Citigold

Market Outlook

November 2015

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Markets getting support from dovish central banks

ECB President Mario Draghi recently signalled that the central bank is likely to increase its stimulus measures at its meeting in December to combat inflation that is running below its target. At the same time, the People's Bank of China (PBoC) announced a 25 bps cut of its benchmark interest rate to 4.35% and a 50 bps reduction in the reserve requirement ratio for its banking sector to 17.50%. Citi analysts continue to expect three more RRR cuts from now into 1H next year.

Finally, despite signs of slowing economic growth and inflation that is running below its target, the Bank of Japan's (BoJ) kept its stimulus measures unchanged on 30 October. Nevertheless, Citi analysts continue to expect further monetary easing by late January 2016, before annual wage negotiations get started next spring, because policymakers appear to be keenly conscious of wage talks.

Macro Overview

- **US:** Economy continues to grow at an above-potential pace; First hike may be in spring 2016.
- **Europe:** Some modest fiscal loosening may support an upswing in domestic demand. Citi analysts raise their 2016 GDP forecasts by 0.1pp to 1.6%
- **Japan:** Economy facing sluggish consumer spending and tepid inflation; Further easing expected by Jan 2016.
- **Asia:** Growth remains challenging; Expect accommodative monetary bias to persist.

Equities: Overweight

- This global bull market is ageing, but not finished. We suspect that the markets have already moved to price in a mild global EPS contraction. Nevertheless, we favour Europe and Japan equities where central banks are supportive and EPS momentum are reasonable.

Bonds: Underweight

- **High Grade:** Valuations appear attractive; Favour financials.
- **EMD:** Remain cautious in both local and US dollar denominated debt.

Commodities: Neutral

- **Gold:** Neutral-to-bearish beyond the 6-12 month horizon.
- **Oil:** Further downside expected over the next 3-6 months.

Currencies: Short Term, USD Moving Inversely To Risk

- **EUR:** Mixed Signals.
- **AUD, NZD & CAD:** Medium Term Weakness.

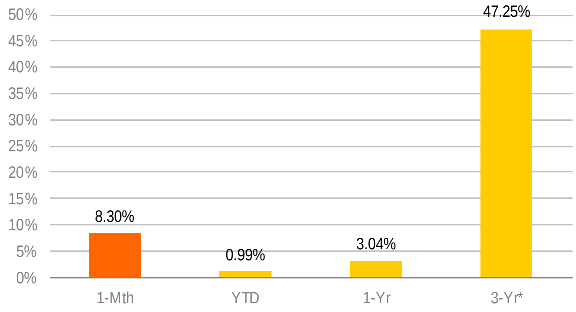
Equity Markets and Commodities

United States

Rate normalization may be delayed until spring 2016

- The economy continues to display healthy momentum, evident in construction activity and consumer spending. The solid gain in motor vehicle sales suggests that consumers are becoming more confident. Third quarter private domestic demand probably expanded by more than 3.5% at an annualised rate.
- The September FOMC minutes confirmed that the decision to delay lift-off was based largely on continued uncertainty about whether inflation would rise to the 2% target in the medium-term. While policymakers expect to tighten this year, financial market volatility and low inflation probably may delay action until the spring 2016.
- From an equity perspective, Citi analysts remain constructive while preferring to buy on weakness rather than chasing the tape. Our end-2016 S&P500 target is 2200 and we believe large-caps and value may outperform. Sector wise, Financials may benefit from Fed policy.

Chart 1
S&P 500 Index



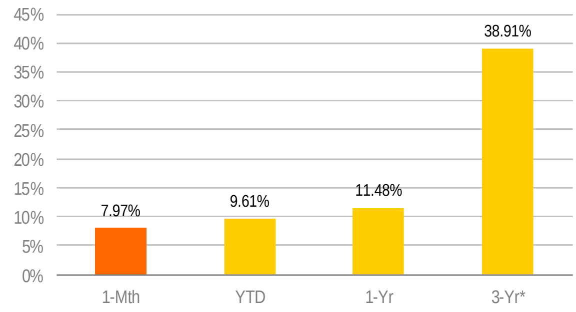
*Denotes cumulative performance
Performance data as of 31 October 2015
Source: Bloomberg

