Citigold

Market Outlook

July 2015

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Greece Defaults; Contagion Risks Limited

Greek government failed to make the EUR 1.6bn IMF debt payment due on 30 June and becomes the first nation to default on IMF since Mugabe's Zimbabwe. Given the increasing risk of a 'Grexit', Citi analysts' view of contagion risk to other economies and markets seem limited. Below are their key takeaways.

Given 1) fundamental improvements across Europe; 2) broad cyclical recovery; and 3) committed European Central Bank (ECB) liquidity support, contagion risks to the rest of Europe as well as globally may be limited. Especially, the ECB is by far the most flexible and powerful source of policy support in the event of contagion. Given that the bulk of debt in the Eurozone is Euro-denominated, the ECB has extremely deep pockets – through its ability to create euro base money – to react to potentially significant financial turmoil. The ECB has three types of powerful instruments: Liquidity policies, Quantitative Easing (QE) and other asset purchases as well as OMT (Outright Monetary Transactions).

The Greek saga has sent risk assets in Europe sharply lower with the Stoxx Europe 600 sliding almost 5% in June. Given Citi analysts' bullish outlook for European equities over the next 12-18 months, however, their strategy continues to be a "Buy-on-the-dips". Indeed Citi analysts expect a good combination of improving fundamentals and further liquidity-driven re-rating to support European equities in the longer term. Focus on 3 'L's: 1) leadership; 2) leverage; and 3) liquidity'.

Macro Overview

- **US:** Expect rate increases to begin in September and prepare for market volatility.
- **Europe:** Inflation is rebounding, but unlikely that ECB will taper asset purchases before Sep-16.
- **Japan:** Core inflation may undershoot Bank of Japan's (BoJ's) bullish forecast, prompting easing later this year.
- **Asia:** More policy support is expected in China, including Reserve Ratio Requirement and policy rate cuts in response to downside risks in the economy.

Equities: Overweight

- Slightly less accommodative prospective monetary policies, a modest deterioration in the growth/ inflation split and ongoing concerns about Greece leave Citi analysts nervous that elevated bond, FX and European equity volatility could yet translate into wider equity market volatility/ corrections in the near-term. Nonetheless, Citi analysts still favour equities over fixed income longer term.

Bonds: Underweight

- **Euro bonds:** Peripheral spreads likely to remain volatile until a resolution on Greece is reached.
- **EMD:** Expect FX volatility to persist this year; favour external debt markets over local markets.

Currencies: USD Correction Extends

- **GBP:** Post Election Bounce Then Mixed Bag.
- **AUD & CAD:** Near Term Upside.

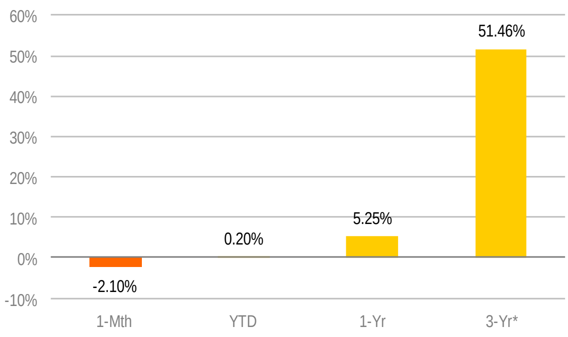
Equity Markets

United States

Case for September interest rate hike appears stronger

- Recent data affirms Citi analysts' estimate of underlying economic growth to be in the 2.5-to-3% range. The initially-reported weakness reflected the harsh winter in the east coast, west coast port strike, as well as residual seasonality. Citi analysts anticipate growth near 3% in Q2 15 and Q3 15 while inflation will is likely to remain subdued.
- On the back of the recent Fed meeting, Citi analysts now expect the first rate hike in September, because of evidence that moderate growth may be sufficient to close the output gap in the medium term.
- From an equity perspective, moderate gains are possible by year-end but Citi analysts do not expect a powerful 2H15 rally for the S&P 500 which is projected to end 2015 at 2,200. Favoured areas include Banks, Insurance and REITs within Financials and Tech Hardware and Software & Services in IT.

