SOGN.PA	France	20 Jan 05	€76.5	€126.3	61.7	30.8	1M	9.2	10.6	2.2	21.6	4.1	NA	1.0
Golden West Fin	GDW	USA	9 Mar 06	$68.67	$77.07	12.2	16.8	2M	7.3	15.1	2.4	17.0	0.4	NA	3.0
TCF Financial	TCB	USA	9 Mar 06	$25.05	$26.53	5.9	-2.2	2M	-1.0	13.4	3.4	26.0	3.5	NA	3.0
Commerzbank	CBKG.DE	Germany	21 Jun 06	€27.54	€26.63	-2.9	10.1	1H	29.9	11.6	1.3	12.0	2.8	NA	2.0
Diversified Financials (MSCI AC World Weight: 7.0%)															**11.0**
Deutsche Bank	DBKGn.DE	Germany	2 Dec 04	€65.65	€95.01	38.4	24.8	1M	25.4	9.9	1.6	16.7	3.5	NA	2.0
UBS	UBSN.VX	Switzerlanc	20 Sep 04	SwF44.55	SwF73.6	68.8	24.2	1M	13.5	13.3	3.1	24.9	2.6	NA	2.0
SLM	SLM	USA	9 Mar 06	$55.97	$51.98	-7.1	-5.6	1L	12.9	18.3	5.3	33.5	1.9	NA	2.0
Broker/Dealer Basket*			29 Sep 05			23.9	15.5								5.0
Insurance (MSCI AC World Weight: 4.7%)															**6.0**
Allianz	ALVG.DE	Germany	10 Mar 05	€96.4	€136.55	34.0	14.8	1M	22.3	9.9	1.3	13.8	1.9	NA	2.0
Axa SA	AXAF.PA	France	20 Sep 04	€16.78346	€29.29	82.3	17.8	1M	9.2	12.5	1.7	12.8	3.4	NA	2.0
Zurich	ZURN.VX	Switzerlanc	20 Sep 04	SwF183	SwF306.25	71.0	15.5	1M	16.1	9.6	1.5	15.4	2.8	NA	2.0
Real Estate (MSCI AC World Weight: 2.2%)															**2.0**
iStar Financial	SFI	USA	9 Mar 06	$38.8	$41.88	7.9	17.5	1M	5.7	11.8	2.1	18.9	7.3	0.9	2.0
Software & Services (MSCI AC World Weight: 3.4%)															**4.0**
Internet Basket*			25 May 06			9.5	0.9								4.0
Tech Hardware & Equip (MSCI AC World Weight: 5.1%)															**8.0**
Tech Networking Basket*			29 Sep 05			3.8	4.4								8.0
Semi & Semi Equip (MSCI AC World Weight: 2.2%)															**4.0**
Semis Basket*			25 May 06			-2.0	9.2								4.0
Telecom (MSCI AC World Weight: 4.6%)															**5.0**
Chunghwa Telecom	2412.TW	Taiwan	10 May 05	NT$59.80392	NT$53.7	-15.1	-4.0	1L	-4.7	11.6	1.5	12.9	7.2	6.2	1.0
BT Group	BT.L	UK	23 Aug 05	£2.21	£2.635	24.2	29.1	1M	16.1	12.3	11.1	98.0	5.2	2.2	2.0
Telenor	TEL.OL	Norway	10 Mar 05	NOK57.5	NOK83.7	37.0	32.1	1H	45.9	14.1	2.7	21.7	3.0	3.1	2.0
Utilities (MSCI AC World Weight: 4.2%)															**3.0**
FPL Group Inc	FPL	USA	9 Mar 06	$39.02	$45.36	16.2	9.1	1M	11.3	15.8	1.9	12.9	3.3	-5.0	3.0
Total									**17.0**	**13.9**	**2.5**	**17.7**	**1.1**	**0.6**	**98.0**
Cash															**2.0**

Note: Valuations, earnings, and ROE (return on equity) are based on I/B/E/S consensus data. FY1 refers to next fiscal year-end, which for most firms is 12/2006. FY1 = 3/2006 for Japanese companies. P/E, P/B for the Portfolio is stock-weighted average of E/P (earnings to price) and B/P (book to price) and then inverted. D/P (dividend to price) and FCF (free cash flow). Yield is simple stock-weighted average of stock D/P and FCF yield. Aggregate EPS growth is the median growth for Portfolio stocks. Portfolio ROE = Portfolio P/B divided by Portfolio P/E. * MSCI Benchmark weights, as of September 28, are scaled to add up to 98%. Neutral Cash weight is assumed to be 4%. To get the official MSCI weights, divide the shown weights by 0.98.

Source: Citigroup Investment Research and Global Equity Strategy

Constituents of the SubSector Baskets in the Global Model Portfolio

Company	RIC	Mkt	Date Added	Price Added	Price 28Sep06	U$ Perf Since Added (%)	U$ YTD Perf (%)	Rating	FY1 EPSG (%)	FY1 P/E (x)	FY1 P/B (x)	FY1 ROE (%)	FY1 Div Yld (%)	Free CF Yld (%)	Wght (%)
Broker/Dealer Basket (6 companies)						**23.9**	**15.5**								**5.0**
Morgan Stanley	MS	USA	29 Sep 05	$53.85	$72.89	35.4	28.5	1M	34.0	11.0	2.2	22.1	1.5	NA	0.8
Goldman Sachs	GS	USA	29 Sep 05	$121.22	$170	40.2	33.1	2H	55.7	9.7	2.4	28.4	0.8	NA	0.8
Merrill Lynch	MER	USA	29 Sep 05	$61.31	$79.09	29.0	16.8	1M	0.0	15.0	2.0	15.9	1.3	NA	0.8
Lehman Bros	LEH	USA	29 Sep 05	$58.465	$73.35	25.5	14.5	2H	23.4	10.9	2.2	23.4	0.7	NA	0.8
Charles Schwab	SCH	USA	29 Sep 05	$14.25	$17.85	25.3	21.7	1M	42.0	22.5	4.5	22.1	0.6	NA	0.8
Ameritrade	AMTD	USA	29 Sep 05	$21.41	$18.81	-12.1	-21.6	1M	10.2	21.1	6.6	33.4	0.0	NA	0.8
Tech Networking Basket (9 companies)						**3.8**	**4.4**								**8.0**
Cisco Systems	CSCO	USA	29 Sep 05	$17.86	$23.48	31.5	37.1	1H	15.0	18.6	5.1	28.0	0.0	4.5	0.9
Qualcomm Inc	QCOM	USA	29 Sep 05	$44.99	$37.02	-17.7	-14.1	1H	39.6	22.7	4.6	20.0	1.2	2.5	0.9
Motorola Inc	MOT	USA	29 Sep 05	$22.21	$24.89	12.1	10.2	1H	17.3	18.8	3.3	19.2	0.7	5.7	0.9
Corning Inc	GLW	USA	29 Sep 05	$18.7	$24.73	32.2	25.8	2S	23.3	23.6	5.2	23.9	0.0	0.8	0.9
Lucent Tech	LU	USA	29 Sep 05	$3.22	$2.33	-27.6	-12.4	1H	-22.9	17.8	11.1	74.4	0.0	5.0	0.9
Juniper Netwrks	JNPR	USA	29 Sep 05	$23.68	$17.34	-26.8	-22.2	2H	2.9	23.4	1.5	5.6	0.0	5.4	0.9
Harris	HRS	USA	29 Sep 05	$41.05	$44.8	9.1	4.2	2M	21.0	16.7	3.1	20.8	1.0	3.0	0.9
Avaya	AV	USA	29 Sep 05	$10.1	$11.64	15.2	9.1	2S	-20.0	25.1	2.7	11.1	0.0	7.3	0.9
Tellabs Inc	TLAB	USA	29 Sep 05	$10.51	$11.13	5.9	2.1	2H	-1.5	20.5	1.6	8.3	0.0	5.3	0.9
Semis Basket (12 companies)						**-2.0**	**9.3**								**4.0**
Advanced Micro [	AMD	USA	25 May 06	$30.97	$25.07	-19.1	-18.1	1H	80.2	22.4	2.3	13.0	0.0	-2.3	0.3
MEMC Electronic	WFR	USA	25 May 06	$34.41	$38	10.4	71.4	2H	73.1	20.3	7.8	44.4	0.0	1.7	0.3
Intersil	ISIL	USA	25 May 06	$27.24	$24.59	-9.7	-1.2	1H	64.8	19.9	1.5	6.7	0.7	2.9	0.3
Silicon Labs	SLAB	USA	25 May 06	$38.61	$31.01	-19.7	-15.4	1S	3.9	25.1	2.9	10.5	0.0	4.1	0.3
Micron Technolog	MU	USA	25 May 06	$16.17	$17.44	7.9	31.0	2S	0.7	59.7	1.7	4.9	0.0	3.0	0.3
Veeco Instrum	VECO	USA	25 May 06	$24.69	$20.27	-17.9	17.0	2S	102.4	21.8	2.3	9.0	0.0	3.1	0.3
Freescale Semi	FSL.B	USA	25 May 06	$30.53	$37.96	24.3	50.8	1H	58.1	18.1	3.0	16.9	0.0	5.1	0.3
National Semicon	NSM	USA	25 May 06	$25.29	$23.76	-6.0	-8.5	1H	-3.4	18.4	4.1	37.8	0.6	6.8	0.3
Skyworks Solutns	SWKS	USA	25 May 06	$5.73	$5.37	-6.3	5.5	1S	-26.3	27.0	1.0	3.9	0.0	6.9	0.3
KLA Tencor	KLAC	USA	25 May 06	$40.01	$44.74	11.8	-9.3	2H	0.2	24.3	2.6	13.0	1.1	4.9	0.3
ATMI Inc	ATMI	USA	25 May 06	$26.33	$29.36	11.5	5.0	2H	20.6	28.6	2.4	8.2	0.0	2.8	0.3
Analog Devices	ADI	USA	25 May 06	$33.53	$29.7	-11.4	-17.2	2S	28.5	18.2	2.9	15.9	1.9	3.8	0.3
Biotech Basket (13 companies)						**-10.0**	**-12.4**								**7.0**
Amgen Inc	AMGN	USA	29 Sep 05	$79.77	$71.55	-10.3	-9.3	1M	19.8	18.7	3.3	22.0	0.0	4.5	0.6
Celgene Corp	CELG	USA	29 Sep 05	$26.8	$43.37	61.8	33.9	1H	165.8	85.9	17.8	22.2	0.0	-0.1	0.6
Genentech Inc	DNA	USA	29 Sep 05	$83.55	$82.2	-1.6	-11.1	1H	59.3	40.3	10.4	26.3	0.0	0.9	0.6
DOV Pharma	DOVP	USA	29 Sep 05	$17.06	$0.88	-94.8	-94.0	2S	NA	-0.3	-6.1	NM	0.0	-252.2	0.6
Gilead Sciences	GILD	USA	29 Sep 05	$47.5	$68.63	44.5	30.5	1H	36.3	30.3	8.1	31.3	0.0	2.9	0.6
Martek Biosci	MATK	USA	29 Sep 05	$34.82	$21.32	-38.8	-13.3	2S	30.4	34.1	1.5	5.6	0.0	-2.0	0.6
NPS Pharmaceut	NPSP	USA	29 Sep 05	$10.46	$3.84	-63.3	-67.6	2S	NA	-1.4	-1.0	69.0	0.0	-109.9	0.6
PDL BioPharma	PDLI	USA	29 Sep 05	$27.87	$19.41	-30.4	-31.7	1S	NM	115.5	6.5	4.2	0.0	-1.9	0.6
Biogen Idec	BIIB	USA	29 Sep 05	$38.6	$44.74	15.9	-1.2	2H	33.2	21.4	1.9	9.0	0.0	3.0	0.6
Genzyme Corp	GENZ	USA	29 Sep 05	$71.7	$68.09	-5.0	-3.8	1M	19.7	25.0	3.8	16.3	0.0	3.7	0.6
Millennium Pharm	MLNM	USA	29 Sep 05	$9.26	$9.78	5.6	0.8	2S	NA	NM	1.7	0.5	0.0	-4.3	0.6
Pharmion	PHRM	USA	29 Sep 05	$21.77	$21.04	-3.4	18.4	2S	NM	-42.6	2.2	-11.7	0.0	1.2	0.6
Internet Basket (7 companies)						**-12.6**	**-19.9**								**4.0**
Bankrate Inc	RATE	USA	25 May 06	$43.64	$26.6	-39.0	-9.9	2H	60.9	29.0	2.9	15.4	0.0	3.5	0.5
Amazon Com Inc	AMZN	USA	25 May 06	$35.63	$31.84	-10.6	-32.5	2H	-49.6	75.3	26.5	62.4	0.0	2.8	0.5
Google	GOOG	USA	25 May 06	$382.99	$403.58	5.4	-2.7	1H	74.2	40.6	8.5	24.2	0.0	1.3	0.5
Yahoo	YHOO	USA	25 May 06	$32.92	$25.33	-23.1	-35.3	1H	-18.1	53.3	4.1	8.3	0.0	3.5	0.5
eBay Inc	EBAY	USA	25 May 06	$33.88	$28.41	-16.1	-34.3	1H	16.7	28.3	3.4	12.6	0.0	4.2	0.5
Monster Wrldwd	MNST	USA	25 May 06	$51.44	$36.29	-29.5	-11.1	1H	37.3	29.1	4.2	16.5	0.0	3.4	0.5
CNET Networks	CNET	USA	25 May 06	$9.44	$9.67	2.4	-34.2	1S	-16.5	44.6	5.0	18.8	0.0	3.0	0.5
ValueClick	VCLK	USA	25 May 06	$16.69	$18.28	9.5	0.9	1H	16.4	34.8	3.1	8.9	0.0	3.9	0.5

We recommend a basket of Buy or Hold rated stocks in five sub-sectors we believe will outperform when the U.S. Risk-Love is low, as is the case now. The stocks are covered by our colleagues in Citigroup Investment Research and provide diversification by covering roughly 80%–90% of the total capitalization sub-sectors. Our goal is to reduce the risk to the model portfolio from stock-specific risks without hopefully sacrificing too much performance.

Source: Citigroup Investment Research and Global Equity Strategy

Global Model Portfolio Total Return (US$) Since Inception (September 20, 2004) to September 28, 2006

	Year-to-Date	Since Sep 20, 2004		
Global Model Portfolio	12.72%	46.19%	**Sharpe Ratio***	**1.36**
Benchmark: MSCI AC World (US$)	9.46%	33.28%	**Tracking Error****	**4.06%**
Relative Return	**3.26%**	**12.91%**		

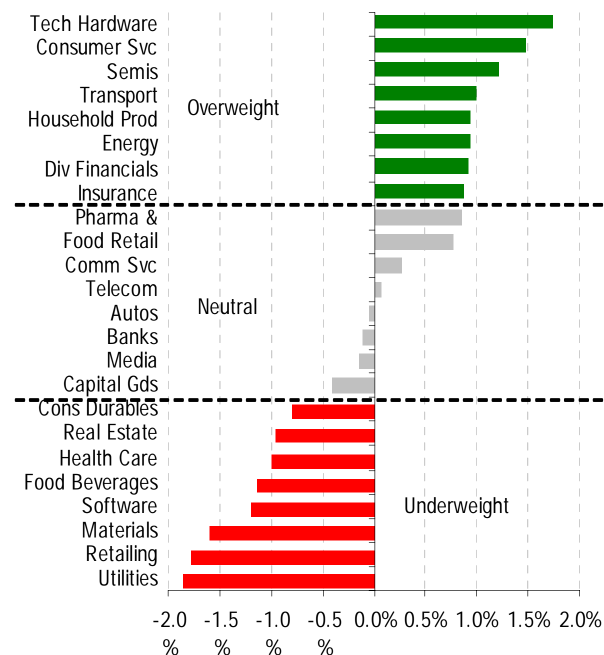
Model portfolio total return based on daily index calculations by Abacus Analytics. Assumes stocks are held in the fixed weights assigned in the model portfolio. The U.S. Dollar is the currency used to express performance. A complete list of changes to the Global Model Portfolio is available upon request. Returns are GROSS of Management and Transaction Fees. Past Performance is Not Indicative of Future Results.

*Sharpe Ratio (Portfolio Performance adjusted for Total Risk) = Annualized Excess Return / Portfolio Volatility since inception.

**Annualized Tracking Error versus the MSCI AC World Index since inception.

Source: Abacus Analytics

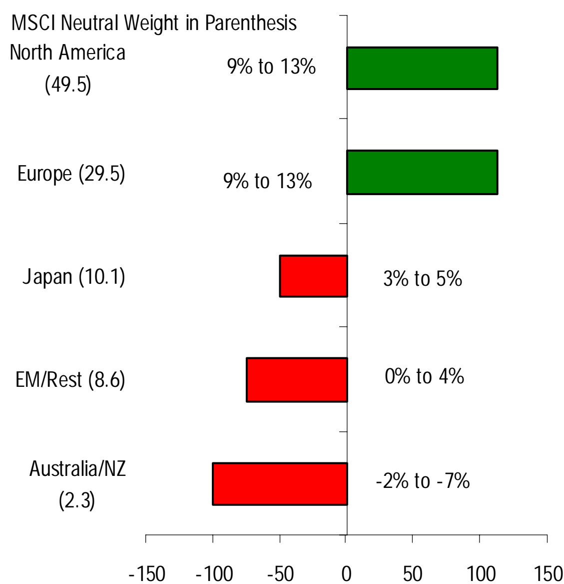
Recommended Global Industry Overweights/Underweights Based on *Top-Down Sector Selection**



*The bar charts reflect our top-down view of industry allocations. The size of the underweight/overweight positions in the model stock portfolio are broadly consistent with these sector views. However, the absolute sizes of the underweight/overweight positions are influenced by other factors such as industry size, the macroeconomic cycle and the desired tracking error versus the benchmark.

Source: Citigroup Investment Research and Global Equity Strategy

Recommended Global Regional Overweights/Underweights Based on *Top-Down Regional Allocation***



**The top-down regional returns for North America, Europe, Japan and Emerging Markets are based on "Market Expected Return Indicator" (MERI) models. For methodology, please see The Global Investigator, July 12, 2004, "Global Asset Allocation: Overweight Equities, US/Europe Bonds, Trash Cash". Australia forecast based on Australian strategy team's latest published outlook.

Source: Citigroup Investment Research and Global Equity Strategy

Table of Contents

Strategy by Region

Global — The Plutonomy Symposium — Rising Tides Lifting Yachts 7

U.S. — Calibrating 2007 Targets 21

Europe — Avoiding the Mega-traps 27

Japan — Birth of the Abe Administration 31

Asia-Pacific — If It's Due to Speculation=Bullish; If Due to Weaker Growth=Bearish 37

Latin America — Think Small 43

Model Portfolio, Fund Flows, Market Intelligence, Analytics

Global Quantitative Angles 49

Weekly U.S. Mutual Fund Flows
(All-Equity: up US$835 million, All-Taxable Bonds: down US$215 million,
All-Money-Market: down US$7,715 million). 51

Investor "Risk-Love" (Investor Sentiment) and Asset-Price-Based Global Growth Indicators
U.S. Risk-Love is slowly climbing in the valley of distress. In Japan, Risk-love is neutral but in Europe it stays close to euphoria. Sentiment in the Emerging Markets also remains elevated near the euphoria zone. The asset-price-based global growth indicator is near its long-term average, suggesting moderate global growth ahead. 54

Global Market Intelligence 56

Global Stock Model Portfolio — Summary Matrix 58

The Least Preferred Stocks Portfolio 59

Correction: Forbes' Cost of Living Extremely Well Index Updated (Figures 10 and 12, page 14)

This page intentionally left blank.

GLOBAL

Ajay Kapur, CFA
1-212-816-4813
ajay.kapur@citigroup.com
New York

Niall MacLeod
44-20-7986-4449
niall.j.macleod@citigroup.com
London

Narendra Singh
1-212-816-2807
narendra.singh@citigroup.com
New York

Priscilla Luk
Hong Kong

Hao Hong, CFA
1-212-816-1180
hao.hong@citigroup.com
New York

Audrey Seybert
New York

Global Equity Strategy

The Plutonomy Symposium — Rising Tides Lifting Yachts

- **Time to re-commit to plutonomy stocks – Binge on Bling[1]**
  Equity multiples appear too low, the profit share of GDP is high and likely going higher, stocks look likely to beat housing, and we are bullish on equities. Uber-rich, the plutonomists, are likely to see net worth-income ratios surge, driving luxury consumption. Buy plutonomy stocks (list inside).

- **Plutonomy stocks at a premium, but relative pricing power is key**
  While trading at a 'worrying' 30% P/B premium to the market, this has no predictive power. Relative pricing power of luxury goods versus CPI is key for plutonomy stock performance. With stronger equities, higher profit share, bling pricing power is likely to rise.

- **Our Plutonomy conference take-aways**
  The key challenge for corporates in this space is to maintain the mystique of prestige while trying to grow revenue and hit the mass-affluent market. Finding pure-plays on the plutonomy theme, however, is tricky.

- **Plutonomy and the Great Conundrums of our age**
  We think the balance sheets of the rich are in great shape, and will get much better. Their behavior overwhelms that of the "average" consumer. A -10% savings rate for the rich has a trivial impact on even the *growth* in their net worth – don't be shocked if the savings rate worsens as equities do well.

- **What could go wrong?**
  Globalization, productivity, a rising profit share and dis-inflation have helped plutonomy. Beyond war, inflation, the end of the technology/productivity wave and/or financial collapse, which have killed previous plutonomies, we think the most potent and short-term threat would be societies demanding a more 'equitable' share of wealth.

[1] Bling – the imaginary sound that light makes when it hits a diamond according to the rap artist B.G. (2005). Source: Wikipedia.

The Plutonomy Symposium — Rising Tides Lifting Yachts

Plutonomy update

It's almost a year since we made up the word Plutonomy. From time to time, in the strategy world at Citigroup, we have a tendency to make up words, to describe some of our more out of the box thoughts. Our European colleagues three years back first referred to de-equitization to describe the wave of private equity and cash funded bids for equities they expected to see over the coming years with free cash flow yields very high, and corporate bond yields very low. Not only do they appear to have been spot on in their prediction but the word is now heard around the world (this year we've heard it back to us in meetings from Melbourne to Tokyo, Cape-Town to Helsinki, Moscow to Dublin and from New York to San Fran) in the press, and on TV. Robert, Jonathan and Hasan, our European colleagues, tell us they wish they'd trademarked this ugly word when they made it up.

So back to Plutonomy. Another neologism and one we in the global team made up. Like de-equitization, it's not the word that's important, but what it describes.

About a year ago, we started doing work on segmenting the so-called consumer, into different types of consumers – rich through poor. We were fascinated by how, when we did this, we found possible explanations for why the world hadn't spun off its axis in response to some of the problems that many commentators seem to endlessly worry about, such as global imbalances or high oil prices.

To us there are certain economies, driven by massive income and wealth inequality – plutonomies – where the rich are so rich that their behavior – be it negative savings, or just very low consumption of oil as a % of their income – overwhelms that of the "average" or median consumer. Last year, for example, we suggested that in the US, the top 20% of consumers might account for nearly 60% of income and spending. The bottom 20% by contrast account, on our data, for about 3% of income and spending. We have no moral opinion on whether this income inequality is good or bad, just that it matters a great deal, when we think about the mystical 'consumer' in the US or other plutonomy countries such as the UK, Australia or Canada.

A second conclusion of our analysis was that the forces which had driven the recent 20 year rise in income inequality were likely to continue over the next few years.

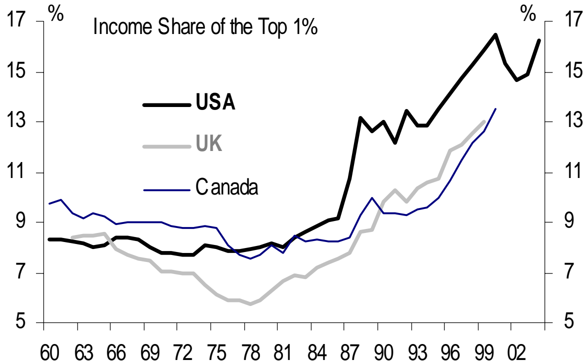
And a third conclusion was that Plutonomy would likely drive a positive operating environment for companies selling to or servicing the rich.

Last week Citigroup hosted a Plutonomy Symposium in London, where a number of companies and commentators discussed the outlook for the Plutonomists. These were mainly luxury goods companies, or companies servicing the ultra-high net worth community. We had a number of industry experts also share their views.

Plutonomy – the story so far…

Over the last 20 years or so, in certain countries, the rich have been getting substantially richer. As Figure 1 shows, the share of the top 1% of the population of income has grown substantially in countries such as the US, UK and Canada. The countries, which apparently tolerate income inequality, are what we call plutonomy countries – economies powered by a relatively small number of rich people.

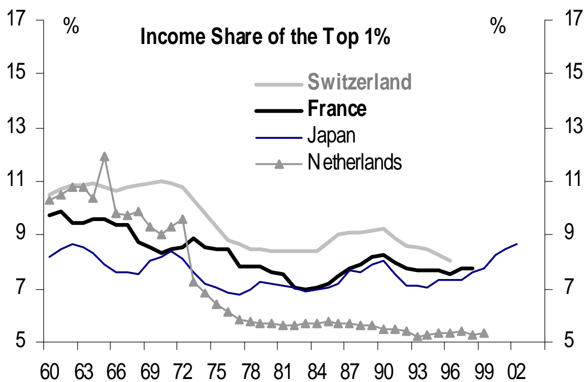
Figure 1. The share of top income groups in the Plutonomies - US, UK and Canada: high and rising. The income share of the top 1% in the US in 2004 = 16.2% of total income; The top 5% = 31.0% of total income



Source: Emmanuel Saez (website: elsa.berkeley.edu/~saez); " Top Incomes in the Netherlands and the United Kingdom over the Twentieth Century", A B Atkinson and Wiemer Salverda; "The Evolution of High Incomes in Northern America: Lessons from Canadian Evidence" Emmanuel Saez and Michael Veall; Citigroup Investment Research.

The rise of this inequality is not universal. In a number of other countries – the non-plutonomies – income inequality has remained around the levels of the mid 1970s. Egalitarianism rules. See Figure 2.

Figure 2. The Egalitarian Bunch: Japan, France, Switzerland, the Netherlands. The Income Share of the Top 1% Is Relatively Small Compared to Plutonomies



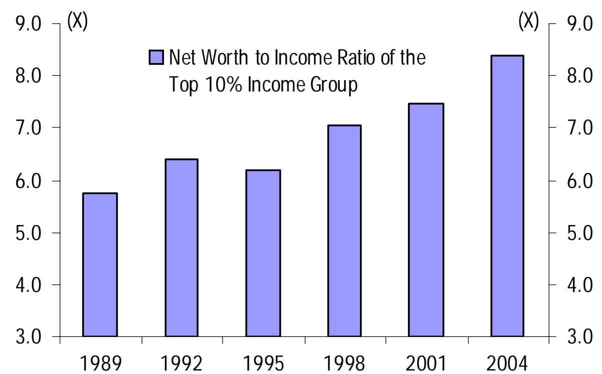
Source: Dell, Fabian; Piketty, Thomas; Saez, Emmanuel; "Income and Wealth Concentration in the Switzerland Over the 20th Century". Moriguchi, Chiaki & Saez, Emmanuel. "The Evolution of Income Concentration in Japan, 1885 – 2002: Evidence from Income Tax Statistics". Piketty, Thomas "Income Inequality in France 1901 – 1998". Atkinson, A.B. and Salverda, Wiemer "Top Incomes in the Netherlands and the United Kingdom over the Twentieth Century"; Citigroup Investment Research.

To us, two things matter about this. Firstly, how have the rich become richer (and shortly, what will happen to this wealth) and secondly what are the economic implications of this?

Firstly, why have the rich become richer? We only have data for the US on this subject.

Figure 3 shows the net worth to income ratios for the top 10% of US households. Since 1989, this ratio is up roughly 50%, from 5.8 to 8.4, as the wealth of the rich in the US has risen substantially.

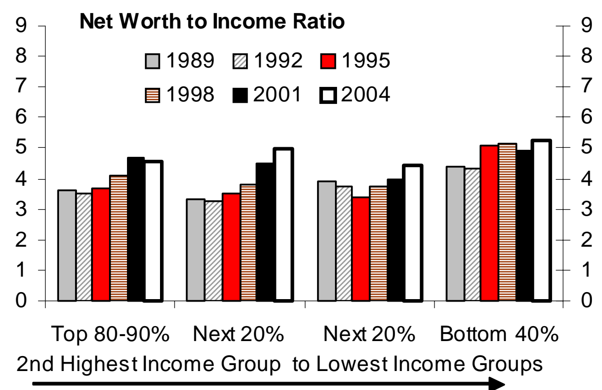
Figure 3. The Net Worth to Income Ratio of the Top 10% of US households has risen to 8.4 in 2004 from 5.8 in 1989



Source: Survey of Consumer Finances, US Federal Reserve Board and Citigroup Investment Research

This has not been an economy-wide benefit. Figure 4 shows the net worth to income ratio of the "lower" 90% of Americans. Their wealth to income ratio has not risen much, particularly since 1995.

Figure 4. The Net Worth to Income ratio of the "lower" 90% of Americans has not risen as much as the top 10%



Source: Survey of Consumer Finances, US Federal Reserve Board and Citigroup Investment Research

What has driven this? We see three drivers. *Firstly*, the bull market in financial assets – particularly equities – as inflation has fallen, has benefited those

whose assets have been invested, particularly in equities as the disinflation was also accompanied by strong earnings growth as margins rose.

Secondly, the rise of managerial capitalism, with CEO remuneration increasingly tied into EPS growth and equity performance. *Finally*, as with previous waves of plutonomy – such as sixteenth century Spain, seventeenth century Holland, Industrial Revolution Britain, the Gilded Age and the Roaring Twenties in the US – the ongoing technological revolution has generated a new wave of ultra-high net worth individuals.

Every three years or so, the Fed publishes the Survey of Consumer Finances (SCF) which allows us to peer into the fortunes of various segments of US households. The balance sheets of the rich are very heavily exposed to business equity and equities, while for the next 80% of Americans, housing tends to be their biggest asset, with equities amounting to a small fraction of their net worth. The rich have benefited immensely from owning equities during the bull market.

