Citigold

# Market Outlook

April 2015

# When will the Fed be ready to act?

**In the recent FOMC meeting, the committee removed the word "patient" as a description for when it would hike rates, instead remarking that a rate hike "remains unlikely at the April" meeting. Chairman Yellen said this did not mean the Fed would be "impatient" but would "finally raise rates" if and when data confirm the committee's baseline views.**

**Overall, Citi analysts believe the signal to the market is that the Fed is on the path to raising interest rates, but not in a big hurry. We remain longer-term bullish on equities and anticipate the USD to resume its upward trend, but expect there could be volatility as the Fed's monetary policy evolves later this year. In this environment, we prefer selective sectors in the US with a tilt toward cyclical such as Financials and Tech.**

## Macro Overview

- **US:** Fed has affirmed that interest rate normalization is dependent on the strength of incoming data.
- **Europe:** Cyclical recovery may gain momentum; ECB's QE program may continue beyond Sep 2016.
- **Japan:** Above-trend growth anticipated; BoJ may implement additional easing measures in July.
- **Asia:** Citi analysts maintain our below-consensus 1Q GDP forecast at 6.7% for China and expect two more policy rate cuts and 2-3 more RRR cuts in 2015.

## Equities: Overweight

- Equities are no longer cheap following a few years of re-rating but are not rich either across the board.
- We overweight regions where QE support is a positive (Japan and Europe) relative to richer markets (US) or regions with poor growth dynamics such as EM (Asia is the only overweight within EM space).

## Bonds: Underweight

- **High Yield:** Favouring relative value in higher-quality Single-B and Double-B credits.
- **Emerging Market Debt:** Cautious on local debt given improving prospects for stronger USD.

## Commodities: Neutral

- **Gold:** Appears to lack in positive momentum.
- **Oil:** Brent prices could return to the $60 range by year-end.

## Currencies: FOMC Less Patient, More Cautious?

- **GBP:** Stronger vs. EUR, Weaker vs. USD.
- **EM Asia:** Relative outperformance to continue relative to other EM currencies.

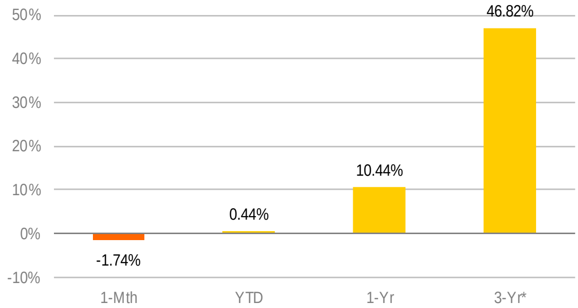
# Equity Markets and Commodities

## United States

### Monetary policy dependent on strength of data

- We are cutting our 2015 growth forecast by 0.2 percentage points to 3.1% because of recent data showing weaker-than-expected consumption and a pullback in construction. While we expect the temporary boost from lower energy prices to dissipate in 2016, GDP should still grow at an above-potential pace.
- Chair Yellen has affirmed that interest rate normalization will begin once incoming data raises the Fed's confidence in their inflation forecast showing that inflation will rise to the 2% target in the "medium term." We believe that the uncertainty about the outlook for inflation and GDP growth may not support such increased confidence until year end.
- From an equity perspective, we prefer the more domestic plays and companies less sensitive to the currency effects. We favour retailing and consumer durable. Also we continue to see opportunities in Financials (Banks and REITs) as well as IT (Software & Hardware).

Chart 1
S&P 500 Index



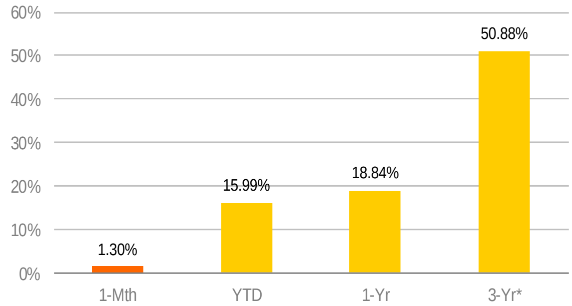

*Denotes cumulative performance
Performance data as of 31 March 2015
Source: Bloomberg

