Standpoint

Q3 | 2015

Global Market Analysis by Citi EMEA Consumer Bank

Casting a Critical Eye on "Bondification"

After 7 years of deleveraging, public austerity programs, significant cost reduction policies in the private sectors, Central Banks' quantitative easing policies, low economic growth, low inflation and the ongoing strategy by investors of flight to quality, the lines that define the features of traditional risky and non-risky asset classes have become increasingly blurred and the frontier that separated equities from bonds increasingly porous.

"Changes in the correlations of the broad asset classes, the search for yield and interest rate volatility have shaken the foundation of traditional investment strategies"

Indeed, since the onset of the Global Financial Crisis in 2008, 3 major developments have driven investors and asset managers to re-think their investment strategies. The first development began in the early days of the crisis and is the broad trend of positive correlation of asset classes; asset classes prices tended to move in the same direction. Although rare in history, it is not surprising that a world characterized by deleveraging and low inflation, quantitative easing is a tidal wave driving all boats, risky and non-risky, in the same direction. Another development occurred 3 years ago when government bond yields fell below equity dividend yields for the first time in half a century across Developed Markets. Equities became an increasingly appealing alternative source of yield for income-seeking investors, in response to falling bond yields and narrowing spreads. The final development was reminders that Treasury yields dangerously close to zero can actually be volatile as demonstrated

Citi Outlook

A snapshot of Citi's global market views across a select group of asset classes, regions and currencies over the next three to six months.

The Market Outlook reflects Citi analysts' assessment of each asset class independently.

The Global Investment Committee ('GIC') made no changes to recommended portfolio weightings at its latest asset allocation meeting. The Committee decided to maintain its existing overall equity/bond asset allocation. The allocation remains overweight risk assets and underweight interest rate risk. The GIC maintains overweight in equities, with overweights in US, Japan, Asia ex-Japan and Europe. This is offset with an underweight in fixed income, concentrated in a heavy underweight in developed sovereign bonds. Within its fixed income portfolio, the GIC has small overweight position in high-yield while positions in emerging market debt are underweight and investment grade corporate bonds are neutral.

The committee noted that the global backdrop of both continued growth and substantial additional easing provides context to the current markets instability. Beyond near term Grexit uncertainties, Quantitative easing in the Eurozone has catalyzed a financial market recovery that could mirror Japan's of recent years. The "bigger picture" for the Fed is that the central bank is almost certain to tighten very modestly.

Global equities	
Market	**Outlook**
	Positive
US	Positive
Europe	Positive
Japan	Positive
Latin America	Negative
Asia Pacific	Positive
Emerging Europe	Neutral

Global fixed income	
Market	**Outlook**
	Negative
Global Government	Negative
Global IG Corporate	Neutral
Developed High Yield	Positive
Emerging Market Debts	Negative

Global currencies	
Currency	**Outlook**
Euro	Negative
Yen	Neutral
British Pound	Neutral

Data Source: Citigroup Global Markets Inc. Weighting provided by Citi EMEA Consumer Bank as of July 2015.

by the yield shock of April 2013 and the bond selloff of the first half of this year. In other words, at current yield levels, the traditional risk-free asset class appears actually increasingly like a return-free risky asset class.

In a context where bond income is so low and interest-rate risk increasing, pragmatic investors don't hesitate to chase returns by taking on more risk to gain income. The most popular of these return chasing strategies today is called "bondification".

Bondification is the term used to describe a low-volatility strategy in equities for the objective of generating a smoother return trend whilst producing a relatively higher income than that received from a bond. This is achieved by investing in stocks with stronger dividend growth, lower debt ratio, stronger pricing power, stronger free cash flows and a higher return on equity.

"Bondification has provided a pragmatic answer in the current context of global markets, but its resilience capacity to waves of risk aversion is dubious"

Although bondification is only at an early stage, Citi analysts think this is going to remain an important investment trend in the future with interest rates at historic lows and nearly 70 percent of the world's investable assets being held by retirees or near-retirees, whose main investment goal resides in generating income. To these investors, the promises of traditional models of asset allocation decisions could appear insufficient.

However, beyond the appealing relative income advantages, bondification also has obvious weaknesses which investors should be aware of. The first one is related to the type of stocks fitting the strategy. In order to reduce volatility and preserve income, bondification strategies tend to tilt investors toward sectors such as Real Estate, Telecommunications and Utilities. Whilst these are good in terms of income, they are also very sensitive to interest rates movements, which means they are not only likely to underperform bonds in a period of rising yields, as observed during the yield shocks of April 2013 and 1H 2015, but also cyclical equities, which are positively correlated to interest-rate rises.

"Excessive exposure to interest rate sensitive non-cyclical equities could generate underperformance during a monetary hiking cycle, without granting the safe-haven label Treasuries have"

This being said, the bondifiaction trend raises two very valid questions for portfolio managers: What's the added value of diversification when correlations are so high; and is there anything like risk-free today?

