November 2011

FIXED INCOME STRATEGY REPORT

European debt concerns and slowing growth - have fuelled the rally in core government bonds. Risk aversion has stimulated safe haven demand, while disappointing economic data has forced inflation expectations lower. Citi analysts expect interest rates to remain low for an extended period of time and for longer-dated bond yields to fall further.

Emerging market debt - prices continue to fall. Despite improved credit quality and lower default risks, Citi analysts still expect EM bonds to remain under pressure.

Long duration high grade corporate debt - remains favourite fixed income asset for Citi analysts, as low interest rates and strong underlying fundamentals are likely to drive outperformance. Our analysts expect fiscal and geopolitical concerns to keep the financial sector volatile. They favour defensive non-cyclical sectors.

Sectors	12 Months View	Investment Rationale
Dev. Market (Core) Sovereigns	Outperform	Risk aversion, slow growth and fading inflation pressures keep rates low; long-term rates are decreasing at faster rate than short-term rates, especially in Europe; Favour Gilts
EU Periphery Sovereigns*	Underperform	Yields and default swaps to stay at record highs; current proposals not sufficient to stabilize periphery; avoid any exposure
Emerging Market Sovereigns	Market Perform	EM markets under pressure due to capital flight fuelled by growth fears and EU periphery; Stay defensive in high quality issuer; Easing inflation pressure should buffer market strains
Global Inflation-Linked	Market Perform	Breakevens have fallen as growth prospects decline; inflation expectations to drop further; Citi expects to underperform nominals
High Grade Corporates	Outperform	Fundamentals solid and valuations have become more compelling; favour long-dated bonds and defensive sectors
High Yield Corporates	Underperform	Citi analysts remain cautious near term and await a better entry point despite improved valuations; favour BB issuers

**EU Periphery Sovereigns include government bonds from EU nations that require large subsidies to keep their economies stable.*

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Developed markets

European debt concerns and slowing growth have boosted the growth in core government bonds. Risk aversion has stimulated safe haven demand, while disappointing economic data has forced inflation expectations lower. Even in emerging nations, where inflation pressures are more prevalent, tighter monetary policy has been postponed, and some easing has transpired (see Brazil and Turkey).These conditions have generated a rally. The 30-year US Treasury yield has declined by 55% since its peak on February 10, and 10-year yields fell to a record low of 1.72%. Sovereigns have posted the largest gains in the market this year, led by UK gilts, US Treasuries, and German Bunds (Fig 1).

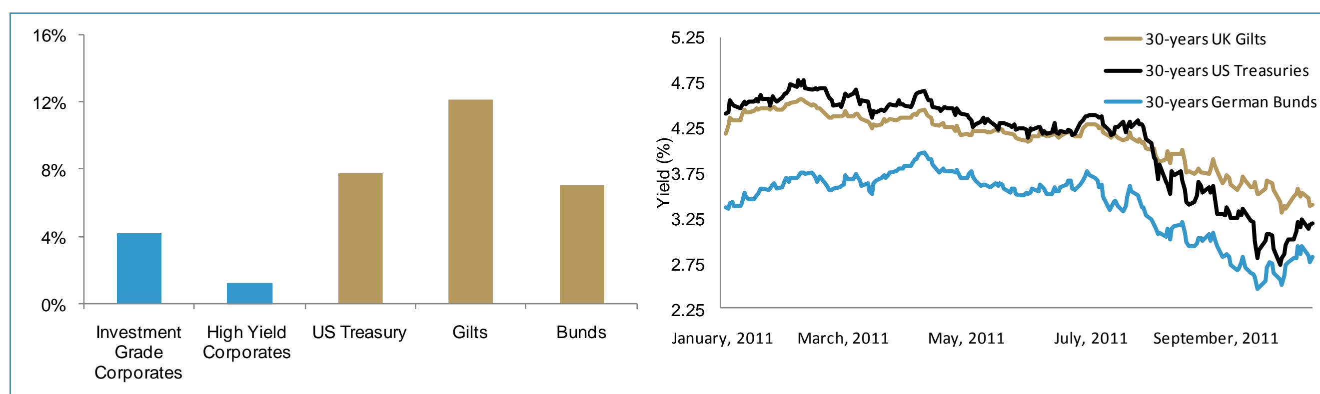

Figure 1: Bond Market total returns (YTD) measured by Citi Global Bond Indices and long-dated government yields changes (YTD)
Source: Bloomberg, Citi
Past performance is no indication of future results.