## Euro - Area

### ECB may continue asset purchases beyond Sep16

- Currency weakness is likely to boost exports and indirectly lift corporate profits and fixed investment. Fiscal policy is also turning more supportive. Barring an accidental euro exit by Greece, we believe that the buffer provided by the ECB's APP will continue to insulate euro area periphery member states from contagion risk.
- Turning to inflation, we argue the weakest readings are behind us and that deflation is ending. We believe that the 2016 inflation rebound will be temporary, and that inflation rates may likely fall back in 2017. This may well lead the ECB to continue asset purchases beyond Sep-16.
- In this environment, Citi's strategy focuses on (1) Yield strategies (High dividend yields and growth stocks), (2) Cyclicals/Financials over Defensives, (3) Potential deequitisation cases (companies with a strong balance sheet) and (4) Beneficiaries of weak Euro and companies with high sales exposure to the US.

Chart 2
Dow Jones Stoxx 600 Index



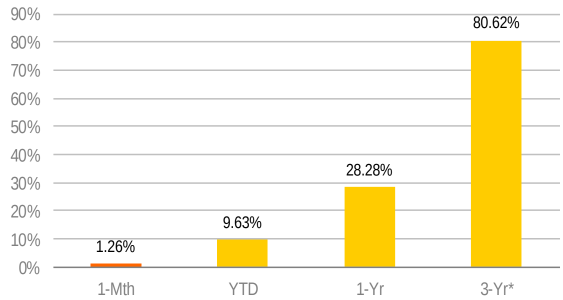

*Denotes cumulative performance
Performance data as of 31 March 2015
Source: Bloomberg

## Japan

### BoJ may implement additional easing measures in July

- We expect the economy could continue to grow at an above-trend pace in coming quarters. Most importantly, consumer spending may recover with solid growth in employment, a modest rise in wages and sharply lower energy prices. Moreover, resilience in the US economy and a pick-up in the global high-tech cycle appear to be boosting Japan's exports. Finally, we expect business investment to return to an upward track in 2015.
- Citi analysts expect the BoJ may implement additional easing measures this July as a gap between the BoJ's still bullish inflation forecasts and actual inflation becomes more evident.
- Within the market, we prefer consumer cyclical, financials and industrials while underweight energy stocks, healthcare and consumer durables.

Chart 3
Topix Index



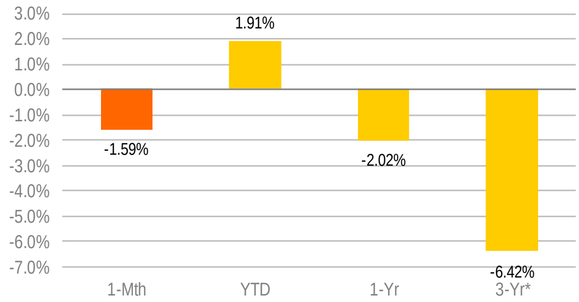

*Denotes cumulative performance
Performance data as of 31 March 2015
Source: Bloomberg

## Emerging Markets (Asia, CEEMEA and Latam)

### Asia continues to stand out

- EM had a quicker pace of earnings downgrades than DM. This was largely driven by the downgrades in Lat Am especially in Brazil and Chile. EMEA's revisions were flat, pulled down by Russia and Hungary but buoyed by Czech and Poland. Asia's revisions weakened due to downgrades from India and Indonesia
- We foresee sentiment to remain weak in the near-term as we expect further gains in USD of around 10-15% over the next year or so to impact EM growth. Having said that, EM's PE ratio is trading at 0.54 standard deviation below mean, suggesting equity valuations are still undervalued.
- As a result, we prefer to be selective and favour current account surplus/commodity importer countries. In our view, Asia stands out over Latam and CEEMEA. It continues to be the only region with positive earnings revision relative to EM.

