Citigold Private Client

A time to be nimble

Keeping balance in a slow growth environment

2016 Annual Outlook

International Personal Bank

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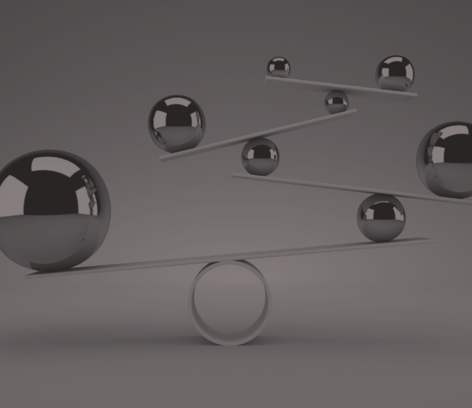

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Here we are again, start of another year and wondering what is in store for the global economy and financial markets. Last year was again another challenging one for investors as we experienced uncertainty and heighten volatility. The global economic recovery remained uneven and on the heels of this, monetary policy with the exception of the US remained very accommodative.

In 2015, our base case view was that growth was going to be uneven. The US economy was expected to remain on a modest growth path with other major regions remaining tentative. In such an environment, we expected divergent monetary policies among major central banks. Our portfolio alignment as such was to overweight equities and to have a bias towards the US dollar. In equities, our call was overweight Europe and Japan and to be selective in the United States (US). In Emerging Markets (EM), we were overweight Asia particularly North Asia.

Overall in what was a volatile year, our views saw a mixed performance. In equities, European and Japanese equities outperformed and registered positive returns while as expected the US markets were relatively flat. In EM, the markets were very challenging and even in Asia, performance was disappointing given multiple headwinds. China which was an overweight for us, was especially turbulent as we saw an uptick in volatility. In currencies, the US dollar did strengthen, particularly against EM currencies. Commodities were weaker while in the bond markets, performance was relatively muted.

So as we head into 2016, the economic landscape continues to be challenging. The US economy is growing at a modest pace while the rest of the world is struggling to maintain momentum. Japan and Europe are growing at subpar rates while China is expected to continue slowing to around 6%. Most other EM countries are anticipated to experience slow growth and those with large commodity exposure may even fall into recession. Overall, Citi expects the global economy to grow at around 2.8%. Against this background, the divergent monetary policies of 2015 could continue into 2016. Indeed the central banks such as the Bank of Japan (BoJ), European Central Bank (ECB) and the People's bank of China (PBoC) will remain accommodative in 2016 and this should be supportive for a relatively stronger US dollar. As far as the US Federal Reserve (Fed) is concerned, while rate normalization has begun in December, we expect the trajectory to be shallow and believe that the second increase is unlikely to occur until mid-2016. Commodity markets in such an environment will remain subdued but pockets of opportunities may develop.

As for asset allocation, equity markets continue to remain an overweight in 2016 but sector selection will be important. In Developed markets, Europe and Japan continue to be Citi's preferred markets as both regions are beneficiaries of Quantitative Easing (QE), stronger earnings and a weaker currency. But here again right sector selection is likely to add to performance. One particular sector that stands out in both regions is Financials. Meanwhile, the US is looking relatively expensive but there are pockets of value and opportunity in sectors such as Financials, Technology and Industrials. In EM, we remain cautious and very selective. We still prefer Asia as it has the best risk/reward parameters. Our view is that China is expected to continue the restructuring of its economy in 2016 and the government's longer term plan is to promote new drivers of growth. On valuations, H-shares look more attractive than their onshore A-shares but there will be a need to distinguish the "New" vs "Old" economy sectors to achieve performance.

So while the outlook for financial markets will remain uncertain in 2016, there will still be opportunities. Expect volatility to remain heightened in a maturing bull market but being nimble and having proper asset allocation will be essential in achieving appropriate returns.

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MACRO THEMES – DIVERGENCE

- A modest global growth, albeit with regional differences
- Persistence of divergent monetary policy
- Fed hike is not a game changer
- Slowing 'Old' China and emerging 'New' China
- A transitional year for commodities

KEY RISKS – DIVERSIFICATION

- China's hard landing and EM led recession
- Stiff devaluation in RMB and capital flow pressure
- Higher inflation and a steeper tightening cycle

STRATEGIES TO POSITION FOR 2016 – DE-RISKING

- Foreign Exchange (FX) Market
  - ✓ Further modest strength in US Dollar
- Equity Market
  - ✓ Remain overweight on Equities but continue de-risking
  - ✓ Japan and Europe's multi-year leadership
  - ✓ EM - reduction of risk exposures
  - ✓ Alpha over beta - sectors vs. markets
  - ✓ Disruptive technology in the digital era
  - ✓ New style consumption in China
- Fixed Income
  - ✓ Higher quality credits for better risk/reward calculus

ASSET ALLOCATIONS FOR 2016		
GLOBAL EQUITIES	OW	
US	OW	
Europe	OW	
Japan	OW	
EM Asia	OW	OW China, Taiwan and Singapore
Latin America	UW	Neutral on Mexico; UW Brazil
Eastern Europe	UW	OW Poland; Neutral on Russia; Slightly UW Turkey and South Africa
GLOBAL BONDS	UW	
Global Government	UW	
Investment Grade	OW	Prefer US
High Yield	OW	Prefer Europe
EM Debts	UW	
COMMODITIES	NEUTRAL	
Gold	Bearish	
Energy	Neutral on Natural Gas; Bearish on Crude	
Base Metal	Bullish on Copper, Zinc; Neutral on Nickel and Bearish on Aluminium	
Agriculture	Bullish on Coffee, Corn and Sugar; Neutral on Cotton, Soybeans and Wheat	
CURRENCIES		
USD	Positive	
EUR	Negative	
JPY	Negative	

TURN! TURN! TURN?

Turn! Turn! Turn! (To Everything There Is a Season) – by The Byrds (1965)
To everything, there is a season
A time to be born, a time to die
A time to plant and a time to reap
A time to build up. A time to break down

'Turn! Turn! Turn! (To Everything There Is a Season)' was a big hit when the famous American folk-rock band The Byrds released the single in 1965.

After seven years of historically unprecedented accommodation, the United States (US) interest rate cycle has turned as rates normalization started in December 2015. Meanwhile, China is struggling to balance between reform and growth by shifting its investment-driven 'old' economy towards the 'new' economy. Moreover, with twin support from China's credit boom and the commodity-related investment boom fading, year-on-year (YoY) gross domestic product (GDP) growth for emerging markets (EMs) ex-China is now below 2% YoY and – for the first time in over 10 years – has fallen below advanced economy growth.

Do these details suggest a turning point for current bull markets? We believe that these market developments affect sectoral or regional leadership, but we doubt that it will prove a major turning point for the market as a whole. Indeed, this bull market is maturing and volatility is rising but it is too early to call its end.

