Citigold

Market Outlook

August 2016

Emerging Markets: Changing fortunes?

Emerging Markets (EM) appears to be enjoying a change in fortunes. A strong US dollar, prospects of Fed rate hikes, falling commodity prices and a slowing China were headwinds which plagued EM. These headwinds seem to be abating, and the change or delta is positive, providing a boost to EM assets.

With more than 30% of global sovereign bonds at negative yields and two thirds of all investment grade bonds yielding below 2%, the higher yields offered by EM debt may likely continue to appeal to investors. Meanwhile, Citi's more constructive view on EM equities is biased on markets that are more exposed to a recovery in commodity prices. These factors suggest that the rally in EM assets may have further to run. Investors can look to gain some exposure to EM within a diversified portfolio. However, a significant improvement in EM economic growth and earnings has yet to materialize. Indeed, the recent attempted coup in Turkey underscores the political risks still plaguing much of the emerging world.

Macro Overview

- **US:** Moderate growth at a 2% pace. Expect one Fed policy rate hike this year, likely in December.
- **Europe:** Further monetary policy support likely in Sep; UK referendum uncertainty poses a key risk.
- **Japan:** Additional policy rate cut from -0.10% currently to -0.3% expected in January 2017.
- **Asia:** China's economy stabilised in 2Q16 underpinned by fiscal stimulus and credit easing. GDP growth was steady at 6.7%YoY, though we think the economy still faces substantial headwinds in 2H16.

Equities: Neutral

- Globally, we believe equity income offers more value relative to fixed income. However, in light of the strong recent rally, a neutral allocation now appears more appropriate. Within equities, we are modestly overweight Latin America on the back of recovering commodity prices.

Bonds: Slightly Underweight

- **Investment Grade:** US IG credit remains the largest relative overweight as they are benefitting from falling sovereign interest rates around the world and relatively high yields.
- **EM Debt:** Decline in volatility and dovish Fed may support local EM Debt in the near-term. We are overweight in Latin America (hard and local currency), local currency Asian bonds, and neutral EMEA.

Commodities: Neutral

- **Gold:** Safe-haven revival in 2H on the back of protracted macro uncertainty
- **Oil:** Prices could move higher over the medium term as global oil supplies continue to fall.

Currencies: Dollar Still Range Bound

- **GBP:** Downside risk.
- **AUD, NZD & CAD: Rate** cuts priced in for AUD and NZD.

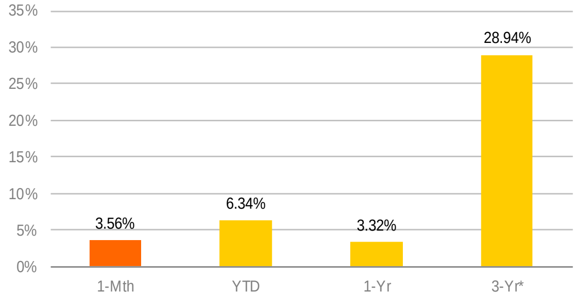
Equity Markets and Commodities

United States

Next Fed hike likely postponed to December

- Moderate growth at a 2% pace continues to be Citi's baseline, with inflation rising slowly. Real activity was surprisingly robust in the second quarter, as recent data showed widespread gains in production and consumption. Industrial production picked up in June across the major categories. Consumer expenditures showed signs of accelerating. Risks to the outlook for 2H16 have become better balanced with stronger domestic data.
- Monetary policy is expected to remain unchanged as the FOMC waits for more data to assess the impact of the Brexit vote, and determine whether domestic growth improvements can be sustained. The potential for a December rate hike remains intact.
- Disappointing 1Q16 earnings led us to reduce our 2016 S&P 500 profits projection but we still believe that the 1H16 rebound in WTI, US dollar weakness and rising ISM manufacturing new orders may support a 2H16 earnings recovery. In terms of strategy, we see large-caps outperforming small-caps. Rising bond yields should support value stocks over growth.

