International Personal Bank

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FIXED INCOME
STRATEGY REPORT

Citi analysts expect interest rates to grind higher - during the second half of the year as the macro backdrop improves and inflation firms. That said, the magnitude of the shift is likely to be modest, in their view. There is limited scope for steepening at the long end of the curve, and volatility is likely to remain fairly subdued.

Citi analysts remain constructive about high yield corporate debt - despite historically low absolute yields and narrow post-crisis spreads. US and European markets have both generated gains of about 5.4% year-to-date, outperforming most fixed income sectors.

Citi analysts remain concerned - that the rally in emerging market (EM) debt has not been driven by any broad-based improvements in fundamentals. Local market valuations have grown more attractive compared to external debt given higher absolute yields and historically low currency volatility.

Sectors	12 Months View	Investment Rationale
Dev. Market (Core) Sovereigns	**Underperform**	Defensive on duration exposures as gradually higher rates expected; Bunds to outperform UST and Gilts as Eurozone growth lags
EU Periphery Sovereigns*	**Outperform**	ECB initiatives bolster return prospects; Financial conditions to remain resilient; Further spread compression imminent
Emerging Market Sovereigns	**Underperform**	Valuations fairly rich relative to largely unchanged fundamentals; Gains likely to hold near term given complacent markets and healthy risk appetite fueled by accommodative major central banks; Favour short duration and lighten exposure to fragile credits
High Grade Corporates	**Market perform**	Direction of rates key to performance; Favour Euro over USD, financials over non-financials & BBB-rated versus higher quality
High Yield Corporates	**Outperform**	Remain constructive despite less attractive valuations; Favour € issuers over USD; Value in Single-B rated credits

**EU Periphery Sovereigns include bonds from countries such as Greece, Ireland, Italy, Portugal and Spain.*

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.

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Developed Markets Government Bonds

Citi analysts expect interest rates to grind higher during the second half of the year as the macro backdrop improves and inflation firms. That said, the magnitude of this shift is likely to be relatively modest through year-end. As such, there is limited scope for steepening at the long end of the curve, and volatility is likely to remain subdued.

The widely anticipated backup in bond yields this year has thus far been trumped by disappointing data, safe haven flows fuelled by geopolitical concerns, and a rash of short covering that culminated in May. The few who've been overweight duration since benchmark rates peaked in December have been amply rewarded. Indeed, long-dated exposures have generated the most impressive gains YTD.

While UK Gilts and US Treasuries have been bolstered by the decline in rates during the first six months of the year, returns are likely to be mostly flat through year-end. In these markets, improving economic activity should foster modestly higher real yields and a slight drag on overall performance. Citi analysts continue to expect the Bank of England to hike rates during the fourth quarter of this year, followed by the US Federal Reserve in mid-2015.

While Citi analysts did not anticipate a substantial drop in rates six months ago, they did project German Bunds to outperform their major market peers. Sluggish Euro-area growth and anemic inflation suggest that this trend should continue. By comparison, Gilts and Treasuries are more vulnerable to upside rate pressures (for reasons already discussed), suggesting that UST/Bund and Gilt/Bund spreads could widen further. In the US, intermediate maturities appear to be the least attractive part of the curve, in Citi analysts view. Among the major rate markets, long JGBs are poised to generate the best performance during the second half of the year given their expectations for local rates to remain fairly unchanged.

Emerging Markets Government Bonds

Emerging market debt (local, hard currency, corporate bonds) continues to profit from historically low volatility, depressed UST rates and elevated local real yields. Indeed, USD-denominated sovereigns gained 70bp in June, boosting returns to 9.3% YTD. Local EM debt markets have generated 7.1% (unhedged to USD), while EM corporate debt has risen by 6.3%. These markets have outperformed developed HG and HY corporate bond markets YTD. The global reach for yield is clearly evident in EM, where performance has been led by the high risk, high beta countries. These issuers retain attractive absolute yields (i.e., Brazil, Hungary, Indonesia, Turkey, Venezuela) but weak fundamentals. Case in point: Argentina bonds have risen by nearly 18% this year despite increased risks of another default.

