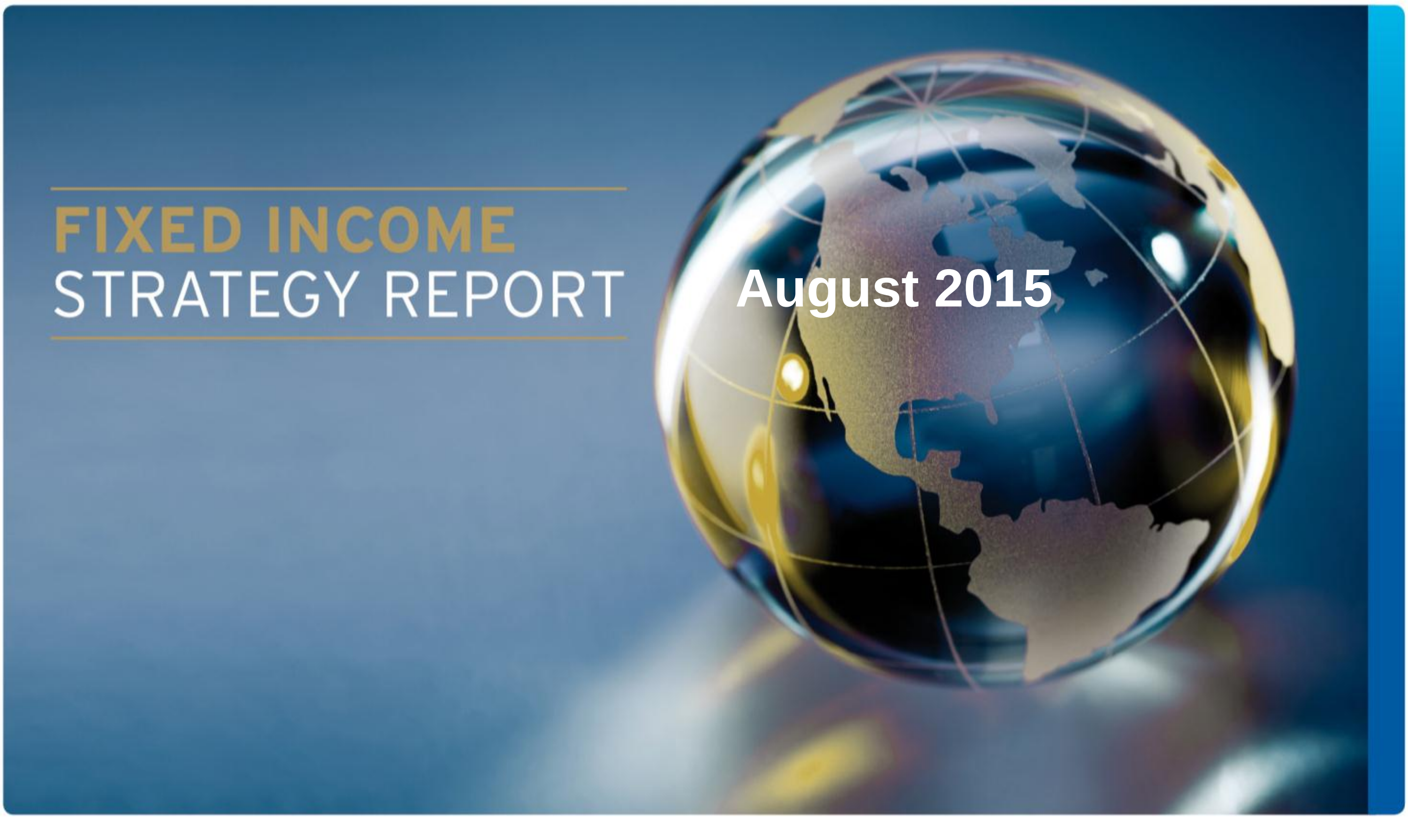

Citi analysts see the lack of liquidity in the fixed income market as being one of the key concerns for investors today. There is liquidity. Though regulation has changed to make the banking system more robust, bank dealers remain the central intermediaries in providing pricing for both the fixed income and equity markets. There are more onerous conditions for banks in relation to capital requirements which impinge upon liquidity, Citi analysts believe liquidity will remain in the markets.

