April 2014

The New Global Environment

Debt Management in Developing Countries: New Frontiers and Ongoing Challenges

Market Outlook: 2014

1. Economic Outlook

Political and policy issues are likely to create recurrent episodes of heightened uncertainty, with persistent tail risks. Significant divergence in economic performance between Europe and the US.

Europe

- Return to positive GDP growth in 2014
- Banking union and fiscal sustainability in periphery countries
- Periphery government gross debt/GDP at record highs
- EU policymakers remain reluctant with regard to:
  - Financial burdens on bondholders
  - Direct bank recapitalisation facility

US

- The once-strong correlation between US economic policy uncertainty and credit spreads broke down during QE
- With Fed continuing tapering this year, policy uncertainty regains its role as an important risk factor
- Recurring budget crises and short-term agreements
- 2014 GDP growth expect to rise

2. Rates Outlook

US and European rates are expected to diverge. Whether this forecast materialises in 2014 will be of paramount importance. Could higher UST yields drag Bunds wider?

Europe

- The ECB has decided to validate market expectations for no change in policy rates, keeping both standard as well as non-standard policy unchanged
- Subdued economic environment and low inflationary pressure
- 10-Year Bund yields expected to rise only marginally
- Could higher UST yields drag Bunds higher?

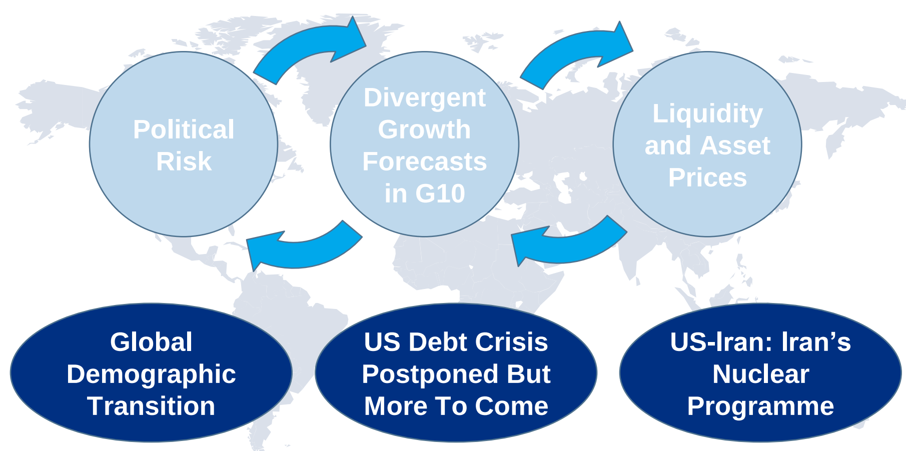
US

- The statement after the March FOMC meeting pointed to a possible earlier interest rate rise, revising the median forecast for the Fed funds rate to 1% by the end of 2015. Tapering will continue as planned with a further $10bn reduction in the FED's monthly bond purchase to $55bn
- The outlook for inflation to remain below 2.00% target
- Base case anticipates an end to QE by September 2014

3. Credit Market

- Bond issuance boom in Europe
- Credit spreads at post crisis lows
- Fund outflows
- Heavy supply
- Risk of rising/normalising rates

4. Geopolitical Issues



Source: Citi's Global Economic Outlook and Strategy, European Credit Weekly, Interest Rate Strategy, Creditbrief, Global Macro and Strategy Weekly

Key Themes for 2014

Looking to the year ahead, Citi's research analysts believe that the tail risks that could stall or paralyze global economic recovery have diminished further, although risks in the euro area and across the general geopolitical outlook remain. Renewed concerns surrounding emerging markets have surfaced as investors have become increasingly focused on policy credibility.

1

Global Economics

- *Global GDP estimated at ~3.10% in 2014*
- *Monetary policy will likely remain supportive*

2

Emerging Markets "The Fragile 5"

- *Warning signs:*

I. *Prior domestic credit boom/bubble;*
II. *Open capital account;*
III. *Large current account deficit and stock of foreign currency liabilities*

3

China

- *Investment-led growth looks outsized vs. history*
- *China now more leveraged than pre-crisis US or Europe*
- *Property price-to-income at 9.2x (vs 2.5x in US and 6.4x in UK)*

4

Japan

- *Abenomics entering 'third row' – expect structural reforms to loose monetary policy and fiscal flexibility*
- *New policy to encourage corporate managers to focus on investor returns*

5

Ukraine Conflict

- *Risk that Russian intervention could extend beyond Crimea*
- *Tensions between Russia and the US/EU have surfaced with potential to generate trade and commercial disruption*

6

Corporate Re-Leveraging

- *ROEs still below pre-crisis levels and stability has returned*
- *Expect increased demands from shareholders in form of buybacks or dividends*