Citi analysts remain concerned that the EM rally has not been driven by any broad-based improvements in fundamentals. Prospects for export growth are generally lackluster (despite an uptick in developed market imports) and current account deficits persist. Moreover, geopolitical risks prevail (i.e., Ukraine/Russia, Middle-East tensions) and the pace of China growth is unclear.

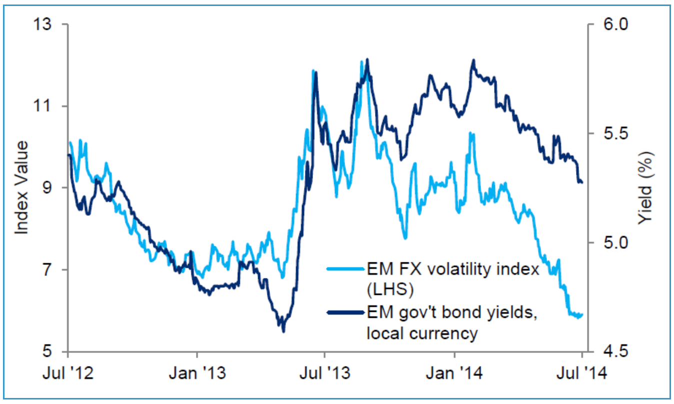

Figure 1: Declining FX volatility has fuelled drop in local yields
Source: Bloomberg.
Past performance is no indication of future results

While the rally is likely to be sustained near term, EM debt markets are not likely to maintain the pace of recent gains. Local markets are more attractive given higher absolute yields and historically low currency volatility (Fig. 1). The biggest risk to local markets is higher DM rates. Indeed, rising US yields typically correlate with a reduced appetite for EM debt. While we do not anticipate a severe correction similar to 2013, higher UST rates are poised to be the principal drag on performance. Therefore Citi analysts recommend retaining a short duration bias in external debt, favouring opportunities in the corporate market, and hedging currency exposures where possible.

Investment Grade Corporate Bonds

USD high grade corporate debt returns were slightly positive in June (14bp) as spreads narrowed to a 9-year low. European HG credit easily outperformed USD issuers as Bund yields declined, generating a 45bp gain last month. Even if we adjust for index duration, European credit has outperformed USD corporates by 210bp year-to-date. The demand for yield continues to drive fund flows into corporate credit. Indeed, high grade corporate bond funds have received nearly $39 billion YTD, compared to about $13 billion of outflows in 2013. Potentially higher US Treasury rates remain the biggest risk to future performance. Citi analysts expect returns for the second half of this year to be modest or negative. Citi analysts continue to favour EUR credits over USD and GBP, financial issuers over non-financial sectors, and BBB-rated credits versus higher-quality names.

High Yield Corporate Bonds

While European high yield struggled to maintain its recent pace of gains, USD HY debt posted another strong month. US HY rose by about 85bp in June compared to a roughly flat (+5bp) showing by European HY. That said, the US and European markets have both gained about 5.4% YTD, outperforming most fixed income sectors. Citi analysts remain constructive about HY despite historically low absolute yields and narrow post-crisis spreads. The market (and further spread compression) should be well-supported by low volatility, declining default rates, and scarce alternatives for attractive yield. The magnitude of spread compression in Europe is likely to outperform US HY given new ECB stimulus and the likelihood of “lower-for-longer” government yields. Citi analysts still favour Single-B rated issuers. Mutual funds have continued to shed bank loans since expectations for higher rates were revised downward. Outflows are approximately $5.5 billion YTD. This trend has been offset entirely by CLO manager demand. Indeed, CLO’s were issued at a record pace during 2Q’14 ($38 billion). While Citi analysts continue to favour conventional HY debt over bank loans, prices have steadily risen since bottoming in late April and the sector has gained 2.7% YTD.