We continue to see equity outperformance albeit returns are likely to be modest. While risks related to China and the US Federal Reserve (Fed) may likely dominate in 2016, we believe that a major blow to risk assets is unlikely. However, the Fed turning towards a tightening bias and China's transitioning to a new economic model from the investment-driven 'old' economy suggest investors should have a discerning eye while gradually de-risking to hedge against volatility ahead.

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What is in store for 2016? Here are the top macro and market themes that we think may dominate in 2016.

1. **ANOTHER YEAR OF MODEST GLOBAL GROWTH, ALBEIT WITH REGIONAL DIFFERENCES**

Although global growth has been slow and fears of global recession have dampened market sentiment in 2015, we expect 2016 could be another year of modest global growth powered by improving consumption in developed markets (DMs). Citi's predicted global growth rates are 2.8% and 3.2% in 2016 and 2017 respectively, better than the growth rate of 2.6% expected for 2015, although we suspect that risks to our forecasts still lie to the downside especially for EMs.

While weak growth — and risks of a further slowdown — are mainly EM-centered, DM growth seems relatively encouraging. Recovery of the global economy will be led by the US, as its economy continues to display healthy momentum, evident in construction activity and consumer spending. The solid gain in motor vehicle sales suggests that consumers are becoming more confident. Citi analysts expect the US economy to continue to grow at an above-potential pace of 2.5% in 2016.

A modest loosening in the Eurozone policy fiscal stance for 2016 is likely to support economic activity, despite some divergence across countries. After the Eurozone grew 0.9% in 2014 allaying fears of a recession, the region may continue to grow at a modest pace of 1.5% and 1.6% in 2015 and 2016 respectively.

Citi analysts continue to expect the BoJ to ease policy again in early 2016. To achieve the 2% inflation target, in our view, policymakers would try to lift inflation expectations through further easing before the Spring wage negotiations to facilitate wage hikes and the January meeting could be the most plausible timing for the BoJ's action. With further easing measures as our base case, we expect Japan to achieve above-trend growth of 1.1% in 2016 (following -0.1% growth in 2014 and 0.5% in 2015).

Growth in EMs may continue to outpace DMs, albeit much weaker than in the past decade. Our forecast for EM growth in 2016 is 4%, higher than the 3.5% in 2015. However, the modest pickup in activity forecast for 2016 is mainly driven by our expectation about mean reversions in a few countries that faced a serious slowdown in activity during 2015 (e.g. Russia and Brazil), while most other EM countries are expected to see similar or lower growth in 2016 than in the past.

With the manufacturing sector being near-recession and with much weaker growth in fixed asset investment (FAI), growth in China still remains challenging as the government tries to balance growth and reforms. However, we expect the Chinese economy to avoid an abrupt negative shock to growth, as it is likely to rebound modestly in the first-half of 2016, given that the manufacturing sector may trough on credit-led investment and stable consumption growth, while further near-term monetary easing and policy bank lending may curb downside risks. Against this backdrop, Citi analysts expect China to grow 6.9% in 2015 and 6.3% in 2016 (after 7.3% growth in 2014).

2. **MONETARY POLICY DIVERGENCE BUT STILL LOWER FOR LONGER FOR MOST ADVANCED ECONOMY (AE) CENTRAL BANKS**

Monetary policy divergence remains a key macro theme in 2016, with the Fed's rate hike in contrast to the European Central Bank and BoJ's further easing of monetary policy in response to lower inflation than previously forecast.

While policy divergence and thus rate differentials among DM markets could bring mixed fortunes for certain asset classes and changes in market leadership, global extraordinarily easy monetary policy in aggregate may likely persist for longer as the Fed is expected to raise interest rates very gradually.

3. **FED HIKE IS NOT A GAME CHANGER**

We do not expect the early stages of a US tightening cycle to disrupt global financial markets as the Fed appears to be managing market expectations about the future path of rates.

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The pace of rate increases is expected to be much slower than in past cycles, given that Citi economists expect the Federal Funds Target rate to rise by only 75bp to 1% by the end of 2016 and 50bp further to 1.5% by the end of 2017. By contrast, in the last three Fed hiking cycles, policy rates rose by 200bps in the first year alone, with the trough-to-peak difference in a post-1971 cyclical recovery typically around 500bps, with a similar magnitude peak-to-trough Federal Funds target rate.

With the much slower pace than before, the impact of the actual lift-off may not be as devastating as the market capitulation in the summer when fears were overdone, although markets may see some short-term post-hike volatility as there has been in the past.

4. SLOWING CHINA'S OLD SECTORS AND EMERGING NEW CHINA ENGINES

After achieving double-digit growth rates for decades, China's growth fell to sub 7% in 2015, as China's growth engines – such as FAI and exports – have not driven growth as they did in the past decades.

Although the People's bank of China continues to ease monetary policy, financial conditions have not significantly improved, as the banking system has little appetite to lend and pass on that easing.

Chinese growth is still on a downward trend but this trend reflects some degree of rebalancing in the economy. Many 'old' sectors" face significant difficulties (excess capacity, excessive leverage, loss of competitiveness, etc.) leading the primary and secondary sectors to a sharp slowdown. Meanwhile, services have probably continued to grow at a relatively healthy pace.

Although pick-ups in consumer and service sectors are not enough to compensate for the growth gap – given the large size of the struggling 'old' sectors – we believe markets will focus on the positive aspects of the reforms and China's new economic model.

5. A CRITICAL TRANSITIONAL YEAR FOR COMMODITIES

A combination of weakness in Chinese demand, persistent oversupply, and continued US Dollar appreciation has sent commodity prices lower in 2015 than during the commodity super-cycle. While low commodity prices have benefited commodity importers (including China and India as well as a large number of advanced economies, including the Eurozone and Japan), the boost to consumption from low oil prices has underwhelmed almost everywhere.

Unlike in 2015, we do not think that low commodities prices and thus disinflation pressures are among key drivers for asset performance in 2016, as some of these disinflationary factors may ease, as prices stabilize in 2016.

Indeed, 2016 is shaping up to be a critical transitional year for commodities, as the market grapples with conflicting signals of whether and how rapidly supply/demand fundamentals are shifting to balance for many commodities. This transition predicates a more persistent price recovery by 2017 for oil and base metals, and possibly agriculture.

As for oil prices, while sharp declines in US rig counts in 2015 could begin to make meaningful impacts on production growth, we may see oil prices rebounding in the second half (2H) of 2016, given that the first quarter (1Q) of 2016 may see fresh lows, as Iranian barrels return to the market.

While mining supply cuts may support a rebound for some metals, weather risks and acreage cuts could drive a turn in the agriculture cycle by the 2016/17 crop year.

For bulk commodities, such as iron ore and thermal/coking coal, a recovery may remain elusive in 2016 as weak demand expectations and the China slow-down weigh more heavily on those underliers.

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RISKS FOR 2016

In 2015, liquidity concerns due to the Fed rate hike and fears of a China-led global recession had dented sentiment during the current maturing bull cycle. These risks may remain in 2016, but we believe the likelihood of a major blow to risk assets as a result of the Fed or China will be limited.