Citi view is therefore unchanged. Our analysts expect interest rates to remain low for an extended period of time. They expect flatter yield curves as even lower long-term government rates discount declining growth and corporate earnings expectations.
Political leaders in Western countries face massive structural deficits requiring deep cuts in expenditures to please credit rating analysts and angry body of voters. This features prominently in the UK, where fiscal belt-tightening has repressed growth (2Q GDP reported on October 4 was 0.1%). The challenge continues to be with central banks as policymakers are doing everything possible to support recoveries and prevent deflation. The Federal Reserve has already committed to keep its policy rate at zero until mid 2013 and in September announced $400 billion effort to swap short-term Treasury debt on its balance sheet for longer-dated bonds. The Bank of England (BoE) has followed the Fed's example. On October 6, the BoE announced that it would not only restart bond purchases, but also increase the size of its program. The Monetary Policy Committee increased the purchase ceiling by £75 billion to £275 billion—the largest expansion since stimulus began in March 2009.
On the same day, the European Central Bank (ECB) kept their overnight rate at 1.5% and restarted their covered bond purchase program. Citi analysts expect the ECB to cut its overnight rate back to 1.0% by year-end. Considering slower growth combined with periphery countries facing sustained negative pressure on their ratings, Citi expects highly rated (core AAA) EU sovereign markets to post gains. At the long end of the curve, Citi analysts continue to favour UK gilts given their view that increased quantitative easing (QE) measures will push yields lower, and as worsening economic prospects generate lower inflation pressures.

Emerging Markets Sovereigns

September was challenging for Emerging Market (EM) debt. Global dollar denominated debt widened by 115 basis points and prices fell by nearly 6.5 points, producing a 5% loss in September. Returns fell to 5.8% year to date (YTD), after peaking at 7.5% in early September. The sell-off has been driven by flight to quality and liquidity as concerns about the European debt crisis escalate. EM markets have enjoyed massive inflows during the last few years ($170 billion). Last week in September however, EM funds faced $3.5 billion of redemptions, the largest weekly outflow on record. Local markets have fared better than external debt. In local currency terms, these markets were lower by only 0.5% in September. That said, investors who did not hedge currency exposures fared poorly. Currency spot rates fell by more than 7.0% last month, generating an 11% decline in local market debt (in USD terms). In Citi view, EM will remain under pressure as prevailing uncertainties persist. Potential underperformance

will continue to be driven by technical factors rather than fundamentals. Default risks have fallen and credit quality among EM issuers has improved enough to converge with many developed nations (Fig 4). Although Citi analysts favour EM debt over the long term, returns are likely to be limited until some stability returns to global markets. In this climate, Citi analysts prefer US dollar denominated EM bonds issued by highly rated countries, such as Mexico, Brazil and Malaysia.

Inflation linked

The impressive gains garnered by inflation-linked government debt during the first half of this year have recently been eclipsed by gains in conventional government bonds. The reversal is due to downward revisions of global growth expectations and slowing activity in the emerging world. While a few upward surprises to inflation data has boosted short-term breakeven rates* recently (particularly in Europe, due mostly to Italian inflation and energy prices), these trends will fade during the fourth quarter, in a view of Citi analysts. Even though breakevens have largely retreated below long-term norms, Citi analysts are reluctant to add exposure as they expect conventional government debt to outperform.

Investment grade

Global high grade corporate spreads continued to widen by 50 basis points (bp) in September, rising to 290bp. Despite the widest spreads since July 2009, bond prices continued to be resilient. Prices declined by only one point as yields rose by 30bp to just under 4.0%. US corporates continued to outperform as the market participants demanded higher risk premiums for European securities due to deep concerns about the troubled periphery countries. Year to date, US issuers have outperformed European companies by 315bp (6.05% vs. 2.91%, respectively), and bond prices are still higher year to date (Fig 2).

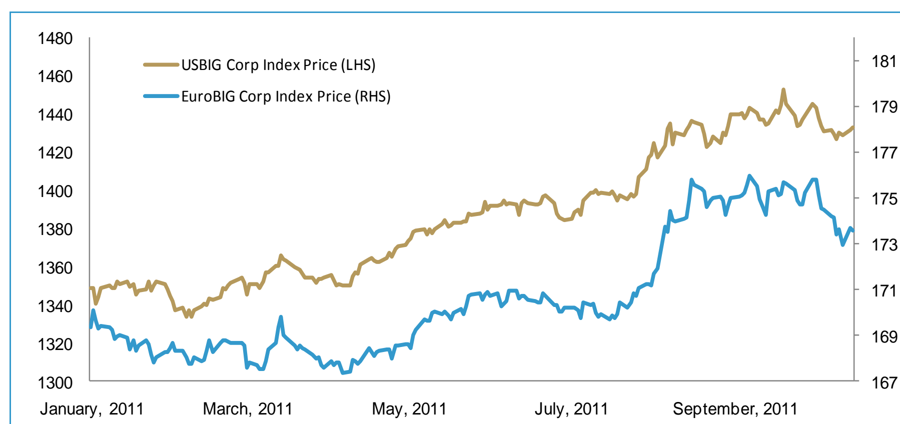

Figure 2: US corporates have fared better vs. European issuers (measured by Citi Global Bond Indices) Source Bloomberg, Citi
Past performance is no indication of future results.

High grade corporate debt remains Citi's strongest conviction for fixed income investors. Despite the volatility in bank and finance sectors, the fundamental backdrop for corporate balance sheets continues to improve. Most companies have taken advantage of the low interest rate environment to refinance debt, extend debt maturities and enhance liquidity profiles. Cash balances remain high and debt leverage ratios are much-improved (Fig 3).