Chart 1
S&P 500 Index



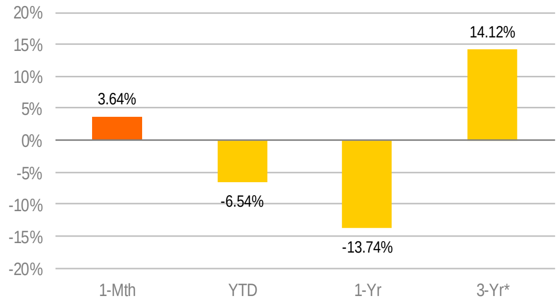
*Denotes cumulative performance
Performance data as of 29 July 2016
Source: Bloomberg

Euro - Area

Economy expanding at modest rate

- We leave our 2016-17 real GDP growth forecasts unchanged at 1.5% and 1.1%, respectively. For 2017, however, we expect GDP growth of 1.1% (below consensus view of 1.3%), as we remain mindful of the impact of political uncertainty and of the uptick in inflation on households' real disposable incomes.
- Looking ahead to the September 8 meeting, we expect the ECB to extend its QE programme for at least six months beyond Mar-17, and to announce a small 10bp cut in the Main Refinancing Operations (MRO) rate.
- We target 2016-17E EPS growth of 0-5%. This reflects our base case of no "synchronised and significant" global recession in 2016-17E and an end to commodity EPS headwinds. To hedge against political risk, Citi analysts prefer companies with strong balance sheets, surplus free cash flow & international exposure.

Chart 2
Dow Jones Stoxx 600 Index



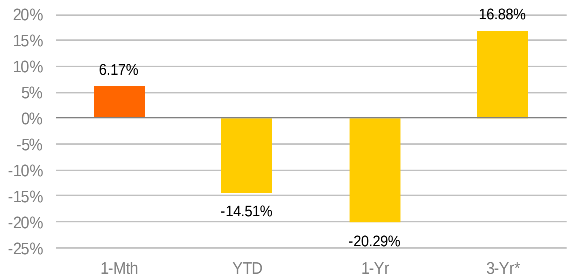
*Denotes cumulative performance
Performance data as of 29 July 2016
Source: Bloomberg

Japan

BoJ may cut policy rate in January 2017

- The BoJ decided to implement further monetary easing at its monetary policy meeting held on July 28-29. However, the new easing is based mainly around increased ETF purchases to ¥6trn from ¥3.3trn a year, and the BoJ did not lower interest rates further or expand QE. Looking ahead, Citi analysts expect the BoJ to cut policy rate to -0.3% (from -0.1% currently) in January 2017. By then, it should have become clear that the central bank's 2% inflation target is unlikely to be met within FY2017.
- Citi's TOPIX forecasts are 1,350 for end-16 and 1,450 for mid-17. We forecast EPS growth of +5.0% in FY16 and anticipate a modest re-rating to a PER of 14.0x. In terms of strategy, we prefer defensive sectors that benefit from domestic demand. Citi is cautious on banks and insurers based on expectations of an expansion in the BoJ's Negative Interest Rate Policy (NIRP).

Chart 3
Topix Index



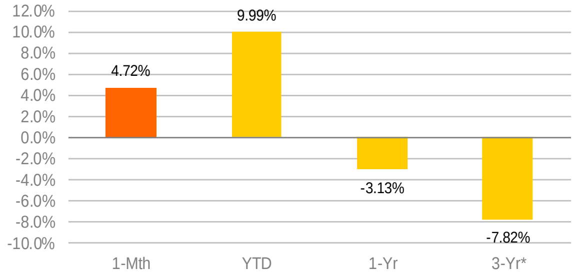
*Denotes cumulative performance
Performance data as of 29 July2016
Source: Bloomberg

Emerging Markets (Asia, CEEMEA and Latam)

Modestly overweight Latin America

- The first half of 2016 proved to be a volatile period for global markets but EM managed to outperform DM by ~5%. Weaker US$ has helped reduce the liquidity strains in EM with improvements in central bank assets growth. For the second half we expect the year on year comparisons to get better for a wide range of indicators such as export growth which would lend support to EM equities.
- Nevertheless, earnings revisions relative to DM have become weaker again. Consensus earnings growth for 2016 is at 6.5%. We forecast a growth of 0-4%
- Despite the structural problems EM economies still face, we think a lot of bad news is already in the price. Valuations for most of EM are already low. On an absolute basis, both PE and PB are below historical mean by 1 and 0.5 standard deviations respectively.
- Within the region, Citi analysts are modestly overweight Latin America on the back of recovering commodity prices.

