

Private Bank

# Extending the cycle

MID-YEAR OUTLOOK 2016







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# Extending the cycle

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**Steven Wieting**, Global Chief Investment Strategist

Central banks are seeking to extend the economic recovery, but their intentions have generated confusion. This represents an opportunity.

The world's most important central banks want to support and strengthen the global economic expansion. Even the US Federal Reserve, which is again contemplating a small, but earlier-than-expected rate-hike, cares most about sustaining the expansion. The Fed – along with several other key central banks – altered its policy after a significant global recession scare at the start of the year. In several cases, the central banks have taken easing-steps even more significant than those they took in 2015. However, their message is not getting through.

The problem is that they have complicated their message by trying to offset the impact of divergences between their monetary policies. Such divergences – where some central banks are easing and others are tightening – affected currency markets acutely last year. At its worst, this represented a potential financial shock for the world economy and markets. China's currency came under pressure twice in the past year, and US dollar funding for other emerging markets dried up. Their policy approach in 2016 marks an improvement, as we will discuss. Yet complexity itself is weighing upon investors' confidence to take risks.

In fixed-income markets, central banks have still been highly influential. About 30% of investment grade sovereign

bonds now have negative yields, meaning investors pay more for bonds than the market value of future interest and principal repayments. Negative sovereign yields have driven investors into credit markets, where US long-term investment grade credit has returned 9% in 2016 so far – **figure 1** – and 7% for US high yield.

In foreign-exchange markets, central banks' efforts to offset divergence have weakened the US dollar and created new worries, despite generating relief from the worries of 2015 just noted. The Fed's caution following its December interest-rate rise was one driver of this. Another was European Central Bank President Draghi's comment that negative interest rates would not be the bank's main tool going forward. Instead,

he placed emphasis upon measures to boost domestic demand, such as corporate-bond purchases. While the impact of any policy-measures on global growth is likely to be limited, just as in recent years, it is clearly more positive than competitive devaluations. Yet because currency weakness was seen as a key gauge of the effectiveness of central-bank actions, developments in the foreign-exchange markets this year have attracted more attention than the improvements in local credit markets.

Along with the apparent bottoming of the crude-oil price, measures to offset divergence have created different beneficiaries of central-bank policy steps in 2016. One beneficiary of the new policy approach has been the Japanese yen, which despite the world's

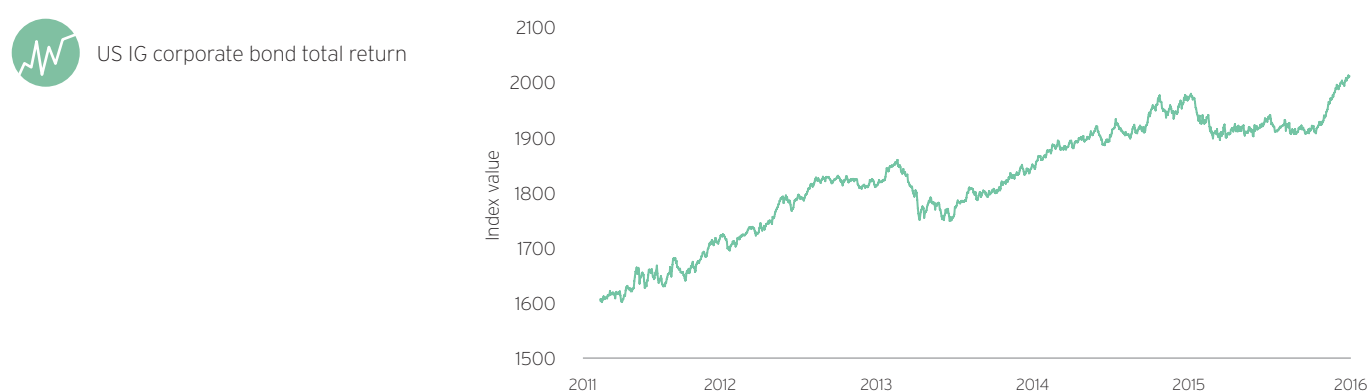
largest quantitative easing program has strengthened sharply. This will likely lead to yet more easing steps in Japan. Commodity-sensitive emerging markets have also been strong performers so far in 2016. We call these “convergence” sectors, as opposed to “divergence” sectors, or those that rise alongside the US dollar upon Fed tightening – **figure 2**.

For now, the global economic recovery remains intact. And we have seen some

evidence this year that the economic expansion in the US, the world’s largest individual economy, might last for longer than we previously thought. Since we published [Outlook 2016 – Late Cycle Investing](#), US labor-force participation has grown at its fastest rate for the seven-year economic recovery so far. The trend could mean a longer US and global recovery than our base-case assumes. We always thought an economic peak was a

greater risk for 2017 than for 2016. Under certain conditions, though, the US labor-force recovery could prolong the expansion even further. Still, such an outcome wouldn’t defer a future economic peak forever. Eventually, a recession is inevitable, and this will likely see financial-market performance diverge once more, with the US dollar strengthening and emerging markets weakening.

Figure 1. Making the grade



Source: Bloomberg, as of 17 May 2016. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future returns. Real results may vary.

Figure 2. Returns in market segments aided by divergence or convergence

	Eurozone equities	Euro/US dollar	Japan equities	Yen/US dollar	Emerging market equities	Emerging market currencies	Commodities	Global equities	Global fixed income
Divergence								0.7%	
Convergence	-2.0%	2.7%	-6.1%	8.5%	-0.1%	1.4%	4.2%		3.8%

Source: Bloomberg, as of 24 May 2016. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future returns. Real results may vary. \*Divergence and convergence is defined here in terms US dollar strength and weakness. Please see glossary for definitions of market segments.

We have seen some evidence this year that the economic expansion in the US might last for longer than we previously thought.

Figure 3. Key changes to our asset allocation in 2016 to date

Global equities overweight cut from +3.5% to +1.0%
Global fixed income underweight cut from -3.5% to -1.3%
US high grade corporate debt raise to double-overweight
Developed and emerging Asian equities cut to neutral
Brazil and Canada equities raised to neutral
Latin American debt raised to overweight
US Treasury Inflation Protected Securities (TIPS) raised to overweight
Cash raised to overweight

Source: Citi Private Bank, as of May 2016. The recommendations refer to tactical weighting adjustments on a 12-18 month view made by our Global Investment Committee to our strategic asset allocations, which take a ten-year view. Overweight and underweight signify having a greater or lesser allocation to an asset class or sub-asset class than our long-term strategic asset allocations, while neutral signifies having an allocation in line with our long-term strategic asset allocations.

With many markets having registered significant gains over recent years, we have shifted our asset allocation to a less bullish position than where it was when asset prices were depressed - **figure 3**. Still, we do expect monetary policy to have a positive effect on markets in the period immediately ahead, but also for divergences between central banks' policies to reassert themselves. The Fed reaffirming its tightening plans, however cautious, is a reminder of this. Also, with the oil sector worldwide having endured a recession already, we have started to add to our exposure, as we see it better positioned now to withstand a future demand downturn.

Coming into 2016, we expected the divergence between easing policies of the European and Japanese central banks and the US Federal Reserve's tightening to impact a range of financial markets, particularly in foreign exchange. However, in light of China's currency turmoil, central bankers have sought to avoid "competitive devaluations" and the Fed retreated from its tightening plans, at least partially. The European Central Bank's March easing steps - including corporate bond purchases and negative rate funding for banks - were designed to support domestic credit growth while minimizing the impact through the Euro's exchange rate. Therefore,

contrary to our expectations, the Euro and Japanese yen have seen a strong counter-trend rally against the US dollar. We have adjusted some of our key positions accordingly - see *Our highest-conviction views for 2016 revisited*.

Nevertheless, divergences in monetary policy around the world are set to persist. The ECB and Bank of Japan have joined the Swiss National Bank in setting negative interest rates in 2016, pushing global rates to unprecedented lows. And they could conceivably extend their current asset-purchasing programs - **figure 4** - until the end of the decade. We believe that might drive the US dollar above its 2015 highs in due course. Once an economic peak is reached, however, we see the Fed joining its peers in easing once more. In the meantime, we stay underweight of bonds bearing negative or negligible yields. Despite their strong performance, we believe they carry significant risks and insufficient rewards. Falling yields should make equity dividend yields look more appealing than they currently do.

By paring back the extent of its tightening plans this year, the Fed has made it easier for central banks in riskier, emerging markets to attract capital and strengthen their exchange rates. And energy-exporting emerging markets received a further boost

With the oil sector worldwide having endured a recession already, we have started to add to our exposure, as we see it better positioned now to withstand a future demand downturn.

