Soft economic data and safe-haven demand - has fuelled a decline in interest rates and an impressive rally across fixed income markets. This has fostered outsized gains across a range of duration-laden products. Long-dated German Bunds, US Treasuries, and perpetual bonds have all generated about 6.0% gains year-to-date.

These trends - run contrary to our analysts' baseline expectations for a modestly higher rate climate this year. They remain undeterred. In their view, core sovereigns are still poised to underperform credit and equity markets as term structures normalize and the recent rally fades.

While core rates could remain range bound in the near term – our analysts recommend lightening positions in rate-sensitive sectors, swapping out of lower-coupon securities, and taking profits in higher quality corporates. They favour high yield credit over longer duration exposures, and to enhance potential returns by integrating strategies that involve lower liquidity and floating rate instruments.

Sectors	12 Months View	Investment Rationale
Dev. Market (Core) Sovereigns	**Underperform**	Favour short duration strategies as intermittently higher bond yields are expected in 2014; Bunds poised to outperform UST and UK Gilts as ECB policy remains accommodative.
EU Periphery Sovereigns*	**Outperform**	Risks are ring-fenced, for now; Growth and banking concerns persist, but have marginally improved; Financial conditions to remain resilient and further spread compression likely.
Emerging Market Sovereigns	**Underperform**	Deteriorating conditions have somewhat abated; Our analysts remain cautious; Favour short duration positions and lighten exposure to fragile credits; Favour external vs. local issues given FX volatility.
High Grade Corporates	**Market perform**	Expect modest gains in 2014 due to performance drag from higher core rates; Favour shorter duration, financials over non-fin.
High Yield Corporates	**Outperform**	Valuations are less compelling, but still wide spreads and low default rates to fuel further gains.

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

Important Information

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Developed Government Bonds

Benchmark rates have been range-bound since the beginning of February and remain near the lowest levels of the year. While government bonds remain poised to underperform the broad market by year-end, softer-than-expected data and safe-haven demand have bolstered returns this year. As our analysts expected, Bunds remain on track to outperform other major government markets this year. Slowing economic momentum has helped to depress real yields, while forward inflation expectations have drifted lower across most major markets. Not surprisingly, the long-end of the curve has flattened substantially since January, fuelling impressive gains in duration-laden products (Figure 1).

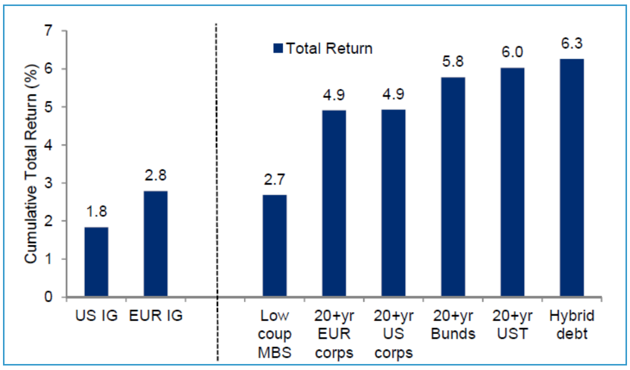

Figure 1: Long duration has outperformed this year
Source: The Yield Book.
Past performance is no indication of future results

These developments run contrary to Citi analysts' expectations for modestly higher rates this year. Our analysts continue to believe that DM growth is improving, and that rates will trend higher as real yields normalize further. To be sure, US activity has slowed. As such, Citi pared back the 2014 US GDP forecast by 0.5%, and our analysts slightly cut the year-end target for the 10-year Treasury yield, from 3.3% to 3.2%. In other developed markets, Citi growth and interest rate forecasts are largely unchanged, except in the UK, where 10-year Gilt forecasts were recently lowered by 20bp.

The recent rate rally provides an attractive window of opportunity to reposition bond portfolios for the more challenging climate ahead. While rates are unlikely to trade much above current ranges near term, our analysts encourage investors with longer-term objectives to shed duration and overweight exposures to rate sensitive sectors (such as government and agency bonds).

Given the weaker backdrop, many investors are wondering whether the FOMC would stop tapering asset purchases. This is unlikely for a number of reasons. First, the Fed's Beige Book report released on March 5 concluded that weather-induced disruptions are largely responsible for slowing activity (implying that growth should improve once this impact fades). Second, policymakers are not convinced that EM volatility presents a threat to US financial conditions or economic prospects. Finally, the next FOMC will be the first to be chaired by Janet Yellen. Unless data proves especially weak, it is doubtful that the new Chairman would consider it an opportune time to cement her reputation as a "dove."

Emerging Market Debt

Deteriorating conditions in emerging market debt has somewhat abated, for now. External markets (hard currency) issuers have especially benefited from the broad decline in core government yields. Indeed, USD denominated EM sovereign debt has risen by 2.3%, year-to-date. Indonesia and the Philippines have led outperformance in Asia (+4.25% YTD). In Latin America (+1.8% YTD), returns have lagged due to the fiscal strains and social unrest in Argentina and Venezuela (-4.0% and -2.5% YTD, respectively).