7

M&A

- *Corporates under pressure as lags in organic growth force them to look elsewhere*
- *High cash balances persist*
- *Funding cheap and available*

8

Pensions

- *Funds nearing fully funded status*
- *Pensions looking to de-risk portfolio – switch into Fixed Income assets*
- *Basis risk may exist*

9

Green Bonds

- *Citi recently co-authored the Green Bond Principles*
- *We expect Green Bonds to be a large feature of 2014*

Benchmark Yield Environment – UST

The harsh winter weather dampened growth at the start of the year, but we expect most of the weakness will be reversed in coming months. Fiscal drag is dissipating and Fed policy is intent on holding down rates. The economy has enough headroom to expand at an above average pace over the forecast horizon, especially with financial conditions providing a significant tailwind. Rate hikes are not expected until mid-2015, with inflation remaining below the Fed's 2% target.

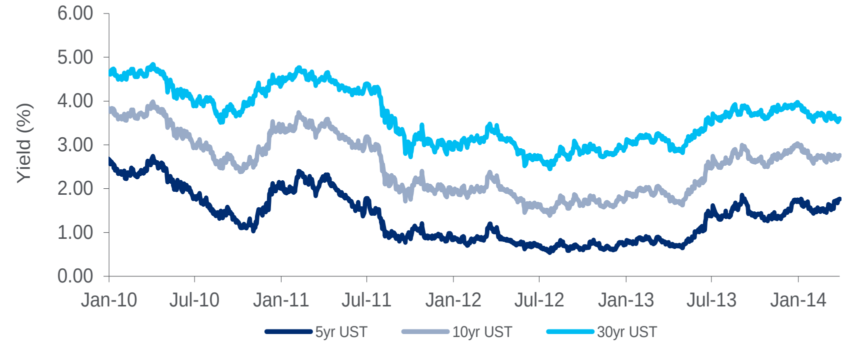
Market Commentary

Investors are looking for direction so far in 2014, and despite mixed economic data and deteriorating tone abroad, the Fed continues to pull back accommodative policies

- **Economy:** 2014 GDP growth is expected to rise, driving 10-year USTs to 3.10% by end of 2014. Non-farm payrolls increased by 175K (vs. 149k expected) in February and previous months were revised down slightly, suggesting a weather effect in December and January only and a return to normality in February. The outlook for inflation is to remain below the 2.00% target

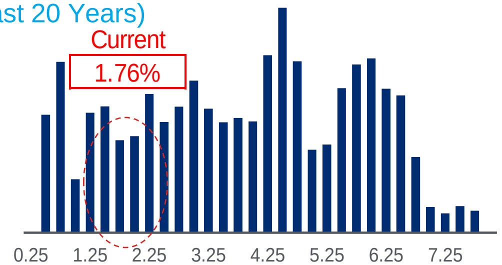
- **Fed Action:** The statement after the March FOMC meeting pointed to a possible earlier interest rate rise, revising the median forecast for the Fed funds rate to 1% by the end of 2015. Tapering will continue as planned with a further $10bn reduction in the FED's monthly bond purchase to $55bn

Historical UST Yield Development



	Current	2Q 14F	3Q 14F	4Q 14F	1Q 15F	2Q 15F
Fed Base Rate	0.25	0.25	0.25	0.25	0.25	0.25
10-yr UST	2.76	2.85	3.10	3.35	3.50	3.60
10-yr UST Swap	2.87	3.00	3.25	3.50	3.65	3.75

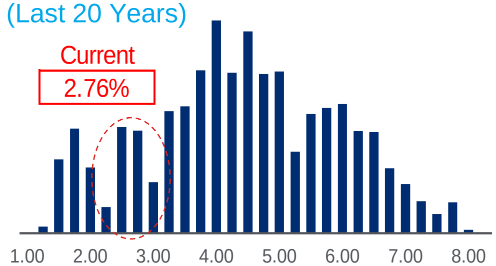
5-Year UST Yield Distribution
(Last 20 Years)



5 year Treasury Yield	
Min	0.54%
Average	3.97%
Max	7.90%

Lower than current level 17.16% of the time

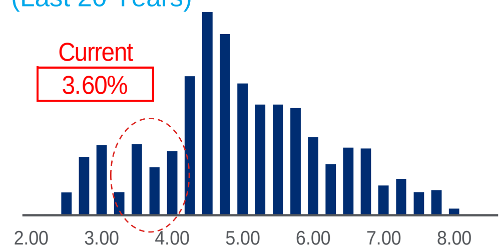
10-Year UST Yield Distribution
(Last 20 Years)



10 year Treasury Yield	
Min	1.39%
Average	4.55%
Max	8.03%

Lower than current level 14.29% of the time

30-Year UST Yield Distribution
(Last 20 Years)



30 year Treasury Yield	
Min	2.45%
Average	5.10%
Max	8.16%

Lower than current level 10.94% of the time

Source: Bloomberg and Citi Investment Research, as of 31st March 2014

Benchmark Yield Environment – Bund

2014 and 2015 GDP forecasts to be 1.3% and 1.6%, respectively. Yet headwinds remain in the form of the persistently strong euro, recent wobbles in EM markets and the risks of further disruption related to Crimea.

