International Personal Bank

FIXED INCOME STRATEGY REPORT

December 2014

Bond markets face an increasingly challenging environment in 2015. While performance during the past year was bolstered by a decline in core government rates, there is little scope for fixed- income investors to expect similar support in the New Year.

Though Citi analysts do not anticipate a sharp reversal in long-term rates or a spike in volatility, there is sufficient evidence to conclude that US and UK rates will rise moderately in 2015 as extraordinary central bank policies are unwound. Citi analysts expect the Bank of England and the US Federal Reserve to begin tightening monetary policy during the fourth quarter of next year, whereas European Central Bank rate hikes remain at least three years away.

Heightened geopolitical risks, unconventional central bank actions, and currency prospects contribute to the level of rates and fixed- income performance in the coming year. Citi analysts expect the euro to weaken further as the ECB embarks on quantitative easing measures to revive economic activity.

Sectors	12 Months View		Investment Rationale
Dev. Market (Core) Sovereigns	**Underperform**		Divergent fundamentals to boost rates in the US/UK while Eurozone and Japan remain anchored; favour duration exposure in EGBs
EU Periphery Sovereigns*	**Outperform**		Recent and prospective ECB actions further promotes periphery spread compression; favour Spain and Portugal
Emerging Market Sovereigns	**USD**	**Market perform**	Favour hard currency sovereigns/ corporate over local debt given improving prospects for stronger USD; prefer manufacturing vs. commodity exporters, and surplus over deficit countries; favour Asia over CEEMEA and LatAm.
	Local	**Underperform**	
High Grade Corporates	**Market perform**		Direction of rates key to performance; favour short duration US corps, long duration EUR & financials over non-financials
High Yield Corporates	**Market perform**		Recent selloff provides attractive entry point for new exposures; both Euro and USD-denominated issues offer value; favour single-B credits

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

Developed Markets Government Bonds

Bond markets face an increasingly challenging environment in 2015. While performance during the past year was bolstered by a substantial decline in core government rates and benign market volatility, there is little scope for fixed- income investors to expect similar support in the New Year. Even though Citi analysts do not anticipate a sharp reversal in long-term rates or a spike in volatility, there is enough evidence to conclude that both will rise moderately in 2015 as extraordinary central-bank policies are unwound.

To be sure, Citi analysts do not expect market movements to be uniform across regions. While core rates tend to reflect positive correlations over time, growth prospects have diverged among the major economies. In short, the healing process is simply more advanced in the US and UK than in the Eurozone or Japan. This is why – six years after cutting overnight rates close to zero – Citi analysts expect the Bank of England and the US Federal Reserve to begin tightening monetary policy during the fourth quarter of next year.

Currently, the market does not anticipate the European Central Bank (ECB) to hike rates for four more years, while Citi analysts believe it will be closer to three. No matter whether it’s three years or four, investors should be mindful that diverging growth prospects will anchor Eurozone and Japanese rates around historically low levels even as the US and UK central banks begin to tighten monetary policy. This divergence is already reflected in benchmark rates. During the past two years, 10-year US and UK government yields have featured progressively wider spreads over comparable debt securities in Germany and Japan. Citi analysts expect these relationships to persist.

Central bank rate hikes in the US and UK will directly impact the shape of the yield curve, with short-term rates expected to rise more than long-term rates. While short rates are beholden to policy changes, the long end of the curve is more accurately a reflection of growth expectations, inflation prospects, and term premiums. The magnitude of any rise in longer-dated yields is likely to be limited if economic activity improves only modestly, inflation expectations remain subdued and term premiums are restrained by slightly higher volatility and safe haven flows.

Although short- to intermediate-term bonds are more susceptible to central- bank policy tightening, Citi analysts expect price declines to be fairly limited given the inherent low duration of these securities. This is why Citi analysts maintain a preference for shorter duration exposures in US and UK sovereigns but are more comfortable with longer-dated maturities in the Eurozone and Japan.

Emerging Markets Government Bonds

Citi analysts see currency volatility and growth challenges putting pressure on EM sovereigns in 2015 but see these pressures being concentrated. Citi analysts have noted that EM yield curves tend to steepen when the currency is under pressure, even if the market is willing to see through the impact of currency on central bank behaviour. Combined with Federal Reserve hawkishness, Citi analysts are either neutral duration (in CEMEEA, where there is an offsetting benefit from likely ECB action), or underweight (in LatAm). In aggregate, this sees Citi analysts move from a large duration overweight to a small underweight in EM sovereign debt. Citi analysts continue to prefer high quality manufacturing exporters (e.g., Korea, Philippines, Mexico, and India) due to their resilience in times of increased volatility.

