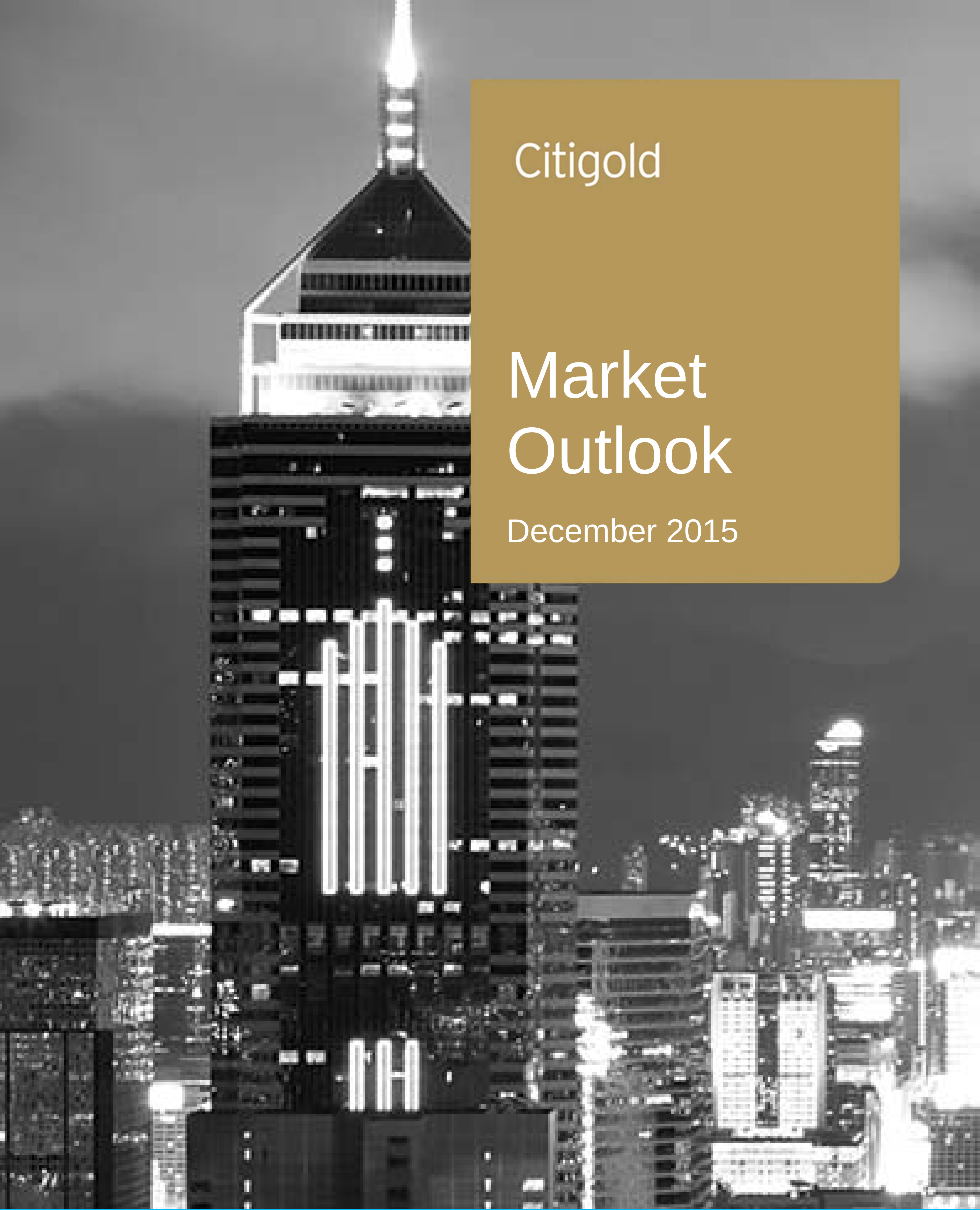

Citigold

Market Outlook

December 2015

citibank

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What does policy divergence mean for markets?

With the recent release of the FOMC meeting minutes, Citi analysts believe that the Fed's path of rate normalization may begin in December, and the second rate increase is unlikely to occur until mid-2016. The very shallow projected trajectory leaves the policy rate at 1% by end-2016, 1.5% by end-2017, and 2.25% by end-2018.