Figure 5. Non-Financial and Any Asset holdings by income group: Only 18% of assets of the top 10% income group invested in primary residence; for other income groups the percentage is around 40%-45%

Family characteristic	Vehicles	Primary Residence	Other residential property	Equity in nonresidential property	Business equity	Other	Any nonfinancial asset	Any asset
	PERCENTAGE of families holding assets)							
All Families	84.1	64.7	11.8	9.2	11.1	9.0	90.9	96.4
Percentiles of income								
Less than 20	58.2	39.7	4.0	3.7	4.5	3.7	70.0	84.4
20-39.9	85.3	55.4	7.7	5.6	6.6	6.4	91.4	97.9
40-59.9	91.1	62.6	9.1	7.3	8.8	7.2	95.9	99.9
60-79.9	92.8	77.3	12.6	11.0	12.9	12.2	97.7	99.7
80-89.9	93.8	85.9	16.7	15.5	16.5	10.0	99.2	100.0
90-100	**92.3**	**91.3**	**34.5**	**22.0**	**28.8**	**21.1**	**99.6**	**100.0**
	MEAN VALUE of holdings for families *holding assets* (thousands of 2004 dollars)							
All families	16.4	141.8	130.6	165.6	474.2	49.5	212.7	316.9
Percentiles of income								
Less than 20	6.8	69.2	69.5	90.7	230.0	15.2	69.3	73.7
20-39.9	9.7	96.3	53.6	61.2	111.4	12.6	84.6	116.3
40-59.9	13.8	108.7	85.0	66.1	127.9	16.3	110.2	156.7
60-79.9	19.0	133.4	106.5	100.5	179.1	30.3	176.0	255.8
80-89.9	24.3	170.8	126.9	99.8	241.1	49.3	253.0	400.3
90-100	**32.8**	**292.0**	**222.9**	**421.2**	**1328.3**	**128.9**	**878.7**	**1478.6**
	Value of the asset holding as % of Any asset holding*							
Less than 20	6.4%	44.2%	4.5%	5.4%	16.6%	0.9%	78.0%	100.0%
20-39.9	7.3%	46.9%	3.6%	3.0%	6.5%	0.7%	67.9%	100.0%
40-59.9	8.0%	43.5%	4.9%	3.1%	7.2%	0.7%	67.5%	100.0%
60-79.9	6.9%	40.4%	5.3%	4.3%	9.1%	1.4%	67.4%	100.0%
80-89.9	5.7%	36.7%	5.3%	3.9%	9.9%	1.2%	62.7%	100.0%
90-100	**2.0%**	**18.0%**	**5.2%**	**6.3%**	**25.9%**	**1.8%**	**59.2%**	**100.0%**

*Percentage share are calculated over only those holding assets in the category. The mean values have not been adjusted for outliers.

Source: 2004 Survey of Consumer Finance, http://www.federalreserve.gov/pubs/oss/oss2/2004/scf2004home.html and Citigroup Investment Research

Figure 6. There is no "average" consumer. The share of high income households in consumption is very large

From Consumer Finance Survey (2004)					Consumption share using Maki/Palumbo savings rate				Other estimates	
Percentile of Income	Mean Net Worth ('000 $)	Net Worth share (%)	Mean Income ('000 $)	Income share (%)	Income Quintiles	Income Share (%)	Assumed Savings Rate**	Implied Consumption Share**	Income Share (2005 CPS^)	Consumption Share (2004 CES^^)
Less than 20	73	3.2%	10.8	3.1%	Bottom 20%	3.1%	7.1	3.3%	3.4%	8.2%
20-39.9	122	5.4%	26.1	7.4%	20-39.9%	7.4%	7.4	7.5%	8.6%	12.6%
40-59.9	194	8.6%	43.4	12.3%	Mid 20%	12.3%	2.9	12.5%	14.6%	17.0%
60-79.9	343	15.3%	69.1	19.5%	60-79.9%	19.5%	2.6	19.2%	23.0%	23.5%
80-89.9	485	10.8%	106.5	15.1%	Top 20%	57.8%	-2.1	57.5%	50.4%	38.6%
90-100	2,534	56.5%	302.1	42.7%						

* The Survey of Consumer Finances (SCF) is a triennial survey of the balance sheet, pension, income, and other demographic characteristics of U.S. families. The survey also gathers information on the use of financial institutions. It is conducted by the Federal Reserve Board.
** The savings rate is assumed from estimates from "Disentangling the Wealth Effect: A Cohort Analysis of Household Saving in the 1990s", Dean M. Maki and Michael G. Palumbo, April 2001, http://www.federalreserve.gov/pubs/feds/2001/200121/200121pap.pdf. They found that "the groups of households that benefited the most from the recent runup in equity wealth—those with high incomes or who have attained some college education—were also the groups that substantially decreased their rates of saving. Further, econometric analysis of these data produces coefficient estimates for the propensity to consume out of wealth that are closely aligned with typical estimates obtained from aggregate data. Taken together, our results corroborate a direct view of the wealth effect on consumption." We back the consumption from income data from the Survey of Consumer Finances and their savings rate for income groups. The SCF income is before tax income. To back out consumption we have assumed the following effective state, local and federal tax rates (from the lowest income group to the highest income group): 20%, 23%, 27%, 30%, and 32% (source: http://www.ctj.org/).
^Census Population Survey. Sources of income distribution data are the decennial censuses of population and the Current Population Survey (CPS), both products of the U.S. Census Bureau. Annual data on income of families, individuals, and households are found on the Census Web site at http://www.census.gov/hhes/www/income.html
Mean income is substantially higher in the SCF than in the CPS, primarily because the CPS truncates incomes above a certain amount to obscure respondents who might otherwise be identifiable.
^^Consumer Expenditure Survey is conducted by Bureau of Labor Statistics. Data includes the expenditures and income of consumers, as well as the demographic characteristics of those consumers.
Source: Citigroup Investment Research

To us there are a number of important consequences of this income inequality. Firstly, there is no such thing as "the" consumer.

Figure 6 shows the percentage of income and consumption each income quintile accounts for, using data from the US Fed's 2004 Survey of Consumer Finances (SCF) and the US Census Bureau's 2004 Consumer Expenditure Survey (CES). The top quintile of income group accounts for 67% of wealth, 50% to 58% of income and, 39% to 59% of consumption, depending on the method of calculation (see footnotes to Figure 6 for details). The variance in income (and consumption) estimates reflects the treatment of outliers (the very rich) in the surveys.

The Survey of Consumer Finances excludes the exceptionally rich. We estimate that the Forbes 400 richest families account for roughly 2.4% of the nation's total net worth. Their inclusion would further skew income and consumption towards the top 20% income group.

This is why for example, we worry less about the impact of high oil prices on aggregate consumption, when oil accounts for approximately 5.8% of the spending basket of the top 20% of Americans, though it accounts for 8.5% of the "average" (the middle 20%) consumer's spending basket. Clearly high oil prices are a burden for many parts of our communities. However, without making any moral judgment, income inequality being what it is, just makes this group less relevant in the aggregate data.

The conclusion? We should worry less about what the average consumer – say the 50th percentile – is going to do, when that consumer is (we think) less relevant to the aggregate data than how the wealthy feel and what they are doing. This is simply a case of mathematics, not morality.

The second consequence we feel is that the behavior of the rich might explain one of the great conundrums out there – that of the current account deficit, and why the dollar has yet to spin-off into collapse.

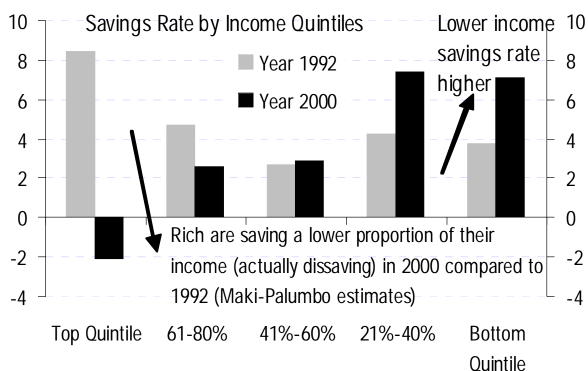
A paper by two Fed economists (Maki and Palumbo, see Figure 7), in 2001 demonstrated that the low savings rate in the 1990s, the oft-cited

reason behind the current account deficit in the US, was a function of the negative savings rates of the top 20% of Americans. Of course, since 2000, when these data stop, the housing boom in the US also must have lowered the savings rates of the bottom 80% of US households – we expect them to reverse that behavior. Still, the overall savings rate is likely to be driven by the top 20%, not the changes made by the bottom 80%.

In our view, equities, the main asset of the rich are undervalued. Also, the profit share of GDP, while high is likely to go even higher (productivity, globalization, the older boomers, a powerful voting bloc, becoming long the profit share, less the wage share of GDP). With a possibly higher equity multiple attached to a higher profit share we expect the rich to see an even more robust expansion in net worth to income.

This impetus to their very low savings rates should only intensify, keeping their savings rates low. Ergo, it is also highly likely that the negative overall US household savings rates, driven by the rich (despite the possibly higher savings rates by the bottom 80%) continues. Of course, we expect the perma-bear crowd to continue to be baffled and concerned by this persistence of negative US savings rates (and the related rise in the US current account deficit).

Figure 7. The savings rate of the rich fell in the 1990s while those of lower income groups rose



Source: Maki, Dean M. & Palumbo, Michael G. "Disentangling the Wealth Effect: A Cohort Analysis of Household Saving in the 1990's". Board of Governors of the Federal Reserve System & Putnam Investments. April 2001.

In meetings around the world, we are often struck by the virulence with which some clients attack the apparent profligacy of the mythical US consumer. This of course pales into insignificance besides the attacks on their profligacy by established journals and the intellectual glitterati, who have highlighted the US current account deficit and negative savings risk as a risk to the US and global economies, and the dollar, for many years. And yet, this 'profligacy' has persisted, and indeed apparently worsened.

As the Fed paper showed, the negative savings rate was a function of the behavior of the top 20% of Americans, who dis-saved. And why not, in our opinion. After all, their net worth as a fraction of their income is up 50% over the last 15 years .We think it is perfectly logical for someone whose net worth to income ratio has risen 50% in 15 years to worry less about saving from income.

As Figure 8 shows, for someone whose net worth is 8x their income, a negative savings rate of 5% (assuming a 40% tax rate), would be equivalent to running down 0.4% of their net worth. This is a fraction of the 12.7% annual average increase in the S&P500 price index since 1982 (we have ignored dividends as these are included in income for the purposes of the savings rate calculation).

Figure 8. When The Net Worth to Income ratio is high, as is the case with the top income group now, the impact of dis-saving on net worth is relatively small

	Net Worth/Income Ratio				
	4	5	6	7	8
Savings Rate	Implied Change in % of Net Worth				
5%	0.8%	0.6%	0.5%	0.4%	0.4%
4%	0.6%	0.5%	0.4%	0.3%	0.3%
3%	0.5%	0.4%	0.3%	0.3%	0.2%
2%	0.3%	0.2%	0.2%	0.2%	0.2%
1%	0.2%	0.1%	0.1%	0.1%	0.1%
0%	0.0%	0.0%	0.0%	0.0%	0.0%
-1%	-0.2%	-0.1%	-0.1%	-0.1%	-0.1%
-2%	-0.3%	-0.2%	-0.2%	-0.2%	-0.2%
-3%	-0.5%	-0.4%	-0.3%	-0.3%	-0.2%
-4%	-0.6%	-0.5%	-0.4%	-0.3%	-0.3%
-5%	-0.8%	-0.6%	-0.5%	-0.4%	-0.4%

Note: We assume a fixed tax rate of 40% in these calculations

Source: Citigroup Investment Research

Not all of the assets of the rich are in equities of course, but even assuming a more cautious assumption of growth of say 8% in their assets, one can see why a low or mildly negative savings rate by the rich is something of an irrelevance – it is a cash flow measure that ignores balance sheet returns.

Risk and plutonomy

In the plutonomy countries there appears to be a greater willingness to take on risk, and this is reflected in the general asset allocation to risk assets.

Figure 9. Plutonomies appear to favor equities more in asset allocation

	% of assets of mutual funds, pension funds and insurance companies			
	Equities	Bonds	Money Mkt	Other
France	27	10	47	16
Germany	27	48	4	21
Italy	23	47	17	13
Spain	39	33	25	3
UK	75	15	1	9
US	53	36	3	8

For the US, the aggregation is over Mutual Funds, Closed End Funds, ETF, Life Insurance, Private-Casualty Insurance, Private Pension Funds, State/Local Govt Retirement, and Federal Govt Retirement Funds. Bonds include all credit market instruments including open market paper, treasury securities, agency- and GSE-backed securities, municipal securities, corporate and foreign bonds, and mortgages. Money market holdings include checkable deposits and currency, time and savings deposits, money market fund shares and security RPs. US data is from 2006Q2 Federal Reserve Board Flow of Funds database.
For Europe the data is for mutual funds. Ex the UK, pension funds and insurance companies typically have a low weighting to equities in most other European countries..
Source: US Federal Reserve Board, National Association of Mutual Funds and Citigroup Investment Research.

The point is that in some countries such as the UK, Canada and the US, there is a greater willingness to own equities – a higher risk, but higher return asset. This willingness to eat up the risk premium means that, all other things being equal, the asset bases of the equity owner will grow faster than that of the debt holder. Those crazy dis-savers in the US or UK may actually be not so crazy after all – they are making an allocation to faster growing equities precisely at a time when they are cheap. And if they are "borrowing" over US$200 billion every quarter (the US current account deficit) to do this, are they not actually employing sensible financial theory – taking advantage of cheap debt to spend while watching their equity portfolio grow in excess of the cost of debt?

Dopamine is often associated with a greater willingness to take on risk. It has been suggested that countries with large immigrant populations tend to have higher levels of dopamine in their populations, and therefore are more likely to take on risk. We find this hypothesis intriguing, as it suggests a possible link between wealth generation and plutonomy. [2]

Playing plutonomy

So far we've looked at the theory. But how do we make money out of this? Well for starters, by worrying less about "the consumer" and spending more time segmenting the data. Secondly, we can worry less about the apparent profligacy of the so-called US consumer, or their cousins in the other plutonomy countries like the UK or Canada. Finally, we can identify stocks than benefit from the concept of the rich getting richer.

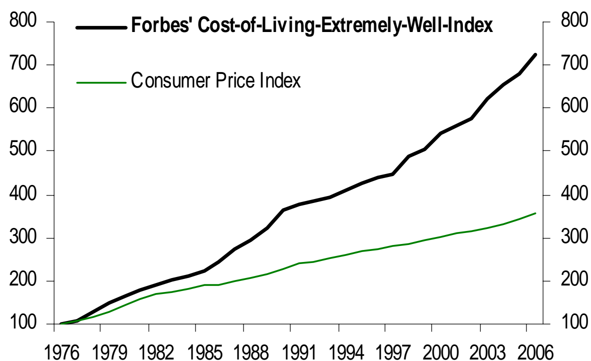
As the rich having been getting richer over the last 20 years or so – both in terms of their share of income and wealth – so too businesses that have been servicing the rich or selling to them have enjoyed a favorable operating backdrop.

One way we can measure this is by looking at the pricing power of luxury items, and comparing this to standard inflation. We can do this by using Forbes' "Cost of Living Extremely Well Index". Figure 10 shows this. Since 1976, the prices of luxury goods items have risen at twice the rate of the aggregate CPI.

[2] "*The Hypomanic Edge - The Link Between (a Little) Craziness and (a Lot of) Success in America*", John Gartner.

"American Mania", Peter Whybrow.

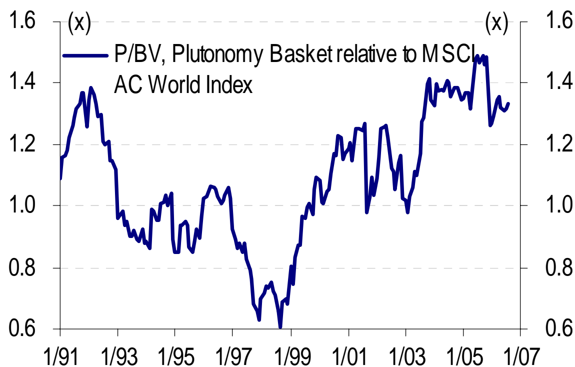
Figure 10 Luxury goods price inflation exceeds overall inflation. In past year CLEWI is up 7% while CPI is up about 4%



Source: www.Forbes.com/clewi, Bureau of Labor Statistics

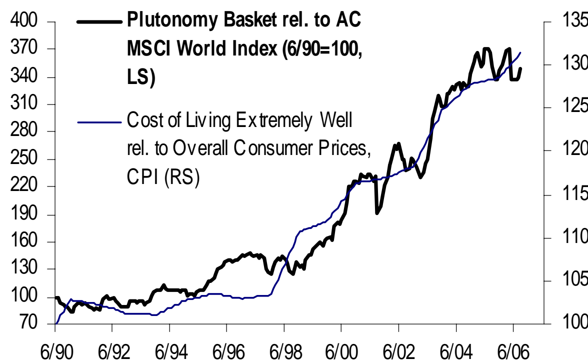
In previous editions of the Global Investigator[3], we have highlighted why we believe margins are likely to keep rising in coming years, driving equity returns higher, helping the rich (who tend to be long the profit share) get even richer. Given this thesis, we put together a basket of "plutonomy" stocks (please see the appendix for a list of plutonomy stocks), that we thought derived a disproportionate amount of their revenue from selling to the rich. Not all of these are pure play businesses on the ultra-rich, indeed it is difficult to find pure-plays on the ultra-high net worth plutonomists.

Figure 11. The Plutonomy basket is relatively expensive ......



Source: MSCI and Citigroup Investment Research

Figure 12 ...but will likely continue to outperform the market index as long as luxury inflation exceeds overall inflation



Source: www.Forbes.com/clewi, Bureau of Labor Statistics, MSCI and Citigroup Investment Research

Over the last 20 years, this equal-weighted basket has performed well, rising on average by 17.1% annually, comfortably outperforming the MSCI World index annual return by 6.8% annually.

We have found that, though the basket is relatively expensive on a P/B basis to the overall market, the basket has performed well relative to the market, when luxury inflation is strong relative to overall inflation.

As an aside, our colleagues in our European derivatives team have created a European synthetic plutonomy basket/instrument. Details available from Cian Fitzgerald (Citigroup Equity Derivatives London. For important disclosures please see: http://www.optionsclearing.com/publications/risks/riskstoc.pdf)

The Symposium

To take a look at this luxury theme in more detail, Citigroup hosted a Plutonomy Symposium last week in London. The conference was attended by a number of luxury goods companies, service providers and private banks, as well as industry experts. Rather than focusing on the merits of individual companies, we kept most of the sessions to a more thematic panel-based discussion.

Slides from the Symposium and the original agenda are available for a limited time on the following website (apologies for the rather long address):

[3] See, for instance, "Profiting from the Profit Wave", August 19, 2005 and "Global Earnings Growth: The Energizer Bunny", August 18, 2006.

https://www.seeuthere.com/rsvp/invitation/invitation.asp?id=/m1c9c382-506623187671

Our first panel consisted of representatives from Orient Express Hotels, NetJets, Baglioni Hotels, and Wynn Resorts. One of the most interesting comments to come out of the panel was Simon Sherwood's (CEO of Orient Express) remark that the one thing that the rich cannot typically buy is time. So choosing to spend time with a great product is essential. This was a recurrent theme. True plutonomists typically seek more unique experiences, rather than standard service. This was echoed by NetJets who added that high-end customers don't want special rates, or discounts, nor are they really interested in the general concept of expense, but rather they want what's "special". The CEO of Baglioni Hotels added that to this end, "brand trust" was exceptionally important. Plutonomy products are transitioning from "things" to the less tangible but equally exclusive "one of a kind" experiences.

The themes that kept coming out of the panel were the importance of uniqueness, exclusivity and quality. Cost was less important, though for the mass-affluent market this clearly was more of an issue. The challenge seemed to be maintaining a balance between exclusivity and revenue growth – how to keep a brand exclusive and high quality yet at the same time appeal to as wide an audience as possible. Wynn attempts to achieve this through attacking the aspirational market as well as the actual plutonomy market (they are the biggest Ferrari dealer in Nevada). For Baglioni, the only way to maintain the balance between exclusivity and uniqueness was to remain small. Obviously this becomes harder for publicly quoted companies with shareholder pressure for growth. As Simon Sherwood put it, it's very difficult to remain serving the plutonomy forever, without a constant upgrading – what is exclusive today is unlikely to remain so in 20 years time.

Mid morning we switched tacks a bit, and focused more on luxury products, with the CEOs of Asprey and Mariella Burani Fashion Group, Gianluca Brozetti and Giovanni Burani and James Lawson, head of research at Ledbury Research, the ultra-high net worth consultant firm.

James started us off by explaining the four reasons consumers buy luxury products – 1) I want to show off, 2) I want to explore, 3) I work hard, and deserve this and 4) I want others to ask me about this, my area of expertise (e.g. become a wine expert). Mr. Brozzetti talked about how Asprey were the ultimate long-term Plutonomy company, having served the ultra-rich for over 200 years. He went on to explain how vital it is that luxury businesses understand demand, and work out the balance between exclusivity and mass market. The trick seems to be to create a mystique of maintaining prestige and yet appealing to as wide an audience as possible. It is vitally important to stay loyal to key aspects of the brand and not dilute this. While Asprey are clearly appealing to the prestige market, Mariella Burani has moved more into the mass-affluence area of affordable fashion. While they think that the mid-market is dead, they believe that the mass market of aspirational buyers is very much alive, but the key is to have very strong brand integrity and use only suppliers that themselves use high quality materials and highly skilled labor.

New markets – emerging markets – have become extremely important. But for the ultra-rich plutonomists, they don't tend to be part of a specific geography, but tend to be very global, hanging out in plutonomy destinations with fellow plutonomists. For example in London 60% of houses in London costing over £4million are now sold to non-Brits.

Late morning, two seasoned luxury goods investors – Scilla Huang Sun who runs Clariden Bank's Luxury Goods fund, and Susanne Seibel of Greyshrike Capital – shared their thoughts with us about investing in the luxury space.

Scilla identified the growth dynamics, especially with Asia/emerging markets, and the growing community of the wealthy, as being the key drivers behind this premium growth area. The added benefit of pricing power, makes it almost unique. Both Scilla and Susanne highlighted that though

the sector does tend to underperform in times of crisis, sales are typically quite defensive. Scilla identified family-owned companies as being better at focusing on profitability, though these are often smaller. Scilla also highlighted innovation as key to the success of brands. Susanne also highlighted size as being important, with smaller companies better able to grow. As a hedge fund manager, Sussane's warning was that valuations alone were not a reason to short a stock in this space.

In the Financial panel, Marianne Hay, Citigroup's CEO of Global Wealth Management, Europe, pointed out that wealth generation is now coming from ideas, knowledge and aspirations (entrepreneurial ventures) and not the traditional streams such as agrarian, industrial and corporate channels. There is also a life cycle that is emerging with the new plutonomists, "Apprentice, Journeyman, Master". As the cycle continues, Global Wealth Management companies are assisting these "Master" plutonomists with structuring their wealth through succession plans and philanthropy in addition to traditional investments.

Marianne was joined in a panel discussion by Jan Bielinksi of Julius Baer and Peter Clarke of Man Group for a lively discussion on changing demographics, whether we were in a golden trend of growth in asset inflows (generally answered yes), and fees and whether it was the adviser or organization that mattered (in Europe, more the organization, in the US more the adviser).

Later in the day, we were joined by a number of other presenters, such as Dr. Iain Robertson, of Sotheby's Institute of Art, who is an expert on art as an investment class, Geordie Greig, editor of Tatler magazine, and our colleague Philip Anker of Citigroup Alternative Investments.

Investing in art feeds into the 4th reason for investing in luxury products described by James Lawson, "I want others to ask me about this". A classic example of a wealthy individual that became hooked on art was JP Morgan – often described as a somewhat rough individual – who used his wealth to acquire entry in to the rarefied art world. In addition to providing the often sought out mystique of wealth, art is literally a tangible asset and acts as a safe haven, making this market unique from any other investment product. The market itself is likely the most unpredictable of markets (an investment will literally be "en vogue" or not and it is hard to determine when a product will fall in or out of fashion) and as no two products are exactly alike the difficulty in pricing increases the perception (and reality) of exclusivity. If you have it, no one else can possess the same thing. Art also appeals to the human psyche in acquiring "more and better".

As it is considered the pinnacle of luxury products, there are hierarchies within the individual collectibles market, beginning with rare vintages and graduating up to paintings. One drawback to this investment class is the risk of illiquidity, though a repeated theme throughout the day from the experts was that "rich people don't need liquidity – they already have it".

Continuing on the issue of illiquidity – our Citigroup Alternative Investments specialist Philip Anker re-iterated the concept that the ultra-rich are not only tolerant of downside risk, they do not require liquidity in their investments in his fascinating comments on "The New Asset Allocation Paradigm of Ultra-High Net Worth Investors".

There is further evidence for this as investing in infrastructure is a growing trend for the very rich. As Ultra-High Net Worth investors can afford risk and illiquidity, they do require a non-bureaucratic investment process in order to maintain their first-mover advantage and subsequent rewards due to scarce capacity. They tend to have access to the best managers and information and seek out and drive financial innovations and creativity. Another social implication is the access of charities and foundations to these financial innovations. Large foundations usually have boards and steering committees comprised of wealthy individuals or family trust representatives.

The risks to plutonomy

Our thesis is that the plutonomists are likely to get even richer over the coming years. This could mean global imbalances get even larger, without the planet getting knocked of its axis and sucked into the cosmos.

But this thesis is not without its risks. Plutonomies have existed before and they have come to an end.

To this end we see four primary risks. The first, war and/or inflation. Secondly, financial collapse. Three, the end of the technological revolution. Finally, political pressure to end the increase in income and wealth inequality.

Looking back over time, wars have been pretty bad times for wealth. Both because of the destruction of physical assets, and/or confiscation of wealth, but also more generally as wars have tended to be inflationary. And inflation itself is a major destroyer of financial wealth (just as disinflation has helped create wealth over the last 24 years). Global conflict/revolution on a scale that could destroy the wealth of the plutonomy countries looks to us unlikely in the short term.

Secondly, financial collapse. As much of the wealth of the plutonomists is held in one shape or other in financial wealth (as opposed to land or property), the state of the financial system is important. Financial collapse, as in the Great Depression in the US, would be a serious challenge to the plutonomists. While we have worried periodically about systemic financial risk, say in the aftermath of the LTCM debacle, it is beyond us to speculate about financial collapse. This would however be a serious issue for the rich.

A third challenge would be the end of the wave of technological revolution. The great plutonomy waves of previous centuries, such as the Gilded Age, the Industrial Revolution in Britain, the era of Dutch supremacy, were often associated with technological and financial progress. Economies advanced through progress, with the gains in the first instance disproportionately going to the innovator and risk takers. Were the technology revolution to dissipate, it is likely that the income gains would channel less to the top. Furthermore, technology waves are usually associated with productivity gains, which in turn tend to help keep inflation low and profit growth high. This in turn being a major source of financial wealth creation. So an end of this positive spur would be unhelpful to plutonomy. We see the current internet and communications revolution as being far from dead.

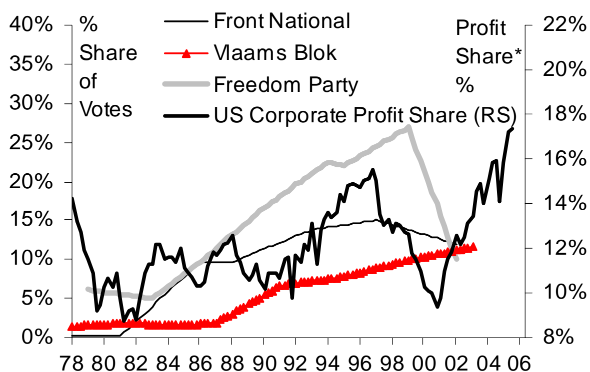
Perhaps the most immediate challenge to Plutonomy comes from the political process. Ultimately, the rise in income and wealth inequality to some extent is an economic disenfranchisement of the masses to the benefit of the few. However in democracies this is rarely tolerated forever.

One of the key forces helping plutonomists over the last 20 years has been the rise in the profit share – the flip side of the fall in the wage share in GDP. As plutonomists or capitalists tend to be long the profit share, they have benefited from trends like globalization and the productivity revolution, disproportionately. However, labor has, relatively speaking, lost out.

We see the biggest threat to plutonomy as coming from a rise in political demands to reduce income inequality, spread the wealth more evenly, and challenge forces such as globalization which have benefited profit and wealth growth.

Globalization has come in for its fair share of attack of late. And political attention on immigration and protectionism is never far from the surface. As we suggested in our note in October last year, reactionary political forces are likely to rise as globalization persists and the losers in developed economies gain in numbers. To an extent we see this happening in Europe, for example, where the rise in the profit share (fall in the wage share) has come at the same time as the rise of right-wing, generally anti-immigration parties (please see Figure 13).

Figure 13. The ascendancy of European right-wing, generally anti-immigration, parties has coincided with a rise in profit share (a fall in wage share)



*US Corporate Profits Before Tax adj. For IVA & CCA as % of Gross Value Added
Source: Wikipedia, US Bureau of Economic Analysis and Citigroup Investment Research

On the other hand, ageing populations in countries where there are developed and well-financed pension schemes, and a big equity component in these, are probably more tolerant of a rising profit share. As individuals move from being workers to retirees, their incomes shift from being earned as wages, to dividends and savings, which are more linked to profits. This would suggest that in the UK and US for example, demographics might support – politically – a higher profit share, though this might not hold true, for example, in a country like France.

So, is plutonomy under threat politically? We are keeping an eye on this one. At the moment, it is too early to make this call. Calls for protectionism and an end to immigration grow louder by the day, but they are difficult to measure. But a substantial percentage of Americans are in favor of repealing the estate tax (though only 2%, roughly, will ever pay it), which does not resonate as a population determined to destroy wealth inequality.

The political process is the greatest threat to plutonomy. We don't see it as a threat today in most countries. But we are alert to changes here.

Conclusion

The rise of the plutonomy has been an incredibly important development of the last 25 years. We think the huge increases in wealth and income inequality that has occurred as the rich have become richer helps explain many conundrums that simplistic analysis of "the average consumer" ignores.

The rich earn a lot. They are worth a lot. They don't tend to save out of income. They are apparently impervious to US$70 oil, run negative savings rates, and are, we believe, largely to 'blame', for the negative savings rates in plutonomy countries. Not that rich people in non-plutonomy countries aren't doing exactly the same, or feeling the same forces. It's just that in egalitarian countries like Japan or most of Europe ex the UK, there simply aren't enough rich folks to influence the data in the way that there are in plutonomy countries like the UK, US or Canada.