Chart 4
MSCI Emerging Markets Index



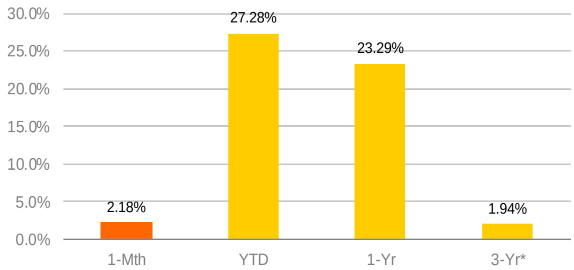
*Denotes cumulative performance
Performance data as of 29 July 2016
Source: Bloomberg

Gold

Safe-haven revival in 2H

- Gold prices rallied 8-10% to trailing-2Y highs in post-Brexit trading following the EU referendum vote on June 23rd. But the market has since sold-off to around $1,350/oz. at the end of July.
- The US dollar index (DXY) has surged to 16-week highs and should stay in the short-term, in our view, placing some pressure on gold prices into August.
- Looking forward, Citi expects just one Fed rate hike into the end of the year. A combination of a weaker US dollar in 6-12 months, as well as a return of previously deferred Asian demand should continue to support gold prices in 2H16.

Chart 5
GOLDS Commodity Index



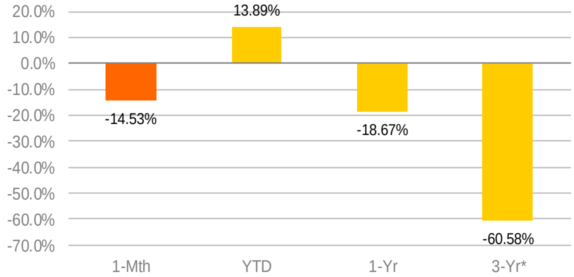
*Denotes cumulative performance
Performance data as of 29 July 2016
Source: Bloomberg

Oil

Prices could move higher

- Brent and WTI spot prices have retraced to the mid $40s as some of the 2Q16 investor optimism has cooled.
- Moving forward however, Citi expects oil prices to move higher as global oil supplies continue to recede and as oil inventories are needed to replace incremental oil demand growth.
- Indeed, the IEA estimates that global oil supplies dropped 750-k b/d y/y in June, as a combination of declining US and ex-US non-OPEC oil production starts to offset the growth seen out of OPEC, which is itself starting to slow. Iranian crude exports for July have been down over 300-k b/d relative to the 2.1-m b/d level seen in 2Q16 while supply disruptions in Libya, Nigeria and Venezuela show little sign of abating anytime soon.

Chart 6
Brent Oil



*Denotes cumulative performance
Performance data as of 29 July 2016
Source: Bloomberg

Bond Markets

US Investment grade credit remains the largest relative overweight

US Treasuries

- The low global interest rate environment should anchor the long-end for US Treasuries as foreign investors continue to bid up safe haven, higher yielding USD assets.
- We remain overweight US Treasury debt.

Investment Grade Corporates

- US IG credit remains the largest relative overweight as they are benefitting from falling sovereign interest rates around the world and relatively high yields.
- Given low yields and ongoing political headwinds, we moved Euro IG corporate bonds to a neutral.

High-Yield

- We slightly decreased the overweight to Euro HY, and kept the full overweight to US HY.
- Energy bonds have bounced back sharply, but selective opportunity remains for lower risk credits within the asset class.

Emerging Market Debt

- Energy sensitive countries are likely to benefit from improving crude oil prices and a cautious US Fed.
- We are overweight in Latin America (hard currency and local), local Asian bonds, and neutral EMEA.

