August 2015

Capital Markets: Promise or Peril?

Presentation to FOTEGAL

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Table of Contents

1. Capital Markets: Volatility & Uncertainty

Positioning for Take-Off Amidst the Fog

Key Global Macro Themes

What are Citi Economists Focused on?

Macro Developments are Increasingly Correlated

- Risks of Grexit Remain
- EU Growth & ECB QE
- US Fed Rate Hike
- Downturn in Chinese Equities & Limited Growth
- Iran Nuclear Deal Bearish for Oil

Challenging & Volatile Markets

Many markets have been suffering from volatility and uncertainty. As seen below, currencies, commodities, and the broader EM indices have been affected.

VIX Index 2015YTD

USD / MXN Exchange Rate 2015YTD

Western Asset Emerging Markets Fund 2015YTD (“EMD”)

WTI Crude Future 2015YTD

Source: Bloomberg as of August 21, 2015

Market Expectations from the Fed

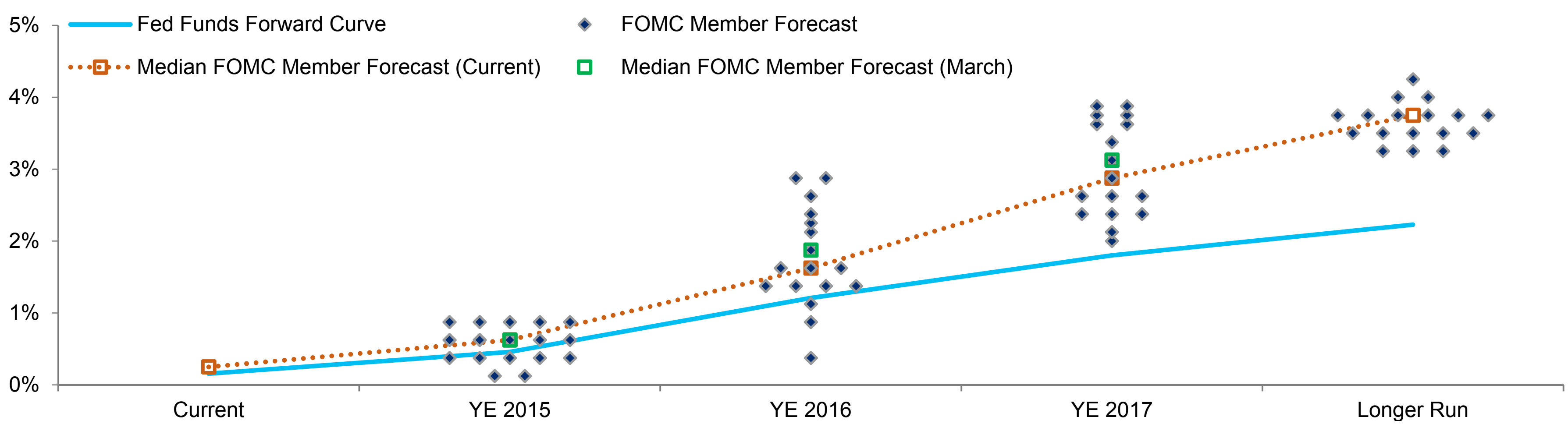
FOMC Still Predicts 2015 Fed Funds Rate Hike

Economic Projections of Federal Reserve Board Members and Federal Reserve Bank Presidents, June 2015 (End of Year Median Forecasts):

	2015	2016	2017	Longer run
Real GDP	1.90%	2.55%	2.30%	2.15%
Unemployment Rate	5.25%	5.00%	5.00%	5.10%
Core PCE	0.70%	1.75%	1.95%	2.00%
Fed Funds	0.625%	1.625%	2.875%	3.75%

Source: Federal Reserve

… and a Gradual Rise in Rates Thereafter



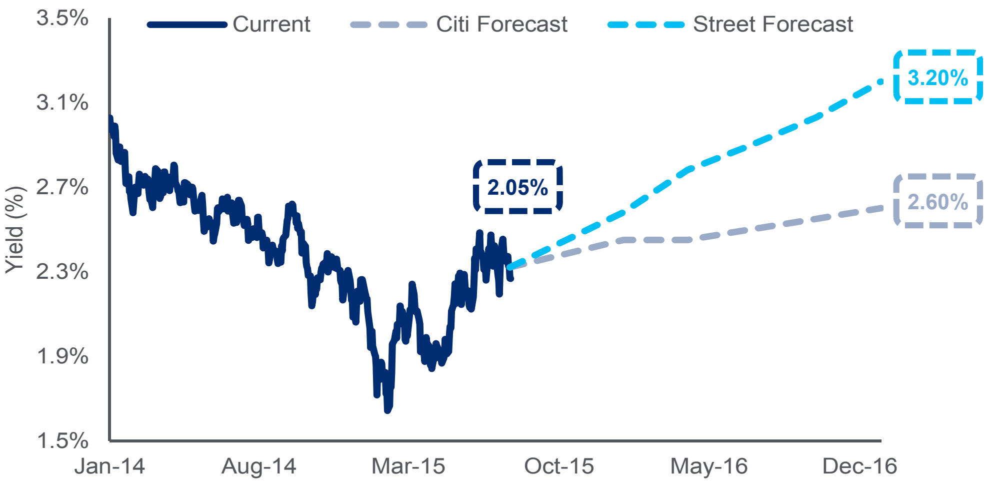
Note: Quarterly forecasts are projected period averages

Source: Citi Research, Bloomberg

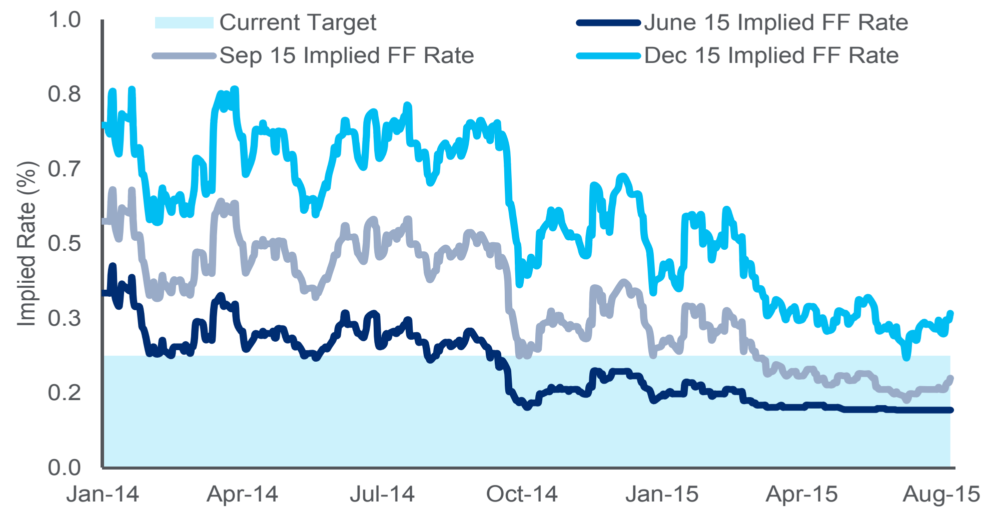
U.S. Rate Forecast & Economic Outlook

10-Year Treasury Yield Forecast

Rate hikes are expected to come in late 2015; both Citi and the Street forecast a rising rate environment throughout the year