Citi analysts specify that as long as markets remain calm, the volatility spikes we have seen remain a limited threat. Markets may be less deep than before the financial crisis, Citi analysts do not see the relative fall in liquidity as a systemic issue. Citi analysts also believe that central banks could limit any sell offs and therefore market dips could present buying opportunities.

Sectors	12 Months View		Investment Rationale
Dev. Market (Core) Sovereigns	**Underperform**		Slow-paced US recovery and Federal Reserve expected to manage normalization path; neutral duration; effect of European Central Bank's quantitative easing programme expected to push Eurozone rates lower.
EU Periphery Sovereigns*	**Market perform**		Greek bailout and the ECB's QE provides support for peripheral spreads. Prefer Spain and Portugal.
Emerging Market Sovereigns	**USD**	**Outperform**	Favour external debt markets over local markets, though increasing defensiveness near term as FX volatility to persist; Asia remains Citi analysts' most favoured-region.
	Local	**Underperform**	
High Grade Corporates	**Market perform**		Performs largely tied to direction of core sovereign bond markets; favour opportunities in subordinated financial debt
High Yield Corporates	**Outperform**		Favour higher absolute yields in US HY vs. euro HY issues; diversification opportunities in USD Asia market. Favour BBs.

**EU Periphery Sovereigns include bonds from Ireland, Italy, Portugal and Spain.*
Source: Citi analysts 4/08/15

This month we are going to look at the issue of liquidity a little deeper

Liquidity, especially in fixed income markets, has become a growing issue for investors post the Global Financial Crisis (GFC). The reason for this is largely due to US regulatory changes which are intended to make the financial system more robust in the face of the next crisis, whenever that may be. It's not there is no liquidity, there is. The fear is that liquidity cold dry up should we see a severe reaction to an event such as the US raising their interest rate.

We are still in the situation where bank dealers are the main providers of pricing for both fixed income and equities. In fact trading volumes themselves (US and Japan in particular) are close to record highs and bid-offer spreads remain tight. Importantly, Citi analysts believe liquidity will remain in the future, even when considering the changes in regulation such as the Volcker Rule. To expand why the changes in regulation are instilling a degree of fear in market participants the core changes include: caps on inventories; specified holding periods for certain securities; capital requirements strengthened; and stress tests. The result is bank dealers are less willing to take risks.

However, assets managed by mutual funds and exchange-traded funds have grown exponentially over the past five years – taking up the slack from the dealers and absorbing the significant increase in corporate debt market and representing nearly 25% of investors in the corporate bond market. This does raise concerns as direction of flows into funds can be fickle and negative performance can create a negative feedback loop. A lack of liquidity and widened spreads could compound this problem.

Recently the effects of quantitative easing (QE) have masked this issue. That we have had a backstop of central banks keeping yields low volatility has been suppressed and investors have been on a hunt-for-yield diet. This has encouraged a herd mentality and created crowded trades. With the US set to be the first to reverse its QE programme and raise rate Citi analysts expect volatility to be reinstated.

Citi analysts note that the recent fears about both China and Greece has seen spikes of volatility across asset classes and in the context of this discussion on liquidity, consensus positions have been able to unwind relatively quickly. Citi analysts do not consider these spikes in volatility as a systematic threat as long as the markets remain calm.

With respect to investing with the consideration of illiquidity, Citi analysts recommend patience. Citi analysts highlight that sharp market movements without justification in fundamentals are often quick to reverse. In such situations Citi analysts note buyers may be able to seize absolute return opportunities. But, in the main, investors are not going to sit and wait and watch the market to find such opportunities. Leveraged positions should be monitored with due care and attention. Citi analysts write that holding negatively correlated assets is also a solution e.g long-dated US Treasuries vs equities, single bonds vs. a mutual funds. Off-the-run securities are also a possibility for those clients who are income orientated as they are less liquid and therefore would perform relatively better should liquidity dry up. For income-oriented clients, the types of cash bonds to own today could be the most illiquid ones, these would most likely be the larger, more frequently traded, benchmark-type securities.

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With respect to fixed income securities, please note that in general, as prevailing interest rates rise, fixed income securities prices will fall. High Yield bonds are subject to additional risks such as increased risk of default and greater volatility because of the lower credit quality of the issues.

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