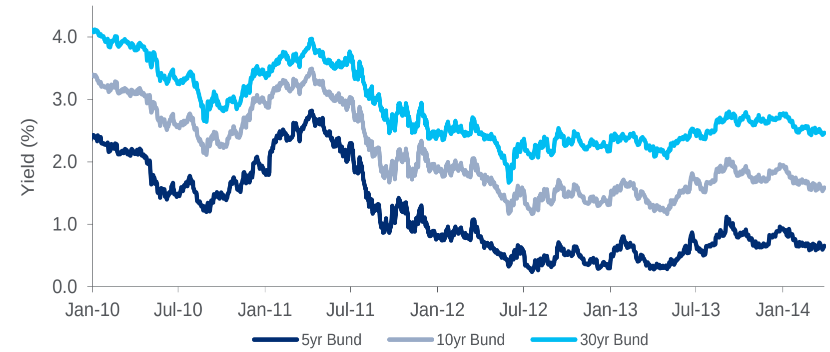
Market Commentary

Financial market fragmentation is receding and investors are showing steady appetite for periphery government debt, ignoring the German constitutional court's decision to refer the OMT to the European Court of Justice

- **Economy:** Citi expects the modest recovery to continue while risks of a very subdued inflation trajectory extending into 2016 persist. Further on the agenda are topics regarding banking union and fiscal sustainability in periphery countries as well as periphery government gross debt/GDP being at record highs

- **ECB Action:** The ECB decided to leave all rates unchanged and firmly reiterated its forward guidance of 'low or lower' rates for an extended period of time. The ECB argued that headline inflation would likely undershoot its 'below but close to 2%' objective for the next three years. Monetary policy stance will likely remain accommodative even after some improvement in the economy.

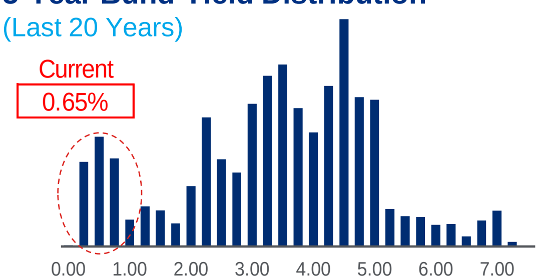
Historical Bund Yield Development



	Current	2Q 14F	3Q 14F	4Q 14F	1Q 15F	2Q 15F
Euro Repo Rate	0.25%	0.10%	0.10%	0.10%	0.10%	0.10%
10-yr Bund	1.59	1.65	1.70	1.80	1.90	1.90
10-yr EUR Swap	1.80	1.90	1.90	2.00	2.10	2.10

5-Year Bund Yield Distribution

(Last 20 Years)

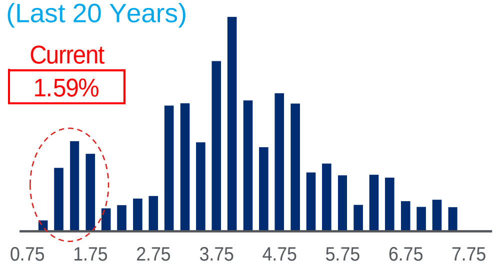


5 year Bund Yield	
Min	0.24%
Average	3.53%
Max	7.38%

Lower than current level
6.36% of the time

10-Year Bund Yield Distribution

(Last 20 Years)

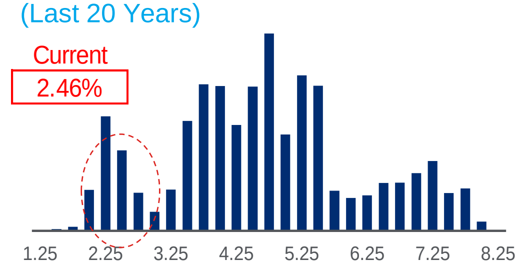


10 year Bund Yield	
Min	1.17%
Average	4.19%
Max	7.76%

Lower than current level
5.34% of the time

30-Year Bund Yield Distribution

(Last 20 Years)