On the other hand, the ECB and BOJ seem set to ease further. We expect another round of monetary policy loosening for the last meeting of 2015 on Dec 3 for the ECB, while the BOJ is likely to announce more QE by late January 2016. For markets, this suggests a flatter yield curve in US rates, outperformance of stocks in the easing markets (Euro area & Japan), a stronger USD in FX markets and a bias for DM to outperform EM in the credit space.

Macro Overview

- **US:** First hike may occur in Dec; though trajectory expected to be shallow and second increase unlikely to occur until mid-2016.
- **Europe:** Expect a 20bp cut in the deposit rate and an extension of the purchases by at least six months to Mar17, on top of the expansion of the monthly purchases by €15bn from Jan16.
- **Japan:** Sluggish consumer spending and tepid inflation may force BoJ to ease further in Jan16.
- **Asia:** Growth remains challenging due to subdued external demand; Expect accommodative monetary bias to persist.

Equities: Overweight

- This global bull market is ageing, but not finished. We suspect that the markets have already moved to price in a mild global EPS contraction. Nevertheless, we favour Europe and Japan equities where central banks are supportive and EPS momentum are reasonable. Our strategy has a mild cyclical tilt, with Financials being the stand-out favourite across the regions.

Bonds: Underweight

- **High Yield:** Constructive on HY (ex-energy) as risk-on momentum may continue into year-end.
- **EMD:** Remain cautious in both local and US dollar denominated debt.

Commodities: Neutral

- **Gold:** More downside risk as USD continues to strengthen.
- **Oil:** Prices may rise to end-16 but not before a troubling 1H.

Currencies: USD Appreciation Cycle Continues

- **EUR:** Policy Divergence Is Back.
- **AUD, NZD & CAD:** Downside Likely.

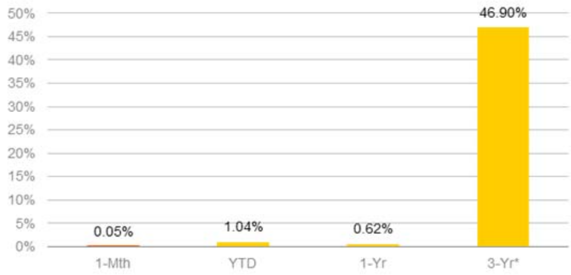
Equity Markets and Commodities

United States

First rate hike likely in December

- We project US domestic demand to rise by close to 3% YoY in the next three years. While the drag on GDP growth from the dollar's sharp appreciation since last summer would amount to roughly 0.5 percentage point per year, nevertheless, domestic final sales growth is expected to be bolstered by robust consumption growth for the next two years (close to 3% in 2016, roughly 2.5% in 2017).
- The Fed is likely to hike rates at the upcoming December meeting, barring some unexpected last-minute downside news. Questions about the near-term robustness of the US recovery stem from slowing growth abroad, the sharp rise in the dollar, and other dis-inflationary pressures from commodity and energy prices.
- From an equity perspective, Citi analysts choose to remain selective and prefer to focus on cyclical sectors such as Financials and Technology. In contrast, we are underweight Consumer Discretionary as we find that it has historically been a consistent underperformer after previous rate hikes.

Chart 1
S&P 500 Index



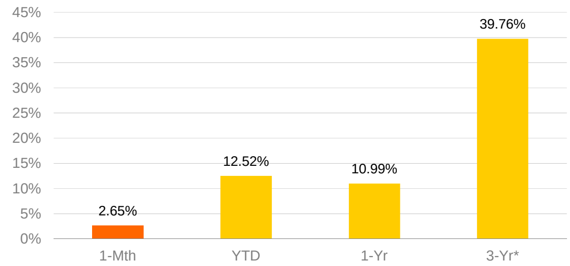
*Denotes cumulative performance
Performance data as of 30 November 2015
Source: Bloomberg

Euro - Area

ECB may extend QE in December

- The euro area remains on a fragile recovery path. But modest fiscal policy support, a weaker euro and cheaper bank funding costs paint a slightly more constructive picture, particularly in the periphery. Citi analysts have lifted their 2016 GDP forecast by 0.1% (to 1.8%) and 2017 forecasts by 0.15% (to 1.9%).
- Although inflation is rising, it remains below target, challenging the ECB's credibility. As a result, we expect the ECB to deliver further monetary policy support at the upcoming December meeting and also (either then or in 1H16) to announce extending its asset purchase programme into 2017, eventually doubling the size of QE.
- Consensus estimates suggest double-digit EPS for 2015-17E. Support for further growth comes from: 1) resilient/reasonable GDP growth, 2) weaker oil prices, 3) weaker euro, 4) improvements in Europe's financials/banks. We back growth and re-rating to drive the Stoxx to 400 at end-2015 and 440 at end-2016.

