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Investment Strategy
Private Clients

2/4

April 2019 · 2nd quarter

At a glance

- Our base case scenario for the coming quarters is one of global growth stabilisation, indeed even somewhat of a recovery – provided Chinese and US negotiators manage to settle the trade dispute.
- In the face of slowing US growth, global trade tensions and muted inflation, the Fed has decided to pause its normalisation process.
- Persistent Eurozone economic weakness, though largely externally-driven, is worrisome – especially as there seems little more that monetary policy can do at this point.
- Year-to-date Japanese cyclical conditions have proven quite challenging, but Abe's new 101 trillion yen budget signals determination to push through with the final consumption tax hike.
- With the Fed on hold and currencies stabilising, emerging central banks should not have to tighten monetary policy much this year – unlike in 2018.
- While concerns of a central bank-induced recession have been largely put to rest, the risk of a prolonged trade slowdown weighing on the global economy remains – warranting a still balanced and disciplined approach to portfolio risk.
- In Forex, the combination of US deceleration, a dovish Fed and gradually improving world growth argues for a weaker dollar over time – save against the euro (at least for now), itself restrained by a super-accommodative ECB.

Quarterly publication of
Lombard Odier Investment Solutions – Strategy

Important information
Please read the important information at the end of the document.
Data as of 1 April 2019

Current global economic weakness is mostly about trade

The sudden and sharp trade recession lies at the root of the current global slowdown. In today's integrated world, with broadly diversified trade partners, open current and capital accounts, as well as tight international financial linkages, a trade shock directly impacts overall economic activity.

The good news is that the transmission channel should also work in the reverse direction. So, if the US/China dispute gets settled and a solution to Brexit is found, a rebound in activity can be expected. Which is why our base case scenario for the coming quarters is one of global growth stabilisation, indeed even somewhat of a recovery. An improvement in the global trade outlook would be particularly favourable to Asia and Europe, where pressure from the external sector has weighed the most on economic trends (see charts 1 and 2, page 04).

Although signs of improvement are slow to materialise, a number of activity indicators do offer some cause for optimism. The global manufacturing PMI stopped declining in March (unchanged at 50.6) and 75% of countries are above the 50 threshold (i.e. in expansion territory), the best ratio since November. The services component of the global PMI has progressed to 53.7, with 77% of countries in expansionary territory. The Harpex and Baltic Dry indices, which provide a timely measure of global container shipping activity, appear to be bottoming (see chart 3 – page 04). Finally, and more specifically, the Chinese pulse is starting to beat a little faster, with stronger credit growth and an encouraging rebound in the manufacturing PMI to an 8-month high of 50.8 (consistent with annual GDP growth around 6%). This improvement was then confirmed by a better-than-expected Caixin services PMI: at 54.4 it reached its highest level since January 2018.

We acknowledge that these green shoots are still fairly tentative and, to develop further, will require a trade deal between the US and China. Only such a development would remove the uncertainty and allow confidence and activity to pick up more decisively. In the event that Chinese and US negotiators do not come to terms, domestic demand dynamics in Europe and Asia, but also in the US, would be unable to defy external softness.

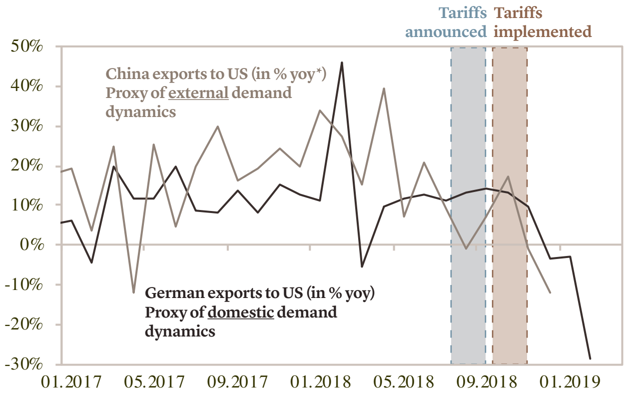
For now, discussions are moving in the right direction, with the damage already incurred from the trade war having incentivized both sides to find common ground. From a Chinese point of view, notwithstanding the ongoing transition towards domestic drivers, the economy remains very sensitive to trade flows. As for the US, even though exports have a lesser GDP weight, the global slowdown caused by the trade war has proved a major headwind for companies. This leaves us hopeful – albeit still vigilant, as the margin for policy missteps remains non-negligible – that a US/China deal will eventually be struck, involving no further increase in tariff rates and possibly also the removal of some of the existing ones.

With the Federal Reserve (Fed) taking a more dovish stance just a couple of weeks after the European Central Bank (ECB) decided to defer any potential interest rate hike to 2020 and announced the launch of a new series of targeted longer-term refinancing operations (TLTROs), the change in monetary policy trend is

Note: Unless otherwise stated, all data mentioned in this publication is based on the following sources: Datastream, Bloomberg, Lombard Odier calculations.

1. Trade has taken a hit with the collapse of Chinese demand

German exports to China plunged in H2 2018

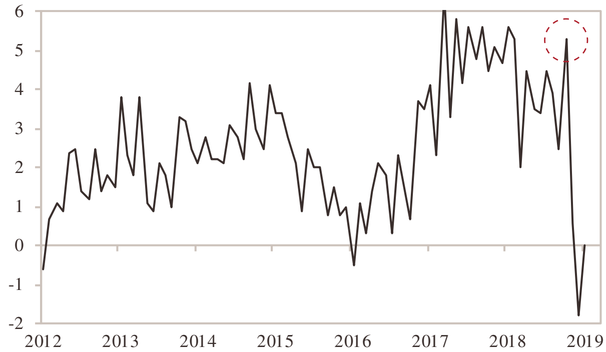


*year on year

Sources: Datastream, Bloomberg, Lombard Odier calculations

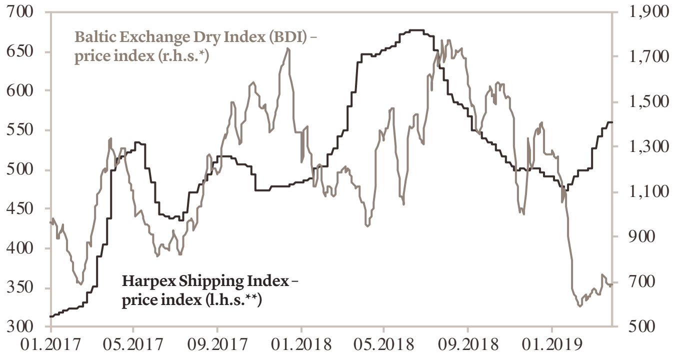
2. US tariffs caused a plunge in global trade flows