30 year Bund Yield	
Min	1.67%
Average	4.79%
Max	8.14%

Lower than current level
6.95% of the time

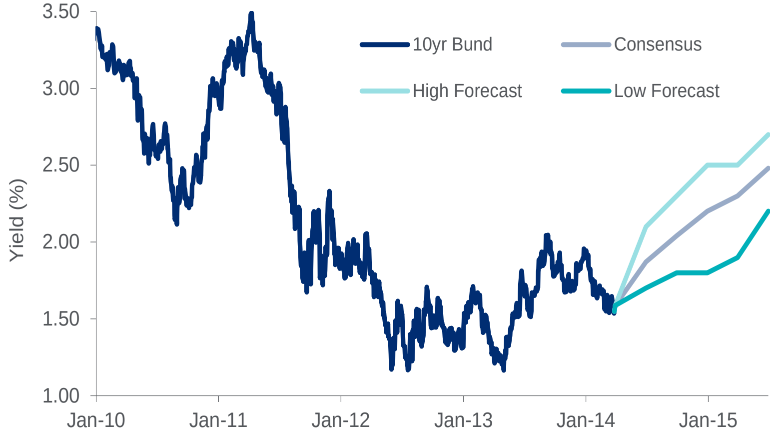
Source: Bloomberg and Citi Investment Research, as of 31st March 2014

Benchmark Rates Outlook

The Fed pointed to earlier interest rate rises and revised its forecasts for the Base Rate to increase to 1 per cent by the end of 2015. Tapering continues as planned and bond repurchases were cut another $10bn to $55bn.

UST Benchmark Rates

EUR Benchmark Rates



Consensus Economic Forecasts

	Current	2Q 14	3Q 14	4Q 14	1Q 15	2Q 15
Fed Base Rate (%)	0.25	0.25	0.25	0.25	0.25	0.25
2yr Note (%)	0.44	0.50	0.70	0.90	1.15	1.40
5yr Note (%)	1.75	1.85	2.10	2.40	2.60	2.75
10yr Note (%)	2.76	2.85	3.10	3.35	3.50	3.60
30yr Note (%)	3.59	3.70	3.90	4.05	4.20	4.25
GDP (YoY, %)	1.90	2.90	2.70	2.80	3.30	3.10
PCE Deflator (YoY, %)	1.20	1.50	1.50	1.70	1.70	1.70
Unemployment Rate (%)	6.97	6.50	6.20	6.10	6.00	6.00
CA Balance (% of GDP)	-2.22	-2.00	-1.90	-1.80	-1.70	-1.60

Consensus Economic Forecasts

	Current	2Q 14	3Q 14	4Q 14	1Q 15	2Q 15
ECB Repo Rate (%)	0.25	0.10	0.10	0.10	0.10	0.10
2yr Bund (%)	0.17	0.05	0.05	0.10	0.10	0.10
5yr Bund (%)	0.65	0.50	0.50	0.50	0.60	0.60
10yr Bund (%)	1.59	1.65	1.70	1.80	1.90	1.90
30yr Bund (%)	2.46	2.55	2.55	2.55	2.55	2.55
GDP (YoY, %)	0.50	1.70	1.40	1.70	1.50	1.60
CPI (YoY, %)	0.60	0.90	0.60	0.80	0.80	0.70
Unemployment Rate (%)	12.0	11.9	11.7	11.7	11.6	11.4
EURUSD	1.37	1.39	1.39	1.40	1.40	1.40

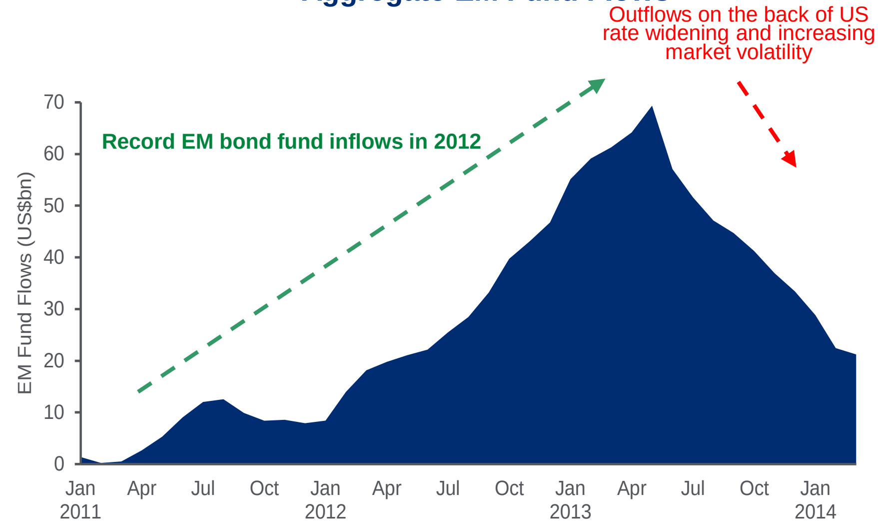
Source: Bloomberg and Citi Investment Research, as of 31st March 2014