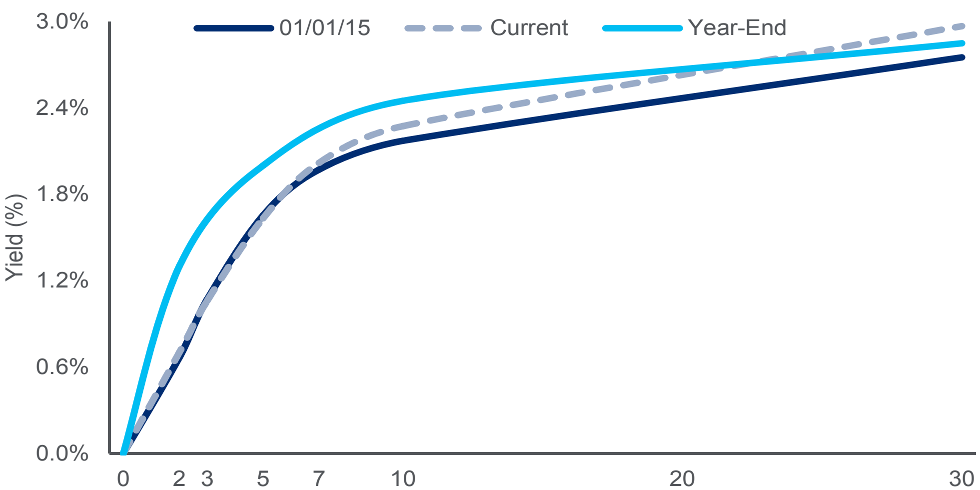


Implied FF Rates



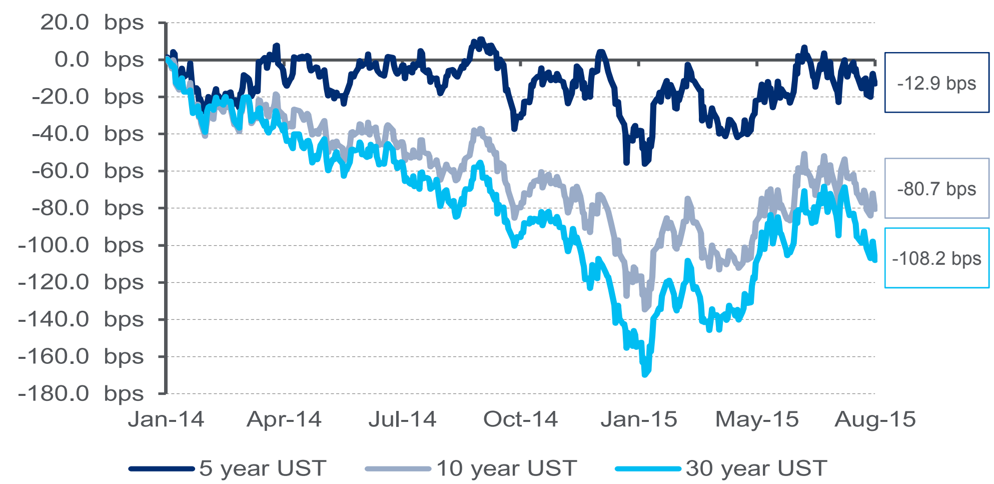
The US Treasury Curve is Expected to Flatten

The impending rate hike is expected to push up near-term rates, while low inflation continues to put downward pressure on long-term rates



Current and Historic Treasury Rates

Rates dropped significantly in 2014, however we are seeing a steady increase starting in the early winter months of 2015 with some stability; we expect this trend to continue.



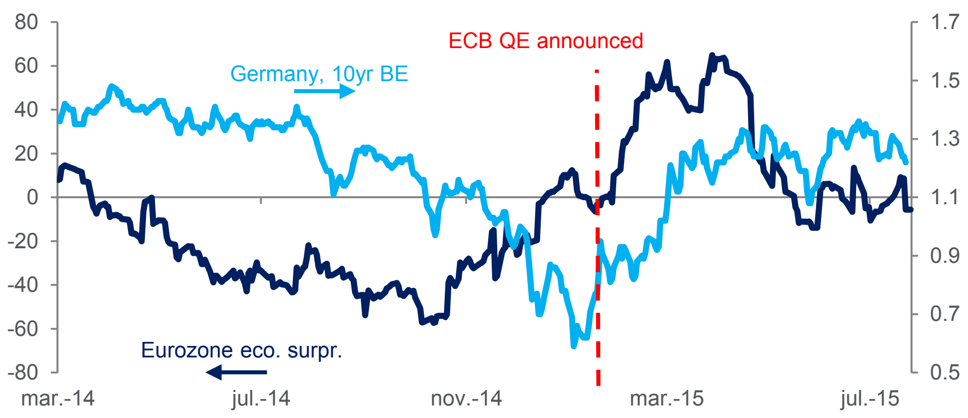
Source: Bloomberg, Citi

Could the ECB Taper Early? Not in this Market!

The ECB's decision to taper, and the timing, would centre around the impact the programme is having on real economic data points. Although, there has been an increase in growth and inflation forecasts, the key measures of inflation are still well below historical levels. Citi doesn't expect tapering to occur until Sep-2016, at the earliest.

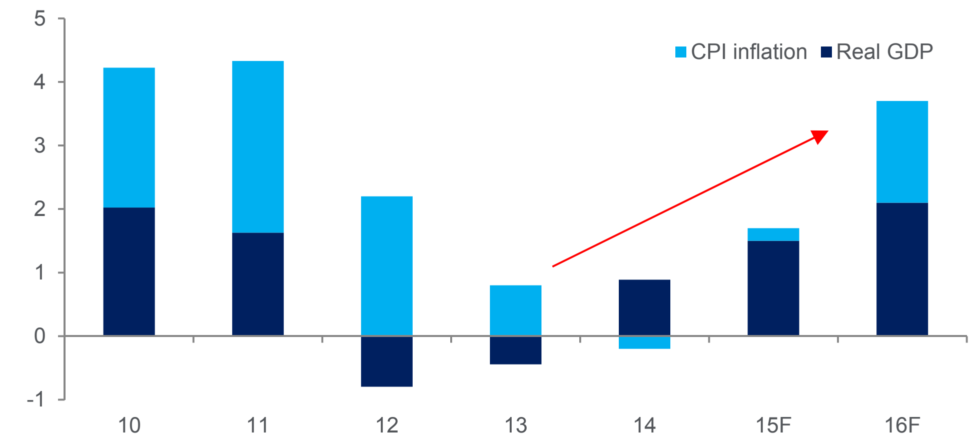
Eurozone Eco. Surprises vs. 10yr German Breakeven Yield