Trade volume growth, in % yoy



Sources: Datastream, Bloomberg, Lombard Odier calculations

3. Shipping indices: a timely indicator of global trade flows



* right hand scale, ** left hand scale

Sources: Datastream, Bloomberg, Lombard Odier calculations

notable. Near-term risks of tighter financial conditions, that would have put the expansion at risk, have receded. Even though the aforementioned trade and Brexit issues still need monitoring, this more accommodative monetary stance represents a material change in the outlook. Not only should it help make the environment more predictable for a while, it could also serve to prolong the cycle.

To conclude, we would continue to point out that the current investment environment is unprecedented in many ways. The long-term theme of low Western world growth, combined with more immediate trade-related dangers, has led central banks to keep monetary conditions supportive for longer. The Fed has taken a pause in its tightening cycle even before reaching the neutral rate, and despite a full employment situation, while the ECB may struggle to ever normalise its rate policy. Our investment strategy continues to focus on making the most of this "low growth but easy money" context.

Samy Chaar, Chief Economist

United States
Recession or soft landing?

In a nutshell

- In the face of slowing US growth, global trade tensions and muted inflation, the Fed has decided to pause its normalisation process – with no further rate hikes now expected this year.
- This surprisingly dovish Fed guidance caused some segments of the yield curve to invert, in turn prompting recession fears.
- For now, though, strong consumer tailwinds point rather to a soft-landing scenario.

The Fed's March decisions were more dovish than expected, with guidance of essentially unchanged rates going forward (the famed "dot plot"– see chart 4) and an earlier-than-expected ending of the balance sheet normalisation process, now due to slow down in May and wrap-up in October.

While this does not necessarily mark the end of the tightening cycle, the Fed has effectively, in the face of decelerating domestic growth, global trade risks and muted inflation, decided to remain patient for an extended period. Our base case is now one of no hikes in 2019.

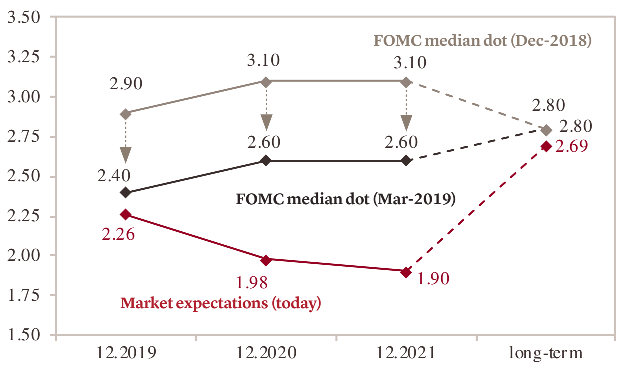
Financial conditions eased upon this dovish Fed guidance, leading some segments of the yield curve to invert for the first time since 2007 (see chart 5) and hence prompting recession concerns. While we do take the yield curve signal seriously, we also note that it still requires confirmation, both along the maturity spectrum and in terms of other economic indicators (particularly since the Fed may never reach restrictive territory), and that there has historically been a time lag between inversion and a US recession (ranging from nine months to two years). We thus continue to believe that this economic cycle has legs, even if it is getting quite aged.

We would notably point out the strength of the employment/consumer landscape. Accounting for 70% of US GDP, US consumption currently enjoys far too many tailwinds (full employment, growing wages, low oil prices, available credit) to imagine that recession lurks just around the corner. Also, the drop in mortgage interest rates will boost residential investment, lifting home sales and construction.

Ultimately, a near-zero real Fed rate argues for a soft landing rather than a recession scenario. Until (or unless) the Fed finds itself forced to revert back to monetary normalisation, owing to employment/wage developments or perhaps to excessive leverage in the public and corporate sectors, the US economy should continue to grow at a pace close to its average for this cycle.

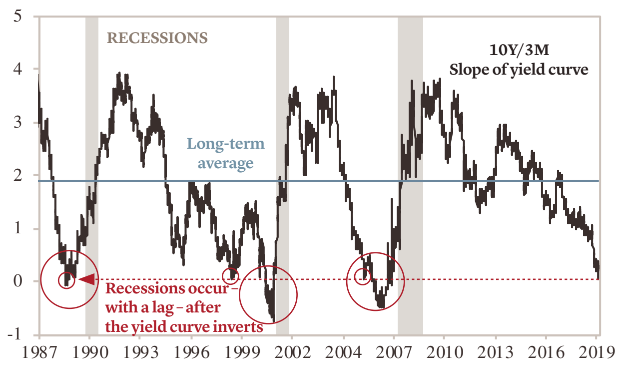
Samy Chaar, Chief Economist

4. Fed "dot plot" vs. market expectations
In %



Sources: Datastream, Bloomberg, Lombard Odier calculations

5. Some segments of the yield curve have now inverted
Differential between US 10-year Treasury and 3-month T-bill yields, in %



Sources: Bloomberg, Datastream, Lombard Odier calculations

Europe
(When) does the slowdown end?

