Market Outlook

December 2014

Equities Markets

Feature

In Citi analysts' view, the expansionary phase the US is enjoying compared to the rest of the Developed Markets is a consequence of the extraordinary economic stimulus provided by the sharp decrease of energy prices the country has benefited over the past 5 years. A slowdown in global demand coupled with the highest US oil output in more than 30 years have contributed to more than a 40 percent drop in the price of Brent crude from a high of $115 a barrel in June 2014. This could represent a unique stimulus for the rest of the world.

In particular, the crisis-ravaged Euro Periphery is looking forward to an unexpected boon from the oil drop after years of economic contraction left record debt levels and unemployment that hold back the economic recovery. As importers of oil, the countries gain economically from the plummeting price through lower energy costs and increased buying power for consumers.

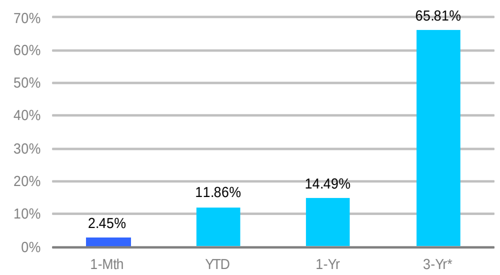
United States

- Slowing growth abroad and the resultant dollar appreciation have raised downside risks to the US expansion. However, there are supports from lower oil prices and lower long-term yields. Thus Citi analysts still expect the economy to grow at an above trend rate of 3.0% in 2015.

- As the unemployment rate declines toward the natural rate by end-2016, this implies modest below Fed-target inflation through most of 2017. Consequently, Citi analysts forecast the first rate increase for December 2015, followed by a moderate pace of rate increases.

- From an equity perspective, Citi analysts recently raised their S&P 500 Earnings per Share growth forecasts for 2015 (+7% annual). That said, they caution that a short-term pullback is possible, as investor attention shifts towards the timing of Fed rate hikes.

S&P 500 Index



*Denotes cumulative performance
Performance data as of 30 November 2014
Source: Bloomberg

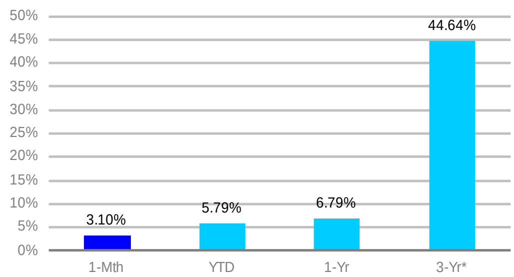
Euro-Area

- Citi analysts are cutting their 2015 GDP growth forecast by 0.3% to 1.1% and look for inflation to stay below 1%, averaging 0.9% in 2015.

- In light of this, the European Central Bank (ECB) may deliver additional monetary stimulus in 2015. Citi analysts expect a full Quantitative Easing (QE) program, including government bond purchases, to be launched in Q115, with a preference for the Jan 22 meeting. Given the large output gap, Citi analysts believe the ECB will have to rely on a much weaker euro (and maybe more QE) to stop inflation expectations from falling further.

- Equities have re-rated sharply since mid-12, from 10x P/E to 17-18x, so it is harder for investors to find value. But an improving economy and liquidity (flows, corporate activity, QE) should support further upside for stocks.

DJ Eurostoxx 600 Index



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Equities Markets

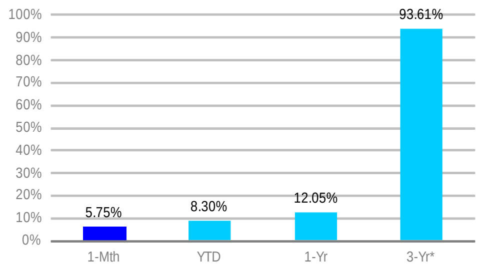
Japan

– The economy is likely to maintain above-trend growth, expanding at 0.9% in 2015, in part thanks to lower oil prices and postponement of the consumption tax hike from Oct 15 to Apr 17.

– However, Citi analysts expect core inflation could undershoot the Bank of Japan's bullish forecasts in 2015 and believe this may prompt policymakers to implement additional easing measures next summer.

- Although valuations have recovered since last May, Japanese equities are still not expensive. With US rate hike forecasts, the recent Bank of Japan easing, a spike in Nippon Individual Savings Account (NISA) investment and Yen depreciation are likely to push stocks higher, according to Citi analysts.

Topix Index



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Source: Bloomberg

Asia Pacific

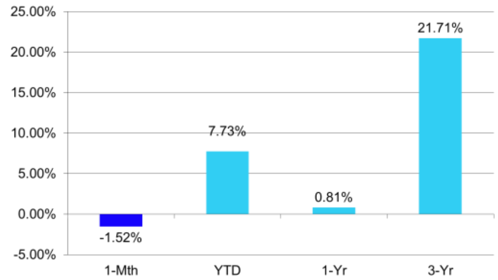
– Economic data are generally supportive of a more pro-growth angle in Asia. Indeed amongst the Emerging Markets, Asia is likely to expand at a faster rate (6.1%) than other Emerging Markets.