One key feature of the traditional asset allocation model is to compare asset returns to the risk-free rate. This rate is derived from the yield on long-term government bonds, but nobody would regard bonds at their current valuations as "risk-free". These models were developed in the early 1950's, when US 10-years yields were around 2.5% -not much higher than today. Interestingly, during the 30 years that followed, Treasury yields continued higher to reach 15% in the early 80's – not a solid basis to consider government bonds more "risk-free" than today.

In a more highly-correlated and low-yield investment world, chasing returns rather than diversifying may be a sign that practicality reigns among investors, but the lack of concern for the bigger picture is surprising. Indeed, higher correlation is a consequence of quantitative easing policies, and the end of these policies will modify the dynamic of financial markets.

Investors keeping a disciplined eye on the bigger picture should be wary of the consequences of "Bondification" strategies. Constructing a portfolio is about selecting asset classes that can balance the risks of each other; volatility associated with equities and interest rates for bonds, and allocating resources to get an adequate exposure to long-term growth and protection against short term shocks. In that regards, thinking that equities or unconstrained bond strategies can serve as safe-haven surrogates may deliver unpleasant surprises.

Europe and North America

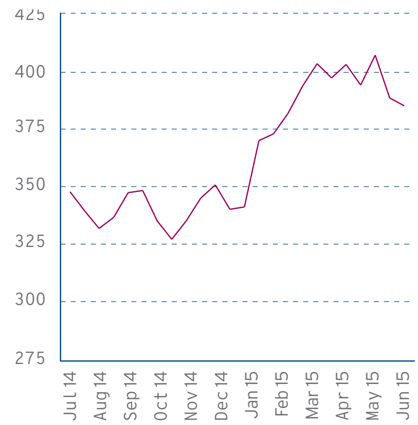
Europe equities

Recovery Resilient to Near Term Risks

Citi analysts see the balance of risks as now more neutral, in their view, in light of the recent rise in government bond yields and the euro. Although inflation is rebounding, they see no real risk that the European Central Bank (ECB) will taper asset purchases before Sep-2016. Finally, the situation in Greece remains a concern, Citi analysts continue to believe the negative spill-overs of potential Greece related risks will be contained in the context of greater ECB flexibility, firmer economic recovery and marginal banking exposure.

Over in the UK, the economy's underlying momentum remains solid, as evident in a range of business and consumer surveys. That said Citi analysts expect that CPI inflation will stay well below the 2.0% target next year. Against this backdrop, the Bank of England is likely to remain in no rush to hike rates, and Citi analysts pencil in the first hike for 1Q16 – but with solid economic growth eventually leading the central bank to hike more than markets price in.

Stronger macro and a weaker euro are helping to drive net Earnings Per Share upgrades in Europe. Citi analysts' bullish stance on Euro Area equities is based on a market that "doubles up", i.e. growth plus re-rating. They favour companies with strong balance sheets and surplus free cash flows, with a preference towards financials sector. Likewise in UK, Citi analysts' positive view is based on either a modest re-rating or 10% dividend growth in 2015. While commodity downgrades remain the key drag, GBP weakness could provide support for dollar earners.



DJ Stoxx 600

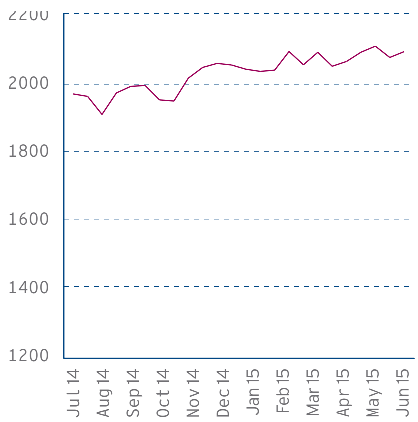
Data source: Bloomberg as of 30 June 2015

North America equities

Economic Growth Re-accelerates

Temporary influences such as the harsh winter weather have led Citi analysts to lower their projected annual growth for 2015 to 2.5%. However, they continue to expect a rebound later this year. Indeed, economic fundamentals have not changed materially. Job gains average roughly 250K per month, generating labour-based income gains of approximately 4% Year-on-Year. Moreover, they continue to expect a boost to consumption growth from lower gasoline prices, especially with the approach of the summer driving season. Although the rebound from weather effects and lower gasoline prices could dissipate later this year and in 2016, the drag from the strong dollar remains a downside risk to Citi analysts' outlook. Fed Chair Yellen has affirmed that rate normalization will begin once incoming data raises the Fed's confidence that inflation will approach the 2% target in the "medium term." Citi analysts believe that the likely flow of incoming data about the outlook for inflation and growth may not support such increased confidence until around year-end.