In a nutshell

- Current Eurozone economic weakness is largely externally-driven, with domestic consumption so far supported by solid labour market trends.
- However, its persistence is worrisome – especially as there seems little more that monetary policy can do at this point.
- While fiscal stimulus would be a more effective response, it is unlikely to materialise judging by recent history. An improvement in global trade, and no new accidents, seem a prerequisite for a pick-up in growth.

The near-term Eurozone outlook hinges on whether the ongoing trade-related weakness will persist, and how likely it is to spill over to domestic demand in a material way. The answers are –of course– interrelated: the longer trade remains weak, the more confidence, investment, employment and consumption may be impacted.

While murky, the global trade outlook is arguably a little less dark now than at the end of 2018. If recent tentative signs of improvement are indeed confirmed and world trade recovers, this would undoubtedly be positive for the Eurozone. By contrast, any additional risks, such as a possible US decision to impose tariffs on European autos, would be the last thing that European economies need right now.

Domestic demand is supported by growing employment, rising wages and, with inflation low, strong purchasing power. These are powerful and not particularly volatile drivers, which is why we place a great deal of emphasis on them. That said, domestic-focused sectors are not devoid of signs of weakness. Services have slowed less than manufacturing but have not been immune. And the pace of job creation is bound to moderate as the cycle matures.

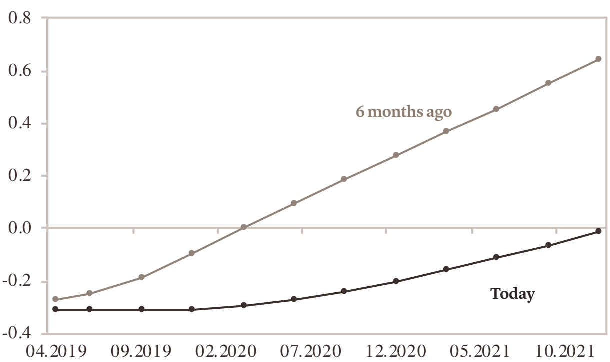
The most critical issue is the limited room for policy response. Although the ECB insists that its toolbox is ready for use, we think there is little of impact it can do at this point. The March announcement was a case in point: the ECB extended its forward guidance on interest rates and announced new TLTROs. This may prevent any unwarranted tightening, and markets have certainly taken note of the message (see chart 6), but it is unlikely to significantly boost growth.

The fact that current economic weakness is largely externally-driven complicates matters. Easier monetary policy can help when domestic demand is weak or the lending channel is broken – of which there is little evidence today. In fact, as chart 7 shows, Eurozone money growth has barely slowed, despite the ending of QE. But the sharp sell-off in European bank stocks following the March meeting also points to potentially negative effects of the current monetary stance. A fiscal policy response would be more effective at a time of negative interest rates – but hopes for a more stimulatory euro area fiscal stance have often proved misplaced to date, as the countries with the most leeway are unwilling to use it. So, with policy response likely to be either absent or ineffective, Europe can only hope that world trade improves – and accidents are avoided (see Brexit discussion).

Bill Papadakis, Macro Strategist

6. A significant repricing of ECB policy rate expectations

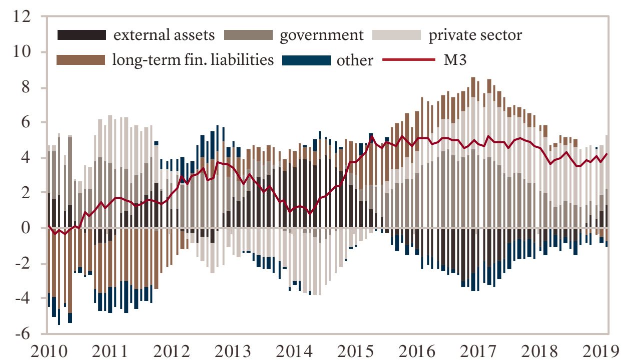
Rate expectations derived from Euribor futures prices



Sources: Bloomberg, Lombard Odier calculations

7. Eurozone money growth barely affected by the ending of QE

M3 growth and contributions, in % yoy



Sources: Bloomberg, Lombard Odier calculations

A messy path – with some light at the end of the tunnel

Deadlines have come and gone, but the Brexit saga is still with us – and has become increasingly complicated. To the surprise of many, the first part of the story – negotiations between the UK and the EU27 – went rather smoothly. The resultant Withdrawal Agreement, however, then failed to be ratified by the UK Parliament, being voted down twice, by wide margins. This impasse led to a request for a deadline extension by the UK government in order to avoid the risk of "no deal" Brexit on March 29. While the EU assented, it only provided an extension until mid-April – as the UK would have to decide to hold European elections for a longer one.

Since the beginning of the process, our base case has been that Brexit occurs in a rather orderly fashion, with a Withdrawal Agreement in place and a transition period that lasts a number of years. This is a critical point as a "no deal" scenario would be far more disruptive, in large part because of the lack of such a period that allows all economic agents to adjust to the new status quo. Although the path has narrowed, a smooth Brexit remains our central scenario and we think the UK Parliament's clear opposition to leaving without a deal provides support to this view. Consequently, our forecasts envisage sterling upside on a medium-term perspective, with GBPUSD appreciating towards the 1.35-1.40 range and EURGBP falling towards 0.82 (or below). This is because UK parliamentary approval of a Withdrawal Agreement would lead to the pricing out of (whatever is left of) the "no deal" Brexit premium and potentially the pricing in of tighter monetary policy by the Bank of England.

That said, Theresa May's inability to gather sufficient support for her deal, despite having reached such a late stage of the process, is a worrisome sign. More recently, PM May has shown willingness to pursue a softer Brexit path, such as staying in a customs union with the EU, by forming cross-party consensus around this objective. This shift may provide the impetus needed to avoid "no deal", although it is not yet clear that it will be successful.

