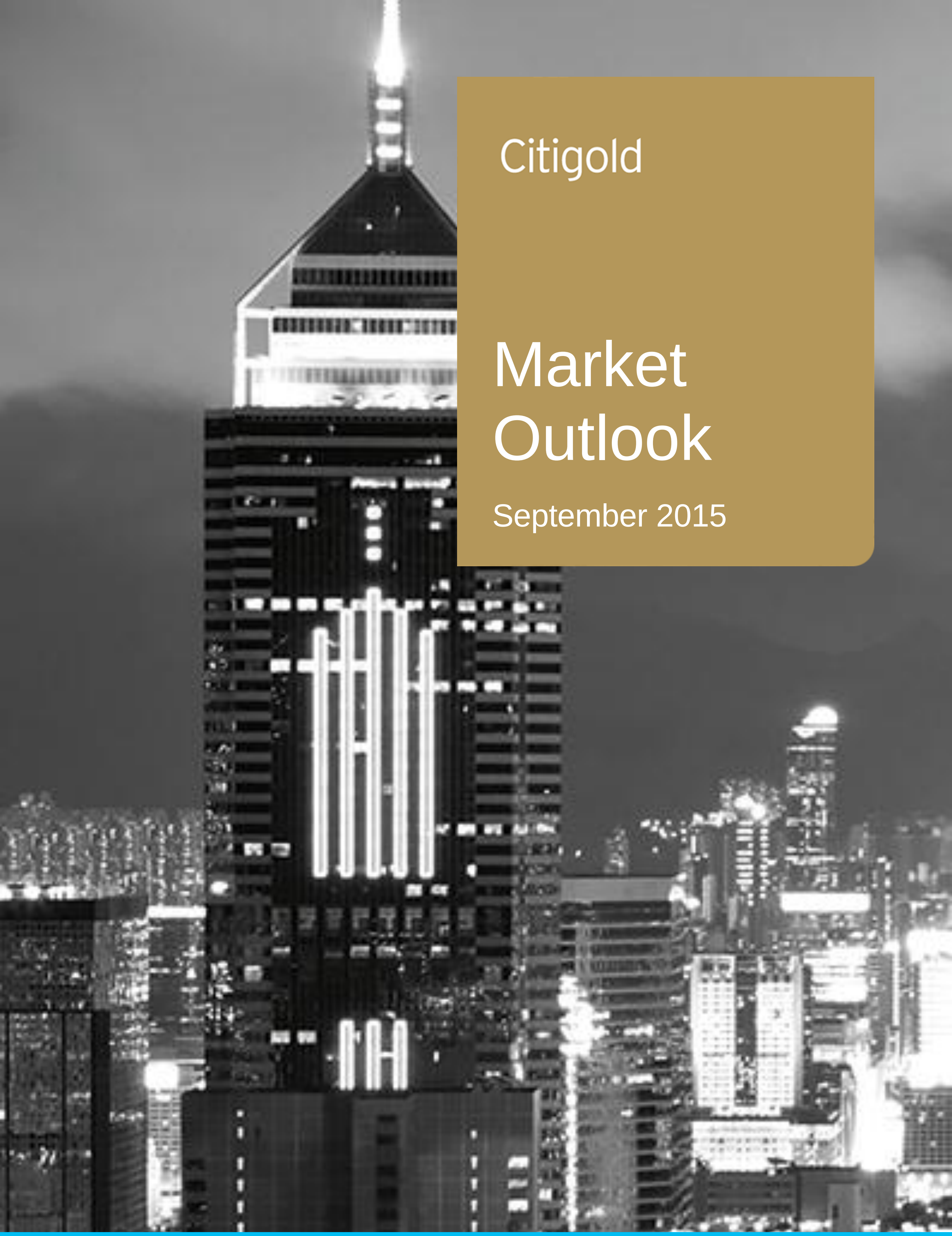
Citigold

Market Outlook

September 2015



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What Does The Chinese Devaluation Mean?

