1 MARCH 2018

EM Asia - Still Room to Grow

Despite recent financial market volatility, ‘Goldilocks’ conditions of moderate economic growth and low inflation still prevail for most trade/open economies, with exports largely backed by robust Chinese and global demand.

After robust economic growth of 6.1% in 2017, emerging market (EM) Asia’s 2018 growth is likely to moderate marginally to 5.9% – but remains at a healthy pace.

For China, a 6.5% growth is expected this year – although the economy may be off to a slow start at 6.4% year-over-year in Q1 and climb to 6.6% year-over-year in Q4.

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Market Performance

In the US – the Dow Jones Industrial Average, S&P 500 and Nasdaq Composite all declined by -5.96%, -5.54% and -3.10% respectively. The European Stoxx 600 also declined by -5.23% while the Nikkei 225 and the Topix were down by -6.62% and -5.91% respectively.

The MSCI Emerging Markets lost -6.12%, the decline of which was led by MSCI Latin America (-5.37%).

Meanwhile, the MSCI Emerging Europe and MSCI AsiaXJapan lost -2.80% and -6.14% respectively.

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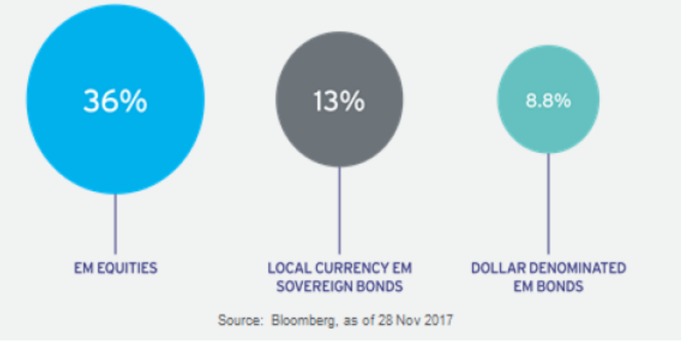
- Inflationary pressure may rise from 2.0% in 2017 to 2.5% this year, although it appears to be largely modest. Inflation has remained largely benign outside of the Philippines.
- Despite these benign macro conditions, politics could put some pressure on policies in a few EM Asia markets. For instance, India's 2019 budget already has tinges of populism that may keep the Reserve Bank of India on guard.
- Equities: EM Asia remains one of Citi's largest relative overweight positions as the region has seen currency strength even in the face of Fed tightening. This reflects balance sheet improvements since the Asian crisis period two decades ago and more recent actions to cap risks in China.
- The Fed and US policy could still cause a setback, but solid domestic economic growth and low valuations are supportive.
- Within EM Asia – Citi is overweight on China, Taiwan, South Korea, Indonesia, India, Malaysia and Thailand as the cyclical upturn in the world economy and structurally lower oil price are likely to favor Asian economies.
- Bonds: Higher relative yields, a better fundamental backdrop in EM economies and a USD that is likely to be near the end of a six-year bull market should all be supportive for EM bonds. Citi analysts remain overweight on EM Asian and EMEA local currency bonds.

"EM Asia remains one of Citi's largest relative overweight positions."

EM assets performed strongly in 2017 (% return in USD)



Source: Bloomberg. As of 28 November 2017.

Can Treasury Yields Continue to Climb?

With 10-year US Treasury yields breaching 2.9% recently – its highest levels since 2014 – can yields go any higher?

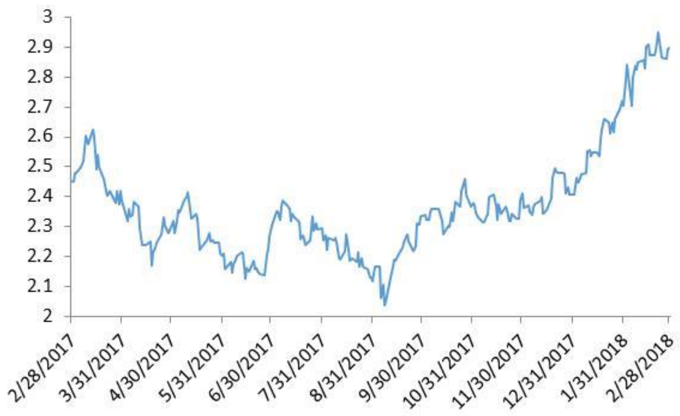
- Rising growth expectations, higher energy prices and improving inflation measures have coincided with a significant pick-up in long duration supply as wider fiscal deficits in the US has led to an increase in Treasury issuance.