In the meantime, markets have shown little concern about the worst-case outcomes. As illustrated by chart 8, both the UK equity market and the value of the GBP suggest that a smooth resolution is almost taken for granted by most investors. Since the European Court of Justice (ECJ) ruled last December that the UK can unilaterally revoke the Article 50 notification and remain in the EU, the domestic-focused FTSE250 equity index has gained 8%, while the GBP has strengthened by more than 5% in trade-weighted terms.

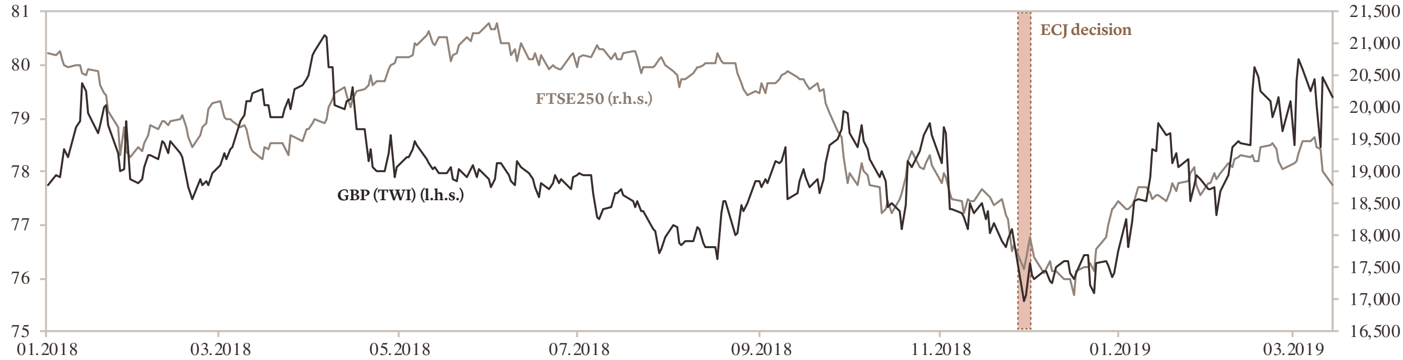
Markets have clearly taken comfort from this court decision – but a more cautious approach seems warranted. The fact that the UK government has the right to revoke the notification doesn't mean it will, especially given how little support there is for this among members of the ruling Conservative Party, and how divisive it could prove.

It is not certain that a smooth, "soft" Brexit scenario will prevail, and even less so that a "no Brexit" scenario may materialise. Which means that the possibility of "no deal" should not be dismissed. Given the potentially large impact of such an outcome and the favourable market conditions, hedging GBP downside (via short-term GBPUSD puts) makes sense: if the tail risk materialises, the downside to sterling would be substantial. In the aftermath of the referendum result, GBPUSD fell towards 1.20, undershooting our (then) fair value estimate (1.57) by 23%. With our models now suggesting that the new GBPUSD fair value is around 1.40, a similar divergence to the downside could take GBPUSD between 1.15 and 1.10, i.e. a near 15% drop from current levels.

Bill Papadakis, Macro Strategist, and Vasileios Gkionakis, Global Head of FX Strategy

8. Markets have lately shown surprisingly little concern about a "no deal" scenario

Price history of domestically-focused FTSE250 equity index and trade-weighted GBP



Sources: Bloomberg, Lombard Odier calculations

Japan
Abe's 101 trillion yen

In a nutshell

- Cyclical conditions so far this year have proven quite challenging due to overseas economic uncertainties; if second quarter growth is not solid, full year 2019 growth could end up close to 0%.
- Abe cabinet's new 101 trillion yen budget signals determination to push through with the final consumption tax hike – and probably a willingness to use fiscal policy more actively in the future.
- The Bank of Japan could introduce new policy tweaks if growth falls short, but the hurdle for game-changing policy remains very high.

The Japanese economy slowed rather sharply in the first quarter, possibly even contracting slightly, due to weak global trade, cautious business sentiment and fundamental labour market limitations. This trend is likely to reverse mid-year, assuming global growth rebounds on consumer resilience and better macro/trade policies, but the visible loss of momentum in the year of another consumption tax hike has put both the Abe cabinet and the Bank of Japan (BoJ) in a tricky position.

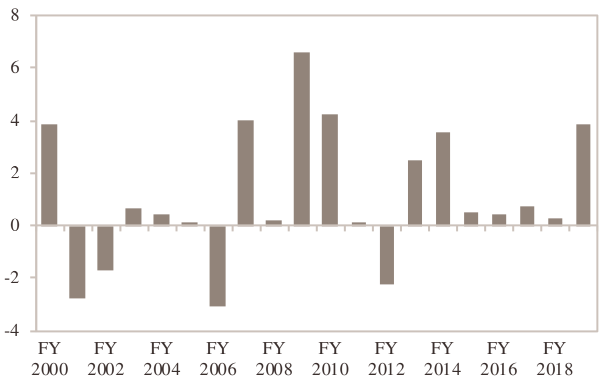
On the fiscal front, the government nonetheless seems rather determined to pursue its current course. Abe's new fiscal year 2019 101 trillion yen budget – just passed by both chambers in the Diet – marks the largest expenditure boost of his term (see chart 9). It simply reflects campaign pledges during the last snap election for the lower house, with Abe having promised to use fresh fiscal receipts from the tax hike to provide subsidies for free education and infant care, in addition to conventional fiscal measures such as public investment to offset the negative impact on households. The upfront fiscal commitment is a clear sign that the cabinet is ready to go ahead with corresponding revenue raising measures.

On the monetary front, the obstacle for additional easing is not as large but the BoJ is probably biased not to use its policy instruments actively for the time being. Partly due to constraints (both legal and political) on the purchase of foreign assets, any new announcement of quantitative targets on domestic assets would immediately run into perceptions of long-term shortages – with the BoJ already owning close to half of outstanding Japanese government bonds and nearly 80% of index-tracking exchange-traded funds (see chart 10). And with the public and the banking lobby strongly opposed to deeper negative interest rates, it is unlikely that the BoJ can consider more aggressive rate cuts or yield target changes in the absence of a stark external event.

