

## Equities

14 December 2011 | 14 pages

# Equity Strategy

## Special Report – The Raging Bull Thesis

### ■ Equities

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- **Six major developments argue for a new secular bull market beginning within the next 12-18 months.** The investment community is distracted by having lost 50%+ in stocks twice since 2000, the plunge in home prices, peak-like profit margins, employment challenges and a potential European sovereign debt/banking crisis, but there are changes that may provide catalysts for a major shift in equity price direction.
- **A nascent US housing recovery could emerge after excess homes get absorbed in the middle of 2012.** There are indications that excess home supply is dwindling, and that could provide a floor in home prices, bank/mortgage losses, construction industry job pressures, consumer confidence and even GDP drags. After six years, the housing bubble deflation may end as it often takes that long to absorb such excesses.
- **An American manufacturing renaissance appears to be taking place.** Reports of companies bringing back manufacturing to the US have emerged due to higher land costs and wages in China, and there appears to be a much more competitive dynamic in America currently. While many have perceived the US manufacturing base as being in permanent decline, there are indications of a turn taking place.
- **Fiscal responsibility could address rising risk premiums and allow for multiple expansion.** By 2013-14, the US will begin to experience a sharp increase in mandatory fiscal spending, based on current budget assumptions, and we suspect that a response will be hammered out by the country's political leadership to address this problem. Indeed, proposals have come forward such as the Bowles-Simpson commission's report that many see as a promising start. Interestingly, Americans seem more willing to accept these options as they show their concern via "wrong track" polls.
- **The demographics of the baby boom "echo" should support a new cadre of investors.** Many wonder about the propensity for aging boomers to prefer the alleged safety of fixed income instruments, but the group of 35-39 year olds that is larger than its parental cohort will be entering their savings years beginning in late 2012. This new group is unencumbered by the memory of suffering severe portfolio losses and thus may be new buyers of equities, especially if bond yields move up in 2013.
- **The US is moving towards energy self sufficiency via the development of shale oil and gas fields as well as NGL substitution.** While US oil production peaked in the mid-1980s, horizontal drilling and shale hydrocarbon extraction technologies are generating a renewed pickup in drilling activity that combined with NGL development and imports from Canada and Mexico could make the US almost energy independent.
- **Technological innovation and penetration of smart mobile devices is likely to compel major new investment.** Every 15 years or so, the US undergoes substantial technological change that can act as an economic propellant. The sheer magnitude of mobility growth brings computing, the internet, purchasing and entertainment in one's palm and argues for significant investment in software, infrastructure, bandwidth and more efficient chips, batteries and production techniques. Fortunately, the US remains the global IT leader.

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

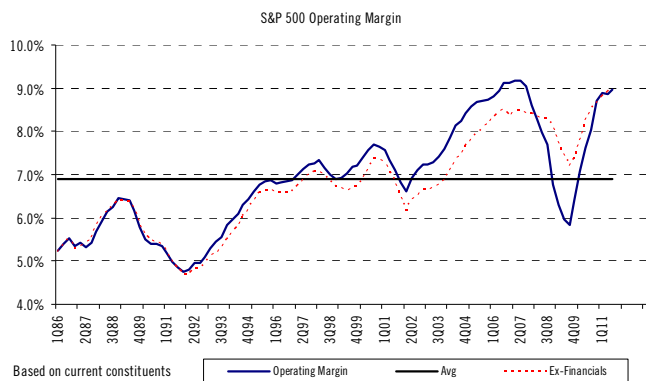
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## The Potential End of the Trading Market Thesis

In December 2001, we penned our first Trading Places report, highlighting the probability that the bursting of the tech bubble would generate a trading environment similar to the 1930s and 1970s in the US and the 1990s in Japan. Essentially we argued that after major bubbles deflate, it can take more than a decade for markets to find a new base from which to grow but sharp trading rallies and pullbacks can provide moneymaking opportunities for adroit investors. Since late 2001, we wrote 10 more such Trading Places reports through 2011 reminding investors of the notion that one had to give up on the buy and hold strategies that had dominated the mindset of the 1990s. Investment would have to rely on key metrics such as tracking investor sentiment, earnings expectations, valuation signals and the credit cost backdrop. And, while we think these drivers can persist and support equities in the near term, we may be closing in on the end of this trading market regime. Indeed, we see a number of major changes that appear to be coming to the fore and should support a new era of the secular bull market run. While we imagine that most investors are deeply skeptical of such an argument after years on the seeming roller coaster market, especially given recent volatility, we would remind them that they were equally unwilling to buy into our trading thesis a decade ago. One can debate the premise but it is far more worthwhile to consider the argument thoughtfully before discounting it; and in that context, we perceive at least six substantive developments that could alter the outlook dramatically.

