Slowing global growth prospects and sharply lower inflation expectations continue to anchor historically low benchmark rates across developed markets. This trend has been especially impressive in the United States, where 30-year UST yields dropped to a record low by the end of January. A more notable trend occurred on February 3-4, when 10-year Bund yields traded below JGBs for the first time.

Outside of the European Central Bank (ECB) purchase program announcement last month, 13 other central banks have eased policy since early January. These policies have reinforced the recent momentum in bond yields, and are unlikely to reverse course anytime soon.

Despite the deflationary impact of lower energy prices, Citi analysts see the US Federal Reserve as likely to initiate gradual rate hikes during the second half of the year given improving US prospects. But the dearth of price pressures and stubbornly low inflation expectations should keep long-dated yields lower than many investors currently expect.

Sectors	12 Months View		Investment Rationale
Dev. Market (Core) Sovereigns	**Underperform**		Divergent fundamentals to modestly boost rates in the US/UK while Eurozone and Japan remain anchored; favour European duration
EU Periphery Sovereigns*	**Outperform**		Quantitative easing expected to promote further spread compression vs. German Bunds; 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**		Fabour USD over EUR issuers given attractive valuations and inflows supported by a weaker EUR. Favour BBB-rated credits and subordinated bank bonds.
High Yield Corporates	**Outperform**		Recent selloff provides attractive entry point for new exposures. Both Eur and USD offer value; favour high-B and BB credits

**EU Periphery Sovereigns include bonds from Greece, Ireland, Italy, Portugal and Spain.*
Source: Citi analysts 09/02/15

Developed Markets Government Bonds

Slowing global growth prospects and lower inflation expectations (fuelled by the energy shock) continue to anchor historically low benchmark rates across developed markets. This trend has been more impressive in the United States, where economic data confirms a sustainable recovery remains intact; 30-year UST yields dropped to a record low by the end of January, while 10s declined to their lowest level in nearly two years.

A more notable trend (for bond history buffs, at least) occurred on February 3-4, when 10-year Bund yields traded below JGBs for the first time. That relationship has somewhat normalized (both yield 0.35% at time of publication) but remains a testament to the prevailing challenges in the Eurozone even as the ECB prepares to buy government bonds next month. The potential efficacy of the effort is debatable, especially since the entire term structure for German government yields already trade below 1.0%. Elsewhere in Europe, UK 10-year Gilt yields have drifted to record lows and Swiss rates are negative through 10-years maturities.

Not surprisingly, the same factors that have driven rates to such low levels since the beginning of the year have also triggered an impressive array of accommodative actions from concerned policymakers. Beside the ECB purchase program announcement, no fewer than 13 other central banks have eased monetary policy since early January. These policies have reinforced the recent momentum in bond yields, and are Unlikely to reverse course anytime soon.

That said, the Fed prefers to view the deflationary impact of lower energy prices as “transitory” and is still likely to initiate gradual rate hikes during the second half of the year given improving US prospects. But the dearth of price pressures and stubbornly low inflation expectations should keep long-dated yields lower than many investors currently expect. While higher real yields naturally track stronger growth, low inflation compensation and a depressed term premium could inhibit the magnitude of any substantial reversal.

Recent experience with quantitative easing in the US suggests, counter-intuitively, that government yields should begin to rise as bond purchases commence. This is because rate markets start to discount some reflationary impact due to the new stimulus. While history can be useful as a guide, Citi analysts expect any rise in long-dated yields to be much more benign in Europe given the geopolitical risks, bank regulatory constraints, and embedded structural challenges that are unique to the region.

Emerging Markets (EM) Government Bonds

Evolving political dynamics, idiosyncratic macro events, declining energy prices, and heightened currency volatility demand that EM investors become more discerning. For example, Latin American external (USD) sovereign debt has declined by 3.2% during the last few months but dispersion in performance across the region has been significant; Venezuela debt has fell by 43.8%, while Chile, Mexico and Peru have gained over 4.0%. The same trend holds true in Eastern Europe; geopolitics have hurt Russia and Ukraine (lower by 11% and 34%, respectively), lower oil prices have lifted bonds and FX in Hungary and Turkey. Citi analysts favour hard currency debt over local currency, as FX volatility is expected to persist. Though hedging can offset some associated risks, it can also substantially haircut the benefits of enhanced carry.

Asia continues to be Citi analysts’ most-favoured EM region. The decline in oil prices is having a positive economic effect on the region, which is dominated by energy importers. Moreover, the announcement of open-ended bond purchases by the ECB is likely to boost demand for higher-yielding local debt markets, like India and Indonesia. In Citi analysts’ view, Asia will continue to be the most resilient region in EM given its current account surpluses, lower levels of foreign debt service, and increasingly accommodative central banks. Citi analysts favour BBB-rated corporates and higher-yielding opportunities in hybrids. Despite the likelihood of further near term gains in Hungary and Turkey, Citi analysts remain cautious on EMEA credits. The Russia/Ukraine conflict is fragile, and regional bank deleveraging could constrain credit access to eastern European countries. In Latin America, Citi analysts continue to avoid Venezuela. However, aggressive investors with a longer view should consider selective exposures in Brazil. Though the Petrobras scandal suggests volatility is likely to remain quite high near term, aggressive recent moves by fiscal and monetary policymakers suggests that the country is less likely to jeopardize its investment grade rating.

Investment Grade Corporate Bonds

High grade corporates have benefitted from the decline in core rates and expectations for ECB quantitative easing. After rising by about 7.0% in 2014, USD credit markets have tacked on another 3.0% YTD. In Europe, corporates have generated nearly 9.0% total returns since the beginning of 2014. The sharp drop in risk-free rates is largely responsible for these outsized gains. Indeed, stripping away the benefits of the US Treasury rally, duration-adjusted total returns for USD corporate bonds was actually negative last year (-0.45%); these adjusted returns for European credit would be a meagre 1.5%. In Citi analysts' view, the direction of risk-free rates will continue to have a significant impact on prospective returns this year. That said, high quality corporates could be able to post positive returns for the remainder of the year. Modest gains should be underpinned by the ECB bond purchase programme, to begin in March, and only a small rise in government rates. Citi analysts favour USD credit over Euro issuers given attractive valuations and inflows supported by a weaker euro. Citi analysts favour BBB-rated credits and subordinated bank bonds.

High-Yield (HY) Corporate Bonds

During the last four months of 2014, the fall in oil prices and concerns about global growth wiped out c.460bp from USD HY. This was largely due to the correction in the energy sector (roughly 17%of the US HY index), which declined by 13.8% between September and December of last year. Euro HY also weakened, but was relatively insulated due to the absence of energy issuers and expectations for ECB quantitative easing. Euro HY has risen by 1.34% YTD (compared to 1.19% for US HY). Ex-energy, the HY market retains the same beneficial characteristics that supported Citi analysts' conviction last year. That is, fundamentals have not materially weakened, debt maturities have been extended, default rates should remain low (yes, even in energy), and the appetite for higher yields has not waned. Citi analysts favour relative value among higher-quality B or BB credits.

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