Our Plutonomy Symposium in London looked at the challenges and opportunities presented by this fast growing market. The general message was that the rich wanted great service, uniqueness, quality and that the traditional concept of cost was far less than value. Time is of great value, rather than money. The rich value personal attention and uniqueness. While it is difficult for companies to retain prestige and continue to provide excellent service, the underlying market/demand looks exceptionally strong.

Our own view is that the rich are likely to keep getting even richer, and enjoy an even greater share of the wealth pie over the coming years. We think rising profit margins will keep profit growth strong, and equities are at any rate undervalued. And the rich tend to be disproportionately exposed to the equity markets. While there are challenges to this, not least through populations/the political process demanding a more "equitable" share of the wealth, in the short term we think the trend of the rich getting richer is likely to persist. Plutonomy related stocks should, we think, continue to see strong demand and inflation-beating pricing power.

Changes to the Least Preferred Portfolio

We are removing **Abbot Laboratories** (ABT, 3M, USD48.33) from our least preferred stocks portfolio, as the stock's quantitative ranking has dropped and thus satisfies one of our pre-defined rules for stock deletion from the Least Preferred Stocks Portfolio. A full history of changes to our portfolio is available on request.

Appendix: A diversified basket of Plutonomy stocks

Company	RIC	CIR Rating	Sector	Mcap (U$m)	Price 27Sep06
Beneteau	BEN.PA	NR	Cons Durables/ Apparel	1,526	€65.3
Bulgari	BULG.MI	NR	Cons Durables/ Apparel	3,823	€9.97
Burberry	BRBY.L	1M	Cons Durables/ Apparel	4,244	£4.975
Coach	COH	NR	Cons Durables/ Apparel	12,586	$33.71
Dickson Concepts	0113.HK	NR	Retailing	313	$8.29
Four Seasons Hotels	FSH-SV.TO	NR	Consumer Services	2,111	$69.88
Hermes	RMS.PA	NR	Cons Durables/ Apparel	9,766	€67.5
Julius Baer	BAER.VX	1H	Div Financials	11,122	SwF118.6
Kuoni	KUNN.S	2M	Consumer Services	1,543	SwF655
LVMH	MC.PA	1M	Cons Durables/ Apparel	50,434	€78.95
Mandarin Oriental	MOIL.SI	NR	Consumer Services	1,191	$1.16
Polo Ralph Lauren	RL	NR	Cons Durables/ Apparel	3,983	$64.32
Porsche	PSHG_p.DE	3H	Automobiles	9,081	€777.35
Richemont	CFR.VX	1M	Cons Durables/ Apparel	28,028	SwF60.5
Rodriguez Group	ROD.PA	NR	Cons Durables/ Apparel	583	€39.94
Shangri-La Asia	0069.HK	NR	Consumer Services	5,435	$15.88
Shinwa Art Auction	2437	NR	Consumer Services	180	¥383000
Sothebys	BID	NR	Consumer Services	2,037	$30.11
Tasaki Shinju	7968	NR	Cons Durables/ Apparel	181	¥540
Tiffanys	TIF	NR	Retailing	4,609	$33.5
Tod's	TOD.MI	2M	Cons Durables/ Apparel	2,408	€63.75
Toll Brothers	TOL	1H	Cons Durables/ Apparel	4,370	$28.16
Vontobel	VONN.SW	NR	Div Financials	2,656	SwF49.75
Wolford	WOF.F	NR	Cons Durables/ Apparel	151	€22.7

Source: Worldscope, FactSet, and Citigroup Investment Research

This page intentionally left blank.

U.S.

Tobias M. Levkovich
1-212-816-1623
tobias.levkovich@citigroup.com
New York

Lori Calvasina
New York

Lorraine Schmitt
New York

Daniel Kaskawits
New York

U.S. Equity Strategy

Calibrating 2007 Targets

- **We are introducing year-end 2007 targets of 1,500 and 12,750 for the S&P 500 and Dow Jones Industrial Average (DJIA), respectively.**
- **The new targets have been derived using eight different methodologies, including investor sentiment, valuation, and earnings, and then triangulating to a reasonable outcome.**
- **The various approaches generated results for the S&P 500 that ranged between 1,400 on the low end to 1,630 on the high end, suggesting that the downside risk seems modest, especially given swollen cash positions on many corporate balance sheets.**
- **Our 2006 objectives remain unchanged at 1,400 for the S&P 500 and 11,900 for the DJIA.**

U.S. Valuations — Sector

9/28/2006	Free Mkt Cap US$m	P/E 05E	P/E 06E	P/E 07E	EPS YoY % 05E	EPS YoY % 06E	EPS YoY % 07E	P/B 06E	ROE 06E	Div Yld 06E	EV/ Sales 05	EV/ EBITDA 05	Weekly Perf %	YTD Perf %
United States*	**12,461,920**	**17.9**	**15.8**	**14.3**	**15.8**	**15.6**	**10.8**	**2.7**	**16.8**	**2.0**	**1.9**	**10.1**	**1.6**	**6.8**
Energy	1,123,552	13.1	10.5	9.8	50.2	24.5	7.5	2.6	24.8	1.5	1.3	6.5	3.6	8.9
Materials	345,606	16.5	12.7	12.2	16.8	31.4	3.4	2.6	19.6	2.7	1.4	8.4	2.3	3.6
Capital Goods	1,060,480	19.2	16.8	14.7	17.3	14.4	14.1	3.0	17.9	2.1	2.1	11.9	3.0	6.4
Comm Svc & Supp	91,812	21.3	19.2	17.1	2.0	10.4	12.3	3.3	17.1	1.8	1.6	8.5	2.0	2.2
Transport	173,807	20.6	16.7	14.8	30.3	22.8	13.5	2.6	15.3	1.5	1.8	8.8	4.1	4.8
Autos & Components	62,245	11.4	12.6	15.6	-25.6	NM	54.7	1.8	16.1	2.2	1.0	9.2	4.9	18.1
Consumer Durables	161,810	11.8	12.8	13.3	18.0	-6.0	-3.2	2.2	17.3	1.7	1.0	7.3	3.0	-5.6
Consumer Services	238,524	22.5	20.9	18.5	15.0	7.5	13.0	3.6	15.8	1.3	2.8	11.5	1.0	5.9
Media	468,710	25.2	22.6	19.9	34.5	26.1	27.9	1.8	8.2	0.9	2.6	10.3	2.0	12.4
Retailing	457,252	18.7	17.1	14.9	19.0	11.2	14.5	2.6	15.1	1.1	1.0	8.6	2.2	2.7
Food & Staples Retailing	284,916	21.4	19.4	16.9	11.4	10.6	14.2	3.2	16.7	0.8	0.7	10.5	1.0	7.5
Food Bev & Tobacco	552,560	18.8	17.9	16.5	5.0	5.6	7.7	4.6	24.8	2.8	2.2	11.8	-1.0	9.7
Household Products	271,062	21.9	21.3	18.8	6.3	2.8	13.7	3.6	16.2	2.0	3.5	16.7	1.0	8.6
Health Care Equip & Svc	556,854	20.0	18.8	16.4	15.9	7.6	14.5	3.0	15.8	0.4	1.7	12.7	-1.4	-5.4
Pharma & Biotech	1,008,397	19.1	18.4	16.9	5.2	3.9	9.2	3.9	20.9	2.4	4.0	13.0	0.9	10.3
Banks	739,117	13.3	12.8	11.7	9.6	3.4	9.5	1.9	15.0	3.2	NA	NA	1.0	8.1
Div Financials	1,223,538	15.0	13.0	12.0	8.7	15.5	8.7	2.1	16.1	2.5	NA	NA	1.5	12.7
Insurance	578,673	16.2	11.1	10.6	0.9	63.3	5.3	1.7	15.2	1.4	NA	NA	1.7	2.6
Real Estate	238,882	42.0	35.8	35.2	9.8	16.1	1.2	2.5	6.4	3.4	8.4	18.5	0.8	19.6
Software & Services	746,785	26.8	23.9	20.2	12.1	11.8	19.5	5.1	21.0	0.8	4.0	14.7	1.6	1.6
Tech Hardware & Equip	847,519	22.2	19.3	16.8	23.0	14.6	15.2	3.6	17.6	0.6	1.8	11.3	1.5	6.3
Semi & Semi Equip	366,152	20.9	21.7	18.1	21.4	-4.5	19.4	3.3	15.1	1.2	3.0	8.6	4.2	-7.7
Telecom	434,295	18.6	16.3	15.0	17.4	17.8	8.4	2.1	12.8	3.2	2.9	8.1	-0.3	22.9
Utilities	429,373	17.1	16.0	14.1	16.3	7.2	13.2	1.9	11.7	3.5	2.2	8.8	2.1	8.7

Note: The above data are compiled based on companies in MSCI USA. The market capitalization for sectors and regions are free-float adjusted. P/E, EPS Growth, P/B, Dividend Yield, and ROE are aggregated from IBES consensus estimates (calendarized to December year-end) with current prices. EV/Sales and EV/Ebitda are aggregated from Worldscope data (EV uses current market capitalization, EBITDA and Sales use 2005 or last reported year before 2005) NM = Not Meaningful; NA = Not Available.
Source: Citigroup Investment Research, IBES Consensus, Worldscope, MSCI, and FactSet

Calibrating 2007 Targets

As has become our custom in September, we are establishing our year-end targets for the following year, using various approaches to arrive at the objective. Thus, we are setting a year-end 2007 S&P 500 target of 1,500 and a DJIA target of 12,750. Indeed, we envision another year of high-single-digit gains, closely in sync with projected earnings gains (expected to grow 7.4% next year), as we suspect the various pushes and pulls of peak earnings concerns and inflation (and thereby interest rate) worries of broadly restraining P/E multiple expansion. For details about our Russell 2000 target, we would look to the Small- & Mid-Cap Strategy commentary (see "Introducing our 2007 Small- and Mid-Cap Targets").

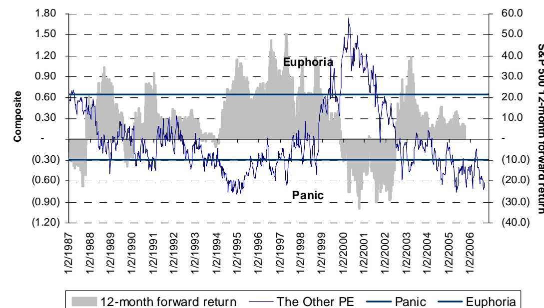
In our opinion, the actual target can be the least important outcome — even though many investors focus on that end result. The process of evaluating various targeting methodologies is far more insightful, and reveals the important risks to the outlook for investors. Accordingly, we will walk through our process, which involved eight primary approaches, ranging from proprietary valuation models to novel earnings expectations concepts and exclusive sentiment indicators. Thus, we consider our methods to be rather unique and backed by probability analysis.

We should also stress that we used the current S&P level of 1,318 (September 19 close) to calculate the appreciation potential rather than our year-end 2006 S&P target of 1,400 in order to have room to lift targets in the future if necessary. As such, we tend to take what we consider a more conservative approach in our analytical process.

The end results range from a low of 1,401 (using the P/E Bull's-Eye approach) to a high of 1,629 (using the Valuation to Bond Yield and Risk Premium Panic/Euphoria Model), but the preponderance of the evidence is coming to the high 1,400s and low 1,500s, which has allowed us to center on the 1,500 level. As a reminder, our Dow Jones objective is derived from the relationship the S&P 500 and the DJIA enjoy over time . Therefore, at roughly 8.50x the S&P 500 target, one gets to 12,750 on the Dow.

In particular, we have noted that our Panic/Euphoria Model, which attempts to capture overall investment community sentiment via activity-based conviction (such as short interest, cash holdings, put/call ratios, margin debt, etc.), rather than just pure survey data, is in "panic" territory (see Figure 1). Note that readings below the panic line have resulted in higher stock prices one year later in 97% of all past such occurrences in the nearly 20-year study (which was conducted using weekly data points). On average, the gains have been 19% over the course of the next year, and the study is generating an outcome of roughly 1,570–1,575 by the fourth quarter of 2007.

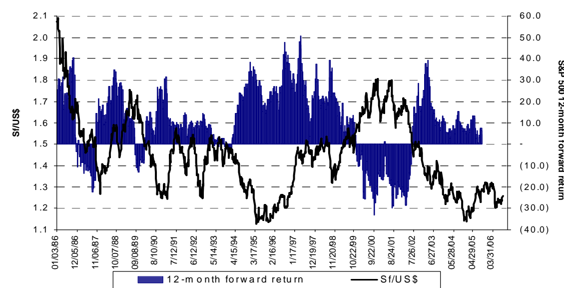
Figure 1. The Panic/Euphoria Model (Other PE)SM



Source: CIR U.S. Equity Strategy

When just looking at the U.S. dollar/Swiss franc indicator (see Figure 2), one can arrive at another sentiment-induced target of 1,525–1,530. We often get questions about this approach: Put simply, when anxiety levels rise, the flight to safety in currency markets often benefits the franc. Thus, one can readily see the inverse relationship between the currency and the equity markets.

Figure 2. Swiss Franc/U.S. Dollar vs. S&P 500 12-month Forward Return

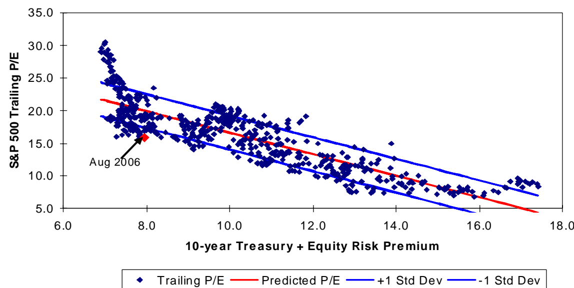


Source: FactSet and CIR U.S. Equity Strategy

We also consider our valuation work based on bond yields and our estimate of equity risk premiums to be quite valid when considering where appropriate P/E ratios should be. In particular, our valuation work along these lines (see Figure 3) provides a powerful R-squared correlation of 0.734 looking at monthly data going back 45 years (dramatically better than the

so-called Fed Model correlations). The analysis shows that the market is trading more than one standard deviation below the trend line, which has happened in more than 85 previous monthly observances — all of which ended with gains for equity markets 12 months later. The average gain was better than 23%, arguing for a target price of 1,630, as the current valuation level is arguably more than 20% below "fair value."

Figure 3. S&P 500 P/E vs. 10-year Treasury & Equity Risk Premium



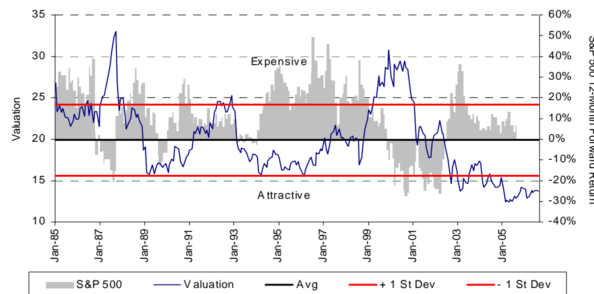
Source: Haver Analytics and CIR U.S. Equity Strategy

On the other valuation extreme, our P/E Bull's-Eye study, which tracks trailing 12-month P/E ratios by month looking back 65 years, suggests that the forward gains may only come to about 7%, yielding 1,400–1,410. However, we must stress that the model does not differentiate between different inflation or interest rate environments. Given the 16.04x P/E multiple currently, the readings are borderline versus the "sweet spot" of 14x-16x, which yields the best 12-month subsequent outcome for appreciation potential.

Additionally, a review of our forward P/E Bull's-Eye study, using a forward P/E of approximately 14.8x (assuming our year-end 2006 target of 1,400 is achieved, and applying Citigroup economists' 2007 EPS estimate of $94.50) yields a target of 1,479. Historically, this forward P/E level has been followed by a higher stock market over the subsequent 12 months 72.6% of the time. From these forward P/E levels, the ensuing 12-month gains have averaged 12.2%.

When we consider the clean balance sheets of the companies in the S&P 500, we find that the stock index price gains could get us closer to 1,490 using the debt-adjusted valuation (seen in Figure 4). This approach attempts to incorporate debt levels into the valuation mix since highly leveraged entities (such as financial stocks) usually sport low P/E multiples, and many companies with no debt (such as technology companies) are accorded much higher P/E ratios. Thus, we try to bridge the EV/EBITDA metric into P/E terms, especially since the notion of using EV/EBITDA is based on thinking like an owner, but minority shareholders have little say on corporate cash uses. Thus, that "ownership" mentality has limitations.

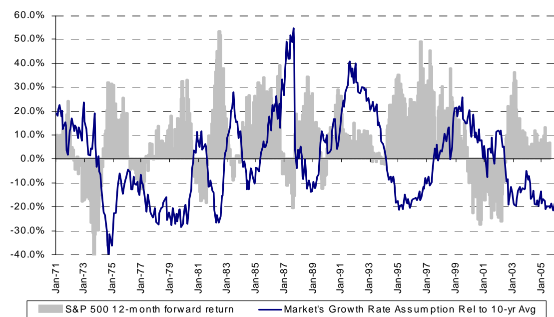
Figure 4. Debt-Adjusted Valuation of the S&P 500



Source: CIR U.S. Equity Strategy

One of our favorite methods currently is the implied earnings growth approach, which we discussed in our September 15 *Monday Morning Musings*. This method tries to capture the full investment community's expectations for long-term earnings growth. As can be seen from Figure 5, when expectations are at steep discounts to average earnings growth (versus the prior 10-year average), stock prices typically rally meaningfully. This approach produces a target price nearing 1,520–1,540, depending on whether we use average or median results.

Figure 5. S&P 500 Implied Long-Term Earnings Growth Expectations



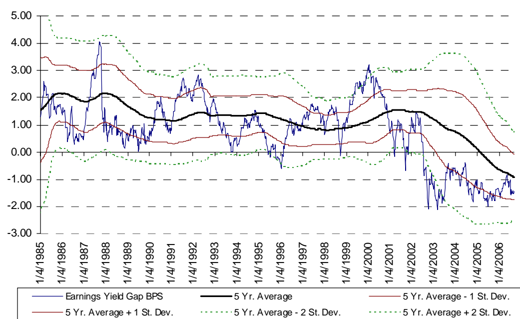
Source: CIR U.S. Equity Strategy

Lastly, if we consider price/book relative to inflation trends, we can arrive at roughly 1,500 as well. Using current book value of about $425 (as of the end of the second quarter) and adding the next six quarters of earnings less dividends, plus some potential one-time charges, we can see book value in the $500 area at

the end of 2007. Using a 3x multiple to book, which would coincide with inflation in the higher 2% area (conservatively set above our economists' forecast), argues for 1,500 on the S&P 500.

Thus, the average of the various approaches comes to 1,516. Moreover, if we drop the high and low and redo the calculations, we still arrive at 1,516. Therefore, we think the 1,500 level makes sense, with some slight upside. To be fair, when we use earnings yield gap analysis (see Figure 6), we find no extreme outcome that would push us in any direction, though the data support more equity market gains.

Figure 6. Earnings Yield Gap Analysis (10-Year Treasury Yield Less Earnings Yield; Trailing 4Q EPS)



Source: Haver Analytics and CIR U.S. Equity Strategy

On the risk front, we would note that the S&P 500 (ex-Financials) cash holdings to market cap does provide some downside protection (see Figure 7) since markets have stabilized in the past at the 9% level (following the stock market crash in 1987 and the tech bubble burst in 2000–02). Thus, with cash in the low-8% area, we believe the downside is limited. Bear in mind that this cash does not include the estimated $1.5 trillion of private equity buying power and the potential for some of the $6.25 trillion in household sector deposits (money market funds, bank accounts, and certificates of deposits expiring within a year) that could be used for equity purchases. Thus, we see an impressive cash cushion for the markets.

Figure 7. S&P 500 Cash as % of Market Cap ex-Financials

Source: FactSet and CIR U.S. Equity Strategy

Other risks range from energy supply disruptions, geopolitical shocks, economic nationalism/ protectionism, and unanticipated inflation, to sharp dollar weakness. On the other hand, we have not built in any benefit from the Presidential cycle, which would argue that the S&P should trade up to 1,470–1,475 by the end of next year, given that markets typically do well in the third year of the presidency.

We do think that some dislocation may occur in the first half of 2007 as earnings growth slows meaningfully and scares off some investors. Plus, if our S&P 500 target for year-end 2006 proves accurate, that would imply a late- year rally that could spike up sentiment near term, and leave markets vulnerable to profit-taking in early 2007. Moreover, excessive strength by consumers could lead some to believe the Fed will need to hike rates again next year. While we believe that an industrial economic slowdown may force the Fed to ultimately go to a "definitive hold," there may be some volatility in markets as this view works itself out. Nonetheless, the outlook over the next 12–15 months looks quite rewarding for equities, even as the investment community continues to scale its "cliffs of concern."

U.S. Sector and Stock Selection

	Statistical Overview							Analyst Ratings, Targets & Estimates							Attributes	
	Date Added	Price Added	Price 9/26/2006	Perf. Since Added	Mkt Cap (mil)	2006 Perf. YTD	Fiscal Year End	Rating	Price Target	EPS Estimates Next	EPS Estimates Cur.	P/E Next	P/E Cur.	5-Year Beta	Div. Yield
CONSUMER DISCRETIONARY															
Marriott International (MAR)	11/6/2003	$21.54	$38.68	79.61 %	$15,636	15.51%	Dec	1M	$45.00	$1.87	$1.56	20.7	24.8	1.06	0.6%
Federated Dept. Stores (FD)	7/22/2005	$37.88	$41.65	9.97 %	$22,639	25.58%	Jan	1M	$48.00	$3.21	$2.44	13.0	17.1	1.35	1.2%
Omnicom (OMC)	6/24/2005	$78.55	$92.83	18.18 %	$15,948	9.04%	Dec	1M	$104.00	$5.38	$4.90	17.3	18.9	1.13	1.1%
McDonald's (MCD)	6/23/2006	$32.60	$39.06	19.82 %	$47,899	15.84%	Dec	1L	$42.00	$2.45	$2.34	15.9	16.7	0.82	1.7%
News Corp. (NWS.A)	7/14/2006	$18.71	$19.75	5.56 %	$62,325	27.01%	Jun	1M	$22.00	$1.19	$1.07	16.6	18.5	1.29	0.6%
Harrah's (HET)	1/4/2006	$71.72	$64.65	-9.86 %	$11,968	-9.31%	Dec	1M	$80.00	$4.05	$3.58	16.0	18.1	0.82	**2.5%**
CONSUMER STAPLES															
Avon Products (AVP)	4/13/2006	$31.08	$30.60	-1.54 %	$13,699	7.18%	Dec	1M	$36.00	$1.62	$1.08	18.9	28.3	0.46	**2.3%**
Conagra (CAG)	1/4/2006	$20.59	$24.27	17.87 %	$12,399	19.67%	May	1M	$27.00	$1.53	$1.30	15.9	18.7	0.49	**3.0%**
ENERGY															
Occidental Petroleum (OXY)	4/13/2006	$48.16	$46.65	-3.13 %	$39,435	16.80%	Dec	1M	$60.00	$5.89	$5.77	7.9	8.1	0.81	**1.9%**
Halliburton (HAL)	5/6/2003	$11.08	$28.42	156.50 %	$29,244	-8.26%	Dec	1H	$57.00	$2.50	$2.00	11.4	14.2	0.94	1.1%
FINANCIALS															
Charles Schwab Corp. (SCHW)	4/1/2005	$10.45	$17.67	69.09 %	$22,538	20.45%	Dec	1M	$22.00	$0.90	$0.78	19.6	22.7	1.83	0.7%
Fifth Third Bancorp (FITB)	7/19/2006	$37.69	$39.37	4.46 %	$21,964	4.37%	Dec	1L	$43.00	$2.85	$2.70	13.8	14.6	0.79	**4.1%**
MetLife (MET)	1/4/2006	$50.83	$57.08	12.30 %	$43,334	16.49%	Dec	1M	$65.00	$5.25	$5.00	10.9	11.4	0.97	0.9%
Merrill Lynch (MER)	4/22/2005	$53.18	$79.03	48.61 %	$70,715	16.68%	Dec	1M	$95.00	$6.80	$5.05	11.6	15.6	1.43	1.3%
HEALTH CARE															
Sepracor (SEPR)	1/4/2006	$50.11	$46.69	-6.82 %	$4,899	-9.52%	Dec	1H	$66.00	$2.17	$1.13	21.5	41.3	1.49	0.0%
Amgen (AMGN)	1/10/2005	$62.97	$70.75	12.36 %	$82,778	-10.28%	Dec	1M	$100.00	$4.25	$3.82	16.6	18.5	0.79	0.0%
Wyeth (WYE)	1/28/2004	$41.05	$50.67	23.43 %	$68,152	9.98%	Dec	1M	$59.00	$3.38	$3.15	15.0	16.1	1.08	**2.0%**
Johnson & Johnson (JNJ)	11/22/2004	$60.54	$64.67	6.82 %	$189,741	7.60%	Dec	1L	$73.00	$4.00	$3.67	16.2	17.6	0.59	**2.3%**
INDUSTRIALS															
United Technologies (UTX)	2/27/2006	$58.76	$63.61	8.25 %	$64,337	13.77%	Dec	1M	$72.00	$4.05	$3.65	15.7	17.4	0.93	1.7%
Honeywell International (HON)	2/27/2006	$41.57	$40.45	-2.69 %	$33,126	8.59%	Dec	1M	$52.00	$2.95	$2.52	13.7	16.1	1.37	**2.2%**
INFORMATION TECHNOLOGY															
Fiserv (FISV)	1/4/2006	$44.30	$47.97	8.28 %	$8,380	10.86%	Dec	1M	$53.00	$2.91	$2.55	16.5	18.8	1.28	0.0%
Apple (AAPL)	6/23/2006	$58.83	$77.61	31.92 %	$66,200	7.96%	Sept	1H	$80.00	$2.77	$2.17	28.0	35.8	1.26	0.0%
Cisco (CSCO)	2/21/2005	$17.30	$23.50	35.84 %	$142,387	37.27%	July	1H	$26.00	$1.40	$1.26	16.8	18.7	1.50	0.0%
IBM (IBM)	10/17/2005	$82.59	$82.50	-0.11 %	$125,552	0.36%	Dec	1M	$91.00	$6.35	$5.87	13.0	14.1	1.21	1.5%
TELECOM SERVICES															
Alltel* (AT)	6/23/2006	$50.72	$57.15	12.68 %	$22,264	10.64%	Dec	1M	$63.00	$3.37	$2.68	17.0	21.3	0.84	0.9%
UTILITIES															
Exelon (EXC)	9/9/2005	$55.66	$60.85	9.32 %	$40,739	14.51%	Dec	1M	$65.00	$4.85	$3.30	12.5	18.4	0.45	**2.6%**

Overweight	Neutral	Underweight
Consumer Discretionary	Energy	Consumer Staples
Healthcare		Financials
Information Technology		Industrials
Telecom Services		Materials
		Utilities

*Alltel 6/23/2006 price added has been adjusted to reflect the spinoff of its wireline business

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: Citigroup Investment Research U.S. Equity Strategy, S&P Global Indices, and FactSet

This page intentionally left blank.

EUROPE

Darren Brooks
44-20-7986-3944
darren.brooks@citigroup.com
London

Robert Buckland
44-20-7986-3947
robert.buckland@citigroup.com
London

Jonathan Stubbs
44-20-7986-4218
jonathan.stubbs@citigroup.com
London

Hasan Tevfik
44-20-7986 4110
hasan.tevfik@citigroup.com
London

Pan European Strategy

Avoiding the Mega-traps

➤ Valuation divergence

Mid-caps have outperformed a rising and falling market since 2000. They now trade at a 21% premium to large-caps, despite weaker fundamentals.

➤ Mega-drag

The mega-caps have lagged most. They now trade on a P/E of just 11.7x 12-month forward earnings. We estimate that there is €550bn of unrealised value in the mega-caps but struggle to see how this value will be unlocked.

➤ Mega-caps Underweight M&A

Due to political constraints and sheer size, mega-caps remain the least likely M&A candidates. An Overweight in mega-caps is an Underweight in M&A. That does not seem like a sensible trade right now.

➤ **Buy large ex-mega-caps**

We now prefer the large ex mega-cap size band. These €10-€40bn market cap stocks are cheaper than mid-caps but more likely to see value realisation than mega-caps.