Credit Market Environment & EM Bond Fund Flows

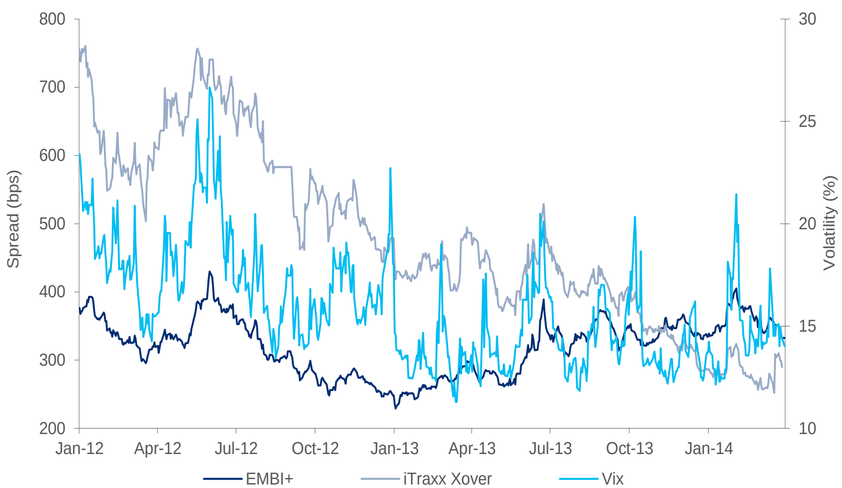
Key Market Indicators

	31-Mar	24-Mar	02-Jan	Δ 24-Mar	Δ 02-Jan
Indicator					
iTraxx Xover	281 bps	310 bps	287 bps	-29 bps	-6 bps
EM Bond Index +	333 bps	351 bps	339 bps	-18 bps	-6 bps
VIX Volatility	14.01%	15.09%	14.23%	-1.08 %	-0.22 %
S&P	1,872 pts	1,857 pts	1,832 pts	+15 pts	+40 pts
EuroStoxx	3,183 pts	3,053 pts	3,060 pts	+130 pts	+123 pts
Nikkei	14,828 pts	14,224 pts	15,909 pts	+604 pts	-1,081 pts
EUR/USD	1.38	1.38	1.37	-0.00	+0.01
Benchmark Rates					
5yr UST	1.76%	1.73%	1.72%	+0.03%	+0.04%
10yr UST	2.76%	2.73%	2.99%	+0.03%	-0.23%
30yr UST	3.59%	3.56%	3.92%	+0.03%	-0.33%
5yr US$ Swap	1.84%	1.82%	1.77%	+0.02%	+0.07%
10yr US$ Swap	2.88%	2.85%	3.06%	+0.03%	-0.19%
30yr US$ Swap	3.57%	3.54%	3.90%	+0.02%	-0.33%

