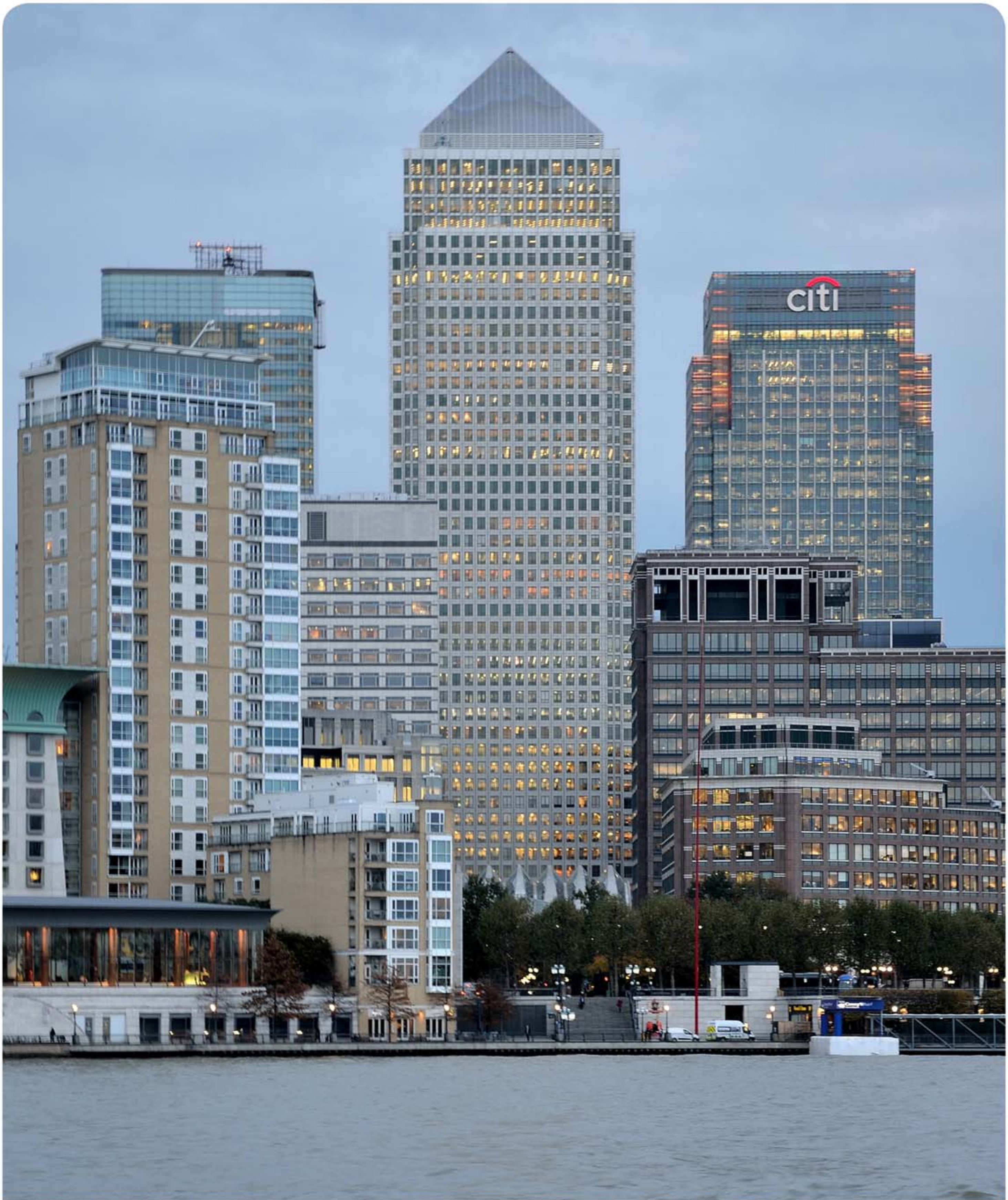


# Market Outlook

## More Economic Divergences, More Volatility

November 2014

# Equities Markets

## Feature

**As global markets hover between price peaks and volatility lows, global investors are dealing with a cacophony of new information. Indeed investors have to face new monetary policy paradigm, with the European Central Bank (ECB) endorsing Quantitative Easing (QE), the US Federal Reserve ending their version of QE and a pension fund revolution in Japan. This information competes for investor attention alongside economic data, earnings results and a fragile political context in Emerging Markets (EM).**

**In Citi analysts' view, market reactions should be seen through the lens of heightened volatility, re-established just recently, which is expected to remain in place. The recent rally in global equities and institutional investor positioning ahead of key catalysts should be weighed when interpreting market reactions, and most importantly, the implications looking forward.**