Chart 2
Dow Jones Stoxx 600 Index



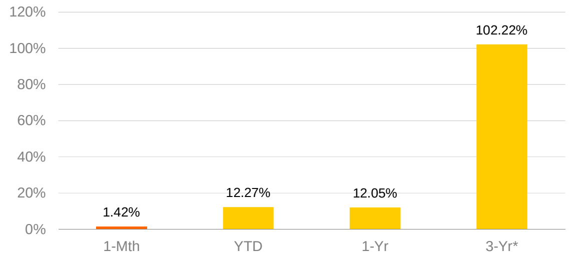
*Denotes cumulative performance
Performance data as of 30 November 2015
Source: Bloomberg

Japan

BoJ likely to ease in early 2016

- We expect sub-1% growth in 2016 and 2017. Both cyclical and structural factors may likely continue to weigh on economic activity, while the consumption tax hike slated in April 2017 probably may exert a significant downward pressure on the economy again.
- The BoJ looks likely to implement additional easing measures in early 2016 as the 2% inflation target remains difficult to achieve barring additional action.
- Though we could see EPS growth of around 6.9% in 2016, the pace of growth in earnings is likely slower than the double digit growth we saw in 2015 as there may be limited room for weaker currency and/or lower crude. Based on this, Citi analysts set their TOPIX target for mid-2016 and end-2016 at 1,750 and 1,800 respectively.

Chart 3
Topix Index



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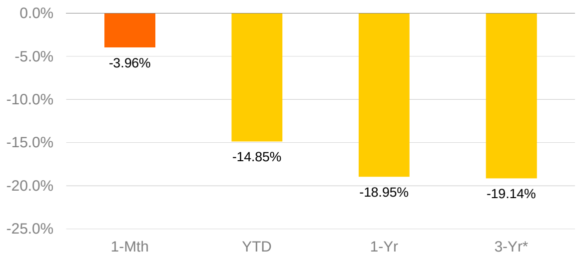
Source: Bloomberg

Emerging Markets (Asia, CEEMEA and Latam)
Asia remains the preferred region

- Growth forecasts continue to be revised lower in EM. The biggest fear globally remains China and growth sustainability. Current account deficit economies are still seeing their currencies being dragged lower. Looking at real effective exchange rates, we see more downside risk for the commodity producers. We prefer Asia vs EMEA and Lat Am.
- EPS revisions in EM remain much weaker than in DM. Within EM, anything related to commodities is seeing weaker earnings. EPS in USD terms in both EMEA and Lat AM are already below their 08 lows. This is not the case for Asia. For EM, it is easy to see 2015 earnings ending down in aggregate by 10-15% driven by FX translation and commodity hits. Even post the weak earnings out of EMEA and Lat Am we still see earnings risk there. In Asia, the risk remains to the export side and the negative impact of operating leverage.

Chart 4
MSCI Emerging Markets Index

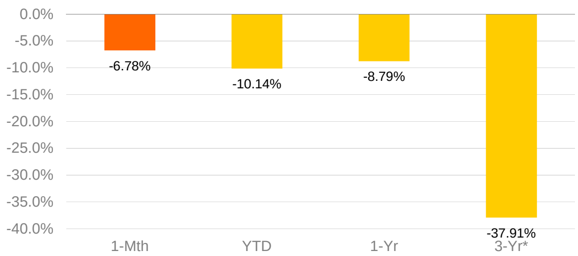


*Denotes cumulative performance
Performance data as of 30 November 2015
Source: Bloomberg

Gold
More downside risk as USD continues to strengthen

- November has been another difficult month for gold with prices falling over 9% to below $1,080/t oz.
- Going forward, dollar strength next year would be enhanced particularly if the pace of future Fed hikes surprises to the upside, given that rates markets are currently pricing in a relatively shallow path of policy normalization. Though dollar appreciation in 2016 is unlikely to match that of 2015, we continue to see downside risk for the yellow metal through next year as gold continues to trade closely with the USD.
- To be sure, the potential for further global macro volatility could keep bullion prices from completely tanking in our view, particularly given the market's seeming sensitivity to any negative headlines out of China and broader EM.
- Thus, Citi analysts believe gold prices may average $995/oz. in 2016.

