Global Strategy: Bulletin

Global Strategist: Bulletin | January 6, 2016

China Revives the Risk That Drove August Swoon.

- By setting a much weaker than expected yuan "fixing" today, China's central bank may be speeding up currency depreciation. Thus, the driver of the August global financial market swoon is back. While Chinese local A-shares rose today, most global financial markets are weakening significantly as they assess the risk (and other factors).

- Peoples Bank of China (PBOC) intentions remain unclear. For example, if the cost of intervention is impacting its decisions, it can only be estimated with lagged foreign reserves data.

- The impact may be less of a shock the second time around, particularly as forward markets now price significant depreciation in 2016 already (as much as an additional -6%). By comparison, markets were unprepared last August after a decade of CNY appreciation. We would expect global asset markets to react negatively until the size of the CNY depreciation is somewhat more clear. This was also the case last August/September.

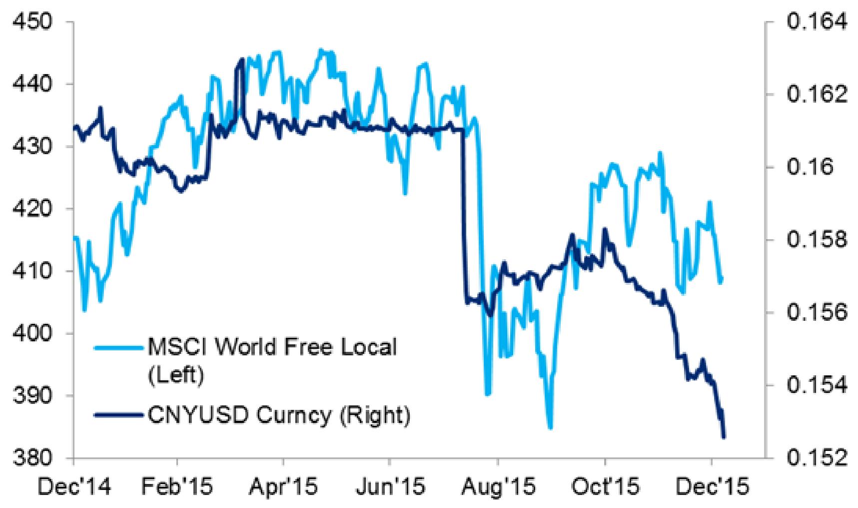
- It would take a very large depreciation in China and a series of competitive devaluations in other currencies (where external currency debt burdens are high) to threaten global recovery. Global macro policies would also adjust around this view to drive offsetting stimulus. However, global investors should see China's currency as a market driver this year just as oil was in 2015.

Implications of Faster RMB Depreciation

Less than one week into 2016, the world has been greeted with China's equity slump, Saudi-Iran conflict and a possible nuclear test by North Korea. As discussed in our Monday bulletin ("The Big Long," US-Dollar Cycles and their Painful Extremes), most importantly, the fundamental driver of the August 2015 market swoon is back – China's currency depreciation. While this may be less of a shock the second time around, particularly as forward markets already price in meaningful depreciation this year, we should expect global asset markets to react negatively until the size of the CNY depreciation is somewhat clearer.

Global investors should see China's currency as a market driver this year just as oil was in 2015. For the moment, in the event of accelerated further depreciation, we would expect a cross-market selloff that patterns the August swoon (see figure 1).

Figure 1. MSCI World vs CNY



Source: Bloomberg as of January 6, 2016.

