Global Market Analysis by Citi EMEA Regional Consumer Bank

Standpoint

Annual Outlook 2015

Contents

Forecasts may not be attained. Past performance is no guarantee of future results. There are additional risks associated with foreign investments.

Global Context in 2015

Divergences and Convergences

Looking at the various consensus forecasts and expectations for 2015, the coming year looks like a repeat of the views for 2014 with weak but positive global GDP growth led by the US, higher US dollar, higher equities and higher bond yields. Economic divergences are likely to increase further with on one hand regions such as the US and UK showing signs of strengthening and on the other hand weaker regions such as the Euro Area and Japan struggling to avoid recessionary scenarios. As economic trends diverge, monetary policies will also be characterized by major divergences. Indeed, according to Citi analysts, 50% of the world is expected to remain accommodative while the remainder is likely to hike interest rates. Whilst increased divergences don't necessarily put in peril a base case scenario that is favourable to risky assets, it is likely to drive more instability and volatility in global markets.

"The global convergence towards low inflation, a trend initiated by continuously underperforming economic growth and which accelerated with the collapse of oil prices, is likely to influence markets stability in 2015"

While the consensus reflects the hypothesis of a weak global economic growth, Citi analysts think global growth is actually set to disappoint again. They hold the view that the economic recovery is extraordinarily weak because there is an endemic excess of savings over investments that only a spontaneous eruption of animal spirits boosting domestic consumption and/or capital formation, a major boost from external demand, or aggressive expansionary policies can resolve. But in a world with such limited growth and ample resource underutilization, low inflation is actually likely to emerge. "Low-flation" in turn contributes to prolonging the period of low growth when nominal policy rates are near the zero lower bound, limiting the effectiveness of traditional policies.

From Cyclical to Secular Stagnation

Growth is insufficient and output gaps remain wide open despite some gains in labour market conditions. The global financial crisis (GFC) is gradually fading in memory, yet the pace of economic recovery leaves much to be desired. For years, economists have naturally blamed fiscal consolidation and private deleveraging, for the lack of final demand. However, except in Japan, 2014 was hardly a year of additional fiscal tightening and, furthermore, private sector deleveraging has slowed almost everywhere. Monetary policy accommodation remains extensive across the board, and real policy rates are negative in Developed Markets (DM). However, once policy rates are near the lower boundary, the transmission mechanism relies more on wealth and liquidity effects which seem to have lost some of their punch. In the US, for instance, household wealth increased in value by nearly $15 trillion since the launch of the third round of quantitative easing (QE3) yet consumer spending has only grown a modest 2.5%, in contrast with the pre-crisis high propensity to spend out of wealth. Citi analysts advance two explanations for the apparent fall in the US marginal propensity to spend out of wealth. The first is that the increase in wealth since the GFC is likely to have been more unequally distributed than in the past and the second is that since the GFC, household wealth increases, especially those associated with higher home prices, have not been leveraged to the same degree as prior to the crisis as mortgage equity withdrawal has been more limited.

"The same way that consumers sport a lower marginal propensity to spend out of wealth, corporates with still fairly healthy balance sheets are reluctant to engage in capital expenditure"

W. Buiter
Citi Chief Economist.

Investment in the DMs has been disappointing, despite the low level of real interest rates. Interestingly, corporate leverage started to increase at the launch of QE3 but with Treasury yields half of earnings yields; the higher leverage has been mostly used for other purposes than to support increased capital expenditures, which includes equity buy-backs, extraordinary dividends or mergers and acquisitions. With the lack of investments and in the absence of an external shock to boost demand, the negative output gap and the underutilization of labor become persistent, unemployed

turn into long-term unemployed, real interest rates stay low, inflation drifts inexorably lower, and cyclical stagnation becomes secular.

Global Monetary Stance Remains Expansionary

In that economic quasi stagnation and "low-flation" context, Citi analysts think central banks aiming to increase inflation are likely to undertake expansionary quantitative and qualitative easing policies. The Bank of Japan (BoJ) recently announced a first expansion of its aggressive QE program, expanding the menu and scope of asset purchases. It is now the European Central Bank (ECB)'s turn to pursue its own 1trn euros large scale asset purchases, probably in early 2015.

> "While it is technically possible to have more negative nominal policy rates in Developed Markets than those observed today, operational constraints make it difficult for central banks to implement them"
>
> **W. Buiter**
> **Citi Chief Economist.**

Even in those advanced economies where the output gap is closing more materially (the US and the UK, mainly) Citi analysts now imagine that the Fed will initiate the zero-exit of the Fed Funds target rate beginning in December 2015 and will proceed at a very moderate pace to reach a new normal rate only after 2018. Meanwhile, the Bank of England is expected to start raising Bank Rate slightly before the Fed's zero-exit, unless uncertainty preceding or following the general elections of May 2015 severely damage domestic demand.

