Citigold

Market Outlook

October 2016

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Oil prices may be supported by OPEC agreement

At an informal meeting on September 28, the 14 OPEC member countries reached a broad agreement to cut crude production to a range of 32.5 to 33 million barrels per day by November. This compares with 33.24 million barrels per day in August. If implemented, this is the first time in eight years OPEC has agreed to a production adjustment.

There is lot of scepticism over implementation and success of such an agreement. Also many question the extent of reduction to be effective. But the willingness of OPEC to act on supply together with reported declines in crude oil inventories may keep oil prices supported. Thus, Citi reaffirms its Brent crude oil price view of a $40-50 trading range in 2H16, rising toward the upper bound of this range into 4Q16 and potentially above $50 depending more on winter weather than OPEC action. Citi continues to see 2017 Brent averaging $60, with 4Q17 reaching $65.

Macro Overview

- **US:** Sep FOMC statement supports rate hike in Dec; Presidential election poses uncertainty.
- **Europe:** ECB may announce at least six more months of QE expansion in Dec; Political risks are rising.
- **Japan:** Further rate cut to -0.2% expected in January 2017; Yen strength is a key risk.
- **Asia:** Rising activity in real estate, infrastructure and auto sectors has helped stabilise China's economy but a dip in private investment may weigh on growth; Expect one RRR cut and interest rate cut this year.

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

- **IG Corporates:** IG corp should benefit from lower core sovereign rates; Favour select issuers in US energy and telecom. Financials are still likely to underperform due to low yields and a flatter yield curve.
- **EM Debt:** Decline in volatility and dovish Fed may support local EM Debt in the near-term. Citi analysts are overweight in Latin America (hard and local currency) as well as local currency Asian bonds while remaining neutral EMEA.

Commodities: Neutral

- **Gold:** Likely range bound in near term.
- **Oil:** Prices may be supported by OPEC agreement.

Currencies: Election Risks Aside, $ Has Probably Peaked

- **EUR:** More Resilient.
- **GBP:** Expect Weakness vs EUR.

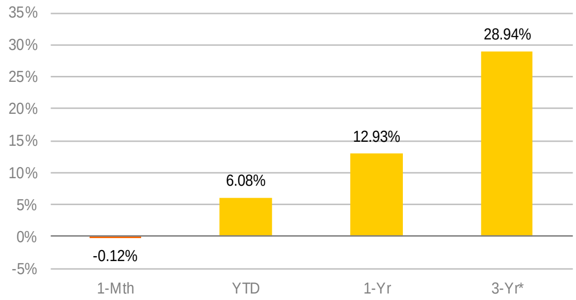
Equity Markets and Commodities

United States

Sept FOMC statement supports rate hike in Dec

- Moderate growth continues to be Citi's baseline forecast. Official data have been more robust than implied by the dive in the ISM non-manufacturing survey. Nevertheless, the most recent data for retail sales and industrial production have been weaker than expected. Growth continues to be supported by consumer spending and robust, albeit slowing, job growth.
- The September FOMC statement indicated that the case for a second rate hike has strengthened, pending confirmation from data. Citi believes a December hike remains likely so long as labour markets continue to improve, growth remains above potential, inflation proceeds toward target, and markets remain calm.
- Citi analysts are constructive about US equities in the long term although the market may see some volatility in the short term given election uncertainty. Citi analysts have set their mid-2017 and end-2017 S&P targets at 2,250 and 2,325 respectively, on the back of an expected 6% earnings growth for next year.

Chart 1
S&P 500 Index



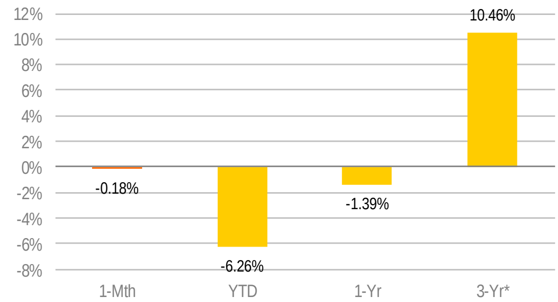
*Denotes cumulative performance
Performance data as of 30 September 2016
Source: Bloomberg

Euro - Area

Economy expanding at modest rate

- Citi raise its GDP forecast by 0.2pp in 2017 to 1.4% and by 0.1pp in 2018 to 1.6%. A significant part of this upgrade comes from the decision to remove Grexit from its base case, and signs that Brexit-related drag might be slightly less significant than initially expected.
- The ECB did not change any interest rates at the 8 Sep meeting and confirmed that it intends to purchase €80bn of assets per month. At the 8 Dec meeting, the ECB may announce at least six more months of QE. Citi's base case remains that the asset purchase programme (APP) may likely run until Sep-18, inclusive of six months of tapering, with a first rate hike in Dec-19.
- From an equities perspective, Citi remains neutral on Europe. While valuations are not expensive, a packed electoral calendar for the coming year could prove disruptive. Against a muted economic recovery, it may be difficult for the market to outperform.