Euro - Area

ECB may extend QE in December

- Citi analysts raise their 2015 GDP forecasts by 0.2pp to 1.5% but cut the 2016 estimate by 0.4pp to 1.5%, to incorporate some slowdown in external demand, particularly from Emerging Asia. Turning to inflation, a slightly higher EUR/USD trajectory compared to last month and limited upside risks in terms of commodity prices are likely to flatten the inflation profile further.
- As such, another round of monetary policy loosening is our baseline for the last meeting of 2015 on Dec 3. We expect the ECB may announce that it intends to extend or expand the pace of asset purchases, with an extension the more likely option.
- There is modest positive momentum in Europe EPS. Support for further growth comes from: 1) resilient/reasonable GDP growth, 2) weaker oil prices, 3) weaker euro, 4) improvements in Europe's financials/banks. We back growth and re-rating to drive the Stoxx to 400 at end-2015 and 440 at end-2016.

Chart 2
Dow Jones Stoxx 600 Index



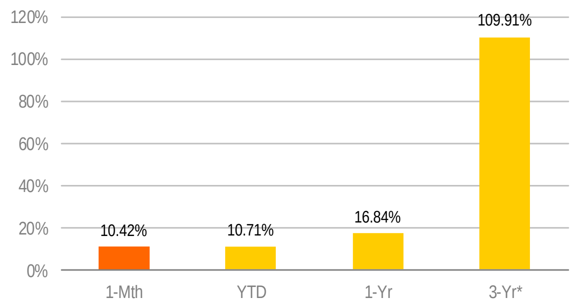
*Denotes cumulative performance
Performance data as of 31 October 2015
Source: Bloomberg

Japan

BoJ likely to ease in coming months

- The economy is facing significant challenges on two fronts, on external front Asian economic slowdown and on domestic front lacklustre consumption. Concerns for deflationary pressure may pressure the BoJ to implement another QE in the coming months.
- Indeed, further monetary easing is expected by late January 2016, before annual wage negotiations get started next spring, because policymakers appear to be keenly conscious of wage talks.
- We estimate EPS growth in FY15 to be 17.5% YoY, exceptionally high growth compared to other major markets. However, it should be due largely to windfalls from weak currency and low crude import cost. Though we should continue to see EPS growth in 2016, the pace of growth in earnings may slow as there will likely be limited room for weaker currency and/or lower crude. EPS growth forecast for FY16 is 6.9%.

Chart 3
Topix Index



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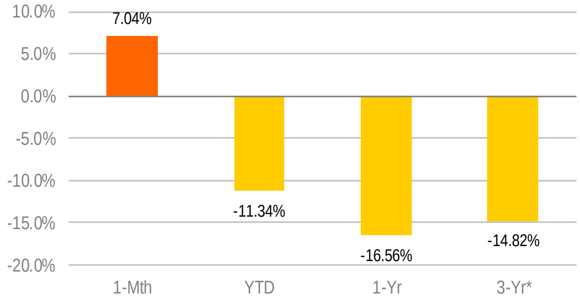
Source: Bloomberg

Emerging Markets (Asia, CEEMEA and Latam)

Asia remains the preferred region

- EPS revisions in EM remain much weaker than in DM. Within EM, anything related to commodities is seeing weaker earnings. EPS in USD terms in both EMEA and Lat AM are already below their lows in 2008. This is not the case for Asia. For EM, it is easy to see 2015 earnings ending down in aggregate by 10-15% driven by FX translation and commodity hits. Even post the weak earnings out of EMEA and Lat Am we still see earnings risk there. In Asia, the risk remains to the export side and the negative impact of operating leverage.
- In terms of valuations, Lat Am remains the most expensive. Asia and EMEA are at or close to 1stdev below the mean, levels seen in prior recessions
- Within EM, Citi analysts prefer Asia vs EMEA and Lat Am. With US rates set to rise soon, concerns regarding Fx and CA deficits will remain at the forefront.

