



Citigold

Market Outlook

September 2016

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Is the rally in US equities sustainable?

In the US, all 3 major stock market indices - S&P500, Dow Jones Industrials and Nasdaq hit record highs recently. Despite the stellar performance, returns have been driven mostly by multiple expansion rather than earnings growth. As such, Citi analysts remain neutral on US equities given that we may see some potential volatility around the Presidential election which is scheduled for 8 November 2016.

In contrast Citi analysts still prefer US Investment Grade Corporates as well as US and European High Yields. The BoE's new bond buying program has pushed gilt yields to negative territory. This is likely to spill over and benefit other bond sectors. Recent comments from Federal Reserve Chairwoman Yellen point to a stronger case for resuming rate normalization. However, weaker than expected retail sales numbers suggest that the Fed is likely to keep rates on hold in September and may proceed cautiously after hiking in December.

Macro Overview

- **US:** Moderate growth of 2%; Fed rate hike likely in December; Presidential election poses uncertainty.
- **Europe:** More ECB stimulus likely in Sep; Political risks are rising i.e. upcoming Italian referendum.
- **Japan:** Further rate cut to -0.2% expected in January 2017; Yen strength continues to be key risk.
- **Asia:** Soft data in July suggests growth momentum has decelerated sharply in China. Fiscal policy may become more proactive and monetary policy could be eased further.

Equities: Neutral

- Slow growth, low inflation, easy central banks and a range-bound \$ continue to support markets, especially Emerging Markets (EM). We maintain a slight positive bias for EM over Developed Markets (DM). Citi analysts are modestly overweight Latin America on the back of recovering commodity prices.

Bonds: Slightly Underweight

- **High Yield:** Citi analysts prefer select high quality US energy names while double-B Euro HY issuers are likely to benefit from ECB corporate bond purchases.
- **EM Debt:** Decline in volatility and dovish Fed may support local EM Debt in the near-term. We are overweight in Latin America (hard and local currency), local currency Asian bonds, and neutral EMEA.

Commodities: Neutral

- **Gold:** Safe-haven revival on the back of protracted macro uncertainty.
- **Oil:** Prices could move higher as global oil supplies continue to fall and demand picks up.

Currencies: Dollar Peak Looking More Likely

- **GBP:** More Bank of England (BoE) Driven Downside Risk.
- **EM Asia:** Higher USDCNY, But Limited Side Effects.

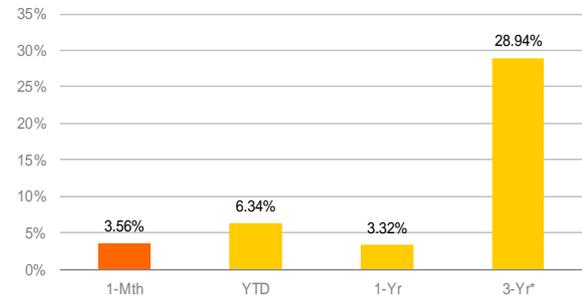
Equity Markets and Commodities

United States

Stronger case for rate hike but no action yet

- We expect underlying economic activity may continue to expand on a 2% growth trajectory in the medium term. Consumer expenditures remain the main growth driver, supported by robust job growth. Housing temporarily has lost momentum in Q2, but we expect a rebound toward end-2016. Near-term risks stem from drag induced by heightened policy uncertainty ahead of the presidential election.
- Recent comments from Yellen point to a stronger case for resuming rate normalization. However, Citi analysts believe that December remains more likely as we get assurance that the economic expansion is on track.
- All three major US stock market indices hit record highs recently. Despite the stellar performance, returns have been driven mostly by multiple expansion rather than earnings growth. In terms of strategy, we see large-caps outperforming small-caps. Rising bond yields could support value stocks over growth.