RISK # 1: CHINA'S HARD LANDING AND EM LED GLOBAL RECESSION

What worries us most is a much slower than expected China and EM growth that may lead to a global recession. It is not a highly probable event, but a high impact event on financial markets.

The three main sources of China's GDP growth — exports, and public and private domestic spending — are constrained. In 2015, China's Renminbi (RMB) devaluation and weak macro data triggered a fear that China and EM slowdown will broaden into DM economies. EMs fell victim to a severe external shock due to weakening growth in China and the collapse of global trade growth, while most EM countries are unable to offset this shock as their policy tools are limited due to highly leveraged economies.

However, we believe that the fears of the spillover effects to global growth are overstated. China growth is slowing but it is not melting down. In fact we believe China may see rebounds in growth in 2016 amid continued Chinese authorities' easing measures and a global recovery. While risks to our forecasts probably lie to the downside, we see no new signs of a economic collapse in 2016.

RISK # 2: CHINA-LED DEVALUATION IN EM CURRENCIES AND CAPITAL FLOW PRESSURE

A much stronger US Dollar may add downward pressure on RMB and increase market volatility in a period of Fed tightening. While we believe the market rout in response to China's devaluation of August 2015 was overdone, a reemergence of China led-EM currency pressures and fears of further capital outflow could be a problem for sentiment in 2016.

However, we do not see any rapid currency depreciation in the RMB. On 30 November 2015, the International Monetary Fund (IMF) finally announced that the RMB will become the fifth currency in its special drawing rights (SDR) basket effective from 1 October 2016. With the RMB being assigned a 10.92% weight in the basket, Citi analysts estimate that additional allocations from reserve managers could be as much as 0.5-1% of China's GDP for the next few years.

Citi analysts expect modest weakness (4-5%) in RMB by end-2016, setting their 6-12 month forecast for USDCNY at 6.7, with reserve allocations to RMB helping to trim the net capital outflows that are likely as the economy slows, rates fall, and investment rules are further liberalized.

RISK # 3: HIGHER INFLATION AND A STEEPER TIGHTENING CYCLE

Another risk scenario is associated with higher than expected inflation in the US which could lead to a steeper tightening cycle if US growth proves resilient to the Fed's lift-off. We believe that this is likely but less impactful than the other risks stated above.

Although headline inflation may improve, while recovering from the commodity price shock, we believe inflation in the US will remain benign throughout 2016-2017. The core Personal Consumption Expenditures (PCE) deflator is likely to hover at 1.7% in 2016 and 1.8% in 2017, higher than the likely 2015 reading of 1.3% but still below the Fed's 2% inflation target. The Atlanta Fed hourly wage tracker shows that while wage pressures climbed in 2014, they have remained fairly muted in 2015. Without wage pressures, it is difficult to imagine sustained pickups in inflation.

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INVESTMENT THEMES

Let's turn to our investment strategy to position for macro themes and risks likely to unfold in 2016.

We would like to start the year with a more balanced portfolio and reduce risks given elevated asset prices and the high volatility likely in 2016. In terms of market directions, 2015 could be a preview for 2016 as key drivers of returns in 2015 remain intact, however, investors may need to lower their expectations on returns and seek alpha, not beta, as taking a view and being on the right side of market scenarios may outperform rather than buying the broad market index.

1. **FOREIGN EXCHANGE MARKET: FURTHER MODEST STRENGTH IN THE US DOLLAR** While the US Dollar spot index, which measures the performance of the currency against a basket of major global currencies, soared to 8% this year in anticipation of the Fed lift-off, we hardly see what could weaken the US Dollar significantly in the coming year.

   As divergent and monetary policies continue in 2016, the US Dollar rally looks set to continue, although it may not see the same YoY appreciation in 2016 as in 2015. Citi economists foresee an additional 3-5% or more increase in the US Dollar index in the 6-12 month horizon. While the Euro and the Japanese Yen are most likely to suffer from downward pressure, EM currencies may experience a more diverse performance with divergent economic outlooks and political uncertainties playing a significant role.

   A stronger US Dollar is an important driver of relative asset performance: in general, it is negatively correlated with commodity prices and a headwind for earnings in US corporates. When investing in foreign assets, it is more important to consider the impacts from currency moves. Against outlooks for the further US Dollar strength and increasing volatility in the currency market, hedging on non-US dollar assets could increase returns or provide a buffer for potential loss due to fluctuations in currency.

2. **EQUITY MARKET:**
   1) **Overweight on Equity while keeping some power dry**

      We find the fundamental market backdrop still supportive for global equities in 2016. However, with the economic expansion aging and many key financial asset markets having enjoyed generous gains in the past six years, being on the right side of market developments by being in the right market or sector would dictate performance in 2016. Divergent monetary policies, different growth cycles, and spillover effects from the FX and commodity markets may present distinct macro environments for each market and sector.

      Global equities no longer look especially cheap in absolute terms. Having hit a 12x Price-To-Earning low in 2011 at the worst of the Eurozone crisis, the valuation of global equities has re-rated back to the long-run median of 17x P/E. While equity valuations still look less demanding than valuations in other asset classes, earnings will be a key to send equities further higher in the coming years. We expect global earnings to grow 9.9% and 11.3% in 2015 and 2016 respectively.

      To begin in 2016, we would keep some powder dry and prefer to buy the dips. We have reduced the extent of our overweight in global equities. In making the move, we pared back equity overweight in US large capitalization equity and reduced some overweight in Emerging Asia including China H-Shares and Taiwan positions. Shares in South Africa and Turkey were reduced to small underweights.

   2) **Japan and Europe's multi-year leadership**

      As we expected, equities in Europe and Japan outperformed US equities in 2015 after lagging behind in the past few years. We believe that Europe and Japan's leadership in the equity space remains a multi-year one as Europe and Japan are at an early-to-mid cycle in terms of their quantitative easing.

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We maintain full overweight positions in the Eurozone and Japan on a currency-hedged or partially currency-hedged basis. Given this combination of possible earnings momentum and reasonable valuation, we expect European equities to provide a double digit return in 2016 with our end-2016 forecast for Eurostoxx at 440, which is roughly 14% higher than the current level as of 2 December 2015. Japan, with its internally-funded low interest rates, negative equity correlation to currency, and potential for industrial recovery, seems to be one of the strongest equity market beneficiaries of Fed policy tightening. With our end-16 target for the Topix at 1850, Japanese equity is forecast to rise 15% in 2016.

3) Emerging markets – Reduction of risk exposures

Amid a highly bearish market consensus, EM equities have underperformed DMs since 2011. Even after five years of EM equity underperformance, we do not expect the trend to reverse anytime soon. While many EM opportunities have improved over long horizons, we continue to see several headwinds in the coming year. These include prolonged distress for petroleum-producer debt, US Dollar strength, and the potential resumption of Chinese currency pressures.