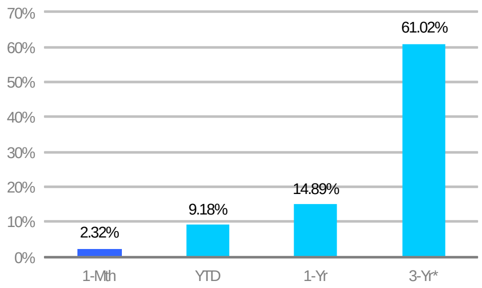
## United States

– Slowing growth abroad and the dollar's recent appreciation have raised downside risks to the US economy. However, declines in energy prices and Treasury yields are providing an offset. These changes collectively raise the uncertainty in Citi analysts' growth forecasts, while also dampening inflation prospects. While Citi analysts continue to hold the view that the Fed will not raise rates until September 2015; the risks are now tilting in favour of a later lift-off.

- Improving capital spending trends and hiring intentions point to a continued economic expansion which should be supportive for corporate earnings. As such, Citi analysts remain constructive and think that 2015 can be a respectable year for equity markets.

- Stronger USD may be a headwind and commodity price weakness also may restrain the upside in Earnings-per- Share (EPS) growth.

**S&P 500 Index**




*Denotes cumulative performance
Performance data as of 31 October 2014
Source: Bloomberg

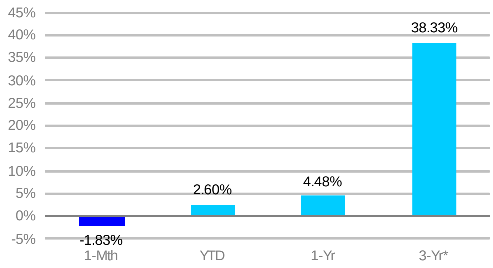
## Euro-Area

– Citi analysts are cutting their 2015 GDP growth forecast by 0.3% to 1.1% and 2016 GDP forecast by 0.1% to 1.7%. Citi analysts look for inflation to stay below 1%, averaging 0.5% in 2014 and 0.9% in 2015. In light of higher risks to inflation expectations, Citi analysts expect the ECB to deliver more stimulus, altering the composition of its asset purchase program and greatly expanding its scale to incorporate government bonds as part of a QE announcement in late 2014/early 2015.

- From an equity perspective, Citi analysts remain bullish longer term though cautious in near term. They see a potential pull-back in share prices as entry opportunities.

- Citi analysts believe we are still some way from the end of this economic and profits cycle. They expect 10% EPS growth per annum in 2014-15 which should support decent equity returns from here without further significant re-rating.

**DJ Eurostoxx 600 Index**

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Performance data as of 31 October 2014
Source: Bloomberg

# Equities Markets

## Japan

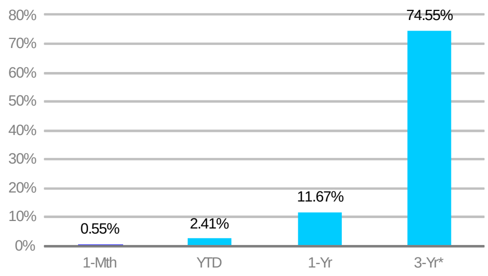
– The Bank of Japan (BOJ) and the Government Pension Investment Fund (GPIF) surprised markets with significant additional monetary stimulus and a major shift in asset allocation towards higher-risk assets.

– These announcements came earlier than expected, as recent political backlash and official commentaries appeared to reduce the odds of immediate action.

The impact is bearish for the yen, bullish Japanese equities, and positive for risk appetite globally, which is likely to continue in the near- to medium-term.

- These decisions could enable the government to move ahead with plans to hike the consumption tax further, likely in October 2015. Before then, greater fiscal easing is also likely, as the BOJ enables additional borrowing.

**Topix Index**

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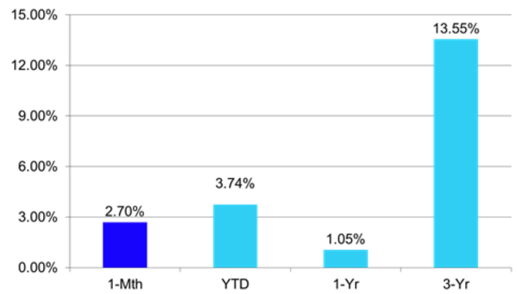
Source: Bloomberg

## Asia Pacific

– The downtrend of growth has continued in China in Q3 despite support from net exports, with the impact of property market correction being felt in the broader economy. Looking ahead, the contribution from external demand may become less positive. Citi analysts keep the annual GDP growth forecast at 7.3% for 2014, and lower 2014 inflation forecast from 2.3% to 2.1%. In light of downside growth and inflation risks, Citi analysts continue to anticipate a 25bps rate cut by the year-end.