Citi analysts' positive view on the US stock market relies on a performance expectation that may mostly matches earnings growth, especially once the Fed begins to lift rates. Equities typically climb for many months after the first hike, not to mention the third year of a presidential cycle is typically strong for equities. Indeed, Citi analysts' 2015 Earnings-Per-Share (EPS) estimate encompasses 3% expected GDP growth which would normally correspond to a 13% EPS boost. Citi analysts are estimating less than half that (albeit above consensus of 2%). In terms of strategy, large caps and value are likely to lead in 2015 with Financials and Technology being the favoured sectors. Indeed, balance sheets remain strong and capital expenditure is expected to grow double digits in the IT sector.



S&P 500 Index

Data source: Bloomberg as of 30 June 2015

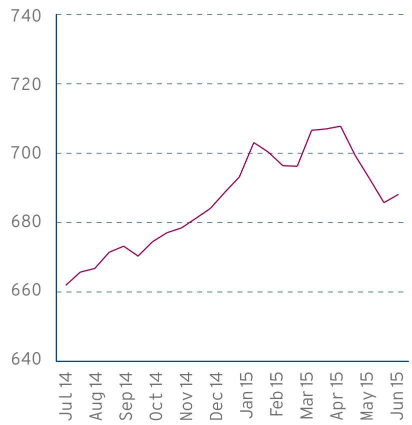
Global Sovereign and Corporate Bonds

Global Sovereign Bonds

Inflation Expectations to be Trimmed Down

Headline GDP growth expectations were unchanged in May (2.7% globally) but the trend has been a series of downgrades thus far in the year. US growth disappointed in Q1 and forward prospects look modest in spite of an expected Q2 rebound, and Euro Area growth is also expected to be low despite strong stimulus. As such, Citi analysts continue to expect persistent low-inflation for developed markets. In emerging markets, growth prospects have weakened in key sectors with Russia and potentially Brazil in a contractionary state, China managing its deceleration to a lower-growth trajectory with its associated risks and only India in a position to surprise to the upside, though valuations there appear rich and oil prices have crept higher in the interim.

Citi analysts also note that the correction in global bond yields has been a function of higher inflation expectations, however there is little evidence of imminent inflation given below-potential global growth, low likelihood that ECB's Asset Purchase Plan (APP) and China's stimulus sustainably raise inflation and potential downside to energy prices in 3Q. Against this backdrop, US rate expectations have moved lower in the last five months with expectations of a Fed hike pushed back to year-end with potential for further delay should downside risk to growth forecasts and/or an intensification of external deflationary pressures materialize. Citi analysts expect the intermediate part of the Treasury curve to perform well with the market potentially pricing in an even slower pace of normalization of fed funds.



Citigroup World Government Bond Index

Data source: Bloomberg as of 30 June 2015

Inflation pressures are still subdued, and uncertainty around Greece is additionally supportive for Treasuries.

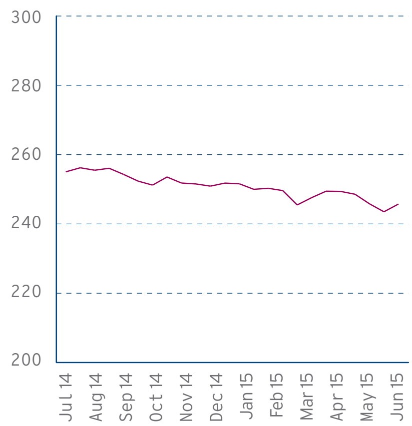
Corporate Bonds

High Yield Spreads More Attractive

Euro Investment Grade spreads have now given up all their pre-APP gains on the back of Greek uncertainty and Bund volatility. So far, ECB APP has clearly not created the squeeze in rates, and associated trickledown into credit Citi analysts had expected. In their view the following factors carry merit: stretched positioning, unfavourable risk/reward trade off and a change in the global outlook has to be acknowledged. A final consideration is whether the squeeze has just not started yet. But the interesting debate is obviously whether they are temporary or permanent factors, discussed in whatever happened to the ECB APP squeeze on Euro fixed income?

Turning to the US, it would seem that relentless supply, low yields, poor liquidity, and the prospect of a Fed hike have weighed on the performance of Investment Grade (IG) credit this year among other factors. And relative to high yield, IG credit looks to be completely out of its league in 2015. High yield's(HY) outperformance versus IG is even more remarkable when viewed in the context of what is and isn't driving it. For one, investors haven't had to dip down the ratings spectrum much at all to produce returns.

Citi analysts think the case for lightening up on HY in favour of IG broadly boils down to one's belief in mean-reversion and more specifically the likelihood of IG supply slowing or HY supply picking up. However, as the pressure on IG isn't likely to change in the near term, there may be some scope for HY spreads to squeeze tighter versus IG or for the relationship



Citigroup World Corporate Bond Index

Data source: Bloomberg as of 30 June 2015

to tread water at current levels rather than correct, in Citi analysts' opinion.

