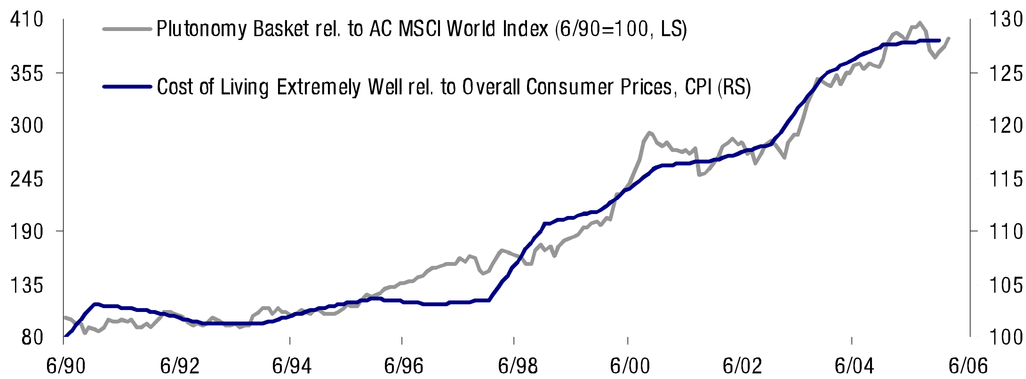
Figure 10. The Performance of the Plutonomy Basket Relative to the MSCI World Index Moves In Line with The Pricing Power of the Plutonomy Companies



Source: Citigroup Investment Research, Forbes and MSCI

If we are right, that the rich are going to keep getting richer over the coming years, then this outperformance should, in our opinion, continue. In the short term, we also think them attractive. Of these stocks, we would highlight two in particular – Richemont and LVMH are in our model portfolio.

LVMH recently announced their 2005 results, which indicated robust demand. The company also reiterated their positive outlook for 2006. In the words of our analyst Constanza Mardones, there is "no sign of a slowdown in any of (LVMH's) major markets". Constanza thinks the outlook for earnings looks "highly favorable" with a plausible chance of upgrades to come. The stock trades on 21x Constanza's forecast 2006 eps, and 11.5x 2006E EV/EBITDA.

Richemont recently announced 3Q results, with comparable sales up 14%. Underlying US revenues were up 18% (plutonomy at work). Our analyst Bruce Hubbard is bullish on the Richemont story as operational leverage is leading to margin improvements. Indeed, stronger margins have caused Bruce to upgrade EBIT by almost 25% over the course of the last 12 months. Though in Bruce's own words, the valuation argument no longer looks compelling, he believes that upgrades to forecasts will continue to give upside to the shares. The stock trades on a P/E of 18.6x Bruce's 2006 estimated earnings.

RISKS – WHAT COULD GO WRONG?

Our whole plutonomy thesis is based on the idea that the rich will keep getting richer. This thesis is not without its risks. For example, a policy error leading to asset deflation, would likely damage plutonomy. Furthermore, the rising wealth gap between the rich and poor will probably at some point lead to a political backlash. Whilst the rich are getting a greater share of the wealth, and the poor a lesser share, political enfrachisement remains as was – one person, one vote (in the plutonomies). At some point it is likely that labor will fight back against the rising profit share of the rich and there will be a political backlash against the rising wealth of the rich. This could be felt through higher taxation (on the rich or indirectly though higher corporate taxes/regulation) or through trying to protect indigenous laborers, in a push-back on globalization – either anti-immigration, or protectionism. We don't see this happening yet, though there are signs of rising political tensions. However we are keeping a close eye on developments.

CONCLUSION

The latest Survey of Consumer Finances for 2004 from the Fed, just released, shows that the richest 20% of Americans have gotten even wealthier since the last survey was conducted in *outlook for their financial status over the next 12 months is evident among the wealthiest group of investors (assets of $1 million or more), with 46% saying they will be better off financially in the coming year*", (see Appendix 1 for the background and methodology of the survey which was first released in January 2006).

