



Citigold

Market Outlook

May 2016

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Could Commodities be a Catalyst for Optimism?

As we head into mid year, the main underlying market themes have not really changed much. Emerging market growth continues to threaten the global economy, and investors are questioning whether central banks have the tools to deal with the challenge. The resulting low yield and high volatility environment is also taking a toll on sentiment. Commodity prices are interwoven right through the narrative. However, there may be some cause for cautious optimism.

Indeed, the outlook for commodities has notably improved in the past few months, and this seems to be having a calming influence on markets. Citi expects a better outlook for the second half of the year, but uncertainty and heightened volatility in the markets through 1Q and into 2Q may have prevented this from being reflected in the broader risk environment. Nevertheless, Citi commodities team sees scope for oil to rebound towards \$60 by 2017, which may be the catalyst for a shift in sentiment.

Macro Overview

- **US:** 1H16 slowdown may dissipate slowly; Expect one Fed policy rate hike this year, likely in Sep.
- **Europe:** Additional monetary policy support likely in Sep; UK referendum uncertainty poses a key risk.
- **Japan:** Further easing measures expected (policy rate from -0.10% currently to -0.3%) in July.
- **Asia:** Growth remains challenging as trade recovery is elusive. China's stable FX policy and Fed dovishness have reduced capital outflow pressures, which has boosted the room to ease for some CBs.

Equities: Slightly Overweight

- We suspect that global equities are trapped in a trading range, with the downside limited by yield attractions and the upside capped by the mediocre EPS outlook. Our MSCI AC World end-2016 target of 490 reflects a reduction in our top-down EPS growth forecast for 2016 to 3%.

Bonds: Slightly Underweight

- **High Yield:** Valuations still attractive, though volatility expected to remain.
- **EM Debt:** Decline in volatility and dovish Fed may support local EM Debt in the near-term.

Commodities: Neutral

- **Gold:** Positive momentum may fade into 2H16.
- **Oil:** Prices look to have bottomed.

Currencies: Weak USD In No Man's Land

- **GBP:** EU Referendum Continues To Dominate.
- **EUR:** Could We Break Up From The 1.05-1.15 Range?

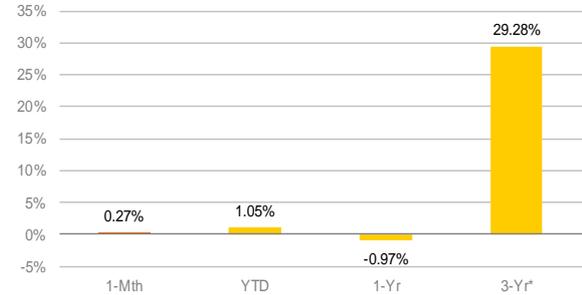
Equity Markets and Commodities

United States

Next Fed hike likely postponed to Sep

- Citi analysts downgraded our outlook for 2016 and 2017 growth (from 2.1% to 1.7% and from 2.4% to 2.1%, respectively) to reflect reduced momentum at the start of this year and more persistent drag from transitory factors.
- Inflation also remains subdued, as the apparent pickup in consumer price inflation earlier this year may have stalled. We continue to believe that there may be only one rate increase this year — likely in September — and the rate hike could be pushed back in the event of financial market volatility or if growth disappoints.
- We expect S&P 500 EPS to grow 4.9% in 2016, recognizing that by mid-year, the FX translation hits should mitigate and the same is likely to be true for Energy sector profits. The better profits environment should provide a constructive backdrop for stocks in the long term. However in the near term, we envision restraints owing to expected EBIT margin pressures, the impact of additional Fed rate hikes and political plus geopolitical uncertainties.