The divergence between the monetary policy paths of the US and UK on the one hand, and the Eurozone and Japan on the other, activates an important transmission mechanism for QE policies: the exchange rate. On the basis of the hypothesis that the lower marginal propensity to spend out of wealth observed in the US is also present in Europe and Japan, the best hope for a lift in inflation is likely to be through the exchange rate. In consequence, Citi analysts anticipate further weakness in the Yen, Euro and in Emerging Markets (EM) currencies vis-à-vis the US dollar in 2015.

Figure 1. 2015 Citi Forecasts

End of period	GDP Growth	CPI Inflation
Global	3.1	2.5
United States	3.0	1.4
Japan	0.9	1.4
Euro Area	1.1	0.8
Germany	1.1	1.1
France	0.7	0.9
Italy	0.3	0.5
Spain	2.0	0.2
United Kingdom	3.0	1.3
China	6.9	1.9
India	6.5	6.2
Czech	2.3	1.2
Hungary	2.5	1.7
Poland	3.4	0.8
Russia	-1.0	7.6
Brazil	0.5	6.5

Source: Citi Research

Energy

The Energy Revolution Goes Global

Low global activity leads to low commodity prices, this is a well-known economic relationship which is now commonly used to explain the recent 30% collapse of oil prices. However, Citi analysts think that the recent weakness in oil prices is not just driven by a reduction in oil demand caused by a lower global GDP growth and by policies that promote a less commodity-intensive, energy intensive and carbon-intensive composition of production and demand, but is to a large extent the reflection of a technological disruption that led to a large (distributional) global shock. These three themes marked the second semester of 2014 and, Citi analysts think, will continue to shape economic and political outcomes in 2015.

Shale Fracking Boom

The Shale fracking boom that occurred in the US has led to a major change in the structure of the energy markets. According to the International Energy Agency (IEA) data, the U.S. is pumping the most oil in 27 years, adding more than 3 million barrels of daily supply since 2008. In parallel, the US imports of oil decreased by 25% compared to their 2008 levels and IEA forecast that foreign deliveries will meet 22% of US oil needs next year, the lowest level since 1970. We cannot wave off the negative impact on oil prices from lower economic activity in Europe, China and to some extent Japan compared to 2008, but the shale revolution occurring in the US, the largest energy consumer in the world, impacts both supply and demand, in a large scale and for a long time.

"North America has pushed out an incredible amount of crude oil that it used to import and the world doesn't need that much"

E. Morse
Citi Commodity Strategist.

The biggest effect from shale gas to date has been in the U.S., where an already well developed oil & gas industry combined with attractive geological characteristics meant that this shale has been the first to be developed extensively and some of the cheapest to extract. Shale gas now accounts for a third of total U.S. natural gas production, more than compensating for the decline in conventional natural gas production. The boom in shale gas production has allowed the U.S. to reclaim its place as the world's largest natural gas producer, edging out Russia, with a sizable lead over all the other major gas producers. The exploitation of shale gas has led to a renaissance in total U.S. natural gas production since 2005. Reversing a decade-long decline, production has risen from a low of approx. 18 tcf in 2006 to a record high of approx. 23 Trillion Cubic Feet (tcf) in 2011. U.S. shale gas production is expected to continue its growth in the medium term according to the US Energy Information Administration which will position shale gas as the dominant source of natural gas in the U.S., accounting for 50% of the total U.S. natural gas supply of 28 tcf.

The effect of the shale gas boom can be clearly seen in the decline of US natural gas imports, and the changing fate of U.S. policy towards Liquid Natural Gas (LNG). Just a decade ago, the U.S. imported up to 18% of the amount of natural gas that it consumed. Since 2005, however, the import rate has fallen sharply, and in 2012 sat at just 5.6% of U.S. natural gas consumption. Consequently, the U.S. now expects to become a net exporter of natural gas in the near future. One of the immediate consequences of this 'technology change' in the gas industry has been dramatically lower gas prices in the U.S., where the Henry Hub natural gas price benchmark fell from its peak of $13.28/MMBtu in early July 2008 to a low of $1.89/MMBtu in April 2012. The fall in U.S. natural gas imports contrasts with the fortunes of the European Union, which imports over 60% of its natural gas, and China, which in the last 10 years has shifted from being a net exporter of natural gas, to being a large net importer.