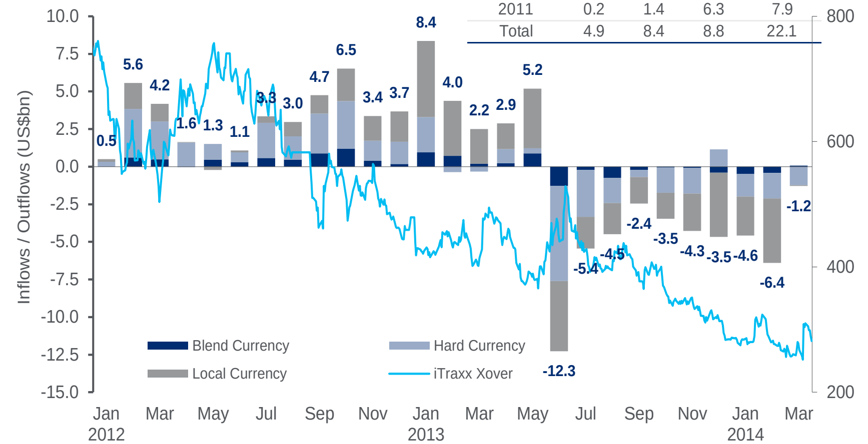
Aggregate EM Fund Flows



Credit and Volatility Indices



Monthly EM Fund Flows

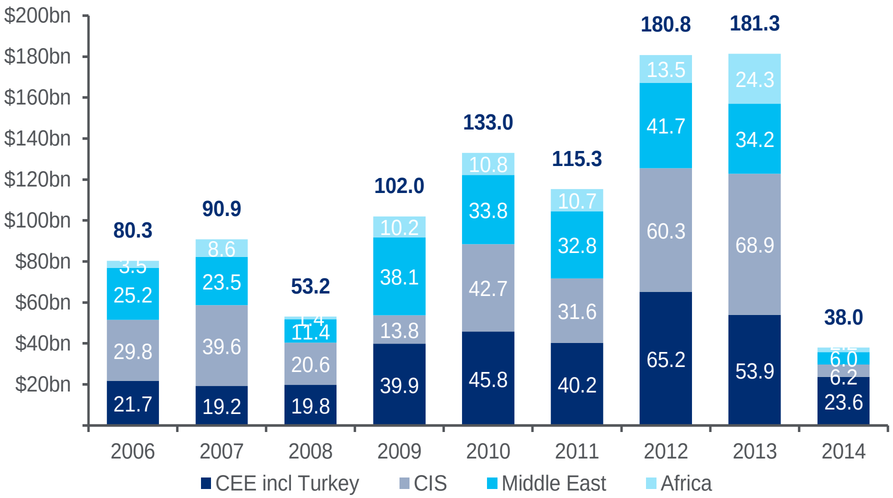


US$ bn Equiv				Total
2014	-0.8	-4.0	-6.6	-11.4
2013	0.0	-10.9	-2.4	-13.3
2012	5.5	21.9	11.4	38.8
2011	0.2	1.4	6.3	7.9
Total	4.9	8.4	8.8	22.1

Source: Bloomberg, Citi, as of 31st March 2014

EM Technical Environment and Primary Market Activity

CEEMEA Issuance by Region - *Record Year 2013*



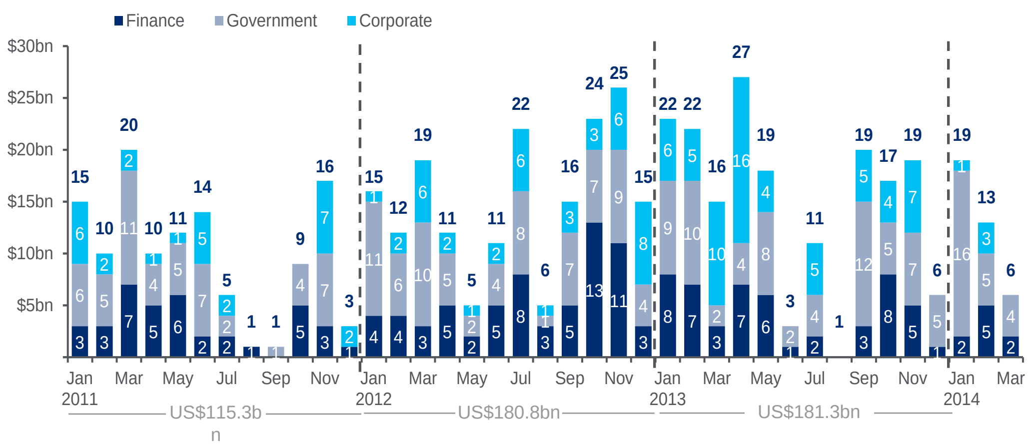
Selected Recent CEEMEA Offerings

Date	Borrower	Ratings	Size	Coupon	Maturity	Pricing
24-Mar	mBank	Baa3/BBB+/A	€500mn	2.375%	Apr-19	MS+145
18-Mar	Hungary	Ba1/BB/BB+	$1,000mn	4.000%	Mar-19	T+260
18-Mar	Hungary	Ba1/BB/BB+	$2,000mn	5.375%	Mar-24	T+287.5
12-Mar	NBAD	Aa3/AA-/AA-	A$400mn	4.750%	Mar-19	ASW+125
10-Mar	Azerbaijan	Baa3/--/BBB-	$1,250mn	4.750%	Mar-23	T+221.8
27-Feb	Russian Railways	Baa1/BBB/BBB	€500mn	4.600%	Mar-23	MS+293.3
25-Feb	Gazprombank	Baa3/BBB-/BBB-	$750mn	4.960%	Sep-19	T+345
24-Feb	ADCB	A/--/A+	$750mn	3.000%	Mar-19	T+149.8
19-Feb	Gazprom	Baa1/BBB/BBB	€750mn	3.600%	Feb-21	MS+220.8
18-Feb	Sberbank	--/--/BBB-	$1,100mn	5.500%	10NC5	T+402.30
18-Feb	Russian Agricultural Bank (tap)	Baa3/--/BBB-	$500mn	5.100%	Jul-18	T+323
13-Feb	Dubai Investments	--/BB/--	$300mn	4.291%	Feb-19	MS+265
12-Feb	Turkey	Baa3/--/BBB-	$1,500mn	6.625%	Feb-45	T+297.2
10-Feb	Nostrum Oil	B2/B+/--	$400mn	6.375%	5NC3	6.375%
10-Feb	B Communications	--/BB-/BB-	$800mn	7.375%	7NC3	T+527
10-Feb	Slovenia	Ba1/A-/BBB+	$1,500mn	4.125%	Feb-19	T+280
10-Feb	Slovenia	Ba1/A-/BBB+	$2,000mn	5.250%	Feb-24	T+280
31-Jan	CE / EP Energy	B1/--/B+	€500mn	7.000%	7NC3	B+598

