Market Outlook

Markets Weigh Further Monetary Support in Europe and Japan

Equities Markets

Feature

Financial markets suffered a minor correction across asset classes in early August - the usually volatile and vulnerable summer period. However, it rebounded sharply despite soft economic data dominating headlines recently. Tepid US retail sales, stagnating growth in the Eurozone and finally, slowing loan growth in China, markets continued to rally as investors are hoping for either more aggressive monetary and/or fiscal stimulus, or a continuation of already easy monetary policy.

Indeed, although Citi analysts expect the Fed to end Quantitative Easing (QE) in Oct 14 and hike rates in 3Q15, ample liquidity is still anticipated coming from both the ECB and Bank of Japan (BOJ) going forward. The former is likely to launch a large scale asset purchase programme in late 2014 or early 2015 while the latter is expected to ease in October 2014. Citi analysts believe this is likely to provide additional support to equities.

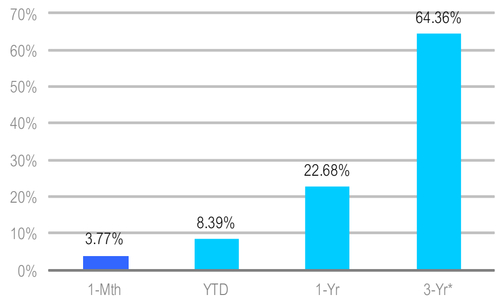
United States

– Improving consumer fundamentals, especially healthy employment and income growth, are pointing to solid growth of 3% or better in the next few quarters. The bounce-back in growth, especially in private domestic demand, may drive the unemployment rate below 6% later this year.

- The Fed has been cutting asset purchases by $10 billion per meeting and should complete the program by October. While the Fed is in the process of revising its exit principles, Citi analysts do not expect rates to increase until 3Q15.

- Finally, Citi analysts remain constructive on US equities over the longer term as the raging bull thesis has legs over many more years given favorable demographics and an underinvested public. Quarterly results have been robust and the guidance from companies has been improving, providing support to share prices.

S&P 500 Index



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

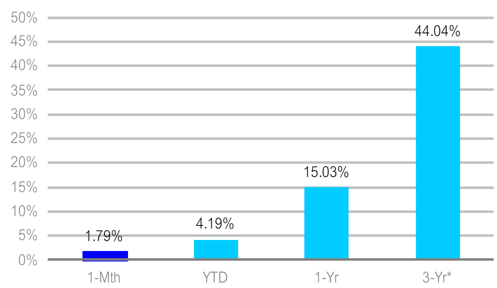
Euro-Area

– Citi analysts lower their GDP forecasts for 2014 and 2015 by 0.3pp and 0.2pp to 0.8% and 1.5%, respectively. This change reflects the disappointing Q2 GDP data, risks that sentiment surveys may weaken further and rising geopolitical risks.

– Generally, the hurdle for additional policy action remains elevated in the short-term following the June announcements (lower key rates and QE). However, Citi analysts maintain a baseline that the risks of a prolonged period of very low inflation and the vulnerability of the recovery may prompt the Governing Council to launch a large scale asset purchase program in late 2014 or early 2015.

- From an equity perspective, Citi analysts see the recent pull-back in share prices as an opportunity. While there are near-term geopolitical risks, Citi analysts believe we are still some way from the end of this economic and profits cycle, expecting 10% Earnings-per-Share 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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Equities Markets

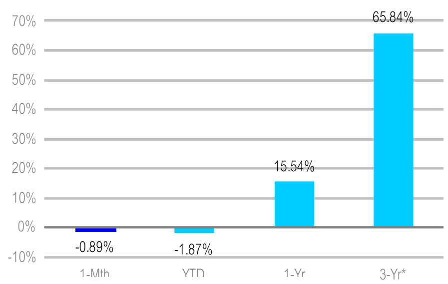
Japan

– Real GDP in Q2 fell by 7.1% annualized after a 6.1% gain in Q1. Consumer spending fell 5.0% QoQ (non-annualized). While Citi analysts expect a rebound in real GDP in Q3, Q2 weakness may have a second-round effect through a slowdown in profits and income.

– In this environment, the BoJ's view on the economy has turned somewhat more nuanced. Citi analysts believe the BoJ may act in late October when it updates its semi-annual outlook report.

Japan is the only major market where Citi analysts are more optimistic on 2014E EPS growth than bottom-up consensus. Citi analysts remain positive on the back of a weaker yen, robust earnings growth and reasonable valuations.

Topix Index



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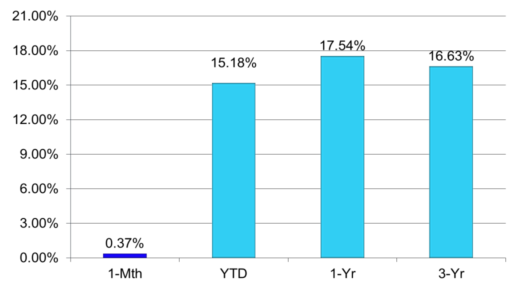
Asia Pacific

– China's growth appears to be stabilizing after a volatile summer. The services Purchase Managers Index first stirred up optimism and also exports growth surprised a bit to the upside. Citi analysts' views remain constructive on Chinese equities given potential portfolio capital inflows on Shanghai-Hong Kong Connect and progress in reforms. Also 1H14 results supports Citi analysts' 8% EPS growth forecast increasing confidence in Chinese equities.

