Standpoint

Q4 | 2014

Global Market Analysis by Citi EMEA Consumer Bank

Globalization: from Convergence to Divergence

Divergence is not really a new topic in the history of the world economy. However, with the increasing importance of the globalization process, world economies have been increasingly intertwined over the last 20 years. This convergence allowed a faster transmission of either positive or negative economic dynamics between economies in particular from larger to smaller markets. It is also worth remembering that a convergence of fiscal and monetary policies on a global scale had been required to address and sort out the 2008 financial crisis and the recession that followed.

"The global economy is facing a "unique situation" after more than three decades of steady growth starting with the integration of China into the global economy."

W.Buiter, Citi Chief Economist

As Developed Markets led by the US initiated their recovery process, Citi analysts observed that recovery came along with increasing divergences between economies. In particular, Citi analysts observe that the transmission of positive economic dynamics through global trade has significantly diminished. Indeed, they see that although world trade volume grew by 3.2% in Q2 from 2.7% in Q1 this year, this remains well below the pre-crisis norm (6.6% Year on Year over 1998-07). In particular, world trade growth remains slightly below global industrial production growth (3.5% YoY), a sharp contrast to the pre-crisis trend whereby world trade growth was usually about twice the pace of global industrial production growth. Various factors may drive the sluggish trend in world trade growth among which the global public and private deleveraging process, the energy revolution in the US and the slowdown in China and the struggle to reform its economy.

Citi Outlook

A snapshot of Citi's global market views across a select group of asset classes, regions and currencies over the next three to six months

Here, Citi analysts assess each asset class independently.

The Global Investment Committee ('GIC') made no changes to recommended portfolio weightings at its latest asset allocation meeting. The Committee decided to maintain its existing overall equity/bond asset allocation. The allocation remains overweight risk assets and underweight interest rate risk. The GIC maintains overweight in equities, with overweights in US, Japan, Asia and Europe. This is offset with an underweight in fixed income, concentrated in a heavy underweight in developed sovereign bonds. Within its fixed income portfolio, the GIC now has small overweight position in high-yield while positions in emerging market debt are underweight and investment grade corporate bonds are neutral.

The committee considers that Beyond near-term speculation over the Fed's message, monetary-policy divergence appears poised to favour US dollar assets heading into 2015. They suspect global flows are likely to be drawn towards US equities and other risky assets, barring a highly localized disruption to the US economy. The committee continues to see the best opportunities over the next 12-18 months in risky assets, but is more cautious looking further out.

Global equities	
Market	**Outlook**
	Positive
US	Positive
Europe	Positive
Japan	Positive
Latin America	Negative
Asia Pacific	Positive
Emerging Europe	Negative

Global fixed income	
Market	**Outlook**
	Negative
Global Government	Negative
Global IG Corporate	Neutral
Developed High Yield	Positive
Emerging Market Debts	Negative

Global currencies	
Currency	**Outlook**
Euro	Negative
Yen	Negative
British Pound	Neutral

Data Source: Citigroup Global Markets Inc. Weighting provided by Citi EMEA Consumer Bank as of October 2014

Going forward, Citi analysts expect that world trade growth will stay well below pre-crisis norms but they don't think that the modest pace of world trade growth will derail the strong domestic-driven expansions in the US and UK, but probably will make for a more uneven global expansion. In that context, it is less likely that countries with subdued domestic demand (e.g. Japan, Euro area) or high private debt burdens (e.g. various Emerging Markets countries) will be bailed out by export-driven growth.

"Over the past 60 years, generally trade has grown faster than GDP. Now we are in an era where it will not. Countries which are reliant on an export-driven economy will face clear challenges."

W.Buiter, Citi Chief Economist

Citi analysts also anticipate that a further level of divergence will be reached in the coming months. Indeed, while divergence was so far rather a story of Emerging Markets vs Developed Markets in a globally supportive monetary context, persistent economic divergence is likely to be reflected in sizeable monetary policy divergence among DMs going forward. The Fed is set to end asset purchases during the 4th quarter, while the Bank of England is expected to start hiking rates in the next six months, with the Fed tightening around Q3-2015. By contrast, further easing via asset purchases are expected in Japan and the Euro area in the coming months. All in all, Citi analysts think that on a global GDP basis, slightly more than half of the world will ease monetary conditions, and slightly less than half will tighten in 2015. However, with the US Fed gradually moving to the "tightening" side, Citi analysts anticipate further economic divergence and instability which in turn should also be increasingly reflected in financial markets. From an economic perspective, Emerging Markets weakened by excessive debts, current account deficits and unresponsive domestic consumption will be forced to increase rates to prevent investments outflows and currency devaluations which is likely to weigh further on their GDP growth. On the other hand, the Euro Area and Japan will benefit from the consecutive weakening of their currency against the US dollar as it boosts inflation and competitiveness.

"The credit bull market is over; spreads start to rise as investor appetite for rising leverage wanes. But the equity bull market continues as profits and CEO risk appetites rise further."