Europe Valuations – Sector

9/28/2006	Free Mkt Cap US$m	P/E 05E	P/E 06E	P/E 07E	EPS YoY % 05E	EPS YoY % 06E	EPS YoY % 07E	P/B 06E	ROE 06E	Div Yld 06E	EV/ Sales 05	EV/ EBITDA 05	Weekly Perf %	YTD Perf %
Europe*	**7,979,230**	**15.0**	**13.4**	**12.4**	**17.0**	**12.3**	**8.0**	**2.3**	**16.8**	**3.1**	**1.5**	**8.2**	**0.5**	**17.5**
Energy	816,877	10.6	9.5	9.6	39.1	11.7	-0.4	2.5	25.9	3.5	1.0	4.9	1.4	7.9
Materials	560,809	14.8	11.2	10.6	40.4	31.0	3.5	2.0	18.5	2.7	1.7	8.3	1.0	22.8
Capital Goods	506,785	18.8	15.4	13.6	34.7	24.3	13.6	2.6	16.5	2.5	1.2	10.2	0.4	18.5
Comm Svc & Supp	66,047	20.4	17.7	15.1	13.0	13.6	16.9	3.8	19.7	2.3	1.0	11.4	0.5	20.1
Transport	108,063	14.9	15.4	13.6	14.5	-3.1	13.3	2.5	16.4	2.6	1.4	10.3	0.9	23.2
Autos & Components	149,014	12.6	12.8	10.3	28.3	-1.4	23.8	1.3	10.0	2.8	0.8	6.8	0.4	21.7
Consumer Durables	179,484	19.1	16.7	14.3	-17.6	12.8	16.5	2.2	13.5	2.0	1.7	10.8	0.9	13.0
Consumer Services	104,143	17.8	18.6	15.8	-2.7	-4.1	16.6	2.6	12.2	2.9	1.6	12.4	-0.2	12.5
Media	212,476	17.4	16.2	14.6	21.8	8.1	10.6	2.5	15.1	3.1	2.1	10.3	0.5	11.3
Retailing	129,013	20.1	18.7	16.4	8.5	10.6	14.4	3.4	16.5	3.0	1.2	11.7	0.9	26.0
Food & Staples Retailing	157,290	19.1	17.7	15.8	-3.8	8.4	11.5	2.5	14.4	2.3	0.6	10.0	-1.0	28.1
Food Bev & Tobacco	516,866	19.4	17.1	15.5	-0.3	12.5	10.2	3.6	20.7	2.7	2.3	13.0	-0.4	18.1
Household Products	66,910	26.0	23.1	20.6	6.6	12.4	12.4	4.3	18.5	1.6	2.7	16.0	0.6	32.2
Health Care Equip & Svc	63,422	25.7	24.0	20.4	17.9	7.0	17.9	4.2	17.4	1.1	2.2	15.9	1.5	17.4
Pharma & Biotech	652,582	20.3	17.5	16.1	19.1	16.2	9.1	4.2	19.7	2.2	4.4	13.6	0.1	13.8
Banks	1,373,812	13.0	11.6	10.6	14.2	11.6	9.3	2.0	17.4	4.0	NA	NA	-0.4	19.9
Div Financials	490,451	13.4	11.9	11.4	26.5	13.1	4.2	2.2	18.7	3.1	NA	NA	-0.1	25.7
Insurance	464,162	12.6	11.2	10.5	11.6	13.6	6.5	1.7	14.9	3.0	NA	NA	0.8	15.8
Real Estate	103,277	23.2	27.7	25.0	12.4	-16.3	10.8	1.1	4.1	2.6	13.0	8.1	1.8	36.4
Software & Services	81,094	26.3	22.7	19.3	19.7	20.0	19.5	3.7	16.1	1.3	2.2	14.7	0.3	5.5
Tech Hardware & Equip	170,795	18.2	16.1	14.4	20.1	13.1	11.6	3.5	22.1	2.3	1.8	9.8	1.6	5.1
Semi & Semi Equip	37,790	35.6	28.3	19.8	-5.0	149.9	9.4	2.0	7.1	0.3	1.8	8.3	0.1	11.9
Telecom	480,926	12.4	12.5	11.9	4.1	-0.8	5.0	1.6	11.8	5.1	2.3	6.2	1.0	8.5
Utilities	487,142	17.8	16.2	14.6	4.4	9.6	11.3	2.5	15.4	3.8	1.8	7.6	2.3	32.7

Note: The above data are compiled based on companies in MSCI Developed Europe (which includes Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, and United Kingdom). The market capitalization for sectors and regions are free-float adjusted. P/E, EPS Growth, P/B, Dividend Yield, and ROE are aggregated from IBES consensus estimates (calendarized to December year-end) with current prices. EV/Sales and EV/Ebitda are aggregated from Worldscope data (EV uses current market capitalization, EBITDA and Sales use 2005 or last reported year before 2005) NM = Not Meaningful; NA = Not Available.
Source: Citigroup Investment Research, IBES Consensus, Worldscope, MSCI, and FactSet

Avoiding the Mega-traps

Mid-caps outperform

Size has been one of the key themes in the European equity markets. 2006 looks like being the 7th consecutive year where mid-caps outperform large-caps. This means that mid-caps now trade on a 21% premium to large-caps. They traded on a similar discount in 2000. This is one area of the market where the valuation convergence trade hasn't worked.

Mid-cap outperformance does not seem to reflect recent trends in corporate fundamentals. We find that large-caps have a better and less volatile return on equity. They now have less geared balance sheets. They also have stronger earnings momentum. In fact the relationship between relative profitability and relative share prices is particularly difficult to identify at the size level. Deratings and reratings seem to be much more important.

Neither does the divergence in mid- and large-cap share price performance seem to reflect different sector weightings. We neutralise for sectors and find that mid-caps still outperform.

Fund flows are key

We suggest that fund flows have been most important in driving relative size performance. Big stocks need big portfolio inflows to rerate. Inflows were big in the late 1990s and large-caps outperformed accordingly. They have underperformed as those inflows reversed.

Instead, flows now favour the mid-caps. Hedge funds are long mid-caps/short large-caps. Private equity and M&A activity have also favoured the mid-caps. 4% of the DJ Stoxx Mid-Cap index has been acquired in 2006, twice the level of the DJ Stoxx Large-Cap index. Rising shareholder activism favours mid-caps — it costs less to buy a meaningful stake in a smaller company.

We do not expect the flow dynamics to change much over the next 12-18 months. Therefore, unlike many investors (and strategists) we are not yet tempted to call the turn in the large/mid-cap trade. Traditional investors remain wary of equities. Flows into hedge funds and private equity remain strong. Low corporate bond yields mean that the de-equitisation trade remains attractive for mid-caps. Mid-caps would need to re-rate another 28% to stop this trade making sense.

Factors that could meaningfully reverse the relative underperformance of large-caps include: a return to big equity portfolio inflows, a big corporate bond sell-off (which would close off the de-equitisation trade) or an end-cycle collapse in corporate profits. None of these seem particularly likely to us. Perhaps the greatest potential for performance would be an unwinding of the hedge fund size trade. That might be painful, but should not last too long.

Mega-lag

Increasingly, the underperformance of the large-cap indices can be explained by the derating of mega-cap stocks. Despite healthy operational performance, an index of Europe's largest 50 stocks trades on a P/E of just 11.7x, way below the mid-cap multiple of 14.7x. Consequently, most mega-caps now trade on a discount to their sum of parts.

Mega-cap absolute performance seems healthy enough. They have returned 67% since the start of 2003. That puts many other much more fashionable asset classes to shame and hardly seems just cause to pressurise CEOs. But this has not comforted equity investors. All they can see is the opportunity cost of not owning the rest of the market — for example the UK FTSE 250 Mid-Cap index has returned 149% since 2003.

In 2006, outperforming the market has been about not owning mega-caps. They have not seen their fair share of M&A activity. They account for 50% of total market cap but have enjoyed only one bid (Aventis) in the past five years. Of course, bid activity is moving up the size scale but it still remains some way from our mega-cap cut-off. An Overweight in mega-caps amounts to an Underweight in M&A. That does not seem like a sensible trade right now.

Our continued caution on mega-caps is not a criticism of the specific companies. We can see plenty of fundamental evidence to justify their existence. But it is an observation on the market's inability to crystallise an estimated €550bn of unrealised value in the mega-caps. That value will come out in the end but, in the absence of significant portfolio flows back into the equity market, it may be up to management to provide the catalyst – restructuring, capital returns or demergers. This does not come easily to most CEOs — they want to run a bigger not smaller company. As a result we worry that mega-caps could be the relative value traps of this market cycle.

A size strategy

So what should investors do? It is very tempting to make a contrarian call. Switch expensive mid-caps into cheaper large- and particularly mega-caps. But we would resist. In particular, we are not comfortable being Underweight M&A.

Instead, we would shift capital out of the mid-caps into the "large ex mega-cap" part of the market. For the DJ Stoxx, these are the 150 large-cap stocks below the 50 mega-caps. They have market caps of €10bn-€40bn. That's somewhere between RWE and Wm Morrison. They are small enough to be taken over — bid activity now matches that in the mid-cap. And they trade on lower multiples and have better fundamentals than the mid-caps. This is our favourite part of the market right now. The equivalents for the UK are the 85 stocks that rank towards the bottom of the FTSE 100 (£26bn BG down to £3bn C&W).

Strategy outlook

We suspect that UK and European mega-caps will continue to find it difficult to outperform given weak capital flows towards equities. Consequently, we think that it is right for investors to be wary of this size group despite the obvious attraction of cheap valuation. This is our key investment conclusion from this report. Mega-caps tend to be national champions and are unlikely to participate in the most explosive investment theme of the moment — M&A/LBO activity.

We would prefer large ex mega-caps, which have more exposure to this theme and are also cheap. We would prefer this group to the hot mid-caps, which have outperformed for six years and look expensive in relative terms. We do not think this group will underperform, but will face increasing performance competition from the large ex mega-cap index.

At the stock level, our mega-cap strategy is simple. We would Underweight those stocks that are national champions and without best-in-class status or the prospect of aggressive self-help, ie strategic change. We would prefer those few mega-cap stocks that could possibly be taken out, despite their size. These are not national champions. We would also Overweight those that have started, or are likely to start, aggressive strategic change programmes. Last, we would be Neutral those mega-caps that do not have the attraction of strategic change or being taken over, but are best-in-class stocks.

Elsewhere, we look to large ex mega- (and mid-) caps that possess one of, or a combination of, the attributes that we deem necessary to outperform. These are exposure to predatory salvation (M&A/LBO activity), valuation discount to sum-of-the-parts/sector, strategic change, operational excellence and focus on shareholder value. Ideally, companies will have exposure to more than one of these attributes. We have also learnt over the past couple of years that being cheap is an insufficient pre-requisite to future outperformance.

Our closing message is a simple one. We think that M&A and other aspects of de-equitisation will continue to be leading investment themes within European equity markets. Investors who are long mega-caps are, by definition, short M&A. We do not think that this is a sensible strategy right now.

Europe Sector and Stock Selection

Company	RIC	Mkt	Date Added	Price Added	Price 28Sep06	Perf Since Added (%)	Perf YTD (%)	Rating	Price Target	EPSG (%)	P/E	P/B	ROE (%)	Div Yld (%)
Con & Mat (O/W, DJ STOXX Weight: 2.6%)														
Vinci	SGEF.PA	Fr	6 Apr 06	78.35	88.30	12.7	23.8	1L	90.00	8.0	18.0	3.9	21.5	2.6
Saint Gobain	SGOB.PA	Fr	9 May 06	59.60	57.05	-4.3	13.5	1M	68.00	32.8	11.6	1.5	12.7	2.8
Insurance (O/W, DJ STOXX Weight: 7.2%)														
Axa SA	axaf.pa	Fr	8 Sep 05	22.30	29.41	31.9	10.0	1M	32.50	16.5	14.7	1.5	10.2	3.7
Allianz	alvg.de	Bd	23 Feb 06	134.49	137.55	2.3	7.5	1M	155.00	27.9	9.7	1.3	13.5	2.2
Technology (O/W, DJ STOXX Weight: 3.3%)														
Alcatel	cgep.pa	Fr	1 Jan 06	10.47	9.59	-8.4	-8.4	1H	14.00	8.5	17.0	1.6	9.3	1.9
Sage Group	SGE.L	UK	6 Jul 06	2.33	2.53	8.4	-2.1	1M	3.25	11.6	20.3	3.3	16.2	1.4
Basic Resource (O/W, DJ STOXX Weight: 3.4%)														
BHP Billiton	BLT.I	UK	6 Apr 06	11.47	9.21	-19.7	-3.0	1M	15.40	58.4	10.2	4.3	41.9	2.1
Lonmin	LMI.L	UK	6 Apr 06	28.02	25.88	-7.6	60.4	1M	35.00	127.7	18.6	8.0	42.8	1.9

Overweight	Neutral	Underweight
Basic Resources	Autos	Food & Beverage
Construction & Materials	Banks	Health Care
Insurance	Chemicals	Media
Technology	Financial Services	Personal & Household Goods
	Industrial Goods & Services	Retail
	Oil & Gas	Telecommunications
	Utilities	Travel & Leisure

Source: Citigroup Investment Research

JAPAN

Patrick Mohr*, CFA
81-3-5574-5091
patrick.mohr@nikkocitigroup.com
Japan

Tsutomu "Tom" Fujita, CFA
81-3-5574-4889
tsutomu.fujita @citigroup.com
Japan

*U.S. investors please call
Stephen Johnson
+81-3-5574-4252

Japan Equity Strategy

Birth of the Abe Administration

- Shinzo Abe emerged from an extraordinary session of both houses of the Diet on September 26 as Japan's new prime minister, and a new administration took its first steps.
- As we noted in our September 27 memo, Full impact of Abe cabinet's economic policies to be felt in share prices after July 2007 Upper House election, we expect the main themes of the administration to include Mr. Abe's growth strategy based on openness and innovation, as well as smaller government through the sale of state-owned assets
- Foreign investors tend to respond positively to political events in Japan therefore a short term rally on political news flow would not be surprising. Our view is that we are optimistic about the Abe administration but we are also careful not to exaggerate our expectations. The LDP is likely to face stiff competition in the July 2007 Upper House election. The Abe administration's ability to push forward radical reforms depends on victory in that election.
- Accordingly, we think the real impact of the Abe administration's economic policies in terms of equity investment strategy remains to be seen. For now, we expect the Abe administration to focus on issues such as Sino–Japanese and Korean-Japanese relations rather than economic policies that could have a direct impact on the equity market. Visibly improved relations with China and South Korea would strengthen the administration's position going in to the July 2007 election while fitting in neatly with Mr. Abe's long term plan of opening Japan to benefit from Asian growth.

Japan Valuations - Sector

9/28/2006	Free Mkt Cap US$m	P/E 05E	P/E 06E	P/E 07E	EPS YoY % 05E	EPS YoY % 06E	EPS YoY % 07E	P/B 06E	ROE 06E	Div Yld 06E	EV/ Sales 05	EV/ EBITDA 05	Weekly Perf %	YTD Perf %
Japan*	**2,741,553**	**20.5**	**18.7**	**17.1**	**41.8**	**14.5**	**10.5**	**1.9**	**10.0**	**1.1**	**1.2**	**9.0**	**0.4**	**-0.2**
Energy	26,454	9.1	10.4	12.6	84.7	-12.1	-13.3	1.3	12.5	1.9	0.4	5.7	4.3	-7.8
Materials	245,844	16.5	14.4	13.8	54.9	13.1	4.4	1.9	12.8	1.3	1.2	7.8	0.1	0.8
Capital Goods	307,152	19.5	16.0	14.6	167.1	35.7	9.2	1.7	10.6	1.2	1.1	11.2	0.7	-4.7
Comm Svc & Supp	31,607	26.2	23.7	20.6	-1.1	10.5	15.2	1.5	6.5	1.3	0.9	7.0	0.7	-10.7
Transport	113,787	21.0	19.4	17.9	22.5	12.4	6.6	2.0	10.4	1.1	1.6	9.9	-1.9	-3.0
Autos & Components	299,327	14.8	14.6	13.4	17.0	1.8	8.7	1.7	11.8	1.5	1.2	8.4	-0.1	5.8
Consumer Durables	194,503	29.8	24.6	19.9	29.3	97.4	40.7	1.6	6.0	0.9	0.7	7.2	-0.5	6.7
Consumer Services	6,373	33.7	30.4	27.5	7.1	10.7	10.8	1.9	6.3	1.2	1.9	10.5	-2.1	7.7
Media	12,403	33.3	27.7	25.6	11.1	20.4	8.0	1.5	5.7	0.9	2.1	11.4	-0.7	-12.5
Retailing	47,948	26.0	23.0	20.5	50.1	13.1	12.0	2.3	9.8	0.8	0.9	11.8	1.4	-22.8
Food & Staples Retailing	48,730	35.7	25.0	20.9	-23.4	46.9	19.4	2.1	8.3	1.1	0.7	11.3	-0.3	-18.4
Food Bev & Tobacco	67,228	27.5	24.8	22.7	30.8	10.7	9.2	1.8	7.4	1.0	0.8	9.1	0.5	16.1
Household Products	24,501	31.7	27.0	24.5	9.1	17.5	10.3	2.8	10.3	1.4	1.7	11.6	0.0	1.6
Health Care Equip & Svc	20,801	33.9	26.8	23.1	32.0	26.4	16.1	2.8	10.0	0.7	1.7	12.4	-0.8	21.7
Pharma & Biotech	130,748	23.5	22.9	20.6	15.1	9.5	11.2	2.3	9.9	1.6	2.6	9.5	-2.1	14.4
Banks	340,633	17.9	15.7	14.7	88.8	13.9	7.1	2.0	12.8	0.5	NA	NA	2.0	-5.5
Div Financials	119,273	16.0	15.8	15.5	55.0	1.6	6.2	1.7	10.5	1.7	NA	NA	1.9	-15.5
Insurance	68,470	54.4	52.6	49.5	10.8	3.3	6.3	1.3	3.9	0.5	NA	NA	-0.1	2.4
Real Estate	82,248	57.6	38.8	32.2	59.8	31.1	20.7	3.0	7.6	0.8	3.8	25.8	1.3	9.1
Software & Services	54,416	30.9	33.3	29.1	25.0	-2.7	13.2	3.1	9.8	1.1	2.3	11.4	5.3	-17.4
Tech Hardware & Equip	252,749	28.2	25.4	20.9	13.6	25.2	21.3	2.0	7.9	1.0	0.9	8.1	0.1	7.0
Semi & Semi Equip	44,044	33.8	23.3	20.7	19.1	44.2	20.8	2.6	11.4	0.6	2.3	11.4	-0.2	4.1
Telecom	84,417	16.9	18.2	18.1	3.9	-7.4	0.8	1.8	10.1	1.4	1.5	6.4	2.6	1.8
Utilities	117,895	17.8	18.3	16.7	24.4	-2.6	10.0	1.5	8.1	1.9	2.3	8.3	-0.6	13.3

* Note: The above data are compiled based on companies in MSCI Japan. The market capitalization for sectors and regions are free-float adjusted. P/E, EPS Growth, P/B, Dividend Yield, and ROE are aggregated from IBES consensus estimates (calendarized to December year-end) with current prices. EV/Sales and EV/Ebitda are aggregated from Worldscope data (EV uses current market capitalization, EBITDA and Sales use 2005 or last reported year before 2005) NM = Not Meaningful; NA = Not Available.

Source: Citigroup Investment Research, IBES Consensus, Worldscope, MSCI, and FactSet

Birth of the Abe Administration

Shinzo Abe emerged from an extraordinary session of both houses of the Diet on September 26 as Japan's new prime minister, and a new administration took its first steps.

The new cabinet lineup is shown in Figure 1.

FIGURE 1. MEMBERS OF THE ABE CABINET

Assignment	Name	Factions
Prime Minister	Shinzo Abe	Mori
Chief Cabinet Secretary,Abduction issue	Yasuhisa Shiozaki	Niwa and Koga
Minister of Internal Affairs and Communications, Minister of State for Privatization of the Postal Services	Yoshihide Suga	Niwa and Koga
Minister of Justice	Jinen Nagase	Mori
Minister of Foreign Affairs	Taro Aso	Kono
Minister of Finance	Kouji Omi	Mori
Minister of Education, Culture, Sports,Science and Technology	Bunmei Ibuki	Ibuki
Minister of Health, Labor and Welfare	Hakuo Yanagisawa	Niwa and Koga
Minister of Agriculture, Foresty and Fisheries	Toshikatsu Matsuoka	Ibuki
Minister of Economy, Trade and Industry	Akira Amari	Yamazaki
Minister of Land, Infrastructure and Transport	Fuyushiba Tetsuzo	Komeito
Minister of State for Defense	Fumio Kyuma	Tsushima
Minister of the Environment, Minister in Charge of Global Environmental Problems	Masatoshi Wakabayashi	Mori
Minister of State for Okinawa and Northern Territories Affairs, Science and Technology Policy, Innovation,Gender Equality, Social Affairs and Food Safety	Sanae Takaichi	Mori
Chairman of the National Public Safety Commission	Kensei Mizote	Niwa and Koga
Minister of State for Economic and Fiscal Policy and Financial Services	Hiroko Ota	Private sector
Minister of State for Financial Services/(Society) with Second Chances	Yuji Yamamoto	Komura
Minister of State Administrative Reform, Regulatory Reform, Special Zones for Structural Reform, Regional Revitalization and Regional System	Genichiro Sata	Tsushima

Source: LDP, Nikko Citigroup Limited.

Some background information for the economic ministers is provided in Figure 2.

Figure 2. BACKGROUND INFORMATION ON ECONOMIC MISTERS

Assignment	Name	Faction	No. of terms	Age	Main background
Minister of Finance	Kouji Omi	Mori	8	73	Minister of State for Okinawa and Northern Territories Affairs/Science and Technology Policy, Chief of the Economic Planning Agency, Acting Secretary-General, LDP
Minister of Economy, Trade and Industry	Akira Amari	Yamazaki	8	57	Chairman of the Lower House Budget Committee, Minister for Labor
Minister of State for Economic and Fiscal Policy and Financial Services	Hiroko Ota	NA	Public sector	Born in 1954	Cabinet Office, Director-General for Policy Planning (economic and financial analysis), Professor, National Graduate Institute for Policy Studies
Minister of State for Financial Services	Yuji Yamamoto	Koumura	6	54	Vice Minister, Ministry of Finance

Source: LDP, Nikko Citigroup Limited.

Shiozaki set to play key role in implementing the economic policies of the Abe administration

While taking on the position of chief cabinet secretary, we think Yasuhisa Shiozaki will probably also act as the driving force behind the Abe administration's economic policy. Mr. Shiozaki was formerly with the BoJ and has a strong reputation as an economic expert. He looks like a good complement for Abe, who is not an economist himself.

Background information on Mr. Shiozaki is provided in Figure3.

FIGURE 3. BACKGROUND INFORMATION ON YASUHISA SHIOZAKI

Education	3/75	Graduated from University of Tokyo, American Studies, Department of Liberal Arts, College of Arts and Sciences.
	6/82	Graduated from J.F. Kennedy School of Government, Harvard University, Master of Public Administration.
Career	4/75	Bank of Japan
	7/93	Member of the House of Representatives (Ehime 1st District)
	7/95	Member of the House of Councilors (Ehime District)
	9/97	Parliamentary Vice-Minister of Finance
	6/00	Member of the House of Representatives (Ehime 1st District)
	11/03	Member of the House of Representatives (Ehime 1st District)
	10/04	Chairman, Standing Committee on Judicial Affairs, House of Representatives
	9/05	Member of the House of Representatives (Ehime 1st District)
	11/05	Senior Vice-Minister for Foreign Affairs

Source: Website of Yasuhisa Shiozaki.

The role of chief cabinet secretary has become increasingly central since the reorganization of ministries and agencies in 2001, when the functions of the cabinet secretariat were broadened significantly. With the creation of the Cabinet Office by integrating the General Administrative Agency of the Cabinet with the Economic Planning Agency, the secretary also acts as an aide to the Prime Minister. In the third Koizumi cabinet, there were six cabinet-level ministers of state with special briefs (Economic and Fiscal Policy and Financial Services; Science and Technology Policy, Food Safety, and Information Technology; Disaster Management and National Emergency Legislation; Okinawa and Northern Territories

Affairs; Gender Equality and Social Affairs; and Administrative Reform, Regulatory Reform, Special Zones for Structural Reform, and Regional Revitalization), and these ministers were under the authority of the chief cabinet secretary. Such changes expanded the authority of the position, in effect making it something similar to a deputy prime minister.

Shiozaki's association with Abe dates back to 1982, when the first Nakasone cabinet included Shiozaki's father, Jun Shiozaki, as the director General of the Economic Planning Agency and Abe's father, Shintaro Abe, as minister of foreign affairs. At that time, both sons left their positions (Shiozaki at the Bank of Japan and Abe at Kobe Steel) to take up posts as their fathers' secretaries. Abe has publicly described Shiozaki as a close friend, and the ties between the two are strong.

Shiozaki's political philosophy is very close to Abe's. He is a conservative who emphasizes globalism and stimulating the private sector by reducing the role of government. However, he is an expert in economics, which makes him a good complement for Abe—who is not an economist himself. Other heavy hitters playing roles in economic policy include new Finance Minister Koji Omi and METI Minister Akira Amari.

There has been some criticism to the effect that the Abe administration has no clear economic policy and that Abe himself does not understand economics, but we expect it is Shiozaki who will emerge as the guiding light of economic policy in the Abe administration.

Prime minister's job is to make the best use of economic experts

In the past, economic strength has not necessarily been the result of any spectacular policies advanced by the prime minister. For instance, both Takeo Fukuda and Kiichi Miyazawa had served in the Ministry of Finance and were acknowledged mavens of finance. Both had played key roles as economic ministers prior to reaching the top spot, yet one would be hard-pressed to come up with examples of significant economic policy from either of their administrations as prime minister.

On the other hand, economic conditions were brisk and share prices rose substantially during the tenures of Eisaku Sato, Yasuhiro Nakasone, and Junichiro Koizumi—none of whom is generally described as an economic expert. However, prime ministers like Junichiro Koizumi do not have to be economists; it is their job to make use of experts such as Heizo Takenaka.

Mr. Sato was renowned for his skill in delegating authority, using his outstanding political acuity to get the most out of the promising public servants in his administration. These included such future prime ministers as Kakuei Tanaka, Takeo Fukuda, Masayoshi Ohira, and Kiichi Miyazawa. During the seven years and eight months of the Sato administration, the greatest financial crisis was the 1965 recession, when the now-defunct Yamaichi Securities and other major financial institutions came to the verge of collapse. However, Mr. Tanaka and Mr. Fukuda implemented bold strategies that included the first issue of Japanese government bonds since the war and emergency financing by the BoJ, and a recovery was achieved.

The major success of the Naksone administration's economic policies was the implementation of recommendations in the so-called Maekawa Report. Mr. Nakasone set up the Economic Structure Research Panel, headed by former Bank of Japan Governor Haruo Maekawa, in October 1985, and the panel produced its report in April 1986. The administration was also successful in establishing former Keidanren chairman Toshio Doko as a spearhead for administrative reforms.

Share price impact of economic policies to become clearer after the Upper House election

We should not exaggerate our expectations. Mr. Abe needs to lay out his economic policies and get past the July 2007 Upper House election before he can effect real strategies for growth. We think the administration is unlikely to come up with any bold policy moves for the time being, for the following reasons.

1) Effective economic policies require a budget. However, as preparation of the

FY07 budget is already underway, immediate implementation of major policies would be difficult.

2) Prior to the Upper House election, we would expect the administration to avoid discussions on tax reforms, including a potential consumption tax hike.
3) As current economic conditions are good, there is no pressing need for emergency measures.
4) We expect Mr. Abe's immediate focus to be on issues such as setting up a Sino–Japanese summit.

As we noted in our memo of September 27, we expect the main long term themes of the administration to include Mr. Abe's growth strategy based on openness and innovation, as well as smaller government through means such as the sale of state-owned assets. Yet, bold economic policy will require longevity for the administration and the LDP is likely to face stiff competition in the July 2007 Upper House election. The Abe administration's ability to push forward radical reforms is likely to depend on victory. If the ruling party secures a majority in the elections, it could be a longer-term mandate for the administration. However, if the LDP stumbles, the administration's power is likely to be sapped.

Accordingly, as we have stated in the past, we think the real impact of the Abe administration's economic policies in terms of equity investment strategy remains to be seen. For now, we expect the Abe administration to focus on issues such as Sino–Japanese and Korean-Japanese relations rather than policies that could impact the equity market. South Korea and China have both made overtures to the new prime minister which suggests all three countries are ready to start a new chapter in foreign relations. Visibly improved relations with China and South Korea would likely be a popular development for Japanese voters and business organizations and this would strengthen the Abe administration's position going in to the July 2007 Upper House election.

Japan Sector and Stock Selection (as of September 28, 2006)

Company	RIC	Date Added	Price Added	Price 28/Sep/06	Perf Since Added (%)	Perf YTD (%)	Rating	Price Target	EPSG (%)	P/E	P/B	ROE (%)	Div Yld (%)	Portfolio Wght (%)
Consumer Discretionary (-299 bps Underweight, MSCI Japan Weight: 20.5%)														**17.5**
Isuzu Motors Ltd	7202	1/12/05	450	377	-16.2	-16.2	1H	600	18.4	9.5	2.5	26.6	0.8	3.0
Toyota Motor	7203	28/7/03	3,110	6,400	105.8	4.6	1M	10,200	4.6	14.9	2.0	13.5	1.4	5.0
Aisin Seiki	7259	13/4/05	2,465	3,390	37.5	-21.7	1L	5,800	-3.4	16.9	1.5	8.7	0.9	3.5
Mazda Motor Corp	7261	31/1/05	347	715	106.1	32.4	2M	820	26.0	12.3	2.6	20.9	0.7	3.0
Koito	7276	13/4/05	1,018	1,503	47.6	-17.1	1M	2,000	18.6	16.4	1.8	10.8	1.3	3.0
Consumer Staples (-214 bps Underweight, MSCI Japan Weight: 5.1%)														**3.0**
Japan Tobacco	2914	9/5/05	282,000	462,000	63.8	34.3	1M	606,000	6.6	21.1	2.6	12.2	0.7	3.0
Energy (-96 bps Underweight, MSCI Japan Weight: 1.0%)														**0.0**
Financials (-965 bps Underweight, MSCI Japan Weight: 22.2%)														**12.5**
SMFG	8316	13/9/06	1,220,000	1,220,000	0.0	-2.4	1H	1,530,000	13.3	15.5	2.6	16.5	0.2	3.0
Sumitomo Tr&Bk	8403	31/1/05	703	1,224	74.1	1.6	1H	1,375	15.2	18.2	1.9	10.5	1.0	3.0
Mizuho Financial	8411	1/12/05	865,000	911,000	5.3	-2.7	2S	1,000,000	16.9	16.6	2.1	12.7	0.4	3.5
Sumitomo Realty	8830	31/1/05	1,448	3,400	134.8	32.6	1H	3,700	47.7	34.6	4.4	12.8	0.3	3.0
Health Care (-259 bps Underweight, MSCI Japan Weight: 5.6%)														**3.0**
Astellas Pharma	4503	8/6/05	3,860	4,660	20.7	1.3	1M	5,800	18.0	21.9	2.2	10.0	1.7	3.0
Industrials (+1348 bps Overweight, MSCI Japan Weight: 16.5%)														**30.0**
Furukawa Elec	5801	9/3/06	859	784	-8.7	-15.0	1M	1,100	-5.9	23.7	2.5	10.8	0.4	3.5
Komatsu	6301	9/5/05	758	2,030	167.8	4.0	2H	2,500	24.1	14.6	3.3	22.8	0.9	3.5
Kubota	6326	9/5/05	544	955	75.6	-3.6	1H	1,300	2.5	15.3	2.1	13.7	1.0	3.5
NTN Corp	6472	13/4/05	589	932	58.2	0.0	1M	1,070	33.3	17.0	2.4	14.2	1.2	3.0
Fanuc Ltd	6954	8/6/05	6,740	9,150	35.8	-8.6	1H	11,500	13.9	19.5	2.6	13.3	1.0	3.5
Dai Nip Print	7912	15/2/05	1,712	1,803	5.3	-14.1	2M	1,900	-3.0	21.7	1.2	5.7	1.4	3.0
Mitsubishi Corp	8058	14/2/03	817	2,205	169.9	-15.5	1M	2,800	-4.3	11.6	NA	NA	1.5	3.5
Mitsui Osk Lines	9104	20/1/05	611	848	38.8	-17.6	2M	815	-13.7	10.6	2.5	23.0	2.1	3.5
Mitsub Logistics	9301	12/1/06	1,926	1,876	-2.6	-5.5	1M	2,100	40.4	30.4	1.6	5.4	0.5	3.0
Information Technology (-385 bps Underweight, MSCI Japan Weight: 12.9%)														**9.0**
NIDEC Corp	6594	20/1/05	5,995	8,680	44.8	-13.5	2H	8,800	-17.5	29.2	4.8	16.6	0.5	3.0
Hoya Corp	7741	13/4/05	2,948	4,410	49.6	4.0	1M	5,700	15.0	22.7	7.0	30.8	1.3	3.0
Canon Inc	7751	20/1/05	3,507	6,090	73.7	32.4	1M	7,500	-19.1	17.9	2.1	11.9	1.6	3.0
Materials (+1303 bps Overweight, MSCI Japan Weight: 9.0%)														**22.0**
Sumitomo Chemical	4005	31/1/05	536	887	65.5	9.5	1M	1,300	10.3	15.0	2.1	13.9	1.1	3.0
Shin Etsu Chemical	4063	28/7/03	4,370	7,490	71.4	19.5	1M	8,700	28.8	22.3	2.8	12.6	0.5	3.0
JSR Corporation	4185	31/1/05	2,200	2,560	16.4	-17.4	1M	3,700	22.7	17.8	3.1	17.6	0.8	3.0
Hitachi Chemical	4217	31/1/05	1,771	2,825	59.5	-9.5	1M	4,000	10.8	17.2	2.8	16.3	0.8	3.0
Sumitomo Metal	5405	9/5/05	195	455	133.3	0.2	1M	650	-14.1	11.8	3.1	26.4	1.5	3.5
JFE Holdings	5411	31/1/05	2,865	4,640	62.0	17.2	1M	6,800	-7.4	9.7	2.1	22.0	2.1	3.5
Nitto Denko Corp	6988	31/1/05	5,510	6,990	26.9	-23.9	1H	9,000	-3.4	22.3	3.7	16.5	0.8	3.0
Utilities (-127 bps Underweight, MSCI Japan Weight: 4.3%)														**3.0**
Tokyo Gas Co Ltd	9531	14/2/03	354	597	68.6	13.9	1L	640	35.2	19.6	2.3	11.5	1.1	3.0
Telecommunication Services (-306 bps Underweight, MSCI Japan Weight: 3.1%)														**0.0**
Total									**10.0**	**18.1**	**2.7**	**15.4**	**1.0**	**100.0**

Source: MSCI, Citigroup Investment Research, and Nikko Citigroup Limited

This page intentionally left blank.