Turn in macro sentiment post ECB QE announcement



Higher Growth & Higher Headline Inflation as a Result

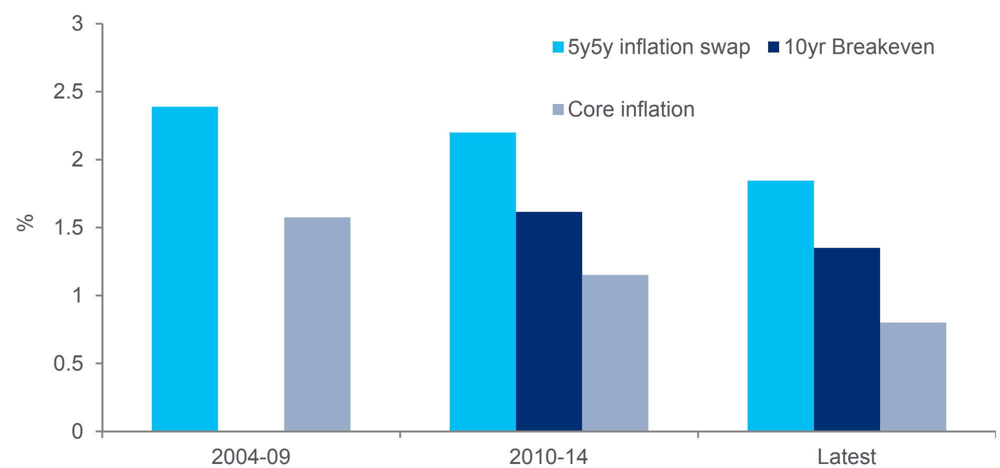
Real growth & CPI inflation; 2015 -16 numbers are Citi forecasts



The ECB is unlikely to taper because

- Inflation expectations remain on the low side
- Core inflation is very low
- Rise in headline inflation in part driven by temporary factors and base effects
- A very large output gap
- The euro would likely strengthen sharply
- Global market volatility and risk

Inflation Measures are Still Well Below Historical Levels



Source: European Credit Outlook H2 2015, Hans Lorenzen

Greece – Grexit Downside Risk

Grexit is still a possibility representing market tail risk. The revised deal takes a firmer approach to fiscal reforms, which are likely to weigh on Greece's political stability and economic performance in the medium term, making Greece's future both challenging and unpredictable.

Despite an Agreed Deal, Grexit is Still a Possibility

A Poorly Designed Framework

- Although a deal was agreed between Athens and its Creditors, the bailout proposal is likely to fail to solve Greece's economic and structural problems

A Large Haircut Likely Required

- Citi economists estimate an upfront principal haircut of €110bn to be required to bring Greece's debt-to-GDP ratio to 120% by 2022

Grexit is Still Citi Economists' Base Case

- The stringent nature of the new programme gives Greece little chance of sustaining its Eurozone position, making Grexit likely in the next 1-3-years

How Might the Bailout Programme Fail?

- Fails to solve Greece's economic and structural reforms
- Poor implementation of Greek supply-side reforms
- Inadequate debt restructuring (significant debt haircut likely required)
- Insufficient flexibility to cope with effects of weakness on public finances and damage to political credibility
- Greece's unwillingness to implement the conditionality of such a programme

The success / failure of a third bailout will depend on i) the strength of a possible economic recovery, following an overhaul in the Greek banking system, and ii) whether debt restructuring discussions are addressed

What are the Key Reforms?

- **Increase in Consumer Tax (VAT)**
  - Unification of VAT rates
- **Pension Reforms**
  - Increase in the national retirement age and cuts to the current pensions regime
  - Increase in health contributions for pensioners from 4-6% of all pension income
- **Activation of a Fiscal Council / Increased Monitoring of Bailout Fund**
  - Responsible of ruling on quasi-automatic spending cuts before finalising bailout
  - Intrusive monitoring of the implementation of reforms and fiscal policies
- **€50bn Greek-based fund**
  - Greek assets to be used (privatised) to fund the cost of recapitalising Greek banks
- **By passing the above reforms, Greece has gained access to a 3-month bridge loan of ~€7bn, which will allow them to finance near-term debt payments**

Implications Going Forward

1. In the near term, the government will likely face a continued cash shortage, given the likelihood that bank liquidity will remain restricted
2. Greek economy to contract by 2.4% YoY in 2015
3. Greece is likely to remain in recession in the coming quarters due to restrictive fiscal and political reforms
4. Failure to lift capital controls and a further increase in unemployment is likely to increase social tensions
5. Poor performance could mean higher risk of undershooting programme targets, thus challenging Eurozone membership

Likely Implications for the Eurozone

- Eurozone GDP 0.3-0.5% weaker per year
- Increased perception of Eurozone political risk
- "Who's next contagion?"

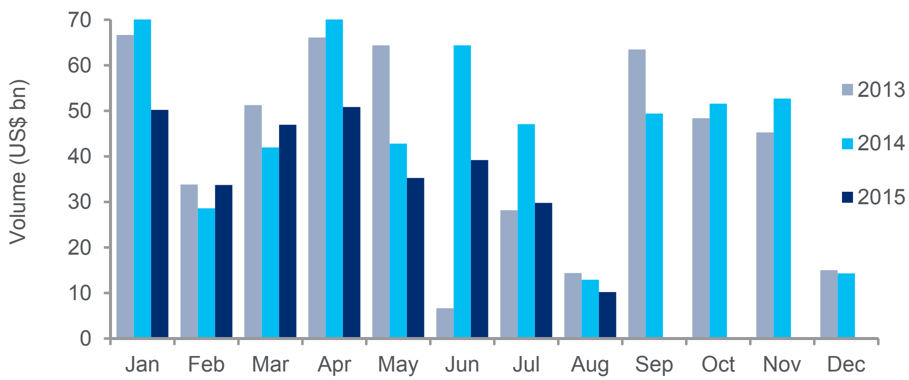
Source: Citi Research:, 17 July 2015; Greece Meeting Marathon Delivers Fragile Comprose", 13 July 2015

Emerging Markets & LatAm: Spreads + Flows Challenge

August continues an already sluggish year for EM. Fund outflows increased as the global equity sell-off and commodity slump drove investors to safer assets. Nonetheless, syndicates expect opportunistic transactions between Labor Day and the September FOMC meeting.