Chart 4
MSCI Emerging Markets Index



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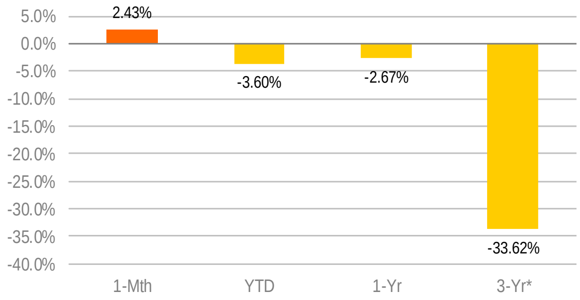
Performance data as of 31 October 2015
Source: Bloomberg

Gold

Neutral-to-bearish beyond the 6-12 month horizon

- October has been a great month for the recently downtrodden gold market as prices have risen 6% MTD versus a decline of 6% in the first three quarters of the year.
- Positive momentum for the yellow metal could continue in the short-term given the breadth of USD weakness, posing a clear upside bias to our 4Q price outlook of $1,110/t oz. But bullion markets can evolve quickly, particularly given the difficulty gold has had holding on to rallies this year.
- Further out, signs of US dollar strength may begin to thaw recent gains in gold prices in 1Q 16 which is when Citi expects the Fed to hike. Improving US initial jobless claims, robust consumer spending data and no government shutdown continue to suggest the domestic economy is achieving Fed targets.
- If this proves to be the case, it could leave gold exposed to a sharp downward correction.

Chart 5
GOLDS Commodity Index



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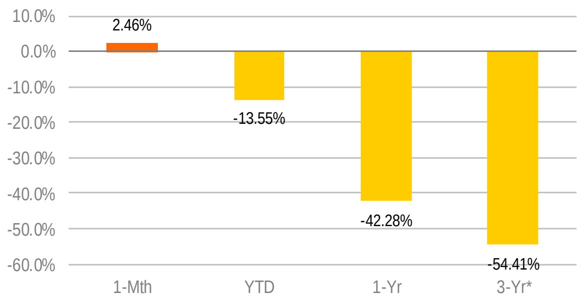
Performance data as of 31 October 2015
Source: Bloomberg

Oil

Further downside expected over the next 3-6 months

- Oil prices have already given back most of their early 4Q15 rally to trade up 4.5% QTD at ~$50.50/bbl (Brent) and Citi expects further downside to prices over the next 3-6 months.
- The fact remains that supply and demand are still out of sync, even with strong demand growth persisting and clear signs of a slowdown in US crude production.
- As a result, oil inventories are set to keep growing and this is with a starting base of high crude and petroleum product inventories. Refinery margins are suffering from refinery output overwhelming end-user demand and with deferred cracking margins moving below $3/bbl in Europe, run cuts now seem in the offing. If this materializes in 1Q16, reducing the expected demand for crude, and Iranian barrels return somewhere in the order of 300-500-k b/d, then the pressure may remain to the downside on a six-month horizon.

Chart 6
Brent Oil



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Bond Markets

High grade corporate bonds: Valuations have become attractive

US Treasuries

- The most likely scenario is that the Fed keeps rates on hold through 2015 and lift off, while possible this year, is more likely in early 2016.
- We think the market may continue to price a terminal rate of less than 2%, and the pace of rate hikes could continue to be priced at between 2 to 3 rate hikes a year for the next couple of years.
- In this context, Citi's 10y forecast for end of 2015 moves to 2.15%.

High Grade Corporates

- In our view, IG credit markets are cheap. Index spreads in both US and European markets are currently at multi-year wides, largely due to heavy new issue supply and EM volatility.
- Though greater spread compression is more likely in euro corporates, we prefer the higher absolute yields in US credit. Financials continue to outperform non-financials, as energy related sectors drag on performance.

High-Yield

- Despite the volatility, we remain constructive on high yield debt (ex-energy).
- US and European HY index yields are at their highest levels in years and spreads look attractive.

Emerging Market Debt

- Despite the recent rally, the fundamental outlook has not changed and we remain cautious on EM debt (sovereign and corporate).
- Slowing economic growth, lingering China concerns and low commodity prices are likely to keep EM FX volatile and external debt spreads wide.
- For investors looking for exposure, we would focus on higher quality issuers.

Euro Bonds

- We continue to look for lower core rates — initially as a function of lower for longer and then as a function of ECB activism.
- This follows from the low inflation backdrop and lower ECB staff projections for HICP, due in December.
- Medium term, and given that the QE programme is unlikely to drive inflation significantly higher amid tepid global growth conditions, long end rates can then rally as markets anticipate more action via rate cuts or a notable pickup in QE volumes.