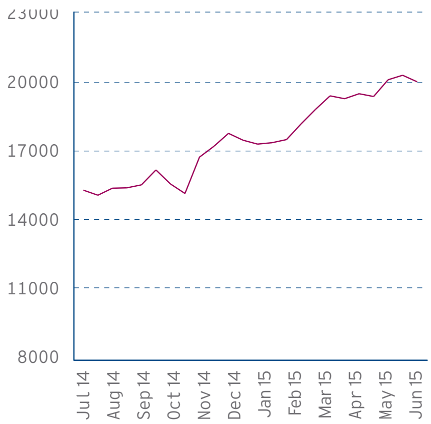
Japan and Asia Pacific

Japan equities

Supportive Earnings Growth

Citi analysts expect the economy may stutter over coming quarters, with 2015 GDP growth forecast anticipated at 0.6%. Most importantly, consumer spending could recover with solid growth in employment, a modest rise in per-capita wages and sharply lower energy prices expected to lift real total employment income. However, Citi analysts are sticking to their view that the Bank of Japan (BoJ) may act again later this year, with a gap between the BoJ's bullish inflation projections and the reality expected to become undeniably evident in the months to come. As for the concrete easing measures, Citi analysts anticipate more of the same: increased purchases of Japan Government Bonds and Exchange Traded Funds.

That said, in the absence of further Quantitative Easing, Citi analysts believe Japanese equities may continue to outperform without needing to rely on Yen weakness thanks to 1) support for Japanese equities from an inflow of public money (supply/demand factor), 2) an increased emphasis on Return on Equity by corporate management (micro-level factor), and 3) the achievement of full employment (macrolevel factor). As such, Citi analysts maintain their positive view on Japanese equities. In terms of sector strategy, they overweight basic materials and IT, which may benefit from the tailwind of a turn for the better in domestic and overseas economies.



NIKKEI 225 Index

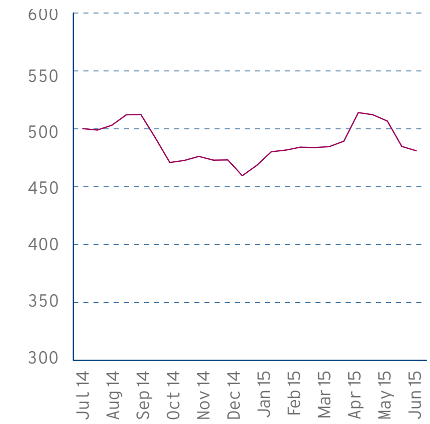
Data source: Bloomberg as of 30 June 2015

Asia Pacific equities

Strong Earnings Not Reflected in Share Prices

The fundamental story in the region is anything but reflationary, with disappointing economic activity for most countries, especially on trade. Citi analysts expect the region to grow 6.2% in 2015, down marginally from 6.4% in 2014. They think the rebound in oil prices is not a material threat to inflation and central banks are likely to be on the neutral to dovish side – India and Indonesia may cut rates, Korea and Thailand are at risk of further easing. While Fed rate hikes could lead to some capital flow volatility, Citi analysts believe that unlike in other Emerging markets (EM), predominant current account surpluses may likely act as important buffers in Asia. In contrast, those with poor current account dynamics and slowing exports may continue to face headwinds going forward.

Although sentiment levels in Asia remain weak, Citi analysts reiterate their overweight position in Asia over Emerging Europe and Latin America. They believe Asia is not in a bubble, but a bull market right now as valuations would have to double before it can be called a bubble. Indeed, Asia is the only region within EM that continues to trade below its long term median. At the same time, earnings in Asia are actually 26% above their pre Global Financial Crisis peak and have outperformed those of the US. With regards to China, Citi analysts consider the June sell-off as a buying opportunity and continue to prefer MSCI China exposure over CSI300 given the performance and valuation discount of H-shares to A-shares.



MSCI Asia Pacific Ex-Japan

Data source: Bloomberg as of 30 June 2015

Overall, within the region, they are overweight on China, Hong Kong, Taiwan and Singapore. Financials, Consumer Disc., Utilities and Technology are the preferred sectors.