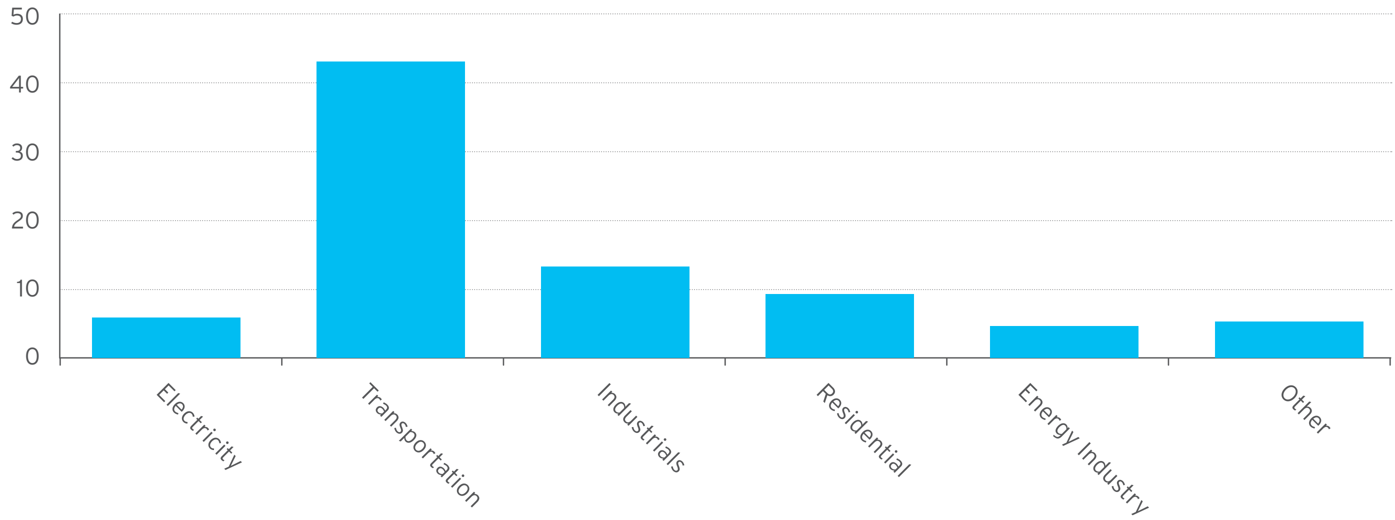
"Geopolitical risks, while largely swamped by the growth of US shale, can drive short-term volatility"

E. Morse
Citi Commodity Strategist.

Oil Substitution

The increased substitution of gas for oil is a contributing factor to Citi analysts' bearishness on longer term oil prices. The key drivers of this bearishness are supply side factors – the ramp up in shale/tight oil production in the US and elsewhere by end decade, Iraqi production climbing rapidly over the coming years and deep and ultra-deep water production

Figure 2. World oil demand by sector (million barrels per day)



Source: IEA, Citi Research

adding an incremental 3.5-mb/d to global supplies, a 50% increase from their current supply volumes.

Demand, however, is also very much in play as the fuel economy of US cars and trucks continues to improve; at the end of August 2012 the Obama administration finalised fuel efficiency standards for U.S. cars and light-duty trucks that mandates 54.5 Miles per Gallon (mpg) by Model Year 2025, which would more than double the fuel economy of new cars and light trucks from the October 2012 level – itself an all-time high – of 24.1 mpg. China, Japan and Europe are all mandating significant improvements in light duty vehicle fuel economy.

Transportation remains the one part of the energy complex in which oil still reigns supreme as a fuel source, but even that is now under attack in every area, be it road, rail, sea or air. Demand is being reined in by much higher fuel economy mandates, and now natural gas and other technologies are becoming increasingly viable substitutes, a process which should accelerate from here on out. Economics and the lack/cost of alternative infrastructure (for example electric vehicle charging points) suggest that oil's dominance of transport will continue far longer, while the power generation market is evolving more quickly. However, while it is earlier stage, the evolution of the transportation industry is underway, and Citi analysts suggest we should be mindful of the early stage similarities with the power generation market, and the likely ultimate outcome.

Over the past few years, Citi's Commodities Strategy team has painted a medium-term bearish picture for oil prices, arguing that by 2017-18 the prevailing floor price of Brent at $90 would become either a medium term mean-reversion level at best, or a new ceiling price at worst. They also argued persistently that short-term market dynamics were putting pressure on prices and the most likely alternative scenario to a weaker market was a much weaker market. Yet financial flows out of commodities, the rapid move from investor net long to net short position, decelerating Chinese growth, and Saudi pricing in Asia drove prices even lower than anticipated. On the basis of four different long term crude forecasting models, they project a medium-term assessment (five years out) of the fair market value for Brent crude between $70-90/bbl.

Portfolio Strategy

Diversification Rather than Rotation

Despite the resurgence of geopolitical, economic uncertainties and volatility during the last 12 months, 2014 has been a rather comfortable year for portfolio allocation decisions. Good in the sense that returns across asset classes have been supportive and benign in the sense that high correlations in a context of supportive returns prevented damages from potential misallocation decisions. Actually, over the past few years, and not only in 2014, QE has had a dramatic impact on asset performance and allocation through the introduction of a new price-insensitive marginal buyer (Central Banks) and by maintaining an environment of low rates and low volatility. However, this is about to change.