ASIA PACIFIC

Markus Rösgen
+852-2501-2752
markus.rosgen@citigroup.com
Hong Kong

Asia Pacific Equity Strategy

If It's Due to Speculation=Bullish; If Due to Weaker Growth=Bearish

- EBIT to sales margins are at a 16-year low — Since 2000, the ratio of finished goods to commodity prices has fallen by 57%. Any reversal in this trend without any slowdown in demand would be hugely positive for margins hence EPS and ROEs. A 25 bps increase in margins raises ROE by 30 bps.

- The biggest beneficiaries are China, Korea and Taiwan — These are the most correlated markets to falling commodity prices, India and Thailand the least. Sector-wise, utilities, technology and consumers have the most to gain. Energy, industrials and materials the most to lose. The other big winner would be small caps, which have been big underperformers vs. large caps.

- Weaker commodities due to weaker global growth=bearish. — Asian corporates are very sensitive to declines in asset turns, which are at a 16-year high. Historically, whenever export growth weakens, export prices decline too, mitigating part of the positive effect of falling export prices. On the back of higher operating leverage, the top line has gained in importance.

Asia ex Japan Valuations – Sector

9/28/2006	Free Mkt Cap US$m	P/E 05E	P/E 06E	P/E 07E	EPS YoY % 05E	EPS YoY % 06E	EPS YoY % 07E	P/B 06E	ROE 06E	Div Yld 06E	EV/ Sales 05	EV/ EBITDA 05	Weekly Perf %	YTD Perf %
Asia Pacific ex Japan*	**1,999,147**	**15.3**	**13.8**	**12.7**	**10.8**	**11.3**	**9.5**	**2.1**	**14.7**	**3.2**	**1.8**	**9.3**	**0.3**	**11.7**
Energy	121,321	11.5	10.1	9.8	21.3	15.7	1.3	2.3	23.9	3.5	1.5	6.6	1.4	20.0
Materials	215,158	10.6	9.6	9.0	20.1	9.4	7.0	1.7	18.3	3.3	2.0	10.1	1.8	9.2
Capital Goods	124,363	19.3	14.9	14.0	14.2	29.8	5.9	1.7	11.9	2.6	1.3	9.7	1.0	15.1
Comm Svc & Supp	11,876	24.9	20.3	19.0	41.1	22.2	7.2	3.1	19.5	3.2	2.1	10.7	8.4	19.5
Transport	68,104	14.2	14.3	15.0	-4.7	-19.5	-3.1	1.6	10.4	3.9	1.9	10.4	-0.4	9.7
Autos & Components	42,691	9.9	12.6	10.4	18.7	-18.8	21.1	1.6	12.4	2.0	0.8	7.2	-1.0	-4.4
Consumer Durables	24,684	16.1	17.3	11.6	-24.3	-7.5	57.7	2.1	12.0	2.7	0.8	7.7	-2.5	-9.1
Consumer Services	31,391	20.0	18.6	16.3	17.2	7.4	13.8	2.5	10.2	3.3	3.9	12.3	1.5	10.2
Media	17,219	20.4	18.9	17.5	11.3	7.8	8.2	3.4	20.4	4.5	4.2	12.7	0.2	6.6
Retailing	26,326	18.6	17.3	14.9	32.4	7.3	16.8	2.3	13.6	2.8	1.6	13.1	-0.2	16.3
Food & Staples Retailing	40,539	24.0	21.0	18.4	12.1	14.6	13.9	3.3	17.6	2.6	0.8	13.5	-0.6	27.6
Food Bev & Tobacco	51,101	20.0	16.8	15.1	4.4	16.3	9.7	2.6	15.0	3.2	1.9	10.5	-0.8	17.6
Household Products	7,939	27.2	23.1	20.1	19.1	17.5	15.0	3.6	18.4	2.1	3.3	21.8	-0.7	23.0
Health Care Equip & Svc	11,051	28.9	22.5	20.6	47.0	28.2	9.5	6.1	21.0	2.8	2.2	14.4	2.5	1.0
Pharma & Biotech	18,955	28.9	22.7	19.7	32.5	27.3	19.0	3.8	19.1	1.2	3.7	14.7	3.8	24.2
Banks	374,375	15.1	13.6	12.3	17.9	18.9	9.1	2.1	15.6	3.8	NA	NA	0.7	11.8
Div Financials	69,139	18.3	15.7	14.6	45.1	18.0	7.5	2.9	15.5	3.4	NA	NA	0.1	10.2
Insurance	77,715	21.9	18.8	17.1	5.0	16.4	9.9	3.6	18.3	2.8	NA	NA	-0.6	32.0
Real Estate	161,401	16.5	16.0	16.3	19.4	3.5	-1.2	1.3	8.0	4.0	6.7	14.0	-0.7	16.2
Software & Services	36,460	40.2	28.6	22.2	32.3	32.8	28.6	9.7	31.4	0.7	7.0	24.2	-0.5	16.9
Tech Hardware & Equip	111,446	20.1	16.2	12.6	-3.2	27.1	55.1	2.4	12.5	2.1	1.2	11.9	-2.1	1.5
Semi & Semi Equip	165,040	15.1	13.6	12.3	-18.1	20.1	10.1	2.4	17.7	2.1	1.9	7.9	0.1	3.7
Telecom	120,619	13.6	13.3	12.6	9.1	0.0	7.6	2.5	17.8	4.3	2.5	6.8	0.1	13.8
Utilities	70,233	13.9	13.6	12.8	9.1	2.6	6.3	2.1	10.9	3.5	3.1	9.5	-0.4	9.5

* Note: The above data are compiled based on companies in MSCI Asia Pacific ex-Japan (which includes Australia, China, Hong Kong, India, Indonesia, Korea, Malaysia, New Zealand, Pakistan, Philippines, Singapore, Taiwan, and Thailand). The market capitalization for sectors and regions are free-float adjusted. P/E, EPS Growth, P/B, Dividend Yield, and ROE are aggregated from IBES consensus estimates (calendarized to December year-end) with current prices. EV/Sales and EV/Ebitda are aggregated from Worldscope data (EV uses current market capitalization, EBITDA and Sales use 2005 or last reported year before 2005) NM = Not Meaningful; NA = Not Available.

Source: Citigroup Investment Research, IBES Consensus, Worldscope, MSCI, and FactSet

If It's Due to Speculation=Bullish; If Due to Weaker Growth=Bearish

Commodity prices have been declining over the course of the last few weeks, the Goldman Sachs commodity index is off 15.9% since hitting the peak in early August. Potentially this is the biggest positive change for Asian markets and our view on the region. For a while our view has been that the relentless rise in commodity prices and an inability of corporate Asia to pass on these higher costs would result in poor earnings growth (1.3% in 05, 7.3% for 06 and 12% for 07) and thus poor performance from the exporters relative to the domestic economy sectors. If and this is a big IF, commodities are now weakening purely due to an excess in speculation, Asian companies would be able to rebuild their margins, the continuous erosion in margins would be halted and actually reversed. EPS growth would accelerate, ROEs would rise and with them multiples would contract and Asia would offer upside not downside risk.

Before you go off and re-mortgage your house, commodity prices may also be falling because of weaker demand; the OECD, USA etc., leading indicators and the performance of bonds are all signaling a period of weaker growth ahead. So rather than the benign excess speculation the issue is demand. If this is behind the current weakness in commodity prices than this is far from bullish, more like bearish. As we highlight in the report, Asia is more turnover sensitive than it is margin sensitive. Historically, whenever volume has slowed, the pricing environment has deteriorated substantially. As per the leading indicators, we expect a period of slowdown and so are of the view that the decline in commodity prices is demand driven rather than purely speculation driven.

Another year goes by, another drop in margins

The margin story of Asian corporates is a rather depressing one sadly. Even though the region has grown strongly, GDP per capita has risen, EBIT margins have gone the other way, down. The trend in Asia ex EBIT margins (ex financials) from 1990 to the present day shows that aside from the occasional uptick, the trend has not been your friend. The surprise to many is that Asian EBIT margins are actually lower today than they were during the Asian crisis of 1997/98. EBIT to sales margins this year will hit a 16-year low. Margins can certainly go lower still, EBIT margins stand at 11.6% having fallen from 15% back in 1990, but what has led to this precipitous margin decline over the last 4 years has been the commodity price rises.

Rising commodity prices and falling export prices= weaker margins

While commodity prices have risen, Asian companies have been unable to pass on these higher commodity prices. The reasons are varied but rest predominately on a lack of brand recognition, hence pricing power and a high degree of industry fragmentation. As a proxy for pricing power we have taken the ratio of US import prices from newly industrialized Asia and the Goldman Sachs commodity index, which has an 82% weight in both oil and industrial metals. Over the course of the period of 1993 to today the correlation between the two series (EBIT margins and the ratio of US import prices and the GS commodities index) stands at 0.6. Not perfect but please bear in mind this includes both the Asian crisis and the tech bubble of 1999-2000. Since 2003, the correlation has risen substantially.

Given the impact of the price component on EBIT margins, any relief from commodity prices can and will come as a huge relief to Asian companies and investors. We have gone back to the two prior periods of commodity price reversals, 1998-99 and then 2000-2002 and looked at the impact this would have on current EBIT margins and ROE. If we were to get a similar reversal – 34% retracement – this time EBIT margins in Asia ex would increase by 1.3 percentage points from 11.6% to 12.8%. This would add a full 1.5 percentage points to ROE and bring it to 16.1%. This would place Asian ROEs within just 0.7 percentage points of the average of the USA and Europe at 16.8%. Yet the average P/BV of these two markets is 2.4 times vs. Asia's 2 times P/BV. Asia ex clearly has upside in the event of a 34% retracement of commodity prices relative to US import prices from Asia ex.

All other things being equal (i.e., no change in leverage, asset turn etc.) a 25 bps increase in EBIT margins has historically increased ROE by roughly 30 bps.

China, Korea and Taiwan to benefit most, India and Thailand least

In terms of individual countries, those with the highest correlation with the ratio of US import prices and the GS commodity index are China, Taiwan and Korea.

The reason is that these three are large exporters and also depend almost entirely on the imports of raw materials for their exports. As such, rising input cost via commodities and declining ex factory prices bode poorly for margins. There is almost no correlation with India and Thailand. The case of India is explainable due to the small part played by exporters in the stock markets. In the case of Thailand, the importance of commodity prices has certainly increased; the weighting of oil has gone from 6% back in 2000 to 29.5% as of the end of August. Yet, the rest of the equity market is hardly affected by the decline in commodity prices given the domestic nature.

Consumers, technology and utilities benefit most, energy, materials least

The sectors that have been most correlated to the sharp rise in commodity have been the utility sector – not every company benefits from the possibility of an automatic pass through; technology companies – higher input costs especially at the manufacturing end without pass-through potential; and consumer staples, which again have found the consumer unwilling to pay higher prices.

At the other end of the scale, energy is negatively correlated, to be expected and for the broad materials and industrials the correlations are very weak. Materials have been able to pass through the higher prices as have some of the industrials (Hutch makes up 12% of the sector index).

Small & mid caps benefit more than big caps from weaker commodities

While small caps have been an outperforming asset class in much of the rest of the world, this has not been the case in Asia ex. Small caps have underperformed large caps by 10.2% since 2005. The main reason is that Asian small caps have a bigger export share than is the case for European and American small caps. Asian small caps also operate on much thinner margins than large caps and hence the impact of margins is much more severe. No surprise then that as commodity prices have risen, margins have suffered and investors have sold down their small cap exposure. The decline in commodity prices is thus a huge plus for this asset class.

Asia's pain has been the rest of GEMS gain

Asia ex has been an underperforming asset class relative to the rest of the GEMS universe. As we in Asia have seen our earnings revised down, Geoffrey Dennis our head of Latam and EMEA research, has seen upward revisions after upward revisions. Earnings in the GEMS universe have outperformed those of Asia ex, hence the underperformance of Asia ex within a GEMS universe. If the decline in commodity prices proves to be a permanent feature, the shoe will be on the other foot as we highlighted above, better margins for Asia and a less optimistic margin outlook for the commodity producers in the GEMS universe. Under those circumstances Asia ex becomes the outperforming asset class after 3 years and 34% of underperformance.

GEM investors overweight LatAm, underweight Asia ex

The reversal of the fortunes for Asia ex have large implications for asset allocation. The average GEMS fund manager has his/her biggest underweight in Asia ex Japan and the largest overweight is in Lat Am. In the case of Asia ex the underweight stands at 277 bps below the neutral weight. Not only is Asia ex an underweight but, the countries that are most sensitive to changes in the input/export price dynamic, China, Korea and Taiwan, are also those that are most underweighted while Thailand is their second biggest overweight! Among the global PMs Asia ex is a small overweight and other emerging markets is a small underweight.

Weaker commodities = bigger current account surpluses

Over the course of the last 6 years the bill for commodity imports to Asia ex has risen by US$ 240 bn. Clearly this is not only due to the rise in commodity prices, part of it is also due to the strong rates of growth of Asian economies but the vast majority is due to the price appreciation of commodities. There has thus been a huge transfer of wealth from Asia to the commodity producers of the world. Between 2004 to 2005, the commodity import bill rose by US$78bn alone. Another way of looking at this is that if the share of commodity imports as a % of all imports returns to the 2000-02 average this implies a saving of US$110bn. No small change. That is equivalent to US$ 46mn per word in this report!

All other things being equal, weaker commodity prices means higher current account surpluses. This means either more purchases of US$ assets in the form of US treasuries so lower US rates hence stronger consumption. Or failure to recycle the US dollars, stronger Asian currencies and potentially as a quid pro quo lower domestic interest rates. Either outcome would be bullish for Asian equities though in the case of the latter, domestic consumption stories would have an edge over exporters.

Weaker commodities due to weaker growth

So far we have just looked at it from one dimension, input cost only, which clearly has positive repercussions. This would follow the "speculation driven commodity weakness" theme. If however the laws of supply and demand apply and commodities are coming off due to a growth slowdown, i.e., the LEIs are right, then it is a very different story. We bring together the two components, yes falling commodity prices hence rising margins but a deterioration in asset turnover. Anything worse than a 250 bps decline in asset turns and margins have to rise significantly to make up the difference. Asset turnover is currently at a 16-year high of 70%.

The reason why the asset turn line has become more important is that the degree of operational leverage has risen in Asia over the course of the last few years. As such, the top line is hugely important to the wellbeing of Asian companies.

Asia Pacific ex-Japan Sector and Stock Selection (Local currency, 2006E)

Company	RIC	Mkt	Date Added	Price Added	Price 27Sep06	Perf YTD (%)	Rating	Price Target (local curr)	EPSG (%)	P/E	P/B	ROE (%)	Yld (%)	Portfolio Wght (%)
Consumer Discretionary (+307 bps Overweight, MSCI AC Asia Pacific ex Japan Weight: 6.9%)														**10.0**
Li & Fung	0494.HK	HK	27 May 04	10.36	19.72	45.1	2L	17.10	8.6	29.7	12.6	42.5	2.9	1.0
Shinsegae	004170.KS	KR	27 May 04	261,000.00	491,500.00	10.9	2L	456,000.00	11.2	19.0	3.2	17.0	0.2	3.0
Singapore Press	SPRM.SI	SG	27 May 04	4.12	4.08	-5.1	1L	5.04	-8.6	17.3	3.8	21.8	5.5	3.0
Tabcorp Holdings	TAH.AX	AU	27 May 04	13.56	15.46	-0.7	1M	18.60	0.0	14.9	2.4	16.2	5.8	3.0
Consumer Staples (-491 bps Underweight, MSCI AC Asia Pacific ex Japan Weight: 4.9%)														**0.0**
Energy (-324 bps Underweight, MSCI AC Asia Pacific ex Japan Weight: 6.2%)														**3.0**
CNOOC	0883.HK	CN	27 May 04	3.28	6.37	21.3	NR	NA	19.4	8.6	2.6	30.4	3.9	1.0
Woodside	WPL.AX	AU	27 May 04	16.01	39.00	-0.5	1M	51.50	46.2	16.3	4.5	27.4	3.5	2.0
Financials (+66 bps Overweight, MSCI AC Asia Pacific ex Japan Weight: 34.3%)														**35.0**
ANZ	ANZ.AX	AU	9 Dec 04	19.70	26.76	11.7	2L	28.00	12.1	14.3	2.6	18.5	4.6	6.0
Chinatrust FHC	2891.TW	TW	27 May 04	25.71	24.95	7.5	1L	25.00	-77.1	62.3	1.8	2.9	1.8	2.0
DBS Group	DBSM.SI	SG	27 May 04	13.80	19.00	15.2	2L	18.90	8.0	14.2	1.6	11.3	3.7	3.0
HSBC	0005.HK	HK	27 May 04	114.00	141.80	13.9	1M	167.00	14.4	11.3	2.0	17.6	4.6	6.0
Kookmin Bank	060000.KS	KR	27 May 04	40,150.00	75,300.00	-1.6	NR	NA	NA	NA	NA	NA	NA	NA
Public Bank Bhd	PUBM.KL	MY	27 May 04	5.50	6.80	3.8	3L	6.50	8.3	14.3	2.8	19.3	6.2	2.0
Shinhan Financ	055550.KS	KR	27 May 04	18,150.00	43,350.00	5.6	1L	55,000.00	11.6	8.6	1.5	17.0	2.8	4.0
SBI	SBI.BO	IN	27 May 04	530.90	999.35	10.1	1L	950.00	0.0	11.9	1.9	16.0	1.4	1.0
Swire Pacific	0019.HK	HK	27 May 04	49.50	83.00	19.3	3L	73.00	4.8	19.8	1.2	6.2	2.7	3.0
Taishin FHC	2887.TW	TW	27 May 04	23.90	16.60	-3.5	1L	20.00	-166.0	44.1	1.1	2.4	0.0	3.0
Health Care (-39 bps Underweight, MSCI AC Asia Pacific ex Japan Weight: 1.4%)														**1.0**
Parkway Holdings	PARM.SI	SG	26 May 05	1.67	2.82	33.6	1L	2.82	17.4	28.0	4.6	16.4	4.4	1.0
Industrials (-14 bps Underweight, MSCI AC Asia Pacific ex Japan Weight: 10.1%)														**10.0**
Brambles Inds	BIL.AX	AU	27 May 04	5.95	12.28	21.3	2L	11.63	0.0	36.5	5.1	13.9	4.8	5.0
Cathay Pacific	0293.HK	HK	27 May 04	14.35	16.26	20.0	1L	16.40	8.7	15.4	1.4	8.8	4.9	2.0
ComfortDelGro	CMDG.SI	SG	30 Nov 05	1.50	1.68	5.0	1L	1.80	-1.1	17.1	2.5	14.4	5.0	2.0
Road Builders	ROAD.KL	MY	31 Aug 05	2.00	2.62	88.5	1L	3.40	0.0	20.4	0.9	4.6	3.4	1.0
Information Technology (-837 bps Underweight, MSCI AC Asia Pacific ex Japan Weight: 15.4%)														**7.0**
Samsung Electronics	005930.KS	KR	27 May 04	506,000.00	659,000.00	0.0	2L	695,000.00	-6.3	13.6	2.2	16.3	0.8	5.0
Wipro	WIPR.BO	IN	27 May 04	267.70	520.25	12.3	NR	NA	28.9	27.4	8.1	29.5	1.1	2.0
Materials (-728 bps Underweight, MSCI AC Asia Pacific ex Japan Weight: 11.3%)														**4.0**
Rio Tinto	RIO.AX	AU	27 May 04	34.77	68.69	-0.4	1M	100.00	63.9	8.6	4.2	48.4	1.7	3.0
Siam Cement	SCC.BK	TH	25 Aug 06	212.00	244.00	0.0	1L	264.00	3.8	9.3	3.5	37.9	6.0	1.0
Utilities (-60 bps Underweight, S&P500 Weight: 2.7%)														**7.0**
HK & China Gas	0003.HK	HK	19 Aug 05	15.80	18.20	10.0	1L	20.60	-0.5	19.3	5.1	26.5	2.0	3.0
KEPCO	015760.KS	KR	27 May 04	19,000.00	37,100.00	-1.9	NR	NA	-8.6	102.8	5.3	5.2	0.3	3.0
Tenaga Nasional	TENA.KL	MY	26 May 05	8.40	9.90	25.0	1L	13.40	57.4	22.3	2.2	9.8	1.6	1.0
Telecommunication Services (+1710 bps Overweight, MSCI AC Asia Pacific ex Japan Weight: 5.9%)														**23.0**
Bharti Airtel Limited	BRTI.BO	IN	27 May 04	153.60	476.35	37.8	1M	500.00	0.0	39.8	10.7	26.9	0.0	1.0
China Netcom	0906.HK	CN	19 Aug 05	13.25	13.78	9.8	1M	16.50	7.3	8.2	1.3	15.4	4.3	1.0
China Telecom	0728.HK	CN	27 May 04	2.43	2.79	-2.1	2L	2.75	4.7	10.4	1.1	11.0	2.9	2.0
DiGi.Com	DSOM.KL	MY	6 Apr 06	9.45	12.10	55.1	1L	14.00	40.5	13.7	6.1	44.2	7.3	2.0
PCCW Limited	0008.HK	HK	5 Jul 05	4.85	4.78	0.1	1M	6.05	27.5	14.7	18.1	123.1	4.1	2.0
Telkom Indonesia	TLKM.JK	ID	27 May 04	3,675.00	8,350.00	41.5	1L	10,000.00	37.3	14.7	5.5	37.2	2.6	1.0
StarHub Ltd	STAR.SI	SG	26 May 05	1.50	2.20	7.3	1L	2.65	25.2	16.9	10.2	60.6	5.0	2.0
Taiwan Mobile	3045.TW	TW	27 May 04	31.20	32.15	12.0	1L	36.00	-1.2	9.9	1.7	17.5	8.1	2.0
Telecom NZ	TEL.NZ	NZ	27 May 04	5.59	4.44	-26.1	1M	5.25	0.0	10.6	8.2	77.8	10.2	5.0
Telstra Corp	TLS.AX	AU	27 May 04	4.70	3.68	-6.4	NR	NA	NA	NA	NA	NA	NA	NA
Total									**3.8**	**23.5**	**4.8**	**24.9**	**3.6**	**100.0**

^Near-term market volatility and short-term trading patterns may cause the Expected Total Return to become temporarily misaligned relative to the hurdle for this stock's fundamental rating, as defined under our current system.

Source: Citigroup Investment Research, MSCI, and IBES

This page intentionally left blank.

LATIN AMERICA & CEEMEA

Geoffrey Dennis
1-212-816-8391
geoffrey.dennis@citigroup.com
New York

Andrew Howell
1-212-816- 2548
andrew.howell@citigroup.com
New York

Jason Press
New York

Think Small

Why small caps should outperform in CEEMEA

➤ **Take a closer look at small caps**

In CEEMEA, large cap stocks have dominated the performance of smaller names for a decade. This run appears to have come to an end in 3Q06, and we think small caps could outperform the pack in 2007.

➤ **In developed markets, the opposite is true.**

European and US large and mega-caps have lagged small and mid-caps since 2000. Why is CEEMEA so different? It comes down to liquidity, the commodity cycle and oligopoly power. All three of these may now be changing.

➤ **Why "think small" now?**

Big stocks look expensive relative to large caps and ROEs look stretched. Small caps are less exposed to the commodity cycle and could benefit from ongoing M&A. However, many sell-side analysts have recently turned more bullish on large-caps.

➤ Small stocks fear liquidity crunches.

For sure, smaller stocks would be more vulnerable to a major withdrawal of liquidity, but we do not expect this to happen. On the other hand, further *moderate* outflows are more likely to punish the large caps.

Emerging Markets (Non-Asian) Valuations – Sector

9/28/2006	Free Mkt Cap US$m	P/E 05E	P/E 06E	P/E 07E	EPS YoY % 05E	EPS YoY % 06E	EPS YoY % 07E	P/B 06E	ROE 06E	Div Yld 06E	EV/ Sales 05	EV/ EBITDA 05	Weekly Perf %	YTD Perf %
Emerging Markets (Non-Asia)*	**945,441**	**14.3**	**12.0**	**10.8**	**31.2**	**20.2**	**9.9**	**2.2**	**17.6**	**2.6**	**2.1**	**7.5**	**0.8**	**10.5**
Energy	263,568	11.6	10.0	9.2	39.5	16.5	8.7	2.0	17.5	1.7	1.9	6.2	3.1	17.0
Materials	166,688	14.1	9.6	9.4	32.2	37.9	1.4	1.8	18.9	3.6	2.5	7.8	2.8	12.0
Capital Goods	35,334	14.4	13.7	12.2	20.6	5.1	12.5	2.1	15.1	2.6	1.1	8.6	0.6	8.8
Transport	15,528	20.0	16.3	13.5	40.3	23.0	23.5	2.2	10.1	2.7	1.5	9.8	1.3	6.9
Autos & Components	944	10.6	10.8	10.8	-63.8	-1.5	-0.4	1.8	16.5	6.0	0.6	4.9	-3.5	-5.6
Consumer Durables	12,401	20.2	14.4	11.8	18.2	32.7	22.7	2.5	15.4	1.7	2.0	10.9	1.9	14.6
Consumer Services	848	30.9	21.4	23.1	80.2	44.4	38.9	1.1	3.5	0.9	2.5	9.2	3.2	52.6
Media	19,723	22.4	18.1	17.0	48.2	23.9	6.5	3.9	21.7	2.2	3.2	9.9	-0.4	-2.3
Retailing	14,109	13.8	11.6	9.8	27.9	18.6	19.3	2.9	24.9	4.1	1.9	11.2	0.8	-13.6
Food & Staples Retailing	20,407	25.1	21.7	17.3	18.6	15.8	25.5	3.6	16.0	1.6	0.9	8.4	0.0	11.1
Food Bev & Tobacco	35,622	20.8	17.4	14.5	5.3	18.2	19.3	2.7	15.9	3.0	2.0	8.7	1.2	8.2
Household Products	3,154	20.3	17.4	15.6	7.8	16.9	11.2	5.5	25.2	4.6	2.7	10.3	1.5	18.4
Health Care Equip & Svc	3,599	24.7	21.6	15.8	33.4	14.4	36.8	4.8	23.1	1.8	3.3	15.2	-2.4	11.9
Pharma & Biotech	29,183	18.4	15.5	14.7	24.0	18.6	5.1	3.6	20.4	0.9	4.7	15.7	1.4	-18.3
Banks	129,336	14.1	12.2	10.3	23.0	22.1	16.9	2.4	20.3	3.2	NA	NA	0.6	6.4
Div Financials	13,500	12.0	11.4	9.6	17.9	7.5	16.1	2.3	21.3	3.7	NA	NA	-4.0	-8.8
Insurance	8,521	8.7	10.1	9.5	57.9	-14.1	6.7	1.3	12.7	4.4	NA	NA	0.3	-8.7
Real Estate	2,744	14.3	12.0	9.2	8.8	18.7	30.7	1.9	16.8	2.8	7.9	11.1	-0.9	3.9
Software & Services	5,103	16.1	15.0	13.8	22.8	7.3	9.1	2.3	15.3	0.1	2.8	9.0	-2.1	-5.0
Tech Hardware & Equip	6,855	24.4	20.6	16.2	42.9	18.6	23.7	2.3	9.1	1.3	2.0	14.1	-2.0	6.3
Telecom	121,198	16.1	14.7	13.3	37.0	15.2	10.4	2.9	19.7	3.0	2.4	7.4	0.1	7.2
Utilities	37,077	16.9	14.3	13.3	34.0	17.8	8.2	1.7	8.7	2.7	2.5	7.8	3.1	21.6

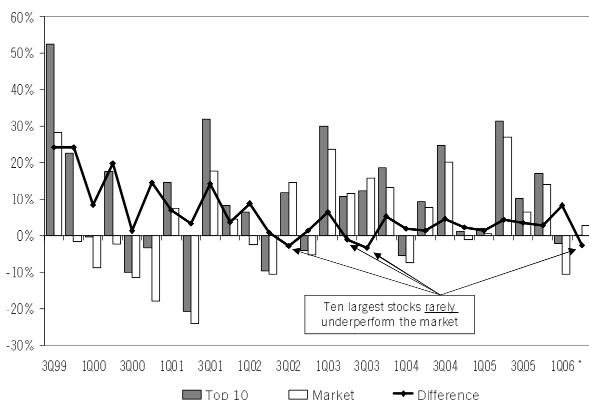
Note: The above data are compiled based on companies in MSCI Emerging Markets excluding Asia (which includes Argentina, Brazil, Chile, Colombia, Czech Republic, Egypt, Hungary, Israel, Jordan, Mexico, Morocco, Peru, Poland, Russia, South Africa, Turkey, and Venezuela). The market capitalization for sectors and regions are free-float adjusted. P/E, EPS Growth, P/B, Dividend Yield, and ROE are aggregated from IBES consensus estimates (calendarized to December year-end) with current prices. EV/Sales and EV/Ebitda are aggregated from Worldscope data (EV uses current market capitalization, EBITDA and Sales use 2005 or last reported year before 2005) NM = Not Meaningful; NA = Not Available.
Source: Citigroup Investment Research, IBES Consensus, Worldscope, MSCI, and FactSet

Think Small

A closer look at small caps

In emerging markets, the mantra that has held consistently true over the past decade has been: “Big is Beautiful”. Quite simply, owning a basket of the largest stocks has a sure way of outperforming the index.[4] In CEEMEA, the 10 largest stocks in the region have outperformed the MSCI EMEA index in all but 3 of the last 27 quarters (the current quarter, ending next week, is likely to be a fourth exception). Since the beginning of 2005, the 10 largest stocks have risen by 92% in USD terms, on average, versus 41% for the region as a whole. And 7 of the top 10 stocks have soundly beaten the index over that period.