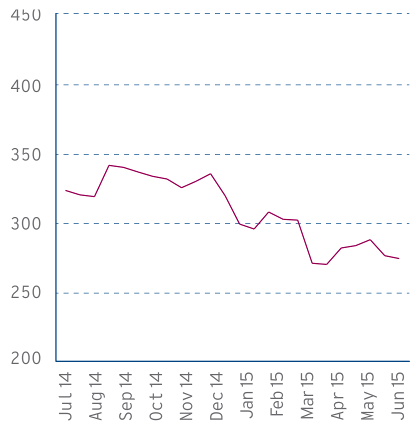
Emerging Europe and Latin America

Emerging Europe equities

Wide Disparities Across the Region

The rise in oil prices is causing the market to reassess inflation risks throughout Emerging Europe, and therefore the outlook for monetary policy. In Central Europe, higher oil prices add to inflationary pressures that are already mounting due to strong growth and disappearing output gaps. Yet it is South Africa where interest rate expectations have risen the most, owing to the additional risks created by electricity shortages and wage pressures. In contrast, Russia is basking in this environment: higher oil prices help strengthen the rouble, push inflation down, and therefore create space for further rate cuts. Within the region, Citi analysts believe that Turkey and South Africa are unlikely to grow at anything near their potential in 2015. For Russia, the 3% contraction this year represents the fifth consecutive year of slowing GDP growth. Poland continues to show good growth momentum, in part thanks to the improved outlook being seen in Germany (key trading partner). Earnings growth from Emerging Europe is expected to be less than 3%, a significant lag to the wider EM universe where 10% is expected. Russia sits as the key drag, with a 9% contraction, whilst South Africa's earnings, although expected to grow, sit at a far lower level than we have usually seen. Furthermore, the first US rate hike, combined with a US$ recovery, can be expected to put pressure on South African and Turkish assets.

As such, Citi analysts are overweight Poland, neutral on Russia and Turkey and underweight on South Africa. Given these challenges, Citi analysts recommend selectiveness and believe quality companies that have stable earnings streams, strong ROEs, and high/stable margins may outperform.



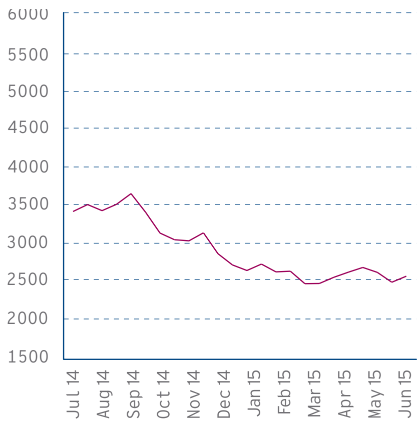
MSCI EM EMEA

Data source: Bloomberg as of 30 June 2015

Latin America equities

Many Headwinds Remain

Citi analysts believe that countries with poor current account dynamics and slowing exports may continue to face headwinds. While the Brazilian Real has strengthened during recent weeks, Citi analysts still expect additional depreciation ahead and look for real GDP to drop 1% this year in Brazil on the back of high interest rates and slow credit growth, plus inevitable fiscal contraction. Meanwhile in Mexico, they still anticipate GDP growth to accelerate but at a slower rate (2.8%) and foresee the central bank to hike interest rates by 25 bps in December. Finally the situation remains challenging in Argentina and Venezuela as the authorities have been extensively relying on external financing to prevent reserves from dropping. Both countries will hold important elections later this year. While Asia and Emerging Europe have a positive free cash flow margin, Latin America does not. In the absence of a rebound in commodities, falling capital expenditure is likely the way forward. At the same time, LatAm also has the lowest Return on equity (ROE) in EM, running at 5.6% -close to the lows seen during the mid 1990's. The good news is given aggregate earnings are already lower than during the Global Financial Crisis, base effects are more favourable going forward. Within the region, Mexico generally stacks up better with ROE still standing at 10.4%, but that is mirrored in valuations. Thus, Citi analysts are neutral on Mexico and underweight Brazilian equities which after the recent rally are approaching a 12-month-forward P/E of 14.0X, far above the historical average of 10.8.



MSCI EM Latin America

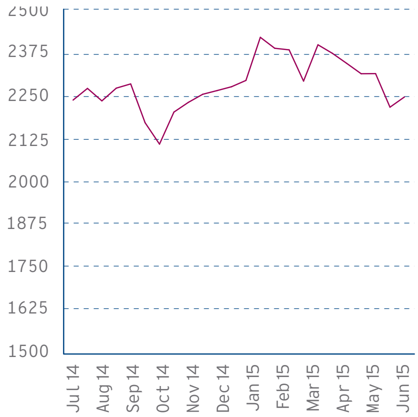
Data source: Bloomberg as of 30 June 2015

Global REITs and Commodities

Real Estate Investment Trusts (REITs)

Rising Yields and Equity Issuance Dampen Returns

REIT stocks are down 15% since peaking in late January. Over the course of the slide, Citi analysts have travelled around the world and spoken with many investors, owners, brokers and market professionals. On one hand, anyone who has direct property exposure talks about solid operating fundamentals, increasing values and an abundance of capital chasing assets. On the other, those involved with public securities talk about weak funds flow to the space. Indeed, flows to dedicated REIT mutual funds and ETFs have been quite weak over the last few months. In fact, US Mutual Fund flows have now been negative 11 of the past 12 weeks while ETFs have been negative 9 of the past 12. While flows from Japanese registered dedicated real estate mutual funds has been a constant positive this year, the flows this past week were flat. At the same time we have had $13bn of REIT equity issuances year to date. While there are some headwinds with weak funds flow and continued equity raises by REITs, Citi analysts are encouraged by the recent uptick in conversations they are having. It feels similar to late 2013 after REITs had come off considerably from their May pre-taper tantrum highs. Whether this interest turns into buying is still tough to tell. But at a minimum it is occurring – and the volume of it is increasing. Outside of equity investors, there is also continued interest from private capital sources who recognize the disconnect between public and private market values. Outside of dedicated REIT products, most generalist investors have had a limited desire to invest in public REIT shares given a belief that REIT stocks will continue to fall alongside rising interest rates.