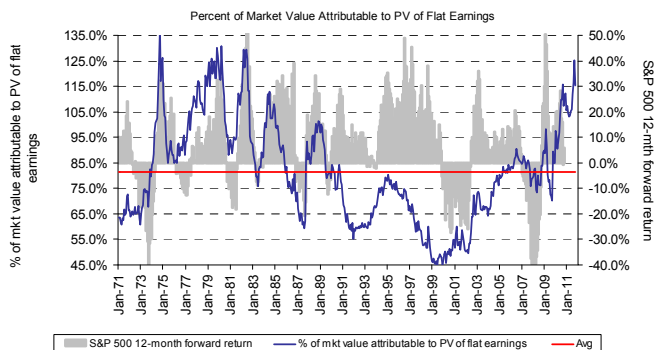
Note that the six factors coming together over the next few years include energy independence, a local manufacturing renaissance, technology-based transformational change, demography, a housing sector bottom and fiscal reform. While each individually is important, the coalescence of these developments could prove to be very powerful for investors. It is relatively rare for just one concept to drive investors in a particular direction but it is often the combination of several catalysts that can act as the fuel for stock price trends. Thus, there is a good reason to be bullish about the coming several years in equities despite fears around high (and thereby perceived unsustainable) corporate profitability (see Figure 1) as well as justified European economic concerns. As we have stressed in the past, current stock prices assume a coming collapse in earnings by virtue of the present value of no earnings growth being well above the current S&P 500 level as we have witnessed in the past just before major stock price rallies (see Figure 2). Keep in mind that the dominant mindset during much of the 1970s and the very early 1980s was that the US had lost its “edge” and that tough economic circumstances could not be overcome. At the time, double-digit unemployment and double-digit inflation contributed to a national malaise while Japan was in its economic ascendancy not to mention a costly war in Vietnam that many saw as an American defeat. Investors perceived equities as doomed due to a focus on “hard” assets and Wall Street was under the cost pressures of “big bang” negotiated rather than fixed commission revenues. A lost decade in investing was also prevalent with few having the stomach for buying stocks.

Figure 1.



Source: FactSet and CIRA – US Equity Strategy

Figure 2.



Source: Haver Analytics and CIRA – US Equity Strategy

We suspect that investors will attempt to discredit the various insights noted below for a new bull run and we fully appreciate their disbelief. Moreover, we think that it may take another year for investors to begin to accept the possibility of these issues, especially given a seminal election next year that will help determine the manner in which fiscal challenges get resolved. With the European experience acting as a prelude for any developed economy that does not address fiscal spending programs that are meaningfully in excess of revenues, America may have to act relatively soon. To some extent, investors may need to know the likely outcome of the 2012 US presidential elections before they are willing to commit investment funds in a big way. Indeed, one might construct two very different portfolios if President Obama were to win re-election versus if his Republican challenger were to be victorious. For example, a portfolio manager might buy solar or wind power stocks if President Obama wins but might buy defense or energy names if he did not. Thus, even if the investment community buys into our new bull driver confluence thesis, they may not be ready to allocate new monies just yet. In addition, any bottoming in housing activity and ultimately home prices will take some time to permeate a very damaged homeowner's psyche.

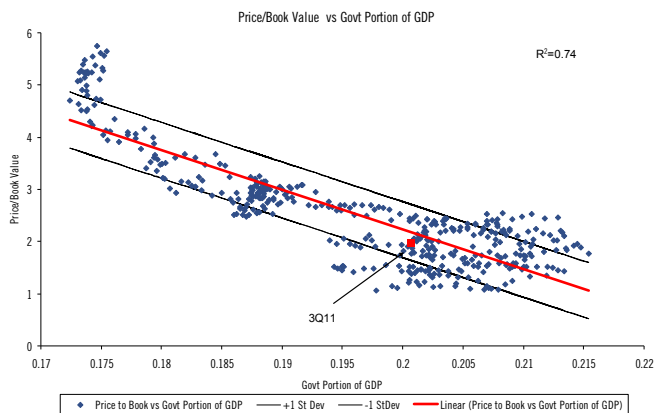
We expect many doubters to emerge and suggest that the view we will outline for the next decade is Pollyanna-like but we should emphasize that our more cautious Trading Places thesis was equally dismissed a decade ago as some saw it as a Cassandra warning. Thus, we would hope that we have earned some degree of credibility and our willingness to go from being bearish in the spring of 2008 to bullish in late 2008/early 2009 shows flexibility rather than a rigid predisposition towards or against equities. Accordingly, we find it compelling and exciting to lay out a much more positive view for stock prices in the coming 10 years.