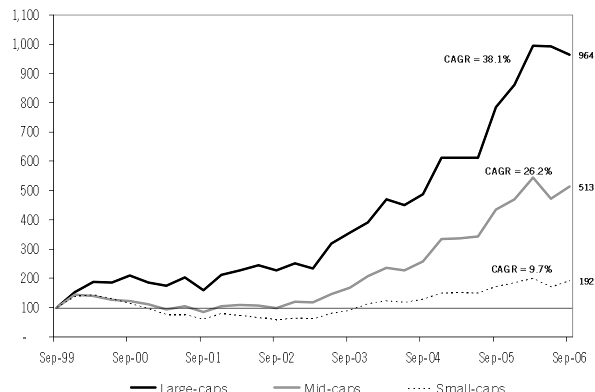
Figure 1. Performance of Top 10 CEEMEA Stocks and Market, Quarterly



*4Q06 is for the quarter to date. Source: FactSet

Even more dramatic than the steady outperformance of largest stocks in the region is the *underperformance* of the smallest. We constructed our own based on the quarterly composition of the MSCI EMEA index consisting of large-caps (the top 10 stocks representing 30-40% of overall MSCI market cap, which some might call “mega-caps”), mid-caps (the next 40-50 stocks, another 40% of market cap) and the small-caps (the 100 smallest stocks, 20-30%). Figure 2 charts their cumulative performance since late 1999, indicating just how decisively the large stocks have outperformed over the period.

Figure 2. Performance of three baskets of CEEMEA stocks (USD)



Source: FactSet

Since 1999, the average quarterly return of the large-cap group was 10%, versus 7% for the mid-caps and just 3% for the small-caps. Put otherwise, the compound annual return of 38.1% over the period for the large caps far outstripped the small-caps at just 9.7%. Indeed, this meager single-digit return for holding the small stuff — during what has arguably been one of the great bull markets in the asset class — suggests that small-cap investing has hardly been worth the effort.

As our European colleagues have shown, the opposite has held true in developed European markets, due to flows (especially hedge funds and private equity) favoring mid-caps in recent years, moderately superior earnings growth prospects for mid-caps, the overvaluation of large-caps back in 2000 and a more skeptical evaluation by investors of the benefits of large-cap synergies. How can we account for the difference?

- Liquidity, liquidity, liquidity. Clearly, a leading factor is that, as emerging markets fundamentals have stabilized and enthusiasm for the asset class has grown, especially from “non-traditional” investors, the larger stocks have received more attention, in the same way as the mid-caps have been favored by newer investors in Europe (especially hedge funds). A large-cap preference results from a host of factors including higher trading volumes and liquidity, better perceived corporate governance, the existence of ADR programs, more analyst research and related factors.

[4] The same also holds true in Latin America (see *Latin America Strategy Notebook: Is it time for Small-Caps?*, 15 May 2006), and in Asia.

- The commodity cycle. A second important point is the fact that — for reasons including economies of scale in natural resource sectors and the way in which assets were privatized in the 1990s — commodity and energy companies tend to be large in CEEMEA. At present, nearly 80% of the market weight of the 10 largest stocks is in energy and materials categories. As Figure 11 indicates, the weight has actually fluctuated quite a bit over time but has frequently been 50% or more[5].

  By contrast, the small-cap grouping contains few energy stocks; although materials is a large group, at 26%, other represented sectors tend to be more domestic in nature such as financials, capital goods and consumer durables, among others. These firms also tend to consume, not produce, commodities.

- Oligopoly power. Alongside the big commodity stocks, many of the other CEEMEA titans — i.e. those in non-commodity sectors — have also done well; stars include MTN Group, OTP Bank, Standard Bank and Teva, all of which have seen big gains over the years. The reason for the strength in these names is more nuanced: large, domestically-oriented emerging market firms, especially in areas such as banking and telecoms, have tended to be industry consolidators, expanding into new markets both domestically and abroad, and leveraging economies of scale. Many have met with success particularly in their further expansion deeper into emerging-land: Growth opportunities have been ample, while competition is frequently constrained due to regulation and other barriers. There is also evidence that emerging markets are good places for large firms operating within "oligopolistic" environments: pro-competitive regulation has often been slow to evolve, while the strong macro environment experienced since 2002 and the acceleration of 'convergence' in various consumer products have all supported growth.

- M&A not yet a major factor. A final reason why European small and mid-cap stocks have seen multiple expansion is that they are seen as more likely to become takeover candidates. Debt financed acquisitions by strategic and private equity buyers have pushed up the value of smaller firms, "forcing" equities markets to re-rate their peers; however this trend has not transferred over to the larger and less-easily-digested mega-caps that are too large to be digested by any single buyer.

[5] The weight of materials declined with the departure of Anglo American from the index in 2004, while the reweighting of Gazprom has boosted energy considerably in 2006.

Why "think small"?

There are several reasons why small caps — the erstwhile laggards of the emerging world — may now be poised to outperform their large-cap peers for the first time in a decade. This call is predicated on our moderately positive outlook for CEEMEA overall; a continuation of modest, if uneven, overall gains could come alongside a modest rotation away from the high-flying large-caps into smaller stocks.

- Valuations. Despite the very strong performance of CEEMEA's titans, large-cap share price rises have on the whole been matched by earnings growth; it thus would be wrong to say that large-caps stand out as particularly expensive on a PE basis. Nevertheless, they have re-rated somewhat over the past year; and while our work shows the small-caps continue to trade at a small premium to large-caps in PE terms, we find the valuation gap between the two has closed considerably in recent months: Small-cap's current trailing PEs of 19x is the lowest level seen in two years (and close to its 7-year average), while large-cap's PE of 18.5 is the *highest* it has been in five years (and also near its average). Yet more compelling to us is the price-to-book metric, which indicates that large-caps are now trading at a considerable premium to small-caps (3.5x versus 2.7x) — a gap not seen except during a brief period in 2002. Nowhere do we find the deep discount attached to large-caps that investors have grown accustomed to in developed Europe.

- Commodity risks. Another reason to shirk large-caps would come from a desire to sidestep their excessive exposure to the commodity cycle. Indeed, one of the reasons large-caps have faltered in the third quarter of 2006 is that a range of commodity prices have come under increasing pressure since the spring, in particular weighing on the oil stocks. At $58/Brent, the oil price is at its lowest level in 6 months and has for the first time in years fallen below Citigroup's own forward 12-month oil price forecast.

  However, it must be remembered that Citigroup's analysts remain relatively positive on the commodity price outlook, forecasting only a moderate fall in copper and nickel, a modest rise in gold and silver, and essentially unchanged oil prices from here. If this holds true then the outlook for commodity names is unlikely to be dire.

- **M&A: more to come.** Although the M&A premium that we see European investors assigning to European stocks does not appear to be priced into CEEMEA small-caps, this may yet prove a factor. As we have highlighted in the past, corporates remain cash-rich, while M&A into emerging markets remains a growing trend. Recent examples of stocks that have seen some added share price “zip” from M&A include Pliva’s takeover bids from Barr/Actavis, Finansbank’s acquisition by NBG and even, to a lesser extent, Cersanit’s acquisition of Opoczno (where we see more upside to come).

- **The risk: liquidity crunch.** A key risk to a bullish call on small caps would come from a major sell-off in CEEMEA. As experienced repeatedly in the early part of the decade, and occasionally since 2003, periods of sharp market declines in CEEMEA tend to augur difficult times for the small stocks that due to their lower liquidity often see outsized downward moves.

- However we are less concerned about this occurring than we might have been in the past, for two primary reasons. First, the growth of the asset class means that the smaller names are somewhat larger and more liquid than they used to be (Figure 18); moreover, the growth of a “captive” domestic investor base in many markets means that a broader base of potential buyers is likely to be available in a scenario where foreigners decide to become aggressive sellers (due to a rise in risk aversion or tightening of global liquidity). This does not mean that small caps will not decline in value in such a scenario, but they may fall by less than they would have previously. The second reason we are less concerned is that a scenario of sharp withdrawal of liquidity looks relatively unlikely to us.

Top small-cap picks

- To those readers who see the logic of our small-cap story, what would we recommend? Figure 3 maps out our preferred CEEMEA stocks with market cap less than $5 billion.

Figure 3. Recommended Small-Caps in CEEMEA

Company	Country	Sector	RIC		Price	Target Price	M Cap US$m	Rating	PE 06E	PE 07E	EPS Growth 06E	EPS Growth 07E	Perf. (LC) -3m	Perf. (LC) -12m
Zentiva	Czech Rep	Pharmaceuticals	ZNTVsp.PR	Kc	1,160	1,600	1,973	1H	18.8	15.0	25%	25%	30%	14%
MobiNil	Egypt	Telecoms	EMOB.CA	£	151.9	220.0	2,647	1M	10.4	10.1	14%	4%	18%	-24%
Vodafone Egypt	Egypt	Telecoms	VODE.CA	£	97.68	133.0	4,085	1L	10.9	10.2	39%	7%	19%	2%
Tallink	Estonia	Shipping	TAL1T.TL	KR	62.77	93.63	700	1H	7.3	4.0	72%	80%	12%	
Gedeon Richter	Hungary	Pharmaceuticals	GDRB.BU	Ft	44,450	60,000	3,828	1M	15.8	13.8	30%	15%	19%	23%
Magyar Telekom	Hungary	Telecoms	MTEL.BU	Ft	887.0	1,050	4,275	1M	10.6	9.6	8%	11%	6%	-15%
Hikma	Jordan	Pharmaceuticals	HIK.L	£	4.05	5.00	1,287	1H	11.2	8.4	37%	34%	15%	
BZ WBK	Poland	Banks	BZWB.WA	Zl	191.0	218.0	4,479	1M	18.2	14.8	49%	23%	12%	62%
LPP	Poland	Retail	LPPP.WA	Zl	690.0	680.0	286.4	1H	34.6	23.2	-15%	49%	45%	-25%
Opoczno	Poland	Building materials	ZNTVsp.PR	Zl	37.40	45.00	209.0	1M	25.1	13.8	n/m	82%	21%	-17%
PGF	Poland	Pharmaceuticals	MDIC.WA	Zl	72.00	75.00	283.2	1L	13.6	13.5	25%	1%	17%	33%
Prokom	Poland	IT Services	PKMD.WA	Zl	134.00	155.00	590.3	1M	16.5	14.9	28%	11%	9%	11%
Softbank	Poland	IT Services	SOBK.WA	Zl	41.20	52.90	333.4	1M	12.8	11.8	65%	9%	15%	19%
Mechel	Russia	Metals	MTL.N	$	21.05	26.90	2,829	1M	10.8	11.4	-31%	-5%	5%	-36%
Novoship	Russia	Shipping	NOMPI.RTS	$	1.78	2.35	669.9	1H	3.8	5.4	-38%	-30%	16%	-6%
Wimm Bill Dann	Russia	Foods	WBD.N	$	45.04	60.00	1,982	1H	26.8	18.0	144%	49%	32%	152%
Edgars	South Africa	Retail	ECOJ.J	R	29.10	38.00	2,163	1M	8.1	7.1	18%	14%	-3%	-9%
JD Group	South Africa	Retail	ZNTVsp.PR	R	64.84	111.0	1,516	1M	7.4	6.4	17%	14%	-5%	-12%
Liberty Group	South Africa	Insurance	LGLJ.J	R	71.81	84.69	2,630	1M	11.0	10.4	-2%	7%	-2%	12%
Metropolitan	South Africa	Insurance	METJ.J	R	12.45	14.40	954.1	1M	12.3	11.0	6%	12%	8%	10%
Truworths	South Africa	Retail	TRUJ.J	R	23.31	29.00	1,478	1M	12.1	10.4	19%	16%	8%	15%
Oriflame	Sweden	Consumer	ORIsdb.ST	SKr	238.0	320.0	1,937	1H	136	121	15%	12%	-1%	15%
Ford Otosan	Turkey	Automotive	FROTO.IS	$	6.96	11.84	2,441	1M	7.9	7.8	5%	1%	5%	6%
Petrol Ofisi	Turkey	Oil & Gas	PTOFS.IS	$	3.35	5.46	1,397	1H	9.0	6.4	-3%	41%	-27%	12%
Tofas	Turkey	Automotive	ZNTVsp.PR	$	2.76	4.00	1,378	1H	19.5	22.0	-33%	-12%	20%	72%
Trakya Cam	Turkey	Building materials	TRKCM.IS	$	2.61	4.32	765	1M	9.0	7.1	52%	27%	24%	-6%
Peter Hambro Min	UK	Metals	POG.L	£	10.49	18.00	1,619	1H	22.7	13.5	209%	68%	-9%	35%

Source: dataCentral

Latin America & CEEMEA Sector and Stock Selection

Company	RIC	Mkt	Date Added	Price Added	Price 28Sep06	Perf Since Added (%)	Perf YTD (%)	Rating	Price Target	EPSG (%)	P/E	P/B	ROE (%)	Div Yld (%)	Portfolio Wght (%)
Consumer Discretionary (+75 bps Overweight, MSCI LatAm Weight: 5.7%)															**6.4**
Grupo Televisa	TV	Mexico	31 Oct 03	9.69	21.13	118.1	5.0	1M	26.00	23.7	17.4	4.0	23.0	0.3	3.2
Homex	HOMEX.MX	Mexico	21 Oct 05	52.28	69.47	32.9	27.3	1M	87.00	52.9	14.1	3.1	21.7	0.0	3.2
Consumer Staples (+607 bps Overweight, MSCI LatAm Weight: 11.8%)															**17.9**
Fomento Econ Mex	FMX	Mexico	4 Aug 05	69.05	96.98	40.4	33.7	1M	114.25	4.2	20.3	2.3	11.5	0.8	6.4
Natura	NATU3.SA	Brazil	6 Jan 06	23.60	26.13	10.7	26.9	1M	31.00	19.2	23.7	16.5	69.3	3.4	3.8
Cia Bebidas Amer	ABV	Brazil	14 Jul 06	38.71	45.75	18.2	20.2	1M	52.00	77.7	24.3	3.3	13.4	2.9	3.8
Cosan Ind Comer	CSAN3.SA	Brazil	29 Sep 06	16.49	16.49	0.0	69.7	1S	50.00	NA	NA	NA	NA	NA	3.8
Energy (+283 bps Overweight, MSCI LatAm Weight: 16.2%)															**19.0**
TENARIS	TS	Argentina	3 Mar 06	36.75	35.90	-2.3	56.8	1H	54.00	47.4	11.3	4.3	38.5	3.0	1.8
Petrobras-A	PBRa	Brazil	14 Jul 06	79.85	74.81	-6.3	16.2	1H	91.00	43.5	5.8	1.8	30.6	3.7	17.2
Financials (-1395 bps Underweight, MSCI LatAm Weight: 14.0%)															**0.0**
Health Care (-18 bps Underweight, MSCI LatAm Weight: 0.2%)															**0.0**
Industrials (-126 bps Underweight, MSCI LatAm Weight: 7.0%)															**5.7**
Copa Airlines	CPA	Panama	25 Aug 06	27.78	33.91	22.1	24.2	1H	42.00	28.6	13.6	4.3	31.2	0.6	1.9
GOL	GOL	Brazil	23 Sep 05	16.13	34.96	116.7	23.9	1M	43.00	81.8	17.3	6.1	35.1	1.2	1.9
Information Technology (Marketweight, MSCI LatAm Weight: 0.0%)															**0.0**
Materials (+219 bps Overweight, MSCI LatAm Weight: 23.2%)															**25.4**
Cemex SA de CV	CX	Mexico	1 Apr 05	17.92	30.11	68.0	4.4	1L	42.00	-43.0	8.7	1.8	20.5	3.8	9.6
Suzano Papel	SUZB5.SA	Brazil	15 May 06	13.00	14.72	13.2	25.1	1H	23.50	-18.6	10.4	1.0	9.5	3.0	7.2
Aracruz Celulose	ARA	Brazil	2 Jun 06	53.35	50.80	-4.8	27.0	1M	65.00	21.5	12.6	3.4	26.7	3.3	7.2
Buenaventura	BVN	Peru	31 Mar 06	24.69	27.54	11.5	-2.7	1H	34.00	64.8	7.8	2.7	34.9	1.7	1.5
Utilities (+168 bps Overweight, MSCI LatAm Weight: 5.7%)															**7.4**
Enersis	ENI	Chile	28 Apr 06	12.21	13.15	7.7	19.7	1M	19.00	485.6	11.1	1.5	13.6	1.6	7.4
Telecommunication Services (+188 bps Overweight, MSCI LatAm Weight: 16.3%)															**18.2**
Telesp	TSP	Brazil	11 Aug 06	22.80	22.59	-0.9	10.5	1M	25.00	14.2	9.3	2.7	28.5	11.9	8.6
America Movil	AMX	Mexico	2 Jun 06	34.58	39.01	12.8	33.3	1M	50.00	30.9	18.3	6.8	37.2	0.6	9.6
Total										**57.3**	**12.7**	**3.7**	**27.7**	**3.2**	**100.0**

Source: Datastream and Citigroup Investment Research

This page intentionally left blank.

QUANTITATIVE

Keith L. Miller
Head of Global Quantitative Research
+1-212-816-2285
keith.l.miller@citigroup.com
New York

Manolis Liodakis, PhD
Global Quantitative Strategist
+44-207-986-3958
manolis.liodakis@citigroup.com
London

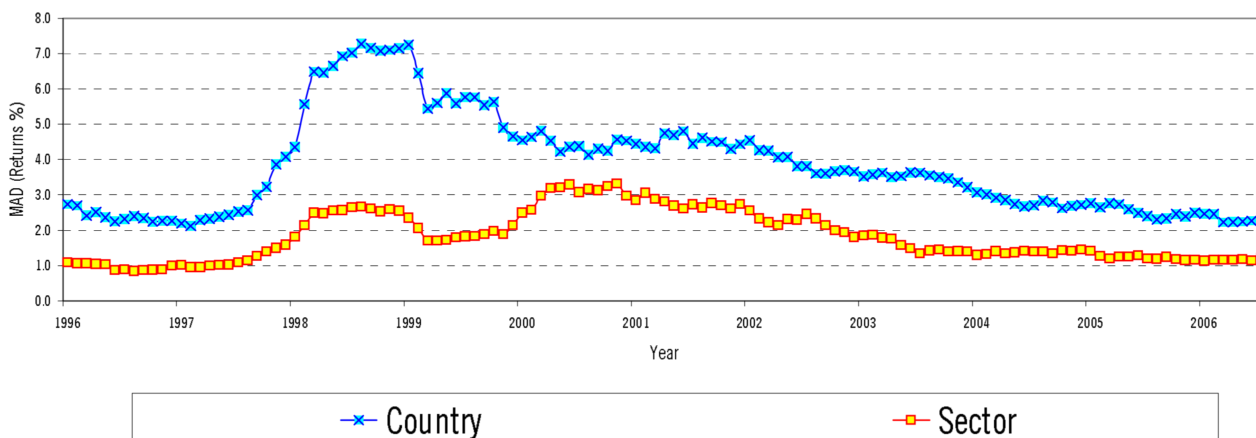
Global Quantitative Angles

Country vs. Sector Effects: The Continued Relevance of Country-Based Investing in Asia

These comments are based on "Country vs. Sector Effects" by Paul Chanin, 13 September 2006

- Country effects dominate — Active country positions in Asia have greater potential to add value and diversify risk than similarly-sized active positions across sectors.
- …suggesting country idiosyncrasies persist — This underscores that understanding the legal, institutional and regulatory frameworks specific to each country remains essential for security valuation in Asia.
- Country bias: sector overlay — With both country and sector effects important within Asia, we believe a matrix approach to equity research remains the most appropriate. This is the way Citigroup structures its sell-side research and is also, we believe, the best structure for buy-side institutions.
- Maximum rewards declining — The maximum reward available from a correct allocation (country or sector) has declined sharply from the post Asian-crisis/TMT-bubble peaks, and is now comparable to pre-crisis levels. This maximum reward is consistent with levels currently seen in Europe - although in Europe, sector effects dominate country effects.
- Market segmentation — Country effects dominate, but a declining contribution of the country factor over time suggests that regional equity markets are becoming less segmented than previously.

Figure 1. Monthly Returns – Relative Rewards Available to Country and Industry Investing in the Asia Pacific ex-Japan



Source: Citigroup Investment Research

Asian Drivers – Focus on Energy

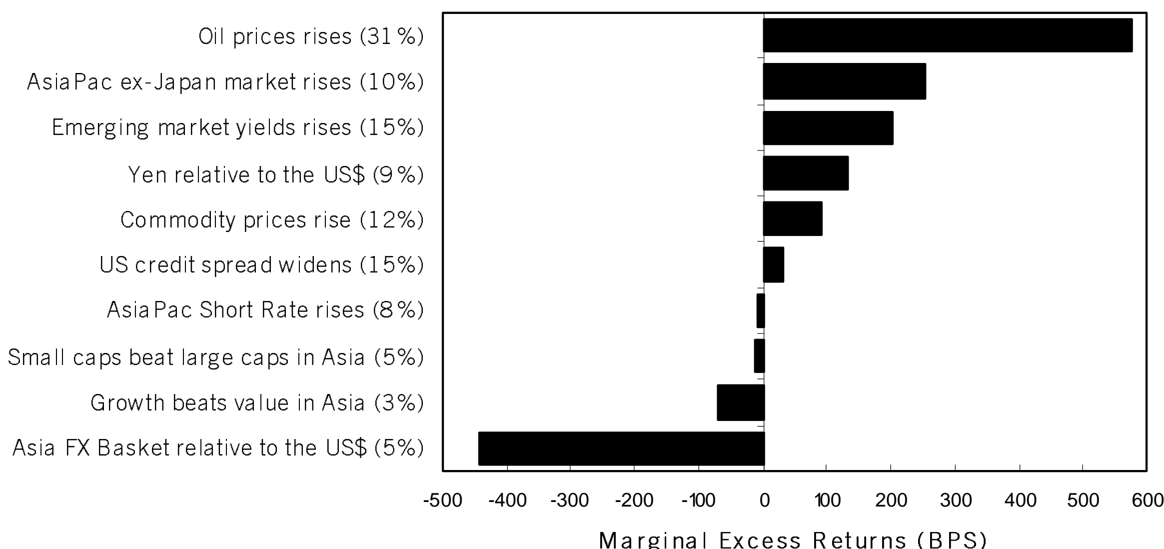
These comments are based on "Asian Drivers – Sector Focus" by Paul Chanin, 13 September 2006

Bottom-up View: Attractive — Energy maintains its position in the Attractive quadrant with support from relative value, strong long-term price momentum, and positive earnings revisions. Energy remains one of our top-ranked sectors, falling just one spot to #3.

Scenario Analysis: Oil Exposure — The dominant macro-risk for Energy stocks comes from oil. If oil continue its recent declines, the sector will likely underperform. Consistent with our belief that high oil prices are usually a likely adjunct to a healthy global economy, we also expect the Asian Energy sector to do well in an environment of rising equity markets and when broader commodity prices rise. Please see Figure 1 below.

What's Working – Resurgence of Value Investing — The last three months have seen a resurgence in the usefulness of valuation strategies in the Energy sector: the best-performing strategies over this period have been the Radar relative value model, with a return of 11.5%; Dividend Yield, with a return of 10.8%; and Trailing P/E, with a return of 10.5%. Figure 2 below shows the top ten stocks for each factor category within the Energy sector.

Figure 1. Scenario Analysis – Energy vs. Region ex Japan



Source: Smith Barney and Standard & Poor's

Figure 2. Scenario Analysis – Energy vs. Region ex Japan

Trailing P/E				Div Yield				%Price Change 12 M			
Name	Sedol	MCap	Value	Name	Sedol	MCap	Value	Name	Sedol	MCap	Value
SK Corp	698837	7,118	4.8	Formosa P'Chem Corp	671871	2,905	7.2	Paladin Res	666846	1,838	205.5
Thai Oil	B0300P	1,324	5.5	S-Oil Corp	640605	2,815	6.2	CNPC HK	634007	1,307	157.8
Oil Search	665760	2,431	5.7	Thai Oil	B0300P	1,324	5.7	Reliance	609962	16,425	107.8
CNPC HK	634007	1,307	5.9	Petrochina	622657	23,399	4.3	Worleyparsons	656247	1,955	89.7
PTT	642038	5,269	6.8	PTT	642038	5,269	4.1	China Shenhua Energy	B09N7M	6,014	59.1
Yanzhou Coal Mining	610989	1,383	7.3	Oil & Natural Gas Corp	613936	5,171	3.7	Australian Worldwideexp	600384	1,113	42.8
GS Corp	B01RJV	1,485	7.6	Santos	677670	5,091	3.6	Petrochina	622657	23,399	40.3
Santos	677670	5,091	8.2	CNOOC	B00G0S	12,726	3.2	China Petroleum	629181	9,991	36.2
S-Oil Corp	640605	2,815	8.5	GS Corp	B01RJV	1,485	3.2	GS Corp	B01RJV	1,485	35.5
China Petroleum	629181	9,991	9.7	PTTExp & Production	B1359K	3,132	3.1	Caltex Australia	616150	2,360	32.3

Source: Smith Barney and Standard & Poor's

GLOBAL

Priscilla Luk
Hong Kong

Ajay Kapur, CFA
1-212-816-4813
ajay.kapur@citigroup.com
U.S.

Hao Hong, CFA
1-212-816-1180
hao.hong@citigroup.com
U.S.

Fund Flows and Proprietary Models

Weekly U.S. Mutual Fund Flows

➤ U.S. All-Equity Funds Struggled to Maintain Positive Inflows

U.S. All-Equity funds had a net outflow of US$395mn on a four-week moving average basis, still struggling to consistently attract inflows. Meanwhile, US$548mn of inflow was added to taxable bond funds last week, again on a four-week moving average basis.

➤ Appetite for High-Risk Equity Funds Remained Subdued

High-yield corporate debt funds saw a net outflow of US$20mn last week and US$138mn exited aggressive growth equity funds, both on a four-week moving average basis.

➤ International and Global Flows Continued to Recover

International equity funds reported a net inflow of US$403mn on a four-week moving average basis. Meanwhile, global equity funds recorded a net inflow of US$55mn. However, investors shied away from putting money into dedicated Emerging Markets equity, Japanese equity and Latin America equity funds.

➤ Risk-Love and Asset-Price-Based Global Growth Indicator

U.S. Risk-Love is slowly climbing in the valley of distress. In Japan, Risk-love is neutral but in Europe it stays close to euphoria. Sentiment in the Emerging Markets also remains elevated near the euphoria zone. The asset-price-based global growth indicator is near its long-term average, suggesting moderate global growth ahead.

