

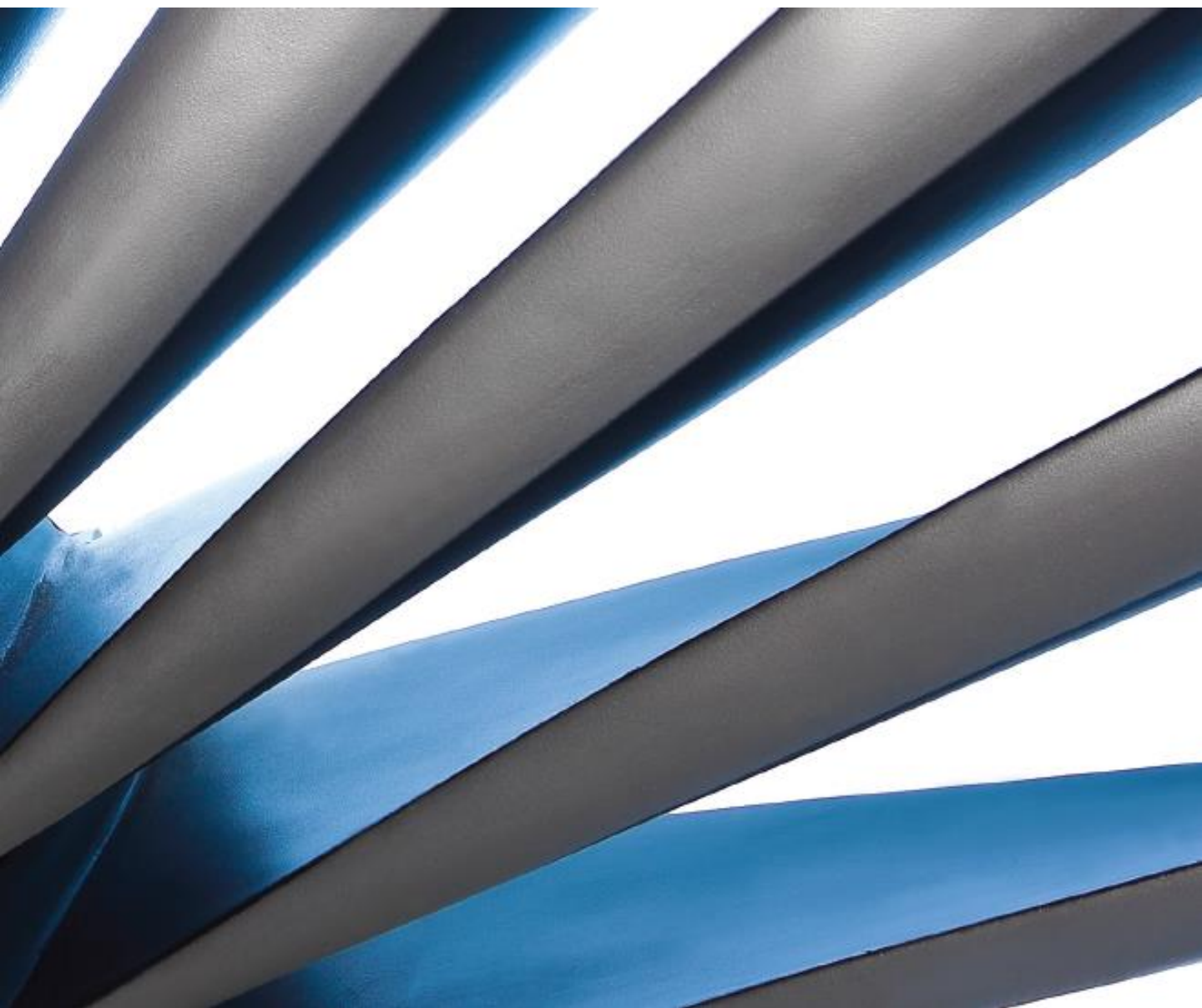
ISSUE

5

Citigold Private Client

PERSPECTIVES

3Q 2017



VIEWS

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Perspectives

Dear Clients,

Following the rally in global equity and bond markets in the first half of the year, investors are likely wondering how they should position their portfolios to benefit from market opportunities and mitigate risks.

