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FIXED INCOME STRATEGY REPORT

Government debt - underperformed most sectors during the first quarter. Our analysts do not believe the recent sell-off signals the start of a structural bear market. Once risk assets finish drowning in a sea of liquidity, fundamentals will reassert themselves and yields will trend lower.

Global corporate bonds - posted their largest quarterly outperformance versus the broad market in nearly three years. Investment grade corporates for our analysts still remain the favourite fixed income asset class. They see best risk–reward is in 7-year to 10-year BBB-rated high beta credits. These issuers feature attractive valuations and are poised to benefit from the current momentum.

High yield spreads - have compressed by about 200 basis points (bps) over the last four months. Although the rally has slowed, investors are still compensated for potential credit risks with spreads around 600 bps, index yields over 7.0%, and default rates around 2.0%. Our analysts remain overweight.

Sectors	12 Months View	Investment Rationale
Dev. Market (Core) Sovereigns	**Market Perform**	Citi anlysts expect backup in rates to fade; slowing growth should help contain the recent uptick in inflation expectations; our anlysts favour Bunds over US Treasuries.
EU Periphery Sovereigns*	**Underperform**	Despite Greece PSI resolution, fiscal concerns are likely to keep spreads volatile; Portugal restructuring likely; avoid exposure.
Emerging Market Sovereigns	**Outperform**	External dollar-denominated sovereign debt is likely to be supported by low US Treasury rates; local emerging market debt is poised to be more volatile and driven by FX.
High Grade Corporates	**Outperform**	Remains Citi anlysts favorite asset class; our anlysts recommend BBB-rated high beta credits; they see value in tobacco and life insurance sectors.
High Yield Corporates	**Market Perform**	Valuations are less compelling but still attractive; focus on high single B to double B issuers with improving fundamentals.

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

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Developed Markets Government Bonds

Government debt underperformed most sectors during the first quarter. Our analysts do not believe that the recent sell-off signals the start of a structural bear market. In their view, the shot in the arm provided by the European Central Bank's (ECB) long-term refinancing operations (LTROs) and better US economic data will fade sometime during the second quarter as global growth begins to disappoint (Figure 1).

Indeed, once risk assets finish drowning in liquidity, fundamentals will reassert themselves and bring investors back down to earth. When that happens, risk assets should pare recent gains and debt markets will rally.

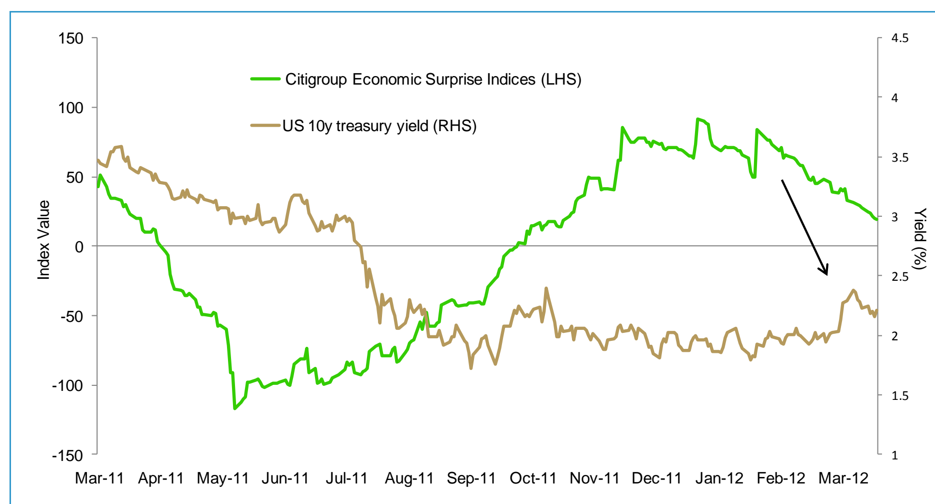

Figure 1: Despite recent rate backup, growth still poised to slow
Source: Bloomberg, Citi
Past performance is no indication of future results.