Although we remain constructive on EM Asia, where we find value and better earnings momentum than other EM peers, we reduced equity weightings in EM Asia as well as EMEA. Having not adjusted exchange rates lower as seen in Latin America, and having already enjoyed a year of low oil prices, we believe the risk/reward trade-off in Asian EM equities has weakened slightly. This led us to make small weight reductions in markets even where the growth outlook is promising (India) and where valuations are cheap (China H-shares and Taiwan).

While we remain underweight on significant petroleum exporting regions in both DM and EM, the larger vulnerabilities to international capital flows and weakness in other commodity exports led us to reduce South Africa and Turkey to slight underweights.

4) Alpha over beta – Sectors vs. markets

Returns in 2016 will be about alpha, not beta. Higher interest rates in the US suggest changes in sector leadership globally. We see a rotation out of the expensive bond proxies into cheap value and cyclicals names. Globally, we still prefer Technology and Healthcare where we see the strongest earnings support. Hence, Healthcare is maintained at overweight.

We cut the global Consumer Discretionary sector to neutral. Historically the sector has consistently underperformed during the early stages of Fed tightening cycles. Furthermore, higher valuations also make this sector vulnerable. On the other hand, we lifted the Global Energy sector to neutral as Energy sectors in the US, Europe and Australia have been upgraded to overweight, while EM and Japan's Energy sectors remain underweight.

CITI'S OVERWEIGHT SECTORS	
Global	Financials, IT and Healthcare
US	Financials, IT, Energy and Industrial
Europe	Financials, IT, Energy and Consumer Discretionary
Japan	Financials, Healthcare and Consumer Staples
EM	Financials, IT, Consumer Discretionary and Utilities

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5) Disruptive Innovation in the Digital Era

While we expect the technology sector to outperform in 2016, our focus is on the transformative technology that may shake up the industry or create a completely new industry.

The term of 'Disruptive Innovation' was coined by Harvard Business School professor Clayton M. Christensen in 1995. 'Disruptive technology' shapes the ways that we live our lives and do businesses, create a new market and value network and eventually disrupt existing markets.

While there are many more areas that are undergoing transformation driven by innovation in technology, new consumer needs or fast-changing regulation environment, we present five specific areas that could drive truly massive economic transformations and disruptions in the coming years: (1) Mobile commerce, (2) Energy revolution, (3) Cars of the future, (4) Automation and advanced robotics, and (5) Social networking service & e-tailers that enable cost-effective purchasing, provide social networking opportunities and manage information for young generations.

6) New China Opportunity

While China's transition to a new economic model with higher growth quality and sustainable growth profile is in progress, albeit still in the early stage, new growth engines (e.g. consumption and services) have been drawing attention.

China's tourist spending abroad is growing close to 40% year on year in 2015. On-line shopping and digital service providers are fast growing. Now we can see many global players in high-end electronics and high-tech industrial equipment emerging in China.

In November 2015, the China State Council released policy guidance to speed up new-style consumption, with a focus on six areas. Our overweighted Information Technology (IT) and Healthcare are clear beneficiaries. Selective quality consumer discretionary and consumer staples also look to benefit. Against this backdrop, investing in 'new' China is one of our investment themes in 2016 and beyond.

Six areas of new-style consumption focus

SERVICES CONSUMPTION
Education: Vocational skills training, cultural and artistic training Healthcare: Health management, sports and fitness, high-end medical, and biomedicine Elders Support: Housekeeping, elderly supplies, and nursing care Culture: Animation games, creative design, network culture, and digital content Tourism: Rural tourism, self-driving car travel, cruise tourism, and tourism facilities
INFORMATION-BASED CONSUMPTION
Internet linkage with manufacturing: robots, vehicles, retailing, transport, agriculture, education, healthcare, tourism, culture, and entertainment Supporting cloud computing, big data, and internet of things Supporting wearable devices and smart home products
GREEN CONSUMPTION
Organic food; air cleaners; water purifiers; water-saving appliances; green home appliances, and green building materials
FASHION CONSUMPTION
Fashion and tailor-made products/services; General aviation and cruises
QUALITY CONSUMPTION
Focus on product quality upgrading
RURAL CONSUMPTION
Telecom communications; culture and entertainment; environmental protection; home appliances; passenger cars Distributed energy; agricultural waste recycling; waste-water treatment facilities, and rural infrastructure

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3. FIXED INCOME – HIGHER QUALITY CREDITS FOR BETTER RISK/REWARD CALCULUS

1) Developed Sovereign Bond

Developed sovereign bonds remain as the largest underweight with heavy underweights in Japan and core Europe. While we still see some vulnerability at the short-end of the US, we believe low inflation should keep long-term rates contained in 2016 and have reduced our underweights in the US Treasury (UST) note. Both intermediate and long-term US treasuries are now at a neutral position. Although absolute yield levels are still not particularly attractive as returns are challenged by the start of Fed hikes, but we believe UST's very low or negative correlation with equities and credit may help dampen portfolio volatility.

2) Investment Grade Bond

While we expect the macro environment will be broadly supportive to credit markets in 2016, we are increasingly of the view that the 'tide is going out' on corporate bond market liquidity. As a result, we have increased a range of other higher quality bonds and increased developed corporate investment grade allocation to overweight. US investment grade credit may generate moderate returns, but present attractive risk-reward. Eurozone investment grade bonds also received a slight overweight as yields and spreads have risen in the face of a likely stepped-up ECB asset buying programme.

3) High-yield Bonds

We continue to view deteriorating credit quality and event risk as key drivers of dispersion both across sectors and issuers. High-yield is maintained at overweight in both US and Europe. Further stimulus provided by the ECB and an improving Eurozone economy may promote further spread compression in European high-yields. In the US, we continue to avoid energy credits, given that some high-yield borrowers may no longer afford low oil prices.

4) EM Debts

EM Debts stay underweight as 2016 may turn less friendly to EM credit, given a slowing EM growth and a risk of further capital outflows. Though policy easing in China removed some of the EM growth hangover, FX volatility may persist. We remain cautious in both external and local EM markets, and favour high quality issuers.

4. MANAGE VOLATILITY

As we foresee a possibly more volatile year in 2016, it is critical for investors to consider ways in which they can prepare for the unexpected events and volatility. Also, we believe that a balanced portfolio with a modest overweight on equities or multi-asset funds would help investors reduce the volatility of their investment returns, given that the negative correlation between equity and bond return provides a very compelling argument for having a diversified portfolio.

For more sophisticated investors, alternative products such as hedge funds or structured/derivatives funds may present some investment opportunities that benefit from higher volatility and unexpected events.