Citi analysts have adjusted our portfolio positioning by increasing exposure to European equities on expectations that political risks will continue to ease. Citi has also increased allocation to Emerging Asian equities as Asian corporate profits are poised to grow more than 10% this year, the highest growth since 2011. Exposure to European investment grade corporate bonds, UK government bonds, US Treasuries and European high yield bonds were reduced given expensive valuations.

After rallying 21% in the first five months of the year, the MSCI World Technology Index has fallen 1.3% from its high in June, with stocks such as Google and Netflix down by more than 3%. Citi analysts remain positive on the technology sector as continued innovation is expected to drive earnings. Technology companies are also returning more cash to shareholders through dividends and share buybacks. For investors seeking exposure to the technology sector, Citi suggests that investors have a diversified portfolio including companies that bring about innovation and disruption as well as traditional manufacturers that are benefiting from increasing digitization.

We hope you find this issue of Perspectives insightful. Please approach your Citigold Private Client Relationship Manager to understand how these developments can affect your portfolio.

Regards

Paul



Paul Hodes

Head of Wealth Management
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Views

3Q17: A bumpier ride ahead but still positive on equities

Even though equity markets have rallied in the first half of the year, Citi analysts continue to be positive on equities given the broadening global expansion and rise in corporate profits.

Turning positive on European (ex-UK) equities...

European equities performed well in the first half of the year, with the Stoxx 600 index rising by 7.5% and 13.7% in euro and USD terms, respectively.

Citi analysts have become more positive on the European equity market. Political risks are waning given the growing likelihood of stronger European Union (EU) leadership. The French-German axis at the heart of Europe is enhanced after the Macron victory.

The EU's increased assertiveness in its Brexit discussions with the UK is likely to help retain the cohesiveness among the other 27 EU nations.

Citi analysts expect the European economy to grow by 2.1% this year with the pickup broadening across the Eurozone. Even with the unfolding recovery, core inflation at 0.7% remains below the European Central Bank's (ECB) 2% target.

While ECB Governor Draghi has become more optimistic on the outlook for the eurozone economy, Citi believes that the ECB will extend its asset purchase programme to mid-2018 although the ECB may reduce the monthly purchase amount. Meanwhile, interest rates are likely to stay on hold until mid-2019.

Given a recovering economy and interest rates remaining low, Citi analysts expect European earnings to grow by 15% this year. Valuations are still reasonable with the EuroStoxx index currently trading at 19x of earnings, a healthy discount to US equities. See Chart 1.

Chart 1: Relative Price to Earnings Ratios for MSCI Europe and US



Source: Citi Research. As of 26 June 2017.

...But less so on UK equities

The UK economy faces multiple headwinds including political risks, policy uncertainty and tough Brexit negotiations. The cyclical downturn is deepening with the recent terrorist threats further dampening business and consumer confidence. Given this backdrop, Citi analysts expect volatility in UK equities and bonds while the Sterling is expected to rise in the near term.

Even if UK avoids a recession, domestic sectors are likely to weaken further, leading Citi analysts to be cautious on UK small and mid-cap equities. Large-caps may be more defensive with more than 70% of revenues coming from overseas and an average dividend yield of more than 3%.

Adding exposures in Asian equities

Citi analysts have increased exposure to Asian equities, expecting strong earnings growth. Economic fundamentals in Asia have been improving. In April-May, exports grew 10% from the same period in prior year. Healthy exports are expected to drive Asian corporate profits with earnings poised to grow more than 10% this year, the highest since 2011.

The six-year USD rally has weighed on Emerging Market (EM) returns. During this period, EM Asian equities gained just 10% compared to 88% gains in US equities.

Citi analysts believe the USD rally has peaked, helping EM Asian equities to outperform. See Chart 2.

Chart 2: USD rally since 2011 had driven EM Asian underperformance



Source: Citi Research. As of 26 June 2017.

Within Asia, Citi analysts are overweight on across China, India, Taiwan, Korea, Thailand and Singapore.