### The Fiscal Problem and Its Likely Resolution

We continue to think that investors are unwilling to pay up for equities while the continuation of budget deficits and growth of national debt erodes the foundation of economic progress. Figure 3 is somewhat controversial but suggests that larger government hurts overall market valuation while Figure 4 shows that large budget deficits are often associated with lower valuation as well. But, we heavily rely on this writer's past experience covering cyclical industrial stocks for 15 years, which often traded at low P/E multiples just as earnings peaked and investors understood that the future EPS trajectory was not going to be good. Some mistakenly saw these allegedly "cheap" stocks as attractively valued but we argued that the overwhelming number of investors correctly understood that the shares were simply

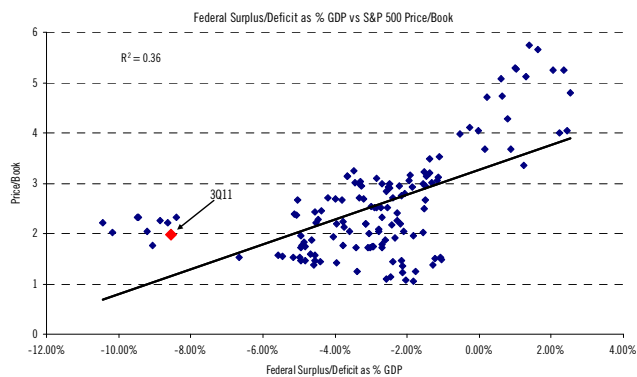
reflecting very questionable ongoing prospects. Every fund manager was able to calculate the same valuation metrics on forward estimates but the belief system in those forecasts was appropriately poor. In essence, the aggregate view of investors is something to learn from rather than to be mocked by supposedly smarter people. The crucial issue is not intellect, it is information – and the masses generally have more information than a select few who just do not have the capacity to gather all relevant data.

Figure 3.



Source: Haver Analytics and CIRA – US Equity Strategy

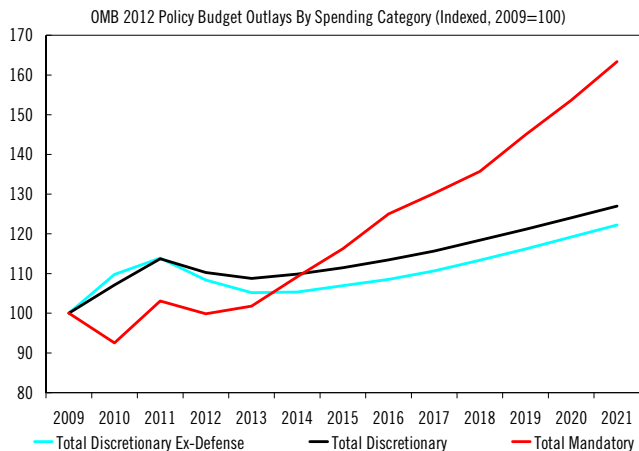
Figure 4.