Now here we are, with record high equity prices and record low yields, volatility is coming back, inflation expectations have collapsed and monetary policies trends are changing. As the rhetoric of the US Fed changed in September, Citi analysts also introduced the idea that US markets in particular were moving into a new phase of the Credit/Equity cycle, which is characterized by higher yields, balance sheet re-leveraging, higher spreads, and a developing earnings momentum which would support equities against bonds. Obviously, the context is becoming a little more complex and investment decisions such as building up equity allocation amid increased volatility and more expensive valuations, or maintain a sufficient bond allocation while current Treasury yields level offer little room for excess return (which by the way was already a major consensus view 12 months ago) will require discipline and focus on long term risk-return goals.

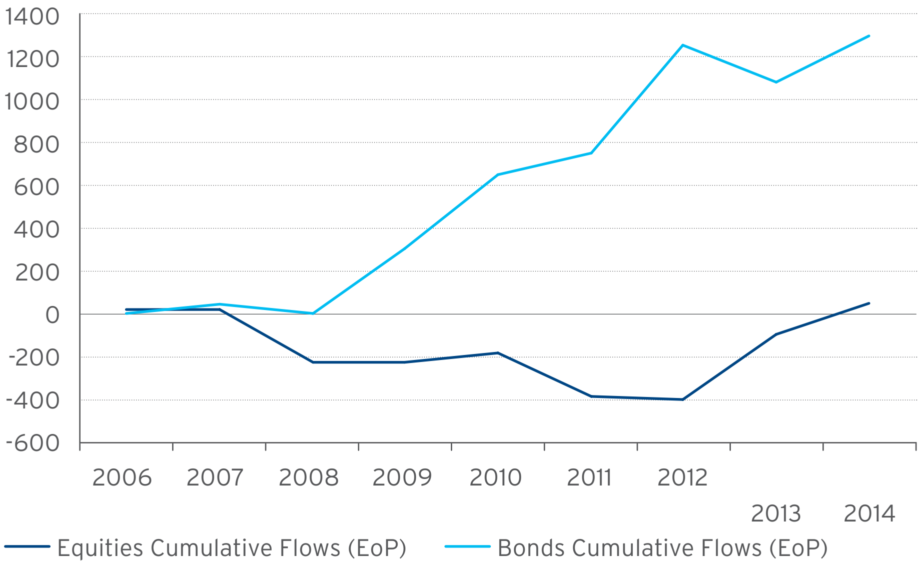
> A key dilemma for high net-worth investors is whether to allocate more to equities now that US equity markets have roughly tripled from their 2008 lows and the recent correction preserves most of those gains.
>
> **S. Wieting**
> **Citi Private Bank Chief Investment Strategist.**

Great Diversification rather than Great Rotation

The topic of a great rotation induced by a turn in the trend of yields has been in the air since the US Federal Reserve first spoke about QE Taper in May 2013. However, Citi analysts think that investors expecting a "great rotation" out of bonds and into equities driven by the turn in the economic cycle are likely to be disappointed. This does not, however, mean that equity returns will be poor relative to fixed income markets. According to them, the major trend underway in asset allocation is not rotation, it is diversification. Investors are not selling bonds to buy equities, and Citi analysts do not expect them to do so. Investors are diversifying out of traditional assets into a range of new assets and asset managers are creating platforms that make it easier for them to do this.

The post QE world will undoubtedly look very different from the one we know today, however there are a number of core developments that we expect to remain in place: a greater bias towards regional market selection on the back of greater global economic divergence, a greater choice of potentially less

Figure 3.



Source: EPFR, Citi Research

correlated assets that will create better diversification, a broader platform of investment products and providers and, of course, a changing regulatory environment.

Bonds and Equities

Those pointing to cheap relative valuation levels of equities relative to bonds may be missing the point. Quantitative easing has distorted market price but it is not clear the end of QE will reverse the moves. Divergent growth patterns and low inflation will outweigh the traditional cyclical patterns.

Equity markets combine cyclical, secular and structural drivers. There is a cyclical equity rotation underway, but it is taking place within the asset class in the shift from high-dividend defensive stocks into more cyclical growth stocks and Emerging Markets stocks into Developed Markets stocks. This does not, however, alter the net demand profile. The secular demand for equities, however, does seem to be turning after nearly two decades of contraction. Citi analysts expect the aggregate demand for equities to continue to rise, but not for cyclical reasons.

"There is still a lot of cash in the system and low rates and low volatility will intensify the pressure on investors and companies to put that cash to work. Equities may be the beneficiary of a period of raised secular demand"

M. Schofield
Citi Global Macro Strategist.

The bond rotation has not yet begun. When it does, it will be a result of rising risk premia in one of the traditional drivers of bonds: interest rate risk, inflation risk or default risk. According to Citi analysts, the end of the twenty year bull market in bonds will likely have very little to do with what investors are doing in equities.

