Market Outlook

March 2014

Escalating Geopolitical Risks

As a Russian invasion of Ukraine has moved from a “tail risk” to a reality, financial markets have responded predictably to this escalation of geo-political risk. Global equity markets have been sharply hurt, particularly European shares, where economic linkages to Russia are larger than elsewhere. U.S. Treasury yields, after rising significantly last year, have fallen back as markets de-risk. These moves are all contrary to Citi’s Global Investment Committee longer-term positioning in markets, but reflect in part the recent strength in equity markets and an embedded expectation of unusually low volatility.

Feature

Escalating Geopolitical Risks

Although political tensions have been persistent for months in Ukraine, their impact on financial markets had been so far inexistent due to the local aspect of the crisis. But the events took on a new turn recently, when Russia, rather than stand by and watch, reportedly took over the Ukrainian region of Crimea (a majority ethnic Russian region). With concerns of larger-scale military conflict, parallels with the 2008 war in Georgia, country break-up and Cold War references all surfacing in the press and analyst commentary, Ukraine is now at the center of attention of investors all over the world.

Worse before it gets better

While events in the Ukraine have taken an unpredictable and dangerous turn, Citi's Global Political Analyst thinks that such extreme scenarios as country break-up are no longer a tail risk, and things have the potential to get much worse before they get better. Russia considers its military assets in Crimea as a critical national interest. It is uncertain the extent to which it will press for further control of other parts of the Ukraine. It is also uncertain how far European and U.S. leaders will press to counter Russia and raise its costs for taking action. A miscalculation could take place, but both sides have an idea of the other's end game. However, Citi analysts would not assume worst case outcomes such as a ground war in Europe involving Russian and NATO forces as the incentives to avoid such a conflict are enormous.

Instead, it seems quite plausible that the events in Georgia in 2008 could serve as a template for future events in Ukraine. Russia succeeded in effectively annexing breakaway regions of Georgia in 2008 without driving a larger European conflagration. However, the difference with the Georgian crisis is that the stakes in Ukraine are higher. Its location between Europe and Russia makes it much more of a geo-political hotspot; it is a major transit point for Russian gas flowing to Europe; and its population is a considerable 46m (of which some 17% are ethnic Russians).

What does not help, and is at least partly at the root of the problem, is that Ukraine is faced with a precarious economic situation. The current account deficit reached 9.4% of GDP in 2013 (a total of $16bn, up from the previous year's $14.8bn); while GDP growth was flat (and just 0.2% in 2012). FX reserves have been running below three months of imports for some time now ($17.9bn as of Jan 2014). Capital outflows are likely to intensify, further threatening the FX reserves position. If the Russian economic support package is taken off the table (yet to be confirmed, but seemingly the most likely outcome), the EU and US (primarily through the IMF) will probably step in with alternative support. Whether their support will be enough to stabilize the situation, and whether it will come through quickly enough, is not clear.

Likely impact on markets going forward

In general, markets will probably have to re-price greater geopolitical uncertainty which had largely receded with the easing the tensions between Iran and the US. More specifically and perhaps counter-intuitively, Citi analysts expect more of an impact on Russia than on Ukraine, and, as an extension, on Emerging Markets rather than on Frontier Markets. This is in line with what we have seen in the equity markets so far. Since the protests in Ukraine began in late November 2013, MSCI Ukraine is sharply up; which is not necessarily saying much given the size of the MSCI Ukraine (total market cap of $1.5bn). Meanwhile MSCI Russia (the 7th-largest emerging market) fell 10% in a matter of hours on 3 March, the first trading day after its military advances in Ukraine, on higher than usual trading volumes.

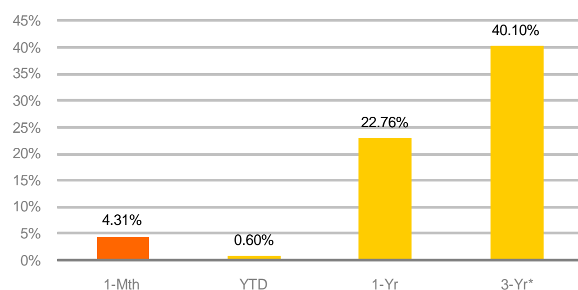
Citi analysts remind that political and geo-political risks are high in frontier markets and should not come as a surprise to equity investors. Ukraine for example, despite being located on the European frontier, and in many respects more advanced than other frontier markets, actually ranks very badly on Citi's frontier markets Governance Grid. Also, there remains a long list of troubled nations and regions where conflicts remain unresolved. Conflict and insecurity coexists with global growth driven by conditions in the regions removed from the conflict. As history shows, past security events on a global scale have rarely coincided with global recessions unless world crude oil supplies have been severely disrupted. Notably, oil and oil producers have benefited from concerns about Russia's supplies. Russia's energy exports to the E.U. could be the largest channel of economic impact in the case of sanctions or an embargo. However, these costs are among the incentives for a resolution on both sides.