Source: Haver Analytics and CIRA – US Equity Strategy

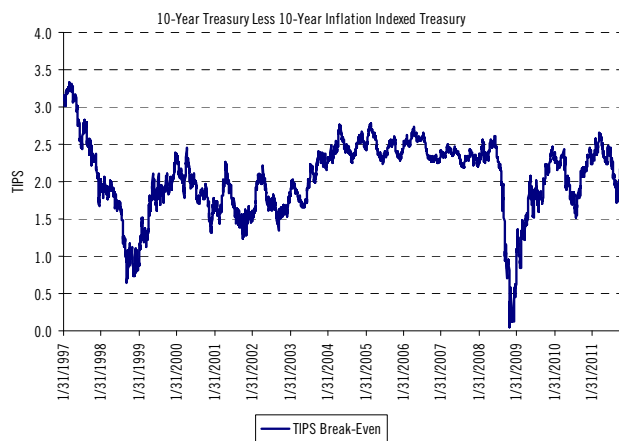
More critically, Figure 5 illustrates that 2014 will be a critical year as federal mandatory spending is set to surge according to the Obama administration budget forecasts, and we suspect that the bond market will not be altogether tolerant at that prospect. Thus, 2013 is the year in which progress will have to be made by the next administration or the bond market may force an outcome the following year in the manner being seen by Italy. If not, growth as a percent of GDP will continue to climb and it seems likely that foreigners who buy nearly half of US Treasuries may require higher interest rates to compensate them for the higher risk they would be undertaking as debt climbs. In contrast, Japan has been self-funding and thus has been able to fund itself cheaply especially given local deflation. Note that the US is not projected to face deflation based on the TIPs breakeven rate (see Figure 6). Nonetheless, some progress will have to be made akin to the efforts seen by both Presidents Reagan and Clinton with bipartisan support. While a sense of bipartisanship seems almost impossible to imagine in DC nowadays, we would submit that the Bowles-Simpson plan and the Rivlin-Domenici proposal both have bipartisan support. Many Democrats understand the limits of the entitlement programs and many Republicans are willing to address taxes under a tax reform bill. Thus, we suspect that compromises will be found, which could unleash new investment that is looking for leadership out of Washington before committing new funds.

Figure 5.



Source: Haver Analytics and CIRA – US Equity Strategy

Figure 6.

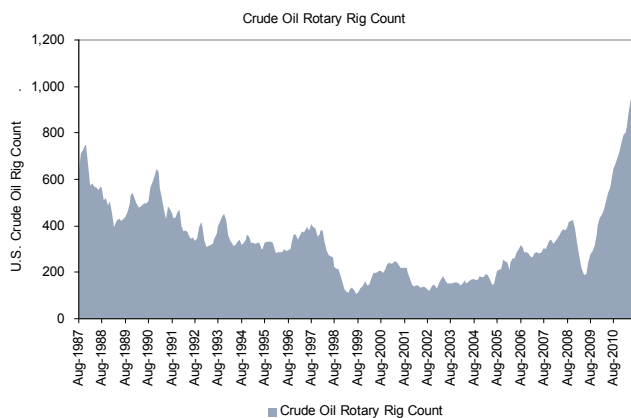


Source: Bloomberg and CIRA – US Equity Strategy

### The Impressive Coming US Energy Story

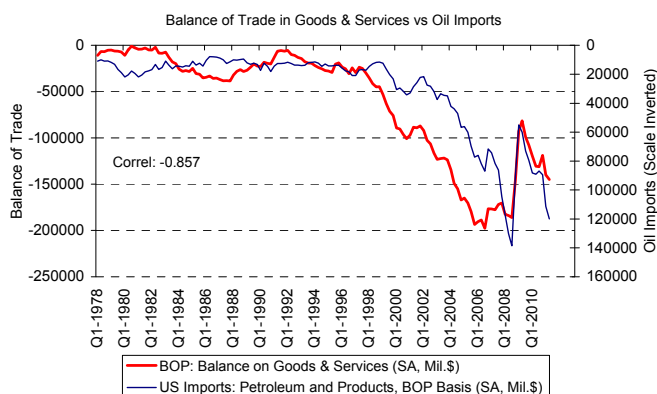
For almost four decades, since the 1973-74 oil embargo, America has been struggling with energy supplies and the need to keep its economy powered by hydrocarbons. Various plans have failed to solve the problem, from CAFE standards to biofuels to electric cars and more. Yet, America stands on the verge of a major change that puts it on a course to near self-sufficiency, according to a past President of OPEC as well as Citi's head of commodities research, Ed Morse. The Gulf of Mexico is expected to see production climb from 1.55 million barrels per day (mbd) of oil to 4.0 mbd by the end of the decade, while shale (or more correctly "tight") oil could add another 2.0 mbd, while a shift to natural gas for heavy trucks could save the country from using another 0.5 mbd. In addition, auto efficiencies and a few other factors also may help. Overall, US imports of oil should drop from 9.0 mbd to 2.0 mbd, which easily can be purchased from Canada and Mexico. Keep in mind that 7.0 mbd would equal \$700 million daily and more than \$250 billion annually. The implications are simply stunning on America's current account figures, trade balances and even potentially the positioning (and cost) of US military forces around the world. The increase in production of shale gas could also add millions of new jobs.

Figure 7.



Source: EIA

Figure 8.