Chart 4
MSCI Emerging Markets Index



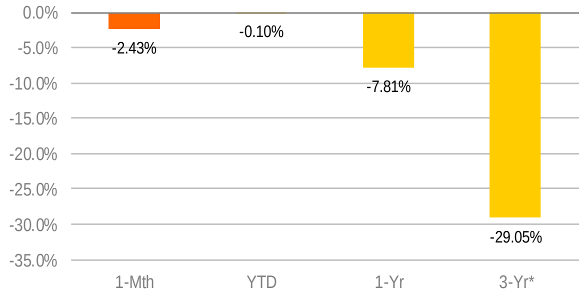

*Denotes cumulative performance
Performance data as of 31 March 2015
Source: Bloomberg

## Gold

### Appears to lack in positive momentum

- Gold's sharp downtrend since late January appears to have been stalled for the time being, prompted by the more dovish tone of the recent FOMC announcement, with a June interest rate hike less priced-in across asset markets. The initial market reaction was supportive to the yellow metal, with COMEX prices trading up from $1,146/oz. to highs of the week north of $1,180/oz.
- However, we do not expect a sustained uptrend in gold over the short-to-medium term on the back of a continued US recovery, as we expect the current inverse USD/Gold relationship to remain a key market driver in the coming months.
- From a fundamental perspective, we also remain cautious on the outlook for gold, as demand strength remains uncertain in the face of seasonal lows in Asian retail sales following peak Lunar New Year and Indian wedding season periods, while central bank buying has been quieter.

Chart 5
GOLDS Commodity Index



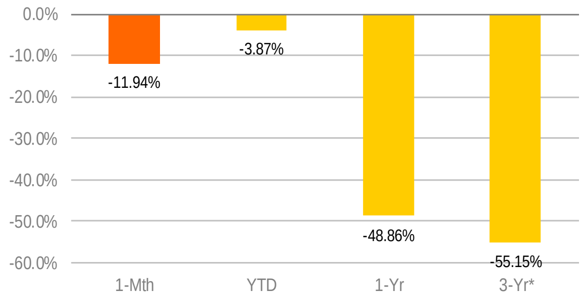

*Denotes cumulative performance
Performance data as of 31 March 2015
Source: Bloomberg

## Oil

### Brent prices could return to the $60 range by year-end

- The combination of resilient US production growth, despite approaching a 50% cut in rig count, and the seasonal downturn in both petroleum product demand (as winter fades) and crude demand (as refiners in the US remain in maintenance season) should see inventory builds continue.
- This may pull down Brent prices as US crude exports rise, especially as European refiners are yet to fully enter turnarounds meaning a bottom has likely not yet been reached for oil prices.
- Indeed, the path to recovery remains a highly uncertain one as the market grapples with a new world of price-based balancing and the ever increasing list of potential geopolitical issues further clouds the view, but by year-end oil prices are expected to return to the $60 range.

Chart 6
Brent Oil




*Denotes cumulative performance
Performance data as of 31 March 2015
Source: Bloomberg

# Bond Markets

## Favour high yield credit

### US Treasuries

- We are lowering our 10y forecast for yearend slightly to 2.50% from 2.60% last month.
- Following the recent FOMC statement, we expect a slightly more gradual path of rate hikes by the Fed than we had earlier anticipated.

### US Corporates

- The relationship between USD and EUR credit markets had been decoupling for the last six months, reaching its widest levels in six years. This has been fuelled by Fed and ECB monetary policy moving in vastly different directions.
- Given more attractive yield propositions in the US, and inflows supported by a weaker euro, we expect this differential to compress.
- This supports the relative value in USD over EUR corporates..

### US High-Yield

- Despite stable fundamentals (ex-energy) and a return to positive bond fund flows, the price of oil is our biggest concern. In our view, if oil prices decline sharply, positive momentum could reverse course.
- As such, we maintain an up-in-quality bias, favouring relative value in higher-quality Single-B and Double-B credits.
- Given our positive fundamental view on the sector, any sharp corrections that improve valuations should be viewed as an opportunity to add exposure.

### Emerging Market Debt

- We reiterate our concerns over evolving political dynamics, declining energy prices, and heightened currency volatility, which require investors to become more discerning.
- Favour hard currency sovereigns/corporates over local debt given improving prospects for stronger USD; Prefer manufacturing vs. commodity exporters, and surplus over deficit countries.

