Citigold

Market Outlook

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Managing volatility and risk

Markets have seen a rise in volatility amid concerns over Greece and China. Citi analysts believe neither of these country-level issues risk a turning point for the world economy. Greek contagion risks have greatly diminished in their view, while in China, the government has taken a number of confidence-boosting measures in order to stabilize the market. Finally, in the US, Citi analysts' base case is for the first rate hike in September. As this reflects an ongoing improvement in the economy, they think equity markets can take this in their stride. Furthermore, they expect the pace of interest rate normalization to be gradual.

Overall, Citi analysts see a modest deterioration in the growth-inflation mix, though this is probably not severe enough to de-rail equity market outperformance. As a result, Citi analysts' base case asset allocation call remains overweight equities versus fixed income.

Macro Overview

- **US:** First rate hike anticipated in September, but developments abroad may pose risks for delay.
- **Europe:** Probability of Grexit is now above 50%; European Central Bank (ECB) likely to maintain accommodative policy stance.
- **Japan:** Sluggishness in consumer spending may weigh on inflation and trigger additional Bank of Japan (BoJ) easing.
- **Asia:** China may see slow growth stabilization in 2H; Citi analysts expect further easing through both interest rates and reserve ratio requirement cuts.

Equities: Overweight

- Overall, Citi analysts maintain their constructive view of a moderately growing global economy. However, prospective Fed rate rises emphasise late-cycle US economic risks and spill-overs when looking out a year or more though this is probably not severe enough to de-rail equity market outperformance. As a result, Citi analysts' base case asset allocation call remains overweight equities versus fixed income.

Bonds: Underweight

- **High Yield:** Valuations appear attractive and fundamentals remain supportive.

Currencies: Expect USD to gain ground

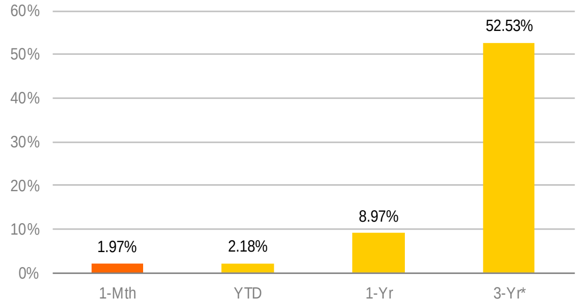
- **EUR:** Resilient to Greece but lower long term.
- **JPY:** Yen weakness delayed due to later quantitative easing.

Equity Markets

United States
Bounce back in growth to near 3% anticipated

- Fundamentals do not appear to have changed materially, and stronger incoming data signal a robust growth rebound near 3% for the rest of 2015. Indeed, Citi analysts see strength returning to a number of sectors, including the labour market, consumer spending, and construction activity.
- To date, incoming data continue to support Citi analysts' projection that the Fed's pre-conditions for interest rate normalization may be met by September. However, if developments in Greece and China become systemic because of policy failures by the ECB or Chinese authorities, there would be a higher risk of a delay in the Fed's first rate hike or an even more gradual pace of increases.
- From an equity perspective, moderate gains are likely by year-end but Citi analysts would advise not to expect a powerful rally in 2H15. Large-caps and value styles may outperform and favoured areas include Financials and Tech.

Chart 1
S&P 500 Index

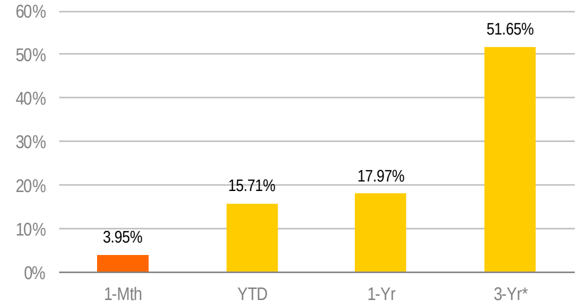


*Denotes cumulative performance
Performance data as of 31 July 2015
Source: Bloomberg