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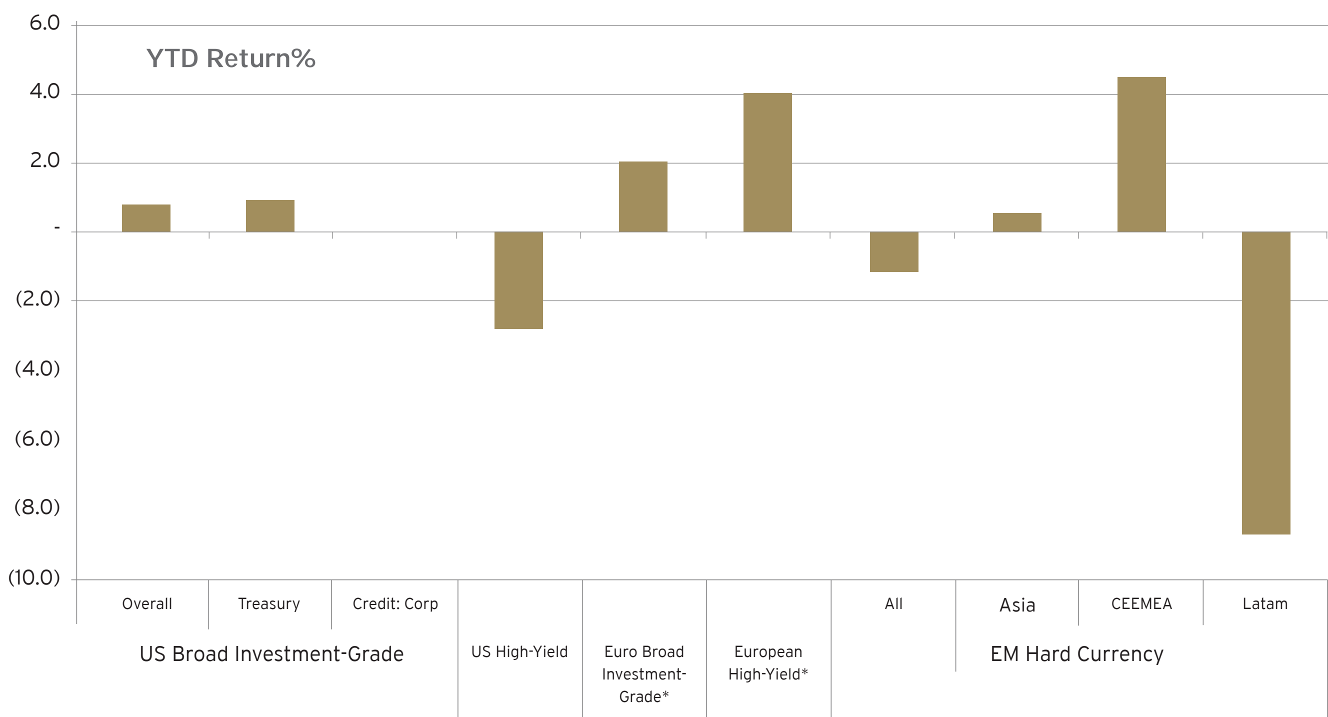
Fixed income has had a challenging year in 2015 with subdued returns in investment-grade credit and downside risks developing in Emerging Markets.

The US interest rate outlook fluctuated significantly but was ultimately more dovish than initially expected as growth expectations went through a long stretch of downward adjustments and inflation expectations remained anchored at very low levels. This left US Treasuries in positive territory for the year at 0.9% in total return (year-to-date as of November 27th). Outside of the government sector, US investment-grade was lacklustre as spreads widened amid a lack of positive catalysts and a generally shareholder-friendly environment that saw leverage increase through the year. US high-yield saw a notable underperformance of -2.9% at first driven by energy, but eventually spreading across other sectors as leverage continued to rise. European indices were in positive territory (2.1% in investment-grade and 4.0% in high-yield), albeit the gains were largely offset by currency movements from a US investor standpoint.

Comparison of year-to-date performance across Citi Fixed Income Indices



Source: Citi Research; *Euro BIG and Euro HY Index returns are shown in Euro-terms. As of 27 November 2015.

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In Emerging Markets, Russia was the star while Brazil came under significant pressure.

Market volatility was centred in the Emerging Markets, which returned a negative 1.3% overall. Developing concerns about the pace and extent of China's slowdown have had far-ranging implications across commodity and foreign exchange markets. Latin America struggled, returning a loss of 8.9% amid a sovereign downgrade caused by a contractionary economic backdrop driven by sharply lower commodity prices and major policy execution challenges. Political risk has also escalated amid a spiralling corruption probe that threatens key political figures. The CEEMEA sector outperformed as the market collapse of Russia credit in Dec-14 set the year up for dramatic spread tightening despite major sovereign downgrades, geo-political risks and lower oil prices. Refinancing risks in Russia were not as significant as expected, helped by funding from China, and bond technical were supportive with assistance from the onshore account base. Russian credit returned 15.4%, outperforming the broader CEEMEA region which was up 4.5%. Asia meanwhile remained the most defensive sector and overcame early volatility from a restructuring in the China property sector to return 0.6% with Chinese property turning out to be the star.

We continue to favour opportunities in US and European credit markets.

The Fed has already commenced lift-off in December, however we do not see this as a major constraint to bond performance since the trajectory of US rates is expected to be extremely shallow given that despite improvements in US housing and unemployment data, inflation pressures are expected to remain benign amid a modest growth backdrop. As such, we continue to favour valuations in US investment-grade, which have widened and offer better relative value, and are constructive on high yield (ex-energy). We also continue to expect hybrid financials and US municipals to outperform.

In European credit, we expect positive performance (in local currency terms) as the ECB recently cut deposit rate by 10bp to -0.3%. Given that the expansion of quantitative easing may likely deepen net negative sovereign bond supply, this may provide strong technical support for Eurozone periphery markets, and we are also overweight Euro investment-grade and high-yield sectors.

Selective in Emerging Market sovereign and corporate debt.

With a continuation of EM-centric structural growth concerns likely to dominate in the year ahead, we are cautious on Emerging Market sectors. We expect EM weakness may persist with Russia and Brazil remaining in economic contraction and the balance of EM also facing structural challenges due to major uncertainties surrounding China and by extension continued depression in commodity markets. In addition, we expect a lack of alternate growth engines either of an export-led variety or through greater economic and institutional integration with the EU or the US. We do see selected sectors such as strategic Chinese state-owned corporates and the India sector (which is a major beneficiary of lower commodity prices) as among the more defensively positioned, and see Russia as well supported in the immediate term. However, Citi analysts expect to see limited additional upside in these sectors and see potential for further volatility in the Brazil and Indonesia sectors which may be vulnerable to further downside in commodity prices and could present better buying opportunities in the year ahead.

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2016 is shaping up to be a critical transitional year for commodities – a year of volatile and ongoing 'W-shaped' price adjustments, as the market grapples with conflicting signals of whether and how rapidly supply/demand fundamentals are shifting to balance for many commodities. This transition predicates a more persistent price recovery by 2017 for oil and base metals, and possibly agriculture. The rising US dollar should be an ongoing headwind for commodities priced in nominal USD, though the pace of dollar strengthening should be slower, easing pressure on commodities.