Highlighted deals are Citi deals

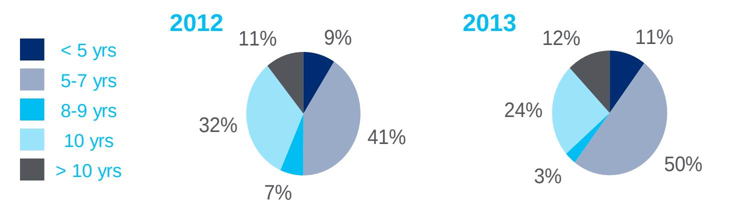
CEEMEA Issuance by Sector – *Visible Seasonality*

…issuers get used to increased volatility and shortened issuances windows

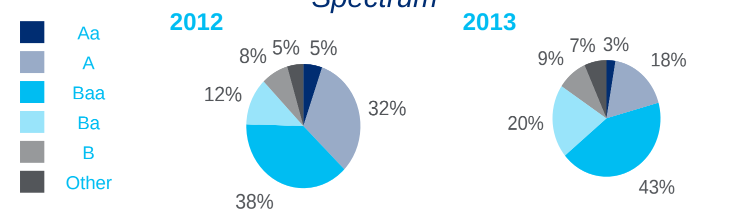


CEEMEA Issuance by Tenor - *Looking for the Sweet Spot*

…offering yield, offering duration



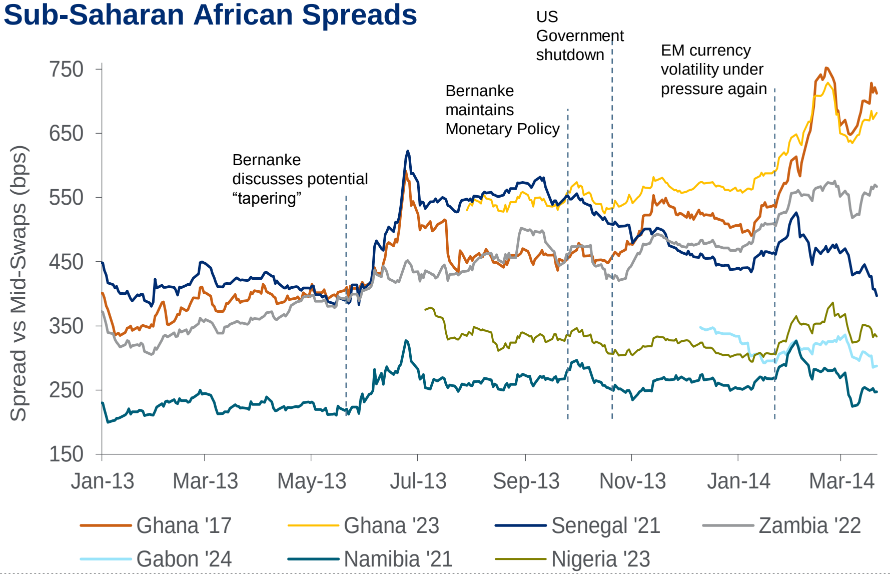
CEEMEA Issuance by Rating - *Across the Rating Spectrum*



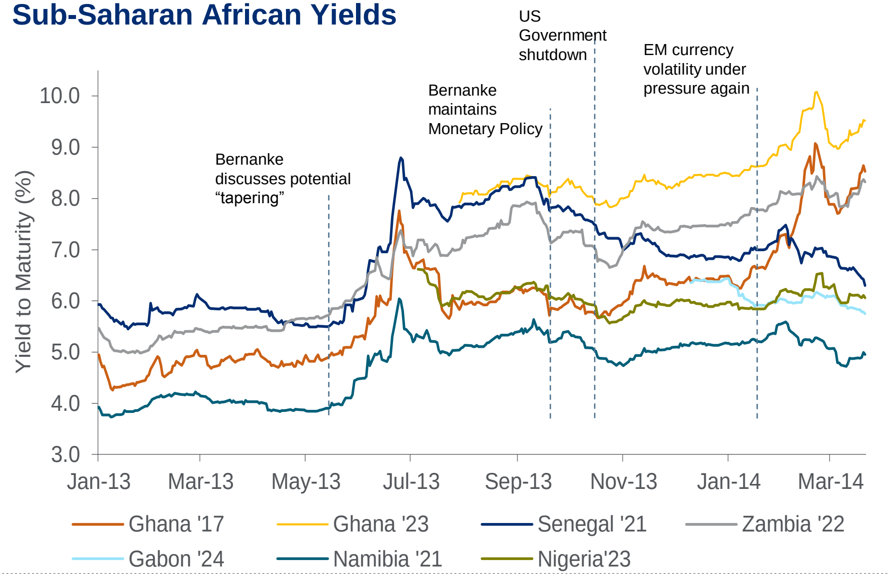
Source: Bloomberg, Dealogic as of 31st March 2014