Bond markets are, by nature, very cyclical over the long-term. The current cycle is, however, extremely unusual. There is very little inflationary pressure to worry bond investors, funding rates are low, and in many regions likely to remain low for a long time. With globalization trends slowing, the divergent regional economic outlook allows bond investors to rotate their duration risk across different geographies rather than across asset classes.

There are some structural patterns driving demand for fixed income assets but these are quite often diverse and mitigating: Citi analysts expect insurance companies to reduce bond exposure and raise equity weightings, while they think pension funds are more likely to reduce equity exposure as their funded status improves.

More diverse, better hedged portfolios

With a divergent global economy, the emergence of new asset classes and the creation of more diverse and solution-based investment platforms (e.g. REITs, Private Equity, Income strategies,...), Citi analysts expect the trend towards in-asset class risk allocation to become more pronounced. Citi analysts expect investors to become increasingly focused on style-based or geographical risk allocations rather than cross-asset decisions. This means a greater focus on income versus growth allocations, yield curve trades, credit curve strategies, risk-neutral cross-border trades or sector allocations.

This does not mean Citi analysts expect a reversal of the recent trend towards multi-asset portfolios. Quite the contrary; they think increasingly diverse portfolios are the future. What it does mean is that the decision to take more risk in a particular asset class is based on an assessment of risk-adjusted return in that asset, that risk allocations in any given asset are not contingent on risk reduction elsewhere and that multi-asset hedging strategies are likely to become an increasingly popular way to manage aggregate risk levels.

As a guide to the future of portfolio allocation behaviours, Citi analysts expect a much more protracted trend towards in-asset class rotations going forward. Diversification rather than rotation is likely to be the dominant cross-asset trend as investors continue their search for sustainable income.

Equities

Supportive but Volatile Context

As the turn of the year approaches, investors increasingly question the sustainability of a bull market which could be endangered by a weakening and diverging global economic context. Clearly the significant volatility that we have witnessed in October has given us food for thought and that, along with the greater uncertainty around the macroeconomic backdrop, has led us to ask whether or not trends might be shifting or whether the recent dip in equity markets should be regarded as a buying opportunity. The first lesson we should take from the recent episode of volatility is that risk is a key component of equity markets' short term and long term returns, something investors tend to forget. Actually, over the past 15 years, 11 saw a global equity markets drawdown of more than 10% and of the four years which ended up with negative annual returns, three were actually recessionary years. Although the chance for a another correction in 2015 is high (we only had one in 3 years), Citi analysts' outlook remains benign and with a greater downgrade to their inflation forecast than to the growth forecast, they think policy makers actually have greater scope to respond to the weakness in growth with more stimulus. All in all, supportive liquidity, earnings and GDP growth mean that Citi remains comfortable with the outlook for risky assets. In the following section, we address the themes Citi analysts think that are likely to influence equity demand in the coming months.