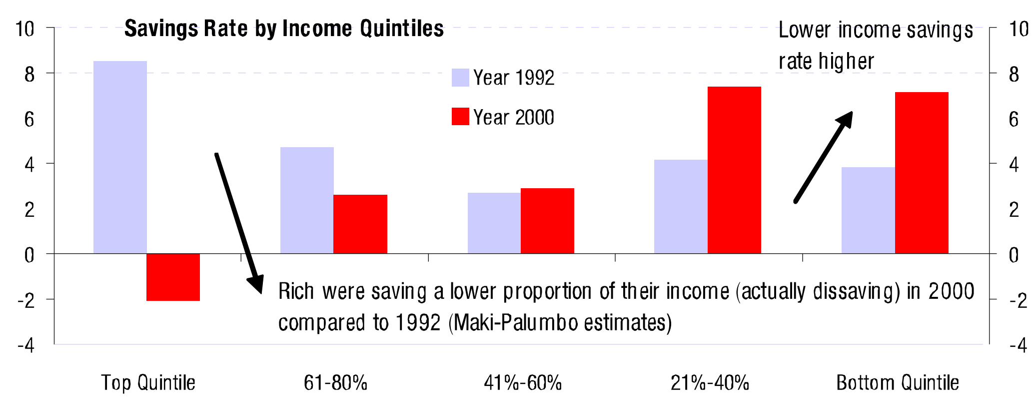
The point here, again, is that the rich are feeling a great deal happier about their prospects, than the "average" American. And as the rich are accounting for an ever larger share of wealth and spending, it is their actions that are dictating economic demand, not the actions of the "average" American.

➤ 3) Low Savings Rates

The "disaster waiting to happen scenario" we hear about most from our clients, is the low savings rates in countries such as the UK and US. Well, we disagree that this is such a big problem in the near term, the time horizon that matters for most equity investors. As we showed in our note on Plutonomy back in October, using data from a paper written by two (then) Fed economists, the low savings rate in the US (and we believe the same holds true in the other plutonomy countries like the UK, Canada and Australia) is a function of the savings habits of the richest 20%. Figure 5 shows the savings rates split down by income quintile in the US. The richest quintile are primarily to blame for the overall fall in the savings rate in recent years – although there low savings behavior has likely been joined in the past few years by the housing-pumped non-plutonomist US consumer.

The rich are being perfectly rational. As their wealth/income ratios have been rising, and as we highlighted earlier, the latest SCF data suggests wealth/income has grown even larger, why should they not consume from their wealth rather than just their income? The more rich people there are in an economy, and the more affluent they feel (as they do right now), the more likely we believe an economy will be to experience falling savings rates. When your wealth has soared, the need to save diminishes. Rational, but apparently a conundrum and an accident waiting to happen, according to the perma-bears. Not to us.

Figure 5. Household Savings Rates of the Rich Fell in the Stock Boom in the 1990s While Those of the Lower Income Groups Rose (Maki-Palumbo Estimates for 1992 and 2000)

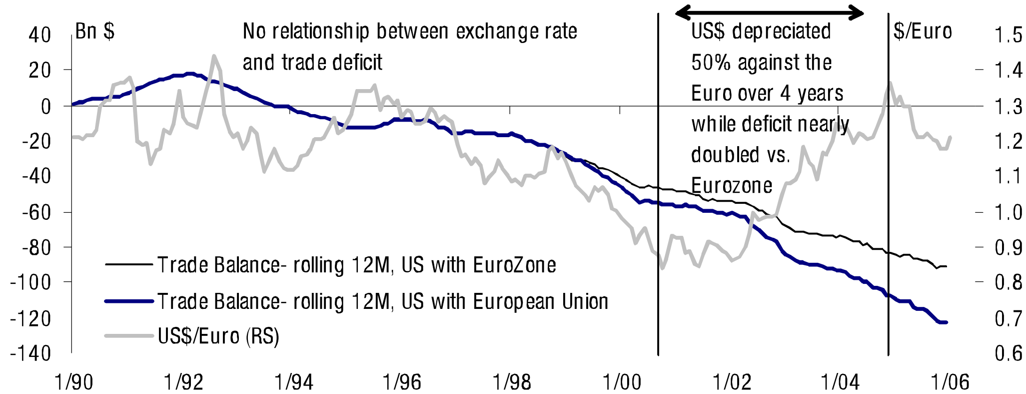


Source: Maki, Dean M. & Palumbo, Michael G. "Disentangling the Wealth Effect: A Cohort Analysis of Household Saving in the 1990's". Board of Governors of the Federal Reserve System & Putnam Investments. April 2001.