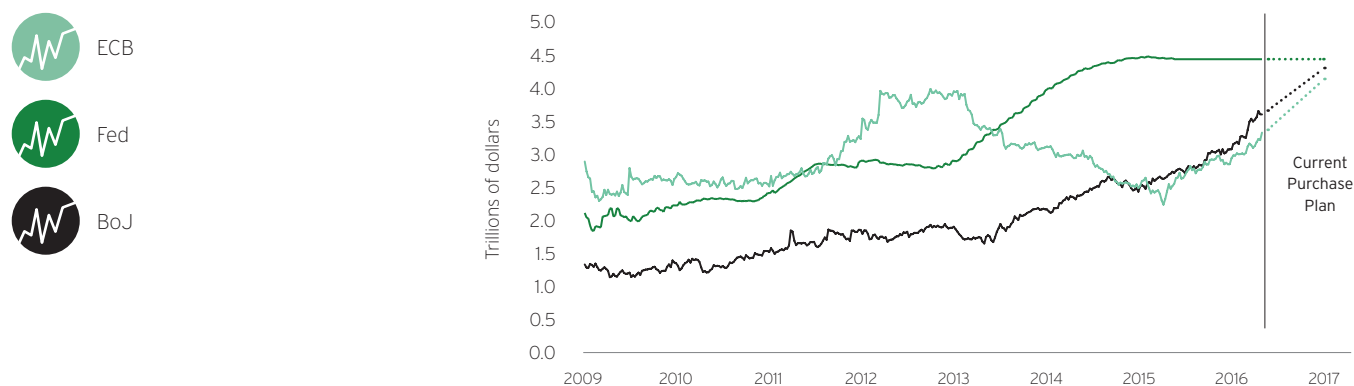
from the bottoming in the oil price in late January, assisted by a 60% decline in new oil exploration activity – **figure 5**. Prior to the heavy falls in the oil price, we advised wholesale avoidance of oil-related credit. This is no longer appropriate, however. We have therefore shifted our asset allocation to take advantage of the latest trends in commodities and emerging markets – see *Navigating emerging markets* and *Our highest-conviction views for 2016 revisited*. But bearing in mind the late-cycle risks for the global economy, we focused these changes largely in lower-risk emerging-market asset classes, such as hard-currency fixed income.

Aside from monetary policy and energy prices, we emphasize the greater-than-usual risks this year from political developments. The UK's referendum on EU membership on 23 June is just one event in 2016 that could have important economic and financial-market impacts. But we would also highlight the potential implications for markets of the US presidential race and of the apparent political shift underway in some of Latin America's leading economies – see *Politics: unusual times*.

In the long run, we believe that the most important drivers of financial markets are fundamentals rather than

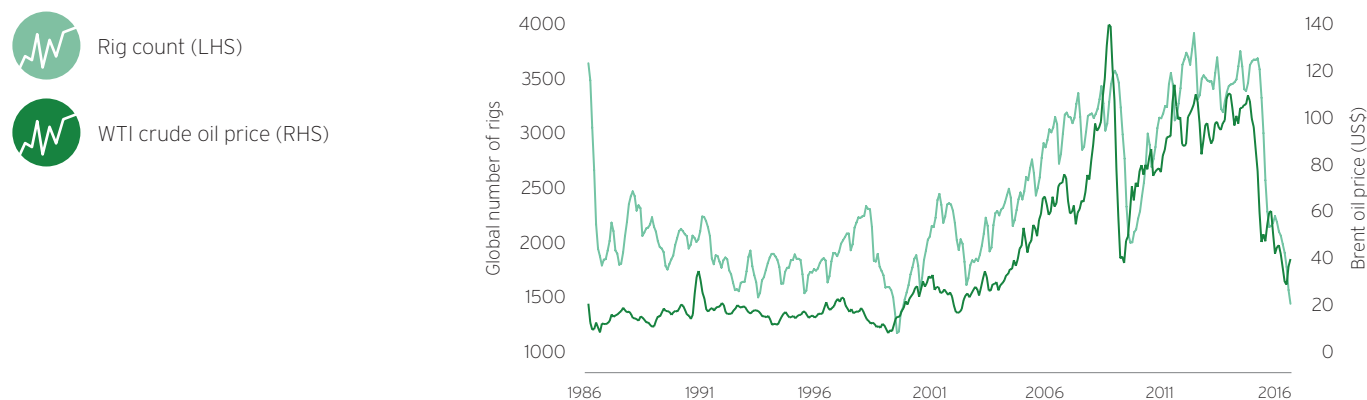
market interventions. Central banks have been able to influence asset prices. But they have not been able to prevent recurrent crises. Nor were they behind the gains in human living standards over time, which instead resulted from technological progress. Our long-term investment view is based primarily upon fundamentals, rather than upon short-term central-bank policies. In today's late-cycle environment, this calls for greater selectivity based on sector-level, fundamental analysis – as we discuss in *Selectivity is key*.

Figure 4. Policy divergence in action



Sources: Bloomberg as of 8 April, 2016. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events.

Figure 5. Drilling's plunge signals drop in future oil-supply growth



Source: Haver Analytics 1996-2016; as of April 2016. Past performance is no guarantee of future returns. Real results may vary.



# Navigating emerging markets: shifting opportunities

**Steven Wieting**, Global Chief Investment Strategist

**Ken Peng**, Asia Strategist

**Jorge Amato**, Latin America Strategist

We see emerging-market investment risks as having shifted somewhat away from Latin America towards Asia and have adjusted our positioning accordingly.

The recovery from the Great Recession of 2009 to date has not been kind to emerging markets (EM). This is particularly true of the largest EM of all. China borrowed heavily from 2009 to finance stimulus, exacerbating its excess industrial capacity and other imbalances.

Nevertheless, its economic growth rate has slowed every year since 2010. China's prior two decades of growth may represent the most rapid and sustained economic growth spurt in history. While relative stages of development still differ markedly as discussed below, the

situation is somewhat akin to Japan's post-war "growth miracle," which once contributed mightily to global economic expansion, but then subsequently ebbed - **figures 1 and 2**. Notably, Japan still grew significantly in an absolute sense long after its peak growth rate.

Figure 1. Capital investment shares of GDP

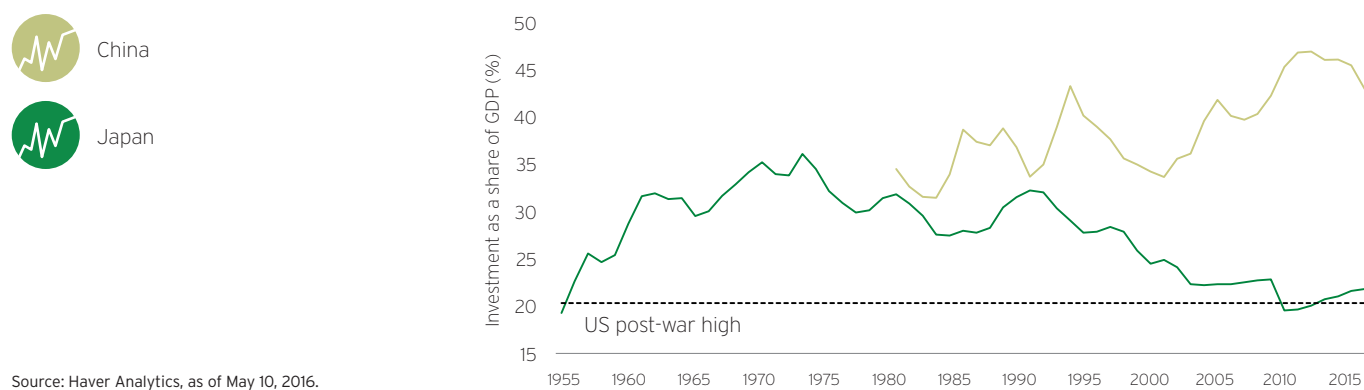


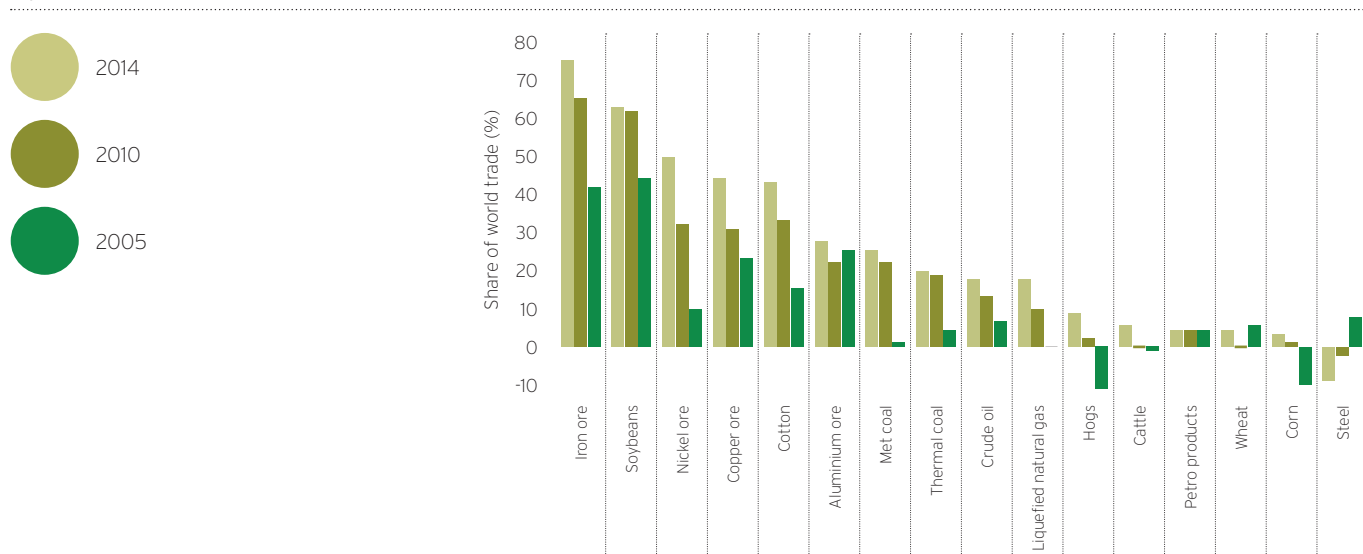


Figure 2. Contribution to global growth

	Japan	China
1960	6.2%	10.1%
1970	<b>11.8%</b>	3.4%
1980	<b>10.4%</b>	7.5%
1990	7.5%	8.9%
2000	5.5%	<b>16.4%</b>
2010	0.8%	<b>27.8%</b>

Source: Penn World Table, as of 28 April 2016.