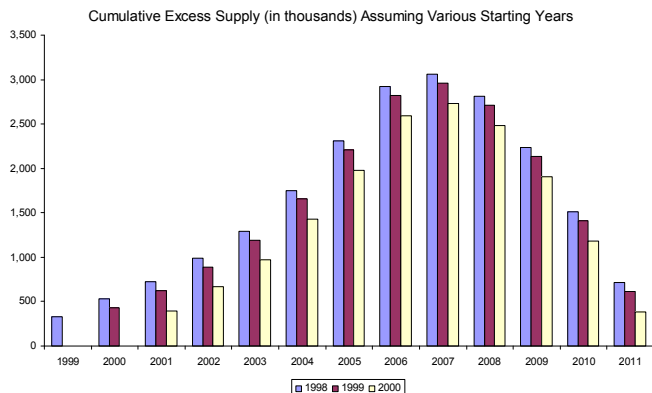
Source: Haver Analytics and CIRA – US Equity Strategy

We suspect that most readers perceive this as more of a dream than a reality but the data is quite persuasive and the investment community could be very much surprised to the upside. Note that other developing regions might become far more dependent on foreign oil in a way that gives America impressive economic advantages as well.

### A Possible Turn in the Housing Sector

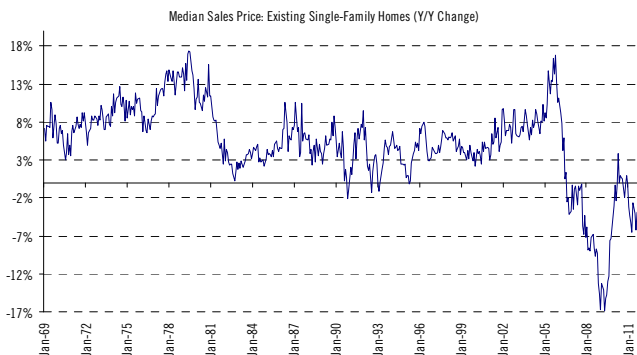
A few months ago, we highlighted work done by Citi's homebuilding analyst, Josh Levin, showing that excess US homes were being worked off (see Figure 9) and that while foreclosures would continue, the terrible overhang that has decimated home prices (see Figure 10), could be hitting a bottom. Moreover, the massive depressant on the American family's zeitgeist might finally wane. Keep in mind, that a bottom in housing has many impacts. The GDP drag could be reversed (see Figure 11) and employment could get a boost given nearly 2 million unemployed construction workers. Note that housing starts are at depression-like levels (see Figure 12).

Figure 9.



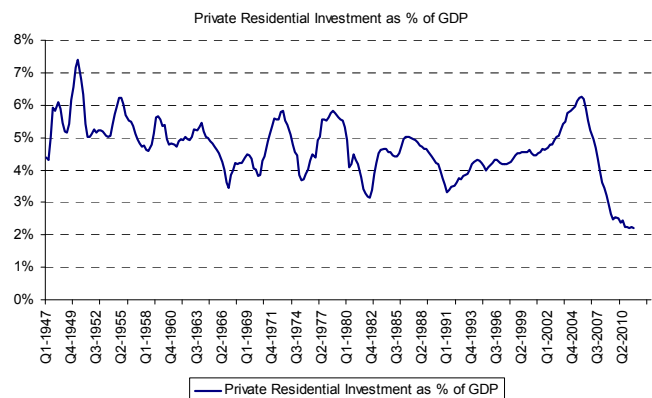
Source: Haver Analytics and CIRA – US Equity Strategy

Figure 10.



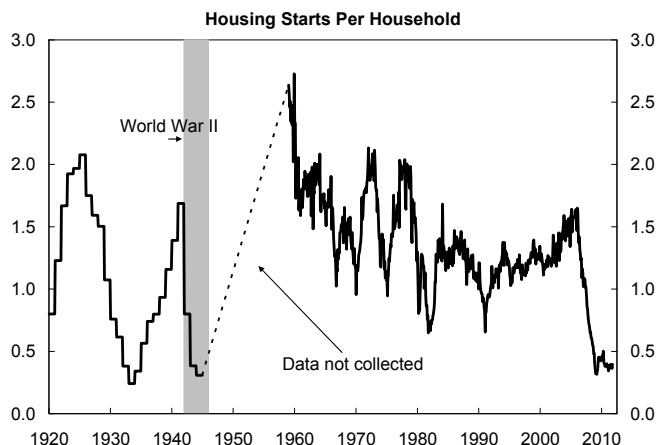
Source: Haver Analytics and CIRA – US Equity Strategy

Figure 11.



