Citigold

Market Outlook

November 2016

Upgrading Financials to Overweight

With numerous challenges plaguing the industry, Financials was one of underperforming sectors in past few years. However, the Financials sector reversed the course during the second half (2H) of this year and started to outperform the broad market. The MSCI Financials index gained 9.7% since the beginning of 2H while the MSCI World index rose 3.5% during the same period.

Low/negative interest rates have reduced profitability at banks, insurers and asset managers. Under increasing regulatory scrutiny, it is also difficult to accurately assess the risks inside these large complex institutions. However, with the sector trading at 12x PE, a 40% discount to MSCI World, Citi believes that much of the bad news has been priced in.

That said, investors will still need to be selective within the sector. Citi analysts favour US banks over European banks given the former has healthier balance sheets and the relatively higher interest rate environment in the US. Within European banks, Citi prefers the French and Swiss banks for their diversified and profitable core businesses. However, Citi analysts remain watchful for any post referendum political risks that could affect the UK banks. Finally for EM banks, asset quality is expected to pick up as economic growth stabilises.

Macro Overview

- **US:** Expect moderate growth supported by consumer spending; Fed likely to raise rates in Dec; Presidential election poses uncertainty.
- **Europe:** ECB may announce at least six more months of QE expansion in Dec; Rising political risks.
- **Japan:** BoJ's next easing may be delayed till July 2017; Yen strength is a key risk.
- **Asia:** China's GDP growth expected at 6.6% in 2016; The PBoC may continue to shun the use of conventional policy tools such as RRR or interest rate cuts until the property market cools.

Equities: Neutral

- Slow growth, low inflation, easy central banks and a range-bound $ continue to support markets, especially Emerging Markets (EM). Citi maintains a slight positive bias for EM over Developed Markets (DM). Citi analysts are modestly overweight Latin America on the back of recovering commodity prices.

Bonds: Slightly Underweight

- **High Yield Corporates:** US HY corporates still offer value, especially in energy.
- **EM Debt:** Favour high yielding opportunities in LatAm debt markets (external and local currency).

Commodities: Neutral

- **Gold:** May trade between $1,225-$1,325/oz next year.
- **Oil:** Prices may be supported.

Currencies: Still a Dollar Range

- **AUD, NZD & CAD:** Momentum May Lose Some Steam.
- **GBP:** Further Weakness Expected.

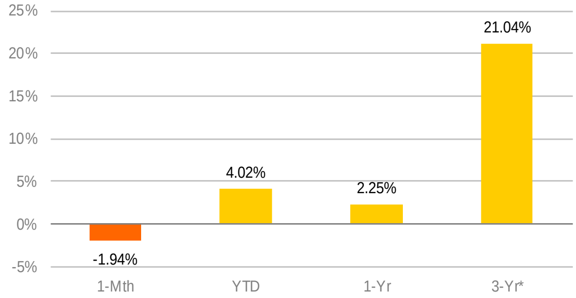
Equity Markets and Commodities

United States

Fed likely to raise rates in December

- Moderate but above potential real GDP growth continues to be Citi's baseline forecast. Following a soft-patch in August, data for September indicate that strong consumer spending continues to support growth. Job growth remains robust but has slowed from a pace of above 200K per month to around 170K per month. Citi analysts continue to forecast gradually rising inflation, as drag from prior US dollar appreciation and low oil prices fade.
- The statement from the September FOMC meeting indicated that most participants likely support a rate hike in December. However, belief that there remains substantial labour market slack may reduce the pace of subsequent rate hikes.
- With weak sentiment, supportive valuations and the likelihood of better EPS in the quarters ahead, Citi analysts find the balance to be tilted in favour of higher stock prices next year. Citi's mid-2017 and 2017 year-end targets stand at 2,250 and 2,325 respectively.