Historical EM Issuance

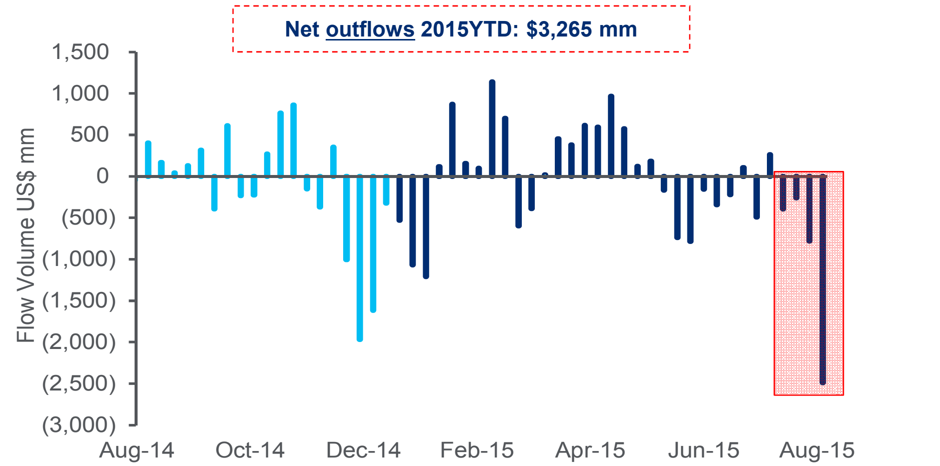
EM issuance for the week was $1.21 bn



YTD Volumes in 2015: $297.3 bn **2014**: $389.0 bn **2013**: $331.6 bn

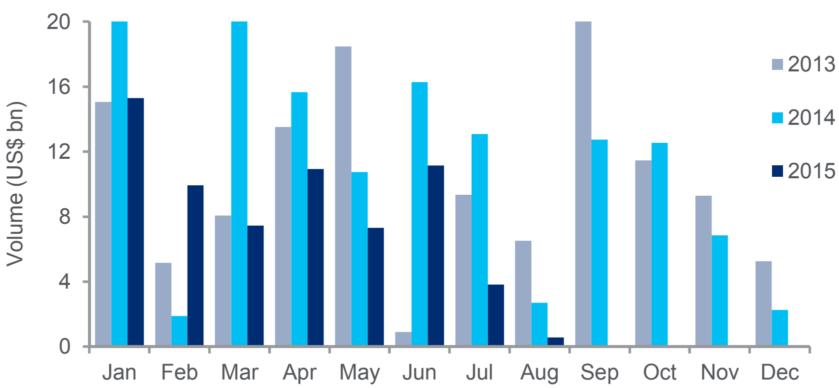
LTM EM Weekly Net Bond Flows

Specialized EM Bond funds saw outflows last week



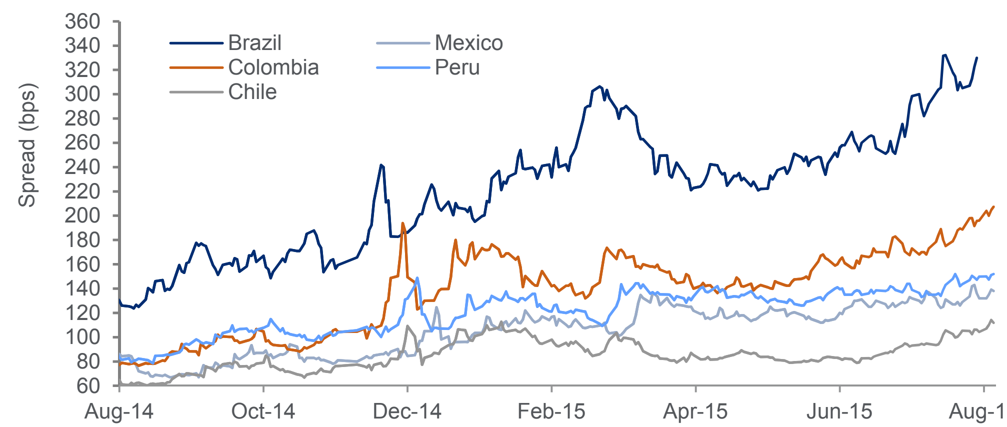
Historical LatAm Issuance

There was one deal in the international market last week



YTD Volumes in 2015: $67.7 bn **2014**: $104.8 bn **2013**: $77.1 bn

Regional 5-Year CDS



Source: Citi as of August 21, 2015

2. Capital Markets Promise:

Infrastructure, Development and Local Capital Markets

Infrastructure Financing Gap Analysis

- The world needs to invest $3.3 trillion a year to approximate a base case of infrastructure needs, or 3.8% of GDP, according to McKinsey
- Governments spend 2 - 3.5% of GDP on average on infrastructure
- Given the pressures on fiscal budgets, governments are likely to spend between 2 - 3% of GDP on infrastructure
- This leaves a gap of between $500 billion to $1.5 trillion for the private sector to fill
- Infrastructure Project Finance (private sector funded debt & equity) currently accounts for $400 billion per year
- Part of the gap can be closed by achieving cost savings and improved efficiencies

Source: Citi, McKinsey

Post Crisis, International Banks Are Back…But Basel III Banks are Constrained

		2010 Transaction Volume
State Bank of India		21,137
Bank of Taiwan		12,005
IDBI		11,019
Axis Bank		8,512
BNP Paribas	✓	8,339
Credit Agricole	✓	7,614
IDFC		7371
MUFJ	✓	6,001
Societe General	✓	5,487
SMBC	✓	4,589
Total Top 10		92,075
…of which int'l banks		32,031

		2014 Transaction Volume
MUFJ	✓	16,227
SMBC	✓	13,451
Mizuho	✓	9,848
BNP Paribas	✓	9,003
Credit Agricole	✓	8,054
ING	✓	7,555
CBA	✓	7,267
HSBC	✓	6,884
Societe General	✓	6,394
SBI Capital		5,647
Total Top 10		92,352
…of which int'l banks		84,691

Int'l banks as share of Top 10: 35% → Int'l banks as share of Top 10: 92%

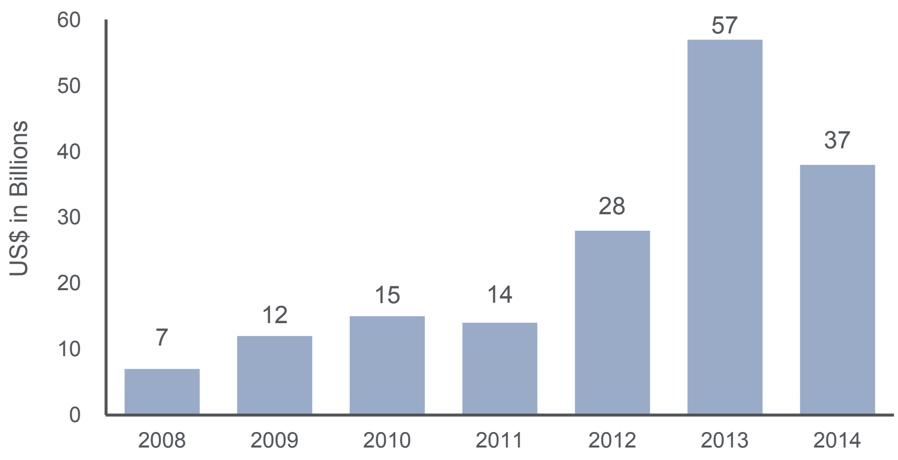
Int'l banks increase: +264%

✓ = "International" Bank

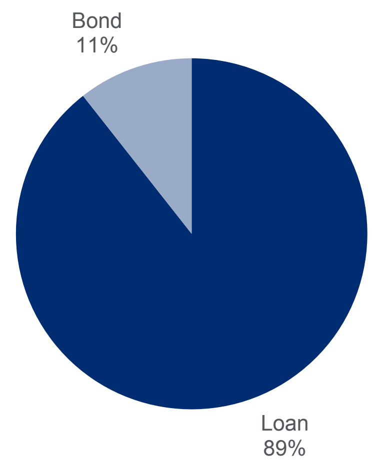
Source: PFI list of top global mandated lead arranger, 2010 and 2014 ; Totals may not sum due to rounding