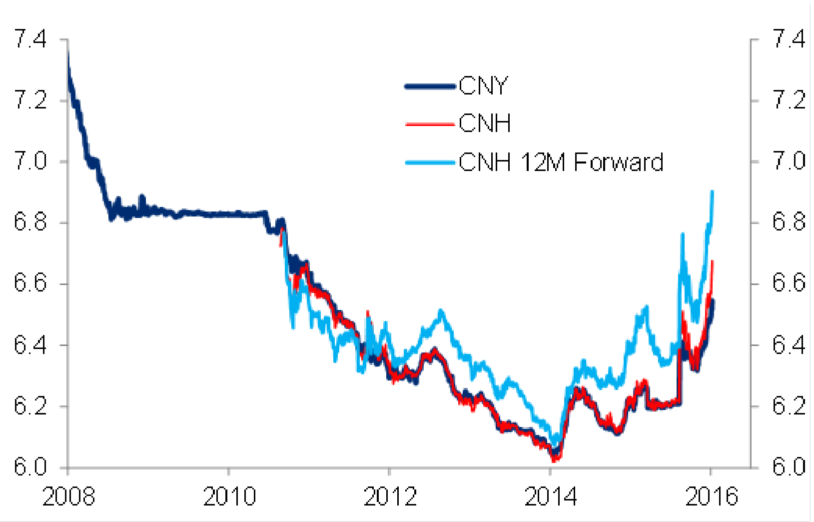
What happened?

After persistent depreciation already seen in Nov-Dec last year, the PBOC appear to have accelerated the pace of depreciation in the New Year. It remains unclear what the PBOC's intentions are, but recent developments raise significant questions about the gradualist approach of China's FX policy.

The PBOC's recent actions are confusing. Late in December, it suspended cross-border Chinese yuan business of several foreign banks, presumably to narrow channels that enable shorting . When the market continued to weaken the CNY on Jan 4th, the PBOC set the reference rate stronger on Jan 5th and managed to stabilize markets somewhat. Then on Jan 6th, the PBOC surprised markets and set the reference rate much weaker than the previous day's close, effectively reversing the stabilization measures of the previous day.

Immediately after the reference rate was announced on Jan 6, the 12-month forward rate leapt over 6.90, weaker than the 2008 crisis peg level of 6.83 (see figure 2).

Figure 2. RMB depreciation has accelerated



Source: Bloomberg as of January 6, 2016.

Chinese exporters clearly may benefit from this, as weaker RMB helps to widen their profit margins. But the impact on overall exports is likely muted because other competitor currencies have also weakened. But capital outflows could intensify as markets continue to expect more depreciation. If this process drags on longer, it would continue to erode FX reserves, which had already fallen by $555bn from Jul 2014 to $3.44tn in Nov 2015. Markets would be closely watching FX reserves data to gauge PBOC's intentions.

Similar to last August, concerns over China exporting deflation would likely dominate markets in coming days, likely with influence over other policymakers. Several Fed speakers have recently noted the risks that China continues to pose to the outlook. The IMF's chief economist warned China not to "spook" markets. These comments all came before today's surprise fixing. Altogether, China's recent currency moves likely would push G3 central banks marginally towards further accommodation, and away from tightening.

As discussed in our Outlook 2016 report, for suitable investors, we recommend exploiting gaps in cross-market volatility to hedge risk. High levels of expected volatility priced in one global asset class can't be expected to be ignored in others.

Steven Wieting
Global Chief Investment Strategist
+1-212-559-0499
Steven.Wieting@citi.com

Ken Peng
Asia Pacific Investment Strategist
+85 2 2868 8904
Ken.peng@citi.com

Disclosures

In any instance where distribution of this communication ("Communication") is subject to the rules of the US Commodity Futures Trading Commission ("CFTC"), this communication constitutes an invitation to consider entering into a derivatives transaction under US CFTC Regulations §§ 1.71 and 23.605, where applicable, but is not a binding offer to buy/sell any financial instrument.

This Communication is prepared by Citi Private Bank ("CPB"), a business of Citigroup, Inc. ("Citigroup"), which provides its clients access to a broad array of products and services available through Citigroup, its bank and non-bank affiliates worldwide (collectively, "Citi"). Not all products and services are provided by all affiliates, or are available at all locations.

