Citigold

Market Outlook

April 2016

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ECB to the rescue

On 10 March 2016, the European Central Bank (ECB) cut the deposit rate by 10bp to -0.4%, and lowered both the main refinancing and marginal lending rates by 5bp to 0.0% and 0.25%, respectively. The ECB also announced new TLTROs and an increase in the monthly asset purchase programme, which from end-2Q16 will also include € IG corporate bonds. Looking ahead, Citi analysts are pushing back the timing of the next cut in the deposit rate to -0.5% from Sep-16 to Mar-17. Our argument is that the ECB will have more time to discuss this option further as part of its objective to *"accelerate the return of inflation to levels below, but close to, 2%".*

Citi analysts think the ECB's latest policy actions are likely to under-pin a more positive period for risk assets, including equities. This suggests support for both European credit and equities through 2016 unless recession knocks. We raise our end-2016 Stoxx target from 360 to 380 (end-16E & end-17E P/E of 17.1x & 14.9x, end-16E & end-17E DY of 3.4% & 3.7%).

Macro Overview

- **US:** Rate hike in April or June unlikely given dovish Fed; Citi now expects one hike in Sep or later in Dec provided data is strong enough and markets remain calm.
- **Europe:** Additional monetary policy support expected; UK referendum uncertainty poses a key risk.
- **Japan:** Further cut in policy rates (from -0.1% currently to -0.3%) expected in July.
- **Asia:** Growth remains challenging as trade recovery is elusive. But, prospect of slower Fed tightening and China's stable FX policy is providing support to capital flows to the region.

Equities: Overweight

- We see a resumption in EPS growth amid low expectations. However, the advanced state of the US recovery and some near-term political risks across the world suggest a more cautious stance. Our MSCI AC World end-2016 target of 485 reflects a reduction in our top-down EPS growth forecast to 3.5%.

Bonds: Underweight

- **High Grade:** USD & EUR IG credit spreads are attractive; Favour US longer duration opportunities.
- **EM Debt:** Mildly positive on EM debt, as valuations have been beaten up and price in existing risks.

Commodities: Neutral

- **Gold:** Supported in near term but bearish into year-end.
- **Oil:** More pain likely before gain.

Currencies: USD Appreciation Out Of Fashion

- **EUR:** Range Seen Holding For Some Time.
- **JPY:** Largely Range Bound Though With Some Risks To The Downside.

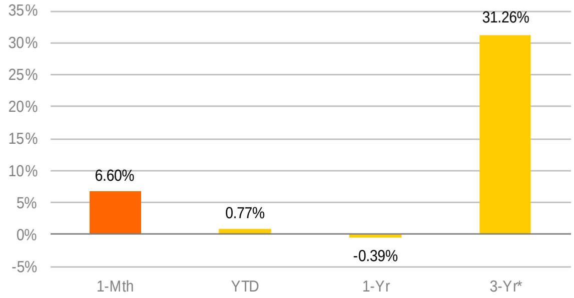
Equity Markets and Commodities

United States

Next Fed hike likely postponed to Sep or Dec

- Despite the additional drag created by heightened market-induced uncertainty, US economic activity continues to expand at a moderate pace. Strong job gains continue to produce income growth that supports spending.
- That said, the recent jump in consumer prices likely does not represent a sustainable rebound in inflation. Along with recent FOMC's dovishness, Citi analysts have lowered our projected number of rate increases this year to possibly one in September or even as late as December.
- Looking at equities, S&P 500 companies will start reporting 1Q16 numbers soon. Earnings revision momentum suggests that beaten up areas like Materials and Financials could get a further bounce. It appears as if Banks, Diversified Financials, Materials and Pharma & Biotech as well as Tech Equipment & Hardware could see some positive surprises given their poor expectations.