Euro - Area
Contagion risk from Greece greatly reduced

- The main change to Citi analysts' forecasts is the re-introduction of Grexit in their base case. Indeed, even if the short-term crisis is managed and a bridge loan plus a two- to-three year third bailout programme for Greece are agreed upon, Citi analysts see Grexit as, eventually, the most likely outcome.
- That said, contagion risk has greatly reduced since 2011-12 due to: the Eurozone economy being in much better shape now; repair of European banks, especially on the capital and funding side. At the same time, Citi analysts expect the ECB to continue to maintain a very accommodative monetary policy stance in the foreseeable future, likely extending its quantitative easing programme beyond Sep-16.
- As such, Citi analysts see upside in European equities, even with a Grexit base case. Citi analysts prefer European financials, e.g. banks, and European de-equitisers, i.e. strong balance sheet and surplus free cash flow stocks.

Chart 2
Dow Jones Stoxx 600 Index



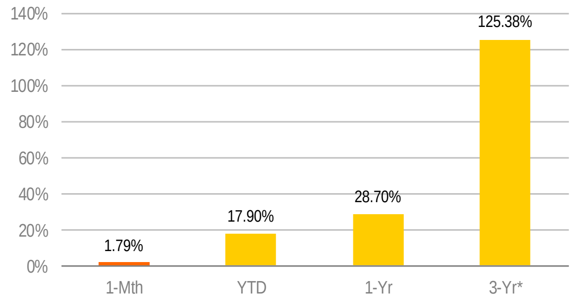
*Denotes cumulative performance
Performance data as of 31 July 2015
Source: Bloomberg

Japan

BoJ may implement easing measures in Oct

- Citi analysts expect business investment to rebound briskly in Q3, but consumer spending and export may remain anaemic. Citi analysts now expect GDP growth of +1.8% QoQ annualized for Q3.
- At the same time, given the fall in crude oil prices, the BoJ may be forced to make meaningful downward revisions to growth and inflation projections in October when policymakers update the economic outlook report. As a result, Citi analysts expect that the BoJ could decide to implement extra easing at that stage.
- Over the medium term, Citi analysts expect Japanese shares to continue outperforming major global markets in 2015. This is thanks to: support for Japanese equities from an inflow of public money (supply/demand factor); an increased emphasis on return on equity by corporate management (micro-level factor); and the achievement of full employment (macro-level factor).

Chart 3
Topix Index



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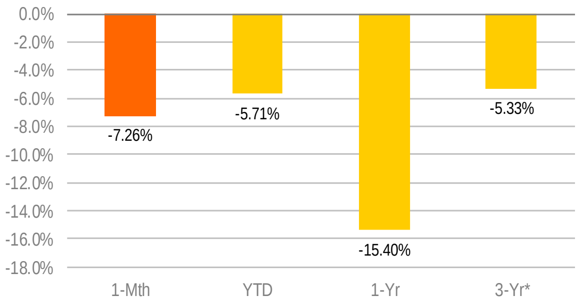
Emerging Markets (Asia, CEEMEA and LatAm)

Favour Asia over EMEA and Lat Am

- Emerging market (EM) EPS (earnings per share) revisions still lag DM (Developed Markets) slightly due to EM's higher weight in materials and energy. Within EM though, Asia continues to have the best earnings with its EPS now at 119% above the financial crisis low.
- EM valuations have moved from below historical average towards average but still trades at a discount to DM. Within EM, the cheapest (on a price/earnings and price/book value basis) region is still Asia, with EMEA ranking next and then Lat Am.
- EM may face higher rates in the second half and the best way to avoid the headwinds is to avoid expensive markets and those with current account deficits. A stronger USD should redistribute profit from commodity producers to consumers. All this lead Citi analysts to favour Asia over both EMEA and Lat Am. Among sectors, Citi analysts overweight financials, technology, consumer discretionary and underweight defensives.

Chart 4
MSCI Emerging Markets Index



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Bond Markets

Favour high yield credit

US Treasuries

- Citi analysts expect the market to price in one rate hike by end of 2015, and beyond this, a path of rate hikes which is gradual, but slightly above the pace priced in by the market.
- Low inflation and subdued global growth together imply a benign picture for the longer end of the curve.

