January 2012

FIXED INCOME
STRATEGY REPORT

The European debt crisis and slowing global growth - are poised to be the principal drivers of return in the fixed income market in 2012. This bodes well for the performance of high-quality fixed income assets, and long-dated securities.

The recent rise in German Bund yields - reminds investors that the meaning of “risk-free” government debt is currently being recalibrated. Our analysts expect that ratings agency actions are not going to put a dent in the US Treasury market.

Citi analyst’s strongest conviction in fixed income - continues to be long-dated high grade corporate bonds. They favour non-financial issuers in the US, where fundamentals are solid. Long-dated UK gilts, which generated the most impressive bond returns of 2011, remain their favourite recommendation in government debt.

Sectors	12 Months View	Investment Rationale
Dev. Market (Core) Sovereigns	**Market Perform**	Increased risk aversion and slowing growth to keep rates low; long duration to outperform; favour long-dated UK gilts
EU Periphery Sovereigns*	**Underperform**	Avoid any exposure; Volatility to stay at record highs as current proposals will not be sufficient to stabilize periphery.
Emerging Market Sovereigns	**Market Perform**	Improved fundamentals offset by heightened risk aversion and capital flight due to EU periphery fears and slowing developed market growth; stay in high quality issuer and external debt.
High Grade Corporates	**Outperform**	Citi analysts recommend long-dated non-financial credits as fundamentals remain broadly solid; Financial sector to remain volatile
High Yield Corporates	**Market Perform**	Valuations attractive relative to default risks, but likely to track equity volatility near term; defensive stance; favour BB issuer

**EU Periphery Sovereigns include bonds from countries such as Greece, Ireland, Italy, Portugal and Spain.*

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Developed Markets Government Bonds

The festering European debt crisis and slowing global growth are set to be the main drivers of return in the fixed income market in 2012. Uncertainties fuelled by periphery Europe and further contagion concerns are likely to keep safe-haven sentiment high. From this perspective our analysts expect good performance of high-quality fixed income assets, long-dated and high liquid debt to continue in this year.

Falling inflation in the developed world promotes a climate of low interest rates, which is good for (current) bondholders, but not so good for investors reaching for yield. Unfortunately, our analysts expect bond yields to be largely capped around recent ranges and to trend lower in some regions like the US and Japan, but especially Europe.

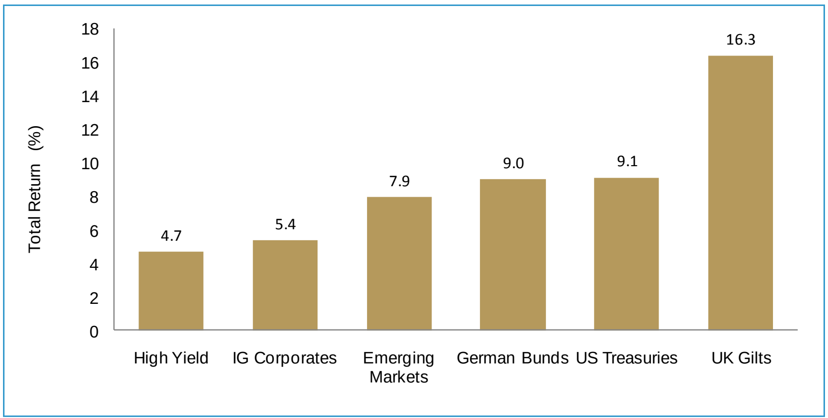

Figure 1: Bond Market total returns (YTD) measured by Citi Global Bond Indices
Source: Bloomberg, Citi
Past performance is no indication of future results.

The United Kingdom (UK) is not immune to the periphery problems in continental Europe. However, gilts are benefiting from the Bank of England's decision on October 6 to boost its bond purchase program from £200 billion to £275 billion. Gilts also benefit from the government's renewed commitment to its austerity plan on November 30, which solidifies the UK's AAA rating. Long-dated UK gilts, which generated the most impressive bond returns of 2011, remain Citi's favourite recommendation in government debt (Fig. 1).

In Citi view bond investors will be recalibrating sovereign risks for years to come. While our analysts do not expect another downgrade to US Treasury debt this year (S&P cut the US from AAA to AA+ on August 5, while Moody's and Fitch assigned negative outlooks to the debt on August 2 and November 28, respectively), the risk of further rating actions could persist until a clearer fiscal path is established in Washington.

Of course, US government bond yields are not dictated by ratings actions. Instead, the Federal Reserve governs levels at the front end of the curve while inflation expectations and demand determine the long end. In Citi analysts view, interest rates aren't going anywhere with the Fed committed to rock bottom policy rates through mid-2013 and inflation pressures muted.