Chart 1
S&P 500 Index



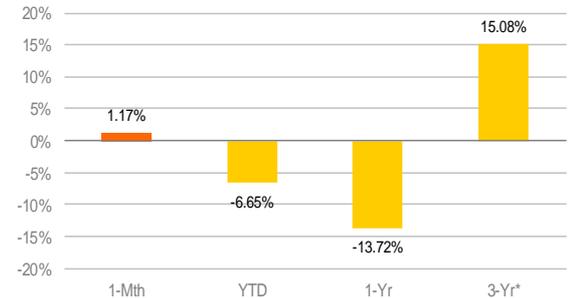
*Denotes cumulative performance
Performance data as of 30 April 2016
Source: Bloomberg

Euro - Area

Economy expanding at modest rate

- Citi's forecast is that real euro area GDP may grow at an annualized rate of 1.8% in 1Q16, which would represent the highest reading since the 2.3% gain in 1Q15. Evidence is growing that ECB actions in 2H15, supplemented by the comprehensive package announced in Mar-16, are having some effects on the transmission of the loose monetary policy stance to the real economy.
- We continue to look for the ECB to deliver further monetary policy stimulus in September, unless the economic picture and inflation developments were to surprise noticeably to the upside.
- The improvement in Europe ex-UK EPS has reversed somewhat in recent months. We have cut our 2016-17E EPS growth forecasts to 0-5%. This reflects our base case of no "synchronised and significant" regional or global recession in 2016-17E. Nevertheless, Citi credit strategists see the ECB's actions supporting tighter credit spreads in 2H16; which should support European equities.

Chart 2
Dow Jones Stoxx 600 Index



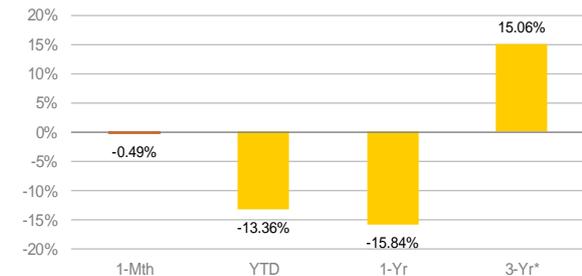
*Denotes cumulative performance
Performance data as of 30 April 2016
Source: Bloomberg

Japan

More BoJ easing measures expected in July

- Citi analysts currently expect the BoJ to ease policy again at its July meeting after the Upper House election. Specifically, we think the BoJ may cut the policy rate from -0.10% currently to -0.3%, while expanding the size of the Loan Support Program.
- Meanwhile, the recent Kumamoto earthquake has also further increased the likelihood that the planned consumption tax hike for 2017 could be postponed.
- From an equity perspective, we forecast EPS growth of +2.7% in FY16. The windfall from last year's yen depreciation is set to drop out, meaning growth may slow sharply, especially in external-demand and high-tech sectors.

Chart 3
Topix Index



*Denotes cumulative performance
Performance data as of 30 April 2016
Source: Bloomberg

Emerging Markets (Asia, CEEMEA and Latam)

Weakness in USD may prove beneficial

- The early part of 2016 proved to be a volatile period for EM but the region managed to pull through with a 5.4% gain in 1Q16. For the near term we expect further weakness in the US\$ may remove one of the major headwinds for EM equities.
- Over the last few years, earnings in US\$ terms have been declining and the equity markets have followed suit. There is a large earnings divergence within EM, with LatAm 68% and EMEA 55% down from the pre-GFC peak vs. Asia up 16%. EPS in EM is forecast to grow at 4.7% in 2016 (consensus), the lowest level since 2010.
- Albeit the structural problems EM economies still face, we think a lot of bad news is already in the price. On a PBV basis, EM is trading at a 28% discount to global. In terms of CAPE, EM is at 1.3sd below 20-year mean. On a PBV basis, LatAm ranks the most expensive at a little below historical average while Asia and EMEA are around a full sd below mean. On a PE basis, LatAm is most expensive followed by EMEA then Asia.