EPRA/NAREIT Global Index

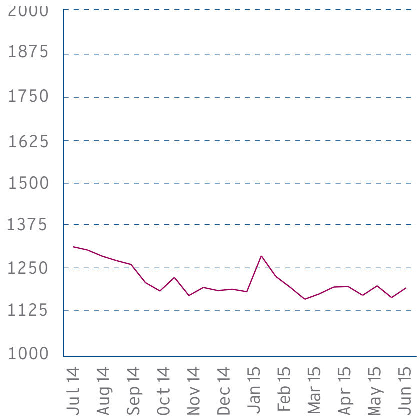
Data source: Bloomberg as of 30 June 2015

Commodities

Supply/Demand Imbalances keep Prices Under Pressure

In oil markets, despite the market clearly still in a state of oversupply, with the physical Brent market looking particularly weak, the seasonal up-turn in crude demand, which is already underway in the US and Asia, along with the continued support of financial investor flows is expected to dominate price action and likely lead prices higher into 3Q15. Demand has surprised a little bit to the upside and US crude production is likely to start slowing down and potentially turn negative following a 58% drop in the oil rig count since its October peak. Yet with US crude futures trading around $60-65/bbl for the end of the year, Citi analysts expect US companies to start hedging more aggressively and the US oil rig count to start increasing in 2H15. Combined with a likely deep refinery maintenance season, a huge volume of crude in storage, another bout of weakness is expected later in the year.

With regards to gold, the US dollar remains at trailing-10Y highs but ultimately range-bound off its YTD peaks. Going forward, Citi analysts expect a more tempered outlook for USD strength. However, they do not expect a sustained uptrend in gold over the short-to-medium term on the back of a continued US recovery, as they expect the current inverse USD/Gold relationship to remain a key market driver in the second-half of 2015. Citi maintains a neutral short-term outlook for gold.



Golds US$/troy oz.

Data source: Bloomberg as of 30 June 2015

Currencies

Euro

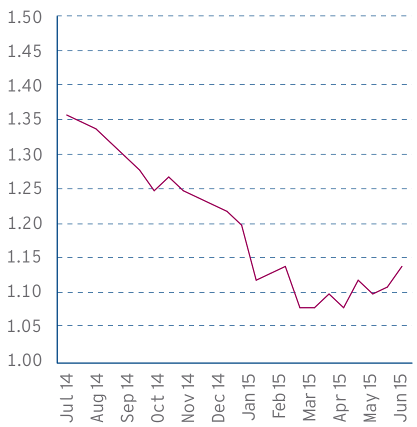
EUR has been the prime beneficiary of the USD correction even as the European Central Bank commenced its massive Quantitative Easing (QE) program in January to expand money supply and help weaken EUR. This is likely due to a number of factors including positioning in the speculative community that was massively short EUR in anticipation of the ECB announcement on QE and has started to unwind as the QE program is now old news. Second, even as US data has slowed in Q1, euro zone data has improved over the same period and notably. Against a backdrop of better euro zone data and likely near term inflation upside which has seen a sharp spike up in euro zone bond yields, the resulting narrowing in interest rate differentials with the US has seen EUR squeezing up. However, this is likely temporary and Citi analysts believe we have probably already seen the highs in EURUSD earlier in May as a weak EUR remains an important intermediate policy objective of the ECB in using QE to stabilize inflation in the Euro Area.

Yen

USD/JPY continued to consolidate in a broad 116-122 sideways range since November, experiencing a trend of higher lows. Whilst USD/JPY is expected to break higher from this range eventually, this is not likely before fundamental drivers re-appear on either the US or Japanese front. And with both the BoJ and Fed seen unlikely to provide such impetus soon (with clear signs emerging from BoJ Governor Kuroda that he is not prepared to ease policy further in the near term given his confidence that Japan will attain its long run CPI goal of 2% by next year), expectations are for further consolidation over the next 3 months or so. But there are risks to this view as Citi's analysts still expect another downward revision in the mid-term review in July. And with the gap between the BoJ's still upbeat inflation projections and reality to become undeniably evident in the months ahead, further easing cannot be ruled out as early as July despite Kuroda's assurances to the contrary. Such an outcome may well then see USDJPY breaking higher from the current range sooner.