Chart 1
S&P 500 Index



*Denotes cumulative performance
Performance data as of 31 August 2016
Source: Bloomberg

Euro - Area

Economy expanding at modest rate

- We raise the euro area GDP forecast by 0.1pp in both 2016 and 2017 to 1.6% and 1.2%, respectively. Given the recent loosening in financial conditions, we would argue that risks to our forecasts are slightly tilted to the upside, despite the fact that we are now above consensus in 2016 (1.5%).
- Citi's 2016 inflation forecast is unchanged at 0.3%, but we added 0.1pp to our 2017 forecast given the higher trajectory of oil price. Nevertheless, we expect more ECB stimulus to combat lowflation soon, probably as early as the 8 September meeting.
- From an equity perspective, we highlight that European equities look reasonable in absolute Dividend Yield (DY) terms and very cheap relative to government and corporate bond yields. To hedge against political risk, Citi analysts prefer companies with strong balance sheets, surplus free cash flow and international exposure.

Chart 2
Dow Jones Stoxx 600 Index



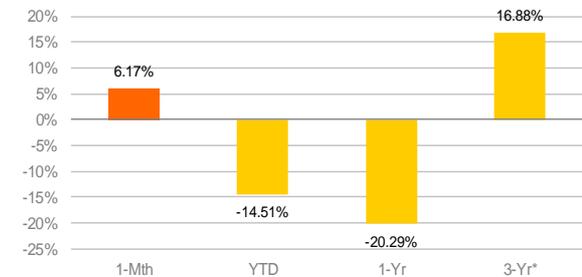
*Denotes cumulative performance
Performance data as of 31 August 2016
Source: Bloomberg

Japan

BoJ may cut policy rate in January 2017

- Citi analysts expect the BoJ may largely justify the effectiveness of its current policy framework including the BoJ's Negative Interest Rate Policy (NIRP) in its Comprehensive Assessment, while carefully communicating its intention to introduce flexibility to its JGB purchase operation at its 20-21 September meeting.
- As such, we believe January 2017 is the earliest timing that the BoJ may implement additional easing in the form of the further rate cuts (to -0.2%), while changing its JGB purchases target from "¥80trn" currently to a range of "¥70trn-¥90trn".
- In terms of equity strategy, we prefer defensive sectors that benefit from domestic demand. Citi is cautious on banks and insurers based on expectations of an expansion in the BoJ's NIRP. Citi analysts caution that rapid yen appreciation could be a key risk for Japanese equities.

Chart 3
Topix Index



*Denotes cumulative performance
Performance data as of 31 August 2016
Source: Bloomberg

Emerging Markets (Asia, CEEMEA and Latam)

Modestly overweight Latin America

- Even post the Emerging Markets (EM) outperformance YTD, 1) the price-to-book value (P/BV) for EM is 0.4 standard deviation (SD) below its historical average. EM currently is still attractively valued; 2) Earnings growth forecasts are rising for the first time in five years; and 3) Central bank liquidity is improving.
- Citi analysts however note that protectionism and a stronger US\$ could be negative for EM. Taiwan, Thailand and Korea would be most vulnerable in trade; in LatAm, Mexico is at greater risk than Brazil. EMEA is vulnerable to a Europe slowdown.
- Nevertheless, a combination of these factors suggests that EM still offers a good risk-reward opportunity. Within the region, we prefer Latin America on the back of improving commodity prices. In sector terms, we remain Overweight banks, consumer discretionary, materials, technology and utilities.

Chart 4
MSCI Emerging Markets Index



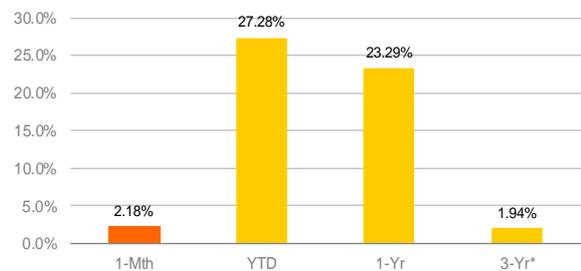
*Denotes cumulative performance
Performance data as of 31 August 2016
Source: Bloomberg

Gold

Safe-haven revival

- For 3Q16 and 4Q16, we have now upgraded our gold price forecasts to \$1,340/oz. and \$1,320/oz., respectively. Though we still expect the Fed to hike in December, elevated political/election uncertainty in the US and the stickiness of ETF and hedge fund flows into gold has led us to boost the 2H16 outlook. We see strong support for gold above \$1,300/oz. through end-2016.
- Citi's 2017 forecast is \$1,280/oz., suggesting a gradual tapering of gold buying as Fed hiking resumes. Though the US dollar remains strong and US short-term rates are slated to rise this winter, but with other G4 central banks continuing loose monetary policy and with core bond yields low to negative, we think gold is likely to remain supported in 2017.