Investment Grade Corporates

- The largest drag on Investment Grade (IG) performance remains the direction of core rates.
- Citi analysts show that 65-75% of IG credit returns are tied to the movement in core government bonds.
- Considering Citi analysts' benign view on rates this year, they are comfortable maintaining a neutral duration view on credit.

High-Yield

- Although market liquidity and volatility may be amplified over the summer months, valuations appear attractive for investors with a longer-term view.
- Moreover, the fundamental environment remains supportive (unlike in high grade credit).
- Citi analysts maintain their overweight in both US and European high yield and look for opportunities in higher quality, BB-rated credits.

Euro Bonds

- 10y Bunds are expected to range-trade in the next few weeks with a modest downside yield bias.
- Citi analysts see economic fair value near 0.80% but negative convexity can make a comeback as a driver on ECB squeeze effects and disinflation, and this could deliver an equilibrium near 0.25%.
- There is some bearish risk via the market preparing for a Fed hike but the Euro curve is already pricing the ECB to follow 21 months after the Fed, which is close to the last cycle.

Japan Bonds

- Citi analysts now expect yields to reach the bottom in 4Q following the change in their call from July to October for the timing of additional easing by the BoJ.
- Citi analysts believe the BoJ may increase Japanese Government Bond (JGB) purchases from the current 80% of issuance to close to 100%, so that domestic banks can turn into a net seller from a net buyer in FY2014.
- 2y and 5y yields may go up, despite a rally in 10y yields, because of the likely decrease in demand for JGBs as marginal investors turn from foreigners back to domestic banks.

Currency

Expect USD to gain ground

China's slowdown, commodity weakness and an overall lower inflation impulse might mean delayed policy normalization in the US. For Greece, broader currency market impacts are seen to be relatively limited and Citi analysts retain as their base case scenario. Citi analysts expect USD gaining slightly vs. G10 over 0-3m, then 8-9% over 6-12m.

EUR: Resilient To Greece But Lower Long Term

- EUR/USD has been resilient for various reasons: position unwinding, real short-rate differentials, equity inflows, Grexit improving Eurozone fundamentals. As some of these unwind, Citi analysts expect the trade to reach1.11 over 0-3m and parity over 6-12m.
- Lower unhedged equity market inflows, increased debt outflows and a relative shift towards tighter US monetary policy are the reasoning Citi analysts put behind this move.

GBP: Flat Then Mixed

- Economic momentum in the UK is picking up with the labour market showing signs of recovery. Citi analysts see the pace of tightening may be slower compared to previous Monetary Policy Committee cycles but is likely to begin earlier and go further than what markets currently project.
- Medium term, Citi analysts expect GBP is likely to strengthen vs. EUR primarily on labour market and monetary policy differences but weaken against the USD.

JPY: Yen Weakness Delayed Due To Later QE

- The BoJ (Bank of Japan) reiterates its upbeat assessment of the economy and signals conviction that the 2% inflation target will be hit without more easing.
- Given this, Citi analysts have delayed their calls for an extension of the current quantitative easing (QE) program, with base case now October.
- A less dovish BoJ alongside broad risk aversion see Citi analysts push out their forecasts for a higher USD/JPY exchange rate, but maintain the 130 pencilled in for the long term. Also note that on current short rate differentials, Citi analysts see no strong signal for the USDJPY either way, supporting Citi analysts' short-term view.

AUD & CAD: Continue To Underperform Medium Term

- **AUD:** Australia's domestic economic data remain mixed and externally, China's slowdown continues to be a real risk to the AUD. Citi analysts are anticipating a cut before year end and expect the RBA (Reserve Bank of Australia) to continue to jawbone the currency lower as exports are anticipated to be the main driver of GDP growth into the end of 2015.
- **CAD:** The downward momentum in oil prices and softer economic data combined with the expected cyclical improvement in US data in 2H15 as well as the outlook for a higher Fed funds rate by end-2015 implies further policy divergence likely being the main driver of USD/CAD higher further out.

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