Citi analysts continue to believe that risk hedges are priced at attractive levels for many current investors. They don't believe all of the declines in global shares or some credit markets have been seen after early March's rout. However, it remains very possible that events in coming weeks could suggest a walk back from this same concern. Even the status quo in Georgia in 2008 and Syria in 2013/14 left investors to focus back on fundamentals in other regions. Similarly, it will not take a perfect resolution of risks in Ukraine for global recovery to continue.

United States: Rate hikes are not expected until later in 2015

- Disruptions caused by extreme winter weather have reinforced a temporary slowing in growth following an unsustainable burst in activity in the second half of last year. The updated forecast shows a resumption of above-average growth through 2015 with unemployment dropping to near 6% this year and inflation staying low but edging above 1.5%. With fiscal drag dissipating, the economy has key supports from still ample resource slack and a strong financial tailwind.
- Monetary policy prospects remain unchanged as the Fed continues to shift the focus of accommodation from asset purchases to anchoring forwards. Officials have set high hurdles for altering a gradual tapering of QE, but preparations for rate hikes are not anticipated until 2015 spring, with modest tightening beginning that summer.
- Shifting to equities, despite underperformance over the past six and 12 months, the S&P 500 Energy group has experienced very little respite in 2014. With higher oil and gas prices, some might have expected a better trend, though it appears as if transitory weather conditions are being assumed and geopolitical risks as well as China concerns may be undermining investor confidence.
- It is important to recognize that Citi's forecast for oil prices has been lifted marginally of late with WTI oil prices expected to average $103 per barrel this year and $95 next year. Since oil and gas prices historically have been key to company earnings and their shares, one cannot expect much upside.
- Another point to consider is the EM effect. Should economic patterns continue to deteriorate in some emerging economies, one could see further downside pressure on energy prices especially given drilling activity in the US. Indeed, Citi analysts are neutral on this sector and expect 1H14 weakness followed by 2H14 strength but relatively flat conditions over the course of the year.

Chart 1: S&P 500 Index

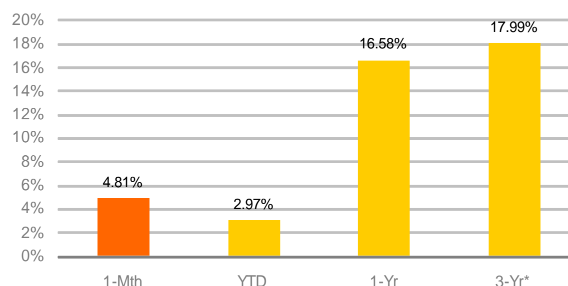


*Denotes cumulative performance
Performance data as of 28 February 2014
Source: Bloomberg

Euro-Area Modest recovery could continue

- At 0.3% QoQ, euro area Q4 GDP growth was slightly stronger than consensus expectations, and confirming a modest re-acceleration in the pace of growth after a temporary slowdown to 0.1% QoQ in Q3.
- With survey evidence continuing to point to a largely similar performance in Jan/Feb, Citi analysts expect another 0.3% QQ gain in 1Q-14. Together with little evidence of much improvement in credit dynamics, Citi analysts doubt that the overall picture has changed sufficiently for the ECB to alter its assessment that the balance of risks to economic activity continues to lie to the downside.
- Looking ahead to the March 7 ECB meeting, Citi analysts believe that the Governing Council may cut its main refinancing rate by 15bp to 0.1%, but leave its deposit rate at 0%.
- With the valuation gap between cheap and expensive stocks close to 25-year lows, Citi analysts believe that earnings leadership/momentum may be a key driver of price leadership within European equities in the coming 12-18 months.
- With interest rates low and with ongoing investor demand for income, Citi analysts also believe that companies generating high and/or surplus free cash flow (FCF) can also perform well in the coming 12- 18 months.
- Both Basic Resources (Mining) and Utilities score well on earnings momentum delta and FCF delta. The FCF improvement for both sectors is being driven by significant reductions in capex. Citi analysts stay Overweight Basic Resources. They are raising Utilities to Neutral, which they have been Underweight for most of the last 5-6 years. Meanwhile, they stay Underweight Oil & Gas as the FCF improvement trend in the sector is weaker and more selective.