Chart 5
GOLDS Commodity Index



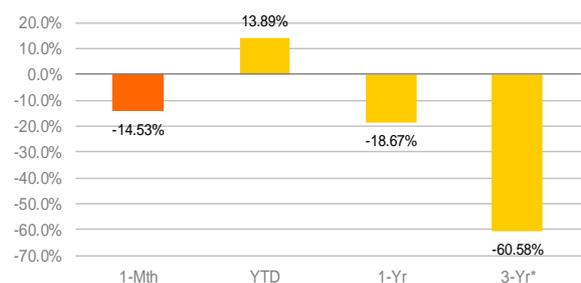
*Denotes cumulative performance
Performance data as of 31 August 2016
Source: Bloomberg

Oil

Rebalancing likely to continue

- Following on from a turbulent few months for oil markets, Citi analysts are reducing our Brent and WTI 3Q16 average to \$47/bbl and \$45/bbl respectively, and marginally lowering our 4Q16 Brent and WTI forecast to \$50/bbl and \$48/bbl respectively to reflect the weaker refinery margin environment and some stronger-than-expected supply.
- Citi's 2017 oil price forecast remains unchanged at \$60/bbl for Brent and \$57/bbl for WTI, as we remain convinced that the on-going rebalancing of non-OPEC supplies, continued oil demand growth and a backdrop of elevated geopolitical risk could tighten balances next year, as stock draws reduce the inventory overhang and sustainably lift oil prices.

Chart 6
Brent Oil



*Denotes cumulative performance
Performance data as of 31 August 2016
Source: Bloomberg

Bond Markets

US Investment grade credit remains the largest relative overweight

US Treasuries

- The low global interest rate environment may anchor the long-end for US Treasuries as foreign investors continue to bid up safe haven, higher yielding USD assets.
- We remain overweight US Treasury debt.

Investment Grade Corporates

- Citi analysts remain overweight IG corporates and favour USD over euro issuers. We favour duration and prefer opportunities between 7-10yrs.
- In terms of sectors, we prefer non-financials over financials, as low rates and flatter yield curves could weigh on bank earnings and yield spreads. Opportunities in energy-related sectors and REITS also look appealing.

High-Yield

- Though the bottoming in oil has supported the rally in High Yield, improving US economic data and accommodative central bank policy has helped fuelled the demand for higher yields and encourage risk-taking.
- There are multiple tail-risks exist which can pressure spreads and stem the rally (i.e., US Elections, post-Brexit uncertainties). That said, default rates (ex-energy) are expected to remain very low.
- Similar to IG, Citi analysts favour USD over euro HY given yields are 1.5x higher. Higher quality energy issuers still offer value, though selectivity is important.

Emerging Market Debt

- Emerging market (EM) debt – both local and external (USD) – has become one of the more compelling investment opportunities in fixed income.
- The earlier deterioration in many EM's from declining oil prices, widening current account deficits and political instability has dissipated. Today, improving commodity prices, lower developed market yields, and dovish Fed/ECB/BOJ policy has helped reverse FX weakness and improve risk sentiment.
- We are overweight in Latin America (hard currency and local), local Asian bonds, and neutral EMEA.

Euro Bonds

- With 10-year German Bund yields in negative territory, we find very little value in core Eurozone (EZ) rates.
- We are also reluctant to chase the Post-Brexit rally in UK Gilts, unless QE becomes a more realistic option.

Japan Bonds

- The JGB yields may likely remain range-bound during the rest of this year.
- We are sceptical that the BoJ's Comprehensive Assessment of monetary policy (due to be published in September) could be a catalyst for Japan's rates markets. In addition, we expect the BoJ may stand pat at its September policy meeting.
- Instead, we expect the BoJ to reduce the policy rate again by 0.1% (to -0.2%) in January 2017 and this could send the JGB yields up to a 10-year tenor lower.