Euro Bonds

- Interest rates in the Euro zone are anaemically low, and are likely to stay that way.
- With 10-year German Bunds reaching a historical low of 3 basis points, we find very little value in core Eurozone (EZ) rates.
- EZ periphery countries offer better value, though spreads are likely to be dominated by political event risk.

Japan Bonds

- While the yield curve steepened over the past month, in part reflecting concerns over the large fiscal economic package, we expect the yield curve may flatten moderately again in the coming months.
- We believe that the real impact from the economic stimulus package is likely to be much smaller than the total size of the package.
- JGB 10-year yields are now negative 15-20bp and offer little value, though also unlikely to move meaningfully higher anytime soon.

Asia Bonds

- With China currency risk becoming less of a concern, Asia USD corporate returns (both IG & HY) continue to improve.
- Nevertheless, we remain cautious on low quality credit, as rising defaults and China’s fundamental challenges pose a risk to recent outperformance.
- On the other hand, we would continue to hold high quality corporate exposure as demand is likely to remain strong.

Currency

Dollar Still Range Bound

Better US Q2 data, slightly more hawkish Fed rhetoric and correction higher in US yields are likely temporary $ positives near term as are ECB and BoJ likely easing. But medium term, USD strength is unlikely to extend given US Presidential uncertainty that may raise risk premia on some $ assets. Flows and valuation metrics imply that $ ranges persist.

EUR: Biding Its Time

- Recent events, including the UK referendum and renewed strains on Italian/European banks, have pushed the spot price lower within existing ranges. Citi expects the ECB to extend its QE program and cut deposit rates in September. This, coupled with rising probability of earlier Fed tightening, could see the pair follow a relatively flat path in the near-term. But some upside over the medium term seems likely on the back of supportive euro area current account surpluses. The spot price also remains significantly below relative interest rate differentials.

GBP: Downside Risk

- Apart from Brexit - led political uncertainty translating into economic uncertainty, the UK also faces triple deficits (trade, fiscal, current account) that may now take a longer time to abate. This will likely weigh on the sterling. At the same time, Citi also expects additional easing from the BoE in coming months as a technical recession looms. The added burden of prolonged uncertainty over the timing of triggering Article 50 to commence formal separation talks with the EU is also negative for the sterling.

JPY: BoJ Uncertainty

- The yen surged after the Bank of Japan (BOJ) disappointed markets on 29 July by announcing a weaker-than-expected monetary policy. Now market focus turns to the fiscal stimulus announcement. Should it disappoint, USDJPY may likely drop further to 100 and possibly 95 in the short term. In the longer term, with the spot price more than one standard deviation above its longer-term fair value and with Japan running a current account surplus of ~3%, the pair is more likely to drift towards 100 or lower than rally.

AUD, NZD & CAD: Cuts Priced For AUD, NZD, But Supported By Risk-On

- **AUD:** Following a rate cut in May, the RBA is likely to adopt a ‘wait-and-see’ approach.. However, Citi thinks low inflation prints will prompt the RBA to consider further rate cuts later in 2016. But a possible 25bp RBA rate cut now appears fully discounted into Aussie market rates and with the fallout of the UK referendum looking relatively contained, the backdrop for AUD remains supportive around the low 0.70s.
- **NZD:** NZD looks elevated against USD and the RBNZ has recently indicated that it needs a lower NZD to improve the country’s terms of trade. Cutting rates has been difficult given NZ’s housing boom. However, given the recent introduction of robust macro-prudential measures to contain house prices, RBNZ now appears on course to cut rates in August, following its recent dovish economic assessment.
- **CAD:** Near term weakness is likely in CAD (vs USD) given the weakness in energy prices and a more hawkish-than-expected Fed. In the medium term, Citi’s expectations of a rebound in oil prices in 2H’16 and 2017 could see the USDCAD re-test its 2016 lows. That said, such declines are likely limited given Citi’s expectations for BoC easing in Q4 which the markets have not priced in.