- At the same time, the Federal Reserve continues to shrink its balance sheet. The Fed has reduced its UST holdings by $18.7 billion since October 2017. Citi estimates that the Fed is expected to reduce their UST portfolio by $230 billion in 2018. With the private sector left to absorb an increasing amount of net supply, investors may demand higher yields.

- However – in Citi's view – a flatter US yield curve and a weaker US dollar could create a limit to UST yields.

"A flatter US yield curve and a weaker US dollar could create a limit to UST yields."

US Treasury 10-year Yields (% over 1 Year)



Source: Bloomberg. As of 28 February 2018.

- Also, certain foreign exchange hedging costs are high at the moment – making hedging currency risk in some bond portfolios uneconomical. Thus, many international US bond investors must accept US currency risk when evaluating the merits of lending to the US.

- Even at low historic yield levels and structural problems with hedging currency risk, Citi analysts see the rise in long-term US bond yields remaining fairly limited in the year ahead – although Citi analysts still expect US high-yield bonds to outperform.

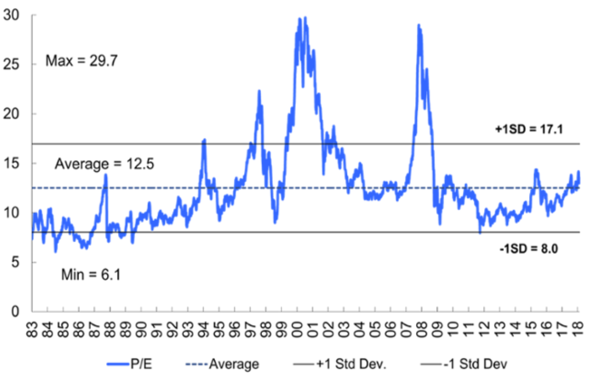
Hong Kong Equities: More Legs to Run?

Despite ~40% rally in the Hang Seng Index (HSI) since the beginning of 2017, HSI is trading at a reasonable ~13.5x FY18E P/E, vs. historical average of 12.5x. Citi's FY18E HSI earnings YoY growth of ~21% is also the most bullish growth forecast since 2010.

- Increasing fund flows from the stock connect are also encouraging. Average daily turnover continues to improve (+80% YTD to ~HK$157bn vs. ~HK$87bn in 2017). Southbound flows now contribute ~14% of total HK turnover.

"The Hang Seng Index is still trading at a reasonable level despite the rally since 2017."

Hang Seng Index Valuation – P/E



Source: Citi Research. As of 22 February 2018.

- Property: Citi analysts continue to expect Landlords to outperform and Developers to underperform. They expect HK home prices to see a strong rally in 1H18 (+2% a month post CNY, or +10% in 1H18), driven by 1) high season post CNY; 2) positive wealth effect, better bonus and higher pay rise; 3) low liquidity secondary market accelerates upward momentum and 4) developers more aggressive on pricing of new launches. However, developers should underperform on widening NAV discount due to increasing risk concerns by equity investors.

- On the other hand, HK retail has seen a fast recovery pace especially in high end segments given 1) a steady job market with modest pay hikes, driving local spending; 2) deferred impact of positive wealth effects from higher home prices and stock price; 3) appreciation of RMB causing HK to appear cheaper to Mainland tourists; 4) low base effect after a three-year decline on luxury items

- Banks and Financials: Strong loan growth and Net Interest Margin (NIM) expansion is likely to support HK banks' EPS growth and RoE expansion in the medium term.

- Macau Gaming: Citi analysts remain bullish on the Macau Gaming sector on its solid fundamentals. Mainland Visitation rose ~12% YoY in the CNY Golden Week vs comparable CNY period last year. Encouraging visitation trends are likely to bode well.