W.Buiter, Citi Chief Economist

Investment strategies will also need to progressively embed this future trend of monetary policy divergence. In bond markets, Citi analysts observe that the gap between US and German long-term interest rates has already breached twenty-year highs and will widen further as US yields increase while German yields continue to decrease. US Corporate bond markets will also be impacted as credit spreads may have reached their bottom in this cycle while companies starting to raise debt exposure will see the quality of their balance sheet deteriorate. In contrast, Citi's framework suggests the equity bull market is maturing, but not over. Indeed, global financial markets generally take US monetary policy tightening in stride, with most risky assets rising both in the six months before and after an initial tightening by the US Federal Reserve. Citi analysts think the same could be true in the coming year as well. However, they also warn that whilst equity price gains driven by rising earnings are generally healthy, the coming phase of the cycle is also more prone to volatility, on the back of more unstable credit spreads and less compelling valuations, and to the creation of market bubbles.

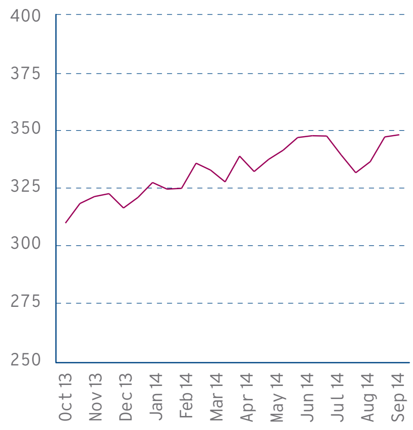
Europe and North America

Europe equities

Monetary Policy Boost

Eurozone GDP forecasts continue to move lower. Citi analysts expect growth of 0.8% this year (vs. 1.3% in March) and 1.4% in 2015 (down from 1.8% in June). Indeed, recent business surveys and data releases suggest economic momentum is weakening, with notable weakness in France and Italy and some softer signs in Germany. In the UK, a healthy economy has not helped listed company earnings which shouldn't be surprising given that 70% of UK plc's revenues come from overseas. In fact, strong sterling, lower commodity prices and weak earnings from banks have all proven a drag on the relative performance of UK equities.

Citi analysts remain optimistic on European equities. They think policy action from the European Central Bank will be a key driver in the near-term, trumping macroeconomic and earnings concerns. Indeed, they believe an improvement in the macro backdrop and the weaker currency should improve companies' earnings. European equities have re-rated sharply since mid-12, from 10x Price/Earnings to 17-18x, so it is harder for investors to find value. But an improving economy and liquidity (flows, Merger & Acquisitions, Quantitative Easing) should support further upside for stock prices. More broadly, they see European Central Bank QE as likely to keep European yields lower for longer through a significant increase in liquidity support which is likely to extend the search for yield/income in European assets, including equities. In Europe, high Dividend Yields (DY) are not at 20-year lows, but they are close to the lower-end of the DY range versus the broader market. Both suggest that high DY does not offer investors an attractive relative value opportunity currently, although versus cash or credit high equity DY would still look attractive.



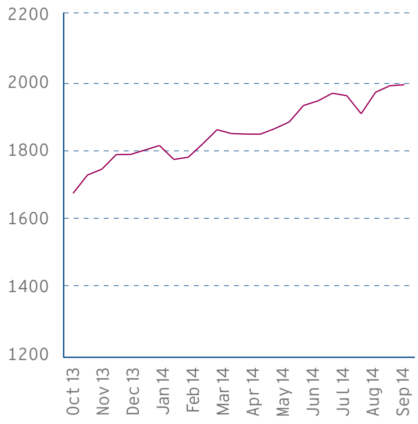
DJ Stoxx 600

Data source: Bloomberg as of 30 September 2014

North America equities

Strong Fundamental Backdrop

Citi analysts have recently upgraded their US GDP forecasts and now expect growth of 2.3% in 2014 and 3.3% in 2015. They expect the economy to grow at an above-trend pace through 2015, helped by dissipating fiscal drag and improving financial conditions. Indeed, improving consumer and business fundamentals, along with supportive financial conditions (including a massive rise in households' wealth) are pointing to a solid 3% growth in the next few quarters. The rebound in growth, especially in private domestic demand, should help drive the unemployment rate below 6% later this year. Meanwhile, the Fed is set to end asset purchases in October and Citi analysts believe the economic outlook is consistent with a first rate hike in Q3 2015. While the broad equity market may need to absorb changes in Fed policy direction over the next few months, the key earnings catalyst for further share price appreciation may have to wait until early 2015 when management teams will have formal budgets to provide more detailed guidance. In that regard, Citi analysts think improving capital spending trends and hiring intentions point to a continued expansion which should be supportive for corporate earnings. They recently raised their Earnings per Share growth forecasts for 2014 (+8% Year on Year) and 2015 (+7% YoY). In addition, US equities do not look expensive to Citi analysts. Citi's normalized earnings yield gap analysis which captures both Cyclically Adjusted Price/Earnings and the market driven 5-year forward swap contract of the 10-year bond yield argues for a high probability of market gains over the next 12 months. Overall, Citi analysts remain constructive for the next 12 months though a short-term pullback is possible, as investor attention shifts towards the timing of Fed rate hikes.