Figure 3. China commodity net imports as % of world trade\*



Source: Citi Research, April 2016. \*Metal ores are measured in US dollar value terms, all others are volumetric.

China's structural slowdown requires significant adjustments elsewhere in the world. This includes softer growth in industrial commodities demand, as China has driven much of the last decade's demand-growth - **figure 3**. Latin American economies and markets have already suffered from weaker Chinese commodity demand before this year.

That said, the sharp decline of Latin American asset prices relative to Asian asset prices suggests that risks have shifted somewhat away from the

former and towards the latter. We have adjusted our tactical asset allocation in emerging markets to reflect this shifting opportunity as follows:

- Cut Asian equities from overweight to neutral
- Reduced underweight to Brazil equities
- Raised Latin American debt - hard-currency and local - from neutral to overweight\*\*

\*\* Source: Citi Private Bank as of May 2016. The recommendations refer to tactical weighting adjustments on a 12-18 month view made by our Global Investment Committee to our strategic asset allocations, which take a ten-year view. Overweight and underweight signify having a greater or lesser allocation to an asset class or sub-asset class than our long-term strategic asset allocations, while neutral signifies having an allocation in line with our long-term strategic asset allocations.

## China reverts to stimulus

China has resorted to debt-fuelled stimulus once again in early 2016. Many key macroeconomic indicators have noticeably improved. Industrial deflation may soon reverse, with producer prices getting their largest boost since 2010, thanks to the weaker Chinese yuan and commodity-price rebound. This is important for Chinese equities because listed firms are dominated by industrial producers. Outside of the bubble and bust of 2014-15, equities have closely tracked producer prices – **figure 4**.

But the data improvement may be hard to sustain, given its dependence on credit growth. Total new financing amounted to RMB6.5tn (US\$1.0tn) in the first quarter of 2016. The outstanding financing represents 221% of GDP, excluding government and financial institutions. At the current 5% average cost, the debt-service burden is excessive and would require lower interest rates to sustain.

Despite these challenges, China largely remains committed to reforms. It continues to improve access to its onshore equity and bond markets, while allowing its exchange rate to become much more market-driven. Its tax reforms favor the services sector while pension changes reduced

# Growth improvements may bring investors back to the sustainable sectors like consumer, insurance, and healthcare.

entitlements to government and state-owned enterprise retirees.

Longer term, urbanization offers significant potential. China is only 35% urbanized if its 200 million rural migrants are not counted as fully urban. Providing migrants full urban entitlements could boost demand for consumer goods, services and real estate.

Much has been said about over-investment in China, where capital stock has doubled since 2010 to \$21tn, nearly one-half that of the US. But on a per capita basis, China has less than one-tenth that of the US. More infrastructure investment in China and across Asia can help to unlock consumer spending.

## Invest in 'new' China

For Chinese equities, we continue to favor industries with sustainable growth and dividends. We think the recent short-covering rally in deep cyclicals

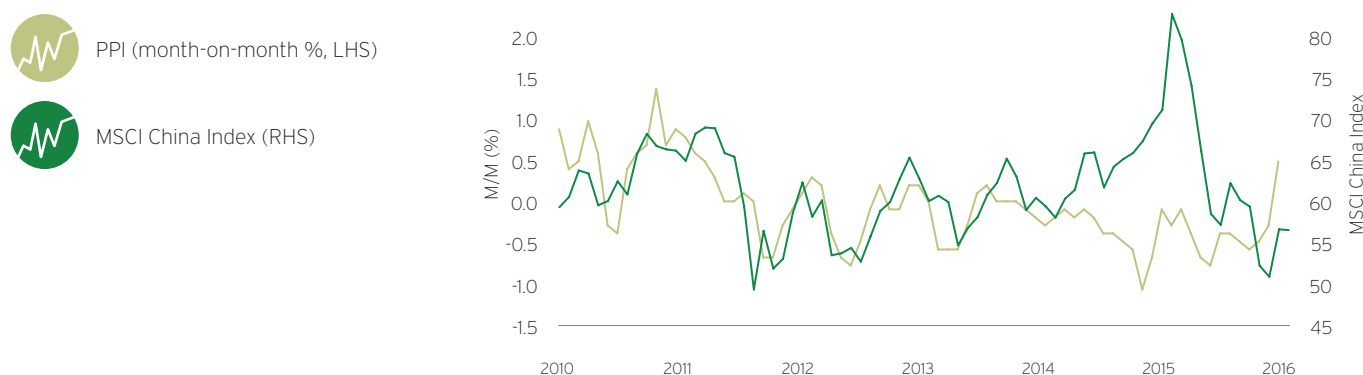
like materials and energy has largely run its course. Growth improvements may bring investors back to the sustainable sectors like consumer, insurance, and healthcare. Banks, however, may remain a value-trap because of China's leverage problem.

We see a case for further depreciation of the yuan. China's high indebtedness will demand lower real interest rates. And the revival of producer price inflation is likely to be temporary. China's authorities are likely to want the yuan to effectively weaken versus a basket of currencies, so as to maintain competitiveness. Moreover, the US dollar is reasserting itself on Fed policy normalization, which is likely to pressure the yuan further.

## Latin America

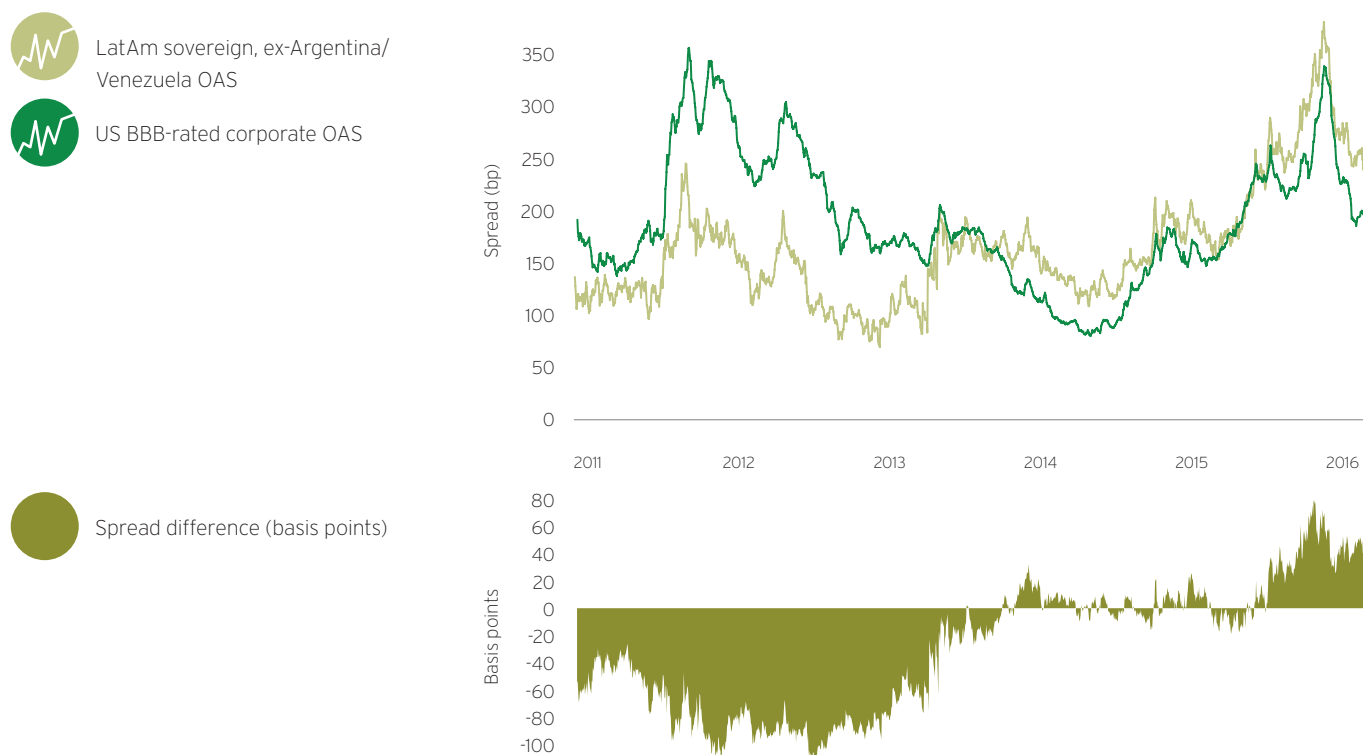
After five years of underperformance and a particularly bleak 2015, Latin American financial markets appear to have turned a corner in early 2016.

Figure 4. China equities have mainly tracked producer prices



Sources: National Bureau of Statistics of China, Bloomberg, as of Mar 2016. PPI is producer price inflation, a measure of selling prices achieved by producers of goods and services.

Figure 5. Latin America yield differential



Source: Bloomberg, as of 1 May 2016. There can be no assurance that these market conditions will remain in the future. Past performance does not guarantee future results. Actual results may differ materially from the forecasts/estimates. Views, opinions, trends and prices expressed are subject to change without prior notice and are expressed solely as a general market commentary and do not constitute investment advice or a guarantee of returns. The option-adjusted spread (OAS) is the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is adjusted to take into account an embedded option. Typically, an analyst would use the Treasury securities yield for the risk-free rate.