Chart 1
S&P 500 Index



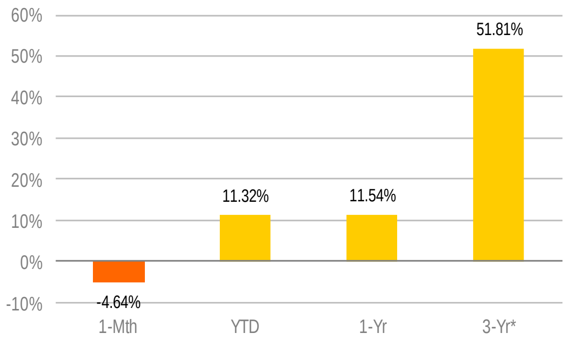
*Denotes cumulative performance
Performance data as of 30 June 2015
Source: Bloomberg

Euro - Area

ECB may continue asset purchases beyond Sep16

- Looking ahead to the rest of 2015, Citi analysts still forecast GDP growth rates in the 0.4-0.5% QoQ range despite the recent rise in government bonds yields and euro. However, financial conditions could worsen significantly if these trends were to extend into H2-2015. Finally, with inflation rates remaining very low, Citi analysts see no real risk that the ECB will taper asset purchases before Sep-16.
- The Greek government failed to make the EUR 1.6bn IMF debt payment due on 30 June. The next significant date is June 5th, the Greek public's referendum on austerity.
- The Greek saga has sent risk assets in Europe sharply lower. Given Citi analysts positive view on European equities, however, Citi analysts would align with strong fundamentals as well as the ECB's QE and thus be inclined to buy on the dips.

Chart 2
Dow Jones Stoxx 600 Index



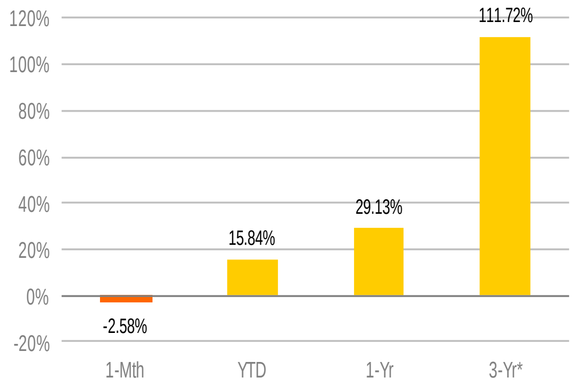
*Denotes cumulative performance
Performance data as of 30 June 2015
Source: Bloomberg

Japan

BoJ may implement easing measures later this year

- Citi analysts are revising down their forecasts for Q2 GDP growth from +1.2% QoQ annualized to +0.5%. Consumer spending, manufacturing activity and exports remained sluggish in recent months than Citi analysts had expected, while business investment showed increasing signs of a renewed pickup.
- Citi analysts believe that increased purchases of Japanese Government Bonds and Exchange Traded Funds are the most likely option with further easing in October 2015,
- Over the medium term Citi analysts expect Japanese shares to rise and continue outperforming major global markets in 2015. This is thanks to 1) support for Japanese equities from an inflow of public money (supply/demand factor), 2) increased emphasis on return on equity by corporate management, and 3) the achievement of full employment.

Chart 3
Topix Index



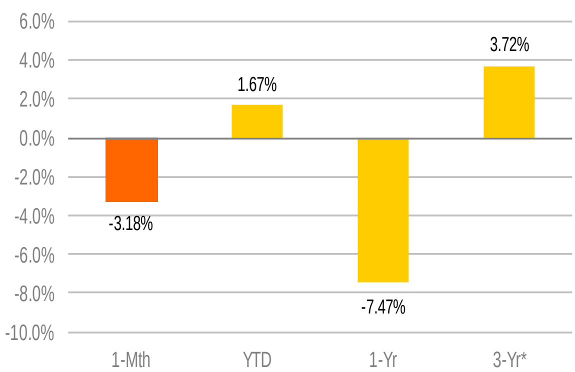
*Denotes cumulative performance
Performance data as of 30 June 2015
Source: Bloomberg

Emerging Markets (Asia, CEEMEA and Latam)

Favour Asia over EMEA and Lat Am

- EM valuations are still supportive, more so in Asia and EMEA, and still trade at a discount to developed markets. Sentiment towards EM remains subdued and investors are still positioning Asia as a consensus underweight.
- Themes for H2: i) US rate hike in 2H will make countries that are both expensive and in current account deficits the most vulnerable; ii) stronger USD should benefit commodity consumers over producers; and iii) El Nino may likely hit the lower GDP-per-capita economies of EM more, as they tend to have a higher % of agriculture weight in GDP and in the CPI indexes.
- Citi analysts favour Asia over EMEA and Lat Am. Within sectors, Citi analysts overweight financials, technology, consumer discretionary and underweight defensives.

Chart 4
MSCI Emerging Markets Index



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

Bond Markets

Favour high yield credit

US Treasuries

- Citi analysts expect the intermediate sector of the Treasury curve to perform well, with the market potentially pricing in an even slower pace of normalization of Fed Funds.
- Inflationary pressures are still subdued, and uncertainty around Greece is additionally supportive for Treasuries.