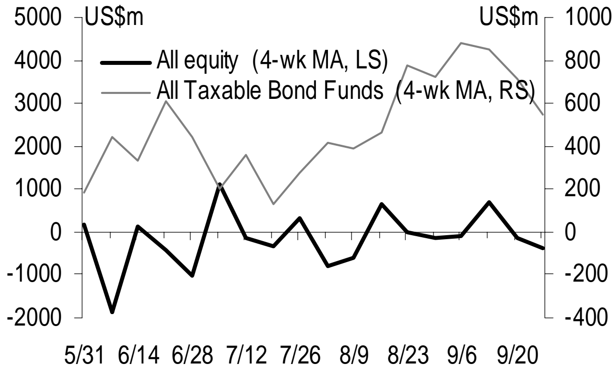
Figure 1. U.S. Mutual Fund Flows for Weekly Reporters

	4-Wk Avg.	Cumulative Net Flows for the Period (US$ Mils)					Total Asset (US$ Bils)	
Category	Ended 27Sep06	2003	2004	2005	Jan-Sep 05	Jan-Sep 06	Weekly Reporters	All Reporters*
All Equity	**-394.7**	**52,932**	**92,081**	**70,295**	**52,814**	**51,545**	**2,503.1**	**4,831.1**
Global Equity	54.6	-1,955	8,344	7,255	6,370	5,181	132.2	286.4
International Equity	402.5	14,813	35,430	49,360	34,393	40,685	429.4	814.0
Japanese Equity	-39.1	1,885	3,429	5,118	1,524	1,391	17.8	31.8
European Equity	48.3	-934	874	1,038	806	3,792	17.5	146.8
Asia/Pacific ex-Japan Equity	1.5	1,548	1,582	2,804	1,388	4,247	16.0	25.9
Latin America Equity	-44.4	188	65	2,026	979	1,385	7.0	9.9
Emerging Markets Equity	-175.1	4,775	5,816	15,917	9,727	10,354	82.2	121.3
Emerging Markets Debt	5.2	890	212	581	414	234	3.5	8.3
U.S. Aggressive Growth Equity	-137.6	12,189	9,910	8,640	3,334	4,513	278.4	492.9
All Taxable Bonds	**547.7**	**43,156**	**6,229**	**8,004**	**9,489**	**18,597**	**646.5**	**1,442.2**
U.S. Corp. High Yield Debt	-19.7	20,142	-3,237	-11,593	-9,819	-3,240	73.8	121.0
All Money Market	**4,550.3**	**-221,634**	**-122,006**	**89,597**	**-13,137**	**142,698**	**2,090.7**	**2,176.1**

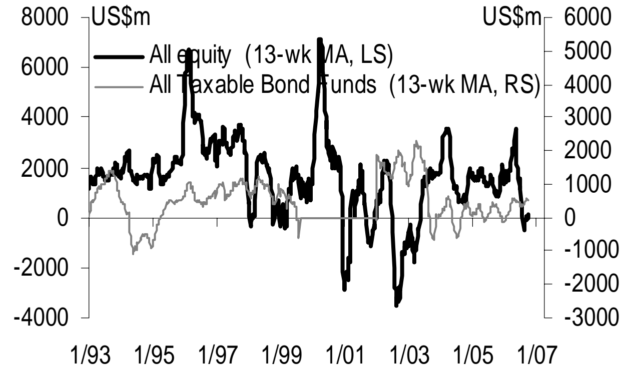
*Include monthly reporters. Source: AMG Data Services

Weekly US Mutual Fund Flows

Figure 2. Flows Into US All Equity and All Taxable Bond Funds

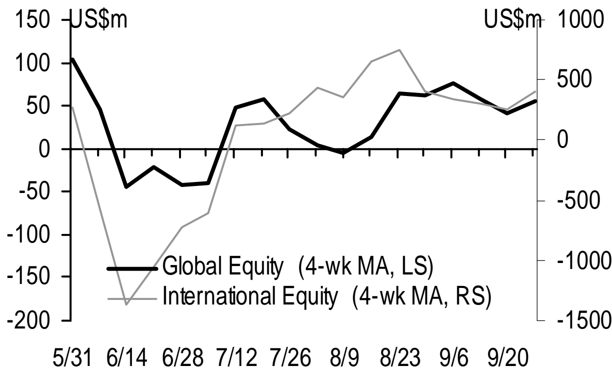


Source: AMG Data Services

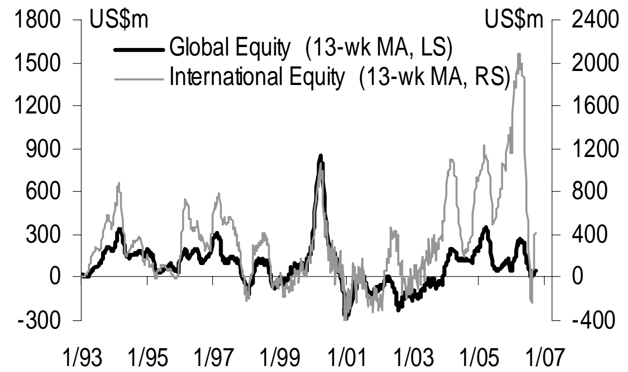


Source: AMG Data Services.

Figure 3. Flows Into International and Global Equity Funds

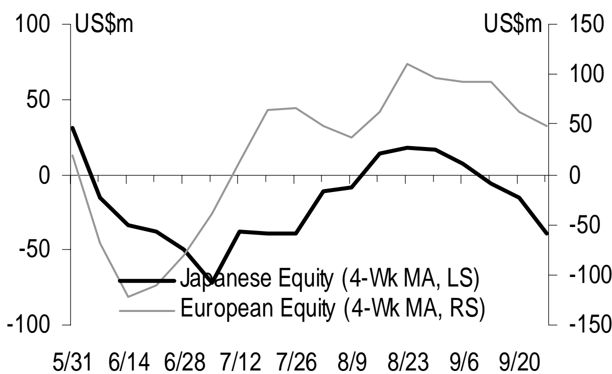


Source: AMG Data Services.

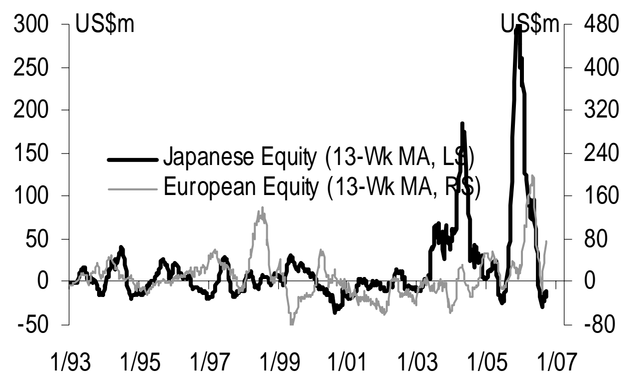


Source: AMG Data Services.

Figure 4. Flows Into Japanese and European Equity Funds

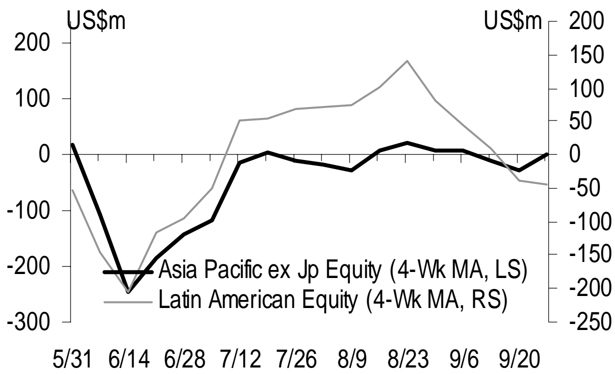


Source: AMG Data Services.

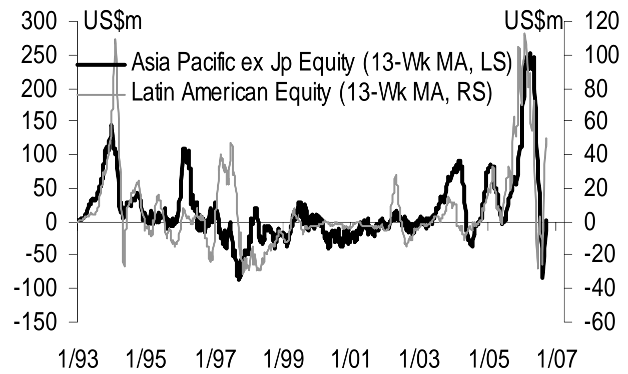


Source: AMG Data Services.

Figure 5. Flows Into Asia/Pacific ex-Japan and Latin American Equity Funds

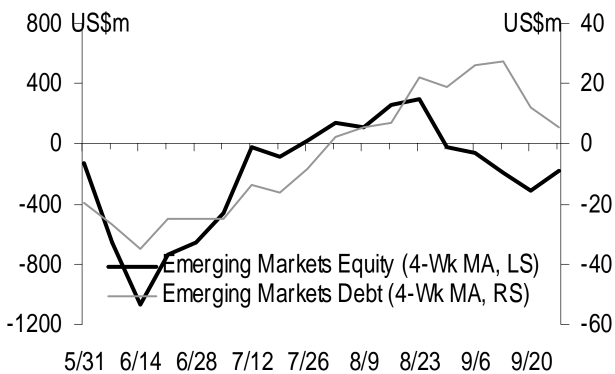


Source: AMG Data Services.

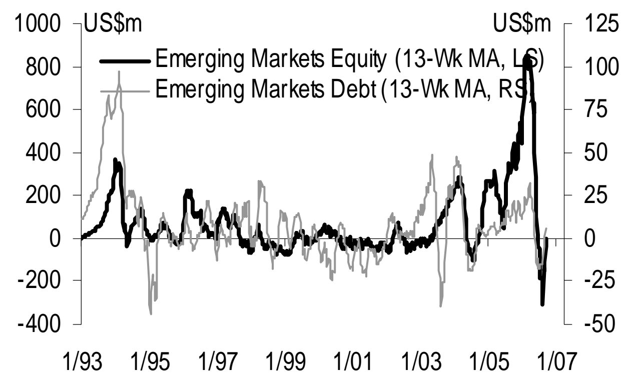


Source: AMG Data Services.

Figure 6. Flows Into Emerging Market Equity and Debt Funds

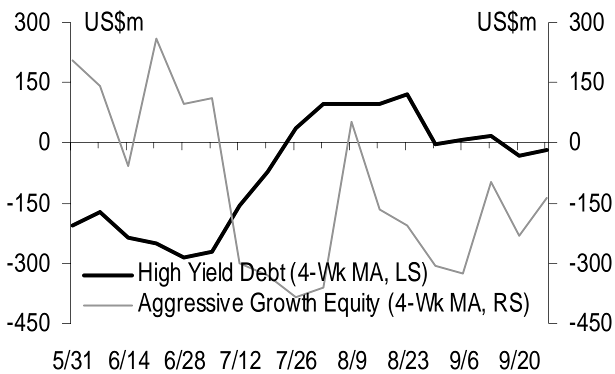


Source: AMG Data Services

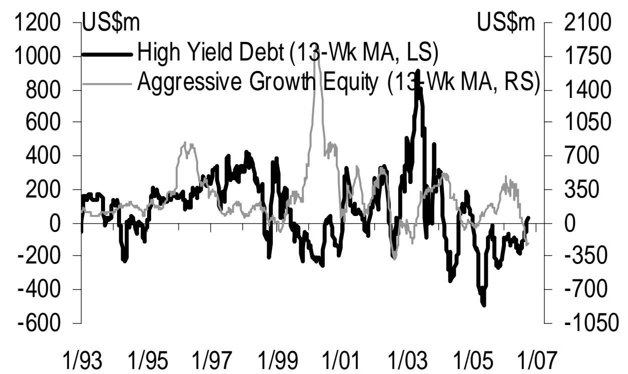


Source: AMG Data Services.

Figure 7. Flows Into US Aggressive Growth Equity and High-Yield Debt Funds



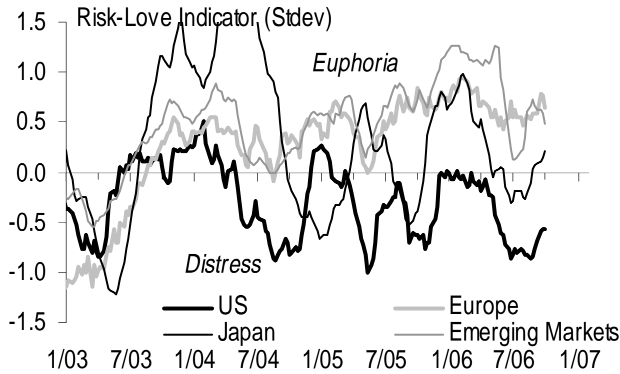
Source: AMG Data Services.



Source: AMG Data Services.

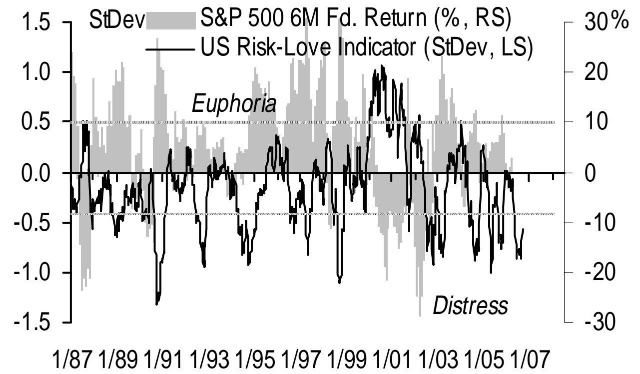
Investor Risk-Love (Sentiment)

Figure 8. Risk-Love Indicators, 2003-2006 Year-to-Date



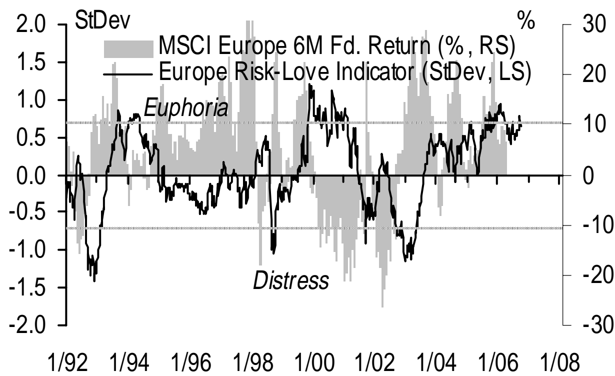
Source: Citigroup Investment Research and MSCI

Figure 9. US Risk-Love Indicator*



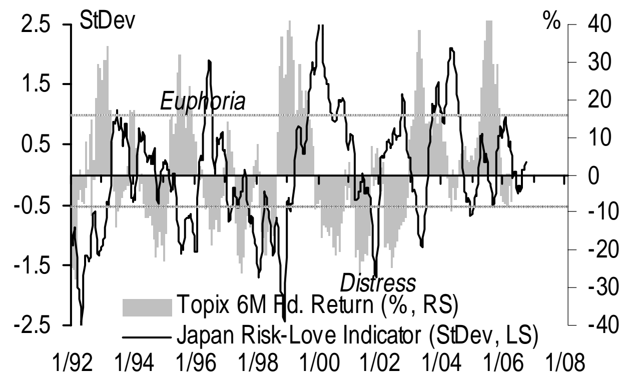
Source: Citigroup Investment Research and MSCI

Figure 10. Europe Risk-Love Indicator



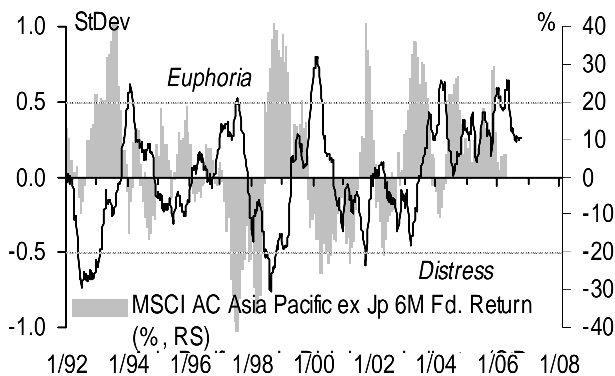
Source: Citigroup Investment Research and MSCI

Figure 11. Japan Risk-Love Indicator



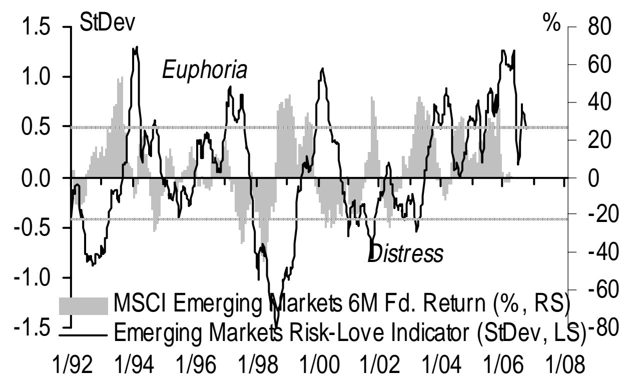
Source: Citigroup Investment Research and MSCI

Figure 12. Asia Pacific ex-Japan Risk-Love Indicator



Source: Citigroup Investment Research and MSCI

Figure 13. Emerging Markets Risk-Love Indicator



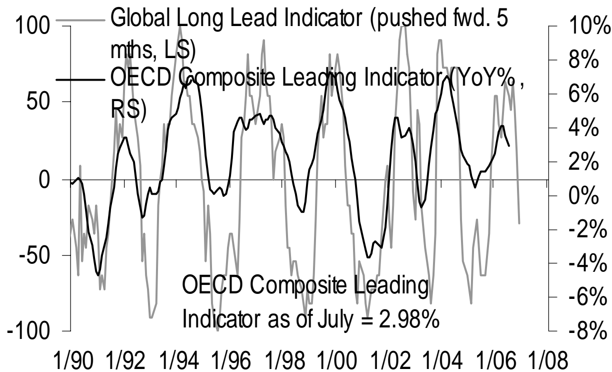
Source: Citigroup Investment Research and MSCI

*Also refer to US strategist Tobias M. Levkovich's "Other P/E Indicator", which tracks US sentiment.

Risk-love is a proprietary contrarian indicator which looks at fund flows, spreads, opinion polls on the market, derivatives data, among others, to measure investor sentiment

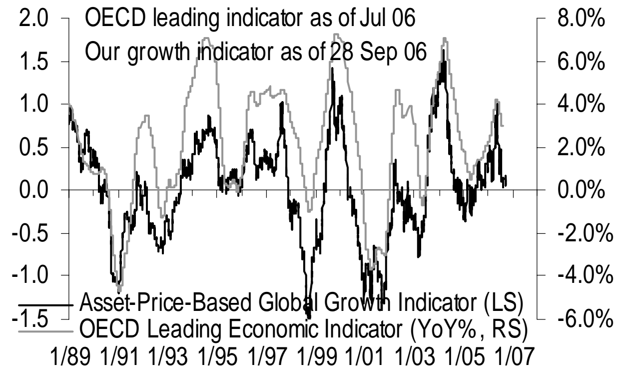
Investor Risk-Love (Sentiment)

Figure 14. Global Long Lead Indicator (MOMLI)*



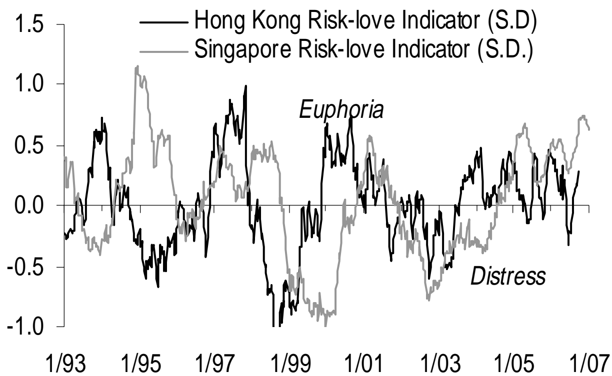
Source: Citigroup Investment Research and Datastream

Figure 15. Asset-Price Based Global Growth Indicator**



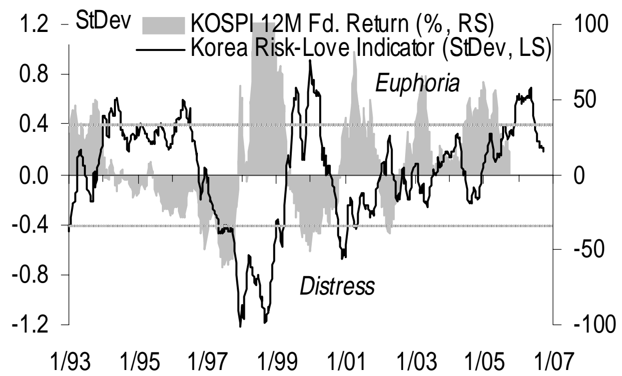
Source: Citigroup Investment Research and Datastream

Figure 16. Hong Kong and Singapore Risk-Love Indicators



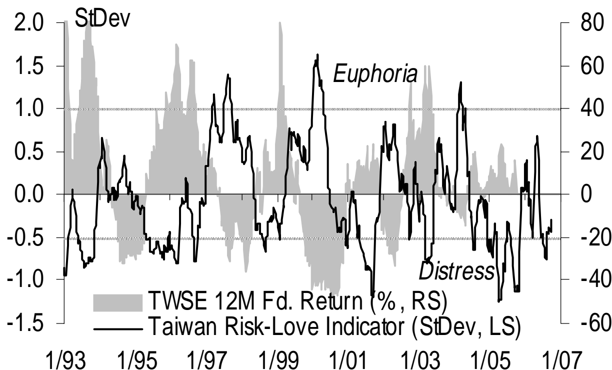
Source: Citigroup Investment Research and Datastream

Figure 17. Korea Risk-Love Indicator



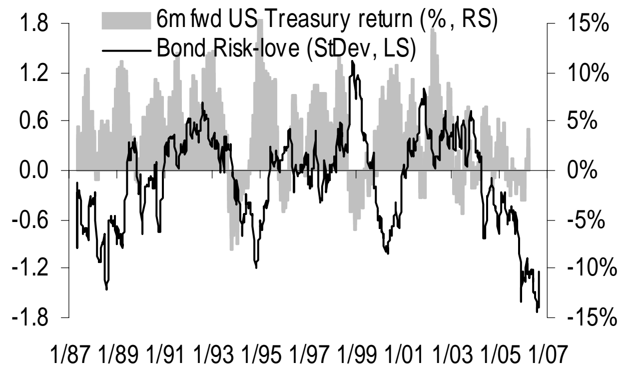
Source: Citigroup Investment Research and Datastream

Figure 18. Taiwan Risk-Love Indicator



Source: Citigroup Investment Research and Datastream

Figure 19. U.S. Bond Risk-Love – U.S. Banks Tend to Do Well on a Six-Month Forward Basis When U.S. Bond Risk Love Is Low and Rising, As Now



Source: Citigroup Investment Research and Datastream

*MOMLI (Global Long Lead Indicator) is our proprietary model to track global economic growth. It leads the official OECD composite leading economic indicator by five months.

**Asset-Price-Based Global Growth Indicator is a proprietary real time indicator of what financial markets are pricing in about impending global growth.

Global Market Intelligence by Country

9/28/2006	Free MC US$m	P/E 05E	P/E 06E	P/E 07E	EPS YoY % 05E	EPS YoY % 06E	EPS YoY % 07E	P/B 06E	ROE 06E	Div Yld 06E	EV/ Sales 05	EV/ EBITDA 05	Weekly Perf %	YTD Perf %
Global*	**27,035,308**	**16.8**	**14.9**	**13.6**	**18.3**	**14.2**	**9.8**	**2.4**	**15.8**	**2.4**	**1.7**	**9.1**	**1.1**	**9.5**
North America	**13,369,936**	**17.8**	**15.7**	**14.2**	**16.3**	**15.5**	**11.0**	**2.7**	**16.8**	**2.0**	**1.9**	**10.1**	**1.7**	**7.0**
United States	12,461,920	17.9	15.8	14.3	15.8	15.6	10.8	2.7	16.8	2.0	1.9	10.1	1.6	6.8
Canada	908,016	16.6	14.6	12.8	25.5	13.7	14.9	2.5	17.3	2.3	2.1	9.2	2.8	10.0
Europe	**7,979,230**	**15.0**	**13.4**	**12.4**	**17.0**	**12.3**	**8.0**	**2.3**	**16.8**	**3.1**	**1.5**	**8.2**	**0.5**	**17.5**
United Kingdom	2,790,040	14.1	12.6	11.9	12.9	11.9	6.5	2.4	18.2	3.4	1.5	7.7	0.1	15.6
France	1,161,080	14.6	13.0	12.1	25.7	9.6	7.7	2.1	15.9	3.0	1.4	8.0	0.6	19.6
Switzerland	827,005	19.4	16.1	14.6	13.1	20.4	9.9	2.9	18.1	2.1	2.6	14.5	0.7	17.1
Germany	825,522	14.7	13.6	12.2	20.4	12.3	9.4	1.7	12.9	2.8	1.0	7.1	0.3	16.2
Netherlands	407,268	13.9	13.7	12.6	1.1	1.6	8.8	2.3	16.9	3.1	1.3	10.5	0.8	19.8
Italy	447,211	14.3	13.1	12.1	38.7	9.1	8.4	2.1	15.6	4.3	2.0	6.4	0.0	15.0
Spain	468,890	16.5	13.9	12.8	18.7	18.6	8.7	2.9	20.9	3.4	2.1	8.2	3.3	27.7
Sweden	283,312	15.9	14.1	13.4	20.7	12.8	5.7	2.5	17.6	3.3	1.7	9.9	-0.5	17.6
Finland	166,247	18.3	15.3	13.4	7.2	19.5	14.1	2.8	18.4	3.2	1.4	10.7	1.6	15.3
Belgium	143,769	13.2	12.3	11.8	14.5	6.1	4.6	1.9	15.8	3.3	1.2	9.0	0.4	20.9
Ireland	96,863	14.2	12.6	11.6	15.1	15.1	10.4	2.4	18.9	2.6	1.5	10.7	-0.1	22.9
Japan	**2,741,553**	**20.5**	**18.7**	**17.1**	**41.8**	**14.5**	**10.5**	**1.9**	**10.0**	**1.1**	**1.2**	**8.9**	**0.4**	**-0.2**
Asia Pacific ex Jp	**1,999,147**	**15.3**	**13.8**	**12.7**	**10.8**	**11.3**	**9.5**	**2.1**	**14.7**	**3.2**	**1.8**	**8.5**	**0.3**	**11.7**
Australia	604,736	16.9	14.4	13.3	20.7	17.4	8.0	2.6	17.9	4.1	2.5	11.5	1.1	9.4
Korea	356,264	11.4	11.5	10.1	2.5	-5.9	15.8	1.7	13.7	2.0	0.9	6.3	0.5	6.6
Hong Kong	196,866	17.1	15.4	16.5	16.2	9.7	-6.8	1.7	10.7	3.1	3.9	11.2	-1.3	11.2
Taiwan	265,194	15.0	13.7	12.0	-0.4	24.5	17.0	2.0	14.1	3.7	1.6	8.8	-0.4	3.6
China	191,635	15.0	13.4	12.4	17.1	16.2	8.3	2.3	16.8	2.7	1.8	6.7	-0.5	31.0
Singapore	97,993	17.5	14.5	14.2	7.9	18.8	3.1	1.9	12.8	3.6	2.7	11.9	1.1	15.8
India	135,418	23.2	19.2	17.0	27.9	15.5	13.3	4.6	22.9	1.3	3.0	13.1	0.9	27.6
Global EM	**2,027,851**	**14.2**	**12.6**	**11.3**	**16.2**	**13.5**	**11.9**	**2.1**	**16.1**	**2.7**	**1.7**	**7.4**	**0.8**	**10.5**
EM (Non-Asia)	**945,441**	**14.3**	**12.0**	**10.8**	**31.2**	**20.2**	**9.9**	**2.2**	**17.6**	**2.7**	**2.1**	**7.5**	**1.6**	**7.6**
South Africa	158,365	15.2	12.5	10.6	25.4	31.5	16.7	2.8	21.8	3.5	1.7	9.4	0.2	-6.7
Brazil	202,381	11.6	9.6	8.1	30.5	12.8	18.3	1.8	14.8	3.8	1.9	6.0	4.5	13.7
Mexico	121,881	16.6	12.7	13.9	36.7	30.8	-8.5	3.1	24.0	1.9	2.3	8.3	0.8	16.6
Israel	55,106	15.9	14.0	13.1	19.8	13.1	6.5	1.9	14.6	2.6	2.7	10.6	1.0	-10.2

*Note: The above data are compiled based on companies in MSCI AC World Index. The market capitalization for regions, markets, and sectors are free-float adjusted. P/E, EPS Growth, P/B, Dividend Yield, and ROE are aggregated from IBES consensus estimates (calendarized to December year-end) with current prices. EV/Sales and EV/Ebitda are aggregated from Worldscope data (EV uses current market capitalization, EBITDA and Sales use 2005 or last reported year before 2005). NM = Not Meaningful; NA = Not Available

Source: Citigroup Investment Research, IBES Consensus, Worldscope, MSCI, and FactSet

Global Market Intelligence by Sector

9/28/2006	Free MC US$m	P/E 05E	P/E 06E	P/E 07E	EPS YoY % 05E	EPS YoY % 06E	EPS YoY % 07E	P/B 06E	ROE 06E	Div Yld 06E	EV/ Sales 05	EV/ EBITDA 05	Weekly Perf %	YTD Perf %
Global*	**27,035,308**	**16.8**	**14.9**	**13.6**	**18.3**	**14.2**	**9.8**	**2.4**	**15.8**	**2.4**	**1.7**	**9.2**	**1.1**	**9.5**
Energy	2,621,662	12.3	10.4	9.9	43.7	17.6	5.6	2.5	23.6	2.3	1.3	5.9	2.8	8.2
Materials	1,672,412	14.5	11.4	10.9	31.7	25.9	4.0	2.1	17.7	2.6	1.6	8.6	1.7	11.9
Capital Goods	2,047,660	19.1	16.2	14.4	31.5	20.6	12.7	2.5	15.4	2.1	1.5	11.1	1.8	7.8
Comm Svc & Supp	203,827	21.8	19.3	16.9	6.2	12.2	14.0	2.8	14.3	2.0	1.3	9.1	1.6	5.5
Transport	512,066	17.9	16.4	14.9	16.9	5.8	9.9	2.3	13.5	2.0	1.7	9.6	1.3	7.6
Autos & Components	562,220	13.3	13.7	12.4	12.8	11.8	17.3	1.6	11.6	2.0	1.0	7.9	0.5	10.0
Consumer Durables	575,854	18.0	17.0	15.2	3.8	13.9	15.6	2.0	11.3	1.6	1.0	8.1	0.9	4.4
Consumer Services	384,637	20.9	20.1	17.6	8.7	3.8	14.1	3.2	14.0	1.9	2.3	11.9	0.7	8.1
Media	750,032	22.0	19.9	17.8	27.7	17.6	19.0	2.0	10.1	1.8	2.5	10.4	1.4	11.3
Retailing	681,837	19.2	17.5	15.3	18.8	11.3	14.5	2.7	15.0	1.7	1.1	9.5	1.8	4.0
Food & Staples Retailing	572,428	21.2	19.4	17.0	4.9	10.9	14.0	2.8	14.8	1.6	0.7	10.5	0.2	10.1
Food Bev & Tobacco	1,226,172	19.5	17.7	16.2	3.5	9.5	9.3	3.7	20.3	2.7	2.0	11.8	-0.6	13.7
Household Products	373,566	23.1	21.9	19.4	6.6	5.4	13.3	3.6	16.1	1.9	3.1	16.1	0.8	12.0
Health Care Equip & Svc	655,728	20.9	19.5	17.0	16.6	8.2	14.8	3.1	15.7	0.6	1.7	13.1	-1.0	-2.6
Pharma & Biotech	1,845,979	19.8	18.3	16.8	10.6	8.9	9.3	3.8	19.1	2.2	4.0	13.0	0.5	11.3
Banks	3,124,640	13.8	12.6	11.5	17.9	10.9	9.4	2.0	16.3	3.3	NA	NA	0.5	11.8
Div Financials	1,925,717	14.7	12.9	12.0	16.0	14.0	7.3	2.1	16.4	2.7	NA	NA	1.0	13.6
Insurance	1,300,502	15.3	12.1	11.4	6.9	32.9	6.4	1.7	14.6	2.1	NA	NA	1.1	8.9
Real Estate	609,859	26.2	25.1	24.1	17.3	3.9	3.6	1.7	6.4	3.0	7.1	14.3	0.7	19.8
Software & Services	929,861	27.2	24.3	20.5	13.9	12.3	19.4	4.8	19.5	0.8	3.6	14.6	1.7	0.8
Tech Hardware & Equip	1,418,490	22.1	19.4	16.6	18.5	15.9	18.6	3.0	14.9	1.1	1.4	10.3	0.9	5.9
Semi & Semi Equip	618,496	20.0	19.1	16.4	3.8	8.3	15.7	2.9	14.9	1.3	2.5	8.6	2.5	-2.8
Telecom	1,273,383	15.0	14.4	13.5	10.3	5.3	6.8	1.9	12.9	3.8	2.4	7.0	0.6	13.2
Utilities	1,148,280	17.3	16.1	14.4	11.6	7.2	11.5	2.1	12.3	3.4	2.1	8.2	1.8	18.8