Since the start of the year, the MSCI Latin America Total Return Index is up nearly 12.7% compared to a 0.2% gain for the S&P 500, -6.7% in the Euro Stoxx 600 index and -6.1% in the Japanese Nikkei 225.<sup>1</sup>

While the region will likely suffer a setback once the global economic cycle peaks, the deep declines already experienced in recent years may mitigate the impact. The Fed's renewed dovishness and the bottoming of crude oil are helpful for now. Crude oil is strongly positively correlated to Latin American markets and negatively correlated to the US dollar. This eases external debt burdens in the region among other impacts.

Although there may be a temptation to take some profits after the first-half

2016 rally, we see further scope for gains, particularly as Citi Research's commodity strategy team expects an incipient upturn in the commodities cycle. Meanwhile, equity valuations remain modest, while fixed-income yields are at historically attractive levels compared to other markets – **figure 5**.

We see Argentina as one of the region's most attractive markets for the coming months. Following President Macri's surprise election in October 2015 – see *Politics unusual* – capital is flowing back into the country.

We expect Argentinian equities and debt to be promoted back from 'frontier' to 'emerging market' status. Their re-inclusion in emerging-market indices would likely benefit prices, as investors would increase their

allocations to bring themselves into line with the benchmarks. And the country's bond yields remain attractive relative to the region.

Brazil's next administration will need to show pragmatism in order to begin to reverse the nation's dire economic conditions. Both fund flows data and anecdotal evidence suggest that investor sentiment remains skeptical about Brazil. Cumulative broad fixed-income market fund flows in Brazil have been falling sharply since 2013 and are now net negative. The 32% low-to-high snap-back in the Bovespa Index erased 2015 losses and could indicate overall low investor positioning.<sup>2</sup> But valuations are still attractive and we would expect continued gains if the next administration responds positively.

<sup>1</sup> Bloomberg, as of 23 May 2016.

<sup>2</sup> Source: Bloomberg. The sharp 48% snap back in the Bovespa between the 20 January lows and the 28 April highs could indicate overall low investor positioning in the index.



# Selectivity is key

**Kris Xippolitos**, Global Head of Fixed Income Strategy  
**Christopher Dhanraj**, North America Strategist

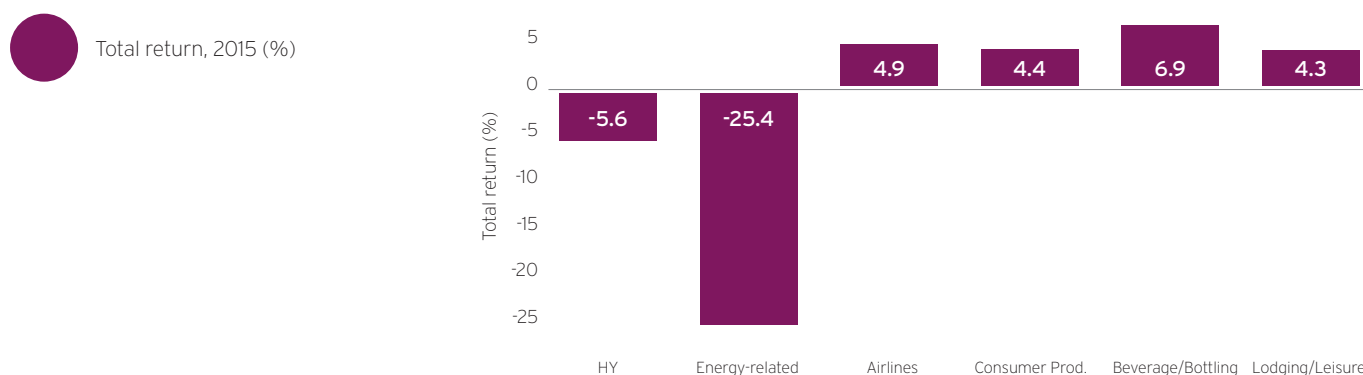
Recent market corrections have seen large, fundamentally-driven divergences in asset-price performance. These create potential opportunities for active managers.

Against a backdrop of recurring global growth concerns, volatility across financial markets has become more prevalent. However, headlines about indiscriminate market weakness ignore the underlying story for the period as a whole. Within the market corrections of the past year, there have been some large divergences in asset-price performance, which have sound fundamental reasons behind them.

One example has been in the US high yield (HY) corporate fixed-income market. Energy-related HY issuers make up nearly 17% of Citi's US High Yield Market Index, such that the sharp drop in energy prices weighed heavily upon overall index performance. During West Texas Intermediate crude oil's 57% decline between June 2015 and February 2016, energy-related HY sectors dropped 40%, contributing to a 13.5% fall in Citi's US High Yield Market Index.<sup>1</sup>

Looking inside this index, however, many of its component sectors actually fared much better. For example, higher-quality BB-rated HY issuers outperformed lower-rated companies, while prices rose in energy-sensitive sectors that benefited from cheaper oil, such as airlines and consumer-related sectors - **figure 1**. Overall, HY debt ex-energy fell by just 1% in 2015.<sup>2</sup>

Figure 1. Non-energy HY sectors fared better during oil decline



Source: The Yield Book, as of 26 Apr 2016. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future returns. Real results may vary.

<sup>1</sup> Sources: Citi Private Bank, as of 5 May 2016.

<sup>2</sup> Source: Citi Private Bank, as of 5 May 2016.

<sup>3</sup> 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 issuers.

We believe that selectivity will remain important going forward. Although we avoided HY energy at the start of 2016, its deep sell-off has created potential opportunities. Given an apparent bottom in the oil price, we think prices could trend higher over time. That said, lower-quality energy producers are likely to continue suffering, as defaults keep rising. So, we prefer to select from high B- and BB-rated energy issuers, whose yields can range between 5% and 8%.<sup>3</sup>

Increased market volatility has also created potential opportunities in equities. Although the S&P 500 Total Return Index has fallen 3.5% in the past year, there have been wide differences

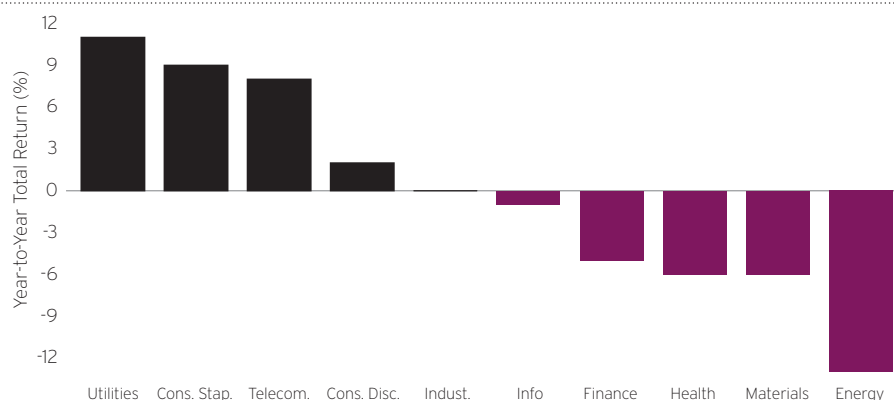
in individual sector performances – **figure 2**. Defensive sectors that benefit from low interest rates – such as utilities and telecoms – have done better. By contrast, energy and materials have struggled.

Likewise, a basket of shares in companies whose debt was rated below investment-grade collectively plunged by 40% – **figure 3**. Between 11 February and 2 May, however, shares in the same basket of sub-investment grade companies – also known as high yield – experienced a 49% rally. We believe that proactive portfolio management could have helped to identify and enable participation in this strong rally. Looking ahead, we believe stability

in commodity prices should aid the recovery in specific equity sectors such as energy and materials, as well as a further rally in shares in companies with sub-investment grade debt.

Today's heightened volatility and frequently-shifting relationships between asset classes and their component assets are typical features of a late-cycle bull market, as we argued in *Outlook 2016*. We believe that such conditions call for more than just passive asset allocation. In the face of this less certain outlook, we advocate a proactive and selective approach to seeking opportunities and managing risk.

Figure 2. S&P 500 Sector Total Returns



Source: 24 May 2016, Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future returns. Real results may vary.

Figure 3. Equities of firms with high-yield debt rebound



Source: FactSet, Haver Analytics and Citi Private Bank, 24 May 2016. To examine the impact that credit rating had on various equities and bonds in the past year, we created an equity basket of below investment grade equities containing all members of the Citi US High Yield Market Index with publicly-traded equities. The basket was created for illustrative purposes only as of November 2015 applying the same weighting formula every year to companies in the Citi US High Yield Market Index that had equities traded on a public US exchange. It is weighted as of 1 January 2016 by the value of outstanding debt to match the composition of the Citi US High Yield Market Index as closely as possible. Citi does not manage any products based upon this basket. Please see *Index definitions* at the end of this document or a description of the Citi US High Yield Market Index. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future returns. Real results may vary.

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.

# Politics: unusual times

**Steven Wieting**, Global Chief Investment Strategist

**Jeffrey Sacks**, EMEA Capital Markets Strategist

**Jorge Amato**, Latin America Strategist

**Maya Issa**, Global Strategy Analyst

## Unusual political trends could shape global economic and market outcomes in 2016 – and beyond.

Politics can exert an important influence over economies and financial markets. This year, however, the risks look higher than usual. As we highlighted in [Outlook 2016](#), popular discontentment is widening political divisions and producing unusual electoral outcomes around the world. The strong performance of candidates from outside the mainstream in the US Presidential race and this month's fiercely-contested EU membership referendum in the UK are prime examples of this. Both could have a

significant impact on economies and markets locally but also further afield.

