International Personal Bank

Volatility in global rates markets has intensified, serving as a reminder of how changes in market dynamics can create pockets of volatility and violent moves in asset prices. After an abrupt sell-off in April, yields in core sovereign debt moved sharply again, as subtle improvements in macro-fundamentals are magnified by low liquidity and consensus positioning.

Since hitting a historical intra-day low of 0.05% two months ago, 10-year German Bund yields have risen 85 basis points, now hovering around 0.9%. 30-year Bunds have declined 25%, nearly giving back all of 2014 performance. Higher Bund yields and modest improvements in US economic data, have pushed Treasury yields to their highest levels since last October, with 10-year US Treasury rates around 2.45%. Citi analysts have been bearish on US rates all year (and remain so) though they do expect some retracement over the coming months due to seasonality and technical market imbalances.

High yield corporate debt appears to be entirely absorbing the negative pressures from rising Treasury and Bund yields.

Sectors	12 Months View		Investment Rationale
Dev. Market (Core) Sovereigns	**Underperform**		Lack of meaningful fundamental support to contain US rates, short term; technical support from ECB QE likely to push EZ yields lower
EU Periphery Sovereigns*	**Outperform**		Near-term volatility likely to persist until Greece bail-out talks are resolved; favour Spain and Portugal
Emerging Market Sovereigns	**USD**	**Outperform**	Favour external debt markets over local markets, as FX volatility to persist; Asia remains Citi analysts' most favoured-region, followed by Latin America; select yield opportunities in USD corporate space
	Local	**Underperform**	
High Grade Corporates	**Market perform**		Performs remains 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; higher yield opportunities in USD Asia market

**EU Periphery Sovereigns include bonds from Greece, Ireland, Italy, Portugal and Spain.*
Source: Citi analysts 12/06/15

Developed Markets Government Bonds

Volatility in global rates markets has intensified, serving as a reminder of how changes in market dynamics can create pockets of volatility and violent moves in asset prices. After an abrupt sell-off in April, yields in core sovereign bond markets have moved sharply again, as subtle improvements in macro fundamentals are being magnified by low liquidity and a reversal in consensus positioning.

10-year German Bund yields are now hovering around 1.0% (after reaching an intraday high of 1.06% on June 10), since positive Eurozone inflation data sparked an un-wind of crowded short euro positions. 10-year Bunds have now lost 8.5% since reaching an historical low yield of0.05% on April 17. 30-year Bunds have declined 24.6% over the same period, nearly giving back all of its 2014 performance. Periphery 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. Their expectation is for a new program to be agreed upon, but only after capital controls are imposed.

In the US, a combination of higher Bund yields and better than expected economic data (i.e. solid May non-farm payrolls), has pushed US Treasury yields to their highest levels since last October. 10-year and 30-year UST rates are now around 2.45% and 3.20%, respectively, 80+ basis points higher than their lows of the year. Citi analysts have been bearish on US rates all year (and remain so). That said, inflation remains benign, the pace of US growth is slow and the pass-through from lower energy prices has not provided the expected momentum in consumer demand. Therefore Citi analysts would expect some retracement over the coming months.

Citi analysts also expect increasing supply/demand imbalances in Eurozone sovereign debt and summer seasonality to keep core government yields relatively contained. Indeed, after ECB QE (European Central Bank Quantitative Easing) purchases, Eurozone sovereign markets will be dealing with negative net supply of about 150 billion euros this summer. A period seasonally characterized by low volumes and lower market liquidity.

Increased volatility and counter-trend sell-offs and rallies are likely to become more prevalent, as such Citi analysts continue to recommend investors add negatively correlated assets to portfolios. US TIPS breakevens are near their widest levels of the year. While carry remains positive, Citi analysts look for further improvements in headline data before expressing a stronger view. In Europe, Citi analysts do not believe the reflation trade will be sustained and expect breakevens to narrow. The size of the ECB program and the direct investment into euro-linkers will be supportive for a further decline in real yields, in their view.

Emerging Markets (EM) Government Bonds

Heightened interest rate and currency volatility has largely contributed to recent underperformance in external and local currency emerging market (EM) debt. Since early May, US dollar denominated EM sovereign debt has declined 2.4%, with Asia underperforming all regions (-2.8%). However, this was mainly due to Indonesia (-4.2%), which makes up nearly 50% of the USD EM sovereign bond index. Lower revisions to growth forecasts, weak tax collections and the potential for further IDR weakness has pressured portfolio outflows and boosted CDS prices. Despite the recent pull-back, USD EM remains one the better performing fixed income assets classes YTD, generating 1.5% in total return and outperforming the broad aggregate index by ~230bp. Asia remains Citi analysts' most-favoured region in both USD and local currency markets. That said, Citi analysts do expect FX volatility to persist this year, and continue to favour external debt markets over local markets. EM corporates have also favoured well, gaining 3.4%YTD. Citi analysts believe EM credit remains a good source of yield in today's low yield environment. That said, persistent volatility and lower market liquidity is likely to limit future performance.

Investment Grade Corporate Bonds

High grade (HG) corporate debt continues to be dragged down by rising core sovereign bond yields and a heavy supply calendar. Since the beginning of May, USD HG has declined 2.9%, with index yields rising ~35 basis points (currently 3.35%) and spreads widening 5-10bp (currently 130bp), depending on sector and duration.

YTD new issuance is quickly approaching $600 billion, following $140 billion in new supply last month (highest month on record), as issuers rush to get ahead of expected US Fed policy tightening. Moreover, M&A activity has picked up (e.g., Healthcare, TMT sectors) which has provoked upward revisions in 2015 supply forecasts. In Europe, the story is similar. The sharp rise in long-dated Bund yields has impacted euro HG returns, which have fallen 4.0% since May 1. Index yields spiked 30bp to 1.3%, the highest levels since Aug 2014. YTD returns are now negative at -1.5%, hedged to US dollars.

As Citi analysts have noted for some time, future performance in HG credit is likely to be heavily influenced by the direction of core risk-free rates. Indeed, when removing the drag from higher US Treasury and Bund yields, corporate returns are still positive YTD. That said, tactical investors could find current valuations relatively attractive. 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. 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. Citi analysts would recommend focusing on sectors where deleveraging remains the priority, like US and European banks. Indeed, subordinated financial structures offers relatively attractive yield pick-up.

High Yield (HY)

Despite heightened interest rate volatility and large declines in core sovereign bond prices, high yield corporate debt has held up relatively well. This is likely due to recent stability in oil prices and relatively less equity volatility. Since May 1, US and European HY bond indices returned -0.4% and -0.1%, respectively, outperforming most long-duration, high quality assets (US Agg declined -1.5%; S&P fell 1.7%). US supply has been robust, with $180 billion issued YTD. On the other hand, the fast pace in European issuance has slowed (€45 billion YTD), as a result of recent market volatility. HY remains the best performing fixed income asset class this year, returning 3.0% YTD.

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 high-grade credit) 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), Citi analysts prefer the higher absolute yields in USD-denominated markets. More specifically in Asia, where HY corporate bond index yields are close to 6.75% (excluding sovereigns). Liquidity is strong, rating agency trends are positive and default rates are among the lowest of all EM regions. Indeed, Asia HY has gain 0.40% over the last month.

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