Chart 2: DJ Euro Stoxx 600 Index



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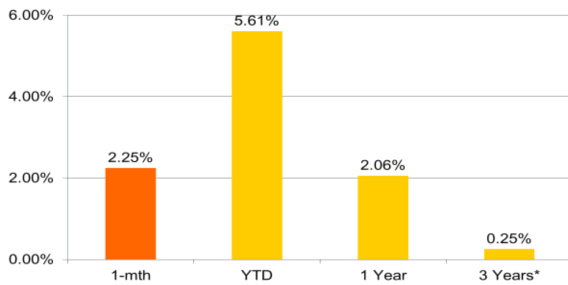
Performance data as of 28 February 2014
Source::: Bloomberg

Equities Markets

Chart 3: MSCI Asia Pacific Index



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Performance data as of 28 February 2014
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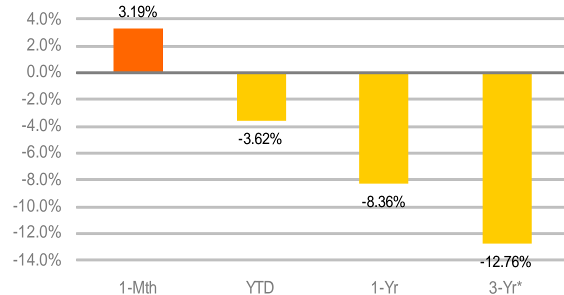
Chart 4: MSCI Emerging Markets Index



*Denotes cumulative performance
Performance data as of 28 February 2014
Source::: Bloomberg

Japan

BoJ could implement additional easing around summertime

- The Japanese economy already appears to be undershooting the BoJ's relatively bullish scenario. First, export volumes have remained range-bound since last summer despite the earlier yen depreciation. Virtually flat growth in Asia, along with an increasing share of overseas production at Japan's manufacturers, is probably capping export growth. Second, if adjusted for ongoing frontloaded demand ahead of the consumption tax hike in April, consumer spending also appears lacklustre. The substantial rise in the CPI driven by yen depreciation has eroded real purchasing power of household nominal income badly. In addition, the 3%-point consumption tax hike likely may lift the core CPI by 2% in the context of only modest growth in wages.

- Citi analysts continue to expect the BoJ to implement additional easing, centered on increased purchases of JGBs, in June or July after having confirmed the negative impact from the tax hike. The BoJ's fresh easing may likely drive renewed yen depreciation and a resultant rally in Japan's equity markets later this year.

Asia Pacific

Fared relatively well in the recent EM selloff

- The region withstood the recent EM sell off relatively well. Growth forecasts are largely unchanged but sentiment improved markedly in Indonesia following the narrowing of the current account deficit. Export performance is mixed in Asia with the exception of Malaysia and Philippines. Lunar new year and US winter blues could keep policymakers on hold for now, with Thailand remaining a growth underperformer amid protracted political turmoil.

- Over in China, while economic data suffer from holiday-related distortions at the beginning of the year, information available so far indicates further softening of economic activity, although the downside risk appears to be mitigated by strength of external demand and steady growth of credit. The current level of output growth may not trigger policy loosening yet.

Emerging Markets

Further currency pressure expected

- Within Emerging Europe, Turkey, having hiked more aggressively, promises a more rapid adjustment process than South Africa. Meanwhile, pressure on currencies where current account deficits are not a threat — Russia, eg — is unlikely to disappear. There, the concern is about the absence of growth rather than the presence of a deficit.

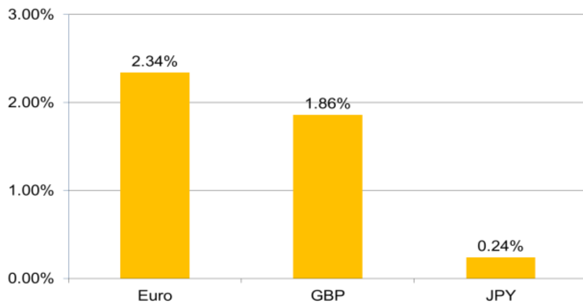
- Following a contraction of 5.6% yoy in 2012, EM Europe EPS is expected to contract further by 0.7% in 2013, and only rebound very modestly in 2014 (3.3%). As such, the EPS growth outlook is the weakest amongst the three EM regions. In terms of valuations, the region's PE multiple of 8.7x (2014E) is at a discount to the rest of EM. However, this is largely due to Russia's extremely low PE of 5.5x 2014E. Citi's MSCI EM EMEA target for end-2014 is 358and preferred market remains Russia.

- From an FX point of view, EM Europe currencies in particular, RUB and TRY are forecast to remain under pressure. Deficits are large and in some cases still growing, with weak growth and rising inflation. At the same time, the Latam region is littered with twin deficit currencies – BRL, CLP and COP – that have made little progress on addressing macro imbalances. Most are also intensely exposed to commodity prices, where Citi analysts forecasts remain bearish.