- **Overweight China:** With their inclusion in MSCI EM, China A-shares will account for only 0.7%, However, Citi analysts believe that this percentage will grow over the longer term. Citi also believes that tighter financial regulations in China are unlikely to derail the broader market.
- **Overweight India:** One of Citi's strong overweight given the potential for policy easing, reform benefits, currency appreciation and earnings growth.
- **Overweight Taiwan, Korea:** Valuations are still attractive despite this year's technology-led rally.
- **Overweight Thailand:** Citi sees potential for higher investment growth as the political outlook stabilizes.

- **Overweight Singapore:** Supported by a stable monetary policy, attractive dividends and low valuations. Further fiscal easing cannot be ruled out as downside risks to property prices are rising given higher rates and tighter liquidity.

Turning more selective in bonds

The 14 basis points decline in the US 10-year Treasury yield in the first half of 2017 has made bonds more expensive. As a result, Citi analysts have reduced their exposures in European and UK investment grade (IG) corporate bonds, UK government bonds (Gilts), short-term US Treasuries and European high yield bonds.

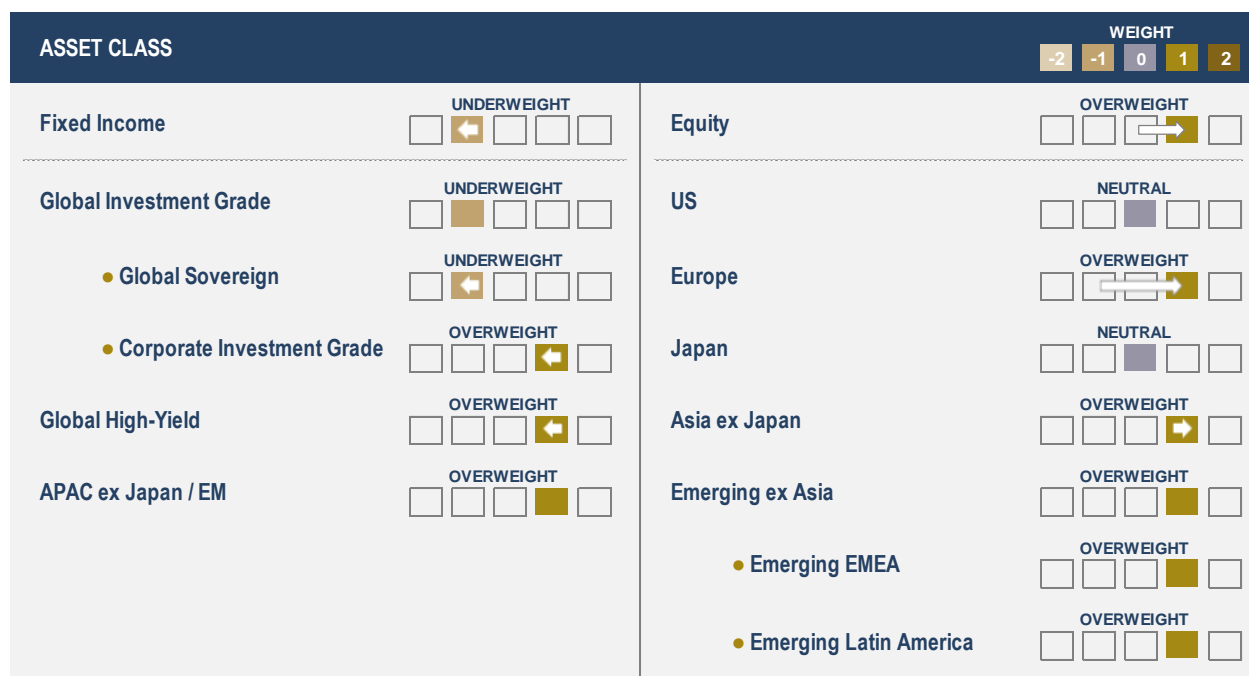
- **Underweight Euro Investment Grade corporate:** 70% of euro IG corporate market yields less than 1.0% and offers little value in Citi's view. Spreads may widen with the ECB likely to announce some tapering of its asset purchases later this year.
- **Neutral Euro High Yield:** Citi analysts reduced their exposures in European high yields from overweight to neutral given expensive valuations and the risk of ECB-induced volatility.
- **Underweight UK Gilts:** Without a clear political outcome, Gilt yields are likely to remain range-bound over the near-term.

