Market Outlook

Yields Set the Pace to Volatility

June 2015

By Citi EMEA Consumer Bank

Equities Markets

Feature

Interest rates around the world moved sharply higher, as low-yield fatigue, disappointing US data and EUR strength triggered a counter-trend sell-off, exacerbated by crowded positioning. Yields on long-dated US Treasuries and German Bunds rose significantly over the course of several weeks, driving negative return performance in many high-quality fixed income markets as well as in risky assets.

Powerful central bank actions coupled with overwhelming consensus positioning have left most asset markets subject to sharp reversals this year. However, these counter-trend movements, led by the unwinding of "crowded" positioning, won't change the longer-term fundamental outlook which drives markets. While Citi analysts remain largely constructive on risk assets with a 12-18-month tactical horizon, they see high correlations across asset classes as a significant market risk in the near term.

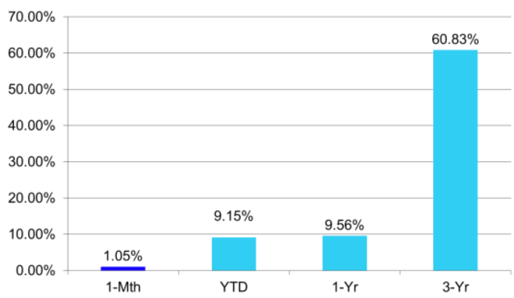
Citi analysts also remind us that we shouldn't forget financial markets provided generous returns in the first four months of 2015, with local equity markets up 20% in the markets exercising Quantitative Easing (QE) - Europe and Asia. Just as achieving market returns can sometimes seem "easier" than usual, difficult market conditions can arise quickly, even when fundamentals are well aligned.

United States

– Temporary influences that hit Q1 GDP growth have lowered Citi analyst' projected annual growth for 2015 to 2.5% from 2.6% last month. However, Citi analysts continue to expect a rebound later this year. The strong US dollar remains a significant risk to the growth outlook. They expect that the recent weak growth and the likelihood of subdued inflation will delay the data-dependent Fed rate hike until year end.

- Citi analysts' expectation for mid-single digit US earnings per share growth this year, low interest rates and rapidly growing dividends leaves them expecting further US market gains. A strengthening dollar trend is also raising demand for U.S. dollar-denominated assets. However, they think U.S. growth is unlikely to upwardly surprise consensus.

S&P 500 Index



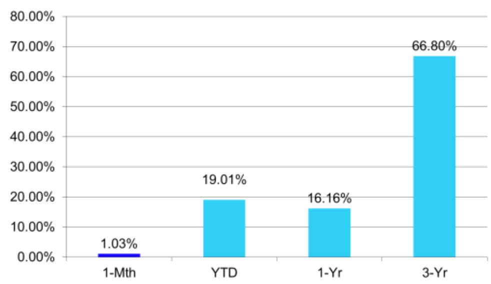
*Denotes cumulative performance
Performance data as of 31 May 2015
Source: Bloomberg

Euro-Area

– Citi analysts leave their 2015 & 2016 GDP forecasts at 1.5% and 2.1%, respectively. In light of the recent rise in government bond yields and the euro, Citi analysts see the balance of risks as being more neutral,. They continue to believe that a deal on Greece remains likely this month as financial pressure intensifies on the Greek government. Although inflation is rebounding, they see no real risk that the European Central Bank will taper asset purchases before Sep-16 (at the earliest).

- In this environment, Citi analysts remain overweight Europe equity broadly as the region benefits from both accelerating economic growth and easing monetary policy, A weaker outlook for the Euro must be taken into account for international investors.

DJ Eurostoxx 600 Index



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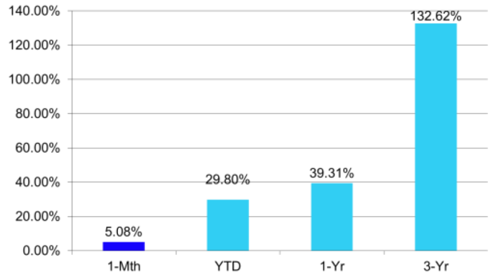
Equities Markets

Japan

– Citi analysts are sticking to their view that the Bank of Japan (BoJ) will act again later this year, due to the gap between the BoJ's bullish inflation projections and the reality expected to become evident in the months to come. As for concrete easing measures, Cit analysts anticipate more of the same, increased purchases of Government Bonds and ETFs.

– Citi analysts believe Japanese equities may continue to outperform global markets. Monetary easing in Japan appears likely to win out with the BoJ further expanding its balance sheet and Prime Minister Abe delaying the 2015 consumption tax hike.