Chart 1
S&P 500 Index



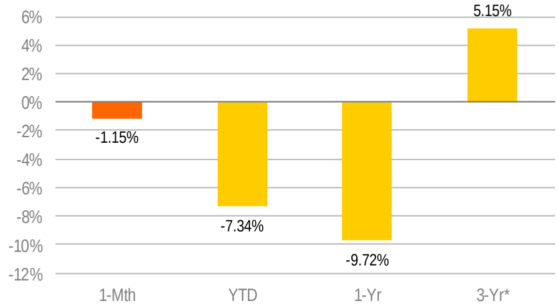
*Denotes cumulative performance
Performance data as of 31 October 2016
Source: Bloomberg

Euro - Area

Recovery remains modest and fragile

- Citi analysts project GDP growth to ease to 1.6% in 2016 and 1.4% in 2017, after 1.9% in 2015. However, the lack of any pick-up in core inflation suggests that inflation dynamics may continue to undershoot the ECB projections in coming years.
- The ECB left all its monetary policy tools unchanged at the 20 October meeting. Looking ahead, Citi analysts believe that the ECB may extend its asset purchase programme by a minimum of six months on 8 December. Citi sees a small reduction in the pace of monthly QE to €60bn as likely from April 2017 onwards.
- Another Eurozone crisis akin to 2011 seems unlikely to be driven by the UK's exit from the EU. However, political risks may be a drag, with the Italian referendum in December and French presidential election next year likely to draw attention. Thus, Citi remains neutral on European equities and set Stoxx600 end-2017 target at 380.

Chart 2
Dow Jones Stoxx 600 Index



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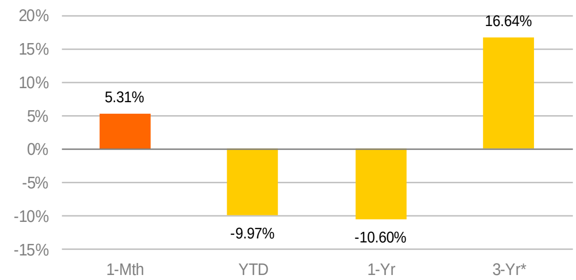
Performance data as of 31 October 2016
Source: Bloomberg

Japan

BoJ may delay policy easing to July 2017

- Citi analysts expect real GDP to grow 0.7% in 2016 and 0.9% in 2017, mostly driven by domestic demand. However, inflation is likely to remain low at -0.4% in 2016 and +0.3% in 2017. A rebound in oil prices is unlikely to counter the effects of yen appreciation, underwhelming wage growth and sluggish consumer spending.
- Citi analysts expect the BoJ to delay policy easing to July 2017. The BoJ has changed its policy framework in a way that is more consistent with a long drawn-out process toward the 2% inflation target. As a result, the BoJ now seems less likely to ease policy even if inflation surprises to the downside.
- Expectation for a stronger yen and a rise in oil prices mean that the external environment is unlikely to be favourable for Japanese equities. Citi remains neutral with its Topix end-2017 target standing at 1,525. In terms of sectors, Energy and Telecoms are preferred.

Chart 3
Topix Index



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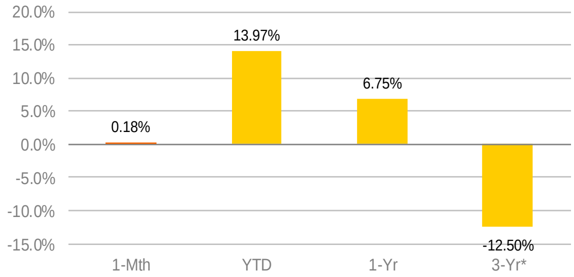
Emerging Markets (Asia, CEEMEA and Latam)

Modestly overweight Latin America

- Real interest rates remain high in most of EM economies and have room to fall further in 2016-17. This is generally supportive towards equities and dividend strategies in particular.
- Furthermore, valuations remain supportive at 0.43 standard deviation below average in terms of trailing P/BV, while Citi analysts expect 14% EPS growth for 2017 in US$ terms.
- A stable-to-weaker US$ allows the asset side of the EM central bank balance sheets to expand. EM reflates, equities go up. A weaker US$ also raises sales for EM corporates thus improving asset turn which ultimately may be helpful to Return on Equity (ROE) and profits. The cycle is improving.
- A combination of these factors suggests that EM still offers a good risk-reward opportunity. Within the region, Citi analysts prefer Latin America on the back of improving commodity prices. Banks, consumer discretionary, materials, technology and utilities are Citi's favoured sectors.