Chart 1
S&P 500 Index



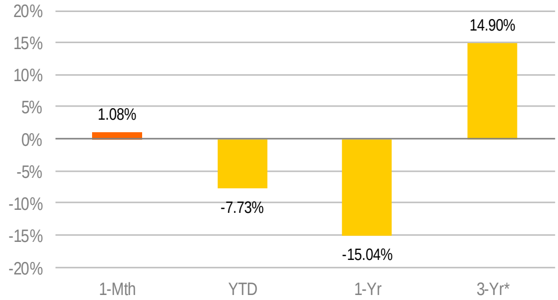
*Denotes cumulative performance
Performance data as of 31 March 2016
Source: Bloomberg

Euro - Area

Raising end-2016 Stoxx target from 360 to 380

- Despite an agreement on dealing with the refugee crisis at the EU summit in mid-March, we doubt that the issue has been resolved. Implementation of the deal may be slow, with significant risks unravelling.
- The ECB also announced a comprehensive package of measures at its March 10 meeting. We expect that the transmission of this monetary easing could add between 0.3-0.4% to the level of GDP, and between 0.1-0.2pp to the price level, by 2018. However, we doubt that it will be enough to achieve the inflation target, hence requiring additional monetary policy support, probably as early as the September 8 meeting.
- Nevertheless, Citi analysts think the ECB's latest policy actions are likely to under-pin a more positive period for risk assets, including equities. We raise our end-2016 Stoxx target from 360 to 380 (end-16E & end-17E P/E of 17.1x & 14.9x, end-16E & end-17E DY of 3.4% & 3.7%).

Chart 2
Dow Jones Stoxx 600 Index



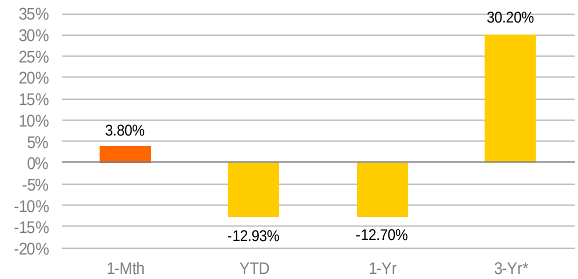
*Denotes cumulative performance
Performance data as of 31 March 2016
Source: Bloomberg

Japan

More BoJ easing measures expected in July

- Citi analysts continue to expect the Bank of Japan (BoJ) may implement additional easing in the form of further reduction in policy rates (from -0.1% currently to -0.3%) in July this year.
- Some market participants expect that prospective downward revisions to the BoJ's inflation projections will push the BoJ to ease policy at its April meeting but we believe that the hurdles for action in April are high. Most notably, the impact of the negative interest rate policy (NIRP) is uncertain and it will likely take more time/data for the BoJ to get a stronger handle on this.
- At the sector level, we think NIRP is likely to prove negative for banks and insurers and positive for electric power & gas, real estate, J-REITs, transportation, and basic materials, among others.

Chart 3
Topix Index



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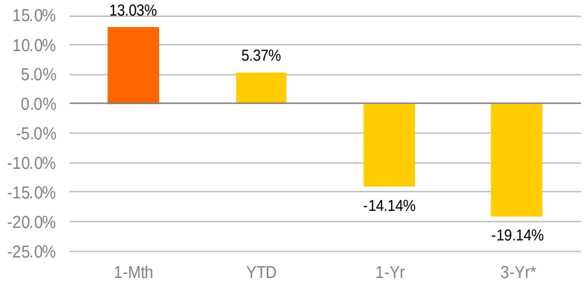
Source: Bloomberg

Emerging Markets (Asia, CEEMEA and Latam)

FY15 earnings disappointed

- Only the GFC and 2001 results seasons were worse; encouragingly, both subsequent results seasons were less disappointing. This time around, the biggest percentage of FY15 misses has come from LatAm; Mexico was a large contributor to the disappointment, Brazil did better. Asia earnings also disappointed, but to a lesser extent, with Korea and India having the most misses. EMEA was the only region to surprise positively.
- Only Taiwan has earnings that are above its post-2000 trend. For Asia overall, earnings are 30% below trend, and they are 63% below trend in EMEA and 68% below in LatAm (all in US$ terms).
- By sector, utilities and tech outperformed even the defensives of telecoms, cons staples and healthcare. Materials and energy are furthest from trend. As 2016 progresses, Citi analysts believe that the base of EPS comparison will become easier.