Citi analysts expect external debt to be resilient in the near term as spreads retrace some of the sharp widening that occurred in early February. Despite Fed tapering, global central bank liquidity remains abundant and solid demand for new supply should persist. Indeed, recent new deals have been well over-subscribed by large investors. That said, our analysts remain defensive about prospects for EM debt markets (particularly among deficit countries) given portfolio outflows, weaker fundamentals, and heightened volatility.

Local EM debt performance has been mixed. Currency volatility driven by idiosyncratic factors has largely dictated the direction of total returns (Fig. 2). In the more fragile EM economies, central bank policy decisions are being shaped by lower export-driven growth, troubling current account deficits, and rising inflation. This has led to sharp currency depreciations.

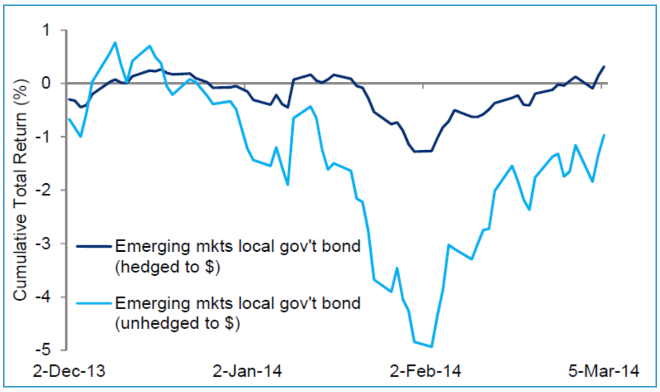

Figure 2: FX volatility has hurt local EM bond returns
Source: The Yield Book
Past performance is no indication of future results

While local EM debt features higher absolute yields and relatively attractive valuations versus DM sovereigns, potential principal returns can be easily eliminated by sudden declines in the currency. Thus, investors who are funding exposures in local currencies should strongly consider hedging FX risks. Our analysts favour short-duration debt in countries retaining conservative trade balances (e.g., South Korea, Taiwan, and Vietnam). They also favour local sovereign debt issued by Mexico, where new structural reforms are poised to strengthen the country's growth outlook and stabilize MXN.

Investment Grade Bonds

The high grade corporate market has been resilient. Indeed, USD and Euro corporate indices have gained 3.1% and 2.1% year-to-date, respectively. While the impressive performance is largely due to the decline in core government bond yields, cash and CDS (credit default swaps) spreads in US and European credit markets have also tightened. Spreads are now around the tightest levels that we have seen since 2007.

Despite generally solid fundamentals and mutual fund inflows, the potential drag from rising interest rates (not credit quality) remains our analysts principal concern for high grade returns this year. This is especially true in the US and the UK, where they project the largest uptick in government yields. Given that valuations are rich and high quality returns are likely to remain correlated with core government yields, Citi analysts recommend profit-taking in current positions. They also expect better entry points in the cash market later this year for new exposures. Investors should continue to defensively position portfolio duration (they favour the 3- to 7-year range). In their view, financial issuers are poised to outperform non-financials.

High Yield Bonds

High yield debt continues to generate impressive returns. Since the beginning of the year, US and European HY bonds have gained about 2.7% and 2.4%, respectively, far outpacing the global equity market (e.g., MSCI World returns are flat, YTD). Contrary to last year, performance has been led by lower beta, Double-B rated issuers. Triple-C rated bonds have underperformed higher quality issuers by 20bp YTD.

US and European HY spreads have narrowed by 45bp to 50bp this year. US spreads have fallen below 400bp, while European spreads are approaching 300bp. Spreads in both markets are trading at post crisis lows (the tightest since July 2007). Moreover, index yields are at (or near) historically low levels despite the 85bp and 30bp rise in 5-year Treasury and Bund rates (respectively) since last May (Figure 3).

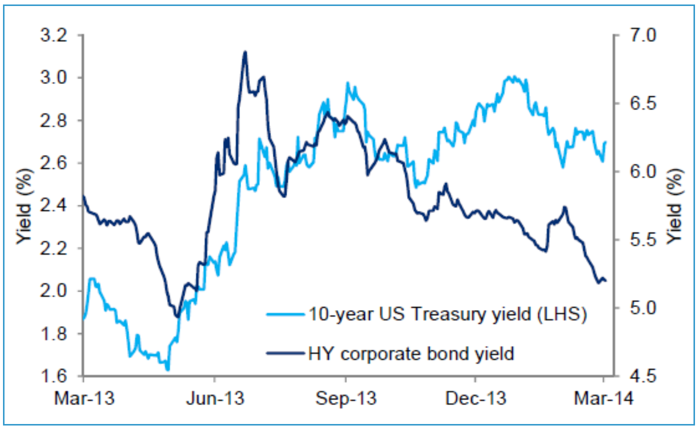

Figure 3: HY yields are near lows, despite higher UST rates
Source: The Yield Book
Past performance is no indication of future results

While bank loans gained only 0.8% (limited by lower Treasury rates and lack of convexity), they continue to attract strong demand (90 consecutive weeks of inflows). Overall, high yield valuations have become less compelling. But our analysts remain constructive on both high yield debt and bank loans. Fundamental and technical trends remain positive. Indeed, they expect low default rates and fund inflows to persist this year.

With rates range bound in the near term, Citi analysts expect unsecured fixed rate debt to outperform. However, once rates resume their upward course later this year, floating rate bank loans should narrow the performance gap.