Source: Haver Analytics and CIRA – US Equity Strategy

Figure 12.

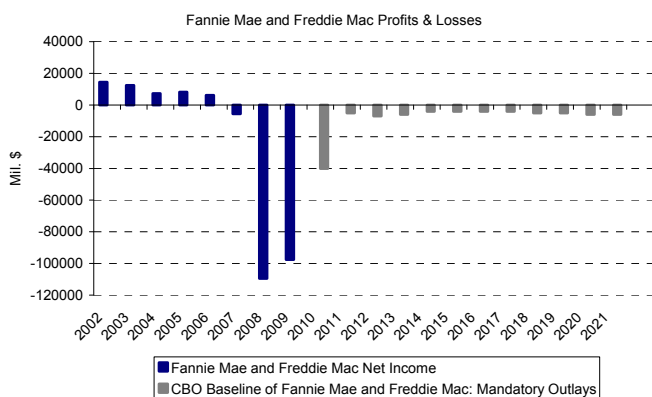


Source: Haver Analytics and CIRA – US Equity Strategy

There are other benefits such as the banking industry no longer having to worry about an endless decline in the value of outstanding mortgages, which could rescue

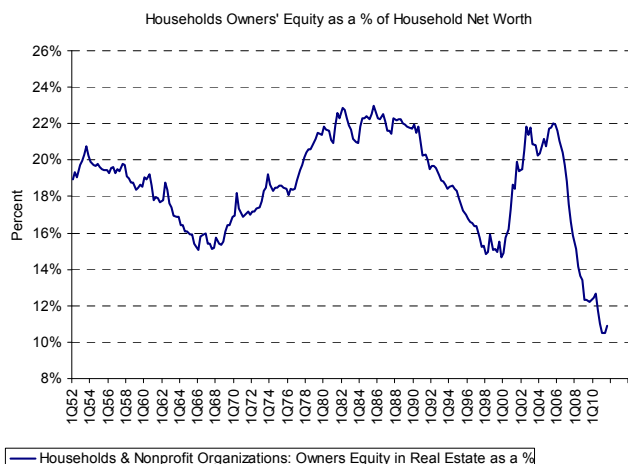
ongoing credit losses, and Fannie Mae as well as Freddie Mac may stop hemorrhaging money (see Figure 13). Note that unemployment rates have been stubbornly high partially due to the lack of mobility from areas that don't have jobs to those that do. As a reminder, home equity accounts for less than 15% of household net worth (see Figure 14) and thus most likely would not massively shift consumer spending, but any improvement has widespread benefits including related industries such as construction materials, home improvement retailers, etc. It seems almost impossible to believe that a positive development in housing would not be welcomed by the investment community, in our opinion.

Figure 13.



Source: Haver Analytics and CIRA – US Equity Strategy

Figure 14.



Source: Haver Analytics and CIRA – US Equity Strategy

## A Manufacturing Renaissance

In the last few months, we have seen companies such as Ford Motor and Emerson Electric bring back manufacturing to the US while Intel is building three new facilities in America and Caterpillar is looking to hire 1,200 workers for a new excavator plant. Intriguingly, both the Boston Consulting Group and AllixPartners have recently released reports discussing the new competitiveness of American manufacturing bases given 15%-20% wage increases in China and volatile transportation costs. Tragic natural disasters in Japan and Thailand also have made companies want to have more domestic sourcing options. We have even heard that building a new plant in Tennessee is cheaper than doing so in China given property price increases in Asia.

Admittedly, there are cheaper sources than the US such as Mexico, Indonesia and Vietnam, but the infrastructure in those countries may not support additional facilities there. Interestingly, BCG claims that by 2015, low labor content manufacturing cost advantages will be in the single digits for China over many low cost states in the US such as South Carolina before considering transport costs. The BCG study goes on to highlight that US manufacturing output is roughly 2.5x greater than it was 40 years ago with 33% fewer workers – this says more about American efficiency than any collapse in US manufacturing capabilities. Companies such as Coleman Company and Peerless Industries are cited as shifting production from China to the US, which may surprise many US investors.