Chart 2
Dow Jones Stoxx 600 Index



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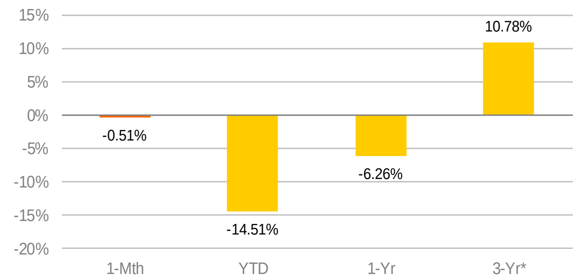
Performance data as of 30 September 2016
Source: Bloomberg

Japan

BoJ may cut policy rate in January 2017

- The BoJ introduced a new policy framework called "QQE (quantitative and qualitative easing) with yield curve control" in Sept. Under this framework, the Bank will control short-term policy rates at -0.1% and also the 10-year JGB yields at "around 0%".
- Citi analysts believe this is unlikely to facilitate achievement of 2% inflation and expect the BoJ may implement additional easing in the form of cuts in short-term policy rates from -0.1% currently to -0.2% in January 2017.
- While the revisions in ETF purchasing methods could be positive for certain sectors, Citi analysts remain neutral on Japanese equities. Further rate cuts (negative for the banks) and concerns over the perceived loss of credibility of the Japanese authorities may weigh on the market.

Chart 3
Topix Index



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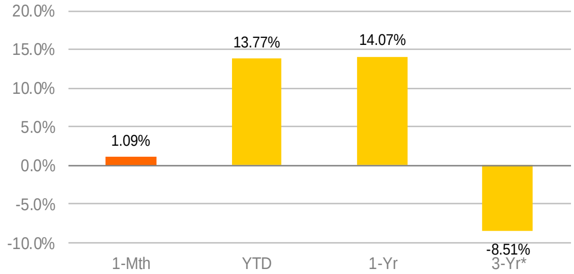
Emerging Markets (Asia, CEEMEA and Latam)

Modestly overweight Latin America

- Dividend yields are higher than bond yields in many EM markets such as Hong Kong, Malaysia, Singapore, Taiwan, Thailand, Poland and Russia. An expected earnings growth recovery and stronger cash flows may help increase dividend payouts in EM.
- Furthermore, the stabilization in the US dollar after a historic period of strengthening has also removed a headwind from many EM assets and economies.
- 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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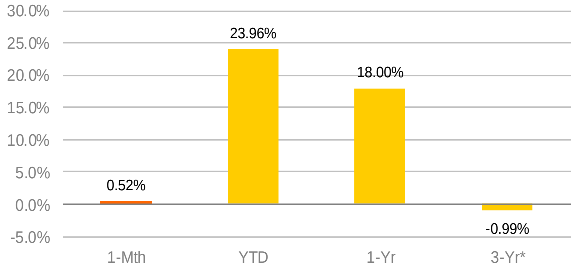
Source: Bloomberg

Gold

Likely range bound in near term

- Precious metals have largely traced side-ways in September, with prices forecast to remain somewhat range-bound in October.
- While the rise of political uncertainty in the US and the EU could be modestly supportive of gold in the coming weeks, Citi analysts maintain their expectation for weaker gold prices of $1,320/oz in 4Q16.
- The lack of meaningful precious metal price reaction following the FOMC rate hike pass on 21st September, could suggest limited further upside in the months ahead.

Chart 5
GOLDS Commodity Index



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Source: Bloomberg

Oil

Prices may be supported by OPEC agreement

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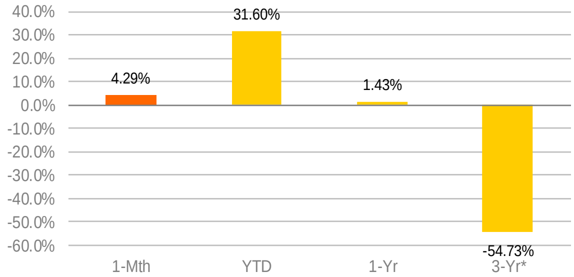
Chart 6
Brent Oil



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Bond Markets

US Investment grade credit remains the largest relative overweight

US Treasuries

- The low global interest rate environment may anchor the long-end for US Treasuries as foreign investors continue to bid up safe haven, higher yielding USD assets.
- Citi analysts remain overweight US Treasury debt.