In mid-August, we saw a surprise move by China's central bank to engineer a devaluation of its currency. The central fixing rate was weakened by nearly 2% on 11 August, the largest such move since the managed peg regime came to existence in 2005. Citi analysts view this as a double-edged sword with the significant capital market reform initiative and better net exports being positive but negatives given the capital outflow and earnings per share (EPS) conversion loss. However, the negatives look manageable given a) buffers of capital outflows due to capital controls, ~3% China/US yield gap & Reserve Ratio Requirement (RRR) cuts, and b) low-single-digit negative impact on 2016 EPS.

As such, Citi analysts expect net exports support, favourable policies and pro-reform stance to drive MSCI China back to its 10-year average forward P/E. Citi analysts continue to favour H- over A-shares though are less bullish as have factored in GDP downgrades and liquidity concerns.

On balance, implications of China's slow growth and weaker RMB on global economy and markets are somewhat complex but Citi analysts expect there to be only a modest drag on growth and inflation for the rest of the world. They therefore reinforce the theme of 'lower for longer' in monetary policy for advanced economies. In August, the global equity market saw a big correction driven in part by fears that the China/Emerging Market (EM) slowdown will broaden into Developed Market economies. While investors appear to be shifting towards pricing in a global recession and China's hard landing, Citi analysts **believe such fears are premature.**

Macro Overview

- **US:** Citi analysts expect a bounce back in growth to near 3%; First rate hike anticipated in September.
- **Europe:** Inflation likely to remain subdued; European Central Bank (ECB) may maintain accommodative policy stance.
- **Japan:** Sluggish consumer spending may weigh on inflation and thereby trigger Bank of Japan easing in 4Q15.
- **Asia:** The People's Bank of China (PBOC) recently cut policy rate by 25bps and adjust RRR down by 50bps; Citi analysts expect four more RRR cuts and one more policy rate cut by mid-2016.

Equities: Overweight

- Overall, while Citi analysts have concerns about a deteriorating earnings outlook and broader macro background for equities, they have retained an overweight in the asset class. The overweight is in Japan, Europe and North Asia within EMs.

Bonds: Underweight

- **High Yield:** Valuations appear attractive and fundamentals remain supportive in the longer term.

Currencies: Bullish Fed in A Broken China Shop

- **EUR:** Still range bound.
- **GBP:** Sideways near term, mixed medium Term.

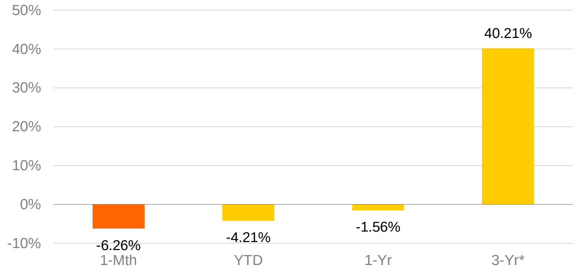
Equity Markets and Commodities

United States

Economy growing above trend

- Incoming data continue to support Citi analysts' view that the US economy is growing at an above-potential pace of 2.5%-3%. There is evidence of this in the growth of payrolls, consumer spending, and construction activity.
- As such, despite heightened global market volatility caused by events in China, Citi analysts see domestic developments pointing to the first rate hike in Sep, although the Fed could delay if financial markets are weak.
- From an equity perspective, earnings are critical for stock prices and investors need to see an EPS pickup for conviction. Citi analysts believe that the easing of drags from Energy and a stronger dollar as the year progresses could improve yoy profits by 4Q15. Thus, while markets are likely to remain volatile in the near term, Citi analysts maintain a moderately bullish stance.

Chart 1
S&P 500 Index



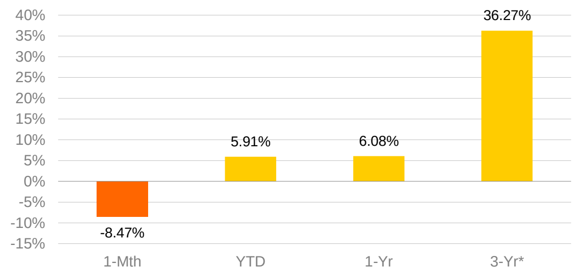
*Denotes cumulative performance
Performance data as of 31 August 2015
Source: Bloomberg