ENERGY

Oil – The oil market remains significantly oversupplied, to the tune of 1-1.5-m b/d, and the return of Iranian barrels in early 2016 materially adds to the overhang. Citi expects 2H16 to be materially better, with non-OPEC declines and Saudi Arabia's production expected to roughly flat-line and Iraq slowing growth from current levels. Forecast demand growth of 1-m b/d points to a balanced market with higher prices by end-2016. Citi's average 2016 forecast for Brent and WTI stand at $51/bbl and WTI at $48/bbl.

Gas – Oversupply remains the theme for global natural gas. We see prices progressing through several stages first before a possible recovery in late 2016. Firstly, over the coming months, conflicting outlooks for winter weather should increase price volatility. By early 2016, prices could stay low and range-bound post-winter due to the perceived resilience in production and the market's belief that it knows how coal-to-gas switching should balance the market. If production falls despite sharply stronger need for gas supply in 2017, prices could rise in late-2016. Thus Citi expects Henry Hub Natural Gas prices to average $3.00/MMBtu in 2016.

PRECIOUS METALS

Gold – Given weak price performance in 2015 and strong USD sentiment, investors may continue to reduce gold exposure and look for returns in equities and bond markets. However, as has been the case in 2015, we expect continued macro risk concerns, plus a supportive physical market to prevent outright price capitulation. Gold prices may average $995/oz. in 2016.

Silver – Despite growth within the renewables sector, demand from the traditional electronics sector has been falling since 2011. This decrease has been precipitated by a weaker economy in China, where silver electronics demand is expected to fall, as well as in other developing countries such as India. Hence, in light of these developments, we expect prices may decline further to average $14.30/oz in 2016.

BASE METALS

Copper – Much debate surrounds the extent of Chinese copper demand growth. However, Citi analysts believe apparent consumption points to Chinese absorption rates of copper growing at 3.8%, suggesting demand remains stronger than expected. Furthermore, from Chile to Zambia, supply disruptions have significantly dented production momentum globally. Indeed, the price rally seen in last April and September have been a direct cause of supply impingement and Citi analysts see this trend continuing into the coming months, forecasting prices to average $5,240/t during 2016.

Aluminium – Further USD strength and associated RMB devaluations may put further downward pressure on smelter costs outside of the USA. In addition, we also believe further RMB devaluations, combined with higher VAT rebates could spur a rebound in Chinese aluminium exports. Citi analysts therefore forecast aluminium prices to average $1,510/t in 2016 with new lows expected in 1Q.

Nickel – Despite only a modest improvement in nickel demand projected for 2016, we still expect the market to move into deficit, on supply cuts and continued declines in Chinese NPI output. However, deficits in a high inventory environment point to only modest price support. Citi analysts have therefore downgraded our 2016 average price expectation by $1,175/t to average $10,875/t.

Zinc – After being the favoured base metal due to deepening concerns over future mine supply, investor interest in zinc has waned on weak global demand growth, and continued robust Chinese refined output growth. Hence we have downgraded our 2016 average price forecast to $1,760/t.

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BULK COMMODITIES

Thermal Coal – Citi analysts expect thermal coal prices to continue to decline in 2016 (averaging $48.00/t for the year) and 2017 as we believe demand from China and developed markets is in terminal decline while we see strong supply growth in India and Colombia.

Metallurgical Coal – Prices are expected to continue to decline in 2016, averaging $70.00/t due to cutbacks in Chinese steel production. Market balances are expected to tighten in the medium-term though as curtailments increase, Indian demand improves and Australian projects are postponed.

Iron Ore – Global iron ore demand has peaked and may remain under pressure from China's structural transition, rising scrap availability, and slowing global population growth. On the supply side, larger steel production cutbacks in 1H16 are then expected to drive prices down to average around $41.00/t in 2016. Risks to our forecast are thus skewed to the downside.

AGRICULTURE

Citi's outlook has been structurally bearish the agri sector and world food price CPI. But benchmark contracts are starting to stabilize and could rise into 2016/17. Since the 2012 drought, CBOT grain prices have plunged 45-55%, CME ethanol prices are down 40% and ICE coffee, cotton and sugar prices have dropped 20-30%. Cocoa is one of the lone crops trading higher today versus 2012/13.

But ag supply cycles are short-lived and typically do not last more than 2-4 years as producers can reallocate acreage/inputs and since supply is weather dependent. Ongoing strong El Niño conditions should provide an upside skew for prices and world food CPI.

Soft commodities such as coffee are likely to rise in 2016 as FX impacts moderate and stock draws support markets. We are neutral cotton between 60-65 cents while cocoa prices can continue trading at historically elevated levels but seem a bit rich north of $3,400/MT, given that high prices crimp demand growth.

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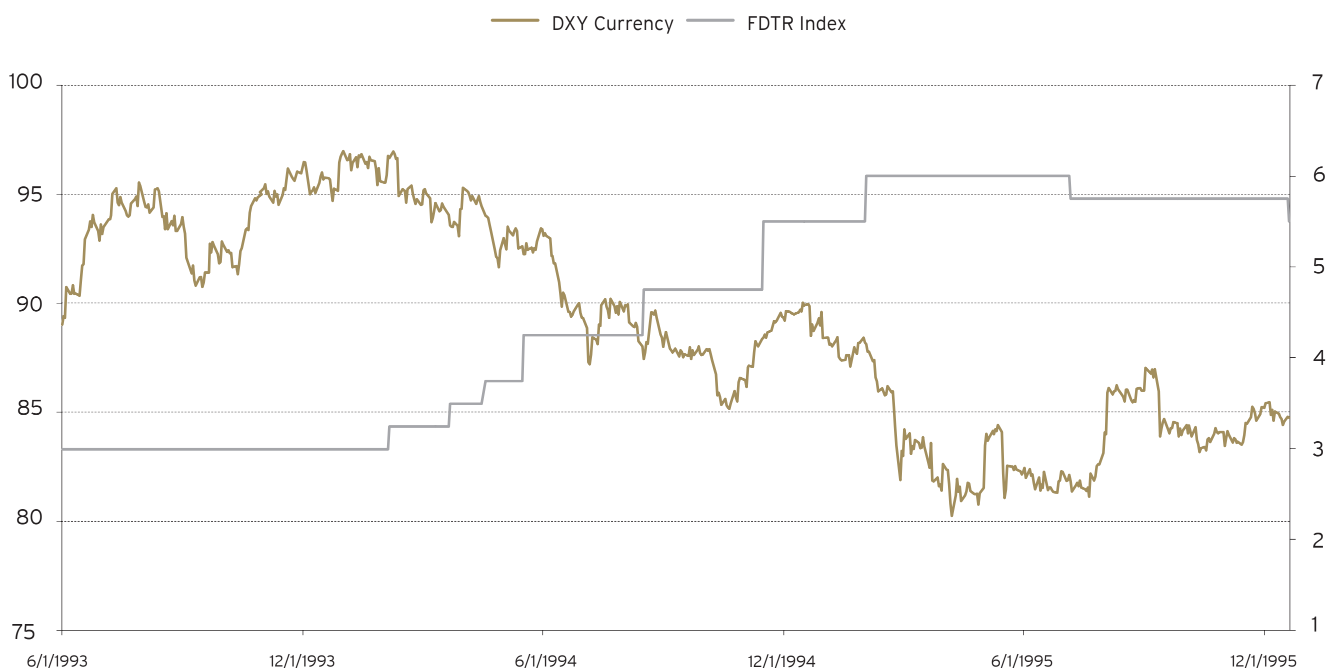
The outlook for FX markets in 2016 is once again likely to be driven by the continuing monetary policy divergence between the US Federal Reserve on the one hand as it embarks on a path towards rate normalization and the rest of the major economies on the other, that are seen retaining their policy easing bias well into 2016 and possibly beyond.