S&P 500 Index

Data source: Bloomberg as of 30 September 2014

Global Sovereign and Corporate Bonds

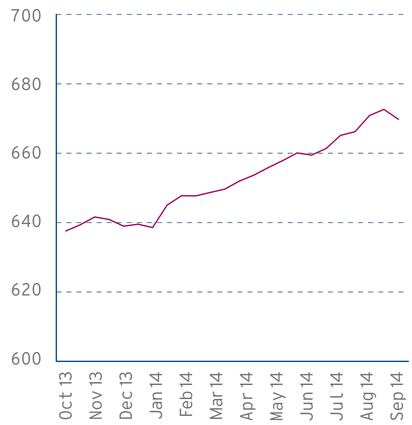
Global Sovereign Bonds

Diverging Yields Trend

US Rates have sold off through September as this summer's geopolitical tensions have eased. A truce in Ukraine at the start of the month was the impetus for a selloff in rates, which has continued throughout the month, and was compounded by the September Federal Open Monetary Committee meeting. The Fed's new economic projections paint a much more hawkish picture of the committee's expectations for rate hikes. Accordingly, Citi analysts are raising their year-end forecasts for 2y, 5y, and 10y rates to reflect heightened expectations of a March rate hike.

In Europe, Citi analysts observe that demand at the 1st refinancing operation was below market expectations. They continue to look for a total amount of around €250bn to be allocated across both the September and December operations. Lower than expected demand together with uncertainties about the modalities of the European Central Bank's bond purchase plan are a real threat to the success of this stimulus package. Citi analysts continue to expect additional stimulus by the ECB, eventually in the form of Quantitative Easing. They therefore maintain their Bund forecast of 0.75% in Q4, followed by a rebound to 1% in Q1-15.

Hard currency Emerging Market sovereigns have been boosted by the decline in core government yields. Regional gains have been broadly positive, led by Asia-Pacific and Latam. Despite the conflict in the Ukraine, Emerging Europe still produced decent returns, led by Turkey and Hungary. Citi analysts remain constructive on EM Bonds as they think dormant inflation pressures in the developed world and increasing ECB bond purchases are likely to prevent core rates from rising too fast. Also, low absolute yields in developed markets and strong risk appetites are likely to underpin high demand for EM assets.



Citigroup World Government Bond Index

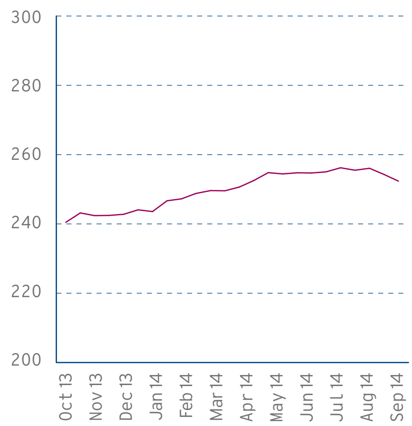
Data source: Bloomberg as of 30 September 2014

Corporate Bonds

Lower Core Yields and Stable Quality

Global investment grade corporate debt returns have already exceeded Citi analysts' 2014 returns expectations on the back of a continued decline in core sovereign bond yields rather than through spread compression. Indeed, Citi analysts estimate that more than 80% of this year's gains are due to the rally in core sovereign debt alone. Although potentially higher rates remain the biggest risk to performance at this stage, the dilution of prospective returns is likely to be modest in the near term. Despite improving economic data in the US, any uptick in core rates is likely to be limited by sluggish Eurozone growth, accommodative monetary policy and geopolitical factors. With only slight rate drag and strong underlying fundamentals, positive returns should persist in credit. That said, returns are poised to be more modest going forward. Spread compression is likely minimal and future returns resemble current coupons. While absolute yields in the US are higher, Citi analysts still expect EU credit to outperform due to increasing ECB support.

Citi analysts remain constructive on high yield corporate debt despite the recent escalation in volatility. After sharply widening by 80bp to 90bp this summer, spreads have retraced tighter by roughly 35bp. High yield credit remains on pace to meet Citi analysts expected 2014 return projections. Credit fundamentals are largely stable, while default and refinancing risks remain low. Also, in September US bond funds have accumulated $3.5 billion of new assets and €4.25 billion in Europe. Citi analysts believe carry is still attractive and value still exists. They continue to favour Single-B rated issuers, which feature a more attractive trade-off of higher yields and lower sensitivity to changes in interest rates than Double-B credits.