In short, Japanese policymakers will continue to tread carefully due to the delicate web of political and technical constraints they face in their reflationary efforts. Barring a shocking cyclical development overseas, the likely path of action remains the same: the Abe cabinet will try to use fiscal measures more actively while the BoJ will likely play only a supporting sideline role.

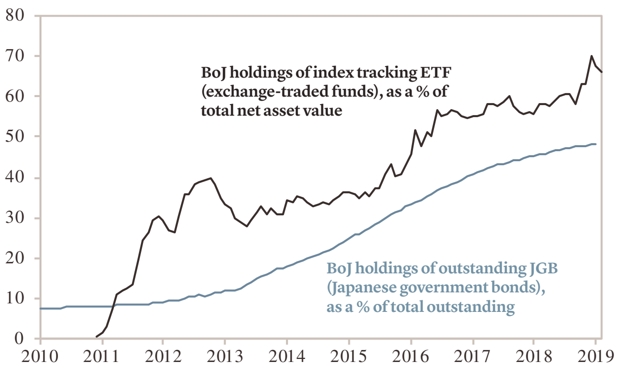
Homin Lee, Macro Strategist – Asia

9. Growth in Japan's initial annual budget
In % yoy



Source: Ministry of Finance

10. The BoJ has accumulated massive holdings of domestic assets



Source: CEIC, Japan Investment Trust Association

Emerging Markets
Is the dovish Fed a game changer for emerging markets?

In a nutshell

- With the Fed on hold, currencies stabilising and favourable oil price base effects, emerging central banks should not have to tighten monetary policy much this year – unlike in 2018.
- Emerging fundamentals are by and large sound, with the weakest links having already broken: economic growth thus looks set to hold up (but not accelerate significantly) this year.
- To be monitored, however, is the political agenda – notably the elections in India, South Africa, Argentina and Indonesia.

The unexpected dovish turn adopted by major Western central banks during the first quarter of 2019 is justifiably leading investors to wonder whether this could be a game-changer for emerging economies.

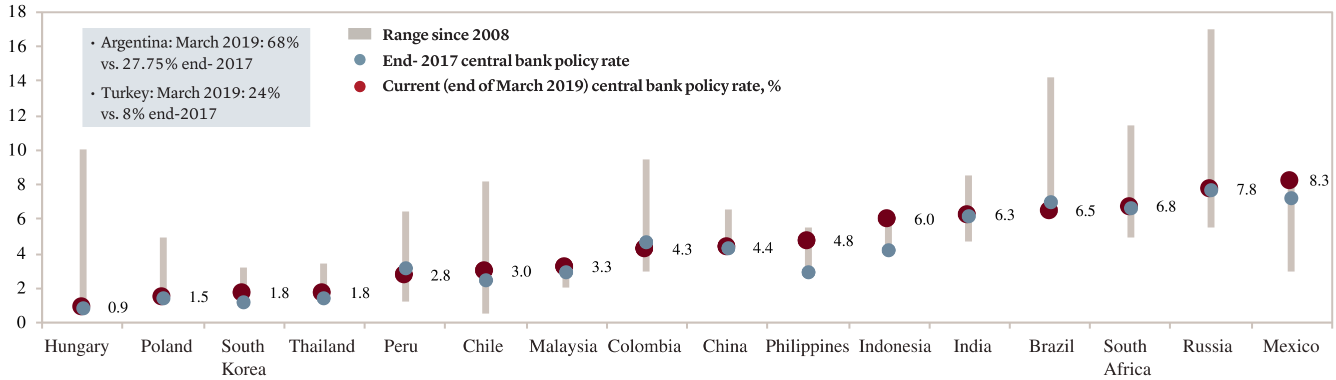
Indeed, last year saw many emerging central banks tighten their monetary policy, more or less in line with the Fed, in order to support their currencies and stem nascent inflation pressures. Half of the 18 countries in our emerging universe thus exhibit higher key rates today than at the end of 2017 (see chart 11). With the Fed on hold, emerging currencies stabilising and favourable oil price year on year base effects keeping a lid on inflation, this tightening trend appears likely to pause in 2019.

In addition, emerging fundamentals are broadly sound, with current account balances that have improved over the past five years, higher official reserves and mostly orthodox fiscal and monetary policies. The weakest links among the larger emerging economies – Turkey and Argentina – broke last year. Other large economies do not suffer the same type of vulnerabilities, meaning that a repetition of 2018's idiosyncratic crises is unlikely. In fact, given still relatively young economic cycles with some upside potential, emerging growth should hold up this year.

This is not to say that we expect a significant acceleration. The lagged effect of past monetary tightening on growth should not be underestimated. Moreover, global economic momentum has softened over the past two quarters and trade growth could well remain subpar worldwide, even in the event of a China/US deal. Finally, the political agenda is particularly heavy in the emerging world this year, with key general elections in India (April 11 to May 19), South Africa (May), Argentina (October) and Indonesia (April). And we should not be complacent regarding political developments in other countries such as Brazil (will President Bolsonaro manage to truly reform the social security system?), Mexico (will President AMLO adopt a completely unpredictable style of governance?) or Turkey (will Erdogan again pressure the central bank to support growth at the expense of currency stability?).

Stéphanie de Torquat, Macro Strategist

11. Monetary policy has turned less accommodative in 2018...
... But most EM tightening cycles may pause with the Fed



Sources: Bloomberg, Lombard Odier calculations

Asset Allocation
Yields to remain lower for longer

In a nutshell

- The change in Fed and ECB stance has reignited investors' risk appetite, driving a strong year-to-date rally in risk assets.
- While concerns of a central bank-induced recession have been largely put to rest, the risk of a prolonged trade slowdown weighing on the global economy remains – warranting a still balanced and disciplined approach to portfolio risk.
- We currently favour carry strategies in the fixed income space, having notably switched our emerging market equity overweight into local debt, and increased corporate credit exposure.
- Our stance in equities is neutral across regions, favouring large- over small-caps on liquidity risk considerations.
- Elsewhere, we see diversification/hedge opportunities in gold and the Japanese yen – and have taken advantage of lower volatility to protect portfolios from tail risks via option strategies.