➤ 4) Global Imbalances and the US Dollar

Finally, the dollar. The perma-bears told us that the current account deficit in the US was too high. It could only be lowered by raising the savings rate of the household sector which in turn would only be accomplished by rising interest rates and/or a dollar collapse. We disagree. To us plutonomists, the current account deficit is largely a function of the savings rate, which is a function of the propensity to save by the rich. As we highlighted above, they are rationally consuming out of their stock of wealth (which incidentally, keeps going up) as well as from their incomes. To them, dollar devaluations are a mild inconvenience, but not a reason to change their spending and dis-savings habits. Here's the real conundrum: if a dollar collapse is the primary way to adjust global imbalances, we would have expected the bilateral trade deficit between the US and Eurozone to have moderated following the dollar's more than 50% devaluation against the Euro between Nov 2000 and Nov 2004. Did that happen? No. The bilateral trade deficit (on a rolling 12 month total basis) *nearly doubled* from $47.5 billion to $83.6 billion. The bottom line to us is that plutonomics is a better explanation of these 'nasty' deficits, and currency manipulation just doesn't change the habits of plutonomists enough to make a difference.

Figure 6. Example of A Conundrum We Believe Plutonomy Sheds Light on: Euro/US$ Exchange Rate Appears Unrelated to the Increasing U.S. Trade Deficit with Europe



Source: CEIC and Citigroup Investment Research

PLUTONOMY AND THE EQUITY MARKETS

There are, in our opinion, two issues for equity investors to consider. Firstly, if we are right, that plutonomy is to blame for many of the apparent conundrums that exist around the world, such as negative savings, current account deficits, no consumer recession despite high oil prices or weak consumer sentiment, then so long as the rich continue to get richer, the likelihood of these conundrums resolving themselves through traditionally disruptive means (currency collapses, consumer recessions etc) looks low. The first consequence for equity investors who worry about these issues, is that the risk premia they ascribe to equities to reflect these conundrums/worries, may be too high.

Secondly, if the rich are to keep getting richer, as we think they will do, then this has on-going positive implications for the businesses selling to the rich. We have called these businesses "Plutonomy stocks". We see three reasons to take another look at those plutonomy stocks.

1) The Survey of Consumer Finances continues to show the robust health of the richest consumers in society. The rising net wealth to incomes ratio (now standing at over 8.4x) is an indication of just how robust the balance sheets of the rich are. While we have concerns about the spending power of the middle-income consumer in the US in the event of a housing slowdown, the richest 10% are less exposed to a housing slowdown, as their wealth is more diversified. They are rich, feeling good about their wealth (as our Citigroup Smith Barney Affluent Investor poll points out) and likely to spend.

2) While not as impressive as in some previous years, nevertheless the Forbes CLEW Index once again shows what pricing power really is. Once more, inflation in luxury goods rose faster than general CPI as we highlighted earlier. The CLEW Index has doubled relative to overall CPI over the last 29 years. Not only is demand for luxury goods likely to be strong in the near future, but pricing power is good too. A rosy combination.

3) Emerging markets. It doesn't take a genius to have spotted that emerging markets are doing well. The recycling of commodity price liquidity is not only benefiting the emerging markets themselves, but is creating a new breed of brash, confident millionaire consumers. This is a boon to the Plutonomy stocks. Short of buying UK football clubs to play the recycling of these cash flows, we can see a much easier way of playing this strong demand theme in buying the plutonomy stocks.

So what are these plutonomy stocks? Figure 7 shows the names that we used to create our Plutonomy basket back in October. This is not an exhaustive list.