Citigroup World Corporate Bond Index

Data source: Bloomberg as of 30 September 2014

Japan and Asia Pacific

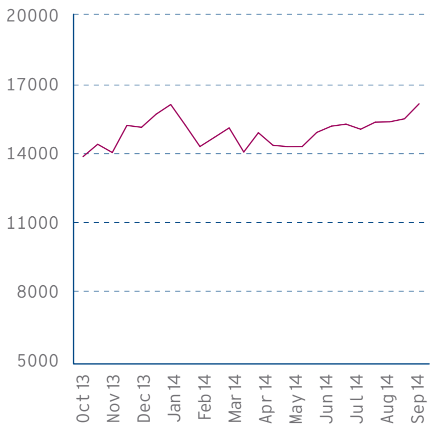
Japan equities

Expecting higher growth

The third quarter of 2014 was relatively favorable for Japanese equities, which rose 5%. The TOPIX Index once again reached local highs in the region of 1300 pts. Stocks were supported by the depreciation of the Yen.

Increased market volatility and moderate sentiment towards Japanese equities are mainly a result of poor economic data after the last consumption tax hike. However the Bank of Japan suggest that weak consumer spending in the last months results from frontloaded demand ahead of the tax hike and influence of unexpected weather conditions this summer. It becomes increasingly likely that the additional tax hike planned for October 2015 will be postponed. But if Prime Minister Abe maintains the earlier announced decision it will have negative impact on consumer spending and households income and finally maintain higher volatility in the Japanese stock market.

Japanese monetary policy is supportive for equities. Furthermore, Citi analysts believe that BoJ will decide on additional monetary easing in the early 2015. The the Bank of Japan will likely increase purchases of risky assets. Moreover, asset management reform at public pension funds could have material impact on TOPIX due to higher allocation in domestic equities at Government Pension Investment Fund and other public pension funds. The GPIF has around ¥126 trillion in assets under management. The proposal of portfolio allocation in domestic stocks is to increase to 20% from the current level of 12%, a significant change.



NIKKEI 225 Index

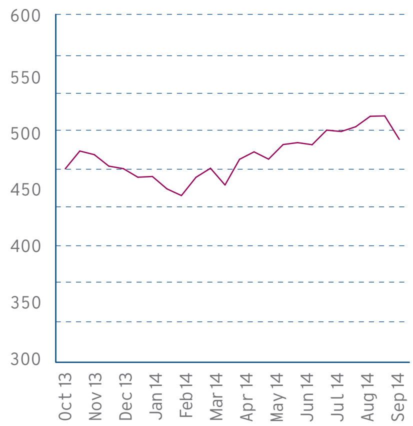
Data source: Bloomberg as of 30 September 2014

Citi analysts assume TOPIX to rise further by end 2015 on the back of better earnings, economic recovery, yen depreciation and pension reform. They still see Japan as one of the most attractive equity markets globally.

Asia Pacific equities

Sentiments Penalized the Region

Recent softer than expected data in China suggest that there are still significant drags for growth in the coming years and raise concerns that the economic momentum is fading. Indeed, August data suggest that the property drag is spreading to other sectors, and Citi analysts think the impact will not be offset by strong exports and targeted policy easing. They recently cut their GDP growth forecasts to 7.3% for 2014 (from 7.5%) and 6.9% for 2015 (from 7.1%) to reflect delays in policy response, and now expect three policy rate cuts between now and mid-2015. Elsewhere in the region Citi analysts anticipate diverging growth, although inflation is benign almost across the board. Citi analysts no longer expect a rate hike in Indonesia, the Malaysia central bank paused and India's hawkish rhetoric is keeping its currency and bonds well supported. Citi's sentiment indicators for the region fell during the last quarter, but with a slowing increment. Strength in the US$ index, negative money flows and weak economic surprises were the top three drivers of weakening sentiment. This is contrary to Citi analysts' belief that Asia as a region among Emerging Markets has the least to worry about from a rising USD. Their rationale is indeed that a stronger US$ leads to weaker commodity prices but only takes away pricing power from commodity producers, and in Asia this segment makes up only 11.3% of market cap.



MSCI Asia Pacific Ex-Japan

Data source: Bloomberg as of 30 September 2014

Emerging Europe and Latin America

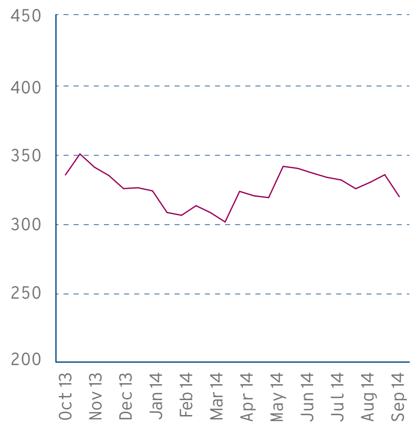
Emerging Europe equities

It's not just about geopolitics Emerging Europe equities are still among the worst-performing asset class since the beginning of this year. This is largely a result of politically-generated turmoil. The whole region has been influenced by the Russia/Ukraine conflict, which has prompted few rounds of trade sanctions undermining growth prospects in many countries. Additionally, sudden expansion of Islamic State in Syria and Iraq poses a serious threat for the local status quo. These developments dominated the sentiment to EM Europe equities in the last weeks.

