For the first half of 2016, US rates have been engaged in a proverbial Tug-O-War. Expectations of policy tightening in the US have ebbed and flowed, as sharp differences in Fed rhetoric has left investors confused over the timing of future rate hikes. Especially ahead of illiquid summer months and a very important UK referendum.

The influence of negative yields is strengthening. Negative interest rate policies by a number of central banks - mainly the European Central Bank and Bank of Japan – have pressed local investors to search for opportunities in longer durations or foreign markets in order to obtain positive yields. Foreign demand for higher yielding US Treasury debt continues to rise.

Sectors	12 to 18 months view relative to benchmark		Investment Rationale
Developed market (DM) core sovereigns	**Neutral**		Modest growth, benign inflation pressures and negative policy rates to keep core rates low Favor longer duration strategies in the US and Eurozone
EU periphery sovereigns*	**Outperform**		Favorable technical environment from ECB QE to support low yields, though political uncertainties and UK referendum likely to keep spreads volatile near term
Emerging market debt	**USD**	**Outperform**	Energy sensitive countries will likely benefit from improving crude oil prices and a cautious US Fed We favor atin America, specifically external (USD) Argentina sovereigns and select Brazilian corporates and uasi-sovereigns
	Local	**Neutral**	
High grade corporates	**Outperform**		We recommend IG corporates to extend portfolio duration in both the US and Europe. Favor select issuers in US energy, subordinated financials EIT sectors
High yield corporates	**Outperform**		Favor both the US and European Y markets Favor select, high uality US energy debt and European issuers that would benefit from ECB corporate bond purchases

Source: Citi Analysts 8 June 2016
EU periphery sovereigns include bonds from Ireland, Italy, Portugal and Spain.
Outperform implies a positive view, while underperform implies a negative view. A neutral view implies our confidence is neither positive nor negative

Along with negative sovereign yields, higher oil prices are helping compress spreads in corporate bond markets (both developed and emerging markets). Since the February low in crude oil, US high yield energy debt has gained over 45%. Expectations for even higher energy prices and relatively attractive valuations are likely to fuel further outperformance. Selectivity is key.

Higher oil should also support Latin America emerging market debt and wider US inflation breakeven spreads. As such, we expect US Treasury Inflation Protected Securities to outperform nominal Treasury debt.

Sovereign debt

Citi Analysts believe a more meaningful influence on US rates is the growing universe of bonds with negative yields (both sovereign and corporate). Negative interest rate policies (NIRP) by a number of central banks – mainly the European Central Bank (ECB) and Bank of Japan (BOJ) – have pressed local investors to search for opportunities in longer durations or foreign markets in order to obtain positive yields. Indeed, 30% of global developed sovereign debt now trades with yields below zero and long-duration government bonds have gained a combined 14% year-to-date (in hedged USD terms).

Citi Analysts continue to favor extending duration in fixed income portfolios, in both the US and European rate markets. However, with 10-year German Bunds reaching a historical low of 3 basis points, we find very little value in core Eurozone rates. Eurozone periphery countries offer better value, though spreads are likely to be dominated by political event risk.

Emerging market debt

Emerging market debt has been well-supported by rising oil prices, attractive valuations and a slow-moving, data-dependent Federal Reserve. Despite a sluggish May, US dollar-denominated EM sovereign and corporate bonds have gained 7.8% and 7.0%, respectively, year-to-date. On the other hand, local EM markets have returned a more modest 3.7% (hedged in USD terms), through largely from Latin America – via Brazil (+12.6% YTD). Though our expectation for higher oil should boost EM assets further (especially in Latin America), uncertainties over the timing of future Federal Reserve policy tightening could drive periods of heightened volatility.

Corporate investment grade

US investment grade (IG) corporate spreads were flat, to slightly wider last month, as investors digested over $200 billion in new issuance. May was the largest volume month of new IG supply since 2014. On the other hand, investors are being challenged by a growing universe of negative yielding assets. Though found primarily in core sovereign debt, negative yields are also beginning to invade credit markets, due to the onset of the ECB's corporate sector purchase program (CSPP). Indeed, 5% of global IG corporates now have yields less than zero. This has kept foreign demand strong for higher yielding US debt – especially from investors in Europe and Asia – as new supply is easily absorbed. Sector performance for May was somewhat mixed, though energy-related IG has rallied hard to start June and YTD returns have now breached 9.0%.

In Europe, IG credit benchmark yields are now below 1.0%. Fueled by ECB QE and the introduction of CSPP, long-duration corporates (15+ years) have outperformed rising 13.0% this year. Though it is undetermined how much the ECB will eventually buy, we expect spreads to tighten further and likely more pronounced in CSPP-eligible securities. Euro-periphery markets and cross-over credits can offer more attractive opportunities, though volatility would likely rise from any negative outcome regarding the UK referendum vote on June 23.

Citi Analysts remain overweight IG corporates, favoring USD over Euro issuers where yields are 2x-3x higher.

Corporate high yield

Global high yield (HY) corporates continue to generate positive performance, though the pace of gains has slowed. After rising 8.7% in the US and 5.6% in Europe, over the previous two months, Citi HY index benchmarks rose a more modest 0.7% and 0.2% in May, respectively. Gains in both regions have been fueled by the decline in IG bond yields, lower rate hike expectations in the US and a 40% rise in crude oil prices

Indeed, the US energy sector has now gained 45% since the February low in West Texas Intermediate. Fund flows still offer a positive technical environment, despite several weeks of heavy outflows in the US. Notably, these flows were driven by very few ETF investors, in order to create liquidity for cash bonds that were becoming hard to find. This implies that demand remains strong, though liquidity may be declining. New supply has improved, though still trending below last year's totals and further supporting valuations.

Citi Analysts favor select opportunities in both US and Euro HY markets. US issuers will likely benefit from relatively attractive valuations (7.0% index yield, spreads +560bp), though Euro HY spreads should compress from a QE-induced "trickle-down" effect. As a result we favor cross-over opportunities (bonds rated both IG and HY) in European issuers that will benefit from ECB CSPP. We also still find valuations in US energy attractive, though selectivity and proactive management remains key.

Important Information