CPB personnel are not research analysts, and the information in this Communication is not intended to constitute "research", as that term is defined by applicable regulations. Unless otherwise indicated, any reference to a research report or research recommendation is not intended to represent the whole report and is not in itself considered a recommendation or research report.

This Communication is provided for information and discussion purposes only, at the recipient's request. The recipient should notify CPB immediately should it at any time wish to cease being provided with such information. Unless otherwise indicated, (i) it does not constitute an offer or recommendation to purchase or sell any security, financial instrument or other product or service, or to attract any funding or deposits, and (ii) it does not constitute a solicitation if it is not subject to the rules of the CFTC (but see discussion above regarding communication subject to CFTC rules) and (iii) it is not intended as an official confirmation of any transaction.

Unless otherwise expressly indicated, this Communication does not take into account the investment objectives, risk profile or financial situation of any particular person and as such, investments mentioned in this document may not be suitable for all investors. Citi is not acting as an investment or other advisor, fiduciary or agent. The information contained herein is not intended to be an exhaustive discussion of the strategies or concepts mentioned herein or tax or legal advice. Recipients of this Communication should obtain advice based on their own individual circumstances from their own tax, financial, legal and other advisors about the risks and merits of any transaction before making an investment decision, and only make such decisions on the basis of their own objectives, experience, risk profile and resources.

The information contained in this Communication is based on generally available information and, although obtained from sources believed by Citi to be reliable, its accuracy and completeness cannot be assured, and such information may be incomplete or condensed. Any assumptions or information contained in this Communication constitute a judgment only as of the date of this document or on any specified dates and is subject to change without notice. Insofar as this Communication may contain historical and forward looking information, past performance is neither a guarantee nor an indication of future results, and future results may not meet expectations due to a variety of economic, market and other factors. Further, any projections of potential risk or return are illustrative and should not be taken as limitations of the maximum possible loss or gain. Any prices, values or estimates provided in this Communication (other than those that are identified as being historical) are indicative only, may change without notice and do not represent firm quotes as to either price or size, nor reflect the value Citi may assign a security in its inventory. Forward looking information does not indicate a level at which Citi is prepared to do a trade and may not account for all relevant assumptions and future conditions. Actual conditions may vary substantially from estimates which could have a negative impact on the value of an instrument.

Views, opinions and estimates expressed herein may differ from the opinions expressed by other Citi businesses or affiliates, and are not intended to be a forecast of future events, a guarantee of future results, or investment advice, and are subject to change without notice based on market and other conditions. Citi is under no duty to update this document and accepts no liability for any loss (whether direct, indirect or consequential) that may arise from any use of the information contained in or derived from this Communication.

Investments in financial instruments or other products carry significant risk, including the possible loss of the principal amount invested. Financial instruments or other products denominated in a foreign currency are subject to exchange rate fluctuations, which may have an adverse effect on the price or value of an investment in such products. This Communication does not purport to identify all risks or material considerations which may be associated with entering into any transaction.

Structured products can be highly illiquid and are not suitable for all investors. Additional information can be found in the disclosure documents of the issuer for each respective structured product described herein. Investing in structured products is intended only for experienced and sophisticated investors who are willing and able to bear the high economic risks of such an investment. Investors should carefully review and consider potential risks before investing.

OTC derivative transactions involve risk and are not suitable for all investors. Investment products are not insured, carry no bank or government guarantee and may lose value. Before entering into these transactions, you should: (i) ensure that you have obtained and considered relevant information from independent reliable sources concerning the financial, economic and political conditions of the relevant markets; (ii) determine that you have the necessary knowledge, sophistication and experience in financial, business and investment matters to be able to evaluate the risks involved, and that you are financially able to bear such risks; and (iii) determine, having considered the foregoing points, that capital markets transactions are suitable and appropriate for your financial, tax, business and investment objectives.