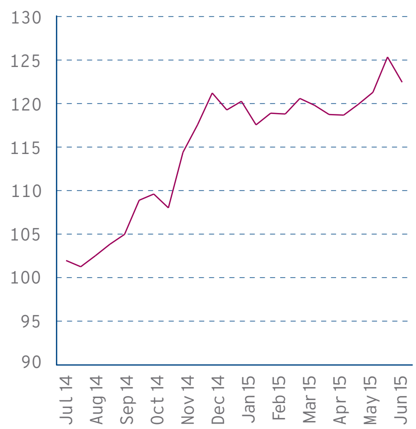
Pound Sterling

Near term, Sterling surged to its highest level in seven months against the dollar in June and reached a 6 1/2-year high versus a basket of its major peers, breaking out of the range it was stuck in for the past months and beating more traditional havens such as the dollar, yen and Swiss franc as Europe's standoff with Greece worsened and traders rolled exposure to the Greek woes against an exposure to fresh signs of Britain's economic strength. Going forward, GBP appears to be in the G10 currencies most resilient to a re-emergence of USD strength later this year. A decisive UK election result combined with a strong economy that sees the UK jobless rate falling rapidly and average earnings growth picking up, may well lead to the Bank of England bringing forward its tightening to later this year compared to money markets that continue to price rate lift-off sometime in the next 12 to 18 months and may likely lead to stronger support for sterling across the board including USD later in the year.



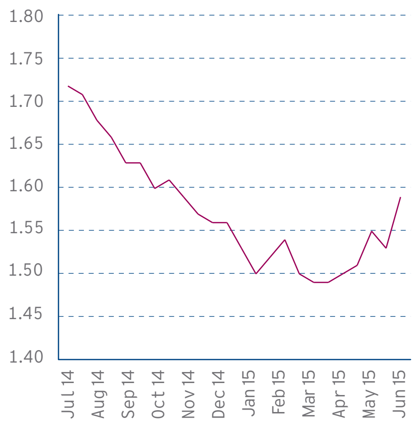
Euro-Dollar (USD/EUR)

Data source: Bloomberg as of 30 June 2015



Dollar-Yen (JPY/USD)

Data source: Bloomberg as of 30 June 2015



Pound-Dollar (USD/GBP)

Data source: Bloomberg as of 30 June 2015

Guest Corner

Frontier Markets: Questions from the road

By Andrew Howell, Citi Frontier Markets Equity Strategist

Question 1: "Higher global interest rates are bad for frontier markets…right?"
In our view, wrong, actually. It sounds logical; as the US starts to raise interest rates at some point later this year, and as global bond yields rise, frontier markets should suffer as liquidity drains out and chases higher returns elsewhere. And indeed a number of FM currencies have come under pressure in recent months: Ukraine foremost, but also Mauritius, Nigeria, Kenya as well as the Euro-linked currencies. Many investors we speak with worry that, as yields rise further, more FX losses are ahead.

In fact, the observed relationship is just the opposite. For the past 15 years, higher bond yields have consistently been associated with outperformance from frontier markets, just as lower yields have seen FM underperform. In fact, nearly all of frontier – including those with current account deficits and floating exchange rates – tend to do well when bond yields rise. And indeed, thus was the case during the so-called "taper tantrum" of 2013, when frontier markets outperformed EM.

Why might this be the case? We think the answer is a simple one. Gradual tightening corresponds with better global growth conditions, which are good for FM economies and risk appetite towards them. Paradoxically, by the time US tightening truly gets underway, dollar strengthening may nearly have nearly run its course as the rest of the world finally starts to play catch-up.

Of course, sharply higher US bond yields would likely be a bad thing for all risk assets, EM and FM alike. But we think the most likely scenario is one of gradual tightening, which FM should be able to "digest" reasonably well.

Q 2. "Your charts say that frontier markets are looking cheap. Really? It does not feel that way to me."
Yes, really. The frontier markets trailing Price/Earnings and Price/Book ratios have diverged from both EM and DM over the past couple of years due to a combination of underperformance and better earnings growth. The frontier PE is now on the biggest discount to either index in several years.

Some tell us they do not like our use of trailing rather than forward PE multiples (we use the more trustworthy trailing series, due to a lack of reliable estimates for many frontier stocks). However if we examine valuations of "comparable" FM/EM stock pairs, we also find evidence of a de-rating, although the degree is not always as extreme. To give a flavor of this, we looked at 4 FM/EM pairs from different sectors: banks; telecoms; energy; and. In all cases, we find that since early 2013 the PE discount has widened (or, in the case of oil and staples, gone from a premium to a discount).

For sure, banks have played an important role in this frontier markets cheapening: they are, of course, the largest sector in frontier markets and one that has clearly been under pressure in places like Nigeria. But FM's de-rating is much broader than just banks, and all the 4 largest FM sectors have cheapened up in relative terms.

Perhaps the best explanation for frontier markets not "feeling" cheaper than they look in these charts, is that the past year has been a story of the re-rating of the rest of the world – especially developed markets, which have gone from 14x to 20x trailing PE – as much as the de-rating of frontier. The fact is that global markets have been getting more expensive fast; the frontier markets have largely missed out on this move.