BCG notes that the “labor content ranges from only about 7 percent for products like video cameras to about 25 percent for a machined auto part. When transportation, duties, and other costs are included, not to mention the expected continued

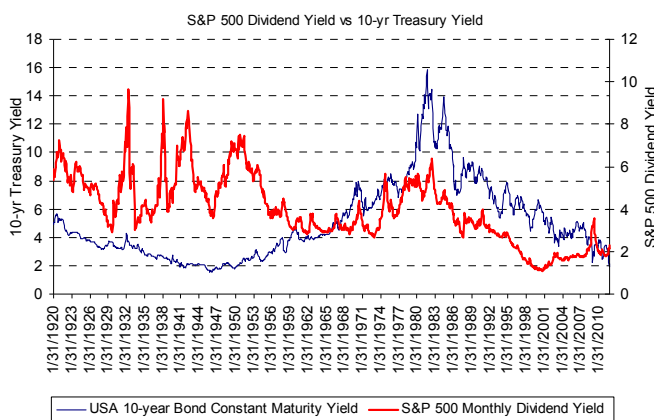
appreciation of China's currency, companies may find that any cost savings to be gained from sourcing in China may not be worth the time and myriad risks and headaches associated with operating a supply chain extending halfway around the world." In addition, rising electricity rates and yuan appreciation are eroding Chinese competitiveness, more than offsetting productivity gains. Moreover, China's workforce dwarfs all of Southeast Asia's combined, which limits the ability to just move manufacturing to Taiwan, for instance.

AlixPartners studied manufacturing costs and made some assumptions about wage increases, transportation costs and yuan appreciation and came to a similar view as BCG, but we would contend that they did not include land prices, electricity rates and challenges in managing supply chains halfway around the world. Nonetheless, the great challenge to America's manufacturing base appears to be ending. It is important to realize that China's manufacturing will still grow but more to serve its own developing needs. Thus, the studies do not argue for any collapse in China but rather suggest a resurgence of US-based manufacturing with all of its benefits.

### Demographics

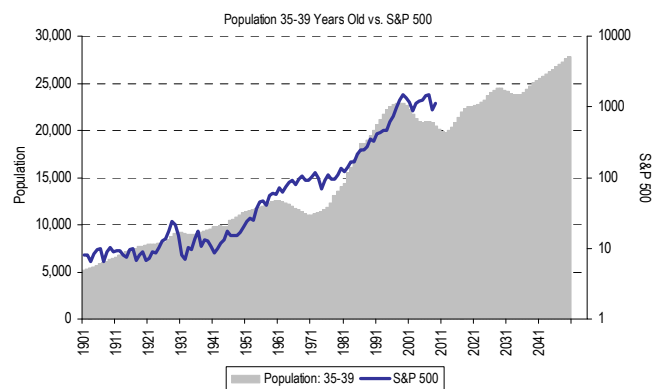
Many market observers have focused on the aging of America and that older Americans will rush to buy fixed income instruments so as to reduce their risk profiles. However, given the relative benefit of dividends versus bond yields (see Figure 15), we suspect that high quality dividend yielders will attract those investors' attention and many fund families have noted that there has been strong interest in new products that provide dividend income to yield starved investors. However, the most fascinating development is the size of the baby boom echo and specifically, the 35-39 year old age group that will be growing meaningfully in the next few years and seems to have an impact on the direction of stock prices (see Figure 16).

Figure 15.



Source: Haver Analytics and CIRA – US Equity Strategy

Figure 16.



Source: Haver Analytics and CIRA – US Equity Strategy

The age group cited is the cohort of people who have married, had a child and bought a home and is now thinking about their children's educations and their own retirement needs. Thus, they need to consider investing and they are not encumbered by the substantive equity market losses experienced since 2000 that many of us have endured. They have not suffered a lost decade in stocks and thus do not harbor any ill will to the asset class. Periods like the 1930s and 1970s, which were also awful times for stock prices were followed by much better market opportunity and thus one should be able to sense a repeat performance if the aforementioned factors have the impact that seem probable.