Going Forward Capital Markets Financing Will be Critical to Fund the Gap

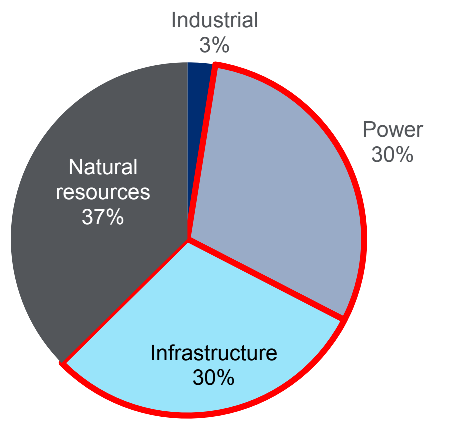
Global Project Bond Volume



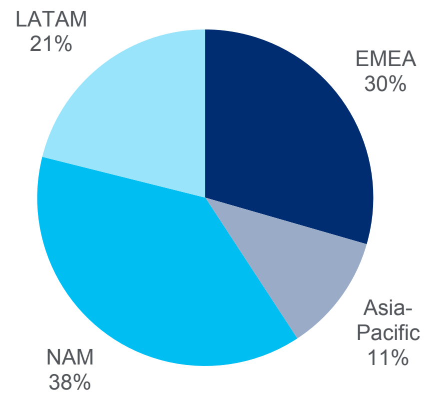
Debt Product Breakdown (2014)



Project Bond Volume by Sector



Project Bond Volume by Region (2014)



Source: Dealogic

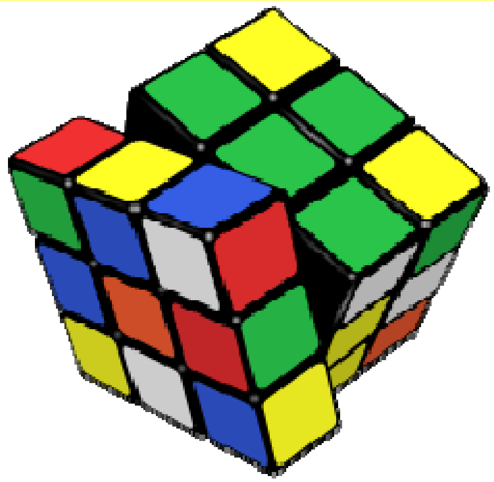
Unlocking More Capital…And Capital Markets

Institutional Debt

- Aversion to construction
- Need a relative value proposition
  - Risk adjusted
  - Liquidity adjusted
- Highly limited appetite for FX & MTM risks
- Transparency & consistency in government policy
- Commercially viable projects
- Solvency 2 and NAIC
- Equity "skin-in-game"
- Rational allocation of risks across equity, debt, epc and government

Sponsors

- No refinancing risk -> need duration capital that will take construction risk
- No or minimal FX risk
- Early certainty-of-execution
- Collaborative creditors
- Cost effective debt financing



Banks

- Construction is core skill set
- Sensitivity to regulators
- Greater focus than ever on Regulatory Capital
- Leverage levels within a project
- Sustainability of long-duration term loans

Governments

- Transparency in process
- Low cost of capital
- Allocate risks to private sector
- Sustainable and dependable long-term sources of finance
- Box political controversies (including environmental)

DFI's

- Expertise:
  - Deal structured
  - Contract standardization
- "Bridging the gap"

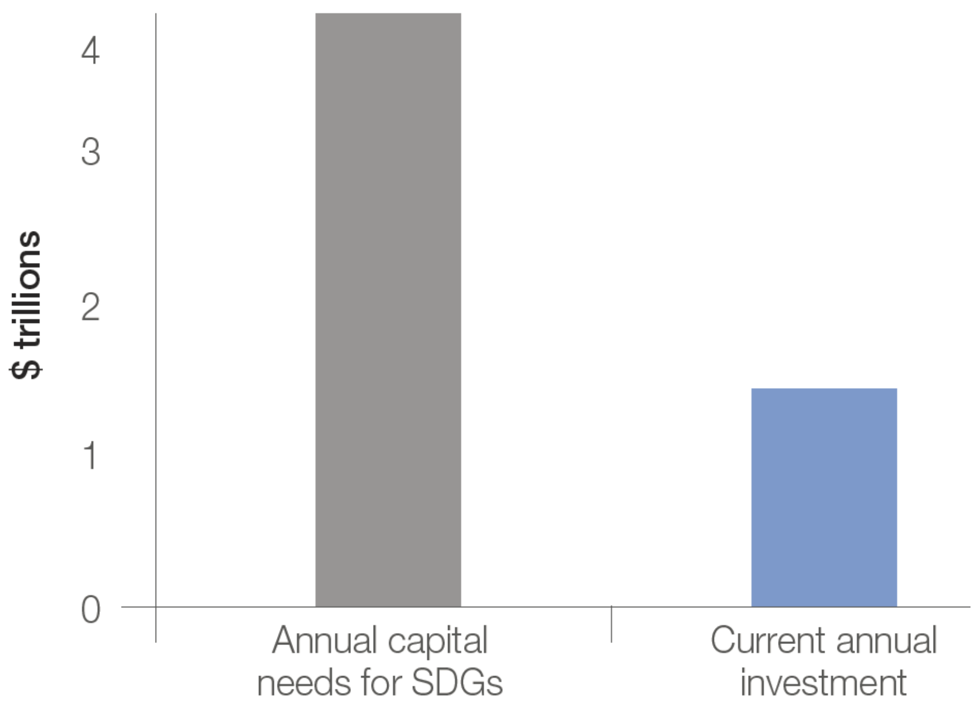
Financing Sustainable Development Goals

- The world's new Sustainable Development Goals include 17 broad based objectives and 169 specific targets
- The estimated annual cost to achieve these goals is $4.5 trillion
- The goals will require a paradigm shift toward doing good and doing well at the same time
- Mostly, financially there will a requirement for an entirely new age of private public partnerships, innovative and blended finance
- The Capital Markets will be one of the drivers of SDG' funding success

Source: Citi, World Economic Forum

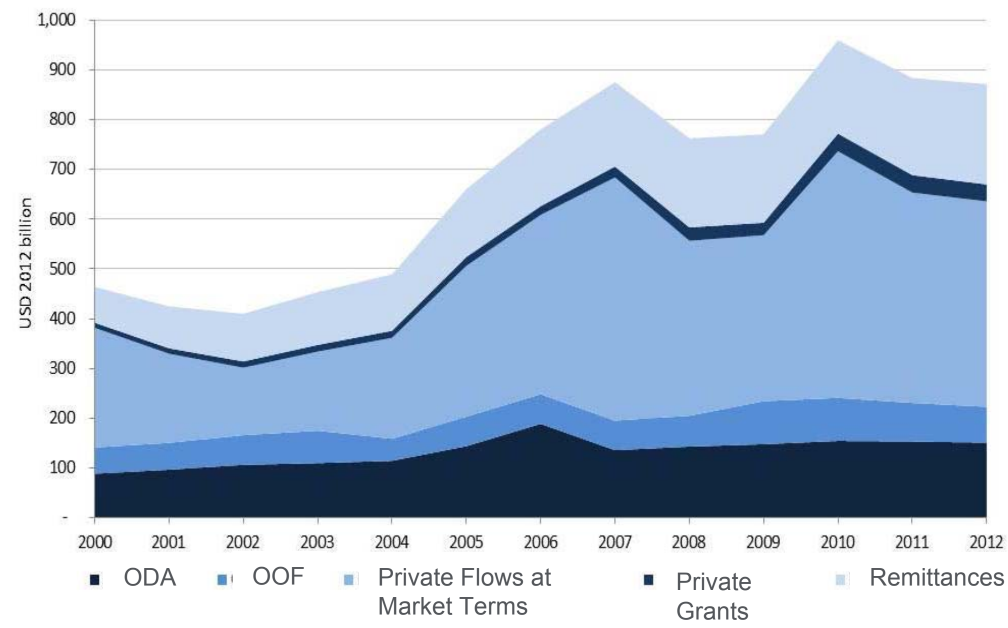
Financing the Sustainable Development Goals' Gap