For now, it would be unwise to ignore the positive momentum reflected in rising equity markets and improved risk appetites. If this continues, bond yields could move modestly higher near term. After all, systemic risks from a potential banking meltdown in Europe has been substantially reduced, the Greek bailout and CDS trigger is behind us (for now), and US economic activity has improved.

With safe-haven sentiment diluted and growth expectations marginally improved, our analysts expect underperformance in conventional government debt versus inflation-linked bonds and spread product, particularly corporates (see following pages for recommendations in these sectors). German Bunds remain our analysts' favourite government market given the substantial growth undertow from periphery countries and the likelihood of additional ECB easing later this year.

Emerging Markets Government Bonds

Despite the fact that external US dollar-denominated and local currency debt has performed well this year, continued outperformance is unlikely to be broad based. While the three biggest developing economies (China, Brazil and India) are likely to maintain loose monetary policies in order to arrest slowing growth, the rest of the emerging world is faces rising inflation, relatively strong growth and a bias towards further monetary tightening. Geopolitical concerns also pose legitimate risks to the sector, such as a potential military conflict in Iran or escalating tensions elsewhere in the Middle East. Our analysts think that these factors will continue to be among the key variables that impact bond yields and currency markets going forward.

External dollar-denominated sovereign debt is likely to be supported by low US Treasury rates and strong mutual fund inflows (about $20 billion year to date). Spreads in high quality sovereigns (Mexico, Brazil, and Indonesia), however, appear stretched, in our analysts view. Our analysts prefer to invest in these countries via the corporate debt market. Increased corporate bond issuance offers opportunities to pick up yield while benefiting from stronger domestic growth. In local bond markets, returns are likely to be fuelled by currency movements. Despite higher yields reflected at the local debt level, total returns from declining interest rates can be completely offset by a depreciating currency. Our analysts favour Mexico Bonos, due to moderate inflation and a balanced monetary policy outlook.

Investment Grade Corporate Bonds

Global corporate bonds posted their largest quarterly outperformance versus the broad market in nearly three years. Since our strategists initiated their recommendation in November 2008, high grade credit has generated returns of nearly 60% and spreads have tightened by over 400 bps.

It’s impressive to consider that global corporate debt has managed to post returns of over 3.5% year to date even though bond yields are near all-time lows. High grade corporates have outperformed the broad fixed income market by 250 bps.

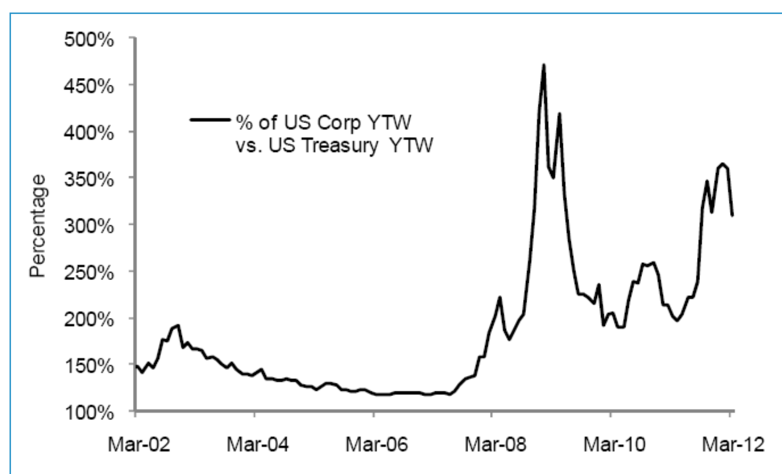

Figure 2: Corp yields as percent of Treasury rates still attractive
Source: The Yield Book
Past performance is no indication of future results.

Solid fundamental and supportive technical (supply/demand) dynamics have contributed to this outperformance. But most of this year’s rally is due to improving economic data in the US and the two LTROs by the ECB that injected €1 trillion of liquidity into the market. Euro and US corporate bond spreads have tightened by 125 bps and 70 bps, respectively, year to date. Index spreads in both currencies have narrowed to about 170 bps.