This material may mention options regulated by the US Securities and Exchange Commission. Before buying or selling options you should obtain and review the current version of the Options Clearing Corporation booklet, Characteristics and Risks of Standardized Options. A copy of the booklet can be obtained upon request from Citigroup Global Markets Inc., 390 Greenwich Street, 3rd Floor, New York, NY 10013 or by clicking the following links,

http://www.theocc.com/components/docs/riskstoc.pdf or

http://www.theocc.com/components/docs/about/publications/november_2012_supplement.pdf.

If you buy options, the maximum loss is the premium. If you sell put options, the risk is the entire notional below the strike. If you sell call options, the risk is unlimited. The actual profit or loss from any trade will depend on the price at which the trades are executed. The prices used herein are historical and may not be available when you order is entered. Commissions and other transaction costs are not considered in these examples. Option trades in general and these trades in particular may not be appropriate for every investor. Unless noted otherwise, the source of all graphs and tables in this report is Citi. Because of the importance of tax considerations to all option transactions, the investor considering options should consult with his/her tax advisor as to how their tax situation is affected by the outcome of contemplated options transactions.

None of the financial instruments or other products mentioned in this Communication (unless expressly stated otherwise) is (i) insured by the Federal Deposit Insurance Corporation or any other governmental authority, or (ii) deposits or other obligations of, or guaranteed by, Citi or any other insured depository institution.

Citi often acts as an issuer of financial instruments and other products, acts as a market maker and trades as principal in many different financial instruments and other products, and can be expected to perform or seek to perform investment banking and other services for the issuer of such financial instruments or other products. The author of this Communication may have discussed the information contained therein with others within or outside Citi, and the author and/or such other Citi personnel may have already acted on the basis of this information (including by trading for Citi's proprietary accounts or communicating the information contained herein to other customers of Citi). Citi, Citi's personnel (including those with whom the author may have consulted in the preparation of this communication), and other customers of Citi may be long or short the financial instruments or other products referred to in this Communication, may have acquired such positions at prices and market conditions that are no longer available, and may have interests different from or adverse to your interests.

IRS Circular 230 Disclosure: Citi and its employees are not in the business of providing, and do not provide, tax or legal advice to any taxpayer outside Citi. Any statement in this Communication regarding tax matters is not intended or written to be used, and cannot be used or relied upon, by any taxpayer for the purpose of avoiding tax penalties. Any such taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

Neither Citi nor any of its affiliates can accept responsibility for the tax treatment of any investment product, whether or not the investment is purchased by a trust or company administered by an affiliate of Citi. Citi assumes that, before making any commitment to invest, the investor and (where applicable, its beneficial owners) have taken whatever tax, legal or other advice the investor/beneficial owners consider necessary and have arranged to account for any tax lawfully due on the income or gains arising from any investment product provided by Citi.

This Communication is for the sole and exclusive use of the intended recipients, and may contain information proprietary to Citi which may not be reproduced or circulated in whole or in part without Citi's prior consent. The manner of circulation and distribution may be restricted by law or regulation in certain countries. Persons who come into possession of this document are required to inform themselves of, and to observe such restrictions. Citi accepts no liability whatsoever for the actions of third parties in this respect. Any unauthorized use, duplication, or disclosure of this document is prohibited by law and may result in prosecution.

Other businesses within Citigroup Inc. and affiliates of Citigroup Inc. may give advice, make recommendations, and take action in the interest of their clients, or for their own accounts, that may differ from the views expressed in this document. All expressions of opinion are current as of the date of this document and are subject to change without notice. Citigroup Inc. is not obligated to provide updates or changes to the information contained in this document.

The expressions of opinion are not intended to be a forecast of future events or a guarantee of future results. Past performance is not a guarantee of future results. Real results may vary.