Investment Grade Corporate Bonds

Citi analysts expect euro-denominated corporate markets to outperform government debt during the coming year. Citi analysts expect this to hold true in other developed markets since corporate bonds tend to be more resilient than other sectors in the early stages of hiking cycles.

While Citi analysts prefer corporate bonds, potential gains in investment grade are likely to be more modest compared to recent years. Low absolute yields and fully-valued spreads – especially in the US – are unlikely to sufficiently offset declines in principal value as interest rates rise. It's worth keeping in mind that falling government rates have largely been responsible for the impressive returns posted by credit markets during the past year.

Corporate-bond spreads have already narrowed in Europe. This is likely to continue owing to the expansion of the ECB's balance sheet. But in the US – where the credit cycle is more mature and quantitative easing has ended – spreads are likely to remain unchanged or widen slightly in 2015. Citi analysts prefer European investment-grade debt over US corporate bonds, and financial over non-financial credits.

Bondholders will likely continue to benefit from the extraordinary shift in global bank regulations. The introduction of new bank rules under Dodd-Frank and Basel III has prompted financial institutions to de-lever balance sheets (through a reduction of high risk assets and/or raising new capital). This is contrary to the re-leveraging that has occurred in the non-financial sector during the last few years.Moreover, the recent ECB asset quality review of European banks promotes greater transparency, more accountability, and stronger balance sheets over time.

High-Yield Corporate Bonds

High-yield markets are poised to generate impressive returns in 2015 compared to higher-quality fixed income sectors. Potential gains could be bolstered by stable fundamentals and the strong demand for higher yields in a historically low rate climate. Solid fundamentals and a fertile primary market have helped to depress corporate default rates. Indeed, while low bond yields have been a burden for savers in recent years, it has been a boon for high yield credits as many issuers refinanced high coupon debt and extended maturities.

As such, Citi analysts expect low default rates to persist. Moody's Investors Service estimates that the global default rate will be 2.3% in 2014, and 2.4% next year. Defaults are projected to remain well-below long-term norms in the US, Europe and Asia. In the US, defaults fell from 2.3% in 2013 to 1.9% in 2014, while the forecast of 2.5% for 2015 is still well-below the historical average of 4.4%. European defaults have declined from 4.4% in 2013 to 2.3% in 2014, and Moody's expects between 1.0% and2.0% in 2015.

The corporate bond default rate in Asia is currently 4.4%, but is expected to decline to 3.3% by year-end, according to Moody's. Citi analysts remain positive about Asia corporate bonds despite Chinese growth concerns, potentially higher US Treasury rates (accompanied by US dollar strength), and geopolitical risks. While these factors may heighten market and local currency volatility, Citi analysts expect stable fundamentals and attractive yields (relative to other corporate markets) to offset some of these concerns and continue to attract foreign investor flows to the region.

Rising bond yields in the US and the UK will generate a drag on performance as central bank rate hikes approach. The higher volatility that typically results from these actions is likely to produce choppier and less robust returns. As such, investors need to be more selective in these markets. Citi analysts expect European corporate bonds to generally fare better given a more favourable rate climate and positive technical backdrop. Despite lower absolute yields, ECB policy initiatives are likely to reinforce strong demand for risk assets – exacerbating the imbalance between supply and demand in private sector debt while underpinning primary markets. Indeed, the ECB measures that are currently underway should continue to depress regional bond yields and market volatility, providing key supports for further gains.

Important Information

“Citi analysts” refers to investment professionals within Citi Research (“CR”), Citi Global Markets Inc. (“CGMI”) and voting members of the Citi Global Investment Committee. Citi Research (CR) is a division of Citigroup Global Markets Inc. (the "Firm"), which does and seeks to do business with companies covered in its research reports. As a result, investors should be aware that the Firm may have a conflict of interest that could affect the objectivity of this report. Investors should consider this report as only a single factor in making their investment decision. For more information, please refer to 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 International Limited is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority. Our firm reference number with our UK regulators is 122342. 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 International Limited has its registered office at Citigroup Centre, Canada Square, Canary Wharf, London E14 5LB. Registered number 01088249. 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. Jersey Branch is a participant in the Jersey Bank Depositors Compensation Scheme. The Scheme offers protection for eligible deposits of up to £50,000. The maximum total amount of compensation is capped at £100,000,000 in any 5 year period. Full details of the Scheme and banking groups covered are available on the States of Jersey website www.gov.je/dcs, or on request. 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.