
Eurozone interest rates dropped to record lows this month as the ECB (European Central Bank) launched its government bond purchase program (QE). Altogether, the ECB intends to purchase €60bn ($66bn) of bonds each month to jumpstart sluggish activity in the region. Though some indicators suggest Eurozone activity is beginning to improve, Citi analysts expect both positive technicals and dormant inflation to keep core rates anchored near current levels. In the Eurozone, the most attractive prospective returns remain in peripheral debt. While Citi analysts continue to favour Spanish over Italian exposure, current levels suggest that Portugal features among the best return prospects.

Economic data continue to generate compelling evidence that the U.S. recovery is intact and raise the possibility that the Federal Reserve will initiate rate hikes during the second half of this year, as Citi analysts expect. Given Fed Chair Yellen’s recent testimony before Congress and the solid labour report released March 6, the Fed seems poised to modify forward guidance at the next meeting.

In corporate bonds, Citi analysts continue to favour USD high grade credit over EUR issuers given more attractive yield propositions in the US, and inflows supported by a weaker euro. In high yield, Citi analysts are cautious over the potential for further oil price declines. Citi analysts favour quality opportunities.

| Sectors | 12 Months View | | Investment Rationale |
|---|---|---|---|
| **Dev. Market (Core) Sovereigns** | **Underperform** | | Divergent fundamentals to modestly boost rates in the US/UK while Eurozone and Japan remain anchored; favour European duration |
| **EU Periphery Sovereigns*** | **Outperform** | | ECB QE is expected to promote further spread compression versus German Bunds; favour Spain and Portugal |
| **Emerging Market Sovereigns** | **USD** | **Market perform** | Favour hard currency sovereigns/ corporate over local debt given improving prospects for stronger USD; prefer manufacturing vs. commodity exporters, and surplus over deficit countries; favour Asia over CEEMEA and LatAm. |
| | **Local** | **Underperform** | |
| **High Grade Corporates** | **Market perform** | | Favour USD over EUR issuers given attractive valuations and inflows supported by a weaker EUR. Favour BBB-rated credits and subordinated bank bonds. |
| **High Yield Corporates** | **Outperform** | | Cautious near term as the potential for lower opil prices could dampen outperformance YTD; favour high quality B- and BB-rated credits. |

**EU Periphery Sovereigns include bonds from Greece, Ireland, Italy, Portugal and Spain.*
*Source: Citi analysts 09/02/15*

## Developed Markets Government Bonds

Interest rates across the Eurozone dropped to record lows this month as the ECB launched its government bond purchase program to complement asset-backed and covered debt purchases already underway. Altogether, the ECB intends to purchase €60 billion (around $66 billion) of bonds each month as part of the effort to jumpstart sluggish activity in the region.

European sovereign yields in the Core Four already trade below zero through five-years to maturity and feature rates at (or below) 1.0% for 30-year debt. In Switzerland, the term structure is negative through 10-years, and 30-year sovereigns are below 50bp. While some indicators suggest Eurozone activity is beginning to improve, Citi analysts expect a combination of positive technicals (i.e.; ECB purchases) and dormant inflation pressures to keep core rates anchored near these unattractive levels.

The most attractive prospective returns for Eurozone investors remain in peripheral debt despite prevailing uncertainties about Greece. Though spreads have compressed materially since the beginning of February, current levels still do not reflect the potential impact of unconventional ECB actions underway and strong investor appetite. Whilst Citi analysts continue to favour Spanish over Italian exposure, current levels suggest that Portugal features among the best return prospects.

Challenging Eurozone trends stand in stark contrast to the US backdrop, where the 10-year benchmark rate has risen from a 21-month low of 1.64% on January 30. Economic releases continue to generate compelling evidence that the U.S. recovery is intact and raises the possibility the Federal Reserve will initiate rate hikes during the second half of this year, as Citi analysts expect. Given Fed Chair Yellen’s recent testimony before Congress and the solid labour report released on March 6, the FOMC seems poised to modify forward guidance at the next meeting, which concludes on March 18. Stay tuned.