- Asia has an advantage in that it is a net importer of commodities. Thus, current weakness in commodity prices is a positive terms of trade shock for Asia.

In turn, Asia's margin outperformance bodes well for its earnings outlook

– Within the region, generally the more northern markets such as China and Taiwan (which Citi analysts prefer) are cheaper vs those in South East, Singapore being the exception. In terms of sectors, the more cyclical sectors such as IT, Financials and Consumer Discretionary are preferred.

MSCI Asia Pacific ex-Japan Index



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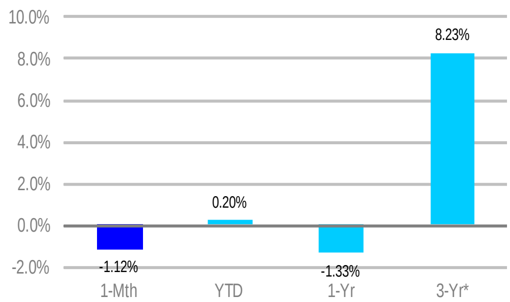
Emerging Markets

– In some ways the fall in oil prices has a predictable effect on the current account balances in Emerging Europe: oil exporters lose - Russia, Nigeria, South Africa- and oil importers win. However, weak commodity prices and a strong dollar are historically associated with low risk appetite, so countries that might be thought to be benefit from lower commodity prices — Turkey, Poland, Hungary for example — might suffer if risk aversion rises against the background of weak commodity prices/strong dollar.

– 2015 appears to be a very difficult one for the Brazilian economy in particular as the high public debt/GDP ratio will likely lead to a gradual fiscal consolidation. Also external conditions (commodity prices and dollar strength) are also negative. Citi analysts cut their GDP growth forecast from 1.0% to 0.5% for 2015 and from 2.8% to 1.8% for 2016. Mexico is amongst the few countries within the region for which Citi analysts sees a promising 2015, as growth should accelerate further while inflation is likely to stay in check.

MSCI Emerging Markets Index



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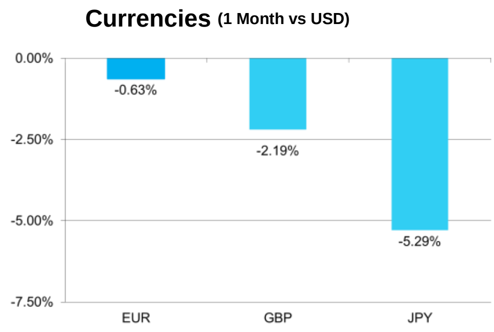
Currencies and Bonds Markets

Currencies

- EURUSD may breach parity over the long term as ECB President Draghi has seemingly reaffirmed a commitment to balance sheet expansion and to restoring the balance sheet to the 3trn EUR peak seen in mid-2012. With euro zone inflation breakevens so weak, the need to act quickly probably means that a weaker EUR is the only option providing the fastest route to re-anchoring inflation expectations.

- Citi analysts think robust domestic growth alone will not be enough to convince the UK's Monetary Policy Committee to raise rates earlier, and low inflation, large twin deficits and political risks are likely to weigh on GBP in the coming months though is expected to remain constructive on crosses (EUR, CHF, JPY).

- USDJPY looks hugely overbought in the short term but medium to long term, is likely to see further upside, driven by expectations of Fed rate hikes sometime in 2H15 and further balance sheet expansion by the BoJ as core inflation remains quite low, maybe below 1% in the upcoming fiscal year.



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Bonds

US Treasuries

Citi analysts now expect only a 25 basis points (bps) rise in funds rate end-2015, versus 75 bps earlier, and have pushed out the date of first hike from Sep-15 to Dec-15. With this change, they are lowering their end 2015 2-year and 10-year yield forecasts by 47 bp and 12bp respectively and projecting a much steeper curve than previously.

Investment Grade Corporates

Prospects for high grade corporate markets in the US and Europe continue to diverge. Credit spreads in the US and UK generally widened (led by the energy sector), whereas spreads for Eurozone issuers declined to post-crisis lows (as expectations about ECB efforts boosts demand). Citi analysts continue to favour European over US issuers given that they expect the ECB to broaden its purchases to government bonds (boosting demand for corporates).

High-Yield

Fundamentals have not materially deteriorated, default rates are expected to remain low, and the "reach for yield" in a low rate climate remains intact. Although Citi analysts expect more spread compression (and less rate drag) in Europe, higher yields in the US credits could also potentially generate impressive gains next year

Emerging Market Debt

While FX volatility should fade somewhat near-term and US rates are likely to be well-anchored in coming months, these trends are likely to reverse next year (higher UST rates and lower oil prices). As such, Citi analysts remain cautious about local EM debt.

Euro Bonds

The environment for core Euro bonds remains constructive into 2015. Increasingly-dovish ECB talk reflects the deterioration of growth and inflation expectations for the Eurozone, in the context of a global slowdown. Additional policy stimulus via sovereign QE remains Citi analysts' baseline scenario and may continue to affect pricing. Therefore, Citi analysts expect only a mild and gradual increase in German 10 years yields towards the end of 2015.

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