- **Underweight UK Investment Grade Corporates:** Spreads could widen as the UK economy weakens and Brexit-related uncertainties build.
- **Neutral US Treasuries:** Any progress on US tax cuts is likely to boost the US economy and push long-term Treasury yields higher.

A bumpier ride

As the equity and bond markets rallied in the first half of the year, markets are likely to be bumpier in the second half.

Citi's portfolio positioning for 3Q17 remains biased towards equities supported by a broadening global expansion and a rise in corporate profits. While the Fed's balance sheet reductions and decreased bond buying by the European Central Bank could lift bond yields and market volatility, the low starting point for yields make equities a more attractive asset class.



Key Takeaways

- Citi analysts have turned more positive on European (ex UK) equities given waning political risks, robust earnings growth and continued attractive valuations.
- Citi increased its exposure in Asian equities. Improving economic fundamentals and the expected end to the 6-year rally in the USD is likely to help Asian markets outperform.
- Expensive valuations led Citi analysts to reduce weightings in European and UK investment grade corporate bonds, UK government bonds, short-term US Treasuries, and European high yield bonds.

Insights

Technology: A mix of east and west, old and new

After rallying 21% in the first five months of the year, the MSCI World Technology Index fell 1.3% from its high in mid June. Citi analysts remain positive on the technology sector given the prospects for higher earnings, dividends and share buybacks. Citi sees opportunities in innovative companies that have disrupted industries as well as in traditional manufacturers that will benefit from increased digitization.

What lies ahead?

As of 13 July, the MSCI World Technology Index is down 1.3% from its high in June, with stocks such as Google and Netflix down by more than 3%. Does the sell-off represent a buying opportunity for investors or do the stretched valuations of some tech stocks suggest that there is more downside to come?

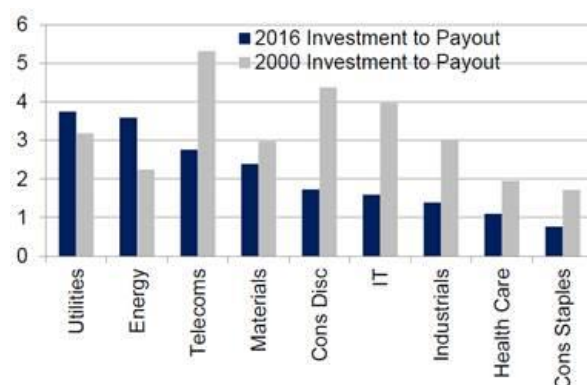
Still positive technology

Citi analysts remain positive on the outlook for the technology sector. Although the sector trading at 18.4x 2017 forward earnings, a 10% premium to the market, Citi analysts believe investors are not overpaying as innovation will continue to drive corporate profits.

Citi analysts expect earnings from the technology sector to rise by 16% and 12% in 2017 and 2018 respectively. This is higher than the 14% and 10% earnings growth expected from global equities over the same period.

Given strong profits, technology companies have been returning more cash to shareholders through dividends and share buybacks. This is a significant shift from the 2000 tech boom where technology companies had favoured capital investments over payouts. In 2016, US tech companies paid out US\$204bn to shareholders, while reinvesting US\$223bn. The ratio of their capital investments over payouts fell from 4x in 2000 to 1.5x in 2016. See chart. In an environment of continued low interest rates, higher payouts are likely to continue to appeal to investors.