Sub-Saharan Africa in the International Debt Markets

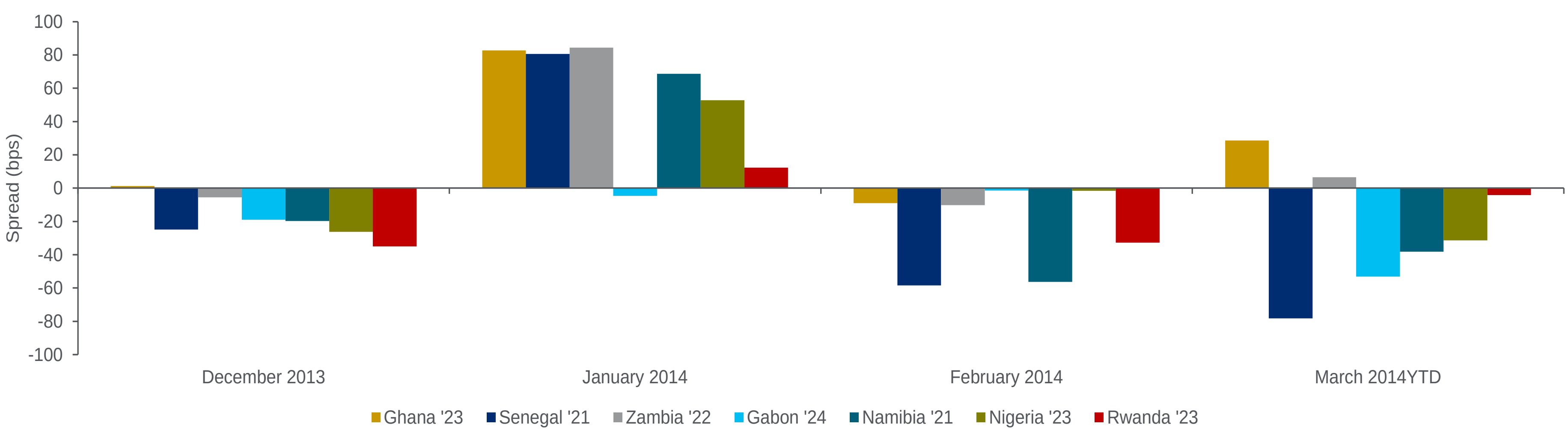
Sub-Saharan African Spreads



Sub-Saharan African Yields



Sub Saharan African Monthly Spread Performance – Dec 2013-YTD



Source: Bloomberg, Citi as of 24th March 2014

Project Finance: Market Trends

Access to the project finance market is contracting as increasingly stringent capital requirements accelerate global banks' consolidation of their balance sheets, placing greater emphasis on the need for engagement with the non-bank private sector to source financing for infrastructure projects.

- Historically over 90% of all project finance globally has been funded in the traditional bank loan market, with the market growing from $110.8bn in 2000 to $208.1bn a decade later
- More stringent capital adequacy and liquidity coverage thresholds under the proposed Basel III and CRD IV directives have raised the risk capital hurdles for banks with long-dated, illiquid project finance assets
- These capital and liquidity requirements translate into higher funding costs for banks
- As major international banks – especially European banks – begin to build their capital buffers ahead of Basel III implementation, many have retreated from exposure to capital-intensive project and asset financing
  - Institutions that still have an appetite for project finance are becoming increasingly selective and offer project financing at higher rates that reflect the increment in funding costs
  - Some banks have also tightened covenants governing recourse to project assets
  - The project finance market has also experienced maturity compression, with lenders typically reluctant to lend in significant volume for tenors over 7-10yrs
    - "Semi-perm" or "mini-perm" structures under which financing is repeatedly rolled over within the project life cycle are becoming increasingly common
- European insurers have also been affected, with new Solvency II rules making it harder for them to hold illiquid assets with long maturities
- These trends mean that banks and insurers are no longer the dominant source of project finance, pointing to a greater potential role for capital markets to bridge the funding gap, for example through well-structured project bonds

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