Volatility in rates, notable the core US Treasury and German Bund markets spiked, post yields reaching 2015 highs. This followed the sharp selloff in the Chinese equity markets and drawn-out negotiations to strike a deal for Greece. However, following the deal on Greece and government intervention in Chinese equity markets, a degree of calm returned and core yields pushed higher again. Citi analysts expect such global risks to remain as a tail risk for sovereigns midterm and highlight the spectre of Grexit as a longer-term risk

Citi analysts maintain their forecast for the initial US rate rise as September 2015 and see the path to normalisation as being measured. Due to low absolute yields, below trend inflation and US dollar strength Citi analysts see tem-premiums being held down and continue to be neutral on duration.

Citi analysts continue to favour high yield bond markets. For diversification, Citi analysts see opportunities in Asia though they prefer higher quality credits as they expect the volatility in equity markets to persist.

Sectors	12 Months View		Investment Rationale
Dev. Market (Core) Sovereigns	**Underperform**		Slow-paced US recovery and Federal Reserve expected to manage normalization path; neutral duration; effect of European Central Bank's quantitative easing programme expected to anchor Eurozone rates.
EU Periphery Sovereigns*	**Outperform**		Deal for Greece and the ECB's QE provides support for peripheral spreads. Prefer Spain and Portugal.
Emerging Market Sovereigns	**USD**	**Outperform**	Favour external debt markets over local markets, though increasing defensiveness near term as FX volatility to persist; Asia remains Citi analysts' most favoured-region.
	Local	**Underperform**	
High Grade Corporates	**Market perform**		Performs largely tied to direction of core sovereign bond markets; favour opportunities in subordinated financial debt
High Yield Corporates	**Outperform**		Favour higher absolute yields in US HY vs. euro HY issues; diversification opportunities in USD Asia market. Favour BBs.

**EU Periphery Sovereigns include bonds from Ireland, Italy, Portugal and Spain.*
Source: Citi analysts 16/07/15

Developed Markets Government Bonds

Over the past month core sovereign debt yields have fallen in response to significant global events, notably the potential consequences of Greek talks seeing investors increase their holdings in safe haven assets; Bund and Treasury yields fell sharply from their YTD highs. Then, with a resolution on the third bailout plan for Greece we saw yields climb again. This continued the higher levels of volatility which were noted here last month and Citi analysts expect for this to remain a theme over the coming months.

Concentrating on Europe, Citi analysts envisage the conditions of the third bailout as being difficult to implement and the reforms required are onerous. In all, In all this keeps Grexit as a long-term risk for Citi analysts. The agreement for Greece is seen as being positive for Eurozone sovereign debt and Citi analyst believe there is room for spread contraction against Bunds. Above this the European Central Bank continues with its Asset Purchase Plan which provides a favourable technical backdrop for Citi analysts as they expect it to cause spreads to tighten.

In the US, though the timing of when interest rates will rise is debatable, what is clear is that the time is coming closer. Citi analysts' base case is for September 2015 with further hikes being executed gradually according to how the economy responds. Citi analysts maintain their neutral view on duration though expecting higher rates as the Fed implements normalisation and note intermediate Treasuries could act as alternatives to the 10year to provide high-quality risk diversification in the face of higher diversification and potential market selloffs.

Emerging Markets (EM) Government Bonds

The same factors are impacting the emerging market space (volatility, risk appetite) but also their greater sensitivity to commodity prices and country-specific aspects. The six weeks from June 1st USD-hedged returns have delivered positive returns, pushing the year to date (YTD) statistic above zero, however unhedged holding have returned -3.8%. Given that Citi analysts are expecting the recent run of volatility to extend (with lower volumes and less liquidity over the summer being additional considerations), they are cautious on unhedged exposures. Citi analysts prefer Asia over the high-beta options (e.g. Russia, Venezuela).

Investment Grade (IG) Corporate Bonds

Events in China and Greece also impacted on the IG markets. Both US and European markets were negatively affected, but the European credits more so; European IG widened c.25ps vs US IG c.10bps. YTD USD- and EUR-denominated IG have both delivered negative returns and underperformed the fixed income universe. So far this year there has been significant supply and Citi analysts expect this to continue after the summer as issuers act before the Federal Reserve is expected to raise rates. Higher supply has kept downward pressure on spreads but the direction of core rates has the greater influence.

High Yield (HY)

High-yield assets were found to be relatively resilient in the face of the increased volatility, with the negative performance of US HY attributed largely to the lower commodity prices. However, the general theme of risk aversion has caused spreads to widen and yields to track higher. Citi analysts would still recommend an overweight position in both US and European HY as they still see valuations as being attractive through the longer term. Relative to IG, Citi analysts see HY fundamentals as more attractive as well. Citi analysts prefer USD-denominated HY over Euro, especially for Asian HY where the USD hedge offers some protection against local volatility. Citi analysts recommend looking for BB-rated credits, the higher end of the HY credit scale.

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With respect to fixed income securities, please note that in general, as prevailing interest rates rise, fixed income securities prices will fall. High Yield bonds are subject to additional risks such as increased risk of default and greater volatility because of the lower credit quality of the issues.

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