- Within LatAm, recent activity prints have come softer in Brazil and Mexico. Thus, Citi analysts have reduced their forecast for 2014 GDP growth in Brazil to 1.3%, although continuing to see activity growing 3.8% this year in Mexico. In Argentina and Venezuela, growth continues to trend down while inflation escalates. The scarcity of foreign currency has been worsening in both countries.

- As for LatAm equities, Citi analysts are expecting reasonable EPS growth both for Mexico and Brazil in 2014E at 9% and 17% respectively. They prefer Mexico to Brazil as the region has the best exposure to an improving US. In particular, selected consumer stocks and REITs are favoured based on acceleration of growth into 2014..

Chart 5: Currencies (1Mth vs US Dollar)



Performance data as of 28 February 2014
Source::: Bloomberg

Currencies

- Citi analysts expect EUR to hold up or trade higher even against the USD, implying noticeable gains vs. weak currencies such as JPY and some EMs. In Citi analysts view, the medium-term driver underpinning the single currency remains the EA's broad balance of payment (BBOP) position. In addition, portfolio and direct investment flows are also positive for the currency. Overall, Citi analysts medium-term forecasts are unchanged with 1.40 still the 6-12 month target.

- Notwithstanding disappointing December labour market data, the cyclical upturn in the UK still looks strong, led by housing, consumer spending and business investment. Given this momentum, Citi analysts believe that the first rate hike could occur in 4Q14 despite the BoE suggesting that rates hikes are unlikely before 1Q15. Over 0-3 months, therefore, Citi analysts expect generalized sterling appreciation to continue with EUR/GBP 0.80 and GBP/USD 1.71 penciled in. Looking out to 6-12 months, however, there are a few risk factors that GBP bulls should probably consider. One is the UK current account which continued to deteriorate sharply. Another is political risk. Within the 6-12 months horizon will come the September 2014 Scottish Independence Referendum and the UK General Election of May 2015 will be looming.

- Citi analysts continue to expect additional BoJ easing around mid-year once sales tax effects are clearer and again in 2015 well after QE stops in the US. Medium term, this monetary ease should push JPY weaker. The often shown relationship between USD/JPY and the ratio in respective monetary bases suggest 'fair value' at around 105-110 for end 2014. And since our economists now also expect a further Y60-70trn of ease in 2015, assuming no new QE from the Fed, pushes implied USD/JPY levels even higher further out. Specifically, Citi analysts expect 105 in 0-3 months, 107 in 6-12 months and 115 in the long term.

Positive on High Yield

US Treasuries

Citi analysts think that fundamental improvements in the economy in 2014 maybe more significant than 2013, but that Treasury yields may rise much more modestly. Citi's rationale is that much of the rise in Treasury yields in 2013 was a 'normalization' of yields from levels which were well below fundamental fair value. Citi analysts have also slightly lowered their yearend 10yr Treasury yield expectation from 3.3% to 3.2%.

Euro Bonds

Citi analysts now expects a 15bp cut in the ECB refi rate at the March meeting and a 10bp deposit rate cut later in the year. Such loosening of monetary policy is likely to remain supportive for the lower-for-longer theme in core EMU rates markets. 10yr Bunds have averaged 1.74% so far over 2014 and Citi analysts do not expect a substantial deviation of Bund yields from the current levels in the coming three quarters. Meanwhile in UK, Citi analysts have brought forward the first rate hike to 4Q14 (previously 2Q15). This suggests that gilts should underperform on a cross-market basis and finally de-couple from Treasuries (for the 10yr gilt-Treasury spread, Citi analysts target +30bp in H2 2014).

IG Corporates

Despite generally strong fundamentals and bond fund inflows, the threat of higher interest rates remains a principal concern for high grade returns this year. Thus, Citi analysts continue to favour defensive duration exposure (3-7 years) and financials over non-financial debt (with a focus on US and core EU bank / insurance issuers).

High-Yield

Citi analysts maintain a constructive view on the High Yield sector despite the heightened risk aversion reflected by volatile equity and FX markets. While "risk-off" periods have historically correlated with credit spread widening (and bond fund outflows), Citi analysts expect strong fundamentals in HY to prevail once market conditions normalize.

Emerging Market Debt

Prevailing fiscal stress and deteriorating current account balances reflect weaker fundamentals. This typically fosters an environment of depreciating currencies and wider credit spread. As such, Citi analysts remain underweight EM debt and prefer to focus on short duration opportunities and limit exposure to high-quality credits.

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