A significant financing gap exists for the SDGs…



Source: UNCTAD

...private flows on market terms and capital markets will be critical



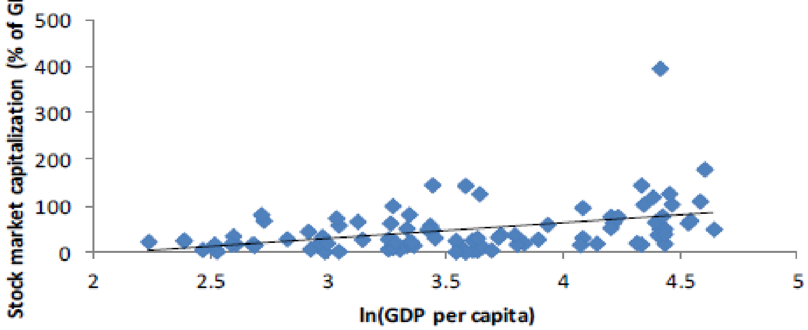
The Promise of Developing Local Capital Markets

1. Allow governments to finance large fiscal deficits without having to resort to financial repression or foreign borrowing
2. Supports the conduct of monetary policy
3. Improve the availability of long term financing, allowing households and firms to better manage interest rate and maturity risk associated with long-term investments
4. The development of local capital markets can improve access to local currency financing
5. Financial deepening alongside the development of banking markets, improving the efficiency of capital allocation in the economy
6. Increase financial integration by attracting foreign capital, which can lower the cost of capital for local firms and household and improve risk sharing across countries
7. Enhance financial stability by improving the ability of financial institutions to manage risk

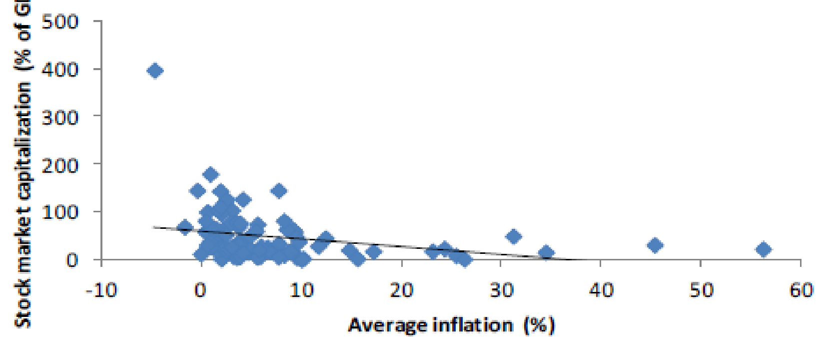
Source: Citi, IMF

Local Market Development and Macroeconomic Conditions

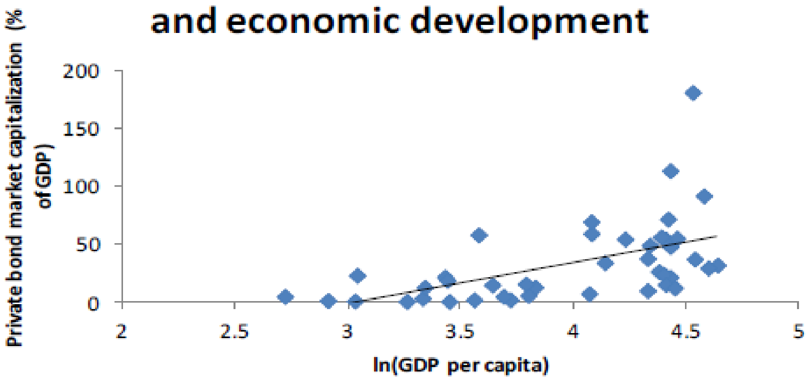
Stock market development and economic development



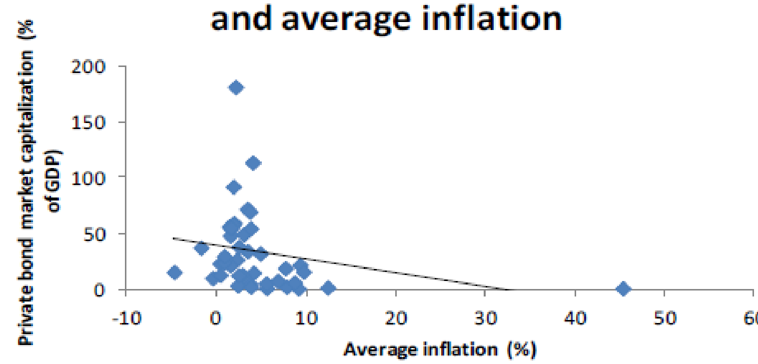
Stock market development and average inflation



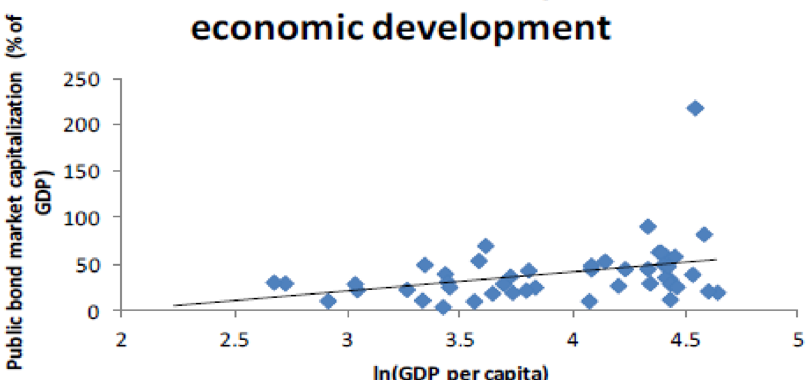
Private bond market development and economic development