Chart 1: Ratio of Capital Investment to Payout (2016 versus 2000)

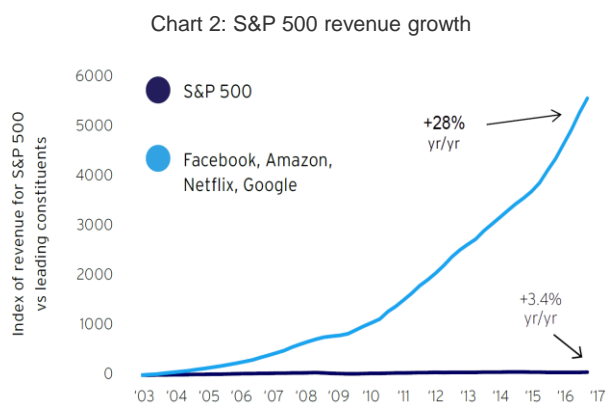


Source: Citi Research, Worldscope, Factset. As of 1 June 2017

Investing in disruptive trends

In the technology sector, companies that have brought innovation have displaced industries and changed the way consumers shop, are entertained and communicate. The most successful of these disruptors has been grouped into FAANGs which includes FaceBook, Apple, Amazon, Netflix and Google while the Asian equivalent BATs include Baidu, Alibaba and Tencent.

Alibaba and Tencent have risen 60% and 47% respectively in the first 6 months of the year. The FAANGs accounted for nearly 30% of the S&P 500's year-to-date gains before June's correction. Since 2003, the S&P 500's revenue growth has been driven by a handful of stocks. See chart. Investors can benefit with some exposure to disruptors in their portfolios.



Sources: Citi Private Bank. As of 12 June 2017.

Given the large market capitalizations of these companies and their inclusion in major indices such as the Nasdaq and the Hang Seng Enterprise Index, investors may already have exposure either through their passive or active investments. With some active managers seeking to identify new disruptors, actively managed investments may provide exposure to disruptors in their early stages of growth.

Don't neglect "Old" technology

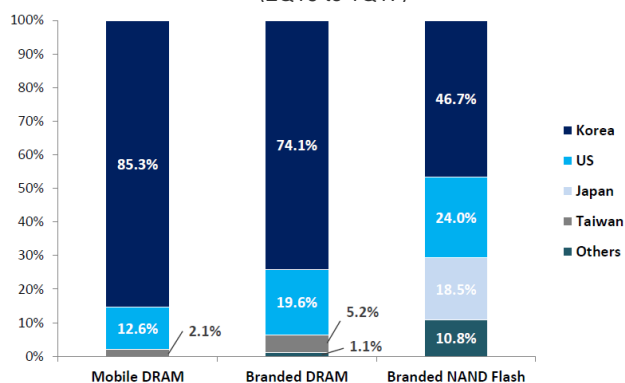
With news headlines often focusing on technology disruptors, it is easy to lose sight of "old technology" companies, for example, manufacturers of memory chips and display screens. With 36% of Taiwan's tech sector revenues coming from the iPhone supply chain, Citi analysts expect Taiwanese technology companies to benefit from the iPhone 8 launch. Korean companies are likely to be dominant suppliers of the Organic Light-Emitting Diode (OLED) screens in the new iPhone 8, which are expected to have much higher margins than existing smartphone models.

The structural trend towards increasing digitization is also positive for memory chip manufacturers. In the past, Dynamic Random-Access Memory (DRAM) chips have been used for personal computers and smartphone applications. Not only is chip intensity of these goods rising - the average memory for smartphones is forecast to grow 33.4% from the previous year to 3.2GB in 2017, the rising usage of "big data" among businesses has also led to the need for increasingly large data centers requiring vast amounts of system memory.

Beyond “big data”, the evolution of various applications including cloud computing, graphic processing, automotive electronics, industrial robotics, machine learning and artificial intelligence is creating an escalating demand for memory chips.

Intel CEO Brian Krzanich estimated that an average self-driving car will generate 4,000 GB of data a day. Taiwanese tech companies are likely to benefit from providing cutting edge applications on this front. Korean companies also have a dominant market share in memory chips, achieved through years of intense price competition and consolidation. See chart.

Chart 3: Revenue Market Share of Manufacturers (2Q16 to 1Q17)



Source: DRAM Exchange. As of 29 June 2017. Country classification is based on the home country of the manufacturer and not the location of the manufacturing facility.

Mix east with west, old with new

Citi analysts remain positive on the outlook of the technology sector and suggest that investors may want to have a diversified exposure to different types of technology companies. While disruptive innovators in the US may be more familiar to investors, Asian technology disruptors are positioned to meet the needs of nearly 4 billion consumers in the region. Manufacturers of memory chips and smartphone screens are also benefitting from this global trend towards increased digitization.

