International Personal Bank

Interest rates around the world moved sharply higher, as low-yield fatigue, disappointing US data and EUR strength triggered a counter-trend sell-off exacerbated by crowded positioning. Yields on long-dated US Treasury and German Bunds rose 50bp over the course of several weeks, driving negative return performance in many high-quality fixed income markets.

Citi analysts remain bearish on core government bond markets, though the extent of the current sell-off appears overdone, in their view. Citi analysts would like to see further improvement in economic data before seeing rates push higher from here. Indeed, recent data in the US has been weak, as economic surprise indices remain near historic lows. In Europe, deflation concerns have faded and upward growth revisions by the European Commission are encouraging. While growth remains substandard, Citi analysts believe an accommodative European Central Bank (ECB) and a healing banking system should support further improvement over time. Citi analysts would avoid near-zero yields in core Eurozone markets and remain deeply underweight German Bunds.

US high yield corporate debt has been one of the few bright spots in fixed income over the last month. Benefitting from the 50% increase in WTI oil prices, US high yield has outperformed the broad fixed income market by 270 basis points. Citi analysts maintain their high conviction.

Sectors	12 Months View		Investment Rationale
Dev. Market (Core) Sovereigns	**Underperform**		Citi analysts remain bearish on core government bond yields, though recent sell-off is overdone; neutral US Treasury duration; underweight core Euro Zone debt
EU Periphery Sovereigns*	**Outperform**		Expect further spread compression post Greece resolution, though volatility likely to persist; favour Spain and Portugal
Emerging Market Sovereigns	**USD**	**Outperform**	Favour external debt markets over local debt markets, as FX volatility to persist; Asia remains 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; financials remain attractive, especially subordinated debt
High Yield Corporates	**Outperform**		Prefer high quality B- and BB-rated credits; yield opportunities in USD-denominated issues, favours both US and Asia

**EU Periphery Sovereigns include bonds from Greece, Ireland, Italy, Portugal and Spain.*
Source: Citi analysts 14/04/15

Developed Markets Government Bonds

Interest rates around the world moved sharply higher over recent weeks, as low-yield fatigue, disappointing US data and EUR strength triggered a counter-trend sell-off exacerbated by crowded positioning. Long-dated US Treasury yields rose to year-to-date highs, with 30-year maturities moving through 3.0% for the first time since December 2014. The long-bond price has now declined nearly 10% over the last three months, bringing overall returns in US Treasury debt to roughly zero, for the year.

While Citi analysts have been bearish on US rates for some time (and remain so), the extent of the current sell-off appears overdone, in their view. Positive US inflation reports (e.g., employee cost index) and continued improvement in the US labour market support higher rates. That said, increasing apprehension over the pace of the economic recovery is concerning. Therefore, Citi analysts would like to see further improvement in economic data before seeing rates push higher from here. Indeed, economic surprise indices remain near historic lows.

Assuming the Fed's base case views are generally confirmed, Citi analysts expect policy tightening to begin toward the latter half of the year. Citi analysts maintain their neutral duration view (current US Treasuries market duration is ~5.5 years). Moreover, even if returns are negative, Citi analysts would still value them as a portfolio hedge in broader asset allocation.

In the Eurozone (EZ), the sell-off in German Bunds has been quick and sharp. After reaching a historical low of 0.075% last month, 10-year Bund yields spiked to a high of .76% on May 14, with the 2s10s yield curve severely steepening by 50bp. Indeed, this was fastest sell-off in German rates since the introduction of the euro in 1995.

While stretched valuations, crowded trades and less liquid markets were likely responsible for the breadth of the sell-off, some economic improvements justified the direction. Deflation concerns have faded and upward growth revisions by the European Commission are encouraging. Though growth remains substandard, Citi analysts believe an accommodative ECB and a healing banking system should support further improvement over time. While regulatory requirements may mean banks must hold negative yield bonds, we advise investors to generally shun these investments. Citi analysts maintain their underweight position on core EZ government debt.

Alternatively, Citi analysts maintain their high conviction on EZ periphery debt which have outperformed throughout the recent volatility. Yields have moved higher, but spreads (to Bunds) have compressed. That said, volatility is likely to remain until there is a resolution on Greece. Citi analysts believe a new program will be agreed upon, but only after capital controls are imposed. Citi analysts favoured EZ markets are Portugal and Spain.

Emerging Markets (EM) Government Bonds

In spite of the recent sell-off in core government rates, returns in US dollar denominated emerging market (EM) sovereign debt have held up relatively well. Since the 3.2% decline in 10yr US Treasury debt – beginning April 17 – USD EM lost a more modest 0.8%. The resilience is even more impressive in euro markets, where euro EM declined 1.0% over the same period, despite a 13.8% collapse in long-dated German Bunds. The outperformance should not be all that surprising, as there was not a material change to the fundamental EM outlook. While the macro environment in LatAm and EMEA remain tenuous, Asia continues to benefit from the decline in oil prices and subdued inflation prospects. Chinese policy remains supportive and Japan continues to run the world's largest QE program. Indeed, 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, especially in the corporate bond market. Asia high-yield valuations are attractive versus Triple-B rated issuers, and Asia high-grade (HG) corporates remains 100bp wider than US HG equivalents.