Topix Index



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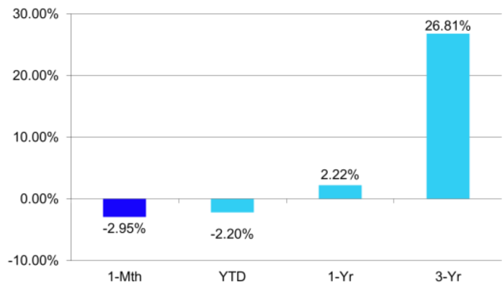
Source: Bloomberg

Asia Pacific

– Citi analysts think the fundamental story in the region is anything but reflationary, with disappointing economic activity for most countries, especially with respect to trade. They think the oil rebound is not a material threat to inflation and central banks will be on the neutral to dovish side — India and Indonesia are likely to cut rates, with Korea and Thailand at risk of further easing. India's reform programme has faced setbacks but Citi analysts think these will prove to be delays rather than cancellations.

– In China, macro indicators show downside risk to Citi analysts' growth forecast of 6.7% YoY in 2Q. The Bank Of China's balance sheet may expand to curtail the cost of capital and accommodate interest rate liberalization as well as the local government debt swap. Citi analysts expect two more 25bp rate cuts, two more rate reductions, and a slightly softer RMB in the near term, which should be supportive for equities.

MSCI Asia Pacific ex-Japan Index



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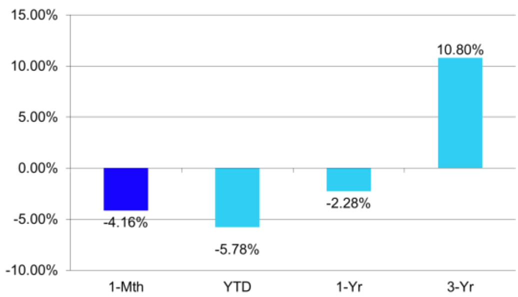
Source: Bloomberg

Emerging Markets

– The rise in oil prices is causing the market to reassess the outlook for monetary policy. In Central Europe, higher oil prices are adding to the inflationary pressures that are already mounting due to strong growth and shrinking output gaps. Yet it's South Africa where interest rate expectations have risen the most, owing to the additional risks created by electricity shortages and wage pressures. In contrast, Russia is basking in this environment: higher oil prices help strengthen the rouble, push inflation down, and create space for further rate cuts.

- Citi analysts are keeping their growth and inflation forecasts for Brazil and Mexico unchanged. In Brazil, they expect a final 25bps hike to the Selic rate in June, but poor growth prospects and a more benign inflation outlook for 2H15 should allow some monetary easing later in the year. For Mexico, they still expect a 25bps hike in December. Citi analysts reduced their underweight to LatAm equities last month given falling valuations, and the currency and commodity price adjustments already in place.

MSCI Emerging Markets Index



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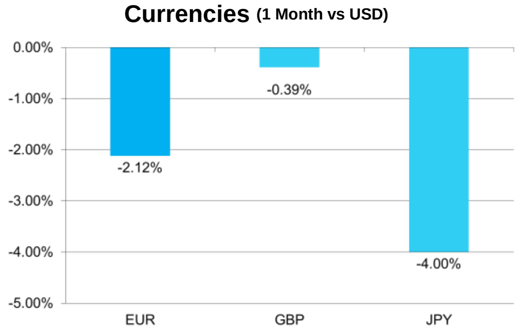
Currencies and Bonds Markets

Currencies

– Data improvement, higher oil prices and positioning coupled with a likely later, than previously expected by markets, US rate hike may see EUR reach 1.15-1.17 over 0-3m. Medium term, further downside is forecast as higher inflation remains a key intermediate policy objective of the ECB. Policy normalization in the US may also see EURUSD drop to parity.

– Election outcome surprise to the upside, with a majority Conservative government led to positive GBP. With markets pricing in Bank of England tightening at a very distant 12 – 18 months' time (the risk being such expectations could be well brought forward) plus a market that is still positioned very short in sterling, the positive momentum in the GBP is likely to hold near term.

- Citi analysts expects a QE extension at the July BoJ meeting which means medium to longer term cyclical and policy divergence could weaken the Yen further. But the prospect for further BoJ easing may already be largely discounted into FX pricing and with yen positioning more neutral and the lower oil prices now helping boost Japan's trade/current account balance, such Yen weakness may be moderate.



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Bonds

US Treasuries

U.S. Treasury yields offer a poor return as a standalone investment, but the record-wide premium on long-term Treasuries over other global safe havens and their negative correlation to equities and credit markets provides value as a risk-hedge in a diversified portfolio.

Investment Grade Corporates

The direction of rates is key to performance. Citi analysts favour financials over non-financials. Despite some balance sheet re-leveraging, they prefer corporates with a neutral weighting in conjunction with an underweight in sovereigns to express a moderate underweight to fixed income overall.

High-Yield (HY)

Citi analysts remain constructive although returns are likely to be modest going forward. Citi analysts maintain their overweight conviction to European and US HY issuers on the back of liquidity support, low default rate and stabilizing energy prices.

Emerging Market Debt

Citi analysts remain underweight the sector given improving prospects for a stronger USD and commodity challenges, although expect Asia to be the most resilient over the next year as it is a major beneficiary of lower oil prices.

Euro Bonds

Recent and prospective ECB actions further promote periphery spread compression. Citi analysts favor Spain and Portugal, though Citi analysts remain underweight Euro government bonds overall given very low yields.

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