Investment Grade Corporates (IG)

- US index yields are at their highest levels since October 2013, and Citi analysts' expectation for core rates to retrace some recent weakness over the summer months, is likely to boost performance in IG.
- That said, the slow deterioration in credit fundamentals remains troublesome over the long-term. Net leverage is rising and cash balances are no longer growing.
- Thus, Citi analysts prefer sectors where deleveraging remains a priority, like US and European banks.

High-Yield (HY)

- Though spreads have modestly widened, HY appears to be entirely absorbing the negative pressures from rising Treasury and Bund yields.
- Moreover, the fundamental environment remains supportive (unlike in IG) and Citi analysts maintain their high conviction.
- Though euro HY markets offer greater potential for outsized spread tightening (Citi analysts are looking for an additional 100bp of tightening), they prefer the higher absolute yields in USD denominated markets.

Emerging Market Debt

- Heightened interest rate and currency volatility has largely contributed to recent underperformance in external and local currency emerging market (EM) debt.
- Asia remains Citi analysts' most-favoured region in both USD and local currency markets.
- That said, Citi analysts expect FX volatility to persist this year, and continue to favour external debt markets over local markets.

Euro Bonds

- Citi analysts expect increasing supply/demand imbalances in Eurozone sovereign debt and summer seasonality to keep core government yields relatively contained.
- Peripheral spreads have also moved wider and will likely remain volatile until a resolution on Greece is reached. Though the actual outcome remains uncertain, Citi analysts believe any contagion across the Eurozone will be contained.

Japan Bonds

- Citi analysts keep their yield forecasts unchanged, despite the global bond sell-off based on their forecast that the BoJ will ease further with an increase in Japanese Government Bond (JGB)purchases at some stage.
- Citi analysts expect the JGB market to decouple from the global bond market to an extent, partly due to likely negative YoY inflation (even on an ex-energy basis) and partly due to additional easing.
- On the other hand, Citi analysts keep their view of relative curve steepening, due partly to a possible increase in term premium — in case the government fails to provide a realizable fiscal reform plan to achieve primary balance equalization by 2020.

Currency

USD Correction Extends

The USD rally may not be over medium term but it is mature. Typically USD up and down cycles tend to last 5-6 years and 10 years respectively. With the US economy clearly slowing (factors include weather, USD strength and the collapse of oil prices), the response from the Fed has turned more dovish indicating no collective rush to normalize rates. Coupled with positioning and Chinese reflation, the USD correction may extend a little further over 0-3m. Further out, Citi analysts see the USD gaining 7-9% vs. G10 currencies over 1-2 years.

EUR: More EUR Near Term Upside

- Data improvement, higher oil prices and positioning coupled with a likely late US hike may see the EUR reach 1.15-1.17 over 0-3m.
- Medium term though, further downside is forecast as a weak EUR remains a key intermediate policy objective of ECB Quantitative Easing along with policy normalization in the US that may ultimately see EURUSD drop to parity.

GBP: Post Election Bounce Then Mixed Bag

- Elections outcome surprise was to the upside, with a majority Conservative government with a strong mandate to lead being overall GBP positive.
- With markets pricing in Bank of England tightening at a very distant 12 – 18 months time (the risk being such expectations could be well brought forward) plus a market that is still positioned very short in sterling, the positive momentum in the GBP is likely to hold near term.
- Medium term though, the cyclical recovery in the US and continual QE for the Eurozone may see USD strengthen vs GBP and also for GBP vs EUR.

JPY: Waiting For Fundamental Input

- Citi analysts expect a QE (Quantitative Easing) extension at the July BoJ (Bank of Japan) meeting which means medium to longer term cyclical and policy divergence could weaken the Yen further.
- But the prospect for further BoJ easing may already be largely discounted into FX pricing and with yen positioning more neutral and the lower oil prices now helping boost Japan’s trade/ current account balance, such Yen weakness may be moderate at best. The USD/JPY consolidation could extend over 0-3m before heading higher towards 125 further out.

AUD & CAD: Near Term Upside

- **AUD:** China’s RRR (Reserve Ratio Requirement) rate cut together with bounce in commodities facilitating the rebound in terms of trade should see another leg higher for the AUD though the prospect for another RBA (Reserve Bank of Australia) rate cut and commodities reversing course is likely to see AUD capped.
- **CAD:** A combination of upward momentum in oil prices and negative US data to see the cross consolidate in the short term. Further out, expected cyclical improvement in the USD against the Bank of Canada backdrop of looser monetary policy for longer (Citi analysts forecast rate hike in 3Q 2016) should imply policy divergence may be the main driver of USD/CAD higher.

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