Chart 4
MSCI Emerging Markets Index



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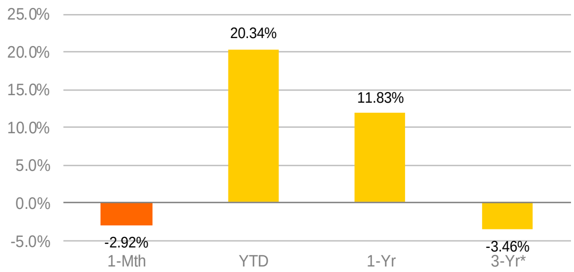
Source: Bloomberg

Gold

May trade between $1,225-$1,325/oz next year

- Citi Economists continue to keep their call for a Fed rate hike in December. This might keep gold from rebounding aggressively in 4Q absent a sell-off in the US dollar or a major surprise in the US election.
- Indeed, the recent back-up in DM bond yields, US dollar strength and reduced tail risk surrounding a Trump victory in the US election has prompted Citi analysts to downgrade gold prices for 4Q16 by ~5% to $1,250/oz.
- Going into 2017, Citi's baseline is for gold prices to trade between $1,225-$1,325/oz based on: 1) Improving realized inflation expectations, which is likely to pick up in 2H17 and; 2) Some reduced financial contagion concerns as markets would have digested both Brexit and the US election results.

Chart 5
GOLDS Commodity Index



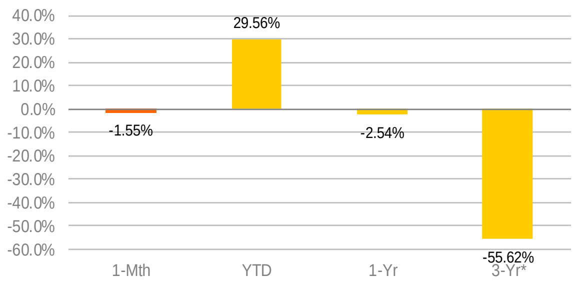
*Denotes cumulative performance
Performance data as of 31 October 2016
Source: Bloomberg

Oil

Prices likely supported

- The combination of tighter product markets, better-than-expected crude stock-draws in the US as well as globally and most importantly a market that now gives OPEC/Saudi Arabia some credibility in regards to an output cut/freeze is leading Citi to raise our 4Q16 Brent price forecast up to $55/bbl from $50 previously.
- Looking further ahead, Citi analysts have lowered our 1Q17 price forecast from $55/bbl to $52/bbl given some potential near-term physical market softness coming from higher Russian, Libyan, Kazakh and Nigerian production impacting 1Q17 markets.
- Citi thinks that it is more likely than not that OPEC could agree to some form of output freeze/cut. Saudi and other OPEC members' fiscal balances clearly look better with a higher oil price, but $50 and above gives a renewed lease of life to US shale producers. Citi believes this puts a "sweet spot" at around $55/bbl in the near-term and is just about where oil prices are now hovering.

Chart 6
Brent Oil



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Bond Markets

US Investment grade credit remains the largest relative overweight

US Treasuries

- Global demand for yield and safe-haven flows still support lower US rates for longer as benign inflation pressures and muddled growth are likely to keep the pace of Fed hikes slow.
- Citi analysts believe any upward yield pressure could likely be felt on shorter maturities. They remain overweight US Treasury debt.

Investment Grade Corporates

- High quality corporate bonds may continue to benefit from low core government rates and strong demand for higher yield.
- In US sectors, Citi favours Energy and Telecom. Recovery in oil prices may fuel further outperformance in the energy sector while Telecom is expected to benefit from improving fundamentals and attractive valuations.
- In euro IG, telecom and energy are preferred, as well as healthcare, which could benefit from positive industry trends.

High-Yield

- Though supported by ECB's bond purchase program, Citi analysts favour higher yielding USD HY over euro HY.
- In particular, opportunities in the Single-B rated space look more attractive, as valuations in Double-B HY are expensive.
- Similar to Citi's conviction in IG corporates, Citi prefers opportunities in HY telecom and energy sectors.

Emerging Market Debt

- Emerging market (EM) bond performance in both local currency and external (USD) debt continues to benefit from the recovery in oil prices and central-bank induced demand for yield.
- More importantly, the cyclical deterioration that plagued many parts of EM for the last several years (i.e., weak growth and rising inflation) has seemingly improved.
- Citi analysts are overweight in Latin America (hard currency and local) as well as local Asian bonds while remaining neutral EMEA.

Euro Bonds

- Citi analysts find limited value in near zero/negative yielding sovereign debt, despite strong ECB supports.
- Despite ECB purchases, political environment is likely to keep volatility elevated. Italy referendum and Portugal downgrade risk should be monitored closely.
- Additionally, despite supportive central bank policy and technical backdrop, Citi analysts are still reluctant to chase UK Gilts unless post-Brexit macro risks build.