Investment Grade Corporates

- Citi analysts remain overweight IG corporates as they are likely to benefit from lower core sovereign rates.
- In US sectors, Citi favours telecom and energy. Financials are still likely to underperform due to low yields and a flatter yield curve.
- 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 purchases, Citi analysts favour higher yielding USD 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

- With 10-year German Bund yields in negative territory, Citi finds very little value in core Eurozone (EZ) rates.
- Additionally, despite supportive central bank policy and technical backdrop, Citi analysts are still reluctant to chase UK Gilts.

Japan Bonds

- The BoJ introduced a new policy framework called "QQE with yield curve control", under which the BoJ will control not only short-term interest rates but also the 10-year JGB yields. The current policy directive stipulates that the BoJ will keep the 10-year JGB yields at "around 0%."
- In Citi's view, the BoJ has powerful tools to cap any substantial rise in the 10-year yields – such as newly-introduced fixed-rate JGB purchase operations – but it seems more difficult to set the floor under yields.
- Citi analysts expect the 10yr yields may continue to stay in modestly negative territory.

Asia Bonds

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

Currency

Election Risks Aside, $ Has Probably Peaked

Long-term $ appreciation cycles tend to end after 5-6 years, suggesting that the current uptrend that began in 2011 may be living on borrowed time and the overshoot relative to rate differentials which opened up over 2015, may now be correcting. This suggests the USD may more likely be peaking. The big risk is the upcoming US election. A Trump win (Citi sees a 40% probability) may likely be a game changer towards a stronger $ given his plan to cut corporate taxes and boost infrastructure investment which could see a fiscal stimulus of up to 5% of GDP.

EUR: More Resilient

- EURUSD is likely to follow a relatively flat path near term. Concerns about Brexit fallout, financial instability in the region and political uncertainty in Italy may likely cap its upside while a dovish Fed along with ECB reluctant to ease near term could likely help support the pair.

GBP: Expect Weakness vs EUR

- While official data has been resilient of late, it does not mean the UK is out of the woods. With EU/UK trade negotiations yet to commence, it may just be the calm before the storm.
- UK is running a trade deficit of 7% GDP and the economy remains vulnerable to downside growth risks. That means the BoE continues to retain its easing bias even as UK data's current resilience suggests the slowdown may not be as bad as imagined in the aftermath of the Brexit vote.
- Overall, a dovish MPC bias on top of a vulnerable balance of payments position is likely to lead to a lower GBP.

JPY: Value and Fundamentals Triumph BoJ

- BoJ's recent comprehensive policy review shows that the exchange rate no longer seems central to BoJ policy and the measures implemented fall well short of market expectations and reinforce market conviction that the BoJ is running out of ammunition. This means the BoJ measures are no longer able to weaken the Yen.
- And with Japan's current account surplus of 3-3.3% of GDP tending to reinforce yen strength and coupled with a dovish Fed, this may likely mean lower levels on USDJPY.

AUD, NZD & CAD: AUD & CAD May Perform, NZD Caught In Crosswinds

- **AUD:** The RBA retains its easing bias despite some recent more upbeat comments from Governor Lowe on the housing as well as the labour markets. However, despite the easing bias, the "grab for yield" dynamic in a risk-on environment is likely to provide a supportive backdrop for AUD to strengthen, absent any shocks surrounding the US presidential elections.
- **NZD:** NZDUSD is likely to trade sideways as crosswinds take effect. The domestic macro backdrop remains firmly robust supporting the pair but divergence with the weak inflation outlook means the RBNZ is still biased to cut rates, possibly by November. And while the "grab for yield" dynamic is also relevant to NZD sentiment, the unit is likely to attract less appeal than AUD even as both units may continue to gain against USD.
- **CAD:** CAD's fortunes remain tied to the recent stability in oil prices as well as USD softness, both of which have helped support CAD in the near-term. However, domestic data remains weak and this may prompt the BoC's hand to cut rates later in the year and makes CAD somewhat vulnerable, especially against its commodity peers. More medium term however, Citi analysts expect higher oil prices and as such, expect USDCAD to test this year's lows.

EM Asia: Likely Higher In The Next 12 Months

- While much has happened since the end of August, little has changed in terms of key determinants of EMFX forecasts. The G3 central banks have held their meetings and their policy stance has changed little. Thus, global yields are likely to remain quite low and interest in EM assets should be high in Citi's view.
- The only risk to EMFX's performance is a Trump win in the US Elections. Based on Trump strong views on trade policy, continued underperformance of global trade may pose a headwind for EMFX and may ultimately neutralize the effects from stronger capital flows into the EM asset class (due to low yields in developed markets). However, at this point, the probability of Trump rocking the boat is at 40% - a fat tail risk but not enough to upset market sentiment.

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