ECB Policies May Support EUR

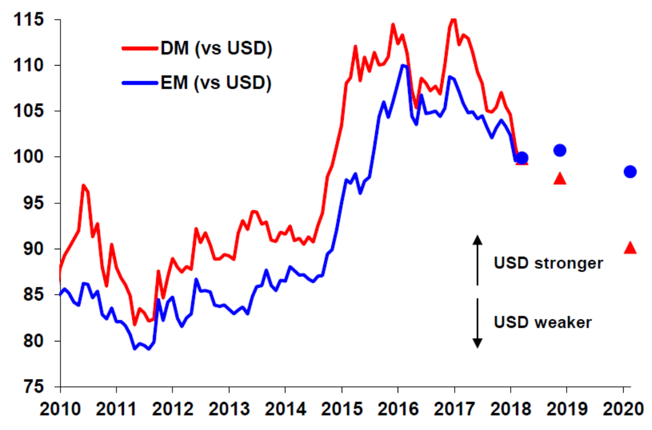
Citi is still bearish on the USD for the medium term as the US government's recent spending bills and tax reform are likely to add pressure to the currency.

- Meanwhile, Citi analysts remain bullish on the EUR for the medium term. This view is driven by actual and expected changes in European Central Bank (ECB) policy. However, periphery politics triggered by the Italian Elections – for example – may pose a risk to the view. Also, the ECB may try to resist EUR appreciation in the short term.

- In Citi's forecasts, EUR/GBP could weaken in the near term but stabilize over the medium term – while longer-term projections (two years) forecast that it could return to above pre-referendum level. The biggest risk to this view remains any faltering in Brexit negotiations leading to pricing of a 'No Deal' scenario.

"EM currencies could be roughly flat over the next six to 12 months, although they might benefit from slightly cheap valuations."

DM & EM – Forecasts Path



Source: Citi Research. As of February 2018.

- According to Citi, medium-term fundamentals are supportive of JPY. Japan's external balances are extremely robust, with the current account surplus reaching an all-time high in October 2017.

- Citi analysts think that emerging market (EM) currencies could be roughly flat over the next six to 12 months, although they might benefit from slightly cheap valuations. This forecast is mainly driven by stronger EUR and equities prices in this period.

- If the CNY continues to strengthen (as driven by USD weakness), more pressure may be exerted on China's trade competitiveness – though Citi analysts believe that the monetary authority may act upon its appreciation if it persists.

World Market at a Glance

	Last price	52-Week	52-Week	Historical Returns (%)			
	28-Feb-18	High	Low	1 week	1 month	1 year	Year-to-date
US / Global							
Dow Jones Industrial Average	25029.20	26616.71	20379.55	0.93%	-5.96%	20.26%	1.25%
S&P 500	2713.83	2872.87	2322.25	0.46%	-5.54%	14.82%	1.50%
NASDAQ	7273.01	7505.77	5769.39	0.76%	-3.10%	24.85%	5.35%
Europe							
MSCI Europe	484.10	523.74	408.40	-1.33%	-6.96%	17.64%	-0.76%
Stoxx Europe 600	379.63	403.72	365.99	-0.39%	-5.23%	2.54%	-2.45%
FTSE100	7231.91	7792.56	7073.03	-0.68%	-5.66%	-0.43%	-5.93%
CAC40	5320.49	5567.03	4897.48	0.35%	-3.77%	9.51%	0.15%
DAX	12435.85	13596.89	11850.27	-0.28%	-6.78%	5.08%	-3.73%
Japan							
NIKKEI225	22068.24	24129.34	18224.68	0.44%	-6.62%	15.43%	-3.06%
Topix	1768.24	1911.31	1452.15	0.38%	-5.91%	15.17%	-2.71%
Emerging Markets							
MSCI Emerging Market	1195.19	1278.53	920.59	-1.20%	-6.12%	27.64%	3.17%
MSCI Latin America	3067.52	3243.07	2423.52	-1.67%	-5.37%	17.98%	8.46%
MSCI Emerging Europe	179.35	187.38	136.46	-1.25%	-2.80%	24.26%	8.31%
MSCI EM Middle East & Africa	308.21	324.53	244.29	-1.69%	-4.42%	23.30%	4.10%
Brazil Bovespa	85353.59	88317.83	60314.70	-0.81%	-0.21%	28.04%	11.72%
Russia RTS	1285.47	1339.41	958.83	-0.44%	-0.10%	16.92%	11.35%
Asia							
MSCI Asia ex-Japan	728.51	780.56	558.47	-0.78%	-6.14%	29.09%	2.11%
Australia S&P/ASX 200	6015.96	6150.00	5629.80	1.22%	-0.56%	5.32%	-0.81%
China HSCEI (H-shares)	12382.08	13962.53	9882.17	-2.40%	-9.78%	20.24%	5.75%
China Shanghai Composite	3259.41	3587.03	3016.53	1.88%	-8.40%	0.55%	-1.44%
Hong Kong Hang Seng	30844.72	33484.08	23438.86	-1.87%	-6.97%	29.92%	3.09%
India Sensex30	34184.04	36443.98	28716.21	1.00%	-5.18%	18.93%	0.37%
Indonesia JCI	6597.22	6693.47	5350.91	-0.70%	-0.95%	22.47%	3.80%
Malaysia KLCI	1856.20	1880.56	1692.33	-0.11%	0.12%	9.59%	3.31%
Korea KOSPI	2427.36	2607.10	2067.68	-0.09%	-5.72%	16.05%	-1.63%
Philippines PSE	8475.29	9078.37	7146.27	-1.61%	-6.26%	17.52%	-0.97%
Singapore STI	3517.94	3611.69	3104.33	0.05%	-1.38%	13.61%	3.38%
Taiwan TAIEX	10815.47	11270.18	9562.75	0.94%	-2.98%	10.92%	1.62%
Thailand SET	1830.13	1852.51	1528.78	1.61%	0.07%	17.35%	4.36%
Commodity							
Oil	61.64	66.66	42.05	-0.06%	-6.80%	14.13%	2.02%
Gold spot	1318.38	1366.18	1194.93	-0.46%	-2.32%	5.61%	1.18%

