International Personal Bank

The rally in European government debt has been extraordinary: negative bond yields have become entrenched through the region; core and soft-core euro sovereign debt trade below zero through five years (to maturity); and German debt is negative out to eight years. Though yields have been falling for some time, the launch of the ECB's quantitative easing program has fuelled the most recent push lower. With purchases intended to be carried out until September 2016, Citi analysts expect downside pressure on Eurozone yields to persist. This supports their current high conviction in long-dated periphery debt, especially Portugal.

Despite the rally in global rates, Citi analysts still expect US Treasury yields to move modestly higher this year, though most likely when economic data surprises turn upward. Assuming the Fed's base case views are generally confirmed, Citi analysts expect policy tightening to begin toward the latter half of the year.

In high grade credit, Citi analysts are neutral duration in the US, but more comfortable with long-duration exposures in Europe. They favour financials and are comfortable moving down in capital structure. In high yield corporates, they are constructive on both US and European markets and maintain an up in quality bias. Citi analysts also favour opportunities in fixed-to-floating rate perpetual.

Sectors	12 Months View		Investment Rationale
Dev. Market (Core) Sovereigns	**Underperform**		Rates expected to rise modestly in the US; negative bond yields in the Eurozone likely to persist; favour European duration
EU Periphery Sovereigns*	**Outperform**		ECB QE is expected to promote further spread compression versus German Bunds; favour Spain and Portugal
Emerging Market Sovereigns	**USD**	**Outperform**	Favour hard currency sovereigns/ corporate over local debt given improving prospects for stronger USD; cautious on CEEMEA and LatAm; favour HY USD debt
	Local	**Underperform**	
High Grade Corporates	**Market perform**		Relative value in USD credits over EUR issuers; favour BBB-rated non-financials and subordinated financial debt.
High Yield Corporates	**Outperform**		Prefer high quality B- and BB-rated credits; favour fixed-to-floating rate structured; value in primary new issuance.

**EU Periphery Sovereigns include bonds from Greece, Ireland, Italy, Portugal and Spain.*
Source: Citi analysts 14/04/15

Developed Markets Government Bonds

The rally in European government debt (EGB) has been extraordinary, as negative bond yields have become more entrenched throughout the region. Core euro (and soft core) sovereign debt now trades with negative yields through five years (to maturity), whereas German debt is now negative out to eight years. Even periphery countries like Italy and Spain have breached zero on the short-end of the curve, and Ireland is negative through 2019.

More notably, Switzerland became the first country to issue 10-year government debt below 0%.On April 8, the SNB sold bonds due in 2025 at a yield of -0.05%. Indeed, the Swiss yield curve now trades negative out to 13-years in maturity.

Though yields have been falling for some time, the launch of the European Central Bank's (ECB) massive bond buying quantitative easing (QE) program has fuelled the most recent push lower. Since March 9, the ECB had purchased roughly €62 billion in sovereign debt, €67 billion in covered bonds and €5 billion in asset-backed securities. This has reinforced US Treasury/German Bund spreads near all-time wides, and dropped 10-year German yields below Japan for the first time in history.

With the current QE program intended to be carried out until at least September 2016, Citi analysts expect downside pressure on Eurozone yields to persist. This supports their current high conviction in long-dated periphery debt, especially Portugal. Indeed, debt issued by periphery countries – with 20+ years to maturity – has gained 18.5% year-to-date, with Portugal debt rising 24%.

In the US, despite a more favourable economic backdrop, yields on Treasury debt remain stubbornly low. Though the 10-year US Treasury (UST) reached 2.25% in early March, weaker economic data, relatively attractive yields, and other geo-political factors, have pushed yields back under 2.0%. Despite the recent rally, Citi analysts still expect yields in the U.S. to move modestly higher this year, though most likely when U.S. economic data surprises turn upward. Assuming the Fed's base case views are generally confirmed, Citi analysts expect policy tightening to begin toward the latter half of the year. Currently, futures markets are pricing an initial rate hike around the September/October FOMC meetings.