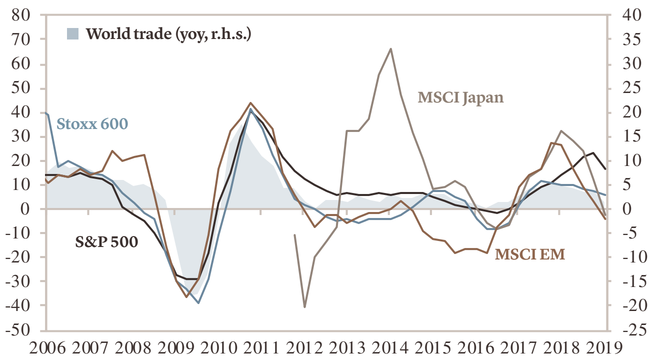
After a painful end to 2018, markets have completely reversed gear since the onset of this year. With the Fed having said that it will pause its monetary tightening cycle, at least throughout 2019, and the ECB putting off a first hike until 2020, market sentiment has shifted, and risk assets have been well supported. The low yield environment is clearly here to stay, easing concerns that excessive central bank tightening will put the expansion at risk. In fact, the biggest risk to our base case scenario now lies in a prolonged slowdown in global trade and its impact on global growth and corporate earnings (see chart 12) – warranting a continued balanced and disciplined stance in terms of portfolio risk exposure.

Historically, the combination of slowing global growth and a pausing Fed favours carry strategies. In emerging markets (EM), with our fundamental target value for equities having been reached, we took profits on the overweight position initiated in early December 2018. EM equities' upward move (close to 10% year-to-date) was driven mostly by a valuation re-rating, with earnings dynamics less supportive. Over the last three months, analysts have indeed sharply cut their 2019 earnings growth projections – perhaps too much so – from 13% to 6%. We thus elected to shift our EM exposure to the fixed income and currencies spaces. The former should benefit from more dovish EM central banks, thanks to lesser pressure from the Fed and inflation, while the latter still appear undervalued and should benefit from investors' search for yield (see Forex section).

We also used our cash holdings (which had become strongly overweight as a result of the risk reduction process conducted during the second half of last year) to reduce our corporate credit underweight, across all profiles. With the rise in financing costs no longer a risk, default rates should remain subdued (see chart 13) – while the increasing share of government yields in negative territory will force investors to shift into corporate bonds. The fact that the US economic

12. A prolonged global trade slowdown is the biggest risk to our base scenario

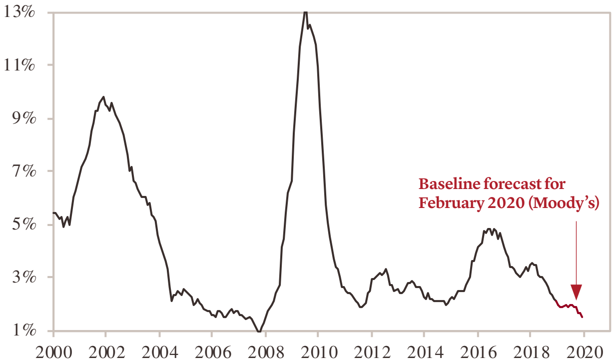
12-month trailing EPS growth, in %



Sources: Datastream, Bloomberg, Lombard Odier calculations

13. Default rate forecasts near historical lows as credit conditions will remain accommodative

Global trailing 12-month issuer-weighted spec-grade default rate, in %



Sources: Datastream, Bloomberg, Lombard Odier calculations

cycle is maturing suggests that it is more prudent to stick to investment-grade corporate credit, rather than slipping down the rating scale. That said, European corporate credit quality is stronger, leverage being lesser, making the BBB-BB segment also an investment option there.

More specifically, in USD portfolios, where the level of rates enables a more balanced fixed income allocation, we have decided to take profits on our short-term inflation-linked bonds position and reinvest the proceeds in investment-grade credit. As for CHF portfolios, we have decided to invest in both corporate bonds and listed real estate – another rate-sensitive asset class. Indeed, current valuations in Swiss listed real estate are still appropriate in a low-yield environment, while the dividend yield, close to 2.7%, largely exceeds corporate bond yields (the spread is actually close to historical highs). Although Swiss real estate has sharply rebounded since we initiated our overweight position in late November 2018, inflows should be reinforced by government bond yields having moved back into negative territory for the foreseeable future.

Our equity positioning is neutral across regions, favouring large- over small-caps. Valuations will remain underpinned by the low yield environment, while on a relative value basis we see no strong signal. As such, earnings dynamics will be key. The 4th quarter 2018 reporting season proved disappointing in Europe, but momentum should improve in coming months – consistent with our expectation of a pick-up in economic activity. In the US, earnings are set to decelerate from their extraordinary 2018 levels, but still maintain a decent pace – more in line with long-term history. The US market's relative defensive bias and its over-exposure to the sectors we favour, notably IT, also lead us to keep the allocation unchanged. In terms of style, we reiterate our cautious view on small-caps, that are liable to suffer from illiquidity in the event of a market correction (see chart 14).

Elsewhere, we continue to look for portfolio diversifying opportunities. In a low yield environment, the hedging capacity of traditional safe havens like the German Bund is significantly reduced (see chart 15). Non-USD investors must find alternatives to their domestic government bonds to mitigate overall portfolio risk. Which is why gold has proved resilient and continues to attract flows, despite the recent return of risk appetite and a stronger dollar (not a typically supportive environment for gold in historical terms). The negative influence of higher real rates on gold is also tending to fade as investors foresee the end of the US tightening cycle. For these reasons, we have switched our broader commodities position into gold.