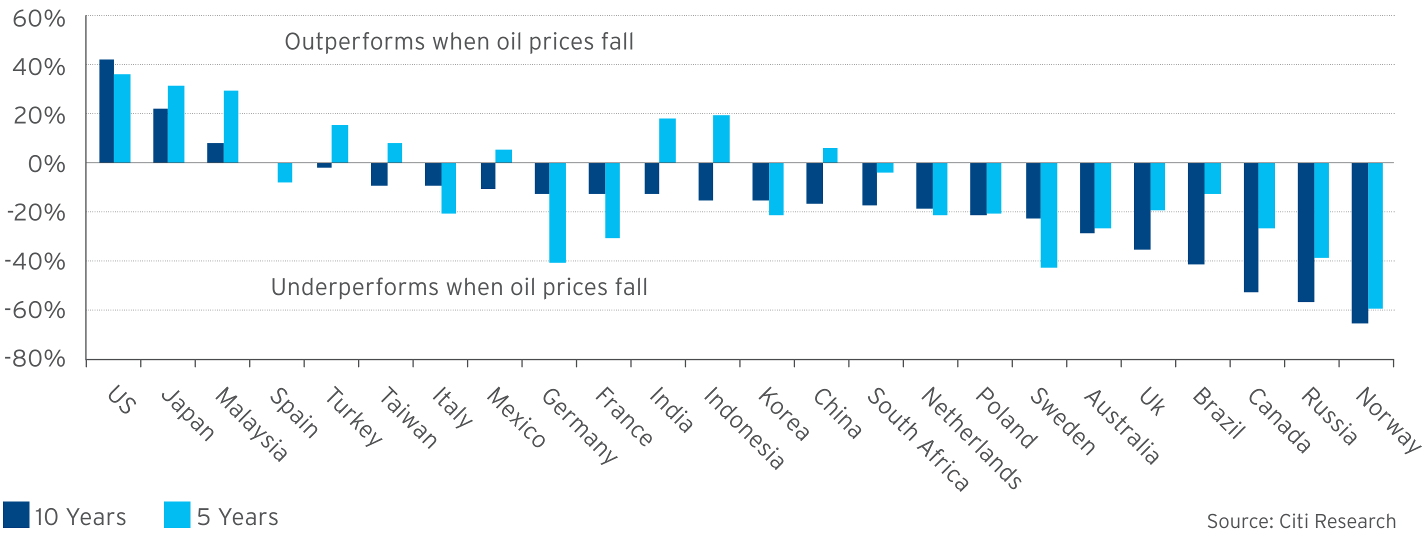
Oil Prices

Brent is down 36% from the $116 peak almost six months ago. This is a significant move (over 1 standard deviation for 6-month rolling performance over last 30 years) even for a commodity known for its high volatility. There is a strong tendency in the common thinking to link falling oil prices with recession, and therefore to consider that lower oil prices lead lower equities.

However, that common thinking is not always right, and what Citi analysts observe is actually quite different.

First of all, global equities actually continue to grind higher despite falling oil prices. Since June, oil prices are sharply down, but global equities rebounded to end up flat in US$ and up 4% in local terms. Also, looking at the previous episodes when oil prices fell by more than 30%, Citi analysts find that the relationship between the performance of global equities and oil prices is pretty mixed. They went up during six out of ten episodes. The two episodes (2001, 2008) when global stocks fell the most along with oil prices were during recessions. However, Citi analysts emphasize that falling oil prices were coincident with recessions, but oil prices did not actually forecast recession. In fact they find that the sharp spikes (not falls) in oil prices tend to precede or perhaps trigger an economic recession. Going forward, Citi analysts are expecting global economic growth to pick up next year. This suggests that the recent fall in oil prices is more supply, than demand related. A demand related drop in the oil price would be more troublesome for global equities.

Figure 4.



Source: Citi Research

Looking at oil prices and relative equity performance of markets around the world, Citi analysts find that Russia, Norway, Canada and Brazil are amongst the markets with the highest correlations (see figure 4). They underperform when oil prices fall, and outperform when oil prices rise. On the flipside, US and Japan seem to outperform the global benchmark when oil prices fall. In EM, Citi analysts highlight that falling oil prices mean that the Energy sector has been a big drag on profit margins in Emerging Europe and Latin America since 2011 given the relative importance of the sector. If oil prices continue to fall margins will stay under pressure. Asia is less reliant on energy so margins should be more resilient.

De-equitisation

This theme is not new to Citi analysts and its foundation relies in the attractive, and significant, corporate funding arbitrage between the cost of debt and equity. This has actually led to significant equity retiral over the past decade.

"De-equitisation strategy has been very successful over the past 5 and 15 years, namely buying companies, which themselves have been buying back their own stock"

R. Buckland
Citi Global Equity Strategist.

As the cost of equity remains high relative to the cost of debt or cash, it makes sense for companies to de-equitise – use cheap debt financing to purchase their own shares through a buyback or another company's shares through a takeover instead of deploying cash to expand top line growth. Going forward Citi analysts expect a continuation of ongoing buyback activity and an increase in global M&A actions over the next 12-18 months.

Search for Yield/Income

In a world of persistently low interest rates investors are starved of yield. The search for it is not going away any time soon, even if the US economy steps into the expansion phase of its economic cycle which tends to be more favourable to cyclical themes. The current search for yield is not just a product of recent QE policies. US Treasury (UST) yields have been falling towards the global equity dividend yield for many years before QE came along. This year's unexpected fall in UST yields has intensified the chase. This continues to compress spreads in the credit world and drive income-hungry investors towards the equity asset class. While many fixed income yields are touching or are close to all-time lows, the global equity dividend yield (DY) still looks reasonable at 2.5% which is competitive with UST yields. Across the regions, DYs of all major markets, except the US, are above the government bond yields.

Size Matters

As Citi analysts see us approaching the maturing bull phase of the cycle, Citi analysts think better performance from mega cap stocks could be an important investment theme for the next 12-18 months. A maturing bull market has been historically characterized by rising volatility, widening credit spreads, large cap outperformance and equity bubbles.

"The long term underperformance of global mega caps means they trade at 20% PE discount, despite their high quality characteristics." (R. Buckland, Citi Global Equity Strategist)

This could make them attractive for non-benchmarked, absolute-return type investors who are currently unimpressed by the low yields available in fixed income markets. With interest rates likely to stay low compared to historic levels, mega-caps can offer decent risk-adjusted returns for these investors.

Fixed Income

Challenging Yields Trend

Back in December 2013, fixed income was one of the most consensual themes for 2014. US Treasury (UST) 10-years yields were trading around 2.8% on a positive momentum. Higher yields was the topic for 2014, a view shared by Citi analysts, but 12 months later UST 10Y are 50 basis points lower, reached a low of 2.13 in October and bonds delivered very decent returns across all sectors. Indeed, in 2014, the total return for 10-year US Treasuries has been about 9%, but an even more robust 14% for external investors measured with the trade-weighted U.S. dollar. Positive economic momentum in the US, tighter labour market and ample liquidity (QE) still make the foundation of a higher yields trend for the coming months. However, in the meantime oil prices have collapsed, the QE-driven wealth effect is not passing through the economy, companies are reluctant to invest, the US dollar has strengthened and key economic areas are slowing (Euro Area, Japan and China). In turn, inflation expectations (figure 5) have collapsed capping the outlook for rates.