### Euro Bonds

- We continue to expect that the combination of negative rates and QE may be a powerful driving force for even lower core yields, ultimately taking 10yr Bunds to negative territory.
- We would turn more cautious if (a) inflation trends turn; (b) the ECB changes course on QE buying, for instance, stopping its purchases on core paper and reallocating the quotas to the periphery.

### Japan Bonds

- We have slightly revised down our yield forecast on the back of global bull flattening, especially in EUR and still remain cautious about the super-long sector.
- We expect seasonal profit taking at the beginning of the new fiscal year and this, together with increased issuance in the sector, could cause a spike in volatility to make yen rates decouple from the global flattening trend.

### Asia Bonds

- Asian rates have dipped a tad lower since the FOMC, but the move has been restrained by much higher oil prices and unchanged US rates.
- Rising geopolitical tensions – if they persist – may damage sentiment in the high-yielding markets of India and Indonesia.
- Despite the vulnerability to higher oil prices, we continue to like rates in Korea, Thailand and Taiwan.

# Currency

## FOMC Less Patient, More Cautious?

Overly bullish positioning into what turns out to be a more dovish than expected Fed FOMC in March with the Fed more concerned about exports and USD strength, is less positive for USD than markets had hoped for. However, Fed concern about a strong USD can delay but not cancel Fed normalization. With over 20 non-US central banks easing monetary policy this year, policy divergence continues to keep the longer term USD bullish view intact even if the near term brings about some further consolidation.

### EUR: Still An ECB Policy Variable

- A weak EUR remains a key intermediate policy objective of the ECB and its super easy monetary policy combined ultimately with Fed normalization could see EURUSD dip well below parity.
- But, markets will also be on watch for signs of a more sustained rebound in euro zone data arising as a result of the ECB's current accommodative stance that could trigger a short term EUR counter-trend rally.

### GBP: Stronger vs. EUR, Weaker vs. USD

- GBP is likely to continue to weaken versus USD but gain against EUR longer term as MPC may hike rates well after the Fed but before ECB exits QE.
- Election risks are a concern but post election policy risks (Brexit and fiscal) appear to be receding even as UK faces the likelihood of a hung parliament (there has been a surge in public support for UK to remain part of the EU and all major parties now favour modest post election fiscal tightening). This should ensure outperformance against EUR over the longer term.

### JPY: Awaiting Anticipation Of BoJ Or Fed Action

- Spot still seems elevated relative to short term yield differentials and market speculative positioning. Furthermore, with lower oil prices boosting the trade balance back into surplus, market sentiment may remain more positive JPY for now, especially ahead of local elections in Japan in April.
- But a limited spillover of wage hikes to smaller firms that leads to only modest inflationary pressures is unlikely to dissuade the BoJ from easing further. Thus over the medium to longer term, cyclical and policy divergence between US and Japan is likely to continue driving USD gains.

### AUD, NZD & CAD: Medium Term Weakness To Persist

- AUD: Subdued inflation pressures and a benign growth outlook led in part by the China slowdown is likely to lead to 2 more RBA rate cuts. Lower rates and the yet to be filled gap from mining led investment means AUD remains considerably overvalued and further depreciation is required over the medium term.
- NZD: In contrast to Australia, an upgrade to NZ's GDP outlook (implying a RBNZ on hold rather than cutting rates) means RBNZ will find it difficult to jawbone the currency lower even if the currency is overvalued according to its REER.
- CAD: A renewed fall in oil prices should drive further weakness in CAD together with the cyclical divergence between the US and Canada that is becoming more apparent (BoC has signalled it is on hold but markets are discounting one 25bp cut whereas Fed rates look toward Fed tightening). Ultimately, the CAD REER may need to be below its historical mean for longer to spur exports.

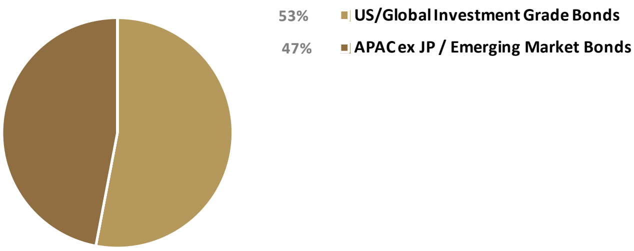
### EM Asia: Relative Outperformance To Continue

- The trend in USD outperformance means Asian currencies as a bloc ought to weaken. Relatively resilient macro stories in Asia, however, ensure that Asia FX still outperforms other EM FX in both the short and medium term.
- In the case of CNY, while FX devaluation is unlikely to be a response to slower growth in China, uncertainties surrounding the outlook include whether PBoC will widen the trading band and/ or change RMB peg to a basket or whether the currency will be part of the SDR.

