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Higher Volatility, But Not a Bear Market

Citi analysts believe financial markets entered Phase 3 of our credit/equity clock in February this year. This is a late-cycle bull market, when credit spreads and volatility start to rise but continued economic growth pushes indices to new highs.

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Market Performance

Global equities as measured by MSCI World Index decreased 3.63% for the week.

US markets were sharply lower for the week, as the Dow Jones Industrial Average declined 2.97%, the S&P 500 Index fell 3.94% and the Nasdaq Composite lost 3.78%.

European equities, as measured by the Stoxx Europe 600 Index, also fell 2.46% alongside Japanese stocks (Nikkei 225: -5.98% and Topix: -5.72%).

Emerging Markets, as measured by MSCI EM index dropped 3.29%, led by MSCI Asia ex Japan (-3.68%), MSCI Emerging Europe (-3.70%) and MSCI Latin America (-0.55%). Within Asia, Korea’s Kospi index was the biggest underperformer, falling 5.99%.
Higher Volatility, But Not a Bear Market (Continued)

What Triggered The Recent Sell-Off?

• **Earnings Revision Index (ERI) Rolling Over** - Company analyst earning revisions downgrades have accelerated recently, pushing our global Earnings Revision Index (ERI) to its lowest reading since mid-2016. The 2018 EM EPS growth estimate has been cut from 17% to 14%, while Europe x UK growth has fallen from 12% to 10%. The US is standing firm at +22%.

• **Rising Political Risks** - At the beginning of October, the Italian Government announced the new Budget Law implying a fiscal deficit of 2.4% for 2019. This is above previous market expectations and EU fiscal rules. Tensions escalated further between Rome and Brussels and threats of a snap election may emerge.

• **Government Bond Sell-Off** - 10 year US Treasury (UST) yields have risen 40bps since August, driven by fears of further Fed tightening. This may have put a strain on equity valuations. UST yields went up by a similar amount in January, with global equities falling by 9% in February.

“Citi’s Bear Market Checklist suggests this is a typical Phase 3 correction.”

• **Citi’s Bear Market Checklist suggests this is a typical Phase 3 correction.** The number of red (and amber) flags have risen during the past year, but only 3.5 out of 18 are indicating sell compared to 17.5 out of 18 in 2000 and 13 out of 18 in 2007. Citi analysts would be concerned if this latest correction flashed 8 or 9 red flags, indicating greater euphoria amongst investors and companies, but it is not the case.
Raising Portfolio Quality: Higher Yields from Low-Risk Assets

Citi is adding overweights to short-term high-quality US bonds to take advantage of the growing opportunity created by higher US interest rates.

- US Treasury yields now average about 3% across all maturities. They may likely rise further if growth endures and the Fed tightens in line with its forecasts.

- As a result, Citi analysts have added significantly to our already overweight holdings of short-duration US Treasuries, corporate IG debt, and also added further to a small overweight in Treasury Inflation Protected Securities as inflation - or even a short-term consumer price spike - presents a downside risk to most asset classes.

"Citi analysts are positive on short-term high-quality US bonds."

- The rise in US interest rates, firming cost pressures, and absence of new tax cuts seem likely to slow the US economy moderately in 2019. In equities, Citi analysts cut US small- and mid-cap (SMID) to a slight underweight in light of their greater volatility and largely higher debt burdens compared to large firms. Citi remains neutral on US large caps.

- While US equites have been the outperformer this year, overly strong investor confidence and rich valuations may limit future returns. Investors who have become highly concentrated in US markets should consider rebalancing and take advantage of opportunities in Asian equities where valuations are more attractive.

- While Asia is sensitive to trade tensions, the extremely low global index weightings for Asian markets present a forward-looking diversification opportunity. 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 4 billion population.
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