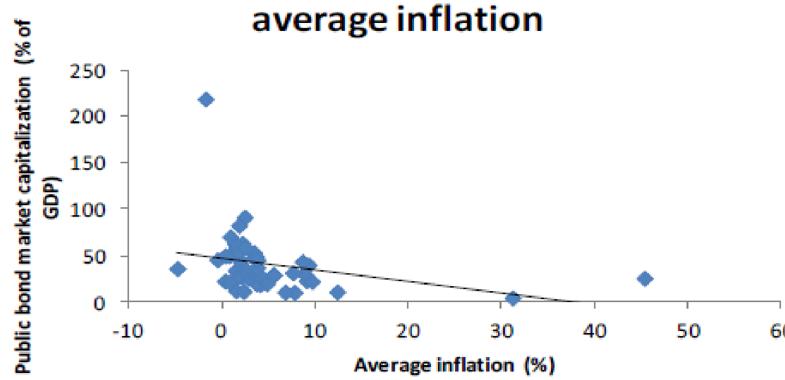
Private bond market development and average inflation



Public bond market development and economic development



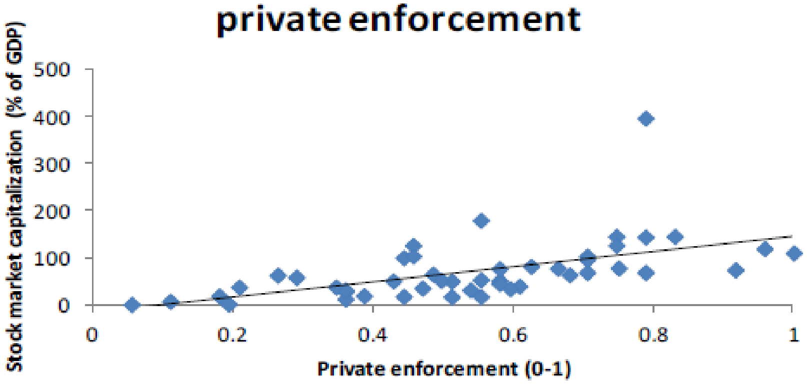
Public bond market development and average inflation



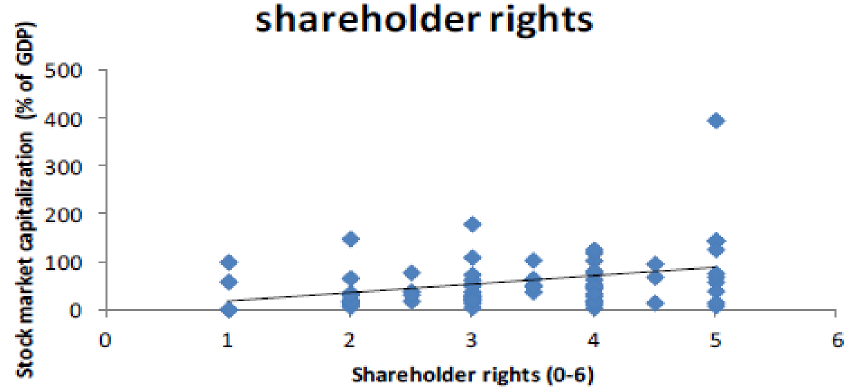
Source: Citi, IMF

Local Market Development and Institutional Setting

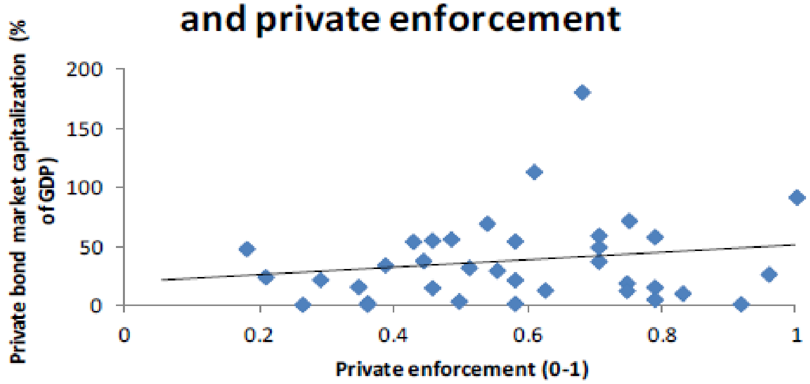
Stock market development and private enforcement



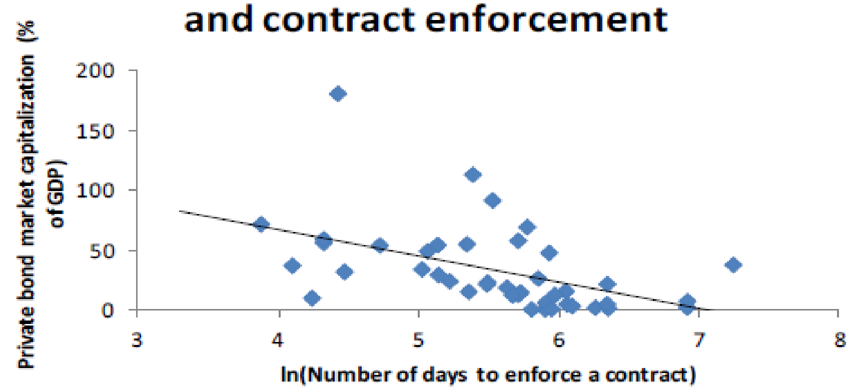
Stock market development and shareholder rights



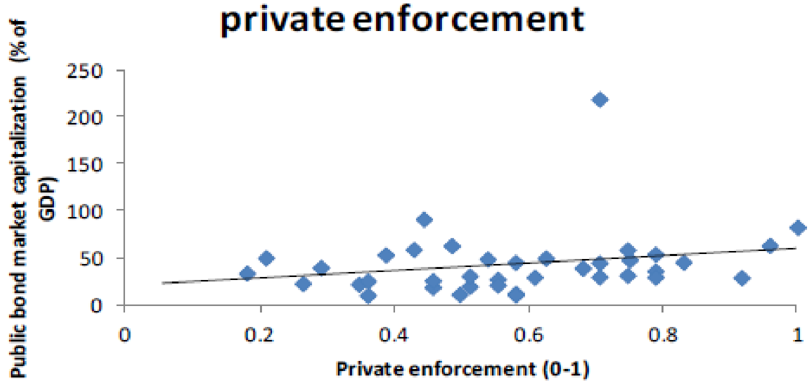
Private bond market development and private enforcement



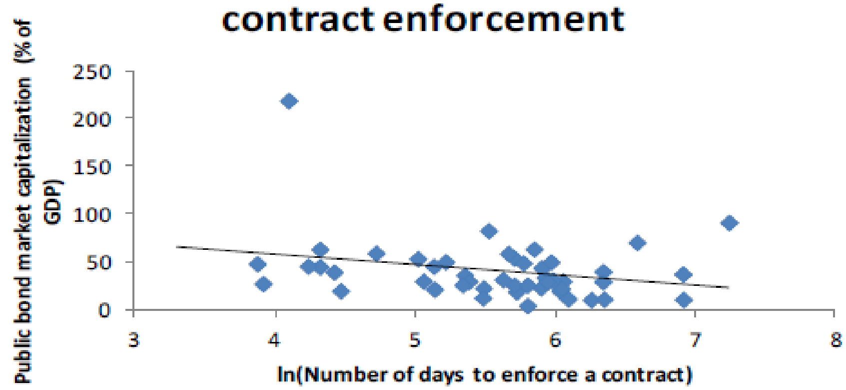
Private bond market development and contract enforcement



Public bond market development and private enforcement



Public bond market development and contract enforcement



Source: Citi, IMF

3. Capital Markets Peril?: Tapering 2.0?

The Debate over Lift-Off: Tapering 2.0 or “Non-Event”?