Japan Bonds

- The BoJ's tolerance for lower JGB yields under the newly introduced Yield Curve Control appears to be somewhat smaller than expected right after the introduction of the new framework.
- However, as about 80 trillion yen in JGB purchases is more than is needed for keeping the yield curve unchanged, Citi analysts expect modest declines over time in the JGB yields at a super-long end of the curve.

Asia Bonds

- In Asia, Citi analysts favour USD Indonesia debts and local India bonds, where attractive yields, improving macro environment and increased foreign ownership of sovereign debt is likely to attract new investors.

Currency

Still a Dollar Range

Dollar still seen as more range bound absent an unexpected Trump win in the US election where the most likely outcome of a Clinton win would see policy continuity. Constraining USD upside are US growth and inflation fundamentals which are unlikely to be strong enough to generate significant Fed tightening but neither is USD likely to weaken enough to produce safe haven demand in a risk off/ recessionary scenario. At the same time, BoJ and ECB policy may also be reaching the limits of maximum accommodation, which implies less accommodative policy – making JPY and EUR more resilient to USD.

EUR: Upside Delayed

- EUR/USD has fallen due to higher US bond yields, concerns about the German and Italian banking sectors and a shift to a "hard" Brexit stance by the UK that is seen as a net negative for Europe.
- Adding to this is the ECB not announcing tapering at the 20 October meeting. Nonetheless, the 1.05 - 1.15 range is likely to persist for now though the medium term could still see a move to the upside from supportive EA current account inflows and the possibility of tapering by the ECB next year.

GBP: Further Weakness Expected

- Following a period of consolidation after dropping sharply post the June referendum, Citi analysts now see renewed declines over the medium term as expectations for a hard Brexit materialize. Fundamentally, recent UK data has been mixed with a sharply weaker sterling benefitting the relatively small manufacturing sector and raising inflation expectations. But still to come are hard data for large companies' investment plans that remain vulnerable to uncertainty surrounding Brexit negotiations and may discourage foreigners from buying relatively cheap UK assets.

JPY: Yields Critical for Direction

- USDJPY is likely to head lower over the medium term with the two likely drivers of recent $/JPY upside (gains in US yields and declining CNY) seen fading over time. Meanwhile, BoJ policy seems less than cohesive currently as it now targets both short term interest rates and the 10y yield (at around zero) as well as retaining a quantitative money base target, making the BoJ's task much more difficult to force $/JPY higher. Finally, a Fed hike in December may also mark the end of US curve steepening that is likely to constrain $/JPY upside.

AUD, NZD & CAD: Momentum May Lose Some Steam

- **AUD:** A more supportive commodities backdrop regarding developments in iron ore prices and rising Chinese steel prices have driven recent AUD gains. But the domestic story appears more mixed with the recently weaker employment data allowing the RBA more degrees of freedom to cut rates if it wishes to particularly if inflation remains stubbornly low. Ultimately though, AUD's direction will be closely tied to the outlook for commodities and while currently supportive, Citi forecasts iron ore prices to drop from the current ~$59 to around $45 next year and that could potentially pose a headwind to AUD strength in 2017.
- **NZD:** A favourable commodities backdrop via the continual improvement in dairy prices appears to have propelled the move higher in NZD. But domestic fundamentals appear more mixed with inflation forecasts having been lowered, potentially making the case for possibly 2 further rate cuts from the RBNZ – one in November and one in February. With that in mind, any NZD upside is likely to be capped especially on crosses against AUD.
- **CAD:** Sentiment has recently been undermined by the raft of weaker Canadian domestic data which has seen the BoC shift to a more dovish stance and which also sees Citi economists forecasting a BoC 25bp rate cut this or early next year. But over the medium term, the recent OPEC output agreement and resulting higher oil prices are likely to become more dominant in supporting both Canadian terms of trade and CAD.

EM Asia: Higher USDCNY, But Limited Side Effects

- EMFX sentiment remains mixed with the sharply decreased likelihood of a Trump presidency and higher oil prices on the back of a possible OPEC deal to cap output supportive of EMFX but emerging concerns about less central bank largesse (ECB and BoJ tapering) accompanied by Fed tightening likely to negatively impact EMFX sentiment.
- China is also coming back as a potential concern with the latest data raising concerns about export underperformance, rising inflationary pressures, a bubble in the property market and rising pressure on the renminbi to depreciate. Thus, the outlook is for a modestly weaker EMFX in 0-3m, but stronger EMFX over the 12m horizon.

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