At this stage, our analysts see no reason to deviate from their strong conviction on high grade credit. In their view, valuations are still attractive. Although credit spreads have compressed to late 2007 levels, they still remain 60 bps to 70 bps above pre-crisis lows. While further spread tightening is likely to be more gradual, analysts believe the high grade credit market continues to offer positive performance this year. To be sure, global corporate bond yields are near historic lows (3.2%), but so are risk-free rates. If you consider corporate yields as a percentage of US treasuries, yields are around 300% higher, near historical highs (Figure 2).

Our analysts favour issuers in high beta sectors. These offer more attractive valuations and benefit from the current momentum in risk appetite. These securities also provide a larger buffer in the event that interest rates spike since higher interest returns help to offset potential principal declines. In financials, Citi analysts favour the life insurance sector. Fourth quarter 2011 earnings results were strong and provided evidence that most issuers improved capital levels and strengthened balance sheets. To enhance yield, analysts recommend investors to consider subordinated debt structures. In the banking sector, stress test results and the LTROs in Europe are likely to support valuations in the near-term. However, as liquidity fades, analysts expect the US to outperform Europe. In non-financials, out analysts continue to favour the tobacco sector due to attractive valuations and their predisposition to generate an enormous amount of free cash-flow. They favour high coupon securities due to the additional yield pickup (despite high dollar prices reflecting investor reluctance to purchase them).

High Yield Corporate Bonds

Much like equities, high yield corporate debt has enjoyed an incredible rally this year. During the last 14 weeks, global high yield debt has posted a positive weekly total return 12 times. Performance has been substantially led by European issuers, which had been beaten down due to periphery concerns. The relief rally in periphery spreads boosted European high yield from very cheap valuations, resulting in a 12.5% year-to-date total return. This outperformed US high yield by nearly 2.3 times (12.5% vs. 5.4%).

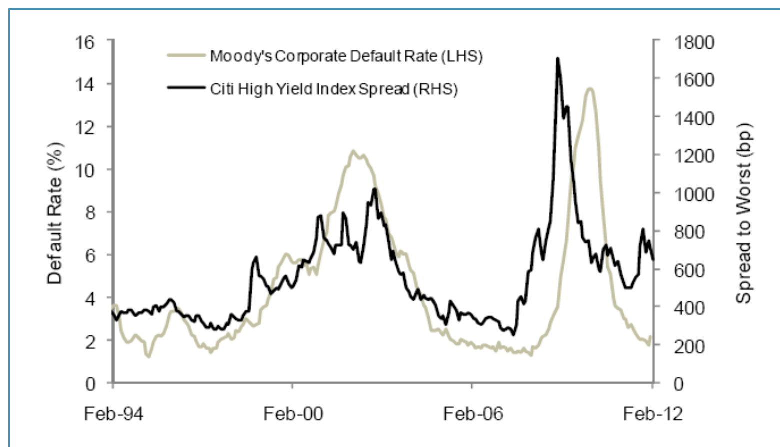

Figure 3: High yields spread valuations attractive vs. defaults
Source: The Yield Book, Moody's
Past performance is no indication of future results.

Our analysts remain overweight in high yield since there are still opportunities to potentially profit from the sector. In their view, investors are well-compensated for potential risks with index spreads near 600 bps, yields greater than 7.0%, and default rates around 2.0% (Figure 3). Investor demand remains near an all- time high as mutual fund inflows rose to nearly $24 billion during the last 16 weeks (a record high). Although new issuance has been fairly strong of late, we believe that supply/demand dynamics remain supportive for high yield.

While Citi analysts are optimistic near-term, they think that risks to global growth is a concern. A pullback in risk assets (especially equities) typically spreads to the high yield market. However they expect that pull-back in high yield may disproportionately impact the lowest quality issuers (Triple-C). Indeed, Triple-Cs has been the most overbought area of the market during the recent rally. Thus, analysts recommend investors to focus on high single B to double B issuers, particularly credits with improving fundamentals. These issuers should be the most resilient and are most likely to outperform should a correction occur.