Key Takeaways

- Citi analysts remain positive on the outlook for the Technology sector and expect continued innovation to drive profits. Increasingly, companies have also been returning cash to shareholders through dividends and share buybacks.
- Investors may want to have some exposure to innovative companies that have disrupted industries as these companies have contributed to most of the market's returns in recent years.
- The global trend towards increased digitization is also benefiting traditional tech companies including manufacturers of memory chips and smart phone screens.

World Market at a Glance

	Last price 11-Jul-17	52-Week High	52-Week Low	Historical Returns (%)			
				1 week	1 month	1 year	Year-to-date
US / Global							
Dow Jones Industrial Average	21409.07	21562.75	17883.56	-0.33%	0.64%	17.46%	8.33%
S&P 500	2425.53	2453.82	2083.79	-0.14%	-0.26%	13.49%	8.34%
NASDAQ	6193.31	6341.70	5002.82	1.36%	-0.24%	24.15%	15.05%
Europe							
MSCI Europe	450.99	461.42	374.45	-0.27%	-0.87%	17.41%	12.73%
Stoxx Europe 600	379.15	396.55	327.02	-0.82%	-2.88%	13.95%	4.91%
FTSE100	7329.76	7598.99	6615.83	-0.37%	-2.62%	9.68%	2.62%
CAC40	5140.60	5442.10	4270.99	-0.66%	-3.00%	20.54%	5.72%
DAX	12437.02	12951.54	9841.11	-0.00%	-2.95%	26.48%	8.33%
Japan							
NIKKEI225	20195.48	20318.11	15921.04	0.81%	0.91%	28.56%	5.66%
Topix	1627.14	1627.79	1262.86	1.08%	2.23%	29.57%	7.15%
Emerging Markets							
MSCI Emerging Market	1018.20	1023.17	837.12	1.14%	0.00%	20.25%	18.08%
MSCI Latin America	2614.77	2765.68	2194.50	2.19%	3.11%	13.80%	11.71%
MSCI Emerging Europe	141.40	153.21	121.87	-0.52%	-2.14%	14.14%	-3.63%
Brazil Bovespa	63832.15	69487.58	53732.82	0.95%	2.61%	18.30%	5.99%
Russia RTS	1001.51	1196.99	898.05	-1.58%	-3.84%	6.39%	-13.09%
Asia							
MSCI Asia ex-Japan	628.94	632.86	505.03	1.39%	-0.08%	23.13%	22.28%
Australia S&P/ASX 200	5728.93	5956.52	5052.10	-0.95%	0.90%	7.34%	1.11%
China HSCEI (H-shares)	10416.20	10727.06	8727.83	1.07%	-1.66%	19.69%	10.87%
China Shanghai Composite	3203.04	3301.21	2931.96	0.64%	1.41%	6.95%	3.20%
Hong Kong Hang Seng	25877.64	26147.30	20957.26	1.92%	-0.59%	23.93%	17.62%
India Sensex30	31747.09	31885.11	25717.93	1.72%	1.55%	14.91%	19.23%
Indonesia JCI	5773.33	5910.24	5022.85	-1.57%	1.72%	13.89%	9.00%
Malaysia KLCI	1755.03	1796.75	1614.11	-0.40%	-1.89%	6.12%	6.90%
Korea KOSPI	2396.00	2402.80	1931.07	0.65%	0.60%	20.49%	18.24%
Philippines PSE	7858.14	8118.44	6499.00	0.31%	-1.65%	-0.09%	14.87%
Singapore STI	3218.80	3275.39	2760.97	0.24%	-1.09%	11.91%	11.73%
Taiwan TAIEX	10415.57	10545.70	8794.30	0.66%	2.12%	18.54%	12.56%
Thailand SET	1569.24	1600.79	1343.13	-0.31%	0.17%	6.87%	1.70%
Commodity							
Oil	45.04	55.24	39.19	-4.31%	-1.72%	0.63%	-16.16%
Gold spot	1217.80	1367.68	1121.03	-0.45%	-3.86%	-10.15%	5.69%

Source: Bloomberg as of 11 July 2017.

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