5 NOVEMBER 2018

US Midterm Elections – What to Expect?

Citi's base case for the US midterm election on November 6 point to a Republican Senate and a Democratic House. Polls, electoral math and a low Presidential approval rating largely favor a Democratic election wave resulting in the Democratic party wresting control of the House of Representatives and ending the Republican party Congressional mandate.

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Market Performance

Global equities as measured by MSCI World Index gained 3.07% for the week.

US markets were sharply lower for the week, as the Dow Jones Industrial Average gained 2.36%, the S&P 500 Index rose 2.42% and the Nasdaq Composite rallied by 2.65%.

European equities, as measured by the Stoxx Europe 600 Index, also rose 3.33% alongside Japanese stocks (Nikkei 225: 5.00% and Topix: 3.93%).

Emerging Markets, as measured by MSCI EM index gained 6.08%, led by MSCI Asia ex Japan (6.70%), MSCI EM Middle East & Africa (6.30%) and MSCI Emerging Europe (4.06%). Within Asia, Hong Kong's HangSeng index was the biggest performer, rising 7.16%.

US Midterm Elections – What to Expect? (Continued)

- This could indicate new oversight of the President and greater resistance to his policies as well as even the potential risk of impeachment proceedings.

Implications for Trade

- Citi analysts do not envision the midterm elections affecting the current US trade negotiations in a meaningful way. It is unlikely that US President Donald Trump will pivot on trade in response to Democratic majorities, given that progressive Democrats and Trump-leaning Republicans are largely united in their skepticism about free trade.

Implications for Equities

- Historically, in the months leading into the midterm elections, defensive stocks outperform cyclicals while higher-quality bonds outperform lower-quality bonds. After the midterm elections, the trend tends to reverse with S&P 500 rallying (see chart below).

- This year, given the backdrop of a mature bull market and rising interest rates environment, Citi believes that the immediate response to the midterm election outcome may be more muted unless there is a surprise result.

Market performance before and after midterm elections

Source: Citi Private Bank. As of July 2018.

- Citi analysts expect there to be little material change across asset classes in Citi's base case scenario of the midterm election outcome.

- The outperformance of US equities in 2018 is driven by late cycle stimulus from 2017 tax cuts as well as investor confidence that US trade could do better given the US administration's trade negotiations. The rise in US interest rates together with an absence of new tax cuts is likely to slow the US economy moderately going into 2019 which may limit future economic growth.

EM Asia: Is the Worst Over?

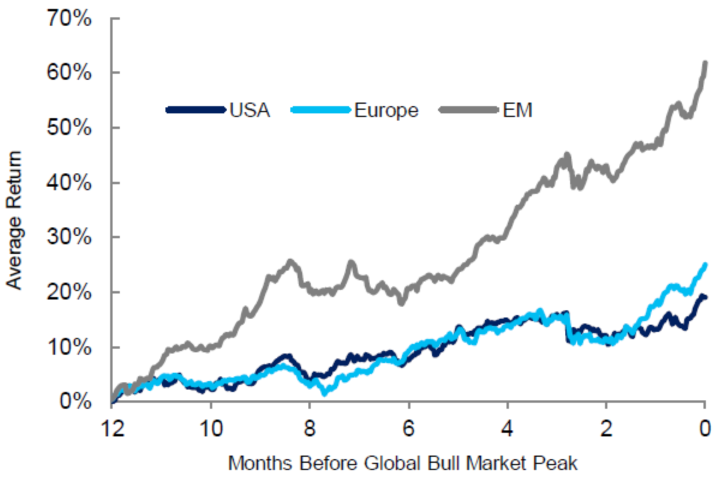
Citi is reallocating a portion of its small overweight on China to other beneficiaries of trade tensions within the region.

- Emerging market (EM) Asian equities have remained under pressure in recent months – weighed down by recent equity sell-offs, a stronger USD, tighter US monetary policy, weaker growth in China and the threat of escalating trade war.

- Despite the Chinese government's fiscal stimulus as well as China's cheap valuations, Citi analysts believe that stimulus will take time to show results. As a result, Citi analysts have reallocated a portion of their small overweight in Chinese equities to other Asian markets such as Malaysia and Thailand – which could benefit from multinationals diversifying their supply chain away from China.

"Citi analysts expect the strongest returns over the next 10 years to come from EM Asian equities."

Average returns in the 12 months leading up to previous three bull market peaks



Source: Citi Private Bank, Factset. As of 18 October 2018.

- Citi analysts expect the strongest returns over the next 10 years to come from EM – and EM Asian equities in particular. While near-term risks remain elevated – especially on the trade front – Citi analysts believe the +20% sell-off from highs earlier this year already encompasses a lot of bad news. EM Asia equities are cheap and have become even cheaper, while fundamentals are generally strong. Economic growth is improving, currencies have fallen sharply, inflation is well-behaved and commodity prices are well-supported.

- Citi analysts see much fear priced into EM Asian markets, leaving potentially attractive returns. On top of that, EM Asia is the only economic zone to consistently gain share of the global economy. It has the highest savings rate of any region, surging incomes and is approaching a population of 4 billion.

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