Citi analysts continue to be underweight in whole Emerging Europe. Even despite the geopolitical tensions, it seems difficult to find fundamentally sound arguments that would justify increased interest in this region.

The largest country in Emerging Europe, Russia, faces external pressure in the form of economic and political sanctions and internal problems such as subdued investment and consumption spending and tight monetary policy. All of this made Citi analysts cut their 2015 GDP growth forecast for Russia from 2,3% to 1,0%. Although the equity market seems cheap, it might still be too early to invest there.

Although Poland seems the most attractive market among Emerging Europe countries, it should be noted however that the signs of slowing economy are more visible recently and the outlook for earnings is still rather poor (Citi analysts see low single-digit growth in 2015). What is more, from the valuation point of view, Polish market does not offer significant potential. The situation in Turkey is also still far from satisfactory. The economy has slowed quite sharply in Q2 and contracted by 0.5% quarterly, which was driven mainly by domestic demand weakness.



MSCI EM EMEA

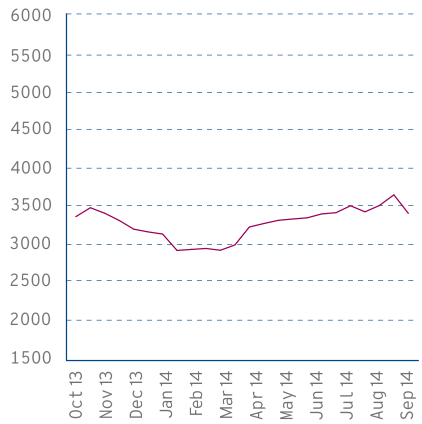
Data source: Bloomberg as of 30 September 2014

Latin America equities

Brazil Elections Overshadow Fundamentals

The Brazilian stock market in recent weeks has followed a simple pattern. Any hint of greater chances of a change in administrations has spurred rallies of what the Brazilian press now calls the "election kit". Any hint that these chances were diminishing produced a drop in markets overall, and relatively better performance by defensives such as utilities and consumer staples, plus exporters. Against a background of pro-dollar global conditions, the Brazilian currency has been sinking, stabilizing only on the type of news that also supported the "election kit" of stocks.

Citi analyst think the market will price equities euphorically in the period between the first and second round of the election as the results of the first round may indeed signal a change in government. Nevertheless, there is the risk of disappointing milestones in polls as the final vote approaches. Citi analysts think the approach towards Brazilian equities has to be rather adapted to that scenario: be aggressive, but only if you can move fast. Otherwise, the political and economic situation in Brazil is still hazardous and Citi analysts think Brazil's challenging fundamentals and unattractive valuations will dictate back again the market's dynamic going forward. Indeed, Brazil shares have rallied sharply since March 2014 and to trade at one standard deviation below average P/E, the Brazil stocks would have to drop another 14% from end September levels. Furthermore, Brazilian earnings are depressed by domestic economic conditions or global commodity pricing. Also, Citi analysts expect further depreciation of BRL against the USD which will weigh further on commodity prices and increase pressures on the country's current account. Finally, Citi analysts observe that funds flows into the region from Developed Markets have turned net negative at the end of the 3rd quarter.



MSCI EM Latin America

Data source: Bloomberg as of 30 September 2014

Global REITs and Commodities

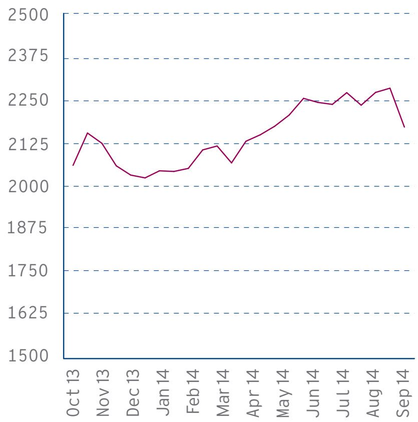
Real Estate Investment Trusts (REITs)

Less Complacency, Supporting Fundamentals

Real estate stocks had a strong year so far and a volatile third quarter - up over 4% by early September and then dropping almost 7%. Heading into the third quarter – despite all the good things about the real estate business – Citi analysts noted that the risk for REIT stocks was tied to potential added equity through follow on offerings and IPOs after a light first half, complacency over interest rates rising, and arguably valuations getting richer as the stocks rallied strongly from the December lows. Unfortunately, all these drove recent volatility and remain "out there" as risks. The "wait" is now on and stocks could be range bound until more clarity develops.

While concerns may linger about continued new equity issuance as well as the perception of the impact of higher interest rates, the underlying drivers of the real estate business do remain very strong and supportive of positive total returns. Operating fundamentals are solid. Capital is widely available at historically low costs and while new supply is increasing, it remains well below norms.

Despite recent heightened risks and volatility, Citi analysts don't think this cycle is completely over for REIT's. Indeed, they observe that lending standards are not irrational; supply is moving up, but not at levels of concern; and interest rates remain low in an overall relatively healthy economy. Therefore, a pullback in fundamentals doesn't appear in the cards. That said, the large excess gains early in the cycle appear to have been made and value from here will be more dependent on each company's ability to create value from internal and external sources, rather than simply capitalization rate compression.