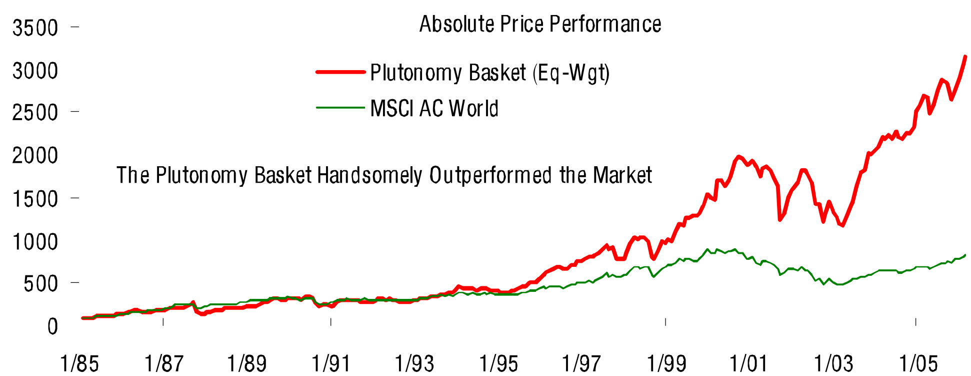
Figure 7. Basket of Plutonomy Stocks

	Company	RIC	Rating	MSCI GICS	Mcap (U$m)	Price (Mar 2)
1	Beneteau	BEN.PA	NR	Cons Durables/ Apparel	1,371	EUR65.65
2	Bulgari	BULG.MI	NR	Cons Durables/ Apparel	3,629	EUR10.16
3	Burberry	BRBY.L	1M	Cons Durables/ Apparel	3,644	£4.6025
4	Coach	COH	NR	Cons Durables/ Apparel	13,893	$36.24
5	Dickson Concepts	0113.HK	NR	Retailing	446	$11.15
6	Four Seasons Hotels	FSH-SV.TO	NR	Consumer Services	1,859	$63.97
7	Hermes	RMS.PA	NR	Cons Durables/ Apparel	9,252	EUR213
8	Julius Baer	BAER.VX	1H	Div Financials	8,387	SwF118.3
9	Kuoni	KUNN.S	1M	Consumer Services	1,286	SwF560
10	LVMH	MC.PA	1M	Cons Durables/ Apparel	46,586	EUR79.35
11	Mandarin Oriental	MOIL.SI	NR	Consumer Services	993	$1
12	Polo Ralph Lauren	RL	NR	Cons Durables/ Apparel	3,629	$58.87
13	Porsche	PSHG_p.DE	3H	Automobiles	7,238	EUR690.34
14	Richemont	CFR.VX	1M	Cons Durables/ Apparel	26,059	SwF59.3
15	Rodriguez Group	ROD.PA	NR	Cons Durables/ Apparel	749	EUR50
16	Shangri-La Asia	0069.HK	NR	Consumer Services	4,072	$12.5
17	Shinwa Art Auction	2437	NR	Consumer Services	204	¥1240000
18	Sothebys	BID	NR	Consumer Services	1,213	$21.1
19	Tasaki Shinju	7968	NR	Cons Durables/ Apparel	212	¥651
20	Tiffanys	TIF	NR	Retailing	5,245	$36.87
21	Tod's	TOD.MI	NR	Cons Durables/ Apparel	2,200	EUR60.7
22	Toll Brothers	TOL	1H	Cons Durables/ Apparel	5,200	$33.52
23	Vontobel	VONN.SW	NR	Div Financials	2,559	SwF51.45
24	Wolford	WOF.F	NR	Cons Durables/ Apparel	127	EUR21.26

Source: Factset and Citigroup Investment Research

These stocks have done very well over the last 20 years. Figure 8 shows the performance of the Plutonomy basket relative to the MSCI AC World Index since 1985. The cumulative annual growth rate of the basket is a cool 17.8%, handsomely outperforming the MSCI World Index.

Figure 8. The Plutonomy Basket Has Handsomely Outperformed the Global Equity Market Since 1985, on Average by 7.3% a Year

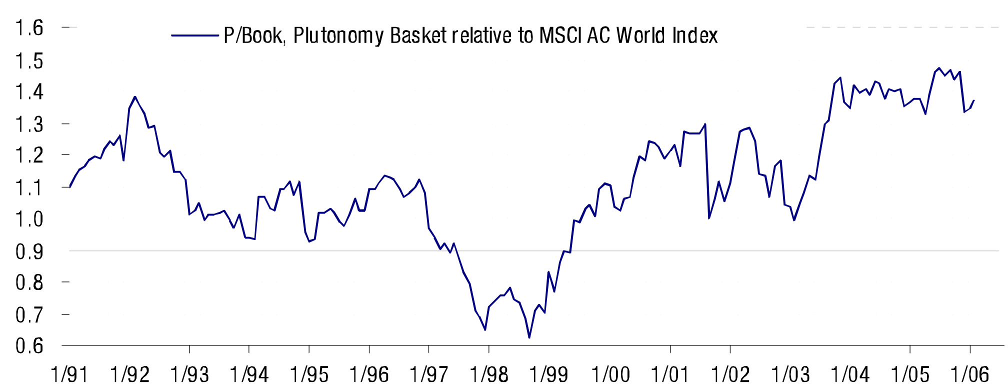


Companies in the Plutonomy Basket:shown in figure 7.

Source: Citigroup Investment Research

Critics will rightly argue, that the Plutonomy stocks are not cheap. We agree – they are currently close to a 15 year P/Book multiple relative high (1.4), compared to the MSCI World Index (figure 9). However, we find there is very limited predictive power in this valuation metric as a sell signal. A better metric for outperformance is relative pricing power – as figure 10 shows, the plutonomy stocks have tended to outperform when they exhibit relative pricing power, as we think they do right now.

Figure 9. The Plutonomy Basket's P/Book Looks Expensive Relative to MSCI World Index But This Has Little Predictive Power For Future Performance



Source: Citigroup Investment Research, Worldscope and MSCI