*Note: The above data are compiled based on companies in MSCI AC World Index. The market capitalization for regions, markets, and sectors are free-float adjusted. P/E, EPS Growth, P/B, Dividend Yield, and ROE are aggregated from IBES consensus estimates (calendarized to December year-end) with current prices. EV/Sales and EV/Ebitda are aggregated from Worldscope data (EV uses current market capitalization, EBITDA and Sales use 2005 or last reported year before 2005). NM = Not Meaningful; NA = Not Available

Source: Citigroup Investment Research, IBES Consensus, Worldscope, MSCI, and FactSet

GLOBAL

Ajay Kapur, CFA
212-816-4813
ajay.kapur@citigroup.com
United States

Global Stock Model Portfolio — Summary Matrix

Global Stock Model Portfolio —Summary Matrix

	U.S.	Europe ex-U.K.	U.K.	Japan	Asia Pac ex-Jp, Emg Mkts	Portfolio Industry Wgt (%)
Energy	Devon, Grant Prideco, Valero (9.0)				Tenaris (2.0)	11.0
Materials						0.0
Capital Goods	Caterpillar (2.0)	MAN (2.0)		Kubota (2.0)		6.0
Comm Serv & Supp						0.0
Transportation						0.0
Autos & Comps				Isuzu Motors, Suzuki Motor (2.0)		2.0
Consumer Durables	Meritage Homes (1.0)	Richemont, LVMH (3.0)				4.0
Consumer Services	Marriott International, McDonald's (1.0)					1.0
Media		MediaSet (2.0)				2.0
Retailing						0.0
Food & Staples Retail		Colruyt (2.0)				2.0
Food Bev & Tobacco	Reynolds American, Archer Daniels (4.0)					4.0
Household Products				Kobayashi Pharma (2.0)		2.0
Health Care Equip & Svc						0.0
Pharma & Biotech	Biotech Basket (7.0)			Tanabe Seiyaku (3.0)		10.0
Banks	Golden West Fin, TCF Financial (6.0)	Commerzbank, BNP Paribas, Societe Generale (5.0)				11.0
Diversified Financials	SLM, Broker/Dealer Basket (7.0)	UBS, Deutsche Bank (4.0)				11.0
Insurance		AXA, Zurich Financial, Allianz AG (6.0)				6.0
Real Estate	iStar Financial (2.0)					2.0
Software & Services	Internet Basket (4.0)					4.0
Tech Hardware & Equip	Tech Networking Basket (8.0)					8.0
Semi & Semi Equip	Semis Basket (4.0)					4.0
Telecom		Telenor (2.0)	BT Group (2.0)		Chunghwa Tel (1.0)	5.0
Utilities	FPL Group (3.0)					3.0
Portfolio Region Wgt (%)	**58.0**	**26.0**	**2.0**	**9.0**	**3.0**	**98.0**
Cash						2.0

Note: Figures in parentheses refer to the total allocated weight in that region and industry group. New additions, if any, shown in bold.
Source: Citigroup Investment Research and Global Equity Strategy

GLOBAL

The Least Preferred Stocks Portfolio

Ajay Kapur, CFA
212-816-4813
ajay.kapur@citigroup.com
United States

The Least Preferred Stocks Portfolio

	Company Names	RIC	Industry Group	Ctry	Rating	Mcap U$m	Date Added	Price Added	Price Sep28	Perf Since Added %	3m Perf %
1	Givaudan	GIVN.VX	Materials	SWITZERLAND	3M	5,768	18Aug06	SwF1,004	SwF1,000.0	-0.4	6.0
2	Rockwell Collins	COL	Capital Goods	US	3M	9364.073	7Jul06	$55.2	$54.6	-1.0	1.0
3	Rentokil	RTO.L	Comm Serv & Supp	UK	3M	4,996	23Feb06	£1.60	£1.47	-8.1	-3.8
4	Alitalia	AZPIa.MI	Transportation	Italy	3H	1442.795	7Jul06	€0.92	€0.82	-10.7	-4.3
5	Fukuyama Trans	9075	Transportation	Japan	3M	930	28Nov05	¥470.0	¥393.0	-16.4	1.3
6	Sanyo Electric	6764	Consumer Durables	Japan	3H	3781.057	23Mar06	¥316.0	¥238.0	-24.7	-1.2
7	Kagome Co Ltd	2811	Food Bev & Tobacco	Japan	3L	1,341	18Aug06	¥1,594	¥1,764	10.7	16.1
8	Takashimaya	8233	Retailing	Japan	3H	4111.738	7Jul06	¥1,399	¥1,480	5.8	3.9
9	Isetan Co Ltd	8238	Retailing	Japan	3M	3,702	7Jul06	¥1,931	¥1,943	0.6	0.5
10	Matalan	MTN.L	Retailing	UK	3M	1439.211	15Sep05	£1.91	£1.88	-1.3	13.9
11	St Jude Medical	STJ	Health Care Equip & Svc	US	3M	12,519	7Jul06	$33.6	$35.5	5.7	12.3
12	Boston Scient	BSX	Health Care Equip & Svc	US	3S	21747.94	23Mar06	$23.5	$14.8	-37.1	-12.9
13	Bankinter	BKT.MC	Banks	Spain	3M	5,524	18Aug06	€54.0	€55.4	2.6	15.9
14	OTE	OTEr.AT	Telecom	Greece	2H	12314.17	12Jan06	€18.5	€19.8	7.0	18.6
15	Shikoku Elec Pwr	9507	Utilities	Japan	3L	5,594	7Jul06	¥2,595	¥2,605	0.4	3.0
16	Kelda Group	KEL.L	Utilities	UK	2L	5706.522	23Feb06	£7.88	£8.50	7.8	12.4

Note: The least preferred stocks portfolio is constructed using quantitative screens (42 factors), input from fundamental analysts and an overlay of our top-down market and sector views.
For details on the screens used, please see The Global Investigator: Short Circuit: Initiating Our Least Preferred Stocks Portfolio", 09/16/05.
At the time of selection, the expected total return of the stocks in this portfolio was below our global equity market expected returns.
The portfolio is rebalanced once a month hence the total expected return of a stock in the portfolio in the interim period may temporarily exceed our global equity market expected returns, currently at 9% to 13% over next 6 to 12 months.
Normally, a stock may be deleted from the least preferred portfolio if it fails to remain in the qualifying deciles of the quantitative screens. There are other reasons for deletion.
A stock will be removed from the portfolio if the fundamental analyst covering the company upgrades it to a Buy or Citigroup Investment Research drops coverage of the company. Also, under a stop-loss rule, if the holding period return (return from its inclusion into the portfolio) of a stock exceeds 30%, we will remove the stock from the least preferred portfolio.
While the portfolio construction takes into account the fundamental analysts' views, it is just one of the many factors that leads to the inclusion of a stock on our least preferred stock list.
Near-term market volatility and short-term trading patterns may cause the Expected Total Return to become temporarily misaligned relative to the hurdle for these stocks' fundamental ratings, as defined under our current system.
A complete list of changes to the Least Preferred Portfolio is available upon request.
Returns are gross of management and transaction fees.
Past performance is not an indicator of future results.
Last rebalanced September 29, 2006.
Source: Citigroup Investment Research

Notes

Analyst Certifications: For each company mentioned in this compendium report, the respective analyst (or analysts) who cover the company (companies) certifies that all of the views expressed in this research report accurately reflect the analyst's (or analysts') personal views about any and all of the subject issuer(s) or securities. The analyst (or analysts) also certify that no part of the analyst's compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.

Morgan Stanley Capital International Inc.'s ("MSCI") MSCI Standard Index Series section of the MSCI Web Site contains documents regarding the MSCI Standard Index Series (collectively, along with any other information on this MSCI Standard Index Series section of the MSCI Web Site, "MSCI Standard Index Series Materials"). The MSCI Standard Index Series Materials have been prepared solely for informational purposes. None of the MSCI Standard Index Series Materials are a recommendation to participate in any particular trading strategy and none may be relied on as such. The user of the information contained in the MSCI Standard Index Series Materials assumes the entire risk of any use made of the information provided therein.

Neither MSCI, its affiliates, nor any other party involved in making or compiling any of MSCI's indices, makes any express or implied warranties or representations with respect to the information contained in the MSCI Standard Index Series Materials (or the results to be obtained by the use thereof), and MSCI, its affiliates, and any other party involved in making or compiling any of MSCI's indices, hereby expressly disclaims all warranties of originality, accuracy, completeness, merchantability or fitness for a particular purpose with respect to any of this information. Without limiting any of the foregoing, in no event shall MSCI, its affiliates, or any other party involved in making or compiling any of MSCI's indices, have any liability relating to the MSCI Standard Index Series Materials for any direct, indirect, special, punitive, consequential or any other damages (including lost profits) even if notified of the possibility of such damages.

The MSCI Standard Index Series Materials may not be reproduced or redisseminated in any form without prior written permission from MSCI. You may not use or permit use of any information in the MSCI Standard Index Series Materials to verify or correct data in any compilation of data or index. Also, you may not use or permit anyone else to use any information in the MSCI Standard Index Series Materials in connection with the writing, trading, marketing or promotion of any financial instruments or products or to create any indices (custom or otherwise).

IMPORTANT DISCLOSURES

Analysts' compensation is determined based upon activities and services intended to benefit the investor clients of Citigroup Global Markets Inc. and its affiliates ("the Firm"). Like all Firm employees, analysts receive compensation that is impacted by overall firm profitability, which includes revenues from, among other business units, the Private Client Division, Institutional Equities, and Investment Banking.

For important disclosures regarding the companies that are the subject of this Citigroup Investment Research product ("the Product"), please contact Citigroup Investment Research, 388 Greenwich Street, 29th Floor, New York, NY, 10013, Attention: Legal/Compliance. In addition, the same important disclosures, with the exception of the Valuation and Risk assessments, are contained on the Firm's disclosure website at www.citigroupgeo.com. Private Client Division clients should refer to www.smithbarney.com/research. Valuation and Risk assessments can be found in the text of the most recent research note/report regarding the subject company.

Citigroup Investment Research Ratings Distribution

Data current as of 30 June 2006	Buy	Hold	Sell
Citigroup Investment Research Global Fundamental Coverage (2754)	46%	39%	15%
% of companies in each rating category that are investment banking clients	45%	43%	34%
Citigroup Investment Research Quantitative World Radar Screen Model Coverage (5493)	31%	41%	29%
% of companies in each rating category that are investment banking clients	29%	26%	22%
Citigroup Investment Research Quantitative Decision Tree Model Coverage (337)	45%	0%	55%
% of companies in each rating category that are investment banking clients	44%	0%	43%
Citigroup Investment Research Quantitative European Value & Momentum Screen (565)	30%	40%	30%
% of companies in each rating category that are investment banking clients	39%	37%	36%
Citigroup Investment Research Asia Quantitative Radar Screen Model Coverage (1608)	20%	60%	20%
% of companies in each rating category that are investment banking clients	27%	18%	16%
Citigroup Investment Research Quant Emerging Markets Radar Screen Model Coverage (1256)	20%	60%	20%
% of companies in each rating category that are investment banking clients	24%	26%	26%
Citigroup Investment Research Australia Quantitative Top 100 Model Coverage (97)	30%	39%	31%
% of companies in each rating category that are investment banking clients	38%	39%	40%
Citigroup Investment Research Australia Quantitative Bottom 200 Model Coverage (157)	30%	39%	31%
% of companies in each rating category that are investment banking clients	9%	2%	6%
Citigroup Investment Research Australia Quantitative Scoring Stocks Model Coverage (10)	50%	0%	50%
% of companies in each rating category that are investment banking clients	20%	0%	20%

Guide to Fundamental Research Investment Ratings:

Citigroup Investment Research's stock recommendations include a risk rating and an investment rating.

Risk ratings, which take into account both price volatility and fundamental criteria, are: Low (L), Medium (M), High (H), and Speculative (S).

Investment ratings are a function of Citigroup Investment Research's expectation of total return (forecast price appreciation and dividend yield within the next 12 months) and risk rating.

For securities in developed markets (US, UK, Europe, Japan, and Australia/New Zealand), investment ratings are: Buy (1) (expected total return of 10% or more for Low-Risk stocks, 15% or more for Medium-Risk stocks, 20% or more for High-Risk stocks, and 35% or more for Speculative stocks); Hold (2) (0%-10% for Low-Risk stocks, 0%-15% for Medium-Risk stocks, 0%-20% for High-Risk stocks, and 0%-35% for Speculative stocks); and Sell (3) (negative total return).

For securities in emerging markets (Asia Pacific, Emerging Europe/Middle East/Africa, and Latin America), investment ratings are: Buy (1) (expected total return of 15% or more for Low-Risk stocks, 20% or more for Medium-Risk stocks, 30% or more for High-Risk stocks, and 40% or more for Speculative stocks); Hold (2) (5%-15% for Low-Risk stocks, 10%-20% for Medium-Risk stocks, 15%-30% for High-Risk stocks, and 20%-40% for Speculative stocks); and Sell (3) (5% or less for Low-Risk stocks, 10% or less for Medium-Risk stocks, 15% or less for High-Risk stocks, and 20% or less for Speculative stocks).

Investment ratings are determined by the ranges described above at the time of initiation of coverage, a change in investment and/or risk rating, or a change in target price (subject to limited management discretion). At other times, the expected total returns may fall outside of these ranges because of market price movements and/or other short-term volatility or trading patterns. Such interim deviations from specified ranges will be permitted but will become subject to review by Research Management. Your decision to buy or sell a security should be based upon your personal investment objectives and should be made only after evaluating the stock's expected performance and risk.

Guide to Quantitative Research Investment Ratings:

Citigroup Investment Research Quantitative Research World Radar Screen recommendations are based on a globally consistent framework to measure relative value and momentum for a large number of stocks across global developed and emerging markets. Relative value and momentum rankings are equally weighted to produce a global attractiveness score for each stock. The scores are then ranked and put into deciles. A stock with a decile rating of 1 denotes an attractiveness score in the top 10% of the universe (most attractive). A stock with a decile rating of 10 denotes an attractiveness score in the bottom 10% of the universe (least attractive).

Citigroup Investment Research Quantitative Decision Tree model recommendations are based on a predetermined set of factors to rate the relative attractiveness of stocks. These factors are detailed in the text of the report. Each month, the Decision Tree model forecasts whether stocks are attractive or unattractive relative to other stocks in the same sector (based on the Russell 1000 sector classifications).

Citigroup Investment Research Quantitative European Value & Momentum Screen recommendations are based on a European consistent framework to measure relative value and momentum for a large number of stocks across the European Market. Relative value and momentum rankings are equally weighted to produce a European attractiveness score for each stock. The scores are then ranked and put into deciles. A stock with a decile rating of 1 denotes an attractiveness score in the top 10% of the universe (most attractive). A stock with a decile rating of 10 denotes an attractiveness score in the bottom 10% of the universe (least attractive).

Citigroup Investment Research Asia Quantitative Radar Screen and Emerging Markets Radar Screen model recommendations are based on a regionally consistent framework to measure relative value and momentum for a large number of stocks across regional developed and emerging markets. Relative value and momentum rankings are equally weighted to produce a global attractiveness score for each stock. The scores are then ranked and put into quintiles. A stock with a quintile rating of 1 denotes an attractiveness score in the top 20% of the universe (most attractive). A stock with a quintile rating of 5 denotes an attractiveness score in the bottom 20% of the universe (least attractive).

Citigroup Investment Research Quantitative Australian Stock Selection Screen rankings are based on a consistent framework to measure relative value and earnings momentum for a large number of stocks across the Australian market. Relative value and earnings momentum rankings are weighted to produce a rank within a relevant universe for each stock. The rankings are then put into deciles. A stock with a decile rating of 1 denotes an attractiveness score in the top 10% of the universe (most attractive). A stock with a decile rating of 10 denotes an attractiveness score in the bottom 10% of the universe (least attractive).

Citigroup Investment Research Quantitative Research Australian Scoring Stocks model recommendations are based on a predetermined set of factors to rate the relative attractiveness of stocks. These factors are detailed in the text of the report. Each month, the Australian Scoring Stocks model calculates whether stocks are attractive or unattractive relative to other stocks in the same universe(the S&P/ASX 100) and records the 5 most attractive buys and 5 most attractive sells on the basis of the criteria described in the report.

For purposes of NASD/NYSE ratings-distribution-disclosure rules, a Citigroup Investment Research Quantitative World Radar Screen and European Value & Momentum Screen recommendation of (1), (2) or (3) most closely corresponds to a buy recommendation; a recommendation from this product group of (4), (5), (6) or (7) most closely corresponds to a hold recommendation; and a recommendation of (8), (9) or (10) most closely corresponds to a sell recommendation.

For purposes of NASD/NYSE ratings distribution disclosure rules, a Citigroup Investment Research Asia Quantitative Radar Screen or Quantitative Emerging Markets Radar Screen recommendation of (1) most closely corresponds to a buy recommendation; a Citigroup Investment Research Asia Quantitative Radar Screen or Quantitative Emerging Markets Radar Screen recommendation of (2), (3), (4) most closely corresponds to a hold recommendation; and a recommendation of (5) most closely corresponds to a sell recommendation.

For purposes of NASD/NYSE ratings-distribution-disclosure rules, a Citigroup Investment Research Quantitative Research Decision Tree model recommendation of "attractive" most closely corresponds to a buy recommendation. All other stocks in the sector are considered to be "unattractive" which most closely corresponds to a sell recommendation.

Recommendations are based on the relative attractiveness of a stock, they can not be directly equated to buy, hold and sell categories. Accordingly, your decision to buy or sell a security should be based on your personal investment objectives and only after evaluating the stock's expected relative performance.

For purposes of NASD/NYSE ratings-distribution-disclosure rules, a Citigroup Investment Research Quantitative Australian Stock Selection Screen model ranking in the top third of the universe most closely corresponds, subject to market conditions, to a buy recommendation. A ranking in the bottom third of the universe, subject to market conditions, most closely corresponds to a sell recommendation. All other stocks in the universe correspond to a hold recommendation. However, because Citigroup Investment Research Quantitative Australian Stock Selection Screen model rankings are based on the relative attractiveness of a stock as compared to other stocks in the same universe, they can not be directly equated to buy, hold and sell categories. Accordingly, your decision to buy or sell a security should be based on your personal investment objectives and only after evaluating the stock's expected absolute performance.

For purposes of NASD/NYSE ratings-distribution-disclosure rules, membership of the Citigroup Investment Research Quantitative Australian Scoring Stocks Model buy portfolio most closely corresponds to a buy recommendation; membership of the Citigroup Investment Research Quantitative Australian Scoring Stocks Model sell portfolio most closely corresponds to a sell recommendation. However, because Citigroup Investment Research Quantitative Australian Scoring Stocks Model recommendations are based on the relative attractiveness of a stock, they can not be directly equated to buy, hold and sell categories. Accordingly, your decision to buy or sell a security should be based on your personal investment objectives and only after evaluating the stock's expected absolute performance.

OTHER DISCLOSURES

For securities recommended in the Product in which the Firm is not a market maker, the Firm is a liquidity provider in the issuers' financial instruments and may act as principal in connection with such transactions. The Firm is a regular issuer of traded financial

instruments linked to securities that may have been recommended in the Product. The Firm regularly trades in the securities of the subject company(ies) discussed in the Product. The Firm may engage in securities transactions in a manner inconsistent with the Product and, with respect to securities covered by the Product, will buy or sell from customers on a principal basis.

Securities recommended, offered, or sold by the Firm: (i) are not insured by the Federal Deposit Insurance Corporation; (ii) are not deposits or other obligations of any insured depository institution (including Citibank); and (iii) are subject to investment risks, including the possible loss of the principal amount invested. Although information has been obtained from and is based upon sources that the Firm believes to be reliable, we do not guarantee its accuracy and it may be incomplete and condensed. Note, however, that the Firm has taken all reasonable steps to determine the accuracy and completeness of the disclosures made in the Important Disclosures section of the Product. In producing Products, members of the Firm's research department may have received assistance from the subject company(ies) referred to in the Product. Any such assistance may have included access to sites owned, leased or otherwise operated or controlled by the issuers and meetings with management, employees or other parties associated with the subject company(ies). Firm policy prohibits research analysts from sending draft research to subject companies. However, it should be presumed that the author of the Product has had discussions with the subject company to ensure factual accuracy prior to publication. All opinions, projections and estimates constitute the judgment of the author as of the date of the Product and are subject to change without notice. Prices and availability of financial instruments also are subject to change without notice. Although Citigroup Investment Research does not set a predetermined frequency for publication, if the Product is a fundamental research report, it is the intention of Citigroup Investment Research to provide research coverage of the/those issuer(s) mentioned therein, including in response to news affecting this issuer, subject to applicable quiet periods and capacity constraints. The Product is for informational purposes only and is not intended as an offer or solicitation for the purchase or sale of a security. Any decision to purchase securities mentioned in the Product must take into account existing public information on such security or any registered prospectus.

Investing in non-U.S. securities, including ADRs, may entail certain risks. The securities of non-U.S. issuers may not be registered with, nor be subject to the reporting requirements of the U.S. Securities and Exchange Commission. There may be limited information available on foreign securities. Foreign companies are generally not subject to uniform audit and reporting standards, practices and requirements comparable to those in the U.S. Securities of some foreign companies may be less liquid and their prices more volatile than securities of comparable U.S. companies. In addition, exchange rate movements may have an adverse effect on the value of an investment in a foreign stock and its corresponding dividend payment for U.S. investors. Net dividends to ADR investors are estimated, using withholding tax rates conventions, deemed accurate, but investors are urged to consult their tax advisor for exact dividend computations. Investors who have received the Product from the Firm may be prohibited in certain states or other jurisdictions from purchasing securities mentioned in the Product from the Firm. Please ask your Financial Consultant for additional details. Citigroup Global Markets Inc. takes responsibility for the Product in the United States. Any orders by US investors resulting from the information contained in the Product may be placed only through Citigroup Global Markets Inc.

The Citigroup legal entity that takes responsibility for the production of the Product is the legal entity which the first named author is employed by. The Product is made available in Australia to wholesale clients through Citigroup Global Markets Australia Pty Ltd. (ABN 64 003 114 832 and AFSL No. 240992) and to retail clients through Citigroup Wealth Advisors Pty Ltd. (ABN 19 009 145 555 and AFSL No. 240813), Participants of the ASX Group and regulated by the Australian Securities & Investments Commission. Citigroup Centre, 2 Park Street, Sydney, NSW 2000. If the Product is being made available in certain provinces of Canada by Citigroup Global Markets (Canada) Inc. ("CGM Canada"), CGM Canada has approved the Product. Citigroup Place, 123 Front Street West, Suite 1100, Toronto, Ontario M5J 2M3. The Product may not be distributed to private clients in Germany. The Product is distributed in Germany by Citigroup Global Markets Deutschland AG & Co. KGaA, which is regulated by Bundesanstalt fuer Finanzdienstleistungsaufsicht (BaFin). Frankfurt am Main, Reuterweg 16, 60323 Frankfurt am Main. If the Product is made available in Hong Kong by, or on behalf of, Citigroup Global Markets Asia Ltd., it is attributable to Citigroup Global Markets Asia Ltd., Citibank Tower, Citibank Plaza, 3 Garden Road, Hong Kong. Citigroup Global Markets Asia Ltd. is regulated by Hong Kong Securities and Futures Commission. If the Product is made available in Hong Kong by The Citigroup Private Bank to its clients, it is attributable to Citibank N.A., Citibank Tower, Citibank Plaza, 3 Garden Road, Hong Kong. The Citigroup Private Bank and Citibank N.A. is regulated by the Hong Kong Monetary Authority. The Product is made available in India by Citigroup Global Markets India Private Limited, which is regulated by Securities and Exchange Board of India. Bakhtawar, Nariman Point, Mumbai 400-021. If the Product was prepared by Citigroup Investment Research and distributed in Japan by Nikko Citigroup Ltd., it is being so distributed under license. Nikko Citigroup Limited is regulated by Financial Services Agency, Securities and Exchange Surveillance Commission, Japan Securities Dealers Association, Tokyo Stock Exchange and Osaka Securities Exchange. Akasaka Park Building, 2-20, Akasaka 5-chome, Minato-ku, Tokyo 107-6122. The Product is made available in Korea by Citigroup Global Markets Korea Securities Ltd., which is regulated by Financial Supervisory Commission and the Financial Supervisory Service. Hungkuk Life Insurance Building, 226 Shinmunno 1-GA, Jongno-Gu, Seoul, 110-061. The Product is made available in Malaysia by Citigroup Global Markets Malaysia Sdn Bhd, which is regulated by Malaysia Securities Commission. Menara Citibank, 165 Jalan Ampang, Kuala Lumpur, 50450. The Product is made available in Mexico by Acciones y Valores Banamex, S.A. De C. V., Casa de Bolsa, which is regulated by Comision Nacional Bancaria y de Valores. Reforma 398, Col. Juarez, 06600 Mexico, D.F. In New Zealand the Product is made available through Citigroup Global Markets New Zealand Ltd., a Participant of the New Zealand Exchange Limited and regulated by the New Zealand Securities Commission. Level 19, Mobile on the Park, 157 lambton Quay, Wellington. The Product is made available in Poland by Dom Maklerski Banku Handlowego SA an indirect subsidiary of Citigroup Inc., which is regulated by Komisja Papierów Wartosciowych i Gield. Bank Handlowy w Warszawie S.A. ul. Senatorska 16, 00-923 Warszawa. The Product is made available in the Russian Federation through ZAO Citibank, which is licensed to carry out banking activities in the Russian Federation in accordance with the general banking license issued by the Central Bank of the Russian Federation and brokerage activities in accordance with the license issued by the Federal Service for Financial Markets. Neither the Product nor any information contained in the Product shall be considered as advertising the securities mentioned in this report within the territory of the Russian Federation or outside the Russian Federation. The Product does not constitute an appraisal within the meaning of the Federal Law of the Russian Federation of 29 July 1998 No. 135-FZ (as amended) On Appraisal Activities in the Russian Federation. 8-10 Gasheka Street, 125047 Moscow. The Product is made available in Singapore through Citigroup Global Markets Singapore Pte. Ltd., a Capital Markets Services Licence holder, and regulated by Monetary Authority of Singapore. 1 Temasek Avenue, #39-02 Millenia Tower, Singapore 039192. Citigroup Global Markets (Pty) Ltd. is incorporated in the Republic of South Africa (company registration number 2000/025866/07) and its registered office is at 145 West Street, Sandton, 2196, Saxonwold. Citigroup Global Markets (Pty) Ltd. is regulated by JSE Securities Exchange South Africa, South African Reserve Bank and the Financial Services Board. The investments

and services contained herein are not available to private customers in South Africa. The Product is made available in Taiwan through Citigroup Global Markets Inc. (Taipei Branch), which is regulated by Securities & Futures Bureau. No portion of the report may be reproduced or quoted in Taiwan by the press or any other person. No. 8 Manhattan Building, Hsin Yi Road, Section 5, Taipei 100, Taiwan. The Product is made available in Thailand through Citicorp Securities (Thailand) Ltd., which is regulated by the Securities and Exchange Commission of Thailand. 18/F, 22/F and 29/F, 82 North Sathorn Road, Silom, Bangrak, Bangkok 10500, Thailand. The Product is made available in United Kingdom by Citigroup Global Markets Limited, which is authorised and regulated by Financial Services Authority. This material may relate to investments or services of a person outside of the UK or to other matters which are not regulated by the FSA and further details as to where this may be the case are available upon request in respect of this material. Citigroup Centre, Canada Square, Canary Wharf, London, E14 5LB. The Product is made available in United States by Citigroup Global Markets Inc, which is regulated by NASD, NYSE and the US Securities and Exchange Commission. 388 Greenwich Street, New York, NY 10013. Unless specified to the contrary, within EU Member States, the Product is made available by Citigroup Global Markets Limited, which is regulated by Financial Services Authority. Many European regulators require that a firm must establish, implement and make available a policy for managing conflicts of interest arising as a result of publication or distribution of investment research. The policy applicable to Citigroup Investment Research's Products can be found at www.citigroupgeo.com. Compensation of equity research analysts is determined by equity research management and Citigroup's senior management and is not linked to specific transactions or recommendations. The Product may have been distributed simultaneously, in multiple formats, to the Firm's worldwide institutional and retail customers. The Product is not to be construed as providing investment services in any jurisdiction where the provision of such services would be illegal. Subject to the nature and contents of the Product, the investments described therein are subject to fluctuations in price and/or value and investors may get back less than originally invested. Certain high-volatility investments can be subject to sudden and large falls in value that could equal or exceed the amount invested. Certain investments contained in the Product may have tax implications for private customers whereby levels and basis of taxation may be subject to change. If in doubt, investors should seek advice from a tax adviser. Advice in the Product has been prepared without taking account of the objectives, financial situation or needs of any particular investor. Accordingly, investors should, before acting on the advice, consider the appropriateness of the advice, having regard to their objectives, financial situation and needs.

© 2006 Citigroup Global Markets Inc. Citigroup Investment Research is a division and service mark of Citigroup Global Markets Inc. and its affiliates and is used and registered throughout the world. Citigroup and the Umbrella Device are trademarks and service marks of Citigroup or its affiliates and are used and registered throughout the world. Nikko is a registered trademark of Nikko Cordial Corporation. All rights reserved. Any unauthorized use, duplication, redistribution or disclosure is prohibited by law and will result in prosecution. The Firm accepts no liability whatsoever for the actions of third parties. The Product may provide the addresses of, or contain hyperlinks to, websites. Except to the extent to which the Product refers to website material of the Firm, the Firm has not reviewed the linked site. Equally, except to the extent to which the Product refers to website material of the Firm, the Firm takes no responsibility for, and makes no representations or warranties whatsoever as to, the data and information contained therein. Such address or hyperlink (including addresses or hyperlinks to website material of the Firm) is provided solely for your convenience and information and the content of the linked site does not in anyway form part of this document. Accessing such website or following such link through the Product or the website of the Firm shall be at your own risk and the Firm shall have no liability arising out of, or in connection with, any such referenced website.

ADDITIONAL INFORMATION IS AVAILABLE UPON REQUEST GL09R127