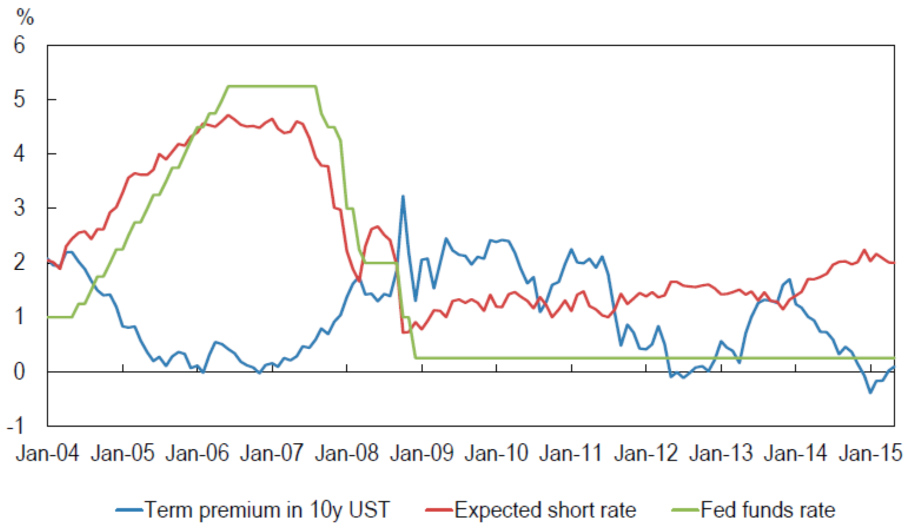
There are five potential reasons why a loft-off may, in and of itself, be less damaging for Emerging Markets than tapering.

1. Lift-off is well-telegraphed. Chances of a large unanticipated move in interest rates are slim
2. Lift-off is part of the normalization process in response to a stronger economy. It is likely to be constrained by monetary policy differential’s impact on dollar
3. Global term premia ought to remain depressed given that cyclical recovery is underway, policy uncertainty is lower, and ECB and BOJ will continue to do QE
4. Valuations appear to provide better compensation for risk than pre-tapering
5. Most of the evidence on positioning suggests that investors carry positions with limited levels of risk

Factors Supporting "Non-event" Thesis

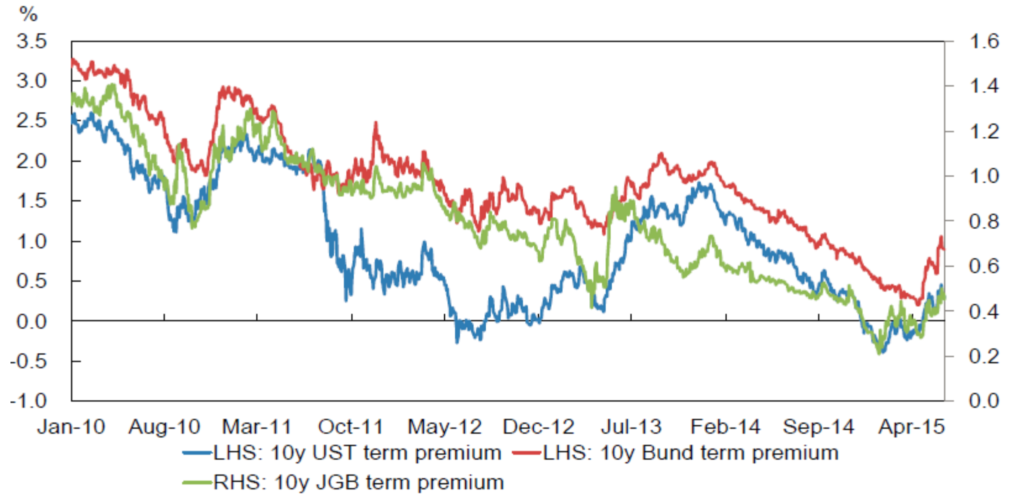
Can lift-off produce a sharp increase in term premia?

Large movements in term premia have occured around recessions



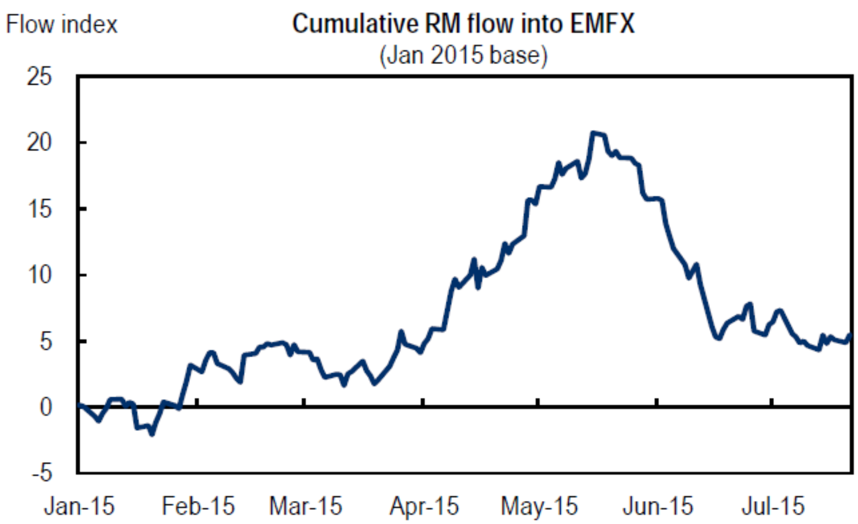
ECB and BoJ QE should continue to depress UST term premia

Evidence of a strong tendency of term premia to co-move across markets



Positioning should help, somewhat

Positions have turned light post Greece and have stayed very small



Risk premia in local rates are now much higher

Source: Bloomberg, Citi Research

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Citi believes that sustainability is good business practice. We work closely with our clients, peer financial institutions, NGOs and other partners to finance solutions to climate change, develop industry standards, reduce our own environmental footprint, and engage with stakeholders to advance shared learning and solutions. Highlights of Citi's unique role in promoting sustainability include: (a) releasing in 2007 a Climate Change Position Statement, the first US financial institution to do so; (b) targeting $50 billion over 10 years to address global climate change: includes significant increases in investment and financing of renewable energy, clean technology, and other carbon-emission reduction activities; (c) committing to an absolute reduction in GHG emissions of all Citi owned and leased properties around the world by 10% by 2011; (d) purchasing more than 234,000 MWh of carbon neutral power for our operations over the last three years; (e) establishing in 2008 the Carbon Principles; a framework for banks and their U.S. power clients to evaluate and address carbon risks in the financing of electric power projects; (f) producing equity research related to climate issues that helps to inform investors on risks and opportunities associated with the issue; and (g) engaging with a broad range of stakeholders on the issue of climate change to help advance understanding and solutions.

Citi works with its clients in greenhouse gas intensive industries to evaluate emerging risks from climate change and, where appropriate, to mitigate those risks.

efficiency, renewable energy and mitigation