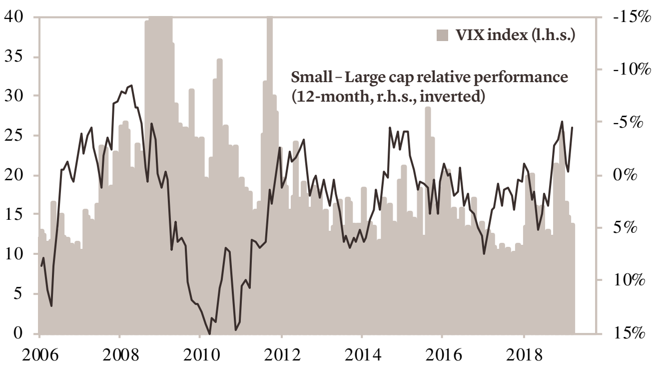
The Japanese yen has also been a means for us to hedge overall portfolio risk. It well fulfilled this mission during the May, August and December volatility episodes of 2018. And while it does face some near-term headwinds (improved risk sentiment, re-emergence of the carry trade), we maintain our exposure as a hedge.

Finally, we are more active and opportunistic on options strategies in the equity and forex spaces notably, taking the opportunity of low volatility to gain protection against tail risks such as Brexit or the ongoing US-China trade negotiations.

Sophie Chardon, Cross-Asset Strategist

14. Small-caps underperform when volatility rises

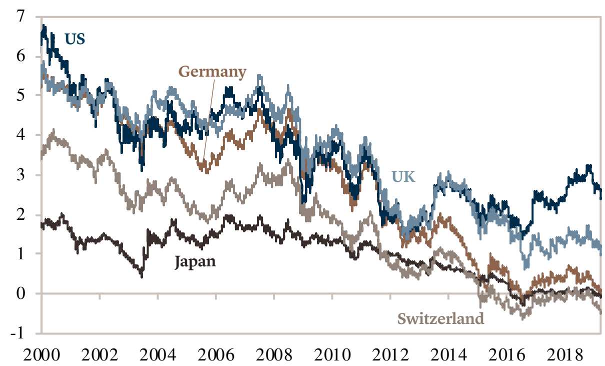
MSCI World relative performance (in %) and VIX index



Sources: Datastream, Bloomberg, Lombard Odier calculations

15. Yields to remain lower for longer in the developed world

10-year yields, in %



Sources: Datastream, Bloomberg, Lombard Odier calculations

Forex
Further dollar downside ahead but EURUSD still faces near-term headwinds

In a nutshell

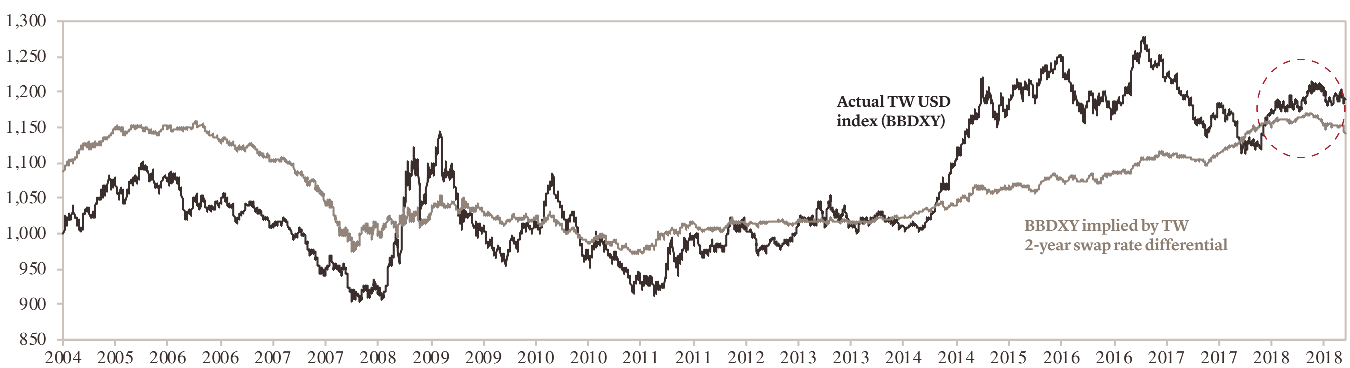
- Our base case of US economic deceleration, a dovish Fed and gradual improving world growth argues for a weaker dollar over time – save against the euro (at least for now), itself restrained by a super-accommodative ECB.
- We remain constructive on emerging currencies, expecting the carry trade to continue to prevail, supported by low sovereign spreads, falling US rates and rising equity markets.
- The risk of an outright deterioration in global growth cannot, however, be dismissed – warranting close monitoring of economic data. In that event, investors would likely flee to the dollar and yen, with EM currencies (particularly those with external imbalances and political issues) suffering damage.

The currency market is currently caught between two (inter-related) themes. On the one hand, major central banks (the Fed and the ECB) have turned noticeably more dovish than expected, raising the probability that accommodative monetary policies stay with us for longer. A prospect that, in principle, supports high-beta and EM currencies. On the other hand, the slowdown in global growth is taking its toll on market sentiment and hence on risk currencies (the more than 5% plunge in the Turkish lira on March 22 being a testament to investor angst). Which of these opposite forces prevails will depend largely on the severity and longevity of the slowdown.

Our central scenario remains that data will stabilise and a deeper slowdown (or, worse, a recession) not materialise. Having said that, we have to admit that this process is taking longer than we expected a few months ago. But there are signs that the worst may be behind us. While yet to stage a meaningful rebound, the Eurozone composite PMI has at least stabilised above the 50 level (that separates expansion from contraction). The latest readings of Chinese PMIs showed a noticeable rebound and fixed asset investment growth appears to have bottomed, aided by the authorities' fiscal expansion. The Baltic Exchange Dry index (which is a proxy for bulk good shipments – a timely indicator of global trade) seems to have stabilised since February, following its sizeable collapse between mid-December and late February (see chart 3, page 04).