That the resulting widening in yield differentials in favour of the US may likely lead to further USD strength is now pretty much a consensus view among analysts. What is open to question however is that given little positive momentum elsewhere, how much USD strength will the US economy be able to absorb before running into trouble and potentially putting the world economy on a path towards a global recession.

The Fed will no doubt be assured to some extent by the history of earlier tightening cycles (1994, 1999 and 2004) where the USD appreciated in advance but in each case gave up ground in the months following the first rate hike - essentially, a buy the rumour sell the fact dynamic.

Fed Commences Its Tightening Cycle And The USD Progressively Gives Up Its Pre-Tightening Gains



Source: Bloomberg. As of 25 November 2015.

But the key difference this time around is that monetary policy divergence in 2016 will be a function of both Fed tightening and the easing bias maintained by others whereas in the earlier cycles, it was only the Fed that was seen adjusting policy. The Fed therefore has its work clearly cut out in its bid to move towards rate normalization but minimize the impact on USD.

With yield differentials the traditional driver of currency movements (chart below), the Fed will have to effectively control the pace of yield divergence as it lifts rates starting December.

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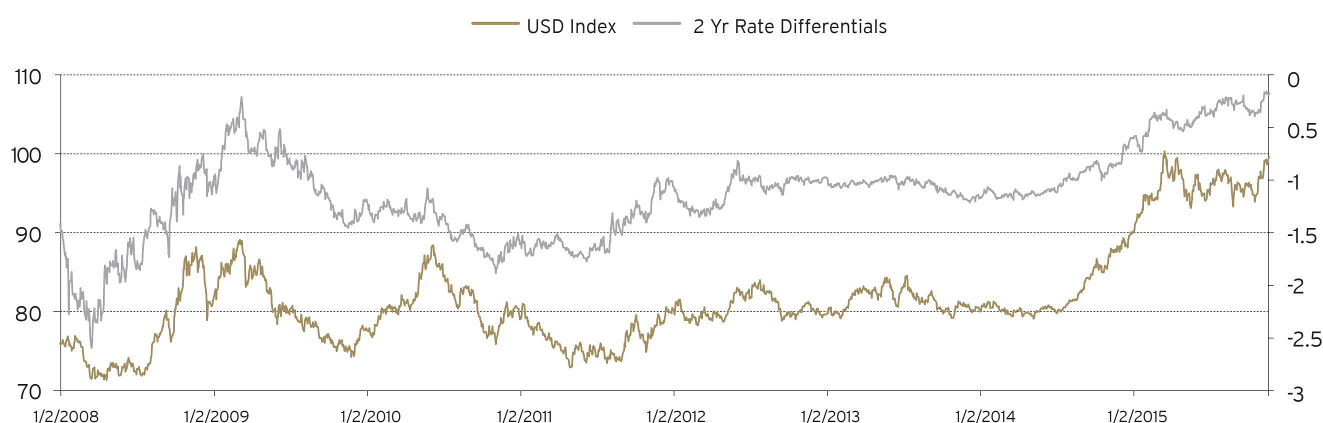
USD – G10 FX 2Yr Interest Rate Differentials Versus USD Index



Methodology: US 2Yr Swap Yield – Average Of The 2Yr Swap Yield Of EURUSD, USDJPY, GBPUSD, AUDUSD, NZDUSD & USDCAD.
Source: Bloomberg. As of 17 November 2015.

A communications strategy from the Fed reinforcing the 'very gradual pace of tightening' mantra at every opportunity

- To stress that the terminal cash rate will be a lot lower than in past business cycles
- Undertake a well-coordinated and calibrated policy approach with the other major central banks

There is no guarantee that the Fed will be able to pull this off. Indeed, a major risk is if the US economy starts to experience a sharper pick-up in wages inflation in 2016 due to the much tighter US jobs market. This will give the Fed little option other than to raise rates more aggressively to stem rising inflation risks and resulting in a much stronger USD.

Equally, a deflationary cycle in China or a further drop in inflation expectations in the euro zone or Japan could see a more aggressive easing stance out of their respective central banks which in turn, would also lead to a much sharper appreciation in USD than what the Fed would like to see.

But barring either scenario, a Fed tightening cycle that is able to deliver minimal USD gains may undoubtedly see huge dividends in the form of a longer lasting US recovery even if other major economies fail to perform. So the rewards are simply too high for the Fed to ignore and ultimately, in the absence of growth elsewhere, the reality is that the Fed has few other strategies to pursue.

But while the Fed is likely to engage more pro-actively with markets to signal a very 'dovish' path towards rate normalization to minimize USD gains, enlisting the help of other central banks towards adopting a more coordinated and calibrated approach to policy may be more difficult.