Although information in this document has been obtained from sources believed to be reliable, Citigroup Inc. and its affiliates do not guarantee its accuracy or completeness and accept no liability for any direct or consequential losses arising from its use. Throughout this publication where charts indicate that a third party (parties) is the source, please note that the attributed may refer to the raw data received from such parties. No part of this document may be copied, photocopied or duplicated in any form or by any means, or distributed to any person that is not an employee, officer, director, or authorized agent of the recipient without Citigroup Inc.'s prior written consent.

Citigroup Inc. may act as principal for its own account or as agent for another person in connection with transactions placed by Citigroup Inc. for its clients involving securities that are the subject of this document or future editions of the Quadrant and Quadrant Asia.

Bonds are affected by a number of risks, including fluctuations in interest rates, credit risk and prepayment risk. In general, as prevailing interest rates rise, fixed income securities prices will fall. Bonds face credit risk if a decline in an issuer's credit rating, or creditworthiness, causes a bond's price to decline. High yield bonds are subject to additional risks such as increased risk of default and greater volatility because of the lower credit quality of the issues. Finally, bonds can be subject to prepayment risk. When interest rates fall, an issuer may choose to borrow money at a lower interest rate, while paying off its previously issued bonds. As a consequence, underlying bonds will lose the interest payments from the investment and will be forced to reinvest in a market where prevailing interest rates are lower than when the initial investment was made.

Mortgage-backed securities ("MBS"), which include collateralized mortgage obligations ("CMOs"), also referred to as real estate mortgage investment conduits ("REMICs"), may not be suitable for all investors. There is the possibility of early return of principal due to mortgage prepayments, which can reduce expected yield and result in reinvestment risk. Conversely, return of principal may be slower than initial prepayment speed assumptions, extending the average life of the security up to its listed maturity date (also referred to as extension risk).

Additionally, the underlying collateral supporting non-Agency MBS may default on principal and interest payments. In certain cases, this could cause the income stream of the security to decline and result in loss of principal. Further, an insufficient level of credit support may result in a downgrade of a mortgage bond's credit rating and lead to a higher probability of principal loss and increased price volatility. Investments in subordinated MBS involve greater credit risk of default than the senior classes of the same issue. Default risk may be pronounced in cases where the MBS security is secured by, or evidencing an interest in, a relatively small or less diverse pool of underlying mortgage loans.

MBS are also sensitive to interest rate changes which can negatively impact the market value of the security. During times of heightened volatility, MBS can experience greater levels of illiquidity and larger price movements. Price volatility may also occur from other factors including, but not limited to, prepayments, future prepayment expectations, credit concerns, underlying collateral performance and technical changes in the market.

Alternative investments referenced in this report are speculative and entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns, restrictions on transferring interests in the fund, potential lack of diversification, absence of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than mutual funds and advisor risk. Asset allocation does not assure a profit or protect against a loss in declining financial markets. The indexes are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results.

International investing entails greater risk, as well as greater potential rewards compared to US investing. These risks include political and economic uncertainties of foreign countries as well as the risk of currency fluctuations. These risks are magnified in countries with emerging markets, since these countries may have relatively unstable governments and less established markets and economics.

Investing in smaller companies involves greater risks not associated with investing in more established companies, such as business risk, significant stock price fluctuations and illiquidity. Factors affecting commodities generally, index components composed of futures contracts on nickel or copper, which are industrial metals, may be subject to a number of additional factors specific to industrial metals that might cause price volatility. These include changes in the level of industrial activity using industrial metals (including the availability of substitutes such as manmade or synthetic substitutes); disruptions in the supply chain, from mining to storage to smelting or refining; adjustments to inventory; variations in production costs, including storage, labor and energy costs; costs associated with regulatory compliance, including environmental regulations; and changes in industrial, government and consumer demand, both in individual consuming nations and internationally. Index components concentrated in futures contracts on agricultural products, including grains, may be subject to a number of additional factors specific to agricultural products that might cause price volatility. These include weather conditions, including floods, drought and freezing conditions; changes in government policies; planting decisions; and changes in demand for agricultural products, both with end users and as inputs into various industries.