EPRA/NAREIT Global Index
Data source: Bloomberg as of 30 September 2014

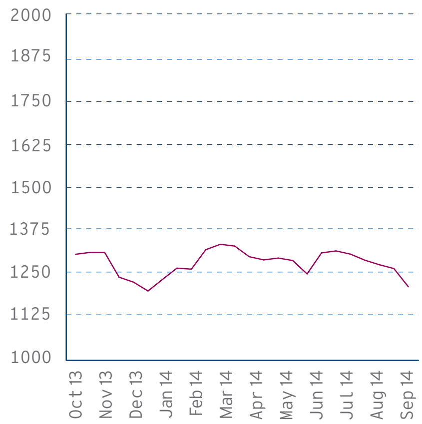
Commodities

Facing a Shrinking Global Trade

Citi analysts observe that a number of factors such as sluggish global economic conditions, stronger US dollar, the faltering commodity intensive Chinese economy, record harvests in the US and Northern Hemisphere, over-supplied crude oil market and outflows of investor funds in passive indices and commodity ETFs have undermined this asset class performance over the past few months.

However, they also point out that a major puzzle impacting commodities stems from the accumulation of an unusually large set of geopolitical factors that point to supply risks ahead. Indeed, so far this year, there has been a marked rise in geopolitical events that would have 'normally' been expected to trigger a price increase, especially in energy markets. The Ukraine crisis and threat of inadequate natural gas supplies in Europe this winter didn't stop UK or continental European natural gas prices from falling. The questioning of international and national borders in Russia/Ukraine and in the rise of the Islamic State in Syria/Iraq had practically no impacts on global oil prices. Citi analysts think this lack of price sensitivity is largely due to trade and payments trends which actually point to a shrinking of global trade and credit as illustrated by the sanctions imposed on Russia, the world's largest hydrocarbon exporting country as well as by China pre-export payments for oil and gas which are removing a significant part of international trade from globalized markets.

Going forward Citi analysts are bullish the platinum group, copper, nickel and lead, coking and thermal coal, cocoa and coffee, because of either geopolitical or fundamental factors.



Golds US$/troy oz.
Data source: Bloomberg as of 30 September 2014

On the other hand, they are bearish WTI crude oil, corn, soybeans and cotton. But overall commodity performance will depend largely on global macroeconomic conditions, which still look weak into 2016.

Currencies

Euro

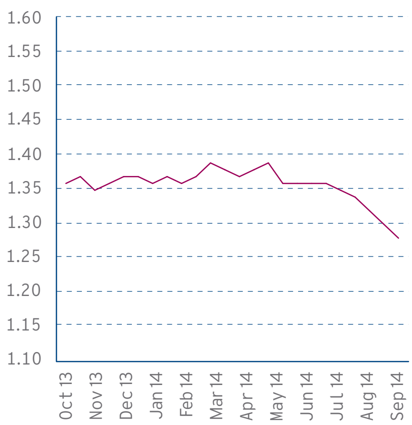
The European Central Bank (ECB) has shifted its focus on the size of its balance sheet, indicating that it aims to return its balance sheet size “significantly towards” beginning-2012 levels, implying perhaps an increase of at least €500-700bn from current levels. The ECB may struggle to achieve the amount of desired private asset purchases and overall balance sheet increase, in which case an additional quantitative easing (QE) programme (this time focused on government bond purchases) would be likely. But Citi analysts argue that even if the ECB manages to achieve the currently desired increase in its balance sheet, an additional purchase programme would be likely, as the recently announced measures are too small to return Eurozone inflation to the ECB’s target. The expectation of further ECB easing is a major driver of the current (and expected future) euro depreciation. This is why Citi analysts do not think that a weaker euro will stand in the way of an eventual broad-based QE programme. Citi analysts forecast EURUS at 1.15 over a 6 to 12 months horizon.

Yen

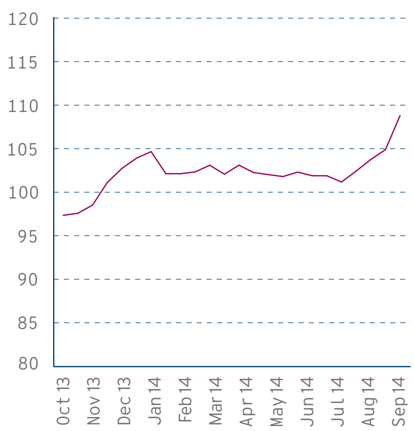
Citi analysts think core inflation ex-tax hike will fall below the 1% mark around the turn of the quarter which is in line with the inflation expectation which also appears to be hovering at around 1%. The distribution of yearly changes in prices for the items included in the core Consumer Price Index is inconsistent with a 2% inflation expectation, in Citi analysts view. They also observe growing concerns among Japanese politicians/policymakers that the further depreciation of the yen will damage small firms and households. Citi analysts are sceptical that the Bank of Japan will implement additional policy measures that could lead to a further significant yen depreciation. Meanwhile, the government is most likely to decide to introduce another supplementary budget when Prime Minister Abe makes an official decision to implement the second consumption tax hike. However, it seems extremely difficult to craft a supplementary budget that can offset the impact from the upcoming second hike adequately. Citi analysts forecast USDJPY at 115 and EURJPY at 132 over a 6 to 12 months horizon.