In the world we envisage, characterised by a surprisingly dovish Fed, a slowing of the US economy from artificially high levels (due to the fiscal stimulus) and a very gradual pickup in the rest of the world's growth, we continue to think that the US dollar will sustain gradual losses. It is indeed striking that the trade-weighted (TW) 2-year swap rate differential between the US and its seven most important trading partners has narrowed by 19 basis points (bp) since the last FOMC meeting (March 20) as US rates have fallen across the board. On this metric alone, the TW dollar appears to be around 5% overvalued (see chart 16), which is roughly in line with the combination of our BEER[1] and FEER[2] model estimates. The size of the misalignment is not extreme for now, thus unlikely to be a dominant driver, but under the assumption of global data stabilisation, valuation

16. Falling US rates suggest a modest dollar overvaluation



Sources: Datastream, Bloomberg, Lombard Odier calculations

considerations will likely add to the impulses from the dovish Fed and waning fiscal impact and push the USD lower – particularly since US risk premia are set to rise on the back of a ballooning US twin deficit.

Dollar weakness is, however, unlikely to be broadly shared by all major currencies, at least for the next three to six months. For instance, the EURUSD is restrained, in our view, by a super-dovish ECB, whose new guidance suggests that the risk of rates remaining negative for longer has increased. Only a decisive improvement in economic data would allow for meaningful upside on the EURUSD, with 1.15 continuing to represent a strong resistance level for the near future.

We reiterate our preference for USDJPY downside in view of very attractive valuation (around 9% by our estimate) and lower US yields (the US 10-year yield has now wiped out all of its 2018 rise).

In the rest of G10, we still expect currencies with strong buffers (i.e. strong current account and budget balances) to outperform, notably Sweden and Norway. We see also modest upside in AUD and CAD, largely because we consider market expectations for the future path of their monetary policies as overly bearish.

We are also constructive on EM currencies and anticipate that the carry trade will perform well, albeit at a slower pace than that experienced since September 2018. Our fair value model for the EM FX universe (which utilises US 10-year yields, EM total debt (as % of GDP), the US-EM growth differential and previous episodes of US recessions) suggests that EM currencies as a whole are about 5-6% undervalued (see chart 17). If we are correct about the future direction of growth (US lower, EM a tad higher) and the prospect for lower US yields, then EM FX fair value should increase further, suggesting more upside for EM currencies.

Moreover, the factors that have historically been well correlated with the FX carry trade remain supportive. More specifically, EM sovereign spreads are low (though they did exhibit a small spike towards the end of the first quarter that warrants monitoring), US rates are significantly lower than their November 2018 peak (the US 10-year swap rate has fallen by 86 bp during the period) while equity markets have remained in an uptrend. Although some of these tailwinds may abate somewhat, as investors turn more cautious due to the maturity of the US cycle, we still think there is room for high yielders to perform well on a three- to six-month horizon. We continue to favour higher yielding EM FX that are undervalued and also likely to be supported by positive idiosyncratic factors, such as the RUB (strong oil prices) and the BRL (reform implementation). MXN – a classic high yielder – should also perform reasonably well. TRY and ZAR remain the wildcards: they have very messy and complicated political outlooks, with a myriad of potential risks, but historically rank among the best performing currencies when the carry trade is supported.

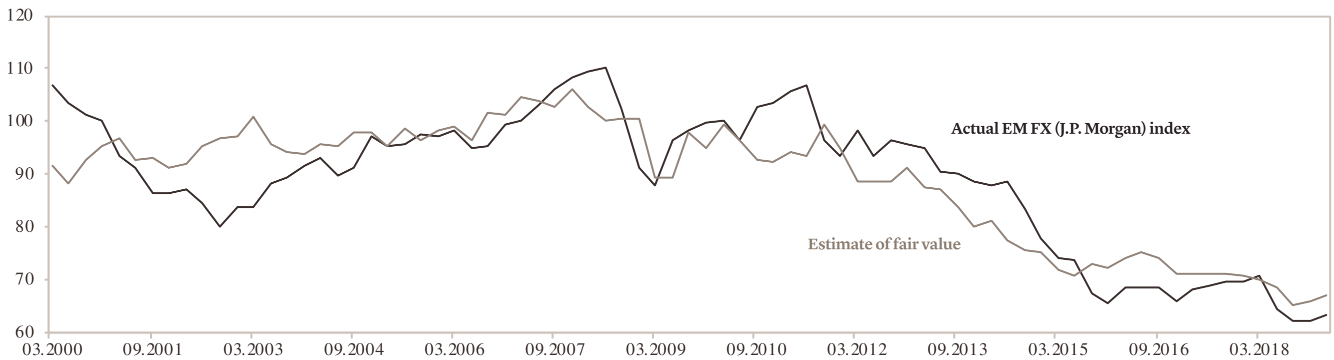
The risk to all these views is an outright deterioration in the global growth outlook – which cannot be dismissed at this stage. Global confidence indicators and hard data thus need close monitoring for the next few months for any evidence that the world economy growth may be rolling over. Should that happen, investor risk aversion would flare up and a flight to safety occur. The dollar and yen would likely be the main beneficiaries while EM FX – especially externally imbalanced and politically troubled ones, like the ZAR and TRY – would post meaningful losses.

Vasileios Gkionakis, Global Head of FX Strategy

[1] The BEER (Behavioral Equilibrium Exchange Rate) model uses econometric methods to estimate equilibrium FX rates based on a set of macroeconomic variables (terms of trade, investment as a share of GDP and real rates within a panel data set across G10 FX).

[2] The FEER (Fundamental Equilibrium Exchange Rate) model calculates the exchange rate required to bring macroeconomic balance (full employment, low inflation and a sustainable current account balance).

17. Emerging currencies too low relative to fundamentals



Sources: Datastream, Bloomberg, Lombard Odier calculations

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