Gold

Positive momentum may fade into 2H16

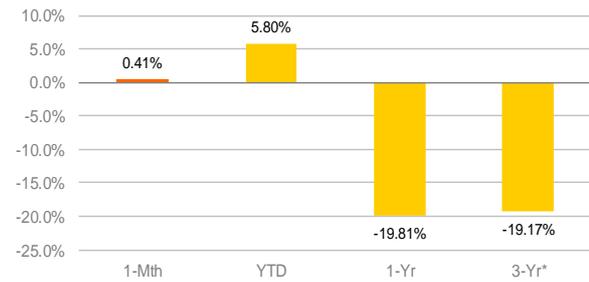
- Spot gold has traded within a tight range since March. The inverse correlation to the US dollar has deepened recently while correlations to equities and other risk assets have weakened, suggesting that the gold market has reverted to more 'normal' price drivers as risk aversion has faded.
- These influencing factors may include an updated Fed outlook which has become a bit more dovish in recent months just as volatility has come in across most other asset markets.
- We expect positive gold price momentum to continue to fade into the second half of the year as oil prices continue to recover. An increase in oil prices should boost sentiment on risk assets such as equities and EMFX and reduce investor appetite for safe-haven products including gold.

Oil

Prices look to have bottomed

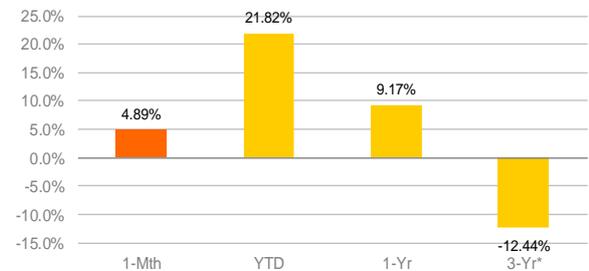
- Low prices are finally leading to sustained supply declines, which should mean that oil inventories can begin to draw down over 3Q16, the first quarter to do so since 4Q13.
- Additionally, further geopolitical supply disruptions have tightened up markets more than expected in the short-term, in Nigeria, Iraq, Colombia, and most recently, briefly in Kuwait with the oil workers' strikes which hit half of the country's 3-m b/d of oil production.
- Due to these factors and macro and financial factors, Citi has raised its 2Q16 and 3Q16 oil price forecasts to \$39 and \$46 for Brent respectively, but is keeping forecasts for 4Q16 onwards unchanged. Citi continues to expect Brent prices in the \$50s by 4Q'16, and averaging \$60 in 2017 in the base case.

Chart 4
MSCI Emerging Markets Index



*Denotes cumulative performance
Performance data as of 30 April 2016
Source: Bloomberg

Chart 5
GOLDS Commodity Index



*Denotes cumulative performance
Performance data as of 30 April 2016
Source: Bloomberg

Chart 6
Brent Oil



*Denotes cumulative performance
Performance data as of 30 April 2016
Source: Bloomberg

Bond Markets

Overweight investment grade and high yield corporate debt

US Treasuries

- We maintain our high conviction for extending duration in high quality, US dollar fixed income. Treasury yields are attractive versus other developed bond markets and inflation expectations are likely to remain low.

High Grade Corporates

- In US, High quality energy spreads look attractive, though likely to remain volatile, and we still favour subordinated financials.
- In Citi's view, best opportunities in Euro credit are in the periphery, where the lift from ECB QE also favour being long-duration.

High-Yield

- We remain overweight both US and European high yield debt.
- Despite the rise in oil prices, defaults in the energy sector are still likely to rise. Opportunities exist in higher rated HY energy issuers, though selectivity is key.

Emerging Market Debt

- Though the decline in market volatility may support further gains in local currency markets, we prefer hard currency EM debt over the longer term. Although our conviction for US dollar strength has moderated, eventual tightening of US monetary policy remains a headwind for EM FX.
- We favour select markets in Latin America, though downside risks of a short-term technical correction have increased. We favour opportunities in Argentina and Brazil, in both sovereign and select corporates.

Euro Bonds

- Interest rates in the Euro zone are anaemically low, and are likely to stay that way. 10-year Bunds are barely positive at 0.1%. The strong technical imbalance created by monthly ECB QE bond purchases is expected to keep net supply negative all year. Indeed, 40% of all Euro zone sovereign debt already yields less than zero.
- This dynamic may keep long-dated yields low (or lower), as investors are forced to extend duration for positive yields. In our view, best opportunities exist in EZ periphery markets.

Japan Bonds

- A further rate cut looks likely in the not-too-distant future given the prospective inflation shortfall relative to the BoJ's bullish forecasts, with the July action being our base case scenario.
- We witnessed the relatively sharp sell-off of the super-long sector recently after the rapid declines in the yields. However, we expect yields may settle down again if, as we anticipate, markets start pricing in a further rate cut in this summer.