Pound Sterling

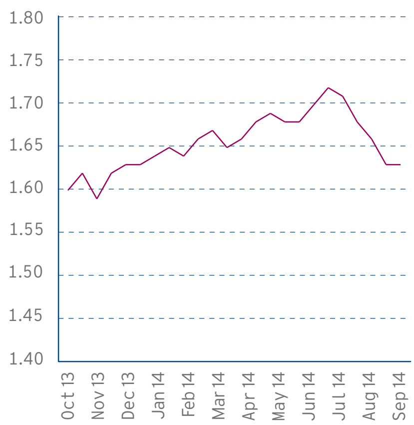
UK real GDP growth has markedly outperformed consensus this year and is likely to continue to do so in 2015, in Citi analysts view. The Office for National Statistics (ONS) upward revisions to GDP growth indicates that the economy’s underlying health is markedly better than the Monetary Policy Committee (MPC) and consensus acknowledge. In particular, the revised ONS data suggest a powerful recovery in business investment which makes Citi analysts more confident that the supportive trends in profits, capacity use and credit availability will be reflected in further rapid investment growth. However, recent disappointing housing data, sentiment indicators and weakness in UK’s main trading partners may warrant some cautiousness and forced investors to push back bets on early stimulus removal. Furthermore, policymakers comments appear to endorse a very slow rate hiking path. The Financial Policy Committee recommendation that BoE expands its macroprudential toolkit to regulate the housing market would be seen as a substitute for rate hikes. Citi analysts forecast GBPUSD at 158 and EURGBP at 0.73 over a 6 to 12 months horizon.



Euro-Dollar (USD/EUR)
Data source: Bloomberg as of 30 September 2014



Dollar-Yen (JPY/USD)
Data source: Bloomberg as of 30 September 2014



Pound-Dollar (USD/GBP)
Data source: Bloomberg as of 30 September 2014

Guest Corner

War & Peace: Shale, Central Banks Underpin Investor Indifference to Geopolitics

by Tina Fordham, Citi Chief Global Political Analyst

Geopolitical risks are proliferating... The annexation of Crimea and ISIS' rejection of the Sykes-Picot borders in the Middle East risk the return of border disputes, unseen since WWII. Tensions between Russia and the West have prompted sanctions and a revival of nuclear rhetoric, while the US has authorized air strikes against ISIS in Iraq. These developments are taking place in a more uncertain security environment, compounded by declining defense budgets, reduced public appetite for military intervention and rising anti-establishment sentiment. In the short-term, Citi analysts think investor indifference to geopolitical risks is largely justified. But given deteriorating security and political fundamentals, and the prospect of waning Quantitative Easing, this is unlikely to last.

...Yet financial markets are largely unmoved, treating these risks as idiosyncratic and localizing them. For now, Citi analysts think equity markets are largely justified in failing to price in worsening geopolitical risks. Investors focus on the US because it dominates global equity markets, accounting for 50% of market cap. Emerging Markets economies account for 10% of equity market cap. This helps explain why investors care most about what's happening in Developed Markets economies, the US in particular.

What accounts for this disconnect? Historically, geopolitical risks have impacted markets through one of two transmission mechanisms: a growth shock or an oil price shock--or both, as in the 1973 crisis. Today, central bank support has limited the impact of disappointing growth on markets, and the emergence of US shale has muted the impact of an oil price shock, raising the question of whether markets have outsourced geopolitical risks to central banks.

The economic impact of political tensions is not restricted to the 'conflict zones' themselves.

When the EU and the US imposed very broad-based sanctions on Iraq or Syria, EU and US exports to these two countries (which were of course only a small fraction of total EU and US exports) fell by 90% and more within two years. And even if Citi analysts exclude the most extreme episodes, the effects can still be significant. For instance, in 2012, anti-Japanese protests in China were a major reason behind the more than 10% decline of Japanese exports to China in that year. Currently, Russia-related tensions are probably the single biggest reason why Eurozone growth has both weakened and been weaker than expected in 2014 so far. Exports to Russia are falling by 10-20%YY across Eurozone countries and roughly 15%YY for the Eurozone as a whole. The fall in exports cannot be linked exclusively to the political tensions (let alone specific sanctions), as the Russian economy has been weakening for some time, but equally the tensions have adverse effects on the Eurozone economy beyond their direct impact on exports. Thus, the tensions have clearly affected business (and more recently even consumer) sentiment in the Eurozone, and in particular in Germany. Investment prospects, which had steadily improved in much of the Eurozone over the previous 18 months, have weakened again, too. Overall, Citi analysts estimated that Russia-related developments are lowering Eurozone growth by perhaps 0.2- 0.3pp of GDP or more per year, even as sanctions remain relatively contained. A further major escalation, including the possibility of durable disruption of commodity supplies to Russia-dependent Europe has the potential to throw the Eurozone back into recession.