Q 3: "OK, so maybe frontier markets are getting relatively cheaper. But isn't earnings growth slower than in EM?"
Actually, it is faster. Which is what we would hope for, since better growth is the reason we brave the headaches, the volatility and the lower liquidity of these markets in the first place. We have good news for you: frontier markets have indeed delivered better EPS growth in recent years, although it has been a less overwhelming victory than we might like, as well as an inconsistent one. EBIT growth in FM has beaten EM in 3 of the past 5 years, with the best outperformance coming in 2012 and the worst in 2009. The outperformers were financials, materials, consumer discretionary and energy, while telecoms and health care lagged their EM peers.

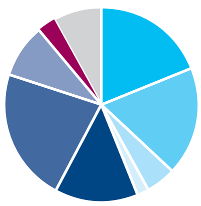
The suggested allocations are intended to be general in nature and are not to be construed as specific investment advice. Investors are encouraged to consult with their Financial Professional to determine their allocation needs based on their risk tolerance, suitability and goals.

Spotlight on allocations

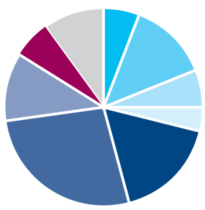
Global model portfolios

- Cash **20%**
- Developed IG Government Bonds **45%**
- Global IG Corporate Bonds **20%**
- Global Equities **15%**

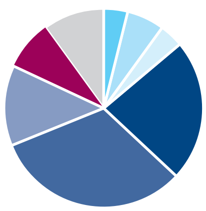
- Developed IG Government Bonds **34%**
- Global IG Corporate Bonds **25%**
- High Yield Bonds **6%**
- European Equities **7%**
- US Equities **11%**
- Global Equities **12%**
- Global REITs **5%**



- Developed IG Government Bonds **19%**
- Global IG Corporate Bonds **18%**
- High Yield Bonds **5%**
- Emerging Market Debt **2%**
- European Equities **14%**
- US Equities **22%**
- Pacific Equities **9%**
- Emerging Markets Equities **3%**
- Global REITs **8%**



- Developed IG Government Bonds **6%**
- Global IG Corporate Bonds **13%**
- High Yield Bonds **6%**
- Emerging Market Debt **4%**
- European Equities **17%**
- US Equities **27%**
- Pacific Equities **11%**
- Emerging Markets Equities **6%**
- Global REITs **10%**



- Global IG Corporate Bonds **4%**
- High Yield Bonds **6%**
- Emerging Market Debt **4%**
- European Equities **23%**
- US Equities **32%**
- Pacific Equities **13%**
- Emerging Markets Equities **8%**
- Global REITs **10%**

About the Citi Asset Allocation Process

The Citibank tactical portfolio allocations are based on the work of the Global Investment Committee (GIC) of Citi Private Bank. The membership of the committee is comprised of experienced investment specialists from across Citi. The GIC deliberates on the macroeconomic and financial market environment in order to formulate an outlook across multiple asset classes and is responsible for maintaining tactical model portfolios based on this outlook. The tactical weights that are applied to the Citibank portfolios are aligned to the decisions of the GIC.

Allocation to bond and equity markets

The Global Investment Committee (GIC) has decided to maintain positions across asset classes with an overall Overweight stance in Global equities.

Overall the GIC now stays overweight on equities, neutral on commodities and underweight on fixed income.

The GIC believes that medium term outlook for equities remains favourable though short term risks have increased markedly on the back of falling oil prices, Grexit risks and sell-off in China. Overall, equities continue to offer better risk/reward than credit this year while both returns are likely to be below last year's gains as the attractiveness of valuations has somewhat deteriorated.

Allocation to regional equity markets

The GIC maintained its overweight in US, Europe and Japan and Asia ex-Japan. Emerging Market equities continue to be underweight.

Within the equity universe, the GIC has the largest overweight positions to US equities with a brightening outlook given signs of growing corporate capital expenditure combined with improving housing and job markets feed through into economic growth although the Fed's taper process could generate periods of volatility. Exposure to Asian equities has been maintained on the basis of valuation not reflecting the strong earnings growth momentum in the region.

And the GIC believes that Japan may resume grinding higher even though at a slower pace supported by new political leadership taking a more aggressive stance on fiscal and monetary policy. Also the GIC maintains its position in Europe equities given still attractive valuations and improving monetary support from the ECB. Meanwhile the GIC is now Neutral on Emerging Europe and Underweight Latin America equities with selectiveness suggested with regards to country allocation.

Allocation to government and credit markets

The GIC is heavily underweight sovereign bonds, with US Treasuries bearing the brunt of the underweight, and Emerging Market debt on the back of increasing yields and currency risks. They have small overweight position in High yield bonds. Investment grade allocation of the GIC are now neutral on the basis of narrower spreads capping the scope for gains in a period of rising yields.

Forecasts may not be attained. Past performance is no guarantee of future results. There are additional risks associated with foreign investments.

GRA26045 07/15