Investment Grade Corporate Bonds

Citi analysts' biggest concern in the high grade (HG) corporate market over the last several quarters has been the asset's dependence on the direction of core government rates. Over the last month, returns in both the US dollar and euro markets declined by 2.6% and 1.7%, respectively, following the sharp rise in Treasuries and German Bunds. This brought year-to-date performance to roughly zero. In Citi analysts' view, there has been no fundamental shift in their outlook on HG credit. Yields have become relatively more attractive (>3.0% in US corps), spreads have generally moved sideways for the last several months (still tighter on the year), and new supply continues at a robust pace. Moreover, Citi analysts argue whether economic data fully supports the extent of the rise in long-dated core sovereign bond yields. Though improving, the pace of US growth has been questioned and inflation expectations remain relatively benign. Citi analysts would expect any retracement in rates to benefit the near-term performance in HG. That said, they believe recent market movements will become more frequent. The size of the HG corporate bond market has grown significantly over recent years, as bank dealer's willingness to assume risk has declined While "buy-and-hold" investors may be rewarded with higher yields in less liquid, "off-the-run" bonds, Citi analysts would prefer giving up a few basis points for larger, benchmark-size issues which trade more frequently.

High-Yield (HY) Corporate Bonds

US high yield (HY) corporate debt has been one of the few bright spots in fixed income over the last several months, despite sharp declines in core government bonds yields and bond mutual fund outflows ($3.5 billion outflow over the last two weeks). Benefiting from the 50% increase in WTI oil prices (energy makes up 17% of the US HY market), high yield corporates gained 140bp since the beginning of April, while the broader fixed income market fell 1.3%. Indeed, HY energy has rallied 5.3% over the same period, while HY ex-energy still gained 0.5%. In Europe, HY flows also slowed and recent performance is slightly negative. That said, euro HY has still outperformed euro HG by over 100bp. Citi analysts' favourable view on US and European HY has not changed, though they prefer the higher absolute yields in USD denominated markets. This includes Asia, where index yields are close to 6.5%. The regional momentum in monetary policy remains committed toward easy credit, which has provided comfort for investors to add risk. Liquidity remains strong, rating agency trends are positive and default rates are among the lowest of all EM regions. More notably, the yield gap between triple-B rated and double-B rated Asia credit remains wide, offering investor's potential value when considering moving down in credit quality.

Important Information

“Citi analysts” refers to investment professionals within Citi Research (“CR”), Citi Global Markets Inc. (“CGMI”) and voting members of the Citi Global Investment Committee. For important disclosures concerning companies covered by Citi's Equity Research analysts, please refer to the attached link: https://www.citivelocity.com/cvr/eppublic/citi_research_disclosures.

This document is based on information provided by Citigroup Investment Research, Citigroup Global Markets, Citigroup Global Wealth Management and Citigroup Alternative Investments. It is provided for your information only. It is not intended as an offer or solicitation for the purchase or sale of any security. Information in this document has been prepared without taking account of the objectives, financial situation or needs of any particular investor. Accordingly, investors should, before acting on the information, consider its appropriateness, having regard to their objectives, financial situation and needs. Any decision to purchase securities mentioned herein should be made based on a review of your particular circumstances with your financial adviser.

You should be aware that there may be additional risks associated with international investing, including foreign economic, political, monetary and/or legal factors, changing currency exchange rates, foreign taxes, and differences in financial and accounting standards. These risks may be magnified in emerging markets. International investing may not be for everyone.

With respect to fixed income securities, please note that in general, as prevailing interest rates rise, fixed income securities prices will fall. High Yield bonds are subject to additional risks such as increased risk of default and greater volatility because of the lower credit quality of the issues.

Investments referred to in this document are not recommendations of Citibank or its affiliates. Although information has been obtained from and is based upon sources that Citibank believes to be reliable, we do not guarantee its accuracy and it may be incomplete and condensed. All opinions, projections and estimates constitute the judgment of the author as of the date of publication and are subject to change without notice. Prices and availability of financial instruments also are subject to change without notice. **Past performance is no guarantee of future results. Investment products are (i) not insured by any government agency; (ii) not a deposit or other obligation of, or guaranteed by, the depository institution; and (iii) subject to investment risks, including possible loss of the principal amount invested.** All forecasts are expressions of opinion, are not a guarantee of future results, are subject to change without notice and may not meet our expectations due to a variety of economic, market and other factors.

The document is not to be construed as a solicitation or recommendation of investment advice. Subject to the nature and contents of the document, the investments described herein are subject to fluctuations in price and/or value and investors may get back less than originally invested. Certain high-volatility investments can be subject to sudden and large falls in value that could equal the amount invested. Certain investments contained in the document may have tax implications for private customers whereby levels and basis of taxation may be subject to change. Citibank does not provide tax advice and investors should seek advice from a tax adviser. Citibank N.A., London Branch is authorised and regulated by the Office of the Comptroller of the Currency (USA) and authorised by the Prudential Regulation Authority. Subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details about the extent of regulation by the Prudential Regulation Authority are available from us on request. Our firm reference number with our UK regulators is 124704. Citibank International Limited is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority. Our firm reference number with our UK regulators is 122342. Citibank N.A., London Branch is registered as a branch in the UK at Citigroup Centre, Canada Square, Canary Wharf, London E14 5LB. Registered number BR001018. Citibank International Limited has its registered office at Citigroup Centre, Canada Square, Canary Wharf, London E14 5LB. Registered number 01088249. In Jersey, this document is communicated by Citibank N.A., Jersey Branch which has its registered address at PO Box 104, 38 Esplanade, St Helier, Jersey JE4 8QB. Citibank N.A., Jersey Branch is regulated by the Jersey Financial Services Commission. Citibank N.A. Jersey Branch is a participant in the Jersey Bank Depositors Compensation Scheme. The Scheme offers protection for eligible deposits of up to £50,000. The maximum total amount of compensation is capped at £100,000,000 in any 5 year period. Full details of the Scheme and banking groups covered are available on the States of Jersey website www.gov.je/dcs, or on request. Citibank N.A. is incorporated with limited liability in the USA. Head office: 399 Park Avenue, New York, NY 10043, USA. Calls may be monitored or recorded for training and service quality purposes.