Source: Citi Research as of 1 March 2018.

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Currency Forecasts

	Currency	Last price 28-Feb-18	Forecasts Mar-18	Jun-18	Sep-18	Dec-18
G10-US Dollar						
Euro	EURUSD	1.22	1.24	1.26	1.28	1.28
Japanese yen	USDJPY	107	110	109	108	108
British Pound	GBPUSD	1.38	1.40	1.41	1.42	1.42
Swiss Franc	USDCHF	0.94	0.96	0.95	0.95	0.95
Australian Dollar	AUDUSD	0.78	0.81	0.82	0.82	0.82
New Zealand	NZDUSD	0.72	0.73	0.74	0.74	0.74
Canadian Dollar	USDCAD	1.28	1.23	1.21	1.20	1.20
EM Asia						
Chinese Renminbi	USDCNY	6.33	6.48	6.45	6.41	6.35
Hong Kong	USDHKD	7.83	7.81	7.82	7.83	7.83
Indonesian Rupiah	USDIDR	13,745	13,083	13,271	13,461	13,500
Indian Rupee	USDINR	65.2	64.7	65.3	65.9	66.0
Korean Won	USDKRW	1,083	1,058	1,055	1,051	1,048
Malaysian Ringgit	USDMYR	3.92	3.78	3.75	3.71	3.68
Philippine Peso	USDPHP	52.1	50.7	50.5	50.3	50.3
Singapore Dollar	USDSGD	1.32	1.32	1.31	1.30	1.30
Thai Baht	USDTHB	31.4	31.4	31.2	31.0	31.3
Taiwan Dollar	USDTWD	29.2	29.5	29.4	29.4	29.3
EM Europe						
Czech Koruna	USDCZK	20.84	20.43	19.95	19.47	19.42
Hungarian Forint	USDHUF	257	251	247	244	245
Polish Zloty	USDPLN	3.42	3.36	3.31	3.25	3.24
Israeli Shekel	USDILS	3.48	3.41	3.39	3.38	3.38
Russian Ruble	USDRUB	56.3	55.9	55.2	54.6	55.0
Turkish Lira	USDTRY	3.80	3.87	3.90	3.94	3.99
South African Rand	USDZAR	11.80	12.23	12.17	12.11	12.08
EM Latam						
Brazilian Real	USDBRL	3.25	3.18	3.16	3.15	3.16
Chilean Peso	USDCLP	594	600	598	596	601
Mexican Peso	USDMXN	18.8	18.9	18.6	18.4	17.9
Colombian Peso	USDCOP	2864	2908	2927	2946	2958

Source: Citi Research as of 1 March 2018.

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