– Over the next 12 months, Asia earnings growth is expected to be above trend driven by Taiwan, HK, the Philippines and Thailand. Asia has positive valuations, good relative revisions and money growth with P/E for Asia is close to 1SD below the mean and P/BV 0.6SD below. China and Korea are the cheapest markets, the Philippines and India the most expensive.

MSCI Asia Pacific ex-Japan Index



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Source: Bloomberg

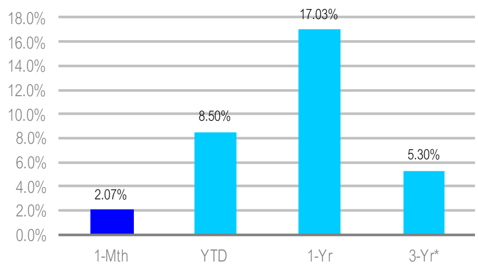
Emerging Markets

– EM equities have rallied but sentiment towards the asset class is still neutral. EM valuations are cheap, earnings momentum is okay and data surprises stronger than in Developed Markets. There is little historical evidence that a stronger USD or higher US yields may hurt relative EM equity market performance in the mid-term.

– Citi analysts' expectations of mid-single digit earnings growth this year in CEEMEA is a result of across the board weak macro, and the impact of a declining oil price on the Russian energy sector. That said, currency weakness can help earnings to an extent that overall downgrades may not be as intense as initially feared.

– In Latin America, Citi analysts prefer Mexico as it stands out on structural reforms, market-oriented policy and linkage to a US manufacturing renaissance.

MSCI Emerging Markets Index



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Currencies and Bonds Markets

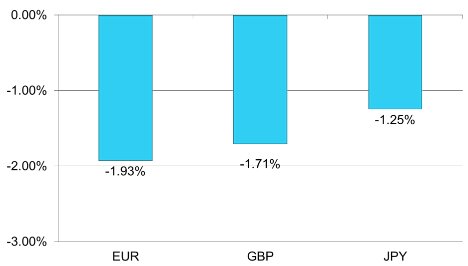
Currencies

– The ECB exceeded market expectations on all major points but weak data is hurting the EUR. Citi analysts continue to see risks for EUR on the downside. A key downside break would be if ECB opened door to additional policy measures. They think that the single currency could lose more ground against higher yielding currencies like AUD as well as GBP where the tightening cycle beckons.

– GBP longs were shaken post-inflation report with investors' skepticism of Yellen's view spreading to that of Carney's. With markets now pricing the first full hike around April, risks could be on the more hawkish side. In FX, the extent of positioning squaring should limit further downside for GBP and Citi analysts continue to like it higher against EUR. Sterling lost ground more recently following another weak retail sales release and evidence that 'rebalancing' ambitions have yet to produce results. Weak data could highlight the downside risks to the BoE's latest somewhat optimistic growth projection.

– Investors are beginning to show impatience with poor economic outcomes, and even the BoJ has acknowledged slippage, however weakly. Explicit easing bias is not on the front burner, but the long- awaited turn in Monetary Committee tone has left JPY hovering around 104. In the near term, USD drivers are likely to be key. However, once there is a clearer picture on the timing of easing from the BoJ, a move closer to the 108-110 level could be on the cards.

Currencies **(1 Month vs USD)**



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Bonds

US Treasuries

Treasury yields started August on their highs after the strong 2Q GDP figure (4.0% QoQ), and fell gradually over the month. The rally was further fuelled by the uptick in the jobless rate, the authorization of US airstrikes in Iraq and the recent escalation of tensions in Ukraine. These rallies are part of a general lowering in yields and flattening of the curve over the course of the year, which Citi analysts believe is partly due to the ongoing monetary easing in Europe.

IG Corporates

Potentially higher US Treasury rates remain the biggest risk to future performance and Citi analysts expect returns for the second half of this 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 remain constructive about High Yields (HY) despite historically low absolute yields and narrow post-crisis spreads. The market (and further spread compression) should be well-supported by low volatility, declining default rates, and scarce alternatives for attractive yield. In particular, Citi analysts favor € HY debt over $ denominated HY bonds.

Emerging Market Debt

Citi analysts remain concerned that the EM rally has not been driven by any broad-based improvements in fundamentals. Prospects for export growth are generally lackluster (despite an uptick in developed market imports) and current account deficits persist. Moreover, geopolitical risks prevail (i.e., Ukraine/Russia, Middle-East tensions) and the pace of China growth is unclear. While the rally is likely to be sustained near term, EM debt markets are not likely to maintain the pace of recent gains.

Euro Bonds

A further, unanticipated deterioration of Eurozone fundamentals has significantly increased the probability of the ECB having to ease through QE by yearend. Citi analysts have lowered the year end Bund forecast to 0.75%, followed by a rebound to 1% in Q1-15, which is a reaction observed in other episodes of QE. From there, Citi analysts expect Bunds to reach 1.50% by Q3-15, a more justified fundamental yield level.

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