Low-flation

The merely modest pace of global growth is proving unsatisfactory to many policymakers, as evidenced by new easing steps in Japan, China and the strongest language used in at least two years by European Central Bank (ECB) President Mario Draghi, who said the decline in inflation and inflation expectations needs to be arrested "as fast as possible." In that context, Citi analysts forecast flat developed country inflation from 2013 to 2015 at around 1.3-1.4%. What is probably more open to question is the distribution of that inflation. Most investors would recognize that underlying inflation remains low, probably too low, in Japan and the Euro Area and that this is why local policymakers are actively expanding balance sheets to thwart deflationary risks.

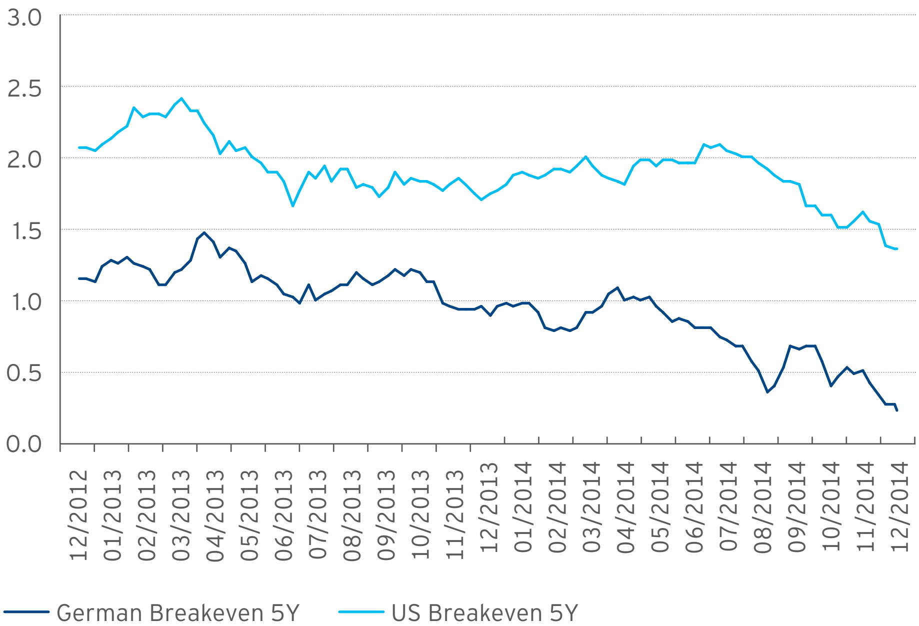
But in the UK, and especially the US, investors still seem to expect higher inflation based on locally shrinking output gaps, stronger growth and tighter labour markets. As a result, consensus expectations are for earlier monetary tightening in these countries and higher bond yields. EM economies are seen as somewhere in between the DM/ Japan economic weakness and Anglo-Saxon rising underlying inflation risks.

> "The low-flation transference view of the world means that rates stay lower in core countries than simple analyses based only on local fundamentals would suggest"
>
> **J.Hale**
> **Citi Macro Strategist.**

Global Demand

Despite economic divergences, Citi analysts consider that low-flation is a global trend. They indeed see two transmission mechanisms for this. The first is the economic link whereby low-flation is exported from Japan, the EA and maybe wider Asia via FX markets. The second is via capital flows. Indeed, as of the first quarter of 2014, foreign investors owned around half of all outstanding Treasury securities and Citi analysts see among them three large groups of potential buyers for USTs. The first group is Japanese institutional investors as the reallocation of the Government Pension Fund to international bonds from currently 11% to 15% combine with similar actions in other public reserve funds could generate 40-45bn of new buying in USTs, according to Citi analysts.

Figure 5.



Source: Bloomberg

A second group of buyers could be European investors. Citi analysts observed that the EA current account surplus has surged from a 2-3% of GDP range to 3.7% recently. They think that if the ECB is successful in weakening the EUR via QE, but not in boosting domestic demand, this surge may not be temporary. This implies a huge potential recycling need in USD terms given the size of the EA economy. Further to this, should new ECB laws be introduced to place a limit on banks' exposure to their own government debt, this could prompt €1.1trn in rebalancing of EA banks' sovereign debt portfolios, a further case for capital flows supporting other markets.

A final group of potential buyers is the same group that flattened the US curve as the Fed tightened in 2004-05 i.e. non-Japan Asian Central Banks. Indeed, Chinese and other policymakers may be increasingly upset with JPY and EUR depreciation, which may prompt FX intervention to be stepped up. Of course this means demand for USTs.