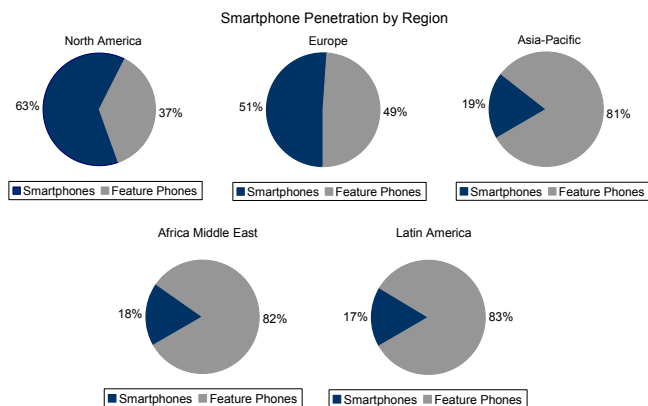
## Technological Innovation

Growth in technological mobility should have a very dramatic effect on economic development. The PC had a staggering impact in the mid-1980s as did the Internet in the late 1990s and the mid-2010s should be driven by mobility as smart devices penetrate the market even more. One can easily perceive the smart phone becoming one's wallet as well as communication device and that requires massive new investment on infrastructure ranging from better security software, faster chips, longer life batteries and more broadband spectrum especially in the wireless world. America still has a dominant position in the technology industry and has been the leader in smart device penetration.

Figure 17 shows that developed economies have better than 50% market penetration of smart phones already while global penetration is only 27% and growing fast. The network effect of apps has also been overwhelming with many wanting to access the various features and options they perceive to need. Once they have these devices, individuals and businesses open up a series of new requirements that cause massive new investment. As we highlighted in our Mobility Madness reports (dated February, 18, 2010), a new digital wave is coming and its adoption has only accelerated from earlier forecasts. As a result, we expect technology to be another source of US-driven growth.

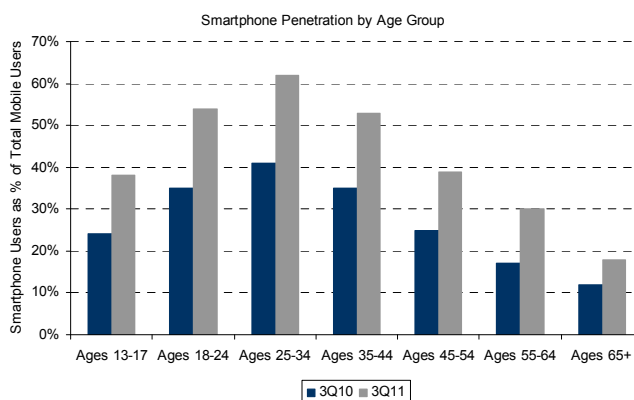
Interestingly, Nielsen's third quarter survey of mobile users showed that 43 percent of all US mobile phone subscribers own a smart phone, but the majority of those under the age of 44 have one. Nielsen estimates that 62% of adults aged 25-34 report owning a smart phone. Among those 18-24 and 35-44, the penetration rate is better than 50%, and 40% of teenagers and those 45-54 reported owning a smart phone versus a more basic cell phone. As a side note, Android remains the most popular smart phone operating system in the United States, with 43% of the market, while Apple is the top device maker, with a 28% share.

Figure 17.



Source: VisionMobile

Figure 18.



Source: Nielsen

## Conclusion

The outlook for the US is far better over the next couple of years, in our opinion, as the full confluence of the various trends highlighted above come together. We strongly doubt that investors will give the market much credit for this in the next 12 months, but the combination of a housing bottom and recovery, energy independence, a manufacturing revival, technological innovation, demography and fiscal adjustment can prove to be a very powerful series of forces. In our view,

equity risk premiums are elevated due partially to the long-term US fiscal instability matched with the problems in Europe that ultimately compresses S&P 500 valuation.

Our sense is that investors would look at American markets from a very different vantage point as the likely trends converge. Factors such as energy self sufficiency and a manufacturing revival would dramatically change the perspective on the US where such concepts were not even being contemplated by the majority of the investment community. While we do not expect the markets to react to these drivers in the near term, their coalescence could generate a much more impressive rally over the next few years, and we suspect that such views are far from the current consensus.

In the short term, the Trading Places thesis remains intact, but one can begin to see the potential for an end to the “lost” decade in US equities over the next couple of years. Even the housing sector’s bust will end, recognizing that the industry peaked in 2006 and next year will be the sixth year of decline. This report’s function is to begin educating investors to a market regime change that we deem very probable.

## Appendix A-1

### Analyst Certification

The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

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	<b>Buy</b>	<b>Hold</b>	<b>Sell</b>	<b>Buy</b>	<b>Hold</b>	<b>Sell</b>
Citi Investment Research & Analysis Global Fundamental Coverage	59%	34%	7%	10%	79%	10%
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