– Soft inflation and sluggish growth have led to easing expectations in India, possibly Korea, and eventually, Singapore. Thailand will likely keep its accommodative monetary policy until end-2015. Indonesia's new government is likely to hike subsidized fuel prices soon, but — with the credit slowdown — Citi analysts do not expect monetary policy to react to what is likely to be a transitory price shock.

**MSCI Asia Pacific ex-Japan Index**

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Performance data as of 31 October 2014
Source: Bloomberg

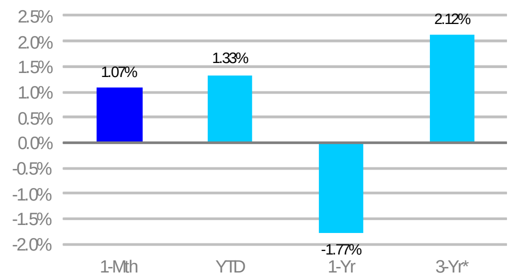
## Emerging Markets

– In some ways the fall in oil prices has a predictable effect on the current account balances in Emerging Europe: oil exporters lose and oil importers win. But weak commodity prices and a strong dollar are historically associated with low risk appetite, so countries that might be thought to be benefit from lower commodity prices — Turkey, Poland, Hungary for example — might suffer if risk aversion rises against the background of weak commodity prices/strong dollar.

– Now that Brazil's elections are past, President Rousseff's administration will have to focus on improving the fiscal accounts and boosting growth, at a time when inflation is close to the upper limit of the central bank's target band. Citi analysts are cutting their 2014 growth forecasts for Mexico, but continue to expect real GDP to increase by 3.9% in 2015.

- Going forward, the focus is on the stronger US$ and higher US rates.

**MSCI Emerging Markets Index**

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Performance data as of 31 October 2014
Source: Bloomberg

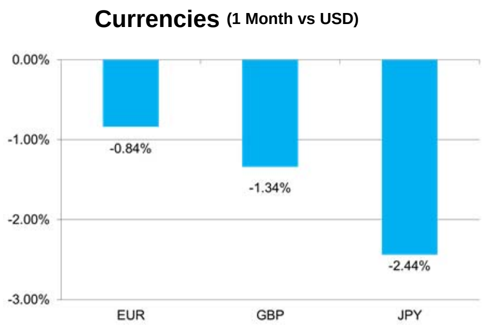
# Currencies and Bonds Markets

## Currencies

– The weak EUR is the most direct way of eliminating deflation risk, so ECB now is hugely focused on getting EUR lower. The ECB at the start of November that TLTRO is two last into 2016. That said, ECB easing is far from finished and the longer term risk remains on the downside.

– Disappointing housing data and Bank of England (BoE) comments led investors to push back bets on early stimulus removal. This could continue to weigh on the pound in the next weeks. Furthermore, policymakers' comments appear to endorse a very slow and steady rate increase. Government proposals that the BoE expands its remit to regulate the mortgage market would be seen as a substitute for rate hikes.

- Japanese officials have been more vocal, discussing JPY weakness as the currency has sold off sharply. Comments stick closely to typical G20 speak so far, but a renewed indication of concern on negative domestic fallout would risk slowing pace of depreciation.

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Source: Bloomberg

## Bonds

### US Treasuries

Core rates reversed course after staging a sharp selloff during the first half of September. The rally punctuates a surprisingly impressive performance that has transpired across global rate markets this year. The decline in US breakeven rates and medium-term inflation expectations has been bolstered by the notable strength of the US dollar. Currency strength typically dilutes price pressures and is likely to attract increased investor flows into US fixed income assets.

### IG Corporates

Potentially higher US Treasury rates remain the biggest risk to future performance and Citi analysts expect returns for next year to be muted. Thus, Citi analysts continue to favour EUR credits over USD and GBP, financial issuers over non-financial sectors, and BBB-rated credits versus higher-quality names.

### High-Yield

Citi analysts expectation for higher rates (especially in the US and UK) is poised to generate an undertow to performance. Heightened volatility is likely to dilute returns, suggesting that investors need to be more selective. This being said, Fundamentals have not materially deteriorated, default rates are expected to remain low, and the risk appetite for higher yields remains intact

### Emerging Market Debt

External (hard currency) and local EM bond markets fell sharply last month as market volatility spiked and risk appetites faded on the back of Chinese slowdown, USD strength and profit taking. While Citi analysts do not expect last summer's EM selloff to recur, intrinsic risks suggest that investors need to be more selective about market exposures. Citi analysts favour issuers from high quality, manufacturing export countries with improving fundamentals.

### Euro Bonds

Currently, the market does not anticipate the ECB to hike rates for four more years (Citi analysts believes it will be closer to three). No matter – whether it's three or four years, investors should keep in mind that diverging growth prospects will anchor Eurozone rates around historically low levels even as US and UK central banks commence tightening cycles. This divergence is already being reflected in benchmark rates.

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