Euro - Area

ECB may remain accommodative as inflation stays low

- With a financial assistance agreement to Greece formally ratified by the Eurogroup on August 14 and the prospect of further aid disbursement in the coming weeks, Citi analysts think that the euro area economy could grow at a slightly faster pace in 2H15.
- At the same time, lower commodity (energy) prices tend to be a positive signal for euro area GDP growth, whilst reinforcing the likelihood that inflation may undershoot the ECB's target. As a result, Citi analysts continue to believe that the ECB could err on the side of caution, reinforcing their scenario of a likely extension of the quantitative easing programme beyond Sep-16.
- Despite an emerging value case for European companies with Asia-Pac/China exposure, Citi analysts continue to skew their preference towards stocks with domestic or US exposure, positive earnings momentum, and less than 2x price/book.

Chart 2
Dow Jones Stoxx 600 Index



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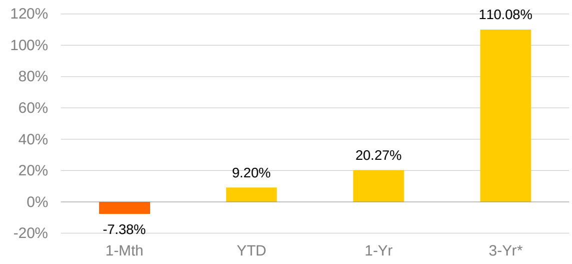
Source: Bloomberg

Japan

BoJ could implement easing between Oct and Jan 2016

- Citi analysts see that the current external environment remains tough for exports; an eventual pickup in economic activity in trading partners — probably driven by the US — may revive Japan's exports in 2H15. This, along with prospective solid growth in private capex, could put GDP growth back on a modest, positive track in Q3 and beyond.
- On the other hand, consumer spending appears weaker and with inflation likely to remain subdued, Citi analysts expect the BoJ may be forced to implement additional easing measures somewhere between late October 2015 and January 2016.
- As the market adjusts due to overseas events, Citi analysts' central strategy for a mature bull period in the equity cycle is to buy the dips but not chase the rallies. However, Citi analysts also think it a good idea to select defensive names in preparation for the emergence of downside risk or a growing sense that equities have overheated. Citi analysts are overweight defensive sectors such as healthcare and consumer staples, while neutral on basic materials and industrials.

Chart 3
Topix Index



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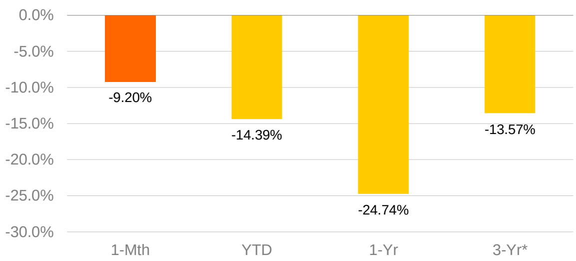
Source: Bloomberg

Emerging Markets (Asia, CEEMEA and Latam)

Overweight Asia; Underweight EMEA and Lat Am

- Return on Invested Capital (ROIC) in EM has fallen to the same level as that of Europe, but Europe has seen US$80bn of flows YTD vs US$30bn outflows for EM. Within EM, Asia leads in terms of ROIC, followed by EMEA and then Lat AM. ROIC has fallen in all markets except Taiwan.
- Asia generally has better capex discipline and a lower correlation with declining terms of trade. On ROIC vs P/BV, the markets that are cheap are China, HK, Korea, Taiwan, Russia and Turkey, while the Philippines, India and Indonesia are relatively expensive. Elsewhere, Citi analysts find Mexico is richly priced, as is South Africa.
- In EMEA and Lat Am, corporate profits are determined by the terms of trade. Until these improve, the profit outlook is unlikely to turn around. In contrast, Asia is showing the biggest improvement since the late 1980's.

Chart 4
MSCI Emerging Markets Index



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Bond Markets

Favour high yield credit

US Treasuries

- Citi analysts expect the market to price in one rate hike by end of 2015, and a path of rate hikes that is gradual, but slightly above the pace of hikes priced in the market.
- Low inflation and subdued global growth together imply a benign picture for the longer end of the curve.