The economic impact of geopolitical uncertainties also extends beyond the immediate conflict periods. Sanctions often remain on the books for a long time, hindering trade and cross-border investment. More generally, geopolitical uncertainties and tensions and the lack of a widely accepted international modus operandi has contributed to a halt in the multi-decade trend of globalization of trade and financial flows and selected reversals. The effects of this change in trend are gradual and difficult to estimate precisely, but can be substantial over time.

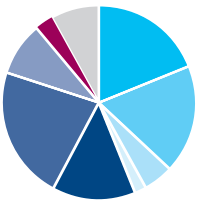
The suggested allocations are intended to be general in nature and are not to be construed as specific investment advice. Investors are encouraged to consult with their Financial Professional to determine their allocation needs based on their risk tolerance, suitability and goals.

Spotlight on allocations

Global model portfolios

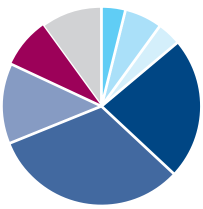
- Cash **20%**
- Developed IG Government Bonds **45%**
- Global IG Corporate Bonds **20%**
- Global Equities **15%**

- Developed IG Government Bonds **34%**
- Global IG Corporate Bonds **25%**
- High Yield Bonds **6%**
- European Equities **6%**
- US Equities **11%**
- Global Equities **13%**
- Global REITs **5%**



- Developed IG Government Bonds **19%**
- Global IG Corporate Bonds **18%**
- High Yield Bonds **5%**
- Emerging Market Debt **2%**
- European Equities **14%**
- US Equities **22%**
- Pacific Equities **9%**
- Emerging Markets Equities **3%**
- Global REITs **8%**

- Developed IG Government Bonds **6%**
- Global IG Corporate Bonds **13%**
- High Yield Bonds **6%**
- Emerging Market Debt **4%**
- European Equities **17%**
- US Equities **27%**
- Pacific Equities **11%**
- Emerging Markets Equities **6%**
- Global REITs **10%**



- Global IG Corporate Bonds **4%**
- High Yield Bonds **6%**
- Emerging Market Debt **4%**
- European Equities **23%**
- US Equities **32%**
- Pacific Equities **13%**
- Emerging Markets Equities **8%**
- Global REITs **10%**

About the Citi Asset Allocation Process

The Citibank tactical portfolio allocations are based on the work of the Global Investment Committee (GIC) of Citi Private Bank. The membership of the committee is comprised of experienced investment specialists from across Citi. The GIC deliberates on the macroeconomic and financial market environment in order to formulate an outlook across multiple asset classes and is responsible for maintaining tactical model portfolios based on this outlook. The tactical weights that are applied to the Citibank portfolios are aligned to the decisions of the GIC.

Allocation to bond and equity markets

The Global Investment Committee (GIC) has decided to maintain positions across asset classes with an overall Overweight stance in Global equities.

Overall the GIC now stays overweight on equities and underweight on fixed income.

The GIC believes that medium term outlook for equities remains favourable though short term risks have increased on the back of geopolitical tension and increased economic divergences. Overall, equities continue to offer better risk/reward than credit this year while both returns are likely to be below last year's gains as the attractiveness of valuations has somewhat deteriorated.

Allocation to regional equity markets

The GIC maintained its overweight in US, Europe and Japan and Asia. Emerging Market equities continue to be underweight.

Within the equity universe, the GIC has the largest overweight positions to US equities with a brightening outlook given signs of growing corporate capital expenditure combined with improving housing and job markets feed through into economic growth although the Fed's taper process could generate periods of volatility. Exposure to Asian equities has been maintained on the basis of valuation not reflecting the strong earnings growth momentum in the region.

And the GIC believes that Japan may resume grinding higher even though at a slower pace supported by new political leadership taking a more aggressive stance on fiscal and monetary policy. Also the GIC maintains its position in Europe equities given still attractive valuations and improving monetary support from the ECB. Meanwhile the GIC is now Underweight in Emerging Europe and Latin America equities, and suggest selectiveness with regards to country allocation.

Allocation to government and credit markets

The GIC is heavily underweight sovereign bonds, with US Treasuries bearing the brunt of the underweight, and Emerging Market debt on the back of increasing yields and currency risks. They have small overweight position in High yield bonds. Investment grade allocation of the GIC are now neutral on the basis of narrower spreads capping the scope for gains in a period of rising yields.

Important Disclosure

"Citi analysts" refers to investment professionals within Citi Investment Research and Analysis, Citigroup Global Markets and voting members of the Global Investment Committee and Global Portfolio Committee of Citi Private Bank.

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