Important political shifts are also underway outside of developed markets. The ongoing attempt to remove Brazil's President permanently comes as Latin America's largest economy suffers its worst downturn in decades, while some neighbouring countries are shedding the policies that have dominated the region's agenda in recent years. In the Middle East, various states are exploring

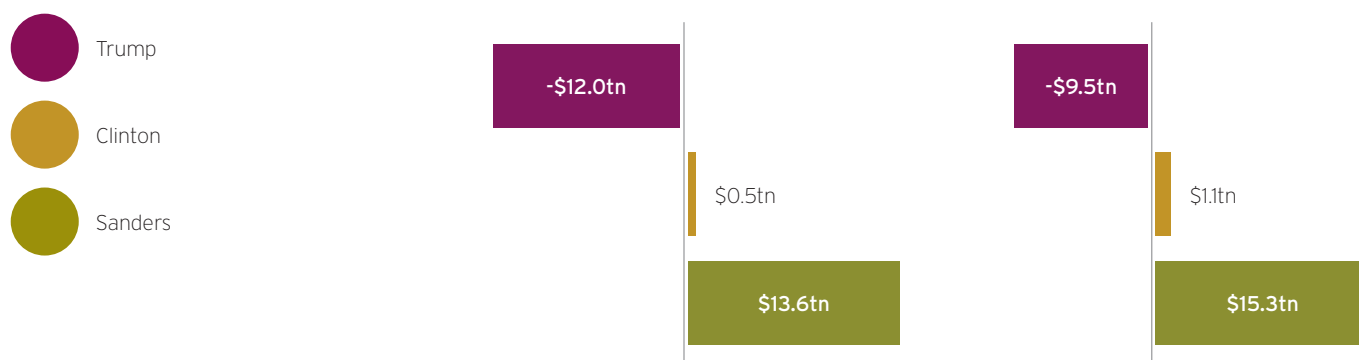
economic reforms in order to avert social and political unrest.

How far the US and its allies prospectively retreat from international affairs *relative* to others - including China and Russia - may be a key question for economists, security experts and investors in the years to come. We continue to monitor all of these trends closely, as we seek to mitigate the impact of any political spill-overs upon portfolios, but also to exploit potential opportunities that may arise.

The US Presidential race and this month's fiercely-contested EU membership referendum in the UK could have a significant impact on economies and markets locally but also further afield.



Figure 1. Ten-year Federal revenue impact assumptions, US\$ trillions



Sources: Tax Policy Center and Tax Foundation, as of May 2016. The Tax Policy Center is considered a 'center' or 'center-left' analytical source while the Tax Foundation is considered a center-right analytical source. All forecasts are expressions of opinion and are subject to change without notice and are not intended as a guarantee of future events. For illustrative purposes only.

### US election: status quo most likely

World markets have so far taken the US Presidential election in their stride. As of 24 May, an average of five polls puts Democrat Hillary Clinton as the likeliest next President ahead of Republican rival Donald Trump. While Clinton's Democratic rival Bernie Sanders remains in the nomination race, experts reckon that Clinton's lead over Sanders among Democratic delegates to become the party's nominee is already insurmountable.

**Figure 1** shows estimates of the ten-year cumulative Federal revenue impact of the three candidates' policies, produced by two unaffiliated US think-tanks. Clinton's tax proposals are closest to the status quo, which may explain financial markets' composure to date. While a Clinton presidency may represent the status quo, markets will also focus on her Congressional support. A substantial Clinton victory might also entail control of both houses of Congress switching from Republican to Democratic. This could have meaningful impact on industry

sectors such as healthcare, energy and finance. Depending on the polling leading up to November, sector rotation may also occur if a GOP status quo in Congress is maintained.

Meanwhile, Sanders is campaigning for very large tax and spending increases, and Trump for substantial tax-cuts. Were Donald Trump to win the election, a good deal of volatility in the US dollar and Treasury yields could follow merely due to the potential for enactment of his protectionist policies and unfunded deficit spending. This could offset any positive effects from his agenda of deregulation and lower taxes, which would otherwise benefit equities.

### Britain's date with EU destiny

On 23 June 2016, the United Kingdom (UK) will vote on whether to remain within the European Union (EU). The debate is likely to be dominated by issues of immigration, sovereignty, and the economy. It comes at a point when the economy is already vulnerable, with growth having slowed from above 3% to around 2%, and the UK heavily

dependent on overseas funding of its large current-account and fiscal deficits.

The only UK asset class to weaken much so far has been Sterling, down 4.5% year to date. The FTSE 100 index remains nearly unchanged in 2016 to date, while UK government bonds yields have fallen moderately. A 'remain' vote could see a Sterling-led relief-rally. In subsequent years, though, the ruling Conservative party could suffer destabilising tensions between its pro- and anti-EU wings, while the UK might still experience strained relations with fellow-EU members.

Citi economists suggest that a 'leave' vote could further slow the UK's growth to around 1%, while doubling the recent inflation uptick to 1%, pressuring all UK assets in the short-term. While the UK's departure may be less economically significant for the EU, it could further stoke political pressure from other discontented members. Citi Research political analysts put the probability of a 'leave' vote at 30-40%.

## Latin America's wind of change

Popular discontent is re-shaping Latin American politics. Lower commodity prices and weaker economic growth have undermined the redistributive policies put in place by many of the region's left-leaning governments in the 2000s. The election of the market-friendly President Mauricio Macri in Argentina in October 2015 and the recent failure of a left-wing candidate to make it to the second round of Peru's presidential elections both highlight the shift that is underway.

A permanent change in Brazil's administration looks almost certain following a congressional vote to impeach President Dilma Rousseff. Social discontent is running high as the

country's economy remains mired in its worst recession for decades. High real rates on the country's local-currency debt are pressuring the public finances. Sovereign external debt, however, is quite low at around 20% of GDP, so a foreign-currency default seems unlikely. Today's Brazilian asset-price valuations would look compelling if a stable government were to emerge and an economic recovery to begin.

## Middle East looks beyond energy

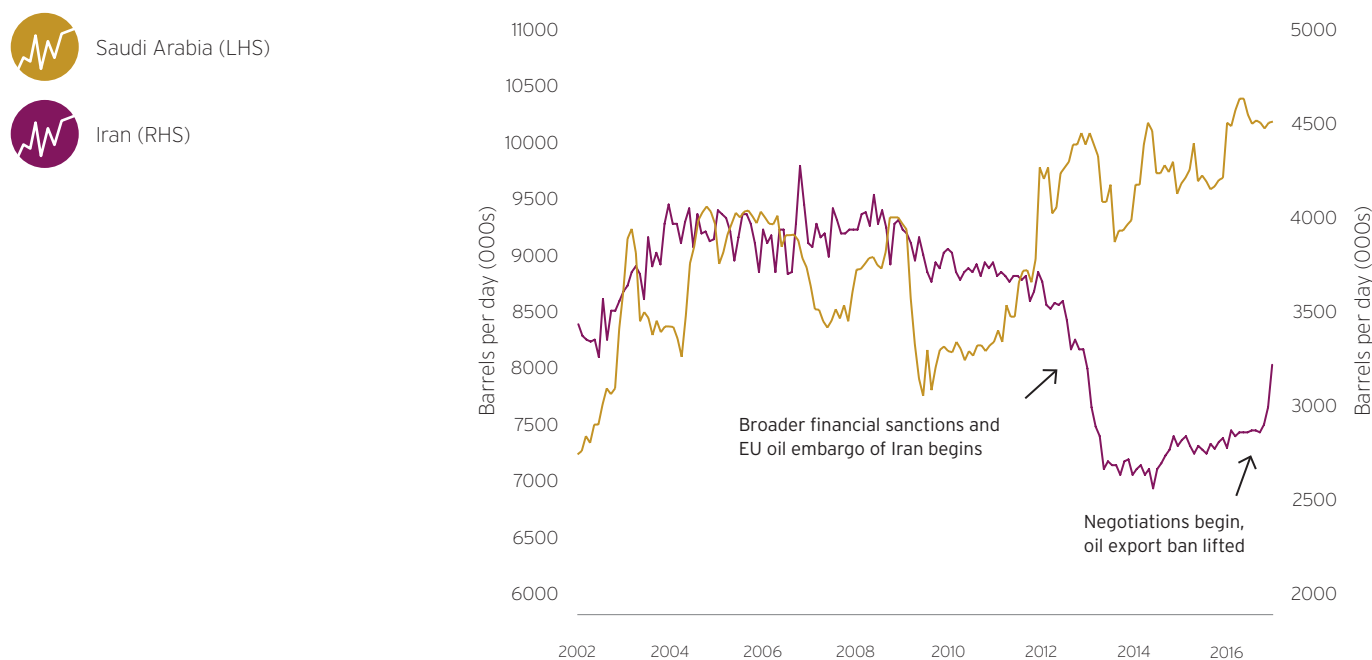
The schism between Saudi Arabia and the Gulf states on one side and Iran on the other has had potent effects on global markets in 2016. As negotiations began to lift sanctions preventing Iranian oil exports, Saudi Arabia boosted its production - **figure 2**. In April, a deal

among producers to freeze oil output collapsed after Saudi Arabia insisted upon Iran also participating. These tensions have contributed to oil-price volatility and could have further impact going forward, especially if they flared up at a time of weaker energy demand.