Citi analysts favour corporate bonds with longer dated maturities (consistent with their preference for long duration high-quality securities). They expect interest rates in the core developed nations to remain low (or move lower) for the foreseeable future and expect corporate bond spreads to normalize over time. Current spread levels are mainly a reflection of the rally in risk-free rates (as mentioned above, bond prices have been resilient). When the market's focus finally shifts away from concerns about Europe to slowing global growth, Citi analysts expect corporate bond spreads to compress. The longer the duration of a fixed income security, the more sensitive that security becomes to changes in interest rates. Thus, if interest rates decline, an investor would garner a larger total return with longer-dated debt.

**Difference between the nominal yield on a conventional bond and the real yield on an inflation-indexed bond of* the same

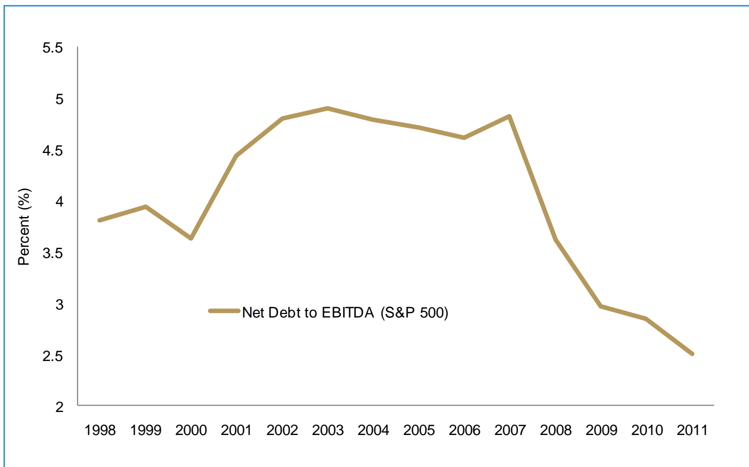

Figure 3: Corporate leverage has substantially declined
Source Bloomberg, Citi
Past performance is no indication of future results.

Debt leverage ratios improved further. Net debt to EBITDA (earnings before interest, tax, depreciation and amortization), a key gauge on leverage, for industrial companies in the S&P 500 is at its lowest level since 2000.

Despite relatively strong balance sheets and limited exposures to peripheral Europe debt in the US, Citi analysts expect the entire bank and finance sector to continue to underperform. Indeed, further spread widening is likely even among the highest quality financial issuers. Our analysts expect volatility to persist until a substantial resolution for the European periphery occurs. They still prefer US as opposed to European financials, and expect senior debt to outperform subordinated issues, especially as prospects for EU bank recapitalization intensifies.
Citi continue to favour defensive non-cyclical sectors, such as tobacco, food and health care. Our analysts also recommend cable/media issuers due to their relatively better resilience during periods of economic uncertainty.

High Yield

High yield corporate debt continued to face steep declines in September as prices declined by more than six points. High yield securities fell by 3.0% last month, lifting its decline to 6.5% since the beginning of August. Global high yield spreads are now approaching 900bp; European high yield bonds are already well above 1000bp, it is widest since September 2009. Slowing global growth and uncertainties about the European periphery have been the principal drivers behind the sharp correction in high yield debt. Although current spread and absolute yield levels have become more compelling, Citi analysts still don't recommend that investors add exposure. Headline risks are still carrying on, which will weigh heavily on high yield debt despite attractive fundamentals. For example, Citi analysts don't expect to see a forceful resolution in the Euro zone that would calm volatility anytime soon, and political uncertainty in the US will heighten in coming months.
Citi remains underweight high yield. Investors seeking allocations to this sector should continue to focus on double-B-rated issuers — these have outperformed the broad high yield market YTD. Our analysts expect this higher quality trend to continue as risk aversion persists (Fig 4).

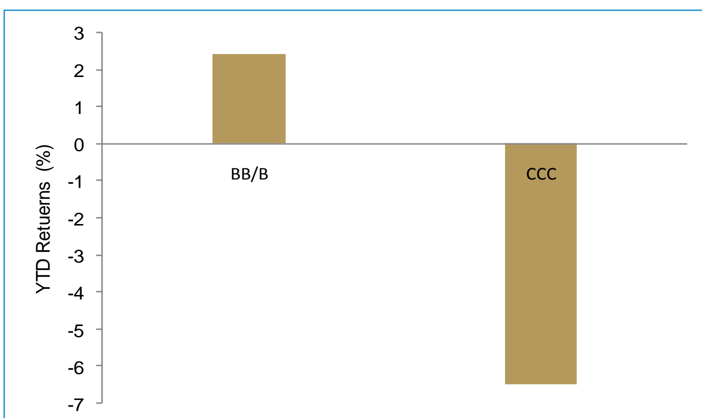

Figure 4: Higher quality double-B issuers have outperformed (YTD)
Source Bloomberg, Citi
Past performance is no indication of future results.