Despite improving fundamentals in the US and policy rate hikes later this year, the potential backup in US bond yields is likely to be fairly benign. The spread between the UST and German 10-year is currently at a record wide, highlighting the attractiveness of Treasury debt along with a stronger dollar. These factors are compounded by a global deflationary undertow and compressed term premium, suggesting that the magnitude of any backup in rates at the long end of the curve will be contained. The upcoming Fed hiking cycle is likely to closely resemble the 2004-2006 period. The bear flattening that proceeds will be driven by higher short-dated yields with only a marginal impact on long-term rates.

## Emerging Markets (EM) Government Bonds

Hard currency emerging market debt (USD and EUR) performance has continued to improve, as central banks around the world appear harmonized in easing monetary policy. 21 central banks have eased policy this year (half of which are EM countries) in an effort to stifle deflationary trends and mitigate the effects from a weaker euro and yen. Overall, US dollar-denominated EM debt gained 0.40% last month (+1.5% YTD). That said, the disparity in performance across the EM landscape remains wide. While Venezuela enjoyed a sharp improvement in USD bonds last month (+19.5%), persistent turmoil in Eastern Europe fuelled a 20% decline in Ukraine sovereign debt. Citi analysts have reiterated their concerns over evolving political dynamics, idiosyncratic macro events, declining energy prices, and heightened currency volatility, which require investors to become more discerning. Citi analysts continue to favour hard currency debt over local currency, as FX volatility is expected to persist. Though hedging can offset some risks associated with these markets, it can also substantially haircut the benefits of enhanced carry.

Asia continues to be Citi analysts’ most-favoured region in both USD debt and local currency markets. Central banks are largely easing and lower oil prices are having a positive economic effect on the region (especially north-Asia). More importantly, as bond purchase programs by the ECB and Bank of Japan keep core rates moving toward zero, investors are likely to remain persistent in their search for higher yields. Indeed, Asian USD investment grade bonds may offer an additional yield over US issuers – and even more attractive when compared to euro denominated securities. Citi analysts remain cautious on the EMEA region. The Russia/Ukraine conflict is fragile, and regional bank deleveraging could constrain credit access to eastern European countries. In Latin America, Citi analysts continue to avoid Venezuela. However, aggressive investors with a longer view should consider selective exposures in Brazil.

**Investment Grade Corporate Bonds**

Spreads in US and European high-grade corporates compressed meaningfully last month. US credit outpaced euro-denominated corporates, with spreads declining by 15bp vs. 8bp, respectively. Despite heavy new supply YTD, spread performance has been supported by solid 4Q14 earnings, strong fund inflows, and Bank of Japan /ECB quantitative easing. That said, for the last six months the relationship between USD and EUR credit markets had been decoupling, reaching its widest levels in six years. This has been fuelled by Fed and ECB monetary policy moving in different directions. Given more attractive yield propositions in the US, and inflows supported by a weaker euro, Citi analysts expect this differential to compress. This supports the relative value recommendation introduced last month, favouring USD over EUR corporates. Though non-financial fundamentals have somewhat weakened, the key near-term risk remains the direction of risk-free rates. Despite the recent tightening of US spreads, indices declined by 1.0% (since 10-year UST yields increased 50bp). Citi analysts are neutral duration in the US and remain more comfortable with long-duration exposures in Europe.

**High-Yield (HY) Corporate Bonds**

US and European high yield continues to outperform as stabilizing oil prices dampen volatility in the energy sector. Since the oil price bottomed in late January, USD and euro HY spreads have tightened by 55bp and 85bp, respectively. Moreover, US HY yields have dipped below 6.0% -- their lowest levels since November 2014 (energy sector yields declined from 9.0% to 8.0%). While European HY index composition is quite different (no energy exposure, shorter duration), yields continue to breach new lows, currently near 4.0%. Both markets have gained over 3.0% YTD. Despite stable fundamentals (ex-energy) and a return to positive bond fund flows ($6.7bln in US HY inflows YTD), the price of oil is Citi analysts' biggest concern. In their view, if oil prices decline sharply, positive momentum will reverse course. Although current market positioning may not be as crowded (i.e., in energy), spreads will likely widen. Citi analysts maintain a quality bias, favouring relative value in higher-quality Single-B and Double-B credits. Given their positive fundamental view on the sector, any sharp corrections that improve valuations should be viewed as an opportunity to add exposure.

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