Chart 5
GOLDS Commodity Index

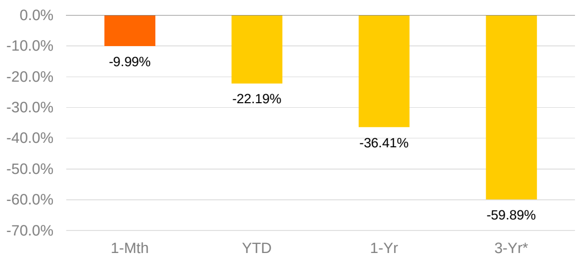


*Denotes cumulative performance
Performance data as of 30 November 2015
Source: Bloomberg

Oil
Prices may rise to end-16 but not before a troubling 1H

- The oil market is expected to return to balance, but the pressures of Iranian crude returning to market and the potential of on-land crude storage outside of the US getting full suggest that Brent may remain in the mid-to-low 40's for the first half of next year.
- Citi expects 2H16 to be materially better, with non-OPEC declines and Saudi Arabia's production expected to roughly flat-line and Iraq slowing growth from current levels.
- On the demand side, 2015 YoY growth is expected at 1.7-m b/d while 2016 oil growth is expected to drop to ~1-m b/d due to weak economic and industrial EM backdrop, continuing strength of the USD and economic struggles in commodity exporting countries
- Citi's average 2016 forecast for Brent and WTI stand at $51/bbl and WTI at $48/bbl.

Chart 6
Brent Oil



*Denotes cumulative performance
Performance data as of 30 November 2015
Source: Bloomberg

Bond Markets

High grade corporate bonds: Valuations have become attractive

US Treasuries

- Liftoff in fed funds is quite likely in December, given the continued guidance by the Fed after the October FOMC.
- We think the market may continue to price a terminal rate of below 2%, and 2 to 3 rate hikes a year for the next couple of years.
- The longer end of the curve, i.e. 10y and out could benefit from low inflation risk and subdued global growth prospects over the next few years.

High Grade Corporates

- Overall, valuations in US IG credit remain attractive and are supported by low Treasury rates and an improving US economy.
- In this environment, homebuilders could continue to benefit. Spreads in the sector remain wide versus credit benchmarks, and benefit from improving home prices.

High-Yield

- We remain constructive on high yield debt as risk-on momentum is likely to continue into year-end. Though rate volatility could build as we approach December's Fed meeting, further stimulus provided by the ECB and PBOC could keep credit markets calm and promote further spread compression.
- In the US, we continue to avoid energy credits, as oil prices are likely to remain low. In Europe, we favour retailers and food/beverage sectors, which could be supported by an improving Eurozone economy. In Asia, we prefer to take an up-in-quality approach in sectors that could benefit from further policy stimulus (i.e. real estate).

Emerging Market Debt

- Despite the renewed confidence in EM risk, fundamentals remain weak. Positive performance could continue over the near-term, but underlying concerns which existed earlier this year remain in place.
- Economic growth across most of the EM world is slowing, led by a decline in exports. The near term outlook for oil prices remain weak, and the Fed, is likely to begin tightening policy in December.
- Though policy easing in China removed some of the EM growth hangover, FX volatility may persist. We remain cautious in both external and local EM markets, and favour high quality issuers.

Euro Bonds

- We expect Bund yields to find a new equilibrium around 0.2% in the near-term, before drifting very gently higher.
- Domestic and international appetite for EGBs is unlikely to rise much in 2016, leaving the ECB the main (if not only) sizeable buyer in town. These forecasts imply a steeper yield curve.
- In terms of upside risks, we note the current downbeat expectations for commodity prices, which are partly reflected into market-based inflation expectations. Market liquidity and the introduction of risk weights are likely to be key medium-term risks for EGB markets.