Against this backdrop, Saudi Arabia lately revealed 'Vision 2030'. This ambitious national transformation program aims to reduce economic dependency upon oil by privatizing state oil interests and diversifying its private sector. Other Gulf states have similar aims. Containing social discontentment in the region may depend much on their success.

*Malcolm Spittler, Investment Analyst, also contributed to this article.*

Figure 2. Saudis pumping hard



Source: Oil & Gas Journal, as of May 2016.

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# Our highest-conviction views for 2016 revisited

We review our top ideas for this year so far and make some important changes.

We presented our highest-conviction views in *Outlook 2016* to highlight the asset classes and assets where we saw solid return opportunities with various implementation possibilities. Several months later, we revisit and review these ideas. Despite many unexpected twists and turns in the market this year, many of our views remain intact. But we also now make some important changes, most notably to two of our oil-price related ideas.

## View in late 2015

Long Eurozone equities, manage Euro exposure
Long selective US equities, such as high-growth transformative sectors
Long Japanese equities, manage yen exposure
Position for flatter US and UK yield curves
Long-term municipal bonds attractive for US taxpayers
Manage exposure to oil-price victims in credit markets
Short Euro/US dollar
Long volatility in crude oil
Buy distressed assets low-cost oil producers via private equity
Long income-producing real estate, especially in key global cities

## Update as of 1 June 2016

Remain overweight, but reduce scale
Remain overweight, but reduce scale
Reduce overweight substantially
Maintain, but expect delay from Fed uncertainty
Reiterate our view
Reverse position after oil-price drop
Maintain, but expect delay
Reverse position after oil-price drop
Reiterate our view
Reiterate our view



### Manage exposure to oil-price victims; Buy distressed assets of low-cost-oil producers via private equity

Our view to avoid the debt of more vulnerable oil-drillers was borne out as high-yield energy bonds fell to a low of 52% of their par value in mid-February. This implied a massive rise in defaults and low recovery-rates for US oil-drillers' debt. Given forward-looking fundamentals, however, we now believe that the drop went too far. Global oil-exploration activity has fallen nearly 60% from its highs, with an accelerated decline over the past year. Today's mothballed production and investment-cuts may boost the oil price in 2017 and beyond. This also reinforces our call to buy distressed energy assets via private equity. While we are not suggesting exposure to every security in the sector, we are reversing our stance and are starting to look opportunistically at particular credits and would consider increasing exposure to high quality energy-producer equities.

### Long crude oil volatility

Crude-oil volatility spiked early this year, as we were expecting. But when it did so, we did not believe that the fundamental outlook pointed to another halving of the oil price from its lows of around \$28, as some options

transactions were implying. Instead, we thought the sharp volatility spike created a potential income-generating opportunity. We continue to see this as the case. We therefore recommend potentially generating yield through a short crude volatility position.

### Position for flatter US and UK yield curves

Our view that yield curves in the US and UK would flatten this year has also proved correct. However, short-term rates have risen slightly less than we would have expected, as both the Federal Reserve and Bank of England have scaled back tightening plans. The flattening has occurred by way of US and UK 10-year yields falling 45 and 65 basis points respectively relative to their corresponding 1-year yields. While yield curves may not flatten dramatically over the remainder of 2016, we reiterate our original view for the longer term.

### Short Euro/US dollar

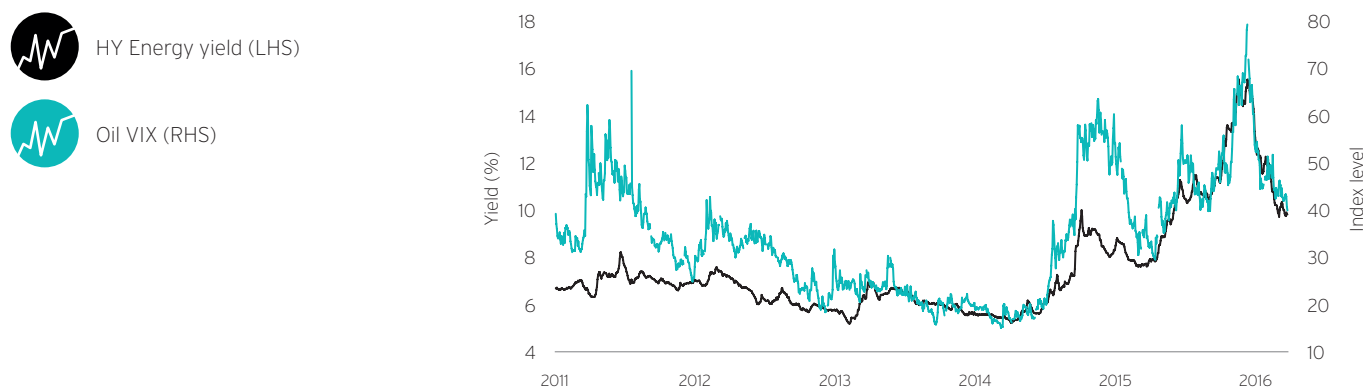
As we expected, the European Central Bank implemented a multi-year Quantitative Easing program in early 2016. Base money creation is running at a pace of nearly 9% of GDP a year, and is set to propel the ECB's balance sheet towards the size of the Fed's next year. However, owing to the steps

taken to limit to currency impact and the unwinding of short positions, the Euro has strengthened since we published our view. But we still see the single currency as ultimately likely to head lower against the US dollar. Admittedly, there are risks to this view, especially should the Fed reverse its tightening plans earlier than we expect. So, we reiterate our original view, although it may take longer to come about than we previously thought.

### Reducing equity exposure: Eurozone, Japan, and US

Going into 2016, we thought that differences in the monetary policies of leading central banks were likely to influence financial markets significantly. Specifically, we saw Eurozone and Japanese equities as potential beneficiaries of this. We therefore recommended long positions in these markets, coupled with management of exposure to the Euro and Japanese yen, which we expected to weaken. While the central banks have taken measures to limit the impact of their divergent monetary policies on exchange rates and both the Euro and Japanese yen have strengthened in 2016. However, their efforts to boost domestic economic growth are even more important than exchange-rate effects.

Figure 1. High Yield Energy Bond Price Index and crude oil 3-month implied volatility



Source: Yield book, Bloomberg Jan-2011-April 2016. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future returns. Real results may vary.

We still see a positive case for Eurozone equities. They trade at a large valuation discount to US peers based on cyclically-adjusted earnings. Also, the Eurozone is at an earlier stage of its economic revival and corporate earnings have more room to recover. But we would stress that Eurozone equities' potentially stronger returns are only proportional to their greater risks. We now recommend slightly reducing exposure to currency-managed Eurozone equities while maintaining an overweight.

We noted at the start of the year the extremely strong tendency of Japanese equities to move in the opposite direction to the Japanese yen. Rather than weakening, as we had expected, the yen has strengthened sharply amidst heavy short-covering. In line with the established pattern, equities have sold off substantially - **figure 2**. While the Bank of Japan is set to pursue further substantial monetary easing, which could well benefit local equities, we have already twice lowered our overweight position in 2016. We advocate substantially reducing exposure to currency-managed Japanese equities while still expecting the return environment to turn positive once more.

## The persistence of very low and even negative interest rates across much of the world reinforces our case for holding selective income-producing properties.

We also recommended being long of selective US equities, such as high-growth transformative sectors. Our suggestion was to combine long-term secular growth equities - such as healthcare and staples, especially those with exposure to emerging markets - and high-quality dividend payers. We continue to stress the likelihood of falling correlations between individual stocks, which calls for greater selectivity - see *Selectivity is key*. In line with our moves in overall equity weightings in 2016, we advocate slightly reducing exposure here too.

### Long-income producing real estate, especially in key global cities

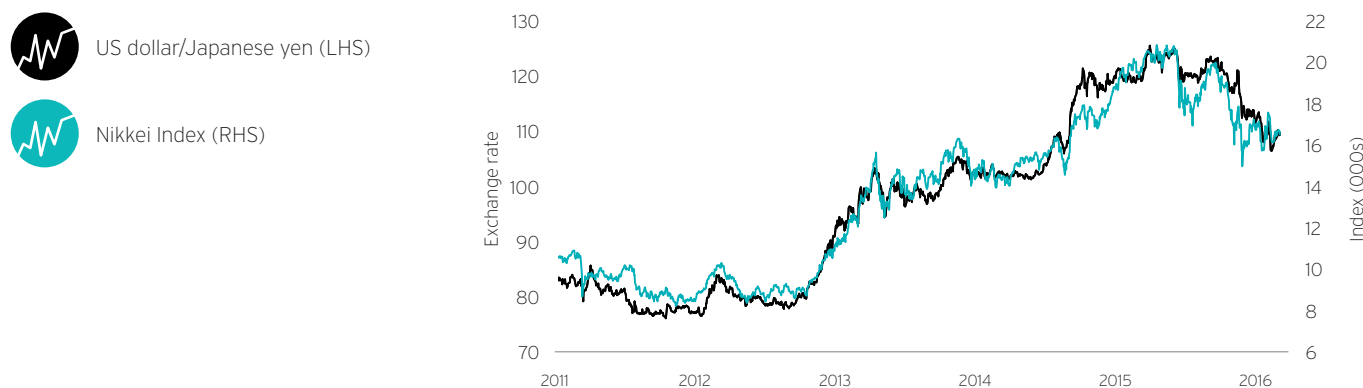
The persistence of very low and even negative interest rates across much of the world reinforces our case for holding selective income-producing properties. Some such properties

can offer an attractive spread over financing costs, particularly those located in gateway cities, while new supply has lagged behind the economic recovery in some locations. We reiterate our original recommendation.