Asia Bonds

- In Asia, we favour local India debt. Attractive yields, improving macro environment and increased foreign ownership of sovereign debt are likely to attract new investors.

Currency

Dollar Peak Looking More Likely

Recent commentary from Fed officials points to modest and delayed Fed tightening. Thus the US monetary policy story is not hawkish enough to support the USD nor is the economy weak enough to generate significant safe haven demand for USD. Moreover, long-term USD appreciation cycles tend to end after 5-6 years, suggesting that the current uptrend that began in 2011 may be living on borrowed time and the overshoot relative to rate differentials which opened up over 2005, may now be correcting. This suggests the USD may more likely be peaking.

EUR: Biding Its Time

- Concerns about Italian banks, Brexit and impact of ECB's QE are capping the upside while continuation of a dovish Fed and market focus on falling equilibrium levels for US employment and growth mean the \$ is unlikely to rally significantly either. With these factors in mind, EURUSD is likely to follow a relatively flat path near term.
- Over the medium term, with yields/ yield spreads low and falling, cross border capital flows likely remaining subdued and currencies backed by current account surpluses such as EUR are likely to do well.

GBP: More BoE Driven Downside Risk

- The BoE seems more concerned about downside risks to growth than upside risks to inflation in its announcement of easing measures at the 4 August meeting. This places GBP on the back foot and more could be on the way as the BoE has not ruled out lower rates and a further extension to its asset purchase program should it be necessary.
- And with the UK economy running a sizable tradable goods deficit and a current account deficit coupled with the risk the UK could head into a recession risk, the accompanying falling interest rates might make it harder to finance the large external deficit. Thus, the sterling real effective exchange rate runs the risk of falling through its recent lows given such fundamental headwinds.

JPY: Value and Fundamentals Triumph BoJ

- Hopes for a significant BoJ stimulus seem to be fading and fundamentals and valuation are trumping BoJ risk. With Japan running a current account surplus and a real effective exchange rate that is below average, JPY looks as if there is still some further upside remaining near term. A relatively benign outlook for the Fed may also likely add to the downward pressure on the pair. Coupled with the fading impact of BoJ easing steps, all these suggest \$/JPY lower and in medium term.

AUD, NZD & CAD: More Dovish Antipodeans But Grab For Yield Dominates

- **AUD:** The RBA's recent rate cut to all-time lows is probably not the last and Citi analysts now expect another cut in the cash rate in November with risk of further easing depending on path of global yields. AUD's resilience to the RBA rate cut however shows a renewed appetite for the unit given the supportive backdrop for risk assets amid a Fed on hold. This "grab for yield" dynamic therefore is likely to offset the negative impact of falling interest rates and the most likely outcome for AUD is a relatively unchanged pair over the medium term.
- **NZD:** NZD/USD continues to be resilient given the global search for carry despite the recent cut in interest rates by the RBNZ. The Bank acknowledges the need to deliver further easing to spur inflation and therefore, Citi analysts also continue to expect further cuts in the coming months (November and February). However, the "grab for yield" dynamic is also likely to ensure that NZDUSD remains within current levels over medium term.
- **CAD:** CAD's fortunes remain tied to the outlook for oil and the recent bounce higher in oil prices remains one of the key drivers supporting the unit. However, domestic data remains weak which may spur rate cut expectations in Q4, and this could offset some of the oil related positive sentiment in the currency. Medium term though, Citi's more positive outlook on oil prices in 2017 means CAD is likely to be the outperformer within the commodity bloc.

EM Asia: Higher USDCNY, But Limited Side Effects

- Over the next 12 months, US rates are seen drifting higher though at a modest pace, oil prices are seen strengthening and with the US elections out of the way, the backdrop is likely to provide an overall bullish macro environment for EMFX as a whole. That said, for Asia in particular where CNY remains the most important driver in the region, its continued depreciation against USD, albeit relatively contained, is likely to see Asia EM FX relatively underperform within the EM space and against the G3 over the 12-month horizon.

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