Japan Bonds

- We expect Yen rates to remain decoupled from US rates and the 10Yr yield to reach 20bp due to likely extra easing by the BoJ plus the likely shift from foreign bonds to domestic bonds by domestic investors due to increased FX hedging costs.
- Further forward, we expect JGB yields to peak in 1Q 2017 if, as scheduled, the consumption tax is hiked by 2% in April 2017.

Asia Bonds

- With commodities under pressure, FX pass-through still contained, and a renewed widening in output gaps, we expect that in many instances central banks may be tipped into cutting rates further and sooner than expected.
- We expect duration in China, India, Taiwan and Korea may outperform, but we remain cautious of holding duration exposure in Indonesia, Malaysia and Philippines.

Currency

USD: Appreciation Cycle Continues

December Fed lift-off is now a high probability though in the past three policy cycles (1994, 1999, 2004), USD has appreciated in advance but given up ground in the months following the first hike. So while broader USD appreciation of some 5 – 6% is possible and would be in line with the 5-6 year norm into 2016 and only to end when medium term sentiment in other major economies turns structurally more positive, USD gains are likely to come by at a very gradual pace.

EUR: Policy Divergence Is Back

- EUR/USD is expected to weaken further reflecting the renewed likelihood of Fed and ECB monetary policy divergence with the latter likely to deliver a 10bp deposit rate cut plus around EUR 15bn extra asset purchases for the nine months to September 2016 at the December 3 meeting.

GBP: In The Middle Of Policy Divergence

- Sterling has been strengthening versus EUR but weakening versus USD and these trends are expected to continue over the medium term as the BoE is unlikely to follow the ECB with additional easing, neither is it likely to follow the Fed to hike any time soon given external headwinds from a strong pound and ongoing weakness in commodities.
- Brexit also remains a medium term downside risk for GBP and with UK short end yields not expecting MPC tightening to lift rates by 4Q16 at the earliest, that plus Brexit concerns are likely to cap GBP/USD gains for now.

JPY: Money Base Expansion = Higher

- Further upside is seen in USD/JPY over the medium term, with the key driver being the growth in the money base of Japan relative to the US with the prospect of extra BoJ QE (likely seen at the 29 January 2016 meeting) adding to the negative bias in JPY
- Concerns about China/ EM led global recession may lead some investors to consider JPY as a possible risk hedge and may see JPY retain a modestly positive risk premia but expectations of Fed tightening versus BoJ easing could prevail to lead JPY lower.

AUD, NZD & CAD: Downside Likely

- **AUD:** The RBA decided to remain on hold at its November 3rd meeting but also retained a lower inflation and growth outlook. Employment has been the one bright shining light though Citi economists do not expect that the spectacular growth in jobs seen in the October report may last. And with iron ore prices resuming their downward momentum, and Citi's commodity price forecasts still bearish from here, further deterioration in Australian exports at a time of subdued domestic demand growth implies a longer period of below trend growth, meaning that RBA support may likely come in the form of further monetary easing possibly at the February meeting. This could ensure further weakness in AUD/USD over the medium term.
- **NZD:** There has been something of a recent stabilization in domestic data in a period when dairy prices have rallied 56% since the lows in August and this makes the decision on the official cash rate in December more finely balanced (a NZD supportive). But more medium term, external vulnerabilities remain with NZ's two largest export partners slowing and the RBNZ also ultimately expected to cut rates further at least once more.
- **CAD:** Whilst current yield differentials suggest CAD may be undervalued, sensitivity to oil prices continues to keep USD/CAD elevated. With WTI prices once again collapsing this month as near term supply imbalances prevail, USD/CAD is likely to face continuing upward momentum over the medium term.

EM Asia: Can The Rally Last?

- The combination of a stronger USD and possible risk aversion in EM as Fed raises rates together with the more medium term weakness in commodity prices and a slower China willing to let its currency depreciate, means that exchange rates in EM may likely continue to depreciate.
- Meanwhile in China, CNY has been relatively stable over the past month as authorities continue to display commitment to the new managed float ahead of IMF's SDR inclusion and over the next three months, this is likely to continue. But with IMF now giving the nod, this may steadily take some pressure off to keep RMB stable and see the unit resume its weakening trend given the evolution of China's medium term growth outlook remains highly uncertain.

Important Disclosure

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