### Long-term municipal bonds attractive for US taxpayers

Given the late stage of the business cycle, we previously pointed out the potential for risk-adjusted returns on longer-term municipal bonds to outperform US equities. In 2016 to date, the former have produced a tax-equivalent return for US income-taxpayers of 5.2%, compared to 1.5% for the latter. We continue to see long-term munis as attractive for US taxpayers owing to their yields and higher-quality credit ratings and therefore reiterate our original recommendation.

Figure 2. Stronger yen, weaker stocks



Source: Bloomberg, as of 5 May 2016. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future returns. Real results may vary.

## Asset class definitions

Global Developed Market Equity is composed of MSCI indices capturing large-, mid- and small-cap representation across 23 individual developed-market countries, as weighted by the market capitalization of these countries. The composite covers approximately 95% of the free float-adjusted market capitalization in each country.

Global Emerging Market Equity is composed of MSCI indices capturing large and mid-cap representation across 20 individual emerging-market countries. The composite covers approximately 85% of the free float-adjusted market capitalization in each country. For the purposes of supplemental long-term historical data, local-market country indices are used, wherever applicable.

Global Equity is represented by the MSCI ACWI Index, capturing all sources of equity returns in 23 developed and 23 emerging markets.

Global Developed Investment Grade Fixed Income is composed of Barclays indices capturing investment-grade debt from twenty different local currency markets. The composite includes fixed-rate treasury, government-related, and investment grade rated corporate and securitized bonds from the developed-market issuers. Local market indices for US, UK and Japan are used for supplemental historical data.

Global Fixed Income is represented by the Barclays Multiverse Index, with returns hedged into US dollars.

Global High Yield Fixed Income is composed of Barclays indices measuring the non-investment grade, fixed-rate corporate bonds denominated in US dollars, British pounds and Euros. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below, excluding emerging market debt. Ibbotson High Yield Index, a broad high yield index including bonds across the maturity spectrum, within the BB-B rated credit quality spectrum, included in the below-investment-grade universe, is used for supplemental historical data.

Global Emerging Fixed Income is composed of Barclays indices measuring performance of fixed-rate local currency emerging markets government debt for 19 different markets across Latin America, EMEA and Asia regions. iBoxx ABF China Govt. Bond, the Markit iBoxx ABF Index comprising local currency debt from China, is used for supplemental historical data.

Cash is represented by US 3-month Government Bond TR, measuring the US dollar-denominated active 3-Month, fixed-rate, nominal debt issues by the US Treasury.

Hedge Funds is composed of investment managers employing different investment styles as characterized by different sub categories - HFRI Equity Long/Short: Positions both long and short in primarily equity and equity derivative securities; HFRI Credit: Positions in corporate fixed income securities; HFRI Event Driven: Positions in companies currently or prospectively involved in wide variety of corporate transactions; HFRI Relative Value: Positions based on a valuation discrepancy between multiple securities; HFRI Multi Strategy: Positions based on realization of a spread between related yield instruments; HFRI Macro: Positions based on movements in underlying economic variables and their impact on different markets; Barclays Trader CTA Index: The composite performance of established programs (Commodity Trading Advisors) with more than four years of performance history.

Private Equity characteristics are driven by those for Developed Market Small Cap Equities, adjusted for illiquidity, sector concentration, and greater leverage.

Real Estate contains all Equity REITs (US REITs and publicly-traded real estate companies) not designated as Timber REITs or Infrastructure REITs: NAREIT US REIT Index, NAREIT Canada REIT Index, NAREIT UK REIT Index, NAREIT Switzerland REIT Index, NAREIT Euro-zone REIT Index.

Commodities contains the index composites - GSCI Precious Metals Index, GSCI Energy Index, GSCI Industrial Metals Index, and GSCI Agricultural Index - measuring investment performance in different markets, namely precious metals (e.g. gold, silver), energy commodity (e.g. oil, coal), industrial metals (e.g. copper, iron ore), and agricultural commodity (i.e. soy, coffee) respectively. Reuters/Jeffries CRB Spot Price Index, the TR/CC CRB Excess Return Index, an arithmetic average of commodity futures prices with monthly rebalancing, is used for supplemental historical data.

## Index definitions

The Bloomberg-JPMorgan Asia Currency Index (ADXY) is a US dollar tradable index of emerging Asian currencies, which serves as a benchmark for monitoring Asia's currency markets on an aggregate basis. It is a spot index of emerging Asia's most actively traded currency pairs valued against the US dollar.

The Bovespa Index is a market-capitalization weighted index of around 50 stocks that trade on the São Paulo Stock, Mercantile & Futures Exchange.

The CBOE Crude Oil ETF Volatility Index ("Oil VIX", Ticker - OVX) measures the market's expectation of 30-day volatility of crude oil prices by applying the VIX® methodology to United States Oil Fund, LP (Ticker - USO) options spanning a wide range of strike prices.

Commodity Index is the S&P Gold Sachs Commodity Index (S&P GSCI), a composite index of commodity sector returns representing an unleveraged, long-only investment in commodity futures that is broadly diversified across the spectrum of commodities.

The CBOE Volatility Index (VIX) is a measure of expectations of near-term volatility based on S&P 500 stock index option prices.

The Citi US High-Yield Market Index is a US Dollar-denominated index which measures the performance of high-yield debt issued by corporations domiciled in the US or Canada. Recognized as a broad measure of the North American high-yield market, the index includes cash-pay, deferred-interest securities, and debt issued under Rule 144A in unregistered form. Sub-indices are available in any combination of industry sector, maturity, and rating.

The CSI 300 is a capitalization-weighted index compiled by the China Securities Index Company Ltd and tracks 300 stocks traded on the Shanghai and Shenzhen stock exchanges.

The Currency Volatility Index (CVIX) seeks to provide a benchmark for currency market participants, representing investors' expectation of future volatility, and is calculated as the arithmetic average of the 3-month level of implied volatility for all the major currency pairs.

The DAX 30 is an index of the 30 most actively traded German blue chip stocks on the Frankfurt Stock Exchange. The value of the index is based on a free-float weighted system and average daily volume.

The Deutsche Bank Currency Volatility index (CVIX) is a measure of investors' expectations of future volatility, and is calculated as the arithmetic average of the 3-month level of implied volatility for all the major currency pairs.

The Dow Jones Industrial Average – commonly known as the Dow – is a price-weighted stock market index that tracks the performance of 30 large US companies chosen by a committee.

Emerging market currencies are represented by the OITP (Other important trading partners) index is a weighted average of the foreign exchange values of the U.S. dollar against a subset of currencies in the broad index that do not circulate widely outside the country of issue. The weights are derived by rescaling the currencies' respective weights in the broad index so that they sum to 1 in each sub-index.

European equities are represented by the MSCI Europe index, which captures large- and mid-cap representation across 15 Developed Markets (DM) countries in Europe. It covers approximately 85% of the free float-adjusted market capitalization across the European Developed Markets equity universe.

The Euro Stoxx 600 is an index representing the performance of 600 large-, mid-, and -small capitalization companies across 18 countries across Europe.

The FTSE 100 is a capitalization-weighted equity index representing the performance of 100 large-capitalization companies listed on the London Stock Exchange.

Gold is represented by the commodity futures price for gold.

The Hang Seng index is a free-float adjusted market capitalization stock market index in Hong Kong, which aims to represent the leading companies in that country.

The High Yield Energy Bond Price index measures the price performance of US bonds with ratings below investment grade comprising energy and natural resources industries.

Japan equities are represented by the MSCI Japan index, which is designed to measure the performance of the large- and mid-cap segments of the Japanese market. It covers approximately 85% of the free float-adjusted market capitalization in Japan.

The MOVE (Merrill Lynch Option Volatility Estimate) Index measures the implied volatility of US Treasury markets based on options pricing.

The MSCI All Country World Index represents 48 developed and emerging equity markets. Index components are weighted by market capitalization.

The MSCI Asia ex-Japan index has large and mid-cap representation across 2 of 3 Developed Markets countries and 8 Emerging Markets countries in Asia. It captures approximately 85% of the free float-adjusted market capitalization in each country.

The MSCI China index has large- and mid-cap representation across China H shares, B shares, Red chips and P chips. With 139 constituents, it covers about 85% of this China equity universe.

The MSCI Emerging Markets Index represents the performance of large- and mid-equities from 23 emerging countries, covering approximately 85% of the free float-adjusted market capitalization in each country.

The MSCI KLD 400 Social Index is a capitalization-weighted index of 400 US securities that provides exposure to companies with outstanding Environmental, Social and Governance (ESG) ratings and excludes companies whose products have negative social or environmental impacts. The parent index is MSCI USA IMI.

The MSCI Emerging Markets (EM) Latin America Index captures large and mid cap representation across 5 Emerging Markets (EM) countries\* in Latin America. With 121 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The MSCI USA Investable Market Index (IMI) measures the performance of the large, mid and small cap segments of the US market. With 2,469 constituents, the index covers approximately 99% of the free float-adjusted market capitalization in the US.

The MSCI World Index represents the performance of more than 1,600 large- and mid-cap stocks across 23 developed markets countries. The index covers approximately 85% of the free float-adjusted market capitalization in each country.