# Model Portfolios

## Risk level 2: Model Portfolio

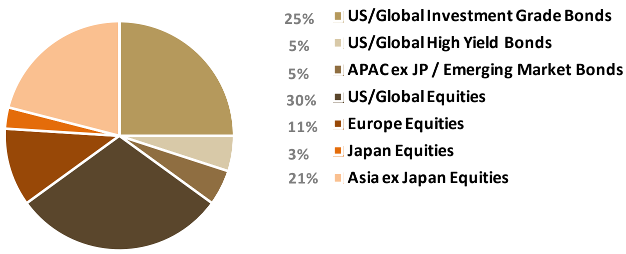
### CONSERVATIVE




| Changes from | 4Q 2014 |
|---|---|
| **Fixed Income** | **No change** |
| **Equity** | **No exposure** |

## Risk level 3: Model Portfolio

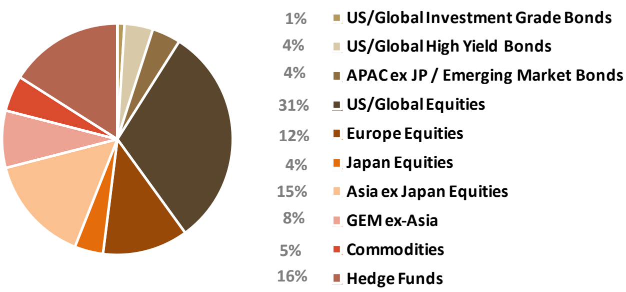
### MODERATE




| Changes from | 4Q 2014 |
|---|---|
| **Fixed Income** | ⇧ **+2%** |
| US/Global Investment Grade Bonds | ⇧ +1% |
| APAC ex JP / Emerging Market Bonds | ⇧ +1% |
| **Equity** | ⇩ **-2%** |
| Europe Equities | ⇩ -1% |
| Asia ex Japan Equities | ⇩ -1% |

## Risk level 4: Model Portfolio

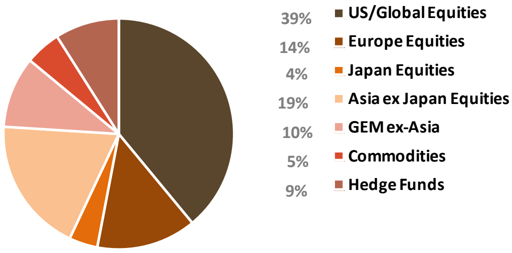
### AGGRESSIVE




| Changes from | 4Q 2014 |
|---|---|
| **Fixed Income** | ⇧ **+1%** |
| US/Global Investment Grade Bonds | ⇧ +1% |
| **Equity** | ⇩ **-1%** |
| Europe Equities | ⇩ -1% |

## Risk level 5/6: Model Portfolio

### VERY AGGRESSIVE / SPECIALIZED




| Changes from | 4Q 2014 |
|---|---|
| **Fixed Income** | **No exposure** |
| **Equity** | **No change** |

# Spotlight on Allocations

## Asia Model Portfolio

This section shows the revisions to asset allocations decided by Citibank Asia Model Portfolio Committee on 14 Jan 2015.

Citibank's Asia Model Portfolios provide a guide to possible diversification of investment portfolios and serve as an asset allocation reference tool both for periodic evaluation and prospective investments. Citibank Model Portfolios are developed by Citibank's in-house Global and Regional investment specialists to cater to investors with various risk profiles (based on Citibank's risk assessment) and provide them with:

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- Up-to-date asset allocations which are reviewed and revised periodically by Citibank's Research teams to reflect changing market conditions in respect of relevant asset classes
- Access to our best-in-class research from the Global Investment Committee

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