Citi analysts believe at this stage in the cycle, taking duration bets is a risky proposition. With numerous internal and external macro factors pulling on U.S. Treasury rates every day, maintaining a neutral duration position in fixed income portfolios appears a more prudent management approach. Especially when considering that consensus forecasts for year-end 10yr Treasury yields have declined 100bp over the last 6 months. Even if future returns are negative for long Treasuries, Citi analysts would still value them as a portfolio hedge in broader asset allocation.

Emerging Markets (EM) Government Bonds

After some weakness in early March, hard currency emerging market (EM) debt bounced back strongly after the FOMC (Federal Open Market Committee) lowered inflation and growth projections. As a result, futures markets pushed out rate hike expectations and reignited investors reach for yield. US dollar-denominated EM spreads and yields have declined 50bp since the March 18 announcement; the markets lowest level of the year (350bp). Over that span, USD EM debt has gained 3.8%, bringing YTD returns to 3.5%. Performance in Asia and EMEA regions stand out, both rising 4.3% YTD. To be fair, EMEA returns are skewed by a 14% return in Russia debt (mainly due to liquidity issues in the repo market), which makes up roughly 20% of the EMEA index. Ex-Russia, EMEA has only gained 1.0% and Citi analysts remain cautious. In Latin America, lower oil prices, declines in growth expectations and heightened political risks keep Citi analysts underweight.

Asia continues to be Citi analysts' most-favoured region in both USD debt and local currency markets. China monetary policy easing and growth supportive reforms have had a calming effect, while Japan runs the world's largest QE program keeping local rates low, and demand for yield high. Moreover, six other Asia-Pacific countries have cut policy rates this year (Australia, India, Indonesia, Korea, Pakistan, and Thailand). The decline in oil prices has also been a boon for many Asia net-importing countries, like India, where subdued inflation prospects has allowed the RBI (Reserve Bank of India) to maintain its current easing cycle. That said, Citi analysts expect FX volatility to persist this year, and continue to favour external debt markets over local markets, especially in the corporate bond market. Valuations in both Asia high grade and high yield credit are more attractive when compared to US issuers. While the value proposition has become less attractive in high yield, Asia HG corps is still 100bp wider than US HG equivalents.

Investment Grade Corporate Bonds

Spreads in both US and European high grade (HG) corporate debt widened last month, as core government rates rallied and record-setting supply was absorbed by the market. Indeed, US HG supply reached a quarterly record of $325 billion in 1Q ‘15, while European issuance reached a record €170 billion. Exacerbating the widening has been the rally in UST and German Bund yields, which outpaced the decline in HG corporate yields. As Citi analysts have highlighted previously, HG performance remains highly correlated to the direction of risk-free rates. Despite posting gains of 2.2% and 1.3% YTD, duration-adjusted returns for US and euro corporates are 200bp and 100bp lower, respectively. With US rates unlikely to move sharply higher and euro-area rates anchored, Citi analysts are neutral on duration in US credit, but remain more comfortable with long-duration exposures in Europe. Citi analysts favour financials and are comfortable moving down in capital structure. In non-financials, Citi analysts favour opportunities in the automotive sector based on a stronger fundamental backdrop from lower commodity costs.

High-Yield (HY) Corporate Bonds

Stable energy prices and a significant shift lower in Federal Reserve inflation expectations, reversed a brief sell-off in high yield (HY) which began in early-March. Since the March 18 meeting, US HY fund flows reversed course (after several weeks of outflows), spreads tightened 30bp and yields dropped roughly 40bp. This has helped boost YTD performance to 3.2%. In Europe, HY spreads were largely wider as new issuance for 1Q ’15 was the second-highest quarterly volume on record (€31 billion). Moreover, half of the new supply was issued in March alone (€15 billion). Though returns were flat in March, euro HY has gained 3.5% YTD. Citi analysts remain favourable on both the US and European HY. Though US HY offers investors higher yields and the support of a stronger dollar, euro HY debt is likely to benefit from less rate drag, and greater potential for spread tightening (supported by ECB QE). Citi analysts anticipate both markets to generate 7-8% total returns for 2015 (in local terms), as fundamentals remain stable and default rates low. Citi analysts maintain an up-in-quality bias, favouring relative value in higher-quality Single-B and Double-B credits. Citi analysts favour issuers in the services and telecommunications sector and remain cautious on the energy sector.

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