Investment Grade (IG) Corporates

- The largest drag on Investment Grade performance remains the direction of core rates.
- Citi analysts show that 65-75% of IG credit returns are tied core government bonds returns.
- Considering Citi analysts' benign view on rates this year, they are comfortable maintaining a neutral duration view on credit.

High-Yield

- While oil prices and summer seasonality is expected to drive some near-term volatility, longer-term expectations remain positive.
- Fundamentals (ex-energy) are solid, balance sheet liquidity is robust and yields continue to provide relative value in a low yield environment.

Euro Bonds

- 10y Bund yields are expected to edge lower despite Citi analysts' expectation of a Fed rate hike in September.
- The key dynamics at play are, firstly, that the ECB finds itself getting further behind its inflation objectives as the Asian devaluation against the rest of the world forces a greater degree of disinflation. Secondly, growth momentum has waned in Europe (and globally).
- The net effect is that the Fed rate hike path is being priced as a small and slow-paced hike cycle.
- This infers that the market can continue to trade a lower for longer.

Japan Bonds

- There is an increasing political risk in Japan. Firstly, the declining approval rating of the Abe cabinet (currently around 35%) could cause PM Abe to lose the LDP leadership election in September (likely on the 20th) and put an end to Abenomics including quantitative easing by the BoJ.
- Secondly, the decline in Abe's approval rating, along with weaker-than-expected growth, implies an increasing risk of the second consumption tax hike (currently scheduled for Apr 2017) may be postponed ahead of the upper-house election in summer 2016.
- Such a postponement would make it extremely difficult to achieve the primary balance target by 2020 and could push up fiscal premiums in the market.
- Citi analysts expect markets to continue to rally though political risk is likely to increase in coming weeks.

Currency

Bullish Fed in A Broken China Shop

Slow growth and low inflation in China likely means weaker commodity prices and world trade, with multiplier effects to developed economies and an extended period of low DM inflation and accommodative monetary policy. This likely manifests itself in USD gains vs commodity exporters but a less obvious upside vs other DM currencies because Fed normalization is likely to be more limited, delayed and stretched.

EUR: Still Range Bound

- Euro is likely to continue consolidating in a 1.08-1.13 range. Helping to hold the EUR up are (1) an oversold currency that has also overshot levels consistent with real expected short term interest rate differentials, and (2) supportive net portfolio inflows.
- With Euro data looking ok, the ECB could be on a quantitative easing auto-pilot at least through 1Q16 while Fed tightening may be extended, lowered or delayed by events in China, keeping Euro range bound.

GBP: Sideways Near Term, Mixed Medium Term

- Citi analysts now expect the Bank of England to wait a little longer than the Fed to commence raising rates with only two hikes likely next year due to: (1) a lower 2015-16 inflation outlook; (2) less weight on financial stability arguments; (3) greater risks that early tightening could cause a sharp FX appreciation.
- With GBP currently pricing in line with rate differentials therefore, sterling could trade sideways versus EUR and USD over the next 3 months but strengthen versus EUR medium term.

JPY: Rising Trend Still

- Further upside in USDJPY is likely in the medium term with the main drivers being: US cyclical outperformance and generalized USD gains; rising yield divergence between US and Japan; and continued expansion of Japan's monetary base versus a stable US monetary base; a more broad-based rise in credit and money in the US.

AUD & CAD: Medium Term Weakness

- **AUD:** China's growth risks plus Australia's central bank lowering its growth forecast for 2016 from 3.25% to 3.0% (and still subject to further downside risks) could see a further 25bp cut to the base rate before the end of the year. This could see AUD/USD weakness continue over the medium term.
- **CAD:** With CAD tracking oil, the potential impact of higher Iranian sales, a rising US rig count and stronger, USD should keep CAD negative. With current Canadian fundamentals still yet to emerge from the shadows cast by last year's oil price shock, this suggests an extended period of low interest rates following the Bank of Canada's 25bp policy rate cut in July (to 0.50%) with the risk that it could consider lowering interest rates further, thus adding to the weak tone in CAD.

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