EM Asia: Adjusting To A More Distant Fed

- The Brexit shock has led investors to diversify away from the euro bloc. As a result, EM currencies have staged a broad rally. However, the gains appear to be running out of momentum. The medium to longer term challenges associated with higher US rates and China’s economic transition imply renewed pressure on EM currencies.

General Disclosure

"Citi analysts" refers to investment professionals within Citi Research ("CR"), Citi Global Markets Inc. ("CGMI") and voting members of the Citi Global Investment Committee. For important disclosures concerning companies covered by Citi's Equity Research analysts, please refer to the attached link: https://www.citivelocity.com/cvr/eppublic/citi_research_disclosures.

This document is based on information provided by Citigroup Investment Research, Citigroup Global Markets, Citigroup Global Wealth Management and Citigroup Alternative Investments. It is provided for your information only. It is not intended as an offer or solicitation for the purchase or sale of any security. Information in this document has been prepared without taking account of the objectives, financial situation or needs of any particular investor. Accordingly, investors should, before acting on the information, consider its appropriateness, having regard to their objectives, financial situation and needs. Any decision to purchase securities mentioned herein should be made based on a review of your particular circumstances with your financial adviser.

Investments referred to in this document are not recommendations of Citibank or its affiliates. Although information has been obtained from and is based upon sources that Citibank believes to be reliable, we do not guarantee its accuracy and it may be incomplete and condensed. All opinions, projections and estimates constitute the judgment of the author as of the date of publication and are subject to change without notice. Prices and availability of financial instruments also are subject to change without notice. **Past performance is no guarantee of future results.** Investment products are (i) not insured by any government agency; (ii) not a deposit or other obligation of, or guaranteed by, the depository institution; and (iii) subject to investment risks, including possible loss of the principal amount invested. All forecasts are expressions of opinion, are not a guarantee of future results, are subject to change without notice and may not meet our expectations due to a variety of economic, market and other factors.

The document is not to be construed as a solicitation or recommendation of investment advice. Subject to the nature and contents of the document, the investments described herein are subject to fluctuations in price and/or value and investors may get back less than originally invested. Certain high-volatility investments can be subject to sudden and large falls in value that could equal the amount invested. Certain investments contained in the document may have tax implications for private customers whereby levels and basis of taxation may be subject to change. Citibank does not provide tax advice and investors should seek advice from a tax adviser.

Citibank N.A., London Branch is authorised and regulated by the Office of the Comptroller of the Currency (USA) and authorised by the Prudential Regulation Authority. Subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details about the extent of regulation by the Prudential Regulation Authority are available from us on request. Our firm reference number with our UK regulators is 124704. Citibank Europe plc is authorised by the Central Bank of Ireland and by the Prudential Regulation Authority. It is subject to supervision by the Central Bank of Ireland, and subject to limited regulation by the Financial Conduct Authority and the Prudential Regulation Authority. Details about the extent of our authorisation and regulation by the Prudential Regulation Authority, and regulation by the Financial Conduct Authority are available from us on request. Citibank Europe plc, UK Branch is registered as a branch in the register of companies for England and Wales with registered number BR017844. Its registered address is Citigroup Centre, Canada Square, Canary Wharf, London E14 5LB. VAT No.: GB 429 6256 29. Citibank N.A., London Branch is registered as a branch in the UK at Citigroup Centre, Canada Square, Canary Wharf, London E14 5LB. Registered number BR001018. Citibank Europe plc is registered in Ireland with number 132781, with its registered office at 1 North Wall Quay, Dublin 1. Citibank Europe plc is regulated by the Central Bank of Ireland. Ultimately owned by Citigroup Inc., New York, USA. In Jersey, this document is communicated by Citibank N.A., Jersey Branch which has its registered address at PO BOX 104, 38 Esplanade, St Helier, Jersey, JE4 8QB. Citibank, N.A., Jersey Branch is regulated by the Jersey Financial Services Commission. Citibank N.A. is incorporated with limited liability in the USA. Head office: 399 Park Avenue, New York, NY 10043, USA. Calls may be monitored or recorded for training and service quality purposes.