Looking forward, Citi analysts see the Fed on hold for nearly another year, low-flation persisting, USD strength helping to redistribute low inflation from Europe and Japan to the US and capital flows to USTs likely to be significant from Japan, non-Japan Asia and, especially the Euro Area. As a result, a risk to the Citi analysts' view of higher yields is that markets somewhat repeat a muted version of the 2004-2006 episode where the Fed tightened 425bp but the 10y UST yield broadly traded sideways.

Long-Term US Bonds

Despite a base case scenario envisaging higher yields, Citi analysts have slightly raised their allocation to US Treasury debt. While they remain underweight Treasuries overall, they have moved to a neutral position on long-term U.S. bonds reflecting the steep yield curve, and record high US yield premiums to other safe haven bond markets such as German Bunds. The 5% rally in the US 10-year note price during the 10% global stock market rout of early October also shows the portfolio benefits of such holdings even as Treasuries remain richly priced and higher long-term Treasury yields are still likely ahead. Citi analysts do not find Treasury yields appealing as a stand-alone asset. However, the negative correlation to equities and positive carry of long-term Treasuries makes the asset among the very few effective risk hedges available within standard asset allocations. Meanwhile, some international buyers with depreciating home currencies may even find the absolute return prospects for U.S. long-term bonds at 2.5% in U.S. dollars appealing.

Impact of Oil Prices

Citi analysts observe that the effect of oil price decline has been felt most acutely in the US High Yield (HY) credit market. US High Yield spreads have widened by 115 bps since mid-June. This is not very surprising perhaps given that US shale companies have borrowed a lot in HY market. Citi's US credit team highlights that the energy sector's weight in the US high yield index has been rising and it is at historical highs now (17% vs 8% in 2008) while Energy stocks are currently 9% of the US equity market. This is especially important, given that the overall US High Yield market has grown substantially to $1.1trn this year, up from $575bn before the financial crisis. This high flow concentration in a less liquid sector could turn out problematic when some more credit-specific issues arise as there is a wide divergence in asset quality and management competence.

Citi analysts also find US Investment grade sensitive to the development of an extreme oil price scenario as the dry-up in petrodollars could hurt demand in the sector. They indeed highlight that there is a strong correlation between the growth in oil and gas related sovereign wealth fund assets and oil prices. The assets of these funds have been growing by roughly $500bn per year since 2009 and they tend to be an important investor in fixed income securities. Of course, oil prices staying below $80 means that a big buyer of the market disappears which may put pressure on fixed income assets. In European credit, Citi analysts highlight that the effect of the drop in oil prices has not been felt as much, even in the energy sector. They actually think that the ECB is probably not in a position to ignore the disinflationary effect of lower oil prices and QE is supportive for spreads in early 2015.

All in all, it might not seem like the right time to put money into credit. Yields on corporate bonds are about as low as they have ever been, and despite recent weakness, spreads are near their 2007 tights. Although the debt service burden is low, corporate leverage is substantially higher than normal at this stage of the cycle. It is likely to rise further as companies replace margin growth with debt-funded shareholder-friendly activities to boost share prices. It is hard indeed to dispute that the equity market continues to have a much better risk/reward profile than credit in the current cycle.

Citi Forecasts Tables

Figure 6. Commodity Prices Forecasts

Average	2015	2016
Oil WTI (USD/bbl)	72	75
Oil Brent (USD/bbl)	80	85
HH Natural Gas (USD/MMBtu)	3.7	4.2
Aluminum (USD/MT)	2,000	2,100
Copper (USD/MT)	7,035	7,700
Nickel (USD/MT)	21,625	25,250
Gold (USD/T. oz)	1,220	1,260
Silver (USD/T. oz)	16.5	17.2
Platinum (USD/T. oz)	1,360	1,540
Hard Coking Coal (USD/MT)	122	140
Iron Ore (USD/MT)	65	65

Figure 7. 2015 Rates Forecasts

End of period (%)	Short Rates	Long Term (10Y)
United States	0.50	2.95
Japan	0.10	0.55
Euro Area (Bunds)	0.05	1.15
United Kingdom	0.75	2.6
China	2.25	3.46
India	7	8
Hungary	2.1	3.87
Poland	2	2.88
Russia	8.5	9.29
Brazil	12	12.52

Figure 8. 2015 Exchange Rate Forecasts

End of period (%)	vs USD	vs EUR
United States	NA	1.07
Japan	128	137
Euro	1.07	NA
Canada	1.19	1.27
Australia	0.79	1.36
Norway	7.55	8.07
Switzerland	1.15	1.22
United Kingdom	1.37	0.78
China	6.18	6.6
India	62.6	66.9
Poland	3.9	4.17
Russia	51.2	54.6
Brazil	2.79	2.98

Source: Citi Research

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