Chart 4
MSCI Emerging Markets Index



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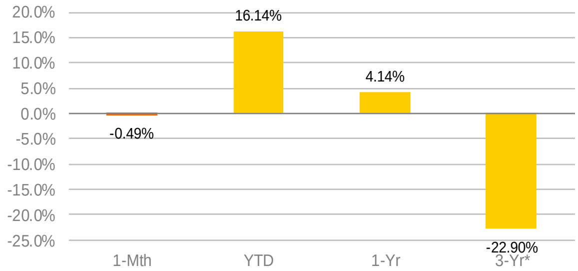
Source: Bloomberg

Gold

Supported in near term but bearish into year-end

- As seen in recent weeks, ongoing cautiousness amongst both investors and policymakers may likely keep riskoff buying strong and rate hike expectations tempered until a more sustained risk asset rebound is in play.
- But as the oil price recovery becomes more credible into 2H16, lingering uncertainty over EM growth may likely subside significantly and help to rejuvenate investor confidence in the global economy, weakening the demand for gold as a safe-haven and potential inciting more aggressive policy normalization from the Fed.
- Thus, Citi analysts continue to see gold prices staying supported in the short-term, but longer-term we are positioned bearish into year-end, and forecast gold prices to average $1185/oz in 2016.

Chart 5
GOLDS Commodity Index



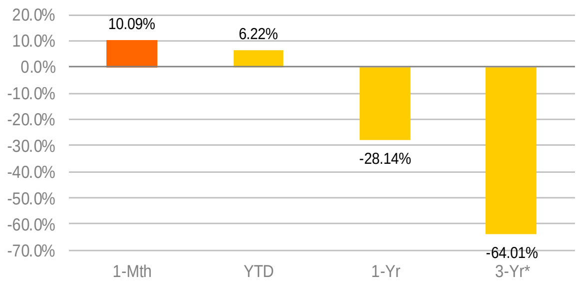
*Denotes cumulative performance
Performance data as of 31 March 2016
Source: Bloomberg

Oil

More pain likely before gain

- With Brent prices now ~$15/bbl off their YTD lows, it seems that the bottom may be in for oil prices. Yet the oil price path in 2016 is still littered with uncertainties and near-term fundamental challenges can push oil prices lower in the 2Q16.
- The supply-side rebalancing is underway but the market is not out of the woods just yet. Oil markets still have to navigate through the upcoming maintenance seasons in Europe and Asia before the expected summer support arrives.
- Indeed, the market may have gotten a little ahead of itself but we maintain the view that oil prices should trade in the $40's during the summer and can reach above $50/bbl by year-end.

Chart 6
Brent Oil



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Performance data as of 31 March 2016
Source: Bloomberg

Bond Markets

US and European investment grade corporate spreads remain attractive

US Treasuries

- We expect US yields to stay subdued in 2016 as the combination of slowing global growth, low inflation and underperformance of risk assets continue to benefit Treasuries.

High Grade Corporates

- In the US, long-duration maturities gained 1.6% in February and industrial sectors outperformed, as credit curves flattened and energy-related sectors were fuelled by higher oil prices. Despite the tightening, benchmark yields near 3.6% are still attractive and spreads remain wide, relative to historical norms. Fundamentals have weakened (i.e., rising net leverage) but we believe a large majority of bad news is already priced in. We favour longer duration opportunities, as we have little concern over rising long-term US rates
- Meanwhile, we note that the spread gap has widened drastically between GBP and EUR denominated credit, mainly driven by increased risks surrounding a possible “Brexit”. Although GBP credit looks attractive, we are neutral due to the uncertainty and that spreads would likely widen further upon a “yes” vote.

High-Yield

- We believe US HY debt has further to run, as global financial markets further recover. Though not as cheap, benchmark yields are still over 8.0% (7.0% ex-energy) and spreads remain relatively attractive.
- We remind investors that the stabilization in oil may not likely save low quality oil producers, and default rates are expected to rise. Current energy default rates are 12.0% vs. 3.0% for the rest of the US HY universe. As a result, selectivity will be important, as volatility will likely persist for the foreseeable future.

Emerging Market Debt

- In our view, commodity prices have likely seen the lows of the current cycle and China currency devaluation is expected to remain stable (though continue to weaken). Moreover, we expect markets to come back to reality over fears of global economic contraction.
- As a result, we turn mildly positive on EM external debt (neutral on local markets), considering valuations have been beaten up for so long and appropriately price in existing risks, particularly in Latin America. That said, poor economic outlook and political uncertainties are likely to keep EM assets and currencies volatile.