Asia Bonds

- In Asia HY, performance has been flat since the beginning of the year, bouncing within a -1.0% to +1.0% range, ignoring the volatility in local equity markets.
- This is much different than the moves we saw in 2015, where China HY moved up +7.5% from the initial CNY devaluation in August through year-end. However, as we noted previously, further local currency weakness would make external debt obligations more expensive to finance, hurting HY issuers.

Currency

Weak USD In No Man's Land

Despite better sentiment in risk assets, recovery in EM asset markets, higher core inflation in the US and firmer commodity prices, Citi analysts have downgraded their outlook for the US economy. As a result, expectations for an imminent acceleration in Fed tightening remain depressed and USD sentiment is likely to remain soft.

EUR: Could We Break Up From The 1.05-1.15 Range?

- Despite divergent policy in recent months, EUR stubbornly remains near the top of its 1.05 – 1.15 range and so long as US growth remains mediocre and USD sentiment remains soft, it is unlikely EURUSD may fall below the bottom end of the band.
- Added to that are euro positives such as the euro area's sizeable current account surplus and the ECB now less willing to cut rates that could also encourage further upside in the currency whereas the euro negatives such as renewed strains in Greece, Brexit fallout risk or banking problems in the euro area appear to have become less critical overall.
- Finally, speculative positioning remains short EUR and broader real money hedges may also be triggered were 1.15 to be breached to the upside, possible triggering further upside.

GBP: EU Referendum Continues To Dominate

- The EU referendum is approximately two months away but with polls now leaning slightly more towards 'Brexit' (note Citi still attaches only a 30-40% chance of Brexit) coupled with rising inflation expectations as the era of low-inflation now appears to be over in the UK, skews the risks towards a more sustained rally in sterling.
- This also probably means that in case of a "Brexit" surprise, the downside risks to sterling may not be as great as before, given the improving inflation outlook.

JPY: BoJ Uncertainty

- Citi analysts expect the BoJ may ease in July with the measures likely to be more limited than some in the markets expect. Nevertheless, expectations regarding further monetary easing by the BoJ may still drive up USD/JPY somewhat higher in the near term with higher oil prices also supporting the move.
- But doubts about the efficacy of BoJ's monetary stimulus and a relatively benign Fed in the months ahead is likely to ease the upward pressure on USDJPY later this year.

AUD, NZD & CAD: Gains Seen Limited By CB Easing Bias

- **AUD:** While it may be too early to judge the impact of a higher AUD, as the recent currency appreciation is likely driven by the gains in base metal (iron ore) prices, the RBA is likely to react if inflation and economic activity significantly weakens (as highlighted by the recent weak Q1 CPI result). With the April RBA meeting now considered 'live' for a possible rate cut following the weak Q1 CPI result, the 0.80 area now looks to be a much firmer cap on the currency in the near term.
- **NZD:** New Zealand continues to exhibit low inflation expectations and an elevated currency against a backdrop of subdued dairy prices. Citi analysts expect the detrimental impact on NZ's terms of trade may likely lead to the RBNZ contemplating cutting rates in June. But a soft USD and a general willingness to fade central bank rate cuts suggests little change in NZD/USD overall in the near term.
- **CAD:** The recent surge in oil prices sees USD/CAD breaking significant technical support levels and with our Citi Commodities Team now bullish on oil for the first time in three years, USDCAD is likely to fall further albeit modestly, given CAD's high delta to WTI prices. Restraining CAD's gains however may likely be the BoC's bias to ease, particularly given lingering uncertainty about global growth prospects.

EM Asia: The CNY Upgrade

- More signs of macro stability in China, higher commodity prices, and a weaker USD have all contributed to improving risk appetite that has seen EM FX rallying.
- In the near term, EM FX may continue to benefit but over the medium term, EM fundamentals are not out of the woods yet, and that means currencies should still weaken, though the reversal of the strong dollar trend and higher commodity prices mean that depreciation may not be as acute.

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