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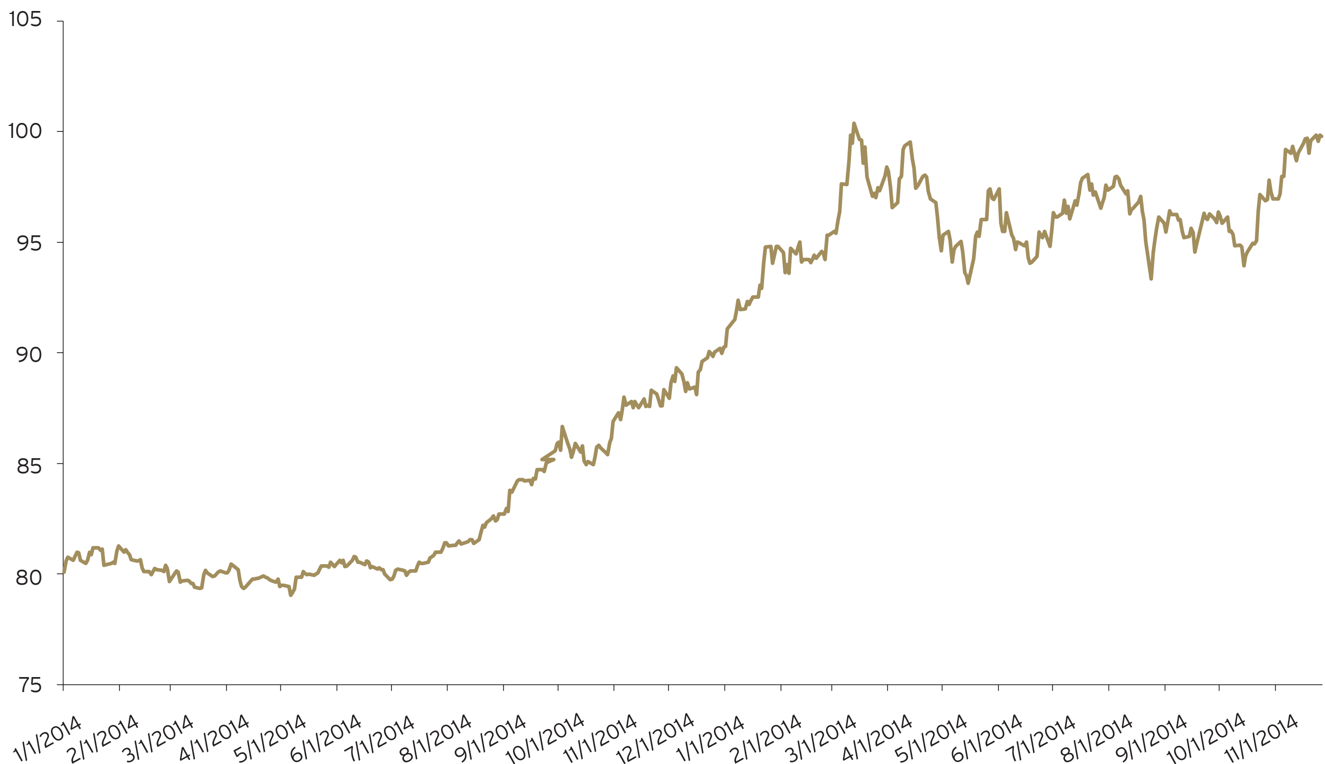
Some of the other central banks such as the ECB are tied to their own domestic agenda where still declining inflation rates and sluggish growth are pushing them towards further easing and potentially further weakening their currencies. But if they judge there to be more utility in indirectly helping the Fed boost the US economy via keeping USD gains in check and exporting their way to the US to promote better growth at home than a direct stimulus boost to their economies from easier monetary policy and weaker currencies, then this could mean that the USD Index is likely to see some 5 - 6% gains at best in 2016, primarily against EM and probably half that versus the G10.

There is some evidence this may already be happening with the Reserve Bank or Australia's (RBA), Reserve Bank of New Zealand (RBNZ) and the BoJ having kept policy unchanged more recently, even when markets had expected them to ease further. We also note that the ECB's much talked about stimulus expansion in December also seems to be meeting with resistance from some ECB members and runs the risk of being watered down when the time comes to deliver.

A calibrated and coordinated policy approach from the G10 major central banks is not new and may well be the mantra for 2016 that will help minimize and keep FX volatility in check, leaving FX pairs in similar ranges to 2015 though with a bias to buy USD on any positioning induced dips, a scenario similar to 2015 than 2014.

Where USD could maximize gains is versus Asia EM where China becomes more relevant, especially as Chinese authorities relax their exchange rate regime and let the RMB depreciate further to stimulate their economy. With RMB seen as the anchor for the rest of EM Asia, most Asian currencies could potentially test new lows against USD with the spectre of lower domestic growth and monetary easing only compounding the negatives.

USD Index - January 2014 To November 2015



Source: Bloomberg. As of 26 November 2015.

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ECONOMIC GROWTH & INFLATION FORECASTS

	GDP			INFLATION		
	2015F	2016F	2017F	2015F	2016F	2017F
Global	2.6%	2.8%	3.1%	2.2%	2.7%	3.0%
US	2.5%	2.5%	2.5%	0.3%	1.6%	1.8%
Europe	1.5%	1.8%	1.7%	0.1%	1.1%	1.5%
Japan	0.6%	0.7%	0.3%	0.9%	0.6%	1.6%
Latin America	-0.5%	0.0%	2.4%	11.7%	12.9%	15.0%
Emerging Europe	-0.5%	1.7%	2.9%	9.9%	6.0%	5.1%
Middle East & North Africa	2.8%	2.3%	3.2%	4.3%	4.6%	5.1%
Asia	5.9%	5.7%	5.8%	2.0%	2.3%	2.5%
China	6.9%	6.3%	6.2%	1.4%	1.7%	2.0%
Hong Kong	2.5%	2.0%	2.3%	3.0%	2.0%	1.9%
India	7.5%	7.8%	8.2%	5.0%	4.8%	5.0%
Indonesia	4.7%	4.5%	4.9%	6.4%	5.3%	4.3%
Malaysia	5.0%	4.6%	4.7%	2.1%	3.2%	3.0%
Philippines	5.8%	5.1%	5.5%	1.4%	1.1%	1.7%
Singapore	1.6%	1.5%	2.0%	-0.5%	0.5%	1.5%
South Korea	2.5%	2.4%	2.8%	0.7%	1.7%	2.4%
Taiwan	0.6%	1.8%	2.5%	-0.2%	1.4%	1.4%
Thailand	2.9%	2.4%	2.8%	-0.8%	0.4%	1.1%

Source: Forecasts from Citi Research. As of 30 November 2015.

EXCHANGE RATE FORECASTS (VS. USD)

	1Q16	2Q16	3Q16	4Q16
Europe	1.03	1.01	1.00	1.01
Japan	126	127	128	129
UK	1.49	1.48	1.47	1.48
Australia	0.68	0.67	0.66	0.67
China	6.53	6.64	6.69	6.67
Hong Kong	7.77	7.78	7.79	7.78
India	67.1	67.7	68.0	68.0
Indonesia	14209	14395	14500	14500
Malaysia	4.47	4.49	4.48	4.44
Philippines	47.9	48.3	48.4	48.1
Singapore	1.45	1.46	1.47	1.46
South Korea	1196	1215	1221	1212
Taiwan	33.4	33.8	33.9	33.7
Thailand	36.8	37.1	37.2	37.0

Source: Forecasts from Citi Research. As of 30 November 2015.

INTEREST RATE FORECASTS

	CURRENT	1Q16	2Q16	3Q16	4Q16
US	0.50%	0.50%	0.75%	0.75%	1.00%
Europe	0.05%	0.05%	0.05%	0.05%	0.05%
Japan	0.10%	0.10%	0.10%	0.10%	0.10%
Australia	2.00%	1.75%	1.75%	1.75%	1.75%
UK	0.50%	0.50%	0.50%	0.75%	1.00%

Source: Forecasts from Citi Research. As of 30 November 2015. Current rates as of 17 December 2015.

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