Euro Bonds

- Bund yields have met our target of 0.2-0.3% and have scope to push lower and even test negative yields. The reasoning is that (a) ECB policy stimulus is unlikely to increase medium-term inflation expectations; and (b) Further policy measures are likely to see even more scarcity risk priced into Bunds.

Japan Bonds

- We stick with our view that the BOJ may continue to cut rates and that the yield curve could steepen. The rates market is now less aggressive at pricing further BOJ cuts after the negative reaction to recent easing from FX and equity markets. However, we believe this adverse reaction was partly due to fiscal year-end effects. We expect the market to start pricing in further cuts in the new fiscal year.
- We believe volatility in the super-long sector may increase even more towards the end of the year, while that up to 10 year should be contained by the lending support program where the rate is likely to be lowered.

Asia Bonds

- In Asia HY, performance has been flat since the beginning of the year, bouncing within a -1.0% to +1.0% range, ignoring the volatility in local equity markets.
- This is much different than the moves we saw in 2015, where China HY moved up +7.5% from the initial CNY devaluation in August through year-end. However as we noted previously, further local currency weakness would make external debt obligations more expensive to finance, hurting HY issuers.

Currency

USD Appreciation Out Of Fashion

USD is broadly seen as range bound vs. G10 currencies over the medium term forecast horizon though higher vs. EM currencies. More broadly, the range bound nature against G10 FX comes despite significant monetary policy divergence and suggests waning appetite for further robust USD gains as US economic performance remains neither strong enough to encourage a super hawkish Fed nor weak enough to stimulate safe haven currency demand.

EUR: Range Seen Holding For Some Time

- Limited upside seen near term in euro as the most recent ECB meeting seems to signal less of a desire to cut rates further or to use the currency directly as an instrument policy.
- At the same time however, downside risks also appear limited near-term given markets are already pricing in expected policy rates differentials with the US and given the ECB's aggressive package is aimed at lifting the Eurozone economy.
- As a result, a more range bound euro seen at current levels though decidedly lower than its medium to longer term fair value.

GBP: Brexit Risk Premia Build

- Near term, weakness in GBP seen likely as Brexit risk premia continues to build as markets approach the June 23rd June referendum.
- Brexit aside however, the macro forces shaping the BoE's mindset probably have not changed all that much lately and moderate growth and generally subdued inflation expectations are still seen translating to higher rates, but not until 2017.
- Such an outcome, and assuming a no-Brexit base case, is likely to see a relief rally in sterling from depressed levels over the medium to longer term.

JPY: Largely Range Bound Though With Some Risks To The Downside

- Like euro, a largely range bound unit as international pressure builds on Japan not to use exchange rate as a policy tool combined with the increasing dislocation between US-Japan rate differentials and the exchange rate that should see the unit consolidating in a range.
- Either side of that however lie risks – a stronger US economy and a hawkish Fed would present downside risks to the Yen outlook whereas a very risk-averse recessionary scenario would likely be a more positive backdrop for Yen.

AUD, NZD & CAD: AUD & CAD Strength, NZD Anchored

- **AUD:** The recent rise in iron ore and copper prices accompanying the improvement in global risk appetite, a more resilient domestic economy, a more positive technical picture against the backdrop of more balanced positioning continues to favour further moderate gains in AUD. The key risk however is should AUD appreciate too quickly and too sharply, then this could see stronger 'jawboning' from the RBA and may even bring the prospect of further rate cuts back on the table.
- **NZD:** With the RBNZ expected to cut rates further following the most recent meeting given its concerns about the low domestic inflation expectations, combined with the challenging outlook for diary prices, NZD gains appear to be more firmly capped as the unit underperforms its trans-Tasmanian cousin AUD.
- **CAD:** CAD's high delta to WTI prices that is now more supportive of the currency given our Citi Commodity team's call that oil prices may be bottoming needs to be balanced with the rates outlook that sees Citi Economists calling for one additional rate cut from the BoC versus 2 Fed rate hikes – this argues for CAD trading sideways in a range over the medium to longer term.

EM Asia: The CNY Upgrade

- The recent stronger CNY fixings, a broadly calmer China backdrop, and higher commodities prices combined with the Fed delivering a dovish message more recently, is likely to see EM FX continue to perform in the short term.
- But the strength is unlikely to hold through the year, and indeed EM FX weakness is likely to return as EM domestic and external fundamentals are still in need of further improvement over the medium to longer term.

Important Disclosure