If economic conditions don't improve materially, our analysts expect the third round of quantitative easing (QE) to commence in the US this year. The decision to reinvest maturing debt from the Fed's $2.8 trillion balance sheet into agency mortgage-backed securities (MBS), which was announced with Operation Twist, opened the door for outright purchases of mortgage debt in QE3.

Emerging Markets Government Bonds

While inflation is still relatively high in many emerging economies, slowing growth and falling food prices should contain interest rates and bolster the case for monetary policy. For example, China eased its banks' reserve requirements on December 5 and Brazil's central bank has cut the overnight Selic rate for the third straight meeting since August. In Latin America, Citi analysts favour Mexico and Brazil government debt. In Asia, they recommend local currency bonds in Indonesia and South Korea, but would avoid India, where inflation pressures persist. They also think that investors should limit exposure to eastern European issuers due to strong ties to the Western European banks.

Investment Grade Corporate Bonds

The strongest conviction for Citi analysts in fixed income continues to be long-dated high grade corporate bonds. They favour non-financial issuers in the US, where fundamentals are solid, balance sheets are strong and liquidity is robust. While slowing growth will compress profits, these companies feature much-improved balance sheets, record cash balances and low financing needs. Financial metrics are broadly even healthier than pre-crisis levels. For example, net debt to EBITDA among non-financial issuers has continued to reach new lows as companies reduce debt burdens and refinance existing borrowings into longer-dated (and lower coupon) obligations.

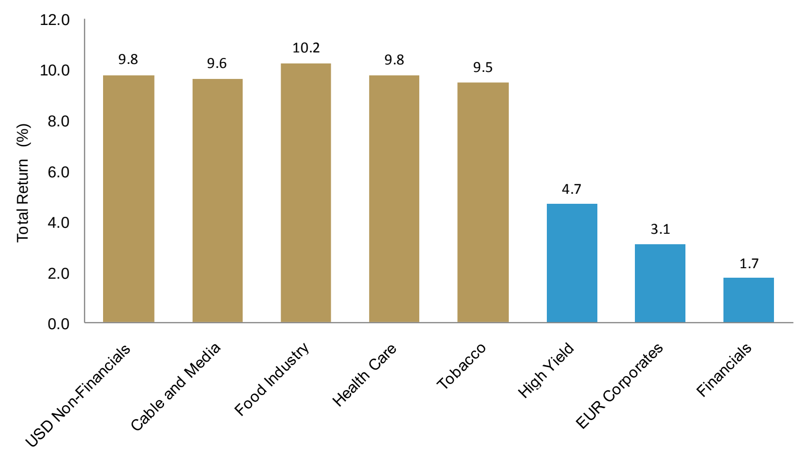

Figure 2: Best corporate gains in defensive, non-financial high grade issuers
Source: Bloomberg, Citi
Past performance is no indication of future results.

Given Citi's expectation for low rates to continue through this year, our analysts estimate that USD high grade corporates should again generate good returns (with the majority of those gains due to carry, or coupon). Their favourite defensive sectors include cable/media, chemicals, health care, tobacco and food. Each features issuers that have strong cash flows, stable operating results and are likely to be more resilient than even higher quality financial issuers as economic uncertainties persist. (Fig. 2)

Financial institutions also retain stronger balance sheets and historically attractive valuations. However, Citi analysts are reluctant to add any bank exposure given the heightened risks in Europe and persistent strains in the wholesale funding markets. Potential bank recapitalizations and sovereign restructurings in Europe will boost risk premiums and volatility across the sector.

Indeed, Citi analysts expect the entire bank and finance sector to underperform nonfinancial corporate bonds globally even among the highest quality issuers that retain manageable exposures to European peripheral debt. EU financial institutions could therefore continue to underperform comparably rated (ex-EU) issuers and senior debt is poised to outperform subordinated securities as recapitalization plans intensify.

High Yield Corporate Bonds

Lower-rated asset classes, such as high yield (HY), are bound to remain volatile despite relatively decent valuations. Citi analysts are in no doubt that fundamentals have improved, near-term refinancing risks have greatly diminished, and that current spreads overcompensate for potential default risks. However, as long as risk appetite remains depressed, lower-rated debt is likely to underperform. This is especially true in Europe, where capital markets are closed to high yield issuers. To make matters worse, EU banks have reduced lending capacity as they shore up balance sheets to meet tougher regulatory standards (Basel III).

Citi analysts concede that valuations in spread markets and low-quality instruments look much more compelling than high-quality yields. However, without a forceful resolution for the European periphery and improved mechanisms to prevent contagion, risk appetites will be sorely tested this year. Investors should stay defensive, retain an up-in-quality bias and resist the temptation to add risk to their portfolios.