Japan Bonds

- The market is likely to retain expectations for additional easing by the BOJ until early next year, despite the BOJ keeping its stimulus measures unchanged on October 30.
- Given that the next increase is likely to be the last expansion in JGB purchases, investors may start to take profits this time rather than add duration risk.
- 10y yield is likely to keep declining near term to sub-30bp levels.

Asia Bonds

- With commodities under pressure, FX pass-through still contained, and a renewed widening in output gaps, we expect that in many instances central banks may be tipped into cutting rates further and sooner than was previously expected.
- We expect duration in China, India, Taiwan and Korea may outperform, but we remain cautious of holding duration exposure in Indonesia, Malaysia and Philippines.

Currency

USD: Short Term, USD Moving Inversely To Risk

A notable driver of USD since mid-August has been risk appetite moving inversely to the S&P500 in a similar way to the 2008 to late 2011 period. This may reflect the waxing and waning of Fed rate expectations (lower rates, lower USD, better equities) but most likely, reflects a shortage of USD funding for EM economies, especially those over-borrowed in USD. However, this inverse risk/ -USD correlation is not expected to last medium term and USD is still seen gaining some 5-7% vs. both G10 and vs EM FX over 6-12m.

EUR: Mixed Signals

- EUR/USD is currently undervalued relative to real rate differentials as the ECB struggles to achieve higher inflation/ inflation expectations.
- And while ECB is expected to expand QE (likely Dec) and Fed expected to raise rates, this is already partially discounted into relative real rates.
- In addition, EUR continues to find support from flows with the EMU bloc running a sizeable (and apparently still rising) current account surplus of around 3-3.5% of GDP.

GBP: Middling Performance

- Low inflation, concerns regarding a mid-cycle slowdown and delayed MPC rate hike expectations all seem to have dented sterling sentiment.
- Given that the preconditions for MPC hiking (sustained above-trend growth, firming domestic costs and increases in core inflation) are not evident yet and with legacy effects from a strong pound and weak external costs likely to keep inflationary pressures in check, GBP may likely struggle against the USD though strengthen against the EUR and JPY, both regions where Citi expects additional monetary easing.

JPY: Medium term Upside

- Further upside in USD/JPY is expected over the medium term due to the US cyclical outperformance and generalized USD gains resulting from rising yields in the US relative to Japan aided by the continued expansion of the Japanese monetary base (QE).

AUD, NZD & CAD: Medium Term Weakness

- **AUD:** A slower global growth and inflation profile, coupled with weak domestic data means that another RBA cut is likely in the coming months. Australia's external position also continues to deteriorate, with the current account deficit expected to hit -4.7% of GDP, the largest deficit since Q1 2010. All this should ensure that AUD remains soft in the medium term.
- **NZD:** There has been something of a recent stabilization in domestic data in a period when dairy prices have rallied 56% since the lows in August. All this makes the decision on the Official Cash Rate (OCR) this month finely balanced (a NZD supportive) but more medium term, external vulnerabilities remain with New Zealand's two largest export partners slowing and the RBNZ is also ultimately expected to cut rates further at least once more. As a result, NZD may fall further in order to protect agricultural incomes and create a sustainable current account balance.
- **CAD:** Canadian fundamentals are still emerging from the shadows cast by last year's oil price shock but for now, much of the economic hardship appears to be priced in, leading to the current bounce in CAD. The recent bounce in crude oil has also undoubtedly helped Canadian terms of trade and with Citi commodity strategists forecasting WTI one year from now at around $55/bl, this could see CAD as being more resilient against USD than AUD or NZD.

EM Asia: Can The Rally Last?

- September has seen many EM currencies touch their weakest levels in years, drawing parallels with 1998. But the recent rebound in EM FX based on Fed inaction is likely to be fleeting since cyclical and structural economic challenges in EM remain severe given low commodity prices, slower China and eventually higher US rates & USD.
- Meanwhile, Chinese authorities may relax their exchange rate regime and let RMB depreciate in the medium term so as to increase the effectiveness of the policy transmission mechanism to arrest the slowdown in China's growth.

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