The MSCI World ex-USA Index represents the performance of large- and mid-cap representation across 22 of 23 developed markets countries excluding the United States. With 1,005 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The Nikkei 225 tracks the performance of 225 leading stocks on the Tokyo Stock Exchange (TSE). The components of this index are reviewed yearly. Since it is a price-weighted index, the movement of the stocks is weighted without regard to their market capitalization.

Oil is represented by the West Texas Intermediate Crude Oil price.

The Oil VIX – ticker OVX – measures the market's expectation of 30-day volatility of crude oil prices by applying the VIX methodology to United States Oil Fund, LP – ticker USO – options, spanning a wide range of strike prices.

The Standard & Poor's 500 Index is a capitalization-weighted index that includes a representative sample of 500 leading companies in leading industries of the US economy. Although the S&P 500 focuses on the large cap segment of the market, with over 80% coverage of US equities, it is also an ideal proxy for the total market.

US Investment Grade Corporate Debt Total Return Index is an index made up of investment-grade debt issued by US companies, measured on a total return basis.

USD vs developed currencies is a broad weighted average index of the foreign exchange values of the US dollar against the currencies of a large group of major U.S. trading partners.

USD vs emerging markets = The OITP (other important trading partners) index is a weighted average of the foreign exchange values of the US dollar against a subset of currencies in the broad index that do not circulate widely outside the country of issue.

Citi Private Bank Hedge Fund categorizations

Diversifier, Return Enhancer and Volatility Dampener are internal descriptors based on a fund's strategy and objective that HFRM has developed and uses to categorize



hedge funds. Such descriptors have not been approved by the relevant portfolio managers. The internal classification noted above is subject to change without notice to investors. Many portfolio managers offer multiple products that could have a different objective or classification from that of the fund identified herein. Diversification does not ensure against loss of principal invested.

Volatility Dampeners are hedge funds that typically are expected by HFRM to have low to moderate correlation and/or beta to traditional markets and seek low volatility and relatively consistent returns. The portfolio managers of such funds often attempt to eliminate a substantial portion of market risk via hedges and trade construction. This classification is based on the analysis and subjective views of HFRM. The internal classification is subject to change without notice to investors and there is no guarantee that the funds will perform as described above. It is important to note that the market strategy described above may not completely eliminate market risk. There is no guarantee that hedge funds classified as "Volatility Dampeners" will perform as described above. Hedge funds should not be invested in based on their classification as "Volatility Dampeners" and other assets in a client's overall portfolio should be taken into consideration before an investment is made.

Diversifiers are hedge funds that typically are expected by HFRM to display low or negative correlation and/or beta to traditional asset classes though they may display significant degrees of market correlation at certain points of the investment cycle. The portfolio managers of such funds are often long volatility and generally may provide attractive diversification benefits to a client's portfolio though returns are often "unpredictable" and can be volatile. This internal classification is based on the analysis and subjective views of HFRM. The internal classification is subject to change without notice to investors and there is no guarantee that the funds will perform as described above. It is important to note that the market strategy described above may not completely eliminate market risk. There is no guarantee that hedge funds classified as "Diversifiers" will perform as described above. Hedge funds should not be invested in based on their classification as "Diversifiers" and other assets in a client's overall portfolio should be taken into consideration before an investment is made.

Return Enhancers are hedge funds that are expected by HFRM to generally seek to outperform traditional risk assets over the course of an investment cycle while still providing some measure of downside protection. The portfolio managers of such funds typically have a higher correlation and/or beta to traditional markets. There is also a higher level of risk associated with these types of strategies. This internal classification is based on the analysis and subjective views of HFRM. The internal classification is subject to change without notice to investors and there is no guarantee that the funds will perform as described above. It is important to note that the market strategy described above may not completely eliminate market risk. There is no guarantee that hedge funds classified as "Return Enhancers" will perform as described above. Hedge funds should not be invested in based on their classifications as "Return Enhancers" and other assets in a client's overall portfolio should be taken into consideration before an investment is made.

#### Other terminology

Adaptive Valuations Strategies is Citi Private Bank's own strategic asset allocation methodology. It determines the suitable long-term mix of assets for each client's investment portfolio.

Alpha is a measure of absolute positive or negative performance, adjusted for risk. It is commonly seen as a way of capturing an investor's skill in generating returns.

Beta is a measure of the relationship between one asset class and another. It compares the average change in the return of one asset class relative to the average historical change in another. The beta of High Yield would be 0.5x to Equities if, on average, High Yield rises by 5% whenever Equities rise by 10%.

Correlation is a statistical measure of how two assets or asset classes move in relation to one another. Correlation is measured on a scale of 100% to -100%. A correlation of 100% implies perfect positive correlation, meaning that two assets or asset classes move in the same direction all of the time. A correlation of -100% implies perfect negative correlation, such that two assets or asset classes move in the opposite direction to each other all the time. A correlation of 0% implies zero correlation, such that there is no relationship between the movements in the two over time.

Extreme Downside Risk (EDR) is a measure used to estimate the risk of an asset allocation. EDR seeks to estimate the typical type of loss, over a 12-month time horizon, that an asset allocation may experience in a period of extreme market stress. It is calculated using a proprietary methodology and database. For a given asset allocation, this approach estimates the loss, over a 12-month time horizon, that the asset allocation may have experienced during historical periods of extreme market stress. EDR is calculated by taking the average loss in the worst 5% of this historical periods of extreme market stress. EDR does not estimate the maximum possible loss. Potential losses for a given asset allocation may exceed the value of the EDR.

Strategic Return Estimates are Citi Private Bank's forecast of returns for specific asset classes over a 10-year time horizon. The forecast for each specific asset class is made using a proprietary methodology that is appropriate for that asset class. Equity asset classes are forecast using a proprietary methodology based on the calculation of valuation levels with the assumption these valuation levels revert to their long-term trends over time. Fixed Income asset classes are forecast using a proprietary methodology based on current yield levels. Other asset classes have other specific forecasting methodologies. Please note that hedge funds, private equity, real estate, structured products and managed futures are generally illiquid investments and are subject to restrictions on transferability and resale. Each SRE is gross of actual client fees and expenses. Components of the methodology used to create the SREs include the rate of return for various asset classes based on indices. Termination and replacement of investments may subject investors to new or different charges. Past performance is not indicative of future results. Future rates of return cannot be predicted with certainty. Investments that pay higher rates of return are often subject to higher risk and greater potential loss in an extreme scenario. The actual rate of return on investments can vary widely over time, especially for long-term investments. This includes the potential loss of principal on your investment. It is not possible to invest directly in an index.

Tactical asset allocation looks to adjust the strategic asset allocation of a client's investment portfolio to incorporate shorter-term market insights.

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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.

International investing may not be for everyone. There may be additional risk associated with international investing, including foreign, economic, political, monetary and/or legal factors, changing currency exchange rates, foreign taxes, and differences in financial and accounting standards. The possibility that adverse political events, financial problems, or natural disasters in a country or region will cause investments in that country or region to lose value. The risks of investing in emerging or developing markets can be substantially greater than the risks of investing in developed markets.

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.

## REITS

REITs are subject to special risk considerations similar to those associated with the direct ownership of real estate. Real estate valuations may be subject to factors such as changing general and local economic, financial, competitive, and environmental conditions. REITs may not be suitable for every investor. Dividend income from REITs will generally not be treated as qualified dividend income and therefore will not be eligible for reduced rates of taxation. There may be additional risk associated with international investing, including foreign, economic, political, monetary and/or legal factors, changing currency exchange rates, foreign taxes, and differences in financial and accounting standards.

## Master Limited Partnership

- Energy Related MLPs May Exhibit High Volatility. While not historically very volatile, in certain market environments Energy Related MLPs may exhibit high volatility.
- Changes in Regulatory or Tax Treatment of Energy Related MLPs. If the IRS changes the current tax treatment of the master limited partnerships included in the Basket of Energy Related MLPs thereby subjecting them to higher rates of taxation, or if other regulatory authorities enact regulations which negatively affect the ability of the master limited partnerships to generate income or distribute dividends to holders of common units, the return on the Notes, if any, could be dramatically reduced.
- Concentration Risk. Investment in a basket of Energy Related MLPs may expose the investor to concentration risk due to industry, geographical, political, and regulatory concentration.
  - The price and dividends paid by Energy Related MLPs may be affected by a number of factors, including:
    - Worldwide and domestic supplies of, and demand for, crude oil, natural gas, natural gas liquids, hydrocarbon products and refined products;
    - Changes in tax or other laws affecting MLPs generally;
    - Regulatory changes affecting pipeline fees and other regulatory fees in the energy sector;
    - The effects of political events and government regulation;
    - The impact of direct government intervention, such as embargos;
    - Changes in fiscal, monetary and exchange control programs;
    - Changes in the relative prices of competing energy products;
    - Changes in the output and trade of oil and other energy producers;
    - Changes in environmental and weather conditions;
    - The impact of environment laws and regulations and technological changes affecting the cost of producing and processing, and the demand for, energy products;
    - Decreased supply of hydrocarbon products available to be processed due to fewer discoveries of new hydrocarbon reserves, short- or long-term supply distributions or otherwise;
    - Risks of regulatory actions and/or litigation, including as a result of leaks, explosions or other accidents relating to energy products;
    - Uncertainty or instability resulting from an escalation or additional outbreak of armed hostilities or further acts of terrorism in the United States or elsewhere;
    - General economic and geopolitical conditions in the United States and worldwide.



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.

Please read offering documents and/or prospectus information carefully for the risks associated with the particular MBS security you are purchasing.

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