The information contained herein is not intended to be an exhaustive discussion of the strategies or concepts mentioned herein or tax or legal advice. Readers interested in the strategies or concepts should consult their tax, legal, or other advisors, as appropriate. Citi Private Bank is a business of Citigroup Inc. ("Citigroup"), which provides its clients access to a broad array of products and services available through bank and non-bank affiliates of Citigroup. Not all products and services are provided by all affiliates or are available at all locations. In the US, brokerage products and services are provided by Citigroup Global Markets Inc. ("CGMI"), member SIPC. Accounts carried by Pershing LLC, member FINRA, NYSE, SIPC. CGMI and Citibank, N.A are affiliated companies under the common control of Citigroup. Outside the US, brokerage products and services are provided by other Citigroup affiliates. Investment Management services (including portfolio management) are available through CGMI, Citibank, N.A. and other affiliated advisory businesses.

In Hong Kong, this document is issued by CPB operating through Citibank, N.A., Hong Kong branch, which is regulated by the Hong Kong Monetary Authority. Any questions in connection with the contents in this document should be directed to registered or licensed representatives of the aforementioned entity. In Singapore, this document is issued by CPB operating through Citibank, N.A., Singapore branch, which is regulated by the Monetary Authority of Singapore. Any questions in connection with the contents in this document should be directed to registered or licensed representatives of the aforementioned entity.

In the United Kingdom, Citibank N.A., London Branch (registered branch number BR001018), Citigroup Centre, Canada Square, Canary Wharf, London, E14 5LB, is authorised and regulated by the Office of the Comptroller of the Currency (USA) and authorised by the Prudential Regulation Authority. Subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details about the extent of our regulation by the Prudential Regulation Authority are available from us on request. The contact number for Citibank N.A., London Branch is +44 (0)20 7508 8000.

Citibank International Ltd (registered number 1088249), Citigroup Centre, Canada Square, Canary Wharf, London, E14 5LB, is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority. The contact number for Citibank International Ltd is +44 (0)20 7508 8000.

In Jersey, this document is communicated by Citibank N.A., Jersey Branch which has its registered address at PO Box 104, 38 Esplanade, St Helier, Jersey JE4 8QB. Citibank N.A., Jersey Branch is regulated by the Jersey Financial Services Commission. Citibank N.A. Jersey Branch is a participant in the Jersey Bank Depositors Compensation Scheme. The Scheme offers protection for eligible deposits of up to £50,000. The maximum total amount of compensation is capped at £100,000,000 in any 5 year period. Full details of the Scheme and banking groups covered are available on the States of Jersey website www.gov.je/dcs, or on request.

In Canada, Citi Private Bank is a division of Citibank Canada, a Schedule II Canadian chartered bank. Certain investment products are made available through Citibank Canada Investment Funds Limited ("CCIFL"), a wholly owned subsidiary of Citibank Canada. Investment Products are subject to investment risk, including possible loss of principal amount invested. Investment Products are not insured by the CDIC, FDIC or depository insurance regime of any jurisdiction and are not guaranteed by Citigroup or any affiliate thereof.

CCIFL is not currently a member, and does not intend to become a member of the Mutual Fund Dealers Association of Canada ("MFDA"); consequently, clients of CCIFL will not have available to them investor protection benefits that would otherwise derive from membership of CCIFL in the MFDA, including coverage under any investor protection plan for clients of members of the MFDA.

This document is for information purposes only and does not constitute an offer to sell or a solicitation of an offer to buy any securities to any person in any jurisdiction. The information set out herein may be subject to updating, completion, revision, verification and amendment and such information may change materially.

Citigroup, its affiliates and any of the officers, directors, employees, representatives or agents shall not be held liable for any direct, indirect, incidental, special, or consequential damages, including loss of profits, arising out of the use of information contained herein, including through errors whether caused by negligence or otherwise.